3. THE ECONOMY

- The NSW economy outperformed the nation in 2016-17 and is set to do so again in 2017-18, with above-trend economic growth forecast over the next three years.
- In 2017-18, Gross State Product (GSP) is forecast to rise by 3 per cent. Above-trend growth of 2¾ per cent is anticipated in 2018-19 and 2019-20. The new GSP outlook is a ¼ of a percentage point stronger in all years than was expected at the 2016-17 Half-Yearly Review (HYR).
- Business investment, public infrastructure and dwelling construction are all showing significant strength, lifting construction activity and employment to record levels. The State's $72.7 billion, four-year infrastructure program is expected to boost economic growth by an average of ½ a percentage point a year over the next two years.
- The labour market is forecast to improve in line with the strength in economic activity, with above-trend employment growth of 1¾ per cent forecast for 2017-18 and 2018-19. The unemployment rate is expected to remain low at slightly under 5 per cent over the next two years.
- Regional NSW is benefiting from rising demand for services which has driven employment growth of 4.9 per cent since April 2015, the strongest regional employment growth of all states.
- Inflation is expected to remain around 2¼ per cent in 2017-18 and increase very gradually over the forward estimates.

3.1 New South Wales economic outlook

The NSW economy continued to outperform the nation in 2016-17, with GSP estimated to have increased by an above-trend 2¾ per cent (see Table 3.1).

Table 3.1: Economic performance and outlook [(a)1]

New South Wales	2015-16 Outcomes	2016-17 Forecasts	2017-18 Forecasts	2018-19 Forecasts	2019-20 Projections	2020-21 Projections
Real state final demand	4.4	3¼	3½	2¾	-	-
Real gross state product	3.5	2¾	3	2¾	2¾	2½
Employment	3.8	¾	1¾	1¾	1½	1¼
Unemployment rate[(b)]	5.4	5	5	5	4¾	4¾
Sydney consumer price index[(c)]	1.5	2	2¼	2¼	2½	2½
Wage price index	2.1	2	2¼	2½	2¾	3
Nominal gross state product	4.9	5¾	4¾	4½	4¾	4¾
Population	1.4	1½	1½	1½	1½	1½

(a) Per cent change, year average, unless otherwise indicated
(b) Year average, per cent
(c) 2015-16 to 2020-21 includes a ¼ percentage point contribution from tobacco excise increases
Source: ABS 5206.0, 5220.0, 6202.0, 6401.0, 6345.0, 3101.0 and Treasury

1 Economic forecasts are based on data available at the time they were prepared, which includes results to June 2016 for GSP, to the March quarter 2017 for state final demand, the wage price index and the consumer price index, to the September quarter 2016 for population and to April 2017 for the labour force.

Investment—both public and private—has been the bedrock of economic growth over the last year. Business investment, public infrastructure and dwelling construction are all exhibiting strength, lifting construction activity and employment in the State to record levels. Service exports are also contributing strongly to economic growth, underpinned by overseas visitors and international student enrolments expanding at double digit rates.

The NSW economy will continue to benefit from low interest rates, a lower Australian dollar, strong demand from Asia, above-trend population growth and a historically large infrastructure and residential construction pipeline. The key drivers of growth in the near term are forecast to be overseas exports, dwelling investment and public capital expenditure. Further out, business investment, household consumption and interstate trade are expected to become stronger drivers of growth.

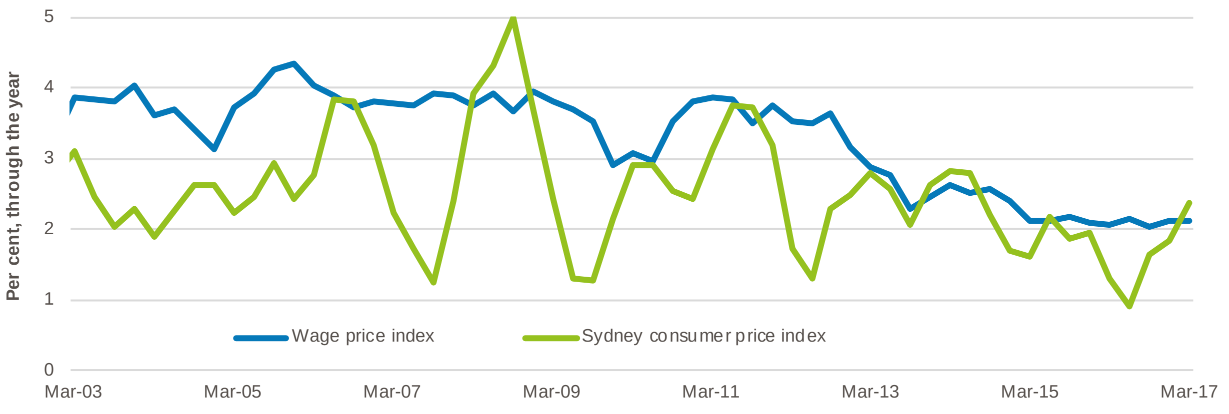
Indicators point to solid **labour market** conditions, with the unemployment rate remaining close to estimates of full employment in 2016-17. Productivity growth has lifted strongly through 2016-17, suggesting that firms have turned their focus to improving efficiency.

