Bank of Melbourne

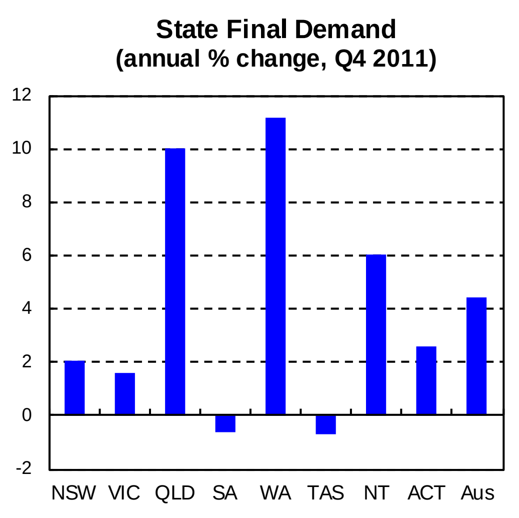
VICTORIAN ECONOMIC OUTLOOK

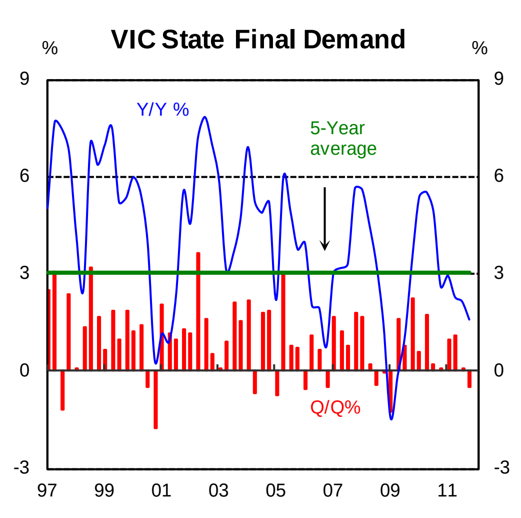
Wednesday, 30 May 2012

- Prior to 2011, Victoria had been one of the country's strong State performers. A key factor underpinning Victoria's success story has been firm population growth and a buoyant residential housing market.
- More recently, State final demand has slowed significantly from a peak of 5.5% in 2010 to an annual rate of 1.6% in the year to December 2011. The current pace of growth is well below the five-year average of 3.0%.
- Slowing population growth and a return to average levels of dwelling investment is dampening economic growth. Further, key sectors in Victoria such as manufacturing, education and tourism have been affected by the high Australian dollar.
- The impetus from the high terms of trade and the mining boom is less apparent in Victoria than other States, and Victoria is not facing the same boom in business investment. However, Victoria still benefits with Melbourne being one of the world's leading suppliers of office services to mining.
- The correction in house prices has been sharper in Melbourne than Australia-wide, but this is in part because Melbourne house prices had stronger growth previously. Softening house prices have resulted in a slowdown in dwelling investment, albeit from very high levels, and will therefore likely continue to drag on growth. However, house prices should be close to bottoming, and a recovery could come through towards the end of the year.
- On balance, the Victorian economy is likely to grow below trend in 2011-12 and 2012-13. Challenges remain for Victoria which includes the ongoing strength of the Australian dollar and sluggish conditions in the housing market in the near-term. Problems in Europe and a slowdown in Chinese growth also pose downside risks to growth in Australia and Victoria and are providing significant uncertainty for consumers and businesses.
- There are however some positives to the outlook for the Victorian economy. Population growth is stabilising and a change in immigration and visa policies should be supportive of population growth, the housing market and economic growth. Melbourne's accolade as the most liveable city in the world is a major draw card for attracting residents .[1] Another bright spot in the economy is the number of road and rail projects in the pipeline. These will support business and public investment. Victoria's household sector will also benefit from the 50 basis point rate cut from the Reserve Bank (RBA) in May, with the possibility of more to come.

