

# State Economic Report

Tuesday, 27 January 2015



Bank of Melbourne

## Victorian Economic Outlook

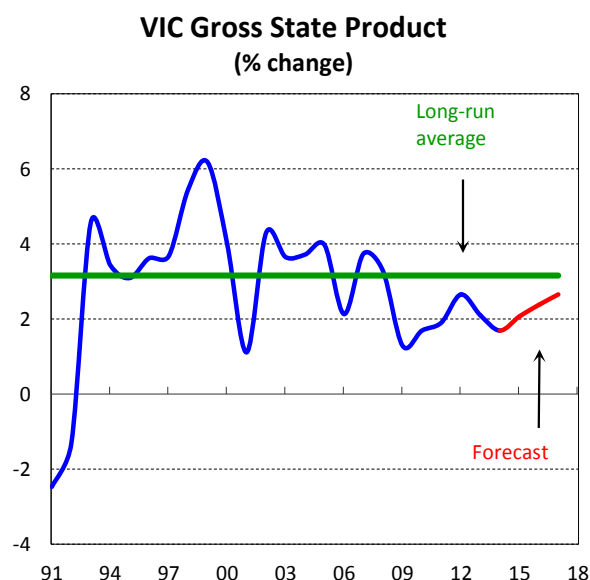
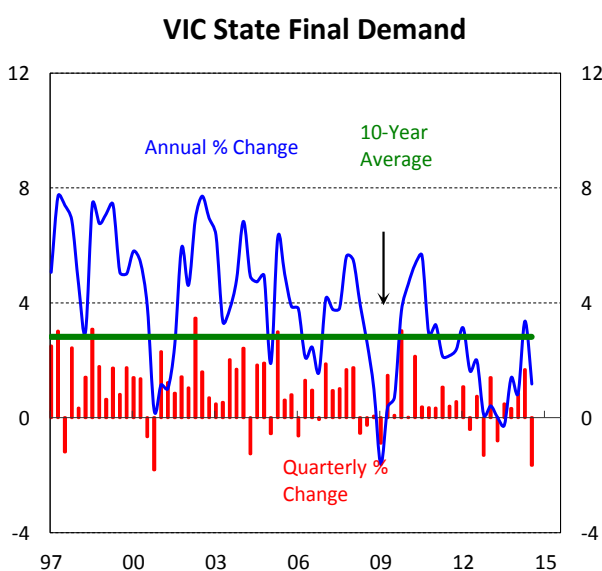
### Summary

- The Victorian economy has continued to grow at a pace below par. While the State should benefit from the transition occurring from mining to other sectors of the economy, some of the headwinds for the State have continued to weigh on economic activity.
- The strength of the Australian dollar has been one of the major constraints on activity in the State. Victoria's relatively large manufacturing sector and the presence of its education and tourism sectors mean that economic activity in Victoria tends to be more sensitive to the Australian dollar's movements than other States.
- We however, continue to be optimistic that there will be a gradual improvement in Victoria. A further drop in the Australian dollar should ease pressure on Victoria's key sectors. Additionally, the extended period of low interest rates will support consumer spending and provide support to the housing sector.
- The housing market in Melbourne has been relatively strong over the past two years, although house price growth has moderated. House prices and residential construction will continue to receive support from strong population growth and low interest rates, although prices will likely moderate further.
- In 2014, Victoria's economy added the most jobs in seven years. The solid pace of job growth in Victoria is at odds with below trend economic activity, but could signal that an improvement in sentiment is occurring. Nonetheless, the uneven outlook suggests that a more moderate pace of growth in employment is likely over coming months. The still elevated unemployment rate at 6.5% continues to suggest that spare capacity exists in Victoria's labour market.
- A newly instated State Government adds some uncertainty to Victoria's previously solid infrastructure spending outlook. It appears unlikely that the \$14bn East-West Link will go ahead, although it is possible that other projects will take its place.

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 continued to grow at a pace below par. While the State should benefit from the transition occurring from mining to other sectors of the economy, some of the headwinds for the State have continued to weigh on economic activity.

Growth in the Victorian economy has been subdued, at just 1.7% in 2013-14. Although not too far from our forecast of 1.8%, it was down from growth of 2.1% in 2012-13 and the slowest in four years. Growth was also well below its long-run average of 2.7%.

