WALGA

WORKING FOR LOCAL GOVERNMENT

Local Government Economic Briefing

Current and Relevant Information for Officers and Elected Members

February 2019

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Local Government
Economic Briefing

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As Local Governments prepare their annual budgets, it is important that these are underpinned by realistic assumptions about future revenue streams and spending requirements.

Understanding the broader economic and policy environment can assist Local Governments with this task. The economic and policy environment can provide insights into any potential impacts on key sources of revenue and likely changes in demand for services. It can also help to identify risks that may prevent the projected budget outcome from being achieved.

This update provides a snapshot of the key economic trends and policy changes in the coming year which are relevant to Local Government's budget and strategic planning activities.

KEY POINTS

The WA economy is expected to continue its recovery in the year ahead – albeit at a modest pace.

The continued improvement in the economy is likely to bring some good news for Local Governments in terms of relief from the pressures that the downturn created, such as late payments and lower revenues from fees and charges.

However it will also foster increasing inflationary pressures.

Local Governments should be prudent and factor these changes into their forward projections.

WA Economic Update

After falling into recession for the first time in 26 years in 2016-17, the WA economy emerged from its slump to end the 2018 year on a more positive note.

The latest State Accounts figures that were released in November show that WA has returned to growth, with gross state product expanding by 1.9% during 2017 18. The pick-up in activity was largely driven by the external sector, as the additional capacity that has come on stream after years of investment in major mining projects has started to pay off in terms of higher exports.

While the return to the positive is certainly welcome news, it is important to recognise that the state's economic recovery is still fragile. Although our economy is once again expanding, growth rates are still subdued and remain well below the long term average of 4.3%.

The delicate nature of growth reflects the ongoing weakness in the domestic economy as the impact of the mining investment downturn continues to be felt. This is best reflected in business investment which finally arrested its four years of decline during 2017 18, but increased by only 0.1% during the year. However, this is due to the timing of the arrival of a number of offshore LNG platforms, which has taken longer and cost more than anticipated. As a result, the boost this has provided to business investment is expected to be only temporary.

The housing market also continues to struggle despite the official cash rate remaining at a record low 1.5%, due to weak growth in wages and more modest population growth. Dwelling investment fell in 2017-18 by 2.85%, following a 24% fall in the previous year. Household spending also remains contained, growing by just 1.7%. Spending remains focussed on essential items such as food (up 3.2%), health (up 3.8%) and education (up 3%).

Labour market conditions have improved, but remain patchy. The State's unemployment rate rose back up to 6.8% in January 2019 – equal to its most recent peak of 6.8% in March 2018. However, employment has continued to rise, with a net 800 jobs created over the last year. In a positive sign, some 28,700 full time roles were created over this period.

Underemployment still remains an issue, with some 131,700 Western Australians seeking more hours in January 2019 – well above the long term average of 60,000, though this is down from the peak of 151,400 underemployed persons in August 2018.

Looking forward, the WA economy is expected to continue its recovery in the year ahead – albeit at a modest pace. Treasury's latest estimates contained in the Mid Year Review show that the WA economy is now expected to grow by 3% in 2018-19 and 3.5% in 2019-20 on the back of continued strong growth in exports, and a gradual recovery in the domestic economy.

Economic Forecasts

	5 year average	2017-18 %	2018-19 %	2019-20 %	2020-21 %	2021-22 %
Gross State Product	**1.9**	**1.9**	**3.0**	**3.5**	**3.0**	**3.0**
Household Consumption	1.3	1.6	1.5	2.75	3.0	3.5
Business Investment	-13.4	0.2	-11.0	6.0	7.0	6.0
Dwelling Investment	-0.7	-2.6	-4.0	6.25	8.0	4.75
Exports	6.0	4.8	7.0	3.5	2.0	1.5
Imports	-3.7	-4.8	-2.5	2.75	3.0	3.0
Unemployment Rate	**5.7**	**6.1**	**6.0**	**5.75**	**5.5**	**5.25**

