Tuesday, 25 August 2015

Victorian Economic Outlook

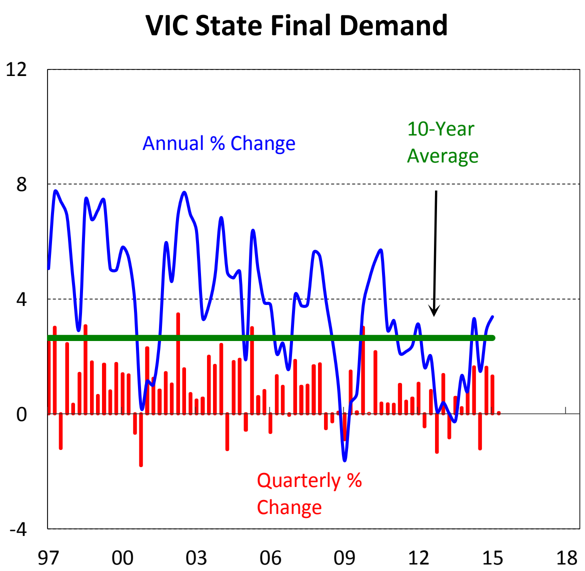
Summary

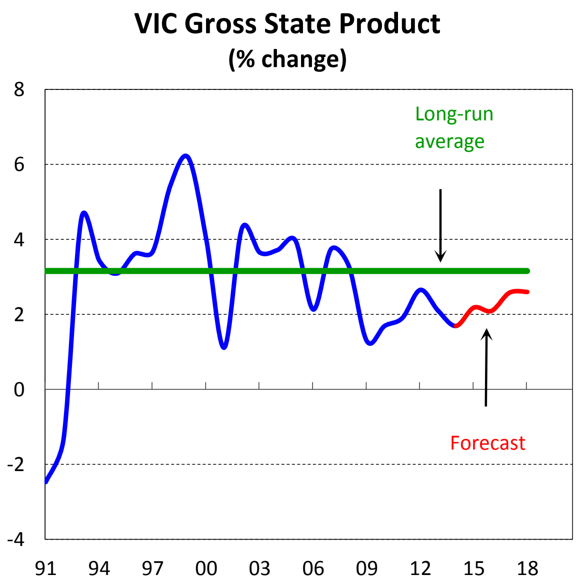
- The Victorian economy has had its fair share of headwinds in recent years, but the tide may be turning. For some time, we have been optimistic that the low interest rate environment and the weakening Australian dollar will support an improvement in Victoria's economy. This is increasingly becoming evident in spending and employment indicators.
- Consumer spending in Victoria has gained momentum in recent months. The solid growth in house prices in recent years combined with low interest rates are providing support to consumer spending.
- The upswing in Melbourne's housing market has continued over the past few years. Indeed in recent months, dwelling price growth has accelerated thanks to further reductions to interest rates earlier in the year, and supported further growth in dwelling investment.
- Business investment is improving, and the pickup in retail and employment, along with solid population growth, provide promising signs for the outlook. Business survey measures suggest uncertainty remains, but the lower Australian dollar will continue to provide support to Victorian businesses.
- Job growth in Victoria has been solid in recent months, and improved in step with a pickup in economic activity. A slowly improving economy suggests that further moderate job gains are in prospect and that Victoria's unemployment rate could be close to stabilising.
- There are some headwinds that still face Victoria's economy. It remains questionable how much longer Victoria can sustain its current high levels of residential building activity. This has been elevated for some time. The end of car manufacturing will also impact on activity and jobs in the State.
- We estimate the Victorian economy grew at an annual pace of 2.2% in 2014-15 after just 1.7% growth in 2013-14. Growth this year and next could continue to remain below its long-run average, but should continue at a moderate pace.

