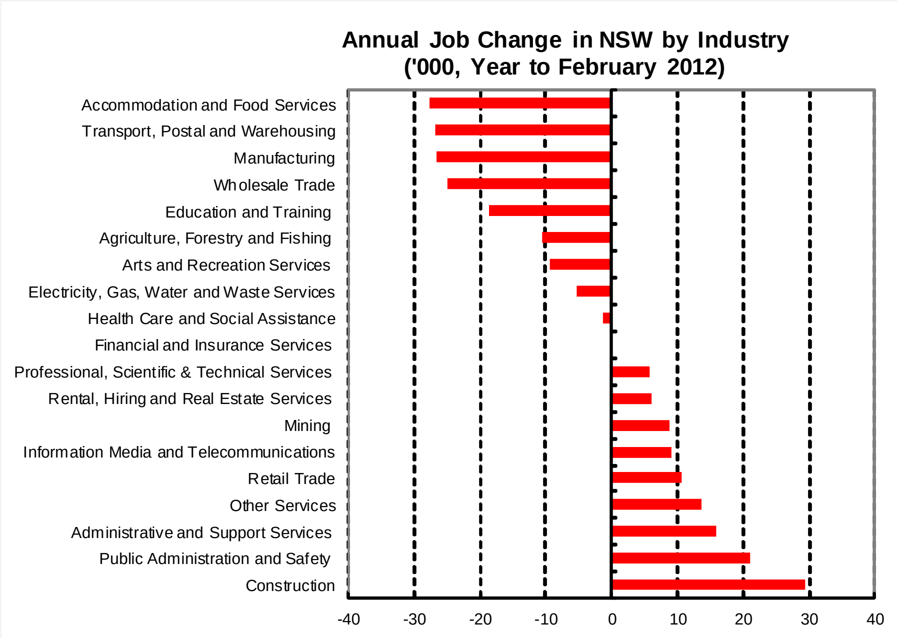
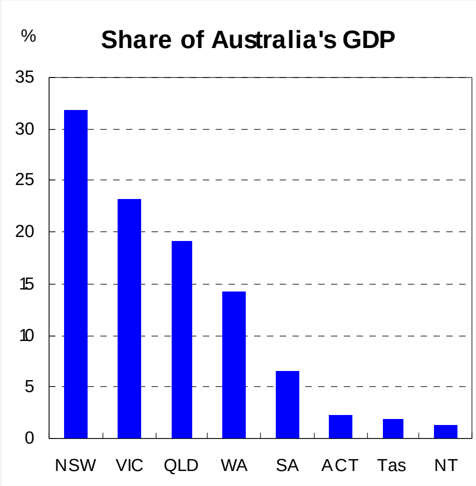
NSW ECONOMIC OUTLOOK

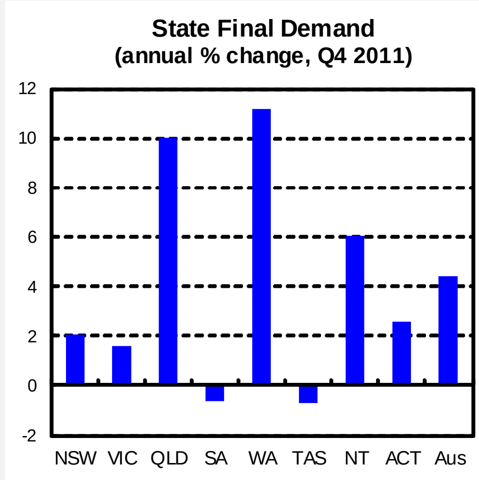
Monday, 26 March 2012

Summary:

