

STATE UPDATE: SOUTH AUSTRALIA

JULY 2016



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KEY POINTS:

Green shoots emerging for SA economy but fundamentals remain soft

CHART 1: STATE GSP GROWTH FORECASTS

Annual growth (%)

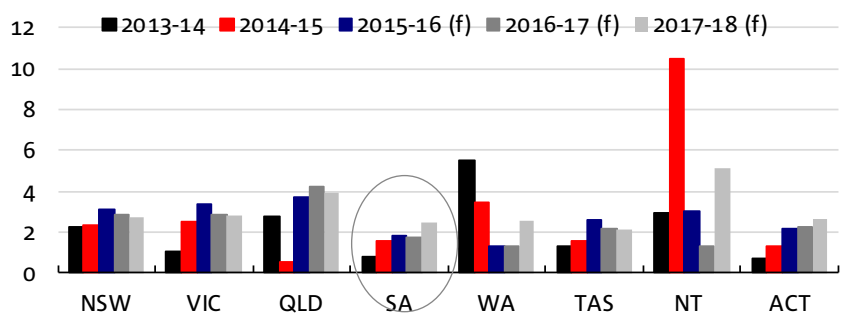
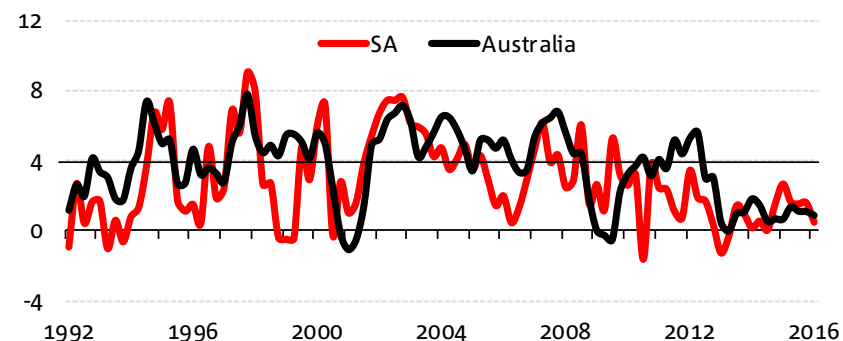


CHART 2: STATE FINAL DEMAND

Per cent (%)



- More recently, there are some signs of green shoot emerging for the SA economy; the lower AUD is offering support to areas such as hospitality and education exports, while notable improvements in business conditions and confidence in the NAB Business Survey are a welcome sign that the economic situation is beginning to turn. Recent policy announcements at both the state and federal level, aimed at promoting jobs and economic growth, are also encouraging, although the likely size and timing of their impact is unlikely to fully offset major headwinds, such as the imminent end to car manufacturing activity. Household income growth continues to gain traction, which in turn is supporting retail spending and household consumption. That said, SA's well-known economic challenges, such as the narrowing industrial base -- characterised more recently by the shutdown of Arrium's steelworks in Wyalla -- and an industry mix that may not appeal enough to younger workers, have continued to result in a net outflow of interstate migration, weak labour market conditions and limited demand and price impetus for residential property. Following moderate growth in real GSP of 1.8% in 2015-16, we expect the SA economy to grow by another 1.8% in 16-17 and by 2.4% in 2017-18 . The unemployment rate is expected to gradually fall from 7.3% in 15-16 to 7.0% in 16-17 and 6.8% in 2017-18.

There is now more certainty that all of the 12 new submarines under the \$50 bn Future Submarines project announced by Federal Government will be built at Osborne in Adelaide starting 2018. This project is expected to create around 2800 new jobs, with 1700 of them at the ASC plant on the Port River at Osborne. However, this will only provide partial offset to the expected 3,000 job losses due to the imminent closure of Holden's car manufacturing plant at Elizabeth over the course of four years to 2017. **With the construction of Royal Adelaide Hospital coming to an end, possibly by December this year, there could be a fall-off in construction activity in the near term, but this will be partly offset by a pick-up in housing construction, indicated by a rise in residential housing approvals.**

- After moving sideways for a number of years, residential property prices in Adelaide appear to have turned up more notably since the start of 2016, although at a rate that is much lower than the national average. However, the average regional house price has continued to contract over the year to date. **We expect Adelaide house prices to grow moderately in 2016 by 3.5%, before easing to 1.7% in 2017.**
- Supported by surprisingly resilient wages growth, household consumption is a standout contributor to SA's recent economic performance, with retail spending and household expenditure growth maintaining strong momentum. This is despite generally weak labour market conditions as SA continues to experience the highest unemployment rate across the states and territories.
- **Business conditions have gained some momentum of late, characterised by higher capacity utilisation and an upturn in the NAB Business Conditions index, although the business investment outlook remains weak and the office vacancy rate is elevated.** Capital expenditure expectations for buildings and structures suggest a notable deterioration for 2016-17.
- In terms of goods exports, the value of SA's mineral shipments fell sharply last year, but a partial recovery of commodity prices this year is likely to see a lift in SA's overall exports. Meanwhile, the lower AUD continues to deliver dividends to the state's services sectors through higher international student enrolments and overall tourism expenditure.

IN FOCUS:

Structural changes in SA economy reflected in the labour market

- The SA labour market has deteriorated notably relative to the national average since late 2012. A slowing and ageing civilian population and weaker participation rate (Chart 3) have led to subdued growth in SA's labour force (Chart 4).
- Part of this reflects the ongoing structural changes in the industry make-up of the state which is seeing an erosion of its manufacturing base, as evidenced by the recent struggle of Arrium steelworks in Wyalla, while the imminent closure of Holden's Elizabeth plant next year is likely to see further job losses.
- Consequently, employment growth in SA has fallen below its civilian population growth, and has mostly lagged the national average since 2011 (Chart 5).
- Despite the soft growth in labour force, tepid employment growth has resulted in a gradual rise in SA unemployment rate since 2012, to be the highest among all states (Chart 6). It has moderated somewhat in the last six months, but it is largely attributable to a shrinking labour force rather than a pick-up in employment growth.

