

# Weekly Commentary

14 November 2011

## Turn for the worse

The European debt crisis took a nasty turn last week, as the market's focus shifted from Greece to Italy – a much more dangerous proposition, as Europe's existing rescue facilities are nowhere near large enough to provide a bailout. Both the Greek and Italian Prime Ministers resigned last week, with the hope that this will pave the way for new interim governments that can push through tough austerity programs. But at this point it's not clear that any sort of fiscal hairshirt will be enough to restore investors' confidence.

Even without considering these latest developments in Europe, the Reserve Bank's November Financial Stability Report (FSR) revealed a high degree of alarm about global economic conditions, another sign that interest rate hikes are likely to be delayed. Last week's domestic data, on balance, will have given them further reason to do so.

The FSR noted a significant deterioration in its financial stability gauges since the May report, particularly in global conditions. Forecasts for trading partner growth have been revised down to 3.1% for this year (was 3.3% in the September Monetary Policy Statement) and 3.8% next year (was 4.2%). But the greater source of concern was the Greek sovereign debt crisis and the risk of contagion to other highly indebted countries. The main concern for New Zealand is that: "The exposure of European banks to distressed sovereigns has adversely affected global debt markets, which are an important source of funding for New Zealand's banks."

The banks are still seen as relatively well-placed to handle this threat, having moved towards more stable forms of funding since the 2008 financial crisis. However, in recognition of the difficult conditions in offshore credit markets at the moment, the RBNZ announced that the planned increase in the minimum Core Funding Ratio (CFR) from 70% to 75% will be delayed by six months until January 2013.

The delay is more of a symbolic move than an actual easing – the major banks already have CFRs above 75%, and given that the increase is only being delayed, it's unlikely that banks will plan on running down their core funding levels in the interim. Instead, we see the delay as recognition that macro-prudential tools such

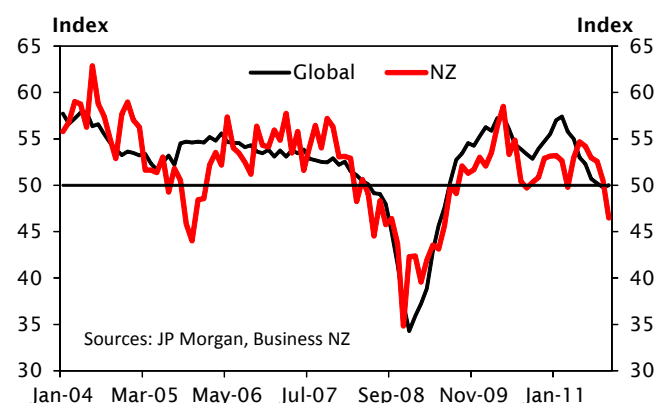
as the CFR are not the win-win scenario that some would like to believe – they could prove useful in helping the RBNZ to lean against the wind during credit booms, but they make it harder to ease credit conditions when needed.

While the FSR steers clear of direct comment on monetary policy, the extent of the downgrade to the RBNZ's global outlook would certainly justify delaying rate hikes, beyond the March 2012 date that was indicated in the September MPS. Our view remains that the first OCR hike will be pushed out to June next year.

The local data calendar began last week with electronic card transactions, which rose 1.8% in October – a more convincing Rugby World Cup-related bounce after a 0.7% rise in September. The gains were led by clothing, fuel and domestic travel; less so in the hospitality sector during the month, although card billings there have been rising sharply since April. We estimate that credit card spending rose 3.4% while debit cards were up 0.5% – consistent with most of the lift in spending coming from overseas visitors, while the net response by locals was more subdued.

House sales rose 4% in seasonally adjusted terms in October, reversing a 3% drop in September. The details, however, point to a noisy Sep-Oct period rather than a change of direction in the market. In particular, the sharp September fall in sales in Auckland, Waikato and Wellington – the main RWC hosting regions

### Manufacturing PMIs



– were unwound in October. The stratified price index was up 3.4% on a year ago, with the most significant price pressures once again in Auckland, reflecting population growth and previous under-building.

The Crown accounts didn't show a great start to the fiscal year, with a worse than expected operating deficit of \$2.5bn in the three months to September. That said, the figures were only one month's advance on the pre-election fiscal update (PREFU) that was published in late October, and monthly figures are often volatile relative to forecasts. But given the starting point for the fiscal accounts, and the trend in global conditions, we should be more sensitive to any downside surprises than to upside ones.

