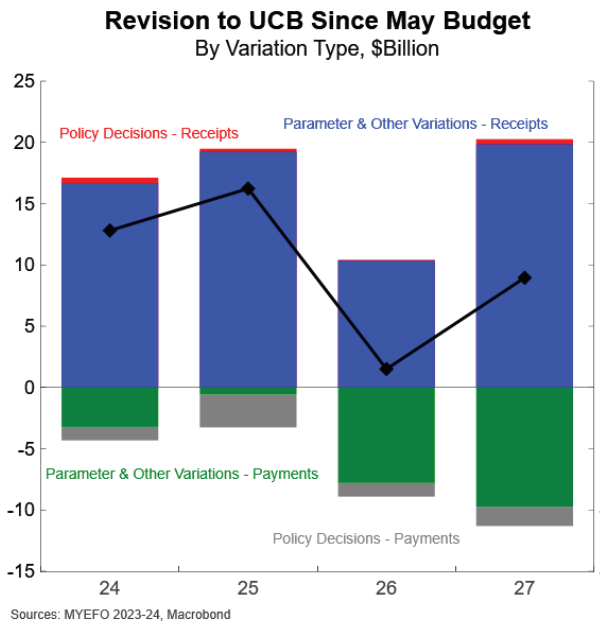
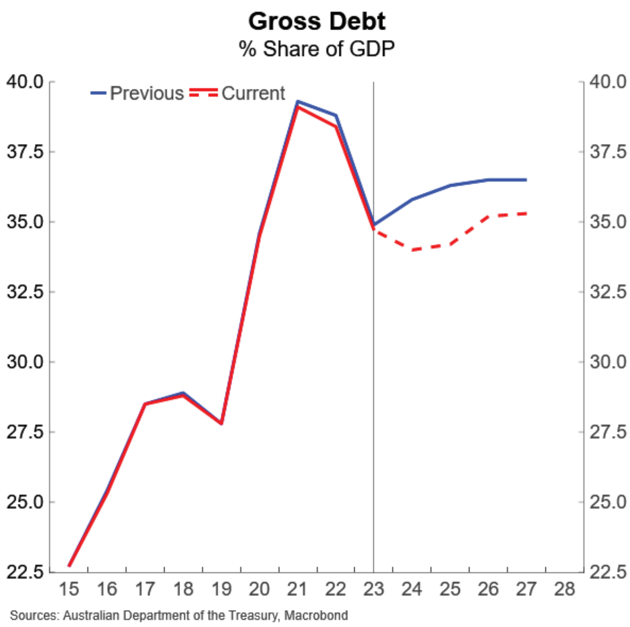
BULLETIN

13 December 2023

Mid-Year Economic and Fiscal Outlook
On track for another surplus

- **The budget bottom line is forecast to be $40 billion better over the four years to 2026-27. This was driven by a sizable $66.1 billion upgrade in expected receipts, partly offset by higher expenses ($21.3 billion) and new spending measures ($5.2 billion). This has lowered the peak in both net and gross debt as a share of the economy.**
- **As we expected, the 2023-24 budget deficit was revised lower to $1.1 billion (or 0.0% of GDP), from the $13.9 billion expected back in the May Budget. We continue to expect the 2023-24 Final Budget Outcome will show a surplus of at least $11 billion when unveiled next September.**
- **Treasury continues to expect the economy will slow over the next few years to grow below trend with the unemployment rate drifting higher to 4.5% in 2025-26. The economic outlook was broadly unchanged with some near-term strength driven by investment and public spending, partly offset by lower household spending. Importantly, Treasury continues to expect inflation to drift lower and be at 2.75% by mid-2025.**
- **Was the MYEFO update a showcase in "responsible budget management" as the Treasurer claimed? A large share of the windfall was banked, which we have argued is the prudent approach given we are amid a temporary budget sweet spot.**
- **However, to assess the broader question – whether fiscal policy is reducing inflationary pressures, we must look at the totality of fiscal settings not just what happened in one update. Treasury's analysis of the structural budget position suggests that the budget in 2023-24 is neutral with respect to inflation – it is neither adding nor reducing inflationary pressures.**
- **While neutral, policy settings are impacting cohorts differently – workers are being squeezed by bracket creep, but some of this drag is being offset by targeted temporary measures, such as cost of living relief measures, and spending on infrastructure.**





Economic outlook – A soft economic landing is expected.

