Macro
Economics – Australia

HSBC Global Research

Australia in 2015

Still rebalancing

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Paul Bloxham
Chief Economist, Australia and New Zealand
HSBC Bank Australia Limited
+61 2 9255 2635 paulbloxham@hsbc.com.au

Daniel Smith
Economist
HSBC Bank Australia Limited
+61 2 9006 5729 daniel.john.smith@hsbc.com.au

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- **Iron ore and coal prices fell sharply in 2014, which has been a drag on the resources sector and national income**
- **But this is being largely offset by rising resource export volumes, a housing boom and rising consumer spending**
- **We forecast GDP growth to remain at 2.8% in 2015, rising to 3.2% in 2016, as growth rebalances away from mining**

Absorbing a commodity price fall

Falling iron ore and coal prices have been a drag on Australia's national income and present a challenge to the country's growth prospects. The decline in commodity prices has seen nominal GDP grow more slowly than expected, corporate profits weaken and tax revenues fall. Mining investment has also declined after a substantial ramp-up in previous years.

A number of factors have, however, largely offset the negative impact on real GDP. First, resources export volumes have risen sharply as new capacity has come on line. Second, a record-low RBA policy rate and low market rates have driven a strong pick-up in housing prices and construction, and solid growth in consumer spending. Finally, non-mining business conditions have improved, supported by low interest rates and a lower AUD.

This rebalancing of growth is expected to continue in 2015 and 2016. Resource export growth is also expected to be supported by a substantial ramp-up in exports of liquefied natural gas, adding 0.8ppts to GDP growth in 2015-16.

A continued low RBA cash rate is expected to support strong housing market activity and, along with a lower AUD, should drive a rise in non-mining business investment and a pick-up in hiring. Lower oil prices are expected to be positive for households and most businesses, supporting domestic demand. Federal and state government spending on infrastructure should support demand as well, particularly in the second half of the year. We expect GDP growth to remain below trend in 2015, at 2.8%, rising to 3.2% in 2016.

Mining takes a hit

- Commodity prices have fallen in recent months and mining investment is declining, after a sizeable ramp-up in previous years
- The impact on GDP growth is being partly offset by a strong rise in resource export volumes and falling capital imports
- Activity in the non-resources sectors is also gradually picking up pace, supported by low interest rates and a falling AUD

Australia's commodity export prices have fallen sharply

Commodity prices fell sharply through 2014, driving a further decline in Australia's terms of trade (the ratio of export to import prices) (Chart 1). Over the year to the third quarter of 2014, the terms of trade fell by 9% and we expect a further decline took place in the fourth quarter. Although commodity prices remain historically high, they are now well below their 2011 peaks.

1. Commodity prices have fallen by more than expected

Source: ABS

For Australia, the most important declines in commodity prices have been in the iron ore and coal markets, given their high weights in Australia's export basket. Iron ore, which accounts for around 20% of Australia's total exports, saw its price fall by 50% last year. Coking coal, which accounts for 7% of exports, saw a price fall of 17%, and thermal coal, which accounts for 5% of exports, had a price fall of 26% in the past year.

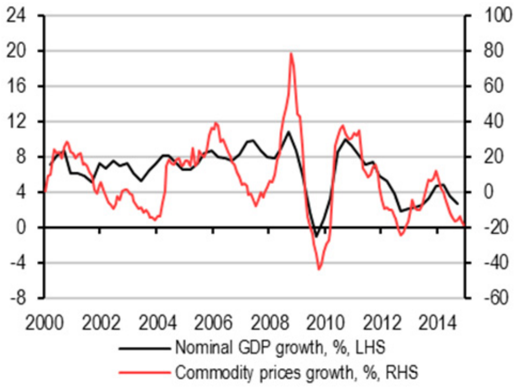
Oil prices, which are down by 55% over the past year, have a less clear impact on Australia's economy. Australia is a net importer of petroleum products, so lower oil prices benefit Australian consumers (discussed further below). However, Australia is a net energy exporter, so to the extent that lower oil prices put downward pressure on coal and gas prices, lower oil prices could reduce local incomes.

The overall decline in the prices of Australia's commodity export basket is a net drag on national income. Nominal GDP growth is highly positively correlated with commodity prices, with the recent falls in prices implying that a further weakening in nominal GDP growth is likely in the near term (Chart 2). The Q3 GDP print saw nominal GDP actually fall by 0.1% q-o-q to be only 2.7% higher y-o-y (by comparison, real GDP rose by 0.3% q-o-q to also be 2.7% higher y-o-y).

Put simply, although Australia's output has been growing, falling commodity prices have meant that less income is being accrued for any given rise in output.

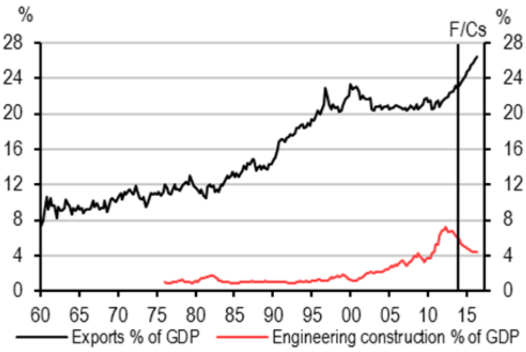
The fall in commodity prices and incomes comes at a time when mining investment is already in decline in Australia, following a sizeable ramp-up in 2011 and 2012 (Chart 3). Engineering investment, which is mostly in the mining sector, fell by -16% y-o-y in Q3. As the current stock of resources sector projects is completed and fewer new projects get started, mining investment is expected to continue to fall through 2015 and into 2016.

2. Lower commodity prices are a drag national income



Source: ABS, RBA

3. Mining investment fall is being offset by export ramp-up



Source: ABS, HSBC estimates

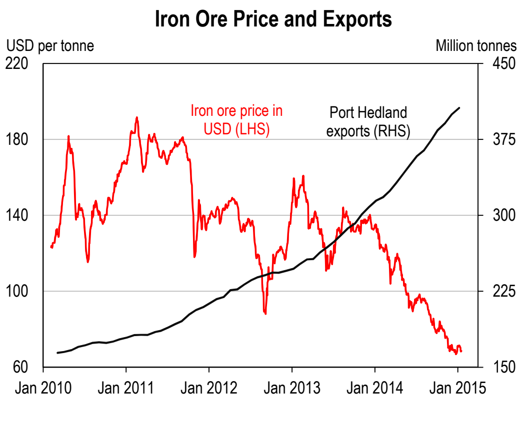
Impact of falls is being partly offset

There are a number of factors that are expected to offset the impact on the economy of the fall in commodity prices and the decline in mining investment.

First is the ramp-up in resources exports, as new capacity continues to come on line. Our estimates suggest that, up to the third quarter of 2014, the fall in mining investment has been more than offset by the strong rise in iron ore and coal export volumes, as new capacity has ramped up. Over the past year, iron ore export volumes have risen by 29% (Chart 4).

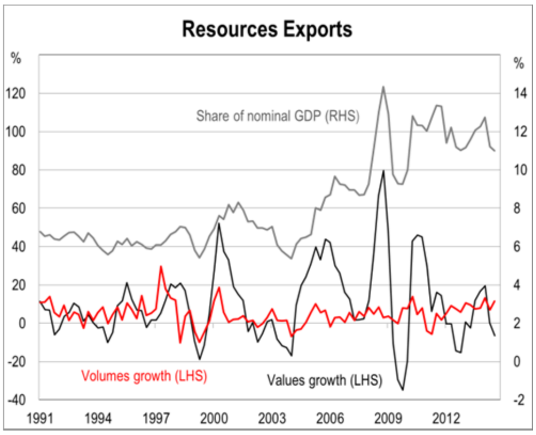
Indeed, a key reason why iron ore prices have fallen is that Australia's export volumes have ramped up. As Australia is the world's largest exporter of iron ore, a strong rise in production affects global prices. So far, the ramp-up in resources export volumes has been enough to largely offset the impact of the falling export prices, such that resources exports have remained a high share of GDP (Chart 5).

