



Department of Treasury and Finance  
Government of Western Australia

Western Australian  
**E c o n o m i c**  
**S u m m a r y**

SUMMER-AUTUMN 2006

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**CONTENTS**

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<b>EXECUTIVE SUMMARY .....</b>	<b>2</b>
<b>1. THE ECONOMY .....</b>	<b>4</b>
OVERVIEW .....	4
HOUSEHOLD CONSUMPTION .....	6
DWELLING INVESTMENT.....	11
BUSINESS INVESTMENT .....	17
TRADE AND THE WORLD ECONOMY.....	21
LABOUR MARKET .....	35
PRICES, INCOMES AND INTEREST RATES.....	43
INTERNATIONAL CONDITIONS.....	48
<b>2. LABOUR SUPPLY IN WESTERN AUSTRALIA.....</b>	<b>51</b>
<b>3. CHINA: AN ECONOMIC AND STRUCTURAL     OUTLOOK.....</b>	<b>71</b>
<b>4. 2006-07 BUDGET .....</b>	<b>82</b>
<b>APPENDIX 1 WESTERN AUSTRALIAN EXPORTS     BY COMMODITY .....</b>	<b>90</b>
<b>APPENDIX 2 WESTERN AUSTRALIAN EXPORTS     BY DESTINATION .....</b>	<b>91</b>
<b>GLOSSARY.....</b>	<b>92</b>

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## EXECUTIVE SUMMARY

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*Economic activity in Western Australia is buoyant, underpinned by household consumption and business investment. Western Australia's domestic economy grew by 1.7% in the March quarter 2006 and by 9.0% in annual average terms<sup>1</sup> in the year to March.*

*The strength of economic activity in Western Australia is reflected in household consumption, which has drawn impetus from a range of factors including low unemployment, strong wages growth, rising house prices (generating a wealth effect), and high levels of consumer confidence. High fuel prices and the prospect of further interest rate rises appear to have had no discernable negative effect on Western Australians' household consumption to this point. While growth in household consumption has moderated over the past year, it is still high both by historical standards and compared to national trends. Household consumption grew by 0.7% in the March quarter 2006 and increased by 6.4% in the year to March.*

*The housing market in Western Australia also has considerable momentum with population growth, high consumer sentiment and employment and earnings growth contributing to strong dwelling investment. Although dwelling investment fell by 0.4% during the March quarter, it grew by 6.5% over the year to March. Forward indicators for the housing market point to a high level of new dwelling construction activity and robust demand for established houses continuing into 2006-07.*

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<sup>1</sup> The annual average growth rate compares the level of activity in a 4-quarter period with the previous 4 quarters – in this case, comparing the period from June 2005 to March 2006 with the period from June 2004 to March 2005. This gives a less volatile measure of annual growth than the more common practice of comparing a particular month or quarter with the same month or quarter of the previous year.

*Most of the expansion in Western Australia's domestic economy in the March quarter 2006 was due to an increase in business investment, reflecting growth in major resource-related projects. High global demand and prices for many of the main commodities produced in Western Australia have induced strong growth in investment, reflected by business investment growth of 4.7% in the March quarter and annual average growth of 28.4%. The outlook for business investment in the State is positive, with activity in the near term likely to be sustained by the significant number of resource-related projects already under way, and further capacity expansions expected in key mineral and energy developments over the next year or so.*

*External conditions have been particularly favourable for Western Australia, with strong growth in China currently a major driver of Western Australian investment and exports. China's growth is also driving the economic growth of many of its neighbouring countries, many of which are also Western Australia's key trading partners. For example, the economic expansion in Japan is also likely to boost export demand.*

*Western Australia's robust economic conditions are also reflected in the labour market. Employment growth is high, with annual average growth remaining strong (although it has decelerated recently due to limited labour supply). The State's unemployment rate is at its lowest level since the current data series began in 1978.*

*This edition of the Economic Summary has three feature articles:*

- The first outlines recent trends in the State's labour supply and examines some of the economic and welfare implications of current labour shortages in Western Australia;*
- The second discusses China's economic and structural outlook; and*
- The third provides an outline of the State's fiscal outlook as presented in the 2006-07 Budget, which was delivered on the 11 May.*

## 1. THE ECONOMY

### OVERVIEW

- *The Western Australian economy showed considerable strength across a range of indicators in the March quarter 2006, with State Final Demand increasing by 1.7% in the quarter and by 9.0% in annual average terms<sup>2</sup>.*

Domestic demand in Western Australia increased by 1.7% during the March quarter 2006, with household consumption and business investment the main components contributing to growth. Over the year, domestic demand in Western Australia rose by 9.0%, with the rate of growth in domestic economic activity during the quarter and year exceeding national growth.

#### State Final Demand

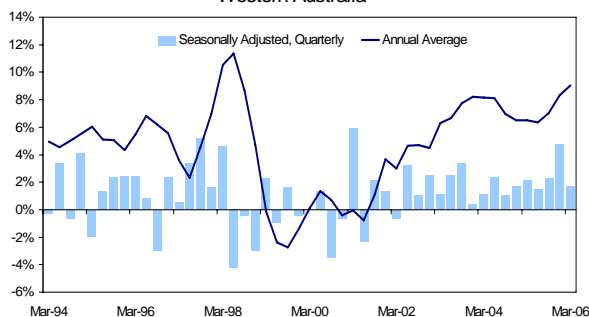
Real Growth (%)

March quarter 2006

	qtr	yr*
NSW	0.0	2.9
Vic	0.1	4.0
Qld	3.3	6.1
<b>WA</b>	<b>1.7</b>	<b>9.0</b>
SA	0.7	3.6
Tas	0.7	6.2
<b>Aust</b>	<b>0.8</b>	<b>4.6</b>

\* In annual average terms.

DOMESTIC DEMAND GROWTH  
Western Australia



Source: ABS Cat. 5206.0

<sup>2</sup> The annual average growth rate compares the level of activity in a 4-quarter period with activity the previous 4 quarters - in this case, comparing the period from June 2005 to March 2006 with the period from June 2004 to March 2005. This gives a less volatile measure of annual growth than the more common practice of comparing activity in a particular month or quarter with the same month or quarter of the previous year.

**Household consumption** increased by 0.7% in the March quarter 2006, after growing by 1.1% in the previous quarter. Consumer spending seems unaffected so far by high and unpredictable fuel prices and the prospect of further interest rate rises.

**Dwelling investment** in Western Australia is at a record high, driven by favourable economic fundamentals including rising population growth, strong commodity prices, and high employment and earnings. Housing market indicators such as building approvals point to continuing high levels of activity in both the established market and new dwelling construction.

**Business investment** in Western Australia grew by 8.0% over the quarter to March, and by 28.4% in annual average terms.

The 2006-07 State Budget forecasts<sup>3</sup> estimate that the Western Australian economy grew by 4.75% in 2005-06, driven by a strong domestic economy, with consumer spending and business investment the main contributors to growth. Spending on dwelling investment is also expected to contribute to growth, as the State's labour market and investor activity fuel housing demand.

Growth in domestic economic activity is expected to ease in 2006-07, with State Final Demand forecast to increase by 4.0%. This will follow what is likely to have been the fifth consecutive year of above-trend growth in domestic economic activity, with the forecast moderation in domestic growth a result of softer growth in household consumption, business investment and dwelling investment.

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<sup>3</sup> Released on 11 May 2006, see Budget Paper 3 for economic forecasts and analysis [http://www.dtf.wa.gov.au/cms/uploadedFiles/200607\\_BP3.pdf](http://www.dtf.wa.gov.au/cms/uploadedFiles/200607_BP3.pdf)

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## HOUSEHOLD CONSUMPTION

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- *Household consumption rose by 0.7% in the March quarter 2006, despite further rises in fuel prices and the likelihood of a further tightening in the cash rate.*
- *Consumption growth has been supported by a range of factors including rising house prices, employment and wages growth, and high levels of consumer confidence.*
- *Growth in consumption in Western Australia has moderated over the past year, but is still high both by historical standards and compared to national trends. In annual average terms, household consumption increased by 6.4% in the year to March, above the 3.8% growth recorded nationally.*
- *Partial indicators of consumption (e.g. retail turnover and new motor vehicle sales) suggest that household consumption growth will be positive in the near term.*

### **Recent Conditions**

Western Australia's real household consumption increased by 0.7% in the March quarter 2006, following growth of 1.1% in the December quarter 2005. In annual average terms, real consumption rose by 4.4% in the year to March.

Several factors are supporting consumption growth. Strong growth in Western Australia's residential property prices, and increases in share prices to early 2006, have raised household wealth. High levels of consumer confidence and relatively low interest rates (despite the increase in May) have also supported borrowing and spending. Household disposable incomes have been boosted by high employment levels and earnings growth, and rising net migration has also contributed to demand growth.

These factors have more than offset any negative effects on consumption of rising fuel prices and concerns at the likelihood of a further rise in the cash rate following May's rate rise.

Real annual growth in consumption has nonetheless decelerated in recent quarters, reflecting a downward shift in growth from the unsustainably high increases in consumer spending to mid 2004 (see following chart).

## Household Consumption

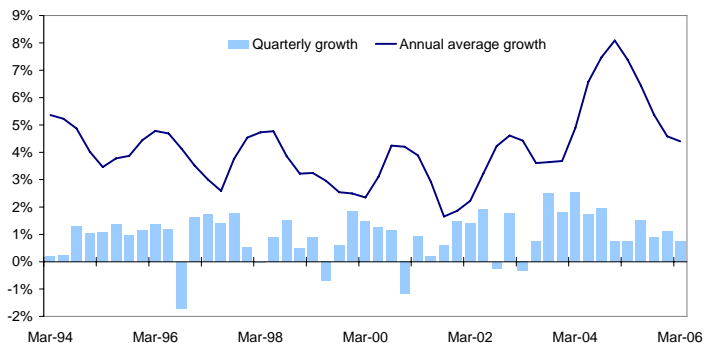
Real Growth (%)

Period to March 2006

	qtr	yr*
NSW	0.7	2.1
Vic	1.3	3.1
Qld	0.8	3.8
<b>WA</b>	<b>0.7</b>	<b>4.4</b>
SA	0.4	2.6
Tas	1.0	5.0
<b>Aust</b>	<b>0.9</b>	<b>3.0</b>

\* In annual average terms

HOUSEHOLD CONSUMPTION GROWTH  
Western Australia



Source: ABS Cat. 5206.0

Western Australian real household consumption was fairly strong across most categories in the March quarter 2006. Spending on electricity, gas and other fuel increased by 2.7%, clothing and footwear by 2.3%, food by 2.0%, furnishings and household equipment by 2.0%, operation of vehicles by 1.5%, rent and other dwelling costs by 1.1% and insurance and other financial services by 1.0%.

These increases were partly offset by a decline in spending on transport services (down 3.5%), cigarettes and tobacco (down 3.3%), recreation and culture (down 1.5%), purchase of vehicles (down 0.4%) and hotels, cafes and accommodation (down 0.1%).

### Retail Turnover

Retail turnover accounts for about 40% of private consumption in Western Australia, and underlying trend growth in retail sales has accelerated since late 2005.

The volume of retail turnover rose by 2.3% in the March quarter. More recent (nominal) data indicate that turnover rose by 3.2% in the three months to April 2006, more than double its long-term average rate of quarterly growth. In annual average terms, nominal retail turnover growth was 6.4%, well above national growth of 3.8%.



**Retail Turnover**

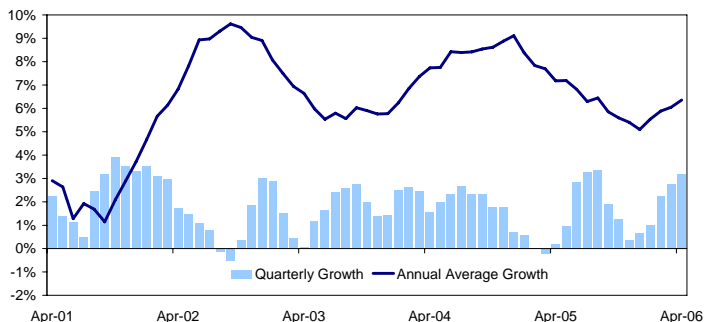
Nominal Growth (%)

Period to April 2006

	qtr*	yr*
NSW	1.4	2.6
Vic	3.5	3.6
Qld	1.7	5.1
<b>WA</b>	<b>3.2</b>	<b>6.4</b>
SA	2.3	1.9
Tas	1.0	6.6
<b>Aust</b>	<b>2.2</b>	<b>3.8</b>

\* In annual average terms.

RETAIL TURNOVER  
Western Australia

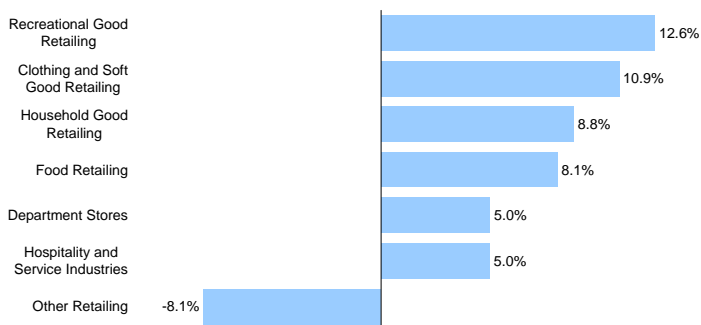


Source: ABS Cat. 8501.0

At 6.4%, retail turnover growth in annual average terms is still below its most recent peak of 9.1% in the year to December 2004, and is around its long-term average rate of growth.

In annual average terms growth in expenditure over the year to April was strongest on recreational items (such as books, sport, toys and games and leisure equipment) (albeit, from a much smaller base). Growth in spending in other sectors including food, household goods retailing, and clothing and soft goods retailing was also relatively high over the period. This increase in discretionary spending during the period perhaps reflects favourable economic conditions and a high level of consumer confidence - only 'other retailing' (which includes pharmaceutical retailing, and retailing not elsewhere classified) fell over the period.

WA RETAIL SALES BY INDUSTRY\*  
Annual Average to April 2006, Western Australia



Source: ABS Cat. 8501.0

### New Motor Vehicle Sales

Annual average growth in new motor vehicle sales was 10.1% in Western Australia for April 2006, well above sales growth of 0.7% Australia-wide. Sales of new motor vehicles rose by 2.1% during April.

The 20% rise in petrol prices<sup>4</sup> seems to have had no detrimental effect on the number of cars sold, but may be affecting the types of cars sold, or perhaps encouraging the replacement of older less fuel-efficient cars with newer ones<sup>5</sup>.

New motor vehicle sales fell across the three months to April 2006 in all States apart from Tasmania. In Western Australia, some 25,900 new motor vehicles were sold in the period, falling by 1.6% from the three months to January 2006. This was mainly a result of a fall in passenger and sports utility vehicles sales, with sales of 'other' vehicles (such as panel vans and utilities) partly offsetting this decline.

### New Motor Vehicle Sales

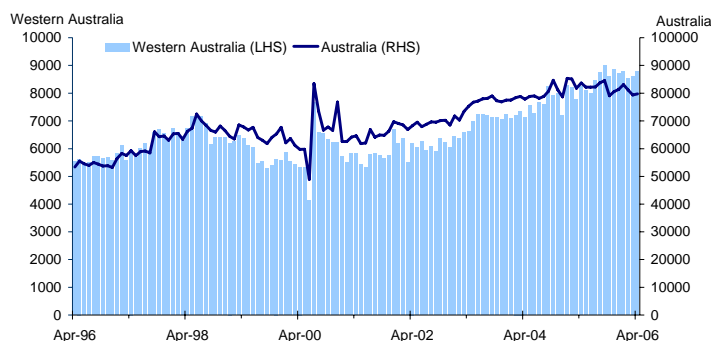
#### *Nominal Growth (%)*

#### *Period to April 2006*

	<i>qtr</i>	<i>yr*</i>
NSW	-0.8	-2.8
Vic	-4.6	0.4
Qld	-0.9	2.7
<b>WA</b>	<b>-1.6</b>	<b>10.1</b>
SA	-2.7	-1.3
Tas	1.9	-3.4
<b>Aust</b>	<b>-2.0</b>	<b>0.7</b>

\* In annual average terms.

MONTHLY SALES OF NEW MOTOR VEHICLES  
Western Australia and Australia, Seasonally Adjusted



Source: ABS Cat. 9314.0

### *Outlook*

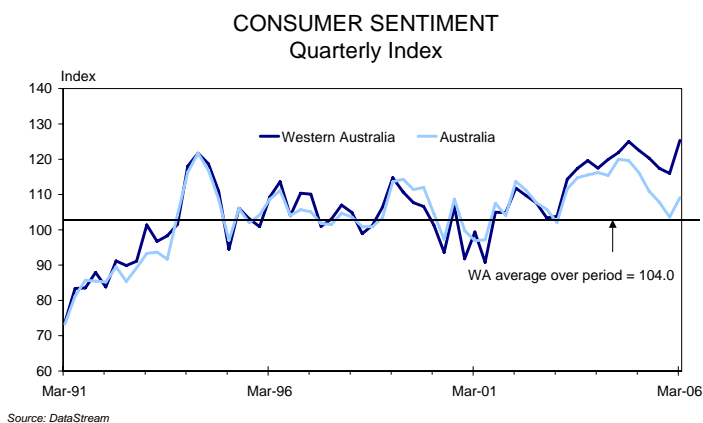
High levels of consumer sentiment, relatively low interest rates, low unemployment and wealth effects from property price rises should sustain further growth in household consumption in Western Australia.

<sup>4</sup> Source: Unleaded Perth metropolitan \$p/L from [www.fuelwatch.wa.gov.au](http://www.fuelwatch.wa.gov.au)

<sup>5</sup> Source: Fuel efficient cars, [www.mynrma.com.au](http://www.mynrma.com.au)

These favourable influences appear to have more than offset the effects of interest rate rises and high fuel prices, with many households appearing to have adjusted their budgets to take account of persistent high fuel prices.

National consumer sentiment fell after the Reserve Bank of Australia's May 2006 interest rate increase, but consumer sentiment in Western Australia rose slightly<sup>6</sup>. Over the March quarter, consumer sentiment fell in Western Australia (as it did across the country) but was higher than its long-term average and higher than sentiment nationally.



The DTF's 2006-07 Budget forecasts are for household consumption to increase by 5.0% in 2005-06 and 3.5% in 2006-07.

<sup>6</sup> As monthly consumer sentiment data are typically volatile, quarterly data are preferred, but the effect of May's interest rate rise will not be reflected in the quarterly numbers for some months.

## DWELLING INVESTMENT

- *Dwelling investment in Western Australia grew by 2.2% in trend terms in the March quarter 2006, underpinned by positive housing market fundamentals and a large backlog of work under way.*
- *Forward indicators for the housing market point to a high level of new dwelling construction activity and robust demand for established houses continuing in the near term.*
- *Dwelling investment is expected to grow by 8.5% in 2004-05, followed by an increase of 5.5% in 2006-07.*

### Recent Conditions

Favourable economic conditions, including population growth, high consumer sentiment and employment and earnings growth, have generated strong dwelling investment activity in Western Australia.

While dwelling investment levels are high, the rate of growth may be stabilising. Seasonally adjusted dwelling investment fell by 0.4% in the March quarter 2006, but this followed an increase of 8.4% in the December quarter 2005. In less volatile trend terms, dwelling investment grew by 2.2% in the March quarter, compared to a decline nationally of 2.0% (see following chart).

### Dwelling Investment

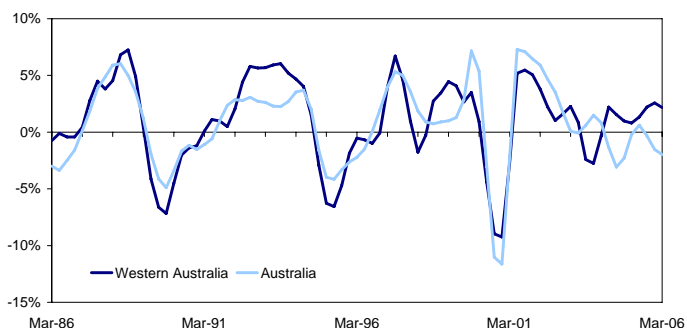
Real Growth (%)

Period to March 2006

	qtr	yr*
NSW	-2.2	-10.4
Vic	-5.8	-2.5
Qld	2.5	3.0
<b>WA</b>	<b>-0.4</b>	<b>6.5</b>
SA	6.7	7.6
Tas	4.0	-1.0
<b>Aust</b>	<b>-0.6</b>	<b>-1.9</b>

\* In annual average terms.