The Government's fresh economic forecasts continue to paint a sanguine picture for the prospects of a soft landing. The major economic indicators were left largely unchanged. Inflation and growth were revised higher in 2023-24, reflecting near-term strength driven by investment and public spending, partly offset by lower household spending.

However, the overall economic narrative remains. The forecasts reflect a 'goldilocks' return to the top of the inflation target by the middle of 2025, accompanied by below trend but still positive growth in economic activity, and a slight increase in the unemployment rate to 4.5% in 2025-26.

If realised, this would be a remarkable achievement and would be consistent with the RBA's goal of a 'soft landing'. The Government is more optimistic than the RBA when it comes to expected progress on inflation. The RBA expects inflation to be at 3.0% by mid-2025.

MYEFO 2023–24 vs May 2023 Budget Economic Forecasts

KEY AGGREGATES AND PARAMETERS				
	Forecasts			
	2023–24	2024–25	2025–26	2026–27
Economic Aggregates:				
Real GDP				
May 2023	1.50	2.25	2.75	2.75
MYEFO	1.75	2.25	2.50	2.75
Change	0.25	0.00	–0.25	0.00
Employment				
May 2023	1.00	1.00	1.75	1.75
MYEFO	1.50	1.00	1.50	1.75
Change	0.50	0.00	–0.25	0.00
Unemployment rate				
May 2023	4.25	4.50	4.50	4.25
MYEFO	4.25	4.50	4.50	4.25
Change	0.00	0.00	0.00	0.00
Consumer price index				
May 2023	3.25	2.75	2.50	2.50
MYEFO	3.75	2.75	2.50	2.50
Change	0.50	0.00	0.00	0.00
Wage price index				
May 2023	4.00	3.25	3.25	3.50
MYEFO	4.00	3.25	3.50	3.50
Change	0.00	0.00	0.25	0.00
Nominal GDP				
May 2023	1.25	2.50	5.25	5.25
MYEFO	4.25	2.25	4.50	5.00
Change	3.00	–0.25	–0.75	–0.25
Net overseas migration ('000)				
May 2023	315	260	260	260
MYEFO	375	250	255	235
Change	60	–10	–5	–25

Source: MYEFO 2023-24

* GDP data are percentage change on the previous year. The consumer price index, employment and wage price index are through the year growth to the June quarter. The unemployment rate is for the June quarter.

However, the overarching outlook for the Australian economy is broadly similar across the two institutions.

The migration intake has been a hot topic recently. As expected, the MYEFO forecasts upgrade the outlook for net overseas migration (NOM) in 2023-24 by 60k to 375k. We suspect that this will likely undershoot the eventual outcome. In 2024-25, forecasts for NOM have been marked down slightly to 250k, likely reflecting the expected impact of the Government's recently announced migration strategy.

Fiscal outlook – Revenue windfalls deliver sweet spot for the nation's finances.

In the lead up to today's release the Treasurer made clear the update will show fiscal policy continues to support the RBA and place downward pressure on inflation, predominantly by banking the revenue windfalls from the stronger economy.

True to his word, the MYEFO showed a significant improvement. Over the four years to 2026-27 the expected underlying cash balance improved by around $40 billion. This was driven by a sizable $66.1 billion improvement in expected receipts, primarily tax receipts, partly offset by higher payments ($21.3 billion over the four years to 2026-27) and new spending measures ($5.2 billion).

