SOUTH AUSTRALIAN OUTLOOK

Wednesday, 2 November 2011

Summary:

- **South Australia is the fifth largest economy in Australia. It comprises around a 6% share of Australia's economy and has a population of 1.6 million. It is ranked as one of the most liveable cities in the world, one of the least costliest places to do business, is emerging as Australia's education city and is regarded as the high-technology centre for Australia's defence industry.**
- **South Australia has not yet joined the ranks of the resource-rich States but there is significant mining potential on tap. Indeed, the State has been ranked as the 27th most prospective mining location in the world and is home to almost 40% of the recoverable uranium deposits.**
- **Turning to the pace of economic growth, the South Australian economy bounced in the June quarter. State final demand jumped 2.0% in the June quarter, second only to Queensland. The annual rate of growth rose by 2.7%, below the 10-year average of 3.1%, but it was enough to put an end to the near year long softening trend in the annual growth rate.**
- **The biggest driver of growth in the South Australian economy, much like the Australian economy, is private business investment. Business investment in South Australia is strong and is benefiting from its growing mining sector. Business investment rose by 13.2% over the year to the June quarter in South Australia, the fastest annual pace in 6½ years. It is faster than the annual growth of 10.5% recorded for Australia in the same period.**
- **Business investment in South Australia will be in for another boon if BHP's proposal to expand Olympic Dam gets the go ahead. It is estimated that this expansion is worth around $30 billion. The size of this project means there would be a significant boost to employment and economic activity through spending on capital equipment and infrastructure. On October 10, BHP won environmental approval for the mine expansion. BHP Billiton's board is due to make a decision on the expansion in Q1 2012, and the go ahead will make it the world's largest open-cut mine.**
- **Recent strong growth in South Australian exports has also added to the overall pace of growth. Export volumes lifted nearly 26% over the year to the June quarter. A record winter crop amid better-than-expected rainfall boosted agricultural exports. And mineral exports, now South Australia's largest exports category, are benefiting from strong Asian demand.**
- **While South Australia is outperforming the national average in business investment, the same cannot be said about consumer spending, especially retailing. Retail trade is down 1.1% in the year to August compared with a rise of 2.1% across Australia. Retail sales growth has languished, as consumer caution lingers. Recent volatility in global financial markets and fears about the global growth outlook might prolong the caution.**
- **Housing conditions are also softening in South Australia. This week's RBA rate cut will provide some relief but interest rates are still likely to bite. Further, the end of the boost to the first-homeowners' grant is having a deeper impact in SA where median house prices are lower.**
- **South Australia, however, has some strings to its bow when it comes to the housing market. Adelaide is considered as one of the most liveable cities in the world – ranking in the top ten in a recent poll. Adelaide and South Australia more generally are one of the most affordable places to live in Australia, although affordability is low nationally and in the Festival State.**
- **Jobs growth in South Australia has softened considerably in line with national trends. South Australia's unemployment rate sits at 5.6% in September, above the national rate at 5.2%.**
- **The downside risks for the South Australian economy in the near term include the potential for ongoing household caution and global growth risks. Weaker global growth prospects may prolong household caution and weigh on business and consumer confidence. A slowing in population growth and addressing the net interstate migration outflows will also be challenges for South Australia.**
- **Increased potential for mineral production and the proposal for an expansion of the Olympic Dam mine, however, are strong potential positives in the longer-term outlook for SA.**

Overview

South Australia is the fifth largest economy in Australia and comprises a 6.1% share of Australia's gross domestic product (GDP). The services sector is the largest and fastest growing sector in South Australia.

Manufacturing remains the biggest sector in the South Australian economy, but it has been declining in importance over the years. The decline in importance of manufacturing reflects a move away from a traditional manufacturing base towards an expansion in new, advanced and knowledge-intensive services.

Financial & insurance services and healthcare & social assistance are the next biggest industries in the South Australian economy.

