

Weekly Commentary

26 April 2010

It's all going to plan

The Reserve Bank is currently in a sweet spot. Having held to its commitment to keep interest rates low until mid-2010, it is now seeing sufficient evidence of a recovery to carry out its plan for 'normalisation'.

That plan, as laid out in the March *Monetary Policy Statement*, is for an extended tightening cycle that could see the OCR rise by 3% or more over the next few years. The RBNZ has consistently stated that if the recovery continued to pan out in line with forecasts, the tightening was expected to begin "around the middle of 2010". Tellingly, the "if" part of that statement was dropped in March, which suggests that by then the RBNZ was already satisfied with the case for a mid-year move.

With the start date rapidly approaching, the market will be keenly focused on Thursday's OCR review, ready to parse the statement for any subtle hints about the timing and size of rate hikes. With such a mammoth task ahead of the RBNZ in coming years, you could argue that the exact timing of the first move is neither here nor there. Nonetheless, it's important to financial markets, and for anyone looking to time their move into longer-term borrowing rates (plus bragging rights for economists).

Our view, shared by the majority of analysts, is that the first hike will come in June. But there are some who argue that July or even September is a more likely prospect – perhaps reflecting scepticism

about the strength of the recovery, and/or a view that the RBNZ should wait for more information before acting. Certainly financial markets have taken some of the recent data as a disappointment, with the odds for a June rate hike shortening from close to 100% just after the March *MPS* to around 40% today.

We don't share the market's concerns, and more to the point we don't think the RBNZ will either. What matters in this instance is how the economy is tracking against the RBNZ's forecasts, not against the market's. On that metric, the data has stacked up well, and if anything has been a touch stronger.

Since March, we've seen that GDP grew by 0.8% in the December quarter, in line with market forecasts and ahead of the RBNZ's pick of 0.6%. The main contributions came from solid growth in private spending, strong gains in agriculture and manufacturing, and a rebuilding of depleted inventories. The March quarter may not be shaping up quite as well, with signs of caution in consumption and housing that may reflect nervousness about possible tax changes to property. But right now there are sufficient drivers of growth elsewhere, as the goods-producing sectors take up the baton.

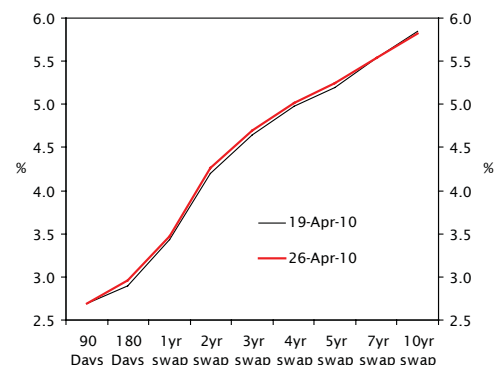
We've also seen very favourable conditions for many exporters, with strong growth in our key trading partners in Australia and Asia, an NZD/AUD exchange rate close to ten-year lows, and record high prices for our

basket of commodity exports. Drought conditions in many parts of the country are a concern for dairy exports – and are partly responsible for the rise in prices – but one small mercy is that this has come at the tail end of the season; total output looks to be on a par with the previous season, and we estimate that industry-wide revenue will be about \$1½bn higher.

Overall, the economy looks on track to meet the RBNZ's forecasts of 3.2% growth this year and 4.2% next year – similar to our view but well ahead of other market forecasters. It's worth remembering that the RBNZ's forecasts have been in this ballpark for many months; it's the rest of the market that lately has been moving up to meet them.

The latest data to leave the market rumbling about a delay to rate hikes was last week's CPI, which rose 0.4% in the March quarter. This was a downside

NZ Interest Rates



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

surprise to the market – but not to the RBNZ, which expected a 0.3% rise.

