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Authors:

Tony Pearson

Deputy Chief Economist and Head of
Industry and Strategic Research
+61 3 9273 5083
Tony.Pearson@anz.com

Mark Rodrigues

Senior Economist, Industry and
Strategic Research
+61 3 9273 6286
Mark.Rodrigues@anz.com

Julie Toth

Senior Economist, Industry and
Strategic Research
+61 3 9273 6252
Julie.Toth@anz.com

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Tony Pearson
Deputy Chief Economist

The big picture

Economic climate becomes more problematic

The business environment has become more challenging over the past few months with interest rates in Australia climbing to 12 year highs; the A\$ rising to the highest level in a quarter of a century; and global oil prices reaching all time highs. Together, these will contribute to a sharp slowing in the overall pace of economic growth over the next year.

High interest rates in Australia primarily reflect the aggressive inflation fighting actions of the Reserve Bank of Australia. It has raised the official cash rate on four occasions over the past year – in August, November, February and March – taking the cash rate to 7.25%, the highest in 12 years. The Reserve Bank has been raising interest rates in order to slow the growth of domestic economic activity and to thereby take some steam out of burgeoning price pressures. A range of “partial indicators” of demand such as retail sales, consumer confidence, dwelling construction approvals and credit suggest that a slowdown is now underway.

That might suggest that the Reserve Bank’s job is done. Unfortunately, we don’t think so. The problem is that inflation has been accelerating since the end of 2005. Over the year to the March quarter this year core inflation rose by 4¼%, the highest pace since the Reserve first began targeting inflation in the early 1990s. We believe inflation will accelerate again over the next six months, to peak in the September quarter at just under 5%. In this environment we believe the Reserve Bank will have no choice but to increase interest rates again later this year.

One of the factors driving global inflationary pressures has been the rising cost of oil. Global oil prices have more than doubled over the year to June 2008, recently reaching over US\$140 per barrel, an all time high. Fuel prices in Australia have closely followed global trends, with retail petrol prices recently reaching a peak of A\$1.70 a litre in some state capitals. While prices will continue to fluctuate, we do not expect any substantive relief going forward. High fuel prices are becoming a feature of our economic environment.

While high fuel prices can be inflationary, they also act as a “tax” on industries and households, reducing spending on other goods and services and reducing growth. The industries most directly affected are transport (passenger and freight), energy, and sections of manufacturing that rely on petrochemicals, such as plastics, cosmetics and chemical manufacturers. All industries that operate fuel-based machinery are also affected, including agriculture, most manufacturing segments, wholesale and retail distributors, construction and mining. There are also second-round effects through reduced consumer spending.

High interest rates and high commodity prices have lifted the A\$ to the highest level in 25 years, with a recent peak of around US\$0.9650. We now believe the currency will go through parity with the US\$ before year end and remain at very high levels until at least mid 2009. This will present a significant challenge to exporters who do not have the advantage of high commodity prices, and for domestic producers competing against cheaper imported goods and services.

These factors in combination will lead to a significant slowing in economic growth in Australia. In 2008-09 growth in GDP will be around 2.3%, a significant slowdown from the estimated 3.9% in 2007-08. This slowing will not be even across the regions. The resource-heavy states and territories will be insulated in part from the slowing in domestic demand by continued strong investment in mining and related infrastructure. The unfortunate implication is that the brunt of the slowdown will be borne by the regions with relatively smaller mining sectors along the south eastern seaboard. In particular, New South Wales, and to a lesser extent, Victoria, will feel the full effects of the winding back of household spending and the strong headwinds faced by business sectors such as manufacturing, property, tourism, hospitality, retail and financial services. These states could be heading for their weakest economic activity since the recession

Economic growth is set to slow

Interest rates have risen and there are now signs that demand is slowing

Inflation looks set to accelerate in the short term...

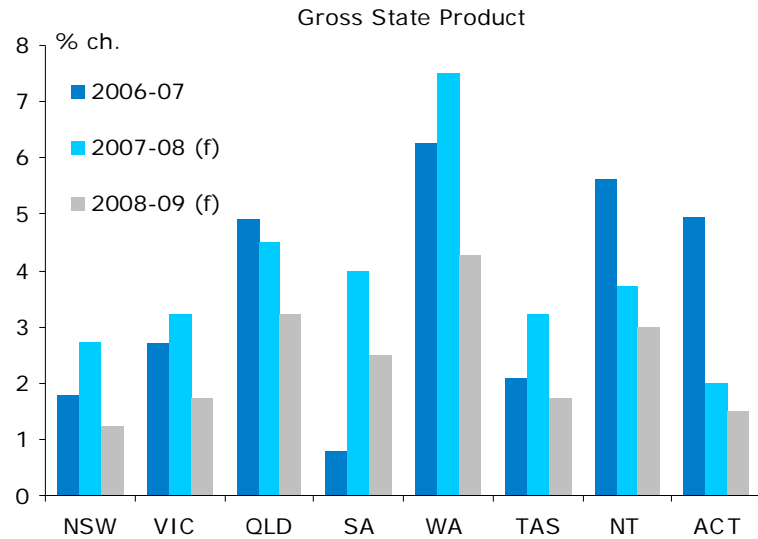
...driven in part by rising oil prices

Higher fuel prices are also acting as a ‘tax’ on business and households alike

Economic growth is set to slow in 2008-09, with the bulk of the slowdown to be borne by the non mining-intensive states

of the early 1990s. South Australia will fare better, buoyed by continued strong investment associated with the coming boost to mining activity in the centre and north of the state. The bottom line is that the gulf in economic performance between the mining “haves” and “have nots” is set to widen.

The gulf in economic performance between the mining “haves” and “have nots” is set to widen



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

New South Wales: Brace for the slowdown

Tony Pearson, Deputy Chief Economist

NSW growth to slow sharply

We have been expecting economic activity in New South Wales to begin to wilt under the headwinds of higher interest rates, high fuel costs and the high A\$. There are signs that this slowdown is now underway.

Trend state final demand rose by only 0.6% in the March quarter, the slowest quarter of growth for five quarters, and continuing the progressive slowing in activity apparent since the middle of last year. This cooling in momentum has been broad based, with slower growth in household spending, a sharp cooling in dwelling investment (trend dwelling investment fell in the March quarter), and a slowing in public sector consumption. Seasonally adjusted data also reveal a softness in private business investment (down 0.3% in the March quarter), offset by strong public sector investment (up by 10.2% in the March quarter although this sector is volatile and lumpy).

Early data suggest activity continued to cool into the June quarter. Trend retail spending fell marginally in May (-0.02%) and trend private sector dwelling construction approvals fell by 3.1% in the month, the fifth consecutive month of decline.

It seems the more sombre economic mood is also impacting on dwelling prices. The median price of established houses in Sydney fell by 1.5% in the March quarter, after three quarters of quite solid gains totalling 8.5%.

This cooling in activity has not yet impacted on the labour market, reflecting the lags between economic activity and employment. Growth in employment has been surprisingly strong, reaching an annual trend rate of 3.0% over the year to May, around the strongest pace in eight years, and amongst the strongest in the country. In trend terms, the unemployment rate is currently sitting at 4.5%, the lowest in over 30 years.

Population growth is holding steady at its recent higher pace of 1.1% per annum, although that still leaves it amongst the weakest of the states and territories, broadly on par with South Australia and ahead of Tasmania. Total population is increasing by around 73,000 a year, with accelerating international immigration (currently 54,000) and strong natural increase (43,000). The population weakness relative to the other states lies in interstate emigration. In net terms, New South Wales continues to lose the largest number of people to other states and territories (currently around 24,000 a year).

The omens suggest the New South Wales economy will weaken over the next year. The Reserve Bank continues to warn of the need to sharply wind back

domestic demand, and has backed its rhetoric with action, lifting the cash rate to the highest level in 12 years. We expect further increases in interest rates over the next six months.

New South Wales is exposed on a number of fronts. For a start, it has a relatively low exposure to the booming mining industry. While it certainly has mining, in particular a vibrant export coal sector, it only comprises a relatively small share of total industry value added, currently around 2½%. This means the continued strong performance of the mining sector won't provide the insurance against the slowing in demand that it does in the more mining-intensive regions.

Second, households in New South Wales are labouring under the highest average household debt interest servicing burden in the country. As a result, higher interest rates will erode household budgets faster and impact on spending more quickly in New South Wales than elsewhere.

