

# Australia in 2024

## Managing an economy at 'full employment'

- ◆ Achieving 'full employment' is a great positive, but sustaining it, as policymakers are seeking to do ...
- ◆ ... while bringing high inflation back to target, is challenging – we see the RBA as unlikely to cut its cash rate in 2024
- ◆ Fiscal policymakers ought to focus on productivity-enhancing reform to help boost supply and disinflate the economy

## Hard policy trade-offs on the 'narrow pathway'

The RBA has an ambitious plan to bring inflation back to its 2-3% target while still maintaining close to full employment. The central bank's own forecasts suggest that CPI inflation falls from 5.4% in Q3 2023 (having peaked at 7.8% y-o-y in Q4 2022) to 2.9% y-o-y by late 2025, while, on its forecasts, the unemployment rate rises by less than 1.0ppt from its trough. History shows a larger rise in the unemployment rate typically occurs when inflation falls by this much.

Seeking to maintain close to full employment while disinflating leaves policymakers with hard choices. For the RBA, any upside surprises to its own inflation forecasts could mean more monetary tightening, or a longer period of above-neutral interest rates. Our central case is that a tangible upside surprise to inflation is unlikely, but that the sticky nature of services inflation – particularly in rents and labour-intensive services – means inflation is likely to remain above target through 2024.

To disinflate, an extended period of suppressed demand is likely to be needed, weakening economic growth. Consumer spending is expected to weaken further. The housing market is forecast to cool, albeit significant supply constraints mean that we still expect positive single-digit growth in housing prices in 2024. As population growth slows, following exceptional strength in 2023, we expect this to weigh on growth. Demand for commodities and elevated commodity prices are set to support national incomes and growth. We see GDP growth slowing from 2.0% in 2023 to 1.5% in 2024. On a per capita basis, we see GDP falling again in 2024.

Another year of Federal fiscal surpluses is expected, but fiscal policymakers still face tough choices. Any boost to net fiscal spending would support already high inflation. Already legislated income tax cuts that are due to arrive mid-year are set to support consumption and inflation, and state government spending programmes remain buoyant. A focus on productivity-enhancing reform that boosts the supply side of the economy would be the best way to help to disinflate the economy. In the absence of a marked supply-side improvement, demand will need to be suppressed for longer.

*This is a Free to View version of a report with the same title published on 22-Jan-2024. Please contact your HSBC representative or email [AskResearch@hsbc.com](mailto:AskResearch@hsbc.com) for more information.*

## Free to View Economics - Australia

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# Downturn to disinflate ... is there a better way?

- ◆ Inflation is still too high, despite falling, and to get it back to target, demand needs to remain suppressed, or the supply side improved
- ◆ Consumer spending is set to be weak in 2024, as pandemic-related excess savings are run down and the unemployment rate rises
- ◆ Population growth is set to slow, but to support GDP growth ... after falling in 2023, per capita GDP is set to fall again in 2024

## The high inflation challenge – a short refresher

The much stronger recovery in demand than supply after the pandemic re-opening ...

... drove inflation to multi-decade highs ...

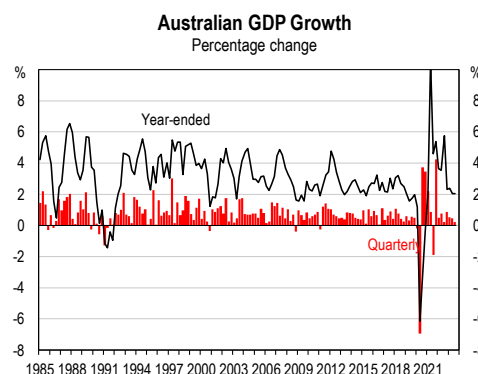
... prompting the RBA to lift its cash rate by 425bp

As Australia's economy re-opened, in late 2021 and 2022, after the COVID-19 pandemic, aggregate demand picked up well in excess of the economy's ability to meet it with aggregate supply (Chart 1).

In addition to the re-opening itself, demand was supported by substantial accumulation of savings by households through the pandemic, which then began to be drawn down. On the supply side, disruptions that were due to the pandemic, persisted even as the economic re-opening was under way and the Russia-Ukraine war forced a sharp rise in commodity prices.

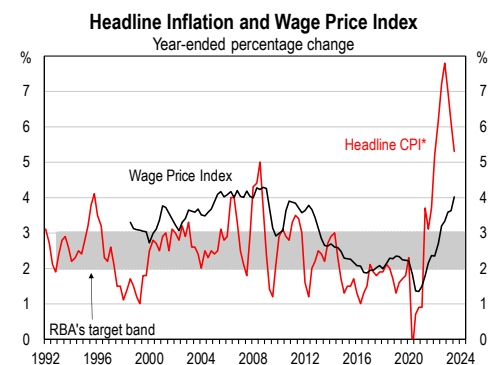
As a result, annual inflation picked up in 2022 to rates not seen in many decades, eventually peaking in Q4 2022 at 7.8% (8.4% on the monthly CPI indicator), which is a long way above the RBA's 2-3% target band (Chart 2). Strong demand, due to the re-opening, also drove a significant need for more workers, pushing the unemployment rate down to its lowest level in 50 years, at 3.4% in Q3 2022, and driving a pick-up in wages growth.

### 1. The re-opening and excess savings supported GDP growth ...



Source: ABS

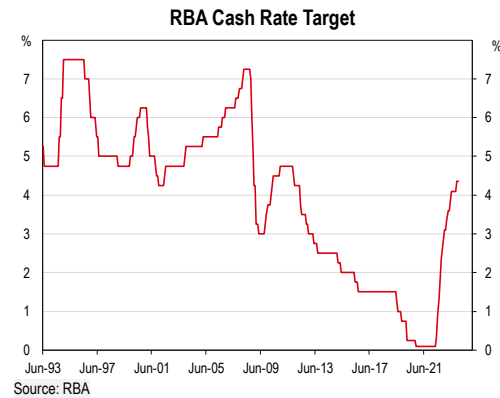
### 2. ... which, along with constrained supply, lifted inflation



\* Less interest and tax changes in 1999/2000

Source: ABS

### 3. The RBA has lifted its cash rate by a hefty 425bp to bring inflation down



### 4. The unemployment rate has risen, but remains historically low



This prompted the RBA to lift its cash rate substantially and rapidly – much earlier and more abruptly than previously expected, but still later than many other central banks. The RBA delivered 400bp of tightening between May 2022 and June 2023, and added to this with a further 25bp hike in November 2023, amid signs of persistent inflationary pressure (Chart 3).

Through 2023, inflation began to come down. On the supply side, many of the pandemic-related supply disruptions faded, the border re-opened (which boosted labour supply) and the acute effects of the Russia-Ukraine war on key commodity prices also passed. Aggregate demand also slowed, as monetary tightening weighed on consumer spending.

**Inflation has fallen from its peak, but remains above the RBA's 2-3% target**

However, inflation has fallen only slowly, and it is still well above the RBA's 2-3% target band, at 5.4% y-o-y in Q3 2023; 4.3% y-o-y on the monthly CPI indicator in November 2023. The unemployment rate was 3.9% in December 2023, up from its multi-decade low of 3.4% in October 2022; however, at this level, it is still historically low and below the estimates of a 'natural rate', or 'full employment' (Chart 4).

