2. THE ECONOMY

- The New South Wales economy has rebounded strongly since the depths of the COVID-19 pandemic. This largely reflects progress in easing social distancing measures and effective government and monetary stimulus. Economic activity and employment have both rebounded, exceeding pre-COVID levels, around a year earlier than previously expected.
- Above-trend growth is forecast on balance over the next four years as the economy returns to its full potential, with average growth of 2¾ per cent per annum.
- Spare capacity in the labour market is now expected to dissipate much sooner than earlier forecast. All the jobs lost at the height of the pandemic have since returned, with 36,000 more people employed now than prior to the pandemic. An additional 200,000 workers are expected to be employed by June 2025 (relative to the March quarter 2021), when the unemployment rate is forecast to reach estimates of full employment (around 4½ per cent).
- A tighter labour market will support wages growth and inflation, although growth in the wage price index is forecast to remain well below the historical average. Inflation is likely to remain low before eventually rising modestly to the lower half of the Reserve Bank of Australia's 2-3 per cent target range. The NSW Government's new wages policy will also support faster wages growth in the public sector.
- The Commonwealth's forecast for a delay in the opening of international borders (to the middle of 2022) represents a near-term constraint to the continued strong recovery in the economy.
- While reopening the international border will lead to a rise in outbound travel, the loss of international students, inbound tourists and migrants represents a greater negative impact to the outlook. The ongoing border closure will continue to weigh on population growth, which is expected to be 0.7 per cent on average over the next four years, compared to a pre-COVID rate of 1.3 per cent (over 2018-19).
- The unpredictable nature of the pandemic means that risks to the outlook will persist. Delays in the vaccine rollout could disrupt the recovery underway, especially if they result in a further delay in reopening the international border.
- The Government's infrastructure investment of $108.5 billion and targeted stimulus will continue to bolster the economy in the near-term, while productivity reforms in this Budget will help to shore up growth and prosperity for the future.

Table 2.1: NSW economic performance and outlook[(a)]

	2019-20 Outcome	2020-21 Forecasts	2021-22 Forecasts	2022-23 Forecasts	2023-24 Forecasts	2024-25 Forecasts
Real state final demand	(1.9)	2¼ (½)	3½ (2)	1¼ (2)	2½ (3¼)	3
Real gross state product	(0.7)	¾ (-½)	3¼ (2¾)	1 (2)	3¼ (2¾)	3¼
Employment	0.0	¼ (-¼)	1¼ (¾)	½ (1)	1¼ (1)	1¾
Unemployment rate [(b)]	6.5	5¾ (6½)	5¼ (6)	5 (5¾)	4¾ (5)	4½
Sydney consumer price index	1.0	1½ (1¼)	1¾ (1½)	1¾ (1½)	2¼ (1¾)	2¼
Wage price index	2.0	1½ (1¼)	2 (1½)	2¼ (1½)	2¼ (1¾)	2½
Nominal gross state product	0.0	2¼ (1¾)	5½ (4)	2½ (3¼)	4 (4¼)	4½
Population [(c)]	1.0	0.0	-0.1 (0.2)	0.7	1.1	1.2

(a) Per cent change, annual average unless otherwise stated. Previous forecast (2020-21 Half-Yearly Review) in parenthesis where different.
(b) June quarter, per cent.
(c) Per cent change through the year to 30 June. Forecasts are rounded to the nearest 0.1 percentage points.

Sources: ABS 5206.0, 5220.0, 6202.0, 6401.0, 6345.0, 3101.0 and NSW Treasury

2.1 The economy is bouncing back faster than expected

The NSW economy has outperformed expectations as at the time of the 2020-21 Half-Yearly Review (February 2021). State final demand (SFD) had surpassed pre-COVID levels by early 2021. Meanwhile, all the nearly 270,000 jobs shed between February and May of last year have been regained. Employment in May 2021 is around 36,000 higher than its pre-pandemic level, with the State's unemployment rate in the June quarter so far dropping to 5.3 per cent.

The strength of the rebound has been heavily aided by:

- the removal of most social distancing measures sooner than anticipated, supported by public confidence in the NSW health system to manage outbreaks of the virus without significant lockdowns
- the effectiveness of monetary and government support programs for business and households.

These factors have contributed to a recent record high reading for business confidence and an 11-year high for consumer sentiment.

The speed of the bounce-back has substantially reduced (but not eliminated) the risk of more permanent impacts on economic activity and employment.

Stronger household spending and the buoyant housing market have driven much of the State's recovery to date. Both have benefited significantly from economic stimulus and an easing of restrictions. Momentum from these sectors is expected to spill into other parts of the economy, driving up the demand for labour and further lowering the unemployment rate.

The primary factor preventing the economy's return to its pre-COVID growth path is the ongoing closure of Australia's international border. Based on current Commonwealth migration policies, the population in New South Wales will remain well below pre-COVID projections. This will remain the case even after international borders are reopened, which is now expected to occur around the middle of 2022, around six months later than previously thought.

The Commonwealth's delay in reopening Australia's international border will slow down economic and employment growth, but will not derail the recovery. The near-term loss in population growth reduces aggregate demand and cuts off an important source of skilled and unskilled labour. It also increases the risk of longer-term effects for industries reliant on international travel, such as education and Sydney CBD tourism.

There is potential for impacted industries to recovery quickly once borders open following the successful rollout of vaccines. In the meantime, very low interest rates and ongoing fiscal stimulus are helping to fill the void.

While part of the rebound in the economy reflects a bring forward of activity from future years, there also is an improvement in underlying economic conditions. Economic growth forecasts subsequently are revised higher across much of the budget horizon, with most years now expected to see above-trend growth. In addition to the support from policy, the stronger-than-expected economy has given businesses the confidence to rehire staff, reducing uncertainty and with it the need for precautionary saving by households. This is a significant turnaround in fortunes that should boost economic activity on a per capita basis beyond its pre-COVID trends in the coming years.

Given the revised outlook, the State's unemployment rate is now expected to fall faster than previously forecast and reach a level consistent with full employment by 2024-25.[1] This translates to an increase in employment of almost 450,000 since the depths of the COVID-19 pandemic in mid-2020.

[1] Full employment is estimated to be around a 4½ per cent unemployment rate. This is considered the lowest rate of unemployment that can be sustained without inflation becoming an issue.

There is potential for the outlook to improve further over coming years. Despite the population constraints, there are other levers to drive growth, including:

- higher labour participation, particularly for women and older age cohorts
- faster growth in productivity, which in recent years has been well below the historical average.