4. Iron ore export volumes have risen strongly



Source: Bloomberg, Pilbara Ports Authority

5. Export volume ramp-up largely offsetting the price fall



Source: ABS

A second factor offsetting the impact of the decline in mining investment is that capital imports have fallen over the past year, as mining investment has declined. This reduces the domestic impact of the fall in mining investment.

In terms of real GDP, we estimate that the decline in investment so far has been more than offset by the combination of rising export volumes and falling capital imports, such that mining GDP (in real terms) is still growing, albeit much more slowly than in 2011 and 2012.

In 2015, we expect this story to continue. Mining GDP should continue to get support from rising export volumes, particularly as Australia's new liquefied natural gas (LNG) plants are expected to begin to come on line in coming quarters. The seven major LNG projects being built in Australia are scheduled to begin ramping up production from 2015, and we expect this to result in a 330% rise in LNG exports by 2019.

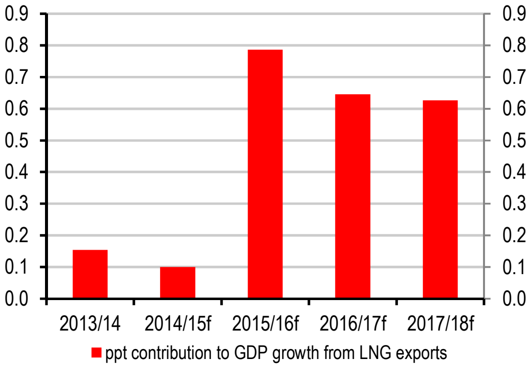
Our estimates suggest that LNG exports will go from contributing around 0.1ppts to Australia's GDP growth in 2014-15 to 0.8ppts in 2015-16 (Chart 6). As all seven of Australia's new major LNG plants gradually come on line, we expect LNG exports to contribute an average of around +0.7ppts to real GDP growth in each of the coming three years. For more details on Australia's LNG story, see our report *Downunder digest: Australia's LNG export boom to begin*, 30 October 2014.

In short, we expect that real GDP will continue to be supported by the mining sector in coming years, despite the fall in investment and commodity prices, as resources export volumes are expected to rise and capital imports are expected to fall.

The outlook for nominal GDP is, however, more complicated, as it relies on forecasts for commodity prices and currencies.

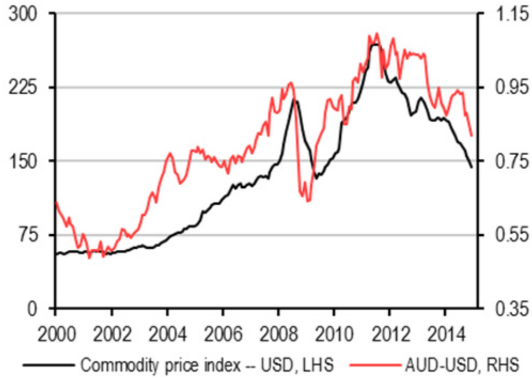
As shown above, in Chart 2, the fall in commodity prices already implies a drag on nominal GDP growth. Part of the problem is that the AUD has not fallen in line with the recent decline in commodity prices (Chart 7). Prices of Australia's commodity exports have fallen by 25% in USD terms over the past year, which has only been partly offset by the 8% depreciation of the AUD against the USD. Further declines in the AUD, as we expect will occur over the coming year, would help to mitigate the impact of falling commodity prices on domestic income growth.

6. LNG export ramp-up is just beginning



Source: BREE, HSBC estimates

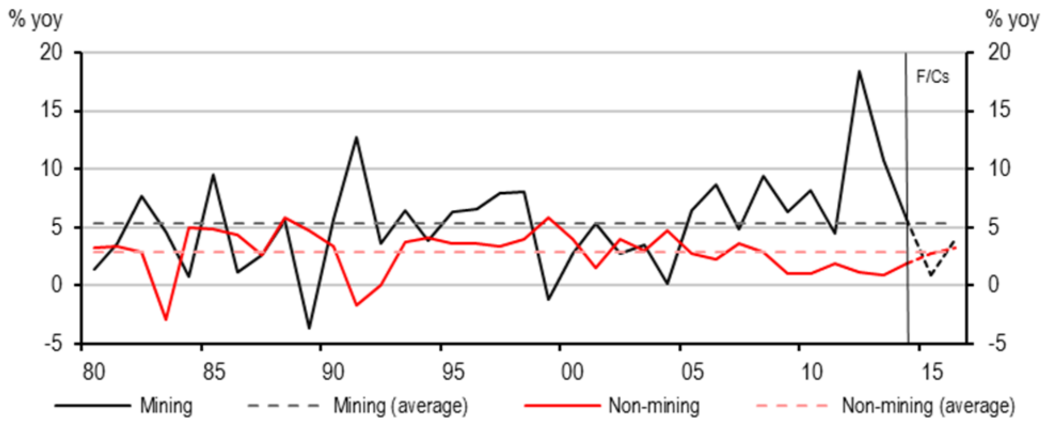
7. A lower AUD will help support local incomes



Source: ABS, RBA

We continue to expect growth to rebalance from the mining to non-mining sectors of the economy in 2015 and 2016 (Chart 8). Growth in mining GDP is expected to slow to only a small positive rate this year, while non-mining GDP is expected to gradually lift to above its long-run average pace.

8. Mining GDP is slowing, while other sectors gradually lift



Source: ABS, HSBC estimates

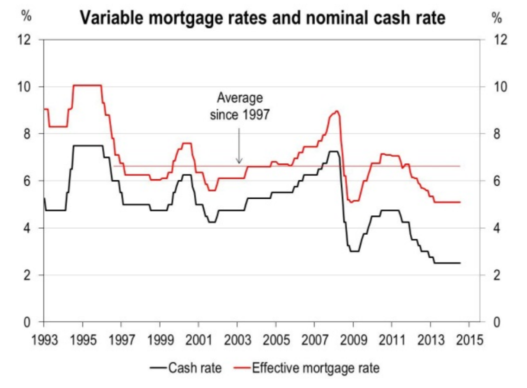
Activity in non-mining sectors is lifting

- Low interest rates are supporting a pick-up in housing market activity, consumption, business conditions and credit growth
- Further depreciation of the AUD should help to further support the domestic economy through improved competitiveness
- Nonetheless, we expect below-trend growth in 2015, as the pick-up in non-mining activity is working against a significant fall in mining investment and recent falls in commodity prices

Monetary policy is working

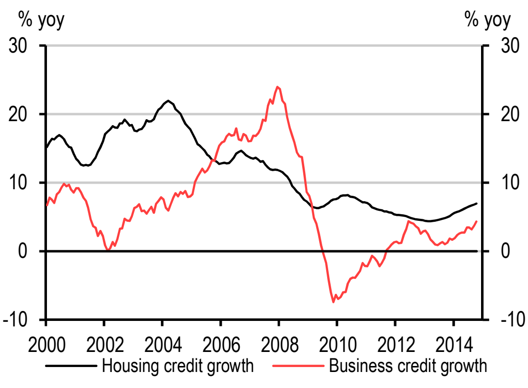
To offset the impact of the anticipated slowdown in mining sector activity, the RBA has held its cash rate at 2.50%, its lowest level in history, since August 2013 (Chart 9). There are clear signs that loose monetary policy is working. Growth is rebalancing away from the mining sector towards the non-mining sectors, although this process has been only gradual. One sign that monetary policy is working is that credit growth has picked up in recent months, running at 5.9% y-o-y in November, up from 3.5% a year earlier. Housing credit has picked up most strongly, although business credit has also started to rise recently (Chart 10).

