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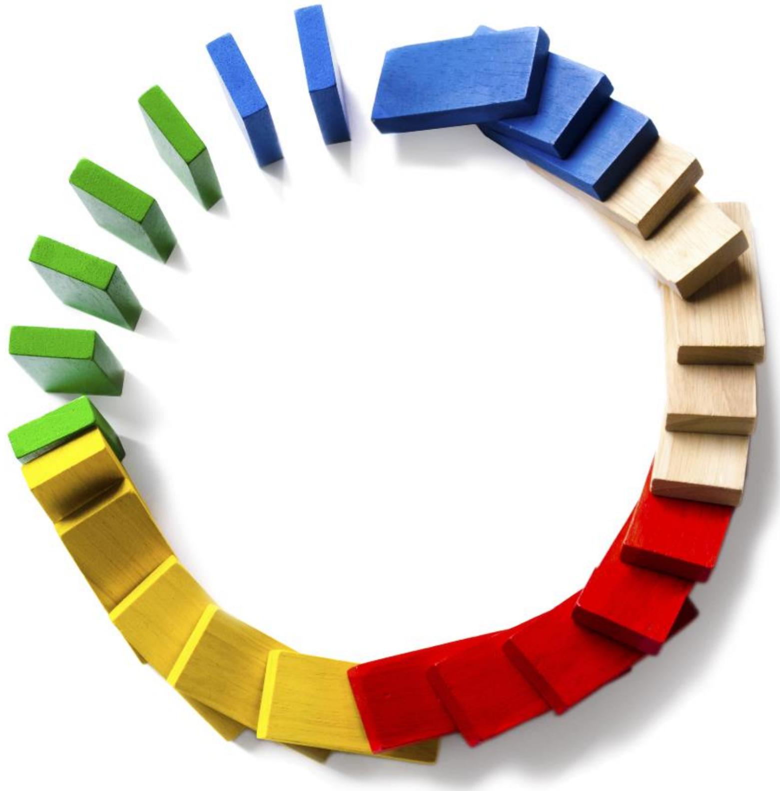


WA Economic Outlook

Almost done with the downturn

December 2017

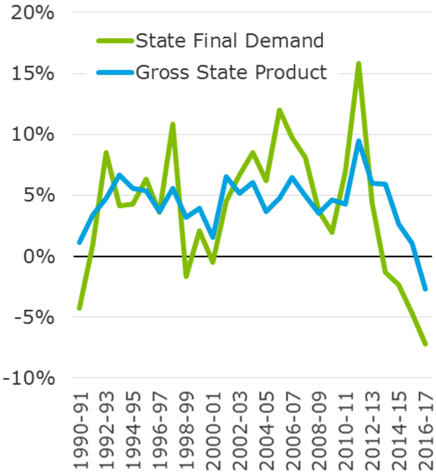
Cautious optimism as WA begins to turn a corner

Talk of economic recovery in WA might seem premature given recent economic data. In mid-November, estimates of Gross State Product (or GSP, a measure of total economic output) for 2016-17 showed the WA economy had contracted by 2.7% in real terms. This ended a 26-year run of economic growth in WA (since the State GSP accounts series began - Chart 1).

Although GSP fell for the first time in a long time in 2016-17, State Final Demand declined by a record high 7.2% in the same year, marking four consecutive years of contraction. State Final Demand is a narrower measure of growth, focusing on domestic activity as it excludes international trade and other items.

Chart 1: End of an era

WA Gross State Product and State Final Demand, yearly % change



Source: ABS Cat. 5220.0

2016-17 marked a departure from recent years when, thanks to rising exports, Western Australia's headline GSP growth figure has remained in positive territory even as State Final Demand tanked. All that investment in production capacity in the resources sector has helped to boost export earnings. However, exports (which continued to rise in 2016-17) could no longer make WA look untouchable in 2016-17.

The 2.7% contraction in WA GSP caught many off guard. Our own estimates suggested growth of 0.5% in 2016-17, while WA Treasury predicted 0.25% growth for 2016-17 in the 2017-18 State Budget released in September. The Chamber of Commerce and Industry of WA (CCI) also expected growth of 0.5% in 2016-17. So what went wrong?

