State Economic Report

Wednesday, 18 June 2014

NSW Economic Outlook

Summary

- NSW should continue to benefit from shifting growth drivers in the economy and low interest rates and is set to outperform growth Australia-wide.
- The improving outlook for NSW is a welcome change from NSW's previous status as a laggard over the past decade as mining investment in the resource States drove economic growth. A more diversified economy in NSW will mean an easier transition from mining investment to non-mining investment, with lower interest rates particularly supportive given larger average mortgages in NSW.
- Household consumption had started to pick up, particularly in NSW. However, the Federal Budget weighed on consumer sentiment and there is a risk this may flow through to consumer spending.
- Growth in State final demand for NSW was strong in the March quarter, lifting above its long-term average in annual terms for the first time since the June quarter 2012. Private investment, including dwelling investment, infrastructure and commercial construction were key drivers of growth in the March quarter and this trend is expected to continue.
- The 2014-15 NSW State Budget indicated Government spending on infrastructure will be supportive of growth over the next four years.
- Sydney house prices are rising at a healthy clip and have outperformed the Australian capital city average. House price gains are likely to slow this year as affordability barriers are reached for some buyers, although an ongoing undersupply of dwellings in Sydney will continue to be supportive. Residential construction has begun to improve and a pipeline of strength in building approvals indicates this will continue.
- The healthy pipeline of road and rail projects will be another positive for the NSW growth outlook and will assist in filling the gap from weaker mining investment in the State. There are also signs of improvement in non-dwelling construction after lacklustre growth over the past few years.
- Low interest rates, the solid housing market and gains in business investment should result in a pickup in NSW gross State product in 2014-15. We expect growth of 2.8% in 2013-14, rising to 3.0% in 2014-15, which would be the fastest growth in the State in 15 years.

Economic Growth

NSW has been the major beneficiary of the shifting growth drivers in the Australian economy and should continue to outperform other States. The stronger growth in NSW over the past year is a welcome change from NSW's previous status as a laggard over the past decade as mining investment in the resource States drove economic growth. The mining investment boom over that period and the accompanying higher interest rates weighed more heavily on NSW given its higher house prices and larger average mortgages and the relatively small size of the mining industry in NSW.

Low interest rates have been a boon for the housing market, which is a bright spot for Australia and particularly NSW. House prices have risen nationally over the past year, with Sydney leading the way. Recovering house prices have encouraged a recovery in residential construction which is expected to continue this year.

State final demand in NSW has grown strongly, rising 2.4% in the March quarter, the strongest quarterly growth since the December quarter 2009. For the year to the March quarter, State final demand in NSW rose 4.7%, compared to domestic final demand Australia-wide of 1.6% in the year to the March quarter.

Percentage Shares of the Economy*

Industries	NSW	Australia
Financial and insurance services	13.7	9.3
Manufacturing	8.7	7.9
Professional, scientific and technical services	9.0	7.7
Health care and social assistance	7.6	7.4
Construction	6.2	8.8
Transport, postal and warehousing	5.7	5.6
Wholesale trade	5.2	4.9
Public administration and safety	5.9	6.0
Education and training	5.5	5.3
Information media and telecommunications	4.6	3.1
Retail trade	5.0	5.3
Mining	3.7	11.2
Administrative and support services	4.2	3.4
Accommodation and food services	3.3	2.7
Electricity, gas, water and waste services	3.1	2.9
Rental, hiring and real estate services	3.4	3.0
Other services	2.2	2.0
Agriculture, forestry and fishing	1.7	2.4
Arts and recreation services	1.1	0.9

