

ECONOMIC BRIEFING

JULY 2022





OVERVIEW



Australian GDP rose 0.8% in the March quarter despite the impact of Omicron in the Eastern States.

The positive growth in this quarter contrasts with the negative growth in the September quarter during the Delta outbreak in NSW, Victoria and the ACT. This was also the quarter that was impacted by severe flooding in QLD and NSW.



The Perth Consumer Price Index (CPI) shot up 3.27% in the March quarter to reach 7.6% for the year well above the national results of 2.1% quarterly and 5.1% annual growth. Major contributors to the Perth CPI were the cost of dwelling construction (+15.8%), fuel (+11.1%) and rent (+2.3%).

The Reserve Bank of Australia responded by increasing the cash rate target 1.25% over the last three months, seeking to dampen demand to get on top of inflation.



The WA domestic economy saw its strongest quarter of economic growth for a year, driven by Government Consumption and Government Investment, which was largely related to the COVID-19 response and major infrastructure project expenditure.

State Final Demand grew 2.2% in the March quarter and 4.9% over the last 12 months.



Local Government costs continue to increase at a rapid pace.

This is particularly evident in the infrastructure sector where roads, buildings and other infrastructure form a large part of Local Government budgets.



LGCI expectations for 2022-23, have been revised upwards from 2.5% to 3.2% as global and local factors driving inflation continue to add to cost pressures felt by the sector.

How long inflation remains at elevated levels will depend on the supply constraints such as restrictions on trade and labour supply, the impact on commodity prices from the Ukraine conflict and the persistence of demand pressures from elevated stimulus spending from the pandemic recovery.



The LGCI is expected to return to 2.4% in 2023-24, although this may be revised upwards in future quarters if the inflationary factors remain unresolved.



A shortage of skilled and unskilled labour is a real concern for the WA economy as the unemployment rate sits at 3.4%.

Job vacancies remain at record highs and outnumber job seekers. The participation rate is also at near record highs, suggesting there is little spare capacity in the labour market. Despite this and the high price rises across the economy, wages growth remains modest and well below the rate of inflation.



WALGA forecasts annual growth of the **Local Government Cost Index (LGCI) to reach 5.9% by the end of 2021-22**. This has been revised upwards by 0.2% from last quarter as construction costs continue to grow rapidly.

While construction costs are increasing at double digit rates, the growth in the index is more modest, weighed down by employee costs which account for one-third of the index and are increasing at just 2%.

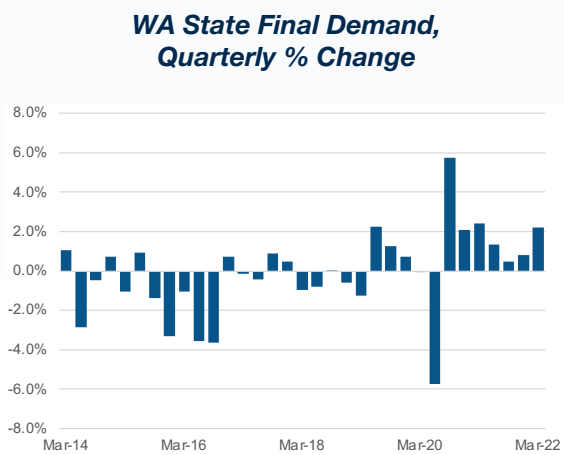
NOTE

The **LGCI is a sector-wide cost index**. Due to the significant challenges with forecasting in the current economic environment. It is important that **Local Governments take into account their own local issues and experiences when considering cost pressures**.

It would also be prudent for Local Governments to **prepare for multiple scenarios for cost increases in coming years**.

