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WA Economic Outlook

What comes next?

May 2021

Deloitte Access Economics

The Western Australian economy has bounced back from the lows of 2020. But 2021 still holds plenty of challenges.

More than a year has passed since COVID-19 was declared a global pandemic. And just over a year from that initial uncertainty and outright panic, the world's attention is now turning from tracking case numbers to tracking the rollout of vaccines (thanks to the Herculean effort of the world's medical research community).

Achieving a high rate of vaccination is the only path to truly moving on from both the health and economic crises in the long term. And Australia is trailing other advanced economies in progressing toward that goal.

The vaccine rollout does need to be put in context. In some countries, the vaccine represents the only means of stemming hundreds or thousands of new COVID-19 deaths every day. Thankfully, Australia is not in that position. But the recent three-day snap lockdown in the Perth and Peel regions is a reminder that this virus can rear its head at any time.

Nonetheless, being a vaccine laggard does present risks for Australia. It means Australians will be more susceptible to potential future outbreaks and increases the likelihood that governments will be forced to respond to outbreaks with hard lockdown measures. On-again-off-again lockdowns and border closures will undermine much of the progress made in restoring consumer and business confidence, in turn taking the wind out of the sails of an otherwise roaring economic recovery.

The challenges around access to vaccines and their safety has caused the Commonwealth to review its COVID-19 vaccination program rollout. However, to both protect Australians' health and shore up the economic recovery, there is no substitute for the safe, full vaccination of as many Australian adults as possible, as quickly as possible.

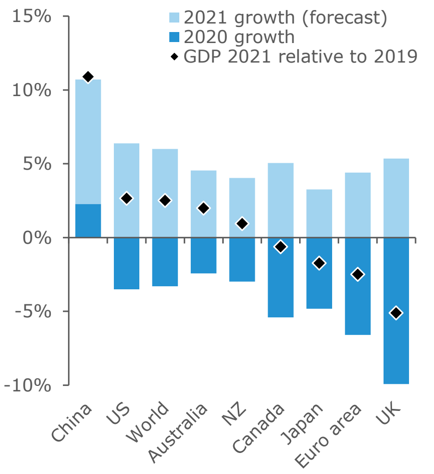
The global economic recovery is well underway

Off the back of the global vaccine rollout, the IMF is forecasting that the world economy will grow by 6 per cent in 2021, following a 3.3 per cent contraction in 2020.

In Australia, the IMF forecasts that real GDP will grow by around 4.5 per cent in 2021, offsetting the 2.4 per cent contraction in 2020 so that cumulatively, Australia's economy will be around 2 per cent larger in 2021 than in 2019 (Chart 1) – a remarkable outcome if achieved considering the significant economic uncertainty that existed in 2020.

Chart 1: What goes down must come up

Real GDP growth



Source: IMF World Economic Outlook Apr-21

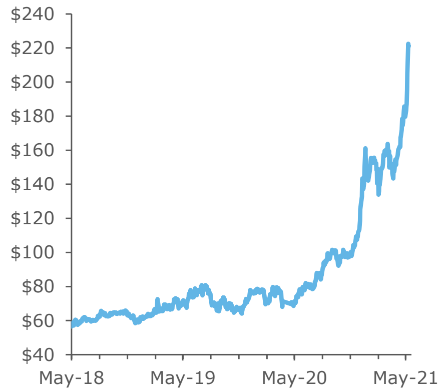
On this measure, Australia is well ahead of most advanced economies but slightly lags the US and the world average. China is an extraordinary outlier among the world's large economies, having overcome its harsh but short and early COVID-19 experience to lead the world in economic recovery. The IMF projects Chinese real GDP to be 11 per cent larger in 2021 than in 2019.