The Government can play a key role in encouraging improvement in both these drivers, through an effective reform agenda (see Box 1.3 - Boosting productivity and the quality of services). Doing so will lift the economy's potential, whilst increasing living standards of NSW residents.

Despite the stronger economy, risks will remain heightened while the global pandemic endures. Risks that could affect the recovery include the emergence of new strains of the virus, elevated rates of infection in some countries and further delays in the vaccine rollout. A fast and effective vaccine rollout is crucial to supporting public confidence and ensuring Australia (and New South Wales) can reopen to the world as quickly as possible.

While the recovery in the economy is expected to be strong enough to withstand the conclusion of the Commonwealth's JobKeeper program back in late March, its cessation along with other measures (which have artificially suppressed business failures) could weigh on labour market conditions to a greater degree than expected.

Beyond the pandemic, other risks include disruptions to trade and a tightening in macroprudential policy in response to the strong housing market. These risks have heightened in recent months. See section 2.6 for further analysis on upside and downside risks.

2.2 Global outlook and implications for New South Wales

The International Monetary Fund (IMF) has upgraded its 2021 and 2022 global growth forecasts. These revisions reflect not only the stronger-than-expected rebound in activity to date, but optimism in the rollout of vaccines across the major developed economies and additional fiscal stimulus in the United States. In its April 2021 outlook, the IMF:

- revised 2021 global growth up 0.5 percentage points since January to 6.0 per cent
- revised 2022 growth up 0.2 percentage points to 4.4 per cent.

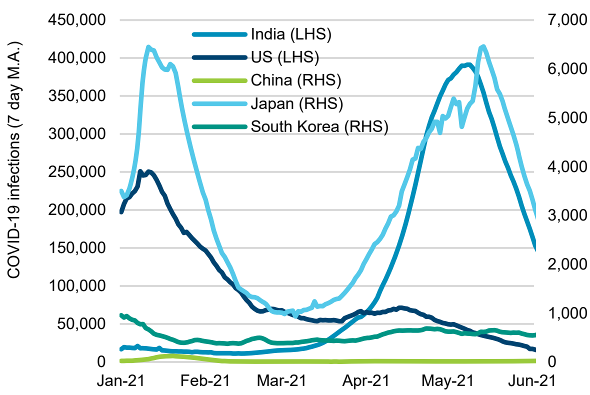
The upward revisions are most pronounced for advanced economies.

The growth outlook for NSW's major trading partners (MTP)[2] is slightly stronger in 2021 (at 6.3 per cent).

Despite the stronger forecasts, the international economic recovery will remain precarious while the pandemic is ongoing and until the vaccine rollout has progressed significantly further. A resurgence in COVID-19 infections, like what was seen earlier this year in India, could still impede the global recovery (Chart 2.1).

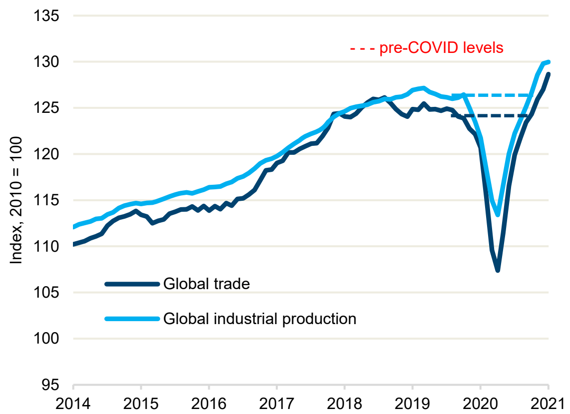
[2] Major Trading Partner (MTP) growth is a trade weighted measure of global growth, using NSW trade weights. This places more significance on growth in countries that currently demand more of the State's exports.

Chart 2.1: COVID-19 infection trends for selected MTPs



Source: Our World in Data and NSW Treasury

Chart 2.2: World trade activity back above pre-COVID level



Source: The CPB World Trade Monitor and NSW Treasury

Reopening the NSW economy to the world

International border restrictions remain a major impediment to NSW economic growth. The border closure has dealt a significant blow to the $1.8 billion in monthly personal travel and education related exports from New South Wales. Meanwhile, lower migration negatively impacts aggregate demand in the economy and potentially adds to labour supply pressures.

While New South Wales usually runs a tourism expenditure deficit (more spending by NSW residents overseas than foreign visitors spend in New South Wales, Chart 2.3), tourism is an important sector and a major employer of local workers. Estimates suggest that for every $1 spent in the tourism industry, an additional $0.84 is spent elsewhere in the economy.[3] According to Tourism Research Australia, in 2018-19 the direct and indirect value of the tourism industry to the NSW economy was equivalent to around 6.1 per cent of GSP, and provides employment for close to 300,000 persons (or 7.3 per cent of total employment in the State).

The education sector, meanwhile, has felt the impact of fewer international students. The number of international students arriving to New South Wales was down 99.8 per cent in February 2021 compared to a year before. International student enrolments were down around 18 per cent through the year to February 2021, with commencements down more than 40 per cent over the same period (refer to Chart 2.4).[4] Fewer commencements today are likely to flow through to fewer enrolments in following years, impacting education providers for several years to come.

In addition to the direct impact on education providers, the drop in international students has much broader impacts on the economy. Less than half of student spending is on tuition fees, with the rest spent on housing and general goods and services. Student activity also has large multiplier effects on the rest of the economy. Estimates suggest that each student creates on average 0.36 new jobs in the economy.[5] Based on the change in enrolments to date, relative to last year, this would imply a loss of around 15,000 jobs.

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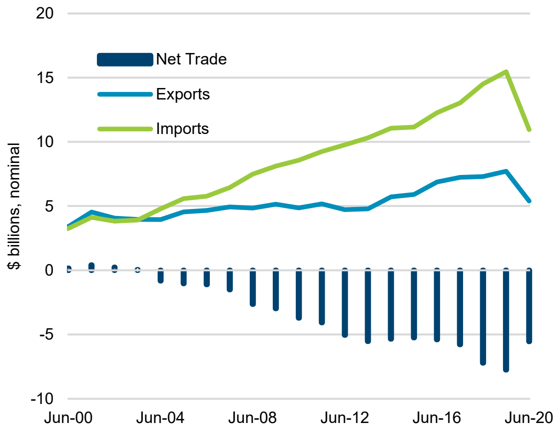
3 Based on 2018-19 figures in the Tourism Research Australia State Tourism Satellite Account (STSA).

