

Chapter 2:

THE ECONOMY

2.1 Introduction

2.2 Economic Trends and Outlook

2.3 Alternative Budget Scenarios

2.1 INTRODUCTION

Both the revenue and the outlay sides of the Budget are affected by conditions in the New South Wales and Australian economies. This chapter reviews the recent performance of these economies, and provides forecasts for the economic variables that underlie the 1998-99 Budget.

The expectation for 1998-99, as summarised in Figure 2.1, is for slightly slower growth in both national and State output compared with 1997-98. Average national employment growth is expected to be slightly stronger but not enough to make substantial inroads into unemployment.

In the following two years, growth in the economy and in employment are expected to increase to about 3½ - 4 per cent and 2 - 2½ per cent respectively. New South Wales is expected to experience slightly above average growth during this time. Annual inflation is expected to increase, returning it to the Reserve Bank's target range in 1998-99 and may move slightly higher again during the succeeding two years.

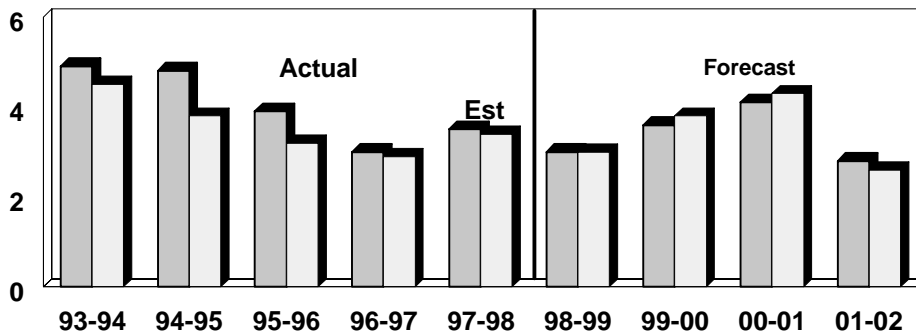
Economic forecasts are always subject to uncertainty, and therefore subject to a number of caveats. The qualifications below should be borne in mind when interpreting the forecasts contained in the next section.

- Only partial data was available for the preceding year when forecasts were being prepared. National accounts data, for example, was available only for the first half of 1997-98, when forecasting 1998-99.
- The forecasts are subject to a number of data related issues -
 - Much of the data that influences the forecasts is subject to revision. From 1998-99, the ABS will implement a new System of National Accounts which will to some extent alter the record of past and future trends in economic growth.
 - The quality of State economic data is significantly poorer than National Accounts data. This led the ABS to discontinue producing quarterly Gross State Product (GSP) estimates. No annual data will be released before the next century. Therefore all GSP data in the Budget (and all ratios to GSP) must be treated as estimates.
 - The ABS will adopt a changed definition of consumer price inflation from 1998-99 which will exclude mortgage interest charges. Hence trends in the Consumer Price Index after June 1998 will not be directly comparable with trends prior to that date.
- The forecasts are significantly influenced by assumptions regarding events which are themselves very uncertain, such as the outlook for the Asian and world economies, future wages outcomes and the industrial relations climate, and the Commonwealth Government's fiscal strategy.

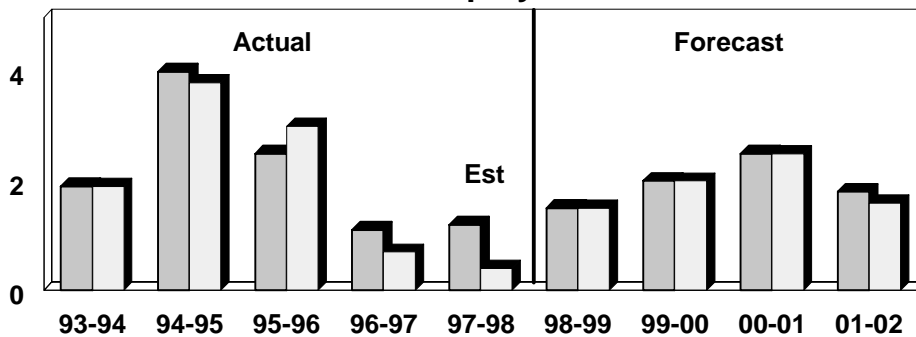
In addition, the relationship between the economy and Budget outcomes is imprecise, and therefore the implications of changes in the economic forecasts for the Budget cannot be precisely determined.