China's investment-led recovery sends iron ore to decade highs

China's strong recovery has been underpinned by surging activity in heavy industry, namely construction and manufacturing. Industrial production grew by 14.1 per cent over the year to March 2021, supporting first-quarter GDP growth of more than 18 per cent year-on-year. Aggressive stimulus directed towards fixed capital investment has contributed to a spike in demand for iron ore. Consequently, iron ore prices have climbed as high as US$230 per tonne in recent weeks as Chinese steel mill output surges (Chart 2), surpassing the previous all-time high of around US$193 set in 2011 in the wake of China's post-GFC stimulus spend.

Chart 2: Iron ore soaring

Iron ore price, 62% Fe China CFR, (US$ per tonne)

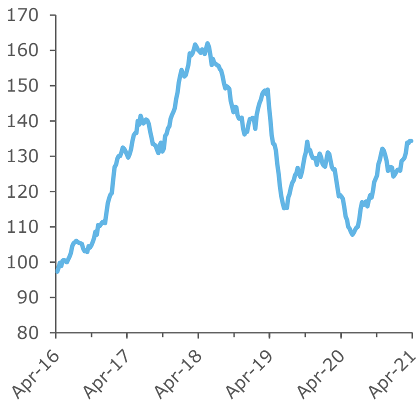


Source: Bloomberg, SGX TSI Iron Ore Futures

Prices at these heights aren't likely to be sustainable as highly favourable demand and supply conditions moderate. We expect demand to stabilise as Chinese stimulus measures eventually fade and credit growth is restrained. Iron ore inventories in China are also being built up to multi-year highs (Chart 3).

Chart 3: Stocking up

Weekly iron ore ports inventory, China (million tonnes)



Source: Bloomberg, Steelhome

On the supply side, tightness is expected to ease as Vale eventually overcomes COVID-19 related operational issues and gradually restores lost output. But that's no cause for panic. The inevitable correction in commodity prices won't halt the State's economic recovery. Remember, soaring prices are good for shareholders and tax collectors, but material benefits to the real economy only occur if higher profits and royalties are reinvested in wage uplifts and new, job-creating activity.

Little significant new investment in iron ore mines has been triggered over the last 12 months even as prices have ramped up, and we see similar caution for now among miners amid expectations that current prices are unlikely to be sustained. In the Federal Budget handed down in May, for example, Commonwealth Treasury is predicting a return to US$55 per tonne (FOB terms) in the first quarter of 2022.

Labour market bounces back

The 'V-shaped' economic recovery in WA is perhaps nowhere better demonstrated than in the labour market. The latest ABS survey revealed the WA unemployment rate had fallen to 4.8 per cent in March 2021. Unemployment is now below pre-COVID levels and is also below the nation-wide figure of 5.6 per cent.

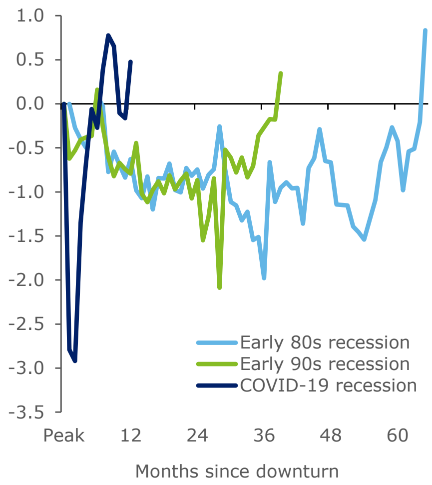
A word of caution: State unemployment figures tend to be more volatile than at the national level, and it must be remembered that JobKeeper – which was supporting around 1 in 10 WA businesses even in its reduced form – was still in place when the March labour force data was collected. All eyes will be closely watching the release of the April data, which will provide the first taste of post-JobKeeper labour market conditions.

Nonetheless, the scale of the labour market recovery is truly remarkable – especially compared to previous recessions. On most measures, the labour market has recovered within 12 months of the pandemic commencing: the level of employment and the rate of participation in the labour force are higher, and the unemployment rate is lower.

