2. THE ECONOMY

- Inflation has continued to ease over the past year with softening activity and a gradual rise in the unemployment rate, though elevated services inflation is delaying the easing in overall inflation.
- Cost-of-living pressures have weighed on household spending and slowed growth in the New South Wales domestic economy.
- Public demand is providing some offset, while strong population growth is supporting business investment and continued employment growth.
- The slowdown in economic activity is expected to continue in the short term, driving a relatively modest lift in the unemployment rate and a further easing in inflation.
- Momentum in activity is anticipated to recover in 2024-25 as cost-of-living pressures ease.
- Overall, the outlook is consistent with a soft landing for the economy.
- The risks to the outlook centre primarily on geopolitical risks and uncertainty around the path for global inflation and interest rates.

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

	2022-23 Outcome	2023-24 Forecast	2024-25 Forecast	2025-26 Forecast	2026-27 Forecast	2027-28 Forecast
Real state final demand[(b)]	4.8	1 (1½)	1¼ (1½)	2¼ (2)	2½ (2¾)	2½
Real gross state product	3.7	1½	2 (1¼)	2	2¼ (2½)	2¼
Employment	6	2½ (1½)	1 (½)	1	1½	1½
Unemployment rate[(c)]	3.2	4 (3¾)	4½	4½	4¼	4
Sydney consumer price index	7.1	4¼ (4½)	3 (3¼)	2¾	2½	2½
Wage price index	3.3	4	3¾	3½ (3¼)	3¼	3½
Nominal gross state product	10	5 (3¾)	5¾ (3)	4¾ (4)	4½ (5¼)	4¼
Population[(d)]	2.2	2.1 (1.7)	1.2 (1.3)	1.2 (1.3)	1.1 (1.2)	1.1

(a) Forecasts are rounded to the nearest quarter point and are annual average per cent change, unless otherwise indicated. 2023-24 Half-Yearly Review forecasts in parentheses where different.
(b) Forecasts completed prior to publication of the March quarter 2024 National Accounts by the Australian Bureau of Statistics (ABS).
(c) June quarter, per cent.
(d) Per cent change through the year to 30 June. Forecasts rounded to nearest 0.1 percentage point.

Note: Commodity prices are assumed to follow Consensus Economics forecasts as of April 2024. Broadly consistent with market expectations, the RBA cash rate is assumed to decline from early 2025 and steadily move back toward a more neutral setting within the forward estimates. The Australian dollar trade-weighted index is assumed to average 65.1 across the forecast period.

Source: ABS and NSW Treasury

2.1 The New South Wales economy is slowing

Cost-of-living pressures have slowed domestic spending

Growth in the New South Wales domestic economy has slowed following the post-pandemic recovery as cost-of-living pressures have weighed on consumers, offsetting the strong growth in labour income over the last year.

The initial driver of these pressures was high inflation. In particular, growth in the prices of essential goods and services have continued to outstrip price growth for discretionary items. Within essentials, insurance and financial services, housing, education and health saw the highest price growth through the year to the March quarter 2024.

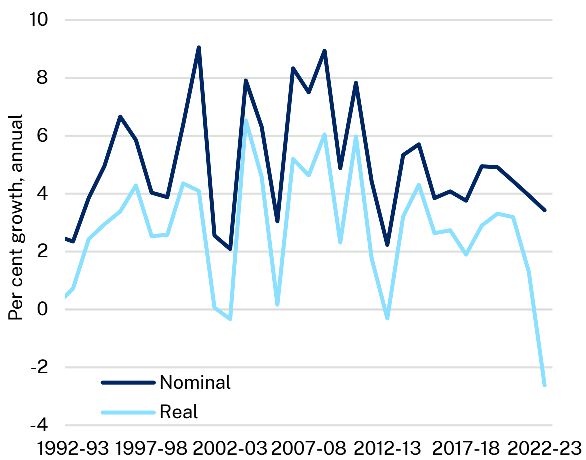
This has constrained households' real purchasing power and slowed growth in real consumer purchases, particularly for discretionary items, even as households maintained solid growth in nominal spending.

More recently, nominal disposable income has been weighed down by the combination of tax bracket creep and higher interest rates (Chart 2.1). The latter reflects the Reserve Bank of Australia's (RBA) actions to bring inflation back down to its target range.

The softening in spending would have been greater were it not for households absorbing some of these pressures by saving less of their income. The national savings rate, which measures the additional amount households save each quarter, fell in the September quarter 2023 to its lowest level since 2007, and has remained low since then.

