

ANZ Economic Outlook

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- Global economic growth has accelerated swiftly since the middle of last year, and is expected to average 4½% in 2004 – the best outcome since 2000. The persistence of large current account imbalances among the world's major economic regions does pose some risks to the outlook for 2005. *page 2*

Asian outlook

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Gross Domestic Product

% ch	2001	2002	2003(e)	2004(f)	2005(f)
North America	0.6	2.2	3	4¼	3¼
Western Europe	1.7	1.1	¾	2	2½
Japan	0.4	-0.3	2¼	2½	2
Australia	2.6	3.6	2¾	4	3¼
New Zealand	2.5	4.4	3½	2¾	2¼
China	7.3	8.0	9	8½	7½
Other East Asia	2.0	4.6	4	5½	5
South Asia	5.0	4.3	7	6¼	6
South America	0.8	-0.9	1¼	3¾	3¾
E.Europe & Russia	4.0	3.5	5	4¼	3¾
World	2.2	2.7	3½	4½	4

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International outlook

Global growth to be stronger in 2004

The global economy has strengthened noticeably since the middle of 2003 and is entering 2004 with considerable momentum. Most major leading indicators of global economic activity suggest that the upswing is still accelerating. Moreover, although the US and China are clearly the major locomotives for the global economy, the upturn is becoming more broadly based, with nearly every major economy experiencing stronger growth than at this time last year.

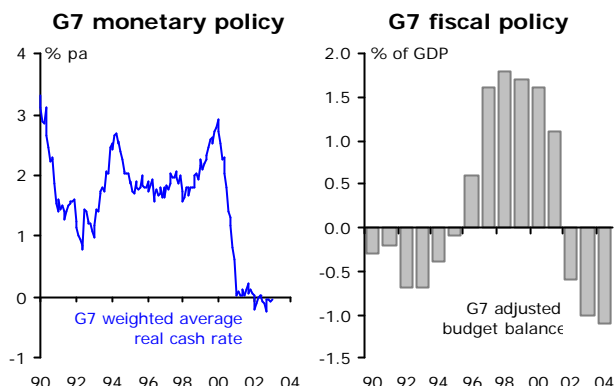
It now seems likely that world economy will grow by nearly 4½% this year, the best outcome since 2000 and an improvement of 1 pc point over the estimated result for 2003.

The recovery in the global economy is being driven largely by the monetary and fiscal policy stimulus effected by central banks and governments, particularly in the United States, over the past few years. This stimulus has had to contend with a series of 'headwinds' and shocks – including the effects of the collapse of the 1990s equities bubble, on-going security concerns, higher oil prices and the SARS epidemic. These factors have by no means entirely disappeared, although their adverse effects on economic growth have diminished. Conversely, improving financial conditions, in particular the rise in share prices from their lows around March last year, and rising business and consumer confidence are now exerting a positive influence on global growth in most countries.

US economic growth is forecast to average 4½% in 2004, a somewhat stronger outcome than we envisaged three months ago, partly as a result of growth in the second half of last year being more rapid than we had anticipated and hence providing a larger 'base effect' for this year. The recovery is still expected to be driven, to a greater extent than in previous cycles, by business investment, reflecting the much improved state of corporate balance sheets and the focus on achieving profit growth through productivity gains. Growth in household spending is however also likely to be stronger than previously forecast, with consumers being less constrained by the poor state of household balance sheets than we anticipated three months ago.

Japan's economic recovery is expected to continue in 2004, with growth averaging almost 2½% (the strongest since 1996). Exports and business investment will again be the major contributors to growth, but a modest upturn in consumer spending is also in prospect as the labour market gradually improves.

Highly expansionary policy settings ...



G7 cash rate is deflated by 12-months to core inflation; budget balances abstract from the impact of the business cycle on expenditures and tax revenues, and also exclude net interest payments. Sources: Datastream; OECD; Economics@ANZ.

... are finally producing a strong upturn



Sources: National statistical agencies; Economics@ANZ.

Recorded growth in China's economy is expected to slow slightly from 9% in 2003 to around 8½% in 2004, reflecting an easing in fixed investment from the frenetic pace of last year. In other East Asian economies, however, economic activity is expected to be faster than in 2003, largely as a result of stronger growth in external demand.

A more modest upturn is in prospect for the euro area, with growth expected to average 2% in 2004. Although interest rates are at record lows, fiscal policy has been less expansionary and the appreciation of the euro (which has borne the brunt of the decline in the US\$) will dampen the impact of stronger global demand to a greater extent than in other major economies.

The biggest risks to the prospects for sustained growth in the global economy arise from the external imbalances among the major economies and the possibility of large, destabilizing swings in major currencies, which we explore further below.

Inflation cycle gradually turning

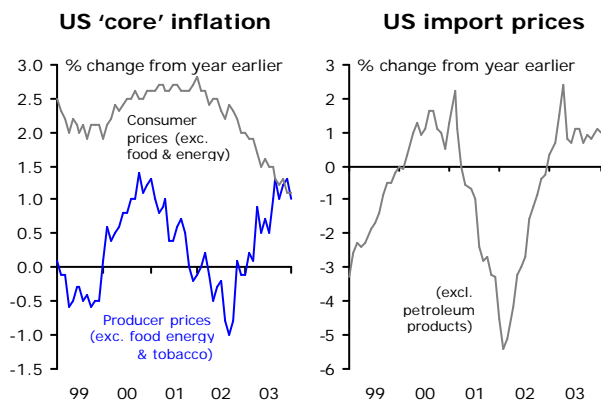
The early years of this decade have been accompanied by significant downward pressure on prices in most major economies. In the US, 'core' inflation at the consumer level has fallen to just over 1%, its lowest level since the mid-1960s. In Japan, consumer prices have fallen almost continuously since late in 1998, while a number of other Asian economies have also experienced lengthy periods of negative inflation. Disinflationary pressures have been less sustained in the euro area, although during 2003 core inflation fell to less than 2%.

It may thus seem surprising to be mentioning inflation at this point. Many of the factors responsible for the decline in inflation over the past decade remain intact. In particular, intense global competition, especially from low-cost producers in Asia, and rapid technological change, will continue to exert downward pressure on both labour costs and prices. However, above-trend growth in the global economy will this year begin to make some inroads into the excess capacity which has been an additional source of disinflationary pressure in recent years.

At the top end of the supply chain, it is already apparent that the disinflationary pressures have receded. In the US, prices of crude materials, excluding food and energy, rose by more than 20% during 2003, the fastest rate in 15 years. Producer prices for 'core' finished goods increased 0.9% over the year to December after falling by 0.5% over the previous year. Prices of imported goods have also begun rising, reflecting the decline in the US\$ over the past two years.

To date, these 'upstream' price increases have been more than offset at the consumer level by falling labour costs and slowing services sector inflation, and this effect is likely to continue through the first half of this year.

US 'upstream' price inflation has turned



Sources: US Bureau of Labor Statistics; Bureau of Economic Analysis.

By the second half of 2004, however, after more than a year of above-trend growth in demand, 'core' consumer price inflation in the US is likely to be edging upwards, and is expected to average close to the Fed's (implicit) 'comfort zone' of about 2% during 2005.

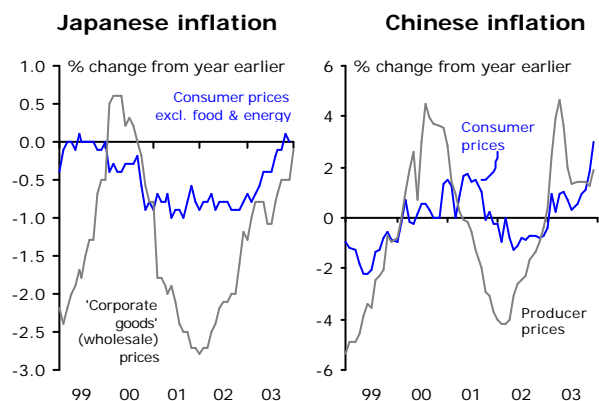
Deflationary pressures are also abating in Asia. In China, consumer prices rose by 3.2% over the year to December, the fastest pace since early-1997, and following declines in 2001 and 2002. The turnaround in consumer price inflation is partly attributable to higher food prices, but other indicators also suggest that prices more generally are no longer falling.

Japan recorded its first positive 'core' inflation rate in October in 4½ years. Again, one-off factors (in this case, a policy-induced increase in medical costs and a rise in tobacco taxes) were partly responsible for this result. However inflation measures which have not been distorted by these factors, such as the 'corporate goods' (wholesale) price index, also suggest that deflationary pressures in Japan are beginning to recede. Production capacity has fallen by more than 10% over the past five years and employers are no longer cutting employee earnings. Consumer prices are likely to continue declining until late in 2005, but (even allowing for the impact of a stronger yen) at a slower rate than in recent years.

The euro zone is the only major economy where inflation is likely to decline during 2004, reflecting the impact of the much greater appreciation of the euro than of other major currencies in the context of a more subdued upturn in economic activity. Falling inflation will allow the ECB to cut rates a final time in June.

Elsewhere, inflation will be rising only gradually from historically low levels. As a result, major central banks will be under far less pressure to adjust monetary policy in the 'pre-emptive' manner of previous cycles.

Asian deflation is easing



Sources: Japan Home Ministry; Bank of Japan; China National Bureau of Statistics.

Risks to sustainable global growth

Although the near-term outlook for the global economy has become more promising over the past few months, doubts remain as to whether the stronger growth now in prospect for 2004 will be sustained. In particular, large external imbalances between the US and its major trading partners could at some point prompt a more destabilizing exchange rate movements than have occurred thus far, with potentially adverse consequences for global economic growth.

The US current account deficit exceeded US\$500bn (5% of GDP) last year, and will likely top \$600bn in 2004. East Asian current account surpluses totalled around \$220bn (just over 3% of East Asia's GDP) in 2003, and are projected to widen to almost \$250bn this year, while Western Europe's combined surplus is forecast to increase from around \$90bn last year to over \$110bn in 2004.

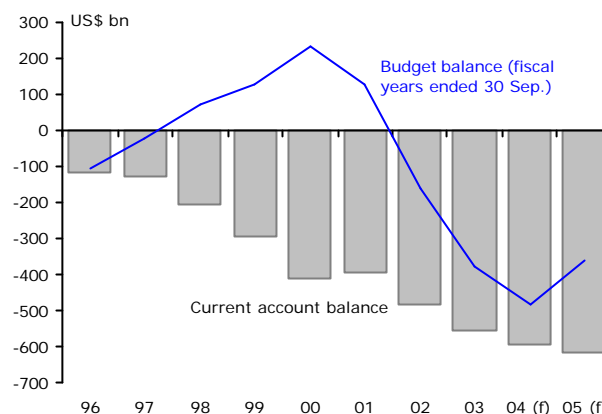
The US Federal budget deficit is expected to widen to \$477bn (4¼%) of GDP in the current US fiscal year, following a \$375bn deficit in the year ended 30 September last. A little over half the deterioration in the budget balance (compared with the continuing surpluses projected as recently as January 2001) is attributable to the Administration's tax cuts and to discretionary increases in spending. Although Congressional Budget Office projections suggest that the deficit will decline significantly after 2005, these incorporate a number of questionable assumptions, including a sharp rise in personal income tax revenues relative to GDP and adherence to very tight caps on discretionary spending.

The US has incurred larger budget deficits (as a share of GDP) in the early 1980s than that projected for the current fiscal year; and the ratio of Federal government debt to GDP was considerably higher in the decades after World War II than the 40% forecast for 2005 and 2006.

During those periods, however, US private sector saving was higher, relative to GDP, than at present; while the US was a net external creditor. The US has never been as dependent on foreign capital inflows to finance its budget deficit as it is at present. While Japan, Germany and France are also incurring large budget deficits (and have higher public debt to GDP ratios than the US) these countries have much higher rates of private sector saving and are running current account surpluses.

Total US net international liabilities stood at nearly 25% of GDP at the end of 2002, and will reach 40% of GDP within the next few years – 'an unprecedented level for a large industrial country', according to a recent IMF study (Muhleisen and Towe, January 2004).

US 'twin deficits'



Sources: Bureau of Economic Analysis; Congressional Budget Office.

As noted here previously, the US has the unique privilege of borrowing from foreigners in its own currency; its large and liquid financial markets and its traditional 'safe haven' status also enable it to attract relatively more capital than other countries with large external deficits have been able to do. The burden of financing the US current account deficit has also been eased by the willingness of Asian central banks to accumulate large volumes of US Treasury securities in order to offset upward pressure on their own currencies.

None of this means, however, that there is no upper limit to the appetite of foreign investors (or central banks) for US assets. Indeed, as the US has become increasingly reliant on borrowing (as opposed to equity inflows) to finance its current account deficit, at interest rates which are lower than in any other major market except Japan, the US\$ has fallen by an average of more than 20% against other major currencies since February 2002.

The US\$ is expected to continue to decline at least through to the middle of this year, bottoming at around \$1.35 against the euro and ¥100 against the yen, when the Fed is likely to begin a gradual process of 'normalizing' short-term interest rates.

To date, the decline in the US dollar has not had any adverse consequences for long-term interest rates or share prices in the US. US domestic financial markets, like the Fed and the Administration, have taken an essentially benign view of the downward trend in the dollar. The risk of a more disorderly fall in the dollar, precipitating sharply higher longer-term rates and lower share prices, in turn inducing a marked slowdown in US private sector spending, is likely to remain small over the next two years. However the next US Administration may be forced to confront some politically unpalatable choices if that risk is not to rise further over the medium term.

