

# Westpac Regional Economic Report

Third Quarter 2008



The most up to date trends  
and economic forecasts in  
Australian agriculture

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**Your future is our future**

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# The regions feel impact of global crisis

Global financial and economic conditions have moved on significantly since our last Regional Report with the intensification of the global credit crisis. A co-ordinated package of measures from governments, central banks and regulators is expected to see credit markets improve. Even so, the real economy impact of the crisis to date means that a global recession will be difficult to avoid. The IMF slashed their 2009 world growth forecast to 3.0%, downgraded from 3.9% in July. We concur with the IMF's assessment and expect the Australian economy to slow, but avoid recession.

In this Report we consider the implications for commodities and regional Australia of the credit crisis and the associated deterioration in world economic growth prospects.

Global commodity prices have, not surprisingly, corrected sharply lower during September and October. Commodity price forecasts for 2009 have in general been marked down as a result. For Australian commodity prices there are some key points to be mindful of in this time of general 'doom and gloom'.

The Australian dollar is playing a cushioning role, as it typically does during such volatile times. Since July the AUD has fallen from 98.5¢ to 61.8¢ – a 37% decline. Most of the fall, although not the magnitude, can be attributed to deteriorating sentiment towards the growth outlook for the world economy and the associated impact on commodity prices and risk. Since July Westpac's commodity price index (the WCFI) has fallen by about 45% and the base metals component by 47%. Simplistically these falls have been broadly comparable with the fall in the AUD. However, our modelling work indicates that the relationship should not be a simple one-to-one, indicating that the AUD has probably over-reacted to the commodity story.

A feature of this global economic cycle is the wedge between conditions in the advanced economies and emerging markets. The advanced economies are expected to stall in 2009, with growth in the US, Europe and Japan forecast to be close to zero. The silver lining is that in the emerging economies, growth is slowing not slumping. This is significant because of the increasingly important role of emerging countries demand for a number of commodities, both soft and bulks.

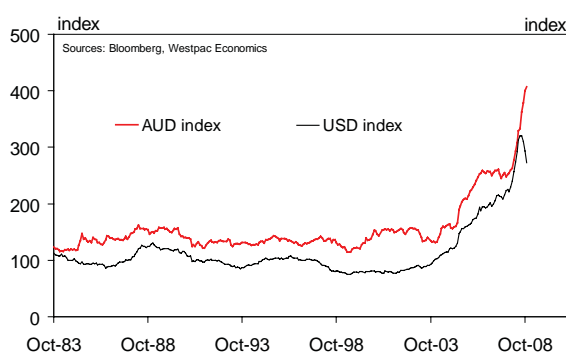
During this period of turmoil and market volatility and dislocation, it is worth restating key underlying fundamentals for many commodities. In the grains markets, for instance, low inventories and positive demand for food, feed plus still solid demand for feedstock of bio-fuel production, suggest we should hold a bias for higher prices over the medium term. Rising incomes in the developing world are a structural positive for agricultural commodity prices, in particular grains, due to rising feed demand to support rapidly rising livestock production. These fundamentals will reassert themselves as the current global slowdown passes.

Considering commodity markets on a case by case basis, significant divergences are apparent in price movements. For example, movements in vegetable oil and sugar prices provide a sharp contrast. Soy prices have plunged, moving lock step with crude despite only a fraction of soy oil production being used in the manufacture of bio-diesel. At some stage, food market fundamentals will reassert themselves. The sugar price has, however, proved to be particularly resilient. The world sugar market has tightened as consumption is boosted by policies to encourage ethanol use.

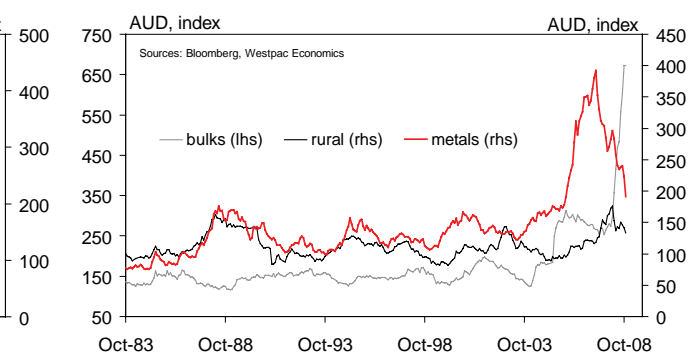
For the local grain sector, the focus is on production prospects. The 2008/09 year will be a good one, but not quite as good as expected a couple of months ago because of insufficient moisture in some parts and frost damage in WA. The wheat crop, even on recent lower forecasts, is expected to rebound 60% from last year.

**Justin Smirk and Andrew Hanlan**, Senior Economists

## Commodity prices supported by AUD



## Farm commodities flat in A\$



# Hang on: world recession ahead

The global credit crisis intensified in recent months. With bank solvency across various countries called into question, credit markets seized up as banks became less inclined to lend to one another. Governments, central banks and regulators finally recognised that a substantial and far reaching co-ordinated approach to the crisis was necessary.

These co-ordinated measures are expected to see credit markets improve, although a return to 'normal' conditions will take some. Even so, the real economy impact of the crisis to date means that a global recession will be difficult to avoid. The IMF slashed their 2009 world growth forecast to 3.0%, downgraded from 3.9% in July. We concur with the IMF's assessment.

The advanced economies are expected to stall in 2009, with growth in the US, Europe and Japan forecast to be close to zero (see table below). The silver lining is that in the emerging economies, growth is slowing not slumping. Notably, China is forecast to expand by 9% next year. This will provide some support to commodities. The Australian economy, with its exposure to both the emerging economies and the advanced, is expected to avoid recession. The timely and aggressive easing of macro-policy by the RBA and the Federal Government will play a key role in cushioning the global downturn.

**United States:** Our analysis of household balance sheets and the history of banking centred financial crises convinces us that the US cannot avoid a painful recession. We expect personal consumption to fall 0.6% in 2009 and GDP to grow just 0.2%. In terms of GDP, this is not as bad as the 1991 recession (-0.2%) but the projected decline in domestic final demand in 2009 (-0.9%) will be the worst since the 1980 recession (-1%) and considerably nastier than 2001 (+0.9%). We now see the Fed slashing rates further - to a meek 0.50%. The twin imperatives of restoring bank profits and staving off even worse asset price deflation demand a sub 1% Fed funds rate

**Europe:** The full force of the global banking crisis hit Europe in late September, and found policy-makers and politicians scrambling for a response. The ECB meeting of Oct 2 came and went without relief. Then, on October 8, the ECB cut its repo rate by 50bps to 3.75%, as part of coordinated global action to prevent self flagellating markets from injuring themselves further.

**Japan:** The heavy anchor of declining real household income growth, falling profits and decelerating external demand conspired to spill red ink all over the Q2 national accounts. Underlying these trends was a horrendous fall in the terms of trade. The economic fallout from recent financial developments in the US and Europe will not help matters, with declining export volumes being the last thing that a vulnerable Japanese corporate sector needs. As a result of this confluence of adverse developments we have slashed our 2008H2 and 2009 growth forecasts.

**China:** The weaker outlook for the advanced economies, detailed throughout this report, have encouraged us to mark down Chinese export growth even further. That pushes our 2009 growth forecast down to 9.3%, the lowest since 2002. That said, we feel that the economy will be responsive to stimulus, with a major fiscal boost on the way and a banking system willing and able to act as the vessel for transmitting easier monetary conditions to households and business. Economies that have not already eased monetary policy soon will. The alacrity of this shift, and the depth and duration of the easing cycle, will be determined by the degree of traction gained by policy initiatives in China, the US and Europe.

**Asia:** The region is bracing itself for the most challenging external environment since 2001. Recent developments in advanced country banking systems and financial markets have substantially increased the likelihood of a protracted downturn. It is anticipated that those economies that have not already eased monetary policy soon will. The alacrity of this shift, and the depth and duration of the easing cycle, will be determined by the degree of traction gained by policy initiatives in China, the US and Europe.

## Summary of world GDP growth

Real GDP %ann	2003	2004	2005	2006	2007	2008f	2009f
United States	2.5	3.6	3.1	2.9	2.2	1.8	0.2
Europe	0.8	2.1	1.6	2.8	2.6	1.2	0.6
Japan	1.5	2.9	2.2	2.8	1.9	0.4	0.3
China	10.0	10.1	10.4	11.6	11.9	9.9	9.3
East Asia	4.4	6.0	5.1	5.6	5.9	5.0	3.9
Emerging ex-East Asia	5.2	6.6	6.0	6.7	6.7	6.0	4.8
Australia	3.0	3.8	2.8	2.8	4.2	2.5	2.0
New Zealand	3.4	4.5	2.8	1.6	3.1	0.6	2.8
<b>World</b>	<b>3.6</b>	<b>4.9</b>	<b>4.4</b>	<b>5.0</b>	<b>4.9</b>	<b>3.9</b>	<b>3.0</b>

Sources: IMF, Westpac Economics. Aggregates weighted at purchasing power parity exchange rates from ICP 2005.

# Hang on: world recession ahead

Chart 1.

## US house prices

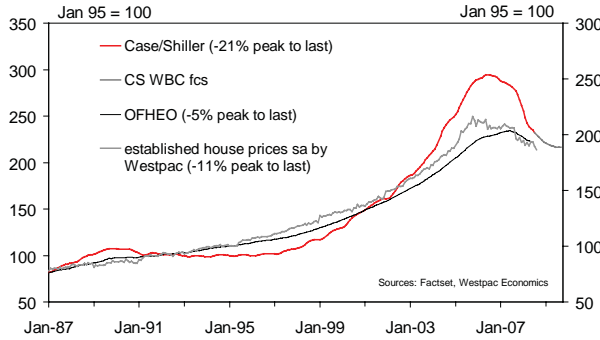


Chart 2.

## US credit standards have tightened

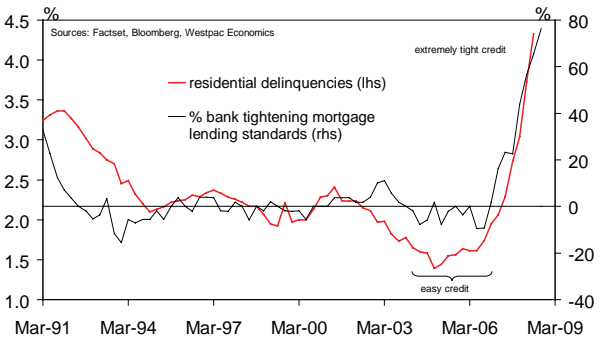


Chart 3.

