National Australia Bank

State Economic Update – October 2012

NSW

Economic conditions in NSW are likely to improve only marginally over the coming year with conditions within the state likely to vary wildly. As opposed to its southern neighbour, NSW does have an investment driver, with around $20 billion in the mining investment pipeline. NSW also has the tightest housing market in the country, suggesting that dwelling investment could provide a catalyst for growth. The timing of this boost in dwelling investment, however, is in question. Building approvals data, while improving, remain quite weak meaning that any kick to growth may not come until mid-to-late 2013, if not later. Elsewhere, conditions remain challenging. Consumer caution and a subdued manufacturing sector are weighing on non-residential construction and household consumption while the recent falls in commodity prices could impact export incomes. While mining investment provides a welcome boost to the state, the relatively small share of this to the NSW economy suggests that NSW will likely grow below trend in 2012-13.

Victoria

By all measures, the Victorian economy continues to under perform the national average, with SFD growth slowing to 2.1 per cent in 2011-12 while Victorian businesses are among the least confident in the country. In fact, were it not for household consumption of services (accounting for 1.2 percentage points of SFD growth), the Victorian economy would look much weaker on national accounts measures. Plaguing the Victorian economy is the ongoing structural adjustment to the high AUD, impacting manufacturing and services trade, once key drivers of the Victorian economy. Private investment should remain weak, as dwelling investment responds to lower prices. Interstate trade may provide some relief as Victoria is a net beneficiary of trade with the resource states. However, much of the capital equipment required for the mining investment boom is sourced through foreign trade, meaning interstate trade potential may be limited. In all, we see Victoria remaining the weakest of the mainland states and conditions are likely to remain very subdued through 2012-13.

Queensland

In terms of economic growth, Queensland is firmly entrenched in the fast lane of the multi-speed economy with SFD growth having accelerated to 9.5 per cent in 2011-12. Underpinning growth was a massive 38 per cent increase in private business investment as the construction phase of a number of major coal and LNG projects kicked off. Elsewhere, however, the Queensland economy is showing signs of weakness, particularly in the south-east. The stubbornly high AUD is biting into tourism, international student enrolments and manufacturing exports while a weak housing market in the south-east has kept dwellings investment subdued. Similarly, with most growth in Queensland taking place in the more capital intensive parts of the economy, unemployment is among the highest in the country. Coming into 2012-13, we expect above-trend growth, however, as factors impacting the labour intensive parts of the Queensland economy persist, unemployment could remain relatively high.

Western Australia

The WA economy is in a league of its own, with SFD growth of almost 15 per cent in 2011-12, underpinned largely by a 42 per cent increase in private business investment. Even the household sector, a drag on growth in other states, is strong with household consumption increasing 6.3 per cent (largely due to income growth rather than a reduction in the savings rate) while discretionary spending has also been solid. One area of weakness has been dwelling investment although recent weakness should unwind given the uplift in underlying demand. In all, the size and scale of the mining investment boom should see WA easily outperform the rest of the country for much of the foreseeable future.

South Australia

Conditions in the SA economy are very much subdued, with SFD generally underperforming through 2011-12, growing at just 1.9 per cent. More recently, SA has seen a slight pick up in growth in non-residential building construction although this has been largely offset by broad-based weakness elsewhere. With the recent delay of the Olympic Dam expansion and little else in terms of mining capital expenditure, economic growth in SA is likely to remain sluggish through 2012-13.

Tasmania

Tasmania's economy is very much the weakest of the Australian states. SFD contracted by 1.2 per cent in 2011-12 while the outlook remains very bleak. Tasmanian consumers are the most cautious in the country, and government de-leveraging has been felt more harshly in Tasmania than elsewhere (due to public demand accounting for 29 per cent of SFD). Some support may be provided by hydro and dairy related investment. However, growth will still be very much subdued through 2012-13.

State Forecasts	Gross State Product (Annual % change)		Unemployment Rate (Average rate)	
	11/12f	12/13f	11/12f	12/13f
NSW	2.5	1.5	5.2	5.4
VIC	2.3	1.3	5.4	5.7
QLD	4.8	3.5	5.6	5.7
SA	1.5	2.0	5.3	5.5
WA	6.8	4.5	4.1	3.8
TAS	0.5	1.0	6.3	7.8
Australia	3.4	2.3	5.2	5.4

Source: NAB Economics

The multi-speed economy still present

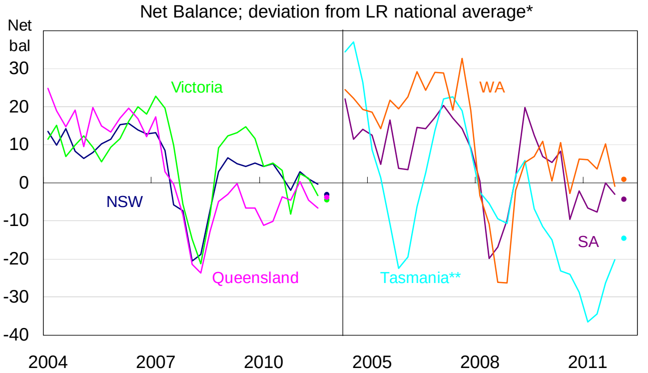
The June 2012 NAB Quarterly Business Survey showed further softening in activity in the Australian economy, after showing signs of strengthening through the second half of last year. While the disparity between sector performances that has become a feature of the Australian economy over the past two years has narrowed in the quarter, it still remains quite apparent. Various sectors affect state conditions differently and so the 'multi-speed' nature of the Australian economy is also very apparent across states. The June quarter survey showed that conditions in WA continued to be supported by the relative strength in the mining sector, though they did soften a little, in line with the softening in non-rural commodity prices during the quarter. Conditions also held up relatively well in NSW, while they were relatively poor in Queensland and Victoria. Tasmania continued to under perform all other states in the June quarter, although care should be taken when interpreting these data due to small sample size.