A bright spot for the economy in coming years will be the mining sector, which is showing signs of life once again with a number of new projects recently approved and moving into the construction phase in the year ahead. This will see business investment being to increase from 2019-20 onwards. Work has already commenced on BHP's $4.7 billion South Flank mine, while Fortescue's $1.7 billion Eliwana mine and Rio Tinto's $2.2 billion Koodaideri mine will be under construction during 2019. As well as the new construction activity, the mining sector will also be supported in coming years by maintenance on existing mines. Although conditions in the mining sector are improving, we can't expect to see a return to the mining boom conditions that were experienced between 2006 and 2012. It will therefore be important that there remains a focus on building on the State's strengths to identify new drivers of long term sustainable economic growth.

The downturn in the housing market is also finally expected to bottom out in the year ahead, although we can't expect to see a return to a booming market any time soon. REIWA expect sales activity in 2019 to remain similar to the past year, though there is a possibility that rising consumer confidence levels, coupled with improved housing affordability, could translate into increased sales volumes in 2019.[i]

The continued improvement in the economy is likely to bring some good news for Local Governments in terms of relief from the pressures that the downturn created, such as late payments and lower revenues from fees and charges, however it will also bring with it a return to higher prices.

The improved economic conditions will also come as welcome news to the State Government, which will receive a boost to the budget bottom line as the economy starts to improve. In fact, the latest figures released in the Mid-Year Financial Projections Statement in late December 2018 revealed that the budget will return to surplus a year ahead of schedule. An operating surplus of $1 billion is now expected for 2019-20, primarily on the back of the GST revenue windfall and higher iron ore royalties. The GST windfall will account for around 80% of the improvement in the budget position across the forward estimate period.

Looking forward, the WA economy is expected to continue its recovery in the year ahead – albeit at a modest pace.

For Local Governments, it is important to note that the State Government remains committed to the task of budget repair, particularly debt reduction and expenditure constraint, so it is not likely that the pick up in revenue will translate into spending on new programs and initiatives.

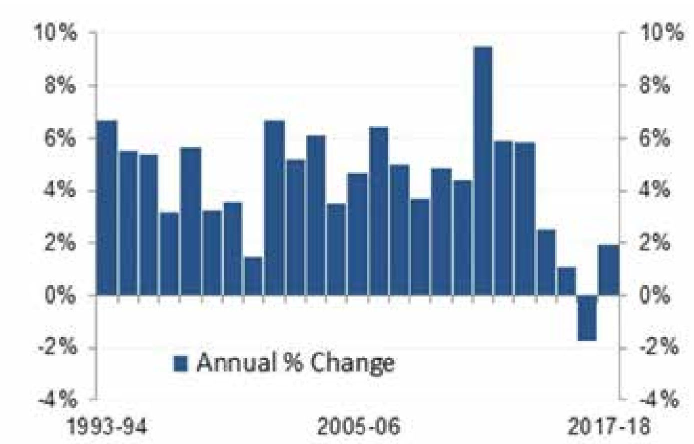
While net debt is now expected to peak at $37.9 billion in June 2020 (down from $41 billion estimated previously), this remains at a record high level. Debt at this level is costing the state over $900 million per year in interest payments. The Government has recognised that reducing debt to more manageable levels is an important objective, and has committed that the first three years of the GST top up funding will be directed into the State's Debt Reduction Account. This move is anticipated to save the state $200 million over the next three years from levels forecast at the time of the Budget.

Key Indicators

Economic Growth

Gross State Product, WA

- The WA economy returned to modest growth in 2017-18, after falling into recession for the first time in 26 years in the previous year.
- Gross state product expanded by 1.9% during the year, on the back of continued strong growth in exports and the return to modest growth in the domestic economy.
- The improvement in the WA economy is expected to continue in the year ahead, with Treasury forecasting growth of 3% in the latest figures released in the Mid-Year Financial Projections Statement.
- Thereafter growth is expected to pick up to 3.5% in 2019-20 and 3% for the remainder of the forecast period. However, this still remains below the long term average growth rate of 4.7%.

