

CHAPTER 9: THE ECONOMY

- ◆ The New South Wales economy performed strongly in 2007-08 with state final demand growing by 4¼ per cent, employment increasing by 2½ per cent and the unemployment rate declining to a generational low of 4½ per cent.
- ◆ Growth in the economy is projected to slow in 2008-09 under the weight of restrictive monetary policy and weaker global conditions, though Asian demand for resources will be a buffer.
- ◆ Interest-sensitive sectors such as housing will face particularly challenging conditions.
- ◆ Inflation is expected to begin easing during 2008-09, allowing monetary policy to remain on hold.
- ◆ Sources of risk to the outlook include prospects for global growth, credit markets and oil prices; domestic pressures on demand and inflation; and rainfall prospects for agriculture.

9.1 INTRODUCTION

Budget estimates reflect forecasts for the economy. Economic performance is cyclical, and state governments do not control the policy levers that influence the cycle. Other things being equal, an economic upswing improves State tax growth and the size of the GST revenue pool. Because State taxes also rely on the property cycle, however, the relationship between the economy and the budget is not straightforward.

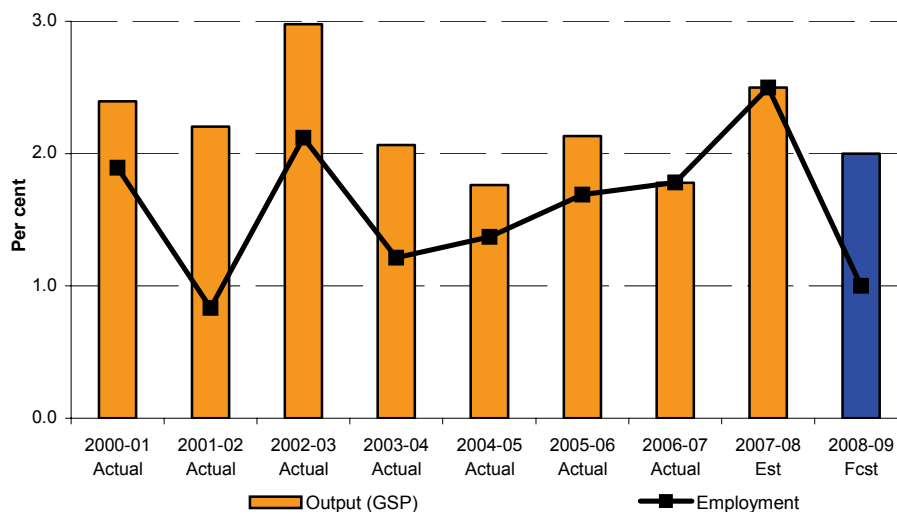
Setting aside cyclical factors, economic performance in the medium term is likely to reflect trend growth in population, participation and productivity.

This chapter reviews recent economic performance and outlines the economic forecasts underpinning the 2008-09 Budget estimates. It then assesses the risks to the economic outlook, and the sensitivity of the Budget to variations in economic parameters.

9.2 OVERVIEW

At this time last year, the economic outlook was positive. Strong world growth was expected to drive export demand and terms of trade gains. A mild US slowdown would be offset by robust growth in other world regions. Despite some emerging capacity constraints, Australian wage and price pressures were expected to be consistent with stable monetary policy. The NSW economy was expected to gain momentum, with agriculture recovering from drought, improved dwelling construction and stronger business investment.

Chart 9.1: NSW output and employment growth (annual per cent change)



Economic outcomes have differed from expectations, as the economy reduced momentum in the second half of 2007-08 following a strong first half:

- ◆ Instead of the mild slowdown assumed at budget time, the United States appears to be now in, or close to, recession. The collapse of the US subprime mortgage market had a significant impact on world financial markets especially during the first quarter of 2008.
- ◆ Asia (particularly China and India), however, maintained strong internal growth and high demand for Australian commodities.

- ◆ Rising terms of trade, high resource sector investment, and the stimulus from tax cuts tightened capacity constraints in the Australian economy during the first half. Inflation edged higher, leading to four rate rises by the RBA between August 2007 and March 2008. Consumer sentiment declined sharply in the second half, and the housing recovery came to a halt.
- ◆ In New South Wales, the drought did not break for the 2007-08 winter crops, and interest rate rises delayed further recovery in the dwelling sector. But aggregate State growth was sustained by strong employment and consumption through mid-year, and by solid growth in public infrastructure investment.

Performance in 2008-09 will be constrained by a weaker world economy, although resilient Asian demand for Australian resources will be a buffer. Output and employment growth nationally and in New South Wales are likely to slow. Tight global credit markets and domestic monetary policy may weigh against investment, while a softer job market and high mortgage costs will constrain consumption. Offsets will include income tax cuts, further strong public sector investment and improved farm conditions. Inflation will slow through the year – which may allow monetary policy to remain on hold. There are significant risks to this outlook for growth and inflation.

9.3 RECENT PERFORMANCE¹

Economic performance in 2007-08 proceeded in two distinct halves. In the first six months, demand strengthened supported by stronger terms of trade, reduced income taxes and increased Commonwealth spending. As a result, inflationary pressures increased and monetary policy was tightened. In the second half, world financial markets and global economic prospects turned sharply downward. In response to tighter monetary policy and tighter credit markets, domestic demand appears to have slowed.

NSW economic trends differed somewhat from the national pattern. At the year's outset NSW performance was modest relative to the rest of Australia with low direct exposure to the resources sector and protracted drought. By mid-year, however, State performance had begun to lift on the back of solid corporate sector performance, rising household disposable income and spending, and evidence the drought was finally nearing an end. This improvement was not sustained in the final six months.