Finally, the state remains the most exposed to the continued fallout from the global financial crisis, with over 40% of Australia's finance and insurance industry located in the state.

In 2007-08 GSP growth will be around 2¾%, with the government projecting only a slight slowing to around 2% in 2008-09. That seems optimistic given the strong headwinds. We believe economic activity will slow more sharply to only 1¼%.

Budget 2008-09: tight expense control and more for infrastructure

The 2008-09 state budget shows commendable restraint in recurrent expenditure. Total spending is projected to increase by only 4.2% compared with an average increase of 5.8% over the previous four years. However, the key element of expenditure control is limiting public sector pay rises to just 2.5%, with anything above that to be offset by efficiency savings. The idea is to limit "cost to taxpayers" to 2.5%, but wage gains above that can be achieved through higher productivity. Labour unions have already indicated their opposition to such tight control of public sector salaries.

The budget provides for a surplus of \$268mn in 2008-09, which on the surface represents a deterioration on the estimated 2007-08 result of \$700mn. However, this is partly due to a change in accounting standards. On the old basis the 2008-09 surplus would have been \$737mn. Budgets are projected to be similarly prudent over the next three years with surpluses to average \$700mn.

There was quite a lot of fanfare about the huge infrastructure spend, with a projected 23% increase in 2008-09 to \$13.9bn. However, some of the planned increase in spending in 2008-09 reflects under-spending of \$1.23bn in 2007-08, so half of

the increase from \$11.3bn to \$13.9bn is deferred spending, largely due to a delay in finalising the contract for the Kurnell desalination plant. Having said that, projected spending across transport, electricity, water and environment, health, education and housing is all good in a state where infrastructure has been chronically underfunded for many years. Perhaps the only cautionary point is whether the state will be able to fully deliver at a time when the manpower and materials needed to deliver new infrastructure is tightly stretched. There is also a risk of further upward pressure on costs and the crowding out of the private sector.

The government's plans to privatise its electricity generation assets seemed to have stalled at the time of writing, with strong opposition from the Labor party, unions, and some Labor members of parliament. Proceeds from the sale, if it happens, are projected to be between \$10bn to \$15bn, with the funds to be directed towards the state's infrastructure bill.

Further, a new long-term infrastructure strategy is to be released soon, with a rumoured \$140bn to be committed over 10 years, a significant increase from the \$110bn strategy outlined in 2006.

The 2008-09 Budget also contained significant cuts in business taxes. Payroll tax is to be cut by \$1.9bn over 4 years. The rate is to be reduced from 6% to 5.75% from 2009, to 5.65% from 2010, and to 5.5% from 2011. This seems to provide a useful boon to business, although most of the tax savings are in future years, with just \$344mn planned for 2008-09. Also, payroll tax rates will still be lower in some other states, with Queensland at 4.75% and Victoria at 4.95%. Payroll tax thresholds will also now be indexed to inflation, making New South Wales the only jurisdiction with such a practice. A further benefit to business was that the abolition of transfer duty on non-land business assets will be

brought forward by 18 months from 1 July 2012 to 1 January 2011, representing a further tax cut of \$270mn over the forward estimates.

State borrowings increased to fund infrastructure

The government copped flak from some quarters for the proposed increase in debt in the 2008-09 Budget. The level of net debt in the general government sector will increase in 2008-09 and over the forward estimates period, reaching \$7.8bn by June 2012 (1.7% of GSP). This will partially fund ongoing high levels of general government and non-commercial public trading enterprise capital expenditure, and is still well below the level prevailing in 1995. Total state net debt is projected to increase more than in the general government sector, reflecting the significant capital expenditure plans of around \$57.6bn over the four years to 2011-12. Total state net debt is forecast to rise to \$41.7bn (9.1% of GSP) by June 2012.

There is nothing intrinsically wrong with governments borrowing money. It all depends on the reasons for borrowing and the purposes to which it is put. Borrowing to fund infrastructure can be justified where the asset will service the needs of current and future generations. In this case the debt provides a mechanism for sharing the servicing and repayment costs across the generations which will use the asset; it is the ultimate expression of "user pays". Borrowing for infrastructure can also be sensible where the investment expands the income-producing base of the economy, providing additional revenue for the future repayment of the debt. Borrowing by the public sector to offset times of weakness in private sector activity and taxation revenue can also be justified as a countercyclical mechanism – as long as the debt is repaid when private sector activity improves and revenue recovers. On this basis there seems little to criticise.

Economic data – New South Wales

Monthly data (% change)	Dec-07	Jan-08	Feb-08	Mar-08	Apr-08	May-08
Retail sales	0.7	-0.4	0.4	-0.5	0.0	0.5
Private building approvals	-24.0	-3.0	0.3	3.2	-7.0	4.4
Employment	0.2	0.4	0.7	0.4	-0.1	-0.5
Unemployment rate, %	4.6	4.5	4.2	4.4	4.5	4.7
Quarterly data (% change)	Dec-06	Mar-07	Jun-07	Sep-07	Dec-07	Mar-08
Household consumption	1.6	0.9	0.8	1.2	0.0	0.9
Private investment	1.7	3.7	6.3	-0.5	1.7	-1.3
Public demand	-0.1	-1.8	0.9	0.7	1.4	2.2
State final demand	1.3	0.8	1.9	0.7	0.6	0.7
Population, ann. % ch.	1.0	1.0	1.1	1.0	1.1	n.a.
Median house price – Sydney, '\$000s	482.9	481.9	500.3	513.0	523.7	516.1
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	2.8	1.3
Employment	1.2	1.4	1.7	1.8	2.3	1.3
Consumer prices – Sydney	2.2	2.5	3.0	2.7	2.9	3.8

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

Victoria: More challenging economic climate exposes fragility

Mark Rodrigues, Senior Economist

The Victorian economy has been one of the nation's most impressive in recent years, with solid and stable growth achieved without any meaningful direct exposure to the resources boom. But as financial conditions tighten further, oil prices continue to surge, consumer confidence tumbles, and the exchange rate tests record highs, the fragility of the state's economy is becoming increasingly apparent.

High frequency indicators such as retail sales and building approvals have already turned down in recent months, and with interest rates expected to rise further in the second half of 2008, things are likely to get worse before they stabilise. Overall, we expect economic growth in Victoria to slow to just 1¾% in 2008-09, almost half the estimated pace of 3¼% in 2007-08.

Slowdown already in train

Recent data suggest that the slowing in economic activity has already begun. Growth in final demand in Victoria slowed to just 0.6% in the March quarter 2008, well down on the average quarterly growth rate of 1.1% achieved in 2007. And partial indicators suggest that conditions have deteriorated further since then. Retail sales, for example, have declined in two of the past four months. Residential construction is also showing signs of stress, with private building approvals falling in two of the past three months (to May).

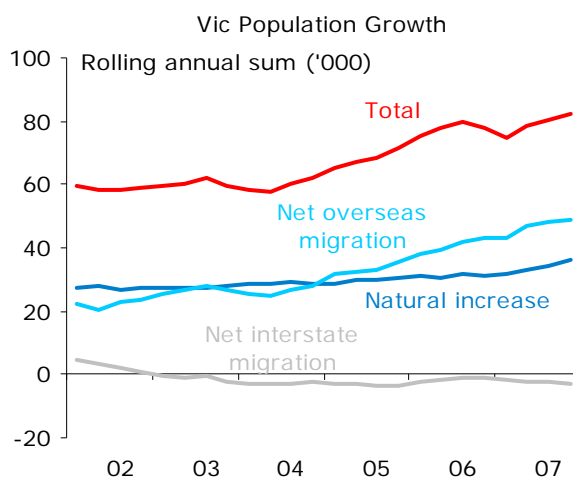
The poor prognosis for the Victorian economy is not all that surprising when you consider its economic structure:

- First, it has little meaningful exposure to the current resources boom, with the mining industry contributing just 2.2% to state factor income in 2006-07 (by way of comparison, the corresponding figure in Western Australia is 30%);
- Secondly, the state is relatively reliant on the manufacturing sector, which contributed 13.6% to state factor income in 2006-07, and which has been adversely impacted by the rising A\$ over recent years. Victoria is also Australia's largest destination for international students, and demand in this sector has been similarly affected by the high A\$, as has tourism more broadly;
- Finally, Victoria, along with New South Wales, is heavily exposed to the finance & insurance and property & business services industries, which together accounted for almost one-quarter of state factor income in 2006-07, and have been amongst the industries hit hardest by the global credit crisis.