US to grow 4½% in 2004, 3¼% in 2005

Growth in the US economy has picked up more strongly than expected since the first half of last year, and most of the major leading indicators point to continued above-trend growth at least into the first half of 2004.

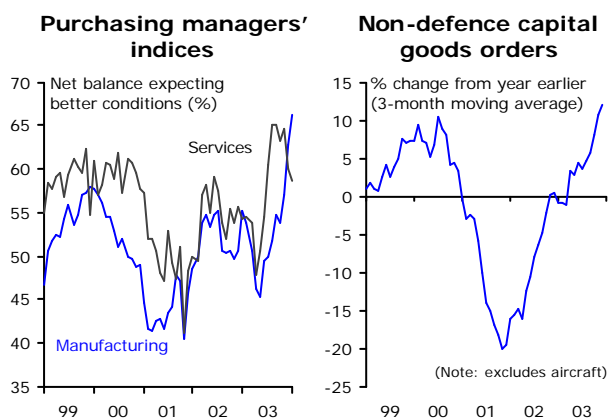
Moreover, the upturn has been surprisingly broadly-based. All the major components of private domestic spending accelerated over the course of 2003, as did exports, while the protracted run-down in inventories appears to have ended in the final quarter of last year.

To a greater extent than in previous cycles, the present upturn is being driven by capital expenditures. The plunge in business investment, by the equivalent of 2½% of GDP at its greatest extent, following the collapse of the 1990s boom was the main reason for the weakness in overall economic growth during 2001-02, and this is now being decisively reversed. Aggressive cost-cutting and balance sheet restructuring has greatly enhanced the leverage of corporate profits to economic activity. After-tax corporate profits have risen by nearly 3 pc points of GDP from their low point in 2001. After an extended period of uncertainty (heightened by the regulatory backlash against the spate of corporate scandals in 2002 and the long build-up to the war in Iraq), capital expenditures on equipment and software are now growing at rates not seen since the late 1990s.

Consumer spending has been less constrained by the weakness of household balance sheets than we had previously expected, in large measure because households have saved a smaller than anticipated proportion of their mid-year tax cuts. Housing activity has also remained surprisingly strong.

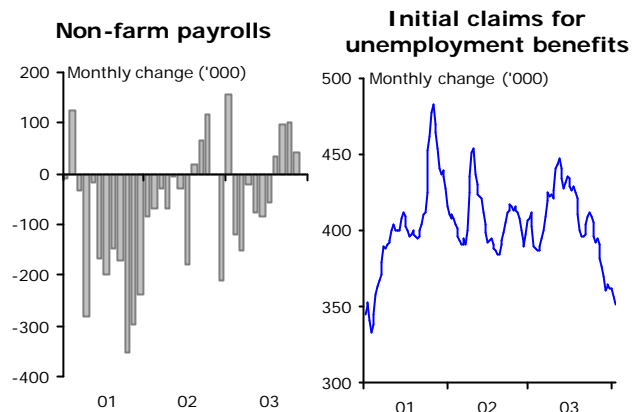
The recovery in employment has by contrast been disappointingly slow.

Encouraging US leading indicators



Sources: Institute of Supply Management; US Commerce Department.

Employment growth should pick up



Sources: US Bureau of Labor Statistics

Non-farm payrolls have risen by an average of just over 50,000 per month since bottoming last July, while the fall in unemployment from 6.3% to 5.7% over the second half of last year has been almost largely due to a decline in workforce participation (though that in turn is concentrated among younger age groups and is not wholly the result of a 'discouraged worker effect').

There are nonetheless good reasons to expect the labour market to improve more convincingly in the first half of this year. The employment components of both the manufacturing and services sector purchasing managers' indices rose above 50 in the closing months of last year, while initial claims for unemployment insurance benefits have fallen to their lowest level since early 2001. Stronger jobs growth, reaching around 200,000 per month, should in turn contribute to sustaining growth in consumer spending at over a 3% annual rate.

By the September quarter, the US economy will have been growing at an above trend pace for over a year, and (as noted earlier in this section), consumer price inflation is likely to have passed its low point. Although the Federal Reserve will be under no pressure to tighten monetary policy in the 'pre-emptive' manner of previous cycles, the imperative to keep real short term interest rates at zero will have greatly diminished. We expect the first move in August, before the commencement of the formal part of the Presidential election campaign.

As interest rates gradually rise during 2005 and the impetus from the current highly expansionary stance of fiscal policy fades (and with the 'base effects' of the unsustainably rapid growth of the second half of 2003 'dropping out'), US GDP growth is expected to ease back to an average of about 3¼% in 2005, from this year's 4½%.

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Euro area joins the global recovery

The euro area joined the global recovery in the third quarter when real GDP rose by 0.4% from Q2. This modest increase, which followed three quarters of flat or negative growth, left GDP just 0.3% above its year-earlier level. Germany grew by 0.2% from the previous quarter, the first increase for a year, and there were stronger recoveries in France and Italy with quarterly rises of 0.4% and 0.5% respectively. Spain was again the fastest-growing economy in the euro area with a quarterly rise of 0.7% and growth over the year of 2.4%.

The recovery in the euro area was mainly due to exports, which rose by 2.0% from the previous quarter despite the adverse impact of the rising euro on export competitiveness. Private consumption remained subdued while fixed investment registered another decline. With GDP growth in the final quarter expected to have been at a similar pace to Q3, the full-year increase in 2003 is likely to have been around 0.4% and the weakest since the contraction in 1993.

A gradual recovery in economic activity is expected to be sustained in 2004. Exports are forecast to rise, with the beneficial impact of global recovery outweighing the detrimental impact of euro appreciation. Business and consumer confidence have improved significantly since mid-2003 with increased spending in these areas expected over coming months. Real GDP growth is forecast to reach around 2% in 2004.

Germany's economic reform package was approved by Parliament in December. Tax cuts planned for January 2004 will now be spread over 2 years, a government concession necessary to secure opposition support for structural reforms. The immediate boost to the economy will be small, but labour and social security reforms are a significant step in reducing rigidities that have hampered economic performance for many years. The government recognises that further reforms are necessary, but it is likely to be some time before it sets out its specific proposals following the drawn-out political battle of recent months.

The EU's Stability and Growth Pact, designed to prevent the budget deficits of individual countries rising above 3% of GDP, was effectively destroyed in November 2003 when Finance Ministers decided to suspend the sanctions mechanism of the Pact. This was threatening Germany and France with financial penalties, in the form of non-interest bearing deposits and eventually fines, for repeatedly running budget deficits above 3% of GDP.

Most economists, and many EU officials, considered the Pact to be seriously flawed in requiring fiscal policy to be tightened in several countries at a time

of weak economic activity, but the majority decision to suspend the sanctions mechanism is strongly opposed by some smaller EU countries and the European Commission which has responsibility for upholding the EU's rules. As well as being appalled by the blatant disregard of the Pact by France and Germany - the latter was its instigator - they are concerned about the adverse impact on the EU's creditworthiness, and about the danger of the decision being used as a precedent that will hamper decision-making and adherence to agreed rules and procedures in other areas. The latter concern is heightened by the increased strain that the EU's forthcoming expansion from 15 to 25 countries in May will place on its internal workings. The European Commission has launched a lawsuit challenging the November decision.

The biggest threat to economic recovery is the strength of the euro, which is adversely affecting export prospects. The euro reached a record high of almost US\$1.29 against the declining US dollar on 9 January 2004, 44% above its end-2001 level. The ECB has expressed concern about the euro's rapid rise, but its appreciation against the US dollar seems set to continue over coming months. It seems unlikely that the US will actively try to stem the dollar's decline, or that Asian countries will pay much heed to calls by European politicians for greater flexibility of their own currencies, so that a small group of currencies, of which the euro is the most prominent, do not have to continue to bear the brunt of the US dollar's decline.

The ECB may resort to sporadic intervention on fx markets to demonstrate its growing concern about the euro's rise, but ANZ expects the euro to rise to around US\$1.35 by mid-2004. While the ECB is at present unwilling to cut its interest rates, a further significant rise in the euro is likely to trigger a reduction in mid-year. On the assumption that the ECB remains unwilling to cut interest rates over the next few months then a cut of 50bps in the main refinancing rate to 1.50% would probably be needed to have an impact on the exchange rate. Such a move would also bolster the fragile recovery and inflation is unlikely to be an obstacle as it is expected to fall below the ECB's 2% ceiling soon.

The UK economy is expected to grow by around 3% in 2004, assisted by fiscal stimulus and with exports benefiting from international recovery and sterling's decline against the euro. Although the pound has risen sharply against the US dollar since early-2002, the US market accounts for only about 16% of UK exports and is much less important than the euro area with a share of around 52%. Positive economic news is reinforcing expectations of a further interest rate rise in the short term.

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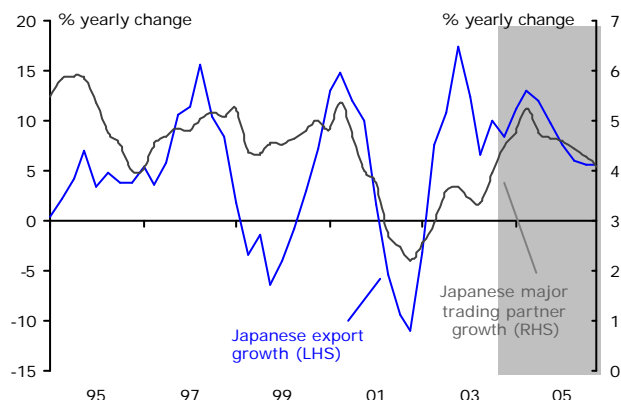
Japanese cyclical upturn continues

The Japanese economy grew at a solid 1.4% annualised rate in the September quarter and looks to have maintained this pace over the December quarter. As has been the case throughout the year, private, not public spending, is driving growth. Export sales are leading the upturn, driven by the rapidly growing Chinese market and increased global demand for Japan's high-technology goods. Private business investment is also strong, growing at around the fastest pace since 2000. In contrast, government consumption growth has slowed to the lowest rate in five years and public investment has declined in each of the last six quarters.

Ongoing growth in private spending is the key to transforming Japan's current cyclical upturn into a broadly-based sustainable recovery. The latest indicators on this front are positive. In the short-term, exports are likely to remain the engine of growth. While the higher yen has caused some downgrade to the outlook, Japanese exports are nevertheless expected to grow solidly this year, supported by the expected upturn in demand amongst Japan's major trading partners, particularly the United States. The impact of stronger global demand has shown up in the most recent figures, which show that merchandise export sales increased 1.6% in December, despite a 3-year high in the yen.

Japan can withstand a higher yen

Stronger global demand will support export growth



Source: Bank of Japan, Datastream, Economics@ANZ

The ability of Japan to withstand the higher yen is also supported by Bank of Japan (BoJ) research, which concludes that the Japanese economy has become significantly less vulnerable to fluctuations in the yen. This reflects increased movement of production offshore as well as more widespread hedging against exchange rate risk. As a result, the BoJ now estimates that a sustained 10% rise in the yen will strip 0.2% off growth in the first year, rising to a 0.6% subtraction in the second year. This compares with the BoJ's 2001 estimates of subtractions of 0.2% and 1% from growth.

Furthermore, even if the US\$/¥ rate increased to ANZ's forecast of 100, in *real* terms, the currency will still be well below previous peaks.

Over 2004 Japanese economic growth should become more broadly-based. Export growth should fuel higher industrial production and aid a further gradual recovery in business investment. Certainly, the mood looks right with business confidence higher amongst both small and large firms. Ongoing recovery in corporate profitability is paramount to sustaining this investment recovery, however, such that continued structural reform and corporate balance sheet clean up remain crucial. While the labour market data out of Japan remains mixed, the unemployment rate does appear to have peaked. Higher exports and capital spending should eventually flow through to greater job creation, supporting a gradual upturn in household consumption, which so far remains subdued.

The rate of deflation has also softened to be close to 0% in recent months. In October, Japan's core inflation rate actually increased, the first rise since 1999, although this mostly reflected a rise in government taxes on tobacco and medical costs. The still large amounts of spare capacity in the Japanese economy means that inflation is some time away. However, as the recovery continues, deflationary pressures should also continue to ease, even allowing for a further rise in the yen.

Another key to sustaining the current cyclical upturn will be getting the policy decisions right. The BoJ has signalled its intentions to continue its quantitative easing policy to keep monetary policy highly expansionary with the central bank raising its liquidity target by ¥3tn in January, despite improving signs out of the real economy. Authorities are also trying to insulate the economy from 'excessive volatility' in the yen. A record ¥20tn was spent on foreign currency intervention in 2003 and the Government has since increased by a third the cap for market intervention funds to ¥100tn. Fiscal policy, in contrast, may become contractionary. The Government's commitment to achieving budget balance by 2013 is unlikely to be reached without higher taxes, with the first round of ¥500bn set to hit individuals in fiscal year 2004.

The Japanese economy does continue to face considerable hurdles, including the higher yen, fragile banking and corporate sectors and the poorer performance of smaller, domestic-oriented firms relative to larger, export-oriented firms. However these hurdles should not be insurmountable, especially in the short-run. The outlook for Japan looks brighter than for many years with GDP growth of 2½% expected in 2004, softening to 2% in 2005.

