November 2004
IMF Country Report No. 04/353

Australia: 2004 Article IV Consultation—Staff Report; Staff Statement; and Public Information Notice on the Executive Board Discussion

Under Article IV of the IMF's Articles of Agreement, the IMF holds bilateral discussions with members, usually every year. In the context of the 2004 Article IV consultation with Australia, the following documents have been released and are included in this package:

- the staff report for the 2004 Article IV consultation, prepared by a staff team of the IMF, following discussions that ended on **July 25, 2004,** with the officials of Australia on economic developments and policies. **Based on information available at the time of these discussions, the staff report was completed on August 30, 2004.** The views expressed in the staff report are those of the staff team and do not necessarily reflect the views of the Executive Board of the IMF.

- a staff statement of **October 27, 2004** updating information on recent developments.

- a Public Information Notice (PIN) summarizing the **views of the Executive Board as expressed during its October 27, 2004 discussion** of the staff report that concluded the Article IV consultation.

The document listed below have been or will be separately released.

Selected Issues Paper

The policy of publication of staff reports and other documents allows for the deletion of market-sensitive information.

To assist the IMF in evaluating the publication policy, reader comments are invited and may be sent by e-mail to publicationpolicy@imf.org.

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INTERNATIONAL MONETARY FUND

AUSTRALIA

Staff Report for the 2004 Article IV Consultation

Prepared by the Staff Representatives for the
2004 Consultation with Australia

Approved by David T. Coe and Michael Hadjimichael

August 30, 2004

- The 2004 Article IV consultation discussions were held in Sydney, Melbourne, and Canberra during June 17–25, 2004.

- The staff team consisted of Messrs. Coe (Head), Senhadji, Salgado, Edimon (all APD), and Wei (RES). Mr. Callaghan (Executive Director) attended the meetings in Sydney and Canberra. The mission met with Treasurer Costello, Reserve Bank of Australia Governor Macfarlane, Treasury Secretary Henry, other senior government officials, and representatives of labor unions, business and financial sectors, and academia.

- At the conclusion of the 2003 Article IV consultation on October 22, 2003 (IMF Country Report 03/337), Executive Directors attributed Australia's robust economic growth with low inflation to the enhanced resilience of the economy, gained through prudent macroeconomic policies conducted within transparent policy frameworks and steadfast implementation of structural reforms. Directors regarded Australia's fiscal position as fundamentally sound, but noted the potential for significant pressures associated with longer-term population ageing. They praised the authorities' strategy to cope with these pressures by raising labor force participation rates and productivity growth. In particular, Directors considered further reform of the personal income tax system and a comprehensive overhaul of the complex system of income support to be essential elements of the authorities' strategy. Macroeconomic and structural policies are sound and are consistent with Fund advice.

- Australia has accepted the obligations of Article VIII, Sections 2, 3, and 4, and it maintains an exchange system that is free of restrictions on payments and transfers for current international transactions. Australia publishes high-quality economic and financial data on a timely basis, and subscribes to the Special Data Dissemination Standard.

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EXECUTIVE SUMMARY

Economic Background

- **The expansion is now entering its 13th year, with unemployment falling to a level not seen since the early 1980s.** After slowing in the first half of 2003, economic growth rebounded, underpinned by continued buoyancy of domestic demand, an improvement in the external environment, and a gradual recovery from the drought. For the year as a whole, economic growth was 3 percent, inflation stayed within the Reserve Bank of Australia's (RBA) target range of 2−3 percent, and the fiscal position remained strong. However, the current account worsened due to Australia's relatively strong cyclical position, a substantial appreciation of the Australian dollar, and the drought.

- **Growth is expected to increase to about 3¾ percent this year, with inflation remaining within the official target range.** The main risk to the outlook relates to overheating in the housing market, but recent indicators suggest a soft landing is likely. Other risks include a re-emergence of drought, sustained high oil prices, or a weakening of external demand. While no single risk appears to pose a significant threat in the short term, a combination of external and domestic shocks could shake confidence and spark a sharp increase in household saving rates that could severely weaken GDP growth. There is also upside potential if domestic demand remains robust as net exports strengthen and fiscal stimulus comes on stream.

Policy Discussions

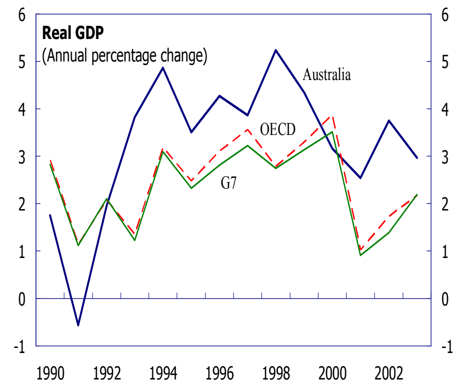
- **The mission broadly endorsed the current macroeconomic policy settings.** The staff supports the RBA's decision to keep monetary policy on hold since the two 25 basis point increases in the policy interest rate late last year. The RBA's wait-and-see stance is appropriate in light of subdued inflation pressures and remaining uncertainties in the housing market. While public finances remain sound, the authorities agreed with the mission that the small surpluses projected in the 2004 Budget hinge on continued buoyancy of fiscal revenue growth. In the short run, the stimulatory effect of the fiscal package could complicate monetary policy implementation if it comes into play when domestic demand growth is still significantly above trend. Over the longer term, the government intends to address fiscal problems stemming from population ageing through structural reforms to increase productivity growth and labor force participation.

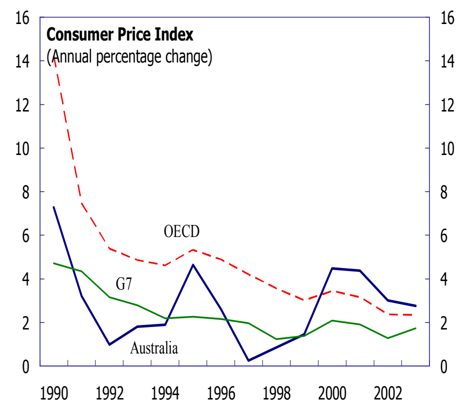
- **There do not appear to be significant vulnerabilities in the financial system**. Although banks have substantial exposure to the housing market, stress tests indicate that even a large decline in house prices would not have systemic implications for the banking system.

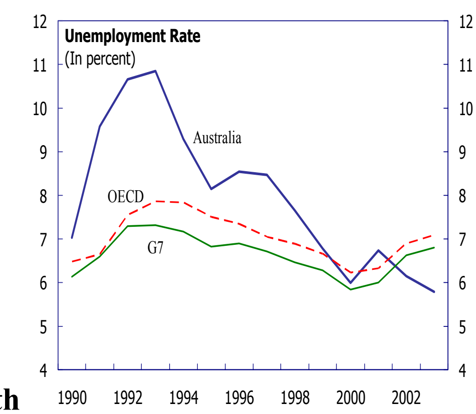
- **Australia is a strong supporter of multilateral trade liberalization.** With little progress on the multilateral front until recently, however, the authorities have pursued a number of free trade agreements, although they are aware of the risk that bilateral agreements may dilute efforts to conclude successfully the WTO negotiations.

I. Overview

1. **Australia continues to reap the benefits of sustained implementation of appropriate macroeconomic policies and structural reforms.** These benefits are apparent in strong economic growth, low inflation, and substantial declines in the unemployment rate and public indebtedness. Reforms, a transparent framework for macroeconomic policies, and a floating exchange rate have also made the Australian economy much more flexible and resilient, as demonstrated by the longevity of the current expansion despite a series of severe domestic and external shocks.







2. **The expansion is now entering its 13th year, with unemployment falling to a level not seen since the early 1980s.** Growth is expected to increase to about 3¾ percent this year, with inflation remaining comfortably within the official target range. The main risk to the outlook relates to overheating in the housing market and the associated build-up in household indebtedness, but recent indicators suggest a soft landing is likely. Although deposit-taking institutions have substantial exposure to the housing market, stress tests indicate that even a large decline in house prices would not have systemic implications for the banking system.

3. **Monetary policy has been kept on hold since the two 25 basis point increases in the policy interest rate late last year, and the public finances are sound**. The Reserve Bank of Australia's (RBA) wait-and-see stance is appropriate in light of subdued inflation pressures and remaining uncertainties in the housing market. The 2004 Budget projects continued small surpluses, while still having room for a package of tax cuts and expenditure initiatives. Over the longer term, the government intends to address fiscal problems stemming from population ageing through structural reforms to increase productivity growth and labor force participation.

4. **In the short run, Australia is likely to continue to outperform most OECD countries in terms of economic growth, as it has since the early 1990s. In the longer term, however, there is no guarantee that growth will remain strong, not least because of the prospective demographic transition to an older population.** Just as structural reforms boosted the Australian economy out of the economic doldrums of the 1970s and 1980s, it is necessary in a world of rapid technological change and globalization to continue the reform process to maintain growth in the future. Indeed, there is no reason why Australia should not aspire to even higher growth to close the productivity gap with the most advanced economies.

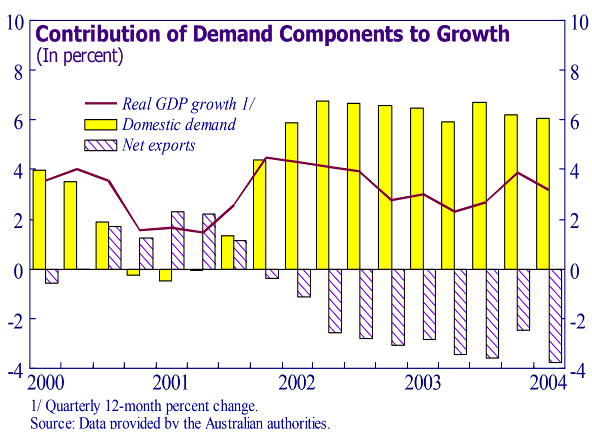
5. **The staff support the authorities' ambitious agenda of reforms to raise productivity and labor force participation to meet the challenges of an ageing population.** If successfully implemented, this would move Australia to the forefront of defining international best practice in the area of structural policies to address the economic implications of ageing, as it is now in the area of macroeconomic policies. There is a risk, however, that the comparatively strong recent economic performance will engender complacency, which will sap the political will and public support for further structural reforms.

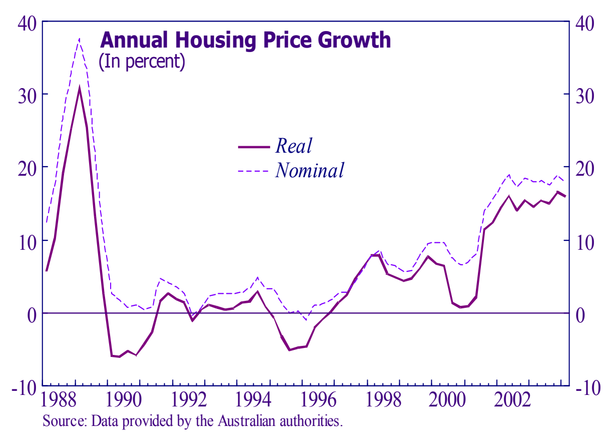
6. **Prime Minister John Howard is expected to call for federal elections before 2005.** The governing Liberal-National Party Coalition was elected to its third consecutive term in November 2001 with a majority in the House of Representatives but not in the Senate.

II. Recent Economic Developments and Outlook

A. Recent Developments

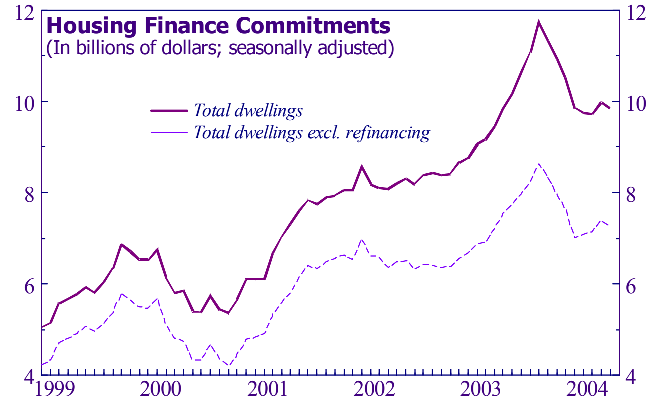
7. **After slowing in the first half of 2003, economic growth rebounded, underpinned by continued buoyancy of domestic demand and a gradual recovery from the drought.** For the year as whole, real GDP growth was 3 percent, only moderately lower than the 3.8 percent in 2002. Buoyant domestic demand continued to offset weak net exports and a large decline in agricultural output, which dropped by 33 percent in the year to March 2003. The strength in domestic demand was broad based, with consumption, housing investment, and business investment all growing at above-trend rates. Domestic spending in 2003 was underpinned by supportive financial conditions, substantial increases in household wealth from the surge in dwelling prices—prices for established houses grew in real terms by about 16 percent a year in 2002 and 2003—and rising equity prices. A strong labor market—the unemployment rate fell to 5.6 percent in 2003—and a rebound in farm incomes in the second half of 2003 also boosted domestic demand. In contrast, net exports have been a drag on GDP growth over the past couple of years, reflecting the combined effects of strong





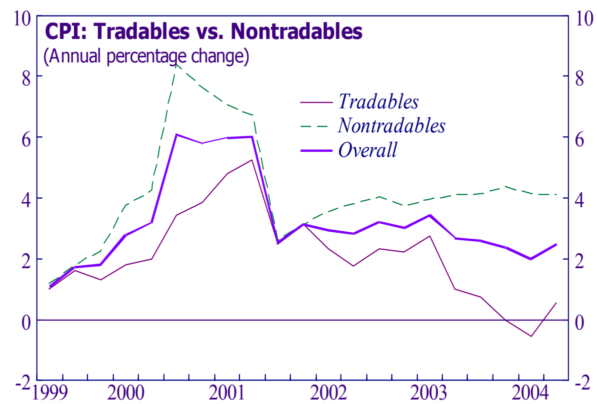
domestic demand, a weak external environment, a substantial appreciation of the Australian dollar, and the drought. Notwithstanding the rebound in agricultural output and a firming of external demand in the second half of 2003, the current account deficit deteriorated from 4.4 percent of GDP in 2002 to 6 percent in 2003.

8. **Despite a weaker-than-expected first quarter of 2004, the expansion retained significant momentum.** Quarterly GDP growth slowed from 1.3 percent in the last quarter of 2003 to 0.2 percent in the first quarter of 2004. However, domestic demand remained strong with a seasonally adjusted annual rate of growth of 5 percent, only slightly lower than the 5¼ percent in the last quarter of 2003. The housing sector appeared to cool somewhat in late 2003 and early 2004, with declining prices in some markets and easing in the auction clearance rate, building approvals, and lending for housing. While exports firmed in the first quarter of 2004, reflecting a strong rebound in agriculture, a boost in imports pushed net exports to a record low, subtracting 3¾ percentage points from GDP growth.



Source: Data provided by the Australian authorities.

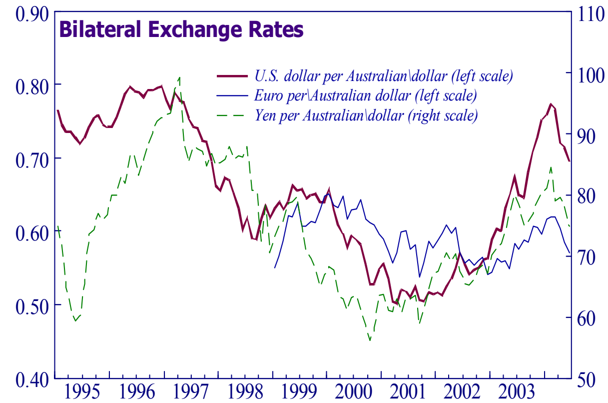
9. **Australia's recent inflation performance has been marked by contrasting influences from strong domestic demand on the one hand and a substantial appreciation of the Australian dollar on the other.** After a temporary spike in March 2003, reflecting mainly a run-up in energy prices, overall CPI inflation gradually declined to the lower bound of the RBA's target range of 2–3 percent in the first quarter of 2004, before edging up to 2½ percent in the second quarter due to the easing of the Australian dollar and a surge in oil prices. However, the overall inflation measure masks very different trends in tradables and nontradables inflation. While CPI inflation for nontradable goods has remained above 4 percent since March 2003, price increases for tradable goods have declined sharply since March 2003 due to the large appreciation of the Australian dollar. More recently, there has been a pick up in tradable good prices associated with the ongoing boom in commodity prices and easing of the Australian dollar.



Source: Data provided by the Australian authorities.

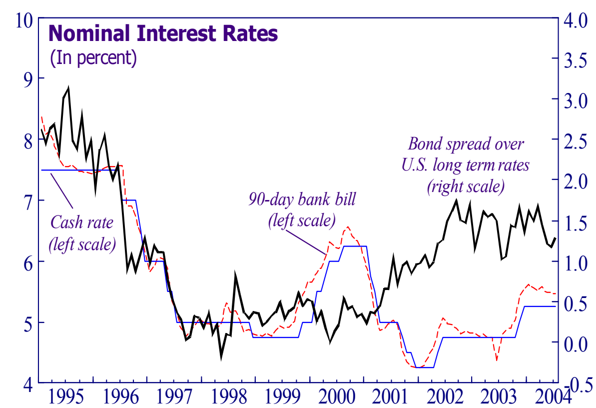
10. **The Australian dollar appreciated significantly during the past two years.** From its low in April 2001 to its recent peak in February 2004, the Australian dollar strengthened by 65 percent against the U.S. dollar. On a trade-weighted basis, the currency appreciated by 41 percent, reflecting the weakness in the U.S. dollar, which dragged along closely-linked currencies of some of Australia's trading-partners, a widening in interest rate differentials due to Australia's more favorable cyclical position, and strong commodity prices. This

appreciation also reflected a bounce back from the Australian dollar's significantly undervalued level in 2001. Indeed, at the February 2004 peak, the Australian dollar was only 21 percent above its ten-year average against the U.S. dollar (20 percent above on a trade-weighted basis).[1] From February to July 2004, the Australian dollar eased but remained 6 percent above its ten-year average against the U.S. dollar (9 percent on a trade-weighted basis). The RBA took advantage of the currency's strength to rebuild its official reserves—which had declined to the unusually low level of US$3½ billion in early 2002—which increased by US$11¾ billion during the two years to February 2004, with little change in subsequent months. Official reserves net of swap commitments were US$17.1 billion in June 2004, equivalent to 1½ months of imports of goods and services.



Source: International Monetary Fund.