- **Over the past year the NSW economy has grown at a modest but below average pace. Looking forward, reduced financial market volatility, stable house prices and a firmer job market are expected to see the pace of growth tick up in 2012-13.**
- **Business investment has been a major driver of growth in NSW, albeit at a slower pace than in the resource States of QLD and WA. The outlook is for engineering construction to remain strong in the year ahead.**
- **The annual pace of retail spending growth in NSW has weakened to 0.4% over the past twelve months. A broader measure, consumption spending, contained within the national accounts, is on par with national figures with real growth of 3.5% for the year to December 2011.**
- **House prices nationally showed signs of stabilising towards the end of the year, led by NSW. Some of the pick-up in housing activity in NSW may prove temporary given stamp duty changes for first home buyers, but lower interest rates and a lack of supply should support house prices and home building in NSW.**
- **The labour market remains tight in NSW with the unemployment rate at 5.2%, however, job growth has softened considerably over the past year. The unemployment rate is expected to edge up in the short term in the face of global economic uncertainty.**
- **We expect an improvement in demand, production and employment for the NSW economy in 2012-13. This view is based on reduced volatility in global financial markets, improved consumer sentiment, stable house prices and a firmer job market.**




%
Share of Australia's GDP
35
30
25
20
15
10
5
0
NSW
VIC
QLD
WA
SA
ACT
Tas
NT


State Final Demand
(annual % change, Q4 2011)
12
10
8
6
4
2
0
-2
NSW
VIC
QLD
SA
WA
TAS
NT
ACT
Aus

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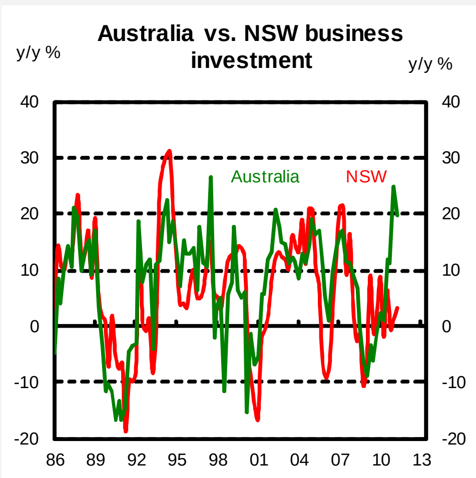
Economic outlook:

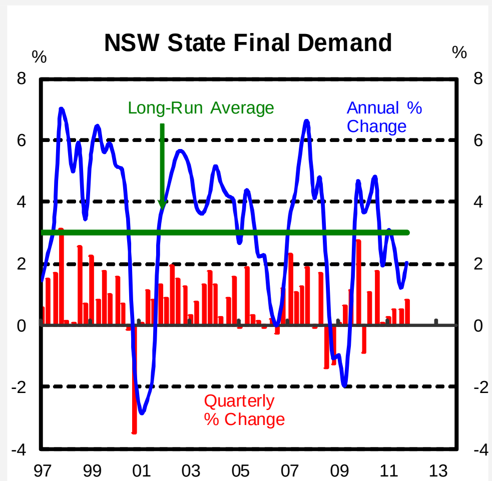
The NSW economy grew at a moderate pace in the 2010-11 (the latest full set of data available), despite its less prominent resource sector, the high Australian dollar and slowing population growth. Gross State product in NSW rose by 2.2% in 2010-11, above the long-run average of 2% and also above national GDP growth of 1.9%. Growth in NSW outpaced that of Australia as the floods and cyclone in early 2011 had a larger negative impact on growth in other States, especially Queensland.

Business investment was a major driver of growth in NSW over 2010-11, rising 3.1% and led by engineering construction. Household consumption and dwelling investment also grew strongly in 2010-11.

A less comprehensive measure of economic activity is State final demand. This measure of activity does not include exports and imports but is published quarterly as opposed to annually for gross State product. The latest print covers the December quarter 2011.

NSW State final demand rose by 0.8% in the December quarter and annual growth rebounded





to 2.0%, although it remains below the long-term average of 3.2%.

Several headwinds face the NSW economy. These include the high Australian dollar (which weighs heavily in NSW where there are prominent sectors outside of mining), consumer caution (which impacts NSW where mortgages are highest) and the budget woes still facing Europe.

Caution amongst householders and businesses, suggests credit growth in NSW will remain subdued and will weigh on the prominent financial services industry resident within the State. While Australian banks are well placed to cope with disruptions caused by events in Europe, they are not immune from the impact of slow growth.

