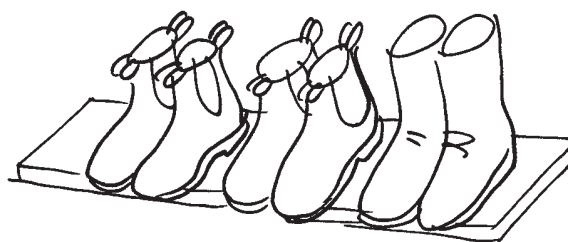
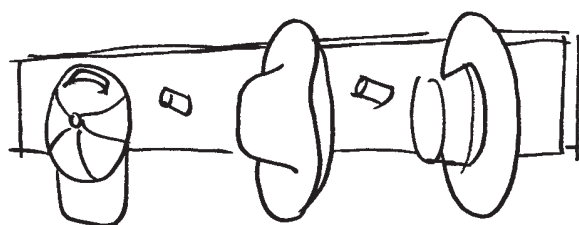


Regional Economic Report

Summer 2006

- Despite better than expected seasonal conditions, Australian farmers continue to face a significant cost-price squeeze.
- Global economic growth is set to slow, softening the demand for all Australian commodity exports.
- The resumption of US exports to Japan will weigh on beef prices, however, high oil prices will be supportive of sugar producers returns.
- Interest rates to remain on hold while the Australian dollar is set to depreciate through 2006.



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Westpac Economics

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Global growth the defining issue for 2006

For the first Regional Economic Report of 2006 we outline some of the key factors driving economic growth in regional Australia. The year just gone was one of many mixed blessings. Parts of regional Australia received a significant boost from surging resources prices. Western Australia and Queensland, the resource rich states, have been the main drivers of national economic growth. Beef prices rose to record highs. Sugar prices hit a decade high as demand conditions out-stripped supply. Dairy prices also remained robust as global exports were still constrained by the lingering effects of the drought in Australia and New Zealand. However, it appears that wool may have entered a cyclical decline as prices have not responded to a positive environment of robust global demand, rising crude oil prices and firm cotton prices.

A major factor for Australia will be a moderation in global growth in 2006. This prediction is based on the increasingly vulnerable nature of the upswing in economic growth in both the US and China. The US slowdown will be driven by higher interest rates, higher petrol prices, a neutral fiscal policy and, perhaps most importantly, a slowdown in the US housing market. This would then hit Chinese growth as since 2004, the slack in Chinese domestic demand has been more than offset by consistent strength in the export sector.

This slowdown in global growth is the bedrock for our forecast for a correction in commodity prices. When we balance this against an expected increase in supply, the result is a forecast decline of 24 per cent in base metal prices by the end of 2007. It is also why we expect oil prices to ease in 2006. However, the impact will not be the same for all commodities. While it is clear that soft-coking coal and thermal coal prices are definitively heading south, premium coking coal and iron ore prices are expected to remain well supported by shortages of supply and robust demand.

With cattle prices hitting a record high in 2005, we thought it would be timely to take a look and the outlook for the cattle industry. Our base case is that 2005/06 will be the cycle peak in cattle prices. Last year, prices were boosted by the US being excluded from the Japanese market, rising demand for Australian beef in the US and limited domestic supply here as the herd was rebuilt after the drought. As these "shocks" fade in 2006 prices will come under downward pressure. However, cattle prices are not excessively high in real terms and this, along with only a modest lift in production, suggests cattle prices can remain relatively high through 2006.

Despite the late start to the season, the 2005/06 crop has shaped up to be one of the best in five years. While we can't be certain what 2006 will bring in terms of rainfall, the recent summer storms in many regions has boosted subsoil moisture, thereby increasing the likelihood of a sound start to winter cropping programmes. Cotton production will be limited by low water storage in Queensland. The incomes of sugar farmers should remain well supported by high prices in 2006. Solid domestic and export demand has boosted both lamb and sheep prices. Wool prices are likely to continue their cyclical downtrend. Wool is at risk of becoming a by-product of sheep meat production. While low prices should stimulate demand for wool at some stage, we are yet to see that eventuate.

While the above may sound a little pessimistic, the scenario does have a silver lining. The correction in commodity prices, and slower world growth, underpins our view that the next move in local interest rates will be down and that the Australian dollar should depreciate below US70¢ in 2006. A weaker Australian dollar should provide something of an offset to any moderation in commodity prices.

Justin Smirk, Senior Economist ph (61-2) 9284 9336

The Australian dollar and interest rate outlook

In 2005, interest rates held the key for the Australian dollar.

We are entering a very difficult period for those people who have the challenge of predicting the AUD. Our call that the AUD would fall around 5¢ through 2005 from its peak in June has been broadly correct. That call was predicated on a narrowing in the interest rate differential with the US of 1 per cent, and a downturn in commodity prices.

However, commodity prices rose in 2005 ...

Our interest rate forecast has been correct, however, commodity prices have actually risen further. One might infer from that (hypothetically) if our commodity expectations had also been met, the AUD would have fallen more than our 5¢ forecast. Since June, the various commodity indices which we follow have been surprisingly strong.

... and lower commodity prices are need for a further correction.

These outcomes have severely tried our patience as we await the strong supply response that has been typically associated with a sharp run-up in prices, and by extension, a sharp run-down in inventories. There are a number of reasons why we might have been disappointed by the supply side. They include the greater concentration of the mining industry since the previous cycle; heightened publicity around the environmental impact of hard rock mining, leading to tougher hurdles for bringing new reserves into commission; disruptive natural disasters and labour disputes in some critical production belts; a lack of investment in infrastructure by both private and public sectors through the late 1990s; and a huge backlog of orders for critical capital inputs to the mining production process.

We are out of consensus with our rate cut view.

We remain confident that the Bank will not be raising rates in 2006. That still puts us well outside the consensus of economists. Of the twelve major houses, nine are forecasting rate hikes in 2006, two no change, and one (ourselves) looking for a rate cut near year's end or in the first half of 2007. There is some comfort that the forecasts for rate hikes have been progressively pushed out from the first half of 2005 to early 2006. We have consistently argued that growth would under-perform sufficiently to keep rates on hold until global factors lead to a general downward move in rates by 2007.

But the RBA needs to see an acceleration in inflation to raise rates ...

The Reserve Bank of Australia noted in its November statement that as its forecast for core inflation "level out" at 3 per cent in 2006 (currently 2.6 per cent), there is littler room for error. Indeed headline inflation has already reached 3 per cent due to surging petrol prices. If the Bank observed an unexpectedly stronger demand environment or sustained upward pressure on wages, it has indicated that it would be prepared to tighten policy.

... an event we think is unlikely ...

Our view is that those events are unlikely to occur. The consumer still represents the key to the outlook for demand growth. We have seen consumer spending growth slow from an average of nearly 5 per cent in 2003 and 2004 to a probable 3 per cent in 2005. Excessive levels of household debt and contracting house prices in Sydney, Melbourne and now Brisbane are likely to ensure consumers remain conservative for some considerable time.

... as household debt burdens weigh on domestic demand ...

Debt servicing ratios have risen to record levels. Affordability has deteriorated sharply and the overall increase in real house prices has been almost double the increases in previous booms of the early 1970s and late 1980s. Further, consumers were much more aggressive users of home equity to finance consumption in this cycle than in previous cycles. An extended adjustment period will be necessary for the consumer.

... and labour market pressures ease.

The second risk to the RBA's inflation forecast would be the labour market. An unexpected surge in wages would probably see the Bank raising its inflation forecast and needing to tighten rates. We believe that evidence is already in place that the labour market is in the process of a typical lagged adjustment to the slowdown in consumer spending. Monthly trend employment growth has fallen from 30k to zero; the unemployment rate has bottomed out, and wage increases appear to have plateaued.

The Australian dollar and interest rate outlook

Chart 1.
AUD/USD & AUD/JPY

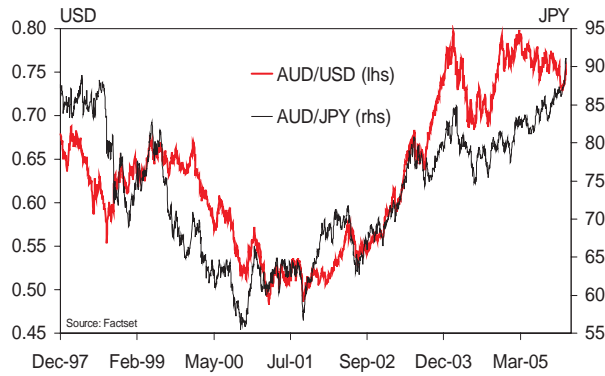


Chart 2.
AUD/EUR & AUD/NZD

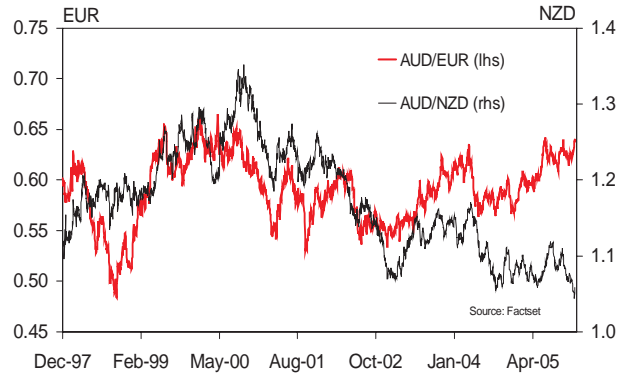


Chart 3.
Actual, fitted & forecast Australian dollar

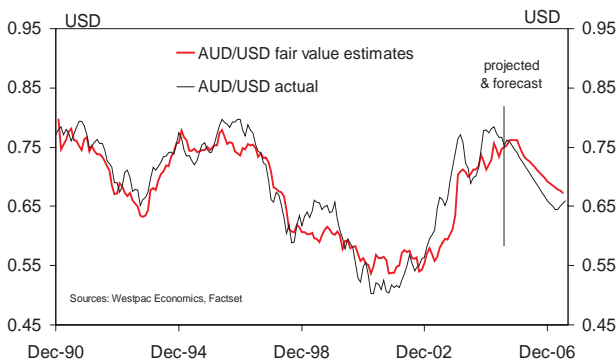


Chart 4.
Market rates bounce off lows

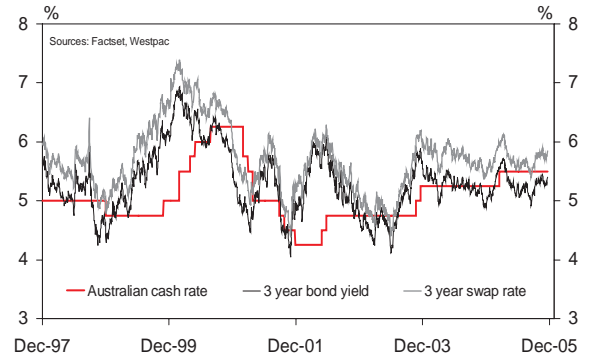


Chart 5.
Real spending back into line with incomes

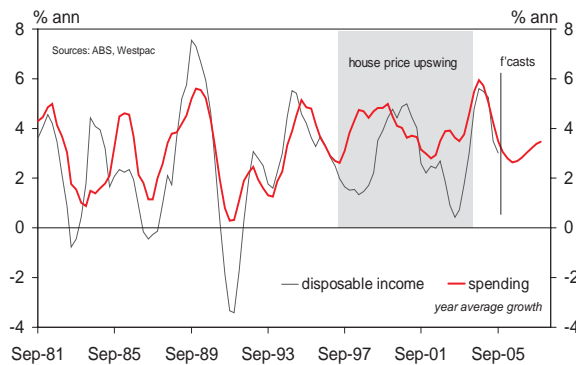
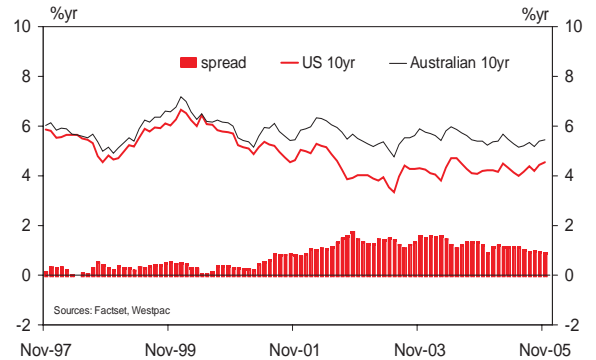


