



State Economic Update – September 2013

NSW

The New South Wales economy has performed well relative to most states over the past six months, with its diversified industry structure helping to cushion the economy from the mining investment slowdown. With New South Wales households more sensitive to interest rates, lower interest rates should support household consumption, a faster housing recovery and a gradual improvement in non-mining business investment growth. The recent depreciation of the Australian dollar (AUD) should support activity in trade-exposed sectors. Of course, the New South Wales economy is not entirely immune to the slowdown in mining investment, but the transition towards exports growth should provide a boost to gross state product (GSP) from 2014-15. The New South Wales economy should gradually strengthen as demand from resource-intensive states improves and the upswing in housing investment becomes more entrenched.

Victoria

The Victorian economy has a diversified (largely non-mining) industry structure, making it more stable than many of the other states. Lower interest rates and improved consumer sentiment are expected to underpin household consumption growth, while partial data suggest further improvement in property market conditions. Victoria should also benefit from increased net interstate trade, while a weaker AUD should support stronger exports. While there are several areas of potential growth, there remain a number of inherent weaknesses in the Victorian economy. Fiscal consolidation will continue to restrain government spending and investment for some time. Victoria also has a relatively large share of industries facing challenging conditions, including manufacturing, retail and wholesale trade. The Victorian outlook appears relatively stable, although growth is expected to remain below-trend over the forecast horizon.

Queensland

Queensland has benefited greatly from the rapid surge in mining investment that, up until recently, was growing at an exceptionally high speed. While the strength in mining has strengthened the Queensland economy relative to the other states, the non-mining sector continues to struggle, not helped by ex-Tropical Cyclone Oswald in early 2013. While dwelling investment is recovering, helped by lower interest rates and faster net migration, the Queensland housing market has generally underperformed. This in part reflects the relative cautiousness of Queensland consumers, with the high AUD and still soft global growth weighing heavily on trade exposed and labour intensive sectors. Looking ahead, a downturn in business investment is expected to be negative for Queensland's growth, but stronger household consumption and dwelling investment growth should help to offset this. While a lower AUD should assist growth, weakness in labour intensive parts of the state may keep the unemployment rate elevated for some time.

Western Australia

The swelling in mining investment has been an enormous support to the Western Australian economy, with growth spilling into other parts of the state and other states. But this has made Western Australia highly vulnerable to mining industry conditions. The mining boom brought with it increased population growth, which has boosted dwelling investment and household consumption, with the latter also benefiting from the high AUD via increased purchasing power. As mining investment unwinds, so too will growth. Given the labour intensity of mining investment, employment growth is expected to slow. This is likely to put increased pressure on the domestic economy, with housing market activity expected to stabilise, and the easing in income and population growth expected to limit demand.

South Australia

Growth in the South Australian economy moderated over 2012-13, with consumer spending and housing demand remaining subdued. Sectors exposed to the high AUD continue to face challenges, though they should be supported by the recent dollar depreciation. Non-specialised parts of the manufacturing sector have faced especially difficult conditions, including motor vehicle manufacturing and associated supply firms, which will have implications for further growth. A net outflow of migration will keep labour market conditions reasonably subdued. Overtime, the rising Asian middle class will increase world demand for high quality food and wine, which should be supportive for South Australia.

Tasmania

The Tasmanian economy continued to under perform relative to the rest of Australia, with state final demand contracting by 2.9% in 2012-13. With Tasmania struggling to remain competitive in the mainland and overseas markets and lower population growth presenting ongoing problems for its household sector, there appears to be little upside to the near-term outlook for this state. Nonetheless, the recent dollar depreciation should provide some relief to trade-dependent sectors, and there will be opportunities for investment in dairy and agriculture sectors over coming years. Government revenue pressures will keep public spending restrained over the forecast horizon, contributing to the reasonably subdued outlook for growth in 2013-14.

State Forecasts

	Gross State Product			Unemployment Rate		
	Annual % change			Average annual rate		
	12/13	13/14 ^f	14/15 ^f	12/13	13/14 ^f	14/15 ^f
NSW	2.3	2.5	2.9	5.2	6.0	6.4
VIC	1.5	2.3	2.8	5.6	6.1	6.6
QLD	3.8	1.8	2.6	6.0	6.3	7.2
SA	1.8	1.0	2.0	5.8	7.0	7.5
WA	5.0	2.8	2.5	4.4	5.5	6.6
TAS	-1.3	0.5	1.3	7.3	8.5	9.5
Australia	2.9	2.2	2.8	5.3	6.2	6.8

Source: NAB Economics

State conditions continue to disappoint especially in mining states where investment slowdown is taking a toll

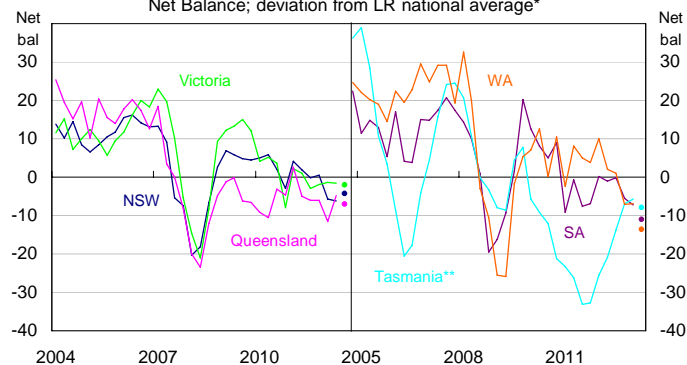
The NAB Quarterly Business Survey showed a marginal deterioration in overall business conditions in the June quarter, with the level remaining close to four year lows. While all states experienced difficult conditions in the quarter, there has been a pronounced slowing in activity in the resource-rich states over the past year or so where it is apparent that the mining slowdown is spreading beyond that sector. As a result, Western Australian, Queensland and to a lesser extent South Australia will face more structural headwinds than elsewhere. While conditions in New South Wales and Victoria have remained subdued, activity here has largely stabilised as a result of these states being more diversified and less exposed to the mining investment slowdown. Over time, the structural diversity of the industry make up in these states can be expected to support stronger growth.

