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WA Economic Outlook

Getting back on the bike

April 2018

Overview

"Why do we fall Bruce? So we can get back up again." - Thomas Wayne (Batman's dad)

The upturn in prospects for WA, identified in our December outlook, is not only continuing but gathering momentum. Three important factors are driving this:

First, stronger global growth and sustained Chinese demand for commodities has held up WA's export earnings. This has offset disappointing domestic growth. High levels of investment to meet the needs of an urbanising China population continue to support iron ore prices. We expect WA's export growth will continue to be the state's most important economic engine over the next five years as the export of LNG ramps up.

Second, the WA economy is finally beginning to shake the slowdown in business investment that has dragged growth lower since 2012. As a number of the large scale investment projects started during the mining construction boom reach completion, the Deloitte Access Economics *Investment Monitor* suggests investment is flattening out. Investment is likely to become a net positive contributor to WA growth over the next five years, however at a lower level of around 9% of GSP, compared to the 25% peak experienced during the mining construction boom.

Third, emerging growth is translating effectively into employment, supporting a self-reinforcing recovery. WA's employment to population ratio has risen 1.0 percentage points to 64.2% during the last 12 months.

At the same time full-time and part-time employment numbers are rising. Pleasingly, the share of people underemployed – those willing to work longer but without the opportunities - is falling.

Together these factors have contributed to an increasingly upward momentum in the economy. ABS trend data – data that controls for seasonal variations and irregular events such as Easter and Lunar New Year – show state final demand rose by 1.1% in the final quarter of 2017 compared to last year. A clear upward trend. The challenge will be ensuring growth filters fully across the WA economy to broaden the growth base.

Our last WA Outlook emphasised the importance of a recovery in household income and expenditure, but this remains weak. Recent growth in employment has reduced spare capacity in the labour market, but there is still a fair way to go before a lack of available workers begins to put upward pressure on wages.

Indications are that Perth's property market is also past the worst. January new building approvals fell year on year, but improved on a monthly basis. Property prices continue to decline but at a slowing rate.

Finally, while the improving outlook for growth bodes well for government tax revenues this has yet to materialise. Weak property markets and wage growth have hampered payroll revenue and property taxes. Recent improvements in the state finances have been driven by increased commonwealth grants, dividends and limited spending growth. The State Government envisages a period of tightly managed expenditure to reduce the growth in state debt, and return the budget to surplus in 2020/21, in line with Budget forecasts.

The principle risks to WA's fledgling recovery continue to be beyond the control of local policy makers. A sharp, unexpected slowdown in Chinese growth is likely to have a disproportionate effect on WA relative to other states given the importance of commodities to our growth profile. This is a low risk over the forecast horizon, given the acute awareness of Chinese policy makers to this problem - as reflected by progress toward less credit reliant growth in China.

Domestically, sharp increases in interest rates could also undermine WA growth. We expect monetary policy to remain accommodative for the foreseeable future to manage the risk of high levels of indebtedness across the country.

Overall the prospects for WA are encouraging but it remains early days. Official data illustrates a shaken economy, knocked off its bike and in the process of getting back in the saddle: shakily at first, the WA economy is re-establishing balance and we expect it to pedal-off, albeit at a much slower pace.

Detail

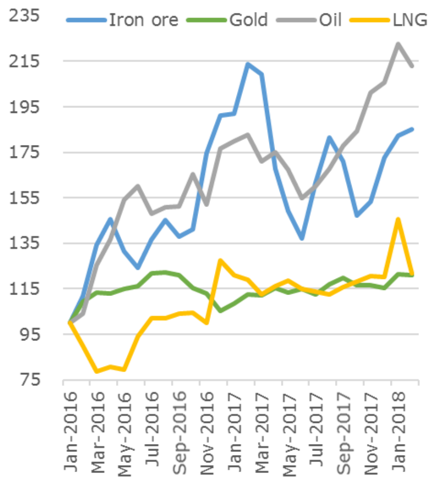
Chinese growth continues to support WA exports

WA continues to benefit from the high levels of investment in China driving economic development within the country. Chinese demand accounts for around a 70% of global iron ore imports, and over 80% of the iron ore exported from WA.

Improving global growth has supported continuing Chinese demand. This, in turn, pushed the price of iron ore upwards in recent months, prior to the new steel tariffs announced by the US. Meanwhile, resurgent global growth as well as geopolitical uncertainty have supported price gains for gold and petroleum (oil and gas), WA's second and third largest exports respectively (chart 1).

