3. THE ECONOMY

- New South Wales' economic outperformance, which began in 2014-15, continued in 2017-18 with expectations of 3 per cent economic growth. This will mark an exceptional four-year period with economic growth above trend (2½ per cent) and above the national average. Household consumption, public infrastructure, dwelling construction and service exports have been the key drivers of this strong performance.
- The NSW economy is forecast to perform well in 2018-19 and 2019-20, with gross state product (GSP) increasing by 2¾ per cent in both years. Growth drivers are shifting from dwelling construction and household consumption, towards business investment and more broad-based strength in exports.
- The State's record infrastructure program and its spillover into private investment continues to drive growth. Almost half of the national pipeline of public engineering projects underway is in New South Wales. Strengthening global and national economies are expected to boost exports, spurring businesses to lift investment and employment.
- The labour market is experiencing strong momentum, with employment growth of 3 per cent forecast in 2017-18. This has fostered near record workforce participation, which combined with above-trend population growth is expected to see the unemployment rate stabilise at around 4¾ per cent over the forward estimates.
- A tightening national labour market, rising advertised salaries and emerging wage pressures in certain industries set the preconditions for a modest rise in wages growth over the next few years.
- Strong jobs growth has provided a boost to household income and consumption in 2017-18. Over the next two years, the prospect of easing house prices, modest wages growth, elevated household debt and tightening financial conditions are expected to keep consumption growth below its long-run average.

3.1 A strong economic outlook

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

New South Wales	2016-17 Outcome	2017-18 Forecasts	2018-19 Forecasts	2019-20 Forecasts	2020-21 Projections	2021-22 Projections
Real state final demand	3.9	3¾	3	3	-	-
Real gross state product	2.9	3	2¾	2¾	2½	2½
Employment	1.0	3	1¾	1½	1¼	1¼
Unemployment rate [(b)]	5.0	4¾	4¾	4¾	4¾	4¾
Sydney consumer price index [(c)]	2.0	2	2¼	2¼	2½	2½
Wage price index	2.0	2	2½	2¾	3	3¼
Nominal gross state product	6.4	5	4	4½	5	5
Population [(d)]	1.6	1.6	1.6	1.5	1.4	1.4

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

(a) Per cent change, annual average unless otherwise indicated
(b) Annual average, per cent
(c) 2017-18 to 2020-21 include a ¼ percentage point contribution from tobacco excise increases
(d) Per cent change through the year to 30 June. Forecasts are rounded to the nearest 0.1 percentage points.

[1] Economic forecasts are based on data available at the time they were prepared, which includes results to June 2017 for GSP, to the December quarter 2017 for state final demand, to the March quarter 2018 for the wage price index and the consumer price index, to the September quarter 2017 for population and to April 2018 for the labour force.

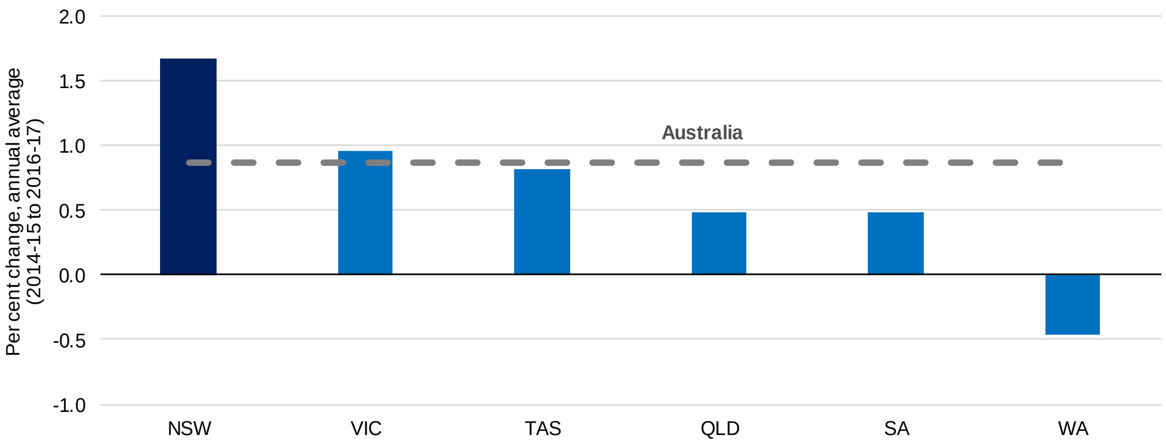
Since 2014-15 the NSW economy has shown exceptional strength, with per capita GSP growth averaging 1.7 per cent a year, by far the strongest among the states (see Chart 3.1). This strong growth has also flowed to New South Wales' regions (see Box 3.1).

This strength has been underpinned by households—through dwelling investment and household consumption—supported by strong gains in dwelling prices, above-trend population growth and low interest rates. Public investment has also made an impressive contribution, reflecting the Government's asset recycling strategy, with positive spillovers for business investment and employment. Service exports are another highlight, with relatively broad-based growth across *tourism*, *education* and *professional and technical business services*. Education related travel has been a standout.

While conditions in the housing market continue to soften, the overall economic outlook remains favourable. External demand conditions are likely to improve as the national and global economies strengthen. Growing Asian demand, low interest rates, a lower Australian dollar, above-trend population growth, and a historically large infrastructure and residential construction pipeline continue to provide support.

Consequently, the economy is forecast to maintain above-trend growth for the next two years. The pace is, however, expected to ease and the composition of growth shift towards exports and business investment and away from household consumption and dwelling investment.