Aside from some isolated price increases, the general picture was one of subdued inflation to date. The main contributors were a 7% rise in petrol prices, a 1% rise in food, and the usual seasonal increases (tobacco and education fees) and decreases (international airfares). The stronger exchange rate in late 2009 flowed through to large price declines for clothing and footwear (-1.2%), furniture and floor coverings (-2.1%), appliances (-1.6%), and audio-visual equipment (-5.7%).

Domestically generated (non-tradables) inflation was subdued at 0.5%. Rents continued to slowly accelerate, rising 0.5% this quarter, and most services registered another quarter of steady price increases. We were surprised that housing construction costs only rose by 0.2%. But industry sources have said that price increases are on the way, and the latest

QSBO showed a sharp rise in the number of construction firms intending to raise prices, so we may have simply jumped the gun. (We have revised up our tentative Q2 inflation forecast from 0.3% to 0.5%, in line with the RBNZ.)

Overall, the CPI will have given the RBNZ no reason to question its forecasts. Annual inflation is currently at its lowest ebb, but the recession has merely pushed it down to the middle of the 1-3% target range. Even with a steep tightening profile built into its forecasts, the RBNZ expects annual inflation to head back towards the top of the target range by the end of next year.

Hence, we expect this week's OCR review statement to reinforce that rate hikes are coming, right on schedule. The RBNZ will be happy that it's done the right thing to date by committing to keep rates low for an extended period. Now, it will be equally happy that the economy is recovering as expected, and that there is no need

to delay rate hikes beyond what's been signalled already.

Fixed vs. floating: The prospect of OCR hikes through the second half of the year and beyond will eventually flow through to short-term fixed rates, which have only seen small increases to date and remain at historically low levels. As a result, we could see more borrowers moving to fix at the favourable rates still on offer – and the experience of March/April last year shows that these types of flows can put a great deal of upward pressure on mortgage rates. With floating and one-year fixed rates around similar levels, there may not seem to be much advantage in fixing right now, but those who wait until they see the whites of the RBNZ's eyes before fixing are likely to face much less attractive options. Repaying more than the minimum amount and spreading the loan over a mix of terms can help to reduce overall risk regarding uncertain future interest rate changes.

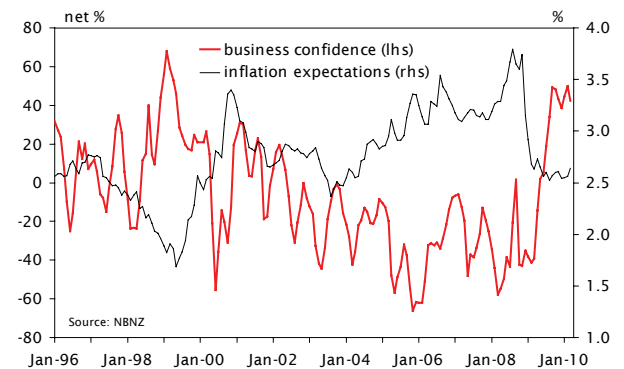
Key Data Previews

NZ Apr NBNZ business confidence

Apr 28, Last: 42.5%

- Business confidence eased in March, having reached a ten-year high in February. Investment intentions rose slightly, while the other activity indicators dipped but remained above their long-run averages.
- Recent industry-level indicators have generally been strong, validating the high levels of confidence seen in the last six months. Card transactions in the retail sector rose 2.1%, residential building consents rose 6%, and the Business NZ surveys of manufacturing and services both rose to new cycle highs in March.
- Agriculture may be the odd one out, with record commodity export prices weighed against a confidence-sapping drought in many parts of the country.