## Euro CPI and M3 growth both decelerating

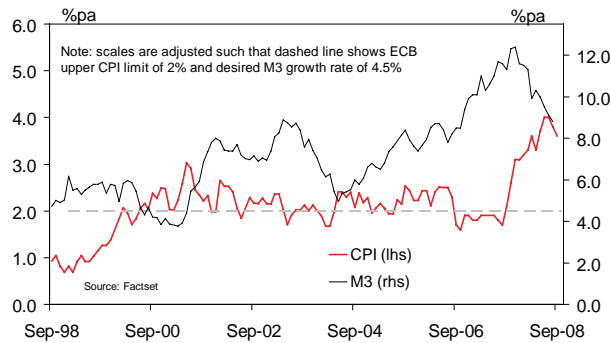


Chart 4.

## Business surveys point to UK recession

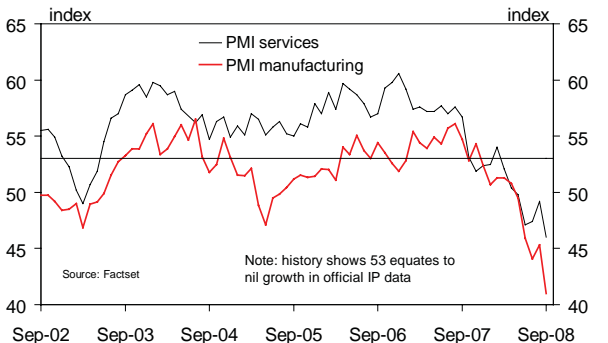


Chart 5.

## China: central government fiscal position

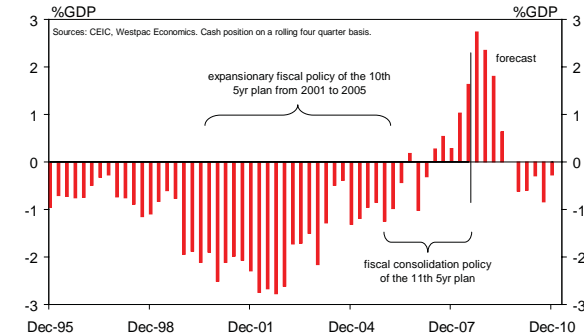
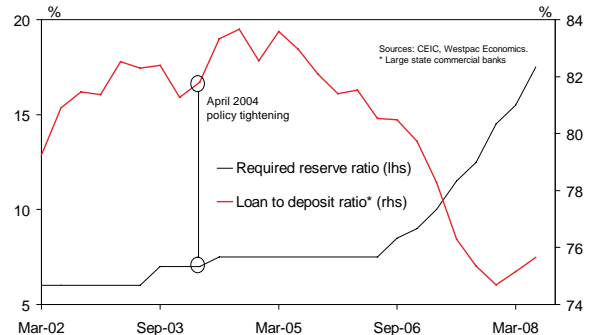


Chart 6.

## China: lending by large banks & policy



Past performance is not a reliable indicator of future performance. The forecasts given above are predictive in character. Whilst every effort has been taken to ensure that the assumptions on which the forecasts are based are reasonable, the forecasts may be affected by incorrect assumptions or by known or unknown risks and uncertainties. The results ultimately achieved may differ substantially from these forecasts.

# Australian dollar at the mercy of liquidation

## The currency markets ...

The Australian dollar was trading around 81½¢ early in September. In the period since it has been a wild ride for the little Aussie, trading in a range bounded by 85¢ and 62¢. Moreover, the swings in a day have been as great as 4¢ on a number of occasions. In mid October the currency was trading around US68¢ before it fell to 62¢ only to then bounce back to 68¢. We expect the currency to remain under pressure while the extraordinary circumstances of the present remain in place. After bottoming out at 62¢ we foresee a sustained recovery from the second quarter of next year to around 74¢ by year's end.

## ... have fallen out of love with the AUD ...

Since July 15, the AUD fell from 98.5¢ to a low of 61.8¢. Most of the fall can be attributed to deteriorating sentiment towards the growth outlook for the world economy and the associated impact on commodity prices and risk. Since July Westpac's commodity price index (the WCFI) has fallen by 45% and the base metals component has fallen by 47%. Simplistically these falls have been broadly comparable with the fall in the AUD.

## ... as risk appetite runs down to zero.

Nevertheless the global economic gloom and its associated impact on commodities and our commodity currency status explain a good deal of the AUD's weakness. Other factors such as the sharp fall in local interest rates have also played a role. However, we expect that those economies which have the flexibility to stimulate demand with large rate cuts will find that going forward their currencies are rewarded since their growth outlook and their sovereign credit risk can improve. For example when we saw the RBA unexpectedly cut rates by 100bps instead of the widely anticipated 50bps.

## Fair value is around 80¢ ...

Our model is indicating that AUD fair value is around 80¢, a decline of more than 15¢ from the peak. Fair value models can hardly be expected to capture all of the effect of such dramatic swings in markets. Our commodity price profile for 2009 points to a modest increase in fair value from mid 2009 with an 83¢ target by year's end. That profile is dictated by our core view that the Chinese authorities will adopt an aggressive pro growth policy replacing the previous "inflation containment" policy of the previous year. A relatively resilient Australian economy supported by aggressive rate cuts; expansionary fiscal policy; on going income boost from high iron ore and coal prices (inflated by AUD depreciation); will also support a recovery in 2009.

## ... but near term risks are clearly downward.

The near term represents downside risks for AUD. Global markets are equating the AUD with global risk. We do not see global risk concerns abating until well into 2009. The AUD's vulnerability to the tribulations of offshore markets will dominate its fortunes during the next six months. Its reliance on global capital markets to fund the foreign debt is well known by markets and represents an ongoing weakness for the AUD.

## The AUD decline is a form of discount ...

For example, it is well known that Australia's foreign debt is largely financed by counterparties lending to Australian banks rather than to the Australian government or Australian corporates. The shutdown of global funding markets has pushed the Australian banks back onshore for the bulk of their new wholesale funding. Other foreign lenders/investors will be required to replace the traditional foreign lenders to the banks. That process is likely to require the AUD to fall further to attract new investors/lenders. Foreigners may be attracted to equities held by Australian investors. The pipeline of inward foreign direct investment deals should also be inflated by the cheaper currency. Alternatively we may see Australian fund managers moving funds out of foreign assets into Australian assets, locking away the 30% gain from the recent fall in the exchange rate.

## ... to lure foreign investors back.

If the markets remained closed for an extended period then the funding arrangements used by the central bank to finance the expansion of its balance sheet might need to be reviewed. A neat solution would be for the government to issue bonds to foreign investors to finance the central bank's loans to the domestic banks. That would dramatically change the assessed risk profile of the Australian economy as markets' assessed Australia's "challenge" in financing its foreign debt moving from the need to attract foreigners to lend to banks to attracting foreigners to lend to the Commonwealth government. Such a development, which cannot be expected in the very short term would provide undoubted support for the AUD and the economy.

# Australian dollar at the mercy of liquidation

Chart 1.

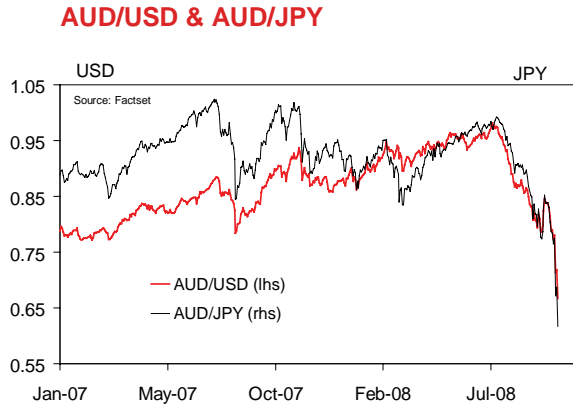


Chart 2.

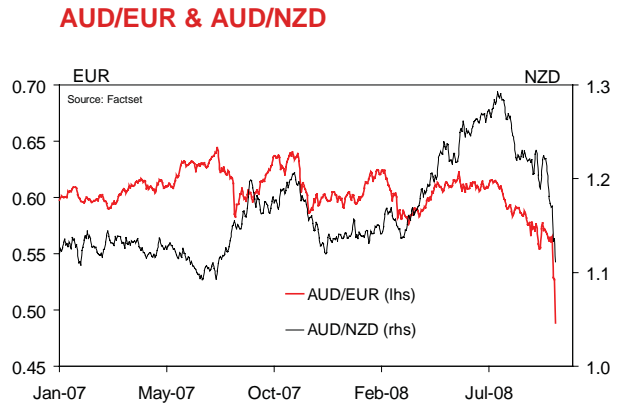


Chart 3.

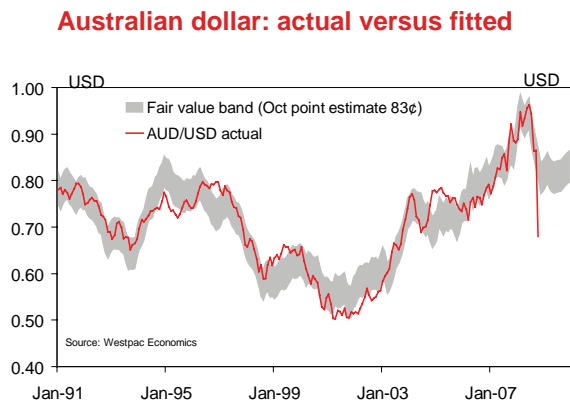


Chart 4.

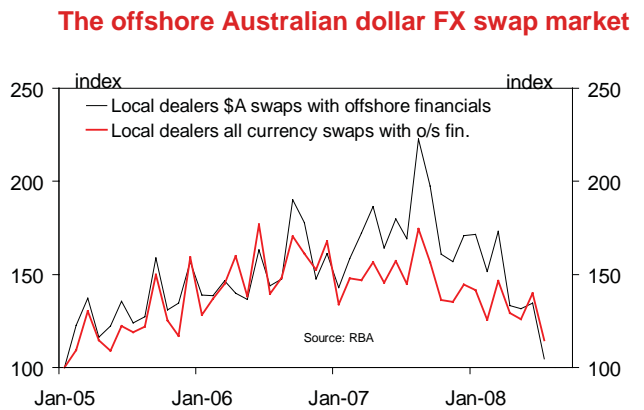


Chart 5.

