

STATE UPDATE: VICTORIA

JULY 2016

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KEY POINTS:

A broadening non-mining recovery boosts Victorian economic performance

CHART 1: STATE GSP GROWTH FORECASTS

Annual growth

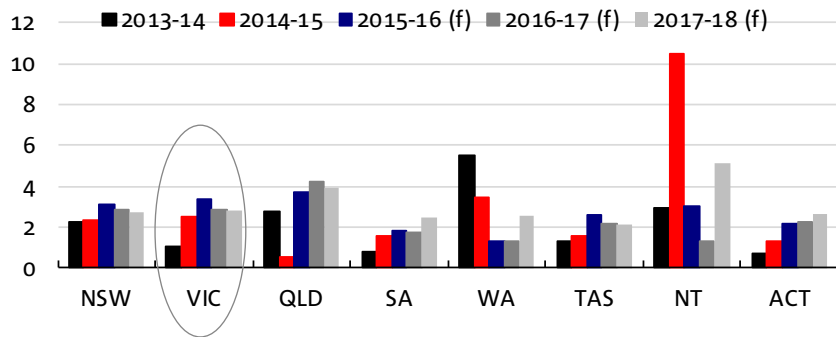
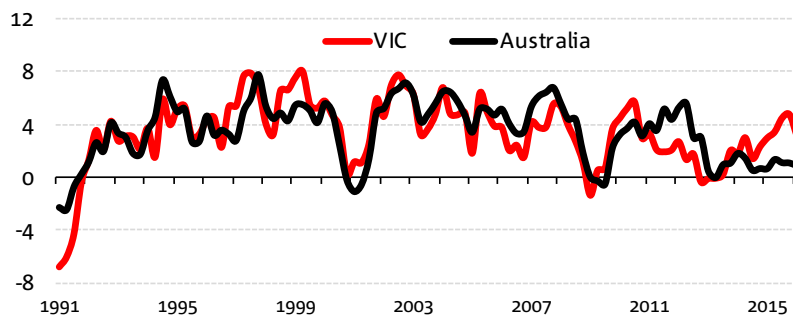


CHART 2: STATE FINAL DEMAND

Per cent (%)



- The broadening of the recovery in non-mining activity continues to benefit the diversified economy of Victoria, especially through the pick-up in the services sector. Strong employment and housing market growth has helped to prop up household consumption and dwelling investment respectively, although the positive impetus from the housing market and the construction pipeline is likely to fade in the medium term. However, this will be partly offset by the large infrastructure investment by the Victorian government in the Western Distributor and Metro Tunnel projects. Victorian business conditions have shown signs of renewed strength in recent months after a slow patch from mid-2015 to early 2016. The labour market has shown further improvement, although unemployment and underutilisation rates are still elevated by historical comparisons. **The medium-term challenge for VIC will be to maintain momentum in state final demand growth as the contribution from the housing sector and AUD depreciation begins to fade. We forecast Victorian real GSP growth to be around 3.3% in 2015-16, before moderating to 2.9% in 2016-17 and 2.8% in 2017-18. Correspondingly, the unemployment rate is forecast to fall moderately to 5.6% by end 16-17 and then rise moderately to 5.8% by end 17-18, from 6.0% in 15-16.**

The Victorian services sectors continue to outperform the traditional sectors. Aided by the low AUD, foreign student enrolments have picked up strongly, with 2015 numbers breaking the previous record set in 2009. Meanwhile, the NAB Monthly Business Survey and aviation statistics also suggest that inbound tourism to Victoria from domestic and foreign sources has continued to improve. **Supported by low interest rates and strong asset price growth, Victorian household consumption growth has held up reasonably well, although a higher unemployment predicted as a result of a likely slowdown in the dwelling construction sector could be a downside risk on income growth.** While consumers have clearly become more optimistic in recent times, NAB Consumer Behaviour Survey shows that overall spending preferences remain geared towards the essential items.

- The Victorian labour market saw further improvements in early 2016, despite employment growth slowing as part-time jobs growth eased. That said, the number of jobs created were sufficient to keep unemployment trickling downwards, although the underutilisation rate remains elevated. The imminent closures of Toyota and Ford plants by 2017 are expected to shed around 3,500 direct manufacturing jobs, while indirect job loss through parts suppliers could be much larger. The relatively high unemployment rate in Victoria is also partly attributable to the strong growth in its labour force brought about by net overseas migration and interstate migration. Victoria had the highest population growth across all states and territories in the year to September quarter 2015 at 1.7%, compared to 1.3% nationally.
- Dwelling investment has been a major contributor to the economy, marked by record levels of dwelling approvals for apartments and units, although we are now past the peak. As a result, the construction pipeline continues to reach new record levels. This will contribute strongly to the state's growth in 2016 and 2017, but its contribution to growth is expected to wane from H2 2016 onwards. Meanwhile, business investment growth has remained modest despite low borrowing costs and improved business conditions. Encouragingly, the capacity utilisation rates of Victorian firms are now outpacing national average, and should provide further incentive for business investment.
- Spurred by a lower AUD, Victorian exports have gained significant momentum, driven by strong education and rural commodity exports. Given the expected further depreciation of the currency, the outlook for Victorian merchandise and services exports appears favourable.

IN FOCUS:

Victoria continues to reap the benefits of strong population growth

- Victorian population growth continues to outpace the other states, driven by strong net overseas and interstate migration (Chart 3).
- Victorian employment growth has eased since the start of the year, after growing strongly over 2015 led by part-time jobs (Chart 4). Full-time jobs rose notably in the year to May 2016, with Australia-born workers accounting for more than 70% of the increase (Chart 5).
- The broadening of non-mining recovery is evident in the continued outperformance of Victorian services sectors relative to the traditional sectors (except for transport and utilities) in terms of business confidence and conditions, according to NAB Business Survey (Chart 6).

CHART 3: POPULATION GROWTH DRIVERS IN VICTORIA IN THE YEAR TO SEP 15

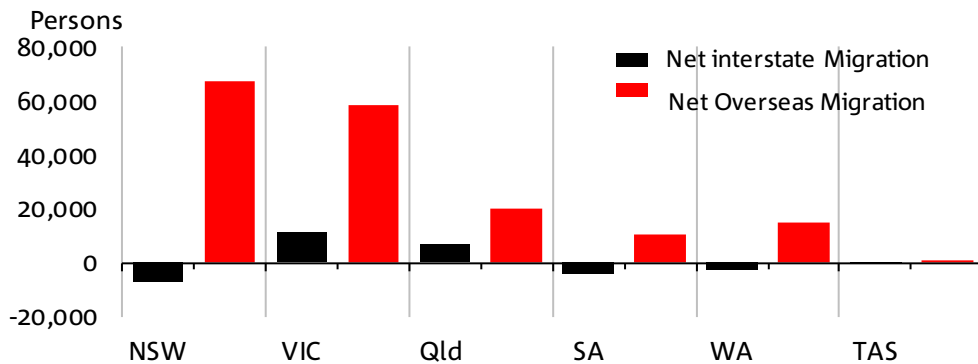
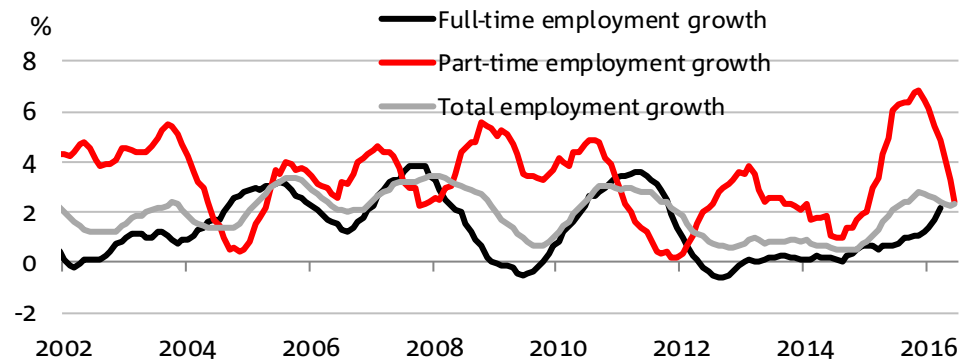