Strong population growth will provide a cushion...

The one saving grace for Victoria, preventing it from travelling down the same path as New South Wales, is that population growth remains very strong. In the year ended December 2007, Victoria's population expanded at a three decade-high pace of 1.6%. In absolute terms, Victoria's gain of 82,400 people was bettered only by Queensland.

Strong population growth has prevented Victoria travelling down the same path as NSW



Source: Australian Bureau of Statistics

Victoria's population growth in 2007 was driven by natural increase (equivalent to 44% of the total increase) and net overseas migration (59%), though was partly offset by a small (net) exodus of people interstate.

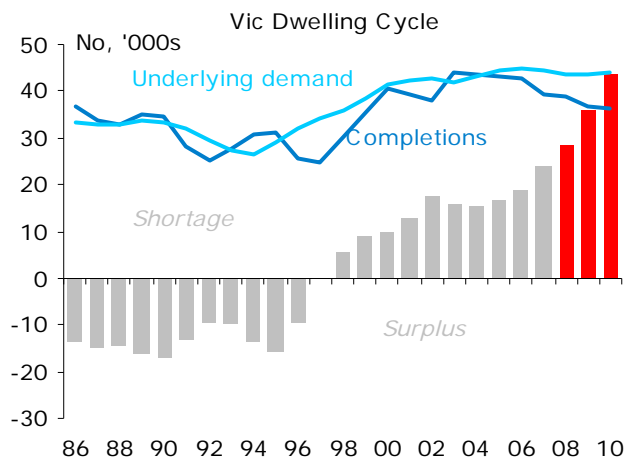
Looking forward, it seems likely that the population boom will continue in earnest. With the unemployment rate at historically tight levels, it seems likely that labour shortages will continue to drive immigration policy. The Rudd Government has already budgeted for an additional 31,000 places in the skilled migration program in 2008-09, and companies are increasingly resorting to temporary employment visas to ease labour constraints. Victoria is certain to continue to benefit from these developments.

...though it is intensifying the housing shortage

Victoria's rising population has intensified demand for residential accommodation at the same time that rising interest rates have put the brakes on new construction. Not surprisingly, market conditions have tightened significantly. We estimate that there is currently a shortage of housing stock equivalent to over 7 months of production at the current pace. With interest rates expected to rise further in the second half of 2008, this shortage will only intensify.

The tightness of the housing market is reflected in a number of indicators. In the to-buy market, house prices in Melbourne are up almost 26% in the past year, the strongest growth of any capital city. Renters aren't faring much better either, with the rental vacancy rate now sitting around 1% and advertised rental prices up almost 20% in the past year.

Victoria's housing shortage is set to intensify



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

Infrastructure bursting at the seams

Capacity constraints don't end in the residential accommodation sector. Melbourne's public infrastructure – particularly in transport – is being stretched to its limits. For example, patronage on Melbourne's train network has jumped 33% since 2005, resulting in rising congestion and delays through the network.

Investment is responding. Total investment in Victoria is currently running at 36.7% of final demand, well above the average of 30% through

the 1990s. High rates of investment look set to continue for the foreseeable future, with the stock of non-residential building work yet to be done valued at \$5bn as at the end of 2007, up 42% on a year earlier. Meanwhile, Access Economics estimates that there is some \$4.8bn worth of investment in the state that has been committed to but not yet commenced and a further \$53.8bn worth of projects either under consideration or possible.

The state government will be responsible for a significant portion of investment over the next few years, having committed a total of around \$20bn over the five years to 2011-12 to infrastructure in the 2008-09 Budget. This includes \$491mn for health, \$592mn for education, \$663mn for roads and \$490mn for rail infrastructure. And these figures could balloon if the government accepts the main recommendations of the Eddington Report, which call for a \$7bn rail tunnel from Footscray to Caulfield and a new \$1.5bn rail line from Werribee to Deer Park.

Other key measures in the 2008-09 Budget include land tax cuts worth \$490mn over four years, payroll tax cuts worth \$170mn, and increases in stamp duty on land transfer thresholds worth \$332mn. All of this will be delivered whilst still maintaining a relatively healthy operating surplus of \$828mn in 2008-09 and an average of \$907mn over the following three years.

Of course, this is contingent on the government's economic forecast of 3% per annum growth between 2008-09 and 2010-11 being realised. We think the near term forecasts are highly suspect, and expect growth of almost half what the government is forecasting in 2008-09.

Economic data – Victoria

Monthly data (% change)	Dec-07	Jan-08	Feb-08	Mar-08	Apr-08	May-08
Retail sales	0.9	0.9	-1.6	0.4	-0.8	0.6
Private building approvals	0.8	0.5	1.8	-2.9	-7.1	2.7
Employment	0.5	0.3	-0.1	-0.8	0.5	0.2
Unemployment rate, %	4.7	4.5	4.1	4.3	4.6	4.3
Quarterly data (% change)	Dec-06	Mar-07	Jun-07	Sep-07	Dec-07	Mar-08
Household consumption	1.5	1.1	0.6	1.0	1.9	0.9
Private investment	-3.2	3.9	2.0	2.4	1.0	0.2
Public demand	2.6	-4.1	1.8	-2.4	2.6	0.1
State final demand	0.7	0.6	1.1	0.6	1.8	0.6
Population, ann. % ch.	1.5	1.5	1.5	1.6	1.6	n.a.
Median house price – Melbourne, \$'000s	322.1	327.5	351.0	369.0	395.9	412.2
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	2.8	1.8
Consumer prices – Melbourne	2.3	2.0	3.1	2.6	3.5	3.9

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

Queensland: Solid economic performance set to continue

Tony Pearson, Deputy Chief Economist

Strong overall, though some sectors labouring in a more difficult environment

In recent years Queensland has been one of the strongest performing economies in Australia. Although that overall strong performance is set to continue, there are some sectors which are labouring under the impact of higher interest rates and the high A\$.

Trend state final demand increased by a solid 1.3% in the March quarter, the equal second strongest increase behind only Tasmania and line ball with the Northern Territory. This reflected increases across the board in household consumption, dwelling investment and government spending. Seasonally adjusted data show private business investment and public investment were also strong. Nevertheless, this result suggested some loss of economic momentum in the state, with the March quarter increase in trend state final demand at the weakest for three years, and only around half of the increase in the March quarter a year earlier.

Two sectors in particular are showing signs of softening. The first is housing. House price growth seems solid with an increase of 2.8% in Brisbane house prices in the March quarter, and 21% over the year. But there are signs of a cooling in momentum with the March quarter rise being the slowest in over a year. The construction side of the housing market is losing momentum more clearly, with trend construction approvals in April around 8% lower than the October 2007 peak. Both these developments are linked to a slowing since mid 2007 in the flow of housing finance approvals for owner occupation, with 20% fewer approvals in April than the May 2007 peak. It seems that the progressive increases in interest rates are beginning to impact on the housing market, traditionally one of the strengths of the Queensland economy.

The tourism industry is also under pressure as the high A\$ and high fuel prices increase travel costs for both overseas and domestic travellers. Data on short term international arrivals to Australia show a steady slide in visitor numbers over 2006, 2007 and into 2008. Over the year to April 2008 short term international arrivals for the purposes of a holiday totalled 2.77 million, 7% lower than in the peak year ending January 2006. Data for Queensland show the biggest falls in short term visitor numbers from Japan (down 15% for the year ended March 2008 for all purposes including holiday, family visit, business and so on) and from the rest of Asia (down 1%), offset in part by increases from the Americas. Data from the National Visitor Survey conducted by Tourism Research Australia show domestic visitor tourist accommodation room occupancy rates in Queensland fell in calendar year 2007 by 0.1%, with the largest falls in the more distant regions of the

far north, the Whitsundays and Mackay, offset by increased occupancy in the regions closer to major metropolitan centres such as the Gold, Sunshine and Fraser coasts.

The labour market is reflecting this slowing in economic momentum. Employment growth has slowed sharply over the past year, to just under 2% per annum in April, the slowest of any of the states and territories. As a result the unemployment rate has stopped falling, stabilising at around 3.6% over the past year. This is still lower than the national average of 4.2% and remains the third lowest in the country, but other regions have continued to record further gains on this front while Queensland has stood still.

