National Australia Bank

State Economic Update – 27 August 2010

NSW

As in the other states, business conditions have rebounded strongly in New South Wales (NSW) since early 2009 and the worst of the global financial crisis. So far in 2010, however, both state business conditions and confidence have eased as public sector stimulus begins to have less of an effect. Looking forward, conditions are expected to improve in line with the broader Australian economy. However, NSW Gross State Product (GSP) is expected to be weak relative to the other states, growing by 3 per cent over FY2010/11.

Victoria

Businesses remain confident in Victoria, consistent with strong spending growth in the state over the year to March 2010. Of the state governments, the Victorian Treasury is reporting the biggest turnaround in operating conditions, with strong operating surpluses expected over the forward estimates. We expect Victorian GSP growth of around 2½ per cent in FY2009/10 before strengthening to around 3¼ per cent in FY2010/11.

Queensland

Despite strong commodity price growth and a relatively high exposure to the mining sector, Queensland has experienced weak business conditions so far in 2010. Even so, strong non-residential investment is expected to support the economy over the coming year with infrastructure spending to have positive spillover effects for export growth and the labour market. In FY2010/11, we are expecting GSP growth of 3¼ per cent and the unemployment rate to decline, averaging 4¾ per cent in the year.

WA

While business conditions in Western Australia (WA) have been relatively flat over 2010 they remain well above long-run average levels. In addition, a long pipeline of non-residential investment is expected to boost growth in the state, with the major economic concern being the re-emergence of capacity constraints in the period ahead. In FY2010/11, we are expecting GSP growth of 4½ per cent, leading to a fall in the unemployment rate to around 4 per cent.

SA

Both business conditions and confidence in South Australia (SA) declined over the first half of 2010, although both remain above long-run average levels. Of all the states, public investment in SA grew the most over the year to March 2010 with marked increases in the capital expenditure of SA Water and the SA Housing Trust. Over FY2010/11, we are expecting GSP growth of 3¼ per cent and the unemployment rate to average 4¾ per cent – in line with the broader national economy.

Forecasts

	Gross State Product Annual % change		Unemployment Rate Average rate	
	09/10f	10/11f	09/10	10/11f
NSW	2	3	5¾	5¼
VIC	2½	3¼	5½	4¾
QLD	2¼	3¼	5¾	4¾
SA	2¾	3¼	5¼	4¾
WA	3½	4½	5	4
Australia	2¼	3¼	5½	4¾

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Composition of production

When comparing economic conditions across states, it is important to review the varying contribution of industry sectors to each economy (see Table). The largest disparity arises for the mining sector, which contributes 27 per cent to aggregate production in WA but a significantly lower amount in NSW, Victoria and SA. While still important in Queensland, mining is less significant there than in WA, with the sector contributing 9 per cent to 2009 production. The NSW and Victorian economies have a greater reliance on the Finance & Insurance and Property & Business Services sectors, while SA is the state most dependant on the manufacturing sector.

	2008/09 Share of State Production (%)					
	NSW	**VIC**	**QLD**	**SA**	**WA**	**Australia**
Agriculture	2	3	2	5	4	**3**
Mining	3	2	9	4	27	**7**
Manufacturing	9	11	9	12	7	**9**
Construction	7	6	9	6	10	**7**
Wholesale Trade	5	6	5	5	3	**5**
Retail Trade	5	5	6	5	4	**5**
Finance & Insurance	15	13	7	9	5	**11**
Property & Business Services	14	13	11	10	11	**12**
Other	41	40	42	43	30	**40**

Source: ABS

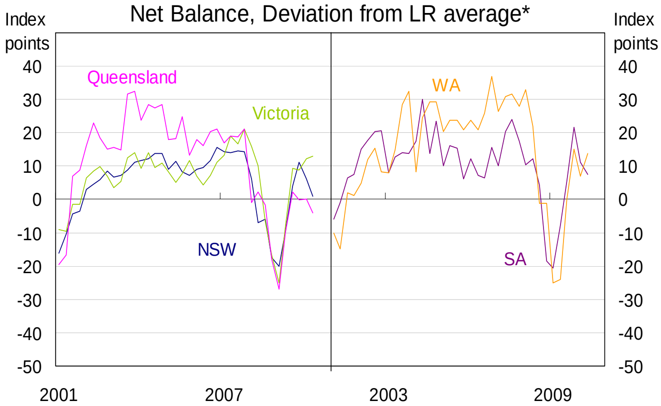
Conditions have eased following a sharp recovery

In the June Quarter 2010, the NAB Quarterly Business Survey reported a further moderation in some state business conditions (see Graph 1). This follows a period of sharp recovery across all states since the depths of the financial crisis in March 2009. In June, Victoria and WA were the only states to record an improvement, with the indices currently 13 and 14 points above the long-run national average respectively. Elsewhere, despite large dips in March and June, conditions in SA remain strong, while Queensland is the only state currently experiencing weak activity by historical standards.

