2. THE ECONOMY

- Economic activity in New South Wales has broadly rebounded post-COVID, supported by a strong labour market.
- High inflation and numerous interest rate rises over the past year have increased pressure on household budgets.
- Due to higher inflation for essential goods and services, cost of living pressures are most acute for lower income households. Employee households, on average, have experienced the largest increase in living costs, largely reflecting the proportion of household income devoted to rising mortgages and rents.
- Strong population and relative weakness in new housing supply is expected to continue to drive up rents. This will support dwelling prices.
- Household spending has softened, which is contributing to weaker economic growth. Strong population growth and a resilient labour market will help to moderate this slowdown.
- Inflation is expected to gradually return to the Reserve Bank of Australia's (RBA) target, which will eventually see economic growth return to usual long-run levels.
- Risks to the economic outlook remain elevated and centre primarily on the persistence of inflation and the lagged effect of the sharp rises in interest rates, globally and domestically, on economic growth.

Table 2.1: New South Wales economic performance and outlook[(a)(b)]

	2021-22 Outcome	2022-23 Outcome[(c)]	2023-24 Forecast	2024-25 Forecast	2025-26 Forecast	2026-27 Forecast
Real state final demand	3.2	4.3 (4¾)	1¼ (1)	1½ (2½)	2¼ (2¾)	2¾
Real gross state product	1.8	3¾	1¼ (1½)	1¼ (2¼)	2 (2½)	2¼
Employment	1.0	5.8 (5½)	1¾ (¾)	¼ (1¼)	1	1½
Unemployment rate[(d)]	3.7	3.1 (3½)	3¾ (4½)	4¾ (4)	4½ (4)	4¼
Sydney consumer price index	3.9	7.1 (7)	4¾ (4¼)	3 (2¾)	2¾	2½
Wage price index	2.4	3.3 (3¾)	4	3¾ (3½)	3¼	3¼
Nominal gross state product	7.4	10 (9¼)	3½ (2¾)	3½ (3¼)	4½	4¾
Population[(e)]	0.9	1.8 (1.2)	1.4 (1.2)	1.3 (1.2)	1.2	1.2

(a) Per cent change, annual average unless otherwise stated. Previous forecast (2023 Pre-election Budget Update) in parenthesis where different.
(b) Commodity prices are assumed to follow Consensus Economics forecasts as of July 2023. The RBA's interest rate path over the course of 2023 and 2024 is assumed to be broadly in line with the assumptions underpinning the RBA Statement on Monetary Policy (August 2023). The Australian dollar trade-weighted index is assumed to average 63.8 across the forecast period. Net overseas migration is assumed to increase in line with Australian Government projections.
(c) 2022-23 figures are outcomes for all metrics except real gross state product, nominal gross state product and population, which are forecasts.
(d) June quarter, per cent.
(e) Per cent change through the year to 30 June. Forecasts are rounded to the nearest 0.1 percentage points.

Source: Australian Bureau of Statistics (ABS) and NSW Treasury

2.1 The New South Wales economy remains resilient

Central banks have responded to high inflation

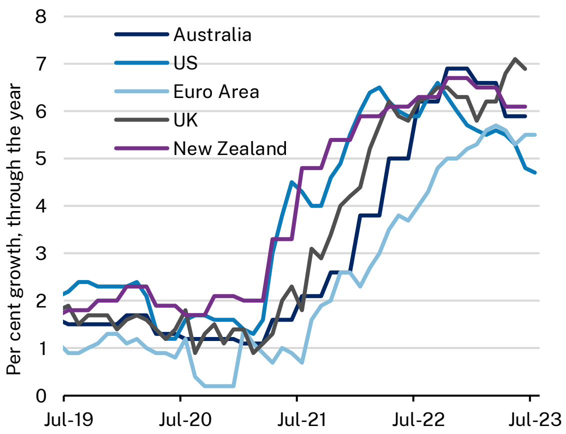
Domestic and global economic growth rebounded faster than expected from the COVID pandemic. Fiscal and monetary stimulus, combined with household savings accumulated during the pandemic, supported a sharp recovery in demand. Consumer spending patterns quickly returned to normal levels following the removal of COVID restrictions, supporting a sharp recovery in employment. The unemployment rate subsequently fell to multi-decade lows.

By contrast, global supply chains took longer to recover. The imbalance between the recovery in demand and supply, as well as the disruptions to energy and food markets caused by Russia's invasion of Ukraine, drove inflation to multi-decade highs in many countries (see Chart 2.1). Consequently, policy measures designed to support demand as the economy exited from COVID restrictions have instead further added to inflation.

High inflation affects the health of the economy. It reduces long-run economic growth by distorting investment and spending decisions. It also has distributional impacts, especially when inflation is driven by necessities such as food, shelter and utilities (water, gas and electricity). These items make up a larger share of household budgets for those on low incomes.

Central banks across the developed world have increased interest rates sharply to slow demand and bring inflation back to target levels (see Chart 2.2). The RBA has undertaken the fastest and largest tightening cycle since it began targeting inflation in the early 1990s. Since May 2022, it has raised the cash rate by four percentage points to 4.10 per cent. The RBA has assessed that interest rates are now at a level where they are restricting economic growth.