WA'S DOMESTIC ECONOMY

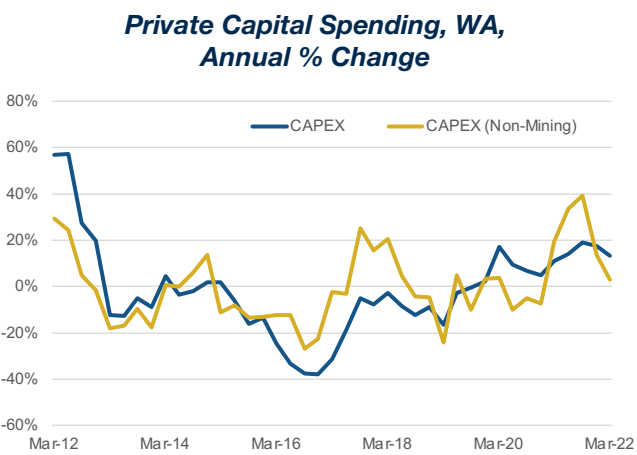
continues to grow



The WA domestic economy recorded its seventh straight quarter of growth in March, increasing by 2.2%. The impact of WA’s Omicron wave will be reflected in the June quarter results.

Government expenditure has driven growth this quarter, in particular health spending related to COVID-19. Similarly, the last year has seen elevated Government investment, which is also a strong contributor to growth.

Household consumption was flat in the March quarter. This will be further impacted by the recent COVID-19 wave and rate rises in the June and September quarters.



The last few years have seen a return to growth of business investment in both the mining and non-mining sectors. This follows half a decade of negative growth as construction on major projects was completed and business confidence was adversely affected.

Business investment requires a stable economic environment where organisations feel confident to invest, so the challenges around interest rate rises, global supply issues and the tight labour market may impact future quarters.

TREASURY FORECASTS

WA's economy to see moderate growth in coming years

	2020-21 %	2021-22 %	2022-23 %	2023-24 %	2024-25 %
Gross State Product	2.6	3.75	2.0	1.0	1.5
Household Consumption	2.7	5.0	2.25	2.75	2.5
Business Investment	4.6	4.75	8.25	4.0	0.5
Dwelling Investment	2.0	12.75	0.5	-3.0	1.5
Government Investment	4.0	12.5	16.5	7.5	3.25
Exports	0.5	1.75	1.0	0.5	0.25
Imports	4.6	2.5	4.5	3.0	1.5
Employment Growth	1.8	5.0	2.0	1.25	1.25
Unemployment Rate	6.1	4.0	3.75	3.75	3.75
Participation Rate	68.0	69.2	69.4	69.1	68.8
Wage Price Index	1.5	2.0	2.75	3.0	3.0

WA Budget highlighted a rapid change in the economic climate since December’s Mid-year Review.

As growth in Household Consumption and Dwelling Investment slows after the stimulus-fuelled recent highs, Business Investment is expected to be a key driver of economic growth, along with ongoing Government Investment.

Low unemployment and a high participation rate as Treasury forecasts the labour market to remain strong through the forward estimates with modest growth in jobs and wages.

RISING COSTS

hit business and consumer confidence across Australia

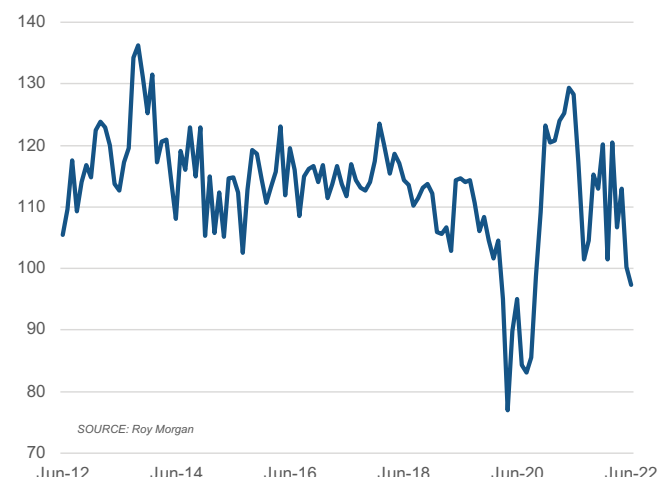
The Roy Morgan Business Confidence Index sits well below the highs of mid-2021 with 59% of respondents expecting “bad times” over the next 12 months. According to CCIWA, 83% of WA businesses are struggling to fill a skilled position and 76% have experienced increasing material costs.