** As % of GSP and GDP less ownership of dwellings*

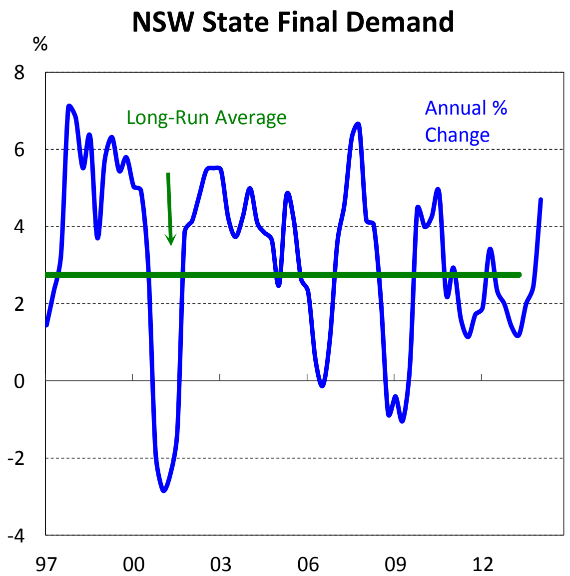
Source: ABS, St.George

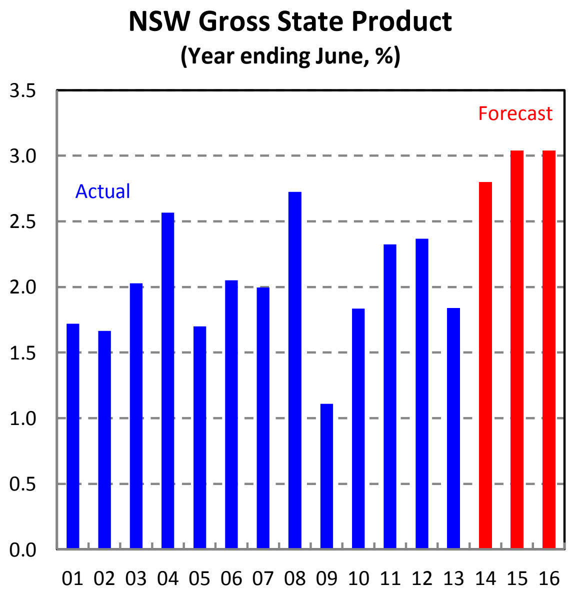
Annual growth in NSW State final demand has just lifted above its long-run average of 2.7% in the March quarter. Low interest rates, a reduction in household caution, rising house prices and the somewhat lower Aussie dollar have boosted economic growth. Low interest rates and higher household wealth should support consumer spending and residential construction should continue to lift.

Additionally, a large pipeline of road and rail infrastructure spending in NSW should also be supportive of growth while mining investment is softening. NSW was a major beneficiary of infrastructure spending in the Federal Budget. Projects in the pipeline in NSW include the WestConnex road project, the NorthConnex road, the North West Rail Link project and the South West Rail Link project.

We estimate that the NSW economy grew by 2.8% in 2013-14 following 1.8% growth in 2012-13. Stronger investment on infrastructure, further recovery in dwelling investment and low interest rates should support a further pickup in growth in 2013-14. If NSW growth turns out as forecast in 2013-14, it would be the fastest growth for the State in 14 years. (See page 9 for more detailed forecasts).

Over the long-term, industries such as tourism, international education, wealth management, gas and agribusiness have been considered as areas of strong growth within the global economy. Many of these sectors have a presence in the NSW economy and NSW has the potential to take advantage of these key growth areas.