Percentage Shares of the Economy*		
Industries	**Australia**	**VIC**
Financial and insurance services	11.3	13.5
Manufacturing	9.6	10.9
Professional, scientific and technical services	7.7	9.4
Construction	9.0	7.8
Health care and social assistance	6.8	7.0
Education and training	5.2	6.3
Retail trade	5.2	5.9
Transport, postal and warehousing	6.0	5.6
Wholesale trade	4.9	5.4
Information media and telecommunications	3.8	4.5
Public administration and safety	5.8	4.2
Administrative and support services	2.8	3.3
Agriculture, forestry and fishing	2.8	3.0
Mining	8.5	2.8
Accommodation and food services	2.7	2.7
Rental, hiring and real estate services	2.4	2.4
Electricity, gas, water and waste services	2.6	2.3
Other services	2.0	2.0
Arts and recreation services	1.0	1.3

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





Economic Growth

The pace of Victorian economic growth eased back over 2011 after very strong growth in 2010 as measured by State final demand. State final demand slowed from a peak of 5.5% in the year to June 2010 to an annual rate of 1.6% in the year to December 2011. In the December quarter 2011, State final demand contracted 0.5%.

Strong population growth and a buoyant housing market gave a boost to Victorian economic growth from mid-2009. However, softer population growth and a pullback in dwelling investment from historically high levels have significantly dampened economic activity.

Some of Victoria's larger sectors including manufacturing and education services have been under pressure due to the effects of the high Australian dollar. Furthermore, the impetus from the high terms of trade and the mining boom is less apparent in Victoria than other States, with Victoria not facing the same boom in business investment.

Victoria still benefits from the resources boom with Melbourne being one of the world's leading suppliers of office services to mining. Most of Australia's large mining and minerals processing companies are headquartered in Melbourne and the city is also a major centre for mining project management, research and development.

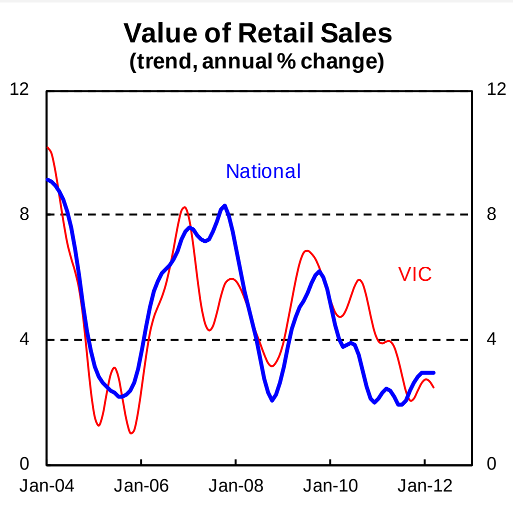
State final demand for Victoria is well below its 5-year average of 2.9%. Victoria has fallen behind domestic final demand (for Australia) of 4.4% and sits in sixth place behind WA (11.1%), QLD (10.0%), Northern Territory (6.0%), ACT (2.6%) and NSW (2.0%).

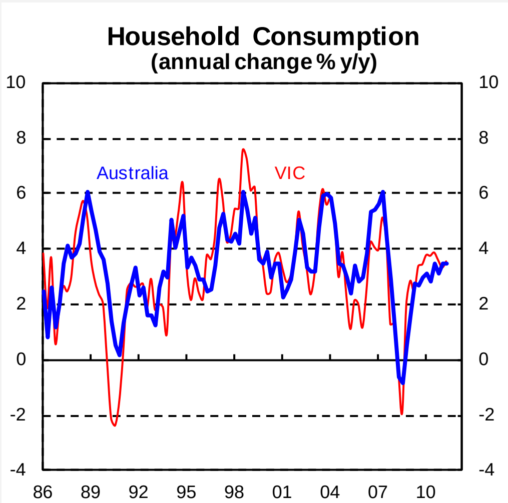
Note that ideally, gross State product would be a more comprehensive measure of growth, since this measure takes into account exports and imports. The high Australian dollar is weighing on some of Victoria's major exports which include education, tourism and manufacturing. However, agricultural exports have been boosted by better growing conditions. Meanwhile, imports are likely to be dampened by soft demand from businesses.

In the December quarter, exports of goods fell 5.2%, more than offsetting a 2.7% decline in goods imports. However, goods exports were growing at an annual pace of 5.3% in the year to December, exceeding annual import growth of 3.8%, suggesting that net exports could provide a positive contribution to growth in 2011-12.

