

State Update: Western Australia – January 2016

NAB Group Economics



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Contents

[Key points](#)

[In Focus: How progressed is the mining downturn?](#) 3

[Consumer and household sector](#) 4

[Business sector](#) 5

[Labour market](#) 7

[Demographics](#) 8

[Residential property](#) 9

[Fiscal outlook and semis](#) 10

[Economic structure](#) 12

Key points

- Western Australia is well into the throes of the mining investment downturn, which is having a dramatic impact across many segments of the economy. Offsets from stronger mineral export volumes helped to prop up Gross State Product (GSP) growth in 2014-15, but big declines in State Final Demand (SFD) has had a major impact on the state's labour market and asset prices. These trends are expected to continue given the lack of momentum in non-mining sectors. **Consequently, we expect GSP growth in WA to continue its slowdown from rates over 5% in past years (on average), to below 2% in 2015-16. A ramping-up in LNG exports in subsequent years should see growth lift, but to less than previously forecast (Charts 1 & 2).**
- The final construction stages of major WA mining projects has driven a decline in WA business investment, which fell more than 11% over the year to Q3 2015 and is down almost 30% from its 2012 peak. Despite this, the downturn in WA mining investment does not appear to have progressed as much as it has in Qld, although a **significant depletion in the mining investment pipeline suggests further falls in mining capex are on the way.**
- In addition, falls in iron ore prices have weighed on mining revenues despite an increase in production and export volumes.** This then has implications for government revenues, worsening the states fiscal position – the budget update included a \$1.2b downward revision to iron ore royalty revenues over the forecast period reflecting (conservative?) cuts to iron ore prices expectations. The hit to revenues is limiting the state Government's capacity to respond to economic headwinds through fiscal policy – the mid-year Budget update included new 'corrective measures' to address the deteriorating fiscal position (saving an estimated \$1.3b in net debt over the period to mid-2019).
- Spill over effects from the mining headwinds are clearly evident in the broader WA economy. **Wages have been in decline and population growth has returned to near pre-boom rates** – primarily due to lower overseas migration, although interstate migration has now reversed. A climbing unemployment rate and falling incomes have contributed to poor growth in household consumption, while property prices have fallen and dwelling construction slowed – although still expected to outpace housing demand, maintaining pressure on prices.
- Slower population growth has not prevented further deterioration in the unemployment rate. The trend unemployment rate for WA has risen steadily to 6.5%, up from a pre-GFC low of around 2.7%, and its highest rate since early 2002. That said, mining sector job losses have been a little less than previously expected, but could imply more significant job shedding yet to come. **Consequently, the unemployment rate is expected to peak around 6½% this year before gradually improving.**
- There are very few signs that non-mining sectors are gaining enough momentum to offset the mining headwinds.** The NAB Business Survey shows that capacity utilisation remains muted, and capex intentions are easing. Nevertheless, business conditions have stabilised (albeit at subdued levels), sustained by the State's services industry.

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Chart 1: State GSP Growth Forecasts

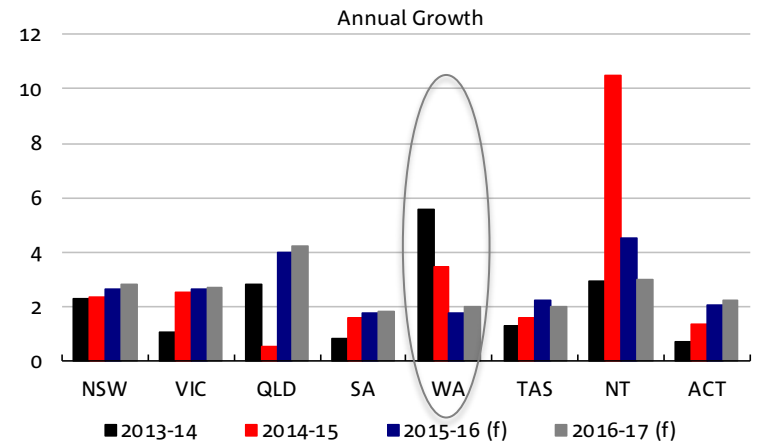
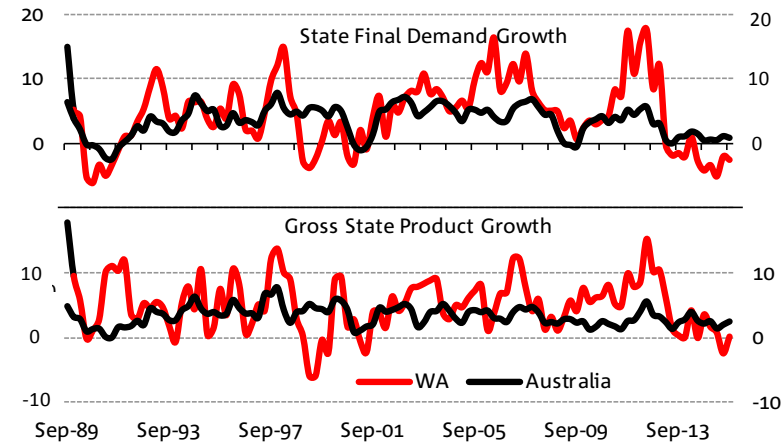


Chart 2: State Growth



* NAB estimate

Sources: ABS; NAB Economics



In Focus: How progressed is the mining downturn?

The mining downturn in WA is now well underway. The drag from lower commodity prices and investment have to-date more than offset the ramping up of mineral exports as new projects become operational. Based on estimates of the states iron ore export volumes, anticipated price declines could wipe out almost US\$20b in mining revenues this financial year alone. There is also a risk that prices could fall up to US\$12 per tonne more than expected, cutting out another US\$9b in revenue. This naturally has flow on effects to the state economy and Government revenues (slide 10 for details).

Going forward, attention will increasingly shift to the LNG market as major projects in WA are completed and exports ramp up – Budget estimates have WA LNG production capacity more than doubling to 50 million tonnes in 2018/19 (of which, around 38 million tonnes are contracted). However, significant falls in oil prices (linked to gas prices) compared to when these projects were first conceived, will likely leave many of them unprofitable.

State domestic final demand and property markets have already been hit hard by falling investment and incomes, and with the pipeline of projects depleting quickly, there is potential for more significant declines to come (Chart 4 & 5). Comparison with mining investment declines in QLD illustrate potentially how much further the declines could go (Chart 5). The impact on the labour market and wages is likely to pick up.