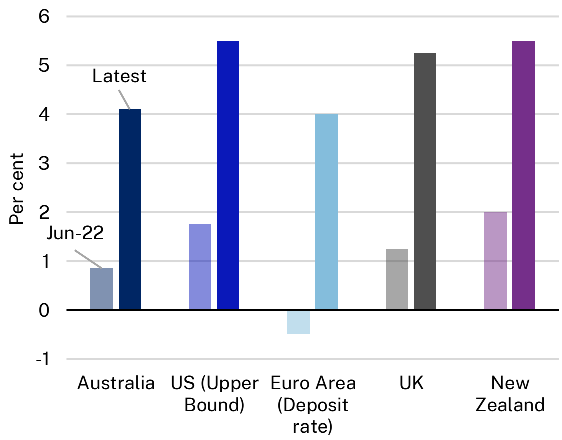
Chart 2.1: Annual core inflation[(a)]



Source: ABS, Bloomberg, NSW Treasury

(a) The frequency and measures core inflation vary across countries.

Chart 2.2: Global cash rates



Source: RBA, Bloomberg, NSW Treasury

High inflation and interest rates are impacting household budgets

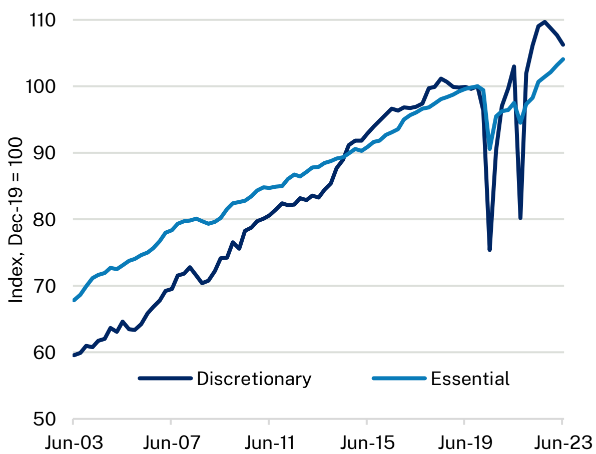
The rapid increase in interest rates, combined with elevated cost-of-living pressures, has contributed to a moderation in economic growth over recent quarters. This has been driven by a slowdown in household consumption. In particular, discretionary spending (on non-essential goods and services) has softened as higher interest rates have restricted disposable incomes nationally (see Chart 2.3). The national household savings rate, which measures the flow of new savings (including superannuation) as a share of total disposable income, has fallen sharply. Having increased sharply during the COVID pandemic, it is now below its pre-COVID level.

Dwelling investment has also eased with residential building approvals, on a trend basis, remaining below their decade average. There has been some pick-up in recent months which may in part be due to the turnaround in house prices seen in the first half of 2023. Having fallen sharply during 2022, Sydney's dwelling prices have risen 8.8 per cent since January 2023, despite a deterioration in mortgage affordability.

Low levels of advertised housing listings have helped soften the impact of higher interest rates on prices. Demand for housing, meanwhile, has intensified due to the sharp increase in net overseas migration. This has helped drive rental vacancy rates down to around their historical low levels. In response, the CoreLogic measure of advertised rents has surged by 20 per cent through the year to August 2023. This has encouraged first home buyers into the housing market. The strong labour market and household savings accumulated through the COVID pandemic has helped some households absorb interest rate increases to date.

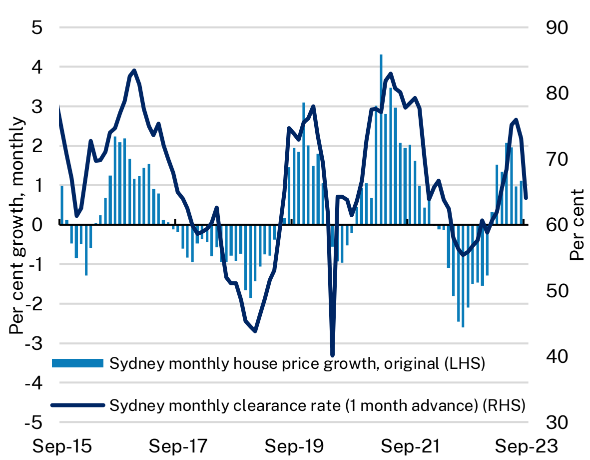
More recently, the pace of increase in dwelling prices has shown signs of easing. Sydney dwelling prices grew on average by 1 per cent in July and August, following average monthly growth of 1.6 per cent in the four preceding months. That said, Sydney's auction clearance rate remains above 60 per cent, which means further house price rises are likely in the near term (see Chart 2.4).

Chart 2.3: NSW real discretionary vs essential consumption



Source: ABS and NSW Treasury

Chart 2.4: NSW auction clearance rates and house prices



Source: CoreLogic and NSW Treasury

The labour market has remained strong

The rest of the economy has continued to be largely resilient. Despite rising costs, elevated sales and profitability have helped support survey measures of business conditions. Business investment has also remained solid as firms respond to high demand and historically low levels of spare production capacity.

