

Weekly Commentary

24 May 2010

Tax-y ride

The 2010 Budget was more like the one that the Government would have liked to deliver last year – providing both up-front support to the economy, and structural improvements through changes to the tax system.

Tax reform was widely expected to be the most significant part of the Budget, and the changes went even further than we anticipated. Across-the-board income tax cuts, along with adjustments to benefits, will more than compensate for an increase in GST from 12.5% to 15% in October. The company tax rate will drop from 30% to 28% next April, well ahead of the timetable for a similar cut in Australia. And the tax treatment around property has been toughened up.

The Budget was based around an improved outlook for the economy. Real GDP growth is forecast to be above-trend over the next four years, primarily driven by the global recovery and the lagged effects of the easing in monetary conditions since 2008. Even so, the pickup in tax revenue is expected to be constrained over the next few years. Subdued business profitability in the early stages of recovery and the accumulation of tax losses will remain key features through the current fiscal year, and the timing of the tax changes means a shortfall in revenue between 2011 and 2013. It is not until 2014 that the tax changes are expected to be broadly revenue-neutral.

The core Crown operating deficit is

forecast to rise to a peak of \$8.6bn (4.2% of GDP) in FY 2011. That is worse than projected in the half-year fiscal update in December, reflecting lower tax revenues in the near term and delays in some planned expenditure. Importantly, the operating balance is expected to be back in surplus in FY 2016 (equivalent to 0.6% of GDP), two years earlier than previously projected. That would see net core Crown debt rise from 9.3% of GDP in 2009 to a peak of 26.5% in 2014 (previous forecast was 29%), which compares favourably with the fiscal position in many other OECD economies.

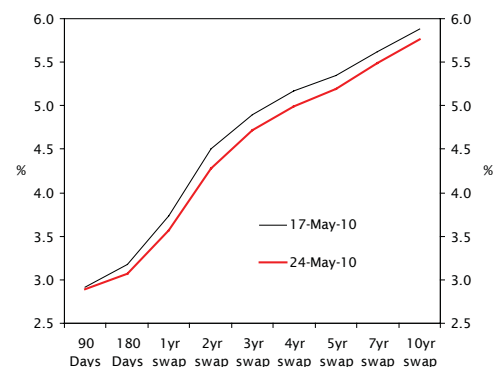
We see the tax reforms as clearly beneficial for potential economic growth. By promoting the fundamental drivers of economic growth (i.e. workforce participation, saving and investment), the reforms will in time push New Zealand onto a higher growth path. Moreover, the timing of the tax changes means that the Budget is mildly more stimulatory than expected in the near term. However, the adjustment to the tax changes will have a range of effects on the economy, as we detailed in a recent Bulletin (*"The bigGST step"*, 12 February).

The tax changes are a clear negative for house price growth – with the biggest impact coming from the drop in the top income tax rate. More precisely, it's the narrowing of the gap between the marginal tax rate on income (down from 38% to 33%) and capital gains (zero, except

for those deemed to be active traders). We estimate that the income tax cut will, in time, reduce the value of housing by around 10% relative to what it would have been under a 38% tax rate. That's not to say that prices will fall by 10%; more likely, they will stay flat for longer than otherwise, while incomes catch up.

Some property segments, and some individual owners, could be hit particularly hard by the tax changes. Removing the ability to claim depreciation against taxable income (for buildings deemed to have a useful life of 50 years or more) will hurt the most leveraged and cash-poor property investors, some of whom may have to sell to less-leveraged investors with positive cashflow. This would depress property prices in the short term, especially lower-end properties where investors are most active.

NZ Interest Rates



*Yield curve is yields on bank bills to 180 days, fixed interest rate swaps for 1 year onwards.

The income tax cuts were designed so that income earners will be left better off even after the anticipated price increases from the GST hike. It's worth noting that the changes go a long way towards improving the perceived fairness of New Zealand's tax system. Previously, you had to earn \$224,000 a year before you'd be paying less income tax in New Zealand than you would in Australia; now the crossover point is just \$44,000, which is close to the median income. Admittedly the difference would be marginal for many people, but it may help to limit the outflow of Kiwis to Australia that is gathering pace again.

The change in the mix of tax should encourage more household saving. Bear in mind that a higher consumption tax in itself doesn't encourage saving – savings simply represent future consumption, which can also be expected to incur GST. Rather, it's the substitution away from

income taxes, which effectively give a double whammy to savings – once when the income is earned, and again on the accrued interest on savings.