Food prices continued to soften by much more than we expected. The 1.3% drop in October was the third month in a row that prices have fallen by 1% or more, and annual inflation has slowed from 7.9% three months ago to 1.1% now (last year's GST hike dropped out of the calculation in October, accounting for about 2pts of the drop).

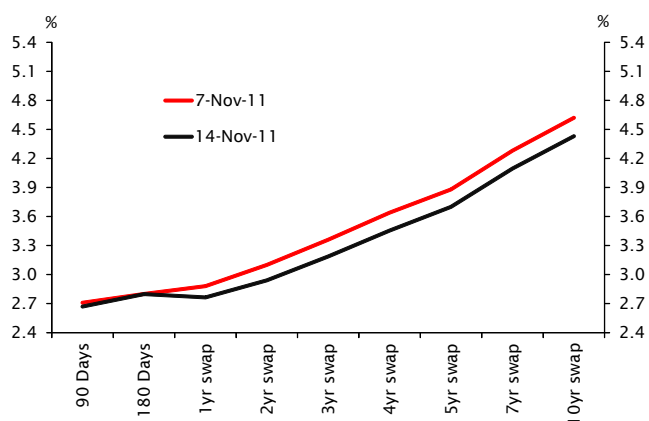
The fact that prices fell in the first month of the quarter has a significant effect on our Q4 inflation forecast, even assuming some post-RWC rebound in prices next month. In the last week or so we've also received information about price cuts in other areas – petrol, wine, and broadband internet. (Interestingly, these were also the big negatives in the Q3 CPI.) Put together, we've revised down our Q4 CPI forecast from 0.5% to 0.2%. This would put annual inflation at 2.4% for the end of this year, and a low point of 1.6% in June 2012.

Finally, there were simply no redeeming features to the October manufacturing PMI, which fell 4pts to 46.5, a level that suggests activity is now contracting. The RWC was seen as a disruptive factor on balance, but no more so than in September. And the slowing global economy doesn't entirely excuse the weakness in this survey

either – no other region, not even Europe, has seen as large a fall in its PMI survey in the last three months. We will be keeping a close eye on this sector from here.

**Fixed versus floating:** Floating remains a relatively low-risk option for now, although fixing will become a consideration again by early next year. Little upward pressure on interest rates from offshore looks likely any time soon, and in its October review the RBNZ confirmed that it will watch and wait while global financial conditions remain this uncertain. But rate hikes remain likely over the longer term, and if current pressures in offshore markets persist, higher bank funding costs could drive additional increases in future mortgage rates, independently of RBNZ action – indeed, our expectation for OCR hikes to be delayed until June 2012 is at least as much a reflection of this risk as of the state of the economy. Based on our latest forecasts and current market pricing, fixing for two or three years is likely to result in a lower interest bill than remaining on floating for the entire period.

**NZ interest rates**



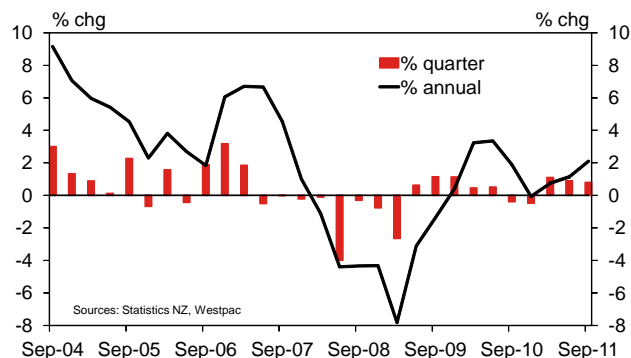
**Key Data Previews**

**NZ Q3 real retail sales**

Nov 14, Last: 0.9%, mkt f/c: 0.6%, WBC f/c: 0.8%

- Retail sales volumes have seen remarkably steady growth through this year, even through disruptions such as the February earthquake. Even so, they have barely started down the road to recovery, having recovered less than a quarter of the 10% drop in sales per capita during the recession.
- We estimate that total retail sales volumes rose another 0.8% in the September quarter (ex-auto 0.6%). Based on electronic card transaction data, the strongest gains were in the sectors positioned to benefit from the Rugby World Cup - hospitality, clothing and fuel - while domestically-oriented areas such as durable goods were down slightly.
- Cards data alone suggest 0.6% growth; we've assumed some increase in the share of cash transactions due to the higher number of overseas visitors during the tournament.

