STATE UPDATE: WESTERN AUSTRALIA

National Australia Bank

JULY 2016

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KEY POINTS

CHART 1: STATE GSP GROWTH FORECASTS

Annual growth

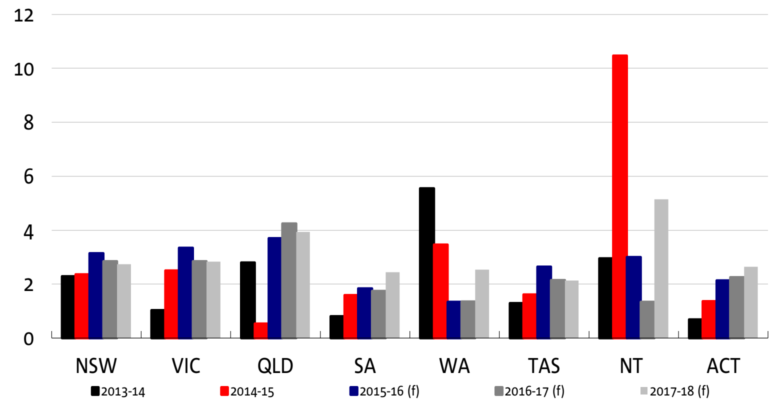
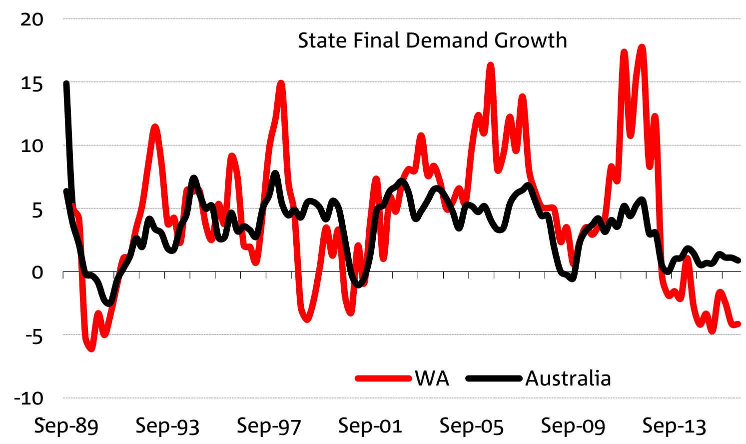


CHART 2: STATE FINAL DEMAND GROWTH

Per cent



Source: ABS and NAB Group Economics

- The main themes for the WA economy are largely unchanged, with the evolution of the mining boom driving the state's economic conditions. Much lower commodity prices and falling mining investment are having a momentous impact on the economy, well beyond the mining sector itself. The true impact of these events have been somewhat masked by the offsetting impact from net export volumes, while domestic demand, nominal growth and incomes are all very weak. These trends are expected to continue given the lack of momentum in non-mining sectors. **Consequently, we expect real GSP growth in WA to continue its slowdown from rates of over 5% p.a. in past years (2011-12 through 2013-14), to below 2% in 2015-16 and 2016-17. A ramping-up in LNG exports should see growth lift, but to less than previously forecast (Charts 1 & 2).**

  Business investment has plummeted 17½% over the past year as **the states flagging economy fails to incite anywhere near enough capex** to (even partially) offset the sheer scale of the decline in mining investment underway as projects reach completion. Business investment is now down 40% from its 2012 peak. Despite this, the downturn in WA mining investment does not appear to have progressed as much as it has in Queensland, although **a severely diminished pipeline suggests significant falls are still to come**.

  The rest of the economy is also feeling the effects of negative spillovers from the mining sector, with **weakness especially evident in local asset markets**. Excess supply is quickly mounting, which is putting the commercial property market under pressure and is likely to constrain investment in new capacity for some time. The hit to income and the labour market has also seen residential property prices in decline, while dwelling construction activity has come off sharply – consistent with vacancy rates near 6%.

- **Lower commodity prices (and the weakening economy) have taken a toll on government revenue and the state's fiscal position.** The decline in royalty incomes has slowed in 2015-16 and will probably stabilise somewhat over coming years, however, our forecast for iron ore prices of around US$40 per tonne (spot, CFR) suggest there may be material downside risk to government revenue projections. A weak revenue outlook is limiting the state Government's capacity to stimulate the economy. Nonetheless, there were fewer savings measures implemented in the recent Budget, prompting an upward revision to projected deficits and net debt.

  An rising unemployment rate over recent years has kept wages growth very weak, while falling property prices (hitting wealth) and a drop in population growth back to pre-boom rates are all weighing on household consumption. With further job losses expected from the mining sector and domestic demand likely to remain soft, the unemployment rate is expected to remain elevated – although slower population growth will provide some assistance to the headline rate. **The unemployment rate is expected to peak around 6½% this year before gradually improving.**

  Most leading indicators are pointing to further weakness in WA's domestic demand, with very few signs that non-mining sectors are gaining enough momentum to offset the mining headwinds. Spare capacity remains large and business conditions are still weak (despite improving a little) according to the NAB Business Survey, while capex intentions have deteriorated further.

IN FOCUS:

Mining headwinds continue, with a large impact on labour and asset markets

Headwinds from the mining sector remain the biggest influencing factor on the WA economy. Even though prices for major commodities such as iron ore are largely expected to stabilise, the negative impact on investment and employment looks set to continue.

At the national level, NAB expects mining investment to decline by a further 70%, with the industry shedding an estimated 50k jobs. More of the job cuts in the mining sector going forward are likely to stem from WA for a number of reasons: 1) WA's mining investment and employment cycles are currently less progressed than Queensland, 2) WA accounts for a larger share of total investment and employment in the country, and 3) the labour intensity of mining operation in WA is lower than in Queensland. The relatively more concentrated industry structure of WA also renders it to be more vulnerable.

Spill overs have also been particularly evident in local asset markets. Excess supply is quickly mounting, putting the commercial property market under pressure and will keep new investment well contained. The hit to income and the labour market has also seen residential property prices in decline, while dwelling construction activity has come off sharply – consistent with vacancy rates near 6%.

