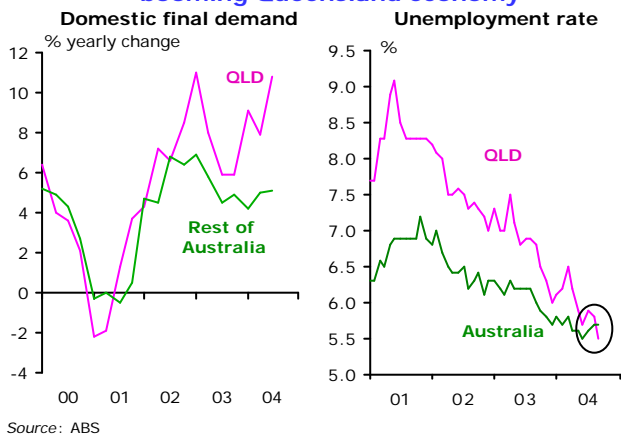


# State Economic Update

## No raining on the Queensland parade

The Queensland economy is on a roll. The sunshine State has seen off the recent challenges of the drought, SARS and the global recession to post considerably faster economic growth than the national average in each of the last five years. 2003-04 was no exception, with State economic growth estimated to have exceeded 4½%, well outpacing overall Australian economic growth of 3.6% in the period. The sustained strong performance of the Queensland economy has facilitated a sharp reduction in the State's unemployment rate. At 5.5%, Queensland's unemployment rate is now at the lowest level in over 23 years and, for the first time in around a decade, below the Australian average. (Chart 1).

**Chart 1: Strong domestic spending is driving a booming Queensland economy**



Queensland's recent strong performance has been driven by a booming domestic economy. Household consumption spending, dwelling investment and business investment are all running hot, driving exceptional growth in State final demand of 10.8% in the June quarter. This was by far the strongest of all of the States and was well above the 6.1% rise in domestic final demand recorded by Australia as a whole.

The raging pace of domestic spending in Queensland was more than enough to offset another relatively disappointing export performance, a pattern repeated across every State and Territory. In the case of Queensland, strong exports of livestock and cereals were hardly enough to offset a disappointing performance by exports of raw and processed minerals and manufactures. A number of supply disruptions in the mining sector, including bad weather and transportation constraints<sup>1</sup>, prevented

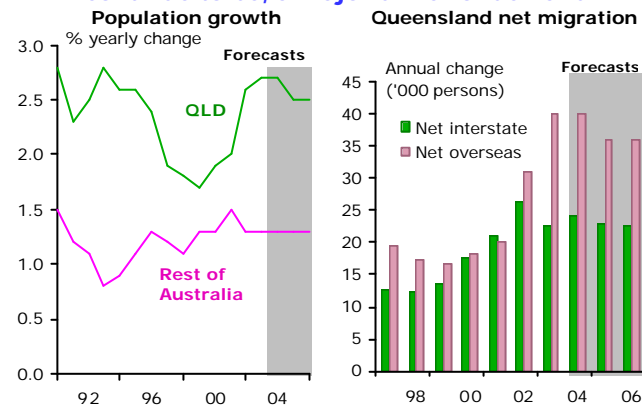
<sup>1</sup> A collapse of a reclaimer at the Dalrymple Port in the March quarter reduced export capability.

these exports from riding the benefits of the strong global economy.

## Populate, populate, populate

The lure of a warm climate and beach lifestyle is causing masses to flock to the Sunshine State. Queensland attracts by far the highest level of interstate migration of all the States and Territories and is the third most popular state (after New South Wales and Victoria) for overseas migrants. Primarily as a result of the high rate of net interstate migration Queensland has by far the fastest population growth of all Australia's States and Territories, averaging 2% per annum over the last decade compared with the national average of 1.2% per annum (Chart 2). Around 19% of all Australian residents now live in Queensland, up from 16% 20 years ago. This population boom has undoubtedly been one of the biggest drivers of Queensland's recent rapid economic growth, underpinning strong demand in Queensland for housing and consumer goods as well as expanding the breadth and depth of the workforce, ultimately aiding Queensland's desirability as an investment destination.

**Chart 2: Population growth has been, and will continue to be, a major driver of demand**



Source: ABS and Economics@ANZ

Queensland should continue to enjoy rapid population growth for some time to come. Overseas migration levels look set to hold up and strong economic prospects and, of course, the appealing climate and lifestyle will ensure Queensland remains the favourite destination for interstate migrants. However, as Queensland expands it is also losing some characteristics, in particular relatively affordable housing, which had previously made it a desirable place of 'resettlement'. The erosion of this 'comparative advantage' will likely see net interstate migration, and thus overall population growth, temper a little compared with recent strong outcomes.