Consumers are also pessimistic, with the ANZ-Roy Morgan Consumer Confidence Index showing that sentiment has dropped to levels not seen since April 2020 as the rising cost of living and interest rate rises weigh heavily.

Consumer Confidence Index, Australia

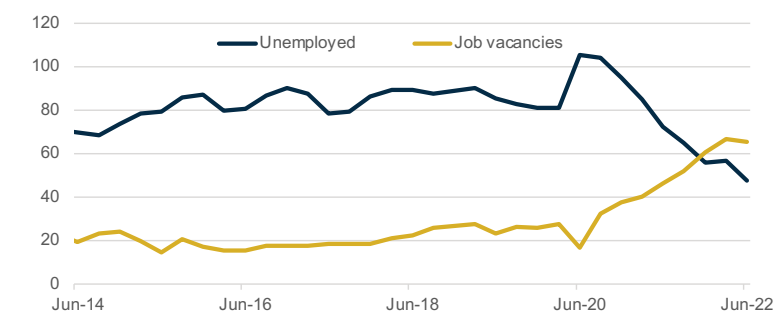


Business Confidence Index, Australia



A STRONG LABOUR MARKET

Job Vacancies vs Unemployed Persons, WA Public and Private, '000s



In May, WA's unemployment rate stood at 3.4% - well down on the COVID-19 induced high of 8.5% in June 2020.

The participation rate recently reached 70% for the first time and is currently at 69.3%, indicating that there is little spare capacity in the domestic labour market.

Job vacancies in WA are at historically high levels with 65,200 jobs available in June 2022 compared to the 51,100 unemployed people in the same month.

Monthly hours worked in WA are well back above pre-pandemic levels.

The great hope for businesses is that the reopening of the state and international borders will bring in workers, but this will not be an immediate solution to the State's labour force needs.

However, housing remains a problem with the Perth rental vacancy rate at 1.1% and many regional centres even lower.

Monthly Hours Worked, WA, Millions



...BUT WAGES ARE SLOW TO GROW...



Labour markets are tightening but wages are rising well below the rate of inflation.

Wages, as measured by the Wages Price Index (excluding bonuses), increased by 2.15% in WA for the year to March 2022, the highest annual rise since 2014.

Wages are a lagging indicator as it takes time to for wage rises to increase through the enterprise bargaining process and in the public sector.

The Fair Work Commission increased the National Minimum Wage by 5.2% and award minimum wages by 4.6% earlier this month. The WA Industrial Relations Commission increased the State minimum wage by 5.25%.

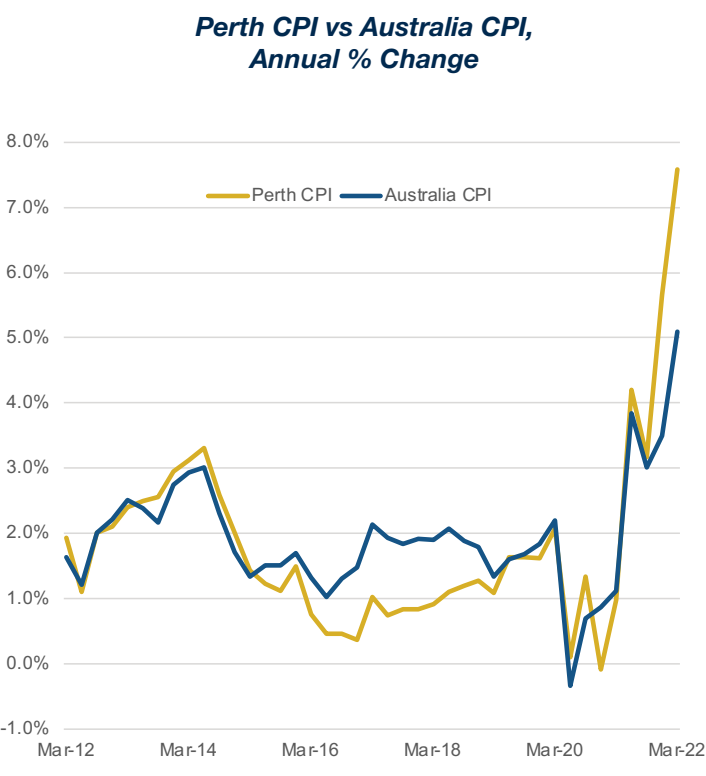
The Superannuation Guarantee increased 0.5% to 10.5% on July 1, with a further 0.5% increase scheduled in 12 months time.

