

# Regional Economic Report

Spring 2004

- Continuing dry conditions are holding back the rural sector.
- Resources are booming and mining jobs are back to 1980s levels.
- Housing is correcting but the regions still appear to be performing strongly.
- In 2005, interest rates to move higher and the Australian dollar to weaken.



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## Executive summary

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**Regional Australia has bounced back from the drought, but the recovery has been hindered by dry conditions particularly along the east coast. This lack of rainfall may explain the hesitancy of farmers to re-employ the 100,000 farm workers who lost their jobs during the drought. But the news is not all bad for farming. It appears that many have taken a positive longer-term view on farming as demonstrated by the surge in tractor sales to levels we have not seen since the late 1980s.**

The real positive for regional Australia in the current year is the booming resource sector. Employment in mining has returned to levels we have not seen since the 1980s. Strong global demand boosted by continued acceleration in the rate of growth in Chinese demand drove the stock of many commodities to very low levels. Following years of underinvestment, supply has been slow to respond taking many commodity prices to record levels. Global demand is expected to slow and supply will respond in time taking prices down again. However, in the short-run the limited ability for producers to respond will keep prices at very robust levels.

For the Australian economy, the outlook for the year ahead is dependent on a smooth transition in growth away from housing and domestic demand and towards exports. New dwelling activity has eased but so far to date, the downturn has been very modest. Consumer spending has moderated but the outlook remains positive with spending power being boosted by the sizable government payments. All in all, the outlook for consumer spending remains positive with consumer sentiment at a decade high and unemployment at holding at a generational low. Therefore, if the Australian dollar were to weaken just as there was a recovery in retail spending, then the case for higher interest rates would build. We believe this scenario will be unfolding early in 2005.

It has been a year since the housing sector started to cool and it is evident that an uneven reaction is underway. So far, the most significant correction is in the established housing markets in the capital cities with reports of house prices falling in the first half of 2004. And while housing construction activity does appear to be correcting in the cities, the regions are still powering on. This does raise a nagging concern that those centres with mediocre population growth may be facing a drawn out price/construction cycle.

The key for the global economy is that the US is expected to decelerate, not stall, and China will have a soft-landing when growth slows to 8%. Higher oil prices are a risk for the outlook if they remain at current levels but while current supply and demand conditions are tight, they are not excruciatingly so. So with a reasonable global stockpile of oil, prices should move lower once we have passed the period of supply uncertainty.

The Australian dollar has recently received a fillip from higher commodity prices and a renewed interest by Japanese retail investors has taken the Australian dollar back up to US73¢. As commodity prices ease in 2005, and the US Fed has further closed the relative gap between US and Australian interest rates, we expect to see the Australian dollar back under US70¢.

## The lack of rain is holding back the regional economy

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Production has bounced back from the prior drought ...

Farm production, and thus farm incomes, bounced back from the lows of the drought. As chart one highlights the downturn in income, and thus the stress on farming through 2002/03, was the greatest we have seen since the 1980s. Fortunately, the farm sector went into the drought in a very healthy financial shape. Farmers' ability to minimise the damage of drought has also come a long way in the last 20 years. As such, last year's post drought bounce was very dramatic, with some regions reaping record crops.

... but dry conditions remain a constraint in 2004.

We had suspected that the recovery from the drought would be delayed as flocks and herds were rebuilt from the drought lows. However, rainfall has been very disappointing so far this year. For the six-months to September, rainfall was significantly below average along much of the east coast, stretching from Proserpine in the north to Bega in south. The outlook is also not very promising either and many regions will now struggle to reach seasonal averages by the end of November. According to the Bureau of Meteorology, the chances of receiving average rainfall has widely dropped below 20%, and is now below 10%, along much of the east coast.

Farm employment remains at a drought low ...

This lack of rainfall may explain the hesitancy of farmers to re-employ. Total farming jobs fell almost 100,000 in the drought and have made no recovery since then. But the drought may not be the only story for farm employment, as farmers appear willing to invest in equipment suggesting a positive outlook for the industry. This is demonstrated by the post drought surge in tractor sales. Estimates released by the Tractor and Machinery Association has tractor sales rising to 9,800 unit in 2004, a level we have not seen since the late 1980s.

... while a surge in tractor sales suggests farmers remain optimistic.

The rise in tractor sales may suggest something more fundamental is happening to farm employment. It is possible that many farmers have taken the opportunity to review the efficiency of their operations and see where they can do more with less labour. If the increase in tractor sales is representative of an aggregate rise in capital intensity, then the drought may have induced a structural shift in employment. If this is the case, while the return of more normal seasonal conditions will see farm production rise further, many of the 100,000 jobs lost may not return in the medium term. At risk from such an outcome are those smaller regional communities that are currently struggling to justify a stable supply of community services.

Farm commodity prices remain at robust levels.

The news is, thankfully, not all bad for the regions. The first positive point to note is that global farm commodity prices are at levels we have not seen since the early 1990s. Lay on top of this Westpac's forecast for the Australian dollar to move sub US70¢ in 2005, and the outlook for farm incomes remains healthy.

Regional economies should be riding a resources boom ...

The other major positive for the regions is the booming resource sector. Spurred on by strong global growth, a late surge in Chinese demand, and supply shortages, the Westpac non-farm commodities price index has surged 30% this year taking the index to record levels. As such, it is not surprising that employment in mining has risen back to levels not seen since the late 1980s. Given the gains in productivity achieved since then, we can deduce a significant surge in mining activity. This expansion may be starting to appear in the regional economic data with WA, the state with the most significant exposure to mining, out-performing the more domestically focussed eastern states.

... and also get the benefit of a rebound in tourism.

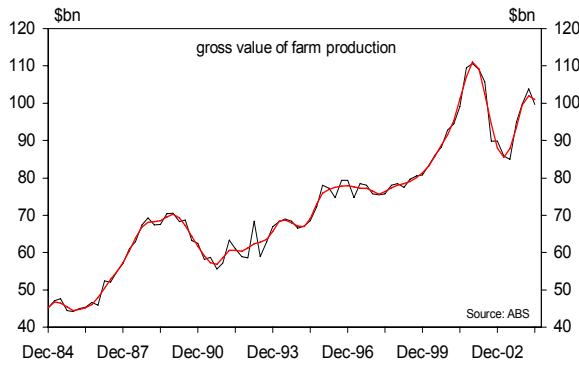
A final positive for the regional economy is the recovery in tourism. The recent gains in monthly tourist arrivals has taken the number back to levels not seen since the Sydney Olympics. Westpac's forecasts for a weaker dollar will help boost overseas arrivals and spending, as well as act as a disincentive for overseas holidays by Australians.

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# The lack of rain is holding back the regional economy

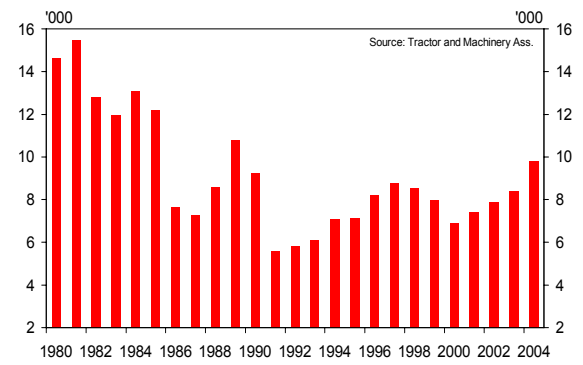
**Chart 1.**

**Farm production & income bounce back ...**



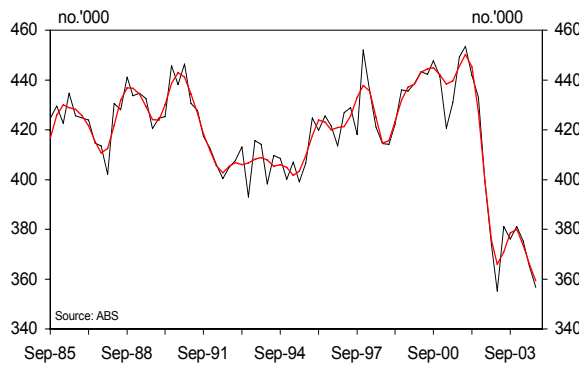
**Chart 2.**

**... spurring on farm investment ...**



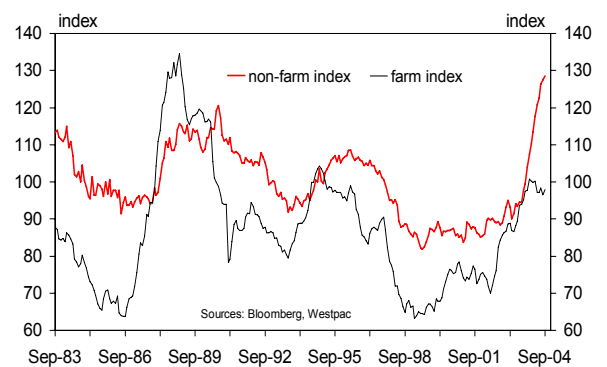
**Chart 3.**

**... but farming jobs are back to drought lows**



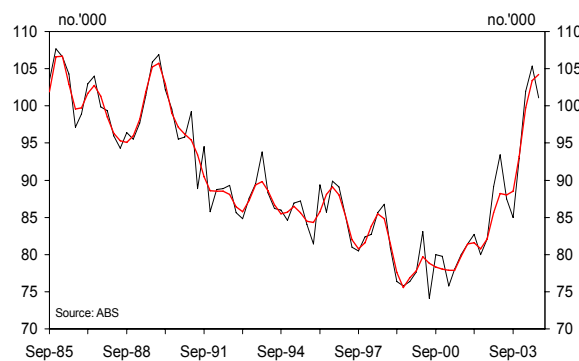
**Chart 4.**

**Westpac Commodities Index**  
In AUD and USD 1994/95 = 100 monthly averages



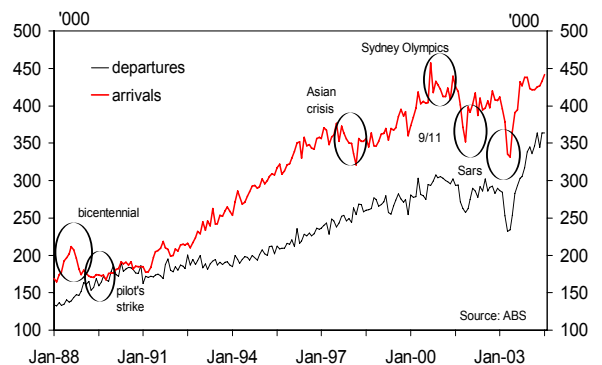
**Chart 5.**

**Mining jobs at late 1980s levels**



**Chart 6.**

**International departures levelling out**



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## The economic outlook still points to higher interest rates

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The growth rotation from domestic demand to exports is underway.