DWELLING INVESTMENT  
3-Monthly % Change, Trend



Source: ABS Cat. 5206.0

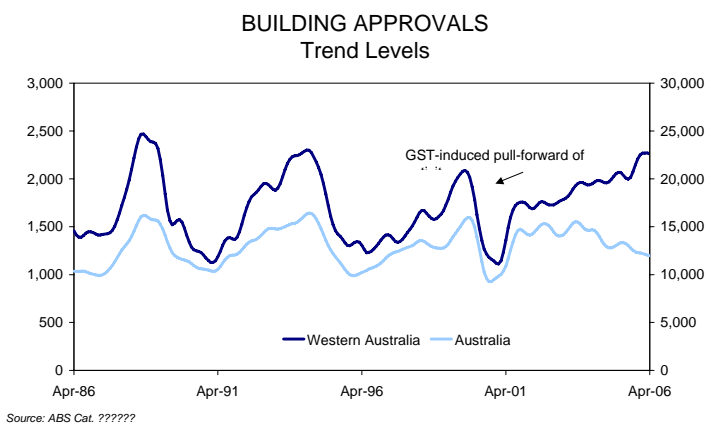
### Housing Indicators

The housing market in Western Australia has considerable momentum, with recent data indicating high levels of activity for both construction and established housing.

### Residential Construction

New dwelling construction grew by 1.4% in seasonally adjusted terms in the March quarter, and by 2.3% in underlying trend terms.

Seasonally adjusted building approvals tend to be volatile. Western Australia's approvals rebounded in April, following a decline in February that in turn followed large increases in previous months. However, the underlying trend indicates that approvals may have peaked, with a small drop between March and April 2006.



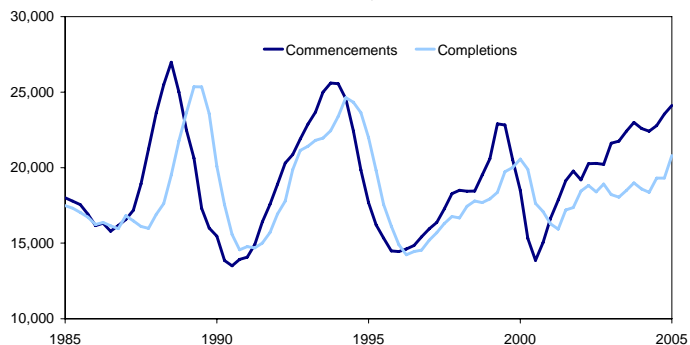
The number of building approvals is nonetheless still high by historical standards (see preceding chart), indicating that the high level of residential construction activity is likely to be sustained in the near term.

The number of dwelling commencements<sup>7</sup> in Western Australia declined by 5.0% in the December quarter 2005, following a cumulative increase of 17.5% over the previous three quarters.

However, the decline in dwelling commencements may reflect capacity constraints rather than to a moderation in demand, and dwelling commencements are still at a high level.

<sup>7</sup> Although building approvals are a more timely indication of trends in residential construction activity, dwelling commencements data are a more accurate indication of the number of dwellings that were actually commenced in a particular period.

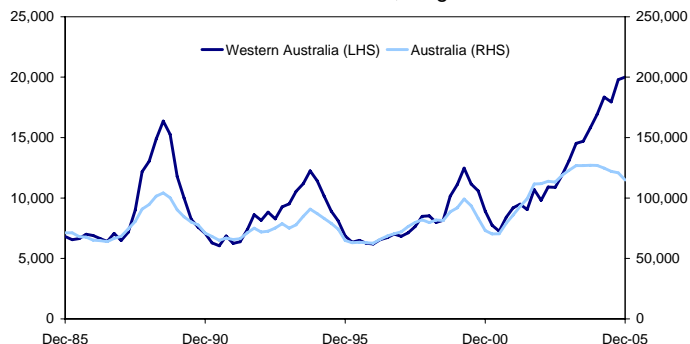
RESIDENTIAL CONSTRUCTION ACTIVITY  
Western Australia, Annual Total



Source: ABS Cat. ????????

The trend number of residential buildings commenced in Western Australia has exceeded completions in each quarter since September 2001, leading to the stock of dwellings under construction rising to a record high of more than 20,000. In contrast, Australia’s softer housing market has seen the stock of dwellings under construction decline from its September 2004 peak (see following chart).

STOCK OF DWELLINGS UNDER CONSTRUCTION  
Western Australia, Original

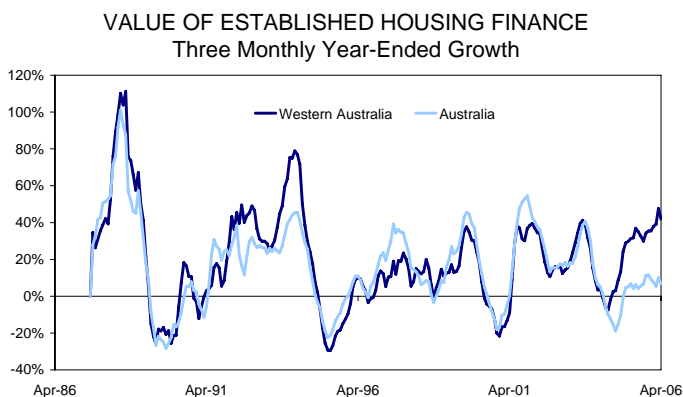


Source: ABS Cat. 8752.0

### Established Homes

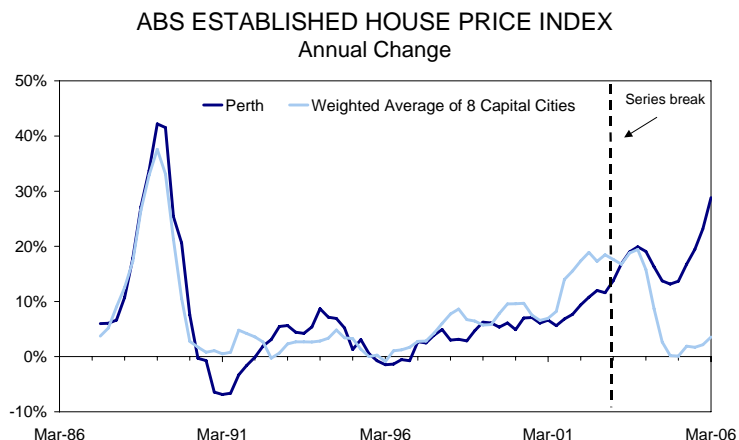
Ownership transfer costs<sup>8</sup> grew by 3.7% in seasonally adjusted terms during the March quarter, and by 2.8% in underlying trend terms. Data on housing finance in Western Australia also indicate growth in both the volume of activity and in the average price of established houses.

The number of owner occupied housing finance commitments for established houses (excluding refinancing) was 16.6% higher in the three months to April 2006 than in the corresponding period of 2005. The total value of finance for established houses (including for both owner occupiers and investors, but excluding refinancing) was 41.8% higher over the same period (see following chart).



This increase in the value of commitments reflects both a rise in the volume of transactions and recent increases in established house prices. Established house price data from the Australian Bureau of Statistics indicate that Perth prices grew by 8.8% in the March quarter 2006, to be 28.8% higher than in the March quarter 2005 (see following chart).

<sup>8</sup> Ownership transfer costs comprise costs such as legal/conveyancing fees, real estate agent/auctioneer fees, and government taxes/charges (such as stamp duty), and include such costs for newly built and established dwellings, other buildings and structures and unoccupied land.



These trends are broadly consistent with data from the Real Estate Institute of Western Australia, which indicate that the median house price for Perth of \$353,000 in the March quarter 2006 was 23.9% higher than the March quarter 2005.<sup>9</sup>

### **Outlook**

The Western Australian Government's 2005-06 Budget forecasts estimate that dwelling investment grew by 8.5% in 2005-06, reflecting activity in the residential construction sector, and also strong activity in the established housing market.

The large amount of residential construction work yet to be done, and the favourable economic fundamentals currently supporting Western Australia's housing market, should underpin growth in demand for new housing into 2006-07, with dwelling investment forecast to increase by 5.5%.

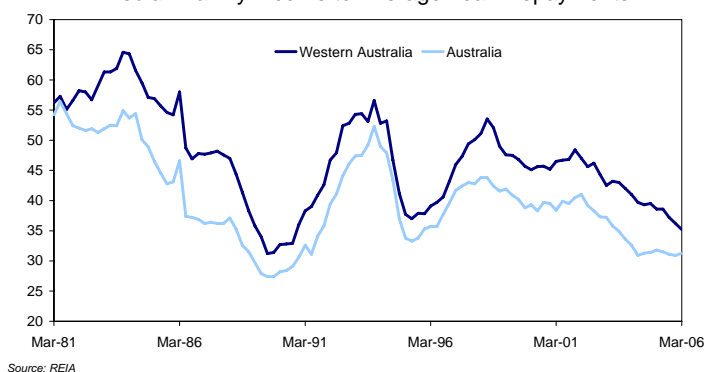
<sup>9</sup> Real Estate Institute of Western Australia (2006), Media release – *March quarter figures – Perth still growing strongly*, 17 May.



Declining home loan affordability in Western Australia represents a risk to this positive outlook. According to the Real Estate Institute of Australia, the ratio of median family income to average loan repayments for Western Australia declined by 2.8% in the March quarter 2006, to be 8.8% lower than in the March quarter 2005 (see following chart).<sup>10</sup>

House prices in Western Australia are still more affordable than in the larger States, despite this decline.

REIA HOME LOAN AFFORDABILITY INDICATOR  
Median Family Income to Average Loan Repayments



<sup>10</sup> Real Estate Institute of Australia (2006), *Home loan affordability report*, Quarterly survey no. 86, March quarter.

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## BUSINESS INVESTMENT

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- *Business investment grew by 8.0% in trend terms in the March quarter 2006, mainly reflecting growth in major resource-related projects. This activity also underpinned the annual average growth in investment of 28.4% for the year to the March quarter 2006.*
- *Activity in the near term is likely to be sustained by the significant number of resource-related projects already under way, and further capacity expansions expected in key mineral and energy developments over the next year or so.*
- *Shortages of labour and some key inputs (such as steel) are influencing the timing and costs of some large projects. While high commodity prices are helping to offset these costs, capacity constraints are affecting the ability of projects to meet budgets and timelines.*
- *Western Australia's key commodity prices are likely to remain strong in the near term, and this should support sustained high levels of business investment. Construction activity already under way is sustain growth in income flows and employment levels in Western Australia, even though cost pressures are likely to persist in the short term.*
- *Forecasts from the Western Australian Government's recently released 2006-07 Budget are for business investment to grow by 15.0% in 2005-06, before easing to 5.0% in 2006-07 and 3.0% in 2007-08.*

### **Recent Conditions**

High global demand and prices for many of the main commodities produced in Western Australia has induced strong growth in investment (see section on Commodity Prices in the [Trade and the World Economy](#) section).

Trend business investment in Western Australia grew by 8.0% over the quarter to March and by 28.4%, in annual average terms, for the year to the March quarter 2006.

## Business Investment

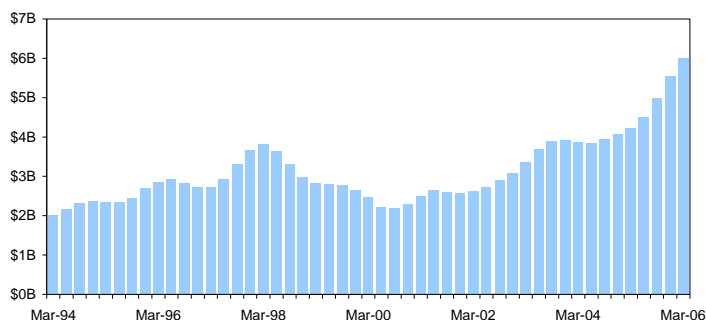
Real Growth (%)

March Qtr 2006

	qtr*	yr
NSW	-0.8	17.1
Vic	1.9	16.3
Qld	6.4	17.3
<b>WA</b>	<b>8.0</b>	<b>28.4</b>
SA	0.5	6.3
Tas	1.0	23.4
<b>Aust</b>	<b>3.2</b>	<b>18.2</b>

\* In trend terms.

BUSINESS INVESTMENT  
Quarterly, Trend Levels, Western Australia



Source: ABS 5206.0 Table 80

As a result, Western Australia now accounts for nearly 19% of all major Australian investment projects currently under construction<sup>11</sup>. Major private sector resource-related projects under way in the State include<sup>12</sup>:

- BHP Billiton's \$2.3 billion Ravensthorpe nickel project;
- the North West Shelf Consortium's \$2.0 billion 5<sup>th</sup> LNG train;
- Hamersley Iron's \$1.6 billion Yandicoogina iron ore mine & Port of Dampier upgrade;
- Woodside's \$1.5 billion Enfield, Vincent & Laverda oil & gas project;
- Hancock Prospecting / Rio Tinto's \$1.3 billion Hope Downs Iron Ore project; and
- BHP Billiton's \$750 million 'Rapid Growth 2' iron ore expansion.

## Outlook

A number of indicators point to favourable conditions promoting further growth in business investment over at least the next year or so.

<sup>11</sup> Access Economics Investment Monitor (March Quarter, 2006) – data is for all projects worth \$5 million or higher, and includes projects for both the private and public sectors.

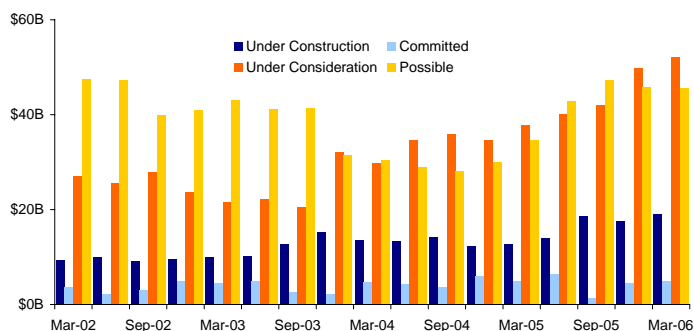
<sup>12</sup> Major projects worth at least \$500 million or more, Access Economics Investment Monitor (March Quarter, 2006)

Strong global economic growth has generated high demand and prices for the State's commodities exports. Company profit levels are high, despite recent declines in the prices of many resource stocks and other equities.

Western Australian businesses' capital investment intentions<sup>13</sup> and expectations of future near term conditions<sup>14</sup> are very positive.

Activity over the next few years is likely to be sustained by the significant number of private sector resource-related projects already under way (see list above), as well as further capacity expansions expected in key mineral and energy developments.

VALUE OF PROJECTS BY STATUS  
Western Australia



Source: Access Economics Investment Monitor

The \$48.1 billion worth of private sector projects currently under active consideration<sup>15</sup> in the State (see previous chart) bodes well for the overall outlook for business investment, but not all will go ahead. Many of these projects are competing for the same (scarce) pool of appropriately skilled labour (as well as other key resources). Of the ones that do go ahead, some of these may not commence for some years.

<sup>13</sup> ABS Private New Capital Expenditure and Expected Expenditure, Catalogue 5625.0

<sup>14</sup> CCI-BankWest Survey of WA Business Expectations, June quarter 2006

<sup>15</sup> Access Economics Investment Monitor (March Quarter, 2006)

Ongoing high input costs and resource constraints may cause some crowding out the more marginal investment projects - particularly for those that are not resource-related, and so may not be benefiting high world commodity prices. Such constraints are unlikely to ease in the near term, given the large number of major projects expected over the next year or so.

Proponents of major resource-related projects may be able to mitigate some of these constraints. For example, various strategies have been employed to enable the North West Shelf Consortium's fifth LNG train to be constructed using an estimated five million person hours, compared to the similarly-designed fourth LNG train, which required twelve million hours<sup>16</sup>.

Global supply of many of the State's main commodity exports is likely to increase over time, as other producers as well as Western Australia are investing heavily to boost capacity to take advantage of strong global demand. This may lead to a drop in commodity prices in the medium to longer term, but in the short term prices are forecast to remain high. The Australian Bureau of Agricultural and Resource Economics (ABARE) forecasts that its index of unit export returns for Australian commodities will increase by 5.9% in 2006-07, following a rise of 24.0% in 2005-06, reflecting further increases in higher prices for mineral and energy commodities on world markets<sup>17</sup>.

Forecasts from the 2006-07 Western Australian Government Budget are for business investment to grow by 15.0% in 2005-06<sup>18</sup>, before easing to 5.0% in 2006-07 and 3.0% in 2007-08.

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<sup>16</sup> Woodside LNG Phase V Expansion Update (Newsletter 1, December 2005)

<sup>17</sup> ABARE, *Australian Commodities*, June Quarter 2006, p.279

<sup>18</sup> A very strong March quarter (2006) result from ABS' latest State Accounts data release (Catalogue number 5206.0, published after the 2006-07 Budget) means that business investment is now growing by a robust 28.4% (in annual average terms).

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## TRADE AND THE WORLD ECONOMY

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- *Real exports declined by 5.2% in the March quarter 2006, partly reflecting lost output due to disruptions and shutdowns resulting from cyclone activity in January and February.*
- *Real imports grew by 9.7% in the March quarter. The volume of imports has more than doubled in the past four years.*
- *More recent nominal trade data indicate that the value of Western Australia's exports is strengthening, as strong prices more than offset relatively weak export volumes.*

### *Net Exports*

In the past two years the State's rising export prices have generated a steady increase in the value of Western Australia's merchandise trade surplus, despite strong growth in imports. However, export volume growth has been sluggish, and it appears that the strong business investment of recent years (see page 16) has not yet translated into significant increases in export capacity.

In the March quarter 2006 export volumes were affected by cyclones that caused shutdowns and disrupted output in the State's resource-rich North West. Over the three months to April 2006, Western Australia's trade surplus fell by 1.2% (or \$74 million) in nominal terms<sup>19</sup> when compared to same period a year earlier. Nationally, the trade deficit improved by \$2.3 billion over the same period.

Western Australia's nominal merchandise trade surplus of \$28.0 billion over the year to April 2006 is the State's largest on record, to be \$4.3 billion larger than the previous year. In comparison, the country as a whole recorded a deficit of \$15.2 billion, the smallest deficit since the year to April 2003, which is steadily improving as Western Australia's (and to a lesser extent Queensland's) trade surplus widens.

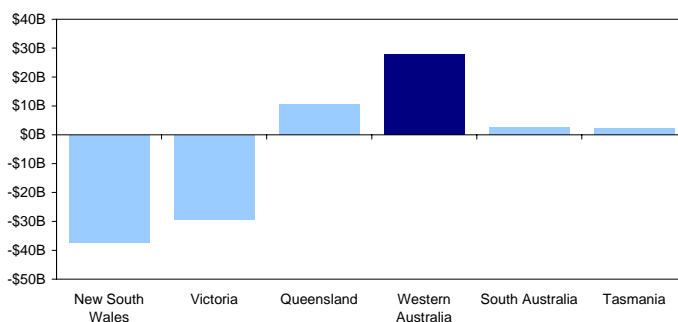
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<sup>19</sup> Trade data are based on two main sources, both from the ABS. Nominal data on trade values is not adjusted for price effects, although it provides a more timely indication of international trade patterns. Real data (based on ABS' National Accounts chain volume series) lags a few months behind nominal data but provides a better indication of international trade patterns that are not affected by changes in the prices of traded goods.

In real terms, net exports fell by 15.0% over the March quarter 2006, following an increase of 6.8% the previous quarter. Net exports were 5.4% lower in annual average terms over the year to March 2006.

The 2006-07 Budget forecasts the net export sector to make a small detraction from growth (decreasing by 3.75% in real terms) over 2005-06, as strong imports growth is expected to more than offset a moderate increase in the volume of exports.

