Trends

MAY 2015
A bulletin of economic developments in South Australia

The State of Defence

An economic analysis of defence manufacturing in South Australia

Inside this issue

bankSA
banksa.com.au

Chief Executive's Foreword

A South Australian strength

Welcome to the latest edition of BankSA's economic bulletin, *Trends*, compiled in conjunction with Deloitte Access Economics.

In this edition, we examine the future of defence manufacturing in South Australia, a topic *Trends* originally examined in 2008 when Australia was experiencing rapid growth in its defence spending and conditions were ideal for South Australia's defence manufacturing sector.

With the benefit of hindsight, it's now interesting to note that back in 2008 *Trends* did acknowledge the underlying fragility of the positive outlook for South Australia's defence sector.

In fact, in 2007, the Australian Strategic Policy Institute (ASPI) raised the possibility of conflicts between defence goals and the budgetary means to achieve them. Fast forward to 2015 and renewed budgetary challenges are seeing the Federal Government searching for ways to cut costs, potentially worsening the outlook for the range of current defence manufacturing projects in the pipeline in South Australia.

In this edition, our economists and analysts have stepped beyond the current debate and speculation in order to assess what's at stake, and the range of possible outcomes.

We've already seen job losses in South Australia's defence manufacturing sector and, as the report states, there are more to come. Work on the Air Warfare Destroyer (AWD) project has hit its peak and will soon begin winding down, and with key decisions pending, we can't expect to see much momentum in the sector before the early 2020s.

Yet the future isn't quite as bleak as you may think. As the detail in this edition highlights:

- Even if Australia's next submarine fleet is sourced outside of Adelaide, it is likely that two-thirds of all the costs associated with outfitting and maintaining those submarines must ultimately occur in Australia, with a substantial share of that within South Australia.
- We also have potential roles in the delivery of the Future Frigates program, offshore patrol vessels and Pacific patrol boats, as well as Australia's next generation of armoured fighting vehicles.
- In addition, the Federal Government has now indicated it will aim to avoid the sector's marked peaks and troughs via a 'continuous build strategy'.

This would indicate that the future isn't necessarily as grim as some of the headline catching news suggests.

However, it would be naïve to ignore the fact that in the short term more jobs will indeed be lost and as the main *Trends* article states, "South Australians have every reason to be alert".

As always, Australian defence funding must respond not merely to our strategic needs as a nation, but also to our national capacity to pay for it.

Those balances have shifted over time and while the Federal Government has stated, as we would expect, that the nation's defence and security is its first priority, it can't be its only priority.

Spending must also be considered in the context of the national capacity to fund it.

Not an ideal scenario for South Australia's defence manufacturing sector, a sector looking for funding certainty. Neither is it good news for the wider South Australian community which is wondering what will happen to a key part of our economy.

We know that defence is big business in South Australia and as *Trends* says, "this State is home to a 'who's who' of the world's leading defence industry players – the likes of ASC, BAE Systems Australia, Lockheed Martin Australia and Saab Systems. And, in turn, those heavy hitters have supply chain links to the likes of the Nova Group and the Barton Vale Group of companies".

These firms have longstanding operations in South Australia thanks to a history of strength in this area, meaning that Adelaide and the rest of the State are home to a workforce with the necessary skills for the advanced manufacturing that underlies defence projects.

The State's 2011 *Strategic Plan* notes that *"South Australia is now widely recognised as the Defence State – home to 25 percent of Australia's specialist defence industry. Over 24,700 South Australians are employed directly or indirectly by defence activities, an increase of 55% from 2003"*, while Defence SA notes that, as at 30 June 2011, South Australia's defence sector employed 26,882 people (12,655 direct and 14,227 indirect jobs).

These large numbers point to a substantial economic benefit from defence spending as a whole in South Australia, with a large portion of that subject to the big shipbuilding contracts dominating the news in recent times.

Naval shipbuilding is, by its very nature, prone to peaks and troughs in workload.

We had a combination of projects which pushed direct employment in these naval shipbuilding projects to more than 10,000 people across the nation, many of them here in South Australia.

But then, as these projects were completed, employment declined. By 2007, each of those three projects had effectively wrapped up, and there was a lull until the current Hobart class AWD build phase began.

Striving to avoid peaks and troughs is a difficult task at the best of times, but it has been made much harder because the industry's number one customer – the Australian Government – has delayed multi-billion dollar decisions in the face of a challenging budget environment.

This presents issues now for South Australia's shipbuilding industry.

However, while the debate surrounding the Future Submarines project has been particularly fierce, it is important that Australians in general – and South Australians in particular – don't see this as a life or death struggle.

Buying and equipping submarines is a complex business.

Building Australia's Future Submarines in Adelaide would be a great outcome for South Australian industry. But so too would building those same submarines in Japan or Germany if South Australia secures the outfitting and maintenance activities for the submarines.

The involvement of Australia's defence industries in the development, construction and sustainment of our Future Submarines is important to this State, but there needs to be greater recognition that there are many roles to play here, and that involvement by South Australian industry should play to the State's strengths.

In addition to South Australia's involvement in the Future Submarines and Future Frigates programs, we will also have a role in Joint Strike Fighter maintenance and a degree of involvement via the provision of some components. Locally headquartered firms will also be involved in delivering maintenance elsewhere in Australia, helping to support jobs here in South Australia.

The report concludes that South Australia's aim to reinforce its role as Australia's Defence State makes sense, in part because the State already has a strong set of competitive advantages in defence, and is globally competitive in many related fields.

The State Government and the local sector will need to adapt in the face of new developments and challenges, the report says.

If the big looming decisions don't go our way, South Australia could still benefit from opportunities in both the build phase and later sustainment activities even if a foreign submarine is selected as the basis for Australia's new submarines.

We will watch and wait with interest – alert, but not alarmed.

N. C. Reade.

Nick Reade
Chief Executive, BankSA

26,882

South Australians are employed directly or indirectly in defence activities

25%

of Australia's specialist defence businesses are in South Australia

55%

increase in defence employment in South Australia since 2003

If the big looming decisions don't go our way, South Australia could still benefit from opportunities in both the build phase and later sustainment activities even if a foreign submarine is selected as the basis for Australia's new submarines.

The State of Defence

"It isn't rocket science." - Unknown

"We think it's time to look closely at the future prospects for defence costs and Australia's ability to pay. If there's going to be a train smash between our military goals and financial means, the sooner we know the better." - The Australian Strategic Policy Institute, 2007

"(The) Valley of Death cannot be avoided and no decision this Government could make now could stop it." - Kevin Andrews, Federal Defence Minister, 2015

"We're good at this." So began our report the last time *Trends* considered the future of the defence manufacturing sector in South Australia (*In Our Defence,* May 2008).

Our conclusions then were straightforward:

- The nation was amid rapid growth in its defence spending;
- There was the potential for more to come, with Defence experts warning that 'bloc obsolescence' meant each of our Army, Navy and Air Force would be faced with the need to replace ageing weapons systems and related equipment at much the same time; and
- South Australia had a competitive advantage in these areas, thanks to the wider manufacturing sector presence in the State and the existing scale and scope of defence-related operations.

Or, in other words, it looked as if the times would suit this State's defence manufacturing sector.

Yet, our earlier report also noted the underlying fragility of that outlook. In particular, it quoted the Australian Strategic Policy Institute (ASPI) – a quote we have repeated at the start of this article – that, "If there's going to be a train smash between our military goals and financial means, the sooner we know the better".

It is this latter caveat that now is the root cause of many of the banner headlines of recent months. Many of those stories argue that the "train smash" that ASPI worried about some years ago is almost upon us, as the Federal Government looks to manage competing Budget pressures by cutting costs and potentially worsening what had already been looming as a mooted 'Valley of Death', as a range of the State's current pipeline of defence manufacturing work wound up before anything arrives to take its place.

But what's the truth? This report aims to step behind the banner headlines of the moment to assess just what's at stake, and the range of possible outcomes.

Our conclusion is rather less loud than some views of the moment. Yes, job losses have already begun in the defence manufacturing sector in this State, and there will be more to come. The work on the Air Warfare Destroyer (AWD) project has reached its peak and will soon begin winding down, and – almost regardless of key decisions from here – it would be hard to see work associated with either the new submarines or the Future Frigates program gathering much momentum before the early 2020s.

Yet the future isn't quite as bleak as you may think:

- Even if Australia's next submarine fleet is sourced outside of Adelaide, it is likely that two-thirds of all the costs associated with outfitting and maintaining the submarines must ultimately occur in Australia, with a substantial share of that right here in this State.
- There is also the potential for roles for this State in the delivery of the Future Frigates program, offshore patrol vessels and Pacific patrol boats, as well as in the likes of Australia's next generation of armoured fighting vehicles.
- The Federal Government has indicated it will aim to avoid peaks and troughs via a 'continuous build strategy'.

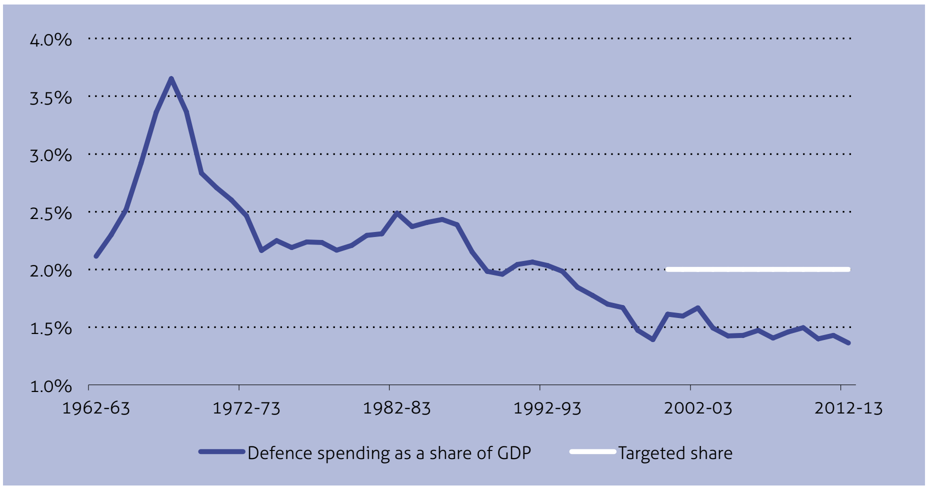
That conclusion doesn't say there's no problem here. In the short-term, we expect there will be an impact on jobs.

Yet the analysis here does suggest that the challenges have been easy to overstate. South Australians have every reason to be alert. But it may be overdoing it to be alarmed.

Where will they get the money for that?

Australian defence funding must respond not merely to our strategic defence needs as a nation, but also to broader pressures on the

CHART 1
DEFENCE SPENDING AS A SHARE OF AUSTRALIAN NATIONAL INCOME



Source: Australian Bureau of Statistics, Reserve Bank of Australia

Federal Budget.

Those balances have shifted over time.

Chart 1 (above) traces overall defence spending as a share of Australian national income back to the 1960s. It shows:

- The impact of security concerns during the Vietnam War in general and the Cold War in particular;
- The 'peace dividend' as the Cold War came to an end in the late 1980s and early 1990s; and
- The more recent spending cuts that have reduced defence spending as a share of the national economic pie to levels that hadn't been seen since the 1930s.

That chart also shows the current Government's target of a return to a spending share of 2% of national income.

That of itself indicates that there is a gap of about $10 billion a year between current practice and the aspirational goals of governments.

While the Federal Government has noted "that the nation's defence and security is its first priority", it can't be its only priority, and spending needs to be considered in the context of broader calls on a constrained Budget and national capacity to pay.

After all, defence is undoubtedly vital, but governments also have to pay pensions and benefits, fund much of the national healthcare system, and substantially subsidise education.

And the problem there is that Australian Governments – of all political stripes – have spent the benefits from the resource driven Budget boom.

The Budget benefits of the boom

While the resources boom of the last decade was good for the economy, it was stunningly good for the Federal Budget. That's because the boom pushed up commodity prices, such as coal and iron ore, in turn boosting the tax take.

There are only ever two major drivers of the Budget: the health of the economy and the decisions of politicians. Chart 2 (page 6) uses Treasury's own numbers to show the impact of these on the Budget's trajectory as at each update.

Starting with the 2000-01 Budget, it tracks the cumulative effect of shifts in the economy on the Budget projections.

Canberra's numbers are always given over four years, but even when you divide the 2008 peak by four, that's a gift to the Budget which briefly peaked at over $80 billion a year.

The global financial crisis (GFC) then rapidly halved that Budget bonanza, but China's own stimulus in response to the GFC sent commodity prices soaring to even higher peaks.

The policy costs that accompanied the boom

From the start of the last decade, successive governments of both political persuasions gave back this tax windfall via a combination of lower taxes and increased expenditure.

