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Macroeconomic analysis for pricing submission

WaterNSW

31 May 2024

Executive summary

Introduction

WaterNSW is required to prepare a 2024 Pricing Submission to the Independent Pricing and Regulatory Tribunal of New South Wales (IPART). The Pricing Submission should publicly explain, justify and document WaterNSW's proposed prices for its services. The key building blocks for the pricing submission include forecasts of operating and capital expenditure over the next regulatory period (the 2024 determination period covering 2025-26 to 2029-30). To assist with understanding the outlook for key economic and price variables, WaterNSW has engaged Deloitte Access Economics to examine the evolution of the NSW economy over recent years and to forecast key macroeconomic variables that are relevant to Water NSW's future operating and capital expenditure.

Economic conditions and outlook

The international economic picture has become more clouded over the past three months. The extent to which tensions in the Middle East have escalated, and expectations for interest rate cuts in the US have changed, are litmus tests of the level of economic uncertainty of the moment. Changes have been less pronounced in Australia. Financial markets have overreacted to lumpy labour market readings and US inflation prints, but Deloitte Access Economics' forecasts are not materially different. The expected timing of a first cut in interest rates has been pushed back slightly, though forecast economic growth remains similar over both the short- and medium-term horizon.

Reporting on a financial year basis, Deloitte Access Economics expects national employment growth to slow to 2.6% (around 353,000 jobs) in 2023-24 and 0.9% (around 131,000 jobs) in 2024-25 as weaker economic conditions create headwinds for employers. Alongside slowing employment growth, the unemployment rate is expected to gradually increase to 4.6% by the end of 2024, which would see an additional 111,400 Australians join the ranks of the unemployed.

In terms of prices, Deloitte Access Economics sees 2024 and 2025 being characterised by inflation returning to target across most major global economies, with an increasing likelihood of official interest rate cuts as 2024 goes on. Wage growth has accelerated across Australia, but there are signs that it is at or near its peak. Importantly, wage growth is expected to continue to outpace consumer price inflation in each quarter going forward.

Purpose of this work

To support WaterNSW's pricing submission by:

- Assessing current economic conditions in NSW and forecasting the outlook over the next five years
- Examining the historic performance of key price and wage series that are relevant to WaterNSW's total expenditure
- Forecasting broad price and wage series relevant to WaterNSW's pricing submission

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Economic activity

Economic conditions remain subdued, but cost of living relief is on the horizon

Australian real Gross Domestic Product (GDP) rose 0.2% over the December 2023 quarter, an increase of 2.1% annually. In New South Wales (NSW), real Gross State Product (GSP) fell 0.1% in the quarter, a 1.4% gain over the year.

So far, 2024 has felt like the economy is in a holding pattern. International disruptions and a backlog of homebuilding complicate the picture for a data dependent central bank, delaying a pivot to growth. High interest rates have led to higher mortgage repayments, while a shortage of housing supply has resulted in significant rent increases. Additionally, high inflation levels in the past year have compelled consumers to reduce spending. This is evident from a 0.9% decline in discretionary spending during the December 2023 quarter.

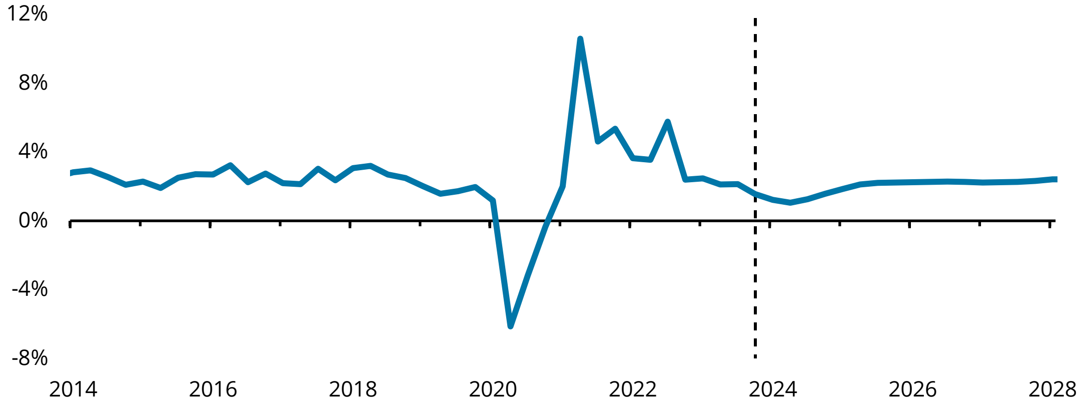
Cost of living pressures have taken their toll on NSW households. Australia's largest state saw a 0.2% decline in real household consumption in the December 2023 quarter, driven by a pullback in demand for non-essential goods and services including dining out at cafés and restaurants, and purchases of clothing and footwear.

Excluding the pandemic period, the expected economic growth of 1.3% in calendar year 2024 would be the weakest since the early 1990s recession. As the pace of price growth continues to decelerate, revamped Stage 3 tax cuts and gradual improvements in real wages will support household finances in the second half of the year.

Australian economic growth is expected to pick up in the coming years, with forecast growth of 2.1% in the 2025 calendar year and 2.3% in 2026. New South Wales GSP is forecast to grow 1.0% in 2024 and 1.9% in 2025 – below the pace of growth in the national economy, before accelerating to grow in line with the wider national economy in 2026.

