

State Update: New South Wales – January 2016

NAB Group Economics



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Key points

- NSW has been well positioned to enjoy the benefits of a lower AUD and interest rates. **Robust state final demand has underpinned the states growth and labour market, and will remain the primary driver going forward as activity broadens across sectors.** In contrast, **subdued export demand will remain a drag on overall growth, although tourism has seen improvement.** Overall, **Gross State Product (GSP) growth is expected to pick up slightly to 2.6% in 2015-16 and 2.8% in 2016-17 (Chart 1).** From 2017, rising interest rates will be a risk to NSW given its relatively high debt levels. **The challenge for NSW will be maintaining strong SFD growth as momentum from the housing sector begins to fade over the course of 2016.**
- Subdued conditions in other (mining) states and internationally has remained a hindrance for the traded sector, despite assistance from previous AUD depreciation.** But, with Australia's transition away from mining investment led growth drivers, state final demand has been stronger in NSW than the national aggregate (Chart 2).
- Residential property has played a key role in the states recent economic performance. **Dwelling construction activity has picked up considerably over the past two years and is expected to remain elevated given record levels of residential projects in the construction pipeline.** However, with additional supply and worsening affordability starting to reflect on property prices, **further growth in the pipeline is likely to be muted.** Additionally, notably **softer property price performance going forward will weigh on the substantial positive effects on consumption.**
- The positive spill-overs from residential markets, while arguably more muted than experienced historically, have still been notable – especially early in the market rally.** The impact on household wealth (along with some assistance from tourist arrivals) helped to offset ongoing restraint in income growth, underpinning reasonably solid growth in household consumption. Stronger than expected transfer duties have also lent support to state government finances. Going forward, **weaker expectations for property prices will cap consumption growth amidst subdued wages growth, although solid employment will provide some support.**
- Labour market statistics have been volatile, but point to a pronounced improvement late in 2015.** Unemployment is falling in both Greater Sydney and the rest of NSW, although the latter remains somewhat elevated. Business indicators, including the NAB Business Survey, suggest that labour intensive (non-mining) sectors of the economy are well positioned to drive employment higher. However, additional labour supply (from the mining states) is expected to keep falls in the unemployment rate relatively modest. **The unemployment rate is forecast to drift downwards toward 5% by mid-2017.**
- Robust business conditions and rising capacity utilisation are supportive of business investment, while public infrastructure spending will provide key support to the local economy over coming years.** However, despite improvements in the business environment, growth in private investment has been a little disappointing to date – a trend that may continue given the relative performance of less capital intensive sectors.
- Despite a light downgrade to our growth forecast, a diverse industry mix and support from a lower AUD and interest rates will see NSW remaining a standout across the states.

Contact

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Chart 1: State GSP Growth Forecasts

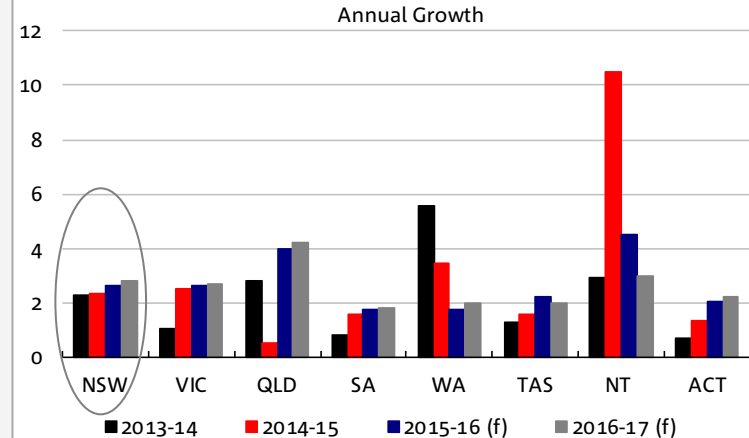
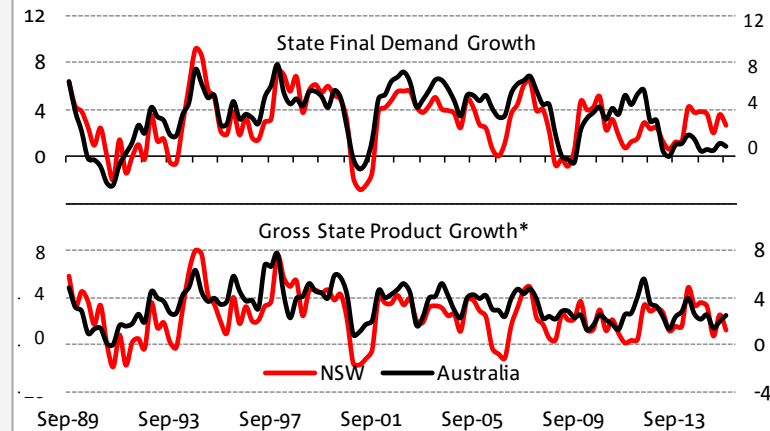


Chart 2: State Growth



*NAB Estimate

Sources: ABS; NAB Economics



In Focus: Have the residential spill-overs reached their peak?

Positive impetus for the housing market will likely start to fade over the course of 2016, as more subdued price performance and added supply, limits new construction activity and potential spill-overs to consumption. Foreign buyers and years of pent-up demand in the NSW housing market will continue to provide support to construction for the time being, although will contribute less in a growth sense. However, falling rental yields, tighter lending conditions for investors and a sharp ramp-up in supply (outpacing population growth), is expected to have an impact on construction in the

medium-term). Nevertheless, approvals for new units continue to push to new highs, namely in apartments, highlighting the escalating risk to this market segment.

Regarding spill-overs, recent RBA analysis suggests wealth channels have become less powerful over time. Nonetheless, stronger consumption growth in NSW has coincided with higher property prices. Softer price growth will likely weigh on consumption, although ongoing (solid) employment growth and strong tourist arrivals will provide some offset.

Chart 3: Construction activity (000s of dwellings)

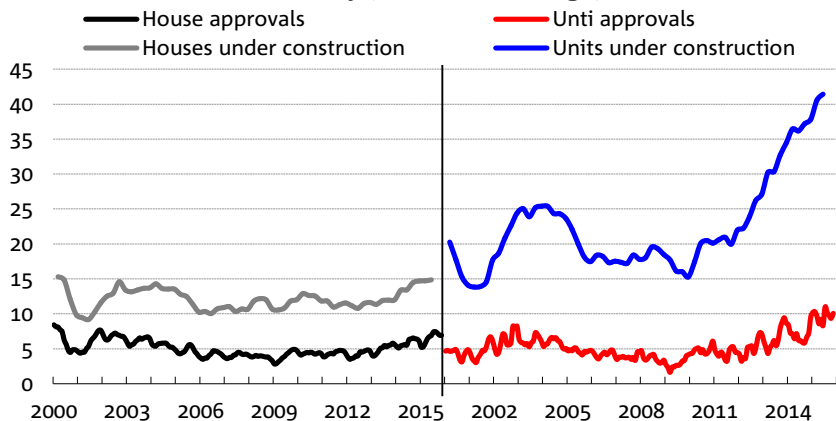


Chart 4: Approvals relative to population growth (LRA = 100)