Chart 3 (right) adds the cumulative effect of policy decisions over the four year forward estimates, on revenue and spending at each Budget update.

Under the Coalition, that increased spending came via the likes of higher family payments and the baby bonus while, under Labor, expenditure initially increased due to the stimulus measures introduced in response to the GFC, then in a more lasting fashion thereafter, via new funding for health, education and disability insurance, as well as compensation costs associated with the mining and carbon taxes.

Ongoing Budget woes

Both the economics and the politics of Budget repair are still worsening.

The economy continues to do no favours for revenue raising by either the Federal or state governments:

- Commodity prices continue to trend lower, and at the same time wage gains are bumping along the bottom at record lows;
- The most volatile driver of national income (and hence the tax take), profits, is under pressure; and
- The driver of the largest part of national income, wages and salaries are similarly hard pressed – again with impacts on the tax take.

Chart 4 (page 7) shows just how quickly the commodity headwinds are growing.

That is throwing another large spanner into the process of Budget repair, and hence potentially too into the hopes and expectations around Federal funding for defence projects in our State.

And so, it is in this environment in which:

- South Australia's defence manufacturing sector is looking for funding certainty; and
- The wider South Australian public is wondering what will happen to a key part of our economy.

What do defence industries mean for South Australia?

That, of course, begs a key question here. Just how large is defence manufacturing as a share of the State's economy and employment base?

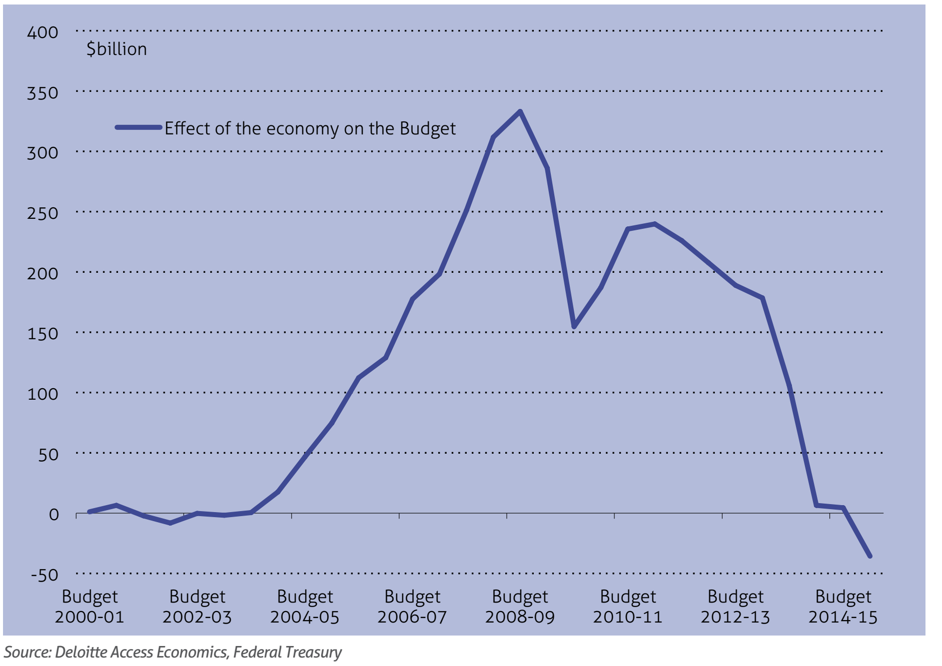
Defence is big business in South Australia. In fact, as the Australian Industry Group has pointed out, this State is home to a 'who's who' of the world's leading defence industry players – the likes of ASC, BAE Systems Australia, Lockheed Martin Australia and Saab Systems.

And, in turn, those heavy hitters have supply chain links to the likes of the Nova Group and the Barton Vale Group of companies.

Such a cluster isn't a coincidence. These firms have longstanding operations in South Australia thanks to:

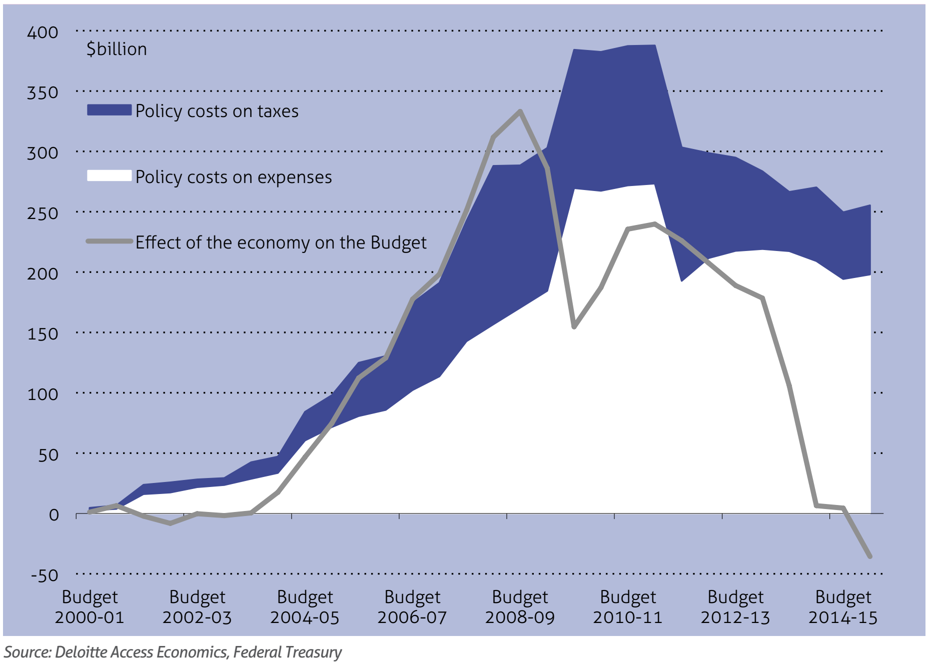
- A history of strength in this area, meaning that Adelaide and the rest of the State are home to a workforce with the requisite skills for the advanced manufacturing that underlies defence projects. In fact, much

CHART 2
THE EFFECT OF THE ECONOMY ON THE BUDGET



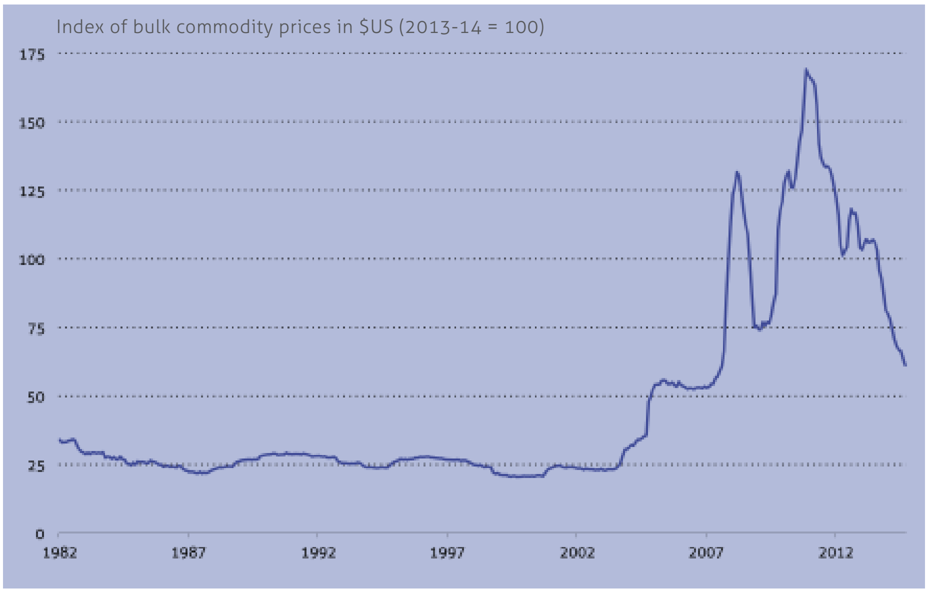
Source: Deloitte Access Economics, Federal Treasury

CHART 3
IMPACT OF (1) POLICY DECISIONS AND (2) THE ECONOMY ON THE BUDGET



Source: Deloitte Access Economics, Federal Treasury

CHART 4
THE COMMODITY PRICE CRUNCH CONTINUES



Source: Reserve Bank of Australia

of the defence-related employment in this State is at the professional level (including the likes of architects, engineers, systems and software designers, programmers and business professionals);

- Strong and bipartisan government support – successive state governments have actively promoted defence manufacturing in South Australia and, in turn, successive federal governments have provided much of the requisite funding; and
- A strong research base – the Defence Science and Technology Organisation (DSTO) laboratories combined with a defence research focus in the State's universities and TAFEs to feed back into the skills base that this sector needs.

That's a virtuous loop. In fact, economists have long pointed to such clusters of activity in everything from cars to chemicals – South Australia just happens to have one in defence manufacturing.

But how many jobs are we talking about? There have been a few different estimates over time.

The State's 2011 Strategic Plan notes that "South Australia is now widely recognised as the Defence State – home to 25 percent of Australia's specialist defence industry. Over 24,700 South Australians are employed directly or indirectly in defence activities, an increase of 55% from 2003", while Defence SA notes that, as at 30 June 2011, South Australia's defence sector employed 26,882 people (12,655 direct and 14,227 indirect jobs).

Those are big numbers, pointing to a substantial economic benefit from defence spending as a whole in South Australia, with a large portion of that subject to the big shipbuilding contracts dominating the news in recent times.

They are also a reminder that a substantial portion of the South Australian economy is tied to the spending power of the Australian Government – a link which had been a positive in the past decade but has become notably shakier more recently.

Into the shadow of the Valley of Death?

Naval shipbuilding is, by its very nature, prone to peaks and troughs in workload. Each major vessel is a massive project, and keeping such projects rolling off the production line requires careful planning and long lead times.

Those peaks and troughs are what are at issue when people point to the potential for a 'Valley of Death' lying ahead. In brief, and as Chart 5 (page 8) shows, the peak of direct employment in naval shipbuilding in this State was in the late 1990s. At that stage there were three big projects on the go – the construction of the ANZAC frigates, the Collins class submarines and the Huon minehunters.

That combination of projects pushed direct employment in these naval shipbuilding projects to more than 10,000 people across the nation, many of them here in South Australia.

But as these projects were completed, employment declined. By 2007, each of those three projects had effectively wrapped up, and there was a lull in such work until the current Hobart class AWD build phase began.

And the 'Valley of Death'? Regardless of any decisions at this stage, there's a developing problem ahead. Work on the AWDs has already reached its peak and will shortly begin winding down, and the naval work potential in the likes of submarines and future frigates is unlikely to be meaningfully supporting jobs in the State until the early 2020s.

Given the long lead times involved in these sorts of projects, there's little chance to avoid a problem in the next few years – indeed, avoiding it would have required decisions to be taken some years ago. It is in that context that, Kevin Andrews, the Federal Defence Minister, recently argued that the "Valley of Death cannot be avoided and no decision this Government could make now could stop it".

Such juggling of long lead times to avoid peaks and troughs is a difficult task at the best of times, but it has been made much harder because the industry's number one customer – the Australian Government – has delayed multi-billion dollar decisions in the face of a challenging Budget environment.

Despite the oft-stated intentions of both sides of Federal politics, the harsh reality of the Budget bottom-line means multi-billion dollar price tags have given the decision-makers in Canberra pause for thought.

It is that pause which has Australia's future naval shipbuilding projects running up against time, capability and cost constraints.

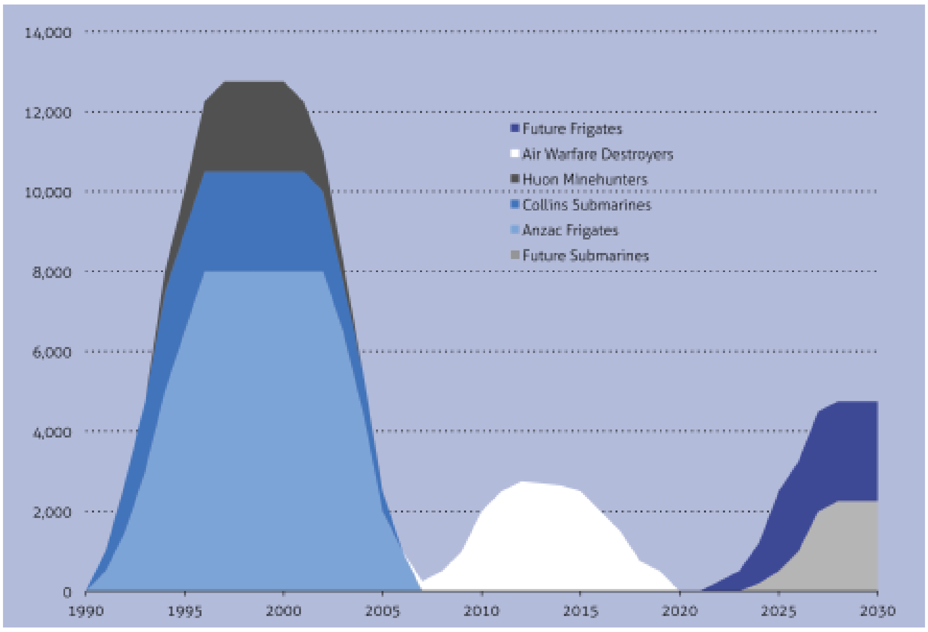
Those problems are about to come home to roost for South Australia's shipbuilding industry.