Figure 2.1
Key Indicators
 Percentage Changes

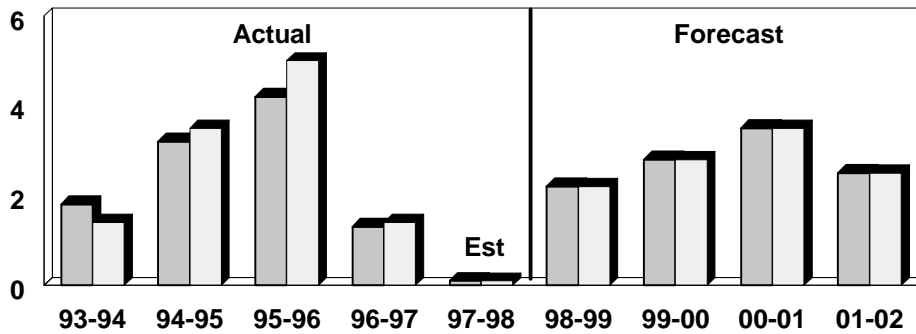
Gross Domestic Product



Employment



Consumer Price Index



■ Australia □ New South Wales

2.2 ECONOMIC TRENDS AND OUTLOOK

Given the timing of this Budget much of the information utilised in this section only covers the period to the end of the December 1997 quarter. More recent data has been used where available.

RECENT PERFORMANCE OF THE AUSTRALIAN AND NSW ECONOMIES

Real national Gross Domestic Product (GDP(I)) grew by 3.1 per cent in calendar 1997, down from 3.7 per cent in the preceding year. Growth was slower in December quarter 1997 following strong advances in the preceding two quarters. Partial indicators for the March 1998 quarter suggest that dwelling construction and business investment remained strong, but employment growth was slower. Business and consumer surveys reported a more pessimistic outlook due to the weaker economic prospects for Asian partner countries.

New South Wales' GSP growth in 1996-97 of 2.9 per cent was in line with the national average. Growth in State Final Demand (SFD) increased from 3.3 per cent in calendar 1996 to 3.7 per cent in calendar 1997, with somewhat slower growth in government consumption and business investment offset by higher private consumption, dwelling construction, and public sector investment. For 1997-98 as a whole, SFD is likely to increase by 5½ per cent while GSP can be expected to increase by 3½ per cent, similar to national GDP growth.

Labour Market

National employment growth slowed from 2½ per cent in 1995-96 to 1 per cent in 1996-97, and remained at 1 per cent for the first three quarters of 1997-98. The shift from full time to part time work continued, so that growth in effective hours worked was less than growth in number of persons employed. For 1997-98 as a whole employment growth is expected to average 1¼ per cent, but a fall in labour force participation will nonetheless allow a half a percentage point decline in the national unemployment rate.

Employment growth in New South Wales was somewhat more moderate than nationally, declining from 3 per cent in 1995-96 to ¾ per cent in 1996-97 and easing slightly lower during the first three quarters of 1997-98. By sector, the largest gains in NSW employment during the first nine months of 1997-98 were achieved in Property and Business Services, in Agriculture, Health and Community Services. The sectors recording the greatest declines were Finance and Insurance, Government, Retail Trade, and Education.

New South Wales employment increased by 20,100 in April 1998, bringing the State's unemployment rate down to 7.2 per cent. This was the lowest unemployment rate recorded in New South Wales since 1990, and it was 0.7 of a percentage point lower than the 7.9 per cent national average unemployment rate. The State's twelve-month average unemployment rate in the year to April 1998 was 7.8 per cent compared to 8.4 per cent nationally.

Wages

The growth in national adult weekly ordinary time earnings (AWOTE) remained steady at 4 per cent per annum in calendar years 1996 and 1997, with a sharp rise in September 1997 offset by a very moderate result for December. AWOTE growth remained at 4 per cent through the year to the March quarter. There was a significant deceleration in the pace of wage growth in Federal enterprise bargaining agreements during the first half of 1997-98. The Australian Industrial Relations Commission (AIRC) Safety Net Review in April 1998 provided increases of between \$10 and \$14 per week (equivalent to 4 per cent at the minimum wage rate) to workers not having access to other mechanisms to secure wage increases.

Wage growth in New South Wales averaged 3 per cent in calendar year 1997 (and 2.9 per cent in the year ending March 1998), down from 4.3 per cent in calendar year 1996.

