Economic conditions in Western Australia should steady from 2018. However, the new State Government has its work cut out.

State conditions: WA continues to feel the cold hard reality of the commodity cycle

From CEOs to labourers, from small cap miners to the corner store. The commodity cycle has claimed many victims in WA in recent years. The Liberal-Nationals Government can now be added to that list.

The size of Labor’s sweeping victory in the recent State election was as unexpected as it was emphatic. And no doubt the state of government finances and the local economy – both suffering from the end of the State’s resources investment boom – loomed large in the minds of the voting public.

At the peak of the boom in 2012, Perth’s St Georges Terrace buzzed with optimism. The State epitomised the ‘right place, right time’ adage. Gross State Product (GSP) – a measure of economic output – increased by 7.3% that year on the back of burgeoning investment in the resources sector. Miners (and businesses more generally) were responding to growing Chinese demand with bucket loads of investment.

What goes up...

But fast forward just five years and the once high-flying WA economy is shuffling through the cold hard reality of the commodity cycle. And it is proof of another adage: ‘what goes up...’. Business investment – the driver of the State’s recent wealth boom – has fallen dramatically, in response to a drop in Chinese demand and lower global commodity prices. In 2017, we expect business investment in WA to return to 2007 levels in real terms – one-third of what it was at its peak in 2012 (Chart 1.1).

Hitting where it hurts

While West Aussies are no strangers to economic volatility, the current transition certainly hurts. And that pain is felt most in the labour market. In net terms, the WA workforce has shrunk by almost 5,500 over the past year, a near record 91,000 West Australians were unemployed in February 2017, and the State’s unemployment rate has now climbed above the national average.

Chart 1.1: Back to the future

WA business investment, real terms

Source: Deloitte Access Economics

Under such conditions, it is unsurprising that private consumption (aggregate spending by households) in WA has slowed to a crawl. Like many advanced economies, private consumption in WA is the largest component of GSP – it has accounted for an average of 44% of GSP over the past 20 years.

However, consumption is estimated to have increased by an average of just 1.7% per annum over the three years to 2016 – a far cry from its long-term average growth trend of 4.1% per annum.

State finances: not much in the tank

With consumption sluggish and business investment on the sidelines, government spending has not been able to fill the void. State coffers have already been exhausted by what the former State Government labelled a ‘perfect storm’ (Chart 1.2) of having to use high but volatile revenue to fund ever growing spending commitments.

Chart 1.2: Storm damage

WA General Govt. operating balance

Source: WA State Treasury

Rapid population and economic growth did indeed require greater outlays on infrastructure and government services, although arguably not all of these outlays could be described as productive.

Meanwhile, falling royalty revenue and taxation receipts, as well as a backward-looking system of GST carve-up (the State will receive just 30.3 cents for every dollar of GST it generates in 2016-17) have seen the State caught short.

However, the gaping hole left by the retraction in business investment – close to $27bn in real terms between 2013 and 2016 – could never be covered by the State Government, even if its balance sheet was healthy. By way of comparison, State Treasury’s entire
revenue take for the same period was close to $27bn in nominal terms.

**Five long years**

With business and consumer confidence at a low ebb, and the State Government constrained by the fiscal situation, 2017 is likely to be another year of economic decline in WA. State Final Demand (a narrower measure of economic activity, which excludes exports and imports) is expected to fall by 4% in 2017. This will mark an unenviable streak of five consecutive calendar years of contraction in the west.

State Final Demand is expected to fall by 4% in 2017, marking five consecutive calendar years of negative growth.

Adding exports and imports to State Final Demand gives the commonly used GSP measure of output. According to this measure, the WA economy is projected to grow by 1.6% in 2017. Because of higher exports, GSP growth has remained in positive territory despite the souring commodity cycle (Chart 1.3), although GSP growth is much lower than its long term average.

**Chart 1.3: State of volatility**

**WA State Final Demand and GSP, annual % change**

State outlook: WA domestic economy to halt its decline

While 2017 is expected to be another year of economic decline in WA, we expect State Final Demand to increase in 2018 (+2.1%), halting its five-year contraction (Chart 1.3).

A recovery in private consumption (+3.1% - see Chart 1.4) underpins our more optimistic outlook. Although this rate of consumption growth remains below the long term average (+4.1%), it is a welcome improvement from the lean years that have prevailed since the end of the investment boom.

**Chart 1.4: Return of the consumer**

**WA private consumption, real terms, annual % change**

At some stage however there is a snap-back as pent-up demand is finally released. And the conditions for that seem ripe over the coming years amidst weaker consumer price growth and stronger wage inflation.

Consumer prices in Perth rose by an average of 3.3% per annum over the five years to 2011 as labour shortages emerged and wages skyrocketed (Chart 1.5) – sandgropers regularly complained about $5 lattes, $15 pints, and $50 steaks.

However, consumer prices have displayed restraint over the five years since 2011, rising by just 1.8% per annum. Prices are projected to rise by an average of 2% per annum over the next four years to 2020.

A recovery in private consumption underpins our more optimistic outlook from 2018.
While Perth prices are coming back down to earth, real pay packets are looking slightly fatter (Chart 1.5). Wage growth slowed significantly following the boom (+2.4% per annum over the four years to 2016 compared to +4% growth per annum over the previous 4 years). The WA wage price index is expected to rise by an average of 2.6% per annum over the four years to 2020 as conditions steady.

**Chart 1.5: Show me the money!**
*WA wage price index and Perth consumer price index, annual % change*

Source: Deloitte Access Economics

But we are by no means predicting a return to wild consumer spending. Our forecast suggests that consumption growth will remain below its long-term average level, partly contained by a flattening in population growth. WA’s population growth was lower than the national average in 2015 for the first time in a long time. And we expect this trend to continue to 2020 amidst the weak labour market in WA.

