Victorian Economic Outlook

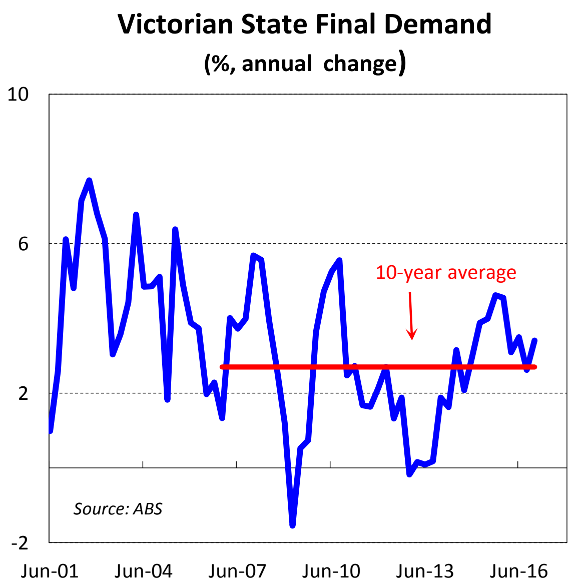
Summary

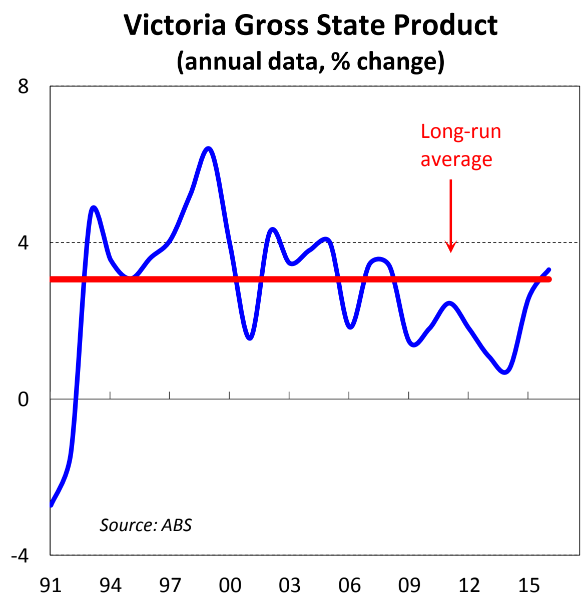
- The Victorian economy has performed well over the past couple of years. Growth in **gross state product** in Victoria has picked up to 3.3% in 2015-16, following growth of 2.6% in 2014-15. **State final demand** is a more regular but narrower measure of economic activity. This gauge rose to 3.4% in the year to the December quarter, which is well above the long-run average and underscores the robust nature of economic activity in Victoria.
- **Employment** grew at a brisk annual rate of 3.8% in April – that is much faster than any other State or territory. This pace of jobs growth reflects the firm rate of economic activity in the State. The unemployment rate sits at 6.1% with a rise in people joining the labour force preventing a decline, despite solid jobs growth.
- Growth in jobs continues to support **consumer spending** in Victoria, but very weak wages growth has restrained shoppers. Consumer spending is showing signs of strain in Victoria, mirroring the story in the rest of the country. Annual growth in retail spending stood at 2.8% in March, which is below the long-run average of 4.2%. While Victorian retail spending growth is only moderate, it is above the national annual pace of 2.1%, reflecting the relatively strength in Victoria's economy compared with most other States.
- Growth in Melbourne **dwelling prices** remains strong and on the radar for regulators and policymakers. In the year to April, prices rose by 15.3%, which was the second fastest pace of annual growth among all capital cities. We expect the growth of dwelling prices to moderate due to the increased supply of dwelling stock and the impact of the recent widening of supervisory measures to lenders.
- After a weak start for **business investment** in 2016, it picked up in the second half of last year. While the outlook nationally for business investment remains subdued, in Victoria the outlook is more positive, although challenges remain for some sectors, including manufacturing.
- **Tourism** numbers are growing in Victoria. The Garden State has now taken over from Queensland as the second favourite destination of tourists to Australia.
- The **Victorian government** revealed in its **State Budge**t earlier this month that it expects an operating surplus of $1.2 billion in 2017-18. This follows an estimated operating surplus of $1.3 billion in 2016-17. Surpluses are projected to continue over the forecast period to 2020-21. The Victorian budget forecasts increased infrastructure spending, which should help support economic growth through lifting jobs and construction.

