



ECONOMIC BRIEFING

OCTOBER 2022

OVERVIEW



As the WA economy emerges from the COVID-19 pandemic, it is facing a new challenge in the form of **rising prices and capacity constraints**.



Inflation is impacting Local Governments' **capacity to deliver infrastructure programs**, with key challenges reported including rising costs for materials and labour, accessing key supplies, and delays in the timing of major projects.



Inflation is surging across global economies, driven primarily by the conflict in Ukraine which is pushing commodity (particularly oil) prices skywards, as well as supply chain issues resulting from efforts to contain COVID-19, particularly in China.



Rapid cost increases in these areas has seen the **Local Government Cost index (LGCI) continue to accelerate**, increasing by 6.4% over the year to June 2022. Increases of this magnitude have not been seen since the peak of the mining boom back in 2008. The LGCI measures cost increases for key expenditure items for WA Local Governments.



State and Federal Governments are **unwinding stimulus programs** as we approach the end of the COVID-19 pandemic. At the same time, the Reserve Bank has been quick to shift from its emergency monetary policy settings, **raising the official cash rate** from 0.1% in April 2022 to 2.6% by October 2022.



However, it's **not just the cost of construction** that is on the rise. In recent months, there have also been increases in the costs of other key services such as **vehicle and equipment hire, real estate and engineering services**.





There are signs that the **tight labour market and widespread shortages of workers, is starting to exert pressure on wages**. Wages represent more than a third of the sector's cost base and have been contained in recent years, taking some of the pressure off growth in the sector's costs. However the **wage price index picked up in the June quarter of 2022 to reach its highest annual rate of growth since 2013**. The public sector has also come under pressure to raise wages, with the State Government agreeing to increase its offer to public servants to a minimum annual increase of 3% for two years, plus \$3,000, higher for those on salaries less than \$104,000.



The number of people employed in the state and the hours worked have reached a ceiling despite businesses crying out for more workers. **Job vacancies also remain at historically high levels** and outnumber the number of unemployed people available to absorb these roles.



Looking ahead, growth in the **LGCI is expected to peak in 2021-22, before slowing to 3.3% and 2.4% respectively in the following two years**. It is important to note that **costs are not predicted to fall – but to stabilise** at higher levels.



The **outlook for the WA economy more broadly is also uncertain**. Forecasts for the WA economy will next be updated in December in the State Government's Mid Year Financial Projections Statement. Given the significant risks on the horizon from the slowing global economy, rising interest rates and ongoing capacity constraints, **there may be a case for Treasury to revise growth projections for the WA economy lower**.

NOTE

The significant challenges of forecasting in the current economic environment, mean **the LGCI should be used with caution**. The LGCI will be subject to revisions in coming months, as the impact of major economic shocks such as the pandemic, war in Ukraine, and the impact of recent rate rises become clearer. An increase in wage pressures may also see the index revised higher.

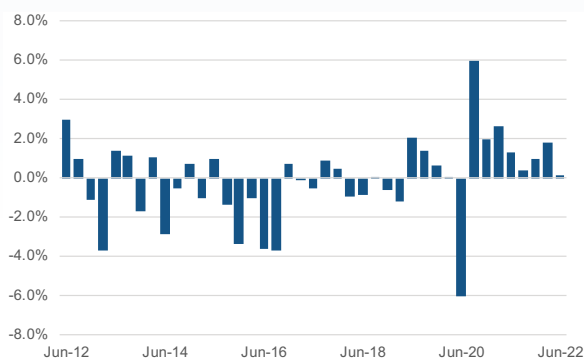
It is important that Local Governments take into account their own local issues and experiences when considering cost pressures. It would also be prudent for Local Governments to prepare for multiple scenarios for cost increases in coming years.



WA ECONOMY CONTINUES TO GROW

but at a slower pace

**WA State Final Demand,
Quarterly % Change**



**Retail Turnover, WA,
Annual % Change**



SOURCE: ABS; WALGA

The WA economy continues to record healthy growth, however this is slowing as COVID-19 related stimulus spending unwinds. State final demand grew by 0.1% during the quarter, and is 3.3% higher than a year earlier – well down from the peak of 12.3% in annual growth in June 2021.