The increase in GST will also have some significant short-term effects on inflation and consumption, which will require a careful interpretation of the data. There is likely to be a boost to retail spending – especially for durables – as people bring forward some purchases to beat the GST hike, followed by a post-October slowdown. (Note that the retail trade survey is reported ex-GST, which will make it easier to untangle the price/volume effects.)

As for prices, Treasury is forecasting annual inflation to reach 5.9% in March 2011 (or a still-high 3.1% without the increases in GST and tobacco excise). This in itself isn't a threat to the RBNZ's

inflation target, but coming at a time when inflation expectations are already elevated, it will keep the pressure on the RBNZ to begin normalising monetary policy settings soon.

Fixed vs. floating: Stronger data and a more confident tone from the RBNZ have cleared the path for a series of rate hikes, with June the most likely starting date. The decision to fix or float is finely balanced – floating rates are lower than short-term fixed rates at the moment, but they are likely to rise faster as the RBNZ increases the OCR. Fixing, if even for a short term, has the advantage of greater certainty around cash flows, at a time when floating rates could be rising rapidly. Repaying more than the minimum amount, and spreading the loan over a mix of terms, can also help to reduce the overall risk around uncertain future interest rate changes.

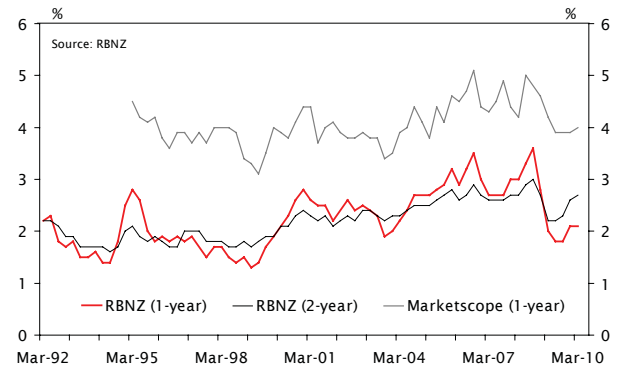
Key Data Previews

NZ Q2 RBNZ survey of inflation expectations

May 25, 2yr ahead – Last: 2.7%, WBC f/c: 2.6%

- The RBNZ's 2-year-ahead inflation expectations survey rose from 2.2% to 2.7% during 2009, as the economy recovered from recession.
- The RBNZ will be watching this number very carefully. Inflation could soon spike temporarily to 5% due to a possible GST hike, higher ACC charges, and the Emissions Trading Scheme. The risk for the RBNZ is that this one-off boost to inflation translates into persistently higher inflation expectations, which would necessitate a monetary policy response. Conversely, if inflation expectations remain contained the RBNZ can safely "look through" the near-term spike.
- The two-year measure is a gauge of inflation expectations beyond the GST hike, and is therefore the measure to watch here. One-year inflation expectations will no doubt jump in anticipation of GST.

NZ inflation expectations

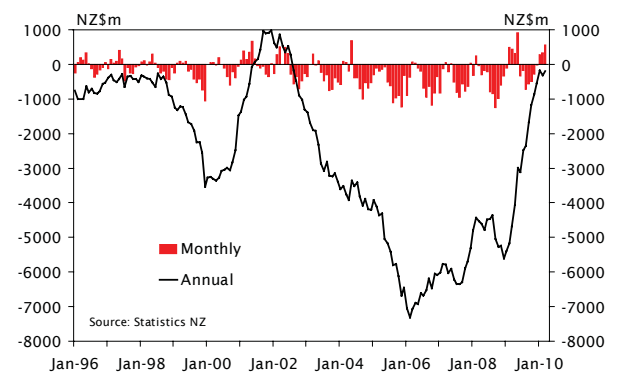


NZ Apr merchandise trade NZDm

May 27, Last: 567, WBC f/c: 330

- The merchandise trade balance has been firmly in surplus for the past three months, due to high export prices and a low quantity of imports.
- Export prices have risen further, but drought may now be impacting the quantity of dairy products exported. We therefore anticipate export receipts merely equal to last year's depressed level.
- The import bill is expected to remain low, due to the high NZD and ongoing consumer caution. The forecast balance is similar to last April.

