ANZ ECONOMIC OUTLOOK

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International outlook

- The upswing in the global business cycle peaked around the middle of last year and the global economy is now clearly softening. The main reason for the slowdown in global growth is the rapidly deteriorating outlook for the US.
  (Saul Eslake: page 2)

Australian outlook

- Recent annual growth figures mask a sharp weakening of underlying domestic demand. The deterioration in most areas of private demand suggest a marked slowing in the Australian economy in 2000-01 is unavoidable.
  (Paul Braddick: page 6)

Interest and exchange rate outlook

- A much lower than expected Q4 CPI leaves the RBA free to match further rate cuts by the Fed. ANZ expects around 100bps of easing from the RBA in 2001. The A$ should continue to trend higher, to around 0.62, by the end of 2001.
  (Karen Pringle & David de Garis: page 10)

New Zealand outlook

- Despite slower global growth, prospects for the NZ economy over 2001 remain favourable and, given the associated inflation risks, the RBNZ will maintain a relatively hawkish stance compared to most of the world's major central banks.
  (David Drage: page 14)

State outlook

- Economic conditions in 2000-01 are expected to be uneven amongst the states. The "sun-belt" states are expected to out-perform the south-eastern states aided by their exposure to increasing tourist arrivals and key mining and rural commodity exports.
  (Tim Toohey: page 17)

Economic chartbook

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INTERNATIONAL OUTLOOK

The world economy is now clearly slowing

As we suggested in October, the upswing in the global business cycle peaked around the middle of last year, and the global economy is now clearly softening. From an estimated 4.8% in 2000 – the best result since 1984 – global growth is expected to slow to a little under 3½% this year, a downward revision of ½ pc point from our October forecast.

By conventional yardsticks, this does not qualify as a 'hard landing'. Indeed, 3½% is equivalent to the long-term trend rate of growth in the world economy over the past 30 years. 'Global recessions' – as in 1974, 1982 and 1991 – have been associated with world growth of less than 2%.

However, the projected slowdown in growth between 2000 and 2001 – of around 1¼-1½ pc points – is quite marked by historical standards. On only three occasions in the past thirty years has world growth fallen by more than 1½ pc points from one year to the next (1973-74, 1979-80 and 1997-98). From that perspective, the turnaround in global growth is very significant.

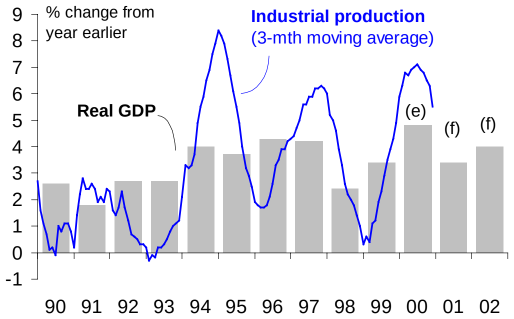
The main reason for the projected slowdown in global growth is the rapidly deteriorating outlook for the United States, for which we have cut our 2001 growth forecast to 2% (from 3% in October). The tepid recovery in the Japanese economy also appears to be faltering, prompting a downward revision of 1 pc point to our 2001 forecast. Reflecting these changes, and a number of domestic developments, the forecast for growth in non-Japan Asia has also been lowered by ¾ pc point. By contrast, the forecast for Europe is little changed from three months ago.

Outlook for world economic growth

	% change -			
	1999	2000 (e)	2001 (f)	2002 (f)
North America	4.2	5.0	2	3¼
Western Europe	2.3	3.3	2¾	2¾
Japan	0.3	1.9	1	2
China	7.1	8.0	7	7½
Other Asia (a)	5.2	6.1	4¾	5½
Australia and NZ	4.5	4.0	3¼	4¼
Latin America	0.3	4.4	3¾	4
E. Europe & Russia	2.0	5.6	5	4½
Total (b)	**3.3**	**4.8**	**3½**	**4**

(a) Includes South Asia (b) Weighted by GDP at purchasing power parity (PPP) exchange rates.

World economic growth



Note: 'World industrial production' compiled using data for 33 countries weighted in accordance with average 1993-97 GDP at market exchange rates. GDP based on 50 countries aggregated using 'purchasing power parity' weights.
Sources: National agencies, IMF, OECD and Economics@ANZ.

Although there are a number of important differences between the current slowdown and that of 1998, we anticipate that, as was the case then, timely action by the world's leading central banks will do much to forestall a fully-fledged global recession. The US Federal Reserve's unexpected rate cut early this month is consistent with that view. Except in Japan, fiscal policy will also be more supportive of economic growth. Given the lags involved, these actions will not prevent a major slowdown this year; but they should be sufficient to produce a rebound in world growth to around 4% in 2002.

The US is leading the global slowdown

Through the second half of the 1990s, the US was the powerhouse of the global economy. Over the four years to the June quarter 2000, the US economy grew at an average annual rate of 4.5%, including a 6% spurt over the last four quarters of that period. But since then, the US economy has slowed abruptly, to (on our estimates) an annual rate of less than 2%. Private sector jobs growth, which had averaged 223,000 per month over the four years to June 2000, dropped to an average of just 84,000 per month during the final quarter of last year – the weakest since the September quarter of 1992.

Some slowing in the US economy was widely expected in the wake of the Federal Reserve's tightening of monetary policy begun in mid-1999, which entailed a cumulative increase of 175 basis points in the Federal funds rate.

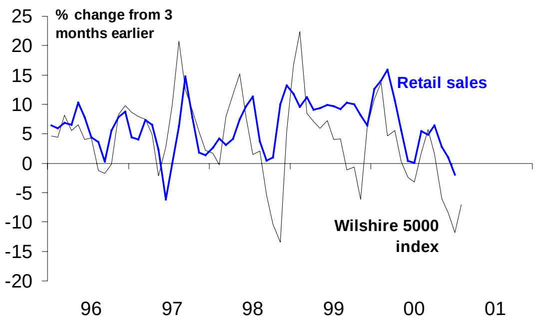
The effects of rising interest rates have been re-inforced by the impact of higher energy costs. Although crude oil prices have now fallen by more than 20% from their mid-November peak, natural gas and electricity prices remain high.

Because households have been unable to offset rising energy costs with wage increases (as they did in the oil shocks of the 1970s), the rise in energy costs has had an effect similar to that of a tax increase. In much the same way, because businesses have, in general, been unable to recoup higher energy costs through price increases, profit margins have been squeezed.

The abruptness of the slowdown owes much to the reversal in the US stockmarket. Over the five years to 1999, total returns on US stocks (with dividends re-invested) averaged 30% per annum. The value of personal stock holdings, directly and through mutual funds, rose by some US$7.5 trillion, equivalent to almost an entire year's personal disposable income. Federal Reserve estimates suggest that 'wealth effects' flowing from this extraordinary increase in equity values have boosted overall spending by around 1% per annum in recent years. This has been paralleled by the decline in the US personal saving rate from around 5% in the mid-1990s to –0.8% in November last year, and in the widening of the US current account deficit to 4.5% of GDP.

However, 2000 turned out to be the first 'down' year for the US stock market since 1992 and the total return of –11.6% was the worst result since 1974. Although textbooks, and many formal economic models, suggest that 'wealth effects' show up with long lags, the more recent US experience has been that changes in share market values affect consumer spending quite quickly.

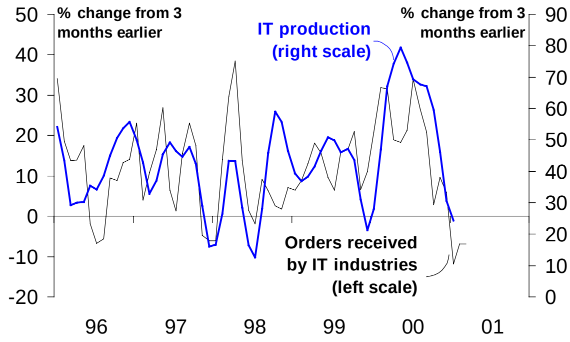
US share prices and retail sales



Note: The Wilshire 5000 index is the broadest gauge of US share prices. Changes in retail sales are at seasonally adjusted annual rates.
Sources: Datastream; US Commerce Department.

The decline in share prices is also affecting economic activity through its impact on technology spending. The share market provided much of the wherewithal for heavy spending by 'new economy' companies, not just on hardware and software but also on advertising, premises and personnel. That channel is now effectively closed. By one count, 210 internet companies ceased operations in 2000 (86 of them in November and December), entailing the loss of 15,000 jobs and US$1.5bn in investment.

IT orders and production



Note: 'IT production' refers to production of computers, semi-conductors and communications equipment. IT orders are a 3-month moving average.
Sources: Federal Reserve Board; Commerce Department.

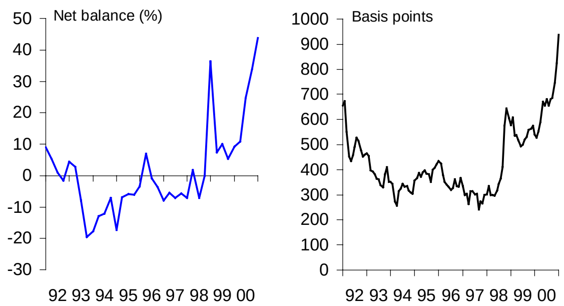
This shakeout clearly has further to run. And the boom in technology spending by businesses in established industries also appears to have passed its peak, prompting a classic cyclical inventory adjustment in the technology sector.

With the benefit of hindsight, although the much-feared disruptions associated with last year's 'Y2K' event did not occur, preparations for it were probably a much more important influence on fluctuations in the US economy. Spending on hardware and software surged ahead of the 'Y2K' deadline, adding to the pace of domestic spending and contributing (albeit perhaps at the margin) to rising inflation. Software prices, which fell on average by 8.3% over the five years to end-1998, have since risen by 7.7%; while the rate of decline in hardware prices also slowed markedly from early 1999 onwards.

The abrupt slowdown in the US economy also comes on the heels of a marked tightening in the availability of credit. The Federal Reserve's Senior Loan Officer survey indicates that bank lending standards were tightened quite dramatically over the second half of last year; while in the capital markets the spreads between yields on sub-investment grade and 'AAA' rated debt widened to their largest since the 'junk bond crises' of the early 1990s.

Credit standards

Banks tightening business loan credit standards | **Spreads between 'high yield' and AAA-rated bonds**



Sources: Federal Reserve Board; Lehman Bros.

Finally, a steep rise in the tax burden may also have heightened the vulnerability of personal spending to a shock such as last year's reversal in the stock market. Tax payments as a percentage of personal income have risen by more than 3½ pc points over the past five years, to the highest level since 1974.

In all, we expect growth in the US economy to average just 2% in 2001, down from an estimated 5.1% last year. For an economy whose potential growth rate is now reckoned to be around 4%, this represents a significant shortfall in growth, and is likely to be accompanied by a fairly sharp rise in unemployment, to an expected 5½% by the end of the year. It thus undoubtedly 'feels' like a recession in many respects, even if – on our forecasts at least – it does not meet the traditional test of at least two successive quarters of negative GDP growth.

With that prospect, the 50 bp cut in the Fed funds rate announced in the first week of this year will not be the last. The funds rate will likely fall a further 75bp over the next six months, taking it back to 5¼% by June. As of mid-January the financial markets were pricing a 4¾% funds rate by July, which is not implausible if the economy were to slow even more than we expect. This possibility, though not the most likely outcome in our assessment, can't be lightly dismissed.

As we discussed here in October, the combination of weaker growth, lower interest rates and poorly-performing asset markets means that the US will attract a smaller share of cross-border investment flows, resulting in a continuing retracement of last year's gains in the US$ against the currencies of other countries which last year 'lost out' against the US in the competition for global capital. In particular, the euro should regain parity with the dollar by the middle of this year.