CHART 4: EMPLOYMENT GROWTH
12-month rolling growth (%)



Source: ABS, NAB Group Economics

CHART 5: PART-TIME AND FULL-TIME EMPLOYMENT GROWTH BY COUNTRY OF BIRTH

12 months to May 2016, '000s

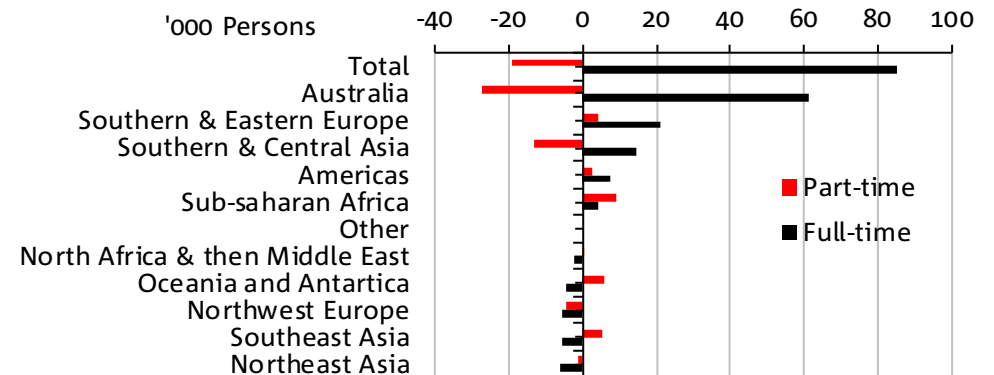
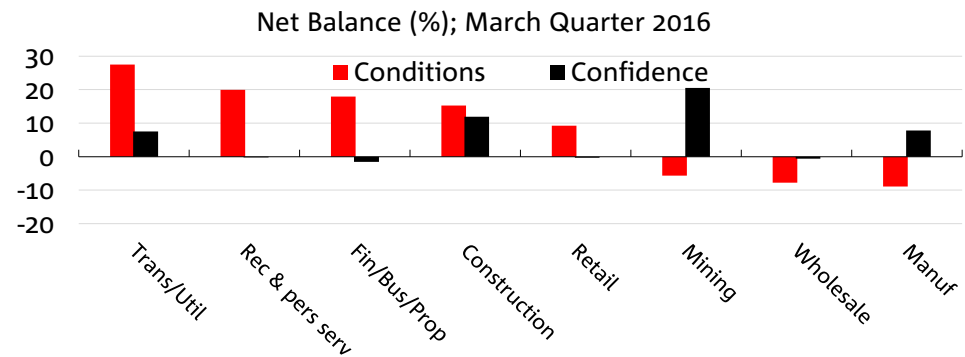


CHART 6: VIC BUSINESS CONDITIONS AND CONFIDENCE BY INDUSTRY

Net balance



CONSUMER AND HOUSEHOLD SECTOR:

Consumption is holding up, supported by strong employment growth

- Household consumption growth has held up on the back of strong employment growth, with further evidence that wages growth is gaining momentum as well (Chart 7 and Chart 8).
- Retail sales growth has maintained a strong pace since 2013, with the direct impetus from the housing market likely a factor (Chart 8).
- Based on our survey, consumers are now less inclined to spend on discretionary items such as travel, home improvements etc., while continuing to focus on paying down their debt and incur most spending on essential items such as medical expenses, transport and utilities (Chart 9).

CHART 7: TOTAL COMPENSATION OF EMPLOYEES AND NOMINAL HOUSEHOLD CONSUMPTION GROWTH

Year-on-year percentage growth

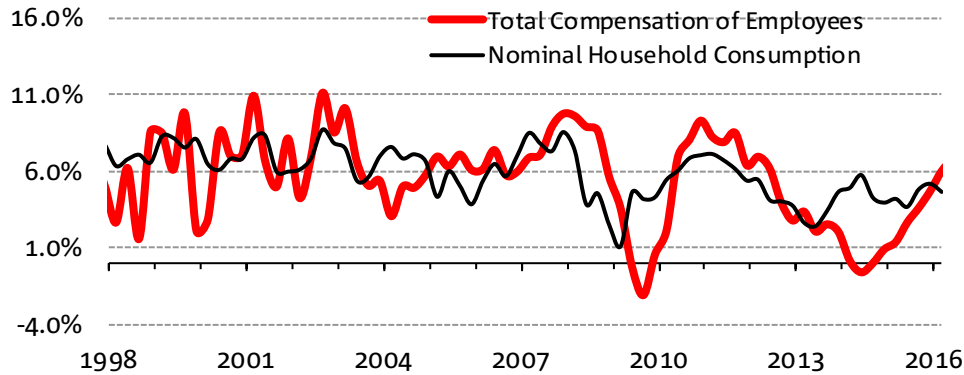


CHART 8: RETAIL TURNOVER AND HOUSE PRICE GROWTH

Year-on-year percentage growth

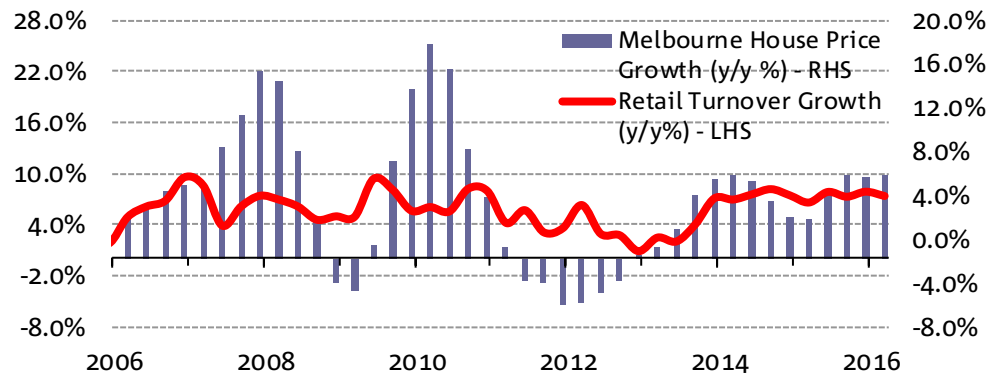
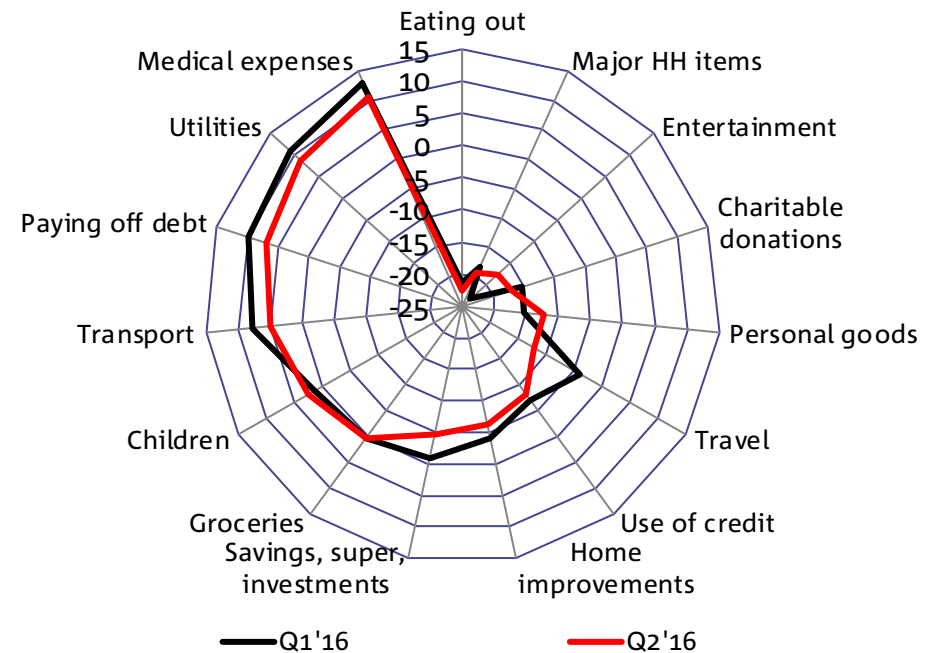