The short term sovereign debt woes facing Europe have eased in recent weeks but longer term budget constraints remain. Budget cuts in Europe are a threat to economic growth in Australia and NSW since Europe is a major market for China and other parts of Asia. Europe is expected to slip into recession during 2012.

There are positives supporting economic activity in NSW. These include a good pipeline of engineering construction activity, a robust and growing coal industry and ongoing population growth. There are also signs of stabilisation in the housing market which could recover later this year provided there is no further significant fall out from Europe.

On balance, we expect NSW economic activity to remain soft this financial year, before returning to trend in 2012-13.

Labour market:

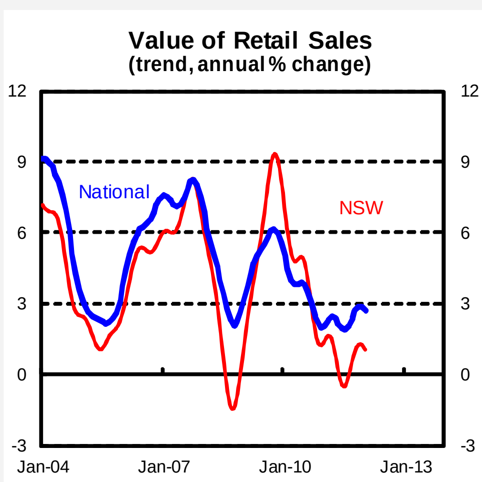
The labour market in NSW softened over the past year. In the year to February 2011, NSW added more than 135k jobs, which represented 45% of the total jobs created in Australia over that period. However, in the year to February 2012, NSW shed 31k jobs. The loss of jobs reflects difficult trading conditions in some industries and cautiousness in hiring by firms due to the uncertain global backdrop.

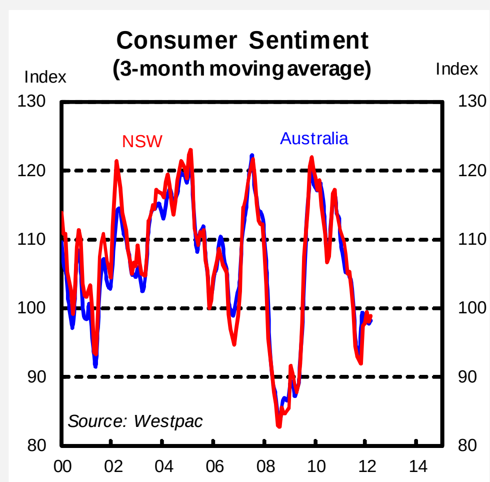
Despite job losses, the NSW labour markets still remains relatively tight. In NSW, the unemployment rate has edged up from a cyclical low in December 2010 of 4.6% to 5.2% in February 2012. NSW's unemployment rate sits on par with the national rate of 5.2%.

Over the year to February 2012, job growth was strongest in the construction industry (where almost 30k new jobs were created), followed by public administration & safety and the administrative & support industry.

In terms of the fastest employment growth over the year to February 2012, the mining and construction industries were the standout performers, with the mining boom and investment-related construction driving jobs growth. The number of mining jobs rose by 22.5% in the year to February, while construction jobs gained 10.8% over the same period. The accommodation and food services sector saw a decline of 27.7k jobs over the past twelve months while in percentage terms the wholesale trade sector saw a 16.7% decline in jobs.

We expect the NSW unemployment rate to edge higher through this year, although underlying growth in the economy will prevent excessive job losses and a steep increase in the rate of unemployment.





Consumer spending:

Retail sales were subdued over 2011 and into the start of 2012, as relatively high interest rates, a softer labour market and global economic uncertainties have led consumers to tighten their purse strings. NSW has been one of the hardest hit States, in part, because of the pressures of servicing the largest mortgages across the nation and in part because it has less exposure to the mining boom than some of the other States.

On the positive side, recent rate cuts from the Reserve Bank of Australia in November and December last year have eased some of the strain on consumers. Strong growth in incomes will also continue to support consumption.

