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The RBA has achieved its desired slowing in the economy, with consumers feeling the most pain.. The recent easing in financial pressures – lower interest rates, lower fuel prices and a lower A\$ - should boost activity through 2009, although the RBA will need to continue to constrain growth to a little below trend to allow room for inflation to subside. *Page 2*

New South Wales: On the brink

The New South Wales economy has been buffeted particularly hard by the headwinds of high interest rates and high fuel prices. With final demand turning negative in the June quarter and retail sales, building approvals and employment all falling further since then, there is a palpable sense that the economy is on the brink of recession. *Page 4*

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The big picture

The hard rain falls on NSW

Economic momentum in Australia has been slowing for 18 months. In the June quarter 2008 GDP increased at a trend annualised rate of just under 2%, about one third of the pace in the March quarter 2007. This slowing has not been an accidental response to slowing global growth or the shakeout in the global financial system. Rather, it has been a cooling deliberately engineered by the Reserve Bank of Australia, through progressive increases in interest rates, in order to dampen uncomfortably high price pressures.

The slowdown has not been even across all sectors of the economy. The primary burden of higher interest rates has been borne by the household sector. In conjunction with higher fuel prices and a moderation in household asset values, this has led to a significant slowing in household consumption. A spillover effect of subdued household spending power has been continued softness in dwelling construction. In contrast, business investment has remained very strong, largely but not only in mining, and business profitability has remained high, despite the recent quarter century high in the A\$.

The relative performance of the states can be viewed in the light of the differential performance of the household and business sectors. Those states with a greater reliance on domestically generated demand and the activity of the household sector have performed less well while states and territories with a greater reliance on business spending and investment have continued to do relatively better.

The state which has been most negatively impacted by these developments has been New South Wales. New South Wales was the only state to experience negative growth in state final demand in the June quarter. No other state came remotely close; the next slowest growth in the quarter was a perfectly respectable positive 1% by South Australia. New South Wales has suffered the perfect storm. Its households are the most highly indebted, and so most sensitive to higher interest rates. Population growth is the second slowest in the country. Sydney is (arguably) the financial capital of Australia, and is bearing the brunt of financial market uncertainty. The residential construction industry is in recession, partly due to lack of demand, but also due to the highest government developer fees and charges. And the business investment boom has largely bypassed the state. As a result, New South Wales is one of only two states in which employment is now falling (the other is the Australian Capital Territory).

Looking forward, the squeeze on the household sector will loosen now that financial pressures are beginning to ease. The September cut in the official cash rate is likely to be followed by another 25bp reduction by year end. Petrol prices have fallen in response to the sharp fall in global oil prices. And for the business sector the nearly US\$20 fall in the A\$ will boost exporters incomes, and also improve international competitiveness, important for hard hit export service industries such as tourism. Combined with still strong business investment, this should produce a lift in the growth rate of all states through 2009, but particularly for New South Wales.

It would not do though to become too optimistic about the short term upside for growth. The dominant influence over the next year or so will be the Reserve Bank's desire to hold Australian GDP growth a little below trend – say at no more than 3% - to allow room for inflationary pressures to subside. With some states continuing to grow more quickly than that on the back of very strong business investment, states such as New South Wales with a heavier reliance on domestically generated demand will continue to lag the pack.

The slowing in economic growth reflects deliberate monetary policy action

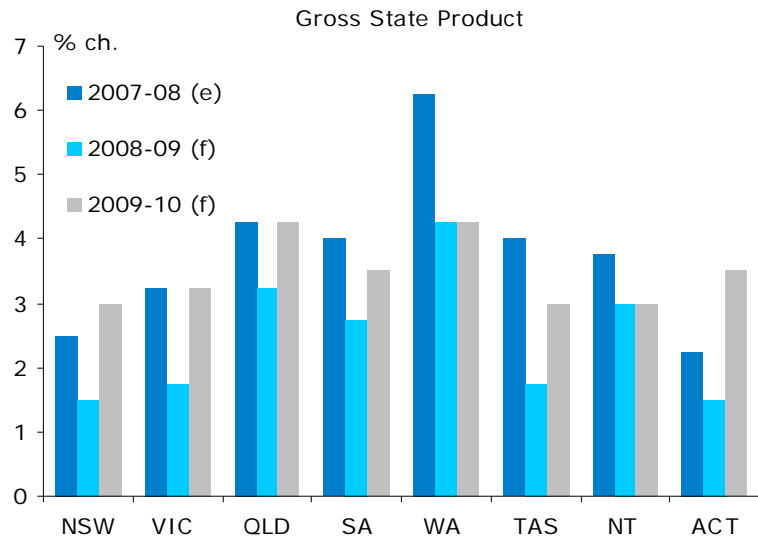
Households have been hardest hit by high interest rates

The slowdown is most marked in NSW, where households are more indebted on average

Financial pressures are easing...

...but the resource-rich states will continue to outperform

Resource-rich states to continue to outperform



Sources: Australian Bureau of Statistics and ANZ

New South Wales: On the brink

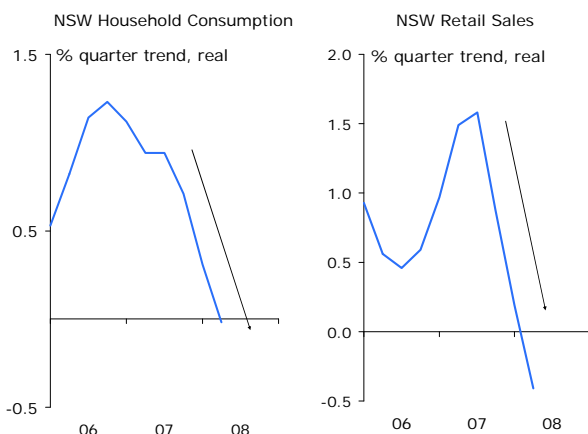
Tony Pearson, Deputy Chief Economist

NSW leads the pack into negative growth

For some time now we have been warning of a sharp slowing in New South Wales economic activity. Unfortunately that prediction has now come true, with state final demand contracting by 0.1% in the June quarter. New South Wales was the only state to experience negative growth. And what was particularly galling is that no other state came remotely close; the next slowest growth in the quarter was a perfectly respectable +1% by SA.

In the June quarter spending by households was very soft, with consumption falling by 0.8%. Private sector investment was also weak, falling by 0.3%, the second consecutive quarterly decline. Within this, falls in dwelling investment were only partly offset by small increases in non-dwelling business investment. The saving grace was continued solid spending by governments on both consumption and investment which prevented a more dire overall outcome for state final demand.

NSW household spending heads south



Source: Australian Bureau of Statistics

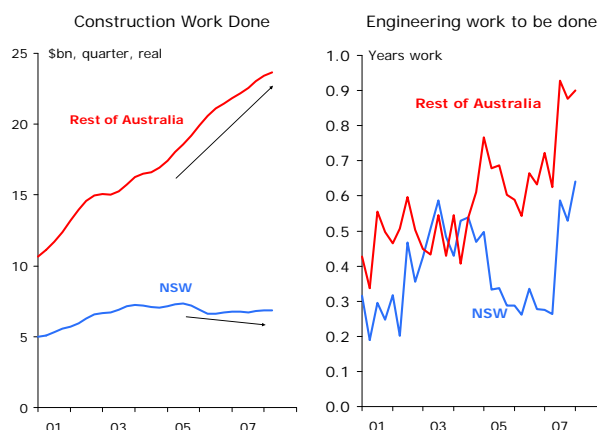
Early data suggest activity continued to cool into the September quarter. The residential sector remains very weak. Trend dwelling construction approvals fell by 1% in July, continuing the persistent decline evident through 2008. The number of housing finance commitments for owner occupation declined by 3.9% in July to be down 23% from the December peak.

