



AUSTRALIA

February 2019

2018 ARTICLE IV CONSULTATION—PRESS RELEASE; STAFF REPORT; AND STATEMENT BY THE EXECUTIVE DIRECTOR FOR AUSTRALIA

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 2018 Article IV consultation with Australia, the following documents have been released and are included in this package:

- A **Press Release** summarizing the views of the Executive Board as expressed during its February 4, 2019 consideration of the staff report that concluded the Article IV consultation with Australia.
- The **Staff Report** prepared by a staff team of the IMF for the Executive Board's consideration on February 4, 2019, following discussions that ended on November 20, 2018, 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 January 18, 2019.
- An **Informational Annex** prepared by the IMF staff.
- A **Statement by the Executive Director** for Australia.

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

Selected Issues
Financial Stability System Assessment

The IMF's transparency policy allows for the deletion of market-sensitive information and premature disclosure of the authorities' policy intentions in published staff reports and other documents.

Copies of this report are available to the public from

International Monetary Fund • Publication Services
PO Box 92780 • Washington, D.C. 20090
Telephone: (202) 623-7430 • Fax: (202) 623-7201
E-mail: publications@imf.org Web: <http://www.imf.org>
Price: \$18.00 per printed copy

International Monetary Fund
Washington, D.C.



Press Release No. 19/xx
FOR IMMEDIATE RELEASE
February __, 2019

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

IMF Executive Board Concludes 2018 Article IV Consultation with Australia

On February 4, 2019, the Executive Board of the International Monetary Fund (IMF) concluded the Article IV consultation¹ with Australia.

Australia has advanced further in its economic rebalancing after the end of the mining investment boom of the 2000s. Economic growth picked up to rates above that of potential output in the first half of 2018, with solid private and public consumption and residential investment more than offsetting the drag from delays in public investment plans and drought. Growth slowed down somewhat in 2018Q3. Labor market conditions also improved, with strong employment growth and declining unemployment.

The housing market has been cooling after a long boom. The cooling since mid-2017 reflects a number of factors, including the bottoming out of interest rates globally, the weakening of foreign and domestic investor demand, and the tightening of lending standards and bank capital requirements. The housing market correction is helping housing affordability, but accumulated vulnerabilities related to house prices and debt levels remain high. On the supply side, progress has been made in using City Deals, agreements across all levels of government that integrate planning and infrastructure delivery for new developments and redevelopments.

The fiscal policy stance has been supportive, with increased infrastructure spending. The Commonwealth government deficit has narrowed to 0.3 percent of GDP and should move into surplus in FY2019/20. The authorities have accelerated the lowering of the company tax rate for small companies with a turnover of up to A\$50 million to 25 percent by FY2021/22 and set up a schedule for cutting personal income taxes and rationalizing the tax brackets over the next seven years. This should maintain a tax-to-GDP ceiling at the federal level of 23.9 percent of GDP while protecting its commitment to a budget surplus of 1 percent of GDP over the business cycle as a medium-term fiscal anchor.

The monetary policy stance remains accommodative, with the current policy rate being on hold at 1.5 percent since August 2016 and inflation hovering just below the lower end of the Reserve

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 prepares a report, which forms the basis for discussion by the Executive Board.

Bank of Australia's (RBA's) target range of 2-3 percent. The cash rate setting implies a real policy rate of zero relative to estimates of the real neutral interest rate in the range of 1-2 percent.

Australian banks are well capitalized and profitable. In 2018Q3 compared with end-2017, banks' regulatory capital to risk-weighted assets ratio remained stable at 14.7 percent, and the return on assets increased by 0.2 percentage point to 1.4 percent. The ratio of liquid assets to total assets remained relatively stable at 17.2 percent in 2018Q3. Stress tests under Financial Sector Assessment Program (FSAP), conducted in parallel with the Article IV consultation, found banks to be resilient to solvency and liquidity stress but also noted the vulnerability to external funding shocks, given that banks' wholesale funding accounts for about one-third of total liabilities, of which two-thirds are from external sources.

The Australian Prudential Regulatory Authorities (APRA) continues to put strong emphasis on sound lending standards, and conditional on a bank's assurance about such standards, it removed caps limiting investor and interest-only lending in 2018. The capital adequacy framework for banks was further refined in 2018, with APRA establishing a framework and timeline for introducing a minimum leverage ratio for Australian banks and proposing changes to increase banks' loss absorbing capacity.

Recent structural policy efforts have focused on addressing infrastructure gaps, research and development (R&D), tax reform, and energy policy. Federal and state governments have ramped up infrastructure spending further, adding around 0.5 percent of GDP per year in the 2018 budgets and updates over the next 3 years. The federal government has reformed the system of R&D tax incentives to make it more efficient. They have also cut personal income and company taxes as outlined above. Energy sector reform for reliability issues has proceeded at federal and state levels, and the government remains committed to meeting its Paris Agreement obligations.

Executive Board Assessment²

Executive Directors commended the authorities for their sound macroeconomic management and strong policy framework which have contributed to over two decades of robust and resilient economic performance. Directors noted that although growth is expected to remain above trend in the near term, a weaker global economic environment, high household debt, and vulnerabilities in the housing sector could weigh on medium-term growth. Against this background, they highlighted the importance of maintaining supportive macroeconomic policies to secure stronger demand momentum, address macrofinancial risks, and boost long-term productivity and potential growth.

Directors agreed that continued macroeconomic policy support is essential until full employment and the inflation target are firmly within reach. They considered monetary policy to be appropriately accommodative in the current circumstances and advised that policy normalization should depend on firmer upward pressures on prices.

² 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. An explanation of any qualifiers used in summings up can be found here: <http://www.imf.org/external/np/sec/misc/qualifiers.htm>.

Directors welcomed the supportive fiscal policy stance. They commended Australia's infrastructure investment boost as a critical source of demand in the near term. Directors also welcomed the authorities' prudent medium-term fiscal plans, targeting budget surpluses from FY2019/20. The principle of running budget surpluses in good times has been an important anchor for fiscal discipline in Australia. Directors generally considered that a medium-term debt anchor could further help strengthen the medium-term fiscal strategy. Noting the uncertainty about the recent strength in revenues, Directors encouraged the authorities to exercise prudence in approving permanent tax cuts or expenditure increases.

Directors agreed that the macroeconomic policy response needs to be flexible. They noted that given limited conventional monetary policy space, discretionary fiscal stimulus may need to complement monetary easing in the event downside risks materialize. Most Directors noted that Australia's substantial fiscal space could be utilized for further increases in high-quality infrastructure spending to boost potential growth. At the same time, a number of Directors noted that the fiscal space could be preserved as a buffer to deal with shocks.

Directors welcomed the authorities' macroprudential interventions to reduce credit risk and reinforce sound lending standards. They concurred that, with high prices for residential real estate along with elevated household debt, macroprudential policies should hold the course on the improved lending standards and further strengthen bank resilience by refining the capital adequacy framework. Directors also saw merit in expanding and strengthening the macroprudential toolkit to allow for more flexible responses to financial stability risks.

Directors welcomed that Australia's financial system remains fundamentally sound. They supported the FSAP recommendations to strengthen systemic risk oversight of the financial sector. They generally noted that the quality of supervision would be further bolstered by strengthening enforcement powers to support effective risk management and by making additional investment in data and analytical tools. Directors encouraged the authorities to strengthen the integration of systemic risk analysis and stress testing with supervisory processes, complete the resolution framework, and expedite the development of bank-specific resolution plans.

Directors underscored the need to remain vigilant about housing market developments. They noted that while the housing market correction is helping housing affordability, continued housing supply reforms remain critical for broad affordability and to reduce macrofinancial vulnerabilities. Directors generally encouraged the authorities to explore, where possible, alternative and effective non-discriminatory measures for buyers.

Directors stressed that to lift productivity and longer-term growth, sustained structural policy efforts will be needed. These should focus on continuing to close macro-critical gaps in infrastructure, greater female labor force participation, research and development, sustainability of energy policy, as well as broad tax reform. Directors welcomed the authorities' commitment to openness and trade and their participation in the Comprehensive and Progressive Agreement for Trans-Pacific Partnership.

Table 1. Australia: Main Economic Indicators, 2014-2024
(Annual percent change, unless otherwise indicated)

	2014	2015	2016	2017	2018	2019	2020	2021	2022	2023	2024
					Est.	Projections					
NATIONAL ACCOUNTS											
Real GDP	2.6	2.5	2.8	2.4	3.0	2.7	2.6	2.6	2.6	2.6	2.6
Domestic demand	0.9	1.2	1.8	2.9	3.0	2.6	2.7	2.6	2.6	2.6	2.6
Private consumption	2.5	2.4	2.7	2.4	2.6	2.5	2.7	2.6	2.6	2.6	2.6
Public consumption	0.3	4.4	4.8	4.0	4.1	2.8	2.4	2.0	2.1	2.2	2.2
Investment	-1.9	-3.6	-2.3	3.0	2.9	2.3	2.7	3.0	2.9	2.8	2.8
Public	-3.3	-1.8	13.3	9.1	0.2	5.4	1.5	0.6	0.4	0.4	0.4
Private business	-6.1	-9.6	-11.2	3.2	4.0	3.7	4.9	4.3	4.3	4.2	4.3
Dwelling	9.6	8.9	7.9	-2.4	5.5	-1.3	-0.1	2.4	2.3	2.0	1.7
Net exports (contribution to growth, percentage points)	1.6	0.9	1.3	-0.8	0.3	0.2	0.0	0.1	0.1	0.1	0.1
Gross domestic income	1.0	-0.1	2.8	4.8	3.1	1.7	2.5	2.2	2.3	2.6	2.7
Investment (percent of GDP) 1/	26.4	25.9	24.7	24.1	24.3	24.2	24.2	24.2	24.2	24.1	23.9
Public	4.4	4.4	4.8	5.0	4.9	5.0	4.9	4.8	4.7	4.6	4.4
Private	22.0	21.4	19.7	19.1	19.3	19.2	19.2	19.3	19.4	19.4	19.4
Mining investment	7.1	5.4	3.9	3.1	2.8	2.7	2.7	2.7	2.6	2.6	2.6
Non-mining investment	15.0	16.1	15.9	16.0	16.4	16.4	16.5	16.6	16.8	16.8	16.9
Savings (gross, percent of GDP)	23.3	21.6	20.9	22.0	21.7	21.5	21.3	21.2	21.1	21.1	21.2
Potential output	2.8	2.6	2.5	2.5	2.6	2.5	2.6	2.6	2.6	2.6	2.6
Output gap (percent of potential)	-0.9	-1.0	-0.8	-0.9	-0.5	-0.3	-0.2	-0.1	-0.1	0.0	0.0
LABOR MARKET											
Employment	0.6	2.0	1.8	2.3	2.7	2.1	1.9	1.7	1.7	1.7	1.7
Unemployment (percent of labor force)	6.1	6.1	5.7	5.6	5.3	4.8	4.8	4.8	4.8	4.8	4.8
Wages (nominal percent change)	2.5	2.1	1.9	1.9	2.1	2.5	3.0	3.3	3.2	3.3	3.3
PRICES											
Terms of trade index (goods, avg)	103	90	90	103	104	98	97	95	94	94	94
% change	-8.0	-12.4	-0.4	14.4	0.9	-5.5	-0.8	-1.8	-1.4	-0.3	0.5
Iron ore prices (index)	77	44	46	56	55	48	47	47	47	47	47
Coal prices (index)	81	67	75	101	120	108	102	99	99	99	99
LNG prices (index)	95	61	42	41	56	49	45	44	44	44	44
Crude prices (Brent; index)	91	48	40	50	65	57	57	56	57	57	58
Consumer prices (avg)	2.5	1.5	1.3	2.0	2.0	2.1	2.4	2.5	2.5	2.5	2.5
Core consumer prices (avg)	2.6	2.3	1.7	1.6	1.6	2.1	2.3	2.5	2.5	2.5	2.5
GDP deflator (avg)	0.3	-0.8	1.0	3.6	1.7	1.0	2.1	2.1	2.3	2.6	2.4
FINANCIAL											
Reserve Bank of Australia cash rate (percent, avg)	2.5	2.1	1.7	1.5	1.5	1.5	1.8	2.3	2.7	3.2	3.5
10-year treasury bond yield (percent, avg)	3.7	2.7	2.3	2.6	2.8	3.2	3.5	4.0	4.5	5.0	5.1
Mortgage lending rate (percent, avg)	6.0	5.6	5.4	5.2	5.6	5.6	6.1	6.6	7.1	7.6	7.6
MACRO-FINANCIAL											
Credit to the private sector	7.4	8.1	7.0	4.6	4.7	3.7	3.6	4.0	4.6	4.7	4.8
House price index	120	131	141	148	141	135	136	137	141	144	148
% change	6.7	8.7	7.7	5.0	-4.4	-4.1	0.3	1.0	2.5	2.5	2.5
House price-to-income, capital cities (ratio)	4.2	4.5	4.7	4.8	4.5	4.1	3.9	3.8	3.7	3.6	3.5
Interest payments (percent of disposable income)	8.9	8.8	8.6	8.9	9.7	9.2	9.9	10.6	11.3	11.9	11.8
Household savings (percent of disposable income)	7.4	6.3	4.9	3.9	2.5	2.3	2.5	2.6	2.7	3.0	3.1
Household debt (percent of disposable income) 2/	167	173	180	187	188	176	174	171	169	167	165
Business credit (percent of GDP)	48	51	51	50	50	50	50	50	50	50	50
GENERAL GOVERNMENT (percent of GDP) 3/											
Revenue	33.9	34.6	34.8	34.9	35.6	36.0	35.9	35.8	35.7	35.6	35.6
Expenditure	36.8	37.4	37.4	36.4	36.7	37.5	36.6	35.9	35.6	35.6	35.6
Net lending/borrowing	-2.9	-2.8	-2.6	-1.5	-1.2	-1.5	-0.7	-0.1	0.1	0.0	0.0
Operating balance	-1.6	-1.5	-1.1	-0.1	0.4	0.4	1.1	1.6	1.7	1.6	1.6
Cyclically adjusted balance	-2.5	-2.4	-2.1	-1.1	-0.9	-1.3	-0.6	0.0	0.1	0.0	0.0
Gross debt	34.1	37.8	40.5	40.7	40.7	41.4	40.8	40.1	39.3	37.9	36.7
Net debt	15.5	17.9	18.9	18.4	19.3	20.6	20.3	19.8	19.1	18.0	17.0
Net worth	52.0	49.4	49.3	49.0	48.6	50.3	50.3	50.4	50.0	49.1	48.5
BALANCE OF PAYMENTS											
Current account (percent of GDP)	-3.1	-4.6	-3.3	-2.6	-2.4	-2.7	-2.9	-3.0	-3.1	-3.0	-2.8
Export volume	6.9	6.5	6.8	3.5	5.3	2.4	2.5	2.9	3.1	3.2	3.2
Import volume	-1.4	1.9	0.1	7.7	3.8	1.7	2.6	2.7	2.9	2.9	2.9
Net international investment position (percent of GDP)	-52	-56	-57	-54	-50	-51	-52	-52	-53	-53	-53
Gross official reserves (bn A\$)	66	63	74	85	...	...	...	...	...	...	...
MEMORANDUM ITEMS											
Nominal GDP (bn A\$)	1,615	1,641	1,704	1,808	1,894	1,965	2,059	2,158	2,265	2,385	2,506
Percent change	3.0	1.6	3.9	6.1	4.8	3.7	4.8	4.8	5.0	5.3	5.1
Real net national disposable income per capita (% change)	-0.8	-2.1	1.1	2.7	1.2	0.2	0.4	0.1	0.2	0.4	0.6
Population (million)	23.6	24.0	24.4	24.8	25.2	25.6	26.0	26.4	26.8	27.2	27.7
Nominal effective exchange rate	99	92	92	94	...	...	...	...	...	...	...
Real effective exchange rate	100	93	93	96	...	...	...	...	...	...	...

Sources: Authorities' data; IMF *World Economic Outlook* database; and IMF staff estimates and projections.

1/ Includes changes in inventories.

2/ Reflects the national accounts measure of household debt, including to the financial sector, state and federal governments and foreign overseas banks and governments. It also includes other accounts payable to these sectors and a range of other smaller entities including pension funds.

3/ Calendar year.



AUSTRALIA

STAFF REPORT FOR THE 2018 ARTICLE IV CONSULTATION

January 18, 2019

KEY ISSUES

Context. Australia experienced only a minor downturn after the end of the mining investment and commodity price boom but, as elsewhere, the adjustment and rebalancing has been slow, with below-target inflation and low wage growth amid economic slack. Macro-financial vulnerabilities relating to high household debt and low housing affordability have become major concerns after a recent housing boom.

Outlooks and risks. Above-trend growth is expected to continue in the near term, although the momentum should moderate in a weaker global economic environment. The baseline forecasts entail a soft landing in the housing market, but a stronger market correction remains a risk. Overall, near-term risks to growth are to the downside, mirroring the global risk picture, with the impact of shocks potentially being amplified by high household debt.

Policy recommendations. Priorities are the following:

- **Continuing a supportive macroeconomic policy stance.** The current accommodative monetary policy stance remains appropriate. The boost to infrastructure investment has been an overdue catalyst to domestic demand growth and will help meet the needs of a growing population. The unwinding should only start once full employment and inflation within the target range are firmly within reach.
- **Holding the course on macroprudential policies.** The housing market correction in train entails a welcome decline of related vulnerabilities. Stringent lending standards should be maintained, as household debt levels and associated risks remain elevated. The 2018 FSAP recommends that the macroprudential toolkit be strengthened to allow more flexible and targeted responses to financial stability risks. The regulatory framework would benefit from bolstering systemic risk oversight, supervision, and crisis management.
- **Raising potential growth.** The increase in infrastructure investment should help raise productivity and support longer-term growth. Tax reform, sustained promotion of innovation and competition, and energy reform should complement these positive efforts and encourage inclusivity.

Approved By
Odd Per Brekk (APD)
and Rupa Duttagupta
(SPR)

Discussions were held in Canberra, Melbourne, and Sydney during November 7-20, 2018. The staff team comprised Thomas Helbling (head), Dirk Muir, Masahiro Nozaki, Yu Ching Wong (all APD), and Nigel Jenkinson (MCM), with Elena Loukoianova (APD) from HQ. Nigel Ray and Gemma Preston (OED) joined the discussions. Ioana Hussiada and Nadine Dubost assisted from HQ.

CONTENTS

CONTEXT	4
RECENT DEVELOPMENTS, OUTLOOK, AND RISKS	5
A. Developments Over the Past Year	5
B. Outlook	8
C. Risks	10
D. Authorities' Views on Outlook and Risks	11
MACROECONOMIC POLICIES	11
MACROFINANCIAL POLICIES	15
HOUSING MARKETS AND POLICIES	18
FOSTERING GROWTH	19
STAFF APPRAISAL	24
BOXES	
1. Implications of Greater Female and Old-Age Labor Force Participation	27
2. Australia's Housing Price Correction in Perspective	29
FIGURES	
1. Australia on the Final Leg in the Adjustment and Rebalancing after the Mining Boom	31
2. Current Account Improving After Rebalancing and a Terms of Trade Rebound	32
3. Housing Market Imbalances and Vulnerabilities after A Boom	33
4. Monetary Policy Has Supported the Adjustment After the End of the Mining Boom	34
5. Public Finances Focused on Infrastructure and Lowering Debt	35
6. Banking System Remains Strong	36
7. Financial Market Indicators: New Lows for Yields and Spreads	37
8. Interconnections and Spillovers	38
9. Australia's Macro-Structural Position	39
10. Australia in International Comparison	40

TABLES

1. Main Economic Indicators, 2014-2024	41
2. Fiscal Accounts, 2013/14-2023/24	42
3. Balance of Payments, 2014-2024	43
4. Monetary and Financial Sector, 2014-2024	44
5. Selected Financial Soundness Indicators of the Banking Sector	45

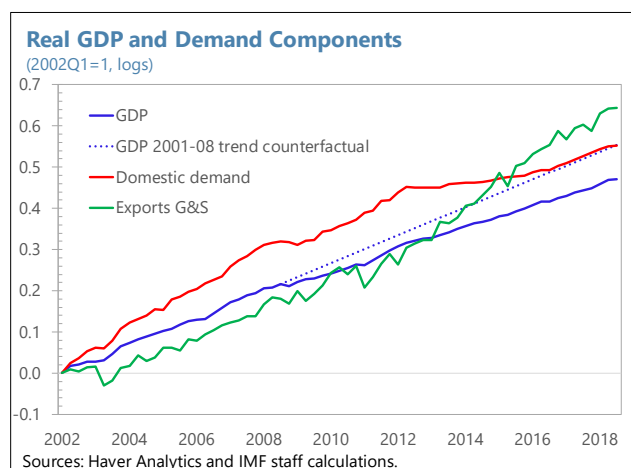
ANNEXES

I. External Sector Assessment	46
II. Risk Assessment Matrix	47
III. Debt Sustainability Analysis	48
IV. Selected Key Macroprudential Policy Measures, 2014-18	51
V. Key FSAP Recommendations	53

CONTEXT

1. Australia is on the final leg of rebalancing and adjustment after the end of the commodity price and mining investment boom.

Exchange rate flexibility and monetary easing have moderated the adverse demand impacts, as have the orientation of its exports towards the dynamic Asia economies and rapid population growth supported by immigration. Nevertheless, as in many other advanced economies since the Global Financial Crisis (GFC), the adjustment to the demand shocks has been protracted, with weak inflation and low wage growth amid persistent economic slack. Although nominal wage growth has started to pick up, it is slow and has not yet contributed significantly to inflation, which has remained below the Reserve Bank of Australia's (RBA's) target range of 2 to 3 percent.



2. The housing market has started to cool after a long boom, but accumulated vulnerabilities are high. The large house price increases after the GFC were primarily driven by demand fundamentals, amplified by supply constraints. But household debt has risen to around 190 percent of households' gross disposable income as a result, and housing assets have become overvalued. Housing market dynamics have eased since mid-2017, as interest rates have bottomed out, investor demand has weakened, and lending standards and bank capital requirements have been tightened. Commercial bank exposure to residential real estate has remained substantial at over 50 percent of total assets.

