Victorian Economic Outlook

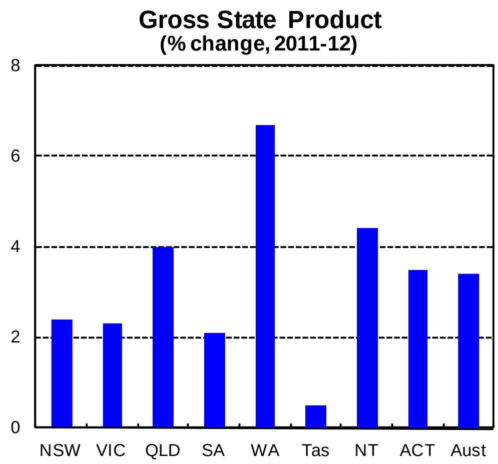
Summary

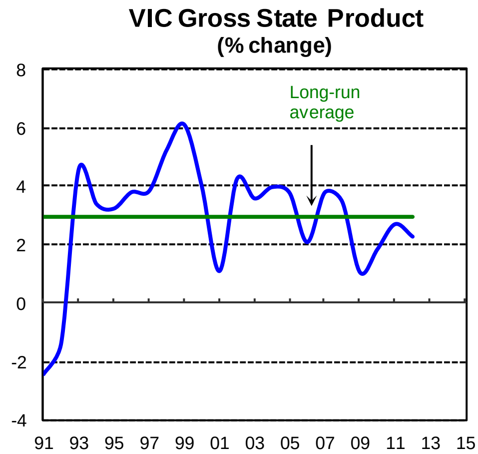
- The Victorian economy has been through difficult conditions over the past few years. Victoria's key sectors, manufacturing, education and tourism are facing a squeeze from the high currency. These challenging times are reflected in contracting final demand. In the year to December 2012, State final demand fell 0.1%, the first annual decline since 2009. Although contracting final demand doesn't necessarily equate to a "recession", it still indicates that Victoria is going through a rough patch.
- We are optimistic that the worst has past and the outlook appears brighter. Lower interest rates are having an effect on consumer spending and the housing sector. In time, we expect that a pickup in the household sector should flow into other parts of the economy. Reflecting the challenges facing Victoria, we expect growth to remain below trend in 2013-14, but improving from 2012-13.
- The downside risks facing the Victorian economy remain, including the high Australian dollar. There is also the risk that the prolonged caution of consumers and businesses will continue to dampen spending and employment.
- House prices in Melbourne are slowly recovering, and are starting to post positive annual growth. We expect the pickup in population growth and low interest rates will underpin further recovery in the Melbourne housing market. However, the recovery in house prices and dwelling investment is likely to lag behind other States, in part because housing in Victoria had performed relatively well in earlier years.
- The VECCI-Bank of Melbourne Survey of Business Trends and Prospects continues to suggest that difficult conditions remain for Victorian firms, although confidence has improved. Of respondents surveyed in the March quarter, 17 percent expect the Victorian outlook to strengthen in the coming year, up from 13 percent recorded in the previous quarter. However, 38 percent of respondents still expect the Victorian economy to weaken.

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

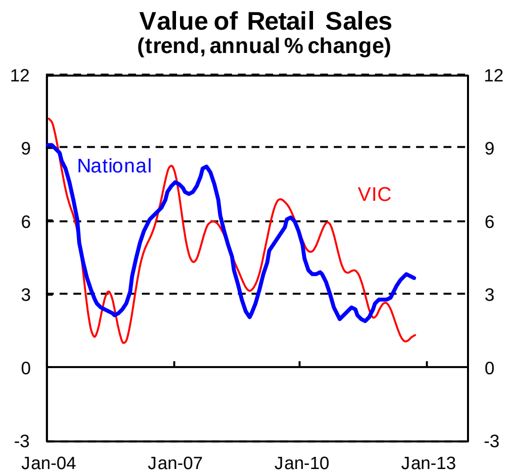
The Victorian economy has been through difficult conditions over the past few years, and has been struggling with the high Australian dollar more than some other States. Victoria's key sectors, manufacturing, education and tourism are facing a squeeze from the high currency.