Chart 6.
US bonds back-up as Fed talks tough



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The world growth outlook

The consensus is sanguine.	At the time of writing, the consensus view is that the world economy is in the midst of a formidable expansion which will continue through 2006. This view has been solidified by an extremely resilient global manufacturing sector through the second half of 2005, led of course by the strength of the US consumer. Our view differs from the consensus. We see the growth spurt in the second half of the 2005 as the tail end of the boom and choose not to extrapolate recent growth performance. Rather, we are focussed on the increasingly vulnerable nature of the upswing in both the US and China, and the potential risks that a slowdown in these twin engines will create.
Our view is less optimistic.	Our view is based on the expectation of an earlier than anticipated slowdown in the US housing market, higher interest rates, high petrol prices and neutral fiscal policy which all point towards a below trend consumption performance in 2006.
A slowdown in the US ...	A slower rate of demand growth in the US makes China's 9 per cent plus growth look increasingly precarious. In addition, the composition of growth has changed substantially. Whereas in the year to mid 2004 domestic demand was the dominant contributor to growth, the imposition of administrative controls slowed the domestic economy. At the same time, consistent strength in the export sector saw the trade surplus widen sharply enabling exports to take up the slack from a growth perspective. If the US slows, China's ability to maintain such a large net export position is questionable.
... will help bring China to heel.	Further, the massive increase in manufacturing capacity brought about by the fixed investment boom creates the potential for an internal inventory accumulation next year. That would squeeze profits and restrict production, both of which would hit growth.
Japan will be resilient.	For the past fifteen years, that sort of prognosis would provide a gloomy outlook for Japan and East Asia. But in this instance, our feeling is that Japan can rely on domestic demand in 2006. Corporate and bank balance sheets are sound; the labour market has improved; profit growth is solid; and most importantly, asset prices have begun reflating.
Expect convergence in East Asia.	The major ASEAN states have seen much stronger consumption growth than the more highly developed North Asian economies. Capital spending outcomes have been particularly diverse. We expect something of a growth convergence between North and the South-East in 2006, with Korea on the way up and the ASEAN on the way down.
The EU glacier may be moving.	Positive signs have been emerging from the European manufacturing sector for some time now. On the other hand the household spending recovery remains elusive. Having noted that the EU tends to lag global upswings due to its rigid factor markets, we were not surprised by its insipid performance through 2004 and 2005. Likewise, we are prepared for an outcome closer to trend in 2006. The European consumer is 10% of the world economy. So while growth upside is limited in absolute terms, a stronger performance would have a material arithmetic impact on global growth.

Summary of world GDP growth

%	2000	2001	2002	2003	2004	2005f	2006f
United States	3.7	0.8	1.9	3.0	4.5	3.7	3.5
China	8.0	7.3	8.0	9.1	9.5	9.4	7.6
Japan	2.3	0.2	-0.3	1.4	2.7	2.3	1.7
East Asia	6.6	1.7	4.7	3.6	5.7	4.6	4.6
Europe	3.5	1.6	0.9	0.6	2.0	1.5	1.9
Australia	3.2	2.4	3.9	3.1	3.5	2.5	3.0
New Zealand	3.3	2.9	4.8	3.4	4.4	2.5	1.9
World	5.2	2.7	3.0	3.6	4.9	4.4	3.9

Source: IMF, Westpac Economics. Aggregates weighted at purchasing power parity exchange rates. These forecast were prepared on 9 September 2005.

The world growth outlook

Chart 1.

Global growth: a sequential slowdown

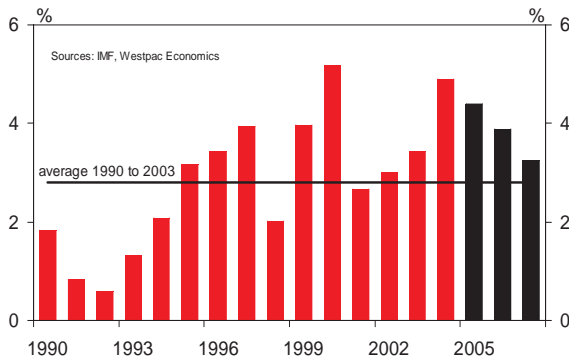


Chart 2.

World growth quarterly proxy*

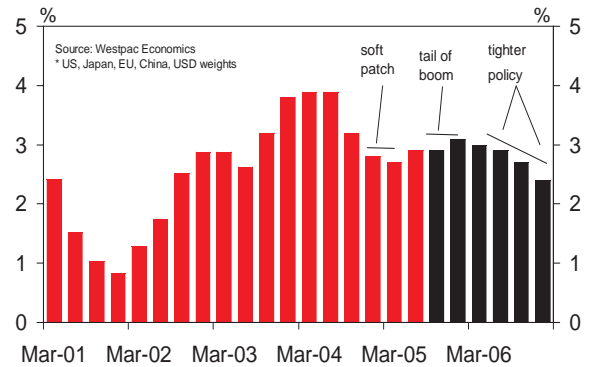


Chart 3.

Global manufacturing activity & sentiment

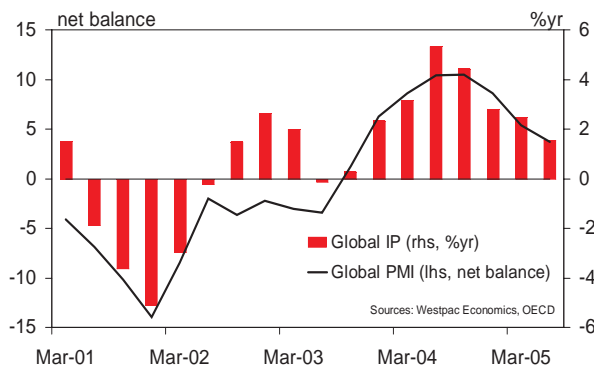


Chart 4.

The areas to watch

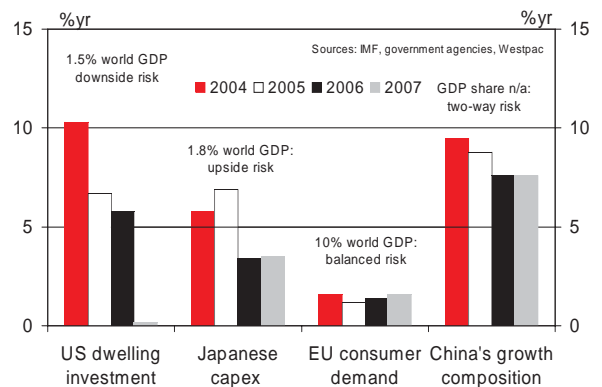


Chart 5.

China's resilience has been a net export story

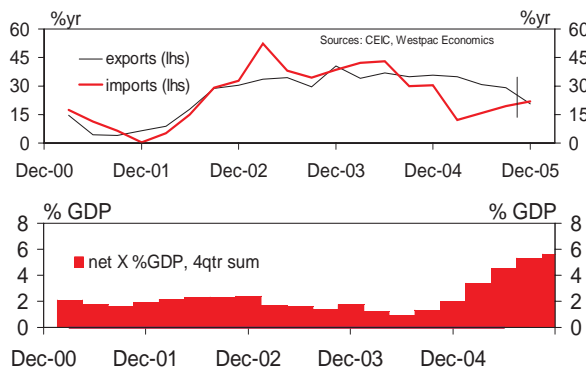
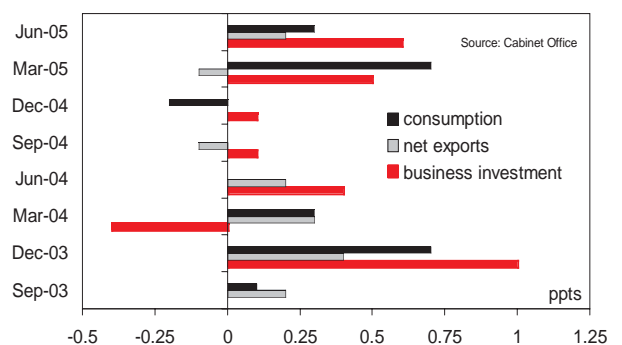


Chart 6.

Contributions to Japanese GDP growth



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Coast-to-coast, the resource states lead the way

State economic performances diverged in 2005.

In this piece, we provide readers with a summary and comparison of the economic performance of Australia's six states. We draw on the lessons from the states' recent performance to assess the prospects for the states over the next 12 months.

NSW has the weakest economic performance in a decade.

The slowdown in domestic final demand at the national level is now evident across all of the states although this is by no means uniform. **In NSW, final demand contracted 0.8% in the third quarter, the weakest performance in the state in over a decade** (excluding the post-GST period). Low housing affordability, particularly in Sydney, has contributed to moderating population growth and the associated flow on effects to dwelling activity and household spending have been pronounced. On top of this, real house prices have fallen 15 per cent in Sydney over the past 18 months. However, the flip side of declining house prices is that housing affordability, while still quite low, has been improving. This has encouraged owner-occupiers and first home buyers to return to the market. On that basis, we expect house prices to stabilise over the coming year in NSW. This should see economic growth improve in 2006, although a return to trend performance is the best that can be expected.

Victoria and South Australia on par with the national average.

Conditions in Victoria and South Australia remain broadly in line with the national average, as has been the case for some time now. For South Australia, this is somewhat of a surprise, given that population growth in the state is close to ½ per cent slower than the national average. This resilient performance is likely to reflect a more muted downturn in the South Australia property market compared with the rest of the country, particularly NSW. In Victoria, it is a similar story, although population growth has been in line with the national average for some time now. However, both states have a large manufacturing base and we are less confident about the general manufacturing investment outlook compared with that of the mining sector.

On the export front, manufactured exports have had a mixed performance over the past year but we expect a depreciation of the currency will see some improvement in 2006. Taken together, these factors suggest Victoria and South Australia will stay the course and continue to record growth around the national average.

The resource states remain a source of strength.

Queensland and Western Australia remain a source of strength for the Australian economy, with final demand growth averaging 2.0 per cent in both states. However, trend growth has slowed over the past year, particularly in Queensland. The sunshine state is in the midst of a significant property market correction. Housing affordability in the state's capital is now below the national average, which is beginning to crimp population growth in the state. The resource price boom will provide some offset and continue to support investment and exports but for the most part the income and second round benefits will mainly be captured in regional areas of the state. Queensland will continue to be a source of growth for the Australian economy but its days of significant outperformance are drawing to an end.

Western Australia has maintained its above average performance into the second half of 2005. The resource price boom has driven a robust business investment upswing. The second round effects of stronger population and employment growth have also been influential. In turn, this has contributed to buoyant dwelling investment activity and accelerating house price growth. Additional capacity coming on line in the resource sector will help maintain strong export volumes growth. These factors are not expected to dissipate as we move into 2006 and as such, we expect Western Australia's outperformance to continue through this period.

Coast-to-coast, the resource states lead the way

Chart 1.

Demand growth

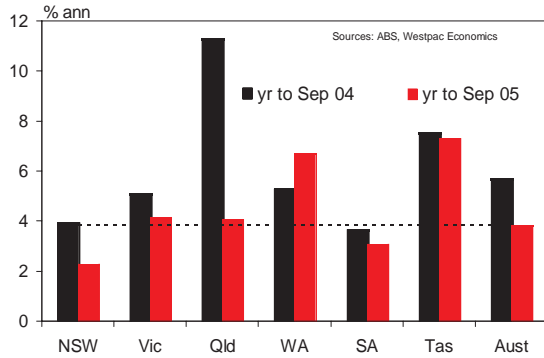


Chart 2.