CHART 9: NAB CONSUMER ANXIETY SURVEY - CONSUMER SPENDING PREFERENCES

Changes in Consumer Spending Preferences (net balance)



BUSINESS SECTOR:

Victorian business conditions outperforming national average

- According to the monthly NAB Business Survey, business conditions (in trend terms) in Victoria, together with NSW, have been among the top performing since late 2014 (Chart 10).
- The sustained strength in Victorian business conditions has manifested in a rising trend in capacity utilisation, which is now above the national average (Chart 11).

- Overall, Victorian business investment outlook is mixed. Victorian business investment growth has lost some momentum since late last year, although a pick-up in the 12-month capex expectations index in the NAB Business Survey suggests that business investment appetite by firms could be increasing (Chart 12).
- The NAB Business Survey also reveals that services sectors in Victoria such as transport and utility; recreational and personal; as well as financial, business and property services are outperforming the traditional sectors (Chart 13).

CHART 10: SPREAD IN NAB BUSINESS CONDITIONS

Net balance, 3-month-moving-average

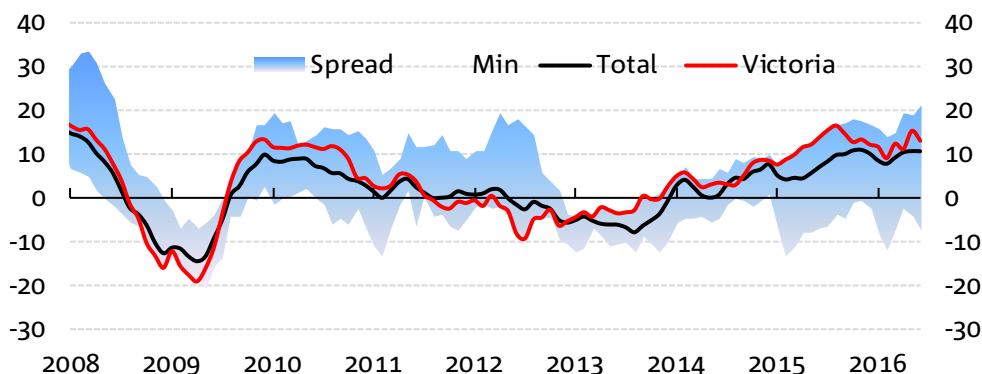


CHART 11: NAB BUSINESS SURVEY – CAPACITY UTILISATION

Per cent of total capacity (%)

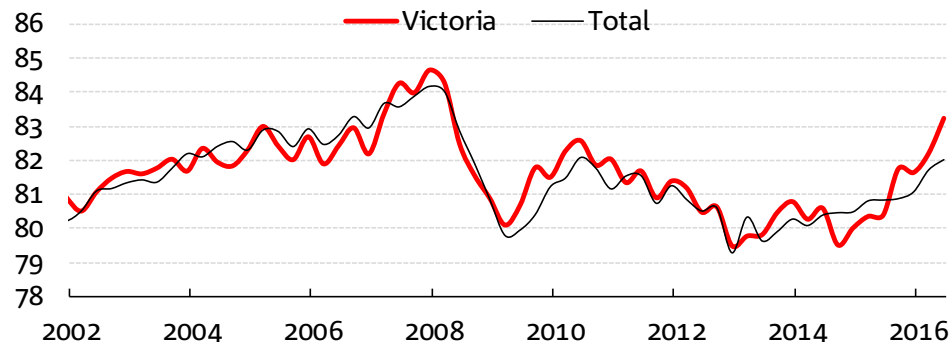


CHART 12: NAB SURVEY CAPEX EXPECTATIONS & PRIVATE BUSINESS INVESTMENT GROWTH

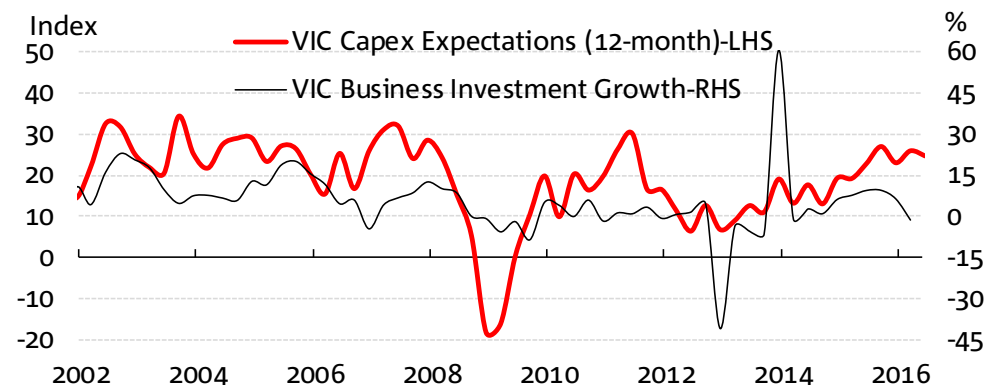
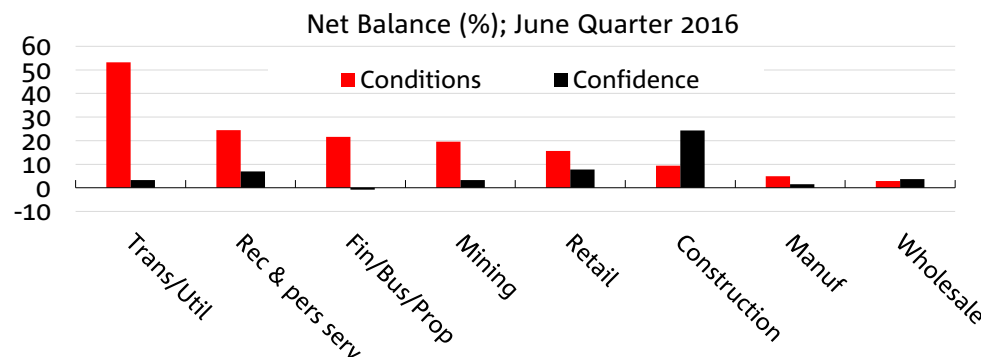


CHART 13: BUSINESS CONDITIONS AND CONFIDENCE BY INDUSTRY

Net balance



COMMERCIAL PROPERTY/NON-RESIDENTIAL INVESTMENT:

Business investment outlook mixed, despite improving business conditions

- The outlook for Victorian business investment appears mixed, despite generally improving business conditions and confidence as reported in the NAB Business Survey. After an initial recovery in the aftermath of GFC, non-residential building approvals have been tracking sideways to easing slightly for the last four years, except for the “Other” (which mainly includes hotels and other forms of recreational accommodation), and to a lesser extent, “Warehouses” categories which have shown some upward momentum (Chart 14).
- Office vacancy rates have eased recently, driven by fewer office approvals in 2015 and more robust demand for office spaces (Chart 15). Our NAB Commercial Survey suggests the sentiment in the Office segment has been positive for a while now (despite deteriorating more recently), while sentiment in the Industrial segment has improved notably overtime (Chart 16).
- Business investment appetite remains restrained among firms in Victoria, evident in their relatively flat capital expenditure expectations in buildings & structures and machinery & equipment for 2015-16 (Chart 17).

