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Economics@ANZ

Special Economic Report

Outlook for the Australian States

Macroeconomic overview

The overall macro economic prognosis for the Australian economy remains favourable in 2006/2007. Australian growth will accelerate through 2006 as dwelling investment rebounds, commodity exports strengthen (as new mines and infrastructure come on line), and as rural production and exports recover in response to widespread rains. We have GDP growth rising from 2.6% in 2005 to 3.1% in 2006 and 3.6% in 2007. Within that generally positive national environment the relative performance of the state economies will be a function of four broad influences.

First, the national house price boom is over, with prices of established houses rising by just 1% over the year to September quarter 2005. There are marked regional differences, with prices in Sydney, Melbourne, Brisbane, Hobart and Canberra falling in the September quarter, while prices in Darwin, Perth and Adelaide increased. These differences partly reflect timing in that the price boom began in the south eastern states and consequently has matured there earlier than in the other states. It also reflects the changing nature of the economic drivers, with the resources boom and related infrastructure investment powering economic activity and house prices in WA and NT. (Refer the December quarter ANZ Property Outlook for in depth analysis of trends in the property market).

Second, the mix of economic activity in Australia has moved away from domestic demand towards external demand. The end of the house price boom has led to a slowing in household consumption and in dwelling construction. The impetus to growth is now stemming more from the mining boom. This reflects the 2 decade high in global growth in 2004, continued strong (though somewhat down from 2004) growth in 2005, and an expectation that global activity will remain above trend in 2006.

This is boosting Australian economic activity through increased corporate profitability, particularly for the mining and infrastructure sectors, with the related spinoffs (in those sectors) of stronger business investment, and stronger growth in jobs and employee remuneration. The government sector is also benefiting through higher company tax and personal income receipts, and higher mining royalties. The states which can best leverage off the mining boom are outperforming and will continue to outperform those states which cannot.

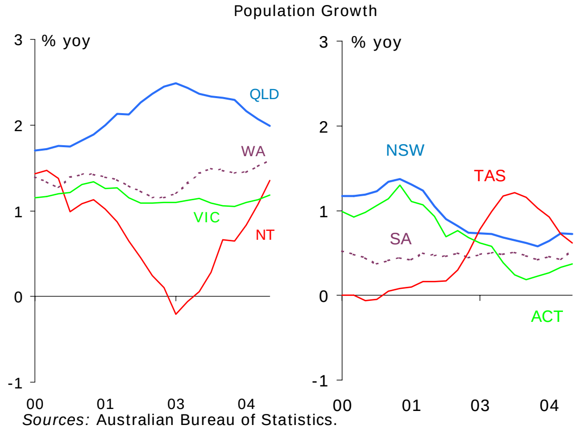
Contribution to total state factor income
Selected industries %

	Agri	Mining	Manuf	Electric Gas Water	Finance & Insurce	Prop & Bus
NSW	2	2	12	2	**10**	**15**
VIC	3	1	**15**	3	**9**	**14**
QLD	4	8	11	2	5	10
SA	**6**	2	**16**	3	6	10
WA	5	**21**	9	3	4	11
TAS	**7**	2	**16**	**5**	6	6
NT	3	**20**	8	2	3	8
ACT	0	0	2	2	4	**13**
AUST	3	5	12	2	7	13

Source. ABS Cat No 5220.0.

Third, the wide disparity in population growth between states will continue. Queensland has enjoyed the strongest pace of population growth in recent years and this is expected to continue to underpin economic activity in that state. WA has recently enjoyed increased inflows from other states in response to increased employment opportunities.

Population growth differs between states



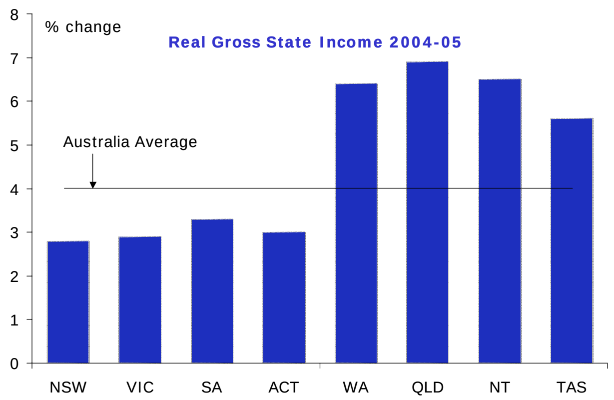
Sources: Australian Bureau of Statistics.