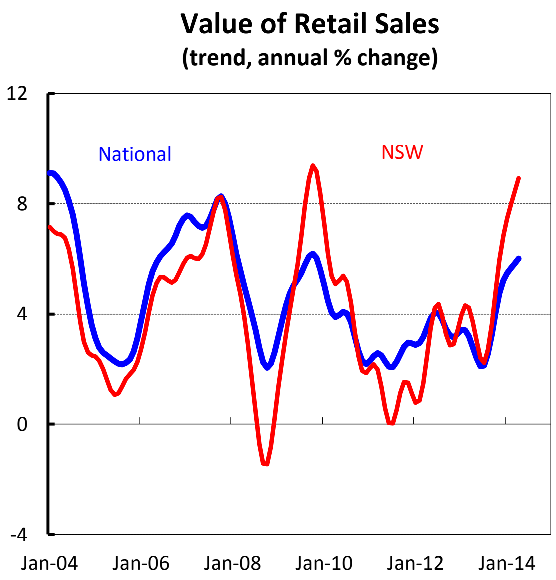


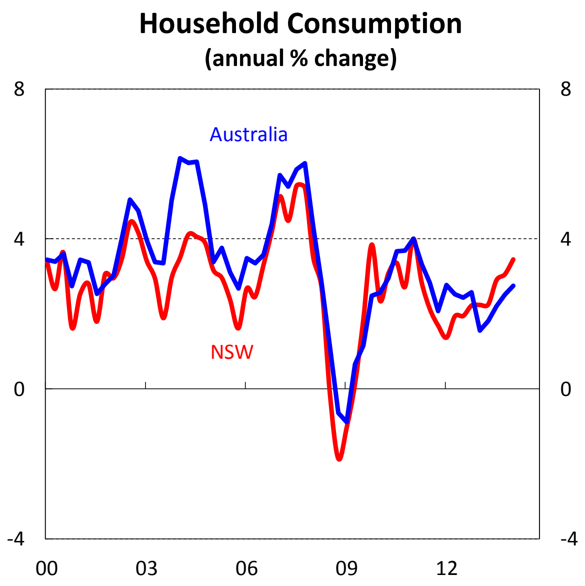


Consumer Spending

Consumer spending in NSW has grown at a solid pace over the last year, picking up from lacklustre growth following the GFC. Household caution has lifted somewhat, especially in NSW where rising house prices and household wealth and tentative growth in employment have aided consumers' willingness to spend. In the year to March 2014, household consumption expenditure rose by 3.5%, the strongest annual growth rate in three years.

By sector in NSW, insurance spending showed the strongest growth in the year to the March quarter (12.2%), followed by furnishing and household equipment (7.3%), as consumers deck out their new homes, and clothing and footwear sales (7.2%). It is encouraging to see strength in some discretionary areas of consumer spending.





Retail sales have gained traction in NSW over the past year. In the year to April, NSW retail sales were up 8.1%. Low interest rates remain supportive of retail sales, however, consumer sentiment has taken a step backwards in recent months. Westpac-MI consumer sentiment was tracking at a subdued level, before the May Federal Budget weighed heavily on sentiment, sending it well into pessimistic territory.

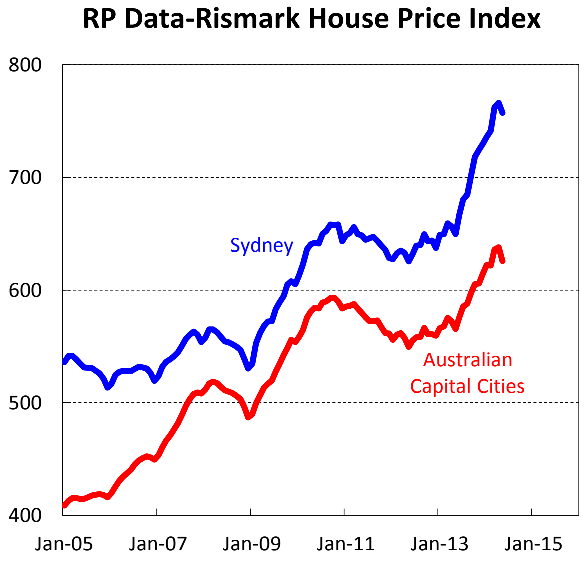
In NSW consumer sentiment fell very sharply in May (a decline of 19.8% in NSW compared to a decline of 6.8% nationally in May.) This only partially rebounded in June, with a 5.7% increase to a reading of 95.5 for consumer sentiment in NSW. The reading remains below 100, indicating more consumers in the State are pessimistic than optimistic.