Over more recent months, conditions have turned down quite sharply in mining – falling from the most recent peak of +52 index points in April to +5 points in September – and this has had a noticeable impact on conditions in WA. The softening in mining conditions has coincided with recent sharp declines in non-rural commodity prices, which have been driven by a slowing in demand from China, as well as the general weakness in global economic activity. Government compensation payments to households in May and June provided temporary support to consumer dependent sectors of the economy – in particular, retail and wholesale – and subsequently boosted activity in the more consumer dependent states, namely Victoria and South Australia. However, we have seen some unwinding of this stimulus more recently and activity in these industries and states remains relatively poor overall. Consistent with a general softening in state conditions in the June quarter, business confidence also deteriorated across states and appears to have remained downbeat in more recent months.

Graph 1

NAB Business Conditions Index

Net Balance; deviation from LR national average*

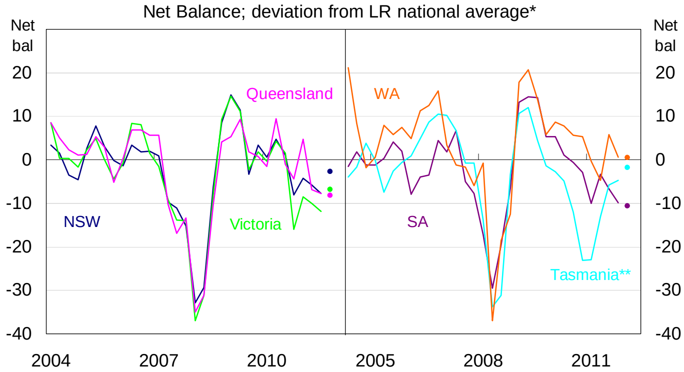


* Deviation from national average since Sep 1989. Data are seasonally adjusted. Dots represent September quarter 2012 estimates from NAB monthly business survey.
** Data have been trended using 5-term Henderson trend (due to small sample size)

Graph 2

NAB Business Confidence Index

Net Balance; deviation from LR national average*



* Deviation from national average since Sep 1989. Data are seasonally adjusted. Dots represent September quarter 2012 estimates from NAB monthly business survey.
** Data have been trended using 5-term Henderson trend (due to small sample size)

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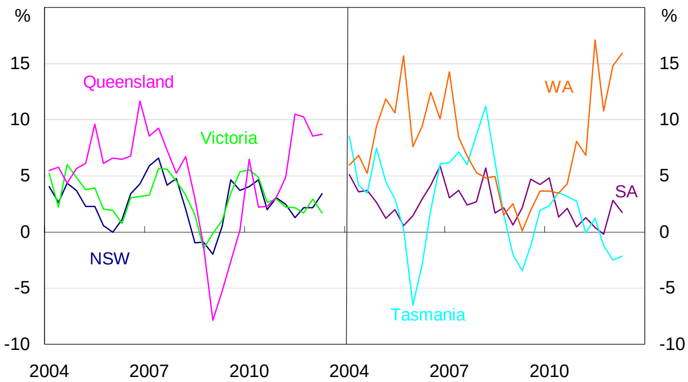
Households limit spending in the face of wavering confidence

Domestic final demand in Australia rose by 5½ per cent over the year to June 2012, compared to growth of 3¼ over the year to June 2011. Despite the solid outcome over the year, the quarterly profile has been fairly volatile in recent quarters, with demand softening significantly in the June quarter, following a sharp increase in activity in the March quarter. Contributing to the recent strength in demand has been the general pick up in household consumption, which makes up around 55 per cent of total final demand. Through the year, household final consumption expenditure growth was particularly strong in WA, followed by Queensland, NSW, Victoria and SA, while it declined in Tasmania. With the exception of Tasmania, total household spending growth has recovered solidly across the states since the GFC but is relatively soft when compared to history, which is consistent with the soft upward trend in state final demand.