NBNZ Business Confidence

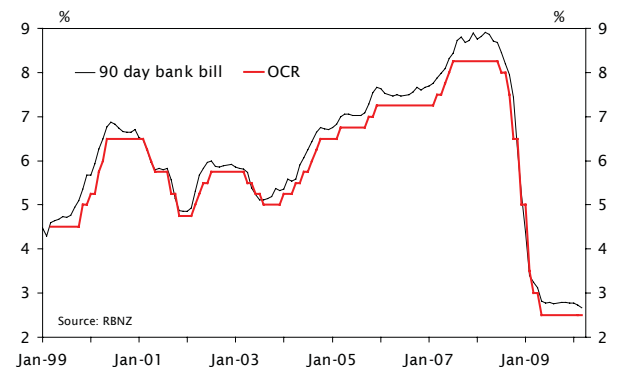


NZ RBNZ OCR review

Apr 29, Last: 2.50%, WBC f/c: 2.50%, Mkt f/c: 2.50%

- The RBNZ is currently in a sweet spot. Having held to its commitment to keep interest rates low until mid-year, it is now in a position to start the 'normalisation' process.
- The March *Monetary Policy Statement* made it clear that an extended tightening cycle is on the way.
- Market expectations for the first rate hike are wavering between June and July. We see no reason to expect a delay beyond June – recent data has largely matched or exceeded the RBNZ's forecasts.

NZ OCR and 90 day rate

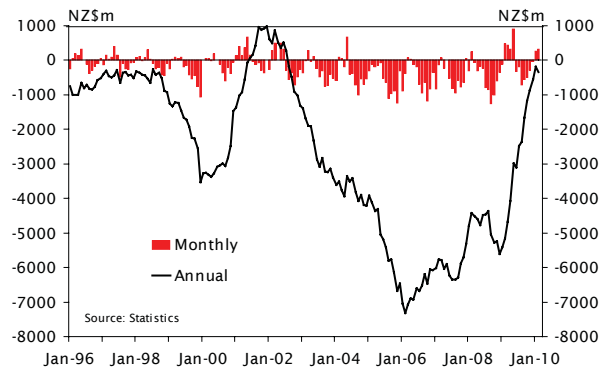


NZ Mar merchandise trade NZDm

Apr 29, Last: +321, WBC f/c: +850

- We predict a huge trade surplus for March, furthering the recent trend.
- Export receipts were probably high, due to record global commodity prices and the low NZD/AUD exchange rate. Agricultural export volumes will reflect the good growing conditions that prevailed in January and February. The drought, which began in March for most of NZ, will affect export volumes only in later months.
- The consumer slowdown of Q1 2010 is probably now translating into subdued import volumes. The higher NZD/USD and highish NZD/JPY will also help keep the import bill down.

NZ merchandise trade balance

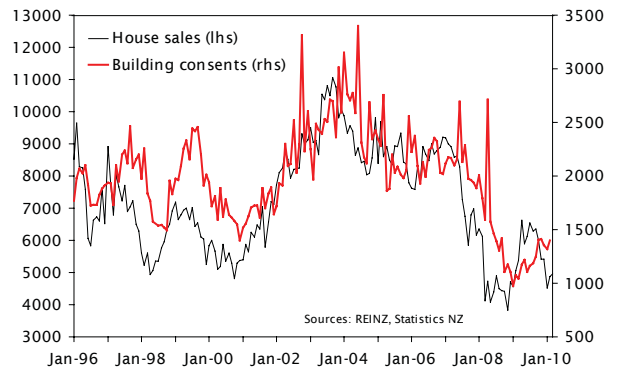


NZ Mar building consents s.a.

Apr 30, Last: 5.9%, WBC f/c: 7.0%

- Dwelling consents unwound some of their recent losses in February, rising almost 6% as ex-apartment consents surged.
- We expect a further solid increase in March, as apartment consents pick up from recent extreme lows (13) and ex-apartment consent issuance holds onto the 10% gain experienced in February.
- Activity in the non-residential space continues to be weak, with the value of consents in February 17% lower than a year ago. We expect this weakness to persist for a while yet, as firms focus on investment in plant and machinery in the early stages of the recovery.