NZ merchandise trade balance

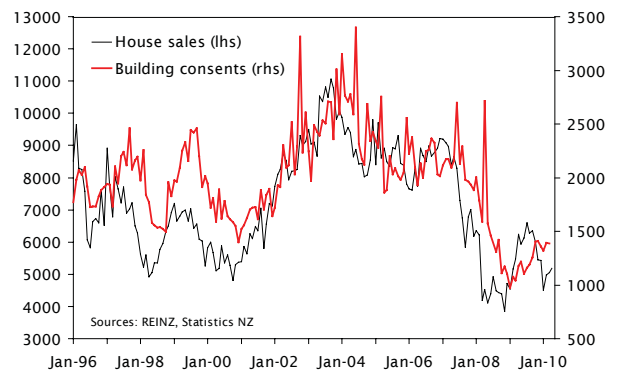


NZ Apr building consents s.a.

May 28, Last: -0.4%, WBC f/c: 2.0%

- Recent volatility in the dwelling consent figures continued in March, with ex-apartment consents unwinding almost all of the gains made in February, while apartment consents rebounded from recent extraordinarily low levels.
- We expect at least some of the weakness in March was due to uncertainty around upcoming tax changes, which has also clearly affected house sales in recent months. That suggests that consent issuance may be soft for another couple of months until that uncertainty clears.
- Activity in the non-residential space picked up in March, but the trend remains weak. We expect this weakness to persist for a while yet, although recent business surveys are showing signs that sentiment in this space has turned.

NZ housing activity

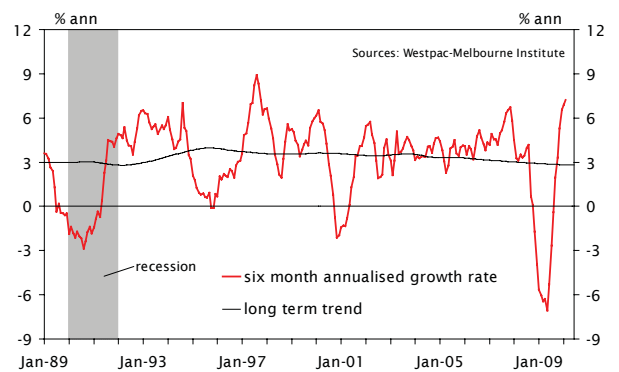


Aus Mar Westpac-MI Leading Index

May 26, Last: 7.2% annualised

- The *Westpac-Melbourne Institute Leading Index* continued to point to strong growth in Feb. The annualised growth rate in the index – a guide to the likely pace of activity over the following three to nine months – was 7.2%, a long way above its long term trend of 2.8%.
- Despite intensifying global financial turmoil through April-May, the Index’s monthly components actually had a solid March. Equity markets continued their recovery from January’s sell-off (ASX rose 5.1% in the month, though it has since slumped 11.5% courtesy of Europe’s sovereign debt crisis); dwelling approvals jumped 15.3% as apartments spiked; money supply growth rose to 1.5%, its fastest pace since July 2008; and US industrial production edged up after stalling flat in Feb.

Westpac-MI Leading Index

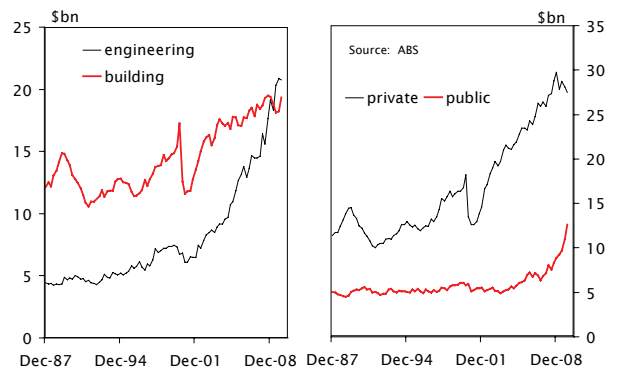


Aus Q1 construction work done

May 26, Last: 2.6%, WBC f/c: 2.8%, Mkt f/c: 4.0%, Range: -1.0% to 8.1%

- Construction activity is set to start 2010 on a positive, with a forecast rise of 2.8% in Q1.
- A burst of public works – with a focus on schools as well as housing – is expected to have moved a notch higher. We’re forecasting a 5% rise in Q1 following jumps of 13% in Q3 and 14% in Q4.
- Private construction work may have turned the corner. Following falls in the last two quarters and a 7.5% decline through 2009, we anticipate a near 2% rise in Q1. Residential is responding to prior super low interest rates and government incentives. Engineering, which was choppy through 2009, will receive a boost from the start up of Gorgon. While non-residential building, down 24% from the 2008Q3 peak, will be cushioned by work in the education segment.