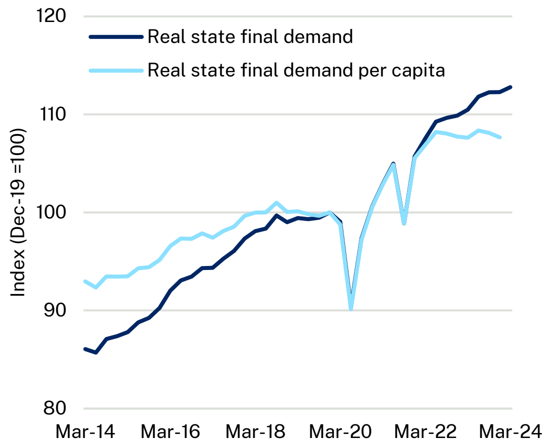
Notwithstanding this weakness at the household level, aggregate demand in the economy, as measured by state final demand (SFD), still managed to grow by 2.1 per cent through the year to the March quarter 2024 (Chart 2.2). This relative resilience in aggregate demand is due to ongoing strength in international migration and support from public demand.

Chart 2.1: NSW gross household disposable income



Source: ABS and NSW Treasury

Chart 2.2: NSW state final demand



Source: ABS and NSW Treasury

Box 2.1: Economic performance has been uneven across the states

Cost-of-living pressures have been evident across the country. High inflation and rising interest rates have an inherently broad-based impact.

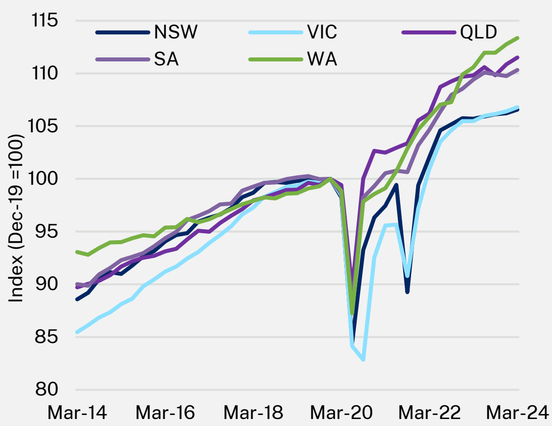
Nevertheless, economic performance across the country has been uneven since these pressures emerged, especially in the household sector.

For New South Wales and Victoria, these pressures occurred following the Delta lockdowns, a headwind unique to these states, putting them at a weaker starting position.

Interest rates have risen across all states, but the increase has especially impacted the disposable income of households in New South Wales, Victoria, Queensland and South Australia. At the aggregate level, these states saw the greatest increase in the share of gross income going to dwelling interest in 2022-23 compared to 2021-22.

Given this, household consumption growth has slowed in these states, particularly New South Wales, which has seen the weakest growth in household consumption since the June quarter 2022 at 1.9 per cent. This is compared to 2.6 per cent in Queensland, 3.2 per cent in Victoria and 3.7 per cent in South Australia (Chart 2.3).

Chart 2.3: Real household consumption



Source: ABS and NSW Treasury

Newer borrowers in New South Wales have been particularly squeezed. The share of household earnings going to mortgage payments on new loans in the State has increased more than in all other states since May 2022. This is in part because the median dwelling price in New South Wales is the highest across the country.

Outside the consumer sector, business investment has been a strong performer across most states. Tight labour markets and continued spending at the aggregate level has supported business activity relatively broadly.

Public demand has also supported growth across the country.

Additionally, while population growth has been strong for most states due to net overseas migration, New South Wales has seen large outward migration to other states, which weighs on overall demand.

Housing construction has been weak despite price growth

Higher interest rates and construction costs, combined with delays due to a lack of labour and materials, are compressing construction sector margins, especially for larger residential projects. These factors have negatively impacted the feasibility of new residential projects, contributing to a sharp decline in the number of dwelling approvals, on a trend basis, over the past year to their lowest level in a decade. These pressures have also seen a rise in construction insolvencies, which may delay any recovery in construction activity.

Meanwhile, demand from strong population growth has seen house prices continue to rise through the first few months of 2024, despite high interest rates constraining affordability for prospective first home buyers. As of November 2023, it would take an average earner in New South Wales around 13 years to save for a deposit on a dwelling of median value.[1] Existing homeowners have likely fared better as relatively healthy equity levels and strong wages growth have helped counter the significant rise in mortgage payments.

Renters have also faced significant increases in housing costs, in large part due to the substantial imbalance between demand and supply in the rental market. Strong demand has kept the rental vacancy rate in Greater Sydney at a very low level of around 1.0 per cent, supporting strong growth in rents.