The WA Treasury anticipates wage growth across WA of 2.75% in 2022-23 and 3.0% in 2023-24.

With CPI increasing faster than wages, real wages are decreasing. This is expected to place pressure on wages going forward and may see forecasts revised upwards.

Without an increase in real wages, economic growth will be impeded as household consumption accounts for close to a third of Gross State Product.

...DESPITE INFLATION TAKING OFF



Headline inflation in Australia rose 2.1% in the March quarter to reach 5.1% for the year. This was driven by increases in fuel and housing costs.

Underlying inflation exceeded the Reserve Bank's inflation target of 2-3% with the Trimmed Mean reaching 3.7% in the March quarter.

In WA, the Perth CPI reached 3.3% for the quarter and 7.6% in annual terms. As well as residential building costs, rents also increased significantly due to low supply.

In May, the RBA increased the cash rate target for the first time since 2010 by 25bps. This was followed by an increase of 50bps in both June and July, the largest monthly increases since 2000.

The RBA is foreshadowing further interest rate rises in coming months, with major banks expecting the cash rate target to exceed 2% by year end.



IMPLICATIONS FOR BORROWING COSTS

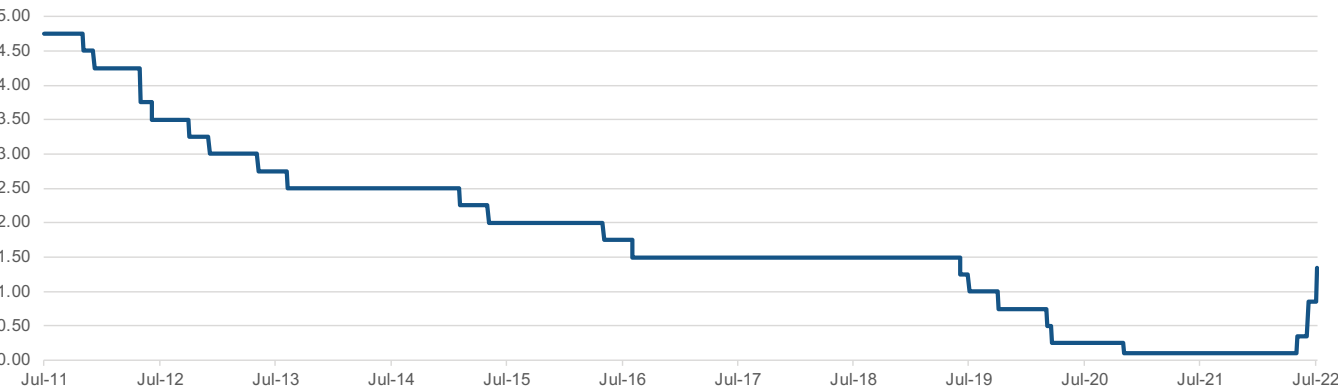
The bulk of Local Government borrowings are long-term fixed rate loans through the WA Treasury Corporation (WATC) that will not be impacted by the recent interest rate rises until the loan matures. However, the cost of new borrowings is above the recent lows and increasing as the RBA's cash rate target rises.

When Local Governments use a short-term loan facility through the WATC, drawdowns are priced at a margin

to the 90-day Bank Bill Swap Rate, which maintains a close relationship with the RBA cash rate. Recent increases from the RBA and expectations for further rises will mean that the cost of short term financing for Local Governments is on the rise.

For those Local Governments with significant cash deposits, the rise in the cash rate target will see higher returns as existing deposits mature.

RBA Cash Rate Target, Australia, %



LOCAL GOVERNMENT COSTS

| continue to climb

Local Governments are experiencing strong growth in costs, as reflected in the Local Government Cost Index (LGCI).