The impact of the withdrawal of stimulus is best reflected in public investment figures, which fell by 3.5% during the quarter. Public investment stood only 0.7% higher over the year to June 2022, well down from the double-digit figures recorded over the past year.

The ability to undertake a significant stimulus program was provided by the State's solid financial position. In 2021-22, WA's Net Operating Surplus reached \$6 billion with Net Debt falling to \$29.2 billion – the lowest

level since 2014-15. This has provided fiscal capacity for the State Government to invest in \$7.2 billion of infrastructure over the year.

Dwelling and business investment also weighed on growth, contracting by 10.6% and 5.3% respectively over the year to June 2022.

The bright spot for the domestic economy during the June quarter was household consumption, which expanded by 1.4% - 6% higher than a year earlier. Growth in household consumption is expected to ease in coming quarters in line with the recent hikes in interest rates. This is reflected in retail turnover, which has dropped from its stimulus fuelled highs, but still remains above pre-pandemic levels.

HOUSING ACTIVITY EASING

| as stimulus unwinds

New construction activity is slowing in line with the end of Commonwealth and State Government COVID-19 stimulus.

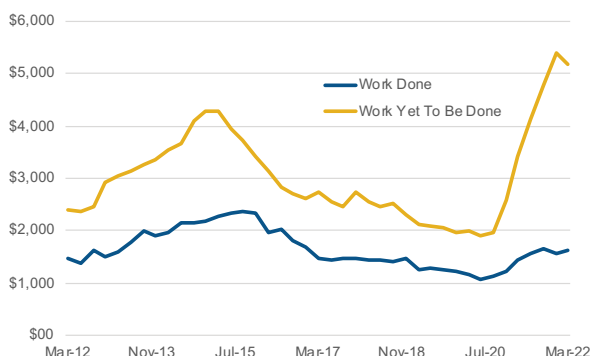
This is clearly reflected in housing finance commitments, which have now been falling in annual terms for eight consecutive months. Owner-occupier housing finance commitments were down by 13.3% over the year to June.

Similarly, residential building approvals have been falling since December 2021, and are down more than 30% over the year to June 2022.

Housing commencements are also receding from their recent peak, down by 35% over the year to March 2022.

While forward looking indicators of the housing market suggest activity is starting to ease, there remains a significant pipeline of work still to be completed. In March 2022, there was more than \$5.2 billion of residential construction work that remains outstanding. Based on the current rates of work completed, it is expected that the residential construction market will remain tight through the remainder of the financial year.

Work Done v Work yet to be Done, WA, \$m



Housing Commencements, WA, Quarterly % Change





INFLATION IS THE NEW CHALLENGE

| facing the WA economy

The WA economy remained resilient through the COVID-19 pandemic, however it now faces a new challenge in the form of rising prices and capacity constraints.

Inflation is the key issue facing economies around the world, and Australia (including WA) is not immune from this.

For the first time since December 2020, the Australian CPI increased at a faster quarterly rate than the Perth CPI, rising by 1.8%. In annual terms, growing at 6.1%.

Importantly, it is not just headline measures of inflation that have recorded strong increases. Measures of underlying inflation such as the trimmed mean and weighted median are also running outside of the Reserve Bank of Australia's (RBA) target band (4.9% and 4.2% respectively). These measures are used by the RBA to exclude items that have the largest price changes (both positive and negative) to ensure that outliers do not distort the data.

Local prices are also rising rapidly, with the latest data showing that the Perth CPI increased by 1.7% in the June quarter of 2022, and 7.4% over the last 12 months.

The key drivers of the Perth CPI over the year to June included fuel (up 34.1%), new housing (up 24.8%), rents (up 9%) and electricity (up 13.3%).

From October, the Australian Bureau of Statistics will publish a monthly CPI indicator, which will provide more timely insights into price pressures facing households.



COST INCREASES

| are widespread

It's not just consumers that are facing rising prices, but businesses and Government as well.

