State Economic Report

Thursday, 22 November 2012

Bank of Melbourne

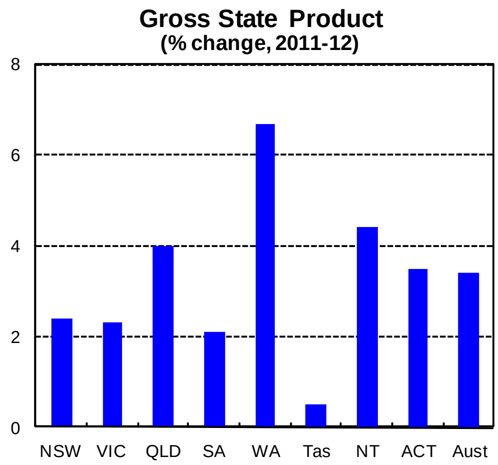
Victorian Economic Outlook

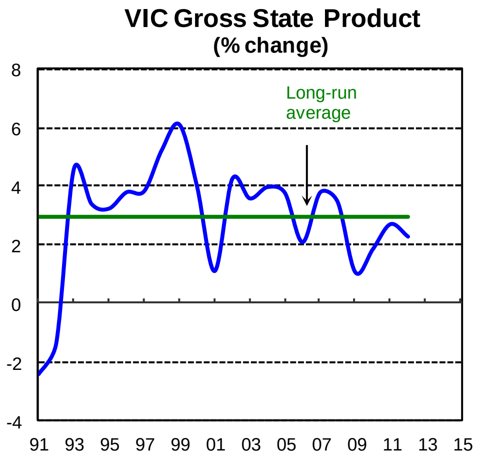
Summary

- The Victorian economy has been through difficult conditions over the past few years. GSP grew by 2.3% in 2011-12, easing from growth of 2.7% in 2010-11, and remains below the long-run average of 3.0%. By comparison, Australian GDP grew by 3.4% in 2011-12.
- The high Australian dollar is one of the major headwinds that have impacted negatively on Victoria's manufacturing, education and tourism sectors which are some of Victoria's key areas. Additionally, Victoria has not witnessed the same benefit from the run up in the terms of trade as some other States.
- House prices have shown some tentative signs of stabilising in Melbourne, although they have continued to underperform Australia-wide house prices. Dwelling construction may also be in the improvement lane. We expect the housing market in Victoria to stabilise further and for house prices to rise moderately in coming months.
- The VECCI-Bank of Melbourne Survey of Business Trends and Prospects suggests that difficult conditions remain for Victoria. A net 9% of respondents reported weaker business conditions over the September quarter. Business confidence in the Victorian economy was also weak, although there has been improvement in the September quarter. A total 51% of respondents expecting weaker conditions for the State economy in the year to September 2013. In contrast, 11% of respondents expect the State economy to strengthen over the same period.
- The Victorian economy will likely continue to face the challenges of the high Australian dollar and an uncertain global outlook, but there are some promising signs. The five rate cuts since November 2011 appear to have had some impact on the economy, albeit still tentative. Although there is the risk that the prolonged caution of consumers and businesses will continue weigh on spending and employment, the RBA has hinted it is keen to support some of the softer areas of the economy, and should adjust monetary policy accordingly. Victoria is therefore, one of the States set to benefit. On balance, growth in the Victorian economy is likely to remain below trend in 2012-13 before picking up in 2013-14.

Percentage Shares of the Economy*		
Industries	**Victoria**	**Australia**
Financial and insurance services	14.6	11.1
Manufacturing	9.9	8.6
Professional, scientific and technical services	9.1	7.5
Health care and social assistance	7.6	6.9
Construction	6.9	8.7
Retail trade	6.3	5.1
Education and training	6.1	4.9
Transport, postal and warehousing	5.7	5.7
Wholesale trade	5.5	5.1
Public administration and safety	4.5	5.7
Information media and telecommunications	4.1	3.3
Administrative and support services	3.2	2.7
Agriculture, forestry and fishing	3.0	2.7
Accommodation and food services	2.7	2.7
Rental, hiring and real estate services	2.6	2.4
Electricity, gas, water and waste services	2.4	2.7
Mining	2.4	11.3
Other services	2.2	2.1
Arts and recreation services	1.2	0.9