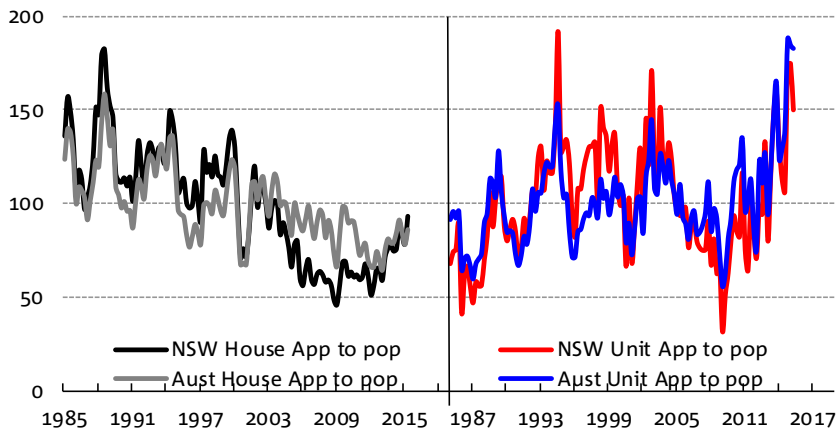


Chart 5: Pent-up demand for NSW housing

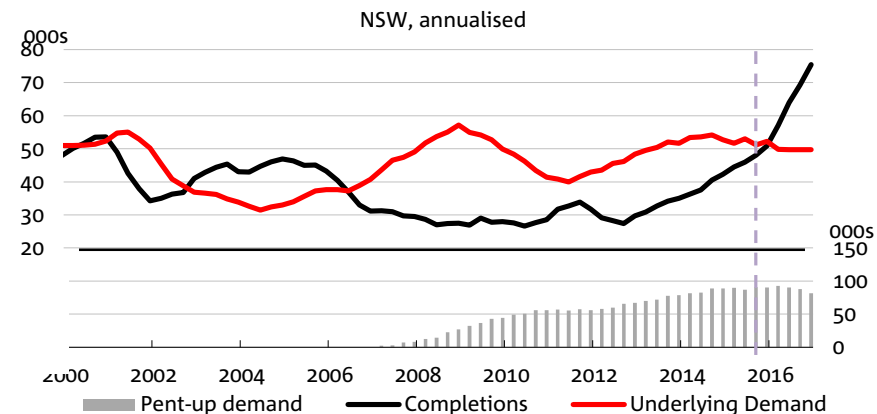
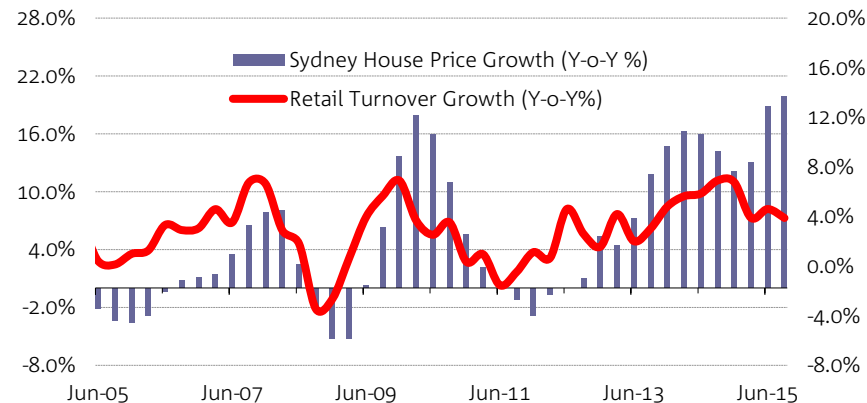


Chart 9: Retail Turnover and House Price Growth





Wealth effects on consumption fading, employment and tourism helping provide some offset

Although average labour income growth has remained subdued in NSW, recent strong employment outcomes has meant that aggregate income growth picked up in recent quarters – helping provide some support to household consumption, although growth has moderated. At the same time, rising visitor arrivals is providing additional support to retail sales (although is not captured in household consumption as it is attributed to exports).

To date, wealth effects from house prices has helped to support consumption during a period of low income growth. With the market cooling, consumption growth will be increasingly reliant on income/employment

growth and visitor arrivals. That said, the labour market is expected to improve, but only gradually.

The Q4 2015 NAB Consumer Anxiety Survey showed further declines in consumer anxiety amid signs of improvement in the labour market, although this is yet to translate into notably stronger spending behaviours. Consumers remain cautious with their spending, choosing to focus on paying down debt.

But while there was little change in attitudes toward consumer spending in the quarter, spending intentions for these items have improved considerably from the same time last year.

Chart 7: Compensation of Employees and Household Consumption Growth (YoY)

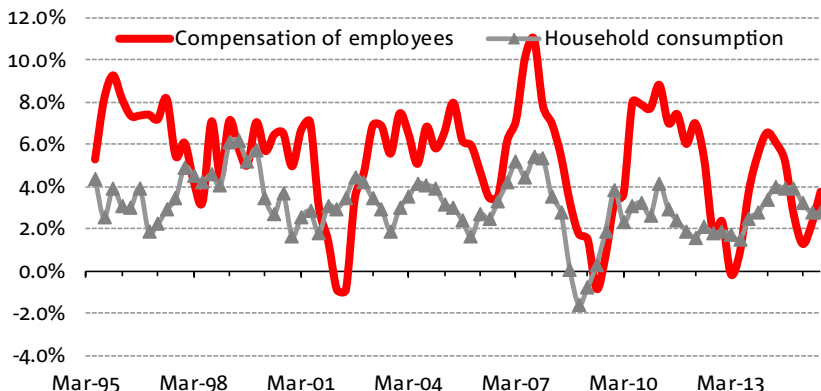
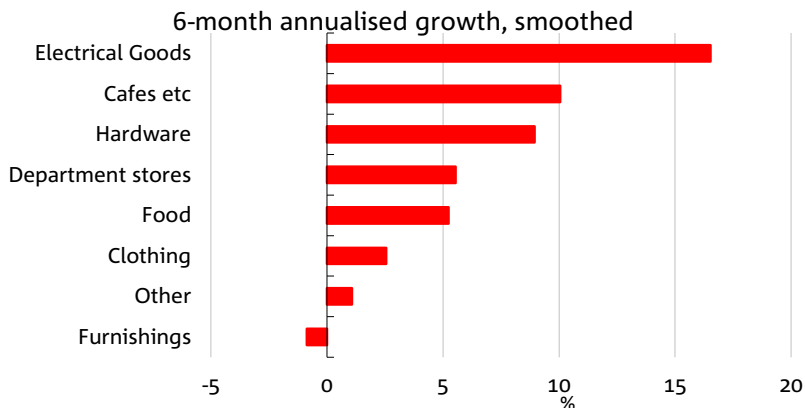
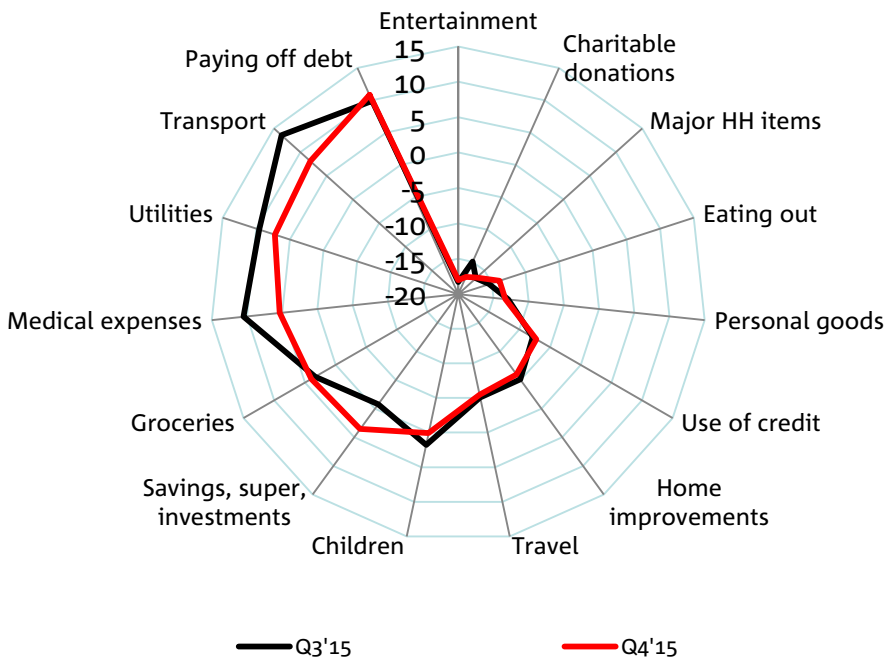


