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WA Economic Outlook

What's on the horizon?

June 2017

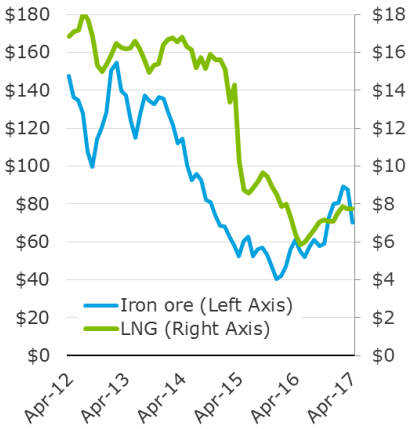
With the worst of the downturn passing, it's time to have a serious think about Western Australia's economic future

This financial year, WA remained unlucky last on basically every front, including capital city house price growth and retail turnover growth. This isn't likely to change much in 2017-18, though exports should increasingly ramp-up and support headline growth.

Exports have this year been given a welcome boost from higher commodity prices. After falling steadily since mid-2011, the rebound in commodity prices in 2016 was as sharp as it was unexpected (Chart 1).

Chart 1: Welcome back

Iron ore (CFR spot, US$/dmtu) and LNG prices (Japan, US$/mmbtu)



Source: World Bank

World iron ore prices have more than doubled since their late 2015 low, while oil prices are up by almost 25% over the past year. LNG prices (Japan) have gained 21% over the same period. Prices have recovered at the same time that new mines and gas fields commissioned during the resources boom proceed to production phase. This has underpinned an increase in the quantity of commodity production, and this combination of higher prices and expanded production should see WA export earnings increase by 10% in real terms over 2016-17.

Mining boom 2.0?

However, the recovery in commodity prices does not mark the start of another mining boom. The drivers of the recent recovery are not something you'd bet the house on to continue.

Prices have benefited from a perfect storm of supply disruptions and restrictions, a potential overshoot of negative positioning in commodity futures markets, and the return of Chinese stimulus.

These factors hint that the recent increase in commodity prices will take on a temporary nature. Indeed, some commodity prices have already begun to fall.

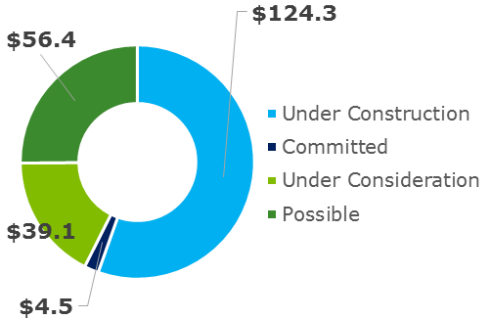
Once bitten, twice shy

Without price certainty, it's no wonder the investment pipeline in WA is looking so sick. Project proponents are not yet confident enough to dust off all those projects that have been sitting on the shelf since the resources boom busted in 2012.

The State's pipeline of investment projects confirms WA's investment anemia (Chart 2). Over half of the pipeline is represented by projects under construction – and of these, most are reaching their conclusion (e.g. Prelude, Wheatstone and Gorgon). But it's the tiny dark blue slither of 'committed' projects in Chart 2 that is of most concern. There are not many projects ready to replace the tide of investment that has occurred in WA in recent years.

Chart 2: Pipe dreams

WA investment project pipeline, by project status, $bn



Source: Deloitte Access Economics

Projects in the 'committed' part of the investment pipeline include some of the road and rail projects announced as part of the recent $1.6bn funding package committed to WA in the Federal Budget. But as Chart 2 shows, this is a drop in the ocean compared to the value of the mega-projects finishing up in the resources sector.

While the value of projects 'under consideration' and 'possible' looks healthy ($95bn), most of these projects are in the resources sector, and are probably unlikely to proceed further down the development path in the near term.

The cost conscious era

In this context, Woodside's recent announcement that it may revive the Browse project is welcome. However, the brownfields nature of the proposal is notable. Woodside's plan for the project now entails less outlay compared to the previous floating LNG concept, by channeling gas into existing onshore infrastructure on the North West Shelf.