Percentage Shares of the Economy*		
Industries	**Victoria**	**Australia**
Financial and insurance services	12.2	9.9
Professional, scientific and technical services	9.7	7.5
Manufacturing	8.8	7.5
Health care and social assistance	8.1	7.6
Construction	7.5	9.4
Retail trade	6.6	5.3
Education and training	6.5	5.4
Wholesale trade	5.5	4.6
Transport, postal and warehousing	5.3	5.6
Public administration and safety	5.1	6.3
Information media and telecommunications	4.2	3.3
Rental, hiring and real estate services	3.2	3.2
Electricity, gas, water and waste services	3.1	3.2
Administrative and support services	3.1	3.3
Agriculture, forestry and fishing	2.9	2.7
Accommodation and food services	2.6	2.7
Mining	2.5	9.6
Other services	2.0	2.1
Arts and recreation services	1.1	0.9

** as % of Industry gross value added 2013-14, excluding ownership of dwellings*
Source: ABS, Bank of Melbourne

Economic Growth





The Victorian economy has had its fair share of headwinds in recent years, but the tide may be turning. For some time, we have been optimistic that the low interest rate environment and the weakening Australian dollar will support an improvement in Victoria's economy. This is increasingly becoming evident in spending and employment indicators. State final demand grew at its strongest annual pace in 4½ years at 3.4% in the March quarter, and that economic growth picked up in 2014-15.

That being said, there are also some headwinds that still face Victoria's economy. It remains questionable how much longer Victoria can sustain its high levels of residential building activity. This has been elevated for some time. The end of car manufacturing will also impact on activity and jobs in the State. There also continues to be uncertainty regarding the outlook for business spending. However, stronger retail and employment should help support investment, and the low Australian dollar is expected to further boost confidence and activity. Strong population growth and the buoyant housing market are also propping up economic activity.

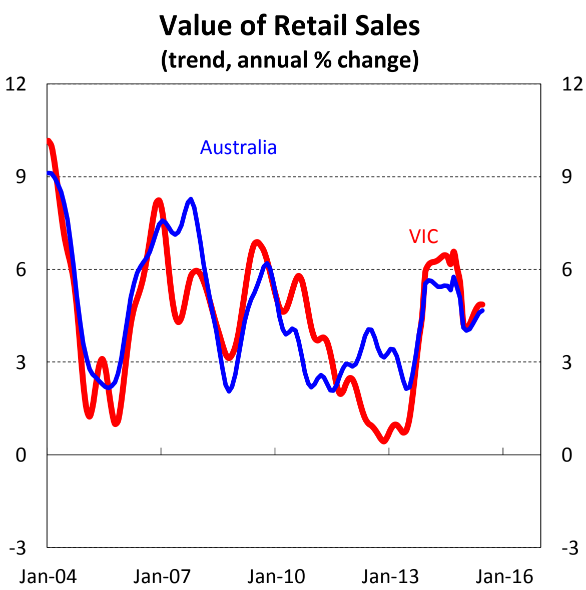
We estimate the Victorian economy grew at an annual pace of 2.2% in 2014-15 after just 1.7% growth in 2013-14. While an improvement, it remains below the long-run average pace of growth, and may remain so over the near term. Growth this year and next could continue to remain below its long-run average, but should continue at a moderate pace. (Please see page 8 for more detailed forecasts).

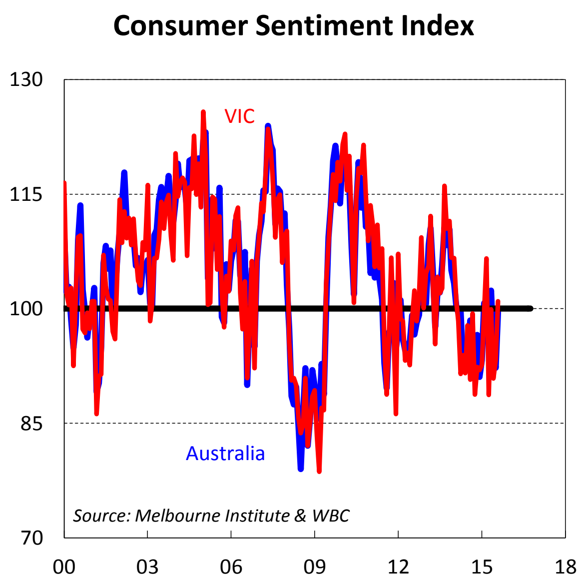
Consumer Spending

Consumer spending in Victoria has gained momentum in recent months, picking up to an annual pace of 2.8% in the March quarter. The solid growth in house prices in recent years combined with low interest rates are providing support to consumer spending. Annual growth was the strongest in three years and above the 10-year average of 2.5%.