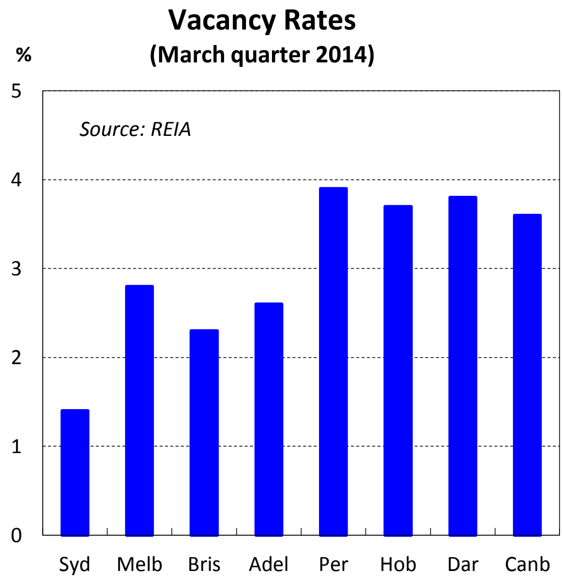
While consumer spending in NSW should continue to benefit from low interest rates, risks remain. The sharp deterioration in consumer sentiment could flow through to weaker consumer spending in coming months. Additionally, high household debt levels and an uncertain outlook for the labour market could constrain growth in household consumption.

Housing

The residential housing market has improved further this year driven by lower interest rates and rising population growth rates. With the highest house prices and largest mortgages of all capital cities, the NSW housing market has been the greatest beneficiary of lower interest rates.

According to RP Data-Rismark, Sydney dwelling prices are up 16.6% in the year to May, which is a significant improvement on the 3.9% increase in the year to May 2013. Sydney house prices have outperformed the national capital city average this year. In May, Sydney and national dwelling prices fell for the first time since May 2013, suggesting some of the heat may have started to come out of the property market.



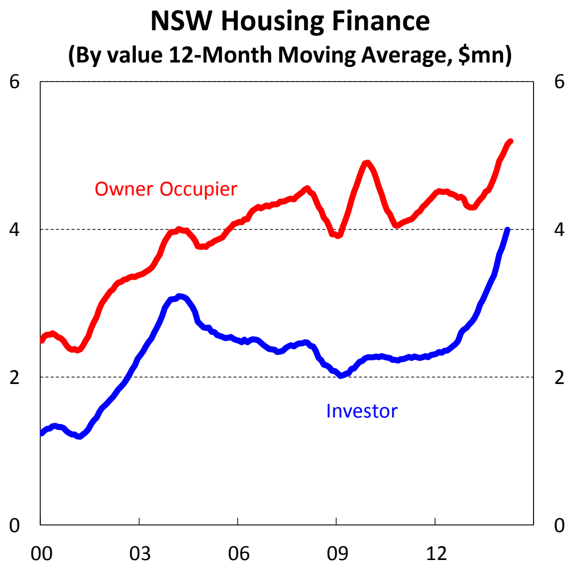


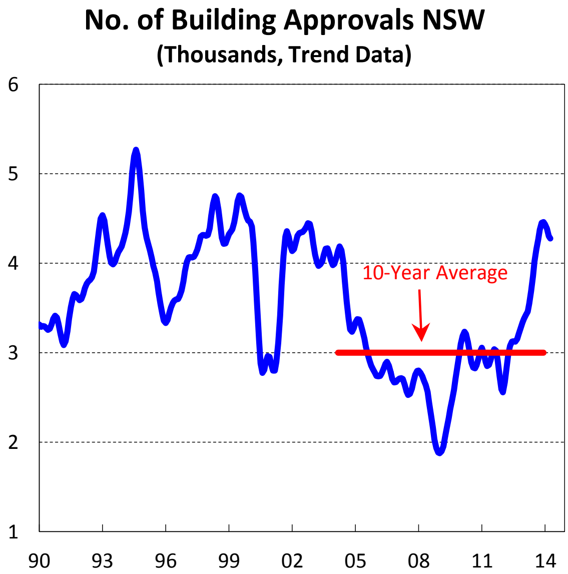
NSW has gone through a lengthy period of under-building resulting in a housing shortage, which is providing a floor for house prices. Population growth slowed in NSW in 2011, from a peak in 2008-09, but growth has again picked up, with overseas migration gaining strongly in 2012/2013. The housing shortage, which exists nationally, is particularly acute in NSW.