**NZ real retail sales**

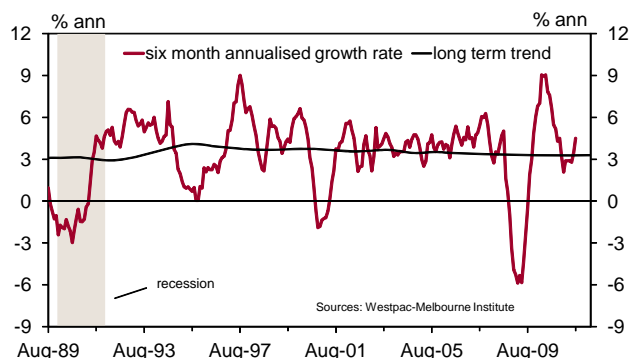


### Aus Sep Westpac-MI Leading Index

Nov 16, Last: 4.5% annualised

- The annualised growth rate of the *Westpac-Melbourne Institute Leading Index* rose to 4.5% in August from 3.5% in July, comfortably above the long term trend rate of 3.3%. Ordinarily this would signal a shift to above-trend economic growth heading into 2012. However, there are good reasons to be cautious in interpreting recent signals - in particular, the exceptional volatility due to severe weather events in the first half of the year is making it much harder to get a reliable fix on underlying trends.
- The September update will include some very weak monthly figures on dwelling approvals (-13.6% more than reversing the 10.7% jump in Aug) and equities (the ASX down 6.9% in the month vs the milder 2.9% fall in August). Against this though, money supply posted a strong 2.6% rise and US industrial production rose 0.2%, slightly better than the flat August.

### Westpac - MI Leading Index



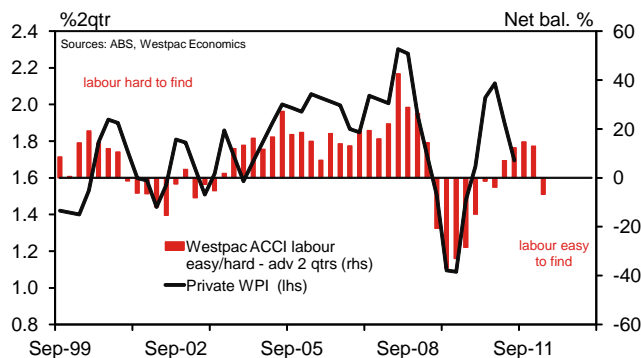
### Aus Q3 wage price index

Nov 16, Last: 0.9%, WBC f/c: 0.8%

Mkt f/c: 0.9%, Range: 0.7% to 1.1%

- The WPI rose 0.9%qtr in Q2, less than market expectations for a 1% rise, with the annual pace easing from 3.9%yr to 3.8%yr. The main reason for the softer than expected print was the surprisingly weak 0.7%qtr rise in private sector wages. The annual rate for private sector wage inflation has now dipped to 3.8%yr from 4.0%yr in Q1.
- The labour market has softened this year, 35k full-time jobs have been lost since March, the unemployment rate lifted from 4.9% to 5.2% (was 5.3% in Sept) and the Westpac-ACCI survey suggests it is now easy to find staff. This suggests downward pressure on wages is evolving. But wage outcomes tend to be a bit sticky so we have pencilled in a 0.8%qtr which would see the annual rate drop to 3.6%yr from 3.8%yr.