Chart: Australian economic growth, real GDP

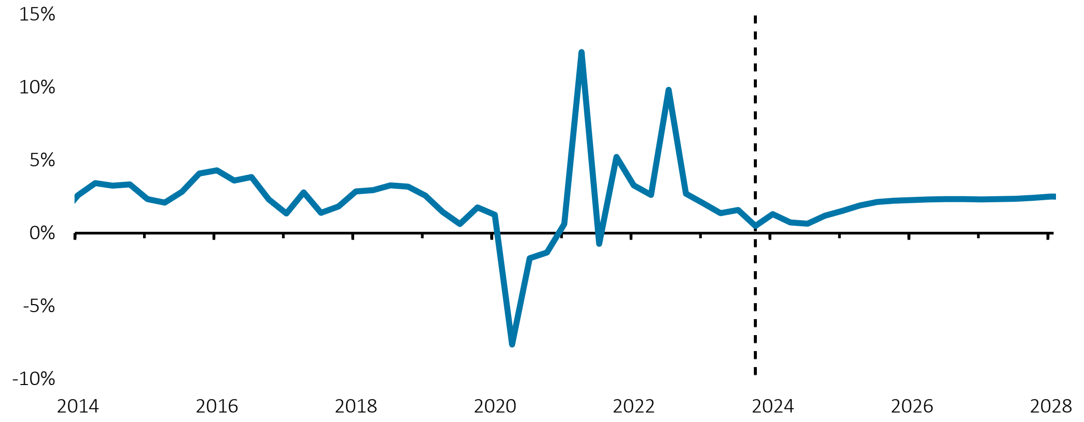
Change over previous 12 months



Source: Australian Bureau of Statistics; Deloitte Access Economics

Chart: New South Wales economic growth, real GSP

Change over previous 12 months



Source: Australian Bureau of Statistics; Deloitte Access Economics

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Inflation

The disinflation path back to the RBA's target proves to be longer than expected

In Australia, Consumer Price Index (CPI) inflation (price growth of the goods and services that households typically buy) exceeded expectations in the March quarter of 2024, growing 1.0% to be 3.6% higher over the year. While quarterly inflation was higher than anticipated, it is important to note that inflation is decelerating, albeit at a slower pace than expected. This is evident when comparing the current annual growth rate of 3.6% to the 4.1% recorded in December 2023.

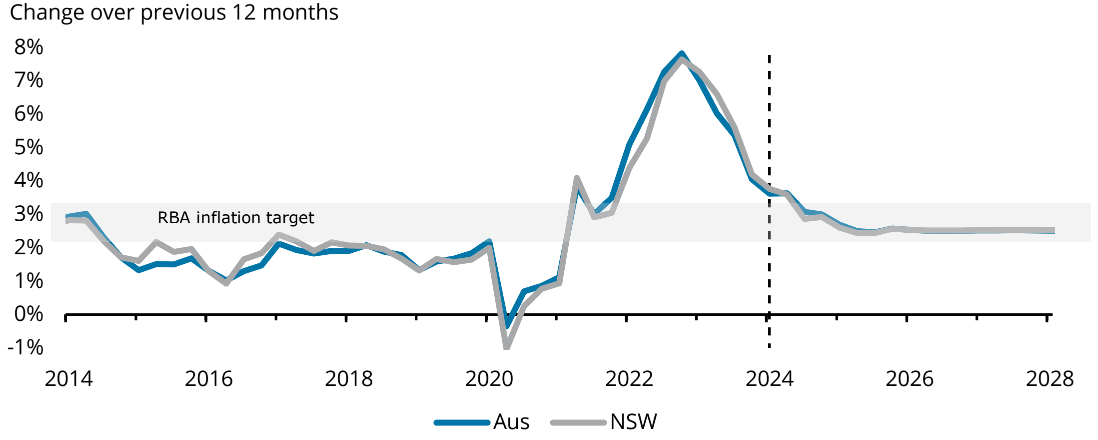
In NSW, inflation for the quarter was also higher than expected, with a growth rate of 1.0% in the March quarter of 2024, up from 0.4% growth in the December quarter of 2023. The annual inflation rate declined from 4.2% in December 2023 to 3.8% in March 2024.

Note that *price levels* are expected to continue increasing, even though the future rate of *price growth* in Australia is expected to keep moderating (towards the Reserve Bank's 2 to 3% target). The rate of inflation remains higher than that target for now due to persistent services inflation, particularly in household services and insurance, which remained high in the March quarter.

Deloitte Access Economics predicts that Australian CPI will slow to a calendar year average of 3.3% in 2024, further decreasing to 2.6% in 2025 and 2.5% in 2026. New South Wales CPI is expected to be 3.0% in 2024, moderating to 2.6% in 2025 and 2.5% in 2026.

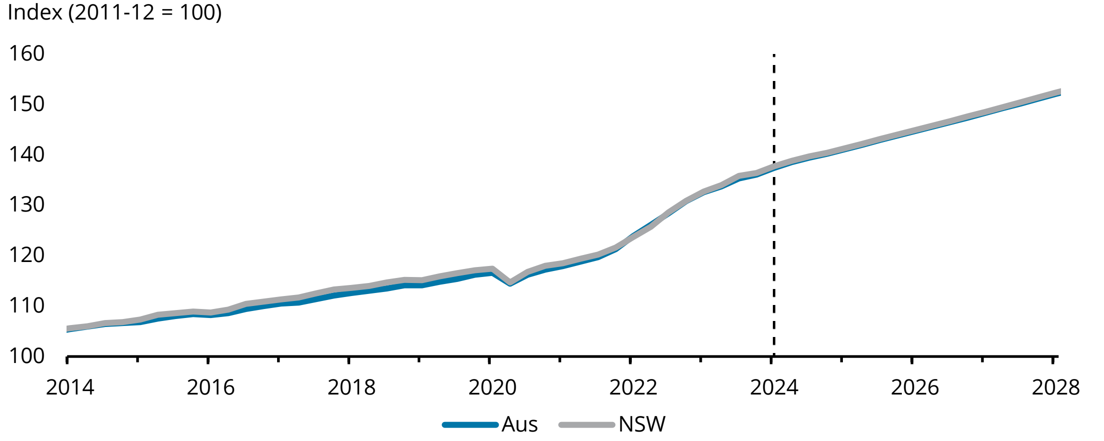
These forecasts see Australian headline CPI inflation return to the Reserve Bank's target range of 2 to 3% in the first half of 2025. This is somewhat earlier than the RBA's own forecasts which expect inflation to hit its target range by mid to late 2025 and reach 2.5% in 2026.