CHART 3: MINING INVESTMENT & EMPLOYMENT

Thousands; Dollar millions

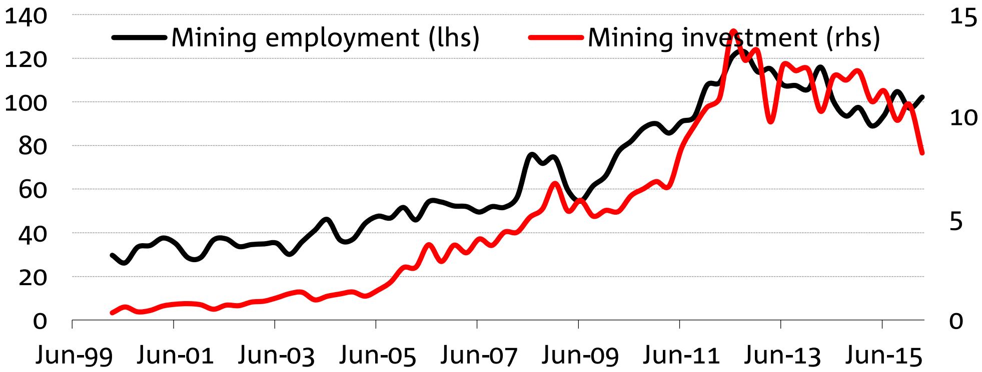


CHART 4: RESIDENTIAL PROPERTY HAS TAKEN A HIT

Per cent

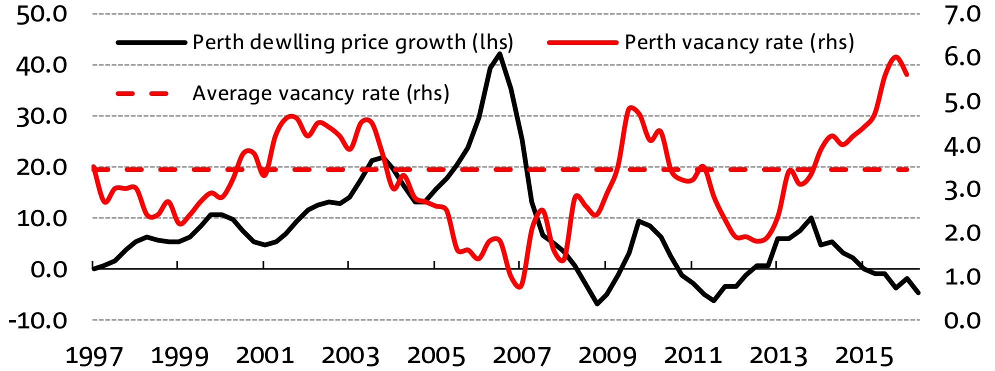
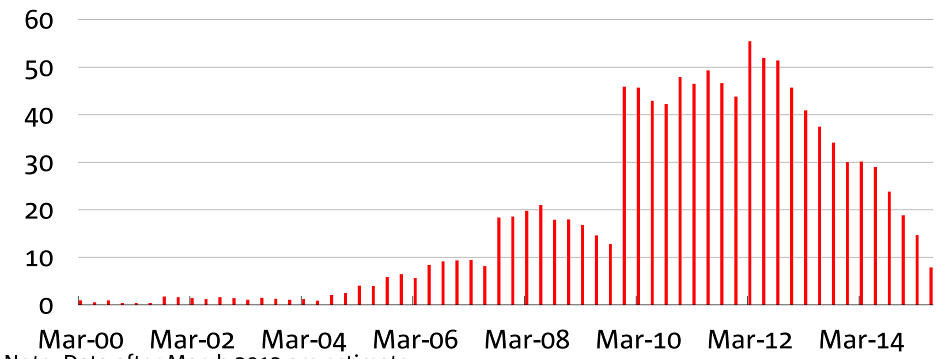


CHART 5: ENGINEERING WORK YET TO BE DONE, HEAVY INDUSTRY

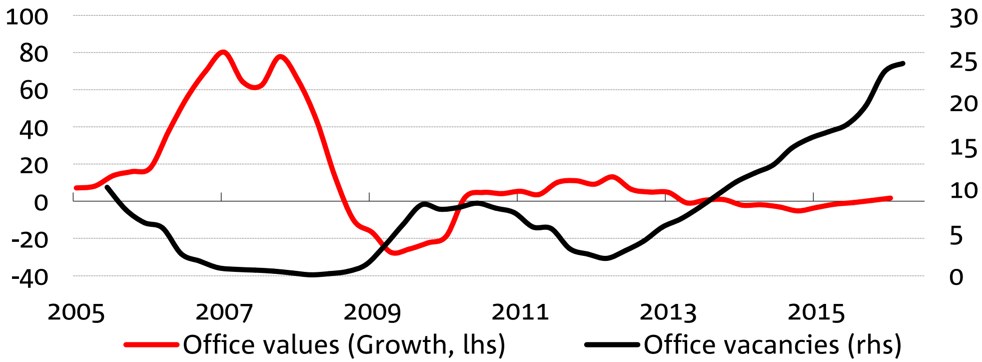
Billion dollars



Note: Data after March 2013 are estimate

CHART 6: COMMERCIAL PROPERTY FEELING THE PINCH

Per cent



Source: ABS, JLL, REIA, NAB Group Economics

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CONSUMER SPENDING:

Wealth and income effects from the mining downturn still taking their toll

Growth in household consumption remains very subdued at around 2% over the year to Q1 2015. Both population and labour market trends are having a negative impact, which is compounded by negative wealth effects from the housing market and a hit to consumer confidence.

Given that the labour market adjustment has further to run, consumption can be expected to remain very subdued for a while yet. Similarly, a persistently weak labour market and lower population growth is likely to see residential property prices fall further, meaning that wealth effects will continue to be a drag on consumption growth going forward (Chart 8).

CHART 7: NOMINAL COMPENSATION OF EMPLOYEES AND HOUSEHOLD CONSUMPTION GROWTH

Year-on-year percentage growth

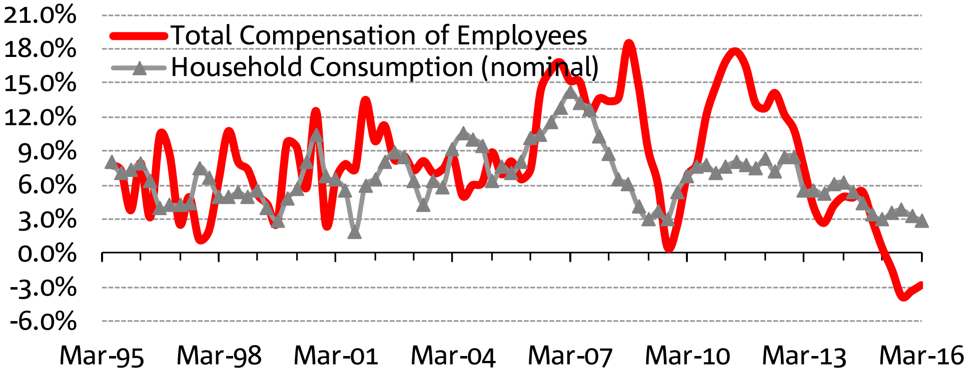
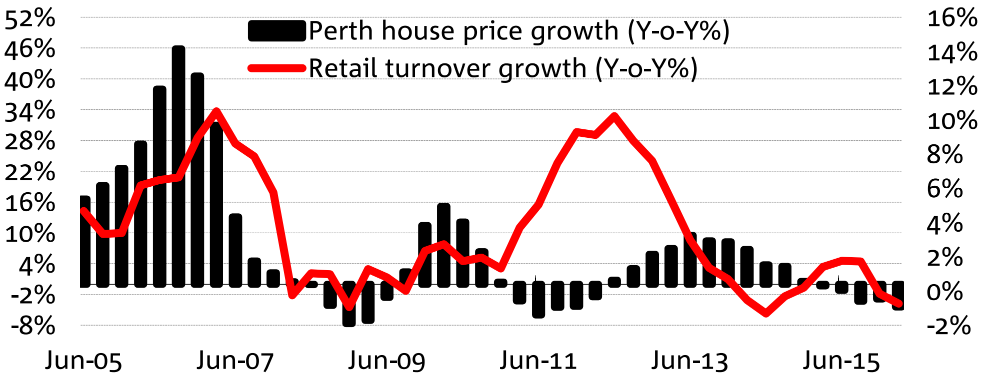