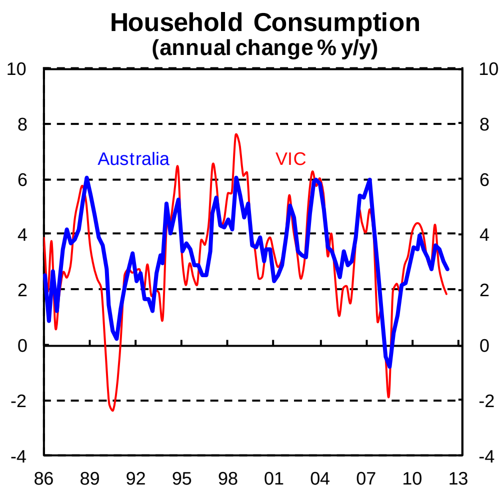
These challenging times are reflected in Victoria's State final demand, which has contracted for three consecutive quarters. In the year to December 2012, State final demand fell 0.1%, the first annual decline since 2009. Although contracting final demand doesn't necessarily equate to a "recession", it still indicates that Victoria is going through a rough patch. State final demand is still a more timely indicator of State economic performance in comparison to Gross State product.

Gross State product (GSP) is only available on an annual basis, but it is a more comprehensive measure of State growth as it also includes net exports and incorporates incomes and production. The latest available data saw GSP growth of 2.3% in 2011-12, easing from growth of 2.7% in 2010-11. We expect Victorian growth to soften further in 2012-13 but to still post positive growth despite State final demand contracting over the second half of 2012.

The outlook for Victoria remains mixed, and some of the challenges facing the State are likely to remain for some time. Unfortunately for Victoria’s key sectors, we expect the Australian dollar will remain relatively strong. However, we are optimistic that the worst has past and the outlook appears a little brighter. Lower interest rates are having an effect on household spending and the housing sector. In time, we expect that a pickup in the household sector should flow onto other parts of the economy.

After growth of 1.7% in 2012-13, we expect the Victorian economy to improve in 2013-14 and for growth to pick up to 2.4%, although remaining below trend. The Victorian Treasury is forecasting similar growth of 1.5% in 2012-13 and 2.25% in 2013-14. (Please see page 8 for more detailed forecasts).





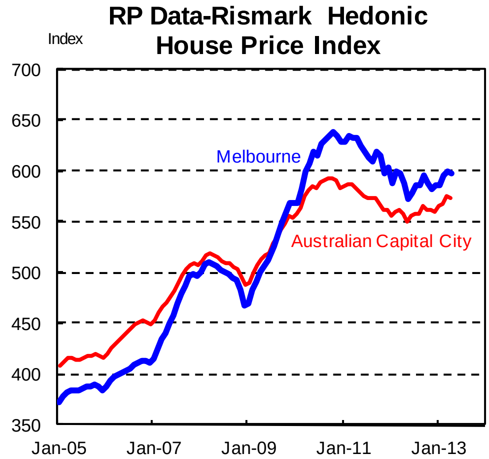
Consumer Spending

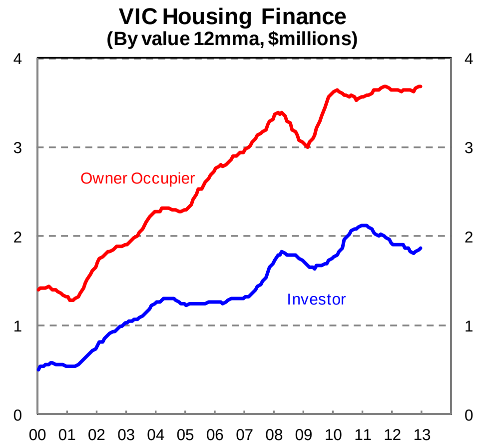
Household consumption has been weak in Victoria, and did not post any growth in the two quarters to December 2012. Annual growth has subsequently dropped sharply from a peak of 4.3% in the year to March 2012 to 1.8% in the year to December 2012, well below long-run average growth of 3.1%. The slowdown in Victorian household consumption over second half of 2012 is in line with household consumption Australia-wide, although in Victoria, consumers have pulled back from spending further. By comparison, Australian household consumption grew by 2.8% in the year to December 2012.

There are however, more recent signs that households are slowly opening their purse strings, signaling that lower interest rates are starting to boost consumer spending. In the March quarter, retail spending (volumes) picked up across the country, and grew 2.6% in Victoria. This was the strongest quarterly increase in almost seven years. Annual growth is still subdued, at 1.5% in the year to the March quarter, and below the ten-year average of 3.3% growth.

