WALGA

WORKING FOR LOCAL GOVERNMENT

Local Government Economic Briefing

Current and Relevant Information for Officers and Elected Members

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Local Government
Economic Briefing

March 2018

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

A sound understanding of 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

WA economy set to improve in 2018, but growth will remain below the long-run average for the foreseeable future.

This will bring some good news for Local Governments, as pressure from late payments and lower fees and charges revenue ease.

Cost pressures will record a modest increase in line with the improved conditions.

Funding from other levels of Government may come under pressure as the State and Federal budgets remains weak, though some grant opportunities are still available.

Local Governments should take a cautious approach to factoring any improvements in the economy into their projections.

WA Economic Update

2017 proved to be another tough year for Western Australians, as our economy finally succumbed to the mining downturn and fell into recession.

But despite official data revealing that the WA economy contracted by 2.7% during the past financial year – bringing to an end 26 straight years of growth – there are signs that 2018 will be a more positive year.

Some encouraging partial indicators of the economy have begun to emerge in recent weeks.

A particularly encouraging sign came from the quarterly State Accounts figures, which showed that the WA domestic economy grew in annual terms for the first time in over three years in September 2017, rising by 1.3%. The expansion in the domestic economy is particularly important, as this sector is critical for job creation.

We have already started to see the improvement in the domestic economy translate into more favourable conditions in the state's labour market.

Some 24,300 jobs were created over the year to January 2018. In a sign that employers are becoming more optimistic about expanding their business, a significant number of these (11,800) were full-time roles.

However, there is still considerable slack in the labour market, which is reflected in the historically high levels of underemployment – those people who are in the workforce but would prefer more hours.

The number of unemployed people in WA hit its highest level on record in June 2016 at more than 145,000 workers. This number remains at a historically high level of 131,000 workers in December 2017.

While 2018 is set to be a better year, this is not to say that the WA economy will return to its previous rapid growth trajectory.

In fact, WA Treasury has recently revised down its forecasts for economic growth in the 2017-18 Mid-Year Financial Projections Statements. Treasury now expects the WA economy will grow by 2.5%, down from the 3% estimate contained in the budget papers just a few months back.

Treasury's forecasts reflect the spare capacity that still exists in the economy, which will take some time to be absorbed.

This means that the recovery will occur at a gradual pace, with economic growth in WA expected to remain below the long-term average of 4.7% per annum for the foreseeable future.

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

While there is good reason to believe that 2018 will be a more positive year, the recovery remains fragile, and the WA economy will still face headwinds this year as it moves to its new, more modest, growth trajectory.

In this environment, Local Governments should be cautious about factoring improvements in the economy into their projections.

Economic Forecasts

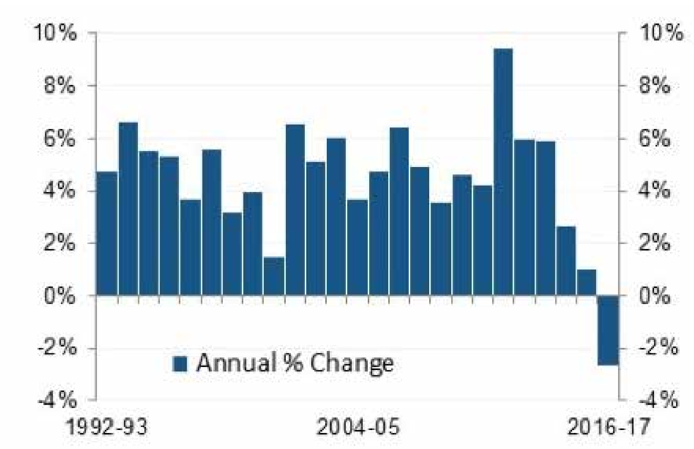
	5 year average	2016-17 %	2017-18 %	2018-19 %	2019-20 %	2020-21 %
Gross State Product	2.6	-2.7	2.5	3.0	3.0	3.0
Household Consumption	1.6	0.5	0.75	1.75	2.75	3.0
Business Investment	-12.2	-28.6	-12.0	-8.5	-6.0	7.0
Dwelling Investment	2.7	-19.8	-3.5	5.0	3.5	3.25
Exports	6.9	7.3	7.5	5.0	2.5	2.0
Imports	-1.7	-0.4	-3.25	-1.5	3.0	3.25
Unemployment Rate	5.4	6.2	5.75	5.75	5.5	5.25

