WALGA Economic Briefing

March 2021

Summary

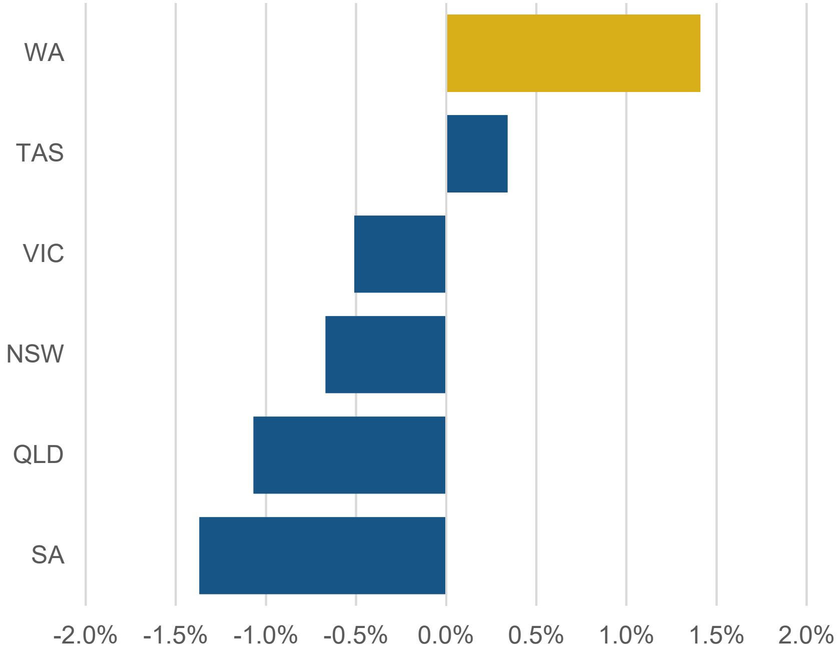
- The WA economy has recovered faster from the COVID-19 pandemic and is performing better than other states.
- This has been driven by the continued strength of the mining sector as a result of strong demand for our key commodity exports. The successful containment of COVID-19 which allowed restrictions to be removed earlier than other states, and significant amounts of Government stimulus spending have also supported the WA economy over the past year.
- However, the recovery is still fragile. Economic growth still remains below the long term average and will be underpinned by Government spending in the near term. Sectors such as tourism, transport and education will continue to suffer from the ongoing restrictions on borders and international travel.
- This will mean that spare capacity exists in the economy, which will keep a lid on overall price pressures faced by Local Governments in the short term.
- The Local Government Cost Index is expected to rise by **1.4% in 2021-22**, and **2% in 2022-23**.
- The increase in the index reflects an expected increase in wage, construction and machinery and equipment costs, as the economic recovery gathers pace.