A slow loosening of the economy partly reflects the RBA's own policy approach, which has involved prioritising maintaining as close to full employment as possible, while also accepting a slow rate of disinflation. It also reflected a positive shock to the economy in 2023, in the form of exceptionally strong population growth, due to a rapid rise in net inward migration. Although this boosted labour supply, as expected, it also supported demand and inflation.

## The economy is still operating at, or beyond, sustainable rates

As 2024 arrives, although growth has slowed, the unemployment rate has risen and inflation has come down from its peak (as the charts above show), the Australian economy is still operating beyond its medium-term capacity.

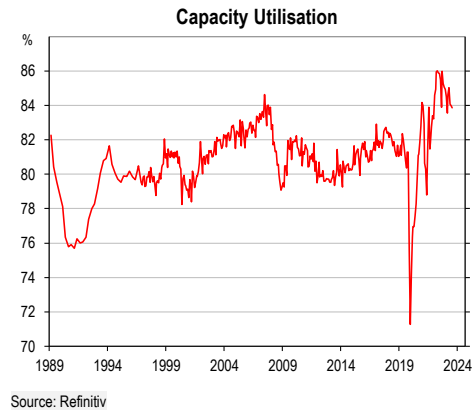
That is, aggregate demand is still running ahead of aggregate supply.

**Demand likely still exceeds the supply capacity of the economy**

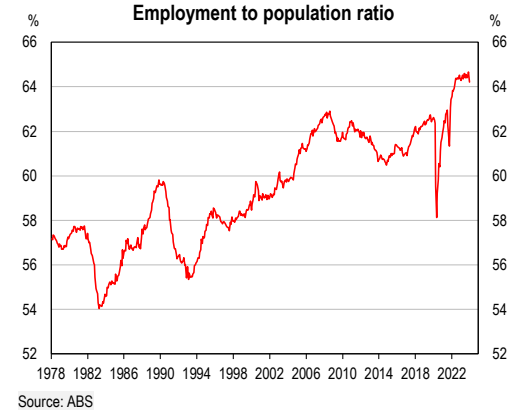
One way to demonstrate the balance of demand and supply in the economy is to look at survey measures of capacity utilisation. In business surveys, firms report that capacity utilisation has fallen from its exceptionally high level in late 2022, but that it still remains at historically high levels – at around the peaks reached during the prior inflation surge in 2007 (Chart 5).

Another way to observe that the economy is near or beyond its full capacity is the strength of the jobs market. A long-run view shows the employment-to-population ratio is currently near its all-time high (Chart 6). The unemployment and underemployment rates have risen (see Chart 4 above); however, at its current level, the unemployment rate is still the 15th lowest monthly reading in the 551 months of the monthly labour market survey.

### 5. Capacity utilisation has fallen, but remains high ...



### 6. ... alongside a record-high employment rate



## Inflation has come down, but is still too high

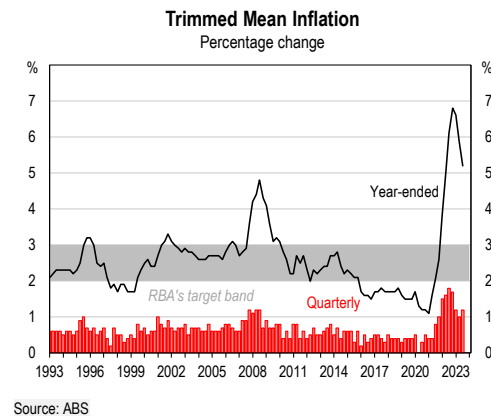
Of course, as the supply side of the economy is unobservable, the clearest metrics that reveal the balance of demand and supply in the economy are price indicators – particularly, CPI inflation and wages growth.

This is, after all, one of the reasons for having an inflation-targeting regime. When inflation is rising, or above target, it is a clear sign of excess demand, suggesting monetary policy tightening may be needed. When inflation is falling, or below target, demand is weaker than supply in the economy, and loosening monetary policy is in order.

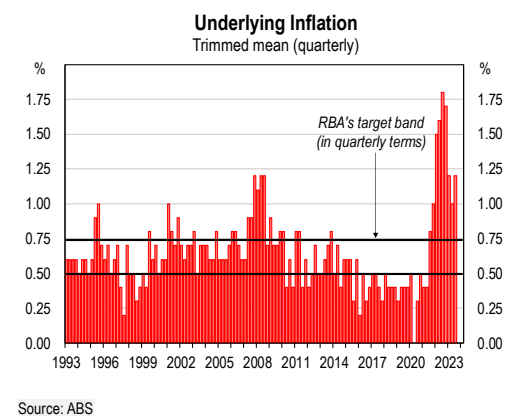
Core inflation has remained elevated ...

Although inflation has been falling from its high peak rates, it is still well above the RBA's 2-3% target band. This is true on a y-o-y basis, with the key core measure of inflation at 5.2% in Q3 2023 (Chart 7). It is also the case on a quarterly basis, with the q-o-q measure for Q3 2023 showing a pick-up in the pace of underlying inflation in Q3 2023, and to a rate that is still well above the RBA's 2-3% target band (Chart 8).

### 7. Trimmed mean inflation has fallen, but remains well above the RBA's target ...



### 8. ... on both an annual and quarterly rate



Although the more-timely, but far more volatile and still experimental, monthly CPI indicator shows further disinflation up to November 2023, it, too, is still well above the RBA's 2-3% target band (Chart 9). The monthly trimmed mean indicator ran at 4.6% y-o-y in November 2023.

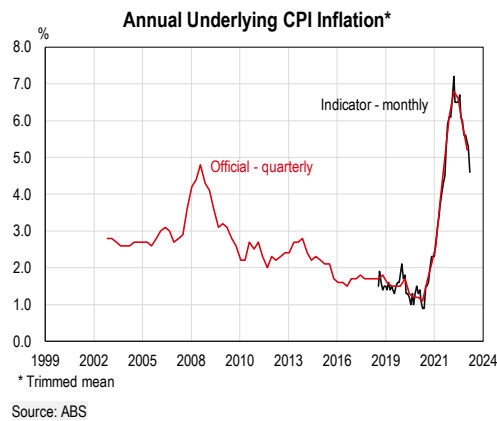
In our view, the 'easier' part of the disinflation process has already occurred. The shocks that drove up inflation earlier, including the Russia-Ukraine war, elevated commodity prices, and the impact of the pandemic, have largely faded.

... reflecting some of the 'sticky' components of inflation, including rents

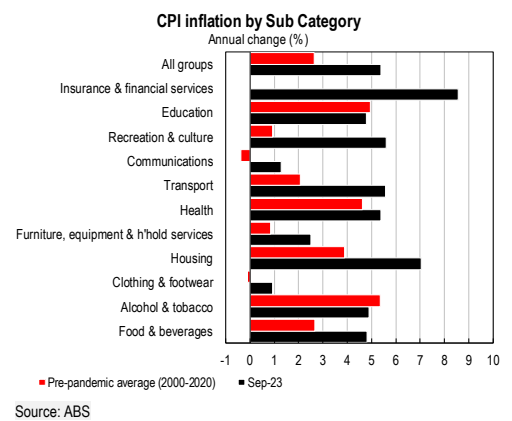
More recently, the key drivers of inflation have been increasingly domestic (Chart 10).