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Asian outlook

Growth momentum building across Asia

The past year has seen patchy economic growth, with a number of countries badly affected in the first half of 2003 by SARS and continued weakness in export demand, particularly for electronics goods. However, by the second half, a significant strengthening in growth was evident, and providing the global economy performs as expected, the region should perform more strongly in 2004. In particular, South Korea, Taiwan, Hong Kong, Singapore and Malaysia are expected to turn in much stronger growth this year. In contrast, China, which provided the growth backbone in 2003 but which is facing supply bottlenecks and rising inflation, is taking steps to cool domestic demand, and should see moderately slower growth this year.

Economic growth in Asia

% ch.	2003 (e)	2004 (f)	2005 (f)
China	9.1	8½	7½
Hong Kong	2.5	4	3
Indonesia	4.0	4½	4¾
Malaysia	5.0	6¼	6
Philippines	4.5	4	4
Singapore	0.8	5¾	4¾
South Korea	2.9	6	5½
Taiwan	2.8	4¾	3
Thailand	6.3	7	6
Vietnam	7.2	7½	7
East Asia*	7.3	7.5	6.6
(ex China)	3.9	5.4	4.9

* weighted GDP at PPP exchange rates

Democracy on show in Asia

The practice and institutions of democracy vary enormously across the east Asian region. In some countries the institutions are well established, in some they are still evolving, in others virtually non-existent. In some countries there is vigorous popular participation, both through the ballot box and in the streets, while in others the processes are orchestrated by dominant political parties. This year will see an unusual coincidence of elections in a number of countries, and there could be some changes in leadership.

- In Indonesia, elections for the legislature will be held on 5 April and the first round of the country's first-ever direct presidential election is scheduled for 5 July with a run-off, if necessary, in September. The period ahead of the presidential election is likely to be characterised by political manoeuvring and strategic alliance-building, as the country treads new ground in selecting its leader.

- There was a smooth leadership handover in Malaysia at end-October 2003 when Abdullah Ahmad Badawi succeeded Dr Mahathir Mohamad as prime minister. He is expected to seek to consolidate his political authority by calling a general election within a few months.
- Hong Kong is due to hold Legislative Council elections in September, which could provide a further test for the chief executive, Tung Chee-Hwa, after his support group, the Democratic Alliance for Betterment of Hong Kong, lost ground at council elections last November.
- The Philippines will hold elections in May for the presidency, the House of Representatives and half the Senate. The president is elected for a single six-year term, but as the incumbent, President Gloria Arroyo, was elected Vice-President in 1998 and took over mid-term, she is eligible to run this year. Four other candidates will be contesting the presidency.
- In South Korea, parliamentary elections are due in April 2004. Whatever the outcome, there is likely to be a difficult working relationship with President Roh, whose term in office is due to end in February 2008, and whose leadership has been undermined by a series of political scandals and diminished support base.
- Of all the elections to be held, most tension will surround Taiwan's presidential election to be held on 10 March, and the referendum on the same day. The issue of independence for Taiwan is seen as a vote-winner, but China has indicated disapproval of any discussion on the matter. As the campaign proceeds, there is a risk that antagonism across the straits could intensify.

China starts to apply the brakes

China's economy expanded by 9.9% in the final quarter of 2003 with full-year growth reaching 9.1%, the strongest since 1996. Strong demand is exposing supply constraints in sectors such as power, transport, coal and grains. In recent years, demand has been boosted by public spending and foreign investment. In 2003, these drivers were supplemented by a rapid expansion of domestic credit. The authorities initial response, in July, was to tighten the rules on lending for apartments, which were escalating in price. More recently, in September, the bank reserve requirement was raised from 6% to 7% to restrict credit generally. Extra-budgetary public spending, which has been used in the past four years to boost demand, is likely to be scaled down in 2004.

Inflation has risen to reach 3.2% in December, but the CPI in China is not a good gauge of overheating. With the prices of many goods and services fixed by the state, excess demand may be reflected in shortages rather than rising prices. Manufacturers with excess capacity and facing rising input costs may be unable to raise their product prices, and forced to take the impact on their profits.

A strong rise in imports is both a symptom of, and a safety valve for, overheating. China's imports rose 40% in 2003, while exports grew 35%. Imports from the rest of Asia were particularly strong, providing a boost to the region.

Despite strong economic growth and its large trade surplus with the US, the authorities will continue to resist pressures for a revaluation of the renminbi. However, the prospect of a currency regime change, such as broader trading bands or pegging to a currency basket, is growing.

Rebound in Hong Kong – but deflation persists

The economy has rebounded strongly after the severe SARS-induced dip in April and May, and growth for the full year is expected to have been around 2½%. Business and consumer sentiment have been boosted by the free trade agreement with China, effective from January 2004, and the sharp rise in share prices (which rose 50% between the low in April 2003 and end-December), and significantly stronger growth is expected this year. The unemployment rate reached 8.7% over the three months to July - the highest level in 30 years. It has subsequently eased to 7.3%, measured over the three months to December.

The collapse in demand during the SARS epidemic triggered aggressive discounting and pushed the CPI down sharply in May, June and July. There has been a minor recovery in prices since then, in line with a rebound in retail sales volume which was up 5.2% over the year to November. Nevertheless, annual inflation is still negative at -1.9% over the 12 months to December.

Brighter prospects for Singapore

Advance estimates indicate that the Singapore economy expanded by a slower-than-expected 3.7% over the year to Q4 2003. This brought growth for 2003 to 0.8%, the slowest among the East Asian economies. Nevertheless, economic activity in the second half of 2003 recovered strongly after the steep SARS-induced decline and sluggish external demand in the first half.

Brighter global economic prospects are expected to lift the manufacturing and services sectors in 2004.

After three years of weak economic growth, real GDP is forecast to rebound to around 5¾% in 2004. Average annual inflation is likely to edge up in 2004 to around 1% from an estimated 0.5% in 2003, partly reflecting a one-percentage point increase in the GST to 5% from 1 January.

Singapore was able to draw a respectable level of investment in 2003 despite a lacklustre global economic environment with S\$7.5bn worth of net investment commitments in manufacturing (the bulk of which constitutes foreign commitments), just S\$500mn short of the 2003 target. This underscores the country's pro-business climate, well-established infrastructure, domestic political stability and benefits related to a series of bilateral free trade agreements, with the latest to come into force being the US-Singapore free trade agreement on 1 January. The challenge remains to maintain a conducive and competitive business environment to sustain these levels of investment, which underpin manufacturing activity, in the face of intense competition from China and Malaysia.

Taiwan's recovery driven by exports ...

After slumping in the SARS-affected second quarter, the economy is recovering and is expected to have grown by around 2.8% in 2003. Among partial indicators, the composite leading indicator has turned decisively upwards, but is still well below previous peaks. Exports rose 9.5% in 2003, but this statistic obscures the way exports have built momentum through the year, and were running at an annual growth rate of 21% by December. A high level of export orders bodes well for sustained growth next year. Despite the improving economy, unemployment remains stubbornly high. The latest reading (November) was 4.7%, down from a peak level of 5.35% seen in August 2002. Annual inflation continues to hover around or below zero.

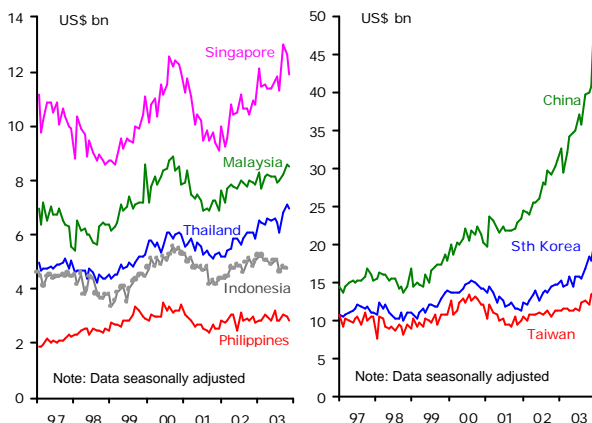
Perhaps with an eye to the upcoming elections, the government has announced plans for 10 major infrastructure projects costing some US\$14bn. The programme is unlikely to give an early boost to the economy, as funding will need to be approved by the opposition-dominated legislature.

... and so is South Korea's

The Korean economy is estimated to have grown at a faster pace of 3.6% over the year to Q4 2003, bringing growth for 2003 to 2.9%. Growth is expected to rise to around 6% in 2004, underpinned by external demand. With exports to China growing at a rapid pace (average annual growth of 50% in the second half of 2003), China has overtaken the US to become South Korea's largest export market. Domestic demand, which has put a drag on the economy, is likely to recover only gradually as high

levels of household debt discourage growth in private consumption. While investment is expected to respond to improved export demand, labour unrest and political uncertainty are likely to be mitigating factors. Interest rates are expected to remain steady in the first half of the year to support the domestic recovery. The key overnight call rate was left unchanged at 3.75% at the central bank's January meeting.

Exports driving recovery in East Asia



Sources: National statistical agencies; Datastream.

Fears of economic overheating in Thailand

Full-year growth is expected to have been around 6.3% in 2003, up from 5.4% in 2002 and the strongest annual increase since 1995. The strong performance of exports provided a basis for the improvement in 2003, but a 1.6% quarter-on-quarter GDP rise in the third quarter was mainly due to a surge in inventories.

Prime Minister Thaksin expects even faster economic growth over coming years and projects that real GDP will rise by 8% and 10% respectively in 2004 and 2005. With the stock market rising by 117% in 2003 and significantly out-performing other Asian markets, and real estate prices also rising strongly, such ambitious forecasts are exacerbating fears of economic overheating and the development of speculative bubbles in financial markets. The Bank of Thailand's benchmark 14-day repo rate has been held at a record low of 1.25% since the last reduction in June 2003.

Global economic recovery and continued strong growth in China are positive for Thai exports in 2004. The authorities are, however, becoming increasingly concerned about the impact of the strong currency (up by almost 9% against the depreciating US dollar in 2003 and at a 3½-year high in January 2004) on export competitiveness. With the baht's recent rise against the US dollar exceeding that of most other Asian currencies, the central bank has placed limits on short-term

deposits from non-residents at commercial banks and has also intervened on the foreign exchange market to curb its rise.

New economic objectives in Malaysia

One of main priorities of the new prime minister, Abdullah Badawi, is to shift from 'crony capitalism' to a business environment that is transparent, accountable and based on an open-tendering system, a move that would strengthen Malaysia's attractions to foreign investors. He has also expressed scepticism about large infrastructure projects; an ambitious railway construction project has been postponed and the government is considering scaling-back the large Bakun Dam hydroelectric project.

Real GDP growth is now expected to have been around 5% in 2003 following a strong performance in the third quarter. Malaysia has an open economy and economic growth prospects are being bolstered by stronger-than-expected growth in its major export markets, and by the boost to export competitiveness provided by the depreciation of the ringgit which is pegged to the US dollar. Real GDP growth is expected to rise to around 6¼% in 2004.

The government intends to retain the fixed ringgit peg to the US dollar for the time being. However, the fixed peg restricts the flexibility of economic policy, and the prospect that Malaysia will adopt a managed float by, say, end-2005 now seems quite high. The probability of any change to the exchange rate regime will increase if the recent rapid depreciation of the US dollar continues or if China adopts a more flexible exchange rate policy.

The improved outlook for economic growth should allow Malaysia to significantly reduce its budget deficit and there are good prospects that a balanced federal budget will be achieved ahead of the government's 2006 target.

A bigger current account deficit in Vietnam

Real GDP rose by 7.2% in 2003 according to official figures, marginally above annual growth of 6.8-7.0% during 2000-2002 despite the adverse impact of SARS in the second quarter. Industry and construction, which account for about 40% of total GDP, grew by 10.3% in 2003, while agriculture and services grew by 3.2% and 6.6% respectively.

Strong economic growth is fuelling demand for imports, which rose by almost 27% in US dollar terms in 2003. This exceeded export growth of 19% and the visible trade deficit widened to US\$5.1bn from US\$2.8bn in 2002. It is estimated that the current account deficit rose from less than 2% of GDP in 2002 to over 5% in 2003.

Vietnam's economic achievements over recent years include a significant reduction in poverty and much greater engagement with the world economy. However, while real GDP growth is expected to be sustained around 7-7½% per annum over the next year or two, concerns are mounting that growth could slow unless economic reform is speeded up. The IMF has reiterated that commercially-based decision-making in the state-owned enterprise and banking sectors is a key requirement to sustain solid growth. Regulatory and transparency issues also continue to impede economic modernisation. Faster reform is also needed to secure WTO membership by 2005, which would be particularly beneficial to the textiles sector and would significantly boost Vietnam's appeal to foreign investors.

Philippines - sluggish exports contribute to underperformance

After recovering sharply in late-2001, exports from the Philippines have been sluggish for almost two years. In the first eleven months of 2003, exports were up by just 2% on the corresponding period of 2002, while most other countries in the region enjoyed a significantly stronger pickup. Reports suggest that Philippines is losing ground to China in global electronics markets.

The mediocre trade performance, combined with a poor image as an investment destination (reflecting concerns over security, governance, corruption, inefficiency etc) have weighed on the peso. In the past two years the peso has continued to drift against a weakening US dollar, in contrast to other regional currencies (excluding those that are pegged), which have been trending upwards. With exports and government spending playing a minor role, the main growth driver in 2003 was private consumption. Full year growth is estimated to have been 4½%, and a similar performance is expected for 2004.

Policy continuity essential in Indonesia

While political uncertainty ahead of the elections is bound to affect business and consumer sentiment, our main case scenario assumes that the election outcomes will not produce a significant shift in macroeconomic policy. Indonesia's political and economic profile has improved in recent years and policy continuity is necessary to maintain it. The expiry of Indonesia's loan arrangement with the IMF in December 2003 makes it essential for the government to deliver on reform commitments in order to lift investor confidence.