Having said that, Queensland demographics remain sound. Population growth accelerated in the December quarter 2007 to an annual rate of 2.3%, marginally below the Northern Territory and Western Australia. That is an addition of nearly 97,000 people to Queensland over the year, by far the strongest absolute increase of any state or territory (the next biggest increase was Victoria with 82,500). The acceleration in population growth reflected a big jump in the natural increase, to 35,450 a year, and a further slight increase in international immigration to 35,800 a year. Interstate immigration eased a touch to 25,650.

Meanwhile, Queensland's mining sector is going from strength to strength, with further stellar increases in coal prices in the 2008-09 contract year (steaming coal prices more than doubled, coking coal prices more than tripled), and aggressive planned increases in production and exports.

Budget surprise dip into the red will be temporary

Queensland has always prided itself on running a stringent and conservative fiscal policy, so there was some surprise when the headline net operating position for the general government sector in 2007-08 was announced as a deficit of \$995 million. This reflected lower than expected proceeds from investments as a result of the global financial volatility and equity market falls; returns on investments in 2007-08 are estimated at 2% rather than the previously budgeted 7.5% (Late reports at time of writing suggested a further substantial deterioration in the state's finances through June, giving investment returns of -2.5% and a net operating deficit of \$2 billion for 2007-08).

The 2008-09 Budget moved to plug this revenue hole in forward years in two ways. The first was to transfer investment assets from the Queensland Investment Corporation (QIC) to the Queensland Treasury Corporation (QTC) in exchange for a government bond earning the long-term average rate of 7.5%. This removes fluctuations in

investment earnings from the headline net operating position in that it provides certainty of returns. QTC will now bear the investment return volatility of the assets invested with QIC.

Second, the 2008-09 Budget underpinned revenue flows with a substantial lift in projected coal royalties, the product of both a lift in the royalty rate and further stellar increases in contract coal prices. The Budget announced a new two-tier coal royalty rate, starting at 7% for coal revenue up to \$100 a tonne, rising to 10% of the prices that is above \$100 a tonne. Coupled with massive increases in contract coal prices, coal royalties next year will triple to \$3.2bn, the single biggest source of revenue for Queensland, beating the boom state's traditional big earners, transfer duty and payroll tax. This, along with a gain in general tax revenue, will lift general government revenues by 13.3% in 2008-09, returning the operating position to a surplus of \$809mn, with smaller but still solid surpluses over the next three years.

The 2008-09 Budget also includes tax relief in politically sensitive areas, with changes to transfer duty, land tax, payroll tax and mortgage duty. In particular there are further reductions in stamp duty for first home buyers and the abolition of mortgage duty has been brought forward to 1 July 2008.

The strong revenue growth allows a solid increase in operating expenses of 7.5% to \$35.8bn in 2008-09.

The centerpiece of the 2008-09 Budget is a 19% lift in infrastructure spending to \$17bn across both the general government sector and public non-financial corporations. This covers projects in transport, water, education, and health. The capital works program (with the exception of the Mt Isa, Cairns

and Mackay hospitals) will be funded in part from the operating surplus and also by borrowings (\$10.9bn in 2008-09). The hospitals are being funded through an innovative arrangement involving the long-term lease of the Mackay and Cairns airports and the disposal of the remaining public sector stake in Brisbane airport.

Economic growth to consolidate

Budget papers estimate growth in gross state product of 3¼% in 2007-08. Growth is expected to accelerate to 4¼% in 2008-09, with a softening in household consumption more than offset by stronger net exports and an acceleration in business investment. The labour market is expected to continue along its recent more subdued track, with the unemployment rate set to stabilise at around 3¾%.

The government's growth forecast may be a little optimistic as it is based on assumptions of no further interest rate rises and an easing in the A\$ towards the end of the financial year. In contrast, we believe interest rates will move higher in 2008 as the Reserve Bank seeks to subdue burgeoning inflationary pressures and that the A\$ is likely to rise through parity with the US\$ by the end of 2008. We also are concerned that for Australia as a whole capacity constraints will prevent full realisation of the aggressive public and private sector infrastructure investment plans. Overall it is more likely that Queensland GSP growth in 2008-09 will be slightly lower than in 2007-08. But there is nothing shabby about that in what will be a difficult economic environment, and it would again leave Queensland as one of the top performing regions in Australia.

Economic data – Queensland

Monthly data (% change)	Dec-07	Jan-08	Feb-08	Mar-08	Apr-08	May-08
Retail sales	-0.1	-1.2	0.8	0.9	-0.6	1.2
Private building approvals	19.0	-17.1	-3.5	-16.3	38.1	-23.3
Employment	0.0	-0.3	0.7	0.1	0.3	0.3
Unemployment rate, %	3.5	3.4	3.6	3.7	3.8	3.8
Quarterly data (% change)	Dec-06	Mar-07	Jun-07	Sep-07	Dec-07	Mar-08
Household consumption	1.7	1.5	0.9	1.0	2.4	0.3
Private investment	2.0	8.4	1.2	-3.3	2.4	1.4
Public demand	0.6	-1.9	11.0	0.3	3.1	2.7
State final demand	1.5	2.5	3.1	-0.3	2.5	1.1
Population, ann. % ch.	2.2	2.3	2.2	2.2	2.3	n.a.
Median house price – Brisbane, \$'000s	334.0	347.8	370.1	388.0	408.5	420.1
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	4.5	3.3
Employment	3.3	5.2	3.5	4.6	3.0	2.5
Consumer prices – Brisbane	2.9	2.6	3.1	3.3	4.0	4.4

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

Western Australia: Boom continues, but some doing it tougher

Mark Rodrigues, Senior Economist

Western Australia will remain the nation's economic powerhouse, though the combination of rising interest rates and petrol prices, the high A\$, the maturing of the housing cycle and the recent disruption to the state's gas supplies suggests that some sections of the economy will be doing it tougher than in many years.

Overall GSP growth is projected to ease to 4¼% in 2008-09, from an estimated peak of 7½% this year.

Investment drives growth as consumers begin to feel the pinch

Final demand in Western Australia increased by 1.4% in the March quarter to be 6.7% higher over the year. While still impressive, this represents a marked slowing from the recent peak of 12.4% per annum growth recorded in the September quarter 2007.

Recent economic growth has been underpinned by strong investment activity, with business investment up 4.6% in the quarter and public investment up 11.2%. In contrast, consumer-driven sectors have softened in line with sentiment. Consumer spending fell by 0.3% in the March quarter 2008, the first quarterly decline in five years. Meanwhile, dwelling investment fell by 1.8% in the March quarter, the second consecutive quarterly decline in the series.

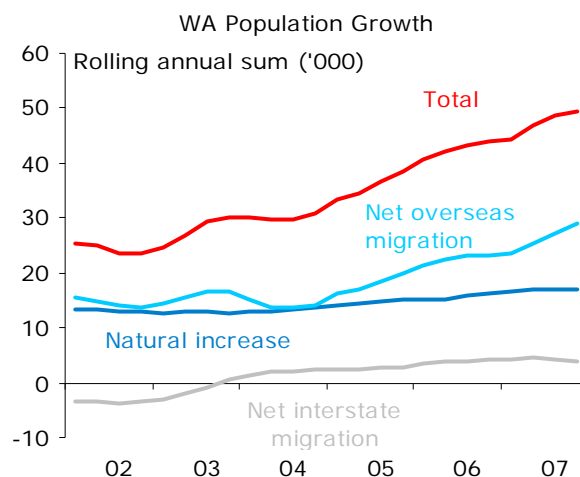
Partial data point to a rebound in consumer spending since March, but fundamentals suggest that we are unlikely to see a return to the 6-7% per annum growth rates witnessed over 2007. In particular, the labour market looks to have plateaued and may even be loosening, albeit ever so gently. Employment has been either flat or falling in each month since February, with annual growth slipping to 1.9% from 3.7% in November last year. Not surprisingly, the unemployment rate has begun to tick up, although at 3.7%, it remains consistent with any reasonable sense of 'full employment'.

The outlook for residential construction is somewhat less benign, with rising interest rates hitting at a time when the state's market is already at a mature stage of the cycle, reinforcing the downward momentum. Residential construction approvals fell a further 4.4% in May, following a staggering 19% drop in April. Approvals are now down some 12% on year-ago levels. In the broader market, prices have finally stabilised, having increased by over 140% between 2003 and 2007.