The south eastern seaboard states and Tasmania have seen some minor variations in population growth but generally will – with the exception of Victoria - continue to underperform the north and west.

Fourth, state budgets will continue to be pressured by slowing revenues and increasing costs. Revenue growth has been negatively impacted by the end of the property boom (reflecting a sharp decline in the volume of property transactions and associated stamp duties) and some slowing in the growth of GST income as household consumption has cooled. For some states this has been compensated by higher mining royalties. At the same time expenses have continued to rise, partly due to public service wage rises but also due to increased demand for services, particularly infrastructure and health services, in those states with strongly rising populations and or aging populations. One solution to these pressures in the past has been the privatisation of assets or provision of new infrastructure through public private partnerships, although recent public backlash and increased scrutiny of such projects, particularly in NSW, might slow recourse to such solutions going forward.

Disparities in these fundamental drivers have led to stark differences in the economic performances of the states. The states which enjoyed the fastest growth over the past year were those which had a higher reliance on the mining industry and/or rapid population growth. This led to above average performance by the Northern Territory, Queensland, Western Australia and Tasmania. In contrast, the mainland south eastern states were disproportionally affected by the end of the housing boom and by job losses in motor vehicle manufacturing; textiles, clothing and footwear; and other manufacturing industries. This marked difference in growth performance is expected to narrow over the next two years, as a cooling in the mining boom and some recovery in domestic drivers of growth leads to a more equal performance. The recent relatively strong performance of Tasmania may be short lived, with the easing of the recent spike in population growth and the end of the house price boom removing two key economic drivers.

Stark differences in the economic performance of the states



Source: Australian Bureau of Statistics

NSW

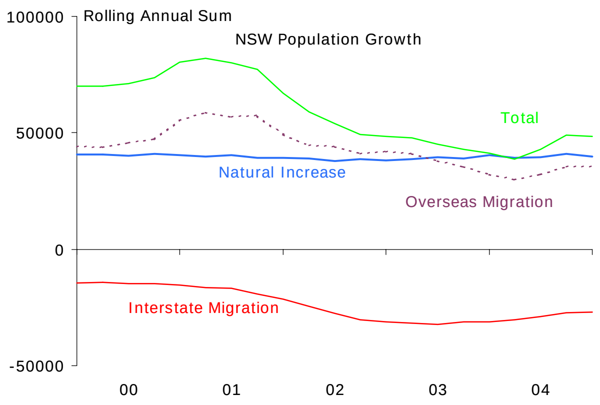
NSW used to be known as the Premier State but recently it would be more apt to call it the state of disappointment. In 2004-05 NSW had the weakest economy of any state or territory, with growth in Real Gross State Income (RGSI) of just 2.8%, compared to an Australian average of 4.0% and peak growth of 6.9% in Queensland. (RGSI is used as a measure of growth, as an alternative to the more commonly used Gross State Product, because it better captures the terms of trade effect from the mining boom).

The poor performance has been partly the result of its industry composition. NSW has the heaviest reliance on the industries of finance and insurance, and property and business services, which together comprise a quarter of total state economic activity. It also has a low relative exposure to the booming mining industry, at just 2% of state income. As a result, the cooling in the residential property market – which has been far more severe in NSW in terms of prices, sales volumes and construction activity - has been a significant depressor of economic activity, growth and employment, with little offset provided by the booming mining industry.

Reflecting the poor economic performance, the labour market has not been as buoyant as in some other states, with growth in employment of 2% (trend data) over the year to June 2005. This was still sufficient to drive the unemployment rate to a three decade low of 5.1%, although this was partly because job seekers were moving to regions with more rapid employment growth (see below). In recent months some cracks have begun to appear, with employment falling in each of the three months to November and the unemployment rate rising to 5.3%.