Chart 3: Iron ore spot and contract prices (US\$/t, NAB Fcst)

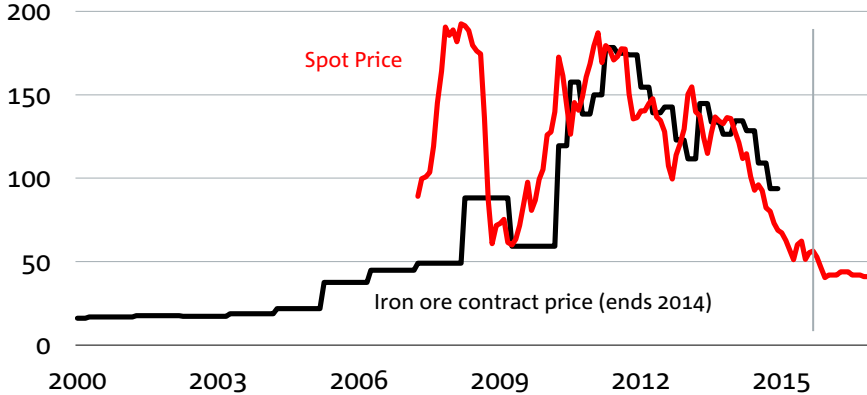
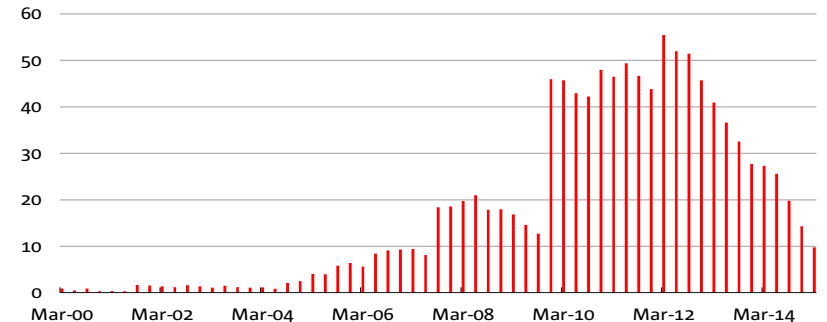


Chart 4: Engineering work yet to be done, heavy industry, WA (\$bn)



Note: Data after March 2013 are estimate

Chart 5: Mining investment & employment

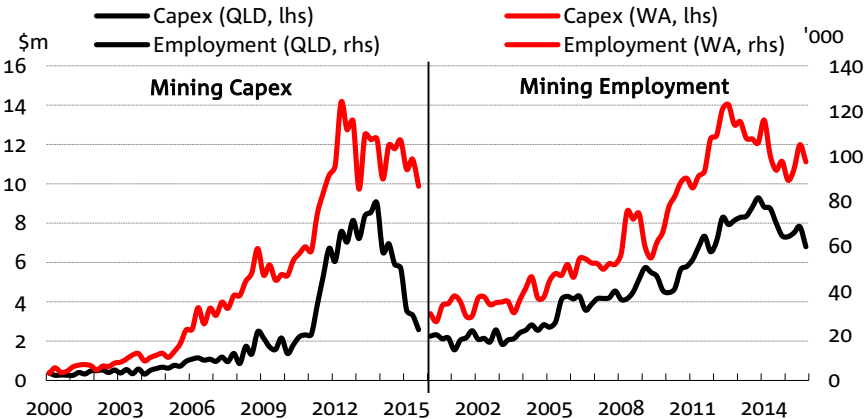
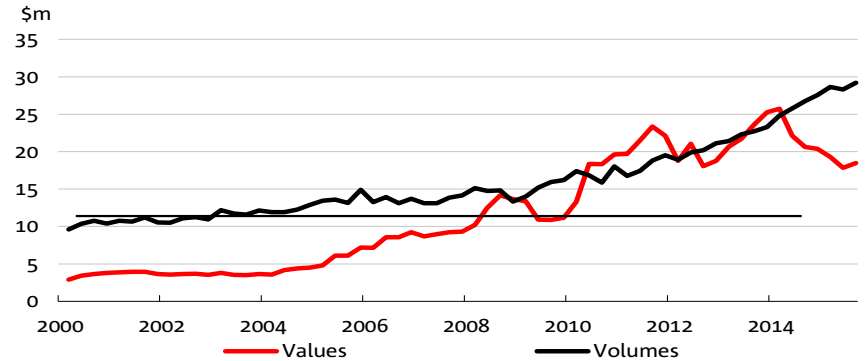


Chart 5b: Australian metal ore exports





Consumers feeling the pinch from low wage growth, and now falling property prices

Growth in household consumption in 2014/15 was its lowest in 25 years (at 1.1%), reflecting both the slowing population growth and a sharp decline in incomes (Chart 6). Given the anticipated economic rebalancing away from the mining states, these trends are likely to continue – particularly as average mining wages eventually realign with national averages.

These themes will continue to play out through property markets, meaning that lower prices will pose an additional drag on consumption via wealth effects (Chart 8).

Chart 6: Average Compensation and Household Consumption Growth (YoY)

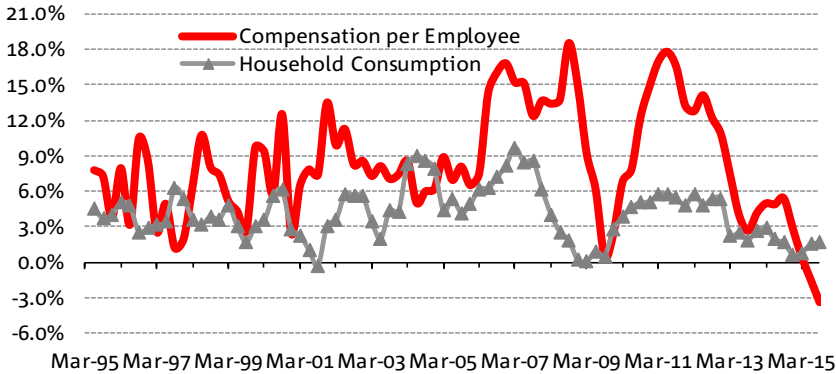
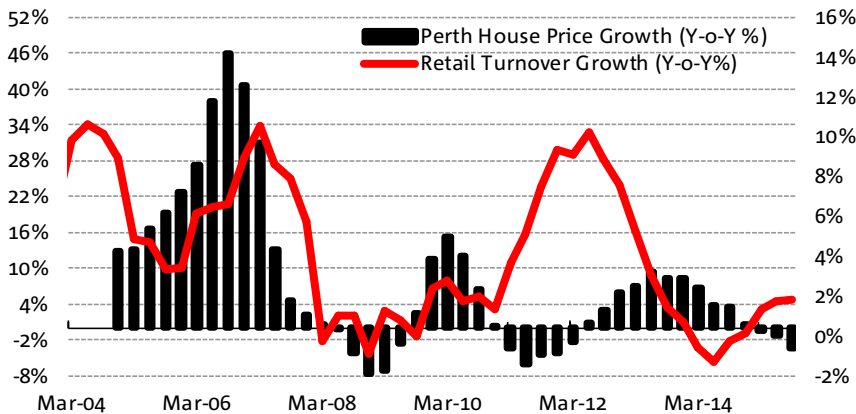


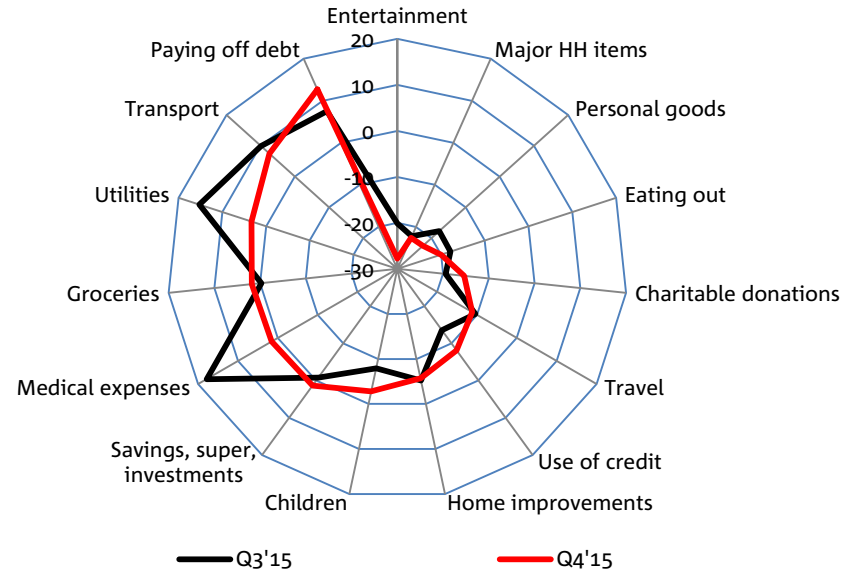
Chart 8: WA Retail sales & house price growth



The Q4 2015 NAB Consumer Anxiety Survey showed further declines in consumer anxiety despite ongoing deterioration in the labour market and additional economic headwinds. Consequently, this is yet to translate into notably stronger spending behaviours. Consumers remain cautious with their spending, choosing to focus on paying down debt (Chart 7).