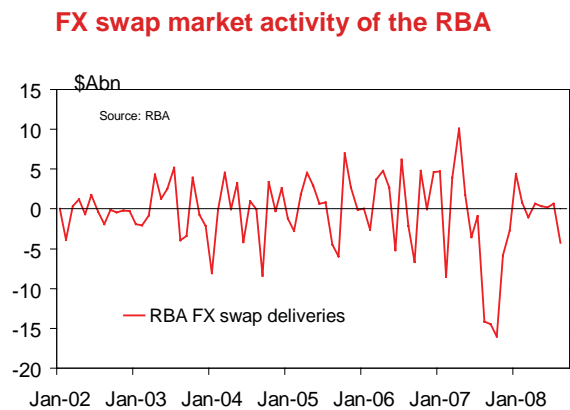
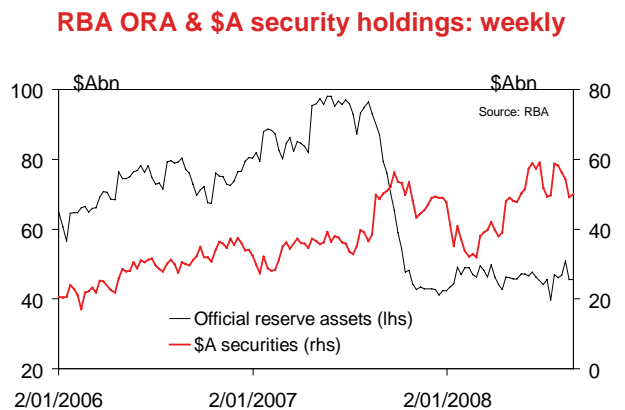


Chart 6.



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# Australian interest rates, more cuts to come

## **The RBA cut by 100bps on October 7 ...**

The Reserve Bank surprised markets by cutting the overnight cash rate by 100bps to 6.0% on October 7. This should not be interpreted as a panic decision. It totally surprised markets because we have not seen policy move in 100bp tranches since the 100bp rate hike in October 1994. The size of the move certainly highlights the gravity of the current global crisis but it emphasises the flexibility which Australia has to deal with the global crisis. Australian rates are still near global highs giving the authorities plenty of scope to use monetary policy to offset the contractionary pressures of the credit crisis.

## **... and the banks passed on 80bps.**

As exemplified by Westpac's passing on of a 0.8% rate cut for variable mortgages Australian banks are profitable and strongly capitalised and are in the position to support monetary policy – unlike the responses we saw from the UK and US banks when their central banks cut rates last year. Those banks are now being given another chance to support monetary policy but we expect that there will be little impact on mortgage rates.

## **External conditions drove the move ...**

The most important reason given by the RBA was the significant deterioration in global financial markets. Furthermore, the Governor said "financing is likely to be difficult around the world for some time ahead". The second most important reason given was a substantial revision to the Bank's view about the growth outlook for Asia – that is now being described as having seen a "significant moderation" and the terms of trade are now confidently predicted to fall, with global inflation also likely to moderate. With these two factors in place, the Bank is taking a forward looking approach to growth and inflation risks in Australia. They refer to "the risk that demand and output could be significantly weaker than earlier expected ... inflation would most likely fall faster than earlier forecast".

## **... and the RBA is now heading for neutral ...**

The conclusion by the Bank is that a "significantly less restrictive stance of monetary policy" was required. I believe this terminology is important because one can reasonably conclude that the Bank believes that policy will still be restrictive after the move. In previous easing cycles, which have been associated with much less threatening global and domestic economic risks, the Bank has chosen to move to a neutral/expansionary stance within one year, with cuts of 200 to 250bps in total. In those earlier periods, inflation was contained, being in the 2½% to 3% range.

## **... and then some.**

However in those episodes there were no risks associated with the functioning of the financial system either domestically or globally, or the genuine prospect of a global recession. The Bank has now clearly enunciated its position that a sharp downturn in demand conditions will ensure that inflation declines. Consequently, we expect that this cycle will be more aggressive than the previous two, where it took around a year to move back to neutral. The level of the RBA cash rate that equates with neutral will be determined by the degree to which the banks pass on the RBA rate cuts. Policy is likely to be determined more by the need to get the variable mortgage rate down by 2% than a target level for the cash rate.

## **Funding issues persist ...**

Westpac's bold decision to cut the variable mortgage rate by 0.8% following last month's 0.25% cut means that in terms of the mortgage rate we are more than half way there. But progress in achieving the additional 1% cut might be more difficult. Wholesale borrowing costs (about half of bank requirements) are more than 1% higher than before the crisis began. Retail borrowing costs have also tightened significantly as the smaller institutions that are now denied access to funding in global markets pressure domestic funding costs. A test of whether we can expect further bold moves from the banks will be the degree to which they are able to manage down retail deposit rates. Banks are intermediaries. They can hardly be expected to aggressively cut lending rates if deposit rates do not also fall.

## **... which will push the RBA lower.**

For a full pass-through, the neutral cash rate would be around 5.50%, but we expect that with the credit crisis almost certain to persist for the next six months at least, neutral is much more likely to be 5% for the official cash rate. The Bank is now likely to set its objective to move policy into the expansionary range which we think will be defined as 5% on the cash rate or below. That suggests to us that we can expect another 150bps in total of RBA rate cuts within the next three to six months. We expect 50bp moves in both November and December.

# Australian interest rates, more cuts to come

Chart 1.

## RBA: an aggressive reduction in rates

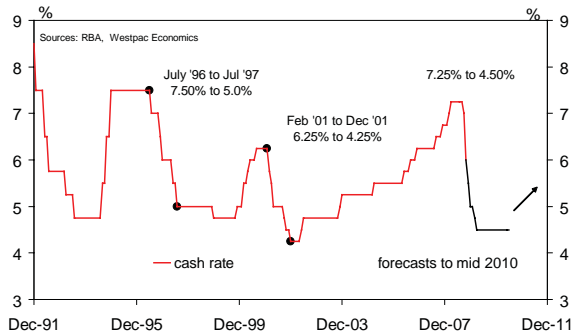


Chart 2.

## Australian interest rates

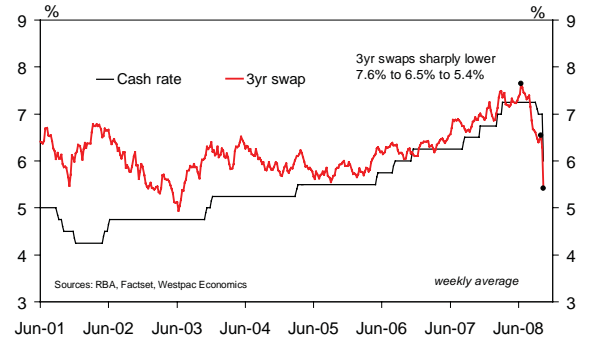


Chart 3.

## Funding spreads

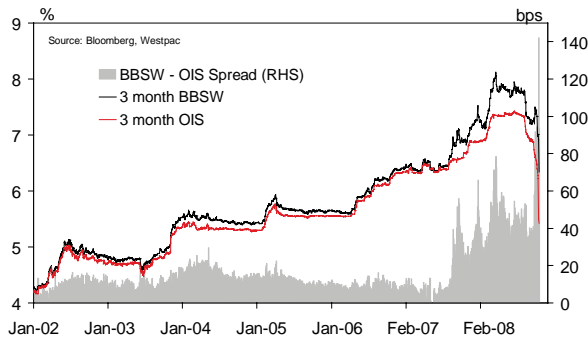


Chart 4.

## Credit growth remained soft in August

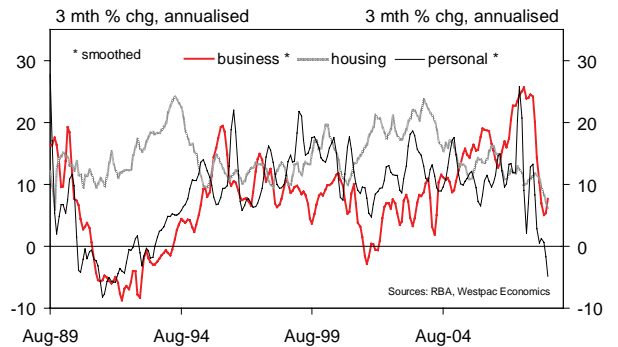


Chart 5.

## Consumer Sentiment hit by financial crisis

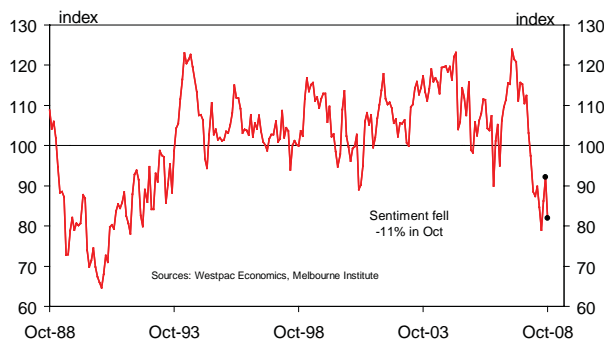
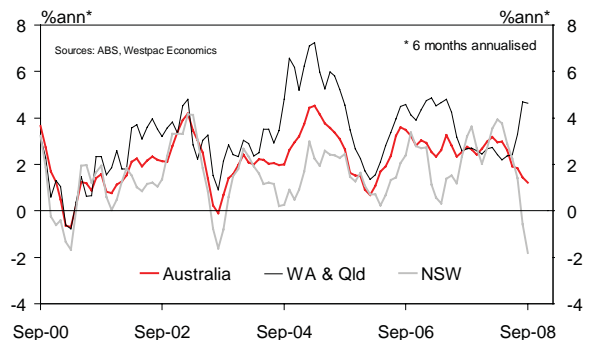


Chart 6.

## Jobs growth slows, particularly in NSW



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# Wheat and oilseeds

## Grains feel the impact of global downturn ...

Grain markets are feeling the impact from the global crisis. The oilseed market in particular has been harshly treated as crude oil plunges from record highs. Wheat prices, which were set to decline as supply responded, have also pulled back sharply.

The focus locally is on production prospects. The 2008/09 year will be a good one, but not quite as good as expected a couple of months ago.

## ... but medium term fundamentals remain.

During this period of turmoil and market volatility and dislocation, it is worth restating key underlying fundamentals for the grains markets. Low inventories and positive demand for food, feed plus still solid demand for feedstock of bio-fuel production, suggest we should hold a bias for higher prices over the medium term. Rising incomes in the developing world are a structural positive for agricultural commodity prices, in particular grains, due to rising feed demand to support rapidly rising livestock production. These fundamentals will reassert themselves as the current global slowdown passes.