Percentage Shares of the Economy*		
Industries	**Australia**	**SA**
Manufacturing	10.0	13.8
Financial and insurance services	11.9	9.9
Health care and social assistance	6.6	8.8
Construction	8.1	7.8
Public administration and safety	5.6	6.2
Professional, scientific and technical services	7.1	6.2
Transport, postal and warehousing	5.5	5.6
Retail trade	5.0	5.3
Wholesale trade	5.2	5.2
Education and training	4.7	5.2
Agriculture, forestry and fishing	2.6	4.9
Mining	11.0	4.1
Information media and telecommunications	3.5	3.4
Electricity, gas, water and waste services	2.3	3.1
Accommodation and food services	2.4	2.5
Rental, hiring and real estate services	3.1	2.5
Administrative and support services	2.7	2.3
Other services	1.9	2.2
Arts and recreation services	0.9	0.9

** as % of Industry gross value added, excluding ownership of dwellings Source: ABS, St.George*

South Australia has significant mining potential it can tap. Indeed, the State could well join the ranks of the resource-rich States with some reinvention. As evidence of this, Canada's Fraser Institute recently ranked South Australia as the 27th most prospective mining location in the world.

This mining potential includes South Australia's possession of almost 40% of the world's recoverable uranium deposits. This mining potential is expected to translate to projects soon. One of the most highly publicised projects is the massive expansion proposal of BHP's Olympic Dam. This project will provide a large impetus to business investment as well as an increase in South Australia's export potential. The project will also provide a boost to local employment over the medium term.

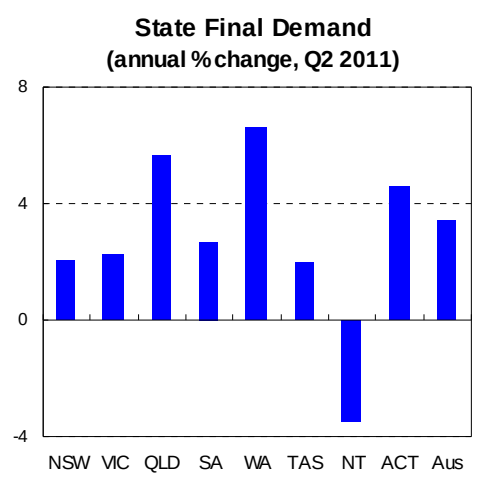
One of the other strings to South Australia's bow is Adelaide's emerging status as the 'education city'. It is home to a world-class education system that includes four internationally recognised universities, an extensive vocational training system and a wide range of specialised tertiary institutions.

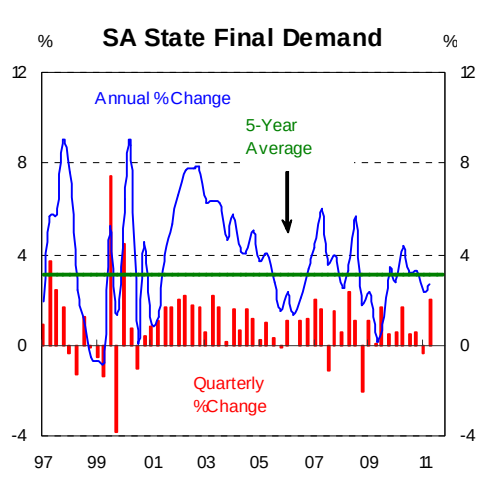
Yet another string to South Australia's bow is that Adelaide is rated as the equal eighth most liveable city in the world[1] and within Australia it is the second least costly city to set up and do business.

South Australia is also the high-technology centre for Australia's defence industry, with more than $10 billion in contracts. The $8 billion Air Warfare Destroyer project at Osborne near Port Adelaide is underway and these contracts are long-life projects that are generally quarantined from the swings in the business cycle. The Federal Government's recent announcement that the twelve next-generation submarines will be assembled in Adelaide is a major win for South Australia and worth an estimated $30 billion.