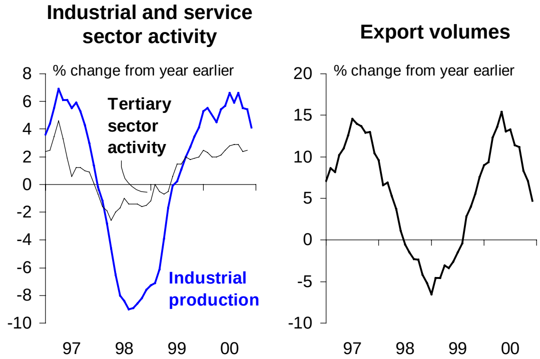
The deteriorating outlook for the economy also increases the odds that some form of income tax cut will be enacted this year. Slower growth lessens the force of the main economic objection to tax cuts when they were first proposed by George W. Bush, as a presidential candidate, last year. As proposed during the campaign, the incoming Administration's tax cuts do not begin to take effect until fiscal 2002. The Bush Administration will doubtless seek to accelerate the tax cuts; but will almost certainly need to compromise with Congressional Democrats over their size and distribution.

Japan's tentative recovery faltering (again)

Japan's economic recovery, always tentative and heavily dependent on support from public spending, is faltering once again. Consumer spending has remained weak, restrained by persistent weakness in employment (despite some signs of a pick-up in overtime worked and the number of job offers) and by on-going concerns about the viability of both public and private pension commitments which have resulted in a renewed upward trend in personal saving.

In the absence of a pick-up in consumer spending, the recovery in activity has relied on business investment, public works programs and exports. Last year's surge in business investment, led by technology spending, appears to be peaking. Export volume growth has more than halved since last April, reflecting the influence of last year's yen strength and weakening markets in the US and elsewhere in Asia. And public spending is no longer adding to overall growth as the impetus from previous stimulus packages fade and subsequent packages are, of necessity, smaller than their predecessors.

Japanese economy slowing



Note: Data shown as three-month moving averages.
Sources: Ministry of International Trade and Industry; Ministry of Finance.

An additional concern is the risk of further weakness in the financial system. The 35% decline in the Japanese stock market since mid-April has further eroded the capital of the banking system, and the financial position of the insurance industry is continuing to deteriorate.

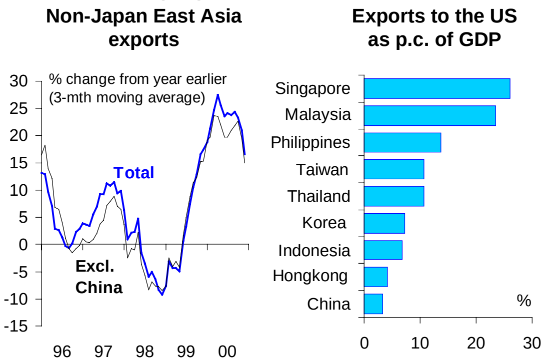
In retrospect, the Bank of Japan's decision last August to abandon its zero interest rate policy may have been premature. However, the BoJ is unlikely to revert to that policy in the absence of another financial crisis. Nor is there much scope for further significant fiscal stimulus. Although Japan is better-placed than most countries to cope with a public debt to GDP ratio approaching 130%, even it cannot continue running deficits of over 6% of GDP (the current MoF forecast for FY 2002) indefinitely.

In these circumstances, the only plausible policy response is to accommodate renewed depreciation of the yen, which is likely to drift towards ¥118 to the US$ by mid-year. A longer-term solution to Japan's economic stagnation remains elusive.

Asian economies exposed to US slowdown

Since the financial crisis of 1997-98, East Asia's 'emerging' economies have become even more dependent on exports, especially of high technology products and components, to the United States. The downturn in US technology spending is thus likely to have a significant impact on these economies' growth rates in 2001. The slowdown in Japan, which for most East Asian emerging economies is the second largest market, will also have some adverse impact. A significant slowing in regional export growth was already apparent during the second half of last year and this can be expected to intensify over coming months.

'Emerging' Asia's export slowdown



Note: exports are measured in US$. Trade shares are for 1999.
Sources: National statistical agencies and central banks; Datastream.

The sharp falls in most regional stock markets will also have an adverse effect on domestic spending, especially in Korea and Taiwan, while political factors will continue to hinder much-needed reforms in Indonesia, the Philippines and possibly Thailand.

Of all the Asian economies China and Hong Kong appear best placed to weather the global slowdown. They are the least exposed to the US in terms of exports as a share of GDP, will benefit from the expected decline in the US$ (to which their currencies are pegged) and have experienced much smaller declines in their stockmarkets. By contrast, the sharpest growth slowdowns are likely to occur in Korea, Taiwan, Singapore and Malaysia.

The last Asian export slowdown, in 1996, helped set the stage for the financial crisis of 1997-98 by exacerbating the region's dependence on short-term capital inflows to finance its widening current account deficits. Since then, all Asian economies have run current account surpluses and, despite the prospect of slower export growth, should remain in surplus in 2001 (since import growth is also expected to moderate). Thus, while economic and political factors may weigh on individual currencies, region-wide currency instability seems unlikely.

Limited fall-out for Europe

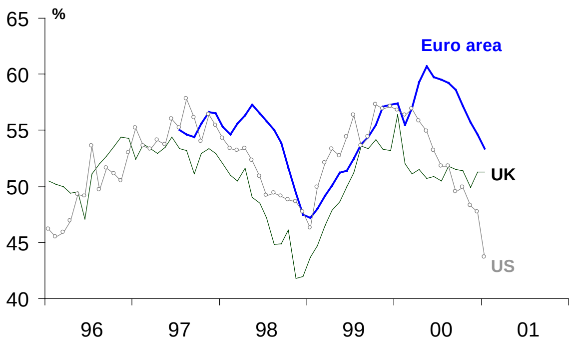
Of all the world's major regions Europe will experience the least slowing in economic activity this year. There is no denying that economic growth in Europe has slowed since the middle of last year. But to date, the slowdown has been much less marked – for example, while the US purchasing managers' index fell in January to its lowest level since April 1991, the corresponding indices for Germany, France, the UK and Italy remain above 50%.

Some of the factors which have contributed to the slowdown in the US have also been present in Europe – most obviously rising interest rates and higher petrol prices (exacerbated by last year's slump in the euro). But the factors which account for the abruptness of the downturn in US growth are not nearly as important in Europe. European households are less exposed to equities than their counterparts across the Atlantic. Technology production accounts for a much smaller share of most European economies' output (Finland is an exception) than it does in the US. There has not been any abrupt tightening of European bank lending standards, and capital markets are much less important as a source of debt finance in Europe than in the US. And tax cuts have already begun to take effect in many European economies.

Europe's trade exposure to the US is fairly small – about 4½% of GDP for the UK and a little over 2% for the euro area. However European companies are rather more exposed to the US downturn through their (much-enlarged) direct investments in the US.

Given that weakness in the euro and concern over the possible inflationary consequences of higher oil prices were major factors in the 225 bp increase in the ECB's benchmark repo rate during 1999-2000, the reversal of these influences, combined with the downside risks posed by the slowing global economy, should prompt a 75bp decline in the repo rate this year.

Purchasing managers' indices – Europe and US



Note: The purchasing managers' indices summarize the opinions of purchasing managers at manufacturing operations regarding production, new orders, prices, employment, supplier backlogs, inventory levels, etc. *Sources:* Reuters; UK CIPM; US NAPM.

AUSTRALIAN OUTLOOK

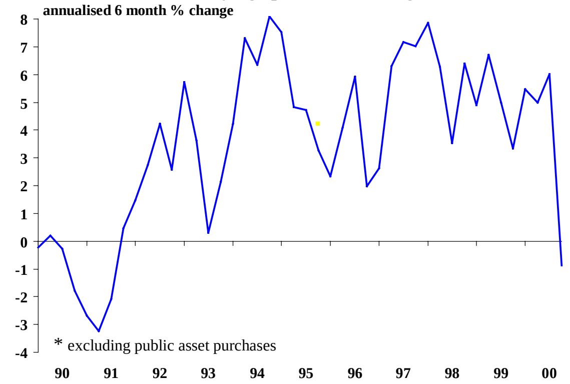
Headline growth masks a sharp slowdown

Headline GDP growth over the year to September 1999 remained buoyant at 4.2% and annual growth has now been above 4% for an unprecedented[1] 14 quarters.

However, aggregate annual growth figures mask a sharp weakening of underlying domestic demand over the past 6 months, particularly in the private sector. After averaging growth of just under 6% over the past 3 financial years, annualised six monthly growth in private demand slipped to –0.9% in the September quarter; the first negative figure since the recession in 1991.

Private demand growth has collapsed

Real underlying* private demand growth



Source: ABS Cat. 5206.0

Moreover, economic activity would clearly have slowed both further and earlier in the absence of the one-off stimuli provided by the Sydney Olympic games and pull-forward of domestic spending ahead of the GST.

The deterioration evident in most areas of private sector demand, combined with downward revisions to the global growth outlook, suggest a marked slowing in the Australian economy in 2000-01 is unavoidable. And the weakness of many partial indicators, including retail trade and employment in recent months, make Federal Treasury's growth projection of 4% seem very optimistic.

We have recently downgraded our GDP growth forecast for 2000-01 to 3% (from 3.5%) and we expect growth in calendar 2001 will be even weaker at 2.7%. The downturn in private sector demand will be led by a collapse in building activity and weakened household spending. With the private sector arguably already in recession, growth in 2001 remains highly dependent on ongoing strength in exports and public spending. Expected strong revenue growth from the new tax system should support public spending, particularly in the lead-up to the Federal election (which we expect in November 2001). However, the marked downgrading of the global growth outlook, combined with a strengthening $A and weakened rural production, raise serious doubts over the sustainability of last year's buoyant export growth.

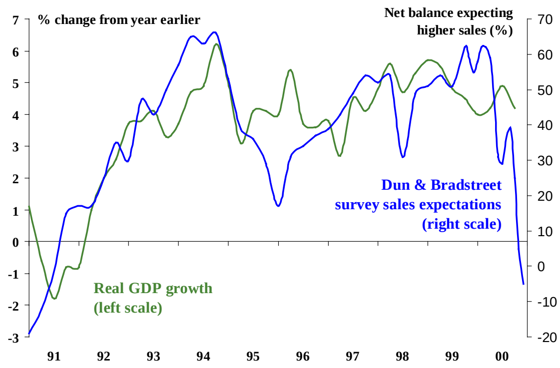
The economic slowdown in 2001 will, in all likelihood, be sharp but we also believe it will be temporary. Growth should recover to 4% in 2002 on the back of a rebound in global demand, lower interest rates and recoveries in both housing and non-residential building investment.

Soft landing may feel like recession

Despite weakening economic growth and rising unemployment, a slowdown in GDP growth to 3% in 2000-01 would be widely characterised as a 'soft landing'. However, the downturn in private sector demand is expected to be quite severe and for many businesses will probably feel more like a recession. This is particularly the case in the building and construction sector (and associated upstream industries) due to synchronised sharp downturns in housing, non-residential building and engineering construction. Retailers are also being hard hit by weakened growth in household spending. Sharp reductions in demand are occurring at the same time as many businesses face a squeeze on margins due to rising import and input costs (and the apparent inability to raise prices) while also dealing with the additional administrative burden and cash flow implications of the new Business Activity Statement.

Business sentiment has plunged

Expected sales and real GDP growth



Sources: Dun & Bradstreet; ABS.

Corporate insolvencies have risen considerably over the past year and a wide range of business surveys

[1] at least since 1960

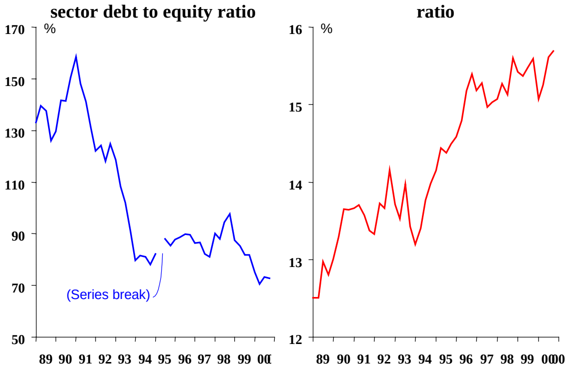
confirm that business confidence has deteriorated sharply in the past 6 months. Initial falls were associated with uncertainty surrounding the new tax system. However, recent declines reflect a substantial squeeze on margins and increased doubts over future demand growth.