CHART 3: SA AND AUS LABOUR MARKET PARTICIPATION RATE

Per cent of labour force

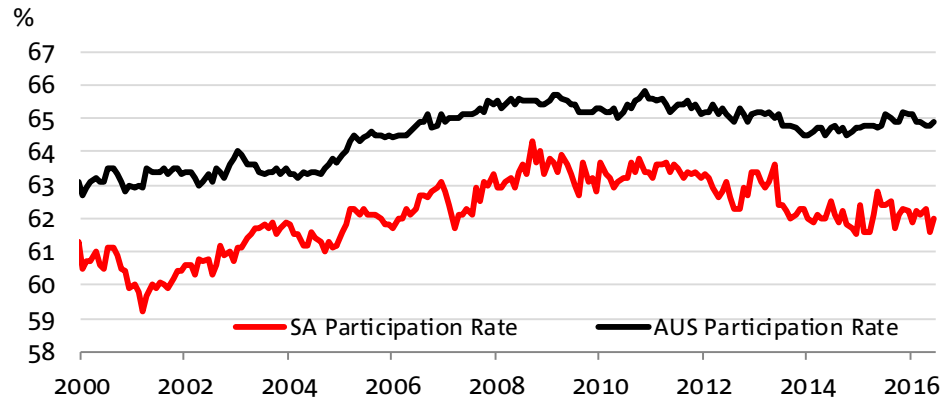


CHART 4: SA AND AUS LABOUR FORCE GROWTH

Year-on-year percentage growth

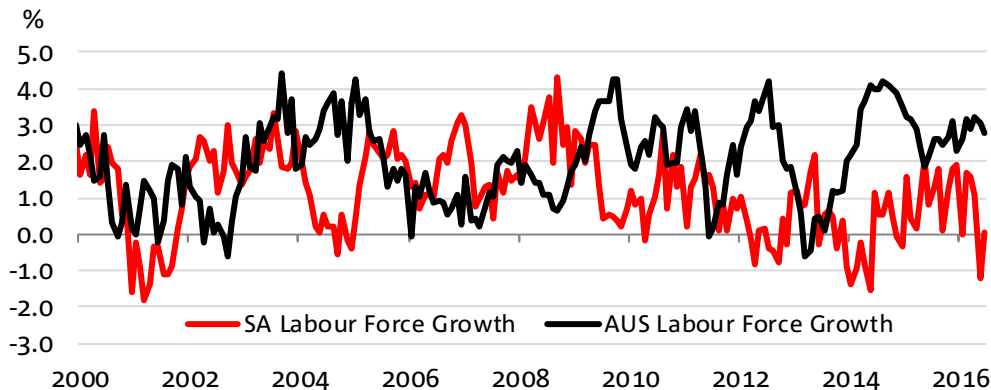


CHART 5: SA AND AUS EMPLOYMENT GROWTH

Year-on-year percentage growth

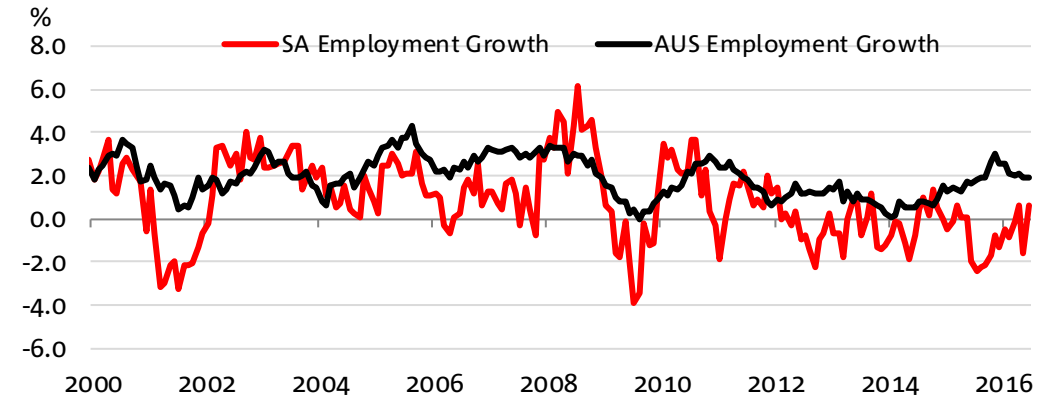
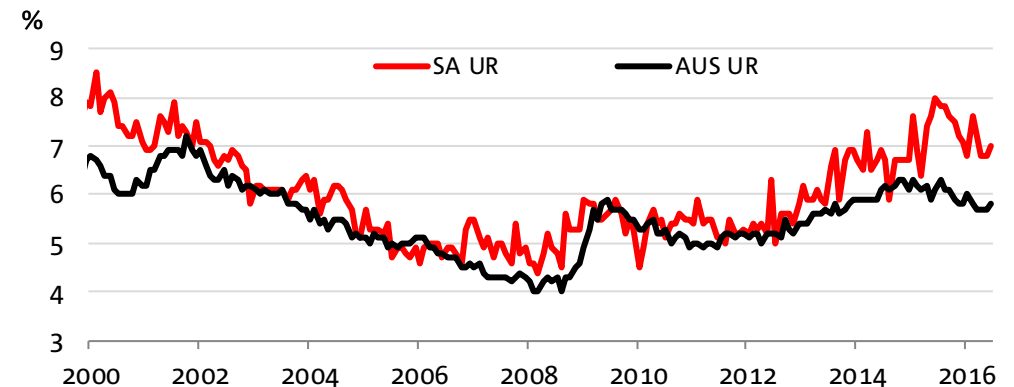


CHART 6: SA AND AUS UNEMPLOYMENT RATE

Per cent of labour force



CONSUMER AND HOUSEHOLD SECTOR:

A pick-up in income helps to support retail and household spending

- Wages growth in SA has managed to maintain momentum, which is helping to support household consumption growth (Chart 7).
- As a result, retail spending growth remains reasonably resilient. In turn this appears to be offering some support to house price growth, which is showing some tentative signs of a pick-up (Chart 8).
- Probably reflecting the soft fundamentals in the labour market, SA consumers have become more conservative in their spending patterns. Based on our survey, consumers are now less inclined to incur more credit card debt and spend on discretionary items such as travel, home improvements etc., while continuing to focus on paying down their debt and concentrating most spending on essential items such as medical expenses, transport and utilities (Chart 9).