For instance, strong rental price inflation, elevated housing costs, and high services inflation, have all been key factors. These components of inflation are also ones that are typically sticky. Services inflation was 5.8% y-o-y in Q3 2023, only a touch below its recent peak of 6.3% y-o-y, a quarter prior. Likewise, while local food price inflation and housing cost inflation have fallen from their respective peaks, they remain too high. Annual rental price inflation, in particular, has yet to have peaked, having risen to 7.6% y-o-y in Q3 2023 (and remaining high in the monthly CPI indicator measure as well).

### 9. The disinflation process has continued into Q4 2023



### 10. Most inflation components remain above average



Disinflation is expected to continue in 2024

In 2024, we expect further disinflation. Our central case has (annual average) headline CPI inflation falling from 5.7% in 2023 to 3.5% in 2024 and 2.8% in 2025. Assisting the disinflation process is likely to be the ongoing lagged impact of the RBA's monetary tightening, which we see as weighing on growth further.

Two key markets that matter for the outlook for inflation are the housing market and the labour market. Slowing rental price inflation and wages growth are both expected to assist disinflation, but we expect the slowdown in both of these to be gradual.

Rental price inflation has been buoyed by tight supply and strong migration. A key assumption for easing rental price inflation is the slowdown forecast in the government's latest migration projections for 2023/24 and 2024/25 (see Chart 17 below), which assume migration returns back towards 'normal' rates. We also expect the average household size, which has increased in 2023, to continue to rise, effectively easing housing demand.

### Wage growth has picked up ... but productivity has not

Wages growth has risen to well above pre-pandemic rates ...

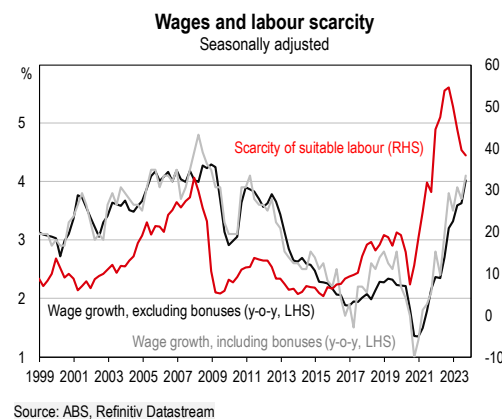
The wage price index has picked up, from running at around 2% a year in the pre-pandemic low inflation period, to having risen by 4.0% y-o-y in Q3 2023 (Chart 11). The key catalyst has been an exceptionally tight jobs market. In addition, the minimum and award wages lifted by the much more than in the past, contributing to the pick-up in wages growth. On 1 July 2023, the national award wage was raised by 5.75% and the recent wages negotiation outcomes for healthcare workers lifted the industry's respective minimum award wage by 15%.

... supporting high inflation, particularly given recent productivity outcomes

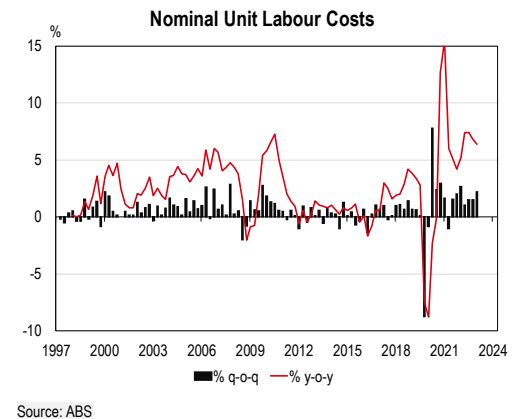
However, the timely indicators, such as business surveys and the RBA's own business liaison programme, suggest that it is likely to be around its peak rate, as labour supply has been boosted by the re-opened border and the influx of migrants.

A further complication is that the acceleration in wages growth has significantly outpaced productivity growth in the past couple of years. Indeed, productivity growth has been dismal, with productivity falling by 6% from its peak in Q1 2022, and down 2.1% y-o-y up to Q3 2023 (a topic we discuss in further detail below). As a result, unit labour costs are growing at a rate that is well in excess of that which is consistent with the RBA's 2-3% inflation target (Chart 12).

#### 11. Wages growth has lifted above the too-low pre-pandemic rates ...



#### 12. ... though unit labour costs are growing at a too-high rate



### The policy choices: weaken demand or improve supply

Bringing inflation back to target can involve either slowing down demand or improving supply. Much of the policy approach has, so far, been on managing demand, with the RBA lifting its cash rate substantially.

Federal fiscal policymakers have also taken a fairly cautious approach, saving the bulk of the revenue upside surprises that have arrived over the past year, rather than deploying them and boosting spending. The automatic stabilisers in the budget have also been allowed to work, with a stronger economy meaning fewer benefits being paid and high inflation driving more taxpayers into higher tax brackets ('bracket creep'), increasing the tax take. Stronger-than-expected commodity prices have also boosted tax revenues and pushed the Federal budget into surplus in 2022/23. We expect the budget is likely to be in surplus again in 2023/24.

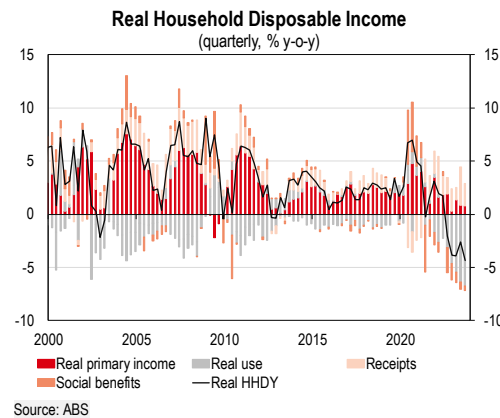
#### Monetary tightening to weaken demand has been the main approach

As a result of the RBA's tightening, and tightening fiscal settings, household disposable incomes have been falling (Chart 13). High inflation itself has also weighed on household disposable incomes in real terms, which have been falling at their fastest rate since the early 1980s. This has slowed down growth in household consumption (Chart 14).

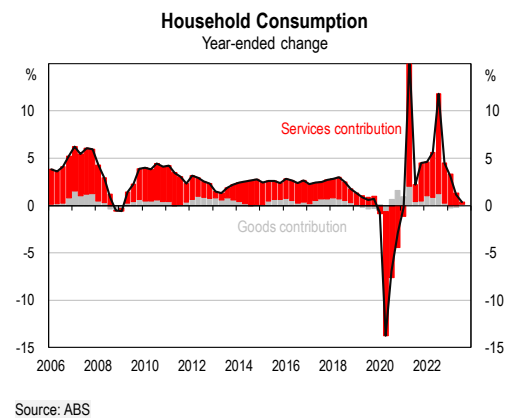
Much of the policy response to inflation has sought to reduce demand pressures ...