But while there was little change in attitudes toward consumer spending in the quarter, spending intentions for these items have improved considerably from the same time last year.

Chart 7: Changes in Spending Behaviours by State: WA





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

According to the NAB Business Survey, capacity utilisation of businesses in WA has been surprisingly steady, albeit somewhat below previous levels and lower than the national average (Chart 9). Subdued levels of capacity utilisation are consistent with soft business conditions in the state, although these have also held up a little better than expected (Chart 11).

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

Investment intentions from the NAB Survey have been surprisingly resilient, largely reflecting the survey’s emphasis on non-mining industries (Chart 11). Nevertheless, intentions have been easing back recently, more consistent with much weaker results in the ABS Capex Survey (slide 6, Chart 12).

Services sectors have the best business conditions in the NAB Survey, with construction also holding up marginally (likely due to residential activity, which has passed its peak – weighing on confidence). Elsewhere, most industries have been negatively affected by the mining headwinds (Chart 13).

Chart 9: NAB Business Survey – Capacity Utilisation (%)

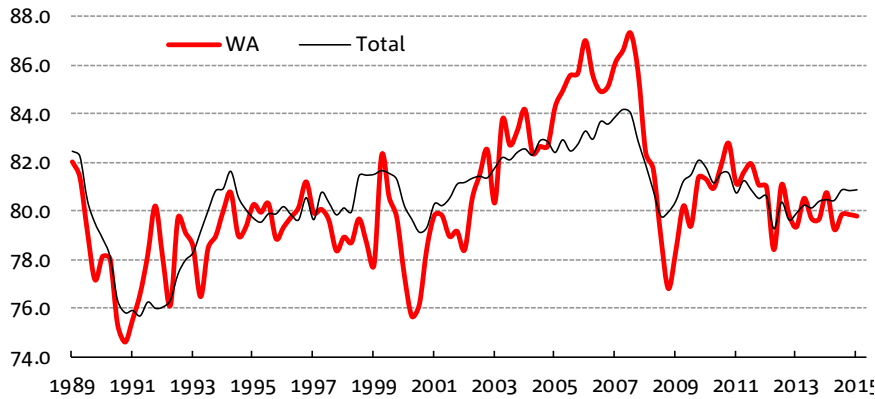


Chart 10: Spread in NAB Business Conditions (net balance)

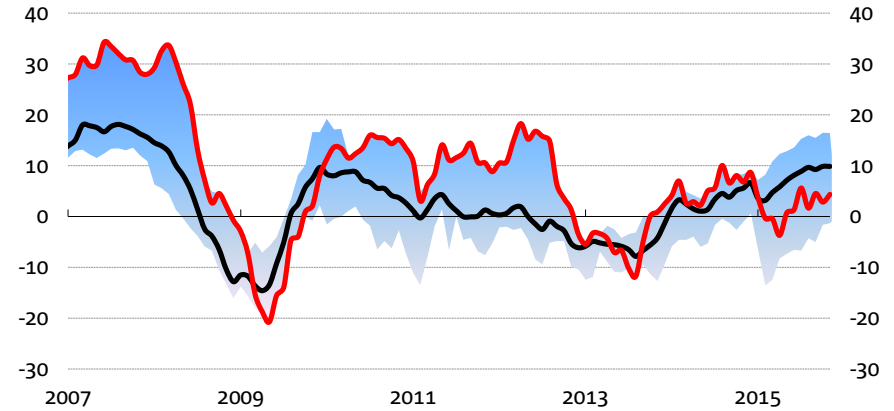


Chart 11: NAB Survey Capex Expectations & Private Business Investment Growth

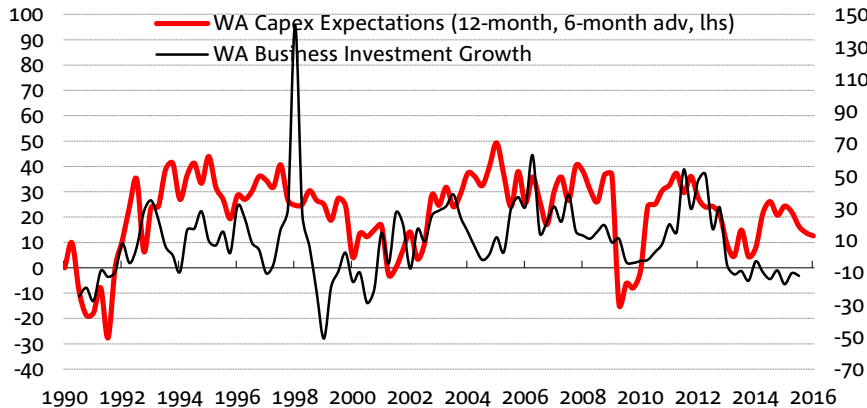
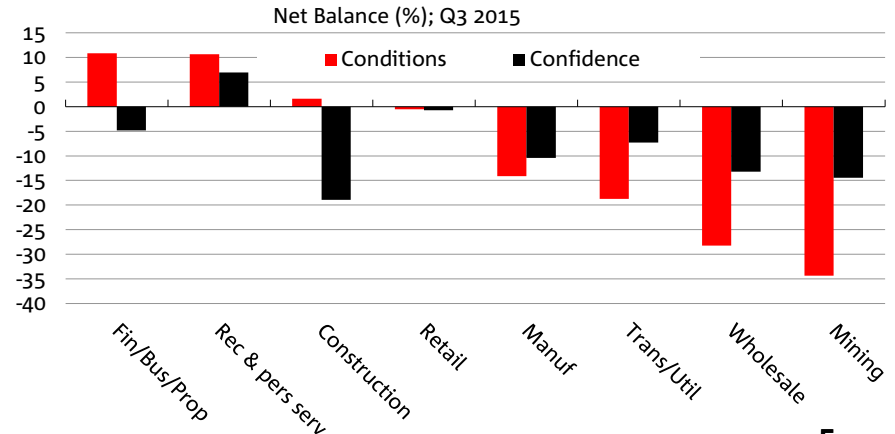


Chart 12: WA Business Conditions & Confidence by State



Sources: ABS; NAB Economics



Non-residential construction activity soft with no sign of non-mining recovery

Indicators of business investment are generally very soft as non-mining sectors fail to fill the void left behind by mining investment. Non-residential building approvals dropped heavily in late 2015, although there were some large projects approved in the second half of the year, particularly in the entertainment and accommodation sector (Chart 13).