CHART 8: RETAIL TURNOVER AND HOUSE PRICE GROWTH

Year-on-year percentage growth

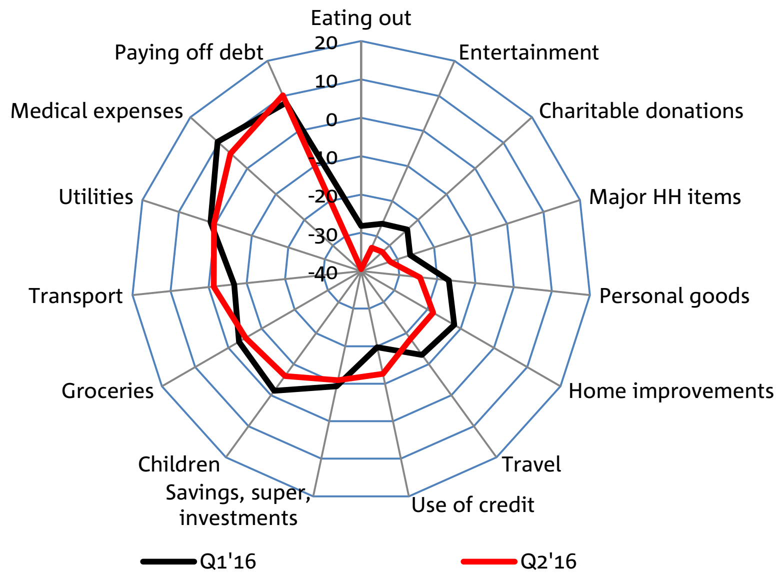


The Q2 2016 NAB Consumer Anxiety Survey showed a lift in consumer sentiment. Despite that, the state has the highest share of anxious consumers, consistent with the weak economic and labour market conditions – the unemployment rate remains elevated despite easing a little of late. Consequently, spending behaviours remain fairly consistent with what you would expect from cautious households. Consumers remain focussed on paying down debt and covering non-discretionary spending such as medical (Chart 9).

Consumers also indicated an intention to pull back their spending on a number of items (both essential and non-essential), although there was a modest increase in intentions to spend on transport. Surprisingly, there was also an increase in consumer intentions to take on debt (albeit still negative).

CHART 9: NAB CONSUMER ANXIETY SURVEY - CONSUMER SPENDING PREFERENCES

Changes in Consumer Spending Preferences (net balance)



Source: ABS, NAB Group Economics

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BUSINESS CONDITIONS:

Service sectors report reasonable business environment, but drag from mining is too large

Consistent with moderate economic growth and the closing stages of the mining investment boom, the NAB Business Survey is showing relatively elevated rates of spare capacity for firms in WA – capacity utilisation is below the national average (Chart 10). Similarly, business conditions remain very weak and are currently the lowest of all the Australian states despite stabilising more recently (perhaps as key commodity prices have bounced, although we don't expect this to last).

The NAB Survey is weighted towards the non-mining industries. Conditions in the mining and construction industries are much weaker than the state aggregate – a more accurate reflection of the true business environment.

Investment intentions from the NAB Survey have been surprising resilient, largely reflecting the survey's emphasis on non-mining industries (Chart 12). Nevertheless, intentions remain below the historical average, albeit not as weak as suggested by the ABS Capex Survey (slide 6, Chart 15).

Most industry groupings are showing quite soft business conditions, but some service sectors are holding up comparatively better. In particular, finance/ property/ business services are showing positive conditions despite difficulties facing mining services – confidence is also quite upbeat for this industry (Chart 13).

CHART 10: NAB BUSINESS SURVEY – CAPACITY UTILISATION

Per cent of full capacity

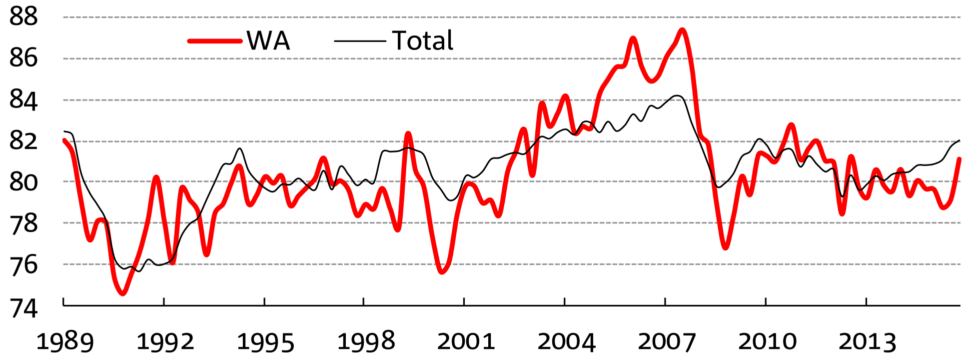


CHART 11: SPREAD IN NAB BUSINESS CONDITIONS

Net balance

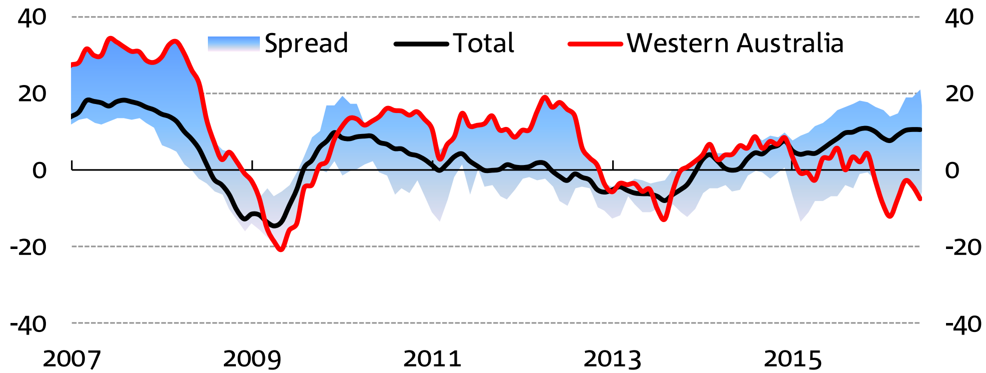


CHART 12: NAB SURVEY CAPEX EXPECTATIONS & PRIVATE BUSINESS INVESTMENT GROWTH

Net balance; Per cent growth

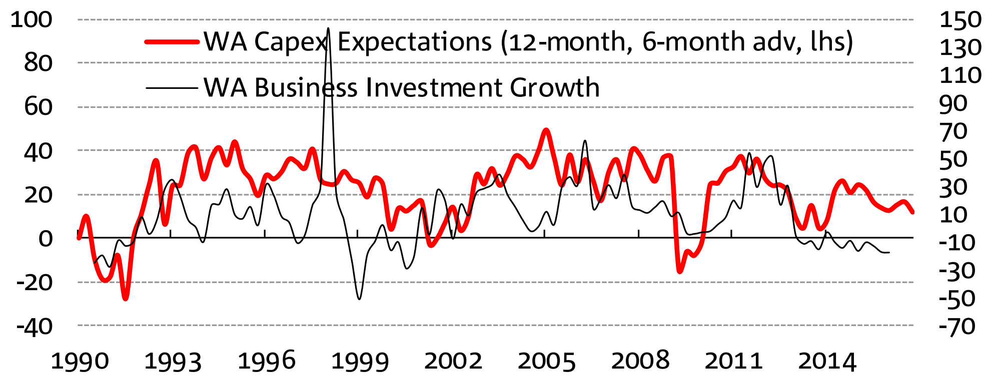
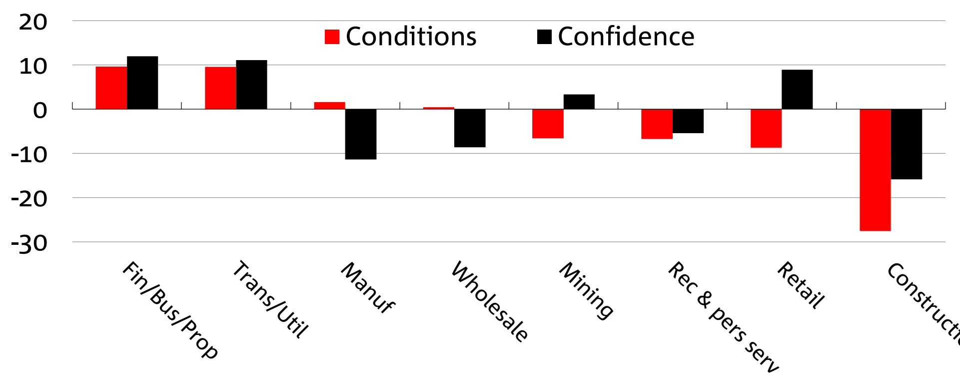


CHART 13: WA BUSINESS CONDITIONS & CONFIDENCE BY INDUSTRY

Net balance, Q2 2016



Source: ABS, NAB Group Economics

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INVESTMENT:

Outlook remains downbeat for non-residential construction. Mining investment to contract further

Business investment continues to contract in WA as major mining investment projects reach completion. However, the headwinds generated by the mining sector are having a big impact on investment more generally. However, there have been large projects in the entertainment, accommodation and retail/wholesale sectors more recently – elsewhere, non-res building approvals have been muted (Chart 14).