The key in the months ahead for the Australian economy is the rotation in growth towards exports and away from domestic spending. This is reinforced by our expected shift in the mix of monetary conditions. That is, we anticipate the RBA lifting rates early next year, and at the same time, the Australian dollar should we back below US70¢.

The growth risks are tilted to the downside ...

Australian growth should be in the "steady, but not spectacular", zone of around 3½% in 2004 and again in 2005. In terms of the risks for 2005, which would be the fourteenth year of this economic expansion, we argue they becoming tilted to the downside. Downside risks manifest most notably in consumers, who may have run their race; housing, which will be constrained by higher interest rates; and the non-residential construction cycles (building & engineering), which have matured.

... as new dwelling constructions ease ....

New dwelling construction made a very small contribution to growth in the second quarter of 2004 and we anticipate construction activity is weakening further with dwelling approvals now 6% below their peak. Whilst that is a very modest fall compared with past cycles, it is a downturn nonetheless and indicative of a decline to some extent. Of course, any further lift in interest rates is likely to trigger a second leg down in approvals.

... and consumer spending moderates.

Consumer spending has moderated a bit but the immediate outlook remains positive. Spending power is currently being inflated by the sizeable government payments, which more than compensate for the rise in petrol prices. Beyond that, with housing activity weakening and income growth likely to moderate, consumer spending growth is likely to be a little sub-par. Of course, if house prices were to fall precipitously, consumption and overall economic growth would be appreciably weaker.

Business investment is a key factor and there are questions here on the outlook ...

The business sector remains a key factor. Investment resumed its upward trend after a small dip in first quarter. However, the signs for this sector are mixed with the ABS capital expenditure survey pointing to a meek 2½% rise in machinery and equipment investment in 2004/05. We suspect this is overly pessimistic as profits rose 10% last year and are set to expand further. The latest Westpac-ACCI survey of manufacturing also lends support to a healthy equipment spending forecast.

... but with the world growing at a 4% pace exports are still in an expansionary mode.

With the world growing at a 4½% pace in 2004, and forecast to be 4% in 2005, an export recovery (of sorts) is underway. So far it is the bounce in rural goods that has lifted exports. This is likely to broaden as new capacity in resources sector comes on stream over the year ahead, as demonstrated by the rise in mining employment. Moreover, the peeling off of the Aussie dollar will enhance competitiveness, a development to be welcomed particularly by our services and manufacturing exporters.

The RBA appears to be more comfortable with recent developments ...

In its most recent policy statement, the RBA revealed an apparent comfort with the trends in the housing market, in particular the fact that the "growth in house prices has slowed [and] the pace of household credit [growth] has declined." In addition, the most recent data flows, and our own expectations for data for the next two months are unlikely to be sufficient to provide the RBA with a convincing case to raise interest rates before the end of the year.

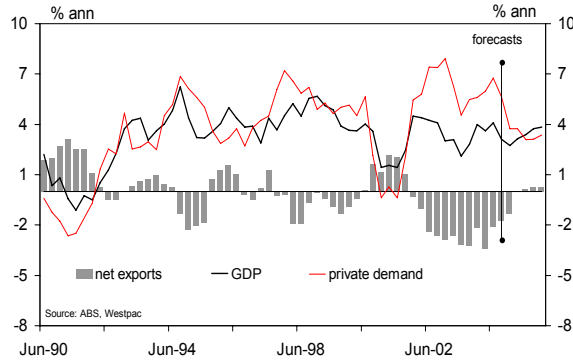
... however we still expect to see rates higher in 2005.

However, we do expect the case for higher interest rates will be more convincing early in 2005 due to a recovery in retail spending, a continuing low unemployment rate and the falling Australian dollar, as this will place upwards pressure on the inflation outlook.

# The economic outlook still points to higher interest rates.

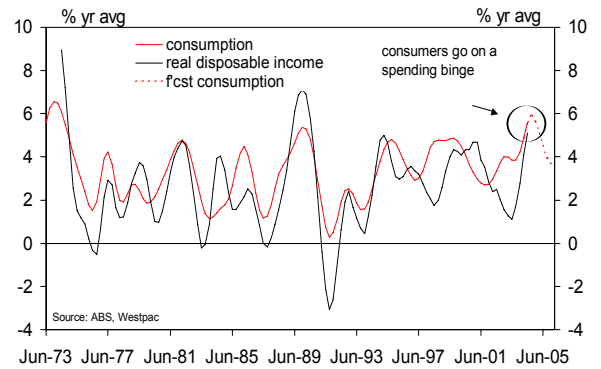
**Chart 1.**

**Growth rotation on the way**



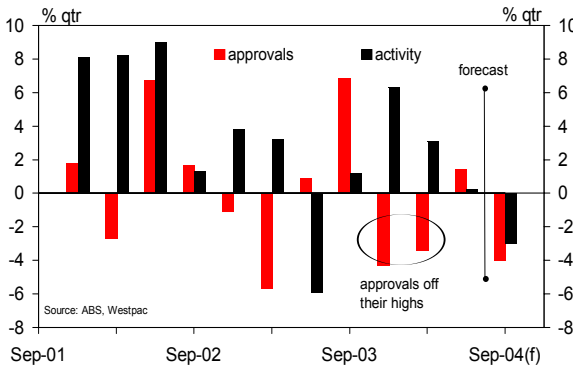
**Chart 2.**

**Consumption spend – fastest in 30 years**



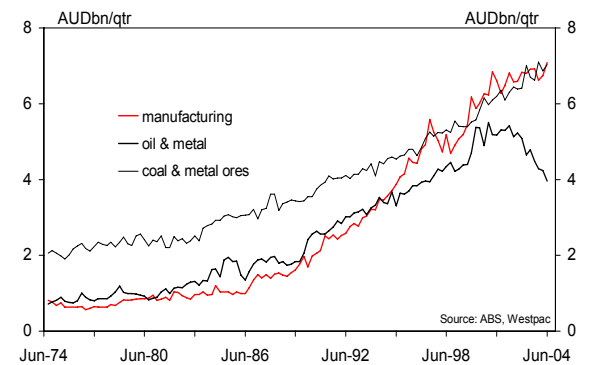
**Chart 3.**

**New dwelling activity to weaken**



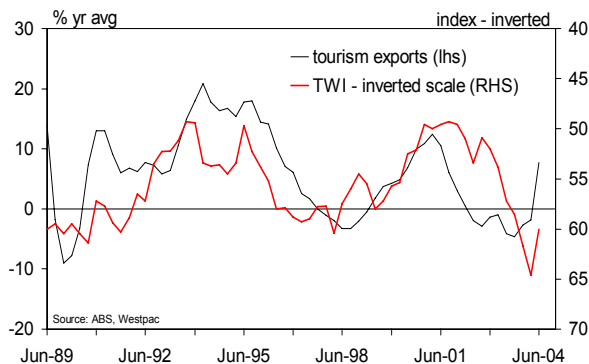
**Chart 4.**

**Non-rural exports, a mixed performance**



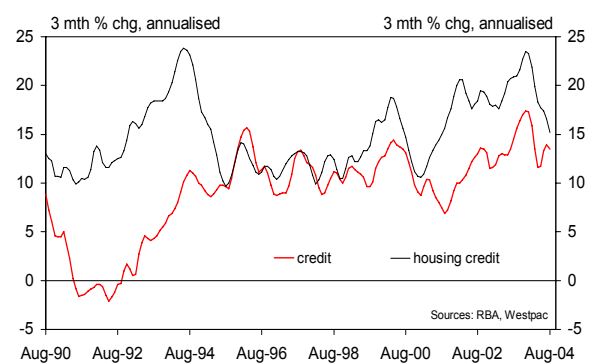
**Chart 5.**

**AUD correction a positive for exporters**



**Chart 6.**

**Credit growth eases**



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## Australian housing – an uneven response

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One year on since the housing sector cooled ...

The housing sector has cooled since late 2003, in part under its own weight, and because the Reserve Bank lifted interest rates by half a percent. We are almost a year on since the market turned and it is apparent that, at least at this stage, the reaction has been uneven. While we would expect this to remain a feature of the current downturn, we also suspect that current divergences partly reflect differing speeds of reaction.

... an uneven reaction is evident.

The current uneven cooling of the housing sector is apparent across the various segments of the market, most notably across the capital city / regional Australia divide.

As the established market corrects...

The established segment of the housing market has shown a more pronounced correction than that of new dwelling construction. That should come as no great surprise. At a time of persistently low interest rates between April 2001 and the end of 2003, there was a sharp run-up in established house prices. Prices in the capital cities surged 55% over this 2½ year period (compared with a 24% rise over the previous 2½ years). More dramatically, prices in the regions jumped 60% between mid-2001 and the end of 2003, which compares with a modest 10% increase over the earlier 2½ years.

...following sharp run-up in prices, particularly in regions.