11. **Monetary policy has successfully managed the countervailing influences on inflation and the heightened uncertainty during 2003.** The Official Cash Rate (OCR) remained unchanged during the first three quarters of 2003, reflecting the balancing of conflicting risks to the outlook at the time. The RBA had to contend with, on the one hand, the potential for protracted weakness in the external environment, further appreciation of the Australian dollar, and uncertainty about the recovery from the drought, and, on the other hand, continued rapid growth in housing credit (Box 1). While keeping interest rates unchanged, the RBA has actively sought to raise public awareness about the unsustainability of the housing market boom. By the end of 2003, however, with external risks to the Australian economy abating, domestic demand growing faster than expected, signs of recovery in the agricultural sector emerging, and the housing sector continuing to expand at an unsustainable rate, the RBA increased the OCR by 25 basis points in both November and December. The RBA kept the OCR unchanged at its policy meetings in the first half of 2004 based on emerging signs of easing domestic spending, a cooling in the housing market, and subdued inflation pressures.



Source: International Monetary Fund.

[1] The real effective exchange rate of the Australian dollar was estimated to be overvalued by at most 10 percent in the March 2004 CGER assessment, although this overvaluation would have declined as the currency has subsequently depreciated.

12. **The December 2003 Mid-Year Economic and Fiscal Outlook (MYEFO) depicted a stronger outlook than in the 2003 Budget.**[2] The near-term economic outlook had improved with the global recovery taking hold, an easing in drought conditions, and continued strength in the domestic economy. As a result, increases in expenditure due to additional policy measures announced since the 2003 Budget were more than offset by higher than expected revenue, reflecting significantly higher estimated corporate tax revenue. Consequently, the 2003 Budget estimate of a Commonwealth cash surplus of $A 2.2 billion (0.3 percent of GDP) for 2003/04 was revised upward in the December 2003 MYEFO to $A 4.6 billion (0.6 percent of GDP). The projected medium-term Commonwealth fiscal surplus was also raised marginally.

13. **The 2004 Budget contained a $A 37 billion package of additional tax cuts and new expenditure initiatives over five years (an average of about 0.9 percent of GDP each year), while maintaining a modest cash surplus through the medium term.** The centerpiece of the Budget was the government's *More Help for Families* package, which provides assistance to Australian families, continues the government's ongoing structural tax reform, and enhances incentives to save for retirement (Box 2). An underlying cash surplus of $A 2.4 billion (0.3 percent of GDP) was estimated for 2004/05, compared with $A 3.8 billion in the December 2003 MYEFO. Small underlying cash surpluses of between 0.2 and 0.4 percent of GDP were projected to continue for the foreseeable future, and Commonwealth net debt was projected to turn negative in 2007/08.

B. Economic Outlook

14. **Strong momentum in domestic demand, recovery from the drought, and an improving external environment are expected to boost real GDP growth to near potential of about 3¾ percent in 2004.** The long awaited rebalancing of sources of growth is expected during the second half of the year, with domestic demand growth gradually returning to trend and net exports becoming an alternative engine of growth. The two interest rate increases in late 2003 seem to have dampened dwelling investment and household consumption, although recent data show an acceleration in retail trade due to the new *Maternity Payment* disbursed on July 1, 2004. And while business investment remains strong, surveys of investment intentions for 2004−05 suggest that the investment cycle has reached its peak. The gradual cooling of domestic demand is expected to be, at least partially, offset by a pick up in external demand for nonagricultural exports and a rebound in agricultural output. The recent moderation of the Australian dollar will further strengthen the contribution of net exports to economic growth.

15. **There are a number of important risks to the near-term outlook.** The main risk centers on the housing market and the associated build up of household indebtedness. The RBA has been very alert to this risk during the past few years and has taken a number of measures, including raising interest rates, to contain it. Scattered evidence in late 2003 and

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[2] The 2003 Budget was released in May 2003, covering the financial year 2003/04 that ended June 30, 2004, and was updated in the December 2003 MYEFO.

early 2004 suggests a soft landing in the housing market. There are other risks: a re-emergence of drought; sustained high oil prices; a weakening of external demand, perhaps associated with a slowdown in China;[3] and building inflation pressures from a tight labor market, a further depreciation of the currency, or a combination of both. But none of these, in isolation, is likely to pose a significant risk in the short term. A combination of external and domestic shocks, however, could shake confidence and spark a sharp increase in household saving rates that could severely weaken domestic demand; if this were to occur when the expected recovery in net exports fails to emerge, the impact on GDP growth could be marked. While such a worst-case scenario cannot be ruled out, it is not the most likely outcome. These downside risks are balanced by the upside potential of domestic demand remaining robust as net exports strengthen and fiscal stimulus comes on stream.

16. **Medium-term prospects remain favorable.** Australia's transparent and effective monetary and fiscal policy frameworks, healthy public finances, and the government's commitment to carry forward its pro-growth strategy should sustain growth around Australia's potential of 3¾ percent. This suggests that the current, historically low unemployment rate of about 5½ percent may remain broadly unchanged. The current account deficit is projected to decline to 4 percent of GDP as the effects of the drought dissipate, the economy returns to its medium-term growth path, the pick-up in global economic activity takes hold, and favorable terms of trade developments continue (Box 3). However, the persistent current account deficit and relatively high household debt continue to be potential vulnerabilities to the Australian economy.

III. POLICY DISCUSSIONS

17. **The authorities and the staff broadly agree on the appropriate settings for macroeconomic policies in the short-to-medium term and on the key elements in the authorities' strategy to deal with Australia's longer-term policy challenges.** The policy discussions focused on the uncertainties surrounding the outlook, the appropriate monetary and fiscal policy mix, and longer-term fiscal pressures on public spending associated with rapidly increasing healthcare costs and the ageing of the population.

A. Macroeconomic Policies

Monetary Policy and the Exchange Rate

18. **The RBA has kept monetary policy on hold since the two 25 basis point increases in the Official Cash Rate late last year.** With the economy continuing to grow at a brisk pace, even in the face of a cooling housing sector, pressures on underlying inflation may start to build during the second half of 2004 as the restraining influence from the earlier appreciation of the exchange rate fades. These considerations prompted the RBA to signal in its August *Monetary Policy Statement* that Australian interest rates would likely have to

[3] Staff analysis suggests that a hard landing in China—based on a scenario where a sharp slowdown in investment growth leads to a 10 percentage point decline in China's import growth and a decline in world commodity prices—could result in a half to 1 percentage point decrease in Australia's GDP, although the full effects would be mostly felt only after a few years.

increase at some stage in the current expansion. This tightening could come soon if wage growth—which has been relatively subdued so far—increases, oil prices remain high, the Australian dollar depreciates further.

19. **The authorities noted that exchange rate flexibility has cushioned the Australian economy from external shocks, with economic agents adapting well to large exchange rate swings, including through hedging practices.** At the same time, they believe that intervention in the foreign exchange market may be warranted to help reverse an apparent overshoot in the exchange rate in either direction; or to calm a disorderly market, which could lead to significant ask-bid spreads and loss of liquidity.[4] The foreign exchange reserves used to intervene had fallen to an unusually low level in early 2002. As noted, the RBA took advantage of favorable market conditions to rebuild its stock of reserves until mid-February 2004, but has remained on the sidelines subsequently as the Australian dollar eased. Looking ahead, conditions seem favorable for a gradual depreciation of the Australian dollar toward its long-term average value, with a global pick up in economic activity and the expected increase in world interest rates. While recent exchange rate cycles suggest considerable persistence, econometric evidence indicates that the exchange rate tends to converge to its equilibrium level rather quickly when hit by large shocks.[5]

Fiscal Policy

20. **Although fiscal policy remains fundamentally sound, the new package unveiled in the 2004 Budget could pose some risk to the medium-term outlook.** Owing to the strength of the economy and buoyancy of revenue, the underlying cash balance is projected to remain positive for the foreseeable future despite the package of tax cuts and new expenditure initiatives in the budget. However, this relatively favorable outlook hinges on significantly stronger revenue than projected in December 2003, by a cumulative $A 29 billion over five years, which is expected to largely offset the cost of the new package. The authorities are cognizant of the risks to the fiscal outlook and would take appropriate measures if revenue turns out weaker than projected. The mission noted that the short-term stimulatory effect of the $A 37 billion package, of which $A 14 billion is earmarked for 2004/05 and 2005/06 (an average of about 0.9 percent of GDP each year), could complicate monetary policy formulation if it comes into play when growth of domestic demand is still significantly above potential. The authorities believe that the stimulus from the package will be relatively small,[6] and, in any case, that is appropriate in view of the downside risks.

[4] The RBA's intervention policy is described in http://www.rba.gov.au/Education/exchange_rate.html

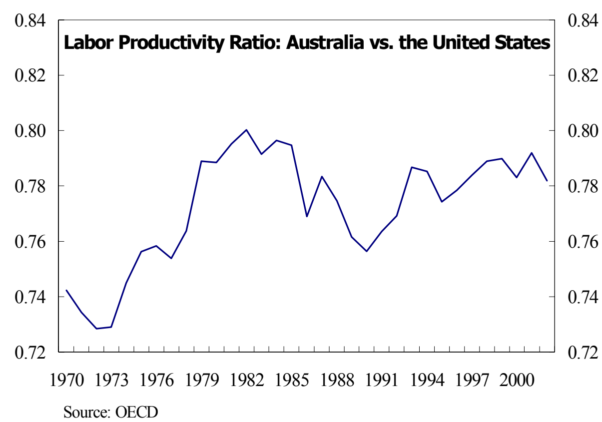
[5] See "Speed of Convergence of the Real Exchange Rate to Equilibrium," in the accompanying Selected Issues paper.

[6] For 2004/05, the staff estimates the fiscal impulse from the package at about 1 percent, which is consistent with estimates from market participants. The authorities estimate the impact to be somewhat less, perhaps ½ percent of GDP.

B. Structural Policies

21. **Notwithstanding the relatively positive medium-term outlook, Australia faces significant long-term spending pressures due to increasing healthcare costs and population ageing.** The *Intergenerational Report* published as part of the 2002 Budget identified the sources of these fiscal pressures and estimated their potential magnitude to be a financing gap of about 5 percent of GDP in the Commonwealth budget by 2042, assuming no policy or behavioral changes. Compared with other industrialized countries, Australia is well placed to respond to these intergenerational pressures, because of the strength of its fiscal position. However, a measured and timely response to the challenges highlighted in the *Intergenerational Report* will render them much more manageable.

22. **While Australia has narrowed the productivity gap with respect to leading industrial countries, perseverance with structural reforms is needed to make further progress.** The strong performance over the past decade arose from the concerted efforts of successive governments to improve both the microeconomic and macroeconomic environment in Australia.[7] In particular, product and labor market liberalization has spurred competition, increased efficiency, and encouraged the adoption of productivity-enhancing information and communication technologies. As a result, competitiveness has improved, potential growth has increased—perhaps by as much as 1 percentage point[8]—and business cycle fluctuations have been dampened, keeping actual growth close to potential. In a world of rapid technological change and globalization, it is necessary to continue the reform process to close the productivity gap with the most advanced economies and maintain adequate rates of growth to face the long-term challenges of an ageing population.



[7] See "Trade Liberalization and Economic Growth: Australia's Experience," in the accompanying Selected Issues paper.

[8] Average real GDP growth increased from 2.7 percent in the decade prior to structural reforms (1975−84) to 3.9 percent in the past decade.

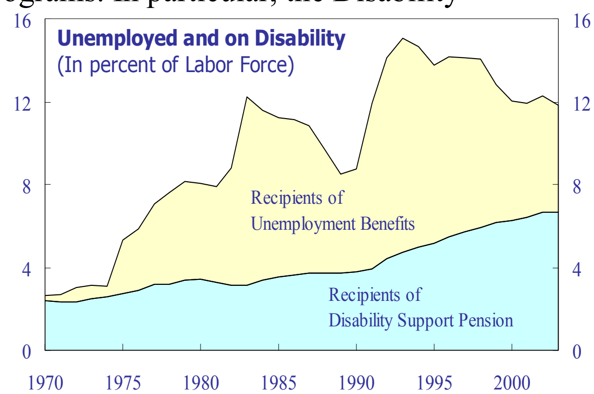
Labor and Productivity Indicators
(Average growth rates, in percent)

	GDP per capita			Labor Productivity 1/			TFP 2/		Labor Force Participation Rate 3/		
	1970-85	1985-95	1995-02	1970-85	1985-95	1995-02	1985-95	1995-02	1970-85	1985-95	1995-02
Australia	1.8	1.9	2.4	1.8	1.3	2.5	1.2	2.1	60.9	61.9	62.9
Canada	2.1	1.3	2.2	1.7	0.9	1.8	0.0	1.0	63.6	66.2	65.5
United Kingdom	1.7	2.3	2.2	2.7	2.0	2.0	1.2	0.9	62.0	63.0	62.8
United States	2.4	2.0	1.7	1.6	1.2	2.0	0.8	1.1	62.3	66.0	66.9

Source: OECD productivity database.
1/ GDP per hour worked.
2/ Based on 'harmonised' price indices for information and communication technology capital goods.
3/ Labor force as a percent of population aged 15–64.

23. **The government has outlined five complementary policy areas that could lift labor force participation and promote productivity growth**:[9]

- **Better incentives for work.** The challenge is to redesign the tax and income support systems to encourage higher workforce participation while providing an adequate and well-targeted safety net. The current income support system remains complex and costly, and imposes high effective marginal tax rates (EMTRs) on individuals moving from income support to work. The system also needs to be better targeted by tightening eligibility for income support programs. In particular, the Disability Support Pension (DSP) program has grown rapidly, with 6¾ percent of the labor force in the program in 2003, exceeding the unemployment rate of 5½ percent. One of the criteria to qualify for the DSP is continuing inability to work 30 or more hours a week, which is almost twice as many hours as the 16 hours a week worked on average by part-time workers in Australia. A government proposal to tighten eligibility for the DSP continues to be blocked in the Senate. To avoid encouraging people to leave the workforce early, the government has also proposed to amend the superannuation laws to relax the requirement that workers between the ages of 55 and 65 must leave work before they can access their superannuation benefits. Finally, the 2004 Budget contains new measures to reduce disincentives to participation, including tax cuts in the form of a further increase in thresholds for marginal tax rates affecting medium- and high-income families (following a more modest increase last year),[10] and reductions in taper rates on family tax benefits.



Source: Australian Treasury

[9] *Australia's Demographic Challenges*, Australian Government, February 2004 and Budget 2004.

[10] Despite the recent increases in tax thresholds, the top marginal tax rate of 47 percent applies at a relatively low income threshold of $A 80,001, about twice average income.

- **Enhancing flexibility in the workplace.** The government agenda of proposed amendments to the *Workplace Relations Act* continues to simplify procedures, increase labor market flexibility, and link wages and work conditions to productivity. However, the wage bargaining system needs further simplification, including a reduction in the overlap of the federal and state award systems and a diminished role of the award system in setting the minimum wage, which has contributed to a relatively high unemployment rate for low-skilled workers.[11] While the government has secured passage of some industrial relations legislation over the past few years, several of its proposals were blocked in the Senate.[12] New government initiatives include enhancing the *Job Network Program* designed to help unemployed workers find a new job, extending the government's childcare program, and introducing legislation to remove age discrimination for federal government jobs.

- **Improving the capacity for work.** The government has aimed to reduce skill mismatch in the labor market by improving the education system, enhancing training, promoting a closer relationship between the education system and the business sector, and maintaining a competitive tax system to attract and retain talented people.

- **Investment in science, innovation, and infrastructure.** The 2004 Budget extends the government's *Backing Australia's Ability*, a science and innovation program, by $A 5.3 billion (following a $A 3 billion package in 2001). The 2004 Budget also includes a new infrastructure investment program, *AusLink*, with an additional $A 1.9 billion over the next 5 years allocated to upgrade the Australian road and rail systems.

- **Enhancing competitiveness of product markets.** Central, state, and territory governments agreed in 1995 to implement a range of competition reforms under the National Competition Policy (NCP) framework to boost long-run economic growth. There have been substantial benefits from the implementation of the NCP and other competition related reforms, including in the electricity, gas, road transport, and water sectors. The Government has recently asked the Productivity Commission to inquire into the impact of competition policy reforms undertaken to date, and to identify priority areas for further competition reform.

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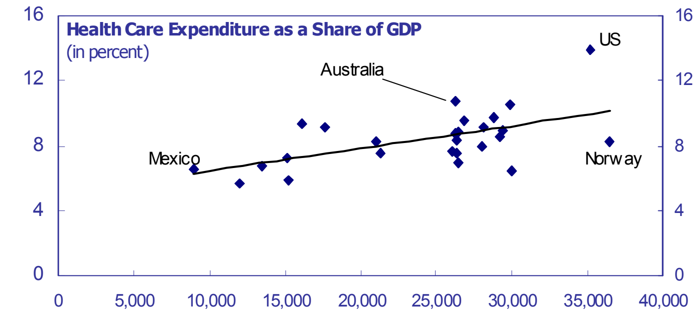
[11] Even though the award system has been significantly simplified over recent years, it still covers 20 areas or conditions, including wages, working conditions, leave policy, etc.

[12] Including an amendment to the unfair dismissal laws to minimize their impact on employment, a proposal to simplify bargaining procedures, and a proposal to improve the processes around the union right of entry to workplaces.

24. **Controlling government outlays on healthcare is also necessary to close the long-term fiscal gap.** The interaction of an ageing population, technological innovation in the healthcare sector, and the "luxury goods" nature of healthcare services—which implies that the share of income spent on healthcare services increases with the level of income per capita—will boost demand for healthcare services and put significant pressure on public expenditure. The recent amendment to the Pharmaceutical Benefit Scheme (PBS), the fastest growing component of healthcare spending, will increase patient co-payment and safety net thresholds by 21 percent starting January 1, 2005,[13] helping contain the growth of public spending. Although the 2004 Budget includes more resources for preventive health, which could reduce future healthcare costs, additional measures are needed to preserve the long-run viability of the healthcare system.



Source: Australian Treasury

C. Financial Sector Issues

25. **The financial system is sound, with a strong risk management culture.** Banks, the most important financial intermediaries from a systemic risk perspective, are, in general, well capitalized, very profitable, and carry few bad debts. This reflects the long-running expansion of the domestic economy and the important improvements in risk management following the problems of the early 1990s. In the non-banking sector, the insurance and superannuation industries have also benefited from the robust economic environment, the recovery in equity markets, and a global increase in insurance premia due to heightened geopolitical uncertainties.

26. **The financial system is well positioned to withstand a possible correction in the housing market.** While there are indications of increased risk in mortgage portfolios, it is difficult to envisage scenarios in which developments in the housing market alone could pose a systemic risk to the financial system. Recent stress tests by the Australian Prudential Regulation Authority (APRA) indicate that even if house prices fell by 30 percent and mortgage default rates increased dramatically, more than 90 percent of deposit-taking institutions would continue to meet minimum regulatory capital requirements.[14] For the small number of institutions that fell below the minimum, the breach was estimated to be small.