Graph 1

NAB Business Conditions Index

Net Balance, Deviation from LR average*



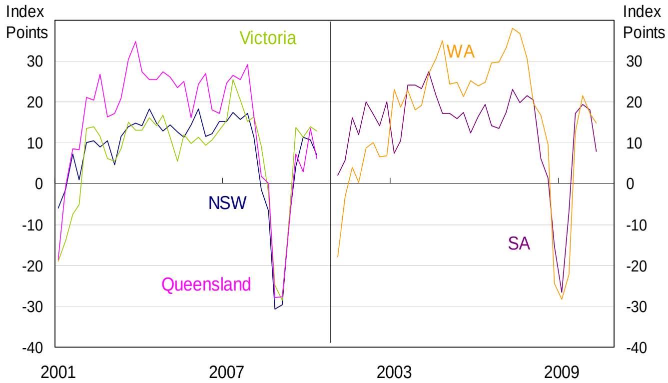
* Deviation from national average since Sep 1989. Data are seasonally adjusted.
Source: NAB

Consistent with the weakening in current conditions, business confidence declined across all states in the June Quarter 2010 (see Graph 2). While a significant weakening in SA is consistent with the recent slump in actual conditions, business confidence across the states remains above long-run average levels and a far cry from the lows plumbed during the financial crisis.

Graph 2

NAB Business Confidence Index

Net Balance, Deviation from LR average*



* Data are seasonally adjusted. Average of quarterly observations since Sep 1989

Source: NAB

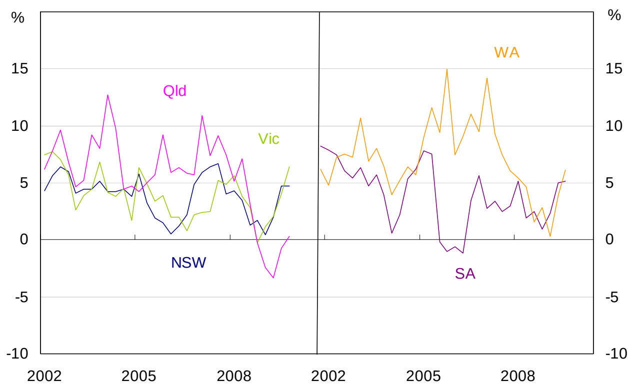
Spending growth is holding up, though conditions in Queensland remain poor

Real state final demand (SFD) in Australia has increased over the past year, rising by 4.4 per cent over the year to March 2010 (see Graph 3). The turnaround in spending has been most pronounced in Victoria, with SFD growing by 6.4 per cent over the year to March 2010. However, demand in NSW, SA and WA have all also grown by a comparable amount. It is well documented that the Australian economy weathered the financial crisis better than most, but this was particularly noticeable in the resilience of the labour market. As a result, household spending in most states has recovered strongly (see Graph 4). Of these, WA is the standout, with household consumption expenditure growing by close to 6 per cent through the year to March 2010. Consistent with the findings of the NAB Monthly Business Survey, Queensland has been the state with the weakest SFD growth.

Graph 3

Real State Final Demand

Year-ended percentage change

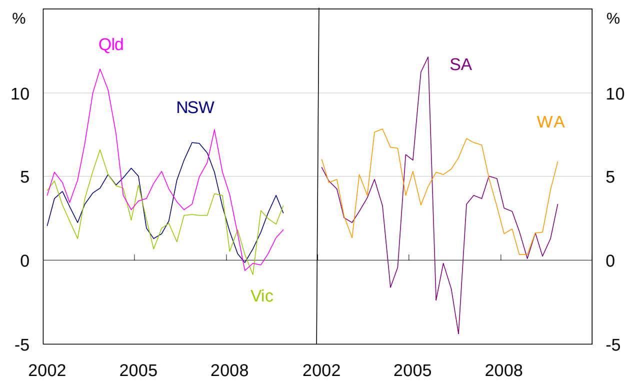


Source: ABS, NAB Economics

Graph 4

Real Household Final Consumption Expenditure

Year-ended percentage change



Source: ABS, NAB Group Economics

The public sector has been a significant source of capital investment over the past year

For all states, public sector spending has contributed significantly to the demand recovery (see Table). Post-GFC business de-leveraging has caused private capital investment to have a negligible impact on demand growth in all states, other than Victoria, over the past year. However, the effect of this has been more than offset by large scale public sector spending on capital works (in all states other than Queensland). SA offers the best example of this, with public gross fixed capital formation rising by 38 per cent in the year to March 2010, with a substantial part of this reflecting increased capital expenditure by SA Water and the SA Housing Trust.