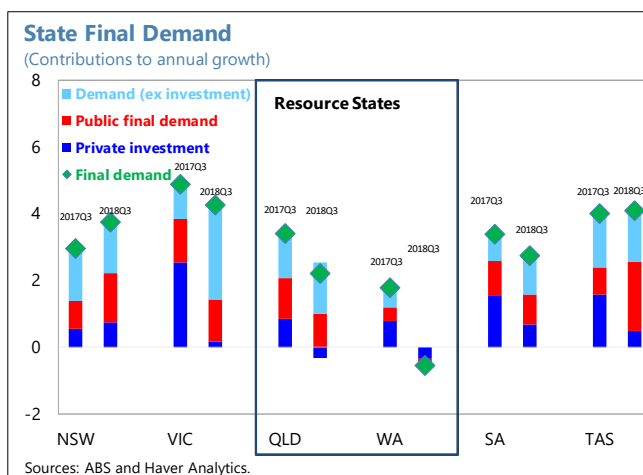
3. Australia has benefitted from China's rapid growth, but, by the same token, is now more exposed to China-related risks, while also facing other structural challenges. It faces infrastructure gaps after more than a decade of rapid population growth, challenges of urbanization and agglomeration, and housing supply constraints. While increased trade and commodity linkages with China have led to substantial income gains, productivity growth has been lagging. As in other advanced economies, potential growth has been lower since the GFC, and securing future productivity is an important policy challenge.

RECENT DEVELOPMENTS, OUTLOOK, AND RISKS

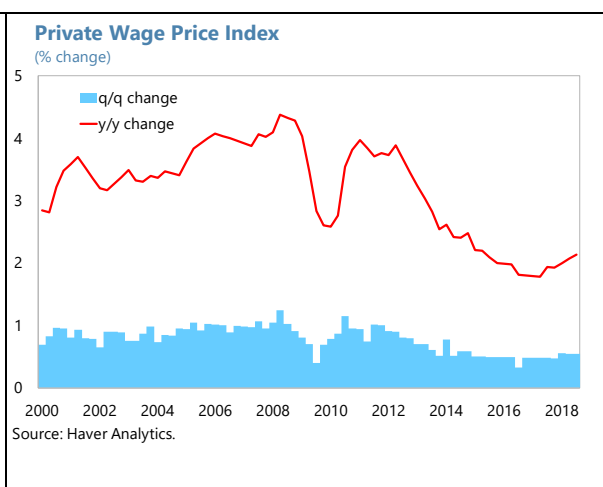
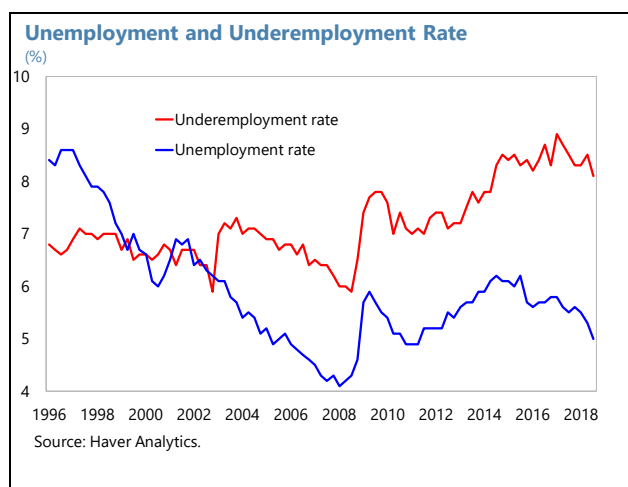
A. Developments Over the Past Year

4. Growth picked up to above trend in the first half of 2018 driven by domestic demand before slowing in 2018Q3, but inflation and wage growth has remained subdued.

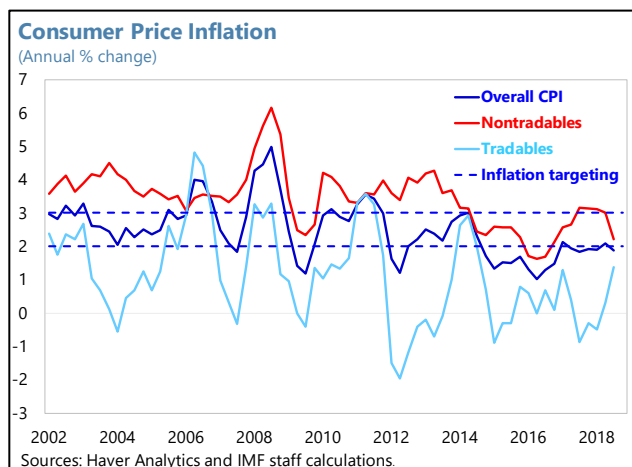
- Demand.** Annual growth has picked up to 3.0 percent in 2018Q1-Q2, with solid private and public consumption and residential investment more than offsetting the drag from delays in public investment plans and drought. After a prolonged sharp contraction, mining investment has stabilized, supporting a rebound in Western Australia. Growth slowed down in 2018Q3, as private consumption and non-mining business investment moderated, offsetting an increase in public investment. Reflecting weak disposable income growth, the household saving ratio has declined further.



- Labor markets.** The economic momentum has resulted in improvements in labor market conditions, with the unemployment rate declining to 5.1 percent in November, closer to staff's estimate of NAIRU of 4.8 percent. Other indicators, however, suggest continued labor market slack, including the underemployment rate, which, while starting to decline, remains well above its longer-term average. Wage growth remains weak—although it has started to pick up recently—likely reflecting multiple factors including greater labor force participation from female and older workers in response to cyclical labor market conditions (Box 1), sticky adjustment of longer-duration wage contracts, and structural change in the economy and labor markets.

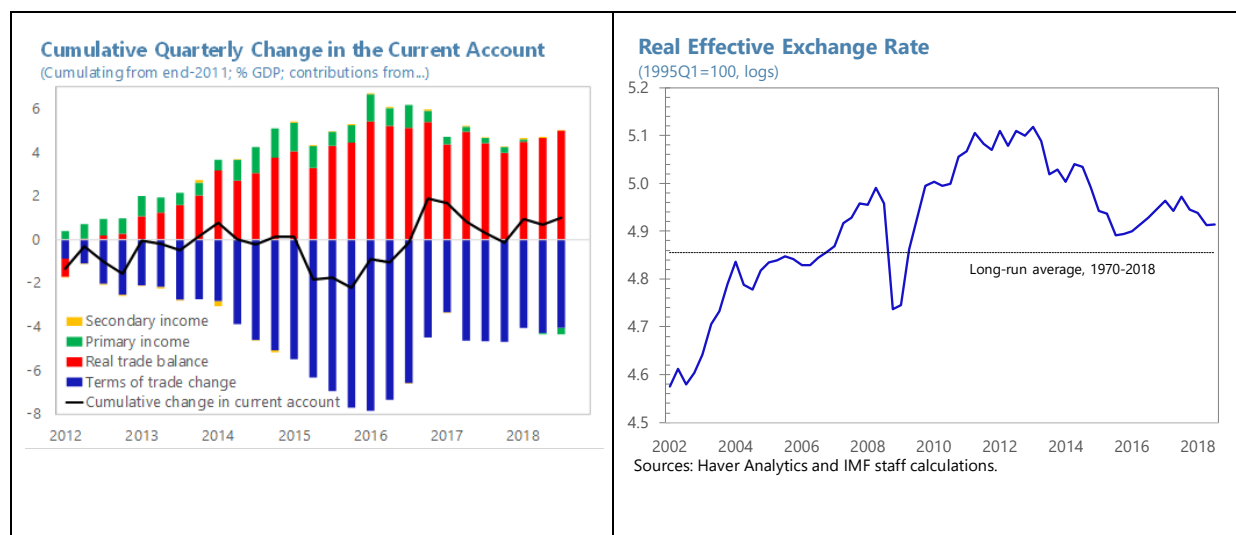


- **Prices.** Headline inflation has hovered around the floor of the Reserve Bank of Australia’s (RBA’s) target range of 2-3 percent. The disinflationary effects from strong retail competition have weighed on core inflation, while one-off declines in some administrative prices have temporarily lowered headline inflation.



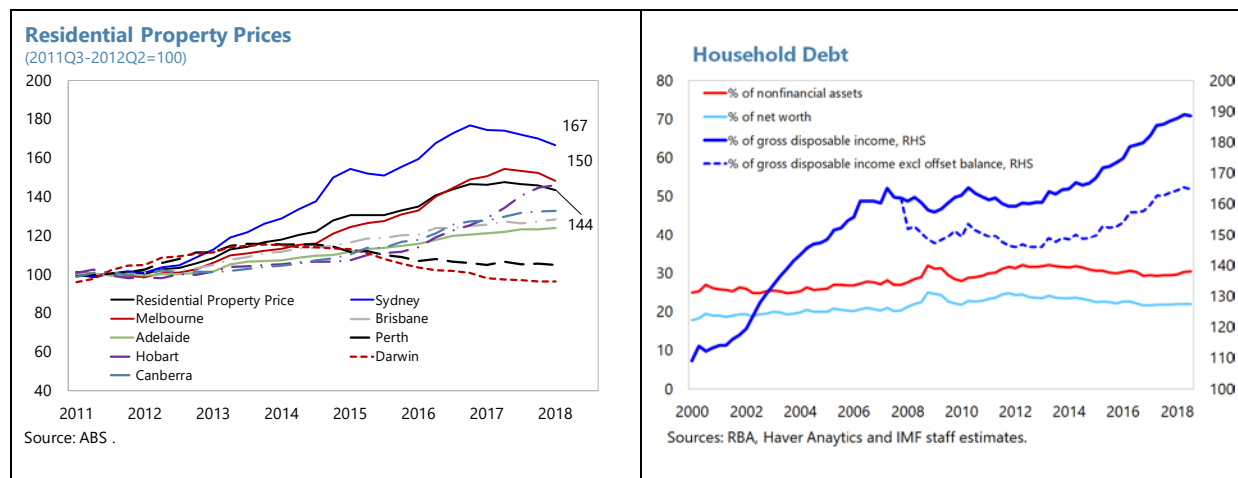
5. The external position in 2018 is tentatively assessed to be broadly in line with fundamentals and desired policies.

The current account deficit narrowed substantially in 2017 and 2018, mostly reflecting stronger terms of trade and a ramp-up in new resource exports including liquified natural gas. As in the 2017 External Balance Assessment, the preliminary mid-point estimate of the current account gap in 2018 is -1.0 percent of GDP, suggesting that the current account deficit has remained broadly in line with fundamentals and desirable policies (Annex I). After substantial real depreciation so far in 2018, driven in part by a widening interest differential in favor of the U.S. dollar, the picture has been less clear-cut for the exchange rate, as some estimates of the related gaps suggest continued overvaluation. Given current policies, the current account deficit is projected to remain within 2½-3 percent of GDP over the medium term, lower than the historical average.

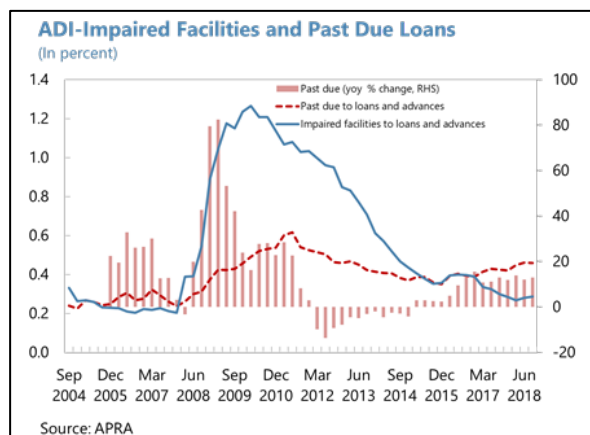


6. The housing market has been cooling. House prices, after rising by 70 percent in the past decade at the national level and by roughly 100 percent in Sydney and 90 percent in Melbourne, have started to decline. A cooling market momentum has also been evident in a lower turnover of the housing stock and lower public auction clearance rates. Several factors have contributed to the cooling, including tightening credit supply, an increase in the housing supply coming to the market, and easing domestic and foreign demand. Nevertheless, rental vacancy rates have remained stable

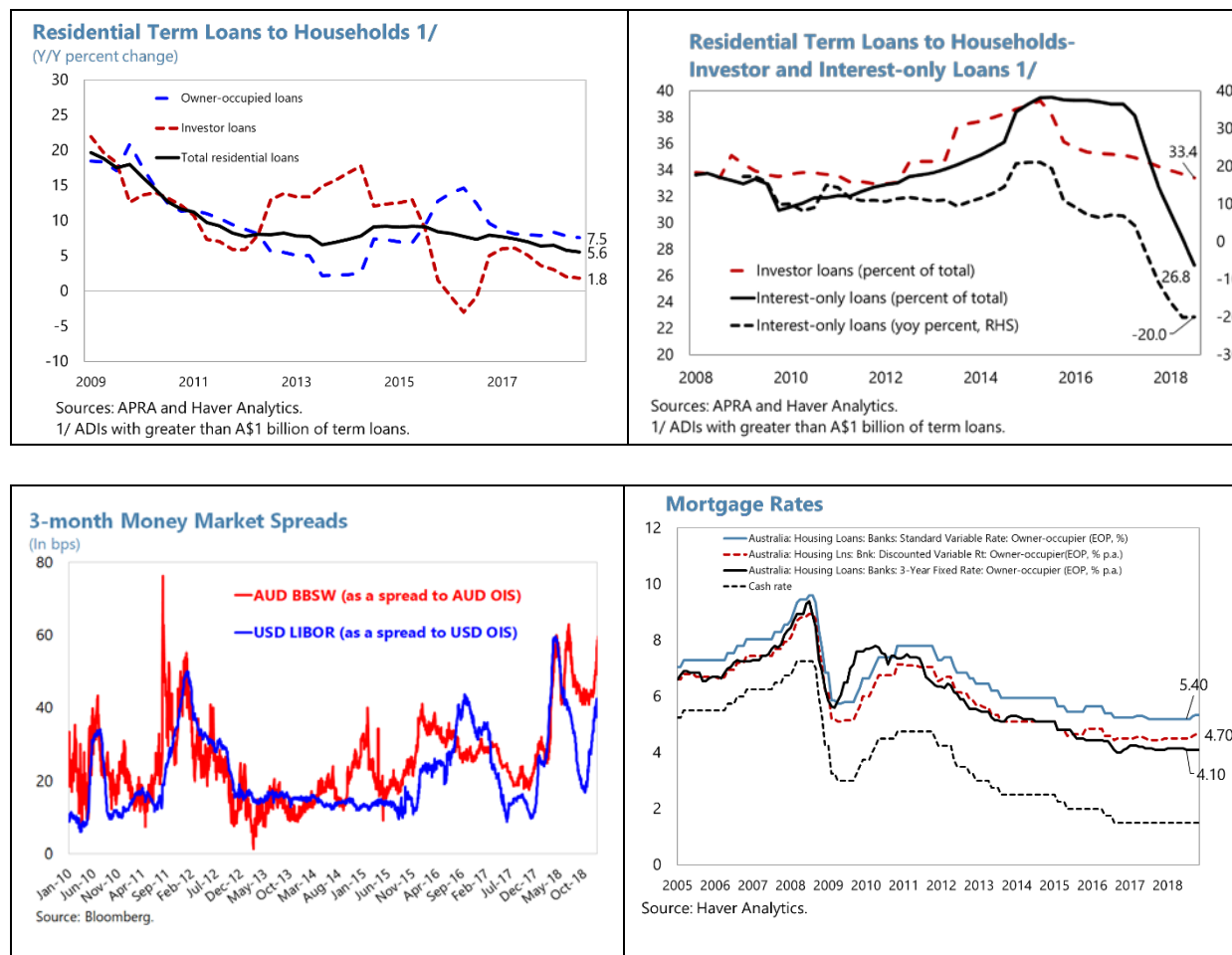
or declined in the smaller capital cities, while the increased supply of new dwellings available for rent has been absorbed by strong population growth. Residential investment growth has picked up in the first three quarters of 2018, and the pipeline of pending residential construction has remained strong, as has the completion rate of new apartment buildings with significant shares of presales.



7. The mortgage credit cycle peaked in mid-2015, and interest rates appear to have bottomed out. Annual housing credit growth slowed to 5 percent in October 2018. Growth in lending to investors has been much lower following prudential measures to curb riskier mortgages (especially interest-only loans) in April 2017. Banks have reportedly further tightened their lending standards in response to evidence of misconduct emerging from the *Royal Commission into Misconduct in the Banking, Superannuation, and Financial Services Industry* and asset quality risks associated with a cooling housing market. Following a small but sustained increase in wholesale funding costs reflecting in part spillovers from U.S. monetary policy normalization, three of the major banks raised mortgage rates by 14-16 basis points in September and October 2018. However, the interest rates for new mortgages have remained lower than those of existing mortgages, reportedly because of increased competition among banks for high credit-quality borrowers. Housing loan delinquencies have been trending up, albeit remaining at low levels.



8. Australian banks are well capitalized and profitable. Following the requirement for capital to be “unquestionably strong,” banks’ capital levels are high in relation to international comparators. Banks’ dependency on wholesale funding has been reduced but remains substantial at about one-third of total liabilities, of which two-thirds are from external sources.



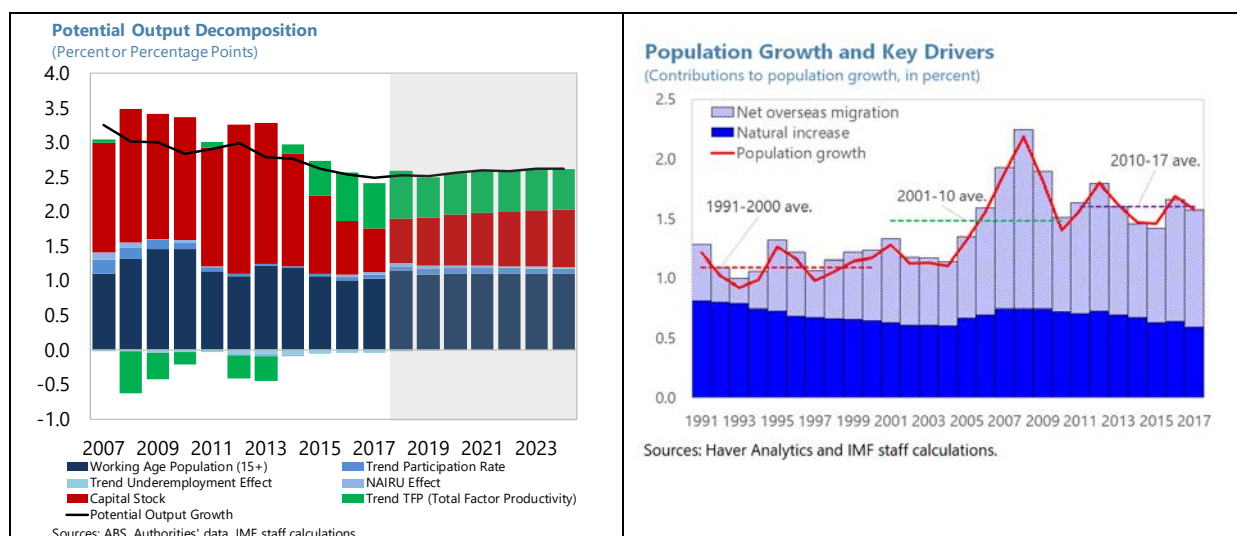
B. Outlook

9. The economy is expected to adjust toward potential growth, full employment, and inflation well within the target range, but the process will be gradual.

- Growth should gradually moderate to that of potential output.** The rebound in non-mining private business investment and public infrastructure spending, as suggested by a strong pipeline of capital projects, is projected to offset the expected contraction in dwelling investment in the near term. Mining investment is projected to increase at a rate consistent with capital stock maintenance, removing a major drag on domestic demand growth. Private consumption growth is predicted to remain close to potential output growth, supported by employment gains and gradual wage increases but tempered by pressures from debt reduction and higher saving rates, given tightening lending standards and conditions. Net exports will contribute less to growth, reflecting drought-related supply declines, the end of the ramp-up in liquified natural gas (LNG) exports, and lower growth in China and the global economy. Macroeconomic policies are assumed to adjust, with growth moderating towards that of potential output in the medium term.

- **Inflation is forecast to return to the midpoint of the target range over the next two to three years.** With growth above or close to potential, the output and unemployment gaps will be closing and underemployment will decline, leading to upward pressure on wages and prices. In the near term, disinflationary effects from continued strong retail competition and the recent one-off declines in some administered prices will weigh on inflation.
- **The housing market correction should be mild and short-lived.** The correction is assumed to continue over the next year or so, with some contraction in dwelling investment and further price declines, as in previous episodes (Box 2). In the context of continued strong growth and improving labor markets, the negative feedback effects on banks’ asset quality and the real economy (including through wealth effects) should remain modest. At the same time, the underlying demand for housing should hold up because of robust population growth, which should eventually lead the way for a house price rebound. The negative credit supply shock is also expected to ease, as banks have already responded with stricter enforcement of existing lending standards in anticipation of the recommendations from the banking royal commission due in February 2019. With this correction, house price overvaluation should decrease, while household debt ratios should stabilize and then decline.

10. After declining over the past decade, potential output growth is forecast to stabilize at 2.6 percent in the medium term. Productivity has recovered somewhat, even with diminishing capital deepening since the end of the mining investment boom. Trend total factor productivity (TFP) is assumed to remain broadly stable, with a small increase over the projection period on account of increased infrastructure investment and higher spending on research and development (R&D). Labor input is projected to grow steadily, as immigration is assumed to maintain population growth and there is scope for higher labor force participation by female and older populations.



C. Risks

11. Downside risks to economic growth have increased with a less favorable global risk picture, the housing market downturn, and uncertainties about domestic demand (Annex II).

