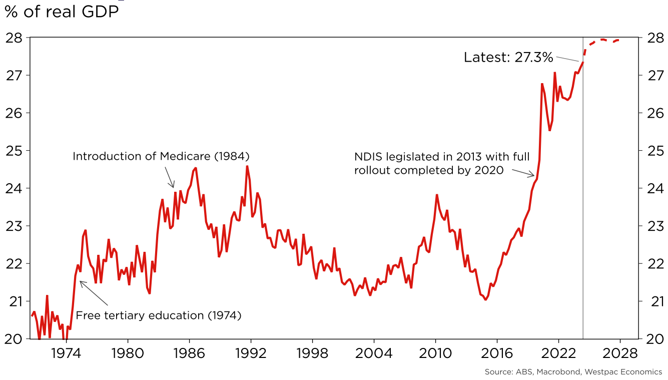
23 September 2024

EXPANSION IN PUBLIC DEMAND TO SEE A TEPID RECOVERY IN THE PRIVATE SECTOR

Key points

- The increase in public spending as a share of the real economy has been unprecedented in speed and scale.
- This lowers growth in measured labour productivity, but the direct impact on CPI inflation is likely to be muted given public services are heavily subsidised.
- Indirectly, growing public spending (both federal and state) in areas with capacity constraints (such as construction) is bidding away resources from the private sector, elongating the disinflationary process and adding to the RBA's concerns.
- The National Accounts showed the private sector needs support. With the RBA increasingly concerned that inflation is too "sticky", monetary support is unlikely this year and will be gradual when it arrives (consistent with our interest rate outlook).

New public demand to reach 28% of GDP



- It takes time for a sector that has been squeezed in this way to recover. When the growth baton is eventually passed back to the private sector, the recovery is therefore likely to be tepid.
- Reflecting this, we have lowered our growth forecast by 1ppt in 2026, with the near-term growth mix also expected to be skewed more towards public demand.

Economy quietly undergoing historic transition

Pat Bustamante
Senior Economist, Westpac Group
P: +61 468 571 786
E: pat.bustamante@westpac.com.au

A lot has been written about Australia's recent productivity performance. Measured labour productivity has been unusually volatile due to the disruptions caused by the pandemic and its aftermath, and now, as public spending (both federal and state) grows to a record high share of the economy.

In the transition to a larger public sector, measured growth in labour productivity will likely be soft. The composition of output will be shifting towards industries with lower levels of measured productivity due to measurement difficulties and errors, public regulations and intrinsic constraints (i.e. the mining sector may be able to double its output by investing more, but this is much harder to achieve for care workers).

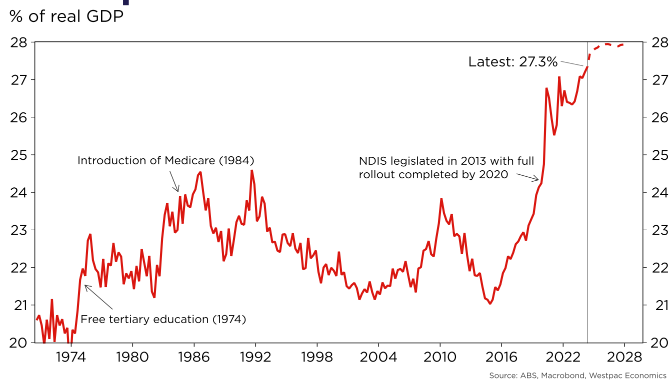
As the surge in public spending plateaus, this compositional effect will fade. Productivity will likely return to around its pre-pandemic trend, although this too remains uncertain. Outside the mining and non-market (or public) sectors, labour productivity has already rebounded strongly, growing 1.7%yr in the June quarter 2024. This strong showing could be partly due to the supply side of the economy normalising following the pandemic, and/or increased competition for labour from the public sector driving productivity enhancing investment and process change elsewhere.