Gross Fixed Capital Formation - March 2010					
	Annual average percentage change				
	NSW	VIC	QLD	SA	WA
Private	0.7	3.4	-11.7	0.7	1.4
Public	12.7	10.4	10.0	38.4	15.4
Total	**3.2**	**4.4**	**-6.8**	**7.0**	**2.9**

Source: ABS, NAB

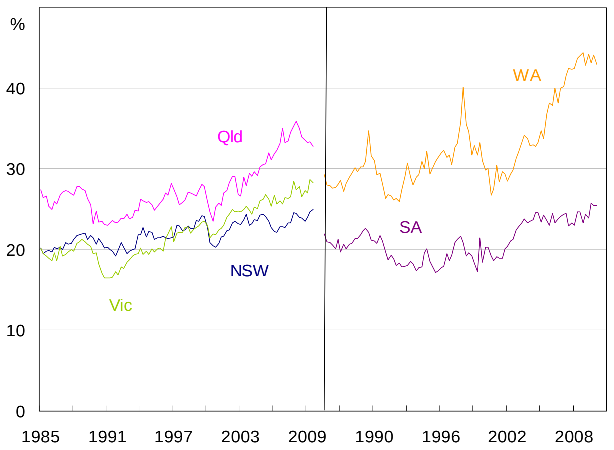
Capital spending has been increasingly concentrated in the mining regions

Despite languid private sector capital spending, the share of business investment in SFD has risen in all states since the mid-1980's (Graph 5). Production growth in the mining regions of WA and Queensland is now particularly dependant on capital investment, reflecting the capital-intensity of the industry, with investment located close to minerals operations. The mining industry in WA currently accounts for 20 per cent of Australian capital expenditure, with the share of the Queensland mining sector also around historic highs (see Graph 6).

Graph 5

Total Gross Fixed Capital Expenditure

Proportion of State Final Demand

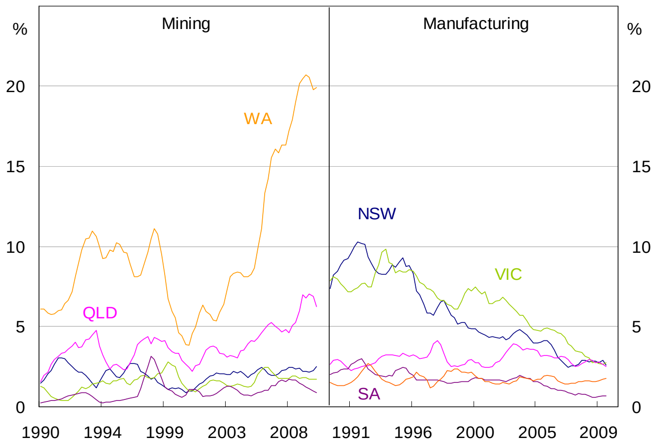


Source: ABS, NAB Group Economics

Graph 6

Capital Expenditure by Industry

Proportion of Total Australian Capital Expenditure, annual sum



Source: ABS, NAB

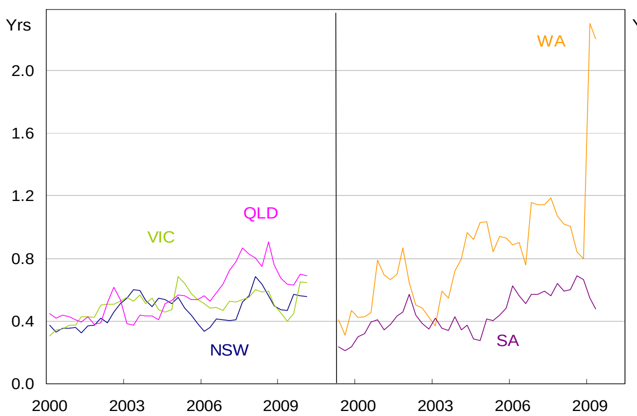
Substantial non-residential business investment planned for WA

Looking forward, after falling through 2009, the value of planned residential and non-residential construction picked up in most states between September 2009 and March 2010. Consistent with reports of production constraints in the mining sector, the pipeline for non-residential construction in WA has risen substantially since September 2009 – partly reflecting the commencement of the Gorgon Liquefied Natural Gas project (see Graph 7). Despite this, the pipeline for residential construction in the state remains short, raising concerns for housing affordability in WA and the ability of the mining industry to attract the number of workers needed to meet planned production (see Graph 8).

