Bank of Melbourne

QLD ECONOMIC OUTLOOK

9 January 2012

Summary:

- **Queensland is the third largest economy in Australia and comprises a 19.1% share of Australia's GDP. While the mining industry gains much attention, the construction and manufacturing industries are Queensland's largest. There is also a heavy focus on Queensland's export sector, with major exports including coal, tourism and other commodities.**
- **Queensland has had its fair share of headwinds facing its economy in recent times. These include the natural disasters early in 2011, slowing population growth, a sluggish housing market and the strong Aussie dollar weighing heavily on its tourism sector. Nonetheless, the benefits of the mining boom are beginning to shine through, predominantly through business investment. Reconstruction after the natural disasters is also underway and adding to growth.**
- **Reflecting the adverse weather events, Queensland gross state product grew by only 0.2% in 2010-11. However, a recovery in economic activity is underway. State final demand jumped by a strong 3.5% in the September quarter. For the year, State final demand is up a robust 9.3%, the fastest annual rate in more than four years. In both quarterly and annual terms in the September quarter, Queensland's State final demand growth was second only to WA.**
- **The biggest driver of growth in the Queensland economy, much like the Australian economy, is private business investment. In the September quarter, business investment in Queensland soared to an annual rate of 47.2%, the strongest annual pace since 1994.**
- **Business investment intentions in Australia for this year are very strong led by the mining sector. The pipeline of major projects for Queensland is very large with work currently underway or under consideration including a number of LNG and coal projects. Thus strong growth in business investment for Queensland is set to continue.**
- **Exports have been slow to recover after the disruption to coal exports earlier in the year. Flooding in coal pits from January has hampered production and a full recovery is not expected until early next year. The strong Australian dollar is also weighing on tourism. Queensland export volumes should however rebound strongly this fiscal year, as coal exports continue to improve and the large scale spending on business investment boosts export capacity.**
- **Household consumption in Queensland accelerated to an annual pace of 4.7% in the September quarter, the fastest annual pace in over three years, after subdued growth throughout last year and the beginning of 2011. Consumer spending has been supported by strong income growth. Retail spending has also picked up in recent months, but the pace of growth remains below Queensland's long-term average.**
- **Brisbane has been one of the weakest housing markets over this year but Brisbane also had one of the strongest run ups before the GFC. The current decline in Brisbane house prices is greater than the national capital city average, but it is coming off very strong growth cycles over the past ten years. We expect house prices to start to stabilise in the first half of this year and then start to recover later in 2012. The two recent RBA rate cuts and the prospect of more easing early next year should help revive demand for residential housing in Brisbane. However, it will be a mixed story in some other parts of Queensland.**
- **Residential construction in Queensland has been soft, and a weaker trend is likely to continue as indicated by sharp drops in building approvals. Further, residential construction is likely to be "crowded out" by engineering construction driven by the mining industry. There is a slight undersupply of housing in Brisbane and is set to grow this year and next. Brisbane's rental market is tight as indicated by a low vacancy rate. This should continue to support growth in rents, and help set the preconditions for a recovery in the housing market.**
- **The Queensland labour market has softened a little more sharply than the trend nationally over the past year. Slower employment growth has led to the unemployment rate rising to 5.8% in Queensland, compared to 5.3% nationally. The floods and cyclones have negatively impacted employment earlier in the year. Further, developments in Europe and the downside risks to the global economy are also likely weighing on firms' hiring intentions.**

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Overview

Queensland is the third largest economy in Australia and comprises a 19.1% share of Australia's gross domestic product (GDP). It is also the third most populous state in Australia, after New South Wales and Victoria, with a population over 4.5 million.

The mining boom has seen Queensland gaining more attention as one of Australia's major resource-rich states. Despite this, in the year to June 2011, the mining industry was the third largest, behind the manufacturing and construction industries. As well as being the largest industry in Queensland, the construction industry also showed the strongest growth rate in the year to June 2011, and this strong growth is likely to have continued into the current financial year.

Housing construction in Queensland has slowed on moderating house prices, slowing population growth and rising unemployment, but housing construction is not the rising star in Queensland's construction industry. While the mining sector itself many not be the largest industry in Queensland, it is spurring huge amounts of construction activity as production capacity is increased to meet demand in the mining industry. Engineering work commencing in the state is surging and there remains a huge amount of work in the pipeline.