Summary

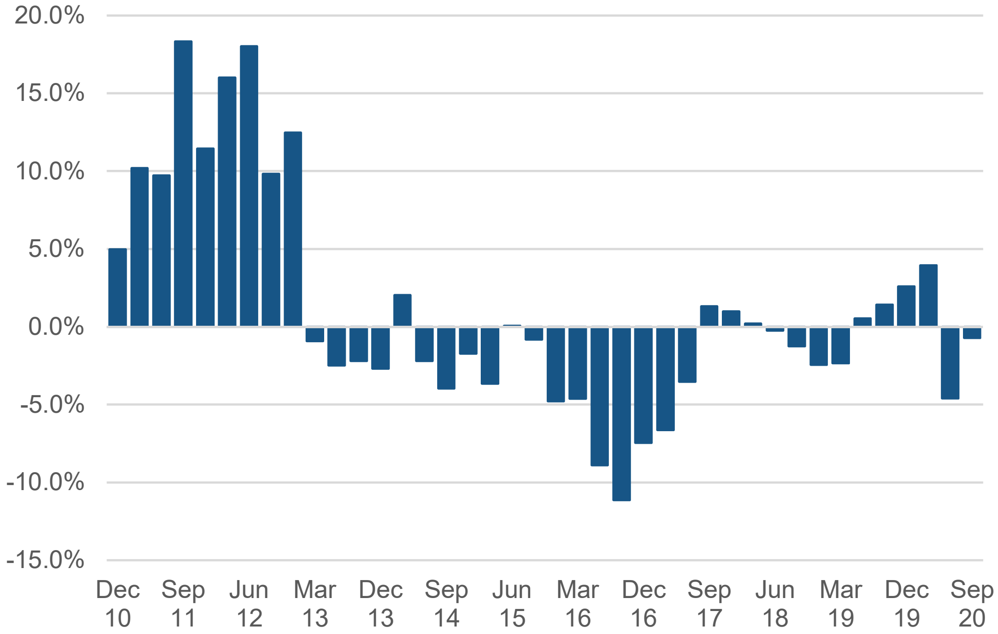
- Given the significant uncertainty that exists around the economic outlook, Local Governments should consider these forecasts with caution, given there are risks to both the upside and downside.
- Construction and infrastructure cost estimates may be revised higher in coming periods as a result of resurgence in activity in the state's housing market, on the back of the significant stimulus spending. This is expected to lead to:
  - Increased workload in processing approvals; monitoring and enforcement of building works
  - Increased charges where services are contracted out to building surveyors
  - Potentially higher labour costs and delays for Local Government infrastructure/building projects
- By contrast, another wave of COVID-19 and an extended period of lock down could delay the return to "normal" activity, and see cost pressures remain contained for an extended period of time.
- It is prudent for Local Governments to prepare for multiple scenarios for cost increases coming years. WALGA will continue to monitor cost pressures and provide updates to the forecasts as more information becomes available.
- The current environment of low interest costs creates an opportunity for Local Governments to review their financing, funding and investment arrangements.

The WA economy has recovered faster and is performing better than other States

2019-20 GSP, % Change



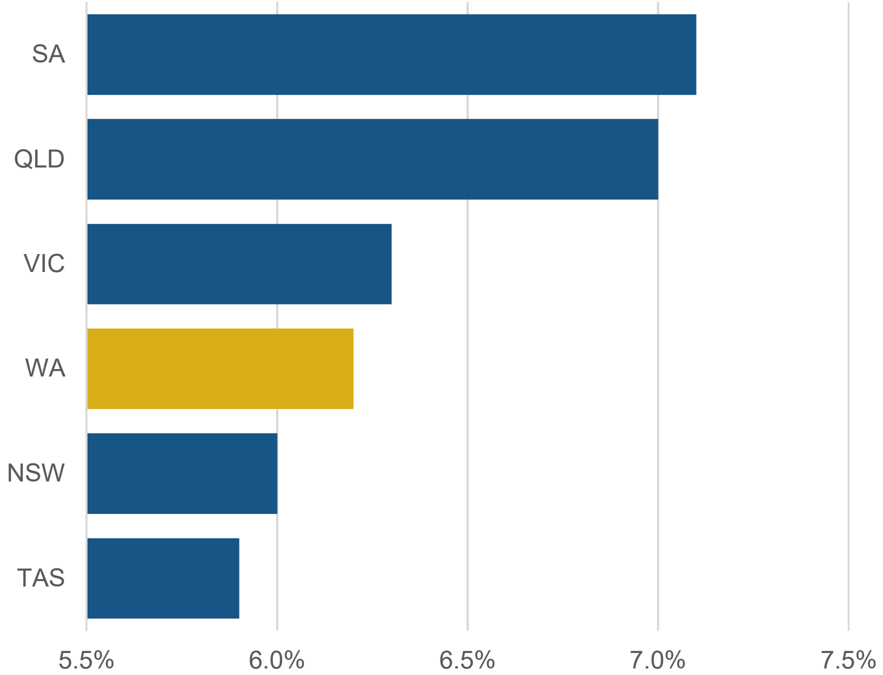
WA State Final Demand Annual % Change



- Although the WA economy recorded a significant contraction in the domestic economy in June 2020, it still grew during the last financial year. The latest State Accounts figures that were released in November show that the WA economy expanded by 1.4% during 2019-20 – the fastest of all states.
- WA's quicker than expected recovery has been driven by the successful containment of COVID-19, which allowed restrictions to be removed earlier than other states; the strong mining sector which has continued to perform well during the year; and significant levels of State and Commonwealth Government stimulus spending.