Graph 3

Real State Final Demand

Year-ended percentage change

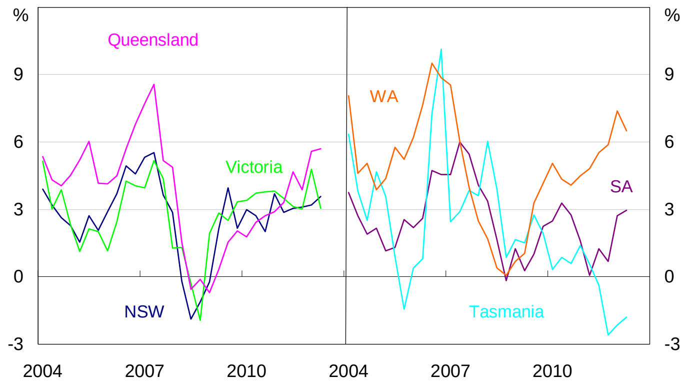


Sources: ABS; NAB

Graph 4

Real Household Final Consumption Expenditure

Year-ended percentage change



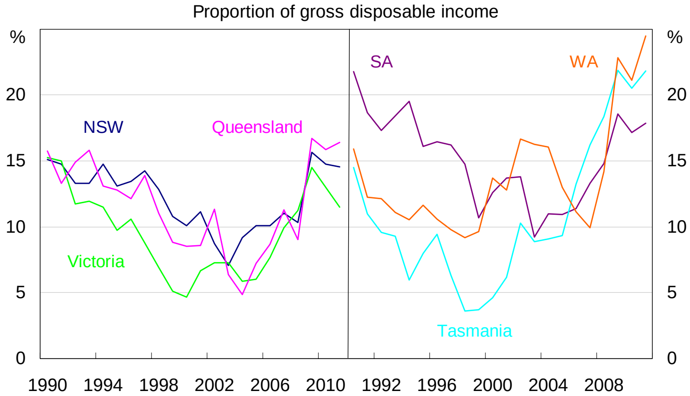
Sources: ABS; NAB

The average consumer has become increasingly cautious since the onset of the global financial crisis (GFC), limiting their consumption of discretionary items in order to help de-leverage their balance sheets. This is evidenced by the sharp fall in consumption spending across the states just through the GFC, when household savings behaviour was significantly affected by the destruction of wealth that occurred through losses in financial markets. Rising interest rates on deposits also provided added incentives for households to save. Improved consumer confidence over recent months suggests that households may have become more confident about their financial positions, particularly in light of lower borrowing rates, which could potentially flow through to more spending in coming quarters. While there are a number of measurement issues associated with the calculation of saving rates, the recent upward shift in aggregate savings appears to have been broad-based across all states (see Graph). Relative to gross disposable income, the rise in household saving has been particularly pronounced in WA. This reflects household disposable income growth in WA (averaging an annual rate of 11½ per cent per year since 2007) outpacing growth in consumption expenditure (averaging an annual pace of 4½ per cent per year since 2007).

Graph 5

Household Savings*

Proportion of gross disposable income



* Includes consumption of fixed capital

Sources: ABS; NAB

Public Sector Investment Makes Way for Private Investment

The unwinding of public demand continues, which has become very apparent in the pattern of capital investment across the states. When filtering out the components of capital investment within the SFD statistics, we find that public capital investment across the states has generally fallen as the infrastructure spend associated with the Commonwealth fiscal stimulus has unwound while state governments are intent on balancing their budgets, resulting in a lack of public capital expenditure. The pull-back in public investment is most apparent in SA, Tasmania, Victoria and NSW. In contrast, public capital spending in Queensland eased only slightly while in WA, it has actually increased.

Gross Fixed Capital Formation - June 2012

	Year-ended percentage change					
	NSW	VIC	QLD	SA	WA	TAS
Private	2.1	1.3	28.6	5.3	30.3	1.8
Public	-8.6	-9.3	-1.3	-19.1	4.2	-15.6
Total	**-0.5**	**-0.8**	**21.2**	**-0.9**	**26.8**	**-3.8**

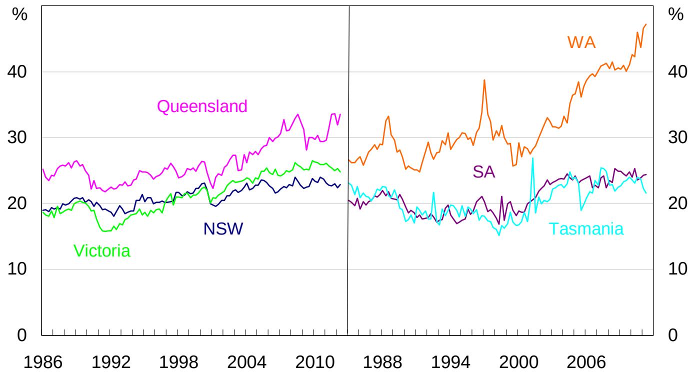
Sources: ABS; NAB

Capital investment has expanded rapidly over much of the past decade, resulting in a broad-based increase in capital expenditure as a share of state final demand across the Australian states (see Graph). More recently, capital expenditure has surged at an unprecedented pace in WA and Queensland as the mining investment boom continues to gather pace. The mining sector in WA currently accounts for almost 29 per cent of total capital expenditure in Australia, while the Queensland mining industry accounts for close to 17 per cent, its highest share in recent history (see Graph). Given the resource intensive nature of the mining investment boom, the strength in mining investment growth has not been without cost to other sectors. There has been a clear step down in investment in the steadily declining manufacturing sector, which has come under increased pressure from the high AUD as well as the progressive dismantling of tariff protection. Overall, the outlook for business investment remains strong – largely due to investment in the resources sector – which should continue to support growth for many years to come.