Queensland relies heavily on exports, which are mostly commodities and also tourism. Coal is Queensland's largest export, and the most important sector in the State's mining industry. Additionally, Queensland is the world's second larger producer of lead, third largest producer of zinc and fifth largest silver producer. Mining projects in the pipeline in Queensland are concentrated in thermal coal, LNG and coking coal.

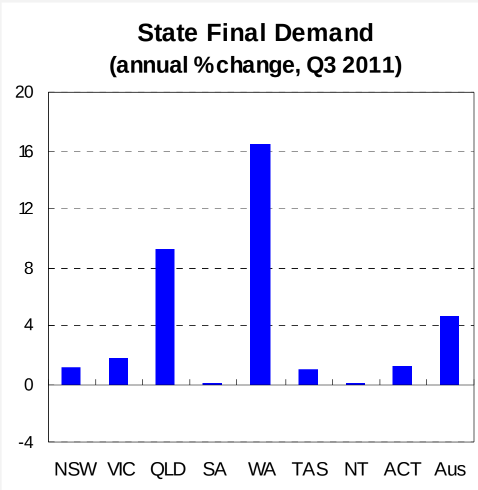
Percentage Shares of the Economy*

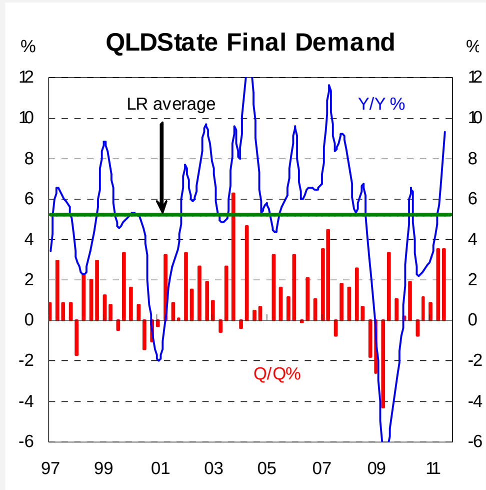
Industries	Australia	QLD
Construction	0.1	9.2
Manufacturing	0.5	7.7
Mining	3.5	7.5
Financial and insurance services	2.5	6.8
Transport, postal and warehousing	0.6	6.5
Health care and social assistance	2.6	6.0
Professional, scientific and technical services	3.4	5.5
Public administration and safety	2.2	5.3
Retail trade	2.3	5.2
Wholesale trade	0.8	4.9
Education and training	7.0	4.1
Agriculture, forestry and fishing	2.6	3.0
Accommodation and food services	8.2	2.4
Electricity, gas, water and waste services	1.5	2.3
Rental, hiring and real estate services	5.5	2.1
Information media and telecommunications	0.8	2.1
Administrative and support services	10.3	1.9
Other services	4.8	1.7
Arts and recreation services	5.3	0.6

** For Australia, using GDP and for QLD, using GSP; Source: ABS, St.George*

Economic Growth

Queensland experienced strong growth in the September quarter of 2011, as measured by state final demand. State final demand jumped by strong 3.5% in Queensland in the September quarter, following increases of 3.5% in the June quarter and 0.8% in the March quarter. For the year, Queensland's state final demand is up a robust 9.3%, the fastest annual rate in more than four years. In both quarterly and annual terms in the September quarter, Queensland's state final demand growth was second only to Western Australia.





The annual growth rate of 9.3% (in state final demand) is well above the domestic final demand reading of 4.6% for the national economy, and stronger than the ten-year average growth rate in Queensland state final demand of 5.5%.

A broader measure of economic growth is gross state product (GSP) which includes inventories and net exports, but this measure is published only annually on a State basis. Exports from Queensland slumped substantially in the March quarter after the floods hampered coal production, and although exports improved in the June and September quarters, they are yet to fully recover. Taking into account the detraction from net exports, GSP rose by just 0.2% in 2010-11, well below the ten-year average of 4.1%.

The significant growth driver for Queensland and the wider Australian economy remains private business investment (discussed below). Nationally, slower population growth, relatively high interest rates and cautiousness by households are having a dampening impact on housing and consumption. Some sectors are also being weighed down by the high Australian dollar. This has been painfully evident in Queensland's large tourism sector (the State's second biggest export earner). Overall, Queensland has enjoyed strong upside to its economic growth, given the size of its mining sector and the current mining boom. The Queensland Resources Sector Growth Outlook Study of the mining industry indicated there were 66 large projects (greater than $300 million each) that were under study (which significantly represents in excess of 50% of the projects), committed to, or under construction, and estimated the total capital expenditure of these projects to 2020, of $142 billion. However, escalating worries from abroad are adding to downside risks to economic activity for Queensland and Australia.