The strength of the Australian dollar has been one of the major constraints on activity in the State. Victoria's relatively large manufacturing sector and the presence of its education and tourism sectors mean that economic activity in Victoria tends to be more sensitive to the Australian dollar's movements than other States.

More recent data indicate that Victoria is continuing to struggle through 2014-15. State final demand contracted 1.6% in the September quarter for an annual pace of 1.2%. The weak momentum suggests that a below trend pace of growth is likely to continue over the medium term.

We, however, continue to be optimistic that there will be a gradual improvement in Victoria. A further drop in the Australian dollar should ease pressure on Victoria's key sectors. Additionally, the extended period of low interest rates will support consumer spending and provide support to the housing sector.

That being said, there continue to be risks to Victoria's outlook. It remains questionable how much longer Victoria can sustain such high levels of building activity within residential housing, although it is likely that it will remain elevated in the near-term. Additionally, there are structural shifts within the manufacturing industry that are occurring, despite the depreciation in the Australian dollar. The end of car manufacturing in Australia will have flow on effects to the Victorian economy and related sectors, although the possible impact needs to be put into context (please see Labour Market section for more details). The decision by the new State government to scrap the \$14bn East-West Link also suggests that the significant infrastructure spend appears more uncertain now, although it's possible that other projects will take its place.

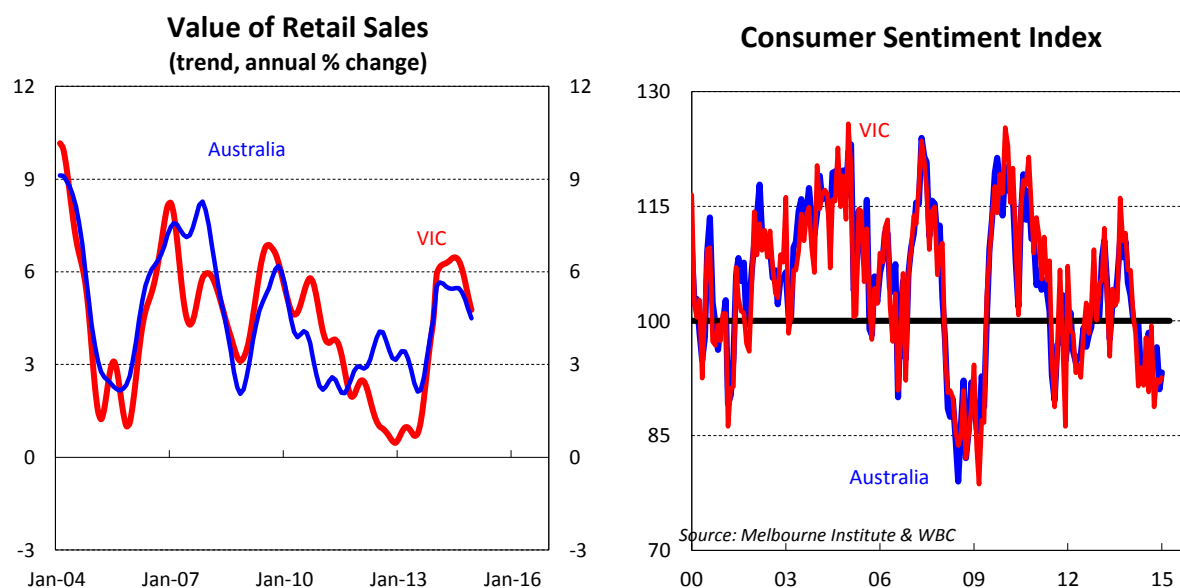
We expect growth of 2.1% in 2014-15, up from the 1.7% growth recorded in 2013-14 but remaining below trend. (Please see page 9 for more detailed forecasts).

### **Consumer Spending**

Consumer spending in Victoria has been growing modestly, and lifted 2.4% (in real terms) in the year to the September quarter. The solid growth in house prices in recent years combined with low interest rates are providing support to consumer spending. This pace of growth, however, sits just below the long-run average of 2.6%.

The strongest growth in consumer spending over the year to the September quarter was largely in services. These included spending on hotels, cafés & restaurants (8.8%), communications (6.9%) and health (6.2%).

Spending on retail goods and services has also been firm in Victoria. It lifted 5.7% in the year to November, well above its long-run average of 4.0%. The pace of growth in Victoria is outpacing growth Australia-wide of 5.0%, and likely reflects the relative outperformance of the Melbourne housing market in recent years.