Chart: Headline consumer price index growth



Source: Australian Bureau of Statistics; Deloitte Access Economics

Chart: Headline consumer price index level



Source: Australian Bureau of Statistics; Deloitte Access Economics

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Interest rates

Official interest rate cuts are expected in late 2024 and early 2025

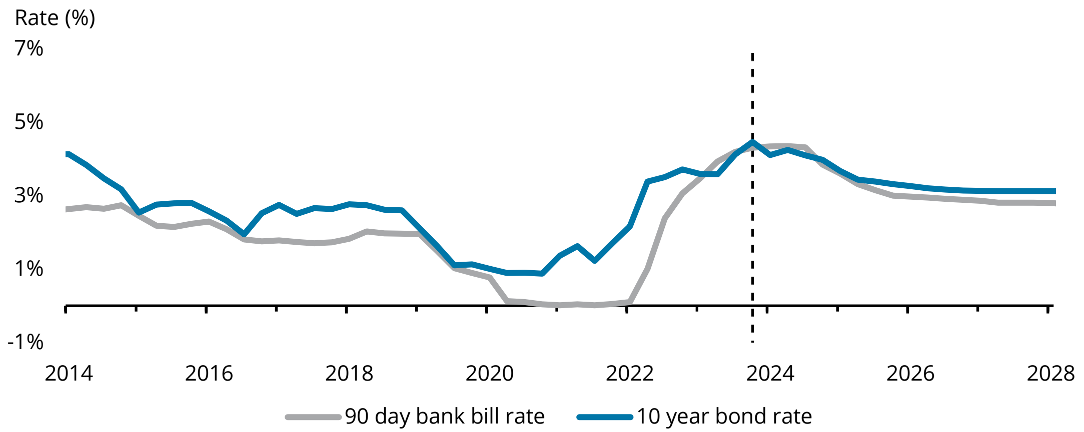
In its May 2024 Board meeting, the RBA decided to maintain the official cash rate target at 4.35%. According to the RBA Board Minutes for May, there were discussions about increasing the rate due to higher-than-expected inflation. However, the decision to hold was upheld by the fact that inflation was primarily non-consumer related, and consumer spending was in fact relatively weak.

Deloitte Access Economics predicts that the first rate cut will likely occur in November 2024, followed by another cut in December and two more in the first half of 2025. That would see the cash rate finish the 2024-25 financial year around 100 basis points lower than it began.

Since the start of 2024, long term interest rates have been relatively stable, ranging between 4.0% and 4.2%. Long term interest rates are likely to remain in this range over the balance of 2024, as central banks are adopting a cautious approach and waiting for relevant data before making any rate changes. It is expected that long term interest rates will gradually return to an average of just over 3%, as seen in the decade prior to the pandemic.

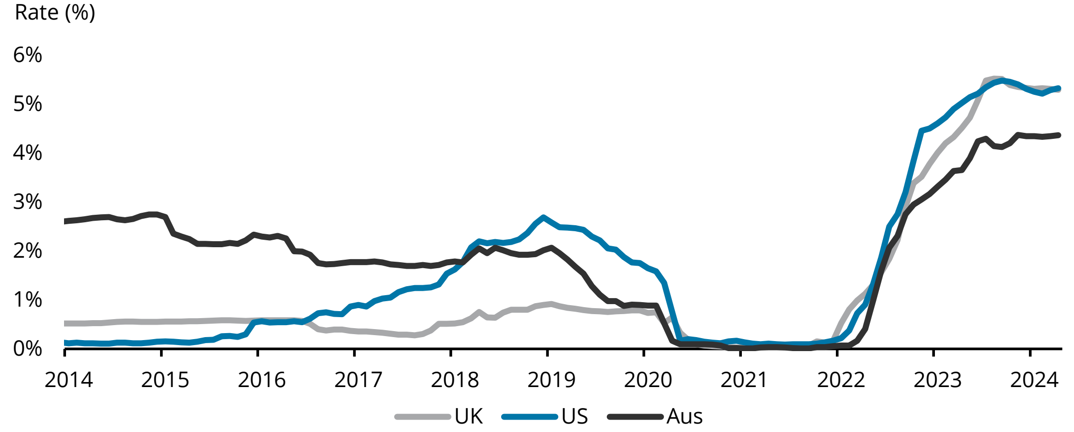
Deloitte Access Economics forecasts the 90-day bank bill rate (a proxy for the cash rate) to be 3.8% by the end of 2024 and drop to 3.0% at the end of 2025. The 10-year bond rate is expected to be 4.0% at the end 2024 and 3.3% in 2025.

