State Economic Report

Thursday, 19 December 2013

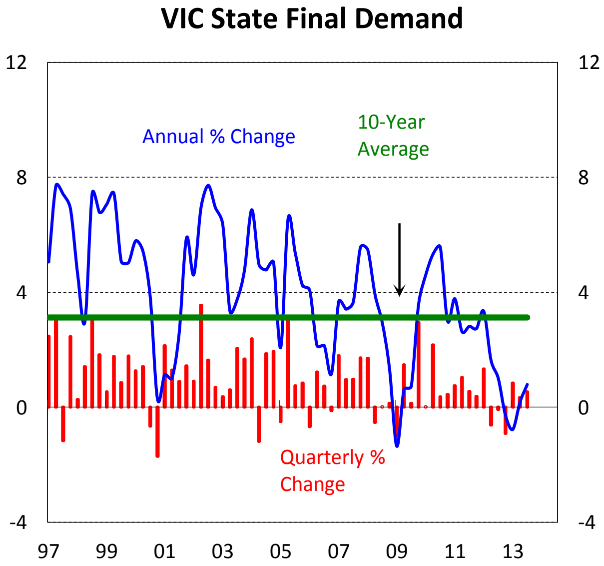
Bank of Melbourne

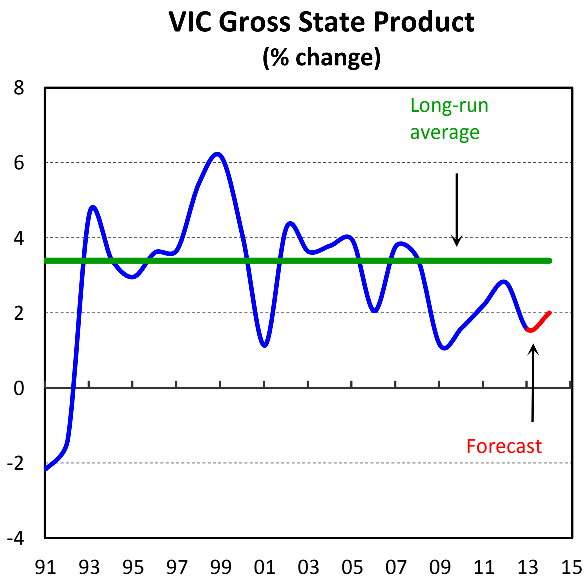
Victorian Economic Outlook

Summary

- Victorian economy will likely remain in third gear over the next twelve months. The high Australian dollar has restrained the economy, given many key sectors are dependent on the currency, including education and travel and manufacturing.
- Despite recent challenges, there are growing signs that the Victorian economy is improving. Low interest rates are providing support to consumer spending and the housing sector. Additionally, a weaker Australian dollar is also alleviating Victoria's trade-exposed sectors.
- After growth of 1.6% in 2012-13, we expect the pace of growth in Victoria to remain below trend, but to pick up in 2013-14 as low interest rates takes further effect and provide support to the broader Victorian economy.
- Strong population growth, low interest rates and improved affordability should continue to support house prices in Melbourne. After estimated growth of around 7 per cent in 2013, we expect moderate growth in Melbourne house prices next year. The upswing in house prices should keep residential construction activity at an elevated level.
- Soft conditions in the labour market have resulted in a gradual rise in Victoria's unemployment rate. An improvement in business confidence and a pickup in economic activity should eventually result in greater hiring activity. However, a modest pace of job growth is likely to continue into early next year. Therefore, we are likely to see the unemployment rate edge higher and peak some time mid next year.
- The VECCI-Bank of Melbourne Survey of Business Trends and Prospects is suggesting that businesses are much more confident about the outlook. Of respondents surveyed in the September quarter, 32 per cent expect the Victorian outlook to strengthen in the coming year, up 15 percentage points on the June quarter. Additionally, a lower proportion of respondents are expecting the Victorian economy to weaken down from 34 per cent in the June quarter to 17 per cent in the September quarter.

Economic Growth





The Victoria economy has had its fair share of challenges over the past year. The high Australian dollar has been a constraint, given many key sectors are dependent on the currency, including education and travel and manufacturing.