Strong economic activity and solid forward indicators of labour demand suggest that employment growth should accelerate through 2017-18. Strong activity in the labour-intensive services sector, which appears to be attracting a larger share of household consumption and exports, should also support a pickup in employment growth.

Over the forward estimates, the unemployment rate is expected to gradually drift down to 4¾ per cent, which is the estimate of full employment. The decline will be gradual despite strong employment growth. This is due to spare capacity in the NSW labour market as indicated by measures such as underemployment, average hours worked, wages growth and workforce participation.

It also reflects the relative strength of the NSW labour market, which is expected to continue to attract above-trend inward migration, drawing on significant interstate and global excess capacity. Strong levels of overseas and interstate migration are expected to result in average annual population growth of around 1½ per cent over the next four years—½ a percentage point above the long-run average.

Chart 3.1: Modest wages growth and inflation pressures



Source: ABS 6401.0, 6345.0 and Treasury

Spare labour market capacity has subdued **wages growth** over recent years, with slow wage growth observed across Australia and other advanced economies around the globe. This likely reflects factors beyond spare capacity, such as strong competition, low inflation and modest productivity growth also weighing on wages (see Chart 3.1).

Wage Price Index (WPI) growth is expected to remain soft in 2017-18 at 2¼ per cent, only slightly up from its current rate of 2.1 per cent through the year to the March quarter 2017. The WPI is forecast to gradually increase to 2½ per cent in 2018-19, as some of the factors weighing on wages slowly dissipate. Stronger wages growth is expected to be led by sectors such as construction and professional services, which are the most exposed to the current construction boom.

Inflationary pressures in Sydney and across Australia have been particularly weak over the past two years, held down by strong retail competition, spare capacity in labour and product markets, a generally soft global inflationary environment, and until recently, falling petrol prices.

There are signs that inflation will increase very gradually over the next few years. Higher global commodity prices (particularly for oil) and a strengthening global economy are expected to contribute to some inflationary pressures. A lower Australian dollar, consistent with falling terms of trade, is also expected to put some upward pressure on inflation through its impact on the price of imported goods.

Rising housing construction costs are likely to feed into inflation, with tentative signs of cost escalation of key inputs and rising construction wages. Added to this, price determinations by the Australian Energy Regulator and supply constraints will feed utility price pressures.

Notwithstanding these upward pressures, inflation is expected to remain within the Reserve Bank of Australia's target range due to modest wages growth and competitive pressures—particularly in the retail sector. Growth in the Sydney consumer price index is forecast to gradually move higher to 2¼ per cent in 2017-18 and 2018-19, and 2½ per cent in the out years.

Interstate exports have been weak in recent years in line with the slowdown in demand from the rest of Australia. The unwinding of the mining investment boom is expected to continue to weigh on interstate exports over the next year, before stronger national activity sees interstate exports add to GSP growth.

Business investment and public infrastructure spending will drive ongoing growth in construction

As the State's infrastructure and asset recycling program has ramped up, publicly-led infrastructure has become a key driver of economic growth—with strong investment flows coming through in both the public and private sector.

Increases in construction activity boost demand and contribute to employment and economic growth (see Box 3.1). Underpinned by the State's $72.7 billion four-year capital program, public investment in New South Wales is expected to boost economic growth by an average of ½ a percentage point a year over the next two years. This is around five times the historical average contribution to growth of 0.1 percentage points.

The State's infrastructure investment is being delivered by government agencies, public corporations and private sector partners (see Charts 3.3 and 3.4). Depending on the nature of the public-private partnership (PPP), some of these public infrastructure projects are flowing into Australian Bureau of Statistics (ABS) measures of private investment. The ABS attributes the construction activity of some of these projects to the private sector and, upon completion, transfers the infrastructure as a second-hand asset to the public sector. Business investment is also being boosted by publicly-led private investment, such as the $3.0 billion NorthConnex Motorway, $1 billion Northern Beaches Hospital and the transfer of the electricity network to the private sector.