NZ housing activity (monthly, seasonally adjusted)

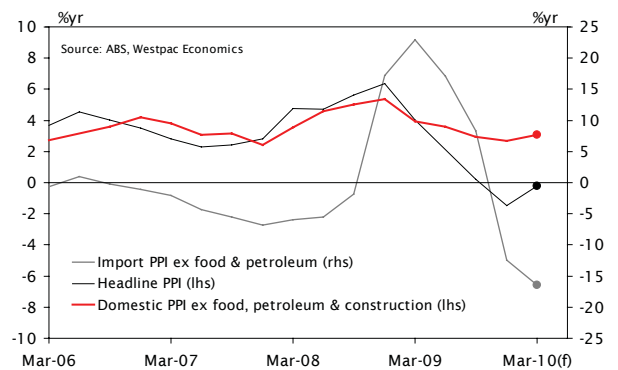


Aus Q1 PPI

Apr 27, Last: -0.4%, WBC f/c: 0.9%, Mkt f/c: 0.6%, Range: -0.5% to 1.0%

- The Q4 PPI fell 0.4%qtr cutting the annual rate to -1.5%yr. Non-core items subtracted 0.07ppts from the qtrly rate (food +0.6%, petroleum -6.8%). Core import prices fell 5.5% with the AUD TWI up 6.6%, utilities were near stable, and the domestic core ex-construction and utilities rose a subdued 0.6%. This more than offset a higher 0.3% rise in construction prices to give a weak total core PPI of -0.4%qtr.
- The core PPI is f/c to rebound 0.7%qtr in Q1. Weak mfg pricing power is expected to see a flat domestic core ex-construction and utilities, but utilities are f/c to rise 2.6%, construction prices are f/c to bounce 1.3%, and core import prices are f/c to stabilise (-0.1% after prior steep falls) with the steadier AUD. Food prices (+1.0%) and petroleum (+5.0%) give a further addition, resulting in a total PPI rebound of 0.9%qtr, lifting the annual rate to -0.2%yr from -1.5%yr previously.

PPI: total up on utilities, construction, oil, food

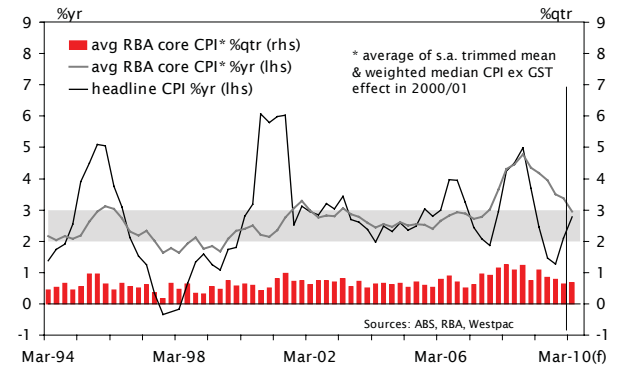


Aus Q1 CPI

Apr 28, Last: 0.5%, WBC f/c: 0.8%, Mkt f/c: 0.8%, Range: 0.4% to 1.1%

- Our Q1 headline CPI f/c is +0.8%qtr which, with a weak +0.1% result from a year ago dropping out, lifts annual inflation to 2.8%yr from 2.1%. Quarterly increases in vegetables, annual education fee rises, higher electricity, a 3.2% rebound in petrol, higher deposit & loan facilities, and strong house purchase costs are f/c to be partially offset by deeper New Year discounting in import-intensive items across clothing, household and recreational goods.
- With the falls we expect in import-intensive items largely dropping out of the trimmed distribution, and strong increases in heavily weighted items including financial services, petrol and vegetables accounting for most of the 15% removed from the top of the distribution, more items with 'high' rises remain in the trimmed mean, giving an avg underlying f/c of +0.7%qtr (vs 0.6%qtr prev) and 3.0%yr (vs 3.4%yr prev).