... and has clearly driven a slowdown in household consumption

### 13. Real household disposable income has fallen sharply ...



### 14. ... weighing on household consumption



Household consumption, in aggregate, has been buffered ...

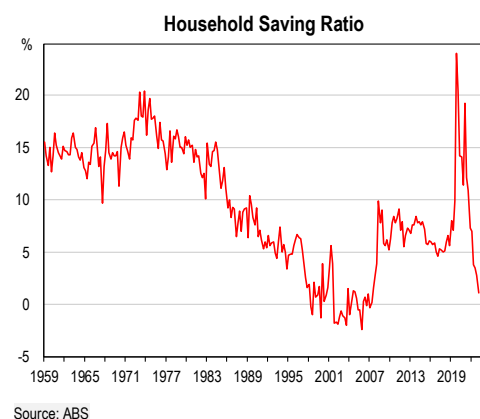
### High excess saving and strong population growth have supported demand

However, two key factors have worked to offset the negative impact on consumer spending of falling household disposable incomes.

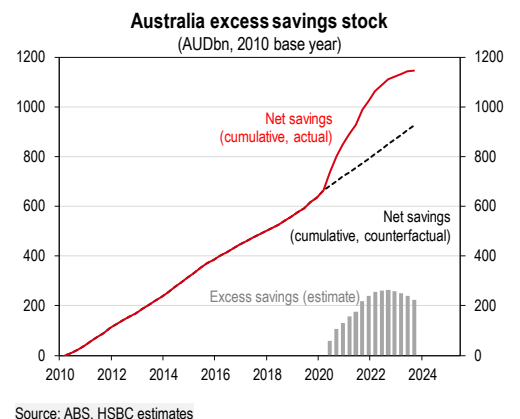
First, there has been the drawdown of excess household savings that were accumulated through the pandemic.

Households saved an estimated excess AUD260bn during the pandemic, equivalent to around 11% of annual nominal GDP (22% of household consumption), reflected in a sharp rise in the household saving ratio. In short, households boosted their saving as they received substantial fiscal transfers through the pandemic, but due to restrictions on activity, were unable to spend it at the time (Chart 15). However, as of Q3 2023, the saving ratio had fallen to 1.1%, well below the pre-pandemic (2015-20) average of 6.1%, as households have started to draw down their savings to support consumption (Chart 16).

### 15. The household saving ratio has fallen sharply ...



### 16. ... as consumers draw down their accumulated excess savings

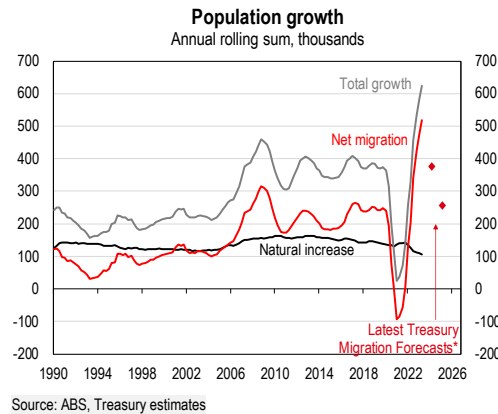


... by accumulated excess savings and strong population growth

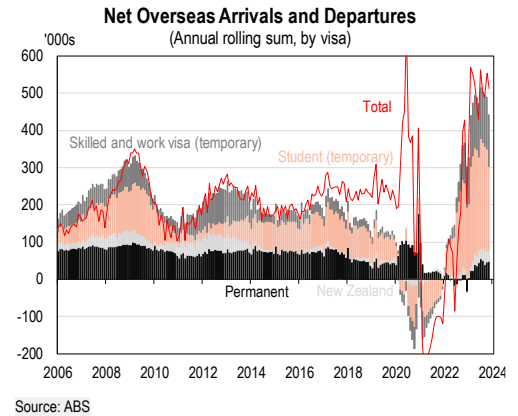
Second, population growth surged in 2023, supported by strong net migration that substantially exceeded policymakers' prior expectations. Australia's population grew by 624k people in the financial year 2022/23, with 83% of that increase coming from net migration, which rose to a multi-decade high of 518k people. As recently as late 2022, policymakers had assumed that only net 235k migrants would arrive in 2022/23.



### 17. Population growth has exceeded expectations, but is forecast to slow



### 18. A return of students has been a key contributor to population growth



**Polymakers expect the pace of migration to slow**

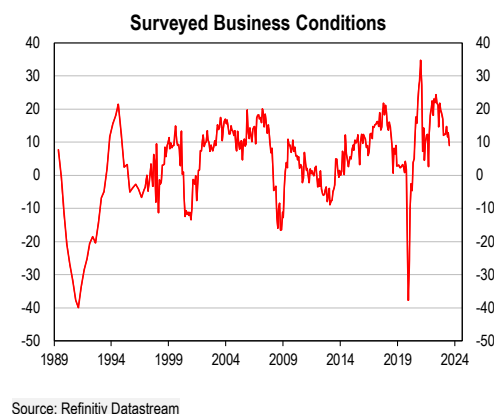
The Treasury in its December 2023 fiscal update projected net migration to decline to +375k in 2023/24 (an upwards revision of 60k from the May 2023 Budget) and to +250k in 2024/25 (Chart 17). Ongoing strong migration is likely to support aggregate demand, as inward migration has also added to demand for goods, services and housing. However, lower migration numbers in 2024 should provide less of a support for GDP growth relative to 2023.

### Business conditions positive, albeit below peaks levels

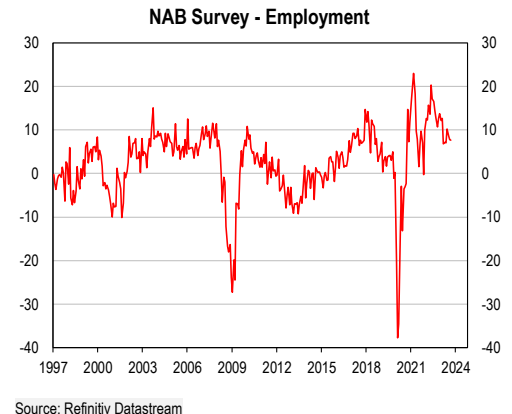
The tightened financial conditions and effect of high inflation on slowing the real economy have also seen some easing in surveyed business conditions (Chart 19). Business conditions fell through 2023 to their lowest level since 2021, but still remain above average. Notably, business employment intentions are also still positive (Chart 20).