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





Economic Growth

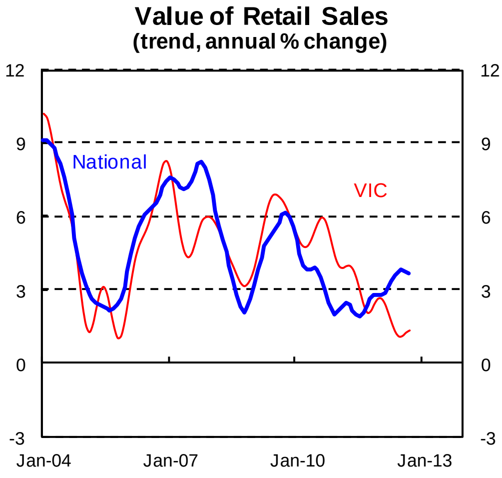
The Victorian economy has been through difficult conditions over the past few years. GSP grew by 2.3% in 2011-12, easing from growth of 2.7% in 2010-11, and remains below the long-run average of 3.0%. By comparison, Australian GDP grew by 3.4% in 2011-12.

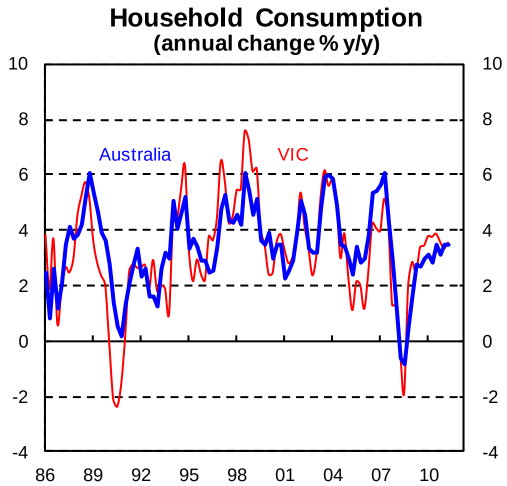
The high Australian dollar is one of the major headwinds that have impacted negatively on Victoria's manufacturing, education and tourism sectors which are some of Victoria's key areas.

Additionally, Victoria has not witnessed the same benefits from the run up in the terms of trade seen in some other States. Business investment grew by a modest 2.3% in the year to June 2012, but the pace of growth has lagged behind the likes of Queensland and Western Australia.

The Victorian economy will likely continue to face the challenges of the high Australian dollar and an uncertain global outlook; however there are some promising signs. The five rate cuts since November 2011 have begun to have some impact on the housing market. As the stimulus from lower interest rates continues to flow on to the economy, with the possibility of another rate cut in the pipeline, we expect to see further signs of stabilisation in housing. There is the risk that the prolonged caution of consumers and businesses will continue to weigh on spending and employment. However, the RBA has hinted it is keen to support some of the softer areas of the economy, and should adjust monetary policy accordingly. Victoria is therefore, one of the States set to benefit.

After below-trend growth of 2.3% in 2011-12, we expect a similar outcome of 2.4% in 2012-13, before picking up close to trend growth of 2.8% in 2013-14. The Victorian Treasury's latest forecasts published in May were for below trend economic growth of 1.75% in 2012-13 and for growth to pick up close to trend growth of 2.75% in 2013-14 and subsequent years. (Please see page 8 for more detailed forecasts)





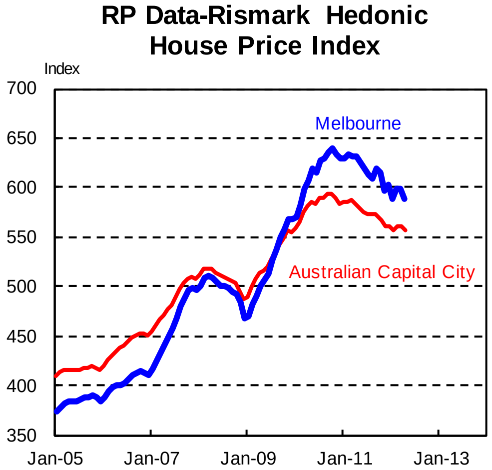
Consumer Spending

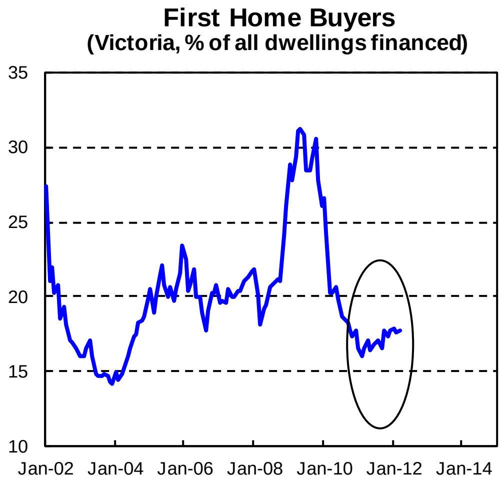
After a brief and slight pickup earlier in the year, retail sales growth has been subdued in Victoria, rising by just 1.5% in the year to September. It has remained well below the long-run average of 5.0% for over a year, and retail sales nationally where the value of retail sales grew by 3.6% in the year to September.