The strongest growth in consumer spending over the year to the March quarter was for furnishings & household equipment (8.8%), largely reflecting elevated activity within the housing market. Other services such as communications (8.2%) and recreation and culture (6.8%) also recorded solid growth.

Retail spending data points to a further pickup in consumer spending in Victoria in recent months. Growth stood at 5.3% in June, which was the strongest in seven months, and above the long-run average of 4.2%.





With interest rates expected to remain near record lows for some time and house prices to rise further, we expect consumer spending in Victoria to be well-supported. A lift in consumer sentiment in August provides an encouraging sign that household spending will continue to grow at a moderate pace.

According to the Westpac-Melbourne Institute survey, consumer sentiment for Victoria rose to 101.0 in August, the first time the index has exceeded 100 (point where optimists outweigh pessimists) in five months.

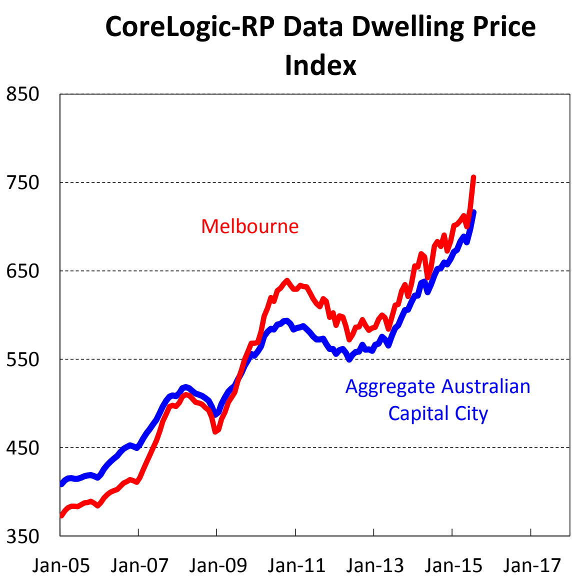
Soft income growth, however, remains a risk to the outlook, and could limit the capacity for households to increase spending. Nonetheless, the currently high level of household savings suggests that there is room for consumers to maintain a pace of spending stronger than growth in incomes. This would still require a sustained lift in confidence and ongoing improvement in the labour market.

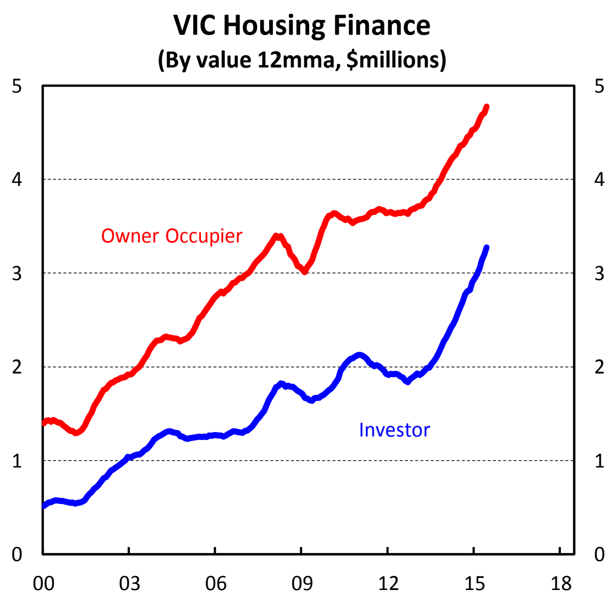
Housing

The upswing in Melbourne's housing market has continued over the past few years. Indeed in recent months, dwelling price growth has accelerated thanks to further reductions to interest rates earlier in the year. In July, dwelling prices rose 11.5% in the year, the strongest annual growth in 11 months. Growth exceeded the average for Australian capital cities which rose 11.1% over the same period.

Investors continue to be a major driver of demand. The proportion of new housing loans extended to investors is sitting at just above 40%, and annual growth to investors is at nearly 30%. Recent measures by APRA to temper investor housing demand could see growth moderate. However, investor demand should continue to be strong while interest rates remain low.

Owner-occupier demand is also being supported by low interest rates. Lending to owner occupiers grew at a moderate annual pace of 4.9% in June, and the number of loans has been above its long-run average for 26 consecutive months.





