



# Outlook for the Economy and Some Considerations for New South Wales 2011/12 Budget

Report prepared for Unions New South Wales  
By BIS Shrapnel Pty Limited



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ECONOMICS

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This report has been prepared for Unions New South Wales in relation to the upcoming New South Wales 2011/12 Budget.

For the purposes of this report, we draw on our latest macroeconomic forecasts from the BIS Shrapnel report *Long Term Forecasts: 2011 – 2026* (released in August). We also draw on our latest residential forecasts from *Residential Property Prospects 2011 – 2014* and *Building In Australia 2011 – 2026* report while the engineering construction forecasts are sourced from our *Engineering Construction in Australia 2010/11 – 2024/25* report. In addition, we sourced data from the Australian Bureau of Statistics (ABS).

BIS Shrapnel is an independent economic forecasting and industry research company. We regularly produce industry research and forecasting reports on the building, construction and resources sectors. We undertake both commissioned reports for market participants and regular multi-client reports. All efforts have been made to ensure that the information contained in this report is accurate and appropriate at the time of writing.



## SOME CONSIDERATIONS FOR THE NSW BUDGET

The NSW economy is in a soft patch. We think we will get through this period of weakness, although the current ructions in world financial markets are impacting on confidence and can delay recovery. In our forecasts we have assumed a solid recovery as households loosen the purse strings (after a period of increasing precautionary savings) and as private investment comes through and replaces government investment as a driver of growth. The strength of now-committed minerals projects will underpin solid growth over the next five years. Near term, we are looking for a strong contribution from residential, flat non-dwelling building and only a moderate decline in government infrastructure spending.

Government spending will be an important element underpinning the recovery. On that basis, we make the following comments in relation to the forthcoming NSW budget.

1. We know that budgets will be tight and there will be constraints on expenditure. However, the Premier's recent comments on a budget "black hole" are more emotive than real. According to recent Treasury estimates there will be a surplus this year followed by a deficit of \$1.3 billion per annum, on average, in subsequent years, around 2% of expenditure. Since then, the Treasurer has flagged a further deterioration in revenue estimates, particularly stamp duties, amounting to "some hundreds of millions of dollars" this year.

We should ensure that any cuts to departmental budgets don't impact on the provision of services. There is a not a lot of fat in the system. The Premier has stated that we won't lose any front line jobs. But we have to recognise that loss of support staff could tie up front line employees, leaving them less time to fulfil their front line tasks with subsequent negative impacts on service users and the community. And increased pressure on services staff can and does impact on their performance. Some, often the most able and experienced, leave government employment to work in the private sector.

We need to recognise that state government revenues are highly cyclical (in particular transfer duties) and that governments make more revenue from growth than from maximising revenues from each transaction. That is, a boost to the residential property market will provide a strong boost to revenues and strong growth will boost residential property. This will reduce the deficit projected for the forward estimate period ie over 2012/13 to 2014/15.

Hence, business as usual, in particular if we can stimulate solid growth in NSW, shouldn't affect the state's AAA credit rating.

2. Accordingly, we shouldn't panic about wages. A 2.5% cap on wage increases doesn't make sense. With CPI inflation forecast by BIS Shrapnel to average around 3.3% over the next five years, a 2.5% base increase in wages will not maintain real wages — it would lead to an erosion of real wages for NSW public sector employees of nearly 1% per annum. With stronger economic conditions around Australia and the likelihood of emerging labour shortages over the next few years, there will be difficulty in retaining and attracting good staff.

The approach adopted by the NSW Government in formulating the 2.5% cap on wages is to rely on the RBA to achieve its agreement with the Commonwealth Government to maintain national CPI inflation within a range of 2-3% over the cycle, ie an average of 2.5%. But this target objective is in practice a medium-term objective which allows for the CPI to go outside the target range, as long as the RBA pursues a monetary policy to bring the CPI back within its target range over the medium-term. That is, BIS Shrapnel and most other economists understand that 'over the cycle' implies a time period of 3 to 5 years. By clinging to the 2.5% CPI forecast, the NSW Treasury is ignoring the current reality that CPI inflation is well above the 2.5% mid-point and is likely to remain above that point for the next five years.

3. A strong infrastructure investment programme is essential to provide services and to underpin growth. We need to recognise that governments around Australia, including NSW, were underinvesting through the 1990s and into the middle of the last decade as governments focussed on reducing deficits and debt. That's why we ran into infrastructure bottlenecks in the middle of the last decade. And that's what sparked the current round of infrastructure spending. We haven't caught up yet. We suggest that a strong infrastructure investment programme is essential to kick start recovery in the NSW economy and get us out of the current weak patch. Once begun, the recovery will build momentum, boosting consumer spending, residential property and building, and NSW jobs. And that's what will, at the same time, boost government revenues.
4. The Government needs to maintain services to prevent leakage of NSW residents and employees to other states. Residential construction is a key driver of growth. The construction of dwellings has not kept pace with underlying demand and, as a result, subsequently property markets in New South Wales, and in particular Sydney, remain chronically undersupplied. Moreover, it is particularly important to replace job losses in trade-exposed industries. (Government procurement power could be used here.) The recent Port Kembla steel job cuts are just the next in what has been a long line of loss of Australian jobs offshore. Australian trade-exposed industries cannot compete at this level of currency.

## AUSTRALIAN ECONOMIC OUTLOOK

Unlike many of the developed Western economies, Australia didn't experience a Financial Crisis and recession. The global financial crisis (GFC) was a reaction to the preceding debt-fuelled boom. While Australia experienced a debt-fuelled boom, we were slow into the game. Commercial building and many equities were over-gearred and overvalued. But the boom had not yet taken investment over the top. Residential building was undersupplied following the bursting of the residential "bubble" in 2003. Commercial building was on the way to oversupply, but the GFC pulled the rug out from under development before most markets had a chance to oversupply. And business investment had not yet gone over the top. The result was that, while asset prices corrected, unlike many other developed economies, there were only minor write-offs in the banking system and in particular for Australia's four major banks. The banking system came through relatively unscathed with the 'four pillars' emerging stronger than ever.

The result was that Australia did not experience a financial crisis but had a credit squeeze. Hence, Australia experienced a downturn rather than a recession. Early and strong government stimulus drove an initial rebound which has now stalled, with households in precautionary savings mode and many businesses, yet to fully recover in revenue and profit terms since the downturn, still in cash preservation mode and reluctant to invest.

Meanwhile, the current shock to world financial markets coming from sovereign debt issues, weak growth, the US downgrade, and reflected in the setback to equity markets, has impacted on confidence, prolonging precautionary saving in Australia, and delaying recovery.

The economy will get through the current soft patch as households loosen the purse strings (after a period of increasing precautionary savings) and as private investment comes through and replaces government investment as a driver of growth. The strength of now-committed minerals projects will underpin solid growth over the next five years.

But that means the emergence of capacity constraints (as demand recovers in the face of constrained supply resulting from the setback to private investment triggered by the GFC) and skilled labour constraints 18 months to 2 years from now. At that time, the Reserve Bank will respond to the emergence of demand inflationary pressures with aggressive rises in interest rates.

Growth will exhibit marked differences between sectors.

- The strong segment is populated by mining and mining investment-related sectors.
- The weak sectors are the trade-exposed industries such as manufacturing, tourism and education which are subject to the whims of the A\$. The strength of the Australian dollar has affected the competitiveness of trade-exposed industries (domestically produced tradeables).
- Between the weak and strong sectors, the bulk of industry is sheltered from the high currency but not yet recovering the losses of revenue and profit after the GFC-induced downturn. Typically, they are in cost containment mode, delaying investment. As the recovery proceeds, they will expand to cater for growth, underwriting a broadening of growth. Property and construction fit into this category. So does housing, business services and sectors servicing generalised business investment.