A delay between work on Australia's AWDs and the construction of Future Frigates means the 'Valley of Death' will see shipbuilding jobs all but dry up for as long as five years.

While this jobs drought isn't expected to arrive in earnest until 2017 and 2018, work on the AWDs has already peaked and will shortly begin to wind down.

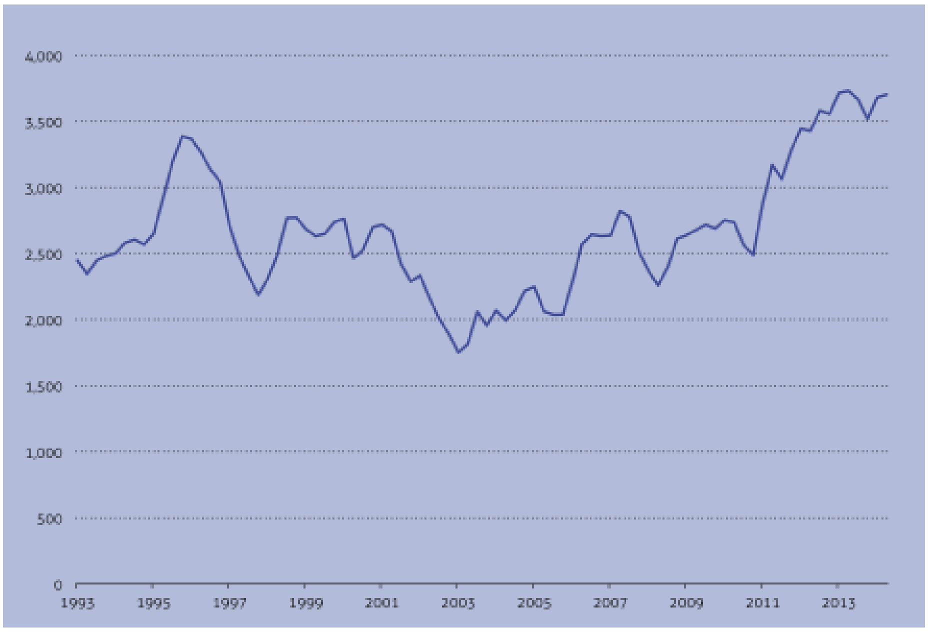
That suggests some harder times to come for

CHART 5
EMPLOYMENT IN KEY NAVAL SHIPBUILDING PROJECTS IN AUSTRALIA



Source: Defence Teaming Centre Inc, Deloitte Access Economics

CHART 6
SMOOTHED EMPLOYMENT IN 'OTHER TRANSPORT MANUFACTURING' IN SOUTH AUSTRALIA



Source: Australian Bureau of Statistics

defence manufacturing in South Australia, with many commentators warning of the risk that key capabilities and many of the industry's high skilled workers may leave the industry – jeopardising the ability of the State to compete for future shipbuilding projects.

Yet the job figures quoted earlier – with the total sector and related employment accounting for more than 20,000 jobs in South Australia – include those in the armed services and related support staff, as well as those employed in the defence manufacturing sector. In practice, those jobs are not at risk.

Rather, it is those employed in the defence manufacturing sector of interest here, with Defence SA's estimate being that "In 2010-11, the State's defence industry directly employed 5,189 full-time equivalent (FTE) positions".

It is arguably the latter number which is the key to the current debate. Moreover, that figure of more than 5,000 jobs is for defence manufacturing as a whole, and therefore includes a number of jobs outside naval shipbuilding in the State.

It is hard to put an exact figure on the latter, but Chart 6 (left) shows estimates from the Bureau of Statistics for employment in the 'other transport manufacturing sector' in South Australia. Those estimates have been considerably smoothed, because – as is not unusual for small sectors – the data is pretty volatile.

And it is worth remembering that these latter figures also include a range of activities (such as employment in making railway rolling stock and in aircraft manufacturing and in pleasure craft boat building, as well as in naval shipbuilding).

Data from the 2011 Census indicates that, as at that date, around 1,650 South Australians identified themselves as working in naval shipbuilding.

There is a broadly similar figure available from ASC, which notes that, "we employ over 2,400 permanent personnel across our three facilities in South Australia and Western Australia".

So the 'Valley of Death' - if it eventuated - may mean direct job losses of the order of 2,000 or 2,500 people.

That is still a big number. And it hides considerable personal distress for individual families. In addition, many of these job losses may arrive at much the same time as car manufacturing in South Australia ends, with an associated loss of jobs in parts manufacturing as well.

That says the 'Valley of Death' is part of a larger problem, and that its timing couldn't have been much worse for the State and for affected workers.

Yet equally a sense of proportion is appropriate. With around 800,000 jobs in total in this State, that says somewhere around one in every 400 jobs is directly at risk from the 'Valley of Death', with the potential for that number to be perhaps doubled once indirect jobs are accounted for.

So as large as those numbers are, they aren't

make or break for the State's economy and its employment base – rather, the 'Valley of Death' is one of a number of known challenges that this State's economy faces.

And it is too easy to be negative here. As the economists have been noting, what grabs the headlines isn't the sole story on the outlook for this State's economy. In particular, the strength in interest rates and exchange rates which has bedevilled this State over the past decade has changed. Interest rates are at or near record lows, and the Australian dollar is well off its recent peaks.

These latter developments haven't resulted in headlines about job prospects in this State to the extent that Holden or the defence issues have done. But it is wrong to discount them: lower interest and exchange rates are powerful job generators, and they are kicking in at a time when this State's job outlook is in need of such assistance.

It's far from all or nothing on submarines

The debate surrounding the Future Submarines project has been particularly fierce. While that is a healthy conversation to be having as a nation, it is important that Australians in general – and South Australians in particular – don't see this as a life or death struggle.

Buying and equipping submarines is a complex business that doesn't lend itself particularly well to the sorts of banner headlines and bold statements made in the recent debate.

Building Australia's Future Submarines in Adelaide would be a great outcome for South Australian industry. But so too would building those same submarines in Japan or Germany.

The involvement of Australia's defence industries in the development, construction and sustainment of our Future Submarines is important to this State, but there needs to be greater recognition that there are many roles to play here, and that involvement by South Australian industry should play to the State's strengths.

More importantly for South Australia's defence industries, the work won't end when the submarines are ready. As anyone who drives a Japanese, German or French car will attest, there are just as many jobs on offer here in Australia maintaining and refitting imported machines as there are for locally made alternatives.

In fact, it has been estimated that, even if Australia's next submarine fleet is sourced outside of Adelaide, it is likely that two-thirds of all the costs associated with outfitting and maintaining those submarines must ultimately occur right here in Australia, with a substantial share of that here in this State. To take an obvious example, a choice to go with Japanese submarines would be likely to require that those same submarines would have American weapon systems added to them right here in Adelaide.

As Federal Defence Minister, Kevin Andrews, recently noted: "When it comes to Future Submarines, Australian industry will play an important role in delivering the best possible equipment at the best value for money. There will be many new high-skill jobs in Australia for the life of the Submarine program, decades into the future. Significant work will be undertaken in Australia during the build phase. At a minimum, this includes combat system integration, design assurance and land-based testing. There will be significant opportunities arising from the support and maintenance of the submarine for decades. In dollar terms, this often accounts for two-thirds of the investment. All three potential international partners will require significant redesign work to be undertaken on their existing submarines. There are opportunities here for Australia. I want to make it clear – that maintenance can occur in Australia, even if there is an overseas build."

And that view – that submarine spending isn't an all-or-nothing decision – has been borne out in history. It isn't merely true of the Collins class submarines of today or the future submarines of tomorrow. For example, Australia's previous Oberon class submarines were sustained – and indeed upgraded – in Australia despite being stamped 'made in the UK'.

The same applies to maintenance of the ANZAC class frigates. These ships will be facing increasing maintenance and sustainment costs as they age ahead of the first Future Frigates being ready for service. That too points to ongoing work for Australia's shipbuilders.

Or, in other words, this isn't a fight over whether this State gets any dollars – merely over how much of those dollars that it gets.

Submarines aren't the only opportunity

Submarines aren't the only opportunity in town as far as the future of South Australia's defence manufacturing sector is concerned.

In addition to ongoing work from submarines, there are potential roles for this State in the delivery of the Future Frigates program, in the construction of offshore patrol vessels and Pacific patrol boats, as well as in the design and build of Australia's next generation of armoured fighting vehicles (including the likes of replacements for the Australian Light Armoured Vehicle, and new armoured personnel carriers to replace Army's current M113 Armoured Personnel Carriers).

And then consider roles in Joint Strike Fighter maintenance, which won't just occur in Queensland and New South Wales. This State will have a degree of involvement via the provision of some components, and also as Adelaide-headquartered firms will be involved in delivering maintenance elsewhere in Australia (helping to support jobs here in South Australia).

That list alone points to a broader set of opportunities both past and present where this State has either already won work or can reasonably be expected to get a fair share of what is in the pipeline.

Moreover, not only is there other potential out there, but also a greater understanding of the need to avoid future peaks and troughs.

In particular, the Federal Government has now indicated it will aim to avoid peaks and troughs via a 'continuous build strategy'.

Final words

South Australia's aim to reinforce its role as Australia's Defence State makes sense, in part because the State already has a strong set of competitive advantages in defence, and is globally competitive in many related fields.

However, the State Government and the local sector will need to adapt in the face of new developments and challenges.

One of those challenges is the constrained Federal Budget and increased scrutiny on all spending decisions, and large defence acquisitions in particular.

Another is the delay that has occured in decisions on major defence acquisitions. If we wanted to avoid a gap between current work

on the AWDs and future work on the likes of submarines and frigates, then the relevant decisions should have been taken some years ago.

Yet, amid the heated debate and banner headlines of the moment, it is easy to forget the complexity of defence spending and its role in the South Australian economy.

Yes, decisions around the Future Submarines and Future Frigates programs are important for the State and, yes, the 'Valley of Death' will present a significant challenge to the local shipbuilding industry.

But that isn't cause for despair.

That is because even if the big decisions don't go the way of the State's shipbuilders, those decisions are not nearly as clear-cut and final as the headlines would have you believe. South Australia could still benefit from opportunities in both the build phase and later sustainment activities even if a foreign submarine is selected as the basis for Australia's new submarines.

Besides, the industry in this State is about more than simply submarines, with major new contracts in a range of areas offering further opportunities for the sector.

That says 'the worst' is an unlikely outcome. Even if the worst is to occur – with every single defence shipbuilding job in this State lost – then those direct job losses would account for something like 2,000 or 2,500 people in a State workforce of 800,000.

It would be a big blow. But it is also unlikely. And it wouldn't be make or break for the wider South Australian economic outlook.

We also shouldn't forget that lower interest rates and exchange rates will also be powerful job generators for this State.

So South Australians have every reason to be alert. But it may be overdoing it to be alarmed.

State's growing tourism sector

The main article in this issue of *Trends* examines the outlook for defence manufacturing in South Australia – where there are challenges as well as opportunities. Similarly, and as the Statistical Appendix illustrates, there are already challenges for the South Australian economy with population growth continuing to lag the national average, the earlier lift in housing construction beginning to cool, and increasing pressures on the State's job market amid a rising rate of unemployment.

Yet there is clear evidence of good news on several fronts, and this article looks at the detail on one of them – tourism. This is one sector in Australia which is poised to show growth post the mining boom.

In part, the good news on the tourism front is a reflection of favourable movements now occurring in exchange rates, but it also reflects the rising demand for overseas holidays from Asia's growing middle class.