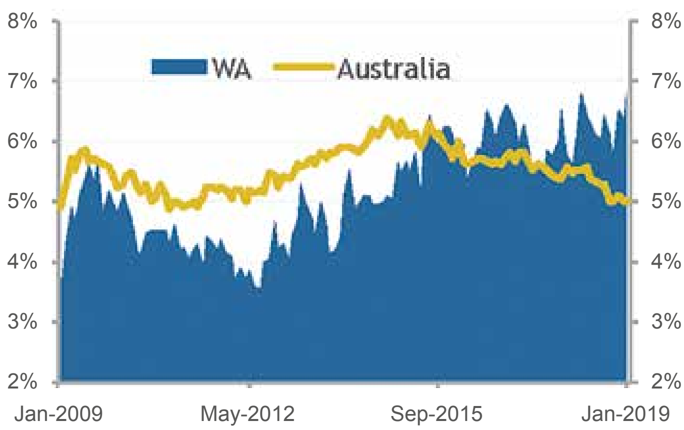


State Final Demand, WA

- State final demand is a measure of the domestic economy – the value of all goods and services that are consumed and invested in WA rather than through interstate or international trade.
- In annual terms, the WA domestic economy grew in 2017-18 for the first time in four years (up 1%). The improved result has occurred as business investment stabilised during 2017-18, after four years of decline.
- However, the latest quarterly results show that the domestic economy is still fragile, contracting by 0.5% over the year to September 2018.
- The contraction during the quarter reflected continued weakness in business investment, which fell by 3.4% over the year to September 2018.
- Household consumption also remained subdued, rising by just 0.7% in annual terms.
- Dwelling investment on the other hand has shown signs of improvement, growing by 5% over the year to September 2018 – the third consecutive annual increase, after declining in annual terms for the previous eight quarters.
- Government spending also remained subdued, rising by 0.8%, while Government investment declined by 11.4%.
- Looking ahead, the domestic economy is expected to improve in the years ahead and make an increasing contribution to growth. Treasury estimates predict the WA domestic economy will still contract by 0.5% in 2018-19, before growing by 3.5% in 2019-20 and 3.75% respectively in both 2020-21 and 2021-11.

Labour and Demographics

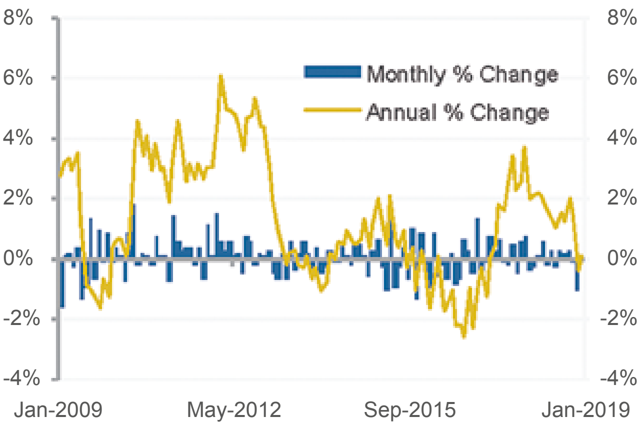
Unemployment Rate, WA vs Australia



- The WA unemployment rate has remained elevated in recent months, rising back up to 6.8% in January 2019 – well above the most recent low of 2.3% recorded in October 2008.