The Dun and Bradstreet survey shows business sales and profit expectations have fallen to levels not seen since the recession in the early 1990s. The severe downgrading of business confidence raises serious questions over the likely strength of business investment, employment and profits growth in 2001.

However, corporate profitability has been extremely healthy with corporate gross operating surpluses up 17.2% over the year to September 2000. While profit growth is expected to weaken in 2001, the corporate sector as a whole is much better placed to withstand a cyclical downturn than it was in the early 1990s. The debt to equity ratio for the corporate sector has halved from its early 1990s peak. This stands in stark contrast to the household sector where rising indebtedness has left it far more exposed to higher interest rates.

Corporate sector is less exposed than households

Non-financial corporate sector debt to equity ratio | **Household debt to asset ratio**



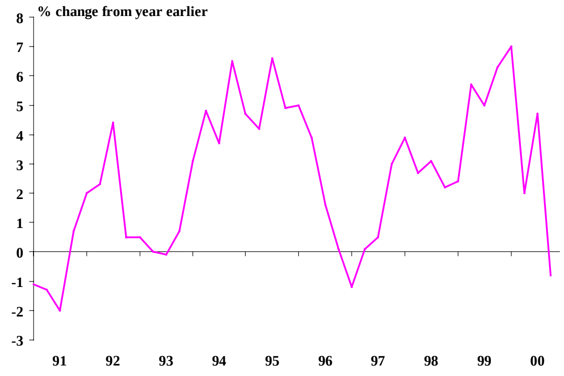
Sources: ABS; Economics@ANZ.

Household cash flows are being squeezed

A confluence of negative influences have squeezed household cash flows producing a sharp weakening in consumer spending over the course of last year. These influences include increased debt-servicing costs, falling employment, rising petrol prices and the payment of the final Telstra 2 instalment in early November. Negative wealth effects, weakened consumer sentiment and increased uncertainty surrounding both the new tax system and the general economic outlook have compounded these factors. A surge in motor vehicle purchases in the second half of 2000 has also diverted cash flow away from retail trade.
At the end of 1999, annual growth in real retail trade was running at 7%. However, spending growth collapsed in 2000 and real retail trade fell by 0.8% over the year to the September quarter. The weakness was particularly marked in discretionary retail categories with the worst hit being clothing, department stores and recreational goods. Furniture and floor coverings retailing has also been adversely affected by the downturn in housing construction.

Retail spending has collapsed

Real retail sales



Source: ABS Cat. 8501.0

Nonetheless, many of these negative influences peaked in the December quarter last year and retail spending should recover modestly in 2001. Despite the recent rebound in crude oil prices, petrol prices are still expected to fall over 2001, partially reversing the earlier drag on discretionary spending. Interest rates have peaked and we expect the official cash rate to be cut by 100 basis points by mid-year. This will reduce debt servicing costs and bolster consumer sentiment. A marked rise in the household savings ratio suggests that last year's income tax cuts have largely been saved due to uncertainties about the economic outlook. So any improvement in consumer sentiment could quickly translate into a rebound in spending.

Private investment is falling sharply

While slower consumer spending contributes to reduced GDP growth in 2000-01, the key factor behind the economic slowdown is a collapse in private investment. After expanding by 6.4% in 1999-00, real private gross fixed capital expenditure[2] is forecast to fall by 5.7% in 2000-01. The downturn will be led by sharp declines in both housing and non-residential construction.

Leading indicators of the housing market have recovered modestly in recent months, however, they remain at very low levels and continue to foreshadow a sharp downturn in activity in 2000-01.
Expectations that a backlog of work under construction would support activity in the immediate post-GST period proved false and dwelling investment collapsed in the September quarter,

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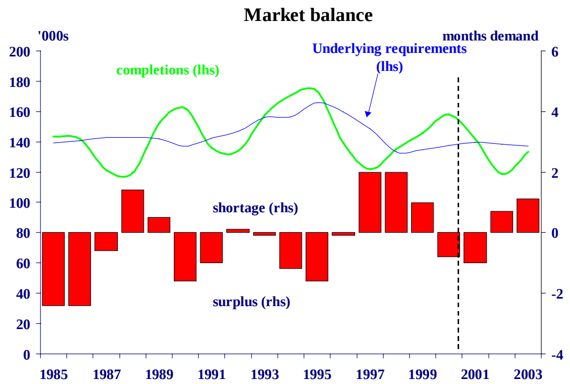
[2] Including housing, excluding public asset purchases

falling by 22%. We expect activity will fall further in the December and March quarters (reflecting the fall in building approvals to date) and forecast a year average decline of 17% in dwelling investment in 2000-01.

The post-GST cyclical downturn in house building will clearly be severe, but forecast declines in interest rates should underpin renewed growth in 2002. Despite a major pull-forward of building activity ahead of the GST, our estimate of the excess housing supply this year remains modest compared to earlier market downturns and we expect the market will return to pent-up demand in 2001-02.

Excess housing supply is modest by past standards

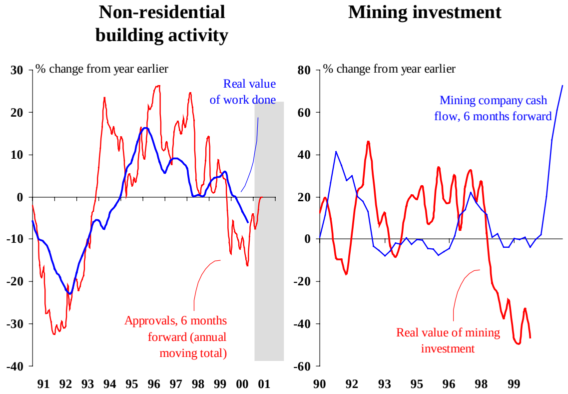


Housing starts reached 172,100 in 1999-00 and are forecast to fall to just 117,000 in 2000-01, before recovering to 128,000 in 2001-02.

After already falling by 11.5% in 2000-01, we expect a further marked decline in *real non-residential construction* in the current fiscal year. A bunching of major non-residential building and infrastructure projects in 1998 and 1999 saw non-residential construction's share of GDP reach levels not seen since the late 1980s. Such activity levels were unsustainable and both non-residential building and engineering construction have weakened sharply since mid-1999. The downturn in construction activity has been compounded by a collapse of mining investment that has persisted since the Asian crisis.

Nonetheless, recent non-residential building approvals figures suggest the sector may be close to bottoming and improving fundamentals in many sectors (particularly offices) foreshadow a rebound in building activity in 2001-02. Engineering construction activity is also forecast to recover in 2001-02 as mining investment rebounds (underpinned by improved A$ commodity prices and buoyant cash flow) and several major infrastructure projects are commenced. Strong rises in commodity export volumes (and weak investment) have lifted capacity utilisation in the mining sector necessitating a rebound in investment if potential export growth is to be achieved.

Non-res. investment should rebound in 2001-02



Public spending likely to remain strong...

Buoyant public spending has continued to support growth, contributing 1.3% of the 4.2% total GDP growth over the year to September. Despite a slowing of economic activity, strong revenue gains from the new tax system will test the Government's commitment to fiscal responsibility in the lead-up to the federal election.

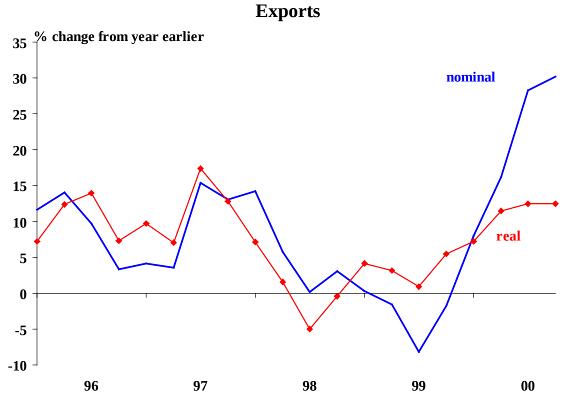
Fiscal policy has already been loosened substantially in the past year with the large income tax cuts that accompanied the new tax system. Public financial commitments already announced, including increased defence spending, the Alice Springs to Darwin railway, the regional roads package and the Parramatta to Chatswood rail link, suggest fiscal settings will be eased further and public spending is likely to remain strong this year.

...but export strength is unlikely to be sustained

Robust global demand and a 'super competitive' currency underpinned a surge in Australian exports over the past year. In the year to September, export volumes expanded by 12.4% and sharp increases in A$ prices lifted export values by over 30%.

However, this growth is unlikely to be sustained in 2001. Global growth has clearly slowed in the past 6 months and is likely to moderate export demand growth in 2001. Moreover, a strengthening A$ will reduce A$ prices for most commodity exports. In addition, capacity constraints in the mining sector (following the collapse in mining investment) will limit non-rural export growth and adverse weather conditions in 2000 (wheat production is forecast to be down by 22%) will result in a *fall* in rural export volumes this year.

Exports strong, but likely to slow



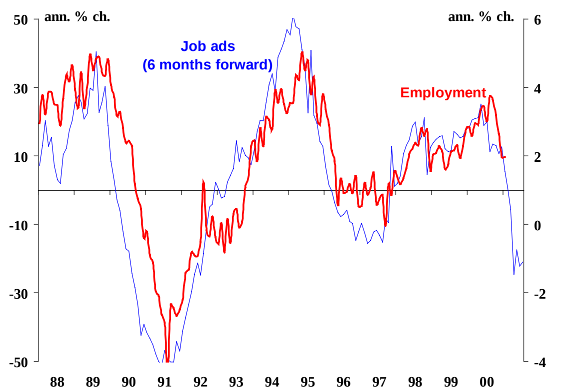
Source: ABS Cat. 5206, 5368

The strength of exports last year coincided with a sharp weakening of import demand. Consequently, net exports contributed strongly to growth in the second half of 2000 and the current account deficit narrowed dramatically[3]. However, we believe the best is now behind us and that the current account will widen (albeit slowly) in 2001 and that net exports will detract marginally from growth.

Employment growth has weakened sharply

Employment surged in mid 2000, expanding by 3.7% over the year to July, driving the unemployment rate down to 6.3%. Though the peak in employment may have been boosted by special factors (Olympics, GST), employment has weakened sharply since and the unemployment rate rose to 6.6% in December.

Job ads foreshadow further falls in employment



Source: ABS Cat. 6202, ANZ

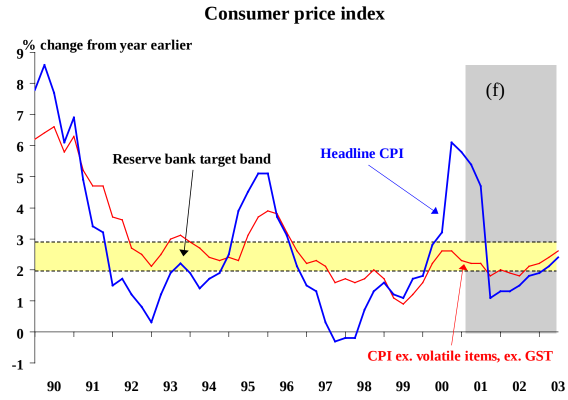
The weakening in employment has been particularly marked in full-time jobs with annual growth slowing to only 1.4%. The sharp decline in ANZ jobs over 2000 combined with falling business confidence and tightened profit margins, foreshadows further weakness in the labour market in early 2001. We expect employment growth of just 1.5% over the year to December 2001, lifting the unemployment rate back to 7% by year-end.

Inflation fears dissipate

A recovery in the A$, falling petrol prices, reduced economic growth expectations and a surprisingly low December quarter CPI outcome, have removed much of the upside risks to the inflation outlook. Despite burgeoning upstream price pressures, inflation rose by only 0.3% in the December quarter reflecting the inability of business to pass through cost rises to consumers in the current competitive business environment.

While we do expect some price rises in the March quarter (i.e. motor vehicles), the weakness of domestic demand suggests the ability to pass on widespread cost increases will remain limited.