## Bumper wheat harvest - although forecasts scaled back a little.

### Wheat

The Australian wheat harvest in 2008/09 will be a bumper one, sharply rebounding from the drought ravaged last two years. The size of the rebound has, however, been scaled back a little over the last two months. ABARE was forecasting production to be 23,680kt, up 81% from 13,039kt in 2007/08. More recent private sector forecasts are around the 21,000kt mark. There has been insufficient moisture in SA and parts of Victoria, plus some frost damage in WA. So far NSW and Qld production prospects are holding up.

It is a similar story for Australian barley production. The latest forecasts are around 6,800kt, scaled back from 7,900kt because of less upbeat prospects in WA, Vic and SA. Such an outcome still represents a rebound from 5,920kt in 2007/08 but falls short of outcomes earlier in the decade.

## Wheat prices hit by global turmoil ...

The wheat market is feeling the impact of global turmoil. The liquidity crisis and fund redemptions has led to a sharp decline in CBOT futures, declining from around US\$8.50/bushel in July to US\$5.50/bushel in mid-October. That is well off the record US\$11.53 price in February

## ... while vegetable oil prices plunge, following crude lower.

### Oilseeds

Vegetable oil prices have felt the full force of the global melt down. Prices have tumbled as slowing world growth undermines energy prices. Crude oil, trading at US\$145 a barrel in early July, moved below US\$70 in mid-October, a 52% plunge. Over the same period, vegetable oil prices dropped 45%.

This lock step movement of soy and crude is despite the fact that only a fraction of total soy oil production is used in the manufacture of bio-diesel. At some stage, food market fundamentals will reassert themselves. Just when that will be is difficult to confidently predict in the current volatile environment. It is worth noting that soy oil at US35¢/lb in mid-October is approaching the US30¢/lb price in early 2007, ahead of the sharp run-up.

## Food market fundamentals will reassert themselves

It could be argued that the sharp retreat in crude oil prices will reduce the move into bio-diesel. A dramatic rethink appears unlikely however. Policy makers in oil importing nations will remain mindful of their vulnerability to sharp spikes in crude prices. The bio-diesel push looks set to continue for some time yet.

Australian canola production, while set to be up on 2007/08, is not as promising as appeared earlier. Forecasts have been scaled back to around 1,400kt from 1650kt, which compares with the 1,065kt outcome last year. The crop disappointment is spread across NSW, SA and Vic, with some offset from an upgrade to the major producing state of WA.

# Wheat and oilseeds

Chart 1.

## Wheat prices

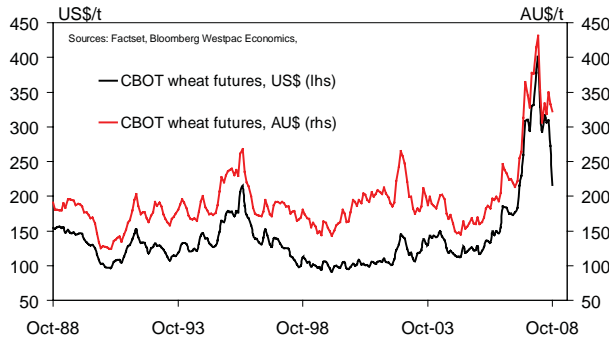


Chart 2.

## Wheat consumption per person

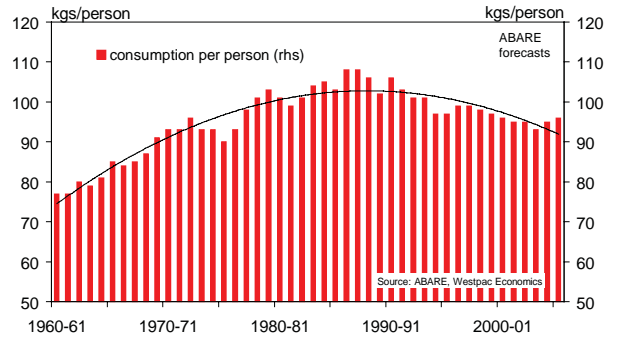


Chart 3.

## World corn and barley prices

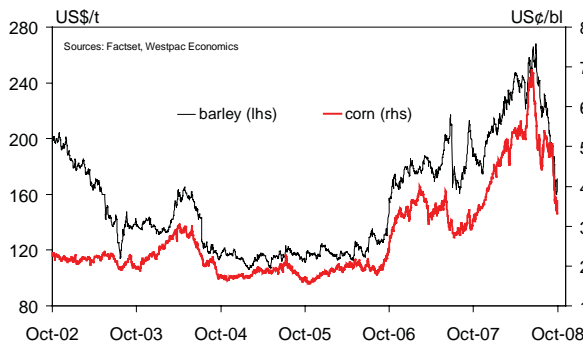


Chart 4.

## World canola & soybean prices

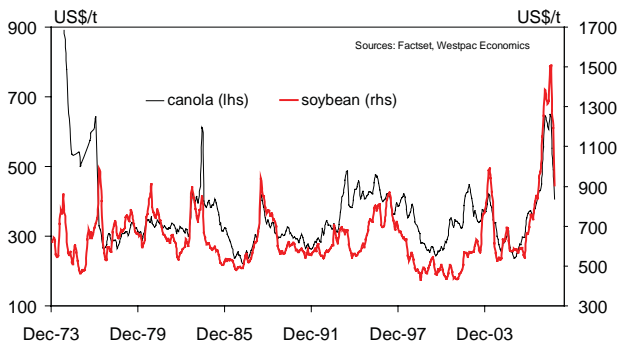


Chart 5.

## Ethanol spread to gasoline

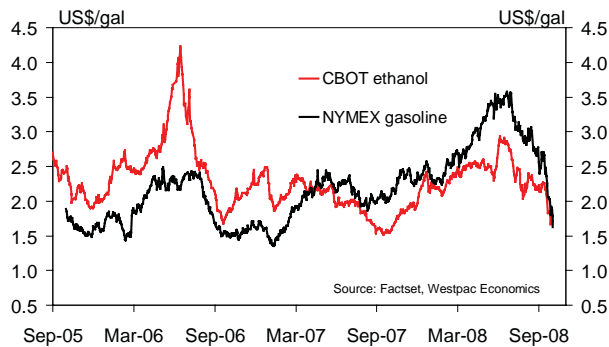
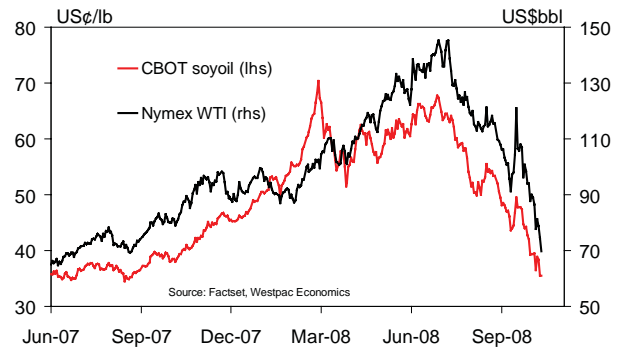


Chart 6.

## Soyoil & crude take the elevator down



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# Sugar, cotton and wool

<p><b>Sugar prices prove resilient</b> ...</p>	<p><b>Sugar</b> The sugar market provides a contrast to developments for vegetable oils. While soy oil prices have moved lock step with crude, the sugar price has proved to be particularly resilient.</p> <p>Sugar prices did moderate in September and October, to be at around US11.40¢/lb. That represents a 9% decline from the first half year average, a modest correction in the scheme of things and a far smaller move than the plunge in the Australian dollar.</p>
<p><b>... as market tightens.</b></p>	<p>Three months ago sugar market fundamentals were not very exciting. Demand was growing but supply was surging as producers responded to the higher prices of 2005/06. More recently, a tightening of the world sugar market has become evident. Notably, inventory levels in 2007/08 were not as high as previously believed and are now expected to stabilise rather than rise in 2008/09. World consumption is looking stronger, boosted by active policies to encourage ethanol use. Also, production is expected to decline by 3% reflecting some switching into other crops seen as relatively more attractive.</p> <p>On the local front, CSR plans to covert its ethanol distillery at Sarina in Qld to sole production of fuel grade ethanol and away from partial production of industrial grade ethanol. This is in response to growing domestic demand for ethanol blended fuel</p>
<p><b>Cotton price rally derailed.</b></p>	<p><b>Cotton</b> The rally in cotton prices evident early in 2008 has been derailed by the global recession. World prices dropped to US53¢/lb in October, well down from US75¢ mid-year – representing a sharp 30% correction.</p> <p>The prospect was for global cotton use to outpace production for a fourth year. That has now been called into question. Rapid growth in cotton use in China and India, the world's largest consumers, appears to have stalled. Rising disposable income and the ending of the Multi-Fibre Agreement, which solidified buoyant textile exports, have been the drivers of cotton demand in these two markets. The recessionary conditions in the advanced economies will dent export growth.</p> <p>Limiting the downside to prices is an expected drop in world cotton production. ABARE is forecasting a 6% drop. As noted previously, the world's largest exporter, the US, is set to see a sharp fall in cotton acreage – to its lowest since 1989. That is in response to a switching to more lucrative crops</p>
<p><b>Wool market hit by recession in advanced economies ...</b></p>	<p><b>Wool</b> The wool market has been hit by the global recession, which comes as no surprise.</p> <p>The fortunes of the wool industry remain closely linked to prosperity in the industrialised world. It is the advanced economies where economic conditions are weakest and set to deteriorate further in 2009. Many of the most advanced economies will be in or close to recession, notably: NZ, Canada, the US, the UK and Europe.</p> <p>Wool prices in this environment have continued to retreat. ABARE in September forecast the eastern market indicator to average A880¢/kg in 2008/09, thereby reversing the bulk of the gain in 2007/08. Even with the collapse in the Australian dollar, the Aussie dollar price slumped to \$830¢/kg in late September and October.</p> <p>One mitigating factor to the downside of wool prices is the low level of wool stocks. World stocks are forecast by ABARE to decline to 100kt in 2008/09. While that is down on last year's outcome, it is not as low as the 80kt expected just three months ago.</p>
<p><b>... and Australian production continues downward trend.</b></p>	<p>For the Australian wool industry, the downward trend in production is set to continue. Indeed, forecasts have been scaled back for the 2008/09 year. ABARE now expects output of 424kt, a 4.3% decline on the year prior. To place that in perspective, that represents a 21% drop from the 2005/06 peak. The flock is decreasing and the sheep sector is looking more like that in New Zealand, where the focus is on lamb production. High world grain prices are pushing up feed costs and also encouraging, particularly in WA, farmers to switch into grain production.</p>

# Sugar, cotton and wool

Chart 1.