Population growth in NSW has slowed, in terms of both total numbers and the growth rate, from an annual rate of 1.3% in mid 2001 to a rate of about 0.7% in early 2005. This is partly the result of reduced immigration from offshore, although NSW continues to receive more migrants than any other state. It also reflects an increase in migration from NSW to other states, particularly Queensland. The latter is a product of retirees heading for the sun, but also reflects a flight from the high costs (especially housing) and congestion and reduced employment opportunities of Sydney by working age people and young families.

NSW population growth has slowed



Source: Australian Bureau of Statistics

NSW budget weakens. When it rains it pours. As well as the weaker growth momentum and slower population growth in NSW, there has also been a deterioration in public finances. The NSW Labour government had made a feature of its strong fiscal position, with 8 consecutive operating surpluses and a program of steady debt reduction. For 2005-06 the government had initially projected a net operating surplus of $303mn but the mid year review revealed this has deteriorated to the point where the budget will only just be in surplus ($21mn). Even worse, the 2006-07 net operating surplus was initially forecast at $481mn but is now projected at a deficit exceeding $500mn.

NSW's budgetary problems reflect increases in public health and education costs and public sector wages, and a revenue downturn from the end of the property price boom and the abolition of the vendor duty on investment property.

In response, the government is seeking to cut recurrent spending, but has suggested the budget is unlikely to return to surplus until 2008-09. It is also looking at what else there is left in the cupboard to sell. It has flagged the privatisation of its 58% stake in Snowy Hydro, which would raise more than $1bn, and be used to fund infrastructure rather than for recurrent spending.

On the positive side, NSW government debt levels are low. General government underlying net debt has fallen from $12.2bn (7.1% GSP) in June 1995 to $2.3bn (0.8%GSP) in June 2005. At this point the state's AAA credit rating is not under threat.

Taking a broader perspective, the true state of NSW's finances was never as good as it seemed. The budget surpluses refer to the operating side of the state accounts only. That is, there is sufficient revenue to cover recurrent expenditure, but the government is still able to borrow to fund capital works without affecting the quoted operating surplus (although to be fair total debt levels have been reduced). Also, the government has transferred formerly public expenditure to the private sector through Private Public Partnerships for key infrastructure projects such as roads. The voting public still pays, but through direct user pays fees rather than state taxes. Whether this is a good deal for the public, and the most efficient means of providing public infrastructure, is a function of whether the long run cost to the end user is higher or lower. That is an issue about which there has much debate. Having said that, NSW is not alone, with these issues also impacting on other states budgets to some extent.

A new beginning? Some of the weak performance by NSW has to be sheeted home to the previous labour administration which seemed to have an anti-growth mindset and questionable competence. Former Premier Carr famously declared "Sydney is full", encouraging migrants (and hence business) to go elsewhere. The much reviled vendor tax on investment properties discouraged new investment into residential real estate and served to further depress what was already a declining property market. Years of underinvestment in public infrastructure was highlighted by chronic problems with the rail system. The private public partnerships championed by the previous administration have now been found to have anti competitive elements that are not in the best interests of end users.

These issues appear to have been recognised by new Premier Iemma and there are encouraging signs of change. The Premier has declared NSW is open for business. The vendor tax on investment properties has been abolished. New guidelines have been drawn up for private public partnerships which provide for transparent agreements and tighter controls on concessionary arrangements for the private operators of monopoly assets. New timetables facilitate more timely trains (although that has been achieved by cutting services!).

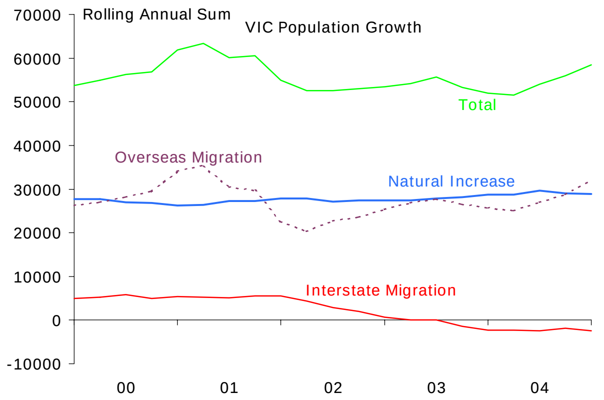
Victoria

Victoria recorded the second weakest growth rate in 2004/05, only slightly ahead of NSW. This primarily reflected its relatively high dependence on manufacturing, finance and property, and business services, and a very low leverage to the booming export commodity industries. Victoria had been an early beneficiary from the residential property price boom, but also was one of the first states to feel the slowdown, with prices being essentially flat since December quarter 2003.