Inflation risks have diminished



Sources: ABS; Economics@ANZ.

We estimate annual inflation (ex. GST, ex. volatile items) was running at only 2.3% in the December quarter. And despite apparent strong upstream price pressures, there appears to be little risk that this 'core' measure of inflation will threaten the upper end of the Reserve Bank's 2 to 3% target band in the near future. In fact, headline inflation (ex. GST) is forecast to fall below the bottom of the target band by mid-year as economic growth slows, petrol prices fall, and further indirect tax changes are introduced[4]. This suggests that little stands in the way of interest rate cuts over the first half of 2001.

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[3] The goods and services balance is likely to record a *surplus* in the December quarter.

[4] The abolition of stamp duty on quoted marketable securities, the abolition of Financial Institutions Duty and vehicle GST input tax credits to be raised from 0% to 5%

INTEREST AND EXCHANGE RATE OUTLOOK

The global easing cycle has begun

The surprising and aggressive 50bp cut in the US Federal Reserve funds rate on 3 January triggered a sharp re-assessment in global financial markets as to the timing and extent of interest rate cuts expected from a range of central banks during 2001, including the Reserve Bank of Australia.

Previously we had anticipated around 75 bps of Fed easing in total. Now we expect a more aggressive 125 bps of easing by mid-year. We expect the Fed to quickly follow its early January move with another 25bps reduction at the FOMC meeting on Jan 30-31 (50bp is a strong possibility given further economic weakness), followed by further 25bp cuts at the meetings scheduled for March 20 and May 15.

RBA is now free to match the Fed

In Australia, we also anticipate that the RBA will move to cut interest rates sooner and by more than previously thought. The sharp turnaround in global sentiment and the weaker outlook for the US economy clearly signals storm clouds approaching for Australia that were not evident a few months ago. As well, domestic economic data has shown a sharp weakening in private sector activity - in many areas to levels not seen since the last recession.

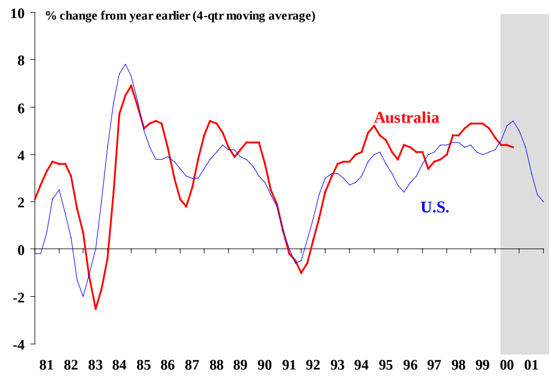
Residual inflation risks evident in Q4 'upstream' price indicators had threatened to delay the beginning of the RBA's easing cycle significantly beyond that of the Fed. But a much lower than expected December quarter CPI in late January removed this final hurdle and leaves the RBA free to respond to the deterioration in economic activity, matching further rate cuts by the Fed if it wishes.

Q4 CPI data showed the inflation outlook improving more rapidly than expected. Indeed, weakening domestic demand has seen a return of discounting and made it extremely difficult for businesses to pass on upstream price rises to consumers. This severe margin squeeze helps explain the sharp falls evident in business sentiment and profit expectations and, in turn, implies even weaker investment and employment going forward. The two main sources of cost pressures over the past year have been the low $A and rising oil prices. These are now abating and should allow businesses to rebuild profit margins without lifting prices.

Adjusting for our estimate of GST effects and petrol prices suggests that 'ongoing' inflation remains benign at around 2.3%. And, as higher quarterly rises a year ago drop out of the annual calculations, both 'headline' and 'ongoing' inflation are set to fall back below the RBA's target later this year.

As a result, ANZ envisages the RBA will move to cut interest rates following their first meeting for the year on February 6, by at least 25bps and quite possibly by 50bps (depending on what the US Fed decides to do a week earlier). We then expect a further 75bps of easing by mid year - 100bps in total. A series of 25bp cuts in April, May and June (keeping pace with 25bps cuts in the US in March and May) seems the most likely pattern, though it is indeed possible that any of these could be a larger 50bp move depending on economic circumstances.

US and Australian economic cycles



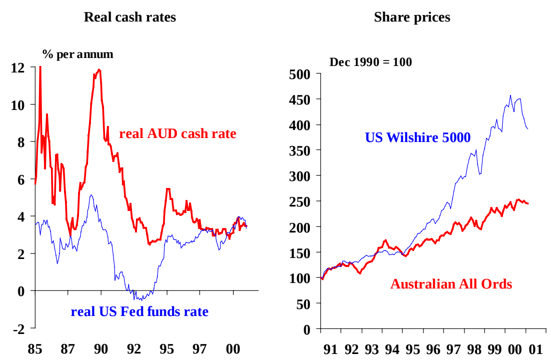
Sources: Australian Bureau of Statistics; US Department of Commerce; Economics@ANZ forecasts.

Overall, we expect only marginally less easing in total from the RBA than from the US Fed. The correlation between the US and Australian economic cycles continues to be surprisingly close and both economies are set to slow appreciably this year. But, Australia's overall GDP growth is not expected to slow as much as in the US and US policy was tighter than Australia's to begin with. This is especially the case when account is taken of the level of the real Fed funds rate relative to its long run average and the strength in the US dollar exchange rate this past year.

Australia's economy is being cushioned by the (still) weak Australian dollar, which is boosting external demand and has led to a solid improvement in the trade and current account balances. Australian economic activity is also being supported by looser fiscal policy, in part from the tax cuts which accompanied the introduction of the GST last year and also via stepped up levels of government spending (set to continue in this election year).

Moreover, Australia has not experienced anywhere near the same degree of wealth creation (and subsequent destruction) from the stock market. The All Ordinaries in Australia is off just 2% from its peak whereas the US Wilshire 5000 (a broad measure of equity prices) is down 16% and the Nasdaq (even with the bounce in recent weeks) is off 45%. As well, the US is experiencing a severe tightening in credit conditions and bank lending standards. There is little evidence of this situation in Australia, with credit growth still very strong.

Real cash rates and wealth effects



Note: 'Real' rates deflated by 'core' inflation in the US and 'on-going' inflation (excluding GST effects) in Australia.

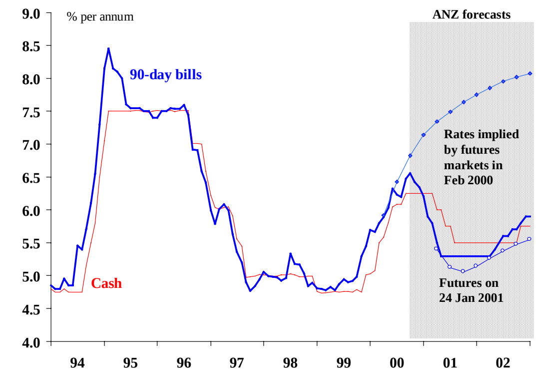
One reason the RBA's easing cycle may lag the Fed in both pace and timing is that the central bank may be keen to ensure that Australia's short term interest rates remain above US rates for a while. The RBA still has one eye on the currency, which is recovering from record lows and would not want to do anything to destabilise it.

The RBA will also be keen to get any policy adjustments over by mid-year given that an election is likely to be held in the second half of the year. The central bank would prefer to be "out of the picture" when electioneering gets more fully underway. We expect the election to be held in November though earlier dates are possible.

Market interest rates look 'fairly' priced

Australian bank bill futures in late January (immediately after the low Q4 CPI) were priced for RBA rate cuts of up to 125bps by the end of September 2001. This is only a little more than ANZ's expectation for 100bps of easing. Similarly, 1 to 3 year swap rates at around 5.4% are attractive levels for businesses looking to lock in funding for the year, but it is likely that yields could fall even further as forecasters become increasingly bearish on US and Australian growth prospects.

ANZ and market rate cut expectations



Sources: Reuters; Economics@ANZ.

In the past, interest rate markets have most severely 'overshot' in terms of cash rate expectations several months *after* the tightening/easing cycle has actually begun. This happens because the economy reacts to policy changes with a lag and there is a tendency for markets to think that the central bank is going to need to do a lot more (than is ultimately required) to achieve its objective.

In the last tightening cycle which began in November 1999, markets were most pessimistic about economic prospects in February after the second rate hike by the RBA (the only time in that cycle that the RBA hiked by 50bps rather than 25bps). At that time, bank bill futures were pricing for almost 7% cash rates by the end of 2000 and 7.5% by the end of 2001. The eventual peak in cash rates was, of course, only 6.25%.

Too soon to get bearish on bonds

Despite the recent rise in bond yields, it is still a little too early to become bearish on bonds outright. 10 year US treasury yields fell from 6.8% in January 2000 to 4.9% in early January and have recently risen to around 5.3%. Australian ten-year yields fell from 7.2% a year ago to 5.3% in early January.

However, it seems highly likely we will see up to another 50bp fall in bond yields in coming months as markets respond to signs of weakness in the economy and the whole yield curve shifts down as rate cuts come through. However, by mid-year, bond yields are likely to have begun to rise again, with yield curves steepening as recession risk is priced out of the market, sentiment about global growth turns positive in response to rate cuts early in the year and as global stock-markets recover.

The A$ turns the corner

On 22 November, the A$/US$ reached an all time low of 0.5070. Since then, the US dollar has fallen in value relative to many currencies, including the Euro, sterling, the Swiss Franc, the A$ and the NZ$. The Australian dollar rose to around $US0.55-0.57 and ANZ expects it will continue to trend higher to around 0.62 by the end of 2001, close to its 'fair value'.

In the just released January 2001 issue of *Foreign Exchange Consensus Forecasts*, the median forecast for A$/US$ at the end of 2001 also remains in the low 0.60s, now at 0.61. This is changed from recent month's surveys. Market analysts remain cautious about A$ prospects, with the currency having disappointed expectations a year ago that it would reach $US0.70 by the end of 2000. Despite the A$/US$ having already bounced six cents from its all time low in six weeks, forecasts for the Australian dollar point to higher levels, though with caution given uncertainties in the Asian region and the global economy more generally.

Much of the market commentary attributes the recovery in the A$ to the depreciation of the US$ (appreciation of the Euro). While this has indeed been a catalyst, Australian dollar-specific fundamental factors have arguably been important. These include commodity prices, interest rate differentials, and Australia's external accounts.

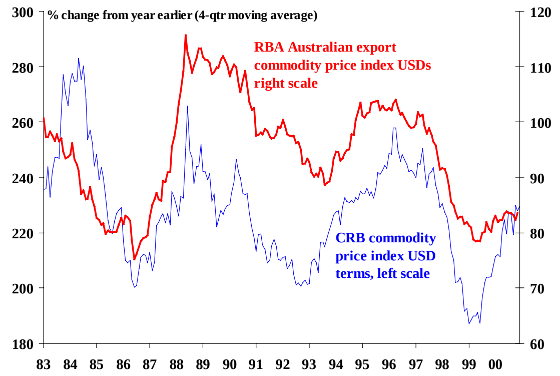
Commodity prices neutral to positive

With US growth slowing sharply and the global economy under threat, it is perhaps not surprising that world commodity prices remain near historical lows. The CRB commodity price index has been trading so far this year between 225-230, barely 1.1% above its level in the December quarter. Similarly, the RBA commodity price index - used by ANZ to estimate 'fair value' for the A$/US$ - has been flat to a little higher over the course of 2000 despite strong world economic growth, increasing 4.1% over the year to December. Even with this rise, Australian export commodity prices remain not far above their historical lows.

World and US energy prices have been the exception to generally sluggish commodity prices in recent times, supported by tight US inventories of natural gas and OPEC endeavours to support world oil prices through supply restrictions. Energy prices are also important in the RBA commodity price index, but are represented by coal prices and liquified natural gas. Oil is not directly included in the RBA commodity price index.

Other commodity prices have been mixed, with rises in the prices of grains, industrial commodities and meat. Precious metal prices have been mixed, with gold and silver prices falling, offset by increases in platinum prices.