Population trends diverge

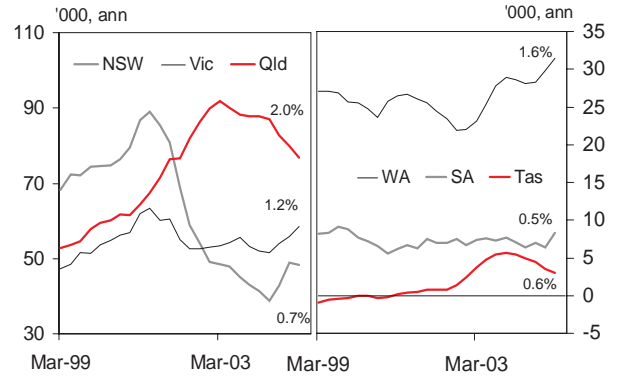


Chart 3.

State demand growth – a comparison

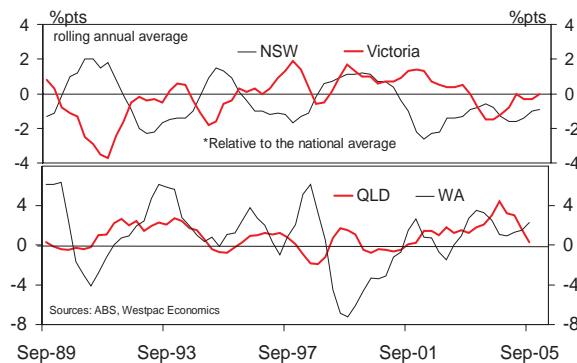


Chart 4.

Established house prices

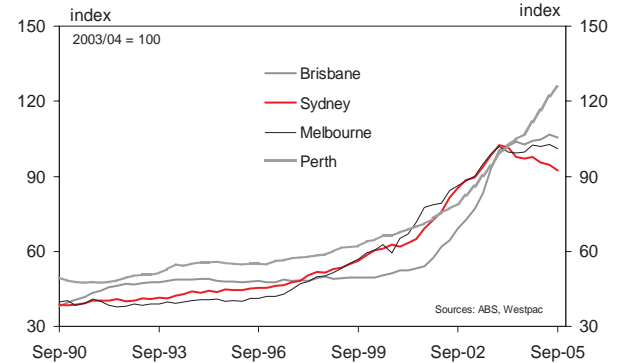


Chart 5.

Relative terms of trade by state

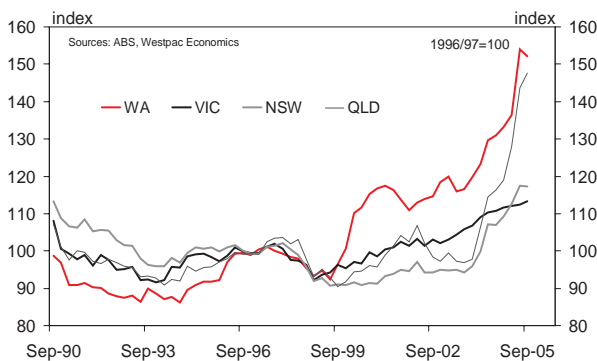
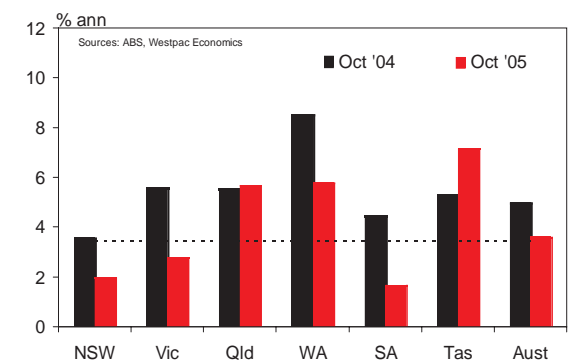


Chart 6.

Retail: days of booming sales pass



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The commodity price cycle

Slowing demand ...

It is Westpac's vision of the impending global slowdown forms the bedrock of our overall economic view. It also informs the outlook for commodity prices. However, supply is just as important for the outlook. In this article, we attempt to balance the demand and supply sides of our analysis. With particular focus on base metals, we argue that the projected increase in supply on top of the slowdown in demand growth will see prices fall in 2006. We are forecasting USD base metal prices to fall 25% from peak to trough by the end of 2007. However, given the recent surge in prices, such a profile would see the annual average price fall just 4¼ % in 2006 compared to the average price in 2005. As a reference point, stable prices through 2006 from the December 2005 starting point would produce a 7% gain in year average terms.

... and expanded supply ...

Australia's resource exports have seen a spectacular 30 per cent increase in prices in 2005. Starting from a higher base, base metal prices rose a more modest 11 per cent with much of that advance back-loaded in the last three months of the year. Much has been made of the continuation of solid demand growth out of the US and China in boosting prices. However, base metal inventories stabilised in July and have since risen slightly more than 20%. Even copper inventories, where there has been some of the greatest speculative activity, have turned around rising more than 150 per cent over the same period.

... will push inventories up ...

Historically, a rise in inventories of this scale would have been a signal for a downward shift in price. Given the very low level of inventories the absolute scale of the rise is hardly earth shattering. But nonetheless, if demand is truly out-stripping supply you would expect inventories to have fallen further. As such, this does suggest that we have seen an increase in supply matching the increase in demand. As noted earlier even copper inventories, the metal traditionally most highly sensitive to world growth, have risen sharply since July.

... and prices down.

Using an analogous methodology to that underpinning the Westpac commodities indices, we have created a base metals mine production index. It highlights that mine production responds to higher prices. And if the price rise is large enough, the response can extend over a number of years. This extension is logical as high prices stimulate new investment which can take a number of years to complete and bring on line. What is interesting is that this index is telling us that mine production rose 4 per cent in 2004 and 4.6% in 2005. The 4.6 per cent increase in mine production in 2005 was enough to stabilise inventories. Taking AME's forecast for a 4½ output increase in 2006, and a further 6% in 2007, and bringing that together with an environment of softening demand, and we should see inventories rise significantly and thus prices fall.

We are looking at a small fall in real SDR terms ...

To capture the above, we have developed a model of real metal prices (in SDR terms) with the OECD leading indicator, OECD industrial production, mine production and Chinese base metal imports as the explanatory variables. This model has had a very good fit with the data since 1977 and is pointing to a 3% fall in prices in 2006. We take some comfort from the fact that the model is forecasting a small fall in base metal prices. Ergo, the model suggests 2006 should be the turning point.

... and something heftier in nominal US dollars.

The last piece of the puzzle is the current speculation that miners will be able to negotiate contract price rises for the bulk commodities in 2006. We are not convinced, as there has been a clear increase in iron ore production. Global steel production has grown 25 per cent over the last three years but iron ore production lifted more than 35 per cent. As such, we think it will be very difficult for the miners to achieve a price increase, with steel producers set to bargain very hard for a reduction in price.

The commodity price cycle

Chart 1.

Commodity prices to fall 25% by 2007

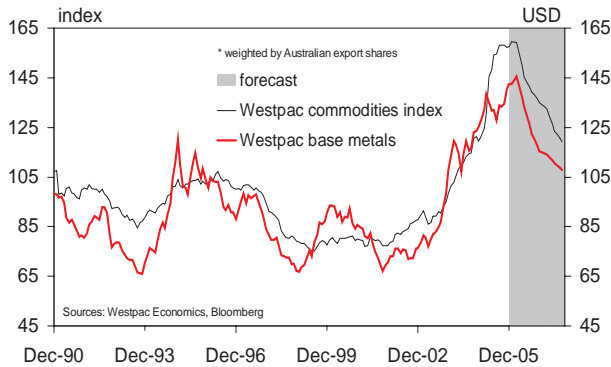


Chart 2.

Westpac base metals inventories index

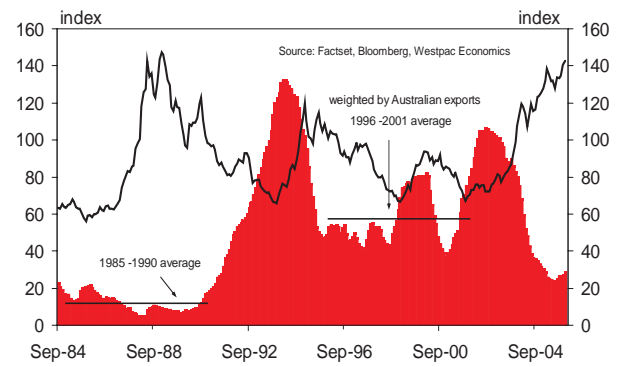


Chart 3.

Base metal inventories and prices

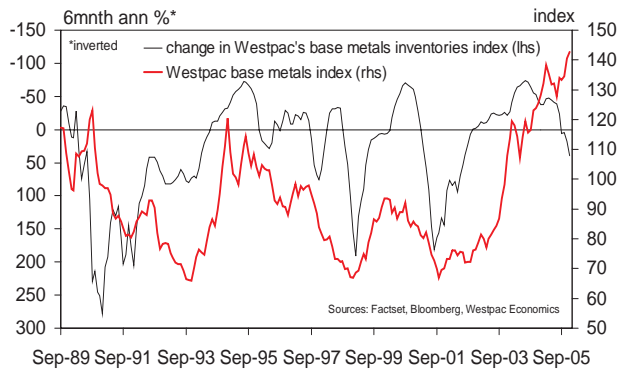


Chart 4.

Mine production tends to follow prices

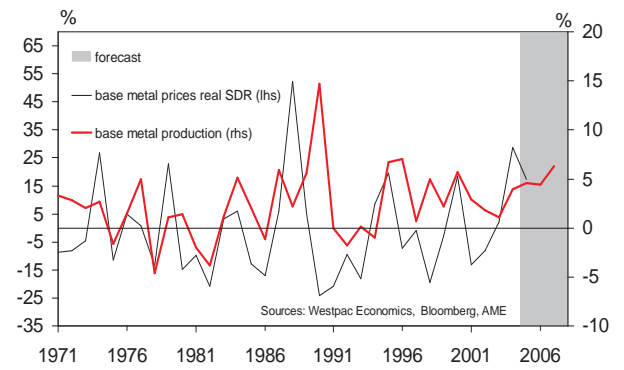


Chart 5.

Prices to pull back from current highs

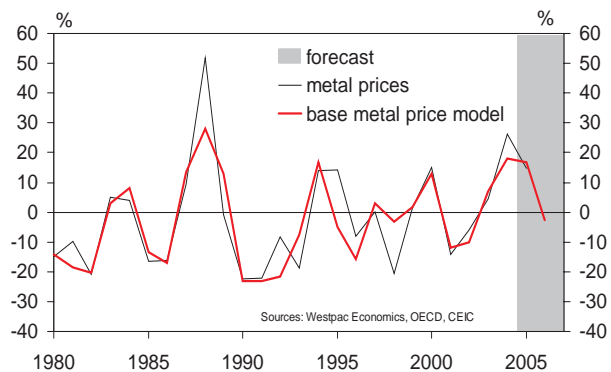
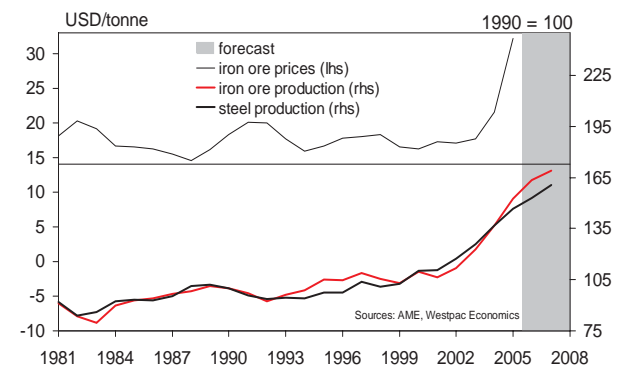


Chart 6.

Iron ore production has lifted already



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The beef industry is nearing the peak of the cycle

Cattle prices rose to a record high in 2005 ...