Inflation: core back to target, headline rising

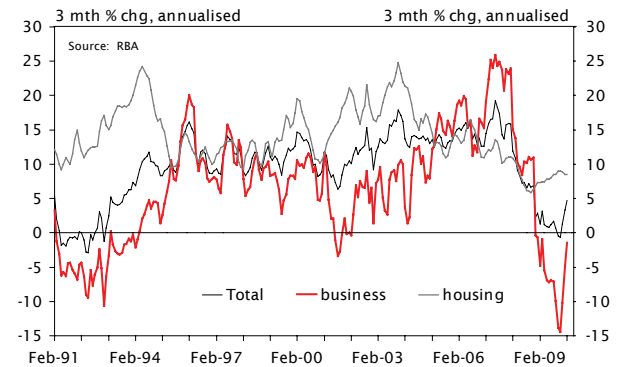


Aus Mar credit

Apr 30, Last: 0.4%, WBC f/c: 0.4%, Mkt f/c: 0.4%, Range: 0.2% to 0.5%

- Credit to the private sector appears to have turned the corner. We expect further confirmation of that from the March data, forecasting a rise of 0.4% – a repeat of the February outcome.
- Notably, business credit is contracting at a slower rate: -0.4% in the last three months, after -8.3% in the year to November. The process of deleveraging is well advanced and firms are now looking to respond to improving economic conditions.
- Housing credit growth is ticking over at around an 8.5% annualised pace – which is relatively subdued by historical experience. Higher interest rates and the winding back of government incentives to FHBs has slowed the owner-occupier segment a touch. However, this has been offset to date by investors returning to the market in greater numbers.

Credit momentum now clearly improving

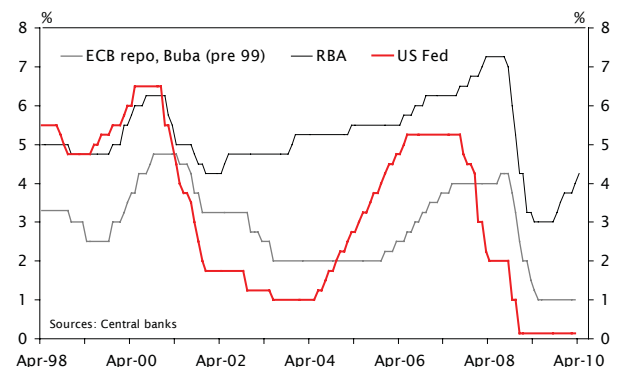


US FOMC rate decision

Apr 28, Last: 0-0.25%, WBC f/c: 0-0.25%, Mkt f/c: 0-0.25%

- Rates were left on hold at 0-0.25% on Mar 16 and the statement was similar to that issued after the Mar 16 meeting, with no major tweaks in the economic assessment; the commitment to maintain “exceptionally low levels of the federal funds rate for an extended period” remained, as it has for a year now. Once again there was one dissenter, Tom Hoenig, who preferred to drop the “extended period” commitment. The remainder of the statement noted the wind down of the Fed’s special liquidity facilities and MBS purchases.
- Since the Mar meeting, jobs and housing data have improved somewhat and expectations for Q1 GDP growth have risen. But inflation has surprised to the downside and key Fed officials including chair Bernanke have indicated current policy is appropriate given the risks from housing, credit conditions and the high jobless rate. We expect another on hold outcome.