The big hope for the Victorian economy in 2006 is the Commonwealth Games in March. Some $1bn has been allocated to build and improve infrastructure, including $430mn for upgrades to the MCG. However, this money won't contribute to economic activity in 2006 – it has already been mostly spent. There are also ticket sales and TV rights, although these will not directly impact on economic activity. For the games the main boost in 2006 will come from spending by visitors – rough projections are for 90,000 international and interstate visitors.

Although the Games are receiving a lot of hype, the experience with the 2000 Sydney Olympics raises the risk that the economic reality may fall somewhat short of expectations. During the Sydney Olympics total household spending didn't receive the anticipated boost, because residents stopped spending while they watched the games – the "couch potato" effect. Also, spending remained flat for months after the games as the Sydney population went through a post-games flat spot.

Victorian population growth is steady



Source: Australian Bureau of Statistics

The Victorian labour market has been solid, with growth in employment over the year to June 2005 of 3.4%, driving the unemployment rate down to 5.4%. As in NSW, in the final months of 2005 there has been some loss of momentum, with three consecutive falls in employment and a rise in the unemployment rate to 5.5%.

Perhaps surprisingly, in contrast to its softer economic performance, Victoria is ranked among the states with the higher population growth, above 1%pa. Population growth has been relatively steady over the past 5 years, and is more or less evenly split between natural increase and international immigration. Net interstate migration is broadly neutral for growth.

Victoria maintains solid fiscal position. Although the Victorian budget position faces many of the same pressures as NSW, with a slowing in state revenue from property and no direct offsetting boost from the mining boom, its budget remains in a much healthier shape. The state is expected to maintain a solid operating budget surplus. At the mid year review the 2005-06 surplus was revised down only slightly from $365mn to $331mn, and the budget is projected to remain in surplus over the next four years with an average of $416mn pa.

The state will maintain a strong infrastructure spending program averaging $2.8bn pa over the four years to 2008-09, with major projects in Melbourne and regional areas including new tollroads, rail upgrades and hospitals. Net debt is projected to increase but to remain low overall, rising from $1.5bn (0.7% GSP) at 30 June 2005 to $5.4bn (2.0% GSP) at 30 June 2009. The state retains its AAA rating.

Queensland

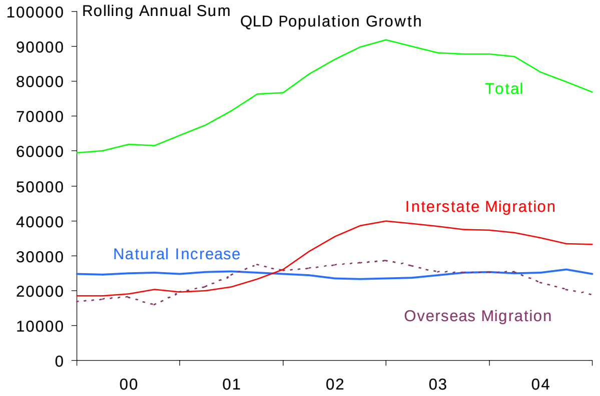
Queensland takes gold in a number of categories – fastest growing state, highest population growth, and most diversified industry structure. The latter observation may be something of a surprise because there is a colloquial belief that Queensland's industry structure is heavily skewed towards mining and agriculture. While the proportions of those two industries are slightly higher than the national average, they are a long way short of the peak states. This is partly a product of rapid urbanisation, particularly in the south east, and also the result of the continued growth of tourism (which doesn't appear in the state accounts as a discrete industry). These developments are changing the nature of the economy away from its historical drivers. Such diversity is undoubtedly a positive development for sustainable growth which will be less affected by future volatility in the agricultural and mining industries.