Chart 6: NSW Retail sales growth by category



Source: ABS; NAB Economics

Chart 8: NAB Consumer Anxiety Survey – spending behaviour (net balance index)





Conditions for business investment favourable, but firms still reluctant to spend on capex

The NAB Monthly Business Survey is showing a notably improved business environment in NSW, with service based sectors generally leading the way. According to the Survey, capacity utilisation for businesses in NSW is not far from previous peaks, and is well above the national average (Chart 10). Similarly, business conditions in the state have trended higher, making the state a notable outperformer (Chart 11).

It remains to be seen whether tighter capacity (labour & capital) will prompt higher wages and investment growth.

Indeed, there are still a number of challenges to the business investment outlook, particularly as conditions in capital intensive industries are taking longer to improve. Measures of investment intentions are mixed, with expectations from the NAB Survey looking solid (Chart 12), while ABS capex expectations are muted (slide 6). Uncertainty is keeping firms reluctant to invest without very high expected rates of return (hurdle rates).

Services sectors have consistently shown the best business conditions in the NAB Survey, but confidence has been more mixed (Chart 13).

Chart 10: NAB Business Survey – Capacity Utilisation

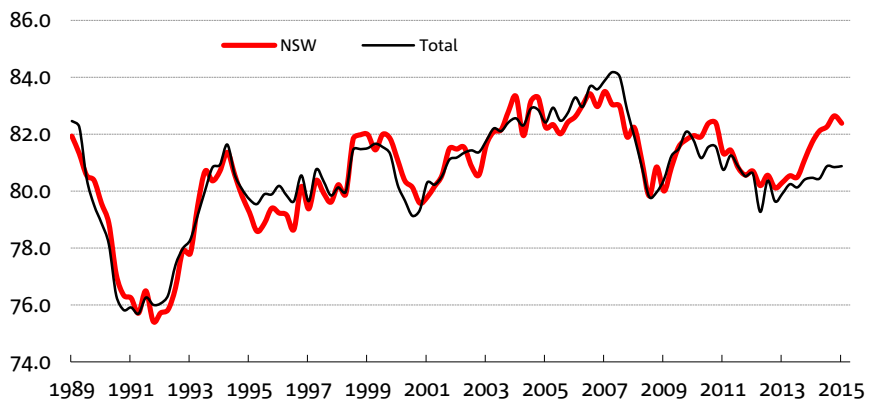
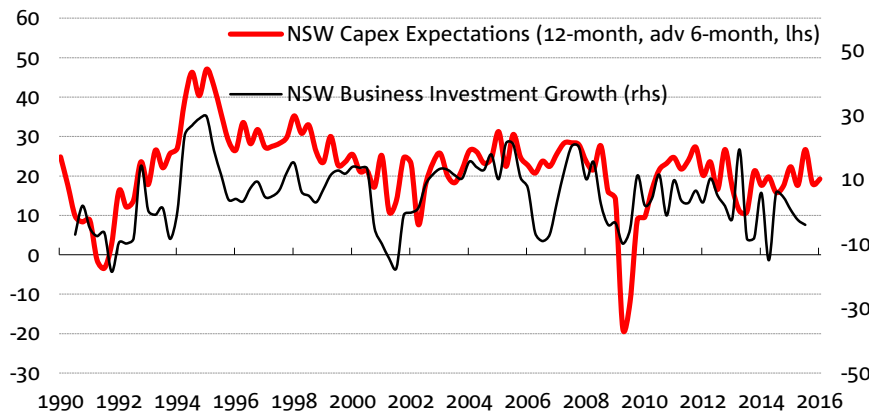


Chart 12: NAB Survey Capex Expectations & Private Business Investment Growth



Sources: ABS; NAB Economics

Chart 11: Spread in NAB Business Conditions

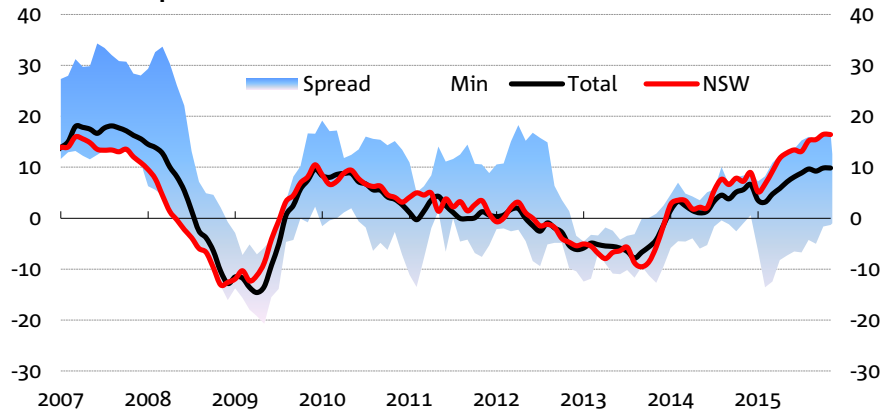
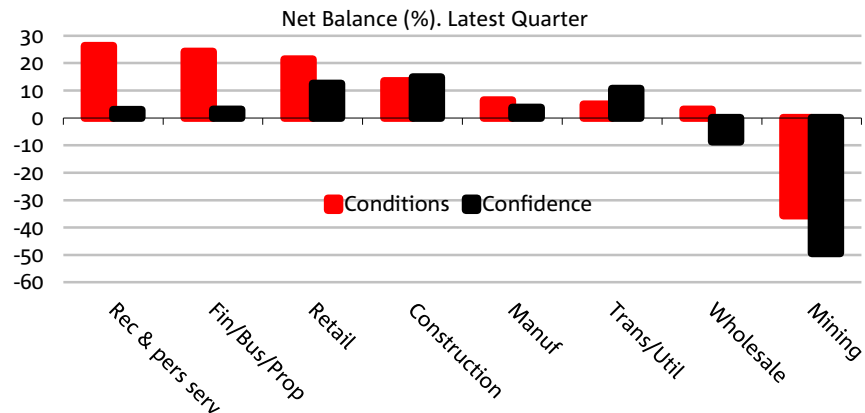


Chart 13: NSW Business Conditions & Confidence by State





Indicators of investment intentions are mixed in response to high 'hurdle rates'

Commercial building activity has not been as vigorous as that seen in the residential market, with approvals broadly tracking sideways. This does however mask variations across sectors, with retail/wholesale and office approvals starting to improve as the previously strong 'other' component subsides (Chart 14).

Lower office vacancy rates are consistent with a gradual improvement in office approvals, and notably higher sentiment in the market according to NAB Commercial Property Survey (Charts 16 & 17).