Chart 3.1: NSW average GSP per capita growth since 2014-15 has outperformed other states



Source: ABS 5220.0 and NSW Treasury

The public sector is expected to remain a key source of strength, underpinned by the State's record $87.2 billion four-year capital program and the expansion of services such as the National Disability Insurance Scheme (NDIS). Public investment is expected to contribute around ½ a percentage point to economic growth, on average, over 2017-18 and 2018-19. This is consistent with its contribution over the previous two years and around four times the historical average. Supported by the approval of new major transport projects, public investment is forecast to boost economic growth by a ¼ of a percentage point in 2019-20. In addition to the direct contribution during the construction phase, this infrastructure will significantly increase the productive capacity of the economy in the long term (see Chapter 4 in this *Budget Statement*).

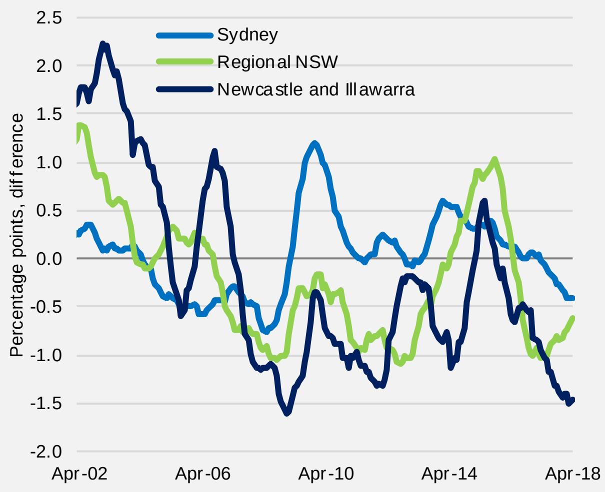
Business investment is forecast to grow faster over the three forecast years than at any time since 2008-09. Buoyed by public infrastructure investment and broadening demand for exports, business investment is expected to contribute around twice its long-run average to economic growth (see Box 3.3). This is expected to partially offset a modest outlook for household consumption growth and easing dwelling construction. Growth in household consumption is expected to be below its long-run average over the next two years as declining house prices, high household debt, modest wages growth and tightening credit conditions see households limit spending. While the dwelling construction cycle has peaked, the large pipeline of projects is expected to support elevated levels of activity for some time yet.

Box 3.1: Prospering regional economies[2]

In regional New South Wales employment growth has accelerated over the past three years, averaging 2.4 per cent annually, well above the long-run average of 1.5 per cent. This growth has been concentrated in full-time employment, which accounted for more than 66 per cent of additional jobs in the regions. Regional female employment growth has been particularly impressive, growing by 3.6 per cent annually over the past three years, accounting for 70 per cent of total regional employment growth.

Strong employment growth has contributed to a significant fall in the regional unemployment rate, from its post-mining boom peak of 7.3 per cent in 2015, to 5.7 per cent currently. This is 0.6 percentage points below its long-term level (see Chart 3.2).

Chart 3.2: *The regional unemployment rate is well below its long run average[(a)]*



Source: ABS 6291.0.55.001 and NSW Treasury

(a) Unemployment rate deviation from long run average

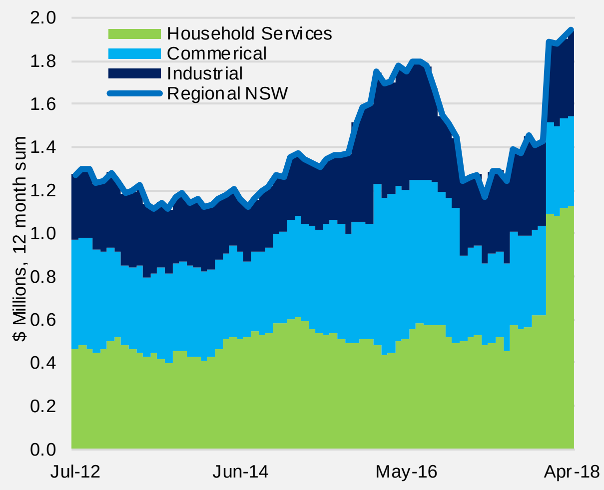
Solid labour market conditions, affordable housing and attractive lifestyles are enticing more people from Sydney, Newcastle and the Illawarra to regional areas—in net terms 13,000 people made the move in 2016-17. Around 57 per cent of this flow was to three regions—the Mid North Coast, the Hunter Valley (excluding Newcastle) and the Central Coast.

This trend is expected to continue as job vacancies for these regions (including Newcastle) rose by 17.2 per cent, on average, over the year to April 2018.

This migration and strong employment growth are driving demand for housing outside of Sydney. The value of residential building approvals in regional New South Wales is at a record high of $4.5 billion over the last year. The Hunter Valley (excluding Newcastle), Central Coast and Richmond-Tweed account for 38.8 per cent of demand. Approvals in Newcastle and the Illawarra are up 57 per cent over the past three-years, reaching a record high. This has partially offset slowing approvals in Sydney.

Private non-residential building approvals are also at a record high in regional areas (see Chart 3.3). Increased demand for services has seen annual approvals for household service-related buildings double over the past year. This growth has been concentrated in the Coffs Harbour-Grafton and the Mid North Coast areas.