Economic Growth

South Australia experienced strong growth in the June quarter, as measured by State final demand. State final demand jumped by solid 2.0% in South Australia in the June quarter, second only to Queensland (which grew by 3.5%). The annual rate of growth rose by 2.7% is below the10-year average of 3.1%, but it put an end to the softening trend in the annual growth rate (which had been easing since reaching a 4.4% pace in the June quarter of 2010).





The annual growth rate of 2.7% is below the domestic final demand reading of 3.4% for the national economy.

Note that ideally, gross state product (GSP) would be used to assess broad economic growth, which includes inventories and net exports, but the data isn't available quarterly.

The significant growth driver for South Australia and the wider Australian economy remains private business investment (discussed below). But slower population growth, relatively high interest rates and cautiousness by households are having a dampening impact on housing and consumption. Some sectors are also being weighed down by the high Australian dollar. Meanwhile, escalating worries from abroad are adding to downside risks to economic activity for Australia and South Australia.

The South Australian Treasury expects robust economic growth in 2011-12 and 2012-13 of 2.75%, which is just under the average pace of growth witnessed over the last five years of 3.1%. We think the risks to these forecasts are close to balanced.

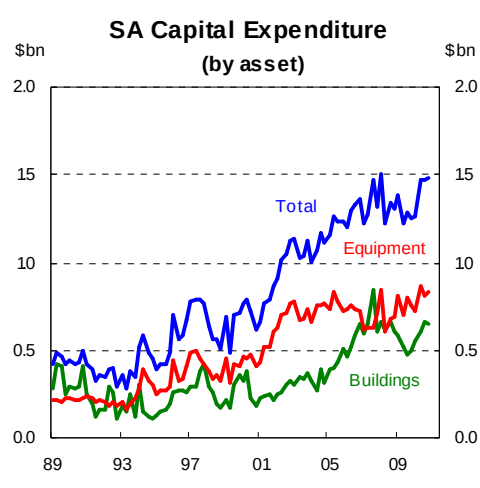
Business Investment

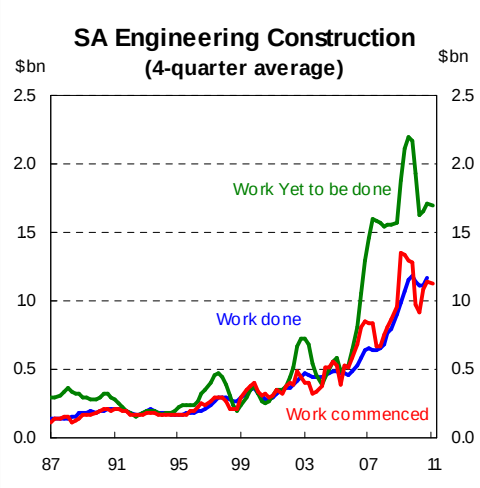
The mining boom and strong terms of trade in Australia are expected to lead to an increase in private business investment over the coming year. Nationally, businesses raised capital expenditure by 11.9% in 2010-11 and it is estimated they intend to increase spending by approximately 32% in 2011-12 (according to the most recent survey from the ABS).

Business investment in South Australia is strong and is benefiting from its strong and growing mining sector. Business investment rose by 13.2% over the year to the June quarter in South Australia, the fastest annual pace in 6½ years. It is faster than the annual growth of 10.5% recorded for Australia in the quarter.

Much like the national trend, a big driver of strong business investment has been driven by engineering construction. The pipeline for engineering construction is high nationally and in South Australia, largely reflecting strong infrastructure demand from the resource sector. Construction engineering rose by 31.9% over the year to June 2011 in South Australia.

The volume of projects in South Australia are being led by the $1.8 billion desalination plant at Port Stanvac (due to be completed by late 2012) along with a number of other transport projects. The $840 million South Road upgrade program is underway and the $812 million South Road Superway is establishing a north-south corridor between the Port River Expressway and Regency Road. The $546 million Northern Expressway project is also underway and the $460 million Gawler rail line electrification, as part of the wider rail revitalisation project will be ongoing until 2016.