The LGCI increased 1.2% for the March quarter to reach 5.2% annual growth, the highest level since 2008.

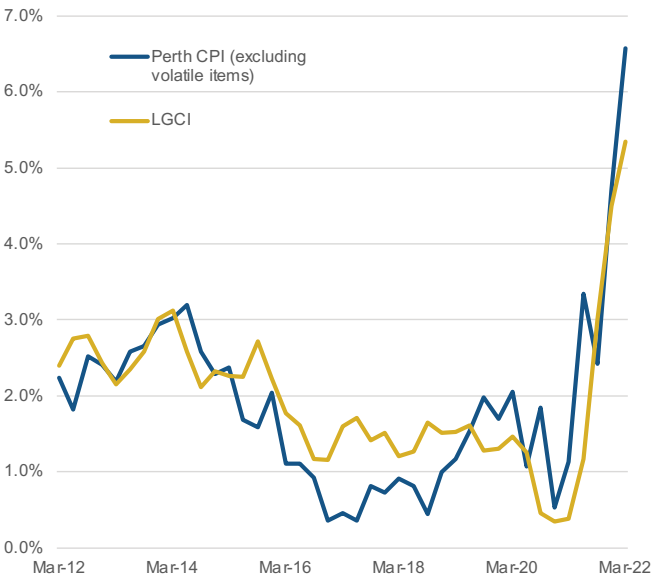
The story continued from last quarter with rising costs driven by steep increases in Building Construction costs (up 5% for the quarter) and Road and Bridge construction costs (up 3% for the quarter).

The unprecedented rise in construction costs is a challenge for Local Governments seeking to develop and maintain their infrastructure and utilise their State and Federal infrastructure grants.

Despite the high construction costs, the LGCI is lower than the Perth CPI as a third of the LGCI is weighted towards Employee Costs which are growing at the modest rate of 2.0%. Weightings are determined by that category's proportion of total Local Government expenditure in WA.

The persistence of inflationary pressures has driven an upwards revision of the LGCI to 3.2% in 2022-23 before returning to 2.4% in 2023-24.

LGCI vs Perth CPI, Annual % Change





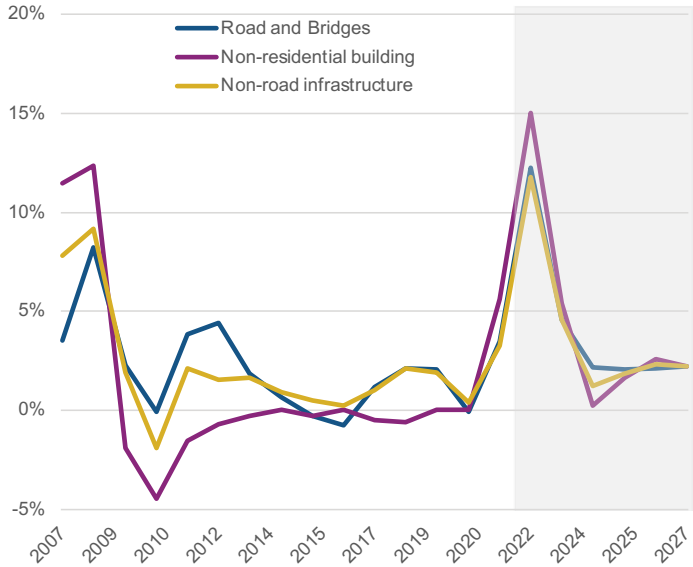
LGCI COMPONENTS

| Forecast % Change

Component	Weighting	2020-21(a)	2021-22(f)	2022-23(f)	2023-24(f)
Employee costs	35%	1.5	2.0	2.75	3.0
Materials and contracts	28%	-0.9	5.3	3.0	2.7
Furniture	1%	-0.1	8.2	1.3	1.3
Non-residential building	5%	5.6	15.0	5.4	0.2
Machinery and Equipment	5%	-0.5	8.4	2.5	1.9
Non-road infrastructure	9%	5.2	11.8	4.6	1.2
Road and bridge construction	10%	3.5	12.3	4.5	2.2
Utilities	3%	0.0	1.4	2.5	2.5
Insurance	1%	2.2	7.0	2.9	2.8
Other costs	3%	2.9	4.0	2.8	2.5
LGCI	100%	1.4	5.9	3.2	2.4

CONSTRUCTION COST GROWTH

| to peak soon...



