2. THE ECONOMY

- The NSW economy has rebounded strongly from the Delta lockdown last year, despite the Omicron outbreak and floods in late 2021 and early 2022.
- Successful vaccination of the population has enabled households and businesses to transition to living with COVID-19 in the community, supporting the economic recovery and job creation. Consequently, the labour market has tightened, with the monthly unemployment rate dropping to a historically low level.
- Global forces are impacting the NSW economic outlook including the ongoing impacts of COVID-19 and Russia's invasion of Ukraine. Strong growth in the demand for goods at a time of strained global supply and tight labour markets has driven inflation across the developed world to multi-decade highs. Central banks, including the Reserve Bank of Australia, are responding by commencing the process of raising interest rates and removing stimulus.
- The NSW economy is expected to grow at an above trend pace, on average, across the forecast horizon. This is supported by strong near-term momentum in the labour market and the resilient state of aggregate balance sheets. Monetary policy meanwhile remains supportive of growth in the near term, even with the prospect of interest rate increases over the forecast horizon. This in turn should support continued strength in employment, with the unemployment rate remaining low across the forecast horizon.
- Wages growth is expected to be stronger over the forecast period. While inflation is expected to ease from its current rapid pace, a tight labour market and a range of global forces will see inflation remain higher than prior to the pandemic.
- Notwithstanding the positive central forecast, the outlook remains subject to an unusually high degree of uncertainty and risks, primarily to the downside. These include COVID-19, uncertainty around the pace and extent of monetary policy tightening, both within Australia and abroad, the invasion of Ukraine, and concerns over the sustainability of China's growth trajectory.

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

	2020-21 Outcome	2021-22 Forecasts	2022-23 Forecasts	2023-24 Forecasts	2024-25 Forecasts	2025-26 Forecasts
Real State Final Demand	3.0	2¾	5½ (5)	1¾ (1)	2¼ (2½)	2
Real Gross State Product	1.4	1½ (2½)	4¼ (3¼)	2¾ (1½)	2½ (2¼)	1½
Employment	0.4	1 (½)	3 (2¼)	1	1¼	1
Unemployment rate [(b)]	5.2	3¾ (5¼)	3¾ (4½)	3½ (4½)	3½ (4¼)	3¾
Sydney Consumer Price Index	1.5	4 (2½)	5½ (2¼)	3 (2½)	3 (2½)	2¾
Wage Price Index	1.5	2¼	3½ (2¼)	3¼ (2½)	3¼ (2¾)	3¼
Nominal Gross State Product	3.0	6¾ (8)	9¾ (4¼)	4½ (2¼)	3 (3¾)	3¼
Population [(c)]	0.3	0.1 (0.4)	0.6 (0.7)	1.0 (1.1)	1.1 (1.2)	1.1

(a) Per cent change, annual average unless otherwise stated. Previous forecast (2021-22 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.
Note: Commodity prices are assumed to follow Consensus forecasts as at May 2022. The RBA is assumed to increase interest rates over the course of 2022 and 2023 broadly in line with the assumptions used in the RBA Statement on Monetary Policy (May 2022). The Australian dollar trade-weighted index is assumed to average 63.6 across the forecast period. Policy proposals during the Commonwealth election are not incorporated into the forecasts. An allowance is made in the forecasts for the impact on the economy of continued COVID-19 cases in the community. The magnitude of the allowance averages around 0.1 per cent of GSP per annum across the budget and forward years.
Source: ABS and NSW Treasury

2.1 NSW economy is showing strong momentum

A fast recovery since the Delta lockdown

The domestic economy has recovered strongly since the Delta lockdown, broadly in line with expectations at the time of the 2021-22 Half-Yearly Review.

The rapid rebound in economic activity is largely attributed to the unprecedented fiscal support to households and businesses from the Commonwealth and NSW Governments such as JobSaver, the COVID-19 Business Grant, and the COVID-19 Micro-business Grant, combined with ongoing monetary stimulus from the Reserve Bank of Australia (RBA).

By early 2022, the NSW economy had more than fully recovered all of the 245,000 in lost employment seen during the Delta lockdown, with employment comfortably above the level prior to the lockdown.

The Omicron outbreak briefly threatened the recovery in early 2022. The main economic impact of Omicron was seen in a sharp fall in hours worked in January as employees needed to take time off work due to illness and isolation requirements for close contacts. In contrast, other economic indicators such as employment and retail turnover held up relatively well.

As rules around the isolation of close contacts eased, the impact of Omicron on the economy has also diminished. Despite the elevated level of Omicron cases, the overall impact on the economy was smaller than seen for previous variants. This owed to a range of factors including the successful vaccination of the population, support and stimulus measures, and the adaptability of households and businesses as they transitioned towards living with COVID-19 in the community.

Severe storms and floods also caused extensive disruption and damage in impacted areas of New South Wales in early 2022. While this was devastating for many local communities especially in the State's Northern Rivers, it was not enough to derail the strength of the broader economic recovery underway in New South Wales.

Growth in State Final Demand (SFD) in 2021-22 is expected to be 2¾ per cent, in line with expectations at the time of the 2021-22 Half-Yearly Review. While expectations for the domestic economy in 2021-22 have remained unchanged, an increase in imports in the March quarter 2022 has resulted in expected growth in Gross State Product (GSP) in 2021-22 being revised down to 1½ per cent. This compares to expectations at the time of the 2021-22 Half-Yearly Review of 2½ per cent.