Interest rates and inflation have been successfully brought down over the course of 2003 and bode well for economic activity. The benchmark 1-month SBI rate was under 8% in late January from 12.9%

a year ago. Inflation was 5.1% over the year to December 2003, the lowest since July 2000. However, the scope for a further decline in inflation is limited in 2004 given the likelihood of exchange rate weakness amid political uncertainty in this election year. Real GDP is forecast to grow at a slightly higher pace of 4½% in 2004 after an estimated 4% in 2003 as external demand gains momentum. However, relatively weak long-term investment flows continue to impede prospects.

Risks to the outlook

Apart from country-specific risks, there are some factors which could have a broad regional impact. The SARS outbreak last year was an example of something completely unexpected which had a dramatic economic impact. Fortunately, the recent cases of SARS have been quickly identified and contained, but the risk of another serious outbreak cannot be ignored. A more immediate threat is the outbreak of avian flu virus, which is spreading rapidly and by late-January had been detected in birds in ten Asian countries with humans affected in Vietnam and Thailand. There is no evidence, as yet, that the disease is spreading from person-to-person and the World Health Organization has not recommended travel restrictions to the affected countries. Large numbers of chicken have been slaughtered and many countries have banned poultry imports from affected countries.

Another risk arises from the export-driven nature of the recovery in most countries. Unusually, the major export markets of the US and Japan are expanding at the same time, and within the region, China has become a major impetus for its neighbours. China is expected to lose some momentum this year, and if either the US or Japan falters, then the favourable forecasts for East Asia would need downward revision.

The global economy has benefited from low interest rates for some years. Now, bond yields have begun to rise, and the impact will be greater on countries such as Indonesia and Philippines which have significant external and domestic public debt. While the rise in yields is not expected to be dramatic, it could be exacerbated by an increase in emerging market spreads.

Another dampener - at least for the resource-poor countries - could come from commodity prices, especially oil. Against expectations, oil prices have remained high since the end of the war in Iraq, and prices of coal and base metals have risen strongly. This is placing pressure on profits and could contribute to monetary tightening.

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Australian outlook

Activity likely to peak mid-year

The Australian economy appears to have rebounded smartly from its mid-year slump, with GDP rising by 1.2% in the September quarter, the strongest quarterly performance in nearly two years. Once again though, the divergence between the external and domestic sectors of the economy was stark. Gross national expenditure (which is the sum of spending by business, households and government) continued to bubble along at a 6½% annual pace in the third quarter, led by particularly strong growth in consumer spending. At the same time the subtraction from growth from net exports¹ extended to nine quarters, the longest such stretch since the data was first collected in the late 1950s.

Net exports subtracted ½ of a percentage point from GDP growth in the September quarter, bringing the cumulative subtraction from growth up to 3.6 percentage points over the last year alone. Both sides of the equation are responsible for this abysmal performance. On the exports side the recovery in volumes to date has been unusually modest, given the rebound in the global economy but in part that reflects the lingering impact of the drought and the sluggishness of tourism. On the imports side the strength of the domestic economy, not to mention its nature (with business investment relatively import intensive) has supported growth in imports, while the rising Australian dollar has made imported items cheaper, thus stimulating demand.

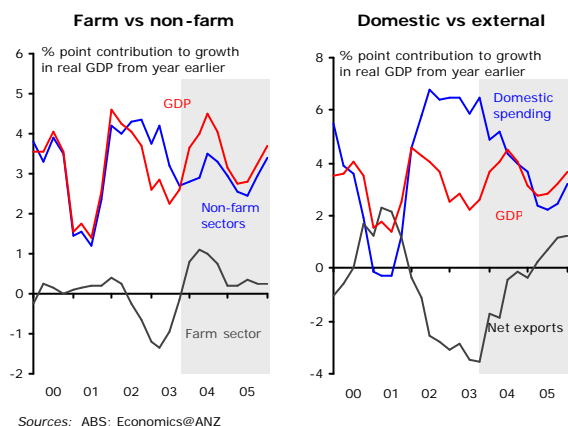
Partial data that has been filtering in for the fourth quarter points to another strong GDP result. In particular retail spending remained firm in late 2003, with households seemingly shrugging off higher interest rates. This in part reflects the strength of the labour market, with the number of people in work rising by 185,000 in the five months to December, pushing the unemployment rate down to a 14 year low of 5.6%. Indeed, the robust labour market likely underpinned the January result for consumer confidence, which shot to a nine year high.

In another plus for December quarter growth, export volumes appear to have strengthened in the late stages of 2003, reflecting both the positive impact of the Rugby World Cup along with a pick-up in demand for some non-rural goods. The huge amount of construction work in progress suggests another big quarter for the industry in the December quarter, while business surveys also revealed generally strong confidence and activity levels.

The domestic economy has started 2004 with some momentum behind it. GDP growth is not expected to peak until mid-year, at around 4½% in year-on-year terms. Nevertheless, the outlook for exports has been shaved down for the first half of the year, due the sharp appreciation of the Australian dollar over 2003. Overall, Australian economic growth is expected to strengthen to 3¾% in 2003-04 (previously 3½%), although the outlook for 2004-05 has dimmed, with growth of 3¼% predicted (previously 3¾%).

Domestic demand is expected to slow in 2004-05, as higher interest rates start to take effect, and will be only partly offset by a stronger net export contribution. Inflation in the near-term is expected to be slightly weaker than previously forecast, reflecting the rising Australian dollar. This outlook is based on our expectation for a further 25 basis point rise in interest rates in the March quarter and a further appreciation of the Australian dollar to a peak of US0.82¢ by mid-year (see the Financial Markets article on page 19 for more details).

Further strength likely in GDP growth



Consumer spending to fade over 2004

Consumer spending has been noticeably resilient and it is not surprising really, given that the fundamentals have rarely been as positive. Real private consumption rose by 1.7% in the September quarter, the strongest quarterly result in 4½ years. Households have benefited from rising wealth, largely as a result of higher house prices, strong demand for labour, with the employment to population ratio rising to near historical high and falls in prices for major durable items, such as motor vehicles and imported electrical equipment. To cap it all off interest rates also remained at relatively low levels for much of 2003.

¹ Export volumes minus import volumes

It is unlikely that these fundamentals will remain quite as supportive for household spending growth in 2004, although our central case is only for a relatively modest slowdown in consumer spending in 2004-05. While the impact of household wealth on spending is difficult to quantify, it is highly unlikely that households will continue to benefit from rapidly rising house prices to the extent that they have in recent years. Nevertheless, as long as house price falls are averted, the gains in wealth to date should provide some support for spending over the longer-term. Moreover, a moderation in employment growth is also expected over the course of 2004 and a mild upturn in the unemployment rate is predicted. Household incomes should still benefit this year from some improvement in real wages growth coupled with increased purchasing power as a result of the appreciating exchange rate. Consumer spending could also get a kick along from a pre-election tax cut in the second half of this year, although it is unlikely to be large enough to have much of an impact in isolation.

The wild card in this game however, is and will continue to be, the debt servicing obligations of households. The debt to income ratio for the persona² sector rose to a record 138% of income in the September quarter while interest payments rose to 8.7% of income, even before the latest 50 basis points increase in interest rates, reflecting record mortgage interest repayments. There is little compelling evidence of stress in the household sector in aggregate to date from a rising debt servicing burden. To be sure, household savings rates have continued to sink and the accumulation of financial assets has moderated in recent years, but there is scant evidence that households are defaulting on debt or cutting back on purchases due to a higher debt servicing burden. Indeed it is in the more discretionary areas of household spending that sales growth has been the strongest.

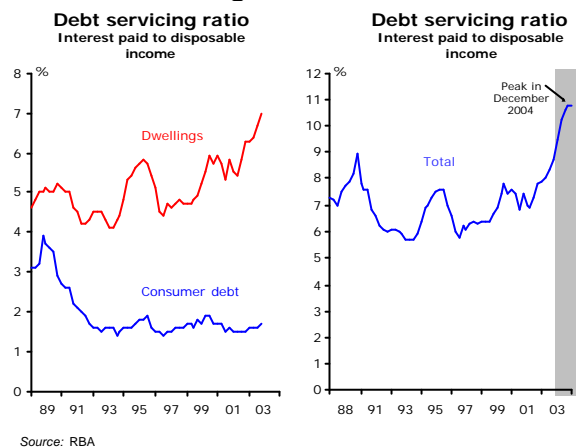
Nevertheless, the household sector is likely to be under further pressure in the period ahead. Based on our expectation for a further 25 basis point increase in interest rates this year, the debt servicing ratio for households will rise from 8.7% at present to peak close to 11% by the end of 2004, the bulk of which will be mortgage interest payments. Given this figure is the aggregate for the household sector, some of which have no debt, it does mask a much higher debt servicing burden for households with debt. Around 30% of households currently have a mortgage, suggesting that mortgage interest payments are on average around 21% of income for those households with debt. Some households will have a much higher debt burden than this figure though, particularly younger households and those in lower income groups (with

² excludes unincorporated enterprises

the two categories clearly related, given that young people tend to have a large mortgage when a home is first purchased). The Melbourne Institute Household Saving Report suggests that 4.5% of Australian households used more than 50% of their income to service debt in the December quarter 2003, with around 40% of these classified as lower income households³.

Given that lower income groups have a tendency to spend a greater proportion of their income, the concentration of debt in the groups suggested by the survey does have implications for household spending over 2004. Nevertheless, the relatively small proportion of households facing a high debt servicing burden along with the generally healthy balance sheets of middle and higher income earners (with the latter also benefiting from higher share prices) should act as a stabilising force. We expect that real private consumption growth likely peaked in the December quarter 2003 and will average 4¾% in 2003-04 before slowing to around 3¼% in 2004-05.

Debt servicing burden to rise further



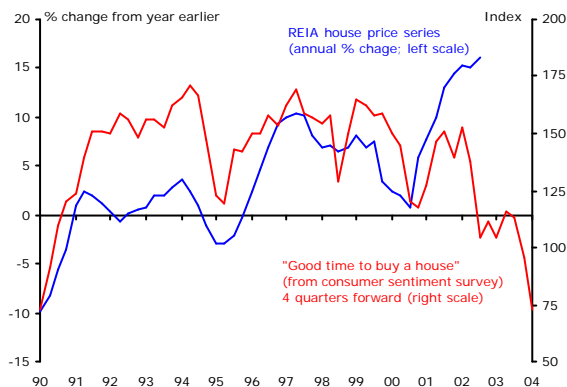
Residential property market slowing

All indicators are currently pointing to a moderation in the residential property market over 2004-05. The high level of building approvals and amount of work in the pipeline suggests that construction activity will remain firm until mid-year, after which higher interest rates are expected to lead to a modest downturn in activity. Certainly it appears that the rise in interest rates to date has been effective in dampening sentiment, with falls in both investor/builder and owner occupier housing finance approvals evident in late 2003. There are also signs that residential property prices are slowing and lower auction clearance rates suggests that this adjustment is likely to continue. Indeed the downturn in sentiment as measured by 'whether it is

³ Defined by the Melbourne Institute as households with incomes less than \$40,000 per year

a good time to buy a house' in the Melbourne Institute consumer sentiment survey, does appear to have a good relationship with property prices (see chart below) and is another piece of evidence portending a slowdown in property prices.

Sentiment could point to slower house prices



Sources: REIA; Westpac/Melbourne Institute

Whether a sharp slowdown in the property market can be averted depends largely on the future path of interest rates. Our expectation is for only one more rise in interest rates, which is likely to lead to only a modest downturn in construction activity, albeit with some divergence between the States. The ongoing deterioration in housing affordability will also add to downwards pressure on prices, although widespread house price falls are not expected. However it is not difficult to imagine a more severe downturn if interest rates (or expectations) rose significantly higher. It is a fine balance though, for if interest rates remain too low for too long then there is the chance of more supply coming on stream than can be absorbed by the market. This would pose downside risks over the medium-term. Nevertheless, with encouraging signs that more sober sentiment is permeating through the property market, there is a good chance for a soft landing.

Robust domestic economy buoys business

While things couldn't really get much better for households, the same can also be said for much of Australia's business sector. Those industries focussed on the domestic economy have been the best performers this year, particularly those directly exposed to the household sector, while externally-oriented industries have continued to do it tough. Although demand conditions have varied for firms, depending on their orientation, costs have remained generally benign. For those firms relying on imported inputs, the rising Australian dollar has delivered considerable benefits to the bottom line. Moreover, businesses have gained from modest growth in wages; albeit in tandem with a cyclical slowing in productivity, meaning that unit labour

costs have remained broadly static. Together, strong demand and moderate costs have delivered solid growth in business profitability and along with rising capacity utilisation and low interest rates have spurred new capital expenditure.

Private capital expenditure rose by 2% in the September quarter, to be 11% higher over the year and has been strong across the board. There is still a massive amount of construction work in the pipeline, amounting to around \$15bn, suggesting that business investment will continue to be a valuable underpin for activity over the course of this year. Also adding to this generally positive picture is the expectation of further growth in plant and equipment investment. With surveyed measures of capacity utilisation currently at fourteen year highs, business balance sheets generally healthy and the stronger dollar lowering the price of imported equipment, the likelihood is for further increases in plant and equipment investment in the near term.