- **On the external side**, given Australia's reliance on exports to China—coal, iron ore, tourism, and education services—it is particularly exposed to the downside risks from the ongoing trade tensions between China and the United States, and China's economic rebalancing, potentially reinforcing each other.¹ These risks could delay the closure of the output gap, although there are also upside risks to the terms of trade in the near term. A sharp tightening of global financial conditions could spill over into internationally integrated domestic financial markets, raising funding costs in the economy and lowering disposable income of debtors, with the impact also depending on the response of the Australian dollar.
- **On the domestic side**, the housing market correction may be deeper and longer than anticipated, especially if banks are overly cautious in extending credit. While households' incomes are relatively resilient to smaller interest rate increases, larger negative shocks, domestic and external alike, would likely interact with and amplify the housing correction. Domestic demand would also turn out weaker if wage growth remained subdued or investment spillovers were smaller. On the other hand, a stronger pickup in the non-mining business sector, larger spillovers from public infrastructure investment, and the Australian dollar depreciation over the past year could boost near-term growth more than projected. Over the medium term, potential output growth could either be lower if TFP weakens as elsewhere or higher with effective structural reforms.

Estimated Impact of Interest Rate Changes on Household and Housing Debt				
	Household Debt		Housing Debt	
	Baseline Dec-17	Alternate 1/	Baseline Dec-17	Alternate 1/
Interest payment (quarterly, A\$bil)	28,034	33,941	22,823	27,253
Implicit interest rates (percent)	4.7	5.7	5.2	6.2
DSTI (interest payment only, quarterly, percent)	8.9	10.7	7.2	8.6

Sources: RBA, ABS, and IMF staff calculations.
1/ Alternate scenario assumes a 1 percentage point increase in interest rates.

¹ The significant role of trade linkages between Australia and China were examined in Karam and Muir, 2018, "Australia's Linkages with China: Prospects and Ramifications of China's Economic Transition", in *Australia: Selected Issues*, IMF Country Report No. 18/45 (also available as IMF Working Paper 18/119).

D. Authorities' Views on Outlook and Risks

12. The authorities expected near-term growth to remain around 3 percent, a little above estimates of potential growth. Solid growth in employment, corporate profits, and public demand would support household incomes, consumption, and business investment in a low interest rate environment. By 2020, housing investment was expected to slow and LNG exports were expected to reach capacity. Remaining slack in the labor market would diminish steadily, with the unemployment rate expected to decline further. Nonetheless, the pickup in wage growth and inflation was expected to be gradual, given remaining labor market slack and continued increasing competition in the retail sector.

13. The authorities emphasized that the correction in the housing market has been orderly, in the context of a strong economy. The declines in house prices, particularly in Sydney and Melbourne, must be seen against the large price increases previously. The correction was taking place in a strong economy, including low unemployment, and few pockets of excess housing supply.

14. Downside risks from the housing market correction are a concern. Officials noted that these risks include an excessive moderation in credit flows, possibly from banks overreacting to the banking royal commission and the housing correction, unexpected strong caution by market participants in response to the correction, or from the interaction with other negative surprises shocks in the context of high levels of household debt. The authorities expected the impact of the housing correction on consumption through wealth effects to be small, but highlighted uncertainty around prospects for private consumption, given continued low wage growth amid household debt.

15. The authorities agreed that downside risks to economic growth had increased with a less favorable global risk picture. While the impact of US-China trade tensions on the Australian economy had been muted so far, partly because of policy stimulus in China, their escalation could weaken global growth and economic activity in Australia, particularly through commodity market and services trade channels. A sharp tightening of global financial conditions could spill over into domestic financial markets, raising funding costs and lowering disposable income of debtors. The impact would be mitigated by exchange rate flexibility, with the Australian dollar typically depreciating in those circumstances.

MACROECONOMIC POLICIES

Context

16. The monetary policy rate has been on hold at 1.5 percent since August 2016. The monetary policy stance is accommodative, with the current cash rate setting implying a slightly negative real policy rate relative to estimates of the real neutral interest rate in the range of 1-2 percent. Financial conditions have remained broadly unchanged in 2018, while a small steepening of the domestic short-term yield curve has been broadly offset by the depreciation of the Australian dollar. The RBA has recently signaled that the next move in the cash rate will likely be an increase,

but that the currently accommodative policy stance will be needed for some time, given weak inflation.

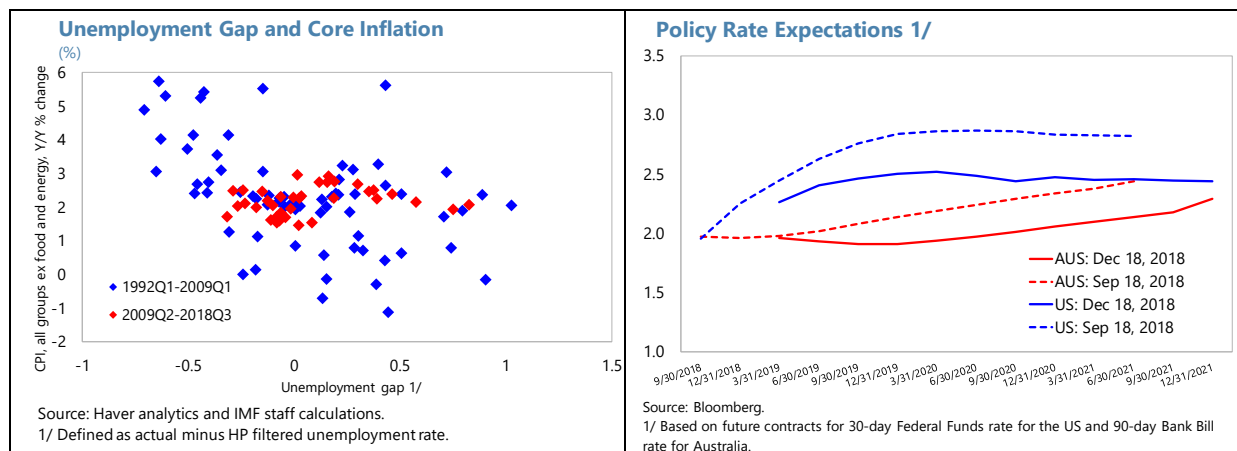
17. The fiscal policy stance has remained supportive. General government expenditure has grown faster than potential output since 2016, partly owing to an infrastructure investment boost. Nevertheless, the Commonwealth and general government budget deficits have narrowed, primarily reflecting strong revenue growth with the economy's improving cyclical position, stronger terms of trade, and, until recently, the housing boom. With stronger revenue collection in the current fiscal year, the Commonwealth's Mid-Year Economic and Fiscal Outlook (MYEFO) of December 2018 incorporated higher spending on education, health care, and aged care, with some matching at the state level, as well as increased infrastructure spending.

Staff's Views

18. Continued macroeconomic policy support is essential for completing the economic rebalancing after the end of the mining investment boom. While the unemployment rate is approaching NAIRU, labor market slack is likely to be larger than indicated by the implied cyclical unemployment rate. Relatively high underemployment corroborates this view, consistent with a greater role of adjustment along the hours-worked dimension in this recovery. At the same time, labor force participation has been increasing, especially for females and older workers, groups which tend to have stronger responses to cyclical changes in labor market conditions (Box 1). Cyclical upward pressure on wages will likely emerge only with a substantial and uncertain lag once full employment is reached. At the same time, the infrastructure investment boost has been a catalyst for the economic rebalancing, with continued uncertainty about whether the nascent rebound in private business investment is strong enough to offset the drag from balance sheets constraints on private consumption and an expected decline in residential investment.

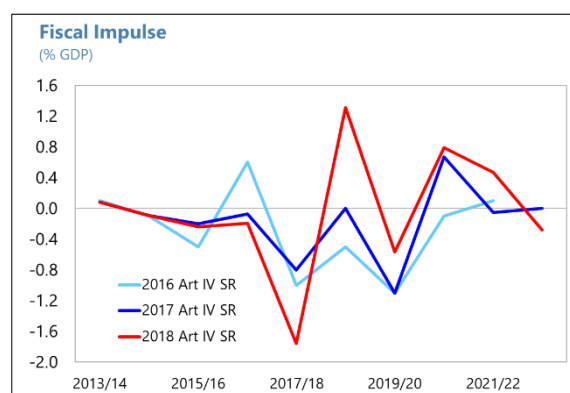
19. The monetary policy stance should be accommodative until evidence of more substantive upward pressures on wages and prices emerges. Staff concurs with the RBA that the policy stance is sufficiently accommodative for inflation to return gradually to the 2-3 percent target range. A tightening bias is premature at this point, given the labor market slack and downside risks to the near-term outlook and inflation. With unusually persistent inflation undershooting and continued uncertainty about the timing and magnitude of cyclical upward pressures on prices, the monetary policy stance needs to emphasize commitment to the inflation targets and clear guidance on when labor market conditions will merit policy normalization. With the recent increase in the share of households with high debt in Australia, normalization would likely have to be gradual.² In these circumstances, the cash flow channel (through the impact of interest payments on households' disposable income) will likely be relatively more important in the transmission of monetary policy, which, everything else equal, should also increase its effectiveness.

² Loukoianova, E., Y. Wong, and I. Hussiada, 2019, "Riskiness of the Household Debt in Australia and Its Impact on Monetary Policy," IMF Working Paper, forthcoming.



20. The infrastructure investment boost has provided welcome aggregate demand support.

With further increases in spending envelopes, real expenditure growth is projected to remain above that of potential output in 2019, owing to continued high growth in public investment. Australia has substantial fiscal space and could, therefore, consider further increases in infrastructure spending. At the same time, capacity constraints appear to have held back implementation. The appropriate sequencing of projects between levels of government and regions, especially Melbourne and Sydney, will thus remain important in ensuring a steady growth impetus from the infrastructure investment program in the near term.



21. The government’s medium-term fiscal strategy appropriately aims to reach a balanced budget by FY2019/20 and run budget surpluses thereafter. This fiscal path is predicated on a further cyclical revenue recovery and would still be consistent with the Commonwealth and state governments continuing to run ambitious infrastructure investment programs and structural reforms in support of higher growth under the baseline outlook. The principle of running budget surpluses in good times has been a core element of the medium-term fiscal strategies under Australia’s fiscal framework. This principle has helped in preserving fiscal discipline. Looking forward, the projected surpluses under the baseline outlook should not be cut short prematurely through permanent tax cuts or increases in current spending. Some of the recent revenue strength may well turn out to be more temporary than expected. In this respect, a rigid interpretation of the cap on Commonwealth tax revenue of 23.9 percent of GDP formalized in the FY2018/19 budget might not be consistent with the principle of running sustained budget surpluses in good times.

22. A role for medium-term debt anchors could be considered as a complementary element in medium-term fiscal strategies. As Australia’s recent experience demonstrates, there can be considerable upward drift in debt ratios from shocks with protracted effects, a medium-term budget balance anchor notwithstanding. While Australia has substantial fiscal space and current

debt levels are still relatively low, the drift might make meeting the principle of low debt levels set out in the *Charter of Budget Honesty Act* more challenging over the medium term. In the context of increased downside risks to the outlook and an environment in which discretionary fiscal stimulus might be needed more frequently, and given the limited conventional monetary policy space, some role for a debt anchor in the medium-term fiscal strategy might be considered. Options include the occasional resetting of the budget balance anchor based on recent debt developments or replacing the budget balance anchor with a debt anchor, with flexibility over the economic cycle.³

23. If downside risks to the economic growth outlook materialize, macroeconomic policy responses will need to be flexible. Monetary policy has been the primary policy tool for macroeconomic stabilization, while the fiscal policy response has been to let automatic stabilizers play out. But with more limited conventional monetary policy space, a fiscal stimulus would likely need to be a part of an effective overall policy response if major downside risks were to materialize. Australia's substantial fiscal space allows for fiscal policy to respond as necessary.

Authorities' Views

24. The RBA expected to keep the policy rate on hold in the near term given its forecast of gradual progress in meeting its dual employment and inflation objectives. A pickup in wage growth was likely to be necessary for inflation to be sustainably within the target range. RBA officials noted that this would require an economy that has been in full employment for some time, but also emphasized the considerable uncertainty around these developments. Private consumption in an environment of high household debt and housing price declines was another source of uncertainty. Officials also noted that mortgage lending rates remained low in general and for high quality new mortgage loans in particular, despite some increases in bank funding costs on the back of higher money market rates.

25. The government highlighted the stronger budget outturn and the earlier return to budget surpluses by the Commonwealth. The Commonwealth government expects a return to budget surpluses as of FY2019/20. The FY2018/19 budget already incorporated an improved fiscal outlook, which provided the space to cancel the 2019 increase in the Medicare levy put in place last year and to cut PIT for middle and lower income households over the next seven years. The government also formalized a speed limit on tax collection, which should remain below 23.9 percent of GDP, the average in the 2000s before the GFC. The FY2018/19 MYEFO showed a further improvement in the underlying cash balance of A\$15.0 billion over the four years to FY2021/22. This budget balance path will enhance Australia's fiscal space and allow for a flexible policy response in case of a downturn.

26. The infrastructure push will continue. Revenue and spending outcomes for the states have been better than expected as well, with most states intending to increase infrastructure spending further, and run surpluses if possible. Both levels of government are concerned about risks

³ These issues are discussed further in the accompanying Selected Issues Paper, Muir, 2019, "Evaluating and Reinforcing the Commonwealth of Australia's Fiscal Strategy."

of capacity constraints slowing the pace and increasing the cost of the ongoing infrastructure push. New South Wales and Victoria are already discussing how to coordinate schedules to help address these risks.

27. The authorities agreed that a severe negative shock might require a combined monetary and fiscal policy response. With the nominal policy rate at 1.5 percent, the RBA still has space for further rate reductions, although the effective lower bound on nominal policy rates would more likely be a constraint. Officials emphasized, however, that the policy response would depend on the nature of the shock. If the latter were country-specific, for example, the Australian dollar would likely depreciate in real effective terms, raising expected inflation and nominal interest rates, everything else equal. As for unconventional monetary policy responses, there were several options for the RBA to use its balance sheet within the current institutional and legal framework.

MACROFINANCIAL POLICIES⁴

Context

28. The authorities have pursued a two-track approach to manage structural financial vulnerabilities. This approach distinguishes between issues related to the asset and the liability side of bank balance sheets.

- ***The regulatory emphasis on banks applying strong lending standards remains, but caps limiting investor and interest-only lending were removed by end-2018.*** Prudential interventions introduced by the Australian Prudential Regulation Authority (APRA) sought to lower systemic risks from rapid household credit growth and already high debt levels at the outset of the recent housing boom (Annex IV). Besides stronger lending standards, the interventions have also limited higher-risk investor and interest-only lending through caps (“benchmarks”). More recently, APRA removed the caps restricting a bank’s annual investor lending growth to 10 percent (effective as of July 1, 2018) and its interest-only lending to 30 percent of new loans (effective as of January 1, 2019). The removals were motivated by the measures having reached their goals. Implementation has been bank-specific, conditional on a bank’s assurances to APRA with respect to the strength of its lending standards.
- ***The capital adequacy framework for banks was further refined in 2018.*** Since the GFC, APRA has raised capital adequacy requirements in several steps and introduced tighter liquidity requirements, including a net stable funding ratio in line with Basel III requirements. In 2018, APRA established a framework and timeline for introducing a minimum leverage ratio for Australian banks and proposed changes to the capital adequacy framework to increase banks’ loss absorbing capacity.

29. FSAP stress test results found banks’ solvency and liquidity to be relatively resilient to stress, but the tests also highlight banks’ continued vulnerability to external funding shocks.

⁴ The *Financial System Stability Assessment* prepared by the FSAP mission is presented in Country Report No. 19/xx.

The tests examined the resilience of the ten largest banks in Australia to a combined shock involving a significant slowdown in China, a sharp correction in real estate valuation, and marked tightening of global financial conditions. While the tests revealed some pressure on capital, the banks examined would still be meeting regulatory minima. Liquidity stress tests revealed some vulnerabilities to severe stress given continued reliance on wholesale funding. Cross-border analysis revealed banks' exposure to potential credit and funding shocks from several advanced countries, notably the United Kingdom and the United States, the regional financial centers of Singapore and Hong Kong SAR, as well as from parent-subsidiary linkages with New Zealand.

30. AUSTRAC has taken several steps to strengthen its AML/CFT supervision. These include increasing its focus on institutions' inherent ML/TF risks and prioritizing higher risk institutions. Initial work has also been undertaken to bring designated non-financial businesses and professions (DNFBPs) under the AML/CFT regime. There is however scope to increase the number of onsite inspections and further improve the sanctioning regime.

Staff's Views

31. Financial vulnerabilities from household debt and house price overvaluation will stay elevated. Under the orderly correction in the baseline scenario, house price overvaluation diminishes and average household debt ratios decline over time. Even so, household debt ratios will remain high over the next few years, as will related vulnerabilities. While lower shares of higher-risk household debt (e.g., interest-only mortgages or high LTV mortgages) should have lowered aggregate default probabilities on household liabilities held by banks, those probabilities are also related to debt levels, debt distribution, and the value of assets at risks. At the same time, the amplification of the economic impact of shocks through household debt channels and the possibility of adverse feedback loops between real estate values, bank credit, and economic activity remain a concern.

32. Against such vulnerabilities, macroprudential policy should hold the course on implementation of stricter lending standards. The prudential caps restricting investor loans and interest-only mortgages have contributed to slowing household credit growth and cooling the housing market. With the end of the housing boom, the benchmark on investor lending growth had not been binding prior to its removal, and investor loan growth has moderated further since. The removal of the cap on interest-only mortgages will provide more flexibility in the pace of conversions of interest-only loans to principal-and-interest loans, which would have been concentrated over the next three years with the benchmark still in place. The recent declines in the share of interest-only loans is a welcome development and should be maintained. Borrowers of interest-only loans are more exposed to adverse shocks given the higher balances they face over the life of the mortgage. If the lending standard assurances required for the removal of the caps prove insufficient in maintaining a lower share of interest-only loans, the authorities should stand ready to reintroduce caps on such loans.

33. The readiness of an extended macroprudential toolkit should be explored. The prudential measures used by APRA in the recent housing and credit boom have dampened growth

in high-risk lending and reinforced sound lending practices. A further tightening is not warranted at this point in the cycle. Nevertheless, given the prospect of interest rates remaining low and household debt ratios remaining high for some time, and expectations of continued strong growth in housing demand, the authorities should prepare for a possibility of another house price boom or increased macrofinancial vulnerabilities for other reasons. Having a broad macroprudential toolkit ready for deployment would provide for a flexible and targeted response to systemic risks that could emerge. An extended toolkit relative to measures used recently could include borrower-based restrictions, such as loan-to-value caps, income-based ratios, such as limits on loan (or debt)-to-income, as well as refined debt-serviceability requirements. Readiness would require that data, legal, and regulatory requirements have been addressed.

34. The Australian authorities have developed a robust regulatory framework, but further reinforcement in two broad domains would be beneficial:

- **The systemic risk oversight of the financial sector could be strengthened.** The parallel 2018 Financial Sector Assessment Program (FSAP) recommends buttressing the financial stability framework by strengthening the transparency of the work of the Council of Financial Regulators (CFR) on the identification of systemic risks and actions taken to mitigate them. Improving the granularity and consistency of data collection and provision would support the analysis of systemic risks and policy formulation.
- **Financial supervision and financial crisis management arrangements should be further bolstered.** The FSAP's specific recommendations include increasing the independence and budgetary autonomy of the regulatory agencies, strengthening the supervisory approach, particularly in the areas of governance, risk management, and conduct, and enhancing the stress testing framework for solvency, liquidity, and contagion risks. The FSAP also recommends strengthening the integration of systemic risk analysis and stress testing into supervisory processes, completing the resolution policy framework, and expediting the development of bank-specific resolution plans. Recent announcements of additional funding for the regulatory agencies are welcome (Annex V).

35. There is scope for further improvements to the AML/CFT regime ahead of the next FATF assessment planned for 2020. AUSTRAC should increase its supervisory resources and the number on onsite inspections, further strengthen the effectiveness of its sanctions regime, and expand the AML/CFT regime to cover all DNFBPs starting with trust and company service providers, lawyers and real estate professionals as they have been assessed as presenting higher ML/TF risk.

Authorities' Views

36. The authorities noted that stricter enforcement of conduct and regulatory standards is already underway but voiced concerns about an excessive moderation in credit flows. They underscored that Australian banks remain strongly capitalized, have considerable liquidity buffers and on the whole manage credit risk effectively by global standards. Despite incidents of misconduct identified by the banking royal commission, non-performing loan ratios have been low.

Officials also highlighted that lending and governance standards for banks have already been tightened and that the main challenge now is enforcement. While banks need to comply with standards and take responsible loan decisions, they should not be unduly constrained in taking and managing responsible risk.

37. The authorities are in broad agreement with the thrust of the FSAP’s findings and recommendations. The CFR is taking steps to enhance the transparency of its operations. It recently released its first quarterly statement following its December meeting. The statements will outline the main issues discussed at each CFR meeting. The authorities took note of shortfalls in the granularity and consistency of data to support the analysis of supervisory and systemic risks and the formulation of policy. The recommendation on the need for additional investment in data and in analytical tools will be useful in bringing about the change.