While the extent of price movements since 2003 is somewhat unclear (particularly for the regions), we know that lending for established properties is well down, falling 20% since last October, although all of that fall occurred in the initial three months. The ABS measure of capital city prices shows that Sydney has fared the worst, with prices down 2.1% over the first half of 2004, compared with a 0.3% dip in Melbourne, while prices rose by an average 6.7% in the other state capitals.

The *value* of housing finance for the construction of new dwellings, which is only about 20% of that for established, is a picture of resilience, with lending now little changed from that of late 2003. However, owner-occupiers lending for new construction is down 8% in value terms and has fallen almost 19% in number terms.

Construction activity downturn proving to be mild ...

The implication is that construction activity of new dwellings will weaken. Although the downturn is so far shaping up to be relatively mild compared with past downturns, with total dwelling approvals off about 10% from the peak of last September, this significantly less than the typical fall of 30% to 40% in past downturns.

... with regions still powering on ...

In fact, the outlook for the regions remains quite positive for now. Activity will remain at high levels into 2005, with dwelling approvals for the regions all but unchanged from last September. 'Regional' Queensland will be particularly active, with approvals at a decade high, no doubt boosted by strong population growth.

By contrast dwelling approvals have weakened in the capital cities and are down an average of 16% from last September. Sydney and Brisbane are off by more than 20%, and Melbourne is down 15%. Perth and Adelaide have held up better, with some sizeable apartment projects recently approved.

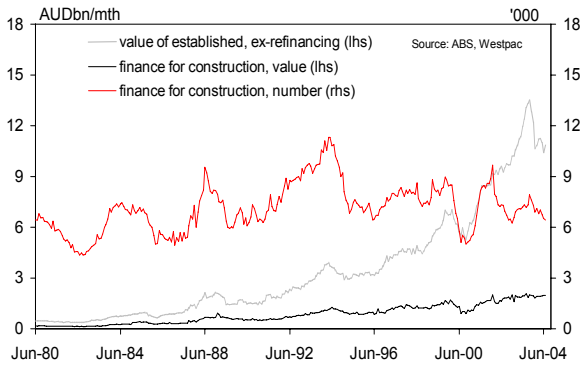
...but risk that vacancy rates jump in some regional centres

The ongoing strength of new dwelling construction in the regions no doubt reflects the shift in relative prices. As noted above, regional established prices jumped 60% (54% in real terms) between mid-2001 and the end of 2003. Over the previous fifteen years, the period for which we have data, overall real prices were stagnate though, obviously performance does vary wildly across centres. The nagging concern is that those regional centres with mediocre population growth will see not only an upgrading of the housing stock but also a marked lift in the vacancy rate. In such instances the price/construction cycle can prove to be particularly drawn out.

# Australian housing – an uneven response

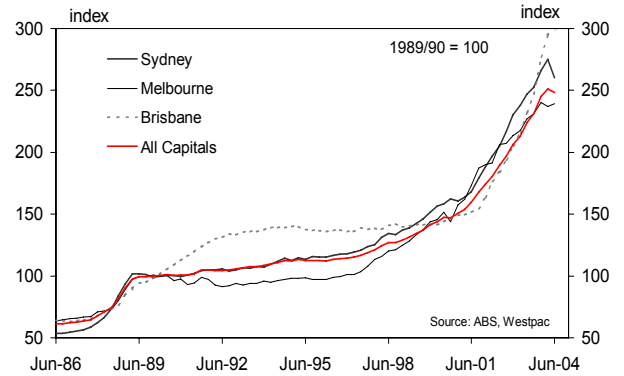
**Chart 1.**

**Housing finance falls for established**



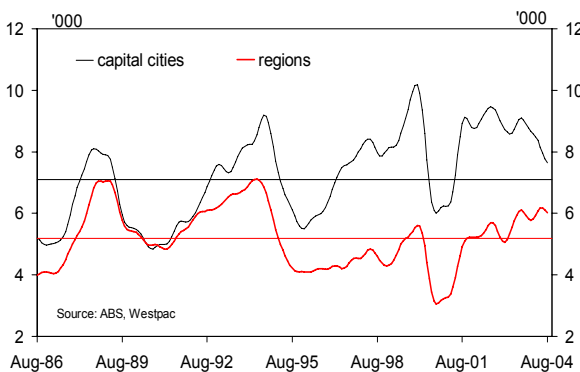
**Chart 2.**

**House prices had a great run**



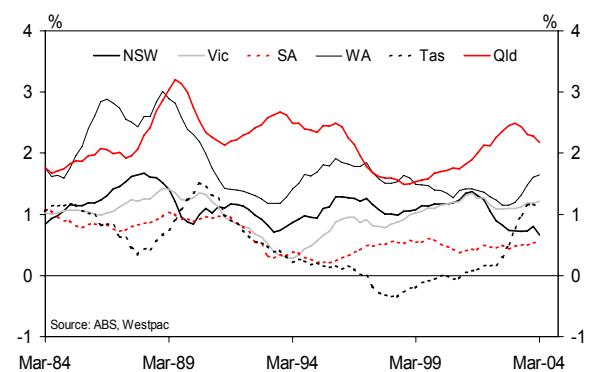
**Chart 3.**

**Dwelling approvals prove resilient in regions**



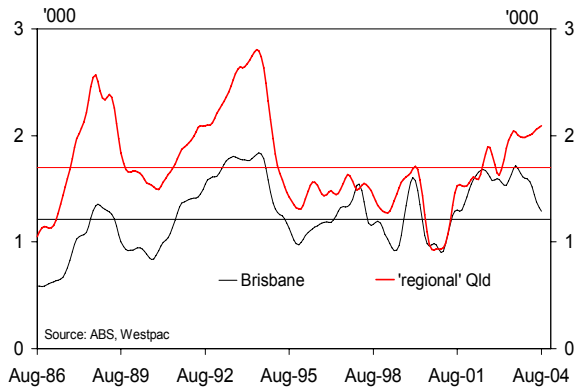
**Chart 4.**

**State population – people on the move**



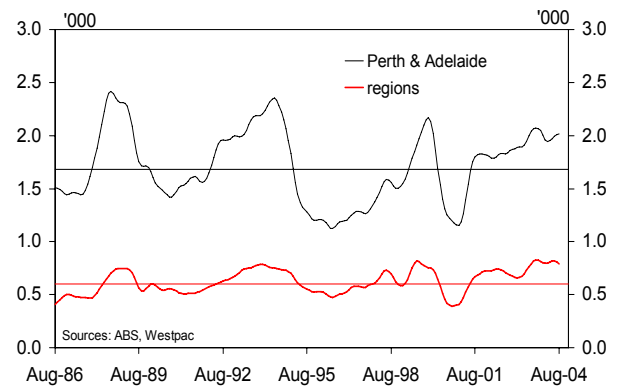
**Chart 5.**

**Qld, a divergence emerges**



**Chart 6.**

**WA & SA holding up**



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## The global economy - modest deceleration in 2005

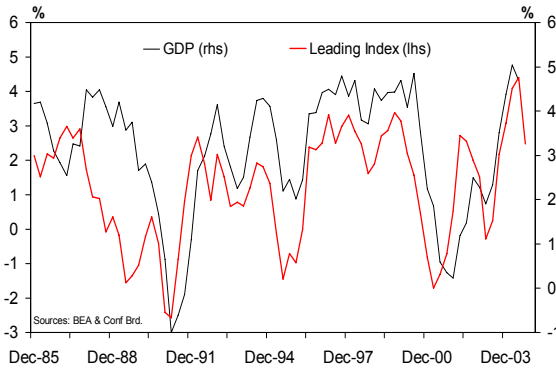
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Markets something of a puzzle.	Given the schizophrenic state of financial markets at present, one could be excused for being confused about the outlook for the global economy. The bond markets, and to a lesser extent the equity markets, are suggesting that the global economy will slow quite markedly. In stark contrast, the commodity markets are suggesting that the global economy will barely miss a beat in 2005. We are of the view that global growth has passed its peak but that the slowdown will be fairly modest. We expect global growth of 4.5% in 2004, slowing to a still robust 4% in 2005. High oil prices and tighter policy settings are the key threats to this optimistic outlook.
Energy prices are a risk ... ... but Fed stays the course.	In the US, the underlying fundamentals for the economy remain sound, although, the higher energy prices rise the greater the threat of another downturn. The US Federal Reserve has embarked on the normalisation of interest rates and interest rates have been raised by 25bps at each of the three meetings since mid year. Importantly, the Fed continues to reiterated that interest rates remains accommodative following the most recent hike on 21 September. We believe this sentiment remains consistent with our view that the Fed will continue to lift rates by 25bps at each and every meeting well into 2005.
US economy to decelerate but not stall.	The markets are singing to a different tune and have even toyed with the possibility that the Fed would pause at 1.75%. Sceptics point to significant headwinds for the US economy over the coming year in the form of a reversal of fiscal stimulus, the removal of monetary stimulus and the tax-like effect of higher energy prices. The economy will slow, but only modestly. We expect growth to decelerate from around 4.5% in 2004 to a more sustainable 3.5%, rather than a sharp slowdown to a below trend level.
Commodity prices receive a boost from China.	Back in April this year, the Chinese authorities announced measures to curb investment in several sectors that were 'overheating'. This sparked concerns of a hard landing in China and triggered a sharp fall in commodity prices ex energy. These fears were clearly over-stated. The Chinese economy has barely slowed and reflecting that, commodity prices are now back above their April peak. We expect growth to be just below 8% in 2005 from just above that figure in 2004.
Japan's prospects best in a decade	Japan has been the real surprise packet in 2004 and looks set to grow by at least 4%. But this growth has been largely driven by external demand. Nonetheless, Japan has a much better chance to purge itself of previous excesses than at any other time since the bursting of the bubble in the early 1990s. Major structural challenges lie ahead, independent of a favourable cycle.
ECB on the sidelines.	The European economy appears to have lost momentum relative to the first half of 2004. The various business surveys and other leading indicators suggest the economy is decelerating. It seems that higher oil prices and moderating global growth have detracted from what was already a lacklustre domestic growth story. We maintain our view that the European Central Bank will not begin re-tightening monetary policy until the middle of 2005 at the earliest. We expect European growth of just below 2% both this year and next.
Yen to appreciate the most in 2005.	For the major currencies, we expect the yen to be the star performer over the coming year. The massive current account surpluses being generated by Japan, along with bureaucrats being more comfortable with an appreciating currency, will be the key factors. The other Asian currencies will be dragged along for the ride. China remains the exception, with the peg set to hold for some time yet. Meanwhile, a widening interest rate spread will favour an appreciating US dollar against the euro.

