

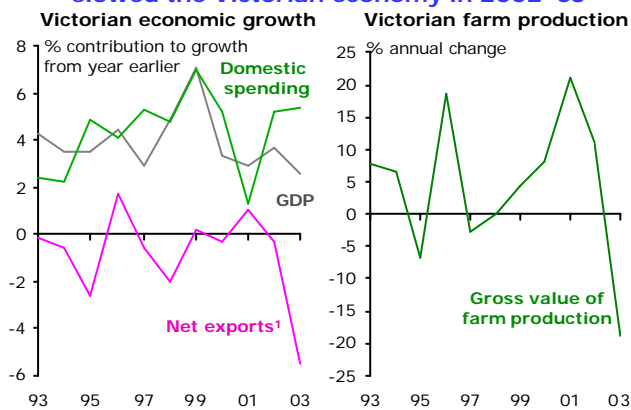
# State Economic Update

## Victoria: Have the good times gone?

The Victorian economy has performed well in recent times. State economic growth has moved broadly in tandem with the national economy, which is unsurprising given Victoria's relatively diversified economic base. Overall, growth in Victoria has actually slightly outperformed the national average over the last five years. This has allowed solid employment growth which has helped push the unemployment rate down to 5.2% in November, the lowest of all the States.

Nevertheless, economic growth in Victoria did slow over the last year, from 3.7% in 2001-02 to just 2.8% in 2002-03. The main factors driving Australian growth down in the last year – the drought and weak global growth – also weighed heavily on Victoria (chart 1). The drought saw the State's value of agricultural production plunge by 20% in 2002-03, which, combined with weak global demand saw export volumes fall by 10%. This was much more severe than the 1% fall in total Australian exports over the same period, reflecting Victoria's relatively higher globally-exposed manufacturing base and also the relocation of a major gold processing plant to Western Australia, which caused a significant one-off decline in gold exports from the State.

**Chart 1: The drought and weak global growth slowed the Victorian economy in 2002-03**



Source: ABS <sup>1</sup> Dragged down by the relocation of a gold-refinery to Western Australia

Better prospects for exports, due to improved seasonal conditions and global demand, and continued strong business investment should see brighter times ahead for the Victorian economy. However, in contrast to the recent past, demographic factors will make it hard for the Victorian economy to exceed and perhaps even meet the growth rate of the Australian economy as a whole. While far from the worst performing, and unlikely to see any erosion in per capita economic growth, Victoria is still likely to remain one of the relatively softer performing States over

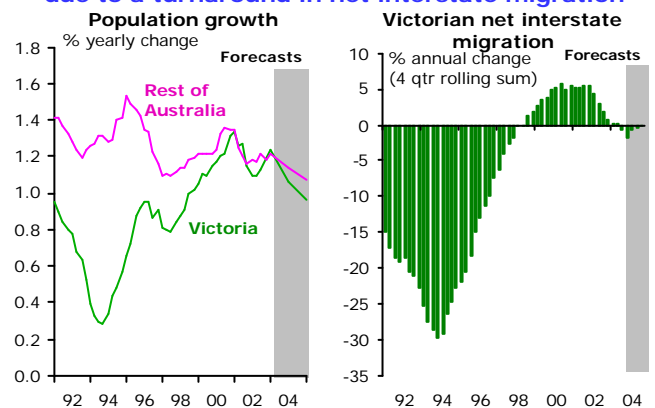
the next few years. In 2003-04 the Victorian economy is forecast to grow by 3¼%, softening to 3% in 2004-05.

## Losing its appeal as the 'place to be'

Population growth and economic growth are essentially circular. Population growth drives economic growth, underpinning spending, employment and ultimately output. In turn, brighter economic prospects aids population growth, with migrants attracted to regions with better job and income prospects. Population growth has been a big part of Victoria's economic story over the last decade.

For most of the 1990s population growth in Victoria has lagged the national average. This was mainly due to high levels of interstate migration away from the State as Victorians sought out employment opportunities in other more prosperous regions in the aftermath of the early 1990s State recession (Chart 2). An improved economic performance saw this trend gradually arrested from the mid-1990s, with interstate migration to Victoria turning positive again by the end of the decade. This brought the State's total population growth back in line with the national average, and has proved to be a significant driver of Victoria's economy in recent times, supporting household consumption, the housing market and employment.