¹ Unless otherwise indicated, the sources for statistical information in this chapter are ABS (Australian Bureau of Statistics) data releases and NSW Treasury estimates. Economic estimates are based on data available as at May 2008, which included: results to June 2007 for gross state product; to September 2007 for population; to December 2007 for state final demand; to March 2008 for consumer prices and the wage price index; and to April 2008 for employment.

At the Half-Yearly Budget Review in December 2007, the gathering strength in the economy was reflected in upward revisions to forecasts for demand, output and the labour market. Projections in this Budget reflect further upward revisions to activity in the first half, but weakening prospects for output growth in the second half of 2007-08.

Table 9.1: Revised 2007-08 estimates

(Year average percent change, unless otherwise indicated)

	2007-08 Budget	Half-Yearly Review	Current Estimate
State final demand	3½	4	4¼
Gross state product	2½	2¾	2½
Employment	1½	2	2½
Unemployment rate (year average, per cent)	5	4¾	4½
Sydney CPI (pct through the year to June quarter)	3¼	2½	3¾
Wages (wage price index, ordinary time)	4	4	3¾

Population growth accelerated to 1 per cent in the year to September 2007 from 0.9 per cent a year earlier with faster natural increase and higher overseas migration. The more timely working age population series recorded an even stronger acceleration, to an average 1.3 per cent growth in the year to April 2008 from 1 per cent a year earlier. Stronger population growth provided support for employment, consumption and housing investment.

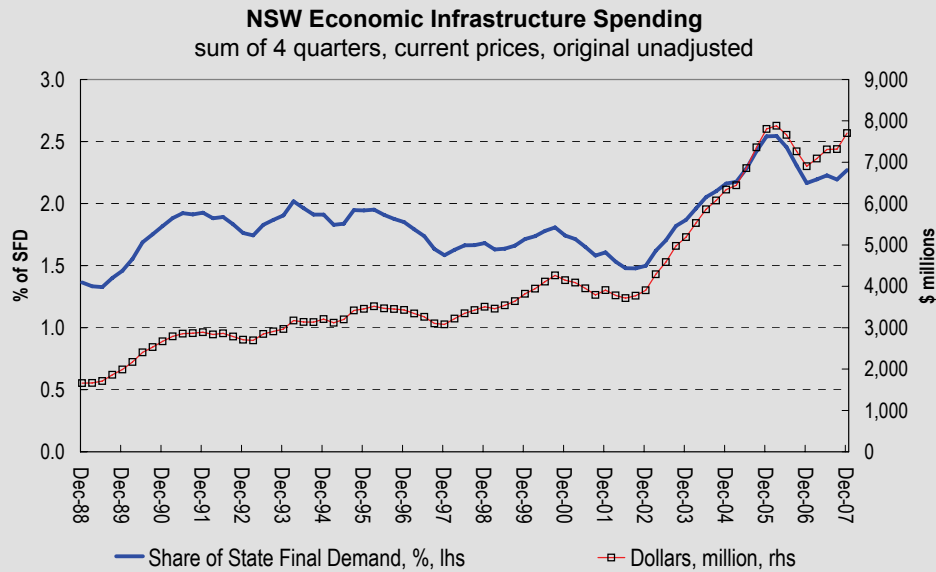
Consumer spending improved strongly in the first half of 2007-08, with annual growth averaging 4.1 per cent in the six months to December 2007, up from 3 per cent in the same period a year earlier. Consumer demand was boosted by lower taxes, strong labour market conditions, rising terms of trade and an improving share market. Consumption appeared to soften in early 2008, as interest rates were increased by the RBA to bring inflation back to the 2–3 per cent target. There were steep declines in consumer sentiment, slower growth in car sales and flatter retail turnover. Sources of consumer unease were rising interest rates, higher prices (particularly food, rents and petrol), share market losses and a stream of negative economic news from abroad.

Dwelling construction showed signs of recovery during the first half of 2007-08, with modest gains in new construction and a strong lift in alterations and additions in the December quarter. Progress seemed to falter in early 2008, with weaker trends in housing finance and dwelling approvals in response to higher interest rates and tighter credit conditions – although strong population growth, rising rental prices and very tight vacancy rates attested to strong underlying demand in the housing market.

Box 9.1: Economic infrastructure spending in New South Wales

The 2008-09 Budget estimates show a substantial near-term lift in total state capital spending. This capital spending includes “social” infrastructure (such as hospitals, schools etc) and “economic” infrastructure (such as roads, rail, harbours, water and electricity). This Box examines recent trends in aggregate economic infrastructure spending in New South Wales by the private and public sectors, as captured by the ABS Engineering Construction Survey. Private sector spending includes government initiated private public partnership projects.

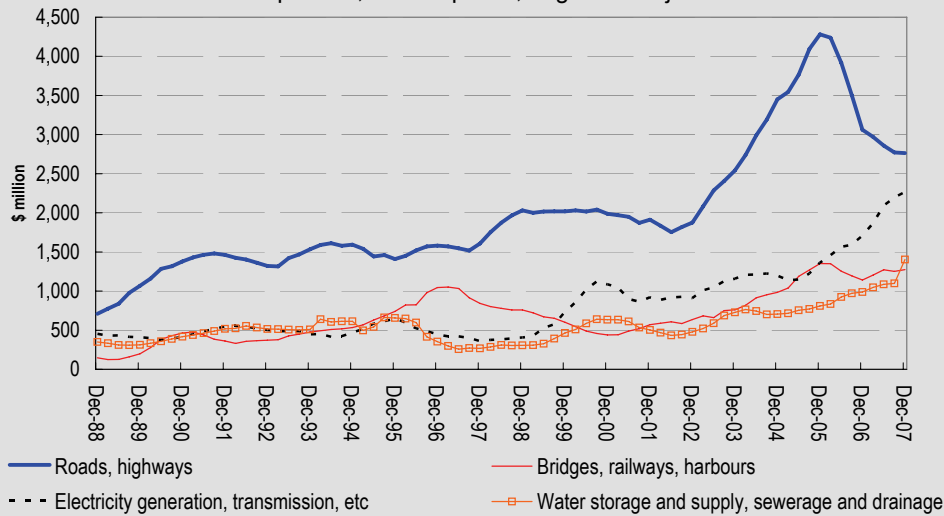
The graph shows a measure of total economic infrastructure spending namely the value of engineering construction work done on roads, bridges, railways, harbours, electricity generators and transmission, water, sewerage and drainage.