Prices

Inflation as measured by the headline Consumer Price Index (CPI) slowed from 2½ per cent in calendar year 1996 to ¼ per cent in calendar year 1997. CPI growth was negative through the year to March 1998 and is expected to average zero in financial year 1997-98. The slowdown was sustained by declining mortgage interest rates due to monetary policy easings in 1996-97 and competition among lending institutions. A stronger exchange rate through the first half of 1997 helped restrain import costs, as did lower world petroleum prices and moderation in wage pressures.

The “underlying” CPI (which excludes mortgage interest rates, petroleum and various other items) also moderated its growth from 2.7 per cent in calendar year 1996 to 1.7 per cent in 1997 and 1½ per cent (forecast) for financial year 1997-98 as a whole.

The rate of headline inflation in New South Wales tended to track developments at the national level, averaging ¼ per cent in calendar year 1997 and zero per cent (forecast) for financial year 1997-98.

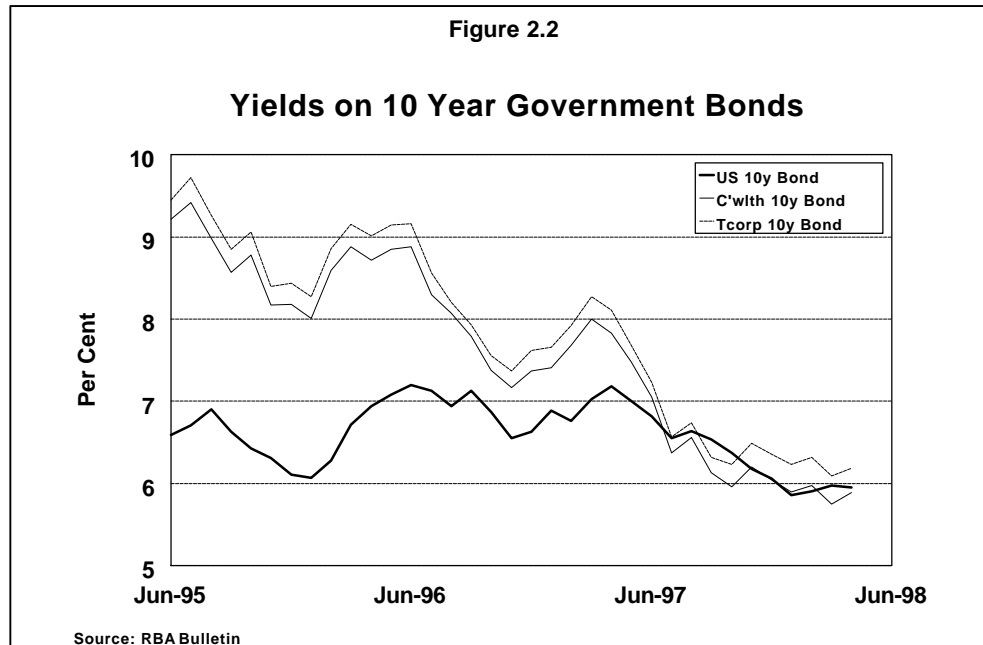
Balance of Payments and Exchange Rates

Australia’s current account deficit narrowed from \$21.9 billion (4½ per cent of GDP) in 1995-96 to \$17.7 billion (3½ per cent of GDP) in 1996-97. This reflected lower interest rates, a stronger exchange rate, and a substantial improvement in Australia’s terms of trade (the ratio of export prices to import prices) – factors which offset a doubling in the real growth of imports over the same period. The improvement also reflected a sell-off of RBA gold reserves.

In 1997-98 the current account deficit is expected to widen once again, to around \$24.5 billion or 4.5 per cent of GDP, reflecting a decline in exports (particularly net tourism receipts), a weaker exchange rate, and continued growth in imports responding to strong domestic demand conditions.

Interest Rates

Monetary policy was held steady during 1997-98. There was little sign of inflationary pressures necessitating tighter policy, while at the same time domestic demand growth seemed strong enough to discount the need for further policy easing. There was concern not to further complicate the unfolding Asian financial crisis.



Australian long bond rates declined steadily from March 1997 through the first quarter of 1998. This reflected falling demand in world capital markets, benign domestic inflationary conditions, reduced government deficit financing requirements, sales of public assets to retire debt, and a movement of funds out of countries most exposed to the Asian financial crisis. The margin between Australian and United States bond yields narrowed (and occasionally reversed) during 1997-98 in reflection of favourable domestic financial trends.