Chart 14: Non-residential Building Approvals (\$ millions)

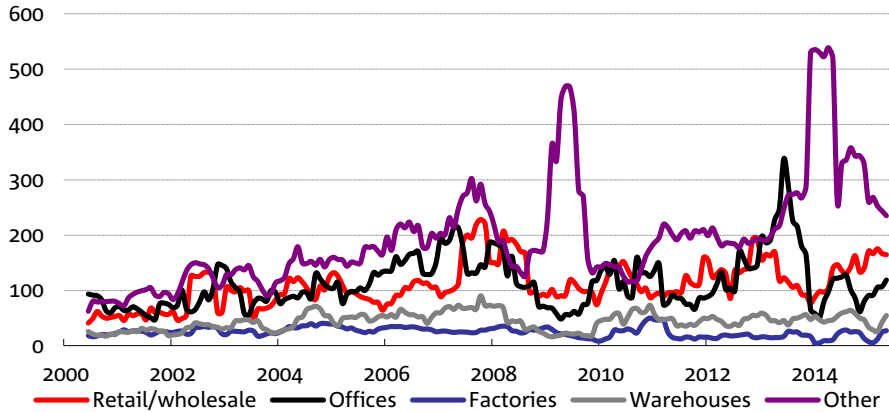
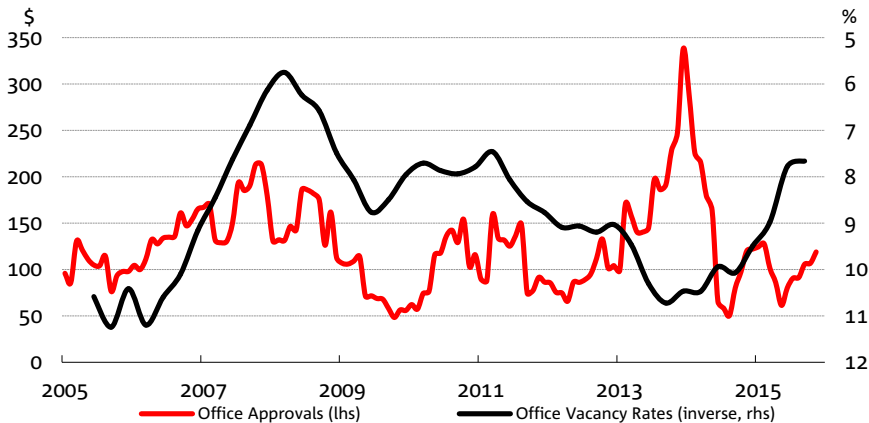


Chart 16: NSW Office Market Conditions



Official measures of capex intentions continue to suggest a subdued outlook, partly explained by a further contraction in mining investment. This supports the idea that improved business conditions in traditionally less capital intensive sectors in having a more muted effect on capex.

Expected capital expenditure (capex) by businesses (according to the ABS survey) suggests that spending on buildings and structures in NSW is likely to remain relatively flat in the next 12 months, while planned spending on machinery and equipment is expected to improve moderately (Chart 15).

Chart 15: NSW Capital Expenditure & Expectations

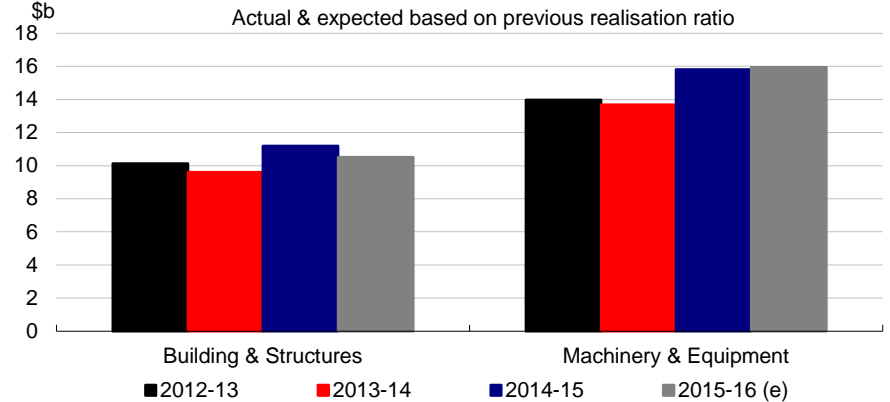
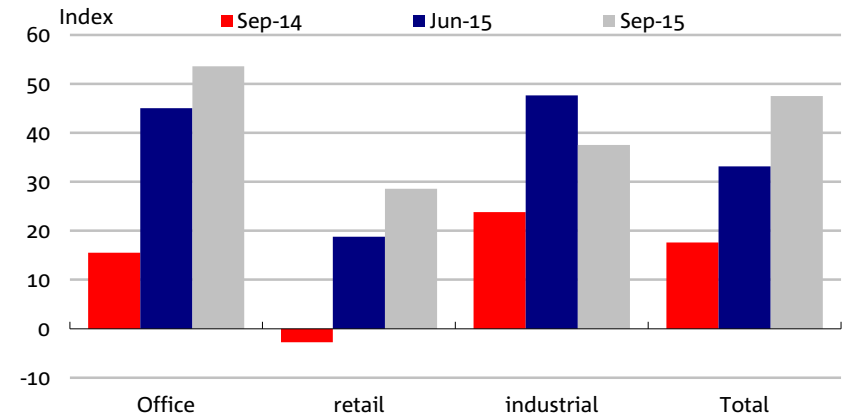


Chart 17: NAB Commercial Property Index - NSW





Labour market strengthening, led by service sectors

Improving labour market conditions has become increasingly more broad based, as unemployment rates in regional NSW falls from previously elevated levels – to be more consistent with low rates in Greater Sydney (Chart 18).

Job growth in NSW has remained impressive, rising by almost 180k over the year to November 2015 – a record high – although there have been some issues affecting the accuracy of these statistics of late. Consistent with strong jobs growth, the unemployment rate has eased to 5.2% (from 6.3% at the start of the year), despite solid population growth and higher participation.

Chart 18: Unemployment rate by region, % nsa

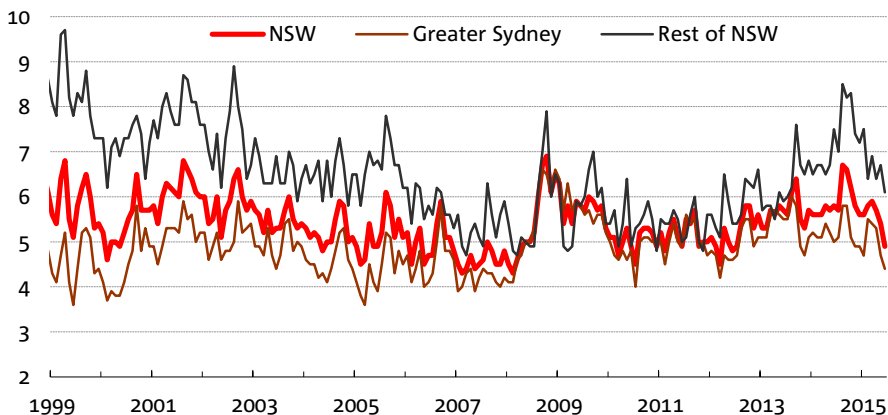
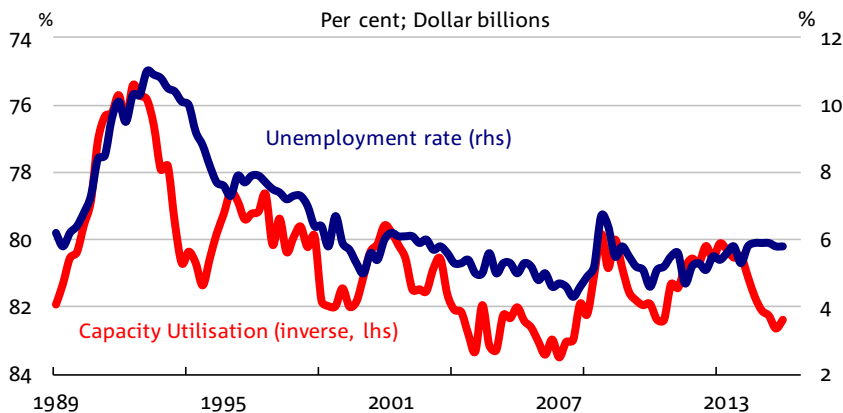