**Export dividends**

Along with stronger consumption activity, higher export volumes will also support headline economic growth in WA. Exports will continue to rise as all that investment in new resource sector projects comes to an end and production is ramped-up. However, weak commodity prices will still put a dampener on the value of our export receipts.

Commodity prices have recently lifted due to short-term supply constraints and Chinese stimulus, however, this is unlikely to support long term growth in export earnings nor encourage a fresh round of investment in WA (at least nowhere near what we have experienced in the recent past).

China is still undergoing a transition away from investment and export-led growth – the type of growth that requires intensive use of iron ore, oil and gas etc. – towards consumption.

**Business investment: from hero to long term average**

Although exports and consumption are expected to support WA economic growth, business investment – specifically engineering related investment – has long been the superstar of WA’s economic success: from the rise of iron ore mining in the 1960s and 70s, to the emergence of a globally significant oil and gas sector in the 1980s and 90s.

Yes, exports are a larger share of the State economy (Chart 1.6), however, the flow-on benefits of the State’s investment cycles to the broader economy tend to be more significant than those generated by the higher export earnings that typically follow those cycles.

The current economic pain being felt is largely because investment is sitting on the bench following the most recent expansion.

The bad news is that it is difficult to see the investment outlook improving in WA in the foreseeable future. Yes, we expect the drop in investment to bottom-out in 2017 at around $18bn.

However, while investment is expected to firm-up from 2017; as a proportion of GSP, it is projected to remain below its long term average of 9-10% in the near future (Chart 1.6). Not quite the superstar as much as a contributor off the bench.

**Chart 1.6: Yin and yang**
*WA net exports and business investment as a share of GSP*

Source: Deloitte Access Economics
Keynes, Friedman, Balboa

So with the economic pain likely to ease somewhat and conditions to become more 'normal' over the medium term, what's next for WA?

It’s a question that new Premier Mark McGowan and many in his Government will be asking in the coming weeks and months. When considering such strategically critical questions, it is useful to draw on the sage advice of Rocky Balboa: "It ain't how hard you hit; it's about how hard you can get hit, and keep moving”.

While the State’s economic transition is certainly hitting hard, it is also giving WA an opportunity to think about how to 'keep moving' while the economic punches are being swung. And we are beginning to see WA ducking and weaving.

Silver linings

The resources sector is becoming leaner and meaner in the current commodity price environment, making WA more competitive at what we do best.

Chart 1.7: Holding up the fort

Change in gross operating surplus and gross mixed income, WA, by sector, current prices, five years to 2015-16

<table>
<thead>
<tr>
<th>Sector</th>
<th>2015-16</th>
<th>2016-17</th>
<th>2017-18</th>
<th>2018-19</th>
</tr>
</thead>
<tbody>
<tr>
<td>Mining &amp; Oil &amp; Gas</td>
<td>-$22.5bn</td>
<td>$1.0bn</td>
<td>$3.0bn</td>
<td>$5.0bn</td>
</tr>
<tr>
<td>Professional, scientific &amp; technical</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Manufacturing</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Administrative &amp; support services</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Wholesale trade</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Information media &amp; telecoms</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Other services</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Retail trade</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Utilities</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Arts &amp; recreation</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Education &amp; training</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Accommodation &amp; food</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Public administration &amp; safety</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Health care &amp; social assistance</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Retail, hiring &amp; real estate</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Transport, postal &amp; warehousing</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Finance &amp; insurance</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Agriculture, forestry &amp; fishing</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

Source: ABS 5220.0 State Accounts

Others sectors of the economy have managed to register growth (although small) since the resources boom ended (Chart 1.7) as skills shortages, wage pressures and other input costs ease. This is creating a somewhat diversified – if less spectacular – growth dynamic.

Over the long term, many of the big ticket opportunities for the State will again lie to the north, as China and South East Asia continue to urbanise. But this growth dynamic is unlikely to be as dazzling as the recent boom because it’s much more long-term in nature.

Population projections prepared by the United Nations suggest that East and South Eastern Asia could see up to 500m more people residing in urban areas of its borders by 2050. That’s a lot of new homes, offices, factories, roads, railways, energy, food, educational needs and tourism desires that WA could play a part in fulfilling over the coming 30 years.

No pressure, but...

The incoming brief for the new State Government is a tough one: support growth in the short term within a constrained fiscal environment, while repairing the State budget and helping to position the State to capitalise on long-term opportunities. Premier McGowan will probably very quickly relate to what Coldplay meant when they said: “Nobody said it was easy. No one ever said it would be this hard”.

Table 1.1: Key economic forecasts, Western Australia (%)

<table>
<thead>
<tr>
<th>Parameter</th>
<th>2017</th>
<th>2018</th>
<th>2019</th>
</tr>
</thead>
<tbody>
<tr>
<td>Gross State Product</td>
<td>1.6</td>
<td>1.8</td>
<td>2.1</td>
</tr>
<tr>
<td>State Final Demand</td>
<td>-4.0</td>
<td>2.1</td>
<td>3.2</td>
</tr>
<tr>
<td>Business investment</td>
<td>-34.5</td>
<td>-1.9</td>
<td>2.8</td>
</tr>
<tr>
<td>Exports</td>
<td>6.9</td>
<td>1.6</td>
<td>3.2</td>
</tr>
<tr>
<td>Unemployment rate</td>
<td>6.6</td>
<td>6.3</td>
<td>6.1</td>
</tr>
<tr>
<td>Consumer prices</td>
<td>1.9</td>
<td>2.1</td>
<td>2.0</td>
</tr>
</tbody>
</table>

Source: Deloitte Access Economics

Note: Gross State Product, State Final Demand, business investment, exports, and consumer prices are all expressed as real annual % changes.