4 Student enrolments represents actual course enrolments (not the number of students enrolled). Student commencements refers only to new student enrolment.

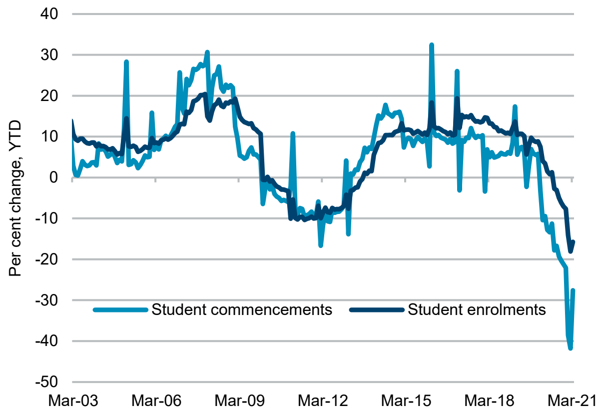
5 Jobs supported are based on Department of Education and Training, Research Snapshot, March 2019.

Chart 2.3: NSW tourism trade deficit



Source: ABS 5368.0.55.003 and NSW Treasury

Chart 2.4: International student commencements and enrolments collapsing



Source: Department of Education, Skills and Employment and NSW Treasury

The impact of closed international borders on migration and population growth may be even larger than the disruption to trade. The loss in population equates to a permanent loss in potential economic growth and aggregate demand that accumulates over time. It also can accentuate labour shortages in the economy (both skilled and unskilled).

While the re-opening of international borders is expected to occur from mid-2022, the increased flow of arrivals and departures is likely to be gradual. The speed of recovery will depend on the unfolding health and vaccination situation both in Australia and abroad (see Box 2.1 for assumptions). Once borders reopen, the immediate impact on net tourism exports is likely to be negative as Australians increase travel overseas. Over time, this will be more than offset by the positive impact of a gradual lift in international students and a return to more normal levels of inwards migration.

Box 2.1 Health assumptions that underpin the economic outlook

Closed international borders are the most significant restriction remaining in terms of economic costs.

The assumptions in the 2021-22 Budget regarding Australia's international border align with those in the 2021-22 Commonwealth Budget. This reflects the fact that the Commonwealth Government controls the policy levers around Australia's international borders and the vaccine rollout. The anticipated reopening of borders has been delayed another six months to mid-2022, following the assumed vaccination of most of the adult population by end-2021.

Thereafter, the return of international students and permanent migrants is assumed to be gradual.

Any material increase in outbound or inbound tourism is not anticipated until the second half of 2022. Some inbound travel of New Zealand tourists to NSW without quarantine restrictions has resumed, but are still well down on usual levels.

NSW tourists are now permitted to travel to New Zealand, although temporary disruptions already have occurred following localised COVID-19 outbreaks.

The Commonwealth has indicated the possibility of additional travel bubbles, although the economic benefit of these is expected to be marginal.

Similarly, the NSW Government has announced a pilot program to commence the return of some international students through the quarantine system from the middle of 2021.

No interstate border restrictions are assumed, although recent outbreaks of the virus suggest an ongoing risk that other states could continue to sporadically close borders in response to community COVID-19 transmissions.

The domestic economy is expected to remain largely free of restrictions. It is assumed that economic restrictions eased since the peak of the pandemic – such as limits on weddings, the 4sqm rule and capacity limits on theatres and sporting events – will not be reimposed.

2.3 The NSW economic outlook

Employment is already past pre-COVID levels

The labour market recovery was even better than had been expected earlier this year. The stronger rebound has been aided by the successful suppression of the COVID-19 virus, allowing for the removal of most social distancing measures much sooner than anticipated, and the effectiveness of government stimulus support for businesses and households.

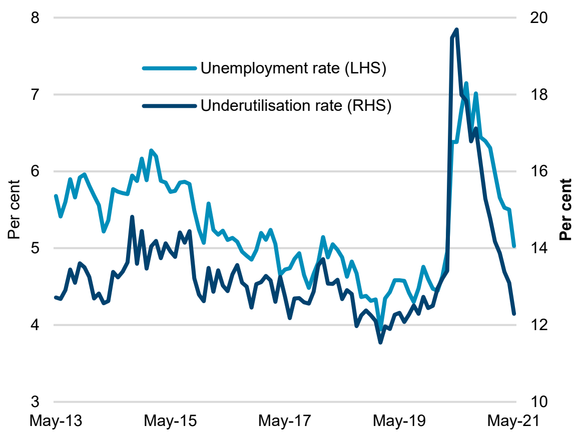
By the middle of the June quarter 2021, the jobs lost between February and May 2020 had been more than regained, with the level of employment 0.9 per cent above its pre-COVID level.

Solid employment growth has meant that the unemployment rate has dropped sharply to 5.3 per cent so far in the June quarter, from a high of 7.1 per cent in July 2020 (Chart 2.5). Still, the unemployment rate remains higher than pre-COVID, and at a level suggesting that some degree of spare capacity remains in the labour market.

The participation rate is now above pre-COVID levels, with female participation reaching a record high of 61.7 per cent in May, while the participation of older age cohorts also has been elevated. This has helped to partially offset the labour supply pressures emanating from the lack of population growth due to closed international borders. Higher participation by these cohorts likely reflects a combination of both temporary and structural factors accelerated by COVID-19.

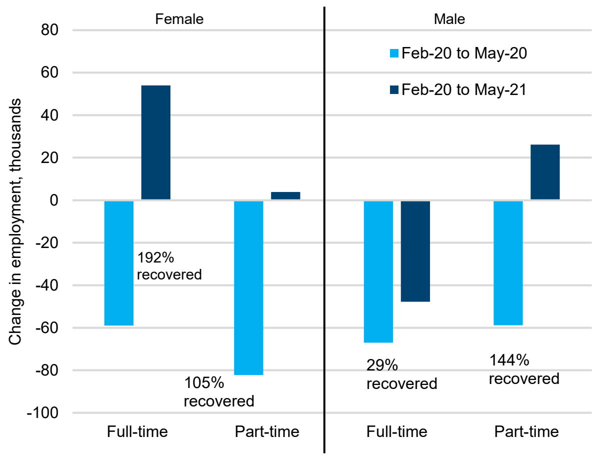
While the rebound in employment has been strong, it has not been uniform across all segments of the labour market. At the start of the pandemic, women faced greater job losses (Chart 2.6). Since then, the employment recovery for women has been strong across both full-time and part-time jobs. Full-time job recovery has been particularly strong in the last few months. In contrast, the recovery in the number of men employed full-time has lagged. This may reflect a reluctance of previously full-time male workers to take up new positions. Younger cohorts also trail the employment recovery seen across the broader labour market. Employment for 20-29 year-olds was about 4.1 per cent below pre-COVID levels in April. However, employment is up for the much smaller 15-19 year-old cohort.[6]

Chart 2.5: Spare capacity in the labour market



Source: ABS 6202.0 and NSW Treasury

Chart 2.6: Employment recovery by gender



Source: ABS 6202.0 and NSW Treasury

The end of the *JobKeeper* wage subsidy program is likely to result in some volatility in employment, especially in the short-term. The end of other business support measures, such as the moratorium on insolvencies, also may weigh on the demand for labour.