However, the outlook for 2004-05 is not quite as robust. Business profitability is likely to come under pressure in the second half of 2004 as consumer spending slows and unit labour costs tick-up. Moreover, external financing conditions are unlikely to remain as favourable as they are at present. While the stronger dollar may favour imported machinery and equipment in the near term, it could also hinder the development of resource projects if sustained, while higher construction costs could also be seen as a negative. Certainly, there seems to be an absence of major projects on the drawing board, with the Access Economics Investment Monitor reporting just 96 new projects recorded in the December quarter, the lowest level in three years.

Exporters still struggling

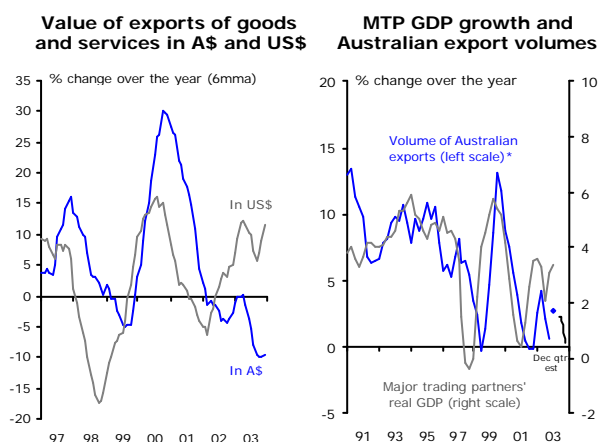
The much heralded recovery in exports failed to materialise in the first three quarters of 2003, with the value of goods and services exports sinking back to early 2000 levels. While export volumes have been affected by the drought and a cautious recovery in global tourism, the stronger A\$ has also more than eroded gains in US\$ prices for many of Australia's exports, not to mention competitiveness. We are cautiously optimistic about the outlook for exports, although the stronger Australian dollar and the outbreak of avian flu are key risks.

Services exports seem best placed to outperform in the near term, given the surge in visitor arrivals in late 2003 to the highest level since June 2001. Furthermore, the A\$ has appreciated relatively modestly against the NZ dollar and the UK pound, with these two countries accounting for 30% of total tourist arrivals. A significant rebound in rural exports should also become apparent in the March quarter, as the near record grain harvest is

exported, while recent rain points to an improvement in rural production from Eastern Australia later this year. Furthermore, a number of large resource projects have been completed or are due for completion shortly and non-rural commodity production should increase accordingly. Finally, some of Australia's manufactured exports, particularly elaborately transformed manufacturers, are more dependent on income growth and have established niche markets. This could suggest some resilience to the stronger A\$, particularly as the global economy gains further momentum.

While prospects for gains in export volumes are reasonable, the rising A\$ is likely to continue to impact on prices and thus exporter incomes. Commodity prices have risen strongly in US\$ terms and there is the expectation for further increases over the course of 2004. In particular some non-rural commodity producers are arguing for higher US\$ prices in contract negotiations currently underway, given not just the strength of demand for some commodities but also the negative income effects from the stronger A\$. Moreover, prices of some rural commodities should also rise as a result of sectoral specific shocks, such as BSE and dry conditions in several countries. However with the US\$ still expected to have further to fall, Australia's commodity producers will continue to see their A\$ incomes dampened for some time. Manufactured goods exporters will also continue to struggle with the higher dollar, with further cuts in prices and volumes expected. The higher dollar is expected to see the value of exports drop by around 7% in 2003-04, although volumes should rise modestly. In 2004-05, both volumes and values should strengthen.

Australian export volumes should improve



Source: ABS *excluding rural and abnormals

Domestic inflation pressure building

One of the repercussions of a domestic economy that is encountering capacity constraints is rising inflationary pressure. This is most apparent in the

construction industry where the sheer volume of work underway is stretching resources and has underpinned a general rise in domestic producer prices. The December quarter CPI also revealed the extent to which these domestic inflationary pressures are affecting consumer prices, with non-tradeables prices rising at a 4.4% annual rate, the fastest inflation rate in over a decade. The impact of this acceleration on headline inflation to date has been more than offset by the higher A\$, which has dampened the price of tradeables (items whose prices are determined on the world market), leaving the CPI 0.5% higher in the December quarter and 2.4% higher over the year.

We expect that headline inflation will moderate further over the course of 2004 and indeed could remain below the 2-3% target band for much of this year. In 2005 though, as the effects of the appreciating A\$ start to wane, inflation is likely to accelerate, to above the target band in the second half of 2005. Rising labour costs due to the relatively tight labour market are expected to exert some upwards pressure on prices, although it is unlikely to become a major issue, given the expectation for a moderation in employment growth. While 'white collar' industries are likely to see the strongest demand for labour over 2004 and 2005, employment growth in 'blue collar' industries (which tend to be quite labour intensive) is expected to moderate, after a couple of strong years.

Tightening cycle close to an end

Perhaps more than usual, the Reserve Bank of Australia faces a difficult balancing act. It appears that domestic price pressures are accelerating, although in the short-term, the stronger A\$ will see a below target inflation rate for several quarters in 2004. In addition, there are mixed signals on the economy. While parts of the domestic economy are still travelling solidly, there are signs of a cooling in the property market and exporters incomes are being hit by the high A\$. We believe that the balance of risks to growth and inflation are tilted to the upside. That is, there is still a slightly greater chance for further outperformance of the Australian economy (including through a stronger global economy) and accelerating inflationary pressure than for a slowdown in activity, particularly in the property market. As such, we expect one further 25bps increase in interest rates in coming months, to a peak of 5.5%. Thereafter, the RBA is expected to remain on hold, with a 5.5% cash rate likely to be judged appropriate for the relatively mature stage of Australia's economic cycle (see Financial Markets article on page 19 for more details).

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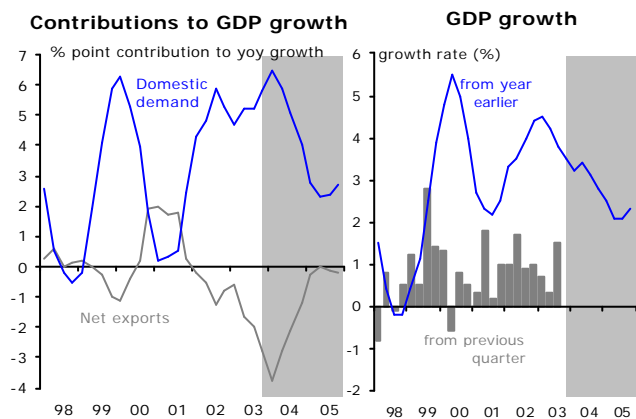
New Zealand outlook

Sectoral tug of war

The domestic and external sectors of the New Zealand economy continue to pull in opposite directions. Driven primarily by strong consumer spending and residential investment, GDP recorded a 1.5% bounceback in the September quarter after a June quarter beset by SARS and electricity problems. But due largely to ongoing weakness in net exports, growth slowed from the peak of 4.5% earlier in 2003 to 3.8% in the September year.

Ongoing strength in the domestic economy creates some upside risks to growth during the first half of 2004. Nevertheless, weaker export incomes, higher interest rates and slowing population growth are expected to increasingly undermine domestic growth during the second half of year and into 2005. As a consequence, growth is expected to slow to around 2½% during 2004-05. Indeed, further strong gains in the NZ\$ in early 2004 have reinforced the downside risks for the NZ economy over this period.

Growth to slow further in 2004/05



Sources: Statistics NZ; Economics@ANZ

Domestic economy continues to fire

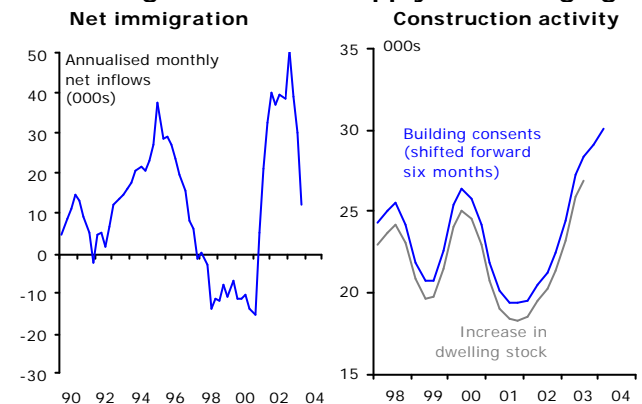
Momentum in the domestic economy is likely to be maintained during the first half of 2004. Household income growth and hence the prospects for consumer spending continue to be supported by a strong labour market. The unemployment rate has dropped to fresh 16 year lows at 4.4%, with surveyed hiring intentions and ANZ Job Ads continuing to suggest further solid employment growth – at least in the near term.

For the time being, the housing market remains in catch-up mode after two years of very strong population growth, driven by unprecedented rates of net immigration. Sales activity appears to have continued apace in early 2004, while the median sale price in December was up around 20% on the

same time in 2002. However, housing demand and supply will increasingly move towards balance as the year progresses.

On the demand side, population growth is slowing with the rate of net immigration falling sharply over the past six months. There was a seasonally adjusted net inflow of just 1,020 people in November – a rate consistent with an annual addition to New Zealand's population of 12,240 people and the weakest seasonally adjusted monthly inflow since May 2001. This is down significantly from average net inflows of around 3,500 per month during the second half of 2002 and the first half of 2003, which generated an annual rate in excess of 42,000. A recovering world economy and some easing in perceptions of geopolitical risk has seen departures of New Zealanders start to increase and, coupled with the tightening of entry criteria, the numbers of new arrivals decline. The relative strength of New Zealand's labour market should continue to provide some support to net immigration. But slowing population growth will see the requirements for new housing ease accordingly.

Housing demand and supply is converging



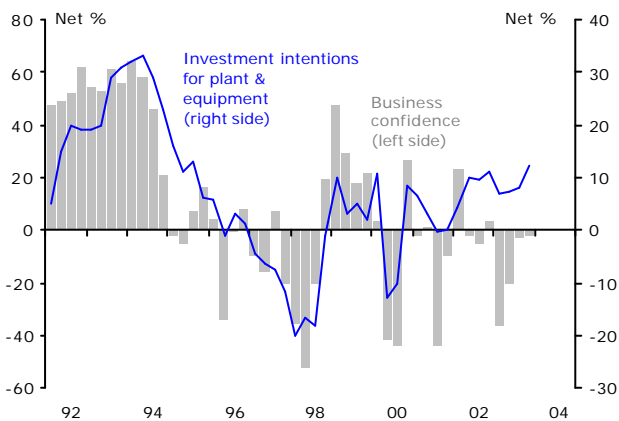
Sources: Statistics NZ; Economics@ANZ

On the supply side, strong residential construction over the past year has already added significantly to the dwelling stock. With the number of building consents issued – particularly for housing – continuing to swell in late 2003, a further considerable increase in the dwelling stock is in the pipeline for the year ahead. In the face of slowing population growth, this increased supply is likely to start to take some of the heat out of the housing market as the year progresses. Accordingly, while residential investment is expected to remain strong over the first half of 2004, this strength is likely to start to wane later in the year and into 2005.

Meanwhile, the prospects for business investment, which grew by nearly 9% in the year to September 2003, are also relatively favourable. A prolonged

period of high capacity utilisation, which has been most pronounced in the construction sector, has seen investment intentions lift. The NZIER's December quarter survey of business opinion revealed that a net 12% of respondents expect to increase spending on plant and equipment – the highest since 1995. However, intentions still remain well below the levels reached during a similar period of high capacity utilisation in the mid 1990s. The key difference between the two periods is that business confidence is weaker at present – particularly amongst exporters under pressure from strong NZ\$ gains. Regardless, the rise in intentions is sufficient to support further strength in business investment during 2004. Ironically (given the difficulties it is creating for exporters), currency strength is reinforcing the attractiveness of business investment by reducing the costs of imported capital goods – an important influence for investment decisions in a small country like New Zealand where relatively few of these products are made locally. Persistent shortages of skilled labour and the prospect of further tightening of industrial relations law may also be prompting business to examine the potential for capital substitution.

Soft sentiment has restrained investment



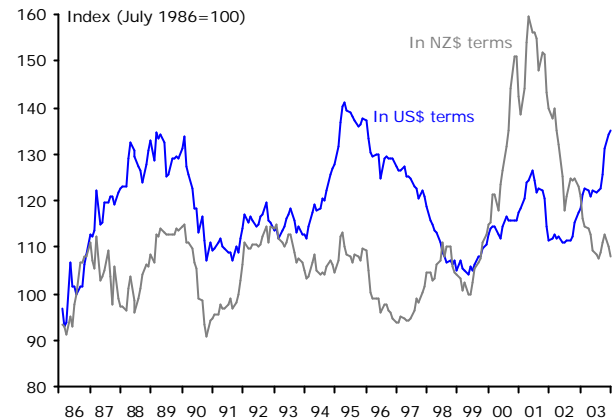
Sources: NZIER; Economics@ANZ

NZ\$ to increasingly undermine growth

While the residential and business investment outlook suggests that near term domestic prospects are favourable, the export sector continues to suffer the ravages of a rampant NZ\$. Despite ongoing strength in key export markets – with the ANZ world commodity price index gaining further ground during the second half of 2003 to reach eight year highs – the NZ\$ commodity price index had returned to midyear lows by the end of 2003. Indeed, the sharp gains in the NZ\$ early in the New Year are likely to have pushed commodity export prices down to lows not seen since 1999. The hedging activities of major exporters – particularly in the case of dairy products – continue to mute and delay the impact of NZ\$ gains on export incomes,

but a fall of more than 30% in commodity export prices since their highs in the first half of 2001 is likely to further undermine export revenue in 2004.

