WHAT CAN MARTIN TELL US ABOUT THE INTERACTION BETWEEN PRIVATE AND PUBLIC DEMAND[1]

We consider two stylised scenarios in MARTIN to explore downside risks to public demand, the interaction between public and private demand . We model a scenario where the declines in expenditure are concentrated in the healthcare sector, leading to a large employment response, and another where the declines are concentrated in the construction sector, freeing up capacity for private investment.

Motivation and Narrative

After a decade of public demand growing as a share of the economy, the staff forecasts project this share to stabilise, with private demand returning as the primary driver of the economy. The timing of this transition and the interaction between private and public demand over the forecast period remain key sensitivities to the outlook.

In this note we consider two stylised scenarios in MARTIN to explore how public and private demand interact in the healthcare and construction sectors. Government spending in these sectors has contributed to the growing share of public demand over the last 10 years. Additionally, public spending in these sectors has nuanced interactions with households and firms, competing for labour and material resources but also providing essential services.

In this note we will first discuss how we calibrated the scenarios before stepping through the results.

Calibration

For both scenarios, we use the August 2025 staff forecasts as the baseline and impose a sustained 1 per cent decline in public demand over the forecast horizon[2]. In the healthcare scenario, this flows through public consumption and in the construction scenario this flows through public investment.

We assume no response in tax policy to offset the lower expenditure, resulting in lower government debt. We assume, this reduction in debt has negligible impact on government's creditworthiness and thus long dated yields. We additionally impose standard scenario assumptions, with no cash rate or exchange rate response to the shock. Below we discuss the additional calibration to capture sectoral nuance.

Calibration lower health expenditure scenario

The healthcare sector has a higher labour intensity compared to the broader economy. To capture this, we calibrate a larger employment response, holding healthcare productivity constant. In the scenario, a quarterly 2-billion-dollar reduction in healthcare expenditure translates to a direct decline in heads employment of around 90,000, relative to baseline.

In addition to the employment response, we consider the unemployment and participation rate response. We assume the reduction in healthcare employment predominately flows through as a lower participation rate, with the unemployment rate rising around 10 basis points. This is consistent with recent participation and healthcare employment trends, as strong non-market demand has drawn workers into the labour force at a higher rate than before (2025, forthcoming). In the scenario, as employment growth slows, we expect less workers are pulled into labour force. This is a key judgement in the scenario, so we explore an edge case where lower employment is fully flowed through the unemployment rate, leading to a large increase of around 60 basis points.

1 I would like to thank the SAMM scenarios team for their assistance drafting this note and Natasha Cassidy and for their feedback on the modelling.

2 This shock is a 1 percent decline in the level of total public demand over the forecast horizon.

The provision of healthcare by the government reflects an in-kind transfer of essential services to households. To capture the interaction between public and private demand for these services we assume around half the reduction in expenditure is services delivered directly to households. Households will now need to consume these services privately as part of their essential consumption. This increase in essential consumption can be serviced by the household in two ways, lower discretionary consumption or lower savings. We assume households, finance roughly a quarter of this additional essential consumption through lower savings, consistent with household behaviour during an income shock.

Calibration lower construction expenditure scenario

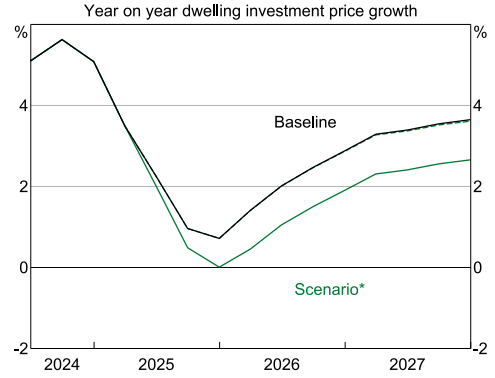
In the second scenario, we assume the reduction in public demand is concentrated in the construction sector, lowering construction demand by around 8 per cent. This large decline frees up capacity in the construction sector leading to a decline in construction prices. Assuming the construction sector has the same price Philips curve slope as the broader economy[3], this translates to a 2.6 per cent decline in construction prices.

As MARTIN does not have a construction sector we map this decline to the relevant expenditure prices in the model. We assume a full pass through to the dwelling investment deflator, meaning housing construction costs fall by 2.6 percent. We then assume a partial pass through to the business investment deflator, proportional to the share of non-dwelling construction activity. Finally, we model the direct pass through to the CPI using the dwelling construction weight. Given the shock is concentrated in the construction sector, we assume minimal response to other deflators.