Percentage Shares of the Economy*

Industries	Victoria	Australia
Financial and insurance services	12.3	9.3
Professional, scientific and technical services	9.6	7.7
Manufacturing	9.4	7.9
Health care and social assistance	8.3	7.4
Construction	7.0	8.8
Education and training	6.4	5.3
Retail trade	6.2	5.3
Transport, postal and warehousing	5.5	5.6
Wholesale trade	5.5	4.9
Public administration and safety	4.9	6.0
Information media and telecommunications	3.8	3.1
Administrative and support services	3.8	3.4
Rental, hiring and real estate services	3.2	3.0
Agriculture, forestry and fishing	2.9	2.4
Accommodation and food services	2.8	2.7
Electricity, gas, water and waste services	2.7	2.9
Mining	2.3	11.2
Other services	2.2	2.0
Arts and recreation services	1.2	0.9

**as % of Industry gross value added 2012-13, excluding ownership of dwellings*

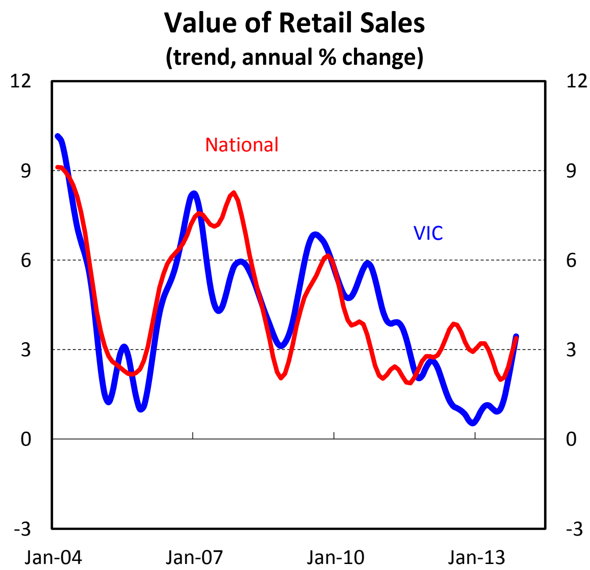
Source: ABS, Bank of Melbourne

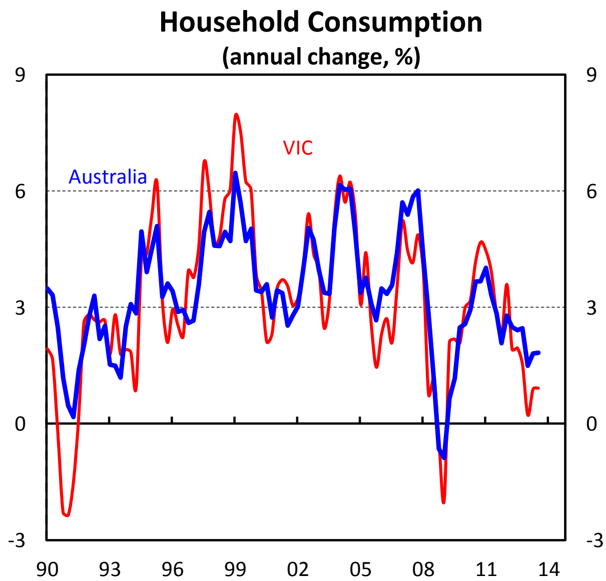
Reflecting these challenges, the Victorian economy slowed from 2.8% in 2011-12 to a lacklustre pace of 1.6% in 2012-13. However, more recent data is suggesting that demand is improving, albeit from a low base. State final demand grew 0.5% in the September quarter, which saw annual growth lift to 0.8%. Although annual growth in State final demand remains soft, it has improved from the annual decline early this year.

Low interest rates are providing support to the housing sector and consumer spending. Additionally, a lower Australian dollar should ease the pressure on Victoria's trade-exposed sectors. We expect that Victoria will witness further improvement as low interest rates take further effect and flow on to other parts of the economy. A number of road and rail infrastructure projects are in the pipeline and will help boost demand and the prospect for a weaker Australian dollar will also provide further relief for education, tourism and manufacturing.

After growth of 1.6% in 2012-13, we expect the Victorian economy to improve this year and for growth to pick up to 2.0% in 2013-14, although remaining below trend. The Victorian Treasury is forecasting similar growth in 2013-14. (Please see page 9 for more detailed forecasts).