More recent monthly data show that business conditions in the mining states have weakened into the September quarter, while conditions in the non-mining states have held up at relatively better levels. The weakness in activity in the mining states is consistent with falling commodity prices and softer Chinese demand. While conditions are generally weak across all industries, activity in the recreation & personal services and finance/ business/ property sectors has held up better than it has elsewhere, supporting activity in NSW and Victoria, where these industries comprise a larger share of state output. Furthermore, a weaker AUD, rising equity prices and lower interest rates may be providing more of a boost to activity in these states. Consistent with the general deterioration in state conditions into the second half of this year, business confidence appears to have weakened everywhere, with the heaviest declines in the mining states. Part of the deterioration in sentiment is likely to reflect external factors, including expectations around when the US Fed will begin tapering its asset purchase program, a slowing in Chinese growth and a temporary hiccup in the equity price rally. However, a bounce in business confidence reported in the latest August monthly survey, which appears to have largely reflected an expectation of political change and more certainty about the future policy framework (this survey was conducted prior to the Federal election on 7 September), represents a decoupling of confidence from conditions, although consumer confidence has also improved.

Graph 1

Quarterly NAB Business Conditions Index

Net Balance; deviation from LR national average*

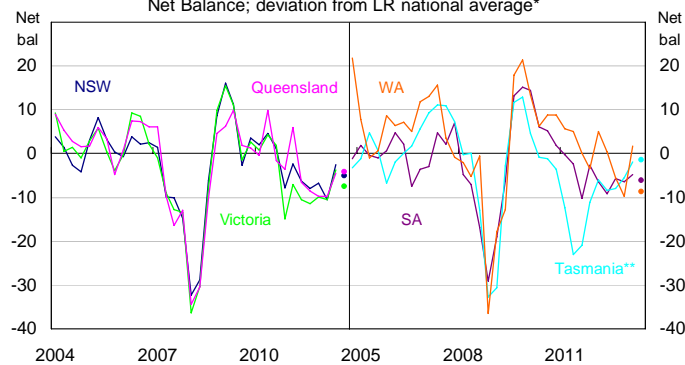


* Deviation from national average since Sep 1989. Data are seasonally adjusted. Dots represent August 2013 outcomes from NAB monthly business survey.
 ** Data have been trended using 5-term Henderson trend (due to small sample size)

Graph 2

Quarterly NAB Business Confidence Index

Net Balance; deviation from LR national average*

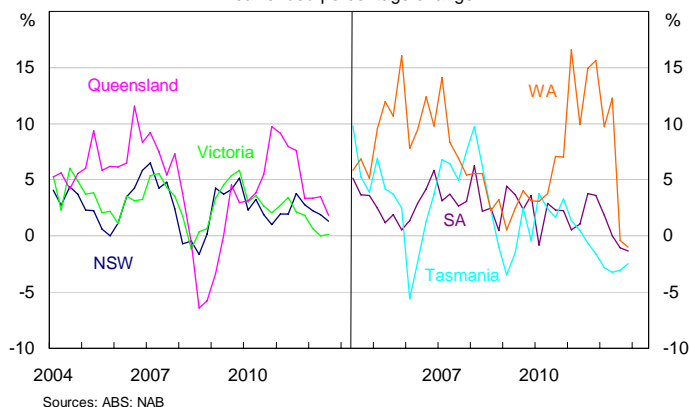


* Deviation from national average since Sep 1989. Data are seasonally adjusted. Dots represent August 2013 outcomes from NAB monthly business survey.
 ** Data have been trended using 5-term Henderson trend (due to small sample size)

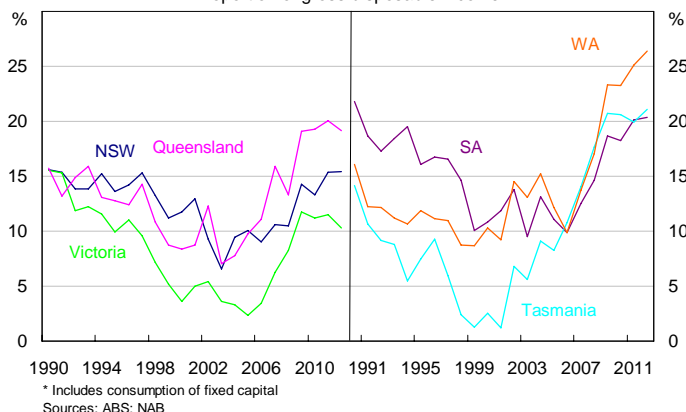
Weakness in household spending persists across all states, with growth falling sharply in previous strong performers

Domestic final demand growth in Australia softened from 6.0% over 2011-12 to 0.6% over 2012-13, representing the weakest outcome since 2009. Contributing to the recent softening in demand has been a decline in investment growth as well as soft growth in private consumption expenditure, with the latter making up almost 55% of total final demand. Through the year growth in household final consumption expenditure has fallen significantly (from an exceptional pace) in Western Australia over the first half of this year, while in levels terms growth was particularly weak in Tasmania and South Australia. Elsewhere, growth was relatively soft compared to a year earlier.