# The global economy - modest deceleration in 2005

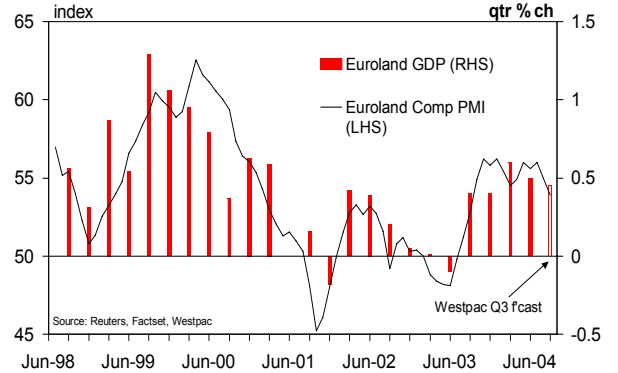
**Chart 1.**

**US growth to decelerate but only modestly**



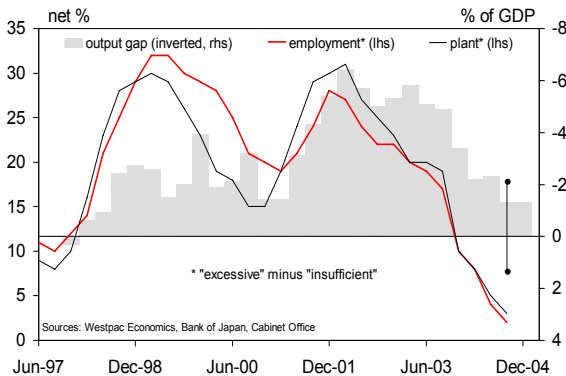
**Chart 2.**

**Euroland PMI suggests growth peaked in Q1**



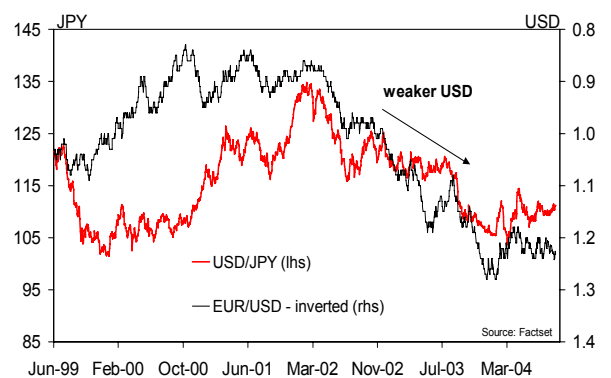
**Chart 3.**

**Japanese excess capacity dwindling**



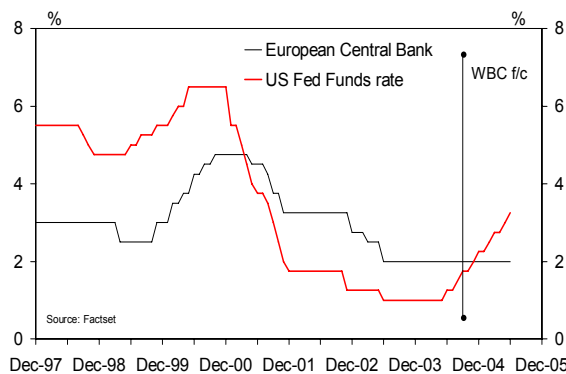
**Chart 4.**

**Major currencies**



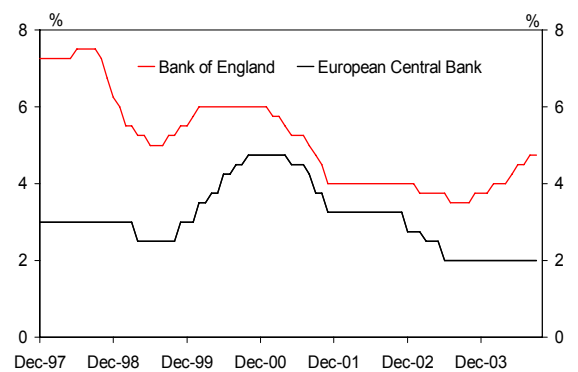
**Chart 5.**

**US rates up, Europe unchanged**



**Chart 6.**

**ECB & BoE on hold**



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## The Australian dollar outlook

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The Australian dollar is at the top of its recent trading range.

During September, the Australian dollar has surged from US69.7¢ to US72.4¢. At the same time the Australian dollar has strengthened against the euro (57.3 to 58.9); and particularly against the Japanese yen (¥75.9 to ¥80.6).

Whilst we have not changed our overall view which looks for Australian dollar to hold within reach of US70¢ through 2004, we have adjusted our near term view to reflect the current bout of strength..

It is not just a weak US dollar story.

Unlike other periods when we have seen substantial moves in the Australian dollar against the US dollar, this time it appears to be an Australian dollar specific story. And this time, you can't link it back to relative interest rates as short-term interest rates in the US have risen by more than they have in Australian which should, in effect, be creating a mildly more negative story for the Australian dollar.

Commodity price have been crucial ...

The specific factors at play on this occasion appear to be the surge in commodity prices and the re-emergence of Japanese investment in Australian dollar securities. Commodity prices have been under upward pressure not only because of the strong levels of demand emanating from China, and elsewhere, but also a slow supply response that markets usually depend upon to stabilise prices. In turn, we have seen commodity prices rising with industrial commodity prices are now just ½% below the March high.

... but the recent rally will reverse in 2005.

Our view that commodity prices will be falling through 2005, we estimate a fall in the region of 10%, is based on the expectation that new supply in these commodities will be developed in response to current record prices. That new supply, as is usually the case with commodity markets, is expected to come on stream just as demand is slowing due to a slowdown in global activity and higher prices. The OECD leading index, our preferred indicator of global growth prospects, is pointing to a slowdown in the developed world. We maintain our view that China's "soft landing", that is a modest slowdown in growth, has only really just begun.

Japanese interest in Australian dollar bonds has re-opened.

The other area of strength for the Australian dollar is Japanese interest in Australian dollar bonds. Known as uridashis, these Australian dollar denominated bonds are usually bought by Japanese retail investors looking for higher yields and this market is stirring. In recent days there have been two uridashi issues totalling \$1.5bn. These issues are always very positive for the Australian dollar as Japanese retail investors usually move in waves. The re-opening of the market with two substantial issues may be a signal that more activity is in the pipeline and currency markets tend to overshoot in anticipation of more business. As a result Japanese interest is pushing the Australian dollar higher against the yen, and thus by default, also higher against other currencies.

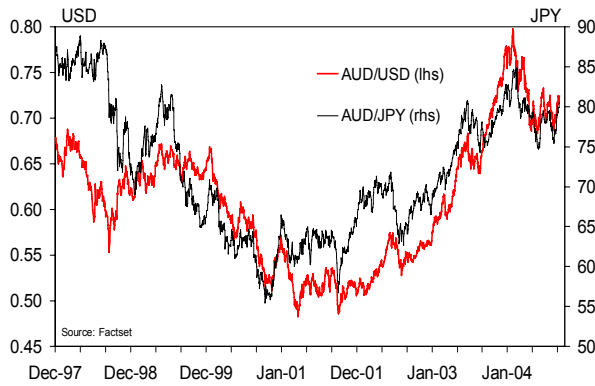
We are, however, not expecting much of an upside for the Australian dollar. At close to 90 yen to the dollar, this is the highest, apart from the brief period in late February, the Australian dollar has been since August 1998. Canny Japanese retail investors are unlikely to over-invest in Australian dollar securities, despite the attractive yield, with the dollar at such "excessive" levels.

Nevertheless, fundamentals still point to a weaker Australian dollar next year.

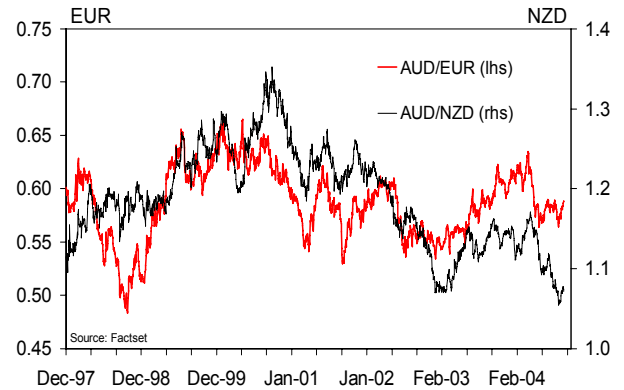
So there are a number of factors that have contributed to the dollar hitting the top of its recent trading ranges. We have always expected that both sides of the range would be tested before a sustained break to the downside eventuates in 2005. The current rally is just another instance. Our assessment of the path of the medium term fundamentals point to a softer Aussie in 2005.