Graph 6

Capital Expenditure*

Proportion of state final demand

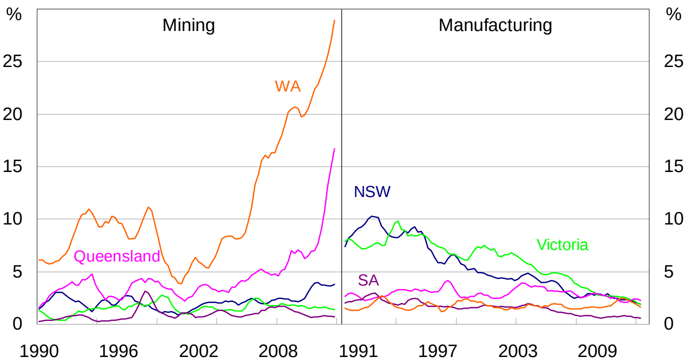


* Total Gross Fixed Capital Formation
Sources: ABS; NAB

Graph 7

Capital Expenditure by Industry by State*

Proportion of total Australian capital expenditure, annual sum



* Data not available for Tasmania
Sources: ABS; NAB

Is the mining boom over?

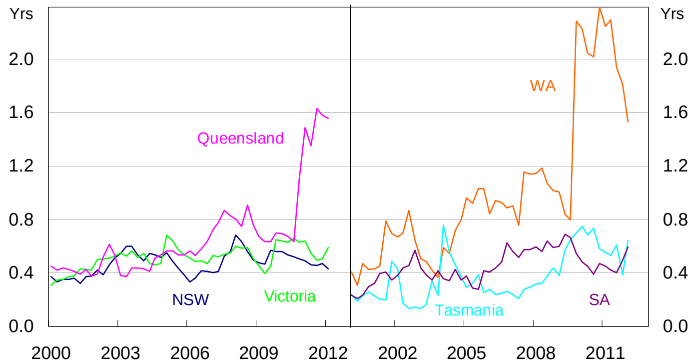
The non-residential investment pipeline continued to expand across Australia in the March quarter 2012, despite a significant outflow of projects from WA and NSW, which likely reflected the shelving of some mining projects. Instead, the influx of projects was largely attributable to increased project listings in Queensland, Victoria and SA. While the value of work yet to be done as a proportion of annual work done fell significantly in WA – and to a lesser extent, Queensland – since September quarter 2011, the non-residential investment pipeline in these states remains very elevated at around one year and seven months long, and together making up around 85 per cent of the total Australian pipeline. According to estimates by the Bureau of Resources and Energy Economics (BREE), there were 98 advanced resource and energy projects under way or committed as at April 2012, representing $260.8 billion or 18 per cent of GDP. This figure is largely made up of LNG projects, reflecting the shift in demand towards lower greenhouse gas emitting energy internationally. Included in the project listings are the $43 billion Gorgon LNG project (WA) and around $40 billion of LNG projects at Gladstone (WA). When constructed, these projects will add to export capacity for LNG, coal, iron ore and other energy and minerals commodities.

Construction work continues to be dominated by engineering construction associated with mining and infrastructure. While we expect the mining investment boom to peak in late 2013 / mid 2014, there is still a significant amount of work in the pipeline yet to be completed. While there have been rumblings that a number of smaller mining investment projects in Australia are being revised following recent commodity price falls, Australia remains a low cost producer of minerals and energy commodities. What the lower commodity prices have done (both for coal and iron) is to bring into doubt some marginal mines (especially coal) with a flow on downsizing in mining related services. Also, expansion plans at more marginal operations are likely to be shelved until there is greater clarity on commodity price expectations. Interestingly, total coal and iron ore production levels are expected to increase in Australian mines.

Graph 8

Non-residential Investment Pipeline*

Work yet to be done as a proportion of annual work done



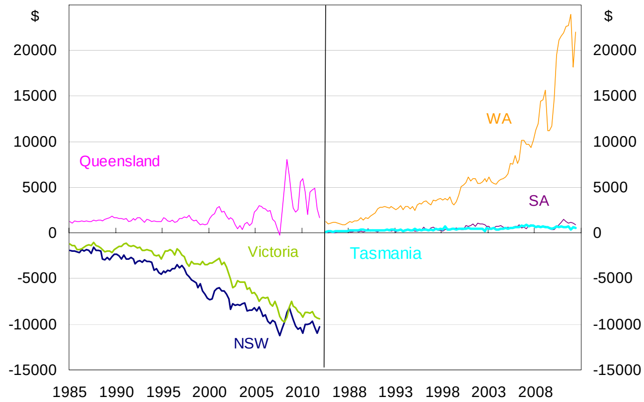
* Calculated as the sum of non-residential building and engineering construction
Sources: ABS; NAB

Nominal net international trade weakening across all states

Despite easing back through the first half of the year, nominal net international exports in WA remain at very elevated levels and continue to easily outperform the rest of Australia, easily explaining the divergence in incomes that has opened up between WA and the rest of Australia over the past decade. In 2011-12, the value of WA net international exports fell 0.7 per cent, although this follows on from an increase of 53 per cent a year earlier. Elsewhere, nominal trade balances have deteriorated, most notably in Queensland, where disruptions to coal exports saw Queensland's nominal trade balance deteriorate 17.1 per cent in 2011-12, with SA and Tasmania have generally struggled under the weight of an elevated AUD, with their trade balances deteriorating more than 10 per cent. In comparison, Victoria and NSW recorded more modest falls although trade balances have deteriorated significantly in recent years[1]. Exports in commodities continue to dominate trade patterns while rural exports have lifted considerably over the past year or so, in line with strong crop conditions and the impact of improving livestock numbers.