### Labour market has some slack, wages ease

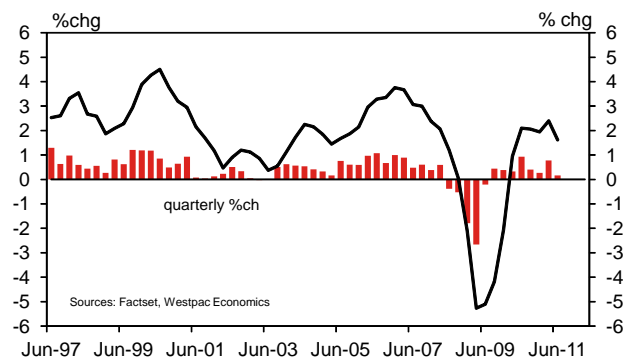


### Euroland Q3 GDP, advance estimate

Nov 15, Last: 0.2% WBC f/c: 0.1%

- Euroland GDP growth slowed from 0.8% to 0.2% in Q2, with German output only rising 0.1% (from 1.3% in Q1). That is the slowest quarter yet of the two year long Euroland recovery.
- The list of European economic indicators that have weakened to the level/pace they were running one or two quarters into the 2008 recession continues to grow: business and consumer confidence, investor sentiment, retail sales and industrial orders. The notable exception is industrial production, held up by order backlogs but these are now being worked through. On our forecasts, Q3 will show just 0.1% growth, and be the last quarter of expansion in Euroland for at least a year.
- Our 2012 growth forecast of -0.6% compares to the EU Commission's unrealistic +0.5% (published 10/11), which implies that Europe will just manage to sidestep recession next year.

### Euro zone GDP growth

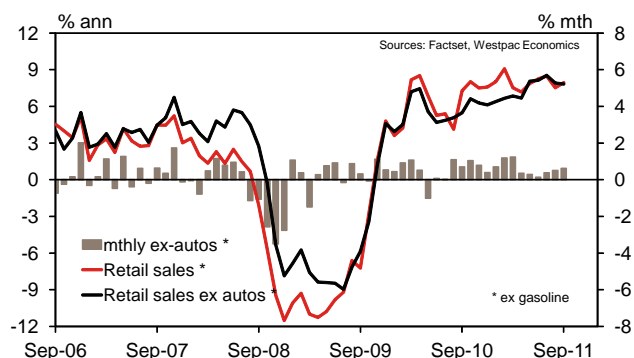


## US Sep retail sales

Nov 15, Last: 1.1%, WBC f/c: 0.5%

- US retail sales rose 1.1% in Sep, helped along by autos up 3.6% and gasoline up 1.2%. But the report also included the first rise in apparel and department stores in 3 months; restaurants and furniture were also a source of strength. Back revisions boosted core retail ex autos and gasoline substantially, to be up 4.6% annualised in Q3 (from 1.7% annualised in Jul-Aug).
- Unit auto sales rose 1.2% in Oct; gasoline prices were lower. Consumer confidence fell sharply in Q3 and early Q4 but household income picked up somewhat in Oct.
- We expect a 0.5% Oct retail gain but just 0.2% ex autos & gas.

## US retail sales



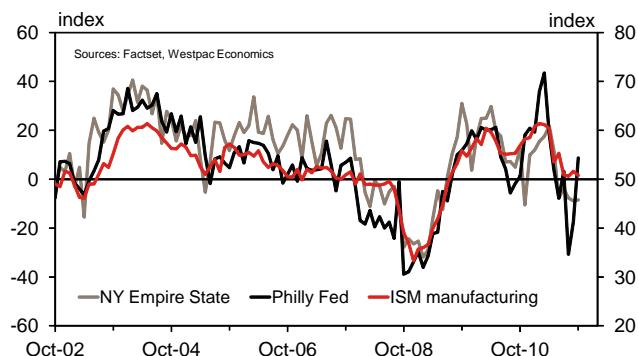
## US Nov NY and Philly Fed surveys

Nov 15, New York Fed: Last: -8.5 WBC f/c: -5.0

Nov 17, Philadelphia Fed: Last: 8.7, WBC f/c: 2.0

- Six months ago we wrote ahead of the May NY/Philly Fed: "We are concerned about the 2011 economic outlook and these surveys should be among the first to sustain a move lower in coming months, if our concerns are justified."
- The NY Fed fell from 22 in April to -8 in June, and has been little changed since. Over roughly the same period the Philly Fed dropped from 43 to -31 before recovering to 9 in Oct.
- There was some overshoot in these surveys, especially Philly, which covers just a hundred of so businesses each and whose headlines are questions about business conditions, not composites of activity detail which has generally not been so negative or volatile. So with the dust settling, we expect readings closer to zero for both these surveys.