Graph 7

Non-residential Investment Pipeline*

Work yet to be done as a proportion of annual work done ('000)



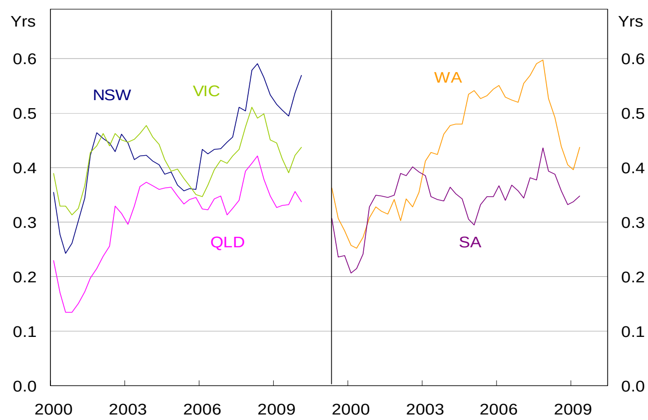
* Calculated by summing non-residential building and engineering construction

Source: ABS, NAB

Graph 8

Residential Building Pipeline

Work yet to be done as a proportion of annual work done ('000)



Source: ABS, NAB

Net export volumes have recently dipped in all states other than WA

Over the past two years, robust demand conditions in non-Japan Asia has meant that Australian export volumes have been supported at a time when global trade has contracted significantly. This has caused the real value of exports to rise across all of the major exporting states since December 2007 (see Graph 9). Nevertheless, persistent weak demand in Australia's developed world trading partners has led to export growth remaining shaky in most of the states. In Queensland, coal exports were disrupted in March by floods and the temporary closure of the major coal terminals at Dalrymple Bay and Hay Point (near Mackay) by Cyclone Ului. Hay Point was also closed in July and August for maintenance work.

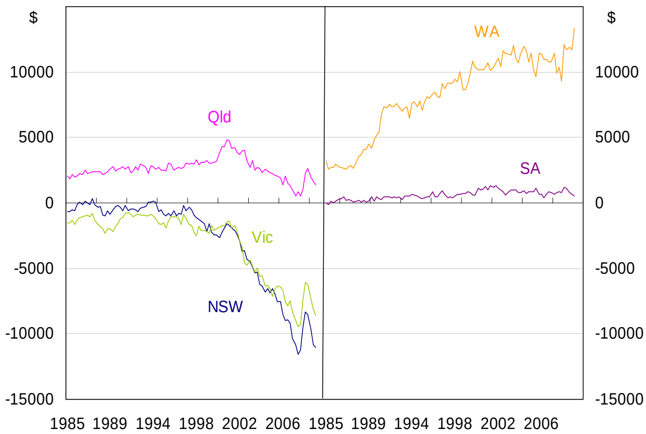
Fragile export growth has coincided with a recovery in Australian import demand following a period where the volume of imports fell significantly – consistent with the pattern of household consumption. Over the year to March 2010, real import growth rose by between 16 and 25 per cent in all states other than Queensland (where imports fell 8 per cent).

The combination of fragile growth in export volumes and a pick-up in import demand has led to net exports falling across all states other than WA. The strength of net exports from WA is unsurprising given that the state produces iron ore relatively intensively, the major input to Chinese steel production.

Care should be exercised in interpreting differences in the levels of net exports across the states because exports are not necessarily shipped from their state of production and international imports into one state may be re-exported to other states. ABS data for interstate trade are unavailable. However, net interstate trade data are available for Queensland from the Office of Economic and Statistical Research (OESR) and indicate that the Queensland deficit on net interstate trade has declined since its peak in December quarter 2008.