Household final consumption expenditure in Victoria, a much broader measure of consumer spending, is however, growing at a healthier pace, rising by 3.1% in the year to June, and is close to long-run average growth of 3.2%. However, the annual pace of household consumption growth Australia-wide is stronger, growing at 4.0% in the year to June.

The outlook for consumer spending is mixed. Further stabilization in house prices and lower interest rates will be supportive factors for consumer spending, although concerns about the labour market and the global outlook are continuing to weigh on sentiment. Additionally, household debt levels remain high and might keep consumers from 'spending up'.

Consumer sentiment surveys however, are suggesting that householders are beginning to be more optimistic about the outlook, and that interest rates are finally having some impact on the economy. The Westpac-Melbourne Institute consumer sentiment index in Victoria has lifted to a reading of 109.3 in November, 7.6% higher than in October and 12.3% higher than a year ago. The index has now been above 100 for two consecutive months, suggesting that Victorians have become more optimistic than pessimistic. Consumers in Victoria also appear more positive than consumers Australia-wide. By comparison, the consumer sentiment index for Australia stood at 104.3 in November.





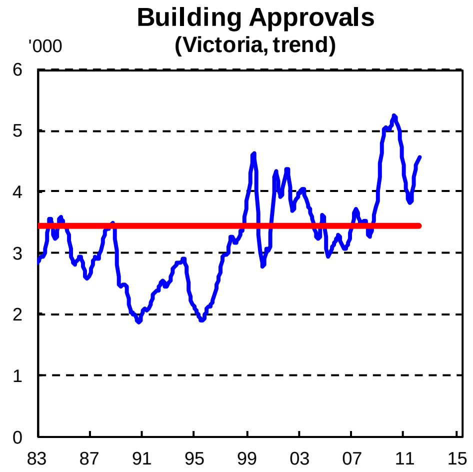
Housing

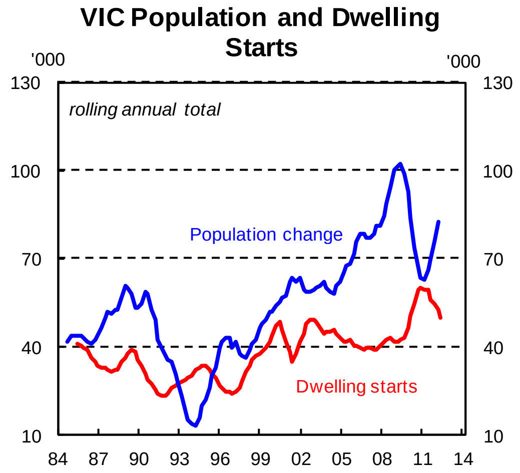
Dwelling prices in Melbourne have declined over the past year. Weakness in house prices was seen in 2011 and early 2012, however, this followed a period of strong growth (on a national and historical comparison) through 2009-10. The pace of decline has eased since mid-year, with dwelling prices falling 4.4% in the year to October, up from a recent trough of -8.4% in the year to May, according to data from RP Data-Rismark. Melbourne dwelling prices have increased in four of the past five months, with lower interest rates from the RBA likely supporting demand.

According to the Australian Bureau of Statistics (ABS), Melbourne house prices slowed sharply from a peak of 26.3% annual growth in the March quarter 2010, to be down 5.6% in the year to December 2011. Since then, Melbourne house price declines have moderated, so that house prices are down 2.3% in the year to September 2012. In the September quarter, Melbourne house prices eked out a small increase of 0.2%, the first quarterly increase in ABS house prices since June 2011.

Population growth in Victoria slowed in early 2011, however, the pace of growth has picked up since then, rising to 1.5% in the year to the March quarter 2012, up from a recent low of 1.1% in the year to March 2011. This improvement in population growth should support demand for housing.