MERCHANDISE TRADE BALANCE  
Year to April 2006 Total



Source: ABS Cat. 5368.0 and 5439.0

### *Exports*

In seasonally adjusted terms, real merchandise exports fell by 5.2% over the March quarter 2006, following growth of 4.2% in the December quarter 2005. Growth in exports has been moderating in annual average terms, reflecting lost exports due to a number of cyclones in the North-West in January and February, following a fluctuating but fairly flat pattern in the previous three quarters. Over the year to March 2006, real exports grew by 2.6%. The 2006-07 Budget estimates growth of 2.25% over 2005-06, as long project lead times and delays in completing some projects means that the recent strong growth in investment has not yet translated into growth in export volumes.

## Exports

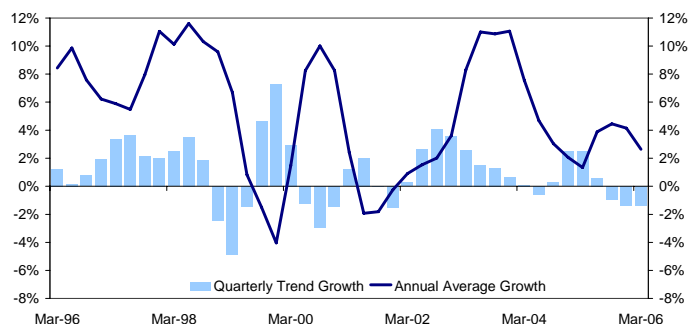
Real Growth (%)

Period to March 2006

	Qtr*	yr
NSW	1.5	3.4
Vic	-0.9	-2.5
Qld	0.1	7.4
<b>WA</b>	<b>-1.4</b>	<b>2.6</b>
SA	-2.1	1.4
Tas	-2.2	4.3
<b>Aust</b>	<b>-0.4</b>	<b>2.6</b>

\* In Trend terms.

REAL MERCHANDISE EXPORTS  
Western Australia



Source: ABS Cat. 5206.0

Growth in export prices was the main factor causing the value of Western Australia's merchandise exports to rise by 19.6% in the three months to April 2006, compared with the corresponding period a year earlier. While still strong, this is lower than the 30%-plus annual growth that was recorded in mid-2005. Nationally, the value of merchandise exports increased by 22.1% over the same period.

### Items Exported

Iron ore is now the State's most valuable mineral export, a result of higher prices and (to a lesser extent, so far) increased capacity. Growth in China is fuelling demand, and record price increases have been negotiated in recent bargaining rounds. Recent price negotiations between the world's largest iron ore producer, CVRD and Germany's steelmaker Thyssenkrupp AG, resulted in a 19% increase in the contract price for iron ore fines for 2006, while Japanese steel mills have also agreed to this contract price increase for iron ore for the Japanese financial year beginning in April 2006.

Over the three months to April 2006, the nominal value of iron ore sales rose by \$1.0 billion (or 49.8%) compared to the three months to April 2005. Most of the increase due to higher prices, with the volume of iron ore exports increasing by 3.0%.

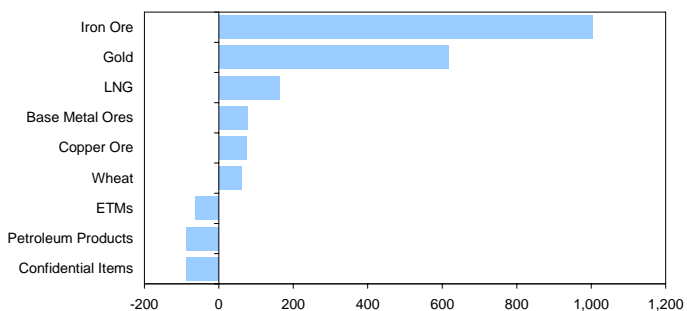


Increases in the value of gold, LNG, base metal and copper ores and wheat also supported export growth, although to a much lesser extent than iron ore.

The value of gold exports increased by \$616.6 million (or 49.7%) over the three months to April 2006. The move of gold refining operations to Western Australia in 2002 has resulted in a large increase in gold imported for re-export, affecting both import and export data. Since then the value and volumes of gold exported has fluctuated, and the higher trade volumes and greater volatility are likely to continue.

The value of LNG exports increased by 21.2% over the three months to April, despite the industry being affected by temporary shutdowns in the State's North West due to cyclone activity in February. This increase is thought to be a result of higher LNG prices and volumes, as the 4th LNG train in the North West Shelf gradually raised production following its commissioning in late 2004. ABARE estimates that LNG production from the North West Shelf project increased by 6.5% in the March quarter 2006 when compared to the same period a year previously.

GROWTH IN EXPORTS\*  
3 months to April 2006 on 3 months to April 2005 (\$m)



\*Commodities with changes greater than \$60 million.  
Source: DOI/R

A decline in the value of exports of petroleum and of confidential items partly offset these gains. In the three months to April 2006, the export of confidential items (which consists of alumina and some nickel) fell by \$87.8 million (or 4.4%). Petroleum exports also fell over the period (down by \$86.2 million or 5.9%), reflecting a 25.5% drop in the volume of petroleum exported, again reflecting production losses due to cyclone activity.

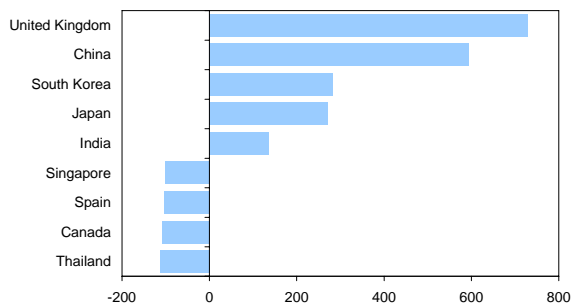
#### Export Destinations

Exports to China, Korea, Japan and India have been growing rapidly in recent months, while the United Kingdom is also attracting an increasing share of the State's exports. In the three months to April 2006, exports to these countries accounted for over 65.1% of the total value of the Western Australia's exports, compared to 48.9% five years ago.

Japan has been the State's largest export market for many years, but China's rapid industrial expansion is driving strong growth in exports. In the three months to April 2006, exports to China exceeded exports to Japan for the first time for any three-month period since the data series began in the late 1980s - Japan accounted for 20.4% of the State's total exports, compared to 21.1% for China.

The early months of 2006 recorded some unusual trade patterns, and China may not remain ahead of Japan as an export destination in the short term. But longer-term trends suggest that Western Australia's export profile is changing, and China may become State's largest export market within a few years. Five years ago, Japan accounted for 24.8% of total exports, compared to 10.2% for China.

CHANGE IN EXPORT DESTINATIONS\*  
3 months to April 2006 on 3 months to April 2005 (\$m)



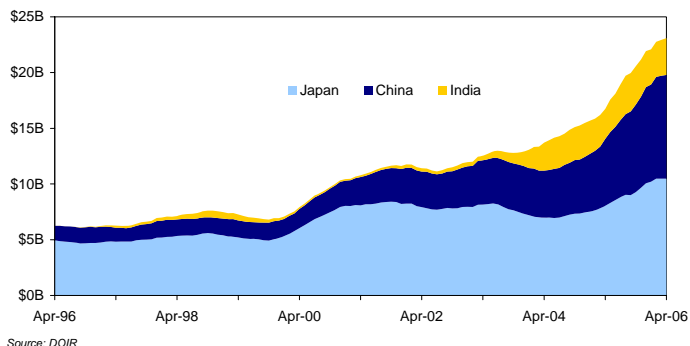
\* Countries with changes greater than \$100 million.  
Source: DOIR

While China and Japan are the largest markets, the largest growth in export value in recent months has been to the United Kingdom.

Over the three months to April 2006, exports to the United Kingdom grew by \$730.4 million in nominal terms when compared to the same period a year earlier, accounting for 7.4 percentage points of the State's overall 19.6% increase in exports. This growth mainly reflects the shift of gold refining and re-export to Western Australia, with the total value of gold exports to the United Kingdom alone, some \$721.6 million higher in the three months to April 2006 than at the same time a year previously.

Growth in the value of exports to China has been very strong in the past two years. Over the three months to April 2006, exports to China rose by \$593.9 million (or 31.4%) in nominal terms compared to the same period a year earlier, contributing 6.0 percentage points to the State's overall 19.6% rate of export growth. This and was almost entirely driven by increases in iron ore exports, which were up by \$590.7 million over the period.

WESTERN AUSTRALIAN MERCHANDISE EXPORTS  
Annual value, current prices



Exports to South Korea, the State's third largest export market, increased by \$283.1 million (or 38.4%) over the three months to April 2006 when compared to the same period a year ago. Korea accounted for 2.9 percentage points of the total 19.6% increase in exports, largely as a result of the export of petroleum (up \$79.9 million), confidential items (up \$69.4 million) and iron ore (up \$62.6 million).

Exports to Japan increased by \$271.5 million (or 12.7%) in the three months to April 2006, when compared to the same period a year earlier, contributing 2.8% to overall growth in exports. The increase was again mostly driven by a rise in the value of iron ore exports due to higher contract prices, although confidential items exports also contributed to growth.

Increases in the State's exports to these countries were partially offset by a fall in the value of exports to Thailand and Canada. Over the three months to April 2006, exports to Thailand fell by \$113.2 million (or 21.5%), largely as a result of a \$185.3 million fall in gold exports. Exports to Canada were \$108.7 million (or 42.9%) lower in the three months to April 2006 compared to the same period a year earlier, largely due to a fall in nickel (down \$77.1 million) and confidential items (down \$33.0 million) exports.

## Imports

Real imports grew by 9.7% in the March quarter 2006, following an increase of 0.5% in the December quarter 2005. The 2006-07 Budget estimated growth in imports of 12.5% over 2005-06, based on rising domestic demand (in particular business investment, which usually translates into high levels of capital imports), and private consumption, which drives consumer goods imports.

### Imports

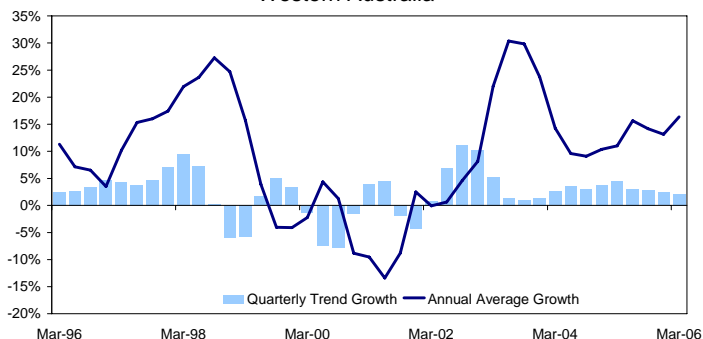
Real Growth (%)

Period to March 2006

	Qtr*	yr
NSW	1.9	8.8
Vic	0.0	8.5
Qld	2.5	8.8
<b>WA</b>	<b>2.1</b>	<b>16.3</b>
SA	-2.2	6.1
Tas	-11.1	-14.8
<b>Aust</b>	<b>1.4</b>	<b>9.2</b>

\* In Trend Terms

REAL MERCHANDISE IMPORTS  
Western Australia



Source: ABS Cat. 5206.0

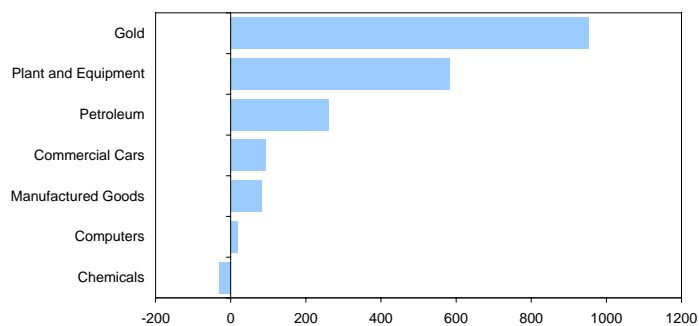
More recent trade data show that the value of merchandise imports into Western Australia increased by 57.2% (or \$2.0 billion) over the three months to April 2006, compared to the same period a year earlier. In annual average terms growth was 32.3% over the 12 months to April 2006.

Imports growth has been strong for some time, and the value of imports has doubled in the past four years. Western Australia's per capita value of imports is now above the national average, for the first time since at least the 1980s, when the current data series began.

The data are distorted, however, by changes in the pattern of gold trading. Imports of gold (for refining and re-export) accounted for almost half of the growth in imports (27.2 percentage points) over the year to April, reflecting the centralisation of the country's gold refining operations in Western Australia. Over the three months to April 2006, the value of gold imports more than doubled, to be 214.7% (or \$952.8 million) higher than the same period a year earlier, with an increase of 59.5% in volume terms.

The value of plant and equipment imports were 54.3% (or \$583.3 million) higher in the three months to April 2006 when compared to the same period a year earlier. This largely reflects the strength of investment by business in the State's capital-intensive resource industry.

GROWTH IN COMMODITY IMPORTS\*  
3 months to April 2006 on 3 months to April 2005 (\$m)



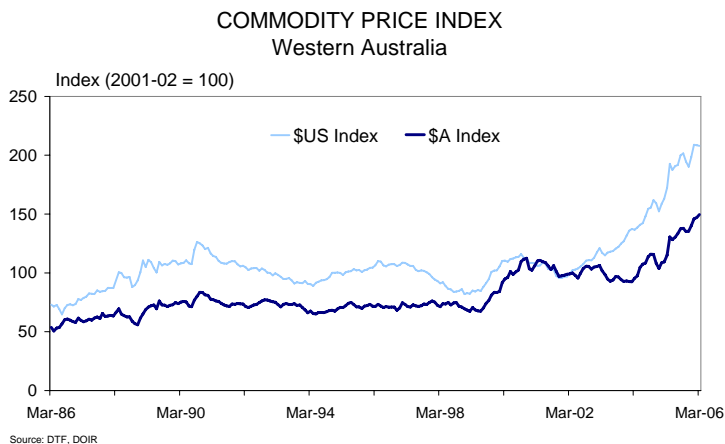
\* Commodities with changes of \$19 million or more  
Source: DOIR

Petroleum imports also made a significant contribution (7.4 percentage points) to overall imports growth over the three months to April 2006. The value of petroleum imports was 49.5% (or \$261.3 million) higher than the three months to April 2005. However, this is largely the result of the significant increase in the price of oil over the period, with the volume of petroleum 6.0% higher over the three months to April 2006.

### *Commodity Price Index<sup>20</sup>*

The March quarter 2006 saw commodity prices grow despite a prolonged period of growth and commodity prices being at near-record highs. The Western Australian commodity price index grew by 7.2% over the quarter in \$US terms, and by 7.9% in \$A terms. Compared to the same period a year earlier, commodity prices were 26.6% and 33.0% higher in US and Australian dollars respectively.

<sup>20</sup> The Western Australian commodity price index, which is compiled by the Department of Treasury and Finance, is based on a 'basket' of commodity exports, weighted according to the relative value of total commodity production in Western Australia.



Much of the expansion in the commodity price index over the past year can be attributed to substantial increases in the price of crude oil and iron ore. Together, these two commodities accounted for over three-quarters (20.25 percentage points) of the overall 26.6% rise in the commodity price index in the year to March 2006.

**GROWTH IN COMMODITY PRICES**

March quarter 2006 on March quarter 2005

	<b>\$US terms</b>	<b>\$A terms</b>
Iron Ore	71.5%	80.2%
Crude Oil	32.5%	39.9%
LNG	6.7%	12.1%
Alumina	18.2%	24.2%
Gold	29.7%	36.3%
Wheat	8.4%	14.0%
Nickel	-3.7%	1.2%
Wool	-7.9%	-3.2%
<b>Total</b>	<b>26.6%</b>	<b>33.0%</b>

### Resource Prices

Latest reports confirm earlier indications of another increase in the iron ore price, with the contract price for the delivery of **iron ore** to steel mills in Japan and China for this Japanese financial year (1 April 2006 to 31 March 2007) increasing by 19.0%, following two record increases of 18.0% and 71.5% for the previous two years. As a result, the price of iron ore has now more than doubled since 2004-05. These price increases have had low-on benefits to the State by way of stimulated investment into the iron ore industry with a number of major mine, port and rail expansions being committed to over the past couple of years.

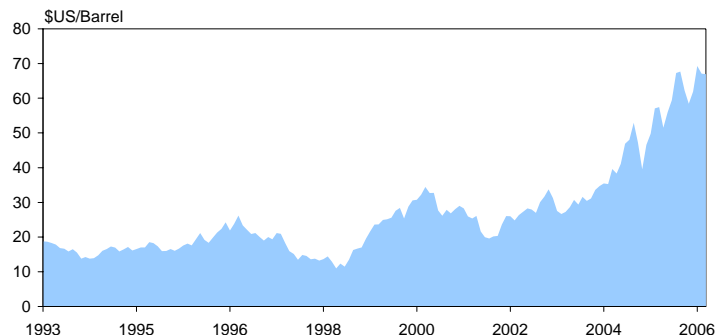
While initial reports suggest any significant supply-side response to iron ore trade may place downward pressure on prices over the longer term, a number of factors on the demand-side appear to be working to keep iron ore prices high. For example, increasing global steel production, and subsequent increase in steel consumption which is being largely driven by China's rapid industrialisation with India and Brazil also adding to demand. Moreover, the acceleration in the US economy, which has been underway for some time now is also beginning to add to further demand for steel.

Strong world economic conditions, together with a limited amount of supply have resulted in significant pressure being applied to the world **oil** market. With the supply and demand for oil so delicately close to balanced, shocks to either (or in this case both) sides of the demand/supply equation can lead to sizeable price shifts. This increased sensitivity in the oil price has been at play for the best part of two years. As a result, the oil price has reached new highs, at least in nominal terms, with the tapis<sup>21</sup> oil price growing by 11.4% over the March quarter 2006, to be 32.5% higher than the same period a year earlier.

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<sup>21</sup> The tapis oil price is the benchmark oil price in the Asian region.



TAPIS OIL PRICE  
Calendar Month Average

Source: DOIR

ABARE forecasts that the price of oil will remain high in 2006, with minor growth in world production not expected to be enough to offset higher consumption growth. In addition, it is also noted that the volatility in the oil price that has characterised the oil price over the past couple of years is expected to continue. Looking further ahead into 2007, ABARE expects only a marginal reduction in the oil price. Not only is world oil production expected to increase, but so is spare production capacity while oil demand is expected to moderate in line with an easing in the global economy.

The price of **gold** averaged \$US554/oz in the March quarter 2006, a 29.7% increase compared to same period a year earlier. Despite such strong price growth, more recently, gold prices continue to surge ahead, with the average for May 2006 reaching \$US672/oz (the gold price has since fallen under the \$US600/oz mark in late June).

Recent strength in the gold price has been attributed to a combination of heightened investor activity and fundamental factors. Investment demand for gold has increased amid concerns surging oil prices would filter through into higher consumer goods prices as producers pass on some of the cost increases, subsequently adding to global inflationary pressures. Meanwhile, some central banks have increased their gold stocks, while growth in world mine production remains sluggish. Meanwhile, fabrication demand from India, Thailand, the Middle East and China has increased strongly.

ABARE forecasts that the price of gold will be supported with growth in 2006 and into 2007, while the gold price is anticipated to ease towards the end of 2007, in line with softening prices for most commodities and as inflationary pressures ease. For the remainder of 2006 at least, the aforementioned pressures are likely to persist and push the gold price higher.

Prices for base metal remain very firm in historical terms. While the \$US spot price of **nickel** was 3.7% lower in the March quarter 2006 than the same period a year earlier, the nickel price surged 17.0% in the quarter and reflects the tight balance between supply and demand which has buoyed the nickel market over the past couple of years. Nevertheless, the nickel price was more than double the level in 2002. Meanwhile, unit export returns for **alumina** are currently around 18.2% higher than a year earlier (in \$US terms), taking the cumulative increase since 2002 to above 60%.

ABARE forecasts that alumina prices will continue to grow in 2006 (by around 7%), with increases in world production unlikely to offset continued growth in demand from China. In contrast, rising nickel production is expected to outpace growth in nickel demand, leading to an easing in prices of around 7% over 2006.

#### Rural Prices

Despite increasing by 8.9% in the March quarter 2006, the eastern market indicator for **wool** remains 3.2% lower (in \$A terms) than the same time a year ago. More recently, the eastern market indicator for wool has rebounded to 746 cents per kilogram, significantly higher than the low of 639 cents per kilogram recorded for December 2005.