CHART 7: AVERAGE COMPENSATION OF EMPLOYEES AND HOUSEHOLD CONSUMPTION GROWTH

Year-on-year percentage growth

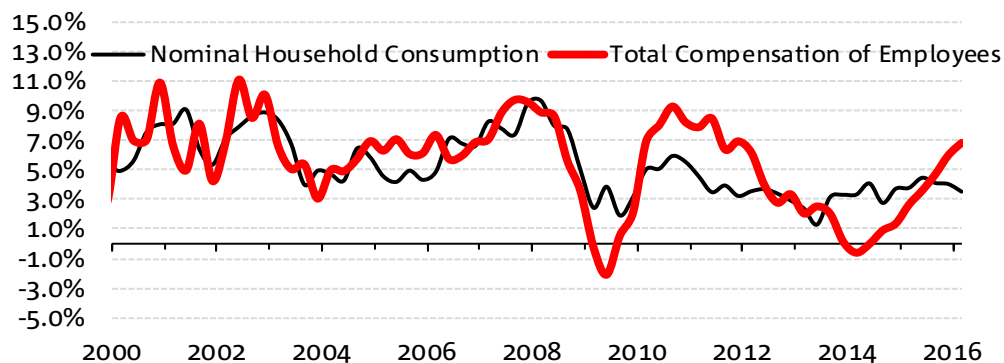


CHART 8: RETAIL TURNOVER AND HOUSE PRICE GROWTH

Year-on-year percentage growth

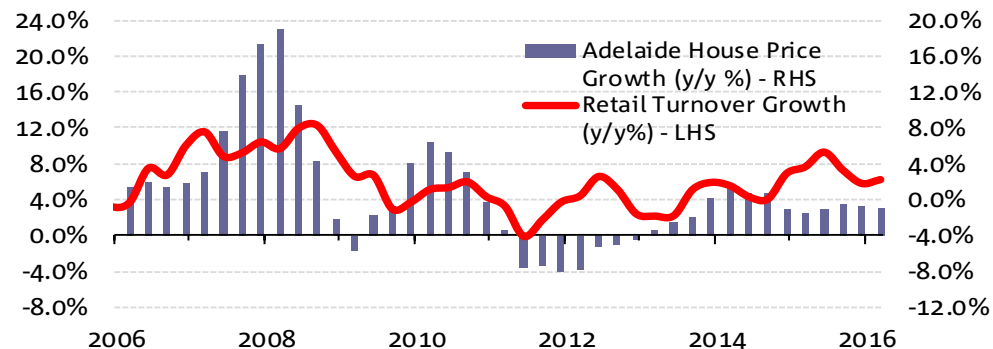
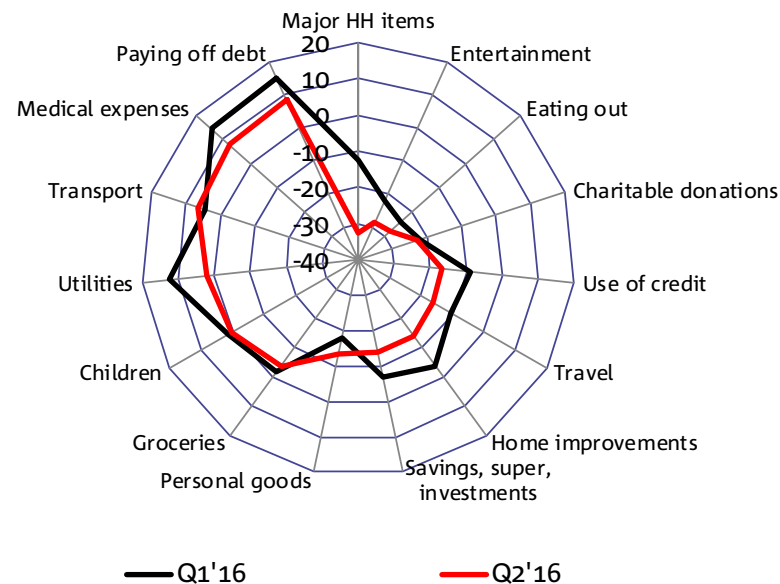


CHART 9: NAB CONSUMER ANXIETY SURVEY - CONSUMER SPENDING PREFERENCES

Changes in Consumer Spending Preferences (net balance)



BUSINESS SECTOR:

SA business conditions and capacity utilisation have improved

- According to the monthly NAB Business Survey, the capacity utilisation of businesses in SA has been improving of late, albeit falling slightly in Q2 (Chart 10). This trend is consistent with the steady improvements in SA business conditions in the past three months, with the index moving into positive territory (Chart 11).

- Consistent with a recent pickup in business conditions, SA capex expectations for the next 12 months have picked up strongly, but business investment growth continues to be subdued. This is likely to be a reflection of the continuously shrinking manufacturing base and weakness in commodity prices (Chart 12), but steadily improving capex expectations suggest that appetite for business investment could improve. In terms of business conditions, the financial services, personal services and transport/utility sectors are the outperformers, while the mining sector is faring the worst (Chart 13).

CHART 10: NAB BUSINESS SURVEY – CAPACITY UTILISATION

Per cent of total capacity (%)

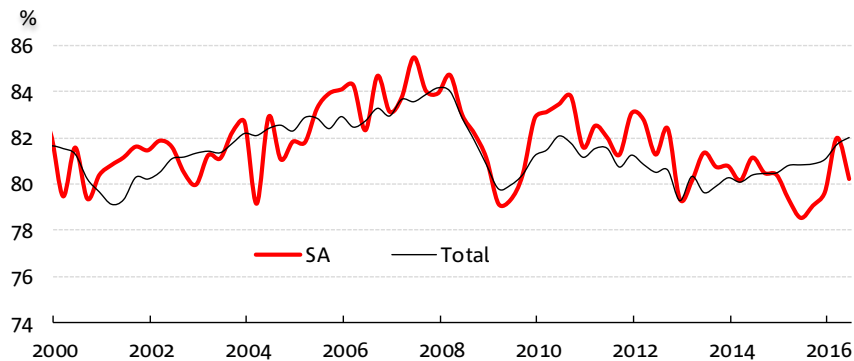
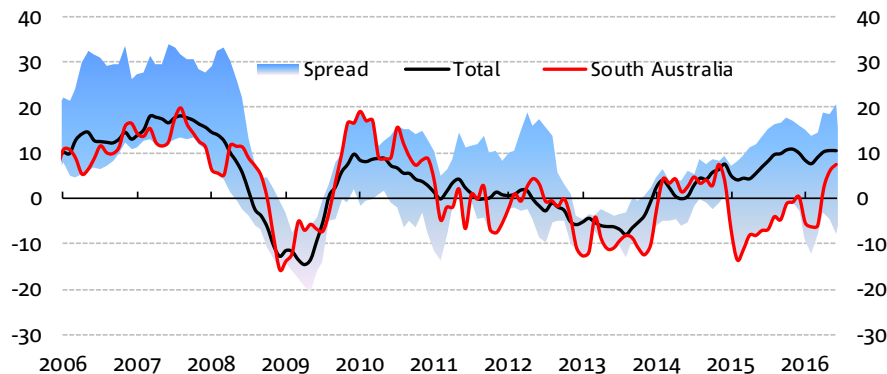


CHART 11: SPREAD IN NAB BUSINESS CONDITIONS

Net balance, 3-month-moving-average



Source: ABS, NAB Group Economics

CHART 12: NAB SURVEY CAPEX EXPECTATIONS & PRIVATE BUSINESS INVESTMENT GROWTH

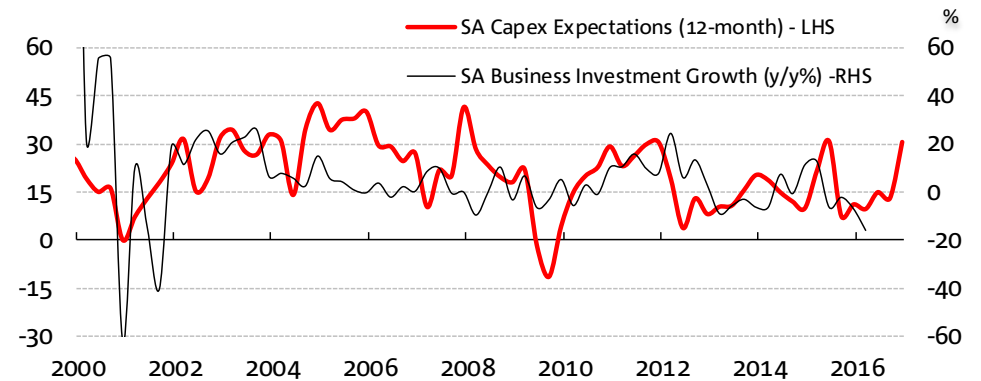
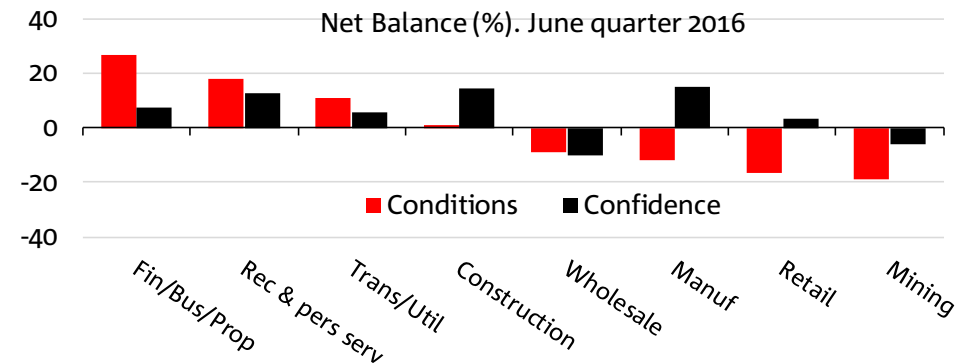