Chart: Australian short- and long-term interest rates



Source: Deloitte Access Economics; Reserve Bank of Australia

Chart: Australian 90-Day interbank rates in comparison to US and UK



Source: Federal Reserve Economic Data

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Historic inflation and interest rates

Two decades of stable inflation and declining interest rates (prior to the current inflation burst)

The recent inflationary burst, and subsequent sharp lift in interest rates, is very much at odds with what has generally been seen over the last two decades. The Australian economy has generally enjoyed a sustained period of low inflation, with average CPI growth over the past two decades of 2.7%, below the current 3.6% inflation rate (and recent peak of 7.8% inflation at end 2022).

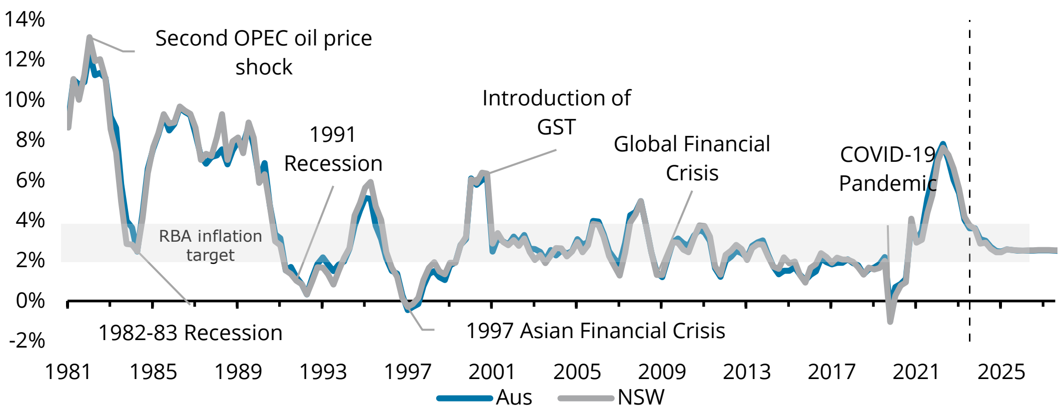
Factors such as low wage growth, technological advancements, and global disinflationary pressures have all contributed to the muted inflation environment during this period.

However, one of the main structural contributions has been the Reserve Bank's introduction of inflation targeting in 1993. Following the 1991 recession the RBA began to steadily cut the official interest rate (the 'cash rate') which dropped from 17% in February 1990 to around 5%, where it remained steady between 1997-2007. Looking at modern history, bar a short time prior to the Global Financial Crisis (GFC) in 2008 when interest rates rose to 7.25%, rates have steadily declined as Australian enjoyed a sustained period of modest inflation.

In 2020, the RBA implemented emergency rate cuts in response to the economic shock caused by the COVID-19 pandemic. The cash rate was reduced to an all-time low of 0.1% in November 2020, where it remained until April 2022.

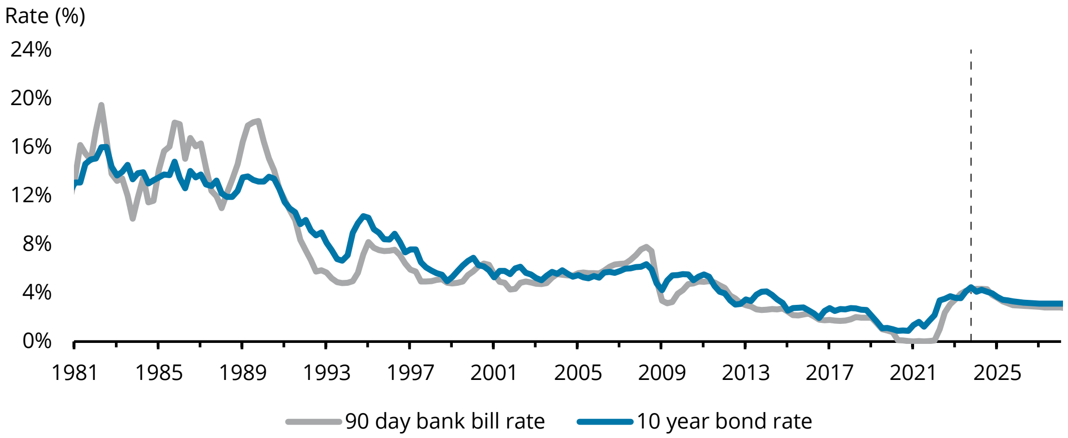
The recent 425 basis point lift in the cash rate since May 2022 is the fastest and largest rate hiking cycle on record, a significant departure from the trend observed in recent decades.

Chart: Headline consumer price index growth



Source: Australian Bureau of Statistics; Deloitte Access Economics

Chart: Australian short- and long-term interest rates



Source: Deloitte Access Economics; Reserve Bank of Australia

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Labour market

The labour market has weakened in 2024 amid macroeconomic headwinds

The Australian labour market has proved to be relatively resilient to the slowdown in the Australian economy. The unemployment rate remains low compared to historical averages, the number of people employed continues to grow, and participation in the workforce is near record highs. This has underpinned an acceleration in wage growth, with growth in the WPI reaching a 16-year high in late 2023. However, conditions in the labour market have begun to ease.