**Business conditions remain historically elevated, but have eased ...**

### 19. Business conditions have eased, but remained above average ...



### 20. ... with a similar trend seen in the employment component

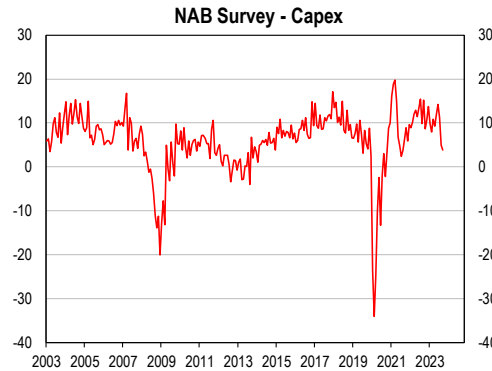


**... partly reflecting softer expectations for capital expenditure by businesses**

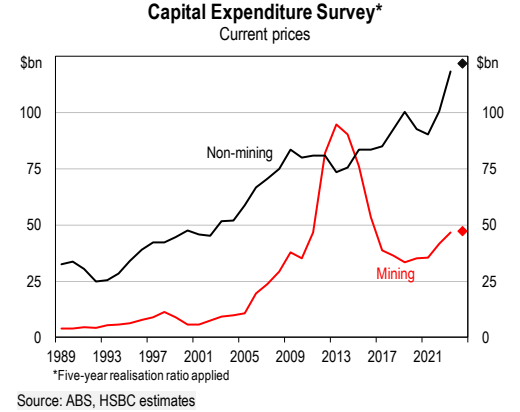
Despite conditions remaining relatively strong, businesses report that capex has eased in recent months (Chart 21). Leading indicators, such as forward orders and confidence, have also softened. However, the ABS measure of expected capital expenditure still remains positive, suggesting some uncertainty about the pathway for business investment (Chart 22).



## 21. The capex component suggests softer business investment ...



## 22. ... though capex spending has been strong to-date



Many of the supply-side disruptions facing the economy have improved ...

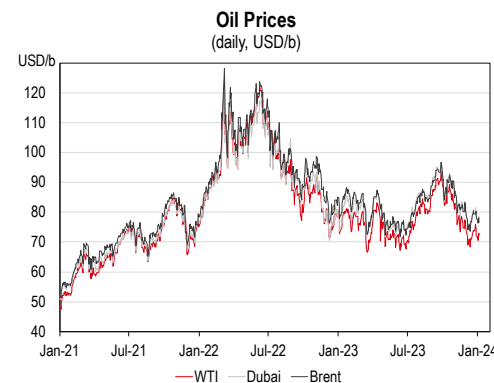
... though supply is still constrained and some clear risks continue

## Supply has improved as many of the pandemic-related disruptions have passed ...

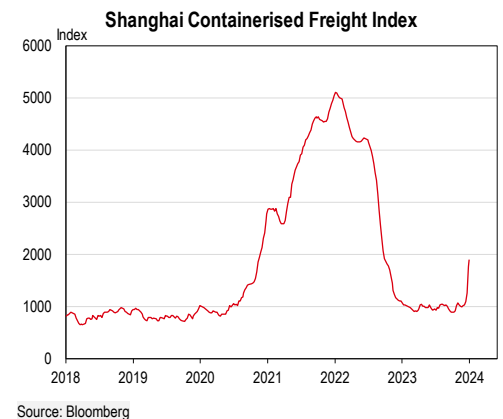
On the supply side of the economy, there has been significant improvement simply as a result of the end of most of the pandemic-related disruptions and the fading of the effects of the Ukraine war on commodity markets. Oil prices, for instance, have fallen well below their peak of USD140/b in March 2022 (Brent benchmark) to around USD78/b currently, despite action from OPEC+ to constrain supply.

However, although the supply side has improved, it is still constrained, and there are a number of key risks, including geopolitics, the energy transition, and climate change, which are likely to mean less help disinflating through lower commodity prices in 2024. For instance, although shipping costs are well below their previous pandemic-related peaks, some costs have ticked up recently, coinciding with conflicts, particularly in the Red Sea (Chart 24).

## 23. Oil prices have trended lower over the past few months ...



## 24. ... though some shipping costs have ticked up again recently



Recent labour productivity outcomes have been weak ...

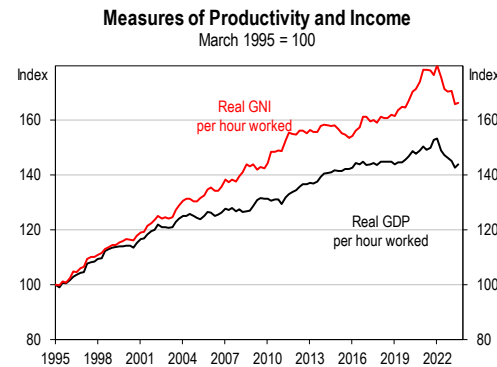
## ... but productivity growth has been dismal

Although the temporary disruptive effects of the pandemic have largely worn off, metrics of the broader supply side of the economy show concerning trends. Notably, labour productivity has fallen sharply (Chart 25). Labour productivity peaked in Q1 2022 and, as of Q3 2023, had fallen by 6%.

... meaning lower rates of wages growth could be inflationary

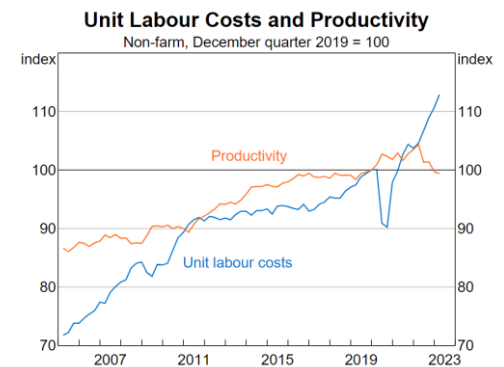
While sluggish productivity growth is not a new challenge for the Australian economy, the sharp fall is particularly worrying for the inflation outlook (Chart 26). An implication of falling or stalled labour productivity, if it persists, is that even a modest pick-up in wages growth could be unsustainable (as we discussed above). Unit labour costs have risen sharply, posing an upside risk to inflation.

## 25. Labour productivity has fallen sharply ...



Source: ABS

## 26. ... contributing to a sharp rise in unit labour costs



Source: RBA

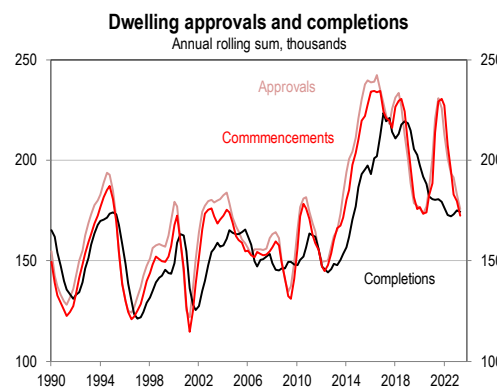
Housing, including rental properties, is in short supply ...

## Housing supply is heavily constrained

Housing is also in short supply in Australia (Chart 27). A recent element of this has been that the housing and residential construction industries have been running up against capacity constraints. Although there is a significant pipeline of residential properties approved and commenced, labour shortages have constrained completions.

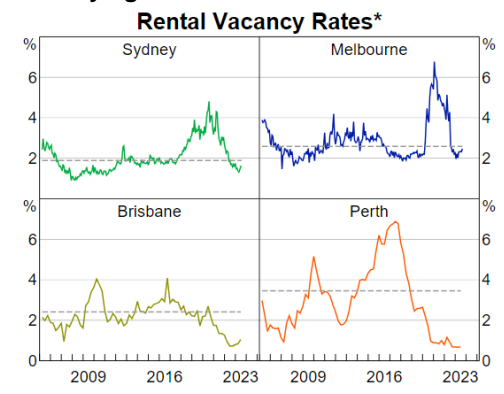
The housing shortage has also been reflected in the rental market (Chart 28). Rental vacancy rates, particularly in capital cities, have stayed low. This has, in turn, lifted rental prices sharply, particularly for newly advertised rents.