In NSW, retail sales eked out growth of just 0.4% in the year to January2012. Over the same period, retail sales nationally were up a subdued 2.7%.

There is a considerable diversity across the States and Territories in terms of retail spending.

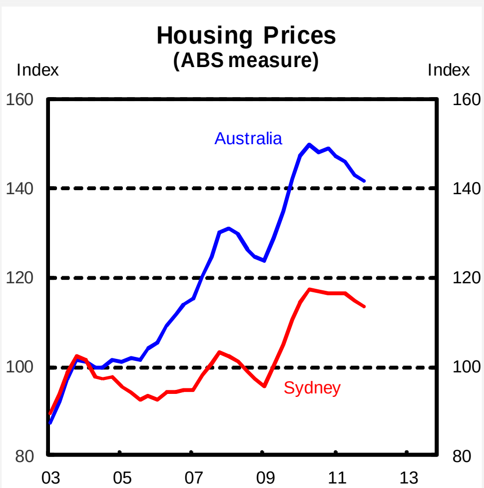
In SA, sales over the year fell 1.1%, while WA's retailing growth soared 9.1%. Both the NSW and national annual growth rates in retail sales are below their long-run averages.

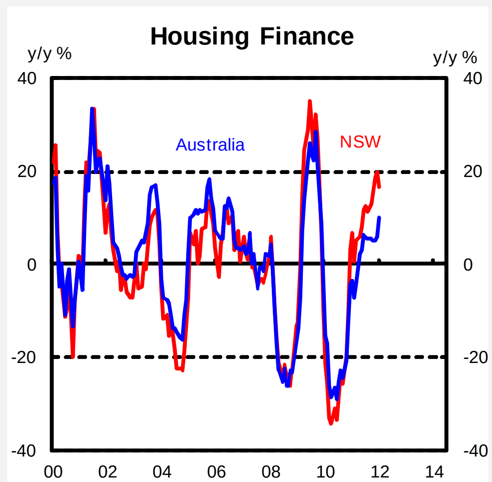
A broader measure of consumer spending is the household final consumption expenditure data in the national accounts. This shows that in the year to the December quarter 2011, NSW household spending rose by a healthier 3.5% and is on par with the growth seen Australia-wide.

Unsettling political news in Australia combined with ongoing bad news out of Europe appears to be weighing on consumer sentiment. Combined with losses of wealth due to the GFC, these have resulted in consumers lifting their rate of savings.

Retailing is also undergoing a broader structural change related to e-commerce, globalisation and the high Australian dollar. While foot traffic in retailing is recording modest growth, online sales are growing rapidly, although they still make up a small percent of total retail purchases – now estimated at close to 5.0% of sales.

Retailing in NSW will improve when consumer sentiment picks up. This will require a tick up in equity markets, stabilization of house prices and a resumption of job growth. Such conditions are expected in the second half of 2012 as the global flow of bad news subsides.





Housing:

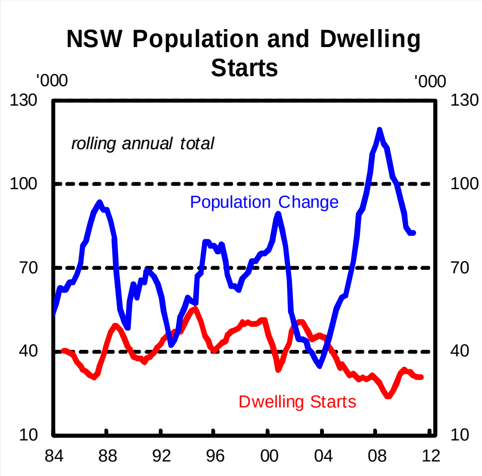
The residential housing market has faced a challenging 2011 in Australia and in NSW due to the combination of higher interest rates, the expiry of the first-home-owner's boost (FHOB) and low affordability.