Australian and world commodity prices



Sources: Reserve Bank of Australia, Reuters

Weakness within the CRB index in recent months has been concentrated in the foods/ soft commodity sub-group. Declines in the prices of coffee, cocoa, and orange juice however, while important components of the CRB have actually had a marginally positive impact on Australia's trade performance as they are commodities that Australia imports.

On the basis of ANZ forecasts for the world economy in 2001 and factoring in the Australian export commodity-specific factors, ANZ is forecasting an increase in the RBA commodity price index of 6.2% over the next 12 months. Farm export commodity prices are forecast to increase by 14%, while non-farm commodity export prices are expected to be much flatter, rising just 2.6%.

Such a rise in commodity prices - based on the international economic outlook (see article on page 1) - should be a neutral to positive factor for the A$ going forward.

The main risk to this view would come from much weaker global industrial demand and/or excess commodity production than we are currently forecasting. The RBA commodity price index reached its all time low point in July 1986. (Those with memories of that time will recall that the A$ reached its then low of $US0.5712 on 28 July 1986.) Commodity prices were then around 10% lower than current levels. On the assumption that commodity prices drop to that level, 'fair value' for the Australian dollar would fall from its current level of $US0.65 to $US0.60, implying limited upside from here.

Interest and growth differentials supportive

Last year, the combination of a red hot US economy and an Australian economy then playing catch up led the market to the conclusion that interest rate spreads and growth prospects would weigh on the A$/US$. And they did. The RBA cash rate was then 25 bps under the Fed funds rate and remained 25-50 bps under Fed funds for the remainder of 2000. Data on the performance of the economy pointed to exceptional out performance of the US economy.

International investors are looking increasingly at growth prospects, with equity markets a good guide. In the six weeks leading up to the surprise Fed easing on 3 January, the NASDAQ lost 20% in value and has since clawed its way back. In the same period up to the easing, the broad trade weighted value of the US$ lost 2% and since the easing has risen by 1%. Markets perceive less US$ risk than was the case at the turn of the year.

Spreads have now turned in favour of the Australian dollar. The RBA cash rate is now 25 basis points above the Fed funds rate (6.25% cf. 6.00%). And we expect a positive interest rate differential to be maintained. Based on our forecasts of nearly 3% growth for the Australian economy in 2001 and 2% growth for the US, expected reductions in interest rates from the RBA are set to be playing catch up with expected reductions in the Fed funds rate.

Yield- and growth-seeking investors are likely to be attracted more to the A$ than the US$ through this year.

When it commences to ease monetary policy in February, a 25bp is more likely. But should the RBA adopt a more bold approach and ease initially by 50bp, that would offer the prospect of a quicker return to stronger economic growth and corporate profitability down the track. With Australian real short-term interest rates high (they are on a par with US real rates) the risk that 50 bps now might stoke inflation looks moderate compared with the growth safeguard such an easing offers. A larger initial RBA easing might see a knee-jerk sell off, but this could well be short-lived.

Should the reaction from the A$ market to a 50bp cut in February - were it to occur - be negative, it could be reasonably be asked whether this would be good or bad for the inflation and growth outlook. The float of the Australian dollar has served the economy well over the years - one need only recall its cushioning role during the Asia crisis. A decline in the $A over the next 6-12 months could be appropriate given very deficient domestic demand and needed, if uncertain, external demand.

Lower CAD a positive for the A$

The past year has seen a dramatic improvement in Australia's external accounts from 5.9% of GDP in 1999 to 3.2% of GDP in the September quarter 2000 with a further fall likely to have been recorded in the December quarter. Continued solid growth in exports into late 2000, and a marked slowdown in the demand for imports have both contributed to a sharper than expected fall in Australia’s external deficit. At times when increasing demands to finance the growing US CAD have made it more difficult for other countries with CADs to attract capital, this should have been a positive for the AUD. But it has not.

ANZ is more cautious about whether the current account deficit will continue to fall from current levels. As the Olympics-boost to service exports washes out of the data, and the global economic slowdown restricts export sales, the current account is forecast to rise to 3.7% of GDP by end 2001, up from an estimated 2.5% in December 2000. Even so, such an outlook is hardly an alarming prospect as far as the A$ is concerned. If recent falls in imports continues as the domestic economy slows, then a further reduction in the CAD is possible.

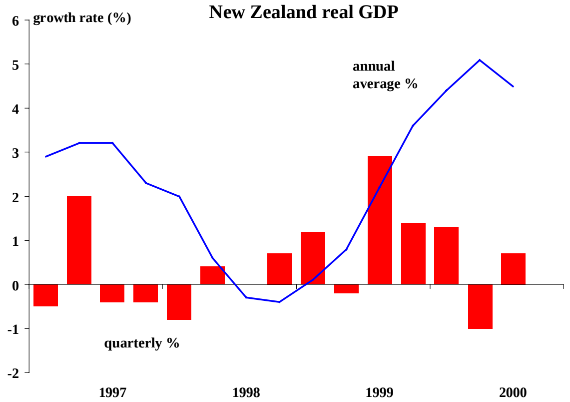
Memories of how the Asia crisis unseated the A$ in 1997-98, as much from the Australian dollar sold lower as a proxy for Asian economic weakness, will at times see some periods of A$ selling emerge within a stronger trend. A return to monthly trade deficits in trend terms may also weigh a little on the A$. However, with the Federal Reserve (and other major central banks) set to ease monetary policy significantly, guarding against a sharp US and global downturn, commodity prices should hold near current low levels. As a result, the A$/US$ is forecast to trend higher through this year. Our assessment is that the A$/US$ is more likely to spend more months of this year above 0.60 than below it.

NEW ZEALAND OUTLOOK

Signs of life returning to the NZ economy

After the contraction in the NZ economy in mid-2000 (with GDP shrinking by 1.0% over the June quarter), signs of economic activity were more encouraging in the second half of the year. GDP rebounded by 0.7% in the September quarter heralding the beginnings of a further upswing in activity along what has been a very uneven path for the economy in the past 2 years.

NewZealand economy rebounds in late 2000



Source: Statistics NZ

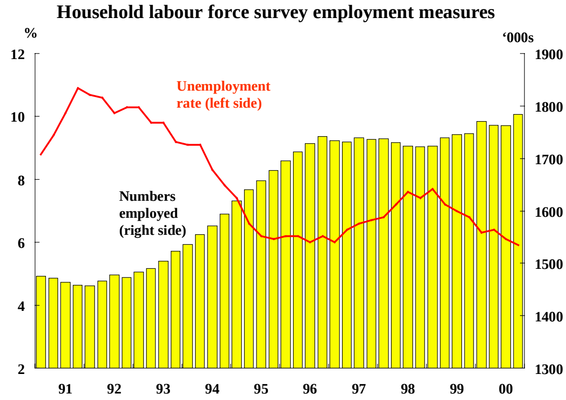
Although annual average growth over the September year was 4.5%, this overstates NZ's growth performance in 2000. The "spike" in GDP over late 1999 has continued to underpin annual average growth in spite of only modest growth in GDP over the first 3 quarters of 2000 (with seasonally adjusted GDP expending by just 1% in total over this period). Consequently, annual average GDP growth is expected to slow sharply to around 3.4% in the full calendar year 2000 as the 1999 growth surge washes out.

The external sector has gone from strength to strength, with export receipts up around 30% on the same time last year. Exporters have continued to reap the benefits of a relatively low NZ$ and robust world growth. While growth in major export markets (especially the US) is slowing, market conditions remain conducive to NZ exporters at least sustaining the gains made over the past year.

Meanwhile, the domestic economy has remained patchy. Notably, the housing market has remained under pressure, with sales volumes in late 2000 down around 20% on the same period a year earlier. That said, a number of indicators over the second half of 2000 have been more upbeat, albeit with some caveats.

Employment increased by a surprising 1.2% in the September quarter, which took the unemployment rate down to a 12 year low of 5.9%. This surprising result contrasted markedly with business surveys around the same time that had suggested a more moderate increase at best. Whilst the strength of the result has been questioned (especially given the supposed concentration of employment growth in sectors such as education and health) it does appear that the demand for labour has been fairly strong. Relatively low wage growth in the private sector (meaning little pressure on real wages) along with comparatively low rates of labour productivity growth have produced an expansion in employment over the past 2 years that has been 'high' in comparison to the rise in output.

Unemployment rate falls to 12 year lows



Source: Statistics NZ

Similarly, retail spending over the past year has been surprisingly strong with sales in most regions well up on year ago levels. Sales have been particularly buoyant in many provincial areas reflecting the continued improvement in export returns (especially for primary products). Specifically, retail sales, adjusted for price movements and excluding motor vehicle sales and servicing, rose by an impressive 1.3% over the September quarter (up 3.3% for the year). While statistical factors may be partly at work here (the figures were boosted by a one-off reclassification of some appliance wholesalers who have moved into retailing) the sales results illustrate at least moderate growth in household spending.

Moreover, anecdotal information (particularly regarding retail sales) to hand over late 2000/early 2001 has begun to paint an increasingly upbeat picture of domestic activity. Several surveys have pointed to a sharp rebound in both business and consumer confidence including the December Quarter Survey of Business Opinion which showed one of the largest turnarounds in business confidence in the history of the survey. These developments reinforce our view that higher incomes associated with very strong export growth over the past year will increasing reinvigorate the domestic economy and create a period of more robust economic growth in 2001.

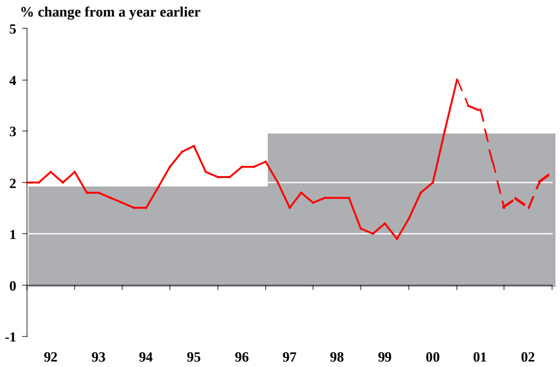
Such an outlook should help to alleviate one source of pressure on the Government's fiscal outlook. While the Government is expecting to achieve an operating surplus over the coming year, a combination of maturing debt and capital expenditures (not included in the operating measure) imply a sizeable 'cash deficit' over this period even assuming the economy remains robust. Any deterioration in the economic outlook (or any slippage in planned expenditure) would necessitate further increases in what is already a sizeable government bond programme.

Inflation breaks out of RBNZ target band

Against this background, inflation has risen rapidly over the past year. Annual CPI inflation rose to 4.0% in the December 2000 year – the highest annual inflation rate since June 1995. This result technically breaches the RBNZ's 0-3% target band, although the Minister of Finance has indicated that he is comfortable with this given that it is expected to be relatively short-lived.

Inflation breaches the RBNZ 0-3% target

Consumer price index



Source: Statistics NZ; NZEconomics@ANZ forecasts.

Much of the rise in inflation (from lows of around 1% in late 1999) has been as a result of the impact of NZ$ weakness and high oil prices over the past year. The effect of these pressures was seen in a range of areas in the December quarter, with widespread price increases in appliances/furnishing, apparel and travel. Moreover, unexpectedly strong price pressures were evident over the quarter in the services sector for the first time in some years.

While the higher headline rate risks fuelling inflation expectations amongst the general public (in turn potentially underpinning second-round price and wage pressures), the December 2000 year result is likely to have been the peak. The CPI is expected to rise only modestly over the March quarter, with the introduction of income-related rents for state housing tenants expected to shave upwards of 0.6% from the quarterly result. This one-off price fall should ensure that the annual inflation rate falls back to within the 0-3% target band by September 2001.

OCR on hold for now

Regardless, the RBNZ's primary focus remains the medium term inflation outlook (ie where inflation will be in 12-24 months). Consequently, aside from the risks of second round price and wage pressures following the recent spike in CPI inflation (and the increasingly widespread nature of price increases), the overriding consideration for the RBNZ remains activity-based medium term inflation pressures.