27. **An abrupt consolidation of household balance sheets could be more damaging.** This could be prompted by a combination of shocks triggering a significant increase in

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[13] Patients reaching the Safety Net thresholds within a calendar year qualify for receiving PBS items at a cheaper price, or free of charge, for the rest of the calendar year.

[14] More details are provided in http://www.apra.gov.au/Insight/loader.cfm?url=/commonspot/security/getfile.cfm&PageID=6643

mortgage interest rates and high unemployment. In turn, this would have a negative impact on banks' balance sheets. Assessing the likelihood of such a scenario is complicated by the fact that there have been few instances, either in Australia or elsewhere, in which balance-sheet adjustment by the household sector has been a major factor shaping an economic downturn. In previous episodes, adjustments by the corporate sector and by financial institutions have typically been the source of difficulties, and the risk of problems emanating from these sectors appears to be quite small.

28. **Australia's vulnerability to adverse external shocks remains low (Annex I).** The external current account deficit has widened, mainly reflecting the sharp appreciation of the Australian dollar and the relatively strong cyclical position of the economy. The low and declining level of public debt, the relatively stable source of external financing, and the strong risk management culture in Australia's financial institutions limit Australia's external vulnerability.[15] Nevertheless, sustained current account deficits and the build-up of external debt, although mainly held by the private financial sector, could leave Australia potentially vulnerable to shifts in market sentiment, suggesting the need for careful monitoring (Box 4). Corporate and banking sector balance sheets are generally sound and have proven to be resilient to large swings in exchange and interest rates. While debt servicing remains manageable, households could be subject to more stress than in the past in the event of a substantial increase in both interest rates and unemployment.

29. **Key recommendations of the Royal Commission that investigated the collapse of Heath International Holdings Insurance Ltd. (HIH) have been implemented.** In response to the HIH Report, the government amended the *Australian Prudential Regulation Authority Act 1998* with the objective of strengthening the governance of APRA, clarifying its role in the financial system, enhancing its disclosure and conflict of interest framework, and promoting closer cooperation with other financial regulators, the Reserve Bank of Australia, and the Australian Securities and Investments Commission. In addition, the *Corporate Law Economic Reform Program* (*Audit Reform and Corporate Disclosure*) *Act 2004* —which became law on July 1, 2004—aims to enhance auditor independence, achieve better disclosure outcomes, and improve enforcement arrangements for corporate misbehavior.

30. **Preparations for the implementation of Basel II are underway.** In 2003**,** APRA issued preliminary guidelines for the adoption of internal risk models to calculate regulatory capital requirements in accordance with the new Basel Accord proposals scheduled for implementation by 2007. APRA does not expect the different approaches for computing capital requirements in Basel II to change the current competitive environment. APRA intends to conform wherever possible to the international consensus on the new Accord, but will amend components when necessary to reflect unique Australian circumstances.

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[15] Stress tests using the external sustainability framework template do not suggest major concerns (Table 5). A large exchange rate depreciation produces a sizable jump in the external debt to GDP ratio. However, the experience in the late 1990s underscores the resilience of the Australian economy to such shocks. Moreover, in the event of a substantial depreciation, the mitigating influence of having foreign currency debt positions that are predominantly hedged is not captured in the framework.

31. **Australia is in full compliance with the recommendations of the FATF on money laundering, following the passage of the Suppression of the Financing of Terrorism Act 2002**. Australia has also ratified and implemented the OECD Convention on Combating the Bribery of Foreign Public Officials in International Business Transactions.

32. **The authorities are interested in participating in a Financial Sector Assessment Program (FSAP).** They indicated during the Article IV consultation in June 2004 that, pending the Treasurer's clearance, Australia would likely participate in a FSAP in 2005–06. This is an opportune time given the consolidation trend in international financial markets and the structural shift in the Australian banking sector toward the housing sector.

D. Trade Policy and Official Assistance

33. **Trade liberalization has been aggressively, and often unilaterally, pursued over the past two decades as an integral aspect of Australia's growth strategy.** Further liberalization is in the pipeline as tariffs are reduced to a maximum of 5 percent on passenger motor vehicles by 2010, and on textiles, clothing, and footwear, by 2015. Australia is a strong supporter of multilateral trade liberalization and seeks to play a constructive role in the Doha Round. With multilateral negotiations stalemated until recently, however, Australia has concluded negotiations for free trade agreements with Singapore, Thailand, and the United States, and is exploring possible agreements with China, ASEAN, and other countries. In addition, Australia has recently provided tariff- and quota-free access for all goods from least developed countries. The authorities are aware of the risks that bilateral agreements may contribute to a proliferation of regional trade blocs, reduce the political will for further unilateral trade liberalization, and dilute efforts on the multilateral front in the context of the WTO. They are determined, however, to only conclude high quality bilateral agreements, and may extend commitments in bilateral agreements to all trading partners.

34. **Australia is the dominant regional power and has long enjoyed close political and economic relationships with the Pacific island countries (Box 5).** This role has been enhanced over the past year with Australia's involvement in Papua New Guinea and the Solomon Islands, which reflected increasing concerns about the lack of sustainable economic progress despite large amounts of external assistance. Australian aid allocations to the Pacific region increased by 60 percent in the 2004–05 Budget. About one-half of the total assistance to the region is expected to go to Papua New Guinea and about one-fourth is expected to be allocated to the Solomon Islands. Overall, Australia provided 0.25 percent of GNP for ODA in 2003, in line with the average for industrial countries but well below the 0.7 percent United Nations target, which Australia remains committed to achieve.

IV. Staff Appraisal

35. **Australia continues to reap the benefits of sustained implementation of appropriate macroeconomic policies and structural reforms.** These benefits are apparent in strong economic growth, low inflation, and substantial declines in the unemployment rate and public indebtedness. Reforms, a transparent framework for macroeconomic policies, and a flexible exchange rate have also made the Australian economy much more flexible and resilient to shocks.

36. **The short-to medium-term outlook remains favorable.** The expansion is now entering its 13th year, with unemployment falling to levels not seen since the early 1980s, and prospects for the expansion to continue are good. Growth is expected to become better balanced during the year, with a cooling in the strong momentum of domestic demand, primarily reflecting a welcomed slowing in dwelling investment and household consumption, and a pick up in net exports as the global economy strengthens and agricultural output rebounds from the drought. It is expected that inflation will remain comfortably within the official target range and that the current account deficit will narrow as a percent of GDP.

37. **There is a broad consensus that the main risk to the short-term outlook centers on the housing market and the associated build up of household indebtedness.** The RBA has been alert to this risk for some time, and has taken a number of steps, including jaw boning and a couple of taps on the monetary brakes to bring the market off the boil. Scattered evidence suggests a soft landing in the housing market, which is what most observers now expect. While no single risk appears to pose a significant threat in the short term, a combination of external and domestic shocks could shake confidence and spark a sharp increase in household saving rates that could severely weaken domestic demand; if this happened when the expected recovery in net exports failed to emerge, GDP growth could decline sharply. While such a worst-case scenario cannot be ruled out, it is not the most likely outcome. Balancing these downside risks is the upside potential of domestic demand remaining robust as net exports strengthen and fiscal stimulus comes on stream.

38. **In any case, macroeconomic policy is well placed to respond in either direction to unexpected conjunctural developments.** For the time being, the RBA's wait and see stance remains appropriate, given benign inflation and remaining uncertainties in the housing market. However, with a monetary policy stance still mildly accommodative and the dampening effect on inflation of the earlier exchange rate appreciation weakening, the stimulatory effect of the fiscal package may complicate monetary policy implementation if it comes into play when domestic demand growth is still robust and external demand is strengthening. On the other hand, if significant downside risks should materialize, fiscal policy has ample room to allow the automatic stabilizers to run their course, or to provide additional discretionary stimulus. There is also a risk that fiscal revenue turns out to be lower than projected in the budget, in which case the execution of the $A 37 billion package of tax cuts and new spending initiatives in the 2004 Budget should be reviewed.

39. **Australia has demonstrated that a flexible exchange rate along with good risk management practices can significantly increase the resilience of the economy.** The flexible exchange rate has helped the Australian economy weather severe external shocks, including the Asian crisis, a global recession, and wide fluctuations in commodity prices. Australia's experience has also shown that large swings in exchange rates do not necessarily have adverse economic effects if foreign exchange risk is well managed. Accordingly, the staff supports the authorities' policy to limit foreign exchange interventions to situations where the exchange rate is clearly misaligned or to calm disorderly market conditions.

40. **Australia faces significant long-term spending pressures due to increasing healthcare costs and population ageing.** The fiscal package in the 2004 Budget is consistent with the government's long-term objective of lifting labor force participation and promoting productivity growth. In addition, the recent passage of changes to the

Pharmaceutical Benefit Scheme will help contain healthcare cost. Future budgets and legislation will need to continue to target areas expected to deliver the highest boost to long-term growth, including: measures to further improve labor market flexibility; reforms to the welfare system to improve work incentives; measures to enhance the competitiveness of product markets, based in part on the forthcoming review of national competition policy by the Productivity Commission; and investment in education, training, research and development, and infrastructure.

41. **The authorities are right to place higher productivity and labor force participation at the center of their strategy to achieve higher growth and close the long-term fiscal gap.** Measures have been taken recently to address some of these issues, including a reduction in effective marginal tax rates for low income families returning to work, and allowing older workers to start drawing down certain superannuation income streams without having to cease work. These are important steps that should be complemented with stronger incentives to remain in the labor force through tighter eligibility requirements for the Disability Support Pension and other income support programs. Further broad-based measures to increase labor market flexibility are also needed, including a reduction in the overlap of the federal and state award systems and a diminished role for the award system in setting the minimum wage, which has contributed to a relatively high unemployment rate for low-skilled workers.

42. **Trade liberalization has been aggressively, and often unilaterally, pursued over the past two decades as an integral aspect of Australia's growth strategy.** Further liberalization of the more protected sectors is in the pipeline. Australia is a strong supporter of multilateral trade liberalization and its pursuit of bilateral free trade agreements is consistent with and supportive of its multilateral efforts. The authorities are aware of the risks that bilateral agreements may contribute to a proliferation of regional trade blocs, reduce the political will for further unilateral trade liberalization, and dilute efforts to conclude successfully the WTO negotiations. IMF staff is encouraged by the authorities' determination to only conclude high quality bilateral agreements, and urge the authorities to extend commitments in bilateral agreements to all trading partners.

43. **The financial system is sound, with a strong risk management culture.** Banks are generally very profitable and well capitalized. Although deposit taking institutions have a substantial exposure to the housing market, APRA stress tests indicate that even a substantial decline in housing prices would not have systemic implications for the banking system. The IMF staff commends APRA for actively preparing the Australian financial system for the implementation of Basel II, and welcomes the authorities' interest in participating in a future Financial Sector Assessment Program.

44. **A hallmark of Australia's recent economic management has been the comprehensiveness of structural reforms and the consistent implementation of stable macroeconomic policies conducted in a transparent framework.** Reforms have been complementary and mutually reinforcing, and hence more likely to succeed. Trade liberalization, for example, has been a catalyst for improved competition, paving the way for reforms in competition policy. Similarly, the RBA's inflation targeting framework and the government's prudent fiscal policies have created an environment of low and stable inflation that has made industrial relations less contentious and eased labor market reforms. Low and

stable inflation has also helped to ensure that relative prices provide accurate signals about where resources can be put to their most productive uses. It is important to continue this comprehensive approach in coming years to meet the medium-term challenges of an ageing population.

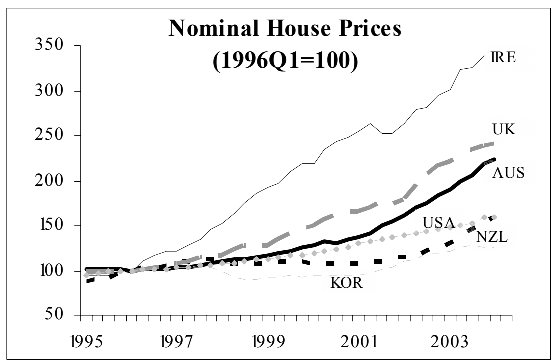
45. **It is proposed that the next Article IV consultation with Australia take place on the standard 12-month cycle.**

Box 1. The House Price Surge in Australia

House prices have increased rapidly in Australia. From the end of 2001 through the first quarter of 2004, prices of established houses surged at an average annual rate of 17¾ percent in nominal terms (14½ percent in real terms). Over the longer term, prices have increased by almost 125 percent (85 percent in real terms) since the last housing cycle trough in March 1996. According to estimates by the Reserve Bank of Australia (RBA), the ratio of housing asset values to incomes is now relatively high in Australia by international standards, whereas a decade ago the ratio was comparable to that observed in other countries.[1]

While there have been previous pronounced house price cycles—including in the early and late 1970s and a very sharp increase in the late 1980s—the current cycle has several unusual features. First, it has occurred in a period when overall inflation was low and continued over a longer period than previous upswings. Thus, the cumulative increase in both real and nominal terms has been much larger.[2] Second, the current boom is nationwide, unlike earlier ones that were specific to regions. Third, the current upswing has been focused on residential properties (including apartments), whereas previous episodes had included commercial properties, where prices have not yet recovered to peaks reached in the late 1980s. Fourth, very strong demand by household investors to buy rental residential properties has played an important role in the current boom, despite low rental yields and high vacancy rates. Loans for investment properties now account for over 40 percent of new housing loans approved by financial institutions and about one-third of banks' outstanding loans—both high by international standards—compared with about 15 percent of new and outstanding loans in the early 1990s.

The recent house price boom in Australia is not unusual compared to booms in other countries. Since 1996, house prices have increased sharply in several other advanced countries, led by Ireland and the United Kingdom. Around 70 percent of Australians own their homes, which compares with house ownership rates in other industrial countries, ranging from 40 percent in Germany to over 80 percent in Spain.



A recent report by Australia's Productivity Commission concludes that house prices have risen more than would be explained by longer-term fundamentals, which include population growth, smaller household size, land supply constraints, household income and wealth gains, the structural reduction in inflation and interest rates, and financial innovations that have eased household access to credit.[3] The report suggests that factors such as negative gearing (that is, for income tax purposes, the ability to deduct expenses on investment properties, including comparatively favorable depreciation charges, against all forms of income), changes to capital gains and other income taxes since 1999, the First Home Owners Scheme (designed to offset the impact of the introduction of the Goods and Services Tax in 1999), and expectations of further price appreciation by households (including investors) have interacted to boost demand for residential properties.

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[1] See RBA, "Submission to the Productivity Commission Inquiry on First Home Ownership," Occasional Paper No. 16, November 2003.

[2] For comparison, the cumulative increase in the late 1980s was 53 percent in nominal terms and 36 percent in real terms, based on data from the Australian Bureau of Statistics.

[3] See Productivity Commission, *First Home Ownership*, Inquiry Report No. 28, March 2004, which also proposes policy changes that could reduce price pressures. See also IMF, "The Determinants of Property Prices in Australia," Chapter I in *Australia—Selected Issues*, Country Report No. 03/336, October 2003.

Box 2. The 2004 Budget

The Budget forecasts continued growth for the Australian economy, with low unemployment and low inflation. GDP growth is projected to moderate slightly from 3¾ percent in 2003/04 to 3½ percent in 2004/05. The fiscal outlook for Australia remains positive, with a forecast underlying cash surplus of $A 2.4 billion in 2004/05 and a small surplus for the following three years.

The centerpiece of the 2004 Budget is the government's *More Help for Families* package which provides assistance to Australian families, continues the government's ongoing structural tax reform, and enhances incentives to save for retirement. The total package amounts to $A 36.7 billion over five years (an average of about 0.9 percent of GDP each year) and consists of three elements:

- **Family Package**

  The *More Help for Families* package costs $A 19.2 billion over five years. The package increases assistance to families and rewards work by relaxing the income test to qualify for family tax benefits. In addition, a new Maternity Payment of $A 3,000 was introduced on July 1, 2004, which will be increased to $A 4,000 on July 1, 2006 and to $A 5,000 on July 1, 2008.

- **Tax Cut**

  Building on the tax cut provided last year, the 2004 Budget seeks to reduce the disincentive of high marginal tax rates through a two-step reduction in personal taxes worth $A 14.7 billion over the next four years. The tax cut increases the thresholds above which incomes are taxed at 30 percent, 42 percent, and 47 percent. This will ensure that over 80 percent of taxpayers face a top marginal tax bracket of no more than 30 percent.

New Personal Tax Rates

Previous Tax Threshold Income Ranges ($A)	New Tax Threshold Income Ranges ($A)		Tax Rate (In Percent)
	From July 1, 2004	From July 1, 2005	
0–6,000	0–6,000	0–6,000	0
6,001–21,600	6,001–21,600	6,001–21,600	17
21,601–52,000	21,601–58,000	21,601–63,000	30
52,001–62,500	58,001–70,000	63,001–80,000	42
62,501+	70,000+	80,000+	47

- **Incentives for Retirement Saving**

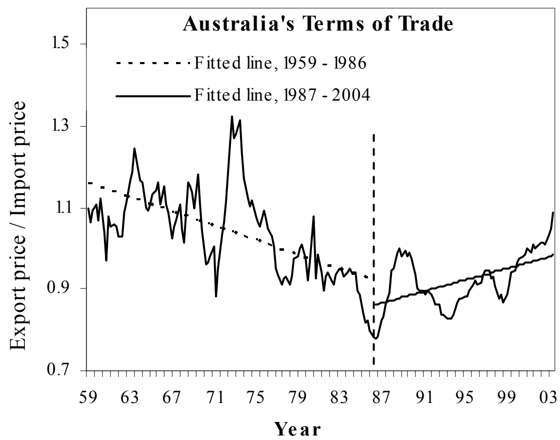
  The 2004 Budget also improves incentives for low- and middle-income people to save for their retirement through superannuation, with a total cost of $A 2.7 billion. The maximum benefit under the superannuation co-contribution scheme was increased to $A 1,500 to match a $A 1,000 personal contribution. The superannuation surcharge rate for high-income earners will be progressively reduced from 15 percent to 7½ percent in 2006–07.

Box 3. What Accounts for the Turnaround in Australia's Terms of Trade?

