NSW ECONOMIC OUTLOOK

Monday, 17 October 2011

Summary:

- **The NSW economy remains an important part of the Australian economy. It is Australia's largest and most populous State and is often characterised as Australia's only true 'global' city.**
- **The global financial crisis hit NSW hard due to the dominance of the finance & insurance industry. However, since the second half of 2009 NSW has embarked on the road to economic recovery. The economic expansion has recently lost some steam but remains intact.**
- **We expect NSW economic activity to soften this financial year before returning to trend next financial year. Our forecasts are slightly less optimistic than the Government's.**
- **The high Australian dollar and household caution are weighing more heavily in NSW where mortgages are highest and non-resource sectors are less prominent. Further, the global financial market woes impact NSW more heavily due to its large finance & insurance industry.**
- **Subdued credit growth in the year ahead will also weigh on NSW's prominent financial services industry. Other key sectors in NSW such as manufacturing and tourism are being squeezed by the relatively high Australian dollar.**
- **Escalating worries from abroad are adding to downside risks to economic activity for Australia and NSW. It has the potential to adversely affect sentiment further and lower state final demand as a result.**
- **Retailing has eased in NSW this year as it has nationally with NSW consumers creating bigger cocoons for themselves. However, retail activity in NSW has picked up in recent months – it posted its biggest back-to-back gain in more than one year.**
- **House prices have softened in NSW, mirroring the national trend, although Sydney has outperformed all other capital cities. We expect NSW house prices to stay soft over the next twelve months as low affordability keeps buyers on the sidelines. But we expect the NSW rental market to tighten further, help setting the conditions for a modest recovery in house prices later next year.**
- **Across Australian capital cities, vacancy rates are lowest and super tight in Sydney. The housing shortage is also starkest in NSW and expected to deteriorate further. Dwelling construction has been anaemic at best. A modest pick up is likely in the year ahead but not enough to address the housing shortage.**
- **The positives in the NSW economy include the benefit the State is receiving from the net income injection courtesy of the rising terms of trade. This growth in income is helping underpin economic activity.**
- **Business investment is an important growth driver nationally. It should also help underpin NSW economic activity, namely through engineering construction. Work yet to be done in the engineering pipeline is at its highest level in more than two decades. Commercial dwelling investment has fallen back.**
- **Mining is a small segment of the NSW economy but NSW's largest export is coal. China's hunger for commodities has driven up commodity prices. Thermal production in the Hunter and Newcastle region of NSW has ramped up as a result. We also expect farming exports to be buoyant in the year ahead.**
- **The labour market remains tight in NSW with the unemployment rate at 5.5% although job growth has softened considerably this year. There is a risk unemployment rate could rise further, however, leading indicators suggest the current slowdown in**

employment has been overdone.

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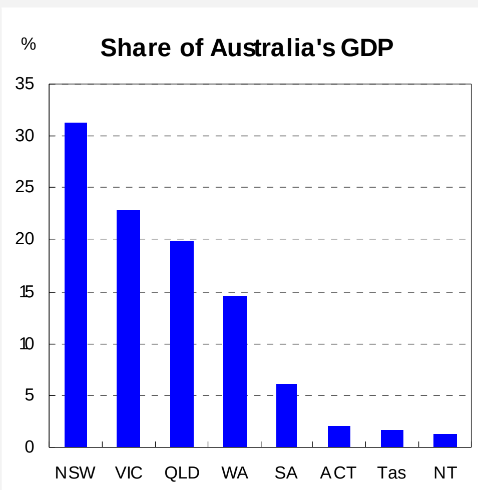
Importance of New South Wales:

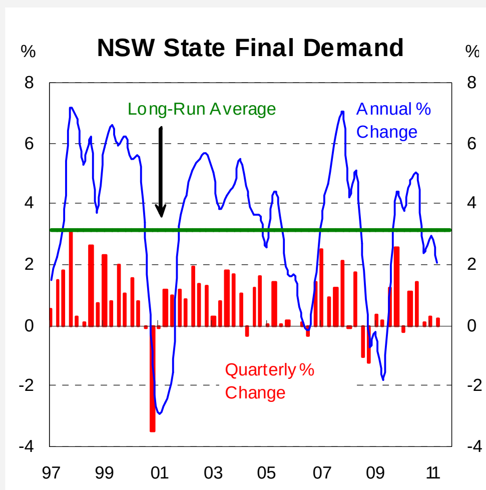
In recent times, the resource-rich States of Queensland and Western Australia, amidst Australia's record high terms of trade and a mining boom, have dominated headlines as Australia's key drivers of economic growth. However, the State of NSW remains a very important part of the Australian economy. It is the largest State economy in Australia, accounting for 31% of Australia's gross domestic product (GDP). The NSW economy is also larger than many national economies in the Asia-Pacific region, including Singapore and Malaysia.

NSW is also the most populous State in Australia, with over seven million residents. It is also the most educated, with the highest proportion of the working age population holding tertiary qualifications.

Sydney is often dubbed the most multicultural city in the Asia Pacific and is a key factor behind its position as Australia's only 'global' city. Its highly skilled labour force, international linkages and its proximity to Asia are some reasons why NSW is an attractive environment to conduct business. In Australia, 48% of the top 500 companies alone are in NSW.

NSW is a leading services State, with 84% of the industry income derived from services. Its capital city of Sydney is known as the financial and business hub of Australia. Consequently, it has a large share of the finance & insurance services, property & business services and communications industry.





Economic growth outlook:

Economic activity in NSW began a recovery in the second half of 2009 after the NSW economy was struck hard by the impact of the global financial crisis (GFC). The GFC was particularly negative for the NSW economy, due to the large share of the financial services industry in NSW. The NSW began to recover in the second half of 2009. Some relatively firm growth outcomes were generally recorded over this time and up until the December quarter of last year. While economic activity continues to grow in NSW, the pace of economic activity has slowed in the last three quarters.

We examine the State final demand data to measure the strength of economic activity. Ideally, gross state product should be looked at, which also includes exports and imports, but this data is only published annually compared with State final demand that is published on a quarterly basis.

In the June quarter, NSW grew by only 0.2%, after 0.3% growth in the March quarter. Compared with the June quarter in 2010, the NSW economy expanded 2.1%, which is under the long-run (or 10-year) average of 3.2%. For the financial year, State final demand rose by 3.1% in 2010-11.

We expect NSW economic activity to soften this financial year before returning to trend next financial year. The high Australian dollar and household caution are weighing more heavily in NSW where mortgages are highest and non-resource sectors are less prominent.

Subdued credit growth in the year ahead will also weigh on NSW's prominent financial services industry. Some key sectors of the NSW economy, such as manufacturing and tourism, are also being squeezed by the relatively high Australian dollar and ongoing consumer caution.

Meanwhile, escalating worries from abroad are adding to downside risks to economic activity for both Australia and NSW. Concerns about the global growth outlook and the sovereign debt problems of Europe have contributed to the recent turmoil in financial markets. This turmoil could potentially hurt sentiment further and spill over to adversely affect demand. Further, slower growth in Europe and the US could dampen exports from Asia, and thus demand for Australia's commodities.

The sovereign debt woes currently plaguing Europe are unlikely to affect the Australia's financial services industry as much as during the GFC, but the industry will not be immune. Australian banks are relatively well placed compared with before the GFC and also in comparison to overseas; they are better capitalised and have lessened their reliance on wholesale funding.

There are positives supporting economic activity in NSW. These include a large amount of engineering construction activity in the pipeline, a recovery in production and ongoing demand for coal exports from Asia.

Political backdrop:

The change from a State labor government to an O'Farrell-led Liberal government earlier this year in NSW marked a major political change. The number of seats the new government won suggests that the population was looking for a change in government and this change might have provided a boost to sentiment.

The State's credit rating remains healthy at AAA from credit-rating agencies Standard & Poor's and Moody's.