CHART 14: NON-RESIDENTIAL BUILDING APPROVALS

Million dollars

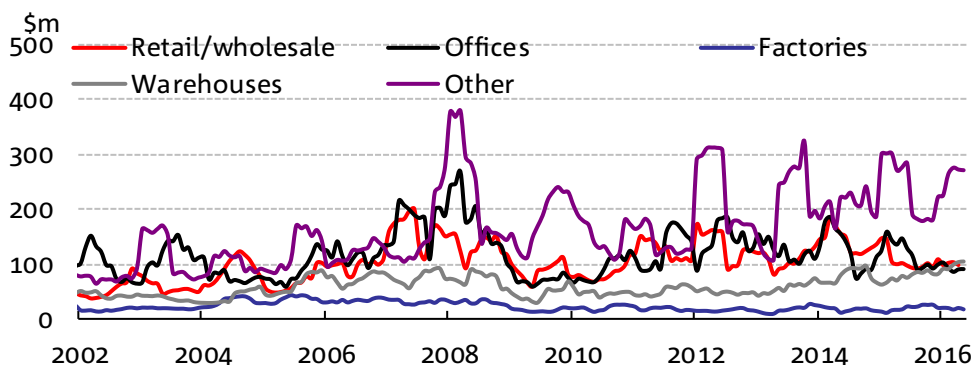
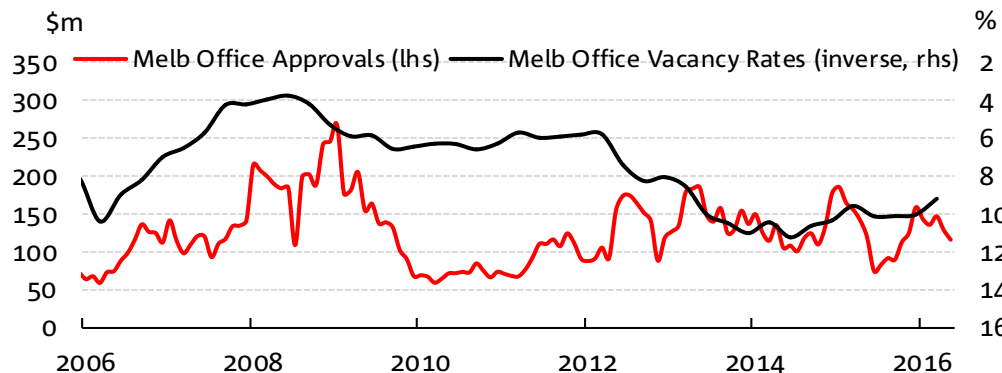


CHART 15: OFFICE APPROVALS AND VACANCY RATES



Source: ABS, NAB Group Economics

CHART 16: NAB COMMERCIAL PROPERTY SURVEY

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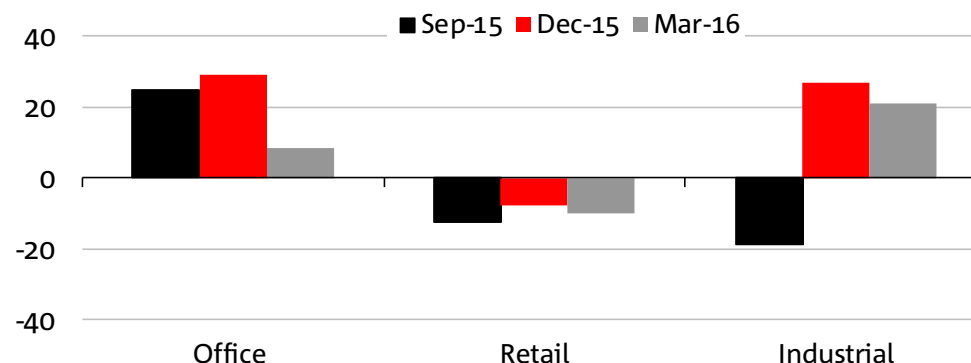
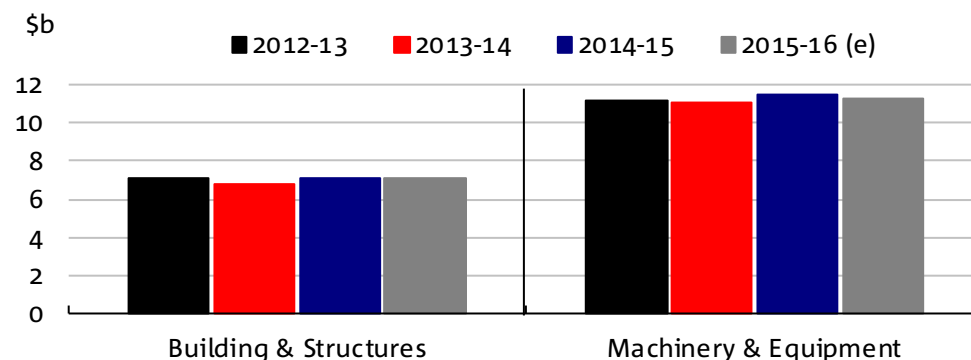


CHART 17: VIC CAPITAL EXPENDITURE & EXPECTATIONS

Actual & expected based on previous realisation ratio



DWELLING INVESTMENT:

Dwelling investment remains strong, but impetus from construction to fade

- The value of residential construction pipeline continues to chart new historical high, spurred by strong dwelling approvals. However, the latter appears to have peaked, which suggests its contribution to the construction pipeline is waning (Chart 18). As such, we expect the contribution from construction activity to GSP growth to start tapering off from mid-17, before reaching a trough in 2018.
- Strong house price growth in the past three years against a backdrop of weak wages growth had resulted in a steady rise in the price-to-income ratio, as well as a decline in rental yields (Chart 19).
- The strength in dwelling approvals has been largely driven by a surge in unit applications, with the Victorian unit approvals to population ratio greatly exceeding national average (Chart 20).