The bounce in retail sales in early 2013 is encouraging, and points to a further pickup in household spending. Rising house prices and share markets, and low interest rates provide a positive backdrop for further improvement. However, an uncertain outlook for the labour market and still high household debt levels suggest that consumption will only grow modestly.

Additionally, consumer sentiment has been fragile, despite improving early in the year. After readings above 100 for seven consecutive months, the Westpac-Melbourne Institute index on consumer sentiment in Victoria weakened to 95.4 in May. Readings below 100 indicate that pessimists outweigh optimists. Consumers in Victoria are also more pessimistic than Australia-wide. By comparison, the consumer sentiment index for Australia stood at 97.6 in May.





Housing

Dwelling prices in Melbourne have slowly recovered and grew at 1.6% in the year to April, according to RP Data-Rismark. This was the strongest annual pace in two years. However, dwelling price growth in Melbourne has lagged behind other capital cities, such as Sydney, Perth and Darwin, and underperformed the Australian capital city average, which grew at 2.7% in the year to April. Dwelling prices also remain well below their peak in late 2010, and suggest that the recovery in the Melbourne housing market has further to run.

The Australian Bureau of Statistics (ABS) measure of house prices has also indicated that Melbourne house prices are recovering. House prices lifted 1.1% in the year to the March quarter, the first positive annual growth in two years.

There is prospect for additional gains in house prices this year. Population growth in Victoria is accelerating. In the year to September 2012, Victoria’s population grew at 1.7%, the strongest annual growth in nearly three years. The pickup in population growth is occurring broadly across Australia. Australia’s population growth has also grown at 1.7% in the year to September. Lower interest rates should also further boost demand from owner occupiers and investors.

Owner occupiers in Victoria and Melbourne are now benefiting from the best housing affordability since 2009, according to the CBA-HIA housing affordability index. While new housing finance in Victoria points to only modest growth in demand by owner-occupiers, there has been a pickup in recent months. In the year to March 2013, owner-occupier home loans grew by 10.0%, the strongest annual pace since late 2009.

The number of first home buyers has been relatively stable at around 18% of total in recent months, although changes to first home buyer policies by the State government could have a temporary dampening impact on first home buyer activity later this year.

As of 1 July 2013, the $7k first home owner grant will no longer be eligible for established homes. Similar policies have been in place in other States. In Victoria, the end of the first home buyers grant will be partially offset by a discount in stamp duty for first home buyers for properties valued up to $600,000. A 40 percent reduction in stamp duty is expected to take effect from 1 July 2013 (currently 30 percent), and 50 percent in from 1 September 2014. The discounts have been progressively increased since 1 July 2011 and will continue to apply to first home buyers of established homes. First home buyers purchasing a new home will still receive the grant, which has been increased to $10k from 1 July 2013.

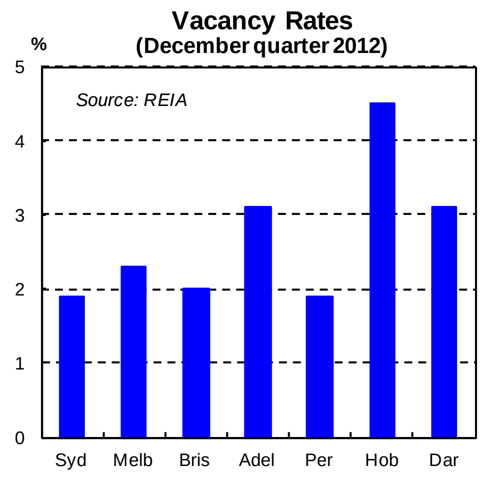
- **Rental Markets**

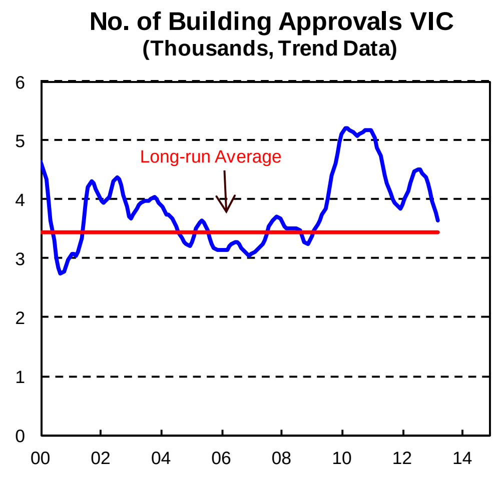
Investor demand has also improved slightly, although less so than in some other capital cities where rental yields are higher. Rental yields have still improved in Melbourne over the past few years, and stable house prices and low interest rates are helping to support investor demand.