The RBA is concerned the current rate of wages growth, coupled with slow growth in labour productivity, could see underlying cost pressures (or unit labour costs) remain elevated and inflation sticky.

Critically, elevated costs pressures must pass through into consumer prices for this risk to materialise. We know pressures in the non-market sector will not fully pass through into consumer prices because public services, such as education and health services, are heavily subsidised by governments.

This is not to say that the increase in public spending has been benign for inflation. Indirectly, increased public spending, particularly in areas that are capacity constrained, such as health, disability support and construction, is bidding away resources from the private sector, elongating the disinflationary process and adding to the RBA's concerns. Since the 2019 calendar year, the underlying cost base in the construction sector has grown by a whopping 36%, compared to around 21% in the non-mining market sector as a whole.

New public demand to reach 28% of GDP



The June quarter National Accounts showed the private sector needs support. With the RBA increasingly concerned that inflation is too "sticky", monetary support is unlikely this year and will be gradual when it arrives (consistent with our interest rate outlook). And when a sector has been squeezed in this way, it takes a while to recover.

When the growth baton is eventually passed back to the private sector, the recovery is therefore likely to be tepid. Reflecting this, we have recently lowered our growth forecast by 1ppt in 2026, with the near-term growth mix also expected to be skewed more towards public demand.

There is a risk that over the medium to longer term we head back to the pre-pandemic situation where growth in private demand was anaemic and we went through a period of wage stagnation, which saw underlying inflation undershoot the RBA's inflation target (see Luci's note available here).

Public demand to reach a new record high

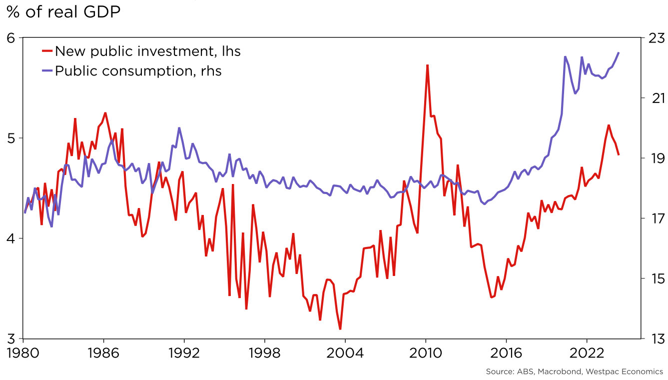
The Australian economy is quietly undergoing one of the largest transitions in modern history, rivalling the structural change driven by the mining investment boom of the 2000s. Geopolitical instability, economic uncertainty and demographic trends (most notably the ageing of the population) have combined to see governments become a larger part of the economy, both here and abroad.

In Australia we have seen new public demand go from a pre pandemic average of around 22.5% of the real economy, to a record high of 27.3% in the June quarter 2024. We are forecasting (based on previous published research) a further increase to around 28% of real GDP by the end of 2025. The increase in new public spending as a share of the real economy is unprecedented in speed and scale (using quarterly ABS data going back to the early 1970s).

This measure of new public spending is a subset of the overall fiscal impulse: it's the provision of heavily subsidised goods and services (including infrastructure services) by both the federal and state governments. Previous work on the aggregate fiscal impulse, which includes social assistance benefits (such as welfare payments) and the revenue side of the budget can be found here.

The increase to date has been driven by government consumption, essentially the increased provision of subsidised public goods and services including childcare, education, healthcare, aged care and disability support. Public investment has also stepped up and is likely to remain elevated as infrastructure investment catches up to the record population growth.

New public demand by component



To be clear, we are not saying this is a bad thing. Governments exist partly to provide citizens with goods and services that the market sector would not. And there are many cases where this generates large social and economic benefits. At issue is the implications of this latest expansion for the Australian economy.