Industry analysis:

In gross value added terms, financial & insurance services are the biggest industry in NSW economy (at 9.4%). It is followed closely by the manufacturing industry at 8.8%. Manufacturing has declined as a share of the State's income, although it is still a vital element of the NSW economy.

Mining is a smaller component of the NSW economy than in other States (at 3.6% compared with the national average of 11%). But mining still makes its presence felt, predominantly in thermal coal. The NSW mining industry comprises 12.6% of Australia's total mining industry and coal is NSW's largest export; coal comprises approx. 30% of the total value of all exports. Further, Newcastle resides in NSW and it has the reputation for being one of the largest coal exporting harbours in the world.

Strong demand from China as a result of its industrialisation has driven up commodity prices over the past decade. Although commodity prices have declined in recent months, they remain at historically high levels. Further, prices for bulk commodities, which include coal (coking and thermal), have held up well compared with prices for oil and other base metals.

Export prices for thermal coal have continued to rise in September while coking coal prices still remain much higher than a year ago. Coal production in NSW has significantly benefited from these higher prices through higher export values and business investment.

Higher commodity prices have resulted in a massive surge in Australia's terms of trade (the ratio of export prices to import prices). The terms of trade in the June quarter struck a record high and the Reserve Bank expects it to reach a fresh record high in the September quarter. The rising terms of trade is providing a net income injection boost to the Australian and NSW economy, which is helping to underpin economic activity.

Some industries other than mining are likely to directly benefit from the resources boom in NSW. One of the most notable industries to benefit is the professional, scientific & technical services industry, which is NSW's third largest industry. This industry includes services in engineering, accounting, architecture, scientific research, computer systems design, accountancy, advertising, market research, legal and management consulting.

Percentage Shares of the Economy*

Industries	Australia	NSW
Financial and insurance services	10.3	15.0
Manufacturing	8.6	8.8
Professional, scientific and technical services	6.1	7.1
Construction	7.0	5.9
Health care and social assistance	5.7	5.3
Transport, postal and warehousing	4.8	4.9
Wholesale trade	4.5	4.6
Public administration and safety	4.8	4.4
Retail trade	4.3	4.1
Education and training	4.1	4.1
Information media and telecommunications	3.0	4.0
Mining	9.4	3.6
Rental, hiring and real estate services	2.6	2.8
Administrative and support services	2.3	2.6
Accommodation and food services	2.0	2.5
Electricity, gas, water and waste services	2.0	2.0
Other services	1.6	1.6
Agriculture, forestry and fishing	2.2	1.3
Arts and recreation services	0.8	0.9

** For Australia, using GDP and for NSW, using GSP; Source: ABS, St.George*

The resources boom and associated rise in the terms of trade has contributed to the appreciation of the Australian dollar (AUD), although it has weakened recently amid heightened risk aversion and concerns about the global growth outlook. In trade-weighted terms, the AUD is slightly higher than a year ago and it is still well above its long-run average. The strong Australian dollar is making it tougher to compete for trade-exposed industries not related to the resources sector. The notable affected industries in NSW include manufacturing, tourism and education. However, total NSW exports are rising and still expected to grow further, largely due to growth in farming and mining.

Interest-sensitive sectors are also doing it tough in NSW because NSW households shoulder the largest mortgages in Australia.

Labour market:

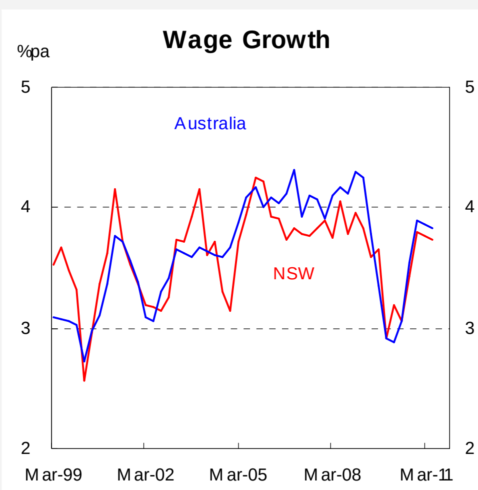
The labour market nationally and in NSW has loosened this year and the unemployment rate has edged higher across most States. However, labour markets remain tight. In NSW, the unemployment rate has edged up from a cyclical low in December 2010 of 4.6% to 5.5% in September 2011. It compares with a lift in the national unemployment rate from 4.9% to 5.2% over the same period. Some of the slowdown in jobs growth has been because the pace of gains recorded over the second half of last year and the early part of this year was too strong to be sustained for a long period of time. But some cautiousness in hiring plans might also have crept in due to the uncertain global backdrop.