- **Rental Markets**

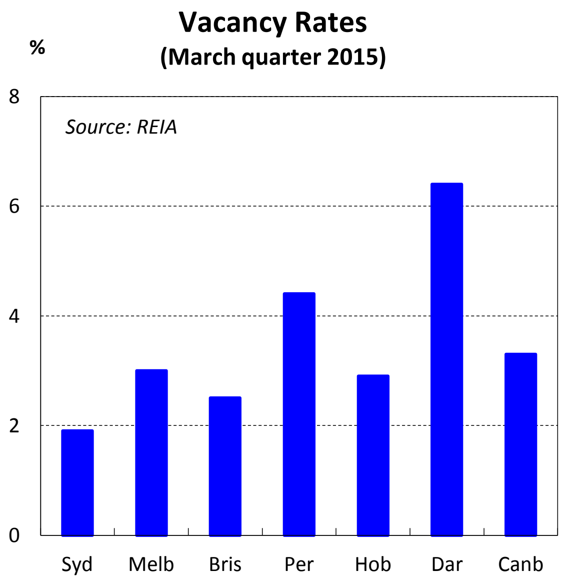
Rental markets have been near balanced, in Melbourne, despite the high level of building activity in recent years. Vacancy rates have been steady in Melbourne over the past year at 3.0% in the March quarter 2015 and signal a largely balanced market.

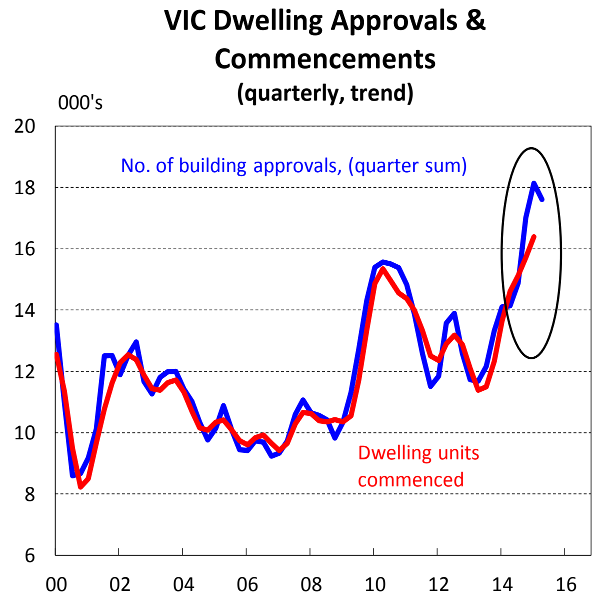
Rents have continued to increase modestly. In the March quarter, rents for a three-bedroom house and for two-bedroom units both rose at an annual pace of 2.6%.

The lift in rents and a balanced rental market point to little sign of oversupply. Strong population growth continues to support demand for housing. Nonetheless, the influx of new apartments still coming on line and strong investor take up suggests that vacancy rates are at risk of edging higher and limiting growth in rents.

- **Dwelling Investment**

Residential building has been relatively elevated in Victoria for many years, and is continuing to build more homes than any other State. In recent years, building activity has been supported by solid gains in dwelling prices, and driven further growth in residential construction. Dwelling investment in Victoria grew at an annual rate of 8.6% in the March quarter, the strongest in 3½ years. In the near-term, building approvals suggest further growth in residential building from its high level.





- **Outlook**

While strength of dwelling investment in Victoria has been somewhat surprising, it remains questionable for how much longer Victoria can sustain such high levels of building activity. The buoyant growth in Victoria's population is a major support for Victorian housing. As long as interest rates remain near record lows, (and they seem likely to remain low for at least another year,) house prices will continue to rise and dwelling investment will remain elevated.

At some point house prices will moderate, particularly given the given the steady lift in supply over the past few years. While we expect further growth for the remainder of this year and next, we anticipate that this will be at a more moderate pace.

Business Investment

Business investment in Victoria has picked up in recent quarters. The transition from mining to non-mining parts of the Australian economy has translated to an improvement business investment in Victoria. The annual pace of growth in business investment lifted to 10.1% in the March quarter, the strongest in 1½ years.