Forward looking indicators of the labour market suggest that any weakness in employment is likely to be temporary. Job vacancies rose almost 14 per cent in the March quarter, indicating that demand for labour remains strong. That said, reports of skills and labour shortages in some occupations, in part a result of international border closures, could see some vacancies go unfilled, limiting the pace of new job creation. According to the NAB Quarterly Business Survey, the proportion of firms facing difficulties finding suitable labour has increased sharply to its highest level since just before the Global Financial Crisis of 2008-09. This is consistent with feedback obtained by the NSW Government through liaison with small business.

On balance, the pace of employment growth will likely slow in coming months, with improvements in the unemployment rate subsequently moderating for a time. Longer term, the unemployment rate is expected to resume its downward trend, reaching estimates of full employment (around 4.5 per cent) by the end of the forecast period.

6 May outcomes by age cohort not available at time of writing.

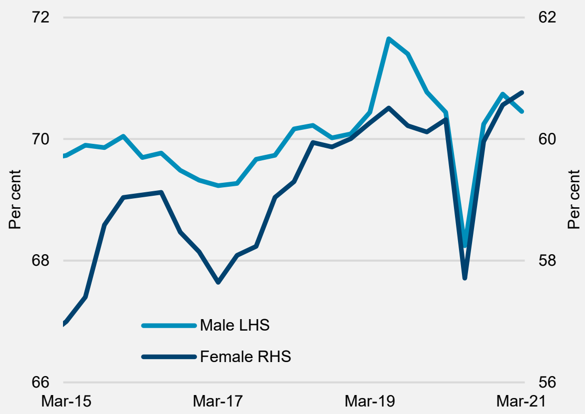
Box 2.2 Female workers crucial to rebound in employment and participation

Labour market outcomes have been much stronger than was anticipated at the start of the pandemic. This is especially the case for women.

Female employment fell by more than 141,000 between February and May 2020, accounting for 53 per cent of the total decline in employment during the depths of the pandemic. Since then, female employment more than reversed the declines recorded during the worst of the pandemic, rebounding by more than 199,000 through to May 2021.

Increased female participation in the labour force has been critical to the rebound in the overall participation rate. The female participation rate experienced an accelerated step up since the worst of the pandemic (Chart 2.7), reaching a record high of 61.7 per cent in May 2021. This acceleration is likely due to a combination of structural and temporary factors brought on by COVID.

Chart 2.7: Labour force participation by gender (quarterly)



Source: ABS 6202.0 and NSW Treasury

Increases in the *JobSeeker* payment and the temporary removal of mutual obligation requirements (e.g. the need to look for work as part of an individual's job plan) likely added to the number of women actively seeking employment.

Another likely driver of increased workforce participation among women is greater workplace flexibility and the accelerated digitisation of the economy. This is particularly beneficial for women, who may have a greater share of parenting or carer responsibilities and otherwise would be unable to enter or re-join the labour force.

While flexible working was gaining traction before COVID-19, there has been an accelerated uptake of the practice in the last 12-months. This has increased participation by those who otherwise would find it challenging to balance personal commitments alongside work.

The rise in female participation continues the long-run upward trend evident since well before COVID-19. Changes in societal norms, better access to childcare and increased educational attainment all have contributed to the rising trend over the last few decades. The female participation rate increased more than 4 percentage points in the decade to December 2019.

The female employment-to-population ratio has increased from less than 40 per cent in the late 1970s, to more than 59 per cent now. Women now make up almost 48 per cent of the State's workforce, up from around 36 per cent in the late 1970s.

Despite these changes, the female participation rate remains about 10 percentage points below that of men. This suggests there are further opportunities to remove barriers to women entering or re-entering the workforce after extended time away.

Household consumption to surpass previous trends

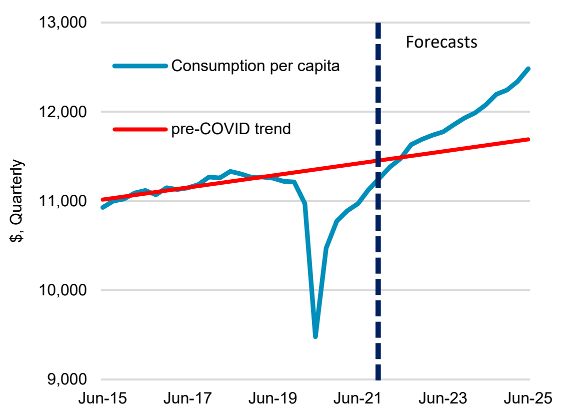
Central to the improvement in the economic outlook has been a rapid bounce-back in household spending. By the March quarter 2021, household consumption had increased 15.0 per cent from the depths of the June quarter 2020 downturn. This accounted for more than 70 per cent of the rebound in overall economic activity. Much of the initial rise in household spending was driven by a strong recovery in spending on services, which were particularly hard hit by the pandemic. This rebound coincided with the easing of restrictions and an associated surge in consumer confidence to its highest level in more than a decade.

A swift improvement in the labour market has helped to solidify the recovery in consumer spending by reducing the need for precautionary savings. Additionally, low interest rates and improving household wealth due to higher house prices have enabled previously credit-constrained households to consume more.

Despite the recovery seen to date, spending on services (particularly transport services) remains below pre-COVID levels. Such spending is weighed down by responses to occasional community COVID-19 transmissions, more people working from home, and reduced tourism activity in certain regions. Spending on goods has remained robust, with real retail sales rising 5.1 per cent through the year to the March quarter 2021. Targeted stimulus measures, such as the NSW Government's Dine & Discover program, are supporting spending on services. The Government's tourism support package is also being rolled out to support the accommodation, entertainment and tourism sectors – see Box 5.1 in Chapter 5 which outlines a range of support measures.