### Is Queensland property in bubble trouble?

The exuberance of Queensland's recent economic performance has had its clearest manifestation in the housing market. Strong population growth, robust income growth within this population base (itself a by-product of solid economic and employment growth) and a rush of investors looking to take advantage of an 'undervalued' market have all combined to provide the perfect setting for a housing boom that just won't stop. While other States appear at the tail end of their cycle, Queensland is still riding high, with housing investment up 25% in the year to the June quarter.

This is not to say that Queensland is immune to broader market conditions. It's taken a while, but last year's interest rate rises are finally taking some of the steam out of Queensland's housing market. Building approvals in the State are currently 17% down from their peak late last year. Demand is weakest for houses, with these approvals down 20% in this period. Demand in the apartment and semi-detached sector has held up slightly better, but is still down 17% from last year's peak. Providing some offset to actual activity from this decline in new approvals however is the large amount of work in the pipeline. Capacity constraints in the building industry have lifted the value of residential work yet to be completed across the State to a record level. Overall, these indicators suggest that dwelling investment in Queensland will moderate, and perhaps even decline a little, over the next six to twelve months. Nevertheless, ongoing demand, mainly due to population growth, should hold up the Queensland housing market a little better than most other States.

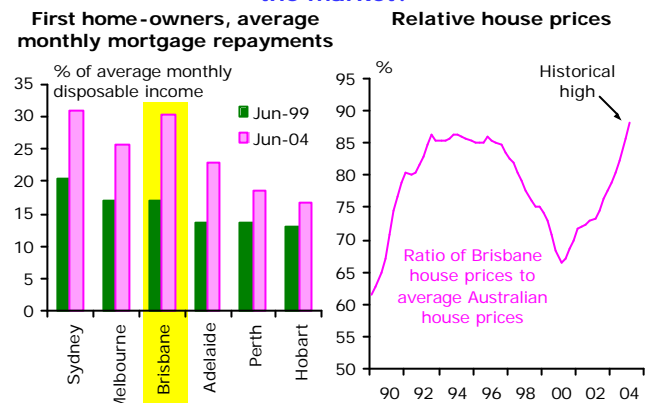
While the prognosis for housing activity in Queensland is relatively healthy, house prices are looking increasingly vulnerable. Queensland property owners have been some of the biggest winners in Australia's recent housing boom. Strong demand has driven Brisbane house prices up by 110% in the last five years, by far the biggest rise of all the State capitals and well above the average national rise of 85% in this period. Significantly, even as the market starts to lose a little bit of momentum, price rises in Brisbane continue to outpace all the other States, rising by 13% in the last six months compared with an average national rise of 5%.

While the majority of the rise in Queensland house prices can be justified by 'fundamental' factors, such as higher population and income growth, Queensland house prices do look like they are starting to head into dangerous territory. First home-owners in Brisbane on average now devote 30% of their monthly income to mortgage repayments, up sharply from 17% five years ago. As a result, first home-owners in Brisbane now face the same relative housing costs as Sydney and higher relative costs than Melbourne (chart 3).

In these circumstances, it is very difficult to see the current pace of Queensland house price growth

sustained. While ongoing population growth will keep demand for housing (new and rental) solid, if prices continue to rise at current rates, locals will no longer be able to afford to buy! The Brisbane market in particular looks ripe for adjustment. Notwithstanding a sudden large boost to incomes (and thus ability to pay) the most likely scenario will see house price growth start to moderate, to be more in line with average income growth. Recent experience in Melbourne and Sydney suggests that intermittent price falls in some Queensland suburbs (particularly at the higher end of the market) could be on the cards, particularly if, as expected, interest rates rise again next year. Sharp and widespread house price falls across the State do not look likely however, given that population growth is supporting demand. Importantly, other broader macroeconomic conditions for housing also remain favourable, with both the unemployment rate and interest rates (even after factoring in further small rises next year) both still near historical lows.

**Chart 3: Is Queensland property pricing itself out of the market?**



Source: ABS, HIA, REIA, Economics@ANZ

The biggest risk is that 'irrational exuberance' causes a further spiral in Queensland house prices. Such a scenario would see Queensland housing become the least affordable of all the States. Not only would this increase the vulnerability of the market to a collapse in house prices, higher relative housing costs would also become a significant deterrent to future migration to the State. If it's not careful, the Queensland housing market may end up 'pricing out' its golden goose.

### Queenslanders still shopping, not dropping

The combination of strong population growth, an enormous rise in average household wealth (due to higher house prices) and falling unemployment has delivered a windfall to Queensland's retail sector. Like so many other indicators, retail spending in Queensland is by far the highest of all the States and Territories, rising by 9% in the year to July, well above national growth of 6.4%. Queenslanders are also spending large on big-ticket items with passenger vehicle sales in the State rising 7% in the year to July. This is fuelling total State consumer spending growth of 10% in yearly terms, almost double the national pace and the strongest in around a decade.