Official rates

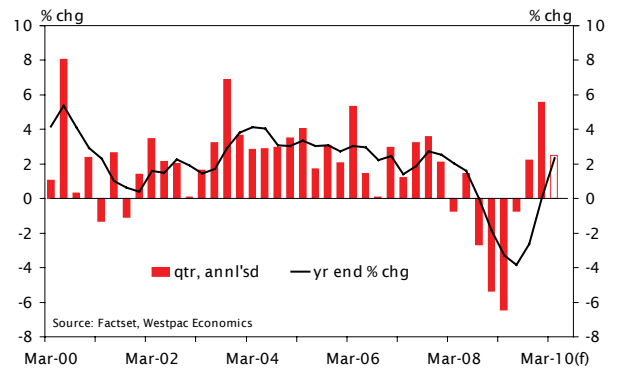


US Q1 GDP advance % annualised

Apr 30, Last: 5.6%, WBC f/c: 2.5%, Mkt f/c: 3.4%

- The US economy felt the full impact of fiscal stimulus (including multiplier effects) and sharply slower inventory rundown in Q4, which lifted the economy's growth pace to 5.6% annualised.
- We expect the third consecutive quarter of growth in Q1, but it probably decelerated to sub 3% annualised. Partial data point to a 3ppt lower contribution from inventories, although there will be some offset from modestly faster consumer and housing spending growth. But we also expect business investment to turn slightly negative and net exports are shaping up as a drag on growth again.
- Q1 should also show very modest inflationary pressures, with the core PCE deflator likely to slow from 1.8% annualised in Q4 to sub 1% in Q1.