Construction work on the rise

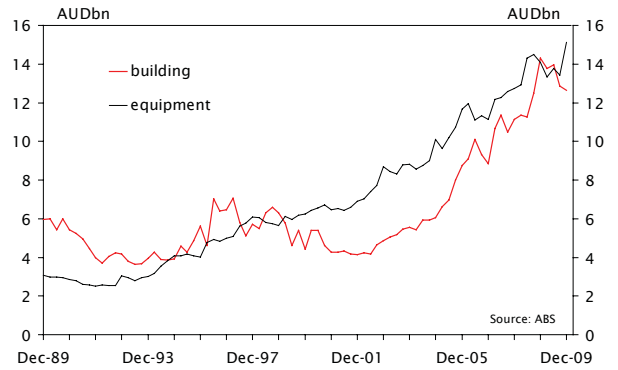


Aus Q1 CAPEX

May 27, Last: 5.5%, WBC f/c: -3.0%, Mkt f/c: 2.5%, Range: -4% to 7%

- The CAPEX survey (which provides only a partial coverage of business investment) is likely to report a pull-back in Q1. We're forecasting a fall of 3.0%.
- Temporary tax breaks boosted equipment investment in Q2 (3.4%) and again in Q4 (12.5%). A reversal will be evident in Q1 - it's just a question of magnitude. We've allowed for a 5% fall. Motor vehicle sales to business retreated an estimated 10% in Q1 after a 30% spike in Q4. However, imports of capital goods appear to have edged higher in the quarter.
- Building and structures activity, which can be lumpy from quarter to quarter, is expected to be broadly flat. Non-residential building (ex-education) still has a little downside, following a sharp slump, but in the infrastructure area we could see a lift in work with the start of Gorgon.

Real capital expenditure (CAPEX survey)

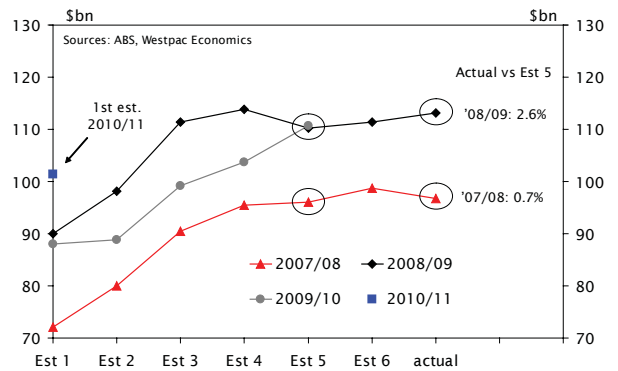


Aus CAPEX intentions

May 27, Last: \$101.4bn

- The 1st estimate of business CAPEX plans for the 2010/11 year was \$101.4bn. That is a very positive reading and we anticipate that the 2nd estimate will also be positive.
- Simply applying the average realisation ratio to the 1st est. implies the value of investment will increase by 18% in 2010/11 from the likely outcome in 2009/10. However, that probably overstates prospects. We're looking for total real business investment to increase by 10%.
- The point to highlight is that the CAPEX figures have just been boosted by construction beginning on the massive \$43bn Gorgon project. Accordingly, it is unreasonable to expect the "typical" upgrade to investment plans from this extraordinarily high level.

CAPEX plans



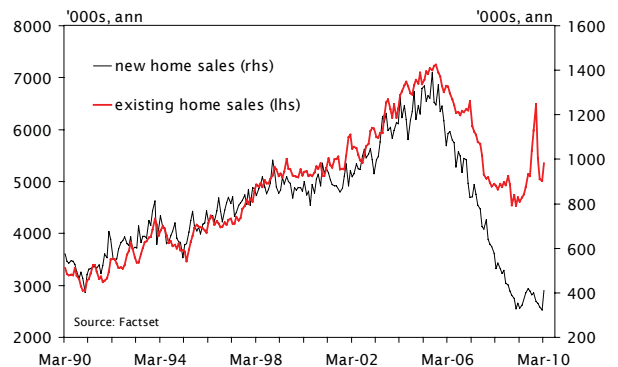
US Apr existing & new home sales

May 24, Existing home sales: Last: 6.8%, WBC f/c: 6.0%, Mkt f/c: 5.6%

May 26, New home sales: Last: 26.9%, WBC f/c: 5.0%, Mkt f/c: 3.4%

- Housing data have turned extremely positive in the past month or two, with a weather-related activity rebound and a scramble by buyers to take advantage of the tax credit that expired on April 30 supporting sales, starts and homebuilder sentiment.
- Existing home sales reflect transactions agreed in months prior, but the separate pending home sales series provides an early lead. Its 14% rise in Feb-Mar suggests that existing home sales should build upon their 7% March rise in April, when we expect a further 6% gain.
- New home sales are volatile and revisions can be severe. They hit a new cycle low in Feb, then jumped 27% in March, due to the extended tax credit and normalising weather. We expect a further 5% gain in April, especially if March is revised lower - but from May sales will likely fall again.