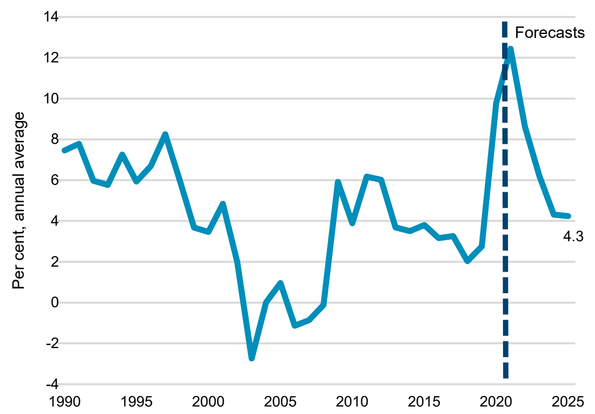
Household consumption is expected to surpass pre-COVID trends on a per capita basis well before the end of the forecast horizon (see Chart 2.8). Spending will be buoyed by continued labour market improvements, additional policy support in the form of income tax cuts and lower precautionary saving (see Chart 2.9). One potential upside to economic growth is that households will draw down on the savings they have accumulated during COVID, to further boost spending in the economy.

Chart 2.8: NSW real per capita consumption



Source: ABS 5206.0 and NSW Treasury

Chart 2.9: NSW net household savings rate



Source: ABS 5206.0 and NSW Treasury

Policy support has contributed to a rapid rebound in the housing market

A solid labour market has combined with low interest rates to drive up the number of property transactions, house prices and construction activity, despite the absence of new migration. Activity also has been stimulated by the Commonwealth's *HomeBuilder* scheme. House prices in Sydney have surged over 20 per cent since the onset of the pandemic (Chart 2.10).

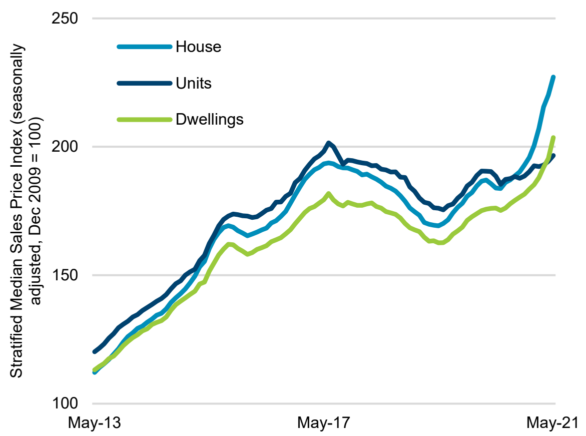
Renovation activity also has been strong as households have redirected money earmarked for overseas holidays into improving their houses. For now, these factors have been more than sufficient to offset the impact of weaker population growth.

The current strength in the housing market, in terms of price growth and new construction, is mainly reflected in houses rather than units. Until recently, it had mainly been underpinned by demand from owner-occupiers. Government policies are supporting first home buyers, with first home buyer activity surging in the second half of 2020. The number of transfer duty concessions to first home buyers was up by more than a third in the second half of 2020 (at nearly 25,000), compared to a year earlier.

Annual house price growth is expected to peak around late-2021. As higher prices encourage more owners to sell, this will work to limit house price growth over time. In addition, higher prices are expected to price out more potential buyers, weighing on demand.

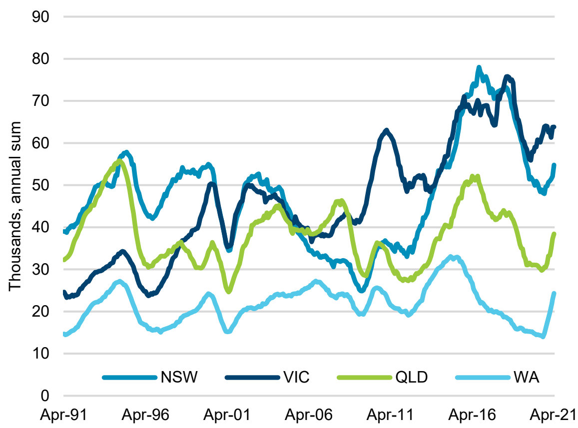
Speculation has emerged around the potential for renewed macroprudential tightening by regulators in response to growing house prices. However, the concentration of lending growth in owner-occupier loans (rather than investors) suggests the current market conditions are less likely to evoke a response from regulators. For now, a significant macroprudential tightening is assumed to be unlikely, though this would change if speculative investor lending was to increase significantly. A major intervention would prompt a downward revision to house prices from baseline, with broad implications for the economic outlook (see Appendix F).

Chart 2.10: Sydney house prices



Source: CoreLogic and NSW Treasury

Chart 2.11: Dwelling approvals



Source: ABS 8731.0 and NSW Treasury

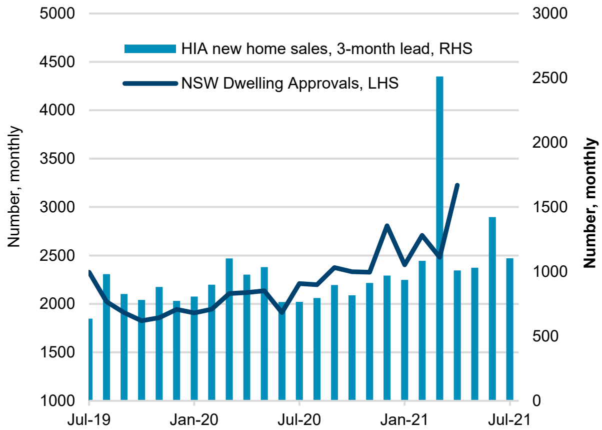
Residential construction is expected to remain strong in the very near term, fuelled by higher house prices, ongoing policy support and low interest rates.

Activity for both new houses and renovations also is being supported by the *HomeBuilder* policy. NSW households lodged over 23,000 applications for the grants scheme, of which more than 16,000 were for new dwellings (equivalent to around 32 per cent of all building approvals in 2019). Building approvals issued by local councils spiked at the end of 2020 and the beginning of 2021, with approvals in April nearly 60 per cent larger than the average month in 2019 (Chart 2.11). At the same time, new home sales leapt more than 100 per cent in the final month of 2020 to record-high levels ahead of the phasing down of the *HomeBuilder* rebate in December, before surging again in March ahead of the program's cessation in early April (Chart 2.12).