Economic infrastructure spending has increased substantially over the last five years, both in dollar terms and as a share of the economy.

Initially growth was driven by road and highway construction including the Lane Cove Tunnel, the Cross City Tunnel and Westlink M7. Following completion of these projects, aggregate spending has eased back, but remains at high levels due to a lift in electricity infrastructure spending (see chart below).

NSW Economic Infrastructure Spending
sum of 4 quarters, current prices, original unadjusted



Looking ahead, total New South Wales economic infrastructure spending should continue to remain at high levels, supported by the State's infrastructure program.

*Business investment*² increased at a strong 10.1 per cent annual rate during the first half of 2007-08, with solid contributions from both non-residential construction and equipment investment. Capital expenditure plans surveyed in December suggested investment growth would remain strong in the remainder of 2007-08. But weakening global economic prospects and tighter financial conditions during the second half of the year trimmed back these expectations, as reflected by trends in private surveys of business confidence.

Though a much smaller share of the economy than business investment, *state and local public investment* (reflecting the Government's infrastructure program) provided a solid boost to NSW economic growth in 2007-08, rising by 9.2 per cent in the six months to December 2007 compared to the same period a year earlier.

With stronger private consumption and public investment offsetting the moderate performance of dwelling investment, *State final demand* is estimated to have increased by ¼ per cent in 2007-08 – up from 2.3 per cent growth in the previous year.

² To compensate for the break in trends caused by Telstra's privatisation at end-2006, Commonwealth public sector enterprise investment has been reallocated from public to private sector for the analysis in this section.

The recovery from drought projected by the Australian Bureau of Agricultural and Resource Economics (ABARE) and the Bureau of Meteorology (BOM) in early 2007 did not eventuate. The absence of follow-up rains reduced winter crop production to the lowest since 1994-95. It also forced the suspension of irrigation water allocations and the abandonment of most summer rice production. Instead of the expected ½ percentage point contribution to GSP growth, weak rural production is likely to have detracted again from State exports and output in 2007-08.

As a major gateway for national imports, but a comparatively modest supplier of national exports, New South Wales usually records a net deficit on *overseas trade*. In 2007-08, NSW manufactured and service exports remained constrained by the rising exchange rate, while rural exports were severely affected by the drought. Annual average growth in merchandise export volumes slowed from 4.6 per cent in 2006 to 1.6 per cent in 2007. Annual growth in merchandise import volumes, by contrast, increased from 9.5 per cent in 2006 to 11.3 per cent in 2007.

Overseas trade, along with balancing items (interstate trade, inventory and statistical discrepancy), may have detracted around 1¾ percentage points from *gross state product*, which is estimated to have increased by 2½ per cent in 2007-08.

The *labour market* made stronger than expected gains, with NSW employment increasing by an estimated 2½ per cent and the unemployment rate declining to an estimated average 4½ per cent in 2007-08 from 5 per cent in 2006-07. In year average terms, employment growth to the March quarter 2008 was strongest in transport and storage, health and community services and manufacturing.

Wage pressures remained moderate during 2007-08 despite a further decline in unemployment and skilled labour shortages in some sectors. Wage pressures in the resources and infrastructure sectors did not flow on to the broader economy. Growth in the NSW Wage Price Index was 3.7 per cent through the year to March 2008 – marginally less than the 3.8 per cent increase through the year to March 2007.

Inflation, as measured by through-the-year growth in the Sydney CPI, increased from 1.7 per cent in June 2007 to 3.9 per cent in March 2008. Accelerating economic activity, particularly in the resources sector, bid up demand for labour and tightened capacity constraints in the national economy, lifting through-the-year underlying inflation³ from 2.8 in June 2007 to 4.3 per cent in March 2008.

³ Underlying inflation as measured by the average of the RBA's weighted median and the trimmed mean analytical CPI indexes.

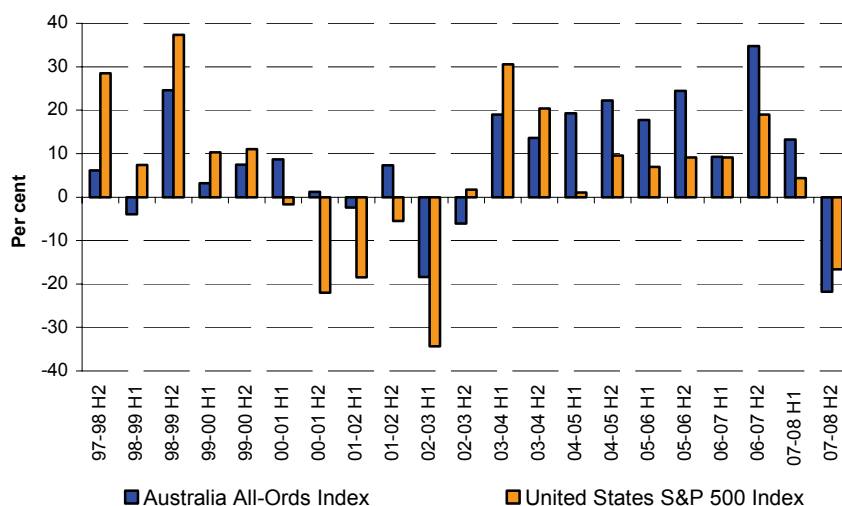
Reflecting the accelerating demand from industrialising Asian economies and some global supply constraints, world prices of tradeable goods (particularly food and energy) contributed to domestic inflation. Rising petrol prices, for example, contributed 0.7 of a percentage point to Sydney CPI inflation in the year to March 2008.