While the Victorian economy will likely continue to face the challenges of the high Australian dollar and an uncertain global outlook, there are some positives for Victoria. The rate cut from the Reserve Bank (RBA) of 50 basis points should help support some important areas of Victoria's economy including consumer spending and housing. Further, it appears that the slowdown in population growth is stabilising. The Federal Government's planned immigration intake is set to increase. Additionally, the Australian Government has recently implemented a number of changes to the student visa program in response to a review released late last year. These measures should facilitate entry for international students, and should help Victoria's education sector. Melbourne's status as the most liveable city in the world is also an important draw card for attracting residents.[1]

The Victorian Treasury expects below trend economic growth in 2011-12 of 1.5% and for it to pick up slightly to 1.75% in 2012-13. In subsequent years, growth is expected to pick up to 2.75%, close to trend growth. We are expecting similar growth of 1.5% in 2011-12, but for stronger growth of 2.0% in 2012-13, as the impact of lower interest rates flow through to the Victorian economy. (Please see page 8 for more detailed forecasts)





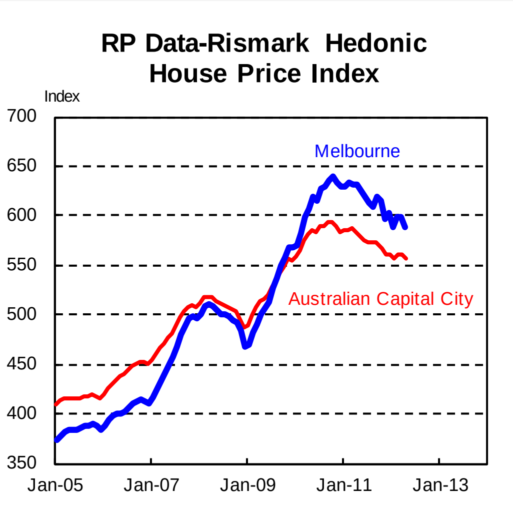
Consumer Spending

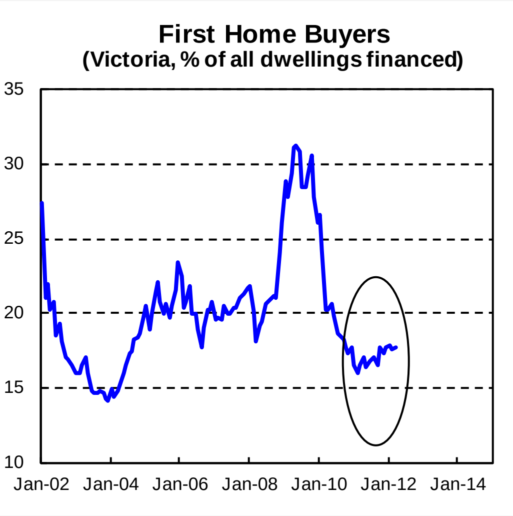
Retail spending in Victoria and nationally has picked up in recent months. In Victoria, the value of retail spending jumped 1.3% in March, while retail sales volumes jumped 1.7% in the March quarter. The bounce likely reflects heavy discounting by retailers. However, retail sales are growing at a historically soft pace. Annual growth in retail sales was 3.6% as of March 2012, weaker than the long-run average of 5.3%, and slightly below growth nationally of 3.7%.

A broader measure of consumer spending is the household final consumption expenditure data in the national accounts. This shows that household consumption is growing at a healthy pace, suggesting that consumers are choosing to spend a greater proportion of their incomes on areas outside of retailing, including services. In the year to the December quarter, household consumption in Victoria rose by 3.6%, in line with the growth seen Australia-wide.

There remains a risk that consumer spending will weaken and that retail spending remains subdued over the near term given the wealth effect of softening house prices, volatile share markets and concerns about job security. Consumer sentiment surveys suggest that householders will be cautious in their behaviour. The Westpac-Melbourne Institute consumer sentiment index in Victoria posted a reading of 94.2 in May indicating that more consumers are pessimistic than optimistic (below 100). The survey also suggests that consumers in Victoria are marginally more pessimistic than Australia, where the index sits at 95.3. However, Victorians appear to be more upbeat following the RBA's decision to cut the cash rate by 50 basis points. The Victorian consumer sentiment index in May is 1.1% higher than in April.