This pipeline of work is much larger than previously expected. The extension to the *HomeBuilder* commencement deadline to 18 months means that more projects will commence. This will provide further support for the residential construction industry into 2022, reducing the impact on economic growth from a drop in new dwelling construction. That said, building approvals are now running well ahead of the change in population, which is depressed due to the lack of inward migration. This suggests a potential oversupply in the near-term relative to the underlying demand for housing (Chart 2.13).

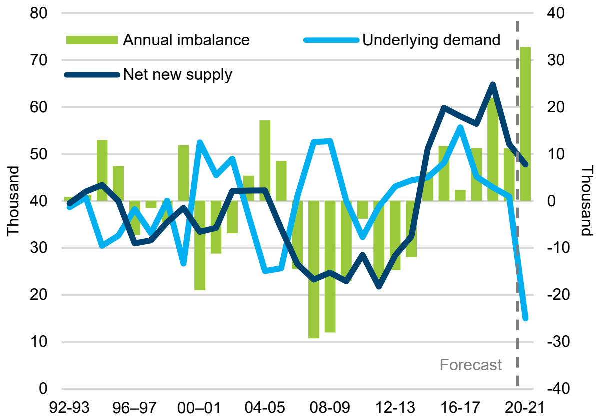
Meanwhile, demand for renovations is expected to drop off in 2022 as discretionary household expenditure is redirected back toward international travel once the border reopens. Once the temporary boost to housing construction and renovation activity from *HomeBuilder* fades, housing activity is expected to ease. Higher interest rates anticipated for 2024 as the Reserve Bank of Australia tightens monetary policy, will accentuate the weakness in demand for housing construction.

Chart 2.12: Early indicators imply spikes in activity from HomeBuilder



Source: ABS 8731.0, HIA and NSW Treasury

Chart 2.13: Low migration to impact underlying housing demand in NSW



Source: ABS 3101.0, 8752.0, 6416.0, Census 2016 and NSW Treasury

The outlook for business investment has improved

A quicker recovery in the broader economy is supporting an improved outlook for business investment. Business confidence in New South Wales has returned, with the NAB Business Survey lifting to record highs in recent months, while capacity utilisation has rebounded, suggesting both a need and an appetite from businesses to invest.

Tax incentives from the Commonwealth Government, which recently have been expanded and extended, also should support investment. This is complemented by NSW Government efforts to support investment like the $250 million Jobs Plus Fund. Consequently, plant and equipment investment has returned to positive growth quickly, although this is consistent with past economic shocks. By contrast, the movement towards more flexible working arrangements, along with a post-COVID acceleration towards greater online spending, is likely to weigh on non-residential construction activity.

Business investment in aggregate is expected to contribute to growth in the economy over the course of 2021-22. Beyond that, the end of tax incentives will become a constraint on investment growth after 2022-23, but this is expected to be more than offset by the improvement in economic conditions. In addition to its direct contribution to economic growth, business investment also will provide a key ingredient for driving future productivity growth as businesses adopt and implement new technologies.

2.4 The role of policy support and the economic outlook

The need for general temporary government support measures has reduced

The swift recovery in the household sector is testament to the success of public support measures in ‘building a bridge’ beyond the crisis. This has left the economy well positioned to grow strongly largely under its own steam. The resilience seen in timely indicators such as retail sales and weekly payrolls suggests that households and businesses have been able to withstand the phased withdrawal in government support that has occurred, including the ending of the *JobKeeper* wage subsidy.

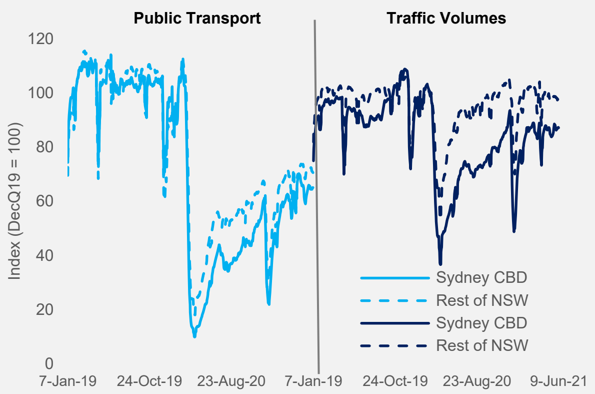
Box 2.3 Economic conditions in the Sydney CBD

The NSW economy is bouncing back better than expected, but the recovery has been uneven. Central Business Districts (CBD) continue to suffer adverse economic impacts.

The Sydney CBD is essential to the State's competitiveness in attracting investment and business activity. The City of Sydney Local Government Area (LGA) accounted for around $130 billion of output in 2019-20, almost 21 per cent of the NSW economy. However the CBD's heavy reliance on international visitors means its recovery will remain constrained so long as international borders are closed.

A shift towards working from home has disproportionately impacted the city centre. The NSW Government's Remote Working Insights report shows an increased preference to work-from-home, although employer policies to promote social distancing in the workplace also is likely to be a factor. The report suggests that remote working could stay 69 per cent above pre-pandemic levels, indicating that not all workers return to the office full time.

Chart 2.14: CBD movement (weekly)



Source: TfNSW

Data on the movement of people around Sydney and the state have shown a clear reluctance to travel into the CBD since the onset of the pandemic (Chart 2.14). However, despite the return of many office workers, aggregate traffic volumes and public transport patronage in the Sydney CBD remain signficantly weaker than the rest of the state.

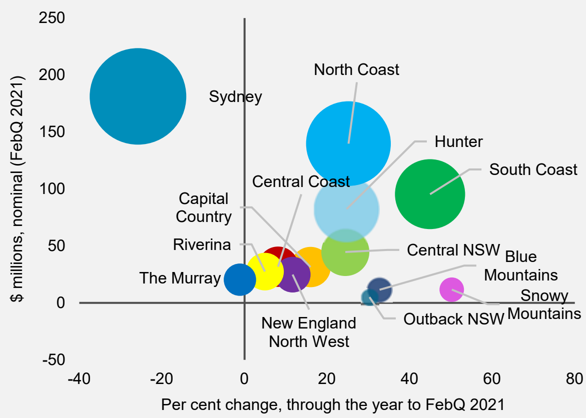
The loss of migration, international students and inbound tourists is having a disproportinate impact on the Sydney CBD.

The tourism related sector will continue to feel the pain from closed international borders for some time.