## Production to ease back in 2008/09

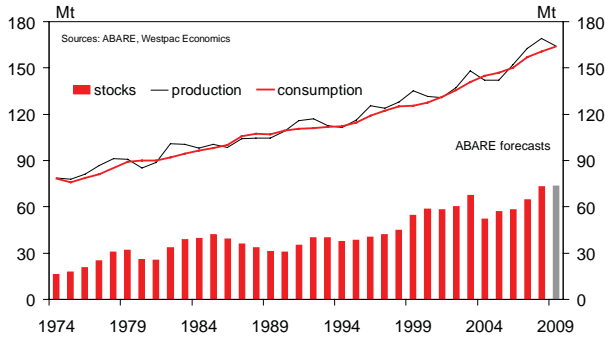


Chart 2.

## Sugar prices resilient

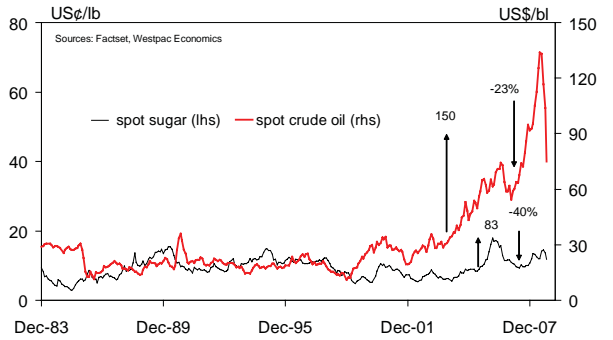


Chart 3.

## Falling cotton stocks supporting prices

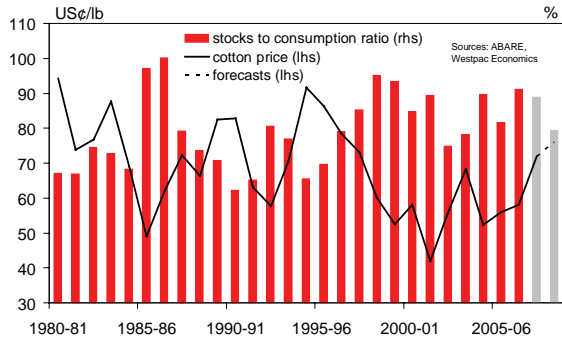


Chart 4.

## Production of cotton textiles

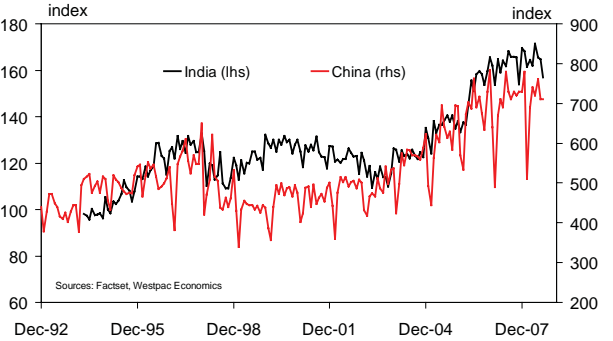


Chart 5.

## Wool stocks remain supportive of prices

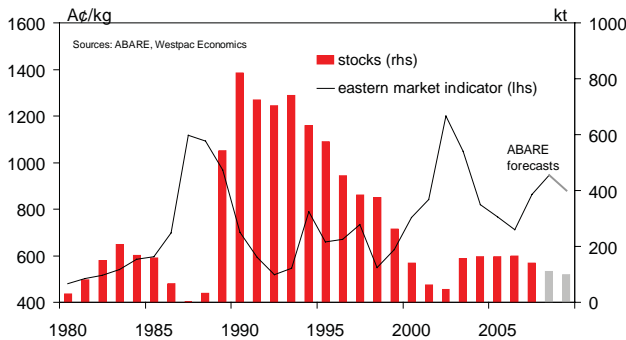
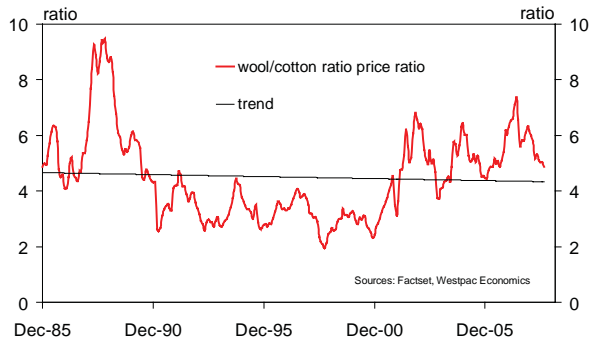


Chart 6.

## Wool more competitive relative to cotton



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# Beef, dairy and sheep

## Lower AUD cushions falling beef prices ...

### Beef

While the beef market has not escaped the global crisis, the impact to date has been relatively mild – from an Australian perspective. US beef futures were down 11% by mid-October from the first half year average. By contrast, given the sharp fall in the AUD, Australian export prices increased over the period, rising by 15%. While that is comforting, further fall out from the global recession is expected. Beef demand is slowing, potentially significantly in the Asian region. This will place additional downward pressure on global prices – partially tempered in 2009 by less beef supply.

## ... but Australian exports hit by US return to Asian region.

On international beef markets, the return of the US to Asia will see Australian exports to the region fall significantly. In Korea, the new protocol for imported beef was implemented in late June. Reports suggest the US had almost 50% market share after just three months, which compares with a 75% to 80% share in the past. US beef exports to Japan have been increasing in recent months, although they remain well below 2002/03 levels. To date, there have been no changes to Japanese import protocols for US beef.

Australian beef production is expected edge fractionally lower in 2008/09 as herd rebuilding begins. ABARE is forecasting a 0.7% decline, following a 3.2% fall in production in 2007/08.

## Dairy prices down ...

### Dairy

World US dollar dairy prices have slumped sharply as the global crisis undermines world commodity prices. Even so, prices are still above historic averages, particularly in Aussie dollar terms.

Skim milk prices moved below US\$3,000/t mark in October, down from a 2007 peak in excess of US\$5,000/t. ABARE was forecasting the price to average around US\$3,500 in 2008/09. Events have moved on since then. Global demand will be weaker than expected, just how much so is unclear. One plus is that in this global recession it is the increasingly important markets of the emerging economies and the oil producing countries that are faring better.

## ... but still elevated by historic norms.

We assess that skim milk prices will settle around \$3,000. However, for the 2008/09 year the risk is for some undershoot, suggesting a price of around \$2,600 is more achievable.

The downward pressure on prices reflects not only the global recession, but also significantly greater supply on export markets from the US. The rise in US dairy exports has occurred as US domestic demand pulls back and aided by the historically low level of the US dollar.

On the supply side, NZ output is expected to rebound strongly from drought, up 9%. However, Australia milk production in 2008/09 is expected to be little changed, as irrigator dependent farms in the Murray-Darling Basin remain constrained.

## Sheep meat prices supported by lack of supply.

### Sheep meat

The good news is that prices in the sheep meat market are hanging in there and rising.

Lack of supply is the key factor at play in this sector. This is particularly true in the European market. General destocking of the flock in Europe and the UK, combined with the effects of the NZ drought, have led to the supply shortfall. In NZ, the impact of drought has been devastating, with an 11% decline in sheep numbers in the year to June 2008. The resulting hole in the breeding stock will be felt for some seasons to come, starting with an expected 23% decline in lamb slaughter this season.

On the local front, ABARE is forecasting the Australian weighted average saleyard price of lambs to increase by 16% in 2008/09, to an average of \$3.90/k. That would, in real terms, represent the highest price since 2004/05. This view reflects tight domestic supply conditions and an expectation of reasonable seasonal conditions.

# Beef, dairy and sheep

Chart 1.

## Beef prices

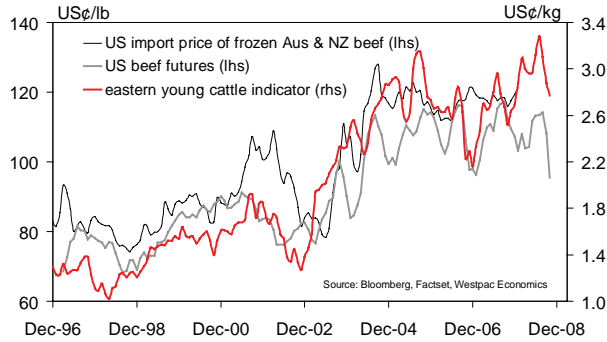


Chart 2.

## Cattle slaughtering lift

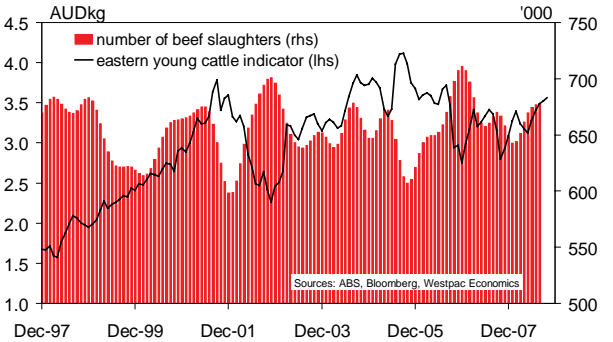


Chart 3.

## Global powdered skim milk prices

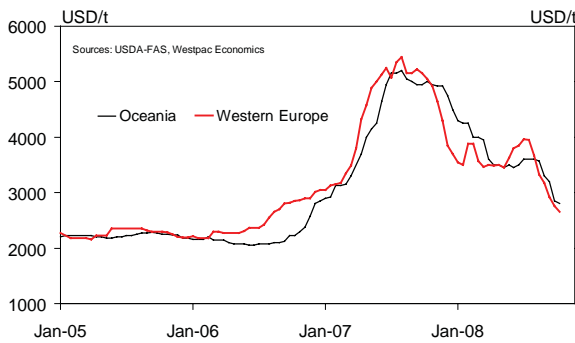


Chart 4.