Households fail to come to the party

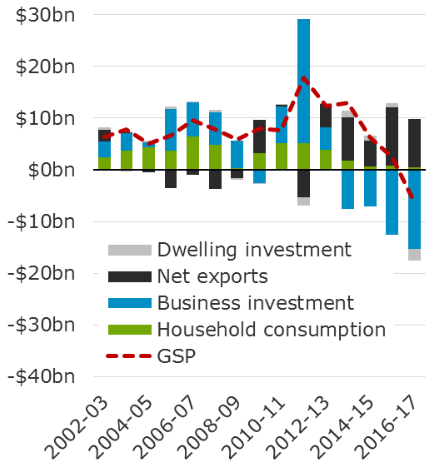
While a sharp decline in business investment was the main culprit behind the negative GSP growth outcome (business investment fell by over $15bn or 28.6% in 2016-17), this was largely expected. Business investment in WA has been coming off atmospheric highs since 2013-14, when commodity prices weakened, no longer supporting large-scale investment by the resources sector.

Dwelling investment, down by almost 20% in 2016-17, also contributed to the overall decrease in economic activity as the WA housing market continued to suffer (Chart 2). However, this decline was also largely expected by us and fellow forecasters.

Rather, it was lower than expected growth in household consumption that led to GSP estimates being far from actual (Chart 2). Household consumption increased by 0.5% in 2016-17 compared to our estimate of 1.1% growth and WA Treasury's expectation for a 1.25% increase. CCI expected a 1.4% rise in household consumption for 2016-17. With household consumption making up 45% of GSP, variances of this magnitude can mean the difference between growth and contraction, especially when there are few other drivers of activity.

Chart 2: Households go MIA

Yearly change in key components of WA Gross State Product (GSP)



Source: ABS Cat. 5220.0

Statistical revisions take a toll

However, not all of these variances can be blamed on misfiring economists. The Australian Bureau of Statistics (ABS) also incorporated revised estimates in this year's release of State Accounts data, which included multi-year revisions to household consumption growth (among other indicators).

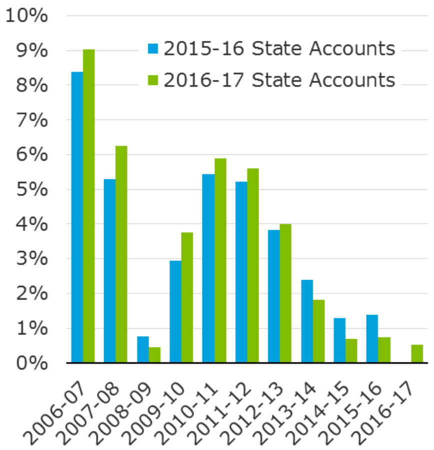
While revisions to historic data are standard fare in the statistics world, this year's revisions go back much farther than usual and are more significant in magnitude as the ABS incorporated new methods, concepts, classifications and data sources in order to maintain consistent time series data.

And the revised data series shows that we did not consume or grow as much as we thought in the last few years. Past consumption growth and past GSP growth have been dialed down significantly from previous data, making estimates based on that previous data look optimistic (Chart 3).

In fact, average growth in household consumption between 2013-14 and 2015-16 was revised down by the ABS to 1.1% per annum, below previous estimates which suggested growth in the order of 1.7% per annum. Seemingly small-fry but a big deal given the importance of consumption to GSP.

Chart 3: All change

Successive estimates of annual growth in WA household consumption



Source: ABS Cat. 5220.0

Signs of recovery emerge

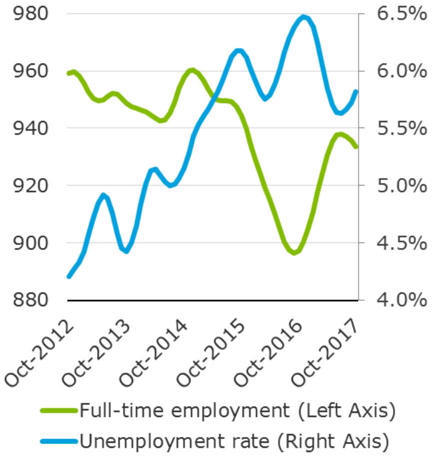
Statistical revisions aside, some fundamentals are encouraging for the WA economy. The latest National Accounts data released in early December (which include quarterly estimates of State economic activity) showed that State Final Demand in WA had increased by 0.4% in trend terms in the first quarter of the 2017-18 financial year. This marks a three-quarter growth streak.