The price of wool is unlikely to rise, at least significantly in the medium term given the continual advancements being made in the textiles industry and the substitutability of wool with synthetics, cotton, and polyesters. Moreover, increasing choices bring about changing consumer preferences. Given these trends are likely to continue, prices are anticipated to remain weak for 2006.

The price of wheat has not only increased over the past year, but the short-term outlook also remains positive. Strong demand is expected to continue, which coupled with a decline in production by the world's major exporting nations, is expected to underpin a modest increase in price. ABARE forecasts that the benchmark price for wheat (US hard red winter, fob Gulf ports) will be 2.0% higher in 2006-07, while prices are tipped to rise further if unfavourable seasonal conditions in the US continue.

## LABOUR MARKET

- *Employment growth in Western Australia was 0.6% over the three months to May 2006.*
- *The unemployment rate fell by 0.4 percentage points to average 3.8% over the three months to May 2006.*
- *The participation rate is near historically high levels – 67.7% over the three months to May 2006.*
- *Tight labour supply and high participation rates are expected to constrain employment growth in the coming quarters, despite indications of strong labour demand.*

### Employment

Employment grew by 0.6% over the three months to May 2006. This was considerably less than the 2.0% recorded for the same three-month period a year earlier, highlighting the slowing in the State's employment growth.

In annual average terms, employment growth in Western Australia over the year to May 2006 was 4.7% (48,000 employed people), compared to the national annual average employment growth rate of 2.4%.

### Employment

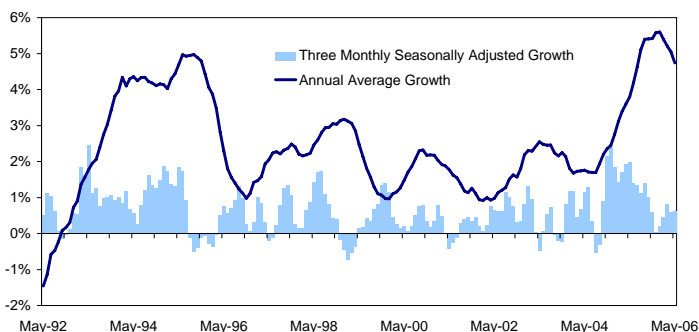
Growth (%)

Period to May 2006

	qtr*	yr
NSW	0.2	1.7
Vic	0.8	1.9
Qld	1.0	3.2
<b>WA</b>	<b>0.6</b>	<b>4.7</b>
SA	-0.3	1.9
Tas	-0.5	3.3
<b>Aust</b>	<b>0.6</b>	<b>2.4</b>

\* In seasonally adjusted terms

EMPLOYMENT GROWTH  
Western Australia



Source: ABS Cat. 6062.0

However, a recent deceleration in employment growth means that three-monthly growth rates have slowed (see chart above). The moderation in employment growth in Western Australia is most likely due to continuing tight labour market supply rather than softening labour demand.

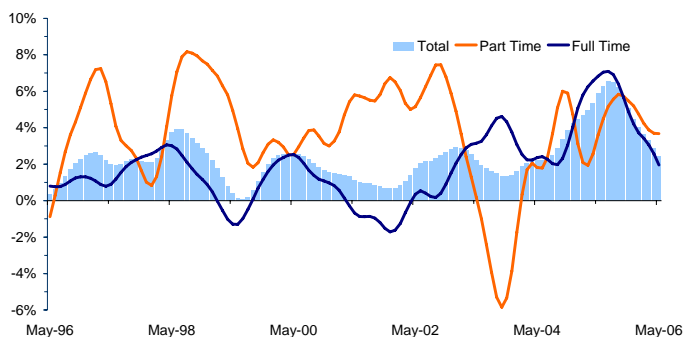
Approximately 20% of the national employment growth over the year to May was in Western Australia.

### *Employment by Type and by Industry*

Full-time employment grew by 0.1% over the three months to May 2006 (0.1% or approximately 900 persons to an average of 751,300 persons) while part-time employment rose by 1.9% (or 5,800 persons) to an average of 314,000.

In trend terms, full-time employment was 1.9% higher in May 2006 compared to May 2005, while part-time employment growth was 3.7% over the same period.

TREND EMPLOYMENT GROWTH, WA  
By Employment Type, Annual % Change

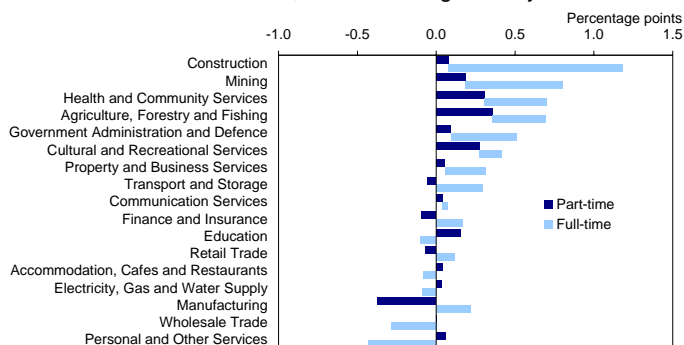


Source: ABS Cat. 6202.0

In annual average terms Western Australia's full-time employment grew by 4.6% over the year to May 2006, while part-time employment rose by 5.0%.

Industries that contributed the most to employment growth over the year to May 2006 were construction (up 13.1%) and mining (up 19.3%). Employment growth in these and a number of other industries more than offset decreases in employment in manufacturing (down 1.6%), wholesale trade (down 6.2%) and personal and other services (down 8.3%).

CONTRIBUTION TO EMPLOYMENT GROWTH  
Western Australia, Annual Average to May 2006



Source: ABS Cat. 6291.0

### *Unemployment Rate*

Western Australia's unemployment rate fell by 0.4 percentage points to 3.8% over the three months to May 2006 (compared to the three months to February 2006). This is the lowest three-monthly unemployment rate recorded since the current series of monthly labour force data began in 1978, and was well below the national average unemployment rate of 5.0% in the same period.

In annual average terms, Western Australia's unemployment rate reached a low of 4.2% over the year to May 2006, again considerably lower than the national unemployment rate of 5.1%, and the lowest annual average unemployment rate of all the States.

The average number of unemployed persons over the year to May 2006 was 45,900 persons, some 4,400 lower than for May 2005.

**Unemployment Rate**

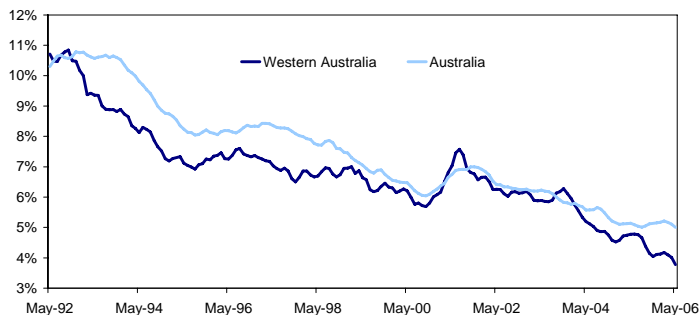
Average rates (%)

Period to May 2006

	qtr*	yr
NSW	5.3	5.3
Vic	5.2	5.3
Qld	4.9	5.0
<b>WA</b>	<b>3.8</b>	<b>4.2</b>
SA	5.4	5.1
Tas	6.5	6.4
<b>Aust</b>	<b>5.0</b>	<b>5.1</b>

\* In seasonally adjusted terms

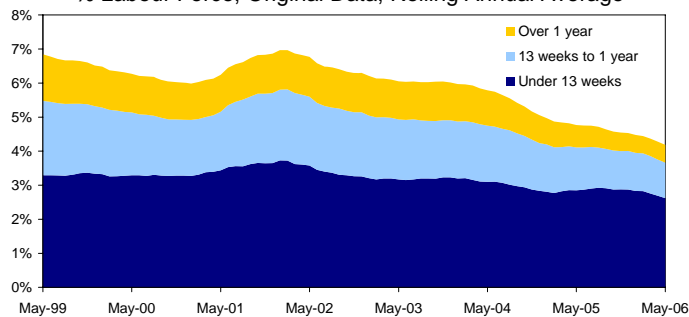
**UNEMPLOYMENT RATE**  
Three Monthly Average, Seasonally Adjusted



Source: ABS Cat. 6202.0

Much of the reduction in the unemployment rate in recent times is due to a reduction in those considered long-term unemployed<sup>22</sup>. As the following chart demonstrates, long-term unemployment has been decreasing as a share of the State's overall unemployment rate while short-term unemployment (less than 13 weeks) has been fairly stable.

**WESTERN AUSTRALIAN UNEMPLOYMENT DURATION**  
% Labour Force, Original Data, Rolling Annual Average



Source: ABS Cat. 6219.0

<sup>22</sup> A person is considered long-term unemployed if they have been unemployed for longer than 52 weeks.

### Youth Unemployment Rate

Western Australia's youth unemployment rate<sup>23</sup> increased slightly over the year to May 2006, up 0.6 percentage points to 16.1% compared to the year to May 2005. Western Australia's rate is substantially lower than the national youth unemployment rate, which fell by 0.6 percentage points to 20.9% over the same period.

### *Participation Rate*

Western Australia's participation rate averaged 67.7% over the three months and 67.8% over the year to May, although more recent trend data suggest that participation is edging down from its peak in mid-2005.

Western Australia's participation rate is consistently higher than the national participation rate, which averaged 64.4% in the three months to May.

### **Participation Rate**

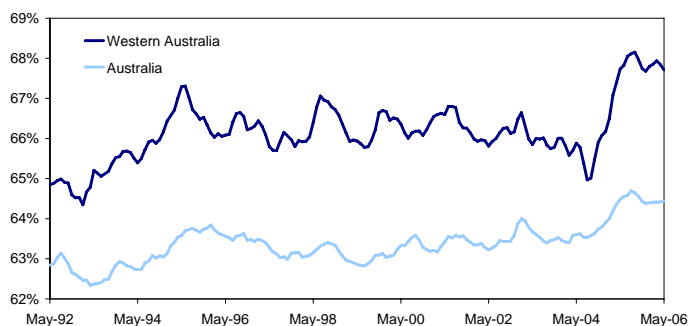
*Average rates (%)*

*Period to May 2006*

	<i>qtr*</i>	<i>yr</i>
NSW	62.8	62.9
Vic	64.3	64.3
Qld	66.2	66.3
<b>WA</b>	<b>67.7</b>	<b>67.8</b>
SA	62.0	62.0
Tas	61.0	65.9
<b>Aust</b>	<b>64.4</b>	<b>64.5</b>

*\* In seasonally adjusted terms*

**PARTICIPATION RATE**  
Three Month Seasonally Adjusted Average



Source: ABS Cat. 6202.0

The Western Australian labour force increased by 4.1%, or approximately 43,400 persons, over the year to May 2006.

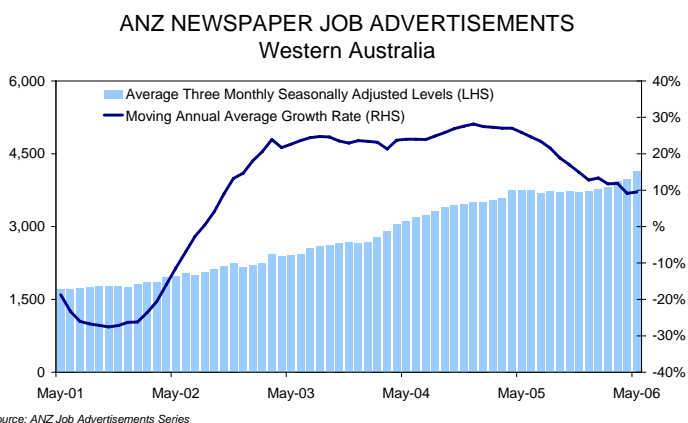
<sup>23</sup> The youth unemployment rate is defined as persons aged 15 to 19 years seeking full-time employment as a share of the 15-19 year labour force. Western Australia's youth unemployment rate, like the other Australian jurisdictions, is typically volatile and hence annual average rates are the preferred measure.



### Short-term outlook

Business surveys and data on job advertisements and skilled vacancies point to strong labour demand persisting in the short term. The large number of resource projects either currently under way or in the planning stages also suggests that labour shortages are unlikely to ease in the near term<sup>24</sup>.

The ANZ Bank Newspaper Job Advertisements series<sup>25</sup> for Western Australia grew by 8.8% over the three months to May 2006 (compared to the three months to February 2006) and the level of newspaper jobs advertisements is near a record high (see following chart). In annual average terms, newspaper job advertisements grew by 9.5% over the year to May 2006.



Employment outlook surveys such as the Manpower *Employment Outlook Survey*, *The Hudson Report* and the CCI-BankWest Survey of *WA Business Expectations* also report strong recruitment expectations for Western Australia in the coming quarters.

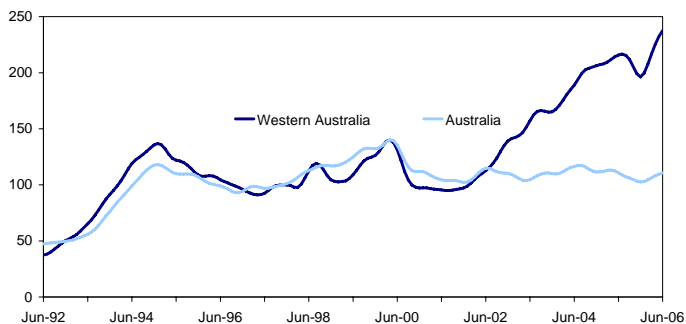
<sup>24</sup> For more information on resource (and other) projects in Western Australia see the Business Investment chapter.

<sup>25</sup> The ANZ Bank has cautioned that newspaper job advertisements are likely becoming a less useful indicator of labour demand due to the growing use of Internet job advertisements. [While the ANZ publish an Internet job advertisement series at a national level, data are not available at a State level].

The extent to which this will translate into employment growth will depend on labour supply, which is currently very tight in Western Australia. This tight labour supply is characterised by the small pool of underemployed<sup>26</sup> and unemployed persons as well as high participation rates. These conditions are likely to present difficulties for employers seeking to recruit labour, in particular skilled labour.

The Department of Employment and Workplace Relations' Skilled Vacancies Index for Western Australia is at a historical high, and substantially above the equivalent national index (see following chart). The index for three months to June 2006 was 8.4% higher than for the same period a year earlier. This contrasts with the fall in the national index of 2.4% over the same period.

SKILLED VACANCIES INDEX  
Trend Data (Index, November 1997 = 100)

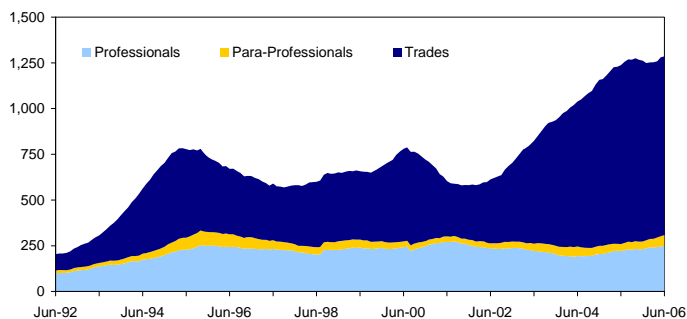


Source: Department of Employment & Workplace Relations

Skill shortages are particularly acute in the trades occupations. Vacancies data indicate that trade skills most affected by skills shortages are construction, metal trades and electrical and electronics trades.

<sup>26</sup> Underemployment refers to employed persons who want, and are available for, more hours of work than they currently have.

### JOB VACANCIES Moving Annual Average



Source: Department of Employment & Workplace Relations

Business surveys also indicate labour shortages, with many businesses reporting difficulties in finding available labour. The CCI-BankWest Survey of WA *Business Expectations* for June 2006 reported that 71% of respondents considered labour availability to be 'scarce', slightly less than the March quarter 2006 (65%) and substantially higher than the June quarter 2005 (62%).

The 2006-07 State Budget forecasts employment in Western Australia to grow by 4.5% in 2005-06 and 2.0% in 2006-07. Unemployment is expected to remain low, with forecasts of 4.25% for both years. The expected deceleration in growth reflects tight supply rather than weakening demand.

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## PRICES, INCOMES AND INTEREST RATES

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- *Perth's consumer price index increased by 1.0% over the March quarter 2006, largely reflecting increases in construction costs of new houses<sup>27</sup> and growth in fuel prices.*
- *Over the year to March 2006, Perth's consumer price index increased by 4.2%, with house purchases the largest contributor to prices growth.*
- *Wages and earnings grew strongly in the March quarter.*
- *The Reserve Bank of Australia increased the official interest rate by 25 basis points to 5.75% in May 2006.*

### *Prices*

High employment, low unemployment and growth in incomes have added to demand pressures in Western Australia. While many businesses report labour shortages and rising cost pressures, however, most businesses do not appear to be fully passing on higher labour and other cost increases to consumers, which may be acting to dampen overall price pressures<sup>28</sup>.

Perth's Consumer Price Index (CPI) increased by 1.0% in the March quarter 2006, following a rise of 0.8% in December. The cost of building new houses was the major driver of growth in Perth's consumer prices during the quarter, and also explains most of the difference between Perth's inflation rate and the national average. This is unlikely to reverse in the near term, as robust housing activity is likely to continue into 2006-07 (see [Dwelling Investment](#) section).

Costs associated with house purchases contributed 0.33 percentage points of the 1.0% increase in the Perth CPI during the quarter, compared to house purchases nationally which contributed 0.03 percentage points of the 0.9% increase in the national CPI over the same period.

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<sup>27</sup> House purchases incorporate construction costs for new houses and major improvements to existing homes and fixed appliances (such as ducted heating and hot water systems).

<sup>28</sup> The Western Australian CCI-BankWest *Survey of Business Expectations* (June 2006) reports that businesses continue to absorb higher labour and input costs, with only a third of businesses increasing their prices in the March quarter 2006. Despite this, around 60% of businesses intend to raise their prices in the coming quarters.

## Consumer Price Index

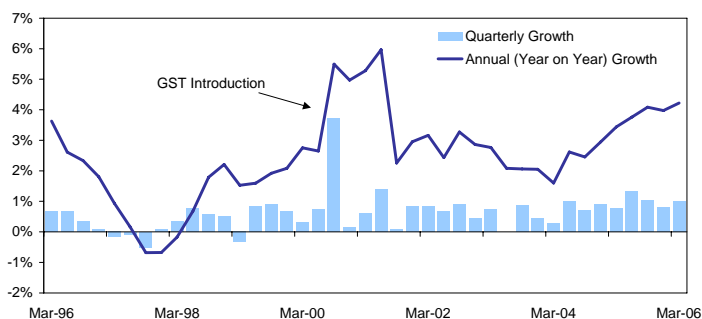
Growth (%)

Period to March 2006

	<i>qtr</i>	<i>yr*</i>
<i>Sydney</i>	0.8	2.7
<i>Melbourne</i>	0.9	2.8
<i>Brisbane</i>	0.9	2.9
<b><i>Perth</i></b>	<b>1.0</b>	<b>4.2</b>
<i>Adelaide</i>	1.0	3.1
<i>Hobart</i>	0.8	2.8
<b><i>Australia</i></b>	<b>0.9</b>	<b>3.0</b>

\* Past quarter on same period a year earlier.

CONSUMER PRICE INDEX  
Perth, % Change



Source: ABS Cat. 6401.0

The CPI for Perth increased by 4.2% over the year to the March quarter, with the CPI nationally growing by 3.0%. Over the past five years, Perth's CPI has grown by 16.1%, faster than the CPI nationally which was up 14.5%. This partly reflects the fact that Perth's housing cycle has lagged behind the eastern states.

The latest budget economic forecasts predict that Perth's CPI will increase by 3.0% in 2006-07. This rate of growth is softer than the 4.0% growth expected for Perth in 2005-06, and reflects an anticipated easing in both housing market and consumer spending activity.

### Incomes

The Wage Price Index increased by 0.9% in the March quarter, while average weekly earnings were flat and average weekly ordinary time earnings (excluding part-time and juvenile workers, and overtime payments) grew by 1.3%.