Chart 20: Unemployment rate & NAB capacity utilisation rate

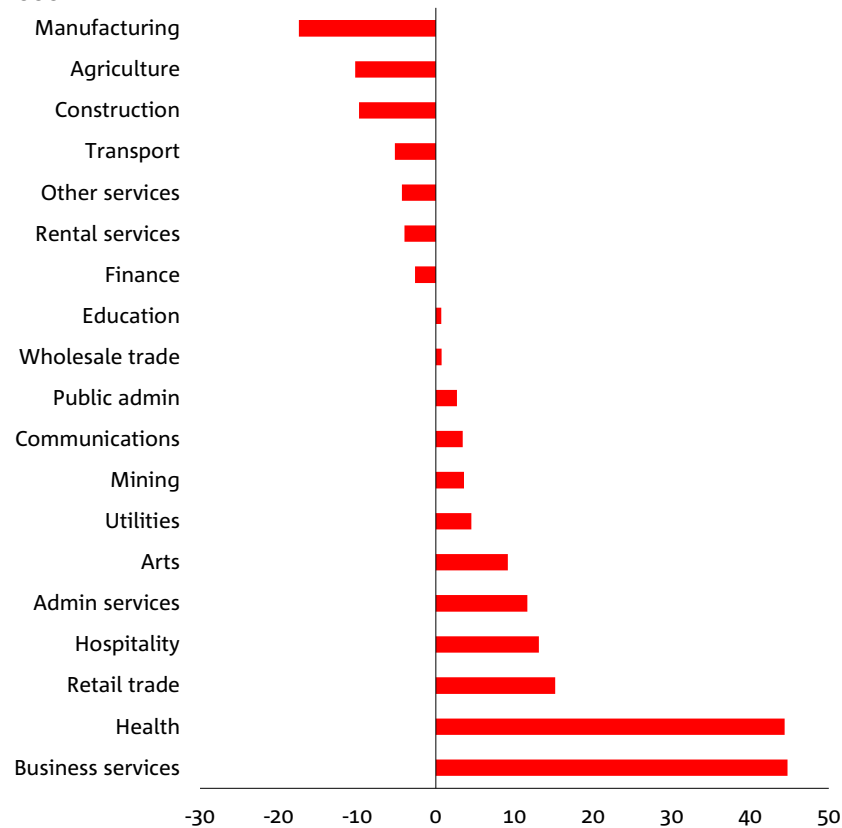


Sources: ABS; NAB Economics

Even with these improvements, high capacity utilisation rates point to further tightening in the NSW labour market (Chart 20).

In the last 12 months to November 2015, most of the jobs created were in personal services (namely health) and business services. Surprisingly, robust residential construction has not translated into additional jobs in the past year. Job losses have been largest in manufacturing (despite AUD assistance) and agriculture – surprising given that NSW has experienced relatively favourable climatic conditions relative to other states. (Chart 19).

Chart 19: Change in employment by industry, last 12 months, NSW, '000





Demographic trends turning more positive as mining investment boom winds down

NSW population growth down from previous peaks, but is holding up at elevated levels, driven by both overseas migration and shrinking interstate outflows – reflecting the relatively more favourable labour market, especially compared to the mining states (Chart 21).

After lagging behind for more than a decade, NSW population growth is now consistent with national average levels (Chart 23).

Population trends are consistent with observations from the labour market. While employment growth in NSW has improved notably, it appears that domestic workers have largely satisfied the growing demand (Chart 22).

Chart 21: NSW Population growth (000s, over the year)

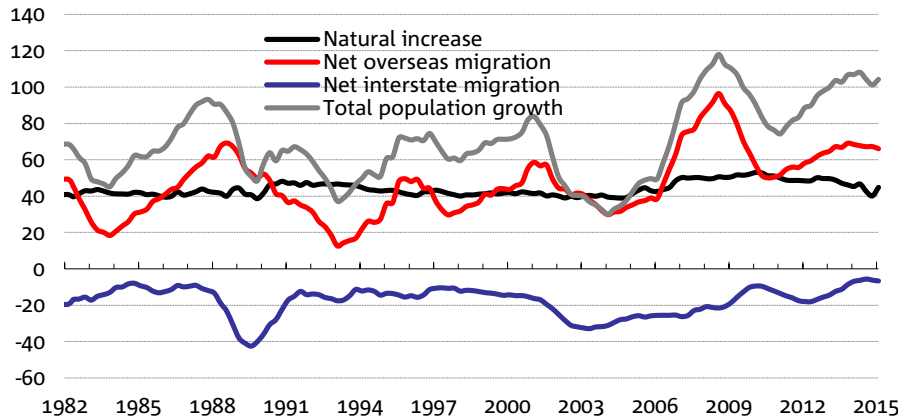


Chart 22: NSW Employment by country of birth

Change in number employed over 12 months (000's)

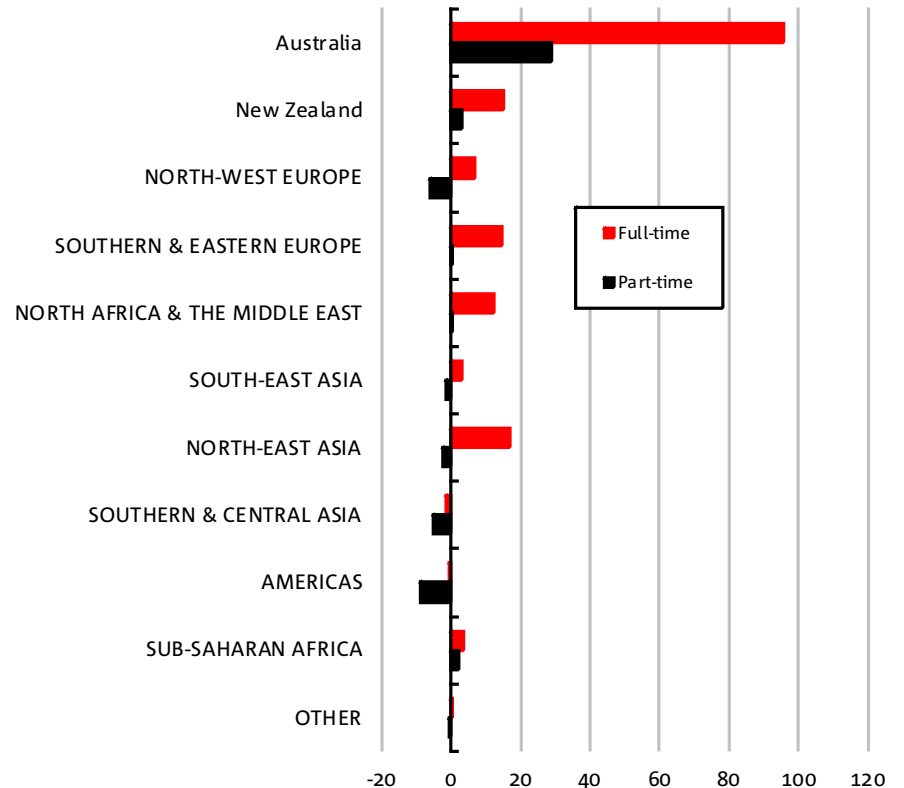
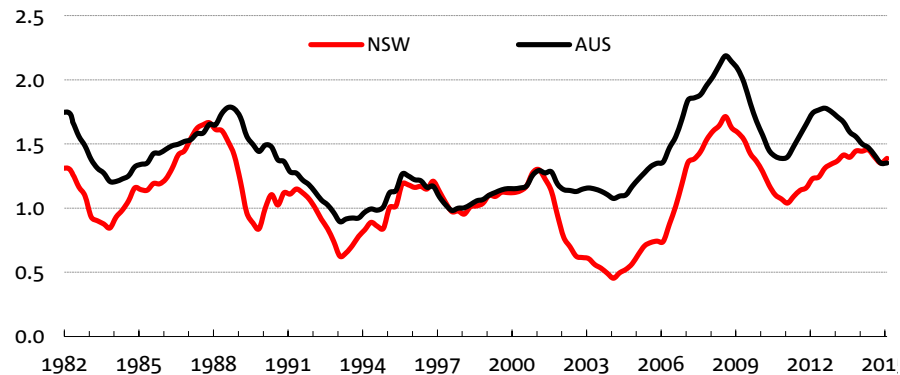