Consumer confidence in WA has also continued its recent upward trend, with CCI's consumer sentiment survey reaching a three-year high in the September quarter 2017. A more positive jobs market explains this boost in confidence.

The ABS measure of job vacancies in WA has increased for five consecutive quarters to August 2017 (+3,800 vacancies) - a feat not achieved since early 2006. Higher vacancies are showing up in lower unemployment data, with the trend unemployment rate in WA falling from 6.4% last October to 5.8% this October (Chart 4). The State's workforce has expanded for 13 consecutive months to October 2017, with over 37,000 jobs added in the year to October.

Chart 4: Trading places

WA full-time employment (000s) and unemployment rate, trend terms



Source: ABS Cat. 6202.0

Encouragingly, 98% of this jobs growth are full-time positions. This is in stark contrast to the previous year. Over the year to October 2016, the number of full-time jobs in WA fell by 47,000 as the total workforce shrank by 20,000 (meaning jobs growth was concentrated within part-time roles alone).

Business investment: the foot of the cliff emerges

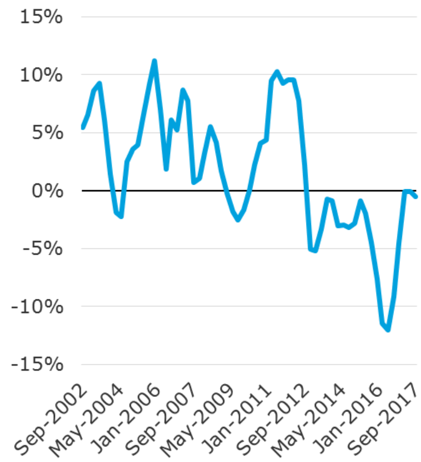
Business investment was the ace in the pack of WA's economic boom. Investment increased by $63bn in the decade to 2012-13. But it has been the bane of our growth dynamic since. Business investment – driven by an unwinding in engineering construction - has fallen every year since its peak in 2012-13. This has wiped $42.5bn off the value of WA economic output in the process.

However, we may be reaching the foot of the investment cliff, which will help to reduce its drag on economic growth. In trend terms, business investment has fallen for 20 consecutive quarters to September 2017, although the rate of decline slowed to just 0.1% in both the March and June quarters, and 0.5% in the September quarter (Chart 5).

We expect business investment to fall by a further 11.2% in 2018 before returning to growth in 2019 (of just 0.2% mind you). This flattening out in investment will support headline economic growth, although who'd have thought five years ago that West Aussies would be cheering a flat-lining in business investment?

Chart 5: The only way is up

WA business investment, quarterly % change, real trend terms



Source: ABS Cat. 5206.0

Exports continue to support growth

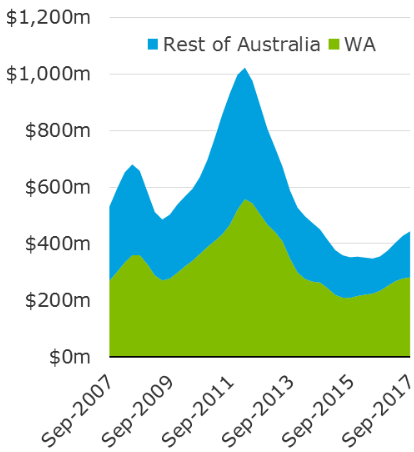
Exports are the genuinely good news story for WA. Net exports (exports less imports) have increased by almost $34bn since 2012-13 helping to offset most of the $42.5bn decline in business investment over the same period.

Goods exports in WA rose by 7.3% in 2016-17, maintaining the State's share of national goods exports at close to 40%. As discussed in our last edition of the *WA Economic Outlook*, higher exports are the legacy of the investment boom in WA, as production rises following all those mega-construction projects in the resources sector.