With cattle prices at record highs, we thought it timely to have a look at current factors driving the market and the longer-term outlook. In 2005 continued strong demand, coupled with increased domestic demand for restocker cattle, resulted in the eastern young cattle indicator peaking at a record higher of 322 cents per kilogramme, a 20 per cent rise on a year earlier. Prices has since eased back as Hot dry conditions, sub-standard livestock quality and the extended closure of several plants for seasonal maintenance all weight on prices. We believe that the beef market will cool in 2005 as demand for Australian beef in key export markets if forecast to ease.

... as US beef was banned from Japan.

The banning of US beef from the Japanese market following the discovery of BSE (bovine spongiform encephalopathy or "mad cows disease") in late 2003 supported both export prices and volumes to Japan. With the exclusion of the US, Australia now accounts for around 90 per cent of the beef imported into Japan. Ag Concepts Unlimited estimates that the US absence from the Japanese market is worth about 62c/kg cwt to 80c/kg cwt to an Australian short-fed steer.

The resumption of US exports to Japan will weigh on prices in 2006.

In assessing the outlook, the timing of the resumption of US imports into Japan is a critical variable. In late October, the Japanese Food and Safety Commission Prion Experts Committee finalised its assessment of the safety of US and Canadian beef. They found that beef and offal from North American cattle aged 20 months or younger is at very low risk of infection, provided that specified risk material, such as heads and spinal cords, are adequately removed. We have assumed that the US beef exports will re-enter the Japanese market in 2006. You have to expect that the US are going to be aggressive sellers into this prized markets in an attempt to recapture market share, which they believe is rightfully theirs. ABARE is forecasting Australian beef exports to fall by 10 per cent in 2005/06 with export prices falling by closer to 10 per cent.

Competition is also set to increase in the US market.

The impact of BSE is also broader than just its impact on the Japanese market. Bans on Canadian beef in the response to the discovery of BSE in mid-2003, along with reduced US female cattle slaughter, Australian export prices to the US rose by almost 18 per cent in 2004/05. This strength was further supported by the continued exclusion of beef products from Brazil and Argentina due to foot and mouth problems. Australian beef exports to the US are tended to be seen as a substitute for cow beef. In 2006, US cow beef production is expected to climb and certain cattle and beef products from Canada are set to re-enter the market. In addition, the continued expansion of exports from Uruguay is expected to provide strong competition for Australian beef. This will place additional downwards pressure on Australian export prices.

Prices hit a record high but not when inflation is taken into account.

With the Australian cattle herd rebuilding following the drought of 2002/03, and the record prices seen in late 2005, it can be useful to put cattle prices in a historical perspective. Research by Ag Concepts Unlimited highlights that while tight demand and supply conditions have pushed cattle prices to a 50 year high, when deflated by the CPI current real prices are not at a record high and in fact are on par with those in 2004, slightly below those of 2001; and close to those experienced in 1988. So the recent rise, which has taken real prices above the 25 year average, is not enough to arrest the longer term downtrend as cattle prices have not kept pace with economy wide price rises.

As the positive shocks fade so will cattle prices.

As current prices are the result of external shocks - drought reducing production and reduced competition in export markets - they do appear to be unsustainable. Overproduction in the mid 1970s in response to earlier high prices saw real cattle prices hit record lows in real terms. While we believe the production response will be more muted this time, it does highlight the risk to prices going forward.

The beef industry is nearing the peak of the cycle

Chart 1.

Beef prices and cattle slaughtering

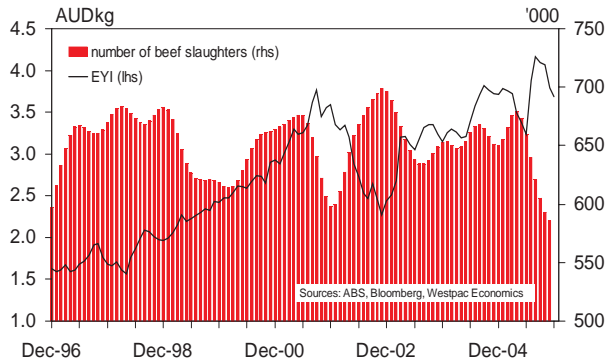


Chart 2.

Australian beef prices

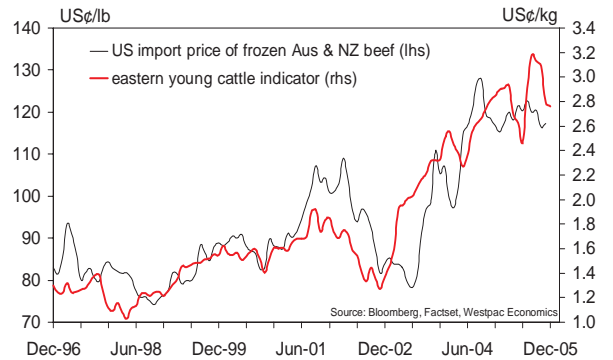


Chart 3.

Australian vs. US beef prices

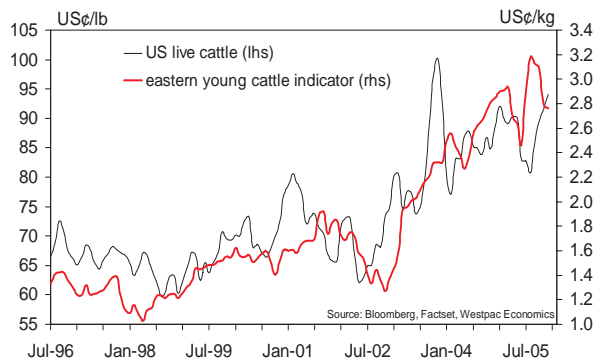


Chart 4.

Real cattle prices are not at record highs

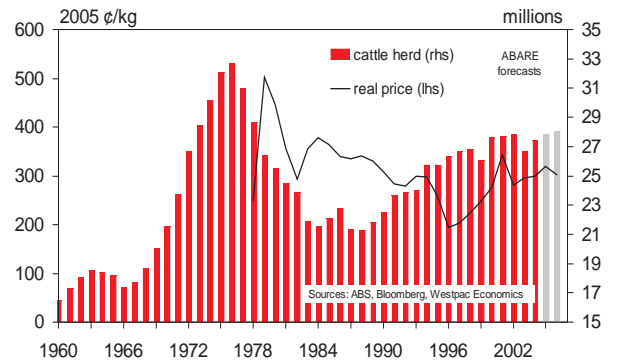


Chart 5.

Beef making the most of opportunities

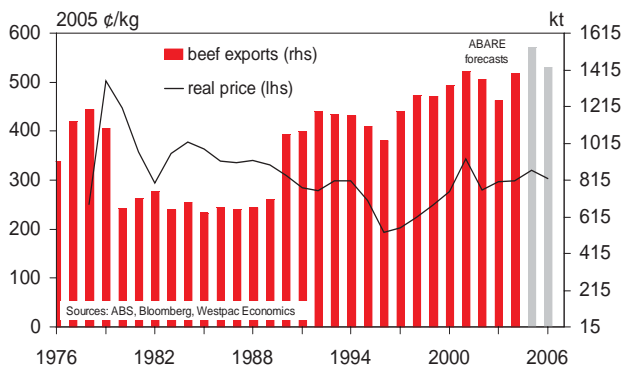
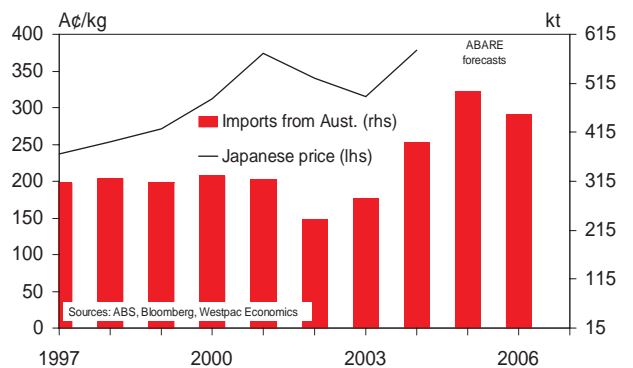


Chart 6.

Beef making the most of opportunities



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Regional industries – grains and oilseeds

So far the market has moved in the opposite direction to ABARE's forecasts.

The 2005/06 crop was the biggest in 5 years.

Lower production will lift corn and barley prices.

Australian production benefits from positive seasonal conditions.

Developments in China will drive the demand growth for oilseeds.

Wheat

In December, ABARE upgraded the outlook for global wheat prices with a forecast for the Australian 2005/06 pool of US\$181 per tonne. On the same day, the AWB dropped their pool estimates to the lowest levels since 1993, and US wheat futures plumbed new contract lows. ABARE is assuming a 13 million tonne fall in global wheat production, a 2% fall, and thus tighter availability leading to 6mmt (or 4.4%) lower end stocks. This estimate looked well wide of the mark when the AWB lowered the pool estimates and the USDA released an outlook for a 4.7 million tonne rise in global production due to significant increases from Australia, Canada, China, Uzbekistan and Kazakhstan. However, ABARE is not alone. A number of private analysts also see the risk of smaller crops in the Ukraine and the US driving prices higher in the first half of 2006.

The Australian wheat crop shaped up to be one of the best in past five years. Despite a late start to the season, winter conditions across much of the eastern states were very favourable. The Western Australian season had a very good start and these favourable conditions continued through the season so despite a few isolated incidents of frost and hail damage, the crop is for forecast to rise by almost 25 per cent. ABARE is forecasting Australian wheat production to rise 4 million tonnes to 24 million tonnes.

Coarse grains

Lower production from the major coarse grain producers, in particular the USA, China and the European Union, is forecast to place upwards pressure on coarse grain prices in 2005/06. ABARE is forecasting corn prices to rise 3 per cent to around US\$100 per tonne. However, as production still remains at historically high levels, corn prices will remain well below the prices received in 2002/03. Barley prices are expected to get a modest fillip as lower production in key producing nations resulting in falling exports but this too will not be enough to recover the ground lost since 2002/03. ABARE is forecasting coarse grain stocks to fall by around 13 per cent with a large percentage of this fall coming from falling Chinese corn stocks.

Australian conditions have been ideal with above average rainfall and cool to mild temperatures in many areas. This has led to a significant increase in coarse grain production while also improving the prospects for summer crops. ABARE is forecasting total barley production to rise over 30 per cent to 8.4 million tonnes. Due to the rise in production, feed barley pool prices are forecast to fall by 8 per cent to \$155 per tonne while malting barley pool prices are forecast to fall by 10 per cent to \$178 per tonne.

Oilseeds - canola

Global consumption of oilseeds and oilseed products is continuing to rise with much of the growth being driven by developments in China. This is being driven by rising incomes which is resulting in increased demand for oilseed meals in animal feed and rising human consumption of vegetable oils. However, at the same time world supplies are also increasing significantly and stocks are currently high. As a result we have seen the global canola indicator price (Winnipeg) fall more than 15% from the June 2005 high. In year average terms, ABARE is forecasting oil seed prices to fall 8 per cent.

The late break to the 2005/06 cropping season in the eastern states has resulted in an 18 per cent fall in the area sown to canola. So despite above average yields, canola production is expected to be down on the 2004/05 season with ABARE forecasting a 20 per cent fall in canola exports. For the 2005/06 summer crops, ABARE is forecasting oilseed production to fall 16 per cent, led by a significant fall in cottonseed production.

Regional industries – grains and oilseeds

Chart 1.

Low stocks supporting wheat prices

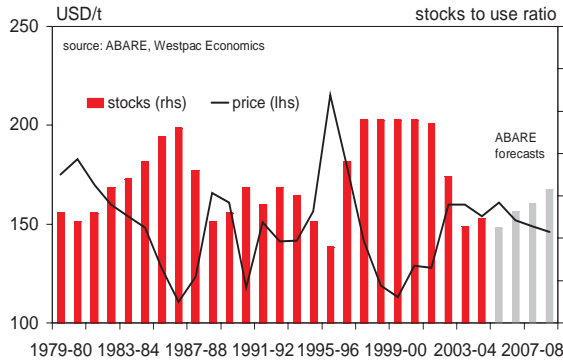


Chart 2.