## Wage Price Index

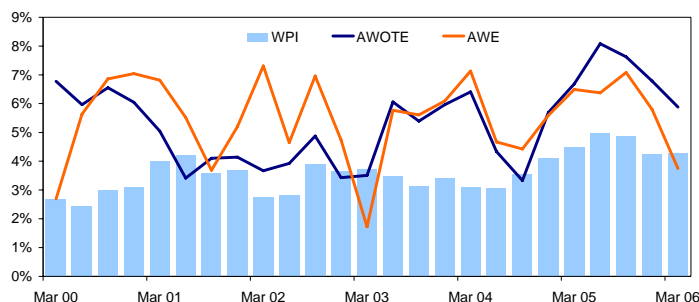
Growth (%)

Period to March 2006

	<i>qtr</i>	<i>yr*</i>
NSW	1.1	4.0
Vic	0.9	3.7
Qld	1.1	4.6
<b>WA</b>	<b>0.9</b>	<b>4.3</b>
SA	0.7	3.7
Tas	1.1	4.1
<b>Aust</b>	<b>1.0</b>	<b>4.0</b>

\* Past quarter on same period a year earlier

WAGES GROWTH  
Annual (Year on Year) Growth, Western Australia



Source: ABS Cat. 6345.0

The Wage Price Index is a better measure of underlying wages growth than the average earnings estimates. It is an index measuring the cost of a fixed basket of jobs, and is designed to measure changes in wages over time for a fixed quantity and quality of labour input. Unlike the average weekly earnings measures, it is designed to measure wage changes rather than levels. As such, it is not subject to the influence of compositional changes in the labour force such as rapid growth in high-paying sectors such as mining.

The Wage Price Index for Western Australia grew by 4.3% through the year to March 2006, the second-highest annual growth of the States. Australia's Wage Price Index increased by 1.0% in the March quarter and by 4.0% through the year. Australian<sup>29</sup> wages growth by industry over the March quarter was highest in electricity, gas and water supply (up by 2.6%), education (up 1.9%) and construction (up 1.7%).

Average weekly ordinary time earnings of full time employees in Western Australia increased by 1.3% over the quarter and 5.9% over the year to February 2006, to \$1,070.4 a week. Australian ordinary time earnings increased by 4.5% to \$1,035.8 a week over the year to February.

<sup>29</sup> State-based wage by industry data are not available.

Average weekly earnings<sup>30</sup> were flat in Western Australia between November 2005 and February 2006, at \$813.0, although earnings rose by 3.7% through the year to February. Australian average earnings increased by 4.4% through the year, to \$816.8.

According to the June CCI-BankWest Survey of WA *Business Expectations*, some 49% of respondents reported higher labour costs compared to 2% who reported lower costs for the quarter.<sup>31</sup>

The 2006-07 Budget forecasts predict that Western Australia's Wage Price Index will increase by 4.5% in 2005-06, underpinned by tight labour market conditions, before easing slightly to 4.25% in 2006-07.

There have not been substantial across-the-board increases in wages in Western Australia, despite the tight labour market. But wages growth in some industries and occupations has been relatively rapid. To the extent that higher wages growth would add to pressures on businesses' input costs (particularly for industries such as construction), wages growth is a risk to the State's future economic growth.

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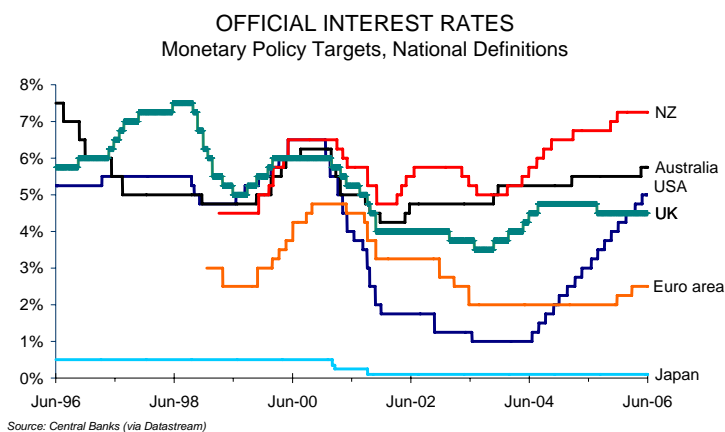
<sup>30</sup> Unlike Average Weekly Ordinary Time Earnings, Average Weekly Earnings includes payments such as overtime and bonuses, in addition to the earnings of part-time, casual and junior employees.

<sup>31</sup> Source: CCI-BankWest, Survey of WA *Business Expectations*, June quarter 2006

### *Interest Rates*

The Reserve Bank of Australia increased interest rates by 25 basis points in May 2006, resulting in the official target cash rate moving to 5.75%.

The Bank's May 2006 *Statement of Monetary Policy* stated that "inflationary risks [had] increased sufficiently to warrant an increase in the cash rate"<sup>32</sup>. Inflationary risks were attributed to favourable international conditions combined with limited spare capacity in the domestic economy. The statement said that the increase in Australia's official interest rate coincided with rising interest rates in other major economies, as they are "normalising interest rates" after a period of low rates.



<sup>32</sup> Reserve Bank of Australia, *Statement of Monetary Policy*, May 2006



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## INTERNATIONAL CONDITIONS

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- *Economic conditions in the global economy are sound and growth in Western Australia's main trading partners is particularly buoyant.*
- *The US and China are driving global expansion, while economic conditions in Japan are steadily improving.*

The world economy has sustained momentum in the first half of 2006, showing resilience to the effects of high and rising oil prices. The economies of China and India have grown strongly over this period, with economic activity in Japan also showing signs of improvement.

The Organisation for Economic Co-operation and Development (OECD) countries as a whole are expected to grow by 3.1% in 2006 and 2.9% in 2007, with the OECD noting that that "business and consumer surveys suggest growth prospects...may be converging in the very near term".<sup>33</sup>

Although world growth is broadening, the USA and China continue to drive much of the pace of global expansion. Real GDP growth in China is expected to be 9.5% in 2006 and there have been signs of excess capacity in some sectors of the Chinese economy (notably manufacturing), which is keeping inflationary pressures low.

China's exports growth led to foreign reserves increasing by 34% to more than US\$818.9 billion in 2005.<sup>34</sup> This is likely to rise further, as the OECD predicts that the current account surplus in China will be 5.5-6% of GDP in 2007. The value of the renminbi is forecast to increase over time, boosting household purchasing power and possibly helping in the development of a foreign exchange market, following the exchange rate reform last July by the Chinese government.

In the US, the Federal Reserve has raised interest rates by 0.25 basis points at each of its last 17 meetings, bringing the federal funds target rate from a 46-year low of 1% in mid-2004 to 5.25% on 29 June 2006.

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<sup>33</sup> Source: OECD, Economic Outlook, May 2006.

<sup>34</sup> BBC News, *Surge in China's foreign reserves*, 16 January 2006.

Further interest rate rises are likely, although the frequency of changes may decrease. Economic growth has been strong in the early part of 2006, with real GDP expected to grow by 3.4% in 2006, among the highest of the G7<sup>35</sup> countries.<sup>36</sup> Rising oil prices could further add to inflationary pressure, as could inflationary expectations, which are also rising.

The current low US household savings and high energy costs could drag down consumption growth. Although higher energy prices could potentially mean nominal consumption growth is increasing, growth in the housing market, a source of strong growth in recent years would place downward pressure on this growth. Housing market activity seems to be waning, with prices in many developed countries beginning to slow markedly after the housing market's strength in recent years. Mortgage applications have declined, and the number of houses on the market is increasing.

Looking forward, the International Monetary Fund expects a slowdown in growth in the US as a lagged response to higher oil prices, higher interest rates and a cooling housing market.<sup>37</sup>

The slow recovery in Japan is grounded in both consumer and corporate spending growth. Domestic demand has been the major driver of growth, although exports have also risen. This is largely due to increased employment, larger corporate profits and increased bank credit. In 2006, GDP growth is expected to be 2.8%, following growth of 3.2% in 2005.<sup>38</sup>

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<sup>35</sup> G7 – Group of seven countries refers specifically to the meeting of the respective Finance Ministers and the Governors of Central Banks. The countries are the US, United Kingdom, Japan, Canada, Germany, Italy and France.

<sup>36</sup> IMF, World Economic Outlook, April 2006.

<sup>37</sup> Op cit (IMF, April 2006).

<sup>38</sup> Source: Bank of Japan, Summary of speech given by Toshihiko Fukui, Governor of the Bank of Japan to the Japan National Press Club in Tokyo on June 20, 2006.

Investment within Japan is robust, with no signs of over-investment in any of the business sectors. Nominal short-term interest rates are still close to zero and economic growth is positive, leading to favourable conditions for borrowers. This is expected to change in July however, when the Bank of Japan is likely to raise interest rates by 25 basis points.<sup>39</sup> If other conditions stay buoyant in Japan, then the raise should not dampen any growth that is currently occurring.

Overall, Japan's economic outlook is improving, with both consumer confidence and business profits high, and unemployment around 4%.<sup>40</sup> While China's rapid economic growth and increasing share of economic activity have attracted most attention of the Asian economies in recent years, productivity and innovation are helping Japan to sustain growth.

Emerging Asia's growth is fairly robust, with rising exports and corporate investment underpinning momentum. Further economic reform, especially with the domestic financial system, will be necessary for these countries in order to sustain economic growth and maintain current account surpluses for the rest of 2006.<sup>41</sup>

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<sup>39</sup> Source: MarketWatch Asia ([www.marketwatch.com](http://www.marketwatch.com))

<sup>40</sup> Source: Bank of Japan ([www.boj.or.jp/en](http://www.boj.or.jp/en)).

<sup>41</sup> IMF, World Economic Outlook, April 2006.

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## 2. LABOUR SUPPLY IN WESTERN AUSTRALIA

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### *Introduction*

Most indicators suggest that labour demand in Western Australia is very strong. Yet recent data point to a slowdown in employment growth, which suggests that the State might be reaching a point where labour supply is acting as a constraint on this growth.

This article looks at the way the strong labour demand of recent years has induced an increase in the size of the labour force and employment. It focuses on two key sources of growth – greater engagement in the labour force among the resident population, and migration into Western Australia from both interstate and overseas. The likely future path of these factors is also considered in some detail, as is their potential impact on growth in labour supply. Of particular interest is whether growth in the supply of labour will be sufficient to satisfy future demand, or whether supply may fall relative to demand, implying that tightness in the State's labour market is likely to persist.

The article concludes with an analysis of the economic and welfare implications of labour shortages in Western Australia.

### *Recent conditions*

Western Australia's labour market has been exceptionally strong over the past two years. Sustained high demand has induced both a considerable reduction in the unemployment rate (which at 3.5% in May 2006 was the lowest since 1975<sup>42</sup>) and a marked rise in labour force participation (currently close to record highs). Together with a steady rise in the State's population, these changes produced a 5.6% increase in employment over 2005 – the highest annual rate since State labour force data were first collected in the early 1970s.

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<sup>42</sup> This comparison draws on a discontinued ABS labour force data series (pre-1978) that is not strictly comparable with the current series.

Current indicators suggest that labour demand is still very high. The ANZ Bank's count of newspaper job advertisements grew by 9.6% in 2005-06. There are now almost twice as many job advertisements per capita in Western Australia as there are in the rest of Australia.<sup>43</sup> The CCI-BankWest measure of labour availability reflects this scarcity, with its index now easily the lowest since it was first compiled in December 1997.<sup>44</sup>

Demand for skilled labour is equally as strong. Skilled vacancies in Western Australia have more than doubled since 2001-02, according to the Australian Government Department of Employment and Workplace Relations.

Despite the apparent strength in labour demand, recent data suggest that employment growth may now be slowing. Average annual growth peaked at 5.6% in the year to January 2006, but has since fallen to 4.4%. As we note in the following section, this decline may stem from labour supply constraints, rather than a drop-off in demand.

### *Drivers of Labour Supply*

At a macroeconomic level, increases in labour demand can be satisfied in two ways: (1) change in the size or composition of the population; and (2) greater engagement in the labour market by the existing population, which is normally achieved by a reduction in unemployment and higher labour force participation.

In this paper, we decompose the contribution of these factors in the following way:

$$EMP = WPOP * PR * (1 - UE)$$

$$\text{or} \quad emp = wpop + pr + (1 - ue)$$

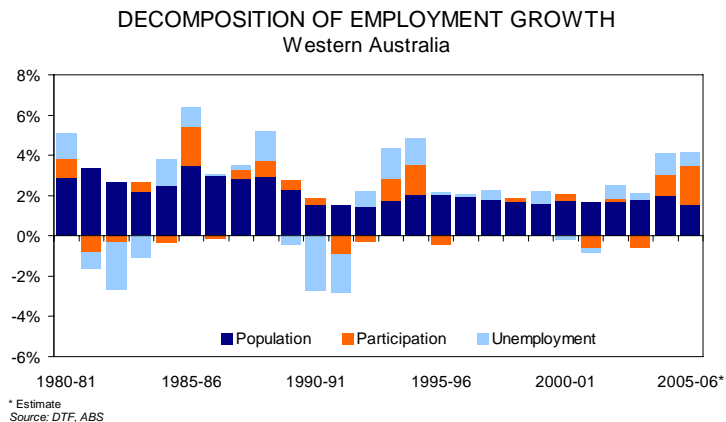
where EMP is total employment, WPOP is the total working age population, PR refers to the participation rate, UE is the unemployment rate and the lower case variables denote log-changes.

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<sup>43</sup> Although a greater shift towards internet job advertising at national level may explain some of this trend. Only newspaper advertisements are counted on a state basis.

<sup>44</sup> CCI-BankWest *Survey of WA Business Expectations*, June Quarter 2006.

This approach holds the effect of each component of employment growth on the remaining components constant, and so some caution should be exercised in interpreting the results illustrated in the chart below.<sup>45</sup>



It is clear from this chart that population growth has accounted for most of the growth in employment since 1980-81. However, changes in the unemployment rate and the participation rate<sup>46</sup> have also frequently played a prominent role in driving employment growth. For instance, a sharp rise in the participation rate in 2005-06 was the largest contributor to employment growth during that year. The remainder of this section examines each of these drivers in more detail.

### Population

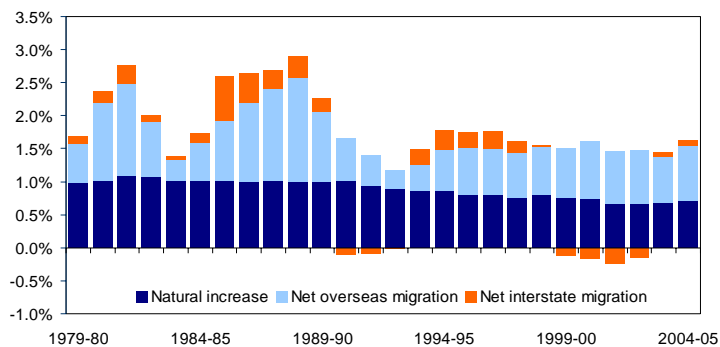
Growth in the resident population is the largest and most consistent source of employment growth in Western Australia. Since 1979-80, population growth has accounted for more than two-thirds of the total increase in employment.

<sup>45</sup> This approach assumes, for example, that migration does not affect unemployment or participation, even though an increase in migration could drive the unemployment rate temporarily higher in a period of weak aggregate demand. Under this method, positive net migration will always contribute to employment growth. While this is not a perfect representation of reality, it serves as a useful guide nonetheless.

<sup>46</sup> This refers to the labour force (the number of employed and unemployed) as a share of the working age population.

To consider this contribution in more detail, it is helpful to examine the individual components of population growth. As the next chart shows, natural increase is a large and stable component of population growth, while total net migration flows (i.e. net interstate migration and net overseas migration) have made a significant, albeit more volatile contribution to change in the State's population.

DECOMPOSITION OF POPULATION GROWTH  
Western Australia

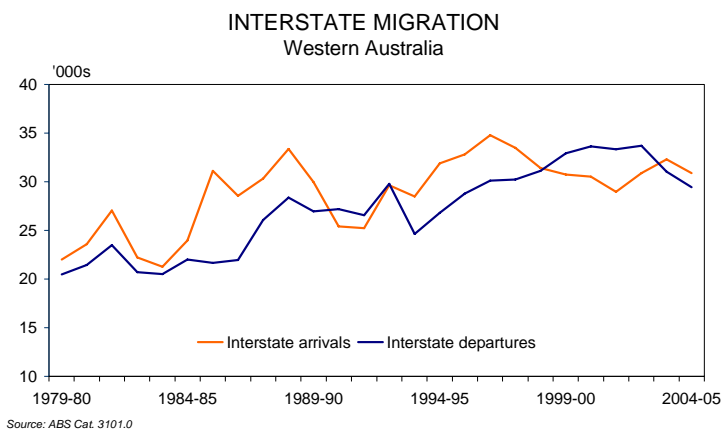


Source: ABS Cat. 3101.0

Looking ahead, it seems unlikely that there will be a significant change in the rate of natural increase. Even if a large increase in the fertility rate were to occur, this would not have a material impact on the size of the labour force for at least two decades. So the contribution of natural increase to growth in Western Australia's labour force is unlikely to rise over the medium term, even if the recent small increase in fertility is sustained.

The prospects of the labour force receiving a large boost from net interstate migration also appear limited. In this case, two factors are likely to act as a constraint on the capacity for internal migration to satisfy large shifts in employment demand. First, as indicated by the previous chart, net interstate migration only accounts for a relatively modest share of growth in the State's population (around 6% of the total increase in the population since 1979-80).

Second, although there is some evidence linking internal migration flows with relative employment opportunities<sup>47</sup>, recent experience indicates that there is only limited scope for interstate migrants to increase the size of the State's labour force. For instance, despite buoyant domestic economic conditions, the number of interstate arrivals to Western Australia fell in 2004-05. A net interstate migration gain occurred only because interstate departures decreased by a larger number (see chart below).



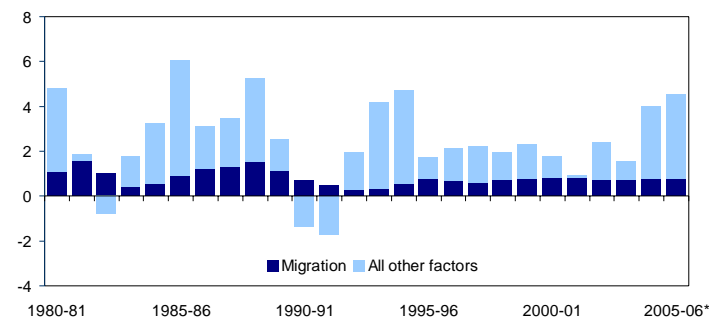
Compared to interstate migration, net overseas migration has been a much larger, but similarly volatile, component of population growth in Western Australia. By extension, and as illustrated in the following chart, net overseas migration makes a meaningful contribution to growth in employment.

<sup>47</sup> DTF *Migration in Western Australia: A Recent Economic History* (forthcoming).



However, there again appears to be only limited potential for this contribution to extend much beyond current levels. The Australian Government's Migration Program (which is a key driver of net overseas migration in Western Australia) would need to increase substantially to deliver moderate gains in the State's employment growth. Based on current State and Territory shares, an increase in the national Migration Program of 65% or 100,000 persons – compared to the 2005-06 target level of 153,000 – would be required to drive a 0.5 percentage point expansion in employment growth in Western Australia.<sup>48</sup>

SOURCES OF EMPLOYMENT GROWTH  
Western Australia



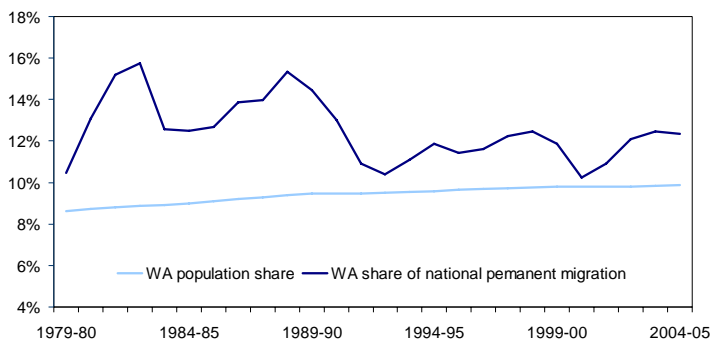
\*Estimated  
Source: ABS, DTF.