**Table 1.1: Australia – Key Economic Indicators**  
**Financial Years**

Year Ended June						Forecasts				
	2007	2008	2009	2010	2011e	2012	2013	2014	2015	2016
<b>EXPENDITURE ON REAL GDP</b>										
<b>Consumption</b>										
– Private	4.3	4.7	0.2	2.1	3.1	3.3	3.8	2.6	2.4	4.0
– Government	3.7	3.2	2.8	1.7	4.2	3.7	2.3	2.5	3.2	3.5
<b>Private Investment</b>										
– Dwellings	1.9	1.2	-1.9	2.1	3.2	4.0	6.1	-1.3	-5.0	5.3
– Real Estate Transfer Exp.	-0.9	0.2	-15.6	10.7	-15.0	9.5	-8.2	-13.4	10.7	13.6
– New Non-Dwelling Construction (+)	12.3	10.1	8.5	-8.2	7.4	11.4	13.9	8.7	-2.2	0.8
– New Non-Dwelling Building (+)	7.6	11.7	-5.3	-18.7	-4.6	6.8	12.3	7.8	-1.9	8.6
– New Engineering Construction (+)	17.9	8.6	24.2	0.9	15.8	14.0	14.8	9.2	-2.4	-3.3
– New Equipment (+)	3.1	19.0	-3.3	-4.8	3.0	15.1	15.5	3.7	-0.3	14.8
– Cultivated Biological Resources	-20.5	-4.5	14.1	2.0	3.4	9.1	-4.9	7.0	-9.0	8.0
– Intellectual Property Products	15.8	15.1	-0.3	3.4	3.0	9.8	14.0	8.7	4.8	10.1
– New Business Investment (+)	7.9	14.5	1.9	-4.9	4.8	12.7	14.3	6.5	-0.4	8.3
<b>Total New Private Investment (+)</b>	<b>5.6</b>	<b>10.1</b>	<b>-0.1</b>	<b>-2.4</b>	<b>3.3</b>	<b>10.3</b>	<b>11.4</b>	<b>4.0</b>	<b>-1.0</b>	<b>7.9</b>
New Public Investment (+)	4.7	10.5	5.9	26.3	5.1	-3.8	-3.5	-3.1	2.2	7.1
<b>Domestic Demand</b>	<b>4.5</b>	<b>6.0</b>	<b>0.8</b>	<b>2.1</b>	<b>3.4</b>	<b>4.5</b>	<b>4.9</b>	<b>2.7</b>	<b>1.7</b>	<b>5.0</b>
Stock Contribution (*)	0.2	0.0	-0.4	0.3	0.0	0.2	-0.1	-0.2	0.0	0.3
<b>Gross National Expenditure (GNE)</b>	<b>4.9</b>	<b>6.0</b>	<b>0.2</b>	<b>2.4</b>	<b>3.4</b>	<b>4.7</b>	<b>4.8</b>	<b>2.4</b>	<b>1.7</b>	<b>5.3</b>
<b>Exports</b>	<b>2.5</b>	<b>4.0</b>	<b>2.6</b>	<b>5.2</b>	<b>0.9</b>	<b>7.1</b>	<b>7.5</b>	<b>7.0</b>	<b>5.5</b>	<b>7.3</b>
<b>Imports</b>	<b>9.1</b>	<b>14.6</b>	<b>-3.3</b>	<b>4.9</b>	<b>10.1</b>	<b>10.4</b>	<b>10.6</b>	<b>4.2</b>	<b>1.8</b>	<b>10.2</b>
External Contribution (*)	-1.3	-2.2	1.2	0.0	-2.0	-0.9	-0.9	0.7	0.9	-0.8
Statistical Discrepancy (*)	0.0	0.0	0.0	-0.2	0.5	-0.3	0.0	0.0	0.0	0.0
<b>GDP</b>	<b>3.6</b>	<b>3.8</b>	<b>1.4</b>	<b>2.3</b>	<b>1.9</b>	<b>3.6</b>	<b>4.0</b>	<b>3.1</b>	<b>2.6</b>	<b>4.5</b>
Farm GDP	-22.0	9.3	23.9	1.5	22.8	3.6	-5.4	5.9	-7.2	6.2
Non-Farm GDP	4.1	3.7	1.1	2.3	1.5	3.6	4.2	3.0	2.8	4.4
<b>Inflation</b>										
CPI (Yr Avg)	2.9	3.4	3.1	2.3	3.1	3.1	3.8	3.6	2.9	3.0
CPI (Jun on Jun)	2.1	4.5	1.5	3.1	3.6	2.7	4.0	3.4	2.5	3.2
Baseline (Jun on Jun)	2.7	3.6	3.6	2.8	2.6	3.0	3.3	3.3	2.6	3.0
Labour Price Index (Jun on Jun)	4.0	4.2	3.8	3.1	4.1	4.4	5.0	4.5	4.0	4.4
Labour Price Index (Yr Avg)	3.9	4.1	4.1	3.1	3.9	4.1	4.8	4.8	4.1	4.2
Average Weekly Earnings (Yr Avg)	3.6	4.9	5.5	5.6	4.2	4.5	5.3	5.9	5.2	4.8
<b>Employment</b>										
– Employment Growth (Yr Avg)	3.1	3.0	1.6	1.4	2.9	2.0	2.9	1.9	0.6	2.3
– Employment Growth (May on May) (%)	3.3	2.7	0.9	2.2	2.3	2.6	3.0	0.8	1.3	2.6
– Unemployment Rate (May) (%)	4.3	4.3	5.8	5.2	5.0	4.5	3.8	4.6	5.1	4.5
<b>Labour Productivity Growth</b>										
– Total	0.5	0.8	-0.2	0.9	-1.0	1.6	0.9	0.8	2.1	2.1
– Non-farm	1.0	0.7	-0.5	0.9	-1.4	1.5	1.1	0.8	2.3	2.0
<b>Interest Rates (30 June)</b>										
– Cash Rate	6.3	7.3	3.0	4.5	4.8	5.3	6.3	6.5	5.0	5.5
– 90-day Bank Bill	6.4	7.8	3.3	4.9	5.0	5.5	6.5	6.4	5.1	5.7
– 10-year Govt. Bonds	6.3	6.5	5.5	5.3	5.2	5.7	6.3	5.2	4.9	5.5
– Prime Overdraft (upper rate)	9.7	11.5	8.8	10.3	10.7	10.9	11.4	11.4	9.7	10.1
– Housing (variable)	8.1	9.5	5.8	7.4	7.8	8.2	9.1	9.0	7.3	7.8
<b>Balance of Payments (\$bn)</b>										
– Goods & Services	-13.5	-24.9	7.6	-3.5	25.3	32.6	32.3	28.9	8.4	-1.9
– Net Income & Transfers	-47.3	-49.4	-46.4	-49.4	-54.7	-59.6	-67.8	-84	-89.5	-89.8
– Current Account	-60.8	-74.3	-38.8	-52.9	-29.4	-27	-35.6	-55.2	-81.2	-91.7
– as a % of GDP	-5.6	-6.3	-3.1	-4.1	-2.1	-1.8	-2.2	-3.2	-4.6	-4.8
<b>Net Foreign Debt</b>										
\$ billion	540	600	624	686	643	631	629	716	780	719
% GDP	49.4	50.6	49.7	53.4	46.1	42.2	39.0	41.8	43.9	42.2
<b>Exchange Rates</b>										
– US\$ per A\$ (Yr Avg)	0.79	0.90	0.75	0.88	0.99	1.08	1.09	1.01	0.86	0.92
– US\$ per A\$ (30 June)	0.85	0.96	0.81	0.85	1.07	1.10	1.10	0.91	0.89	0.95
– SDRs per A\$ (30 June)	0.56	0.59	0.52	0.58	0.67	0.70	0.73	0.62	0.60	0.62
– Trade Weighted Index of A\$: 1970 = 1000 (30 June)	68.9	73.4	64.7	67.3	77.8	81.0	82.7	71.6	69.5	71.8

e: estimate

Source: BIS Shrapnel, ABS Data, RBA

n.f: not forecast

+Expenditure on new assets (or construction work done). Excludes sales (or purchases) of second hand assets

\*Contribution to growth in GDP

## Outlook for GDP growth, inflation and interest rates

The economy hit a soft patch late last year just as the Reserve Bank raised interest rates. This was compounded by the interruptions to production and investment as a result Queensland floods and cyclone. The result was a -1.2 per cent contraction in real gross domestic product (GDP) in the March quarter. Production and investment will rebound in the June quarter but through-the-year growth in GDP will remain relatively modest at 1.9 per cent.

Beyond 2011, the medium term outlook is positive overall. Private investment will recover gradually and build momentum over the next three to four years. Business investment in particular is expected to rise sharply over the next five years and be a key driver of growth. Although consumers remain risk averse and budget conscious, due to uncertainty over a range of political and economic issues, they have built up a significant savings buffer which provides households with latent spending power. Eventually, confidence will return and households will lift spending and make a larger contribution to growth.

Meanwhile, weak advanced world growth and European sovereign debt problems will have little impact on external demand – Australia is an Asian economy now. We forecast real GDP to grow by an average of 3.5 per cent per annum over the three years to 2013/14. We expect rising interest rates to cause a mild downturn in 2014/15 before the economy rebounds quickly and builds momentum thereafter.

Investment in the resources sector has already picked up strongly. There is more to come. Meanwhile, commodity prices remain at historically high levels, supported by China's insatiable demand for steel making raw materials (ie iron-ore and coking coal). This has locked-in another round of mining-related projects over the next five years.