Price pressures became increasingly broad-based during the year, with 57 per cent of items in the national CPI recording more than 3 per cent growth in the year to March 2008, up from 49 per cent a year earlier. Inflation was slightly lower in Sydney than nationally, reflecting the more moderate rate of domestic demand expansion in New South Wales than in the resource states in 2007-08.

The Reserve Bank of Australia (RBA), in its May 2008 *Statement on Monetary Policy*, expects underlying inflation to peak in the first half of 2008, reflecting a projected sharp slowing in non-farm GDP growth over calendar year 2008.

In response to rising inflation, the RBA tightened *monetary policy* four times between August 2007 and March 2008, lifting the cash rate to its highest level since June 1996. The impact of monetary policy was augmented by the severe tightening in global credit conditions resulting from the US subprime mortgage crisis. The average bank standard variable mortgage rate increased from 7.3 per cent in April 2006 to 8.1 per cent in April 2007 and 9.5 per cent in April 2008. Australian long bond yields were comparatively stable, trading within a range of 5.8 to 6.5 per cent between April 2007 and April 2008.

Chart 9.2: Share price index growth (annualised six-monthly average rate of change)^(a)



(a) Data refers to half-yearly (H1/H2) averages except for the second half of 2007-08 which is based on January through to mid-May 2008.

Share prices, though volatile, improved on average in the first half of 2007-08. They declined during the second half, although there were signs of recovery in the final months of the financial year.

9.4 OUTLOOK FOR 2008-09

The economy will start 2008-09 with high inflation and tight monetary policy, offset by stimulus from tax cuts and rising terms of trade. Over the year ahead, the Australian economy will face risks and challenges. Potentially tight world financial markets and lower growth in industrialised economies will contrast with continued robust conditions in the major Asian industrialising economies. The outcome will determine whether inflationary pressures ease sufficiently to keep monetary policy on hold and whether domestic growth moderates gently or slows sharply.

With less direct exposure to buoyant Asia than the major resource States, the NSW economy is relatively more dependent upon a successful “soft landing” in North America and Europe, restoration of liquid credit markets and benign domestic monetary policy.

On balance, tight domestic monetary policy settings are unlikely to change, and economic growth is likely to slow to below trend.

WORLD ECONOMY

Global growth is expected to slow in 2008-09, although the step down will be less severe for Australia’s Asian trading partners. In its April 2008 *World Economic Outlook*, the International Monetary Fund projects world growth at 3¾ per cent in both 2008 and 2009, down from 4.9 per cent in 2007. In 2008, growth is expected to be near zero in the United States and slowing markedly in Japan and Europe. But growth will remain strong (though below the previous year) in China, India and Korea.

Table 9.2: World Economic Prospects

(Per cent change in real GDP, by calendar year)

	2007 <i>Actual</i>	2008 <i>Projected</i>	2009 <i>Projected</i>
World Output	4.9	3.7	3.8
United States	2.2	0.5	0.6
Euro Area	2.6	1.4	1.2
Japan	2.1	1.4	1.5
Korea	5.0	4.2	4.4
China	11.4	9.3	9.5
India	9.2	7.9	8.0

Source: IMF, World Economic Outlook, April 2008

AUSTRALIAN ECONOMY

Several factors will stimulate national economic demand, complicating the task for monetary policy:

- ◆ the momentum in developing Asian economies will maintain commodity prices at high levels. Contracts agreed in the first half of 2008 for principal Australian mineral exports imply further large increases in export prices, partially offset by higher import prices. For example, thermal coal producers using the Port of Newcastle won a 125 per cent increase in annual contract prices in the year that started April 1 to \$125 a ton⁴. Rising terms of trade will continue to encourage production and investment in the resource sector, while adding to real household income across the economy
- ◆ past and prospective income tax reductions will boost household spending capacity and
- ◆ favourable weather conditions and strong world grain prices, if outcomes are in line with ABARE projections, should substantially lift rural production and farm income.

⁴ *Bloomberg - 12-May-08*

Weighing against growth, and providing grounds for monetary policy moderation, are:

- ◆ the severe and potentially protracted slowdown in the United States, given the close historical relationship between economic trends in the United States and Australia. Financial market contagion, rather than trade, is the principal channel through which cyclical shocks are now transmitted from the United States to Australia
- ◆ continued uncertainty in global credit markets may remain an impediment to capital raising for investment and a source of additional operating cost to business and finance
- ◆ the high and rising world price of petroleum (affecting production costs and consumer budgets) and
- ◆ the significant tightening in monetary policy in the last two years, amplified by the global credit market crisis, is already restricting demand and dampening business and consumer confidence, although the full lagged effect is yet to flow through the economy.

On balance, the Australian economy is expected to slow in 2008-09. If so, inflationary pressures are likely to ease, removing the need for further monetary policy intervention.