The shortage of housing has contributed to low vacancy rates in Sydney. These stood at 1.4 % in the March quarter, the lowest vacancy rate of all the capital cities. Vacancy rates below 3% are indicative of tight rental markets and strong demand for rental accommodation and below 2% is considered very tight. Sydney median weekly rents for 3 bedroom houses in the year to the March quarter 2014 rose 4.7% to $450, while rents for 2 bedroom ‘other dwellings’ rose 6.4% to $500 per week.

Investor demand in NSW has picked up strongly suggesting that investors have been encouraged by attractive rental yields, a low interest rate environment and rising house prices, although yields have fallen recently. Tight rental markets continue to suggest strong demand for rental accommodation.

Owner-occupier demand, however, has lagged behind investor demand, with State policy changes impacting first home buyers. First home buyers in NSW as a percentage of all dwellings financed to 7.6% in April, which has increased from a record low of 6.8% in September 2013. However, first home buyer interest in new homes in NSW has lifted. The NSW State Budget reported that the number of First Home Owner Grants for New Homes grew rapidly over 2013-14.





Dwelling price gains in Sydney this year are likely to be more moderate than those seen last year as the impact of low interest rates runs its course and affordability becomes more of an issue for buyers. That being said, residential building activity has picked up, indicating that low interest rates and stabilising house prices have helped to spur life into residential construction. Investment in new dwellings in NSW rose a solid 10.6% in the year to the March quarter 2014. A high level of building approvals suggests the buoyant residential construction activity will continue in the second half of this year.

Business Investment

Business investment had begun to slow in NSW, as the pipeline of mining investment faded, although this fading presents more of a problem for the resource States, than it does for NSW . In the March quarter, private business investment rose 9.2% in NSW and is up 8.7% for the year. This compares to annual declines in business investment in the previous two quarters. In annual terms private capex fell 0.9% in the March quarter in NSW, although this was the strongest performance since the June quarter 2012, when annual growth was last in positive territory. In the March quarter, NSW private capex was strongest in the building and structures category, although investment in the plant, machinery and equipment category also gained for the quarter.

It is worth noting that there remain a number of potential mining projects in the pipeline. The Bureau of Resources and Energy Economics (BREE) has estimated that $3.0bn worth of projects were at the committed stage. These are projects which have received final investment approval and are very likely to go ahead. The majority of projects are within the coal industry including coal mine projects or infrastructure to support coal transportation.

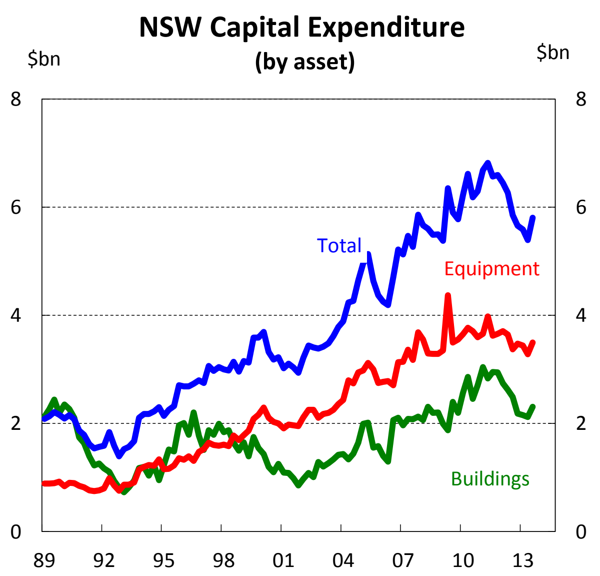
Outside of mining investment, business investment is set to pick up, driven by infrastructure projects and commercial construction. This trend started in the March quarter and should pick up momentum.