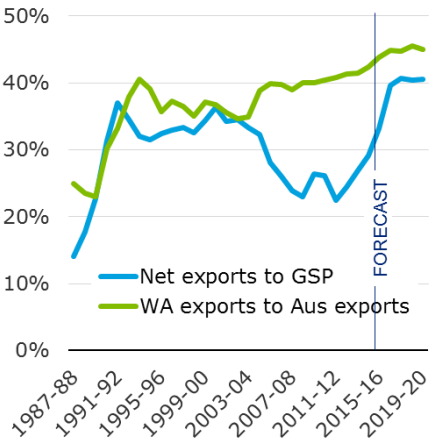
It was inevitable that an era of cost-conscious investment would follow the excesses of the resources boom. The acute input shortages that arose during the scramble to make hay while the sun shone on commodities saw project budgets blow-out. The current era of investment caution, while necessary, is problematic for a

State which was hooked on business investment. In the 10 years to 2012-13, half of the growth in the WA economy was accounted for by business investment. In the four years since, investment has gone backwards, wiping $27bn off State output.

State of exports

While the investment picture in WA resembles a cliff, the legacy of the investment boom in WA is the production and exports boom that follows. As all those new resource projects reach construction completion and begin shipping, our export receipts are getting a bounce (Chart 3).

Chart 3: Exports
WA's net exports as a share of GSP, and exports as a share of Australian exports



Source: Deloitte Access Economics

Gen X and older West Aussies will remember WA's *"State of Excitement"* license plates back in the 1980s and 1990s. While that could not have been further from the truth back then (although we are more exciting nowadays), the *"State of Exports"* tag is far closer to the truth today. WA now accounts for 40% of national exports (up from 22% in 2011-12), and net exports are set to make up almost half of our GSP.

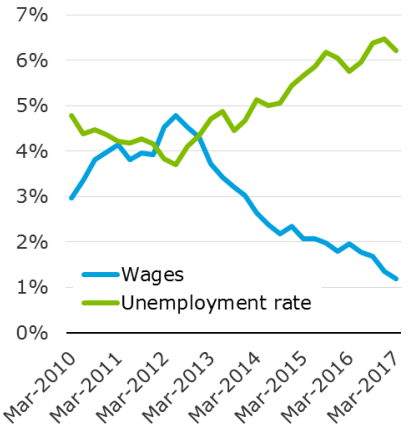
But while export growth is certainly welcome (and currently stopping the WA economy from falling into recession), it does not generate the jobs and flow through to many parts of the economy like the investment phase of the commodity boom. That phase spread the wealth as huge amounts were outlaid in short periods of time to expand production capacity.

In contrast, the returns at the export phase are spread over a much longer period and are directed to those that risk the capital in the first place. So the average punter sees far less of the benefits generated at this stage of investment cycle.

Labour pains

As such, it's little wonder that so much pain is being felt in the WA labour market. Wages grew by just 1.2% in the year to March 2017 (Chart 4), and we expect wages to rise by only 1.7% in 2017-18.

Chart 4: Labour pains
WA wage price index (annual % change) and unemployment rate



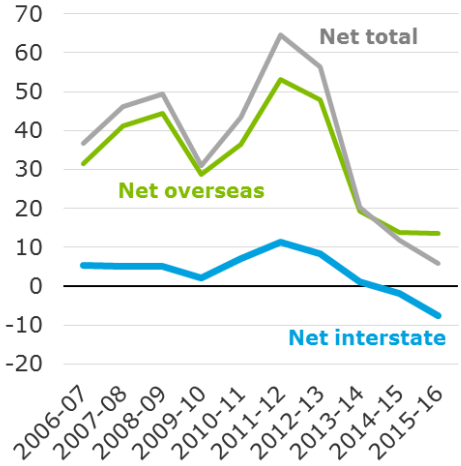
Source: ABS Cat. 6345.0; 6202.0

This reflects weak economic conditions and high labour availability, with a near record 87,800 people unemployed and looking for work in WA in April 2017. However, the rate of joblessness has fallen over the past three months, from 6.3% to 6.1% in April - the lowest unemployment rate in 10 months. But this is unlikely to be a sign of long term recovery. We expect unemployment in WA to remain at around the 6% mark in in 2017-18 and 2018-19.

Go ~~West~~ East!

As the labour market remains soft and wages growth weakens, it is unsurprising that WA's population growth has slowed. State population is expected to grow by just 0.9% in 2016-17 – the lowest yearly growth since modern records began. The slowing in population growth is underpinned by negative net interstate migration (Chart 5).

Chart 5: Straight outta… WA
WA net migration, 000s



Source: ABS Cat. 3412.0

For the second year in a row, more people exited WA to move to other States than the reverse. In fact, 19,000 more people have left WA to go interstate since 2011-12 compared to the number coming in from other States.