The labour market, alongside strong population growth, has been key to the resilience of the economy. The post-pandemic surge in spending saw demand for labour rise considerably. Businesses are continuing to have trouble filling vacant positions, despite the return of overseas migrants helping to ease some of these pressures (see Chart 2.6). Job vacancies have subsequently declined of late, although they remain elevated compared to pre-COVID levels. Net overseas migration, including international students, lifted NSW population by 1.9 per cent through the year to the March quarter 2023. Arrivals data suggests an even larger increase in 2023 to date, indicating that net overseas migration flows might be higher than what is assumed in the forecasts (see Box 2.1). Without this rapid rise in net overseas migration, overall economic activity would be weaker than is currently the case.

Box 2.1: The impact of higher net overseas migration on the New South Wales economy

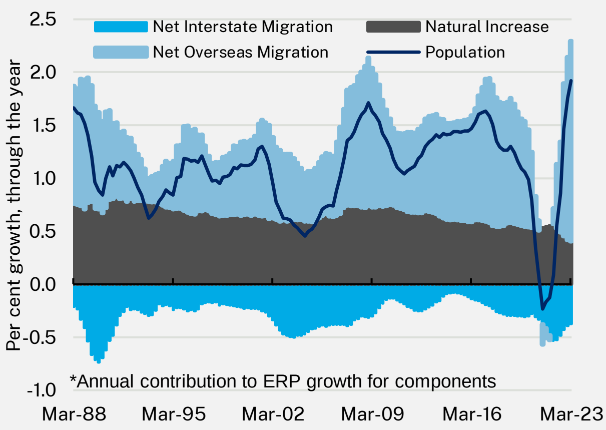
NSW population growth has been heavily impacted in recent years by the COVID pandemic. The closure of international borders through most of 2020 and 2021 meant that net overseas migration (overseas arrivals minus departures) was almost zero in those years.

Since the reopening of borders, net overseas migration has surged (see Chart 2.5). The NSW Budget utilises the Australian Government's forecasts for net overseas migration. The latest forecasts released at the time of the May Budget showed national net overseas migration surging by 401,700 in 2022-23 followed by 316,000 in 2023-24. This compares to an average of 247,600 in the three years prior to the pandemic.

Recent population and overseas arrivals and departures data suggests that net overseas migration may have been significantly higher in 2022-23.

New South Wales is expected to receive more than its population share of net overseas migrants over the forecast period. Net overseas migration will contribute almost 500,000 people to the State's total expected population growth of 580,000 in the five years to 2026-27.

Chart 2.5: NSW components of population growth[(a)]



Source: ABS and NSW Treasury

(a) Annual contribution to ERP growth for components

Sensitivity analysis previously undertaken by NSW Treasury as part of the 2020-21 Budget provides an insight as to what impact stronger population growth might have on the NSW economy. This analysis suggests that if stronger migration boosted the NSW population by 1 per cent (equivalent to an additional 80,000 migrant arrivals compared to the baseline forecast), it would boost NSW gross state product (GSP) by around 1 per cent.

The post-pandemic return of migration and changes to housing preferences has left the State's housing supply struggling to catch up to demand.

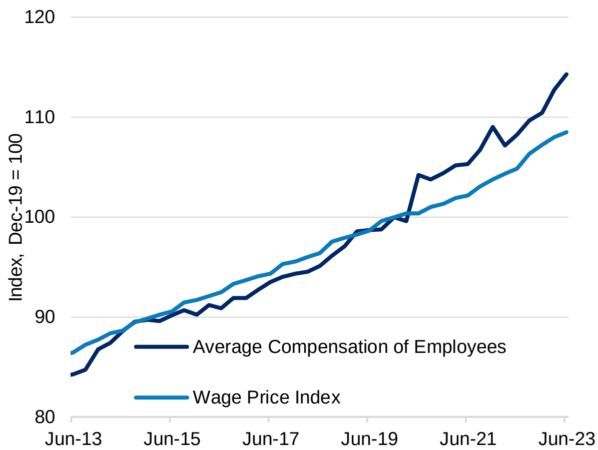
Employment has risen sharply over the past year with labour force participation reaching a record level in late 2022. Employment was 7.0 per cent higher than pre-pandemic levels in August 2023, with the majority of these gains driven by growth in female employment. The unemployment rate consequently fell to a new monthly low of 2.9 per cent in June 2023, but has risen in recent months.

The tight labour market is helping spur growth in nominal wages. Annual nominal wages, as measured by the ABS wage price index (WPI), grew 3.4 per cent in the June quarter 2023 (excluding the increase in compulsory superannuation payments). This pace is among the fastest in over a decade. Broader measures of wages, including the average compensation of employees, has been stronger in recent quarters (see Chart 2.7).