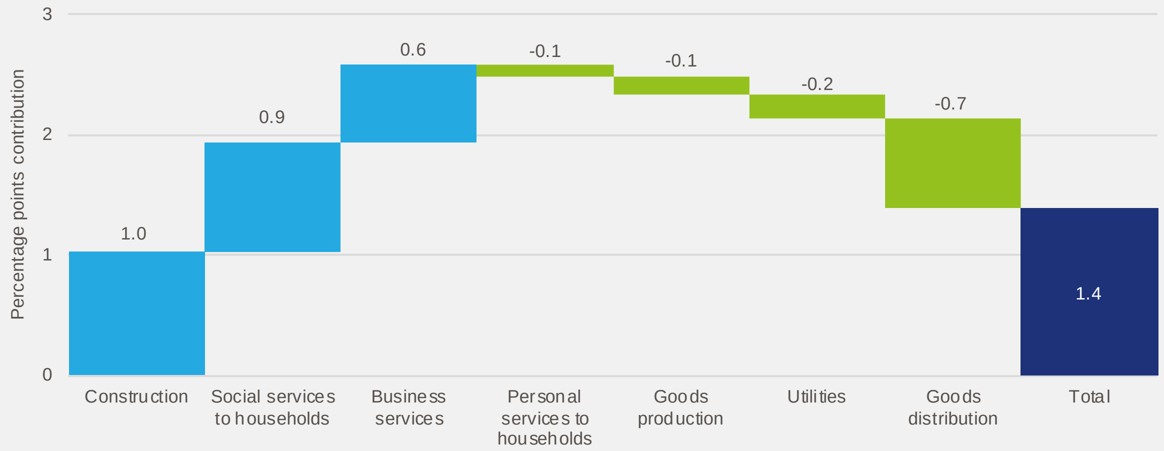
Box 3.1: Housing and infrastructure investment supporting jobs

New South Wales has experienced robust employment growth over recent years, and with the NSW Government continuing to support jobs through its infrastructure investment, business support programs and employment incentive schemes, this is expected to continue.

Over the last two years employment has grown at an annual average rate of 2.3 per cent, well above its long-run average of 1.5 per cent. This has resulted in around 192,000 more people being employed since April 2015. The relative strength of the NSW labour market is highlighted by an unemployment rate below 5 per cent. This is the lowest among the states and has been for nearly two years.

A key driver of this strength has been the construction sector, led by the dwelling investment and public infrastructure boom. Over the year to February 2017 the construction sector accounted for 1 percentage point of total employment growth of 1.4 per cent (see Chart 3.2). This is well above its long run average contribution, and even more impressive considering construction accounts for only a small (around 9 per cent) share of total employment.

Chart 3.2: Construction driving employment growth (a)



(a) Annual average growth to February 2017

Source: ABS 6291.0.55.003 and Treasury

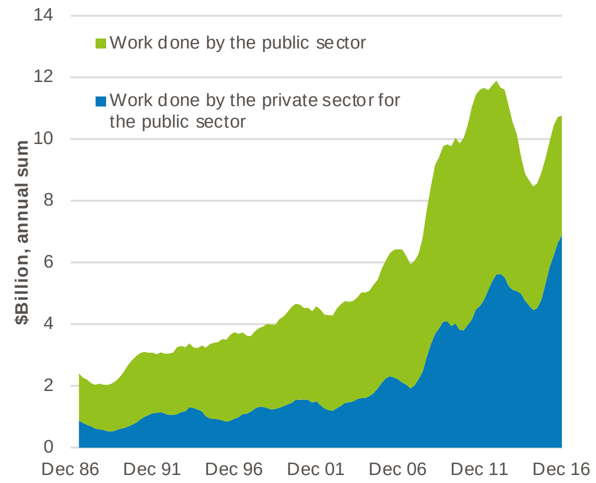
Beyond investment in infrastructure, the Government is supporting employment through a number of initiatives including:

- the Small Business Incentive Scheme, under which NSW small businesses may apply for a grant of up to $2,000 when they hire new employees. To date, the program has received 7,200 applications
- $96 million committed in 2017-18 from the $190 million Jobs for NSW fund, including:
  - $25 million to launch a co-investment vehicle with the private sector to make equity investments in growth companies across New South Wales
  - $20 million to develop a site in the Sydney CBD where start-up incubators and accelerators will co-locate to foster collaboration and create jobs.

Government initiatives, infrastructure investment and increased housing supply will provide continued support for jobs and economic growth—improving services and enhancing economic opportunities.

Business investment is expected to strengthen into 2017-18 and remain strong in 2018-19, with a raft of non-residential building approvals over late 2016 leading to construction activity in coming quarters. Business investment is set to pick up in the short-term accommodation, education, retail and wholesale, office and entertainment, and recreation sectors. Above average capacity utilisation and business conditions are also conducive to an ongoing recovery in business investment.