Reflecting this, the State's miners have continued to reap large profits. The mining sector's pre-tax profits are up by almost 200% over the past year, compared with non-mining profits which increased by less than a quarter over the same period. This largesse on the profits side of the story has started to flow through to exploration expenditure, which has risen in WA in every quarter since December 2015 (Chart 6).

Chart 6: Drill joy

Exploration expenditure, WA and rest of Australia, trend terms



Source: ABS Cat. 8412.0

But the miners of today aren't the manic miners of a decade ago. Better profits aren't being channeled straight into new investment in anticipation of a never-ending boom. Instead, most is going to pay down debt or reward long suffering shareholders. This means there is little reason to expect a substantive round of new investment in minerals and energy resources in WA for some time yet.

With investment flattening out, growth in resource-related exports will continue to support headline economic growth in WA to 2020. We expect exports to rise by 6.7% in 2018, followed by growth of just over 1% in 2019 and 2.6% in 2020 as less new capacity comes online from the resources sector.

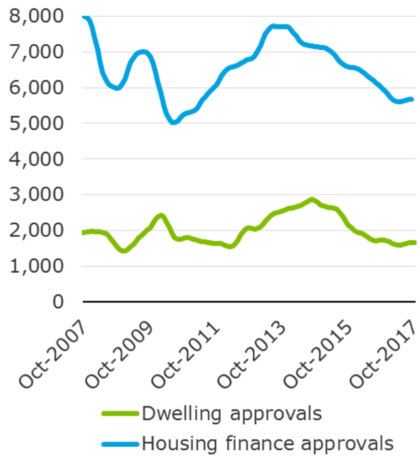
Housing market stabilising

The Perth property market could only sit and watch from the sidelines while property markets in Sydney and Melbourne rose the roof in recent years. Residential property prices in Perth only managed to register growth in two quarters over the three years to June 2017, to sit 8.9% lower over this period. In contrast, Sydney prices rose by over 40% over the same period, and Melbourne prices are up by over 33% (even Hobart and Adelaide managed to register decent residential price growth over this period).

But here too, signs are emerging that demand is stabilising in WA. Approvals to build dwellings in WA have risen for six consecutive months to October 2017, which will give hope to the residential construction sector (Chart 7).

Chart 7: Turning point?

WA dwelling approvals and housing finance (owner occupier) approvals



Source: ABS Cat. 5609.0, 8731.0

Finance approvals for all owner-occupier housing have risen for five consecutive months to September 2017, ending a record 41-month run of consecutive decreases in approvals to April 2017. Low interest rates, stronger job prospects and low housing prices are improving housing affordability.

However, building approvals and finance approvals are both coming off low levels. So while the direction of change is a positive one, the magnitude of these rises are small compared to the beating they've taken in recent years. We expect dwelling investment to decrease by 6.3% in 2018, followed by a further 1.3% decline in 2019 before a return to growth in 2020 (+5.6%).

Indicators to watch

While employment, business investment, exports and housing are all encouraging, those green shoots are yet to flow through to other parts of the economy. We'd need to see sustained growth in other economic indicators before we can confidently say the bad times are behind us.

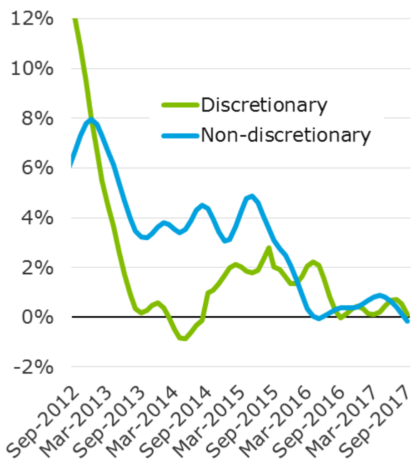
Chief among this is retail turnover – a barometer of household confidence. Retail trade in WA rose by just 0.4% in 2016-17 in trend terms, but has fallen in each of the first three months of the new financial year (Chart 8).

Spending on discretionary goods and services (non-essential items where spending growth usually indicates a good degree of confidence) increased by only 0.3% in 2016-17, and has declined by a further $9m in the first 3 months of this financial year. As a large component of household consumption, retail spending will need to pick-up if household consumption is to contribute to broader economic growth in a more meaningful way.