The proposed Olympic Dam expansion leads the pack of the list of projects being considered. Infrastructure spending from the Olympic Dam project will include a 280 ML/day coastal desalination plant at Point Lowly, a new accommodation village (Hiltaba Village) for workers, a new airport to replace the existing Olympic Dam airport, a rail/road intermodal freight terminal at Pimba and 105km of new rail line to connect Olympic Dam to the national rail network near Pimba, a landing facility south of Port Augusta and 270km of electricity transmission line from Port Augusta.

The Federal Government has given environmental approval to the Olympic Dam expansion. However, an agreement between the SA government and BHP Billiton outlining details still needs to be finalised and legislation related to this agreement is expected to come before parliament before the end of the year. Bi-partisan support suggests that the government will likely pass the legislation. BHP Billiton's board is expected to come to a decision on the project in the March quarter of 2012.

BHP Billiton will not discuss the cost of expansion, although market estimates are for around $30 billion of expenditure. Such expenditure would cause a marked upgrade of our forecasts for growth in South Australia for the out years, via lifting business spending and employment.

An increase in non-dwelling investment in South Australia is expected to add to the upswing in business investment this financial year, after a weak outcome in 2010-11.

Exports

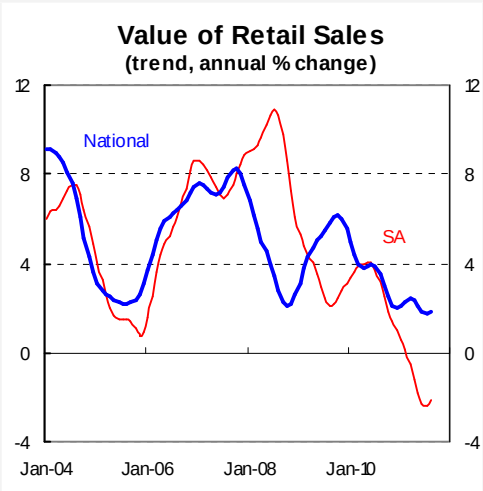
Increased potential for mineral production and the proposed expansion of the Olympic Dam mine if it goes ahead are large positives for the South Australian outlook. While commodity prices have softened recently due to the downside risks for the global economy, they remain at high levels and should support export income.

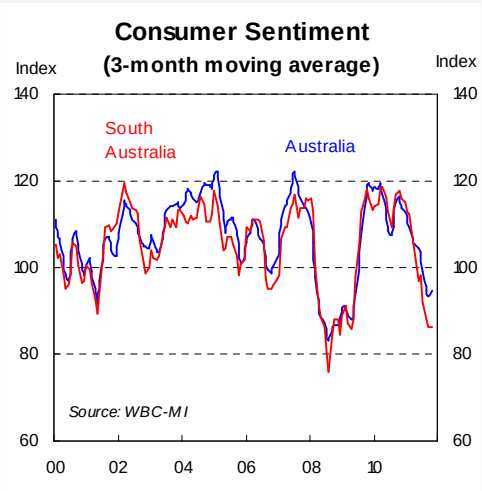
More generally, exports in South Australia are likely to have made a significant contribution to growth over 2010-2011. Despite falling 7.3% in the June quarter 2011, export volumes are 25.5% higher over the year to the June quarter. Better than expected rainfall has led to a record level of winter crop production, which has increased by around 32% in 2010-11. High grain prices combined with the boost in volumes means agricultural incomes should receive a $2.8 billion boost according to the South Australian Treasury department.

Metal ore exports are rising in prominence in South Australia. Mineral exports are now the largest export category for the State with metals accounting for just under 35% of all goods exports. Wine and wheat are the next biggest export markets for South Australia.