CHART 13: BUSINESS CONDITIONS AND CONFIDENCE BY INDUSTRY

Net balance



COMMERCIAL PROPERTY/NON-RESIDENTIAL INVESTMENT:

Activity tracking at low levels, but retail appears resilient. Capex likely to fall.

- Reflecting the soft appetite for business investment, non-residential building approvals have been tracking at low levels, except for “Retail/Wholesale”, which continues to be relatively more resilient (Chart 14). This is consistent with a reasonably robust level of retail and consumer activity.
- SA office vacancy rates, while showing some signs of stabilisation recently, are at their highest level since the start of the series. Accompanied by the downward trending office building approvals, this signals a substantial amount of spare capacity in the commercial property sector (Chart 15).
- As a result, capex expectations for buildings and structures for 2016-17 are notably softer, while planned spending on machinery and equipment is expected to remain at similar levels to previous years (Chart 16).

CHART 14: NON-RESIDENTIAL BUILDING APPROVALS

Million dollars

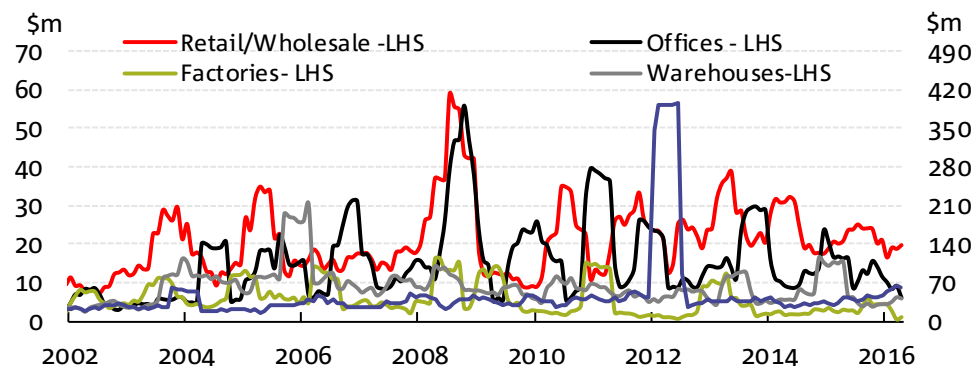


CHART 16: SA CAPITAL EXPENDITURE & EXPECTATIONS

Actual & expected based on previous realisation ratio (\$billion)

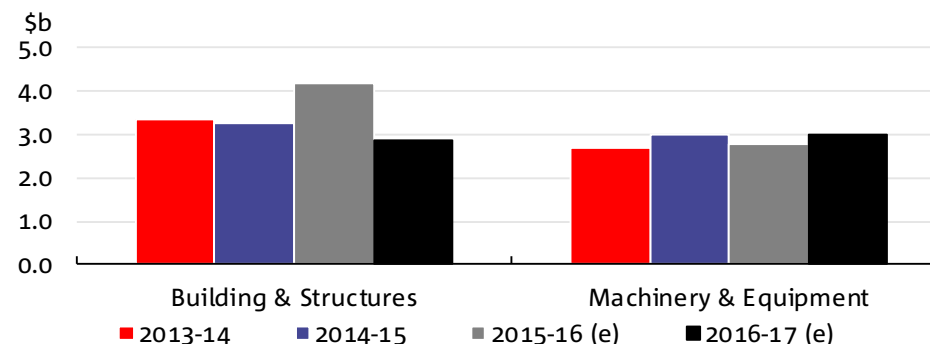
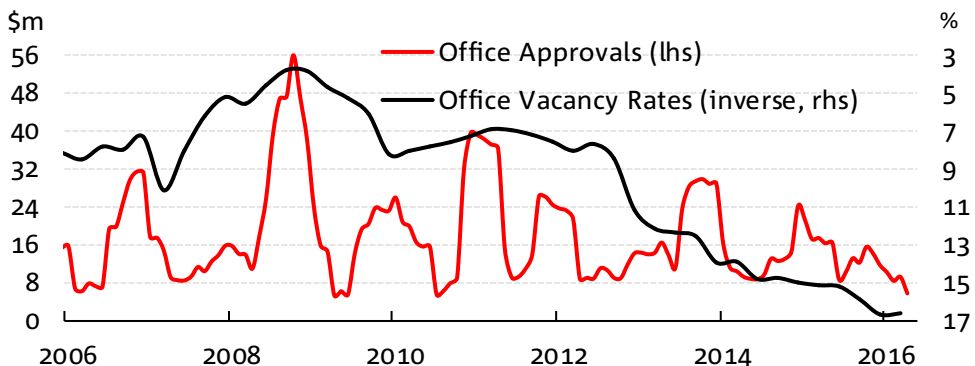


CHART 15: OFFICE APPROVALS AND VACANCY RATES



RESIDENTIAL PROPERTY:

Subdued economic conditions continue to constrain SA housing market

- The residential property sector in Adelaide remains subdued, characterised by only modest residential property price growth since 2012 while the Sydney and Melbourne markets have picked up strongly (Chart 17). Regional house prices have contracted in most months since March 2015 (Chart 18).
- In the year to Q1 2016, western Adelaide led in capital growth for both houses and units (Chart 19).
- Results from the latest NAB Property Survey reveal expectations by industry participants for SA/NT house prices to grow modestly in the short term, before gaining further momentum over the medium term (Chart 20). We expect Adelaide house prices to grow moderately in 2016 by 3.5%, before easing to 1.7% in 2017.