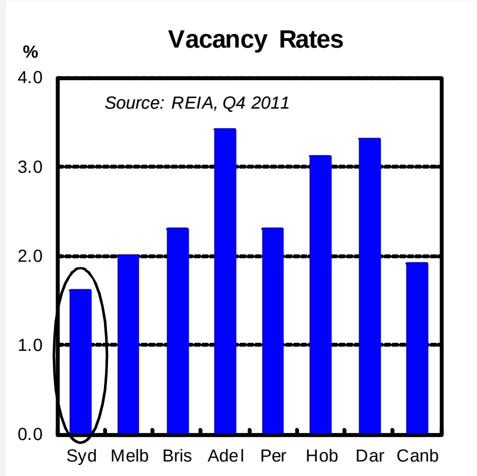
There were signs of stabilisation in house prices nationally towards the end of last year, which were most notable in Sydney. RP Data-Rismark dwelling prices for Sydney rose for three months straight to be 0.7% higher over the December quarter, but down 0.9% for the year. In contrast however, the Australian Bureau of Statistics (ABS) measure of house prices for Sydney fell 1.0% in the December quarter, and was down 2.7% on the year.

Both measures indicate that Sydney prices are outperforming the Australian capital-city average. RP Data-Rismark dwelling prices for Australian capital cities and ABS house prices are down 4.3% and 4.8% over the year to December respectively.

A decline in interest rates has supported demand for home lending across Australia. In NSW the abolition of the stamp duty exemption for first home buyers at the beginning of 2012 supported first home buyer demand in NSW late last year, but could weigh on demand early this year. NSW housing finance slumped in January 2012, although it failed to fully retrace the

jump seen in December. For the year, NSW housing finance is up 18.0%, compared to growth of 10.5% in Australian housing finance in the year to January.





Housing Shortage (Annual, '000s) *					
State	**2009**	**2010**	**2011**	**2012 (e)**	**2013 (f)**
NSW	52.7	66.5	74.3	90.2	101.6
Vic	27.5	29.4	23.1	19.5	22.1
QLD	7.2	-1.2	-2.6	9.4	21.8
SA	0.6	0.3	-2.2	-1.8	-0.8
WA	8.6	5.9	6.8	18.4	28.4
Tas	-0.6	-1.0	-2.0	-2.3	-2.3
NT	1.6	1.5	1.0	1.4	2.6
ACT	1.9	1.7	1.0	-0.9	-1.7
Australia	**99.6**	**103.2**	**99.6**	**133.9**	**171.8**

**As at March 2012, Source: ABS, BIS Shrapnel*

The housing shortage in NSW is providing a floor for house prices with the gap between supply and demand expected to widen further. Population growth has slowed in NSW from a peak in 2008-09, but growth remains solid. Further, after a brief pick up in 2009-10, dwelling commencements have been lacklustre, and growth has not been close to keeping pace with population growth.

The housing shortage, which exists nationally, is particularly acute in NSW. NSW accounts for almost 70% of the national housing shortage, and sits at around 90k dwellings. Furthermore, the shortfall of housing is expected to increase to around 102k dwellings in 2013.

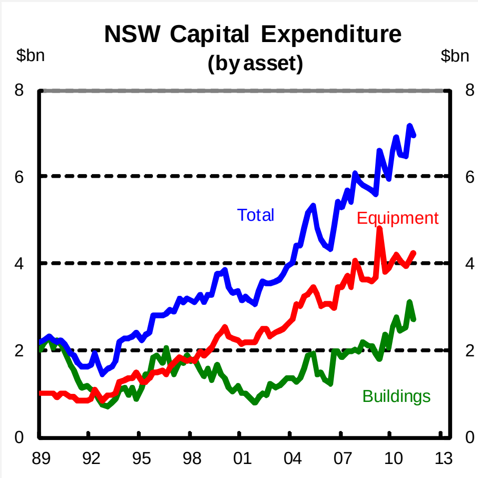
The shortage of housing has contributed to very low vacancy rates in Sydney. These stood at 1.6% in the December quarter, the lowest of all capital cities. Vacancy rates below 2% are indicative of very tight rental markets, and have driven up rents. Median weekly rents in the year to September 2011 are 5.0% higher for 3 bedroom houses and are 3.4% higher for 2 bedroom other dwellings.