Rising office vacancy rates highlight just how weak conditions in the office (and industrial) markets have become -- reciprocated in the NAB Commercial Property Survey (Charts 15 & 16).

Chart 13: Non-residential Building Approvals (\$ millions)

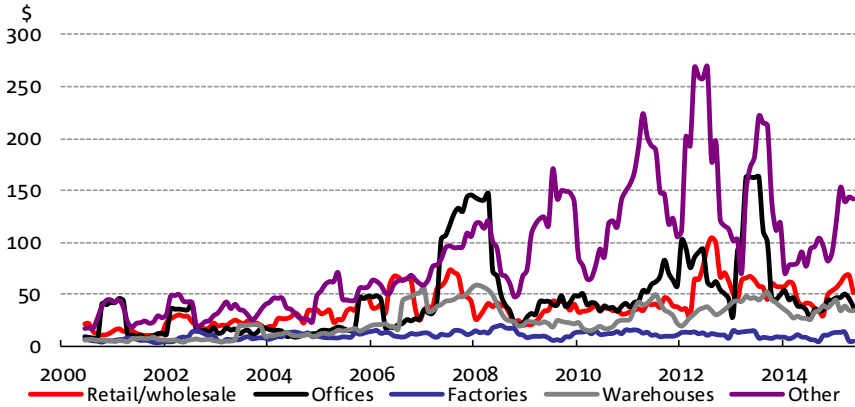
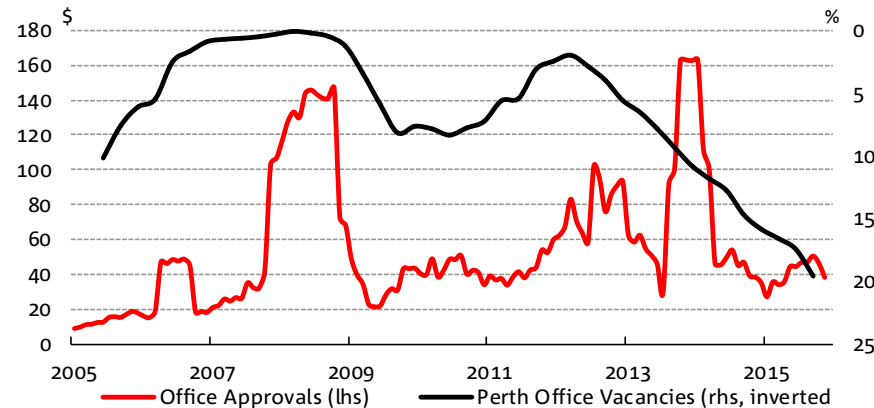


Chart 15: WA Office Market Conditions



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 14), while NAB estimates of engineering work yet to be done (for heavy industry) suggests the drop in spending could be even more severe (Slide 3).

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

Chart 14: WA Capital Expenditure & Expectations

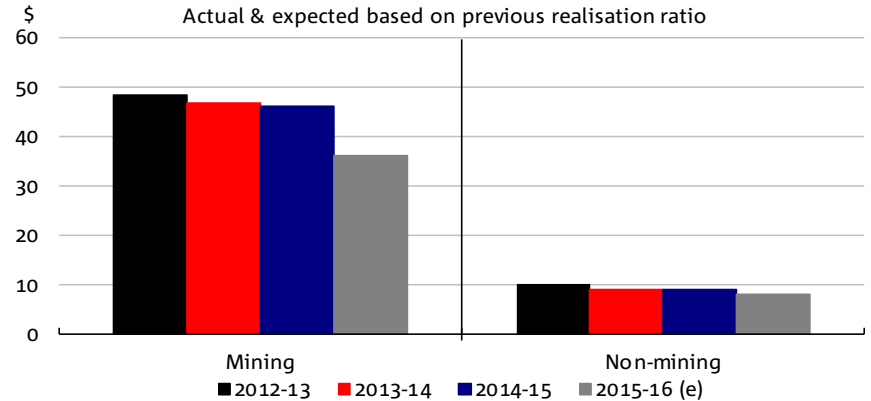
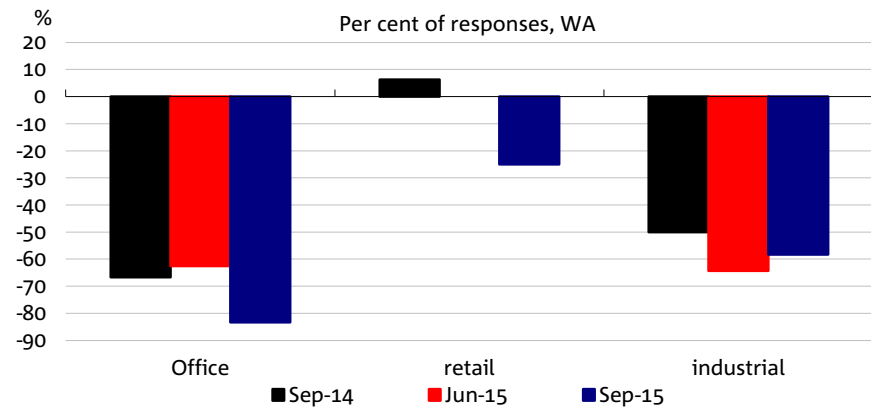


Chart 16: NAB Commercial Property Index - WA





Labour market continues to deteriorate on the back of the mining sector

The labour market has shown further deterioration over the past 6 months, and has not shown any signs of a pending turn around. Despite having a more diverse industry mix than the rest of the state, Perth's labour market has not performed any better, and could deteriorate further as the recent residential construction boom winds down (Chart 17).

Consequently, WA's annual employment turned negative in November, with 5k jobs lost. Participation rates have also remained surprisingly elevated, and slower population growth has not provided enough of an offset. Therefore,

Chart 17: Unemployment rate by region, %

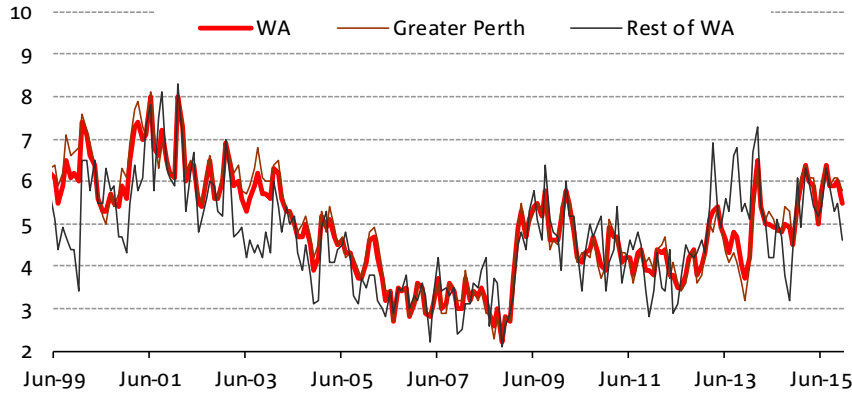
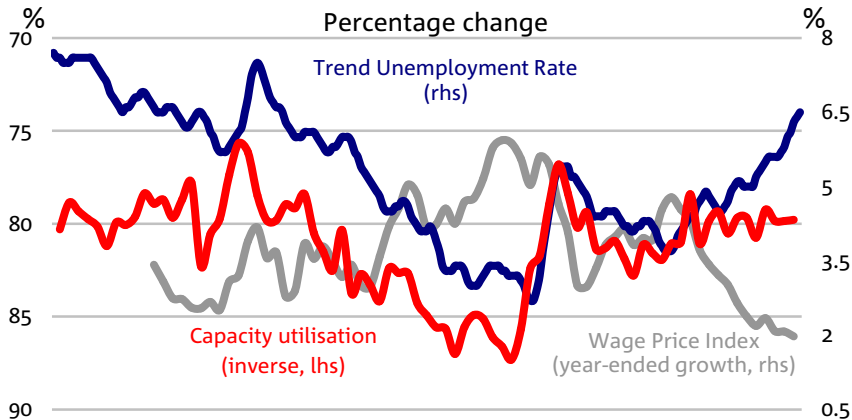