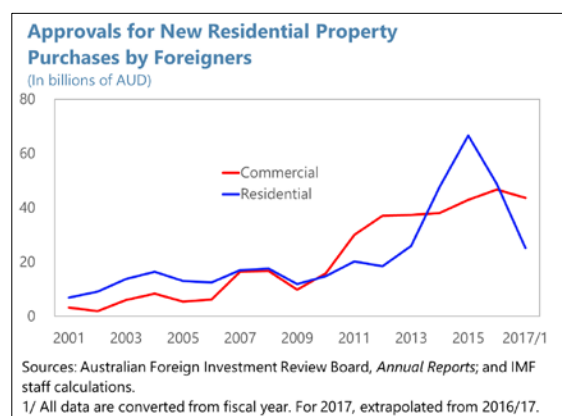
HOUSING MARKETS AND POLICIES

Context

38. The housing market correction is helping housing affordability. Foreign and domestic investor demand has moderated, thereby enhancing opportunities for first-time home buyers and purchases by owner-occupiers more broadly. On the supply side, progress has been made in using City Deals, agreements across all levels of government that integrate planning and infrastructure delivery for new developments and redevelopments. A prominent example—the City Deal for western Sydney—encompasses the development of the urban area around the new airport. Two states (Western Australia and Tasmania) introduced or announced housing-related tax policy measures discriminating between residents and non-residents since the last Article IV Consultation.⁵

Staff’s Views

39. Housing supply reforms will remain critical to restoring housing affordability. While the housing market correction will help, it is unlikely to be sufficient for inclusive, broad-based affordability and growth. The underlying demand for housing is widely expected to remain strong with a robust economic growth outlook for and high population growth in urban areas. At the same time, broad affordability will also be a precondition



⁵ Western Australia announced in its FY2017/18 budget a foreign purchaser duty (stamp duty) surcharge of 4 percent on residential property acquired by foreign individuals, corporations, and trusts to be introduced on January 1, 2019. The FY2018/19 budget increased the rate to 7 percent. Tasmania announced in its FY2018/19 budget a foreign purchaser duty surcharge of 3 percent on residential property acquired by foreign residents with an additional 0.5 percent of the dutiable value for all purchases of primary production land by foreign residents, effective July 1, 2018. These measures would be assessed as capital flow management measures (CFMs) under the IMF’s Institutional View on Capital Flows, as are the existing foreign purchaser duty surcharges imposed by all other states (See also *Australia: Article IV Consultation*, IMF Country Report No. 18/44, p.15).

for a significant reduction in related macro-financial vulnerabilities. As planning, zoning, and other reforms affect supply and prices with long lags, housing supply reforms should, therefore, not be delayed because of the housing market correction. City Deals are a useful catalyst for the large-scale development or redevelopment of urban areas. Nevertheless, this instrument has limited reach, although the Regional Deals envisaged by the government would provide for a welcome extension. Some states should still take the opportunity for further streamlining and consolidation in planning and zoning regulation.

40. Broader tax reforms that also address housing and land use would reinforce the impact of supply-side measures. Stamp duties should be replaced by broader land taxes, which would strengthen incentives for efficient land use. Within the context of a broader tax reform, gradual lowering of capital gains discounts and limits on negative gearing for investors would reduce structural incentives for leveraged investment by households, including in residential real estate. A more limited capital gains tax exemption for owner-occupiers should also be considered.

41. The housing policy measures discriminating nonresident buyers should be reconsidered. As the role of foreign buyers in residential real estate markets has started to decline, the discriminatory measures should be reconsidered, as they may no longer be needed to address housing market imbalances. They should be replaced by alternative and effective non-discriminatory measures where possible (e.g., a general surcharge on all vacant property).

Authorities' Views

42. The state governments of New South Wales and Victoria noted that the fall in housing prices in Sydney and Melbourne was larger than originally projected in their budgets.

Nevertheless, despite their limited progress on zoning and planning reform to reduce impediments to housing supply and affordability, they expected house prices to find support from both housing demand and supply factors. The authorities highlighted that City Deals could be important tools to foster urban housing supply. City Deals have allowed all levels of government to coordinate planning and construction decisions, thereby facilitating infrastructure provision which can in turn support housing supply expansion. Deals agreed on or announced in 2018 included Darwin, Geelong, Hobart, and Perth. There are also plans underway to pilot Regional Deals outside of the major urban areas.

FOSTERING GROWTH

Context

43. The government's structural policy agenda targets areas identified by the Productivity Commission and the OECD. Australia's multifactor productivity growth increased over the past few years but remains below that of some peers. Recent policy efforts have focused on addressing infrastructure gaps, strengthening innovation and R&D capacity, reducing the gender gap in labor force participation, and lowering corporate and personal income tax rates. The government has also

implemented a strategy to reduce gender gaps in labor force participation and representation in senior positions, with the goal of lifting potential output.

44. Some tax policy and revenue sharing reforms have been passed. Personal income tax (PIT) cuts were announced in the FY2018/19 budget and approved by Parliament. The cuts will be phased in over seven years, starting this fiscal year, improving the progressivity of the system and favoring lower income groups.⁶ The proposed company tax reform, which sought to reduce the statutory corporate income tax (CIT) rate gradually from 30 to 25 percent for all companies, has been implemented only partially. The rate reduction to 25 percent by FY2021/22 was legislated for small companies with a turnover below A\$50 million, while a reduction in the CIT rate for larger companies was defeated in the Senate. Horizontal fiscal equalization (HFE) reform was also completed in November 2018, by revising the redistribution mechanism of goods and services tax (GST) revenue to states, which offsets differences in revenue raising capacity and costs of delivering services.

45. Energy policy has come to the forefront with recent increases in energy price volatility. With the opening of domestic natural gas markets to international trade (through LNG production) and closure of coal-based energy sources and exacerbated by difficulties in the distribution network (network reliability issues, lack of storage for some renewable sources, such as solar and wind power), energy prices soared in 2017. The higher prices also highlighted potential inconsistencies between state-level and Commonwealth renewable energy targets (RETs). These developments motivated the 2017 *Independent Review into the Future Security of the National Electricity Market* (the “Finkel review”), which led to reforms, including new and reform of existing energy institutions, involving both the Commonwealth and states. These reforms appear to have contributed to reducing electricity prices in 2018. Nevertheless, there is no agreement yet on nationally integrated policies needed to meet Australia’s commitment to reducing greenhouse gas emissions under the Paris Agreement.

Staff’s Views

46. Closing macro-critical gaps for infrastructure, gender equality, R&D, energy policy, and general tax reform should strengthen productivity growth. Progress has been made in all five areas in recent years and are currently being addressed by the authorities. The infrastructure gap, while a large contributor for stronger productivity growth, already has a stronger baseline position than the other areas. The government implementation for its gender equality strategy continues, as female participation rates continue to rise (Box 1). Staff sees scope for additional measures for the other three areas to stimulate productivity growth, by expanding R&D measures, undertaking broad tax reform, and ensuring an integrated national energy policy.

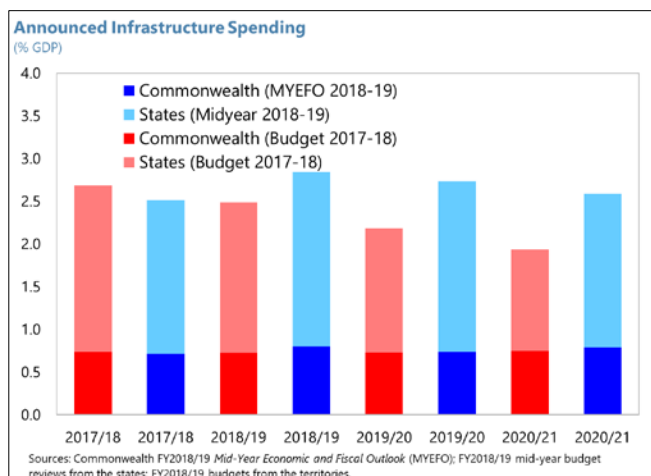
⁶ A more complete analysis can be found in Commonwealth of Australia, 2018, *Budget 2018-19 Budget Strategy and Outlook Budget Paper No. 1*, pp.1-12-1-15.

47. There is scope to further expand infrastructure spending to stimulate productivity.

Australia is a relatively fast-growing economy supported by high population growth, and its infrastructure needs have also been increasing rapidly. The country has a notable infrastructure gap compared to other advanced economies, the closing of which could raise GDP by about one percent in the medium term.⁷ In the last round of budgets, the

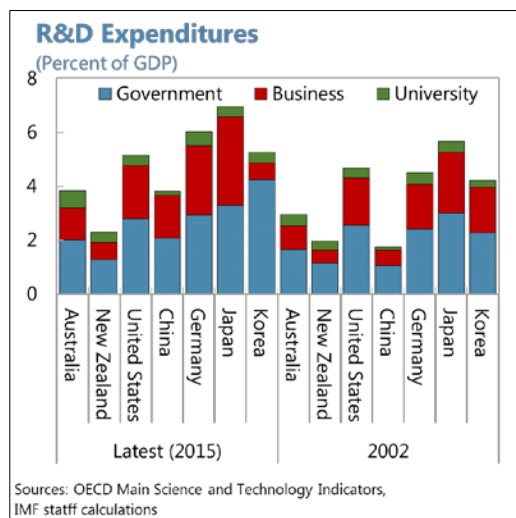
Commonwealth and state governments expanded infrastructure spending planned

over the coming years. There is an average forecasted annual infrastructure gap of roughly 0.35 percent of GDP through 2040 for basic infrastructure (roads, rail, water, ports), and an additional gap in social infrastructure (schools, hospitals, prisons), likely of a lesser magnitude.⁸ The latest budget spending has greatly reduced the gaps in the near term, but there is scope to go further. Planning for additional spending should be expedited, as infrastructure projects require long-term planning and zoning. Gaps may also be opening faster than expected, given the greater-than-expected rapid population growth in Sydney and Melbourne.



48. Further reforms to encourage innovation would reinforce progress made to date.

Spending on R&D has increased in Australia over the past decade. While the main phase of National Innovation and Science Agenda (NISA) is ending in FY2018/19, funding for new research infrastructure over the next 12 years has been increased by A\$1.9 billion. There has been R&D tax credit reform, focused on reducing potential abuses of the current system by larger firms. Instead of focusing only on reducing costs, providing larger tax credits and incentives to further benefit young firms (usually SMEs), perhaps targeted to specific sectors, could also be implemented.⁹ Further work on innovation in the education sector would be welcome along the lines of the *Australia 2030*:



⁷ See *Australia: Article IV Consultation*, IMF Country Report No. 18/44 and Muir, "Infrastructure Investment in Australia: Gaps and Multiplier Effects," *Australia: Selected Issues*, IMF Country Report No. 18/45.

⁸ See Muir (2018), cited in the previous footnote.

⁹ Other options exist and are laid out in "Chapter 2. Fiscal Policies for Innovation and Growth" in IMF, 2016, *Fiscal Monitor: Acting Now, Acting Together*, April 2016.

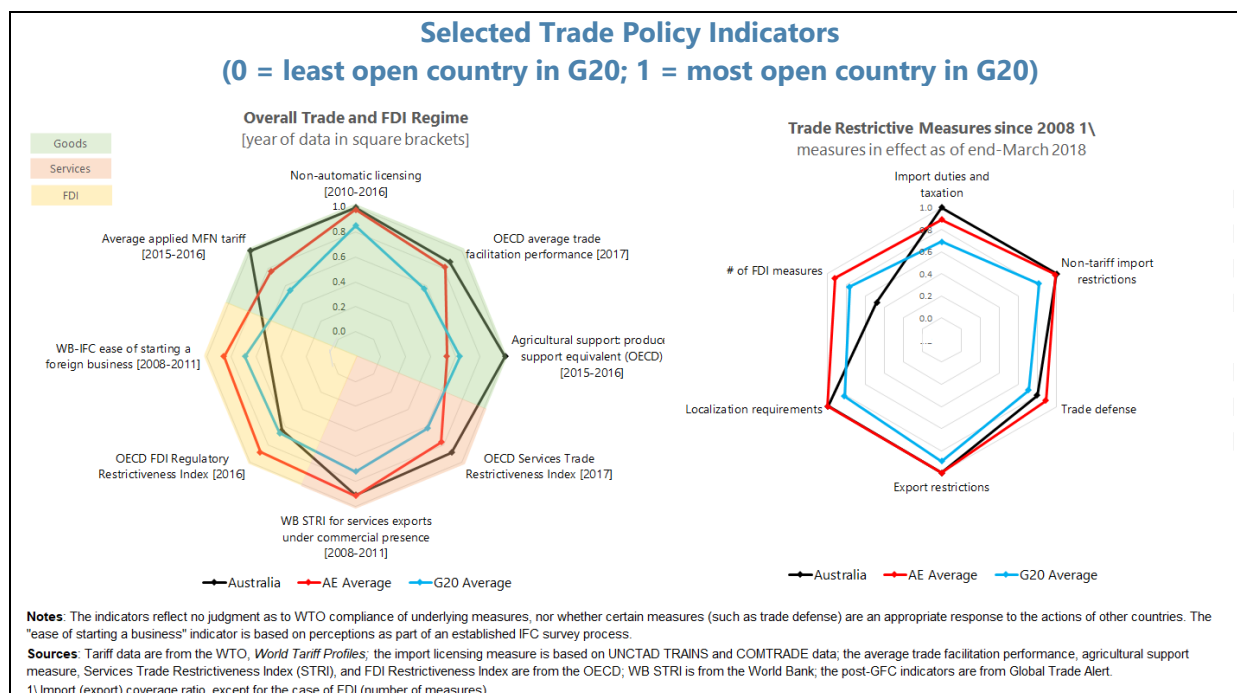
Prosperity through Innovation report, as well as the Productivity Commission's *Shifting the Dial: 5 Year Productivity Review* from 2017.

49. Broad tax reform would support productivity and inclusive growth.¹⁰ The share of direct taxes in Australia's federal tax revenue is higher than the OECD average, partly reflecting relative high effective tax rates in international comparison and shifting from direct to indirect taxes would lower tax distortions and enhance productivity. The Commonwealth government has to date lowered CIT for SMEs and introduced PIT cuts. If these reforms were to be combined with reforms to raise GST revenues and a new attempt to cut CIT for all firms, it could complete the rebalancing of the tax system in a revenue-neutral manner towards indirect taxation. To increase GST revenues, it would be efficient to first broaden the tax base, and then consider the appropriate tax rate to reach the targeted level of revenue. To offset the regressive element from a broader GST coverage, an income-based tax rebate scheme to reduce negative impacts on lower income groups could be included. Such a scheme could be funded in part by a reduction in overly generous tax concessions. Shifting from land transfer stamp duties to a general land tax is also advisable on efficiency grounds.

50. Continued progress on energy policy should further reduce uncertainty for investment decisions. Governments have already made substantial progress on pricing and reliability issues. The clarification in due course of policies to achieve Australia's greenhouse emissions target commitments will also help reduce uncertainty.

51. Staff welcomes the authorities' continued commitment to working actively with international partners to promote the global multilateral trading system. Australia has maintained highly open trade and investment regimes. It has committed to agreements within the WTO, it is completing its accession to the 47-member WTO Government Procurement Agreement, and it has completed domestic ratification of (and is now subject to the commitments under) the WTO Trade Facilitation Agreement. Outside the WTO, Australia has ratified the Comprehensive and Progressive Agreement for the Trans-Pacific Partnership (also known as CPTPP or TPP-11), sending a positive signal in a time of increasing global trade tensions.

¹⁰ See for broad tax reform see Pitt, 2015, "Options for Tax Policy and Federal Fiscal Relations Reform" in *Australia: Selected Issues*, IMF Country Report No. 15/275; for the effects of rebalancing between indirect and direct taxes, see Dizioli, Karam, Muir and Steinlein, 2017, "Australia's Fiscal Framework: Revisiting Options for a Fiscal Anchor," IMF WP/17/286 (originally included in *Australia: Selected Issues*, IMF Country Report No. 17/43).



Authorities' Views

52. The authorities continue to pursue energy reform. The Commonwealth, with the states, has undertaken reforms to the gas market, networks, wholesale and retail electricity markets, and is pursuing further reforms as part of the Australian Consumer and Competition's (ACCC) recommendations to improve competition and reduce electricity prices. Most of the recommendations of the Finkel review have been or will be implemented, including the establishment of the Energy Security Board comprising an independent chair and the heads of all relevant market bodies. The Commonwealth remains committed to reducing carbon emissions by 26 to 28 percent on 2005 levels by 2030 as in the Paris Agreement and is on track to meet its 2020 Kyoto target.

53. Policy reforms to foster innovation have been implemented. Through National Innovation and Science Agenda (NISA), R&D infrastructure has received additional funding. The R&D tax credit regime has been reformed to ensure more efficient and broader use by the private sector. The government is also implementing many of the recommendations from the recently released *2030 Strategic Plan for the Australian Innovation, Science, and Research System*.

54. The authorities agreed with the merit of tax reform but noted the difficult political economy of such reform. Although the Commonwealth government's CIT reform plan was defeated, it successfully passed PIT reform and reforms of the HFE mechanism associated with distributing the GST revenues among the states. Under the reform, from FY2021/22, GST will no longer be distributed to equalize all states' fiscal capacity to that of the state with the strongest fiscal capacity but will transition over six years to equalizing to the fiscal capacity of the stronger of

either New South Wales or Victoria. All states will be better off as a result of the HFE reform, at least until it is revisited in FY2026/27 by the Productivity Commission.

55. The government remains committed to free trade. Besides securing trade agreements with its major trading partners China, Japan and Korea and ratifying the CPTPP, the government continues to pursue negotiations for the Regional Comprehensive Economic Partnership (RCEP) and free trade agreements with other Asian economies such as Indonesia. It supports trade measures by the WTO, as well as initiatives to reform and enhance the effectiveness of the WTO.

STAFF APPRAISAL

56. Australia's economic rebalancing after the end of the mining investment boom advanced further. Economic growth picked up to rates above potential in the first half of 2018, supported by buoyant public demand and solid private consumption, but slowed somewhat in 2018Q3. Labor market conditions also improved, with strong employment growth and declining unemployment, although wage growth remained weak while inflation hovered just below the lower end of the RBA's target range. With the current account deficit shrinking in 2017-18, the external position is broadly consistent with medium-term fundamentals and desired policies.

57. The economy is expected to reach full employment over the next two to three years, but downside risks to the growth outlook have increased. Strong growth in private and public investment should more than offset weaker dwelling investment, as the housing market correction continues. But the recent strong momentum in economic activity will not be sustained, as growth in resource exports will increasingly be constrained by capacity, while modest wage growth, high household debt, and declining house prices will weigh on private consumption growth in the near term. Upward pressures on prices and wages, however, should increase once the economy has been at full employment for some time. The balance of risks is tilted to the downside, with the deterioration in the global risk picture and risks of a deeper housing market correction.

58. Macroeconomic policy support should remain in place until full employment and inflation in the target range are firmly within reach. Domestic demand strength is likely becoming less broad-based in the near term, partly because of the unfolding housing market correction, while net exports will be constrained by resource sector capacity and a weaker global environment. In this situation, the return to full employment and stronger wage and price pressures will remain gradual, with continued risks of inflation remaining below the target range. The infrastructure investment boost will thus be a critical source of demand strength in the near term. With the cash rate at 1.5 percent, monetary policy remains appropriately accommodative, and its normalization should depend on firmer upward pressures on prices.

59. With the economy moving toward full employment, the government's medium-term fiscal plans appropriately target budget surpluses from FY2019/20. The budget has benefited from revenue strength underpinned by progress in the economic rebalancing and stronger-than-expected commodity terms of trade. The principle of running budget surpluses in good times has

been an important anchor of fiscal discipline in Australia. Given considerable uncertainty about how much of the recent revenue surge is cyclical, the expected run of consecutive budget surpluses reflecting the stronger economy should not be stopped through premature permanent tax cuts or expenditure increases. Moreover, with large medium-term swings in net public-debt-to-GDP ratios since the GFC, a complementary role for a debt anchor in Australia's fiscal framework could be considered.

60. With limited conventional monetary policy space, the macroeconomic policy response needs to be flexible if downside risks to growth materialize. Discretionary fiscal stimulus may need to complement monetary easing in economic downturns more frequently than it has in the past. With substantial fiscal space, the effectiveness of the fiscal policy response will depend critically on the readiness for deployment.

61. Managing financial vulnerabilities from high household debt requires macro-prudential policy to hold the course on lending standards. Macroprudential interventions have helped reducing heightened credit risk and reinforcing sound lending standards. With a cooling housing market, household credit growth has moderated, and the need for temporary prudential intervention to manage risks to financial stability has declined. Nevertheless, significant structural financial system vulnerabilities are still present and household debt will remain high, with an orderly housing market correction. Maintaining improved lending standards and further strengthening of banks' resilience through refining the capital adequacy framework will be essential. At the same time, macroprudential policy should focus on expanding and strengthening the toolkit, which will provide for more flexible responses to financial stability risks in the future.

62. The systemic risk oversight of the financial sector could be strengthened. The transparency of the work of the CFR on systemic risks should be strengthened, following FSAP recommendations. Supervision and financial crisis management arrangements should be further improved in several areas, including increased independence and budgetary autonomy of the regulatory agencies, a strengthened supervisory approach, and an enhanced stress testing framework. The authorities should also strengthen the integration of systemic risk analysis and stress testing into supervisory processes, complete the resolution policy framework, and expedite the development of bank-specific resolution plans.

63. Housing supply reforms are critical to restoring housing affordability. The ongoing price correction will help mitigate pressures on affordability. But with the baseline demand outlook for housing still robust and no signs of significant oversupply, meeting the needs of a growing urban population will require strengthening the supply response beyond the current cycle through continued reform. In the context of broader tax reform, changing key tax policy parameters affecting housing demand and land use, including replacing stamp duties with broad-based land taxes, would strengthen the effectiveness of supply-side measures. Housing policy measures discriminating between resident and nonresident buyers should be reconsidered as the role of the latter in residential real estate market has started to decline.

64. The structural policy agenda appropriately targets innovation, infrastructure gaps, tax reform, and energy policy, although progress has been limited in some areas.

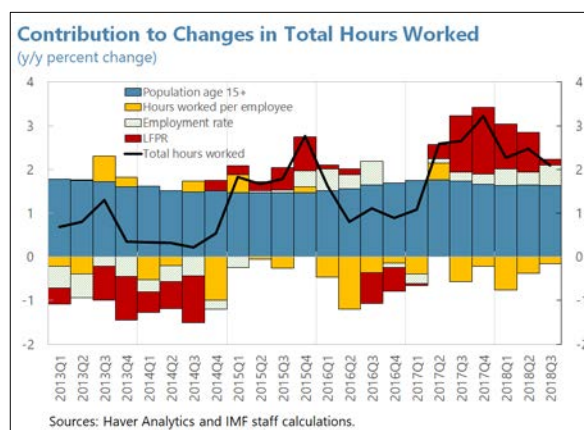
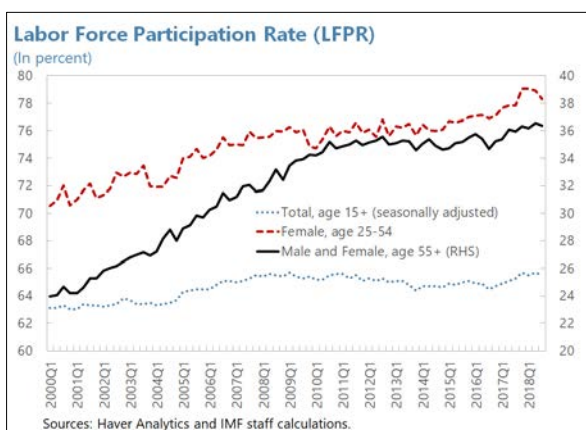
The infrastructure spending envelope could be further increased to close remaining gaps to relieve congestion and maintain existing infrastructure capital. Tax reform would benefit from a broader approach, focusing on a greater role in the tax system for more efficient taxes with stable bases, such as the GST and land taxes, while reducing tax concessions. Clarifying energy and greenhouse gas emissions policies would reduce policy uncertainty and catalyze investment in at least the energy sector, if not more broadly in the economy.