While this outrageous pace of spending is unlikely to prove sustainable, consumer spending in Queensland should nevertheless remain strong over the coming year. Consumer confidence in the State is high and prospects for employment and population growth are solid. The income boost from recent tax cuts and increased family assistance payments should also help keep the cashier tills ringing. Nevertheless, the likelihood of a further slight rise in interest rates and, more significantly, a slower rate of house price (and thus household wealth) growth will take the edge off some discretionary spending, particularly big-ticket household items.

### **Investment the key to sustainability**

While strong consumer spending and a booming housing market have driven the Queensland economy in recent times, this will not guarantee Queensland's longer-term well-being. The key for any economy to laying a sustainable production and employment base is investment. This is perhaps one area where Queensland can try a little harder for unlike consumer spending and housing, business investment in Queensland has not significantly out-performed the rest of Australia. This is not to say that investment spending has been disappointing. In 2003-04 new business investment in Queensland was up a strong 8%. It's just that this is one area where outperformance should be encouraged.

Like the rest of Australia, Queensland looks set to enjoy another solid year of business investment spending over 2004-05. With the majority of projects in the 'construction' phase, this should in turn provide a significant boost to employment growth. While there are some projects planned in the retail, accommodation and office sectors, two sectors – infrastructure and mining – are set to dominate Queensland investment spending in the period ahead.

Strong rates of population growth are putting considerable strains on Queensland infrastructure, particularly in the high-density South East of the State. Electricity shortages during the recent hot summer have exposed the failure of some utilities to meet expanding demand while roads are also becoming frustratingly, and in some cases almost permanently, bottlenecked. Demand for 'social infrastructure' such as health and education services are also expanding rapidly. Additions to and improvements of existing infrastructure are essential to Queensland's future economic growth prospects as well as maintaining and improving the standard of living within the State.

The State Government has responded by committing around \$6bn in capital outlays over 2004-05, with most to be undertaken by Government-owned corporations. Transport and energy are the priorities, accounting for about 60% of these allocated funds. Transportation projects to be accelerated under these funds include the construction of stages 2 and 3 of the Caboolture Northern bypass, a new two-lane link between Caboolture and Mooloolaba and a duplication of the Nerang to Broadbeach rd. Allocated funds for

the energy sector are concentrated in electricity generation and supply with major projects including construction of the Kogan Creek power station, the Townsville Power gas pipeline and reinforcement of the distribution and transmission systems to the Brisbane CBD and the Gold Coast. Capital outlays on rail and port facilities are also due to increase in 2004-05, with a planned upgrade of track infrastructure of the coal network and an expansion of the RG Tanna coal terminal at the Gladstone port.

In addition to these direct capital outlays, the Queensland government is also actively pursuing greater private sector participation in the provision and operation of public infrastructure through public private partnership (PPP) projects. At Budget time the State Government estimated 8 major projects, worth around \$2.7bn had progressed beyond the preliminary assessment stage, including an upgrade of the Gateway Bridge in Brisbane and the development of a cruise and military vessel ocean terminal in Townsville. If they proceed as expected, these projects will provide another source of significant growth in business investment, and ultimately economic growth, in Queensland over 2004-05 and beyond.

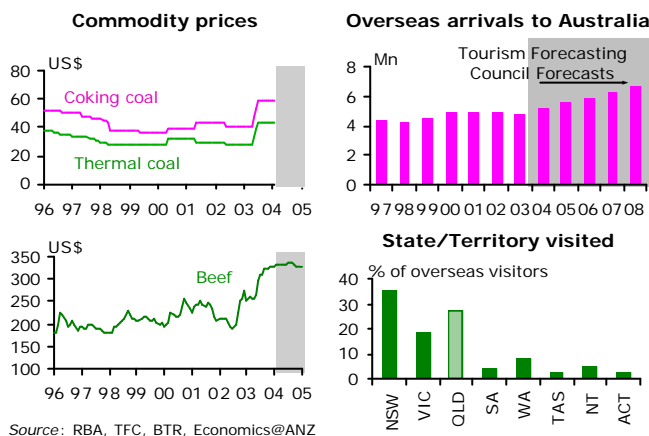
One segment of the Queensland economy for which recent good fortunes have little to do with strong population growth is mining. As if a sunny climate wasn't enough, Queensland is also blessed with more than its fair share of natural (and valuable) mineral resources. The mining industry has been one of the fastest growing industries in Queensland over the last five years with activity expanding on average by almost 15% per annum. Coal is by far the State's dominant resource, accounting for around 75% of total crude mineral exports, with zinc, nickel, lead and gold also mined and shipped out.