Non-residential construction has also been weak in 2008. The trend value of non-residential construction approvals in July was 4.5% lower than at the December 2007 peak.

These recent trends continue the long standing weakness in the New South Wales construction sector. Since peaking in the September quarter 2005, construction work done in New South Wales has declined by 6½%. Over the same period construction work done in the rest of Australia has increased by nearly 28%. And this relatively poor

performance is unlikely to be turned around anytime soon. The pipeline of engineering work yet to be done in New South Wales remains lower than in the rest of Australia when expressed as a multiple of the current pace of work done.

The business investment pipeline remains weak



Source: Australian Bureau of Statistics

The weakness in economic activity is beginning to impact on the labour market. Employment fell in trend terms in May through August, and the trend unemployment rate has edged up to 4.8% from a recent low of 4.5%. To emphasise that point, people in New South Wales are now losing their jobs!

Why is New South Wales, the largest state economy in Australia, performing so poorly? The economy has been buffeted particularly hard by the headwinds of high interest rates and high fuel prices. Households in this state have the highest debt servicing burden, so that financial pressures have a commensurately larger impact in terms of reduced household spending. High interest rates are also continuing to weigh on the residential construction sector by reducing what is already a low level of affordability and adding to the chronic shortage of dwellings across the state. And the state lacks the buffer of a large and buoyant mining sector, with mining contributing just over 2% of gross business value add, compared with around 30% for WA.

A failed privatisation, a mini budget and a new team

With the private sector having essentially gone on strike, with consumption and overall investment heading south, one might expect the state government to step up to the plate with a bit of old fashioned fiscal pump priming and an increased infrastructure spend. And, as we reported in our last quarterly, that was the intention in the 2008-09 state budget.

A key component of that strategy was the privatisation of the state's retail and generation electricity assets, which was expected to raise up to \$15bn for use in the expanded infrastructure program.

Unfortunately the wheels have now largely fallen off with the defeat of that proposal in the upper house. Plan B is a slimmed down privatisation, with the sale of the retail distribution assets, retention of existing generators in government hands, but with future generation capacity to be (potentially) provided by the private sector. This plan could raise up to \$7bn but leaves something in the order of a \$10bn hole in the government accounts.

As a result of the failure of the full privatisation plan in late August, Standard and Poor's (S&P) put the NSW Government and the NSW Treasury Corporation on a negative credit outlook, threatening the much prized and hard won AAA rating. NSW had already flagged a significant rise in borrowings even including the planned privatisation proceeds. State net debt bottomed in 2005 at 4.7% of GSP and had been projected to rise to 7.3% in 2009 and 9.1% in 2012. Without some adjustment to these plans S&P judges there is a risk that debt levels will rise to levels inconsistent with a AAA rating.

The fiscal woes worsened with the announcement by departing Treasurer Costa of a significant deterioration in the states finances in the first two months of the financial year, with lower revenue (due to reduced property stamp duty) and a blowout in spending (largely in health). The Government has announced a mini Budget for mid November.

The climate of uncertainty has not been improved by the replacement of much of the cabinet, including the Premier, Deputy, and Treasurer. The new Premier Rees has announced the mini budget will focus on savings with an eye to preserving the AAA rating. While this is understandable from a fiscal viewpoint, any significant cutting of expenditure will further dampen demand and exacerbate the economic deterioration.

Economic activity should lift through 2009

While the current state of play is bleak, we expect economic activity to begin to lift as some of the headwinds wane. The financial pressures on households will ease in the second half of this year. Household income tax cuts of \$11bn nationally took effect on 1 July, substantially lifting disposable income. Also, the Reserve Bank's September 25bp cut in the cash rate is expected to be followed with another 25bp reduction before year end, easing the household debt repayment burden. These twin boosts to disposable income will be augmented by falls in the price of fuel. Together these factors could be expected to provide a boost to household spending, although weakness in the jobs market and a continued desire to consolidate household finances might engender caution into household spending decisions. Improved household incomes in combination with lower interest rates will also improve borrowing capacity, so demand for credit might be expected to lift, although again we expect households to be cautious. This will improve the capacity to purchase dwellings, flowing through into stronger dwelling construction in 2009. Business investment more generally could be expected to swell as these positives flow through. The danger is that this cautious lift in private sector activity might be offset by the mooted cutbacks in government spending. Public sector consumption (primarily wages) comprises around 16% of state final demand, with public sector investment contributing another 4%. Significant reductions in spending in this one fifth of demand could have substantial impacts on overall economic activity.

We expect economic growth to slow sharply to 1½% in 2008-09, from an estimated 2½% in 2007-08. But economic activity should lift in 2009-10 to around 3.0%, with growth staying at around this pace in 2010-11.

Economic data – New South Wales

Monthly data (% change)	Mar-08	Apr-08	May-08	Jun-08	Jul-08	Aug-08
Retail sales	-0.6	-0.1	0.4	-0.8	-0.8	n.a.
Private building approvals	1.5	-7.2	4.7	-0.7	-3.1	n.a.
Employment	0.4	-0.1	-0.5	0.3	-0.5	-0.5
Unemployment rate, %	4.4	4.5	4.7	4.6	4.7	4.9
Quarterly data (% change)	Mar-07	Jun-07	Sep-07	Dec-07	Mar-08	Jun-08
Household consumption	1.0	0.4	1.1	1.1	0.3	-0.8
Private investment	4.3	5.8	0.7	2.4	-0.1	-0.3
Public demand	-1.1	1.4	-0.3	1.5	2.5	2.1
State final demand	1.2	1.6	0.8	1.4	0.6	-0.1
Population, ann. % ch.	1.0	1.1	1.0	1.1	n.a.	n.a.
Median house price – Sydney, '\$'000s	495.5	514.3	527.4	540.0	535.3	536.9
Annual data (% change)	03-04	04-05	05-06	06-07	07-08 (f)	08-09 (f)
Gross state product	2.1	1.8	2.1	1.8	2.5	1.5
Employment	1.2	1.4	1.7	1.8	2.4	1.0
Consumer prices – Sydney	2.2	2.5	3.0	2.7	3.0	3.6

Sources: Australian Bureau of Statistics and ANZ Economics and Markets Research

Victoria: Outperforming, but for how much longer?

Mark Rodrigues, Senior Economist

The Victorian economy continues to confound the pundits (and economic fundamentals), growing strongly despite numerous headwinds and little meaningful exposure to the resources boom. The question is how long can it continue to defy the odds? We suspect not much longer, and forecast economic growth to almost halve to 1¾% in 2008-09.

Investment drives growth, but a new 'two speed economy' emerges

State final demand grew by 1.8% in the June quarter 2007, among the strongest of all the states and territories. Growth in the quarter was driven by a 9% surge in private business investment, with smaller contributions from dwelling investment (+2.6%) and public demand (+2.4%).

But before we get too carried away with these impressive numbers, it is worth bearing in mind two important points. First, and in part reflecting the strength of investment in the state economy, imports are similarly booming. International imports increased by 2.2% in the June quarter and by 11.6% over the year, which will moderate overall growth in gross state product.

Second, the aggregate figures mask significant weakness in the consumer sector. Household consumption in Victoria fell by 0.4% in the June quarter, the first decline since the December quarter 2002, and the largest quarterly fall in over a decade.

The divergence in the fortunes of the corporate sector, which continues to spend up big on investment, and consumers, who are now clearly in consolidation mode, is emerging as the new 'two speed' economy.

Households set for an extended period of consolidation

Unfortunately for households – and businesses reliant on discretionary consumer spending – the caution implicit in the soft consumer spending figures in Q2 is likely to persist for a little while yet.