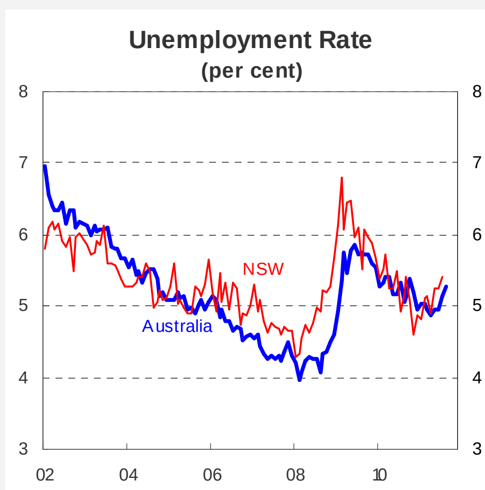
The moderation in jobs has been sharper in NSW, but then the gains last year were also sharper in NSW. Last year, NSW added 138k jobs, which was close to 40% of all jobs created in Australia. However, this year so far, NSW on a net basis has shed around 6k jobs whereas across Australia 41.1k jobs have been added.

There is a risk that the unemployment rate edges higher in NSW and Australia as heightened uncertainty about the global growth outlook could potentially weigh on hiring intentions. However, leading indicators such as job advertisements suggest that the jobs slowdown might be overstated by the official employment data. A recent recovery in business confidence in September further supports this view.

Over the year to August and across industries, the number of job gains was strongest in healthcare & social assistance, accommodation & food services, public administration & safety and financial & insurance services. These trends prevailed, despite the high Aussie dollar weighing on tourism and soft growth in credit.

In terms of the fastest employment growth, the strongest industry was mining. Mining only employs a small fraction of the NSW labour force of 2.0%, but employment growth in this industry was the fastest given the presence of the coal industry in the State. Employment in mining in NSW rose by 14.0% over the year to August.





Wages:

The tight NSW labour market is also reflected in firm wage growth. The best measure of wages in the economy is the wage cost index. The wage cost index in the June quarter rose by 0.6% with annual growth of 3.7% over the year to the June quarter. This annual rate of growth is close to the national wage growth rate of 3.8%. The pace of wages growth is solid, but still relatively well contained, as it is below the Reserve Bank's unofficial 'line in the sand' of 4.5% per annum.

Consumer spending:

Retail sales have been subdued over 2011, as relatively high interest rates and consumer caution have led to consumers tightening their purse strings. NSW has not been immune to the national trends and is one of the hardest hit States because house prices and mortgages are highest.

Caution by consumers has been reflected in weak consumer sentiment. Nationally, and in NSW, the consumer sentiment index reading remains below 100, which indicates that more consumers are more pessimistic than optimistic. NSW is also more pessimistic than the national average. In October, the consumer sentiment index was 92.8 in NSW while the national rate stood at 97.2.