Chart 19: Unemployment rate, wage growth & NAB capacity utilisation rate

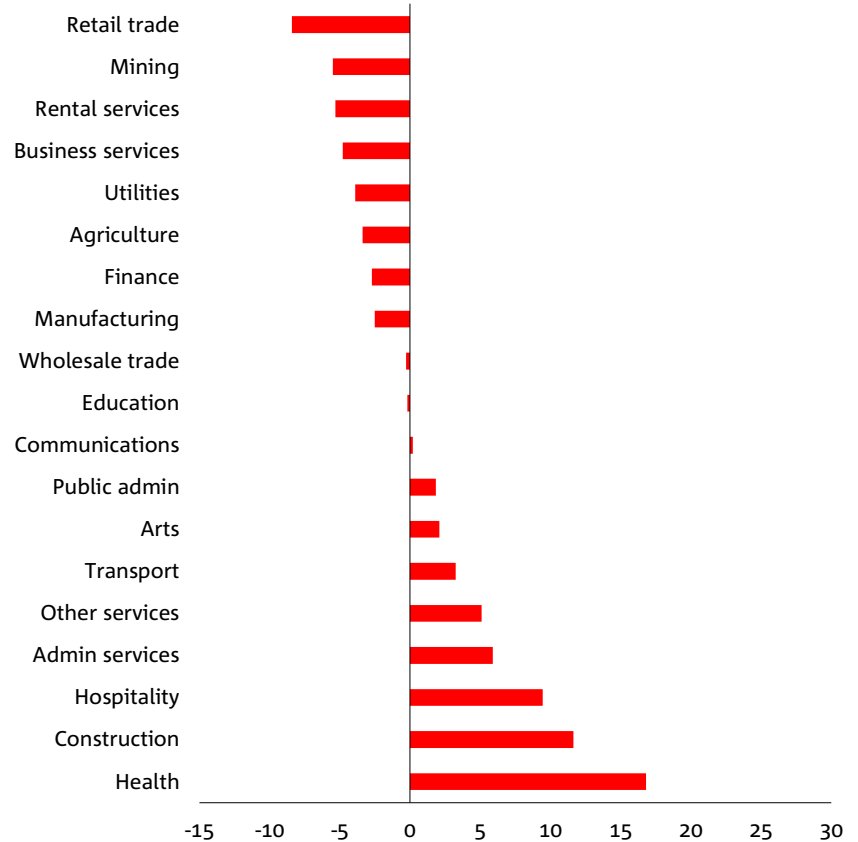


Sources: ABS; NAB Economics

unemployment hit a more than 13-year high of 6.6% in November, and wages growth slowed considerably (Chart 19).

In the last 12 months to November 2015, most of the jobs created were in health – consistent with strong conditions in personal services according to the NAB Business Survey. Unsurprisingly, job losses have been large in mining, consistent with the winding down of relatively labour intensive mining investments, although retail fell the most (Chart 18).

Chart 18: Change in employment by industry, last 12 months, WA, '000





Population boom unwinding as mining investment slows

Since peaking in 2012, WA population growth has slowed considerably. The slowdown has largely been driven by net overseas migration, although the previous net inflow of interstate migration has now reversed. In contrast, natural increase has stayed elevated (Chart 20).

After leading the way for more than a decade, WA population growth is now more consistent with the national average (Chart 22).

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 New Zealand has been particularly pronounced. In contrast, employment of workers born in Australia has increased, although the majority of these jobs appear to be in part-time work (Chart 21).

Chart 20: WA Population growth (000s. over the year)