Chart 3.3: *Household services supporting non-residential building[(a)]*



Source: ABS 8731.0 and NSW Treasury

(a) Private sector building approvals

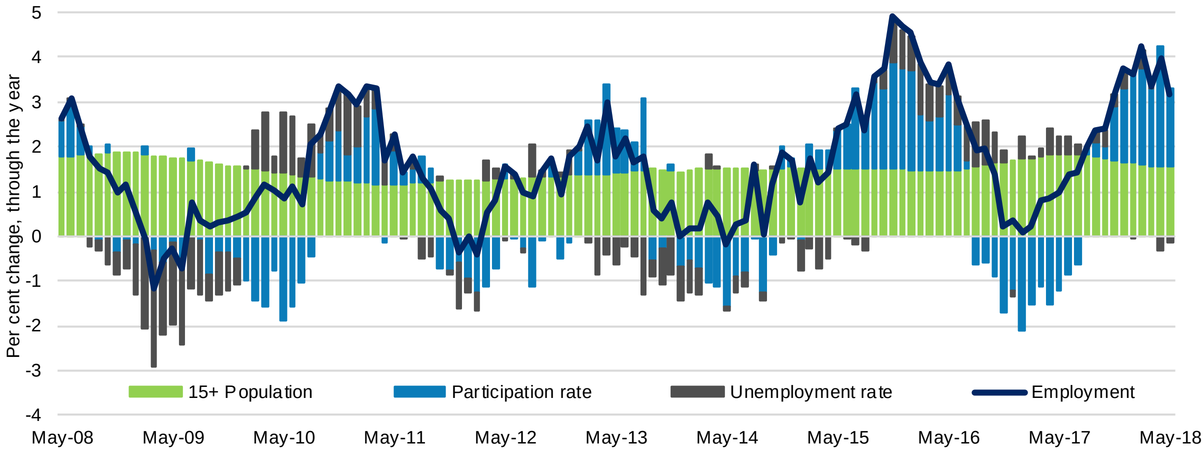
Strong labour markets, attractive living conditions and record construction activity demonstrate that, assisted by the right policies, the State's regional areas can flourish.

2 Regional New South Wales excludes *Sydney*, *Newcastle and Lake Macquarie*, and *Illawarra*, but includes the Central Coast. All figures are presented on an annual average basis.

Strong labour market momentum lifting participation to record highs

Employment growth has rebounded to an estimated 3 per cent in 2017-18, led by full-time jobs, which accounted for more than 60 per cent of additional employment over the past year. At the same time, average hours worked have continued their long-term decline as full-time employees are tending to work fewer hours.

Chart 3.4: Labour supply adjusting to meet labour demand



Source: ABS 6202.0 and NSW Treasury

Employment growth has been concentrated in labour-intensive industries, with the largest contributions coming from *health & social assistance* (0.7 percentage points, supported by the NDIS), *construction* (0.5 percentage points), *education & training* (0.3 percentage points) and *retail trade* (0.7 percentage points).

Demand for labour has been supported by strong economic activity and modest wages growth. Strong demand has encouraged people into the labour force, through inward migration and higher workforce participation (see Chart 3.4). This has kept the unemployment rate fairly stable at around 5 per cent, the lowest of any state. The NSW participation rate is near a record high—led by a record high female participation rate of 59.9 per cent in May 2018 (see Box 3.2).

Forward indicators of labour demand, such as job advertisements and hiring intentions, suggest employment momentum will be maintained in the near term. Over the next two years, employment growth is expected to come down from the current impressive highs to be more consistent with growth in economic activity. Nonetheless the outlook remains upbeat. Employment is forecast to expand by an above-trend rate of 1¾ per cent in 2018-19, and 1½ per cent in 2019-20. With elevated population growth and workforce participation, the unemployment rate is likely to ease only a little further and remain anchored at around 4¾ per cent over the forward estimates. This is consistent with estimates of full employment for New South Wales.

Wages growth and inflation are muted, but expected to gather momentum

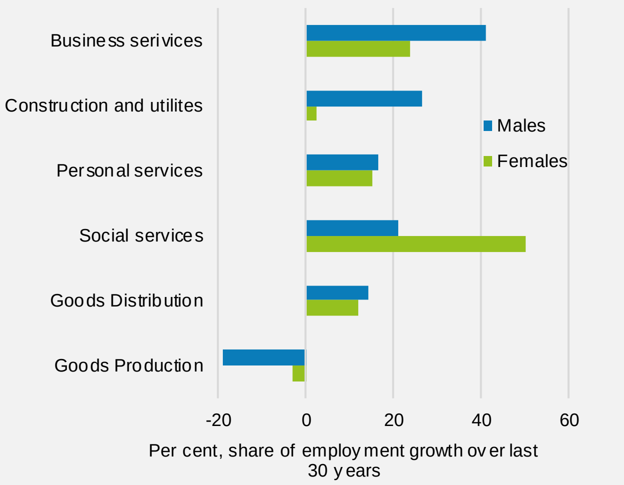
Wages growth has remained modest, weighed down by several factors including national spare capacity, slow productivity growth, low inflation expectations and (until recently) a wages overhang that built up during the mining boom. These conditions, however, are receding and there are signs of emerging wage pressures, especially in the construction, health, education and related sectors. As a result, wages growth is expected to rise gradually, as the national labour market tightens, reaching 3¼ per cent by 2021-22.

Inflation is expected to rise with a tide of stronger wages and import prices, lifted by higher global inflation and a lower Australian dollar. While the risks around the inflation outlook are broadly balanced, intense retail sector competition, lower utility prices and weak conditions in the housing market could all impact the outlook.

Box 3.2: Female workers are reshaping the labour market

Strong labour market conditions are driving outstanding employment and participation outcomes for females. Female employment increased by 4.2 per cent through the year to May 2018, accounting for 62 per cent of overall employment growth. This is well above the 47 per cent female share of the workforce.