Dwelling construction fell sharply in response to moderating house prices in late 2011, following on from very strong growth in 2010 and early 2011. Dwelling starts now appear to be stabilizing, rising 2.8% in the June quarter, the first quarterly increase in a year. Despite falling 17.8% in the year to June, the number of dwelling starts remains well above their decade average. Building approvals remain very volatile, both nationally, and in Victoria. However, looking through this 'noise' there appears to be an upward trend. Building approvals are up 22.2% in the year to September and in trend terms the annual growth in building approvals has been in positive territory for four consecutive months.



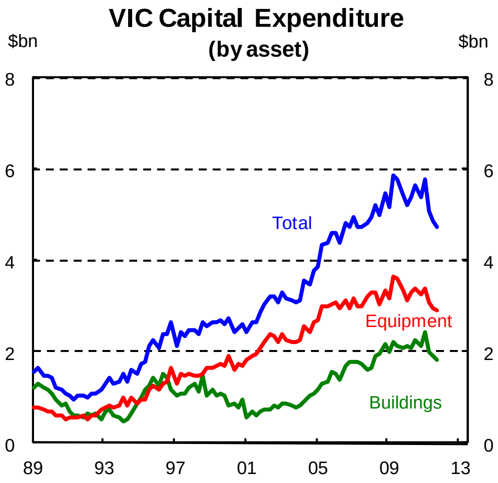


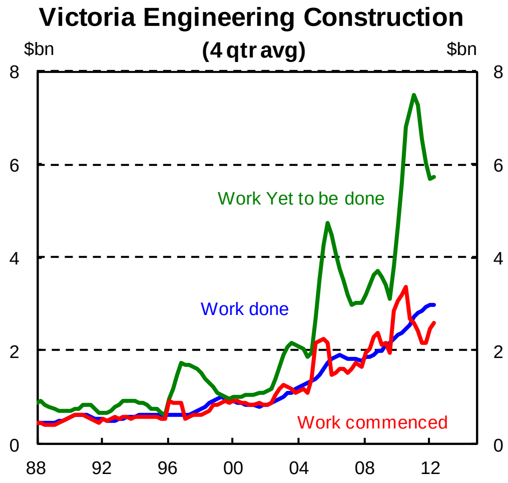
Encouragingly, there has been a pickup in first home buyer activity in Victoria. First home buyer demand is important for driving a recovery in housing, as it provides a market for those wanting to upsize and adds liquidity to the market.

A reduction in stamp duty of 20% for first home buyers since 1 July 2011 for properties valued up to $600,000 may have assisted in boosting first home buyer demand. The State government is also intending to progressively reduce stamp duty further to a combined 50% reduction by 1 September 2014. These measures will be partly offset by expiring incentives for first-home buyers purchasing a newly constructed home. As of 1 July, first home buyers will no longer receive $13k for buying a new property in Melbourne, and will no longer receive an additional $6.5k for new properties in a regional municipality in Victoria.

Rents in Melbourne have remained flat over the past quarter according to the Real Estate Institute of Australia (REIA). In the year to the June quarter 2012, weekly rents were unchanged for three-bedroom houses and grew by 2.9% for 2-bedroom units. Vacancy rates remain very low at 1.8%, which represents a "super-tight" rental market, and suggests that rents have further to rise.

Another positive for the Melbourne housing market and for economic growth is its accolade of being the most liveable city in the world, according to the Economist Intelligence Unit. The rating is based on stability, healthcare, culture and environment, education and infrastructure, and suggests that population growth should remain well-supported. House prices in Victoria are likely to stabilise further and begin to rise moderately in coming months. Concerns about job security and ongoing householder caution could keep potential home buyers sidelined; however lower interest rates and stronger population growth should be supportive factors for house prices. The RBA has delivered 5 rate cuts in the past 12 months and average lending rates are now below their medium-term average.





Business Investment

The Australian economy continues to benefit from the mining boom as it moves through the investment phase. There remain large amounts of business investment in the pipeline, comprised of capital spending, non-residential and engineering construction. Strong growth in capital expenditure and engineering construction has underpinned Australia's investment boom, while non-residential construction activity has been subdued. While lower commodity prices have seen some investment projects shelved, the level of mining investment is likely to be strong over the coming year, on a historical comparison.