Graph 9

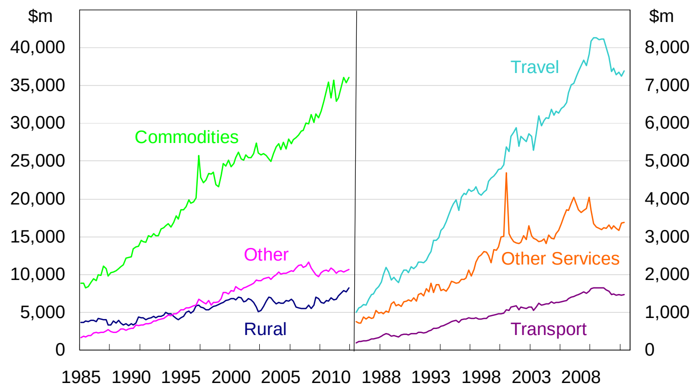
Nominal Net Exports



Source: ABS, NAB Group Economics

Graph 10

Goods & Services Exports



Source: ABS, NAB Group Economics

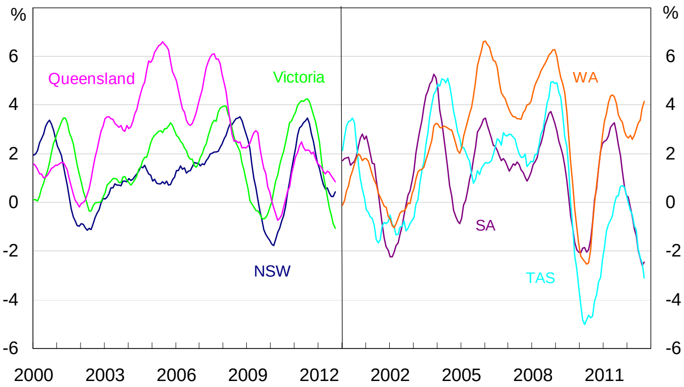
[1] It should be noted that these statistics represent merchandise goods only, and NSW and Victoria are "natural" importers because of their relatively large ports.

While Victoria and NSW typically have large trade deficits in merchandise goods, it is services trade that generally drives export performance within these states, accounting for around two thirds of total exports. According to balance of payments data, Australian services exports contracted by 2.5 per cent in 2011-12, due largely to solid declines in travel and transport services. With the AUD remaining high and further weakness in international student enrolments, it is unlikely that Victoria or NSW will receive any lift in growth from net services trade in the near term.

Labour market conditions soften

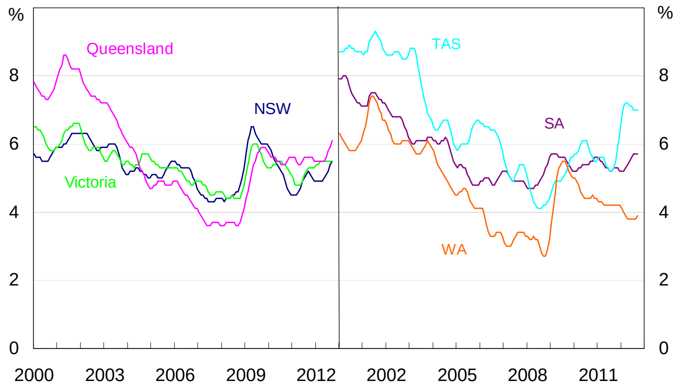
Consistent with the general weakening in employment growth across states since mid 2011, the unemployment rate has tended to edge higher across most states; WA is the only exception, where employment growth has remained relatively strong and the unemployment rate is currently trending close to 4 per cent. The increase in the trend unemployment rate has been particularly concerning in Tasmania, where the rate is currently trending at 7 per cent. Consistent with the general tick up in state unemployment rates over the past year or so, the NAB Quarterly Business Survey shows that the availability of suitable labour has become a less significant constraint on firm's production, particularly in Queensland.