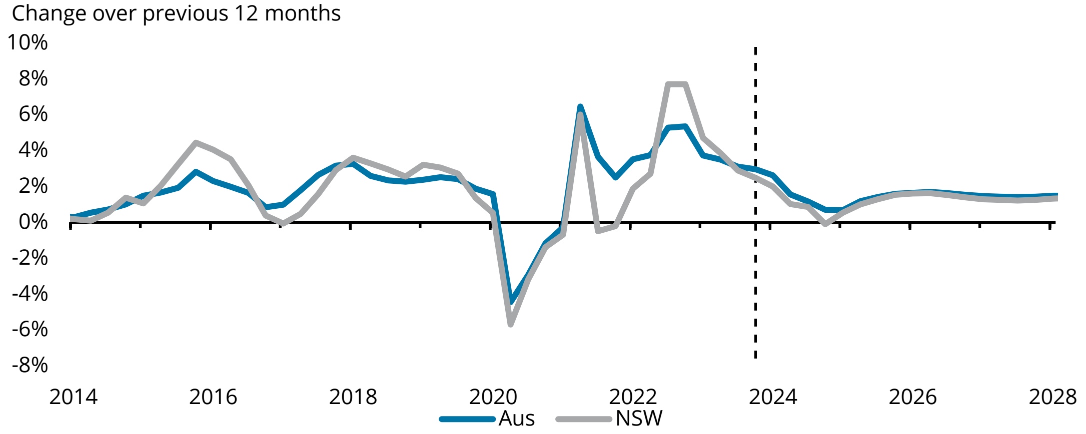
Employment growth moderated across March and April 2024 after strong growth experienced in February 2024. Labour market underutilisation has risen steadily since the end of 2022, now sitting at 10.6%. The unemployment rate increased from 3.8% in March 2024 to 4.1% in April 2024, in seasonally adjusted terms – with almost 600,000 people unemployed in Australia.

Job vacancies also confirm a turning point in labour market conditions. The number of job vacancies fell 6.1% in the first quarter of 2024, picking up speed from the previous quarter and notching up the seventh consecutive quarterly decline since mid-2022. The decline in vacancies is driven by both reduced private and public sector hiring, and record net overseas migration (which is helping to fill open positions).

The New South Wales labour market has softened in recent months after a period of strength. In April 2024 the unemployment rate in NSW was 4.0%, up from 3.8% in March 2024, and the underemployment rate was 6.4% - both just below the national rate.

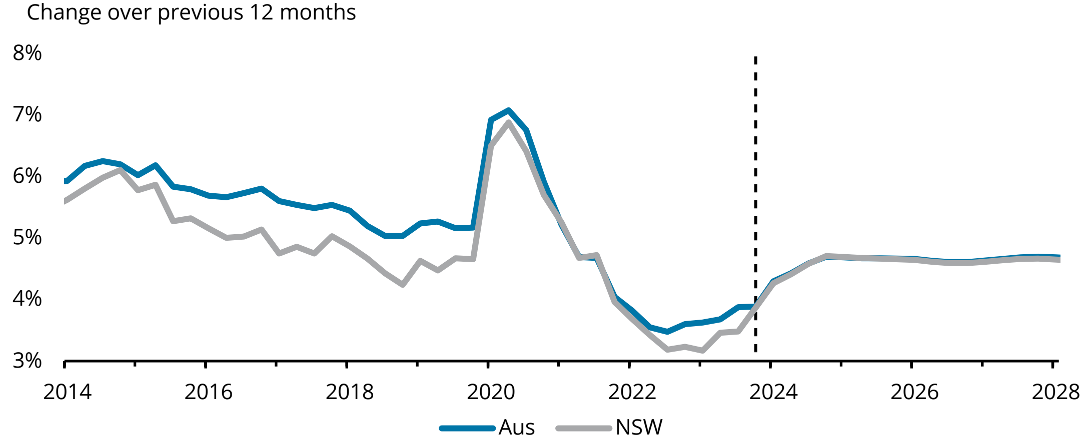
Deloitte Access Economics expects the national unemployment rate will be at 4.6% by the end of 2024, rising to a year-average of 4.7% in 2025. In NSW, unemployment is also expected to reach 4.6% at the end of 2024. Annual employment growth is expected to moderate to 1.5% in Australia and 0.9% in NSW in calendar year 2024 and then further slow in 2025.

Chart: Employment growth



Source: Australian Bureau of Statistics; Deloitte Access Economics

Chart: The unemployment rate



Source: Australian Bureau of Statistics; Deloitte Access Economics

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Wages

Wage growth has peaked, but is still expected to outpace inflation

The Wage Price Index (WPI) grew 0.8% in Australia and 0.6% in NSW over the March 2024 quarter, with annual growth reaching 4.1% and 4.2% respectively. Wage growth has remained at or above 4% for three consecutive quarters. This consecutive growth has not been seen since the March quarter of 2009.

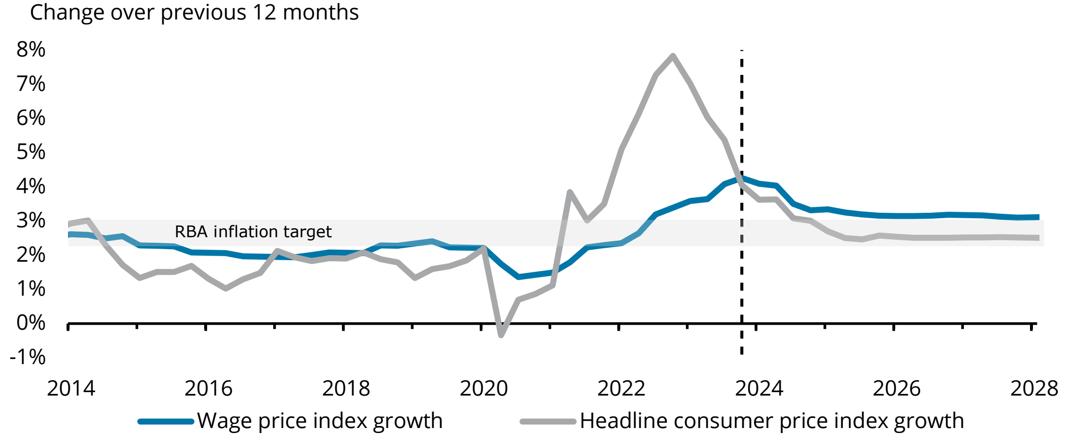
The public sector WPI increased 3.8% in the 12 months to the March quarter of 2024. This is higher compared to the same period last year (3.0%). Annual wage growth in the private sector was marginally lower this quarter at 4.1%. This is the first moderation in the pace of annual wage gains since the September quarter of 2020.