Revisions to 1997-98 Budget Forecasts

The expected outcomes for 1997-98 are little different from Budget projections a year ago.

- Expected GDP growth has been reduced from $3\frac{3}{4}$ per cent to $3\frac{1}{2}$ per cent, reflecting higher than expected domestic demand, offset by weaker than expected net exports.
- NSW GSP is still expected to grow at about $3\frac{1}{2}$ per cent because the structure of the New South Wales economy is more reliant on domestic demand, and less reliant on exports, than other States such as Queensland and Western Australia.
- However the NSW unemployment rate is expected to average $7\frac{3}{4}$ per cent, the same as forecast last year.

- Expected Sydney CPI inflation has been revised downward to zero per cent from 2 per cent originally forecast, to reflect the much lower than expected inflation performance to date.

Estimates for the 1997-98 Budget outcomes are based on these expectations for the economy.

MEDIUM TERM PROSPECTS FOR THE NSW ECONOMY

The economic projections for the Budget year and the three forward years need to be considered in the context of some noteworthy characteristics of the NSW economy. These characteristics have significant implications for the scope for economic growth in New South Wales in the medium term compared to that of other States.

Abstracting from cyclical factors, trend NSW GSP growth has been about 0.4 percentage points less than national GDP growth since State Accounts data was first published for 1984-85¹. Over the period the growth in GSP in New South Wales averaged 2.9 per cent compared to 3.3 per cent nationally. NSW average per capita GSP growth (a better measure of welfare) was 1.7 per cent, just under the national average of 2.0 per cent.

There are no compelling reasons to expect recent trends to change over the next few years, with the possible exception of the economic impacts of the 2000 Sydney Olympics.

- The fact that New South Wales accounts for around one third of the national economy makes it inevitable that the performance of the State economy will be close to that of the national economy.
- New South Wales, as the first of the Australian colonies, has a more mature economy than most of the other States. An important repercussion is that there is less scope for significant additional exploitation of natural resources in New South Wales.
- A consequence of the stage of the State's resource development is that New South Wales does not benefit from growing world demand for some commodities to the same extent as Queensland, Western Australia and the Northern Territory in particular.
- Nevertheless, some of the rapid growth in commodity sectors in other States produce benefits for New South Wales that are not reflected in State Accounts output or income measures. Much of the return to Australian capital that is invested in the resource sectors in other States accrues to New South Wales' residents. This is demonstrated by ABS estimates of higher household income in New South Wales than the national average, which take account of income flows interstate and overseas.

¹ Given the difficulties in compiling the State Accounts, annual differences of this magnitude are generally not significant, although over a 10 year period such a difference consistently would be significant.

- Overall, the industry structure of the NSW economy is the most diverse of all of the States, and also closest to that of the national average. Standard and Poor's have commented that *NSW has a mature and well diversified economy that contributes about 34% of Australia's gross domestic product, and an economy that exports about one-third of its output either overseas or interstate. With the agricultural and mining sectors being proportionately smaller than in other states, the NSW economy is less exposed to commodity cycles*². This has the advantages of reducing the sensitivity of the NSW economy to external shocks, lowering the volatility of State output and income, and helping to ensure that growth in the State tends to be fairly widely spread rather than concentrated in particular sectors. However this structure also tends to limit the extent to which aggregate State growth can be pulled along by fast growth in any one sector.
- Annual population growth in New South Wales has averaged about a quarter of a percentage point below Australia for the last 25 years due to a combination of a relatively low rate of natural population growth, and net interstate emigration. The ABS projects³ that New South Wales' share of the national population will continue to decline over the next half century (though clearly a large degree of uncertainty is attached to such long-run projections). The ABS projects declining state shares for Victoria, South Australia, and Tasmania which will be offset by increasing shares for Queensland, Western Australia, Northern Territory and Australian Capital Territory.
- In the long run, the growth of an economy is closely correlated to its population and productivity growth. On the one hand, additions to population provide an additional source of output demand, and on the other they increase the productive capacity of the economy. However, of more importance is the fact that per capita growth is not affected in a consistent way by absolute population growth, while productivity growth clearly does increase per capita growth.
- New South Wales has a slightly older population structure, with relatively fewer new entrants to the workforce. The future age structure of the population is in part a consequence of the present age structure. ABS projections show New South Wales' share of the most economically active age group will decline more rapidly than its overall share of the national population for the foreseeable future.
- Finally, it is important to note that the NSW economy has performed better than that of other States such as Victoria, South Australia and Tasmania in the last decade or so. Therefore New South Wales cannot benefit from any catch up growth.