Pre-pandemic, international visitors accounted for around half of all tourism spend in the Sydney region, much more than any other region. This accounts for around 90 per cent of all international tourism spending in the state.

Domestic tourism spending in the Sydney region also has declined, by almost a quarter over 2020. In contrast, closed borders saw a shift in preferences that lifted spending in regional areas sharply, particularly in popular tourism regions (Chart 2.15).

Chart 2.15: Domestic tourism in NSW



Source: Destination NSW and NSW Treasury

Additionally, hospitality venues may continue to see some reluctance for people to hold large scale events (such as big weddings) while there are still localised outbreaks and the risk of periodic state border closures.

The NSW Government is continuing to provide targeted support for the Sydney CBD to drive economic activity. Some of the key initiatives include:

- CBD Revitalisation Program: $40 million (including a $20 million partnership with the City of Sydney) for a range of initiatives such as the Al fresco Dining program, late night openings at cultural institutions and arts and cultural events.
- Accommodation vouchers: $20 million to provide $100 accommodation vouchers to NSW residents to stay in Sydney's CBD.
- Sydney CBD vouchers: $50 million for a new Dine & Discover voucher to be used on Fridays in the CBD.

Despite the strong outlook, the need for ongoing support in some sectors will continue, particularly those that remain heavily impacted by the ongoing closure of international borders. This includes the tourism sector and CBD businesses. To that end, the NSW Government is committing $6 billion in new and ongoing economic stimulus expenditure in 2021-22. This includes ongoing payroll tax relief, rebates and initiatives that encourage greater visitation to the CBD.

While the near-term outlook appears positive, the economy remains fragile due to uncertainty around the COVID-19 virus and the lifting of border restrictions. Vulnerable sectors, particularly those still impacted by restrictions, will likely require further support. For example, businesses in the Sydney CBD may need ongoing assistance until the international border reopens.

The rapid rebound in activity has reduced the risk of long-term harm to the economy from the pandemic. However, it will still be some years until the economy returns to levels of activity normally associated with full employment.

Billions of dollars in economic stimulus measures delivered in 2020-21 also have contributed to public demand, making a meaningful contribution to economic growth. Total government consumption and investment made sizable positive contributions to activity during the past year, as public demand increased by 4.6 per cent through the year to March.

State and local public investment contributed 0.4 percentage points to state final demand over the past year, more than 2½ times the long run average, as the state government took action to accelerate projects and build on the existing pipeline of infrastructure projects. The NSW Government's commitment to a record $108.5 billion in infrastructure spending over four years underpins a lift in state and local public investment, which is expected to contribute ½ a percentage point to economic growth in 2021-22.

The economy is now forecast to return to full employment within the Budget period

On the back of the additional near-term strength in household spending and the housing market, state final demand is now back to slightly above its pre-COVID level. This has been achieved more than a year sooner than previously expected. Consistent with this, the labour market has improved significantly, with employment also returning to above pre-COVID levels by May 2021.

While the end of *JobKeeper* and potential headwinds from a likely increase in business insolvencies may slow the pace of recovery in the very near-term, these effects are expected to be temporary.

The speed of recovery in the labour market has helped to limit the likelihood of permanent harm to the economy, allowing the economy to spring back faster than previously expected. Solid labour market conditions and an accelerated trend towards flexible working arrangements post-COVID will contribute to higher labour market participation and growth in labour productivity that will help facilitate above-trend economic growth over most of the Budget period. Ongoing fiscal stimulus and low interest rates also are contributing, particularly with the RBA indicating a preference to wait until inflation is sustainably within its target band before raising interest rates (currently expected in 2024).

Consequently, there is expected to be less spare capacity in the economy over coming years, with the unemployment rate forecast to reach estimates consistent with full employment (around 4½ per cent) by 2024-25. Less spare capacity in the labour market naturally will translate into stronger wages growth, although increases in the compulsory superannuation contribution rate present a drag on take home pay over the forecast horizon. Consequently, the NSW Wage Price Index is expected to accelerate, but remain below long-run rates of growth, over the Budget years.

Higher wages also will mean higher consumer price inflation. Underlying inflation is expected to remain low in the near term, before returning to the RBAs inflation target range of 2-3 per cent by the end of 2023-24. Reflecting this, the NSW Government’s new wages policy will allow for faster wages growth for the State’s public sector employees.

2.5 The state’s economic reform agenda

Productivity reform is required more than ever

While the near-term outlook for the NSW economy is strong, the potential for long-term sustained growth is less certain and generally relies on three fundamental building blocks, known as the 3Ps:

- population growth
- participation in the labour force
- productivity.

Of these, participation and productivity are the critical factors in driving improvements in living standards.

Prior to the crisis, population growth made a significant contribution to economic growth. However, the pandemic has left a long-lasting impact on NSW population growth, as set out in the recent NSW Intergenerational Report.

In terms of addressing labour participation, policy levers are somewhat limited in the short term, especially as labour participation has already lifted to record highs in recent years, driven by increased female participation.

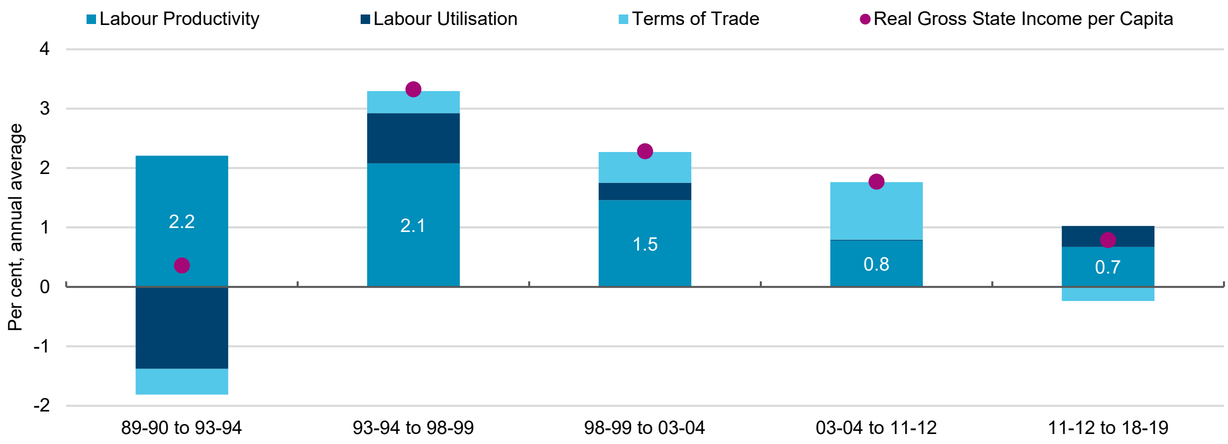
Over the longer term, the ageing of the population will place downward pressure on workforce participation. The Commonwealth holds the strongest levers through its control of the tax, superannuation and transfer systems. The State can influence participation at the margin, through policies on healthcare, training and education, and childcare.

