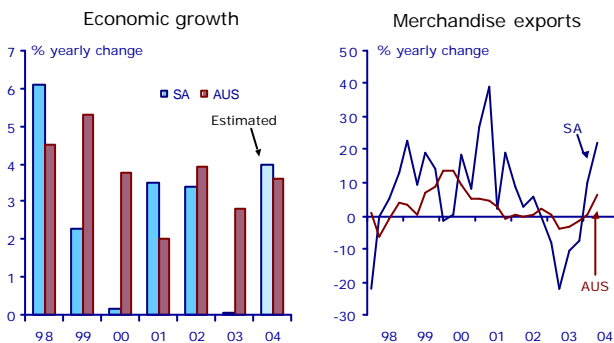


State Economic Update

Speedbumps ahead for South Australia

After a disappointing 2002-03, the South Australian economy bounced back strongly in 2003-04. Economic growth in the State is estimated to have clocked around 4% in the past financial year, well above the mere 0.1% growth recorded in 2002-03. A major factor behind the turnaround was a sharp reversal of fortunes amongst South Australian farmers. Having been devastated by the 2002-03 drought, the rains finally returned to saturate the State's crops, allowing production to double to near record levels. The sharp rebound in farm production together with the strong global economy in turn saw international merchandise exports from South Australia pick up strongly over the first half of 2004. Domestic demand was also strong over the course of last year, underpinned by a buoyant housing market, robust consumer spending and solid business investment. Stronger economic growth in turn has facilitated further improvement in the State's public finances, such that Standard and Poor's have just upgraded the State's credit rating to the highest rating, and in line with all the other mainland States, to AAA+.

Chart 1: The South Australian economy has had a good year with exports recovering strongly



The South Australian economy is different

The South Australian economy is a little bit different to the rest of Australia, in terms of size and structure. While this provides the State with many advantages, it also poses some challenges. An understanding of these differences, and the challenges they pose, is crucial background to examining the outlook for the South Australian economy.

South Australia is Australia's second smallest State, making up just 6% of total Australian economic output, well behind New South Wales (35%), Victoria (25%), Queensland (17%) and Western Australia (11%). Although a relatively small economy does pose some disadvantages, it does not necessarily act

as a constraint on growth and indeed, can actually provide many benefits.

The major challenge for South Australia is slow population growth. Over the last decade population growth in South Australia has averaged just 0.4% per annum, well below the national average growth rate of 1.2% per annum. The slower rate of population growth in South Australia reflects a combination of slower rates of natural increase, lower rates of migration and, significantly, negative net interstate migration. As a result of low population growth South Australia now has a proportionately higher aged population than Australia as a whole. Around 15% of South Australia's population is aged 65 years or over, the highest proportion of aged persons of all States and Territories.

As a result of this relatively large aged population, South Australia is equal to Tasmania in having the highest 'dependency ratio'¹, 34%, of all the States and Territories. This adds considerably to demands for government services, particularly aged care and related health services in South Australia's case. The flipside of a higher dependency ratio is a lower proportion of persons of working age. In particular, South Australia has a relatively low proportion of the population aged 20-34 (20% compared with 22% for Australia as a whole), likely reflecting the high level of interstate migration. This is a potential drag on economic growth in South Australia, as this population cohort tends to have relatively high rates of employment, education and is also the major source of net new demand for housing.

Industry composition is another potential challenge for South Australia. As tends to be the case with a small economy, activity in South Australia is a little bit more narrowly based than the bigger States. Manufacturing is South Australia's dominant industry, accounting for 15% of the State's total output. This is higher than the share of manufacturing nationally, which makes up 12% of total Australian output, and is the highest of all the States except Victoria (which also relies on manufacturing for 15% of total output). The State's biggest manufacturing industries are wine and motor vehicles. While a narrowly-based production base is not always a negative, it nevertheless does increase the vulnerability of the wider economy and community to any negative shocks in the dominant industry. Making things more difficult in South Australia's case is the broader industry composition of the State. An analysis of the slowest growing industries in Australia over the last five years shows that these industries are over-

¹ Ratio of persons aged 0-14yrs and 64yrs and over as a proportion of the total population

represented in the South Australian economy. Unfortunately, as a counter, the State also has a slight under-representation of Australia's fastest growing industries (Table 1).