US GDP growth



Key Data and Events

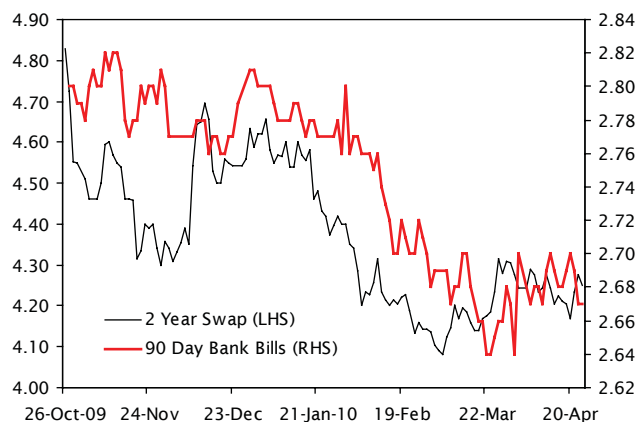
	Last	Market Median	Westpac Forecast	Comments	
Mon 26 Apr					
Aus	ANZAC Day Holiday	-	-	-	Markets closed
	Henry Tax Review	-	-	-	To be released before Budget (11 May), date tbc.
US	Apr Dallas Fed Factory Index	7.2	9.5	9.0	One of the last regional surveys to turn positive.
Eur	ECB's Trichet	-	-	-	Speaking in NY (and elsewhere in US on 27/4)
UK	Apr House Prices %yr	1.3%	-	-	Hometrack series.
	Apr House Prices %yr	9.0%	9.7%	-	Nationwide series, tentative date, data due 26-30/4
Tue 27 Apr					
Aus	Q1 PPI %qtr	-0.4%	0.6%	0.9%	No lge core M drag with steady A\$, higher construction, util, oil & food.
US	Feb House Prices %yr	-0.7%	1.3%	-	S&P/Case Shiller 20 city index.
	Apr Richmond Fed Factory Index	6	9	10	Other regionals have been positive so far this month.
	Apr Consumer Confidence	52.5	53.5	50.0	UoM and weekly confidence lower.
UK	Mar Mortgage Approvals	35k	38k	-	BBA data, not industry wide. Recent peak at 46k in Dec.
	Apr CBI Distributive Trades Survey	13	-	-	Reported sales reversed some of their weather/VAT Feb jump in Mar.
Wed 28 Apr					
NZ	Apr NBNZ Business Confidence	42.5%	-	-	Activity is now validating the high confidence levels in many sectors.
Aus	Q1 Headline CPI %qtr	0.5%	0.8%	0.8%	Higher veges, education, electricity, fuel, D&L, house purchase lift qtrly.
	Q1 Avg RBA Underlying CPI %qtr	0.6%	0.6%	0.7%	Retail discounting to drop out; rises in high-wgt items = higher qtrly core.
	RBA Assist Gov (Financial) Guy Debelle	-	-	-	Mortgage & Finance seminar, 8:30am Sydney
US	FOMC Rate Decision	0-0.25%	0-0.25%	0-0.25%	Exceptionally low rates for an extended period. Like it says on the box
Jpn	Mar Retail Sales %yr	4.2%	3.6%	-	Don't be fooled by the headline: incomes cannot sustain this rate.
Can	Mar House Prices %yr	7.5%	-	-	Teranet National bank index.
Thu 29 Apr					
NZ	RBNZ OCR Review	2.50%	2.50%	2.50%	The RBNZ is on track to begin raising rates in coming months.
	Mar Merchandise Trade NZDm	321	354	850	Huge surplus on high export prices, low import demand.
US	Mar Chicago Fed Nat Activity Idx	-0.64	-0.20	-	Index based on previously released activity data.
	Initial Jobless Claims w/e 24/4	456k	445k	-	-24k last wk, reversing much of prior 2wks rises, which were "statistical"
Eur	Mar Money Supply M3 %yr	-0.4%	-0.1%	-	Still contracting, as is credit to the private sector.
	Apr Business Climate Index	-0.32	-0.12	-	Uninterrupted improvement for twelve months running now.
	Apr Economic Confidence	97.7	99.4	97.0	Some impact from volcanic ash flight disruption?
	Apr Consumer Confidence (F)	-15	-15	-	Advanced reading was a touch better than expected, -15 up from -17
Fri 30 Apr					
NZ	Mar Building Consents s.a.	5.9%	-	7.0%	A bounce back in apartment consents risks a stronger outturn.
Aus	Mar Private Credit	0.4%	0.4%	0.4%	Credit cycle has turned the corner as business begins to stabilise.
US	Q1 GDP Adv % annualised	5.6%	3.4%	2.5%	See text box for forecast detail.
	Q1 Employment Cost Index	0.5%	0.5%	0.4%	Labour market not strong enough to generate cost pressures.
	Apr Chicago PMI	58.8	60.0	61.0	Dipped sharply in Mar, so likely to correct higher too.
	Apr UoM Consumer Sentiment	69.5	71.0	71.0	Some correction higher from steep advance dip.
	Apr NAPM Milwaukee	62.0	-	-	More volatile and less closely watched than the other regionals.
Jpn	Mar Industrial Production	-0.9%	0.8%	-	The easy part (inventory adjustment) is over. Where to now?
	Mar Nationwide Consumer Prices %yr	-1.1%	-1.1%	-	The improvement to date has been in volatile items.
	Apr Tokyo Consumer Prices %yr	-1.8%	-2.1%	-	Services deflation entrenched in line with massive degree of slack.
	Apr Nomura PMI	52.4	-	-	Larger manufacturers in reasonable shape, as per Tankan.
	Mar Unemployment Rate	4.9%	4.9%	-	Casualised workforce still seeing nominal wage declines.
	Mar Housing Starts %yr	-9.3%	-5.8%	-	Japan's dwelling investment decline has been mindboggling.
	Mar Construction Orders %yr	-20.3%	-	-	No finance or demand for private non-res projects.
	BoJ Meeting & 6mthly Report	0.10%	0.10%	0.10%	Main focus is release of central tendency board member forecasts.
Eur	Apr CPI Flash %yr	1.5%	1.5%	1.8%	Further upward pressure from energy prices.
	Mar Unemployment %	10.0%	10.0%	10.0%	German jobless rate edged lower in March, suggesting downside risk.
UK	Apr GfK Consumer Confidence	-15	-15	-18	Nationwide confidence fell sharply in Mar. Election concerns?
Can	Mar Industrial Product Prices	0.0%	0.0%	-	Feb first month without gain since Oct.
	Feb GDP	0.6%	0.3%	-	Jan's solid start to year followed healthy Q4.