Box 2.2: Housing affordability concerns persist, exacerbating cost-of-living pressures, particularly in Western Sydney

New South Wales faces the twin challenges of higher costs of housing, and of living expenses more broadly. This is making it increasingly difficult for families to meet basic needs, with some areas hit harder than others.

As higher construction costs and labour shortages have constrained investment in new dwellings, dwelling rents have continued to rise in the State. Since the month prior to the RBA's current cycle of rate increases, the median advertised rental price for dwellings has risen by approximately 25.8 per cent in Western Sydney, compared to 18.9 per cent across the rest of the State (Chart 2.4).

This has come at a time when residents face mounting pressure from escalating living costs. The Sydney consumer price index (CPI) indicates that essential goods and services prices surged by 4.5 per cent over the year to the March quarter 2024, compared to a modest 2.6 per cent increase in prices of discretionary items.

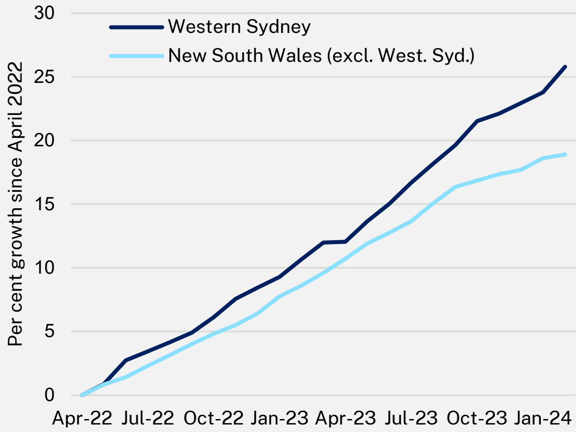
Lower-income households have been disproportionately affected, as they typically allocate a larger portion of their income to essential goods. Western Sydney is particularly hard hit, with latest records putting median household incomes for renters in the region around 27 per cent lower than those across metropolitan Sydney.

For those looking to move from renting to owning, the cost of servicing a new mortgage remains high. Treasury analysis using CoreLogic data shows that the cost of servicing a mortgage taken out in April 2022 on a median dwelling in Western Sydney has risen by 55.0 per cent, compared to 49.5 per cent in the rest of New South Wales (Chart 2.5).

First-time buyers are increasingly relying on financial assistance from parents to afford a deposit, though not all families are in a position to do this. This creates disparities for those without such support, and risks worsening wealth inequality among future generations.

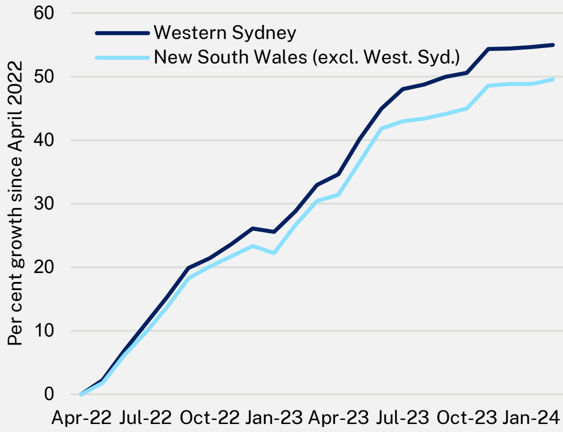
[1] Based on a household with one full-time adult receiving average ordinary-time earnings and generating no non-wage or non-salary income. Assumes 15 per cent of pre-tax earnings are saved and a 20 per cent deposit.

Chart 2.4: Cumulative growth in median advertised rental prices for dwellings since April 2022



Source: CoreLogic and NSW Treasury

Chart 2.5: Cumulative growth in repayments for a new mortgage on a median dwelling since April 2022



Source: CoreLogic and NSW Treasury

Growth in aggregate demand is supporting business and labour conditions

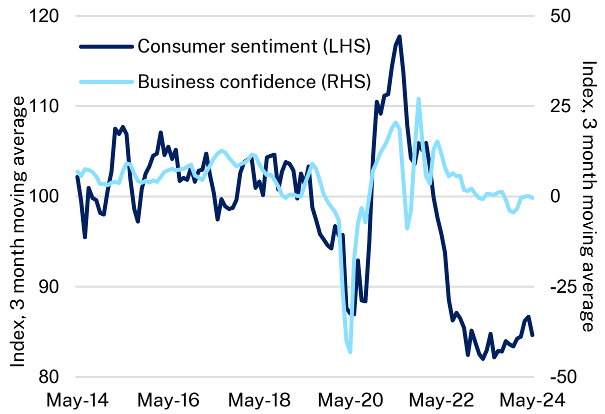
The divergence between individual household spending and aggregate demand in the economy has seen different experiences for businesses and consumers. Individuals have felt the brunt of cost-of-living pressures. In comparison, continued growth in aggregate spending has supported business trading conditions and income. Alongside elevated capacity utilisation, these conditions have supported business investment growth, and continued strength in labour demand at an aggregate level. Reflecting this, business confidence has been more resilient compared with consumer sentiment but both remain below their pre-COVID average (Chart 2.6).