NZ\$ gains continue to dampen export returns



Source: Economics@ANZ

Subject to NZ\$ developments, a stronger world economy should eventually help to resuscitate the fortunes of New Zealand exporters during the next 12-18 months. But this may be partly offset by the likelihood that some of the supply factors that have underpinned world markets for agricultural commodities – such as the impact of the Australian drought – will wane over the year ahead. Moreover, local agricultural production constraints will limit the ability of exporters to continue to partly buffer the impact of currency strength on revenues by achieving export volume growth. Another difficult summer – albeit with dry conditions impacting farmers in the South Island rather than the North this year – is likely to be reflected in lower sheepmeat production in particular.

There are some bright spots. Given the importance of Australia as an export market for manufacturers, their fortunes have been supported by the strength of that economy's performance in recent years. Moreover, the NZ\$ has weakened against the A\$ over the past year, while many manufacturers have enjoyed the added benefit of lower US\$ costs for imported intermediate and capital goods. Elsewhere, the tourism sector has proved immune to NZ\$ strength to date. Indeed, visitor arrivals are currently running at record levels after bouncing back sharply from the negative fallout for international travel of the Iraq war and the SARS outbreak. Regardless, the impact of NZ\$ gains on the cost of New Zealand as a holiday destination for visitors from the US and Asia in particular is likely to increasingly take its toll.

The impact of weaker export incomes on the domestic economy has been relatively limited to date. However, as the experience during and after the sharp run up in the NZ\$ to its previous peak

above US\$0.70 in late 1996 proved (albeit with New Zealand's difficulties during 1997-98 compounded by the Asian financial crisis), it will merely be a matter of time. Despite a recovering world economy, ongoing NZ\$ strength poses downside risks to growth over late 2004 and 2005.

Domestic strength feeding inflation fears

New Zealand's relatively strong growth during 2002-03 has left a legacy of resource pressures. After a brief easing in the September quarter, capacity utilisation returned to near its highs in late 2003. Along with a prolonged shortage of skilled labour which has continued to intensify, this creates upside risks to the medium term inflation outlook.

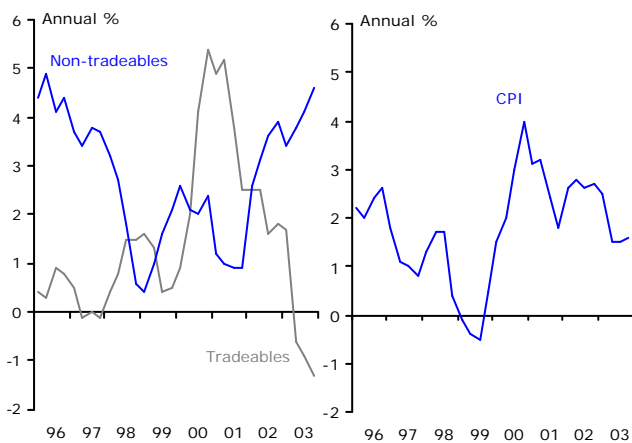
A tight labour market threatens wage inflation



Source: Statistics NZ; NZIER

For the time being, lower import costs resulting from a stronger NZ\$ have kept a lid on CPI inflation, with tradeables prices falling 1.3% during 2003. But reflecting the sources of strength in the domestic economy, housing-related prices pushed non-tradeable inflation up to 4.6% over the same period. The net result was CPI inflation of 1.6%.

The inflation tug of war has intensified



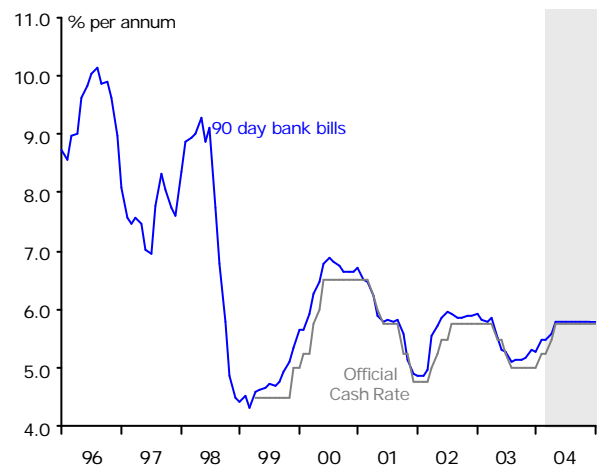
Sources: Statistics NZ; Economics@ANZ

While this remains towards the lower end of the RBNZ's 1-3% target band, the Bank has become increasingly concerned about the medium term outlook. Assuming that the disinflationary influence of currency gains dissipates when the NZ\$ peaks and starts to ease – even though it has proved stronger to date than assumed in the December Monetary Policy Statement projections – the RBNZ fears that inflation will rise significantly over the next couple of years. These fears saw the RBNZ announce a 25 basis point rate rise in January, taking the Official Cash Rate to 5.25%.

Further interest rate rises are likely during the first half of 2004. Weaker export incomes and slowing population growth will eventually do most of the job in reducing domestic inflation pressures, so that the RBNZ is unlikely to feel the need to raise the OCR significantly. This is reinforced by the rise in household debt levels over recent years, with the associated increase in interest rate sensitivity likely to give the RBNZ 'more bang for its buck' – thereby limiting the extent to which interest rates need to rise, relative to previous cycles, in order to contain inflation pressures.

Overall, we expect the OCR to be raised to a peak of 5.75%. The risk of continued significant NZ\$ strength has the potential to limit the extent of rate rises. But in the face of continued near term strength in the domestic economy, some further action is likely to return interest rates to levels that the RBNZ deems less stimulatory.

Further interest rate rises are likely



Sources: RBNZ; Reuters; Economics@ANZ

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Financial markets

Since the last *ANZ Economic Outlook* released in October 2003, two major sets of events have unfolded as far as local interest rate and currency markets are concerned. First, the Reserve Bank of Australia moved quickly at its November Board meeting to re-start its strategy of moving the targeted cash rate towards what it regards as a neutral setting. Second, in recent months there has been a further tangible appreciation in the Australian dollar, especially against the US\$ that has since lost ground. The A\$ has been steady to stronger against other major cross rates.

As far as monetary policy is concerned, ANZ expects that the RBA will move further on the monetary policy front to lift the cash rate into the neutral zone. A cash rate of around 5½% is expected in the months ahead. Quite likely, this will come as early as the February RBA Board meeting. (The cash rate was already at 5¼% at the time of writing in late January.) Thereafter, once the cash rate reaches 5½%, the RBA is expected to leave the cash rate steady at least for several months to review the impact of tighter monetary policy on the economy's interest rate sensitive sectors such as housing. ANZ's forecast is that the cash rate will remain steady at 5½% through the remainder of 2004. In 2005, the RBA is expected to ease monetary policy as a result of a slowing in Australian economic activity in 2004-05.

The Australian dollar is forecast to make further gains. From its current level of US0.76-0.77¢ in late January, the A\$/US\$ rate is forecast to rise US0.82¢ by the middle of the year. Some retracement is expected by year end to around its current level. These forecast movements largely reflect expected volatility in the US dollar which seems set to lose further ground in the months ahead amid news of a still mounting US current account deficit.

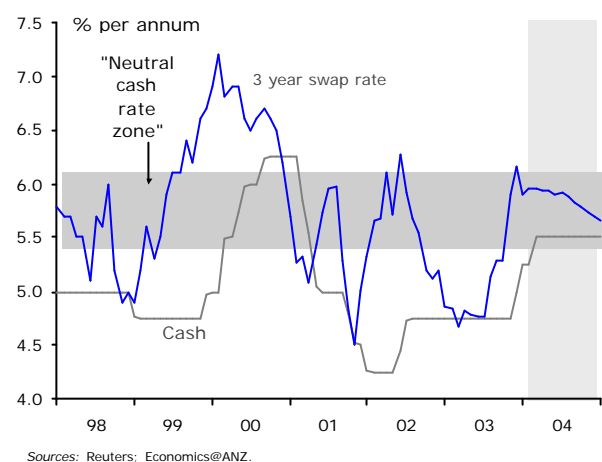
RBA to tread warily from here

Some commentary in the media of late has concentrated on anecdotal reports of a slowdown in residential property markets as sufficient evidence for the RBA to leave the cash rate at 5¼%. We doubt these reports have sufficient weight for the RBA to leave the cash rate at 5¼% with confidence that such a rate will curb unsustainable growth in borrowing and spending, especially by households.

The Australian economy appears to have started 2004 with considerable momentum. This is apparent in the household sector where, despite two interest rate rises, households spending seems to have remained firm.

Retail spending remained firm in late 2003 while consumer confidence rose strongly in January, to its highest level in nine years. A crucial factor in supporting household spending has been the robust labour market, with the unemployment rate falling to a 14-year low. Meanwhile, household wealth has been boosted by ongoing gains to house prices and a rising equity market. Also important in underpinning spending has been lower prices for some items, as a result of heavy discounting by retailers and the appreciating Australian dollar.

A\$ interest rates



No doubt this strength has underpinned conditions in the business sector, with business conditions strengthening in the December quarter according to most business surveys and with further strength anticipated in orders, capital expenditure, profitability and employment. Despite a recent sharp drop in non-residential building approvals, there is still a significant amount of non-residential construction work in the pipeline, with \$A15bn of private sector projects currently underway. On top of this rosy picture, grain boards are reporting near record harvests, suggesting a big rebound in cereals exports in coming months.

Of course it would be misleading not to mention that there are some soft spots in the economy. While there has been a welcome revival in in-bound tourism in late 2003 – arrivals were at the highest since June 2001 – the outbreak of Asian avian flu casts a cloud over further growth, at least in the short term. Moreover, regions of Queensland, Northern New South Wales and South Eastern Victoria remain affected by drought, suggesting the beef and dairy industries and their local economies are in for another tough year. Even in the property markets, there are also signs of slowing in the Melbourne and Sydney residential markets. Australian Property Monitors report sharp falls in median home auction prices and auction clearance

rates in December in excess of normal seasonal fluctuations. Residential construction activity across Australia also looks likely to peak in the first half of 2004, after a remarkably modest cycle, although the risk for the property market continues to be the large number of apartments that were approved in late 2003 on the eastern seaboard.

Inflation lower for now

It is doubtful whether Australia's now lower inflation rate provides much immediate policy leeway for the RBA. In its media release accompanying the December 3 lift in the cash rate to 5.25%, the RBA stated:

"Australia's inflation rate at present is close to the target mid-point. While domestically sourced inflation pressures have risen, the overall inflation rate is being held down by the effects of the higher exchange rate on prices in the tradeables sector. In the short term, these exchange rate effects are likely to reduce the inflation rate further. Once these effects start to fade, however, CPI inflation is expected to be on a rising trajectory given the strength of domestic demand, firming labour market conditions and continuing strong price pressures in the non-tradeables sector of the economy."

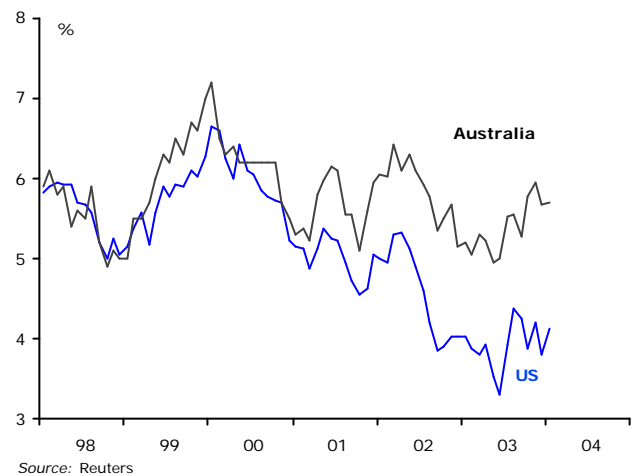
The RBA Governor fleshed out the detail of this broad view further on 8 December when he gave his semi-annual testimony before the House of Representatives Standing Committee on Economics, Finance and Public Administration:

"On inflation, we said last time that we expected the CPI to increase by 2½ per cent over calendar 2003. We now think it will be a little lower at 2¼ per cent, largely due to the exchange rate being higher than assumed in our earlier forecast. Over the course of 2004, we expect the CPI to increase by 2 per cent, but in mid 2004 it could well be below that because the maximum effects of the higher Australian dollar could be being felt then this expectation implies that the profile of inflation will exhibit a shallow U-shape – falling from its present 2½ per cent to below 2 per cent in mid 2004, but then rising back to 2 per cent by end 2004, 2½ per cent by mid 2005, and continuing under upward pressure thereafter."

Based on how the Australian dollar has risen over the past year and where we expect it to rise to over the next six months or so, we expect Australia's inflation rate to dip further in the March quarter to an annual rate of just 1.5%. That rate is well below the 2-3% target espoused by RBA. But given the inflation outlook once the impact of the higher A\$ passes, we think the RBA will judge that a cash rate at 5¼% is still a little too stimulatory and does not sufficiently address their medium-term inflation and debt concerns.

We doubt that CPI results over the next two quarters or so will be "make or break" as far as monetary policy is concerned. The RBA's strategy to lift the cash rate back in to the neutral zone to rein in fast growth in credit and contain growth in domestic demand. It will not be until it is clear that the rate of growth in domestic spending and borrowing has slowed sufficiently to a point that the RBA thinks it wise to release some monetary policy pressure. Such evidence may remain elusive for another quarter or so.