# The Australian dollar outlook

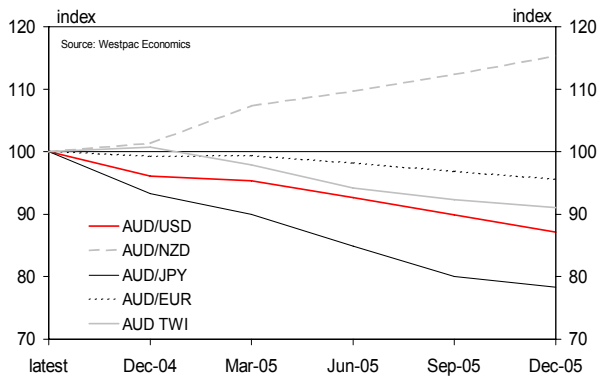
**Chart 1.**  
**AUD/USD & AUD/JPY**



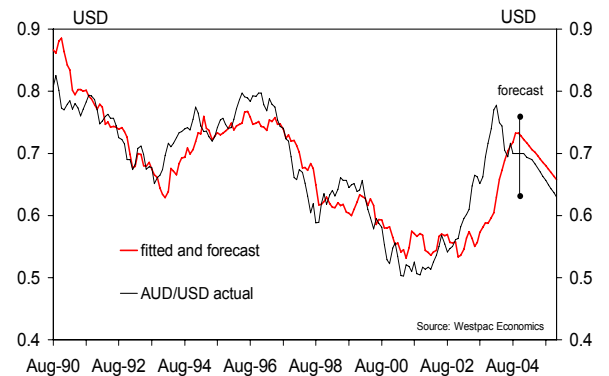
**Chart 2.**  
**AUD/EUR & AUD/NZD**



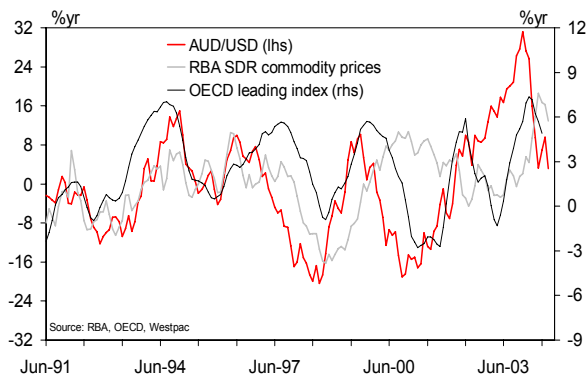
**Chart 3.**  
**AUD profile: trending lower in 2005**



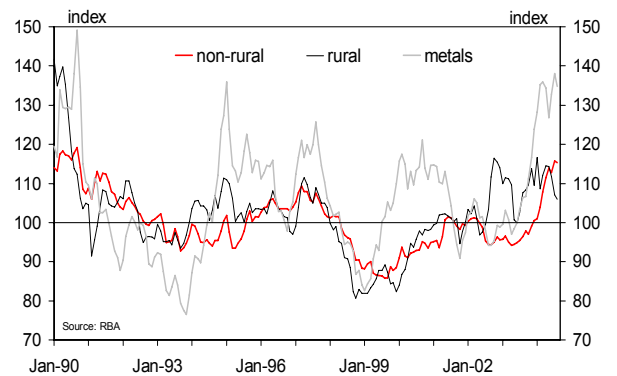
**Chart 4.**  
**Westpac's Australian dollar model**



**Chart 5.**  
**The AUD, commodities and global growth**



**Chart 6.**  
**Australian commodity prices in SDR terms**



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## Global outlook remains critical for resources

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Commodity prices have had a stellar 2004 ...

An underlying support for the AUD in 2004 has been the stellar performance from commodity prices. Westpac's commodities index, which is weighted to represent Australia's commodity exports, has risen 20% in USD terms so far this year. The 55% rise in crude oil prices, and 45% rise in coal prices, has played a major part. But base metal prices have been no laggards either, with the overall base metals index up 19%. Rural commodity prices have been the moderating factor, falling 14% as farm production bounced back from global dry conditions. For the remainder of 2004, extremely low stocks of base metals and the perceived risks to oil supply will hold commodity prices at elevated levels. As we move into 2005 a moderation in Chinese demand, and global growth more generally, will supplement an increase in the supply, will result in prices falling around 10% on the (weighted) average.

... but we expect declines next year.

There is a very close relationship between outlook for world growth and base metal prices. Chart 2 suggests the current run up in commodity prices since January 2002 was related to a steady improvement in the global outlook from November 2001. Since then, sentiment has shifted the other way, with the consensus on world growth easing from 2004 to 2005. Base metal prices can be expected to react lower in that sort of climate.

China is one factor ...

It is clear that China has been, at the margin, a source of additional demand and upward pressure on prices. However, growth in Chinese imports of non-energy commodity are expected to moderate at the same times as demand from industrialised nations. This is all part of the moderation in global demand and thus overall commodity prices. The growth in the Chinese demand for energy is expected to remain very strong as China continues to catch up to the lack of electricity capacity. However, in coal, the peak does appear to have passed. Coal supplies have surged and spot steaming coal prices have been coming off in recent times.

... in a general story of moderating demand.

If it is just an excess demand story, then it would be fair to ask why have overall commodity prices continued to surge as the outlook for global growth has turned? The moderation in freight rates, as measured by the Baltic Dry Index, suggests demand has slowed. The index collapsed earlier this year, when there was a sudden shift in perception on the Chinese economy to the downside, only to bounce back as became clear that there was no immediate threat to Chinese growth. Nevertheless, freight prices are 20% off the peak of February 2004. So if demand has not continued to decelerate, a lack of supply and a rundown in stocks can be deduced. Yet we do not need to deduce it. It is very evident in readily available data.

Low inventory levels remain.

Copper is a good example. Years of low prices saw investment in copper production fall and thus the current infrastructure is "creaking at the seams" trying to keep up with demand. As a result, copper prices spiked to the highest level in eleven years as stocks fell to the lowest level in fourteen. Inventories have stabilised in recent months. However with stocks at such low levels, base metal consumers remain at the mercy of any unforeseen supply shocks.

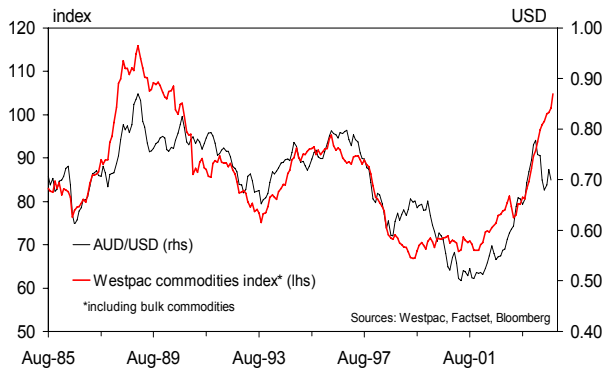
We expect a 10% decline by end 2005.

In the short-run, tight supply and demand conditions will hold commodity prices around current highs. However, supply will respond and we may be seeing the early signs of this in falling spot coal prices. As monetary and fiscal policy is tightened around the developed world, growth is set to moderate, a point reflected consistently by numerous leading indicators. The slowdown in currently expected by the consensus is consistent with a fall in commodity prices. Our figuring puts the scale of the decline around 10% by end 2005.

# Global outlook remains critical for resources

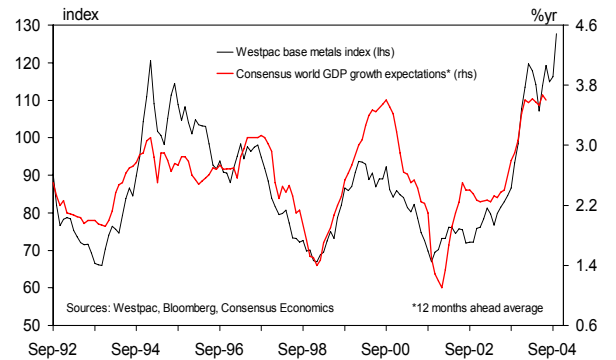
**Chart 1.**

**Commodities have underpinned the AUD**



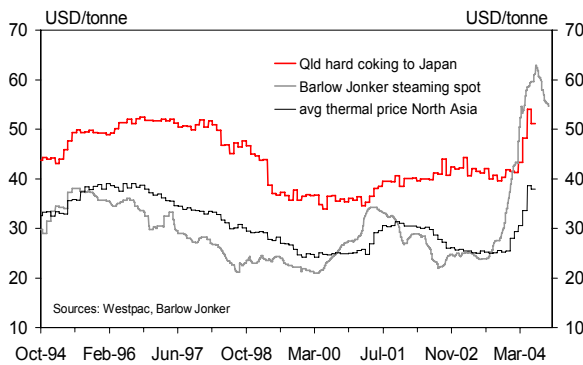
**Chart 2.**

**Base metals and global growth expectations**



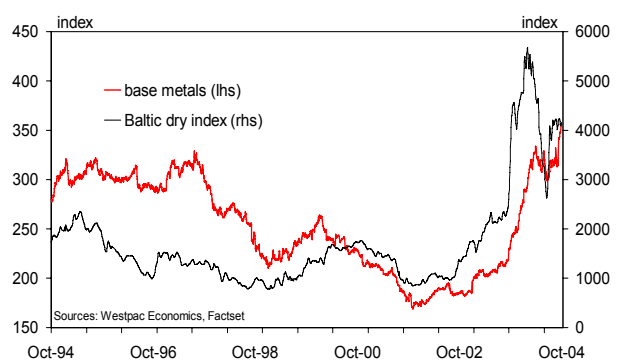
**Chart 3.**

**Coal prices appear to have peaked**



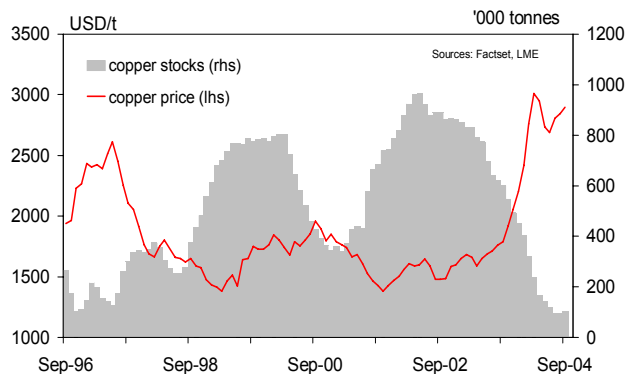
**Chart 4.**

**Freight costs peaked in February 2004**



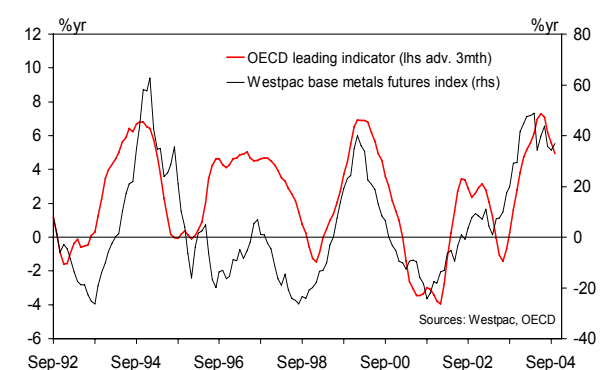
**Chart 5.**

**Copper prices rose as stocks declined**



**Chart 6.**

**World growth is set to moderate**



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## Regional Industries: non-rural commodities