Compare that to the experience of the recessions of the 1980s and 1990s: the initial labour market impacts were less severe, but conditions were depressed for far longer and the participation rate didn't return to pre-recession levels for at least three to five years (Chart 4).

Chart 4: And we're back!

Change in labour force participation rate (ppts), Western Australia



Source: ABS Labour Force Survey

Who'd have thought 12 months ago that the next challenge for the State's labour market could well be a shortage of skills, not an oversupply of workers. A strong recovery in labour demand as businesses reopen – alongside restrictions on interstate and overseas movements – have tightened the labour market over the last few months. As a result, certain skill shortages are beginning to emerge, especially in the mining and construction industries.

In March, job advertisements across the State reached a 10-year high, growing by a resounding 110 per cent year-on-year. Leading the pack were advertised vacancies for construction and mining labourers and construction tradespeople, growing 192 per cent and 184 per cent respectively.

The tightening in this section of the labour market could lead to higher wages growth, sooner. Wage growth in WA is more acutely influenced by the underlying tightness or slack in the labour market given a high proportion of employees being covered by individual arrangement wage contracts, compared to other states and territories. This is due WA's disproportionately high share of employment in mining and mining-related industries (like construction and professional services), which are predominantly covered by individual contracts.

Wage growth among employees with individual contracts tends to lead, while collective agreement and award rates tend to follow with a lag. That suggests WA could be the first to experience accelerating wages growth in Australia. WA private sector wages are already leading the pack with 1.6 per cent year-on-year growth in 2020, the highest across the country.

Our expectation is that WA will record the fastest overall wage growth (across public and private sectors) of any state or territory in the 2021 calendar year too. This has implications for broader inflation across the WA economy given wage growth accounts for around two-thirds of consumer price inflation.

The possibility of multi-speed wage growth and inflation could present a challenge for the Reserve Bank – not dissimilar to the 'two-speed economy' it tackled during the resources boom a decade ago. Adjusting monetary policy to address higher inflation originating in the West would strain the rest of the nation, particularly in the construction industry, as occurred from 2010 to 2012.

That said, our central outlook – shared by the Reserve Bank – is that we are still several years away from unemployment being sustainably low enough to trigger rapid wage growth, and cause inflation to rise to be consistently in the Bank's 2-3 per cent target band. The latest inflation data confirms that there is still a long way to go, with underlying inflation of just 1.1 per cent for Australia, and headline inflation of 1 per cent for Perth, over the year to March 2021.

But there is a risk that more aggressive price growth could occur sooner and to a greater extent in some WA industries, and if so, that WA could leap ahead of the rest of Australia in the near future.

Households, exports power economic growth in 2021

Households bore the brunt of the economic carnage in 2020. Job and income losses, physical restrictions, and fear over the potential medium- and long-term impacts of COVID-19 saw household consumption collapse and the savings rate spike.

Many of those factors have moderated or reversed altogether. Jobs are back to where they were before the pandemic and stronger wage growth is within reach. Consumers now know what to expect from the virus and policymakers' response, and vaccines are boosting confidence. An extraordinary amount of cash from Commonwealth stimulus is washing through the economy, while similarly liberal stimulus measures overseas are stoking growth in key global economies.

All that points to a big year for household spending in 2021. Our expectation is that consumption will grow by 4.9 per cent in WA through the year, contributing 1.8 percentage points to GSP growth (Chart 5).

But we expect net international exports to continue to be the single largest contributor to growth in 2021, adding 3 percentage points to GSP. That's significant, but it comes off the back of two years where – despite commodity prices rising rapidly – growth in export volumes have been relatively weak.

The public sector will continue to play an outsized role in 2021, predominantly through fixed capital investment – which we forecast will grow almost 30 per cent year-on-year as the State Government gets construction underway on many of its major infrastructure projects. Public sector support will trail off in 2022 and beyond, but our expectation is that this will be more than offset by a resumption in private investment as business conditions improve.