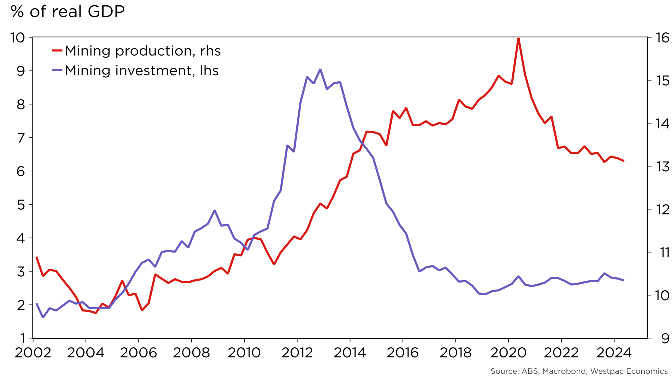
Comparing to the mining expansion

As a basis for comparison, following the mining investment boom, output from the mining sector increased by a similar share of real GDP. Following record high commodity prices, mining investment increased sharply, taking mining output from around 11% of real GDP in 2009 to around 15% of GDP in 2016 – it is currently sitting at around 15% of GDP.

While the expansion is of a similar size, there are many differences. The expansion in the provision of public services has occurred more rapidly, with most of the increase from 2020. It took the mining sector about seven years to make a similar expansion, with a much longer lead time – the investment that was required to increase mining output this much started to ramp up in the early 2000s.

And most importantly, the mining expansion was characterised by the sector quadrupling its capital stock and doubling its capital to labour ratio. This

Mining activity

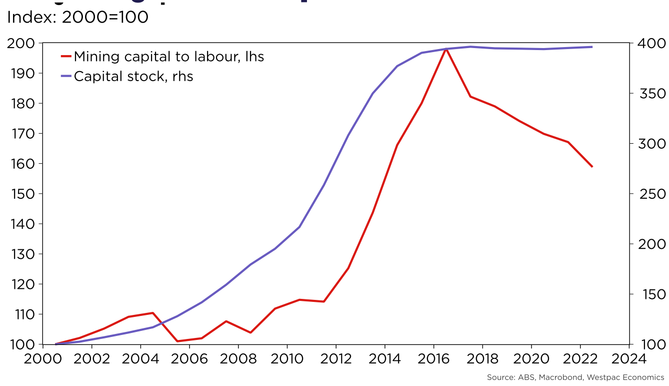


resulted in a capacity boost once this investment and capital equipment were operational. In comparison, the provision of public goods and services is labour intensive, which will mean recurrent government revenue has to continue to fund these goods and services.

In the past when government budgets have gone into the red, bracket creep (or fiscal drag) has become a more important mechanism for fiscal consolidation and to fund recurrent government programs. This dynamic is likely to be repeated, which will weigh on household income growth in the medium term.

While stage 3 tax cuts will provide some immediate support, our projections suggest, in the absence of policy changes, average personal income tax rates will return to 2022-23 peak levels (the second highest in history) by 2026-27 and back to 2023-24 levels (the highest in history) by the end of 2028-29.