9. Interest rates are at record-low levels



Source: RBA

10. Credit growth is rising as monetary policy is working



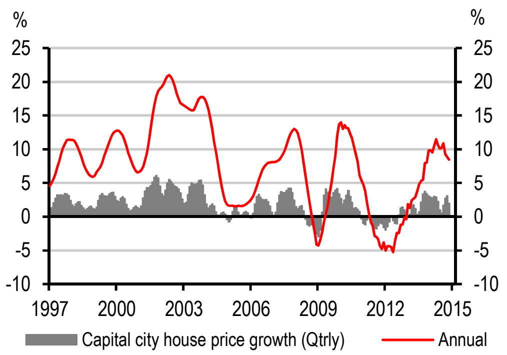
Source: RBA

Housing activity strong

Loose monetary policy has also had a clear impact on the housing market. Mortgage rates are at their lowest levels in over 50 years, due to the record-low cash rate and falling funding costs, which have seen market rates decline further recently.

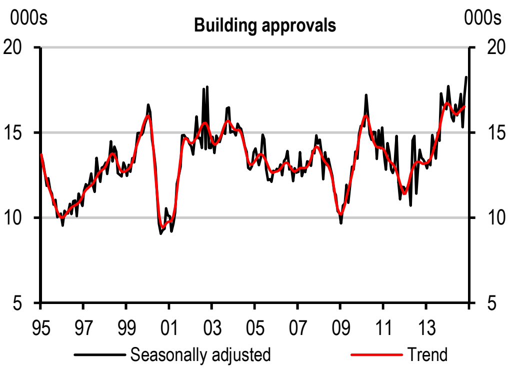
Housing prices have risen by 21% since their trough in mid-2012 and are rising at a y-o-y pace of 8% (Chart 11). The upswing in prices looks largely like a normal-looking housing price cycle, given the current level of interest rates. Housing price growth has been strongest in Sydney (12% y-o-y) and Melbourne (8% y-o-y), in part reflecting that Australia's growth is shifting towards these states and away from the mining states of Western Australia and Queensland. Although the Sydney market is continuing to display some speculative dynamics that remain somewhat worrisome, there are some early signs that the Sydney market has cooled a little recently.

11. Housing prices are still rising strongly



Source: Core-Logic

12. A dwelling investment upswing is underway



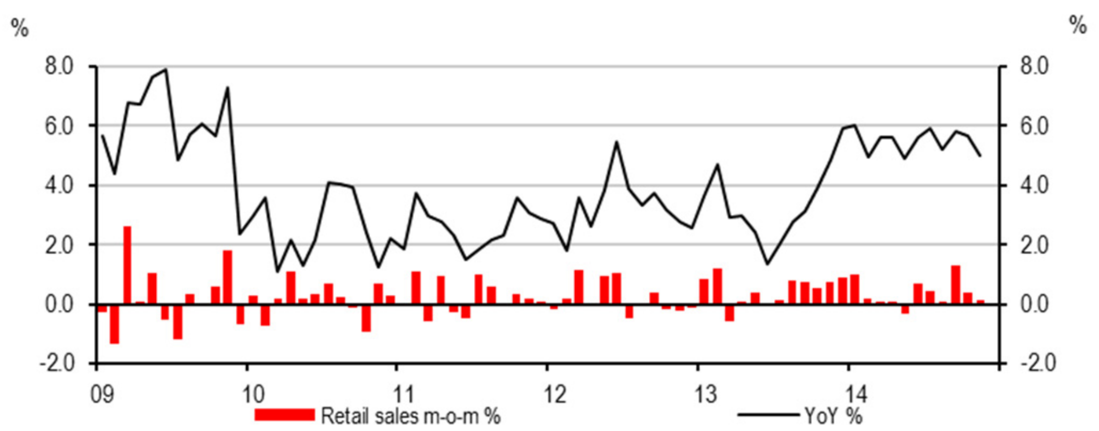
Source: ABS, HSBC estimates

Low interest rates and rising housing prices have also supported a strong increase in dwelling investment (Chart 12). We expect this ramp-up in housing construction to continue into 2015 as we expect mortgage rates to remain low and population growth to remain strong. This ramp-up should help to meet new demand for housing that is being driven by strong population growth and low interest rates, as well as foreign investment. Most estimates suggest that Australia still has an 'under-supply' of housing.

Consumption is lifting

Low interest rates, rising housing prices and a pick-up in housing construction are also supporting a modest lift in household consumption. Retail sales have increased solidly in recent months, with particular strength in purchases of household durable goods (Chart 13). As housing prices continue to rise and more houses are built, a rise in durable goods purchases is what should be expected and is another sign that monetary policy is working. There is also clear evidence in the retail numbers that growth is rebalancing geographically from mining to non-mining states. Growth in retail sales over the past year has been strongest in New South Wales (8.8% y-o-y), followed by Victoria (5.8% y-o-y) and weak in Western Australia (1.0% y-o-y). For more details on the performance of each state, see the final chapter of this report.

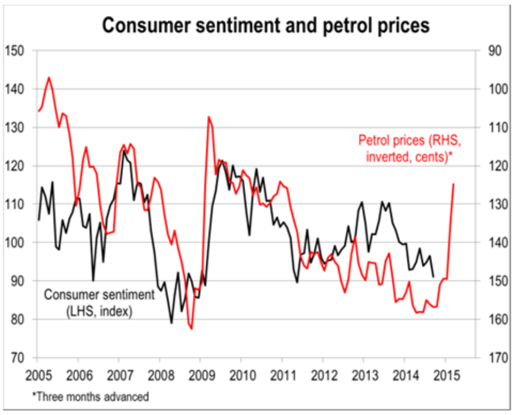
13. Retail sales have been growing at a solid pace recently



Source: ABS

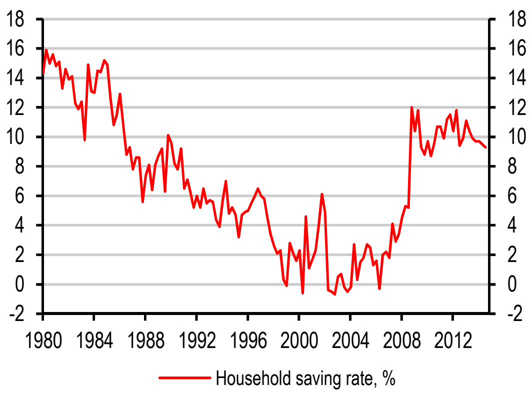
A key support for household spending has been the reduction in the household interest burden that has resulted from low interest rates. The household interest burden is currently at its lowest level since 2003. The recent fall in oil prices is also expected to be a support for household disposable incomes. Retail petrol prices have fallen by 25% since mid-2014, which is expected to boost household disposable incomes by around 0.8%. Historical comparisons show that falling petrol prices are typically positive for consumer sentiment (Chart 14). The recent fall in oil prices is, therefore, expected to be another support for Australia's great rebalancing act. For more details on oil and Australia, *Downunder digest: Lower oil prices should support Australia's rebalancing act*, 13 January 2015.