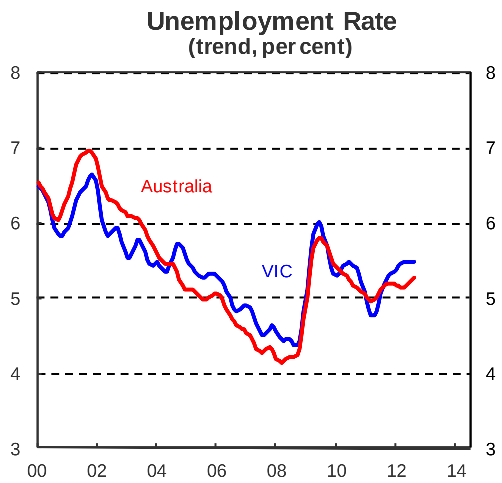
In Victoria, the pace of business investment has lagged behind growth Australia wide, largely because the surge in investment has been driven by the mining industry. Victorian business investment fell 3.7% in the June quarter, almost wiping out the 4.0% increase in the March quarter. Victorian business investment has increased 2.3% over the year to the June quarter. In the June quarter, the decline in business investment was led by engineering construction following strong growth in the previous two quarters.

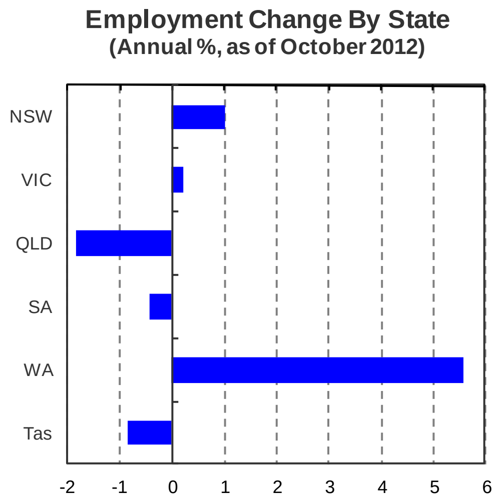
Growth in business investment in Victoria is likely to remain soft, particularly given the uncertain growth outlook faced by firms. The VECCI-Bank of Melbourne survey of business trends and prospects indicates that confidence in the State remains weak. 51% of respondents are expecting weaker conditions for the State economy for the year to September 2013. In contrast, 11% of respondents expect the State economy to strengthen over the same period. This suggests that capital expenditure will remain subdued in Victoria.

Difficult conditions in retailing and a soft job market points to weakness in commercial construction, although there are a number of large projects in the pipeline. These include a $1.3bn development at 5 Collins Street and construction at the old Carton Untied Breweries amounting to $1.2bn. Supporting commercial construction in the healthcare sector is the $1.3bn construction of the Comprehensive Cancer Centre at Parkville.

Government Spending

A positive for economic growth in Victoria is a boost to infrastructure spending which is expected to hit a record in 2012-13. The Victorian Government expects to spend $5.8bn on net infrastructure investment. This includes an expansion at the Port of Melbourne and a number of road and rail projects.





Labour Market

The labour market in Australia and Victoria has been soft, although there has been some improvement in recent months. After job losses throughout June to August, Victoria gained a net 10.3k jobs in September and 7.6k in October. Annual job growth however remains very weak at 0.2% in the year to October.

Soft job growth has seen the Victorian unemployment rate creep up from a cyclical low of 5.1% as at December 2011 to 5.4% in October 2012, although it remains low and is on par with the national unemployment rate. Weak confidence among businesses and ongoing uncertainty about the outlook suggest that there remains a risk that the unemployment rate will edge higher. Leading indicators of employment also point to ongoing weakness in coming months. However, we do not expect the Victorian unemployment rate to rise too sharply.

In the year to August 2012, most jobs have been created in wholesale trade (32.7k), followed by agriculture, forestry and fishing (15.9k) and then manufacturing (13.1k), despite the difficulties facing some of these sectors. These job gains have been offset by net job losses in the year to August within construction (-42.6k), public administration and safety (-18.8k) and administrative and support services (-17.3k), partly reflecting the challenging conditions in the housing market and cuts to government spending.

Bank of Melbourne Forecasts

Economic Indicators, % Change				
	2010-11	**2011-12**	**2012-13 (f)**	**2013-14 (f)**
Gross state product, constant prices	2.70	2.30	2.40	2.80
State final demand	3.70	2.20	2.40	3.40
Employment	3.50	0.40	0.80	1.50
Unemployment rate	5.25	5.30	5.60	5.50
Melbourne CPI	3.30	2.30	2.50	2.50
Wage Price Index	3.80	3.50	3.20	3.60

Source: Bank of Melbourne

We expect growth in Victoria to remain below trend, but for State final demand to pick up in 2012-13, as the full impact of lower interest rates take effect. However, growth is likely to be impacted by slowing exports amid a soft global outlook and a high Australian dollar. We expect growth to recover close to trend growth in 2013-14.

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