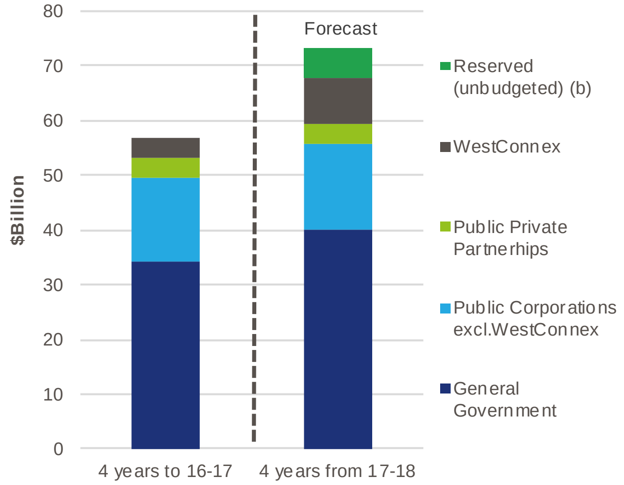
Chart 3.3: Infrastructure delivered by public and private sectors [(a)]



(a) NSW public engineering work for State, local and Commonwealth Governments

Source: ABS 8762.0 and Treasury

Chart 3.4: More public investment to come [(a)]



(a) Excludes land and other non-produced asset transactions. Net of asset sales.
(b) Reservations awaiting Government approval following Infrastructure NSW assurance processes

Source: Treasury

There is also an upside of a further ¼ of a percentage point per year boost to economic growth over the next two years due to Rebuild and Restart reserved projects that are awaiting full assessment by Infrastructure NSW, before they can be approved and budgeted (see Budget Paper 2, Chapter 2).

The timing of the infrastructure surge is well aligned with the broader national economic cycle. New South Wales' infrastructure activity is absorbing spare labour and capital freed up from the unwinding of the mining boom in the rest of Australia—delivering employment and economic growth when it is most needed.

Even after the construction phase is over, new infrastructure will add to the long-term productive capacity of the economy. For example, improved transport infrastructure will reduce travel times and remove supply constraints, eliminating bottlenecks and bringing markets together. It will also support additional housing supply, and expand economic opportunities by bringing people closer to education and jobs. Social infrastructure will also improve the quality and accessibility of services such as health and education.

Following the boost to employment and economic growth during the construction phase, the long-term benefits of this new infrastructure will be significant and permanent. In its economic assessment of Rebuilding NSW—the Government's strategy for asset recycling to fund $20 billion in productive infrastructure investment—Deloitte Access Economics estimated that the State's economy would grow by an additional 3.6 per cent by 2035-36.[2]

[2] November 2014, Deloitte Access Economics, *Economic Impact of the State Infrastructure Strategy – Rebuilding NSW*

Household consumption will rely more on income growth as house price growth moderates

Despite a declining savings rate and robust housing market, household consumption growth has eased since mid-2016 in line with softer employment growth and a moderation in consumer confidence. This is expected to continue in the near term, with weak momentum in retail sales.

Spending by households is forecast to grow at a more modest rate than it has over recent years, growing broadly in line with household income.

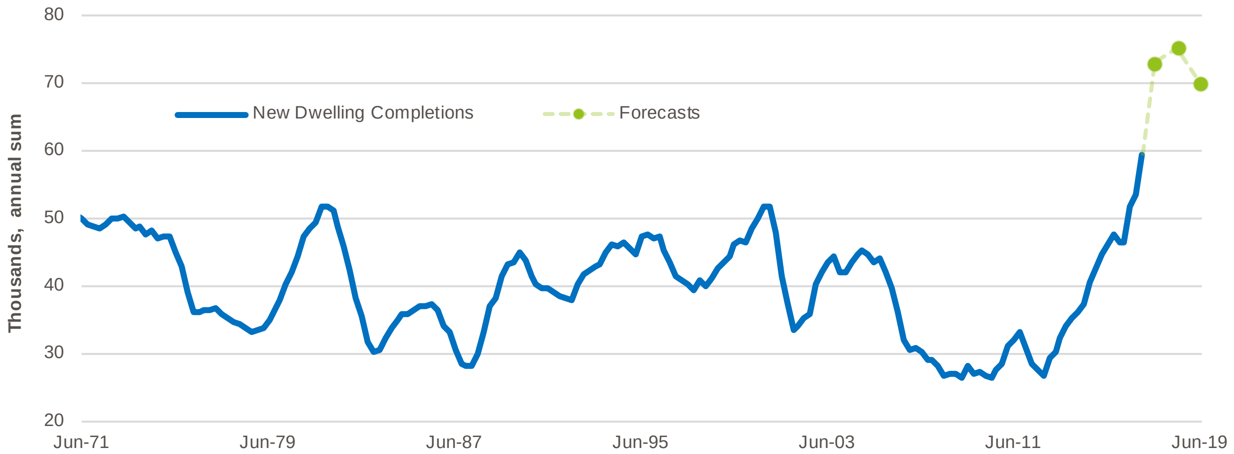
In recent years lower interest rates have reduced mortgage repayments, while above-trend population growth has added to demand. These forces combined with pent-up undersupply have driven double-digit house price growth over the last few years. Higher property values have strengthened household balance sheets, providing consumers with the confidence to lower their savings rate from post-global financial crisis highs. This has underpinned strong consumption growth, even while wages growth has remained moderate.