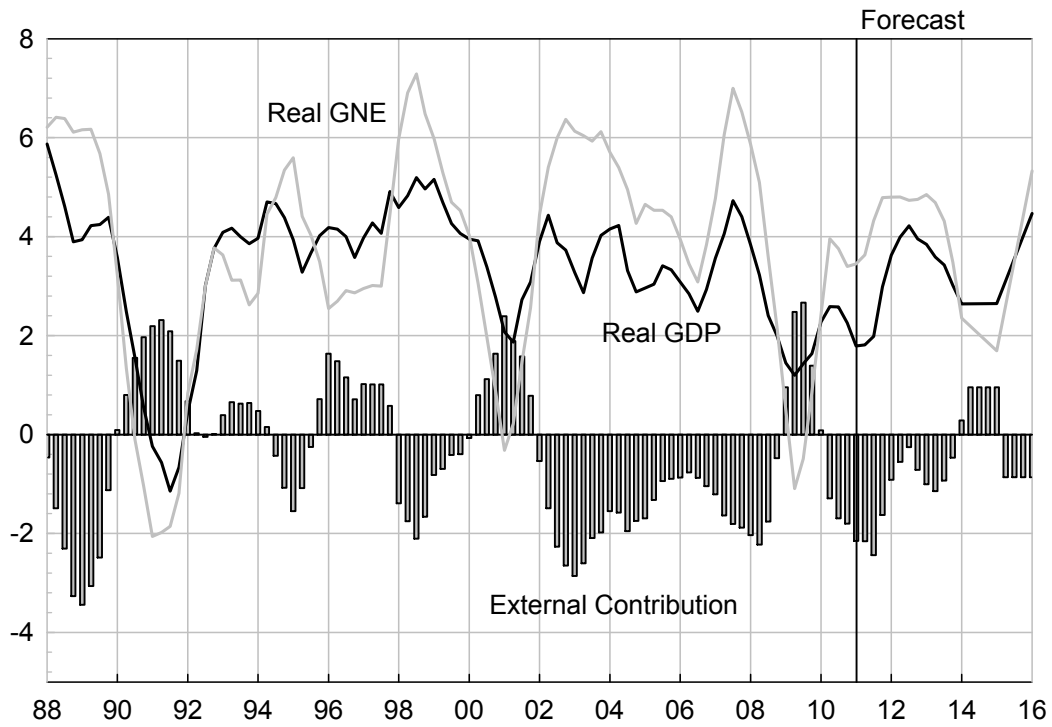
We expect residential markets to improve over the next two years as the economic recovery broadens and as confidence picks up. The key is that, Australia wide, the residential market is under-building and undersupplied. Dwelling completions over 2004/05 to 2010/11 averaged 150,000 per annum compared with annual average underlying demand of around 171,000. This has resulted in an estimated housing stock deficiency of about 120,000 dwellings in mid 2011. Recovery at present is being impeded by dismal confidence and excessive caution by households. Nonetheless, with interest rates still at moderate levels, the chronic deficiency of stock, combined with tight rental vacancies and rising rents will drive a solid recovery in dwelling construction over the next two years.

Private non-dwelling construction has passed the trough of the cycle and begun the long road to recovery. But it will be slow! Demand is expected to recover as the economy picks up momentum through the course of this year and over the next three to five years. Recovering demand and constrained supply (excessive caution by banks and investors suppressed development following the GFC) will result in a tightening of leasing markets leading to a long period of firming rents across the sub-sectors of commercial and industrial construction. This, in turn, will underwrite financial feasibilities and the next round of investment in private commercial and industrial building. We expect Retail building to be the first cab off the rank, followed by Industrial and Commercial (Office) investment. The upswing will build momentum into a boom, peaking in the second half of this decade.

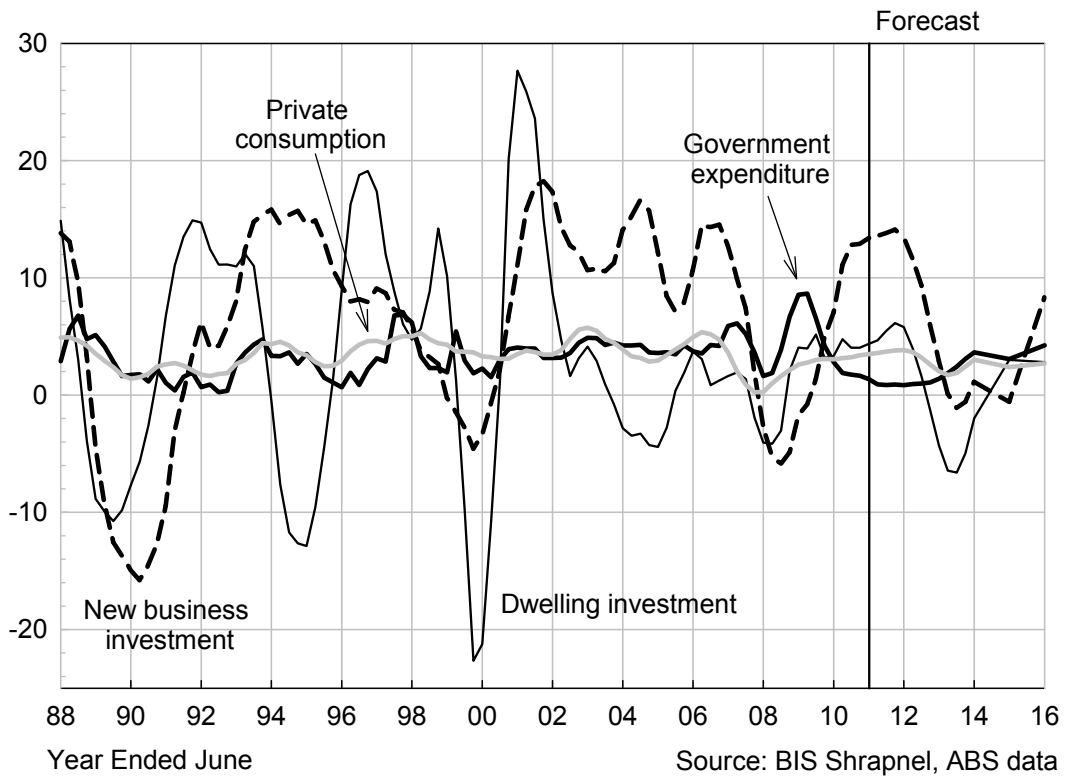
Australia's swift rebound from a GFC-induced downturn and a strong outlook means capacity constraints will soon emerge. This will induce strong levels of investment in new machinery and equipment over the next two years.

The economic outlook among Australia's major export markets, however, has considerable differences. While economic growth in US and Western Europe is expected to remain weak in

**Chart 1.1: Australia – Basic Economic Indicators  
Moving Annual Totals**



**Chart 1.2: Australia: Components of Domestic Demand**



Source: BIS Shrapnel, ABS data

the short term, China, India, Korea and Thailand are expected to record solid growth rates over the next two years and beyond. As the majority of Australia's exports now go to Asian markets, the strong performance of the Chinese and Indian economies as well as Japan's reconstruction following the earthquake will support Australia's external demand well into the medium term.

But it won't all be plain sailing. The high dollar is eroding the competitiveness of the export and import-competing sectors, with imports taking a larger share of the domestic market at the expense of local manufacturers and tradeable services (such as tourism and education) while non-commodity exporters continue to suffer lower revenues and profits. Ultimately, investment will be affected on trade-exposed sectors, while some operations will close down and/or relocate overseas, in many cases meaning a permanent loss of industry. This process has already begun.

Partly offsetting growth in private demand will be declining public investment — as the post-GFC schools, housing and hospitals building programs wind down — and slower growth in government recurrent spending and employment. The desire to return the budget to surplus also means that broadly-based income tax cuts are off the agenda until mid-decade (notwithstanding the recent announcement of tax cuts to compensate households for the proposed price on carbon). The lack of tax cuts will help restrain consumer spending.