Chart 1: Prices for WA commodities

Spot prices (indexed) for iron ore, gold, oil and LNG. Jan 2016=100



Source: World Bank

WA's integration with the global economy means stronger global growth is likely to translate to an improving outlook for the state. However, the benefits of this integration bring accompanying risks.

WA is exposed to a potential slowdown in growth in China should the much touted debt crisis materialise. Separately, a potential escalation in the punitive trade measures being exchanged between major economies - kicked off by recent US steel and aluminium tariffs proposals - could also weigh on global trade.

However, the risk of these issues having a material impact on the WA economy in the near term is pretty low. Chinese growth has become less dependent on credit with the debt to GDP ratio falling in 2017 for the first time in five years. Sharp credit growth in the past means the risk of a debt crisis remains tangible, although Chinese policy makers are acutely aware of this. Progress has been positive and is likely to continue.

The direct effect of the recent US proposal to raise the import tariffs is also likely to be small, even without exemptions. Data show both WA and China export relatively little steel and aluminium to the US, with the US accounting for 1.1% of Chinese steel exports in 2017. As a result, the supply chain impacts of the current measures are likely to be small. Should excess steel be sold on the Australian market, domestic producers would likely face pressure to cut costs in the short run as global supply adjusts to new levels of demand. Australian consumers would temporarily enjoy reduced prices.

However, the impact of an escalation in punitive trade measures between the US and China, causing the latter to turn its back on trade would impose significant costs on Western Australia. It is thus important that any escalation into a dangerous 'tit for tat' trade war is contained. Assuming it is, net trade in WA (exports minus imports) will continue to be a positive contributor to economic growth over the next five years.

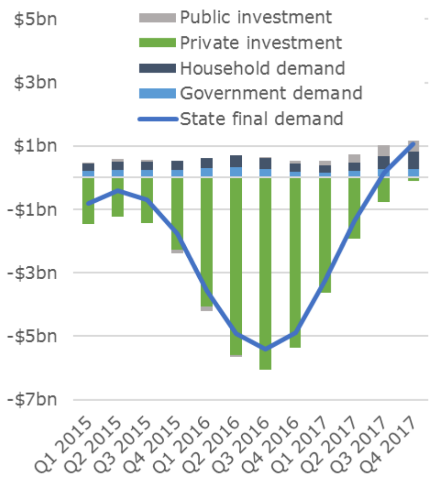
WA growth is becoming broader based

WA state final demand (a narrow measure of economic activity that excludes international trade) has continued on an upward trajectory (chart 2) increasing by 1.1% in the final quarter of 2017.

Underpinning the recovery has been the unwinding of a long drag in business investment as large scale projects commissioned during the mining boom reach completion. Business investment has been around 25% lower during the past year, proving a notable drag on the economic growth.

Chart 2: Better times emerging

Contribution to yearly change in state final demand (trend basis)

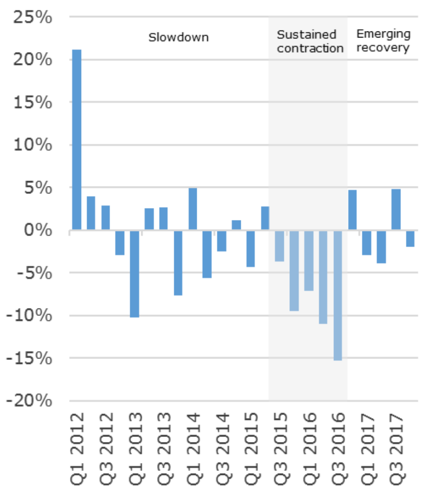


Source: ABS Cat. 5206.0

Recent data show business investment in WA remains volatile, but the worst of the contraction has passed (chart 3).

Chart 3: Business investment

Quarterly percentage change in Private gross fixed capital formation



Source: ABS Cat. 5206.0

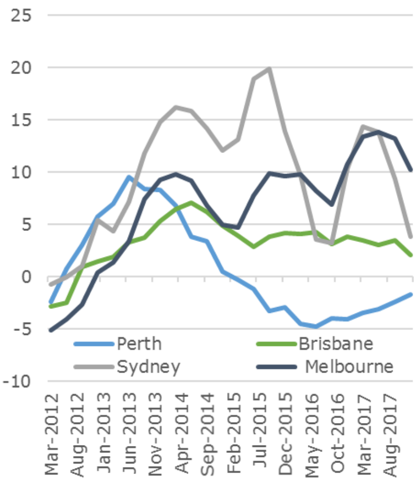
We expect business investment to support broader economic growth in the near term as the global economic outlook improves provided interest rates remain low.