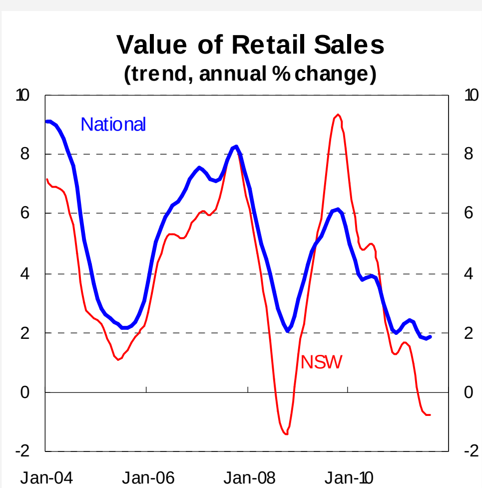
The extreme volatility in financial markets and heightened downside risks to global growth are weighing on sentiment. On a positive note, there was a surprising rebound in consumer sentiment in September, which was followed by a small increase in October. Consumers are likely encouraged by the speculation that the official cash rate might be cut in coming months. In recent months, fixed rates of home loans have declined and the Reserve Bank has opened the door for the possibility of rate cuts if needed. Strong growth in incomes will also continue to support consumption.

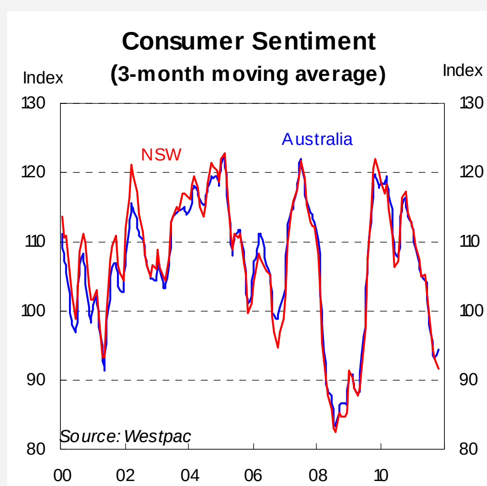
Concurrent with the improvement in sentiment has been a recent pick up in retail sales over July and August. In NSW, retail sales jumped 2.1% over the two months to August. That is the strongest back-to-back growth in retailing since June 2010.

That being said, trend growth in retailing is still soft. In NSW, retail sales are down 0.8% over the year to August in trend terms compared with 1.8% nationally. Both the NSW and national annual growth rates in retail sales are below the long-run average.

A broader measure of consumer spending is the household final consumption expenditure data in the national accounts. It shows that in the year to the June quarter, NSW household spending rose by 2.8%, just below 3.2% growth seen Australia-wide.

Despite the recent pick up in sentiment and retail spending, there continues to be increased uncertainty about the prospects for a resolution to the sovereign debt and banking problems in Europe and the outlook for global economic growth. These factors are likely to keep households cautious for longer and weigh on household spending nationally and in NSW. Continued talk in the press of the possibility of a rate cut, a tight labour market and firm incomes growth will provide some support to consumer spending.





Separate to the cyclical forces at work (and discussed above), retailing is also undergoing a broader structural change related to e-commerce, globalisation and the high Australian

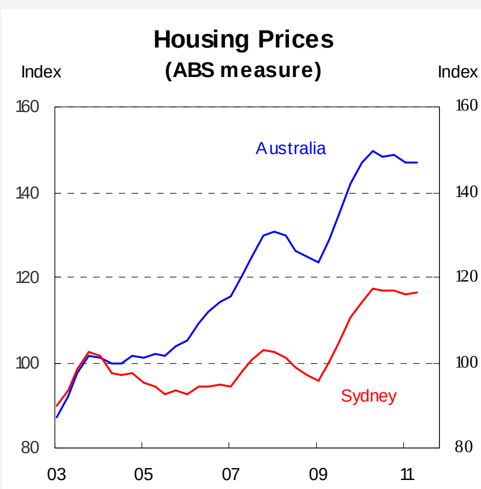
dollar. While foot traffic in retailing is recording modest growth, online sales are growing rapidly. It is estimated that online spending has been growing at an average annual rate of more than 15% since 2005. While online retailing makes up only 3% of overall household consumption, this share is set to get bigger. Online retailing potentially makes it less relevant to have as many multiple physical shopfronts.