Key Indicators

Economic Growth

Gross State Product, WA

- In 2016-17, the WA economy fell into recession for the first time in at least 26 years.
- Gross state product contracted by 2.7% during the year, on the back of a 28.6% fall in business investment. This reflects the continued impact of the mining investment boom reaching an end.
- However, the WA economy is expected to improve in 2017-18, with Treasury forecasting growth of 2.5% in the latest figures released in the Mid-Year Financial Projections Statement.
- Thereafter growth is expected to average 3% between 2018-19 and 2020-21, which is below the long-term average growth rate of 4.7%.



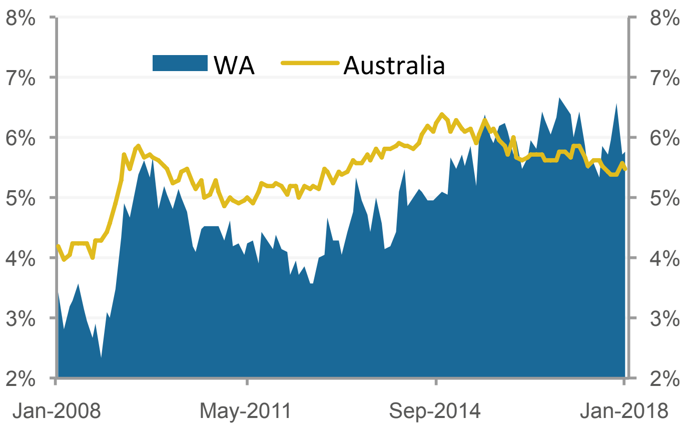
State Final Demand, WA

- 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.
- The WA domestic economy has contracted in annual terms for 18 of the last 20 quarters.
- Despite recording its fourth consecutive yearly decline in 2016-17 (down by 7.2%), quarterly estimates of state final demand have started to turn around in recent months.
- The WA domestic economy grew by 1.3% over the year to September 2017 – the first increase in annual terms since June 2016.
- Growth was underpinned by business investment, which expanded by 5.5% over the year to September 2017. This marks the first annual increase since December 2012, and a clear turnaround from the double-digit falls recorded earlier in the year.
- Household consumption remained subdued, rising by just 0.8%.
- Dwelling investment continued to contract, albeit at a slower pace. Investment in housing was down by 9.6% over the year to September 2017, compared to the double digit falls recorded in the four months previously.
- Government spending and investment also slowed, rising by 0.4% and 7.6% respectively.
- Looking ahead, the domestic economy is still expected to contract in 2017-18 according to Treasury estimates, declining by 2% in 2017-18.

WA economy is set to improve in 2018, but growth will remain below the long-run average for the foreseeable future.

Labour and Demographics

Unemployment Rate, WA vs Australia



- The WA unemployment rate has shown signs of improving in recent months, dropping to 5.7% in January 2018. This is down from the most recent high of 6.6% in November 2016.
- This has been driven by a fall in the number of jobless Western Australians. The number of unemployed people in the state has fallen by 8.7% compared to a year earlier.
- Over the coming year, the unemployment rate is expected to track downwards in line with the improvements in the domestic economy. Treasury expects that WA's unemployment rate will average 5.75% in 2017-18, before falling to 5.25% by 2020-21.