Graph 9

Real Net Exports

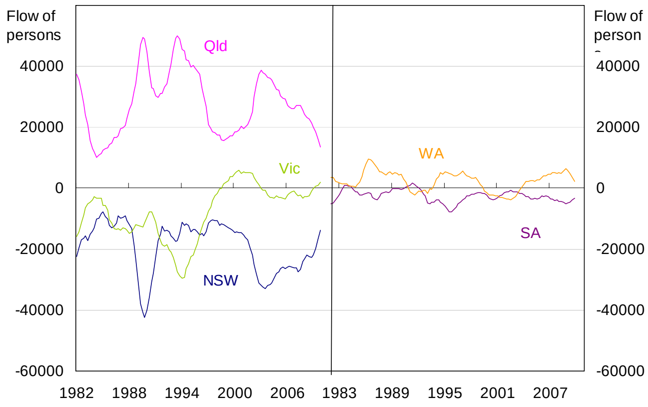


Source: ABS, NAB Group Economics

Rising housing rents in the mining states may be dissuading interstate migration, causing labour shortages

Beginning in the early 1990's, labour unemployment rates have declined broadly across Australian states, with WA and Queensland experiencing labour shortages in the lead up to the financial crisis. Somewhat surprisingly, the impacts of the labour market tightness on net interstate migration appear to have been relatively modest: during the past decade, net interstate migration to Perth has changed little and it has declined to Queensland, while the net outflow of persons from NSW and Victoria has fallen (see Graph 10).

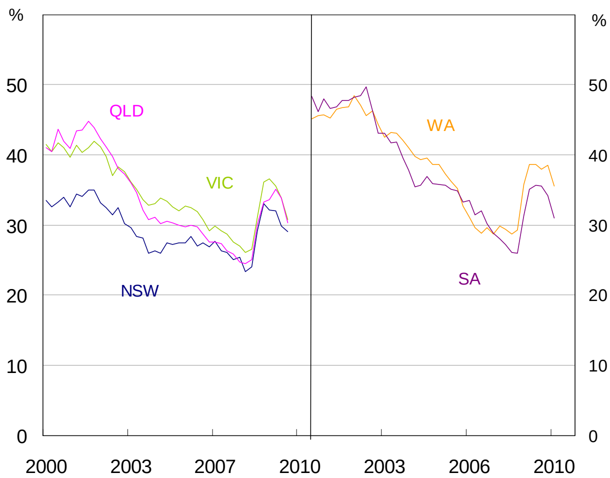
Graph 10
Annual Net Interstate Migration



Source: ABS, NAB Group Economics

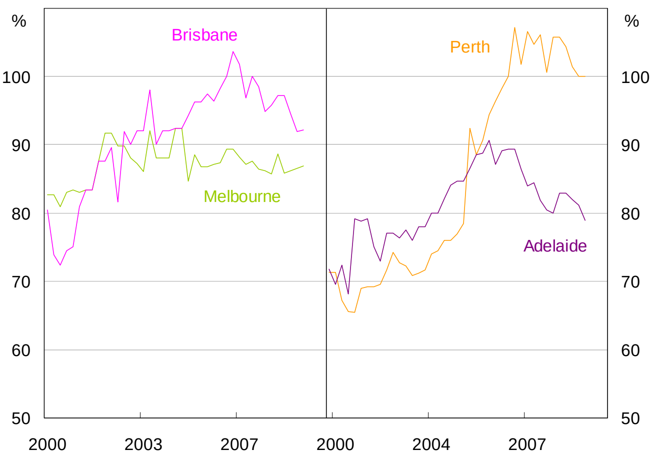
Part of the lack of interstate migration to the mining states may be explained by a rising cost of living in these areas. While indicators of housing affordability suggest that, when controlling for average income, house purchasers find it more affordable in Perth than in the other major states at present, this is not the case for renters (see Graph 11). While the median house price in Perth was around 20 per cent below the median price in Sydney in March 2010, the median rental payment on a three bedroom house was broadly the same (see Graph 12). In Brisbane also, rents have increased markedly relative to Sydney over the past ten years (though there is some evidence of a recent downward trend). To the extent that interstate labour movements are transient in nature, the rental market may be more relevant for explaining constraints to interstate labour mobility than the house purchasing market. As such, rising relative rents at present may be dissuading workers to move to those states experiencing labour shortages.