Most of the jobs lost during COVID have now been recovered

Unemployment Rate, January 2021



SOURCE: ABS CAT 6202

Monthly Hours Worked, WA Millions

- WA's unemployment rate stood at 6.2% in January 2021, down from its COVID-19 induced peak of 8.7% in June 2020.
- Employment has also rebounded, with 88,600 jobs created since COVID-19 saw the workforce drop to its recent low in May 2020. Nearly all jobs lost due to COVID-19 have been recovered.
- Measures of spare capacity have also improved. Monthly hours worked have returned to pre-COVID-19 levels, while the number of underemployed persons has fallen in annual terms for the last six months.

Our budget bottom line has also benefitted from our economic performance

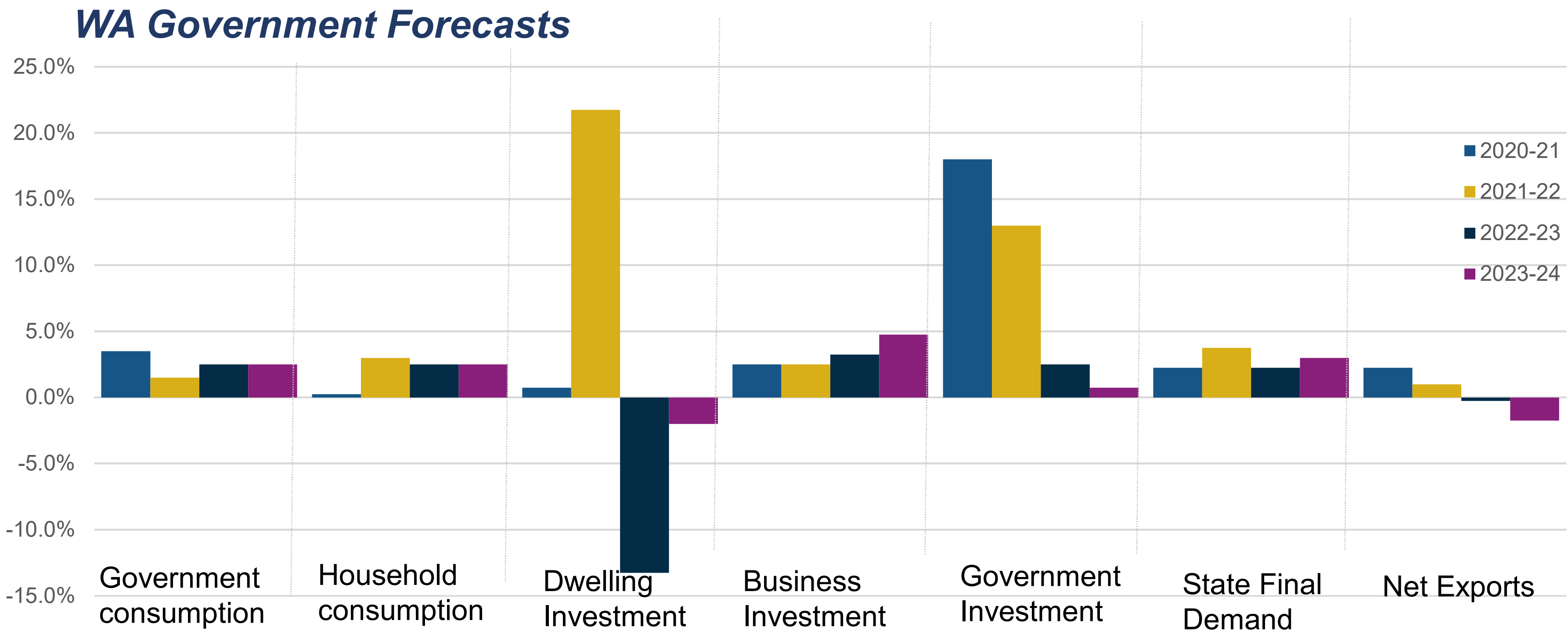
- WA is also the only state in the nation to post a budget surplus over the past year.
- The Pre-Election Financial Projections Statement shows that WA will record a $3.1 billion surplus in 2020-21, with operating surpluses also predicted across the next three years.
- This strong operating result has been driven by higher tax revenues as the economy performed stronger than expected; an increase in royalty revenues, as iron ore prices have risen sharply as a result of supply constraints in Brazil; and a larger than expected share of GST grants from the Commonwealth.
- Total public sector net debt is expected to rise in the short term in order to fund the significant level of COVID-19 related infrastructure stimulus spending, before declining in the final year of the forward estimates.
- Net debt is expected to peak at $40.3 billion in 2022-23.