CHART 18: VIC NUMBER OF DWELLING APPROVALS AND WORK-YET-TO-BE-DONE

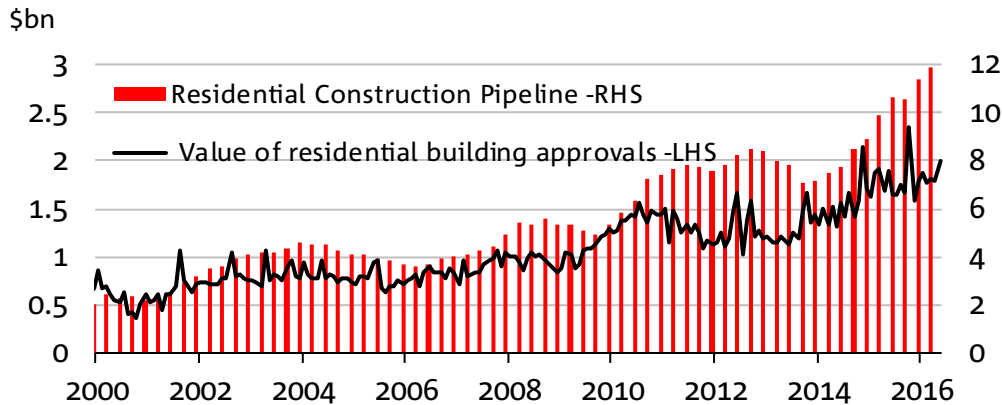


CHART 20: VIC HOUSE AND UNIT APPLICATIONS TO POPULATION RATIO

Long-run Average =100

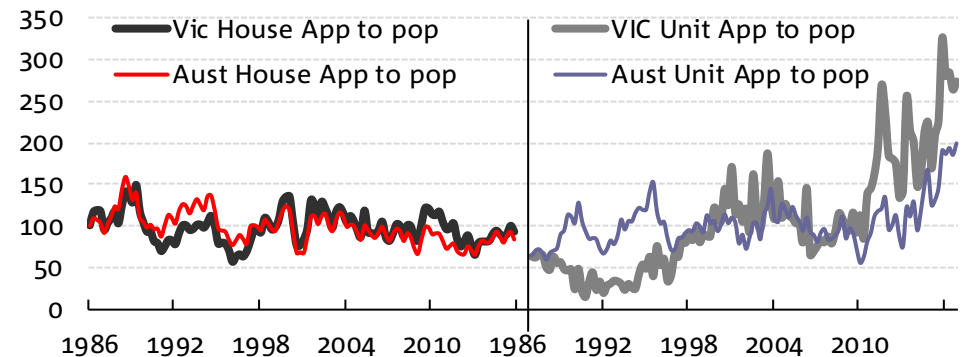
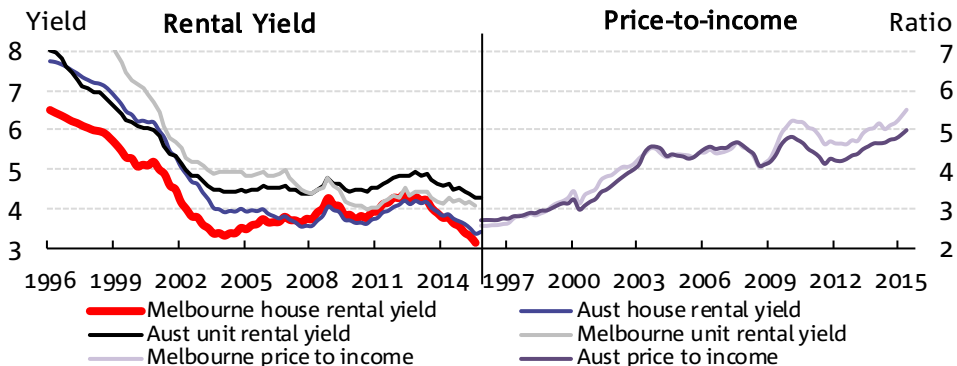


CHART 19: VIC RENTAL YIELDS (%) AND PRICE-TO-INCOME RATIOS



Source: ABS, NAB Group Economics

RESIDENTIAL PROPERTY:

Victorian house price outlook remains relatively resilient

- Melbourne houses have outperformed units and regional houses in terms of capital growth by a significant stretch in the current cycle (Chart 21).
- VIC residential property price growth by sub-region in Melbourne suggests that Eastern Middle Melbourne, Boroondara City, Inner Melbourne and Eastern Outer Melbourne led capital growth for houses in the 12 months to Q3 2015, while Eastern Middle Melbourne and Yarra Ranges Shire dominate in the unit segment (Chart 22).

CHART 21: VIC RESIDENTIAL PROPERTY PRICE GROWTH

Year-on-year growth (%)

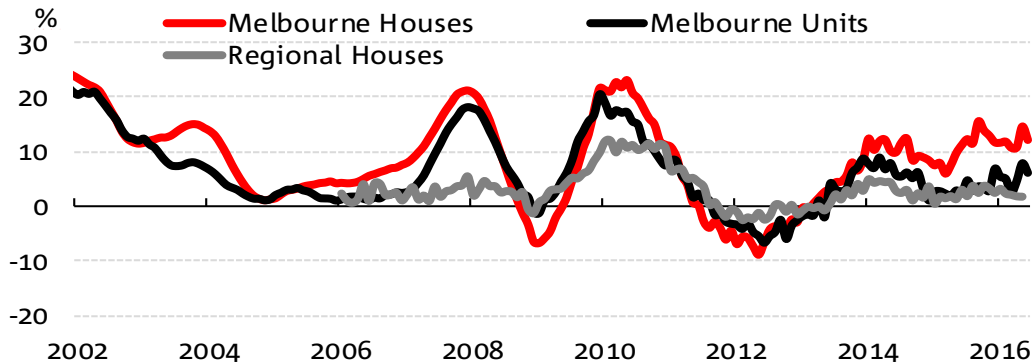
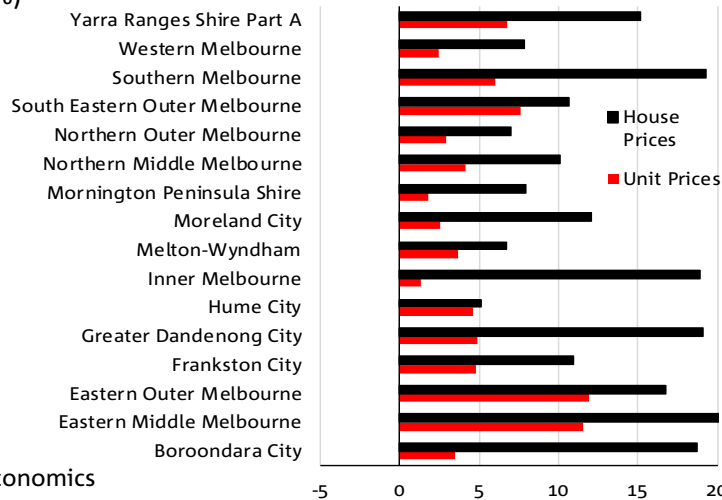


CHART 22: MELBOURNE - MEDIAN PROPERTY PRICE GROWTH (YEAR TO Q1 2016)

Year-on-year growth (%)



- According to the NAB Property Survey, respondents consisting of industry professionals expect VIC property prices to rise moderately in the near to medium term, but not as strong as in the previous years (Chart 23). Please refer to our house price forecasts in the Overview pack.
- In regional Victoria, the Mallee and Ovens-Murray regions were the fastest growing regions for residential properties over the same period, while the Wimmera languished (Chart 24).

CHART 23: NAB PROPERTY SURVEY – HOUSE PRICE EXPECTATIONS

Quarterly growth (%)

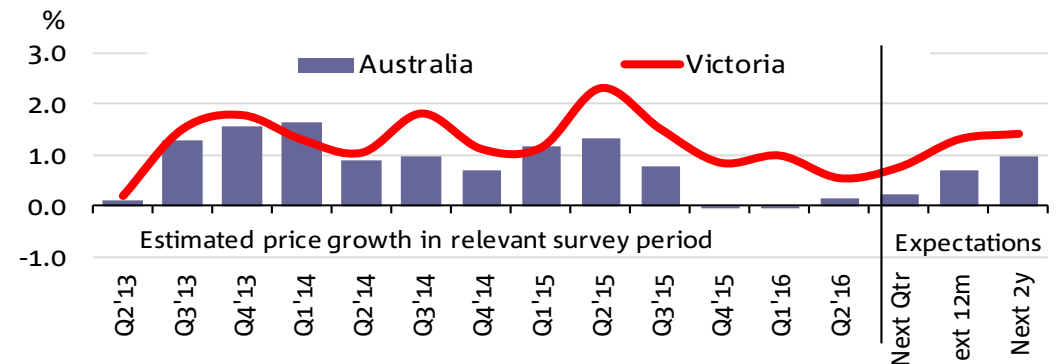
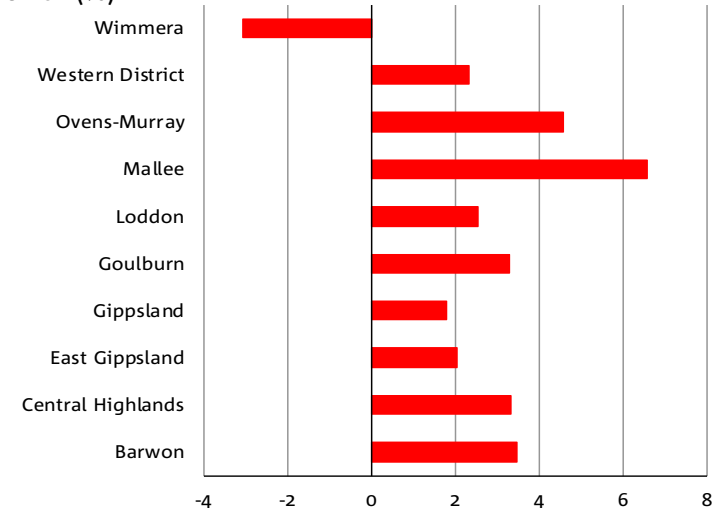