Vehicle sales are also failing to reflect the more positive signs emerging elsewhere in the economy, with sales falling by 7.1% in 2016-17 and slipping further in the first four months of the new financial year.

Chart 8: Spendthrifts wanted

WA retail turnover, annual % change, trend terms



Source: ABS Cat. 8501.0

Although retail spending and vehicle purchases have tended to rise in sync with employment growth, this has not been the case so far despite the 37,000 jobs added in WA over the year to October. While surveys of consumer confidence are showing sentiment is high, this disconnect between what households are feeling and actually doing may reflect the slack that remains in the State's workforce, as measured by underemployment.

Will work for… longer hours

Underemployment refers to people employed part-time who want to work more hours and are available to start work with more hours; or people who are usually employed full-time but who actually work part-time for economic reasons.

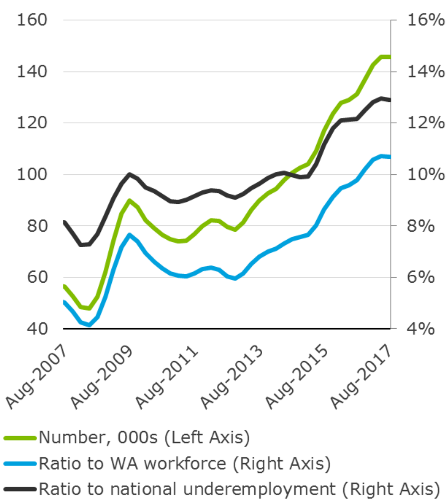
Part-time jobs growth is a key reason why the State's unemployment rate did not balloon in recent years. Some 54,000 part-time roles have been added in WA over the four years to October 2017, despite the fact that the domestic economy has contracted over this period. As it turns out, underlying this growth in part-time employment is a desire to work more but an inability to do so.

The number of underemployed persons in WA remained at high levels in October 2017, while the ratio of underemployed persons to employed persons also remained at record highs (10.7%). WA's share of the national pool of underemployed persons has also taken-off in recent years (Chart 9).

Continued momentum behind full-time jobs growth will hopefully begin to soak-up underemployment in WA. However, with almost 11% of the workforce willing and able to work more but unable to secure more work, it's no wonder that households aren't confident enough to open their wallets and purses just yet.

Chart 9: Under the radar

WA underemployment, total and as a % of State workforce and national underemployment



Source: ABS Cat. 6202.0

And with underemployment high, it's also no wonder that wages growth remains weak in WA. The Wage Price Index in WA increased by only 1.3% over the year to the September quarter, continuing a six-quarter run of annual growth below 2%. This compares against a long term average of 3.5% wages growth per annum. With output weak and workers abundant, employment may grow further before we see wages growth really kick-in. We expect the Wage Price Index to rise by only 1.8% in 2018 followed by growth of 2.9% in 2019 and 3.2% in 2020.

2018: the year of hanging in there

"If I can make it there. I'll make it anywhere." While Sinatra's famous line referred to street-tough New York, it could equally be applied to the challenging conditions faced out West in recent years. The domestic economy has shrunk by $35bn in the past four years, undoing a lot of the $57bn increase in State Final Demand in the prior four year period.

So if you survive this downturn, you're doing pretty well. And we reckon WA is just one year away from a return to some normality – hanging in there is the name of the game for now.

But the 'normal' we envisage is not the investment-fuelled highs of pre-2012, but rather something slower and more sustainable. We expect GSP to rise by 1.7% in 2018, followed by growth of 2.3% in 2019 and 3% in 2020. This compares to a 4.6% long term average rate of economic growth.

Next year should also mark the point in which the WA domestic economy ceases its multi-year decline - just. We expect State Final Demand to rise by 0.1% in 2018, followed by 3% growth in 2019 and 3.2% in 2020.

However, the wafer-thin growth expected for 2018 is predicated on strengthening household consumption. If consumers remain warier than expected, a five-year contraction in State Final Demand is not out of the question. To spend or not to spend? That is the question for WA households in 2018. And the answer will have important ramifications for the broader State economy next year. Let's hope the answer is the former.

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