Some key export sectors for South Australia, such as manufacturing and wine, are being weighed down by the high Australian dollar. The Australian dollar has slid from its post-float high of USD1.1010 in April this year to a low of USD0.9386 on October 4th, reflecting heightened risk aversion and increased fears about the global growth outlook. However, the Aussie dollar has retraced some of these losses to trade above parity. Over the medium to longer term, we can expect the Australian dollar to trade higher than historically has been the case, as it receives underlying support from Australia's attractive interest rates, Australia's rising terms of trade, Australia's strong links to the Asian region and Australia's relatively robust economic fundamentals.

As noted above Adelaide has emerged as the education city. The international student market is worth around $1 billion to the local economy. Indeed, over much of the past five years, South Australia has outstripped the nation in the growth of overseas students. The high Australian dollar has proved challenging for the education sector's drive to continue to attract international students.





Consumer Spending

While South Australia is outperforming the national average in business investment, the same cannot be said about consumer spending. A broad measure of consumer spending is household final consumption expenditure contained in the national accounts. It showed that household consumption in South Australia is currently going through a rough patch. In the year to the June quarter, household consumption in South Australia rose by just 0.2%

compared to growth of 3.2% growth seen Australia-wide and long-term growth in South Australian household consumption of 2.9%.

A notable weak spot in South Australian household consumption was evident in vehicle sales, but this is largely due to supply-chain disruptions in Japan after its natural disasters. This disruption is now easing.

Retail spending is a large component of overall household consumption. Retailing is a weak spot in the economy nationally but again the South Australian economy has witnessed softer growth in retailing compared with the national average. Retailing in South Australia fell 1.1% in the year to August, compared to an increase of 2.1% nationally over the same period, making it the slowest growth State for retail sales. This compares to long-run average growth of 5.5% in South Australian retail sales.

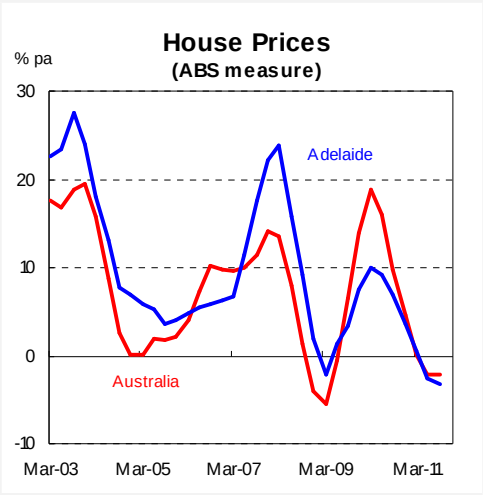
Retail sales growth has languished, as consumers have remained cautious and have chosen to save more. Over the past year, the sub-industries of South Australian retail sales which have performed more poorly have been in more discretionary areas of spending, including clothing (although footwear and other personal accessories showed strong growth), 'other specialised food retailing' and cafes, restaurants and catering services.

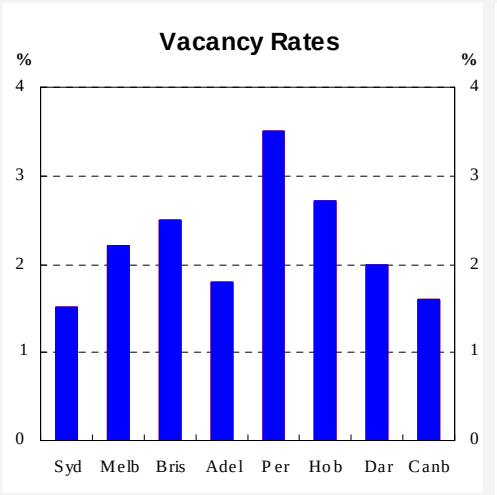
The risk is that retail spending will remain soft over coming months because consumer caution is likely to linger for longer due to recent global developments. The volatility in financial markets and heightened uncertainty about the outlook in the world economy, especially Europe, are likely to keep consumers shackled by caution.