14. Lower petrol prices should support consumer sentiment



Source: ABS, Thomson Reuters Datastream

15. Household saving is edging downwards but remains high



Source: ABS

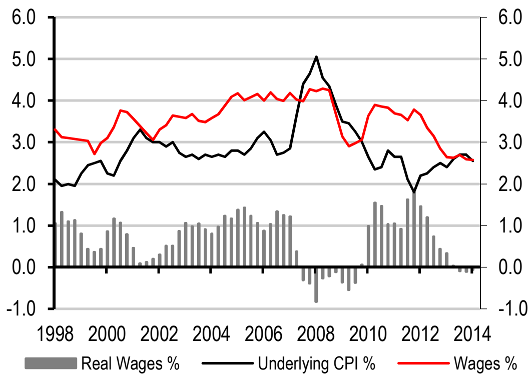
Households may choose to either spend or save the additional disposable income that lower petrol prices and low interest rates leave them. Recent patterns suggest that households are likely to save around 9% of the boost they receive (Chart 15). The fall in interest rates appears to have encouraged households to reduce their saving rate from 11.8% in Q2 2012 to 9.3% in Q3 2014. Given the ramp-up in household saving in 2008 and 2009, there remains significant scope for households to run down saving to support consumption growth in the face of slower income growth. Lower commodity prices and slower growth in national income are already having some impact on labour incomes, with employment growth and wages only weak in recent quarters.

The labour market is loose, but its direction is hard to read

Weaker growth in national incomes, caused by falling commodity prices, is mostly impacting corporate profits, particularly of mining companies, but it has also reduced labour income growth. Wages growth has been particularly weak in recent quarters, with the wage price index running at the slowest pace in its 17-year history of 2.6% y-o-y (Chart 16). With wages growth running at around the same rate as underlying inflation, real wages have been stagnant recently. Weak wages growth is a clear sign that the labour market remains loose, although wages growth does appear to have stabilised in recent quarters, suggesting it may not be loosening further.

However, getting a clear read on the direction of change in the labour market has been made complicated by significant measurement issues in the official labour force survey in recent months. The latter months of 2014 saw significant revisions to recent employment growth estimates in the official labour force survey and to the unemployment rate. The latest estimates suggest the unemployment rate rose from 5.7% at the beginning of 2014 to 6.1% in December. However, other timely indicators of the labour market, such as the job advertisements, vacancies indicators and business surveys, suggest more stable labour market conditions. Chart 17 shows job advertisements, which have been lifting modestly through the year, in contrast to the apparent rise in the official unemployment rate.

16. Wages growth has slowed over the past couple of years



Source: ABS

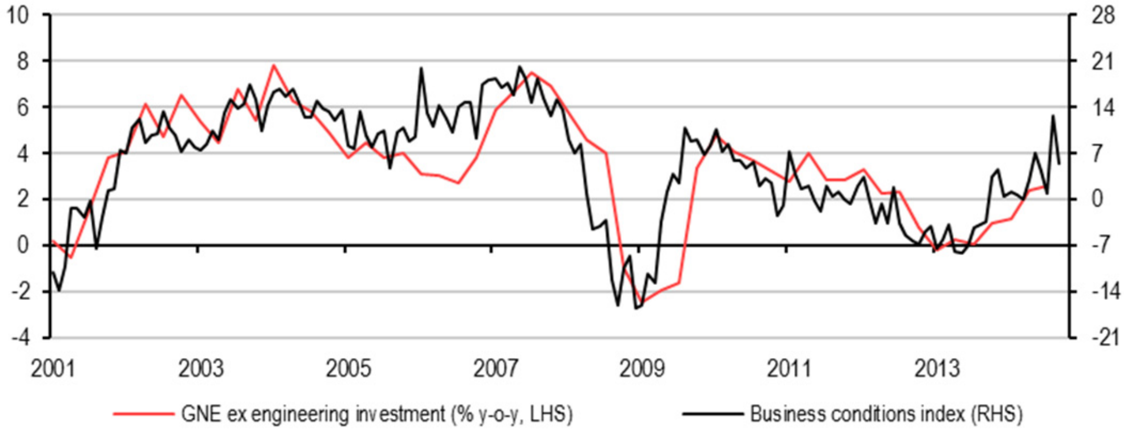
17. Is the labour market deteriorating or stabilising?

Source: ABS, Thomson Reuters Datastream

Business conditions are improving outside of mining

Broad metrics of conditions outside of the mining sector also suggest that growth is rebalancing. The NAB survey of businesses has shown an improvement in business conditions in recent months (Chart 18). The lift in business conditions through the year has been broadly in line with the lift in gross national expenditure, excluding engineering investment (which is our timely proxy for non-mining domestic demand).

18. Business conditions are gradually lifting as growth rebalances towards the non-mining sectors



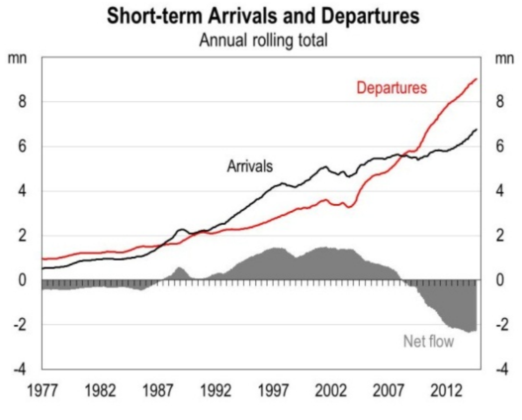
Source: ABS; Thomson Reuters Datastream

Lower AUD should support rebalancing

A lower AUD is expected to support local growth. As we described in the first chapter above, one channel is through the effect on local incomes from commodity exports. Because Australia's commodities are largely sold in USD terms, a fall in the AUD relative to the USD can boost local currency returns for any given commodity price. Given the fall in USD commodity prices, a fall in the AUD is welcome news as it helps to offset the negative income effect of lower commodity prices.

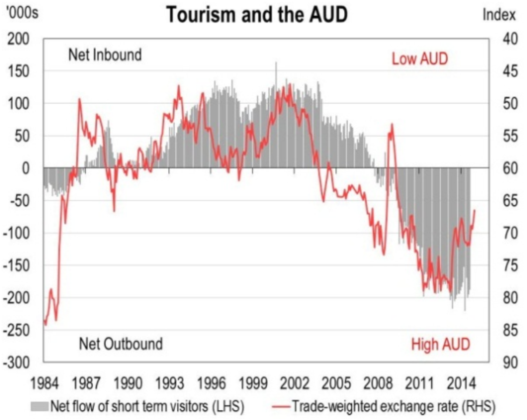
Another channel is through the improvement in global competitiveness for local businesses. This assists exporters and import-competing industries. Beneficiaries should include education exports and tourism industries, amongst others. In recent years the high AUD has encouraged a significant ramp-up in international travel by domestic residents, while arrivals had been somewhat held back (Chart 19). A falling AUD should be expected to continue to reduce the drag on the economy from net departures, which should support the local economy (Chart 20).

19. Departures have been strong in recent years



Source: ABS

20. Lower AUD could encourage less net outbound tourism



Source: ABS, RBA

Still sluggish in 2015, picking up in 2016

Although there are signs that Australia's growth is rebalancing, the pace has been only gradual. At the same time, the recent fall in commodity prices has weakened income growth, which is likely to weigh on output growth in 2015. Although we remain optimistic that commodity prices will stay historically high and we are expecting a modest lift in iron ore prices in 2015, prices are still expected to be lower than previously thought. In addition, we have recently revised down our forecasts for Chinese GDP growth from 7.7% in 2015 to 7.3%.

We expect Australian GDP growth to continue to run at a below-trend pace of 2.8% in 2015, before lifting to 3.2% in 2016 (Table 21). Growth is expected to gradually rebalance from being led by mining to being driven by the non-mining sectors of the economy. CPI inflation is expected to be 1.9% in 2015, rising to 3.0% in 2016. Lower inflation in 2015 reflects the impact of the fall in oil prices and slower local growth, but this is partly offset by the effect of the lower AUD on imported goods prices. In 2016, the pick-up in local growth and a lower AUD are expected to lift inflation.