Support for activity has also come from public demand, which was the largest contributor to growth in state final demand over the past year.

Ongoing labour demand has seen employment rise by 2.0 per cent over the year to May 2024. Falling employment in sectors that are exposed to weak consumer spending, including retail and hospitality, has been more than offset by rising employment, in net terms, in the rest of the economy.

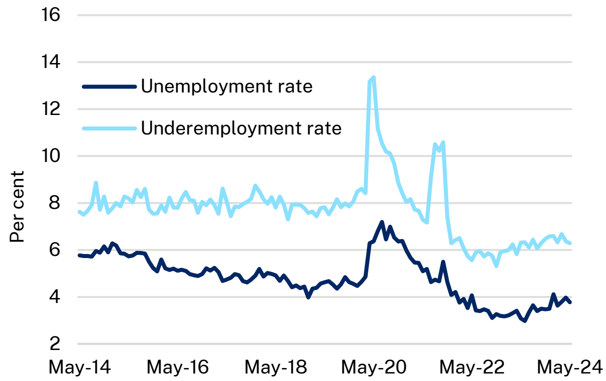
Nevertheless, the unemployment rate has gradually increased from a low of 3.0 per cent in June 2023 to 3.8 per cent in May 2024, as international migration has boosted the supply of labour (Chart 2.7). Other indicators also signal a slackening in the labour market, with the underemployment rate trending upwards, albeit from low levels, while job advertisements have fallen from their peak.

Chart 2.6: NSW consumer sentiment and business confidence



Source: Westpac-Melbourne Institute, NAB and NSW Treasury

Chart 2.7: NSW unemployment rate and underemployment rate



Source: ABS and NSW Treasury

Slowing activity is helping to bring down inflation

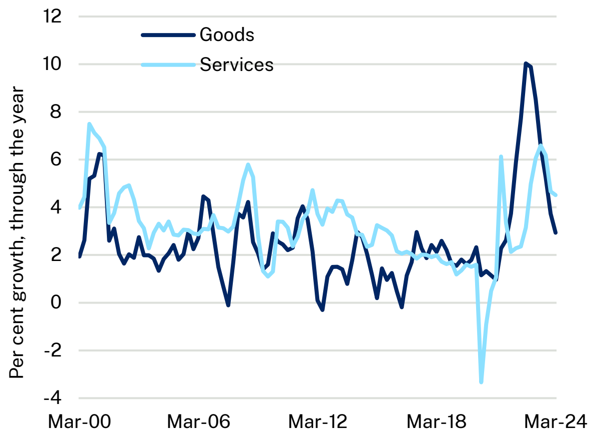
The softening in both spending growth and the labour market has helped bring down inflation. Over the year to the March quarter, Sydney CPI inflation rose by 3.8 per cent, which is half the rate seen over the year to the December 2022 quarter.

Slower inflation initially reflected lower commodity prices and the unwinding of international supply pressures. This saw goods inflation drop from a peak of 10.0 per cent in late 2022 to 2.9 per cent through the year to the March quarter 2024 (Chart 2.8).

Although services inflation has also eased, in part due to Government cost-of-living supports for rents and childcare, it remains relatively elevated at 4.5 per cent as at the March quarter 2024. Inflation across most services categories indicates that strong domestic price pressures remain. This is primarily due to high domestic unit labour cost growth, which itself reflects the combination of faster nominal wage growth and weak productivity growth, on average, since the onset of the pandemic.

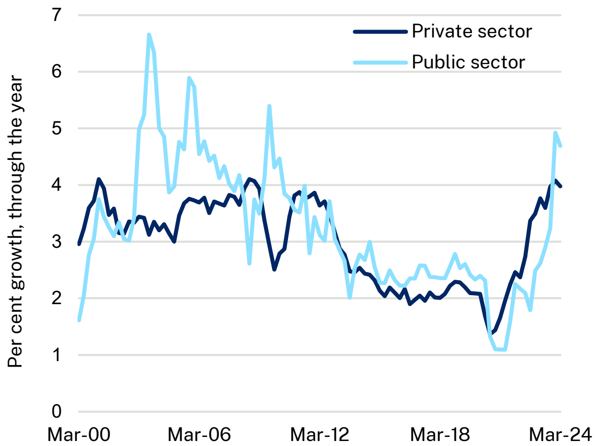
Previous tightness in the labour market and elevated levels of inflation have seen private sector wages over the year to the March quarter 2024, as measured by the New South Wales wage price index (WPI), rise by 4.0 per cent, their fastest pace in more than a decade. Public sector wages have also risen over the past year, due to newly implemented enterprise bargaining agreements, notably for those in the health and education sectors (Chart 2.9).