US housing sales

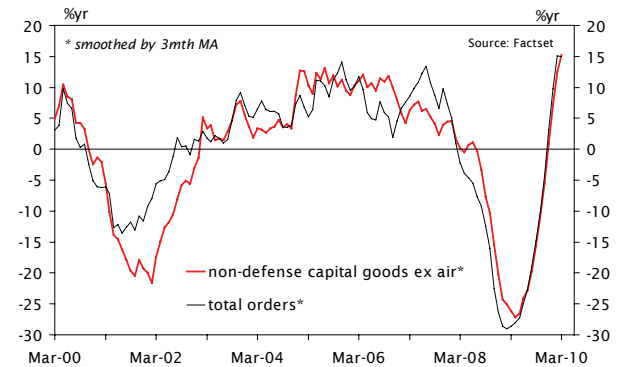


US Apr durable goods orders to post a solid gain

May 26, Last: -1.2%, WBC f/c: 3.0%, Mkt f/c: 1.5%

- Durables orders posted their first headline fall in four months in March but that was primarily due to a large drop in the volatile civilian aircraft category. Ex transport orders rose nearly 3% and the core capital goods component which strips out aircraft and defence orders rose 4%, on top of a 2% rise in February. That suggests some restoration of upward momentum in business investment after a faltering start to capital goods orders at the start of the year.
- April orders are forecast to post a renewed solid 3% gain. The ISM factory survey, including its orders component, surged in April, and industrial production rose sharply, also indicative of solid orders growth. The aircraft component is less clear: Boeing saw 34 777 orders in April vs 43 cheaper 737 model orders in March – but Boeing data have been out of synch with Commerce Dept data of late anyway.

US durable goods orders

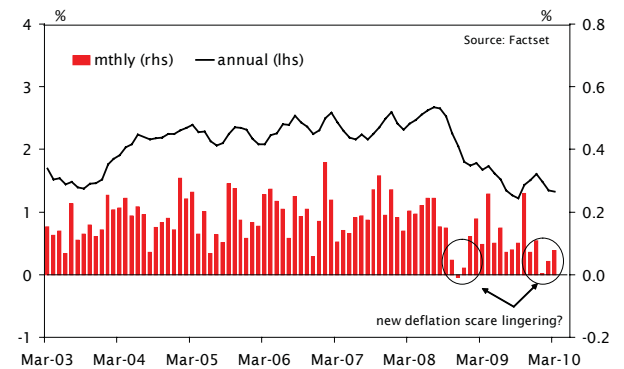


US Apr core PCE deflator: 3rd flat outcome in four mths

May 28, Last: 0.1%, WBC f/c: 0.0%, Mkt f/c: 0.1%

- The core PCE deflator inflation measure has risen by 0.1% or less for the past five months, pulling the annual pace back down to 1.3%yr after a brief spike to 1.6%yr in December 2009. The core CPI has been even softer, recording a rare monthly fall back in Jan and taking the subsequent three months to fully reverse that fall, pulling its annual rate down to 0.9%yr in April.
- In Mar-Apr the core CPI was flat. The tendency of the core PCE to print a little lower than core CPI has broken down recently but it would be unusual for the core PCE to run “hotter” for several months running, so we expect a flat April outcome.
- The April data should also show modest 0.4% personal income growth (constrained by flat hourly earnings last month) and a subdued 0.2% rise in personal spending, consistent with slower retail sales growth in April.