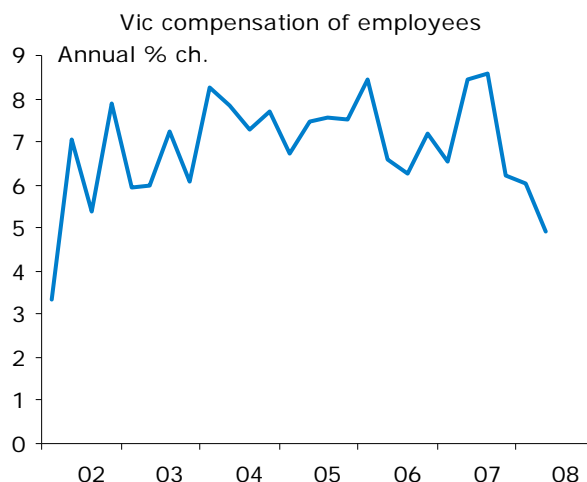
There are a number of reasons for this:

- Confidence remains fragile, and the atmospherics – particularly around the slowing domestic economy and ongoing global financial market turmoil – are unlikely to support a reversal any time soon.
- Cost pressures continue to take a toll. Mortgage and rental burdens have risen sharply in recent years, and have been compounded by higher fuel, food and utilities prices. While both interest costs and petrol prices have eased marginally in recent

months, they remain high relative to even a year ago.

- Income growth has begun to slow. Growth in employee compensation in Victoria slowed to 4.9% in the year to the June quarter 2008, down from 8.5% per annum a year earlier and the slowest rate in over six years. While the latest round of income tax cuts will provide a fillip for households from the September quarter – and indeed was reflected in a massive 3.5% jump in nominal retail sales in Victoria in July – longer term, it is unlikely to offset the effect of slowing employment growth on aggregate incomes.

Income growth for Victorian employees has fallen to its lowest level in over six years



Source: Australian Bureau of Statistics

- Finally, household balance sheets have taken a significant hit with the fall in the Australian equity market compounded by an abrupt halt in established house prices in Melbourne, which up until recently, had been growing at rates in excess of 20% per annum.

The good news is that while the consumer slowdown is likely to play out over an extended period of time, it should be shallower than might otherwise be expected in an economic downturn. The reason is that this time around, businesses are not – and importantly, are not planning to – shed jobs *en masse*. Corporate profitability remains sound and, as discussed below, investment intentions remain strong. So while employment growth has clearly slowed in Victoria, we do not expect to see a significant lift in the unemployment rate from current generational lows.

Another saving grace for Victoria – and in stark contrast to its northern neighbour – is that population growth remains very strong. Over the year to the December quarter 2007, Victoria's population grew by 1.6%, behind only the boom economies of Western Australia, Queensland and

the Northern Territory, and the highest since quarterly data are available back to the early 1980s.

If they come, we will build it...

A natural consequence of Victoria's burgeoning population is that there is increasing demand for residential accommodation. And the sector has been only too happy to oblige. Dwelling investment increased 9% over the year to the June quarter, while private building approvals are up some 16% in the past year.

However, even this has been insufficient to sate demand, and, as a result, the Melbourne housing market has tightened markedly. Advertised rents surged 18.8% over the year to June and rental vacancies have fallen to their lowest levels in 25 years.

Up until recently, Melbourne house prices had been booming, rising at rates of up to 23% per annum. However, house prices stalled in the first half of 2008 and are expected to remain subdued in the months ahead. Home-buyer sentiment has weakened and is *temporarily* outweighing the positive underlying market fundamentals.

While negative sentiment and a slowing economy present some downside risks to the housing market in the near term, interest rate cuts should buoy the Melbourne housing market and see prices grind higher in 2009.

Investment is booming, with the promise of more to come

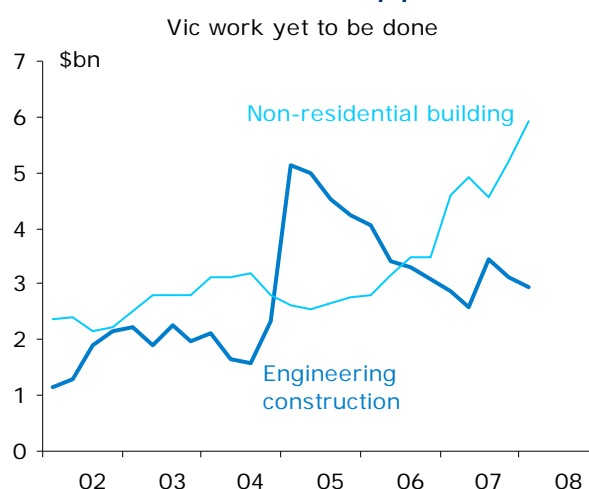
With consumers in consolidation mode and the local housing market temporarily stalled, Victoria's growth is being generated by investment, both from the private and public sectors. Private business investment lifted 9.1% in the June quarter 2008, while public investment was up 9.9%.

The investment boom in Victoria has been prompted by a combination of increasing strains on public

infrastructure such as roads and rail as the population grows, a strong local economy, and environmental concerns.

Importantly, there are good signs the boom still has some way to run. Non-residential building work yet to be done stood at \$5.9bn at the end of the March quarter 2008, up almost 30% on a year earlier. The engineering construction pipeline has slipped somewhat from recent highs with the completion of a number of major road projects, but still remains relatively healthy. Data from the latest Access Investment Monitor lists a further \$54.7bn worth of investment as either 'under consideration' or 'possible'

Still a significant amount of non-dwelling construction in the pipeline



Source: Australian Bureau of Statistics

Overall then, Victoria's medium term outlook is sound, underpinned by strong investment prospects and solid fundamental underpinnings including healthy rates of population growth.

Economic data – Victoria

Monthly data (% change)	Mar-08	Apr-08	May-08	Jun-08	Jul-08	Aug-08
Retail sales	0.2	-0.2	0.6	-2.1	3.5	n.a.
Private building approvals	-1.9	-7.7	3.3	8.9	4.6	n.a.
Employment	-0.7	0.5	0.3	-0.2	-0.1	0.3
Unemployment rate, %	4.3	4.7	4.3	4.6	4.6	4.3
Quarterly data (% change)	Mar-07	Jun-07	Sep-07	Dec-07	Mar-08	Jun-08
Household consumption	1.1	0.6	0.9	1.4	0.8	-0.4
Private investment	4.0	1.6	3.7	1.1	-0.5	7.0
Public demand	-3.7	1.5	-1.5	2.0	0.8	2.4
State final demand	0.8	1.0	1.1	1.4	0.5	1.8
Population, ann. % ch.	1.5	1.5	1.6	1.6	n.a.	n.a.
Median house price – Melbourne, \$'000s	335.3	359.5	377.8	406.0	411.2	410.0
Annual data (% change)	03-04	04-05	05-06	06-07	07-08 (f)	08-09 (f)
Gross state product	4.4	2.4	2.5	2.7	3.3	1.8
Employment	1.7	3.1	1.7	2.7	2.7	1.3
Consumer prices – Melbourne	2.3	2.0	3.1	2.6	3.6	3.5

Sources: Australian Bureau of Statistics and ANZ Economics and Markets Research

Queensland: Coping well against the headwinds

Tony Pearson, Deputy Chief Economist

Continued solid performance

Queensland continues to enjoy a solid pace of economic expansion. State final demand increased by 1.2% in the June quarter for a rate of growth over the year of 5%. That was respectable, although it ranked fourth behind Western Australia, Northern Territory and Tasmania, and was the slowest rate of growth in Queensland since the September quarter 2005. Growth in the quarter was driven by solid private household spending (+0.6%), strong business investment (6.6%) and solid spending on dwellings (2.9%). Public sector spending was softer than in recent quarters but still positive at 0.6%.

Queensland's growth continues to be supported by very strong population growth. Over the year to December the population increased by 2.35%, in line with Western Australia and the Northern Territory in percentage terms. But it was the largest increase in absolute terms (96,900) of any of the states and territories, with the next closest being Victoria, with an increase of 82,400, and with New South Wales ranking a distant third with 72,900. Queensland continues to be a magnet for Aussies from elsewhere, attracting 25,600 interstate immigrants over the year to December.

