

Energy costs continue to put pressure on domestic manufacturing

Government intervention distorts market outcomes

Update: Federal and state politicians were submitted to a crash course in energy economics last week with the release of the Finkel Review. The challenge of sustaining manufacturing in Australia in the face of rising energy costs is increasingly recognised as a major economic challenge. The Review outlined a path forward, but an analysis of energy market economics shows that the policy reform measures at this point are unlikely to constrain growth in the retail cost of energy (gas or electricity) for the foreseeable future.

Insight: Over the past decade every exogenous impact on the energy market has placed upward pressure on prices.

In the gas market, the Australian Government stimulated the demand for Australian gas at the same time as State Governments acted to constrain the supply of gas. The recommendations from the Finkel Review, to increase transparency in the market, are peripheral to the macro impact of supply and demand on the retail price of east coast gas.

The major driver of electricity price increases was an investment cycle in poles and wires caused by political decisions to improve reliability, a regulatory failure to recognise a fall in demand, natural disasters and capital renewal. These were compounded by a range of government interventions in the market relating to renewable/carbon policies that undermined the investor certainty necessary for a capital intensive industry. The absence of bi-partisan support for a long-term policy on carbon will also continue to undermine investor confidence.

The next driver for electricity price rises is likely to come from the generation sector as it upgrades its ageing capital stock to meet future electricity demand.

The Finkel Review includes recommendations to micro aspects of the electricity market which could distort equilibrium pricing, such as the demand response mechanism. This mechanism proposes to distort the market price, without evidence of a market failure, by paying manufacturers not to produce during peak demand times. Paying businesses not to produce is inconsistent with market economics and does not have a good record for improving market outcomes.

With government policy decisions having played a central role in creating the high energy prices impacting manufacturing in Australia, it is likely that they will need to play a role in the solutions.

The energy policy debate has tended to focus on the price impact on Australian households. At the same time, high and rising energy costs are crippling Australia's manufacturers.

Policy makers must acknowledge the role that energy market interventions of the current and previous governments continue to have in the inflated energy prices paid by manufacturers. In order to sustain a viable manufacturing industry in Australia in the face of the inflated energy prices, the government must also consider implementing countervailing interventionist industry policies.

GDP growth slows

GDP increased by just 0.3 per cent during the March 2017 quarter and was 1.7 per cent higher than the same period a year earlier.

The slow GDP growth is at odds with the more recent jobs data that shows that employment growth has accelerated. New jobs are being created at a rate twice as fast as population growth resulting in a fall in the unemployment rate to 5.5% (down 0.2%) in May with the participation rate increasing to an elevated 64.9%.

All other job market indicators, including job advertisements, improved or remain strong.

Housing investment falls

A fall in investment in new housing by 4.4 per cent along with a drop in mining output were the major contributors to the slow GDP figures. Weather was a factor in the low investment levels, but the outcome is consistent with other indicators that activity is decelerating in the sector. This trend is not consistent across the economy as some regions, particularly metropolitan areas, continue to show strong activity.

New apartments continue strong growth

In the context of the residential building cycle cooling off a record high, investment in apartment building is holding up with a record number of new apartments still being constructed. This is helping to meet the strong demand in the housing market.

The *HIA-AIG Performance of Construction Index* supports this direction showing that apartment building activity expanded at its steepest pace since November 2015 (up 13.2 points to 68.5).

Household confidence mixed

This low growth/low inflation environment presents a significant policy challenge for the RBA and Government given the starting point of a low cash rate, fiscal deficits and high household debt.

We see an accumulation of evidence that households are under pressure including in housing/renovations data but also vehicle sales have begun to fall from record highs.

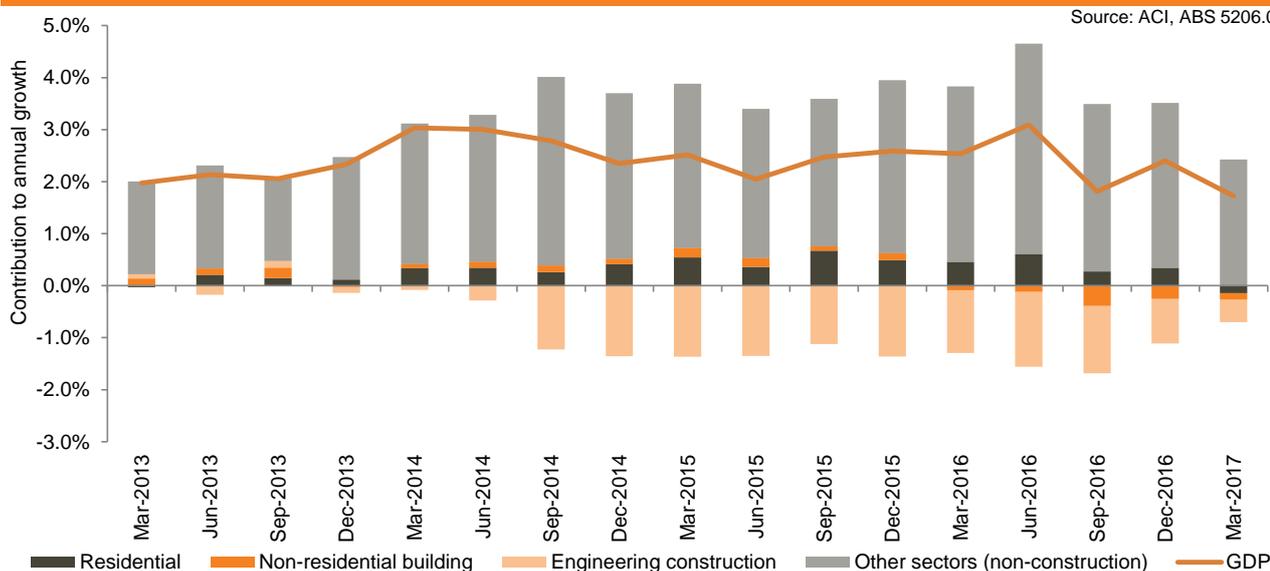
In this environment, it is difficult to see any increase in interest rates this year.

Key Construction Indicators:

There is a relatively strong correlation between construction activity and GDP. The most recent GDP figures show that all three construction sectors (residential, engineering construction, and non-residential building construction) detracted from economic growth during the first quarter of 2017 and this therefore played a significant role in the underwhelming GDP result. To see a sustained return to economic growth we need to see the construction sector making a positive contribution.

CONTRIBUTION OF CONSTRUCTION TO ECONOMIC GROWTH

Source: ACI, ABS 5206.0



The fortnight ahead – key dates and releases

Tuesday 20 June

ABS Residential Property Price Indexes, March 2017 quarter, 11:30am

Wednesday 21 June

HIA State and National Outlook Reports, Autumn 2017, 11am

ACI offers tailored industry analysis, forecasts and research on emerging trends, at a national, state and even regional/local level. If you would like to speak to ACI about a potential research project please email info@aciresearch.com.au

Friday 27 June

ABS Census of Population and Housing, 11:30am

Thursday 29 June

HIA New Home Sales Report, May 2017, 10:30am



AUSTRALIAN CONSTRUCTION INSIGHTS
Research powered by HIA Economics

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