

State Economic Update

Western Australia to remain the leader of the pack

The Western Australian (WA) economy has stood head and shoulders above the other States and Territories' in recent times, to become Australia's fastest growing region. State final demand grew at a blistering 9.3% pace over the year to the June quarter 2003, well above the 4.7% pace recorded for Australia as a whole. This strong performance mainly reflects a boom in business investment in the West, led by the mineral and energy sector. Even more impressive though is that in stark contrast to the rest of the nation, export sales from Western Australia have seen off the severe drought and weak global demand, to actually *increase* in the last year.

Economics@ANZ estimates that the Western Australian economy, as measured by gross state product (GSP), grew by more than 5% in the 2002-03 fiscal year, close to double the overall Australian growth rate of 2.7%. Prospects for the Western Australian economy remain strong for while the business investment boom appears close to peaking, exports are gearing up to fire on all cylinders. Economics@ANZ expects Western Australia to maintain its place as the head of the pack, with GSP forecast to rise by 4½% in 2003-04, compared with 3½% for Australia as a whole.

Riding on the miner's back

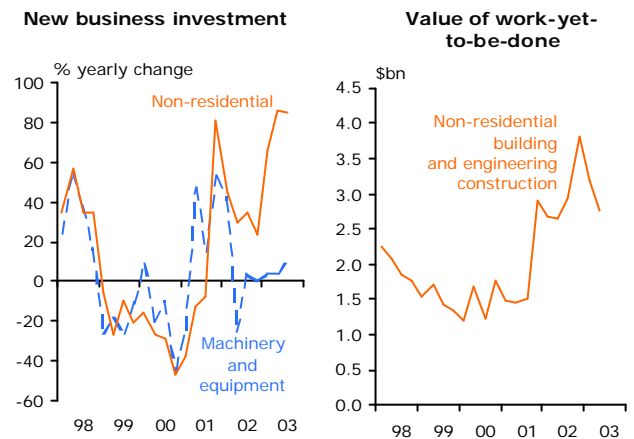
Western Australia is blessed with an abundance of natural resources such that mining and agriculture comprise around 25% of the State's economy, compared with 10% for the national average. The State's economic fortunes are therefore inextricably linked to the conditions in these industries.

The foundations for Western Australia's current 'growth miracle' were put in place in the late nineties and early noughties, when a couple of years of strong A\$ commodity prices underpinned strong mining profits, sparking significant mineral exploration as industry sought to take advantage of the State's natural resources. Increased access to emerging markets, in particular China, has also increased demand for the State's mineral and energy products. These factors led to a surge in investment as businesses, both local and international, sought to either tap into new or extend existing capacity in the resources sector. This spurred growth in the volume of new business investment in the State of 13% in 2001-02 and 22% in 2002-03, well above the 4% and 16% growth recorded for Australia as a whole. Investment to date has been concentrated in non-residential and engineering construction, the volume of which increased by an incredible 60% in the last year. While mining and resource-related manufacturing accounted for the majority of this expenditure, activity has also been supported by a number of other projects in the office, entertainment, retail and hotel sectors.

Business investment should continue to support strong growth in the Western Australian economy for some time to come. Some \$15 billion of projects are now currently either underway or committed, with another \$22 billion of

investment presently under consideration¹. Again, investor interest is mainly concentrated in the resources sector. Nevertheless, as the recent fall off in the amount of work in the pipeline signals, while activity remains strong, the current investment cycle is now close to its peak. There is also likely to be some rotation in growth between the different types of investment with plant and equipment investment set to take off as engineering and non-residential construction is completed and projects move to the 'equipping stage'.

Chart 1: WA's investment boom is peaking



Source: ABS

Exports the key to sustaining the upturn

As the business investment cycle matures, the Western Australian economy will be looking to exports to take over as the driver of growth. With the global economy on track to return to trend over 2004, the drought breaking and increased mining capacity (as a result of earlier strong investment) coming on line, exports could not be better placed. Indeed, increased mineral and energy production has already provided a vital boost to growth with increased capacity of gold, LNG and iron ore allowing Western Australian merchandise exports to grow by an extraordinary 11% in 2002-03. In contrast, total Australian exports of goods posted a small decline in this period. Exports from Western Australia should maintain their current momentum to record near double-digit growth again in both 2003-04 and 2004-05.