Queensland Treasury expects solid economic growth in 2011-12 and 2012-13 of 5.0% and 5.25%, respectively, in Gross State Product, which compares to the average pace of growth witnessed over the last ten years of 5.3%.

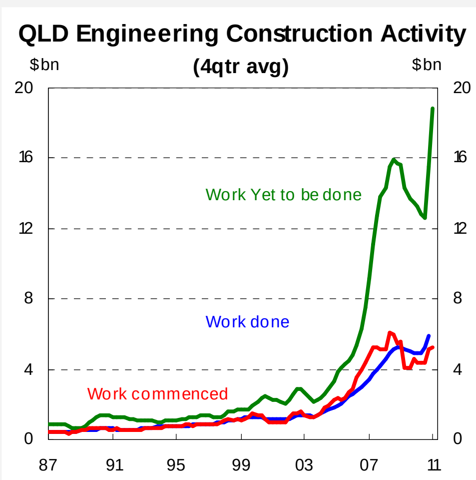
Business Investment

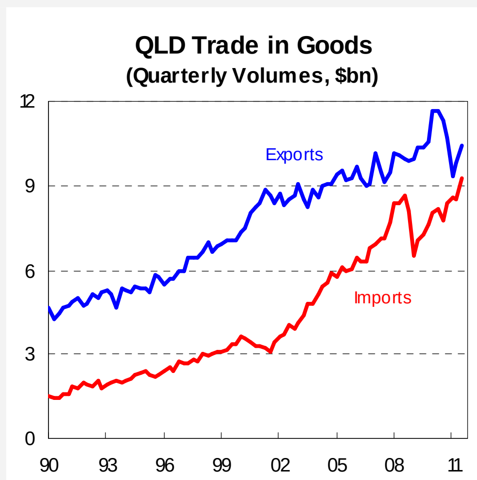
Private business investment has accelerated in Australia, thanks to the high terms of trade and a mining boom, and a large proportion of recent growth in national business investment is in Queensland due to its growing mining industry. Business investment has been a significant driver for growth in Queensland, especially since there have been headwinds facing other areas of the State's economy. In the September quarter, business investment in Queensland soared to an annual rate of 47.2%, the strongest annual pace since 1994, and well above the national annual growth of 22.7%.

Prospects for business investment are also very positive, and will likely remain solid over this fiscal year. Nationally, businesses raised capital expenditure by 11.9% in 2010-11 and it is estimated they intend to increase spending by approximately 34% in 2011-12 (according to the most recent survey from the ABS).

Engineering construction has been a major driver of business investment in Queensland and Australia. Engineering construction in Queensland lifted 86.1%, in the year to the September quarter, the strongest annual pace since the data becomes available in 1983.

Furthermore, the pipeline of construction engineering work is very large. Work currently underway includes a Gladstone LNG processing facility worth $16bn and a $15bn Curtis LNG project. There is also additional work in the planning stages led by a $20bn Australia Pacific LNG project and a number of coal projects.





Net Exports

Exports have been slow to recover in Queensland after the disruption to coal exports earlier in the year (see chart above right). Flooding in coal pits from January has hampered production, and a full recovery is not expected till early next year. Export volumes of goods subsequently fell 6.9% in the year ending June quarter 2011. Exports were the key drag on growth.

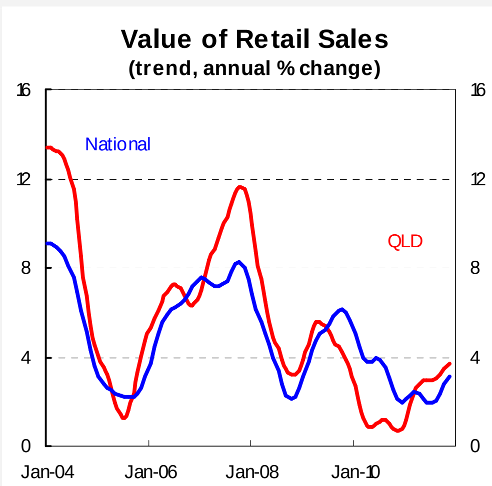
Coal dominates Queensland's total exports of which the majority comprising of coking (metallurgical) coal. Queensland is the largest supplier of seaborne hard coking coal in the world (supplying near 40%). Other major merchandise exports from Queensland comprise largely of commodities and include beef, ores and concentrates of base metals, copper and aluminium.