CHART 17: ADELAIDE HOUSE PRICES AND DWELLINGS TO POPULATION RATIO

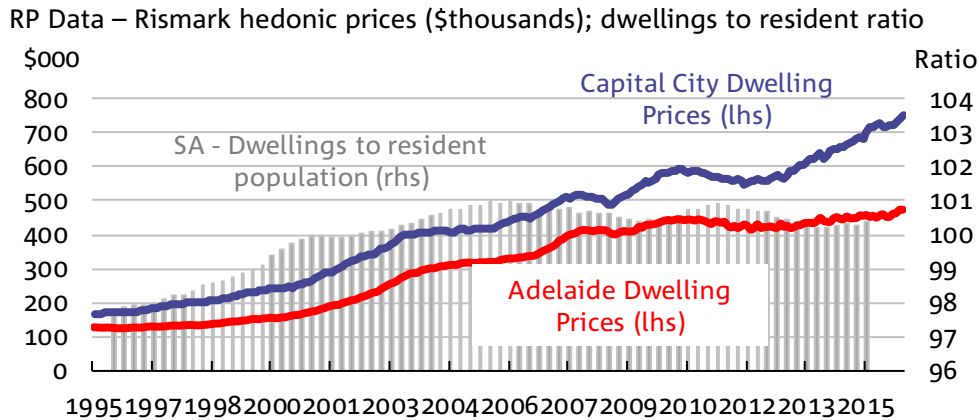


CHART 19: ADELAIDE - MEDIAN PROPERTY PRICE GROWTH

Percentage growth in the year to Q1 2016 (%)

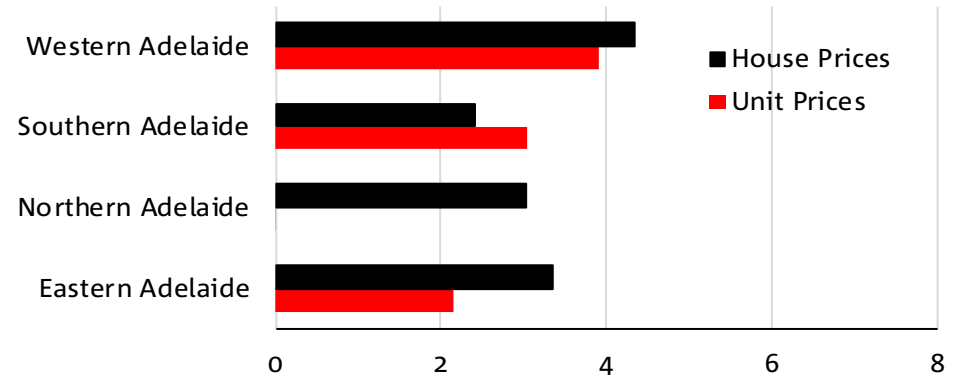
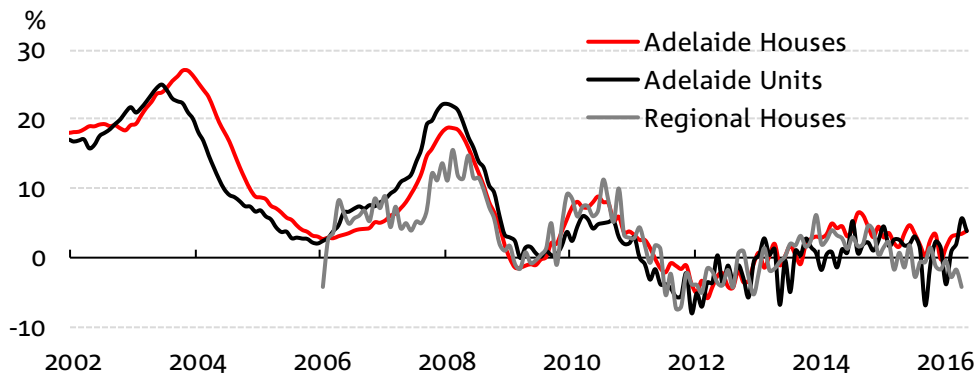


CHART 18: SA RESIDENTIAL PROPERTY PRICE GROWTH (Y/Y%)

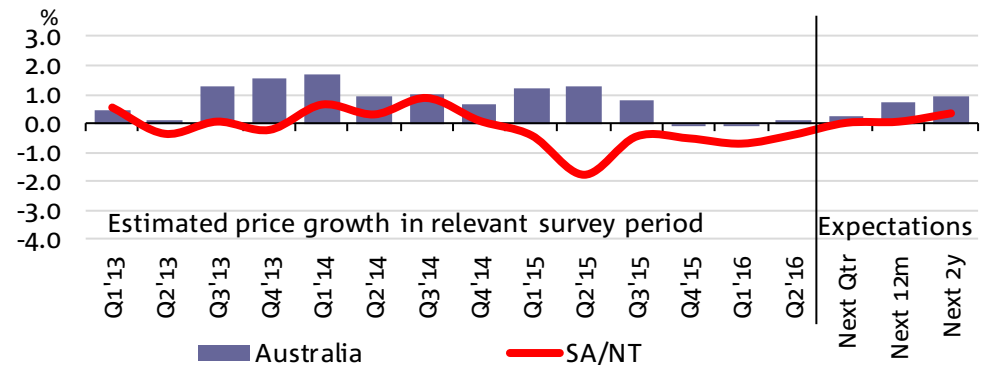
Percentage year-on-year growth (%)



Source: ABS, NAB Group Economics

CHART 20: NAB PROPERTY SURVEY – HOUSE PRICE EXPECTATIONS

Percentage growth (%)



DEMOGRAPHICS:

SA population growth continues to moderate as interstate migration accelerates

- South Australian population growth continued to deteriorate in late 2015 to increasingly diverge from national average growth (Chart 21). It was largely driven by an acceleration in net outbound interstate migration and weaker natural increase (Chart 22).

- More importantly, the SA population continues to age relative to the national average (Chart 23).
- The SA population as a share of the Australian population continues its structural decline (Chart 24).

CHART 21: SA AND AUS POPULATION GROWTH

Year-ended percentage growth (%)

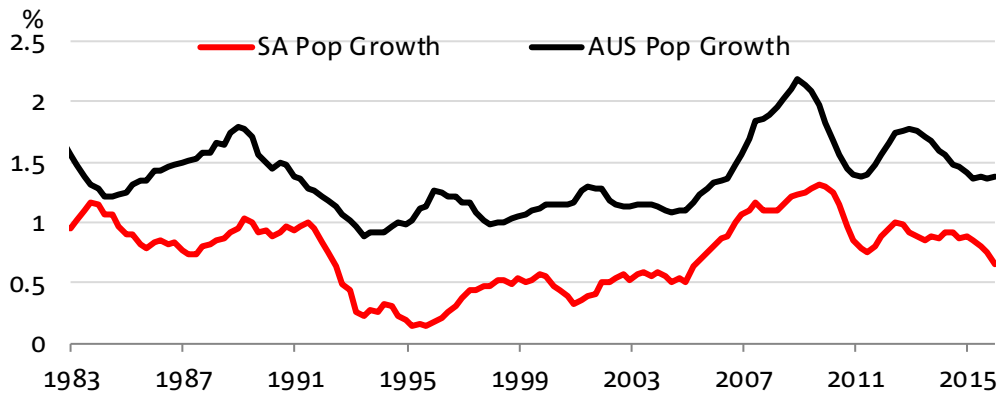


CHART 23: AGE DISTRIBUTION OF SA POPULATION

Percentage share of total resident population (%)