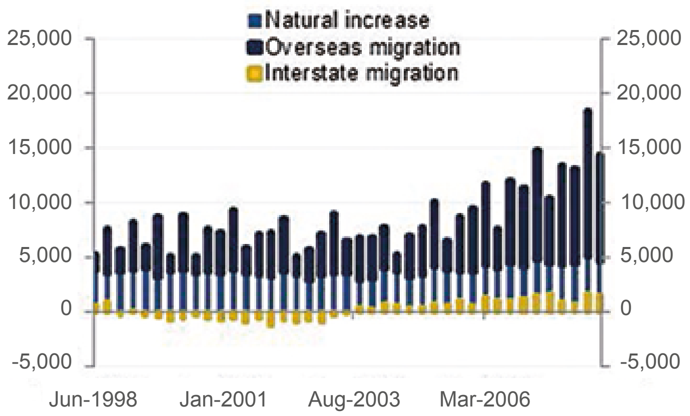
- The relatively high unemployment rate has occurred as job creation has been unable to keep pace with the increasing number of people returning to the workforce. The participation rate stood at 68.4% in January 2019, well above the most recent low of 66.4% in September 2016.
- The number of jobless Western Australians also remains well above the long-term average of 60,400. Some 97,600 Western Australians were out of work in January 2019.
- Over the coming year, the unemployment rate is expected to gradually track downwards in line with the improvements in the domestic economy. Treasury expects that WA's unemployment rate will average 6% in 2018-19 and 5.75% in 2019 20, before falling to 5.25% by 2020-21.

Employment Growth



- After a difficult few years, employment growth in WA has started to improve over the past year.
- Some 1.336 million Western Australians were in work in January 2019, with 51,100 jobs created since September 2016 when employment was at its most recent low of 1.285 million.
- In a positive sign for the labour market, full time employment has started to increase, growing in annual terms for the past seven months. Some 28,700 full time roles have been created over the year to January 2019.
- However, there still remains some spare capacity in the labour market.
- The labour force underutilisation rate (which examples the number of underemployed and unemployed people as a share of the labour force) also remains at historically high levels, standing at 16% in January 2019, compared to its lowest point of 7.1% during the mining boom in 2008. There were 131,700 underemployed persons in WA in January 2019.
- Employment activity is expected to improve in the coming year, with Treasury predicting that the state's workforce will expand by 2% in 2019-20.

Population Growth



- Growth in WA's estimated residential population has started to record a modest turn around, although remains well down on the historically high rates recorded during the mining boom years between 2007 and 2009.
- WA's estimated resident population expanded by 0.8% over the year to June 2018 – the strongest rate of growth since September 2015.
- Growth in WA's population continues to be driven by overseas migration, with a net 2,305 people moving to WA from overseas during the quarter.
- By contrast, net intrastate migration remains in negative territory. WA lost 2,597 people to other states in the June quarter of 2018.
- The natural increase (birth rate) remains elevated, with 4,850 added to the population in the June quarter of 2018 – compared to the long term average of 4,000. The historically high natural population increase in recent years is likely to see a growing demand for child and youth services in coming years.

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Interest Rates

In the minutes of the December monetary policy meeting, the Reserve Bank Board clearly stated that "the next move in the cash rate was more likely to be an increase than a decrease," but in the same sentence noted that there was no pressing case to change the cash rate from its record low of 1.5% the short term.

Despite this direct statement that interest rates will stay on hold for the time being, in the weeks since questions have begun to arise about whether that is still the case.

In fact, over the holiday period, markets have now priced in a 50% chance that interest rates will actually be cut further during the course of 2019, in direct contrast to the Reserve Bank Board's statement.[ii]

The more pessimistic view is being driven by ongoing concerns around the trade war between the United States and China, as well as the continued uncertainty around the impacts of Brexit. Further adding to this perspective has been negative news about the domestic housing market, particularly on the east coast of Australia.[iii]

The decision to change the official cash rate in either direction will be challenging, given the considerable uncertainty that still exists about the economic outlook both overseas and at home.

The most likely scenario is that the cash rate will stay on hold for the time being until clear evidence has emerged that there is a strong case for either a rate cut or hike. This was confirmed by Reserve Bank Governor Phillip Lowe, who stated in a recent speech that there is not a strong case for a near-term change in the cash rate, and that the probabilities between a rate increase and a decrease are now "more evenly balanced".[iv]

As a result, Local Governments can expect to see no major movements in interest rates in the near term unless there is a significant improvement or deterioration in economic conditions – particular in relation to the labour market.