Australian wheat production

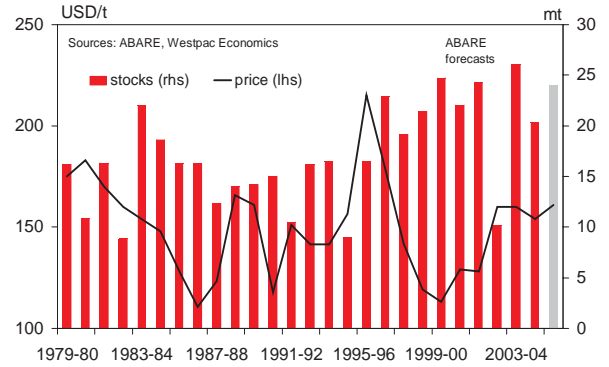


Chart 3.

Wheat price spreads

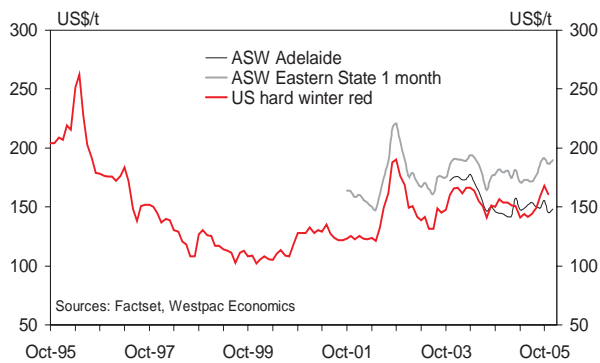


Chart 4.

Stocks build is a drag on corn prices

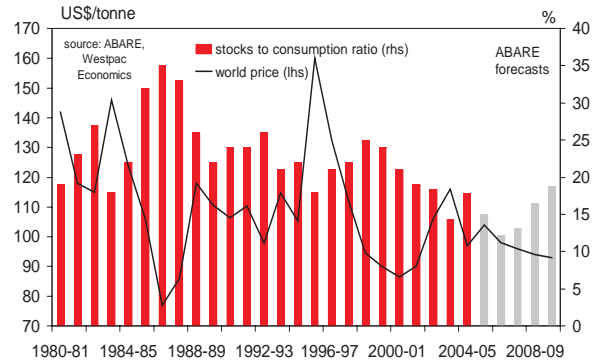


Chart 5.

World corn and barley prices

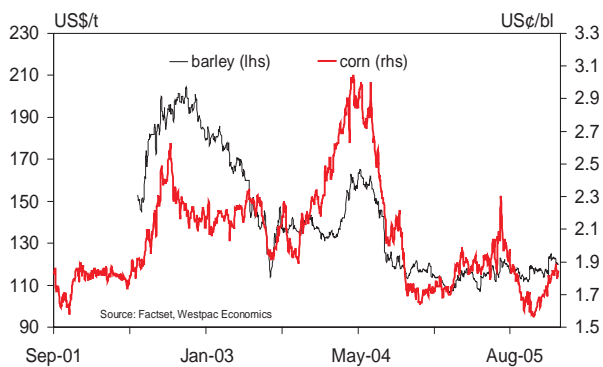
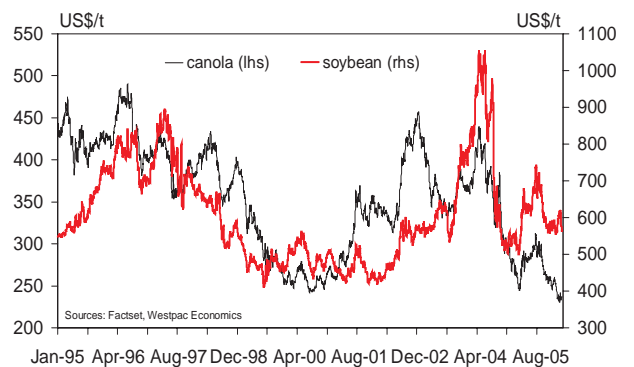


Chart 6.

World canola & soybean prices



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Regional industries – cotton, sugar and sheep

The end of the Multifibre Arrangements has lifted cotton demand and prices.

Cotton

Global cotton production is forecast to fall almost 7 per cent in 2005/06 but it will still be the second highest on record. Lower production from China, reflecting an 11 per cent fall in cotton plantings as growers increased their plantings of winter cereal crops, is the key factor behind the fall. The Chinese authorities have provided incentives for growers to shift away from fibre production to cereal crops in order to improve food security. Cotton demand is forecast to rise by over 3 per cent in 2005/06 reflecting strong demand from China, India and Pakistan. With greater access to the key markets of the USA and Europe via the cessation of the Multifibre Arrangement in 2004, these nations will increase their demand for cotton boosting prices by 5 per cent to US\$55c/lb in 2005/06.

Queensland production is constrained by the lack of water.

The lower levels of water storage in Queensland has lead to ABARE forecasting a 43 per cent fall in cotton production from that state in 2005/06. This will more than offset the 8 per cent increase in NSW cotton production and see total Australian cotton production fall 16 per cent to 545,000 tonnes. The size of last years crops were always going to be hard to beat as favourable growing conditions and the adoption of the genetically modified Bollgard II variety lead to record yields.

Sugar prices are being driven by high crude oil prices.

Sugar

The last few years had seen a significant shift in the sugar market with prices becoming more tightly related to oil prices as Brazil increasingly diverts a higher proportion of its sugar cane production to ethanol. As a result India, and not Brazil, is driving the 4 per cent increase in sugar production in 2005/06. At the same time, strong incomes growth is expected to lead to a 2 per cent increase in world sugar consumption. Continued high rates of economic growth, and thus incomes, in China and India is the main contributing factor in this forecast. It is this combination of robust demand, as well as high oil prices, is behind ABARE's forecast for a 16 per cent rise in sugar prices in 2005/06.

Total sugar cane crushed in Australia is forecast to rise 2 per cent to 38.2 million tonnes in 2005/06. However, above average rainfall in early 2005 delayed the start of the harvest in many parts of Queensland. As a result of the wet conditions, the sugar content of the cane is lower than last year and this is driving ABARE's forecast for a 2 per cent fall in Australian sugar production. However, higher sugar prices are expected to result in a 15 per cent rise in Australian sugar export earnings.

Demand has grown in both domestic and export markets lifting prices.

Lamb and live sheep

In 2005, farmers responded to higher lamb prices by boosting production. In addition, the rapid and welcomed turnaround in seasonal conditions further lifted lamb and sheep meat production. Australian lamb prices have been supported by strong demand from both the domestic and export markets. Success on the export front has been achieved in both the traditional markets, such as the Middle East and the United States, and in the emerging Asian markets. The late but solid break to the season also saw restockers enter the market which buoyed prices in the second half of the year. For 2006, ABARE is forecasting lamb prices to ease with the expected fall in cattle prices but still remain relatively high compared with the prices of the late 1990s.

Live sheep exports continue to grow.

Following the resumption of trade with Saudi Arabia, the export of live sheep has continued to rise sharply. In the September quarter 2005, live sheep exports rose 38 per cent from the same period in 2004. Western Australia remains the main source of Australian live sheep exports but there is expected to be increases in buying from the eastern states in 2006 when supplies in WA begin to tighten.

Regional industries – cotton, sugar and sheep

Chart 1.

Cotton production still relatively high

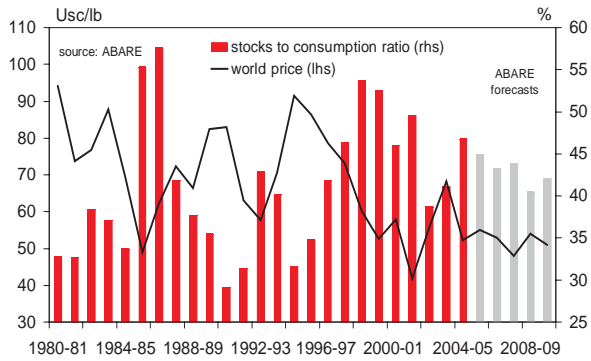


Chart 2.

Real prices around long-term trend

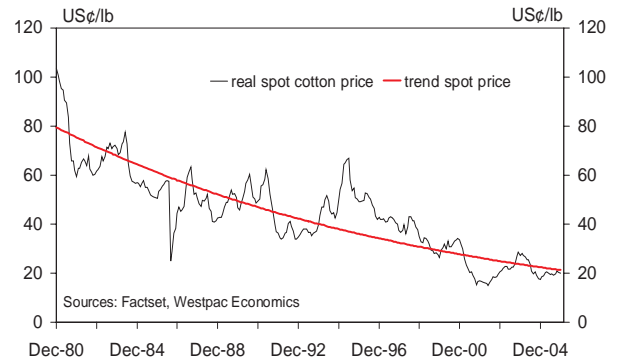


Chart 3.

Sugar lifted Brazilian diversion to ethanol

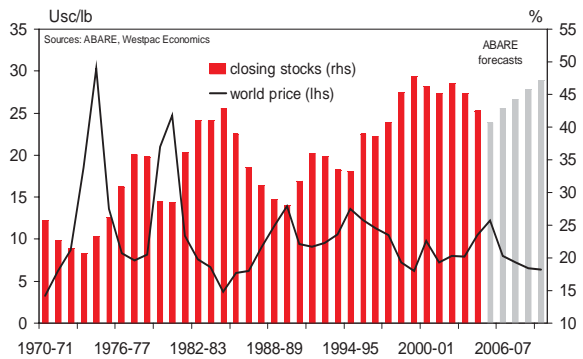


Chart 4.

Sugar prices tied to oil prices, for now

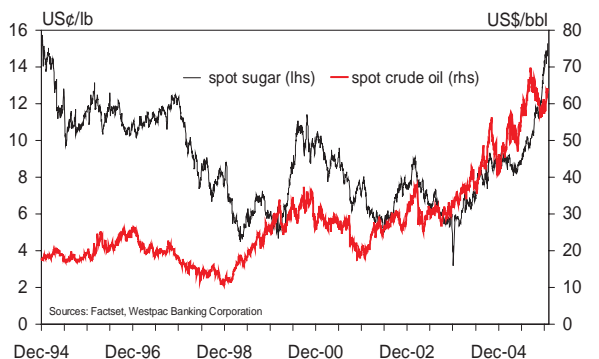


Chart 5.

Real sugar prices breaks through trend

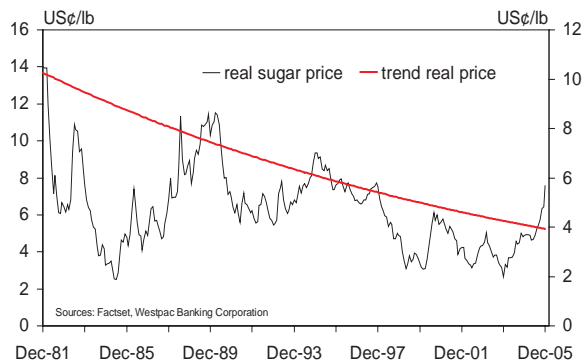
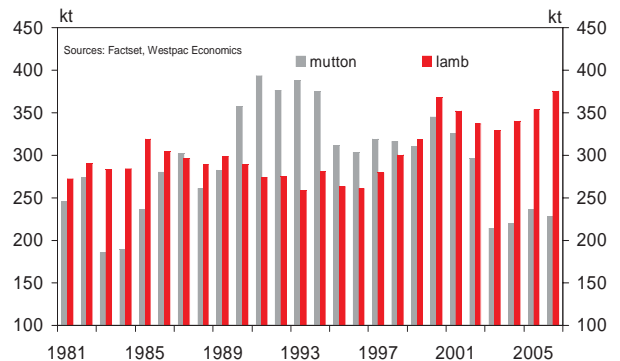


Chart 6.

Solid prices boosting lamb production



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Regional industries – livestock

Wool prices have been in decline since 2002.

Despite robust textile demand, wool prices continued to fall in 2005.

The beef cycle to peak in 2005/06.

Global demand for dairy prices is set to remain robust in 2006.

Dairy farm incomes will be supported by robust prices and rising production.