Graph 11
REIA Home Loan Affordability Indicator
Average ratio of household income to loan payments



Source: REIA, NAB

Graph 12
Housing Rents Relative to Sydney
Based on Median Rent for a 3 bedroom house



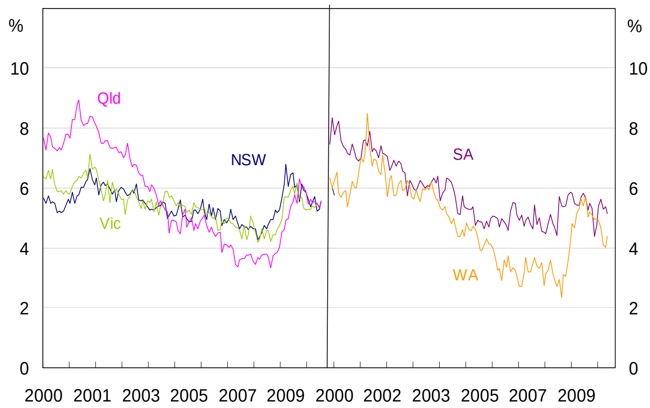
Source: REIA, NAB

Similar state trends in unemployment with WA experiencing the lowest rate

It now appears that, following a period of weaker labour market conditions, the unemployment rate in Australia has peaked. While this occurred earlier for NSW (March 2009), most states reached the high-point in unemployment during the September Quarter 2009 (see Graph 13). From here, we expect further gradual falls in unemployment rates, with the national rate moderating to around 4½ per cent in the second half of 2011.

The GFC brought the state employment-population ratios closer together, with sharper reductions in WA and Queensland than in other states. This process has now partly unwound, with a rise in the national ratio concentrated in WA, Queensland and Victoria. The ratio remains highest in WA (65.8 per cent), followed by Queensland (63.9 per cent) and Victoria (61.8 per cent), with SA (60.1 per cent) and NSW (59.9 per cent) lowest.

Graph 13
Unemployment Rate
Seasonally Adjusted

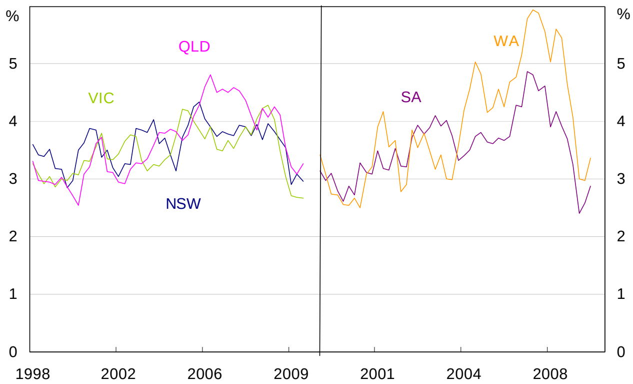


Source: ABS, NAB Group Economics

A turnaround in wage pressures consistent with improving labour market conditions

Consistent with sub-trend demand growth across all states during 2009 and the rise in unemployment, wage pressures moderated over the period (see Graph 14). The wage price index (WPI) shows that average salary growth over the year to June 2010 was between 2¾-3½ per cent in all of the mainland states, down from highs at or above 4 per cent in 2008. Consistent with the recent improvement in the labour market, through the year WPI growth has now bottomed, with salaries in WA and SA showing a clear turnaround. Our expectation of some further tightening in the labour market portends a pick up in wage growth and raises the risk of inflationary pressures ahead.

Graph 14
Wage Price Index
Year-ended percentage change



Source: ABS, NAB Group Economics

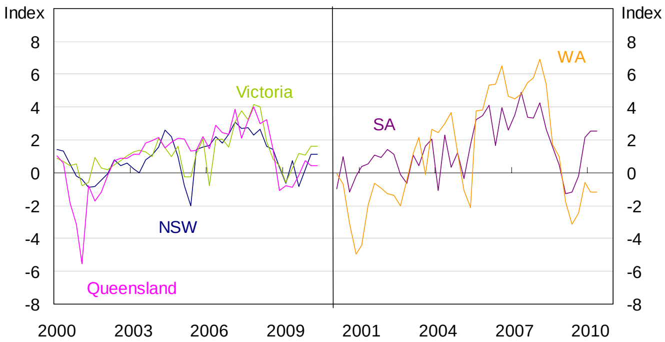
Capacity utilisation levelling off in June in all states other than SA

Mirroring the V-shaped recovery in SFD, the NAB capacity utilisation index has moved higher since mid-2009 (Graph 15). Utilisation rates for most of the mainland states have trended together in the recent period, with spare capacity falling in concert over the expansionary phase before resources were used less intensively beginning in late 2007. This pattern is particularly pronounced in WA, where a higher utilisation rate relative to the other states was observed before it plunged to the lowest of all states in June 2009. The emergence of stronger capacity utilisation since early 2009 has been most distinct in South Australia, although most states experienced a levelling off in utilisation in the June Quarter 2010.