In quarterly terms, public sector wage growth was 0.5%, the smallest growth since the March quarter of 2022. This is partly due to many of the jobs covered by new enterprise agreements and changes to wage caps seeing scheduled pay rises paid in the September or December quarter of 2023 instead of in the March quarter of 2024. However, in NSW, the government has proposed a 10.5% pay increase for public sector workers over the next three years.

NSW wage growth has seemingly peaked in the December 2023 quarter at 4.2%. As private sector wage pressures ease and the unemployment rate steadily ticks up, overall wage growth is expected to slow for the remainder of the year. This is despite upward pressure from award wage decisions and public sector agreements.

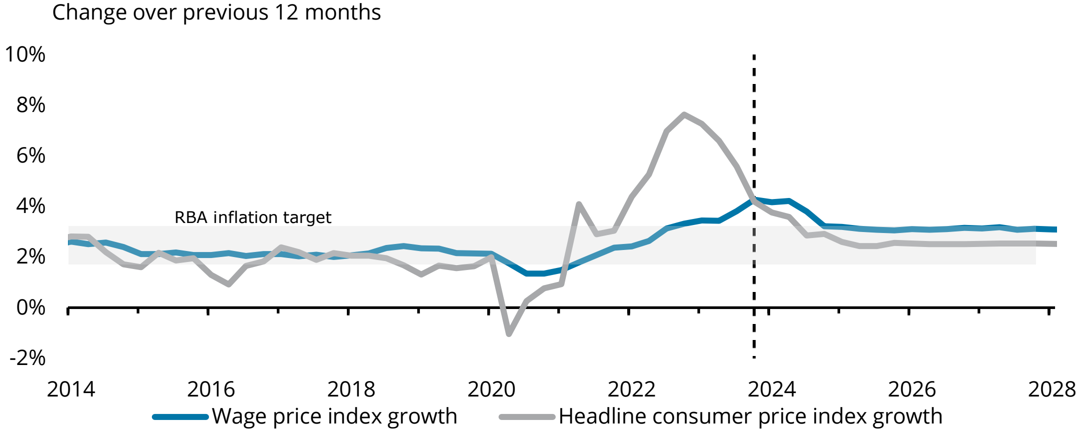
Deloitte Access Economics expects wage growth (based on the WPI) to cool in line with the labour market in the second half of 2024. The WPI is forecast to grow 3.7% in 2024 and 3.2% in 2025. In NSW, wage growth is expected to be slightly higher at 3.9% in 2024 before moderating to 3.1% 2025. These forecasts account for the March 2024 WPI data released by the Australian Bureau of Statistics in May 2024.

Chart: Australia wage price index



Source: Australian Bureau of Statistics; Deloitte Access Economics

Chart: New South Wales wage price index



Source: Australian Bureau of Statistics; Deloitte Access Economics

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Utilities industry wages

National utilities industry wage growth has outpaced wage growth for the overall economy for much of the past decade

The 'utilities' industry is the broad term applying to the electricity, gas, water and waste services industry, which is Division D of the Australian and New Zealand Standard Industrial Classification (ANZSIC). The industry covers activity in the provision of electricity, gas through mains systems, water, drainage and sewage services.

National utilities industry wages grew 1.2% in the March quarter of 2024 to be 4.4% higher in the year. This compares to the 4.2% gain in all industry wages over the same period.

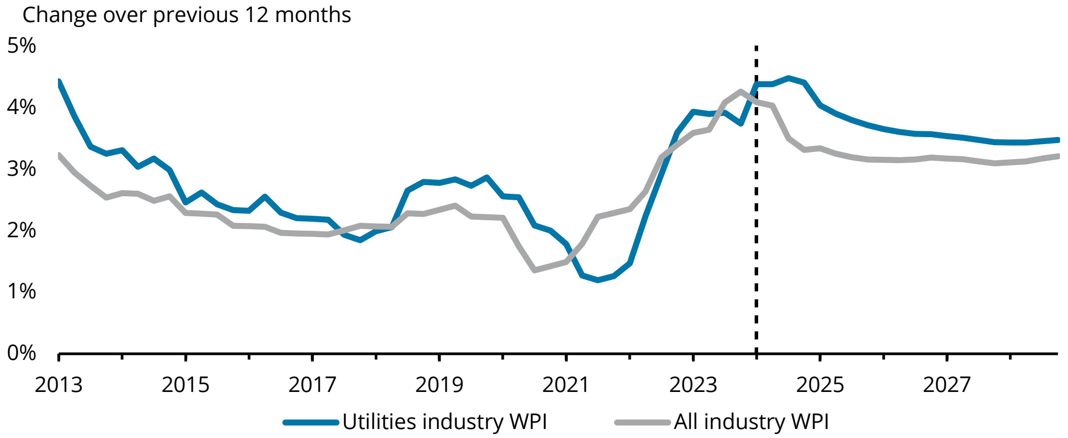
Annual wage growth in NSW utilities was lower than all-industry level for utilities in NSW in the year to March 2024, at 2.8%. This compares to a 4.2% gain in all industry wages in NSW in the year to March quarter 2024.