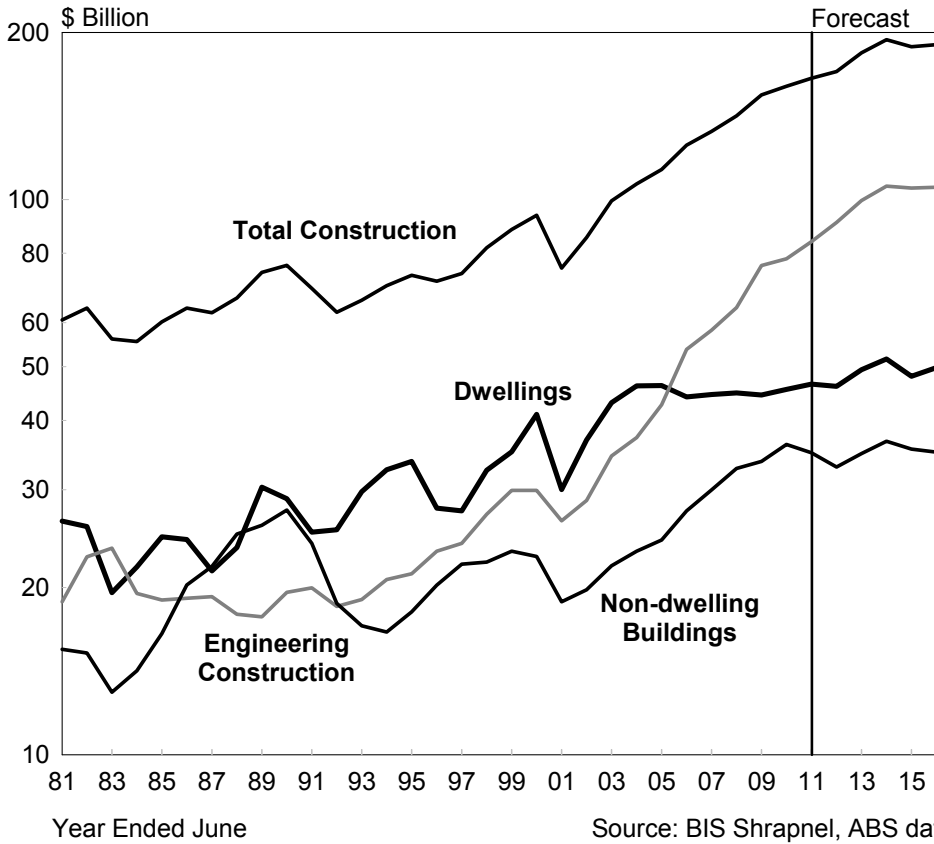
The extent to which consumers choose to loosen their purse strings will determine the speed at which wage and price pressures build over the next 18 months. Consumers have built up a considerable savings buffer, but they will be constrained in their ability to run up debt levels by the watchfulness of the RBA to any signs of excessive demand on the part of households. The RBA knows there is a major phase of mining investment gathering momentum, which is insensitive to interest rates, and will be accompanied both by strong growth in mining incomes and strong resources investment underpinned by record high commodity prices. With the unemployment rate already pushing below 5 per cent, the economy does not have sufficient capacity to accommodate a strong pick-up in demand from households and the additional demand on labour, materials and capital that would generate. The RBA position is to use interest rates to make room for the minerals boom. Housing activity and non-mining domestically produced tradeables will be the collateral damage.

With underlying inflation now appearing to have troughed we expect the RBA to start lifting the cash rate once we're through the current soft patch. However, with budget conscious households adopting a cautious approach to spending, the next rate rise is not expected until later in the year. Nonetheless, as the economic upswing gains momentum and moves towards full employment over the next two years, we expect the RBA will get on the front-foot and move official rates to more restrictive settings. We forecast the next peak in the RBA cash rate at 6.75 per cent (in December 2013) with variable mortgage rates at 9.4 per cent.

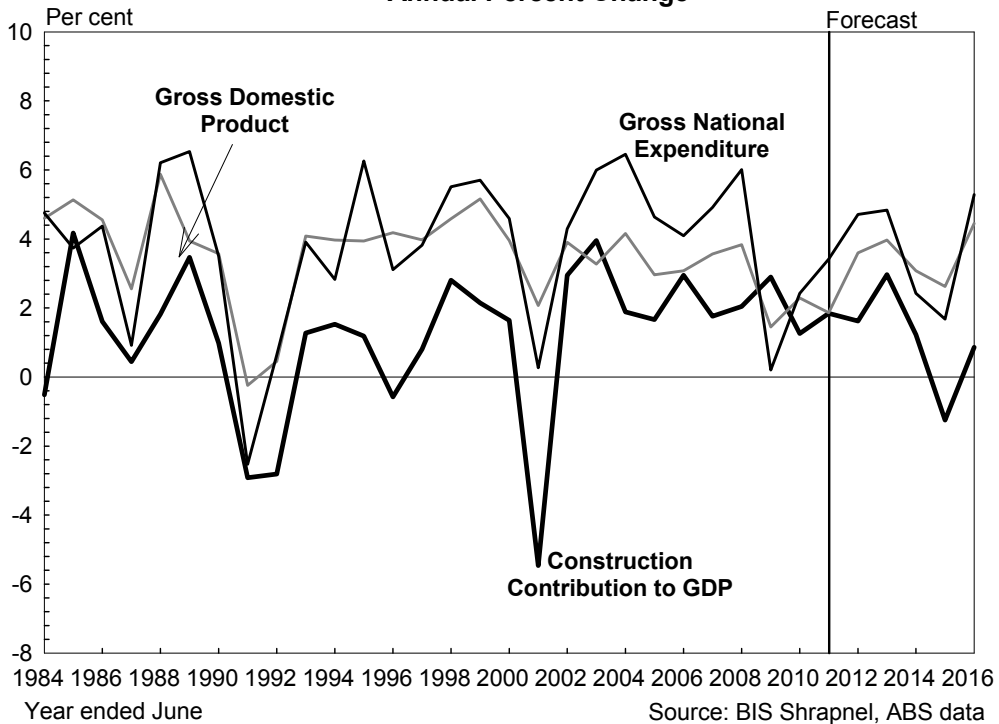
An aggressive series of interest rate rises through 2013 will dampen consumer spending and send housing activity into a controlled downturn through 2014. Generalised business investment will also moderate at the same time, with the overall slowdown in domestic spending and easing of inflationary pressures expected to see interest rates fall back. However, the impact on employment and demand will be modest, with the unemployment rate expected to peak at around 5 per cent in 2015.

The economy is expected to regain momentum from 2015/16, with a strong growth phase in both residential and non-residential building expected to drive growth. By mid-decade, these two markets will typically be characterized by tight supply and a considerable degree of pent-up demand, given building in both sectors will be constrained over the next few years by high interest rates and lingering finance constraints as the economy makes room for the mining investment boom.

### Total Construction - Australia Value of Work Done, Constant 2008/09 Prices



### Construction as a Growth Driver - Australia Annual Percent Change



## PROSPECTS FOR THE NEW SOUTH WALES ECONOMY

Growth was weak in the NSW economy last decade, significantly lower than the Australian average and significantly lower than Victoria.

Investment, in particular construction, is a primary driver of growth. Between 2001 and 2009, NSW construction stagnated. Construction growth over the whole period averaged 0.7% per annum, i.e., it provided virtually zero contribution to growth.

For most of last decade,

- non-dwelling building was flat,
- engineering construction grew by an average 7.1% per annum, but
- residential construction fell post-Olympics, rebounded in the housing bubble of 2002 and 2003, then fell again. It fell by 32%, an average of 2.9% per annum between 2000 and 2009.

Interestingly, NSW construction picked up early post-GFC as residential property rebounded in 2009/10, boosting work done in calendar 2010. But, along with the rest of Australia, residential construction in NSW has stalled in the first half of 2011. Non-dwelling building is still flat to weak, while engineering construction is strong. Total construction work done remains weak in 2011, it fell by 8% in the first half of calendar 2011.

NSW should do much better over the next five years than it did last decade. Economic growth in the state will be underpinned by a relatively buoyant construction sector and improved export volumes and revenues, although higher interest rates will subdue consumer spending.

Private dwelling construction will be one of the key drivers of Gross State Product over the medium term. Over recent years the construction of dwellings has not kept pace with underlying demand and subsequently property markets in New South Wales, and in particular Sydney, remain chronically undersupplied. The stock deficiency is estimated to reach almost 2 years worth of underlying demand by June 2011 (see Table 1.3). Further, underlying demand will continue to increase in coming years as Sydney continues to attract a large (although declining) proportion of Australia's international migration, which is expected to lift again from 2012/13, although population outflows to other states will offset some pressures. With rental yields already relatively high, these extreme demand and supply pressures will cause private dwelling construction to surge over the three years to June 2014.

However, any recurrence of weakness in the state's residential sector represents the biggest risk to our growth forecasts. With housing interest rates expected to rise back over 9% by 2013/14, our forecast depends critically on finance for apartment developments becoming available and a greatly increased supply of residential lots coming onto the market over the next two years. Business investment is expected to strengthen further over the next two years, as the improved outlook for dwelling construction and further increases in coal and minerals investment precipitate a broader pick up in overall business investment. A new round of private infrastructure is expected to boost engineering construction, followed by industrial and commercial buildings. From 2011–12 increases in private sector investment will be partially offset by declines in public sector investment as the current round of projects (largely from the economic stimulus package) is completed and not replaced with a new round of projects. But with overall investment strengthening, this will lead to a pick up in demand for finance, property and business services.