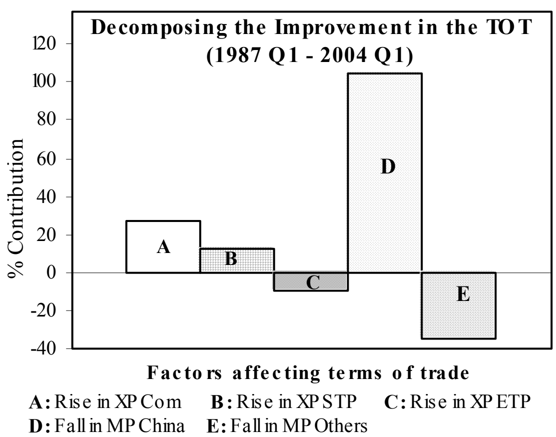
The conventional wisdom, suggested first by Raul Prebisch in 1950, has been that there is a secular decline in the prices of primary products relative to the prices of manufactured goods, implying a secular decline in the terms of trade of commodity exporting countries. During the past decade or so, however, there is some evidence of a break in this trend for some commodity exporting countries. One reason for this could be the increased importance of trade in intermediate goods and the rising importance of low-wage countries such as China as major exporters of manufactured products. This could effectively lead to a "commoditization" of some manufactured products that may subject them to the same forces determining commodity price trends.

The terms of trade (TOT) for Australia, a commodity producer, have turned around after following a declining trend until 1986. Since 1987, the TOT have improved by 40 percent. Does this improvement represent a temporary deviation from the declining trend, or a turnaround that could last for a long time?

Several explanations have been suggested for the TOT improvement. First, the world demand for commodities has increased dramatically in recent years in part due to the rapid industrialization in China that has fanned its voracious appetite for raw materials. Second, the prices of the manufactured products that Australia imports have been declining rapidly, perhaps reflecting "commoditization" or faster-than-average productivity gains in the manufacturing of telecommunication equipment and computer hardware, which are important components of Australia's imports. The two explanations for the import price decline need not be mutually exclusive as China is a major exporter of these products.



The improvement in the Australian TOT can be decomposed into the change in export prices relative to the change in import prices. The export price change can be further decomposed into changes in the prices of commodity exports (XPCOM), the prices of exported products that involve only a simple transformation of raw materials (XPSTP), and the prices of elaborately transformed manufactured products (XPETP). Similarly, the import price change can be decomposed into changes in the prices of those products of which China is a major world exporter (MPChina) and the prices of all other products (MPOthers). The figure describes the percentage contributions to the improvement in the Australian TOT from each of the five components.[1]



The rapid decline in the prices of Australia's imports of goods at which China is a major world exporter is the single most important contributing factor to the steady improvement in the TOT. The rise in the world market prices for the commodities that Australia exports is the second most important factor. On the other hand, two factors have dampened the improvement in its overall terms of trade: a decline in the export prices of the elaborately transformed products, and a rise in the import prices of those products which China does not export on a large scale.

A number of factors suggest that the improvement in Australia's TOT may continue for some time. Given its vast rural population, China's industrialization and urbanization process is likely to last for a sustained period, feeding into a steady demand for raw materials and a prolonged downward pressure on the prices of the manufactured products that China exports or will soon export on a large scale. In addition, other currently poor economies, especially India, are poised to repeat the Chinese experience and become more important trading nations.

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[1] Details are in a forthcoming IMF Working Paper, "Accounting for the Turnaround in the Terms of Trade for Australia," by Shang-Jin Wei.

Box 4. Current Account Reversals in Industrial Countries

Some economists and policy makers have argued that an increase in the current account deficit that results from decentralized (optimal) decisions on private saving and investment made by private agents should not matter or be a concern, including for public policy. Often called the "Lawson Doctrine," this view, however, has come into question owing to a number of currency crises and sharp current account reversals that have occurred in emerging market and industrial countries in recent years.[1] The issue is of particular relevance to Australia in the current conjuncture with the current account deficit around 6 percent of GDP, a government fiscal surplus, and low and declining public sector debt.

The average characteristics of industrial countries that have experienced large current account reversals can be summarized as follows:[2]

- Typically, the reversal involves a **cyclical slowdown** with decreasing income and GDP growth (possibly, related to monetary tightening) and a **real exchange rate depreciation**. There is no significant evidence that the current account deficit itself triggers the cyclical slowdown.
- Although countries that suffered a reversal had a **fiscal deficit** on average, a number of these countries maintained fiscal surpluses, and fiscal balances on average were not deteriorating prior to the reversal. Subsequent to the reversal, however, fiscal balances deteriorated.
- **Interest rates** increased before the reversal and subsequently fell back following the reversal.
- The increase in the current account deficit prior to the reversal reflected on average decreased national (and private) **saving** with a stable domestic **investment** rate. The current account adjustment during the reversal was on average due to a sharp fall in investment with saving only rising slightly.
- Net exports recovered substantially during the current account reversal, owing to increasing **exports** as a share of GDP. **Imports** also increased, but to a lesser degree, as a share of GDP.

Possible explanations for breakdown of the "Lawson Doctrine" include:

- Private saving and investment decisions could be distorted, including due to policy or market failures. Examples of these include excessively optimistic expectations about changes to permanent income that lead to over-consumption and over-borrowing after major policy regime changes (such as from financial sector deregulation) and/or from asset market bubbles (through the associated wealth effects); and the Harberger externality—private borrowers may not internalize the increasing marginal social cost of external borrowing that arises from the upward-sloping supply of foreign capital.
- Private sector liabilities are often contingent public sector liabilities, either because creditors force governments to absorb private sector debts in the aftermath of a crisis or through fiscal policy that may need to be used in the event of a current account adjustment for counter-cyclical purposes or to resolve financial sector crises.
- In a Ricardian equivalence (or forward-looking rational expectations) framework, current account deficits are always the result of private sector decisions, independent of fiscal policy.
- A worsening current account deficit may be a reflection of, or lead to, an unsustainable appreciation in the real exchange rate. An overvalued exchange rate, in turn, could be distortionary.

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[1] The "Lawson Doctrine" is generally attributed to Nigel Lawson, the British Chancellor, who commented on the current account deficit in the United Kingdom in the late 1980s. However, it was also expressed earlier by others, including Jeff Sachs and Max Corden.

[2] Characteristics cited in this box are based on Caroline Freund, 2000, "Current Account Adjustment in Industrialized Countries," International Finance Discussion Paper 692, Board of Governors of the Federal Reserve System, and Sebastian Edwards, 2004, "Thirty Years of Current Account Imbalances, Current Account Reversals, and Sudden Stops," NBER Working Paper 10276. Current account reversals are defined in several ways in the literature but primarily refer to current account deficits that were reduced substantially during one to three-year periods with lower levels of the deficits sustained for a number of years afterwards.

Box 5. Australia and the Pacific Island Countries

Australia has long enjoyed close political and economic relationships with the Pacific island countries and is the dominant regional power. This role has been enhanced over the past year as a result of its involvement in Papua New Guinea and the Solomon Islands. Short-term economic developments in Australia mainly affect the Pacific island countries through tourism. More important medium-term issues are trade liberalization, external assistance, and a possible currency union. In this regard, a prosperous Australian economy benefits the island countries.

Foreign Trade: Australia accounts for a major share of exports and imports of the island economies, based on well established trading relationships. Over the medium term, a major factor will be the impact of the *Pacific Agreement on Closer Economic Relations*, one aim of which is to develop trade among the island countries with Australia; this will be crucial for the Fiji garments sector. With regard to island imports, there are indicators that, in light of the Australian dollar appreciation over the past two years, a few traders have been seeking cheaper Asian sources.

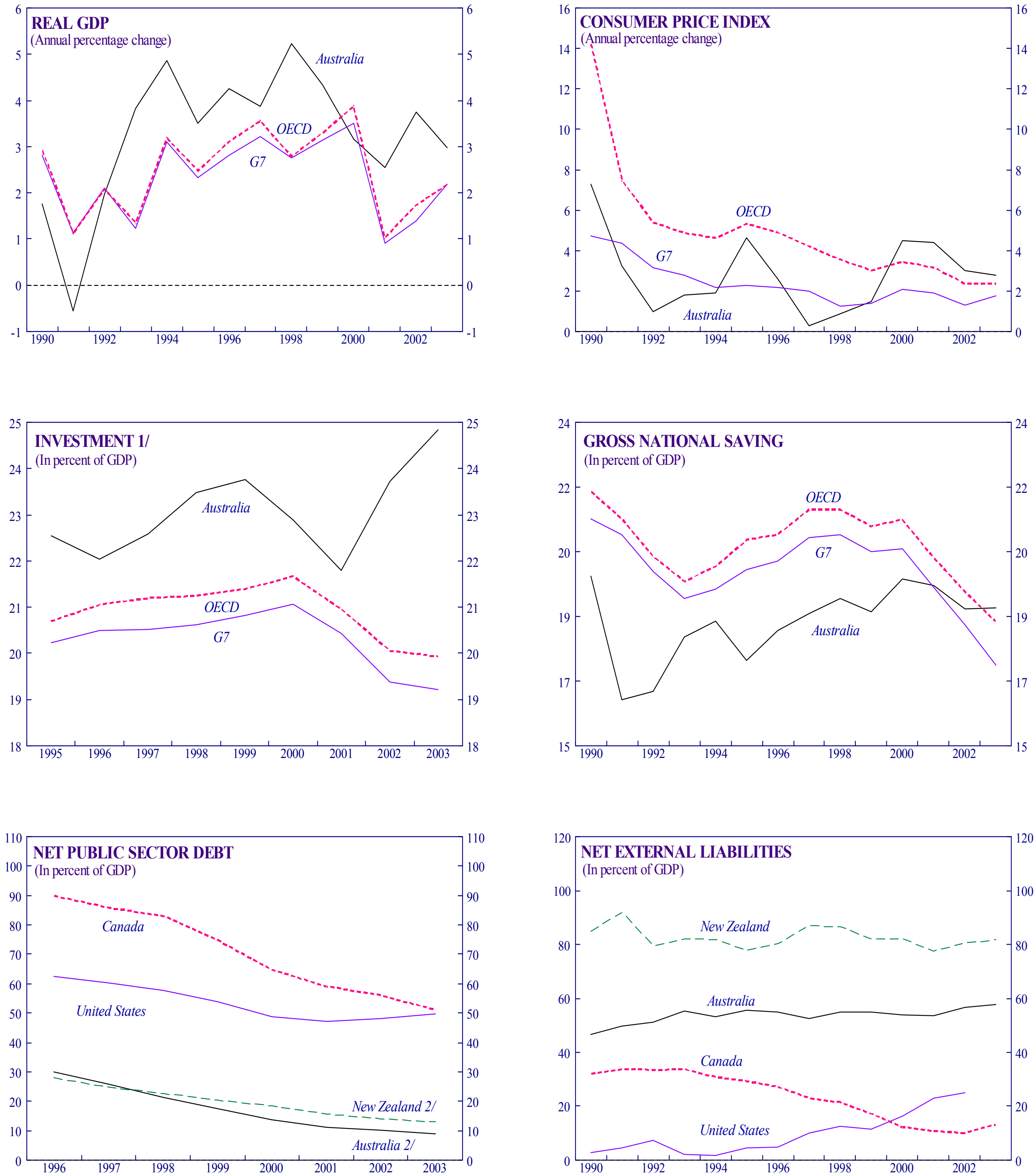
Tourism: This is the main area in which Australian economic developments could have an impact on the Pacific island economies. Australia is the main source of visitors to the region, especially for Fiji and Vanuatu, and as passengers on cruise ships. The perception of the region as a safe haven has helped the tourist industry since 9/11.

External Aid: Australian aid allocations to the Pacific region increased by 60 percent to ($A 569 million) in the 2004 budget; Papua New Guinea accounts for 53 percent and the Solomon Islands for 24 percent of the total. Taking into account the importance of the recent Enhanced Cooperation Program with Papua New Guinea and the Regional Assistance Mission in the Solomon Islands, it is unlikely that the aid program will be reduced in the short run.

Foreign Direct Investment: Pacific island investments in Australia are extremely small and limited primarily to equity holdings by superannuation funds and property purchases from Papua New Guinea sources. Australian investments in the region are mainly related to mineral projects in Papua New Guinea, including the prospective but uncertain Queensland gas pipeline.

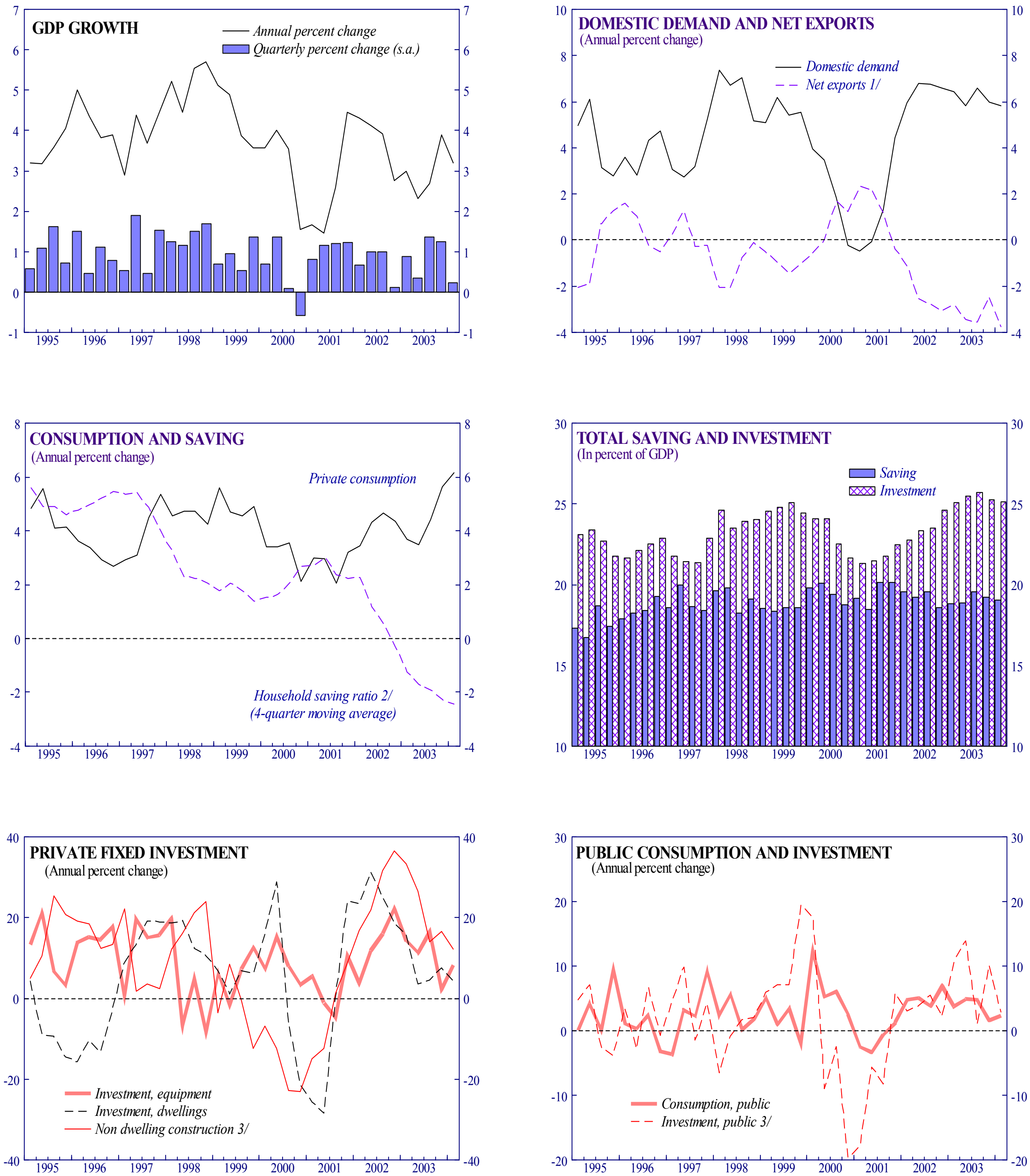
Currency Issues: Provided that the economic policies of the Pacific island countries converge and their overall resilience to external shocks is enhanced by appropriate fiscal and monetary policies, structural reforms, and trade diversification, there could be scope to strengthen financial links between Australia and the island region. At least for the next several years, it seems improbable that there will be radical moves toward regional financial integration; there appears to be no strong view among the island authorities that monetary union would promote the growth of output, employment, and productivity. However, the possible adoption of the Australian dollar as the regional currency has been raised by some island Finance Ministers and Central Bank Governors, and by a 2003 Australian Senate Inquiry.

Figure 1. Australia: Comparisons of Macroeconomic Performance, 1990–2003



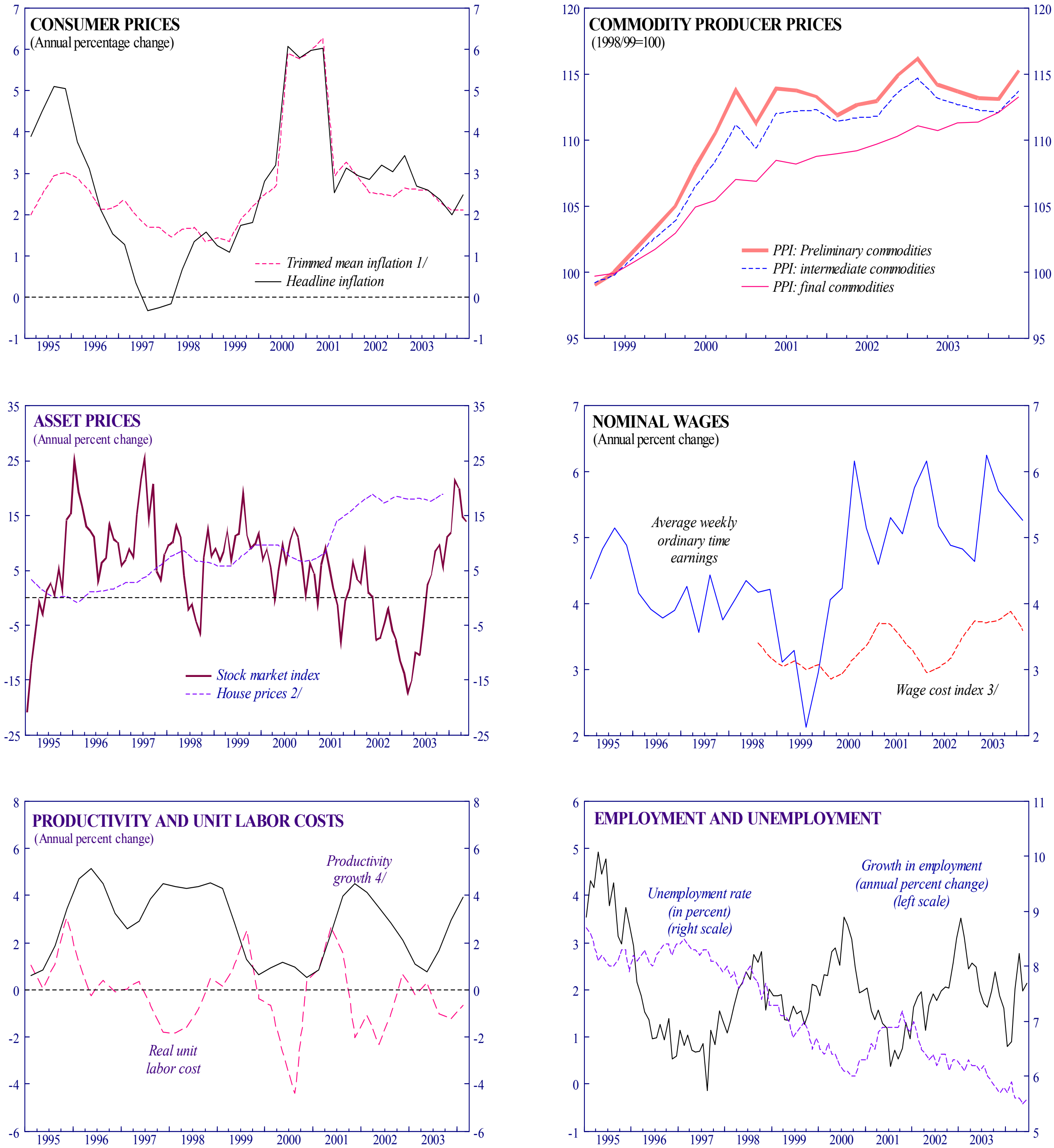
Sources: Data provided by the Australian authorities; IMF; IFS; WEO; and OECD.
1/ Gross fixed capital formation.
2/ Fiscal year.