We expect that the extended period of low interest rates and the buoyant housing market will keep consumer spending growth at a moderate pace. There are however, some key risks to the outlook. One of these risks is the entrenched pessimism among households. According to the Westpac-Melbourne Institute survey of consumer sentiment, the index for Victoria has been below 100 for 11 consecutive months. Readings below 100 indicate that the number of pessimists outweigh optimists. In January, Victoria's consumer sentiment index stood at 92.6, just below the index for Australia at 93.23.

Soft income growth is another risk, and will limit the capacity for households to increase spending. Further strength in consumer spending may need to be accompanied by declines in household savings.

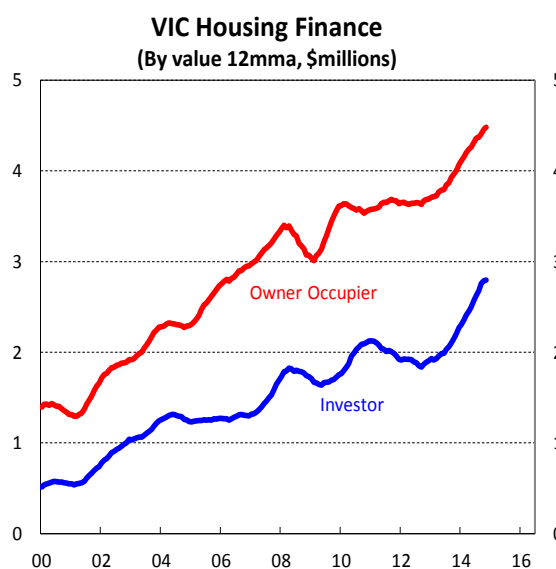
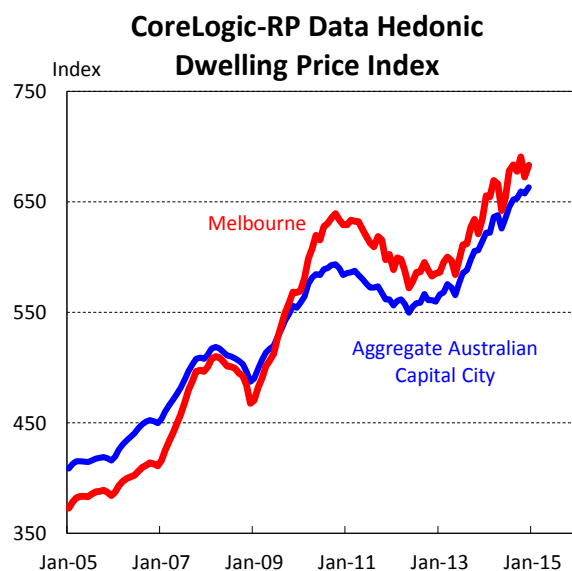
## Housing

The housing market in Melbourne has been relatively strong over the past two years, and has been the second best performing capital city across Australia. However, house price growth has moderated in Melbourne. In 2014, dwelling prices in Melbourne grew by 7.6%, easing from a peak of 11.9% annual growth in January 2014. By comparison, the average for Australian capital cities rose 7.9% in the year to December 2014.

Investors have been a major driver of demand – the proportion of new housing loans extended to investors in Victoria in the 12 months to November has risen to 37.2% from 32.6%, five years prior. Growth in loans to investors however, has softened to a modest annual pace of 4.7% in November.

While the large proportion of investors has received much attention and has been a source of concern for the RBA, owner occupier demand has been growing at a modest pace. In the year to November, the number of owner occupier loans grew at 4.0%. Owner occupier loans have also remained elevated and have stood above 13,500 for 17 consecutive months, a result that hasn't occurred since early 2008.

Much like other States, the proportion of first home buyers in Victoria has been low at 11.9%. That said, the ABS has warned that first home buyer data could be under-reported and be caution should be exercised when using this data. In Victoria, stamp duty discounts of 50% from 1 September 2014 have been applied for first home buyers of an established or new dwelling.