Strong property price growth has also spurred dwelling construction. Dwelling investment is forecast to record its sixth consecutive year of growth in 2017-18, by far the longest period of expansion in the housing stock on record. Historically high approvals over recent years, which peaked at around 77,000 in the 12 months to September 2016, have translated into activity and the build-up of an historically large dwelling construction pipeline. Over 2016 dwelling commencements have increased from 62,000 to 76,000 and completions have increased from 47,000 to 60,000. Dwelling construction activity has been concentrated in multi-storey apartments—which are currently taking a little over two years on average to move from approval to completion.

In 2017, the NSW property market is expected to transition into a supply phase, with past strength in approvals flowing into completions (see Chart 3.5). Approvals are expected to remain at very high levels, although slightly lower than their 2016 peak. Combined with supportive Government policy measures, a healthy construction pipeline, continuing demand and an emerging recovery in home renovations, dwelling investment is expected to increase through 2017-18. As the cycle matures, it is anticipated that 2018-19 will see a modest decline in dwelling investment, albeit remaining at historically high levels.

Tightening lending standards, slow wages growth and strong housing supply are expected to moderate house price growth.

Chart 3.5: The housing boom is reaching the supply phase



Source: ABS 8752.0 and Treasury

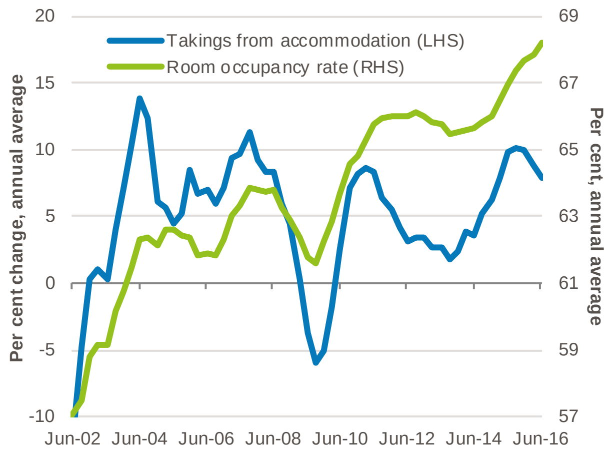
While household balance sheets remain strong—in aggregate mortgage buffers are around two and a half years of scheduled repayments at current interest rates[3]—further marked declines in the savings rate appears unlikely. Household consumption is therefore expected to grow at a below-average rate over the next couple of years, increasing broadly in line with wages and employment. While soft wages growth will continue to be a drag, the expected improvement in employment growth and demand for furnishings and household equipment, due to a pickup in household formation, will provide some support.

The service exports boom will drive employment and business investment

Since early 2013 the Australian dollar has depreciated by around 30 per cent against the United States dollar, setting the scene for growth in non-commodity exports. Led by education and tourism, service exports have helped drive this recovery. With the services sector accounting for 73 per cent of economic activity and 90 per cent of employment in 2015-16, New South Wales has benefited strongly from this trend, especially the regions (see Box 3.2).

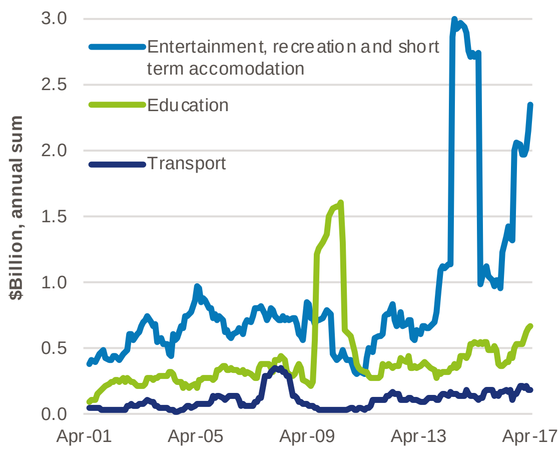
At the national level, tourism and education related services, including travel services for business, education and recreation, as well as transportation services, account for nearly three quarters of total growth in service exports. NSW student enrolments are up by 12.2 per cent on average over the past year and short term visitors are up by 12.0 per cent, with much of this increase being in visitors from China.

Chart 3.6: Rooms are filling up [(a)]



(a) Accommodation with 15 or more rooms
Source: ABS 8635.0 and Treasury

Chart 3.7: Tourism is driving business investment [(a)]



(a) Private building approvals
Source: ABS 8731.0 and Treasury

The rapid increase in visitors to New South Wales is absorbing accommodation capacity. Occupancy rates reached record highs of around 68 per cent in 2015-16, up by around three percentage points over the last two years (see Chart 3.6). The Sydney occupancy rate is even higher, averaging around 83 per cent.