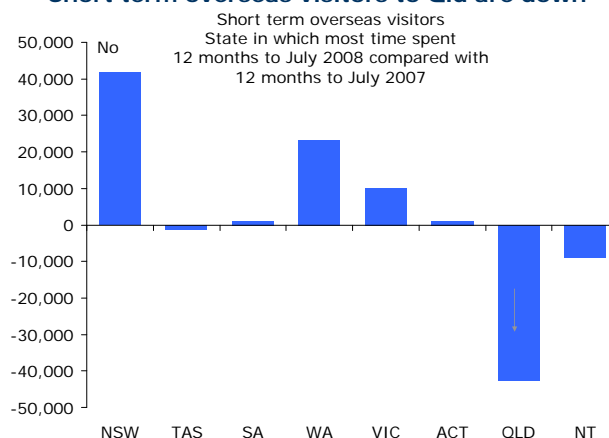
Within this generally favourable story there are however some weak spots. Residential construction activity is decelerating rapidly. Trend approvals to construct dwellings fell by 22% over the 9 months to July, to the lowest level since December 2001. Although Queensland has the highest absolute population growth, the number of dwellings approved for construction is running around 16% lower than in Victoria. The value of housing finance approvals for owner occupation has also fallen sharply, with the flow of approvals in June running close to 30% lower than a year earlier. High interest rates have eroded the willingness and ability of Queenslanders to invest in housing.

This is reflecting in dwelling prices. The quarterly rate of increase has been decelerating since mid 2007, and in the June quarter prices of established houses rose by only 0.6%, the slowest since September 2005. Still, Queenslanders have not got too much to complain about on this front, as prices in some state capitals are now actually falling (Perth, Hobart and Canberra) or are flat (Sydney).

The tourism sector has also continued to suffer under the combined weight of the high A\$ and high fuel prices. The number of short term overseas visitors who spent most of their time in Queensland was 2.5% lower over the year to July than in the previous 12 months; that is a loss of 42,600 visitors. That decline was not Australia wide; over the same period New South Wales lifted short term

visitor numbers who spent most of their time in the state by 41,700.

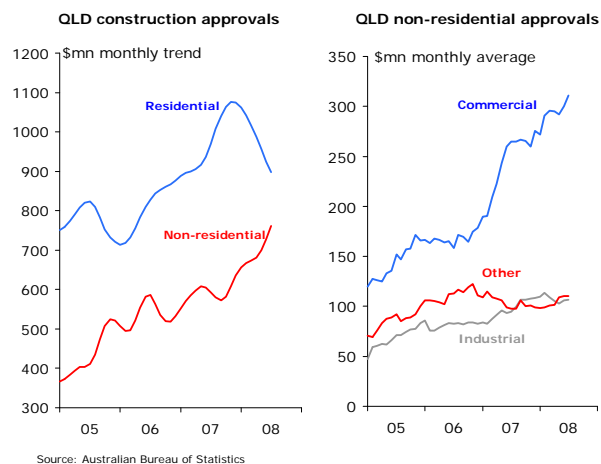
Short term overseas visitors to Qld are down



Source: Australian Bureau of Statistics

In contrast to the softness in residential construction, activity in non-residential construction remains very buoyant. Approvals for commercial property (retail and wholesale, transport, and offices) in particular are very strong, increasing by 17% over the year to July. And the volume of engineering work done rose by close to 25% over the year to the March quarter, with the pipeline of work yet to be done lengthening to around 10 months. This is indicative of very strong business investment in the state.

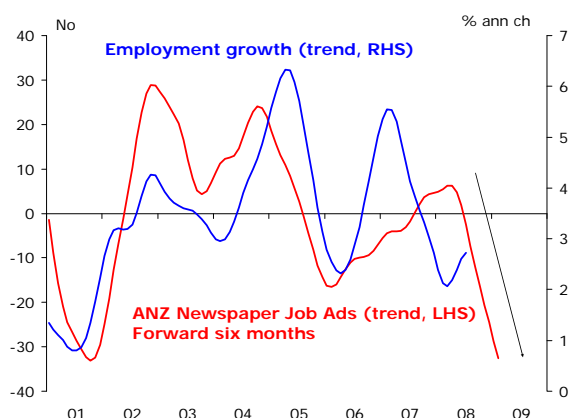
Residential construction down, non-residential up



The general economic buoyancy is supporting growth in employment at an annual trend rate of 3.1%, while the unemployment rate remains around 3.6% (trend), comfortably below the Australian average (4.1%).

Having said that, leading indicators suggest the demand for labour has cooled through 2008. ANZ data show the number of Queensland newspaper job advertisements has fallen in every month of 2008 in trend terms, and suggests that annual growth in employment could cool substantially into 2009.

ANZ Newspaper Job Advertisements point to slowing employment growth in Qld



Source: Australian Bureau of Statistics and ANZ.

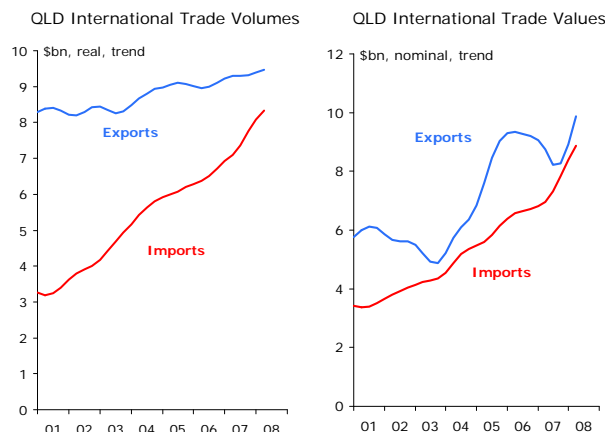
Wages growth continues to cool. Over the year to the June quarter the Wage Price Index rose by 3.9%. This was the third slowest growth rate of all the states and territories, and continued the progressive slowing from the peak growth rate of 4.8% in the June quarter 2006.

The combination of slowing employment growth and muted wage outcomes would normally mean slower growth in household disposable income. There was some offset from 1 July this year from the personal income tax cuts, and disposable incomes will be further boosted by lower interest rates and lower fuel prices. Overall, household spending power is expected to remain buoyant.

The mining boom has been a key driver of economic activity in Queensland since the early 2000s. But what is less well appreciated is that the volume and value of imports has increased more quickly than that of exports. This partly reflects strong household consumption growth, but also is a result of strong

imports of equipment and intermediate inputs as a component of strong business investment. This has produced the somewhat quirky situation where net export volumes have detracted from growth in gross state product over most of the 2000s.

Imports rise more quickly than exports



Source: Australian Bureau of Statistics

This situation is likely to continue for some years yet. There is significant investment in the pipeline (commenced but not yet completed) and the value of committed projects not yet begun continues to increase. This will lead to continued solid increases in imports of machinery and equipment. Export volumes will continue to rise steadily, but the rate of increase will be limited by the speed with which production capacity can be increased and infrastructure bottlenecks are relieved.

Growth in gross state product is estimated to be a respectable 4.25% in 2007-08. Growth will cool in 2008-09 on the back of weaker household consumption and a continued drag from net exports, but will lift in 2009-10 as the benefits from lower interest rates and A\$ begin to flow more strongly.