Graph 3
Real State Final Demand
Year-ended percentage change

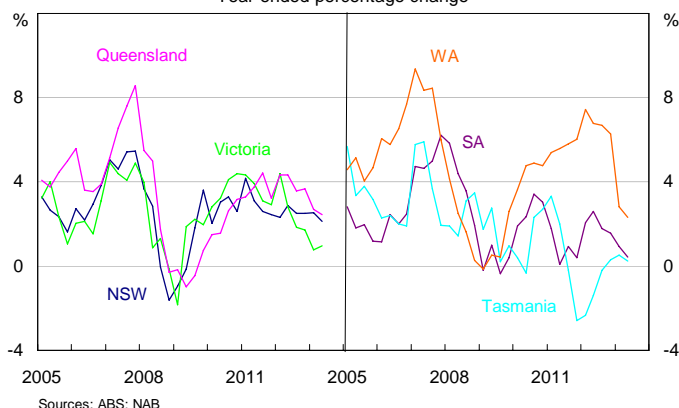


Graph 4
Household Savings*
Proportion of gross disposable income

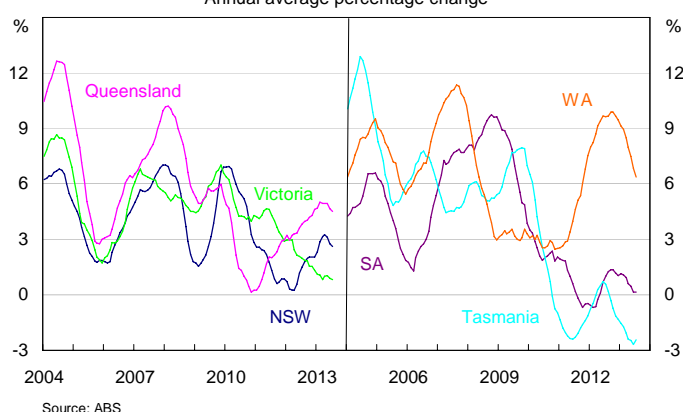


Consumer caution has remained a prominent feature of the Australian economy since the onset of the global financial crisis (GFC), when households re-assessed their spending behaviours in order to help de-leverage their balance sheets. As a result households are now saving a much larger proportion of their disposable income than they were prior to the GFC, and it is clear that this has weighed heavily on consumption. While interest rates have fallen since late 2011, in effect lowering the rate of return available to households on their savings, this does not appear to have discouraged households from continuing to save. The general expectation is for the economy to soften as the transition away from mining investment intensifies. More certainty about the economic outlook may be expected to see households relax their savings patterns, which could help to strengthen household consumption growth. The rise in household saving as a proportion of disposable income has been broad-based across states, though it has been particularly pronounced in Western Australia, where household income growth has run well ahead of consumer spending, despite the strength of the latter (see below). The anticipated slowing in the Western Australia economy combined with a more elevated level of house prices may weigh on the rate of household savings here.

Graph 5
Real Household Final Consumption Expenditure
Year-ended percentage change



Graph 6
Retail Sales Growth
Annual average percentage change



The relative strength of each economy tends to be a strong determinant of consumption behaviours, including retail spending. Household consumption expenditure and retail sales growth in Western Australia have surpassed that of the other states for most of the post-GFC period but a recent sharp slowing in the pace of growth has brought consumption spending in Western Australia back to the pack (annual consumption growth slowed to 2¼% in June quarter 2013, compared to growth of 6¾% one year earlier). Consistent with this slowing and the sharp deterioration in state final demand as a result of the mining downturn, it is likely that the household savings ratio has fallen in this state over the

past year (current data only available to June 2012). Elsewhere, household consumption growth has generally softened but to a lesser degree. Households in New South Wales appear more sensitive to interest rates than the other states, which appear to have helped to support a more stable pace of household spending growth over recent quarters. The level of growth has held up relatively well in Queensland, possibly reflecting temporary factors including repairs following severe weather conditions earlier this year. However, the pace of growth has still fallen notably, probably reflecting the overall softness in labour market conditions and income growth. Tasmania has experienced the weakest growth in household consumption, and indeed consumption was declining for most of 2011-12; this largely reflects the relative weakness in the Tasmanian economy compared to the other states as a result of lower population growth and falling employment. Retail sales, which account for approximately one third of total household consumption expenditure, have exhibited similar trends to consumption growth across the states.

Public sector investment falling as Governments aim to balance their Budgets

With fiscal consolidation a primary focus at present and Commonwealth and State Governments intent on bringing their Budget balances into surplus, public sector demand growth is being heavily constrained. Public capital investment across the states declined significantly over 2012-13 as Commonwealth fiscal spending on infrastructure was unwound and very few new infrastructure projects were implemented. The main casualties of the pull back in underlying public infrastructure spend (which abstracts from asset sales between sectors) have been South Australia, Victoria and Tasmania. The decline in public investment spending in South Australia appears to reflect the unwinding of Government infrastructure programs implemented during 2008-09. In Victoria, there are very few public sector investment projects currently underway and any projects that may come online will take a number of years to get up and running. Meanwhile, significant revenue pressures in Tasmania are weighing on public spending here.

Underlying Gross Fixed Capital Formation - year to June 2013*						
	Year-average percentage change					
	NSW	VIC	QLD	SA	WA**	TAS
Private	3.6	1.4	6.2	-2.1	7.4	-15.5
Public	-9.7	-11.4	-5.0	-16.6	-6.7	-11.3
Total	0.9	-0.6	4.0	-5.2	6.1	-14.3

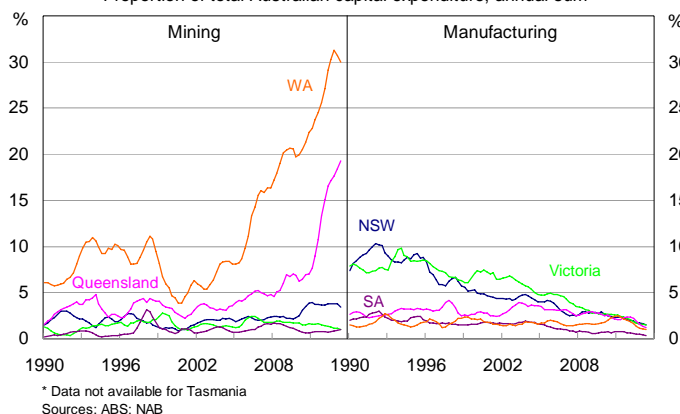
* Abstracting from asset sales between sectors

** Actual: underlying not available from ABS

Sources: ABS; NAB

The Australian economy has seen a terrific expansion in capital investment over much of the past decade. As a result, there has, on average, been a broad-based increase in capital expenditure as a share of state final demand across the Australian states (see Graph). Over more recent years, mining investment has contributed greatly to the capital expansion in Australia, making up the lion's share of total investment. To put things into perspective, the mining sector in Western Australia accounted for 30% of total capital expenditure in Australia over 2012-13, and the Queensland mining industry accounted for 19%. More recently, however, mining investment has peaked and it seems increasingly less likely that the non-mining sector will have the capacity to respond immediately to the mining investment slowdown. The downturn in mining investment is most apparent in Western Australia, where the majority of mining activity is taking place. Mining investment spending is holding up better in Queensland, boosted by investment in three LNG projects which are still being constructed, although business investment is expected to peak in Queensland later this year. To help the transition away from investment, the Queensland Government is looking to broaden the economy by focusing on construction, tourism, resources and agriculture. Elsewhere, the likes of Victoria, New South Wales and South Australia have been less affected given their lesser reliance on mining. Nonetheless, a decline in manufacturing investment, which is coming under pressure from a relatively elevated AUD and increased competition from the emerging market economies, is having a material impact on business investment in those states where manufacturing makes up a larger part of the economy, including South Australia, Victoria and Tasmania. Overall, while there remains a significant amount of (mining) investment in the pipeline, the outlook for business investment continues to soften, with the overall level of business investment expected to be around 15% lower than the current level in two years time.

Graph 7
Capital Expenditure by Industry by State*
 Proportion of total Australian capital expenditure, annual sum



Post the mining investment boom: where to from here?