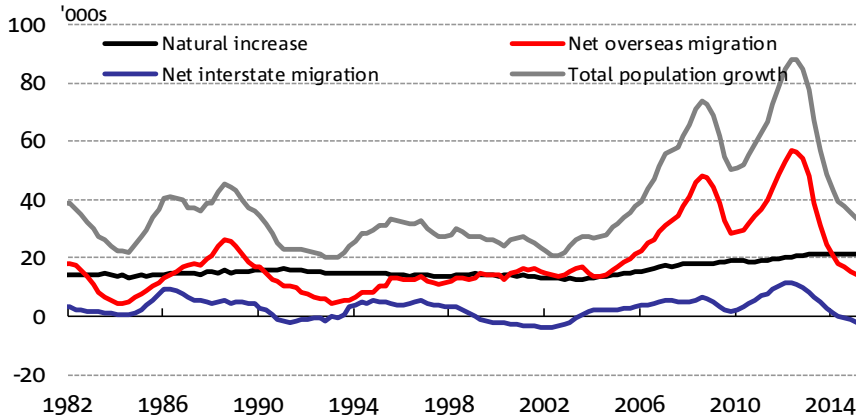


Chart 21: WA Employment by country of birth

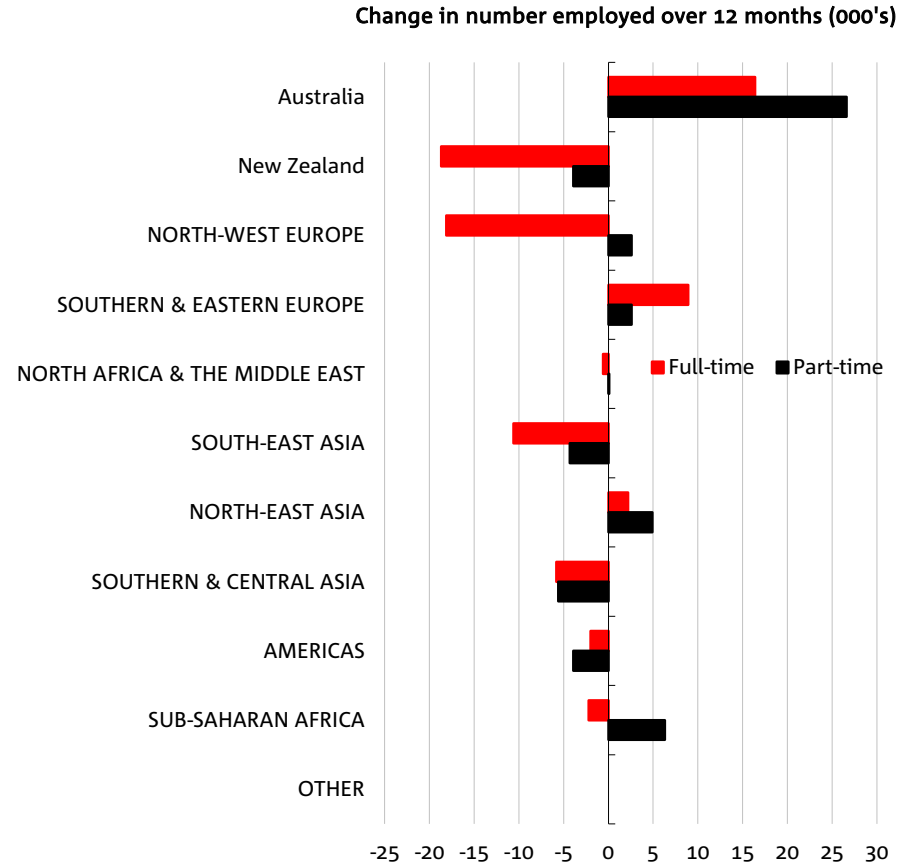
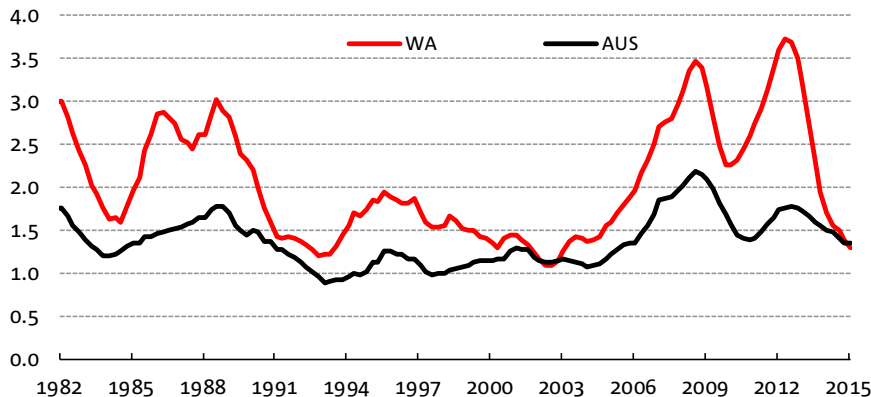


Chart 22: WA Population growth (year-ended growth)



Sources: ABS; NAB Economics



Residential property prices now falling, along with wages and population growth

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 even more closely tied in with mining operations have been hit even harder. The weakness is also now starting to be reflected in construction activity, with both commencements and approvals falling steadily from their recent peaks (Chart 23). Consequently, dwelling investment will provide less support to growth going forward.

On a more positive note, the NAB Property Survey surprisingly suggest a moderate improvement in price performance over coming years, although

Chart 23: WA Residential Approvals & Commencements

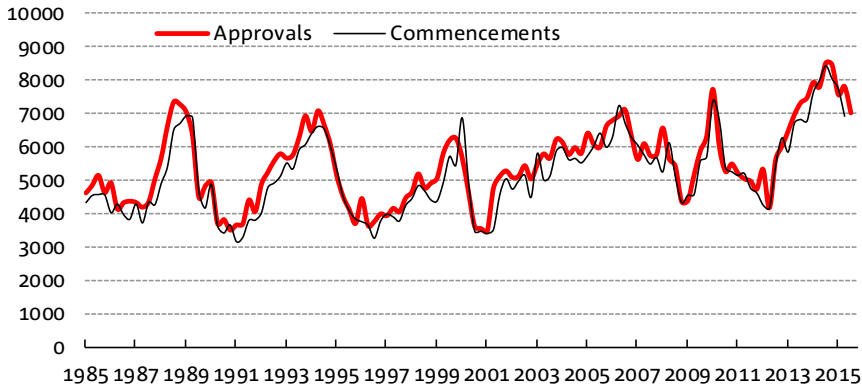
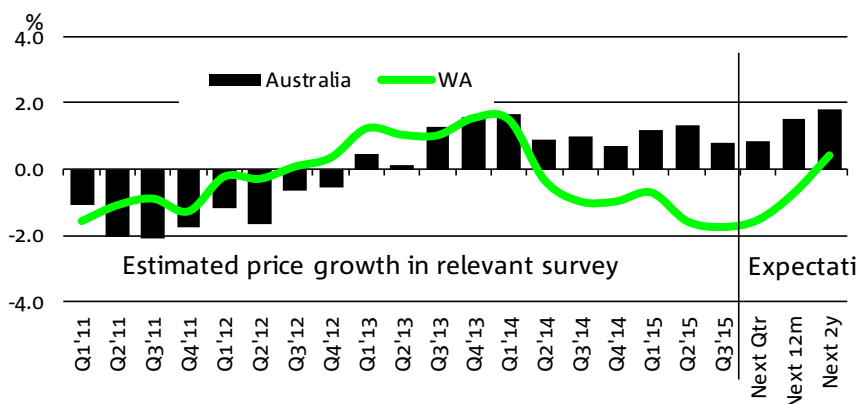


Chart 25: NAB Property Survey – House Price Expectations (%)



Sources: ABS; CoreLogic; NAB Economics

fundamentals probably do not support this view (Chart 26). NAB expects Perth house prices to fall at least another 1% in 2016 (see national summary)

Prices have been falling across property types and regions (Chart 24). Price performance has been particularly weak of late for regional houses, with prices in the south east of the state recording especially large falls, while price declines in Perth houses and units have been notable.

Residential property price growth by sub-region in Perth suggests fairly mixed outcomes for both houses and units across regions, although most segments are in decline (Chart 27).

Chart 24: WA Residential Property Price Growth

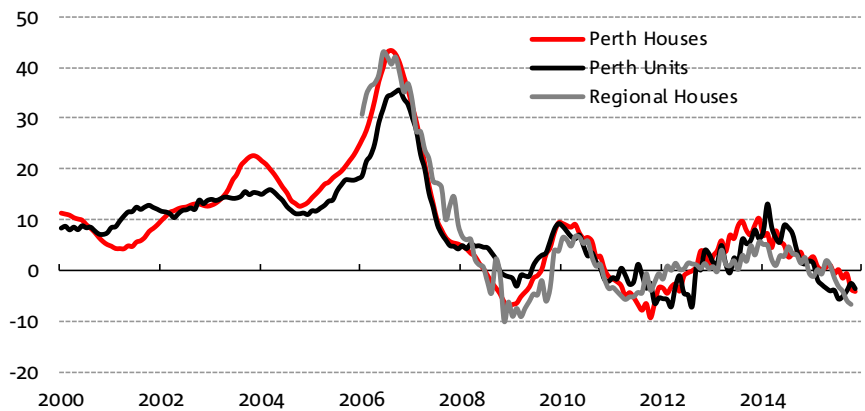
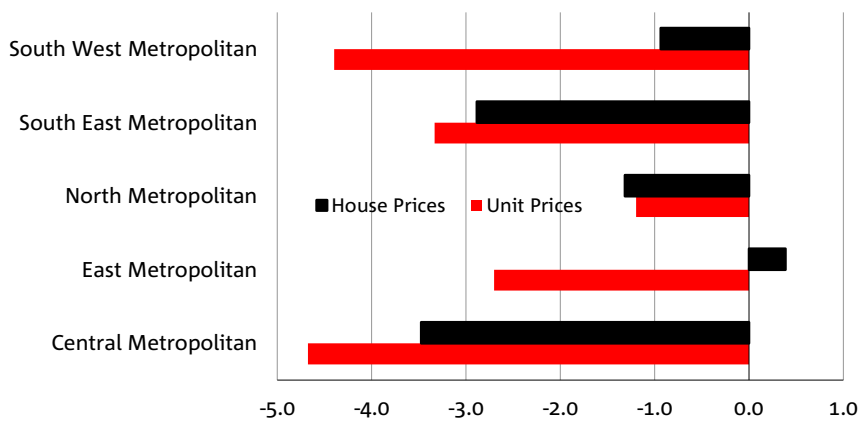


Chart 26: Perth - Median Property Price Growth (year to Q1 2015)





Fiscal position deteriorates further on weaker economy and commodity prices

The mid-year state Budget update showed additional deterioration in the fiscal position and outlook on the back of the weakening domestic economy and lower commodity prices. The anticipated operating deficit for 2015-16 was revised up by \$438m, to \$3.1b and deficits now expected for the following 2 years – 2017-18 was previous forecast as a surplus in the 2015-16 Budget.