Chart 2.6: NSW job vacancies

Source: ABS and NSW Treasury

Chart 2.7: NSW wages



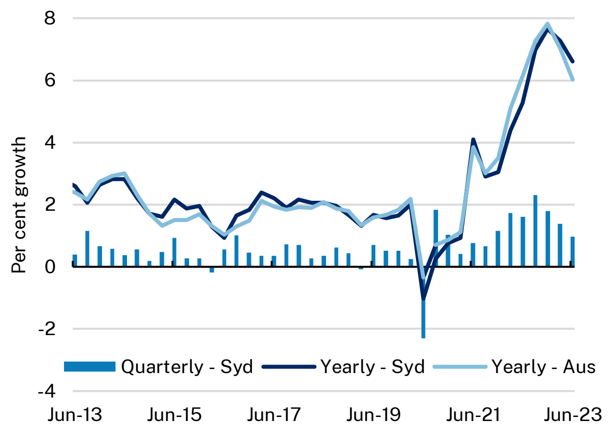
Source: ABS and NSW Treasury

Inflation has begun to ease and the labour market is at a turning point

The normalisation of global supply chains, lower commodity prices and higher interest rates are reducing inflation. Having peaked at the end of 2022, national headline inflation has slowed to 6.0 per cent in the June quarter 2023. The slowing has been less marked in New South Wales, with the Sydney consumer price index standing at 6.6 per cent in the June quarter 2023 (see Chart 2.8).

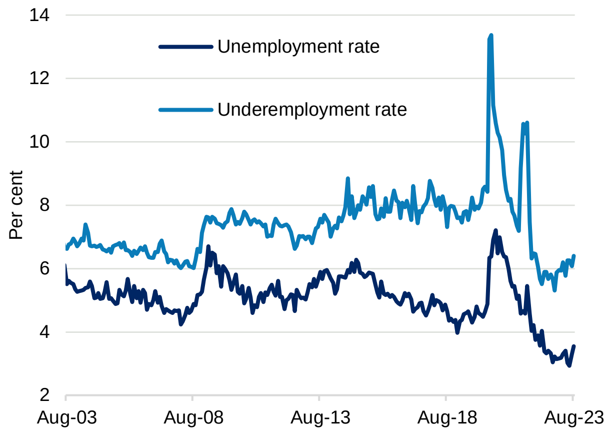
There are also tentative signs the labour market is at a turning point. While the unemployment rate remains very low, it has risen in the last two months to 3.6 per cent. Moreover, the rate of underemployment (which measures those who would like to work longer hours, but who are unable to find suitable work that exists) has been rising since late 2022 (see Chart 2.9). Rising underemployment provides an early indication that demand for labour is slowing. This is because employers, when confronted with a softening in demand for their products, are likely to first reduce hours for their workforce. While it remains historically low, underemployment has risen 1.1 percentage points from the low reached in November 2022.

Chart 2.8: Sydney CPI



Source: ABS and NSW Treasury

Chart 2.9: NSW unemployment and underemployment rate



Source: ABS and NSW Treasury

Box 2.2: How the rising cost of living is affecting the people of New South Wales

While the consumer price index (CPI), on which prices in the Budget forecasts are based, is the most widely cited measure of inflation, it does not fully capture all changes in the cost of living. Importantly, the CPI does not include the cost of servicing a mortgage, and therefore does not reflect the impact of rising interest rates on mortgage-holders. Also, the CPI is designed to capture the average rate of inflation across all households. In practice, spending patterns vary across households with different age and socio-economic profiles.

To account for these and other shortcomings, the ABS produces Living Cost Indexes (LCIs) for selected household types. The ABS calculates LCIs for four different types of households – employees, age pensioners, self-funded retirees, and other government transfer recipients (see Chart 2.10).

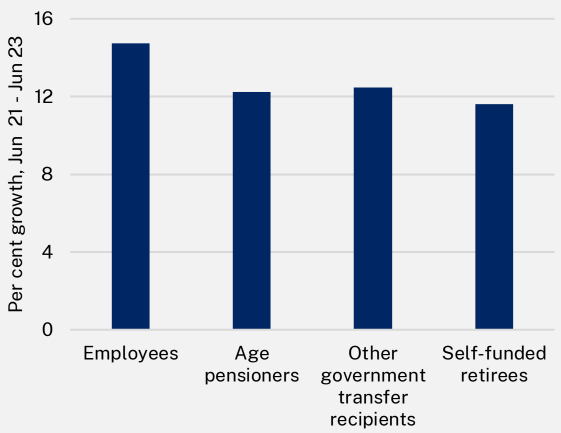
Over the year to June 2023, the LCIs for each cohort grew faster than the 6.0 per cent increase in the CPI. Employee households saw the biggest rise in annual living costs – up 9.6 per cent – reflecting the greater share of mortgage interest repayments in this group. Housing affordability issues are discussed further in Box 2.3.

Cost of living concerns become most acute when inflation is driven by increasing prices for essential items such as food, housing, utilities, healthcare and transport. Households cannot materially reduce spending on these without affecting their wellbeing. When the costs of essential items increase more rapidly, it disproportionately affects lower income families.

This has particularly been the case over the past two years (see Chart 2.11). Over this period, prices of essential goods and services, according to the Sydney CPI, have risen by 13.3 per cent versus a 10.8 per cent increase in discretionary items. Over the year to June 2023, this has affected housing costs in particular.