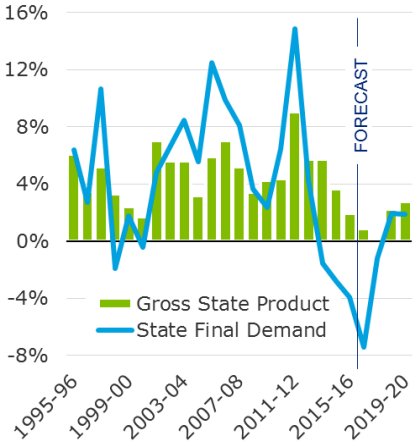
However, net overseas migration remains positive, and is offsetting the flight from WA to other states. But even overseas migration is falling itself as the economic lure of WA dissipates. At the peak in 2011-12, some 21 out of every 100 immigrants arriving in Australia settled in WA. Now for every 100 immigrants, only 8 join us in the West.

More pain, some gain

Our outlook for WA does not differ hugely from our Q1 *WA Economic Outlook* (click here). The numbers still don't look great. Gross State Product (GSP) is expected to rise by 0.9% in 2016-17, and by 0.2% in 2017-18.

This growth is underpinned by net exports, however, stripping away the impact of net exports gives the State final demand measure of output (a measure of domestic economic growth). This measure lays bare the challenges facing WA. The domestic economy is expected to contract by 7.4% this financial year, followed by a further 1.2% decline in 2017-18 before a return to growth thereafter (Chart 6).

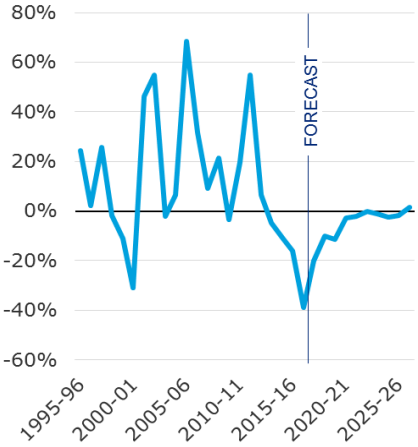
Chart 6: Diminishing returns
WA GSP and final demand, % change



Source: Deloitte Access Economics

As outlined in our Q1 note, the return to growth is underpinned by stronger private consumption as low interest rates, slightly higher wages growth and subdued consumer prices stoke moderate spending growth. However, we don't expect business investment to grow in year-on-year terms until the middle of next decade (Chart 7). Long term forecasting is always a dicey business and many unforeseen things might change this projection. But if this eventuates, it would signal a lost decade of investment for the State. Indeed, the value of WA business investment in the mid-2020s would return to 2005-06 levels, in real terms if this occurred.

Chart 7: Down for the count
WA business investment, annual % change



Source: Deloitte Access Economics

Diversification or bust?

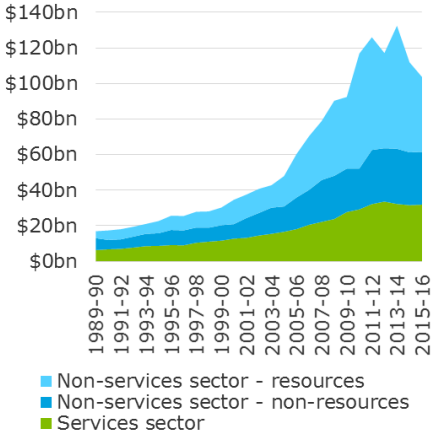
With rapid growth in business investment (underpinned by engineering related investment in the resources sector) having defined the last decade of our growth profile, the potential absence of it as a major driver over the next 10 years poses the critical question*: "What's next for WA?"*

West Australian policy makers, business leaders and the broader community have pondered this question, well, since the post gold rush era. Our State's economic landscape back then, and now is dominated by the resources sector.

Chart 8 shows that output of the WA services sector is much smaller than the non-services sector (resources, manufacturing, agriculture, utilities, construction and wholesale trade).

The problem is that growth in the non-services sector (resources in particular, which makes up 60% of this slice) drives much of the growth in the services sector. So when miners sneeze, retailers catch a cold.

Chart 8: The resource state
WA gross operating surplus and gross mixed income, by sector, current prices



Source: ABS Cat. 5220.0

Therefore, the diversification debate is not just about new industries, but also about forging new markets for existing industries – particularly our services sector. Chart 8 underlines the importance of enabling the services sector to pivot to markets where demand is driven by something less volatile and more sustainable than world commodity prices. These are not easy issues to resolve, although there might be a better way to reach this end goal.

"Funny how the new things are the old things"

Rudyard Kipling was onto something. While the resources sector is often thought of as 'old economy', we should be wary of ignoring it in thinking about new industries and new markets for WA. In fact, resources could be our ticket to achieving greater diversification by leveraging what we're already good at to build new industries and forge new markets.