## 27. Housing completions have remained low ...



Source: ABS

## 28. ... while the rental market is also notably tight



Source: RBA

... reflecting both near-term and deeper-set factors

We see housing supply remaining tight in 2024. In our view, the constraints on Australian housing supply run much deeper than recent pandemic-related disruptive forces. The impact of decisions by successive state and local governments is also being increasingly felt, alongside restrictions from planning and zoning, and lack of infrastructure.

## We expect that demand will need to remain suppressed in 2024

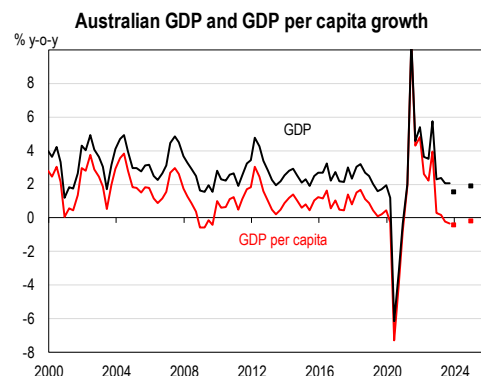
GDP growth is likely to remain subdued in 2024 ...

... though Australia should avoid a technical recession

Our central case is for GDP growth to slow from 2.0% in 2023 to 1.5% in 2024, before lifting to 1.9% in 2025 (Chart 29). While the economy may feel sluggish, we expect a recession to be avoided. The slowdown in growth and inflation in 2024 is expected to be primarily driven by the lagged effect of previous monetary tightening and our forecast that population growth slows.

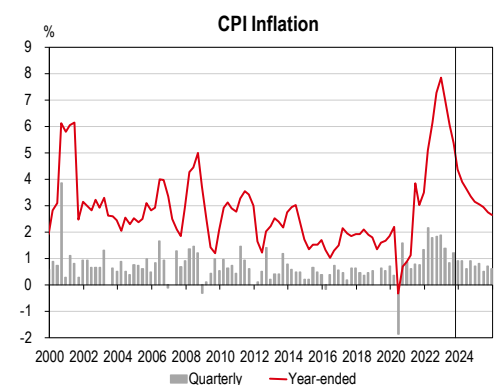
Our forecast assumes continued GDP growth and that Australia does not have two consecutive quarters of falling GDP, which is the typical definition of a 'technical' recession. However, we expect that per capita GDP will have fallen in both 2023 and 2024, suggesting declining living standards, and that the unemployment rate rises in this cycle by around 1.5 percentage points, both markers for recessionary conditions. Whether the economy will tip into a recession is therefore somewhat in the eye of the beholder.

### 29. We expect GDP growth will remain below trend ...



Source: ABS, HSBC estimates

### 30. ... as the economy continues to disinflate in 2024



Source: ABS, HSBC estimates

We are forecasting that inflation will continue to fall, but only slowly and that it will still be above the top edge of the RBA's target band in Q4 2024, albeit only just (Chart 30).

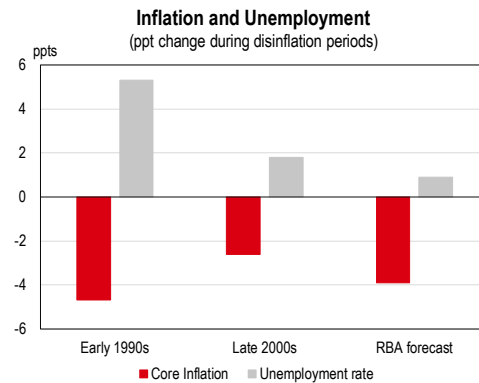
The outlook for the labour market is a key uncertainty, as disinflating ...

A key uncertainty for 2024 is just how much the labour market will loosen for inflation to be able to fall back to the RBA's 2-3% target band. The RBA is forecasting that it can bring inflation down from what was a multi-decade high last year, back to its 2-3% target range, while maintaining close to full employment. However, when inflation has come down in previous cycles, the unemployment rate has risen by far more than the RBA is currently forecasting for this cycle (Chart 31).

... without a large rise in the unemployment rate would be historically unusual

As Chart 31 shows, the early 1990s disinflation, when core inflation fell by 4.7ppts, occurred alongside a 5.3ppts rise in the unemployment rate. The disinflation after the Global Financial Crisis struck, in 2008, saw core inflation fall by 2.6ppts, and the unemployment rate rise by 1.8ppts. The RBA's latest set of published forecasts have a 3.9ppts fall in core inflation, with the unemployment rate only rising by less than 1.0ppt.

### 31. The unemployment rate may need to rise by more than the RBA expects ...



### 32. ... given the magnitude of disinflation required



This trade-off between unemployment and inflation is referred to as the 'Phillips curve'. Here we show a wages Phillips curve (Chart 32). With the unemployment rate at its current low level, wages growth has been picking up to rates not seen in many years and the wages Phillips curve looks to be more similar to its earlier trade-off level, than that seen in the low-inflation period just prior to the pandemic. We see it as likely that the unemployment rate will have to rise by more than the RBA's 2-3% target by 2025.

## Different policy choices in a full-employed economy

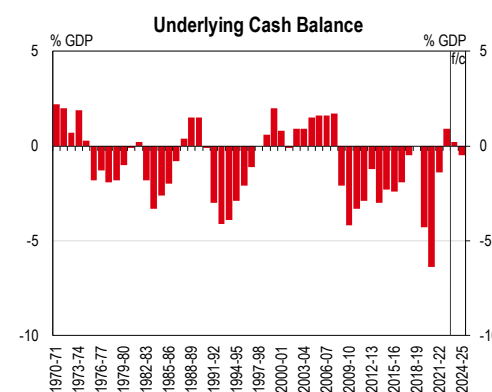
**Our central case has the RBA on hold in 2024**

As a result of our forecasts, we see it as unlikely that the RBA will be able to cut its cash rate anytime soon, given the only slow decline in inflation that we are forecasting. Our central case has the RBA cash rate held steady through 2024, with no cuts until 2025.

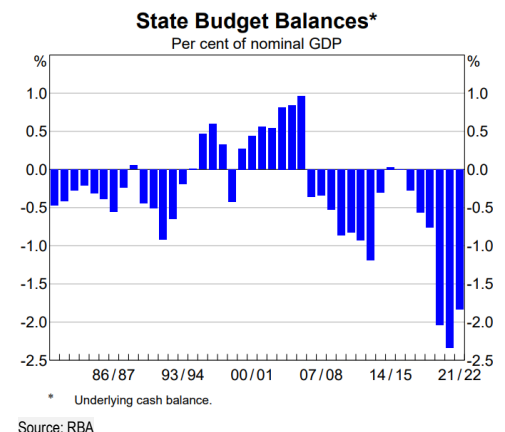
**Fiscal policy has a difficult balancing act ...**

Fiscal policy also has a key role to play. The policy choices at full employment are also hard ones. For instance, any additional net public spending risks adding to inflation, which may see higher interest rates. The approach taken by Federal fiscal policymakers in recent times has been largely consistent with the RBA's own inflation-fighting approach, with the bulk of the upside surprises to tax revenue saved, and a budget surplus delivered in 2022/23 (Chart 33). State budgets have been less helpful for dealing with the inflation challenge (Chart 34).