The outlook for wages for the utilities industry in NSW largely reflects broader economic conditions, as well as the pipeline of infrastructure projects committed to by the state government. Wages in the utilities industry are affected by wages in other skilled worker industries such as construction and mining, as to some extent employers compete for the same pool of workers.

The structural and institutional components which have boosted wage growth historically are expected to support wages in the utilities industry over the forecast period. The utilities industry is relatively capital-intensive and relies on employees who are relatively highly skilled and productive. The outcomes of collective agreements in the utilities industry have often been above the wage increases for the national all industry average due to strong union presence in the industry.

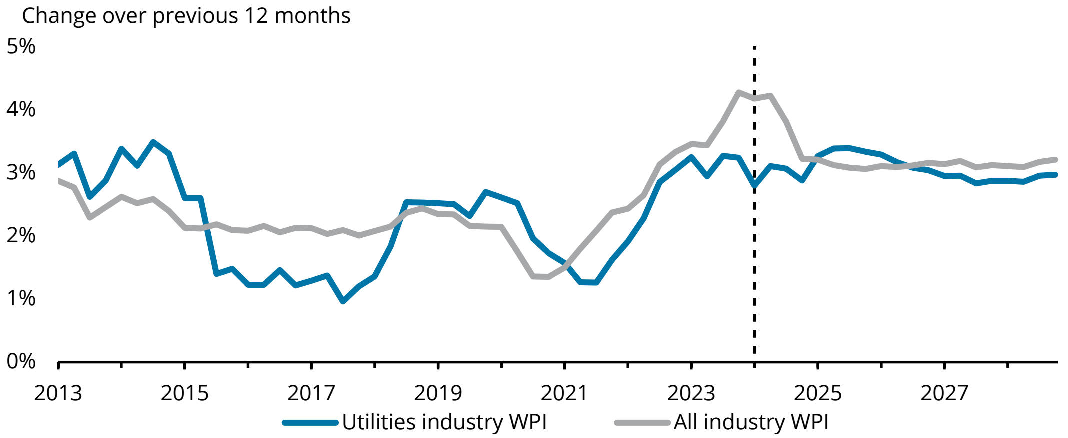
Deloitte Access Economics forecasts Australian utilities industry wages to grow by 4.4% over calendar 2024 before slowing to 3.7% in 2025 as wage pressures moderate across all industries. New South Wales utilities industry wages are expected to remain below the national level and increase by 2.9% over 2024 and 3.3% over 2025.

Chart: Australia utilities wage price index



Source: Australian Bureau of Statistics; Deloitte Access Economics

Chart: New South Wales utilities wage price index



Source: Australian Bureau of Statistics; Deloitte Access Economics

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Producer prices

Overview and inputs to the house construction industry

The Australian Bureau of Statistics publishes Producer Price Indexes (PPIs) that measure the price change of products as they leave the place of production or as they enter the production process (i.e. the prices faced by businesses rather than consumers). Data on inputs (e.g. steel, timber, cement, etc.) is available for the residential construction industry by capital city. Data on outputs is available for the residential, non-residential, and road and bridge construction industries by capital city. Data for total heavy and civil engineering construction is only available for Australia.

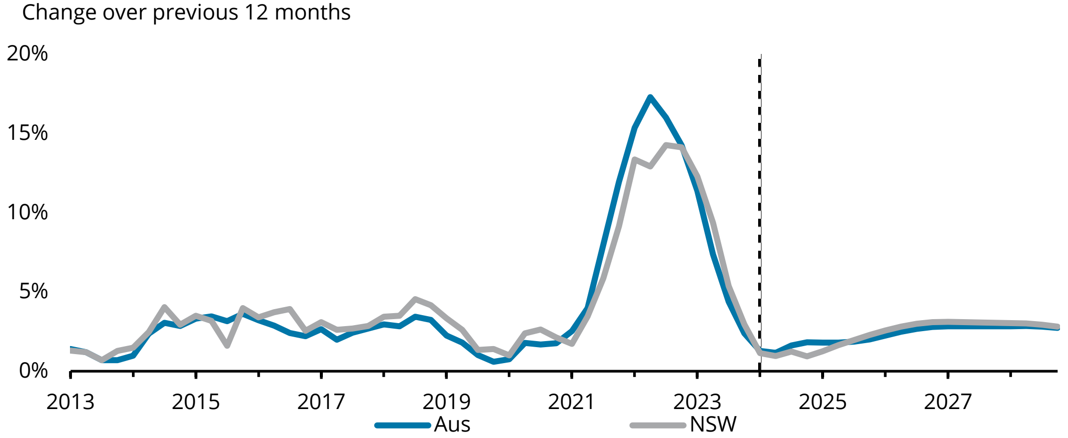
Inputs to the residential construction industry

The price of inputs to residential construction increased 0.4% in the March quarter of 2024, signifying that growth in housing construction input prices has continued to moderate. Input price growth eased over 2023 as supply chains improved and demand for new construction has slowed. As the number of dwellings approved for construction has slowed, products used earlier in the construction process such as structural timber have fallen in price. However, the industry continues to contend with limited labour supply and recent high energy prices.