While this highlights the growing demand for traditional hotel accommodation, the market for non-traditional services like Airbnb has been taking up an increasing market share. In 2015-16 1.4 million nights were booked through Airbnb in New South Wales, with an estimated contribution of around $500 million to GSP, supporting around 4,500 full-time equivalent jobs.[4]

[3] *Household Debt, Housing Prices and Resilience*, speech by Reserve Bank Governor Phil Lowe to Economic Society of Australia, Brisbane, May 2017

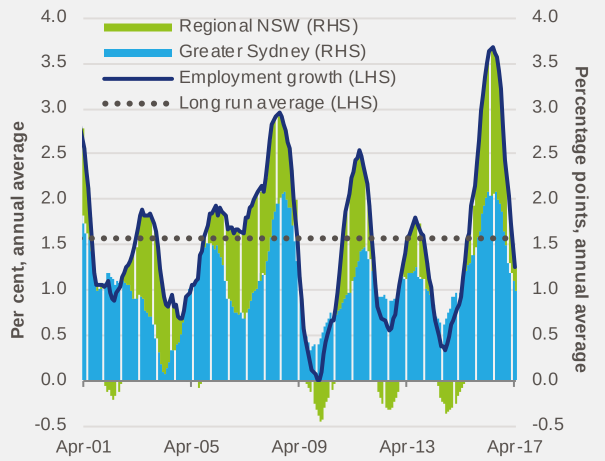
[4] Direct and indirect contributions from the tourism expenditure of Airbnb guests, 2017, Deloitte Access Economics, *Economic effects of Airbnb in Australia.*

Box 3.2: Economic performance of the regions

Employment in regional New South Wales has grown by 4.9 per cent since April 2015, the strongest regional employment growth of all states. The Greater Hunter Valley (including Newcastle and Lake Macquarie), in particular has led the pack, growing by 11.2 per cent (32,300 employed). Richmond-Tweed, growing by 13.0 per cent (12,700 employed) and the Central West of NSW growing by 9.6 per cent (9,300 employed) have also performed strongly. The NSW regional unemployment rate remains low. At 5.5 per cent it is well below the long-run average of 6.5 per cent.

NSW regions have experienced a significant uplift in employment growth over the last two years (see Chart 3.8). This reflects the ability of the regions to adapt to a growing demand for services. As a result, New South Wales' regions have been relatively less affected by the mining investment downturn.

Chart 3.8: When the regions do well, NSW does well



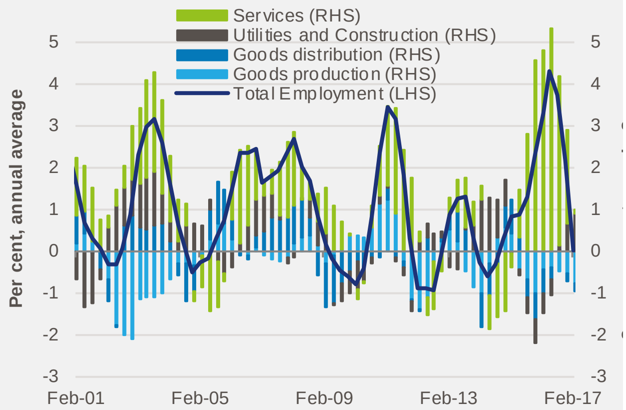
Source: ABS 6291.0.55.001 and Treasury

Over the last two years the move towards a service based regional economy has been pronounced, with almost all of the regional employment gains driven by the services sector (see Chart 3.9). Regional New South Wales now has the highest share of service based employment compared to regions in other states. This share has increased from 51.1 per cent in 2008, to its current level of 57.5 per cent. This growth has been across all service sectors, including social services, personal services and business services.

In particular social services to households, such as public administration, education and health, have grown at an annual average rate of 3.4 per cent over the last decade and accounted for more than two thirds of regional employment growth. Health and social assistance is among one of the largest sectors in regional NSW. With ageing likely to be more pronounced in the regions (as the proportion of aged persons is projected to remain well above the State average), there is likely to be continued growth in the sector.

Regional New South Wales has a different industry structure to Greater Sydney, with a higher share of social services (30.0 per cent, compared to 24.6 per cent) and personal services (14.7 per cent, compared to 11.5 per cent).

Chart 3.9: Services the driver of regional employment



Source: ABS 6291.0.55.003 and Treasury

The overseas and domestic visitor boom has benefited the whole State. In 2016 rural and regional NSW welcomed 58.9 million visitors, a rise of more than 7 per cent on the year before. Regional tourism accommodation added a total of $1 billion to the economy in 2015-16.

Regional employment in food and accommodation services grew 4.1 per cent in the year to February 2017, well above the decade average of 1.7 per cent. Agriculture is another important industry within regional NSW and makes up nearly six per cent of regional NSW employment. As China shifts towards a consumption economy there will be increasing demand for commodities like wheat, grain, cottons, sugars and meats, and this will benefit regional NSW.

With the pickup in demand there is a need for capital renewal and expansion. The capital stock within the accommodation and food industry has been declining since June 2012 and the average age of machinery and buildings has been increasing steadily since June 2000.