Chart 23: NSW Population growth (year-ended growth)





Red hot residential property market showing signs of cooling

Even as property prices start to lose momentum, residential construction shows no real sign of slowing. Residential building approvals have pushed to new highs, pointing to a further increase in commencements from already elevated levels (Chart 24). Consequently, dwelling investment will again make a positive contribution to growth in 2016. However, rapidly increasing supply (particularly apartments), tighter credit conditions, and more subdued prices, will likely limit the number of new projects entering the pipeline.

The NAB Property Survey suggest residential prices growth will slow only

Chart 24: NSW Residential Approvals & Commencements

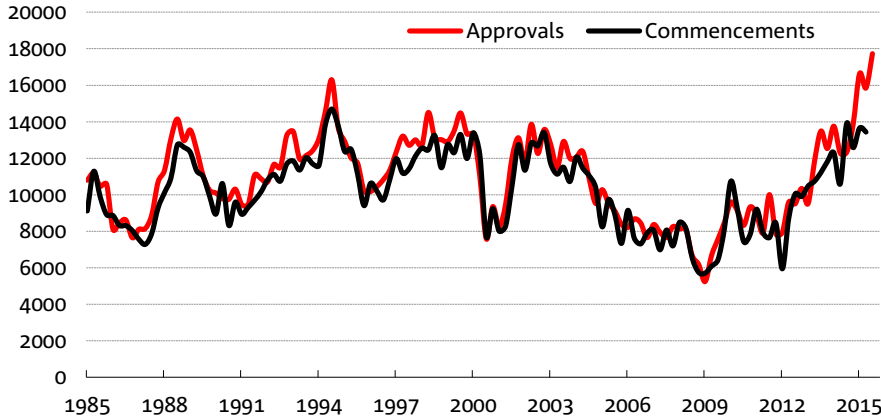
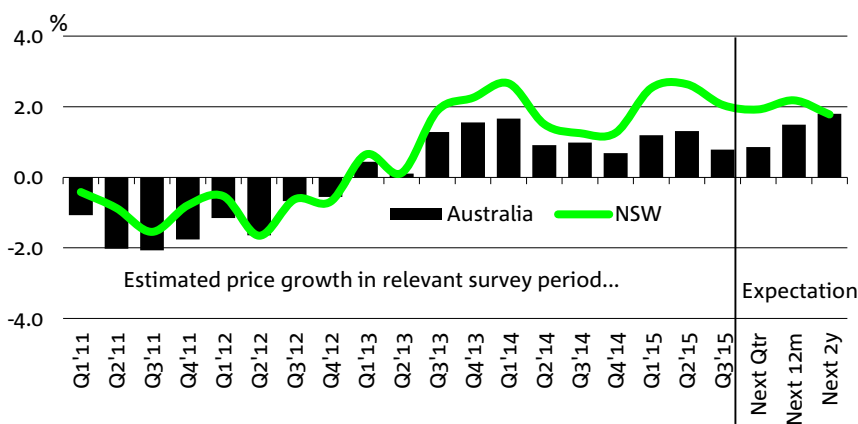


Chart 26: NAB Property Survey – House Price Expectations (%)



modestly in the near-term, before regaining momentum in 1-2 years (Chart 26). NAB's view however is that price growth will remain subdued for quite some time, with the risks likely skewed more to the downside.

Price growth has varied across property types and regions, although all have generally performed reasonably well (Chart 25). Price growth has been particularly strong in Sydney houses, but are now slowing rapidly. Residential property price growth by sub-region in Sydney suggests fairly consistent capital growth for both houses and units across regions (Chart 27).

Chart 25: NSW Residential Property Price Growth

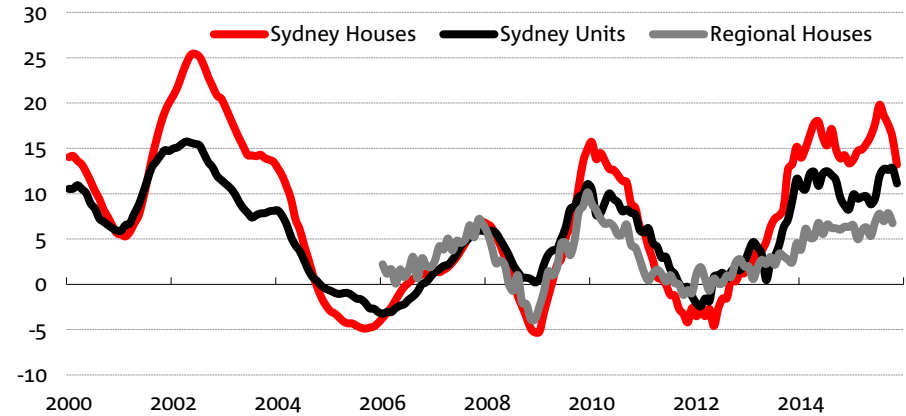
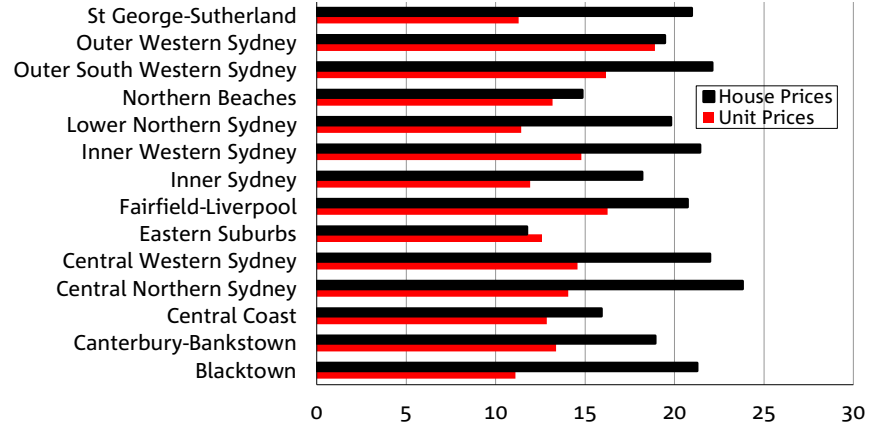


Chart 27: Sydney - Median Property Price Growth (year to Q3 2015)





Fiscal position helped by transfer duties and asset recycling. Extensive infrastructure investment pipeline

The major change to the fiscal outlook in the mid-year review stems from the Government's asset recycling program, namely the long-term lease of TransGrid. Consequently, the operating surplus for 2015-16 has been revised higher (to 0.6% of GSP), and is expected to remain in surplus over the forecast horizon (despite downward revision to 2016-17) (Chart 28).