Consumer Spending





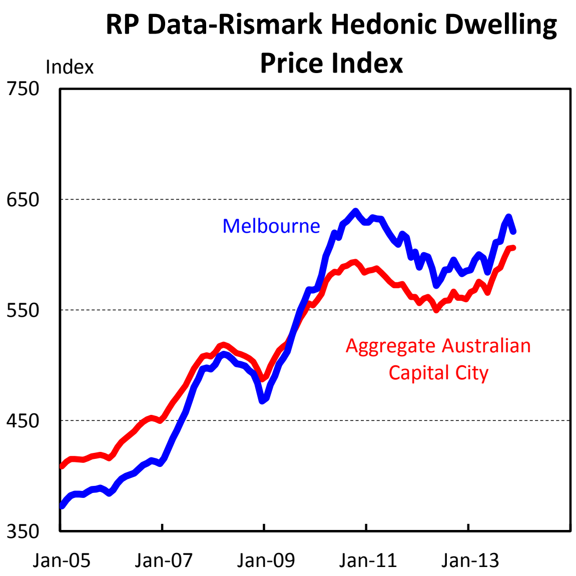
Household consumer spending across Australia and Victoria has been slow to pick up despite the successive interest rate cuts from the RBA since late 2011, rising house prices and share markets and an improvement in confidence.

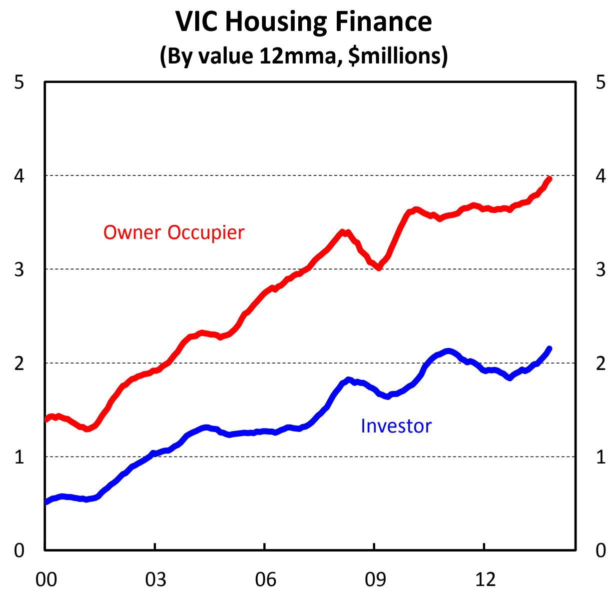
Consumer spending in Victoria has been modest, rising 0.3% in the September quarter for annual growth of 0.9%. Annual growth is well below long-run average of 3.0%. By comparison, Australian consumer spending rose 1.8% in the year to the September quarter.

There are more recent signs however, that consumers are responding to rising household wealth and lower interest rates and are starting to open their purse strings. Retail sales growth is also showing signs that Victorian consumers are becoming a bit more willing to spend. Annual growth in the year to October lifted to 4.0%, the strongest in nearly 2 ½ years. Although retail spending growth is picking up, it remains below the long-run average growth of 4.3%.

The recovery in retail sales recent months is encouraging, and points to a further pickup in household spending. Rising house prices, share market gains and low interest rates provide a positive backdrop for further improvement. A lift in consumer sentiment in recent months also provides a promising sign that consumer spending will improve. Consumer sentiment in Victoria stood at 106.7 in December, which was 6.6% higher on a year ago. Optimists have outweighed pessimists for several months. Victorians were also more optimistic than nationwide; the index for Australia stood at 105.0 as of December.

While we expect an improvement, ongoing concerns regarding job security and a lingering reluctance to take on debt since the GFC suggest that consumption will only grow modestly.





Housing

Housing markets across Australian capital cities and Melbourne have gained momentum over the past year and house prices are now in a clear upswing. According to RP Data-Rismark, dwelling prices in Melbourne gained 6.6% in the year to November. The annual pace of growth was the third best performing among capital cities, behind Sydney and Perth. By comparison, Australia-wide, capital city average dwelling price growth rose 8.0% in the year to November.

The Australian Bureau of Statistics (ABS) measure of house prices also grew by a similar amount for Melbourne. House prices lifted 6.8% in the year to the September quarter, the third consecutive quarter of positive annual growth.

Investors have been a significant driver of housing demand across Australia and in Victoria. However, owner occupier demand is also strengthening. Financing for owner-occupier housing in Victoria witnessed double-digit annual growth for four consecutive months to October.

Owner occupiers are benefiting from improved housing affordability. According to the CBA-HIA, housing affordability is at its highest in several years in both Victoria and Melbourne. Lower interest rates and higher incomes are more than offsetting higher dwelling prices.