## Global dairy prices

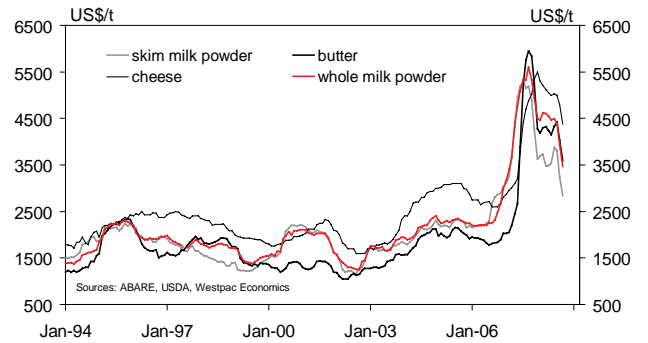


Chart 5.

## Dairy price well above historic norm

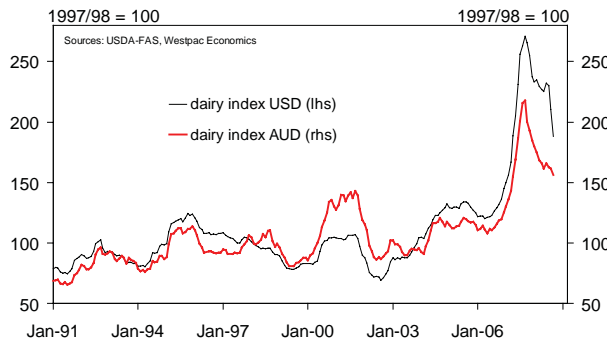
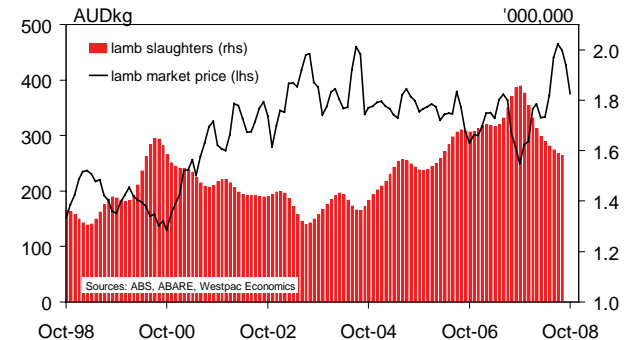


Chart 6.

## Lamb prices and slaughterings



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# Resources being pounded in the chase for cash

## Commodities hit in the flight to cash ...

Financial market, and all asset classes, corrected sharply lower from early July and commodities have not been immune to this whirl wind. Copper has fallen 54%, oil is down 59%, nickel lost 61% while steaming coal (which is used for electricity generation) is down 38%. All up, Westpac's base metals index has fallen 52% but with the more robust nature of our iron ore and coal exports (most which is underpinned by annual contracts) leaving our total commodities export index down just 14% since early July.

## ... but prices are still relatively elevated to history.

Nevertheless, it is clear that the "commodities bubble" has burst with base metals now 53% lower than their mid 2007 peak. But we should this into perspective, base metals are still trading some 80% higher than they were in the last three years of the 1990s and at \$73bbl, oil is still significantly higher than the US\$21bbl in averaged in the three years of the 1990s. So while this is a significant correction, commodity prices are still elevated. There are a number of very powerful negative factor at play and the question must be asked, why haven't prices fallen further?

## Significant negative factors have hit commodities ...

Of the negative factors we can highlight:

- 1. Cyclical pressures from the OECD sliding into recessionary conditions.** This deterioration has occurred more rapidly than many (including ourselves) had anticipated as the ongoing financial market crisis bites into industrial production. The end result has been mass investor selling of commodities and related equities.
- 2. De-leveraging by hedge funds.** Investors are selling assets due to funding issues and trading difficulties resulting in high volatility and increased pressure on commodities.
- 3. Redemptions.** Falling prices can create further pressure as less sophisticated (and sometime even the more sophisticated) investors follow the negative momentum and further sell their more risky assets.
- 4. The credit crunch has hit trade finance.** There are reports of shipments have being cancelled as the banks are now not willing to support what is a more risky transaction.
- 5. US dollar strength.** The US dollar is a powerful force in asset prices and currently the key is repatriation. US investors repatriating investments back into the US is a key force behind the current strength in the US dollar.
- 6. Building concerns about economic growth in China.** Building and construction growth has slowed in China, as has domestic steel consumption and this is being reflected in rising steel inventories at the mills and falling steel and iron ore prices in China.
- 7. New regulatory pressures.** US lobby groups are mounting a concerted attack on what they regard as the disruptive and distorting impact of speculators in commodities markets. Further regulation is anticipated following the bailing out of the US financial system and this has resulted in some fund/index selling by investors.

## ... so why are prices not lower?

## Supply constraints remain a powerful force...

These are all very powerful forces in their own right let alone in combination so the question has to be asked, why have prices not fallen further? We highlight a number of reasons to expect prices to remain well above the 1990s lows:

## ... and emerging market demand remains robust.

- 1. Supply constraints/rising costs.** Constraints on the growth in supply for many commodities remain in place, and in fact would be tightening as falling prices are now bumping against structurally high production costs. Spot prices are now nearing cost curves for a significant proportion of current production for many commodities. Then there is the rising cost of capital, if it can be found, for the more marginal producers resulting in the delay, if not closure, of many projects. As such we expect that the supply response this time may be greater than you would normally expect given the fall in prices.
- 2. The US dollar remains a positive consideration.** As noted earlier we believe the USD is being supported by repatriations from US investors. As such, when this period of repatriation ends, the USD can weaken somewhat into 2009.
- 3. The emerging markets remain a robust source of growth.** Demand growth has remained resilient in China. Questions are being asked about how long this can last with China's GDP growing 9.0%/yr in 2008Q3, falling short of expectations of a 9.7%/yr rise. However, China's stats office blames part of the decline to closure of factories over the Olympics. We believe the Chinese authorities have the fiscal, monetary and administrative fire power to add to the structural force of urbanisation to ensure that growth continues on a solid footing.

# Resources being pounded in the chase for cash

Chart 1.

### Price falls since mid July '08

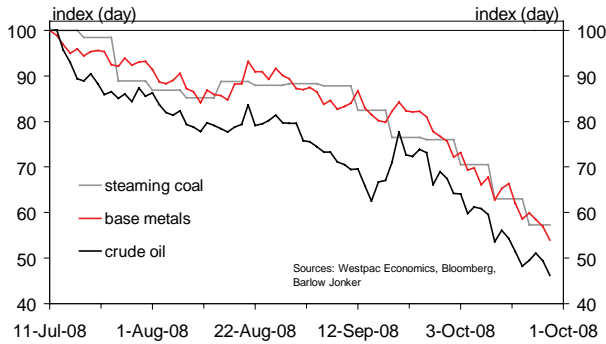


Chart 2.

### Weakness in all base metals

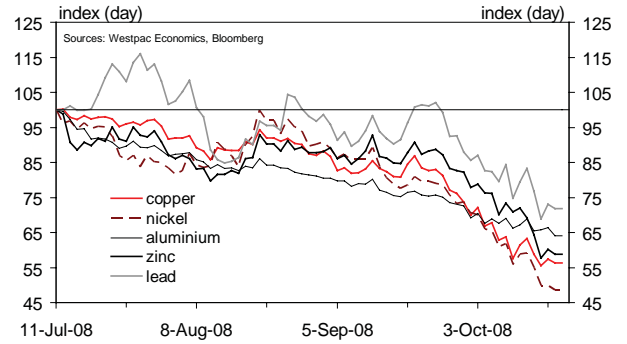


Chart 3.

### Commodities since May '07

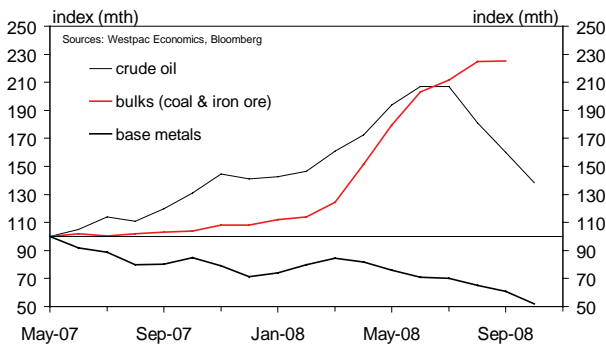


Chart 4.

### OECD indicator & base metal prices

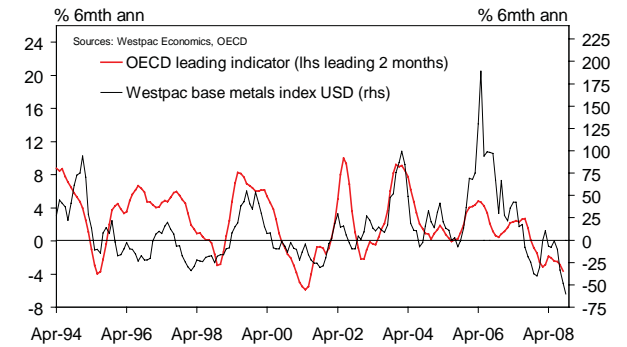


Chart 5.

### Westpac LME metals inventories index

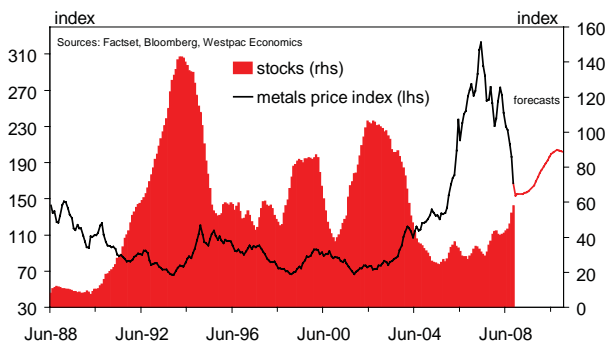
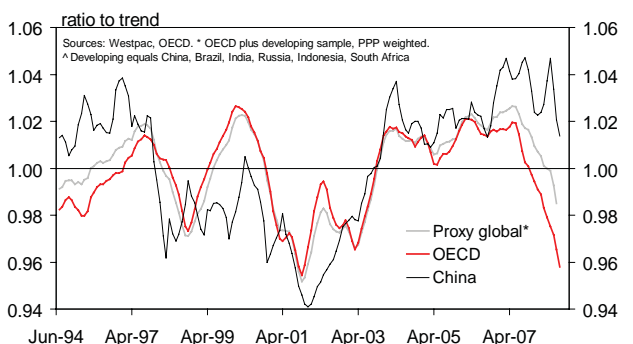


Chart 6.