A robust economic outlook

Following the strong economic recovery since the Delta lockdown, the NSW economy is expected to maintain its strong momentum.

The economy continues to be supported in the near term by fiscal and monetary policy. On the fiscal side, there are a range of programs introduced during the pandemic that are providing ongoing benefit to the economy. Further support will also come over the course of the forecast period from Commonwealth income tax cuts as well as cost of living measures to support households in the face of high inflation.

The current stance of monetary policy also remains highly supportive of growth. Despite increasing in the past two months, the level of the RBA cash rate target, at 0.85 per cent in June, remains very low by historical standards. A sustained rise in interest rates is assumed to occur over the forecast horizon, though this is not expected to derail growth.

Monetary and fiscal support during the pandemic also helped households and businesses to build up aggregate savings. With the economy reopening, these savings are now available to support spending and investment.

This support, combined with the strong near-term momentum in the labour market, should ensure that domestic demand remains robust. In turn, this should drive continued strength of the labour market as well as solid wages growth over the forecast horizon. Section 2.3 provides further analysis of the NSW labour market outlook.

The recent sharp rise in inflation is a negative factor for the economic outlook. While inflation is expected to ease from its current rapid pace, it is expected to remain relatively elevated compared to before the pandemic. This largely reflects global factors including higher commodity prices and strains in global supply chains.

While the central outlook for the economy is positive, risks remain heightened. See section 2.5 for further analysis on upside and downside risks.

2.2 Global forces are shaping the outlook for the NSW economy

The NSW economy is being subjected to the same forces driving the global economic landscape. In response to COVID-19, many central banks around the world provided significant monetary stimulus. Interest rates were cut to their effective lower bound, near zero per cent. A number of central banks implemented unconventional policy measures to provide further stimulus, some of which had been implemented previously in response to the Global Financial Crisis (GFC). Governments across the developed world simultaneously provided stimulus to help protect their economies from the expected adverse impacts on demand and employment.

These policies succeeded in avoiding more significant negative economic impacts. At the same time, the peak of the pandemic globally proved to be shorter lived than many feared. This has resulted in sharp growth in goods demand and a rapid recovery in economic activity as a whole.

Labour markets, meanwhile, have experienced a much faster recovery than expected, with unemployment rates in most cases now at or even below their pre-COVID-19 levels (see Chart 2.1).

At the same time, COVID-19 exposed the fragility of global supply chains to shocks, particularly their reliance on China as a source of global production and just in time inventory management systems. The disruption to production caused by public health measures, especially during the initial outbreak in China, had a profound ripple effect across global supply chains (for further details see Box 2.1).

The combination of these forces has driven inflation across most of the developed world to multi-decade highs (see Chart 2.2). For example, US headline inflation reached a 40 year high of 8.5 per cent in March 2022. While rising headline inflation, in part, reflects a sharp rise in energy prices, core inflation also has surged across a broad range of countries. A common factor has been a surge in goods price inflation, but services inflation also has picked up. Central banks are responding by raising interest rates, with bond yields moving up sharply in expectation this will continue. Notwithstanding this, for now monetary and fiscal settings remain highly stimulatory across the developed world.

Meanwhile the global economy continues to be buffeted by several shocks to supply, notably Russia's invasion of Ukraine (which has a large impact on the supply of several key commodities including gas, oil, coal and wheat), and China's continued pursuit of a zero-COVID-19 policy. There is considerable uncertainty as to when these shocks will be resolved.

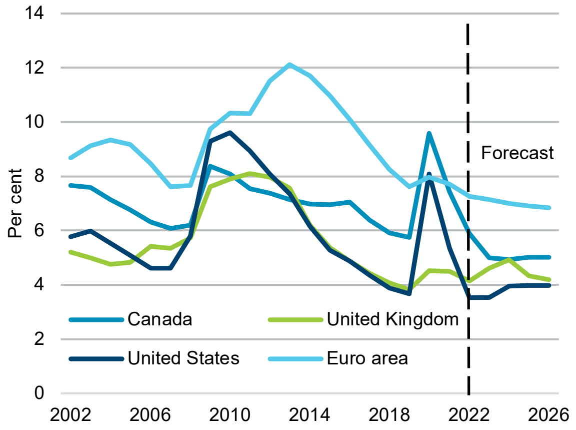
The International Monetary Fund (IMF) cut its outlook for global growth in 2022 to 3.6 per cent from 4.9 per cent in October 2021, reflecting increased sanctions aimed at Russia and new lockdowns in China increasing global supply chain bottlenecks. Faltering global trade growth has implications for the State's key commodity and service exports.

Recent data suggests that international students and tourists have been gradually returning since Australia's international border reopened but numbers remained below pre-COVID-19 levels in March 2022. Meanwhile, departures of Australians travelling abroad have also picked up.

Supported by international arrivals, exports are forecast to grow over the forecast period. Imports are also expected to increase, reflecting the strength of the domestic economy as well as a rise in outbound tourism. Outbound tourism is expected to overtake inbound tourism over the forecast period, reverting to a trend seen prior to the onset of the pandemic.