Western Australia typically attracts a higher share of international immigrants than its population share. A rise in Western Australia's share of immigrants under the Migration Program could also drive higher growth in the State's labour force.

However, recent trends cast some doubt on whether this will occur. As the next chart shows, despite recent strength in the State's economy relative to other States, Western Australia has not secured an appreciable rise in its share of national immigration. In the 1980s, this share exceeded 15% on two occasions, but has not crept much beyond 12% since the 1990s.

<sup>48</sup> This assumes that the effect of each explanatory variable on all of the others is constant. For more information, see note 45.

PERMANENT MIGRATION  
Western Australia



Source: ABS Cat. 3101.0.

Temporary migration is another source of potential growth in the State's labour force. Growth in these migrants has been particularly strong over the past decade, and has in fact often made a larger contribution to total migration than permanent arrivals.<sup>49</sup> However, like permanent immigration, there would need to be a substantial rise in temporary work visas to generate a moderate gain in total employment growth. Moreover, any such increase could only be transitory in nature (although temporary migration can still play an important role in alleviating labour shortages – see next section).

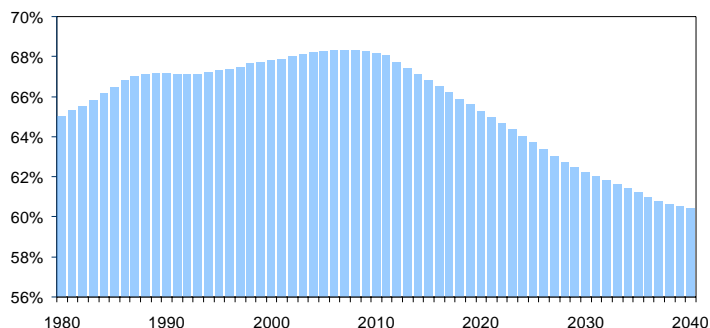
### Working Age Population

The past few decades have witnessed a small but steady rise in the ratio of the working age population to the total resident population (defined here as those aged between 15 and 64 years). The result has been a modest annual boost to the stock of labour available in the State's population.

<sup>49</sup> Much of the growth in temporary migration has been driven by an increase in student visas, which only grant fairly limited working rights.

This trend is likely to reverse by the end of this decade. As indicated by the following chart<sup>50</sup>, the ageing of the State's population will result in a marked decline in the working age share of the population, and a significant drag on growth in the stock of labour beyond 2010.<sup>51</sup>

WORKING AGE SHARE OF THE TOTAL POPULATION  
Western Australia



Source: ABS Cat. 3201.0, 3222.0.

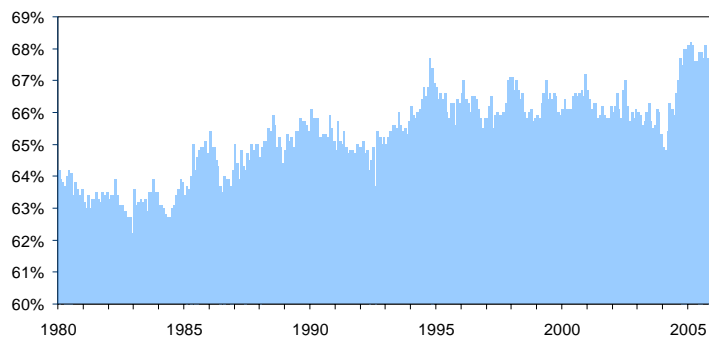
### Participation

The labour force participation rate has an important influence on labour force growth in Western Australia. As a general rule, periods of weak economic activity have been accompanied by a reduction in the participation rate (resulting in a detraction from growth in labour supply), while periods of buoyant activity have encouraged higher participation (boosting labour supply). Overall, a long-term trend increase in Western Australia's participation rate has made an average annual contribution of 0.3% to employment growth since 1980-81.

<sup>50</sup> Based on Australian Bureau of Statistics mid-series population projections.

<sup>51</sup> Change in net migration is unlikely to have a significant influence on the age structure of the population - see Productivity Commission (2004) *Economic Implications of an Ageing Australia*, Final Report, Canberra.

**PARTICIPATION RATE**  
Seasonally adjusted, Western Australia



Source: ABS Cat. 6202.0

In 2004-05 and 2005-06, the participation rate played a particularly prominent role in driving labour force growth. A substantial rise in the participation rate (of more than one percentage point) was responsible for more than 40% of the gain in employment in 2005-06. As the following table indicates, growth in the participation rate in 2005-06 was broadly based, with most age cohorts making a significant contribution to the increase.

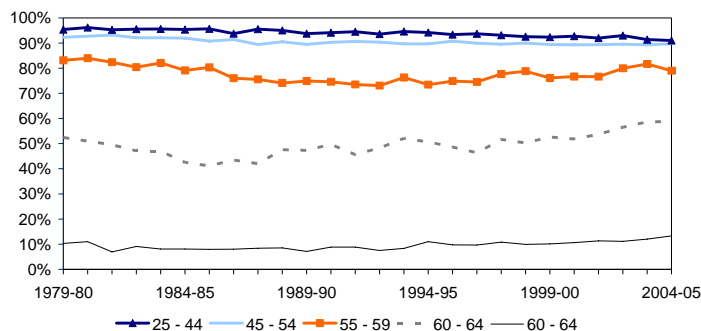
**PARTICIPATION BY AGE COHORT, Western Australia**

Age Cohort	Participation Rate (%)		Change (ppts)	Contribution to change (ppts)
	2004-05	2005-06		
15 - 19	65.7	68.4	2.71	0.21
20 - 24	80.5	82.6	2.12	0.16
25 - 34	79.3	80.8	1.51	0.23
35 - 44	82.0	83.3	1.27	0.21
45 - 54	83.0	84.4	1.39	0.21
55 - 59	69.2	70.7	1.50	0.10
60 - 64	47.4	48.9	1.47	0.07
65 +	8.8	10.0	1.21	0.15
Total	66.5	67.8	1.34	1.34

Source: ABS, DTF.

Looking ahead, there is probably only limited capacity for a significant increase in participation by males aged between 25 and 44 years over the medium term. Participation in this cohort is already high and has only changed marginally over the past 25 years. In contrast, there has been a trend rise in participation by males in older age cohorts over the same period, suggesting that this might be a useful source of future growth in labour supply.<sup>52</sup>

MALE PARTICIPATION RATES BY AGE COHORT  
Annual average, Western Australia

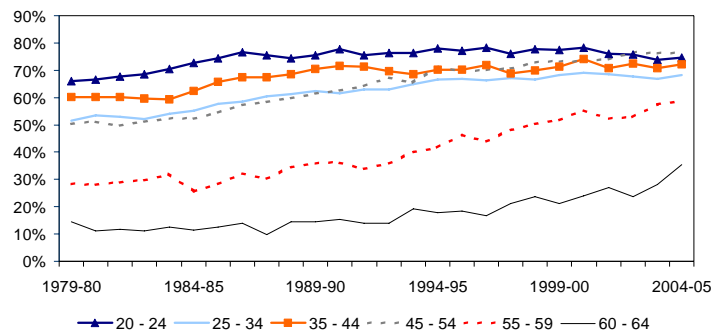


Source: ABS

A continued increase in female participation (associated with improved access to education and training across generations) is another potential source of growth in the State's labour force. Better access to childcare may be an effective mechanism by which to support future growth, particularly in the 25-34 age bracket.

<sup>52</sup> A number of factors might drive this increase, including better employment opportunities, changing employer attitudes towards mature workers, and changes in superannuation eligibility requirements and retirement expectations.

FEMALE PARTICIPATION RATES BY AGE COHORT  
Western Australia



Source: ABS

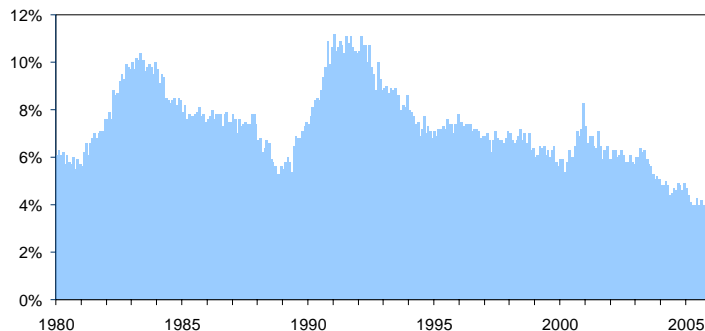
It follows that participation is perhaps a fruitful source of growth in the labour force over the short and medium term. However, the ageing of the State's population means that, in the absence of a substantial rise in participation in older age cohorts, there will be a decline in the aggregate participation rate in coming decades (reflecting the transition of large shares of the population into cohorts that tend to be less engaged in the labour market). Overall, the participation rate could fall by as much as eight percentage points over the next four decades<sup>53</sup> (compared to the current rate of 67.8%), which would be a substantial long-term drag on future growth in the labour force.

### Unemployment

Since 2001-02, the average annual rate of unemployment in Western Australia has fallen from 6.6% to 4.1%, making it an important contributor to employment growth over this period (2.6 percentage points). However, as the State's unemployment rate is now at its lowest level in three decades, the scope for unemployment reductions as a future source of employment growth has become more limited.

<sup>53</sup> For example, see Productivity Commission (2005) *Economic Implications of an Ageing Australia*, Research Report, Canberra.

UNEMPLOYMENT RATE  
Seasonally adjusted, Western Australia



Source: ABS Cat. 6202.0

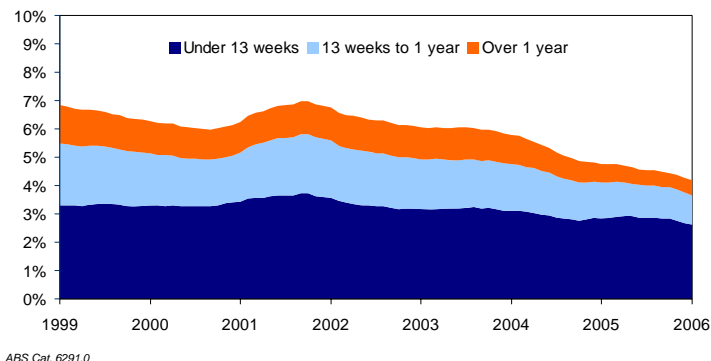
An analysis of the compositional change in unemployment supports this view. Much of the recent decline in the unemployment rate has been brought about by a reduction in the pool of the long-term unemployed (defined here as those who have been unemployed for more than 13 weeks). As shown in the next chart, the number of long-term unemployed in Western Australia has fallen by approximately half since 2001-02.

In contrast, short-term unemployment has varied much less significantly in recent years, indicating that it may have reached a natural floor (indeed it might serve as a good approximation of Western Australia's natural rate of unemployment).<sup>54</sup> As the following chart suggests, there appears only limited scope for the unemployment rate to fall below 3% on a sustained basis.

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<sup>54</sup> Some unemployment may always exist due to ongoing structural change in the economy (structural unemployment) and workers who are temporarily between jobs (frictional unemployment).

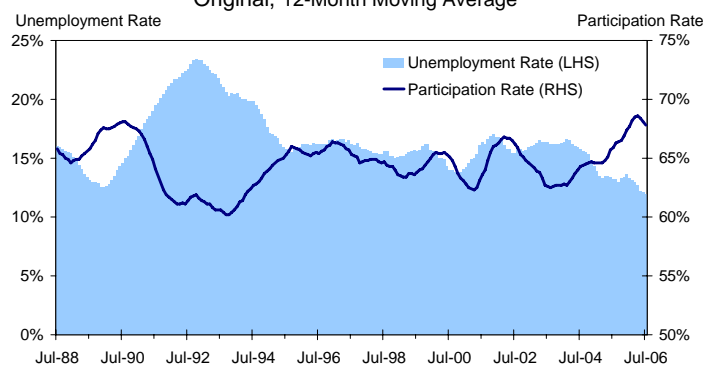
UNEMPLOYMENT RATE BY DURATION  
Rolling annual average, Western Australia



Rates of youth unemployment typically exceed adult unemployment rates by a significant margin, and youth unemployment is a persistent concern for the community and policymakers.

Western Australia’s youth unemployment rate fell in July to its lowest level since the current data series began in 1986<sup>55</sup>, although it remains well above the adult average. The state’s youth participation rate was also near its peak (see following chart).

WA YOUTH UNEMPLOYMENT & PARTICIPATION  
Original, 12-Month Moving Average



<sup>55</sup> State youth labour force data are not seasonally adjusted and are highly volatile from month to month because of the annual influx of school leavers. However, Western Australia’s youth unemployment rate was at its lowest both for the month of July (8.9%) and averaged over the 12 months to July (11.9%).



While falling youth unemployment is a positive trend, it has a potential down side. The proportion of Western Australian 15-19 year olds in full-time education has fallen in the past three years, ending the long-term trend growth in education of the previous two decades. The rise in labour force participation and drop in education participation in this age group may suggest a shift from education to work.

However, the Western Australian Government has recently raised the school leaving age to 16, with a further increase to 17 scheduled for 2008. This should help to prevent any drift towards young workers entering the labour force without the education and skills they need in the longer term. It also means, however, that school leavers and unemployed youth are not a likely source of additional labour supply in the near term.

Although the headline rate of unemployment may not fall much lower, there is some room for a further reduction in underemployment.<sup>56</sup> The number of underemployed persons in Western Australia has decreased by more than 20% since the beginning of 2003, but still represents 2% of the State's labour force (by number). Reducing underemployment further could go some way to meeting employment demand, although increasing the hours worked by people who already have part-time jobs will only boost labour supply as measured by hours worked, not the number of employees. Like unemployment, this is unlikely be a sustainable source of additional labour supply over the long term.

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<sup>56</sup> There are many definitions of under-employment. Here, the definition used is part-time workers who would prefer, and are available for, more hours of work than they currently have.

These demographic constraints mean that, while there will be yearly variations, Western Australia's labour force is probably not capable of growing much beyond an average of 2% a year over the next decade.<sup>57</sup> The implication is that there is reasonably high probability of ongoing labour shortages in Western Australia, particularly if strong economic growth in China is maintained (see next feature article: [China: An Economic and Structural Outlook](#)).

### *Implications of a tight labour market*

Skilled labour shortages have generated much concern in Australia's business community over the past few years. Both the popular and financial press have picked up on this concern, often presenting this issue as a 'crisis' requiring remedial action. This appears to reflect a widely held perception that skilled shortages act as a constraint on economic growth and welfare.

From the perspective of individual firms, labour shortages pose two key problems. First, they place a limit on the ability of businesses to invest and expand, which may prevent firms from achieving economies of scale and international competitiveness. Second, labour shortages can result in higher wage costs and lower returns to capital (holding other factors constant).

These are valid concerns at the firm level, but are they necessarily bad news for the broader economy?

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<sup>57</sup> Based on current ABS mid-series population projections (in which the level of migration is fixed) and likely trends in the participation rate and unemployment rate.

### Economies of scale

Labour shortages limit the number and diversity of businesses that can achieve globally competitive scales of production. They can also limit economies of scale at the industry level by preventing benefits associated with agglomeration or 'thick markets' (for example, local skilled labour pooling, sharing of local inputs and information spillovers).

Determining the extent to which Western Australia's population growth delivers gains from economies of scale, and how this might affect productivity in the aggregate economy, is a difficult task. Indeed, the Productivity Commission recently concluded that there are essentially no reliable quantitative studies on economies of scale in the Australian context.<sup>58</sup>

However, it is important to note that gains from economies of scale can be achieved in a number of ways other than by increasing the size of the population and labour force. For instance, economies of scale in the domestic traded goods and service sectors can be achieved by expanding export markets. This has been a very important mechanism by which the State's mining and agricultural sectors have achieved such gains.

For an existing stock of labour, economies of scale and higher productivity can also be attained by structural change within the economy. It is rare for very small economies to sustain a large number of globally competitive businesses across a wide array of industrial sectors. Rather, these economies concentrate their available resources in those areas where the economy is relatively more efficient and productive. In this way, the whole economy can optimise output per worker.

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<sup>58</sup> Productivity Commission (2006) *Economic Impacts of Migration and Population Growth*, Final Report, April.

### Lost opportunities

It is sometimes argued that scarce labour gives rise to lost opportunities - unless a particular business or industry is established locally by a certain time, the opportunity will be taken overseas in a way that precludes the economic feasibility of future local development.

The significance of this issue is again difficult to judge. However, there is some reason to believe that in the case of Western Australia's resources industry (the State's largest industry by value of production), it might not pose a serious problem.

This is because the State has globally significant mineral reserves, many of which are currently in very high demand. Although labour shortages will delay projects and constrain current growth in production, this could work in favour of the domestic resources industry. When global demand is strong and supply limited due to scarce labour, prices could continue to rise, increasing returns available for producers (i.e. keeping the terms of trade high).<sup>59</sup>

### Wages

The well-known economic laws of demand and supply provide that if an excess of demand should exist in any market, prices will rise to establish a new equilibrium. In the case of Western Australia's labour market, the prospect of limited supply growth and strong labour demand implies sustained upward pressure on wages.

At an economy-wide level, excessive wage growth can be a source of inflation and generate economic volatility, as wage increases eventually choke off labour demand and economic expansion. The result may also be sharply increased unemployment or real wage stagnation.

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<sup>59</sup> The extent to which this process works in favour of the Western Australian economy depends on its level of market power for individual commodities (or whether similar constraints are affecting its competitors) and, more generally, the future path of resource prices.

For example, the Australian Government's Accord policy in the 1980s was designed in part to unwind a sharp rise in unemployment believed to have resulted from strong growth in real wages in the late 1970s and early 1980s.<sup>60</sup> Australian real wages fell in mid-1980s, and on some measures did not return to their pre-Accord peak until the late 1990s.<sup>61</sup>

At a business level, rising wages may cause difficulties for some employers, and in the long run, it is likely that only the more profitable firms will have the capacity to sustain an increase in labour costs. As a general rule, these firms will tend to be the most efficient and productive in a competitive market. Such shifts in relative demand can also affect the distribution of employment between industries, regions, and occupations, sometimes generating economic and social adjustment costs.

However, it is through this reallocation process (i.e. the migration of labour to its most productive uses) that economy-wide productivity is boosted, and rising productivity is an important driver of sustainable growth in real wages. Scarce labour can also induce a shift in the share of income from capital to labour. Such trends represent an important long-term welfare gain to the community, notwithstanding any costs associated with economy-wide structural change.

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<sup>60</sup> Although some analysts question whether wages growth alone explains the rise in unemployment in the early 1980s – see for example Bob Gregory, *A Longer-Run Perspective on Australian Unemployment*, ANU Centre for Economic Policy Research Discussion Paper 425.

<sup>61</sup> For example, real Australian average male total earnings reached \$890 (in 2004-05 dollars) in the June quarter of 1984, but didn't attain that level again until late 1997.

### Other considerations

In addition to the benefits of sustained higher real wages, reducing unemployment is a key goal of government and the wider community. The existence of labour shortages is a natural consequence of success in approaching this target. In Western Australia, a combination of strong labour demand and relatively scarce supply has occasioned a significant welfare gain in the form of lower long-term unemployment (see page 62). It has also resulted in better outcomes in other marginalised segments of the market, including the youth labour market<sup>62</sup> and the underemployed.

It is worth noting too that alternative policy measures (other than those designed to fully utilise the existing stock of labour) could give rise to indirect costs in the longer term. For example, a very large expansion in migration would generate an increase in demand for public goods and services and public infrastructure.

In the shorter term, however, labour shortages do pose some significant short-term risks to the Western Australian economy. There is a danger that competition could result in firms bidding up the price of labour beyond a level that is justified by productivity. This could fuel inflation and create unwelcome economic distortions (including a temporary rise in unemployment), especially if higher wages prove unsustainable for some firms. The 'sticky' nature of wages could prolong this problem, making subsequent adjustment more prolonged and generating a sustained rise in unemployment.

To mitigate these possible outcomes, while still gaining the benefits of strong labour demand, the reallocation of labour to its most productive uses should ideally occur as quickly and efficiently as possible. Systems of education and training that are responsive and adaptable (as much as is practical) to structural change in the economy support this process. Temporary increases in migration can also play an important role by addressing crucial short-term gaps in supply and alleviating inflationary pressures.