Chart 2.8: Sydney CPI



Source: ABS and NSW Treasury

Chart 2.9: NSW public and private sector WPI



Source: ABS and NSW Treasury

2.2 Outlook for the New South Wales economy

Overall, the outlook is consistent with a soft landing for the New South Wales economy. Economic growth is forecast to be subdued in the very near term, before accelerating through the course of 2024-25 as cost-of-living pressures ease.

A similar soft landing is expected for the Australian and global economies. The International Monetary Fund's (IMF) latest outlook for the global economy in April reaffirmed the expectation for a soft landing, despite the aggressive increase in interest rates by major central banks, and concerns around the outlook for the Chinese economy. Central to this outlook was an expected continued easing in global inflation, reflecting the impacts of coordinated monetary policy tightening.

Weaker demand in the near term to loosen the labour market further

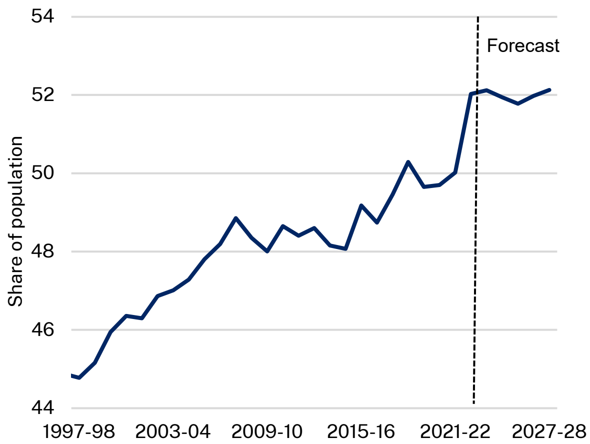
Cost-of-living pressures remain sufficiently elevated to suggest households will remain cautious with their spending in the near term. The gradual rise in unemployment is expected to add further weight to this cautiousness, as is uncertainty over the timing for when household finances will see relief via interest rate cuts.

Investment in new dwellings is also expected to remain weak over the next year, despite continued strength in population growth and the resilience of house prices. This reflects the ongoing impact of tight capacity and elevated costs within the construction industry.

Employment growth is expected to slow further, in line with economic activity. Job creation is forecast to not keep pace with the growth in the supply of labour, causing the unemployment rate to continue to rise to a peak of 4½ per cent in the second half of 2025.

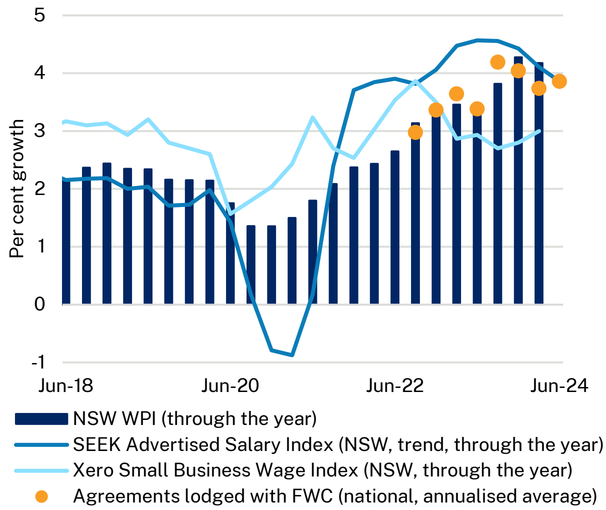
Despite this deterioration, the anticipated peak in the unemployment rate is well below the average of recent decades, and the employment to population ratio is forecast to remain high (Chart 2.10).

Chart 2.10: NSW employment to population ratio



Source: ABS and NSW Treasury

Chart 2.11: Leading indicators of wages



Source: ABS, SEEK, Xero Small Business Insights and NSW Treasury
Note: June quarter 2024 data for FWC agreement approval applications is to 3 May and SEEK data is to April.