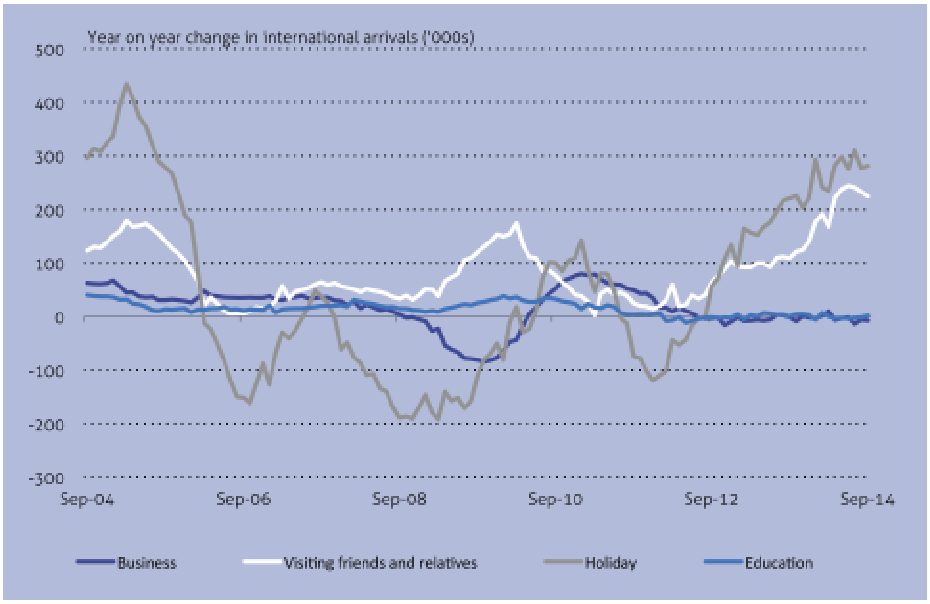
The context: International visitor arrivals to Australia are on the rise

Chart 1 (right) shows the big lift currently being seen in the number of international visitor arrivals to Australia. A total of 3.2 million people visited Australia for an overseas holiday in the past year, and an additional 1.9 million people came to Australia to visit friends and relatives during that time. That adds up to a stunning total of just over five million people visiting Australia for leisure travel in the past 12 months.

The large rise in inbound leisure travel numbers reflects favourable movements for key drivers of inbound tourist numbers. It has been aided by the fast fall in the Australian dollar over the past year, while there was also a steep fall in oil prices in the second half of 2014.

Both these developments are important for tourism. The lower dollar makes it cheaper

CHART 1
INTERNATIONAL VISITOR ARRIVALS TO AUSTRALIA



Source: ABS, Deloitte Access Economics Tourism and Hotel Market Outlook 2015

CHART 2
THE CONTRIBUTION OF TOURISM TO STATE OUTPUT AND JOBS, 2012-13

Source: Tourism Research Australia

for the world to travel here (rather than, say, to Europe or Hawaii). And although cheaper fuel costs are a plus for travel right around the globe, they are a particular positive for a long haul destination such as Australia, where fuel costs are a larger proportion of the overall cost of travel.

At the same time, economic growth in our key tourism markets has remained strong, despite some slowing in countries such as China. In fact, visitor arrivals from Asia continue to boom. Arrivals from China rose by 10% over the past year. This follows a decade where double digit growth has been the norm, but even that was eclipsed over the past year by some of Asia's other emerging stars, with Malaysia, Singapore and Hong Kong all posting growth in traveller numbers into Australia in excess of 14%.

Tourism's importance to the South Australian economy

Tourism is an important industry for South Australia.

As Chart 2 (left) shows, latest estimates of its size suggest that it accounts for about 2.3% of the State's output and 3.8% of the State's employment. To put that into context, that makes tourism about as large an employer as farming – bigger than mining, but less than half the size of current manufacturing employment in the State.

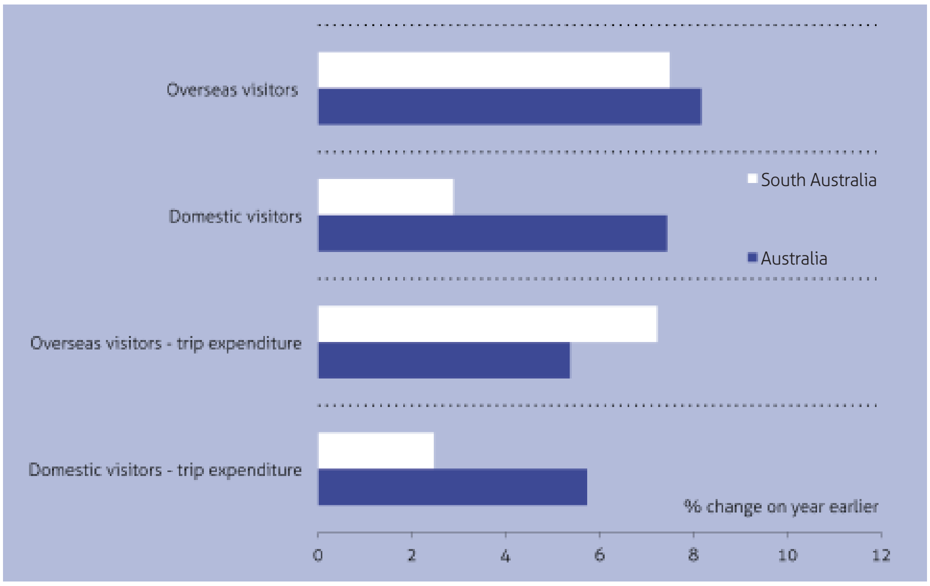
Tourism is a hard industry to pin down because it actually consists of a number of other industries providing services directly to tourists. In South Australia, accommodation (12%), hospitality (30%) and retail trade (21%) all make up a major share of total employment in the tourism industry, while transport is another industry closely linked to tourism.

While an important and sizeable industry for the South Australian economy, tourism accounts for a smaller share of South Australia's output and employment than in a number of other locations such as Queensland, Tasmania and the Northern Territory. That suggests that there is plenty of potential for further growth in South Australia's tourism industry.

It's not surprising that the State's tourism industry is centred in Adelaide. Data from Tourism Research Australia indicates that the vast majority of international visitors come to Adelaide, with the Flinders Ranges, Outback and the Limestone Coast rounding out the top three most popular regions for international tourists.

For domestic overnight visitors, Adelaide was the most popular destination, followed by the Fleurieu Peninsula, Limestone Coast, Yorke Peninsula and the Flinders Ranges.

CHART 3
RECENT GROWTH IN VISITOR NUMBERS AND TRIP EXPENDITURE IN SOUTH AUSTRALIA



Source: Tourism Research Australia

South Australia's tourism industry is growing

As Chart 3 (above) shows, overseas visitor arrivals to South Australia rose by a strong 7.5% over the past year to a total of 390,000 people, with the trip expenditure of those people in the State also rising by a strong 7.2%.

Those are significant numbers.

The positives noted above – a more competitive currency, cheaper fuel costs – help across Australia's tourism markets. Yet arrivals to Adelaide are benefiting from other factors too, including the State's increased connectivity directly to Asian source markets via low cost carriers.

Domestic tourism hasn't seen quite as strong growth in South Australia of late, but it is a large share of total tourist numbers. Overnight domestic visitor numbers in South Australia were up by 2.9% in 2014, with trip expenditure of domestic visitors to the State rising by 2.5%.

Yet the tide may be turning on the latter front too.

One influence on domestic tourism in the State that has been less favourable in recent years has been Australians' ongoing love of overseas travel, with outbound departures growing by 5.2% for the year. However, the fall in the Australian dollar will also help here, changing the dollar decision between Australians holidaying at home or travelling abroad.

And the other good news is that some of these effects have a way to run yet. For example, it is early days in terms of the impact of a lower Australian dollar on traveller decisions. This suggests there is further good news on tourism growth ahead.

Australia's slowing population growth

Economists spend a lot of time talking about dollars, but a rather more fundamental set of figures are those around population trends.

So it is important to note – important for both Australians and for South Australians – that a gradual sea change has begun and a slow slide in the pace of Australian population growth is now underway.

The first chart (right) shows Australian population growth over the past quarter of a century. In brief, it hit peaks in 1989 (at 1.9%), 2008 (at 2.2%) and again in 2012 (at 1.8%).

Those years aren't a coincidence. They roughly mark peaks in business cycles, with the Australian economy travelling at speed in the late 1980s and again ahead of the global financial crisis (GFC), and then rebounding from the GFC.

But at 1.5% over the past year, the pace of population growth has now dropped below what it averaged over the past decade.

CHART 1
AUSTRALIAN POPULATION GROWTH (CHANGE ON YEAR EARLIER)

Equally, that isn't a coincidence either – the Australian economy is cooling after the remarkable resources boom of the past decade. That boom isn't over, but it is changing shape pretty fundamentally. In particular, the shift in the resources boom from its construction phase to its production (or export) phase, means a reduced need for workers and that is because construction is more labour-intensive than production.

How is it that Australian population growth can jump around so markedly? The answer is obvious – it is actually the pace of net migration to this nation that jumps around. And this movement, with a minor lag, broadly corresponds to swings in the economy.

Look at it this way. If you are interested in migrating to another county, then for most of the past decade you would have queued up to get into Australia, rather than many alternative destinations, given that this nation's economic performance has outperformed that of our peers across that period.

But the past couple of years may well have seen you revise the rankings of your desired destination. Right now, unemployment is lower and growth prospects are better in the United States than they are here. Even the United Kingdom has lifted in this area.

That is why the cooling resources boom was always ultimately going to show up in a cooling migration cycle. And that is exactly what has been happening.

Of course, that isn't the only thing happening. Just as net migration responds to the economic tides, there is a less direct, but still relevant effect operating on birth rates. The latter rose during more prosperous years, but have been gently drifting downwards more recently, doing so across a period in which Australian unemployment rates have been gently drifting up. Although the numbers of babies born in the past year is still more than 300,000, that peak has also passed.

As Chart 2 (right) shows the widening gap between overall population growth, and that for working age population. Whereas total population gains – at just over 1.5% in the past year on the latest available data – are a bit below the average of the last decade, they are still comfortably ahead of the two decade average. On the other hand, working age population growth is falling shy of both the one and two decade averages.

That says there is a gap between fundamental drivers of demand (total population) and those of supply (working age population).

This has long been known to be a developing issue for the Australian economy.

Moreover, that gap is set to exist for a while yet. Although part of the recent impact here was

CHART 2
AUSTRALIAN TOTAL AND WORKING AGE POPULATION GROWTH (CHANGE ON YEAR EARLIER)

CHART 3
STATE SHARES OF TOTAL POPULATION

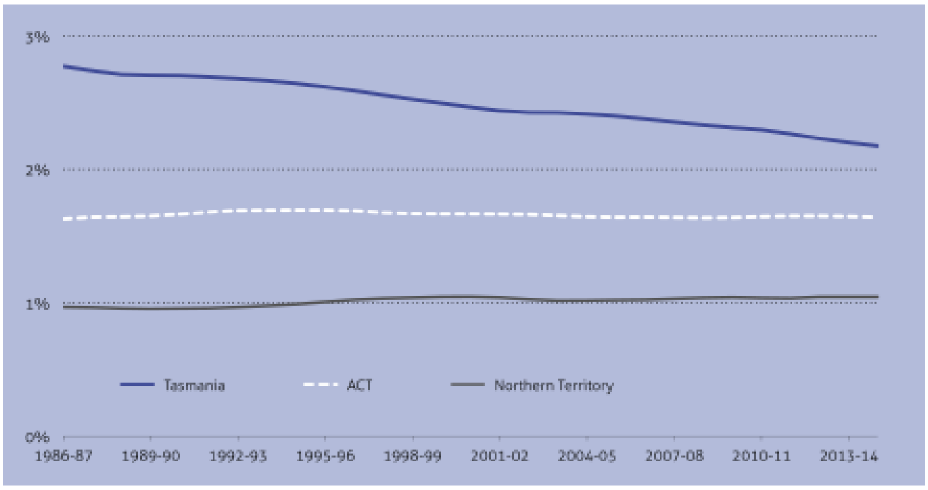
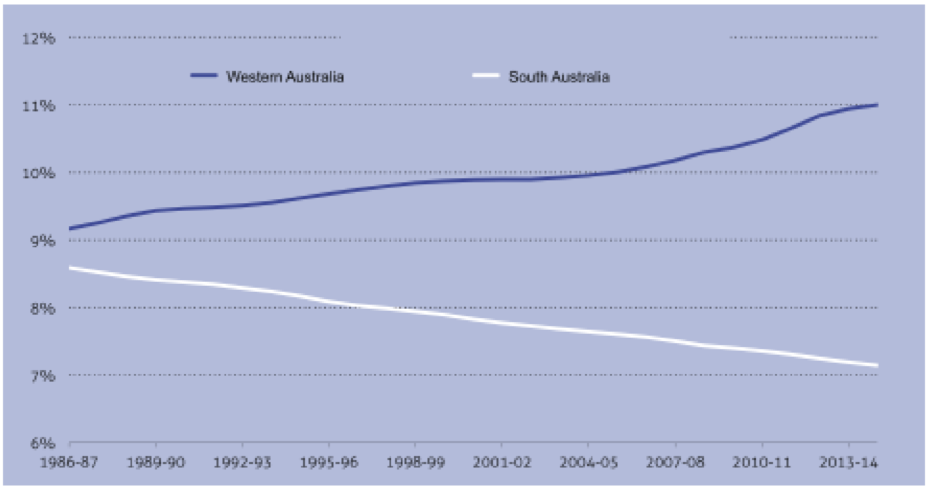


CHART 4
STATE SHARES OF TOTAL POPULATION



a shift to higher birth rates, this is now slowly ebbing once more; the more fundamental and longer lasting driver is the ageing of the Australian population, with the rate of growth among those aged 65 and above not far shy of three times the matching growth rate among those of working age, traditionally shown as those aged 15 to 64.