The risk of negative developments in Europe remains and could lead to greater volatility in financial markets, posing significant downside risk to global growth. These concerns would likely to prolong the caution among consumers and weigh on consumer spending in the near term, although the impact could be mitigated by further cuts to the RBA cash rate.





Housing

House prices in Australia and in Melbourne declined over 2011. The correction in Melbourne has been sharper than Australia-wide, however this is in part because Melbourne house prices saw stronger growth through 2009-10.

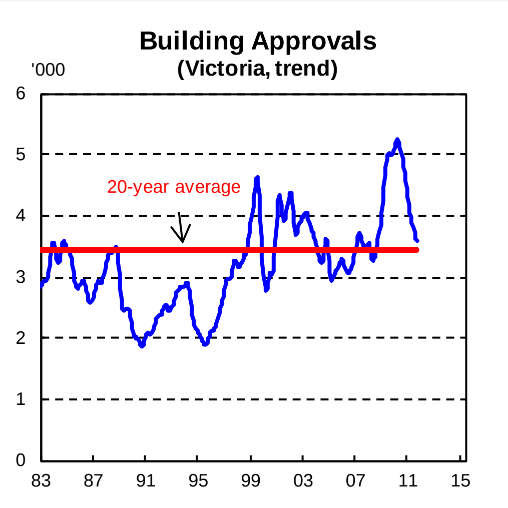
According to the Australian Bureau of Statistics (ABS), Melbourne house prices have slowed sharply from a peak of 26.3% annual growth in the March quarter 2010, to be down 6.6% in the year to March 2012. This compares to a decline of 4.5% across Australia.

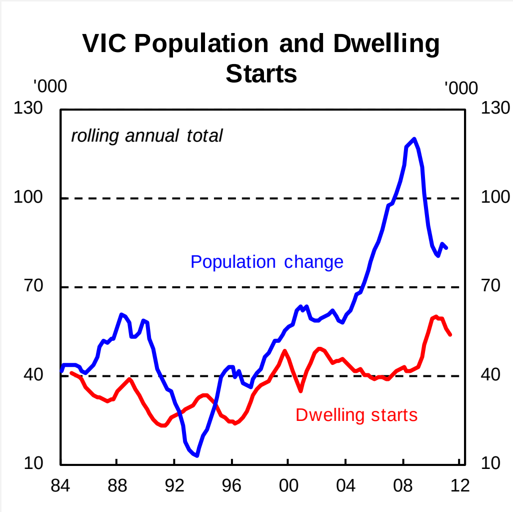
Relatively high interest rates, the end to some first home buyer incentives from both State and Federal governments and a slowdown in population growth in Victoria, have all contributed to the decline in house prices.

Dwelling construction has fallen sharply in response to moderating house prices, which is dragging on economic growth. However, the drop off in residential construction is from very high levels and reflects a return to more normal levels of activity. This stands in contrast to NSW or Queensland where dwelling starts have slumped to historically low levels. Growth in building approvals have slowed sharply, but are now around the 20-year average, suggesting that dwelling construction is unlikely to contribute to growth any time soon.

While the brakes have been put on residential construction, at the same time population growth has slowed. Annual population growth has slowed from a peak of 2.2% in September 2009 to 1.5% in September 2011, but there are signs that the pace of population growth is stabilising.

Strong growth in residential construction and slowing population growth over the past years has helped to alleviate the housing shortage in Victoria. According to BIS Shrapnel, a deficiency in the stock of dwellings is expected to remain, although it is narrowing and set to be much smaller than in NSW. An overall shortage in Victoria should limit further house price declines, but there are areas in Melbourne where there has been a substantial run up in new housing development that could see further sluggish growth in prices for some time.





While there were signs of stabilisation in house prices in some other capital cities earlier in the year, these signals were less evident in Melbourne. RP Data-Rismark dwelling prices for all capital cities were 0.3% higher in the three months to April. Meanwhile, Melbourne dwelling prices were 0.1% lower over the same period. The data suggests that the housing market Australia-wide however still faces difficult conditions. RP Data-Rismark property prices fell 1.7% in Melbourne in April, to be down 7.0% in the year to April. Australian capital city property prices fell 0.8% in April to be 4.5% lower on the year.