Wool

The eastern market indicator for wool has been steadily declining since 2002. It is tempting to blame the appreciation of the Australian dollar on this fall but since 2004 most of the weakness has been due to weakness in the underlying prices of wool in US dollar terms suggesting the demand for wool continues to fall. This fall in prices has been across all microns and at a time when production has been relatively static.

Wool represents a very small percentage of the total fibre market, only 2 per cent in 2004 compared with 36 per cent for cotton and 61 per cent for synthetics. So it is the developments the exports markets, rather than domestic supply effects, that are critical for wool producers returns. And the fact there has been a fundamental shift in the demand for wool is revealed by the fact wool prices continued to fall through 2005 despite rising cotton prices and rising oil prices (the raw material for many synthetics). With no clear evidence of any short-term shift in demand, ABARE is forecasting prices to average 10 per cent lower in 2005/06.

The optimists will argue that at some stage low price will stimulate demand. Unfortunately, we are yet to see any evidence of this.

Beef and veal

Improved seasonal conditions have resulted in greater restocker demand for cattle. However an increase in supply to key export markets, in particular the impact of the re-entry of US beef into the Japanese market, is expected to result in lower prices in 2005/06. ABARE is forecasting a 3 per cent decline in year average terms. (Please see the more detail review of the Australian beef industry in this report.)

Dairy

The continued strength of demand for most dairy products is behind ABARE's forecast for slightly higher dairy product prices in 2005/06. World price rose strongly in 2004/05, the result of rising demand and falling supplies due to the drought in Australia and New Zealand. This gap between supply and demand is narrowing in 2005/06 with a return of average seasonal conditions and increasing milk yields in Australia and New Zealand. This gap will narrow even further as we move through 2006 as production continues to grow at a faster rate than consumption and as such, global prices are forecast to fall.

Butter prices are expected to fall the most as New Zealand production returns to 2004/05 levels and demand from the Russian Federation and Middle East to expected to ease. World cheese and skim milk powder prices are expected to ease in the coming months as Australian and New Zealand exports continue to expand.

The widespread rainfall in June 2005, and sound follow-up rainfalls in September and October has resulted in good pasture growth in the major Australian dairy regions. Production is rising and the major milk processors are reporting yield increases from major milk suppliers in the year to date. For 2005/06 as a whole, ABARE is forecasting milk production to rise 1.5 per cent to 10.3 million tonnes. With relatively high global prices and Westpac's forecast for a depreciation of the Australian dollar, dairy returns are expected to continue to increase in 2005/06.

Regional industries – livestock

Chart 1.

Softer demand so small rise in wool stocks

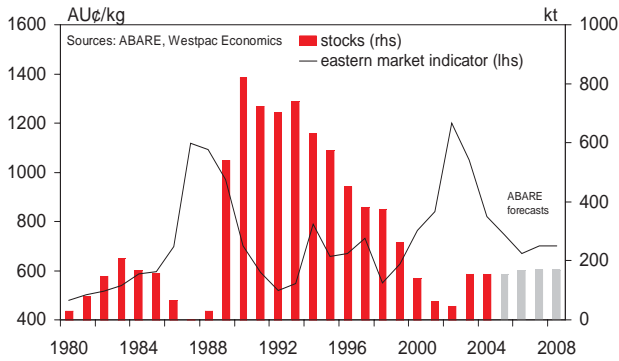


Chart 2.

Real wool prices remain below trend



Chart 3.

Australian dollar has not helped wool prices

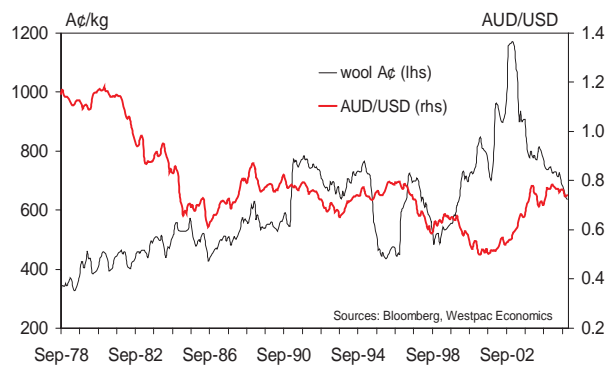


Chart 4.

Beef prices and cattle slaughtering

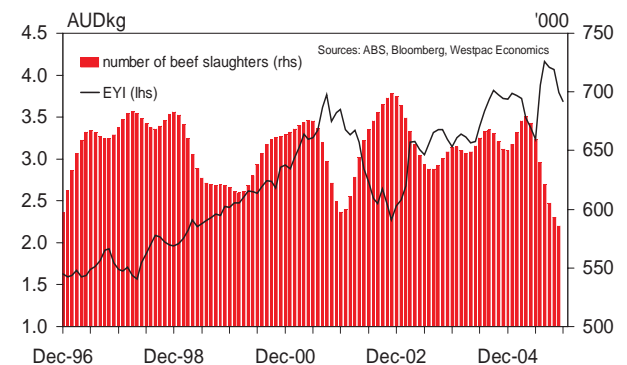


Chart 5.

Strong demand, falling stocks, rising prices

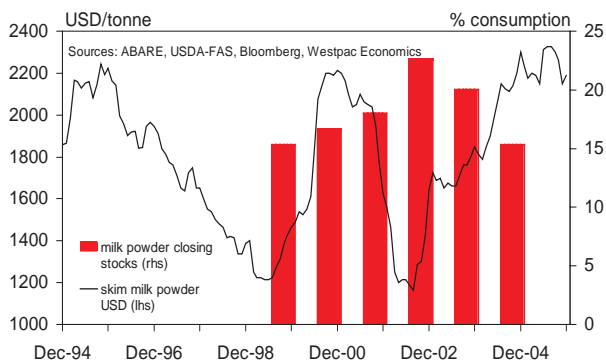
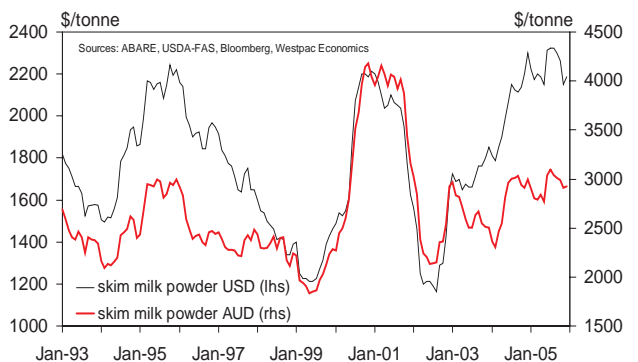


Chart 6.

Dollar is crimping domestic milk prices



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Regional industries – steel and steel inputs

Chinese overproduction is a weight on steel prices.	Steel Prices for hot rolled coil steel prices in Japan, China and the US rose sharply though most of 2004. However, prices in China and the US fell in late 2004 and early 2005 reflecting strong production growth and concerns of slowing demand. The Asian steel market is still struggling as prices have been held back by overcapacity in China. By comparison, the US market was boosted in the second half of 2005 as housing and auto sales fueled domestic demand and US steel output fell.
A downturn in global demand remain the key risk.	Softer economic growth in the second half of 2006, and an increase in low priced imports, poses a risk to US steel prices. China remains a wild card with significant oversupply, particularly for the lower grades of steel, emerging in 2005. In addition, research by AME Mineral Economics suggests margins at many Chinese steel makers are stretched dangerously thin. As such, much will hang on the result of the iron ore and coking coal contract negotiations that are currently underway (see below).
There are a number of "wild cards" for 2006 ...	Iron ore In 2006 there are a number of "wild cards" that could have a significant impact on the iron ore market in 2006. Each one is associated with a high degree of uncertainty which together opens up a wide range of possible outcomes. These "wild cards" includes China's domestic iron ore output, the Chinese steel market and steel production, and India's net iron ore position.
Chinese iron ore production is one ...	Chinese steel production is in significant imbalance. Local manufacturers rely on imports of high-value steels while low-value Chinese products flood the market depressing not only Chinese prices but Asian prices more generally. Chinese authorities are attempting to limit steel making capacity and eliminate outdated smelting capacity but the policies are unlikely to have a material impact in 2006. Nonetheless, shrinking profitability and tighter controls should dampen growth in steel production. In addition, Chinese iron ore production doubled in 2005, much of which is high cost, meaning a nebulous number of possible outcomes are starting to unfold.
... Indian iron ore production is another.	India is then added to the "masala mix" where calls are being made to restrict Indian iron ore exports to preserve the resource for the long-term expansion of the Indian steel industry. Massive growth plans for both steel and iron production, overlaid with the usual Indian political, bureaucratic and logistic bottlenecks, have the potential to cause significant swings in Indian iron ore exports.
We are clear of consensus with our forecast of a fall in contract prices.	We are forecasting for a 10 per cent fall in the 2006 contract prices. Miners argue they have the upper hand and are looking for a 20 per cent rise. But the Japanese contracts traditionally set the benchmark so to some extent buyers negotiate as a block. China is a new, unknown force in this process but nevertheless, we expect steel producers to be dogged in their drive for lower contract prices.
The lower grades of coking coal will be hit the hardest.	Coking (metallurgical) coal The key issue in 2006 will be the decoupling of hard coking (premium) coal from the lower quality semi-soft and low volatile PCI coals. Early negotiations revealed the Japanese steel mills restoring the "traditional" price relatively between semi-soft coking and thermal coal, that is a 40 per cent fall on 2005 contracts. Korea's Posco has locked in a Russian supply of PCI at US\$63 a tonne and an Australian coal producers agreed to sell semi-soft coking coal at US\$53 a tonne. We expect the price of low grade coking coals to fall by 30 per cent to 40 per cent while the price of premium grades, which are in shorter supply, may fall only slightly if at all.

Regional industries – steel and steel inputs

Chart 1.

Steel prices peaked back in late 2004

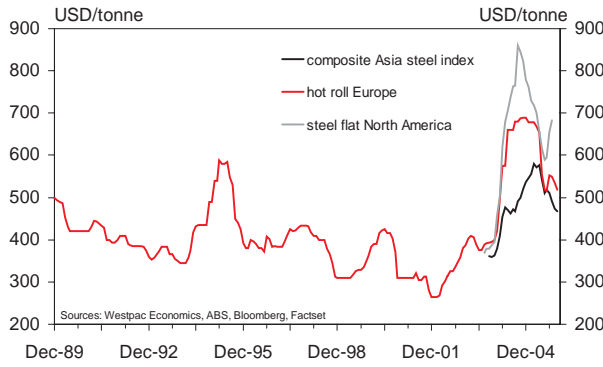


Chart 2.

Steel producers looking for lower contracts

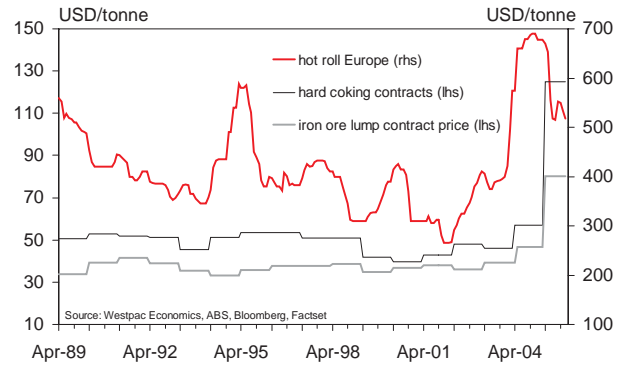


Chart 3.

Consensus forecasts follow the data

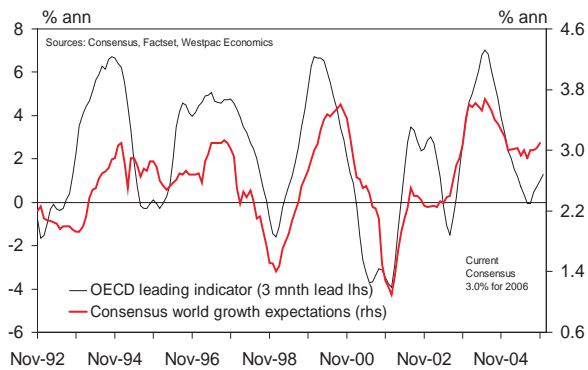


Chart 4.