In response to the rapid rise in construction costs and the challenge this presents to financial planning for Local Governments, WALGA commissioned Macromonitor to forecast construction cost inflation for the next five years.

Three components of the LGCI were considered: Roads and Bridges, Non-residential Building and Non-road Infrastructure.

All are expected to follow a similar pattern of sharp growth in costs in 2021-22, easing in 2022-23 before returning to a lower growth pattern.

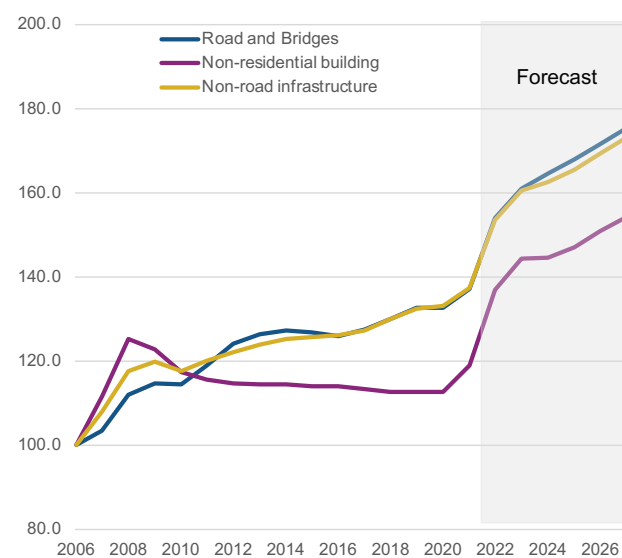
Component	2021-22	2022-23	2023-24
Roads and Bridges	12.3%	4.5%	2.2%
Non-residential Building	15.0%	5.4%	0.2%
Non-road Infrastructure	11.8%	4.6%	1.2%

...BUT COSTS WILL SETTLE AT A HIGHER LEVEL

SIMILAR GROWTH PATTERNS

| for material costs

Construction Cost Indexes, WA



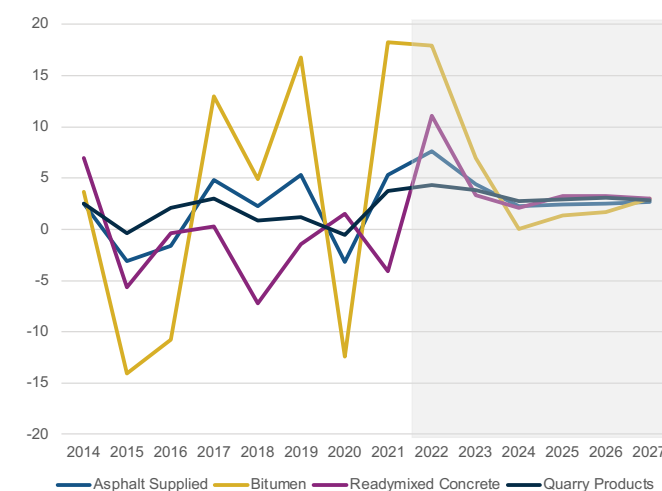
Despite the rapid rise in construction costs, it is not expected that costs will decrease in future years, though the rate of growth will ease.

How long it takes for the growth in prices to slow will depend on how long it takes for the supply challenges from the trade constraints, labour shortages and the war in Ukraine to resolve, as well as the impact on demand of increasing prices, Government stimulus and interest rates.