NEW SOUTH WALES ECONOMY

Challenges for the NSW economy in the year ahead are likely to be greater than for some other states. This reflects the State's relative exposure to interest rates due to higher house prices and household gearing. It also reflects the State's industry structure with more reliance on property and financial services industries than on resource industries, and greater exposure via services and manufacturing to competitiveness losses from exchange rate appreciation.

NSW economic output (GSP) growth is expected to slow from 2½ per cent in 2007-08 to 2 per cent in 2008-09. State final demand growth is expected to slow more significantly from 4¼ to 2½ per cent. Household consumption and business investment growth will be more subdued, but public sector investment will remain strong, and net exports will improve.

Table 9.3: Economic performance and outlook

(Year average per cent change, unless otherwise indicated)

	2006-07 Outcomes	2007-08 Estimates	2008-09 Forecasts
New South Wales			
State final demand	2.3	4¼	2½
Gross state product	1.8	2½	2
Employment	1.8	2½	1
Unemployment rate ^(a)	5.0	4½	4¾
Sydney CPI ^(b)	1.7	3¾	3
Wage price index	3.8	3¾	4
Australia			
Non-farm GDP deflator	4.6	5	6¾
Ten year bond rate ^(a)	5.8	6¼	6¾

*(a) Year average, per cent**(b) Per cent through the year to June quarter*

Private consumption growth will slow in 2008-09, as suggested by lower consumer confidence and slower retail spending growth recorded in the second half of 2007-08⁵. Household budgets will be constrained by high interest expenses and high prices (including for petrol). Above-trend (though moderating) inflation will make it more difficult to maintain real spending. Partially offsetting these factors will be reduced income taxes as well as real income gains from Australia's higher terms of trade.

Dwelling investment will remain under pressure in 2008-09. Underlying demand pressures (rising population growth supported by high overseas migration, historically low rental vacancies and strong growth in rental prices) remain extremely strong. There is no evidence that the share market correction in early 2008 led investors to rebalance portfolios toward property. On the down side, high interest rates, fears of further rises and concern over job security are likely to deter owner-occupiers and investors. On balance, dwelling construction growth is likely to be modest in 2008-09.

⁵ This is consistent with the slowdown in growth of GST receipts projected by the Australian Treasury for 2008-09.

Box 9.2: The NSW economy: changing structure and challenges

New South Wales has the most diversified economy of the Australian states. The relative importance of various industries to the NSW economy means that the recent commodity price boom and financial market instability pose greater challenges relative to other states.

The tables below show, respectively, industry shares of real GSP and employment over the last 15 years. In New South Wales the mining sector's output share has been fairly stable, averaging about 2.4 per cent. This compares to an average of 8.2 per cent for Queensland, 29.3 per cent for Western Australia and 7.3 per cent nationally.

Share of NSW GSP (Gross Value Added Basis, cvm)						
5 Year Average	Agriculture	Mining	Manufacturing	Finance & Insurance	Property & Business	Other
1993-97	2.1%	2.5%	13.2%	8.9%	11.4%	62.0%
1998-02	2.1%	2.4%	11.5%	9.6%	12.7%	61.8%
2003-07	1.6%	2.3%	10.5%	9.9%	14.0%	61.7%

Source: Australian National Accounts: State Accounts, ABS Cat No 5220.0

In contrast, the finance & insurance sector's output share has been increasing in New South Wales, now rivalling that of manufacturing and considerably exceeding the national share average of 6.9 per cent. The same holds for the property & business sector, whose output share has been increasing and is higher in New South Wales than nationally.

Industry Share of NSW Total Employment						
5 Year Average	Agriculture	Mining	Manufacturing	Finance & Insurance	Property & Business	Other
1993-97	4.3%	0.9%	13.9%	4.7%	9.3%	66.8%
1998-02	4.3%	0.6%	12.1%	4.7%	11.9%	66.4%
2003-07	3.0%	0.6%	10.4%	4.9%	12.7%	68.3%

Source: Labour Force, Australia, Detailed, Quarterly, ABS Cat No 6291.0.55.003

The structure of the NSW economy means that it faces different challenges from global shocks. For example, the direct impact of the commodity price boom is likely to be more muted in New South Wales than in the resource states and nationally.

Tighter financial market conditions and less availability of credit will have a more negative effect in New South Wales given the larger finance & insurance sector, with possible flow-on to the larger property & business services sector.

Business investment is expected to grow more moderately in 2008-09 after a strong performance in 2007-08. Initially, the December quarter 2007 *Private New Capital Expenditure Survey* pointed to another strong year of growth in 2008-09, and this was corroborated by the large pipelines of work yet to be done that were reported in building and engineering surveys. Prospects for business investment moderated subsequently as global credit conditions tightened and the outlook for global growth deteriorated. Business surveys in the final quarter of 2007-08 reported sharp falls in new orders and business confidence. While some investment (particularly in infrastructure and resources) remains “locked in” to large multi-year projects, elsewhere companies are likely to trim back investment plans, delay start-ups and slow implementation to adjust to weaker demand and higher financing costs. Therefore, the rate of business investment growth is projected to slow by about half in 2008-09.

Public sector investment will continue to expand strongly, supported by increased State infrastructure spending, as discussed in Budget Paper No. 4 *Infrastructure Statement*. The share of state and local public investment in total state final demand (3.1 per cent) was less than one-quarter that of private business investment (12.9 per cent) in calendar year 2007. Thus, even with the strong further increase expected in 2008-09, the State’s infrastructure program will not be a significant contributor to inflationary pressures.

Net exports performance should improve in 2008-09. Exports growth will be assisted by an assumed farm sector recovery from the drought, high world grain prices and by continued strong North Asian demand for thermal coal – which has seen NSW export prices more than double (in US\$ terms) in recent contracts. The strong Australian dollar, however, will continue to restrain growth in non-resource exports. Slower growth in consumer spending and business investment will moderate the growth of imports.