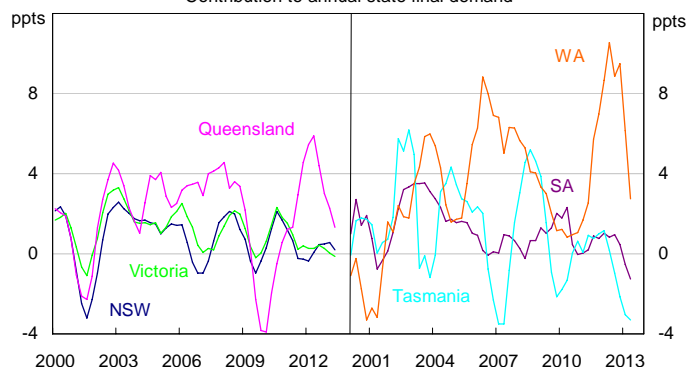
The non-residential investment pipeline peaked in mid-2012, reflecting the significant amount of mining construction that was being completed, combined with a slowing stream of project commencements, with many of the 'mega' mining projects already underway. The decline in the investment pipeline has continued over the past year, with particularly sharp falls occurring in Western Australia and Queensland where mining investment is most embedded. Nonetheless, the pipeline of work yet to be done remains most elevated in these states, at around one year and three months long in Western Australia and one year and one month long in Queensland, which together, represents over half of the total Australian pipeline. The non-mining states are not expected to make a significant contribution to future non-residential investment given already low capacity utilisation and soft demand.

The Australian Bureau of Resources and Energy Economics (BREE) released its updated listings of major mining projects in May this year, which outlined the current state of mining, infrastructure and processing facilities projects in Australia. According to BREE, the total number of committed projects fell from 87 in October 2012 to 73 in April 2013. However, the value of committed projects was broadly unchanged at \$268 billion (17.9% of current annual GDP), largely reflecting cost overruns which do not necessarily add to the volume of activity or capacity. LNG, gas and petroleum projects continue to dominate the pipeline of current and future investment in Australia, making up \$205 billion (76%) of total committed projects, with many of these projects located in Queensland. While the value of minerals and energy investment in the pipeline remains enormous, BREE has highlighted a sharp reduction in the value of projects at the feasibility stage, providing further evidence that the mining investment slowdown is underway. The shift from investment to production and exports will have important implications for output growth and employment.

Graph 8

Investment Expenditure*

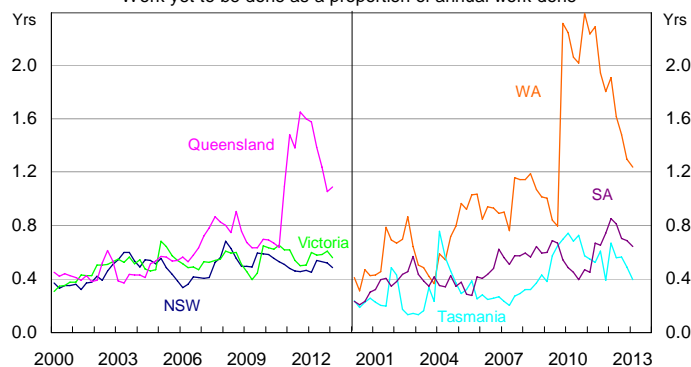
Contribution to annual state final demand



Graph 9

Non-residential Investment Pipeline*

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

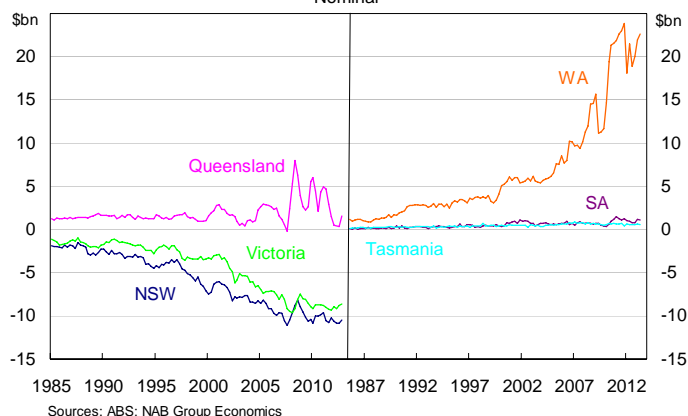


Nominal net international trade strengthening in resource-rich states, but generally softening elsewhere

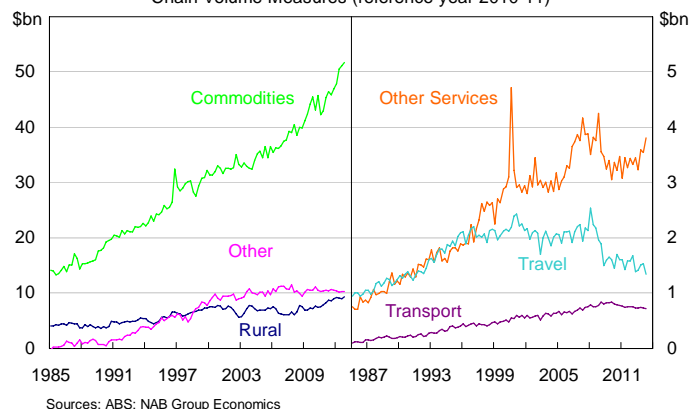
For the first time since 2009, net exports made a positive contribution to annual GDP growth in September quarter 2012, with this trend continuing for the remainder of 2012-13. Following years of intensive investment activity, an increase in mining production capacity in Western Australia and Queensland is now beginning to yield higher export volumes. Net exports have risen solidly in Western Australia in the first half of this year to be at very elevated levels, with the transition from the mining construction to production phase gaining momentum. Queensland's nominal trade balance has lifted modestly over recent quarters, though it remains at a low level relative to recent history, reflecting the current weakness in coal export volumes. Elsewhere, trade balances have been broadly steady in Victoria and New South Wales, with weaker imports helping to (at least temporarily) stem the long-term decline in trade balances in these states. Export activity in South Australia and Tasmania has been subdued, with sectors exposed to the high AUD continuing to face challenges in these states, with particular weakness felt in the less specialised parts of manufacturing.

Looking ahead, further expansions in production capacity are expected to be the key driver of export volumes over coming years, rather than fluctuations in external demand. Production capacity will ramp up solidly in Queensland as LNG projects begin to yield more output. On the demand side, the majority of external demand for Australia's exports will come from China – Australia's largest trading partner – which accounted for almost 32% of the country's merchandise exports in 2012-13. While most of the strength in demand is expected to come from the emerging market economies, the recovery in growth in the major advanced economies should also help to strengthen demand. Exports in commodities continue to dominate trade patterns while rural exports have lifted considerably over the past year or so, in line with improved conditions.