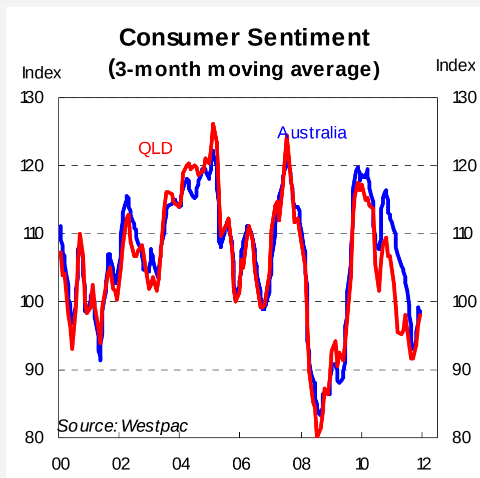
The strong Australian dollar is also weighing on tourism, the State's second largest export earner in 2010. There has also been the negative impact of the natural disasters on tourism in the State.

Over the medium to long-term, the Australian dollar is likely to trade higher than historically is the case due to attractive fundamentals including Australia's high terms of trade, strong trade links to the Asian region and relatively high interest rates. However, the AUD will be subject to the nervousness in financial markets due to the deepening European sovereign debt crisis and likely to face significant volatility over the short-term.

Queensland export volumes should, however, rebound strongly this fiscal year, as coal exports continue to improve. Further, the large scale spending on business investment should also boost capacity for export growth, predominantly through major LNG and mining projects. Strong demand from China and Asia should continue to support commodity exports, although there is increased downside risk for the global economy. Reflecting the darkening global outlook, commodity prices have softened in recent months, but they remain at high levels. Further, coking coal prices have held up relatively well in comparison to other exchange-traded commodities and should continue to support export incomes.

The rebound in export volumes, however, is likely to be partly offset by strong growth in import volumes. The strong expected growth in business investment particularly in Queensland suggests that imports of capital goods will also be very solid.





Consumer Spending

A sluggish housing market, the dampening impact on activity from the floods and cyclones and household caution has weighed on consumer spending in Queensland throughout last year and the beginning of this year. However, it appears that the tides may have turned in recent months with household consumption accelerating to an annual pace of 4.7%, the fastest annual pace in over three years. Household consumption is now stronger than Queensland's long-term average of 4.4% and the national annual rate of 3.8%. Strong growth in wages over the last year is supporting consumer spending in Queensland.

A similar story is told in retailing with retail spending in Queensland picking up in recent months. Retail spending comprises around one third of overall household consumption. As of November, annual retail sales growth has accelerated to 3.7%, just above the national growth rate of 3.1%. But the pace of growth remains below Queensland's long-term average of 6.3%. Retailing is a weak spot in the national economy, dampened by household caution, but also greater competition from online retailing overseas helped by the strong Australian dollar.

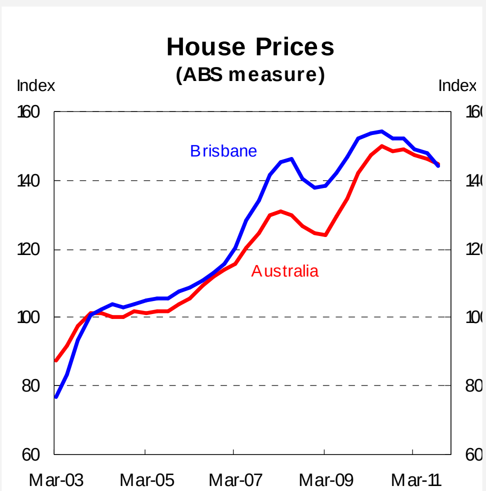
Further, a trend occurring nationally and in Queensland is a greater proportion of incomes being spent on services. Areas of strength in household consumption have been transport services, education and financial services. Other categories, which have had strong growth in spending, include food and alcoholic beverages.