#### - Rental Markets

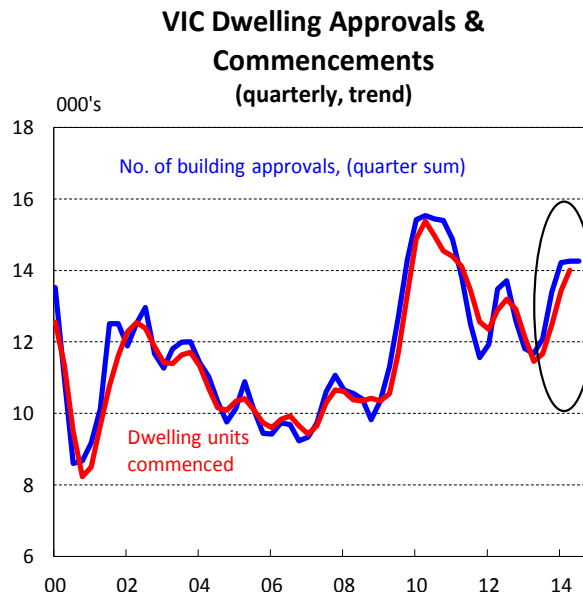
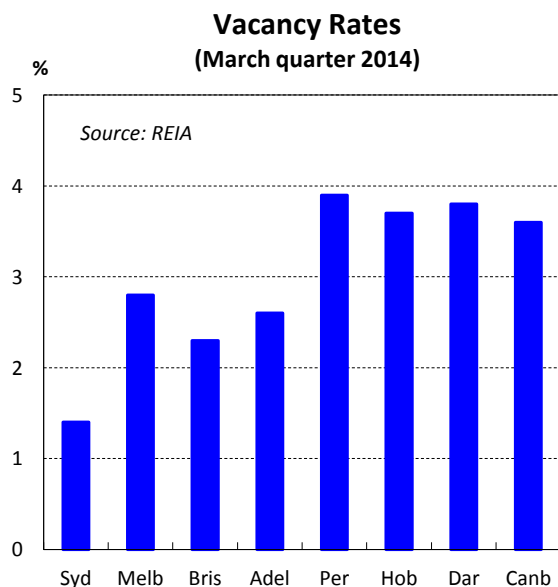
Demand among investors has remained strong despite some softening in rental markets. While vacancy rates indicate a rental market close to balance, at 3.1% in the September quarter, they have edged higher in recent years. By comparison, vacancy rates averaged 2.1% over 2012. Vacancy rates at 3% are considered balanced; while vacancy rates below 3.0% indicate strong demand for rental accommodation.

Rents, however, have continued to rise modestly. For a 3-bedroom house, rents grew 1.4% in the year to the September quarter, while rents on two-bedroom units rose by 3.9% over the same period.

The lift in vacancy rates suggests that there is a risk that there will be limited growth in rents in the near-term, but strong population growth is helping to prop up demand for rental accommodation.

#### - Dwelling Investment

Rising house prices have continued to support residential construction. While residential dwelling investment declined 1.2% in the year to the September quarter in the national accounts, residential construction has remained elevated in Victoria for an extended period. Victoria has built more homes than any other State for several years. Further, a record high in building approvals in November suggests that a heightened level of activity is set to continue in the near-term.



### - Outlook

It remains questionable for how much longer Victoria can sustain such high levels of building activity. However, low interest rates and the lift in house prices will likely keep residential construction at above average levels this year. The firm pace of Victoria's population growth at 1.9% annually in the year to June 2014 will also be supportive of housing demand.

This solid demand for housing should keep house prices growing modestly, although prices will likely moderate further. The steady lift in supply will keep a lid on price growth. Additionally, rising vacancy rates and slowing rental growth could dampen demand among investors.

### Business Investment

After being such a strong driver of growth for the Australian economy, mining investment has started to decline. The hope has been for the drivers of growth to transition to other parts of the economy. Non-mining business investment has started to pick up gradually, suggesting that this transition is occurring, but has remained uneven.