21. Main Australian forecasts

	2013	2014f	2015f	2016f
GDP (%)	2.1	2.8	2.8	3.2
CPI (%)	2.4	2.5	1.9	3.0
Trimmed mean (%)	2.4	2.7	2.4	2.9
AUD/USD*	0.89	0.82	0.78	0.75
Cash rate* (%)	2.50	2.50	2.50	3.50

Source: ABS, RBA, HSBC forecasts. *end-period

We remain upbeat about the medium-term outlook

We remain upbeat about Australia's medium-term prospects, as growth is expected to continue to be supported by increasingly strong ties to Asia. Trade links to Asia are still growing, with a further ramp-up in exports of iron ore, coal and LNG on its way, and we expect rising demand for Australian food, tourism and education as Asia's middle-class incomes rise. Australia's population is becoming more Asia-integrated due to strong migrant flows, which should also help to facilitate greater trade and financial ties. While direct financial linkages to Asia are still small, we expect them to strengthen as Asia's financial system matures. For more on the medium-term outlook for Australia, see our report *Australia's growing links to Asia: Powering growth*, 17 July 2014.

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A challenging rebalancing for policymakers

- The RBA's cash rate is expected to remain low, supporting the rebalancing of growth; we still expect the RBA's next move to be up, rather than down, but not until Q1 2016
- Lower commodity prices are weighing on tax revenues, presenting the government with a fiscal challenge
- Fiscal consolidation may need to be delayed until growth recovers to an above-trend rate and the government ought to remain focused on investing in infrastructure

The RBA looser for longer or will it cut further?

We expect the RBA to maintain its current cash rate setting through 2015, and that rates may need to rise in Q1 2016 as growth is expected to pick up pace.

The recent fall in commodity prices has prompted the market to price in cuts, rather than hikes, from the RBA in 2015. We continue to expect that the RBA is unlikely to deliver further interest rate cuts, although clearly the risk of more cuts has increased. There are a numbers of reasons why we expect the RBA will be reluctant to cut rates further.

First, in the RBA's own words, interest rates are already 'very' low and monetary policy is already working. In much of the RBA's recent commentary, it has noted that businesses are reporting that the level of interest rates is not a factor that is constraining their willingness to increase hiring or investment. As interest rates are not the constraint, it may be that lowering them could achieve little in supporting the business sector.

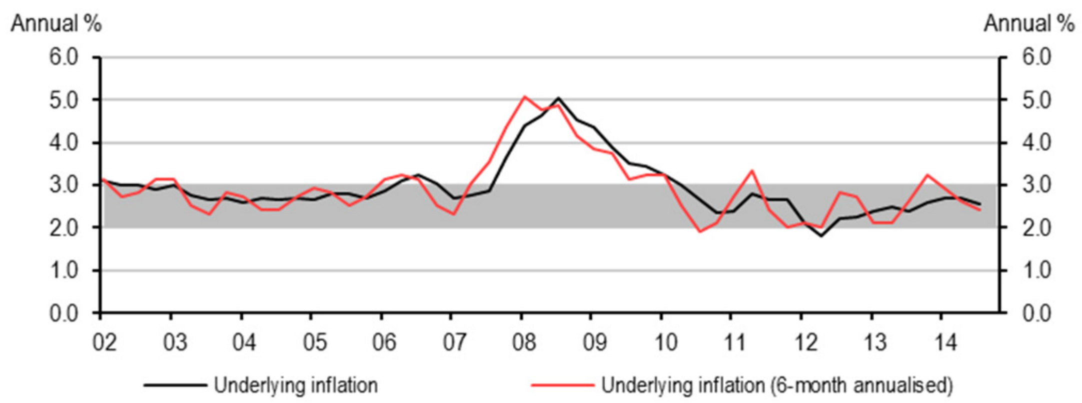
Second, as the RBA has also noted, there are clear signs that low interest rates are already doing their job of supporting a rebalancing of growth. Low interest rates are lifting the housing market, supporting a strong upswing in residential construction, lifting business conditions and driving a pick-up in credit growth (as we have noted above).

Third, further rate cuts could risk over-inflating the housing market, which has already been booming, particularly in Sydney. Although the prudential authorities have recently announced more stringent guidelines for bank mortgage lending (that is, tighter micro-prudential settings), we doubt the central bank will then want to work against the prudential authority's efforts by cutting rates further.

Finally, it seems clear that the RBA would like looser financial conditions to come via a lower AUD, which does appear to be slowly happening. Despite all of this, the idea of cuts cannot be completely dismissed. The key things to watch are:

- Further signs that growth is rebalancing (business surveys, credit growth, etc.)
- Indicators of the labour market, particularly job advertisements and business surveys, rather than the official data, which appear currently to have measurement issues
- The AUD, as a much lower currency would probably do much of the work for the RBA
- The Q4 2014 CPI inflation print, due in late January, as a low inflation number could give the RBA fewer excuses not to cut rates further (Chart 22)

22. Inflation is low enough to leave the RBA with options, but our central case remains that further rate cuts are unlikely

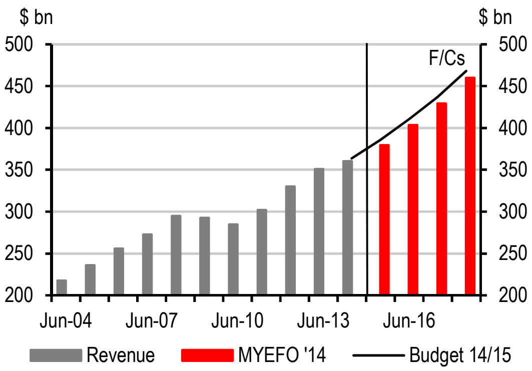


Source: ABS

A growing fiscal challenge

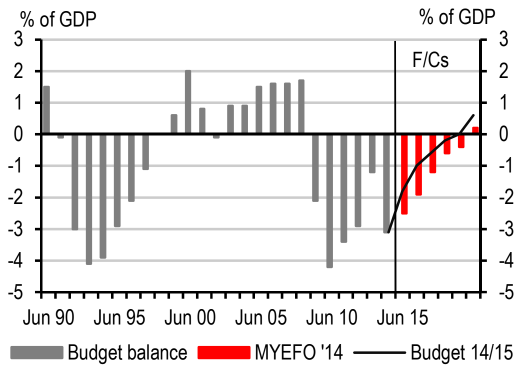
Slower national income growth has also increased the fiscal challenge faced by the Australian government. Commodity prices and wages growth have both surprised the government on the downside, leaving the government with less tax revenue than expected in the latest budget estimates (Chart 23). Underlying government spending has been broadly on track, but the government has been unable to make as many spending cuts as it previously planned, given political challenges in the senate.

23. Revenue forecasts have been downgraded



Source: Australian Treasury

24. Budget deficit now expected for longer



Source: Australian Treasury

The latest government estimates show that the fiscal deficit is expected to narrow only slightly this financial year (2014-15) to 2.5% of GDP from 3.1% of GDP in 2013-14. This is a ‘blowout’ from the May 2014 budget estimates, which had the budget deficit narrowing to 1.8% of GDP (Chart 24). Further out, the government is expecting more gradual consolidation than previously, with a budget surplus not expected until 2019-20.

Infrastructure investment set to pick up

Despite the fiscal challenges, Australia’s state and federal governments are planning to increase infrastructure spending over coming years. The federal government has recently committed AUD3.7bn to various projects, including the West-Connex urban road project in Sydney. Meanwhile, the state governments are selling old assets to fund new projects, with the federal government subsidising a number of these asset ‘recycling’ programmes.