Business investment is responding to this pickup in demand. In the 12 months to April 2017 private building approvals for entertainment, recreation and short term accommodation buildings nearly doubled, reaching $2.3 billion. For example, a South West Sydney accommodation provider receives around 65 per cent of their business from international visitors. Having been at capacity for 95 per cent of the year, they have recently invested $1.5 million to upgrade all rooms to international 5-star standards. The education sector is also showing robust growth—since 2013 approvals for private education buildings have more than doubled reaching $660 million over the last 12 months (see Chart 3.7).

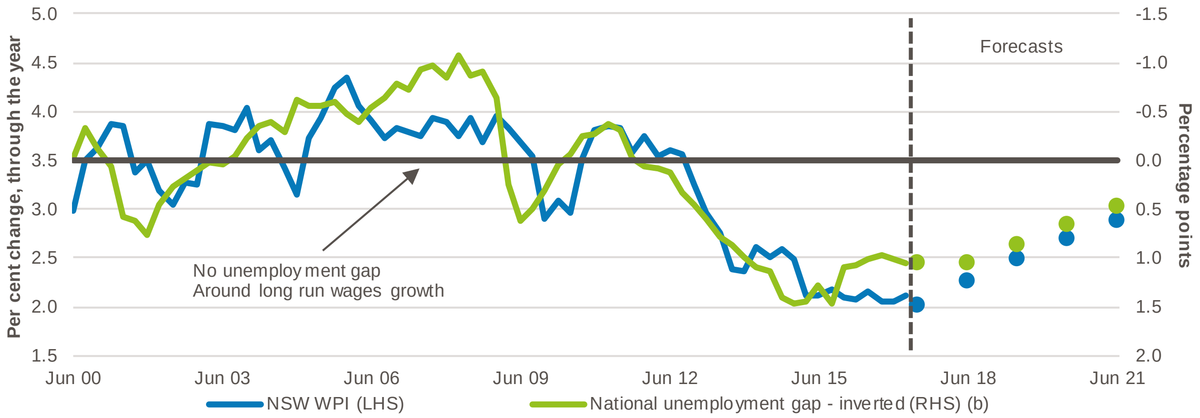
Along with the boost to business investment, the services boom is creating jobs. Since 2012, employment in tertiary education has grown by an annual average rate of 4.8 per cent, accommodation by 4.3 per cent, and the arts and recreation industry by 4.0 per cent—all exceeding the State average of 1.6 per cent.

With domestic household consumption likely to grow below trend over the next few years, the growing Asian middle class and an increasingly competitive exchange rate are expected to underpin a continued services boom.

Inward migration restraining wages and boosting demand

While the NSW labour market has been stronger than the rest of Australia, wages growth has remained soft in recent years, consistent with national and international trends. Annual WPI growth is now close to 2 per cent for both New South Wales and Australia, and is the weakest since the WPI series began in 1997.

Chart 3.10: As the national labour market tightens, NSW wages will lift [(a)]



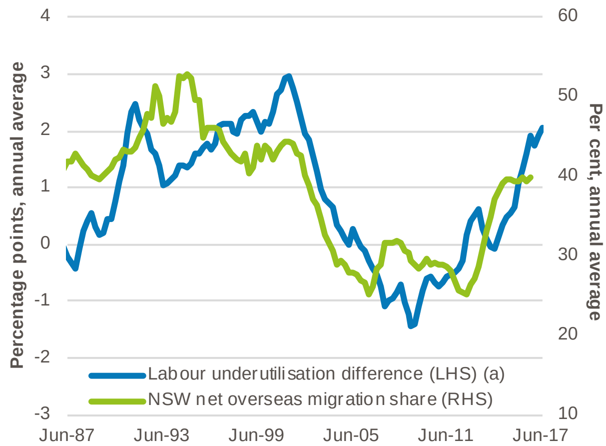
(a) Forecasts are per cent change, year average
(b) The unemployment gap represents the difference between the actual unemployment rate and the unemployment rate associated with full employment

Source: ABS 6345, 6202 and Treasury

With the unemployment rate below 5 per cent, New South Wales is now close to estimates of full employment, which is generally associated with the emergence of wage pressures. The absence of such pressures is partially due to local spare capacity, in terms of cyclically low participation and average hours worked. It is more fully explained, however, by considerable spare capacity both nationally and globally (see Chart 3.10). These national downward wage pressures are being transmitted to New South Wales through migration flows and common product markets.

While the rest of Australia's unemployment rate is around one percentage point above New South Wales', the underutilisation rate—a broader measure of spare capacity that includes employees who would like to work more hours—suggests a larger disparity. Currently the underutilisation rate in New South Wales is 12.9 per cent compared to 15.0 per cent for the rest of Australia.