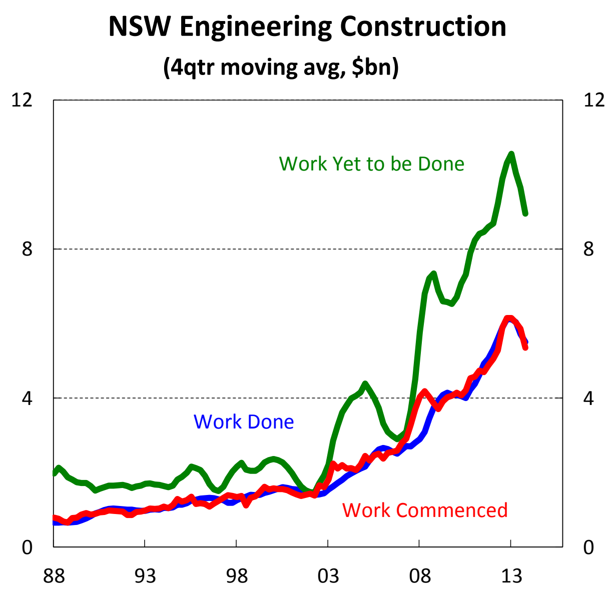
The major driver of investment in coming years will likely be driven by road and rail infrastructure. There are currently a number of projects underway including the$8.3bn North West Rail Link and the $2.0bn South West Rail link. The biggest project in the pipeline is the WestConnex to link Sydney's M4 and M5 motorways through to the Sydney CBD and Sydney Airport, estimated to be worth around $14.9 billion. Construction on the first stage of the project is due to commence in 2015 with the final third stage due to finish in 2023. The $3bn NorthConnex road project is under construction and due for completion in 2019.

State government infrastructure spending is expected to lift from $14.1bn in 2013-14 to $15.0bn in 2014-15. In its 2014-15 Budget, the New South Wales State Government estimated infrastructure spending will total $61.5bn over the next four years, which is a 30% lift on the four years to 2009-10 (excluding Commonwealth Government stimulus funding). Funding for many projects such as the WestConnex will be sourced from a mixture of private sector capital, the Commonwealth Government as well as the State Government.

There are also signs of improvement in non-residential (commercial) construction, after lacklustre growth over the past few years. Low interest rates and increased retail spending are positive signs for the outlook, although soft employment growth remains a drag. The pipeline of projects is dominated by the $6 billion Barangaroo project which will be ongoing till 2020. Commercial construction should continue to see gradual growth over the next few years given various projects in the pipeline led by projects in healthcare.

The healthy pipeline of work suggests that investment activity should continue to grow moderately over the next few years.





Labour Market

After adding a significant number of new jobs earlier this year, jobs growth in NSW has deteriorated in recent months. In the year to May, NSW employment has fallen by 13.1k, with a 22.2k decline in employment in May alone. This followed on from four consecutive months of gains in NSW employment. NSW has underperformed the national jobs market, where 98.7k jobs were added over the year to May.

Annual jobs growth in NSW has declined to -0.4% in the year to May, which is a significant deterioration from the 1.7% annual growth a year earlier in NSW. This compares to national jobs growth of 0.9% in the year to May.

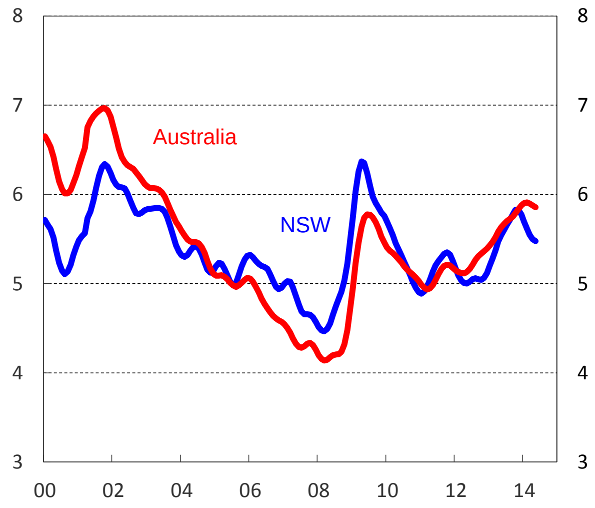
The slowing in employment growth has seen the unemployment rate in NSW rise to 5.7% in May, which is where it was in May 2013, but represents a relapse from the recent low of 5.2% in March 2014.