**Chart 2: Population growth in Victoria is easing, due to a turnaround in net interstate migration**



Source: ABS and Economics@ANZ

More recently however, Victoria has started to lose its appeal as 'the place to be' and net interstate migration has again turned negative. Partly this likely reflects the relatively stronger economic performance (and so job prospects) of some of Australia's other States and Territories. For example Queensland, which continues to

attract a large share of net interstate migration, recorded economic growth of 4.7% in 2002-03 almost double the Victorian performance. Paradoxically, the spin-offs from Victoria's recent prosperity, particularly the relatively high cost of housing, might also now be a factor behind the State's diminishing attraction. Higher houses prices may both encourage migration out of Victoria (as people can afford a better lifestyle elsewhere after selling up) and discourage new migrants (who now face higher 'start-up' costs) from entering Victoria. At this stage, it appears likely that the factors driving net interstate migration away from Victoria will continue for at least the next couple of years. This will see total population growth in Victoria ease back to below the national Australian average.

### Less people means less spending

A slower pace of population growth will, all other things unchanged, mean lower rates of growth of spending on both household consumption and residential housing. This of course does not necessarily mean slower per capita growth (ie. an erosion in living standards), to the extent that the pace of spending does not slow further than population growth.

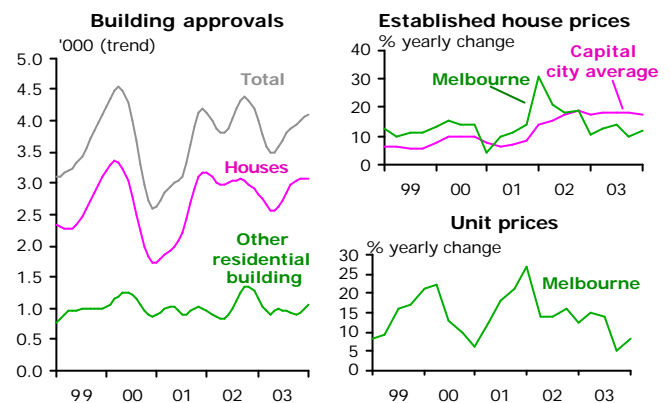
The impact of slower population growth already appears to be showing up on the household consumption side, with spending growth in Victoria easing to below the national average over the last year. This trend is likely to continue over the next few years, with the gap potentially widening as Victoria's population growth eases further. In terms of the cycle though, relatively high consumer confidence, the low unemployment rate and the strong gains in Victorian housing wealth in recent years suggest conditions for household consumption in Victoria will remain pretty solid for most of 2004 growth. However from late 2004/early 2005, household consumption growth in Victoria, similar to the rest of Australia, is likely to slow, mainly as higher interest rates dampen discretionary income and spending.

Strong population growth has also been a significant driver of Victoria's housing market in the last few years, stimulating strong demand and rapid growth in house prices. Growth in dwelling investment in Victoria has consistently outpaced most of the rest of Australia to average around 8½% per annum over the last five years. Strong demand has seen Victoria also lead the national boom in house prices, with house prices in Melbourne now 91% higher than five years ago, compared with the average capital city price rise of 87%. This has had considerable flow on effects to the rest of the State's economy,

contributing strongly to employment and, more indirectly, household consumption, via the personal wealth affects of these strong house price gains.

Nevertheless, the party is almost over with the latest indicators suggesting that the housing market in Victoria is starting to lose some of its, albeit strong, momentum. Residential building approvals appear to have peaked and house price growth has eased considerably (Chart 3). A recent upturn in building approvals and the relatively large pipeline of work should keep dwelling investment in Victoria firm over the first half of 2004 before higher interest rates dampen activity from mid-2004. Dwelling investment in Victoria is then likely to actually decline through 2005.

**Chart 3: Victoria's housing market appears to have peaked**



Source: ABS, REIA

### Victoria's property sector is vulnerable

The prospective decline in the Victorian housing market, in aggregate, is expected to be relatively shallow and fairly orderly. However, with residential building approvals in Melbourne still running higher than ANZ estimates of underlying demand, there is a prospect of a substantial decline in activity over the medium-term<sup>1</sup>. Further, residential property prices in some parts of the State appear to have clearly 'overshot', with ANZ analysis suggesting Melbourne house prices are now around 15% above 'fair value'. Softer demand and lower affordability (partly due to the recent interest rate rises) will likely see Melbourne house price growth weaken considerably to around 3-5% in the year ahead with price falls to be expected in some of the more oversupplied sub-markets. Should building approvals continue to run ahead of underlying demand however, there is a risk that Melbourne