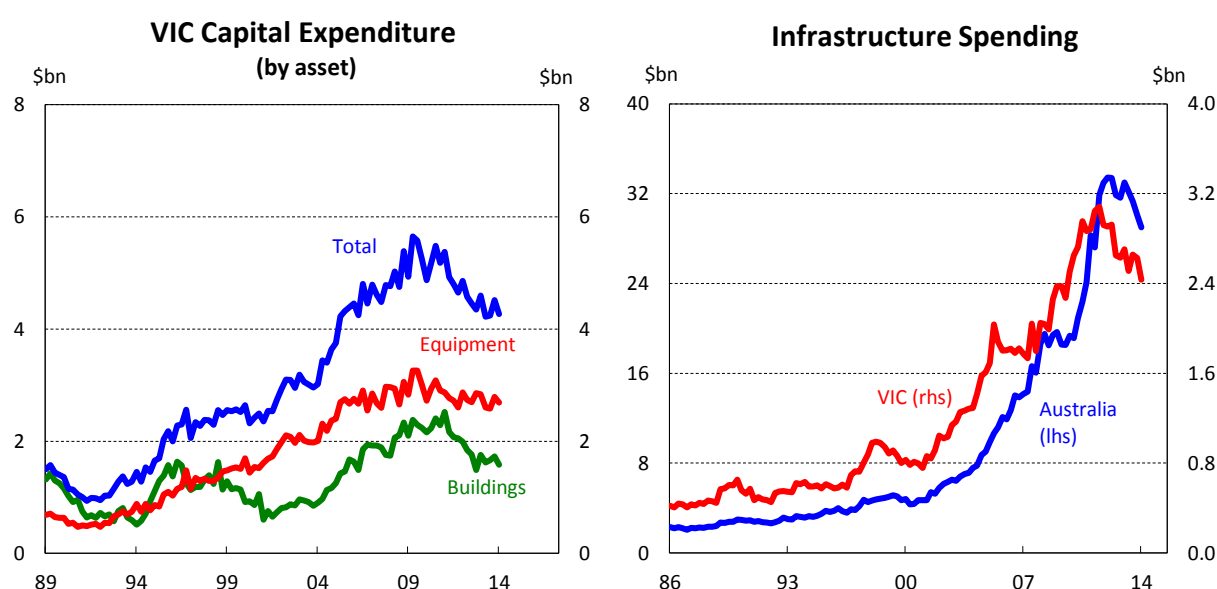
The still subdued conditions in non-mining sectors are evident in business investment trends in Victoria. Business investment in Victoria grew just 1.5% in the year to the September quarter. A further lift in business confidence might be necessary for further a further pick up in business investment.

The VECCI-Bank of Melbourne survey of business trends and prospects in the September quarter indicated that firms in Victoria are slowly becoming more optimistic. The proportion of respondents expecting Victoria's economic performance will weaken in the 12 months to September 2015 lowered from 30% in the previous quarter to 24%. That said, the proportion of respondents anticipating stronger economic growth was unchanged, at 25%. The impact of the recent appreciation of the Australian dollar should hopefully act to boost confidence. The next survey is due for release in mid-February.

The new State Government's plans to scrap the \$14bn East West Link leaves an uncertain pipeline of infrastructure over the near-term. There remain notable projects in the pipeline, including the \$4.1bn regional Rail Link.

The new State government has also pledged to remove 50 level crossings costing \$6bn and planning a \$6bn Melbourne Metro Rail project. Further, the government has also promised to fast track the West Gate Distributor worth \$400-500mn. The plans for infrastructure spending of the current government should become clearer in coming months.

Within commercial construction, major projects underway include the \$1.2bn redevelopment of the former Carlton United Breweries and the \$450mn tower at 567 Collins Street, although these are due to be completed soon. The healthcare sector also has a number of projects under construction including the \$600mn New Bendigo Hospital and the \$277mn Deakin University Epworth Hospital. Despite a healthy level of activity, it appears that the pipeline of projects is narrowing within non-residential construction.



### Victorian State Budget Update

The Victorian State Government is estimating a \$1.1bn surplus in 2014-15, increasing to \$2.2bn in 2015-16. Revenues have been supported by the upswing in the housing market through land transfer duties and tax revenue. Net debt is expected to decline from 6.0% of GSP to 4.6% in 2015-16 before edging up to 4.8% in 2017-18. The Government forecasts Gross State Product (GSP) to grow by 2.25% in 2014-15 and by 2.50% in 2015-16.