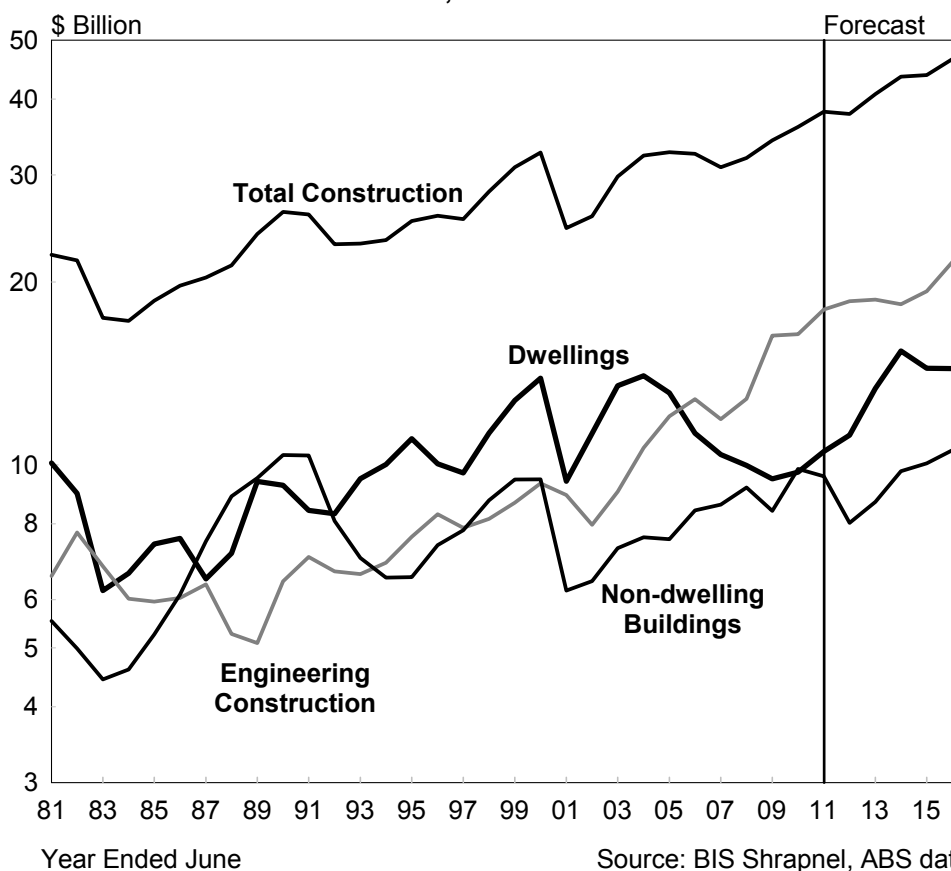
With the Australian dollar expected to remain around or above parity with the US dollar over the next three years, the negative impacts on the state's domestically produced tradeables sectors

will continue to weigh on the overall prospects for GSP. This includes the rural sector, which will suffer from falling revenues from next year when current high world prices (ie in US\$ terms) for a number of agricultural commodities fall back as global supply responds to the current high prices. Falling farm revenues will have regional impacts. However, the key danger is that the prolonged period of the high A\$ will lead to a ‘hollowing out’ of the manufacturing sector, lower levels of manufacturing investment and long term damage to the state’s tourism and education services industries.

Employment growth is forecast to ease back after the 3.4 per cent growth estimated for 2010/11, growing at around 1.5 to 1.7 per cent per annum over the next three years. This will underpin further solid growth in household incomes and expenditure. However, over the medium term, higher interest rates and a lack of tax cuts — as the Commonwealth Government looks to restore a budget surplus — will limit growth in household consumption.

Indeed, by 2013/14 a string of interest rate rises will begin to impact on growth. As mentioned, NSW is particularly sensitive to interest rate movements due to higher levels of mortgage debt. The strong economic growth forecast for 2011/12 and 2012/13 will see the RBA increase interest rates aggressively to curb inflation and avoid the economy overheating. This will lead to a weakening in output and employment growth in 2013/14. But the weakening in the economy is likely to be relatively brief. A subsequent easing in interest rates, a lower A\$ and strengthening in residential, public and business investment are projected to lead to buoyant economic conditions over the second half of the decade.

**Total Construction - NSW**  
Value of Work Done, Constant 2008/09 Prices



Source: BIS Shrapnel, ABS data

Table 1.2: Key Economic Indicators, New South Wales

NEW SOUTH WALES Year Ended June						Forecasts				
	2007	2008	2009	2010	2011e	2012	2013	2014	2015	2016
<b>EXPENDITURE ON GDP</b>										
<b>Consumption</b>										
- Private	4.1	4.5	-0.3	2.5	2.7	2.9	3.2	2.4	2.4	4.2
- Government	2.2	3.2	3.9	2.1	3.5	4.1	2.1	2.3	3.4	3.1
<b>Private Investment</b>										
- Dwellings	-8.3	-2.1	-4.8	3.2	9.9	8.2	14.4	7.9	-4.4	2.2
- New Non-Dwelling Building <sup>(1)</sup>	-2.6	8.5	-13.3	-9.3	9.5	-10.4	13.2	16.3	6.0	6.8
- New Engineering Construction <sup>(1)</sup>	1.0	14.0	27.4	-7.8	25.9	10.3	7.9	3.1	5.9	11.5
- New Equipment <sup>(1)</sup>	-2.8	24.3	-5.5	3.9	-0.8	14.2	14.4	2.8	-0.1	15.9
- Equipment	-3.3	25.0	-6.4	5.6	-0.6	15.1	15.3	3.6	0.2	16.2
- Intangibles	9.7	13.1	-1.9	6.4	3.3	9.5	13.5	8.0	5.5	10.4
- Real Estate Transfer Expenses	1.6	3.8	-5.2	6.3	-14.1	19.0	-10.6	-14.0	11.3	14.0
- New Business Investment	-0.5	16.9	-3.2	0.2	5.1	7.9	12.9	6.1	2.8	12.4
- Total New Private Investment	-3.0	11.4	-4.2	2.2	2.2	9.0	12.2	6.0	1.3	10.3
New Public Investment <sup>(1)</sup>	2.2	3.6	9.1	22.4	5.5	-7.1	-3.3	-4.4	2.1	7.9
<b>Total investment</b>	<b>-1.9</b>	<b>9.8</b>	<b>-1.7</b>	<b>6.5</b>	<b>3.0</b>	<b>4.9</b>	<b>8.7</b>	<b>3.9</b>	<b>1.5</b>	<b>9.8</b>
<b>State Final Demand</b>	<b>2.4</b>	<b>5.5</b>	<b>0.0</b>	<b>3.4</b>	<b>2.9</b>	<b>3.6</b>	<b>4.4</b>	<b>2.8</b>	<b>2.3</b>	<b>5.5</b>
International Exports of Goods & Services	0.3	3.2	2.1	1.5	5.3	n.f.	n.f.	n.f.	n.f.	n.f.
International Imports of Goods & Services	9.9	14.6	-6.2	8.6	11.4	n.f.	n.f.	n.f.	n.f.	n.f.
External Contribution <sup>(2)</sup>	-2.2	-3.1	2.0	-1.9	-2.2	n.f.	n.f.	n.f.	n.f.	n.f.
Balancing Item Contribution <sup>(2)</sup>	2.8	1.2	-1.0	0.4	3.0	n.f.	n.f.	n.f.	n.f.	n.f.
<b>Gross State Product (GSP)</b>	<b>2.8</b>	<b>3.4</b>	<b>1.1</b>	<b>1.7</b>	<b>3.6</b>	<b>3.4</b>	<b>3.5</b>	<b>2.8</b>	<b>2.7</b>	<b>4.3</b>
Population Growth	1.3	1.6	1.6	1.5	1.2	1.2	1.2	1.3	1.2	1.2
GSP per Capita	1.8	2.4	0.1	0.8	2.7	2.5	2.6	2.0	1.9	3.5
<b>Employment Growth (year avg)</b>	<b>2.0</b>	<b>2.9</b>	<b>0.6</b>	<b>1.1</b>	<b>3.4</b>	<b>1.2</b>	<b>2.8</b>	<b>2.0</b>	<b>0.8</b>	<b>2.6</b>
Unemployment Rate (year avg) (%)	5.0	4.6	5.7	5.7	5.1	n.f.	n.f.	n.f.	n.f.	n.f.

e: estimate, n.f: not forecast

<sup>(1)</sup> Expenditure on new assets (or construction work done). Excludes sales (or purchases) of second hand assets.<sup>(2)</sup> Contribution to growth in GSP. Balancing Item includes Net Interstate Trade in Goods and Services, Change in Stocks and Statistical Discrepancy.