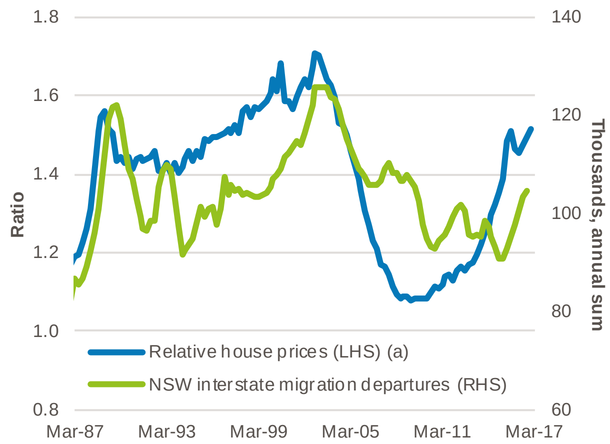
Chart 3.11: Strong labour market attracts migrants



(a) The difference between the underutilisation rate in the Rest of Australia and NSW

Source: ABS 6202.0, 3101.0 and Treasury

Chart 3.12: Housing affordability also drives migration



(a) Detached house prices, NSW/Rest of Australia

Source: ABS 6416.0, 3101.0 and Treasury

The migration program's emphasis on skills and employment has tightened the linkage between labour market strength and people flows. With national net overseas migration (NOM) running close to 200,000 a year, the relative strength of the Australian labour market (compared to the rest of the world) is continuing to draw in large numbers of skilled migrants. New South Wales' relative strength (compared to the rest of Australia) has lifted the State's NOM share to decade highs of around 40 per cent (see Chart 3.11).

Interstate migration, which is normally a large net loss for New South Wales, has strengthened considerably over the last few years. The drivers for interstate arrivals and departures are different: for arrivals the labour market is a 'pull' factor, whereas relative house prices are a 'push' factor and tend to drive departures (see Chart 3.12). Currently the balance of these two forces is towards the 'pull', with a net interstate outflow running at around 12,000 per annum, below the long run average of around 17,000. These flows have lifted inward migration well above the historic average of 0.5 per cent of the population, driving strong working age population growth and demand for goods and services.

3.2 National economic outlook

The near term outlook for the Australian economy has weakened since the 2016-17 Half-Yearly. In 2016-17, national Gross Domestic Product (GDP) is expected to grow by a below-trend rate of 1¾ per cent, reflecting poor weather-related conditions (including the effect of Cyclone Debbie on coal exports) and a delayed pickup in non-residential building.

In 2017-18, national GDP growth is forecast to accelerate slightly to an around trend rate of 2¾ per cent. Despite the economy benefiting from a return to normal export operations, ongoing weakness in household consumption growth, in line with subdued labour income growth, is expected to weigh on the recovery.

National GDP growth is expected to increase to 3 per cent (above trend) in 2018-19 as the drag from mining investment dissipates and labour income growth gradually improves. Strong growth in service exports and public infrastructure are also expected to support growth as dwelling investment turns down and liquefied natural gas production reaches capacity.

3.3 Global economic outlook

There has been a notable cyclical upturn in global manufacturing and trade, along with expectations of a more expansionary fiscal policy in the United States under the new administration. Near-term growth prospects in China have also strengthened on the back of fiscal and monetary policy stimulus. However, the Chinese economy is still expected to transition to a slower and more sustainable growth path as it rebalances away from investment and exports to consumption.

In April 2017 the International Monetary Fund (IMF) forecast global growth to lift from 3.1 per cent in 2016, to 3.5 per cent in 2017 and 3.6 per cent in 2018. These forecasts are largely unchanged from its October 2016 forecasts that underpinned the 2016-17 Half-Yearly Review, but mark the first time in five years that the IMF has upgraded its short-term global growth expectation.

Australia's major trading partners are expected to grow by 4 per cent in 2016-17, in line with outcomes over the last two years, before slowing to 3¾ per cent in 2017-18 and 2018-19. This outlook for growth is below the long run average of 4¼ per cent. Nevertheless, it will increasingly be focused towards demand for services and soft commodities driven by the growing middle class in Asia. New South Wales is more exposed to these sectors than non-rural commodity exports (particularly steel making commodities), which has been the key source of demand over the last decade.

3.4 Risks to the NSW economic outlook

While the risks to the economic outlook appear broadly balanced, uncertainties remain, particularly around the housing market and wages growth.

The largest risk to the forecasts, both to the upside and the downside, is the outlook for the housing market given its highly cyclical nature and large flow-on effects. A significant slowdown in dwelling approvals could see the pipeline exhausted and activity decline by more than expected in 2018-19. Higher than expected interest rates or a sharp decline in dwelling prices could also bring an end to the cycle. On the upside, strong population growth or supportive government policies could boost demand and drive higher-than-expected activity.

The outlook for wages growth, which has flow on effects to inflation, consumption and economic activity, is another key risk. Factors that are currently putting downward pressure on wages, including the mining boom unwinding, could be stronger or last longer than expected. On the upside, capacity constraints in the construction sector, or relative housing affordability slowing inward migration (and therefore available labour supply), could be more pronounced than anticipated.