Given an outlook of strengthening economic activity, the Bank's December Monetary Policy Statement foreshadowed the need for the Official Cash Rate to be raised by 100 basis points (or more) in 2001. Stronger growth is seen by the RBNZ as placing added pressure on the New Zealand economy's already limited spare capacity – thereby adding to medium term inflation risks.

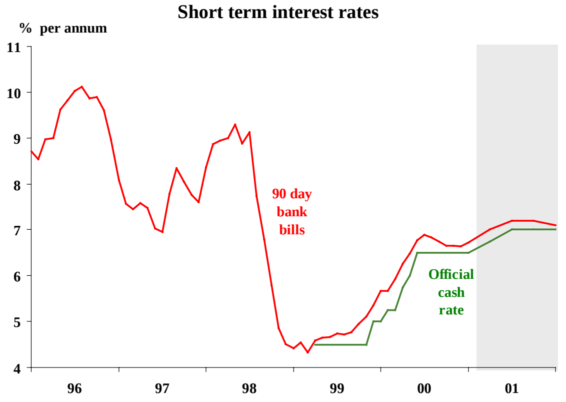
Moreover, the labour market remains tight in spite of patchy economic growth over the past year. The unemployment rate is at an historic low and there are reports of skilled labour shortages throughout the economy – partly a reflection of high rates of outward migration over the past few years. While wage growth has remain subdued to date, the tight labour market (combined with the potential impact of higher CPI inflation on wage demands and the more "union-friendly" industrial relations environment created by the last year's enactment of new employment law) creates clear upside risks to the wage inflation outlook.

However, the US Federal Reserve's surprise decision to cut rates by 50 points in early January has dampened market expectations regarding the NZ interest rate outlook. The deterioration in the US (and world) growth outlook implied by the Fed's actions has been seen by many as potentially undermining NZ's export growth prospects to the extent that the RBNZ will be forced to contemplate cutting rates over the year ahead.

In contrast to most of the rest of the market, ANZ believes that the balance of risks is still towards the

OCR being raised during 2001 – albeit not to the extent implied by the December MPS. Certainly the RBNZ appears to have stepped back from its December views to some extent. At the January Review it left the OCR unchanged and accentuated recent negative developments (such as those surrounding the global growth outlook) in the accompanying statement. Consequently, it is likely that rates will be left on hold for the time being. However, ANZ remains reasonably upbeat on the prospects for the NZ economy over the year ahead and believes that the activity and capacity pressures that the RBNZ feared at the time of the December MPS will still eventually prompt the Bank to raise the OCR at some stage in 2001. At this stage, a rise is unlikely before the middle of the year, by which time the prospects for the world economy may be a little clearer and the Bank will have had a chance to observe the durability of the current upswing in the domestic economy.

Further OCR rises remain in prospect



Source: Reuters; NZEconomics@ANZ

NZ dollar rebounds from historic lows

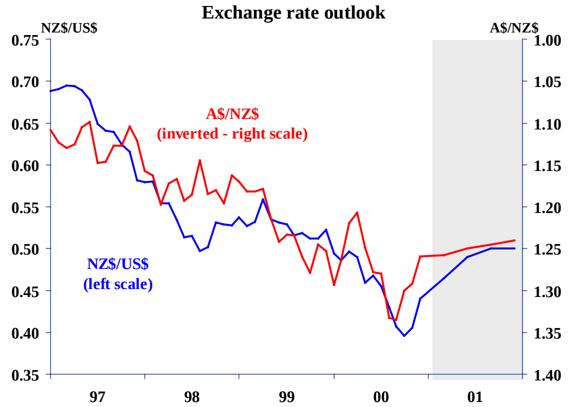
Another factor that could have a bearing on RBNZ decisions regarding the OCR over the year ahead is the path of the NZ$.

The Kiwi has staged a strong recovery over late 2000/early 2001 – by early January it had risen 15% from the all time low of US$0.3895 seen on 19 October. This is partly due to the reversal of US$ strength, which has also seen the Euro and A$ also regain some lost ground. Yet the NZ$ recovery has outpaced that of the A$, so that A$/NZ$ has fallen sharply from its highs at 1.35 in October to around 1.24 currently. The NZ$ recovery has been assisted by news released in late 2000 that the New Zealand's current account deficit, while still high by world standards, narrowed sharply over the September quarter to 6.5% of GDP.

But perhaps the most compelling factor driving NZ$ gains (particularly on cross rates such as A$/NZ$) has been the prospects of interest rate differentials moving clearly in New Zealand's favour over the year ahead. With the RBNZ expected to maintain a relatively hawkish stance compared to the easing bias of the world's major central banks, the NZ$ appears to have become more attractive to investors shifting from growth (equity) to income (fixed interest) assets in the wake of turmoil in world stockmarkets and signs of slowing global growth in recent months.

These developments have seen the NZ$ rise more rapidly than the RBNZ assumed at the time of the December MPS. The NZ$ Trade Weighted Index has risen above 51, compared with the 48.5 average assumed by the RBNZ for the first half of 2001. Yet the experience of the past couple of years – where NZ$ weakness has (until recently) failed to translate into significant rises in consumer prices – appears to made the RBNZ wary of the relationship between the exchange rate and inflation. If the Bank is now acting on the basis that this relationship has become more muted, then the recent NZ$ may be insufficient to negate the need for higher interest rates suggested by the RBNZ in the December MPS. Clearly though, further NZ$ gains at the rate seen recently would eventually be seen as providing some offset. That said, we believe the progress of the Kiwi dollar from this point will be more moderate.

Further NZ$ recovery is expected in 2000



Sources: NZ Economics@ANZ

STATE ECONOMIC UPDATE

New South Wales

Economic growth in NSW, as measured by real gross state product (GSP), averaged 3.7% in 1999-00, 0.6% below the national average of 4.3%. NSW economic growth has averaged a respectable 4.0% per annum since 1992-93. The key drivers of this growth over the last five years have been private consumption expenditure and private business investment.

Private consumption growth over the past five years has been supported by strong increases in real wages and real private wealth. However, real wages growth in NSW peaked at 4.5% in mid-1999, and has since slowed significantly. In terms of state specific wealth effects, NSW has been the largest recipient of house price gains. Sydney's median house prices have increased 114% over the 1990s. The relative expense of Sydney house prices is highlighted by the ratio of median house prices to average household disposable income. This ratio currently stands at a record 5.3 (compared to 3.8 three years earlier).

Assisted by the build-up in infrastructure needs for the Olympics, private business investment per capita in NSW has reached historically high levels. However, the passing of the Olympics has left a void of major infrastructure projects, despite Federal government promises of significant road and rail projects in Sydney. Equipment expenditure is also likely to be subdued in the light of a peaking in company profits and slowing activity. In addition, the dwelling construction downturn has been more concentrated in NSW with dwelling commencements down 39% in the year to September 2000: more than any other state.

The NSW Treasury has forecast a budget surplus of $659 million for 2000-01 with budget surpluses projected in each of the four years to 2003-04. However, several potential risks to the surplus exist. NSW Treasury has assumed 4% growth for 2000-01 which appears optimistic compared to an average of 3% from private sector forecasters. In addition, the NSW government has recently acknowledged that the Olympics will remain a drag upon taxpayers into the future without specifying the size of the impost. Finally, the business sector is intensifying its push for NSW to lose the title of the highest taxing state.

Despite a slowing of growth in 2000-01 in the wake of the Sydney Olympics, the outlook for the NSW economy remains positive. ANZ expects growth to slow from 3.7% in 1999-00 to 2.7% in 2000-01, before recovering to average 3.5% in 2001-02.

Table 1 NSW GSP growth

1997-98	1998-99	1999-00	2000-01(f)	2001-02(f)
4.7	5.3	3.7	2.7	3.5

Victoria

The Victorian economy achieved the second fastest growth rate of the states (equal with Western Australia) over the last five years, with growth averaging 4.6% per annum. Growth over the last five years has been underpinned by private consumption expenditure, housing investment and private business investment.

Consumption expenditure has averaged 4.9% per annum since 1995-96 and represents the single largest contributor to GSP growth. There has been an element of "catch-up" with the rest of Australia (given Victoria contracted more than any other state during the 1991-92 recession). This growth reflected large wealth gains rather than strong growth in real income. Consequently, households financed high consumption growth by borrowing against these wealth gains and by running-down household savings. Recent falls in household wealth have coincided with a rebuilding of household savings (assisted by GST-compensation) and negative real wage growth. Consumption growth has weakened as a result. Since mid-2000 Victoria's retail spend has declined by approximately 8.5% in real terms.

The immediate outlook for Victoria's private investment growth is quite bleak. After a golden era for private investment, where growth averaged 13% per annum over the second half of the 1990s, supported by large-scale investment projects, Victoria faces a void of imminent major investment projects. The Victorian government has committed to $2 billion worth of new projects (mostly road and rail) and a sizeable list of private sector projects are scheduled to begin construction, however, implementation delays will leave the construction sector significantly under-utilised in the interim. Unfortunately, this coincides with contracting housing activity with private dwelling approvals having declined 31% in the year to November.

Victoria's budgetary position appears quite sound with a $953 million surplus expected for 2000-01 and an expected average surplus of $670 million per annum to 2003-04. However, these surpluses are dependent upon economic growth forecasts of 3.75% for 2001-02 and 3.5% for 2002-03, which are in turn reliant upon strong export growth. ANZ's forecast for Victorian export growth is less optimistic. Consequently, Victoria's economic growth is forecast to average 3% for 2000-01 and 3.3% for 2001-02.

Table 2 Victorian GSP growth

1997-98	1998-99	1999-00	2000-01(f)	2001-02(f)
4.9	7.0	4.6	3.0	3.3

Queensland

The Queensland economy has retained the title of the fastest growing state, averaging 5.4% growth per annum in real terms since the 1992 recession, and 6.3% in each of the previous two financial years. Despite consistent out-performance in terms of GSP growth, Queensland ranks below the national average in terms of living standards (as measured by GSP per capita).

As in the larger states, private consumption expenditure has been a key driver of economic growth, contributing on average 3.1% per annum to real GSP growth over the 1990s. The public sector has recently become a significant contributor to economic growth. Public consumption expenditure and general government investment contributed an additional 2.1% to GSP growth over 1999-00. However, this contribution has come at the expense of the state's finances. The underlying cash position for 1999-00 stood at just $18 million, after nine years of rapid economic expansion. Although the surplus is forecast to increase in 2000-01, this surplus may be at risk from election largesse as the Beattie government attempts to re-gain public support in the wake of the vote-rigging scandal.

Real private business investment has fallen 27% since its peak in the March quarter of 1999. Both private equipment and non-dwelling construction have declined by 22% in the year to September. A sharp decline in work yet to be done and a $5.2 billion gap between projects under construction and projects committed does not augur well for the immediate future for business investment. In addition, demographic fundamentals suggest that Queensland has the greatest excess supply of housing among the states, ruling out a housing-led investment recovery.

Nevertheless, the Queensland economy has been a major beneficiary of strong world demand and the depreciation of the currency. The weak $A has enhanced the competitiveness of the state's exports which have increased 10.9% in real terms in the year to September. Although world demand is set to slow and the $A appreciate, Queensland's exports are expected to be supported by a sharp rebound in sugar production, and continued growth in beef, mineral and tourism volumes. Strong import growth in 1999-00 resulted in a negative contribution from net international exports, however, imports fell sharply in the September quarter, consistent with falling business investment and slowing retail trade, while exports increased strongly. Continued contributions from net exports are expected to underwrite Queensland GSP growth of 3.7% in 2000-01 and 4.1% in 2001-02.

Table 3 Queensland GSP growth

1997-98	1998-99	1999-00	2000-01(f)	2001-02(f)
4.3	6.3	6.3	3.7	4.1

Western Australia

The WA economy recorded the second fastest economic growth rate of the states over the last half of the 1990s averaging 4.6% in real terms, equal to that of Victoria. However, WA real state final demand increased just 2.1% in 1999-00 after zero growth in 1998-99. Interestingly, WA government expenditure contributed more to GSP growth than private consumption expenditure, the latter contributing just 1.8% to growth, which was the lowest of any state.