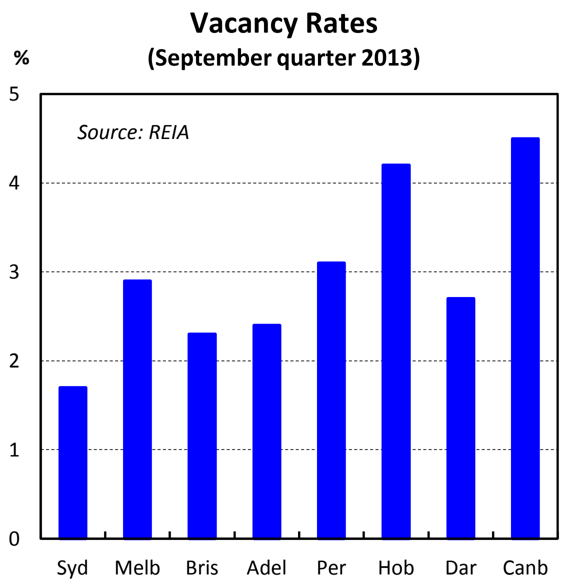
The exception has been first-home buyers, which as a proportion of all dwellings financed fell 11.7%, a record low in September. The drop in first home buyer demand is largely policy driven. As of 1 July 2013, the $7k first home owner grant for established homes was abolished. First-home buyers purchasing a new home will still receive the grant, which was increased to $10k from 1 July 2013. The end of the first-home buyers' grant for established homes in Victoria will be partially offset by a discount in stamp duty for first home buyers for properties valued up to $600k. A 40% reduction in stamp duty took effect from 1 July 2013 (previously 30%) and 50% in from 1 September 2014.   The discounts have been progressively increased since 1 July 2011 and continue to apply to first-home buyers of established homes.

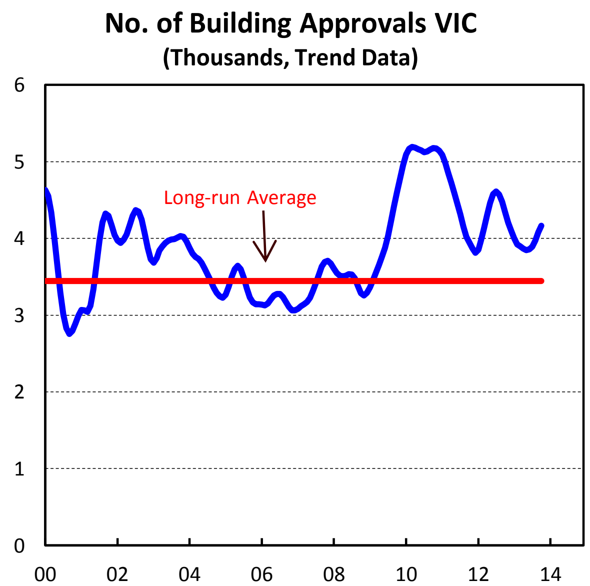
- **Rental Markets**

Investor demand has been solid in Victoria, despite Melbourne rental yields being lower on average than other capital cities across Australia. Nonetheless, rental returns on residential investment in Melbourne remain relatively attractive given interest rates are low and investors are likely attracted by the prospect of capital gains.

Rental markets in Melbourne have stabilised over the past year. In the year to the September quarter, rents on a three-bedroom house lifted a modest 1.5% to $345 per week, according to the Real Estate Institute of Australia (REIA). Similarly, rents on two-bedroom units rose by a modest amount, by 1.4% in the year to the September quarter.

Vacancy rates at 2.9% in the September quarter suggests that the rental market in Melbourne is close to balanced, and suggest that further strong increases in rents are unlikely.





- **Dwelling Investment**

Residential dwelling investment in Victoria has softened this year. Dwelling investment has slowed from annual growth of 7.4% in the year to the December quarter 2012 to an annual pace of 0.2% in the year to the September quarter in Victoria. However, the slowdown in part reflects a return to more sustainable levels of activity. Rising house prices should, however, keep residential construction activity at healthy levels. Building approvals have stabilised at a level above the long-run average, suggesting that relatively high levels of residential building activity should be sustained. Recent changes to first-home buyers' incentives favouring newly constructed homes may provide some support to residential building over the next year. However, dwelling investment may not provide as large a contribution to growth in Victoria in comparison to other States.

- **Outlook**

The supply constraints that affect other parts of the country are not so evident in Victoria and Melbourne, where there have been relatively higher levels of building activity in previous years. However, strong population growth will ensure that demand for housing in Victoria is well-supported. Low interest rates, improved affordability and ongoing investor interest will support demand.