Graph 11
Employment growth
Year-average percentage change



Sources: ABS; NAB

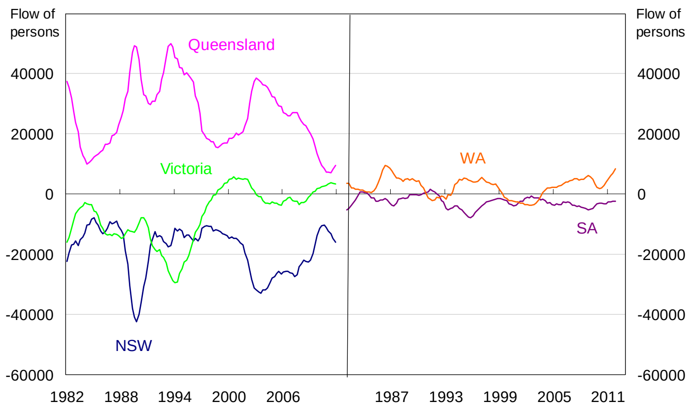
Graph 12
Unemployment Rate
Trend



Sources: ABS; NAB

Labour market indicators generally point to continued soft employment conditions – largely reflecting the frictional impact the structural adjustment in the Australian economy is having on hiring – and we see the unemployment rate rising to above 5½ per cent by end 2014, up from its current trend rate of 5¼ per cent. The higher rate of unemployment is likely to be particularly apparent in the non-mining states – Tasmania, SA, Victoria and, to a lesser extent, NSW, although the weakness in labour intensive parts of Queensland may also keep the unemployment rate high in this state for sometime. There has been a slight pick up in net interstate migration (and net overseas migration) in WA in response to relatively strong labour market conditions, while the other states appear to have been broadly unaffected by the tightness in labour market conditions since mid 2010 (see Graph). During the past decade there has been a general decline in net interstate migration to Queensland, though the flow of people has picked up a little more recently – likely reflecting a shift of people looking for mining work – while the net outflow of persons from NSW has begun to pick up again and Victoria is now benefiting from a (marginally) positive inflow. Net overseas migration has declined across all states since the beginning of 2009, with the relatively high Australian dollar and changed migration policies likely to have discouraged some overseas arrivals.

Graph 13
Annual Net Interstate Migration



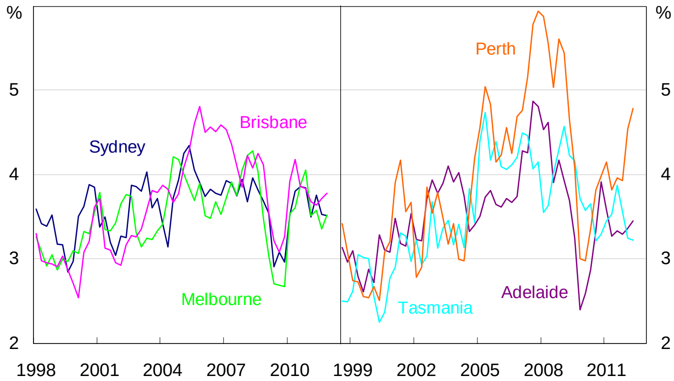
Sources: ABS; NAB

Wage pressures contained, for now

Consistent with the general softness in labour market conditions at present, annual wage growth remains fairly soft in all of the states, with the exception of WA where the expansion in the mining sector is occurring more rapidly than the ability of the labour market to adjust. Wage pressures are expected to remain a concern for the mining states (WA and Queensland), where a significant amount of investment will continue to come online at a very rapid pace – with the mining investment boom not expected to peak until late 2013 / mid 2014 – but the risk of higher wages growth outside of mining appears to have lessened.

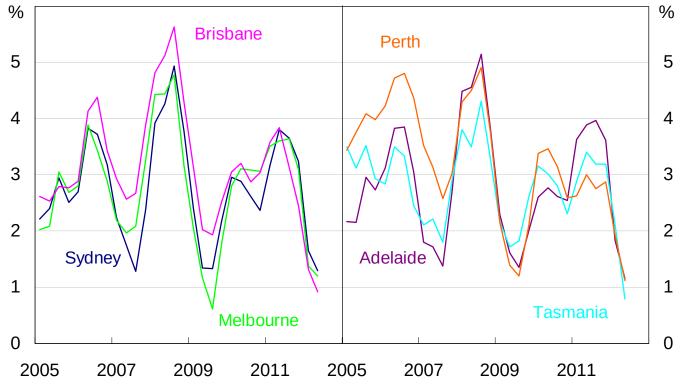
Consumer price inflation has fallen to very low levels over the first half of this year, with the downturn occurring across all of the states, despite notable variations in spending and consumption growth. Inflationary pressures are very well contained at present, largely reflecting the high AUD, generally soft consumer demand, soft wage pressures and the ability of labour to move freely across states. While we may see some added price inflation flow through in coming quarters as a result of the carbon tax, underlying inflation is expected to remain within the RBA's 2-3 per cent target range over the next year or so. This is likely to be the case across states, given the relative softness in the labour market at present. However, there is some risk that wage and price growth will pick up over coming years, as the exchange rate depreciates, the housing market improves and labour market conditions strengthen; in conjunction with relatively accommodative monetary policy settings, which are likely to remain in place for some time.