Weakness is particularly apparent in the commercial office sector, where approvals have weakened, consistent with a significant spike in oversupply – office vacancy rates have recently hit highs of around 25% (Chart 16).

Additionally, the NAB Commercial Property Survey for Q1 2016 shows that both office and industrial property conditions remain extremely weak.

Expected capital expenditure (capex) by businesses (according to the ABS survey) suggest that mining investment in WA will continue to contract over the next 12 months (Chart 15).

Non-mining investment is considerably smaller and the ABS Survey provides no indication that a pick up is underway to help offset declines in mining.

CHART 14: NON-RESIDENTIAL BUILDING APPROVALS

Million dollars

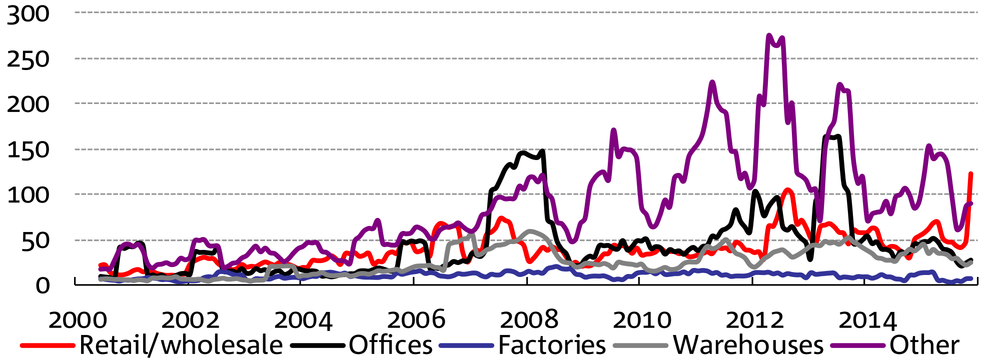


CHART 15: WA CAPITAL EXPENDITURE & EXPECTATIONS

Actual & expected based on previous realisation ratio ($billion)

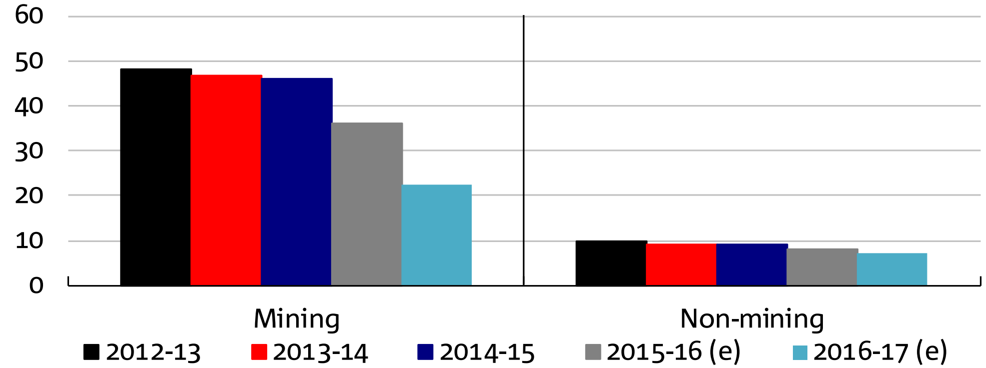


CHART 16: WA OFFICE MARKET CONDITIONS

Million dollars; Per cent of capacity

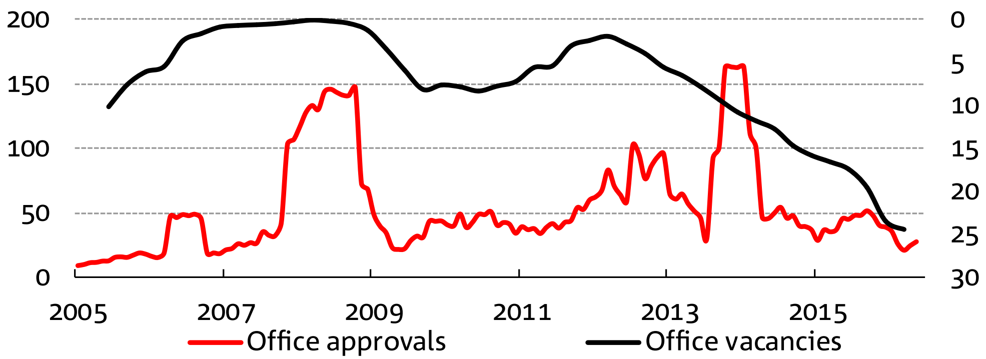
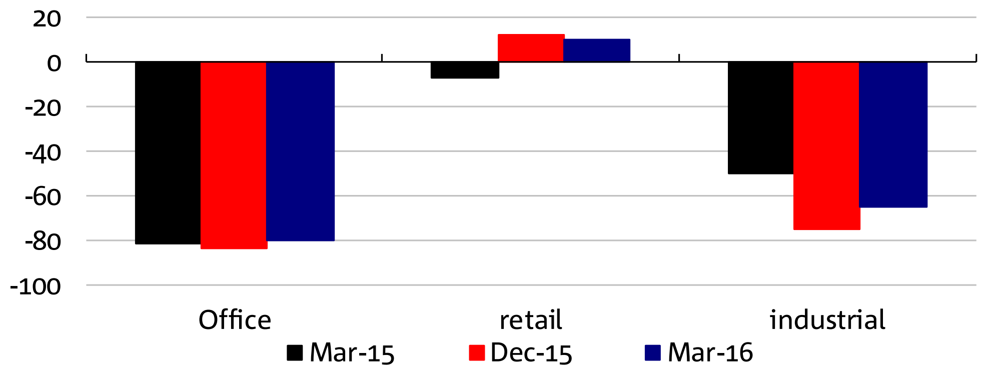


CHART 17: NAB COMMERCIAL PROPERTY INDEX - WA

Per cent of responses



Source: ABS, JLL, NAB Group Economics

LABOUR MARKET:

Labour demand flat, unemployment rate stable with the assistance of population trends

The labour market appears to have stabilised a little better than expected in recent months, although that is partly a reflection of a sharp slowdown in population growth (see slide 8). The unemployment rate has eased from its most recent high, but remains elevated as sluggish domestic demand weighs on labour demand (Chart 18).

WA's employment demand declined by 7.6k in the year to June, while (large) adjustment is still expected in the mining sector, meaning further contraction in employment remains a possibility. Given the subdued labour market and outlook, wages growth will remain weak for quite a while yet (Chart 20).

In the year to Q2 2016, most of the jobs created were still in health, however this may reflect an increase in the labour-intensiveness of projects in the final stages (or simply volatility in the data) – mining investment is expected to fall much further, which will likely see declines in mining employment going forward (Chart 19).