Therefore given the absence of any strong factors offsetting the above, New South Wales' growth in 1998-99 is expected to be close to the national average as discussed in the following section.

² Standard & Poor's news release, May 14, 1998.

³ ABS Pub 3222, Projections of the Populations of Australia States and Territories (1996), Series A assumptions.

ECONOMIC OUTLOOK FOR 1998-99

The estimates and forecasts for the main economic variables that underlie the 1998-99 Budget and forward estimates are shown in Table 2.1.

The outlook for economic growth nationally and in New South Wales in 1998-99 is a little less optimistic than was expected at the time of the 1997-98 Budget. Growth in output is anticipated to decelerate slightly and, as a consequence, employment growth is expected to remain fairly moderate and the unemployment rate should remain stable. Inflation is likely to move up from the very low rate expected in 1997-98 but should not pose a threat to sustainable growth in the remainder of the decade.

- Nationally, economic growth is expected to slow to 3 per cent in 1998-99 from around 3½ per cent in 1997-98.
- While NSW output growth is likely to average less than Australia over a period of years due to lower trend growth in population, nonetheless it may at least equal national growth in 1998-99 due to a comparatively more favourable sectoral composition of demand.
- All components of domestic demand, including dwelling construction and business investment, will continue contributing to growth during 1998-99. But private consumption's contribution will be smaller than in the previous year, and net exports are likely to contribute negatively to aggregate growth.
- Growth in Australian employment is expected to be somewhat stronger in 1998-99 than in the previous year.
- NSW employment is expected to grow at the same rate as Australia in 1998-99.
- Consumer price inflation is likely to increase in 1998-99 but it seems unlikely to move beyond the Reserve Bank's 2 to 3 per cent target band for the underlying rate.

Of the many factors which influence the forecasts, those about which there is the greatest uncertainty include the prospects for the Asian economies and more broadly the world economy, the outlook for industrial relations, and the impact of the next Federal election on economic confidence. Some of these issues are discussed at the end of this section, and an analysis of the possible Budget implications of changes to some critical assumptions is contained in section 2.3.

Private Consumption

Growth in private consumption in both New South Wales and Australia is expected to decline in 1998-99 due to moderate employment growth, slower real wage growth, and less buoyant consumer confidence. Demutualisation of the AMP Society may provide a substantial temporary stimulus at the start of the financial year.

Table 2.1: Economic Performance and Outlook⁽¹⁾

	1996-97	1997-98(e)	1998-99(f)	1999-00(f)	2000-01(f)	2001-02(f)
1. ECONOMIC OUTPUT⁽²⁾						
Income Based GDP	3.0	3½	3	3½	4	2¾
Private Consumption	2.4	5	2¾	3½	4	3
Private Dwelling Construction	1.1	12	7½	-2	-8	2
Business Sector Investment	17.4	10½	7¾	5¾	4¾	2¾
Public Final Demand	1.5	4	3	3¼	2½	1¼
Gross National Expenditure	2.7	5¾	4	3½	2¾	2½
Exports	10.1	4	2	7	11½	8¼
Imports	12.3	13½	6¼	6	6	6½
2. CURRENT ACC'T DEFICIT (\$b)	17.7	24½	32	28	24	22
Per cent of GDP	3.4	4½	5½	4½	3¾	3¼
Net Foreign Debt (\$b) ⁽³⁾	206	228	253	266	275	289
3. PRICES						
National CPI Index	1.3	0	2¼	2¾	3½	2½
Cwlth Treasury "Underlying" CPI	2.0	1½	2¼	2¾	3½	2½
Non-Farm GDP Deflator	1.8	2	1½	2½	3	2¼
Terms of Trade	5.6	3	-3	-1	-1	-½
4. WAGES:⁽⁴⁾						
Survey AWOTE (full time adult)	3.9	4	3¾	4½	4¾	3½
National Accounts AWE	5.3	3¾	3¾	5	5	3
5. NATIONAL EMPLOYMENT	1.1	1¼	1½	2	2½	1¾
Unemployment Rate ⁽⁵⁾	8.7	8¼	8	7¾	7½	7½
6. FINANCIAL VARIABLES⁽⁵⁾						
Interest Rates						
90-day bills	6.3	5	5	6	7½	6½
10-Year	7.6	6	6¼	7	8½	8
Bonds						
Mortgages ⁽⁶⁾	8.3	6¾	6¾	7½	8½	8½
Exchange Rates:						
\$US/\$A Rate	78.1	68¼	64	68	72	73
TWI Index	58.7	59½	58	59	61	62
7. NEW SOUTH WALES						
Output (Gross State Product) ⁽²⁾	2.9	3½	3	3¾	4¼	2½
Private Consumption ⁽²⁾	2.3	4¼	2¾	3½	4¼	2½
Private Dwelling Construction ⁽²⁾	-2.0	11	7½	-2	-7¾	2
Business Sector Investment ⁽²⁾	11.5	11¾	8¼	6¼	4¾	2¼
State Final Demand ⁽²⁾	3.0	5½	3¾	3½	3¼	2
Employment	0.7	½	1½	2	2½	1½
Unemployment Rate ⁽⁵⁾	8.0	7¾	7¼	7¼	7¼	7¼
Inflation (Sydney CPI)	1.4	0	2¼	2¾	3½	2½
Wages AWOTE (full time adult) ⁽⁴⁾	3.6	3½	4	4½	4¾	3½

