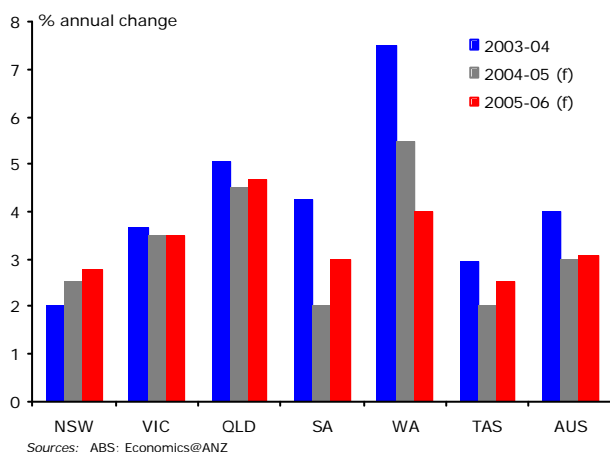


Economic Update

State economic outlook

2003-04 was a good year for most states. A booming resources sector and strong population growth had Western Australia and Queensland firing, the resurrection of South Australia and Tasmania continued apace, and the upcoming Commonwealth Games gave Victoria a boost. Only New South Wales, as it struggled against capacity constraints and the ghosts of housing booms past, disappointed. Most states look set for some cyclical downturn over the coming year, mainly in line with developments in each region's housing sector. The pattern of growth among the states however looks set to remain broadly similar as a strong mining sector and positive migration flows keep Western Australia and Queensland on top.

State economic growth



New South Wales

The New South Wales economy struggled again in 2003-04, posting disappointing growth of just 2.0%, well below aggregate Australian growth of 4.0%. This was the third consecutive year that economic growth in Australia's largest state failed to match the national pace. Despite weak growth, the state's labour market was solid and unemployment ended 2004 at a 23-year low of 5.1%.

Many of the major constraints to growth in the NSW economy over recent years will present ongoing headwinds in the period ahead. These include; the most expensive housing market in the nation, relatively slow population growth, infrastructure bottlenecks and a persistently weak export performance. Addressing these problems requires more than just a 'quick fix' such that economic growth in NSW is likely to continue to lag the national average for now.

Nevertheless, progress in tackling some of these 'limits to growth' is being made. In particular, NSW's aged and overused transport infrastructure is set for overhaul and expansion with big projects in rail, road and port underpinning strong investment spending plans in the state. Better infrastructure should in turn facilitate an improvement in NSW's export performance that has recently been hamstrung by capacity constraints, particularly in port and freight. The lingering effects of drought, which has persisted longer in NSW than other states, should also continue to dissipate in the coming year, providing another much-needed boost to export growth.

One part of the NSW economy that looks more vulnerable than in other states in the short-term is housing. Residential building approvals are down 24% from a year ago and while housing finance approvals in the national market are turning back up, approvals in NSW continue to trend down. This suggests that the downturn in housing activity will persist for a little longer in NSW. Despite a considerable slowdown in house price growth, housing costs in Sydney still swallow a high proportion of the average home owner's disposable income. Such affordability constraints will likely keep house price growth fairly subdued, and will also put a cap on household consumption. While the prognosis is not good this year with building approvals now running well below underlying demand, an emerging shortage in housing should see activity start to turnaround in 2005-06.

In 2004-05 a weaker housing market is expected to be more than offset by an improvement in exports and investment with state economic growth of around 2½% expected. Continued solid investment and exports, together with a recovery in housing, should see growth pick up to 2¾% in 2005-06.

Victoria

Economic growth in Victoria picked up to 3.7% in 2003-04 on the back of improvements in household consumption and exports. Victoria's labour market has also performed solidly with employment growing faster than the national average in 2004. Nevertheless with strong conditions encouraging a rise in labour force participation to a 14-year high, the state's unemployment rate remains above the Australian average at 5.7%.