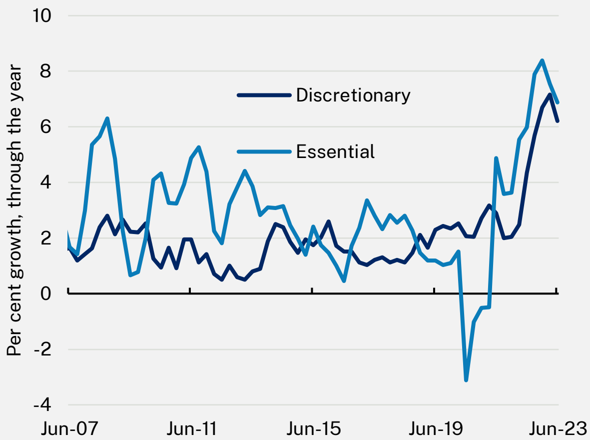
This highlights the importance of targeting policies to support households dealing with cost-of-living challenges as opposed to broad-based support. This is particularly critical in the current economic landscape, in which broad-based spending measures can contribute to inflationary pressures.

Chart 2.10: Living Cost Index by group, Australia



Source: ABS and NSW Treasury

Chart 2.11: CPI by spending category, Sydney



Source: ABS and NSW Treasury

2.2 The NSW economic outlook

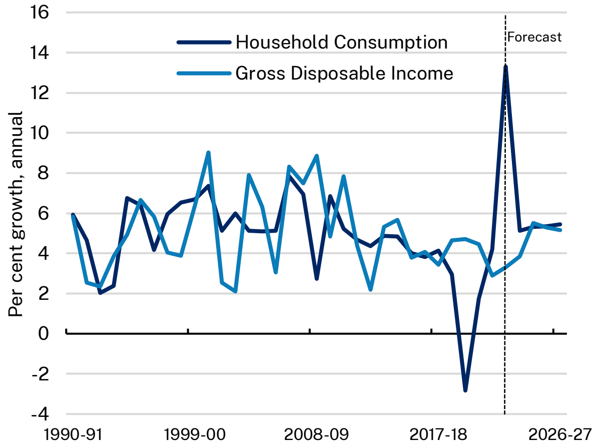
Economic growth is expected to slow, driven by declining household consumption

Looking ahead, those forces which have seen growth moderate recently are likely to see growth weaken further in the near term. The build-up in savings during the pandemic is expected to provide less support for consumers going forward (see Chart 2.12). The national household savings rate is back below its pre-COVID level, despite the lift in the compulsory superannuation guarantee. Reports suggest that excess savings buffers are more likely to belong to older age cohorts, who are less likely to make use of these savings to support spending.

Slowing economic momentum in New South Wales mirrors a slowing underway in the global economy. According to the International Monetary Fund, economic growth in advanced economies is expected to fall to 1.5 per cent this year, from 2.7 per cent in 2022.

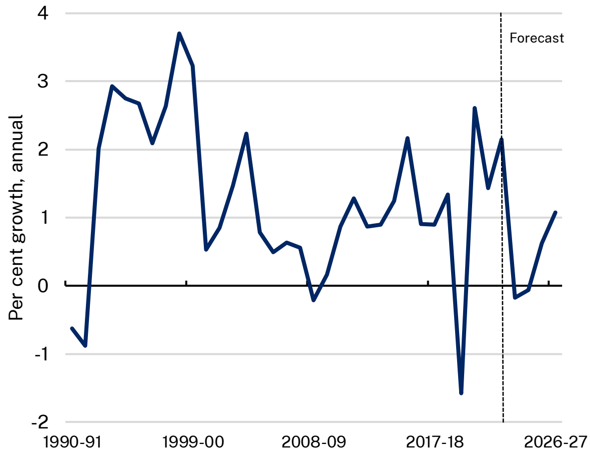
Australia is a relatively small, open economy. Changes in global demand for our goods and services can have significant consequences for domestic growth. New South Wales is particularly exposed to changes in services trade, with almost half of Australia's service exports (including tourism and education) originating in the State. Slowing growth across the State's major trading partners will weigh on domestic exports. Importantly, China, the State's largest trading partner, has experienced a more muted and uneven post-lockdown recovery than expected.

Chart 2.12: NSW nominal household consumption and disposable income



Source: ABS and NSW Treasury

Chart 2.13: NSW real GSP per capita



Source: ABS and NSW Treasury

Our expectation is for a modest slowdown in growth

Several factors prevent a more substantial slowing in household consumption and the broader economy.

Strong population growth, supported by high net overseas migration, will continue to support consumer spending, while also helping to fill job vacancies in the labour market. This strong population growth masks a more significant slowing of the economy on a per capita basis. Per capita GSP is expected to be broadly flat over the next two years (see Chart 2.13). This is the weakest result, excluding the pandemic, since the global financial crisis.