The Producer Price Index (PPI) increased by 1.4% in the June quarter, and is up by 5.6% over the year. The PPI measures the change in the selling price of domestically produced goods and services as they enter or leave the production process, and is an indicator of prices faced by businesses.

The PPI shows sharp increases in prices associated with building construction and heavy and civil

engineering, reflecting the currently skills shortages, supply constraints, and rising fuel and freight costs. For example, in Perth, steel products are up by 35% over the year to June 2022, timber is up by 20.4%, and cement products are up by 11.5%.

Rising costs are not just limited to construction, but are also being experienced in other areas. Some notable increases over the year to June include:



HIRING

(cars, equip)

up **5.1%**



PROFESSIONAL SERVICES

Real estate services

up **13.5%**

Engineering services

up **7.8%**

Employment services

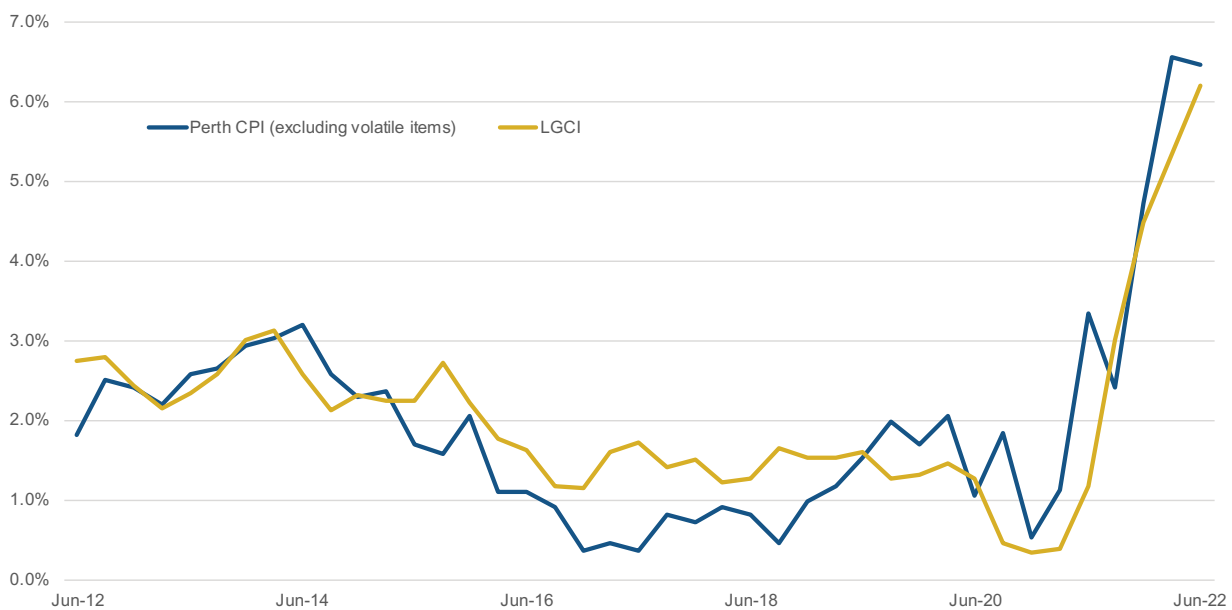
up **5.6%**

Surveying and mapping

up **6.4%**

LOCAL GOVERNMENTS ARE ALSO FEELING THE PINCH

LGCI vs Perth CPI, Annual % Change



SOURCE: ABS; WALGA

Local Governments can't avoid rising prices being experienced across the economy, and this is reflected in the continued high levels of growth in the Local Government Cost Index (LGCI).

Growth in the LGCI continued in the June 2022 quarter, rising by 6.4% over the year. This was the largest annual increase in the index since December 2008, at the height of the resources boom.

This increase was led by sharp rises in construction costs for buildings, roads, bridges and non-road infrastructure as well as machinery and equipment all which saw annual growth in double digits.