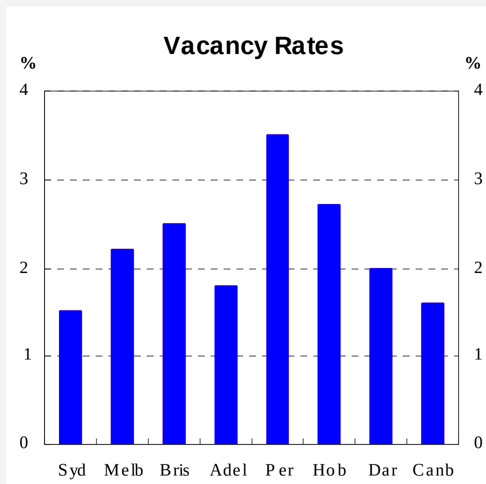
According to the Westpac-Melbourne Institute consumer sentiment survey, Queensland consumers have been more pessimistic than optimistic for most of 2011 on the lingering effects of the floods in January, rising unemployment and a weakening housing market. Confidence in Queensland has since rebounded and is now above the index for Australia, after tracking below Australia's index for much of this year. Consumers in Queensland also remain relatively upbeat despite growing concern about the global economic outlook. In December 2011, Queensland's consumer sentiment index stood at 101.4, above 100.0 and the national index indicating that consumers in Queensland are more optimistic than pessimistic and more optimistic than Australia wide.

Housing

House prices have moderated in Australia and in Queensland over the course of this year. According to the Australian Bureau if Statistics (ABS), house price growth has slowed significantly from a recent peak of 11.2% growth in the year to the March quarter 2010 to be down 5.2% in the year to the September of 2011. It compares with a decline of 2.2% across Australia.

The weakest housing markets are those that have had the largest run up over the preceding few years. Brisbane has been one of the weakest housing markets over this year. So while the current decline in Brisbane house prices is greater than the national capital city average, it is coming off very strong growth cycles over the past ten years.





Other house price data also indicates that house price growth remains subdued. RP Data-Rismark dwelling prices for Brisbane fell 7.0% in the year to November, compared to a decline of 3.0% nationally. With interest rates only recently cut and the end of the boost to the first-home-owners' grant (FHOG), demand for housing has waned. Furthermore, housing affordability remains low. However, the two recent RBA rate cuts and the prospect of more early this year should help revive demand for residential housing in Brisbane.

The population growth rate in Queensland has been declining; it has fallen from a recent peak of 2.9% in December 2008 to 1.6% according to the latest available data. Or in number terms, down from nearly 120k in 2008-09 to less than 80k in 2010-11.

We expect house prices to begin to stabilise in the first half of this year both across Australia and Queensland. But Queensland might stabilise later than the national housing market.

Low unemployment and recent rate cuts are giving support to the housing market but ongoing turmoil in the global economy, low housing affordability and household caution will offset some of the positive influences.

Housing construction is weak across Australia, but particularly in Queensland. It is perhaps more noticeable in Queensland where residential construction is likely to be "crowded out" by engineering construction due the mining industry.

So far, rebuilding due to the floods has failed to provide the construction industry in Queensland with a significant boost. Part of this weakness might be due to a delay in building applications to take advantage of the Queensland Government's $10,000 Building Boost Grant. It is also likely due to the decline in the population growth rate, especially a slowdown in net interstate migration (which is down nearly 60% compared with two years ago).

We expect that a weaker trend of dwelling investment is likely to continue in the short term. Leading indicators of residential dwelling investment suggest building activity will continue to ease. Building approvals in Queensland have fallen 30.1% over the year to October and the number of building approvals in the state is 45% below the long-term average.

According to BIS Shrapnel, Brisbane's dwelling stock remains slightly undersupplied. But this undersupply of dwellings is set to grow from around 6k this year to 14k next year and 23k in 2013. So housing construction over the medium term should recover and grow. The significance of the mining industry in Queensland will also assist the medium-term recovery.

Brisbane's rental vacancy rate is under 3.0%, indicating strong demand for rental accommodation or a shortage of rental accommodation.

We expect a modest price recovery to come through for house prices later in 2012 and continue into 2013. The tight rental market will help set the preconditions for this recovery. However, the price outlook will differ across Queensland. Some parts of the Queensland housing market will take longer to recover, notably those also suffering from lower tourism activity such as the Sunshine Coast. Meanwhile, other parts are likely to see strong growth, particularly the regional centres with an overwhelming concentration of mining investment. An example includes Gladstone where rents have surged more than 20% over to the June quarter 2011 for a three-bedroom house. Similar trends can be observed in Chinchilla, Dalby, Emerald and Mount Isa.