This leaves productivity growth as the primary lever through which the NSW Government can drive long-term improvements in living standards.

Productivity growth is the fundamental source of real wage growth and improved living standards. In the 1990s, New South Wales saw strong productivity growth of over 2 per cent per annum. However, for much of the decade leading up to the COVID-19 pandemic, productivity growth has averaged 0.7 per cent per annum, in line with similar trends observed nationally and globally. (see Chart 2.16).

If productivity growth continues to lag, the economy will struggle to deliver real wage growth, improvements in living standards and sustainable revenue to fund essential public services. By lifting our productivity growth, it is possible to improve wages and living standards without having to work more hours. While government stimulus has played a critical role in buttressing the economy during the pandemic, sustained economic growth will rely more heavily on productivity growth, especially given the lingering effects of lower population growth following the pandemic.

Chart 2.16: Real Gross State Income Per Capita - how NSW growth has slowed



Source: ABS 5220.0, ABS 6202.0 and NSW Treasury

Opportunities for productivity reform

The recent slowdown in productivity growth is a global phenomenon. Since technological innovation is a key driver of productivity, some rebound in productivity growth is likely. However, to repeat the strong growth seen in the past, and to keep up with other developed nations, all levels of government in Australia will need to pursue ambitious reforms. The NSW Government is responding to this challenge. Box 1.3 in Chapter 1 outlines the suite of productivity reforms in this Budget, including planning reform and education and skills investments.

The potential gains from productivity growth are significant. If productivity growth doubled from the current 0.7 per cent per year, real gross state product per person by 2056 would be around $33,000 per year higher. In its recently released Productivity White Paper 2021 'Rebooting the Economy', the NSW Productivity Commission has identified opportunities that would increase NSW GSP by 2 per cent, or $19.4 billion in today's dollars by 2041. This is equivalent to an increase in the income of every NSW citizen over 15 by $2,000 a year, on average.

The White Paper highlights the key policy levers available to state governments that can help boost productivity:

- **Talent:** State governments deliver public schooling and vocational education. By improving these, it can build a more highly skilled, resilient and productive workforce
- **Innovation:** State governments are responsible for many of the laws and regulations we deal with every day. By making these smarter and less onerous, it can protect NSW citizens while making room for world-leading innovations and new technologies
- **Housing:** State governments regulate housing; the biggest expense NSW residents face. Providing the right types of housing, in the right places, at the right times, can make a big difference to labour mobility, productivity and cost of living pressures
- **Infrastructure:** State governments oversee investment in water, energy, and transport infrastructure. By ensuring investments in these sectors are future-focused and responsible, it can lower the cost of living and work more effectively in New South Wales.

These reforms build on significant investments by the Government in progressing some of the NSW Productivity Commission's Green Paper draft recommendations in the 2020-21 Budget. This includes:

- the implementation of a suite of planning reforms to deliver on the NSW Planning Reform Action Plan includes:
  - making planning processes more efficient to reduce assessment times
  - simplifying the system to accommodate new business models and changing needs
  - improving the interface between industry and the Government with a 'one stop shop'
  - investing in ePlanning to bring councils processes into the twenty-first century
  - developing an integrated digital tool to transform the way stakeholders interact with the infrastructure contributions system.
- the establishment of a new Trades Skills Pathways Centre to develop and pilot new flexible pathways into the trades, and support the participation of mature aged workers and women
- implementing a new nation-wide scheme for the automatic mutual recognition of state based occupational licences
- evaluating the relaxation of regulations announced at the onset of COVID-19 to assess their results in order to retain the ones that work.

2.6 Key risks to the outlook

Some near-term risks have reduced because of current economic momentum. This includes a reduced, but not eliminated, risk around the conclusion of the Commonwealth's *JobKeeper* program.

The global pandemic continues to add uncertainty to the broader outlook. Significant risks remain that could postpone, if not derail, the recovery.

While New South Wales has effectively managed community outbreaks of COVID-19, the reimposition of economic restrictions in response to further outbreaks remains the most significant risk to the outlook. While Australia and New South Wales have secured sufficient vaccine supply for the entire population, risks remain around the availability and timing of distribution of the vaccine supply. Uncertainty about the effectiveness of vaccines against new variants could also affect the confidence of governments to reopen their economies.

Any slippage in the rollout of an effective vaccine to the population would likely see a further delay in the reopening of international borders, particularly if we continue to see periodic resurgences in COVID-19 infections globally. A further one-year delay in opening of the international border could see the economy 0.9 percentage point smaller and the unemployment rate 1 percentage point higher by 2022-23. In contrast, achieving an earlier vaccination of the population potentially would facilitate a faster reopening of international borders, with a consequent positive effect on the economy.

Geopolitical tensions with China remain a risk to the outlook. So far, trade disruptions have had a minimal impact on the State economy. However, ongoing tensions have a potential for further escalation, which will continue to cause uncertainty in the trade outlook. At the same time there may be prospects for wider trading opportunities with other nations (e.g. a UK-Australia Free Trade Agreement).

A new risk that has emerged more recently is the potential for macroprudential policy tightening in response to soaring house prices, aiming to reduce any perceived risks to financial stability. Until recently, much of the strength in housing activity had been confined to owner-occupiers. This is a normal response to low interest rates, with no evidence of a material deterioration in lending standards. Such conditions were unlikely to elicit a response from prudential regulators. More recently, investor activity has begun to gather pace, meaning the risk of prudential tightening is not insignificant. Appendix F includes sensitivity analysis on the potential impacts of lower house prices, potentially driven by macroprudential tightening.

As highlighted earlier, there also are scenarios which could lead to a stronger recovery than currently forecast. The dominant upside risk relates to households. History suggests it takes some time before the household saving rate falls back to pre-recession levels. However, the record high level of saving seen during the recent downturn, combined with the much faster than anticipated recovery in employment and incomes, could incentivise consumers to reduce their saving rates faster and to a greater extent than envisaged. This could spur an even larger recovery in consumer spending.