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.

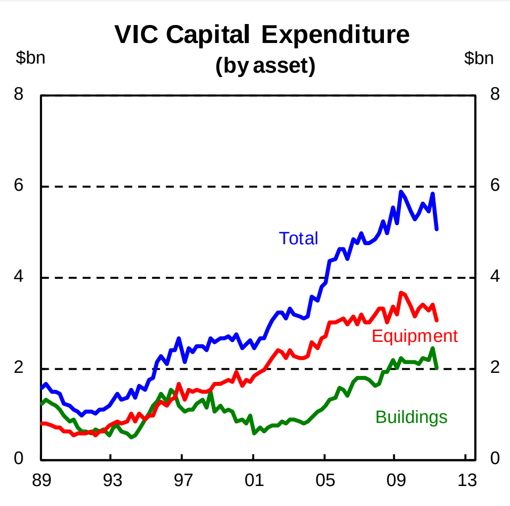
A reduction in stamp duty of 20% for first home buyers since 1 July 2011 for properties valued up to $600,000 may have assisted in boosting first home buyer demand. The State government is also intending to progressively reduce stamp duty further to a combined 50% reduction by 1 September 2014. These 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.

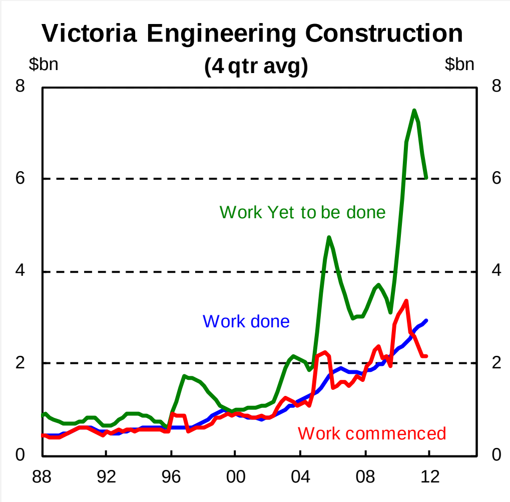
Rents in Melbourne have continued to see positive growth according to the Real Estate Institute of Australia (REIA). In the year to the December 2011, weekly rents grew by 3.0% for three-bedroom houses and 2.9% for 2-bedroom units. Vacancy rates remain low at 2%, which represents a tight rental market, and suggests that rents have further to rise. Increasing rents combined with the recent moderation in house prices suggest that rental yields are becoming more attractive for investors.

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. There is a risk of interstate migration to the resource-rich States, as occurred during the mining boom years of 2003-07. However, Victoria has not yet lost population to other States this time around.

House prices in Victoria are likely to track sideways in coming months and might be close to bottoming. Concerns about job security and ongoing householder caution should keep potential home buyers sidelined; however a recovery could come through towards the end of the year.

The 50 basis points rate cut from the RBA delivered in early May should help provide confidence. Further, rate cuts would also be supportive for the housing market should they emerge as expected, later in the year.





Business Investment

The high terms of trade in Australia is providing a significant boost to business investment, which comprises 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.

In Victoria, business investment has lagged behind the Australia wide pace, largely because the surge in investment has been driven by the mining industry. Victorian business investment fell 4.7% in the December quarter to be down 1.4% over the year. Capital spending has led the decline in business investment, which has been offset by growth in engineering construction activity and non-residential construction.

The outlook for business investment in Victoria is mixed, particularly given the uncertain growth outlook faced by firms. This suggests that capital expenditure will remain subdued in Victoria. Meanwhile, difficult conditions in retailing and a soft job market points to weakness in commercial construction. The one bright spot, however, is engineering construction. There are a reasonable number of engineering projects in the pipeline, which amount to around $6bn according to the ABS. The engineering construction pipeline is predominantly comprised of key transport projects and some repair work following the floods of early 2011.