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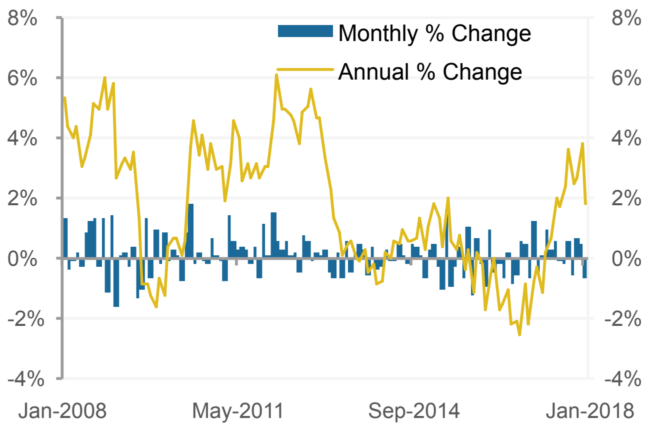
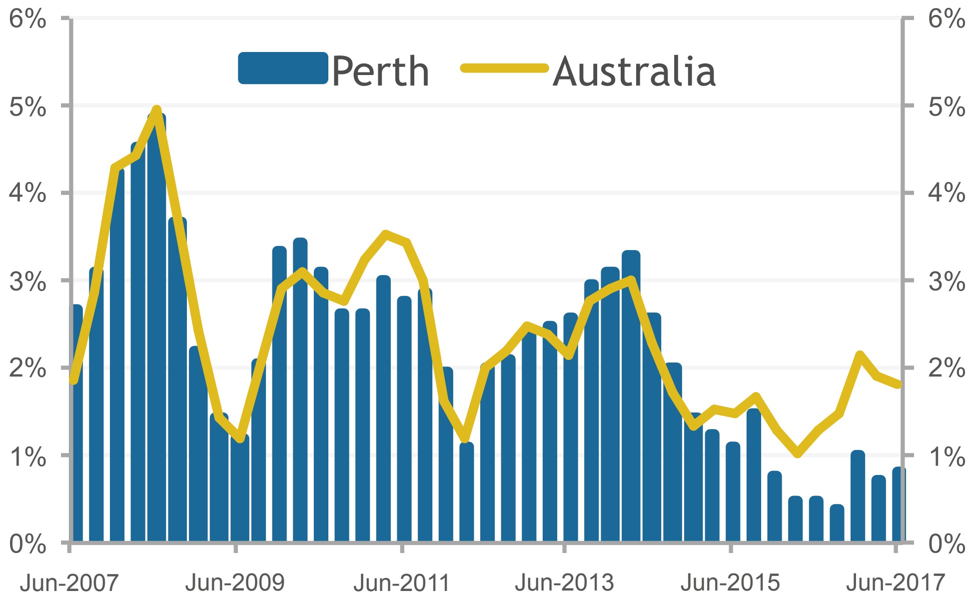
Employment Growth



- After a difficult few years, employment growth in WA has begun to improve in recent months.
- Some 24,300 jobs were created over the year to January 2018. In a sign that employers are becoming more optimistic about expanding their business, a significant number of these (11,800) were full-time roles.
- However, there is still spare capacity in the labour market, which has been reflected in the growing number of underemployed persons.
- The number of unemployed people in WA hit its highest level on record in June 2016 at more than 145,000 workers. This number remains at a historically high level of 131,000 workers in December 2017.
- The labour force underutilisation rate (which examples the number of underemployed and unemployed people as a share of the labour force) has also risen to historically high levels, standing at 15.5%, compared to its lowest point of 7.1% during the mining boom in 2008.
- Employment activity is expected to improve in the coming year, with Treasury predicting that the state's workforce will expand by 2% in 2017-18.

Population Growth



- Growth in WA's estimated residential population has continued to slow from 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 2017 – the strongest rate of growth in two years.
- Growth in WA's population continues to be driven by overseas migration, with a net 2,022 people moving to WA from overseas during the quarter.
- By contrast, net intrastate migration continues to languish in negative territory. WA lost 2,767 people to other states in the June quarter of 2017.
- The natural increase (birth rate) remains elevated, with 5,129 added to the population in the June quarter of 2017 – 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

With the official cash rate at record low levels and the economy starting to show signs of improvement, there has been increasing speculation in recent weeks that the Reserve Bank may increase interest rates in 2018.