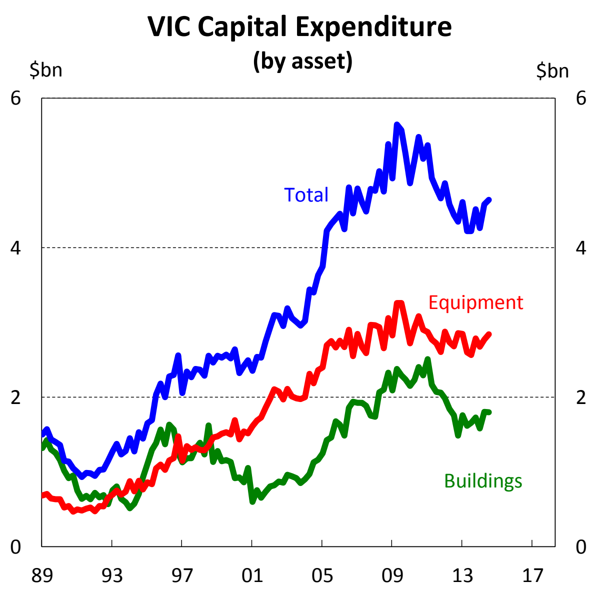
This recovery however, remains tentative as businesses have indicated that they remain cautious about the outlook. According to the ABS capital expenditure survey, non-mining investment Australia-wide is set to decline in 2015-16. Further, business surveys continue to point to uncertainty.

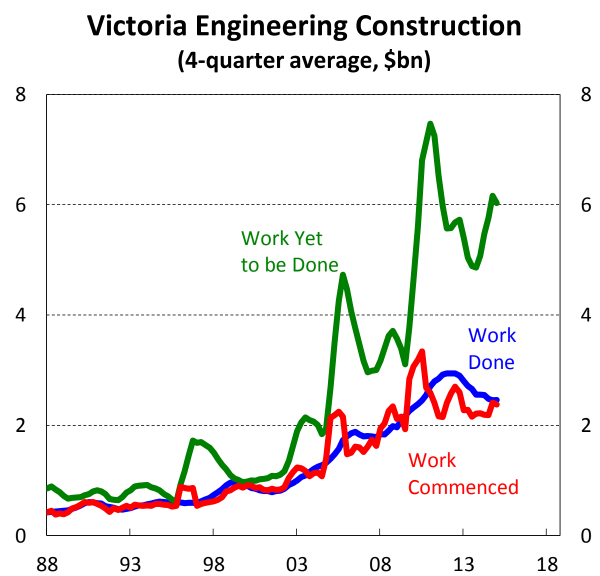
According to the VECCI-Bank of Melbourne survey of business trends and prospects, business sentiment regarding the Victorian economic outlook weakened slightly in the June quarter. A total 15% of respondents expect Victorian economic conditions will improve in the year ahead, down from 17% in the previous survey. The majority of respondents expect economic conditions to remain unchanged.

There are signs, however, that the business investment outlook will continue to recover. Better conditions in retail and the labour market suggest better prospects within commercial construction. The lower currency should also support exports and assist in boosting competitiveness domestically while strong population growth should help underpin economic activity.

The near-term pipeline for both engineering and commercial construction appears promising. Within engineering construction, there is a $1.3bn project to widen the CityLink and Tullamarine Freeways and the $5.5bn Western Distributor road project. While the $14bn East West Link has been shelved, the new State government is planning a $6bn Metro Rail project and $11bn towards underground rail tunnels and new stations across Melbourne CBD.

Within commercial construction, a healthy level of office projects is in the pipeline or under way including a $265mn 80 Collins Street Office Tower, development at Collins Square and the Wesley Church Site Office Development worth $250mn.