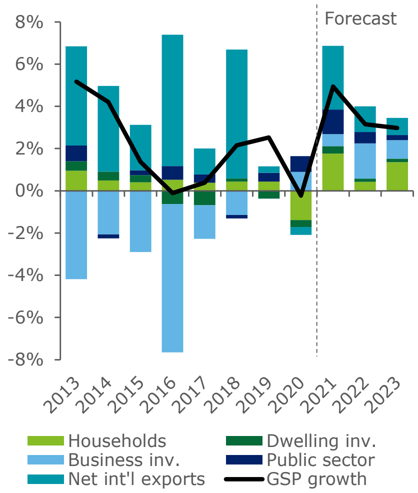
Overall, we expect the State economy to grow by around 5 per cent in the 2021 calendar year (Chart 5), following a marginal 0.2 per cent contraction in 2020.

Housing market booms as stimulus takes hold

As Nobel Prize-winning economist Paul Krugman once said: "*One of the dirty little secrets of monetary policy is that it normally works through housing…*". We're seeing this in spades right now.

Chart 5: Road to recovery

Contributions to WA real GSP growth, calendar year



Source: Deloitte Access Economics

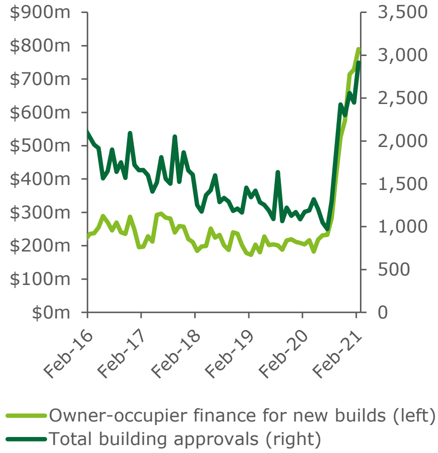
Most residential mortgages in Australia are variable, meaning housing credit is very sensitive to movements in the cash rate. In the early days of the pandemic, the Reserve Bank lowered the cash rate from 0.75 per cent to an all-time low of 0.10 per cent. Borrowing costs followed, with the average owner-occupier mortgage offered by large institutions now below 3 per cent.

Fiscal stimulus has added fuel to the fire. Grants for new builds have reinforced low borrowing costs, sparking a remarkable boom in new credit for dwelling construction and a spike in the number of residential building approvals in WA.

The value of new loan commitments in WA for owner-occupiers building new dwellings increased by a staggering 287 per cent year-on-year in February to $790 million. The increase in residential building approvals is just as spectacular, with growth of 160 per cent over the year to March (Chart 6).

Chart 6: Borrow and build

WA owner-occupier new loan commitments for new dwelling construction ($m, left) and residential building approvals (right)



Source: ABS Lending Indicators; Building Approvals

Low borrowing costs aren't just being taken up for new builds. The value of new loan commitments for existing dwellings in WA grew by more than 50 per cent over the year to February, reaching a seven-year high of almost $1.2 billion.

Strong activity in the residential construction and other housing-related sectors also adds further pressures to shortages of skilled labour, potentially contributing to higher wage growth and putting upward pressure on inflation in WA.

On the supply side, shortages of both owner-occupier and rental accommodation have emerged as Western Australians have returned from interstate and overseas due to travel restrictions. The Perth rental vacancy rate more than halved through 2020 to now sit below 1 per cent - levels not seen since 2013.

Easy credit, supply shortages and higher rents have contributed to the strongest rise in residential housing prices in WA since 2014. The median price increased 4.2 per cent over the year to December 2020 and the industry is predicting double-digit growth for 2021, while the volume of residential property sales is up by 35 per cent year-on-year (Chart 7).

Chart 7: Sold!

Year-on-year change in residential property prices and sales, Perth

Source: ABS Residential Property Prices

State finances are strong, but all risks are to the downside

Act II of the McGowan Government has commenced, providing a sense of certainty about fiscal and policy priorities for WA over the next four years. The election brought about a few key changes, notably the departure of Ben Wyatt and his replacement in the critical Treasury portfolio by the Premier.