Figure 2. Australia: Selected Real Economic Indicators, 1995–2004



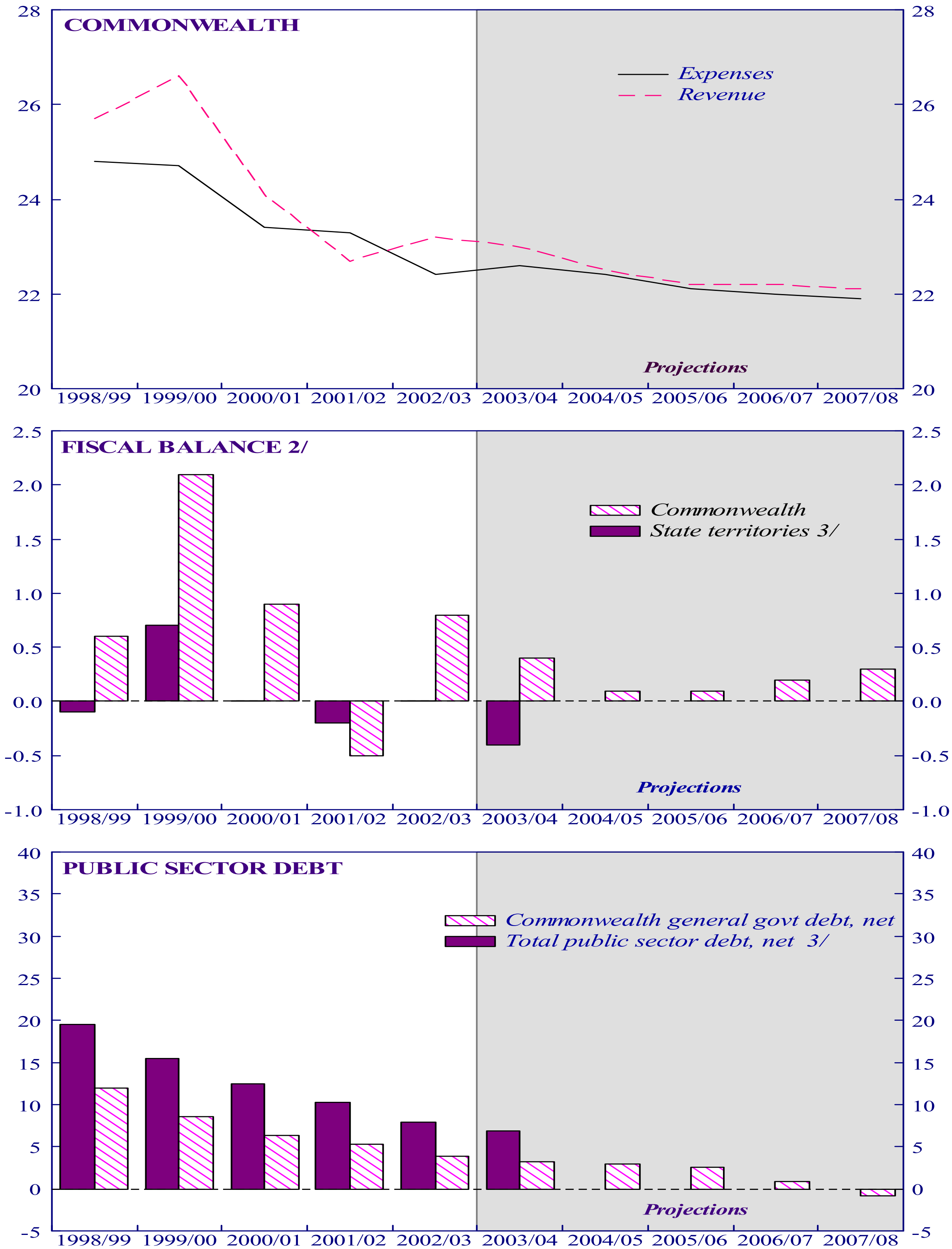
Source: Data provided by the Australian authorities.
1/ Contribution to GDP growth.
2/ Net household saving as a percent of household disposable income.
3/ Adjusted for sale of second-hand assets between sectors.

Figure 3. Australia: Inflation and Labor Market Indicators, 1995–2004



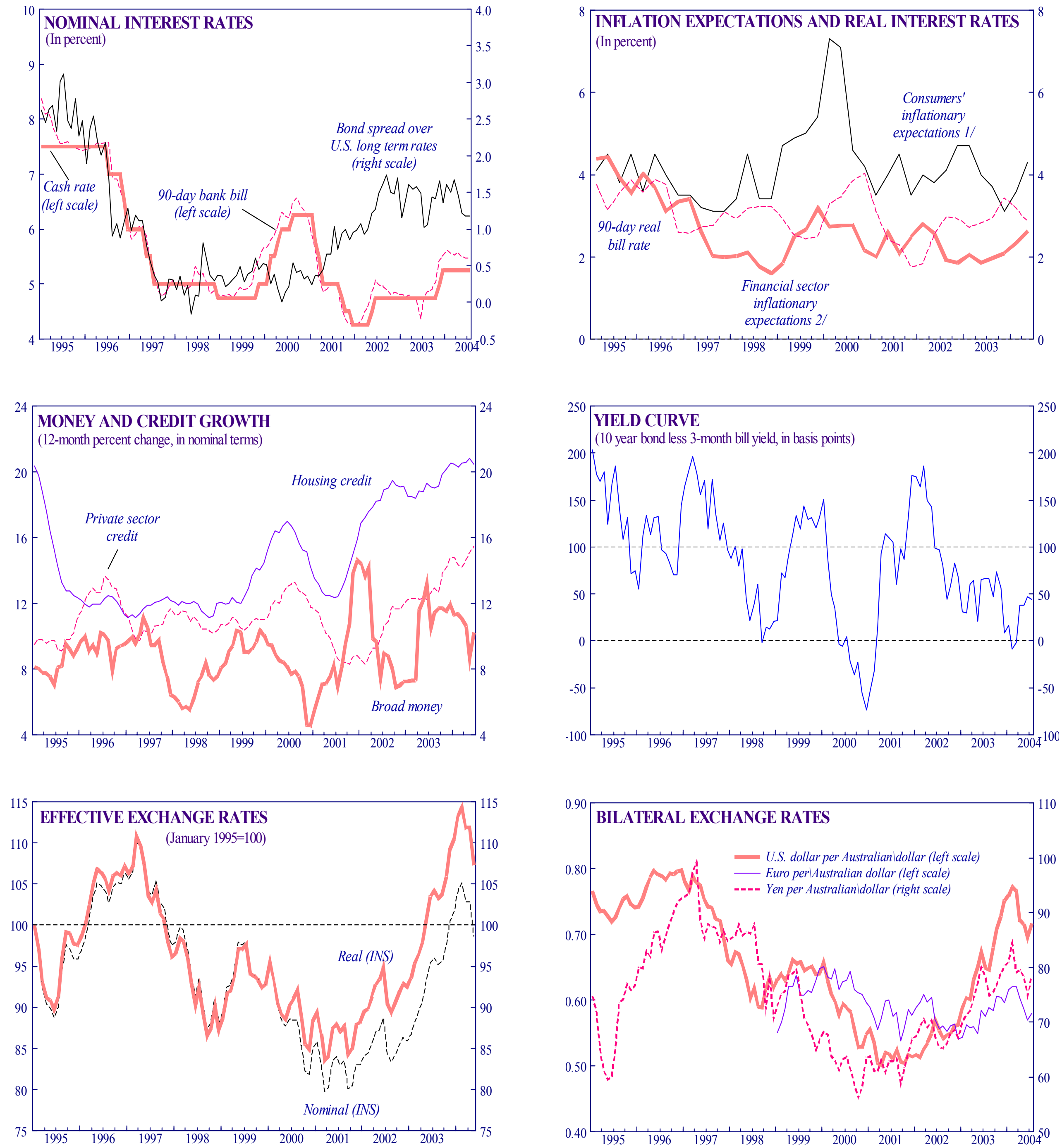
Sources: Australian Bureau of Statistics; and Fund staff estimates.
1/ The “trimmed mean” is calculated as the weighted mean of the central 70 percent of the quarterly price change distribution of all CPI components, with the annual rates based on quarterly calculations. The jump in 2000 CPI reflects the introduction of the Goods and Services Tax .
2/ Weighted average of 8 capital cities, established houses.
3/ The Wage Cost Index is only available from September 1997.
4/ Output per hour worked, nonfarm market sector.

Figure 4. Australia: Fiscal Indicators, 1998/99–2007/08 1/
(In percent of GDP)



Source: Australian budget for 2004/05.
1/ Revenue, expenses, and fiscal balance are on accrual basis.
2/ Fiscal balance is equal to revenue less expenses less net capital expenses.
3/ Data only available to 2003/04.

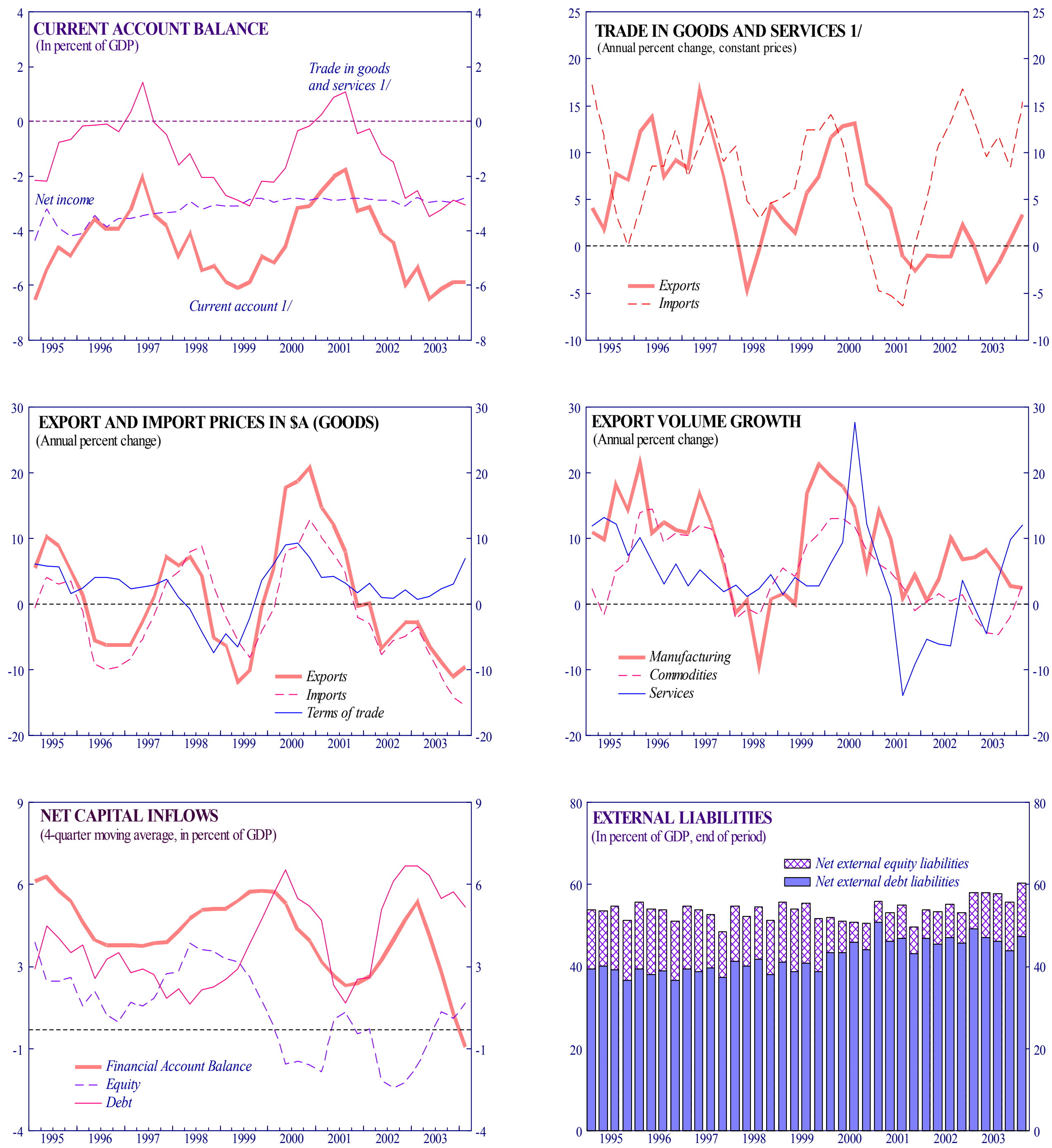
Figure 5. Australia: Selected Monetary Indicators, 1995–2004



Sources: Australian Bureau of Statistics; Reserve Bank of Australia; and Fund staff estimates.

1/ Melbourne Institute Survey, expectation of inflation over next year (median response).
2/ Calculated as the spread between long-term non-indexed and indexed government bonds.

Figure 6. Australia: Balance of Payments and External Liabilities, 1995–2004



Sources: Australian Bureau of Statistics; and Reserve Bank of Australia.

1/ June 1997 exports includes the sale of gold by the Reserve Bank equivalent to 1.5 percent of 1997QII GDP.

Table 1. Australia: Selected Economic and Financial Indicators, 1999-2005

Nominal GDP (2003): $A757 billion (US$514 billion)
Population (2003): 19.94 million
GDP per capita (2003): US$ 25,777
Quota (in millions): SDR 3,236

						Proj.	
	1999	2000	2001	2002	2003	2004	2005
Output and demand (percent change)							
Real GDP	4.3	3.2	2.5	3.8	3.0	3.7	3.3
Total domestic demand	5.6	2.2	1.3	6.5	6.2	4.0	2.1
Private consumption	4.9	3.1	2.8	4.2	4.3	3.9	2.0
Fixed investment	7.0	1.5	-1.1	15.5	9.6	2.8	0.1
Exports of goods and services	4.5	11.2	1.6	0.3	-2.3	5.5	7.5
Imports of goods and services	9.1	7.8	-4.2	11.5	11.3	8.7	-0.2
Inflation and unemployment (in percent)							
CPI inflation	1.5	4.5	4.4	3.0	2.8	2.8	2.5
Unemployment rate	6.9	6.3	6.8	6.4	6.1	5.7	5.9
Saving and investment (in percent of GDP)							
Gross national saving	18.7	19.6	19.5	18.7	18.9	19.1	18.9
General government saving	4.7	2.9	2.7	2.9	3.1	2.6	2.6
Private saving 1/	14.0	16.8	16.8	15.9	15.9	16.5	16.3
Gross capital formation	24.7	23.1	20.7	23.1	24.8	24.4	23.7
Fiscal Indicators (in percent of GDP) 2/							
Commonwealth budget							
Revenue	24.7	26.5	24.0 3/	22.8	23.4	22.8	22.6
Underlying expenditure 4/	24.0	24.4	23.1 3/	22.9	22.4	22.3	22.3
Underlying cash balance 4/	0.7	2.1	0.9	-0.1	1.0	0.6	0.3
Fiscal balance (accrual basis)	0.6	2.1	0.9	-0.5	0.8	0.4	0.1
Money and credit (end of period)							
M1 (percent change)	9.7	9.4	21.3	-9.3	8.7	4.3	0.0 5/
M3 (percent change)	9.4	4.9	14.6	10.3	13.7	10.3	11.8 5/
Private domestic credit (percent change)	11.0	11.8	8.8	11.9	14.7	15.1	15.5 5/
Interest rate (90-day bill, in percent)	5.7	6.2	4.2	4.8	5.5	5.5	5.4 6/
Government bond yield (10-year, in percent)	7.0	5.5	6.0	5.5	5.6	5.8	5.6 6/
Balance of payments (in percent of GDP)							
Current account	-5.7	-4.0	-2.4	-4.4	-6.0	-5.3	-4.8
of which: Trade balance	-2.5	-1.2	0.5	-1.3	-2.9	-2.5	-2.1
Terms of trade (percent change)	-0.9	5.4	1.4	2.3	4.0	7.0	-2.9
External assets and liabilities (in percent of GDP)							
Net external liabilities	55.1	53.8	53.5	56.7	59.5	60.9	63.1
Gross short-term external debt	33.2	40.1	39.8	40.7	36.8	...	...
Net short-term external debt	17.3	22.5	23.7	22.8	17.6	...	...
Gross official reserves	5.5	5.2	5.3	5.2	4.6	4.0	3.8
Exchange rate (end of period)							
US$/$A	0.654	0.554	0.509	0.566	0.750	0.717	0.723 6/
Trade-weighted index	56.4	51.7	50.2	52.0	62.9	60.2	61.7 6/
Nominal effective exchange rate 7/	100.3	92.0	89.8	92.9	110.1	111.4	106.9 5/
Real effective exchange rate 7/	83.3	79.3	79.2	83.1	99.2	100.5	96.3 5/

Sources: Data provided by the Australian authorities; and Fund staff estimates and projections.