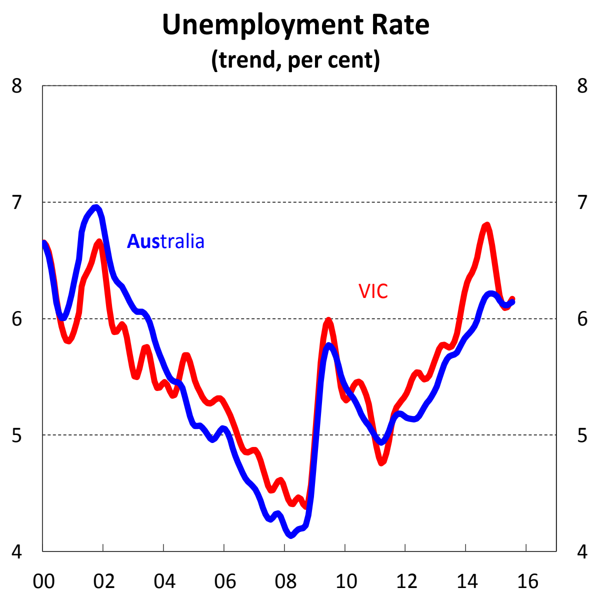
Labour Market

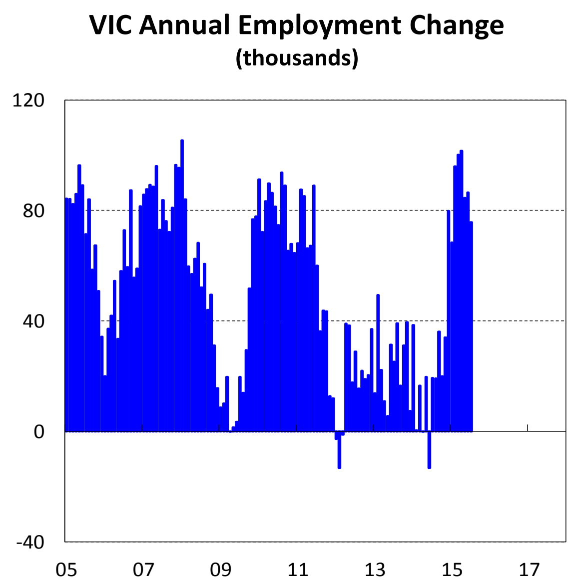
Job growth in Victoria has been solid in recent months, and improved in step with a pickup in economic activity. In the year to July, Victoria's labour market added a 75.7k jobs or grew by 2.6%. Although this was down from a recent peak of 101.6k in April, it remains a solid pace of growth.

Despite the pickup in job growth, Victoria's unemployment rate edged higher to 6.4% in July, down from a recent low of 6.0% in June. However, its unemployment rate is lower than a year ago, which stood at 6.9% in July 2014.

Job gains in Victoria have been concentrated in services. The strongest job gains in the year to May were in professional, scientific and technical services (27.9k), administrative & support services (21.0k) and accommodation & food services (18.2k). The manufacturing industry also managed to see job creation, adding 14.3k over the year to May, despite the well-publicised challenges within the car manufacturing industry. Job losses occurred in agriculture, forestry & fishing (-13.7k), financial & insurance services (-9.7k) and healthcare & social assistance (-9.6k) over the same period.

There remain downside risks to the employment outlook. The cessation of local motor vehicle production is one of these risks, and will affect Victoria more than other States as the majority of workers employed in the industry are located in Victoria. Additionally, given the economy is expected to grow below its long-run average over the next few years, there is a risk that job growth could weaken. However, a slowly improving economy suggests that further moderate job gains are in prospect and that Victoria's unemployment rate could be close to stabilising.





Bank of Melbourne Forecasts

Economic Indicators, % Change				
	2014-15 (f)	2015-16 (f)	2016-17 (f)	2017-18 (f)
Gross state product (GSP)	2.20	2.10	2.60	2.60
State final demand	2.30	1.90	2.50	2.50
Employment	2.20	1.80	1.60	1.60
Unemployment rate	6.40	6.40	6.30	6.20
Melbourne CPI	2.00	2.60	2.70	2.70
Wage Price Index	2.70	2.60	2.80	2.90

Source: Bank of Melbourne

After growth of 1.7% in 2013-14, we expect that growth picked up to 2.2% in 2014-15. Further modest growth is expected for 2015-16. Low interest rates and the lower AUD should continue to provide support to the broader Victorian economy over the next few years.

Contact Listing

Chief Economist

Hans Kunnen
kunnenh@bankofmelbourne.com.au
(02) 8254 8322

Senior Economist

Jo Horton
hortonj@bankofmelbourne.com.au
(02) 8253 6696

Senior Economist

Janu Chan
chanj@bankofmelbourne.com.au
(02) 8253 0898