CHART 18: UNEMPLOYMENT RATE BY REGION

Per cent, nsa

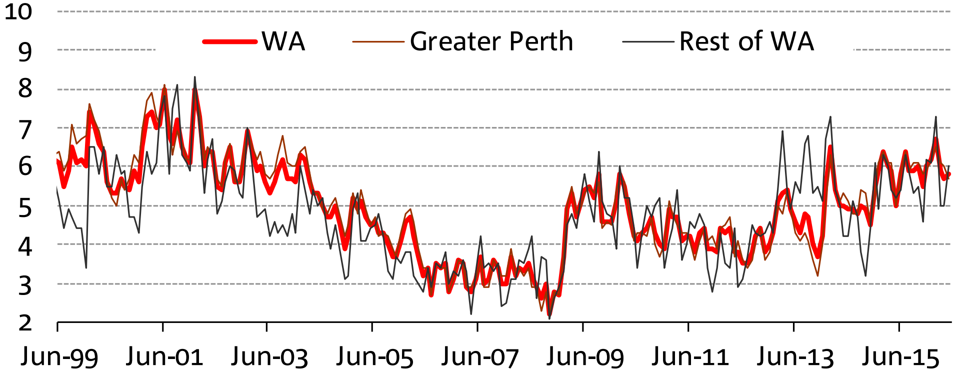


CHART 20: UNEMPLOYMENT RATE & NAB CAPACITY UTILISATION RATE

Per cent

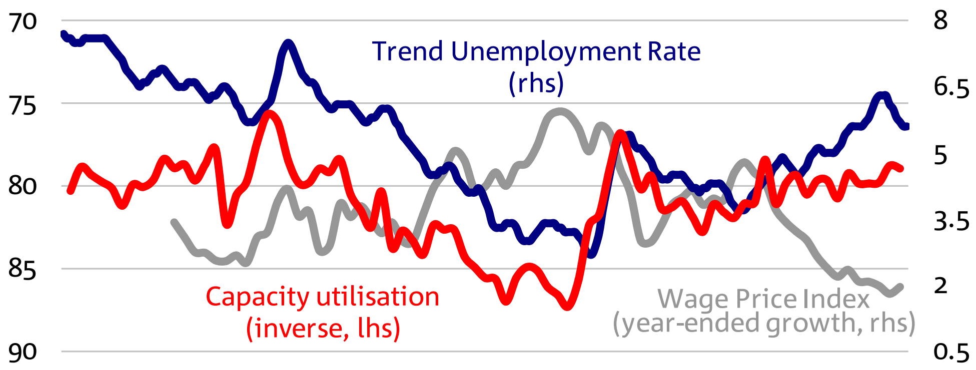
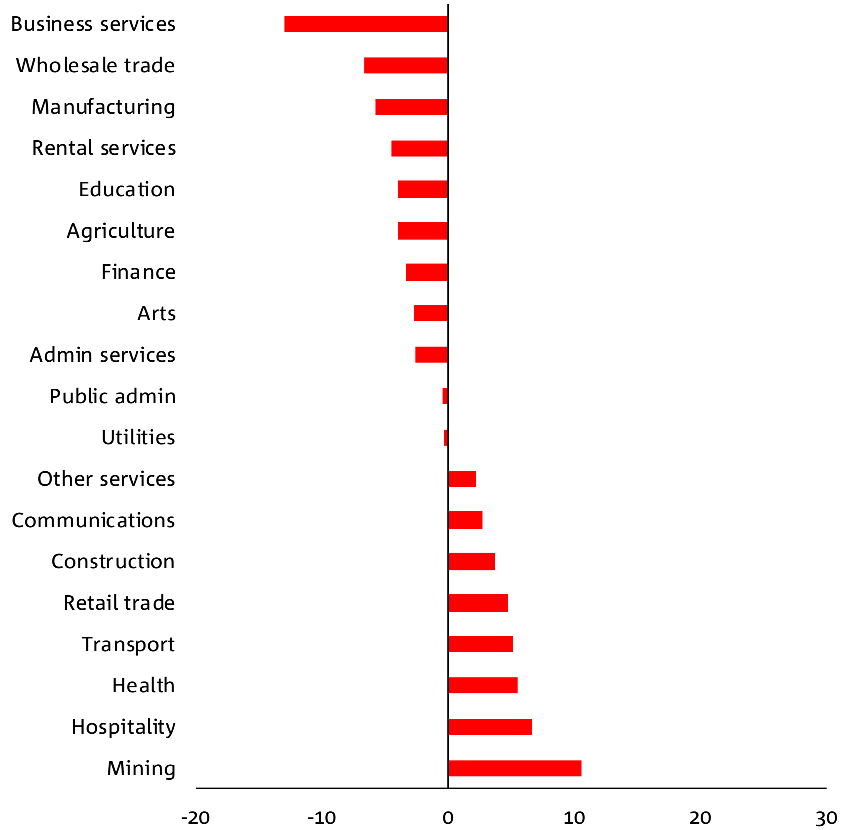


CHART 19: CHANGE IN EMPLOYMENT BY INDUSTRY, WA

Last 12 months, thousands



Source: ABS, NAB Group Economics

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DEMOGRAPHICS:

Population boom has completely unwound, appears to have stabilised

WA population growth has slowed considerably from its peak in 2012. The boom and bust in population growth has largely been driven by net overseas migration, although net interstate migration has now flipped into a slight net outflow. In contrast, natural increase has stayed elevated (Chart 21).

After leading the way for more than a decade, WA population growth is now more consistent with the national average (Chart 23), while timely estimates of civilian working age population suggests growth has dropped below the national average.

Population trends are consistent with observations from the labour market. While job gains in WA have slowed from the levels seen in previous years, it appears as though it is mainly jobs held by non-Australian born workers that have contracted. The fall in the number of employees born in north-west Europe has been particularly pronounced. In contrast, employment of workers born in Australia has increased, although this has been driven entirely by part-time work (Chart 22).

CHART 21: WA POPULATION GROWTH

Thousands, over the year

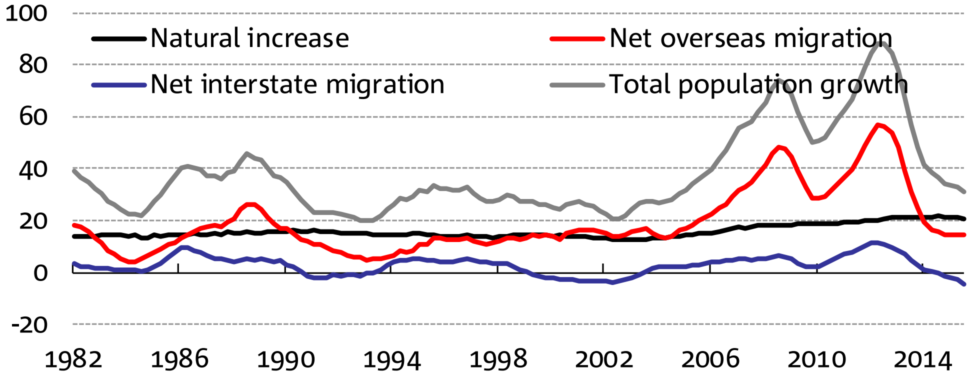
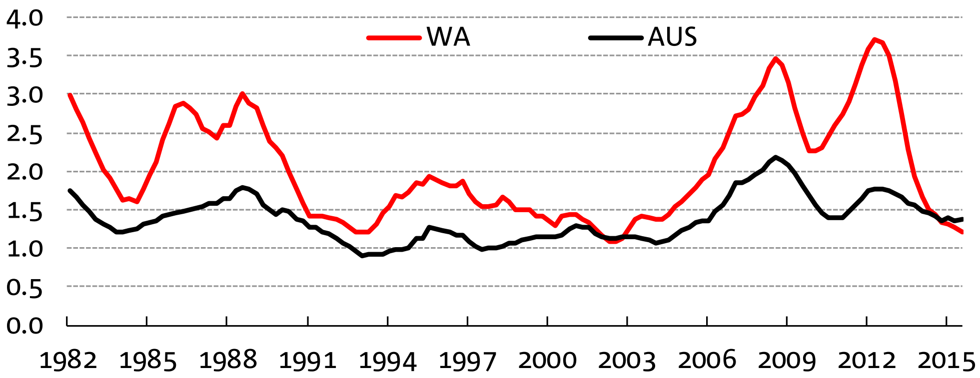