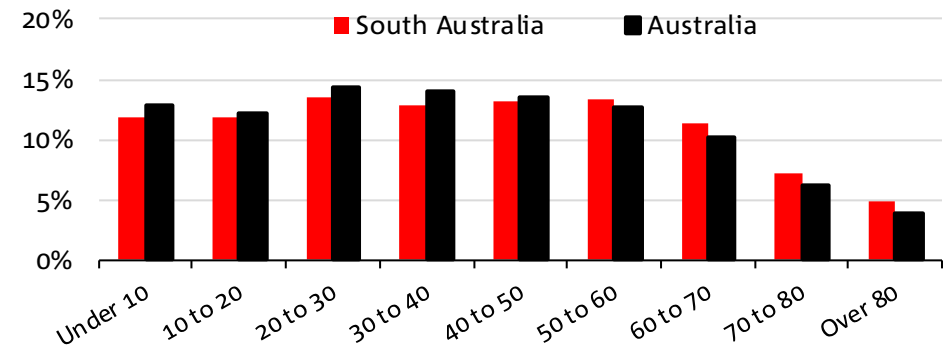


CHART 22: POPULATION GROWTH

Four-quarter rolling sum ('000 persons)

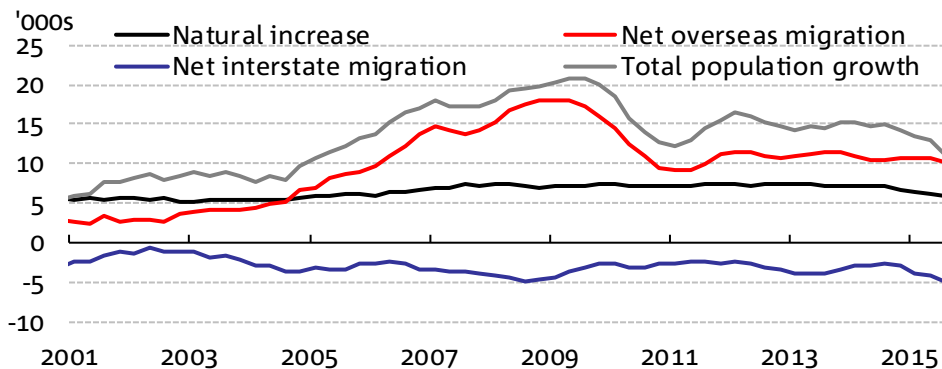
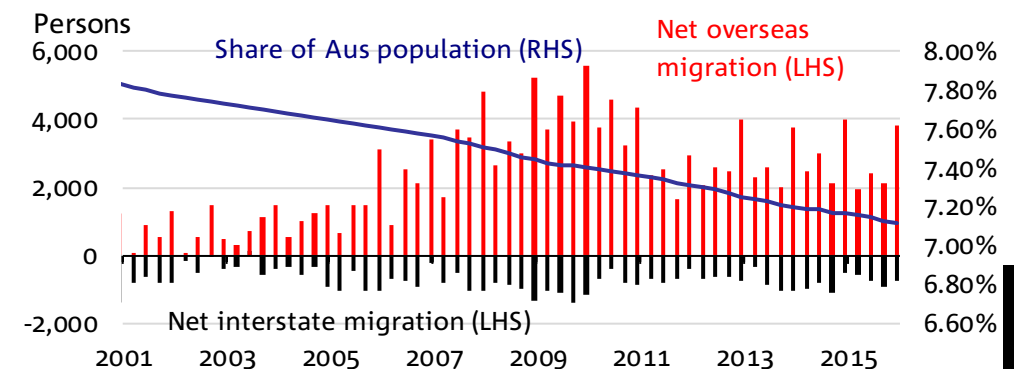


CHART 24: SA SHARE OF AUS POPULATION AND GROWTH IN MIGRATION

Quarterly population change ('000 persons)/SA population as a percentage share of Australian population (%)



LABOUR MARKET:

SA unemployment rate eases, but structural job losses continue

- Labour market conditions in SA have shown some signs of improvement of late, characterised by a moderation in the unemployment rate across regions within the state (Chart 25). However, some of the recent amelioration in the unemployment rate has been partly driven by a further easing in the participation rate (Chart 26).
- That said, the state continues to record the highest unemployment rate among all states in trend terms.
- In the 12 months to May 2016, most of the jobs created were in services sectors, especially those stemming from the public sector, while the more traditional sectors of manufacturing, wholesale and mining continued to experience job losses (Chart 27). Job losses were the largest in the agriculture sector, as wheat production eased from its bumper year in 2014-15.

CHART 25: UNEMPLOYMENT RATE BY REGION

Per cent of labour force (%)