The Westpac-Melbourne Institute measure of consumer sentiment for South Australia has dropped sharply amid heightened global tensions and volatility in financial markets. Consumer sentiment for South Australia slumped 12.7% in October, falling from a reading of 93.4 to 81.5, given ongoing volatility in financial markets and growing concerns about global growth. Sentiment remains below 100, indicating pessimists outweigh optimists. It is also below the overall national sentiment reading of 97.2, indicating that South Australians are more pessimistic than the national average.

Housing

House prices have moderated in Australia and in South Australia over the course of this year. According to the Australian Bureau if Statistics (ABS), South Australian house price growth has slowed significantly from a recent peak of 10.1% growth in the year to the March quarter 2010 to be down 3.2% in the year to the September of 2011. It compares with a decline of 2.2% across Australia.





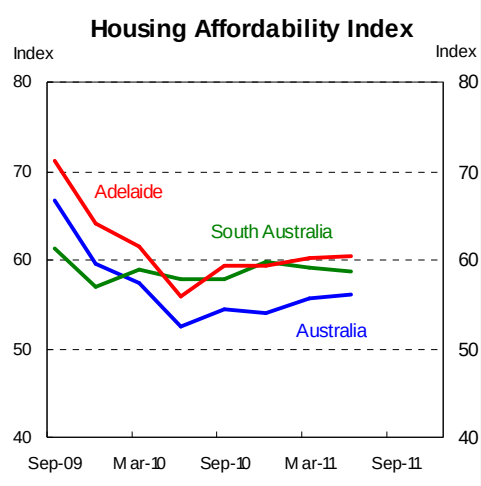
Other house price data also indicates that house price growth remains subdued. RP Data-Rismark house prices fell 0.4% in August for all capital cities and also for Adelaide. On an annual basis, Adelaide's house prices are down 0.5% in September, compared to a decline of 3.7% nationally.

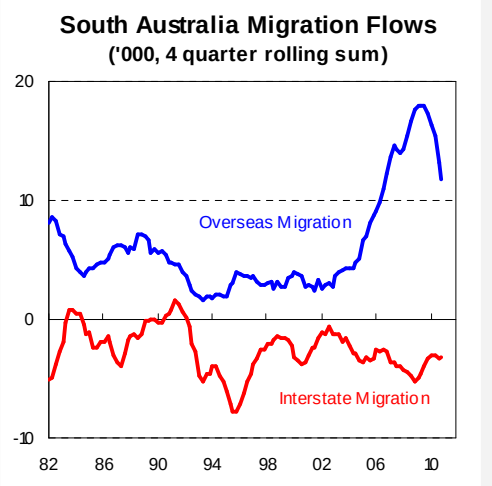
This moderation in house prices is in part due to some correction after strong house price growth in 2010. Relatively high interest rates and the end of the boost to the first-home-owners' grant (FHOG) are also weighing on demand as is low housing affordability. However, this week's rate cut will provide a modest boost and the degree of contraction in housing prices already appears to be easing.

The additional FHOG gave a more pronounced temporary boost in the South Australian housing market where the average mortgage size is smaller than the national average. The median house price is also the second lowest in the country at $410,000 (according to the REIA June quarter report). The number of first-home buyers in South Australia peaked in July 2009, a time when the cash rate reached a 50-year low of 3% and the FHOG was in place.

Areas with favourable housing affordability conditions were particular beneficiaries of the Federal government's additional grants to first-home buyers. However, as these grants have been wound back, South Australia has felt the impact, more so than some less affordable areas.

South Australia is also experiencing a slowdown in population growth, another trend also occurring Australia wide. Annual population growth in South Australia is estimated to have slowed to 1.0% in the December quarter 2010 from a peak of 1.3% as recently as the March quarter 2010. This compares to estimated annual population growth of 1.5% Australia-wide in the December quarter 2010.