Where to next? Chances are that the current slowdown in population growth has fully run its course. That said, much will depend on what happens to net migration to Australia.

The Federal Government's recently released Intergenerational Report (IGR) 2015 assumed net migration of 215,000 from 2018-19. That is rather more than Australia saw in the decade to 2005, when it averaged around 105,000 per year. However, it is a little less than the average of the past decade (at 220,000 per year). It is also more than the assumptions adopted in past IGRs – the 2002 IGR opted for net migration of 90,000 per year, the 2007 IGR plumped for 110,000, and the 2010 IGR assumed 180,000 per year.

It is interesting to note that, at just under 204,000 in the past year, the tide is still going out from net migration. Clearly, the cooling resources boom is taking its toll, though the assumption in the latest Intergenerational Report remains a reasonable one for the longer term.

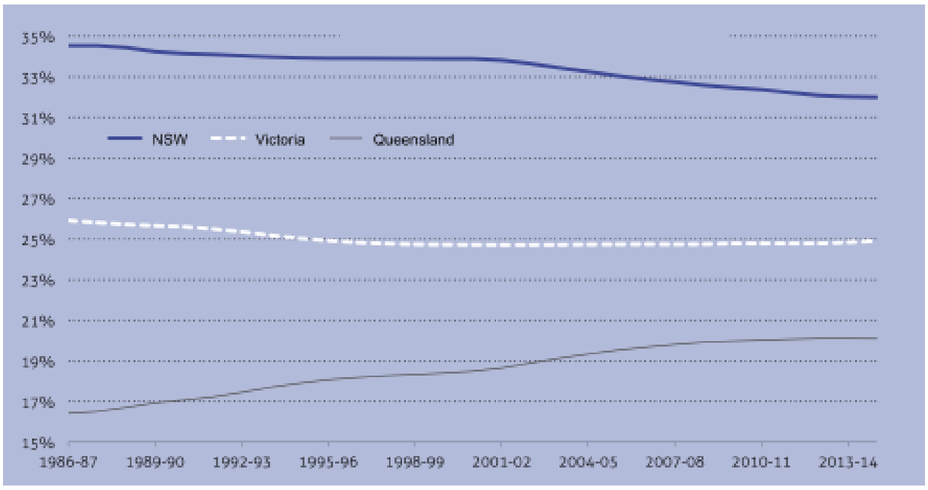
Changing tides at the State level

These changing economic tides are now becoming quite strongly evident in the population stats at the State level. Charts 3, 4 (page 15) and 5 (right) show State relativities. Not surprisingly, New South Wales and Victoria are doing relatively better than they were, and Queensland relatively worse.

Indeed, Victoria's population growth is now comfortably above Australia's, and New South Wales' population growth rate seems set to pass that of Queensland – where the pace of population growth has now dropped back to lows not seen in this century (or, more to the point, last seen by Queensland in the wake of the commodity price falls of the late 1990s).

And although it is indeed Western Australia that continues to lead the nation in terms of its population growth (currently running at 2.1%), that's a long way down from the peak of 3.7% that State briefly touched in the second half of 2012. Not surprisingly, there's a close correlation between the slowdown in Western Australia's population growth and the equivalent slowdown in net migration to this nation.

CHART 5
STATE SHARES OF TOTAL POPULATION



The latest data saw slightly more modest outcomes for both South Australia and for Tasmania, though neither of these two states are particularly in the population firing line as a result of a cooling commodities boom.

On the other hand, both the Northern Territory and the Australian Capital Territory have a bit more on the line. In the case of the Top End, that is because of its resource exposure, and for the ACT it is because the receding commodities tide masks a matching receding tax tide – thereby keeping up the pressure on public service numbers (albeit with a degree of protection provided on the latter front by the political gridlock in the Senate).

3.8%

AVERAGE INCREASE IN PRICES RECEIVED BY SOUTH AUSTRALIAN FARMERS PER YEAR SINCE 2000

$2.4b

SOUTH AUSTRALIA'S EXPORTS OF UNPROCESSED FOOD IN 2013-14

BankSA Rural Price Index

Differing performance across commodities

The BankSA Rural Price Index informs the State's farmers and farm industries how prices are faring for South Australia's farm products, rather than merely how prices are faring across Australia as a whole. The index aggregates price movements across 17 products which make up more than 80% of South Australia's farm output.

There are three groups of products – grains (such as wheat and barley), livestock and related products (dominated by wool, milk and beef), and horticulture (dominated by grapes).

The total and each sub-index are indexed so as to equal 100 as at January 2000. The index itself shows prices in Australian dollars (thereby reflecting the prices received by South Australian farmers), as well as in terms of the prices paid by foreign buyers (that is, prices in foreign currency).

Prices continue a slow upward trend

The overall trend in the prices received by South Australian farmers across recent years has been broadly positive. As Chart R1 shows (see page 19), prices measured in Australia dollars are currently near their historic peaks, and have risen by an average of 3.8% per year since 2000.

But that news has been since 2010 (as the $A line in the chart shows). And the news there would have been worse still except that falling world prices paid by overseas buyers (the other two lines) have been offset as the Australian dollar has finally begun to ease back.

So prices are high by the standards of the past, but they haven't risen much over the past four years, with any good news on that front coming more because the Australian dollar has finally fallen off its perch rather than because the world is paying bigger bucks for what this State's farmers sell.

That currency effect is not a minor benefit – prices received in Australian dollar terms have risen 4.5% across the past two years, whereas world prices are down by around a sixth across that same period.

That has provided an additional level of assistance to the local industry, with the improved competitiveness of local produce on world markets helping boost the volume of rural exports. Since 2009-10, South Australia's exports of unprocessed food have more than doubled – from $1.1 billion to $2.4 billion in 2013-14, a performance that has far outpaced the rate of national increase.

With the currency still moving lower of late, with the potential for more to come given that the dollar still remains above its longer term trend, those benefits can only increase. As a rule of thumb, every cent that the dollar drops against the US dollar adds some $400 million to annual farm revenue (more than 1%) across Australia – with South Australia taking around 15% of that, or $60 million.

BankSA Rural Price Index

Index base : January 2000 = 100	Level	March 2015 % change since Sep 2014	Mar 2014	Mar 2013
AUSTRALIAN DOLLAR INDEX				
Grains	195.7	+5.7%	-0.7%	+4.5%
Livestock and Livestock Product	184.0	-0.3%	+5.5%	+8.3%
Livestock Only	191.5	-1.6%	+5.6%	+10.6%
Horticulture	123.2	-0.9%	+6.3%	-6.7%
TOTAL ($A Based)	**174.8**	**+1.7%**	**+3.4%**	**+4.5%**
SDR INDEX				
Grains	229.3	-1.2%	-8.7%	-17.1%
Livestock and Livestock Product	215.5	-6.8%	-3.0%	-14.1%
Horticulture	144.3	-7.4%	-2.2%	-26.0%
TOTAL (SDR Based)	**204.8**	**-5.0%**	**-4.9%**	**-17.1%**
TOTAL (TWI Based)	**197.6**	**-6.6%**	**-7.9%**	**-16.3%**

Differing performances across categories

Yet, as always, the devil is in the detail. Chart R2 (right) looks at movements for the three key commodity groups within the broader agricultural sector, with the table showing recent growth rates across a range of measures.

The most volatile of these sectors is the crops and grains component. The upward volatility reflects the sharp swings in production levels that can occur – particularly during drought conditions – while the downward volatility reflects the relative ease of transporting the produce from bumper crops between markets. While the recent winter growing season in South Australia saw above average yields, levels were down on the very strong results seen in the previous year. That has helped stabilise wheat prices across the past few years, as has the sharp drop in production from both the European Union and the Black Sea region. However, overall production levels remain strong by historical standards, meaning prices are not tipped to move much in the near term.

The situation is similar for barley – global prices are expected to be stable as production levels ease back from the strong season seen in 2013-14. However, any falls in world prices would be offset by an easing in the Australian dollar, lifting returns to local farmers.

The largest contributor to South Australia's agriculture sector – livestock and livestock products – tends to see less volatility in its prices than does the crops component. After peaking during the drought conditions of 2010 and 2011, prices for sheep fell sharply in 2012 before beginning to recover. Wool prices have been more stable in recent years, while beef prices have been more positive.

Prices are not expected to reach those of earlier years any time soon. However, the easing Australian currency will help keep export volumes at close to record levels, as will increasing demand from China. The impact here is already accelerating – and spreading. China has long accounted for the majority of Australia's wool exports, but it has increased its share of our meat and livestock exports from 3% in 2010-11 to 14% in 2013-14. That rapid lift represents more than $1 billion in additional export earnings across this category alone.

Broader demand for beef has kept prices in that area high as well, although gains in exports to the United States have been partly offset by much stronger competition (and a lift in tariff rates) in the Japanese market. Recent trade agreements will cut into those restrictions, with a change in the way tariffs are triggered, helping lift exports to that market.

The final and smallest component of the index – horticulture – has seen the slowest increase in prices across the past couple of decades. Prices for potatoes and onions increased across the second half of 2014, but have eased since, and remain well below 2012 levels. In contrast, tomato prices spiked in mid-2014 and, while that was short lived, prices have been rising again of late. Overall however, horticulture prices are generally close to the levels seen since 2007. As we examine below, this has been influenced by large falls in prices for wine grapes in recent years.

There is more action on the volumes side of the farm export equation. Key to this is the rise of Chinese demand for all types of Australian agricultural produce. Total sales to China have risen from $3 billion in 2008-09 to close to $9 billion in 2013-14 – or from 1 in even 7 dollars to 1 in every 5 of all farm exports.

In particular, there has been a notable increase in exports of barley and canola, both of which are set to grow further in the future, thanks to reductions in tariffs under regional trade agreements. As is also true of exports of meat and livestock products, demand is spreading to more products, a trend that will help South Australia move from 'the mining boom' to 'the dining boom' as Asia's needs gradually change.

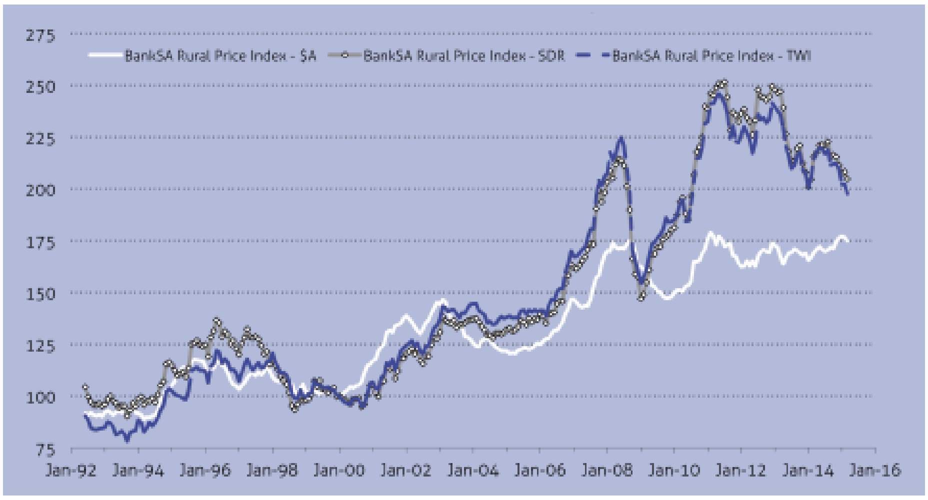
Long term trends in wine grape prices

While overall agricultural prices have moved upwards over time, Chart R2 (right) suggests the prices paid for horticultural produce has been more stable. A key reason for that has been the significant long-term decline in the price of wine grapes across this period.

Chart R3 (page 20) shows average price per tonne received for the wine grapes crushed in Australia since the late 1990s. This is a weighted index that includes the top 10 grape varieties produced in South Australia, of which just three (shiraz, cabernet sauvignon and chardonnay) make up nearly two-thirds of overall production. The break in the series represents a change in the way prices were collected, although prices do appear to have dropped in that year.