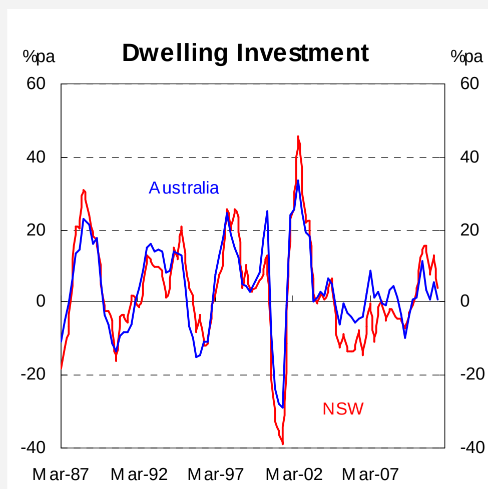
Housing:

House prices across Australia have moderated this year due to the combination of higher interest rates, the expiry of the first-home-owner's boost (FHOB) and low affordability. According to the Australian Bureau of Statistics (ABS) measure, Australian average capital city house prices fell 1.9% in the year to the June quarter. This softening in house prices nationally is replicated in other measures such as the RP-Data-Rismark series, which also revealed prices fell further in the month of August.

House prices in Sydney have moderated in line with the rest of Australia. But Sydney has outperformed the Australian capital-city average according to the ABS, falling by 0.7% in the year to the June quarter. The softness is more dominant in the premium part of the housing market, defined as the 20% most expensive suburbs (according to RP Data-Rismark).

We expect house prices to continue to soften modestly over the next twelve months both across Australia and in NSW, as low affordability continues to hurt. However, the unwinding of market expectations of a rate hike from the RBA from earlier this year has been a positive development for the housing market. The RBA kept rates on hold as expected in October, but has become more dovish in its rhetoric. The RBA has now hinted at the possibility of cutting rates if needed.



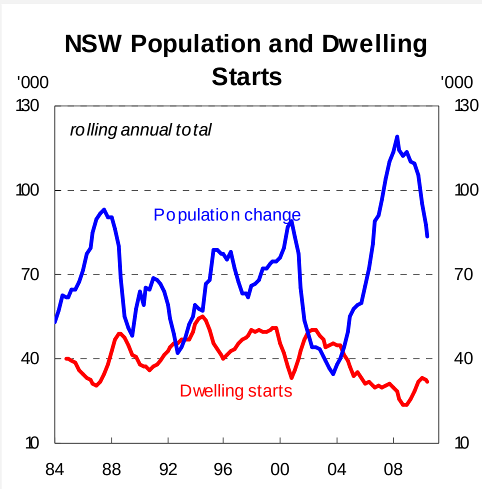


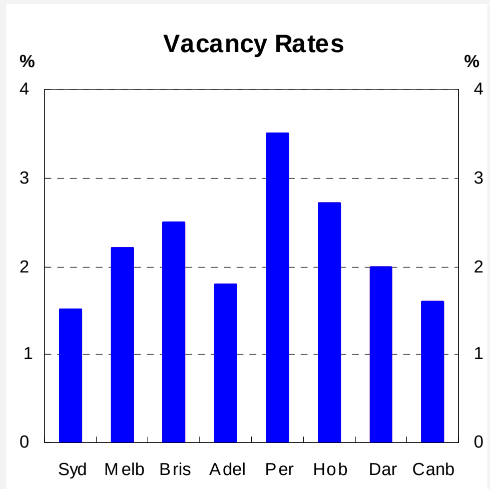
In its Budget, the NSW Government introduced some changes that are likely to impact the NSW housing market. It has limited the transfer duty exemptions for first-home buyers.

From 1 January 2012, first-home buyers buying established dwellings are required to pay stamp duty while only newly constructed homes will be exempt. This measure should support the housing construction industry. However, the removal of the transfer duty exemptions for first-home buyers buying established properties is likely to weigh on first-home buyer demand after January 1 because first-home buyers will be forced to save for longer to meet increased costs associated with buying an existing dwelling. It might also lead to a stronger presence of first-home buyers in the market before 1 January (from a low base), as demand is bought forward to capture the stamp-duty exemption on established dwellings before it ends.