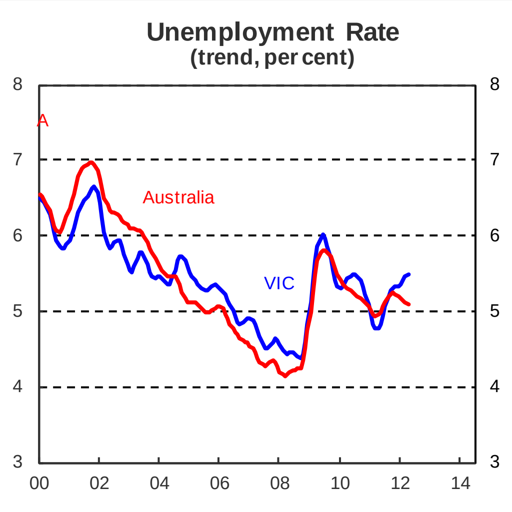
State Budget

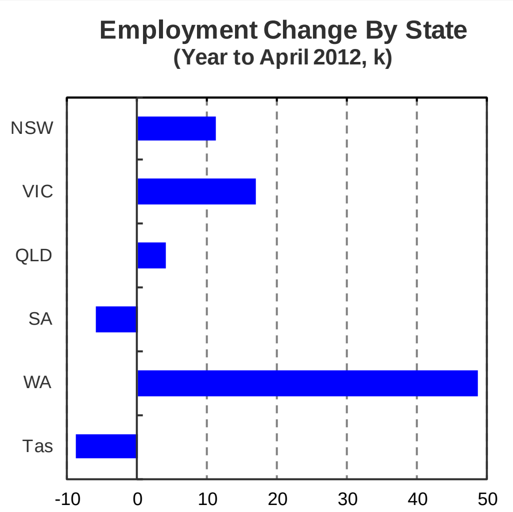
Much like the Federal Budget, the Victorian government has aimed to deliver a Budget surplus in 2012-13. Following a surplus of $126mn in 2011-12, the Victorian government is expecting a surplus of $155mn in 2012-13.

The State budget's bottom line is likely to be further impacted by downgrades to GST revenue and land transfer duties, given that consumption and the property sector have been weaker than the government had previously anticipated.

Some of the budgeted cost savings have resulted from cuts to public sector wages, which includes an additional net reduction of 600 public service positions taking total public sector job losses to 4200, and some limits to pay increases for senior public servants.

A positive for economic growth 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

Australia's and Victoria's labour markets have experienced subdued conditions over the past year or so, although there has been some improvement in recent months. Victoria added a net 0.7k jobs in 2011, a weak result in comparison to 2010 when a net 91.4k jobs were added.

Soft job growth has resulted in Victoria's unemployment rate edging up from a cyclical low of 4.4% in March 2011 to 5.3% in April 2012. Victoria's unemployment rate sits above Australia's of 4.9%.

However, job growth compares favourably to most other States. Victoria added a net 16.8k jobs in the year to April, with only Western Australia adding more jobs over the same period.

The unemployment rate remains low in Victoria, although there is a risk that the unemployment rate could edge higher in Australia and Victoria. Downside risks to global growth resulting from troubles in Europe is creating uncertainty for firms and who may be less inclined to take on new workers.

In the year to February 2012, most jobs have been created in education & training, followed by wholesale trade and professional, scientific & technical services. Wholesale trade is likely benefiting from strong demand for imports associated with the high Australian dollar, while the latter includes occupations that are benefiting from the mining boom. Meanwhile, job losses have occurred in retail trade, transport, postal & warehousing and construction.

Bank of Melbourne Forecasts

Economic Indicators, % Change				
	2009-10	2010-11	2011-12 (f)	2012-13 (f)
Gross state product, constant prices	2.00	2.50	1.50	2.00
State final demand	3.80	3.20	1.40	2.10
Employment	2.80	3.50	0.30	0.90
Unemployment rate	5.50	5.25	5.30	5.50
Melbourne CPI	2.10	3.30	2.30	2.50
Wage Price Index	2.80	3.80	3.50	3.20

Source: Bank of Melbourne

Footnotes:

1. Economic Intelligence Unit, The Liveability Survey, August 2011

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The Detail