Table 1: Industry composition is working against South Australia

	Share of output (%)	
	AUS	SA
Fast-growing industries	35.0	33.0
Health & community services	6.1	7.6
Property & business services	11.7	9.4
Construction	6.4	6.1
Retail trade	5.6	5.6
Transport & storage	4.8	4.5
Slow-growing industries	28.0	32.0
Electricity, gas & water	2.5	2.7
Agriculture, forestry, fishing	3.5	6.4
Mining	5.1	2.6
Education	4.5	5.2
Manufacturing	12.1	14.7

Source: ABS and Economics@ANZ

South Australia's demographic trends and, to a lesser extent, industry structure means that the State's 'potential' growth rate is well below the national average. Over the last five years, economic growth in South Australia has averaged 2¼% per annum compared with 3¼% per annum for Australia as a whole. Supply and access to some basic utilities is also a big challenge and potential constraint on growth in South Australia. The State faces limited water supply that is being further constrained by environmental damage such as salinity and also faces limited electricity supplies. The price of these utilities is rising much faster than any other States, with summer electricity tariffs soaring 32% this year, a crippling price rise for some businesses and households. Water supplies are so acute in some areas that rural towns are already having water trucked in and without an extensive system expansion and new generating capacity it has been warned that South Australia risks power shortages as soon as 2005-06.

In an effort to boost South Australia's economic prospects, the State Government has in recent years adopted a more pro-active approach to addressing these longer-term structural problems. Over recent years the State Government has formed an Economic Development Board, cut payroll tax to a more competitive 5.5% and released a State Strategic Plan and a State Population policy. The latter, which focuses on the retention of young South Australians and attracting skilled migrants is having a little success, with population growth ticking up in recent times on the back of higher overseas migration. The Government has also put its own book in order with public finances now much improved, state debt falling and the Government committed to running budget surpluses. Although much more needs to be done in tackling these problems, the State government is at least making a start in addressing water and

electricity supply and cost problems. Transport links to Adelaide (from Northern Australia and Asia) have also been boosted with the completion of the Adelaide Darwin railway. Overall, it must be said that the South Australian economy is improving as a destination for investment and has many reasons to face the future with renewed optimism.

Stronger investment environment

This renewed optimism is best demonstrated by the strength of new investment in South Australia. In the last two years, business investment has increased by 44%, well above the 26% rise experienced by Australia as a whole. Most of this investment has been concentrated across a range of manufacturing industries, including motor vehicles, wine and paper and there have also been some major construction projects in the electricity and retail sectors as well as the upgrade of the Adelaide Airport. These projects have been an important source of economic growth and employment in recent years, and will add to the State's productive capacity and thus growth prospects over the longer-term.

Against this backdrop, South Australia, more than in other recent periods, finds itself in a good position to see out the challenge of the impending closure of the Mitsubishi plant. The planned closure of the Mitsubishi Lonsdale engine factory at the end of October 2005, together with the decision to reduce the size of the workforce at Mitsubishi's Tonsley Park vehicle assembly factory, will hit both exports and the broader State economy. It is expected that about 1020 workers (0.1% of the total South Australian workforce) will be retrenched from Mitsubishi with job losses likely to extend to some automotive suppliers and dealers.

This is a devastating development for the workers directly involved. However, the closure of the Mitsubishi plant will not represent a total net loss to the South Australian economy, with the State's other major car producers likely to be able to pick up some of Mitsubishi's domestic fleet market. Furthermore, there are still many reasons to be excited about the prospects of the State's automotive industry. Other car producers are travelling well, with Holden, for example, advancing the \$1bn, five-year upgrade of its Elizabeth plant (which will lift production to 200,000 vehicles). In addition, there also some new investment projects getting off the ground in the industry, with Hirotec planning to open a new \$100mn automotive component plant that will hire 200 workers in early 2006, just after the Mitsubishi plant closes. Even Mitsubishi, in the short-term, will continue contributing to the South Australian economy, with the carmaker committing a \$600mn investment to the new Magna model upgrade (in turn saving about 2600 jobs for now).

As well as in the automotive industry, there are also a number of other investment projects currently underway or committed to start soon in the State.

There are a couple of new mixed office-retail-residential projects under construction, including the redevelopment of the Port Adelaide Waterfront and there are also a number of wind farm projects committed, as the State looks to harness alternative energy sources in the face of pending electricity shortages. There is also a range of small-scale projects underway, in road, mineral sands, grain storage and retail. While it is good to see this broad range of projects up and running, there is not enough projects 'in the pipeline' to make up for the completion of some recent major projects. As a result, the rate of growth in business investment in the State looks set to slow sharply over the 2005 and 2006.