### Leading indicators of global growth



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# Weak now but recovery possible in 2009

## Prices are heading one way, for now.

Weakness in equities markets are weighing on base metals prices as sentiment towards the global economy continues to take a turn for the worst. Overlay this with the ongoing de-leveraging in all asset markets and clearly you have to remain cautious about any signs of prices finding a bottom this year. Rising stocks reflect worsening fundamentals, as does the move of the forwards curves into contango – the market is no longer willing to pay a premium for early delivery. At least for remainder of 2008, the weakening demand environment will act as a counter to continuing, and increasing, underperformance in the supply of many commodities. However, current price levels will result in future supply problems, with aluminium, zinc, lead and nickel now all trading below marginal cost. Copper prices are much closer to those levels. We are already hearing the reports of production responding to lower prices but the market remains firmly focused on demand and just how bad it could become.

## A very modest rise in copper stocks.

**Copper.** Stocks at exchanges continue to rise steadily but without the large one-off deliveries that have been seen by other metals. There appears to be a modest pick-up in China's copper imports in September but this looks unlikely to be sustained to the end of the year. Our liaison in China has revealed that many small copper processors are having difficulty in finding the funds to purchase raw material. This lack of demand from processors, rather than finished goods, is a real constraint on Chinese demand.

## Aluminium inventories are building.

**Aluminium.** Inventories continue to build at the LME and we suspect that the wide contango will continue to draw metal into the exchanges. Preliminary data for September suggests a small drop in Chinese exports as the new export taxes take effect. It is estimated that globally, the cost related cut backs in production will see a loss in 1.5Mtpy of supply in 2009 and this is without considering delays in new capacity coming on line.

## Nickel mine are closing but sentiment hit by inventories.

**Nickel.** Nickel stocks at the LME remain at very hefty levels. In September, Chinese imports of refined metal were the lowest since August 2007. Collapsing nickel prices and escalating costs have led to western producers deferring new projects and/all planned expansions. Nickel pig iron costs are spiralling due to rising coke and power prices. Sentiment for the metal remains negative due to the large stock build and weak demand.

## Zinc production still growing despite to collapse in prices.

**Zinc.** Stocks at the LME are rising rapidly, up 11% so far in October. There have also been some speculation of rising un-reported stocks in China as the local market there remains oversupplied. Global output continues to grow despite the lower prices and the prospects remain for further expansion.

## Long dated oil contracts are very sticky.

**Crude oil.** US inventories have drifted 6% higher so far in October. But this places current inventories in the US on par with where they have averaged at this time of year over the last 5 years. While OECD demand is being destroyed, developing world demand continues to grow at around 0.3mbpd. OPEC is taking more overt action to support prices and this should see the market tightening in 2009. This may explain why the longer date forward contracts are rather sticky just under US\$90/bbl compared with a spot that is now closer to US\$60.

## Coal prices have pulled back.

**Coal.** The spot price of Newcastle thermal coal has fallen 45% since the peak in early July. Current price fall now puts the spot price 15% below last year's contract price. The question for the moment is just how low prices will go given reports of well stocked Asian buyers holding off making purchases. Why buy now if you think the price can fall further? And Australian producers are believed to be reluctant to reinforce the impression of lower prices by trading on the spot market.

## Liquidation of significant gold positions.

**Gold.** Gold has followed other precious metals lower as the US dollar strengthened as repatriation of US foreign investments continues, in particular from emerging markets. There is also some evidence of investor liquidations from ETFs. Barclays Capital reports that in the week ending Oct 17, the SPDR Gold Trust was holding of 755.46 tonnes, down from 770.64 tonnes a week earlier.

# Weak now but recovery possible in 2009

Chart 1.

### Non-OECD oil demand continues to grow

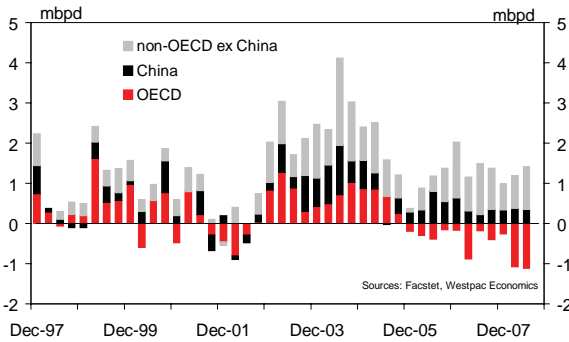


Chart 2.

### Global copper inventories (weekly)

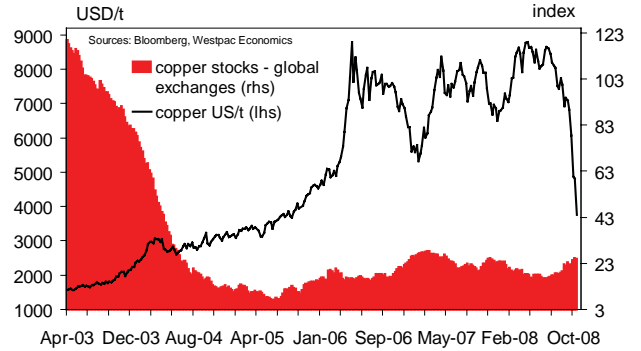


Chart 3.

### LME Aluminium stocks soaring

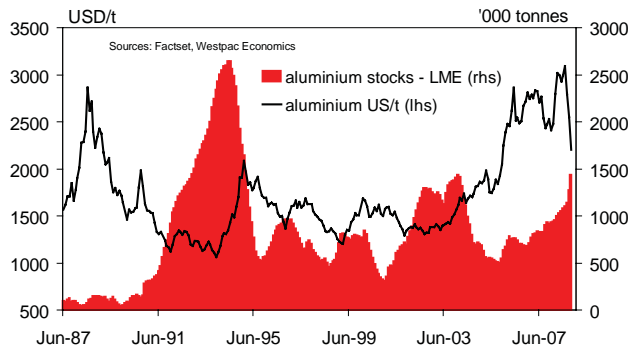


Chart 4.

### Nickel stocks surge again

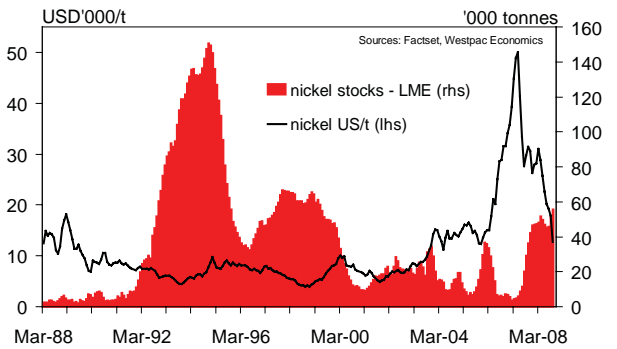


Chart 5.

### Stocks greater than just exchanges

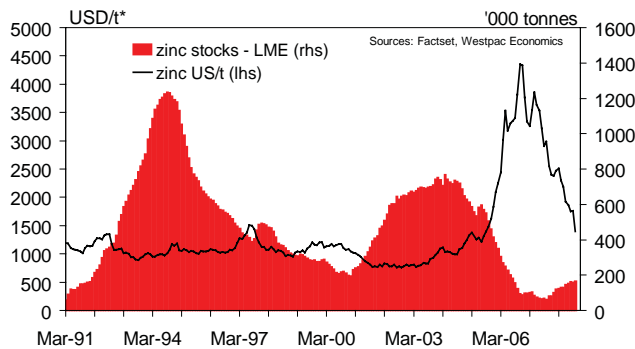
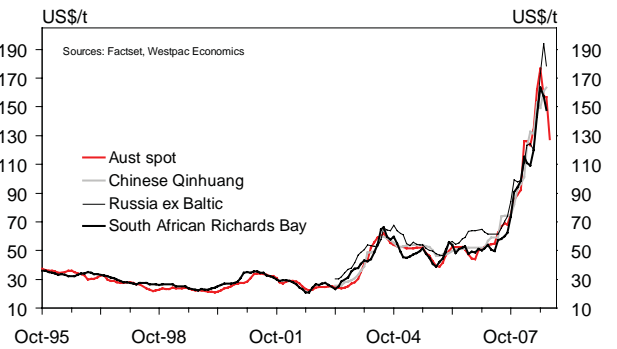


Chart 6.

### Global thermal coal prices correcting



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# Financial forecasts – Australia

## Interest rate forecasts

	Latest (Oct 27)	Dec-08	Mar-09	Jun-09	Sep-09	Dec-09
Cash	6.00	5.00	4.50	4.50	4.50	4.50
90 Day Bill	5.74	4.00	3.80	4.20	4.50	4.75
3 Year Swap	5.19	5.20	5.00	5.35	5.50	5.75
3 Year Bond	4.23	4.30	4.20	4.60	4.90	5.25
10 Year Bond	5.00	5.00	4.80	5.00	5.25	5.70
10 Year Spread to US (bps)	131	160	200	200	200	200

## Currency forecasts

	Latest (Oct 27)	Dec-08	Mar-09	Jun-09	Sep-09	Dec-09
AUD vs						
USD	0.6180	0.65	0.62	0.65	0.69	0.74
JPY	57.71	64	60	64	70	78
EUR	0.4899	0.48	0.45	0.45	0.47	0.50
NZD	1.1070	1.18	1.19	1.19	1.20	1.21
CAD	0.7872	0.76	0.75	0.75	0.76	0.80
GBP	0.3905	0.40	0.37	0.37	0.38	0.41
CHF	0.7199	0.78	0.72	0.73	0.75	0.79
DKK	3.6550	3.59	3.32	3.39	3.50	3.70
SEK	4.8892	4.48	4.10	4.14	4.27	4.52
NOK	4.3328	3.80	3.48	3.55	3.71	3.97
ZAR	6.9544	5.41	5.36	5.52	5.69	5.90
SGD	0.9323	0.96	0.89	0.94	1.00	1.09
HKD	4.8096	5.05	4.81	5.04	5.35	5.74
PHP	30.44	30.88	29.14	30.71	32.78	34.78
THB	21.56	22.98	21.38	22.56	24.20	26.09
MYR	2.2260	2.28	2.15	2.07	2.32	2.31
CNY	4.2520	4.42	4.17	4.30	4.48	4.78
IDR	6335	6240	5921	6224	6624	7123
TWD	20.78	21.39	19.91	21.02	22.50	24.34
KRW	874	894	824	849	915	995
INR	31.02	31.27	29.47	31.09	33.18	35.78

Sources: Bloomberg, Westpac Economics.