The federal government estimates total infrastructure spending will amount to around AUD125bn (8% of GDP) over the next four years. Infrastructure spending should help to support the rebalancing of Australia’s growth away from the mining sector, with the strongest impact expected in the second half of 2015 and into 2016. For more on the infrastructure outlook see our report *Downunder digest: Australia’s infrastructure challenges*, 15 October 2014.

The states at a glance

- Australia's rebalancing of growth favours the non-mining states
- New South Wales is expected to be the strongest performer, supported by a booming housing market and a ramp-up in infrastructure building, followed by Victoria
- Western Australia is expected to see tougher times, while Queensland's coal and LNG sectors are also likely to be under pressure; South Australia's growth is expected to track sideways

New South Wales: Leading the way

Quick stats: *31% of national GDP; 2.1% annual growth in Gross State Product (GSP) in 2013-14; population of 7.5m (32% of Australia's total); unemployment rate averaged 5.9% in Q4 2014 (up from 5.8% a year earlier)*

Economics: New South Wales (NSW) has generally grown at a rate below the national average over recent years. This partly reflects that mining is a comparatively small industry in NSW and that Sydney, Australia's financial capital, was among the hardest hit during the financial crisis (Chart 25). However, NSW is one of the states that now stand to benefit the most from the transition away from mining to other sources of growth. Low interest rates are already spurring a housing boom, with prices rising 12% in Sydney over 2014. Residential construction activity has ramped up and building approvals remain at high levels, despite levelling out recently. Households are clearly feeling the benefit of low rates too: retail sales were up by 8.8% y-o-y in November, by far the strongest performance across the states.

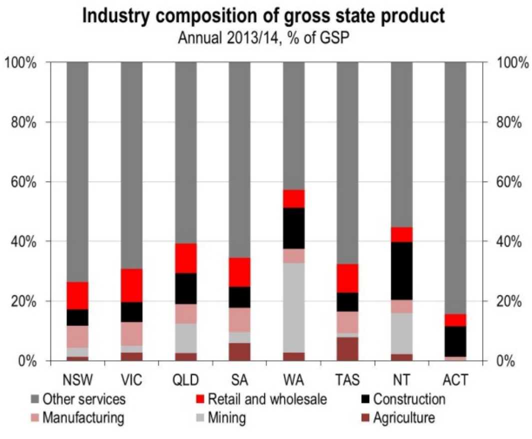
Politics/policy: A NSW state election is due on 28 March 2015. The key issue is likely to be the incumbent coalition's plan to partly privatise state-owned electricity assets and use the proceeds to fund major infrastructure projects. This 'recycling' initiative is expected to total around AUD20bn, most of which is expected to be spent building transport infrastructure.

Victoria: Modest recovery underway

Quick stats: *22% of national GDP; 1.7% annual growth in GSP in 2013-14; population of 5.8m (25% of Australia's total); unemployment rate averaged 6.7% in Q4 2014 (up from 6.3% a year earlier)*

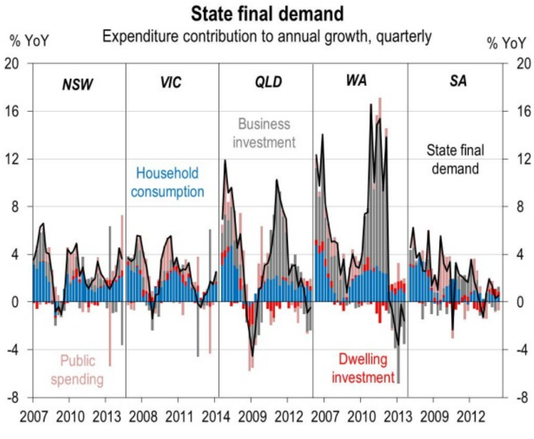
Economics: With no significant mining industry, Victoria has had below-average growth since the global financial crisis. In the decade up to 2007-08, the state averaged growth of +3.6% a year, but since then has averaged just +1.9% a year. The unemployment rate has also been rising steadily since 2010. However, as in NSW, activity does appear to be picking up as the national economy transitions away

25. Mining largest in WA and QLD; services in NSW and VIC



Source: ABS

26. NSW and VIC SFD rising, while QLD and WA contract



Source: ABS

from mining-led activity and low interest rates provide support for growth. Melbourne house prices rose by 8% last year, which has helped support solid retail sales growth of around 6% y-o-y, despite an elevated unemployment rate. The rate of house price growth did slow over the second half of 2014, which may in part be due to strong growth in the supply of housing. In the 12 months to November, 59,000 dwellings were approved, which was 19% more than over 2013.

Politics/policy: Victoria held a state election in November 2014, in which a one-term coalition government lost to the Labor Party. This was the first time in 60 years that a Victorian government only had one term in power. One of the major election issues was the East-West Link, which is a AUD7bn Melbourne road project that the Labor Party has now cancelled (in line with the party's election platform), which may impact activity in the short term.

Queensland: Mining down, tourism up

***Quick stats:** 19% of national GDP; 2.3% annual growth in GSP in 2013-14; population of 4.7m (20% of Australia's total); unemployment rate averaged 6.7% in Q4 2014 (up from 5.9% a year earlier)*

Economics: Along with Western Australia, Queensland has benefited from significant mining sector investment over the past few years (Chart 26). In the post-global financial crisis period, growth peaked at 4.7% a year in 2011-12, at the height of the mining investment boom, although this was still below the pre-financial crisis decade average of 5.2%. Growth in state final demand has now begun to fall as mining investment declines. Total private sector capital formation fell by 7.5% y-o-y in Q2 2014. This drop-off in activity is clearly weighing on activity elsewhere: retail sales growth is running at just 1.6% y-o-y and the unemployment rate rose from 6.0% to 6.7% through 2014 (Chart 27). Low interest rates are providing some support to other sectors, with house price gains of 4.8% over 2014 and a modest upswing in construction activity. The lower AUD should also help support the state's tourism sector.

Politics/policy: A state election is expected on 31 January 2015. As in NSW, the incumbent Liberal National Party is campaigning on a major infrastructure construction agenda to be funded by long-term leasing of state-owned assets, including ports and electricity assets. The planned asset leases are projected to generate as much AUD37bn, the majority of which would be used to pay down part of the state's debt.

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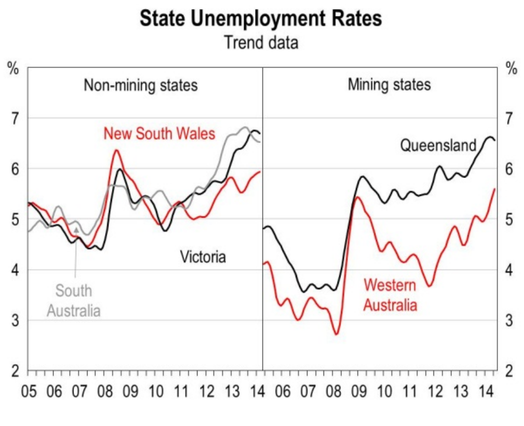
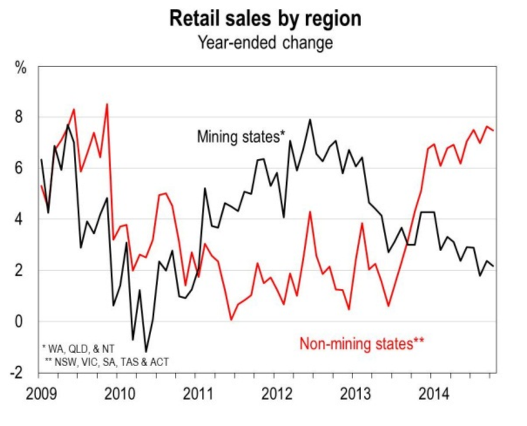
27. Unemployment rate trending higher in Western Australia



Source: ABS

28. Retail sales growth supported by the non-mining states



Source: ABS

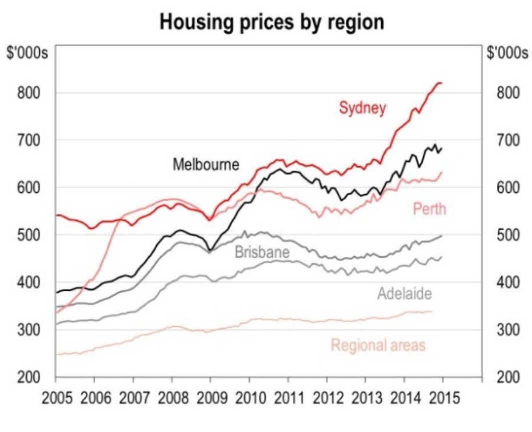
Around AUD8.6bn is expected to be 'recycled' into new infrastructure projects. The opposition Labor Party opposes the asset sales programme.