### 33. The outlook for fiscal policy may slow the disinflation process ...



### 34. ... particularly given spending decisions from States



... particularly given growing demand for cost-of-living support

The Stage 3 tax cuts are also likely to support aggregate demand in 2024 ...

... weighing on the budget balance by an estimates AUD20 billion in 2024/25 ...

Fiscal policymakers ought to remain focused on helping to put further downward pressure on inflation. This includes demand management, but also helping to boost the supply side and productivity, as we discuss further below.

Federal fiscal policymakers may need to continue to deliver tightening to offset the impact of state government spending.

However, with the government likely starting to look ahead to the next election cycle, continued above-target inflation is also likely to put pressure on fiscal policymakers to deliver further cost-of-living support. Unless this is offset by other spending cuts or tax rises, it could support elevated inflation.

Recent reports suggest the government is looking to fast-track some cost-of-living relief ahead of the May 2024 Budget (AFR, 15 January 2024). Cash handouts appear to be off the table, but other options, such as rebates for household energy bills, appear to be under consideration.

One aspect of fiscal policy set to take place in 2024 is the government's legislated Stage 3 income tax cuts, due to commence on 1 July 2024 (Table 35). We see this as likely to support consumption and GDP growth in 2H 2024 onwards, again highlighting the risks to growth and inflation from the fiscal outlook.

Recall, in the 2018 Budget, the former Coalition government announced a multi-year, three-stage, Personal Income Tax Plan, with each stage different in terms of its cost, economic rationale and distributional effects. Largely, Stage 3 is to assist with the ongoing impacts of 'bracket creep' and Australia's relatively high reliance on income taxes.

The 2023-24 Budget projections incorporated the estimated impact of all current policies, with the Stage 3 tax cuts estimated to cost around AUD313 billion over the forward estimates period (to 2033/34), including weighing on the government's budget balance by around AUD20 billion in 2024/25 alone. The estimated cost to the government's budget in 2024/25 is equivalent to 0.8% annual nominal GDP and 1.6% of annual nominal household consumption.

### 35. The Government's three-stage personal income tax plan

	Overview	Main beneficiary
<b>Stage 1 (2018-19 and 2019-20)</b>	A new Low- and Middle-Income Tax Offset (LMITO) of up to \$530 Increase the top threshold of the 32.5% tax bracket from \$87,000 to \$90,000 Increase the maximum Low and Middle-Income Tax Offset (LMITO) from \$530 to \$1,080, and base offset from \$200 to \$255	Income earners on \$30,000 to \$90,000
<b>Stage 2 (2020-21 and 2021-22)</b>	Increase the top tax threshold of the 19% bracket from \$37,000 to \$41,000 Further increase the top threshold of the 32.5% bracket from \$90,000 to \$120,000 Increase the maximum Low Income Tax Offset (LITO) from \$445 to \$645 Further increase the top threshold of the 19% bracket from \$41,000 to \$45,000 Further increase the maximum Low Income Tax Offset (LITO) from \$645 to \$700 with a new taper rate	Income earners on \$90,000 or more
<b>Stage 3 (2024-25)</b>	Remove the 37% tax bracket Increase the threshold for the 45% bracket from \$180,000 to \$200,000 Reduce the 32.5% marginal tax rate to 30% (to apply to everyone earning \$45,000-\$200,000)	Income earners on \$90,000 or more

Source: Treasury

Those individuals in the top taxable income bracket (AUD180k+) are the main beneficiaries of Stage 3, accounting for 44% of the impact on the government's budget balance in 2024/25. Likewise, it is the top income quintile that benefits the most, accounting for 76% of the impact on the government's budget balance in 2024/25.<sup>1</sup>

<sup>1</sup> According to costings by the Parliament Budget Office (May 2023) in 'Distributional analysis of the Stage 3 tax cuts'.

... which could add to inflationary pressures

However, people earning over AUD45,000 per annum are also set to benefit. As of March 2023, the average weekly ordinary time earnings for full-time adults was AUD1,838.10, equivalent to AUD95.8k per annum, meaning the 'average' full-time worker is also set to receive a net benefit.

Finally, it may be the case that, given many households are up against their budget constraints, any additional income, in this case in the form of tax cuts, could see a higher marginal propensity to consume than at other times.

## Best fiscal policy option is to focus on productivity

A policy focus on the supply side would help to disinflate the economy

Demand management is not the only way that fiscal policy can be used to manage the high inflation challenge.

In 2024, a focus on the supply side would be a key help for the RBA in disinflating the economy, while also lifting Australia's long-term potential growth outlook. It would be much more painless to bring inflation down by boosting supply, rather than through a sharp weakening in demand and the widespread job layoffs this could likely entail.

The migration review outlined some possibilities ...

A clear solution for near-term supply-side improvements would be to reduce skills shortages, and to build the housing and infrastructure the economy needs. As noted above, housing appears difficult to address. On skills shortages, the government announced its migration strategy, outline a roadmap to bring migration back to sustainable levels (see Table 36 below).

### 36. Government's Migration Strategy – Action Plan

Action	New Commitment	Timeframe	Area for future reform
<b>Temporary skilled migration</b>	<ul style="list-style-type: none"> <li>- New Skills in Demand visa</li> <li>- New Specialist skills pathway</li> <li>- New Core skills pathway</li> <li>- Legislate indexed income thresholds</li> <li>- Streamline labour market testing</li> </ul>	Late 2024	- Regulate migration for lower paid workers with essential skills
<b>Permanent skilled migration</b>	–	–	<ul style="list-style-type: none"> <li>- Reform 'points test'</li> <li>- Consider new Talent and Innovation visa</li> </ul>
<b>International education</b>	<ul style="list-style-type: none"> <li>- Increase English language requirements</li> <li>- Greater and more targeted scrutiny to high-risk providers</li> <li>- Bolster visa integrity unit in the Department of Home Affairs</li> <li>- Strengthen requirements for education providers</li> <li>- Restrict onshore visa hopping</li> <li>- Strengthen and simplify Temporary Graduate visas</li> </ul>	Late 2023 onwards	- Support international students and graduates to realise their potential
<b>Worker exploitation and misuse of the visa system</b>	<ul style="list-style-type: none"> <li>- Develop a public register of approved sponsors</li> </ul>	Late 2024	<ul style="list-style-type: none"> <li>- Strengthen sponsor application process</li> <li>- Improve post-arrival monitoring and compliance</li> </ul>
<b>Planning overall migration</b>	<ul style="list-style-type: none"> <li>- Plan migration over a long-term horizon</li> <li>- Increase coordination with states and territories</li> <li>- Establish a formal role for Jobs and Skills Australia</li> <li>- Improve the approach to skills recognition and assessment</li> <li>- Launch an enhanced outreach programme</li> <li>- Evidence-based evaluation and monitoring</li> </ul>	Late 2023 onwards	–
<b>Regional visas and the Working Holiday Maker programme</b>	<ul style="list-style-type: none"> <li>- Designate visa processing to regional Australia as the highest processing priority</li> </ul>	Late 2023	- Evaluate regional migration settings and the Working Holiday Maker programme
<b>Indo-Pacific ties</b>	–	–	–
<b>Simplifying the migration system</b>	<ul style="list-style-type: none"> <li>- Abolish unnecessary and duplicative visas</li> <li>- Embed simplification as a key objective</li> </ul>	Late 2023 onwards	–