Australian and US bond yields



The Australian economy has started 2004 with quite a deal of momentum. Private domestic demand – arguably that component of the economy that is most sensitive to changes in monetary policy – is forecast to grow by a still very solid 4¾% in 2004 (we estimate that it rose by 5.3% in 2003) and by 5½% over the year to the June quarter of 2004. Thereafter, as new dwelling investment slows in response to the rise in mortgage interest rates, private spending growth is forecast to slow. In the meantime however, we continue to think that the RBA be more content with a cash rate in the "mid to high 5s" before pausing to reflect on the impact of that policy setting.

Australian bond yields near their peak

The Australian interest rate curve has already flattened significantly since the RBA started increasing the cash rate last November. This has come in the form of both higher short-term rates and steady to lower long-term Australian Government bond yields. Part of this rally reflects the anticipated peak in the cash rate – and in time lower cash rates – and some net reduction in US Treasury long term yields.

US yields moved lower in recent months amid signs that the US Federal Reserve will leave monetary policy unchanged "for a considerable period". At the end January meeting the Fed changed this phrasing

to reflect that “the Committee believes that it can be patient in removing its policy accommodation”. US inflation remains low and employment growth is yet to gain traction, but a combination of especially positive leading indicators and the most stimulatory macroeconomic policy settings for decades will in time re-ignite inflationary concerns in the market place. With economic growth continuing apace, in the process taking up spare capacity, a correction in US bond yields upward has been long overdue. From their current level of just over 4%, having risen since the Fed statement, the US 10 year bond yield is forecast to increase to 4½-5% over the next two quarters or so.

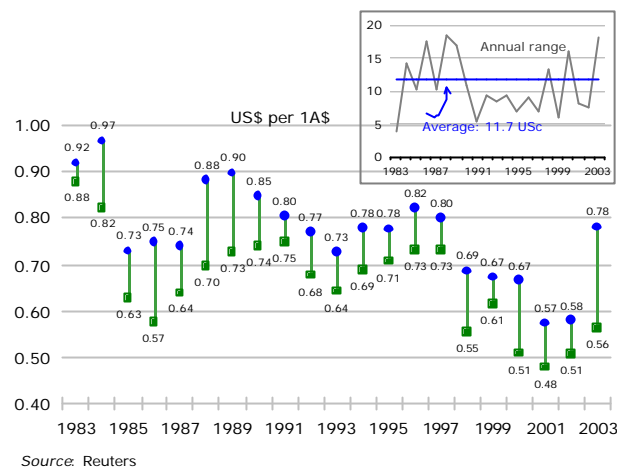
In the process, higher US yields will also serve to place a floor under Australian bond yields, even though the rise in Australian yields will be significantly less. This is because the Australian monetary policy cycle is not in sync with that of the United States. The Australian cash rate is near to the top in this cycle, whereas the Fed funds rate is at its lowest level for five decades. The gap between the Australian cash rate (5¼%) and the Fed funds rate (1%) is expected to narrow from over 4% to below 3% through 2005. This would also see come with a compression at the longer end of the yield curve with the current 1½ppt difference narrowing to 1ppt by the end of this year.

A\$ – an up and down year ahead

Since it was floated, the A\$/US\$ has traded within an overall 48.8 US cent range from a high of US0.9653¢ on 15 and 16 March 1984 to a low of US0.4775¢ reached on 2 April 2001. The A\$/US\$ has had a post float average “high-low” calendar year range of 11.7 US cents. The narrowest range was in 1999, after the Asia crisis, when the range was just 6 US cents. Last year was at the other extreme with a range for the year of over 22 US cents, a new high-low record.

While Australia’s macroeconomic and microeconomic policies were under radical reconstruction in the 1980s, the currency was initially under some trend downward pressure on competitive grounds. But the same has not been true of the 1990s as the economy reaped the benefits of more stable economic policies, with the currency becoming something of a shock absorber, remaining volatile. At the start of last year, we offered the view that the A\$/US\$ rate was not fairly valued at US0.56¢ but should find higher levels in the 60s. Our prediction for the end of last year was US0.62¢, a prediction that looked ambitious at the time against a market median forecast of US0.60¢ and a range of US0.56-0.65¢.

A\$ annual highs and lows



In recent months, US\$ weakness has continued overall though the decline has come, including recently, with periods of increased appetite for US investments. The US economy continues to surprise on the high side. It might of course be that a stellar US economy is re-igniting concerns that the demand for imports from a capital-hungry US corporate sector will continue to fuel the draw of the US economy on foreign savings. Such strong internal investment demand will in fact sustain the US current account deficit at elevated levels. The faster the rate of growth of the US economy, the greater the US current account deficit and the potential for increased pressure on the almighty dollar.

To date, the Federal Reserve’s major currency US\$ effective exchange rate has declined by 25% from its peak reached in January 2002. (The broad effective exchange rate index has declined less so over the same period, by 13%.) Given the outlook for continued strong growth in the US economy relative to its major trading partners, we expect that US\$ index to fall by a further 5-10%, delivering an overall decline of 30%.

The US\$ now looks much closer to what could be regarded as fair value in a historical sense whether the “major currency” US\$ effective exchange rate or the broad currency” US\$ effective exchange rate is used as the benchmark. The depreciation in the US\$ over the past two years from its peak in February 2002 in both the major currency and broad effective exchange US\$ rates has now unwound all of the appreciation seen in the previous three years. Given that major currency re-alignments typically overshoot, a further decline in the US\$ and corresponding rise in the A\$ is in prospect over the months ahead.

The flip side of this US\$ depreciation is continued trend upside on the A\$/US\$ rate over coming months. As a leading indicator of an improving global economy and with attractive interest rates, the A\$ has been at the forefront of US\$

depreciation. We expect that trend to continue for the time being. By the middle of this year, if not sooner, ANZ forecasts that the €/US\$ rate will increase further to around \$1.35 and that the US\$/¥ rate will fall to 100, both reflecting the continued depreciation in the US\$.

On that basis, ANZ expects to see further trend upside in the A\$/US\$ over the next six months to around US0.82¢. During that time, we expect that the A\$/US\$ will also largely hold its ground on the crosses. In the second half of the year, demand for the Australian dollar is expected to wane to around US0.78¢ by the end of the year.

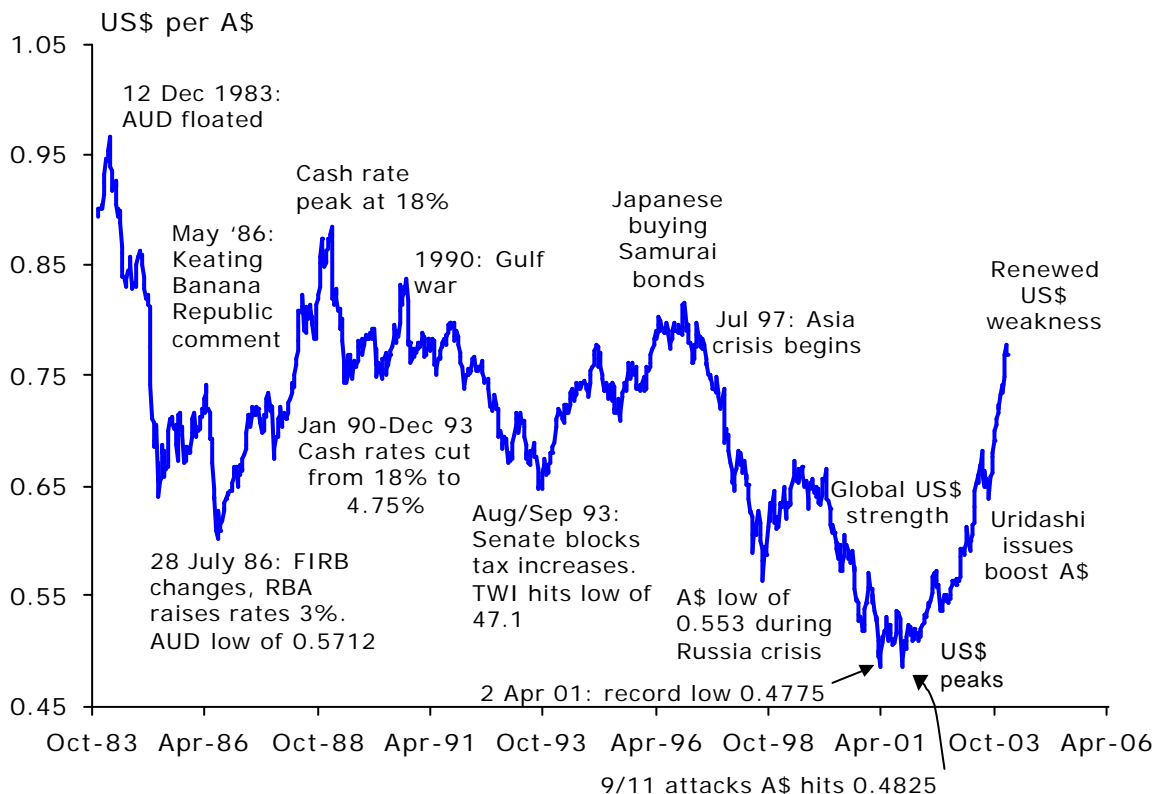
With the US\$ nearer to if not at fair value, taking an outright view on the A\$/US\$ will be increasingly risky in the months ahead. In that sense, it is opportune to examine the A\$ against some of its major cross rates. For now, the foreign exchange market is giving increasing emphasis to the importance of interest rate differentials. We would make a distinction between those central banks that are more sensitive in their setting of official interest rates to currency movements. Already, despite a very strong US economy to which the Canadian economy is inexorably tied, the Bank of Canada has reduced its overnight rate to 2½%. This easing was announced to alleviate pressure on the economy from the rising C\$. In contrast, the Reserve Bank of

New Zealand has already increased interest rates despite strength in its currency and with New Zealand exports representing some 32% of GDP. While the RBNZ ascribes a deal of importance to the deflationary impact of the rising NZ\$, the domestic economy remains strong and this has been the over-riding consideration for the central bank. Further rises in the NZ cash rate are likely in coming months to arrest fast growth in domestic growth in an economy where capacity limits are being reached.

From that viewpoint, we expect that the A\$/C\$ will most likely rise whereas there would be more limited upside in the A\$/NZ\$ rate in the months ahead. Against the UK pound the A\$ is set to remain relatively steady at around £0.41-0.42 given that UK interest rates are forecast to rise in the months ahead. ANZ forecasts that the A\$/€ rate will be relatively steady over the next one to two quarters. It would be totally in keeping with conservative monetary policy approach from the European Central Bank to leave interest rates on hold for the time being, though a final appreciation in the €/US\$ rate above \$US1.30 is set to prompt the ECB into action on the interest rate front later this year.

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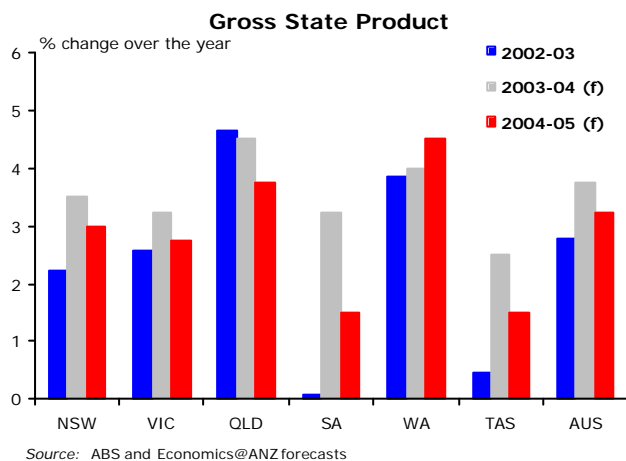
The A\$ since the float



State economic outlook

Australian States face many challenges in the period ahead. While all of the States stand to benefit from a pick up in global growth, the higher A\$ is offsetting many of these gains and is a particular downside risk for some of the smaller export-oriented States. Drought is still affecting parts of Eastern Australia, whereas in other regions farm product is on track for a sharp rebound. Meanwhile the housing cycle is at different stages across the country. Overall, economic growth in most States is expected to pick up this year, with Queensland and Western Australia looking like they have the momentum to again come out on top.

State economic growth



New South Wales

In the face of considerable headwinds, including weak global growth and widespread drought, the New South Wales economy grew by 2.2% in 2002-03. This was below the national growth rate of 2.8%, with both domestic final demand and net exports lagging. Nevertheless, the New South Wales labour market continued to perform well, with the State unemployment rate falling to 5.2% in December 2003, below the national rate of 5.6%.

Economic growth in New South Wales should pick up in 2003-04. While segments of the State remain drought-affected, rainfall has eased conditions elsewhere and agricultural production is starting to recover. This will eventually feed through to higher exports and rural incomes. The rebound in global growth is particularly welcome news for the New South Wales economy, fuelling export growth and, perhaps even more significantly, a rebound in the State's globally exposed corporate sector. Higher corporate discretionary expenditure, in areas such as technology, advertising and finance, will boost white collar employment, which is disproportionately high in New South Wales. This in turn will support household consumption, providing a nice foil to an

expected moderation in the labour intensive construction sector.

That said, while dwelling investment is turning down in New South Wales, the fall looks like it will be considerably more moderate and transitory than in most other States. Despite strong dwelling investment growth of 20% last year, the housing market in New South Wales looks to be broadly in balance, with supply close to matching demand. Nevertheless, some segments of the market, particularly inner-city apartments in Sydney, are clearly oversupplied and, in the absence of an uptick in demand, are at a high risk of major market dislocation via a sharp fall in activity or prices.