1/ Includes public trading enterprises.
2/ Fiscal year ending June 30.
3/ The sharp drop in 2001 reflects tax reform, including income tax cuts, the removal of the Wholesale Sales Tax, and the reduction in grants to States.
4/ Underlying expenditure and balance exclude asset sales and other one-off factors; cash basis.
5/ May 2004.
6/ July 2004.
7/ IMF, Information Notice System index (1990 = 100).

Table 2. Australia: Selected Fiscal Indicators, 1998/99-2007/08 1/
(In percent of GDP)

						Estim.	Projections 2/			
	1998/99	1999/00	2000/01	2001/02	2002/03	2003/04	2004/05	2005/06	2006/07	2007/08
Fiscal accounts (accrual basis) 3/										
Commonwealth government										
Revenue	25.7	26.6	24.1 4/	22.7	23.2	23.0	22.5	22.2	22.2	22.1
Tax	…	24.4	22.5	21.0	21.6	21.5	21.3	21.0	21.0	20.9
Income tax	…	18.8	18.1	16.6	17.4	17.5	17.5	17.4	17.5	17.6
Individuals and other witholding	…	13.6	11.7	12.1	12.1	12.0	12.0	11.9	12.0	12.1
Indirect and other tax	…	5.6	4.4	4.4	4.2	3.9	3.8	3.6	3.5	3.3
Non-tax	…	2.2	1.5	1.8	1.6	1.5	1.2	1.2	1.2	1.2
Expenses	24.8	24.7	23.4 4/	23.3	22.4	22.6	22.4	22.1	22.0	21.9
Salaries and wages	…	…	1.4	1.4	1.4	1.5	1.4	1.4	1.3	1.3
Payments for supply of goods and services	…	…	4.9	4.8	4.9	4.9	5.0	4.9	4.8	4.8
Current transfers	…	16.0	14.4	14.2	13.7	13.8	13.7	13.7	13.7	13.7
Other expenses	…	…	2.7	2.9	2.4	2.4	2.3	2.2	2.1	2.1
Net capital investment	0.2	-0.2	-0.2	-0.1	0.0	0.0	0.0	0.0	0.0	0.0
Fiscal Balance 5/	0.6	2.1	0.9	-0.5	0.8	0.4	0.1	0.1	0.2	0.3
State, Territory, and local government balance	0.3	0.3	-0.1	0.0	0.4	0.1	-0.1	…	…	…
Public Non-financial corporations balance	-0.5	0.5	0.1	-0.1	-0.1	-0.2	…	…	…	…
Non-Financial Public sector balance 6/	0.5	3.0	0.8	-0.5	1.2	0.4	…	…	…	…
Fiscal Accounts (cash basis) 7/										
Commonwealth government										
Revenue	24.7	26.5	24.0 4/	22.8	23.4	22.8	22.6	22.3	22.1	22.1
Underlying expenditure	24.0	24.4	23.1 4/	22.9	22.4	22.3	22.3	22.1	21.8	21.6
Underlying cash balance 8/	0.7	2.1	0.9	-0.1	1.0	0.6	0.3	0.2	0.4	0.4
Memorandum items:										
Commonwealth government net debt 9/ 10/	11.9	8.6	6.4	5.3	3.9	3.2	2.9	2.5	0.8	-0.8
Commonwealth government net worth 9/	-12.9	-6.2	-6.2	-6.7	-6.8	-5.4	-5.0	-4.7	-4.0	-3.7

Sources: Commonwealth of Australia: *Budget Strategy and Outlook, 2004/05.*

1/ Fiscal year ends June 30.
2/ Projections as presented in the *Budget Strategy and Outlook* , *2004/05* .
3/ Accrual data are reported on a consistent basis with Government Financial Statistics (GFS). GST related transactions are excluded since the Commonwealth government conducts them on behalf of states and territories.
4/ The drop in 2000/01 reflects tax reform, including income tax cuts, the removal of the Wholesale Sales Tax, and the reduction in grants to States.
5/ The fiscal balance is equal to revenue less expenses less net capital investment and measures the government's net lending.
6/ The Commonwealth, state, and public enterprise balances may not add up to the public sector balance due to the effect of consolidation.
7/ Due to a break in the series following the introduction of the new accrual accounting standards, cash receipts and payments data from 1999/00 are not directly comparable with earlier years.
8/ The cash equivalent of the fiscal balance.
9/ Staff estimate; adjusted to exclude the above-normal dividend from the RBA in 1999/2000.
10/ Assumes the sale of the government's remaining shareholding in Telstra.

Table 3. Australia: Balance of Payments, 1998-2004
(In percent of GDP)

	1998	1999	2000	2001	2002	2003	2004 Proj
Current account balance	-4.9	-5.7	-4.0	-2.4	-4.4	-6.0	-5.3
Trade balance	-1.4	-2.5	-1.2	0.5	-1.3	-2.9	-2.5
Exports	15.4	14.3	17.0	17.8	16.3	14.0	13.9
Imports	-16.9	-16.8	-18.2	-17.3	-17.6	-16.9	-16.4
Net services	-0.3	-0.2	0.1	-0.1	-0.2	-0.1	0.3
Total credits	4.5	4.4	4.9	4.6	4.3	4.1	4.5
Total debits	-4.8	-4.7	-4.8	-4.7	-4.5	-4.2	-4.2
Net income	-3.1	-2.9	-2.8	-2.8	-2.9	-2.8	-3.1
Receipts	1.8	1.9	2.4	2.2	2.0	1.9	1.9
Payments	-4.9	-4.8	-5.3	-5.1	-5.0	-4.8	-4.9
Net transfers	-0.1	0.0	0.0	0.0	0.0	0.0	0.0
Capital and financial account	5.0	5.7	3.6	2.0	4.6	6.0	…
Capital account	0.2	0.2	0.2	0.2	0.1	0.2	…
Financial account	4.8	5.5	3.5	1.9	4.4	5.9	…
Direct investment transactions: net	0.7	0.9	3.3	-2.0	1.8	-1.3	…
Equity (net)	0.5	0.0	1.3	-0.7	0.0	-1.1	…
Debt (net)	0.2	0.9	2.0	-1.2	1.8	-0.2	…
Portfolio investment transactions: net	0.8	3.1	0.7	2.8	0.8	7.5	…
Equity (net)	2.3	0.9	-2.8	0.8	-2.5	1.1	…
Debt (net)	-1.5	2.2	3.6	2.0	3.3	6.4	…
Financial derivatives (net)	-0.3	0.4	-0.2	0.1	0.1	0.0	…
Other transactions (net)	3.5	1.1	-0.3	0.9	1.8	-0.7	…
Net errors and omissions	0.0	0.0	0.3	0.4	-0.1	-0.1	…
	(Assets and liabilities at end-period)						
Net external liabilities	55.1	55.1	53.8	53.5	56.7	59.5	…
Net external equity liabilities	14.3	13.9	6.9	6.9	8.0	12.8	…
Foreign equity investment in Australia	46.7	52.2	48.7	52.4	47.9	51.2	…
Australian equity investment abroad	-32.4	-37.3	-40.5	-44.0	-39.0	-38.4	…
Net external debt	40.8	41.2	46.8	46.6	48.6	47.4	…
Net public sector	7.4	3.0	2.3	1.6	2.2	1.1	…
Net private sector	33.4	38.3	44.5	44.9	46.4	46.3	…
Gross external debt	62.9	65.0	72.9	73.4	76.4	77.0	…
of which: $A denominated	23.5	23.9	26.5	24.9	27.4	26.6	…
Gross external lending	-22.1	-23.7	-26.1	-26.8	-27.8	-29.6	…
Short-term net external debt (residual maturity basis)	17.4	17.3	22.5	23.7	22.8	17.6	…
Short-term gross external debt	30.6	33.2	40.1	39.8	40.7	36.8	…
Short-term gross external lending	-13.2	-15.9	-17.6	-16.1	-17.9	-19.2	…
Memorandum items:							
Gross official reserves (in $A billion)	25.0	33.6	34.0	36.7	36.4	32.6	…
RBA outstanding forward contracts (in $A billion)	10.1	22.6	24.9	29.5	25.8	25.8	…
Net official reserves (in $A billion)	14.9	10.9	9.1	7.2	10.5	6.8	…
Gross official reserves in months of imports	2.3	2.7	2.7	2.7	2.7	2.3	…
Gross official reserves to ST foreign currency denominated debt (percent)	19.5	23.1	18.9	19.4	19.6	16.3	…
Net official reserves to ST foreign currency denominated debt (percent)	11.6	7.5	5.1	3.8	3.7	1.6	…

Source: Data provided by the Australian authorities; and Fund staff estimates and projections.

Table 4. Australia: Medium-Term Scenario 2004-09

	1993-2002 Average	2000	2001	2002	2003	Projections 2004	2005	2006	2007	2008	2009
Real economic indicators (percent change)											
GDP	3.9	3.2	2.5	3.8	3.0	3.7	3.3	3.7	3.7	3.8	3.8
Total domestic demand	4.2	2.2	1.3	6.5	6.2	4.0	2.1	2.9	2.9	3.5	3.4
Private consumption	3.7	3.1	2.8	4.2	4.3	3.9	2.0	3.3	3.1	3.1	3.1
Total investment	6.8	1.5	-1.1	15.5	9.6	2.8	0.1	3.3	3.2	4.6	4.7
CPI inflation	2.5	4.5	4.4	3.0	2.8	2.8	2.5	2.5	2.5	2.5	2.6
Unemployment rate	7.9	6.3	6.8	6.4	6.1	5.7	5.9	5.8	5.6	5.5	5.5
Saving and investment (percent of GDP)											
Gross national saving	18.6	19.6	19.5	18.7	18.9	19.1	18.9	18.2	18.1	18.3	18.4
General government saving	1.4	2.9	2.7	2.9	3.1	2.6	2.6	2.8	2.8	2.8	3.9
Private saving 1/	17.2	16.8	16.8	15.9	15.9	16.5	16.3	15.5	15.3	15.4	14.6
Gross capital formation	22.8	23.1	20.7	23.1	24.8	24.4	23.7	22.9	22.6	22.6	22.4
Fiscal indicators (percent of GDP) 2/											
Commonwealth Budget											
Revenue	23.9	26.5	24.0	22.8	23.4	22.8	22.6	22.3	22.1	22.1	22.1
Underlying expenditure	24.9	24.4	23.1	22.9	22.4	22.3	22.3	22.1	21.8	21.6	21.6
Underlying balance (cash basis)	-1.3	2.1	0.9	-0.1	1.0	0.6	0.3	0.2	0.4	0.4	0.4
Fiscal balance (accrual basis)	…	2.1	0.9	-0.5	0.8	0.4	0.1	0.1	0.2	0.3	0.3
Public sector net debt 3/	13.1	8.6	6.4	5.3	3.9	3.2	2.9	0.8	-0.8	-2.8	-3.0
Balance of payments (percent of GDP)											
Balance on goods and services	-1.0	-1.1	0.4	-1.5	-3.0	-2.3	-1.5	-1.4	-1.1	-0.9	-0.6
Balance on income and transfers	-3.2	-2.9	-2.8	-3.0	-2.9	-3.1	-3.3	-3.3	-3.4	-3.4	-3.4
Current account balance	-4.2	-4.0	-2.4	-4.4	-6.0	-5.3	-4.8	-4.7	-4.5	-4.3	-4.0
Trade in goods and services (percent change)											
Export volume	6.0	11.0	1.3	-0.2	-1.2	6.1	7.5	9.6	9.1	7.3	7.3
Import volume	7.4	7.4	-4.1	11.4	10.7	8.4	-0.2	5.2	5.4	6.1	5.8
Terms of trade	0.9	5.4	1.4	2.3	4.0	7.0	-2.9	-3.6	-1.4	-0.8	-0.1
Export price	1.5	13.0	8.4	-3.4	-6.4	0.2	1.6	-2.4	-0.6	0.1	0.5
Import price	0.7	6.8	5.9	-4.4	-6.9	-3.2	4.6	1.2	0.8	0.8	0.6
External liabilities (percent of GDP)											
Net external liabilities	54.6	53.8	53.5	56.7	59.5	60.9	63.1	64.8	65.9	66.5	66.4

Sources: Data provided by the Australian authorities; and staff estimates and projections.

1/ Includes public trading enterprises.
2/ Fiscal year basis ending June 30.
3/ Assuming the sale of the government's remaining shareholding in Telstra.

Table 5. Australia: External Debt Sustainability Framework, 1999-2009
(In percent of GDP, unless otherwise indicated)

	1999	2000	2001 (Actual)	2002	2003	10-Year Historical Average	10-Year Standard Deviation	2004	2005	2006	2007 (Projections)	2008	2009	
										I. Baseline Projections				Debt-stabilizing non-interest current account 7/
External debt	64.9	72.8	73.4	76.3	76.4			**76.7**	**79.5**	**81.5**	**83.0**	**79.7**	**79.8**	**-3.1**
Change in external debt	2.1	7.9	0.5	2.9	0.1			0.3	2.8	2.1	1.5	-3.3	0.2	
Identified external debt-creating flows (4+8+9)	-1.7	2.3	1.9	-2.3	-6.5			1.6	0.9	0.5	0.3	-0.1	-0.3	
Current account deficit, excluding interest payments	3.2	1.1	-0.3	2.0	3.8			2.9	1.7	1.5	1.1	0.8	0.7	
Deficit in balance of goods and services	2.7	1.1	-0.4	1.5	3.0			2.3	1.5	1.4	1.0	0.9	0.6	
Exports	18.8	21.8	22.4	20.5	18.0			18.2	19.0	19.4	19.9	20.2	20.5	
Imports	21.5	23.0	22.0	22.0	21.0			20.5	20.5	20.8	20.9	21.1	21.1	
Net non-debt creating capital inflows (negative)	-3.5	-1.3	-1.6	-0.3	-0.7			-1.2	-1.3	-1.3	-1.4	-1.4	-1.4	
Automatic debt dynamics 1/	-1.4	2.4	3.7	-4.0	-9.6			0.0	0.5	0.3	0.6	0.5	0.4	
Contribution from nominal interest rate	2.5	2.9	2.7	2.5	2.1			2.4	3.0	3.2	3.4	3.4	3.3	
Contribution from real GDP growth	-2.5	-2.1	-2.0	-2.5	-1.8			-2.4	-2.5	-2.8	-2.8	-3.0	-2.9	
Contribution from price and exchange rate changes 2/	-1.4	1.6	3.0	-4.0	-10.0			...	...	...	...	...	...	
Residual, incl. change in gross foreign assets (2-3) 3/	3.7	5.6	-1.4	5.2	6.6			-1.4	1.9	1.6	1.2	-3.3	0.5	
External debt-to-exports ratio (in percent)	346.1	333.5	327.8	371.5	424.7			420.5	417.7	421.0	417.3	393.8	389.9	
Gross external financing need (in billions of US dollars) 4/	142.8	160.0	165.1	171.4	217.6			268.2	305.8	319.4	341.1	362.2	368.4	
in percent of GDP	36.6	42.3	46.1	42.8	42.6			44.4	50.3	50.2	51.0	51.1	48.7	
Key Macroeconomic Assumptions						10-Year Historical Average	10-Year Standard Deviation							Projected Average
Real GDP growth (in percent)	4.3	3.2	2.5	3.8	3.0	3.9	0.8	3.7	3.3	3.7	3.7	3.8	3.8	3.7
GDP deflator in US dollars (change in percent)	3.2	-6.2	-7.6	7.5	23.3	2.1	10.7	13.9	-2.6	1.0	1.4	2.0	2.7	3.1
Nominal external interest rate (in percent)	4.3	4.3	3.5	3.7	3.5	4.4	0.9	3.8	4.0	4.2	4.4	4.4	4.4	4.2
Growth of exports (US dollar terms, in percent)	1.5	12.8	-3.0	2.6	11.9	5.7	8.9	19.7	5.0	6.6	8.0	7.7	7.9	9.2
Growth of imports (US dollar terms, in percent)	7.0	3.5	-9.6	12.1	21.9	7.1	9.6	15.2	0.7	6.1	6.0	6.9	6.4	6.9
Current account balance, excluding interest payments	-3.2	-1.1	0.3	-2.0	-3.8	-1.9	1.3	-2.9	-1.7	-1.5	-1.1	-0.8	-0.7	-1.4
Net non-debt creating capital inflows	3.5	1.3	1.6	0.3	0.7	1.9	1.2	1.2	1.3	1.3	1.4	1.4	1.4	1.3
										II. Stress Tests for External Debt Ratio				Debt-stabilizing non-interest current account 7/
A. Alternative Scenarios														
A1. Key variables are at their historical averages in 2005-09 5/								**76.7**	**75.4**	**76.4**	**77.5**	**74.8**	**76.0**	**-3.1**
A2. Country-specific shock in 2005, with reduction in GDP growth (relative to baseline) of one standard deviation 6/								**76.7**	**80.0**	**82.0**	**83.5**	**80.2**	**80.4**	**-3.1**
B. Bound Tests														
B1. Nominal interest rate is at historical average plus two standard deviations in 2005 and 2006								**76.7**	**81.1**	**84.6**	**86.1**	**82.7**	**82.8**	**-3.1**
B2. Real GDP growth is at historical average minus two standard deviations in 2005 and 2006								**76.7**	**80.3**	**83.6**	**85.2**	**81.7**	**81.9**	**-3.1**
B3. Change in US dollar GDP deflator is at historical average minus two standard deviations in 2005 and 2006								**76.7**	**89.3**	**105.4**	**107.3**	**102.0**	**102.4**	**-4.2**
B4. Non-interest current account is at historical average minus two standard deviations in 2005 and 2006								**76.7**	**82.2**	**87.2**	**88.6**	**85.2**	**85.2**	**-3.2**
B5. Combination of 2-5 using one standard deviation shocks								**76.7**	**87.3**	**102.0**	**103.8**	**99.7**	**99.8**	**-3.7**
B6. One time 30 percent nominal depreciation in 2005								**76.7**	**97.3**	**99.7**	**101.4**	**96.7**	**97.0**	**-3.9**

1/ Derived as [r - g - ρ(1+g) + εα(1+r)]/(1+g+ρ+gρ) times previous period debt stock, with r = nominal effective interest rate on external debt; ρ = change in domestic GDP deflator in US dollar terms, g = real GDP growth rate,
e = nominal appreciation (increase in dollar value of domestic currency), and a = share of domestic-currency denominated debt in total external debt.
2/ The contribution from price and exchange rate changes is defined as [-ρ(1+g) + εα(1+r)]/(1+g+ρ+gρ) times previous period debt stock. ρ increases with an appreciating domestic currency (ε > 0) and rising inflation (based on GDP deflator).
3/ For projection, line includes the impact of price and exchange rate changes.
4/ Defined as current account deficit, plus amortization on medium- and long-term debt, plus short-term debt at end of previous period.
5/ The key variables include real GDP growth; nominal interest rate; dollar deflator growth; and both non-interest current account and non-debt inflows in percent of GDP.
6/ The implied change in other key variables under this scenario is discussed in the text.
7/ Long-run, constant balance that stabilizes the debt ratio assuming that key variables (real GDP growth, nominal interest rate, dollar deflator growth, and both non-interest current account and non-debt inflows in percent of GDP) remain at their levels of the last projection year.