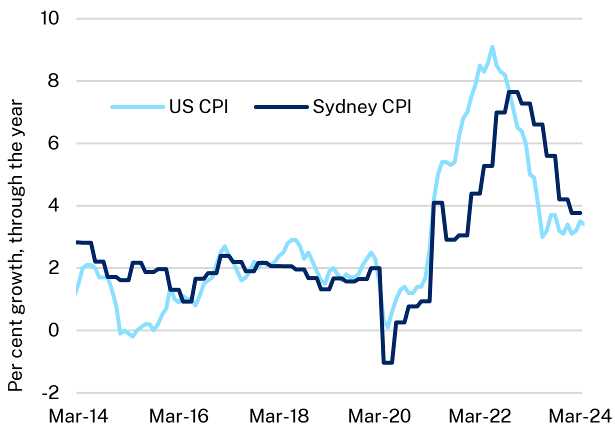
Although this environment suggests wages growth will stay elevated in the near term, a range of timely indicators, including Enterprise Bargaining Agreements lodged with the Fair Work Commission (FWC), suggest that wages growth has reached its peak and should moderate from the latter half of 2024 (Chart 2.11). Nonetheless, annual real wages growth, as measured by the WPI adjusted for the Sydney CPI, is expected to remain in positive territory throughout the forecast horizon.

Inflation expected to continue drifting lower, but services inflation is lagging

National inflation is forecast to maintain its path back towards the RBA's inflation target. Goods inflation is expected to ease further in 2024, driven by sustained improvement in global supply chains. Elevated labour costs in the near term will keep broader services inflation high, although cost-of-living measures such as the Electricity Bill Rebate will suppress headline inflation in 2024-25. Underlying inflation is expected to remain above the RBA's target range until mid-2025.

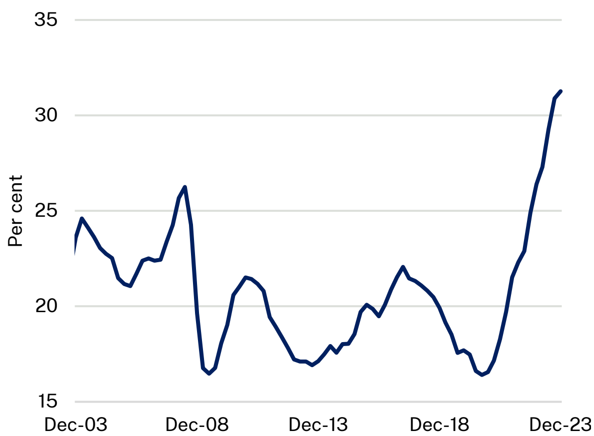
The recent lack of improvement in inflation for the United States has highlighted the risks of declaring success over inflation pressures too early (Chart 2.12). Reflecting this, the RBA's monetary policy committee has noted that greater confidence in inflation's sustainable return to the target range is required before the cash rate can be lowered.

Chart 2.12: United States CPI and Sydney CPI



Source: Bloomberg, ABS and NSW Treasury

Chart 2.13: Servicing costs on a new mortgage as a proportion of owner-occupier earnings in NSW



Source: ABS, CoreLogic, HILDA Survey, RBA and NSW Treasury
Note: Mortgage repayments on a recently purchased NSW dwelling of median value. Assumes a household with two full-time adults on average post-tax earnings for owner-occupiers, with a 20 per cent average tax rate, 20 per cent deposit and a variable rate 30-year loan.

Economy to strengthen through 2024-25 as cost of living comes under control

As inflation continues to move gradually lower against the backdrop of weak growth in demand, conditions are expected to be in place to allow the RBA to start lowering interest rates in the first half of 2025. This is broadly in line with market expectations at the time forecasts were finalised.

The relief given to households should see real consumer spending start to recover. Even before interest rates are cut, low- and middle-income households will receive additional support in the form of the revamped stage 3 income tax cuts. These are expected to provide a modest boost to consumption, relative to the previous structure of these tax cuts, from July 2024. While there is uncertainty around how much of the tax savings will be spent by households, the rebound will be further facilitated by the resilience in labour demand.

New dwelling investment is also forecast to turn around as supply responds to the added demand from recent population growth. This pick-up in construction activity is expected to be supported by higher dwelling prices, and an improvement in developers' profitability, as construction costs and capacity constraints stabilise and potentially ease.