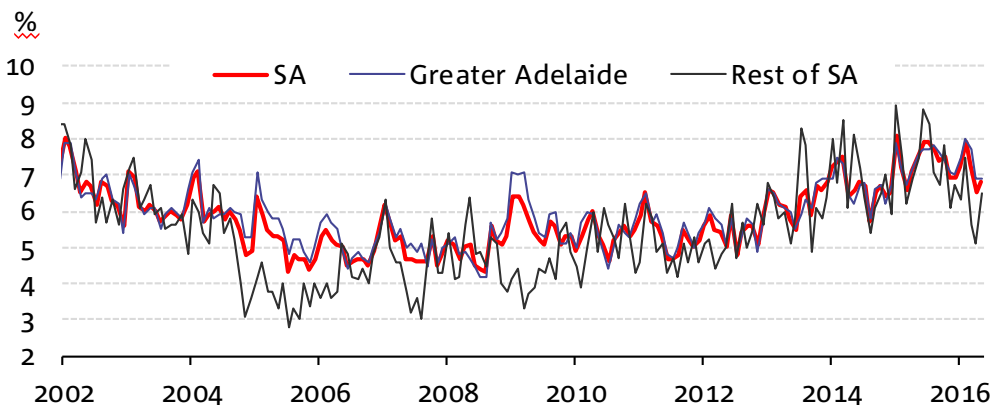


CHART 26: SA UNEMPLOYMENT & PARTICIPATION RATES

Per cent of labour force

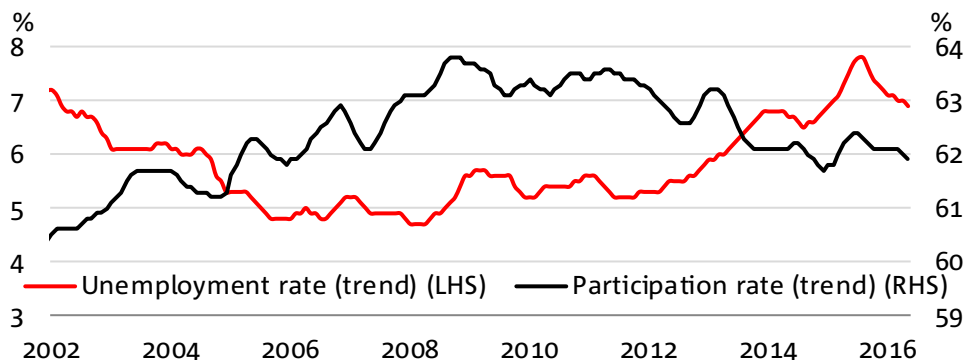
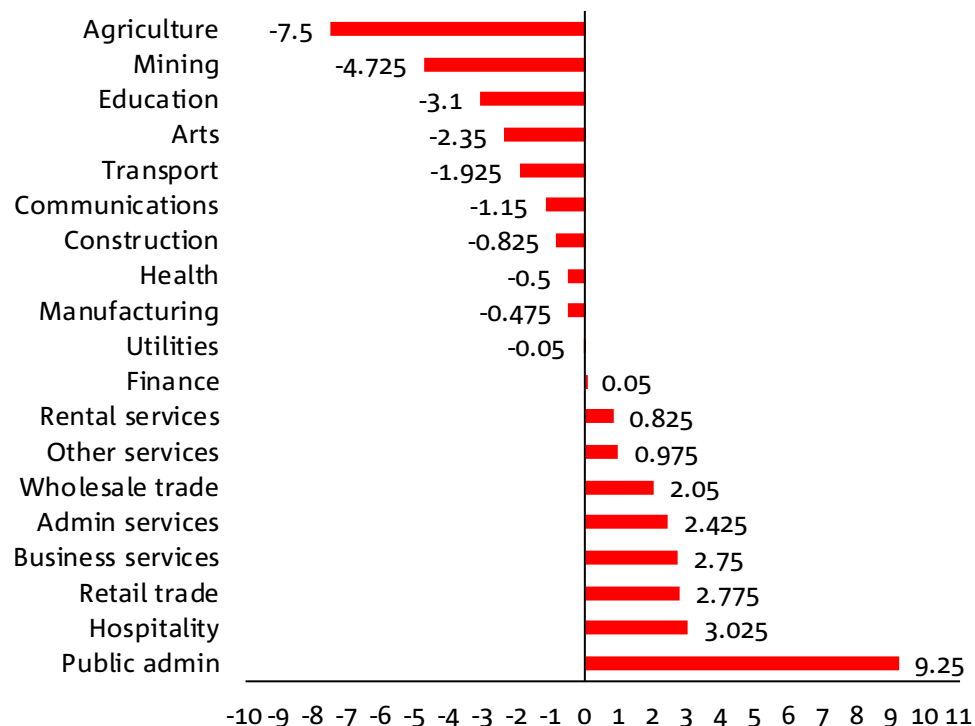


CHART 27: CHANGE IN EMPLOYMENT BY INDUSTRY, LAST 12 MONTHS TO MAY 2016, SA

'Persons ('000)



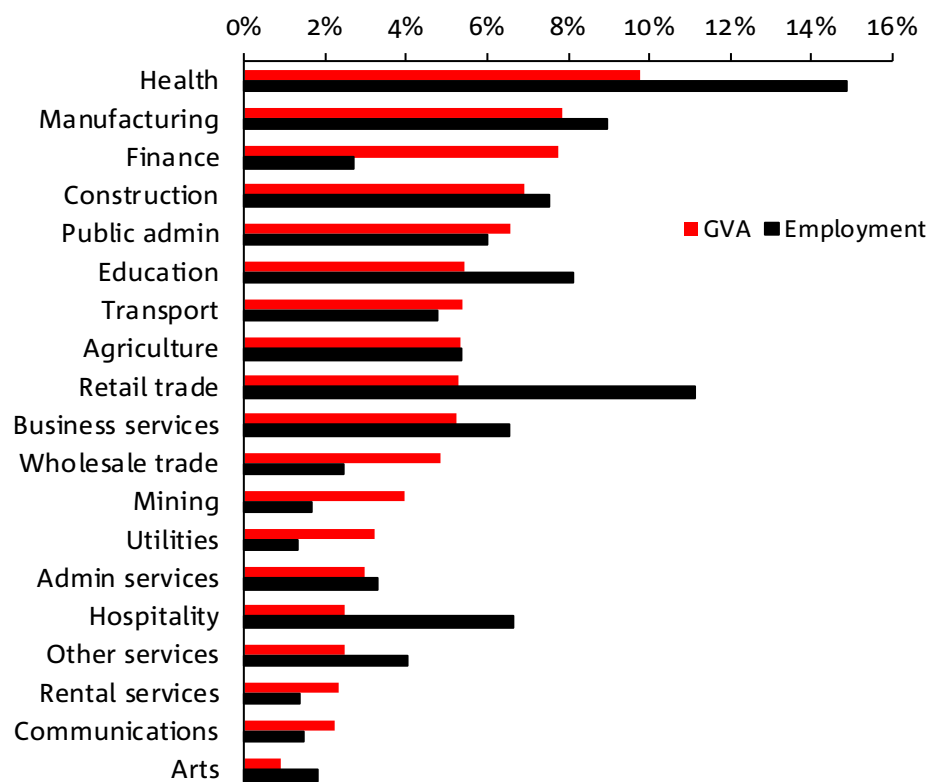
ECONOMIC STRUCTURE AND TRADE

The health sector dominates in terms of output and employment

- The top three sectors in SA by output share are health services, manufacturing and finance & insurance services. The former overtook manufacturing as the largest industry by gross value added in 2008-09 and the largest employer in 2006-07 (Chart 28).
- By employment share, manufacturing (9%) is ranked third behind health & social services (15%) and retail trade (11%).

CHART 28 : COMPOSITION OF EMPLOYMENT & GVA IN 2014-15

Percentage share (%)



- China and the ASEAN bloc are the main trading partners for SA (Chart 29 & 30).
- SA's top commodity exports in 2014-15 included wheat (\$1.3bn), alcoholic beverages (\$1.2bn) and copper (\$1bn). Meanwhile, SA imports mainly refined petroleum (\$1.1bn), passenger motor vehicles (\$0.6bn) and vehicle parts and accessories (Charts 31 & 32).

TABLES 29 & 30: TOP SA EXPORT DESTINATIONS AND IMPORT SOURCE COUNTRIES, 2014-15

Million (\$m)

Value of exports (\$m)		Value of imports (\$m)	
1	China	2251	1645
2	ASEAN	1970	1632
3	US	1626	1407
4	EU	1278	765
5	India	600	629
6	Japan	502	463
7	New Zealand	453	459
8	UK	406	249
9	Taiwan	295	203
10	Korea	264	190
11	HK	236	115
12	Singapore	154	115
13	Germany	122	23

TABLES 31 & 32: TOP SA MERCHANDISE EXPORTS AND IMPORTS

Major exports, goods, 2014-15		Major imports, goods, 2014-15	
	A\$m		A\$m
Wheat	1,300	Refined petroleum	1,115
Alcoholic beverages	1,238	Passenger motor vehicles	643
Copper	951	Vehicle parts & accessories	353
Copper ores & concentrates	927	Goods vehicles	312
Meat (excl beef)	737	Alcoholic beverages	284

FISCAL OUTLOOK

General government net debt forecast to be higher in most years

- Compared to the Mid-Year Budget Review, the SA government has revised its forecast for general government net debt higher for 2015-16 and all years in the forward estimates, except for 2016-17. This primarily reflects higher expected capital investment for the new Royal Adelaide Hospital across all years, with a partial offset from increased capital returns from the Motor Accident Commission (MAC), especially in 2016-17. Net debt is now expected to peak in 2017-18 at \$6.6bn instead of \$6.3bn at 2016-17.
- Relative to the Mid-Year Budget Review (MYBR), total taxation revenues have been revised down in all years, mainly due to lower-than-expected payroll tax, conveyance duty and gambling tax in the year to date. Meanwhile, GST grants have been revised up for 2015-16 but revised down in all other years reflecting changes to SA's expected share of the GST pool, updated population estimates and revised estimates of the national GST pool. GST is the single largest source of revenue for the state at 32% (Chart 34).