It's not all bad news for the housing market, however, with underlying demand for new housing likely to remain strong, suggesting that the fallout from the residential construction downturn for broader house prices should be minimal. In particular, Western Australia continues to post very strong rates of population growth, with the

resource-fuelled economy continuing to lure overseas and interstate migrants. In 2007, population growth was 2.4%, the strongest since the late 1980s and in line with the other boom states of Queensland and the Northern Territory.

WA's strong economy continues to attract migrants from overseas and interstate



Source: Australian Bureau of Statistics

Resources boom continues

Notwithstanding these headwinds, Western Australia's outlook remains sound, buoyed by the ongoing stimulus from the resources boom. Over the past five years, Western Australia's terms of trade have increased around 35%, driven by a 60% increase in export prices. The stimulus from this source looks set to intensify over the coming year, with Rio Tinto recently achieving an 85% increase in contract prices for Pilbara iron ore.

The most visible and direct outcome of the resources boom has been the massive escalation in investment in the Western Australian economy. In real terms, private business investment has grown at an average rate of 21% per annum over the last six years, while the public sector has chimed in with investment growth of 11% per annum over the same period. As a share of final demand, total investment in the Western Australian economy now sits at over 31%, up from rates around 20% at the turn of the century.

In the normal course of events, the investment boom would have peaked by now and would be well and truly into the 'bust' phase of the cycle. Yet there seems little indication of this on the horizon in Western Australia. Engineering construction work yet to be done was worth some \$23.2bn as at the end of the March quarter 2008, up 57% on a year earlier. Meanwhile non-residential building work yet to be done was some \$2.2bn at the end of 2007, up 47% on year-ago levels.

Not to be outdone, the Western Australian government, flush with cash from resource royalties

and a booming economy, announced a record capital works program in its 2008-09 Budget. The program, which includes significant new monies for utilities, health, transport, education and law and order projects, is estimated to be worth \$7.6bn in 2008-09 and \$26.1bn over the next four years.

On top of all of this, Access Economics estimates that there is some \$24.3bn worth of investment in the state that has been committed to but not yet commenced and a further \$100.2bn worth of projects listed as 'under consideration' or 'possible'.

WA's 'other boom'

The key short-term risk to the rosy outlook for Western Australia's resources industry is the disruption to gas supplies caused by the explosion at Apache Energy's gas processing facility at Varanus Island on 3 June. Normally, Varanus Island supplies 350 terajoules (Tj) per day or approximately 30% of Western Australia's gas, primarily to industrial customers. This has the potential to be particularly damaging for the Western Australian economy, which relies on gas to generate around 65% of the electricity used in the state.

The latest advice from Apache Energy is that it expects to restore gas production at a rate of 200Tj per day (or 57% of normal capacity) by 15 August, ramping up to 350Tj per day (full capacity) in December. If these targets are met, we estimate that the maximum loss of electricity production would be 1½% in 2007-08 and 4¼% in 2008-09.

However, in reality, the total loss in electricity generation capacity will be significantly less than this because:

- Gas production from the North-West shelf has been lifted by 50Tj per day to meet some of the shortfall;

- The state government has recommissioned a number of coal-fired power stations, which will free up 75Tj of gas a day;
- The Navy has released 6ML of diesel into the distribution system; and
- A number of affected mines have opted to shut down for routine maintenance or switch to back-up diesel power generators.

Overall, we expect that the total impact of the incident will be relatively small – of the order of ¼ to ½ of a ppt of GSP, with most of this effect likely to be recorded in the September quarter 2008. The bulk of the immediate costs will be borne by resource companies through higher prices for alternative sources of fuel and lost output. We do not anticipate significant second-round effects in the form of reduced capital expenditures and layoffs given the strong profitability of these companies, the tightness of the labour market, and the relatively short duration of the disruption.

Hey Big Spender

This will come as good news to the Western Australian government, which is relying on ongoing strong economic growth to fund an election-gearred budget featuring tax cuts, continued strong growth in expenses and significant increases in infrastructure investment (which have also been partly funded by debt). All of this whilst still maintaining operating surpluses, ranging from a solid \$1.855bn in 2008-09 to a comparatively paltry \$203mn by 2011-12.

Unfortunately, even assuming a relatively modest impact from the Varanus Island incident, the government's expectation that GSP growth will remain significantly above trend at 6.25% in 2008-09 and 5.75% in 2009-10 seems a bit of a stretch, even for Western Australia.

Economic data – Western Australia

Monthly data (% change)	Dec-07	Jan-08	Feb-08	Mar-08	Apr-08	May-08
Retail sales	-0.6	-1.0	-0.5	1.0	1.1	0.4
Private building approvals	-13.3	8.9	0.6	15.7	-19.0	-4.4
Employment	0.9	0.7	-0.1	-0.2	-0.1	0.0
Unemployment rate, %	3.1	3.4	2.8	3.3	3.4	3.7
Quarterly data (% change)	Dec-06	Mar-07	Jun-07	Sep-07	Dec-07	Mar-08
Household consumption	1.8	2.0	0.8	1.3	2.8	-0.3
Private investment	9.7	6.9	10.2	-0.2	-3.0	2.9
Public demand	-0.2	0.9	1.4	-1.6	3.4	2.8
State final demand	4.0	3.4	4.2	0.3	0.8	1.4
Population, ann. % ch.	2.2	2.2	2.3	2.3	2.4	n.a.
Median house price – Perth, \$'000s	463.3	465.7	456.9	465.0	471.4	468.6
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	7.5	4.3
Employment	1.3	4.2	4.9	2.5	3.5	2.3
Consumer prices – Perth	2.1	3.2	4.3	3.9	3.5	4.4

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

South Australia: A short, sweet growth spurt

Julie Toth, Senior Economist

If Australia is currently a country of two economies, then South Australia has most definitely moved up a gear to join the mining boom to its north and west. After a relatively flat 2006-07, gross state product in 2007-08 is likely to have grown at its strongest rate in four years. On crucial economic measures such as private investment and employment however, this much-needed growth spurt looks to be short-lived. 2008-09 will see a slower year for South Australia.

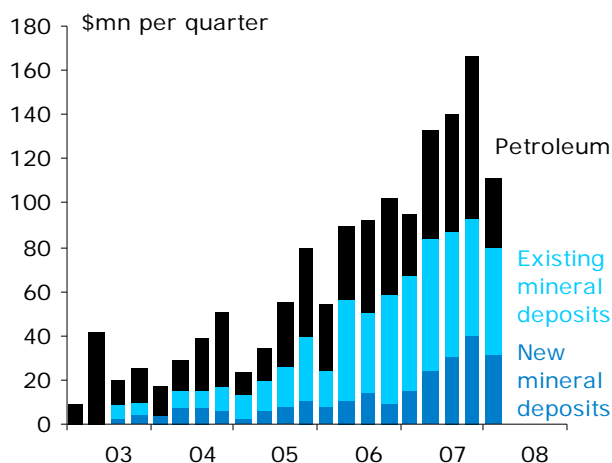
Mining dominates SA investment activity

Private investment (business plus dwellings) in South Australia has been declining for the last four quarters. By the March quarter of 2008, real business investment spending was 11.5% lower than a year earlier and real dwelling investments were worth 1% less. This drop does not bode well for the coming business year.

Nominal capital expenditure however, was 12% higher in March 2008 than a year earlier. South Australian capital expenditure in mining was up 38% and manufacturing was up 45% but expenditure in other industries was down 11%. New commercial vehicle sales grew at an average 16.8% per annum over the first five months of 2008. Mining, and the manufacturing segments supplying and servicing it, are clearly holding the fort on business investment.

As of April, ABARE documented three advanced mining projects worth \$1.2bn under way in South Australia — at Prominent Hill (copper), Honeymoon (uranium) and Angus (zinc). Another 16 projects are in various stages of initial planning, including 4 uranium, 4 copper, 4 gold and 3 iron ore projects.

Record minerals exploration activity in SA



Source: Australian Bureau of Statistics

Exploration activity in South Australia also continued to grow, with the total value of exploration in the first quarter of 2008 up 17.4% from a year earlier. Over the past year, an increasing share of exploration dollars have sought new deposits rather than existing ones. Exciting recent finds include

significant diamond deposits on pastoral land north of Peterborough.

Public infrastructure investment set to grow

Public demand (state and local government) grew strongly in the first quarter 2008, at 1.5% from the previous quarter and 5.5% from the previous year.