Economists are split about when the Reserve Bank will make its move to lift the official cash rate from its current historic low. Some are expecting a lift in rates in 2018, while others believe the RBA may stay on hold for the remainder of the year.

However, there is a general consensus that any rate increases won't occur in the first few months of 2018. Bloomberg's latest survey of 24 economists found almost all expect the Reserve Bank to keep official interest rates on hold through the first three months of the year.

Those commentators whom are predicting that rates will increase have pointed towards the improving local and global economic conditions as key reasons for the cash rate to rise for the first time since November 2010.

Other commentators, however, consider that the Bank will take a more cautious approach given the fragile nature of the recovery and the high level of indebtedness among Australian households. Between June 2016 and September last year, the household debt level has grown at its fastest rate on record, and reached nearly 200% of income by the end of this period.

The decision to increase the cash rate – and the timing of any move – will be challenging, as the Bank will need to finely balance monetary policy settings to ensure that any hikes do not stymie the recovery in the economy.

The likelihood that the official cash rate will stay on hold for the time being were recently confirmed by Reserve Bank Governor Phillip Lowe, who has stated that there is not a strong case for interest rates to move in the short term.

On balance, it is likely that the Reserve Bank will keep interest rates on hold until there is clear evidence that wage pressures – and inflation – are starting to pick up.

While interest rates will stay on hold in the short term, it is clear that the next move for interest rates will be up rather than down. As a result Local Governments should prepare for this in their financial planning activities.

A higher cash rate 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. 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

Although the outlook for WA in 2018 is looking more positive, there are a number of risks on the horizon. If these eventuate, this could mean that growth in WA is weaker than expected.

Given that WA is a small and open economy, it is highly exposed to any changes in global conditions, particularly in our key trading partners in Asia.

The International Monetary Fund (IMF) is "optimistic" about the outlook for the global economy in 2018, and in October 2017 predicted that it would grow by 3.7% in 2018 – its fastest pace since 2011. The modest growth will be underpinned by an improvement in advanced nations as well as continued strong growth in the developing nations.

For WA, the outlook for the Chinese economy is particularly important, given that it is the state's largest trading partner – accounting for around 50% of merchandise exports. Any changes in the Chinese domestic economy can have a major impact on WA's economic outlook.

Although the Chinese economy has continued its expansion, WA Treasury notes that some recent indicators suggest that it may lose steam in the coming year as the property market is starting to cool.

While this would see a modest slowdown, there is also the risk of a sharper downturn in China, as a result of the significant financial risks that have emerged. China's debt levels have been run up from years of continued monetary and fiscal stimulus, with the debt to GDP ratio expected to reach more than 320% by 2022. In an environment where interest rates are rising, this will create stress for heavily indebted companies.

Given that WA is a small and open economy, it is highly exposed to any changes in global conditions, particularly in our key trading partners in Asia.

This situation could be exacerbated by the significant changes to taxation laws in the United States which were signed off in late December 2017. This package of reforms included significant cuts to the company and income tax. These reforms, which came into effect from 1 January 2018, could see a flight of capital from China that would weaken its currency and require the Chinese Central Bank to further tighten monetary policy.

In the worst case scenario, this could lead to clusters of defaults and a more significant crisis if it spreads to the broader economy.

The Chinese Government has already commenced a process of "financial deleveraging", and this is expected to continue in the coming year. The Chinese Government faces a significant balancing act to slow credit growth without causing a sharp downturn in the economy. Any downturn in China would have significant adverse implications for WA given its reliance on China as an export market, and may set back the recovery in the local economy.

Further, concerns about the Chinese economy could also derail confidence among WA businesses and consumers, which has only recently started to improve after remaining weak since 2009 when the impacts of the Global Financial Crisis hit home.

The recovery in the WA economy remains fragile, and a continued improvement in confidence among businesses and consumers will be necessary to ensure that this momentum is maintained.