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Export volumes to surge

Exports of Australia's energy and mineral commodities are expected to surge by 23% in 2004/05. The bulk commodities, namely coal and iron ore, will be the major beneficiaries. Higher production, export volumes and prices will result in surging export values. The outlook for the base metals is more sobering. A supply response from sustained price rises, along with slower demand as world growth slips back a gear, should result in stocks being replenished. This in turn will put downward pressure on prices. The surge in oil prices has gone far beyond the fundamentals of supply and demand. We expect prices to correct significantly over the coming year.

Prices heading higher for coal & iron ore.

### **Coal & Iron Ore**

Strong global demand combined with supply constraints will result in much higher coal prices in 2004/05. China's decision to restrict exports to satisfy domestic consumption has been the key factor in driving prices higher. A lack of infrastructure in key exporting centres has restricted the amount of additional supply of thermal (steaming coal). While there has been substantial investment in metallurgical (coking) coal, most of that will not be on line until 2006. That means higher prices and combined with higher volumes, ABARE expects the value of coal exports to soar by 43%.

It has been a similar story for iron ore with strong growth in steel production fuelling prices. Once again, China was the driver accounting for 60% of the increase in global steel production in the first half of 2004. Higher export volumes and significantly higher prices are likely to lead to export values surging by almost 50% in 2004/05.

Base metals have enjoyed a great run.

### **Base metals**

Base metal prices have surged in recent months after falling quite sharply from April to June on fears of a hard landing in China. The LME metals index is at its highest level in just on a decade. Stock piles have continued to dwindle with consumption outstripping demand. But with global growth having peaked and industrial production decelerating, prices will decline over the coming year. **Nickel** prices are likely to be the exception with resilient stainless steel demand and only a limited supply response set to keep prices high. For the full year 2004/05, Australia will generate solid export earnings from most base metals.

Oil, how high can it go?

### **Crude oil**

The price of oil has been climbing to record highs almost on a daily basis over the last month and at USD53.50/bbl stands 54% above where it commenced the year. We have previously argued that current supply/demand fundamentals do not explain soaring prices. There is no doubt that demand is strong and that rapid growth in energy intensive developing economies has oil consumption growing at a solid rate. But fears of supply disruptions appear to be the primary factor behind soaring prices. The hurricanes that disrupted production in the Gulf of Mexico have added to these concerns. Even the announcement by OPEC that it could add fairly substantially to supply failed to put an end to the price surge. We argue that most of the rise in prices therefore reflects a larger risk premium that will correct over the coming year.

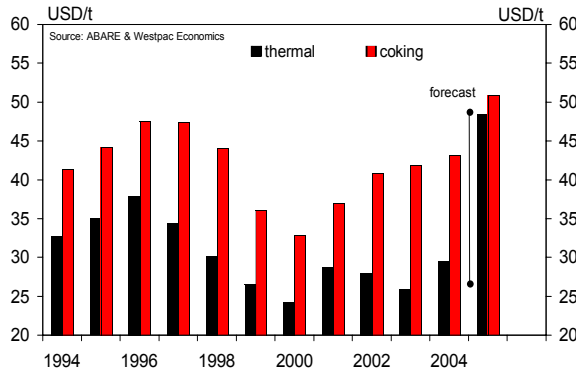
### **Gold**

A weaker USD has been the key factor behind higher gold prices during 2004. The safe haven status of gold in the wake of surging oil prices and fears of both tensions in the Middle East and terrorism has also been important. Our view that the USD is likely to appreciate against most currencies over the coming year suggests that further upside for gold prices is limited.

# Regional Industries: non-rural commodities

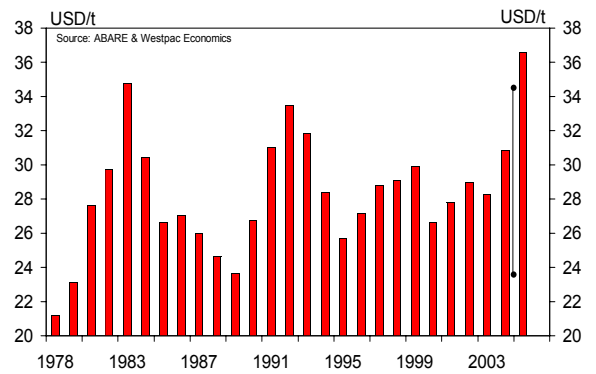
**Chart 1.**

**Coal export prices improve in 2004/05**



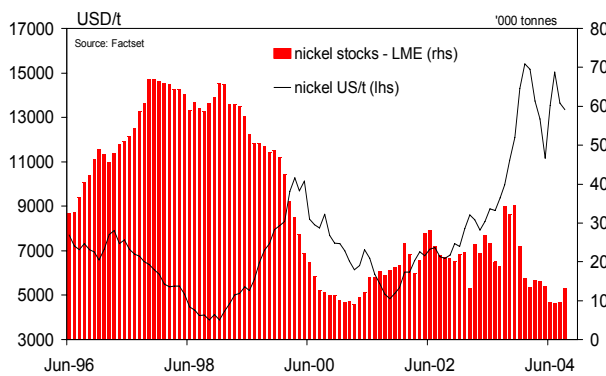
**Chart 2.**

**Iron ore prices to also strengthen in 2004/05**



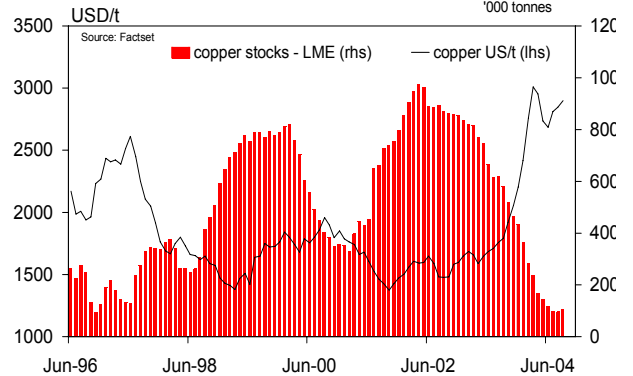
**Chart 3.**

**Nickel prices remain high**



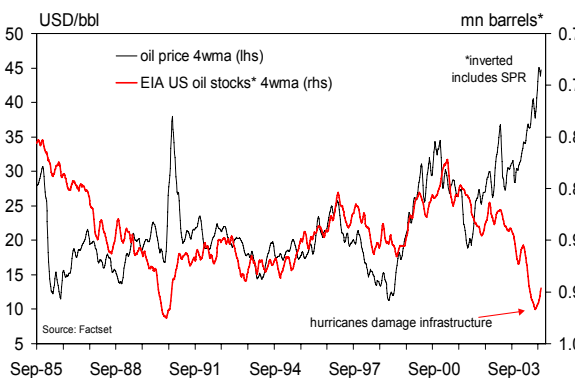
**Chart 4.**

**Copper prices jump as stocks shrink**



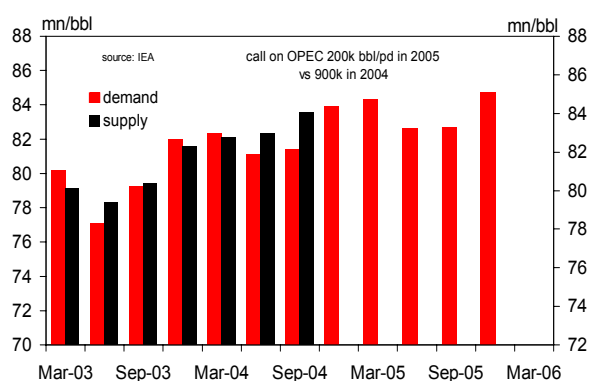
**Chart 5.**

**Fears of supply disruptions driving up oil prices**



**Chart 6.**

**Global supply and demand for oil**



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## Agribusiness outlook, farm incomes & cropping

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Farm production is being constrained by dry conditions ...

... and farm commodity prices appear to have peaked.

Wheat production will be down on last year's record.

Global excess supply is holding down coarse grain prices.

Australian canola production is at the mercy of spring rain.

### **Global prices have peaked but a weaker dollar will help a little**

ABARE is forecasting farm production to equal the 2003/04 post drought year as dry conditions reduce the current year's crop production. Total crop production is forecast to fall slightly, more than offsetting the slight rise in livestock production. Since the release of ABARE's forecasts, below average rainfall has persisted in the south and southeast of Australia, putting further downside risk to these forecasts.