High auction clearance rates in Melbourne also suggest that demand for housing is currently solid and imply that the upswing has further to run. We expect further gains in house prices in Melbourne over 2014 but it is unlikely to perform as well as some other capital cities which are experiencing housing shortages and where rental returns are higher. After an estimated 7% growth in house prices in 2013, we expect growth in 2014 of between 5 to 7%.

Longer-term, Melbourne should continue to attract residents which will help underpin demand for housing. Melbourne was named the most liveable city in the world for the third consecutive year by the Economist Intelligence Unit in 2013. This title reflects Melbourne's high global standards of stability, healthcare, culture and environment, education and infrastructure.

Business Investment

Australian business investment is beginning to plateau, as growth in mining investment slows. Current information from the ABS and the project listings from the Bureau of Resource and Energy Economics (BREE) are suggesting that the decline in mining investment will be gradual. Nonetheless, non-mining investment has been lacklustre and this has been evident in business investment in Victoria.

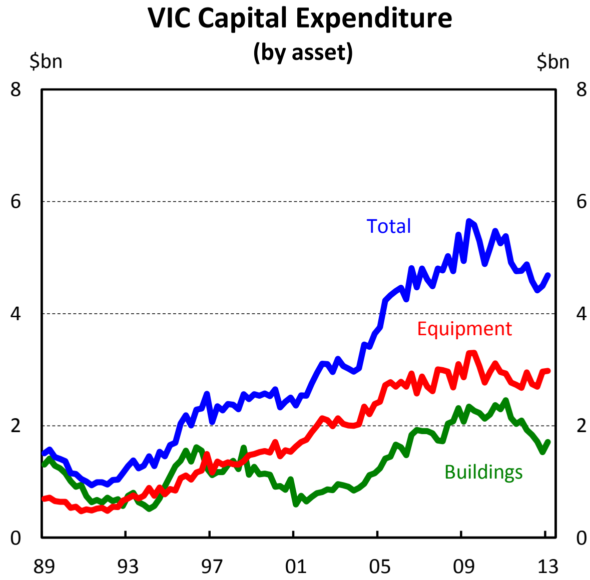
Business investment fell 3.4% in the year to the September quarter in Victoria. It was the fourth consecutive quarter the annual rate was in decline. However, there are signs that business investment in Victoria will pick up, albeit gradually.

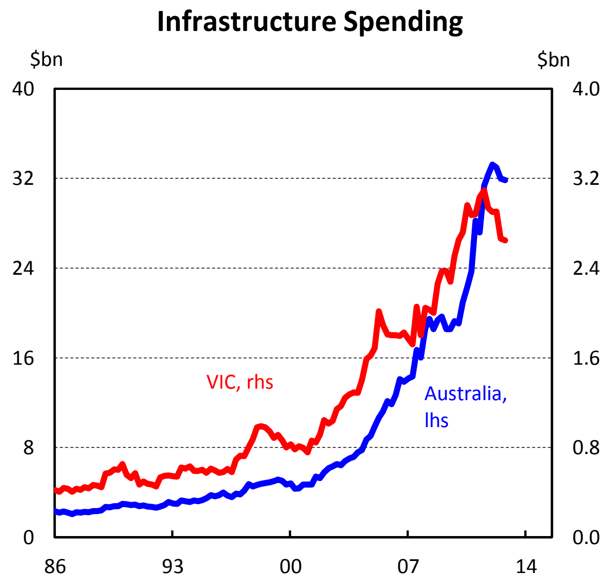
Business confidence in Victoria has improved. According to the VECCI-Bank of Melbourne survey of business trends and prospects expectations for the performance of both the Australian and Victorian economies have improved significantly in the September quarter. The percentage of respondents expecting stronger conditions in Victoria over the next 12 months increased from 17% to 32%. Weaker conditions were expected by 17% in the September quarter, down from 34% in previous quarter. The weaker Australian dollar is also alleviating some of the pressure from trade-exposed industries, although it remains at a high level.

While the pipeline of private sector major projects remains small, there are some major rail and road projects in prospect that have been facilitated by the Victorian State government. These include the EastWest link, connecting the Eastern Freeway and Western Ring Road. The first stage is estimated to be worth $6-8 billion and is scheduled to commence in late 2014.