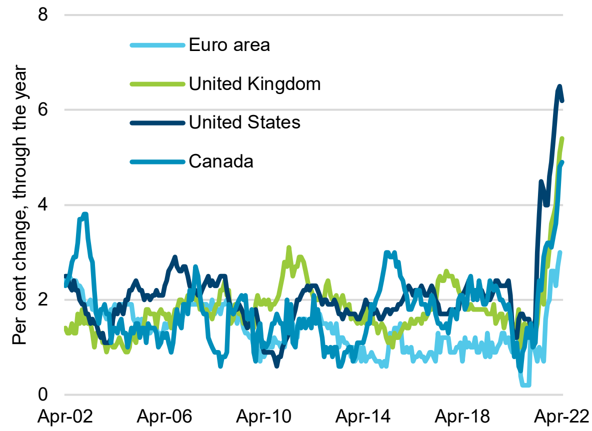
Net overseas migration fell to historic lows due to the closure of Australia's international border which led to a sharp slowdown in population growth. A gradual recovery in net overseas migration is assumed to support stronger population growth over the forecast period, but growth is expected to remain below pre-pandemic levels.

Chart 2.1: Unemployment rate for select countries



Source: IMF

Chart 2.2: Annual core inflation excluding food & energy for select countries



Source: OECD

2.3 The NSW economic outlook

A strong labour market with the monthly unemployment rate historically low

The near-term outlook for the economy is being dominated by the current strong momentum in the labour market.

Most of the impact of Omicron and storms and floods was reflected in falls in hours worked as people were forced to isolate due to illness or close contact rules, or unable to work due to the extreme weather. Total hours worked registered a record decline in January 2022 following the initial Omicron outbreak. Hours worked has rebounded strongly in subsequent months to above its pre-Delta peak (see Chart 2.3).

The level of employment has also risen to be comfortably above the level seen before the Delta outbreak and well above the level that existed before the onset of COVID-19 in early 2020. This has seen the unemployment rate drop to a historically low level in May (see Chart 2.4). Broader measures of spare capacity reinforce the relative lack of spare capacity in the labour market, with the underutilisation rate falling to around its lowest level since 1989.

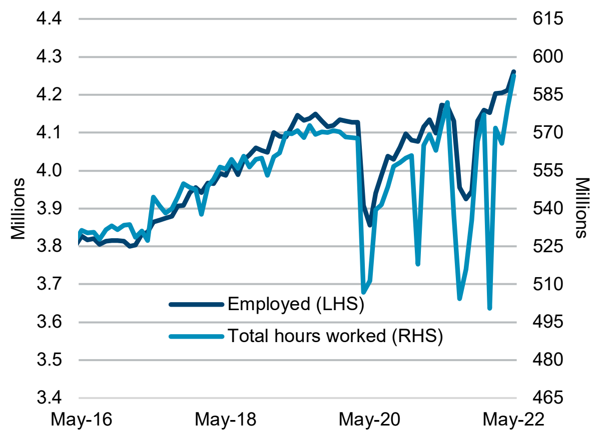
Having dropped during the Delta lockdown, the participation rate is now above pre-COVID-19 levels. Within this, the female participation rate remains well above pre-pandemic levels, while the participation of older age cohorts also remains strong. Participation is also high among younger cohorts. These cohorts, which are traditionally less represented in the labour force, has helped to satisfy high labour demand in the absence of migrant workers.

These higher participation levels likely reflect a combination of both temporary and structural factors accelerated by COVID-19. For example, remote work arrangements have made it easier for pregnant women, workers with caring responsibilities and older workers to remain engaged in the labour force.

Leading indicators suggest there will continue to be strong demand for labour, reflecting high levels of economic activity and robust labour demand. In particular, job vacancies are elevated, with almost a quarter of NSW businesses reporting vacancies, around twice as high as pre-COVID-19 levels.

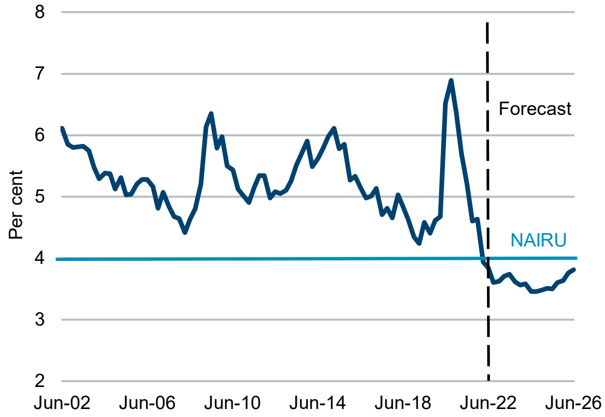
The high level of vacancies is expected to lead to growth in both hours worked and employment, however there is considerable evidence to suggest that employers are struggling to fill vacancies. This has been exacerbated by the lack of overseas migration in the last two years. High labour demand is thus expected to sustain an increase in average hours worked as employers increase existing employee hours to compensate for labour shortages. The unemployment rate is expected to remain near historic lows, at or below the level consistent with full employment (around 4 per cent) until the end of the forecast horizon in June 2026. This is despite a high participation rate supported by strong economic activity and stimulatory policy settings.