In the twelve months to March 2024, input prices to house construction rose 1.3%. Price growth has significantly slowed following the peak of 17.3% recorded in the year to the June quarter of 2022. Input prices rose 0.1% in the March quarter 2024 in Sydney, below the national rate of growth of 0.4% over the same period. The growth rate of input prices for residential construction in Sydney was 1.1% in the year to March 2024.

Australian residential construction price growth is forecast to gradually increase from current low growth to grow by 1.8% over 2024 and 2.0% growth over 2025. New South Wales prices are expected to fall below the national level over the forecast period and increase by 0.9% over 2024 and 2.3% growth in 2025. Price growth is expected to moderately increase over the forecast period as an increase in dwelling construction drives demand for residential construction.

Chart: Inputs to residential construction price index



Source: Australian Bureau of Statistics; Deloitte Access Economics

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Producer prices

Outputs of the construction industry

Outputs of the construction industry

While delivered on-site producer prices are measuring input prices to construction, builders' selling prices are reflected in output price indexes.

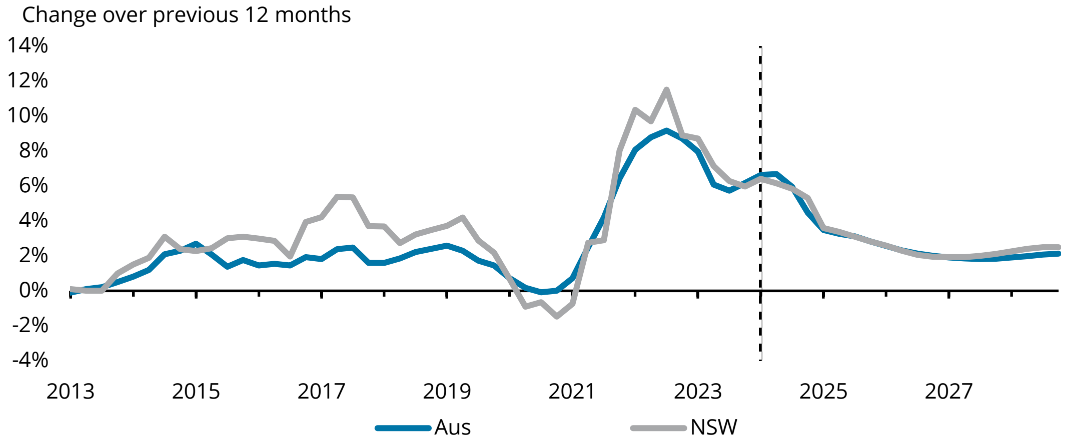
Price pressures in construction industry outputs continue to be driven by labour shortages in an environment with high industry demand. Recent increases in output prices have largely been driven by demand in the non-residential market as the infrastructure pipeline remains strong.

While most material price pressures have been easing, ongoing labour shortages and high demand resulted in output prices increasing for total construction industry outputs in the March quarter of 2024. Australian non-residential building construction prices rose by 1.7% in the March quarter of 2024 to be 6.6% higher over the previous year. Non-residential building construction prices in New South Wales grew at a faster quarterly rate of 2.4% in the March 2024 quarter and 6.4% over the year.

In the near term, Deloitte Access Economics forecasts Australian non-residential building construction prices to grow by 4.5% over calendar year 2024 before slowing to 2.8% growth in 2025 as price pressures driven by labour shortages ease. New South Wales prices are expected to grow by 5.3% over 2024 and 2.8% in 2025.

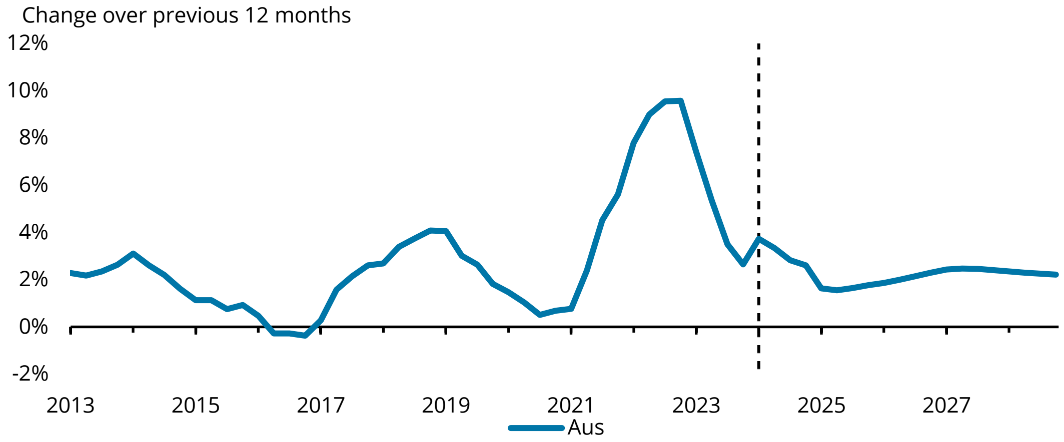
Heavy engineering construction prices rose by 1.4% in the quarter to be 3.7% higher in the year to March 2024. Deloitte Access Economics expects that prices will continue to ease to 2.6% growth over the calendar year in 2024 and 1.8% over 2025 as labour and materials capacity constraints continue to ease. Price growth over the medium turn is expected to trend towards the mid-point of the Reserve Bank of Australia’s target range for inflation of 2-3% annually.

Chart: Non-residential building construction prices



Source: Australian Bureau of Statistics; Deloitte Access Economics

Chart: Heavy engineering construction prices



Source: Australian Bureau of Statistics; Deloitte Access Economics

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