CHART 23: WA POPULATION GROWTH

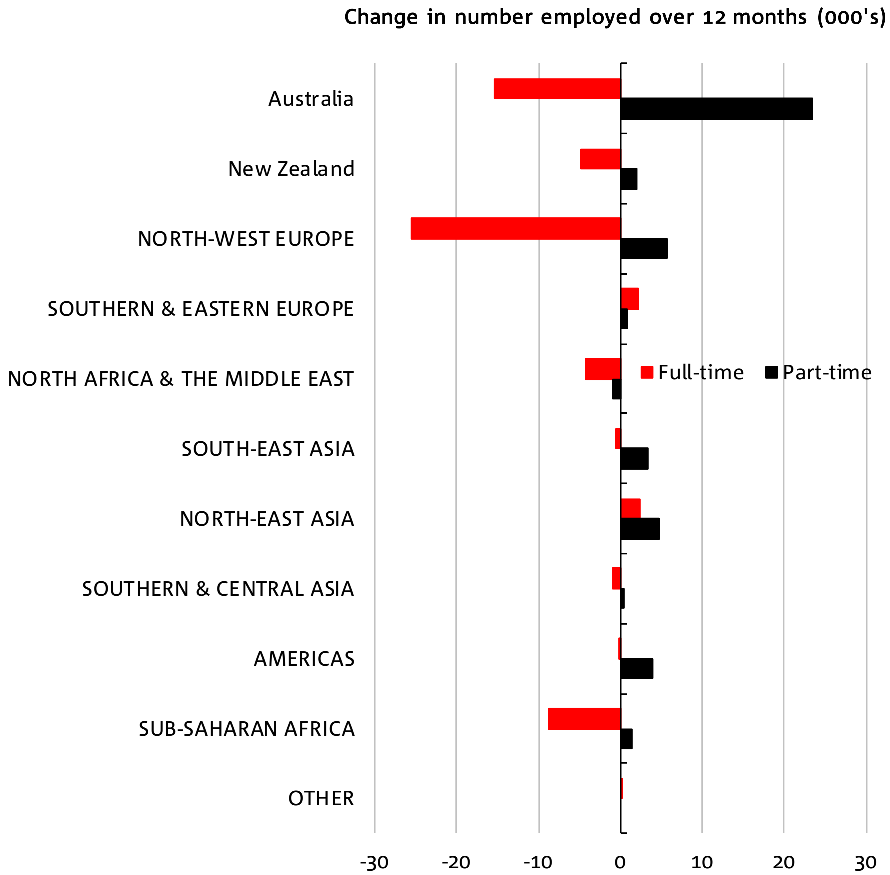
Year-ended growth



Sources: ABS; NAB Economics

CHART 22: WA EMPLOYMENT BY COUNTRY OF BIRTH

Thousands, over the year



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HOUSING MARKET:

Local housing market still feeling the pinch from economy's transition

Falling population and wages growth has taken a toll on the WA housing market, with Perth property prices the worst performing of the capital cities – falling 4.2% over the year to May 2016.

The Perth housing market was the worst performing of the capital cities over 2015, in terms of prices, which fell almost 4%. Some regional areas that are closely tied to mining operations (such as the Pilbara) have been hit particularly hard. The weakness has had a clear impact on construction activity, with dwelling investment contracting from annual state final demand growth in Q1 for the first time since 2012.

Both commencements and approvals have fallen steadily from their past peaks (Chart 24), suggesting dwelling investment will remain subdued.

On a more positive note, the NAB Property Survey suggests a moderate improvement in price performance over coming years, although fundamentals may not support this view (Chart 26). NAB expects Perth house prices to continue with a trend decline over coming months; forecast to fall 5.5% in 2016 and 3.5% in 2017.

Prices have been falling across most property types and regions (Chart 25). For the metro area, unit prices in the south east have fallen the most, although prices have declined in all metro area segments (Chart 27).