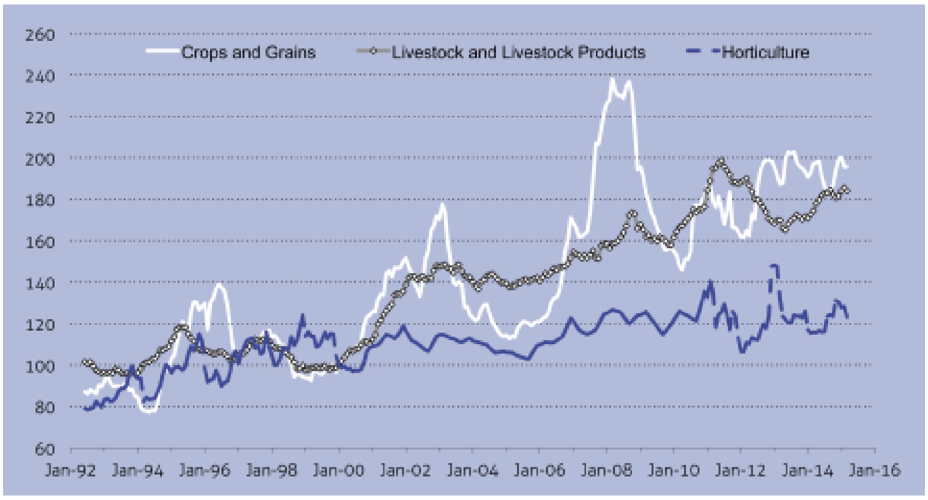
That chart doesn't tell a happy story. The index shows that prices are barely a third of the levels received 15 years ago. Prices have edged down in most years, with a significant impact on profitability within the industry – less than 15% of producers made a profit in 2014. The impact on the number of employees in the industry in South Australia has also been significant. In mid-2012 there were 779 grape growing businesses employing staff in the State (almost all with fewer than 20 employees), but by mid-2014 that had fallen by 12%, to just 688.

CHART R1
BANKSA RURAL PRICE INDEX – JANUARY 2000 = 100



Prepared by Access Economics

CHART R2
COMPONENTS OF THE BANKSA RURAL PRICE INDEX



Prepared by Access Economics

Australian producers have been hit by a number of trends over this time which have pushed prices lower – increasing supply and the buoyant Australian dollar.

The fall in prices has been largely driven by rises in volumes produced over time. Chart R4 (right) shows the increase in production since the late 1980s. Overall, national production has trebled over this time, with a slightly larger increase in other states than in South Australia. The increase in prices – seen in 2008 in the previous chart – followed the poor harvests that saw a sharp fall in production in 2007. Global production has not been quite as buoyant in general across this period, although the past couple of years have seen a resurgence in production from traditional European producers.

Like much of South Australia's manufacturing sector, local producers have also suffered with the high Australian currency, particularly as the Australian dollar has been especially high when measured against the currencies of the key export markets of the United States and Europe.

Wine has also not made the same sorts of leaps into the Chinese market that some other agricultural exports have of late. While overall, China accounts for more than 20% of total exports of agricultural production, it only takes 10% of our wine exports – a share that has not moved significantly in recent years. While that is an issue for the industry, it also represents an opportunity for growth in the next few years. With the Australian dollar well below earlier peaks, the competitiveness of local producers has been boosted in a market that is seeing considerable growth in overall demand.

Alongside the boost from a lower Australian dollar, that may help turn around the prices received by grape growers, lifting their profitability and stabilising the outlook in the industry.

CHART R3
AVERAGE WINE GRAPE PRICES PER TONNE - $

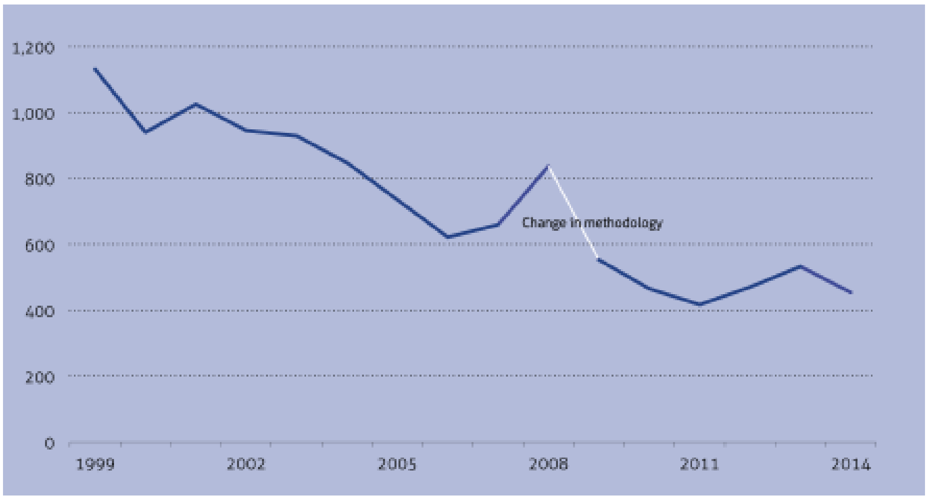
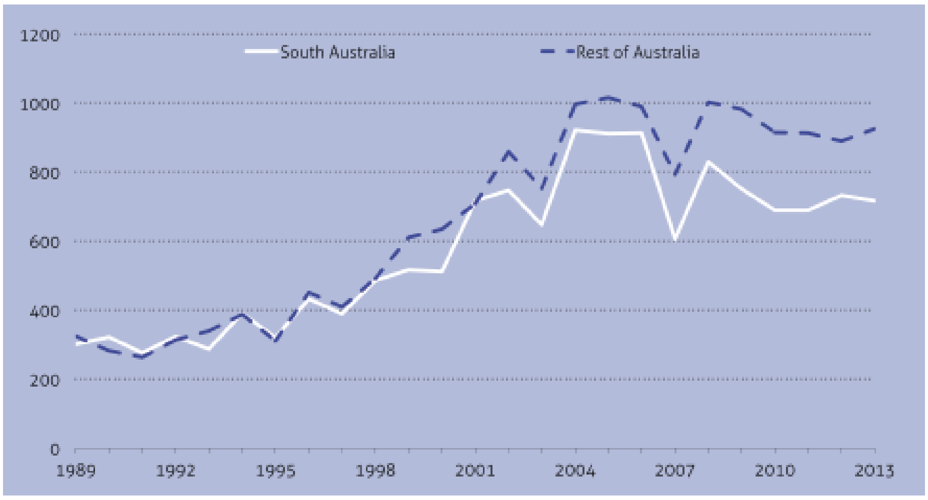
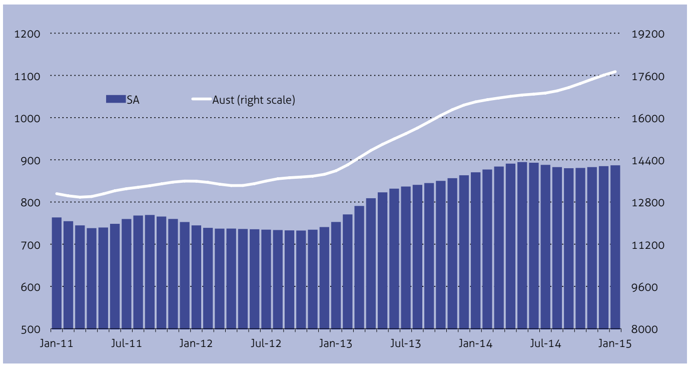


CHART R4
WINEGRAPE PRODUCTION BY STATE - '000 TONNES



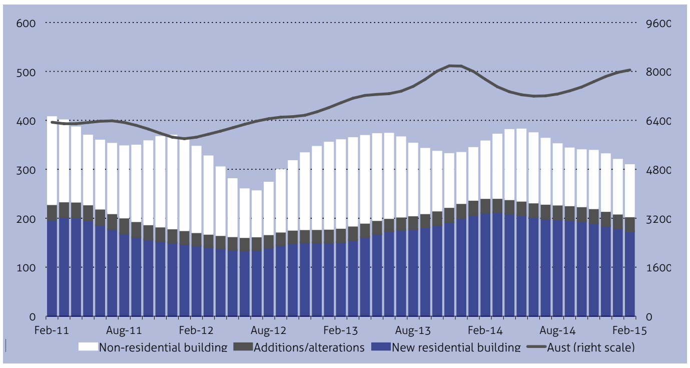
Statistics

CHART 1
SECURED HOUSING FINANCE COMMITMENTS - TREND ($M)



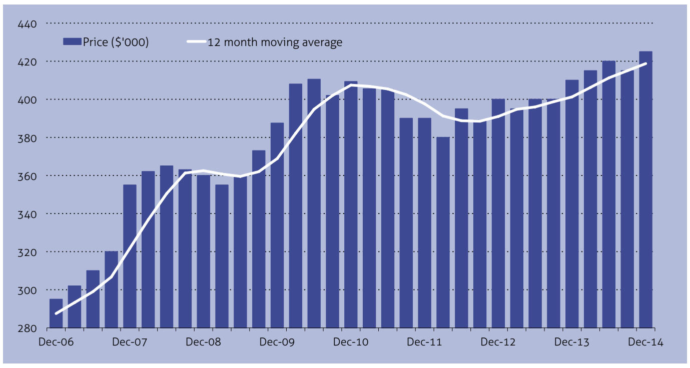
Supported by an extended period of low interest rates, national housing finance commitments have been rising since the start of 2013. Initially, housing finance commitments in South Australia also picked up in line with the national picture. However, housing finance commitments have levelled off in South Australia in recent months, while nationally, housing finance continues to rise. Investors have been particularly active in the Sydney (and to a lesser extent Melbourne) residential property markets. That has caused the Reserve Bank to make cautionary comments about property lending of late, although that issue is rather less of a concern in Adelaide.

CHART 2
BUILDING APPROVALS - TREND ($M)



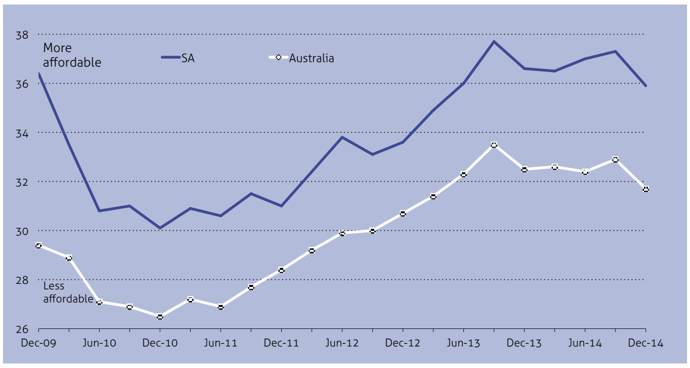
After a peak reached in early 2014 in response to the initial shift towards lower interest rates, the value of new house building approvals in South Australia has been trending down over the past year. The value of non-residential building approvals in South Australia – such as shopping malls and offices – has also softened in recent months. Overall, building approvals across all sectors have fallen in South Australia over the past year. That is a weaker performance than seen nationally, and suggests that the positive effects of lower interest rates are facing stronger headwinds in this State.

CHART 3
MEDIAN PRICE OF HOUSES SOLD ($'000)



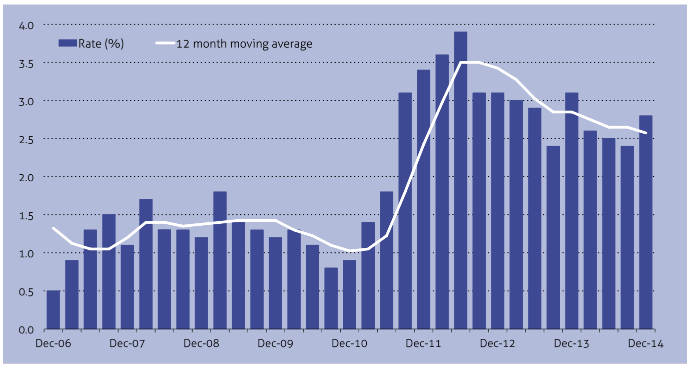
House prices in Adelaide are continuing to rise steadily, as has generally been the case over the past three years. The rise in house prices has been assisted by the impact of an extended period of low mortgage interest rates, which were first lowered in late 2011. The median Adelaide house price is now at around $420,000. That said, the rise in Adelaide's housing prices has not been as large as that seen in Sydney and Melbourne.