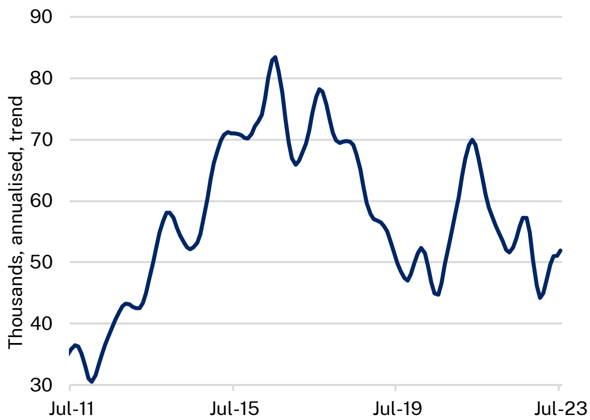
House prices have increased despite higher interest rates. Looking ahead, house prices are expected to be supported by high net overseas migration and relative weakness in new housing supply. This will continue to drive up rents. On balance, this is expected to see modest further growth in Sydney housing prices in the near term.

Despite the strong demand, dwelling investment is expected to be weak in the near term, in line with the softened dwelling approvals earlier in the financial year (see Chart 2.14). In addition, high interest rates, high construction costs and last year's fall in housing prices are expected to hinder projects over the coming year. Further ahead, dwelling investment is expected to gradually recover. This is supported by the stabilisation in dwelling prices and a reduction in interest rates from late 2024.

Business investment intentions suggest that private capital expenditure will stay elevated in the next 12 months, supported by strength in construction activity for electricity generation and transmission (see Chart 2.15). This primarily reflects renewable energy investment as coal-fired power stations are phased out and the private sector takes its own steps towards reducing emissions.

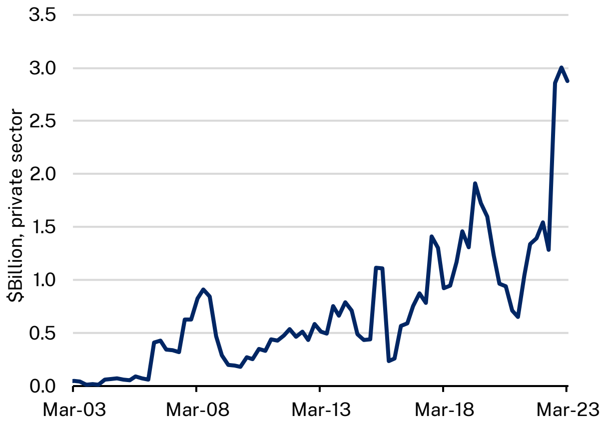
Non-residential building construction, meanwhile, will be supported by the recent strength in commercial and industrial building approvals. By contrast, investment in machinery and equipment will likely ease following the period of significant growth that coincided with Australian Government tax incentives.

Chart 2.14: NSW dwelling approvals



Source: ABS and NSW Treasury

Chart 2.15: NSW value of work yet to be done in electricity generation and transmission



Source: ABS and NSW Treasury

Box 2.3: Housing affordability has been declining and this impacts vulnerable cohorts the most

Housing is a fundamental human need, and foundational to a person's quality of life. It ensures individuals can access employment, infrastructure and services and supports the economy's productive potential.

Housing affordability has declined over the last three decades. Housing costs as a proportion of disposable income have risen since 1994, and demand has consistently outstripped supply. This is felt hardest by the most vulnerable groups. Chart 2.16 highlights that it is those in the lowest income quintile that have seen the biggest increases.

Housing affordability tends to be more of a problem for those under the age of 44, who are more likely to rent. Where they do have a mortgage, individuals are likely to have higher mortgage values and lower savings compared to older cohorts.

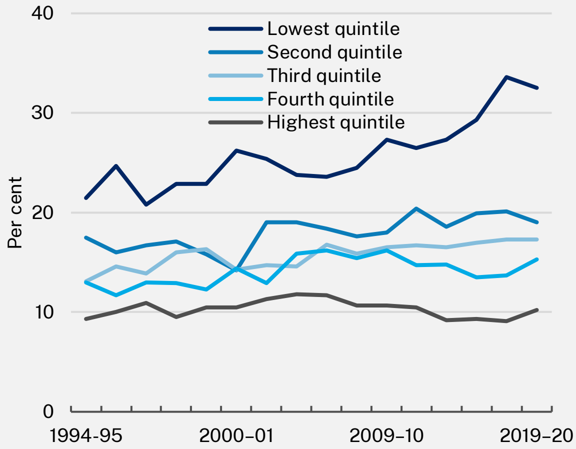
Mortgage holders have been affected by the sharp rise in interest rates since May 2022. Someone who had taken out a variable rate mortgage of $700,000 in April 2022, would have seen their mortgage repayments go up by $17,300 per year.

As seen in Chart 2.17, the cost of servicing a new mortgage is now more than 30 per cent of household income. This is the highest level in real terms since at least 1991, when comparable data became available.

Data from CoreLogic shows that median unit rents in Sydney have also seen significantly high growth, rising by 26.1 per cent since the start of this year, and by 37.3 per cent since February 2020.