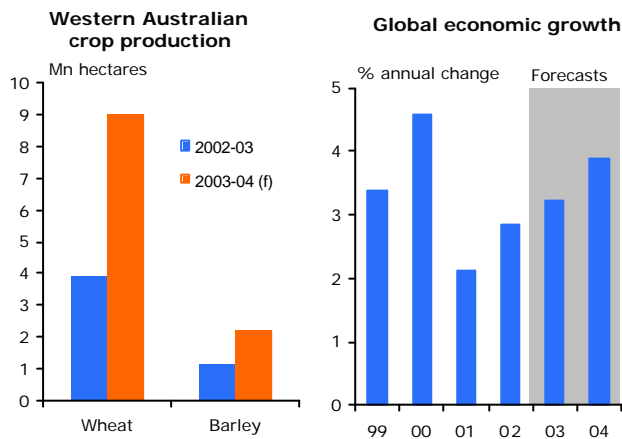
Mineral and energy commodities account for over half of Western Australian exports and with higher capacity in train, look set for a couple of bumper years. Projects either recently completed or near completion that will add to resource exports in 2003-04 include the West Angelas iron ore mine, the Thunderbox gold project and Mining area C. In 2004-05, exports should be boosted significantly from higher LNG production as the 4th train expansion of the North West shelf comes on stream. Stronger demand from the global economy, in particular

¹ Access Economics Investment Monitor, June 2003

Japan and China, should also ensure Western Australian resource exports remain strong.

Western Australia also stands to reap great benefits from recent higher rainfall. Having been ravaged last year by the drought, Western Australia, the nation's largest grain producer, is primed for a record harvest in 2003-04. The State's wheat crop is on track to nearly triple while the barley crop looks set to double. While accounting for only a relatively small proportion (<15%) of total exports, Western Australia's manufactured and tourism-related exports should also turn up as global demand improves (Chart 3).

Chart 2: Factors in place for strong export growth



Source: ABARE, Datastream, Economics@ANZ

Domestic economy performing well

The challenge for the Western Australian economy over the period ahead is to translate strength in the commodities sectors through to other components of domestic spending to create a more broadly-based, overall sustainable growth path.

The State's labour market has received a significant boost from the business investment boom with the unemployment rate in Western Australia below the national average for most of the last year. Higher employment has boosted household incomes, in turn feeding through to higher spending. Retail sales in Western Australia have increased solidly over the last year while consumer sentiment has increased to a 9-year high.

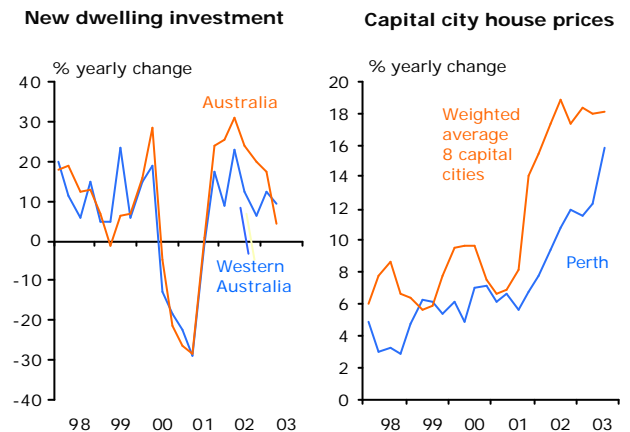
A recent moderation in the ANZ newspaper job ads series for Western Australia suggests that employment growth in the State is likely to soften a little from its current rapid pace in the period ahead. In large part, this reflects the maturation of the business investment cycle, as projects move out of the more labour-intensive construction phase into the more capital-intensive equipping and production stage. Mineral and energy projects in particular are less labour-intensive in the latter stages with the current investment boom estimated to create around 50 000 jobs during the construction phase, but only around 14 000 jobs when operations are

commenced². As mining-related jobs growth moderates over the coming year, new job opportunities will emerge in the agricultural and hospitality sectors, as crop production rebounds and tourism improves.

Overall, employment growth in Western Australia therefore looks set to remain solid, although some wind-down in non-residential building and engineering construction will see the State struggle to replicate the strong jobs growth of last year. The unemployment rate therefore is unlikely to fall much further below its current low level of 6%. A more moderate pace of employment growth will in turn limit the extent to which household consumption growth in Western Australia can continue to outperform. Another constraint to household spending is that Western Australians have not enjoyed as large a rise in housing-related wealth as most of the rest of the nation over the last couple of years.

In spite of comparatively stronger economic growth, house price gains in Western Australia have failed to keep pace with the national average. While the average house price in Perth has increased by a stunning 53% in the last five years, it is still well below the average capital city price increase of 76% in this period. Factors likely to have restrained house price appreciation in the West include a relative abundance of suitable land and also a comparatively higher rate of stamp duty, which the State government has recently increased to be the highest of all States.