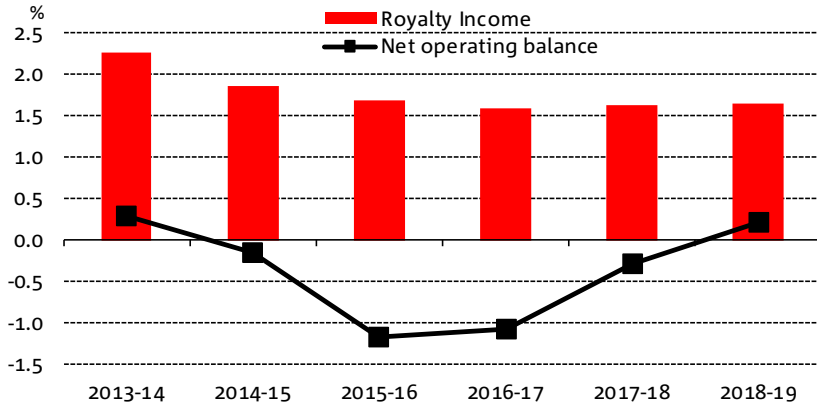
In response to the weaker economic outlook, taxation estimates were revised down \$3.9b over the 4 years to 2018-19. Mining revenue has been revised down by \$2b over the same period, although there may be additional risks to this forecast. The Budget update forecasts iron ore prices to be US\$46 per tonne, which is above current spot prices and NAB's current forecast of US\$42 per tonne. According to sensitivity analysis in the mid-year Budget review, iron ore royalties fall by \$75 million for every USD1 decline in the ore price. Given forecasts for the AUD to start stabilising, depreciation will provide little offset going forward. Therefore, the difference in price could wipe out a further \$300m from royalty revenues. The projections also expect iron ore prices to lift back to around US\$50 by

2018-19. Additionally, Commonwealth grants have been revised down by \$1.3b over four years.

Following these developments, the mid-year Budget update included new 'corrective measures' to address the deteriorating fiscal position, saving an estimated \$1.3b in net debt over the period to mid-2019. On the expenses side, these were revised down by \$1.2b, which includes \$837m in expense saving measures – primarily through a salaries underspend adjustment and a recruitment freeze.

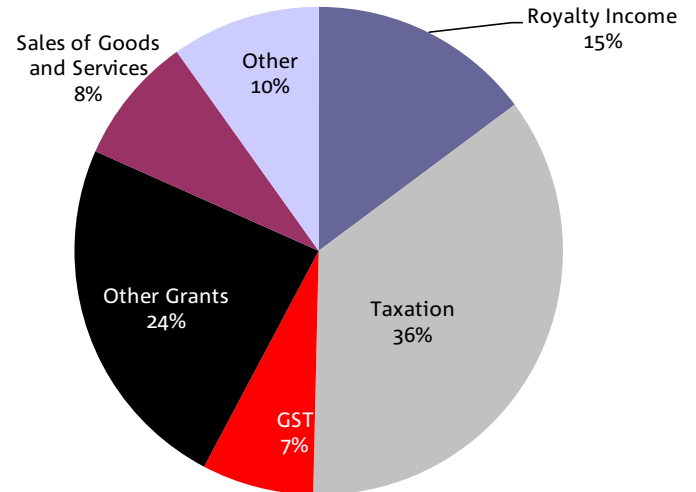
General government sector infrastructure spending is projected to be \$2.5 billion in 2015-16, and will total \$9.8b over the period to 2018-19. Infrastructure investment will make a helpful contribution to the economy, but falls far short of filling the gap left by mining investment. The main focus of infrastructure spending is in health, education and road projects. There were, however, some Asset Investment Program savings measures introduced, saving the general government sector \$201 million over the forward estimates.

Chart 27: WA net operating balance & royalty income (% of GSP)



Source: WA State budget papers

Chart 28: WA Composition of state revenues



Net debt rising, but borrowings not affected

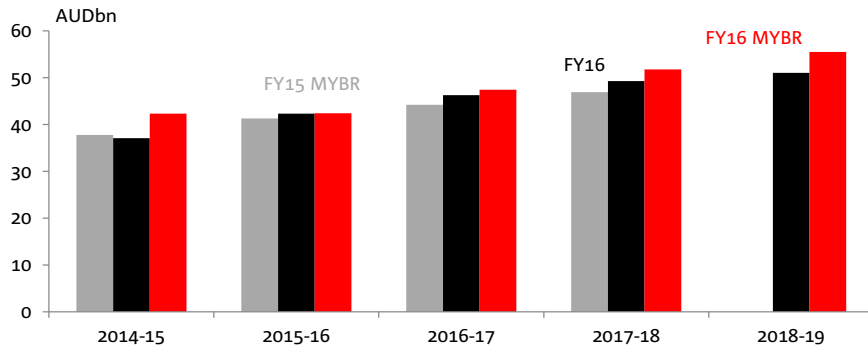
The net debt position is higher than Budget time estimates reflecting the deterioration in the 2014-15 budget position and the deterioration in the operating cash position over the forward estimates. It is now forecast to rise to AUD55bn by 2018-19. As a way to reduce net debt the Government is looking at structured asset sales – including the longer term lease of Fremantle port.

The revised budget estimates have placed further pressure on the key credit metrics which S&P monitors. We note, however, that the metrics continue to

point to improvement in the forward estimates but these too have been revised lower. Pressure remains on tax supported debt.

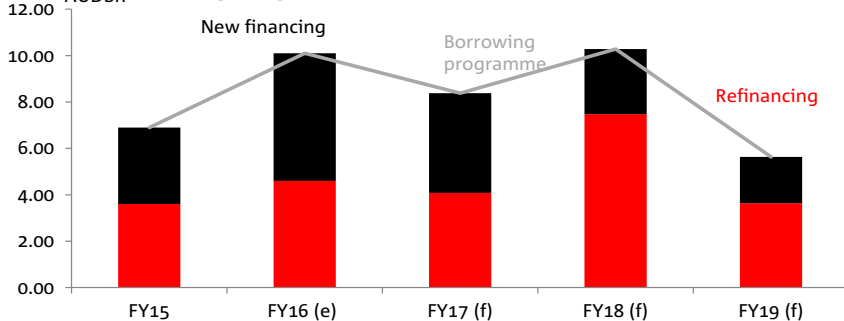
Despite the deterioration in the budget position WATC's updated funding program that is largely unchanged from that provided at the end of November. Total funding for the next six months is at AUD4.4bn (vs end Nov estimate of AUD4.7bn) and comprises AUD744m of new lending and AUD3.6bn of maturities. As at the end of 2015 WATC bonds outstanding stood at AUD38.6bn which is AUD4.45bn above end Jun-15 levels.