US core PCE deflator



Key Data and Events

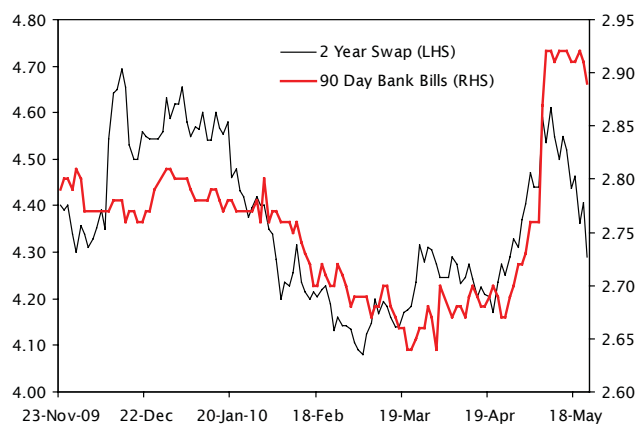
		Last	Market Median	Westpac Forecast	Comments
Mon 24 May					
Aus	Apr Motor Vehicle Sales	-2.7%	2.0%	7.0%	Raw industry figures show April sales up 27%yr; March was 19%yr (sa).
US	Apr Chicago Fed National Act Index	-0.07	-	-	Based on 80 or so previously released activity data (i.e. not a survey).
	Apr Existing Home Sales	6.8%	5.6%	6.0%	Recent Feb-Mar pending sales jump to show in Apr existing data.
Jpn	Mar All-Industry Activity Index	-2.3%	-0.7%	-	Tertiary element fell sharply in Mar on wholesaling activity.
UK	May House Prices %yr	10.5%	9.7%	-	Tentative date for Nationwide series, due 24-28/5.
Tue 25 May					
NZ	Q2 RBNZ 2yr Inflation Expectations	2.7%	-	2.6%	Impact of GST and regulatory change may become apparent.
US	Mar House Prices %yr	0.6%	2.5%	-	S&P-CS series. Annual price growth positive again after 3+ years.
	May Richmond Fed Factory Index	30	25	18	Spike to multi-decade high in April unsustainable.
	May CB Consumer Confidence	57.9	59.0	60.0	Other indicators point to improved confidence so far in May.
	Mar House Prices	-0.2%	0.0%	-	Lesser watched FHFA index.
	Fedspeak	-	-	-	St Louis Fed President Bullard in UK
Eur	Mar Industrial Orders	1.7%	2.5%	2.2%	German orders known up 5% in Mar.
UK	Q1 GDP 1st Rev %qtr	0.2%	0.3%	0.4%	Strong partial data (esp IP) suggest upward revision at least to 0.3%.
	Apr Mortgage Approvals	34.9k	37k	-	BBA data for most banks. BoE's system data due 2/6.
Wed 26 May					
Aus	Mar Leading Index 6m ann'lsd	7.2%	-	-	Way above trend. March pre-dates Europe-inspired financial turmoil.
	Q1 Construction Work Done %qtr	2.6%	4.0%	2.8%	Burst of public work (schools) + private residential & engineering up.
US	Apr Durable Goods Orders	-1.2%	1.5%	3.0%	Strength of industrial production, ISM survey point to decent rebound.
	Apr New Home Sales	26.9%	3.4%	5.0%	Likely revision lower to Mar; sales keep surging ahead of tax credit expiry.
	Fedspeak	-	-	-	Bernanke in Tokyo on central banking issues. Also Plosser/Lacker.
Jpn	Apr Bank of Japan Meeting Minutes	-	-	-	Anything pre-European crisis can be safely disregarded one suspects.
	Apr Corporate Services Prices %yr	-1.1%	-	-	Corporate aversion to costs entrenches deflation in discretionary prices.
	May Small Business Confidence	46.8	-	-	Grinding higher. Some sub-sectors have actually surmounted 50.
Ger	Jun GfK Consumer Confidence	3.8	3.6	-	Labelled June but actually surveyed in first half of May.
Thu 27 May					
NZ	Apr Merchandise Trade NZDm	567	455	330	Drought starting to have an impact on exports.
Aus	Q1 Real CAPEX %qtr	5.5%	2.5%	-3.0%	Equipment down after tax break inflated Q4, building & structures flat.
	CAPEX Intentions, 2010/11 \$bn	101.4	-	-	1st est. 18% above likely '09/10 - boosted by Gorgon (see text box).
US	Q1 GDP 1st Rev ann'lsd	3.2%	3.4%	3.5%	Partial data point to modest upward revision.
	Initial Jobless Claims w/e 22/5	471k	455k	455k	No special factors behind payrolls survey week spike.
	Fedspeak	-	-	-	St Louis Fed President Bullard in Sweden; Chicago Fed's Evans in Tokyo.
Jpn	Apr Trade Balance ¥bn	666	688	-	Modest improvement as Asia-Pacific trade partners show strength.
Ger	May CPI Preliminary %yr	1.0%	1.2%	-	Euro weakness likely to push headline CPI higher in coming months.
UK	May CBI Distributive Trades Survey	13	-	-	Reported sales was steady at 13 in Apr, from 13 in Mar.
Fri 28 May					
NZ	Apr Building Consents s.a.	-0.4%	-	2.0%	Uncertainty around tax likely to suppress activity.
US	Apr Personal Income	0.3%	0.4%	0.4%	Payrolls showed hours worked up but flat earnings growth.
	Apr Personal Spending	0.6%	0.3%	0.2%	Softer retail sales growth in April to show up here.
	Apr Core PCE Deflator	0.1%	0.1%	0.0%	Core CPI was flat for second month running.
	May Chicago PMI	63.8	61.3	58.0	Our view is that US economy will lose momentum mid year so these
	May NAPM-Milwaukee	66.0	64.0	73.0	regional surveys should soon turn lower (like NY Fed).
	May UoM Consumer Sentiment (F)	73.3a	73.4	73.0	Latest equities losses to weigh on late survey responses.
Jpn	Apr Unemployment Rate	5.0%	5.0%	-	Firms are still cautious about costs and are wary of re-hiring.
	Apr National CPI %yr	-1.1%	-1.1%	-	Volatile items leading improvement. Non-traded prices subdued.
	Apr Real Household Spending %yr	4.4%	2.6%	-	Real PCE rose just 0.3% in Q1 and that includes stimulus.
	Apr Retail Sales %yr	4.7%	3.6%	-	Nominal sales driven by base effects & various (expiring) initiatives.
Ger	Apr Retail Sales	-1.6%	-	-	Tentative date only; may not be released till early June.
UK	May GfK Consumer Confidence	-16	-16	-18	Survey timing should capture election uncertainty, stocks slide.