Economic Growth

The pace of growth in gross state product in Victoria has picked up over the past two years, rising by 3.3% in 2015-16, following growth of 2.6% in 2014-15.

State final demand is a more regular measure of state economic activity, but it is not as broad a measure as gross state product. State final demand has been volatile in recent quarters. It jumped by 1.7% in the December quarter, after falling by 0.4% in the September quarter. In the year to the December quarter, state final demand rose by 3.4%, which is above the average growth over the past ten years of 2.7%. It underscores the robust nature of economic activity in Victoria.





Economic growth in Victoria is being supported by low interest rates, the strength in the housing market, solid population growth and a weaker currency relative to a few years ago.

We expect Victoria's economy to continue to grow at a trend pace or slightly above that in coming years. Business investment in both equipment and buildings is expected to remain solid in 2017-18. Investment in infrastructure and transport are expected to boost economic growth and productivity in Victoria. Dwelling investment, which has provided a substantial boost to economic growth in recent years, is forecast to pull back from current levels in coming years.

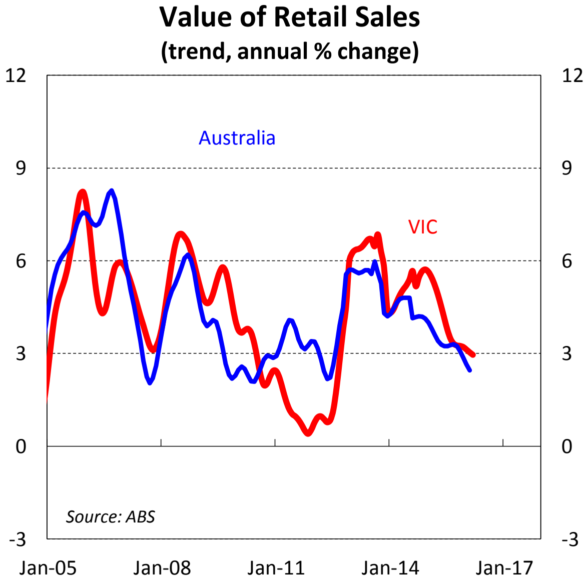
Population growth has strengthened in Victoria. It grew at an annual rate of 2.1% in the September quarter of 2016 (the latest available data), maintaining the pace from the year to the June quarter. This is the strongest rate of increase in the population since 2009. Moreover, Victoria continues to have the fastest population growth across all States and territories.

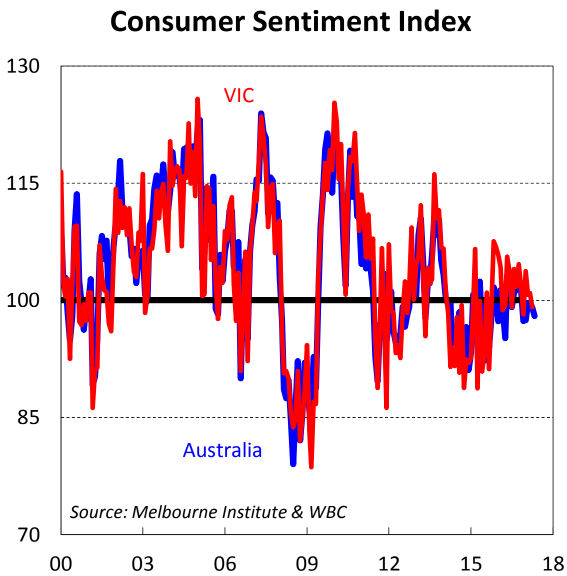
Consumer Spending

Growth in jobs continues to support retail spending in Victoria, although very weak wages growth has restrained spending. Annual growth in retail spending stood at 2.8% in March. This is down from a recent peak in growth of 6.0% in the year to November 2015 and below the long-term average of 4.2%. However, retail spending has softened nationally and the rate of softening in Victoria has not been as sharp as the rest of the country.