As a result of both lower prices and production, ABARE is forecasting total farm income to fall slightly in 2004/05. With farm costs continuing to rise, the net value of farm production is forecast to fall by more than \$1½ billion or 22%. And we don't think that there is much hope for a significant upside surprise to farm commodity prices. At the start of 2003, the US dollar price of Australia's farm commodities peaked at levels not seen since the early 1990s only to fall 15% by January 2004. Since, we have seen a modest recovery as doubts were raised about the northern hemisphere crops and beef prices received a fillip from the closure of Asian markets to US beef. However, the northern hemisphere crop outlook is improving and the US is negotiating for the re-opening of the important Japanese market for their beef. Westpac is forecasting the Australian dollar to fall during 2005 and this should be a modest offset to the unfolding downside risk for farm commodity prices.

### **Wheat**

Winter rainfall across much of the Australian wheat belt has been below the seasonal average, hindering the planting or development of the 2004/05 winter crop. Total wheat production is forecast to fall 11% to around 22 million tonnes.

Australia has benefited from China's increased demand with China accounting for around 5% of Australia's 2003/04 wheat exports. However, Chinese wheat production is forecast to grow by 4% in the current year. Combined with the expected increase in production from the EU, Argentina and Canada then you can see why ABARE is forecasting wheat price to fall more than 7% in US dollar terms.

### **Coarse grains**

The lack of winter rain is also affecting coarse grain production with ABARE forecasting it to fall 11% in 2004/05. Despite continued strong demand, an increase in global production is expected to place continued downward pressure on prices. More recently, bigger than expected barley crops in the EU, Canada and the Black Sea countries, combined with a larger than expected supply of downgraded wheat has seen barley prices fall.

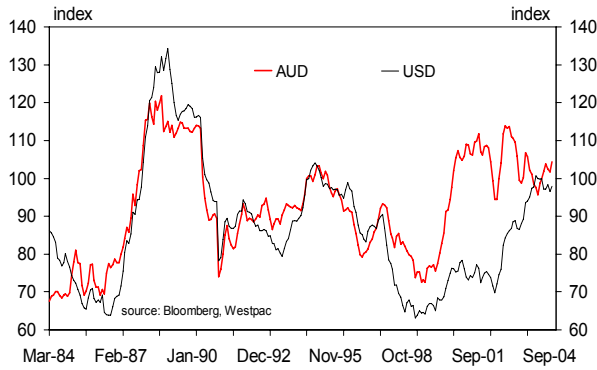
### **Oilseeds**

Australia canola crop is at the mercy of spring rains. ABARE is forecasting canola production to fall around 5% this year but continuing dry conditions put this forecast at risk. Global oilseed prices remain at the mercy of soybean production, the dominant variety in the oilseed markets. With soybean production forecast to increase significantly this year, ABARE is forecasting oilseed prices to fall around 14%. We did see a recent fillip in canola prices due to speculation that frost has significantly damaged the Canadian crop, but prices fell 14% when this proved not to be the case.

# Agribusiness outlook, farm incomes & cropping

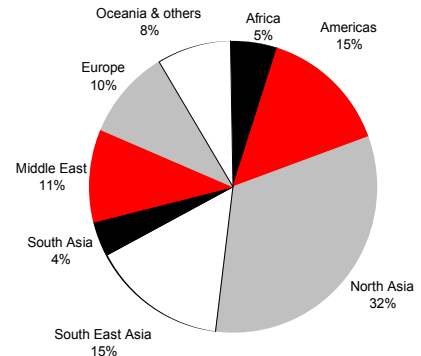
**Chart 1.**

**Westpac-NFF Farm Commodities Index**  
In AUD and USD 1994/95 = 100 monthly averages



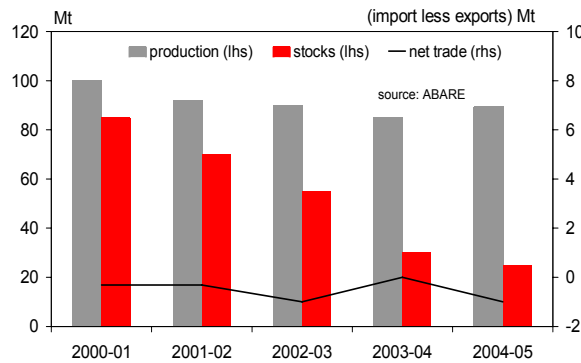
**Chart 2.**

**Destination of Australia's rural exports**



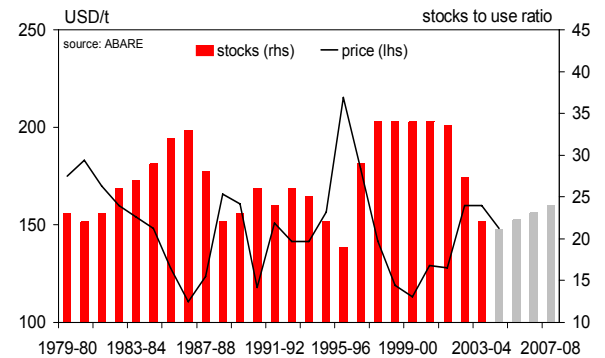
**Chart 3.**

**China is running down its wheat stocks**



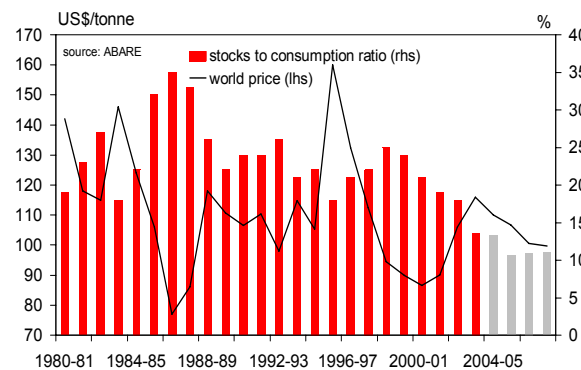
**Chart 4.**

**Wheat prices supported by low stocks**



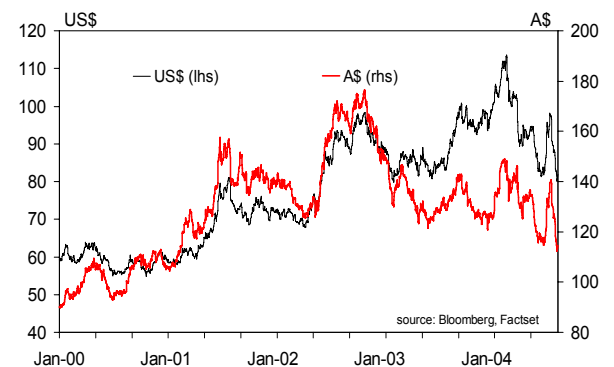
**Chart 5.**

**Coarse grains at the mercy of supply shifts**



**Chart 6.**

**Canola prices have fallen from the peak**



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## Agribusiness outlook, cotton, sugar, beef, wool & dairy

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Cotton production set to bounce back from the drought low.

### Cotton

Australian cotton production is forecast to rise 45% in 2004/05 to just over 2.1 million bales. However, the story is quite mixed across the regions. Queensland has good rainfall in February and March, replenishing on farm water storages. In northern NSW, farm water storages were around 80% of capacity in early September and water allocations are expected to be around 40% of maximum levels. The remaining areas of NSW are facing very dry conditions and water allocations are expected to be limited as most storages are virtually empty. Significant increases in production from China, the United States and Pakistan are expected to lead to sharply lower world cotton prices. ABARE is forecasting the raw cotton indicator price to fall to an average of US61¢/lb in 2004/05 from an average of US70¢/lb a year earlier. There are, however, recent signs that China may fall short of the expected "record" production of 29.5 million bales.

Sugar prices have firmed but the longer-term outlook is hindered by rising production.

### Sugar

Seasonal conditions leading up to the 2004/05 harvest, have been better than the preceding year. However, conditions are still quite dry in most areas, which are resulting in below average crop performance. Nonetheless, cane production is forecast to rise from the drought low with sugar production expected to exceed 5.5 million tonnes this year. World prices have been strengthening principally due to supply disruption in Brazil and India. In addition we continue to see upbeat expectations for economic growth in China and India, two growing sugar markets. Further out, prices are unlikely to remain strong as Brazil and India can produce sugar far more cheaply than Australia.

Beef prices set to ease as the US re-enters the Japanese market.

### Beef

As pasture conditions in many regions are being hampered by poor winter rainfall, the weaker seasonal outlook suggests herd rebuilding is expected to slow in the medium-term. Nevertheless, slaughterings are expected to fall around 3% with fewer cows and calves slaughtered as a proportion of the total. Beef prices have remained firm as tighter supplies have added to strong demand from Japan, Korea and the US. However, prices are expected to ease in 2005 as export prices to Japan ease back as the US re-enters the market. Prices in the US will rise when this happens and this will be supportive of Australian export prices there. Overall, ABARE is forecasting Australian saleyard prices to average slightly higher 2004/05.

Slower world growth will be a drag on wool prices.

### Wool

Australian wool prices have recently returned to the lows of April 2004. Weaker than expected Chinese demand and the rising Australian dollar weighed on the commodity. In addition, October is traditionally the low point for prices due to the strong seasonal supply of new shorn wool. It appears that growers are again continuing to hold large stocks of wool in store. Overall, with world growth expected to slow, prices are forecast to fall closer to 800¢ a kilogramme.

Dairy milk prices set to peak as production rises.