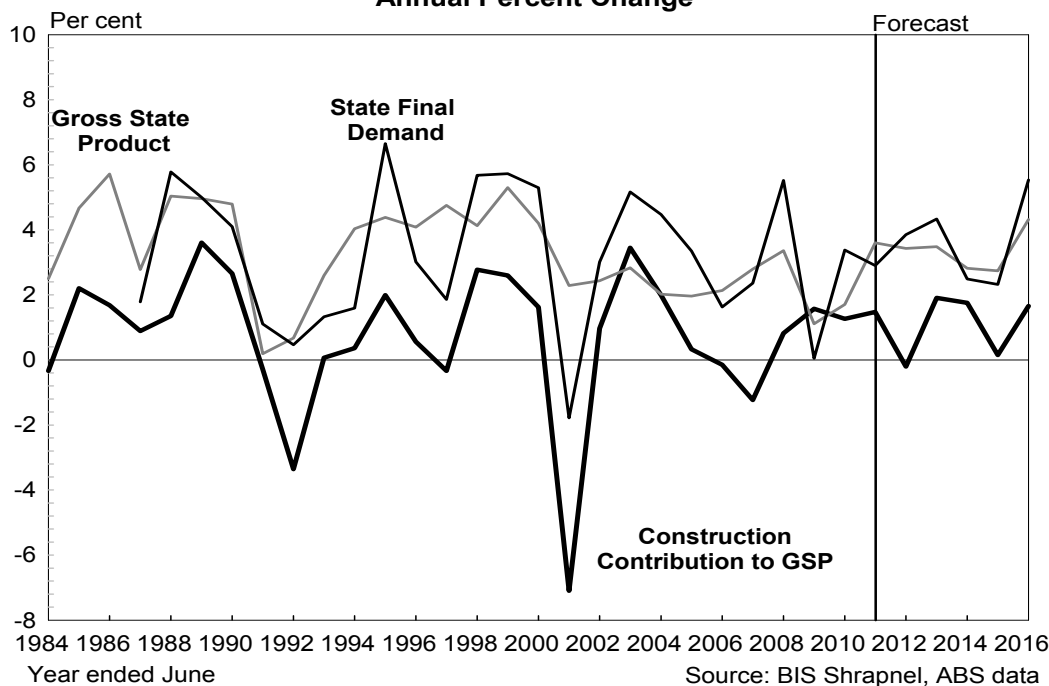
Table 1.3: Underlying demand, dwelling commencements and stock deficiency (excess)

	Underlying Demand ('000) Annual Average	Dwelling Commencements	Dwelling Stock Deficiency As at June (Thousands)		
	2011/12 - 2015/16	Y/E June 2011	2010	2011e	2012f
New South Wales	47.6	31.5	75.2	87.6	100.3
Victoria	48.9	59.0	30.8	20.2	10.9
Queensland	40.8	25.8	5.6	5.7	15.5
South Australia	10.8	10.6	0.2	-1.7	-2.1
Western Australia	27.6	20.7	8.7	8.3	13.2
Tasmania	2.4	3.0	-0.9	-1.7	-2.1
Northern Territory	2.0	1.2	1.7	2.0	2.7
A.C.T.	2.6	5.3	1.6	-0.4	-2.3
<b>Australia</b>	<b>182.8</b>	<b>156.8</b>	<b>122.9</b>	<b>120.0</b>	<b>135.9</b>

f = forecast, e = estimate

Source: BIS Shrapnel &amp; ABS data

### Construction as a Growth Driver - NSW Annual Percent Change



### THE NEW SOUTH WALES BUDGET

In a press release dated April 27, 2011, the Premier Barry O’ Farrell claimed that the NSW budget had a \$5.2 billion ‘black hole’. According to the Premier, the true extent of the budget deficit out to 2014/15 was previously unknown, hence the characterization of the deficit as a budget ‘black-hole’. The Premier’s comments on a budget ‘black hole’ are more emotive than real.

According to the Treasury, the variance between the mid-year review of the Budget (published in December 2010) and the March 2011 update was a deterioration of \$4,300 million and not the \$5,200 million as claimed by the Premier. However, the budget and forward estimates variance (ie up to 2013/14) was in fact \$1,933 million given that there was no published forward estimate for 2014/15 against which to measure the variance. We note that the Treasurer has recently flagged a further deterioration in revenue estimates, particularly stamp duties, amounting to “some hundreds of millions of dollars” this year.

However, even if the accumulated budget deficit for 2012/13 to 2014/15 of \$3,937 million, were to eventuate, we believe it would not endanger the state’s AAA credit rating. Whilst a deficit of \$3,937 million may seem large, it relates to three years and hence is an average of \$1,312 million per annum. Given that the NSW budget is an interaction of total expenses and total revenue which are in the order of \$55 billion, the accumulated deficit would be about 2%. Moreover, the state government’s current net debt and unfunded superannuation level (as a share of total revenue) is about eight percentage points below the level which might lead to a review of the AAA credit rating.

In light of the above, we recommend the following:

1. The NSW government need not panic on wages or on departmental budgets. A 2.5% cap on wage increases doesn’t make sense. It is a real wage cut and the government will have difficulty in attracting new workers particularly in the current tight market for skilled labour.

In addition, the government should ensure that any cuts to departmental budgets don't impact on the provision of services. There is not a lot of fat in the system. The Premier has stated that we won't lose any front line jobs. But we have to recognise that loss of support staff could tie up front line employees, leaving them less time to fulfil their front line duties with subsequent negative impacts on service users and the community.

2. The overriding need is to ensure the economic health of the state. The NSW economy needs a bit of a kick-start. If impeded, the economy could languish but if facilitated there is a pent up demand for housing that could be released to underpin strong construction and hence solid growth over the next five years. Essentially, we need to ensure the economic health of the state to:

- Facilitate recovery from current weak patch; and
- Address the shortage of residential stock.

The extent that we are successful in ensuring the economic health of the state will determine the boost to government revenues. A large part of the weakness of NSW government revenues last decade was the weakness of housing and hence transfer duty revenues, with weak growth also affecting payroll taxes.

### **A 2.5% wage rise will lead to a real wage cut**

The approach adopted by the NSW Government is to rely on the RBA to achieve its agreement with the Commonwealth Government to maintain national CPI inflation within a range of 2-3% over the cycle, i.e. an average of 2.5%. But this target objective is in practice a medium-term objective which allows for the CPI to go outside the target range, as long as the RBA pursues a monetary policy to bring the CPI back within its target range over the medium-term. That is, BIS Shrapnel and most other economists understand that 'over the cycle' implies a time period of 3 to 5 years. By clinging to the 2.5% CPI forecast, the NSW Treasury is ignoring the current reality that CPI inflation is well above the 2.5% mid-point and is likely to remain above that point for the next five years. BIS Shrapnel expects CPI inflation for Australia to average 3.3% per year. Our forecasts are presented in the table 3.1.

With CPI inflation forecast to average around 3.3% over the next five years, a 2.5% base increase in wages will *not* maintain real wages — it would lead to an erosion of real wages for NSW public sector employees of nearly 1% per annum.

### **Outlook for Consumer Price inflation**

Extreme weather events in Australia and high oil prices saw consumer prices shift higher in the first half of 2011. The CPI inflation rose 0.9 per cent in the June 2011 quarter to be 3.6 per cent higher through the year. Meanwhile, annual underlying inflation, which has been on a slow downward drift since the global financial crisis, increased only marginally to 2.3 per cent in the March quarter before rising to 2.9 per cent in June 2011.

BIS Shrapnel believes that underlying inflation reached its cyclical low point (in the current cycle) in the first quarter of this year. A combination of factors including a strengthening economy, a pick-up in upstream price pressures, the waning of the disinflationary effects of the high A\$, and higher rental and utilities inflation will continue to put upward pressure on underlying inflation through the rest of 2011 and into 2012.

By 2013, the economy is expected to hit capacity constraints and demand inflationary pressures will emerge. Moreover, we envisage there is limited scope for a further significant appreciation of the A\$ and this will remove the A\$'s inflation busting qualities. Hence, underlying

tradeables inflation will increase at a faster rate over the next three years. Aggregate CPI inflation over the medium term will also be pushed up by faster growth in wages (due to skilled labour constraints) and the persistence of high rates of inflation in rents, utilities, health, education, child care services and other housing costs.

Overall, we are forecasting that both underlying and headline consumer price inflation will push above 3 per cent by the end of 2012. Headline CPI inflation is forecast to peak at an annual rate of 4 per cent in June 2013, well above the 'baseline' inflation with the imposition of a carbon price

**Table 4.1: CPI Inflation Summary**

	Through-the-year <sup>(1)</sup>			Year Average <sup>(2)</sup>
	CPI Headline			CPI Headline
	Australia <sup>(3)</sup> A% ch.	RBA Headline <sup>(4)</sup> A% ch.	RBA Underlying <sup>(4)</sup> A% ch.	Australia <sup>(3)</sup> A% ch.
Jun-04	2.5	2.5	2.6	2.4
Jun-05	2.5	2.5	2.6	2.4
Jun-06	4.0	4.0	2.9	3.2
Jun-07	2.1	2.1	2.8	2.9
Jun-08	4.5	4.5	4.4	3.4
Sep-08	5.0	5.0	4.8	4.2
Dec-08	3.7	3.7	4.4	4.4
Mar-09	2.5	2.5	4.2	3.9
Jun-09	1.5	1.5	3.9	3.1
Sep-09	1.3	1.3	3.5	2.2
Dec-09	2.1	2.1	3.4	1.8
Mar-10	2.9	2.9	3.1	1.9
Jun-10	3.1	3.1	2.7	2.3
Sep-10	2.8	2.8	2.4	2.7
Dec-10	2.7	2.7	2.2	2.8
Mar-11	3.3	3.3	2.3	3.0
Jun-11	3.6	3.6	2.7	3.1
<b>Forecasts</b>				
Jun-12	2.7	2.5	3.0	3.1
Jun-13	4.0	3.8	3.3	3.8
Jun-14	3.4	n.f.	n.f.	3.6
Jun-15	2.5	n.f.	n.f.	2.9
Jun-16	3.2	n.f.	n.f.	3.0
<b>Annual Average Growth Rates</b>				
July '04-June '08	3.3	3.3	3.1	3.0
July '08 to Jun '11	2.9	2.9	3.1	3.0
July '11 to June '16	3.2	n.a.	n.a.	3.3