Western Australia: Tougher times ahead

Quick stats: *16% of national GDP; 5.5% annual growth in GSP in 2013-14; population of 2.6m (11% of Australia's total); unemployment rate averaged 5.5% in Q4 2014 (up from 4.7% a year earlier)*

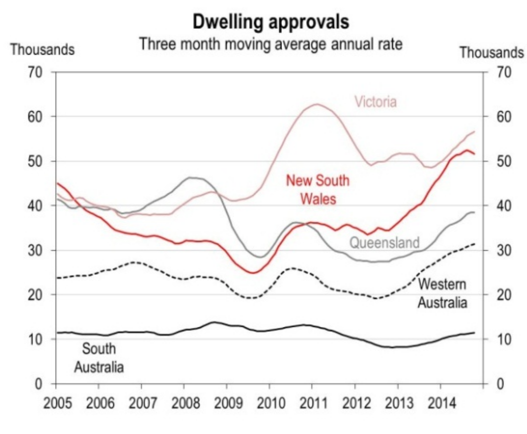
Economics: With mining accounting for 31% of the state's economy, Western Australia is likely to be hardest hit by the mining slowdown. Overall private capital formation declined by 7.0% y-o-y in Q2 2014 and the unemployment rate has risen from 3.7% in mid-2012 to 5.6% at the end of 2014. Despite these headwinds, employment growth has remained fairly robust at 2.8% over 2014, strongest amongst the states. Growth in mining exports continues to drive strong growth in GSP, but state final demand actually fell by 1.9% in 2013-14, largely due to the decline in mining investment. House price growth in Perth is slow, at just 2.1% y-o-y, and retail sales rose at only 1.0% y-o-y in November 2014 (Chart 28 and 29). Nonetheless, low interest rates are lifting housing construction (Chart 30).

29. House price rise strongest in NSW and VIC



Source: RP-Data Corelogic

30. Dwelling construction lifting in all states, led by NSW



Source: ABS

Politics/policy: The current Liberal government won a second term in March 2013. The state's finances have been severely dented by the sharp fall in iron ore prices over the past year, which is resulting in much lower royalty revenues than previously expected. The state received a rating downgrade by Moody's from Aaa to Aa1in August 2014.

South Australia: Tracking sideways

***Quick stats:** 6% of national GDP; 1.3% annual growth in GSP in 2013-14; population of 1.7m (7% of Australia's total); unemployment rate averaged 6.6% in Q4 2014 (down from 6.7% a year earlier)*

Economics: South Australia's economy has averaged just 1.4% annual growth over the past five years. The manufacturing sector, which is a comparatively large part of the state's economy, making up 8.3% of gross state product, has struggled in recent years, due to the strong AUD. Unsurprisingly, given the state's weak growth record, the unemployment rate is amongst the highest in the country, although the trend unemployment rate has been largely stable since mid-2013. There was, however, zero growth in employment over 2014. Despite this, retail sales growth picked up late in the year, to 4.5% y-o-y, supported by low interest rates and a modest rise in housing prices.

Politics/policy: South Australia held an election in March 2014 in which the Labor government was re-elected for its fourth consecutive term. The recent Australia-China free trade agreement should favour South Australia, given the agreement's focus on agriculture and South Australia's significant agricultural and wine-producing regions.

Tasmania: Modest improvement underway

***Quick stats:** 2% of national GDP; 1.2% annual growth in GSP in 2013-14; population of 0.5m (2% of Australia's total); unemployment rate averaged 6.8% in Q4 2014 (down from 7.7% a year earlier)*

Economics: Tasmania's growth rate of 1.2% in 2013-14 was second slowest amongst the states and territories, but was Tasmania's fastest rate of growth in five years. The improvement in growth was driven by a pick-up in household consumption, which was +2.4% higher than in the previous year. Low interest rates should support the local economy and a falling AUD could provide more support for the local tourism industry.

Politics/policy: The current Liberal government was elected in March 2014 and holds 15 of the 25 seats in the Tasmanian House of Assembly. The previous Labor government served four consecutive terms.

Australian Capital Territory: Government cutbacks a drag

***Quick stats:** 2% of national GDP; 0.7% annual growth in GSP in 2013-14; population of 0.4m (1.6% of Australia's total); unemployment rate averaged 4.9% in Q4 2014 (up from 3.8% a year earlier)*

Economics: As the home of Australia's central government, ACT has its fortunes inextricably tied to the public sector. The past year or so has seen a renewed focus on spending restraint following the election of the Liberal coalition government in late 2013 and this has impacted the ACT economy. Growth fell to just +0.7% in 2013-14, the slowest since 1995-96 and trend employment figures were flat over 2014. Trend unemployment is still below the national level, at 4.9%, but has lifted from 3.8% in 2013.

Politics/policy: Fiscal consolidation is likely to continue at the federal level and that is expected to drive subdued job growth in Canberra.

Northern Territory: Gas-fired boom continues

Quick stats: *1% of national GDP; 6.5% annual growth in GSP in 2013-14; population of 0.2m (1% of Australia's total); unemployment rate averaged 3.8% in Q4 2014*

Economics: Northern Territory was the fastest-growing of all the states and territories in the year to June 2014. The region has benefitted in recent years from mining investment projects and particularly from the construction of the Icthys LNG project near Darwin. The Icthys LNG project is expected to cost around USD34bn (including both onshore and offshore facilities) and employ 5,000 workers in its construction phase. As a result of this work, private capital formation in Northern Territory jumped by 122% in 2012 and has continued to increase, albeit at a more modest rate since then. Not surprisingly, this additional activity has resulted in low unemployment and solid growth in retail spending in the region (up 3.2% y-o-y to November).

Politics/policy: The Country Liberal Party holds 14 of the 25 seats in the Northern Territory Legislative Assembly after ousting the previous three-term Labor government in the 2012 election. The next election is expected in August 2016. The focus for economic policy is likely to remain on the development and leveraging of the region's position as a key centre for LNG and associated industries.