Economic data – Queensland

Monthly data (% change)	Mar-08	Apr-08	May-08	Jun-08	Jul-08	Aug-08
Retail sales	0.7	-1.1	0.9	-1.0	2.5	n.a.
Private building approvals	-16.5	41.3	-25.8	-2.1	-10.1	n.a.
Employment	0.1	0.3	0.4	0.0	0.8	0.6
Unemployment rate, %	3.7	3.8	3.8	3.8	3.7	3.3
Quarterly data (% change)	Mar-07	Jun-07	Sep-07	Dec-07	Mar-08	Jun-08
Household consumption	1.7	0.7	1.0	1.8	0.4	0.6
Private investment	7.9	1.4	-2.6	3.1	2.7	2.9
Public demand	-0.5	10.0	0.2	3.4	2.1	0.6
State final demand	2.8	2.8	-0.1	2.5	1.4	1.2
Population, ann. % ch.	2.3	2.2	2.2	2.3	n.a.	n.a.
Median house price – Brisbane, \$'000s	351.1	373.5	391.6	412.0	423.1	425.7
Annual data (% change)	03-04	04-05	05-06	06-07	07-08 (f)	08-09 (f)
Gross state product	6.4	4.6	3.6	4.9	4.3	3.3
Employment	3.3	5.2	3.5	4.6	2.8	2.0
Consumer prices – Brisbane	2.9	2.6	3.1	3.3	4.1	4.2

Sources: Australian Bureau of Statistics and ANZ Economics and Markets Research

Western Australia: A strong but more challenging outlook

Mark Rodrigues, Senior Economist

Western Australia retains one of the strongest economies of all the states and territories, though even it has not escaped the pull-back in consumer spending evident across the country in the second quarter. Add to this falling commodity prices, a housing market that is now clearly past its peak, disruptions to the state's gas supplies through the second half of 2008, and uncertainty over the political leadership of the state following the recent election, and it becomes clear that the state economy faces a challenging period ahead.

Overall, we expect GSP growth to slow to 4¼% in 2008-09 from an estimated 6¼% in 2007-08.

Still booming

The Western Australian economy continues to be amongst the strongest performers in the country. State final demand grew by 2.4% in the June quarter to be 7.2% higher over the year. The result was all the more impressive considering the 3 June explosion on Varanus Island, which knocked out 30% of the state's gas supplies, would certainly have weighed on growth in the last month of the quarter.

The result was driven by investment, with business investment growing by 6.4% in the quarter and dwelling investment up 11.6%. On a less positive note, public demand eased 1.2% while exports fell by 5.7% in the quarter; a likely sign of the impact of the gas crisis on the state's economy in the quarter.

The mighty Western Australian consumer showed its first signs of discomfort in the current cycle, with growth in consumption slowing to just 0.1%. But unlike some other parts of the nation, there are good reasons to think that in Western Australia this was just a temporary phase which consumers will snap out of.

In particular, when all is said and done, the financial fundamentals of the Western Australian consumer remain extremely sound. Employee compensation, for example, grew by 3% in the June quarter alone, and more than 14% in the past year. A key driver of household incomes in the state has been its labour market, and this continues to look as strong as ever. Employment grew by 1.3% in August and 4.4% over the previous year. This has been sufficient to keep the unemployment rate at generational lows of 2.8%. Tightness in the state's labour market is flowing through to wages, with the Wage Price Index growing by 1.4% in the June quarter – second only to the Northern Territory – and by 5.6% over the year.

While still early days, the 1.6% surge in retail sales in July will provide some confidence to businesses reliant on consumer demand.

Housing market has plateaued, but fundamentals remain sound

On the housing front, the market has clearly peaked. In the established market in Perth, prices fell by 2.4% in the June quarter, although the top end of the market still appears to be performing solidly with growth of just under 5%. There is potential for ongoing softness in prices in the coming quarters with negative sentiment and poor affordability still weighing on the market. However, this should be viewed in the context of a doubling of median prices in the past 5 years.

Poor sentiment is also hanging over the residential construction market. While dwelling investment grew strongly in the June quarter, forward indicators point to a bleak second half, with private residential building approvals now down over 18% on year ago levels.

Somewhat perversely, fundamentals actually dictate that Western Australia should be building more rather than less houses. The state's population grew by 2.4% in the year to the December quarter 2007, the fastest pace of any state and the fastest in Western Australia for over 20 years. As a result, underlying demand for housing is continuing to grow well in excess of the rate of new building, and increasingly so, raising the pressure on a market where vacancy rates are already hovering just over 1%.

Not surprisingly in such a tight market, rents are on the rise. 'Advertised' housing rents grew 13% and 18% in Perth and country WA respectively. With the market likely to tighten further as new construction eases, rents are expected to continue to grow strongly in the year ahead

A more challenging business environment

The business environment has become more challenging. In addition to the deteriorating global and domestic economic backdrop confronting all regions around the country, the Western Australian economy is now contending with falling resource commodity prices and constrained gas supplies as a result of the explosion on Apache Energy's gas processing facility at Varanus Island.

The impact of the latter on business has been significant, with users of energy generated from Apache's gas facing higher costs and in some cases, reduced supply. The Chamber of Commerce and Industry Western Australia estimates that the cost of the crisis will total around \$6.7bn, while the RBA has estimated it will wipe ¼ of a percentage point from GDP in the June and September quarters. The latest advice from Apache is that full supply will resume by the end of the year.

The impact of the commodity price boom on the Western Australian economy is best summarised by

the massive escalation in the state's terms of trade. Western Australia's goods terms of trade has increased by some 43% in the last 4 years, and most recently, by over 10% in the June quarter alone. The most recent spike reflects the average 85% increase in contract prices for iron ore that took effect from 1 April. The income generated by these price increases has flowed through the states economy via higher employment and wages, increased investment and higher tax receipts for both the state and federal governments.

WA has benefited enormously from the commodity boom, but for how much longer?



Source: Australian Bureau of Statistics and ANZ

But could this all be about to come to an end? Exchange traded resource commodity prices have fallen sharply in the wake of the global credit crisis and increasing concerns about demand conditions. Crude oil prices are down around 25% from their recent peak, lead, nickel and zinc down between

30% and 40% in the past year, and spot iron ore prices down around 20% in the past six months.

The fall in resource commodity prices will likely impact some of the higher cost, more marginal mines. But by and large, the Western Australian economy is insulated from recent market moves for the time being by two key factors. First is that prices for the state's most significant commodity export – iron ore – is largely locked away in annual contracts. The next opportunity to review contract prices will be for the 2009-10 year commencing 1 April 2009. The second thing to bear in mind is that the scale of investment in the mining sector demands a long term view of prices. It is unlikely that short term fluctuations in prices will derail multi billion dollar, multi decade projects, particularly when prices remain high in a historical context even after recent falls.

To underscore this point, consider that even after all the investment that has occurred in the Western Australian economy in recent years, the pipeline of work still to be done continues to grow. As at the end of the March quarter 2008, engineering construction work yet to be done stood at \$23.2bn, up a staggering 57% on a year earlier. Similarly, non-residential building work yet to be done stood at \$2.4bn, up over 44%. All told, Access Economics estimates that the potential pipeline of investment in Western Australia could be as much as \$170bn.

The outlook for the Western Australian economy, then, remains sound, though not without some challenges that will see economic growth return to more sustainable rates.