Chart 2.3: NSW employment and hours worked



Source: ABS

Chart 2.4: NSW unemployment rate



Source: ABS and NSW Treasury

Labour market strength will support higher wages growth

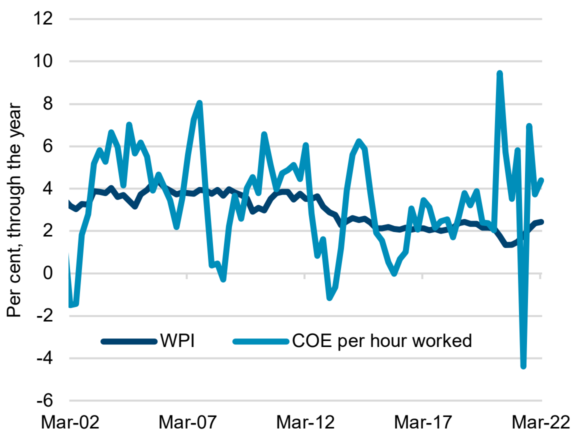
The combination of strong labour demand, the lack of migration over the past two years and increased expectations for future inflation is expected to provide the impetus for higher wages growth. This is, in part, reflected in the NSW Government's new public sector wages policy, which will provide higher wages growth for the State's employees. The new policy provides a 3 per cent increase per annum in 2022-23 and 2023-24, with a potential further 0.5 per cent increase available in 2023-24 for employees that make a substantial contribution to productivity enhancing reforms.

Wages growth as measured by the NSW Wage Price Index (WPI), a measure of wages that adjusts for compositional shifts in employment, rose to 2.4 per cent through the year to the March quarter 2022, the highest rate since late 2018.

Broader wage measures point to even faster growth with employers recently providing larger one-off payments and bonuses to both attract and retain staff. For example, growth of NSW Compensation of Employees (COE) per hour worked, a broader measure of remuneration that includes bonuses, overtime and allowances as well as promotions and compositional shifts in employment, rose to 4.4 per cent through the year to the March quarter of 2022.

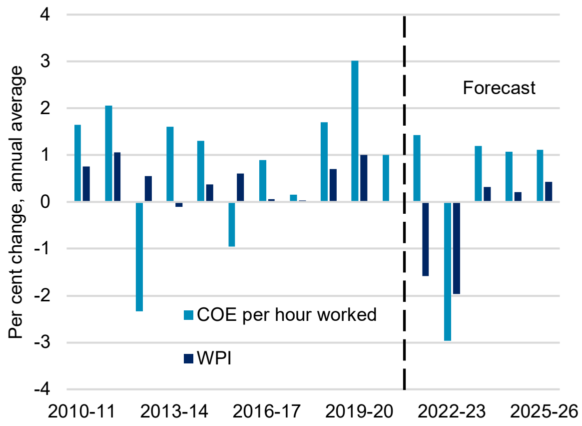
The stronger growth in these broader wage measures is expected to continue as long as the labour market remains tight. Timely information such as the National Australia Bank (NAB) business survey and the RBA's business liaison suggest that labour costs are rising more rapidly, with firms anticipating wages growth to increase more quickly in the coming period.

Chart 2.5: Growth in NSW nominal wages



Source: ABS and NSW Treasury

Chart 2.6: Growth in NSW real wages(a)



Source: ABS and NSW Treasury
(a) Real wages derived as nominal wages deflated by Sydney CPI

Inflation sharply higher but expected to moderate

Driven largely by global factors, consumer prices have increased rapidly over the past year. Annual headline inflation in Sydney was 4.4 per cent through the year to the March quarter 2022, its highest rate since 2008. This was lower than the national figure of 5.1 per cent and also lower than the level of inflation experienced in similar major international economies.

Stressed global supply chains have impacted energy and dwelling construction prices and contributed to the increase in headline inflation. A discussion of global supply chain pressures that have been driving inflation higher is provided in Box 2.1.

Underlying inflation, which excludes items that have particularly large price changes during a given period, point to broader inflationary pressures in the economy. National underlying inflation rose by 3.5 per cent in the March 2022 quarter. This is above the RBA's target band of 2-3 per cent and is the highest rate since December 2009. The Consumer Price Index (CPI) is regarded as an acceptable measure of changes in the cost of living. Detail on cost of living pressures is provided in Box 2.2.

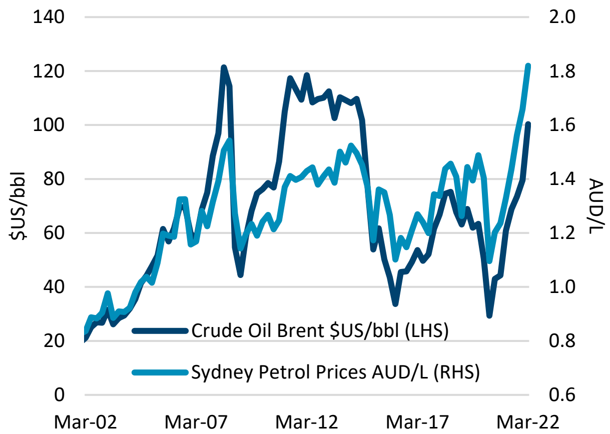
Inflation forecasts have been significantly revised upwards in the near term reflecting ongoing supply chain issues, price pressures in the housing construction sector, elevated energy prices due to Russia's invasion of Ukraine (see Chart 2.7), severe weather impacts on food prices, and higher wages growth.