Population growth is comprised of changes in the birth rate, changes in overseas arrivals and changes in interstate migration. The population growth rate in South Australia has moderated through 2010 to be around 1% per annum, below the 1.5% annual growth rate average witnessed nationally.

Further, South Australia incurs continued losses through interstate migration but net overseas migration is the major driver of the State's population growth. Outflows from South Australia due to interstate migration are more than compensated for by inflows from overseas. Nevertheless, addressing the losses in interstate migration is one of the issues for South Australia.

We expect house prices to continue to soften over the next twelve months both across Australia and in South Australia, as homebuyers remain on the sidelines. Low unemployment

and strong growth in household incomes is giving support to the housing market but ongoing turmoil in the global economy, low housing affordability and household caution will encourage homebuyers to stay on the sidelines.

The expected continuing softening in house prices will flow through to the residential construction market. Dwelling starts in South Australia showed a strong improvement in the June quarter, however, previously dwelling investment has shown a softening trend as seen nationally. We expect that a weaker trend of dwelling investment is likely to continue. Leading indicators of residential dwelling investment suggest building activity will ease. Building approvals in South Australia have fallen 11.5% over the year to September, an improvement from August that recorded the weakest annual growth in more than 10 years. Nevertheless, we are unlikely to see a convincing pick up in residential building in the near term.

According to BIS Shrapnel, Adelaide's dwelling stock remained fairly balanced in 2010, but a slight excess of supply is expected to come on line this year. The very low rental vacancy rate suggests this isn't currently a problem for South Australia.

Rents continue to rise in Adelaide, with the vacancy rate remaining low, at 1.8% in the June quarter. Vacancy rates lower than 3.0% indicate strong demand for rental accommodation or a shortage of rental accommodation. A rate below 2% indicates the rental market is super tight. Indeed, Adelaide has one of the tightest rental markets across the capital cities.

While rents are set to rise further with the prevailing low vacancy rate in Adelaide, Adelaide has one of the lowest weekly rents among the capital cities; a 3-bedroom house is yielding a median rent of $320 per week, the lowest of any capital city for a house this size (according to the REIA). In the units market, a 2-bedroom dwelling yields a rent of $270 per week, the lowest of any capital city (shared with Hobart).

In Adelaide's favour, is its position as one of the most liveable cities in the world. In a report published by the Economic Intelligence Unit in August 2011, Adelaide was ranked among the most favourable top ten cities in the world to live in (with a ranking of equal eighth). In arriving at the scores, cities were assessed in terms of their stability, healthcare services, culture & environment, education and infrastructure.

Adelaide is also one of Australia's most affordable capital cities. According to the HIA housing affordability index, in the June quarter Adelaide has the second most affordable housing amongst Australian capital cities, second only to Hobart. Not only does Adelaide have the advantage of being relatively affordable, but it has new housing developments relatively close to the Adelaide CBD.

When looking across States, South Australia is the third most affordable State behind Tasmania and then Western Australia. Both Adelaide and South Australia are more affordable than the national average. The relatively more affordable housing in Adelaide and South Australia reflects lower median house prices relative to incomes.

Non-residential Construction

Non-residential construction has been lacklustre nationally and in South Australia as the stimulus from the Building the Education Revolution (BER) program fades and as the effects of the global financial crisis linger.

A recovery in non-residential commencements is expected this financial year, albeit from a very low base. Office and industrial building should pick up over the short to medium term, while commitments by federal and State governments for healthcare funding will provide a large boost to health commencements. But other commercial sectors are likely to stay soft.