Looking head, Treasury predicts the continued recovery in the WA economy

	2019-20 %	2020-21 %	2021-22 %	2022-23 %	2023-24 %
Gross State Product	1.4	2.0	2.75	1.25	1.5
Household Consumption	-2.3	0.25	3.0	2.5	2.5
Business Investment	9.5	2.5	2.5	3.25	4.75
Dwelling Investment	-13.2	0.75	21.75	-13.25	-2.0
Exports	0.4	0.0	1.5	1.0	0.25
Imports	1.3	0.25	1.0	2.25	2.5
Unemployment Rate	6.1	6.5	6.0	5.5	5.5

- The February lockdown is not expected to have a material impact on economic growth overall, given that it was for a short period and activity continued among the key sectors of the WA economy.
- Recent improvements in consumer and business sentiment have seen Treasury revise up forecasts for household consumption and business investment.
- A significant increase in dwelling investment activity is expected in the short term due to the strong uptake of State and Federal Government stimulus measures to support housing construction activity.

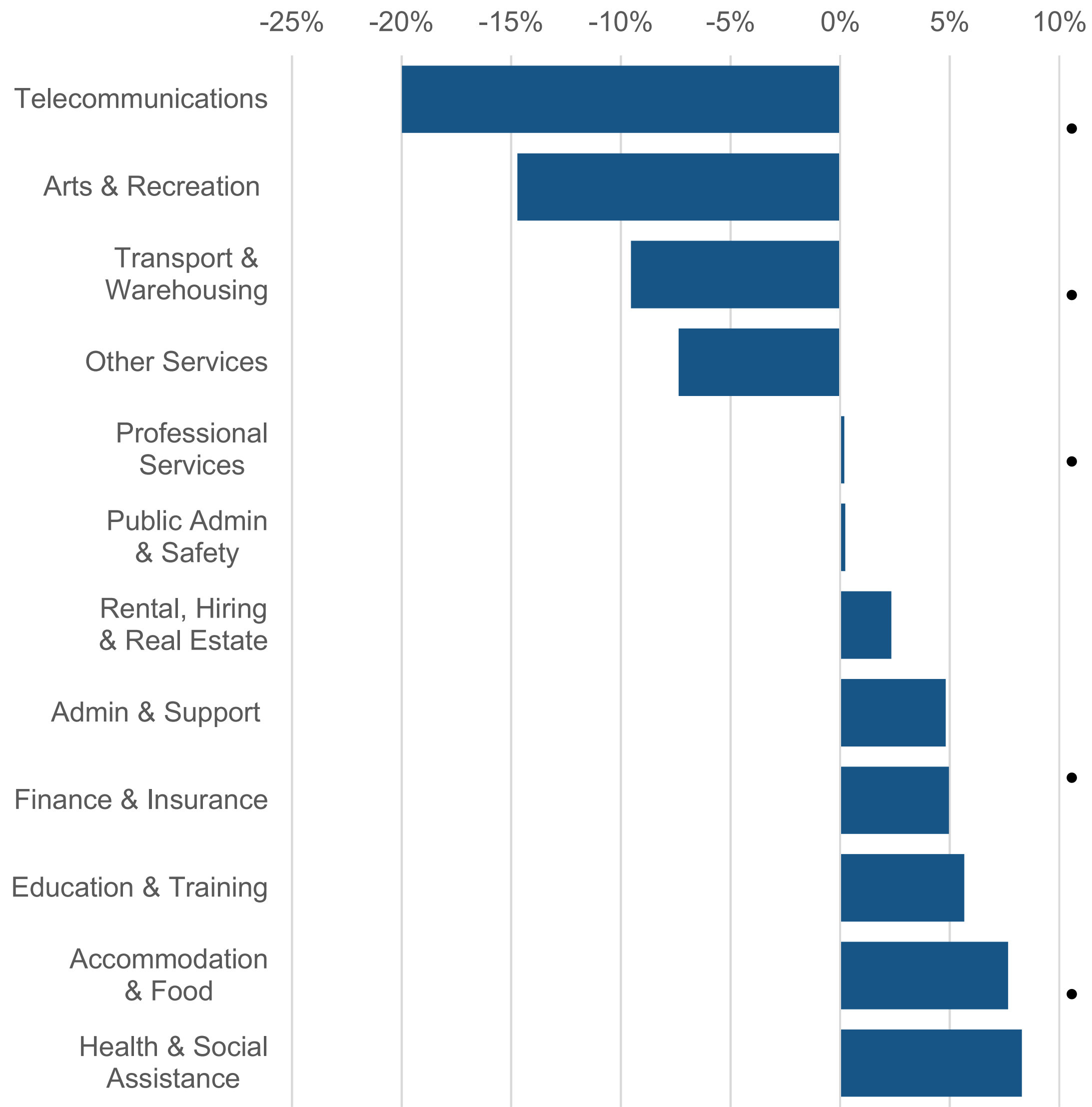
However, the economic recovery is still fragile