CHART 24: WA RESIDENTIAL APPROVALS & COMMENCEMENTS

Per cent

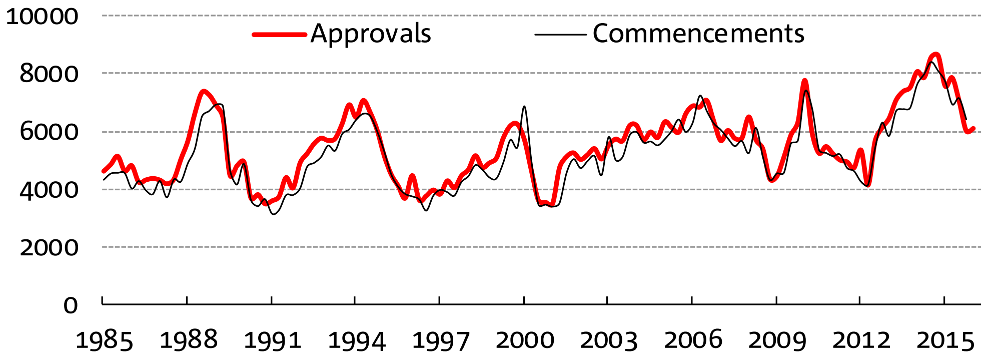


CHART 25: WA RESIDENTIAL PROPERTY PRICE GROWTH

Per cent

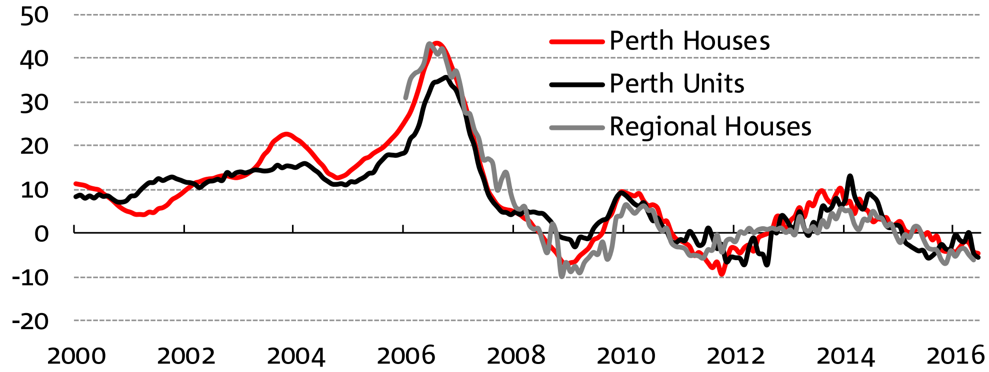


CHART 26: NAB SURVEY – HOUSE PRICE EXPECTATIONS

Per cent

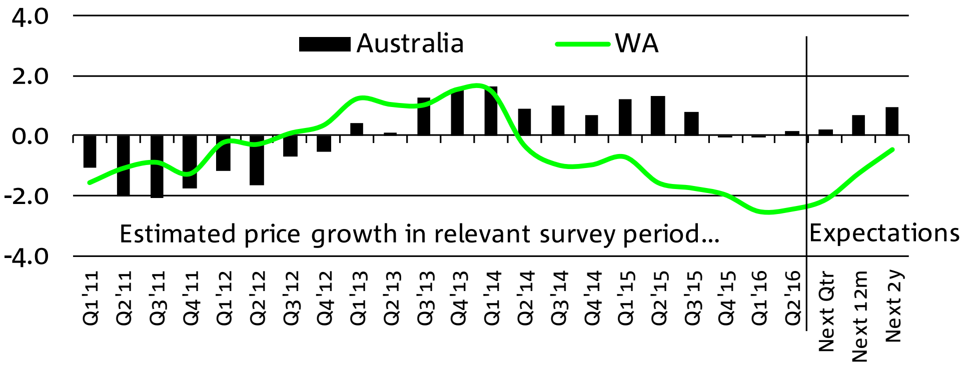
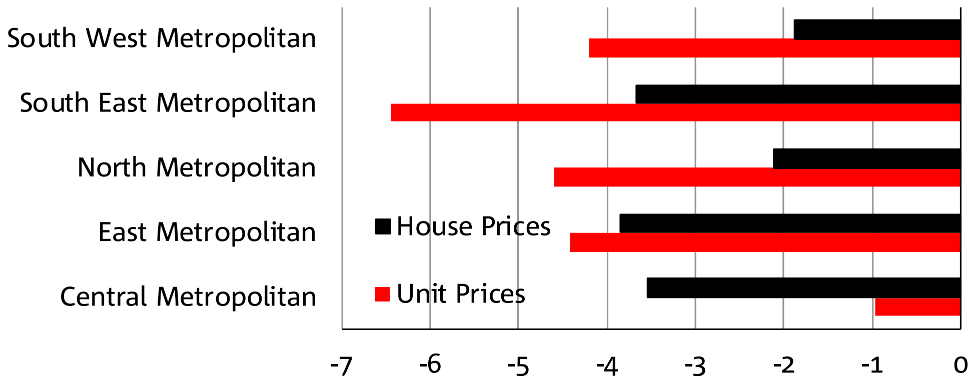


CHART 27: PERTH - MEDIAN PROPERTY PRICE GROWTH

Year to Q1 2016



Source: ABS; CoreLogic; NAB Economics

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FISCAL POSITION:
Deteriorating further on weaker economy and commodity prices

The recent state Budget showed that the fiscal position was a little better than expected at the mid-year review for 2015-16, largely due to higher than budgeted Commonwealth Grants and Royalty income. However, the Budget also showed another marked deterioration in the fiscal outlook driven by continued weakness in revenue collections, albeit with a modest offset from upward revisions to royalty income. The anticipated operating deficit for 2015-16 was revised down by $1.1b, to $2b, but deficits in the following 3 years have been revised up by a collective $2.8b.

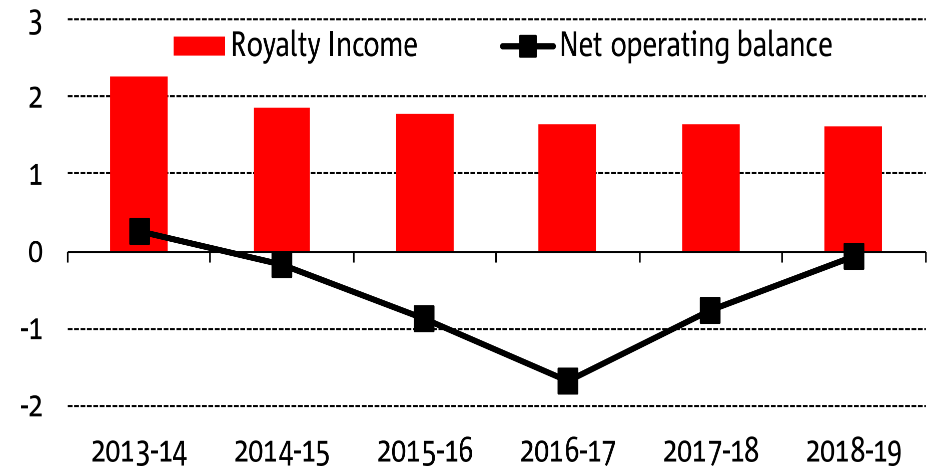
In response to the weaker economic outlook, taxation estimates were revised down $2.2b over the 4 years to 2018-19. Commonwealth grants were also revised down $1b over the same period, which largely reflects a cut to GST grants – following changes to population assumptions. Royalties revenue has actually been revised up by $0.6b over the same period, although the Budget assumption for iron ore prices are around $US10 per tonne higher than NAB's forecast – Budget sensitivities suggest more than a $0.7b hit to royalties revenue if NAB forecasts are correct (although the associated pressure on the AUD will provide some offset).

Despite the weaker outlook, the 2016/17 Budget does little in terms of introducing new revenue raising measures, but did include some savings measures that are expected to more than offset new spending – the biggest being the Government's revised wage policy announced back in February of this year (saving $825m over the forward estimates). However, with some big offsets coming from spending in areas such as hospital services, the total revision to expenses in the period to 2018-19 was only -$745m.

Infrastructure spending is expected to total $22.9 billion over the period to 2019-20. The combined impact of increased investment and higher deficits are expected to raise net debt by an additional $2.5b by 2019, with net debt totalling $25.4b by 2020. However, these estimates do not include potential proceeds from the State's asset sale program. Infrastructure spending in this year's Budget is focussed heavily on education and transport.

CHART 28: WA NET OPERATING BALANCE & ROYALTY INCOME

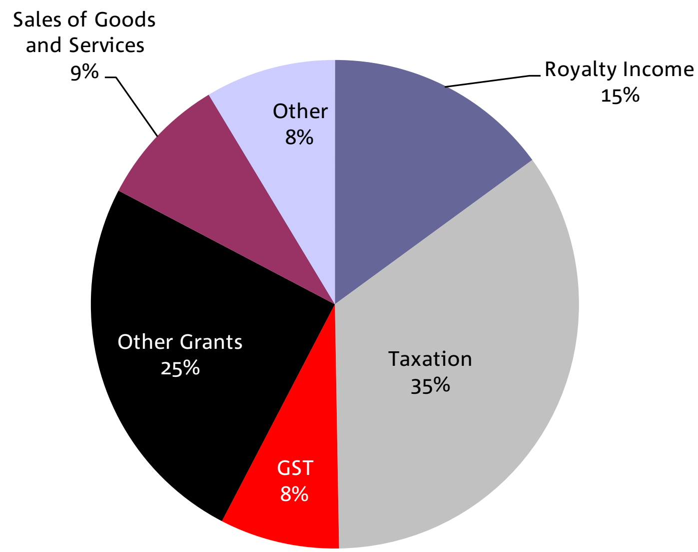
Per cent of GSP



Source:: WA State Budget; NAB Economics

CHART 29: WA COMPOSITION OF STATE REVENUES

Per cent



SEMI BOND MARKET:

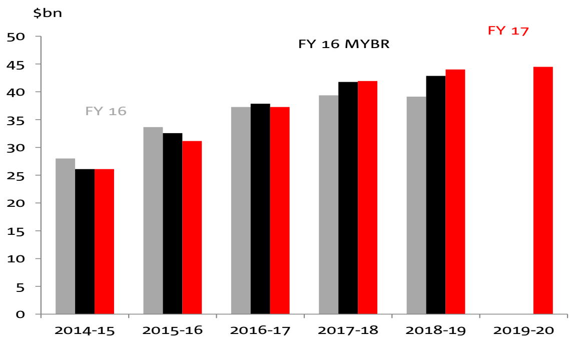
Persistent deficits adding to the debt burden. Asset sales may provide an offset

Ongoing fiscal deficits will keep net debt rising throughout the forecast period, from $31.1bn in 2015-16 to $44.5bn by 2019-20. Asset sales have the potential to significantly reduce state debt down the track with WA adding new ports and Western Power to the list of assets to potentially be sold. WA estimates asset sales will raise $16bn of sales. These proceeds are not included in the budget estimates.