Westpac's global mining job index*

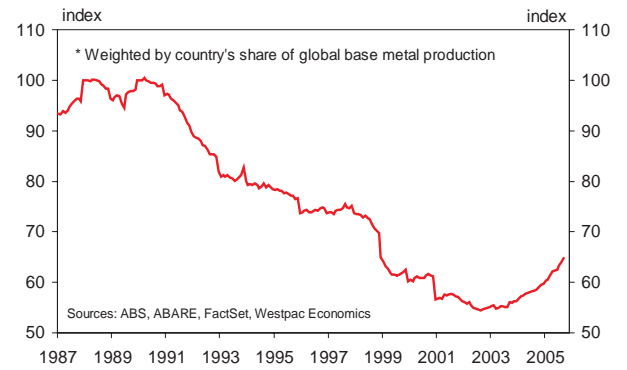


Chart 5.

Iron ore production has lifted already

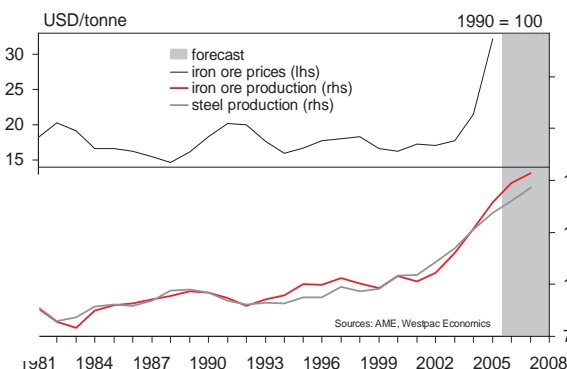
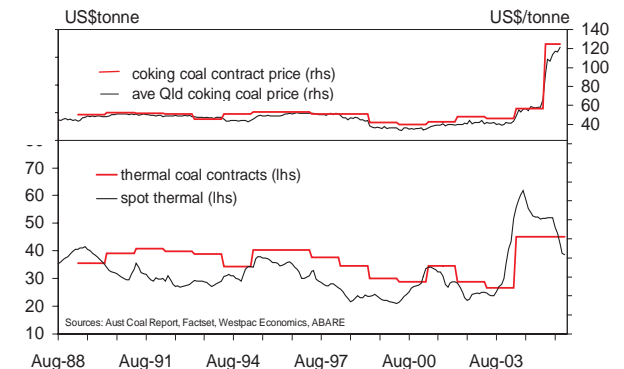


Chart 6.

Coal prices – the thermal/coking divide



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Regional industries – energy

Crude oil supply and demand conditions remain very tight.

Consumption growth set to ease in 2006.

Non-OPEC producers will provide the bulk of the increase in production.

A shortage of refining capacity remains a problem.

The thermal coal market moved into surplus in 2005.

China remains a "wild card"
...

... and contract prices set to fall.

Crude oil

Crude oil supply and demand conditions remain in a very tight situation, a situation clearly revealed when prices hit a high of US\$70 pre barrel late in August when Hurricane Katrina damaged oil producing infrastructure in Mexican Gulf. Prices fluctuated around this level for much of September before declining gradually through October and November. However a cold snap in the northern hemisphere, along with growing tensions with Iran, saw prices recently spike back up to around US\$64 per barrel. And the longer-dated futures contracts continue to hug US\$60 per barrel suggesting the markets do not see much downside risk.

Consumption growth does appear to have eased somewhat in 2005. US consumption declined 2.3 per cent in the year to September 2005 as a result of both the hurricane interruptions to economic activity and the impact of higher petroleum prices. Also higher prices have triggered petroleum pricing reforms in some emerging economies leading to a reduction in consumption growth. Westpac forecast for a moderation in global growth in 2006 suggests the moderation in demand growth should continue.

In the short-term, the significant volatility we have recently seen in oil prices is set to continue as global spare production capacity is likely to increase only gradually. In 2005, OPEC increased production by around 1 million barrels a day and has committed around US\$20 billion to expand production. However, over the past few years, non-OPEC producers have supplied a significant proportion of the increase in world supply. So while OECD production is likely to remain unchanged, countries such as Russia again expected to play a major role in production growth in 2006.

The lack of refining capacity remains the final key risk for oil prices. Utilisation rates for oil refineries remain high around the globe boosting the price of petroleum products and supporting the value of the lighter, cheaper to refine grades of crude. In the short-term, the majority of the increase in refining capacity is planned to be in non-OECD Asia and the Middle East. It is unlikely that this will result in a significant increase in refined products and thus upwards pressure will remain on diesel, gasoline and other petroleum products.

Thermal coal

In 2005, continued growth in exports from Indonesia, Colombia and South Africa saw the global thermal coal market move into surplus in the second half of the year. At the same time, slower demand growth meant spot prices have been falling since mid-2005. In 2006, growth in global demand is expected to ease around 1 per cent as demand flattens in the key Asian markets of Japan, Taiwan and South Korea which together account for 40 per cent of global imports. In addition, exports from low cost producers (Indonesia, Colombia, Australia and South Africa) are projected to add 25.1Mt to the global market.

China remains a wild card in this market and it was the outpacing growth in domestic demand, relative to domestic thermal coal production, that led to an 18% fall in Chinese net thermal coal exports in the first nine months of 2005. Imports are forecast to rise 7 per cent in 2006, a significant moderation from the 43 per cent rise in 2005. However, imports could vary significantly if Chinese production does not match expectations.

Thermal coal spot and tender prices fell 25 per cent though 2005. All the above points to a fall in the 2006/07 contract prices. We are expecting the Japanese benchmark contract to fall around 20 per cent to US\$43 per tonne.

Regional industries – energy

Chart 1.

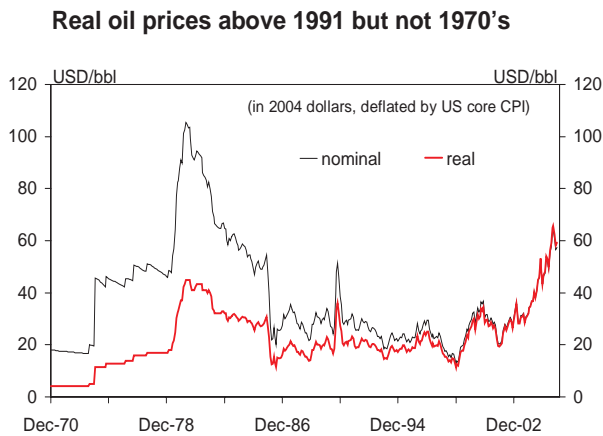


Chart 2.

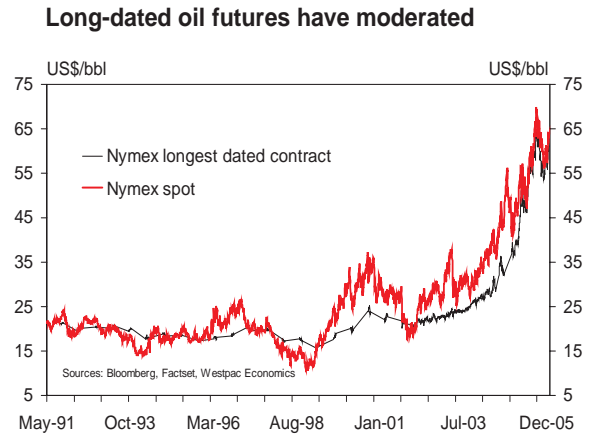


Chart 3.

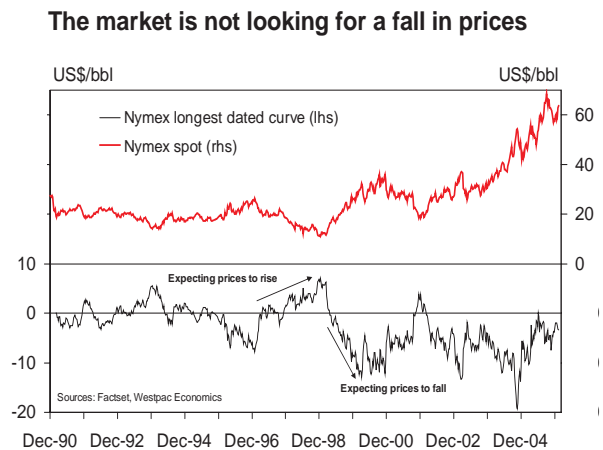


Chart 4.

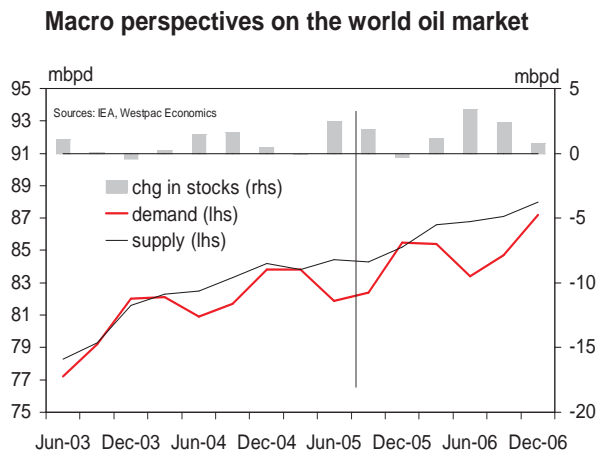


Chart 5.

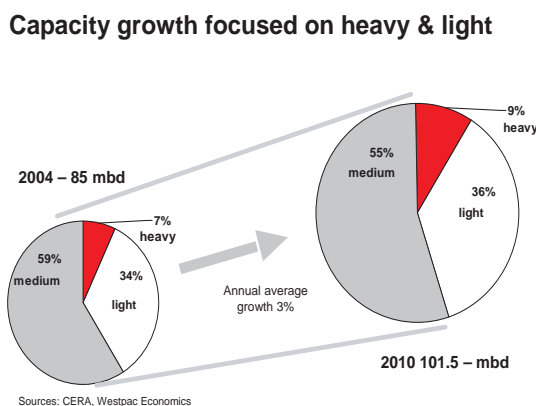
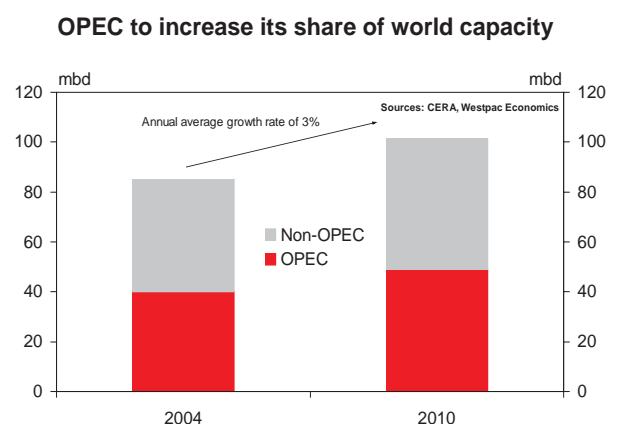


Chart 6.



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Regional industries – base metals and gold

Copper prices set a record high early in 2006, get ready for a correction.

Copper

Copper prices continued to set record highs in 2005 bursting through US\$4,500 per tonne in early December. A strike by rail workers in Chile further threatened supply and prices hit US\$4,710 in January 2006. The market was also shaken by reports of short positions of up to 200,0100t being held by the Chinese Governments State Reserve Bureau (SRB). The SRB has since been delivering metal into the LME and SFE warehouses and it is expected that many of the short positions will be rolled forward – that is the sales have been delayed until a later date. Post Hurricane Katrina reconstruction will add to North American consumption but this will be offset, to some extent, by an increase in supply. Overall, the market is expected to become more balanced in 2006 with an acceleration in the accumulation of copper inventories. We are looking for prices to ease back in 2006 falling around 3 per cent in year average terms.

Rising nickel production to crimp prices.