The pace of business investment should remain solid, dominated by a number of large infrastructure projects, mainly in transportation. This is underpinning strong engineering construction while non-residential building construction should also continue steadily, dominated by new projects in the office and retail sectors. In contrast, a relatively smaller resources and manufacturing sector will likely keep investment in plant and machinery subdued.

After some lean years, the New South Wales economy appears back on track. State economic growth is expected to move broadly in line with the national average, picking up to around 3½% in 2003-04 before softening to 3% in 2004-05.

Victoria

Economic growth in Victoria softened to 2.6% in 2002-03. This was slightly softer than the performance of the overall Australian economy, with Victoria relatively harder hit by the drought and subdued global demand. Nevertheless, Victoria's labour market has held up well, recording an unemployment rate of 5.5% in December, slightly below the national rate of 5.6%.

Most sectors in the Victorian economy look to be in good shape. The low unemployment rate and the large housing wealth gains made by Victorians in the last five years should keep household consumption firm. A prospective pick up corporate discretionary spending and white collar employment is also a plus for the State. Business investment looks like it will also remain solid, led by a large number of office construction projects and also activity ahead of the 2006 Commonwealth Games. Victoria's exports should also enjoy better times ahead as both global demand and agricultural production picks up. There are still some clouds on this horizon however, given that large parts of South Eastern Victoria remain drought-declared. Also, the higher A\$ is a greater concern for Victoria compared with some other States, given Victoria's higher dependence on manufactured industries.

Another area of the Victorian economy that looks vulnerable is the residential property sector. Forward indicators suggest that residential building activity in the State will remain firm over the first half of 2004, with higher interest rates and a slowdown in Victoria's population growth expected to cause activity to drop away from mid-2004 into a shallow decline through 2005. However, although slowing, residential building approvals in Melbourne are still running higher than ANZ estimates of underlying demand. If these approvals move into the construction stage, they will amplify an already oversupplied housing market, increasing the risk of a substantial decline in residential construction activity in Victoria as well as falling house prices over the medium-term.

While there are a number of risks on the horizon, better times do look to be ahead for the Victorian economy. Economic growth is expected to rebound to 3¼% in 2003-04, softening to 2¾% in 2004-05.

Queensland

The Queensland economy grew by 4.7% in 2002-03, the strongest of all the States. This is a remarkable performance by this export-oriented State, and is a result of robust domestic spending which rose an incredible 8.5% last year. Strong economic growth has underpinned a drop in the Queensland unemployment rate to 6% in December 2003, although this is still higher than the national unemployment rate.

The fastest rate of population growth in the country should underpin further solid domestic spending in Queensland over the period ahead. Retail spending growth in Queensland is running at the strongest pace in Australia and conditions remain robust for household consumption, with further falls in the unemployment rate in prospect. Queensland's housing market will also remain strong this year with the high level of building approvals suggesting that activity will be sustained well into 2004. Increased interstate interest in Queensland's comparatively more affordable coastal regions meanwhile should see Queensland house prices continue to rise. Over 2004-05 however building activity is expected to turn down sharply and house price growth is expected to moderate as recent interest rate rises start to impact.

Business investment in Queensland should remain solid and, in contrast to the national trend, may even accelerate over the next few years, underpinned by projects in the resources, retail and office sectors. Pressures created by strong population growth will also likely lead to ongoing investment in infrastructure, particularly transportation.

Queensland exports however look like they will face further challenges over the next twelve months as the recovery in global growth is partly offset by the

impact of the higher A\$. Queensland's rural exports will continue to struggle with parts of the State still drought-declared, the sugar industry adjusting to deregulation and the livestock industry facing a long road to recovery after last year's herd depletions. These headwinds should fade into 2004-05 however, with strong global growth expected to underpin a sharp rebound in exports in that year.

Overall, Queensland is likely to continue to outperform the national average. Economic growth is forecast to soften slightly to 4½% in 2003-04. In 2004-05 a moderation in domestic demand is expected to see economic growth ease to 3¾%.

South Australia

After starting the decade well, economic growth in South Australia slowed to just 0.1% in 2002-03. While the drought in South Australia was not as severe as in some other regions, agriculture makes up a higher share of South Australia's economy relative to the national average so that the negative impact on overall growth from the bad season was disproportionately high. Falling crop and wine production caused international exports from the State to drop by 6% last year, much sharper than the national fall of 0.6%. Labour market conditions also deteriorated, with the South Australian unemployment rate bucking the national trend and actually rising to 6.5% in December, almost a full percentage point above the national rate.

International exports from South Australia are on track to rebound over the next two years. Better seasonal conditions across most of the State should see crop production double last year's level and wine production is also expected to bounce back strongly. South Australia's relatively large manufacturing sector should also contribute to stronger export growth, underpinned by recent capacity expansions. These factors are already flowing through to South Australia's international merchandise exports, which rebounded by a sharp 15% in the September quarter 2003. That said, the higher A\$ is a large blow to this State's currency-sensitive manufacturing-heavy export sector and is a significant downside risks to the outlook.

Domestic demand in South Australia showed extraordinary resilience to grow by 7.9% last year and looks set to maintain considerable momentum this year. Residential building approvals are running at a high level and should support dwelling investment for at least the first half of 2004. Business investment also looks set for another strong year, with a number of large projects, mainly in the manufacturing and energy sectors, supporting spending on both non-residential construction and plant and equipment. Household wealth gains over recent years should more than offset the rise in the unemployment rate, keeping household consumption steady.

In addition to the significant downside risks created by the higher A\$, South Australia faces some other imposing clouds on the horizon. Building approvals are running well ahead of underlying demand, making the South Australian housing market most at risk of all of the States of moving into substantial oversupply. This, combined with the recent rise in interest rates, will likely see dwelling investment fall sharply over 2004-05. Further strong business investment next year is also not assured, given the State's relatively limited industry base.

Overall, solid domestic demand and improved exports should see State economic growth rebound to around 3% in 2003-04. In 2004-05 growth is likely to slow to around 1½% as softer domestic demand offsets a further rebound in export growth.

Western Australia

The Western Australian economy grew by 3.9% in 2002-03, well above the national growth rate. While strong domestic demand drove this good performance, in contrast to other States Western Australian exports also grew strongly. Despite a sharp fall in farm production and weak global demand, a strong non-rural commodities sector saw Western Australian exports rise by 10% in 2002-03, the best performance in over a decade. Western Australia's labour market performance was a little disappointing however, with the unemployment rate finishing 2003 above the national average at 6%.

Domestic spending in the Western Australian economy looks set for another couple of bumper years. Household consumption should grow solidly, underpinned by rising household wealth on the back of rising house prices and the spin-offs from the booming resources sector. A record level of residential building work in the pipeline as well as a high level of building approvals should keep dwelling investment in the State at a solid pace over the coming year, although higher interest rates are likely to dampen activity in 2004-05.

The resources sector should sustain another few years of strong business investment, although there will be some rotation between the different types of spending. With non-residential building and engineering construction appearing to have peaked, most projects will move onto the equipping phase. This will keep imports strong, as will the higher A\$.

After an exceptionally strong performance last year, export growth is actually likely to soften a little in 2003-04. While a predicted record grains crop will see a sharp rebound in rural exports, capacity constraints will prevent another strong year of commodity export growth. Nevertheless, export growth in Western Australia should continue to outpace the national average. Export growth is expected to again accelerate in 2004-05, as new resource capacity comes on stream and as the A\$ retreats from its expected 2003-04 peak.

A major risk facing the Western Australian economy is the higher A\$. At this stage, the higher A\$ is not expected to dampen Western Australian export volumes substantially, with the rebound in global growth and continued rabid demand from China likely to keep demand strong. The higher A\$ will however bite into export incomes. A more significant risk will emerge if the A\$ remains above its long-term average for a sustained period. This would threaten the profitability of many resources projects, dampening State activity and future investment.

Overall, economic growth in Western Australia is expected to remain broadly unchanged at 4% in 2003-04, slightly above the Australian average. In 2004-05, softer domestic demand should be offset by stronger net exports, causing overall State economic growth to pick up to around 4½%.

Tasmania

Following a strong couple of years, Tasmanian economic growth fell to just 0.5% in 2002-03. The pause in growth reflected the completion of a number of large investment projects, including the gas pipeline across the Bass Strait and the Bell Bay power station, which more than offset robust exports and strong household consumption and dwelling investment. Strength across most other sectors of the economy however saw Tasmania's labour market improve markedly, with the unemployment rate falling to 6.8% in December, which is around 22-year lows.

Prospects for the Tasmanian economy are bright. A turnaround in net interstate migration has seen the State's population growth strengthen considerably in the last year. This in turn should continue to drive solid growth in employment, household consumption and dwelling investment. Mainland buyers looking for affordable investment and holiday homes will also continue to boost the State's housing market. The outlook for business investment is also good. The rollout of fibreoptic and gas from the Bass Strait pipelines has commenced for industry and will extend to households in 2005 and a number of wind energy projects are also in either the commencement or development stage. Tasmania's tourism sector is booming and will receive a boost this year from the new Sydney to Devonport ferry. As well as directly impacting exports, higher tourism numbers should also eventually boost investment in the accommodation and hospitality sector.

All of these factors should see Tasmania's economic growth rebound to around 2½% in 2003-04. A slowdown in dwelling investment will likely see growth ease to around 1½% in 2004-05.

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Financial markets forecast table

	End period					End period			
	Sep-2003	Dec-2003	Mar-2004	Jun-2004	Sep-2004	2001/02	2002/03	2003/04	2004/05
	← actual		forecast	→		← actual		forecast	→
Interest rates									
<i>Australia</i>									
90 day bank bills (%p.a.)	4.9	5.5	5.6	5.6	5.6	5.1	4.7	5.6	4.8
10 year bond rate (%p.a.)	5.3	5.7	5.8	5.9	5.9	6.1	5.0	5.9	5.8
<i>United States</i>									
3 month LIBOR (%p.a.)	1.2	1.2	1.2	1.5	1.6	1.9	1.1	1.5	2.8
10 year bond rate (%p.a.)	3.9	4.2	4.3	4.5	4.7	4.8	3.6	4.5	5.3
<i>Euro area</i>									
3 month LIBOR (%p.a.)	2.1	2.1	1.8	1.5	1.5	3.4	2.1	1.5	2.8
<i>New Zealand</i>									
90 day bank bills (%p.a.)	5.2	5.4	5.6	5.8	5.8	6.1	5.3	5.8	5.3
Exchange rates									
AUD/USD	0.68	0.75	0.80	0.82	0.80	0.56	0.67	0.82	0.74
NZD/USD	0.59	0.66	0.70	0.71	0.68	0.49	0.59	0.71	0.63
AUD/JPY	75.4	80.2	82.2	82.0	80.6	67.0	80.6	82.0	76.4
AUD/EUR	0.58	0.60	0.61	0.61	0.60	0.56	0.58	0.61	0.58
AUD/GBP	0.41	0.42	0.42	0.41	0.42	0.37	0.41	0.41	0.40
AUD/NZD	1.14	1.14	1.14	1.16	1.19	1.15	1.15	1.16	1.18
USD/JPY	110.9	106.9	103.5	100.0	100.8	119.4	119.7	100.0	103.3
EUR/USD	1.16	1.26	1.30	1.35	1.33	1.00	1.15	1.35	1.28
A\$ Trade weighted index	59.1	63.5	66.0	66.9	65.6	52.3	59.3	66.9	61.6

Economic forecast table

	Quarterly % change					Annual % change			
	Sep-2003	Dec-2003	Mar-2004	Jun-2004	Sep-2004	2001/02	2002/03	2003/04	2004/05
	actual	forecast				actual	forecast		
Australia									
GDP	1.2	1.4	1.1	0.8	0.7	3.9	2.8	3.7	3.2
- Final demand	1.2	1.4	1.2	0.9	0.9	4.4	6.3	4.7	3.2
- Stocks	0.1	-0.7	0.2	-0.3	0.1	0.0	0.0	0.4	-0.3
- Net exports	-0.5	0.3	-0.2	-0.1	-0.1	-0.7	-3.0	-1.9	0.1
CPI *	0.6	0.5	0.4	0.4	0.6	2.9	3.1	2.1	2.4
Wages	1.2	0.7	1.0	0.7	1.0	3.3	3.5	3.6	3.5
Employment*	0.1	1.2	0.5	0.4	0.3	1.1	2.5	1.9	1.5
Unemployment rate (%)*	6.0	5.6	5.6	5.7	5.8	6.7	6.1	5.7	5.9
Current account deficit (\$b)	-11.9	-11.3	-10.4	-10.0	-9.8	-21.7	-41.0	-43.7	-35.4
- % GDP	-6.1	-5.7	-5.1	-4.9	-4.7	-3.0	-5.5	-5.4	-4.2
New Zealand									
GDP	1.5	0.8	0.7	0.4	0.5	4.0	2.9	3.4	2.0
CPI *	0.5	0.7	0.5	0.4	0.6	2.8	1.5	2.1	2.7
Wages	0.6	0.8	0.8	0.9	0.9	1.6	4.2	3.2	3.6
Employment	1.4	0.1	0.1	0.1	0.1	3.1	1.9	1.7	1.2
Unemployment rate (%)	4.4	4.5	4.6	4.9	5.1	5.1	4.7	4.9	5.0
Current account deficit (\$b)	-6.0	-7.0	-7.4	-7.3	-7.6	-3.2	-5.9	-7.3	-7.9
- % GDP	-4.6	-5.3	-5.5	-5.3	-5.5	-2.6	-4.6	-5.3	-5.6

* December 2003 actuals



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