## US manufacturing surveys



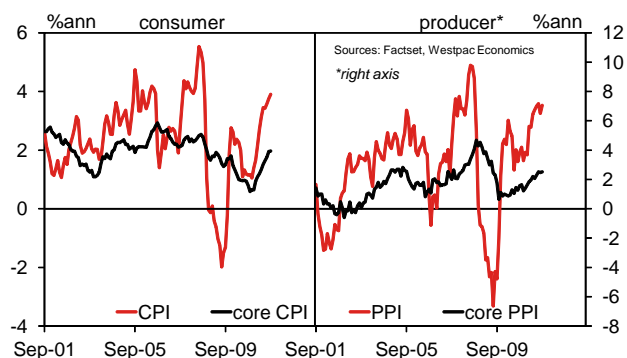
## US Oct PPI and CPI

Nov 15, PPI headline/core: Last: 0.8%/0.2%, WBC f/c: flat/0.2%

Nov 16, CPI headline/core: Last: 0.3%/0.1%, WBC f/c: flat/0.1%

- The PPI's 0.8% rise in Sep was mostly due to a 4.2% jump in gasoline prices which reflects the survey timing and seasonal issues – and almost certainly will be reversed in Oct. Food prices rose 0.6% but the spike in commodity prices that drove this has since abated. The core PPI was up 0.2% with autos and apparel both recording falls; as ever the core rate will be susceptible to any volatility in vehicle prices.
- Sep CPI's 0.3% gain reflected a 2.0% rise in energy and a 0.4% rise in food, but core prices were very soft, rising just 0.054% before rounding to 0.1%. The high weighted owner equivalent rent (25% of the CPI) slowed further to 0.1% in Sep and that, along with lower apparel and auto prices explained the subdued price story last month. We expect it to be repeated in Oct, with headline CPI pulled back to zero by lower gasoline/food prices.

## US price inflation

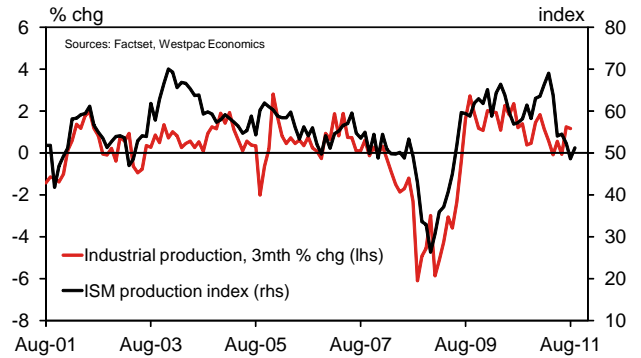


## US Oct industrial production

Nov 16, Last: 0.2%, WBC f/c: 0.6%

- Industrial production was up 0.2% in Sep following a downward revision to the August data to flat from 0.2%. Over Q3 as a whole, industrial production rose 1.3% annualised. Some of the rebound over the quarter appears to be corrective following the supply chain disruption softness in Q2.
- Oct payrolls showed a 0.5% rise in factory hours worked, but the Oct ISM survey production index slipped back to 50.1, for an average of 50.0 over their latest three months, down from 53.6 in May-July. These conflicting signals probably mean that any jump in industrial output is likely to prove transitory rather than sustainable.
- We expect a 0.6% rise in Oct industrial production, including a likely bounce in utility output after declines in Aug-Sep.

## US industrial sector



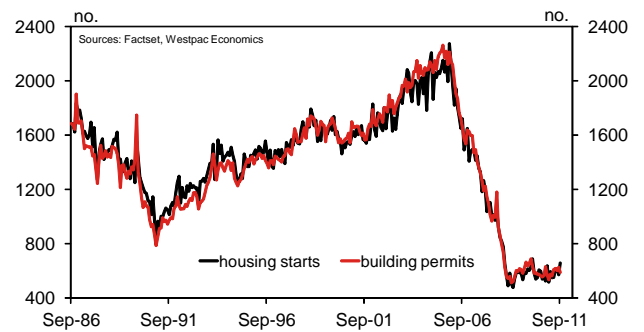
## US Oct housing starts and permits

Nov 17, Starts: Last: 15.0%, WBC f/c: -11.0%

Nov 17, Permits: Last: -5.0%, WBC f/c: 2.5%

- Housing starts jumped 15.0% in Sep, lifted by a 51% surge in volatile multiples, although single family starts were subdued with a 1.7% rise after a cumulative 7% fall in the first 2 months of the quarter. Meanwhile housing permits fell 5.0%, also led by multiples down 14.5%. Single family permits fell 0.2%.
- Abstracting from the multiples noise, in Q3, single family starts were running a 424k annual pace, with permits on 413k. Compared to the same quarter in 2009, when the US economic recovery began, starts are down 15% and permits are off 10%, emphasising how the housing market has gone backwards in this atypical US economic recovery.
- We expect partial reversals of the starts gain/permits loss due to multiples noise, leaving in place a weak underlying story.