Graph 10
Net Exports of Goods
Nominal



Graph 11
Goods & Services Exports
Chain Volume Measures (reference year 2010-11)

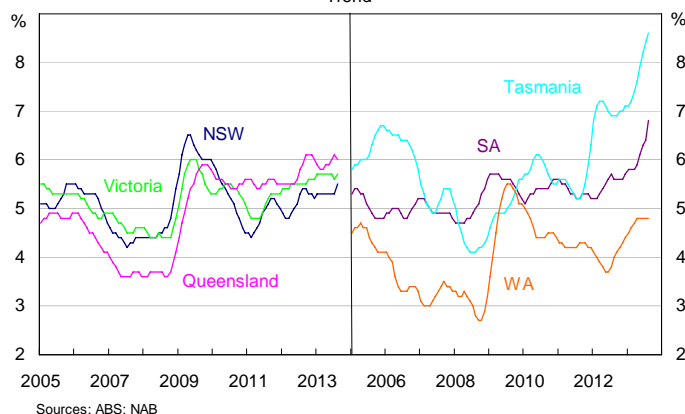


While Victoria and NSW typically have large international trade deficits in merchandise goods, it is services trade that generally drives export performance within these states, accounting for around two thirds of total exports. According to balance of payments data, Australian services exports fell by 0.7% over 2012-13, with falls in transport and travel exports mostly offset by a rise in other services. With a weaker AUD and international student enrolments on the rise, it is possible that Victoria and NSW may benefit from improved net services trade over coming quarters.

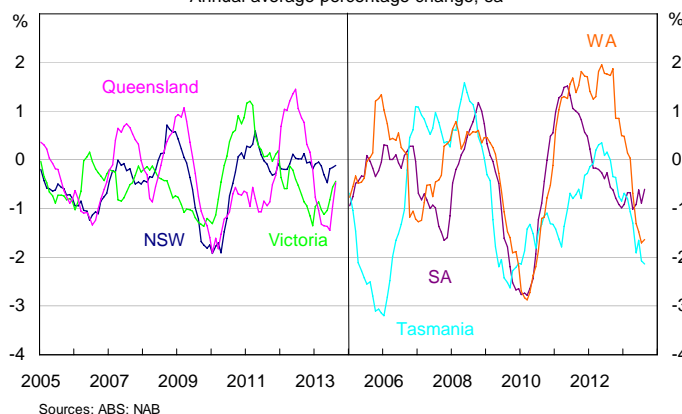
Labour market conditions deteriorate in soft growth environment

The labour market has weakened considerably since our last State Economic Update six months ago. In the soft growth environment, businesses continue to look for ways to operate more efficiently and at a lower cost, which inevitably means reducing employment. Indeed, the pace of employment growth has slowed over the past year and the unemployment rate has gradually risen to 5.8%, from closer to 5.0% a year earlier. There are clear signs that the slowing in labour-intensive mining investment is already having an impact on labour market conditions in Western Australia, with the unemployment rate rising to almost 5% in trend terms in August, up from 4% just one year earlier. The more diversified Victorian, New South Wales and to a lesser extent Queensland economies have been much more resilient to labour market weakness as a result of their more diversified industry structures, with unemployment rates in these states rising just 0.1-0.2 ppts over the past year. The recent upswing in trend rates of unemployment in Tasmania and South Australia have been much more concerning, with current rates of 8.6% (6.9% one year earlier) and 6.8% (5.6%) respectively. The weakness in the Tasmanian labour market is consistent with the difficulties of remaining competitive with mainland Australia and overseas markets, largely reflecting the economy's large exposure to the AUD as well as its mix of industries being skewed towards weaker sectors. Further compounding the weakness in the Tasmanian labour market is the sharp reduction in average hours worked, which will have helped to prevent a further rise in the rate of unemployment. Average hours worked fell sharply in Western Australia, while they were a little lower elsewhere.

Graph 12
Unemployment Rate
Trend



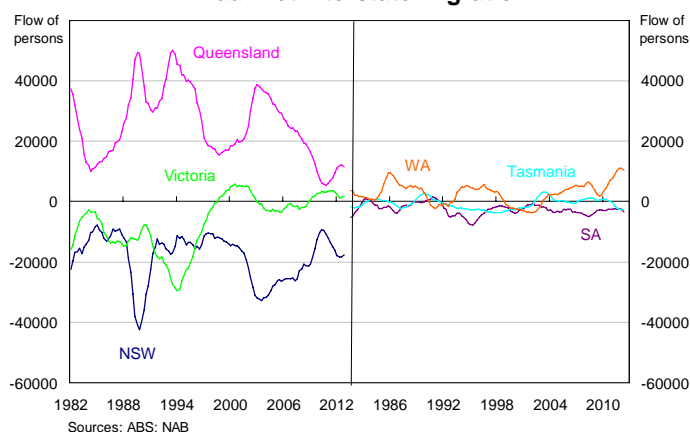
Graph 13
Average Monthly Hours Worked
Annual average percentage change; sa



Labour market indicators generally point to a moderation in employment growth – largely reflecting the frictional impact structural adjustment in the Australian economy is having on hiring. The deterioration is already underway, with employment falling over recent months. We see the unemployment rate exceeding 6% by the end of this year, before rising to around 6¾% by mid-2014. The higher rate of unemployment is likely to be particularly apparent in Tasmania and South Australia, where unemployment is already rising rapidly, while the New South Wales and Victorian economies should be more sheltered due to having more diversified industry structures. In the mining states – Western Australia and Queensland – the decline in labour-intensive mining investment should see unemployment rates rise modestly and remain elevated for some time.

The rate of net interstate migration appears to have stabilised across all states over the second half of 2012 (latest data available). The two largest mining states, Western Australia and Queensland, continue to benefit from a positive flow of interstate migration in response to high levels of mining-related investment in the resource-rich states. Consistent with the weaker outlook for mining investment over the forecast horizon, Western Australia and Queensland are expected to experience a decline in interstate migration. Victoria continues to gain from interstate migration but the gains are only marginal. New South Wales continues to experience an outflow of net interstate migration but the rate of decline has also eased. Tasmania and South Australia have experienced a continued outflow of migration. The outflow of people from these states is having a negative impact of some industries and is contributing to weaker activity relative to the rest of the country.