Graph 1

Lower Public Construction Investment Scenario

Year on year dwelling investment price growth



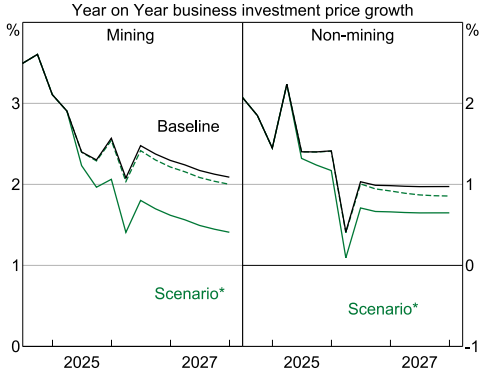
* Dashed line refers to MARTIN response to same government investment shock without additional price shocks.

Source: RBA.

Graph 2

Lower Public Construction Investment Scenario

Year on Year business investment price growth



* Dashed line refers to MARTIN response to same government investment shock without additional price shocks.

Source: RBA.

Results

Lower health expenditure scenario

As discussed, the large reduction in healthcare expenditure drives a large fall in employment relative to baseline, although growth remains positive throughout the forecast horizon[4] (Graph 3). Under the central case, lower employment growth largely flows through a weaker participation rate, with the unemployment rate increasing by roughly 10 basis points. In the edge case, unemployment increases around 60 basis points, leading to a pronounced softening in labour market conditions (Graph 4).

Activity falls directly through lower public consumption but is compounded by weaker household consumption and private investment activity. Activity outcomes are similar in both the central and edge case. Despite a fall in the savings rate of 50 basis points household consumption declines with lower employment and wages. The inflation outcomes are heavily dependent on capacity in the labour market, with inflation declining by around 12 basis points in the central case and 44 basis points in the edge case (Graph 5).

We observe some interaction between market and non-market firms in the labour market. The direct decline in non-market employment is softened by a pickup in market employment. The looser labour market conditions lead to lower labour costs for firms, supporting an increase in market employment. This effect is

3 We use the G-cubed model to sense check this assumption. We find the implied construction sector Philips curve slope in G-cubed is 0.25 with the implied MARTIN Philips curve slope of 0.3. This gives us comfort that this assumption is reasonable.

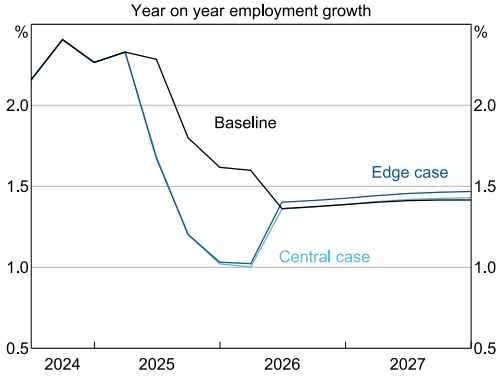
4 Employment growth in the healthcare sector is also broadly positive over the forecast horizon.

larger in the edge case scenario compared to our central case as labour costs fall more in the edge case scenario. Relative to the direct effects these second round effects are marginal (Graph 6).

Graph 3

Lower Healthcare Expenditure Scenario

Year on year employment growth

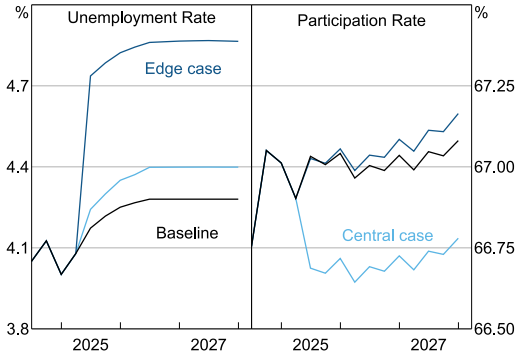


Source: RBA.