The property market is slowly turning

The Perth property market is also showing signs of improvement (chart 4). Although the residential property price index declined by 1.7% in the final quarter of 2017 (Chart 4), prices are now falling at declining rates. This indicates a continuing mismatch in aggregate supply and demand as the market adjusts to slower population growth, tighter credit conditions for investors, and limited appetite to take on new debt.

Chart 4: Residential property

Annual percentage change in Residential Property Price Index



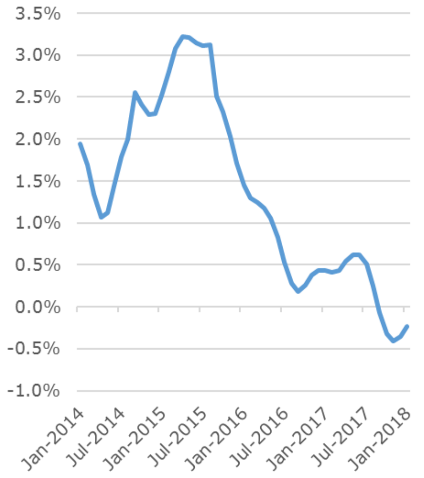
Source: ABS Cat. 6416.0

The effect of falling house prices continues to weigh on household spending. Household consumption increased by 0.5% in the final quarter of 2017 for the fourth consecutive quarter, but remains below the long term average of 1%.

The reticence of households to spend has also contributed to the downward trend in retail sales, which declined by 0.2% year on year in the final quarter of 2017 (chart 5).

Chart 5: Retail sales

Annual % change in WA retail sales



Source: ABS Cat. 8501.0

Expectations play a key role in determining levels of household consumption. While confidence is returning, consumers believe, legitimately, that future pay increases are lower than during the mining construction boom. Willingness to take on debt is also lower. Falling house prices can also weigh on perception via the 'wealth effect' – as the value of an individual's assets decline, people feel poorer, spending less regardless of whether they have money in their pockets.

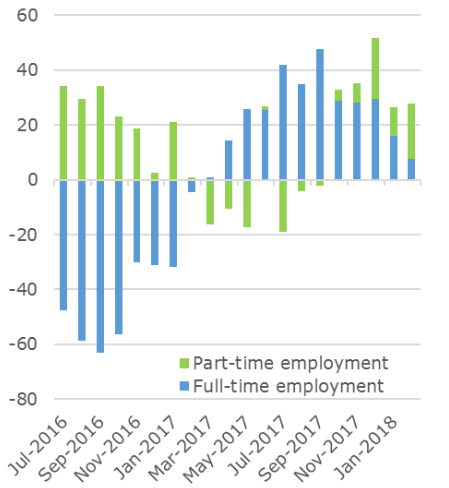
Employment is growing, but wage growth remains slow

Despite uncertainty, the labour market continues to perform well. The number of people employed in WA has increased by around 54,600 since the September 2016 peak in unemployment.

While employment growth is encouraging, the characteristics of this growth provide more reason to be positive. Employment growth has been driven by increasing full time jobs but supplemented by growing part time employment in recent months, indicating a broader based demand for labour (chart 6).

Chart 6: Here we grow again

Annual change in employment, full-time and part-time ('000s)



Source: ABS Cat. 6202.0

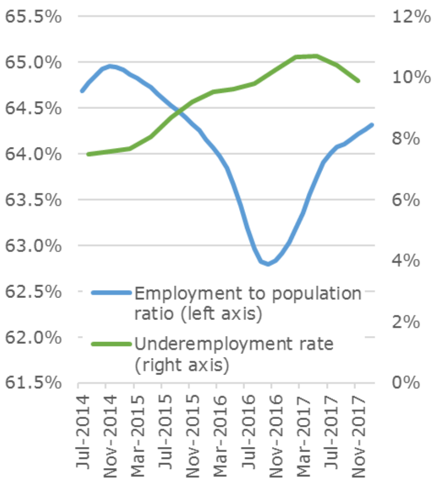
This may reflect a change in hiring behaviour with employers looking to boost the size of their workforces to meet expected demand, rather than indulge in 'labour hoarding' - reducing the hours of those previously employed full-time to retain their skills during recessionary periods, rather than resort to redundancies.