CHART 24: REGIONAL VICTORIA - MEDIAN PROPERTY PRICE GROWTH (YEAR TO Q1 2016)

Year-on-year growth (%)



LABOUR MARKET:

Unemployment in Victoria remains elevated with plenty of spare capacity

- The Victorian unemployment rate is on a downward trend (Chart 25), supported by reasonably strong employment growth (Chart 25). Employment growth since late 2014 has been largely characterised by a strong increase in part-time jobs, although that has lost some momentum since late last year (Chart 26). As such, the true extent of excess capacity in the labour market has not been fully captured by a falling unemployment rate, with the underutilisation rate still high (Chart 27).
- In the 12 months to June 2016, most of the jobs created were in the construction and services sectors. Meanwhile, traditional sectors such as manufacturing, wholesale trade and mining continued to shed jobs (Chart 28).

CHART 25: VIC UNEMPLOYMENT RATE BY REGION

Per cent of labour force (%)

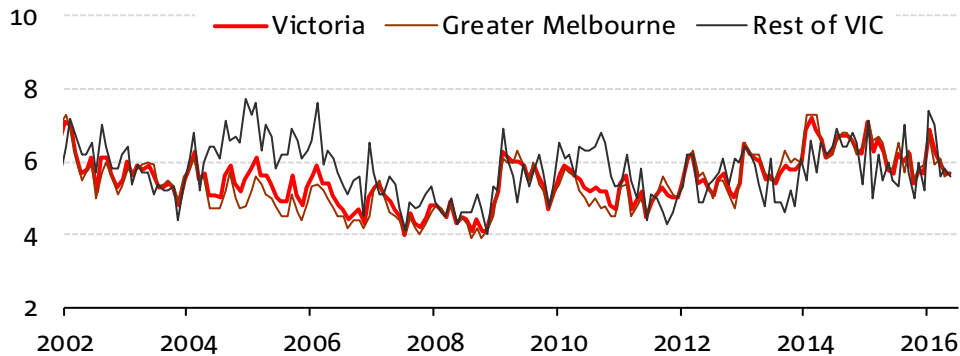


CHART 27: UNEMPLOYMENT AND UNDERUTILISATION RATES

Per cent of labour force (%)

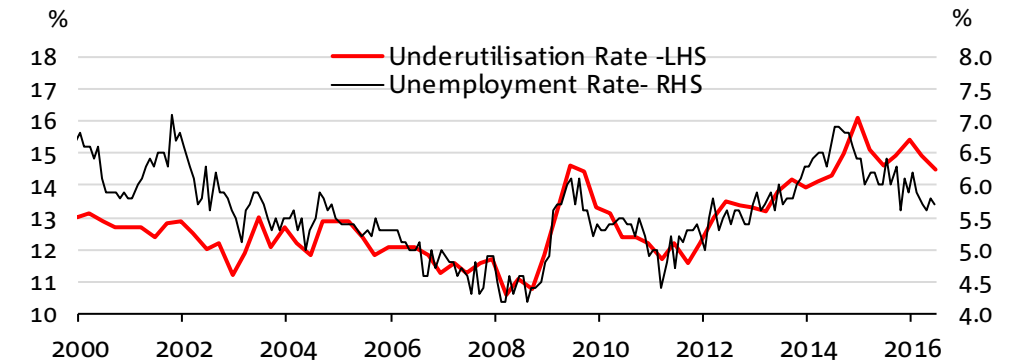


CHART 26: FULL-TIME AND PART-TIME EMPLOYMENT GROWTH

12-month rolling growth (%)

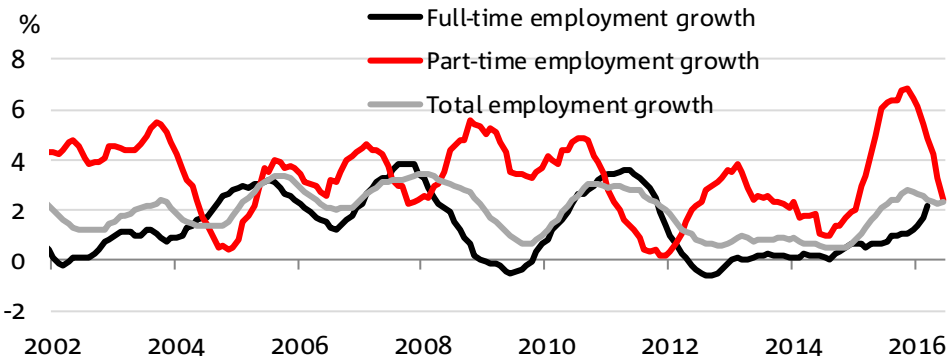
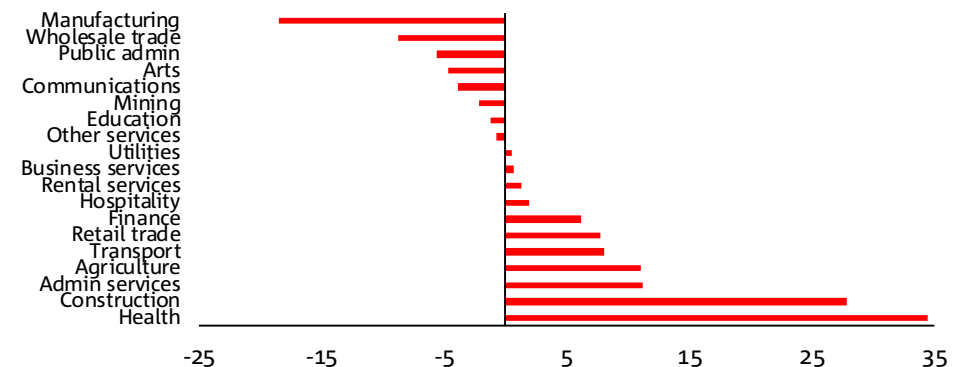


CHART 28: 12-MONTH CHANGE IN EMPLOYMENT BY INDUSTRY TO JUN-16

Thousand persons ('000)



DEMOGRAPHICS:

Victoria continues to register the highest population growth in Australia

- Victorian population growth continues to be the fastest among all states and territories (in year-ended percentage terms) and there has been some renewed momentum over 2015 (Chart 26).
- Since late 2013, growth in net overseas migration has moderated significantly nationally as the mining boom unwinds, albeit to a lesser extent in Victoria. Growth in natural increase has picked up recently, and combined with strong net interstate migration, has helped to support Victorian population growth (Chart 27).