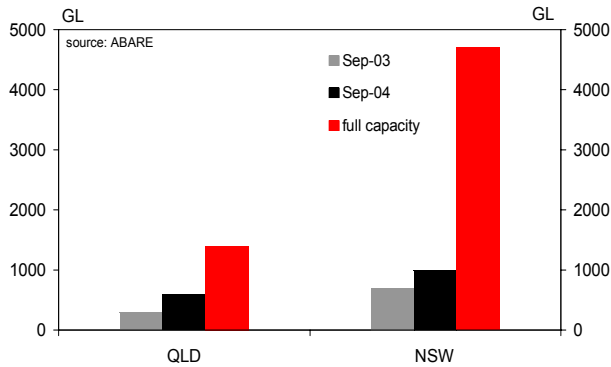
### Dairy

Australian milk production fell 2½% in 2003/04 as dry conditions adversely affected pasture growth and quality. ABARE is forecasting milk production to rise by more than 1½% to 10.2 billion litres in 2004/05. International dairy prices rose strongly in 2003/04 due to lower global supplies and stronger demand from the EU, the Russian Federation, south-east Asia and the Middle East. This strong demand is expected to continue through 2004/05 but there will be an offset in an increase in production. In particular, ABARE is forecasting skim milk powder prices to ease back to US\$1,863/tonne.

# Agribusiness outlook, cotton, sugar, beef, wool & dairy

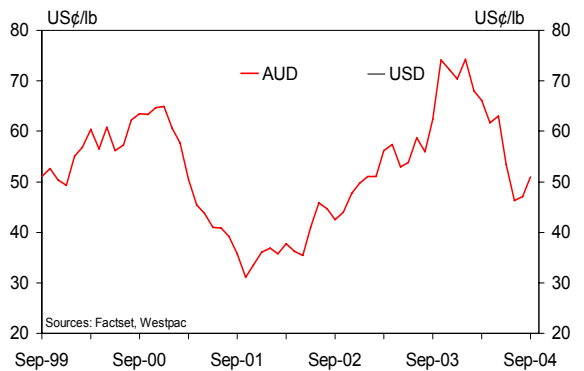
**Chart 1.**

**Water storage in key cotton regions**



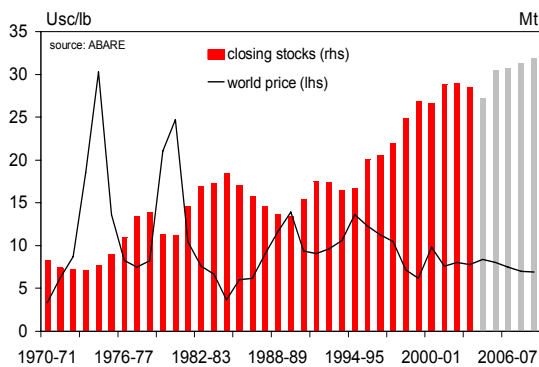
**Chart 2.**

**Cotton prices bounced off the recent low**



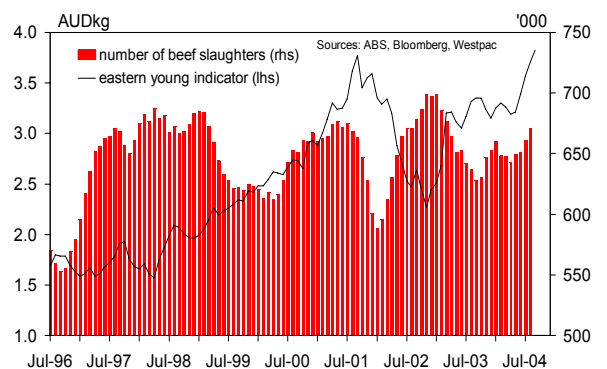
**Chart 3.**

**Stocks continue to suppress sugar prices**



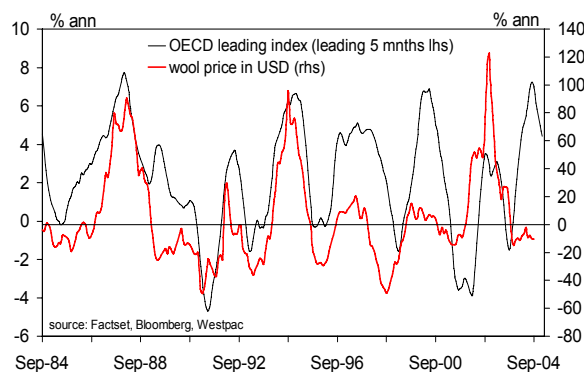
**Chart 4.**

**Beef prices and turnoff, both are rising**



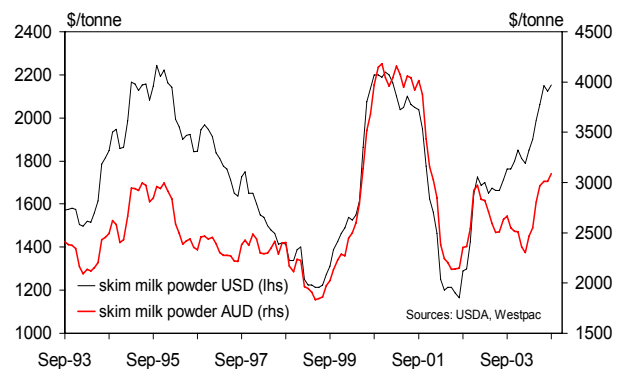
**Chart 5.**

**Wool prices will moderate with global demand**



**Chart 6.**

**Global milk prices remain a positive**

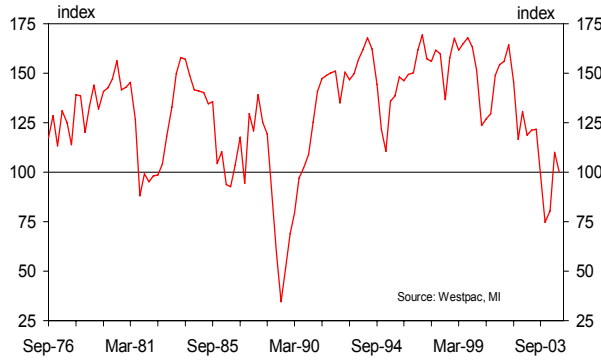


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# Westpac Melbourne Institute Regional Indicators

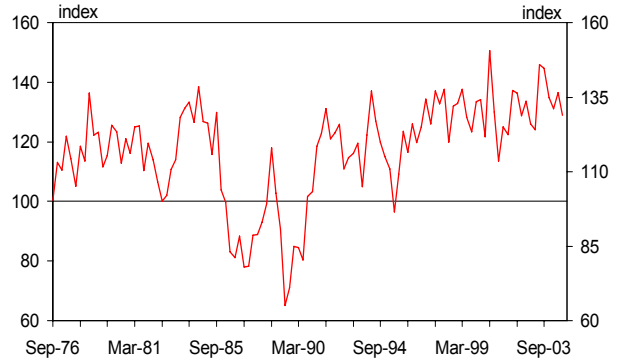
**Chart 1.**

**Westpac-MI Regional Australia Index - Good time to buy a house**



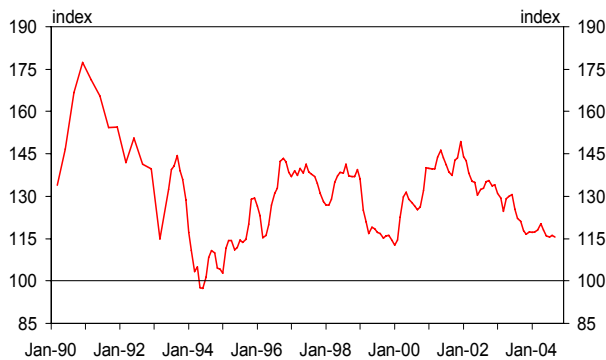
**Chart 2.**

**Westpac-MI Regional Australia Index - Good time to buy a car**



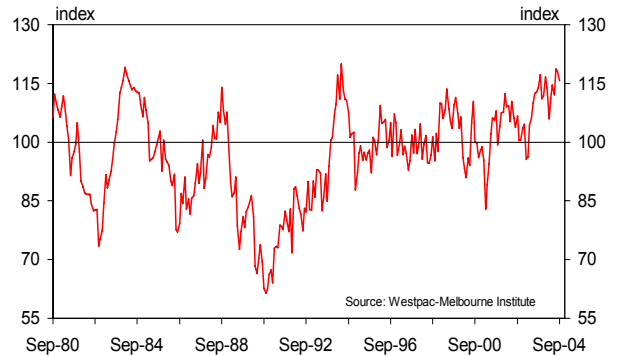
**Chart 3.**

**Westpac-MI Regional Australian Index Unemployment Expectations**



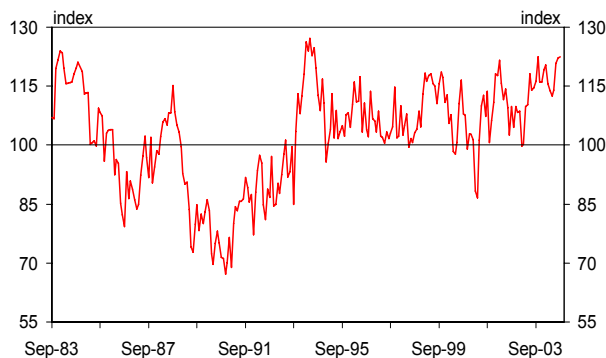
**Chart 4.**

**Westpac-MI Regional Australian Index Consumer Sentiment**



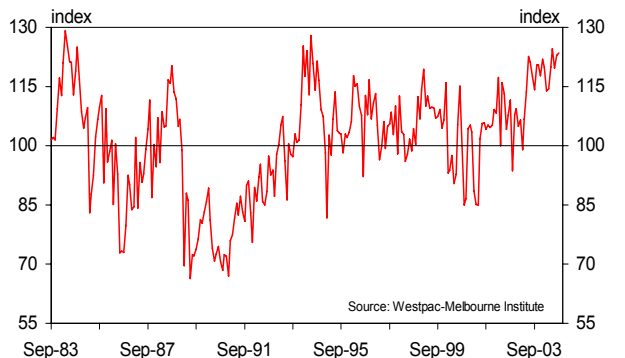
**Chart 5.**

**Westpac-MI NSW Index of Consumer Sentiment**



**Chart 6.**

**Westpac-MI WA Index of Consumer Sentiment**



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