Chart 3.5: Social and business services have driven female employment growth over the past 30 years

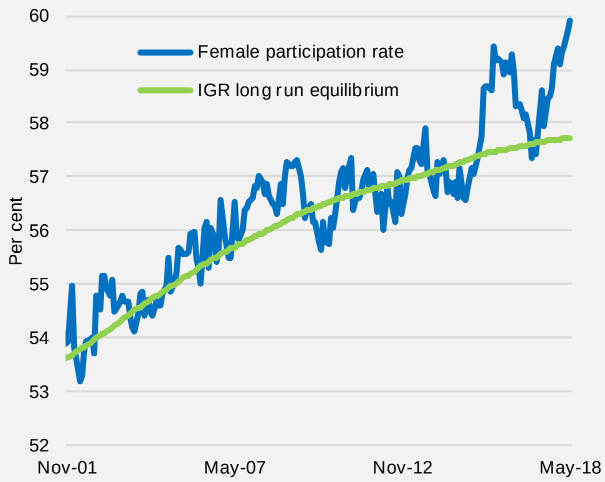


Source: ABS 6291.0.55.003 and NSW Treasury

The industries that contributed the most to female employment growth over the past three decades have been social services such as *healthcare & social assistance* and *education & training*, as well as business services like *professional, scientific & technical services* (see Chart 3.5). The recent strength in female employment has also been concentrated in these industries, which have contributed almost 60 per cent of female employment growth over the past year.

This elevated demand for labour has contributed to a record high female participation rate of 59.9 per cent in May 2018. This is well above the long-run projection for female participation in the 2016 NSW Intergenerational Report (IGR) (see Chart 3.6). Higher participation is providing a much-needed boost to our labour force and lifting the State's overall economic potential.

Chart 3.6: Female participation rate and long run equilibrium[3]



Source: ABS 6202.0 and NSW Treasury IGR

While female participation is at a record high, challenges remain. In 2016-17, 23.9 per cent of females who were available for work but not looking, stated that caring for children was the main reason.

To support families, this Budget invests a further $197.8 million into preschool education under the Start Strong program. This will ensure two years universal access to early childhood education from 2019, supporting better educational outcomes for children and improved workforce outcomes for parents.

[3] Long run equilibrium is determined by long-run workforce participation trends by age and sex and incorporates the effect of migration.

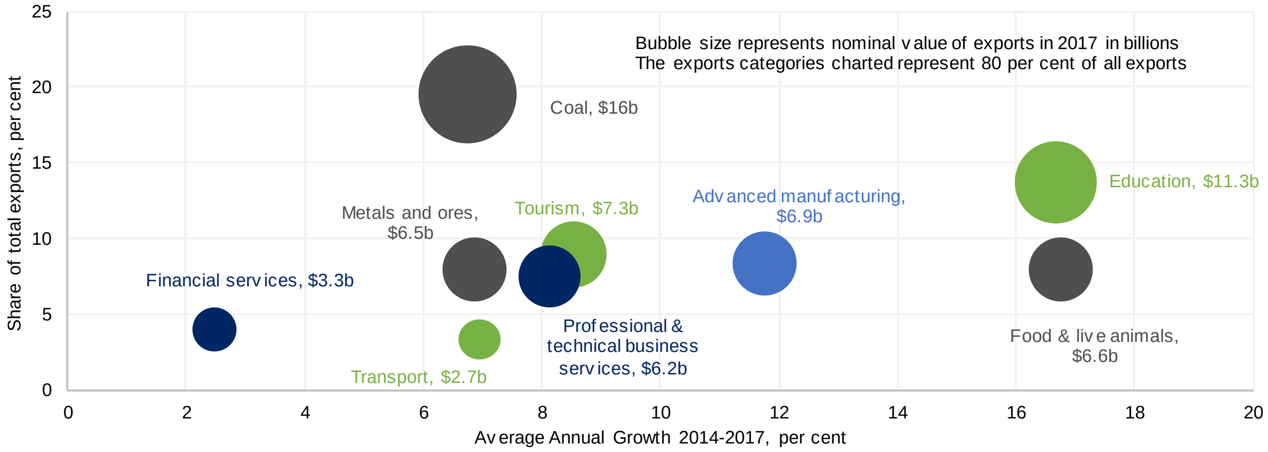
3.2 Supportive conditions for exports and business investment

Export-oriented firms are experiencing a fortuitous blend of economic conditions. Economic growth across the rest of Australia and the global economy has lifted, supporting demand for interstate and international exports. This improvement is helping to drive stronger business investment.

National and global demand is taking off

At the national level, the mining investment downturn is approaching completion. Growth across the rest of Australia is expected to lift above trend as the non-mining sector gathers steam, supported by strong population growth and favourable business conditions. Meanwhile, the global economy is steadily improving, having taken nearly a decade to recover from the Global Financial Crisis. The International Monetary Fund expects above-trend global economic growth of 3.9 per cent in both 2018 and 2019. Moreover, moderating terms of trade and increasing global interest rates are likely to see the Australian dollar ease, providing support to trade-exposed businesses.

Chart 3.7: Large service based industries have seen strong overseas export growth[(a)]



Source: ABS 5368.0.55.003/004, ABS.Stat Beta and NSW Treasury

(a) NSW nominal goods and services exports in 2017

As the economies of New South Wales' trading partners evolve, the composition of exports is expected to change. For instance, China is pursuing plans to transition to a lower, more sustainable growth model where demand is less reliant on investment and exports and tilted more towards household consumption. This rebalancing presents a significant opportunity for New South Wales' largely services-driven economy, particularly for the education and tourism sectors. It is also likely to support advanced manufacturing, such as medical and pharmaceutical products, as well as agricultural exports (see Chart 3.7). New South Wales has the largest advanced manufacturing industry in Australia, with exports having grown by an impressive 11.8 per cent, on average, over the three years to 2017.

