TOP STORY FOR THE WEEK 17 Aug - 21 Aug 2020
Victoria: in a state of debt disaster

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The recent declaration of a state of disaster by the Victorian Government has extended the coronavirus crisis. A health crisis generated an economic crisis. The second shutdown then generated a financial crisis for Victoria.

Victoria has a “AAA” credit rating from Standard & Poor’s and a “Aaa” rating from Moody’s. A coveted AAA/Aaa rating has ensured that interest rates payable on Victorian Government debt are the most favourable available in Australia after the Commonwealth Government. S&P revised its rating outlook to Credit Watch Negative in April 2020 implying a downward revision is possible.

A brutal fall in state economic activity, officially known as gross state product (GSP), is likely. The Victorian Chamber of Industry and Commerce has stated that thousands of businesses will close or transfer to other states. A 3.5% contraction in both 2020 and 2021 is expected as businesses fail or move and an additional 250,000 Victorians join the ranks of the unemployed, effectively doubling Victoria’s jobless rate to 13%.

State government revenue, comprising taxation and Commonwealth grants, is expected to fall by $7.0 billion, or 10%, in 2020/2021. Expenditures will increase by an estimated 5% through additional medical, hospital and coronavirus-related costs. Emergency funds of $24 billion have been set aside for the 2019/2020 and 2020/2021 years. Then there are the consequence of business failures, higher numbers of unemployed along with demands for higher public service salaries. Budget deficits of $12 billion or higher are projected for the next two years.

Net debt was $29.3 billion in Victoria at 1 July 2019. In the 2019/2020 budget, net debt was expected to increase to $69 billion over the next three years. It is now projected to increase to $100 billion over this period. The Victoria Government had stated it would maintain debt at 12% of GSP. Based on these projections of increased debt and falling GSP, debt will approach 19% of GSP in 2022/2023.

Interest as a percentage of revenue was planned in the 2019/2020 budget to be maintained at around average levels. The average over the period from 2009 to 2019 had been around 3.2%. Prior to this crisis, this ratio was expected to rise to 3.7%. With net debt at $100 billion and a lower credit rating, the ratio will approach 6%.

Victoria’s AAA credit rating, which is so prized, will almost certainly be lost. The debt-to-GSP ratio and the interest-to-revenue ratio will likely exceed the ratios required by the ratings agencies for any AAA-rated entity.

The cost in terms of higher interest rates will be between 0.2% and 0.4% per annum if current spreads prevail. On every $10 billion of debt, this amounts to around only $20 million to $40 million per annum. However, in the absence of future budget surpluses, Victorian Government debt will be refinanced at maturity, possibly at less attractive rates.

The task of financial management by future governments has been made so much more difficult. Choices will be required between the provision of services for Victorians, the employment of public servants and servicing debt. Repercussions will be felt for years.

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While house prices have declined in two consecutive quarters nationally, they have declined in three consecutive quarters in Victoria. Melbourne experienced the largest falls (2.3%) of any capital city in Australia. For the six months to June, Mirvac and Stockland have seen share price falls of 30.8% and 26.1% respectively. These residential AREITs are heavily exposed to Victoria's marketplace, with each having roughly 30% of their residential property developments in Victoria and 50% of revenues.

Uncertainty will remain, with Federal Government support payments and bank repayment holidays ending in September. Nationally, the average asking house price fell 0.8% for June, while Melbourne saw the largest declines of 1.5%. National dwelling values are still up 7.8% for the financial year, with Sydney and Melbourne rising by 13.3% and 10.2% respectively. Hobart, Darwin and Canberra, all posted positive returns for the month of June (0.3%, 0.3% and 0.1% respectively).

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