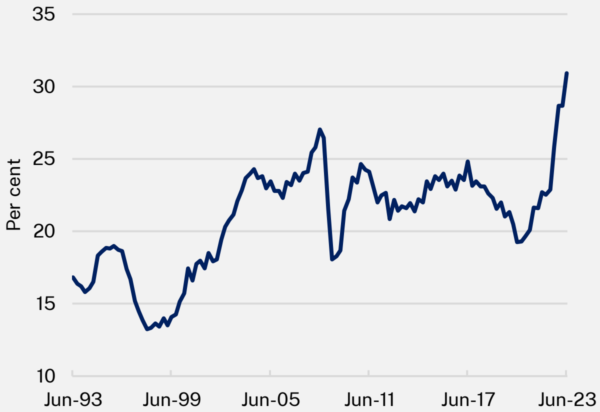
Renters are more likely to experience financial stress compared to individuals who own homes. In New South Wales, the ABS Survey of Income and Housing 2019-20 highlights that more than half of low-income renting households spent over 30 per cent of their income on housing, a greater share than in any other state or territory. Housing stress is also reflected in the 45 per cent surge in priority applicant households on the social housing register between June 2019 to June 2022.

Chart 2.16: NSW housing costs as a proportion of income by equivalised disposable household income quintiles



Source: ABS and NSW Treasury

Chart 2.17: NSW mortgage servicing costs as proportion of income[(a)]



Source: CoreLogic, RBA, ABS and NSW Treasury

(a) Mortgage repayments on a recently purchased NSW dwelling of median value. Assumes an after-tax income of a dual income household, on average incomes, with a 20 per cent deposit and a variable rate 30-year loan.

The labour market remains crucial

Indicators of near-term demand for labour, such as job advertisements and vacancies, have eased, but still suggest employment will remain robust over coming months. This is expected to help keep the unemployment rate at very low levels.

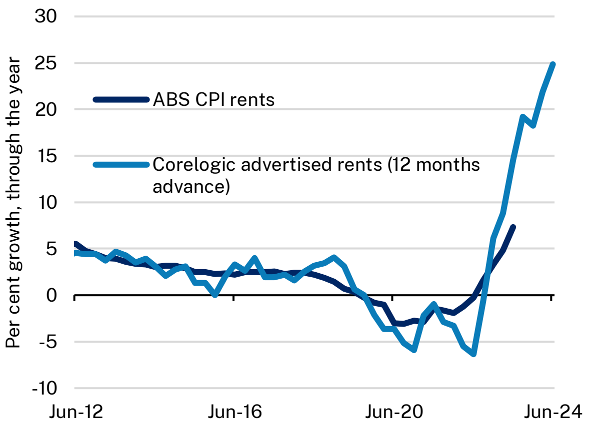
Wages growth is set to increase in the near term in response to a combination of tight labour market conditions, large increases in the minimum and award wages by the Fair Work Commission, and previously announced developments in public sector wages policy.

Nonetheless, global and domestic inflation pressures are expected to ease further over coming quarters. For Australia, headline and trimmed mean inflation are both expected to fall to below 4 per cent by mid-2024, driven by a further softening in global goods inflation. Continued strength in housing rents (see Chart 2.18), which are a large component of the consumer price index, and rising wages growth are expected to see services inflation remain somewhat persistent.

Further out, the slowdown in economic activity, weaker labour productivity and higher wages will weigh on the demand for labour. Employment growth is expected to slow materially in 2024 and remain subdued for some time. This will see the unemployment rate steadily rise to a peak of around 4¾ per cent in early 2025. This is above what NSW Treasury considers to be the rate that is consistent with inflation being steady, often referred to as ‘full employment’ (around 4 per cent, see Chart 2.19). While the increase in unemployment from its currently historically low level is significant, the forecast peak for the unemployment rate remains relatively low by historical standards. For example, it is broadly in line with the unemployment rate prior to the onset of the COVID pandemic, and is lower than the average unemployment rate of 5.2 per cent in the decade prior to the pandemic.

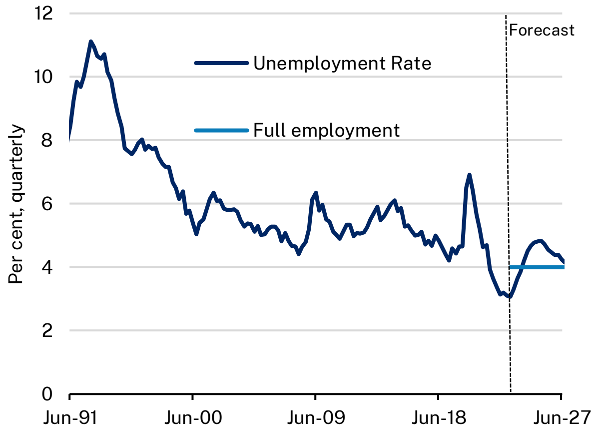
This gradual softening in labour market conditions will see real wages eventually stabilise around levels consistent with anticipated labour productivity. That should help underlying inflation return to within the top of the RBA's target band, although this is currently not expected until mid-2025.