The weakness evident in private consumption expenditure is surprising given WA households recorded the fastest growth in incomes among the states in 1999-00. Real household disposable income averaged 5.8% in WA compared to 3.6% nationally. The weakness is also surprising given solid wealth gains. WA real housing wealth in 1999-00 increased 9.9%, although this was below the national average of 14.8%. The weakness in consumption expenditure can mainly be traced to a sharp increase in household savings. Household savings in WA increased 34% in 1999-00, far outstripping the national average increase of 10.3%.

Real private business investment in WA has fallen dramatically since 1997-98 from a peak of $14.7 billion (24.2% of GSP) to $9.7 billion (15.5% of GSP). The completion of major resource projects and the aftermath of the Asian economic crisis have resulted in a correction in business investment as a share of GSP back towards historical norms. Unfortunately, while a substantial number of large-scale projects remain under consideration there is a dearth of projects scheduled for beginning in the near term. Consequently, further declines in business investment are anticipated. Encouragingly the long anticipated $2.5 billion expansion of the North West Shelf gas project has secured new letters of intent for long-term LNG contracts, moving this important project a step closer to fruition.

Exports remain the lynchpin of the WA economy. Strong world growth and a depreciating currency made WA agricultural and mining exports extremely competitive in 1999-00 while prior investments in capacity contributed to significant output gains. Exports contributed 3.3% to real GSP growth in the year, while imports remained subdued in response to falling investment and poor consumption growth. WA's GSP growth is expected to average 4% in 2000-01 supported by a bounce-back in consumption expenditure and further contributions from net exports.

Table 4 Western Australian GSP growth

1997-98	1998-99	1999-00	2000-01(f)	2001-02(f)
5.9	3.6	4.6	4.0	4.7

South Australia

The volatile performance of the SA economy evident throughout most of the 1990s has persisted in recent years. In the three years since 1997-98 South Australia's real final demand recorded growth rates of 6.5%, 0.1% and 5.7%. Although GSP has been slightly less volatile, real GSP growth has averaged just 3.5% since 1995-96, a full percentage point below the national average.

SA's high reliance upon its manufacturing sector has contributed to this volatility. Unfortunately, the state's manufacturing sector again appears to be entering a slowdown prompted by slowing domestic and international demand. This slowdown is being compounded by a severe squeeze in margins and the lagged impact of interest rate tightening.

Private consumption expenditure increased 3.5% in real terms in 1999-00, providing the underpinning for SA's economic growth performance. Moderate gains in income and wealth provided the foundation for this growth. Encouragingly, SA appears to have maintained its consumption momentum by recording the fastest growth in nominal retail sales among the states (5.9% in the year to November).

Several risks exist for the South Australian economy. Firstly, just as many people migrate from SA to other states as SA attracts from net international migration. Unfortunately, many of the migrants leaving SA are the young and skilled. Secondly, on the basis of Grants Commission data, South Australia remains a high taxing and high spending state. Thirdly, despite recent commitments by Mitsubishi and Toyota to re-invest in the motor vehicle industry, much of the state's manufacturing based is heavily subsidised by taxpayers and exists at marginal global competitive scale - defence and motor vehicle manufacturers are prime examples. Finally, even after abstracting from the affect of the sale of the state's electricity assets, business investment appears set to contract given a looming void in large-scale engineering construction and non-dwelling construction investment projects in the pipeline. As in the larger states this will coincide with the downward phase of SA's construction cycle, resulting in weak private demand conditions through 2001.

South Australian economic growth is forecast to average 1.9% in 2000-01, supported by gains in net trade and public demand growth.

Table 5 South Australian GSP growth

1997-98	1998-99	1999-00	2000-01(f)	2001-02(f)
6.7	2.2	3.5	1.9	3.0

Tasmania

The Tasmanian economy has fallen behind the national economy on virtually all key economic indicators since the 1991-92 recession. Tasmanian real GSP has increased just 1.9% per annum since 1992, 2.4% below the national average. National employment increased 18.7% since 1992, compared to a 5.8% rise in Tasmania. Australia's population has increased by 9.7% since 1992 compared to virtually no change in Tasmania's population. In fact, Tasmania's population has been in decline since the December quarter of 1996. Tasmania has also been unsuccessful in attracting its share of business investment. Real business investment per capita in Tasmania averaged just $1910 since 1992 compared to a national average of $4334. Consequently, Tasmania's living standards, as measured by GSP per capita, are the lowest in Australia.

Encouragingly, real state final demand increased 5.7% in 1999-00, supported by strong contributions from household and government consumption as well as a rebound in private investment.

Real private consumption expenditure increased 3.6% in 1999-00. Part of this growth can be attributed to wealth effects with real housing wealth rising by 11% in the year, although moderate real income gains and the continued run down in household savings were also important.

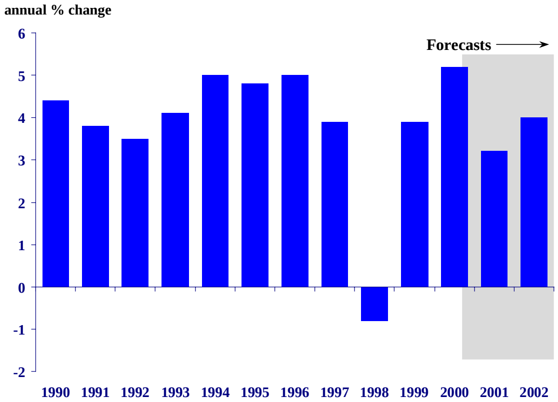
The Tasmanian government's Industry Development Plan has sought to address the problem of under-investment in the state mostly via industry subsidies and government contracts, although payroll tax has been reduced as part of a separate initiative. The Tasmanian Treasury is endeavouring to finance the Industry Development Plan while increasing the Budget surplus from $0.5 million in 1999-00 to $2.6 million in 2000-01. Its success in doing so is dependent upon the Tasmanian economy achieving the 2.7% growth forecast in the Budget for 2000-01. While this growth is above most private sector forecasts, the Basslink and Bell Bay to Longford pipeline projects, connecting Tasmania to the mainland for electricity and gas transfers respectively, will provide a substantial boost to Tasmania's GSP growth in 2001. These projects will provide a much needed boost to investment, employment, income while at the same time promising cheaper power inputs into industry. Tasmania's GSP is forecast to average growth of only 1.8% in 2000-01.

Table 6 Tasmanian GSP growth

1997-98	1998-99	1999-00	2000-01(f)	2001-02(f)
0.4	5.0	1.1	1.8	2.5

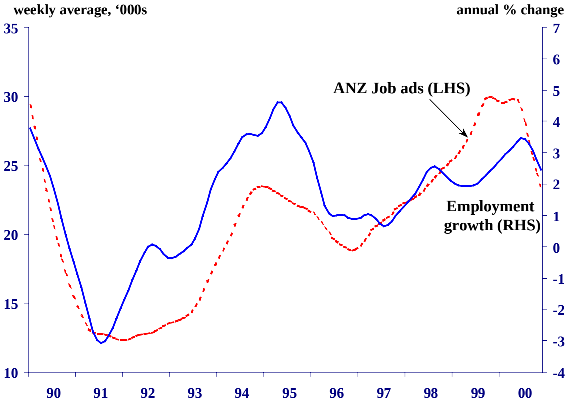
ECONOMIC CHARTBOOK

Major trading partners growth



Source: ANZ forecasts

The labour market

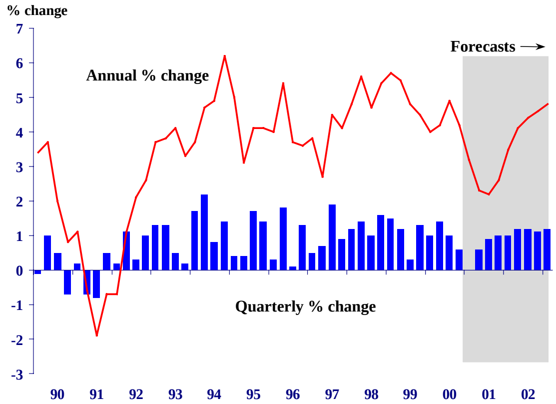


Source: ABS Cat. No. 6202.0 and ANZ

Australia's major trading partners (MTP) economic growth is expected to slow from 5.2% in 1999-00 to 3¼% in 2000-01. The main contributors to this slowing are expected to be South Korea, Singapore, Hong Kong and the US. The slowing US economy affects Australia's MTP growth via two channels, directly through bilateral trade and indirectly through a forecast sharp drop in demand for electronic components which is anticipated to have significant ramifications for East Asian economic growth. MTP economic growth is expected to recover to 4% in 2002.

Despite a slight rebound in the growth of ANZ's job ads series in the month of December, the level of job ads have fallen 21% over the year. The employment market has weakened considerably since July 2000, easing from an annual rate of 3.7% to 2% in December 2000. Much of the slowdown can be attributed to weaker full-time employment growth. Difficult trading conditions in the retail, construction and manufacturing industries should usher in a year of employment growth averaging a lacklustre 2%. Consequently, the unemployment rate is expected to reach 7% by year's end.

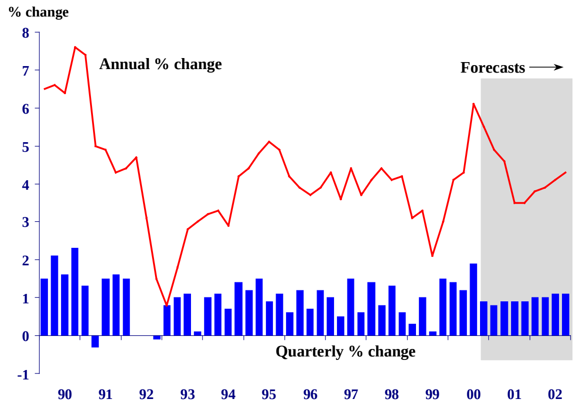
Australian economic growth



Source: ABS Cat. No. 5206.0 and ANZ forecasts

Economic growth in the September quarter increased by 0.6%, a disappointing result considering the Olympics were estimated to have contributed around 1%, however, the result was sufficient to maintain the annual rate of economic growth at 4.2%. Domestic demand fell by 0.7% in the quarter, dragged lower by a dramatic fall in dwelling investment, however, strong contributions from rising stocks and net exports underpinned GDP growth. While stocks are expected to be unwound over coming quarters, ongoing growth in public demand and exports are forecast. Economic growth is expected to average 3% in 2000-01 and 3¾% in 2001-02.

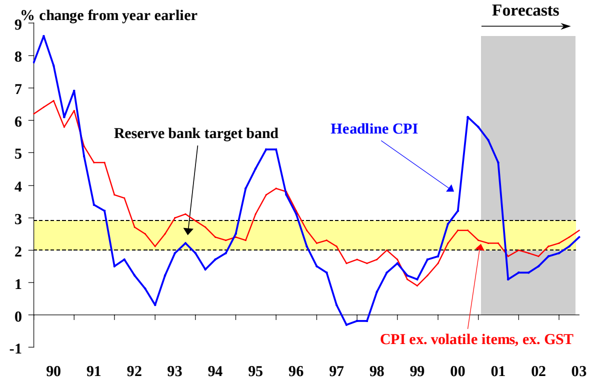
Average wage growth



Source: ABS Cat. No. 6302.0 and ANZ forecasts

Although AWOTE growth spiked sharply higher in the September quarter, partly in response to a peaking of the construction cycle, other measures of wage pressures built up only marginally. The wage cost index increased 3.1% over the year to September 2000 while average non-farm compensation of employees increased by 3.4% over the same period. A small up-tick in enterprise agreements was recorded in the September quarter, however, private sector agreements increased only slightly. Rising unemployment and weak domestic demand should ensure subdued wages pressure over 2001 with AWOTE growth averaging 4.1%.