AUSTRALIA—ECONOMIC VULNERABILITY ASSESSMENT

1. **Australia's vulnerability assessment remains broadly unchanged from the last assessment, and the economy remains well placed to manage adverse external shocks**.[16] While net foreign liabilities remain high, external debt has become more concentrated in private financial corporations with its maturity has shortened, reflecting increased intermediation of flows by banks. The foreign currency component of external debt has risen, although the associated currency risk is mitigated through substantial hedging. Corporate and banking sector balance sheets remain strong, and they have proven to be resilient to large swings in exchange and interest rates in the recent past. Although household balance sheets have expanded in recent years, net worth is comparatively high, and households have proved resilient to past interest rate swings. Housing remains the biggest household asset, and housing debt, which has risen rapidly in the last few years, is the major household liability and a major asset of the banking system. With higher indebtedness and given a rapid rise in housing prices over the past few years, households could be at risk to a major price correction (especially in the investor housing segment of the market), and there could be spillover effects on the banking system.

A. External Position

2. **Net external liabilities have increased from 55 percent of GDP to 60 percent of GDP over the last five years** (Table 1). During this period, the composition of liabilities shifted more toward debt, and financial corporations accounted for a growing proportion of both gross external debt and claims. The private sector now accounts for 88 percent of total external debt, of which financial corporations are the biggest component. Public sector debt declined significantly in recent years, and the ratio of net interest payments to exports has declined steadily, reflecting the relatively lower interest rate environment.

Australia: External Debt Statistics
(In percent of GDP)

	End-December					
	1998	1999	2000	2001	2002	2003
Gross external debt	62.8	64.1	72.3	72.9	77.1	77.1
Public sector	14.7	11.4	10.4	9.8	9.8	8.8
Private sector	48.1	52.7	61.9	63.1	67.4	68.3
of which: Private financial corporations	35.2	40.7	46.6	49.3	52.8	55.1
Australian dollar-denominated	23.4	23.8	26.6	25.0	26.7	26.7
Foreign currency-denominated	39.4	40.3	45.7	47.9	50.4	50.5
Short term	30.6	33.2	40.0	39.8	40.8	36.9
Australian dollar-denominated	8.4	9.1	12.5	12.6	12.8	10.7
Foreign currency-denominated	22.2	24.1	27.6	27.3	28.0	26.2

Sources: Australian Bureau of Statistics and RBA.

3. **Through 2002, the maturity profile of the external debt shortened, and there was an increase in the foreign currency component, but these trends reversed somewhat in 2003.** The medium-term rise in the share of the financial sector's external debt has led to a shortening in the maturity profile of Australia's external debt, as

[16] This annex updates the vulnerability assessment provided in Australia: 2003 Article IV Consultation, *IMF Staff Country Report* No. 03/337, 2003. That assessment concluded that there were no major vulnerability concerns.

the financial sector raises most of its funds at shorter maturities than the government and corporate sectors. At the same time, the share of gross debt denominated in foreign currency has remained broadly flat at under 65 percent in recent years. Australia's foreign currency exposure is mitigated by a high degree of hedging. A 2001 survey by the Australian Bureau of Statistics (ABS), showed that foreign currency assets of Australian entities exceeded foreign currency liabilities at end-June 2001.[17] Private corporations appeared to have relatively minimal direct exposure to exchange risk; a significant portion of their overseas borrowing was hedged naturally. Banks, in contrast, made substantial use of derivatives to hedge their foreign currency exposure. The market for these instruments appears to be reasonably deep and has proven to be resilient given the large swings in the value of the Australian dollar over the past several years.

Australia: Total Foreign Currency Exposure 1/
(In billions of Australian dollars, as of June 30, 2001)

	Net position on foreign currency debt	Foreign equity assets	Net position on foreign currency derivatives	Foreign currency exposure
Banks	-117	31	109	23
Other financial corporations	-28	84	8	64
Official sector				
RBA	36	0	-29	7
General government	1	0	-9	-7
CBA	-8	0	9	1
Other corporations	-50	114	-3	61
Total economy	-165	228	85	149

1/ Negative indicates a short foreign currency position.
Source: Australian Bureau of Statistics.

B. Sectoral Balance Sheets

Corporate Sector

4. **Financial indicators suggest that the nonfinancial corporate sector in Australia remains sound**. The debt-to-equity ratio in the non-financial corporate sector has been gradually increasing in the last few years to over 80 percent in end-June 2003. While this increase raises some concerns, it is noteworthy that the ratio is about half its level in the early 1990s. Moreover, debt as a share of GDP has been reduced significantly during 2002-03. Operating margins have improved and the interest cover ratio indicates a good position. The return on permanent capital has declined in recent years primarily due to debt-funded acquisitions or investments.

Australia: Non-Financial Corporate Financial Indicators
(In percent)

	1998	1999	2000	2001	2002	2003
Balance sheet indicators (end-June)						
Debt-equity ratio	70.6	66.2	66.1	72.3	76.7	80.5
Debt (in percent of GDP)	73.3	76.8	79.6	82.2	76.8	76.2
Profitability indicators 1/						
Operating income/sales	25.3	26.0	26.0	24.6	25.1	26.4
Return on permanent capital	10.3	10.0	10.8	9.1	9.0	9.4
EBITDA interest cover (times)	5.1	5.3	5.7	4.8	5.0	4.9

Sources: Australian Bureau of Statistics, S&P's Australia and New Zealand CreditStats, June 2003, and Fund staff estimates.

1/ Survey median ratios based on Standard and Poor's survey of Australian and New Zealand companies. Australian companies comprise around 85 percent of the survey.

[17] The survey captures around 90 percent of total foreign currency assets and liabilities.

Households

5. **Household balance sheets have continued to expand in recent years.** During 1996-2003, household assets increased substantially with land and dwellings values accounting for 70 percent of the increase the ratio. In contrast, financial assets remain below peak levels reached in 2000-2001, as shares and pension funds have lost value. Since the mid-1990s, household liabilities have also surged with debt for housing accounting for 84 percent of the increase. Overall, household net worth increased by 75 percent of gross disposable income, with the corresponding net wealth elasticity on annual private consumption estimated to be between 3-5 percent.[18] Interest payments on mortgages have also increased to 7¼ percent of disposable income. Households' easier access to credit and the relatively lower interest rate environment have driven Australia's total household debt from a low level by international standards to levels comparable to those in the United Kingdom, and slightly higher than in the United States, although the overall gearing ratio (ratio of liabilities to assets) is still relatively low.[19]

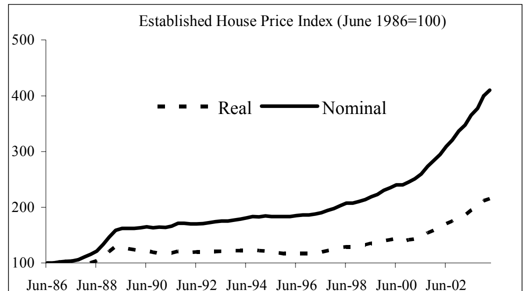
Australia: Household Balance Sheet
(As a percentage of gross disposable income)

	End-June 1998	1999	2000	2001	2002	2003
Net worth	465	482	492	496	503	516
Total assets	567	587	606	609	629	658
Non-financial assets	321	327	337	340	363	394
Dwellings and land	281	288	298	303	327	358
Financial assets	245	260	269	269	266	264
Deposits	57	57	56	56	59	64
Shares	41	50	49	57	54	46
Pension funds	100	107	119	115	111	110
Other	47	46	45	42	43	44
Total liabilities	101	104	114	113	126	142
Housing debt	63	67	74	76	86	100
Interest payments	6.1	6.1	6.9	6.9	6.5	7.3
Dwellings	4.1	4.2	4.7	4.8	4.7	5.5
Household net savings	2.2	2.2	1.5	3.1	1.2	-2.3

Source: Reserve Bank of Australia.

6. **Housing prices have risen significantly since the mid-1990s** (see Box 1). In real terms, the house price index (weighted average for the 8 capital cities) increased by 16¼ percent in 2003 alone—the highest annual increase since 1989. House price increases in some cities, such as Adelaide, Brisbane, and Canberra, have been even higher. Historically, housing prices have not been subject to major downward corrections after periods of very rapid increases. However, unlike the past, the current surge is being driven to an important extent by demand for investment housing, which tends to be concentrated in the central business districts of the major cities and may be more at risk of a price correction. Spillover effects to other segments of the housing market from such a correction could significantly weaken household balance sheets.

Established House Price Index (June 1986=100)



Source: Australian Bureau of Statistics

[18] See IMF, "Housing, Consumption, and Output," Chapter II in *Australia—Selected Issues*, Country Report No. 03/336, October 2003.

[19] "Household Debt: What the Data Show", Reserve Bank of Australia *Bulletin*, March 2003.

Banks

7. **Australia's banking sector performance remains very strong**. With a robust domestic economy, Australian banks remained solidly profitable in 2003; return on assets for the four major banks was over 1 percent and return on equity was 16½ percent.[20] The banking system is also well capitalized, maintaining total capital of around 10 percent and tier-one capital of 7½ percent of risk-weighted assets. The overall asset quality of the banking system remains very high, with the ratio of impaired assets to total assets only about 0.4 percent, and provisions have increased to almost 140 percent of impaired assets. The strength of the Australian banks is reflected in their ratings by independent credit rating agencies—all of the four major banks have a credit rating of AA- or better. However, housing loans comprise about half of total bank loans. Notwithstanding the very low delinquency rates faced by banks on housing loans (less than one percent), a major correction to housing prices could have some spillover effects into the banking system.

Australia: Banks' Balance Sheet Indicators
(Share of total assets)

	End-December					
	1998	1999	2000	2001	2002	2003
Loans	69.3	71.0	69.5	69.7	69.6	67.0
Loans to persons	39.0	39.3	41.2	42.2	41.4	42.0
Housing loans	32.6	32.8	35.2	36.3	35.1	35.8
Commercial loans	26.0	26.7	25.1	24.6	25.6	23.4
Profitability measures 1/						
Net interest margin 2/	2.9	2.7	2.5	2.3	2.2	2.2
Return on average assets	1.0	1.2	1.3	1.0	1.2	1.1
Return on average equity	15.0	18.0	19.4	15.6	18.2	16.4
Capital adequacy ratios 3/						
Tier 1 capital	7.6	7.8	7.1	7.7	7.8	7.6
Total capital	10.3	10.1	9.8	10.5	9.9	10.1
Impaired assets	0.7	0.6	0.5	0.7	0.6	0.4
General and specific provisions 4/	114.7	120.2	132.1	107.1	109.8	138.3
Net foreign currency liabilities	8.0	9.6	11.9	11.7	10.5	9.5

Sources: Australian Prudential Regulation Authority and Bankscope database.
1/ Simple average for the four major banks (National Bank, Commonwealth Bank, Westpac, and Australia and New Zealand bank).
2/ Ratio to average interest earning assets.
3/ Percent of of risk-weighted assets.
4/ Percent of impaired assets.

[20] The four major banks accounted for around 80 percent of banking system loans.

Table 1. Australia: External Debt and Reserve Indicators
(In percent of GDP)

	End-December					
	1998	1999	2000	2001	2002	2003
Net external liabilities	55.0	55.3	54.3	54.7	58.0	60.1
Net external equity liabilities	14.3	14.9	8.2	8.4	8.9	12.1
Foreign equity investment in Australia	46.6	52.2	48.8	52.3	47.8	50.4
Australian equity investment abroad	-32.3	-37.3	-40.6	-43.9	-38.9	-38.3
Net external debt	40.8	40.4	46.1	46.3	49.0	48.0
Net public debt	7.4	3.0	2.3	1.6	2.2	1.1
Net private debt	33.4	37.4	43.8	44.7	46.8	46.9
Gross external debt	62.8	64.1	72.3	72.9	77.1	76.4
Gross external lending	-22.1	-23.7	-26.2	-26.7	-28.1	-28.3
Short-term net external debt (residual maturity basis)	17.4	17.0	22.1	23.6	22.6	18.4
Short-term gross external debt	30.6	33.2	40.0	39.8	40.7	37.3
Short-term gross external lending	-13.2	-16.3	-17.9	-16.2	-18.1	-18.9
Net interest payment to exports	9.1	10.5	10.1	9.4	8.8	8.7
Memorandum items:						
Gross official reserves (in $A billion)	25.0	33.6	34.0	36.5	38.1	44.3
RBA outstanding forward contracts (in $A billion)	10.1	22.6	24.9	29.5	25.0	26.4
Net official reserves (in $A billion)	14.9	10.9	9.1	7.0	13.1	17.9
Gross official reserves (in months of imports)	2.3	2.7	2.7	2.7	2.8	3.3
Gross official reserves to short-term foreign currency denominated debt (percent)	19.5	23.0	18.9	19.3	18.5	21.7

Sources: Australian Bureau of Statistics, Reserve Bank of Australia, and Fund staff estimates.

AUSTRALIA—FUND RELATIONS
(As of June 30, 2004)

A. Financial Relations

I. Membership Status: Joined: 08/05/1947; Article VIII

II. General Resources Account:	**SDR Million**	**Percent Quota**
Quota	3,236.40	100.0
Fund holdings of currency	2,064.19	63.78
Reserve position in Fund	1,172.24	36.22
Financial Transaction Plan transfers (net)	40.00	

III. SDR Department:	**SDR Million**	**Percent Allocation**
Net cumulative allocation	470.55	100.00
Holdings	120.02	25.51
Designation plan	0.00	

IV. Outstanding Purchases and Loans: None

V. Financial Arrangements: None

VI. Projected Obligations to Fund: None

B. Nonfinancial Relations

VII. Exchange Rate Arrangement. Australia accepted the obligations of Article VIII, Sections 2, 3, and 4 on July 1, 1965 and maintains an exchange system that is free of restrictions on payments and transfers for current international transactions. Exchange rates are market determined, but the Reserve Bank of Australia retains discretionary power to intervene**.** On July 30, 2004, the U.S. dollar/Australian dollar exchange rate was US$0.6986=$A 1.00. There are no taxes or subsidies on purchases or sales of foreign exchange. Australia has notified the Fund under Decision 144 of the imposition of exchange restrictions vis–à–vis Iraq, the Federal Republic of Yugoslavia and the Socialist People's Libyan Arab Jamahiriya. In late 1999, Australia imposed restrictions on financial transactions with the Taliban (the Islamic State of Afghanistan), and the UNITA movement in Angola.

VIII. Restrictions on Capital Transactions. Australia maintains a capital transactions regime that is virtually free of restrictions. Two main restrictions on foreigners require: authorization for significant ownership of Australian corporations; and approval for acquisition of real estate.

IX. Last Article IV Consultation, and Consultation Cycle. Discussions for the 2004 Article IV consultation were held in Sydney, Melbourne, and Canberra from June 17 to June 25, 2003. The 2003 consultation (IMF Country Report 03/337) was completed by the Executive Board on October 22, 2003 (SUR/03/106). Australia is on the standard 12–month consultation cycle.

X. Fourth Amendment. Australia has accepted the Fourth Amendment to the Articles of Agreement.

AUSTRALIA—STATISTICAL ISSUES

8. Australia publishes a wide array of economic and financial data. It has subscribed to the Special Data Dissemination Standard (SDDS) and its metadata are posted in the Dissemination Standards Bulletin Board (DSBB).

9. During 2001, the Australian Bureau of Statistics (ABS) undertook a number of projects and initiatives, including the release of a new price measure called Price Index of Domestic Final Purchases (DFP) on an experimental basis, development of new measures of labor underutilization, and improvements in its business indicators survey by merging three previous surveys into one quarterly economic activity survey.

C. Real Sector

Prices

10. The ABS released the experimental DFP in July 2001. The index reflects purchases of Australian residents (households, governments, and businesses), and includes import prices and excludes export prices. The series is confined to final market purchases, and, thus, avoids the issue of multiple counting of price impacts which would result if prices of intermediate stages of production were included.[1] The items and weights for this economy-wide measure of prices are derived from the 1994–95 input-output tables. The series is still in the consultative stage, and is not expected to be published on an ongoing basis until the second half of 2004. With an objective of developing overall labor cost indices, ABS plans to publish in November of 2004 new annual nonwage cost indices, which cover superannuation, workers' compensation, annual leave, and payroll tax. Over the next few years, ABS' program includes updating a set of weights into the CPI, based largely on the 2003–04 household expenditure survey, and introducing indices measuring the change in the prices of financial services in the CPI. From now to mid-2005, for each quarter ABS will release experimental indices for financial services and expects to include them into the headline CPI from the third quarter of 2005.

Labor

11. In February 2002, the ABS released two new measures of labor underutilization. In conjunction with existing unemployment statistics, the new measures provide a broad view of labor underutilization. The two new measures are: (i) the labor force underutilization rate, which is the unemployed plus the underemployed as a percentage of the labor force; and (ii) the extended labor force underutilization rate, which includes the unemployed, plus the underemployed, plus two groups that are marginally attached to the labor force—persons actively looking for work, who are not available to start work in the reference week but available to start work within four weeks, and discouraged job seekers—as a percentage of

[1] Price changes of intermediate purchases are provided by the Stage of Production producer price index introduced in July 2000.

the 'extended' labor force (i.e., the labor force plus the two marginally attached groups). Currently, the new series are available on an annual basis back to 1994, but ABS is working to create a quarterly series for the labor force underutilization rate, which should be available by mid-2004.

5. The ABS also made some changes to its labor force survey questionnaire in April 2001 to better reflect contemporary labor market developments, as well as developments in international standards and practices for collecting labor force statistics. New or extended information was introduced on job tenure, underemployment, hours worked, duration of unemployment, and marginal attachment to the labor force.

Other

6. The ABS has made improvements to its business indicators survey. From the third quarter of 2001, the ABS has merged the Survey of Company Profits, the Survey of Inventories, Sales and Services, and the private sector component of the Survey of Employment and Earnings into a single survey called the Quarterly Business Indicators Survey (QBIS).[2] The changes are expected to improve consistency and coherence of the statistics, particularly for the purposes of compiling the quarterly national accounts, and to enable a better understanding of the reasons for the changes in economic activity. It also significantly reduces the overall statistical reporting burden on businesses and also considerably reduces the sampling error associated with the estimates.