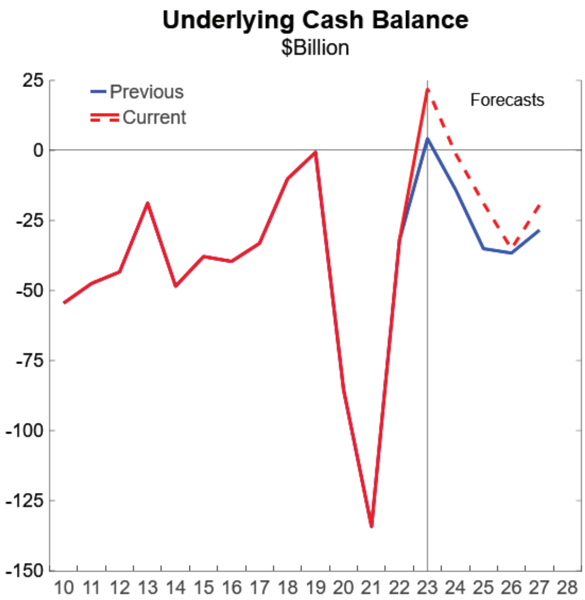
The $66.1 billion improvement in expected receipts were driven entirely by upgrades to expected personal income and company tax receipts, in equal proportion.

The increase in payments were driven by higher global interest rates and public debt interest ($3.6 billion over the four years to 2026-27), higher take up of government programs such as child care ($2.2 billion), higher NDIS costs resulting from the 2023-24 Fair Work Commission Wage review ($2.6 billion) and the banking of capital allocated to the infrastructure pipeline, which was freed due to cancelled projects ($2.2 billion). This is the other side of the automatic stabilisers – higher inflation, wages growth and interest drag on the budget, but only partly offset revenue windfalls.

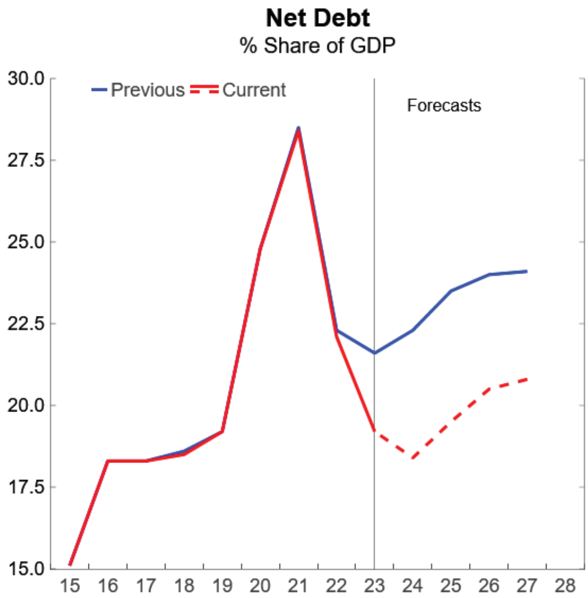
2023-24 fiscal year and beyond

As we expected, the 2023-24 budget deficit was revised lower to $1.1 billion (or 0.0% of GDP), from the $13.9 billion expected back in the May Budget. We continue to expect the 2023-24 Final Budget Outcome will be a sizable surplus of at least $11 billion when unveiled next September.

The bottom line is then expected to deteriorate in the outer years to reach a deficit of around $20 billion (or 0.6% of GDP) in 2026-27. The deterioration results from increasing costs pressures (such as higher net interest), measures impacting the bottom line (such as Stage 3 tax cuts), and the assumed decline in commodity prices over the next four quarters. If commodity prices remain resilient, it is very likely that revenue will continue to surprise on the upside in the near term.



Sources: Australian Department of the Treasury, Macrobond



Sources: Australian Department of the Treasury, Macrobond

Was it enough to put downward pressure on inflation – what does the Structural budget balance say?

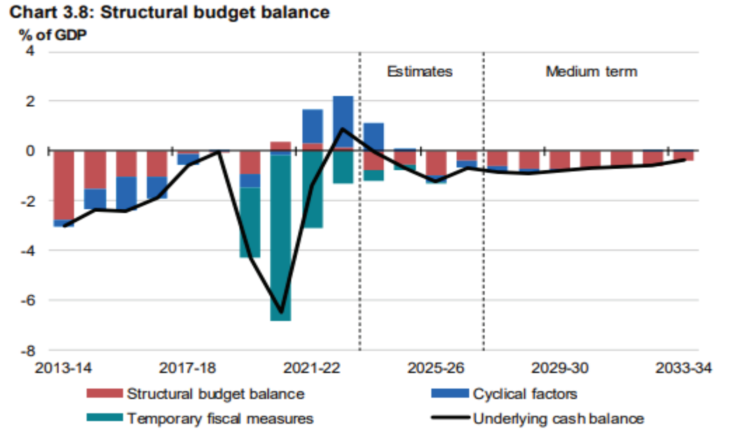
A large share of the windfall was banked, which we have argued is the prudent approach given we are amid a temporary budget sweet spot.