However, in its latest monetary policy decision, the Bank's overall tone still remained upbeat, noting that it is expected that there will be further progress in reducing unemployment and inflation will return to the target over time. On this basis, the Bank appears to have a mild bias towards tightening.

If the next move to interest rates is in fact upwards, this will eventually lead to higher interest rates on borrowings for Local Governments, even though most loans are linked to bond yields.

For Local Governments that have borrowings, the impact of an increase in the cash rate will depend on the type of facility used.

Most Local Government borrowing is provided via low cost loans through the WA Treasury Corporation (WATC). The majority of these are long-term, fixed interest rate, amortising loans. As a result, any increase in the cash rate is not likely to have a major impact on the majority of existing Local Government loans as the interest rates are fixed.

For new loans or those being refinanced, the long term fixed interest rates are generally aligned with WATC 10-year bond yields. Rather than being directly aligned to the cash rate, these are influenced by perceptions of the long term economic outlook, both at home and overseas. In this regard, the expected improvement in the economy and expectation for inflation to rise will mean that long term interest rates will also increase.

An increase in the official cash rate will be most keenly felt by those Local Governments that use short term loan facilities with the WATC. This is because short term loans are priced to the 90-day bill rate, which is directly linked to the cash rate. To this end, Local Governments using these types of facilities may need to prepare for higher costs on these types of loans as they roll over.

Any decision by the RBA to raise the cash rate will not just have implications for borrowings, but also for investments. However, the impact will differ depending on the type of investment, and in some cases, how the market interprets an increase in interest rates.

For cash based investments such as term deposits, any increase in the cash rate is expected to flow through into higher interest rates as deposits roll over upon maturity, or when a new term deposit is established.

The impact on other types of investments such as property or shares remains to be seen, as this will largely depend on how the market perceives an increase in the cash rate. On one hand, it could be viewed as a sign that the economy is on track, and provide a boost to these types of investments. However, concerns about the high level of indebtedness among Australian households or risks that the recovery in the economy will be quashed by an increase in interest rates may in fact see these types of investments respond poorly to an increase in the official cash rate.

Risks to the Outlook

While the outlook for WA in 2019 is more positive, there are some risks on the horizon that may see growth come in weaker than expected.

The most significant risk for WA is that the Chinese economy will slow more than expected. This is because China accounts for more than half of the state's merchandise exports and is the state's most important trading partner.

After recording a decade low growth rate of 6.5% during the September quarter, the latest data for November showed that the Chinese economy has slowed even further – suggesting that growth figures for the final quarter of the year will be even lower. The slowdown was driven by the weakest retail sales in 15 years. Adding to concerns about the slowing Chinese economy is the impact of the trade war with the United States. The IMF is now predicting that the trade tensions will mean that the Chinese economy will grow by just 6.2% in 2019.[v]

On balance however, Treasury notes that the direct impact on WA from the trade war will be small, given that most of the State's exports to China are consumed in the domestic economy (in particular, iron ore being used to produce steel) rather than being re-exported. However, WA will feel the impact if the trade war spills over into a more significant disruption in China's economy.

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Local Government Costs

Cost pressures facing Local Governments have continued their modest ascent according to the latest Local Government Cost Index (LGCI).

The index grew by 0.3% in December 2018, to stand 1.4% higher over the year.

The primary driver of growth in the index in December was road and bridge construction, which grew by 0.5% in the quarter to stand 2.1% higher than a year earlier.