CHART 26: VIC AND AUS POPULATION GROWTH

Year-ended growth (%)

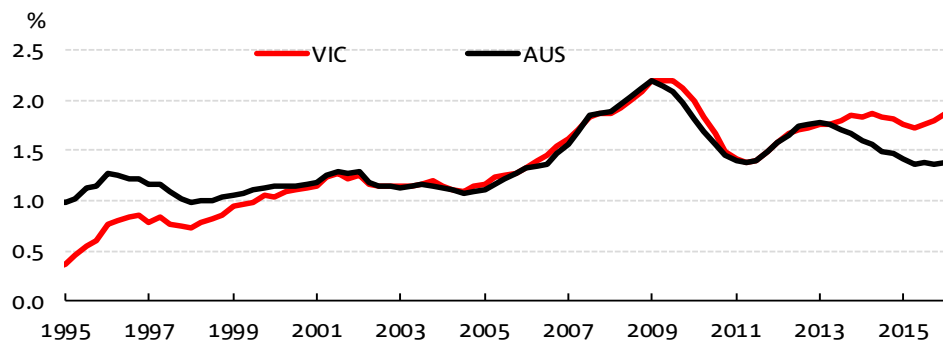
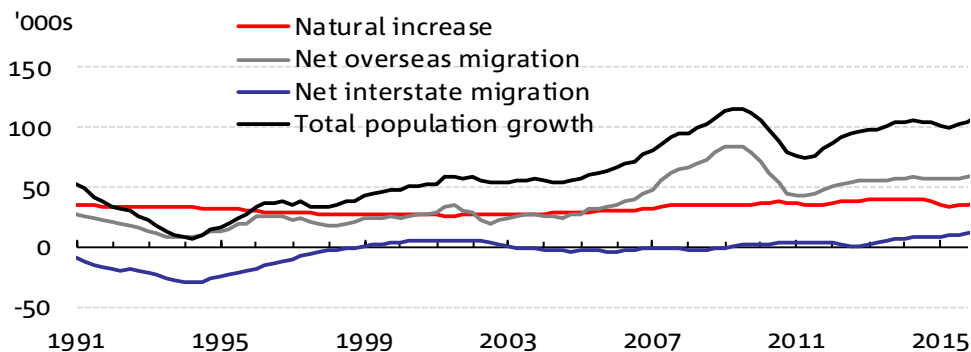


CHART 27: POPULATION GROWTH DRIVERS (000S, OVER THE YEAR)

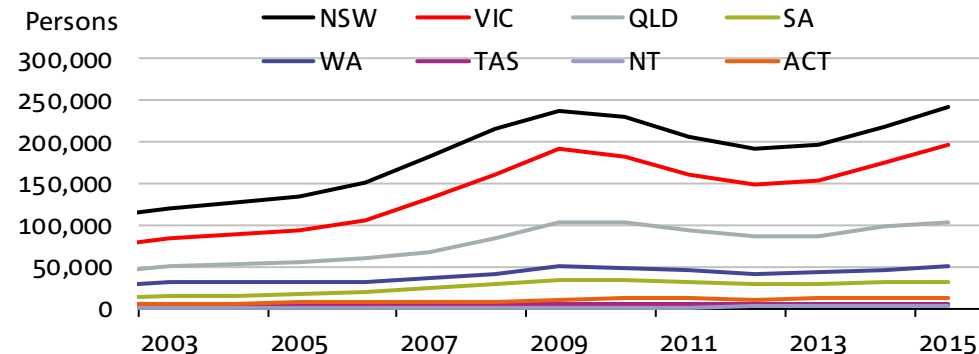
Persons ('000 over the year)



Source: ABS, NAB Group Economics

- Since March 2013, Victorian population growth has consistently outperformed the national average (Chart 28). A strong pick-up in the number of international students, as indicated by student enrolment data for 2014 and 2015, has been partly responsible in propping up net overseas migration into the state (Chart 22).

CHART 28: INTERNATIONAL STUDENT ENROLMENT NUMBERS BY CALENDAR YEAR



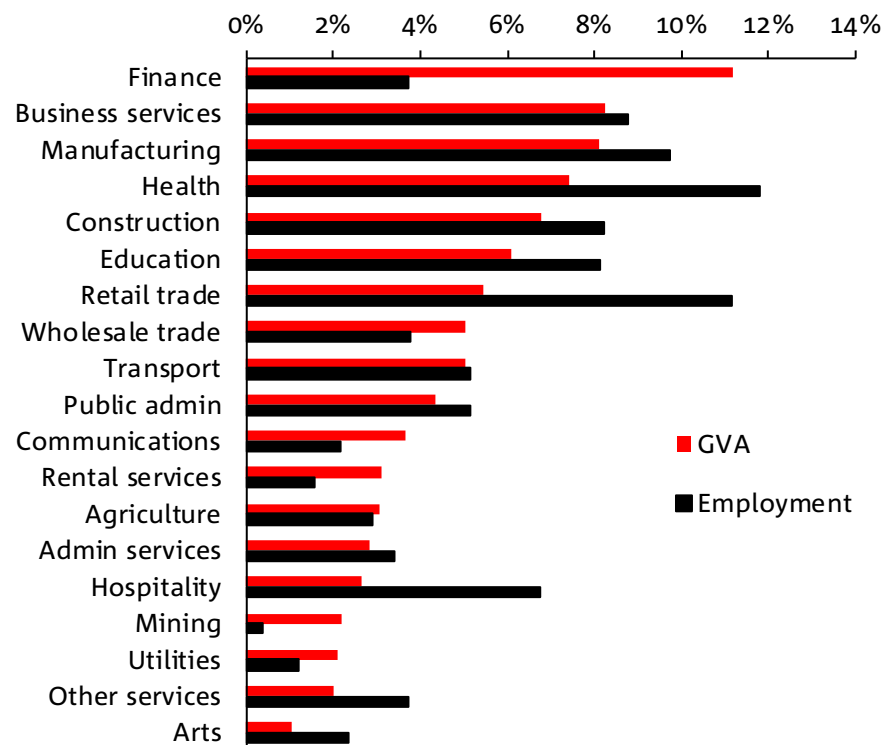
ECONOMIC STRUCTURE AND TRADE

Services sectors are the biggest contributors to production and employment

- Services sectors continued to dominate output shares by industry in 2014-15, with finance and business services accounting 11.2% and 8.2% respectively, ahead of the traditional industry pillar of manufacturing at 8%. The largest employing industries over the same period were healthcare (12.2%), retail trade (11.1%) and manufacturing (9.2%) (Chart 29). The ongoing structural decline in the latter will see its importance in output and employment diminish gradually overtime.

CHART 29 : COMPOSITION OF VIC EMPLOYMENT & GVA IN 2014-15

Percentage share (%)



- China is Victoria's largest trading partner in terms of exports and imports. Victorian goods exports to China in the year to April 2016 was \$4.9 billion (Tables 30-31), but this represents only around a quarter of total imports from the country. Top Victorian goods exports include wool, beef and passenger motor vehicles, while crude imports, passenger vehicles and refined petroleum represent its top three imports (Tables 32-33).

TABLES 30 & 31: TOP VIC EXPORT DESTINATIONS AND IMPORT SOURCE COUNTRIES, 2014-15

Million (\$m)

Value of exports (\$m)		Value of imports (\$m)	
1	China	4889	18232
2	ASEAN	3521	14212
3	US	2742	11320
4	New Zealand	1986	8637
5	EU	1602	4611
6	Japan	1566	4326
7	Korea	893	2645
8	Singapore	840	2132
9	HK	746	1980
10	Taiwan	501	1515
11	India	495	1391
12	UK	361	336
13	Germany	283	

TABLES 32 & 33: TOP VIC MERCHANDISE EXPORTS AND IMPORTS

Major exports, goods, 2014-15		Major imports, goods, 2014-15	
	A\$m		A\$m
Wool & other animal hair (incl tops)	1,528	Passenger motor vehicles	5,983
Beef	1,498	Crude petroleum	4,832
Passenger motor vehicles	1,433	Refined petroleum	1,922
Meat (excl beef)	1,368	Goods vehicles	1,740
Milk, cream, whey & yoghurt	1,166	Vehicle parts & accessories	1,471

FISCAL OUTLOOK

Victorian government predicts strong surpluses in the coming years

- Relative to the 2015-16 Budget Update, the operating surplus has been revised up by \$1,325 million in 2016-17 and \$527 million in 2018-19, but fall by \$48 million in 2017-18.
- This largely reflects the change in timing of specific purpose grants from the Commonwealth government, the inclusion of an allowance for prepaid port license fees associated with entering into a medium-term lease over the operations of the Port of Melbourne, as well as stronger than expected taxation revenue from stamp duty receipts, land tax and GST grants.
- Taxation revenue and GST grants is expected to make up close to 60% of the total Victorian government revenue in 2016-17 (Chart 35).