Housing moving into dangerous territory

Like the rest of the country, a booming housing market has provided a crucial underpin to growth in South Australia in recent years. Dwelling investment was up a strong 21% in the year to the June quarter, the third strongest of all the States behind Tasmania and Queensland. With demand so strong, there has also been a massive rise in the amount of residential construction work that has been commenced but not yet completed with this pipeline work now just off record levels. House prices in the State have also been flying with the median house price in Adelaide doubling in the last five years.

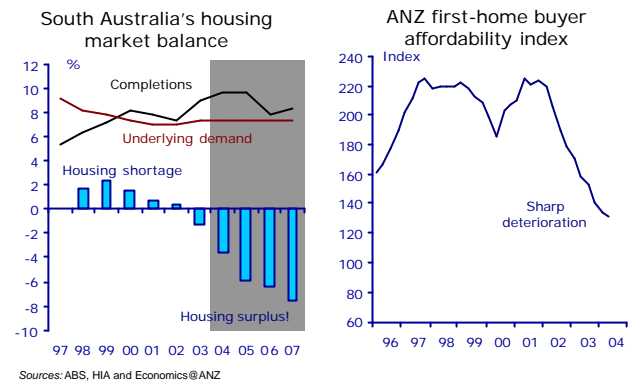
While the party has been raging, the broader picture now suggests that South Australia's housing market is heading for a hangover. Building activity in the State has been running well ahead of underlying requirements, which is constrained by the State's relatively low population growth. Although rental vacancy rates are the lowest of all the States, this will change once the massive amount of residential projects currently in the pipeline are completed. Indeed, a slight easing in pipeline pressures in recent quarters has been accompanied by a corresponding slight rise in vacancy rates.

The latest leading indicators suggest that, like the rest of Australia, demand for housing in the State has eased. Both finance approvals for owner-occupiers and building approvals for new houses have fallen steadily in recent months, implying a modest fall in dwelling investment in the State over the next twelve months looks to be in prospect. However, this modest downturn is not necessarily a sweet ending. Approvals are still running at a relatively high level in the State, and certainly still above a level consistent with the State's underlying demand. In the absence of a further moderation in housing investment, the risk of an even greater problem of housing oversupply in the State, and in response a sharper downturn in the housing market further down the track (and subsequently the State economy), is rising.

In addition, with house prices in the State far outpacing growth in average household incomes, Adelaide house prices are now clearly overvalued with

affordability falling to its lowest level since 1991 (Chart 2). Affordability constraints combined with the prospect of oversupply in the residential housing point to a relatively sharp moderation in South Australian house price growth over the coming period. In the absence of a significant rise in the unemployment rate or a sharp rise in interest rates, sustained house price falls in the State do however look unlikely.

Chart 2: The South Australian property market is heading for a hangover



A slowdown in the housing market will have negative implications for the broader South Australian economy. Most likely it will see the pace of consumer spending in the State slow, as spending on housing-related goods, such as furniture and white goods, moderates while slower rates of housing-related wealth gains will likely also see households pull back from 'big ticket' purchases. With the construction industry a major source of new jobs in South Australia recently, a downturn in the housing market can also be expected to dampen employment growth in the State.

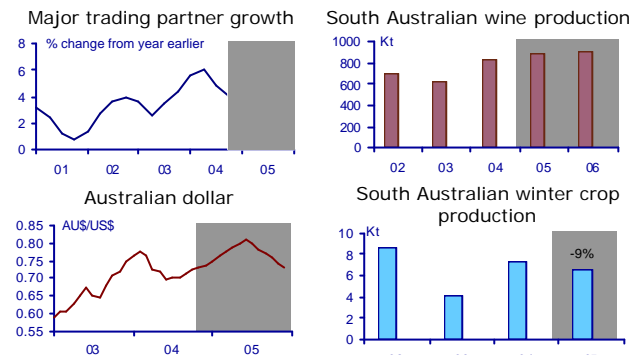
Exporters also face challenges

South Australia's export sector also faces some challenging times ahead. To begin, the rural sector, while currently experiencing much better seasonal conditions than in other States, is unlikely to match the record harvest of last financial year. ABARE is currently forecasting South Australia's winter crop production to be around 9% lower than last year, which in turn will put a drag on export volumes from the State.