Graph 14
Annual Net Interstate Migration



Wage pressures easing, consumer price inflation under control

Soft domestic demand and excess spare capacity have simultaneously weakened demand for labour, which has restrained wage growth to historically low levels. The wage price index, which measures the cost of a unit of labour, rose by 2.9% over the year to June quarter 2013, which was the (equal) softest outcome since March quarter 2000, just prior to the introduction of the GST. Wage growth has been especially subdued in New South Wales and Queensland, rising just 2.8% over the year to June quarter. The weakness in wage growth in part reflects government initiatives aimed at reducing public sector wage burdens. For example, the New South Wales government has imposed a 2½% ceiling on annual remuneration expenses and introduced other measures to manage excess employees. The Victorian government

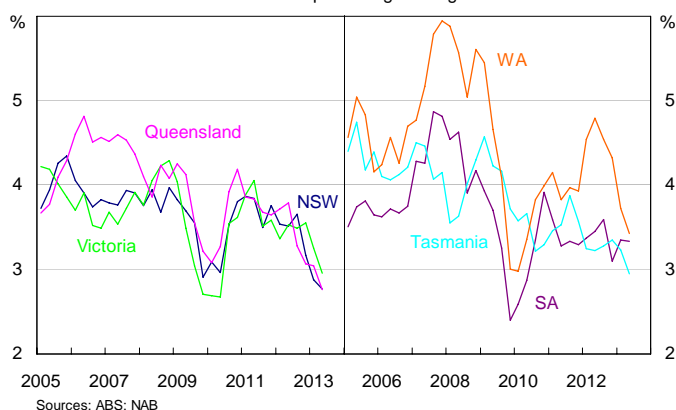
has implemented a similar scheme providing for annualised wage increases of 2½% (larger increases must be offset by genuine productivity gains), supporting below-trend public sector wage growth. Total wage growth in Victoria was also soft, at 3.0% over the year to June quarter. While wage increases remain relatively stronger in WA, rising 3.4% over the year, there has been a clear moderation in quarterly growth in response to increasing spare capacity in the resource-rich part of the state. This momentum is expected to continue throughout 2013-14 as the flow of labour-intensive mining investment continues to ease. These effects will be compounded by a softening in activity in businesses supporting mining, where demand for labour is expected to decline. While wage growth has held up reasonably well in South Australia, up 3.3% over the year, it has generally moderated over the course of 2012-13 in quarterly terms, suggesting growth momentum is trending lower. Growth in Tasmanian wages has been especially soft, up just 2.9% over the year, which is consistent with relatively weak labour market conditions. With labour intensive mining investment set to ease and the non-mining parts of the economy showing little sign of strengthening anytime soon, the outlook for wages remains subdued.

Consistent with soft domestic demand and labour market conditions, quarterly consumer price inflation has moderated across the capital cities since September quarter 2013. In annual terms, inflation across the capitals remained well within (or in the case of Tasmania, below) the RBA's medium-term target of 2-3%, even despite the solid boost to prices in September quarter 2013 which resulted from the implementation of the Federal Government's carbon tax. Underlying measures of consumer price inflation (at the national level) were also relatively soft, with the average of weighted median and trimmed mean CPI measures running at around 2.4% in the June quarter. With the impact of carbon pricing expected to largely wash out of annual inflation numbers from September quarter 2013, we see headline inflation dipping below 2%. Price pressures have moderated notably across all states in the first half of 2013, even despite a series of RBA cash rate cuts which were intended to boost domestic demand. Annual rates of inflation ranged from 1.8% in Hobart to 2.6% in Sydney in the June quarter. The weakness in prices growth in Tasmania reflects a deterioration in discretionary spending to below the level prior to the global economic downturn in 2008. While the recent sharp deterioration in the value of the AUD will add to price pressures through its transmission to higher import costs, the full effects of this will take a long time to wash through the economy. Furthermore, the softness in the domestic economy may restrict the ability of businesses to pass on higher costs, which may see profitability decline rather than prices increase.