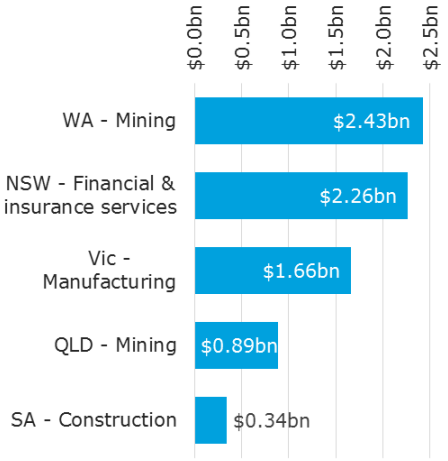
After all, the current makeup of our economy is unlikely to change for the foreseeable future. If the value of output in the non-services sector grew every year at its long term

annual average rate of growth for the next 30 years, then the WA services sector would need to grow at an annual rate 1.3 times faster to "catch-up" with it. So how might we use our smarts in resources extraction and operations to diversify our economy?

Drillers, diggers and digital

An opportunity exists to leverage the knowledge (and dollars) of the resources sector to build the State's capacity for science, technology and innovation. This is not bandwagon-jumping: the WA resources sector is nationally renowned as an avid investor in, and applicant of R&D (Chart 9), particularly in digital. Think driverless mining trucks and autonomous drill rigs in the Pilbara.

Chart 9: Future focussed
Largest investment in R&D, by setcor and by State, 2011–12

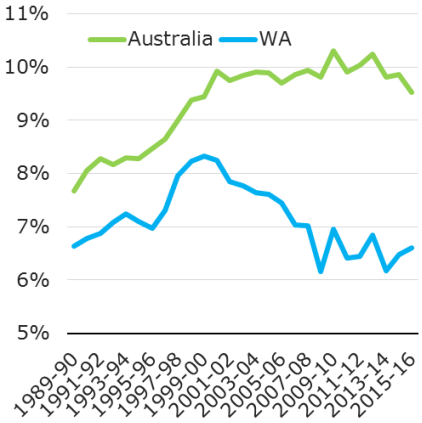


Source: University of WA

The ability of WA's science and technology sector to service the needs of the State's resources industry has previously seen it form a decent chunk of industry output relative to the same sectors on a national scale (Chart 10). However, the value of science and technology output in WA as percentage of total industry output has tread a very different path to the national average since the early 2000s.

Miners and oil and gas producers understandably curtailed investment in technology as their focus shifted to getting new projects off the ground.

Chart 10: Bridging the tech gap
Output of the science and technology sectors as a % of total industry output*



*Source: ABS Cat. 5220.0.*Combined total factor incomes of information media, telecommunications, professional, scientific and technical services sectors*

But timing is everything, and in the current cost-conscious investment climate, the appetite for technology in the resource sector might well be re-kindled - especially as most of its tech investment is aimed at reducing costs and / or increasing productivity.

While WA is pretty good at developing resource-related technology and applying it locally to expand the resources sector, the stretch goal in future might be to export the knowhow to build the State's reputation, while also diffusing and expanding it to other local sectors to inspire growth elsewhere.

There are certainly some bumps along the path to achieving such outcomes (e.g. access to capital, retaining talent and skilled labour, working through patents etc.). But there are immediate opportunities to make quantum leaps forward. For example, the Square Kilometre Array (SKA) - a global endeavour to build the world's largest and most sensitive radio telescope – is to be developed in the Midwest of WA. The SKA requires some serious computer processing power and data science smarts - and big data solutions have significant applications to other sectors, including resources.

The Pawsey Supercomputing Centre located in Perth's Technology Park was developed with the aim of supporting the State's bid for the SKA project. The Centre houses the most powerful supercomputer in the Southern Hemisphere. But more will be needed as the project gets up and running by the mid-2020s.

What's on the horizon for WA?

Deloitte's latest *Building the Lucky Country* publication*: 'What's over the horizon? Recognising opportunity in uncertainty'* (click here) examines possible futures for the State economy. One such scenario considers what happens if Australia goes 'cyber smart': embracing new technology and investing confidently. Disappointingly, the modelling suggests that, under the status quo, Western Australia is expected to benefit the least under this scenario relative to all other states and territories.

New South Wales, Victoria, Queensland and the ACT are the standout beneficiaries of the extra investment spending shaken loose by a better cyber culture given their service sector base and relatively high representation of information technology specialists.

Like it or loathe it, there is no doubt that digital technology will play a bigger part in our economic future than it has to date. Time to think hard about that future and how we can shape our digital destiny to get a bigger slice of the opportunities it presents.

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