The rural recovery is expected to help New South Wales maintain GSP growth at a reasonable rate in 2008-09 despite a near halving of the growth rate of *state final demand*. The contribution of improved agricultural production to jobs growth is unlikely to be as strong as its contribution to GSP. Therefore, NSW *employment* growth is likely to slow from 2½ per cent in 2007-08 to a below-trend rate of around 1 per cent in 2008-09. The unemployment rate at 4¾ per cent will remain well below the 5¾ per cent average of the previous decade.

Wage growth, as measured by the Wage Price Index, is expected to remain around 4 per cent in 2008-09. Slowing employment growth should trim wage competition for skilled labour and tax reductions should moderate calls to compensate for recent cost of living rises.

Consumer price inflation, as measured by through-the-year change in the Sydney CPI, is expected to slow from 3¾ per cent at June 2008 to 3 per cent at June 2009. Inflation in Sydney will remain lower than the national average, reflecting relatively subdued economic conditions at the State level. Slowing demand and increased supply should see inflation return within the RBA 2–3 per cent target range.

Even with the assumed slowing in demand, there are upside risks to the outlook for inflation. One is higher global commodity prices. Another is the danger that recent above-trend CPI increases might become embedded in expectations affecting future price and wage setting behaviour. These factors might delay the assumed slowdown in inflation. Downside risks would include a sharper slowing in domestic demand.

MEDIUM TERM OUTLOOK

Prospects for the NSW economy in the first few years beyond 2008-09 will depend on the strength of the global economy, the business cycle, domestic policy settings and productivity trends. Because these factors cannot be accurately predicted more than a short period ahead, the budget estimates beyond 2008-09 are generally based on economic parameters reflecting expectations for their average performance during the out years of the budget.

Table 9.4: Economic parameters beyond 2008-09

(Per cent change, year average, unless otherwise indicated)

	<i>Medium Term</i>
Gross state product	3¾
Population	1
Employment	1¼
Sydney CPI	2½
Wage price index	3½
Ten year bond rate (year average, per cent)	5¾

9.5 ECONOMIC RISKS

Budget estimates rely on assumptions, forecasts and assessments for the economy and other factors⁶ made when the budget was prepared⁷. This section considers the sensitivity of budget outcomes to changing economic circumstances.

Downside risks to the economic outlook for 2008-09 include a steeper than expected downturn in the United States, tighter global credit, higher world oil prices and delayed recovery from drought. Upside risks would include domestic demand proving stronger than expected despite the current tight stance of monetary policy.

These are some of the substantive risks to the outlook that were identifiable at the time of the Budget's preparation. History suggests that critical factors for economic and fiscal outcomes often were unanticipated or deemed improbable when the forecasts were assembled.

United States economy

The United States economy weakened sharply during 2007 and 2008 as ripples from the housing downturn and related subprime mortgage crisis began to undermine aggregate output growth first within the United States, and then internationally. Despite strong policy intervention (US cash rate cuts from 5¼ per cent in August 2007 to 2 per cent in April 2008, an auction facility to provide short term market liquidity, selective mortgage debt relief, a US\$152 billion fiscal stimulus package and direct intervention for a failing investment bank), the economic slowdown deepened in the first half of 2008.

IMF forecasts for US growth in 2008 were trimmed from 2.8 per cent in July 2007 to 0.5 per cent in April 2008. In April the US Federal Reserve (Fed) estimated that real gross domestic product was flat or slightly down in the first half of 2008 and although activity was expected to strengthen in the second half of 2008, the risks remained to the downside.⁸

In comparison to recent previous shocks (the Asian financial crisis of 1997 and the dot-com bubble of 2000-01) the drivers of the current crisis (a housing downturn, and a deleveraging in financial markets) are yet to run their course and could prove much more difficult and costlier to reverse. Given US influence on global economic and financial performance, if the US downturn proved deeper and more protracted than the Fed forecast, this would dampen growth in the Australian and NSW economies in 2008-09.

⁶ Refer to Chapter 1 for discussion of other risks to budget outcomes.

⁷ Key source publications and their release dates are reported in footnote 1 to this chapter.

⁸ Federal Reserve Chairman Ben Bernanke, The Economic Outlook, testimony to US Congress, April 2, 2008

Credit Markets

In the aftermath of the US subprime mortgage crisis, credit around the world has become harder to secure and much more costly to finance. While financial markets have stabilised somewhat after the first quarter 2008, conditions still remain difficult and uncertain. As Australia's financial capital, New South Wales has special sensitivity to conditions in this sector (refer Box 9.3).

World oil prices

World oil prices climbed by over 80 per cent during 2007-08 from US\$71 per barrel of West Texas Intermediate at end June 2007 to over US\$130 per barrel in May 2008. Factors behind this rise were the depreciation of the US dollar, strong demand (particularly the rapid growth in vehicle usage in industrialising Asian economies) and supply constraints (both political and economic). A speculative run-up in commodity prices in response to rising global inflation may be a further factor. The International Energy Agency (IEA) forecasts that petroleum demand growth will slow in 2008 due to the global downturn, but this has not yet been reflected in prices. Oil futures markets in May 2008 indicate that traders expect the price of crude to remain above US\$120 per barrel through June 2009.

While a stronger A\$ partly buffered Australian consumers, the average Sydney price of unleaded petrol increased from 126 cents per litre in April 2007 to 144 cents per litre in April 2008⁹, and automotive fuel contributed 0.7 points of the total 3.9 percentage points increase in the Sydney CPI through the year to March 2008. As an important input to production and distribution systems, petroleum prices have a pervasive effect on costs across the economy.