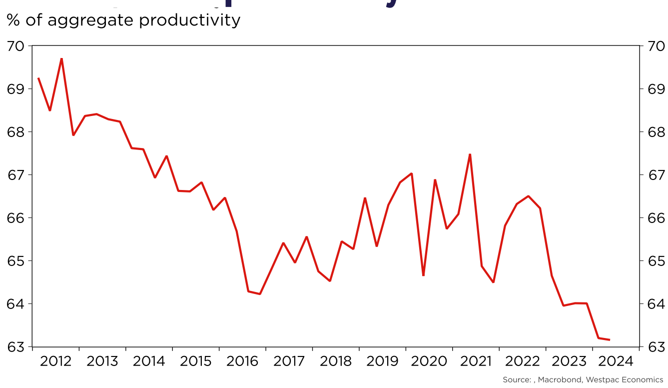
Mining factors of production



Impact on growth in productivity likely to be transitory

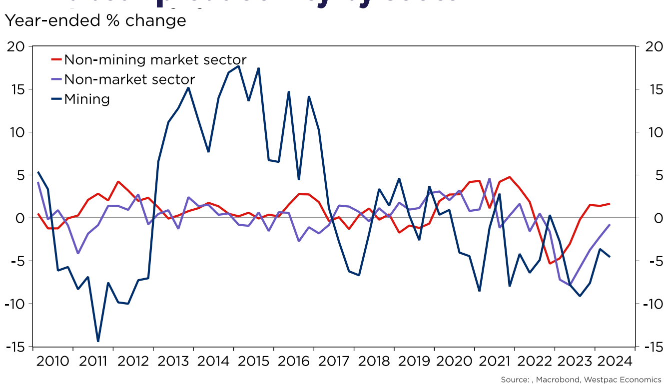
As the expansion in public services continues in line with 2024-25 federal and state budget announcements, compositional effects will weigh on measured growth in aggregate labour productivity. More output will be produced by the non-market sector (the health, education, and public administration industries), where measured productivity is around two thirds of the economy-wide average productivity level.

Non-market productivity



As this unprecedented expansion in public demand slows and comes to an end, productivity will likely return to be around its pre pandemic trend, but this remains uncertain. Outside the mining and non-market (or public) sectors, labour productivity has rebounded strongly.

Labour productivity by sector

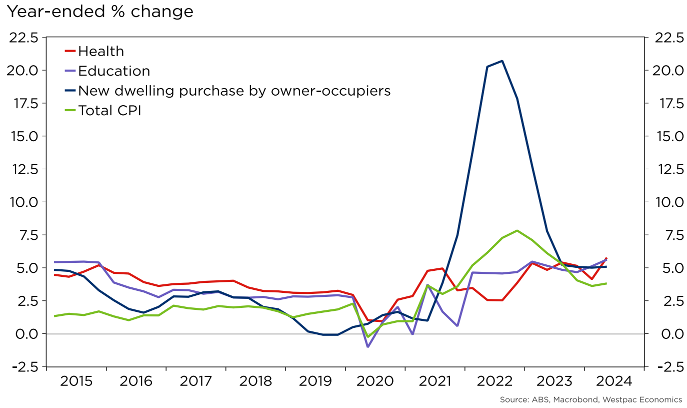


Higher public costs pressures unlikely to get fully passed through into the CPI

For softer growth in productivity to translate to higher consumer prices, the elevated growth in the economy's cost base (or unit labour costs) must be fully passed through to consumers. We know that this will not be the case. In fact, part of the expansion in public services is driven by increased subsidisation of services such as childcare and disability support.

Using the most recent input/output tables, we find that around 70% of the output produced by the health care industry is government funded, around 60% of the services provided by the education industry is funded by governments and the government funds virtually all public administration and safety services – this suggests there will only be partial pass through into the CPI.

Consumer price index by components



But uncertainties remain and it's unclear what this expansion means for ongoing underlying inflationary pressures.

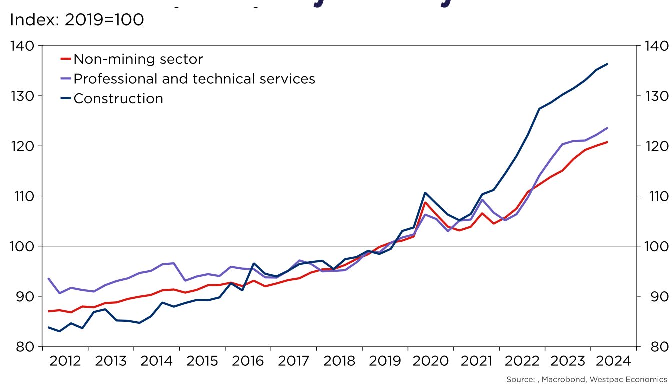
On the one hand, a larger share of the economy will be less sensitive to downside demand shocks, possibly making inflation "stickier". Furthermore, indexation is likely to become more important, given a large share of administered prices are indexed to past inflation, adding to the inertia in Australia's inflation. These are issues we continue to actively explore.