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

### Labour Market

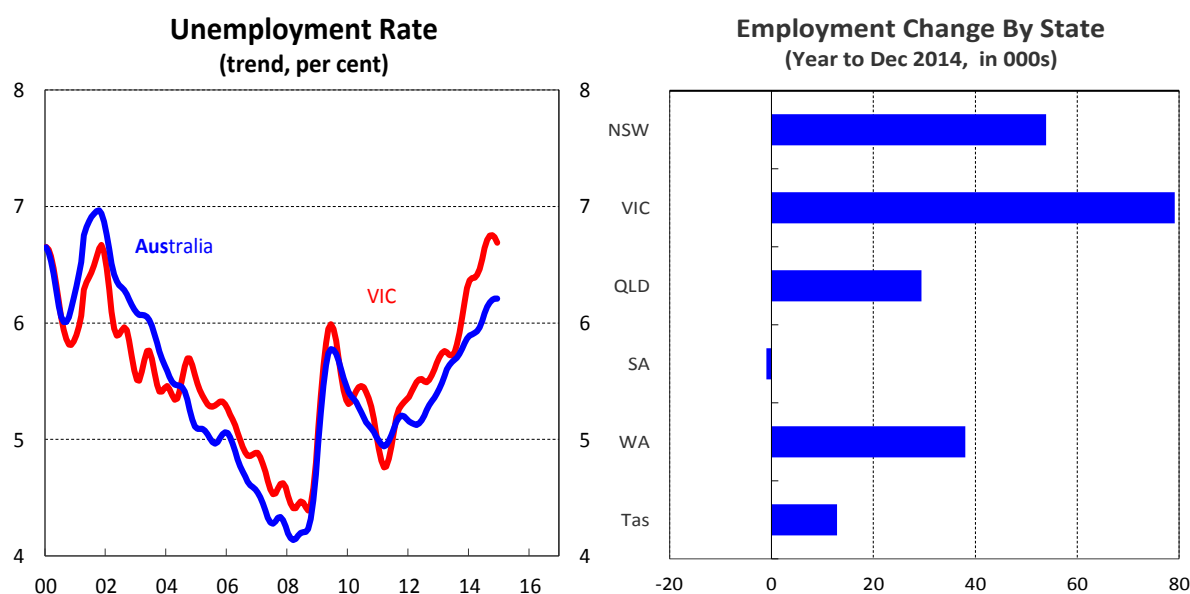
Victoria's labour market has improved significantly over the past year. In 2014, the Victorian economy added 79.1k jobs, the strongest year of job gains in seven years. Much of these job gains occurred in the final two months of 2014. The unemployment rate, however, remained

elevated at 6.5% in December, although it was down from a peak of 6.8% in November. Victoria's unemployment rate continues to sit above the national unemployment rate of 6.1%.

The solid pace of job growth in Victoria is at odds with below trend economic activity, but could signal that an improvement in sentiment is occurring. Nonetheless, the uneven outlook suggests that a more moderate pace of growth in employment is likely over coming months. The still elevated level of the unemployment rate suggests that spare capacity exists in Victoria's labour market.

We expect that Victoria's unemployment rate will remain elevated over the medium term given the risks to the economic 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. These closures could directly impact up to 26k jobs and potentially more in related sectors. A 'worst case' scenario could take the potential job losses to 39k. While the loss of skills and jobs is a blow and a difficult adjustment for Victoria and regional manufacturing centres including Geelong, Altona and Broadmeadows, the scale of job losses needs to be put into context. Potential job losses in a 'worst case' scenario, represents just 1.4% of Victoria's total employed given there were nearly 2.9 million employed in Victoria as of July, and losses are expected to occur over a period of time.



Despite the impending closure of car manufacturing and assembly operations, the manufacturing sector managed to add 16.7k employees in the year to November. Only the retail sector added more jobs at 35.1k. Other industries to add jobs were arts & recreation services (16.5k) and accommodation & food services (16.5k). Job growth in these industries reflects the support from low interest rates on retailing and consumer services.

While the Victorian economy continues to grow at a pace below trend, Victoria's unemployment rate is unlikely to decline in a convincing way. However, we expect that further modest job growth is in prospect.



**Bank of Melbourne Forecasts**

<b>Economic Indicators, % Change</b>				
	<b>2013-14</b>	<b>2014-15 (f)</b>	<b>2015-16 (f)</b>	<b>2016-17 (f)</b>
Gross state product (GSP)	1.70	2.10	2.40	2.70
State final demand	1.40	1.50	2.20	2.60
Employment	0.60	1.70	1.60	1.80
Unemployment rate	6.20	6.60	6.70	6.40
Melbourne CPI	2.80	2.00	2.60	2.70
Wage Price Index	2.70	2.90	2.70	2.80

*Source: Bank of Melbourne*

After growth of 1.7% in 2013-14, we expect growth in Victoria to remain below trend, but to gradually pick up in 2014-15 and 2015-16. Low interest rates and the lower AUD should continue to gain traction and provide support to the broader Victorian economy over the next few years.

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