Fast growth has led to an explosion of jobs, with employment growing by a very rapid 5.8% over the year to June 2005, and the unemployment rate falling to 4.7% in early 2005. Employment growth slowed in the second half of 2005 but remained positive, and the unemployment rate remained at a low 4.8%.

Queensland's population growth remains the highest of all the states at 2%. Inward migration from other states accelerated in the early 2000s as retirees sought the sun and younger folk sought a lower cost of living and better employment opportunities. Immigration from offshore also increased a touch. Both these trends began to ease in early 2003 with a resultant slight cooling in overall population growth.

This solid population increase continues to provide a strong demographic driver for domestically focussed industries such as dwelling construction, consumption goods, and services. It also presents a challenge, in that infrastructure and services require substantial ongoing investment to keep pace. In some sectors a mismatch of demand and supply has developed, with the increasingly stretched health and aged care services being a notable case in point.

Queensland population growth is strong



Source: Australian Bureau of Statistics

Queensland budget remains strong. Queensland has a strong budget position, recording very large operating surpluses in 2003/04 and 2004/05, and with surpluses projected for this year and next. Nevertheless, there has been some deterioration recently, with the 2005/06 surplus revised down by $216mn in response to increased spending on health services and infrastructure programs. Projected surpluses have also been reduced, in large part reflecting additional expenditure under the Health Action Plan. The state retains its AAA rating.

Western Australia

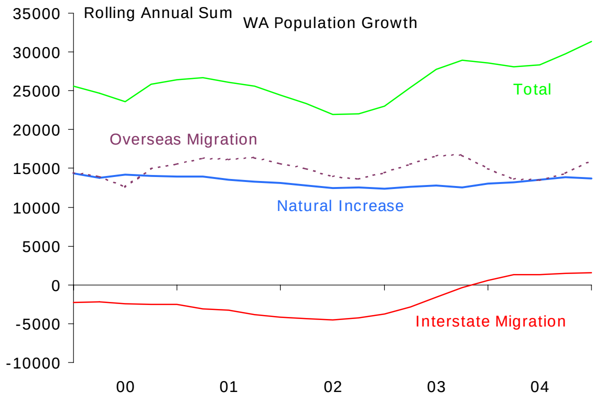
Western Australia was one of the top performing states in 2004-05, with growth in real gross state income of 6½%. It has the equal highest reliance on the mining industry (along with the NT) which comprises fully one fifth of state output. This makes it more exposed to the international business cycle, but over the past two years has left it ideally placed to leverage off the commodity price boom. WA also has a higher than average reliance on the agriculture sector, so the partial emergence from drought is also providing a boost.

There is nothing like a mining boom to create jobs, and over the year to June 2005 employment grew by 5.8%. That momentum slowed in the second half of the year, but was still sufficient to drive the unemployment rate down to 3.9% in November. The very tight labour market conditions are now creating concerns about a wages blowout, with reports of companies paying well over the odds in the scramble to attract workers, especially in more remote locations.

WA enjoys the second fastest population growth, behind Queensland, of about 1.5%. The pace of growth has been relatively steady over the past 5 years, and is the outcome in equal measure of natural increase and international immigration. Net interstate migration tends to be a slight negative for the state, although over the past year there has been some improvement, probably reflecting increased inflows of job seekers attracted by the mining and infrastructure boom.

Although WA is performing very well, it has to be said that is in part due to good luck rather than good management. One area where the WA government has been deficient is in competition policy. The 2003, 2004, and 2005 Reports of the National Competition Council assess WA's performance in implementing national competition policy as being well below that of the other states. Among other things, WA is the only state to heavily restrict weekday retail trading hours and to prohibit large retailers opening on Sundays, and the only state to regulate potato marketing. As a result it has not received from the Commonwealth Government all the funds it could have under the National Competition Policy.

WA population growth is solid



Source: Australian Bureau of Statistics

WA budget boosted by commodity boom. In contrast to the softer than expected outcomes in the SE mainland states, WA's budgetary position is getting stronger on the back of improved economic growth, increased mining royalties, and higher revenues flowing from the still strong property market. The mid year review shows the 2005-06 projected budget operating surplus has more than doubled from $521mn to $1302. The future projected surpluses have also been revised up by an average of $375mn. In short, the WA government is rolling in dough.