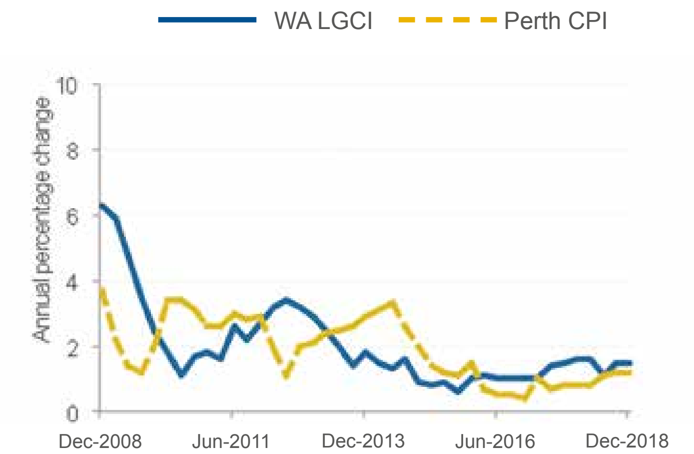
Other prices (Perth CPI) also added to growth in the index, rising by 0.5% in the December quarter and 1.3% compared to a year earlier. Wages also continued to rise by 0.3% in the quarter and 1.6% over the year.

The index was also supported in annual terms by the new regulated tariffs which came into effect for the 2018-19 financial year. Electricity was up by 7.3% in annual terms, while street lighting rose by 3.1%.

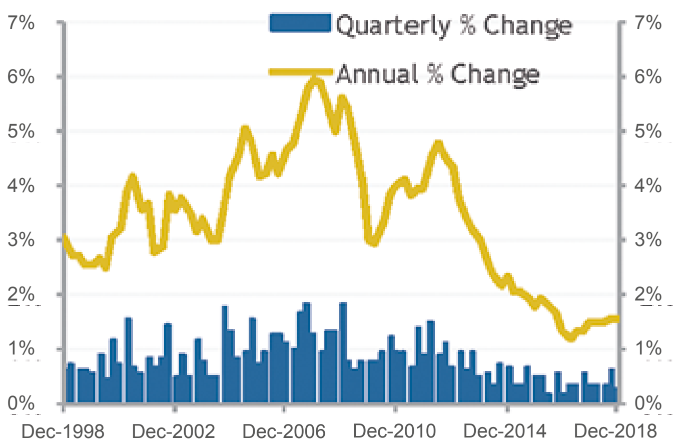
Costs for Local Government

	5 year average	2017-18 %	2018-19 %	2019-20 %	2020-21 %
Wages (WA Wage Price Index)	1.9	1.5	1.75	**2.75**	3.0
Road and Bridge Construction	0.6	1.7	2.7	**1.25**	1.5
Non-residential Building	-0.3	-0.6	1.4	**1.4**	1.4
Other Costs (Perth CPI)	1.5	0.9	1.5	**2.0**	2.5
Machinery and Equipment	1.1	1.9	0.3	**1.0**	1.2
Electricity and Street Lighting	1.1	0	7.4	**6.0**	5.1
Local Government Cost Index	**1.3**	**1.5**	**1.7**	**2.0**	**2.8**

LGCI vs Perth CPI



Wage Price Index, Annual % Change



By contrast, non-residential building costs and machinery and equipment detracted from the index in December. Both indicators were flat during the quarter, and fell in annual terms by 0.2% and 0.1% respectively.

With the economy now in recovery mode, this will see costs faced by Local Governments start to rise in coming years. **It is therefore prudent for Local Governments to prepare for price increases in the future**. While there is spare capacity in the economy at present which see only modest growth in prices in the short term, growth in the LGCI is expected to pick up over the forward estimates as the economy gathers pace.

However, cost increases still remain below the double digit rates of growth experienced during the boom years. WALGA's updated forecasts for the LGCI predict the index will rise by 1.9% in 2019-20, and 2.8% in 2020-21, outpacing increases in consumer costs over this period.

- Wages growth in WA has been modest in recent times.
- The Wage Price Index (WPI) for WA grew by 0.3% in the December quarter of 2018. In annual terms, the index is up by 1.6%.
- WA Treasury expects that wage pressures will continued to record modest growth in the year ahead as labour market conditions start to improve.
- The Wage Price Index is forecast to grow by 1.75% in 2018-19 and 2.75% in 2019-20, before rising to 3.25% by 2021-22.