## US housing starts and permits



## Key Data and Events

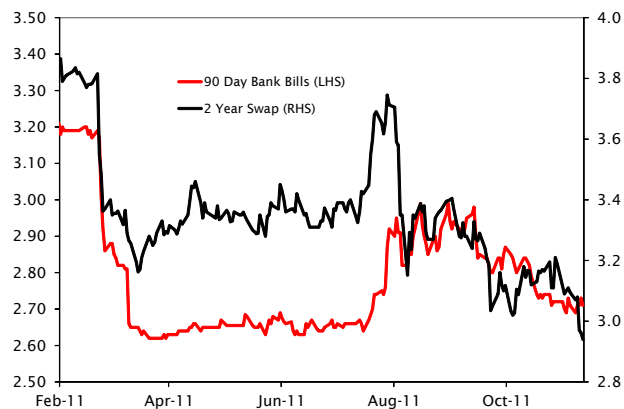
		Last	Market median	Westpac forecast	Risk/Comment
<b>Mon 14</b>					
<b>NZ</b>	Q3 retail sales	0.9%	0.6%	0.8%	RWC boosted spending in hospitality, fuel, clothing.
<b>Jpn</b>	Q3 GDP annualised	-2.1%	5.8%	5.4%	Rebound from disaster. Real output still below Dec-10 level.
	Sep capacity utilisation %mth	2.4%	-	-	Return to normal utilisation levels almost complete.
<b>Eur</b>	Sep industrial production	1.5%	-	-1.0%	German IP down 2.7% in Sep.
<b>UK</b>	Oct consumer confidence	45	-	-	Tentative date for Nationwide index.
<b>US</b>	Q3 mortgage delinquencies	8.4%	-	-	Tentative date for MBA data on defaults and foreclosures.
<b>Tue 15</b>					
<b>Aus</b>	RBA meeting minutes	-	-	-	Rate cut took policy to 'a more neutral stance', but not 'neutral' itself.
	Oct new vehicle sales	-1.5%	-	-0.5%	Industry figures suggest modest slippage in sales.
<b>Eur</b>	Q3 GDP advance	0.2%	-	0.1%	On our forecasts, Q3 will be last quarter of growth for a year.
	Sep trade balance €bn sa	-1.0	-	-	Have not seen a month of surplus yet this year.
<b>UK</b>	Oct CPI %yr	5.2%	-	4.9%	BRC index points to downside risk; CPI may have peaked.
<b>US</b>	Oct PPI	0.8%	0.1%	0.0%	Survey timing likely to capture lower energy prices while core rate still driven by noise in vehicle prices.
	Oct PPI core	0.2%	0.1%	0.2%	
	Oct retail sales	1.1%	0.4%	0.5%	Auto sales up 1.2% but core retailing likely to have slowed given persistent weakness in confidence.
	Oct retail sales ex autos and gas	0.5%	-	0.2%	
	Nov NY Fed factory index	-8.5	-5.7	-5.0	Respondents still worried even if own firms doing OK for now.
	Sep business inventories	0.5%	0.3%	0.3%	Clue to Q3 GDP revision.
	Fedspeak	-	-	-	Bullard, Fisher.
<b>Can</b>	Sep manufacturing sales	1.4%	-	-	Aug lifted by transport, food and energy.
<b>Wed 16</b>					
<b>Aus</b>	Sep Westpac-MI leading index	4.5%	-	-	Above trend but exaggerated by rebound from weather disruptions?
	Q3 wage cost index	0.9%	0.9%	0.8%	A softer labour market points to a moderation in wage outcomes.
<b>Jpn</b>	Bank of Japan decision	0.1%	0.1%	0.1%	¥5trn baby steps not enough to offset Fed, BoE, SNB and ECB action.
<b>Eur</b>	Oct CPI final %yr	3.0% a	-	3.0%	Core rate was 1.6% byr in Sep.
<b>UK</b>	Oct unemployment change	18k	-	20k	Benefit claimant count measure.
	BOE inflation report	-	-	-	Downgraded growth and inflation forecasts. High recession risk.
<b>US</b>	Oct CPI	0.3%	0.0%	0.0%	Energy prices including gasoline will weigh against CPI headline while core pressures are softening too.
	Oct CPI core	0.1%	0.1%	0.1%	
	Sep net long term TIC flows \$bn	57.9	-	-	Inflows picked up as did risk aversion.
	Oct industrial production	0.2%	0.4%	0.6%	Factory hours worked rose 0.5% in Oct.
	Nov NAHB housing market index	18	17	16	Housing market remains in doldrums.
<b>Thu 17</b>					
<b>NZ</b>	Q3 producer prices (outputs)	1.4%	-	-	Likely to fall on lower fuel, dairy prices.
<b>Aus</b>	RBA Governor Stevens speaking	-	-	-	Opening remarks to Inst. of Internal Auditors Forum
<b>UK</b>	Oct retail sales	0.6%	-	0.0%	Survey data suggest retail struggling after Sep blip.
<b>US</b>	Oct housing starts	15.0%	-7.3%	-11.0%	Surge in multiples starts in Sep to reverse to fall in multiples permits
	Oct building permits	-5.0%	1.9%	2.5%	in Sep to reverse.
	Initial jobless claims w/e 12/11	390k	-	400k	Will lowest claims level in seven months be sustained?
	Nov Philadelphia Fed factory index	8.7	10.0	2.0	Respondents still worried even if own firms doing OK for now.
<b>Fri 18</b>					
<b>US</b>	Oct leading index	0.2%	0.5%	0.4%	Not indicating recession, just sluggish growth.
<b>Can</b>	Oct CPI %yr	3.2%	-	-	BoC core rate was 2.2% yr in Sep.
	Oct leading index	-0.1%	-	-	Since May only one month has seen any growth, Jul with 0.1%.