The 2008-09 Budget indicates a net operating surplus of \$160mn in 2008-09, rising to \$424mn by 2011-12. The Government also has plans to greatly increase its borrowings over this period (from a net debt of \$610mn in 2008-09 to an estimated \$1,983mn in 2011-12), so despite a bigger income base and surplus, the state's borrowing ratio (liabilities to revenue) will rise from 70% to 76% over the next four years.

The purpose of this increased public debt is to fund long-term capital infrastructure, including \$10.3bn in public-private-partnership projects over the next four years. Big-ticket projects focus on transport, energy and infrastructure. They will include a desalination plant and water supply works (\$1.5bn), public transport expansion and renewal (\$1.1bn), the new Northern Expressway (\$564mn), new hospitals (\$333mn) and sewerage treatment upgrades (\$270mn).

Agriculture and water outlooks remain bleak

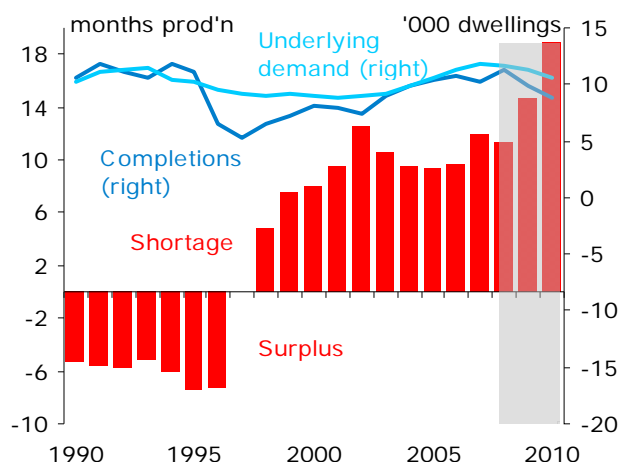
South Australia remains officially dry, with all areas still drought-declared for exceptional circumstances assistance or interim assistance. Good autumn rains and mild temperatures enabled winter crop sowings in many grain-growing districts. ABARE expects South Australia will produce up to 50% more grain than last year in 2008-09, with about the same acreage planted to the major winter crops (wheat, barley and canola) but yields returning to average. This may be compromised by the weather outlook however, with the Bureau of Meteorology forecasting another warmer and drier than average winter ahead. Water flows and irrigation allocations from the Murray River system remain critically low.

Residential property market tightens further

As is the case in other cities, Adelaide's housing shortage is worsening. Dwelling commencements were 23.2% higher in the March quarter 2008 than a year earlier and private building approvals were 12.3% higher. However, with interest rates rising and capacity constraints already showing, the construction of new dwellings is still lagging behind underlying demand. We estimate 11,200 dwellings will be built in 2008, compared to estimated demand of 11,700. This gap will contribute to a growing shortage of 10,600 homes in 2008, rising to 13,800 homes by 2010, or 18.9 months' worth of residential construction work. The mounting strain this is placing on the local property market can be seen in steeply rising prices for established houses in

Adelaide (up 21% per annum) and in the low rental vacancy rate, which has averaged 1.4% over the last 4 quarters.

Residential construction is falling further behind demand. SA housing shortages will worsen



Source: ANZ Economics and Markets Research

SA's households continue to spend despite a softening labour market

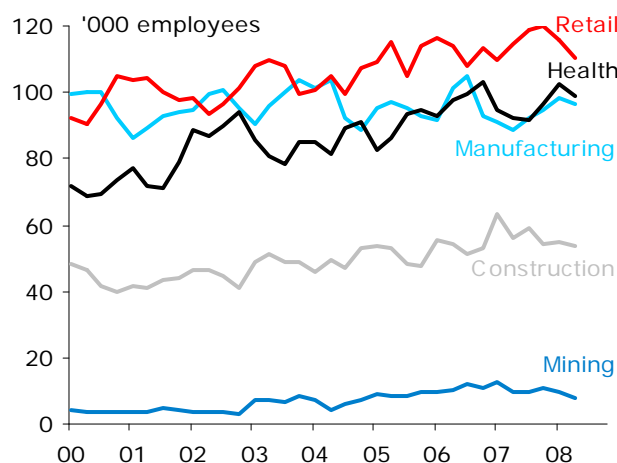
In contrast to other states, South Australian household consumption growth accelerated through 2007-08 (up 6.4% in the year to March), despite slowing employment growth and rising unemployment.

South Australian retail sales have grown strongly in recent months, averaging 9.9% per annum in the first four months of 2008. Retail sales have been healthy across all retail categories except recreational goods. And bucking the national trend, hospitality retail sales (pubs, clubs and restaurants) grew 21.5% over the year to April (compared to just 2.7% nationally). New passenger car sales are also picking up pace (up 5.3% per annum in May), just when other states' car sales are beginning to slow.

South Australian employment hit a peak of 778,000 in March 2008 (and peak growth of 4% per annum), but dropped slightly in May. Even so, May employment remained 2.1% higher than a year earlier. With the participation rate hovering around a record high of 63%, this small decline in employment was enough to push unemployment back up to 5%, the highest of any state.

Quarterly employment data indicate that the state's biggest employer, retail, hit a peak of 120,000 in late 2007 and is now running at around 110,000, 4% less than at the same time last year. Health services has been growing for some years and has now overtaken manufacturing as the state's second largest employing industry. Employment in both health and manufacturing declined a little in the second quarter of 2008, but remained 7% and 9% (respectively) higher than a year earlier. The smaller but crucial mining and construction industries also shed labour in the first two quarters of 2008, with mining down 18% and construction down 4% in May, compared to a year earlier.

SA's largest industries: just off peak employment



Source: Australian Bureau of Statistics

Economic data – South Australia

Monthly Source: data (% change)	Dec-07	Jan-08	Feb-08	Mar-08	Apr-08	May-08
Retail sales	1.5	1.5	0.1	0.5	0.7	1.0
Private building approvals	-18.8	1.0	19.4	-14.6	12.4	7.9
Employment	0.2	-0.3	0.7	0.1	0.0	-0.2
Unemployment rate, %	4.9	4.6	4.5	4.6	4.9	5.0
Quarterly data (% change)	Dec-06	Mar-07	Jun-07	Sep-07	Dec-07	Mar-08
Household consumption	0.9	0.9	0.7	0.7	2.3	2.6
Private investment	-1.5	6.2	0.5	-6.1	-0.6	-1.8
Public demand	1.9	-3.6	1.0	-0.5	3.4	1.5
State final demand	0.6	1.0	0.8	-1.0	2.0	1.5
Population, ann. % ch.	1.0	1.0	1.0	1.0	1.0	n.a.
Median house price – Adelaide, \$'000s	288.3	293.5	311.1	330.0	349.4	356.7
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	2.5
Employment	1.9	1.4	2.0	1.7	2.5	1.5
Consumer prices – Adelaide	3.0	2.3	3.2	2.6	3.3	4.5

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

Tasmania: The quiet achiever

Julie Toth, Senior Economist

The recent first Budget of Tasmania's new Bartlett administration indicates a confident and upbeat mood for the Tasmanian economy. As elsewhere, growth rates are slowing and unemployment has crept up again. But in Tasmania's case, unemployment is up only slightly from lows of 4.2% as recently as April, and employment is at record levels (235,000, up 3.9% over the year to May).

In 2008, jobs growth has been centred on education, health and construction, with smaller rebounds in other sectors also (such as mining, wholesale and retail trade). This jobs growth has come despite some high-profile closures and project delays. Significantly, the 2008-09 Budget notes:

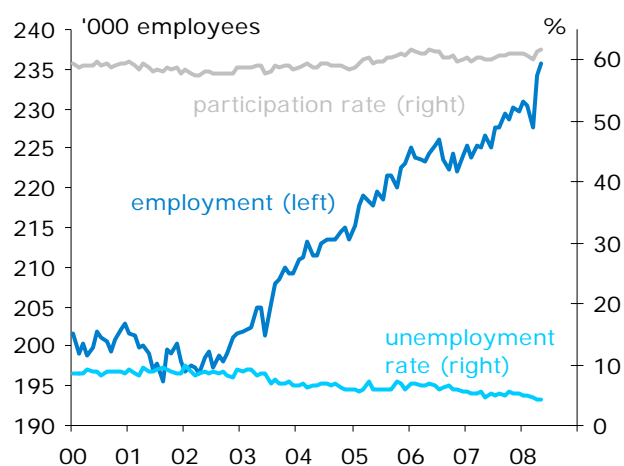
"A decade ago, a delay in a major project, or the closure of a major employer, would have had a measurable impact on consumer and business confidence, and in some cases would have affected some major economic indicators. By contrast, economic activity and employment growth have remained strong in Tasmania over the past year, despite closures such as the Telstra call centre in Launceston and the Blundstone boot factory in Moonah, which altogether have shed 500 jobs. This reflects the high demand for labour, and for skilled workers in particular, and provides evidence that Tasmania's economic performance is likely to remain strong, even if some major projects do not proceed as currently expected".