Graph 14
Wage Price Index
Year-ended percentage change



Sources: ABS; NAB

Graph 15
Consumer Price Index
Year-ended percentage change

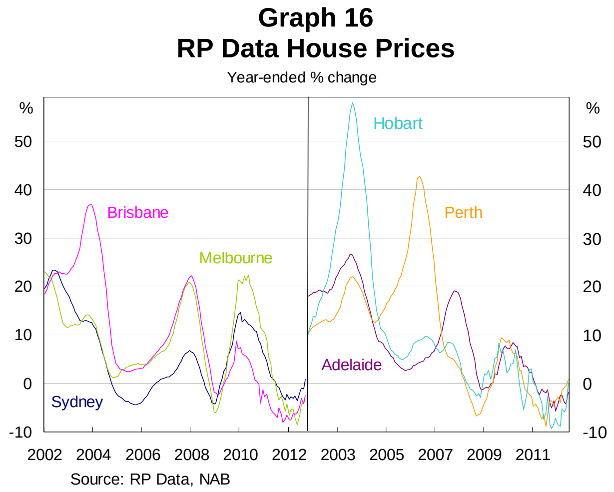


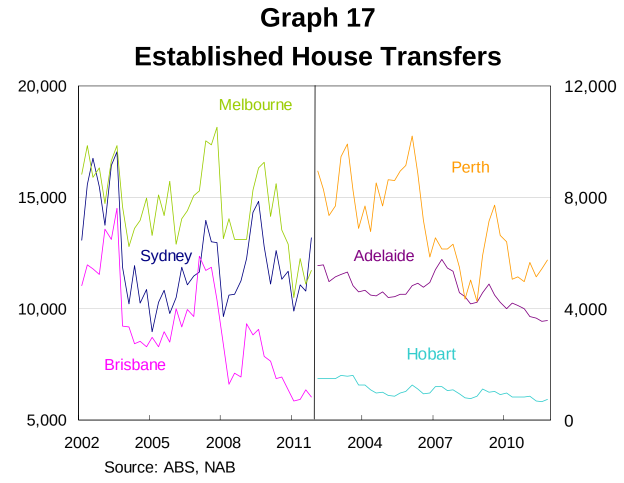
Sources: ABS; NAB

State housing markets recovering through late 2012

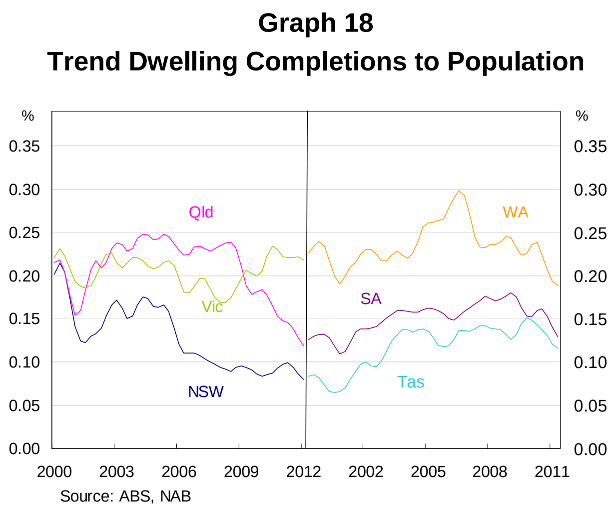
Housing market conditions have increasingly shown signs of recovery since mid year, as the lagged effects of lower interest rates, an up-tick in growth in real rents and sound underlying fundamentals have supported recent improvements in house prices. Nonetheless, prices are still generally lower than year ago levels. According to RP data, average dwelling prices across Australia's capital cities were down 1.2 per cent year-on-year in September. By state, the recovery in the Australian housing market was initially driven by Sydney, where year-on-year price growth turned positive for the first time since June 2011, up a modest 0.9 per cent. Similarly, Perth and Hobart have recorded annual price growth for the first time since 2010, up 0.8 and 0.1 per cent respectively. Elsewhere, annual price growth remains negative although the pace of decline is slowing, with Melbourne down 3.8 per cent, Brisbane down 2.5 per cent and Adelaide down 1.8 per cent.

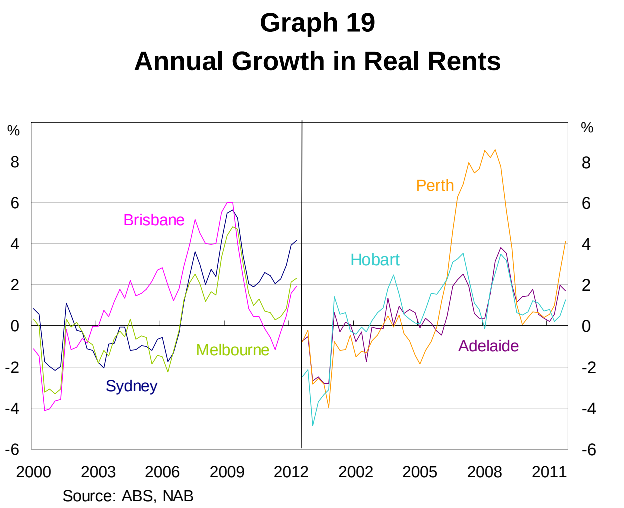
As mentioned in previous updates, much of the recent weakness in the housing market was driven by cyclical factors as structural factors continued to place a solid floor under prices. Relatively low unemployment meant that mortgage arrears had generally remained below 1 per cent of total on-balance sheet loans implying very few forced sales. Similarly, many vendors simply chose to hold on to residential property rather than offload at lower prices, which largely manifests into lower auction clearance rates through the current cycle. Consequently, overall transactions remained fairly subdued through the course of 2011 with some of the sharpest falls in transactions affecting Sydney (although late 2011 was impacted by the massive influx of first homebuyers), Melbourne and Brisbane.