Source: HSBC – adapted from Department of Home Affairs. Note: Existing commitments are not included here

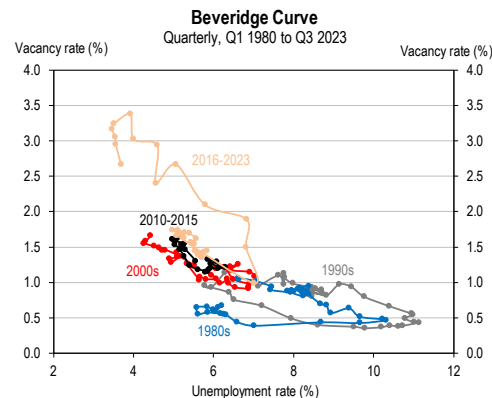
... but is only likely to have an impact over the medium-term ...

This followed the 2023 Review of the Migration System (the Migration Review), which found that the migration system had been neglected enough to require a "10-year rebuild". However, much of the government's new commitments are only expected to be implemented in 'late 2024' as an indicative timeframe, with more fundamental actions left as 'areas for future reform' for consultation in mid-2024.

... while the near-term impact of the re-opening of the border has been clear

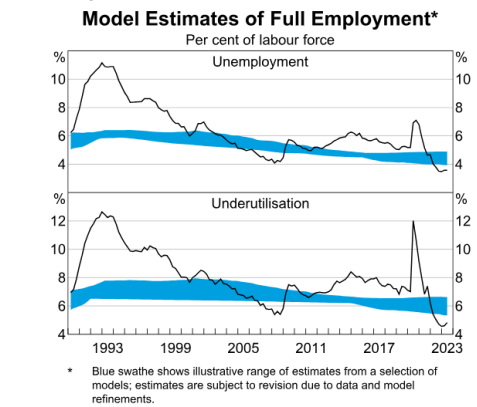
There are already signs of some improvement in job matching, with vacancy rates falling, despite only a small rise in the unemployment rate (Chart 37). However, our view is that this largely reflects the impact of the re-opened border, freeing up the availability of workers coming from offshore to fill skills gaps. Many of the industries where vacancy rates have fallen the most are those where workers have typically been drawn from the pool of migrants in the past.

### 37. Matching skills with jobs became more challenging through the pandemic



Source: ABS, HSBC

### 38. The economy is likely still beyond 'full employment'



Source: RBA, RBA estimates

Some reform has been made in industrial relations, but it is not clear this adds to jobs market flexibility

More generally though, recent industrial relations changes have tended to support a faster pick-up in wages growth. Most recently, the government passed its 'Closing Loopholes' bill through Parliament, which aims to, among other things, ensure that labour hire workers are paid equivalent to rates agreed in enterprise agreements, so called 'same job, same pay'. Other areas, including minimum standards for digital platform gig workers, road transport industry reforms and a better deal for casual workers, are set to be considered in 2024.

This followed successive rounds of reform to Australia's Fair Work Act, with 2022's 'Secure jobs, better pay' bill, which focused on closing the gender pay gap and strengthening flexible working arrangements, among others.

There has been limited progress with tax and competition policy reforms

Other areas policymakers ought to focus on, such as tax reform and competition policy, have made less progress.

Policymakers also ought to focus on tax reform, with little reform in recent years and a tax system that is becoming increasingly inefficient. The Henry Tax Review in 2008, for instance, made 138 recommendations, but almost none of the recommendations were implemented. The 2015 Intergenerational Report also highlighted the benefits tax reform could have, including promoting jobs and growth.

A review on competition policy is also set to progress over a two-year period by a Competition Taskforce. According to the Treasurer, the initial issues to be considered by the review are (1) merger reform; (2) options for coordinated reform with states and territories; (3) non-compete clauses and other employment issues; and (4) issues raised by new technologies, the net-zero transformation and growth in the care economy. The government is also reviewing the Food and Grocery Code of Conduct.

Weak productivity growth is one of the key challenges facing the economy ...

Improving the supply side of the economy is imperative, if productivity growth is to lift. Weak productivity has been an issue in Australia for a long time, although the weakness has been much more acute in the post-pandemic period.

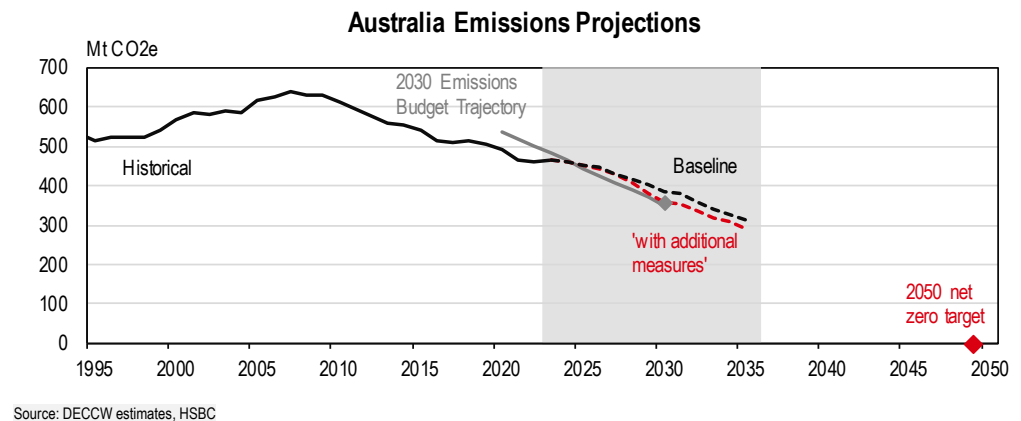


... alongside other challenges, such as the energy transition

The Productivity Commission's 2023 five-yearly Productivity Review outlined a comprehensive roadmap with many policy recommendations. There is no quick fix, with proposed reforms focused on five key areas: (1) building an adaptable workforce; (2) harnessing data, digital technology and diffusion; (3) creating a more dynamic economy; (4) lifting productivity in the non-market sector; and (5) securing net zero at least cost.

On this final point, much more needs to be done to ensure Australia is on the pathway to 'net zero' (Chart 39), although, as we pointed out last year, the energy transition offers the country some of its greatest growth opportunities as well. The government has committed over AUD40 billion so far, covering over 50 policies and measures, including infrastructure and investment. Key legislative milestones have been the Climate Change Act 2022, the reforms to Australia's safeguard mechanism in July 2023, and Australia's second-ever Annual Climate Change Statement in November 2023.

### 39. Australia's emissions projections



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