Over the longer-term, a burgeoning global middle-class—expected to reach over 5 billion in 2030, up from 3.2 billion in 2016—will bring a host of new market opportunities.[4] The vast majority of this new middle class will be in Asia and New South Wales is well positioned to meet their needs, as they exercise their new found purchasing power.

[4] The Unprecedented Expansion of the Global Middle Class, Working Paper 100 (2017), Brookings Institution

Tourism and education services are driving overseas exports

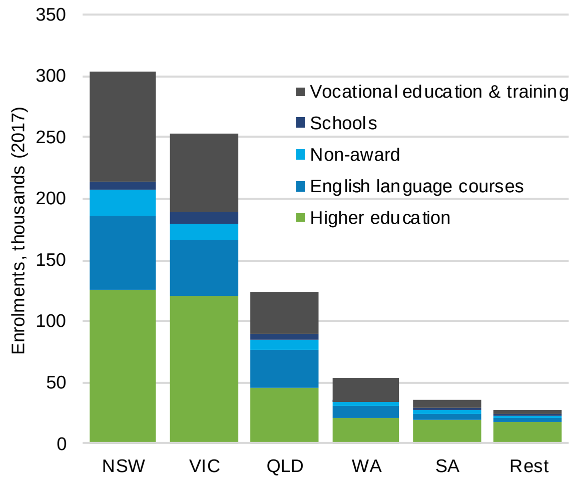
Travel-related exports accounted for more than 50 per cent of overseas services exports in 2017, with their value rising by around 25 per cent over the prior two years. While education-related travel makes up the lion's share of travel exports (see below), tourism remains a key sector. Short-term overseas arrivals to New South Wales increased by around 30 per cent between 2014 and 2017, and are up by 8.3 per cent on average over the year to March 2018.

Growing incomes and economic integration with Asia (especially China) are a major driving force behind this trend. At the national level, the share of visitors from China has doubled since 2010, accounting for almost a third of the total growth in short-term visitors. China was the largest source of international arrivals to New South Wales in 2017, with almost two thirds here for holiday purposes—adding to capacity pressures in accommodation and spurring investment across the State.

Meanwhile, education's share of total service exports increased from around 10 to 30 per cent over almost two decades, overtaking tourism and transport services, to become New South Wales' largest overseas service export. It is also the second largest overseas export industry overall, after coal.

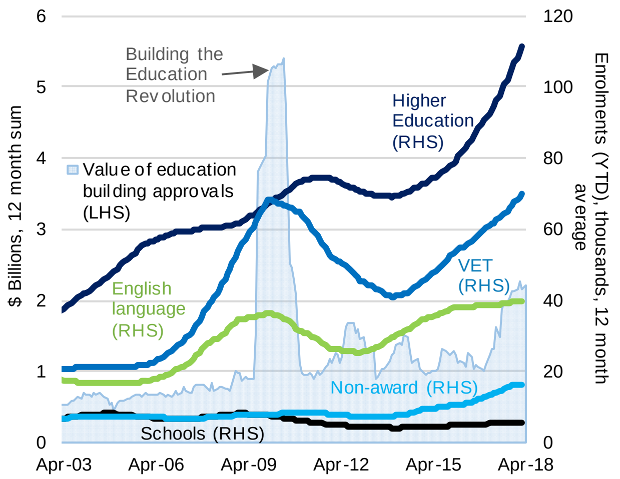
Australia was the third-largest destination in the OECD for international tertiary students in 2015, after the United States and the United Kingdom.[5] There were 624,000 international students across Australia in 2017, of which 38 per cent (or around 237,000) were in New South Wales, with the majority enrolled in tertiary institutions (see Chart 3.8).

Chart 3.8: New South Wales has the most international students



Source: Department of Education and Training and NSW Treasury

Chart 3.9: International students leading to higher education construction



Source: ABS 8731.0, Department of Education and Training and NSW Treasury

The contribution of international students to the State economy is significant, $11.3 billion in 2017, which is $4.0 billion more than the entire tourism industry. Moreover, estimates suggest that international education supported 1.5 per cent of all NSW employment in 2014-15.[6]

For educational institutions, rapid growth in the sector is reflected in increased construction and investment. The current value of annual building approvals in the sector has reached $2.2 billion, levels not seen since the 2009-10 fiscal stimulus programs and the highest of any non-residential sector in the State (see Chart 3.9).

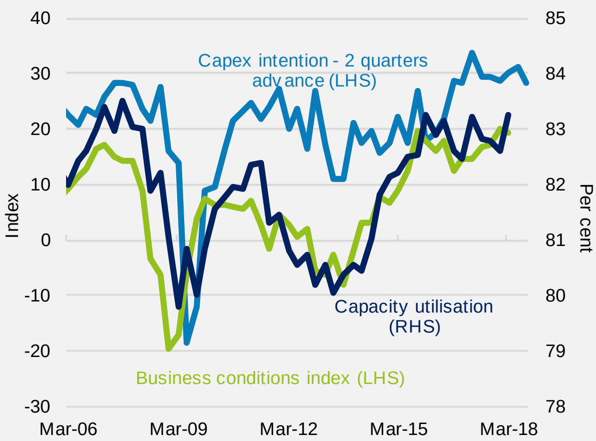
[5] Education at a Glance, OECD Indicators (2017), OECD. Data as of 2015

[6] The Value of International Education to Australia, April 2016, Deloitte Access Economics

Box 3.3: Business investment is set to make a larger contribution to growth

Business investment is a key economic driver, not only for the activity it generates directly, but also because it increases our capital stock. More capital means greater labour productivity, lifting wages, incomes and long-term economic growth.