(1) All figures are annual average rates of change unless otherwise indicated.

(2) Growth in real (constant price) terms.

(3) Levels in June quarter, current \$.

(4) Growth in nominal (current price) terms.

(5) Average for financial year.

(6) Predominant bank variable rate.

(e) Estimate (Rounded to nearest ¼ per cent).

(f) Forecast (Rounded to nearest ¼ per cent).

Dwelling Construction

There is expected to be continued solid growth in private dwelling investment in 1998-99 led by New South Wales and Victoria. Growth in New South Wales will be sustained by a shortage of housing stock, except at the lower price end of the Sydney multi-unit residential market, which may be experiencing some excess supply. Historically low mortgage interest rates will continue to encourage demand.

Business Investment

Business investment growth is forecast to slow to around 7¾ per cent in 1998-99 for Australia with a slightly stronger outcome expected for New South Wales.

Expenditure on plant and equipment, which has grown by an estimated 14 per cent per annum over the last two years in New South Wales, is expected to slow to around 10 per cent in 1998-99 due to reduced export capacity requirements. Non-dwelling construction growth is close to the peak of its cycle and may make only a small contribution to growth of aggregate output in 1998-99. Capital expenditure intentions surveyed by the ABS in December suggest that business investment may be somewhat stronger in NSW than nationally during 1998-99.

A change in business and consumer confidence could lead to business investment growth outcomes significantly different to those forecast. A further economic slowdown in Asia or increases in interest rates in the United States are two of the factors which could affect business confidence.

Public Final Demand

The 1998 National Fiscal Outlook (NFO), partially updated in the Commonwealth Budget, foresees an improvement in the general government underlying balance from a deficit of -1.4 per cent of GDP in 1995-96 to a surplus of +0.7 per cent of GDP in 1998-99, rising to 1.7 per cent of GDP by 2000-01. This improvement would mainly reflect restraint of outlays which are projected (in the NFO) to decline as a ratio to GDP from 33.6 per cent in 1997-98 to 32.3 per cent in 1998-99, and then to 30.3 per cent by 2000-01. This (according to Commonwealth Budget estimates) would bring about a reduction in the ratio of general government net debt to GDP from 21.2 per cent at June 1997 to 8 per cent at June 1999 and 4.1 per cent at June 2001.

A reduced general government sector will tend to play a smaller role in guiding the economy through the business cycle. A lower general government deficit will tend to be reflected in higher national savings and a smaller current account deficit, both of which will have positive implications for the exchange rate.

The projected decline in general government debt may be expected to reduce average yields on government bonds, and to reduce the cost to business of raising capital through commercial debt.

Foreign Trade

Australia's export growth is expected to slow in 1998-99 due to the weakness in Asian markets. Imports also are expected to grow more slowly, given the partial easing of domestic demand pressures. Therefore net exports will make a substantial negative contribution to national output in 1998-99, although perhaps less than in 1997-98.

A flexible exchange rate has provided Australia a partial buffer against declining demand in key export markets. Australian dollar exchange rates are expected to average close to their March 1998 levels during 1998-99. This assumes that markets have already factored in most of the forthcoming deterioration in the current account balance, and that Australian interest rate policy remains unchanged.

The Labour Market

Slightly weaker employment conditions in 1997-98 were accompanied by a slowdown in labour force participation rates, allowing some improvement in the unemployment rate. The expected slowdown in output growth in 1998-99 will restrict employment gains, and unemployment rates are likely to average only slightly lower than in 1997-98.