The TransGrid lease contributed to around half of the \$875.7m improvement to the Budget surplus for 2015-16, while other transfer duties collected in the year to date have also been higher than expected. Going forward, revenue is generally lower compared with Budget due to projected lower Australian Government GST payments and weaker royalties revenue.

General government expenses have been revised since Budget, adding \$1.2 billion over 4 years. The revision mainly reflects the impact of new policy decisions, the carry-over of unspent funds from 2015-16, as well as parameter and technical adjustments (contributing \$527m over four years).

While the Budget still does not fully reflect infrastructure associated with the State's asset recycling program, the pipeline of projects is already large. At the time of the 2015-16 Budget, the Government was committed to spending \$68.6b on infrastructure. In the mid-year review, capital expenditure was revised higher by \$1.3b over the forward estimates, which included \$1.1b in new capital works over four years.

Chart 28: NSW net operating balance & transfer duty revenue (% of GSP)

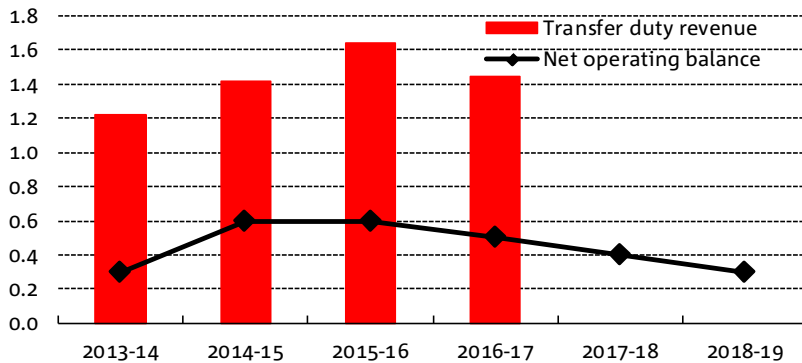
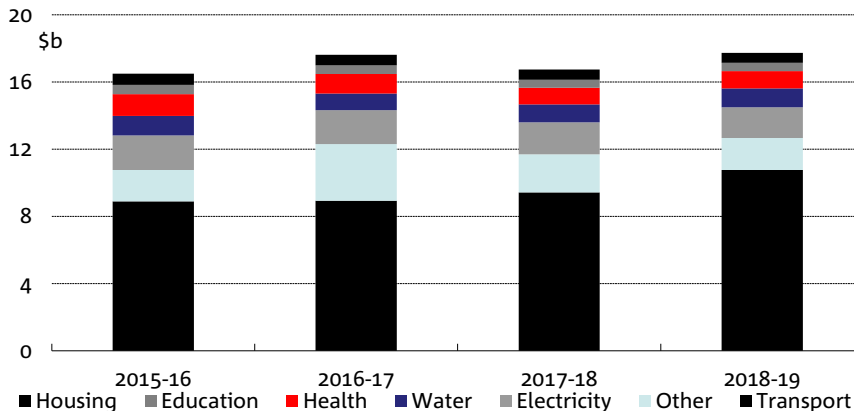
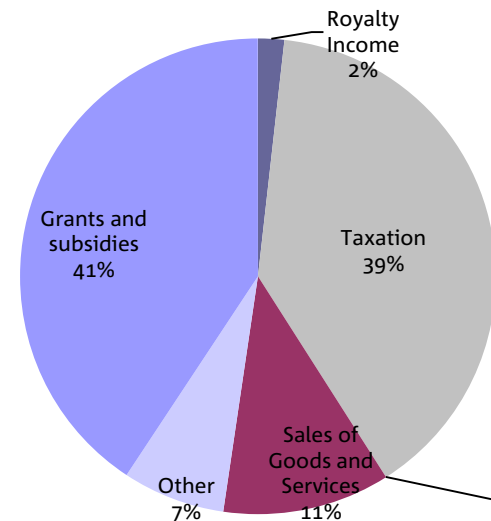


Chart 30: NSW state capital spending by function (as at 15-16 Budget)



Sources: NSW State Budget; NAB Economics

Chart 29: NSW Composition of state revenues



Net debt borrowings decline as asset sales/leases included

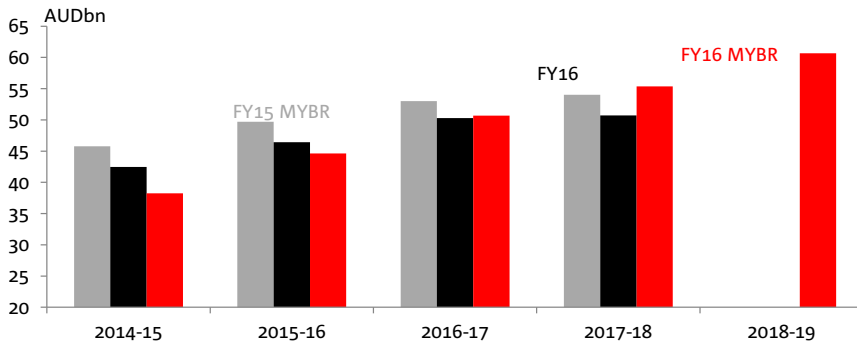
NSW net debt is lower than the Budget projections due to the inclusion of asset sale proceeds from the past year and a better than expected fiscal outlook. The completion of the long-term lease of TransGrid is expected to reduce general government net debt to AUD1.8bn in 2015-16 (AUD8.1bn below Budget time estimates). As the asset sales are reinvested into capital expenditure net debt over the forward estimates increases.

S&P affirmed NSW's AAA rating and stable outlook following the release of the 2015-16 Budget. The updated budget numbers are not seen to affect this

performance is now slightly weaker than previously projected.

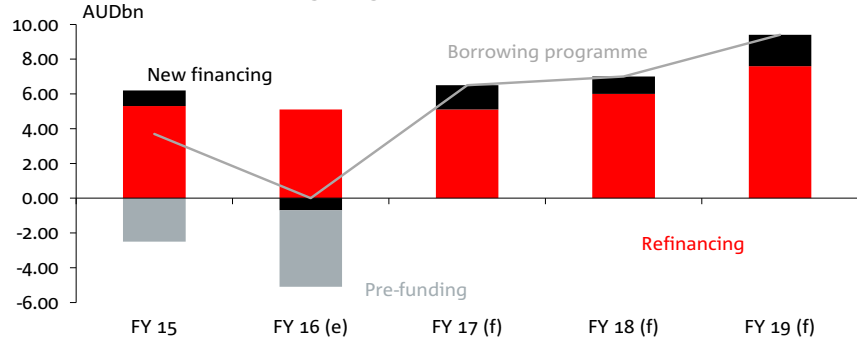
Following the updated MYBR, NSWTC revised its 2015-16 issuance program. NSWTCorp now forecasts that there will be no term funding required in 2015-16. This is down from post Budget time estimate of AUD7.3bn and is largely due to the successful lease of TransGrid (worth AUD2.8bn). In addition, Tcorp now has access to a NSW Government deposit worth AUD4.4bn. As at the end of 2015 Tcorp's bonds outstanding totalled AUD47.69bn which is AUD1.6bn below levels as at end June 2015.