Chart 3.10: Capacity pressures encouraging new investment



Source: NAB Economics and NSW Treasury

Following an extended period of private underinvestment, business are responding to supportive conditions and elevated capacity utilisation (see Chart 3.10). This is becoming evident in construction, where non-residential building approvals indicate a rebound in activity across several sectors—especially education, offices and warehouses.

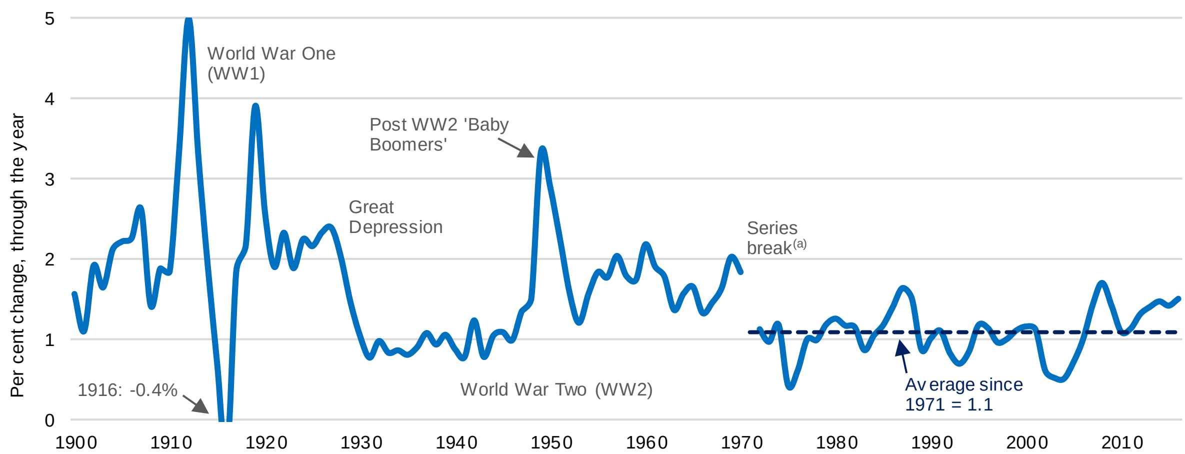
NSW public engineering work yet to be done has reached $10.5 billion, almost half of the national pipeline of public engineering projects. This is spurring private investment as, in 2017, nearly 70 per cent of public sector engineering work was done by the private sector.

Encouragingly, New South Wales is leading the way in business research and development (R&D) and innovation, accounting for a rising share of national business R&D expenditure in recent years (near 40 per cent in 2015-16, from around 30 per cent in 2007-08). There has been a focus in key sectors such as finance and information technology, where New South Wales makes up more than 50 per cent of national business R&D spending.

3.3 Population growth is driving demand

Population growth in New South Wales has been strong over the past decade, averaging 1.4 per cent, well above the 1.1 per cent average since the early 1970s (see Chart 3.11). Population growth is forecast to remain around ½ a percentage point above the long-term average over the next two years. This strong growth will see the population of New South Wales reach 8 million people over the next 12 months.

Chart 3.11: NSW population growth since Federation



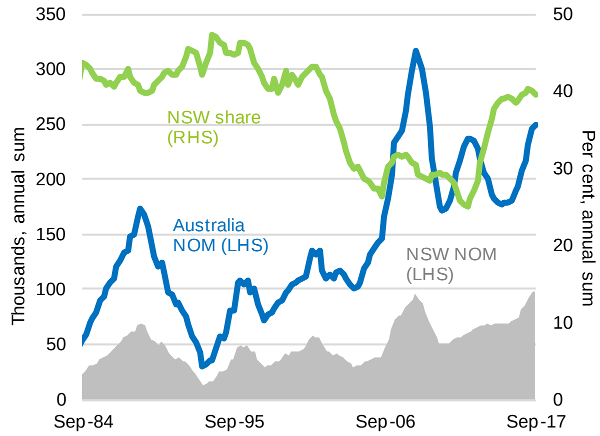
Source: ABS 3101.0, 3105.0.65.001 and NSW Treasury

(a) Switch from ‘actual location’ to ‘usual residence’ concept

Overseas migration has been the key driver of strong population growth

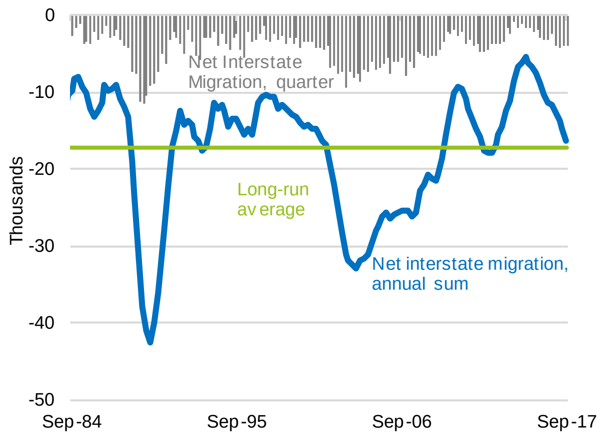
Historically high levels of net migration to Australia, combined with the relative strength of the NSW labour market, have lifted the State's net overseas migration (NOM) to the highest on record, just under 100,000 in 2016-17 (see Chart 3.12). Much of this recent growth has been driven by temporary migrants (mainly overseas students).