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<sup>62</sup> Note the increase in labour force participation by those aged 15-24 years in the table on page 59.

### *Summary*

If current trends in labour demand are maintained, skilled labour shortages may persist for some time in Western Australia. This reflects a slowdown in labour force growth due to a past decline in the rate of natural increase; the prospect of only modest net interstate population transfers; limits on the scope for improving the unemployment rate; and the long-term effect of population ageing on the aggregate participation rate. Increasing the level of immigration is likely to have only a moderate effect on growth in Western Australia's labour force.

Although scarce labour can act as a constraint on the *aggregate* level of economic growth, and could prevent productivity gains from economies of scale in some sectors, the prospect of continued tightness in the labour market is not necessarily cause for alarm.

Strong labour demand will underpin a continued decline in long-term unemployment and better outcomes for other marginalised participants in the labour market. Moreover, if demand for labour continues to exceed supply, in most instances labour will be reallocated to its most productive uses, resulting in a sustained and sustainable increase in real wages and a possible rise in economy-wide productivity. As such, a combination of strong labour demand and limited supply has positive implications for supporting long-term welfare gains in Western Australia's community.

### 3. CHINA: AN ECONOMIC AND STRUCTURAL OUTLOOK

China's rapid industrialisation and growing integration into the global economy have made it a very conspicuous and widely discussed influence on global economic trends in recent years. It is a particularly important influence on the trade environment for Australia and Western Australia, both as an export destination in its own right, and as a catalyst to growth in other valuable export markets in south and east Asia, such as Japan and Korea (see discussion in the [International Conditions](#) chapter of this publication).

This feature article discusses China's recent economic record and outlook. It also discusses how China's high growth rates and social change are linked to a number of structural pressures, both economic and social. In doing this it primarily discusses two main drivers of economic growth - investment and trade - and their role in some of the structural imbalances currently being experienced by China.

#### *Recent economic growth and outlook*

China's economy grew by 9.9% in 2005.<sup>63</sup> More recently, growth has accelerated, with yearly<sup>64</sup> growth of 10.3% in the March quarter 2006 moving to a higher yearly<sup>65</sup> growth rate of 11.3% for the June quarter 2006.<sup>66</sup>

Investment and exports are the key drivers of growth in China. China's exports have become more diversified, and new product varieties are supporting export growth.<sup>67</sup> Strong growth in exports has resulted in China's trade surplus rising to a record \$US102 billion in 2005.<sup>68</sup>

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<sup>63</sup> The World Bank China Quarterly Update - February 2006.

<sup>64</sup> Yearly growth refers to the quarterly level compared to the same quarter in the previous year.

<sup>65</sup> Ibid.

<sup>66</sup> *China: growth may bring tighter money*, Business Week Online, July 18, 2006.

<sup>67</sup> The World Bank China Quarterly Update - May 2006.

<sup>68</sup> *China's 2005 Trade Surplus triples to \$102 billion*, Bloomberg, January 11, 2006.



It seems likely that China's trade surplus for 2006 will be another record high, with the trade surplus of US\$14.5 billion for the month of June easily surpassing the previous monthly surplus record of US\$13 billion (recorded only a month earlier). This now means that China's US\$61.5 billion trade surplus for the first half of 2006 is already 55% higher than for the first half of 2005.<sup>69</sup>

The Chinese economy's heavy reliance on exports exposes it to sudden changes in external conditions, but the global economic outlook remains reasonably positive.<sup>70</sup> The World Bank expects that external demand for Chinese goods will be firm, based on positive forecasts for the US and European economies, and Japan's increasing domestic demand. The World Bank also expects that this positive outlook will prevent too rapid a deceleration in exports from possible negative supply-side effects.<sup>71</sup>

Although the Chinese Government has taken measures to curb excessive growth and over-investment (see remainder of article below), domestic conditions in China still favour continuing strong growth.

Forecasts of GDP growth for 2006 all predict a modest easing from the 9.9% real GDP growth in 2005.<sup>72</sup> The World Bank forecasts 2006 GDP growth for China to be 9.5%, before moderating slightly to 8.5% in 2007. The International Monetary Fund's (IMF) and the Organisation for Economic Co-operation and Development's predict growth rates for China's GDP in 2006 at 9.5% and 9.7% respectively. Like the World Bank, both also expect a slight slowing in growth in 2007, albeit to slightly higher growth rates of 9.0% or more in 2007.

Looking further out, Consensus Economics forecasts that growth will moderate further in the long term, with growth forecast at 8.8% in 2008 and 8.4% in 2009.

### Real GDP Forecasts for China\*

	Growth (%)	
	2006	2007
World Bank	9.5	8.5
OECD	9.7	9.5
IMF	9.5	9.0

\*Source: World Bank Quarterly Report on China May 2006, OECD Economic Outlook May 2006, IMF World Economic Outlook April 2006.

<sup>69</sup> *China's Trade Surplus Hit Record in June* - Associated Press, July 10, 2006.

<sup>70</sup> See International Conditions chapter

<sup>71</sup> Such as the levelling off of foreign direct investment, some exchange rate appreciation (which would make Chinese goods more expensive overseas), and tax measures taken by the Chinese Government to discourage energy-intensive exports.

<sup>72</sup> Although it is worth noting that these forecasts were compiled before the latest June quarter economic growth figures for China were released.

### *Structural issues*

The IMF argues that China needs to focus on long-term structural reforms, such as greater exchange rate flexibility, fiscal spending to reduce Chinese citizens' precautionary savings, and the creation of a wider range of credit instruments in the banking sector (so that households create a more permanent increase in the consumption share of GDP growth over the medium term).<sup>73</sup>

#### Household consumption

Household consumption in China has grown rapidly (supported by income growth), but real consumption growth of around 7.5% a year has not kept pace with GDP growth of around 9.5% a year in the past five years.<sup>74</sup> China's average consumption rate of 59.5% in the past ten years is some 20 percentage points lower than the world average.<sup>75</sup>

Consumption and savings behaviour in China reflect a number of institutional and structural factors. For example, China's fixed exchange rate constrains households' purchasing power – if China's currency (the Yuan, also called the Renminbi) was allowed to float freely, relative import prices would fall in conjunction with any rise in the Yuan.<sup>76</sup>

Social conditions such as a limited welfare and public health system provide a strong incentive for households to have high levels of precautionary savings. There are limited property and other investment channels for private investors, which encourages households to place their savings in standard bank deposits (which typically have much lower rates of return than income generating assets)<sup>77</sup>.

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<sup>73</sup> For more information, see *Rebalancing Growth in China*, IMF Asia and Pacific Regional Economic Outlook – May 2006.

<sup>74</sup> Economist Intelligence Unit estimates for 2000 to 2005, via Datastream.

<sup>75</sup> *Saving deposits in China hit record high as domestic consumption down*, People's Daily Online, 2006.

<sup>76</sup> Given strong global demand for China's exports, the Yuan would likely rise if it was floated.

<sup>77</sup> Ibid.

Growing social pressures (such as rising income inequality between and within regions<sup>78</sup>) make it prudent for China to try to change the composition of economic growth away from exports and investment and towards household consumption.

However, the World Bank believes that household consumption's share of the economy is not likely to pick up soon.<sup>79</sup>

Increasing the purchasing power of households will be key to raising consumption in the medium term. The Chinese Government is looking to use social welfare and other measures as a means to increase incentives for households to use a greater proportion of their disposable income on consumption (rather than savings).<sup>80</sup> Strategies being looked at to achieve this include shifting government spending from investment towards health, education and the social safety net.<sup>81</sup>

#### Investment

Spending on roads, factories and other fixed assets was strong in the first half of the year, with year-on-year growth of 29.8%, an increase of 4.4 percentage points on the same period last year.<sup>82</sup> This highlights the fact that investment is heavy across many sectors of the Chinese economy.

Looking forward, the World Bank believes that China's investment demand will remain strong, though not as high as it was in 2005. Profits grew by 20% in the first 11 months of 2005, although outside the mining sector, profit growth was somewhat weaker.<sup>83</sup> Consensus Economics forecasts fixed asset investment growth to moderate from 25.7% in 2005 to 20.7% in 2006, before slowing to 16.4% in 2007.

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<sup>78</sup> Especially in respect to rural regions, which have not seen the same degree of growth that urban regions have (also see remainder of this article).

<sup>79</sup> The World Bank China Quarterly Update - May 2006.

<sup>80</sup> *China aims to spur consumption by increasing purchasing power*, People's Daily Online, 2005.

<sup>81</sup> Ibid

<sup>82</sup> *More macro control measures needed*, China Economic Net, 2006

<sup>83</sup> World Bank Quarterly Update on China, February 2006.

However, investment also remains an ongoing issue for China's economy.

In a planned system like China's, market signals such as rates of return do not always direct lending and investment to their most productive uses. And despite moves by the Chinese Central Government to slow the economy, many of the local provincial governments in China have tried to increase local growth rates (as encouraged by the 11th Five Year Plan).<sup>84</sup>

The Chinese Government has therefore undertaken direct measures to reduce over-investment. For example, to ease pressure on overheated industries such as aluminium, local governments have been told to defer aluminium projects where possible.<sup>85</sup>

The Chinese Government is also trying to restrict investment in other key industries such as construction, steel and cement,<sup>86</sup> although Government officials state that this is not a repeat of the economic 'crackdown' of 2004.<sup>87</sup>

Such moves have not proved entirely successful however - new total lending in the four months to April 2006 totalled US\$198 billion, some two-thirds of the central bank's target for the full year.<sup>88</sup> The Chinese Government has therefore also moved to address over-investment through the banking system. In April 2006, the People's Bank of China (China's central banking authority) increased interest rates for the first time in 18 months (by 0.27 percentage points to 5.85%), in an attempt to curb strong economic growth fuelled by easy credit (see below) and over-investment.<sup>89</sup>

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<sup>84</sup> China also has a very decentralised government system, with sub-national governments responsible for about 70% of total government expenditure. Source: *Towards more effective redistribution: Reform options for intergovernmental transfer in China*, IMF.

<sup>85</sup> However, if industrial projects that are currently in the pipeline were to still go ahead, aluminium capacity would increase to 11.6 million tonnes this year (and then to 13 million tonnes by 2010). Source: Reuters - *China aims to limit new projects to cool growth*, and *The Economist - Time to hit the brakes*.

<sup>86</sup> *China backs overseas investment*, BBC News, 17 April 2006.

<sup>87</sup> Wang Xiaoguang, a senior analyst with the National Development and Reform Commission (NDRC), *The Australian Financial Review* - 28 April 2006.

<sup>88</sup> *China central bank sells bills to curb bank lending*, [www.asianfinanceblog.com](http://www.asianfinanceblog.com), June 16, 2006.

<sup>89</sup> *Struggling to Keep the Lid On*, *The Economist*, April 27, 2006.

One possible danger of inappropriate or unproductive investment is that it might lead to overcapacity, which in turn could place downwards pressure on prices. While the prospects of a classic deflationary spiral in China are remote,<sup>90</sup> there remains a risk that overcapacity could also lead to declining sales and profits for some producers (which would further worsen the bad debt burden already evident in China's banking system - see below).

Investment has been boosted by the easy availability of credit. A large amount of money available for lending has arisen as a result of a number of factors, such as the savings rate culture within China (see above).

China's trade surplus brings in large amounts of foreign currency, which (under China's fixed exchange rate regime) the People's Bank of China buys in order to keep the Yuan pegged to the US dollar,<sup>91</sup> thereby further adding to China's money supply.

To offset the increase in money supply, the People's Bank of China undertakes a process called "sterilisation" - selling Government bonds to absorb some of the excess liquidity. While it is not easy to determine the extent to which sterilisation efforts have been effective, the People's Bank of China reports that China's broadest measure of money supply (M2) rose by 4% over the year to June 2006.<sup>92</sup> This is higher than the Government's target rate of 16% growth for 2006, but lower than the 19.1% recorded for the year to May 2006.<sup>93</sup>

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<sup>90</sup> In a deflationary spiral, companies cut wages and employment to sustain falling prices, leading to lower household disposable incomes and hence demand, which in turn depresses prices further, and so on. Real GDP typically falls in such circumstances. The prospects of this in China seem remote, as strong economic growth is driving rises in real wages and demand, with falling output prices due more to rising productivity than excess capacity. Source: *Chinese Economy Grows 11.3 Percent in 2Q* [www.examiner.com](http://www.examiner.com), July 18, 2006.

<sup>91</sup> See *The Revaluation of the Chinese Yuan*, Department of Treasury and Finance Western Australian Economic Summary Autumn, 2005.

<sup>92</sup> *China central bank confirms end-June M2 up 18.4%*, [uk.biz.yahoo.com](http://uk.biz.yahoo.com), July 14, 2006.

<sup>93</sup> *Ibid.*

Other factors, such as China's large net foreign direct investment inflows,<sup>94</sup> and that State banks in China do not have to pay dividends,<sup>95</sup> have also increased the amount of money available for lending.

Such factors have led to a rise in cheap credit (and competitive lending rates),<sup>96</sup> which in turn has helped investment grow rapidly. One result of readily available credit is that China's banking system built up a large burden of bad debt - by 1998, it was estimated that the non-performing loans ratio of China's four largest commercial banks was as high as 40%.<sup>97</sup>

More recently however, China's city commercial banks saw their average non-performing loans ratio drop down to 7.7% by the end of 2005. While this ratio is still much higher than the 1% to 2% level reported by leading foreign banks, it represents a fall of almost four percentage points from a year earlier, and was the first time the rate had fallen below 10%.<sup>98</sup>

The Chinese Government has introduced a series of reforms to the country's banking and finance sector. In April 2006, the Government announced plans to allow Chinese businesses and individuals to invest in foreign securities markets in an effort to move the Chinese currency to a more open, market-based currency.<sup>99</sup> China has also recently increased the required reserve ratio for banks<sup>100</sup> by 0.5 of a percentage point, bringing the required ratio to 8%.<sup>101</sup>

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<sup>94</sup> Where large capital inflows are driven by competitive lending rates and high expectations about future growth. Source: IMF Finance and Development Magazine: September 2005.

<sup>95</sup> IMF Policy Discussion Paper - *Modernizing China's Growth Paradigm*.

<sup>96</sup> With the Chinese banking system's benchmark one-year interest rate currently at 5.85%.  
*World Interest Rate Table*, [www.fxstreet.com/fundamental/interest-rates-table](http://www.fxstreet.com/fundamental/interest-rates-table)

<sup>97</sup> *Banking on Reform*, The China Business Review, May-June, 2006.

<sup>98</sup> *Banking on Reform*, The China Business Review, May-June, 2006.

<sup>99</sup> *China Eases Investment Ban*, The Washington Post, April 14, 2006.

<sup>100</sup> This ratio sets the minimum reserves each bank must hold to customers' deposits and notes. These reserves are designed to satisfy withdrawal demand and would normally be in the form of fiat currency stored in a bank vault, or with a central bank.

<sup>101</sup> *China tells banks to raise reserves to curb lending*, Bloomberg, June 16, 2006.

Such moves have helped to ease some of the pressures from high investment and problems in the banking system. Moody's Investors Service holds a stable to positive outlook for China's banking sector as its competitive and regulatory environment undergoes increasing change. May Yan, a Moody's VP/Senior Credit Officer notes that "reform of the large banks is on track" and that "...similar reforms have spread to city commercial banks, rural banks and credit coops, while reforms and regulatory initiatives to strengthen operations and lower systemic risk are apparent".<sup>102</sup>

However, May Yan also notes that "...the average bank financial strength rating of E+ remains one of the lowest on Moody's global scale, due to the system-wide weak financial fundamentals including relatively low capital, provisioning and profitability".<sup>103</sup>

#### Social pressures

As noted above, the widening income gap between the urban and rural populations is a continuing problem for China. While industrialisation is rapid, many rural farmers (most of whom do not own the land they cultivate), struggle at or below the poverty line.<sup>104</sup>

The problem is worst in the western and south-western provinces of China, where agriculture is the main activity.<sup>105</sup> The relatively infertile soil in these areas further complicates the problem, making it difficult for farmers to improve productivity through fertiliser, irrigation or modern technology.<sup>106</sup>

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<sup>102</sup> *Banking System Outlook 2006: China*, Moody's Investors Service, July, 2006.

<sup>103</sup> *Ibid*

<sup>104</sup> *Powerhouse rises on Asia fields*, BBC News, 7<sup>th</sup> July 2006.

<sup>105</sup> The most affected provinces are Qinghai, Sichuan, Gansu, Xinjiang Uighur and Tibet. *Business Week online* : [www.businessweek.com/2000/00\\_19/b3680013.htm](http://www.businessweek.com/2000/00_19/b3680013.htm)

<sup>106</sup> *Income Disparity in China*, Taejoon Han, George Washington University.

The latest figures show that the richest 10% of China's population now earn 9.5 times as much as the poorest 10%, up from 9.1 times in 2003.<sup>107</sup> It is feared that this increasing disparity will create civil unrest within China and encourage even more citizens to move from rural areas to the cities.<sup>108</sup>

While rural residents are barred from moving to urban areas without official permission, this rule is being less rigorously enforced, as it is overridden by growing need for urban workers and the economic opportunities the cities offer.<sup>109</sup> This rural-urban migration causes its own social problems as well, with many urban residents not wanting to have their affluent lifestyle compromised.<sup>110</sup> The media have also portrayed the rural migrants as the main source of crime and violence, causing crowding and violating family planning policies.<sup>111</sup>

One possible solution being debated is that the Government should provide incentives to encourage productivity growth that raises agricultural output above subsistence levels. Land ownership (or at least secure long-term tenure) could be a step forward in rural reform.<sup>112</sup>

However, China's strong economic growth has also generated huge benefits.

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<sup>107</sup> The Standard Newspaper Online, *Growing income gap top problem list*, January 26, 2005. The survey was of 50,000 urban residents.

<sup>108</sup> *Postulating Peasants and Upholding Urbanites: A Reassessment of China's Rural-Urban Divide*, Miriam Gross, University of California - San Diego.

<sup>109</sup> *China rethinks peasant "apartheid"*, BBC News, 10<sup>th</sup> November, 2005.

<sup>110</sup> Johnson, D.G. 1996, *China's Rural and Agricultural Reforms: Successes and Failures*, University of Western Australia, February.

<sup>111</sup> Davin, D. 1996, *Migrants and the Media: Concerns about Rural Migration in the Chinese Press*. Paper presented at the International Conference on the Flow of Rural Labour, June.

<sup>112</sup> *Advocating Land Ownership for the World's Rural Poor*, Roy Prosterman, University of Washington.



Business development as underpinned productivity improvements in many areas of China (in particular the coastal provinces). For example, in the 1980s and 1990s, township and village enterprises<sup>113</sup> were established throughout China. The number of rural enterprises stands at 22.1 million, employing over 138.7 million people.<sup>114</sup>

Special Economic Zones established in the past two decades along coastal areas have also provided an impetus for growth.<sup>115</sup> These zones have somewhat different economic laws to the rest of China (usually more liberal laws), with the aim of encouraging both domestic and foreign investment.<sup>116</sup>

Overall, despite the widening gaps in income, poverty in China has decreased rapidly. Indeed, the IMF reports that the reduction in China's poverty between 1978 and 2002 was the most rapid and extensive improvement in human welfare in history,<sup>117</sup> as illustrated in the table below.

Year	The annual poverty reduction announced by the government (10 thousand)	The growth rate of per capita GDP (%)	The growth rate of farmers' consumption level (%)	The growth rate of farmers' net income per capita (%)
1978-1985	1786	8.3	10.0	15.1
1985-1990	800	6.2	2.5	3.0
1990-1997	500	9.9	8.0	5.0
1997-2002	436	7.7	3.4	3.8
1978-2002	924	8.1	5.6	7.2

Source: China's economic growth and poverty reduction (1978-2002), Hu, A., Hu, L. & Chang, Z.

<sup>113</sup> This is where local populace is mobilised into a specific business or industry through the state.

<sup>114</sup> *China's Township and Village Enterprises*, He Kang, Foreign Language Press.