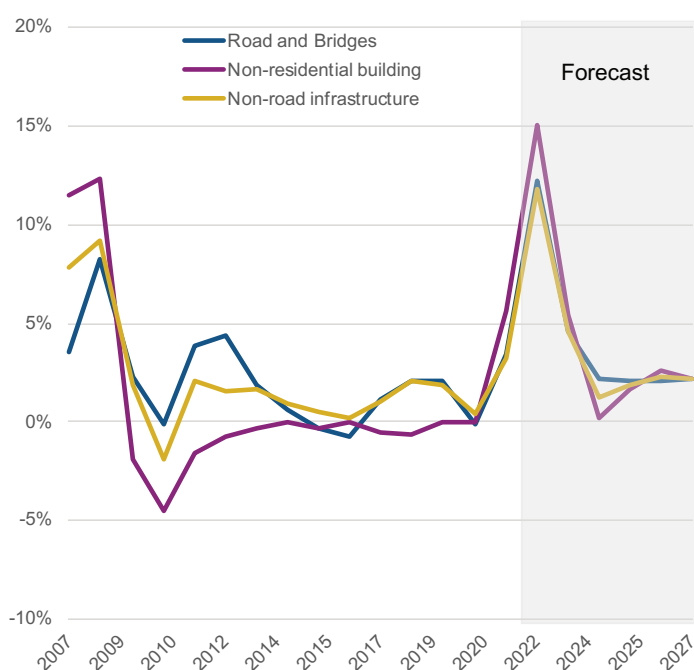
The LGCI would have been higher if not for the moderate growth in employee costs (2.2% during the year) - which make up a third of the index.



CONSTRUCTION COSTS

| remain elevated

**Construction Cost Indexes, WA,
Annual % Change**



SOURCE: ABS; MACROMONITOR

For Local Governments, the impact of inflation has been felt most acutely in terms of its infrastructure program – with key challenges reported by the sector including rising costs for materials and labour, difficulties accessing key supplies, and delays in the timing of major investment projects.

Construction cost forecasts are unchanged from the previous edition of the Economic Briefing and will be updated as soon as new data becomes available.

Roads and Bridges, Non-residential Building and Non-road Infrastructure all recorded sharp growth in 2021-22, but are expected to ease in 2022-23 and return to trend levels thereafter.

Component	2021-22	2022-23	2023-24
Roads and Bridges	12.0%	4.5%	2.2%
Non-residential Building	14.4%	5.4%	0.2%
Non-road Infrastructure	13.9%	4.6%	1.2%

WAGES ARE ALSO STARTING TO RISE

Emerging wage pressures have significant implications for Local Governments given employee costs represent more than a third of the sector's cost base.

Despite labour and skills shortages wages growth has remained contained in recent times, with the Wage Price Index for WA growing below the long term average rate since December 2013.

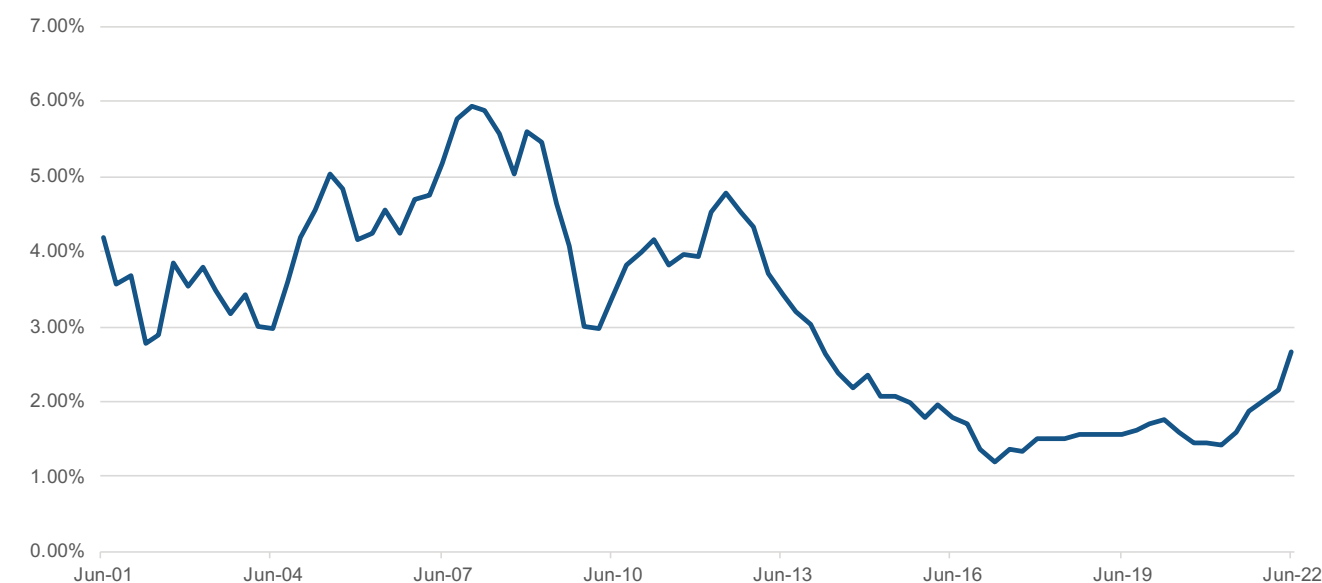
There are now early signs that wage pressures are starting to lift. The Wage Price Index grew by 0.8% in the June quarter of 2022, to reach 2.7% in annual terms. This is the highest growth rate since 2013 and slightly above the national wages growth of 2.6%