65. It is recommended that the next Article IV consultation be held on the standard 12-month cycle.

Box 1. Implications of Greater Female and Old-Age Labor Force Participation

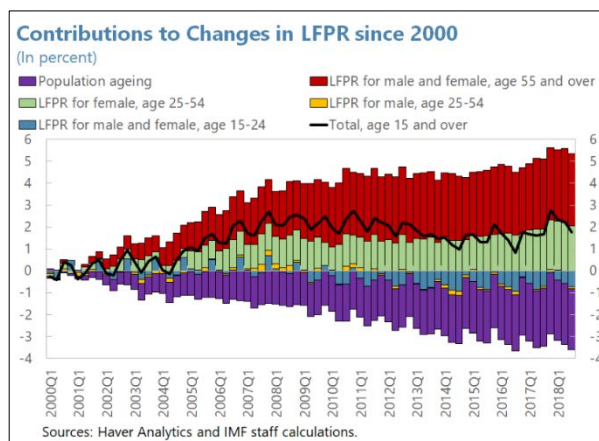
Labor force participation plays a key role in Australia’s labor market dynamics. With stable demographic trends, it drives short- and long-term movements in labor supply. This box reviews developments in labor force participation and macroeconomic implications, focusing on females and older workers. As a key takeaway, cyclical and structural components in labor force participation would have macroeconomic implications. In particular, possible scope for labor force participation rate (LFPR) increases would constitute a labor market slack in the short term as well as contribute to steady labor supply growth that counteracts the impact of the ageing workforce.

Australia’s LFPRs have increased in recent decades, especially for females and older workers. The aggregate LFPR rose from 63.8 percent in 2000 to 66.3 percent in 2017. Prime-age female and old-age LFPRs increased by 7 and 12 percentage points over 2000-17, respectively, while the LFPR for prime-age men remained flat. A pickup in female and old-age LFPRs in 2017 contributed significantly to a rebound in labor inputs growth, as measured by total hours worked, to 3.2 percent (year-over-year) in 2017Q4.



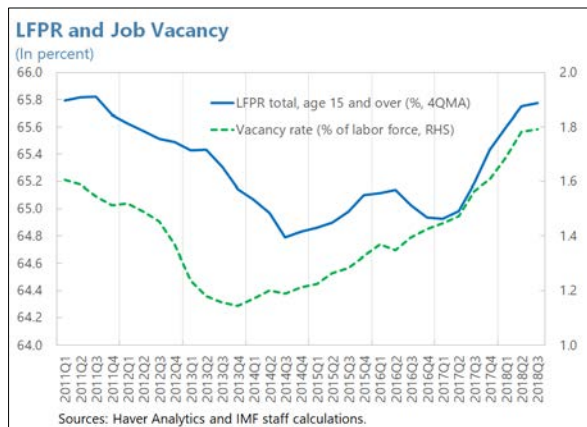
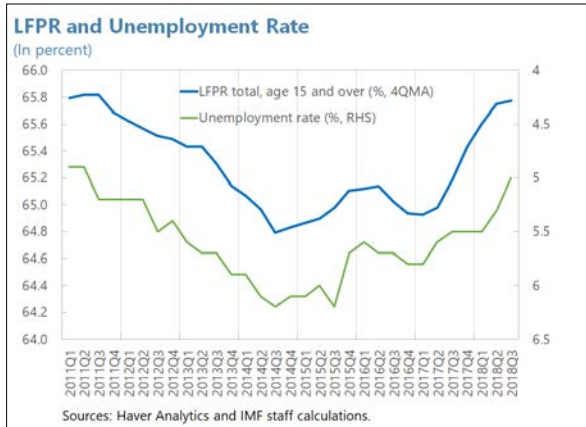
Greater female and old-age labor force participation has counteracted the effect of ageing. The population share of age 65 and above rose from 12.5 percent in 2000 to 15.6 percent in 2017. All things equal, this would bring the LFPR down as prime-age workers reach retirement age. The increase in female and old-age LFPRs, however, more than offset the ageing effect. The labor force grew by 1.9 percent annually over 2000-17, of which the LFPR increase contributed 0.2 percentage points, while working age population growth contributed 1.7 percentage points.

The LFPR is responsive to cyclical labor market conditions. The recent labor market cycle started in 2011, as the unemployment rate began to rise and peaked in 2014. The LFPR moved in tandem, declining over 2011-14 and rebounding since 2014 as the labor market tightened. The rebound in LFPR, especially for prime-age females and older workers, also followed with a lag a recovery in labor demand, as measured by job vacancy. This observation is consistent with an analysis by the RBA, which found that the LFPR has a significant cyclical component and its cyclical sensitivity is large for the young, prime-age females, and old-age males.¹ Rising labor force participation by females and old-age people may have flattened Australia’s labor supply curve, possibly weakening the transmission channel from aggregate demand to wages.



¹ “The Cyclical Behaviour of Labour Force Participation,” *Reserve Bank of Australia Bulletin*, September 2018.

Box 1. Implications of Greater Female and Old-Age Labor Force Participation (concluded)

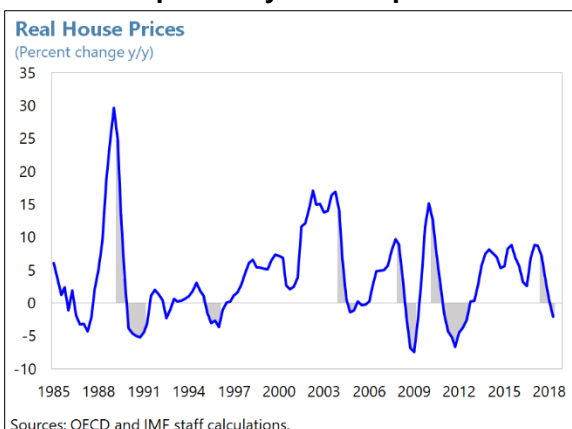
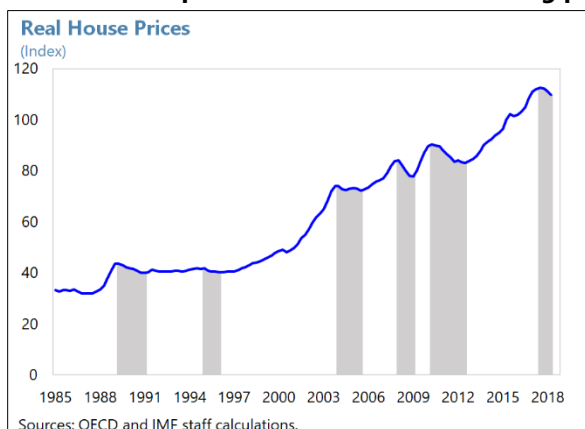


Box 2. Australia’s Housing Price Correction in Perspective

Housing prices have declined since 2017Q4 as housing markets in Sydney and Melbourne have eased following a period of strong price growth. Is this round of house price corrections different from Australian historical and international perspectives?

National housing prices peaked in 2017Q3. Based on the price index released by the Australian Bureau of Statistics, housing prices have declined 2.3 percent in real terms since 2017Q3. The price correction has been led by declines in Sydney and Melbourne, which account for about 60 percent of the nation’s housing value.

Australia has experienced five national housing price downturns previously over the past 3 decades.



In three episodes, housing prices fell by more than 5 percent in real terms (see Table below). The downturn in 1989-91 coincided with a recession. The other two major downturns occurred during the Global Financial Crisis (GFC) in 2008, and in the final stretch of the mining investment boom, during which monetary policy was normalized and Australian banks responded to the higher risk aversion in financial markets after the GFC by raising the level and quality of their capital.

Housing Price Cycles in Australia											
Peak	Trough	Real House Prices				Real ST Interest Rate		Real Housing Credit Peak 4/	Real GDP % Change 1/	Real Household Net Worth % Change 1/	Household Debt to Income (%) Peak
		National % Change 1/	Duration 2/	Melbourne % Change 1/	Sydney % Change 1/	Peak 3/	Trough 3/				
1989Q2	1991Q1	-8.3	7	-15.3	-10.0	6.3	-2.6	1.7	0.2	-0.9	68.5
1995Q1	1996Q1	-3.6	5	-3.6	-2.6	3.2	-1.7	-5.7	4.4	1.7	81.5
2004Q1	2005Q3	-2.4	6	0.6	-11.4	1.3	-0.5	0.9	4.4	10.9	143.4
2008Q1	2009Q1	-7.4	4	-7.7	-9.3	0.4	-4.4	5.5	1.5	-11.4	161.1
2010Q2	2012Q3	-8.2	9	-12.4	-6.8	1.3	-1.7	-2.7	7.5	-1.3	165.3
2017Q3	2018Q3 5/	-2.3	...	-3.8	-6.5	-0.3	0.9	-1.7	2.8	1.6	185.9

Sources: ABS; RBA; OECD; and IMF staff calculations.
 1/ Percent change from peak to trough.
 2/ Number of quarters of falling house prices in 8 capital cities.
 3/ Change in percent points compared to 4 quarters ago.
 4/ Annual growth in real housing credit to households compared to annual growth one year ago.
 5/ Correction is ongoing; trough shows quarter of latest data.

Box 2. Australia’s Housing Price Correction in Perspective (concluded)

The current housing market downturn has several common and some unique features compared to past episodes. A first common feature is that the ongoing house price correction is taking place against a domestic environment of strong growth, relatively low interest rates, and low unemployment, as in 2010-12. Second, as in previous downturns, the price corrections in Sydney and Melbourne are sharper than that of the national average. However, an important difference is that the slowdown in mortgage credit growth, in particular, investor and interest-only loans, has not coincided with a monetary policy tightening, as in previous episodes. Instead, banks have strengthened their lending standards in response to the tightening of macroprudential measures.

Housing markets in several other advanced economies have started to cool after a boom. As in Australia, markets in Canada, Sweden, and the United Kingdom had been booming, reflecting in part common drivers, including low interest rates, relatively strong growth, and, to varying degrees, foreign investor interest. The bottoming out of global interest rates and tightening macroprudential policies were likely common factors contributing to the cooling in all four countries.

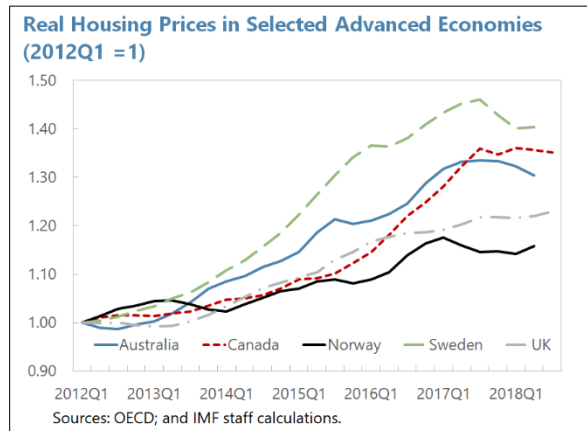
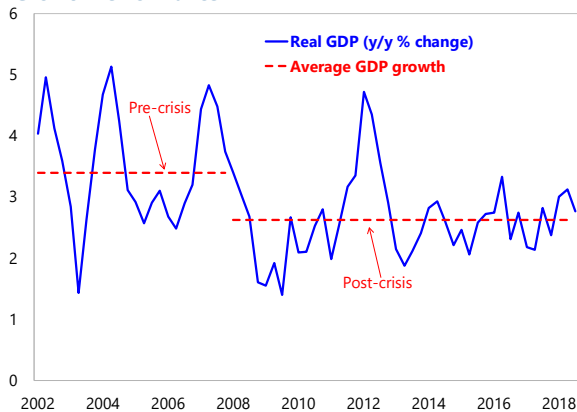


Figure 1. Australia on the Final Leg in the Adjustment and Rebalancing after the Mining Boom

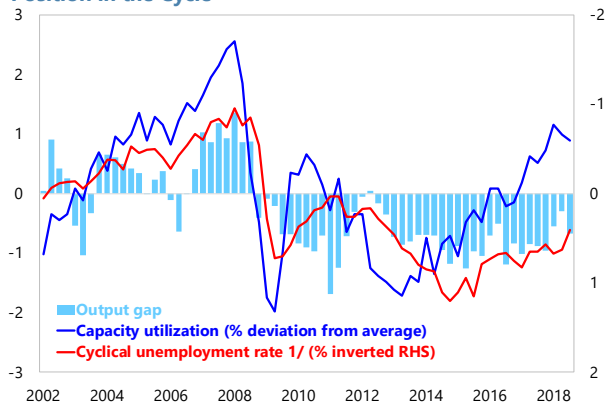
Growth picked up in 2018H1 after recent setbacks, but remains lower on average than it was before the Global Financial Crisis

Growth Performance



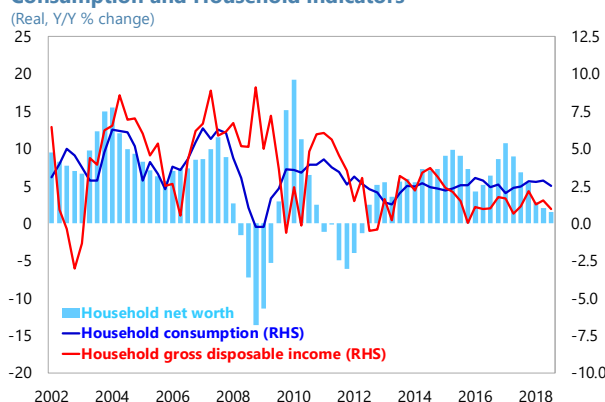
Economic slack has started to decrease with the pickup in activity

Position in the Cycle



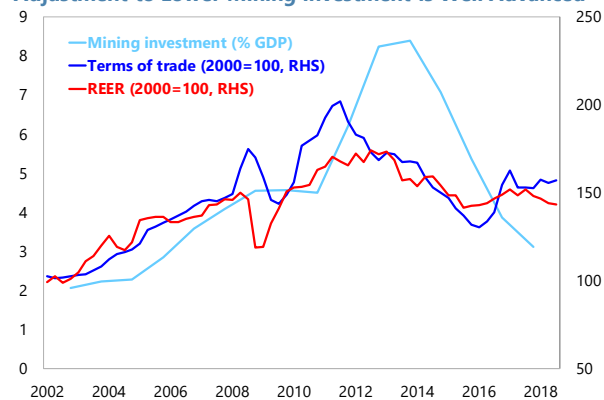
Private consumption has grown ahead of income in the past few years ...

Consumption and Household Indicators



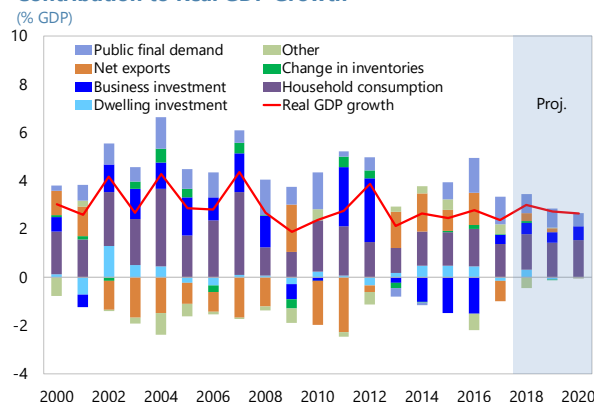
Mining investment has declined sharply after a long boom but seems close to bottoming out

Adjustment to Lower Mining Investment is Well Advanced



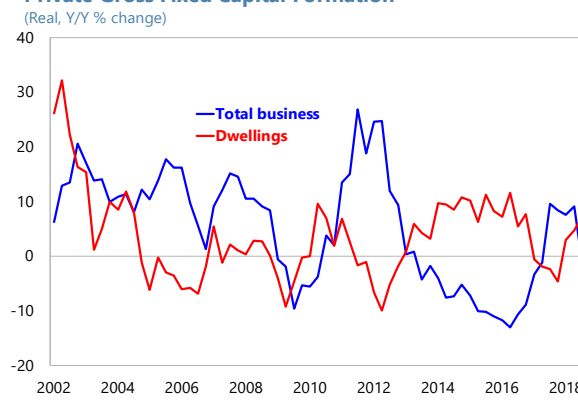
The rebalancing from domestic to external sources of growth has contributed to the moderate growth impact of the mining bust

Contribution to Real GDP Growth



...while business investment has begun to strengthen and residential investment has rebounded in 2018

Private Gross Fixed Capital Formation



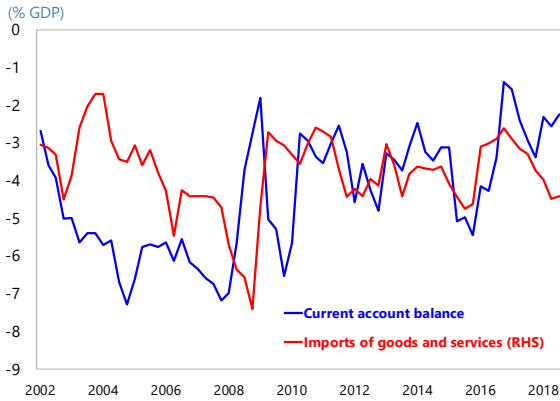
Sources: ABS; Haver Analytics; EconData; and IMF staff calculations.

1/ Defined as unemployment rate minus the non-accelerating inflation rate of unemployment (NAIRU).

Figure 2. Current Account Improving After Rebalancing and a Terms of Trade Rebound

The current account deficit has narrowed in the past few years

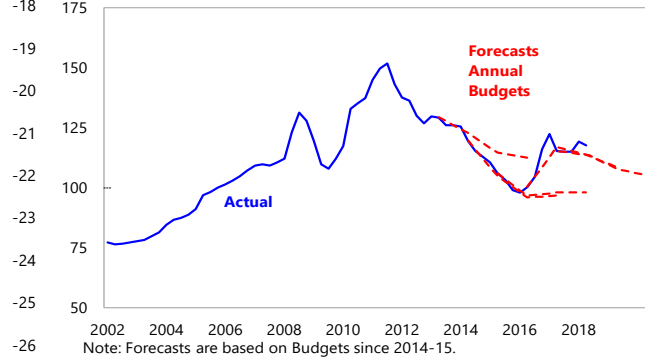
Current Account Balance



The terms of trade rebounded in 2016 and in early 2017 and remain above their early-2016 after recent declines

Terms of Trade

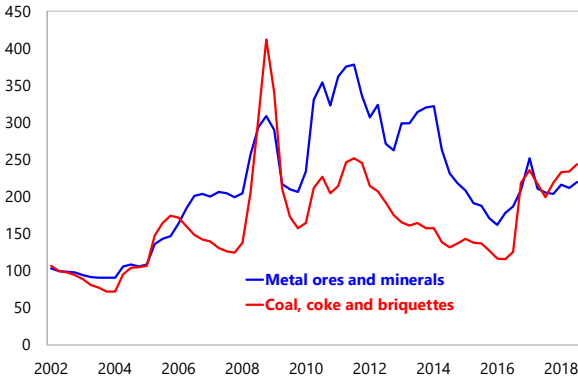
(2015Q3-2016Q2=100; Actual and forecast)



Iron ore prices have recovered from their low reached in early 2016 although some of the gains have been lost recently

Export Prices

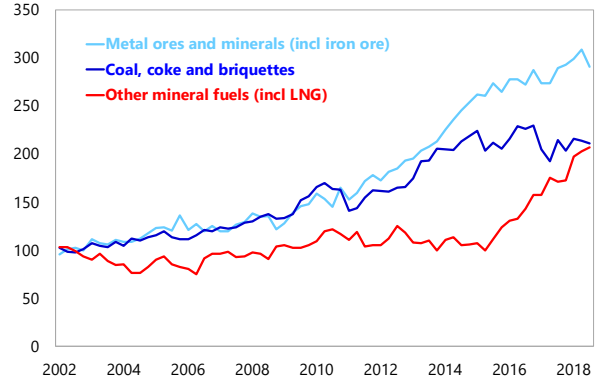
(2002=100)



Commodity export volumes have increased further since the end of the mining boom...