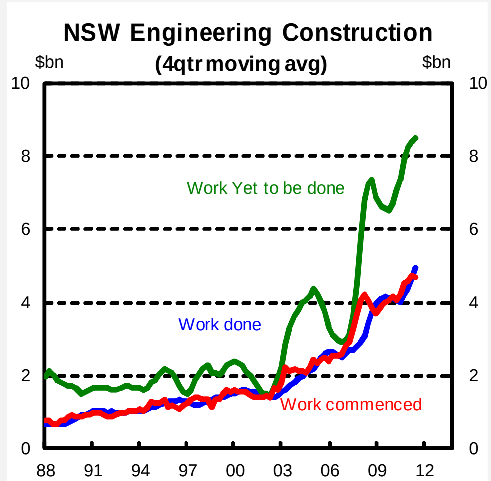
The combination of falling house prices over most of last year and rising rents indicate that rental yields have improved. Furthermore, the extremely tight rental market suggests that rents have further to rise and could lift investor demand for housing.

Provided there is no further adverse fall out from Europe, we expect that house prices will recover in the second half of this year. A more sustained recovery in house prices should eventually induce a supply response and provide a boost to residential construction in 2012-

13.

Business Investment:





Business investment is the growth engine of the Australian economy. In NSW, during early 2011, business investment was particularly soft. It picked up in the second half of the year and by December; NSW business investment had risen 3.2% over the year. Across the nation over the same period business investment rose 19.6%.

The mining boom and strong terms of trade in Australia are expected lead to an increase in investment over the coming year. Based on ABS data, we estimate that businesses intend to raise capital expenditure by a large 36.5% in 2011-12 and 36.4% in 2012-13. This expected spending is predominantly in mining, however, we expect NSW will show overall business investment growth over this period.

Engineering construction has been growing strongly in NSW. Growth in this sector has been witnessed for the past seven quarters with engineering construction up 52.5% since a low in March 2010. The pipeline of engineering construction is quite extensive, suggesting that prospects remain positive and will help support economic activity and jobs in NSW over the next twelve months.

In commercial construction however, the story is less positive and it has yet to recover from the unwinding of federal stimulus. In 2011 the real value of commercial construction declined 8.5% on 2010. Weak growth in non-residential approvals suggests that commercial construction will remain subdued over the near term, although it appears that approvals have bottomed and there are some encouraging signs commercial building will improve later this year.

Key Forecasts:

St.George Banking Group Forecasts:

Economic Indicators:	Long Run Average	*Actual* 2009-10	*Actual* 2010-11	Forecasts 2011-12	Forecasts 2012-13
State final demand, % change	2.90	3.30	3.10	2.30	3.10
Gross state product, % change	2.30	1.70	2.70*	2.00	2.80
Unemployment rate, %	5.40	5.70	5.10	5.30	5.30
Sydney Consumer Price Index, % change	2.80	2.90	3.80	3.00	3.80
Wage Price Index, % change	3.70	3.20	3.70	4.00	4.10

** forecast*

The NSW Government expects State final demand of 2.50% this financial year and 3.25% in 2012-13. Both forecasts have been shaved down from the 2011-12 Budget in September 2011, in light of data that became available in the later months of 2011. Our expectations are a touch lower given the pressures of a high dollar; job cut announcements and tight public spending.

For gross State product, a more comprehensive measure of economic activity (but less frequently published measure), the NSW government expects growth of 2.25% this financial year and 3.00% next financial year. This may be a little optimistic unless monetary policy is eased substantially. While we still expect official interest rates to fall, the magnitude seems unlikely boost sentiment and spending to the extent implied by the NSW Government forecasts.

Our own forecasts sit slightly below those of the Government and are outlined in the accompanying table. The outlook for 2012-13 is for an improvement in demand, production and employment based on reduced volatility in global financial markets, improved consumer sentiment, stable house prices and a firmer job market.

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