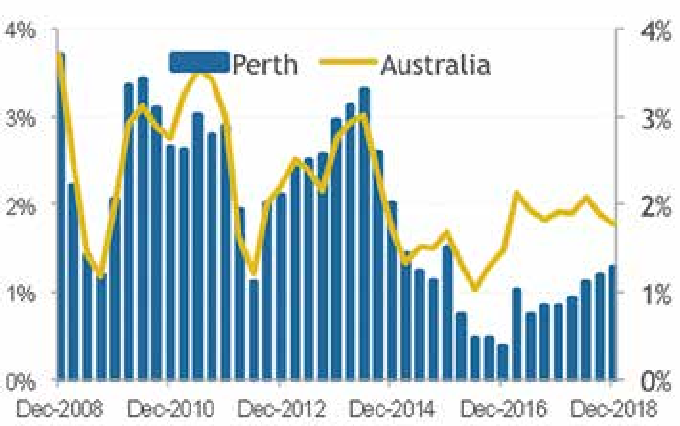
With the economy now in recovery mode, this will see costs faced by Local Governments start to rise in coming years. It is therefore prudent for Local Governments to prepare for price increases in the future.

Construction Costs

- Activity in the non-residential construction sector in WA has started to stabilise in recent times.
- Although excess capacity still exists, it is expected that will start to be absorbed in the coming years which will see costs start to rise. Non-residential construction costs are expected to increase by 1.4% in 2019-20.[vi]
- Road and bridge construction costs are expected to record modest growth in the coming years, rising by 1.25% in 2019-20.

Other Prices

Consumer Price Index



- Price pressures in Perth have started to record modest growth in recent times, though still remain subdued.
- In the December quarter of 2018, the Perth Consumer Price Index (CPI) grew by 0.5%, to stand 1.3% higher than a year earlier.
- Growth in the index over the year was underpinned by higher prices for alcohol and tobacco (up 6.1%), health (up 3.7%) and transport (up 3.6%). By contrast, declines were recorded in the price of communication (-4.5%) and housing (-1.2%).
- Price pressures are expected to record further modest increases in coming years as the economy improves. Treasury predicts the CPI will grow by 2% in 2019-20 and 2.5% in 2020 21.

Other Fees and Charges

Department of Water and Environmental Regulation Fees

Recently, the Department of Water and Environmental Regulation (DWER) set out a proposal for a new fee structure as part of a cost recovery approach for the assessment of applications made under Part V of the Environmental Protection Act 1986 and Rights in Water and Irrigation Act 1914.

DWER consulted on the proposed changes during late 2018.

Although the fee changes have not yet come into effect, the potential for an increase is an important consideration for Local Governments in forward financial planning.

Further detail on the proposed fee structure can be found in the discussion paper:

https://dwer.wa.gov.au/sites/default/files/Cost%20 recovery%20discussion%20paper.pdf

Price pressures in Perth have started to record modest growth in recent times, though still remain subdued.

Utilities

The 2018-19 State Budget set out projected price changes for key electricity and water tariffs. While these are subject to change when the 2019-20 Budget is handed down in May, they are a useful guide for planning purposes.

Electricity Tariffs

	5 year average	2017-18 %	2018-19 %	2019-20 %	2020-21 %	2021-22 %
Medium Business (L3/L4)	4.2	1.1	3.7	**3.7**	3.7	3.7
Medium Business Time of Use (R3)	4.6	3.6	5.5	**5.5**	5.5	5.5
Street Lighting (Z)	4.1	2.8	3.2	**3.2**	3.2	3.2
Unmetered Supply	3.6	5.9	5.2	**5.2**	5.2	5.2

Water Tariffs

	2018-19 %	2019-20 %	2020-21 %	2021-22 %
Water Tariffs	6.0	**6.0**	2.5	2.5

Landfill Levy Rates

Ongoing increases to the landfill levy were announced as part of the 2014-15 State Budget.