Consumer sentiment has held close to a neutral level in Victoria over the past three months. In April, Victorian consumer sentiment stood at 99.2 in May. This reading is below 100, indicating

Victorian consumers are slightly more pessimistic than optimistic, although not markedly so. Consumer sentiment nationally has been marginally weaker than in Victoria in recent months, standing at 98.0 in May.





Housing

Growth in Melbourne dwelling prices remains strong. In the year to April, prices rose by 15.3%, and were the fastest growing among capital cities, after Sydney. We expect the pace of growth will slow to a more moderate pace given growth in supply. House price growth at 16.5% continues to greatly exceed price growth in units at 4.1%.

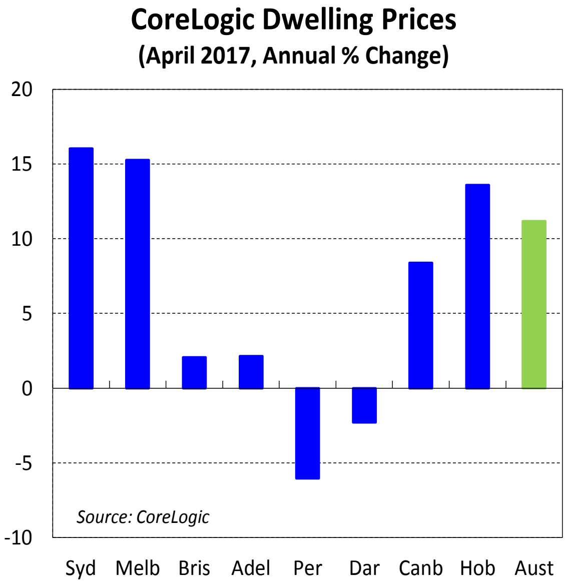
Further evidence of the outlook for dwelling prices is provided by lending data. Growth in the number of owner-occupier home loans approved in Victoria has slowed from a double-digit pace in early 2016 to be down 1.5% in the year to March 2017. The value of investor loans (which has made up around 37% of the value of all loans) recovered from weakness early in 2016, to grow by 3.6% in the year to February 2017.

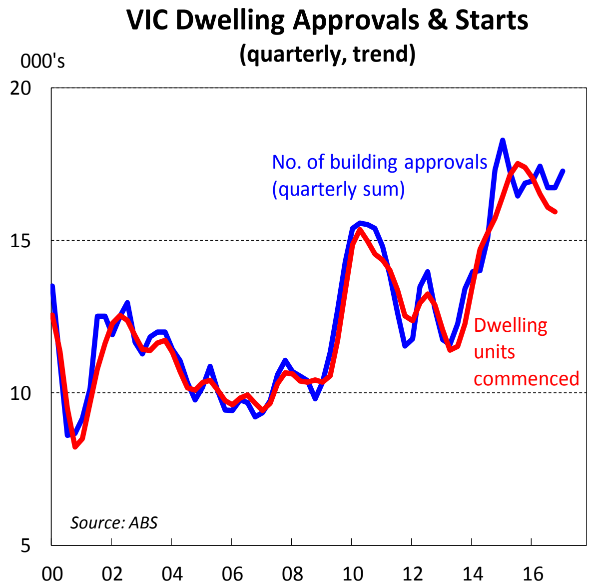
The Australian Prudential Regulation Authority (APRA) widened its macro-prudential restrictions on March 31. It will be several months before we are able to gauge the initial impact of these measures. The recent measures targeted interest-only loans and serviceability metrics and should impact both the investor and owner-occupier segments of the market.