This behavior has also been reflected in high levels of underemployment within WA - workers who are willing to work longer hours but are unable to do so due to a lack of opportunities (chart 7).

February data confirm the falling levels of underemployment as the employment rate has risen: further evidence of increasing demand for labour across the state. These trends are also in line with qualitative evidence suggesting specific skills shortages may be returning in some sectors.

Chart 7: Will work longer hours

Employment to population ratio and underemployment rates – trend data

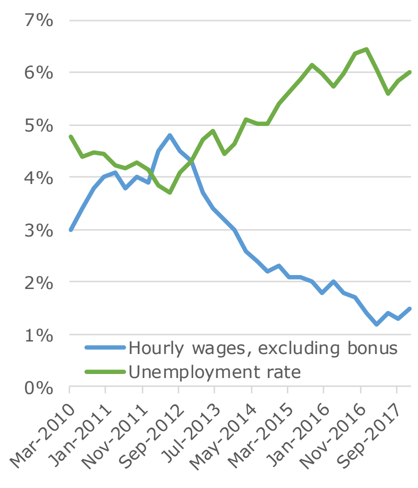


Source: ABS Cat. 6202.0

While positive, WA's unemployment rate remains above the historical average, indicating excess capacity still exists in the labour market. This excess capacity has also limited upward pressure on wages (chart 8).

Chart 8: Labour market capacity

WA unemployment rate and annual % change in average hourly wages



Source: ABS Cat. 6345.0, 6202.0

Weak wage growth has been a common factor of economic recoveries across the developed world. Indicative analysis shows that slow recoveries in productivity growth have been an important contributor, as resources have been transferred to lower productivity sectors such as retail and hotel and catering services.

While the recovering WA economy has yet to translate into additional net revenue for the State Government, measures to contain expenditure growth have supported the State Government's plan for fiscal repair.

Data from the quarterly financial accounts shows that tax revenue was 3.3% lower for the 6 months to December 31 2017, compared to the same period in 2016. The shortfall is being driven by lower land tax, transfer duties and payroll taxes albeit offset by higher royalty revenue, federal grants, GST and dividend payments.

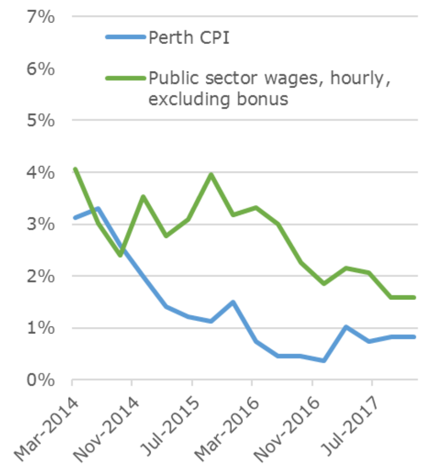
Expenditure growth was well contained, increasing by 0.3% on the same period in 2016. This, in turn, has halved the operating deficit for the first half of the 2017-18 financial year to $701m, down from $1.4bn in the same period in 2016.

Estimates of full year revenue and expenditure set out in WA Treasury's midyear estimates project the operating deficit to rise over the remaining 6 months. It is expected to increase to an annual operating deficit of $2.6bn, 5.3% higher than the $2.4bn achieved in 2016-17.

Containing public sector wage growth will be key and should be supported by the low levels of inflation within the state. While CPI inflation (chart 10) has increased in recent months, increases have been moderate, making the government's policy to limit wage increases to $1,000 more achievable.

Chart 10: Inflation and Public sector wages

Annual Percentage change in public sector wages and Perth CPI inflation



Source: ABS Cat. 6401.0, 6345.0

Overall, the external environment continues to be supportive for the government's planned management of fiscal expenditure. IMF analysis indicates that the economic backdrop is an important consideration. Cutting expenditure too fast during periods of weak growth has the potential to derail emerging recoveries much like the one taking place in WA. At the same time, expenditure needs to be managed to prevent the trajectory of debt becoming unsustainable.

The findings of the recent Langoulant Review hold important lessons for the current State Government regarding spending and investment. Existing expenditure requires review and reallocation to focus on areas that stimulate growth, reallocated from areas where economic impacts are limited.

Behind all this, expenditure needs to be monitored closely during periods of fiscal repair, particularly when risks are beyond the control of policy makers in question. With the release of the 2018-19 State Budget rapidly approaching, we'll see how well the State Government continues to tread this difficult fiscal path.

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