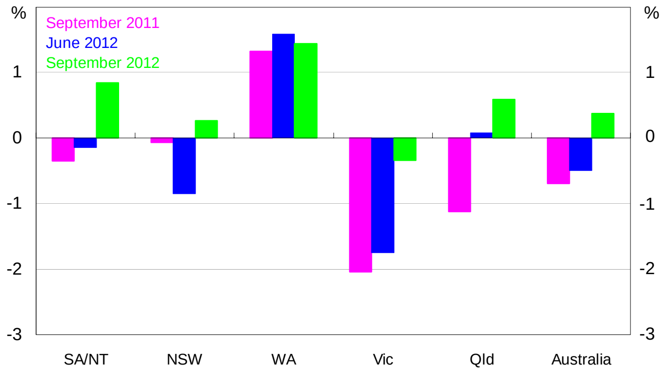
Given the cyclical nature of the housing market, falling prices should eventually result in falling dwelling investment. This became apparent through the second half of 2011 when the ratio of dwelling completions to population began to turn. According to this metric, the NSW housing market, already the tightest in the country, has tightened further while dwelling investment in Queensland has consistently struggled to keep pace with population growth in recent years. Similar trends are also evident in WA, SA and Tasmania. In contrast, the Victorian housing market appears comfortably supplied, which is likely to be a drag on the Victorian housing market for some time. The upshot of falling dwelling investment is rising real rents, which have broadly strengthened since mid 2011, with most upward pressure being exerted in Sydney and Perth. Even Melbourne, where the property market appears relatively well supplied, has experienced solid growth in real rents.





Consistent with increasing signs of a recovery in the housing market, expectations of house prices by market participants has generally lifted over recent months. According to the September quarter NAB Residential Property Survey, respondents expect house prices to lift, predicting a 0.4 per cent increase in house prices in Australia over the next twelve months. By state, respondents were most bullish in WA, predicting a 1.4 per cent increase in prices while respondents were also surprisingly bullish about SA/NT. Expectations for NSW also turned around, partly reflecting Sydney being by far the tightest housing market in the country. In contrast, expectations for Victoria remained negative, a reflection of the supply overhang that persists for the Victorian housing market.

Graph 20
Expected House Price Growth
12 months ahead



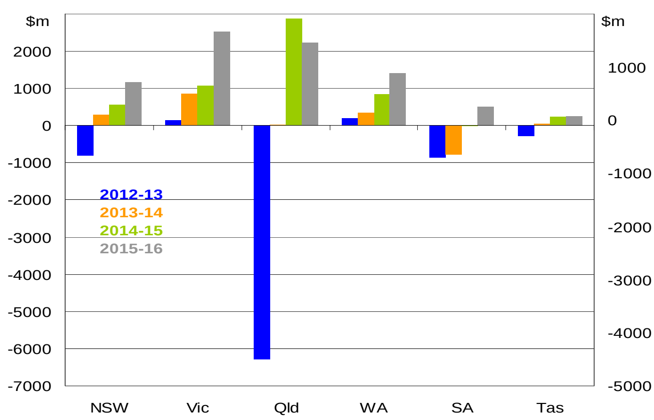
Source: NAB

State government fiscal positions deteriorating

Consistent with a weaker national growth outlook and a relatively narrow tax base that is overweight in some of the weaker parts of the national economy, the fiscal positions of state governments have come under increasing pressure from the revenue side since our last State Economic Update. As a result, the outlook between their mid-year reviews and budgets has softened and this is being reflected in net operating results. According to the 2012-13 budgets of the state treasuries, all states but Victoria revised down their estimates of net operating balances for 2012-13, although the downward revisions mostly reflect the impact of the Commonwealth government bringing forward grants and some expense shifting. In 2012-13, all states except Victoria and WA are forecasting a net operating deficit in 2012-13. Consistent with the Commonwealth, state governments are also de-leveraging. Netting out the impact of revenue and expense shifting reveals that most governments have improved their forecast balances over the forward estimates, although some assumptions on the expense side are likely to be a little optimistic.

By state, Queensland expects a net operating deficit of $6.3 billion in 2012-13 with much of this due to natural disaster grants from the Commonwealth being pushed into 2011-12 and 2013-14. This also has the effect of producing a razor thin net operating surplus in 2013-14. Similarly, the pull-forward of grants is expect to see the net operating balances of NSW and SA deteriorate sharply in 2012-13, with net operating deficits of $824 million and $867 million, respectively. In contrast, Tasmania and WA's net positions were relatively unchanged while Victoria's net operating balance improved in line with recent measures targeting expenses. Over the forward estimates period, all states except SA are expected to return to surplus by 2013-14, with SA not returning to surplus until 2015-16. Underlying the forecast improvement in budget positions is the anticipated recovery in sectors which define the revenue base of state governments, namely consumption and property based taxes. At the same time, state governments assume relatively tame expense growth through the forward estimates. In our view, this is somewhat optimistic given that a number of public sector wage negotiations are still in progress and results from recent outcomes have generally been more expensive than anticipated.

Graph 21
Net Operating Balance



Source: State Treasuries

Composition of production

	2010/11 Share of State Production (%)						
	NSW	VIC	QLD	SA	WA	TAS	Australia
Agriculture	2	3	3	6	1	8	**3**
Mining	3	3	8	4	29	1	**8**
Manufacturing	9	10	8	11	6	10	**9**
Construction	6	7	10	7	12	8	**8**
Wholesale Trade	5	5	5	4	3	3	**4**
Retail Trade	4	5	6	5	4	7	**5**
Finance & Insurance	15	12	7	9	5	8	**10**
Property & Business	13	14	10	9	10	7	**12**
Other	43	41	42	43	29	49	**41**

Source: ABS

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