CHART 33: SA NET OPERATING BALANCE

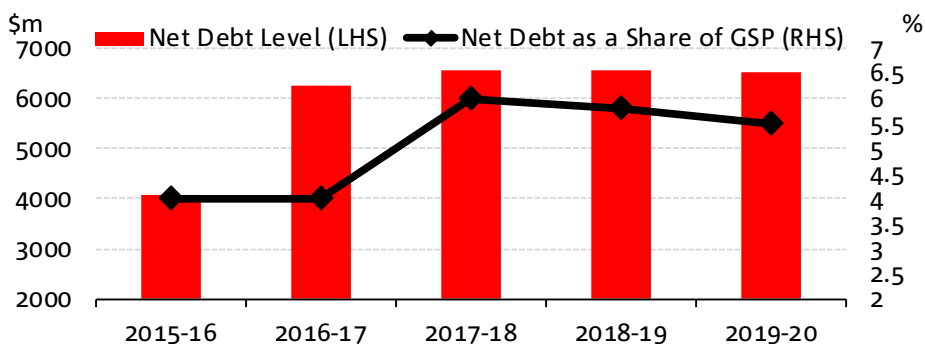
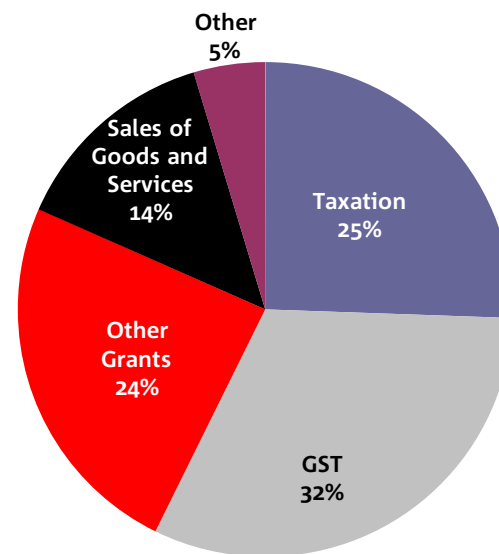


CHART 34: SA COMPOSITION OF STATE REVENUE

Percentage share (%)



SEMI GOVERNMENT BONDS AND CREDIT RATINGS

SA government credit rating metrics at risk of slight downgrade by S&P

- On a total state level, net debt will rise to \$13.8bn in FY 17 (from \$10.9bn) which is expected to be close to the peak for net debt over the forecast horizon. The rise in net debt in FY 17 largely reflects the financial obligations for the new Royal Adelaide Hospital (Chart 35).
- S&P is yet to confirm SA's credit rating. Our estimates of the rating metrics show some slippage from the MYBR but it is not material (Chart 37).
- SAFA funding program for FY17 is \$5.5bn (vs \$3.7bnbn in FY16). This comprises \$0.1bn of new financing, \$2bn of PN and ECP rollovers and \$3.4bn of maturities. For liquidity reasons SAFA plans to refinance the Sep 17 bond line (2.4bn outstanding) via issuing into existing 2025 and 2016 lines and potentially creating 2022, 2024 and 2027 (Chart 38).

CHART 35: SA NON-FINANCIAL PUBLIC SECTOR NET DEBT

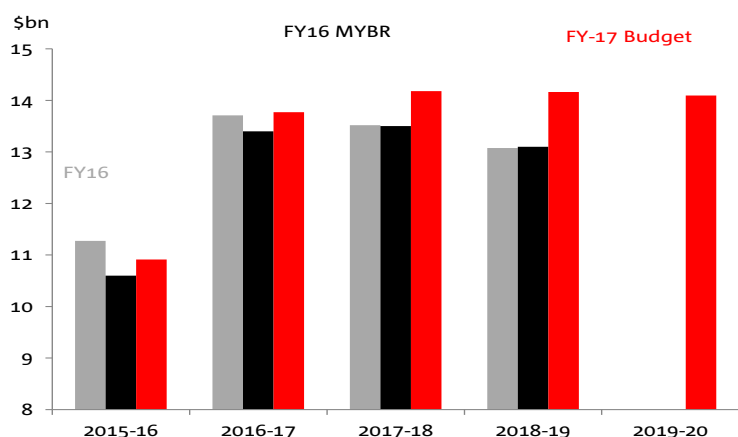


CHART 37: S&P CREDIT METRIC: BUDGET PERFORMANCE METRICS

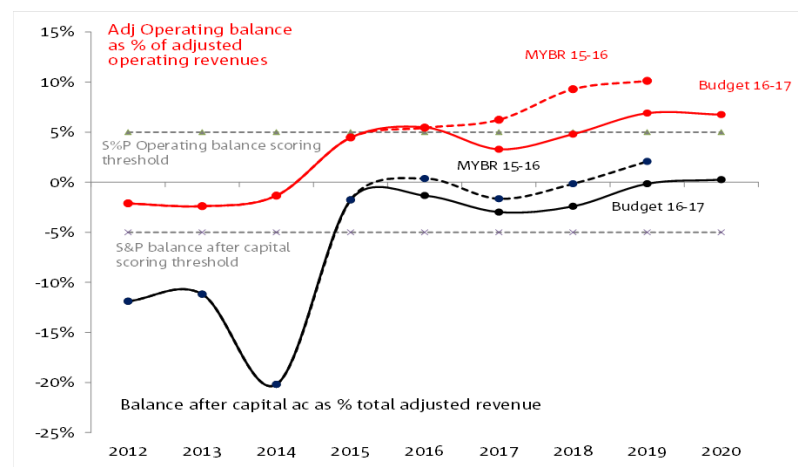
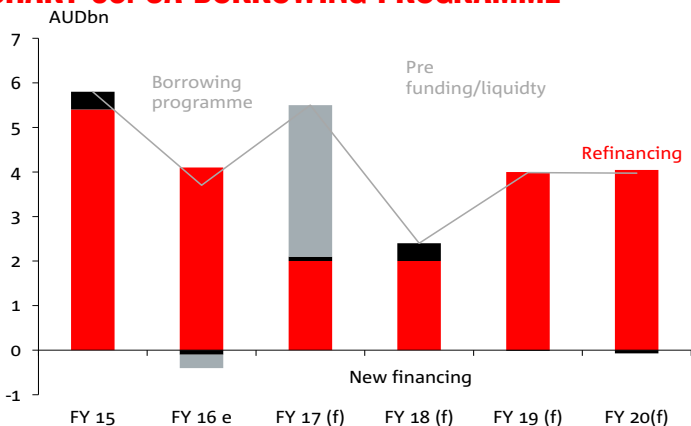


CHART 36: SA BORROWING PROGRAMME



nb: forecasts for new financing estimated from budget

Source: SAFA and SA budget papers

CHART 38: SAFA TERM BONDS OUTSTANDING AS AT END JUNE 2016