Residential building approvals are at high levels and point to further solid activity within housing construction, although the peak in construction appears to have passed. Residential construction has been above average levels for some years in Victoria and will exacerbate concerns of oversupply in certain pockets of Melbourne.

In terms of the rental market, over the December quarter, median rents for houses increased in major regions across the state. The highest increases were in four-bedroom houses in inner Melbourne (7.0%) and in two-bedroom houses in Bendigo (4.0%) over the quarter. Compared to the December quarter of 2015, median rents for houses were steady or increasing across the state with the highest increases in four-bedroom and three-bedroom houses in inner Melbourne (15.0% and 5.9%, respectively).

The rental vacancy rate in Melbourne decreased to 2.4% over the December quarter, a decrease of 0.1 percentage points. It is a notably low vacancy rate, suggesting that the rental market is drum tight in Melbourne.





Business Investment

After a weak start for business investment in 2016, it picked up in the second half of last year. While the outlook nationally for business investment remains subdued, in Victoria the outlook is more solid, although challenges remain for some sectors, including manufacturing.

Within commercial construction, there is a healthy amount of projects for office and retail, including the $2.5 billion Collins Square project. Major projects from the State government include the $11 billion Melbourne Metro Rail project and the $5.5 billion Western Distributor project, which are both due to start in 2018. There is also planning on the $5.5 billion North-East Link.

Business confidence has been elevated in Victoria, and improved in April according to a widely-watched business survey. The elevated level of business confidence should help support the outlook for business spending.

Manufacturing

The struggles within Victoria's manufacturing sector have been well-publicised for sometime. Some of these challenges are long-term and structural, and reflect relatively high labour costs in comparison to other parts of the world. Additionally, economies are shifting production and resources towards services, and corresponds with a shift in consumption patterns globally.

The strength of the Australian dollar in past years has also been factor in keeping manufacturing sector under pressure. Thus, the depreciation in the AUD since early 2013 has been a big benefit and has likely played a part in some recent stabilizing in Victorian manufacturing employment - as a proportion of Victoria's total labour force, manufacturing employment has held at close to 9% since August 2015 although this is remains much lower than in the 1980s when manufacturing took up over 20% share of Victorian employment.

Tourism

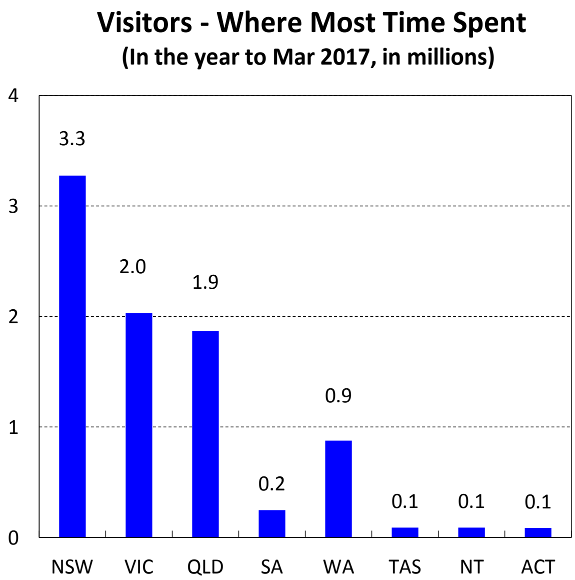
Business spending has strengthened in key sectors such as tourism. Indeed, Victoria has recently overtaken Queensland as the second most popular overseas tourist destination (after NSW). The weaker level of the Australian dollar is helping to boost tourist numbers.