Other projects include the $5.3bn Regional Rail Link from West Werribee to Southern Cross Station. Further down the track, an expansion to the Port of Hastings is in the early stages of planning. The project is estimated to cost around $12bn and could potentially come on line in 2018.

The various project initiatives from the State government are to be funded from a combination of both private and publicly-sourced funds. Government funded infrastructure is projected to increase from $5.4bn to $5.8bn in 2013-14 and lift to $7.2bn in 2014-15.



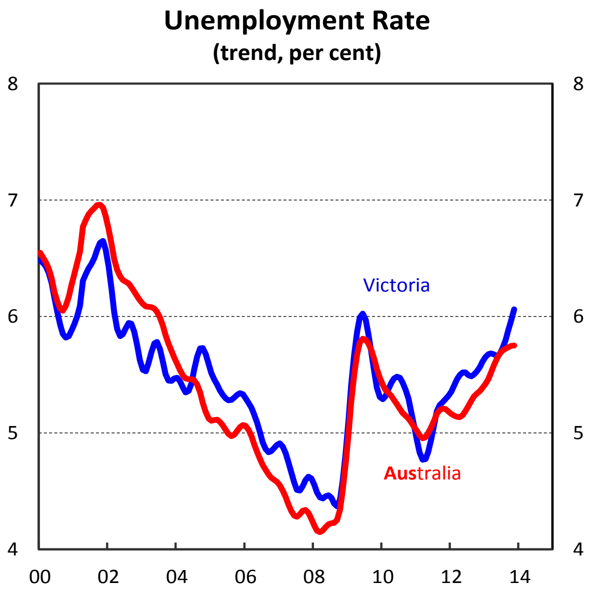


The outlook for commercial construction is also for modest improvement after lacklustre activity in recent years. A number of projects are due to commence in 2013-14 across most sectors including retail, accommodation and warehouses. Commencements in the healthcare sector will be boosted by the $600mn New Bendigo Hospital and the $180mn Deakin University Epworth Hospital. Additionally, there is the $200mn first phase of the Melbourne Airport Southern Precinct due to start.

Victorian State Budget Update

The Victorian State Government is expecting to deliver a $762.9mn surplus in 2013-14 and has estimated budget surpluses in each fiscal year to 2016-17. Given that most cuts to government spending have already occurred, the drag on the Victorian economy from fiscal consolidation from State government spending should be less in coming years.

Victoria holds a triple-A credit rating with stable outlooks from both Moody's and Standard and Poor's.



Labour Market

The conditions in Victoria's labour market broadly mirror those in the Australian labour market – soft job growth that has resulted in a gradual rise in the unemployment rate.

In the year to November, Victoria added 33.4k jobs, more than any other State. However, despite relatively strong job gains, growth hasn't been strong enough to prevent the unemployment rate from rising to 6.2% in November (up from sub 6% earlier in the year).

The breakdown of employment by industry is suggesting that lower interest rates are helping to support the labour market. In the year to August 2013, most jobs have been created in construction (33.6k), which is linked to the interest rate-sensitive housing sector. Professional, scientific and technical services (24.7k), public administration & safety (18.5k) and healthcare and social assistance (11.7k) also added a large proportion of new jobs in Victoria. The largest job losses in the year to August were in wholesale trade (-26.5k), followed by the manufacturing industry (-24.0k), which has been facing a number of headwinds in recent times.

An improvement in business confidence and a pickup in economic activity should eventually result in greater hiring activity. However, a modest pace of job growth is likely to continue into early next year. Therefore we are likely to see the unemployment rate edge higher and peak sometime mid next year.

Bank of Melbourne Forecasts

Economic Indicators, % Change				
	2011-12	**2012-13**	**2013-14 (f)**	**2014-15 (f)**
Gross state product, constant prices	2.80	1.60	2.00	2.60
State final demand	2.60	0.00	1.80	2.20
Employment	0.40	0.80	1.20	2.10
Unemployment rate	5.30	5.60	6.00	5.80
Melbourne CPI	2.30	2.30	2.40	2.50
Wage Price Index	3.50	3.30	2.90	3.10

Source: Bank of Melbourne

After growth of 1.6% in 2012-13, we expect growth in Victoria to remain below trend, but to pick up in 2013-14 as low interest rates takes further effect and provide support to the broader Victorian economy.

Contact Listing

Chief Economist

Besa Deda
dedab@bankofmelbourne.com.au
(02) 8254 3251

Senior Economist

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

Senior Economist
Josephine Horton
hortonj@bankofmelbourne.com.au
(02) 8253 6696

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