Economic data – Western Australia

Monthly data (% change)	Mar-08	Apr-08	May-08	Jun-08	Jul-08	Aug-08
Retail sales	1.4	0.9	0.7	0.4	1.6	n.a.
Private building approvals	16.3	-18.1	5.7	-7.2	1.7	n.a.
Employment	-0.2	-0.1	0.0	0.8	1.4	1.3
Unemployment rate, %	3.3	3.3	3.7	3.2	3.1	2.8
Quarterly data (% change)	Mar-07	Jun-07	Sep-07	Dec-07	Mar-08	Jun-08
Household consumption	1.9	1.2	1.1	1.4	1.6	0.1
Private investment	7.8	8.4	1.0	-2.2	5.8	6.9
Public demand	0.0	1.4	0.2	3.6	2.3	-1.2
State final demand	3.6	3.8	0.9	0.4	3.3	2.4
Population, ann. % ch.	2.2	2.3	2.3	2.4	n.a.	n.a.
Median house price – Perth, '\$000s	462.7	454.0	462.0	467.0	460.9	449.7
Annual data (% change)	03-04	04-05	05-06	06-07	07-08 (f)	08-09 (f)
Gross state product	6.4	4.0	4.8	6.3	6.3	4.3
Employment	1.3	4.2	4.9	2.5	3.5	2.0
Consumer prices – Perth	2.1	3.2	4.3	3.9	3.6	4.1

Sources: Australian Bureau of Statistics and ANZ Economics and Markets Research

South Australia: Hitching a ride on the mining boom

Julie Toth, Senior Economist

Unlike the larger eastern states, South Australian spending kept growing (albeit at a slowing pace) in the June quarter of 2008. South Australian economic confidence is holding up better than elsewhere, among both households and businesses, as the state belatedly joins the club of resource-rich states benefiting from the long-running commodity boom.

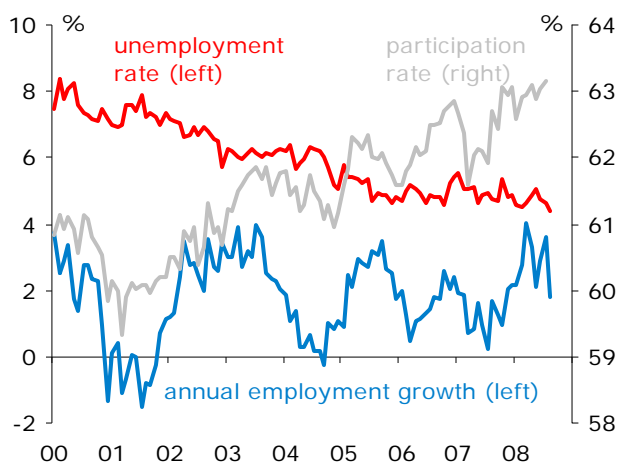
2008: a good vintage for business and jobs

The influence of the mining sector is currently very apparent in South Australia. Exploration activity levels are high (up 17.4% by value in the March quarter of 2008 from a year earlier) and non-dwelling construction bounced back up in the June quarter, to approach the record levels of the same time last year (in real value terms).

Business spending more generally appears to have recovered from its lull at the beginning of the year, but is still not back to 2007's record levels. Total private business investment jumped 3% in the June quarter, but remained 4.5% lower than at June 2007. Similarly, business spending on new plant and equipment was up 4.5% from March (but 3.6% lower than in 2007), while new engineering construction was worth 13.8% more in H1 2008 than in H2 2007 (but was still 5.3% less than the record set in H1 2008).

The previously sleepy north and west of the state are more buoyant. Local populations, residential and commercial construction, and house prices are all on the rise, in response to growing opportunities from mining and the expansion of related activities such as heavy engineering, ports and bulk transport hubs (see our latest ANZ Rural and Regional quarterly).

South Australian jobs growth holding up well



Source: Australian Bureau of Statistics

This burst of business activity is reflected in the local jobs market. South Australian employment is near record levels and despite easing slightly in August, employment growth remains strong. Unemployment is now at a new generational low of

4.4%, although remains slightly above the national rate of 4.1%. The state's labour force participation rate remains at the historically high level of 63.2%.

Murray River remains on the critical list

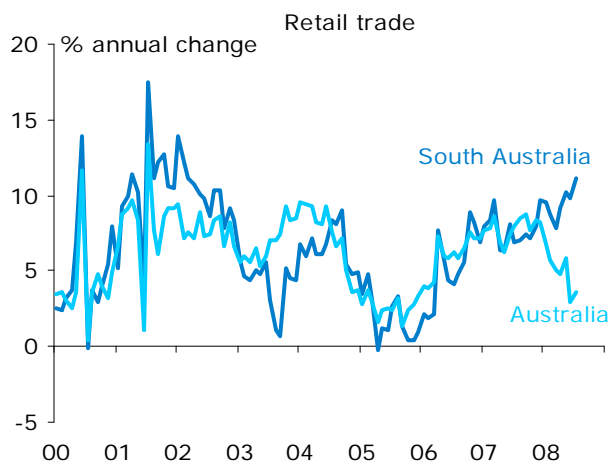
Murray-Darling River basin inflows hit new record lows over winter 2008, after an extended period of prolonged dry conditions. The opening of the irrigation season at 0% allocations in many instances along the Murray highlights the urgency of the debate on future water policy. The economic consequences to irrigation farming in areas without water is increasingly dire, but the environmental costs are also becoming more apparent. Lake Alexandrina, where the River Murray reaches the sea, is now more than half a metre below sea level. As the freshwater lake dries up, it exposes the heavily acid soils, which react to air by producing sulphuric acid. It is increasingly likely that the lake will need to be deliberately flooded with seawater to protect the lake bed from further air exposure.

The state of the Murray — and particularly the future of water allocations from it for irrigation and other purposes — continues to be the darkest spot in an otherwise upbeat outlook for the state's agricultural regions. Naturally, water recycling and infrastructure upgrade projects are a key priority for state and local authorities around the state.

Household spending stays relatively strong

In contrast to the larger states, household consumption, including retail trade sales, have kept growing apace in South Australia. Growth rates have slowed but by no means collapsed. Indeed, South Australian consumption now looks surprisingly strong compared with the rest of the nation. South Australian retail trade grew by 11.1% per annum in July, compared with 3.5% nationally and the highest growth of any state.

Retail trade growth is well above national rate



Source: Australian Bureau of Statistics

The drivers of retail trade growth in South Australia are currently food and household goods retailers.

Hospitality and 'other' retailers also showed healthy growth through H1 2008, with South Australia's hospitality retailers continuing a year-long double-digit growth run that would be the envy of hospitality retailers nationwide.

New motor vehicle sales are also tracking at far stronger growth rates in South Australia than they are in other states. South Australian vehicle sales for the year to August 2008 were 6.7% higher than 2007's record, compared with just 0.7% nationally. This growth was second only to the Northern Territory's roaring car market (up 11.2% in the year to August). Passenger car sales have been particularly strong in South Australia, hitting a recent monthly peak in May 2008 and remaining well above 2007 sales levels into June and July. In contrast, national passenger car sales have been steadily shrinking (in annual growth terms) since January 2008.

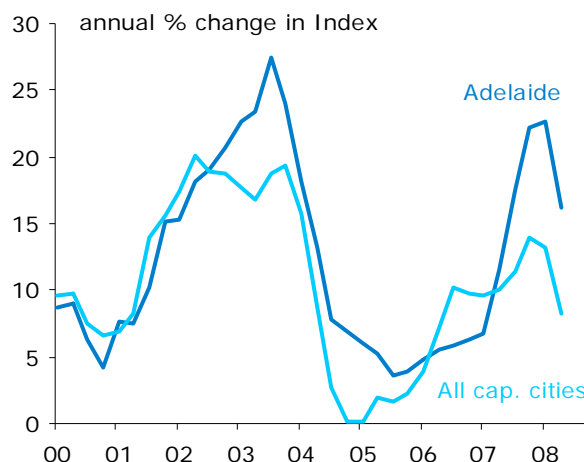
Adelaide's property market is running hot

The South Australian property market has been surprisingly strong given the weaker economy over the past few years. Average Adelaide house prices for example, have doubled over the past six years, including a 22% increase in 2007 alone. Adelaide house price growth has moderated in 2008, but remains well above national average rates. This has been due primarily to a drastic tightening of housing supply/demand state wide, as the local economy surges and population growth picks up pace.

In 2007, 10,300 dwellings were constructed in South Australia, against an estimated underlying demand of 11,900. In 2008, we expect 11,400 dwellings will be built, against an underlying demand of 11,800. Pent-up unmet demand is now approaching 11,000 dwelling units and, with supply continuing to fall short of demand, will reach over

13,000 by 2010 – the equivalent of over 18 months of continuous residential construction activity.