Rents in Melbourne were unchanged in the year to the December quarter 2012, for both three-bedroom houses and two-bedroom units, according to the Real Estate Institute of Australia (REIA). Vacancy rates increased to 2.3% in the December quarter, and remain below 3% indicating that there is still strong demand for rental accommodation in Melbourne.

- **Dwelling Investment**

Residential dwelling construction has held up well in Victoria, while other parts of the country have suffered from a long period of under-building. Dwelling investment grew a modest 5.1% in the year to the December quarter in Victoria. Building approvals have also remained above their long-run average, suggesting that the near-term outlook for residential building activity remains buoyant. However, residential building activity has fallen well below the peak witnessed around 2010, as reflected in a decline in the number of building approvals. Although recent changes in first home buyers' incentives to favour newly constructed homes might provide some slight support to residential building, we continue to expect a return to more a more sustainable level of activity. This would suggest that dwelling investment is unlikely to contribute significantly to Victorian growth this year.





- **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 recent years.

We therefore expect further gains in house prices in Melbourne but it is unlikely to perform as well as some other capital cities where housing shortages are more acute and rental returns are higher. Improved affordability will support demand in the owner-occupier market, while the improvement in rental yields will help support investor demand. The pickup in population growth and low interest rates will underpin further recovery in the Melbourne housing market.

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 second consecutive year by the Economist Intelligence Unit in 2012. This reflects Melbourne's high global standards of stability, healthcare, culture and environment, education and infrastructure.

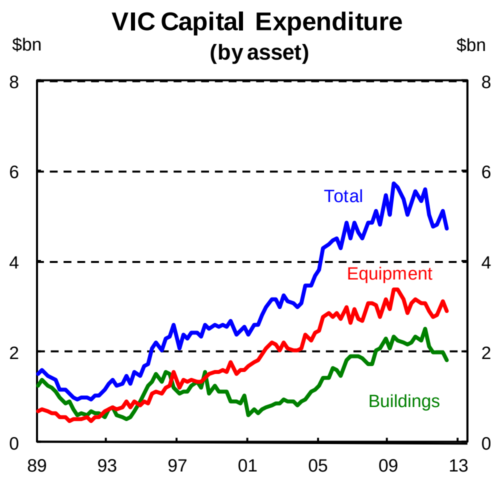
Business Investment

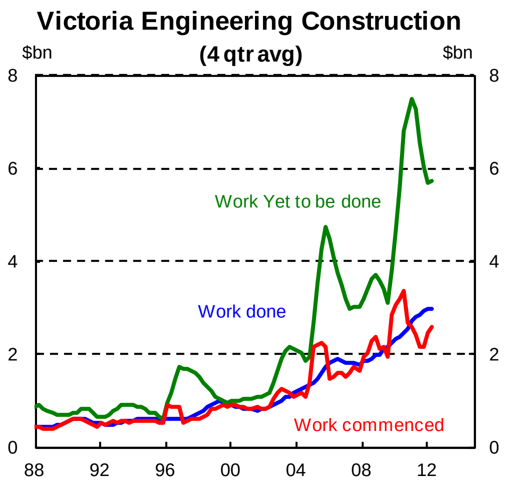
Australian business investment has been a major engine of growth in recent years, driven by the mining sector. The pace of business investment in Victoria has therefore lagged behind growth Australia wide given the bulk of large mining projects have been located in other States.

The most recent data on business investment in the national accounts for the December quarter has been distorted by a large asset transfer from the private to public sector. Prior data revealed modest growth in business investment in the year to the September quarter, rising 7.1%. However, other more recent indicators, such as capital expenditure has been weak, falling 6.1% in the year to the December quarter. Taken with weak confidence and conditions in Victoria according to business surveys, the near-term outlook for business investment remains subdued. The VECCI-Bank of Melbourne survey of business trends and prospects in the March quarter indicates that a net 14 percent of respondents reported weaker conditions in the March quarter, although confidence about the outlook over the next year has improved since the December quarter 2012.