Western Australia Non-Financial Public Sector net debt



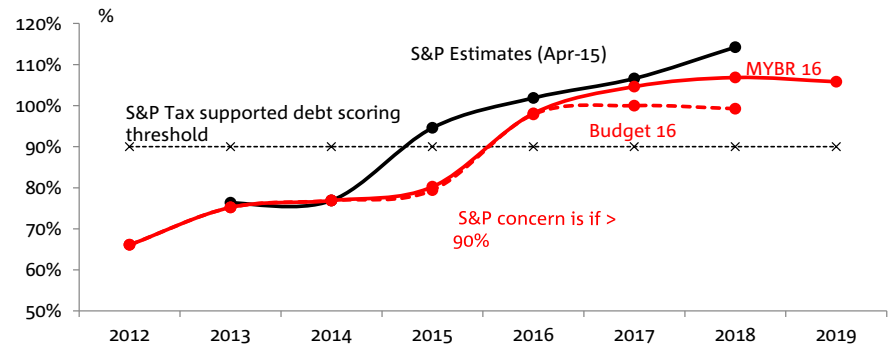
Source: Western Australia budget papers

WATC borrowing programme



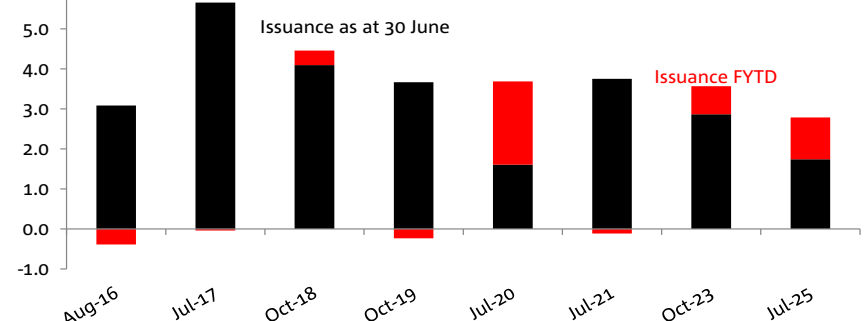
Source: WATC

S&P credit metric: Tax supported debt



Source: Western Australia budget paper, NAB

WATC term bonds outstanding as at end 2015



Source: WATC



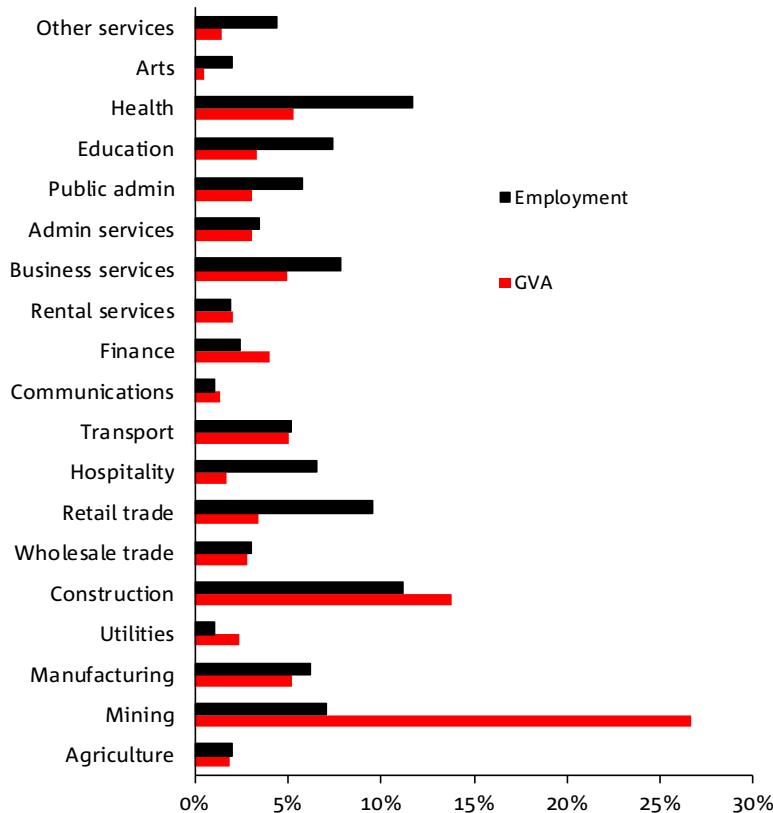
Mineral export volumes up (although delays for LNG), but falling commodity prices hit revenues

The industry share of the mining sector in WA has risen steadily since mid-2000s, reaching a historical-high of 31% 2013-14. That 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 and manufacturing (through the downstream processing of minerals), bolstering construction's share of total economic output. In contrast, the composition of employment is much more diverse, reflecting the relatively higher labour intensity of other industries.

Hard commodities are the main component of WA's export market. Merchandise export volume growth has been strong, supported by better than expected iron ore shipments, although delays in LNG production have been partially offsetting. LNG will increasingly grow in importance as WA's production capacity more than doubles over coming years.

However, lower prices are causing problems in both markets. Lower iron ore prices have already hit incomes significantly, dragging down net exports in current price terms (Chart 34), while 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 in 2016, but risks are mostly to the downside.

Chart 33: Composition of employment & GVA



Sources: ABS; NAB Economics

Chart 34: WA Net Exports (AUD billions)

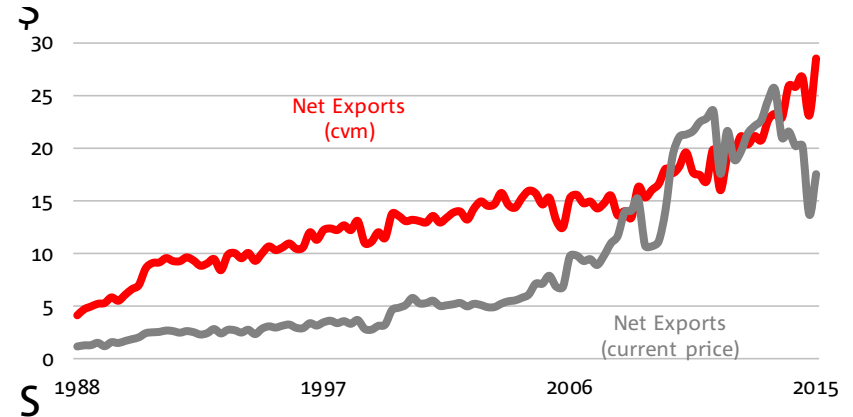


Table: Top export destinations, WA, 12-month sum to Nov 2015

Value of exports (\$m)			Value of imports (\$m)		
1	China	54966	1	ASEAN	8570
2	Japan	17387	2	China	5141
3	ASEAN	10563	3	EU	4493
4	Korea	7399	4	Korea	3322
5	Singapore	3951	5	US	3047
6	EU	2793	6	Singapore	2592
7	India	2066	7	Japan	2316
8	US	1638	8	Germany	1208
9	Taiwan	1518	9	New Zealand	905
10	UK	940	10	UK	861
11	Germany	818	11	Taiwan	349
12	New Zealand	313	12	HK	70
13	HK	214			

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