Chart 3.12: Overseas migration is at all-time highs



Source: ABS 3101.0 and NSW Treasury

Chart 3.13: But, interstate outflows are picking up

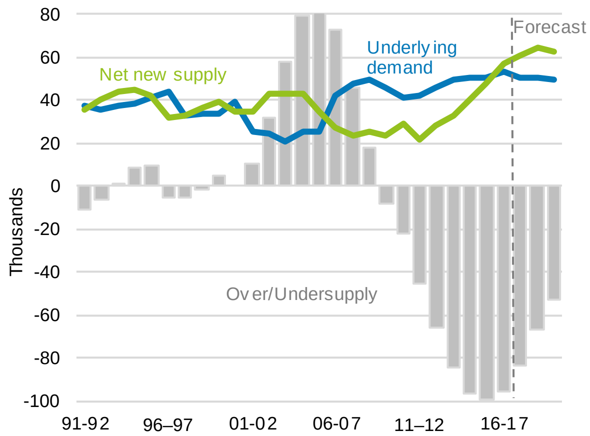


Source: ABS 3101.0 and NSW Treasury

Migration is creating economic benefits, but also challenges

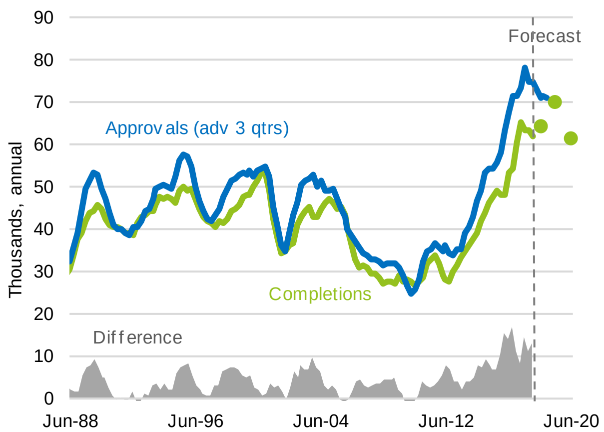
Strong migration has brought economic benefits to New South Wales by increasing workforce participation (since migrants are mostly working age) and fuelling demand for goods and services. But a fast-growing population also brings challenges. Migrants are attracted to major cities where employment and education opportunities are the strongest, placing additional pressure on public services, infrastructure and housing. Interstate outflows have started to lift again recently, and are expected to increase further as economic activity and employment in the rest of Australia improves (see Chart 3.13). This outward movement, combined with a lower share of overseas migrants is expected to see NSW population growth gradually abate, but remain well above trend, over the next few years.

Chart 3.14: Housing undersupply to halve over three years



Source: ABS 6416.0, 3101.0 and NSW Treasury

Chart 3.15: Completions to peak in 2018-19



Source: ABS 8731.0, 8752.0 and NSW Treasury

Meeting the demands of strong population growth requires policies that support the provision of sufficient housing and infrastructure. Chart 3.14 shows how the pent-up undersupply of dwellings peaked at an estimated 100,000 in 2015-16. The current housing construction boom is forecast to push housing completions to record levels and halve the estimated housing undersupply over the next few years.

Dwelling completions are expected to peak in 2018-19 (see Chart 3.15). Nonetheless, the pipeline of residential projects is at a record high. Combined with building approvals holding up better than expected, this points to an elongated, but gradually declining profile for dwelling construction over the next two years.

3.4 Consumption boosted by employment, will rely more on wages

Household consumption growth has been solid over the past year, rising by 2.9 per cent, underpinned by outstanding employment growth. These outcomes suggest a more resilient consumer in 2017-18 than was expected given the headwinds from an easing housing market and modest wages growth.

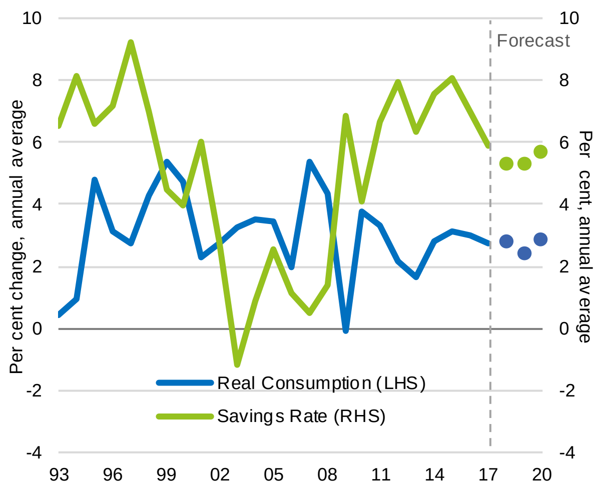
With conditions in the housing market continuing to soften, wealth effects are expected to drag on consumption, particularly over the next year, as households become less willing to further reduce their savings rates. Consumption growth is therefore forecast to be more in line with income growth over the next two years (see Chart 3.16).

Housing market conditions softening

The loss of momentum in the housing market is expected to see house prices remain soft over the next two years, weighed down by tightening credit conditions and a smaller undersupply.

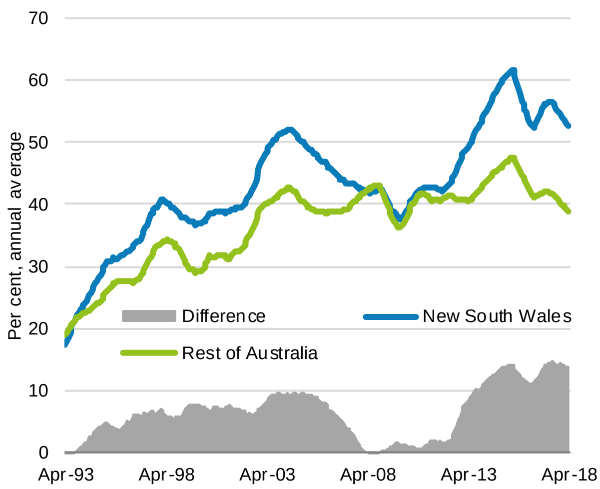
Regulatory changes targeting investors are impacting conditions in New South Wales, where investors account for a high share of housing finance (see Chart 3.17). In the meantime, strong population growth, housing undersupply and historically low interest rates will continue to lend some support.