## New Zealand Economic and Financial Forecasts

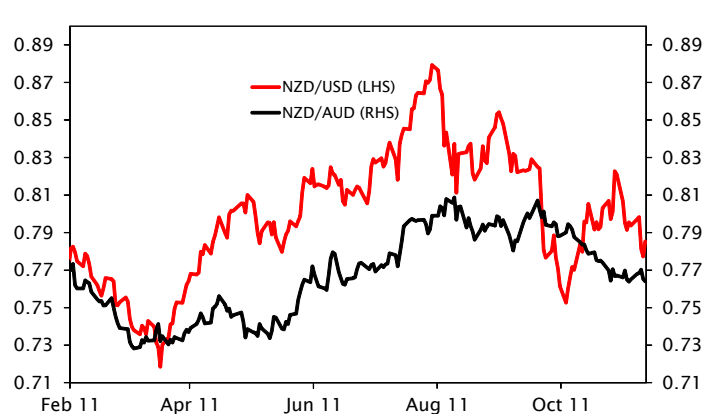
Economic Growth Forecasts	March years				Calendar years			
	2010	2011e	2012f	2013f	2010	2011f	2012f	2013f
% change								
GDP (Production) ann avg	-0.7	1.6	2.3	3.8	1.6	2.0	3.7	3.0
Employment	-0.1	1.8	1.3	2.9	1.3	1.9	3.0	2.1
Unemployment Rate % s.a.	6.1	6.5	6.3	5.3	6.7	6.5	5.5	4.8
CPI	2.0	4.5	2.1	2.6	4.0	2.4	2.3	2.9
Current Account Balance % of GDP	-1.9	-3.6	-4.6	-6.3	-3.5	-4.0	-6.1	-5.5

Financial Forecasts	Dec-11	Mar-12	Jun-12	Sep-12	Dec-12	Mar-13
Cash	2.50	2.50	2.75	3.00	3.25	3.50
90 Day bill	2.80	2.80	3.00	3.30	3.60	3.80
2 Year Swap	3.30	3.50	3.80	4.10	4.40	4.60
5 Year Swap	4.00	4.30	4.50	4.70	4.90	5.10
10 Year Bond	4.50	4.50	4.60	4.70	4.80	4.90
NZD/USD	0.76	0.73	0.71	0.75	0.78	0.80
NZD/AUD	0.77	0.76	0.76	0.77	0.77	0.78
NZD/JPY	58.5	55.5	54.0	58.5	63.2	67.2
NZD/EUR	0.58	0.58	0.59	0.61	0.61	0.63
NZD/GBP	0.50	0.49	0.49	0.50	0.49	0.49
TWI	68.0	66.6	66.2	69.0	70.6	72.4