Export Volumes

(Chained 2015Q3-2016Q2 A\$; 2002=100)

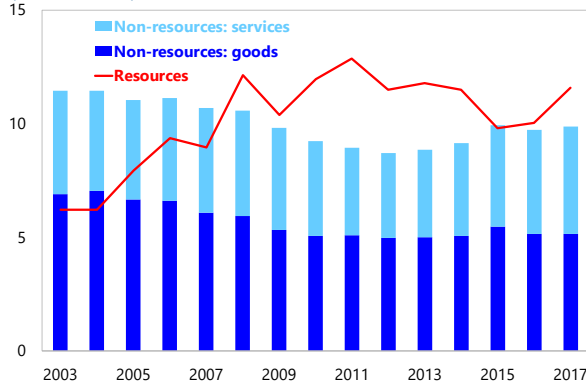


...keeping the value of resource exports broadly constant

The net external liability position is high compared to peers

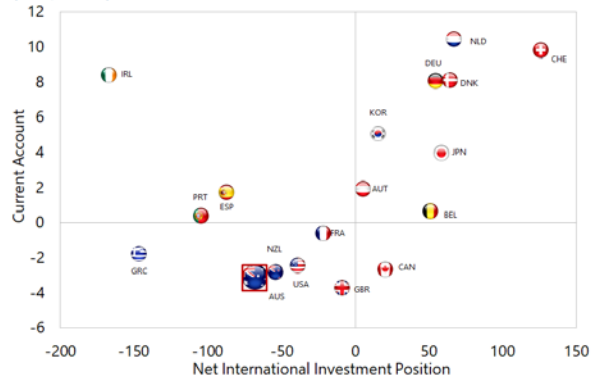
Composition of Exports

(Values in % GDP)



External Position in Comparison

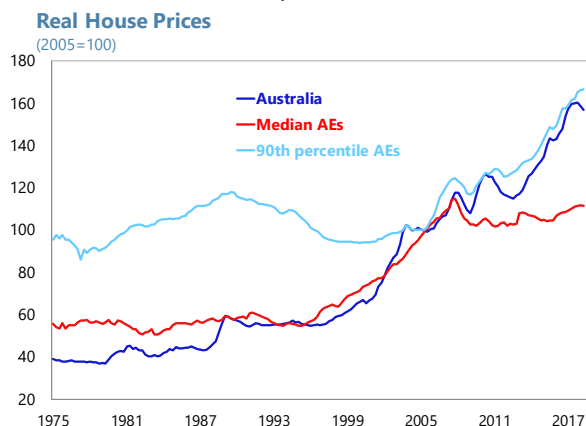
(2017, % GDP)



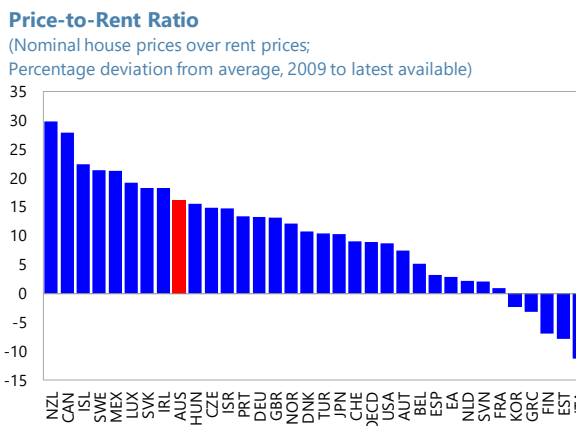
Sources: ABS; RBA; Haver Analytics; IMF, *World Economic Outlook*; and IMF staff calculations.

Figure 3. Housing Market Imbalances and Vulnerabilities after A Boom

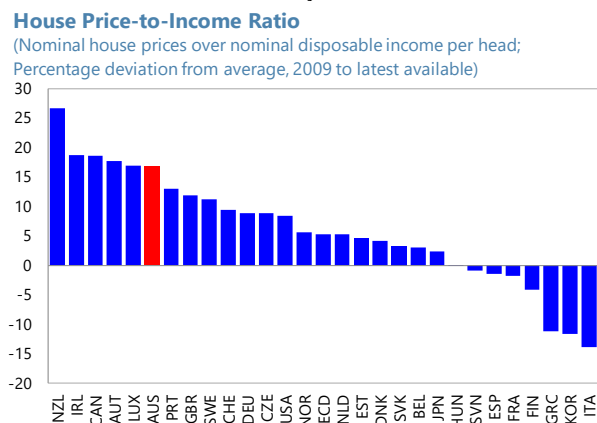
Australia has experienced large house price increases, similar to those in other buoyant markets ...



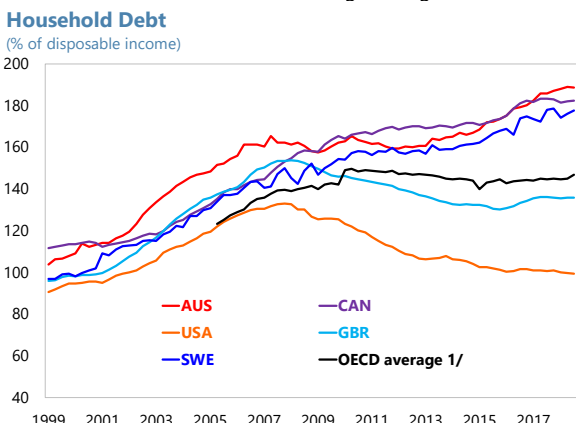
... which has led to upward shifts in valuation metrics ...



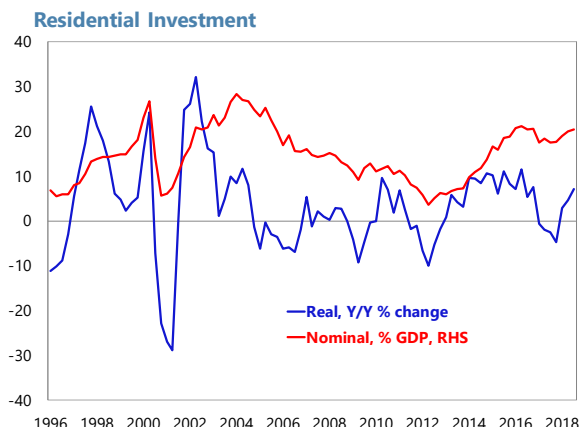
...and downshifts in affordability metrics ...



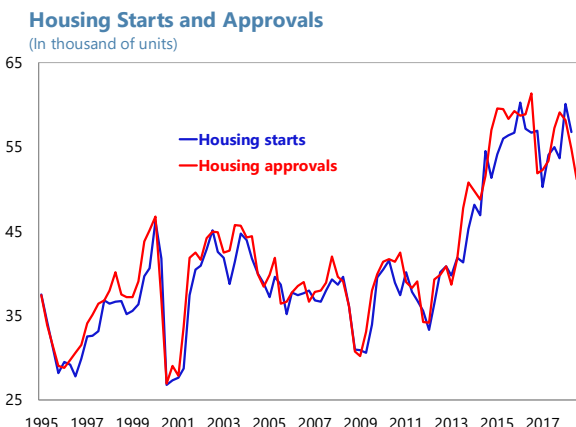
... with household debt ratios among the highest in AEs



High house prices triggered a minor residential investment boom ...



... recent indicator readings suggest a cooling in the housing market



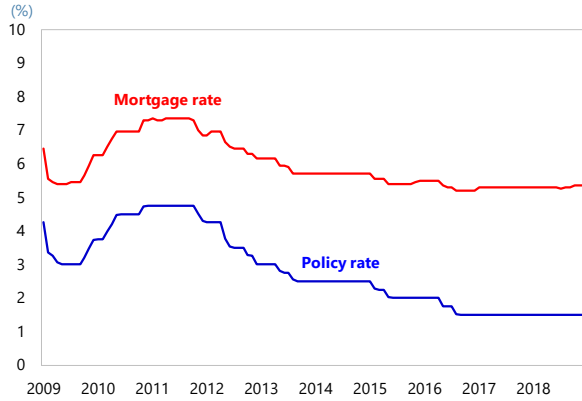
Sources: OECD and Haver Analytics.

1/ Based on a limited number of countries due to the lack of data.

Figure 4. Monetary Policy Has Supported the Adjustment After the End of the Mining Boom

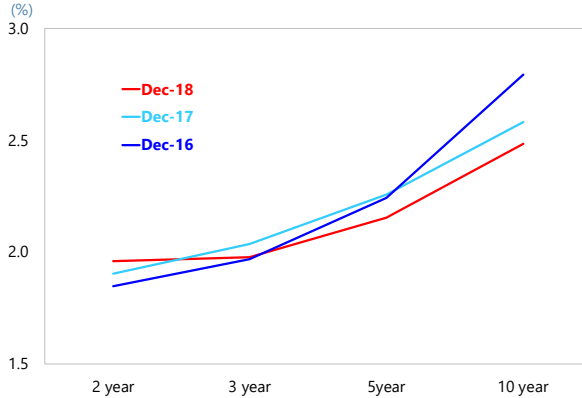
The RBA has kept the policy rate at 1.5 percent since August 2016 ... ensuring an accommodative monetary policy stance

Policy Rate and Mortgage Rate



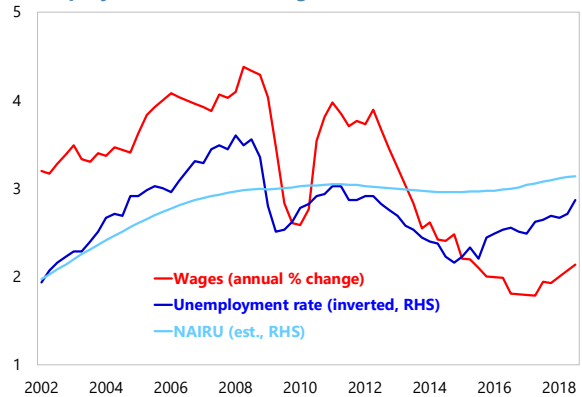
As in other AEs, the yield curves have shifted down

Australia Commonwealth Yield Curves



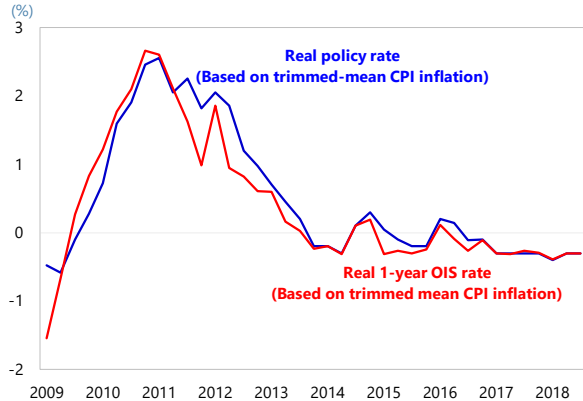
Wage growth has started to pick up

Unemployment Rate and Wages



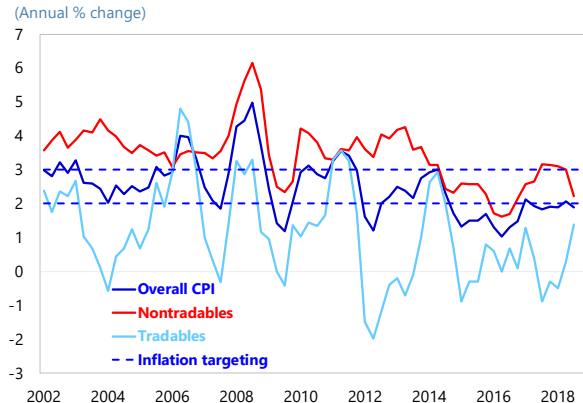
Sources: RBA; Haver Analytics; and IMF staff estimates.

Real Interest Rates



Consumer price inflation has risen from its 2016 low, driven by a pickup in nontradable inflation

Consumer Price Inflation



Financial conditions have remained stable, with the increase in domestic money market rates offset by real currency depreciation

Real Effective Exchange Rate and Terms of Trade

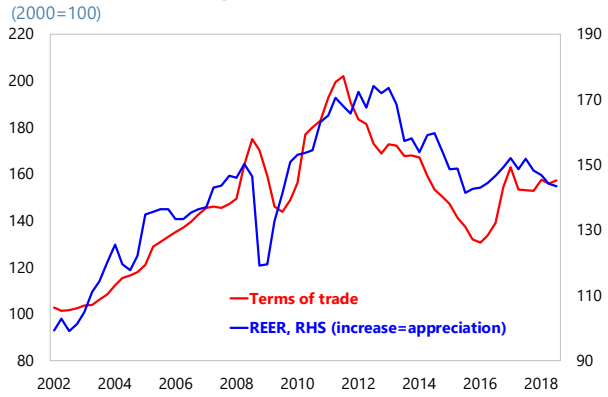
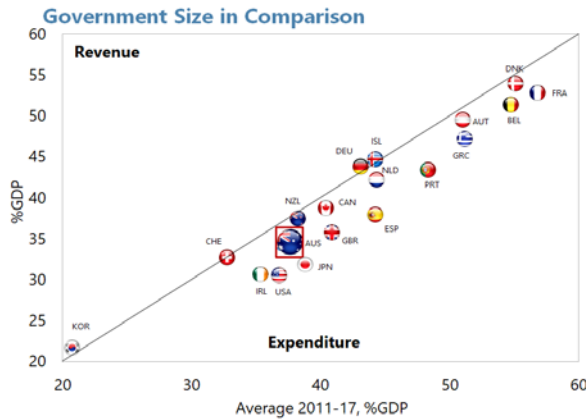
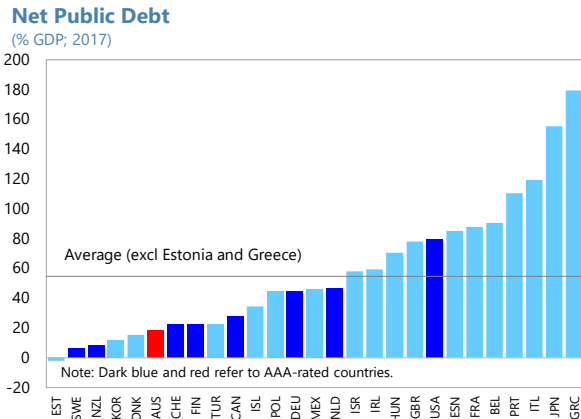


Figure 5. Public Finances Focused on Infrastructure and Lowering Debt

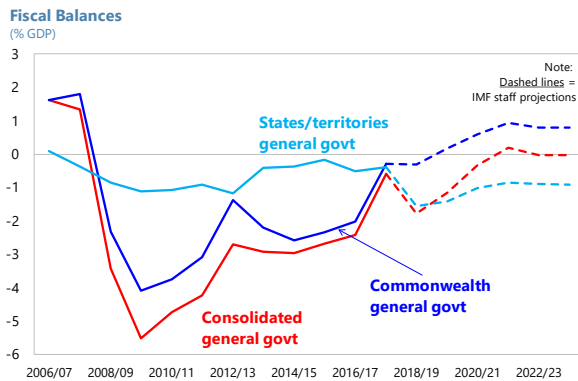
Australia has a relatively small government...



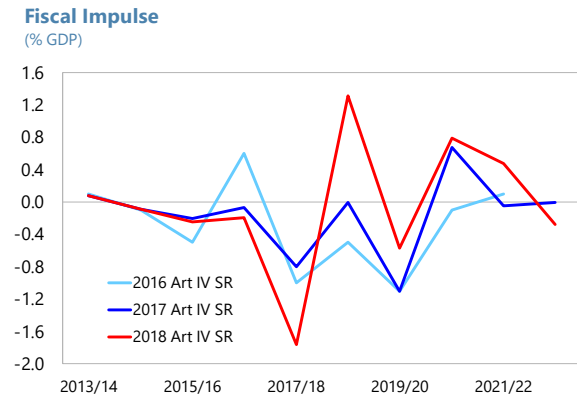
...and a low level of public debt



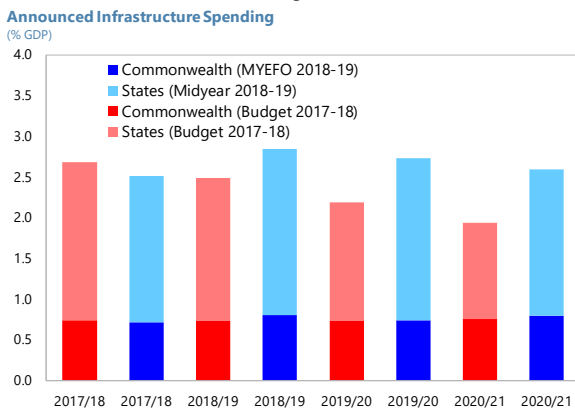
The Commonwealth continues to consolidate while States and Territories stay the course with small deficits...



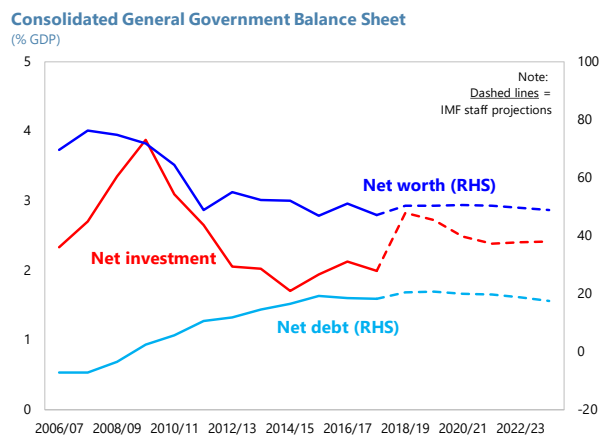
... although the fiscal impulse has become more supportive compared to previous forecasts ...



... as governments increased infrastructure investment relative to the FY2017/18 budgets ...



... maintaining their net worth and stabilizing their net debt

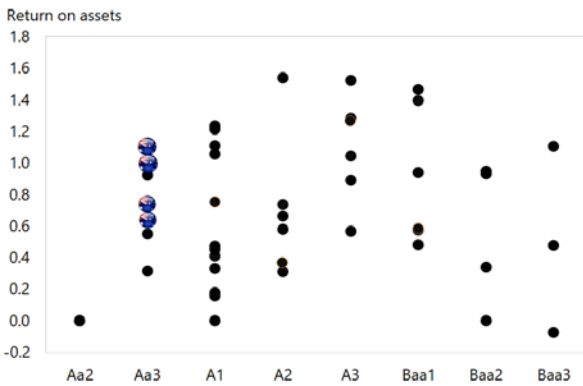


Sources: Commonwealth and State/Territory Treasuries, FY2016/17 and FY2017/18 budgets; IMF, *World Economic Outlook*; and IMF staff estimates and projections.

Figure 6. Banking System Remains Strong

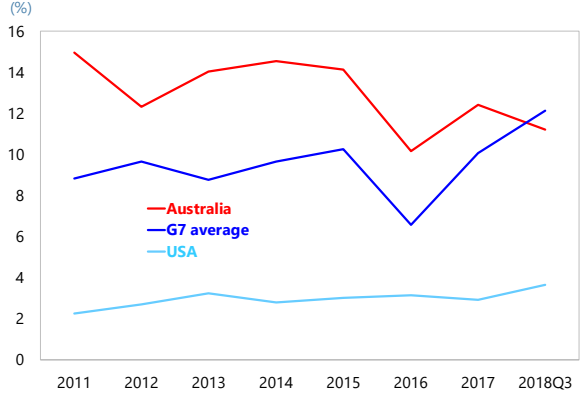
Australian major banks are highly rated...

Bank Ratings



...and profitable even after complying with higher capital and liquidity requirements

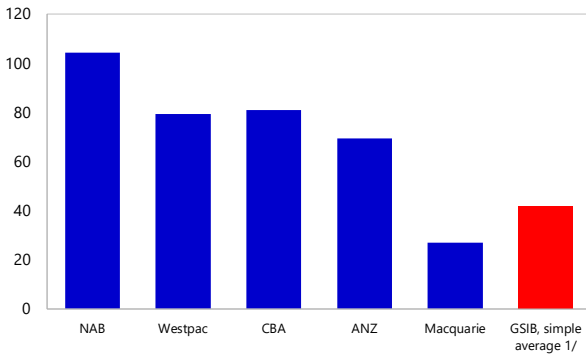
Return on Equity



Dividend pay-out ratios are high

Australian Banks and GSIBs: Dividend Payout Ratio, 2018 or latest available

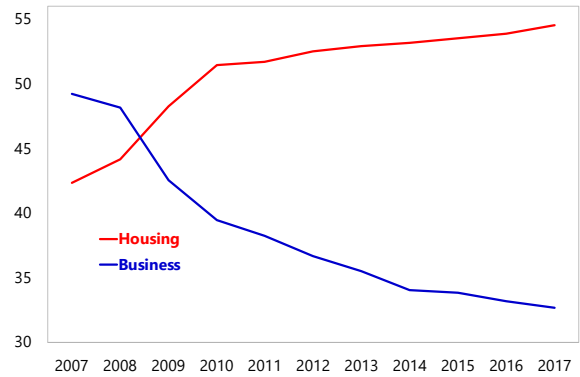
(% net income)



Banks' lending is increasingly concentrated in housing

Banks' Lending Structure

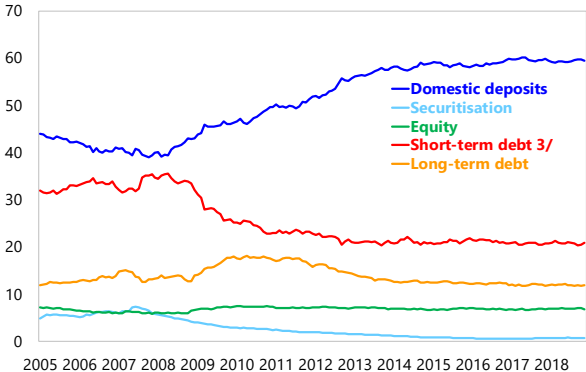
(% total lending)



Banks have reduced the share of short-term offshore wholesale funding and have increased funding from domestic deposits

Banks' Funding 2/

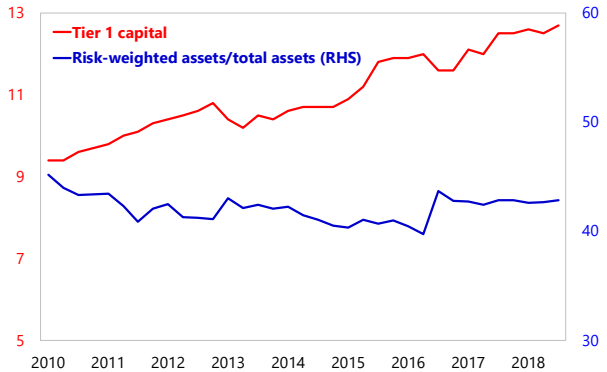
(Domestic books; in share of total)



Higher capital ratios have been in part the result of lower risk weighted assets due to a higher share of mortgage lending

Capital Adequacy Ratios

(%)



Sources: Orbis by Bureau van Dijk; FitchConnect; RBA; APRA; Financial Soundness Indicators; and IMF staff calculations.

1/ GSIBs stands for global systemically important banks. Simple average of 19 GSIBs.

2/ Adjusted for movements in foreign exchange rates.