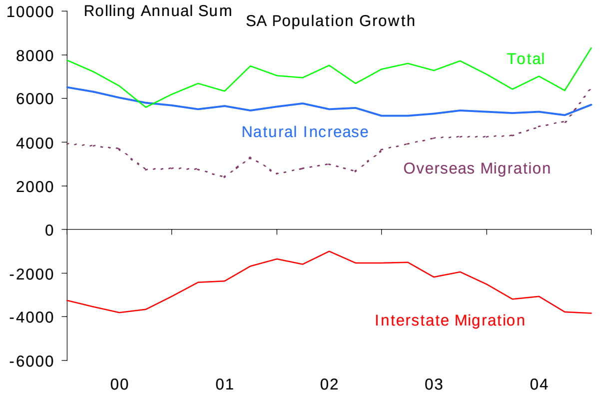
The stronger fiscal position has resulted in lower net debt than originally forecast, although debt levels remain high relative to some other states. Net debt is projected at $5.2bn or 30.7% of revenue as at 30 June 2006. The state retains its AAA rating.

South Australia

In 2004-05 South Australia was the best performing of the group of low growth states of the south eastern seaboard, although its growth of 3¼% in real gross state income was still only half that of the strong growth mining oriented states. SA has a strong reliance on manufacturing, particularly automotive, with General Motors Holden and Mitsubishi assembly plants and associated component suppliers. This sector should have benefited from booming domestic vehicle sales, although it perhaps has struggled more than expected due to a focus on large passenger vehicles, rather than on the stronger selling sectors of sports utility vehicles and more fuel efficient smaller vehicles. SA has also been unable to leverage off the mining boom due to a lower exposure to that sector, although new investment and exploration is occurring.

The labour market has nevertheless been quite buoyant, with growth in employment over the year to June 2005 of 3.2%. Jobs growth stalled in the second half of 2005, but the unemployment rate remained at a 30 year low of 4.9%.

SA population growth is steady



Source: Australian Bureau of Statistics

SA has weak but steady population growth of about 0.5%pa. That is a product of natural increase and inward international migration, which is offset in part by an accelerating net internal exodus to other states.

SA enjoys sound fiscal position. SA has recorded a net operating budget surplus since 2002/03 and is projected to maintain net operating surpluses for the foreseeable future. Net debt has been reduced to low levels in recent years, but no further reduction is anticipated out to 08/09. The state's credit rating was upgraded to AAA in 2004.

Tasmania

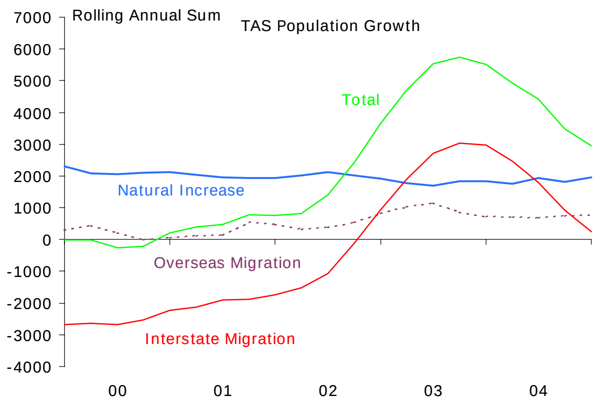
Tasmania has been the surprise performer of the past year, achieving a pace of economic growth to rival that of the booming mining states. And yet its industry composition is quite different, with a low contribution from mining, but the highest dependence on rural industries (including forestry and fishing), the highest dependence on utilities (hydro power), and also the equal highest proportion of manufacturing industries (boosted by businesses directly linked to forestry activities such as wood chipping).

Stronger growth has translated into improved opportunities for labour, with employment growing by 2.8% over the year to June 2005. Nevertheless, the number of new jobs has not been sufficient to absorb the growing labour force, and the unemployment rate has risen from 5.7% to 7.1% over the course of 2005.