The mining industry has rarely seen better times. The global economy is currently growing by the fastest pace in 30 years, which in turn is generating strong demand for mineral resources and causing commodity prices to sky-rocket. Indeed, Queensland producers should be some of the big winners with the prices for coking and steaming coal soaring by 43% and 63% respectively in the last 12 months. Faced with these favourable market conditions, the mining industry in Queensland is in the process of sharply ramping up capacity. Around \$1bn worth of projects are currently under construction in the Queensland mining industry, including the Rolleston open-cut thermal coal mine and the expansion of the Weipa bauxite plant. Projects worth a further \$2bn are under construction in metal and non-metal manufacturing, led by the \$1.5bn Alumina refinery at Gladstone. With a further \$3.5bn of projects under consideration, it appears that the mining sector will continue to underpin strong business investment, and ultimately exports, in Queensland for some time come.

## A favourable environment for exports

As already mentioned, international exports from Queensland, like the rest of Australia, have had a horror run in recent years. Prospects for a turnaround are however encouraging (Chart 4). The large amount of mining and resource processing capacity currently under construction together with the planned expansion of some port facilities should underpin a significant boost to Queensland exports from late 2004/early 2005. The tourism sector also looks set for a good year as ongoing strength in the global economy drives up demand for international travel and holidays. While herd numbers are relatively low, Queensland's livestock producers are also set for another year of strong returns, as strong demand and the Japanese ban on US beef exports (which is now expected to remain well into 2005) keeps upward pressure on prices that are already at record levels. That said, some parts of the farm sector could be in for a rough year. Recent poor rainfall across some parts of the State has ABARE now estimating that Queensland's winter crop production of wheat and barley will fall by 30%.

Chart 4: Exporters face favourable conditions



One significant challenge for Queensland resource exporters is the looming slowdown in China. ANZ is forecasting economic growth in China to slow sharply from 8½% in 2004 to just under 6% in 2005. While China is now an important driver of international resource markets, the impending slowdown will not necessarily be catastrophic. Indeed, it seems likely that some commodities will barely feel a bump. Even as Chinese growth slows, electricity consumption in that nation is expected to continue rising. As a result, thermal coal producers should enjoy even stronger demand and prices. Coking (metallurgical) coal exporters may face a harder time, given that this resource is used in steel-making, one of the areas that Chinese authorities are trying hard to slow. Nevertheless, ABARE expects Chinese demand of coking coal will continue to outstrip local supply, providing favourable conditions for Australian coking coal exporters. At this stage, Queensland finds itself in the fortunate position of not being a big supplier of the two resource exports, alumina and iron-ore, for which Chinese export demand is expected to slow.

## It's not just in the big city!

The spoils of Queensland's rising prosperity have not been limited to Brisbane. Regional Queensland is also booming with house prices stronger, employment rising and wealth increasing. While South East Queensland is leading the way, the entire coastal region, stretching around the Cape to Weipa, is enjoying good times. Whether it's the rise in luxury tourism in North Queensland, the strong trading conditions for Rockhampton's beef producers, the expansion of the Gladstone Port or the heavy investment in central Queensland's coal industry, most of the regional economies are growing solidly and have good prospects. While perhaps not faring as well as the Coastal region, the strong mining and livestock industries, a burgeoning tourism industry and further funding commitments for improved roads and apprenticeships means that Western Queensland can also face the future with optimism.

## Where's the reform agenda?

With the Queensland economy performing so strongly, it is no surprise to find that State finances are in good shape. The Government Budget is projected to remain in surplus out to 2007-08 and the State's net debt position is, in contrast to most other States, negative (such that Queensland holds net financial assets, not debt) at present.

This good fiscal management is to be commended. However while the recent State Budget was a big step in the right direction, the Queensland Government could still be doing more to harness these golden times to progress a structural reform agenda. For instance, there remains a strong case for investigating the merits of privatising some of Queensland's many government-owned corporations, such as Queensland Rail and the State-owned electricity corporations (in generation, transmission and distribution). Education should be another priority. While Queensland school retention rates compare well with the rest of Australia, only 17% of Queenslanders have a higher education qualification, below the national average of 21% and considerably lower than Victoria (24%) and New South Wales (22%). An increased emphasis on higher educational attainment, particularly amongst rural, regional and indigenous populations, should be aggressively pursued. This would further boost labour market outcomes, economic growth, and ultimately living standards.

## Every reason to be optimistic

Looking ahead there is good reason to be optimistic about the Queensland economy. While there are still some challenges, opportunities abound. Solid population growth, increased business investment and favourable conditions for the export sector point to an economy that is going great guns, with strong, and sustainable, prospects. ANZ expects economic growth in the State will continue to outperform the national average to grow by at least 5% in 2004-05 and 2005-06. Let the good times roll on!

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