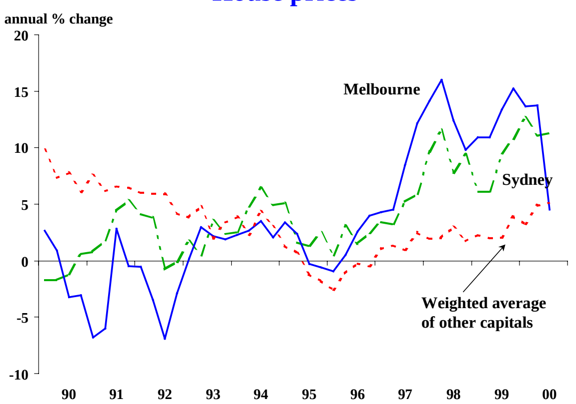
Consumer price index



Sources: ABS; Economics@ANZ.

Falling petrol prices, slowing domestic demand, and an appreciating currency are all supportive of mild inflation outcomes through 2001. Nevertheless, there are still substantial price pressures in the supply chain. Preliminary and intermediate import commodity prices have increased by 27% and 22% respectively in the year to September. In addition, the lower than expected inflation outcome for the September and December quarters suggests that there may still be GST-related price increases to be passed on, although these will be partly mitigated by cost reductions. Inflation is forecast to average 3.5% over 2001.

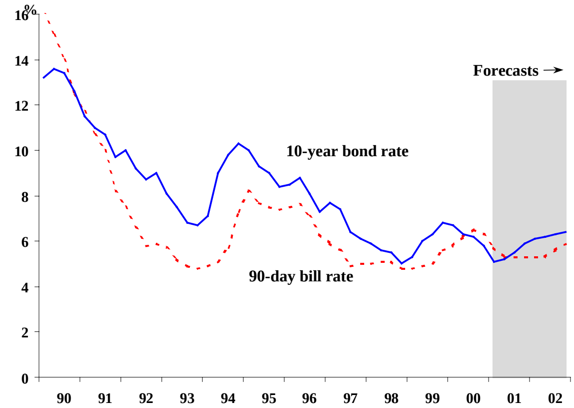
House prices



Source: ABS Cat. No. 6416.0

ABS established house prices fell by 0.1% in the September quarter, the first fall since March 1996. In the year to September housing prices have increased 7.5% compared to 9.7% in the year to June. This slowdown partly reflects higher interest rates, declining rental yields and falling housing affordability over H1 2000. In addition, the $7000 first home buyers scheme has also placed a downward bias on the price series. Forecast lower interest rates and modest household income gains may provide some price support into 2001, however, continued financial market volatility and slowing domestic activity will restrict any strong upward movement.

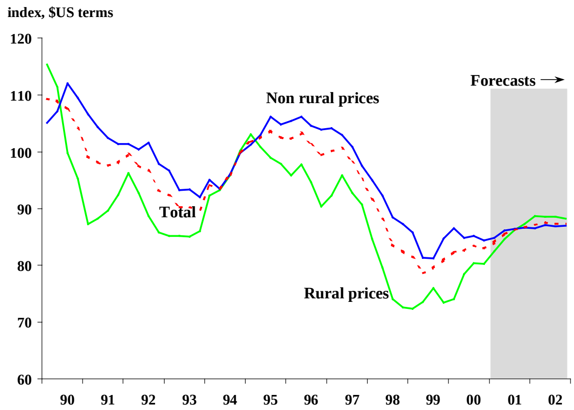
Interest rates



Source: Reuters and ANZ forecasts

The interest rate cycle appears to have peaked after 150 basis points of tightening. Weak retail sales, depressed building activity, slowing employment growth, a moderation in credit growth, declining business sentiment and a remarkably weak 0.3% increase in the CPI in the December quarter are all supportive of a rate cut. An appreciating A$ and an easing in global interest rates also makes the RBA's decision easier. Persistent upstream inflationary pressures are unlikely to prevent the RBA from easing by 25 basis points in February, with a further 75 basis point of easing expected by mid 2001.

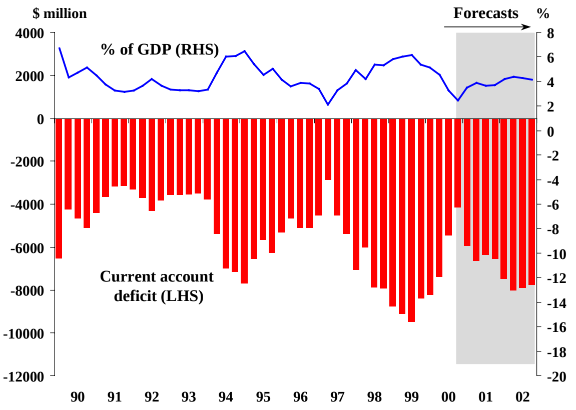
Commodity prices



Source: Reserve Bank Bulletin and ANZ forecasts

The RBA commodity price index expressed in US$ increased 3.9% during calendar 2000, after falls totalling 24% in the four years prior. Commodity prices appear to have lost momentum since the middle of 2000 where they recorded gains of 5% over the year. Currently prices are 2.6% higher than a year earlier. A peaking in Australia's major trading partner economic growth is likely to contain upward price movements. Although rural commodity prices are forecast to rise by 9% in 2001, supported by gains in wheat and beef prices, non-rural commodity prices are forecast to remain flat in 2001, thereby restricting total the commodity prices index to a 3.5% increase.

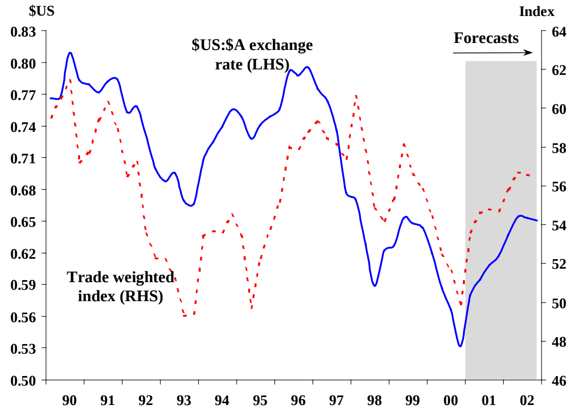
Current account



Source: ABS Cat. No. 5206.0 and ANZ forecasts

Strong export growth of 29.6% in the year to September compared with import growth of 14.4% over the same period has assisted the current account deficit (CAD) as a percent of GDP to improve from 6.2% in September 1999 to just 3.3% in September 2000. The combination of strong world growth, the Olympic Games and an extremely competitive currency assisted this result. However, as world growth eases, the benefits from the Olympics wane, and the currency appreciates, export growth is expected to slow. Although slowing domestic demand will also restrict import growth, the CAD is expected to deteriorate and finish 2001 at 3.7% of GDP.

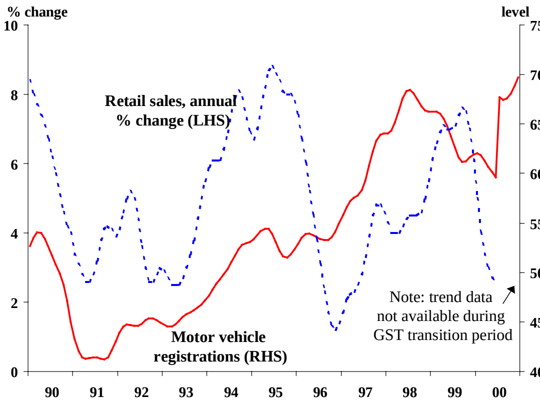
Currency movements



Source: Reuters and ANZ forecasts

The long awaited spike in the currency back towards levels that traditional fundamentals have been suggesting occurred in the December quarter after the currency set a new low of 50.7 US cents on November 22. Since late November the $A/$US rate has bounced by 5 US cents as the US$ was sold-off in response to fears of a hard economic landing in the US and political uncertainties. Further gains in the currency are expected while Australia maintains a positive interest rate differential and the Australian economy out-performs the US in terms of economic growth and the current account deficit. The $A/$US is expected to average 60 US cents over 2001.

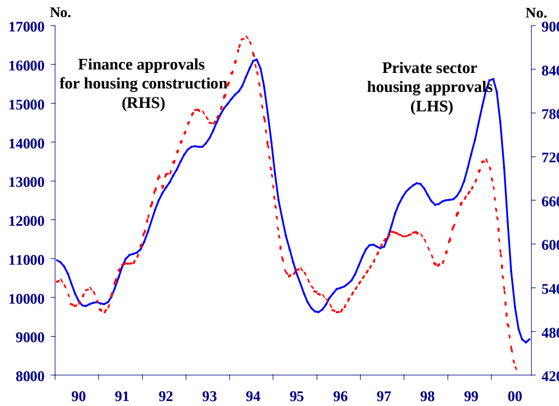
Retail sales and motor vehicle registrations



Source: ABS Cat. No. 9301.0 and 8501.0

The GST inspired volatility evident in the retail sales and motor vehicle registrations data has mostly passed. In the year to November 2000 retail sales increased by 3.0% in nominal terms. Considering that retail inflation has risen in excess of 3% by the GST, retail sales are in decline in real terms. New motor vehicle registrations have been remarkably resilient in the December quarter in the wake of the extraordinary post-GST spike in the September quarter. This resilience partly explains the weakness evident in retail sales as consumers substitute expenditure to price competitive small to medium car sales, crimping retail sales growth.

Housing sector approvals and finance



Source: ABS Cat. No. 8731.0 & 5609.0

New dwelling approvals have fallen by 41.8% in seasonally adjusted terms over the year to November, the largest fall in the series' 16 year history. Clearly the distortions surrounding the introduction of the GST compounded the normal cyclical peak evident in housing approvals, and consequently have amplified the downturn. Nevertheless, two months of positive building approvals and a mild increase in housing finance in November hint at a tentative recovery in housing construction. Forecast interest rate cuts, the first home buyer's scheme and supportive demographic fundamentals should support this recovery in approvals through 2001.

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FORECAST TABLE

	Quarterly % change						Annual % change				
	Jun-2000	Sep-2000	Dec-2000	Mar-2001	Jun-2001	Sep-2001	1998/99	1999/00	2000/01	2001/02	2002/03
	←	actual	forecast			→	←	actual	forecast		→
GDP	1.0	0.6	0.0	0.6	0.9	1.0	5.3	4.4	3.0	3.7	4.7
- Final demand	0.4	-0.7	0.4	0.7	0.9	1.2	5.3	5.2	1.8	4.4	5.2
- Stocks	0.0	0.6	0.0	0.0	0.0	0.0	0.8	-0.3	0.0	0.0	0.0
- Net exports	0.5	0.7	0.4	-0.5	-0.2	-0.2	-0.7	-1.0	1.0	-0.8	-0.7
CPI	0.8	3.7	0.3	0.5	0.2	0.2	1.3	2.4	5.5	1.3	2.1
Wages (ordinary time earnings)	4.3	6.1	5.5	4.9	4.6	3.5	3.7	3.4	5.3	3.7	4.3
Employment	0.9	1.1	-0.5	0.4	0.4	0.4	2.2	1.5	2.2	1.9	1.6
Unemployment rate (%)	6.7	6.3	6.5	6.6	6.8	6.7	6.6	6.7	6.3	6.0	6.2
Current account deficit ($b)	-7.4	-5.5	-4.2	-5.9	-6.6	-6.4	-33.7	-33.5	-22.2	-28.4	-32.2
- % GDP	-4.5	-3.2	-2.5	-3.5	-3.9	-3.7	-5.7	-5.3	-3.3	-4.0	-4.2
90 day bank bills (%p.a.)	6.2	6.5	6.3	5.7	5.3	5.3	4.9	5.7	6.0	5.3	5.9
10 year bond rate (%p.a.)	6.3	6.2	5.8	5.1	5.2	5.5	5.5	6.5	5.6	5.9	6.5
US$/A$	0.59	0.57	0.53	0.58	0.60	0.61	0.62	0.62	0.57	0.63	0.66
Trade weighted index	52.4	51.6	49.9	53.6	54.6	54.8	55.6	54.8	52.4	55.5	56.3
World GDP **							2.5	3.4	4.7	3.4	4.0
Trading partners' GDP **							-0.8	3.9	5.2	3.2	4.0
(**calendar years)							(1998)	(1999)	(2000)	(2001)	(2002)