CHART 34: VIC NET OPERATING BALANCE

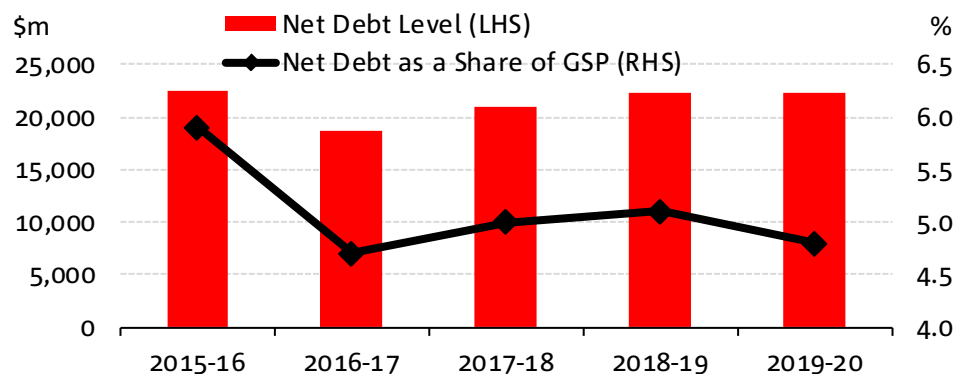
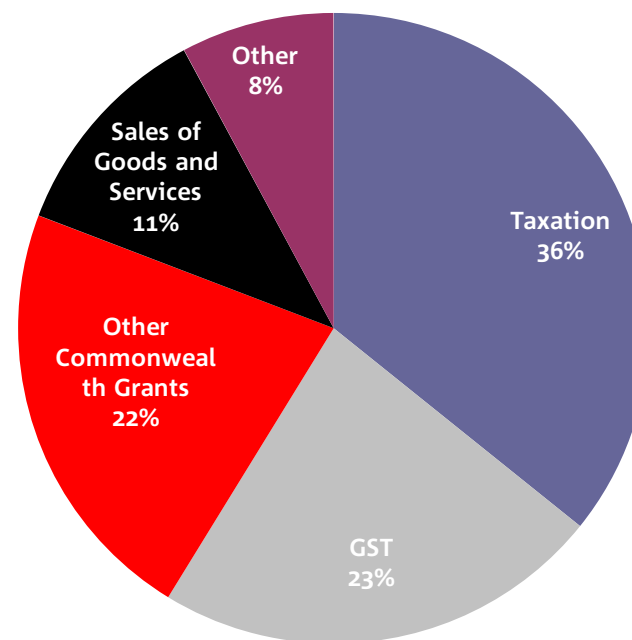


CHART 35: VIC COMPOSITION OF STATE REVENUE FOR 2016-17

Percentage share (%)



SEMI GOVERNMENT AND CREDIT OUTLOOK

Victoria's AAA credit rating to be lowered in the event of Commonwealth downgrade

- The pushing out of the Port of Melbourne lease receipts by a year into 2016-17 results in a drop in General Government net debt from \$22bn in 2015-16 to \$18.6bn in 2017-18, before rising back to the current level. The broader NFPS measure of net debt falls from \$37bn in 2015-16 to \$34bn in 2016-17, before rising to \$39bn by 2019-20.
- Post the release of the 2016-17 budget S&P stated that there is no change to Victoria's AAA credit rating. We note it will be lowered if the Commonwealth's rating is changed.
- Post the budget TCV announced that total funding for FY 17 is a net repayment of \$1.5bn. This comprises \$3.6bn of short term debt repayment and \$2bn of long term borrowing requirement. The funding program is impacted by the long term lease of the Port of Melbourne.

CHART 36: VIC NON-FINANCIAL PUBLIC SECTOR NET DEBT

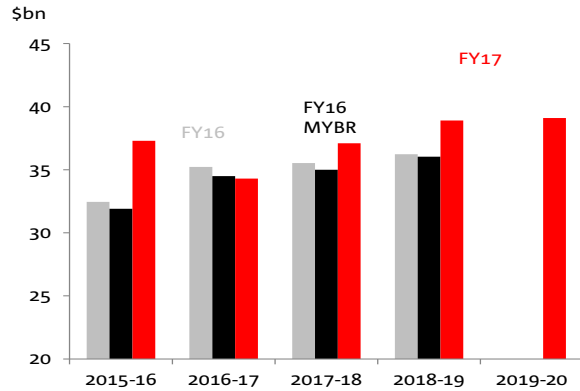
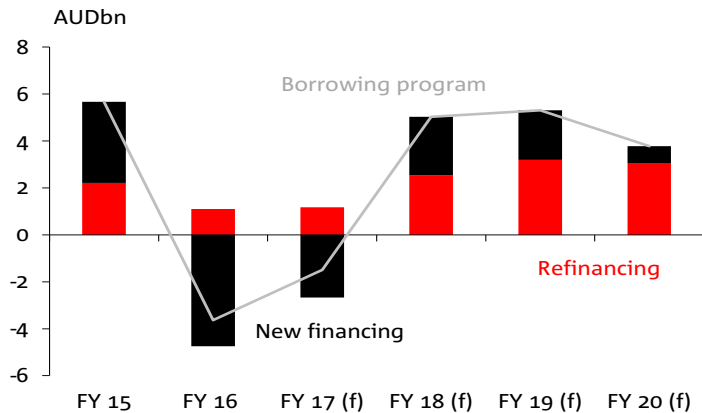
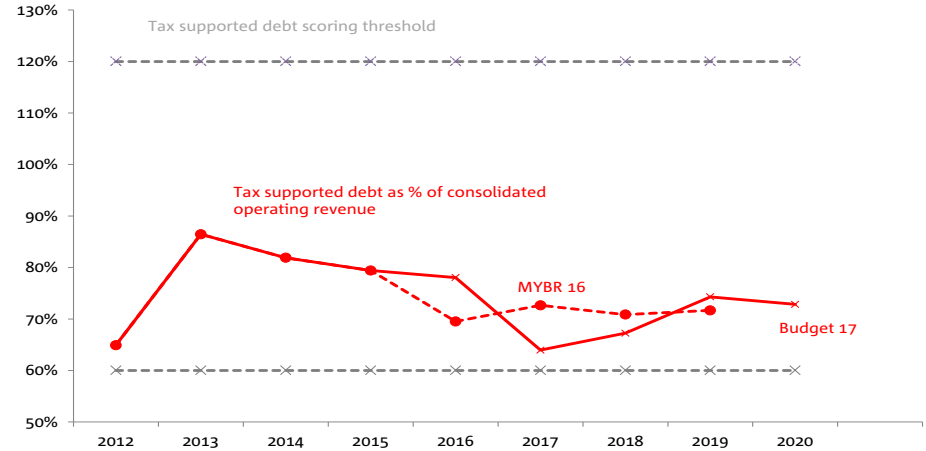


CHART 37: TCV BORROWING PROGRAMME



Source: Victorian budget paper, TCV

CHART 38: S&P CREDIT METRIC: OPERATING BALANCE AS % OF REVENUE



Source: Victoria's budget papers, NAB

CHART 39: CV TERM BONDS OUTSTANDING AS AT END JUNE 2016