S&P is yet to confirm WA's credit rating post the budget. Further deterioration in the budget position maintains pressure on the rating.

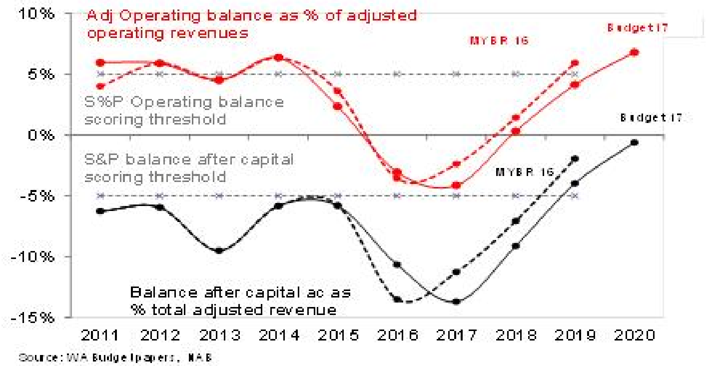
WATC funding program for FY17 is $7.15bn (vs 10bn in FY16) comprising $4.3bn of new financing and $2.85bn of maturities. Benchmark program will be primary source of funding.

WA NON-FINANCIAL PUBLIC SECTOR NET DEBT



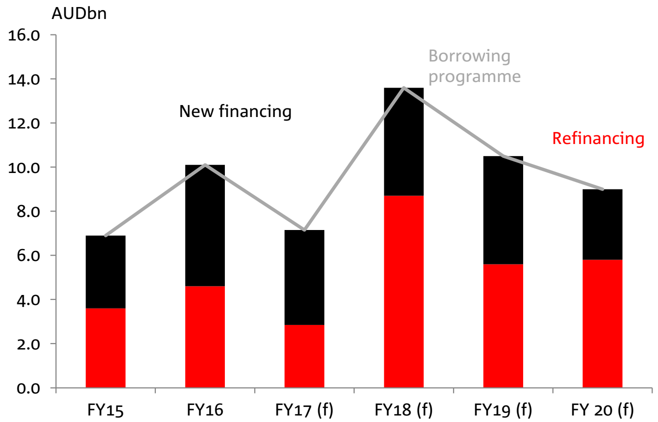
Source: WA budget paper

S&P CREDIT METRIC: BUDGET PERFORMANCE METRICS



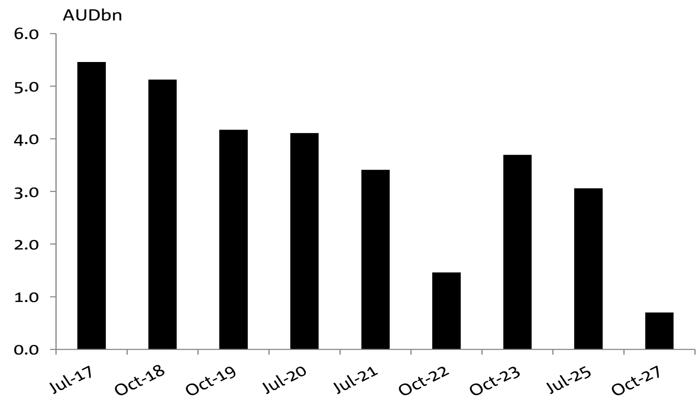
Source: WA budget paper, NAB

WATC BORROWING PROGRAMME



Source: WATC

WATC TERM BONDS OUTSTANDING AS AT END JUNE 2016



Source: WATC

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EXTERNAL TRADE:

Net exports driving real growth until resource production approaches capacity around 2018-19

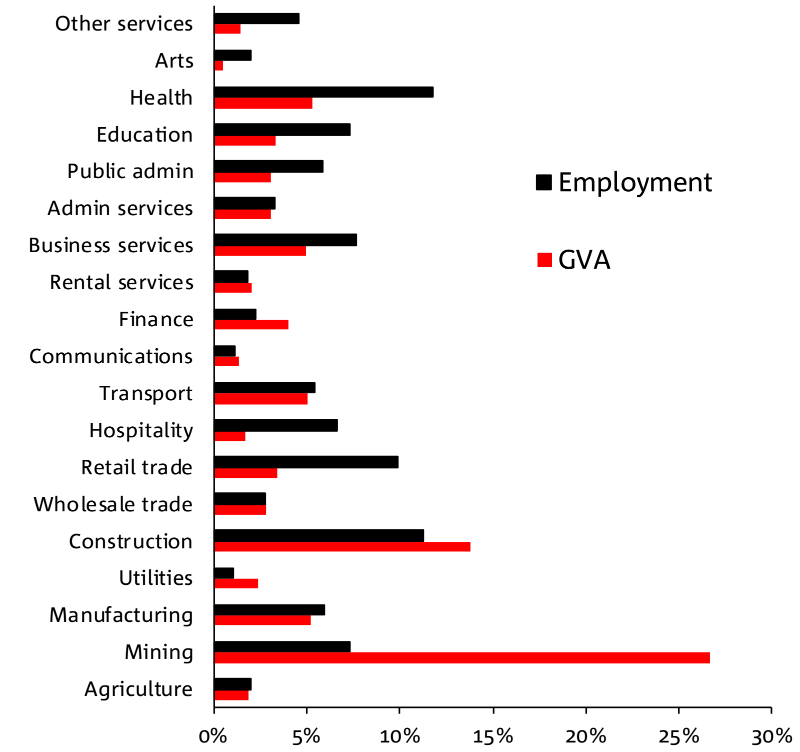
The industry share of the mining sector in WA has risen steadily since mid-2000s, reaching a historical-high of 31% 2013-14. This fell to 27% in 2014-15, which is its lowest since 2005-06, but compares to less than 10% for mining Australia-wide. The once-in-a-generation mining boom has also driven growth in related industries including construction, bolstering construction's share of total economic output. However, a weak outlook for both mining investment and residential construction could unwind some of this share. In contrast, the composition of employment is much more diverse, reflecting the relatively higher labour intensity of other industries.

Growth in merchandise export volumes in WA has slowed a little, but is expected to continue its expansion as iron ore and LNG production ramps up towards full capacity in the coming years. LNG will increasingly grow in importance as WA's production capacity more than doubles. Falling investment/weak domestic demand are having an impact on imports as well, making net exports a major driver of growth in real terms.

However, lower commodity prices have had a big impact on incomes and nominal growth –nominal net merchandise exports have been relatively flat (Chart 35). Weak energy prices could leave much of the new LNG capacity unprofitable. Iron ore prices are expected to stay in the low US$40's per tonne (CFR, spot) in 2016, below government assumptions.

CHART 34: COMPOSITION OF EMPLOYMENT & GVA

Percentage share



Source: ABS, NAB Economics

CHART 35: WA NET TRADE

Million dollars, 3mma

TOP EXPORT DESTINATIONS, NSW

Billion dollars, 12-month average

		Value of exports ($m)			Value of imports ($m)
1	China	52779	1	ASEAN	8690
2	Japan	14598	2	China	5118
3	ASEAN	8289	3	EU	4339
4	Korea	6575	4	US	3282
5	EU	5453	5	Korea	2677
6	UK	3386	6	Japan	2519
7	Singapore	2448	7	Singapore	2132
8	India	1982	8	Germany	956
9	US	1492	9	UK	946
10	Taiwan	1411	10	New Zealand	889
11	Germany	1103	11	Taiwan	298
12	New Zealand	409	12	HK	74
13	HK	343			