- While the outlook is positive, Government is playing a major role in driving the recovery in the short term, which indicates some underlying weakness in economic activity.
- This is reflected in the forward estimates, which shows that projected economic growth for WA remains below the long term average of 4.1%, while estimates for wages and inflation also remain subdued.
- A sustainable recovery will require a further improvement in private sector activity in coming years to absorb additional capacity in the economy as Government stimulus spending unwinds.

Some sectors also continue to feel the impacts of the COVID-19 restrictions

Employment by Industry
Annual % Change to December 2020



- The first COVID-19 lock down significantly impacted almost every industry in WA, and caused job losses across a wide range of sectors.
- Even though the total number of jobs in WA has since recovered, this has not been even across all affected sectors.
- Accommodation and food services was initially the hardest hit, but has since recovered most of the jobs lost.
- Other COVID-19 affected industries have not bounced back quickly. Employment remains lower than before the pandemic hit in telecommunications and information media; arts and recreation and transport, postal and warehousing.
- Ongoing restrictions on travel and borders will mean that sectors such as tourism, events and education will continue to suffer until these are removed.
- There may also be further job losses once the Jobkeeper payments expire on 28 March 2021.

Spare capacity in the economy will keep a lid on cost pressures

- This quarter, WALGA engaged Synergies Economic Consulting to ensure that it remains an accurate and reliable indicator of inflationary pressures in costs that are relevant for Local Governments.
- A revised LGCI has been developed, and uses a basket of 10 cost components instead of the previous six.
- The revised LGCI provides a more accurate indicator of cost movements affecting Local Governments as it makes better distinction between operating and capital costs and uses price indices that align more closely to the nature of goods and services used by Local Governments.

Current LGCI

- Employee costs
- Road and Bridge Construction
- Non-residential building
- Machinery and Equipment
- Electricity and Street Lighting
- Other expenditure