D. Fiscal Sector

7. The Australian Commonwealth (central) Government has introduced accrual budgeting with the 1999/2000 Budget estimates that were released in May 1999. Australia's Consolidated Financial Statements now contain a complete set of financial statements and various summary measures of government performance prepared on an accrual basis in accordance with applicable Australian Accounting Standards. Separate Government Finance Statistics (GFS) statements are produced for the budget and mid-year updates of the estimates and the final budget outcomes publications. The ABS has been producing quarterly GFS estimates for many years as an input into the quarterly national accounts. In March 2004, the ABS published quarterly data on the operations of general government and nonfinancial public corporations, excluding data on financing.

8. Australia is a regular reporter of GFS data for publication in *IFS* and the *GFS Yearbook*. Cash data from the Department of Finance Monthly Financial Statements are used for publication in *IFS*.

[2] An annual economic activity survey has been in place since the early 1990s for the compilation of the annual national accounts.

E. Financial Sector

Due to changes in legislation and new reporting arrangements for banks, the Australian Prudential Regulation Authority (APRA) suspended publication of the *Australian Banking Statistics* beyond March 2002. APRA announced its intention to produce a similar publication in 2003, and began publishing *Monthly Banking Statistics* in March 2004. The *Monthly Banking Statistics,* however, uses slightly different definitions, in particular: (i) it contains only resident data while the Australian Banking Statistics contained both resident and nonresident data; (ii) it includes the Australian-dollar equivalent of foreign currency transactions, while the Australian Banking Statistics excluded foreign currency data; and (iii) it discloses intra-group deposits and loans as separate items, while the Australian Banking Statistics included intra-group deposit and loan data in totals.

F. External Sector

ABS has improved the timeliness of the international investment position (IIP) statistics by releasing the data one quarter earlier. There have also been revisions to IIP data as a result of improved reporting and the identification and correction of errors. The estimates in the July 2004 issue of the *Balance of Payment and International Investment Position* are presented on a calendar year basis, which will allow for better analysis in terms of international comparisons as data for most other countries are available on a calendar year basis. In addition, quarterly External Debt Statistics are now also available in the *Balance of Payment and International Investment Position* publication.

Australia—Core Statistical Indicators
(As of August 2, 2004)

	Exchange Rates	Official Reserves	Reserve/ Base Money	Central Bank Balance Sheet	Broad Money	Interest Rates	Consumer Price Index	Exports/ Imports	Current Account Balance	Overall Govt Balance	GDP/ GNP	External Liabilities
Date of latest observation	08/02/04	06/04	06/04	06/30/04	06/04	08/02/04	06/04	05/04	Q1/04	03/04	Q1/04	3/04
Date received	08/02/04	07/07/04	07/30/04	07/30/04	07/30/04	08/02/04	07/28/04	07/07/04	06/21/04	06/17/04	06/03/04	05/20/04
Frequency of data 1/	D	M	M	W	M	D	Q	M	Q	M	Q	Q
Frequency of Reporting 1/	D	M	M	W	M	D	Q	M	Q	M	Q	Q
Source of data 2/	C	N 5/	N	N	N 5/	C	N 5/	N 5/	N 5/	N 5/	N 5/	N 5/
Mode of reporting 3/	E	E	E	E	E	E	E	E	E	E	E	E
Confidentiality 4/	C	C	C	C	C	C	C	C	C	C	C	C
Frequency of publication	D	M	M	W	M	D	Q	M	Q	Q	Q	Q

1/ D-daily; W-weekly; M-monthly; Q-quarterly; or A-annually.
2/ A-direct reporting by central bank, ministry of finance, or other official agency; N-official publication or press release; P-commercial publication; C-commercial electronic data provider; or E-EIS.
3/ E-electronic data transfer; C-cable or facsimile; T-telephone; M-mail; or V-staff visits.
4/ A-for use by the staff only; B-for use by the staff and the Executive Board; C-unrestricted use; or D-embargoed for a specific period and thereafter for unrestricted use.
5/ A less detailed breakdown of these items is obtained from Reuters before the official publication is received.

Statement by the IMF Staff Representative
October 27, 2004

1. This statement contains information that has become available since the Staff Report was circulated to the Executive Board on August 31, 2004. This information does not alter the thrust of the staff appraisal.

2. In the October 9 national election, Prime Minister John Howard's Liberal-National coalition won a fourth three-year term with an increased majority in the lower house. Following the election the new government announced that its chief goals are maintaining strong economic growth, reforming the industrial relations system, protecting national security, and pursuing free-trade agreements with other countries.

3. The Departments of Treasury and Finance issued a Pre-Election Economic and Fiscal Outlook in early September. The fiscal surplus in 2003/2004 was 0.3 percent of GDP higher than previously expected, owing to both higher tax revenue and lower expenditure. Projected fiscal surpluses for the next four years were also revised upwards, mainly reflecting stronger revenue performance based on the stronger-than expected tax revenue in 2003/2004 and higher nominal GDP in 2004/2005. The fiscal surplus for 2004/05 is now projected at $A 3.6 billion (0.4 percent of GDP), compared with the May budget forecast of $A 0.7 billion. Fiscal surpluses during 2005–08 are also expected to exceed the previous forecast by about 0.4–0.5 percent of GDP each year.

4. Strong domestic demand continued to sustain forward momentum during the second quarter, while the drag on growth from the deficit in net exports weakened. GDP growth in the second quarter picked up slightly to 0.6 percent from 0.5 percent in the first quarter. With exports continuing to recover and import growth retreating after the boost in the first quarter, the deficit on net exports narrowed to 2 percent of GDP in the second quarter from 3½ percent of GDP in the first quarter. More recently, retail trade growth has slowed to 6 percent (y/y) during June-August, compared with 10 percent peaks early in the year. Unemployment remains low.

5. Recent indicators are insistent with a soft landing in the housing market. The price index for established houses fell 1.2 percent in the second quarter after an increase of 2.5 percent in the first quarter. This was the first fall in this index since the third quarter in 2000, although regional markets behaved unevenly as prices fell in Sydney and Canberra but continued to rise in other capital cities. Building approvals and the value of new lending on housing have continued to decline in the past few months; the overall decline in lending in August was driven by a drop in lending to investors, with lending to owner occupiers boosted by the return of first-time buyers to the market.

6. At its regularly scheduled meeting in early October, The Reserve Bank of Australia left the target for the cash rate unchanged at 5.25 percent for the tenth consecutive month.

INTERNATIONAL MONETARY FUND
Public Information Notice
EXTERNAL
RELATIONS
DEPARTMENT

Public Information Notice (PIN) No. 04/124
FOR IMMEDIATE RELEASE
November 8, 2004

International Monetary Fund
700 19th Street, NW
Washington, D. C. 20431 USA

IMF Concludes 2004 Article IV Consultation with Australia

On October 27, 2004, the Executive Board of the International Monetary Fund (IMF) concluded the Article IV consultation with Australia.[1]

Background

The expansion is now entering its 13th year, with unemployment falling to levels not seen since the early 1980s. After slowing in the first half of 2003, economic activity rebounded, underpinned by continued buoyancy of domestic demand and a gradual recovery from the drought. For the year as a whole, real GDP growth was 3 percent, only moderately lower than the 3.8 percent in 2002, as strong domestic demand continued to offset weak net exports and a large decline in agricultural output. The strength in domestic demand was broadly based, with consumption, housing and business investment all growing at above-trend rates. Domestic spending was underpinned by supportive financial conditions, substantial increases in household wealth from a surge in dwelling prices, a strong labor market, and a rebound in farm incomes. The buoyant domestic economy and the substantial appreciation of the Australian dollar led to a deterioration of the current account deficit from 4.4 percent of GDP in 2002 to 6 percent in 2003. A boost in imports pushed net exports to a record low in the first quarter of 2004, before net exports recovered as imports retreated in the second quarter. As a result, GDP growth was weaker than expected, although the economy retained significant momentum.

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[1] Under Article IV of the IMF's Articles of Agreement, the IMF holds bilateral discussions with members, usually every year. A staff team visits the country, collects economic and financial information, and discusses with officials the country's economic developments and policies. On return to headquarters, the staff prepres a report, which forms the basis for discussion by the Executive Board. At the conclusion of the discussion, the Managing Director, as Chairman of the Board, summarizes the views of Executive Directors, and this summary is transmitted to the country's authorities.

Headline inflation, which has remained within the Reserve Bank of Australia's target range of 2–3 percent, masks very different trends in tradables and nontradables inflation. While CPI inflation for nontradable goods was around 4 percent, price increases for tradable goods declined sharply since March 2003 due to the large appreciation of the Australian dollar. Recent data show that the dampening effect on inflation from tradable goods may be eroding due, to a large extent, to the recent easing of the Australian dollar.

Monetary policy was kept on hold during the first three quarters of 2003, reflecting conflicting risks to the outlook at the time. The RBA had to contend with the potential for protracted weakness in the external environment, further appreciation of the Australian dollar, uncertainty about the recovery from the drought, on the one hand, and continued rapid growth in housing credit on the other. By the end of 2003, however, with external risks abating, domestic demand growing faster than expected, signs of recovery in the agricultural sector emerging, and the housing sector continuing to expand at an unsustainable rate, the RBA increased the Official Cash Rate (OCR) by 25 basis points in both November and December. The RBA kept the OCR unchanged at its policy meetings in the first three quarters of 2004, based on emerging signs of easing domestic spending, a cooling in the housing market, and subdued inflation pressures.

The centerpiece of the 2004 Budget is the government's *More Help for Families* package, which provided assistance to Australian families, continued the government's ongoing structural tax reform, and enhanced incentives to save for retirement. It contained additional tax cuts and new expenditure initiatives of $A 37 billion over five years (an average of about 0.9 percent of GDP each year), while maintaining a modest cash surplus of less than ½ percent of GDP each year through the medium term. The Commonwealth net debt was projected to turn negative by 2007/08.

Forward-looking indicators of economic activity point to continuing strength, albeit with some moderation, in domestic demand and there are some signs of slowing in the housing sector. Real GDP growth is projected near potential of about 3¾ percent in 2004. The gradual cooling of domestic demand is expected to be, at least partially, offset by a pick up in external demand and a rebound in the agricultural sector, bringing about the long awaited rebalancing of sources of growth. The main risk to the outlook centers on the housing market and the associated build-up in household indebtedness, but recent indicators suggest a soft landing is likely. Medium-term prospects remain favorable.

Executive Board Assessment

Executive Directors commended the authorities for Australia's strong performance, with six years of budget surpluses, falling public debt, low inflation, high and rising productivity, and a long period of uninterrupted growth that has underpinned a dynamic job market.They attributed this performance to the authorities' exemplary record of macroeconomic and financial management and implementation of structural reforms, carried out in a transparent economic policy formulation framework.

Directors concurred that the outlook for the economy remains favorable. A sharp correction in the housing market, further increases in oil prices, and a weakening of external demand are factors that could affect the positive outlook, but Directors felt that these downside risks were balanced by the upside potential of domestic demand remaining buoyant. Directors agreed that growth is likely to be rebalanced, with domestic demand growth gradually slowing and net exports picking up as the global economy strengthens and agricultural output recovers from the drought. They noted, in particular, recent data that are consistent with a soft landing in the housing market and cooling of domestic demand.

Directors commended the authorities' successful management of monetary policy—based on inflation targeting—in the face of diverging pressures from a strong housing market and robust domestic demand, on the one hand, and weakness of net exports and an appreciation of the Australian dollar, on the other. They pointed out that the main risk in the short term centers on the housing market and the associated buildup of household indebtedness, and considered that the measured actions of the Reserve Bank of Australia, including some tightening of the official cash rate target in late 2003, contributed to a welcomed cooling in the market. They viewed the RBA's current wait-and-see stance as appropriate in light of subdued inflation pressures and remaining uncertainties in the housing market.

Directors agreed that the flexible exchange rate combined with a strong risk management culture have helped increase the resilience of the Australian economy. The significant appreciation of the Australian dollar during the past two years mainly reflected a weak U.S. dollar, strong commodity prices, Australia's more favorable cyclical position compared with other industrial countries, and a bounce back from the Australian dollar's undervalued level in 2001. Directors supported the authorities' policy to limit foreign exchange interventions to situations where the exchange rate is clearly misaligned or to calm disorderly market conditions.

Directors regarded Australia's fiscal position as fundamentally sound, and noted that revenue had remained stronger than expected during the first half of 2004. They endorsed the authorities' medium-term strategy of aiming for a balanced budget over the business cycle to support sustainable economic growth. They called attention to the significant long-term spending pressures due to increasing healthcare costs and population ageing, and welcomed the recent amendment to the Pharmaceutical Benefit Scheme, which will help contain the growth of healthcare spending.

Directors supported the envisaged structural reforms in the 2004 Budget to promote labor force participation and productivity growth in order to achieve higher growth, close the potential long-term fiscal gap, and address the challenge of an ageing population. They welcomed the measures to reform the tax and income support system to provide better incentives to work, such as reducing effective marginal tax rates for low-income families returning to work, allowing older workers to access their superannuation benefits without having to stop working, and tightening the eligibility requirement for the Disability Support Pension. Directors also welcomed the government's plans to take additional measures to further increase labor market flexibility, reform the welfare system, enhance competitiveness, and invest in research and development and infrastructure, in order to further strengthen long-term growth prospects.

Directors commended the soundness of Australia's financial system and strong risk management culture. They welcomed the steps that had been taken to strengthen financial supervision, including the latest legislative changes on insurance industry supervision and audit reform. Directors concurred that developments in the housing market are unlikely to pose systemic risk to the financial system, as indicated by the Australian Prudential Regulation Authority's recent stress tests. While a combination of external and domestic shocks could result in a sharp increase of household savings and weaker GDP growth that would have a negative impact on banks' balance sheets, such a "worst case scenario" is unlikely. At the same time, Directors pointed to potential risks stemming from the sustained high current account deficit and the build-up of private external debt, and advocated close monitoring of corporate and banks' balance sheets. Directors commended the authorities for their preparation for the implementation of Basel II regulatory capital requirements, and welcomed their interest in participating in a Financial Sector Assessment Program in the near future.

Directors praised the authorities for their commitment to trade liberalization. Australia's pursuit of bilateral free trade agreements was seen as supportive of the country's multilateral liberalization efforts. Directors commended the authorities for their recent unilateral decision to provide complete duty- and quota-free market access to the least developed countries, and were encouraged by the envisaged further liberalization of the more protected sectors.

Directors welcomed Australia's constructive involvement in neighboring Pacific Island countries, including a significant increase in aid allocation to the region in the 2004 budget. They noted that the authorities remain committed to achieving the UN official development assistance target.

Public Information Notices (PINs) form part of the IMF's efforts to promote transparency of the IMF's views and analysis of economic developments and policies. With the consent of the country (or countries) concerned, PINs are issued after Executive Board discussions of Article IV consultations with member countries, of its surveillance of developments at the regional level, of post-program monitoring, and of ex post assessments of member countries with longer-term program engagements. PINs are also issued after Executive Board discussions of general policy matters, unless otherwise decided by the Executive Board in a particular case. The Staff Report for the 2004 Article IV Consultation with Australia is also available.

Table 1. Australia: Selected Economic and Financial Indicators, 1998-2003

	1998	1999	2000	2001	2002	2003
Output and demand (percent change)						
Real GDP	5.2	4.3	3.2	2.5	3.8	3.0
Total domestic demand	6.6	5.6	2.2	1.3	6.5	6.2
Private consumption	4.6	4.9	3.1	2.8	4.2	4.3
Fixed investment	8.2	7.0	1.5	-1.1	15.5	9.6
Exports of goods and services	0.0	4.5	11.2	1.6	0.3	-2.3
Imports of goods and services	6.0	9.1	7.8	-4.2	11.5	11.3
Inflation and unemployment (in percent)						
CPI inflation	0.9	1.5	4.5	4.4	3.0	2.8
Unemployment rate	7.7	6.9	6.3	6.8	6.4	6.1
Saving and investment (in percent of GDP)						
Gross national saving	19.0	18.7	19.6	19.5	18.7	18.9
General government saving	3.9	4.7	2.9	2.7	2.9	3.1
Private saving [1]	15.1	14.0	16.8	16.8	15.9	15.9
Gross capital formation	23.9	24.7	23.1	20.7	23.1	24.8
Fiscal Indicators (in percent of GDP) [2]						
Commonwealth budget						
Revenue	24.2	24.7	26.5	24.0[3]	22.8	23.4
Underlying expenditure [4]	24.0	24.0	24.4	23.1[3]	22.9	22.4
Underlying cash balance [4]	-1.0	0.7	2.1	0.9	-0.1	1.0
Fiscal balance (accrual basis)	-0.4	0.6	2.1	0.9	-0.5	0.8
Money and credit (end of period)						
M1 (percent change)	6.1	9.7	9.4	21.3	-9.3	8.7
M3 (percent change)	7.0	9.4	4.9	14.6	10.3	13.7
Private domestic credit (percent change)	10.3	11.0	11.8	8.8	11.9	14.7
Interest rate (90-day bill, in percent)	4.8	5.7	6.2	4.2	4.8	5.5
Government bond yield (10-year, in percent)	5.0	7.0	5.5	6.0	5.5	5.6
Balance of payments (in percent of GDP)						
Current account	-4.9	-5.7	-4.0	-2.4	-4.4	-6.0
of which: Trade balance	-1.4	-2.5	-1.2	0.5	-1.3	-2.9
Terms of trade (percent change)	-4.1	-0.9	5.4	1.4	2.3	4.0
External assets and liabilities (in percent of GDP)						
Net external liabilities	55.1	55.1	53.8	53.5	56.7	59.5
Gross short-term external debt	30.6	33.2	40.1	39.8	40.7	36.8
Net short-term external debt	17.4	17.3	22.5	23.7	22.8	17.6
Gross official reserves	4.3	5.5	5.2	5.3	5.2	4.6
Exchange rate (end of period)						
US$/$A	0.614	0.654	0.554	0.509	0.566	0.750
Trade-weighted index	53.3	56.4	51.7	50.2	52.0	62.9
Nominal effective exchange rate [5]	95.3	100.3	92.0	89.8	92.9	110.1
Real effective exchange rate [5]	78.4	83.3	79.3	79.2	83.1	99.2

Sources: Data provided by the Australian authorities; and IMF staff estimates.
[1] Includes public trading enterprises.
[2] Fiscal year ending June 30.
[3] The sharp drop in 2001 reflects tax reform, including income tax cuts, the removal of the Wholesale Sales Tax, and the reduction in grants to States.
[4] Underlying expenditure and balance exclude asset sales and other one-off factors; cash basis.
[5] IMF, Information Notice System index (1990 = 100).