Despite this, inflation is still expected to peak at a lower rate than has been observed in various other countries. The headline Sydney CPI is expected to increase by 4 per cent in 2021-22 and 5½ per cent in 2022-23, before moderating in 2023-24.

These annual average inflation forecasts mask a more significant near term 'inflation pulse'. Through the year growth in headline inflation is expected to peak in late 2022 before easing back to the top of the RBA's 2-3 per cent inflation target by end 2023. This reflects an anticipated gradual easing of inflationary pressures as global supply chain issues are resolved and the effects of monetary policy normalisation from the RBA, and other global central banks, flow through to the economy. Nevertheless, a strong labour market and the resulting wage growth is expected to limit the decline in inflation, which is expected to ease to 3 per cent in 2023-24.

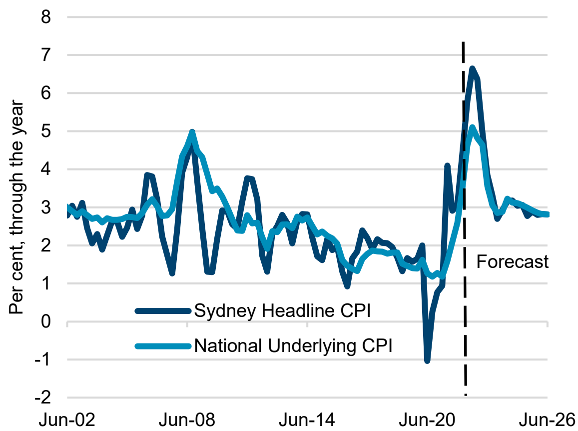
The recent increase in inflation means that real wages will be negative in the near term. As inflation moderates and wages growth picks up, real wages are expected to become positive from 2023-24, with growth being driven by productivity gains (see Chart 2.6).

Chart 2.7: Oil prices and average fuel prices



Source: Bloomberg

Chart 2.8: Sydney headline inflation



Source: ABS and NSW Treasury. Note: RBA series for national underlying CPI prior to Jun 2003. National underlying CPI is the weighted average of the 8 capital cities.

In response to higher inflation, the RBA has lifted the cash rate in successive months to 0.85 per cent in June 2022, which has seen variable mortgage rates lift from historical lows. Further increases to the cash rate are expected. In line with the expected rise in the cash rate and the rise in global bond yields, 3-year fixed rate mortgages have already increased significantly. From a low of 2.0 per cent in mid-2021, lending rates on new fixed rate mortgages with a fixed term of up to 3 years rose to 3.1 per cent in April 2022, while the equivalent indicator lending rates for banks' 3-year fixed rate mortgages have moved to around 4.7 per cent in May 2022.

Box 2.1: Global supply chains are a driver of higher global inflation

Geographically concentrated production and the use of 'just-in-time' inventory management systems have left global supply chains susceptible to shocks.

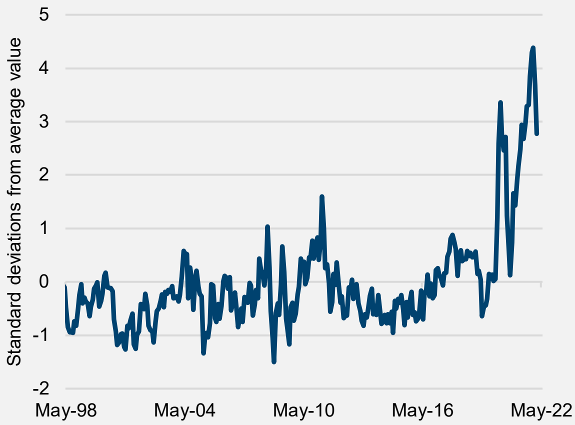
Economic stimulus in response to COVID-19 raised disposable incomes in 2020. At the same time, restrictions constrained spending in the services sector. This drove increased demand for goods at a time when production was constrained.

Shortages in critical goods, such as fertiliser and semiconductor chips which cannot be substituted have impacted downstream industries and led to higher inflation. Semiconductor shortages have adversely impacted global light vehicle production and this is expected to continue in 2022. In 2021, the average price of Australian fertiliser imports rose by 128 per cent.

The Global Supply Chain Pressure Index shows that global supply chains have faced intense pressure since the onset of COVID-19 (Chart 2.9).

Russia's invasion of Ukraine, China's 'zero tolerance' COVID-19 policy and existing backlogs in maritime and inland distribution networks will continue to fuel disruptions in the near term.

Chart 2.9: Global Supply Chain Pressure Index



Source: Federal Reserve Bank of New York

Supply chain disruptions are expected to ease from late 2022 as restrictions are eased, and central bank interest rate increases slow goods demand. Investments in diversifying supply chains and increasing distribution capacity will also assist a return to more normal supply conditions that will put downward pressure on inflation in the longer term.

Box 2.2: Higher inflation has increased the cost of living for NSW households

Surveys reveal that the cost of living is the most significant driver of consumer stress and concern.

Cost of living pressures are acutely felt by households that spend a higher proportion of their incomes on non-discretionary goods and services like food, housing, transport, and utilities. Non-discretionary inflation increased by 5.5 per cent over the past year, more than double the rate of discretionary inflation.