# Commodity price forecasts

annual averages	latest***	Dec-08	Mar-09	Jun-09	Sep-09	Dec-09	Mar-10	Jun-10
<b>all commodities index#</b>	<b>274</b>	<b>274</b>	<b>281</b>	<b>266</b>	<b>266</b>	<b>268</b>	<b>272</b>	<b>277</b>
<b>bulk commodities index#</b>	<b>495</b>	<b>498</b>	<b>490</b>	<b>419</b>	<b>405</b>	<b>396</b>	<b>396</b>	<b>396</b>
iron ore (USD/t)*	92	92	93	80	80	80	80	80
coal (USD/t)*	174	175	170	145	138	133	133	133
<b>WCFI***</b>	<b>177</b>	<b>186</b>	<b>205</b>	<b>224</b>	<b>234</b>	<b>244</b>	<b>252</b>	<b>261</b>
crude oil (USD/bbl) NYMEX	67	70	85	92	100	105	110	117
gold (USD/oz)	736	810	830	850	860	880	900	895
<b>base metals index#</b>	<b>128</b>	<b>135</b>	<b>143</b>	<b>157</b>	<b>163</b>	<b>176</b>	<b>186</b>	<b>197</b>
copper (USD/t)	4,043	4,250	4,600	5,200	5,400	5,600	5,800	6,000
aluminium (USD/t)	1,985	2,050	2,100	2,150	2,200	2,500	2,700	3,000
nickel (USD/t)	9,937	10,700	11,500	13,200	14,500	15,500	16,500	17,000
zinc (USD/t)	1,153	1,250	1,310	1,500	1,550	1,650	1,750	1,850
lead (USD/t)	1,288	1,380	1,450	1,570	1,580	1,625	1,675	1,700
<b>rural commodities index#</b>	<b>88</b>	<b>90</b>	<b>97</b>	<b>112</b>	<b>114</b>	<b>113</b>	<b>112</b>	<b>111</b>
wool AU¢/kg	751	769	887	1,000	1,014	926	838	834
wheat US¢/bu	542	560	610	700	700	700	700	700
sugar US¢/lb	11	12	11	11	10	10	10	10
cotton US¢/lb	52	51	55	65	69	66	65	63

	levels				% change			
annual averages	2006	2007	2008	2009	2006	2007	2008	2009
<b>all commodities index#</b>	<b>188</b>	<b>212</b>	<b>281</b>	<b>270</b>	<b>26</b>	<b>13</b>	<b>32</b>	<b>-4</b>
<b>bulk commodities index#</b>	<b>219</b>	<b>224</b>	<b>407</b>	<b>428</b>	<b>11</b>	<b>2</b>	<b>81</b>	<b>5</b>
iron ore (USD/t)*	44	51	81	83	25	17	60	2
coal (USD/t)*	74	69	137	146	4	-6	98	7
iron ore lump contracts (US\$/t)##	95	103	202	170	19	8	97	-16
coal coking contracts (US\$/t)##	115	97	305	255	-8	-16	216	-16
<b>WCFI***</b>	<b>215</b>	<b>259</b>	<b>266</b>	<b>227</b>	<b>39</b>	<b>21</b>	<b>3</b>	<b>-15</b>
crude oil (USD/bbl) NYMEX	67	73	102	96	18	8	41	-7
gold (USD/oz)	610	703	878	855	36	15	25	-3
<b>base metals index#</b>	<b>225</b>	<b>277</b>	<b>212</b>	<b>160</b>	<b>67</b>	<b>23</b>	<b>-23</b>	<b>-25</b>
copper (USD/t)	6,695	7,121	6,997	5,200	86	6	-2	-26
aluminium (USD/t)	2,585	2,653	2,647	2,238	36	3	0	-15
nickel (USD/t)	23,550	36,600	21,148	13,675	60	55	-42	-35
zinc (USD/t)	3,251	3,260	1,907	1,503	134	0	-42	-21
lead (USD/t)	1,281	2,569	2,127	1,556	34	100	-17	-27
<b>rural commodities index#</b>	<b>85</b>	<b>112</b>	<b>128</b>	<b>109</b>	<b>18</b>	<b>32</b>	<b>14</b>	<b>-15</b>
wool AUD¢/kg	814	988	886	957	6	21	-10	8
wheat USD¢/bu	415	640	805	678	26	54	26	-16
sugar USD¢/lb	15	10	13	11	47	-32	26	-17
cotton USD¢/lb	54	59	67	64	5	10	13	-5

# Chain weighted index: weights are Australian export shares. \* Average Australian export prices fob – Source ABS 5432.0 Merchandise Trade Exports. \*\* WCFI – Westpac commodities futures index. \*\*\* Weekly averages except for bulks. Sources for all tables: Westpac Economics, Bloomberg, ABS.## through the year (%yr) changes Q4/Q4

## Commodity futures contracts

Future contracts	latest***	3rd	6th	9th	12th	18th	24th
crude oil (USD/bbl) NYMEX	67	68	69	71	72	76	78
gold (USD/oz) COMEX	736	738	744	751	758	838	n/a
aluminium (USD/t) LME	1,985	2,005	2,053	2,102	2,149	2,223	2,293
copper (USD/t) LME	4,043	4,048	4,087	4,123	4,153	4,205	4,254
nickel (USD/t) LME	9,937	10,009	10,147	10,266	10,408	10,674	10,900
zinc (USD/t) LME	1,153	1,167	1,195	1,222	1,245	1,287	1,327
lead (USD/t) LME	1,288	1,293	1,303	1,313	1,325	n/a	n/a

Past performance is not a reliable indicator of future performance. The forecasts given above are predictive in character. Whilst every effort has been taken to ensure that the assumptions on which the forecasts are based are reasonable, the forecasts may be affected by incorrect assumptions or by known or unknown risks and uncertainties. The results ultimately achieved may differ substantially from these forecasts.

# Summary of world output

## Economic growth forecasts#

Real GDP %ann	2003	2004	2005	2006	2007	2008f	2009f
<b>World</b>	<b>3.6</b>	<b>4.9</b>	<b>4.4</b>	<b>5.0</b>	<b>4.9</b>	<b>3.9</b>	<b>3.0</b>
United States	2.5	3.6	3.1	2.9	2.2	1.8	0.2
Japan	1.5	2.9	2.2	2.8	1.9	0.4	0.3
Euro zone	0.8	2.0	1.5	2.9	2.6	1.2	0.6
<b>Group of 3</b>	<b>1.7</b>	<b>2.9</b>	<b>2.4</b>	<b>2.8</b>	<b>2.3</b>	<b>1.4</b>	<b>0.4</b>
United Kingdom	2.6	3.2	1.9	2.8	3.0	1.2	0.0
Canada	1.9	3.1	3.1	2.8	2.7	1.8	2.2
Australia	3.0	3.8	2.8	2.8	4.2	2.5	2.0
New Zealand	3.4	4.5	2.8	1.6	3.1	0.6	2.8
<b>OECD total</b>	<b>1.9</b>	<b>3.2</b>	<b>2.6</b>	<b>2.8</b>	<b>2.5</b>	<b>1.6</b>	<b>0.6</b>
China	10.0	10.1	10.4	11.6	11.9	9.9	9.3
Korea	3.1	4.7	4.2	5.1	5.0	4.6	3.5
Taiwan	3.5	6.2	4.2	4.9	5.7	4.3	2.2
Hong Kong	3.0	8.5	7.1	7.0	6.3	4.0	3.0
Singapore	3.5	9.0	7.3	8.2	7.7	3.8	3.0
Indonesia	4.8	5.0	5.7	5.5	6.3	5.9	5.2
Thailand	7.1	6.3	4.5	5.1	4.8	4.8	3.8
Malaysia	5.8	6.8	5.0	5.9	6.3	5.5	4.6
Philippines	4.9	6.4	4.9	5.4	7.3	5.0	4.0
Vietnam	7.3	7.8	8.4	8.2	8.5	7.1	6.8
<b>East Asia</b>	<b>7.5</b>	<b>8.3</b>	<b>8.2</b>	<b>9.2</b>	<b>9.5</b>	<b>7.9</b>	<b>7.3</b>
East Asia ex China	4.4	6.0	5.1	5.6	5.9	5.0	3.9
<b>NIEs*</b>	<b>3.2</b>	<b>5.9</b>	<b>4.8</b>	<b>5.6</b>	<b>5.6</b>	<b>4.4</b>	<b>3.0</b>
India	6.9	7.9	9.1	9.7	9.2	8.2	7.6
Russia	7.3	7.2	6.4	7.4	8.1	7.3	6.0
Brazil	1.1	5.7	3.2	3.8	5.4	5.0	4.3
South Africa	3.1	4.9	5.0	5.4	5.1	3.3	3.0
Mexico	1.4	4.2	2.8	4.8	3.3	2.8	2.0
Argentina	8.8	9.0	9.2	8.5	8.7	6.5	5.0
Chile	4.0	6.0	5.7	4.0	5.0	5.0	3.5
CIS^	7.8	8.2	6.5	8.2	8.5	7.4	5.0
Middle East	6.9	5.9	5.7	5.8	5.8	6.2	5.0
C & E Europe	4.8	6.9	6.1	6.6	5.8	3.8	2.8
Africa	5.3	6.5	5.7	5.9	6.3	6.6	4.2
<b>Emerging ex-East Asia</b>	<b>5.2</b>	<b>6.6</b>	<b>6.0</b>	<b>6.7</b>	<b>6.7</b>	<b>6.0</b>	<b>4.8</b>
Other countries	4.0	8.3	6.7	5.9	6.1	5.0	3.5
<b>World</b>	<b>3.6</b>	<b>4.9</b>	<b>4.4</b>	<b>5.0</b>	<b>4.9</b>	<b>3.9</b>	<b>3.0</b>

#Regional and global groupings are weighted using PPP exchange rates updated to reflect ICP 2005 benchmark revisions. Adding ½ppt to the global headline approximates growth under the prior weighting system \* "NIEs" signifies "Newly Industrialised Economies" as defined by the IMF, viz, Republic of Korea, Hong Kong SAR, Taiwan Province of China, and Singapore. ^ CIS is the Commonwealth of Independent States, including Mongolia. Sources: IMF, Westpac Economics.

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