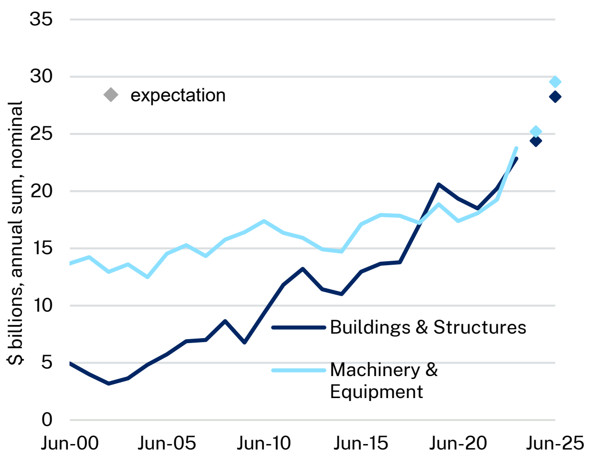
The large existing pipeline of outstanding construction projects is also expected to support dwelling investment as construction backlogs progressively ease, while Government housing reforms should assist supply late in the forward years. Notwithstanding this, on current expectations, achieving the aspirational housing completions target for New South Wales under the 2023 National Housing Accord is likely to prove very challenging.

Despite lower interest rates supporting housing market activity, Sydney dwelling price growth is expected to be modest. The medium-term outlook for dwelling prices reflects both an easing of demand and supply imbalances as construction activity eventually improves, and the impact of affordability constraints (Chart 2.13), with valuations remaining stretched even as interest rates fall.

Business investment, meanwhile, is expected to remain robust. Labour costs are growing strongly, and with capacity utilisation elevated by historical standards, conditions are optimal for capital investment. According to the ABS Private New Capital Expenditure and Expected Expenditure release, businesses expect solid growth in capital expenditure over the rest of 2023-24 and throughout 2024-25 (Chart 2.14). This is further supported by an elevated stock of non-residential construction projects already in the pipeline.

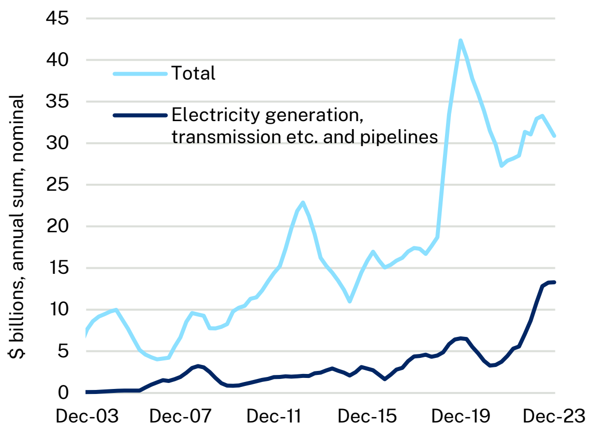
Looking further ahead, while business investment growth is expected to ease, there will be continued support from the ongoing New South Wales energy transition, which is driving significant investment in renewable energy generation (Chart 2.15). Recently announced policies by the Australian Government are also expected to help support businesses with investments in the transition to renewable energy.

Chart 2.14: NSW capital expenditure expectations



Source: ABS and NSW Treasury

Chart 2.15: Existing pipeline of private engineering construction work in NSW



Source: ABS and NSW Treasury

By contrast, public demand, which had been a strong driver of growth during the pandemic, will provide less impetus to economic growth in future years as Governments seek to improve their budget positions. This will help facilitate the transition towards more private sector driven growth in New South Wales.

In terms of the external environment facing businesses, a soft landing for the global economy should lend support to exports. That said, the outlook is more tenuous for commodities, with Chinese authorities yet to undertake sufficient support measures that will definitively stem the weakening in its property sector.

2.3 Long-term drivers of growth

Improving productivity is key to long-term economic growth

In the long run, economic growth in New South Wales will be determined by three factors:

- the size and age structure of our population
- the proportion of people actively engaged in or looking for work
- the level of productivity - that is, how efficiently we produce goods and services, given resources and effort invested.

While rapid population growth is supporting the economy in the short term, it is expected to decline as a driver of economic growth in the long term. Falling fertility rates are slowing natural population growth, which will see our population age over the next 40 years. Migration into New South Wales will become increasingly important for population growth, and for slowing population ageing, though it is not projected to fully offset these trends.

Population ageing will also lead to declining participation rates in the long-term, as higher shares of the population will move into older age groups and retire. This decline is expected to be softened by growing participation rates among women and those aged over 65.

As a result of these trends, productivity growth will become the key driver of prosperity in New South Wales. Over the last 20 years, labour productivity growth has slowed, a result that is consistent with the trend observed across most advanced economies. Declining dynamism and competition, slow technology adoption and low innovation are potential contributors in the Australian context. The *2021-22 NSW Intergenerational Report* also identified climate change as a drag on potential future productivity, including days of work lost to heatwaves and the impacts on agricultural production.