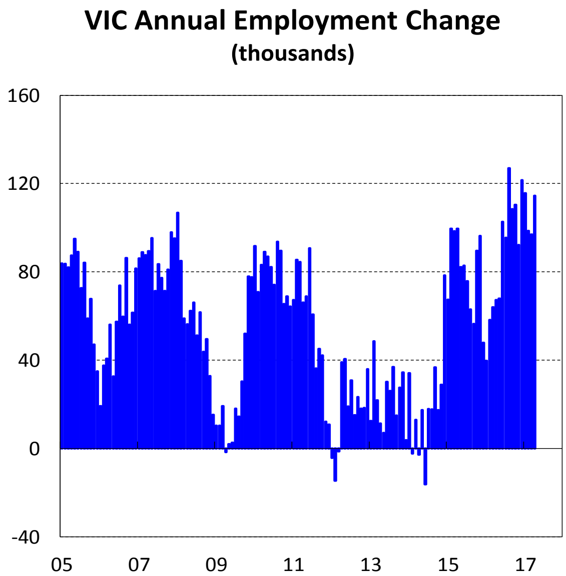
Melbourne's title as the sports capital of Australia is unabashed and a healthy calendar of events and conferences continues to drive leisure tourism. Tourism is an important industry for Victoria, employing close to 10% of Victoria's workforce.

Labour Market

Job growth has been very robust in Victoria over the past year. Employment grew by 115.6k in the year to April, making up the bulk of the growth in jobs nationally of 192.0k over the same time. Indeed, annual job gains have held between 92k and 127k since June last year. Moreover, employment is growing at 3.8% in annual percentage terms – that is well faster than any other State or territory.

Victoria's unemployment rate was steady at 6.1% in April, lower than the recent peak of 6.3% in January 2016, and higher than the national jobless rate of 5.7%. Over the past eighteen months, Victoria has recorded a trend rise in its participation rate to 65.9%, as discouraged unemployed people re-enter the workforce. The rise in the participation rate has prevented the unemployment rate from declining, despite solid job gains.





State Budget

The Victorian Government revealed in its State Budget earlier this month that it expects an operating surplus of $1.2 billion in 2017-18. This follows an estimated operating surplus of $1.3 billion in 2016-17. Surpluses are projected to continue over the forecast period to 2020-21.

The Victorian budget forecasts increased infrastructure spending over the next four years, compared to the past decade. The amount of infrastructure investment is worth$9.6 billion a year over four years. This includes $700 million over four years for the M80 Ring Road upgrade, which will complement the new North East Link, and $300 million in funding for the Mordialloc Bypass.

The budget also includes $556.4 million for improving regional roads. There was an allocation of $498 million for new and upgraded health facilities, infrastructure and health equipment.

There was some other good news for small businesses in the Victorian Government's Budget announcement. Payroll cuts will be brought forward one year, with the threshold increasing from $575,000 to $650,000 effective 1 July 2018, benefitting approximately 38,000 Victorian businesses. This means the payroll tax threshold will rise to $625,000 on 1 July this year.

Other industries to benefit include tourism with $24.8 million for Visit Victoria and $90 million allocated to attract private sector investment and job creation and protect existing businesses.

Regional businesses will get an extra boost by way of a 25% discount on their payroll tax. From 1 July 2017 the payroll tax rate will be reduced by 25% to 3.65% for regional businesses with payrolls that comprise at least 85% associated with regional employees.

Home affordability received a helping hand, with $851 million to abolish stamp duty for first-home buyers (of homes valued up to $600,000) and lower stamp duty on homes valued up to $750,000.

Turning to the education sector, Victorian schools received additional funding, with $269.6 million to buy land for and construct new school and $239.6 million to upgrade schools.

Federal Budget

This year's Federal Budget included some infrastructure measures for Victoria. There will be $1 billion investment in infrastructure in Victoria from the Federal government, including $500 million for regional passenger rail. There was also $100 million committed to upgrading the Geelong-Waurn Ponds rail line and $30 million to help plan the Tullamarine airport rail link.

The Federal budget also committed to deliver the Melbourne to Brisbane Inland Rail project, worth $8.4 billion. Defence land in Maribyrnong will be released for residential development to assist with housing affordability.

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