<sup>1</sup> ANZ Property Outlook, December 2003

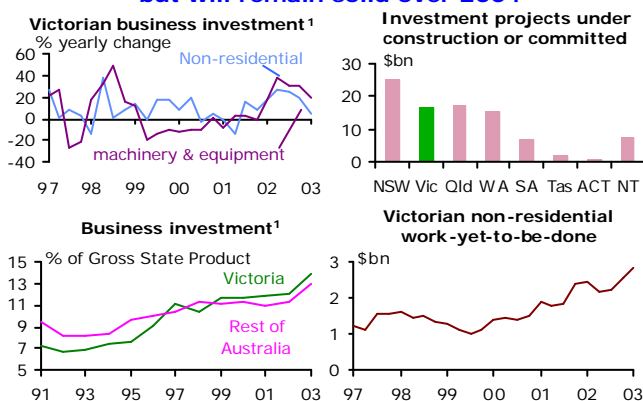
and surround house prices will slow more sharply than these central forecasts.

### Investment will remain strong

One sector that will be less affected by demographic factors in the short-term is investment. This spending operates with a longer-term framework and, to the extent that projects create employment, could potentially be a strong factor in arresting the fall in interstate migration out of Victoria. Also, some of the projects currently under construction in Victoria, such as building related to the Commonwealth games, are 'one-off' projects, less affected by the economic (including interest rate) and demographic cycle.

The latest indicators suggest that investment in Victoria has followed the national cycle, peaking in the latter part of 2003. Nevertheless, the large amount of work in the pipeline and a high number of projects committed should keep investment spending strong in Victoria over 2004 and into 2005 (Chart 4). Conditions look robust for large firms and confidence is also high amongst small and medium-sized businesses. That said, smaller firms will face an increasingly challenging environment, given that spending growth in construction and retail trade (with approximately one-third of all small businesses in Victoria operating in these industries) are both expected to slow from the second half of 2004.

**Chart 4: Investment in Victoria is past its peak, but will remain solid over 2004**



Source: ABS and Access Economics <sup>1</sup>New business investment, excluding net second hand asset sales

Investment spending looks like it will be broadly based across a range of industries. That said office construction is likely to dominate with building strong around the Melbourne central business district (CBD), Docklands and in suburban business parks. Retail shop building however should also be strong on the back of the Queen Victoria site redevelopment and the Spencer Street station upgrade. Hotel building

activity has also gained momentum, in both Melbourne and regional Victoria.

Investment in the cultural, recreational and community sectors will remain strong over the coming period, supported by a range of projects including the MCG and aquatic centre upgrades ahead of the 2006 Commonwealth Games. A large stock of committed transportation projects, including the Calder Highway upgrade, the Pakenham bypass and an expansion of the regional train network will all keep engineering spending strong over the next couple of years. After a few soft years, investment in Victoria's manufacturing sector is set to turn up, boosted by the carmakers with Holden expanding capacity and Toyota committed to an ongoing capital investment program. Even Victoria's relatively small mining sector is in on the act with the development of the Yolla and Minerva gas fields.

While the near-term outlook for investment is good, there are some risks on the horizon, mainly pertaining to the commercial office sector (which makes up around 20% of total non-residential construction in Victoria). The large volume of office construction being undertaken looks like it will far outstrip demand. The office market vacancy rate in Melbourne is already rising and a large portion of the office space due for completion after 2003 is not pre-committed. As well as putting pressure on rental yields, 'oversupply' of office space will dampen overall investment growth past 2005. That said we're not at the early 1990s level of gross overcapacity just yet.

### Export rebound capped by the higher A\$

Victorian exporters have faced a couple of tough years, having been hit hard by the drought and weak global demand. While these headwinds are dissipating, exporters now face the hurdle posed by the rapid appreciation of the Australian dollar, which has increased by 28% against the US\$ in the last 12 months, reaching a six-year high in mid-December of US0.74.55c.

The higher dollar is a greater concern for Victoria over some of the other States and Territories, given Victoria's higher dependence on manufactured industries. An A\$ above US0.70c significantly erodes the competitiveness of Australia's manufactures, dampening not only exports, but also domestic sales given the now lower price of imports. The higher currency is also adversely affecting A\$ returns on US\$ denominated commodity prices, negatively impacting Victorian farmer's incomes.