Wages and Prices

At both the national and State levels, average weekly earnings growth is expected to be around 3¾ to 4 per cent in 1998-99, or broadly unchanged from growth rates experienced during the previous year. The Living Wage Case decision in April 1998 is consistent with that outcome.

The revised CPI to be implemented from 1998-99 onward will exclude interest rates, which have contributed most of the cyclical volatility to the index in previous periods. The revised CPI will therefore behave more like the underlying CPI measure. Hence CPI inflation in 1998-99 will mainly reflect unit labour costs (which are likely to rise by 2-3 per cent), import prices (which may rise by 3-4 per cent due to the weaker exchange rate), and competition pressures (which may intensify with slower economic growth, restraining business margins). On balance, CPI inflation is likely to move up into the RBA's 2-3 per cent target band during 1998-99.

MAJOR RISK FACTORS

Outlook for the World's Major Economies

The Australian and NSW economies are strongly influenced by events in the world's major economies, in particular the United States, Japan, the newly industrialising East Asian economies, and Europe.

Underlying the forecasts for the Australian and NSW economies is the expectation (reflected in recent OECD and IMF projections) that world economic growth in 1998 and 1999 will be considerably slower than in the preceding year, and that the source of the slowdown will be Australia's major Asian trading partners including Korea, Japan, and Southeast Asia. This will constrain Australian exports and increase competing imports pressure.

The slowdown in overseas demand will be partially offset by Australian exchange rate adjustment (partially restoring competitiveness), and by fairly robust domestic economic conditions which otherwise might have sustained economic growth rates in excess of 4 per cent. The economic forecasts assume fairly rapid recovery in the Asian region, as followed the 1995 Mexican financial crisis. Nonetheless the possibility of a more severe and protracted Asian impact (particularly should Japan fail to relaunch growth) cannot be precluded.

A second concern is financial overheating in the United States. United States economic growth has exceeded conventional estimates of its long-run potential over the past year or more, and this has been accompanied by increasingly rapid growth in liquidity and asset price inflation. To date the US monetary authorities have been reluctant to respond out of concern not to exacerbate the Asian financial crisis, and out of belief that the pace of growth would slow of its own accord.

Industrial Relations

The waterfront dispute has underlined once again the vulnerability of the Australian economy to industrial conflicts involving essential business services, which potentially can inflict massive collateral damage on Australian production and employment.

Business Investment

As business investment is one of the most volatile components of GDP growth (fluctuating between a low of -10½ per cent and a high of +17½ per cent over the last six years), it is an important source of uncertainty in the forecasts. It is encouraging therefore to note the strong outlook for business investment in New South Wales revealed in the December 1997 ABS survey of private new capital expenditure. The New South Wales private capital expenditure estimate for 1998-99 was 31.0 per cent higher than the corresponding estimate a year earlier for 1997-98. This increase was a larger than for any other State.

ECONOMIC OUTLOOK FOR THE FORWARD YEARS

Table 2.1 contains forecasts out to 2001-02 predicated on the following medium term economic outlook -

- underlying growth is expected to be fairly robust while Asian economic growth is expected to return fairly rapidly to trend;
- New South Wales and to a lesser extent the national economy is likely to receive a modest boost through the end of the decade from economic activity associated with the 2000 Sydney Olympics;
- it is inevitable that there will be an easing off of growth early next century, and this has been predicted to come through in 2001-02 through slower growth in private investment and a downturn in the business cycle; and
- Australia's non-inflationary growth potential over the coming decade will be lifted by microeconomic and competition policy reforms.

2.3 ALTERNATIVE BUDGET SCENARIOS

Both sides of the NSW Budget are influenced by economic conditions, though to different degrees. Important revenue items which can be quite sensitive to economic factors include payroll tax and stamp duty. Payroll tax is affected by both employment levels and wage rates. Stamp duty from contracts and conveyances and share transfers are affected by changes in trading volumes. Other sources of tax revenue are affected by general economic conditions.

The current Asian economic crisis is an example of a largely unexpected event that may have a significant impact on the Budget. In the short term, the expenditure side of the Budget is relatively insensitive to changes in economic conditions as many expenditure quantities are locked in. Nevertheless, it is appropriate to explore the sensitivity of the Budget to changes in economic conditions.