CHART 4
HOME LOAN AFFORDABILITY - INDICATOR STATISTIC



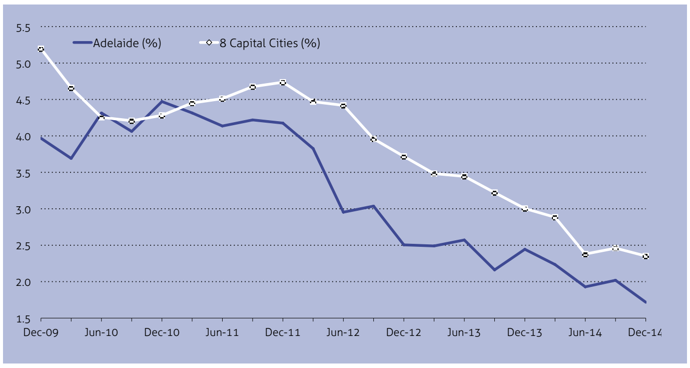
Housing affordability in South Australia remains well above the national average. As has also been true of the national average, affordability edged down a little in the latest data and remains slightly lower than the peak it reached in late 2013. Affordability in South Australia has been supported by a combination of low interest rates on the one hand, as well as by more modest housing prices in Adelaide than seen nationally. However, even though price rises in Adelaide have been less than in some other state capitals, they have been enough to check what would otherwise have been a recent improvement in affordability.

CHART 5
RENTAL ACCOMMODATION VACANCY RATE



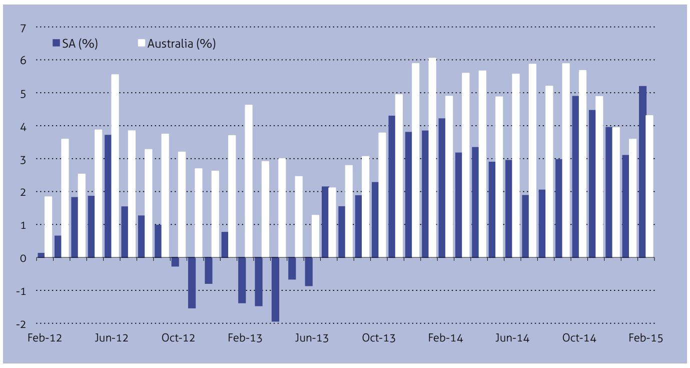
The rental accommodation vacancy rate in Adelaide has generally been trending down since early 2012. Although the latest data indicated a slight upward movement in the vacancy rate, the broader trend is indicative of a gradual tightening in the rental market. That said, vacancy rates are not yet showing signs of returning to their lows of 2010. Even so, a tighter rental market should help boost demand for home ownership in the State, and may help to turn around the recent weakening trend in building approvals.

CHART 6
INDEX OF DWELLING RENTS - % CHANGE ON PREVIOUS YEAR



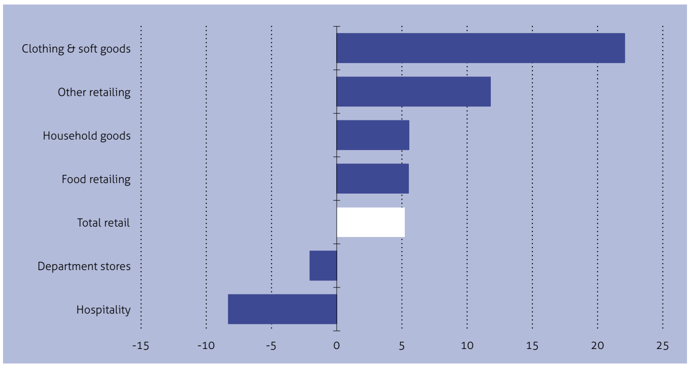
Despite the gradual fall in the rental accommodation vacancy rate in Adelaide, growth in dwelling rents in the State's capital eased further over the second half of 2014, and is now at the lowest level in well over a decade. That mirrors a similar easing in the growth of dwelling rents seen nationally in recent years, although the pace of growth in dwelling rents in South Australia remains lower than the national average, and is now lower than inflation more generally.

CHART 7
RETAIL TRADE - % CHANGE OVER PREVIOUS YEAR - SEASONALLY ADJUSTED SERIES



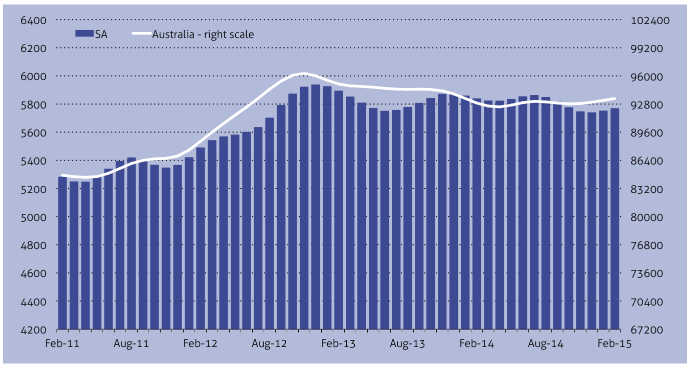
Retail turnover has been recording positive growth in South Australia since the falls in spending recorded in early 2013. Latest data indicate a pick-up in the growth of retail turnover in South Australia in early 2015, with growth picking up to slightly above the national average. Lower interest rates have supported retail turnover growth, as did the fall in petrol prices in late 2014 and the start of 2015, although petrol prices have risen again in recent weeks. That said, retail growth in South Australia may ease back below the national average over time, with weakness in job markets and lower than average population growth expected to weigh on longer term prospects.

CHART 8
RETAIL TRADE BY SECTOR - % CHANGE FEB 2014 TO FEB 2015 - SEASONALLY ADJUSTED



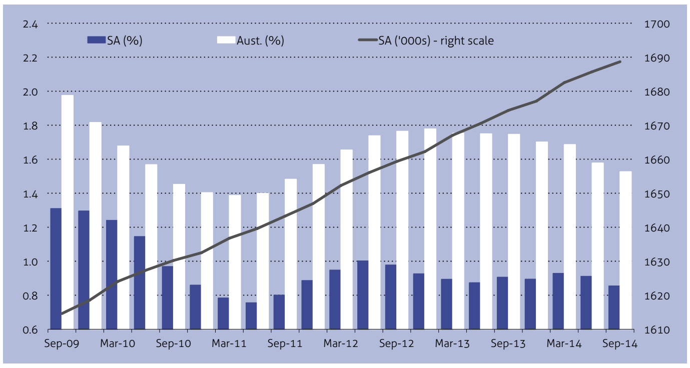
Locally, clothing retailers have continued to see the strongest increase in sales turnover over the past year. Household goods retailing has also seen good growth, with food retailing remaining a steady area of spending gains in the State. In contrast, department stores continue to record shrinking sales, while hospitality retailers also recorded a softer outcome in the latest data.

CHART 9
NEW MOTOR VEHICLE REGISTRATIONS - SEASONALLY ADJUSTED



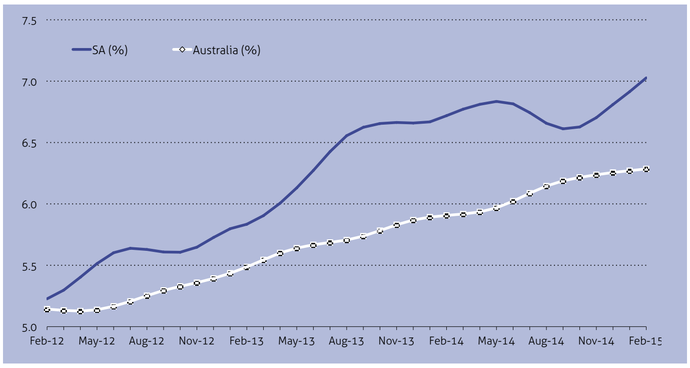
The number of car sales in South Australia is down slightly on their level from 12 months ago. Car sales in both South Australia and nationally have been flat-to-falling in the past two years after recording a strong rise in 2012. That flat result has been recorded despite car affordability in Australia continuing to improve. While the closure of the State's car manufacturing industry is – or will be – bad news for employment numbers, it may actually help to boost car sales in the medium term if it drives a reduction in tariffs. On the other hand, recent falls in the value of the Australian dollar will place upward pressure on the cost of imported cars as well as the cost of fuel, moderating growth in car sales throughout the country.

CHART 10
POPULATION TRENDS - % CHANGE ON PREVIOUS YEAR AND LOCAL LEVEL ('000S)



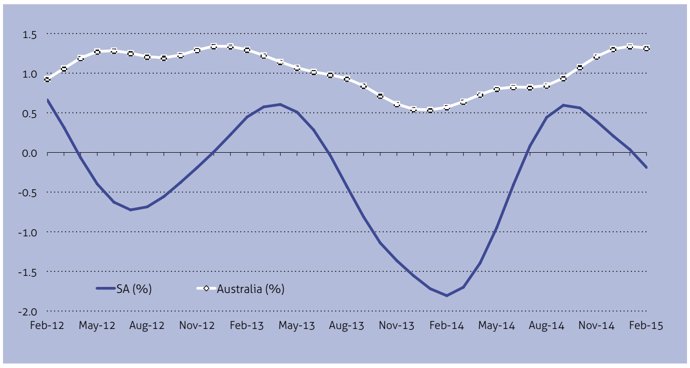
South Australia's population growth remains notably lower than the national average, which has been a long-term problem for the State. However, the gap has closed slightly since the end of 2012, with the national population growth rate easing since then while South Australia's population growth has remained relatively steady.

CHART 11
TREND UNEMPLOYMENT RATE (%)



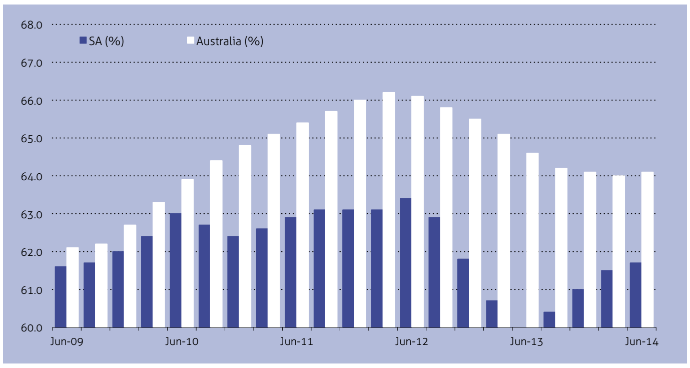
The unemployment rate in South Australia has continued to rise in recent months and is now at around 7%. That means the State's unemployment rate remains well above the national average. Further expected closures in local manufacturing industries may continue to take a toll on unemployment, although recent falls in the Australian dollar and low interest rates will help other sectors to support local employment levels.

CHART 12
EMPLOYMENT - % CHANGE ON PREVIOUS YEAR - TREND SERIES



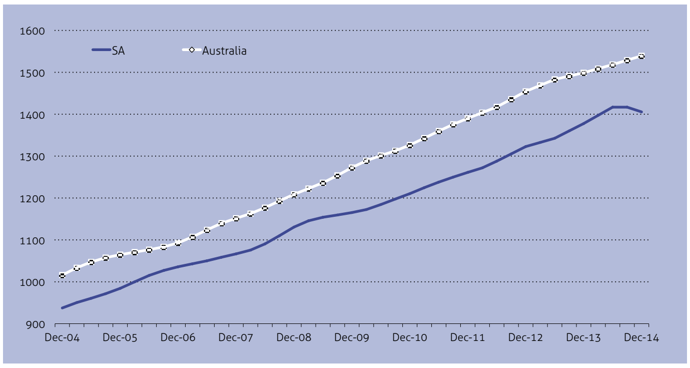
The State's rising unemployment rate has been mirrored in South Australia's weakening employment numbers. The signs of recovery in job growth seen in mid-2014 have since faded, with small job losses recorded over the past year. That means the State has failed to generate sustained job growth over the past three years, which has kept pressure on the unemployment rate. Nationally, job growth has shown a gradual improvement in recent months.

CHART 13
ROOM OCCUPANCY RATE - TREND SERIES



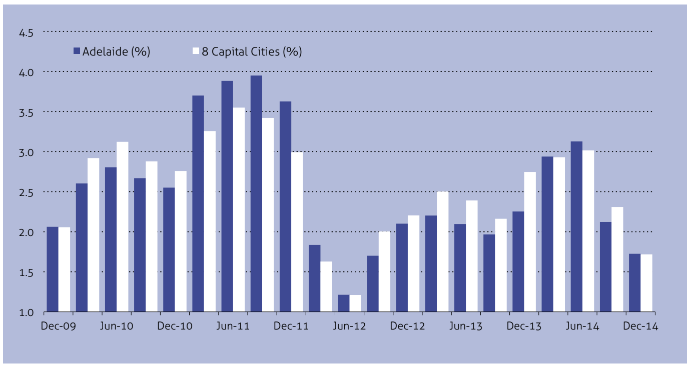
The latest available data indicates that South Australia's room occupancy rates edged upwards through the course of 2013-14. And the news may have improved further since: recent falls in the value of the Australian dollar and in oil prices are good signs for the tourism industry in Australia. Latest data indicates that the number of international visitors to Australia and South Australia have increased over the past year, with continuing growth recorded from source markets in Asia.