Despite the uncertain outlook, the Australian Bureau of Statistics (ABS) has estimated $6.5bn worth of construction engineering (infrastructure) work in the pipeline. The pool has declined from a peak of $8.0bn in 2010, but there are a few noteworthy projects in the pipeline. The majority are within the public sector, and include the $5.3bn regional rail link from West Werribee to Southern Cross Station. There is also the $4.4bn Kipper-Tuna Turrum Project which is leading the way in resource projects. The State government has also recently announced further initiatives which will boost infrastructure spending (see below for more details).

Within commercial construction, health projects are supporting activity led by the $900mn Victorian Comprehensive Cancer Centre. There are also a number of office projects due to commence.

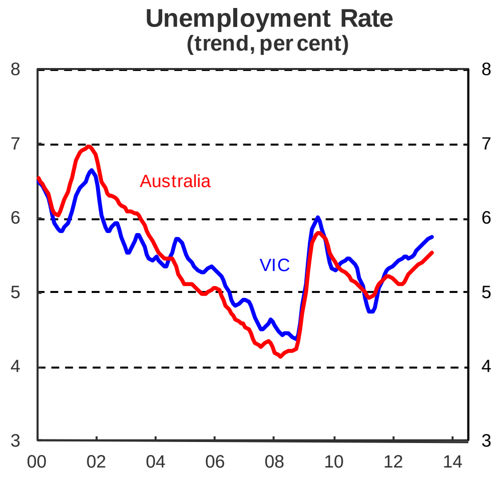


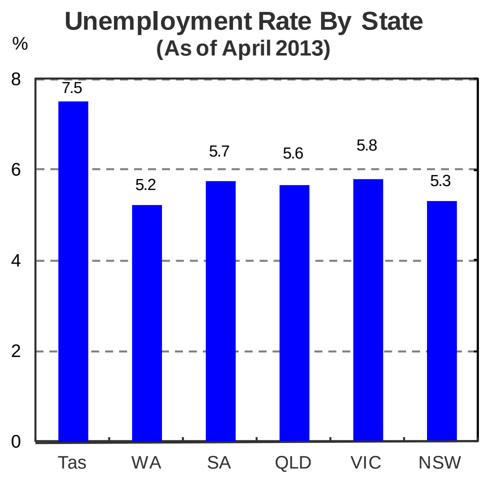


State Budget

The Victorian Budget is more broadly balanced than some other State governments, after large cuts to spending in earlier years. Although this has weighed on growth prospects for 2012-13, government spending initiatives should be more supportive in 2013-14.

A positive development announced in the 2013-14 Budget was an increase in infrastructure spending, despite a downgrade in 2012-13 to $5.4bn (previously $5.8bn). Infrastructure spending is expected to increase to $6.1bn in 2013-14 and $6.6bn in 2014-15, and will support economic activity and productivity for the long-term. This includes the East West Link connecting the CityLink to the Eastern Freeway and planning for the Melbourne Metro Rail Tunnel. The extent of State funding for infrastructure spending is unclear given a proposed public private partnership arrangement and contributions from the Commonwealth Government.





Labour Market

Labour market conditions in Victoria have been subdued and are reflective of weak demand in the State. The State's labour market however has added a net 16.1k jobs in the year to April, a positive pace of job growth, but not enough to prevent the unemployment rate rising from a cyclical low of 5.1% in January 2012 to 5.8% in April 2013.

Ongoing weak business confidence and conditions suggest that firms will still be unwilling to take on new hires. This indicates that the unemployment rate could edge up a bit further, but we expect it to peak close to 6%.

In the year to February 2013, most jobs have been created in retail trade (25.4k), followed by accommodation and food services (14.7 k) and then construction (14.3k). Those sectors closely linked to consumption and housing, are gaining support from lower interest rates, and suggest that the easier monetary policy settings since late 2011 are beginning to boost jobs. The largest job losses in the year to February were in manufacturing (-17.8k), highlighting the difficulties facing the sector. Other industries to lose jobs in the year to February were in administrative and support services (-11.4k) and other services (-9.4k).

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	1.70	2.40
State final demand	3.70	2.20	0.00	2.00
Employment	3.50	0.40	0.80	1.40
Unemployment rate	5.25	5.30	5.60	5.80
Melbourne CPI	3.30	2.30	2.30	2.50
Wage Price Index	3.80	3.50	3.30	3.30

Source: Bank of Melbourne

Weak final demand this year in Victoria is expected result in growth softening to 1.7% in 2012-13. We expect growth in Victoria to remain below trend, but for State final demand to pick up in 2013-14, as lower interest rates provide further support to the economy, and help offset the dampening impact from the high Australian dollar.

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