The range of views on the outlook for the economy appears to be wider this year than in previous years. Recent published forecasts for GDP growth in 1998-99 range from approximately 0 to 5 per cent, though possible outcomes extend beyond this band. The main explanation for the wider range of economic forecasts is uncertainty regarding the impact of the Asian crisis on the domestic economy.

In order to illustrate the potential impact of economic uncertainty on the Budget, three alternative scenarios are explored: a *higher growth* scenario, a *lower growth* scenario, and a *currency crisis* scenario.

Table 2.2: Alternative Economic Scenarios

	Budget Economic Forecasts	Percentage Point Change on Forecasts ⁽¹⁾		
		Higher Growth	Lower Growth	Currency Crisis
	%	% points	% points	% points
Aggregate Demand (GSP)	3.0	+2.1	-3.3	-0.5
NSW Employment	1.5	+1.3	-1.5	-0.5
Wages (AWE)	3.7	+0.3	-0.7	+0.3
Budget Sector Wages	3.5	+0.3	-0.5	+0.3
Consumer Prices (Sydney)	2.2	+0.1	-0.8	+0.6
90-Day Bill Rate	5.0	+1.0	+0.3	+2.0
10-Year Bond Rate	6.3	+1.0	-3.0	+1.0

(1) Alternative economic scenarios are calculated by adding 'percentage point changes' to the 'Budget economic forecasts'.

The *higher growth* scenario represents a view of the Australian and New South Wales economies that is at the top end of expectations. In this scenario output growth of 5 per cent, is driven by stronger employment growth, putting upward pressure on prices and interest rates.

The *lower growth* scenario represents a view on the economy that is at the bottom end of expectations. This scenario is consistent with the Asian economic crisis having an impact that is far greater than that which is generally expected. In this case output and employment are assumed to undergo zero or negative growth.

The *currency crisis* scenario is assumed to be of a similar magnitude to that experienced in 1986, which saw the Australian dollar fall by approximately 15 per cent against the US dollar. (It is *not* comparable in severity to the currency crises recently experienced in some Asian countries.) The scenario is characterised by higher interest rates, higher prices and lower output and employment.

The alternative scenarios are defined in terms of key economic parameters that influence the Budget, with the deviations from the base forecast given in Table 2.2. The values in Table 2.2 represent the average deviations over a twelve-month period. The alternative Budget outcomes in Table 2.3 are on the basis of *no* explicit revenue or expenditure response on the part of the State Government compared to the base forecast.

The expected Budget outcome is for a surplus of \$45 million. However under the *higher growth* scenario the Budget outcome could be a \$275 million surplus (an improvement of \$230 million), while under the *lower growth* scenario the Budget outcome could be a deficit of \$275 million (a deterioration of \$320 million). These are not confidence limits or alternative forecasts, but indicate some of the possible sources of deviation from the base case and potential magnitudes. The *currency crisis* scenario, while not as negative as the *lower growth* scenario in terms of output and employment, provides a similar deterioration in the Budget outcome.

Table 2.3: Alternative Budget Outcomes

	Budget Estimates	Change on Budget Estimate ⁽¹⁾		
		Higher Growth	Lower Growth	Currency Crisis
		\$m	\$m	\$m
Current Financial Result	2,358	+ 235	(-) 335	(-) 310
Outlays	21,845	+ 95	(-) 270	+ 115
Receipts	24,203	+ 330	(-) 605	(-) 195
Tax	14,000	+ 260	(-) 505	(-) 170
Non-tax	10,203	+ 70	(-) 100	(-) 25
Capital Financial Result	(2,314)	(-) 5	+ 10	(-) 10
Outlays	3,112	+ 5	(-) 10	+ 10
Receipts	798
Total Result	45	+ 230	(-) 320	(-) 315

(1) Values should be added to Budget estimate to give a revised Budget estimate. All values are rounded to the nearest \$5 million.

In the *higher growth* scenario there is a modest increase in outlays but this is more than offset by a significant increase in revenue. The *lower growth* scenario sees revenue decline substantially leading to a deficit, despite a decrease in outlays. The *currency crisis* scenario provides the potentially damaging combination of declining revenue *and* increased outlays due to higher interest payments.

These scenarios demonstrate the point that the budget outcome is the difference between two very large values (total outlays and total receipts both exceed \$20 billion), and a given outcome can be achieved in many different ways. Moreover, the composition of revenue in particular could be somewhat different than the base forecasts as the revenue side of the budget is more sensitive to changes in economic conditions than is the expenditure side.