CHART 14
TOTAL AVERAGE WEEKLY EARNINGS ($) - PERSONS IN FULL-TIME EMPLOYMENT



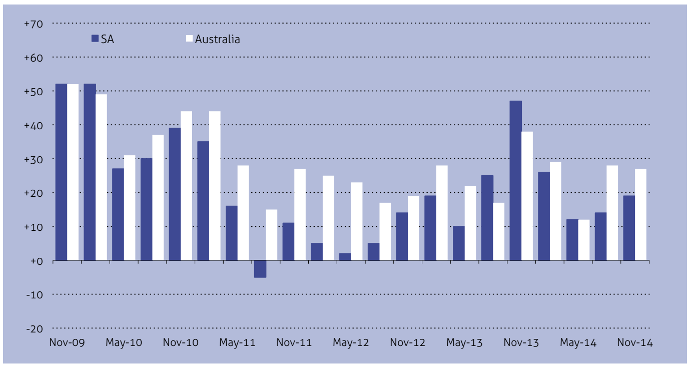
South Australia's wages have continued to remain lower than the national average. In part that reflects the higher wages in mining, finance and professional services where South Australia has a lower representation than does the nation. Low interest rates have supported the demand for finance and professional services of late, particularly in Sydney, even as mining has been under pressure. Latest data indicate that wages weakened in South Australia in late 2014, with the wage gap to the national average widening. That may reflect some of the challenges facing the State's economy, though it is also possible that time may show the recent trend to be nothing more than data volatility.

CHART 15
CONSUMER PRICE INDEX, ALL GROUPS - % CHANGE ON PREVIOUS YEAR



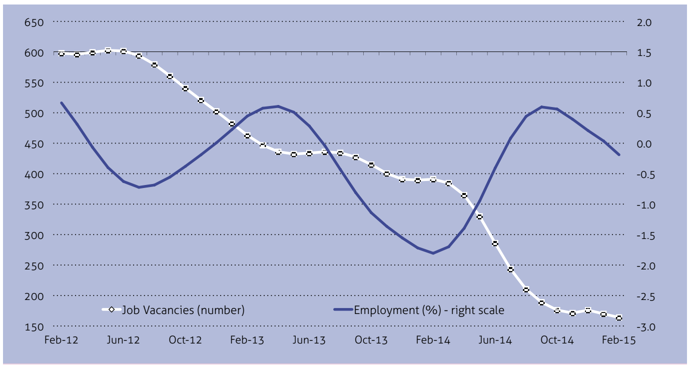
Inflation in Adelaide eased considerably in the second half of 2014, which was also the case nationally. Sharp falls in global crude oil prices over that period resulted in a large fall in local petrol prices, which in turn contributed to the lower outcome for inflation. Inflation is now slightly below the bottom of the 2-3% target preferred by the Reserve Bank. In the near term, weakness in the domestic economy including in wage costs will help to keep a lid on price increases.

CHART 16
SMALL BUSINESS CONFIDENCE - NET BALANCE



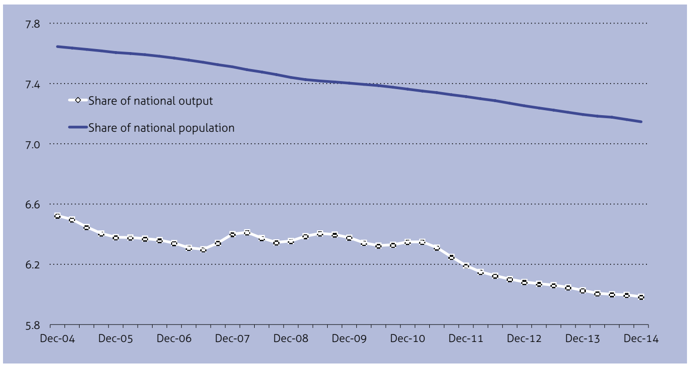
Small business confidence in South Australia picked up slightly in late 2014, but is still below the national average. The latest survey indicated that businesses in South Australia (along with Western Australia and the ACT) were more pessimistic about the economy than other jurisdictions. Businesses in South Australia indicated that lack of work or sales revenue was the main issue affecting their business, and concerns in this area also peaked in the manufacturing sector.

CHART 17
EMPLOYMENT GROWTH & JOB VACANCIES



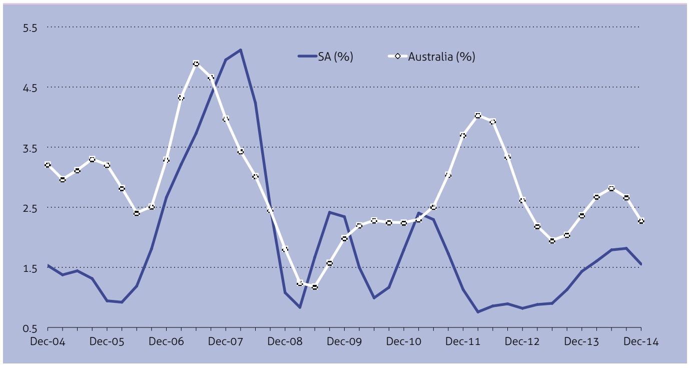
The number of job advertisements in metropolitan newspapers is a less reliable indicator that it was in the past (levels are down 80% since 2007 and, while internet advertisements are collected nationally, this is not as useful at the State level). However, this measure can still be a reasonable pointer at times for the short term employment outlook. Job ads have been relativity steady in recent months, which may suggest some stabilisation in South Australia's employment levels in the near term.

CHART 18
SHARE OF NATIONAL OUTPUT AND POPULATION (%)



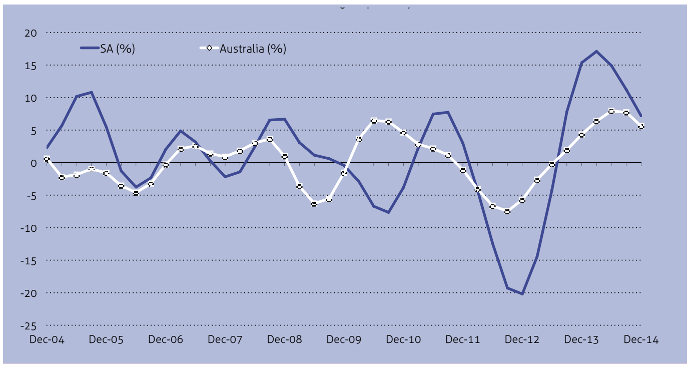
An ongoing theme in South Australia's economy is its decreasing population share. Partly related to that, the State's share of national output also continues to decline in line with (or slightly faster than) the State's population share.

CHART 19
OUTPUT - % CHANGE ON PREVIOUS YEAR



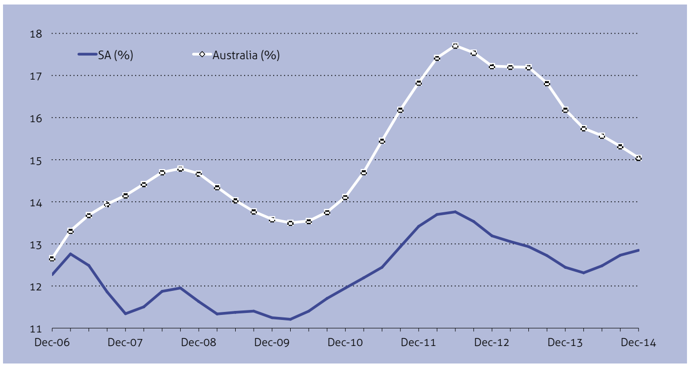
South Australia's output growth eased slightly in late 2014, and remains below the rate of growth seen nationally. A lower than average rate of population growth continues to limit the State's output growth relative to the national average, while troubles in the manufacturing sector (which has been hit by the earlier strength in the Australian dollar) are another drag on the State's output growth. That said, output growth has also eased nationally of late, reflecting the downturn in mining-related construction in the resource states.

CHART 20
DWELLING INVESTMENT - % CHANGE ON PREVIOUS YEAR



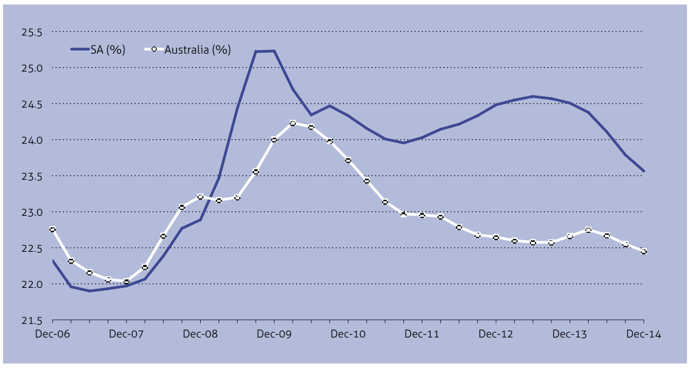
The growth in South Australian housing construction activity has continued to ease back in the latest data. That easing in growth follows what has been a strong upturn in housing construction through 2013 and early 2014, with the State's growth in housing construction now falling back to around the national average. A downward trend in residential building approvals through the course of 2014 suggests a cautious near term outlook, although low interest rates continue to provide some important support.

CHART 21
BUSINESS INVESTMENT - % OF OUTPUT



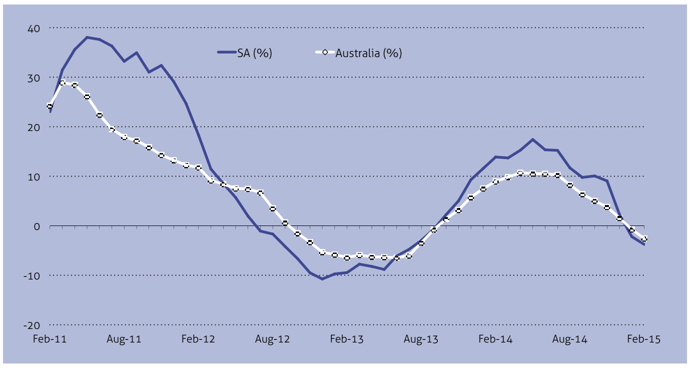
Business investment in South Australia has picked up as a share of the economy over the past year. That is a positive sign, with investment in productive capacity necessary to generate future growth. Nationally, the mining construction 'cliff' has been reflected in weakening investment, thereby bringing South Australia's investment rate closer to the national average – another heartening development.

CHART 22
PUBLIC SECTOR OUTPUT - % OF TOTAL CONSUMPTION AND INVESTMENT



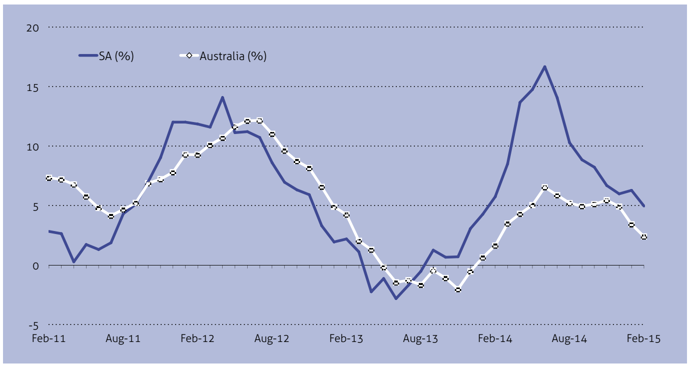
The share of public sector expenditure in the economy continued to fall at both the State and national levels in the second half of 2014. Over the past year, the fall in the share has been greater in South Australia, although the level of public sector expenditure is still relatively high in the State. Ongoing public sector budget pressures suggest a weak outlook for overall public expenditure in the near term.

CHART 23
MERCHANDISE EXPORTS - % CHANGE LAST TWELVE MONTHS TO PREVIOUS



Australia's mining boom is increasingly shifting from the construction phase to the export phase, with the volume of Australia's exports of commodities such as iron ore continuing to grow. However, and despite a depreciation in the currency in recent months, sharp falls in commodity prices are depressing the value of those exports in Australian dollars. Growth in South Australia's exports has also eased of late, reflecting some falls in the exports of metal ores and metal scrap as well as wheat, partially offset by increases in exports of meat and copper.

CHART 24
MERCHANDISE IMPORTS - % CHANGE LAST TWELVE MONTHS TO PREVIOUS



Growth in South Australia's merchandise imports has continued to ease back a bit in the latest data, although it remains higher than the import growth recorded nationally. Australia's growth in imports is down from its peak in mid-2012 as the mining boom moves from a construction phase, which required a high level of capital imports, to an export phase.

Trends May 2015

PRINT POST APPROVED 565001/00271

Defence photos courtesy of the Australian Government Department of Defence and the AWD Alliance.

Published by BankSA, 97 King William Street Adelaide 5000. Copyright reserved.
BSA01870 (05/15)

banksa.com.au