Graph 15

Wage Price Index

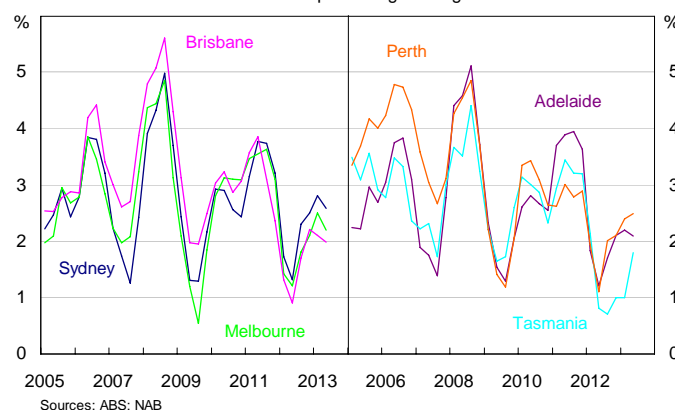
Year-ended percentage change



Graph 16

Consumer Price Index

Year-ended percentage change

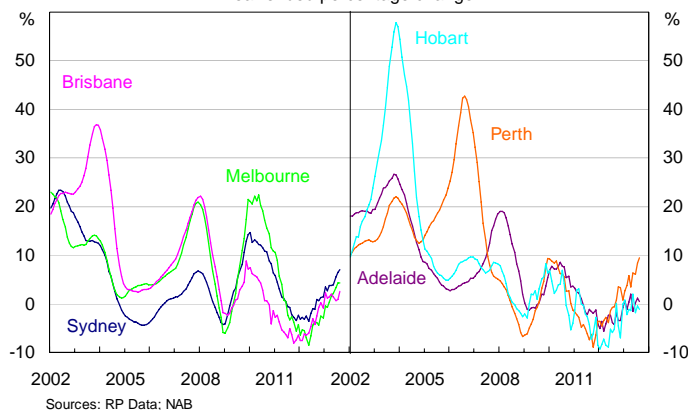


Housing market recovery gaining momentum

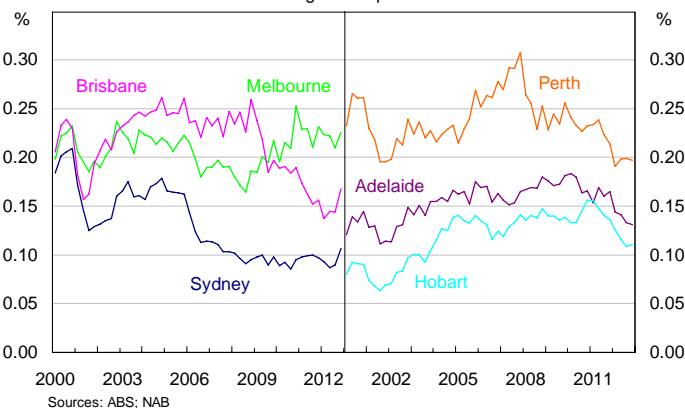
Emerging green shoots in the housing market have gained more traction, with all states reporting higher annual rates of dwellings price growth compared to a year ago when prices were in moderate decline. According to the latest monthly RP Data Rismark data, average dwellings prices across Australia's capital cities rose by 5.3% over the year to August 2013 – the eighth consecutive positive monthly growth outcome – though deviations in annual growth across capital cities remain, meaning the recovery in the housing market has not been equal. Much of the variation in growth reflects the variance in state economic conditions, which is affecting household investment decisions differently. The overall recovery in property prices has been led by Perth, with this state still benefiting from the resources boom, which has boosted population growth and put additional pressure on rental market conditions. The dwelling price recovery has also gained more traction in the Sydney property market, underpinned by solid growth in rental prices, population and household income, as well as an undersupply of housing. Furthermore, New South Wales households appear more sensitive to interest rates than other states, with the low interest rate environment helping to support demand for housing as well as an undersupply in terms of dwellings per person. While the Melbourne property market has taken longer to recover than most other markets, reflecting a correction from especially high growth in the post-GFC housing boom, the dwellings price recovery is also gathering pace in Melbourne. Elsewhere, property markets are less robust in Adelaide and Brisbane,

and prices are still declining in Hobart. It is likely that concerns about the economic outlook and job security are weighing on household investment behaviour in these cities. Nonetheless, the Queensland government's 'Great Start Grant' and Tasmania's 'First Home Builder Boost' should help to support the construction of new dwellings in 2013-14.

Graph 17
RP Data Dwelling Prices
Year-ended percentage change

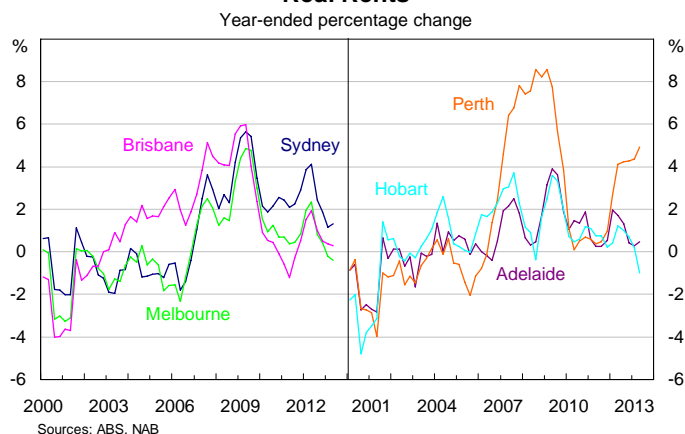


Graph 18
Dwelling Completions to Population Ratios
Average over quarter

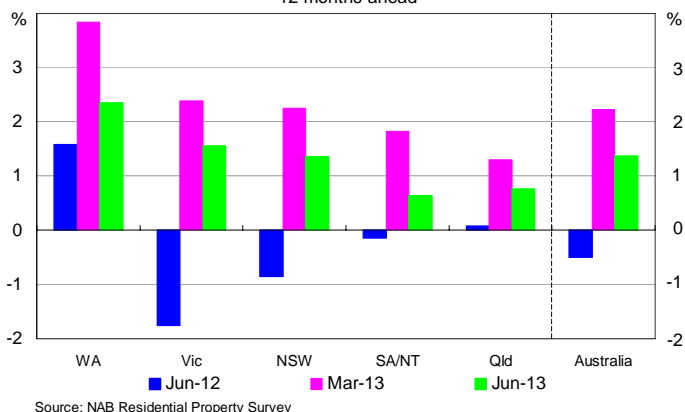


With conditions in the residential property market improving, the outlook for dwellings investment appears to have strengthened. Consistent with the improvement in housing demand, ABS data show that prices for new homes purchased by owner-occupiers rose by 3.6% over the year to June quarter 2013 – the highest pace of annual growth in three years. When combined with a marginally softer 3.2% rise in hourly rates of pay for the construction industry, as well as a modest 1.2% rise in input costs to the house construction industry, the rise in prices for new homes implies that margins have improved a little compared to six months ago, when they were being squeezed. Furthermore, the ABS established house price index, weighted for the eight capital cities, showed a 5.1% rise in house prices over the year to the June quarter 2013. Improving margins and rising house prices should eventually underpin stronger dwellings investment. Indeed, we are already seeing evidence that housing construction rates are improving in some states, with the ratio of dwelling completions to population showing signs of recovering. The Adelaide and Hobart markets are the exception, where very soft economic growth and outflows of net interstate migration are limiting the need for additional dwellings. Nonetheless, the Melbourne, Brisbane and Sydney markets are all benefiting from an increase in the rate of dwellings to population, which should help to reduce the degree of undersupply in these cities. While the rate of dwellings construction has been relatively stable in Perth, this market is continuing to experience a solid pace of additions, especially given the surge in population growth that has occurred over recent years. We expect dwellings construction to strengthen in 2013-14, although finance restrictions may limit growth, at least in the near term.

Graph 19
Real Rents
Year-ended percentage change



Graph 20
Expected House Price Growth
12 months ahead



Underlying demand for housing appears to have strengthened into 2013, helped by lower interest rates and a recent upturn in consumer sentiment. While there are signs of an upswing in housing trends, still soft wages growth and concerns about job security in the deteriorating labour market environment are likely to keep demand for housing somewhat restrained, preventing the exceptional pace of house price growth seen over most of the last decade. Nonetheless, the interest rate environment is expected to remain very accommodative for some time, which should provide continued support to underlying demand.

Consistent with the general downgrade to the outlook for economy over the forward estimates, the June quarter 2013 NAB Residential Property Survey has shown a slight softening in expectations for house prices over 2013-14. Nonetheless, expectations are still for house prices to rise across all states. According to the survey, respondents expect house prices to rise by 1.4% nationally in 2013-14 (2.2% at the time of the March quarter survey), with softer price gains forecast for all states. Expectations remain strongest for Western Australian dwellings, largely reflecting the existing undersupply of housing, although price growth for this state was downgraded most significantly as a result of the faster than anticipated slowing in mining investment, which is impacting the rate of population growth. Expectations were softest in South Australia and Queensland, while they were broadly similar and close to the national average for New South Wales and Victoria.