This year's budget has deployed a dramatic improvement in revenue — almost \$900mn (or 7.6%) more in revenue than was envisaged at the time of last year's Budget — to fund a range of new spending initiatives and infrastructure investment, whilst adhering to a conservative fiscal strategy (in

comparison with that of some other States). This will leave Tasmania's general government sector in a strong financial position. The extra revenue is going toward new spending of more than \$1bn over the next four years. New projects include education, health, and community programs (\$388mn), capital expenditure on roads, hospitals, water and schools (\$622mn) and a new Housing Fund (\$60mn).

Hobart's housing market has eased slightly in recent months, with median established house prices stabilising and the rental vacancy rate now the highest of any state capital — albeit at the historically low level of just 2.3%. Statewide however, dwelling construction approvals and completions are still tracking below our estimate of underlying demand. The shortfall in dwellings is hence expected to grow from 3,100 dwellings in 2007 to over 4,000 dwellings by 2010, or equivalent to 18 months' worth of continuous construction.

Tasmanian employment is at a record high



Source: Australian Bureau of Statistics

Economic data – Tasmania

Monthly data (% change)	Dec-07	Jan-08	Feb-08	Mar-08	Apr-08	May-08
Retail sales	1.3	-1.0	0.3	0.6	1.4	1.3
Private building approvals	4.9	0.4	11.2	-28.7	34.5	1.4
Employment	-0.2	0.5	-0.3	-1.2	2.9	0.6
Unemployment rate, %	5.3	4.9	5.0	4.7	4.2	4.4
Quarterly data (% change)	Dec-06	Mar-07	Jun-07	Sep-07	Dec-07	Mar-08
Household consumption	3.3	1.1	0.8	3.3	2.2	2.2
Private investment	-1.7	4.8	6.0	-0.2	13.1	-4.4
Public demand	9.2	-1.5	2.1	-3.8	3.9	0.4
State final demand	3.9	1.0	2.0	0.9	4.4	0.6
Population, ann. % ch.	0.7	0.6	0.7	0.8	0.8	n.a.
Median house price – Hobart, \$'000s	264.9	272.3	277.6	285.0	296.7	294.6
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	3.3	1.8
Employment	4.5	2.7	3.2	0.8	2.5	1.5
Consumer prices – Hobart	2.5	3.2	3.2	2.5	3.0	3.6

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

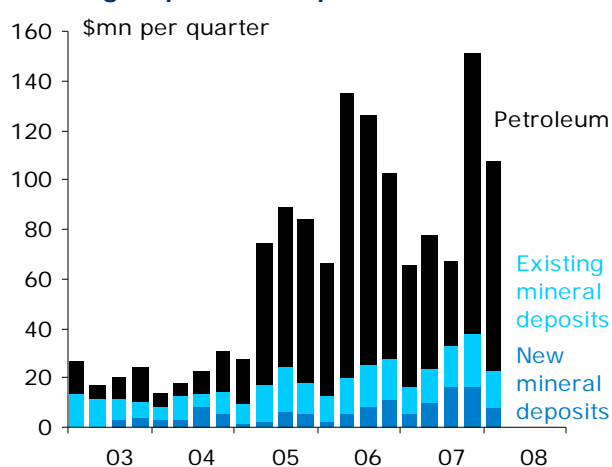
Northern Territory: The juggernaut begins to slow

Julie Toth, Senior Economist

After a bumper year of growth in 2006-07, we estimate the Territory's economy to have slowed to a still-respectable 3.8% per annum in 2007-08. A tougher national and international trading environment will see economic growth slow to around 3% in 2008-09.

Mining activity, investment and exploration remain the backbone of the Territory's economy. As of April, ABARE identified nine advanced mining development projects in the Territory, worth \$1.4bn, plus another 15 less advanced projects, including 7 new petroleum, 2 uranium and 3 gold developments.

Soaring oil prices fire up the hunt for more oil



Source: Australian Bureau of Statistics

Further leaps in international petroleum prices have spurred renewed interest in petroleum exploration activity, but have also meant cost increases for many Territory businesses, due to their typically long travel distances and high transport costs.

Outside mining, business investment appears to have slowed dramatically. Private business

Economic data – Northern Territory

Monthly data (% change)	Dec-07	Jan-08	Feb-08	Mar-08	Apr-08	May-08
Retail sales	3.0	-1.5	1.1	0.4	1.1	0.9
Private building approvals	0.0	3.9	2.5	-1.2	-3.7	-6.4
Employment	0.2	0.2	0.3	0.3	0.3	0.2
Unemployment rate, %	5.0	4.8	4.6	4.3	4.0	3.6
Quarterly data (% change)	Dec-06	Mar-07	Jun-07	Sep-07	Dec-07	Mar-08
Household consumption	0.4	2.0	2.1	9.2	2.0	-1.4
Private investment	-18.1	7.3	-5.8	3.1	-0.2	1.3
Public demand	1.2	0.4	-3.1	3.8	0.6	1.0
State final demand	-4.6	2.7	-1.6	6.0	1.1	0.0
Population, ann. % ch.	2.0	2.0	2.0	2.2	2.4	n.a.
Median house price – Darwin, \$'000s	374.0	385.2	389.5	400.0	409.6	404.2
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	4.8	2.3
Consumer prices – Darwin	1.4	2.2	3.4	4.4	3.4	3.4

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

investment grew 3.7% per annum in March 2008, but almost all of this growth was in machinery and equipment rather than non-dwelling or engineering construction. Total capital expenditure in the Territory fell by a third in March 2008 from a year earlier, to hit its lowest (nominal) level in four years.

For the public sector, infrastructure investment is a priority, with annual spending increasing from \$536mn in 2006-07 to \$711mn in 2007-08 and a record \$870mn in 2008-09. This will be spent on public housing, roads, education and health facilities. For businesses, the Territory is reducing payroll tax (from 6.2 to 5.9%) and other recurrent business taxes. With the sixth consecutive year of a budget cash surplus, this will be funded without raising the Territory's debt to revenue ratio from the current level of around 37%.

The Territory's housing market is already extremely tight but is set to worsen significantly. Darwin's median house price has stabilised in recent months and interest rates have risen. In response, new dwelling completions have fallen from a recent annual peak of 1,400 in 2007 to an expected 1,200 in 2008 and 1,100 in 2009. The value of new dwelling investment has not grown (in annual terms) since September 2007 and the value of dwelling alterations and additions has fallen to less than half its 2006 peak. At the same time, strong population and workforce growth are pushing new housing demand up to around 2,700 new dwellings per year, creating a cumulative shortfall of over 5,000 dwellings. This is equivalent to a staggering 50 months of production, due to the small capacity of the Territory's dwelling construction industry. At current growth rates, the shortfall in Territory dwellings will climb to over 8,000, equivalent to 82 months of production by 2010.

Australian Capital Territory: No relief in sight

Mark Rodrigues, Senior Economist

The ACT economy has slowed markedly since the second half of 2007 as tighter financial conditions and a reprioritisation of spending by the new federal government away from the public service impinge on household consumption and investment activity. Looking forward, we see little impetus for a turnaround in these conditions. Accordingly, economic growth is expected to settle at between 1.5% and 2% over 2007-08 and 2008-09, less than half the pace recorded in 2006-07.

State final demand fell for the second time in two quarters, by 1.6% in the March quarter 2008. Weakness was apparent across the board, with household consumption down 1.6% in the quarter, business investment down 8.1%, dwellings flat and public demand down 1.1%.

Conditions for consumers have apparently not improved at all since the March quarter, with retail spending broadly flat in May after falling in the previous two months. Surprisingly, conditions in the labour market remain relatively buoyant with employment growth remaining solid to May and the unemployment rate holding steady near recent lows at 2.7%. This suggests that weakness in consumer spending is being driven by the impost to disposable incomes from higher interest rates and petrol prices, and low levels of sentiment generally. Or perhaps public servants have been too busy working to spend their incomes!