However, to assess the broader question – whether fiscal policy is reducing inflationary pressures, we must look at the totality of fiscal settings not just what happened in one update.

Treasury analysis which was published in the MYEFO update provides some clues here. It suggests that a budget balance in 2023-24 is neutral with respect to inflation – it is neither adding nor reducing inflationary pressures.

The structural budget balance looks at what the bottom line would be given existing fiscal settings (tax and payment policies) in the absence of temporary factors that are impacting the bottom line – such as persistently high commodity prices. Their analysis suggest that the structural balance is a small deficit in 2023-24. However, this has been completely offset by temporary windfalls which are being banked and improving the budget.

Chart 3.8: Structural budget balance



Note: The approach separating the budgetary impact of temporary measures from structural measures follows the methodology detailed in Treasury Working Paper 2013-01. Cyclical factors measure the estimated impact on the underlying cash balance from automatic stabilisers and cyclical movements in asset and commodity prices. Temporary fiscal measures comprise direct economic and health support measures initiated between the onset of the COVID-19 pandemic and the 2022–23 October Budget. Underspends in these direct economic and health support measures are not captured in the derivation of the structural budget balance, which may result in an improved structural budget balance estimate.

Source: Treasury.

While neutral, policy settings are impacting cohorts differently. As we saw last week, workers are being squeezed by bracket creep, but some of this drag has been offset by targeted temporary measures, such as cost of living relief measures, and spending on infrastructure.

The challenge for the government will be to reduce the structural budget balance overtime though new policies. Analysis in MYEFO shows that the budget position remains in a structural deficit, even out to 2033-34. This reflects long-term cost pressures, particularly health care, aged care, the NDIS, defence, and the interest bill. These have been outlined by governments in previous budgets and intergenerational reports as challenges that will require significant work over coming decades.

Progress on debt quicker than expected.

A stronger budget bottom-line translates into a lower peak in both net and gross debt as a share of the economy.

Gross debt is expected to peak at 35.4% of GDP in 2027-28, this is 0.2 percentage points lower than projected in the May Budget. While debt is expected to be lower, the expected cost of capital has also increased since the May Budget, reflecting the rise in government bond yields. Overall, these counteracting forces net out to a slight increase in interest payments as a share of GDP over the medium term.

Key measures

The Government announced several new measures which increased spending by $5.2 billion over the four years to 2026-27. The Treasurer had flagged that there would be no new cost of living support measures at MYEFO, something the Government is keeping a close eye on the for the upcoming May 2024 Budget.

On the revenue side, there were only small policy tweaks announced since the May budget. This includes reforms to foreign investment fees for foreign investors purchasing established dwellings and a higher rate and lower threshold for capital gains withholding tax on foreign investors.

Domestically, the Government has removed the tax deductibility of general interest charge and shortfall interest charge on corporate tax liabilities. Over the forward estimates, this is expected to add a total of $1.2 billion to Government revenue.

New policies will increase Government expenditure by $6.5 billion over the four years to 2026-27. Key policies include:

- $3.5 billion in additional funding to cover new and amended listings on the pharmaceutical benefits scheme (PBS);
- Additional funding for the 'Home Bonus Scheme' which provides incentive payments to state, territory and local governments to boost housing supply;
- Additional spending to support the NDIS and to reform the aged care sector.

This spending has been partially offset by a $7.4 billion reduction in infrastructure spending, which has been pushed out beyond the forward estimates following the recent infrastructure spending review.

Pat Bustamante, Senior Economist
+61 468 571 786

Jameson Coombs, Economist
+61 401 102 789

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