For many of the states, the recent pattern of capacity utilisation has been inconsistent with movements in the Consumer Price Index (see Graph 16). This may owe to the influence of one-off price movements in various states, or the possibility that utilisation rates are not a significant determinant of inflation until they rise to some critical level - current readings are well below those in 2006-07 when CPI growth last accelerated.

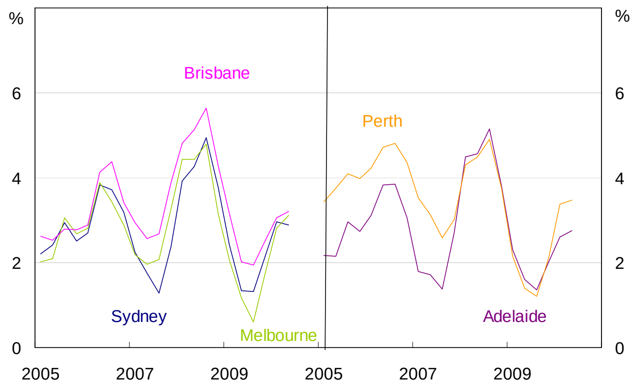
Of the large capital cities, Adelaide and Sydney are the only ones to currently report headline inflation within the Reserve Bank of Australia's 2-3 per cent target band. Through the year to June 2010, Perth experienced the highest inflation rate, at 3.5 per cent.

Graph 15
NAB Capacity Utilisation Index
Divergence from LR average*



* Deviation from national average level since September 1989
Source: NAB

Graph 16
Consumer Price Index
Year-ended percentage change

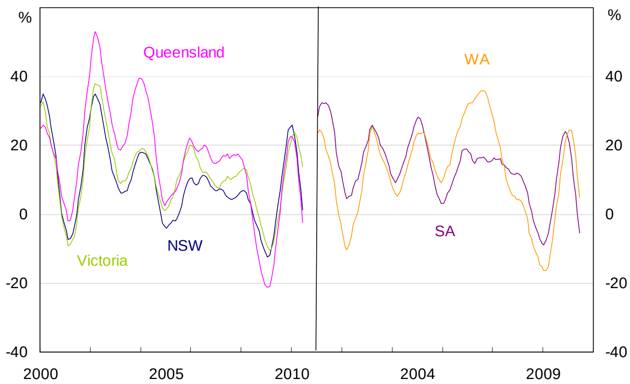


Source: ABS, NAB Group Economics

House price growth especially strong in Sydney and Melbourne, though weaker prices expected across all states

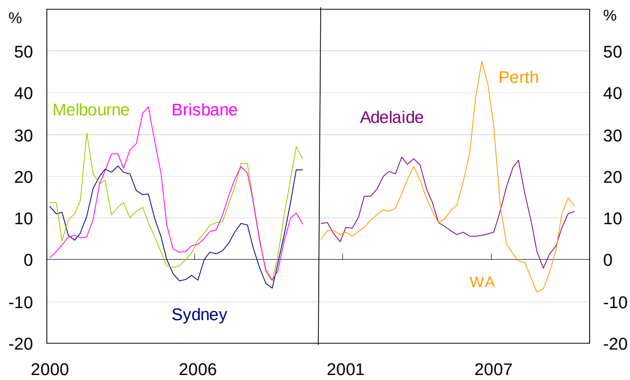
While state-level housing finance data is volatile, owner-occupier loan approvals in all states have dipped recently following a sharp pick-up from early 2009 (see Graph 17). A cumulative increase of 150 basis points in the RBA cash rate and the unwinding of stimulatory fiscal settings are likely to now be curbing households' demand for finance. As yet, this has not shown up in the form of weaker house prices: over the year to June 2010, the value of dwellings in Melbourne and Sydney rose strongly, by around 24 per cent and 21 per cent respectively (see Graph 18). Nevertheless, consistent with weaker auction clearance rates and the moderation in loan approvals, more modest growth in house prices are expected in the short-term. The NAB Australian Residential Property Survey of around 250 respondents from the property sector reported that house price expectations fell across all states in the June Quarter, with the weakest 12 month outlook for the Melbourne and Brisbane markets.