Chart 3.16: Savings rate to stabilise



Source: ABS 5206.0, ABS 5220.0 and NSW Treasury

Chart 3.17: Investors driving the housing market(a)



Source: ABS 5609.0 and ABS 5671.0

(a) Share of the value of housing finance commitments

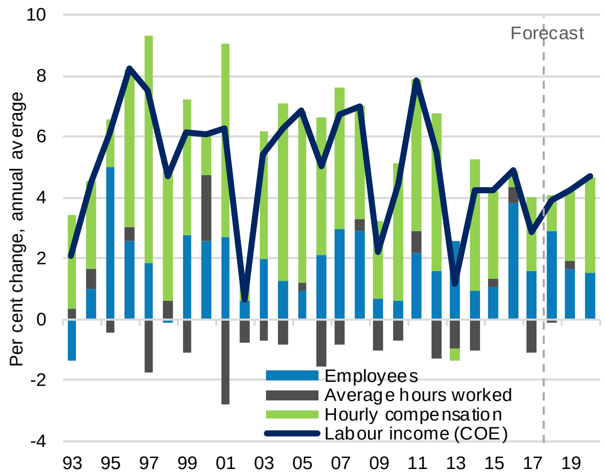
A switch away from interest-only loans could see mortgage repayments rise considerably for some households as they transition to principal and interest. Mortgage buffers and low mortgage arrears, however, indicate a reasonably sound financial position for the average household. Also, the recently announced personal tax cuts by the Commonwealth Government would provide some offset, supporting household income in 2019-20.

Rising wages growth will help to underpin consumption going forward

Above-trend employment growth is leading to tighter national labour market conditions and supporting labour income growth (see Chart 3.18). Nevertheless, labour income is forecast to expand by around 4 per cent in 2017-18—well below its long-run average.

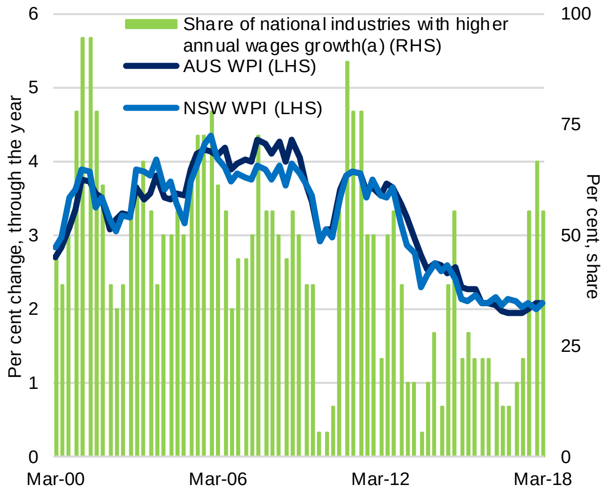
Growth in the wage price index (WPI) has been modest at 2.1 per cent over the past year, with support coming from the larger-than-usual 3.3 per cent increase in minimum and award wages in 2017-18 (see Chart 3.19).

Chart 3.18: Hourly wages to support labour income



Source: ABS 6202.0, 5206.0, 6291.0.55.001 and NSW Treasury

Chart 3.19: Wage pressures are building[(a)]



Source: ABS 6345.0 and NSW Treasury

(a) Industries with higher through the year wages growth compared to last year

Strengthening labour market conditions and a large 3.5 per cent increase in minimum and award wages from 1 July 2018, provide a sound base for a steady build-up in wage pressures. Wage growth is therefore forecast to gradually rise over the forward estimates, consistent with declining spare capacity in the national labour market, increased skill shortages, higher advertised salaries and fewer wage freezes.

Emerging wage pressure in certain industries is expected to gradually filter into the broader economy. *Health care & social assistance* and *construction* continue to experience WPI growth above 2.5 per cent—with support from the ramp-up of the NDIS and high levels of construction activity. Nonetheless, the tendency for wages to be set by national multi-year agreements suggests wages will lift only gradually. The WPI is forecast to grow by 2½ per cent in 2018-19 and 2¾ per cent in 2019-20—remaining well below its long-run average growth of 3½ per cent.

Wages growth is expected to underpin labour income growth, and therefore consumption growth going forward. Household consumption growth is forecast to slow in 2018-19 as the cooling housing market and modest wages growth continues to weigh on spending. Household consumption growth is, however, expected to pick-up in 2019-20 as wages growth gradually improves, the recently announced income tax cuts take effect and conditions in the housing market begin to stabilise.

3.5 Risks to the economic outlook

The near term global growth outlook remains upbeat, posing some upside risk to exports. The medium-term outlook is, however, more uncertain, with risks weighted to the downside. Global growth could face disruption as loose monetary conditions are gradually tightened and the effects of fiscal stimulus in the United States eventually fade. China is another potential source of disruption as the risks around debt levels, shadow (unregulated) banking and the housing market continue to play out. Amplifying these risks is the fact that around the world there is now much less scope for monetary and fiscal policy to respond to potential economic shocks, such as a further escalation in global trade tensions.

Domestic risks centre around the housing market and the outlook for wages over the next two years, and their potential flow-on to household consumption. Several factors could see conditions in the housing market deteriorate more than expected, including prospects for additional tightening of lending standards—heightened by the *Royal Commission into Misconduct in the Banking, Superannuation and Financial Services Industry*.