South Australia's other major export, manufacturing, could also face some challenging times. Global growth, the primary driver of manufacturing exports, performed very strongly over the first part of 2004 but has now past its peak. ANZ expects global growth to slow from around 5% in 2004 to around 4% in 2005. This is still above trend, although if record oil prices do not soon start to ease there is an increasing risk of a sharper slowdown in global growth next year. As well as slower global demand, South Australian manufacturing exporters will also likely have to contend with the disadvantages of a higher Australian dollar. ANZ expects the record

United States current account deficit will weigh on the US\$ over the course of 2005. This in turn will put upward pressure on the Australian dollar, which is expected to appreciate to above US\$0.75c in the first half of next year, with an overshoot above US\$0.80c a possibility. This will adversely affect the price competitiveness of many South Australian (and Australian) exporters.

Chart 3: Outlook strong for some South Australian exports, challenges for others



Sources: Datastream, ABARE, Economics@ANZ

Time for the new kids on the block

While a smaller crop harvest, a moderation in global growth, the likely appreciation of the A\$, as well as the Mitsubishi closure all create significant challenges for South Australia's export industry, there are also many opportunities. Top of the list must sit aquaculture, one of South Australia's fastest growing industries. This export-oriented industry should continue to enjoy buoyant conditions as producers work to build new export markets and further diversify the type of species farmed. The State's famed wine industry is also looking to better times ahead. Good seasonal conditions, restructuring within some of the State's largest wine companies and expansions of a number of wine-bottling plants should see the industry well placed to face the tough conditions in the global wine industry². Moreover, the State's beer producers are also working to expand their market share within a number of different countries, which will provide a good opportunity to build long-term export markets.

International service exports also offers exciting opportunities for South Australia. At present South Australia attracts just 4% of total international visitors to Australia. Given the State's spectacular coast, national parks, wineries, and active arts and cultural scene, there is surely plenty of scope for this industry to improve its 'market share'. Another service that South Australia potentially stands to reap rewards from is in the area of education. International students applying for study visas can earn additional visa points by studying in a regional location, of which Adelaide has been classified. This makes it easier for international students to gain a

² An oversupply of grapes in California and the emergence of exceptionally cheap "extreme value" wines in the US have made things tough for Australian wine exporters recently.

visa if they chose to study in Adelaide, relative to Melbourne or Sydney. This creates an opportunity for South Australia to gain valuable market share in this fast-growing and high-value export market.

Regions doing well

Regional South Australia is an important contributor to the economy, accounting for just 27% of the State's population but 50% of the State's total exports, mainly in agriculture, aquaculture, small-scale manufacturing and processing and tourism. Most regions should remain on a good footing in the period ahead. The Eyre and Northern regions should remain well supported by the aquaculture industry while average seasonal conditions should support agricultural production and sales (including wine) across the Mid North, Adelaide Hills, Barossa, Murraylands, Riverland, Yorke Peninsula and the Northern region. Most of these areas also have an opportunity to expand their tourism market, as does the Fleurieu Peninsula and Kangaroo Island. Light manufacturing is present in most regions and some of these businesses could face some challenging times in the period ahead, potentially adversely affecting Northern Adelaide and the Murraylands and Whyalla. The Yorke Peninsula, which provides the State's main export outlets, could also face some challenges, depending on the performance of the State's export industries in the period ahead.

Economic growth to slow next year

Overall it appears that the drivers of South Australia's recent strong performance are running out of steam and ANZ expects State economic growth will slow from 4% in 2003-04 to around 2% in 2004-05. In the coming period business investment will be hard pressed to match the exceptional growth of recent years even though there are still a range of new projects coming on stream. In addition, South Australia's housing market is looking exceptionally vulnerable. Without a further moderation in new building, this market is in danger of moving into serious oversupply, a development that would dampen the housing market, and potentially the State economy, for many more years to come. Finally, many South Australian exporters will also face some serious challenges ahead with a slowdown in global growth and appreciation of the Australian dollar both in prospect.

After all of that is said however, there are still many reasons to be optimistic about South Australia's longer-term prospects. The recent uptick in population growth is a positive development while the formation of the South Australian Economic Development Board and the turnaround in State finances has improved the business environment. In addition, many export-oriented industries in the State, old and new, have a real opportunity to increase market share with their unique products and face exciting times.

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