One key to Tasmania's recent solid economic performance has been the return to a rising rather than falling population. This has been the result mainly of a strong turnaround in net interstate migration – people are moving to rather than leaving Tasmania – and a small increase in immigration from offshore. Low housing costs and a low cost of living have been key attractions. This population boost was a key driver of the Tasmanian housing boom and stronger growth in employment. Tasmania has also benefited from high quality economic management, with an excellent performance in introducing national competition policy.

The demographic boost has faded over the past year, with net interstate migration falling almost back to zero over the year to March. That in turn has contributed to the end of the house price boom and an easing in employment opportunities. On a more positive note, the proposed new Gunns pulp mill should provide a welcome boost to growth and employment, and the government is providing significant resources ($6.3mn over three years) to support this project.

Tasmanian population boost may not last



Sources: Australian Bureau of Statistics.

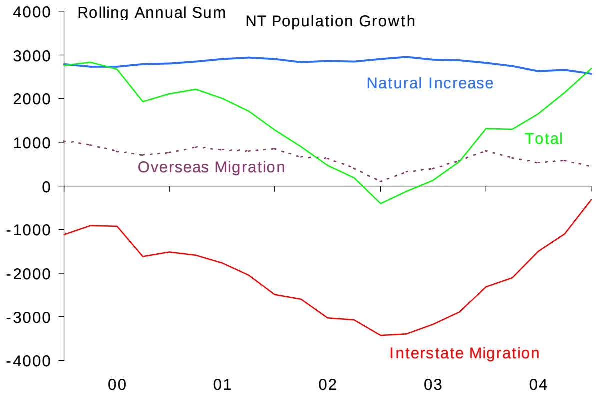
Tasmanian budget is solid. Tasmania's fiscal position is sound. The budget now aims for an operating surplus on a long term sustainable basis. The achievement of this goal has allowed the repayment of $1.6bn debt since 1998, facilitating the projected elimination of general government net debt by 30 June 2006, two years earlier than originally targeted in the fiscal strategy. The improvement in the fiscal position has been rewarded with successive ratings upgrades, to AA+ by Standard and Poors.

Northern Territory

The Northern territory recorded the second highest economic growth in 2004-05, behind Queensland. It has the equal highest dependence on the mining industry, which comprises about one fifth of state output, and is clearly revelling in the boom.

Population growth has been accelerating over the past two years, and is now the third highest in the country at about 1.3%. This rapid turnaround has reflected a slowing in net emigration to other states – improved employment opportunities on the back of the mining boom are encouraging more locals to stay (or less locals to leave) and attracting new job seekers. The unemployment rate reached a low 4.7% in the third quarter of 2005.

NT population begins to grow again



Source: Australian Bureau of Statistics

Continued solid offshore demand for hard commodities should keep the NT economy bubbling along nicely over the next two years. High population growth will also be positive for housing construction and household demand. The high dependence on the mining industry is an achilles heel, in that, as for WA, any downturn in the global economy particularly in Asia would hit the NT economy hard. But that is not our base case and continued solid global economic growth will present a favourable environment for the NT.

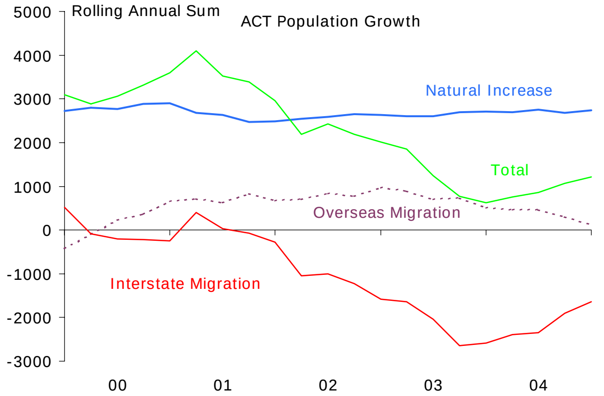
NT budget improves. The NT budget returned to a net operating surplus position in 2004/05 and at the time of the preparation of the 2005/06 budget had been projected to remain in surplus over the forecast period. However, the mid year review projects a return to a small deficit in 2005/06 before the budget returns to balance in 2006/07. The inability to sustain significant surpluses has prevented a reduction of debt. Net debt is expected to remain around the $1.8bn mark over the next three years, just under 20% of GSP. The NT debt is rated Aa2 by Moodys.