Chart 2.18: Sydney housing rents



Source: CoreLogic, ABS and NSW Treasury

Chart 2.19: NSW unemployment rate



Source: ABS and NSW Treasury

Return of inflation to target will allow for interest rate cuts

The RBA see the expected slowdown in economic growth as necessary to bring inflation back down towards the 2-3 per cent target. NSW Treasury's forecasts assume the RBA increases the cash rate once more in coming months.

Gradual slowing of inflation to target means that the RBA is not expected to start lowering interest rates until late 2024. The cash rate is then expected to fall to its long-run sustainable level (which NSW Treasury estimate to be around 2¾ per cent) by around mid-2026. By that time, lower inflation and interest rates should support a lift in consumer spending, and economic growth that is more consistent with the economy's long-run potential (judged to be around 2¼ per cent). Household consumption will also be supported by the Australian Government's stage 3 tax cuts, which are legislated to commence from 1 July 2024.

The labour market is expected to be a little slower to rebound than economic activity, as firms look to recover some of the losses in labour productivity experienced over the past year. At the national level, gross domestic product per hour worked has fallen nearly 7 per cent since the peak in March quarter 2022. This is the weakest outcome since at least the early 1990s.

2.3 Long-term drivers of growth

The economic forecasts detailed above show that demand in the New South Wales and Australian economies has been so strong that it has been challenging the economy's capacity to provide those goods and services.

The resulting high inflation, and related sharp increase in the cost of living, negatively impacts living standards, particularly for certain groups (see Box 2.2 above). The RBA's stated objective is to lower inflation back to its target to support sustainable economic growth over the medium term. Given this, in the short term, the challenge for governments is to manage cost-of-living pressures, particularly for the most vulnerable, without further boosting demand in the economy.

Beyond the short-term macroeconomic environment, maintaining and lifting economic prosperity for the people of New South Wales requires economic growth that is inclusive and sustainable.

The provision of quality services to all, including health services, education and care, is essential to supporting participation and lifting human capital. This enhances the abilities, skill and experience of the current and future working population, and thereby productivity. Human services are also a critical enabler of quality of life, and health and care services will become increasingly important as the population ages and demand grows. At the same time, high quality early childhood education and care is vital. Not only to the building blocks for social and educational development of children, but as one of the principal policies to tackle barriers to gender equality in working life, and ensuring that we retain vital skills in the workforce.

A society that invests in equal opportunities and access to essential services, including the workforce that provides those services, is a society, and economy, that will prosper over time.

Additionally, the economic implications of a warming climate are expected to grow in real terms and relative to the NSW economy. This features alongside population, workforce participation and productivity as a key structural determinant of long-run economic growth and prosperity. The 2021-22 NSW Intergenerational Report highlights that natural disasters could cost the State between $15.8 billion and $17.2 billion per year on average by 2060-61. In addition, further costs accrue from rising sea levels, heatwaves and the impact of changing climate conditions on agricultural production.

The transition to a low carbon economy will similarly shape our future economy. A slow and disorderly energy transition would lead to higher and more volatile electricity prices. It has been estimated that this would leave our economy 0.9 per cent smaller by 2061.

The potential for future shocks underscores the importance of returning to a sustainable fiscal position, to better ensure the Government is able to respond to protect the people of New South Wales.

2.4 Key risks to the outlook

Risks remain unusually elevated

Risks to the outlook continue to be elevated. These risks are centred on uncertainty around:

- the path of inflation back to central bank targets
- the lagged impact on the economy of the sharp increase in interest rates over the past 18 months.

Increased wages growth against the backdrop of weak productivity might result in inflation remaining more elevated than expected. Climate risks, including a potential El Niño weather event, could lead to higher food prices. Should high inflation become entrenched in the wage and price setting behaviours of households and businesses, central banks may feel compelled to raise rates more than expected, slowing the economy even further to ensure inflation returns to target.

On the other hand, global goods prices might decline more than expected given the lagged impact of earlier rate rises and easing global supply chains. This would allow central banks to potentially return interest rates to more neutral levels earlier than currently envisaged, supporting stronger economic growth over the latter part of the forecast horizon.

The economy may be more susceptible than currently assumed to the increase in interest rates. This could contribute to a sharper decline in household consumption and business activity, and with it a larger rise in unemployment, than is currently expected. This risk would be amplified if housing affordability pressures saw a renewed decline in the housing market.

On the flip side, the expected near-term strength in the labour market may provide further support to house prices, which in turn could support consumer activity via increased household wealth. While this would see growth being stronger than expected in the near term, it could also see inflation remain stickier than expected. Given the RBA's current outlook for inflation, this may necessitate additional rate increases to slow growth and ensure inflation returns to target. Cost of living pressures may also work in the opposite direction, deterring non-essential spending.

Other global risks include increased uncertainty over the outlook for Chinese growth, which could impact prices and demand for key NSW exports. In addition, geopolitical risks remain elevated. An escalation in Russia's invasion of the Ukraine could further disrupt commodity markets and supply chains, negatively impacting global economic activity and delaying the return to lower inflation.