The crowding out effect to remain significant

This is not to say that the increase in public spending has been benign for inflation. Indirectly, increased public spending, particularly in areas that are capacity constrained, is bidding away resources from the private sector, elongating the disinflationary process.

Capacity constraints in the construction sector are clearly showing. Other industries which the public (or non-market) sector relies on for inputs, such as the professional and technical services industry, have also experienced above average growth in their underlying cost base since 2019.

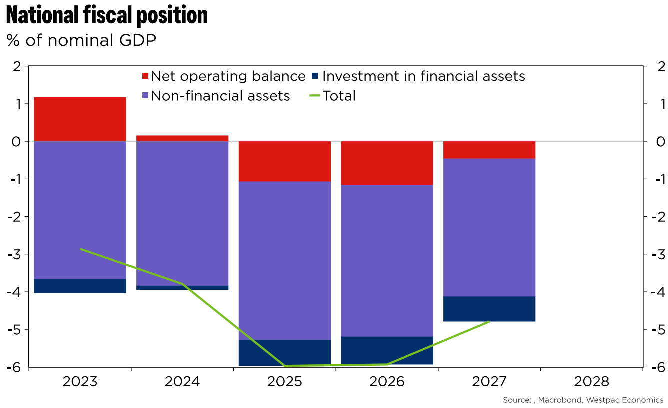
Unit labour costs by industry



And we know going forward governments have announced ambitious plans to help with the housing crisis, transition to net zero emissions and to bolster our defence capabilities, further increasing demand for construction services.

In fact, based on announcements in the 2024-25 federal and state budgets, public investment (comprised mainly of gross investment in non-financial assets such as roads, rail and bridges) is expected to increase by around 1 percentage point of nominal GDP in 2024-25, accounting for around 45% of the national fiscal impulse in 2024-25.

National fiscal position



Conclusion

While lower productivity in the non-market sector may not directly flow through to higher consumer prices, increased spending in areas that are capacity constrained, such as infrastructure construction, is elongating the disinflationary process, adding to the RBA's concerns. The longer this plays out, the weaker activity in the private sector and the slower the eventual recovery. Reflecting this, we have lowered our growth forecast by 1ppt in 2026 and have also reduced our wages growth forecast.

There is a risk that over the medium to longer term we head back to the pre-pandemic situation where growth in private demand was anaemic and we went through a period of wage stagnation, which saw underlying inflation undershoot the middle of the RBA's inflation target.

Authors

Westpac Economics / Australia

Sydney
Level 19, 275 Kent Street
Sydney NSW 2000
Australia

E: economics@westpac.com.au

Luci Ellis
Chief Economist Westpac Group
E: luci.ellis@westpac.com.au

Matthew Hassan
Head of Australian Macro-Forecasting
E: mhassan@westpac.com.au

Elliot Clarke
Head of International Economics
E: eclarke@westpac.com.au

Justin Smirk
Senior Economist
E: jsmirk@westpac.com.au

Pat Bustamante
Senior Economist
E: pat.bustamante@westpac.com.au

Ryan Wells
Economist
E: ryan.wells@westpac.com.au

Illiana Jain
Economist
E: illiana.jain@westpac.com.au

Jameson Coombs
Economist
E: jameson.coombs@westpac.com.au

Westpac Economics / New Zealand

Auckland
Takutai on the Square
Level 8, 16 Takutai Square
Auckland, New Zealand

E: economics@westpac.co.nz

Kelly Eckhold
Chief Economist NZ

Michael Gordon
Senior Economist

Darren Gibbs
Senior Economist

Satish Ranchhod
Senior Economist

Paul Clark
Industry Economist

Westpac Economics / Fiji

Suva
1 Thomson Street
Suva, Fiji

Shamal Chand
Senior Economist
E: shamal.chand@westpac.com.au

IQ

westpaciq.com.au

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