Australian Capital Territory

The ACT was in the low growth pack in 2004-05, with growth in real gross state income of just under 3%.

The ACT has no mining industry and so has been bypassed by the stimulatory impact of strong global demand and the mining boom. It remains dependent on the government sector, property and business services, and education. This is both a strength and a weakness. It is a strength in that average household incomes are high and predictable and employment is relatively secure. This tends to insulate the ACT from the private sector business cycle. But it can also be a weakness, when changes of government or budgetary pressures lead to occasional public service reorganisations.

ACT population growth has eased



Source: Australian Bureau of Statistics

Population growth in the ACT is the weakest of the states, with significant net interstate emigration in recent years, and virtually no net immigration from offshore. This may reflect a maturing of employment opportunities in government and education services; the number of people employed in the ACT has fallen steadily since April 2005. Despite this, the unemployment rate is very low, reaching just 3.2% in mid 2005 before edging up to 3.5% by end year.

Little change is expected in the key drivers going forward. That is, there will be little expansion in government employment opportunities, population growth will remain weak, and there will be little direct impact from the continued buoyant conditions in the mining industry or a rebound in agricultural production. Future growth will depend on the steady increase in public service incomes and spending.

Budget under pressure. The ACT has a chronic budget problem. The mid year review shows an estimated operating deficit for 2005-06 of $356mn (up from an initial estimated deficit of $91.5mn), with projected accumulated deficits over the five years to June 2009 of $1.4bn (the budget had been expected to return to surplus in 2006-07). And with a relatively "steady state" economy it is difficult to envisage where extra revenue streams can be sourced, suggesting the burden of balancing the budget will fall squarely on cost cutting. Despite these difficulties the ACT retains its AAA rating.

State Budgets
Operating Surplus/Deficit
$m

	02/03	03/04	04/05	05/06	06/07
NSW	1752	1146	569	21	-533
%GSP	0.6	0.4	0.2		-0.2
VIC	1531	958	795	331	317
%GSP	0.8	0.5	0.4	0.2	0.1
QLD	17	3339	3926	718	175
%GSP	0.01	2.3	2.6	0.5	0.1
SA	448	385	173	51	78
%GSP	0.8	0.7	0.3	0.1	0.1
WA	257	799	1240	521	435
%GSP	0.3	0.9	1.3	0.5	0.4
NT	-1	-40	23	34	51
%GSP	-0.01	-0.4	0.2	0.3	0.5
ACT	154.6	70.5	52.2	-356	
%GSP	0.9	0.4	0.3	-2.0	
TAS	170	313	134	29	3
%GSP	1.2	2.1	0.9	0.2	0.02

Key State Economic and Population Projections
% pa

		03/04	04/05	05/06	06/07
NSW	Popn	0.72	0.8	0.86	0.91
	GSP	1.4	1.1	1.5	2.75
VIC	Popn	1.18	1.08	1.02	0.97
	GSP	5.3	2.3	3.0	3.5
QLD	Popn	1.99	2.03	1.93	1.83
	GSP	5.2	4.0	4.25	4.50
SA	Popn	0.54	0.42	0.42	0.41
	GSP	2.8	2.6	2.5	2.75
WA	Popn	1.59	1.56	1.56	1.53
	GSP	8.1	2.7	4.5	4.5
NT	Popn	1.35	1.20	1.43	1.41
	GSP	0.2	3.6	6.0	6.0
ACT	Popn	0.37	0.43	0.55	0.82
	GSP	0.4	3.0	2.5	2.5
TAS	Popn	0.62	0.77	0.51	0.31
	GSP	3.7	4.0	3.0	2.5
AUST	Popn	1.1	1.16	1.14	1.12
	GDP	4.0	2.3	2.8	3.5

Source. Population projections are scenario B from ABS Cat No 3222.0. Growth projections from Economics@ANZ.

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