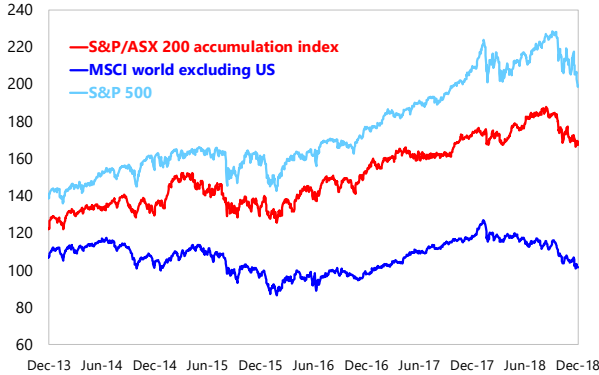
3/ Includes deposits and intragroup funding from non-residents.

Figure 7. Financial Market Indicators: New Lows for Yields and Spreads

Australian equity prices have dropped recently, as equity prices elsewhere.

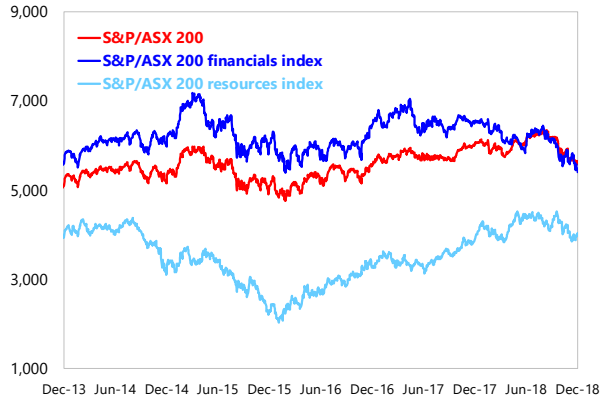
Stock Market Indices

(Jan 2011=100)



The declines have been broad-based, notwithstanding recent iron ore and coal price increases.

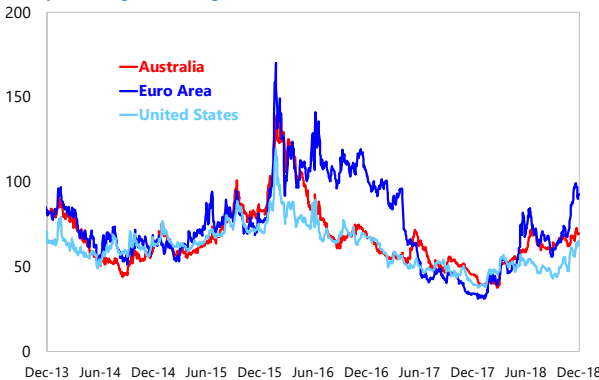
Stock Market Indices



The market perception of Australian banks default risks has risen somewhat recently, as in other advanced economies.

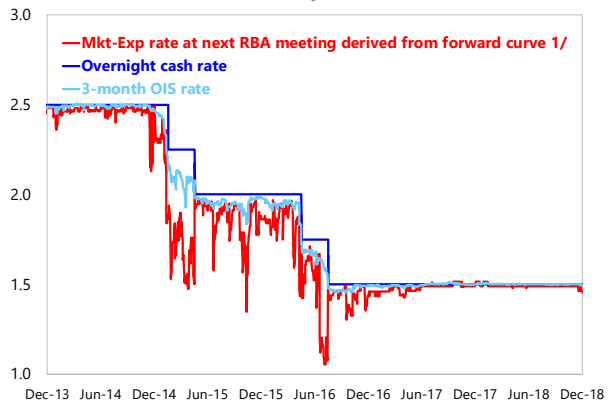
Credit Default Swap (CDS) Spreads

(Five-year, average of four largest banks)



Markets expect policy rates to remain stable at 1.5 percent in 2019.

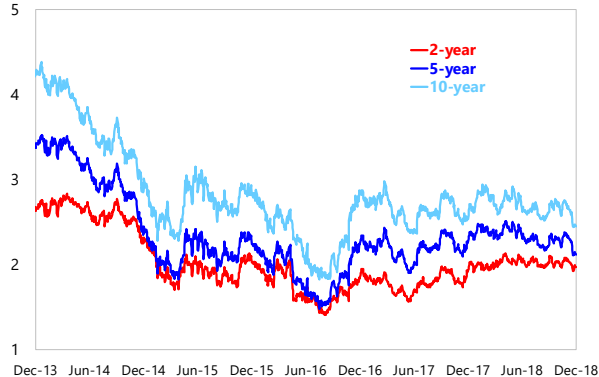
OIS, Cash Rate, and Market Expectations



Government bond yields have been little changed...

Australia Commonwealth Debt Yields

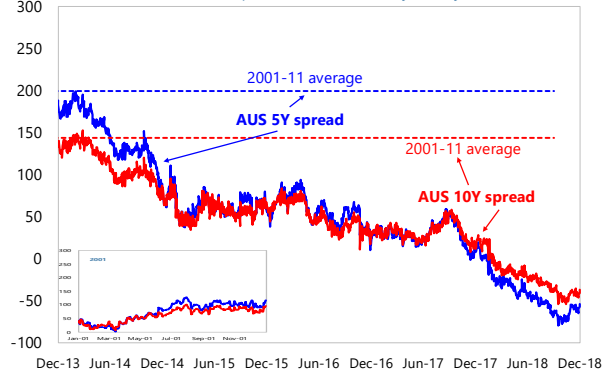
(%)



...while the yield on U.S. Treasury securities have risen above the yield on Australian government securities.

Australia Sovereign Spreads

(Australia Commonwealth bond spread over U.S. Treasury bond yields)



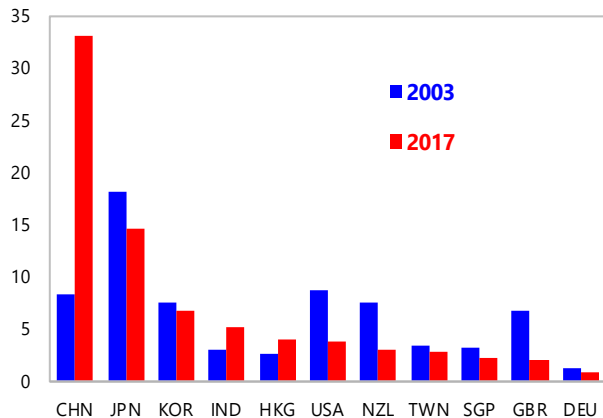
Sources: Bloomberg; RBA; and IMF staff calculations.

Figure 8. Interconnections and Spillovers

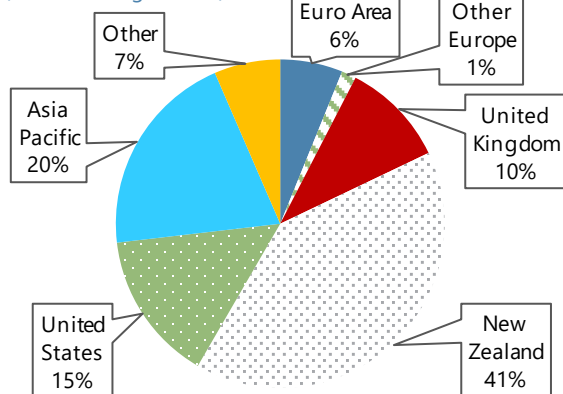
Trade links are mainly with China, with exposure to commodity price shocks...

...while financial links are strong with New Zealand, Asia-Pacific, the U.S., and the U.K.

Merchandise Exports by Destination
(% total)

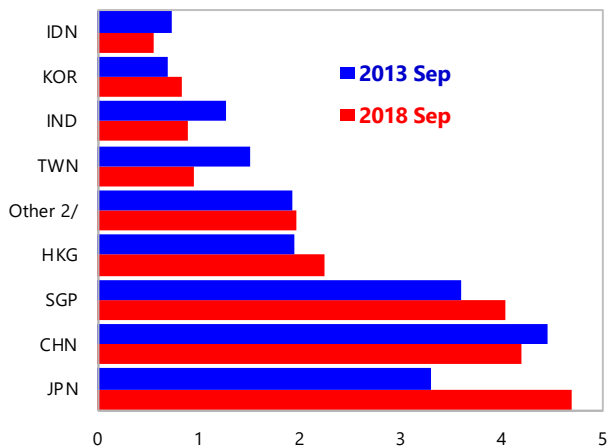


Foreign Claims of Australian Banks, 2018Q3 1/ 2/
(% total foreign claims)



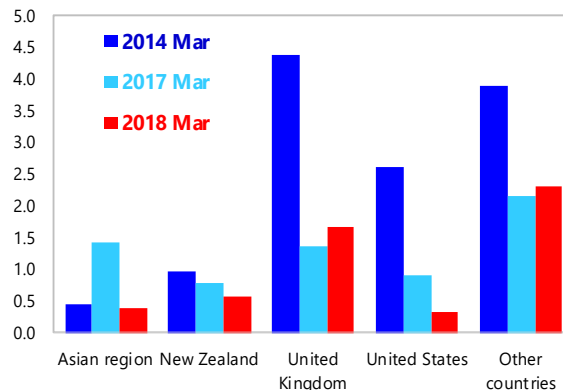
Australian-owned banks have increased significantly their activity in Japan, Hong Kong SAR, and Singapore

Australian-owned Banks' Claims on Asia 1/
(% total foreign claims)



Non-performing assets of banks' overseas operations are low

Non-performing Assets of Australian-owned Banks' Overseas Operations
(% loans by region)



Sources: ABS; APRA; RBA; IMF, *Direction of Trade Statistics*; BIS; and IMF staff calculations.

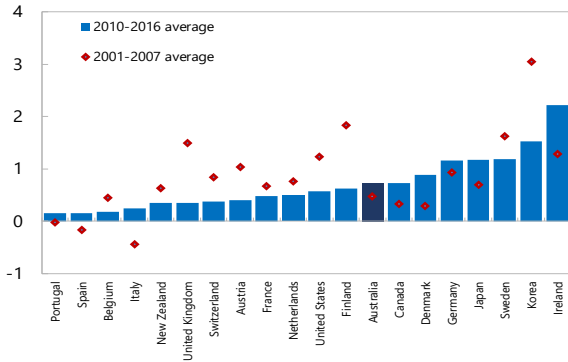
1/ Measured on a consolidated, ultimate risk basis.

2/ Includes Hong Kong SAR, Japan, and Singapore.

Figure 9. Australia's Macro-Structural Position

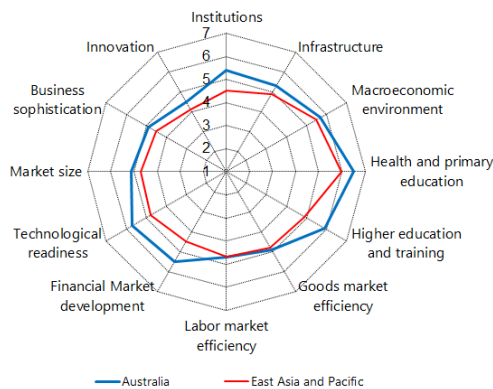
Australia has consistent, but rather low, productivity growth, with potential to improve its standing among its peers ...

Multifactor Productivity Growth
(% year-over-year)



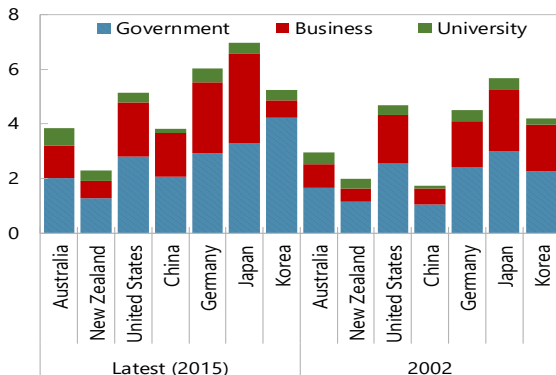
... as it has a favorable economic and regulatory environment (21 out of 137 economies), with room for improvement ...

Australia's Global Competitiveness
(1 to 7; 7 is best)



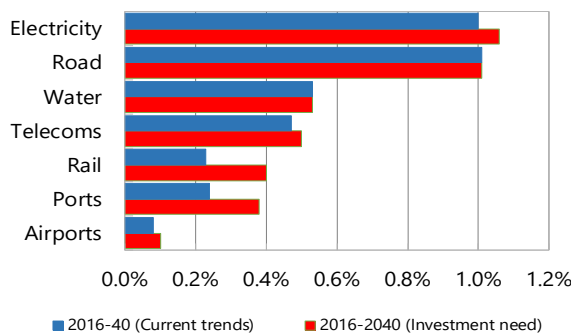
... lagging behind other advanced economies in terms of R&D spending, although it is improving over time ...

R&D Expenditures
(% GDP)



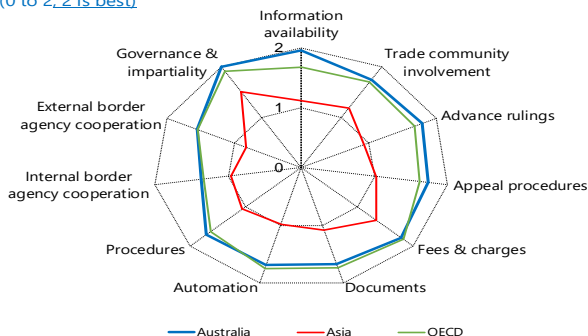
... and it could raise productivity growth by closing infrastructure investment gaps

Infrastructure Investment Gaps
(% GDP)



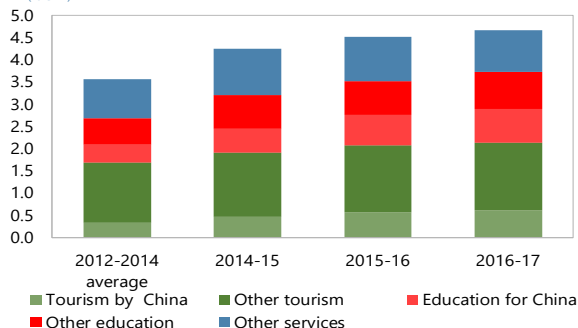
This would complement a trade environment which is already highly conducive to strong foreign relationships...

Ease of Conducting Trade
(0 to 2; 2 is best)



... and its expanding services exports, dominated by education and tourism, increasingly directed to China

Exports of Services
(% GDP)



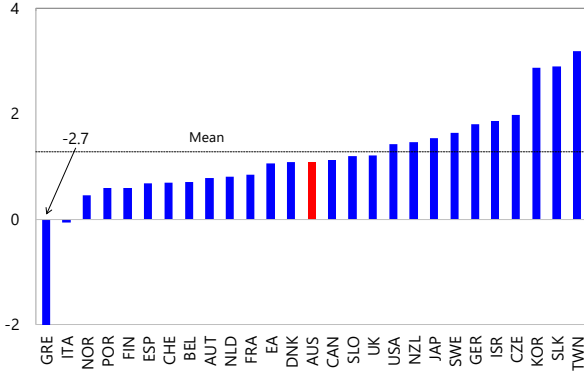
Note: The Global Competitiveness Index combines both official data and survey responses from business executives on several dimensions of competitiveness. This measure of competitiveness is a subjective depiction of competitiveness, particularly in comparison between Australia and its peer group.

Sources: OECD.Stat; World Economic Forum, *The Global Competitiveness Report 2017-2018*; OECD Main Science and Technology Indicators; Oxford Economics and G-20 Global Infrastructure Hub, *Global Infrastructure Outlook*; OECD Trade Facilitation Indicators, Department of Foreign Affairs and Trade, *Trade in Services Australia*, for 2014-15 and 2016-17.

Figure 10. Australia in International Comparison

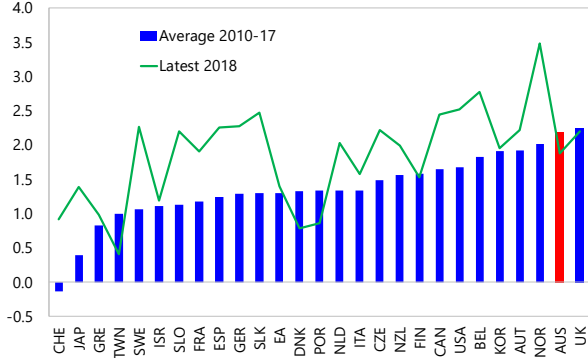
Australia's per capita growth was about average in the past eight years

Average Annual Per Capita Real Growth
(2010-17, % change)



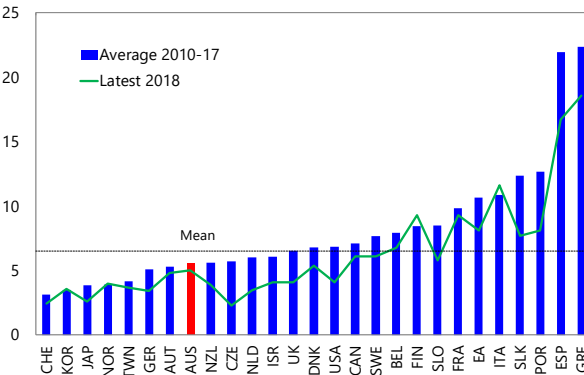
Australia's inflation remained higher than in many other advanced economies

Consumer Price Index
(Y/Y % change)



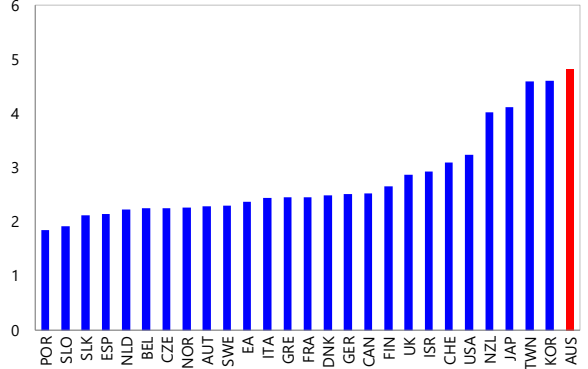
Unemployment is relatively low

Unemployment Rate
(%)



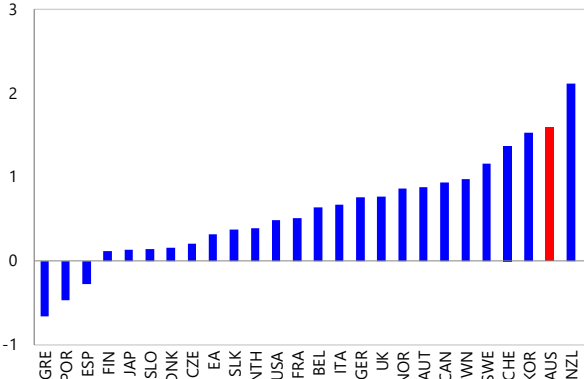
Australia has benefited from growth in dynamic Asian partners

Trading Partner Growth
(average 2010-17, %)



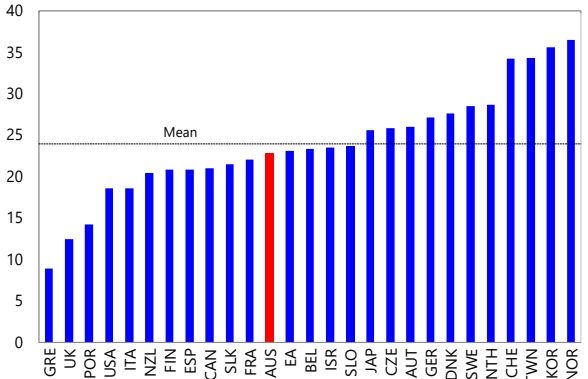
labor force growth has contributed to growth momentum

Labor Force Growth
(average 2010-17, % change)



Australia's national saving ratio is close to average

Gross National Savings
(average 2010-17, in % of GDP)



Source: IMF, World Economic Outlook database.