In the year to February 2014, most jobs in NSW were added in construction (29.2k), followed by healthcare and social assistance (27.9k). The gains in construction employment reflect strength in residential construction in NSW. The greatest job losses, by industry in NSW, were in accommodation and food services (-34.4k) and wholesale trade (-25.3k) in the year to February.

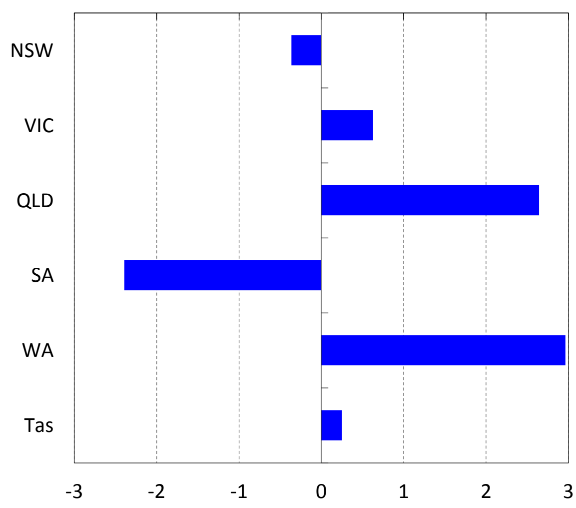
Leading indicators of employment have stabilised, suggesting the unemployment rate is likely close to its peak, although business surveys indicate business' intentions to hire remain subdued.

A strengthening economy should support a gradual pick up in employment growth in NSW over the coming year.

Unemployment Rate
(trend, per cent)



Employment Change By State
(Annual %, as at May 2013)



The 2014-15 NSW State Budget

The NSW State Budget 2014-15 was handed down this week. The NSW Government's bottom line has improved since last year's Budget. A surplus of $988mn is now estimated for 2013-14. A deficit of $283mn is expected for 2014-15. However, a return to surplus is expected in 2015-16 improving to $1.7bn in 2017-18.

A stronger economy and fiscal consolidation in earlier years has left room for the NSW to lift funding in a range of areas. A key initiative is a boost to infrastructure spending, with an estimated $61.5bn expected to be spent on infrastructure over the coming four years. This will help boost business spending and economic activity.

The NSW Government announced significant spending of $1.3bn on Health. This includes the rebuilding of Westmead Hospital, the redevelopment of St. George, Sutherland and Gosford Hospitals, and a new Byron Central Hospital.

A key issue raised in the Budget was the privatisation of NSW's electricity distribution network. The NSW Government has reiterated its intention of continuing with this process. It involves the transfer of 49% of its ownership in a range of electricity transmission and distribution companies to the private sector in the form of a 99-year lease. The proceeds are intended to fund infrastructure.

St.George Banking Group Forecasts

Low interest rates should continue to support a recovery in dwelling investment. Exports should continue to show solid growth on the back of stronger production capacity in thermal coal and a weaker Australian dollar. We also expect an improvement in public and private investment given the healthy pipeline for road and rail infrastructure and improving conditions for non-residential construction. We expect NSW gross State product to pick up from growth of 2.4% in 2012-13 to 2.8% in 2013-14 and 3.0% in 2014-15.

The NSW Government is expecting slightly stronger GSP growth of 3.0% in 2013-14 and similar growth in 2014-15.

St George Banking Group Forecasts:

Economic Indicators, % Change (year average)				
	2013-14 (f)	**2014-15 (f)**	**2015-16 (f)**	**2016-17 (f)**
Gross State Product	2.80	3.00	3.00	3.00
State final demand	3.50	3.30	3.30	3.30
Employment	0.50	1.70	2.00	2.00
Unemployment rate (year average)	5.80	6.00	5.80	5.70
Sydney CPI	2.50	2.50	2.70	2.80
Wage Price Index	2.60	2.70	3.20	3.50

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