Non-residential Construction

Non-residential building has been lacklustre nationally and in Queensland as the stimulus from the Building the Education Revolution (BER) program fades and as the effects of the global financial crisis linger.

More recently, there has been a pick up in Queensland non-residential building rising by 7.7% over the year to the September quarter, although the pick up is coming from a very low base. The recovery in non-residential construction is expected to continue this financial year, led by some major healthcare projects.

Labour Market

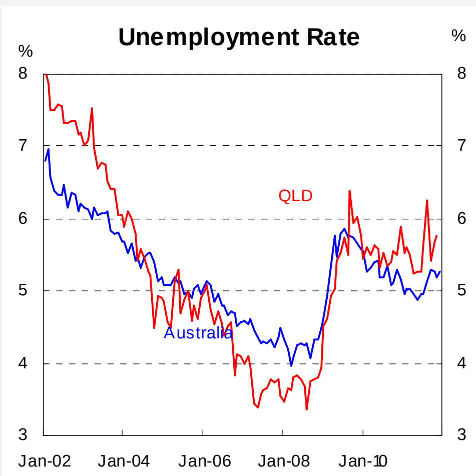
The Queensland labour market has softened a little more sharply than the trend nationally over the past year. Annual employment growth was 0.4% in November in Queensland, which is the same rate as the growth in national employment. Queensland's employment growth is well down from a cyclical peak of 4.1% a year earlier. Given the slower growth in employment, the unemployment rate in November rose to 5.8% in Queensland, compared to 5.3% nationally, and a ten-year average for Queensland also at 5.3%.

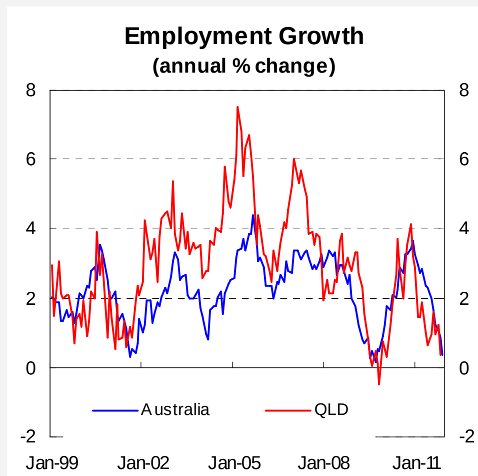
The creation of jobs in Queensland over the past year has been lacklustre, with 9k new jobs, compared to 45k jobs created Australia-wide. The floods and cyclones impacted employment, with a 25k decline in Queensland jobs in February, although jobs recovered in the following two months. The workforce participation rate in Queensland has fallen to 67.5% in November

2011 from 68.2% in December 2010, suggesting those looking for work may have become discouraged as the unemployment rate rises. However, Queensland's workforce participation rate remains well above the national rate, at 65.5%.

Leading indicators of employment – namely job advertisements – suggest the pace of jobs growth will continue to moderate. Further, business conditions improved further in November, while business confidence held its ground. However, if the situation in the Euro zone were to deteriorate further, it is likely this would weigh on businesses' hiring intentions.

The largest employers in Queensland are the health care and social assistance industry (employing 12.1% of the workforce, likely reflecting Queensland's ageing population) and retail trade (which is traditionally a large employer relative to its size). The third largest employer is the construction industry. The mining industry (Queensland's third largest industry) only employs 2.5% of Queensland's workforce, highlighting the capital-intensive nature of the industry, although the mining workforce in Queensland has doubled over the past five years.





Key Forecasts

St.George Banking Group Forecasts:

Economic Indicators	2009-10	2010-11	2011-12 (f)	2012-13 (f)
State Final Demand % change	-0.30	3.20	6.50	5.50
Employment % change	1.00	2.30	2.50	3.00
Unemployment Rate %	5.70	5.50	5.60	5.70
Brisbane CPI % change	2.70	3.30	2.80	3.20
Wage Price Index % change	3.30	4.00	4.00	4.40

Source: St.George Banking Group

Queensland Treasury expect gross state product to expand by 5.0% this financial year and 5.25% in 2012-13, after flat growth last financial year. As noted above, the more regular but narrower measure of economic activity is state final demand. On this measure, we expect state final demand to grow by 6.50% this financial year, after growing 3.20% last financial year.

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The Detail