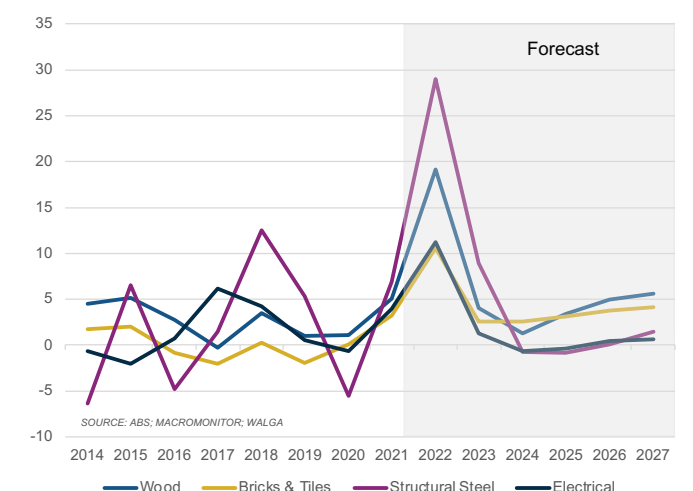
On top of these price increases, regional factors may come into play and Local Governments may experience construction quotes well above the State average. This may be particularly noticeable where there are limited suppliers, acute worker shortages, limited supply of materials or high demand from major infrastructure projects.

There may be benefit in delaying projects until some of these challenges ease. Projects should be considered on a case by case basis.

Road and Bridges Selected Materials Cost, WA, Annual % Change



Non-Residential Selected Materials Cost, WA, Annual % Change



While there are variations across the components of material costs for Road and Bridge construction, and Non-Residential construction, individual materials broadly follow a similar trend of a short and sharp peak in 2021-22 followed by a period of lower growth in subsequent years.

No materials are expected to return to 2020-21 prices.

CONSTRUCTION COST TAKEAWAYS



Construction costs have risen steeply due to:

- Strong construction activity driving up demand for all inputs to construction
- Rising commodity prices as the world economy recovers from the pandemic
- Supply constraints including restraints on trade and domestic labour availability
- The impact on commodity prices of the Ukraine conflict

How quickly the cost inflation will normalise depends on how quickly these factors can be resolved.



Some items that have experienced very high inflation

such as fuel and some metals may see price decreases, but it is likely that after the current spike, construction costs will settle at this higher level and return to low levels of inflation.



Rising interest rates are expected to slow demand and reduce inflationary pressures.



These forecasts are for WA.

There are likely to be regional variations, particularly on inputs (including labour) that are sourced locally where supply has not been able to keep up with increased demand.



The construction cost report is available to WA Local Governments on request.

LGs SHOULD PREPARE

for multiple scenarios in uncertain economic times



The LGCI is a guide for economy-wide cost pressures, and **doesn't take into account local or regional issues** which may impact costs for individual Local Governments. This is particularly relevant in an inflationary environment where prices are changing regularly.



In recent months, Local Governments have reported **significantly higher costs**, particularly in relation to construction than currently reflected in the LGCI. These increases continue to be reflected in the backwards looking datasets and as prices rise, the LGCI will be revised upwards.



It is important that Local Governments take into account their own local issues and experiences when considering cost pressures. It will also be prudent for Local Governments to prepare for **multiple scenarios for cost increases** coming years.



Given the significant challenges of forecasting in the current economic environment, WALGA will continue to **monitor cost pressures** and provide updates to the forecasts as more information becomes available.



NEW STATE GOVERNMENT TARIFFS

| from 1 July 2022

New electricity tariffs take effect from 1 July 2022. The changes in tariffs typically used by Local Governments differ from the 2.5% increase in household and small business tariffs announced in the media.

Changes in the most common Synergy tariffs are:

Tariff	Description	% Change
L1	Business Plan	2.50
L3	Business Plan Fifty	(3.03)
R1	Business Time of Use	2.50
R3	Business Time of Use Fifty	(1.21)
UMS	Unmetered Supply	2.31
Z	Street Lights (South West Interconnected System)	2.81
Z	Street Lights (Horizon Power service area)	5.90

The increase in street light tariffs for the South West Interconnected System is lower than the 3.03% foreshadowed in the 2021-22 State Budget.

The increase in the cost of unmetered supply is slightly above the 2.27% proposed in the previous year.

The increases in business tariffs are higher than the 1.75% increase indicated in the 2021-22 State Budget.



QUESTIONS

If you have any question on the contents of this report, please direct them to the WALGA Economics Team.



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