New Zealand Economic and Financial Forecasts

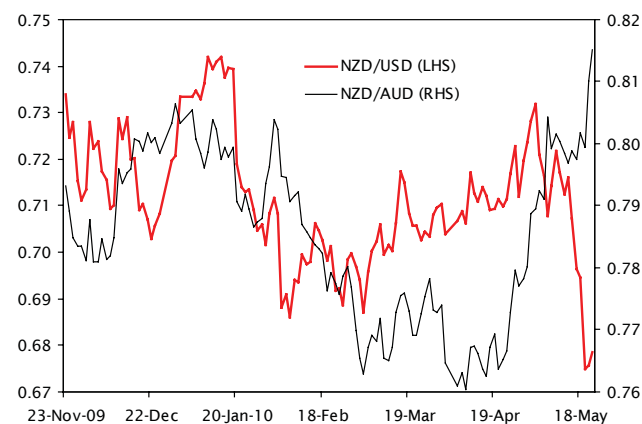
Economic Growth Forecasts	March years				Calendar years			
	2009	2010f	2011f	2012f	2009	2010f	2011f	2012f
% change								
GDP (Production) ann avg	-1.4	-0.3	4.1	4.2	-1.6	3.4	4.4	3.4
Employment	0.7	-0.1	2.1	1.8	-2.4	2.7	1.8	1.3
Unemployment Rate % s.a.	5.1	6.0	5.3	5.0	7.1	5.5	5.0	4.9
CPI*	3.0	2.0	2.6	2.8	2.0	2.5	2.7	2.9
Current Account Balance % of GDP	-7.9	-2.6	-3.3	-4.4	-2.9	-3.0	-4.4	-4.4

Financial Forecasts	Jun-10	Sep-10	Dec-10	Mar-11	Jun-11	Sep-11	Dec-11
Cash	2.75	3.25	3.75	4.25	4.75	5.25	5.75
90 Day bill	3.20	3.70	4.20	4.70	5.20	5.70	6.10
2 Year Swap	4.50	4.80	5.20	5.50	5.90	6.20	6.40
5 Year Swap	5.50	5.70	5.90	6.10	6.30	6.50	6.60
10 Year Bond	6.00	6.00	6.10	6.20	6.30	6.30	6.40
NZD/USD	0.72	0.75	0.78	0.76	0.75	0.74	0.73
NZD/AUD	0.80	0.80	0.82	0.83	0.83	0.83	0.84
NZD/JPY	64.1	68.3	74.1	74.5	76.5	78.4	79.6
NZD/EUR	0.58	0.60	0.63	0.63	0.64	0.64	0.63
NZD/GBP	0.50	0.52	0.54	0.53	0.53	0.53	0.52
TWI	68.6	71.0	74.1	73.8	74.0	74.0	73.9