Private sector wages in WA have increased 3.0% in the last 12 months, well above public sector wages which are increasing at just 1.15% in the same time period.

Federal Enterprise Bargaining also show that the percentage increase in Average Annualised Wage Increases (AAWI) for agreements has been trending upwards. In March 2022, the AAWI for public sector agreements was 2.5%, compared to the most recent low of 1.9% in December 2020.

The State Government has increased its offer to public servants from annual 2.75% increases in December for two years, to a minimum of 3% plus \$3,000, higher for those on salaries less than \$104,000.

Wage Price Index, WA, Annual % Change



SOURCE: ABS; WALGA

LABOUR MARKET CONDITIONS ARE TIGHT

Capacity constraints in the WA economy are clearly reflected in the state's labour market, creating challenges for both public and private sector employers, particularly in terms of the ability to progress major projects and fill key roles.

In recent months, the number of people employed and hours worked have reached a ceiling despite businesses crying out for more workers – this is a risk to future growth in the WA economy.

WA's unemployment rate has remained within a band of 2.9% to 3.4% since March 2022 and as of August 2022 sits at 3.1%, lower than the national average of 3.5%.

The participation rate has also stabilised, suggesting that the labour market has reached a limit within the current settings. Participation is at 69.3% and has been within 1% either way for more than a year.

Job vacancies dropped slightly in June, for the first time in two years. They remain at historic highs and well above the number of unemployed people in the state.

Monthly hours worked in WA have come down slightly, but still remain at historically high levels.

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



SOURCE: ABS; WALGA

Monthly Hours Worked, WA, Millions



SOURCE: ABS; WALGA

MIGRATION IS NEEDED TO ADDRESS LABOUR SHORTAGES

In recent times, population growth in WA has been driven by natural growth.