(1) Average per cent change on corresponding quarter in previous year

(2) Average of four quarters over corresponding average in previous year

(3) BIS Shrapnel forecasts

(4) Underlying is average of weighted median and trimmed median inflation. RBA forecasts from *Statement on Monetary Policy, August 2011* and only available to December 2013.

n.f. not forecast

n.a. not available

and rapid rise in petrol prices adding to headline rate. However, both underlying and headline CPI inflation are projected to decline from 2014, as the high interest rates imposed by the RBA in 2013 finally affect inflationary pressures. The headline CPI forecast to ease to 3.4 per cent and 2.5 per cent through-the-year to June 2014 and June 2015, respectively. We expect inflation to remain near the top of RBA's target band over 2015/16.

The Reserve Bank provides the 'official' view of CPI forecasts. The forecasts contained in the RBA's August 'Statement on Monetary Policy' predicts the headline CPI rate at 3.5% in the December quarter 2011, before falling to 2.5% in the June quarter 2012. According to the RBA, CPI inflation (excluding carbon price) is then expected to rise to 3% by December 2012 and remain within 3 to 3.25 per cent band until December 2013 (RBA current forecasts only extend to December 2013).

## **Reviving the state economy**

### **Housing is the key to a strong economy and recovery in state revenue**

As mentioned in section 2, private dwelling construction will be one of the key drivers of Gross State Product over the medium term. Over recent years the construction of dwellings has not kept pace with underlying demand and subsequently property markets in New South Wales, and in particular Sydney, remain chronically undersupplied. The stock deficiency is estimated to reach almost 2 years worth of underlying demand by June 2011 (see table 1.3). Further, underlying demand will continue to increase in coming years as Sydney continues to attract a large (although declining) proportion of Australia's international migration, which is expected to lift again from 2012/13, although population outflows to other states will offset some pressures.

Another consequence of the persistent severe housing undersupply will be that rental vacancy rates are expected to remain acute and drive solid rental growth, which in turn is likely to encourage investor demand. Overall, these extreme demand and supply pressures will cause private dwelling commencements to surge over the three years to June 2014 (see chart 4.1), which in turn will underpin solid growth in stamp duty revenue for the state.

Transfer duty, although highly cyclical, is an important source of NSW State government revenues. In 2009/10, transfer duty (ie stamp duty on property taxes) contributed nearly 20% of all tax revenue, behind only to payroll tax which contributed 31%. As a proportion of total revenue, transfer duty constituted 6.6% of total revenue. In effect, the state has come to rely on a boom in property market and/or inflation in house prices in order to avoid severe fiscal stress it would otherwise face.

The upswing in dwelling construction combined with growth in Sydney house prices — house price growth in Sydney is projected to strengthen to 6.3% in 2011/12, before accelerating further to 8.8%, which would lift the median house value to \$740,000 at June 2013 — should see transfer duty make a stronger contribution to state revenue over the next three years.

### **Strong infrastructure spending will stimulate economic activity and maintain services**

The construction sector punches well above its weight in the broader economy, because of its high multiplier effects. Construction draws heavily on local labour, locally produced upstream inputs and includes significant downstream expenditure on fit-out items and on new machinery and equipment. This means that construction sector cycles have a disproportionate effect on domestic employment and activity (see chart 3.1 and table 3.1).

Investment, including infrastructure investment, is a primary driver of economic growth. The last decade saw inadequate infrastructure provision which caused bottlenecks and capacity

constraints. Public investment only really began to rise (from the middle of last decade) once capacity constraints emerged and revenues strengthened. But by then, serious capacity constraints in the construction industry meant not only delays completing the infrastructure projects, but also cost blow-outs.

BIS Shrapnel believes that we have significant ground to make up for the under investment of the 1990s and early last decade. We will need to maintain our infrastructure investment in order to reverse the underinvestment of the 1990s/early 2000s and underwrite future productivity increases, economic growth and an improved standard of living.

There will in any case be cuts in spending on schools and, later, hospitals through the forward estimate period as the stimulus projects instituted in the GFC period are completed. We've included that in our forecasts (see table 3.1 and chart 5.5). If reduced, there would be an impact on growth and jobs.