Key economic forecasts

HSBC's forecasts for Australia

	Year-average			Year-ended						
	2014	2015	2016	Q314	Q414f	Q115f	Q215f	Q315f	Q415f	Q116f
%*										
GDP	2.8	2.8	3.2	2.7	2.6	2.3	2.6	3.2	3.4	3.5
Consumption	2.5	2.6	2.9	2.5	2.4	2.6	2.5	2.6	2.8	2.9
Public consumption	2.1	1.9	1.6	1.7	2.1	2.1	2.1	1.7	1.6	1.7
Investment	-2.1	0.0	2.8	-3.0	-2.1	-2.2	-1.9	1.5	2.8	3.2
- Dwelling	7.8	5.2	4.3	6.8	7.4	3.3	4.0	6.7	6.7	5.8
- Business	-4.2	-1.7	1.6	-5.4	-3.4	-2.8	-2.6	-1.5	0.2	1.3
- Public	-3.9	0.5	5.6	-3.9	-7.2	-6.2	-6.2	7.7	8.2	7.2
Final domestic demand	1.2	1.8	2.6	0.9	1.1	1.2	1.2	2.2	2.6	2.7
Domestic demand	1.4	2.1	2.6	1.3	1.6	2.2	1.2	2.3	2.6	2.7
Exports	6.7	8.1	8.8	7.1	7.2	5.2	9.1	8.7	9.4	9.6
Imports	-0.8	4.2	6.4	-0.8	1.4	3.6	2.4	5.0	5.7	6.1
GDP (% quarter)	--	--	--	0.3	0.7	0.7	0.8	0.9	1.0	0.8
CPI	2.5	1.9	3.0	2.3	1.7	1.4	1.6	2.0	2.6	3.2
Trimmed mean	2.7	2.4	2.9	2.6	2.3	2.2	2.2	2.5	2.7	3.0
Unemployment rate	6.1	6.0	5.6	6.1	6.2	6.2	6.1	5.9	5.8	5.7
Labour price index	2.6	2.8	3.5	2.6	2.6	2.6	2.7	2.9	3.1	3.3
Current A/C (%GDP)	-3.0	-3.1	-2.6	-3.1	-3.3	-3.4	-3.2	-3.0	-2.9	-2.7
Terms of trade	-7.5	-5.3	-0.4	-9.0	-10.7	-9.9	-6.4	-2.9	-1.5	-0.5
Budget balance (%GDP)	-3.1	-2.5	-1.9							
Capital city house prices	9.1	6.8	4.6	9.1	6.4	7.0	6.9	7.0	6.6	5.5
Private sector credit	4.9	6.0	6.5	5.1	5.4	5.9	5.9	6.1	6.1	6.2
USD/AUD (end period)	0.83	0.78	0.75	0.87	0.83	0.82	0.80	0.79	0.78	0.77
Cash rate (end period)	2.50	2.50	3.50	2.50	2.50	2.50	2.50	2.50	2.50	2.75

Source: ABS, RBA, HSBC forecasts
*unless otherwise specified

Notes

Disclosure appendix

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Issuer of report
HSBC Bank Australia Limited
Level 32
HSBC Centre
580 George Street
Sydney, NSW 2000, Australia
Telephone: +61 2 9006 5888
Fax: +61 2 9255 2205
Website: www.research.hsbc.com

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[444207]

Global Economics Research Team

Global

Stephen King
Global Head of Economics
+44 20 7991 6700 stephen.king@hsbcib.com

Karen Ward
Senior Global Economist
+44 20 7991 3692 karen.ward@hsbcib.com

James Pomeroy
+44 20 7991 6714 james.pomeroy@hsbc.com

Europe & United Kingdom

Janet Henry
Chief European Economist
+44 20 7991 6711 janet.henry@hsbcib.com

Fabio Balboni
European Economist
+44 20 7992 0374 fabio.balboni@hsbc.com

Simon Wells
Chief UK Economist
+44 20 7991 6718 simon.wells@hsbcib.com

Elizabeth Martins
Economist
+44 20 7991 2170 liz.martins@hsbc.com

Germany

Stefan Schilbe
+49 211910 3137 stefan.schilbe@hsbc.de

Rainer Sartoris
+49 211910 2470 rainer.sartoris@hsbc.de

France

Mathilde Lemoine
+33 1 4070 3266 mathilde.lemoine@hsbc.fr

Francois Letondu
+33 1 4070 3933 francois.letondu@hsbc.fr

North America

Kevin Logan
Chief US Economist
+1 212 525 3195 kevin.r.logan@us.hsbc.com

Ryan Wang
+1 212 525 3181 ryan.wang@us.hsbc.com

David G Watt
+1 416 868 8130 david.g.watt@hsbc.ca

Asia Pacific

Qu Hongbin
Managing Director, Co-head Asian Economics Research and Chief Economist Greater China
+852 2822 2025 hongbinqu@hsbc.com.hk

Frederic Neumann
Managing Director, Co-head Asian Economics Research
+852 2822 4556 fredericneumann@hsbc.com.hk

Paul Bloxham
Chief Economist, Australia and New Zealand
+612 9255 2635 paulbloxham@hsbc.com.au

Pranjul Bhandari
Chief Economist, India
+91 22 2268 1841 pranjul.bhandari@hsbc.co.in

Izumi Devalier
+852 2822 1647 izumidevalier@hsbc.com.hk

Su Sian Lim
+65 6658 8783 susianlim@hsbc.com.sg

Sophia Ma
+86 10 5999 8232 xiaopingma@hsbc.com.cn

Ronald Man
+852 2996 6743 ronaldman@hsbc.com.hk

Trinh Nguyen
+852 2996 6975 trinhdnguyen@hsbc.com.hk

John Zhu
+852 2996 6621 john.zhu@hsbc.com.hk

Joseph Incalcaterra
+852 2822 4687 joseph.f.incalcaterra@hsbc.com.hk

Julia Wang
+852 3604 3663 juliarwang@hsbc.com.hk

Nalin Chutchotitham
+662 614 4887 nalin.chutchotitham@hsbc.co.th

Daniel John Smith
+612 9006 5729 daniel.john.smith@hsbc.com.au

Li Jing
+86 10 5999 8240 jing.econ.li@hsbc.com.cn

Prithviraj Srinivas
+91 22 2268 1076 prithvirajsrinivas@hsbc.co.in

Global Emerging Markets

Murat Ulgen
Global Head of Emerging Markets Research
+44 20 7991 6782 muratulgen@hsbc.com

Bertrand Delgado
EM Strategist
+1 212 525 0745 bertrand.j.delgado@us.hsbc.com

Jessica Wu
EM Strategist
+852-2822 4337 jessica.m.wu@hsbc.com.hk

CEEMEA

Simon Williams
Chief Economist, CEEMEA
+44 20 7718 9563 simon.williams@hsbc.com

Alexander Morozov
Chief Economist, Russia and CIS
+7 495 783 8855 alexander.morozov@hsbc.com

Artem Biryukov
Economist, Russia and CIS
+7 495 721 1515 artem.biryukov@hsbc.com

Agata Urbanska-Giner
Economist, CEE
+44 20 7992 2774 agata.urbanska@hsbcib.com

Melis Metiner
Chief Economist, Turkey
+90 212 376 4618 melismetiner@hsbc.com.tr

David Faulkner
Economist, South Africa
+27 11 676 4569 david.faulkner@za.hsbc.com

Razan Nasser
Economist, Middle East and North Africa
+971 4 423 6928 razan.nasser@hsbc.com

Latin America

Andre Loes
Chief Economist, Latin America
+55 11 3371 8184 andre.a.loes@hsbc.com.br

Argentina

Javier Finkman
Chief Economist, South America ex-Brazil
+54 11 4344 8144 javier.finkman@hsbc.com.ar

Ramiro D Blazquez
Senior Economist
+54 11 4348 2616 ramiro.blazquez@hsbc.com.ar

Jorge Morgenstern
Senior Economist
+54 11 4130 9229 jorge.morgenstern@hsbc.com.ar

Brazil

Constantin Jancso
Senior Economist
+55 11 3371 8183 constantin.c.jancso@hsbc.com.br

Priscila Godoy
Economist
+55 11 3847 5190 priscila.h.godoy@hsbc.com.br

Central America

Lorena Dominguez
Economist
+52 55 5721 2172 lorena.dominguez@hsbc.com.mx