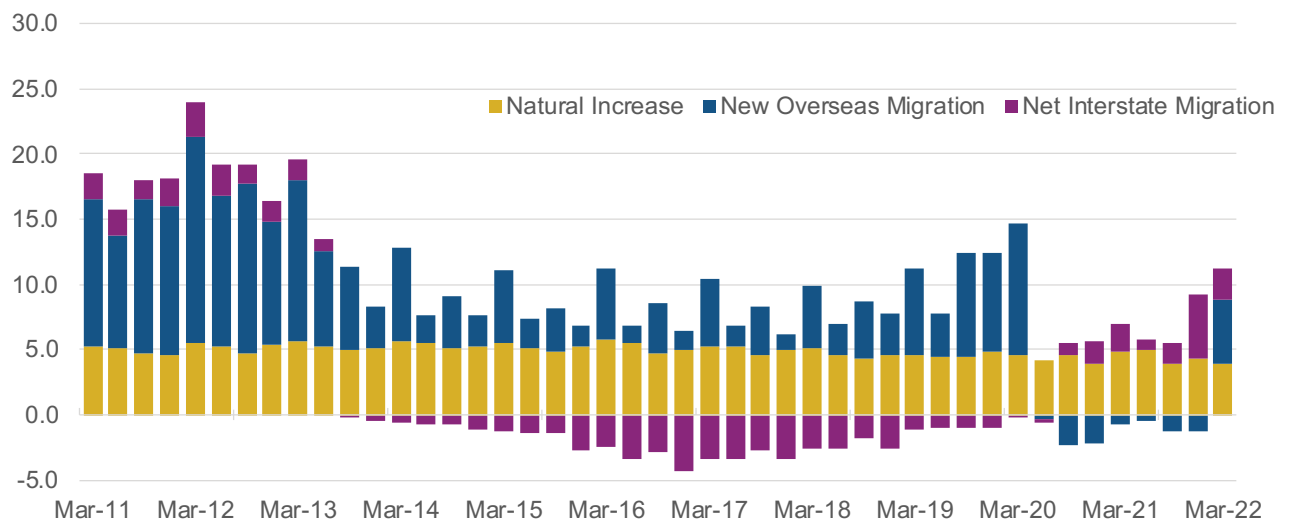
With borders now open, overseas migration was positive in the March quarter of 2022 for the first time in two years. WA recorded the second highest level of interstate migration in the country, behind Queensland.

Additional people moving to the state will help to address the state's labour shortages, however this will take some time. Overall, growth in the estimated residential population is currently running at 1.17%,

below the long term average and well below the growth rates in excess of 3% in 2008 that helped to fuel the rapid rates of economic growth during the mining boom.

Population growth in WA follows the economic cycle. Jobs are the key driver for people to move to WA from overseas or interstate. And this tap is turned off when the state goes through a downturn. This time though, WA is competing for talent with the other states, as well as abroad.

Population Growth, WA, '000s



LGCI EXPECTED TO RISE FURTHER



In line with trends in the broader economy and the outlook for inflation, the LGCI is expected to continue to climb in coming years, albeit at a slower rate.



LGCI is currently forecast to slow to 3.3% by June next year and 2.4% the year after.



The significant challenges of forecasting in the current economic environment, mean **the LGCI should be used with caution**. The LGCI will be subject to revisions in coming months, as the impact of major economic shocks such as the pandemic, war in Ukraine, and the impact of recent rate rises becomes clear. Further, **a larger than expected increase in wages growth may see upward revisions to the forecast for the LGCI**.



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 a inflationary environment where prices are changing regularly.



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** in coming years.



WALGA will continue to **monitor cost pressures** and provide updates to the forecasts as more information becomes available.



A larger than expected increase in wages growth may see upward revisions to the forecast for the LGCI





LGCI COMPONENTS

Forecast % Change

Component	2021-22(a)	2022-23(f)	2023-24(f)	2024-25(f)
Employee costs	2.20	3.00	3.00	3.00
Materials and contracts	5.7	2.9	2.5	2.4
Furniture	7.5	1.4	1.3	1.3
Non-residential building	14.4	5.4	0.2	1.7
Machinery and Equipment	12.2	1.2	2.3	2.2
Non-road infrastructure	13.9	4.6	1.2	1.9
Road and bridge construction	12.0	4.5	2.2	2.1
Utilities	1.4	2.5	2.5	2.5
Insurance	7.0	2.9	2.9	2.8
Other costs	5.9	5.0	2.5	2.5
LGCI	6.4	3.3	2.4	2.5

SOURCE: WALGA

(a) Actual figures

(f) Forecast figures



RBA LIFTS INTEREST RATES

| to tackle inflation

As State and Federal Governments are shifting their fiscal policy stance, the RBA is tightening monetary policy in an attempt to arrest rising inflation.

The RBA has been quick to shift away from its emergency monetary policy settings, increasing the official cash rate from a low of 0.1% in April 2022 to 2.6% by October 2022.

The change in direction of monetary policy reflects not just the external factors that are driving inflation, but also domestic factors such as the tight labour market and capacity constraints in some parts of the economy.