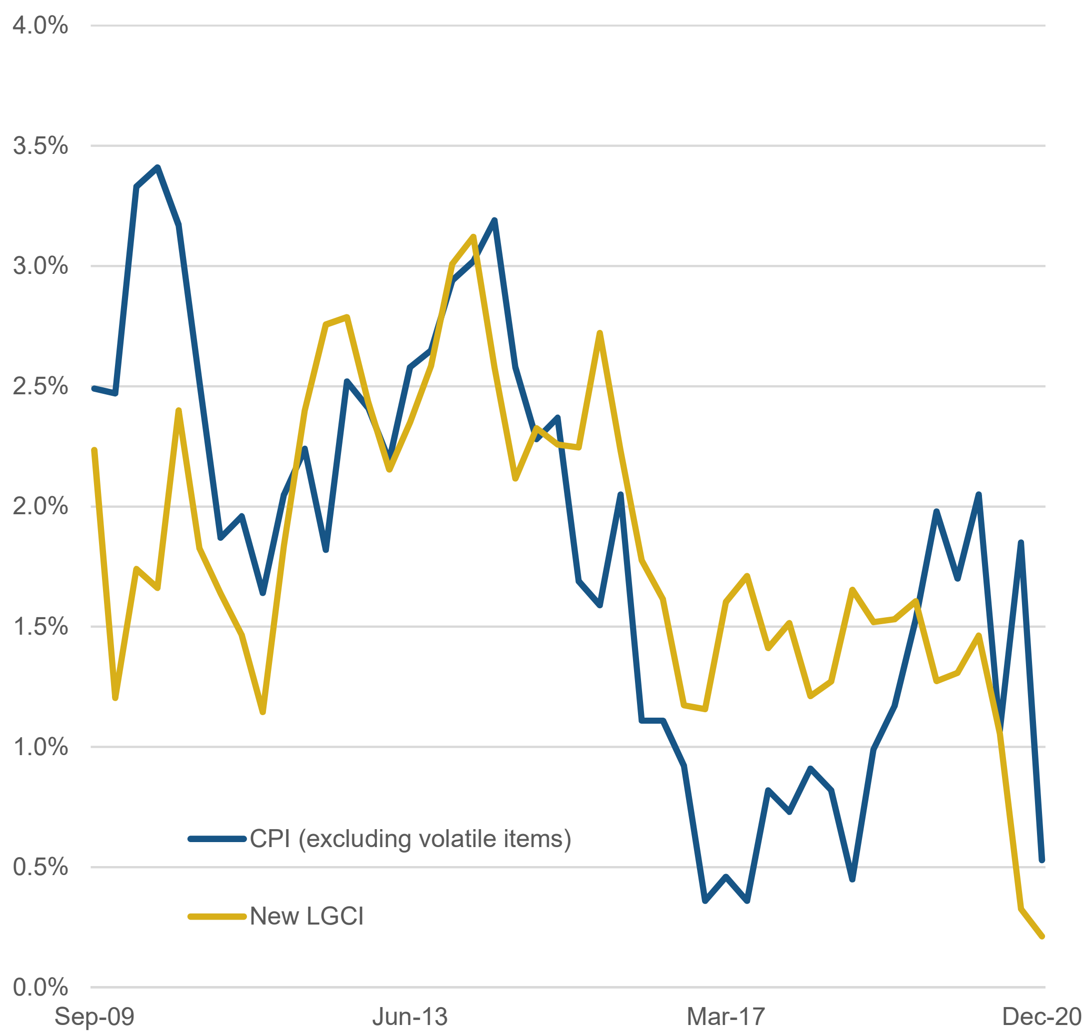
Revised LGCI

- Employee costs
- Materials & Contracts
- Furniture
- Non-residential building
- Machinery and equipment
- Non-road infrastructure
- Road & bridge construction
- Utilities
- Insurance expense
- Other

The LGCI was flat in December 2020...

- Cost pressures facing Local Governments have moderated in recent times.
- In December 2020, the index was largely unchanged, rising by 0.3% in the quarter to stand just 0.2% higher than a year ago.
- This reflects the spare capacity that still exists in the economy, in line with the downturn in activity driven by COVID-19.
- Falls in the cost of road and bridge construction materials and contracts (both down 0.55%) have placed downward pressure on the index during the past quarter.
- Wages costs grew only modestly, rising by 0.9% over the year to December.
- Other components of the index also recorded only small annual increases, including non-residential buildings (up 0.5%), other infrastructure spending (up 0.5%) and machinery and equipment (up 0.7%).
- The largest annual increase was in furniture costs, which rose by 5.4%.

LGCI vs CPI, Annual % Change



But is expected to record a modest increase in the years ahead

- With the economy now in recovery mode, costs faced by Local Governments are likely to increase in coming periods.
- However, the spare capacity that is expected to remain in the economy for a number of years will mean that cost pressures will remain modest.
- WALGA's latest forecasts for the Local Government Cost Index (LGCI) predict costs will rise by **1.4% in 2021-22**, and **2% in 2022-23**.
- The increase in the index reflects an expected increase in wage, construction and machinery and equipment costs, as the economic recovery gathers pace.
- Given the significant uncertainty that exists around the economic outlook, Local Governments should consider cost forecasts with caution, given there are risks to both the upside and downside.
- It is prudent for Local Governments to prepare for multiple scenarios for cost increases coming years. WALGA will continue to monitor cost pressures and provide updates to the forecasts as more information becomes available.