<sup>115</sup> In China, these zones are in the Guangdong, Fujian, Hainan, Shanghai and Liaoning provinces, all of which lie on the coast. Source: [china.org.cn](http://china.org.cn).

<sup>116</sup> *Special Economic Zones and Open Coastal Cities*, [china.org.cn](http://china.org.cn).

<sup>117</sup> *China's economic growth and poverty reduction*, IMF, 2003.

### *Conclusion*

Most forecasters expect that China's rapid economic growth will be sustained at least the next few years, and perhaps even longer. China's structural reform program and attempts at broadening economic activity (towards a more evenly balanced economy, and so that consumers and the poorer provinces gain a greater share of its benefits) are now some of the Chinese Government's greatest economic policy challenges.

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## 4. 2006-07 BUDGET

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This article summarises the major features and financial aggregates presented in the 2006-07 Budget. The budget 'bottom line', the net operating balance of the general government sector as well as the outlook for net debt and the Government's other financial targets that form the basis of its medium term fiscal strategy, are also discussed.

### *Fiscal Strategy*

The Treasurer delivered the Government's sixth budget on 11 May 2006.

The budget focused on the key goals of sharing the State's prosperity with every Western Australian, the delivery of quality services and building capacity for future growth.

The Government aims to achieve these goals through a record level of investment in the State's Capital Works Program, the use of strong operating surpluses to manage public sector debt well within affordable levels, and the increases in the level of key services that address the needs of those in the community in greatest need of support (e.g. children at risk and people with disabilities).

The Government's financial strategy commits to sound financial management principles and maintains the same broad financial targets adopted upon coming to office (reflected in the Government's first budget in 2001-02)<sup>118</sup>. The targets are to:

- maintain or increase real net worth of the total public sector;
- achieve an operating surplus for the general government sector;

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<sup>118</sup> In the 2005-06 Budget, some targets were the subject of minor technical amendments to make them more useful as tools for measuring the impact of the Government's financial management and policy decisions on public sector finances.

- maintain Western Australia's tax competitiveness, as measured by maintaining tax revenue as a share of Gross State Product below the average of other States; and
- retain Western Australia's triple-A credit rating, represented by the following specific targets:
  - maintain the net debt to revenue ratio for the total non-financial public sector at or below 47%; and
  - ensure that real per capita own-purpose expenses for the general government sector do not increase.

The 2006-07 Budget projections are consistent with achievement of each of these targets across 2006-07 and the forward estimates years, with the exception of the general government expense target, with expenses forecast to grow in real per capita growth in 2006-07.

Expenses are forecast to rise by 7.7% in 2006-07, following an estimated 8.5% rate of growth in 2005-06. While these levels are in excess of real per capita growth, they reflect the impact of:

- changes in the timing of a number of significant one-off transactions;
- the demands of sustained population growth and the State's booming economy; and
- have been facilitated by the impact of the boom on public sector finances, particularly revenue, which has delivered significant strengthening in the State's financial position and outlook.

Forecast expense growth in 2005-06 reflects some significant wage outcomes (eg. agreements covering nurses and vocational education lecturers), higher staffing levels in key areas (including health, education and training, and law and order). A number of new initiatives were also implemented by the Government prior to the 2006-07 Budget, in response to demands from the State's booming economy. These include spending to:

- address the current skills shortage;
- enhance the State's counter-terrorism and emergency response capability; and

- install seatbelts on the State's school bus fleet.

As part of the 2006-07 Budget, the Government announced a range of spending initiatives to address priority services, such as:

- responses to the recommendations of the Mahoney Inquiry into offender management;
- additional support for children at risk;
- the provision of additional accommodation support and an incontinence subsidy for the disabled;
- mental health;
- indigenous housing; and
- road safety.

The estimates for 2006-07 also include the bring forward (from 2007-08) of the expense effect of converting a loan to a grant to the owners of the Dampier to Bunbury Natural Gas Pipeline, reflecting expectations about the timing of commitments to expand pipeline's capacity.

The public sector's capacity to afford these higher rates of expense growth in 2005-06 and 2006-07 is accommodated by the strength of recent revenue growth and operating surplus outcomes evident in the projections for these two years.

The State's balance sheet remains in a strong position with sound financial fundamentals in prospect across the forward estimates.

### ***Financial Projections***

The key financial aggregates published in the 2006-07 Budget are summarised in the following table.

<b>Key Budget Aggregates</b>						
Western Australia						
	2004-05	2005-06	2006-07	2007-08	2008-09	2009-10
	Actual	Estimated Actual	Budget Estimate	Budget Estimate	Budget Estimate	Budget Estimate
<b><u>GENERAL GOVERNMENT</u></b>						
Net Operating Balance (\$m)	1,192	1,981	1,275	889	571	447
Revenue (\$m)	14,222	16,123	16,510	16,414	16,575	16,994
Expenses (\$m)	13,030	14,141	15,234	15,526	16,004	16,547
<b><u>TOTAL NON-FINANCIAL PUBLIC SECTOR</u></b>						
Net Debt to Revenue Ratio (%)	25.2	26.2	30.0	33.9	38.3	39.8
<b><u>TOTAL PUBLIC SECTOR</u></b>						
Net Debt at 30 June (\$m)	4,001	4,501	5,413	6,204	7,252	7,730
Capital Works Program (\$m)	4,061	5,100	5,201	4,612	4,339	3,965

Reflecting the impact of current boom conditions, a general government operating surplus of \$1,275 million is projected for 2006-07. This follows an expected record surplus of \$1,981 million in 2005-06 and a previous record surplus outcome of \$1,192 million in 2004-05.

Operating surpluses are forecast to continue in the outyears, albeit at lower levels as boom conditions are expected to ease. These surpluses play a critical role in containing net debt to sustainable and affordable levels, by providing an important source of non-debt funding for the State's Capital Works Program (see *Infrastructure Spending* below).

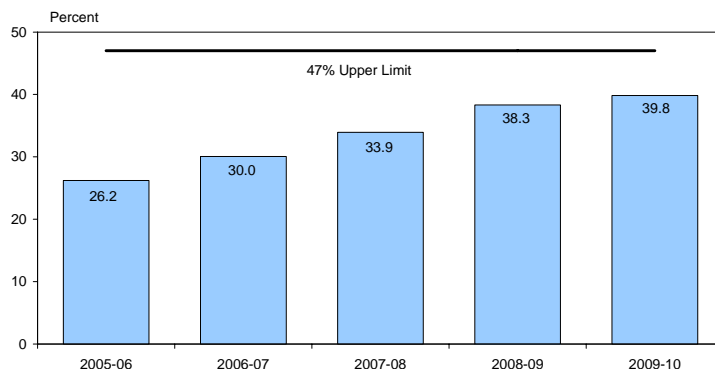
The significant operating surplus outcome for 2005-06 will allow the Government to inject \$1,275 million into the Public Transport Authority in 2006-07, repaying all existing borrowings for the New MetroRail project and funding all remaining works. This decision will leave this significant \$1.6 billion public transport project debt-free on completion and save around \$76 million in annual interest costs.

This continues the Government's policy of using surplus cash as a means of reducing balance sheet risk through early debt repayments. Together with debt repayments using surplus funds from 2003-04 and 2004-05, the New MetroRail decision will result gross borrowing levels that are around \$2.3 billion lower than would otherwise have been achieved, and a significant \$145 million reduction in annual debt servicing costs for the general government sector.

The total non-financial public sector net debt to revenue ratio, which provides an important measure of the affordability of the State's net debt levels and is a key indicator for the State's credit rating assessment, is projected to reach a maximum 39.8% by 2009-10, well below the Government's 47% self-imposed target limit.

#### NET DEBT AS A SHARE OF REVENUE

##### Total Non-Financial Public Sector



The forecast operating surplus of \$1,275 million for 2006-07 reflects a forecast easing in general government revenue growth, which is forecast to increase by \$387 million (or 2.4%) in the budget year, following expectations of very strong revenue growth of 13.4% in 2005-06 (driven by the effect of prevailing economic conditions).

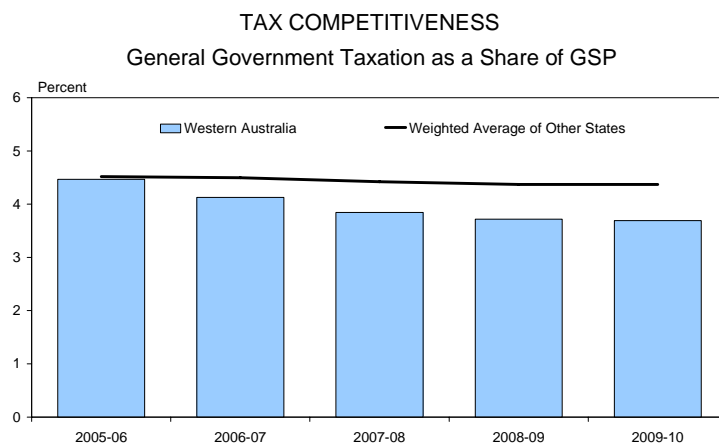
The main factors underpinning the increase in general government revenue in 2006-07 include:

- higher current grants from the Commonwealth reflecting the State's share of forecast increases in national GST collections; and

- higher mining royalty revenue reflecting expected increases in iron ore prices for the Japanese Fiscal Year 2006-07, a higher forecast average oil price and a lower assumed \$A/\$US exchange rate.

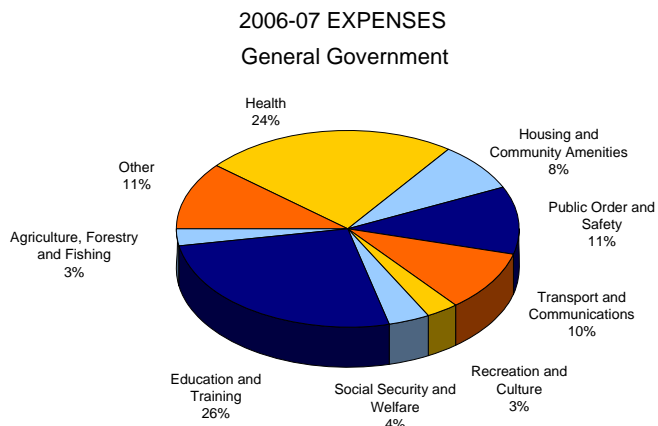
Taxation revenue is expected to decline marginally in 2006-07 (by \$18 million), reflecting further tax relief measures introduced in the 2006-07 Budget (including mortgage duty, rental duty and land tax relief), the impact of a large one-off conveyance duty assessment in 2005-06, and an expected softening of property market conditions.

The taxation relief measures assist in maintaining Western Australia's tax competitiveness. Western Australia's taxation revenue as a share of gross State product is expected to remain below the average of the other States in each year of the forward estimates period, as shown in the following chart.



Expenses are forecast to total \$15.2 billion in 2006-07, representing growth of 7.7% compared with 2005-06. The delivery of key health, education and training and public order and safety services are estimated to account for around 61% of total general government expenses in 2006-07.





Across the remaining forward estimates period, expense growth is forecast to moderate to an average 2.8% per annum. Outyear expense growth accommodates the new initiatives outlined earlier and the full-year impact (from 2007-08) of sector-wide procurement and corporate service reforms. The outyears also accommodate an average 4.5% growth in general government salaries costs, reflecting the Government's wages policy and forecast growth in employee numbers, particularly in the priority service areas (education and training, health, law and order, and community support).

### *Infrastructure Spending*

Significant public investment in infrastructure continues as a priority of the 2006-07 Budget, reflected in a record \$5.2 billion Capital Works Program for 2006-07.

The provision of public sector infrastructure is essential in supporting the State's growing population and the continued ongoing strength of the nation's strongest exporting economy.

Notable capital projects provided for in the budget include:

- improvements to electricity infrastructure across the State, with a focus on the long-term provision of generation, transmission and distribution (e.g. facilitating the connection of new power stations to the South-West Interconnected System grid);

- upgrades to water, wastewater and drainage services (e.g. completion of the Perth Seawater Desalination Plant and accelerated work on the Infill Sewerage program);
- major road construction, improvement and expansion projects (such as the Karratha-Tom Price and New Perth-Bunbury Highway extensions, and reconstruction of the Eyre Highway from Caiguna East to Balladonia);
- planned completion of the New MetroRail project (including the Southern Suburbs railway and underground works in the Perth CBD);
- various upgrades and new works for public schools and TAFE colleges, and for health, police, court and prison facilities; and
- upgrades to port infrastructure around the State to meet the increasing demand from commodity exporters.

Full details of the State's financial projections can be found in Budget Paper No. 3: *Economic and Fiscal Outlook*, together with further detailed supporting commentary. The Budget Papers are available online at [www.ourstatebudget.wa.gov.au](http://www.ourstatebudget.wa.gov.au).

## APPENDIX 1.

## WESTERN AUSTRALIAN EXPORTS BY COMMODITY

	May-05	Jun-05	Jul-05	Aug-05	Sep-05	Oct-05	Nov-05	Dec-05	Jan-06	Feb-06	Mar-06	Apr-06
	\$ Million											
Gold	651.0	340.8	501.3	559.5	403.1	471.4	280.6	806.3	541.4	621.5	505.3	729.6
Iron Ore	984.8	1,009.5	1,042.6	987.7	952.7	1,091.2	1,105.8	1,133.7	807.6	1,045.3	953.5	1020.6
ETMs	198.7	211.9	159.7	235.9	154.8	171.8	194.2	173.9	131.1	198.2	166.7	166.3
Wheat	72.3	115.3	121.7	113.5	148.9	142.3	128.3	166.0	140.0	138.7	154.7	157.1
Petroleum	525.8	493.3	678.5	590.2	506.5	408.6	518.6	609.5	336.0	528.2	451.7	397.6
LNG	308.8	268.1	380.2	338.0	247.8	304.9	389.6	416.7	375.3	310.4	290.1	336.0
Nickel	57.2	70.2	78.3	72.3	41.7	152.7	79.0	127.2	35.5	135.9	81.7	70.6
Wool	54.6	38.3	34.3	29.1	32.6	35.0	40.6	38.1	19.9	42.7	61.5	62.5
Crustaceans	44.1	37.5	30.5	13.8	9.9	12.2	6.3	34.9	54.4	30.8	37.2	58.2
Live Animals	19.3	19.8	22.9	47.2	46.6	37.9	49.3	39.0	46.9	23.7	26.0	14.0
Confidential Items	621.8	644.5	580.7	647.2	519.4	615.0	683.3	703.8	616.3	631.8	664.5	624.9
<b>All Commodities</b>	<b>3,851.0</b>	<b>3,467.0</b>	<b>3,886.0</b>	<b>3,861.0</b>	<b>3,330.0</b>	<b>3,759.0</b>	<b>3,741.0</b>	<b>4,697.0</b>	<b>3,391.0</b>	<b>4,056.0</b>	<b>3,698.0</b>	<b>4,044.0</b>

Source: Australian Bureau of Statistics, unpublished data.

## APPENDIX 2.

## WESTERN AUSTRALIAN EXPORTS BY DESTINATION

	May-05	Jun-05	Jul-05	Aug-05	Sep-05	Oct-05	Nov-05	Dec-05	Jan-06	Feb-06	Mar-06	Apr-06
	\$ Million											
Singapore	171.0	140.7	198.2	140.4	176.3	205.3	86.5	163.8	103.8	124.8	89.3	60.0
Indonesia	119.4	138.5	101.4	127.7	154.2	66.6	72.8	92.4	102.1	162.5	43.7	110.1
Malaysia	19.8	41.3	26.9	25.1	21.0	28.8	15.3	68.2	35.5	20.2	14.9	27.0
Thailand	106.0	115.9	65.2	240.0	187.1	97.6	122.4	102.1	97.1	92.6	141.1	179.6
Philippines	5.5	5.5	3.5	6.2	27.2	5.8	3.4	5.4	9.3	4.8	4.4	4.6
<b>South East Asia</b>	<b>421.7</b>	<b>441.9</b>	<b>395.2</b>	<b>539.4</b>	<b>565.9</b>	<b>404.1</b>	<b>300.4</b>	<b>431.9</b>	<b>347.8</b>	<b>405.0</b>	<b>293.4</b>	<b>381.2</b>
South Korea	340.0	208.2	460.0	291.6	258.1	364.3	442.1	355.6	283.6	356.3	378.3	286.0
China	747.0	713.6	747.0	759.8	697.2	848.5	758.8	1,018.4	538.2	865.7	758.2	860.1
Taiwan	80.0	95.2	93.8	104.0	108.3	111.3	79.4	130.0	60.5	81.2	90.0	159.4
Hong Kong	17.0	12.7	18.8	11.9	25.3	13.1	18.2	20.3	33.3	29.0	33.6	33.8
<b>North East Asia</b>	<b>1,210.0</b>	<b>1,051.0</b>	<b>1,291.0</b>	<b>1,304.0</b>	<b>1,167.0</b>	<b>1,323.0</b>	<b>1,348.0</b>	<b>1,503.0</b>	<b>952.0</b>	<b>1,344.0</b>	<b>1,311.0</b>	<b>1,360.0</b>
Japan	880.0	822.8	963.7	917.4	709.3	897.7	980.3	1,084.5	813.1	877.8	714.7	819.0
United States	120.0	199.6	64.0	105.1	50.5	111.8	149.0	118.2	105.3	117.7	98.7	95.5
United Kingdom	69.0	72.0	91.0	96.9	146.2	184.7	138.0	504.7	328.5	354.5	231.2	361.9
Germany	10.0	4.1	4.2	6.9	19.8	6.7	5.6	8.2	7.4	21.0	8.0	13.9
Canada	33.8	80.4	87.5	6.0	34.9	62.3	20.7	81.9	43.6	44.8	75.2	24.7
France	19.0	22.9	16.9	15.1	12.4	22.9	7.8	23.1	1.4	14.7	39.7	4.0
Italy	30.3	17.4	25.8	8.9	26.9	18.7	15.4	17.1	11.7	18.3	21.7	30.7
<b>Group of Seven</b>	<b>1,162.0</b>	<b>1,219.6</b>	<b>1,253.2</b>	<b>1,156.0</b>	<b>1,000.2</b>	<b>1,306.0</b>	<b>1,316.9</b>	<b>1,838.2</b>	<b>1,310.7</b>	<b>1,448.8</b>	<b>1,189.6</b>	<b>1,350.3</b>
<b>All Destinations</b>	<b>3,851.0</b>	<b>3,467.0</b>	<b>3,886.0</b>	<b>3,861.0</b>	<b>3,330.0</b>	<b>3,759.0</b>	<b>3,741.0</b>	<b>4,697.0</b>	<b>3,391.0</b>	<b>4,056.0</b>	<b>3,698.0</b>	<b>4,044.0</b>

Source: Australian Bureau of Statistics, unpublished data.

## GLOSSARY

**Annual Average Growth.** The annual average growth rate compares the level of activity in a 4-quarter period with the previous 4 quarters – for example, comparing the period from June 2005 to March 2006 with the period from June 2004 to March 2005. This gives a less volatile measure of annual growth than the more common practice of comparing activity in a particular month or quarter with the same month or quarter of the previous year.

**Consumer Price Index (CPI):** An index of the price of a basket of goods purchased by the average household for consumption. It is a subset of the GSP deflator.

**Dwelling Investment:** This consists of three components, which are new dwelling investment, alterations and additions and ownership transfer costs.

**Gross State Product (GSP):** The total output of an economy. It includes expenditure in Western Australia on State final demand plus net expenditures (i.e. exports less imports) from interstate and overseas.

**GSP Deflator:** An index of economy-wide prices. It is the broadest measure of prices in an economy.

**Labour Force:** The number of people of working age who are either employed or actively seeking a job.

**Net Exports:** The value of exports minus the value of imports.

**Nominal Exports:** The value of exports at current world prices and in Australian dollar terms. Changes in nominal exports are a measure of the change in value, which incorporates changes in both export prices and volumes.

**Participation Rate:** The ratio of the labour force to the total working age population.

**Real Exports:** The value of exports adjusted for movements in commodity prices and the exchange rate. As such, changes in real exports only measure changes in the volume of exports.

**State Final Demand (SFD):** The total value of expenditure in Western Australia on private consumption, housing (new housing and alterations and additions), business investment and public consumption and investment. State final demand does not include net expenditure in Western Australia from interstate or overseas.

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