Labour productivity is determined by the personal characteristics of workers in the economy, including their health and education (Box 2.3), as well as broad economic and regulatory settings. This means that people, employers, and governments all play a role in supporting productivity growth.

As our economy evolves, new opportunities will be created. In particular, the transition to net zero and the technological transformation (including the advancement of generative artificial intelligence) present opportunities for productivity growth through improved efficiency and innovation. Risks must be carefully managed in order to reap the benefits of these transitions.

Box 2.3: Returns to health and education

Good health and a quality education enable people to thrive at home and at work. This is foundational for a strong economy. In return, a sustainable and growing economy delivers higher real wages and standards of living, and stronger government revenues that can be reinvested in delivering high quality public services.

Investments in an individual's health and education not only directly improve their wellbeing, but also add to their capacity to engage in work and their stock of human capital - the knowledge, skills and personal characteristics that make an individual more productive and determine the quality of labour. The Australian Government Productivity Commission (2023) found that in Australia, labour quality has generated around 20 per cent of labour productivity growth in recent decades.[2]

Education equips people with the necessary knowledge and tools for engaging in society and employment. It covers the whole lifespan from early childhood through to on-the-job learning.

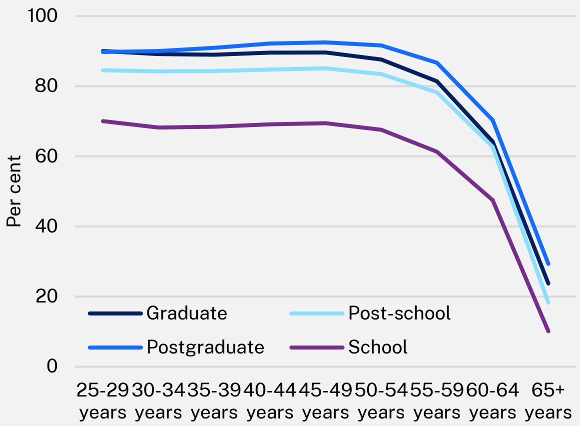
Individuals with higher educational attainment tend to have higher labour force participation, employment and wages, as well as more resilience to economic shocks (Chart 2.16).[3]

Education also provides societal benefits: a more educated workforce enables more innovation and the development of advanced, higher-value industries.

Having good physical and mental health also enables people to participate in society and contribute to the State's economy. Improved health outcomes mean people are more likely to participate in the labour force and spend less time absent from work due to illness. It also means people are more productive while they are working because they can work at their full potential.

Health and education outcomes have been shown to be linked with each other. On the one hand, good health supports a person's ability to engage in education, as well as to gain and retain knowledge more easily; on the other, there is evidence that higher levels of education are associated with greater health literacy and therefore healthier behaviour.

Chart 2.16: NSW labour force participation by 5-age group and level of educational attainment, 2021



Source: ABS and NSW Treasury

[2] Productivity Commission (2023), 5-year Productivity Inquiry: From learning to growth.

[3] Educational attainment is an incomplete measure of the knowledge and skills attributable to education.

2.4 Key risks to the outlook

Risks remain unusually elevated

Many of the risks to the outlook have not changed over the past year. The main source of uncertainties currently facing the outlook revolve around:

- the path of inflation back to central bank targets, and the resulting impact for the path of interest rates
- the potential escalation of geopolitical tensions and their impact on financial markets, trade and the global economy.

While the prospects of a soft landing for the global economy have risen, if recent elevated inflation in the United States were to persist and be replicated elsewhere, central banks may be forced to maintain tighter monetary policy for longer than currently expected.

Domestically, it is also possible that the lagged effects of higher interest rates are yet to fully play out. While some households remain resilient to higher interest rates and inflation, others are doing it tough. As real incomes rise and interest rates fall, these households may remain focused on balance sheet repair, which could constrain the recovery in consumer spending.

Abroad, geopolitical tensions have deteriorated, particularly in the Middle East. A further escalation of these tensions has the potential to weaken confidence, disrupt energy markets (contributing to inflation) and global trade, prolonging shipping times and raising freight costs. Appendix F Economic Scenario Analysis considers the economic impacts from a scenario where geopolitical tensions escalate, disrupting global trade.

Some of the other most notable risks relate to the housing market. On the downside, while house prices have so far proven somewhat resilient to higher interest rates, a deterioration cannot be ruled out given the corrosion in housing affordability. This would become more likely should the labour market weaken materially.

Conversely, it is similarly possible that recent resilience will manifest into stronger-than-expected dwelling prices, once interest rates start to fall, with positive spillovers to household consumption and dwelling investment. Stronger net overseas migration, if it were to persist, would produce a similar outcome.