Graph 17
Owner-occupier Housing Loan Approvals
Annual Average Percentage Change



Source: ABS, NAB Group Economics

Graph 18
House Price Index
Year-ended percentage change



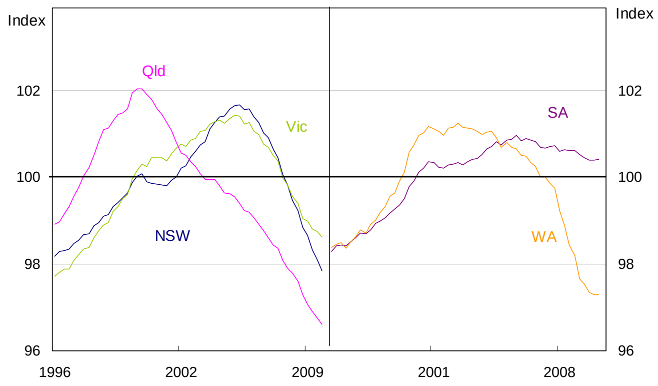
Source: ABS, NAB Group Economics

One factor limiting the extent of house price falls is the under-building of residential dwellings over recent years (see Graph 19). Other than SA, all of the major states have experienced a decline in the ratio of new dwellings to population (relative to the average level since 1996), signalling a shortage of homes being built at present. This was first apparent in Queensland and WA, and partly explains the run-up in house prices in these states over recent years.

Graph 19

Ratio of Dwellings to Resident Population

State average = 100



Source: ABS, NAB Economics

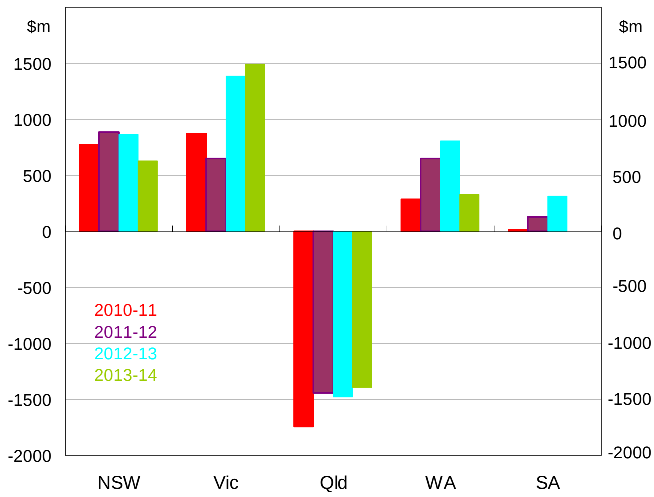
Victorian state government reporting the largest turnaround in operating conditions

Twelve months ago, the fiscal outlook for the State Governments looked bleak, with most state treasuries predicting operating deficits over the forward estimates period. Their main sources of income: payroll tax, property taxes, mining royalties and GST grants looked set to decline significantly given their sensitivity to the economic cycle. However, the expected deterioration in State Government fiscal positions never eventuated. A relatively strong labour market and the shedding of hours, not jobs, ensured that payroll taxes remained relatively stable. Strong population growth and grants to first home buyers also helped to alleviate pressure on the property sector and protect property tax revenues from the worst of the downturn. Mining royalties picked up on commodity price gains as Chinese demand recovered and GST grants were protected by relatively stable household consumption expenditure.

Looking ahead, all state treasuries other than Queensland are forecasting net operating surpluses in 2010-11 (see Graph 20). Victoria is predicting the biggest turnaround, with a net operating surplus of $872 million expected in 2010-11. Driving this outlook is an expected increase in taxation revenue of $796 million and a similar increase in GST grants. At the other end of the spectrum, Queensland is predicting a net operating deficit of $1.754 billion in 2010-11, with an expected return to surplus taking place in 2015-16. Total expenses are expected to increase by around $3 billion in 2010-11, due to increased service provision and higher wage outcomes in enterprise bargaining negotiations. Additionally, Queensland's bottom line continues to be weak due to the downturn, with revenue still around $7 billion lower than predicted in the 2008-09 Budget. New South Wales, Western Australia and South Australia are forecasting net operating surpluses of $773 million, $286 million and $13 million, respectively.

Graph 20

Net Operating Balance



Source: State Treasuries

All states are currently engaged in significant infrastructure investment. Taking into account state government purchases of non-financial assets, all states are expected to run cash deficits in 2010-11. As such, all states are expected to add to net borrowings over the coming twelve months. This poses some risk to operating conditions, as uncertainty in global financial markets can impact on state government borrowing costs.

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