In Sydney, prices for fruit and vegetables, new dwellings, and automotive fuel have all increased sharply over the past year compared to the previous decade (see Chart 2.10).

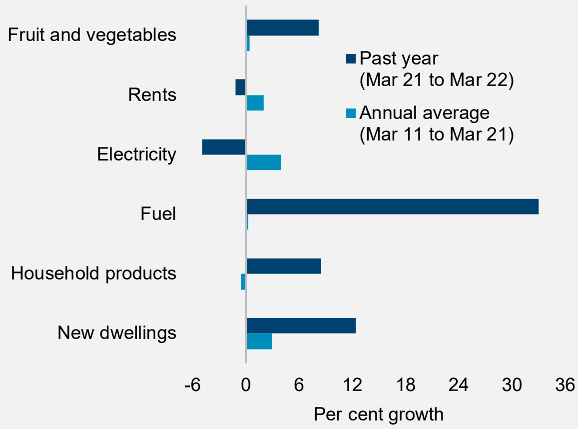
Tight labour markets and global pressures will continue to be a significant driver of near-term inflation.

NSW's electricity market is heavily dependent on coal and gas generation. Higher global prices for these commodities and unplanned generator outages have contributed to a more than doubling of the state's wholesale electricity prices over the last year. This will eventually feed into consumer prices.

Meanwhile, rental prices, which remained contained through the pandemic, are expected to lift given the decline in vacancy rates. Newly advertised rental prices in Sydney have increased by 9.4 per cent over the past year.

The NSW Government has delivered a number of measures to ease the cost-of-living burden on households in the near term. See Box 1.2 in Chapter 1 Budget Overview for further details. Meanwhile, the Electricity Infrastructure Roadmap will deliver on the Government's vision for cheaper, cleaner and more reliable energy over the longer term.

Chart 2.10: Key price categories, Sydney



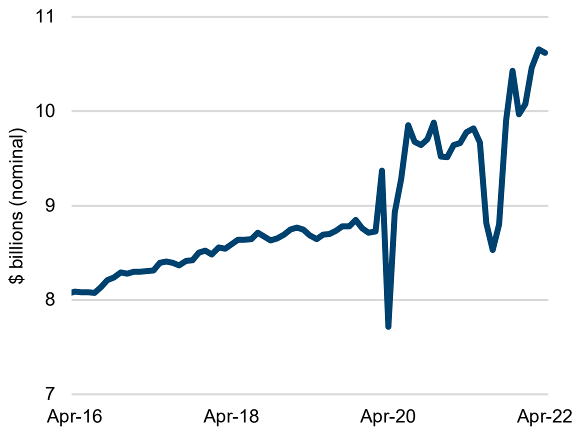
Source: ABS and NSW Treasury

Household consumption supported by growth in household income

The substantial pandemic support by governments combined with recent strength in the labour market have supported real disposable labour income, which rose across the pandemic despite the significant decline in economic activity. This enabled retail spending and broader household consumption to rebound more strongly than expected from last year's Delta outbreak, while also assisting to offset the short-term negative impacts of the Omicron outbreak and floods in early 2022.

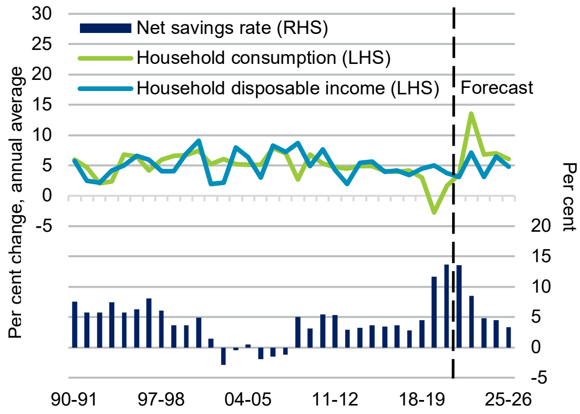
Looking ahead, while sentiment has been impacted by the rising cost of living and interest rates, ongoing strength in employment and rising wages remain important drivers of a positive outlook for household consumption. In addition, households, on average, have built up a large amount of savings during the pandemic. Despite declining from the record levels seen during the pandemic, the household savings rate remains elevated. The savings rate is expected to decline to more historically normal levels over the forecast period (see Chart 2.12). This will allow growth in household consumption to outpace the growth in household income for a period, offsetting the negative impact on consumption from elevated inflation, rising interest rates and a fall in house prices.

Chart 2.11: NSW retail trade



Source: ABS

Chart 2.12: Growth in NSW nominal household consumption and disposable income



Source: ABS and NSW Treasury

Strong momentum in housing, but sensitive to higher interest rates

After strong growth over the pandemic, the Sydney housing market has started to slow, with house prices falling in early 2022 for the first time since early in the pandemic. A number of factors are cooling the market.