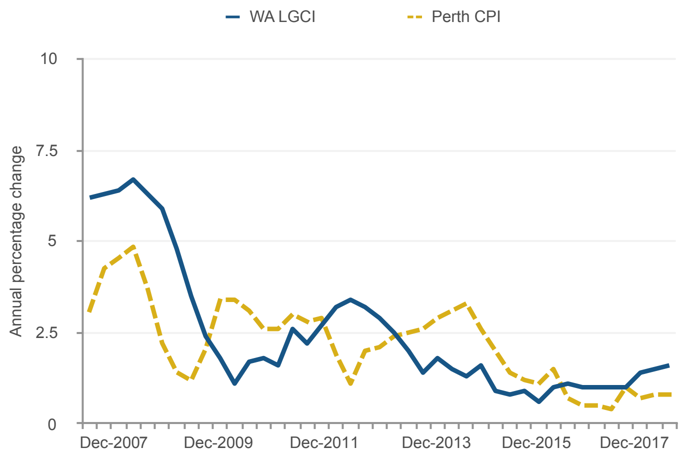
Local Government Costs

Cost pressures facing Local Governments have recorded another modest rise according to the latest Local Government Cost Index (LGCI).

The index grew by 0.4% in December 2017, to stand 1.6% higher over the year. In annual terms, this is the largest increase in the index since September 2014.

The primary driver of growth in the index in December was electricity, which increased by 9.7% in annual terms as new regulated tariffs came into effect for the 2017-18 financial year. Street lighting costs were also up by 2.8% over the year.

LGCI vs Perth CPI



Costs for Local Government

	5 year average	2016-17 %	2017-18 %	2018-19 %	2019-20 %
Wages (WA Wage Price Index) [1]	2.4	1.4	1.5	1.75	2.75
Road and Bridge Construction [2]	0.8	0.8	2.0	1.9	1.9
Non-residential Building [3]	-0.2	-0.4	1.6	1.6	1.6
Other Costs (Perth CPI) [1]	0.7	0.6	1.0	1.5	2.0
Machinery and Equipment [2]	1.3	2.0	1.5	1.5	1.1
Electricity and Street Lighting [4]	2.0	0	7.4	3.3	3.4
Local Government Cost Index	1.4	1.0	1.9	1.8	2.2

Road and bridge construction costs also increased during December, rising by 1.7% compared to a year earlier – the largest increase in four years. Machinery and equipment (2.9%), and wages (1.5%) also added to growth in the index over the year to December 2017.

By contrast, non-residential building costs were the only component of the index to decline, falling by 0.6% over the year to December. Non-residential building costs have been flat or declining since December 2014, and have to some extent countered the pick-up in other costs faced by the Local Government sector in recent times.

With the economy starting to show signs of recovery, this will see costs faced by Local Governments start to rise. It is therefore prudent for Local Governments to prepare for further modest price increases. However, there is still significant spare capacity in the economy which will prevent the return of the double digit rates of prices growth experienced during the boom years. WALGA's updated forecasts for the LGCI predict the index will rise by 1.9% in 2017-18, and 1.8% in 2018-19.

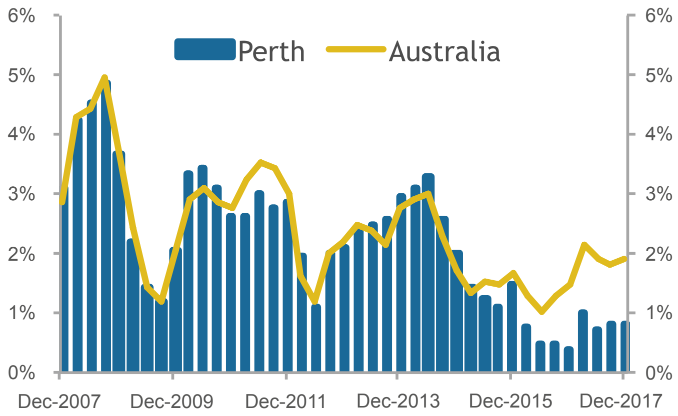
Wage Price Index, Annual % Change

- Downward pressure on wages has started to ease in recent months.
- The Wage Price Index for WA grew by 0.3% in the December quarter of 2017, to stand 1.5% higher over the year.
- 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.