First-home buyers will continue, however, to receive the $7,000 first-home buyers grant for purchases under $835k.

According to the Budget, the NSW Government will also expand the Home Builders Bonus, meaning people aged 55 and over who buy a newly built home costing up to $600,000 will not pay stamp duty on the purchase before 1 July 2012. This was previously only open to those people aged over 65 years.





Importantly for the housing story, a shortage of housing persists in Sydney and nationally. This shortage is particularly acute in NSW at around 88,000 dwellings currently and set to deteriorate to around 113,000 dwellings in 2013. NSW accounts for more than 73% of the national housing shortage.

Population growth has eased from the recent peak in 2008-09 but remains solid. The pick up in dwelling construction has been anaemic at best and means this chronic shortage of housing is set to persist. Dwelling construction should improve modestly in 2011-12 but not by enough to narrow the housing gap between supply and demand.

Housing Shortage (Annual and in '000s) *					
State	**2009**	**2010**	**2011 (e)**	**2012 (f)**	**2013 (f)**
NSW	52.7	75.7	87.9	103.9	113.3
Vic	27.5	30.8	20.2	13.5	12.8
QLD	7.2	5.6	5.7	14.3	22.9
SA	0.6	0.2	-1.7	-2.3	-2.2
WA	8.6	8.7	8.3	13.0	17.0
Tas	-0.6	-0.9	-1.7	-2.1	-2.2
NT	1.6	1.7	2.0	2.7	3.5
ACT	1.9	1.6	-0.4	-2.3	-2.6
Australia	**99.6**	**123.4**	**120.3**	**140.8**	**162.6**

**As at September 2011, Source: ABS, BIS Shrapnel*

The shortage of housing and softening in conditions over the next year means rents are likely to keep rising. Rents have increased over the past year in NSW, for two- and three-bedroom houses and two-bedroom multi-unit dwellings. The tightening rental market is reflected in vacancy rates.

Vacancy rates in Sydney are tight as a drum at 1.5% for the June quarter and are the lowest among all capital cities in Australia. Vacancy rates under 2% are representative of 'super' tight rental markets and suggest that Sydney rents are set to rise further. The tight rental market could help underpin investment demand for housing.

Housing construction has been soft in NSW and most of Australia, which has constrained the supply of housing. Further, house building in NSW has generally lagged behind the rest of Australia for much of the past decade. Some improvement in residential construction occurred throughout 2009-10, but this has since eased following interest rate rises last year and an unwinding of federal-fiscal stimulus. Forward-looking indicators also do not look particularly encouraging.

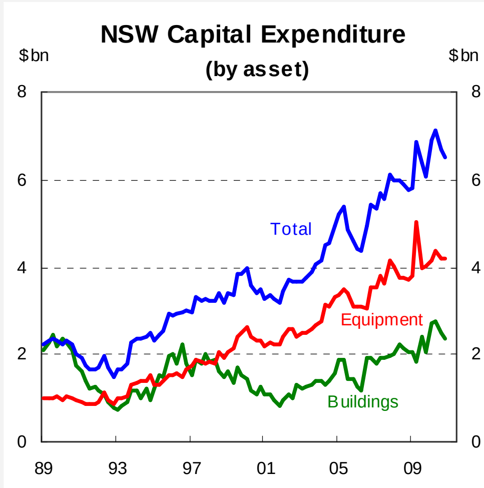
The subdued growth in the housing supply suggests we are unlikely to see house prices weaken substantially; it would be unusual to see a collapse in house prices at a time when unemployment is low and underlying demand is high. Therefore, our prediction is of a softening or moderation in house prices only.