The risk of further oil price increases and volatility remains high.

⁹ Source: Australian Automobile Association.

Box 9.3: Global credit markets

The global financial system came under strain following the US housing downturn and subprime mortgage collapse, which had a domino effect on other financial instruments and institutions. Liquidity problems, announced write-downs and fear of undeclared exposures caused a broad based repricing of risk and unwinding of leverage. Credit conditions tightened, interest rate spreads widened, and key segments of credit markets virtually closed.

The Australian financial system has coped better with the recent strains than have the financial systems of many other countries, although many private and some public entities have reported significant losses. The banking system generally remains profitable and well capitalised, with minimal direct exposure to US subprime problems, and with higher quality and less risky assets. The major banks have remained able to access wholesale funding, albeit at higher spreads and shortened maturities. Rising credit risk and default rates, however, have led to increased bad debt provisioning.

Banks have passed on some of their increased costs to clients, keeping credit available but at a higher price. The effective cost to borrowers has risen by more, as non-bank lenders (reliant on securitisation funding) have been forced to leave the market, narrowing competition and reducing discounts.

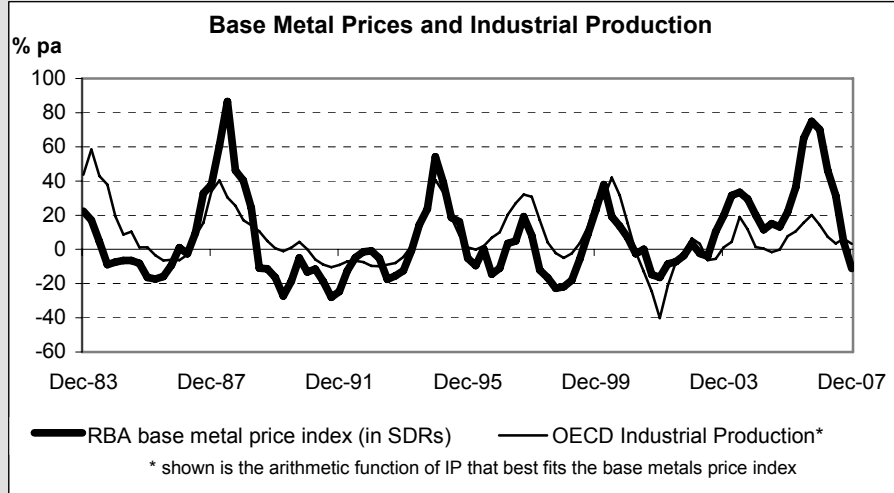
Corporate bond issuance has become almost non-existent. Short-end investors have been reluctant to rollover asset-backed commercial paper, while longer term asset-backed market issuance is extremely low and at elevated spreads. Initially businesses were able to turn back to banks for funding (re-intermediation) and total corporate debt growth remained strong. Business credit expansion appears to have slowed in the second half of 2007-08, however, in response to higher funding costs, tighter borrowing conditions and weaker earnings prospects.

Costs to households have been affected by tighter monetary policy, higher global market costs, and loss of discounting. NSW households are highly geared (interest payments consumed 13.6 per cent of gross household disposable income in 2006-07) and exposed to financial conditions (the NSW housing loan arrears ratio at end-2007 was more than triple the average of other States, and it was up sevenfold from end-2003). This implies relatively greater pressure on NSW consumption and dwelling investment.

Tight credit will remain a constraint on OECD economic growth in 2008-09, and a risk for global recession. The most likely risk to Australia is a prolonged phase of tighter and costlier credit which slows, but does not reverse, economic expansion. Since Sydney is the financial centre of Australia and NSW households are the most highly geared, the domestic impact of tighter global credit will continue to fall disproportionately on New South Wales.

Box 9.4: Commodity bubble?

The strong economic performance of the Australian economy during the last five years is attributable in part to robust export markets, with the RBA Commodity Price Index increasing by 106.4 per cent in Special Drawing Rights (SDR) terms between March 2003 and March 2008, and contracts in early 2008 locking in further large gains for 2008-09.



While the rise of industrialising Asia provides a strong base for commodities in the longer run, they like other cyclical assets do carry significant short-run market risk. First, history suggests that the global slowdown projected by the IMF for 2008 will see a steeper slowdown in industrial production (IP) growth, which is closely correlated with commodity price movements (refer figure above), especially those for Australian metal exports. Second, some analysts argue that the recent surge has lifted commodity prices well beyond what can be supported by economic fundamentals, as speculators buy into commodities as a hedge against inflation and the depreciating US\$, and low US interest rate policy reduces the financial cost of holding them. After the “dot-com” boom, and the securitised housing debt boom, the “next big thing” today is commodities.

Australia is highly geared to the commodity cycle. If commodity prices fell, this could reverse gains in Australia’s terms of trade, weaken the exchange rate, and erode real household incomes.

Strong domestic demand

After 16 years of continuous expansion, and now boosted by the resources boom, capacity constraints in the Australian economy have begun to tighten and inflation has begun to lift. Inflation moved well above the top of the 2–3 per cent RBA target range in the March quarter 2008. In its May 2008 *Statement on Monetary Policy* the RBA projected inflation will remain above the target band for the next two years.

This Budget forecasts a substantial slowdown in national domestic demand and employment and no increase in wage pressures in 2008-09. On that basis, inflation is projected to ease back to the top of the RBA target band by the end of the financial year, allowing monetary policy to remain on hold. Moderation in interest rates is crucial to the resumption of housing investment growth in NSW, and to the maintenance of NSW consumer spending.