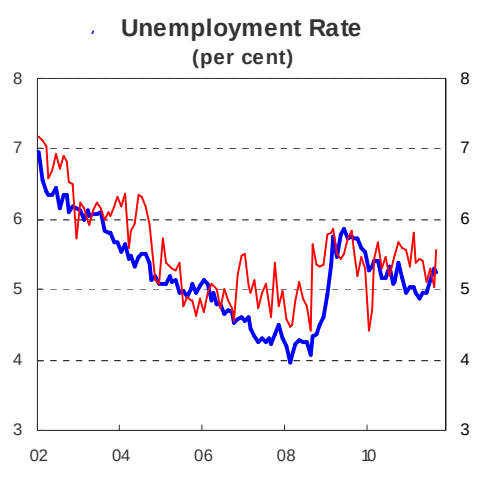
After falling sharply in 2010-11, BIS Shrapnel estimates a 95% surge in the value of non-residential commencements in 2011-12 to $3.7bn, driven by the massive $1.75bn New Royal Adelaide Hospital project.

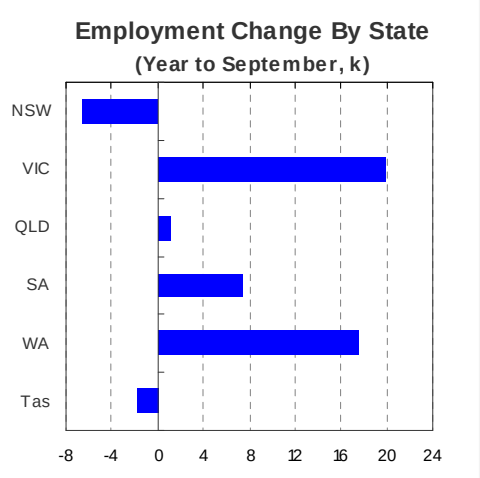
Labour Market

The South Australian labour market has softened in line with the trend nationally. Annual employment growth was 0.9% in September, compared to 1.1% nationally and a cyclical peak of 3.3% in August last year. However, South Australia has added a net 7.4k jobs so far this year, the third most amongst all the States, behind WA and VIC.

Weaker jobs growth has seen the unemployment rate in South Australia jump to 5.6% in September from a cyclical low of 5.0% in August. The September outcome was the highest in seven months, but stills close to the 10-year average of 5.5%. The trend unemployment rate for South Australia, which takes out some of the recent volatility, sits at 5.3% and still points to a tight labour market. This compares to the national unemployment rate of 5.2%.

Leading indicators of employment – namely job advertisements - continue to point to a moderate pace of jobs growth. Further, there has been an encouraging bounce in business confidence and conditions in September, suggesting firms are less pessimistic about the outlook.





Historically, the manufacturing industry accounted for the greatest share of employment in South Australia. The healthcare & social assistance industry is now the biggest employer.

In recent years, the pace of growth in manufacturing jobs in South Australia has failed to keep pace with jobs growth in other industries. Manufacturing jobs have declined over the past ten years to now make up 9.7% of all jobs in South Australia compared with 13.4% ten years ago. Meanwhile jobs in healthcare & social assistance and retail have increased over the same period to make up 12.5% and 11.2% of South Australian jobs, respectively.

St.George Banking Group Forecasts

Economic Indicators, % Change				
	2009-10	2010-11	2011-12 (f)	2012-13 (f)
State Final Demand	2.80	2.90	2.70	2.60
Employment	0.90	1.80	1.40	1.40
Unemployment Rate	5.30	5.40	5.30	5.30
Adelaide CPI	2.20	3.20	3.00	3.00
Wage Price Index	2.80	3.50	4.30	4.20

Source: St.George Banking Group

South Australian Treasury expect gross state product to expand by 2.75% this financial year and next financial year, after 2% after growth in 2010-11. As noted above, the more regular but narrower measure of economic activity is state final demand. On this measure, the South

Australian Treasury expects state final demand to grow by 2.75% this year and next year. Our forecasts are close to these estimates (refer to the table below).

Footnotes:

1. **Economic Intelligence Unit, The Liveability Survey, August 2011**
2. **KPMG Competitive Alternatives Report, 2010**

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