Construction Costs

- Activity in the non-residential construction sector in WA has started to increase in recent times.
- Although excess capacity still exists, it is expected that much of this will be taken up in 2018 which will see costs start to rise. Non-residential construction costs are expected to increase by 2%.
- Road and bridge construction costs are also expected to pick up in the coming years, with projected growth of 1.9% in 2018-19.

Consumer Price Index



Price pressures in Perth still remain subdued, in line with the weaker conditions in the WA economy. In the December quarter of 2017, the Perth Consumer Price Index (CPI) grew by 0.4%, to stand 0.8% higher than a year earlier. Growth in the index over the year was underpinned by higher prices for transport (up 4.1%), health (up 3.9%) and education (up 2.6%). By contrast, declines were recorded in the price of clothing and footwear (-4.3%) and furnishings and household goods (-1.6%). Price pressures are expected to record a modest pick-up in coming years as the economy improves, with Treasury predicting the CPI will grow by 1.5% in 2018-19.

Utilities

The 2017-18 State Budget set out projected price changes for key electricity and water tariffs. While these are subject to change when the 2018-19 Budget is handed down in May, they are a useful guide for planning purposes.

Electricity Tariffs

	5 year average	2016-17 %	2017-18 %	2018-19 %	2019-20 %	2020-21 %
Medium Business (L3/L4)	2.0	2.8	1.1	1.1	1.1	1.1
Medium Business Time of Use (R3)	1.8	5.8	3.6	3.6	3.6	3.6
Street Lighting (Z)	2.8	-5.4	2.8	2.8	2.8	2.8
Unmetered Supply	4.6*	7.3	5.9	5.9	5.9	5.9

*Three year average

Water Tariffs

	2017-18 %	2018-19 %	2019-20 %	2020-21 %
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.

	2017-18 %	2018-19 %	2019-20 %	2020-21 %
Putrescible Rate/tonne	$65	$70	$70	$70
Inert Rate/tonne	$60	$70	$70	$70
Inert Rate/m3	$90	$105	$105	$103

Government Funding

Although the worst of the downturn is now behind us, the modest recovery expected in coming years will not be enough to turn around the State's financial woes.

As a result, there is expected to be a continued focus by the State Government on budget repair. The latest figures contained in the 201718 Mid-Year Financial Projections show that the State's financial position has deteriorated further since the 2017-18 Budget was handed down, with the deficit for this financial year now expected to be $2.6 billion, compared to $2.3 billion a few months earlier.

In recent weeks, the McGowan Government has reaffirmed its pledge to repair the budget with a commitment to implement the findings of its Service Priority Review and the Special Inquiry into the financial management of the previous Government, undertaken by former Under Treasurer John Langoulant.

While the State Government's focus on budget repair is important for the long-term best interests of all Western Australians, it may have short-term implications for the sector through funding cuts or reductions to programs and services.

Roads Funding

Grant payments to Local Government under the State Road Funds to Local Government Agreement have been reduced by $10.3 million in 2017-18, and $9.8 million per annum from 2018-19 to offset the impact of the retention of the vehicle licence fee concessions for Local Government.

Royalties for Regions

The 2017-18 Budget revised the Royalties for Regions program. While the fund hasn't been scrapped, it will now be used to deliver programs that were previously funded from consolidated revenue, such as the Patient Assisted Travel Scheme, and water and drainage subsidies.

Royalties for Regions will also be used to fund essential services to remote communities, TAFE regional subsidies, and upgrades and expansions for a range of regional senior and primary schools.

In practical terms, this will mean the level of funding in regional WA is reduced from previous years.

Grant Opportunities

Local Governments have the opportunity to apply for grant funding from the State and Commonwealth Government. Though not exhaustive, below is a list of some key funding opportunities for Local Government that are currently open for applications.