Another candidate for the weakness in retail activity is the increasingly depressed state of the Territory's housing market. Investment activity has been flat to negative since the June quarter 2007, and is currently down 5% over the year. Things are unlikely to get much better for the Territory's

residential construction industry in the near term, with trend building approvals falling for the fourth consecutive month in May to be down over 40% in the year. Fundamentally, population growth has slowed to 1.3% by the end of 2007, from 1.7% just six months earlier, and the rental market has loosened somewhat over the course of 2007, although it remains relatively tight.

Things aren't looking much better for business investment in the Territory either, with the non-residential construction looking to be well past its peak. New building fell almost 12% in the March quarter and is now down over 25% on a year ago. With interest rates rising and demand easing, particularly from the public sector, there seems little impetus for a marked turnaround in these conditions. Indeed, the public sector is also cutting back on investment, with the federal government, which accounts for the bulk of investment in the Territory, slashing investment by 16% in the past year.

Against this more challenging economic backdrop, the 2008-09 Budget appears to strike a reasonable balance between fiscal prudence and appropriate investment in public infrastructure. The net operating balance is forecast to be in surplus to the tune of \$84.9mn in 2008-09, with surpluses gradually declining thereafter, to \$33.7mn by 2011-12. The centrepiece of the Budget is a 5-year \$1 billion *Building the Future* program which provides funding for health (\$300mn), transport (\$250mn), urban amenities (\$100mn), climate change initiatives (\$100mn) and ICT infrastructure (\$50mn). Importantly, and in contrast to some its larger state counterparts, the Territory has funded its infrastructure program through past and future budget surpluses, not by increasing debt.

Economic data – Australian Capital Territory

Monthly data (% change)	Dec-07	Jan-08	Feb-08	Mar-08	Apr-08	May-08
Retail sales	-0.8	2.0	1.2	-0.4	-0.1	0.1
Total building approvals (trend)	2.4	2.4	-3.5	-4.8	-5.7	-7.4
Employment	0.3	0.4	0.4	0.4	0.4	0.3
Unemployment rate, %	2.5	2.5	2.6	2.6	2.7	2.7
Quarterly data (% change)	Dec-06	Mar-07	Jun-07	Sep-07	Dec-07	Mar-08
Household consumption	1.4	1.3	0.4	-0.1	3.3	-1.6
Private investment	-0.4	1.7	-2.9	-3.3	-3.2	-4.4
Public demand	1.0	0.1	4.0	-3.7	2.5	-1.1
State final demand	1.0	0.7	2.0	-2.5	2.2	-1.6
Population, ann. % ch.	1.2	1.5	1.7	1.5	1.3	n.a.
Median house price – Canberra, \$'000s	413.1	419.4	437.8	460.0	475.1	480.0
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	2.0	1.5
Employment	0.1	2.1	1.2	3.8	1.0	0.8
Consumer prices – Canberra	2.6	2.3	3.6	2.9	3.6	3.7

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

Contacts

ANZ Economics & Markets Research

Saul Eslake

 Chief Economist
 +61 3 9273 6251

Saul.Eslake@anz.com
Fiona Allen

 Business Manager
 +61 3 9273 6224

Fiona.Allen@anz.com
Tony Pearson

 Deputy Chief Economist and
 Head of Industry and Strategic
 Research
 +61 3 9273 5083

Tony.Pearson@anz.com
Mark Rodrigues

 Senior Economist,
 Industry and Strategic Research
 +61 3 9273 6286

Mark.Rodrigues@anz.com
Julie Toth

 Senior Economist,
 Industry and Strategic
 Research
 +61 3 9273 6252

Julie.Toth@anz.com
Warren Hogan

 Co-Head of Australian Economics
 and Interest Rates Research
 +61 2 9227 1562

Warren.Hogan@anz.com
Sally Auld

 Co-Head of Australian Economics
 and Interest Rates Research
 +61 2 9227 1809

Sally.Auld@anz.com
Katie Dean

 Senior Economist,
 Australian Economics and
 Interest Rates Research
 +61 3 9273 1381

Katie.Dean@anz.com
Riki Polygenis

 Economist,
 Australian Economics and
 Interest Rates Research
 +61 3 9273 4060

Riki.Polygenis@anz.com
Dr. Alex Joiner

 Economist,
 Australian Economics and
 Interest Rates Research
 +61 3 9273 6123

Alex.Joiner@anz.com
David Croy

 Strategist,
 Australian Economics and
 Interest Rates Research
 (London)
 +44 20 7378 2070

David.Croy@anz.com
Patricia Gacis

 Strategist,
 Australian Economics and
 Interest Rates Research
 +61 2 9227 1272

Patricia.Gacis@anz.com
Jason Hill

Credit Analyst

Jason.Hill@anz.com
Amy Auster

 Head of Foreign Exchange and
 International Economics
 Research
 +61 3 9273 5417

Amy.Auster@anz.com
Tony Morriss

 Senior Currency Strategist,
 Foreign Exchange and
 International Economics
 Research
 +61 2 9226 6757

Tony.Morriss@anz.com
Jasmine Robinson

 Senior Economist,
 Foreign Exchange and
 International Economics
 Research
 +61 3 9273 6289

Jasmine.Robinson@anz.com
Amber Rabinov

 Economist,
 Foreign Exchange and
 International Economics and
 Commodities Research
 +61 3 9273 4853

Amber.Rabinov@anz.com
Mark Pervan

 Head of Commodities Research
 +61 3 9273 3716

Mark.Pervan@anz.com
Amber Rabinov

 Economist,
 Foreign Exchange and
 International Economics and
 Commodities Research
 +61 3 9273 4853

Amber.Rabinov@anz.com
Paul Braddick

 Head of Property and Financial
 System Research
 +61 3 9273 5987

Paul.Braddick@anz.com
Ange Montalti

 Senior Economist,
 Property and Financial System
 Research
 +61 3 9273 6288

Ange.Montalti@anz.com
Dr. Alex Joiner

 Economist,
 Property and Financial System
 Research
 +61 3 9273 6123

Alex.Joiner@anz.com
Stephanie Wayne

 Research Analyst,
 Property and Financial
 System Research
 +61 3 9273 4075

Stephanie.Wayne@anz.com
Paul Gruenwald

 Head of Economics, Asia
 +65 6419 7902

Paul.Gruenwald@anz.com
Ivy Tan

 Associate Director, Credit
 Research, Markets Asia
 +65 6419 7914

Ivy.Tan@anz.com

Research & Information Services

Mary Yaxley

 Head of Research & Information
 Services
 +61 3 9273 6265

Mary.Yaxley@anz.com
Marilla Rough

 Senior Information Officer, R&IS
 +61 3 9273 6263

Marilla.Rough@anz.com
Manesha Jayasuriya

 Information Officer, R&IS
 +61 3 9273 4121

Manesha.Jayasuriya@anz.com

ANZ New Zealand Research

Cameron Bagrie

 Chief Economist
 +64 4 802 2212

Cameron.Bagrie@anz.com
Khoon Goh

 Senior Economist
 +64 4 802 2357

Khoon.Goh@anznational.co.nz
Philip Borkin

 Economist
 +64 4 802 2199

Philip.Borkin@anznational.co.nz
Steve Edwards

 Economist
 +64 4 802 2217

steve.edwards@anznational.co.nz
Kevin Wilson

 Rural Economist
 +64 4 802 2361

Kevin.Wilson@nbz.co.nz

Important Notice

Australia and New Zealand Banking Group Limited is represented in:

AUSTRALIA by:

Australia and New Zealand Banking Group Limited ABN 11 005 357 522

14th Floor 100 Queen Street, Melbourne, Victoria, 3000, Australia

Telephone +61 3 9273 6224 Fax +61 3 9273 5711

UNITED KINGDOM by:

Australia and New Zealand Banking Group Limited

ABN 11 005 357 522

40 Bank Street, Canary Wharf, London, E14 5EJ, United Kingdom

Telephone +44 20 3229 2121 Fax +44 20 7378 2378

UNITED STATES OF AMERICA by:

ANZ Securities, Inc. (Member of NASD and SIPC)

6th Floor 1177 Avenue of the Americas

New York, NY 10036, United States of America

Tel: +1 212 801 9160 Fax: +1 212 801 9163

NEW ZEALAND by:

ANZ National Bank Limited

Level 7, 1-9 Victoria Street, Wellington, New Zealand

Telephone +64 4 802 2000

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