	2018-19 %	2019-20 %	2020-21 %
Putrescible Rate/tonne	**$70**	$70	$70
Inert Rate/tonne	**$70**	$70	$70
Inert Rate/m³	**$105**	$105	$103

Government Funding

Roads to Recovery

The next five-year tranche of funding for the Federal Government Roads to Recovery Program will commence in 2019-20.

The base level of funding in the new Roads to Recovery Program is marginally higher than in the previous five-year period. However, two tranches of additional funding in the past five years as a result of specific initiatives make this comparison complex, and should be considered by Local Government in the context of their long term financial planning.

The 2018-19 Federal Budget indicates that from 2019-20, Roads to Recovery funding of $400 million per year will be provided. This is a 14.3% increase in the base level of funding $350 million per year provided at the start of the previous five-year program in 2014-15.

However, for Local Governments comparing actual Roads to Recovery receipts over the past five years with the 2019-20 forecast, the following needs to be reconciled.

- The May 2015 Federal Budget included a one off doubling of Roads to Recovery funding in 2015 16, taking the total to $700 million in that year.
- On 23 June 2015 it was announced that as part of securing passage of the Fuel Excise Indexation Legislation the Roads to Recovery Program would receive an additional $1,105 million over two years. Following a number of adjustments, the actual outcome was additional payments to Local Governments nationally of $1,002.2 million over three years, up to and including 2018-19.

Compared with the initial $1,750 million over five years ($350 million per year) from 2014-15, the Roads to Recovery program delivered $3,102 million over five years, a 77% increase.

Western Australian Local Governments receive approximately 14.6% of the national Roads to Recovery funding. The Association has not received any formal advice, but estimates that Western Australian Local Governments will receive approximately $292.4 million through the Roads to Recovery Program in the five years ending June 2024. From this approximately $20.5 million will be allocated to bridges and access roads to remote Aboriginal communities. The balance will be distributed between Local Governments using the Asset Preservation Model maintained by the WA Local Government Grants Commission as the basis.

Western Australian Local Governments receive approximately 14.6% of the national Roads to Recovery funding. The Association has not received any formal advice, but estimates that Western Australian Local Governments will receive approximately $292.4 million through the Roads to Recovery Program in the five years ending June 2024.

Commodity Prices

While 2018 was expected to be a more positive year for commodities, the ongoing political and economic events around the globe meant that the year was somewhat more volatile than expected.

The outlook for commodities is relevant for a number of Local Government activities, including vehicle running costs; road and building materials; and recycling.

- Oil prices are expected to edge up in 2019, and are expected to average $74/bbl during the year, up from $72/bbl in 2018 and $53/bbl in 2017. The increase is expected to be driven by supply side factors which are absorbing spare capacity in the global market, including production declines in Venezuela and the introduction of sanctions on Iran by the United States. These factors are expected to be partly offset by production increases in other Organisation of Petroleum Exporting Countries and Russia.[vii]
- Natural gas prices are expected to stabilise in 2019. The Department of Industry predicts that LNG contract prices - at which most Australian LNG is sold - are forecast to rise in 2018-19 before easing slightly in 2019-20. Meanwhile, spot prices are expected to decline as supply capacity comes on stream particularly from Australia and the United States, which will outstrip growth in LNG demand.[viii]
- Metals prices ended 2018 on a weaker note in line with concerns about the strength of the global economy, driven by the US/China trade dispute. During 2019, metals prices are expected to be mixed.
    - The free on board (FOB) Australia iron ore price is forecast to decline to US$51 a tonne in 2020, on the back of weaker growth in the global economy.[ix]
    - Prices for aluminium are expected to ease from elevated levels in 2018 to US$2,098 a tonne for aluminium and US$354 a tonne for alumina by 2020.[x]
    - Copper prices forecast to rise from US$6,430 a tonne in 2018 to US$8,013 a tonne by 2020 in line with rising demand.[xi]

Metals prices ended 2018 on a weaker note in line with concerns about the strength of the global economy, driven by the US/China trade dispute.

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