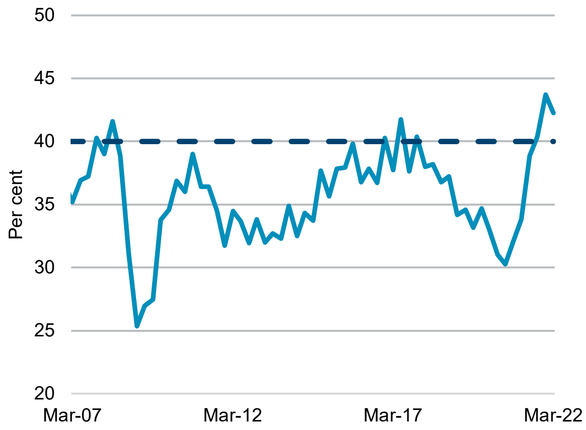
The RBA has lifted the cash rate in successive months which has seen variable mortgage rates lift from historical lows. Fixed mortgage rates have also increased significantly. Further increases to mortgage rates are expected to lower housing prices further.

The Australian Prudential Regulation Authority (APRA) also tightened macroprudential standards in November 2021, by raising the interest rate buffer that banks use to assess the borrowing capacity of new borrowers to 3.0 percentage points. Previously, banks assessing a loan for a new borrower needed to consider a future increase in the interest rate of 2.5 percentage points. The increase of the interest rate buffer has reduced the potential approvable loan amount for a given borrower.

Additionally, the large run up in house prices over the pandemic has pushed more households to the limits of affordability, slowing the market (see Chart 2.13). A key indicator used by APRA to gauge credit exposure is the percentage of loans that exceed six-times a household's income. This has increased from 16 to 23 per cent of new loans since the outset of the pandemic.

Strength in the housing market over the past two years along with low interest rates and the Commonwealth's HomeBuilder grants have generated a significant pipeline of residential construction work. A significant quantity of work remains to be done, as supply chain issues and shortages of materials and labour have caused delays in completing housing projects. Once this work is complete, residential construction is expected to ease, in line with the fall already seen in new project approvals (see Chart 2.14). Renovations are also expected to ease, as households turn their attention outside the home, to recreation and travel now that restrictions have eased both here and around the globe.

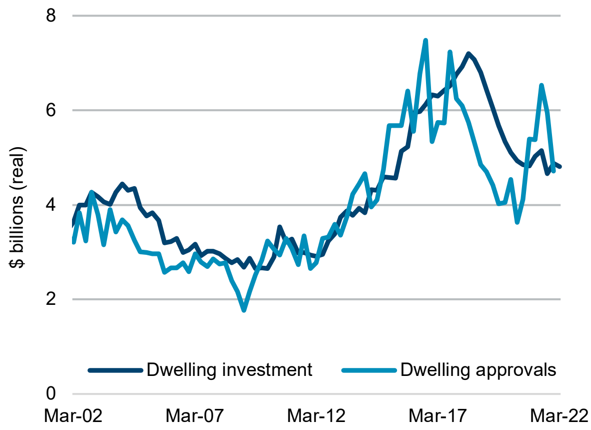
Chart 2.13: Share of income spent on mortgage repayments[(a)]



Source: Corelogic, RBA, ABS and NSW Treasury

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

Chart 2.14: NSW dwelling approvals and dwelling investment



Source: ABS and NSW Treasury

(a) Excludes approvals and investment related to alterations and additions.

Business investment, meanwhile, has been supported by government investment incentives, record infrastructure spending by state governments, low interest rates and the strength of the share market.

Business investment is expected to grow solidly over the forecast horizon supported by a strong economy and Commonwealth tax incentives. The ABS capital expenditure survey indicates that businesses remain positive about investment growth in the face of labour shortages, cost pressures and supply disruptions.

Public demand normalising after temporary COVID-19 increases

Governments across Australia delivered unprecedented fiscal support to moderate the adverse economic and health outcomes associated with the pandemic. Much of this support (including income and business support as well as voucher programs) has been in the form of transfer payments and so is not captured within the strict definition of public demand but has been instrumental in supporting private spending through the worst of the pandemic.

Over the past two years, annual public demand growth in New South Wales increased by 5.5 per cent – almost double its historical average. Conversely, private sector demand was weighed down by COVID-19 outbreaks and associated restrictions, only returning to pre-pandemic levels at the end of 2021.

Public demand is expected to be strong in the short term, driven by a combination of strong government expenditure and the roll out of the State’s record $112.7 billion infrastructure program. As New South Wales emerges from the pandemic, temporary fiscal support will taper.

2.4 The State's economic reform agenda

Sustained growth driven by participation and productivity

While the near-term outlook for the NSW economy is strong, the potential for sustained growth over the longer term is less certain. Further out, growth prospects will rely on three fundamental building blocks, known as the '3Ps':

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

Of these, participation and productivity are the critical factors in driving improvements in living standards. Prior to the pandemic, population growth made a significant contribution to economic growth. However, population growth slowed sharply during the pandemic due to the closure of Australia's international border. Furthermore, key levers affecting population such as immigration are a responsibility of the Commonwealth Government. This has highlighted the importance of the NSW Government focusing on participation and productivity to enhance living standards and build an economy that is resilient to shocks.

Participation has risen to high levels in recent years due to increased female participation and there is the potential for further increases. Over the longer term, the *2021-22 Intergenerational Report* (IGR) found that the ageing of the population will place downward pressure on workforce participation. The IGR also demonstrated the potential lift in per capita economic growth from increasing economic participation.