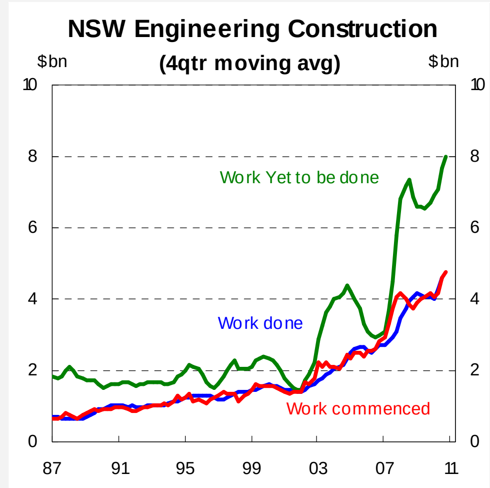
But the tight rental market and shortage of housing means pressures in the housing investment sector are building. Eventually, construction will be forced to shift higher. In the near term, it is unlikely, especially with the backdrop of global woes. But construction levels might start to lift modestly next year, albeit from low levels.

In this year's Budget, the NSW Government also announced it would release 10,000 lots of land over the next four years in outer North-Western and South-Western Sydney (up from its 8,000 new-lot commitment previously), which takes a forward step in addressing the issue of NSW's housing shortage.

The shortage of housing and a tightening of rental markets will likely help establish the conditions needed for a recovery in house prices later next year in NSW. Until then buyers will stay on the sidelines, especially first-home buyers.

Business Investment:





Business investment is the growth engine of the Australian economy. But business investment in NSW recently has lagged behind the rest of Australia. In the June quarter, NSW business investment declined by 1.2% over the year to the June quarter compared with a 10.5% rise over the same time period in Australia.

The mining boom and strong terms of trade in Australia are expected lead to an increase in investment over the coming year nationally and businesses have indicated they intend to raise capital expenditure by 11.8% in 2010-11 and by a large 32.4% in 2011-12. This expected spending is predominantly in mining, but we still expect NSW to also show overall business investment growth over this period.

Investment spending has two parts to it - housing and business. Housing investment has been discussed above. Business investment meanwhile has two components. The first component is engineering construction (covering industrial and resource construction in mining and downstream processing) and engineering work on roads, utilities and the like. The second component is non-residential or commercial building, usually encompassing construction of factories, shopping malls, business estates and schools and the like.

Construction in engineering has been growing strongly, although it has softened in recent quarters in NSW. In the national accounts, construction engineering rose by 17.0% over the year to the June quarter.

Prospects remain positive for construction engineering over the medium term. Work yet to be done in the engineering sector in NSW is estimated at close to $8 billion according to the ABS, the highest since at least the mid 1980s. This work to be started will help underpin economic activity and jobs in NSW.

Works in the pipeline includes a number of key transport projects currently underway, such as the $2.1bn South West rail link and a $1.7bn development of the Hunter Expressway linking the F3 and the Branxton highway. Further, there are a number of mining projects led by the $1.9bn expansion of the Cadia East gold mine near Orange, the development of a $1.1bn Anvil Hill open cut coal mine, a $1bn coal seam gas project near Narrabri and also $900mn to expand the Newcastle coal terminal.

Commercial building approvals in NSW fell back sharply in 2010-11 to the lowest in six years, after an unwinding of federal stimulus. The weakness in the pipeline of new work is flowing through to levels of work underway.

Westfield's $1.2 billion renovation of the Centrepoint, Skygarden and Imperial Arcade buildings in the Sydney CBD remains under construction, with work there due to be completed in mid-2012. Other major projects under construction are led by the health sector, including the long-term upgrade of the Royal North Shore Hospital and the $400 million second stage of a redevelopment of the Liverpool Hospital. The Wagga Wagga Base Hospital is being redeveloped and the third stage of the Nepean Hospital redevelopment is underway.

Key Forecasts:

St.George Banking Group Forecasts:

	Long Run	*Actual*		Forecasts	
Economic Indicators:	**Average**	***2009-10***	***2010-11***	**2011-12**	**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 2.75% this financial year and 3.50% next financial year. For gross state product, a more comprehensive measure of economic activity (but less frequently published measure), the NSW government expects growth of 2.50% this financial year and 3.00% next financial year.

Our own forecasts are slightly below the Government's official forecasts and are detailed in the table.

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