Chart 3: WA's housing market not as hot



Source: ABS

Another factor that may be restraining house price growth in Western Australia is that, in spite of good conditions at home, interstate migration has turned negative. This actually reverses much of the trend of the 1990s, when Western Australia enjoyed migration gains from other States and Territories. This recent trend constrains demand for new housing and has nullified some of the gains to the State from continued strong overseas net migration. Failure to turn interstate migration positive again, or to offset the loss of locals to other States through higher rates of overseas migration,

² Access Economics Investment Monitor, June 2003

will eventually restrain more than just Western Australia's housing market, limiting the pool of available labour, household consumption growth and ultimately overall economic growth. One key to avoiding this risk is through an extended period of strong, broadly-based economic growth, which should reduce the incentive for Western Australians to move across to the East Coast.

Overall though, in the short-term, the prognosis for the broader Western Australian economy (ie. the non-commodities sector) is good. While housing wealth gains have been more moderate in this State, firm employment growth should continue to underpin solid growth in household consumption, albeit at a slightly lower rate than enjoyed in the year just past. Meanwhile, just as Western Australia has missed out on some of the housing boom that has gripped most of the rest of Australia, it is also likely to experience a relatively softer landing over the coming period. Indeed, while some East Coast housing markets are currently turning down, dwelling investment (and its leading indicators) in Western Australia has remained firm. While negative net interstate migration is a concern for this sector, this should be at least partly offset by strong overseas net migration and the higher proportion of Western Australia's population in key household formation age groups. Hence, while the commodities sector is set to again dominate the State's economy, the broader Western Australian economy should continue to enjoy some of the spoils.

All regions to enjoy brighter prospects

While the overall pace of economic growth is expected to moderate a little over 2003-04, growth should be more broadly-based across the different regions of Western Australia compared with last year. The Pilbara has been one of the main recipients of the State's mineral and energy boom and looks set for another bumper year, underpinned by major projects including the Burrup Fertiliser's A\$630mn ammonia plant and the A\$1.2bn Telfer Deeps gold mine expansion. A number of mining projects, including the A\$290mn Argyle diamond mine expansion, should also help the Kimberley region continue to grow solidly, partly offsetting continued tough conditions for livestock producers. This region will also benefit from an upturn in international tourism, while increased domestic flights to Broome should boost domestic tourism. Solid population growth, due to both solid local economic prospects and the 'seachange' phenomenon, will also benefit the Kimberley. The 2002 completion of the Thunderbox gold project will support solid export growth from the Goldfields/Esperance region, which should also benefit from continued high gold prices over the coming year. This region will also receive a boost from a number of smaller investment projects, including the A\$87mn Sunrise Dam underground gold project.

Having been hit hard by the drought and thus missing out on much of last year's good times, prospects are set to turn around sharply in Western Australia's Wheatbelt in 2003-04, as farmers and related industries benefit from the combination of an expected near record grain crop.

The Mid-West region is also set to benefit from a sharp rebound in wheat production while the A\$100mn upgrade to the Geraldton Port will facilitate export growth in the coming year. Having avoided the worst of the drought, agricultural production in the South West should enjoy even better conditions this year. Growth in tourism should also help this region, as should recent solid population growth. Continued tourism and better seasonal conditions should also benefit the Gascoyne while the post-SARS rebound in East Asia is good news for this region's seafood export industry.

With regional conditions strong, it is no surprise to that the outlook for Perth and immediate surrounds are also solid. The mining boom has directly benefited this city, through for example the construction of the Woodside Headquarters and the \$600mn Kwinana HIs melt pig iron and steel plant near Perth. The mining boom has also generated considerable indirect benefits for this city as a large portion of miner's spending money finds its way back to Perth, stimulating retail and motor vehicle sales as well as the housing market.

What are the risks to growth?

There are both positive and negative risks to our central case outlook for the Western Australian economy. On the positive side, business investment could continue to grow more strongly than anticipated, should a sharper than expected rebound in global growth, particularly in the East Asian region, contribute more strongly to profit expectations. There is also the possibility that the expected ramp up in mining production over the coming years could contribute more than anticipated to employment growth in the State, prompting stronger income growth, household spending and dwelling investment.

On the other hand, a higher Australian dollar poses a risk to some of the more marginal resource projects in the West, as already seen by the scaling down of the Methanex methanol plant. Economics@ANZ expects the A\$ to peak at US\$0.70c mid-next year. An appreciation well in excess of this target would likely deter an increasing number of future investment projects as well as putting some export industries under pressure. As noted earlier, negative net interstate migration out of Western Australia is also a concern, given the potential constraint to employment growth and spending over the longer term. Public finances have also caused some concern recently. With the Western Australian economy performing so strongly, it is a surprise to discover that the Government faces a challenge to keep the Budget in the black next year after a \$504mn blow-out in expenditure in fiscal 2003, and that Government net debt is set to rise. Reducing the coffers constrains the Government's capacity to respond to unexpected shocks while any blow-out in net debt poses a direct threat to the State's AAA credit rating. A cut to this rating would raise the cost of borrowing, by government and business, putting the State at a distinct disadvantage to attract further investment.

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