**Chart 3.1: Percentage change in Transfer Duty and Dwelling Construction in NSW**

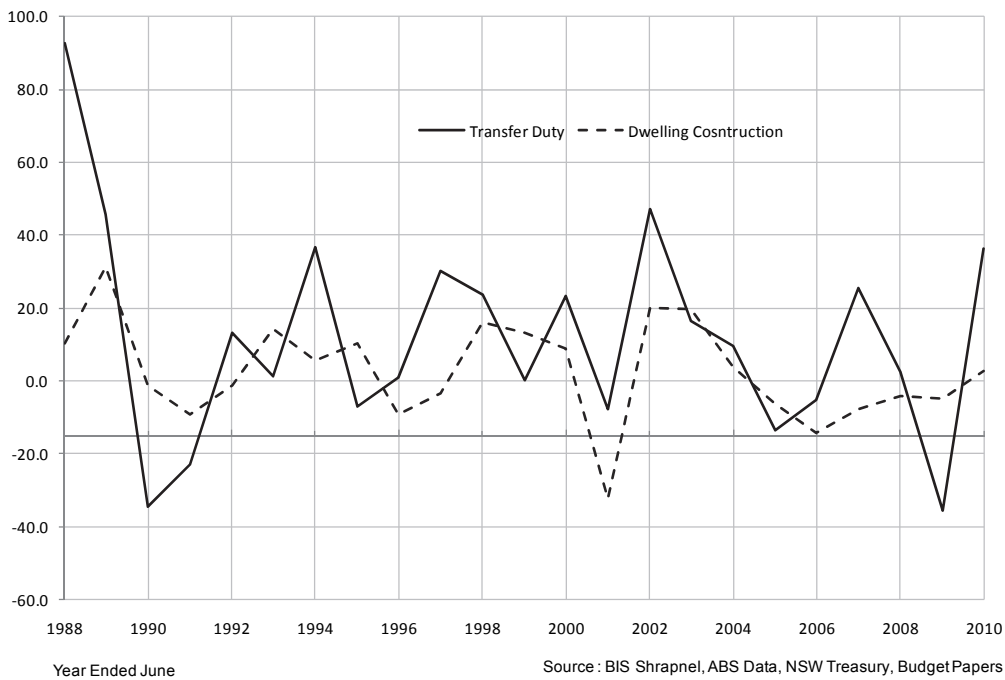


Chart 3.2: Sydney Dwellings – Prices and Activity

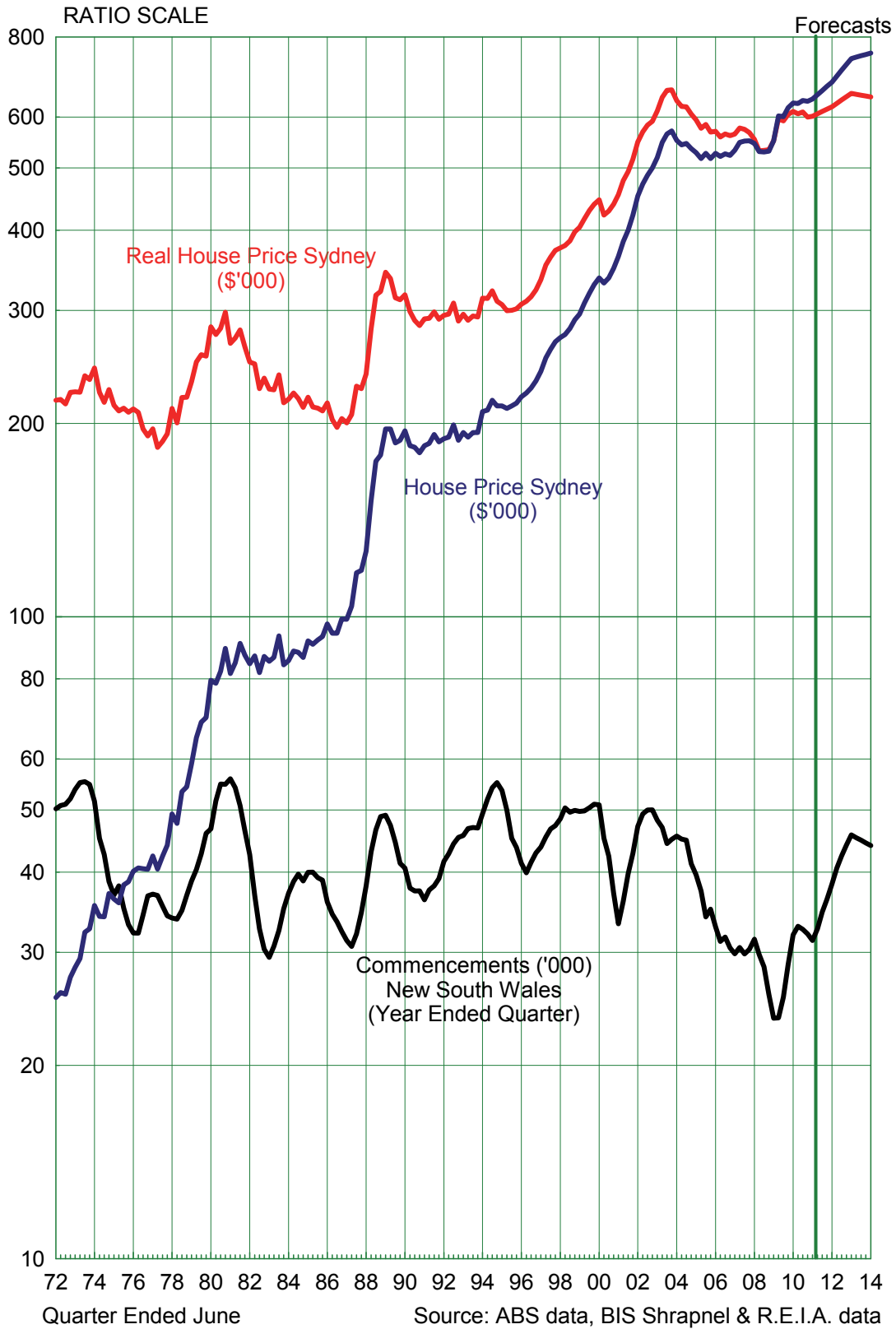


Table 3.1: Construction Contribution to NSW Gross State Product

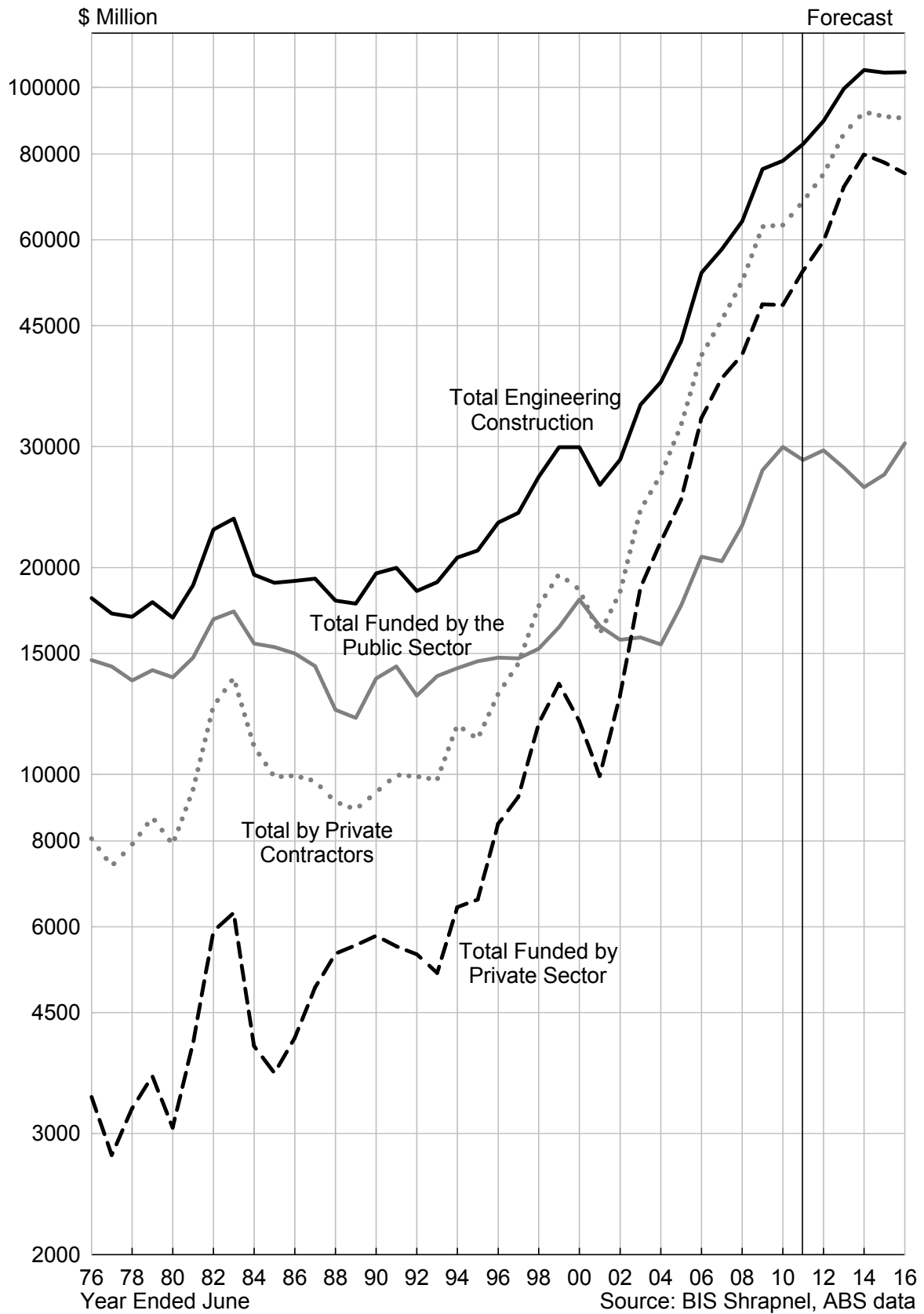
Year Ended June	Dwellings	Non-Dwelling Building	Private Engineering	Public Engineering	Total Construction	Construction contribution to SFD	NSW GSP <sup>(1)</sup>	NSW SFD <sup>(2)</sup>
1992	8,306	8086.1	1601.7	5079.3	23073.0	0.1	0.9	0.5
1993	9,489	7028.7	1300.1	5309.9	23127.5	0.4	2.5	1.3
1994	10,012	6520.9	1606.5	5295.0	23434.4	2.0	4.1	1.6
1995	11,043	6535.4	2246.4	5369.2	25193.9	0.6	4.2	6.7
1996	10,037	7377.8	2838.3	5456.7	25710.0	-0.3	4.1	3.0
1997	9,703	7804.3	2103.0	5774.4	25384.2	2.8	4.5	1.9
1998	11,281	8742.2	2223.4	5928.3	28174.9	2.6	4.1	5.7
1999	12,771	9461.4	2592.6	6069.4	30894.3	1.6	5.3	5.7
2000	13,890	9468.1	2553.7	6769.6	32681.6	-7.1	4.1	5.3
2001	9,397	6210.7	2428.1	6491.2	24527.4	1.0	2.3	-1.8
2002	11,267	6437.3	1888.2	6077.0	25669.0	3.5	2.3	3.0
2003	13,496	7292.9	2612.7	6420.2	29822.3	2.0	3.0	5.2
2004	14,021	7601.6	4167.3	6501.8	32291.5	0.3	1.9	4.5
2005	13,136	7547.4	5293.1	6730.0	32707.0	-0.1	1.9	3.3
2006	11,271	8419.8	5245.1	7578.7	32514.2	-1.2	2.2	1.6
2007	10,400	8602.8	5134.7	6755.7	30893.6	0.8	2.9	2.4
2008	9,976	9178.4	5777.0	7072.0	32003.2	1.6	3.3	5.5
2009	9,486	8399.7	6911.8	9406.8	34204.3	1.3	0.9	0.0
2010	9,730	9848.1	6294.9	10115.8	35989.1	1.5	1.7	3.4
2011	10,520	9577.6	7745.1	10270.0	38112.6	-0.2	3.6	2.9
Forecasts								
2012	11,190	8026.4	8542.5	10054.8	37814.1	0.1	3.4	3.6
2013	13,360	8689.4	9217.1	9488.5	40754.8	1.7	3.5	4.4
2014	15,402	9766.7	9499.1	8882.8	43550.2	2.1	2.8	2.8
2015	14,423	10062.1	10060.6	9248.5	43794.6	0.8	2.7	2.3
2016	14,404	10582.8	11218.5	10381.5	46587.0	0.3	4.3	5.5

Source: BIS Shrapnel, ABS data

(1) GSP is Gross State Product

(2) SFD is State Final Demand

### Total Engineering Construction Australia Value of Work Done - 2008/09 Prices



### Engineering Construction Activity - New South Wales

Value of Work Done - 2008/09 Prices