LGCI Components – Forecast % Change

Component	2019-20	2020-21(f)	2021-22(f)	2022-23(f)
Employee costs	1.7	1.5	1.75	2.0
Materials and contracts	1.9	1.0	1.2	1.2
Furniture	2.7	2.7	2.7	2.6
Non-residential building	-0.1	1.4	1.4	1.4
Machinery and Equipment	1.3	1.5	1.5	1.5
Non-road infrastructure	0.0	0.3	0.3	0.4
Road and bridge construction	-0.1	3.8	2.3	2.3
Utilities	0.5	1.5	1.5	1.4
Insurance	1.4	1.7	1.7	1.7
Other costs	1.3	1.5	1.75	1.75
LGCI	**1.2**	**1.3**	**1.4**	**2.0**

Costs pressures may be driven higher due to increased construction activity…

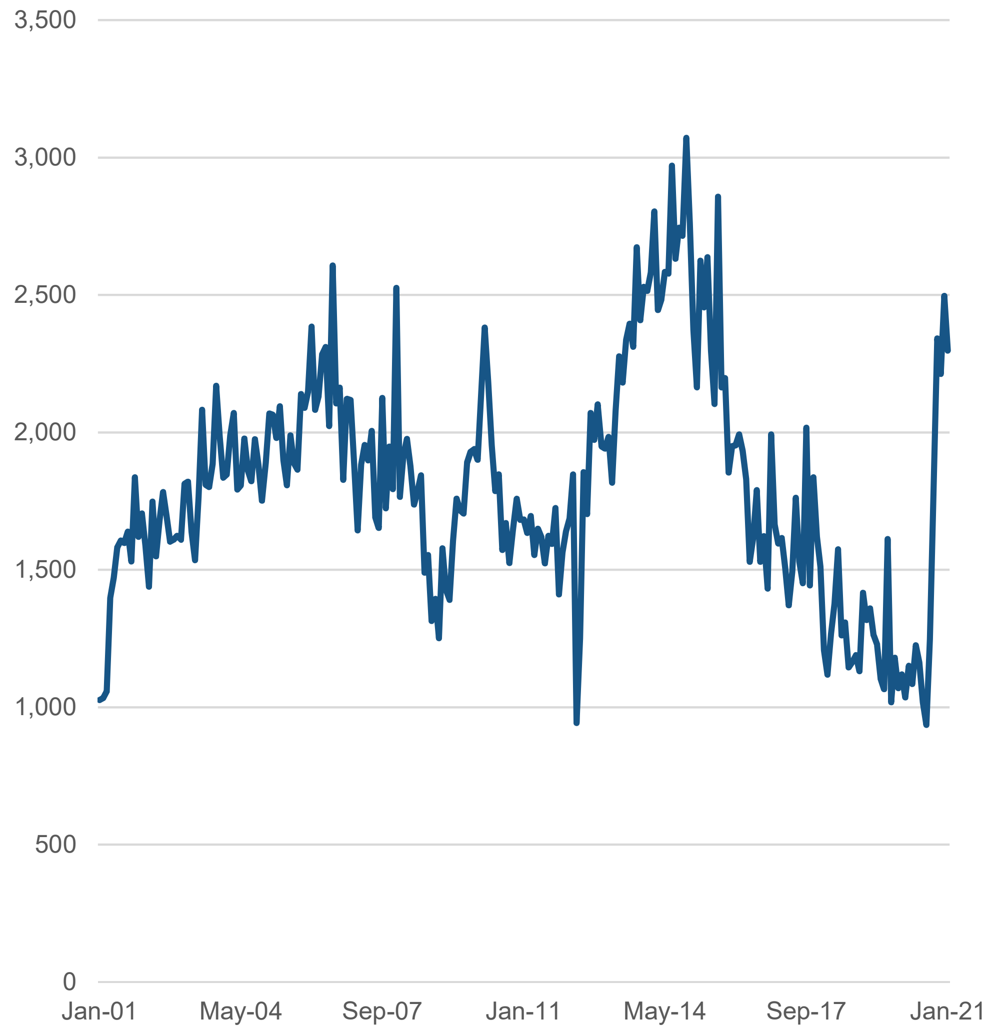
- Construction and infrastructure cost estimates may be revised higher in coming periods as a result of significant activity in the housing market.