New Zealand Economic and Financial Forecasts

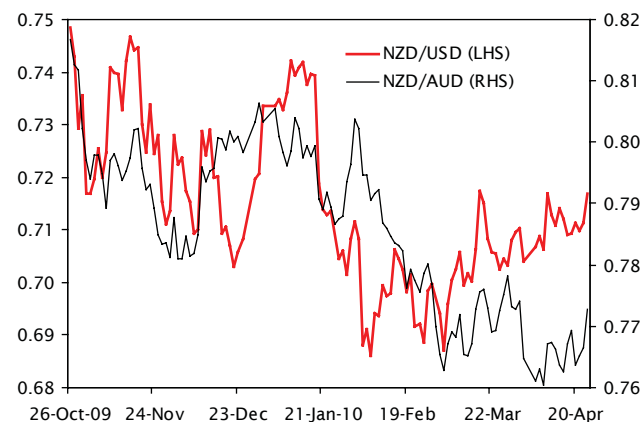
Economic Growth Forecasts	March years				Calendar years			
	2009	2010f	2011f	2012f	2009	2010f	2011f	2012f
% change								
GDP (Production) ann avg	-1.4	-0.3	4.1	4.2	-1.6	3.4	4.4	3.4
Employment	0.7	-1.2	1.7	2.3	-2.4	1.5	2.2	1.4
Unemployment Rate % s.a.	5.0	7.4	6.4	5.3	7.3	6.3	5.5	5.2
CPI	3.0	2.0	2.4	2.8	2.0	2.3	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	0.78	0.80	0.81	0.82	0.82	0.83	0.84
NZD/JPY	65.5	69.8	74.9	75.2	76.5	78.4	79.6
NZD/EUR	0.52	0.54	0.56	0.55	0.55	0.56	0.56
NZD/GBP	0.46	0.47	0.48	0.47	0.47	0.47	0.46
TWI	66.1	68.5	71.1	70.3	70.4	70.8	70.8

2 Year Swap and 90 Day Bank Bills



NZD/USD and NZD/AUD



NZ interest rates as at market open on Monday 26 April 2010

Interest Rates	Current	Two Weeks Ago	One Month Ago
Cash	2.50%	2.50%	2.50%
30 Days	2.62%	2.60%	2.59%
60 Days	2.66%	2.64%	2.63%
90 Days	2.70%	2.69%	2.66%
2 Year Swap	4.27%	4.28%	4.28%
5 Year Swap	5.24%	5.24%	5.25%

NZ foreign currency midrates as at Monday 26 April 2010

Exchange Rates	Current	Two Weeks Ago	One Month Ago
NZD/USD	0.7176	0.7128	0.7033
NZD/EUR	0.5368	0.5245	0.5241
NZD/GBP	0.4665	0.4634	0.4720
NZD/JPY	67.510	66.450	65.090
NZD/AUD	0.7743	0.7674	0.7782
TWI	66.780	65.900	65.700

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	3.2	3.6
CPI inflation % annual	2.8	3.3	3.0	3.7	2.1	2.6	2.8
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	-4.2	-3.1
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	0.7	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	0.3	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 8 April 2010

Interest Rate Forecasts	Latest (Apr 26)	Jun-10	Sep-10	Dec-10	Mar-11	Jun-11
Australia						
Cash	4.25	4.50	4.50	4.50	4.50	5.00
90 Day Bill	4.53	4.50	4.60	4.75	4.75	5.25
10 Year Bond	5.84	5.90	6.00	6.00	6.10	6.75
International						
Fed Funds	0.125	0.125	0.125	0.125	0.125	0.50
US 10 Year Bond	3.81	3.70	3.75	4.00	4.50	5.25
ECB Repo Rate	1.00	1.00	1.00	1.00	1.25	1.50
Exchange Rate Forecasts						
AUD/USD	0.9268	0.94	0.94	0.95	0.93	0.90
USD/JPY	94.07	93	95	98	102	106
EUR/USD	1.3367	1.34	1.36	1.38	1.36	1.32
AUD/NZD	1.2915	1.31	1.25	1.22	1.22	1.20

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