Adelaide house prices outperform other capitals



Source: Australian Bureau of Statistics

Looking forward, the South Australian economy will slow with the rest of the Australian economy in 2008-09, but its more local elements are holding up very well. In particular, employment and household consumption are looking stronger than in the larger states to the east, as the fruits of the state's belated mining boom begin to flow through to the rest of the economy. All of this bodes well for other (non-mining) industries and for the state's housing market going into 2009.

There are also several large and significant state infrastructure projects under way, including key water and transport infrastructure projects. The state of the Murray and the rainfall outlook remain a concern however, for irrigation agriculture and for the state's water supplies more generally. State and federal water initiatives will be crucial going forward.

Economic data – South Australia

Monthly Source: data (% change)	Mar-08	Apr-08	May-08	Jun-08	Jul-08	Aug-08
Retail sales	0.2	0.3	1.4	0.8	1.1	n.a.
Private building approvals	-13.6	15.7	7.9	-0.8	-11.9	n.a.
Employment	0.1	0.0	-0.3	0.6	0.4	-0.3
Unemployment rate, %	4.6	4.9	5.0	4.8	4.6	4.4
Quarterly data (% change)	Mar-07	Jun-07	Sep-07	Dec-07	Mar-08	Jun-08
Household consumption	1.2	0.7	0.7	2.2	1.8	0.7
Private investment	5.5	-0.2	-5.9	-0.9	-1.2	3.0
Public demand	-2.4	0.0	1.0	2.2	1.8	0.1
State final demand	1.3	0.4	-0.6	1.6	1.2	1.0
Population, ann. % ch.	1.0	1.0	1.0	1.0	n.a.	n.a.
Median house price – Adelaide, \$'000s	297.4	315.3	334.4	357.0	364.9	366.4
Annual data (% change)	03-04	04-05	05-06	06-07	07-08 (f)	08-09 (f)
Gross state product	4.3	1.2	2.4	0.8	4.0	2.8
Employment	1.9	1.4	2.0	1.7	2.1	1.5
Consumer prices – Adelaide	3.0	2.3	3.2	2.6	3.3	3.7

Sources: Australian Bureau of Statistics and ANZ Economics and Markets Research

Tasmania: Strongest growth in 4 years

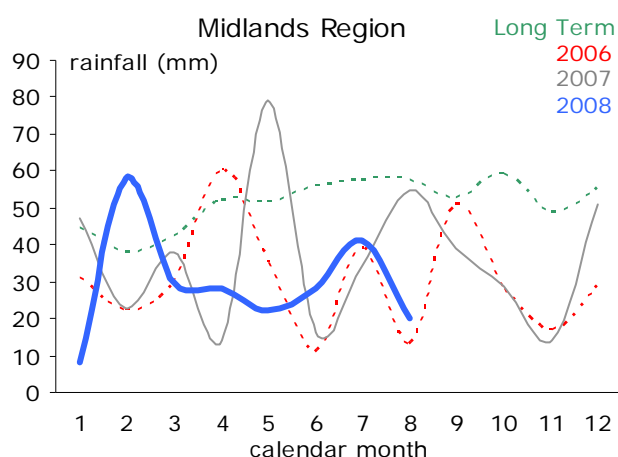
Paul Deane, Economist

Over the last 12 months the Tasmanian economy grew at its fastest rate in four years despite the agricultural sector providing some drag on state output. We estimate that economic growth in Tasmania was 4% per annum in 2007-08.

Highlighting the confidence in the state, private investment grew by 22% annually. This was driven by a large increase in spending on plant and machinery.

In the agriculture sector, production continued to be constrained in many areas by below average rainfall. Areas such as the Midlands and the East Coast of Tasmania have been particularly hard hit. For example, long term average rainfall in the Midlands region is 615mm per annum, but in 2006 and 2007 rainfall was just 366mm and 439mm respectively. Rainfall totals to August in 2008 are so far at a similar level to 2006.

Drought is constraining agricultural output



Source: BOM and ANZ Economics & Markets Research

Economic data – Tasmania

Monthly data (% change)	Mar-08	Apr-08	May-08	Jun-08	Jul-08	Aug-08
Retail sales	0.3	1.4	1.3	-0.5	2.0	n.a.
Private building approvals	-25.5	27.2	3.0	-35.1	100.6	n.a.
Employment	-1.0	2.9	0.7	-0.1	-0.1	2.7
Unemployment rate, %	4.7	4.2	4.3	4.2	4.5	4.0
Quarterly data (% change)	Mar-07	Jun-07	Sep-07	Dec-07	Mar-08	Jun-08
Household consumption	0.9	0.7	2.5	-0.6	1.0	0.3
Private investment	6.2	8.4	-1.6	11.2	-4.0	16.7
Public demand	-1.6	-0.5	-1.6	5.7	1.2	0.1
State final demand	1.1	1.6	0.8	3.0	0.1	3.1
Population, ann. % ch.	0.6	0.7	0.8	0.8	n.a.	n.a.
Median house price – Hobart, \$'000s	284.3	289.9	297.6	310.0	304.4	298.4
Annual data (% change)	03-04	04-05	05-06	06-07	07-08 (f)	08-09 (f)
Gross state product	4.7	3.2	2.8	2.1	4.0	1.8
Employment	4.5	2.7	3.2	0.8	2.7	1.3
Consumer prices – Hobart	2.5	3.2	3.2	2.5	3.0	3.2

Sources: Australian Bureau of Statistics and ANZ Economics and Markets Research

Household consumption has remained solid, rising at a similar rate to the overall Tasmanian economy. Retail sales were resilient in the first half of 2008 in the face of rising interest rates and higher fuel prices. In particular retail sales gained strong momentum over the four months to May. New car sales for the January to August 2008 period increased by 5.2% year-on-year in Tasmania.

Consistent with this relatively healthy level of consumer spending, the labour market has been solid. The unemployment rate in the state has declined to a similar level to the national average.

Housing prices in the state have eased in recent quarters, reflecting a combination of additional supply and weaker sentiment. A significant amount of new stock has entered the market recently, with dwelling starts averaging 2,800 per annum over the last 5 years. The long term average is around 2,700 commencements per year.

Consistent with the rest of Australia, domestic demand in the state is forecast to slow. Economic growth is forecast to be below trend in Tasmania in 2008-09. Those businesses linked to household spending should find conditions more subdued for much of 2008-09. The labour market is also likely to soften. It would not be surprising to see the Tasmanian unemployment rate rise back to early 2008 levels of 5%, given the unemployment rate across Australia is expected to rise slightly over the next 12 months or so.

For 2009 and beyond, the state government is spending an additional \$1bn over the next 4 years, while a return to normal seasonal conditions could help boost the agricultural sector in 2009-10.

Northern Territory: A more sustainable growth path

Paul Deane, Economist

The Northern Territory's economy continued to grow in 2007-08, underpinned by both public and private sector investment and consumer spending. Our estimate remains that the Territory's economy grew by 3.8% per annum in 2007-08.

Business investment remained at very high levels in 2007-08, totalling A\$3.1bn, with investment in plant and equipment a key driver. The last 12 months was also a strong period for public investment, with expenditure increasing by 87%.

In the household sector, retail sales were strong throughout 2007-08, growing by 9% for the 12 months to June 2008. Retail sales rose by 4.1% month on month in July.

Rising sales for new vehicles in the Northern Territory was also apparent. For the 2007-08 financial year, vehicle sales jumped by 10%, driven by an insatiable appetite for Sports Utility Vehicles (SUVs). SUV sales rose by 46% year-on-year and now represent a quarter of all new vehicle sales in the Northern Territory.