State Government

- **Community Safety and Crime Prevention Partnership Fund –** Local Governments and not-for-profit organisations can apply for grants of up to $20,000 to implement initiatives which prevent, report and remove graffiti. State Graffiti Fund opens Wednesday 17 January 2018, 12.00pm (midday) and closes Wednesday 14 March 2018, 12.00pm (midday). More information can be found at: ***www.policewa.smartygrants.com.au/***

- **Grants for Women –** Grants of up to $10,000 are available for Local Government and community service organisations to implement projects that focus on addressing the unique issues faced by women. Closes 30 June 2018. Further information can be found at: ***www.dlgc.wa.gov.au/GrantsFunding/Pages/Grants-for-Women.aspx***

- **Youth Engagement Grants Program –** Grants of up to $10,000 are available for Local Governments and community service organisations to implement projects that engage young people (10–18 years old) in creative ways and help achieve positive outcomes. Closes 30 June 2018. Further information can be found at: ***www.dlgc.wa.gov.au/GrantsFunding/Pages/Youth-Engagement-Grants-Program.aspx***

- **Coastal Adaptation and Protection Grant –** Coastal Adaptation and Protection (CAP) Grants provide financial assistance for local projects that identify and manage coastal hazards. The program seeks to preserve and enhance coastal assets for the general public. It aims to build partnerships with local coastal managers, and help them understand and adapt to coastal hazards. The 2018-19 round will open in February 2018. More information can be found at: ***www.transport.wa.gov.au/imarine/coastal-adaptation-and-protection-cap-grants.asp***

- **Regional and Remote Touring Fund –** The Regional and Remote Touring Fund (RRTF) supports the costs of touring performing arts shows to regional and remote towns and communities in Western Australia, through the provision of grants up to $200,000 to support the direct costs associated with delivering the tour. Applications are open all year round. For more information visit: ***www.dca.wa.gov.au/funding/regional-and-remote-touring-fund/***

- **Community Participation Funding –** Aimed at initiatives to increase participation in sport and active recreation or develop the skills of the people involved in your organisation or local community. This funding is aimed at programs that target Cultural and Linguistically Diverse, Aboriginal communities and people with a disability, with grants limited to $1000–$5000. Applications are open year round, but are only available to regional local governments (in the absence of an eligible sport or recreation organisation). More information is available from: ***www.dsr.wa.gov.au/funding/community-groups***
- **Community Sport and Recreation Facilities Fund –** Grant funding is provided to develop infrastructure for sport and recreation. Applications will open in June, and close in mid to late August. Further information is available from: ***www.dsr.wa.gov.au/funding/facilities-(csrff)/annual-grants***
- **The Project Fund –** The Project Fund provides grants of up to $30,000 available to Local Governments from regional and remote Western Australia. The program is designed to benefit regional and remote artists, arts workers, audiences and communities by supporting and promoting participation in, and access to, art and culture. Applications close midnight 16 March 2018. More information can be found from: ***www.countryartswa.asn.au/our-services/funding/other-funding/project-fund/***

WORLD COMMODITY PRICES

The improvement in commodity prices during 2017 is expected to continue in 2018, in line with the steady increase in demand as the world economy gathers pace.

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 anticipated to rise to $56 per barrel in 2018, from $53 per barrel in 2017. This increase will be underpinned by production cuts in the major oil producing nations in the Middle East and Russia which are expected to continue throughout the year, as well as strong global demand as economic conditions improve. There are significant risks to the forecast however, as prices may be driven higher as a result of political unrest. Alternatively, faster than expected growth in US shale oil production may place downward pressure on prices as supply expands.
- Natural gas prices are expected to increase by 4% in 2018. Although demand is expected to be strong, this will be offset in part by large increases in capacity, in particular from Australia as projects such as Wheatstone move into production.
- Metals prices are forecast to ease slightly in 2018, after a strong 22% gain in 2017. Iron ore prices are projected to fall by 10%, while prices for other base metals such as lead, nickel and zinc are expected to record modest increases. Prices may be revised upwards if demand is greater than expected, or supply limitations from greater environmental restrictions in China.

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