The lag between movements in the cash rate and the impact on the economy means it could take a number of months for the recent interest rate hikes to translate into lower spending. The effectiveness of tightening monetary policy is further complicated by a continuing strong labour market, and sizeable household financial buffers.

The RBA faces a difficult balancing act, in attempting to slow the economy to bring inflation under control, without overshooting and causing a sharper than desired downturn.

This is made more challenging by the interconnected nature of the global economy. In particular, there will be some pressure on the RBA to move interest rates in line with the United States, in an effort to avoid widening the interest rate differential and depreciation of Australian dollar, which would cause the price of imported goods to rise and worsen inflation at home.

The RBA has indicated that the rate of increase in the cash rate is likely to slow in coming months in an effort to avoid excessively slowing the economy and avoid Australia falling into recession.



HIGHER INTEREST RATES

| will increase borrowing costs

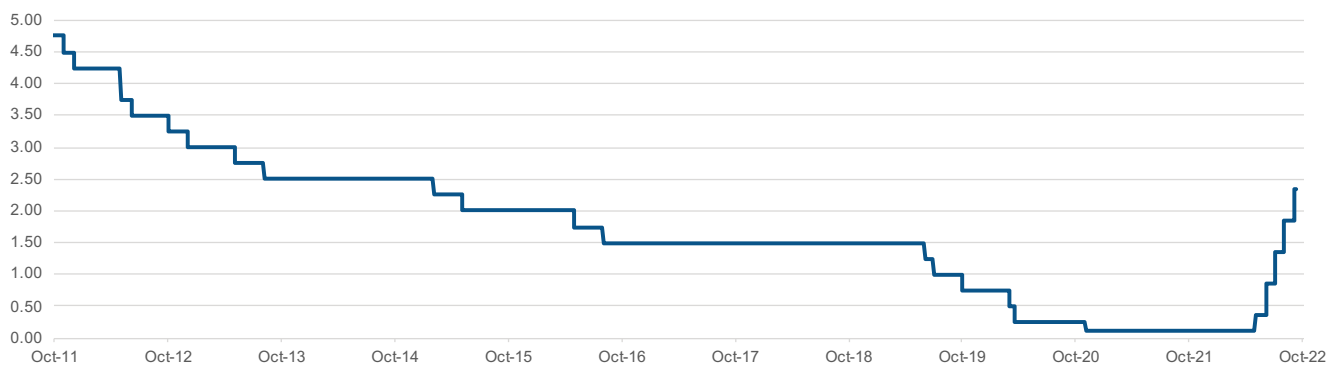
The increase in the cash rate has implications for Local Governments, primarily in terms of new borrowings.

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, %



SOURCE: RBA



WA ECONOMIC OUTLOOK

	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

There have been no new forecast released for the WA economy since the last edition of the economic briefing. New data will be available in late December when the State Government releases its Mid Year Financial Projections Statement.

Treasury's forecasts are likely to be revised from those provided in the Budget, given the changing global and domestic economic environment.

RISKS TO THE OUTLOOK



In considering its forecasts for the WA economy, Treasury is likely to weigh up a range of factors. With the most significant risks on the downside, **growth forecasts for WA are likely to be revised lower.**



The global economy and inflation environment is a key issue. The OECD has recently revised down its forecasts for the global economy in 2023 from 2.8% to 2.2% on the back of the ongoing impacts of the war in Ukraine and moves by central banks around the world to tighten monetary policy.



Of particular note for WA, **the OECD's forecasts for growth in China were revised down to 3.2% from 4.7%.** The Chinese Government is once again moving to stimulate their construction sector which will provide some support for our key export industries. Australian exporters have also been a beneficiary of the sharp increases in commodity prices in recent times.



Locally, there remains a question over the **impact of the recent interest rate rises on domestic economy activity**, and the extent to which the RBA continues to lift the cash rate.



The impact of **capacity constraints – particularly labour shortages** – may also pose a risk to the outlook to the extent that they extend project timeframes, or reduce the viability of others.



QUESTIONS

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



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