Graph 4

Lower Healthcare Expenditure Scenario

Labour Market Outcomes*

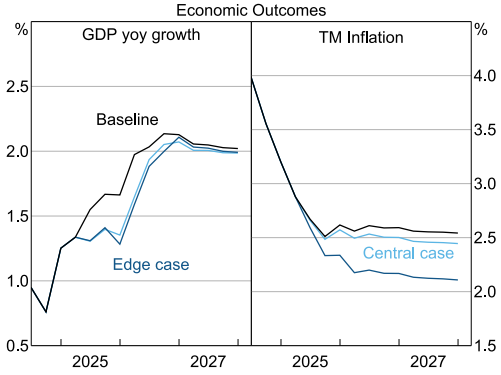


Source: RBA.

Graph 5

Lower Healthcare Expenditure Scenario

Economic Outcomes

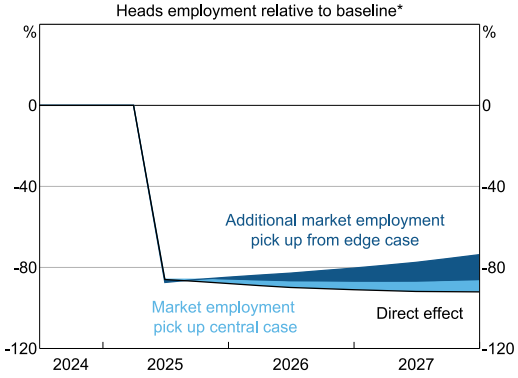


Source: RBA.

Graph 6

Lower Healthcare Expenditure Scenario

Heads employment relative to baseline*



* The pick up in market employment is reflects the difference between the direct shock and final employment outcomes with general equilbrium effects. We assume this difference occurs fully through market employment. This assumption is illustrative and does not influence any outcomes in the scenario.

Source: RBA.

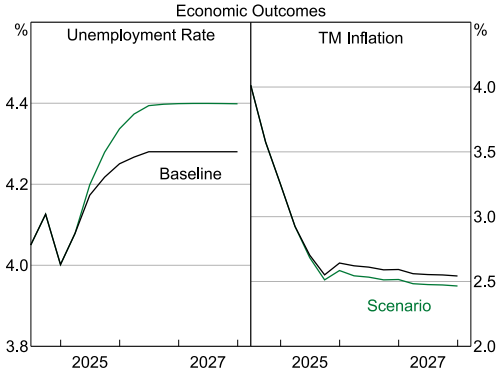
Lower construction expenditure scenario

The construction scenario generates broadly similar dynamics as the central healthcare scenario with lower activity, higher unemployment and lower inflation (Graph 7).

Graph 7

Lower Public Construction Investment Scenario

Economic Outcomes

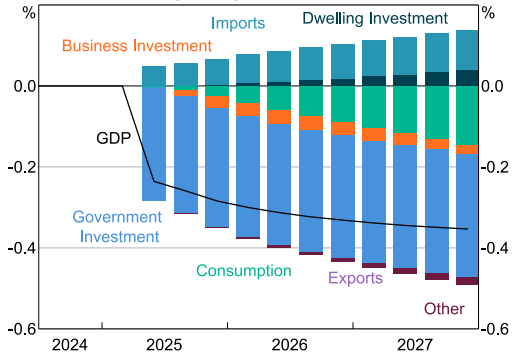


Source: RBA.

Graph 8

Public Construction Scenario - GDP Response

Percentage change in GDP from baseline



Source: RBA.

The reduction in GDP is largely driven through primary effects, with lower government investment heavily weighing on GDP (Graph 8). The reduction in activity is compounded by falling private demand, led by falls in household consumption. We observe some offsetting effects from construction intensive expenditure, with a positive dwelling investment impulse and very muted business investment response.

The relative price response in this scenario captures easing resource crowding out in the construction sector. Even when lower government expenditure frees capacity for private demand, in net private demand falls due to weaker aggregate demand. While it is the case that resource crowding out can weigh on private demand (2025, forthcoming), this exercise shows the effects tend to be concentrated in specific sectors.

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13 August 2025

Public demand and fiscal policy – briefing points

Links to inflation

- We don't decompose inflation into decisions by governments or anyone else
- What matters most for inflation over the medium term/ a couple of years is the balance of aggregate demand and supply in the economy
    - Which in turn depends on decisions made by hholds, businesses and governments as they do what makes the most sense for them - how much to work, how much to spend and what on, etc
    - In theory high levels of any form of spending (be it public or private) in a period of limited spare capacity, such that we think we are in now, can feasibly drive inflationary pressures
- In addition, some of the recent increase in inflation reflects sector-specific factors, such as strength in housing construction costs and durable goods

Economic Analysis Department

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