The outlook for the Victorian economy is bright. The solid labour market should continue to support household consumption and, while falling building approvals ensures a (modest) downturn in dwelling investment next year, improving population growth has seen housing market fundamentals turn more favourable. Business investment meanwhile is powering and has increased to a record share of state activity, spurred by large projects in the office, retail and energy sectors and also in infrastructure, including \$1bn of projects in the lead up to the Commonwealth Games. These projects will keep investment activity strong in the short-term, having pushed the stock of non-residential construction in the pipeline just short of record levels. With a number of new major projects also either in the planning stage or starting up, including the \$2.6bn Mitcham-Frankston Freeway, investment should continue as an important driver of growth.

Victoria's export sector is also enjoying better times, with bumper winter crops underpinning a recovery in the rural sector, higher energy prices providing a windfall for the state's petroleum exporters and an aggressive marketing campaign driving higher numbers of tourist arrivals. With the global economy remaining strong and seasonal conditions still favourable, Victorian exports should continue to improve. The proceeds of ticket sales, broadcasting rights and an influx of international and interstate visitors for the Commonwealth Games in March 2006 will also provide a significant boost to Victorian exports (and the economy) next year.

There are a few risks looming on the horizon. Uncertainty is high about whether demand will be strong enough to meet the large increase in office space set to come onto the market in the next few years and the completion of the Commonwealth Games could see some 'hangover' in investment activity, exports and even consumption. Nevertheless, the outlook for the next few years is strong with state economic growth of around 3½% expected in both 2004-05 and 2005-06.

Queensland

Queensland's star continues to burn brightly with the economy expanding by a strong 5% in 2003-04. This outstanding performance is driving the strongest labour market in the country with employment growing by 4.1% in 2004, twice as fast as the national average. This has pushed the state unemployment rate down to a low 4.8%.

Queensland's export sector looks set to be one of the strongest performing of all the states in the period ahead, underpinned by a booming resources sector. Capacity increases in coal, alumina and aluminium should support strong volume growth while surging global commodity prices (especially coal) ensures strong income gains to this sector. Queensland's other export industries also look well placed. Continued high beef prices should help offset the constraint to sales from herd rebuilding in Queensland's biggest rural industry while the tourism sector is also set for another good year on the back of a continued robust global economy.

The fastest rate of population growth in the country, fuelled by strong rates of interstate and international migration, will also continue to provide significant support to Queensland's economy. This should keep household consumer spending strong, although a repeat of last year's phenomenal performance (volume growth of 8.8%!) looks unlikely. While the booming resources sector is keeping private business investment solid, Queensland's population explosion is also underpinning a strong public investment program in infrastructure, with the State Government committing around \$6.4bn to projects in roads, rail, port, gas and electricity in 2004-05.

One sector that is set for some moderation in the short-term is Queensland's runaway housing market. Building approvals are down by around 20% from year-ago levels, although a record level of residential work-in-the-pipeline will keep the downturn in actual dwelling activity relatively modest. Queensland's phenomenal house price growth of recent years is also stalling. Affordability limits will constrain house price growth in the years ahead with Brisbane houses having now overtaken Sydney as the least affordable in the nation.

Apart from some cyclical downturn in housing, the outlook for Queensland's economy is strong. ANZ is forecasting growth of around 4½% in 2004-05 and 4¾% in 2005-06.

Western Australia

Western Australia's economy is dominated by the export-oriented mining sector and so swings in time with gyrations in global industrial production. It is no surprise then to see that the strongest global economy in 20 years propelled Western Australian economic growth to a decade high of 7.5% in 2003-04, more than twice the national growth rate! Not content with winning the title of

strongest economy, Western Australia also now has the lowest unemployment rate of all the states at 4.4%.

Strong global demand, particularly from resource-hungry China, has seen investment in Western Australia's resources sector skyrocket. There is about \$4bn of projects currently under construction with Access Economics reporting an additional \$2.9bn of projects committed in this sector with another 122 projects (worth at least \$40bn) under consideration or possible! This massive investment program will significantly expand the state's production and export potential and, with resource commodity prices currently booming, the outlook for Western Australian exports over the next few years is nothing short of outstanding.