Overall, the higher A\$ will likely constrain total Victorian export growth during the first half of 2004. This is despite an expected strong upturn in rural exports, with ABARE forecasting the State's 2003-03 winter crop production to be more than triple last year's drought-affected yield<sup>2</sup>. From mid-2004 however, total Victorian international export growth should start to pick up strongly. Rural goods are likely to continue to recover (assuming that average seasonal conditions persist), while stronger global demand should begin to outweigh the impact of the higher currency on manufactured and service exports. The currency is expected to start working in favour of exporters again from mid-year, with ANZ forecasting the A\$ to ease back from a peak of US\$0.76 in June 2004 to US\$0.65 by the end of December 2005.

### Government finances may be squeezed

Favourable revenue outcomes, mainly due to the continued strength in property tax revenue, have seen the State government upgrade its 2003-04 Budget forecasts. The Government now expects to run a standardised operating surplus<sup>3</sup> of \$387mn this fiscal year, up from the projected Budget-time surplus of \$244.5mn.

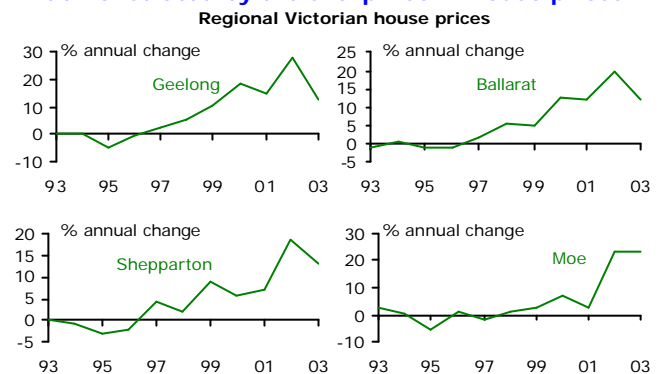
The State Government is forecasting a further improvement in the operating surplus in 2004-05 out to 2006-07. However, there are some risks around this outlook. A sharper than expected correction in the property market (which this paper has outlined as an increasing risk) is a significant negative risk to the Government's revenue projections. On the other side of the ledger, it may prove hard for the Government to cap its expenses at the projected average of 3.4% per annum over the forward estimates, given the emerging pressure on public sector wages in the State. The Government's economic growth forecasts, which for 3½% growth in 2004-05 are a little higher than ANZ's, is another risk to the Government's surplus projections.

### Regional Victoria is looking good

Victoria's strong economic performance over recent years has been distinctive from other periods of prosperity in that the good times have spilled out of Melbourne and into the regions. While there have been ups and downs, more lately drought-related downs, all of Victoria's regions are doing better than they were 5 years ago. The regional housing market demonstrates this well, with regional house prices and rural land values increasing sharply (Chart 5).

Partly, the improving fortunes of the regions reflect the 'seachange' phenomenon. The search for a 'better' lifestyle has seen an increasing population shift out of Melbourne into smaller surrounding inland towns and coastal areas, reversing one of the main factors that dragged down regional growth in earlier decades. The small physical size of Victoria also puts the regions at an advantage relative to other States, with the relatively short commuting time an advantage for both business and households. The other main factor contributing to regional Victoria's prospects is that most of the regional economies have increasingly diversified into small-scale manufacturing and services and so are no longer wholly dependent on farm conditions and tourism.

**Chart 5: While hit hard by the drought, regional Victoria has enjoyed otherwise good conditions, as demonstrated by the sharp rise in house prices**



Source: Residex

The outlook for all of Victoria's main regions is solid. Having suffered badly from the drought and bushfires in 2003, improved farm production and a pick up in tourism should see activity in Northern and North-East Victoria rebound strongly in 2004. Likewise, a sharp rebound in grains and dairy production will sharply boost growth respectively in the Wimmera Mallee region and the Western District. A recovery in dairy production will also be good for Gippsland, with West and South Gippsland also riding the wave of 'seachange' and enjoying strong population growth. Other parts of Gippsland that were adversely affected by changes in the electricity and timber industries are facing the future with renewed optimism. Meanwhile Central Victoria and the Barwon district are the other main beneficiaries of 'lifestyle' migrants from Melbourne and these economies are subsequently performing strongly. Plans for improved transport links between Melbourne and these regions is strengthening business confidence and prospects are good for the service and small-scale domestic-oriented manufacturing industries that are increasingly popping up in these areas. That said, with domestic demand in Victoria forecast to soften over 2005, conditions for these regions may become a little more challenging.

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<sup>2</sup> Australian Crop Report December 2003

<sup>3</sup> Extracts from changes in financial asset prices

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