An expanding labour market has been a key contributing factor to the growth in retail and new vehicle sales in the Northern Territory. The number of people employed increased by around 5% or 5,000 people in 2007-08, with the unemployment rate falling to 2.6% in August 2008. However we do not expect unemployment to fall further in the Territory over the next 12 months.

A weaker household sector should take some of the heat out of the Territory's economy, but mining investment will continue to underpin the state's economy for some time yet.

The commercial construction market is expected to remain strong in Darwin which will support the

Economic data – Northern Territory

Monthly data (% change)	Mar-08	Apr-08	May-08	Jun-08	Jul-08	Aug-08
Retail sales	0.2	1.8	0.5	0.8	4.1	n.a.
Private building approvals (trend)	-1.2	-4.9	-11.5	-15.9	-13.8	n.a.
Employment (trend)	0.4	0.5	0.5	0.0	0.5	0.4
Unemployment rate, % (trend)	4.2	4.0	3.7	3.2	2.8	2.6
Quarterly data (% change)	Mar-07	Jun-07	Sep-07	Dec-07	Mar-08	Jun-08
Household consumption	2.2	1.1	2.0	0.9	-1.0	0.6
Private investment	9.0	-10.1	8.0	-0.1	1.7	1.8
Public demand	0.2	-3.9	4.7	0.6	2.5	3.8
State final demand	3.1	-3.4	4.3	0.6	0.8	2.0
Population, ann. % ch.	2.0	2.0	2.2	2.4	n.a.	n.a.
Median house price – Darwin, \$'000s	388.3	392.5	403.2	418.5	412.1	419.9
Annual data (% change)	03-04	04-05	05-06	06-07	07-08 (f)	08-09 (f)
Gross state product	2.0	5.5	5.5	5.6	3.8	3.0
Employment	-2.9	-1.2	2.9	5.5	5.6	2.3
Consumer prices – Darwin	1.4	2.2	3.4	4.4	3.5	3.2

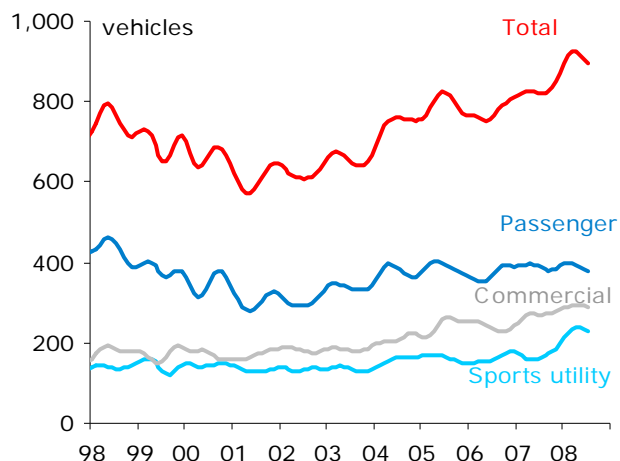
Sources: Australian Bureau of Statistics and ANZ Economics and Markets Research

labour market. Non-residential building approvals rose by 88% to A\$506 million for the 12 months to July 2008. Additional offices and hotels are planned in the Darwin CBD and warehouses at the Darwin Business Park.

This contrasts with subdued demand in private dwelling investment. A dramatic slide in private building approvals threatens to only add to an already undersupplied housing market.

The Northern Territory is already worse than all other Australian jurisdictions except Tasmania in terms of rental affordability. Up until the middle of last year, residential building approvals had tended to average around 100 per month. This figure has trended downwards throughout 2007-08, reaching just 50 approvals in July. This pent-up demand in the residential market will at some point be addressed, adding to the positive outlook for the construction industry and employment in the state.

Strong growth in new vehicle sales



Source: Australian Bureau of Statistics

Australian Capital Territory: A public service downturn

Mark Rodrigues, Senior Economist

The ACT economy continues to do it tough, with stagnant public sector activity compounded by an over-stretched consumer and softening housing market. Overall, we see GSP growth easing further in 2008-09, to just 1.5%.

State final demand rebounded by 1.6% in the June quarter, but it's difficult to see this as anything more than a temporary spike following a weak (negative) March quarter. The result reflected a 2.4% lift in public demand, but a serious question mark remains over whether this signals a shift in the fortunes of public sector or merely reflects quarter to quarter volatility. Business investment also spiked in the quarter (+9.9%), but this sector is only a very small component of the ACT economy.

Elsewhere, the signs remain worrying. Consumer spending fell by 0.1% in the June quarter following very soft growth of just 0.3% in the March quarter. Over the past year, consumer spending in the ACT has lifted by only 1.5%. More recent partial data suggest conditions have continued to deteriorate. Retail spending fell a further 4% in July and is now down 3.6% over the past year.

The deterioration in the ACT economy is underpinned by three key drivers. First, population growth into the ACT is slowing. Between the middle of 2007 and the end of 2007, annual population growth into the ACT slowed from 1.7% to 1.3%, and likely slowed further into 2008. Population growth in the ACT is highly leveraged to the public service employment cycle, and the new government's desire to restrain growth in the public service following a significant expansion during the second half of the previous government's tenure has not been helpful in this regard.

Which brings us to the second key driver: the downturn in the public sector. Above and beyond anything, the ACT is a public service town – public demand accounts for almost 60% of state final demand, most of which is public 'consumption'. Due to the difficulty in measuring public consumption, the ABS essentially measures growth in this by growth in the public service, which as already noted, the federal government is trying to restrain. To reinforce this point, employment growth in the ACT has recently been negative for the past three months, although the state's labour market remains tight, with the unemployment rate at 2.8% in August.

Finally, and reflecting the broader slowdown in the economy, the territory's housing market has stalled, with established house prices in Canberra falling by 1.4% in the June quarter. Negative sentiment is overwhelming fundamentals, which remain very positive. In particular, housing in the city remains amongst the most affordable (as a % of income) in the country and the market is still relatively tight (although vacancy rates have begun to edge up as population growth slows). Building approvals have trended up sharply in recent months, growing at double-digit rates in each of the past four months. While this will translate to stronger dwelling investment in the second half of 2008 and into 2009, it remains unclear if this is actually a positive for the housing market. There's no point building houses and apartments if there's no one to buy them at the end!

Overall then, it is difficult to see a turnaround in the ACT economy until the shackles are taken off the public service and confidence begins to return.

Economic data – Australian Capital Territory

Monthly data (% change)	Mar-08	Apr-08	May-08	Jun-08	Jul-08	Aug-08
Retail sales	-0.5	0.1	-0.2	-1.9	-4.0	n.a.
Total building approvals (trend)	4.9	12.9	16.1	14.8	10.5	n.a.
Employment (trend)	0.4	0.3	0.3	-0.1	-0.3	-0.1
Unemployment rate, % (trend)	2.6	2.6	2.6	2.7	2.8	2.8
Quarterly data (% change)	Mar-07	Jun-07	Sep-07	Dec-07	Mar-08	Jun-08
Household consumption	1.9	0.2	0.8	0.6	0.3	-0.1
Private investment	3.1	-5.0	-1.2	-3.8	-4.4	2.8
Public demand	0.6	3.9	-4.3	2.6	-0.6	2.4
State final demand	1.2	1.8	-2.4	1.3	-0.7	1.6
Population, ann. % ch.	1.5	1.7	1.5	1.3	n.a.	n.a.
Median house price – Canberra, \$'000s	422.7	441.4	463.7	477.5	479.7	473.0
Annual data (% change)	03-04	04-05	05-06	06-07	07-08 (f)	08-09 (f)
Gross state product	1.8	2.4	3.4	5.0	2.3	1.5
Employment	0.1	2.1	1.2	3.8	0.9	0.8
Consumer prices – Canberra	2.6	2.3	3.6	2.9	3.6	3.5

Sources: Australian Bureau of Statistics and ANZ Economics and Markets Research

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