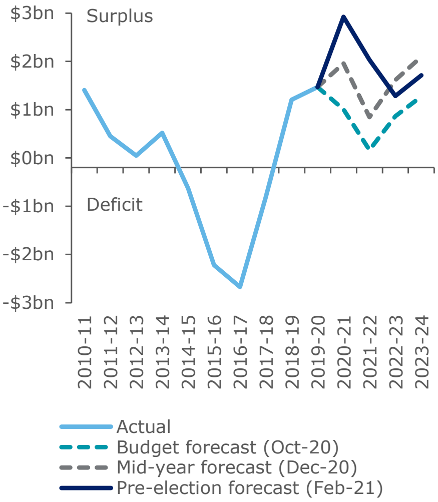
The election featured very few big-ticket promises, with the Government focusing on progressing projects committed during its first term – including a raft of METRONET projects, Westport, and the new Women and Babies Hospital. The pre-election Budget update revealed the size of the planned asset investment spend over the four years to 2023-24 had swelled to a record $28.9 billion. That's plenty to be getting on with in term two.

The scale of Labor's election win was astonishing. The Government benches have swelled to a record size, with 75 out of a total of 95 state MPs. That's a huge success for Labor but also signals that there will be plenty of mouths to feed and plenty of pressure on the expenditure side of the Budget to shore up support, especially in electorates won for the first time by Labor (and only narrowly so).

With a thumping majority in both chambers, the Government will also face few barriers in passing its legislative agenda. This unfettered ability to legislate new programs and spending commitments may also serve as a temptation for the State Government, especially while its operating budget is healthily in the black. The pre-election update revealed $8.7 billion in cumulative operating (accrual) surpluses over the forward estimates – more than double the level predicted in the October 2020 Budget (Chart 8).

Chart 8: Budget bonanza

General govt. net operating balance



Source: WA Treasury

Despite the surpluses, the importance of fiscal discipline hasn't diminished. Across the whole public sector, the Budget isn't projected to return to a cash surplus until 2023-24. That means the infrastructure splash will continue to add to net debt, which is forecast to peak above $40 billion in 2022-23.

So, the State Government has just been re-elected with an expanded majority. A popular Premier has his eye on delivering his signature infrastructure program. The iron ore price is eye-wateringly high and royalty revenue is pouring in. The Budget is forecast to be in surplus on the narrower accrual measure, but in deficit on a cash basis. The Government is borrowing to make up the difference and net debt is continuing to climb. Seen this episode before?

Many of the hallmarks of 2013-14 Coalition Government are there, and the current Government will need to maintain its record of fiscal discipline to avoid experiencing the same pain that its predecessor went through during its second term when commodity prices crashed, key revenue streams tumbled and big-ticket spends had to be cancelled or deferred.

What comes next?

The need to maintain fiscal discipline doesn't mean the State Government hasn't got a mammoth task in front of it. The recovery in headline labour market indicators masks diverse distributional outcomes that the Government will need to manage.

For example, employment in some regions – like the Kimberley and East Pilbara – remains below pre-pandemic levels, as it does for those aged under 25 across the State.

In addition, many of the Government's medium- and long-term priorities, especially around economic diversification, were put on ice during 2020 as the focus switched to the short-term health and fiscal response. That was entirely appropriate, but the need for diversification hasn't gone away.

WA's remarkable economic resilience in 2020 was largely underpinned by deeper concentration in mining and reliance on a temporary spike in construction activity. Indeed, if anything, the pandemic has exposed weakness in other parts of the economy, such as our ability to manufacture goods within the State and export services outside of tourism and tertiary education.

By most measures, the State economy has bounced back from the lows of 2020. But the hard work to shore up economic growth in the medium- to long-term is only just getting started.

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