Nickel

A resurgence in demand took nickel prices through US\$16,000 per tonne early in 2005 before production cutbacks by stainless steel mills saw prices ease in the second half of the year. In fact, outside of China primary nickel consumption decline in 2005. Nevertheless, a resurgence in demand near the end of 2005 took prices back up through US\$14,000 per tonne. For 2006, all major nickel producers are expecting output to increase this year. This includes BHP which is implementing incremental production increases from both Cerro and Kwinana. LME stocks rose to to 37.5kt at the end of December 2005, the largest they have been for over two years. It is this, and a moderation in demand, that is behind our forecast for nickel prices to fall from an average of US\$14,695 per tonne in 2005 to US\$13,200 in 2006.

Any potential price rise will be limited by ample idle capacity.

Aluminium

In 2005, it appears that the Chinese government was finally successful in limiting exports of aluminium which are now half of what they were at the start of 2005. The Chinese authorities want to limit aluminium exports as they are effectively exporting much needed electricity. If the government succeeds in continuing to limit Chinese exports, this will leave the rest of the world in a small deficit. However, as long as this does not blow-out, then existing stockpiles should be sufficient in preventing LME stocks falling below the critical 5 days of consumption levels. However, near the end of 2005 the market was increasing speculating that stronger growth would see this deficit blow out by more than expected. We think this risk may be overstated as there is no shortage of idle smelting capacity that will become economical if prices rise and this should cap any demand driven price rises in 2006.

The outlook for zinc remains upbeat.

Zinc and lead

The signs are there for another good year for zinc miners. Prices should remain robust albeit they will ease from the giddy heights of December 2005. Mine capacity constraints along with rising demand, particularly from China, has resulted in a rapid fall in inventories. Global zinc demand is expected to rise as galvanised production in Europe and the US recovers so zinc prices should remain well supported in 2006. The supply and demand of lead is expected to remain in balance in 2006. With no substantial move in stocks, lead should retain the high price it has enjoyed since early 2004.

We doubt gold prices can stave off a correction to inflation expectations.

Gold

In 2005 rising inflation fears associated with high oil prices, and an indication that the central banks of the Russian Federation and South Africa were considering increasing their gold holdings, boosted gold prices. In 2006, prices are set to ease as oil prices moderate and global inflation risks fade.

Regional industries – base metals and gold

Chart 1.

Westpac base metals inventories index

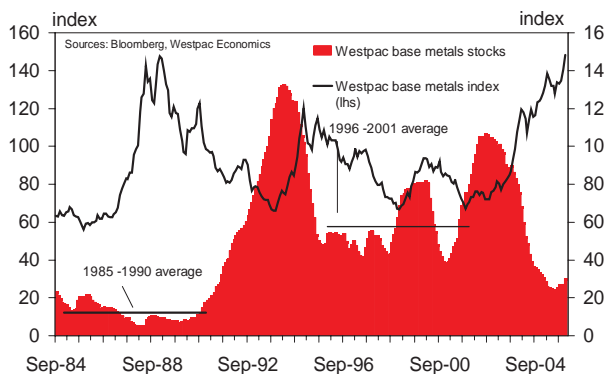


Chart 2.

OECD lead indicator bottomed July 2005

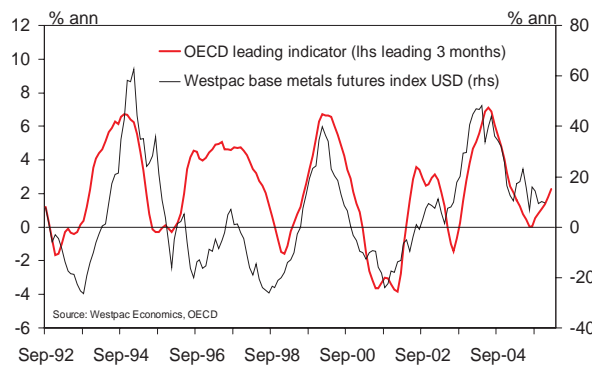


Chart 3.

Copper stocks are stabilising

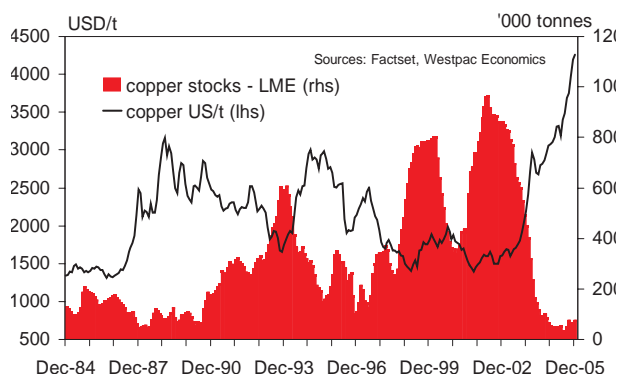


Chart 4.

Aluminium stocks rebuilding

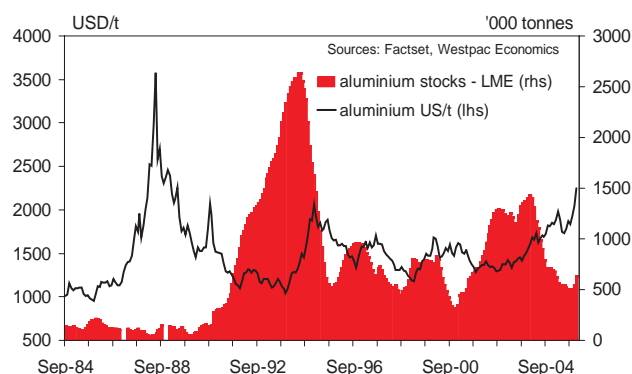


Chart 5.

Nickel prices and stocks

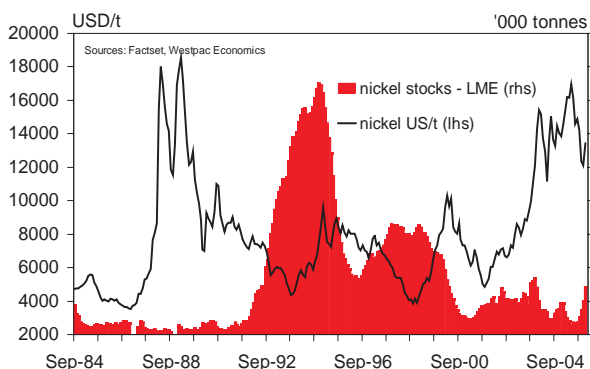
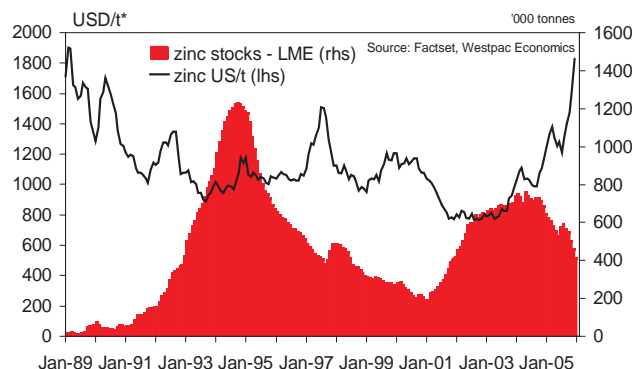


Chart 6.

Even zinc stocks look to be finding a base



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Regional economic indicators

Chart 1.

Westpac Farm Commodities Index

	Current	Percentage change over		
	Dec 05 c)	1 month	6 months	12 months
Beef (AUD\$/kg)	3.67	-1.2	-7.4	-3.8
Wheat (US\$/bu)	339	7.6	2.3	11.5
Wool (AUDc/kg)	717	0.2	-9.3	-11.2
Skim milk powder (US\$/t)	2188	1.7	-5.4	-4.9
Sugar (US\$/lb)	14.23	15.6	62.6	56.8
Cotton (US\$/lb)	54.5	4.6	6.3	16.2
Barley (CAD/t)	125	3.4	5.2	12.0
Canola (CAD/t)	239	-5.8	-18.4	-8.2
USD Index 94/95 = 100	99.6	0.2	2.4	-2.5
AUD/USD US cents	0.75	1.3	-3.1	-0.8
AUD Index 94/95 = 100	99.1	-1.0	5.6	-1.7

a) The index uses daily mid prices to calculate monthly averages
 b) Data source is Bloomberg, USDA FAS, Westpac Economics
 c) Preliminary estimate

Chart 2.

Westpac Farm Commodities Index

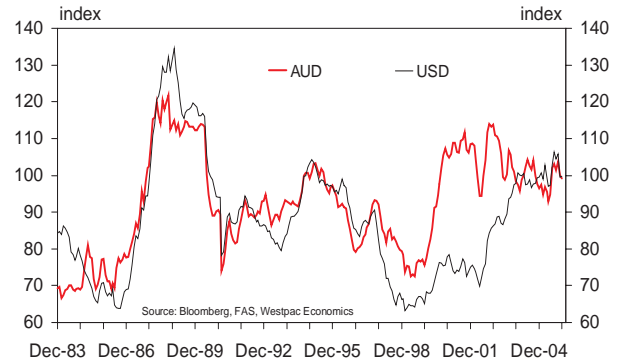


Chart 3.

Farmers are doing more with less labour

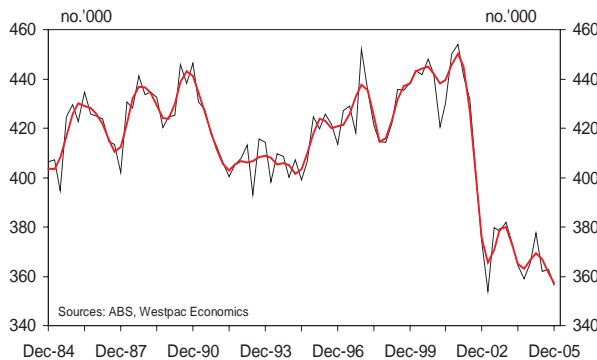


Chart 4.

Mining jobs hitting new highs

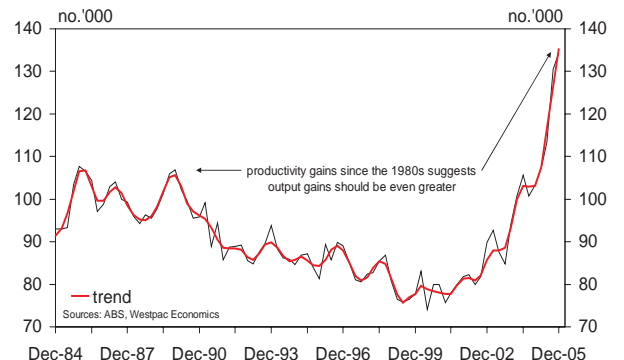


Chart 5.

Farm production remains sub par

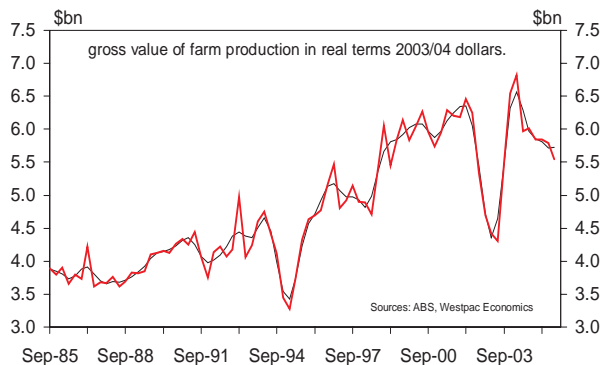
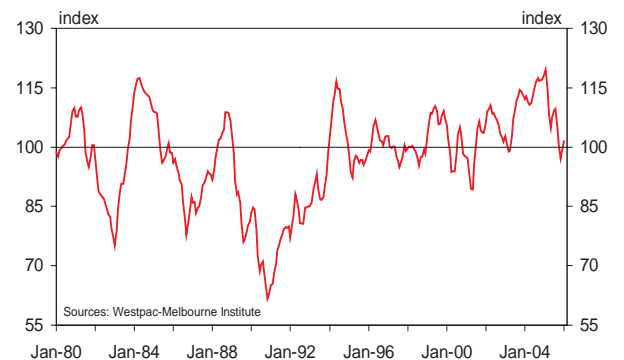


Chart 6.

Regional index of consumer sentiment



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