The windfall from Western Australia's resource exporters is also paying big dividends for its domestic economy, spurring strong employment and household income growth. This in turn is keeping household consumption strong, with retail sales in the West currently growing three times faster than the national average. Strong conditions for households and solid population growth will ensure that Western Australia's housing market experiences a more modest cyclical downturn compared with most other states this year. Indeed, housing investment is well placed to take off again in 2005-06 with housing finance approvals in the State shooting up to a record high in recent months. The strong resources sector is also prompting significant new investment in related sectors, with infrastructure spending strong and office building commencements also picking up as the resource sector steps up demand for 'front office' space and related professional and business services expand.

The heavy reliance of the Western Australian economy on the global cycle does bring significant risks. That said, the drivers of the current upturn, especially the rise of China, are unlikely to reverse anytime soon. The Western Australian economy is therefore expected to remain the leader of the states and grow by around 5½% in 2004-05 and around 4% in 2005-06.

South Australia

The South Australian economy outperformed the national average in 2003-04 as a near record crop harvest, big investment spending and a booming housing market underpinned strong growth of 4.3%. This propelled the state's unemployment rate to a multi-decade low 5.1%.

The South Australian economy is well known for its zig-zag growth pattern and, once again, after the strong performance of last year, some cyclical slowdown looks likely over 2004-05. This will be led by a moderation in housing investment, with building approvals well off earlier peaks, and a fall in rural crop production due to recent adverse seasonal conditions. In addition, the higher A\$ will likely offset some of the benefits to South Australia's manufacturing-dominated export sector from strong global growth.

That said, the cyclical swings in South Australian economic growth are progressively becoming less volatile. Indeed, recent strong investment in manufacturing and infrastructure, an improved competitive environment for businesses and a pleasing uptick in its (still low) population growth rate makes us more positive on South Australia's 'economic fundamentals'. This is underpinning a solid business investment program, with projects in manufacturing (motor vehicles, wine, and paper), electricity and transport leading the way. As well as adding to the productive capacity of the state, these investment projects are also keeping labour market prospects firm. This, in turn, is setting up the housing sector for another good year in 2005-06 with housing finance approvals picking up sharply in recent months to be back at record highs.

South Australian economic growth looks set to slow to around 2½% in 2004-05 before rebounding to around 3.0% in 2005-06. Nevertheless, the oldest population in the country, an export-sector with a bigger than usual vulnerability to the higher A\$, a relatively small share of Australia's booming resources sector and a relatively large agricultural sector means that the short-term outlook for South Australia has more risks than the average state economy.

Tasmania

The awakening of the Tasmanian economy continued last year with state output expanding by a solid 3% in 2003-04, below national growth of 4.0% but higher than this state's medium-term average growth rate of 2.0% per annum. Tasmania's labour market responded strongly with the unemployment rate falling to a 20-year low 5.7%.

A turnaround in population growth, the most affordable housing market in the nation, strong investment spending (mainly in infrastructure) and a booming tourism market, largely as a result of a significant expansion in transport capacity to the island state has been behind Tasmania's recent

strong performance. Notwithstanding some cyclical slowdown, all of these factors should remain supportive in the period ahead. Projects in road and energy are keeping the investment pipeline solid while airfare wars should keep the tourism dollars flowing in. After a sharp fall last year, Tasmania's international merchandise exports have also started to recover, although the higher A\$ remains a considerable hurdle. Tasmania's housing market also still looks relatively well placed. While a fall in building approvals should underpin a modest downturn in activity this year, a recent rebound in housing finance approvals suggests the market still has plenty of steam. Indeed, housing completions are still running below underlying demand, implying a net shortage of houses in the state. With house prices in Hobart still below our estimate of 'fair value' and the recovery in population growth set to

support ongoing demand for dwellings, the medium-term outlook for investment and prices in Tasmania's housing market remains strong.

Cyclical swings in the housing market will likely see economic growth in Tasmania moderate to around 2.0% in 2004-05 before rebounding to around 2½% in 2005-06.

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