State government fiscal positions generally weaker than at the time of mid year reviews

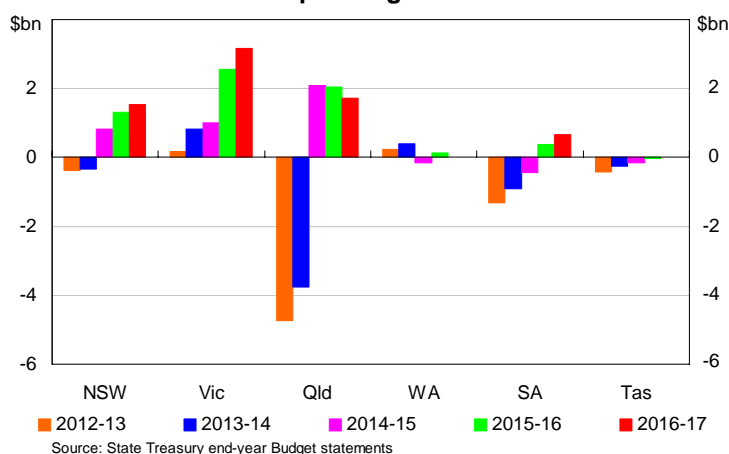
All of the state treasuries have revised down their 2013-14 estimates of GSP since producing their mid-year Budget reviews, reflecting a weaker global economic environment and a softer outlook for labour market activity. The Western Australian Treasury has downgraded its 2013-14 GSP estimate by 1.0 ppt, reflecting a sharper projected decline in business investment in response to the softened outlook for Chinese growth, volatile commodity prices and the possibility of further price declines. Not only have these factors led mining firms to reassess potential projects, but they are also encouraging firms to reassess existing operations by focusing more on reducing costs rather than increasing capacity. In Queensland, ex-Tropical Cyclone Oswald, which caused severe flooding across parts of the state in early 2013, hit agricultural production especially hard and the resulting economic production losses are estimated to be in the order of \$500-700 million in 2012-13 (excludes damage bill for private and business premises and public property). While the Queensland Treasury does not provide an estimate of the impact of the cyclone on 2013-14 growth, a proportion of the 0.75 ppt downward revision to 2013-14 growth is likely to capture this. The expectation for mining investment to decline sharply after 2013, relatively poor housing market fundamentals and soft population growth projections are likely to have been responsible for the remainder of the downgrade. The South Australian Treasury has lowered its GSP growth estimate for 2013-14 by 0.5 ppts, acknowledging that a number of sectors that face challenges ahead, especially trade-exposed sectors and those heavily reliant on consumer spending. Many businesses in these industries are likely to be adversely affected as a result of the softer global growth environment. Victoria and New South Wales, which have more diversified industry structures, look set to weather the effects of the mining transition better than most states. In Victoria, a softer national growth outlook is expected to weigh more heavily on interstate trade, which is a key component of the Victorian economy, while the softer outlook for the global economy is expected to weigh on exports. Similarly, the New South Wales economy is expected to be affected by weakness elsewhere, though the downward growth revision for 2013-14 of 0.25 ppts is slightly below that of Victoria's (0.5 ppts), probably reflecting the relatively high sensitivity of New South Wales households to (lower) interest rates. The outlook for the Tasmanian economy has been revised lower in 2013-14, with this state highly exposed to the still elevated AUD due to its industry mix and especially the types of manufacturing products it exports, which is lessening its competitiveness with the mainland and overseas markets.

With the deterioration in the national growth outlook putting immense pressure on the fiscal positions of state governments since the time the mid-year Budget reviews were submitted, state government revenue projections have generally been revised lower. The deterioration in revenue projections has put increased pressure on state operating balances, which have generally been revised lower as a consequence. Queensland's net operating balance for 2013-14 was revised down by \$3.0bn, mainly due to unanticipated disaster recovery payments following severe weather conditions at the beginning of 2013. Tasmania's net balance was also revised down notably (\$340 million), reflecting a softer outlook for employment growth and other key economic indicators impacting on tax receipts. In contrast, Western Australia's net fiscal operating balance has been revised up (\$570 million), in part reflecting additional revenue of \$475 million that is expected to be generated by the Government's Fiscal Action Plan as well as stronger projections for underlying transfer duty collections and higher forecasts for mining revenue. Elsewhere, net operating balances were little changed for 2013-14, while downgrades to the state government outlooks meant a general deterioration in forecasts for general government net operating balances in 2014-15.

By state, the Queensland Treasury expects its net operating deficit to improve to \$3.8 billion in 2013-14, which is around \$3 billion larger than what was expected at the time of the mid year fiscal and economic review (MYFER). The deterioration in projected deficit largely reflects the incorporation of costs associated with recent flooding caused by ex-Tropical Cyclone Oswald. The Queensland Treasury has projected a \$2.1 billion surplus in 2014-15, as a result of the Government's fiscal repair initiatives, which include reducing debt and targeting full funding of long-term liabilities in accordance with actuarial advice. The net operating deficit for New South Wales improved a touch to \$329 million; with the economic outlook for this state broadly unchanged since MYFER, the improved Budget position largely reflects efforts to restrain expenditure growth. However, for 2014-15 a Budget surplus of \$829 million is anticipated, which is lower than previously projected, reflecting the impact of amendments to the accounting standard applied to superannuation accrual expenses in 2013-14. While South Australia's net operating position is relatively unchanged for

2013-14, adverse revenue movements, including adjustments to expected GST collections and state taxation revenues, have affected the net operating balance for 2014-15. The South Australian Treasury estimates a net operating deficit of \$431 million in 2014-15. Victoria and Western Australia are the only two states forecasting a net operating surplus in 2013-14 (\$818 million and \$386 million respectively). In Victoria, the net operating surplus is projected to rise to \$1.0 billion in 2014-15, which is modestly softer than the surplus estimated at the time of its MYFER, while the Western Australian Treasury projects its net operating balance to deteriorate to a deficit of \$147 million in 2014-15, reflecting lower expected tax revenue due to soft labour market conditions. The Tasmanian Treasury estimates its net operating balance to improve marginally over the forward estimates, rising from a deficit of \$267 million in 2013-14 to a deficit of \$165 million in 2014-15.

Graph 21
Net Operating Balance



Composition of production

	2011/12 Share of State Production (%)						Australia
	NSW	VIC	QLD	SA	WA	TAS	
Agriculture	2	3	3	6	2	8	3
Mining	3	2	11	5	36	2	10
Manufacturing	8	9	8	10	5	9	8
Construction	6	6	9	7	12	7	8
Wholesale Trade	5	5	6	5	3	3	5
Retail Trade	4	6	5	5	3	6	5
Finance & Insurance	15	13	7	9	4	8	10
Property & Business	13	14	11	9	8	7	12
Other	43	42	41	43	26	50	40

Source: ABS

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