- There has been a ramp up in housing activity in WA in recent months, reflected in the sharp increase in building approvals. This has been driven by:

  - historically low interest rates
  - people returning from overseas due to Covid-19, and
  - the State and Federal Covid-19 economic stimulus policies - including building grants and other measures such as rebates for electricity bills which have made home ownership more affordable for people.

- This may cause capacity constraints that affect other sectors (non residential, road construction) that compete for the same labour and materials.

Private Dwelling Approvals, WA



The resurgence in the housing market will also create other pressures for LG

- The increase in housing activity has seen property values rise, and led to higher demand for rental properties in a market where vacancy rates were already low. Perth rental vacancy rates are now at their lowest in nearly a decade, falling below 1% in the December quarter 2020 according to the Real Estate Institute of WA. Higher rental costs has further reduced housing affordability, particularly for people on low incomes.

- The increase in housing activity will have implications for Local Governments in coming years. In particular the sector should prepare for:

  - Increased workload in processing building permit applications (including variations to approvals);
  - Increased charges where the services of a building surveyor are contracted out, due to the potential for strong competition from the private sector for similar certification work;
  - Increased monitoring and enforcement of building works once permits have been issued; and
  - Higher costs of construction labour, which may place budgetary pressures on the cost of new infrastructure projects being planned or underway.

- There may also be greater expectation placed on Local Governments in terms of provision of social housing, as expectations about supporting low income families increases.

- Local Governments in regional areas that are experiencing strong population growth through migration from Perth may experience higher costs in provision of infrastructure and other services.

The potential for another outbreak remains the biggest downside risk to the economy

- By contrast, another wave of COVID-19 and an extended period of lock down could delay the return to “normal” activity, and place downward pressure on costs for an extended period of time.
- The five day lock down in early February demonstrated that WA is not immune from the re-imposition of restrictions to control outbreaks of COVID-19.
- However, the short term nature of the recent lock down means that on this occasion it is expected to have only a limited impact on economic activity.
- The imposition of lock down for a longer time period would have significant impacts for the economy.
- Treasury predicts that a second wave of COVID-19 could have substantial impacts on economic activity, depending on the extent and length of restrictions required. Its modelling showed that a six week lock down could see the State’s domestic economy reduced by $5.6 billion, and around 30,000 jobs lost.
- The impact of the removal of some COVID-19 support measures such as Job Keeper and the moratorium on rental evictions also remains to be seen, and could see forecasts revised lower.

Interest rates are expected to remain low for the foreseeable future

- The Reserve Bank of Australia committed not to increase the cash rate target until progress is made towards strong employment growth and confidence that inflation will be sustainably within 2-3% target band.
- In December 2020, the RBA indicated that given the economic outlook, it was not expecting to increase the cash rate for at least three years.
- This low interest rate environment creates potential opportunities for Local Governments to review their financing and funding arrangements and investment strategy.
- Borrowings can be a prudent financial tool that assists in aligning timing between outlays and available funds, though are not appropriate in all circumstances. Local Governments' debt levels should not be 'as low as possible' in an absolute sense but should instead be as low as possible relative to its needs and capabilities. Depending on a Local Government's circumstances, it is not necessarily better to have less debt than more.
- 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, the majority of existing Local Government loans are unaffected by short term movements in the cash rate as the interest rates are fixed.

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- However, where a Local Government uses a short-term loan facility with WATC, drawdowns are priced at a margin to 90-day Bank Bill Swap Rate (yield on 90 day bank bills), which maintains a close relationship to the RBA cash rate. In this regard, the expectation for the cash rate to remain at historically low levels will likely mean that the cost of short term finance remains relatively low.

- The low interest rate environment can also present challenges and opportunities for Local Governments in terms of their investment strategy.

- For cash based investments such as term deposits, the historically low cash rate is expected to flow through into lower interest rates as deposits roll over upon maturity, or when a new term deposit is established. Returns on traditional bank term deposits have already declined to historically low levels.

Questions

If you have any question on the contents of this report, please direct them to Dana Mason – dmason@walga.asn.au or (08) 9213 2020