Chart 31: NSW Non-Financial Public Sector net debt



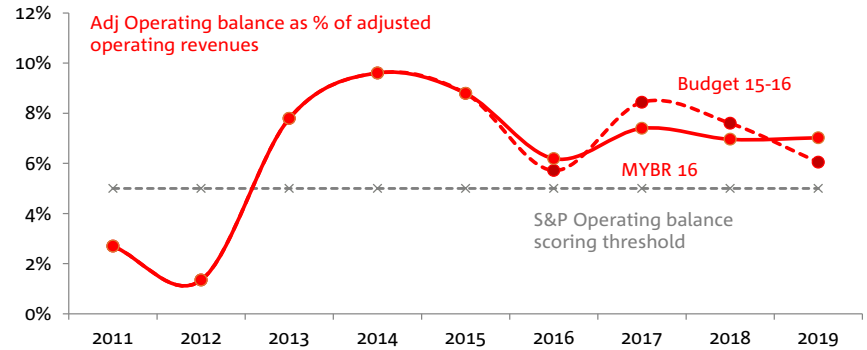
Source: NSW budget papers

Chart 33: NSWTC borrowing programme



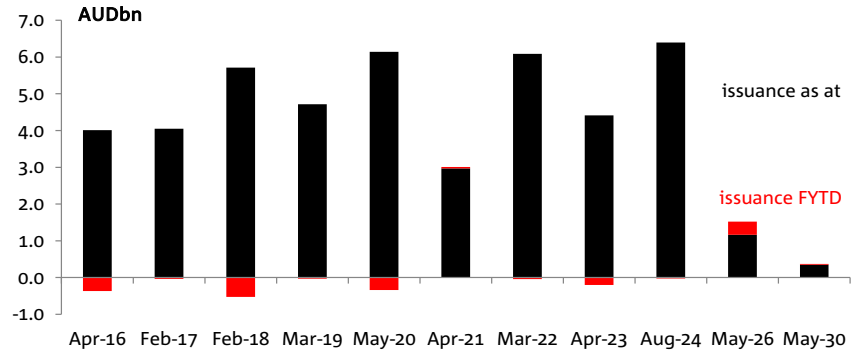
Source: NSWTC

Chart 32: S&P credit metric: Operating balance as % of revenue



Source: NSW budget papers, NAB

Chart 34: NSWTC term bonds outstanding as at end 2015



Source: NSWTC

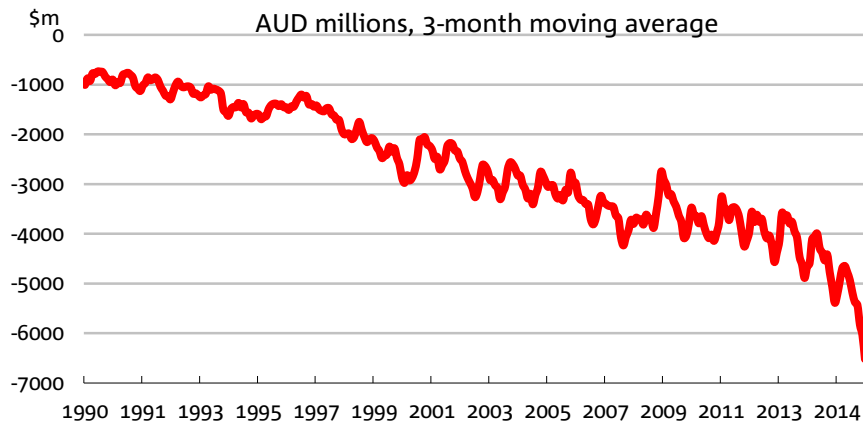


Net exports still subdued, but AUD depreciation is starting to help some traded sectors

The trade position has deteriorated further, reflecting soft economic conditions interstate and internationally. Meanwhile, moderate improvement in domestic demand has supported imports (Chart 35).

Nevertheless, some trade sectors are seeing the benefits of AUD depreciation, especially in services such as tourism. Short-term visitor arrivals to NSW have been steadily increasing (Chart 36).

Chart 35: NSW Net Trade (AUD millions, 3mma)



Top export destinations, NSW, 12-month average to Nov 2015

Value of exports (\$m)		Value of imports (\$m)			
1	Japan	9443	1	China	28999
2	China	5628	2	EU	20833
3	ASEAN	3427	3	ASEAN	13487
4	Korea	3417	4	US	11963
5	US	2921	5	Japan	6541
6	Taiwan	2108	6	Korea	5398
7	New Zealand	2068	7	Germany	5321
8	EU	1833	8	UK	3011
9	India	1303	9	Singapore	2950
10	HK	910	10	New Zealand	2550
11	UK	685	11	Taiwan	2090
12	Singapore	463	12	HK	554
13	Germany	141			

Chart 36: Short-term visitors – state where most time spent

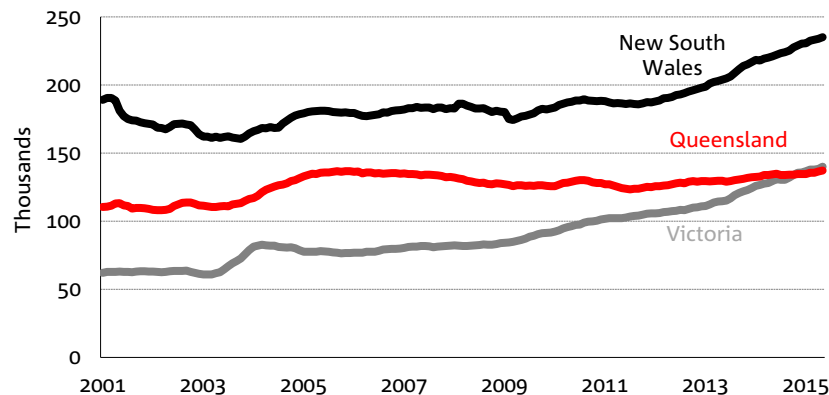
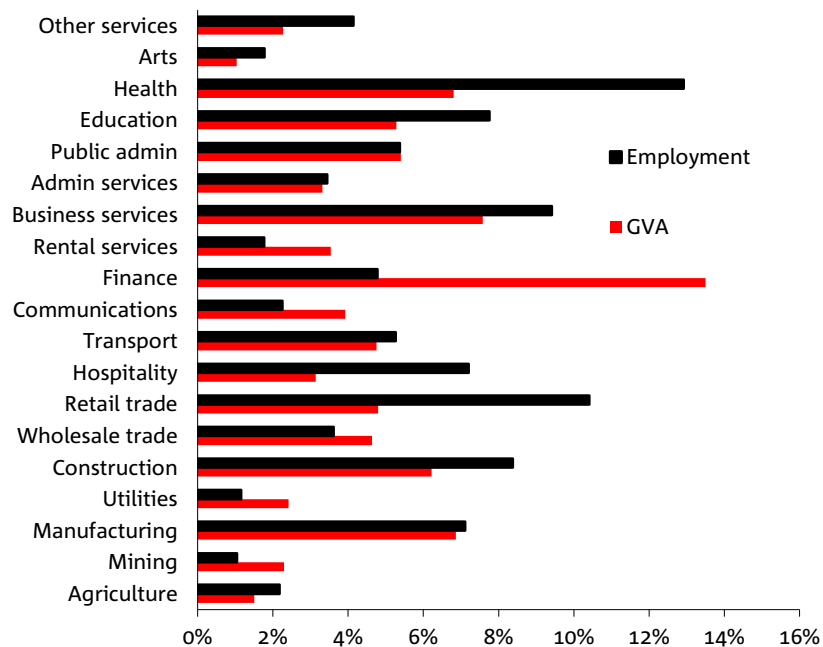


Chart 37: Composition of employment & GVA



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