2 Year Swap and 90 Day Bank Bills



NZD/USD and NZD/AUD



## NZ interest rates as at market open on Monday 14 November 2011

Interest Rates	Current	Two Weeks Ago	One Month Ago
Cash	2.50%	2.50%	2.50%
30 Days	2.67%	2.68%	2.70%
60 Days	2.68%	2.73%	2.78%
90 Days	2.71%	2.72%	2.79%
2 Year Swap	2.94%	3.19%	3.12%
5 Year Swap	3.70%	4.01%	3.91%

## NZ foreign currency mid-rates as at Monday 14 November 2011

Exchange Rates	Current	Two Weeks Ago	One Month Ago
NZD/USD	0.7878	0.8199	0.8034
NZD/EUR	0.5711	0.5798	0.5792
NZD/GBP	0.4897	0.5083	0.5075
NZD/JPY	60.761	62.027	61.854
NZD/AUD	0.7663	0.7659	0.7774
TWI	68.820	70.460	70.150

## Economic and Financial Forecasts

Economic Forecasts (Calendar Years)	2007	2008	2009	2010	2011f	2012f
<b>Australia</b>						
Real GDP % yr	4.6	2.6	1.4	2.7	1.2	2.8
CPI inflation % annual	3.0	3.7	2.1	2.7	3.5	3.3
Unemployment %	4.4	4.3	5.6	5.2	5.1	5.5
Current Account % GDP	-6.3	-4.5	-4.2	-2.7	-2.0	-3.5
<b>United States</b>						
Real GDP %yr	1.9	-0.3	-3.5	3.0	1.8	1.0
Consumer Prices %yr	2.9	3.8	-0.3	1.6	3.2	2.0
Unemployment Rate %	5.8	5.8	9.3	9.6	9.1	9.3
Current Account %GDP	-5.3	-4.7	-2.7	-3.2	-3.3	-3.0
<b>Japan</b>						
Real GDP %yr	2.2	-1.5	-6.6	4.3	-0.4	3.2
Consumer Prices %yr	0.1	1.4	-1.3	-0.7	0.2	0.6
Unemployment Rate %	3.9	4.0	5.1	5.1	4.6	4.5
Current Account %GDP	4.8	3.3	2.8	3.6	2.0	2.1
<b>Euroland</b>						
Real GDP %yr	2.8	0.3	-4.0	1.7	1.6	-0.6
Consumer Prices %yr	2.1	3.3	0.3	1.7	2.5	1.0
Unemployment Rate %	7.5	7.5	9.5	10.0	10.3	11.0
Current Account %GDP	0.2	-0.8	-0.7	-0.5	-0.5	0.0
<b>United Kingdom</b>						
Real GDP %yr	2.7	-0.1	-4.9	1.4	0.9	0.4
Consumer Prices %yr	2.3	3.6	2.2	3.2	4.0	2.2
Unemployment Rate %	5.3	5.6	7.6	7.8	8.3	9.0
Current Account %GDP	-2.6	-1.6	-1.3	-2.4	-2.0	-1.5

Forecasts finalised 7 November 2011

Interest Rate Forecasts	Latest (Nov 14)	Dec-11	Mar-12	Jun-12	Sep 12	Dec 12
<b>Australia</b>						
Cash	4.50	4.50	4.25	4.00	3.75	3.75
90 Day Bill	4.65	4.50	4.25	4.00	3.75	3.80
10 Year Bond	4.12	4.30	4.30	4.40	4.50	4.70
<b>International</b>						
Fed Funds	0.125	0.125	0.125	0.125	0.125	0.125
US 10 Year Bond	2.06	2.10	2.20	2.40	2.50	2.60
ECB Repo Rate	1.25	1.00	0.75	0.75	0.75	0.75

Exchange Rate Forecasts	Latest (Nov 14)	Dec-11	Mar-12	Jun-12	Sep 12	Dec 12
AUD/USD	1.0158	0.99	0.96	0.93	0.97	1.01
USD/JPY	77.55	77	77	76	78	81
EUR/USD	1.3625	1.32	1.26	1.20	1.23	1.27
AUD/NZD	1.3050	1.30	1.32	1.31	1.29	1.29

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