Productivity growth is the fundamental source of real wage growth and improved living standards. However, prior to the pandemic, productivity growth across Australia including New South Wales had shown clear signs of slowing. 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.

The Government is investing in sustainable economic growth through productivity reforms, supporting increased workforce participation and transitioning towards clean energy.

Investing in reforms to support a sustainable and resilient economy

The 2022-23 Budget includes a number of initiatives to lift participation and productivity including:

- *Women's opportunities* – significant reforms will support more women to enter and stay in the workforce and take on more full-time roles, including by improving access to childhood education and care. This will increase participation, including number of hours worked, increase productivity and lift women's wages.
- *Early childhood education* – investment in lifelong learning supports all individuals to reach their potential regardless of personal circumstances. This Budget funds an ambitious package of reforms to support better education and wellbeing outcomes for children in the years before school. By boosting the workforce participation of parents and investing in early learning, the reforms will have immediate and ongoing economic and fiscal benefits.
- *Future economy* – the Budget invests in the future economy and the jobs of tomorrow to unlock the creative potential of our State. This includes an increased investment in research and development, building the latest research infrastructure and establishing innovation precincts across New South Wales. This will support reducing reliance on global supply chains which have been challenged in recent years.

- *Transitioning to a low carbon economy* – by accelerating the transformation to renewable generation, low emission vehicles, and supporting new low carbon industries including green products and services while reducing reliance on oil which is impacted by global forces.
- *Infrastructure program* – significant investment over the past decade has supported the growth of the CBD and Eastern Economic Corridor between Macquarie Park and Sydney Airport. This commitment is ongoing with substantial investments in the Western Parkland City and Central Harbour City that will deliver benefits for Sydney by enabling more efficient and reliable road and rail networks, meeting the needs of a growing population including more locally based, high paid employment opportunities.

In addition, the pandemic has shown the importance of building the resilience of the economy to shocks. This has been further emphasised over the past three years by a wide range of climate events such the summer bushfires of 2019-20, flooding events of 2021 and 2022 and the mouse plague of 2021.

This Budget also supports initiatives that build the resilience of the economy. These include:

- *Investments in health frontline services* – the Budget includes a further investment to continue the health pandemic response. This is supported by a broader enhancement to fund additional health workers. This expenditure will ensure the health system has the capacity it needs to manage the ongoing impacts of the pandemic to support an open and resilient economy going forward.
- *Climate risks* – adapting for tomorrow by reducing the risks to assets and the provision of services from the range of climate events including those experienced in the past three years such as bush fires, floods, storms and mice plagues.

For further information on the Government's investments in this Budget please see Chapter 5 Expenditure.

2.5 Key risks to the outlook

COVID-19 related risks remain, while other global risks are mounting

The economic forecasts anticipate an endemic phase for COVID-19 with limited negative health and economic outcomes. An outbreak of a more virulent COVID-19 variant, that is resistant to current vaccines, remains a significant downside risk to the economic outlook.

The reintroduction of significant mobility restrictions on the population is unlikely but cannot be ruled out. A more likely outcome would be widespread symptomatic infections, which combined with the reintroduction of more stringent isolation requirements, would significantly constrain the supply of labour and weaken business and consumer confidence.

Aside from COVID-19, global factors remain a major source of uncertainty. Russia's invasion of Ukraine has exacerbated the global supply chain pressures that emerged in the wake of COVID-19. It has also driven a sharp increase in a range of key commodity prices, particularly energy (oil, gas and coal) as well as wheat. A prolonged conflict would put pressure on key inputs to production and further intensify price pressures on consumers.

The resulting spike in inflation has already prompted a response from most major central banks, which have started to raise interest rates. The strain on households and businesses runs the risk of derailing the global economic recovery, especially if global central banks tighten monetary policy both at a faster pace, and by more than expected, to combat inflation.

Meanwhile, China continues to pursue a zero COVID-19 strategy, which at times involves severe lockdowns of major regions. These lockdowns are unpredictable and not only impact Chinese growth, but exacerbate supply chain pressures given the critical role of China in the global production chain. Further, China's beleaguered property sector could still trigger a sharper slowdown in the Chinese economy that would impact commodity prices as well as the State's exports.

Global geopolitical tensions remain elevated as well. Further trade restrictions on a broader range of Australia's exported goods and services (including education and tourism) are a significant risk.

Domestic risks include the potential for labour shortages to drive higher than expected wage and price inflation, prompting a faster removal of monetary support. The expected trajectory of monetary policy tightening by the RBA is reasonably swift, although significantly less aggressive than what is expected by financial markets. Higher borrowing costs could slow the economy and lead to higher unemployment. Appendix F Economic Scenario Analysis considers a scenario of more aggressive monetary policy tightening.

The outlook also has some prominent upside risks. If the pandemic continues to recede, that could help to unlock the potential additional consumption from the extra savings accumulated by households during the pandemic. Historical experience shows that the savings rate could easily fall further than currently anticipated, sustaining additional household spending on goods and services.

Finally, given the uncertainty around global supply chain pressures and COVID-19, there is the possibility that constraints on supply are resolved more quickly than currently expected. That would see a lift in economic activity, while helping to ease inflation and allowing central banks to slow the current pace of withdrawal of monetary support. Appendix F Economic Scenario Analysis considers a scenario in which oil prices fall more quickly than expected.