2 Year Swap and 90 Day Bank Bills



NZD/USD and NZD/AUD



NZ interest rates as at market open on Monday 24 May 2010

Interest Rates	Current	Two Weeks Ago	One Month Ago
Cash	2.50%	2.50%	2.50%
30 Days	2.72%	2.66%	2.60%
60 Days	2.81%	2.80%	2.66%
90 Days	2.90%	2.92%	2.67%
2 Year Swap	4.28%	4.61%	4.25%
5 Year Swap	5.19%	5.41%	5.22%

NZ foreign currency midrates as at Monday 24 May 2010

Exchange Rates	Current	Two Weeks Ago	One Month Ago
NZD/USD	0.6763	0.7218	0.7169
NZD/EUR	0.5386	0.5638	0.5364
NZD/GBP	0.4670	0.4852	0.4662
NZD/JPY	60.930	67.240	67.340
NZD/AUD	0.8145	0.8015	0.7728
TWI	65.410	68.450	66.690

* Forecast does not include recently announced GST hike.

Economic and Financial Forecasts

Economic Forecasts (Calendar Years)	2005	2006	2007	2008	2009	2010f	2011f
Australia							
Real GDP % yr	2.8	2.9	4.0	2.4	1.3	3.0	3.8
CPI inflation % annual	2.8	3.3	3.0	3.7	2.1	3.3	3.1
Unemployment %	5.1	4.8	4.4	4.2	5.6	5.1	4.8
Current Account % GDP	-5.8	-5.3	-6.3	-4.4	-4.1	-4.0	-2.6
United States							
Real GDP %yr	3.1	2.7	2.1	0.4	-2.4	2.4	3.0
Consumer Prices %yr	3.4	3.2	2.9	3.8	-0.4	1.3	2.4
Unemployment Rate %	5.1	4.6	5.8	5.8	9.3	9.5	9.2
Current Account %GDP	-6.1	-6.0	-5.3	-4.9	-2.9	-3.1	-2.3
Japan							
Real GDP %yr	1.9	2.8	2.2	-1.5	-5.8	2.3	1.8
Consumer Prices %yr	-0.3	0.2	0.1	1.4	-1.3	-1.1	-0.2
Unemployment Rate %	4.4	4.1	3.9	4.0	5.1	4.8	4.5
Current Account %GDP	3.6	3.9	4.8	3.2	2.8	4.1	4.3
Euroland							
Real GDP %yr	1.8	3.1	2.8	0.5	-4.0	0.6	1.3
Consumer Prices %yr	2.5	2.0	3.1	1.6	0.9	1.0	1.2
Unemployment Rate %	8.8	7.9	7.3	7.8	10.0	10.5	10.5
Current Account %GDP	-0.2	-0.1	0.1	-1.1	-1.0	-0.5	0.0
United Kingdom							
Real GDP %yr	2.2	2.9	2.6	0.5	-4.9	0.5	1.3
Consumer Prices %yr	2.1	3.0	2.1	3.5	2.9	2.0	1.5
Unemployment Rate %	2.8	3.0	2.5	3.1	5.0	5.0	5.0
Current Account %GDP	-2.6	-3.3	-2.7	-1.6	-2.4	-2.0	-1.5

Forecasts finalised 7 May 2010

Interest Rate Forecasts	Latest (May 24)	Jun-10	Sep-10	Dec-10	Mar-11	Jun-11
Australia						
Cash	4.50	4.50	4.75	5.00	5.00	5.25
90 Day Bill	4.67	4.70	5.00	5.20	5.20	5.50
10 Year Bond	5.39	5.60	5.70	5.90	5.90	6.15
International						
Fed Funds	0.125	0.125	0.125	0.125	0.125	0.50
US 10 Year Bond	3.24	3.40	3.45	3.70	4.00	4.75
ECB Repo Rate	1.00	1.00	1.00	1.00	1.25	1.50
Exchange Rate Forecasts						
AUD/USD	0.8303	0.90	0.94	0.95	0.92	0.90
USD/JPY	90.09	89	91	95	98	102
EUR/USD	1.2557	1.24	1.24	1.24	1.20	1.18
AUD/NZD	1.2277	1.25	1.25	1.22	1.21	1.20

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