Strong domestic demand and tight capacity constraints (and tight global markets for food and energy) contributed to a sharp rise in inflationary pressures during 2007-08, and a response from monetary policy. To date these pressures have mainly been contained within the rapidly expanding resources and infrastructure sectors. These pressures could gain momentum, however, if changed inflationary expectations began to influence general wage settlements. There is a risk that national domestic demand might again exceed expectations due to a faster than anticipated recovery in world growth, further terms of trade gains or a step-up in wage pressures. In that case, a further monetary policy response would be almost inevitable.

Two risks are operating in tandem. On one side, excess demand could strain against available capacity, particularly during the first half of 2008-09 before the full weight of previous monetary policy tightening takes effect. This could trigger an early monetary response, possibly in the first six months of the financial year. On the other side, recent large CPI increases could gradually become entrenched in expectations of labour and business decision-makers. Evidence might be slow to emerge, leading to gradually rising pressure on wages and prices. This could trigger a delayed monetary response, possibly in the second half of 2008-09.

Drought

Normal weather conditions are expected in 2008-09, in line with Bureau of Meteorology (BOM) climate projections. In its three-month rainfall projection in April 2008, the BOM anticipated above-average rainfall for northern New South Wales, with average conditions in the remainder. Over 70 per cent of the State remained in drought or marginal in May 2008. With ground moisture levels still low, dam storage depleted and river systems severely degraded, restoring agricultural production requires heavy and sustained rainfall. The BOM has projected an end to above-average rainfall (a so-called La Niña episode) by July, implying drier conditions in the year ahead. While agriculture directly accounted for less than 2 per cent of State output in 2006-07, the sector's volatility in response to drought, and the flow-on to agricultural supplier and user industries, can appreciably affect aggregate State economic performance.

SENSITIVITY OF THE BUDGET TO ECONOMIC PARAMETERS

A guide to the sensitivity of budget expenses and revenues to variations in economic parameters is provided in Table 9.5.

The table gives a 'rule of thumb' measure of the direct impact on the Budget of a change in a given parameter. In each case, the analysis presents the estimated effects of a change in one economic variable, and does not capture the linkages between economic variables that characterise changes in the economy. The table excludes possible policy responses. Changes are assumed to be uniform across the general government sector and across the budget year.

Revenues are sensitive to factors affecting revenue bases (such as the value and volume of property and motor vehicle sales, employment and earnings), profits of public enterprises, investment returns and household consumption (and its influence on GST revenue).

The main State taxes – payroll tax and transfer duty – are sensitive to economic factors. Employment levels and wage rates affect payroll tax collections. Transfer revenue depends on property market activity, with dwelling transactions accounting for about three-quarters of such revenue¹⁰. Many factors (including monetary policy, Commonwealth tax arrangements, unemployment and trends in alternative asset markets) contribute to fluctuations in property turnover.

The arrangements for Commonwealth general purpose and specific purpose payments to the States are described in Chapter 8.

¹⁰ *Non-residential property transactions have far greater variation in size and timing than dwelling transactions. Due to this lumpiness in non-residential transactions, Table 9.5 provides estimates only for the dwellings component.*

Table 9.5: Sensitivity of fiscal aggregates to changes in economic parameters, 2008-09

(Effect of a one percent increase, unless otherwise indicated)

<i>Parameter</i>	<i>Effect on the 2008-09 Budget Result (\$m) ^(a)</i>
A. Factors affecting tax revenue	
Dwelling sales (price or volume)	37
Motor vehicle sales	9
Private sector employment	74
Private sector wages	75
Household disposable income	13
B. Factors affecting grant revenue	
Household consumption ^(b)	130
C. Factors affecting expenses	
Public sector wages and salaries ^(c)	-219
Prices of goods and services	-101
Interest rates ^{(d), (e)}	-5
<i>Effect on 2008-09 Net Financial Liabilities (\$m) ^(f)</i>	
D. Factors affecting Superannuation Liabilities	
Public sector wages and salaries	-180
Sydney CPI	-210
Investment return ^(d)	220
Discount rate ^(d)	4,150
<i>(a) A positive effect (e.g., from increased dwelling sales) improves the budget result, while a negative effect (e.g. from increased public sector wages) weakens the budget result.</i>	
<i>(b) Estimated GST receipts are \$13 billion for 2008-09.</i>	
<i>(c) Takes into account the effect of wages and on-costs (including leave liabilities) and adjusts for areas where there are existing agreements such as for Teachers and Police, which are due to expire in December 2008 and June 2009 respectively.</i>	
<i>(d) Effect of a one percentage point increase in the indicated factor (discount rate, interest rate, or rate of return).</i>	
<i>(e) Excluding the impact of actuarial adjustment to net financial liabilities (NFL).</i>	
<i>(f) A negative effect (e.g. higher public sector wages) increases NFL (weakens the financial position); while a positive effect (eg. improved investment returns) reduces NFL (improves the financial position).</i>	

Expenses are less sensitive than revenues to economic parameters. Expenses are significantly affected by public sector wage outcomes and to a lesser extent by changes in the prices of goods and services purchased by government. Lower levels of general government net debt have greatly reduced the budget's exposure to interest rate fluctuations. The maturity profile of the State's debt portfolio, moreover, limits the immediate impact of interest rate rises.

Net financial liabilities can be affected by accounting adjustments as well as operating results. With the introduction of the new Australian Equivalents to International Financial Reporting Standards (AEIFRS) accounting standard AASB119, superannuation liabilities must be recalculated at the end of each year using a market-determined discount rate. This can lead to significant fluctuations in the general government sector's unfunded liability position.