Table 1. Australia: Main Economic Indicators, 2014-2024
(Annual percent change, unless otherwise indicated)

	2014	2015	2016	2017	2018	2019	2020	2021	2022	2023	2024
					Est.			Projections			
NATIONAL ACCOUNTS											
Real GDP	2.6	2.5	2.8	2.4	3.0	2.7	2.6	2.6	2.6	2.6	2.6
Domestic demand	0.9	1.2	1.8	2.9	3.0	2.6	2.7	2.6	2.6	2.6	2.6
Private consumption	2.5	2.4	2.7	2.4	2.6	2.5	2.7	2.6	2.6	2.6	2.6
Public consumption	0.3	4.4	4.8	4.0	4.1	2.8	2.4	2.0	2.1	2.2	2.2
Investment	-1.9	-3.6	-2.3	3.0	2.9	2.3	2.7	3.0	2.9	2.8	2.8
Public	-3.3	-1.8	13.3	9.1	0.2	5.4	1.5	0.6	0.4	0.4	0.4
Private business	-6.1	-9.6	-11.2	3.2	4.0	3.7	4.9	4.3	4.3	4.2	4.3
Dwelling	9.6	8.9	7.9	-2.4	5.5	-1.3	-0.1	2.4	2.3	2.0	1.7
Net exports (contribution to growth, percentage points)	1.6	0.9	1.3	-0.8	0.3	0.2	0.0	0.1	0.1	0.1	0.1
Gross domestic income	1.0	-0.1	2.8	4.8	3.1	1.7	2.5	2.2	2.3	2.6	2.7
Investment (percent of GDP) 1/	26.4	25.9	24.7	24.1	24.3	24.2	24.2	24.2	24.2	24.1	23.9
Public	4.4	4.4	4.8	5.0	4.9	5.0	4.9	4.8	4.7	4.6	4.4
Private	22.0	21.4	19.7	19.1	19.3	19.2	19.2	19.3	19.4	19.4	19.4
Mining investment	7.1	5.4	3.9	3.1	2.8	2.7	2.7	2.7	2.6	2.6	2.6
Non-mining investment	15.0	16.1	15.9	16.0	16.4	16.4	16.5	16.6	16.8	16.8	16.9
Savings (gross, percent of GDP)	23.3	21.6	20.9	22.0	21.7	21.5	21.3	21.2	21.1	21.1	21.2
Potential output	2.8	2.6	2.5	2.5	2.6	2.5	2.6	2.6	2.6	2.6	2.6
Output gap (percent of potential)	-0.9	-1.0	-0.8	-0.9	-0.5	-0.3	-0.2	-0.1	-0.1	0.0	0.0
LABOR MARKET											
Employment	0.6	2.0	1.8	2.3	2.7	2.1	1.9	1.7	1.7	1.7	1.7
Unemployment (percent of labor force)	6.1	6.1	5.7	5.6	5.3	4.8	4.8	4.8	4.8	4.8	4.8
Wages (nominal percent change)	2.5	2.1	1.9	1.9	2.1	2.5	3.0	3.3	3.2	3.3	3.3
PRICES											
Terms of trade index (goods, avg)	103	90	90	103	104	98	97	95	94	94	94
% change	-8.0	-12.4	-0.4	14.4	0.9	-5.5	-0.8	-1.8	-1.4	-0.3	0.5
Iron ore prices (index)	77	44	46	56	55	48	47	47	47	47	47
Coal prices (index)	81	67	75	101	120	108	102	99	99	99	99
LNG prices (index)	95	61	42	41	56	49	45	44	44	44	44
Crude prices (Brent; index)	91	48	40	50	65	57	57	56	57	57	58
Consumer prices (avg)	2.5	1.5	1.3	2.0	2.0	2.1	2.4	2.5	2.5	2.5	2.5
Core consumer prices (avg)	2.6	2.3	1.7	1.6	1.6	2.1	2.3	2.5	2.5	2.5	2.5
GDP deflator (avg)	0.3	-0.8	1.0	3.6	1.7	1.0	2.1	2.1	2.3	2.6	2.4
FINANCIAL											
Reserve Bank of Australia cash rate (percent, avg)	2.5	2.1	1.7	1.5	1.5	1.5	1.8	2.3	2.7	3.2	3.5
10-year treasury bond yield (percent, avg)	3.7	2.7	2.3	2.6	2.8	3.2	3.5	4.0	4.5	5.0	5.1
Mortgage lending rate (percent, avg)	6.0	5.6	5.4	5.2	5.6	5.6	6.1	6.6	7.1	7.6	7.6
MACRO-FINANCIAL											
Credit to the private sector	7.4	8.1	7.0	4.6	4.7	3.7	3.6	4.0	4.6	4.7	4.8
House price index	120	131	141	148	141	135	136	137	141	144	148
% change	6.7	8.7	7.7	5.0	-4.4	-4.1	0.3	1.0	2.5	2.5	2.5
House price-to-income, capital cities (ratio)	4.2	4.5	4.7	4.8	4.5	4.1	3.9	3.8	3.7	3.6	3.5
Interest payments (percent of disposable income)	8.9	8.8	8.6	8.9	9.7	9.2	9.9	10.6	11.3	11.9	11.8
Household savings (percent of disposable income)	7.4	6.3	4.9	3.9	2.5	2.3	2.5	2.6	2.7	3.0	3.1
Household debt (percent of disposable income) 2/	167	173	180	187	188	176	174	171	169	167	165
Business credit (percent of GDP)	48	51	51	50	50	50	50	50	50	50	50
GENERAL GOVERNMENT (percent of GDP) 3/											
Revenue	33.9	34.6	34.8	34.9	35.6	36.0	35.9	35.8	35.7	35.6	35.6
Expenditure	36.8	37.4	37.4	36.4	36.7	37.5	36.6	35.9	35.6	35.6	35.6
Net lending/borrowing	-2.9	-2.8	-2.6	-1.5	-1.2	-1.5	-0.7	-0.1	0.1	0.0	0.0
Operating balance	-1.6	-1.5	-1.1	-0.1	0.4	0.4	1.1	1.6	1.7	1.6	1.6
Cyclically adjusted balance	-2.5	-2.4	-2.1	-1.1	-0.9	-1.3	-0.6	0.0	0.1	0.0	0.0
Gross debt	34.1	37.8	40.5	40.7	40.7	41.4	40.8	40.1	39.3	37.9	36.7
Net debt	15.5	17.9	18.9	18.4	19.3	20.6	20.3	19.8	19.1	18.0	17.0
Net worth	52.0	49.4	49.3	49.0	48.6	50.3	50.3	50.4	50.0	49.1	48.5
BALANCE OF PAYMENTS											
Current account (percent of GDP)	-3.1	-4.6	-3.3	-2.6	-2.4	-2.7	-2.9	-3.0	-3.1	-3.0	-2.8
Export volume	6.9	6.5	6.8	3.5	5.3	2.4	2.5	2.9	3.1	3.2	3.2
Import volume	-1.4	1.9	0.1	7.7	3.8	1.7	2.6	2.7	2.9	2.9	2.9
Net international investment position (percent of GDP)	-52	-56	-57	-54	-50	-51	-52	-52	-53	-53	-53
Gross official reserves (bn A\$)	66	63	74	85	...	...	...	...	...	...	...
MEMORANDUM ITEMS											
Nominal GDP (bn A\$)	1,615	1,641	1,704	1,808	1,894	1,965	2,059	2,158	2,265	2,385	2,506
Percent change	3.0	1.6	3.9	6.1	4.8	3.7	4.8	4.8	5.0	5.3	5.1
Real net national disposable income per capita (% change)	-0.8	-2.1	1.1	2.7	1.2	0.2	0.4	0.1	0.2	0.4	0.6
Population (million)	23.6	24.0	24.4	24.8	25.2	25.6	26.0	26.4	26.8	27.2	27.7
Nominal effective exchange rate	99	92	92	94	...	...	...	...	...	...	...
Real effective exchange rate	100	93	93	96	...	...	...	...	...	...	...

Sources: Authorities' data; IMF *World Economic Outlook* database; and IMF staff estimates and projections.

1/ Includes changes in inventories.

2/ Reflects the national accounts measure of household debt, including to the financial sector, state and federal governments and foreign overseas banks and governments. It also includes other accounts payable to these sectors and a range of other smaller entities including pension funds.

3/ Calendar year.

Table 2. Australia: Fiscal Accounts, 2013/14-2023/24
(In percent of GDP, unless otherwise indicated)

	2013/14	2014/15	2015/16	2016/17	2017/18	2018/19	2019/20	2020/21	2021/22	2022/23	2023/24
					Est.	Projections					
CONSOLIDATED GENERAL GOVERNMENT OPERATIONS 1/											
Revenue	33.7	34.2	34.8	34.4	35.5	35.9	36.0	35.8	35.8	35.6	35.6
Tax revenue	27.2	27.4	28.0	27.7	28.7	29.0	29.2	29.3	29.5	29.3	29.3
Direct taxes	19.4	20.0	20.2	20.2	21.1	21.5	21.4	21.6	21.7	21.6	21.6
Individual and withholding	13.2	14.1	14.5	14.3	14.5	14.6	14.7	14.9	15.1	15.0	15.0
Corporate	6.2	5.9	5.7	5.9	6.6	6.8	6.7	6.7	6.6	6.6	6.6
Indirect taxes	7.8	7.4	7.8	7.5	7.6	7.6	7.8	7.7	7.7	7.7	7.7
Of which: GST	3.5	3.5	3.6	3.6	3.5	3.6	3.5	3.6	3.6	3.6	3.6
Non-tax revenue	6.5	6.8	6.8	6.8	6.8	6.8	6.8	6.6	6.3	6.3	6.3
Expenditure	36.6	37.2	37.4	36.9	36.1	37.6	37.2	36.1	35.6	35.6	35.6
Expense	35.3	35.9	36.1	35.4	34.9	35.7	35.3	34.4	34.0	34.0	34.0
Employee expenses	9.5	9.7	9.9	9.8	9.6	9.7	9.4	9.2	9.1	9.1	9.1
Other operating expenses (excl. depreciation)	9.2	9.6	9.8	10.0	10.5	11.0	11.1	10.7	10.7	10.7	10.6
Transfers	12.7	12.6	12.3	11.7	10.7	10.9	10.8	10.5	10.4	10.4	10.4
Current	12.1	12.1	11.9	11.3	10.5	10.6	10.5	10.3	10.2	10.2	10.2
Capital	0.6	0.5	0.4	0.4	0.2	0.3	0.3	0.3	0.2	0.2	0.2
Interest (excl. superannuation)	1.4	1.5	1.5	1.4	1.4	1.4	1.4	1.3	1.3	1.3	1.3
Other	2.5	2.6	2.6	2.5	2.6	2.8	2.7	2.6	2.5	2.6	2.6
Net acquisition of nonfinancial assets	1.3	1.2	1.3	1.5	1.2	1.9	1.9	1.7	1.6	1.6	1.6
Of which: Gross fixed capital formation	2.9	2.9	2.9	3.2	3.4	3.8	3.6	3.5	3.3	3.3	3.3
Operating balance	-1.6	-1.7	-1.4	-0.9	0.6	0.1	0.7	1.4	1.8	1.6	1.6
Primary balance	-1.6	-1.5	-1.2	-1.0	0.8	-0.4	0.3	1.0	1.5	1.3	1.3
Net lending (+)/borrowing (-)	-2.9	-2.9	-2.7	-2.4	-0.6	-1.8	-1.1	-0.3	0.2	0.0	0.0
CONSOLIDATED GENERAL GOVERNMENT BALANCE SHEET											
Liabilities	63.9	69.1	78.3	74.5	74.9	69.4	68.7	66.2	64.9	62.3	59.9
Gross debt	32.4	35.8	39.5	41.0	40.4	41.3	41.4	40.2	40.0	38.6	37.3
Commonwealth	23.0	26.3	30.4	32.3	32.2	31.4	30.5	28.8	28.1	26.4	24.8
States, territories and local governments	9.5	9.5	9.1	8.7	8.2	9.9	10.8	11.4	11.9	12.2	12.5
Other liabilities	31.5	33.2	38.8	33.5	34.5	28.1	27.3	26.1	24.9	23.7	22.6
Assets	116.3	120.9	125.2	125.5	122.0	119.6	118.9	116.7	115.3	111.8	108.7
Financial assets	47.7	49.4	50.8	52.6	51.2	49.9	50.1	49.4	49.4	47.7	46.2
Other assets	68.5	71.5	74.3	72.9	70.8	69.8	68.8	67.3	65.8	64.1	62.5
Net financial worth	-16.2	-19.6	-27.5	-21.9	-23.7	-19.5	-18.6	-16.8	-15.5	-14.6	-13.7
Net debt	14.5	16.5	19.1	18.5	18.2	20.4	20.7	19.9	19.7	18.5	17.5
Commonwealth 2/	12.7	14.9	18.1	18.4	18.5	18.3	16.8	15.0	14.0	12.5	11.1
States, territories and local governments	1.8	1.6	1.1	0.2	-0.3	2.1	3.9	4.9	5.7	6.0	6.4
Net worth	52.4	51.9	46.9	51.0	47.2	50.3	50.1	50.4	50.3	49.5	48.8
Commonwealth	-14.4	-17.7	-24.2	-21.7	-22.6	-16.6	-15.2	-13.1	-11.6	-9.8	-8.1
States, territories and local governments	66.8	69.5	71.1	72.7	69.8	66.9	65.4	63.6	61.9	59.3	56.9
MEMORANDUM ITEMS											
Cyclically adjusted balance (in percent of potential GDP)	-2.6	-2.5	-2.2	-2.0	-0.3	-1.6	-1.0	-0.2	0.2	0.0	0.0
Fiscal impulse (change in CAB; in percent of potential GDP)	0.1	-0.1	-0.2	-0.2	-1.8	1.3	-0.6	0.8	0.5	-0.2	0.0
Change in real revenue (percent)	1.4	1.4	2.5	3.4	5.7	3.5	2.5	1.7	2.0	2.2	2.5
Change in real primary expenditure (percent)	4.1	1.3	1.0	2.8	-0.5	5.5	0.6	0.7	1.9	2.8	2.6
Commonwealth general government 3/											
Revenue	20.1	19.9	20.2	20.1	21.1	21.8	21.9	21.9	22.1	22.0	22.0
Expenditure	22.3	22.5	22.6	22.1	21.4	22.1	21.8	21.3	21.2	21.2	21.2
Net lending (+)/borrowing (-)	-2.2	-2.6	-2.3	-2.0	-0.3	-0.3	0.2	0.6	0.9	0.8	0.8
States, territories and local governments 4/											
Revenue	13.2	13.6	14.0	13.8	13.8	13.5	13.5	13.3	13.1	13.1	13.1
Expenditure	13.6	13.7	14.1	13.9	13.8	14.6	14.6	13.9	13.6	13.6	13.6
Net lending (+)/borrowing (-)	-0.4	-0.1	-0.1	-0.2	0.0	-1.1	-1.0	-0.6	-0.5	-0.5	-0.5
Commonwealth transfers to subnational governments											
Of which: General revenue assistance	3.3	3.6	3.6	3.6	3.6	3.6	3.6	3.6	3.7	3.7	3.7
Nonfinancial public sector capital stock	95.8	99.4	103.1	100.1	101.6	101.1	100.9	99.4	97.7	95.5	93.6
GDP (in billion A\$)	1,599	1,624	1,663	1,765	1,848	1,928	2,011	2,109.3	2,208.2	2,325.1	2,444.6

Sources: Authorities' data and IMF staff estimates and projections.

1/ Accrual basis; GFS. Comprises the Commonwealth, and state, territory, and local governments.

2/ Includes Future Fund assets.

3/ Excludes general revenue assistance to states and territories from revenue and expenditure.

4/ Excludes Commonwealth payments for specific purposes from revenue and expenditure.

Table 3. Australia: Balance of Payments, 2014-2024
(In percent of GDP, unless otherwise indicated)

	2014	2015	2016	2017	2018	2019	2020	2021	2022	2023	2024
					Est.			Projections			
BALANCE OF PAYMENTS											
(% GDP)											
Current account	-3.1	-4.6	-3.3	-2.6	-2.4	-2.7	-2.9	-3.0	-3.1	-3.0	-2.8
Balance on goods and services	-0.6	-2.3	-0.8	0.5	0.9	0.0	-0.1	-0.3	-0.5	-0.4	-0.3
Exports of goods and services	20.6	19.7	19.7	21.4	22.8	21.7	21.2	20.6	20.0	19.6	19.3
Exports of goods	16.6	15.3	15.2	16.7	17.8	16.7	16.3	15.8	15.2	14.8	14.6
Of which: Resources	10.5	8.8	8.7	10.5	11.6	10.7	10.2	9.8	9.3	9.0	8.8
Exports of services	4.1	4.5	4.6	4.7	5.0	5.0	4.9	4.9	4.8	4.7	4.7
Imports of goods and service	21.2	22.0	20.6	20.9	21.9	21.7	21.3	21.0	20.5	20.0	19.6
Imports of goods	16.4	16.8	15.7	16.0	16.8	16.7	16.4	16.2	15.8	15.5	15.2
Imports of services	4.9	5.2	4.9	4.9	5.1	5.0	4.9	4.8	4.7	4.5	4.4
Primary income, net	-2.3	-2.3	-2.4	-3.0	-3.3	-2.7	-2.7	-2.6	-2.5	-2.5	-2.4
Interest payments	-1.3	-1.3	-1.2	-1.1	-1.2	-1.2	-1.3	-1.2	-1.2	-1.2	-1.2
Equity income	-0.6	-0.7	-0.8	-1.5	-1.7	-1.3	-1.3	-1.3	-1.2	-1.1	-1.1
Secondary income, net	-0.2	-0.1	-0.1	-0.1	-0.1	-0.1	-0.1	-0.1	-0.1	-0.1	-0.1
Capital and financial account											
Capital account, net	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Financial account, net	3.2	4.8	3.1	2.7	2.5	2.7	2.9	3.1	3.1	3.0	2.8
Direct investment	2.8	3.1	3.6	2.9	3.1	2.4	1.7	1.7	1.7	1.7	1.7
Equity	2.1	1.2	3.0	2.9	3.2	2.4	1.7	1.7	1.7	1.7	1.7
Debt	0.6	2.0	0.6	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Portfolio investment	1.3	2.4	-2.2	0.7	-0.7	0.4	0.5	0.6	0.7	0.7	0.7
Equity	-0.8	0.8	-0.3	-1.0	-1.0	-0.5	-0.3	-0.1	0.0	0.0	0.0
Debt	2.2	1.6	-1.9	1.7	0.4	0.9	0.8	0.7	0.7	0.7	0.7
Financial derivatives	-0.2	-0.1	0.4	-0.7	0.3	-0.1	0.0	-0.1	-0.1	-0.1	-0.1
Other investment	-0.5	-0.9	2.0	0.5	-0.9	0.2	0.8	0.8	0.8	0.7	0.5
Reserve assets	-0.3	0.2	-0.6	-0.7	0.7	0.0	0.0	0.0	0.0	0.0	0.0
Net errors and omissions	0.0	0.0	0.2	-0.1	-0.2	0.0	0.0	0.0	0.0	0.0	0.0
BALANCE SHEET											
Net international investment position	-52	-56	-57	-54	-50	-51	-52	-52	-53	-53	-53
Equity, net	5	5	2	2	5	3	1	0	-2	-3	-5
Assets	65	67	69	72	80	80	80	80	81	81	81
Liabilities	60	62	67	70	75	77	79	81	82	84	85
Debt, net	-58	-61	-59	-56	-55	-54	-53	-52	-51	-50	-49
Assets	60	68	67	62	62	62	62	62	63	62	63
Liabilities	118	129	126	118	117	117	116	115	114	112	111
External assets (gross)	126	135	137	134	142	143	143	143	143	143	143
Equity	65	67	69	72	80	80	80	80	81	81	81
Debt	60	68	67	62	62	62	62	62	63	62	63
External liabilities (gross)	178	191	193	187	193	194	195	195	196	196	197
Equity	60	62	67	70	75	77	79	81	82	84	85
Debt	118	129	126	118	117	117	116	115	114	112	111
Of which: foreign currency, hedged	40	50	43	36	38	38	38	37	37	37	36
A\$-denominated	54	54	58	58	56	55	55	54	54	53	53
Short-term	40	43	44	39	38	38	37	37	37	36	36
MEMORANDUM ITEMS											
Gross official reserves (bn A\$)	66	63	74	85	...	...	...	...	...	...	...
In months of prospective imports	2.2	2.1	2.4	2.5	...	...	...	...	...	...	...
In percent of short-term external debt	10.2	8.8	10.0	12.0	...	...	...	...	...	...	...
Net official reserves (bn A\$)	53	58	58	57	...	...	...	...	...	...	...
Iron ore prices (index)	77	44	46	56	55	48	47	47	47	47	47
Coal prices (index)	81	67	75	101	120	108	102	99	99	99	99
Oil prices (Brent crude; index)	95	61	42	41	56	49	45	44	44	44	44

Sources: Authorities' data and IMF staff estimates and projections.

Table 4. Australia: Monetary and Financial Sector, 2014-2024

	2014	2015	2016	2017	2018	2019	2020	2021	2022	2023	2024
	Projections										
BALANCE SHEET											
	In billions of A\$										
Total assets 1/	3,719	4,023	4,230	4,187	4,387	4,553	4,776	5,004	5,252	5,540	5,849
Currency and deposits	273	275	310	255	267	277	290	304	319	337	356
Securities other than shares	566	607	626	624	653	678	711	745	782	825	871
Loans	2,609	2,894	3,043	3,100	3,245	3,365	3,496	3,641	3,812	3,999	4,196
Claims on government	12	12	11	12	13	13	14	15	15	16	17
Claims on MFI	345	382	391	366	383	398	417	437	459	484	511
Claims on non-MFIs	2,040	2,204	2,359	2,466	2,581	2,676	2,773	2,884	3,018	3,161	3,311
o/w private sector	2,040	2,204	2,359	2,466	2,581	2,676	2,773	2,884	3,018	3,161	3,311
Claims on non-residents	213	295	282	255	267	278	291	305	320	338	357
Shares and other equity	59	56	49	50	52	54	57	60	63	66	70
Other (w/o residual)	211	192	202	185	194	201	211	221	232	245	258
Other	211	192	202	160	170	178	221	253	276	313	357
Total liabilities 1/	3,719	4,023	4,230	4,187	4,387	4,553	4,776	5,004	5,252	5,540	5,849
Capital and reserves	224	256	254	270	283	293	308	322	339	357	377
Borrowing from RBA	73	73	78	87	91	94	99	103	109	115	121
Liabilities to other MFIs	673	759	792	763	799	829	870	912	957	1009	1066
Deposits of non-banks	2,166	2,359	2,503	2,493	2,611	2,710	2,843	2,979	3,127	3,298	3,482
Debt securities	381	385	405	422	442	459	481	504	529	558	589
Other liabilities	202	191	198	153	161	167	175	183	192	203	214
	In percent of GDP										
Total assets (w/o residual) 1/	230	245	248	232	232	232	232	232	232	232	232
Loans	162	176	179	171	171	171	170	169	168	167	166
Claims on MFI	21	23	23	20	20	20	20	20	20	20	20
Claims on non-MFIs	126	134	138	136	136	136	135	134	133	132	131
	Percent change										
Credit non-bank private sector 2/	5.5	6.8	5.6	5.2	4.7	3.7	3.6	4.0	4.6	4.7	4.8
o/w Housing credit	6.7	6.9	6.4	6.8	4.9	3.8	3.2	3.7	4.8	4.9	4.9
o/w Owner-occupied housing	4.7	10.7	7.8	8.4	7.0	5.1	4.3	5.0	6.5	6.5	6.5
o/w Investor housing	10.1	0.8	4.1	3.8	0.9	0.9	0.9	0.9	0.9	0.9	0.9
Personal credit	0.5	5.1	-0.4	-0.5	-1.7	1.0	1.0	1.0	1.0	1.1	1.1
Business credit	4.4	6.9	5.2	3.3	5.3	4.0	4.8	4.9	4.8	5.0	4.9

Sources: IFS (Other Depository Corporations, Table ODC-2SR), RBA, APRA, and IMF staff projections.

Notes: 1/ IFS (Other Depository Corporations, Table ODC-2SR).

2/ RBA (Table D2 Lending and Credit Aggregates).











Table 5. Australia: Selected Financial Soundness Indicators of the Banking Sector
(Year end unless otherwise noted, in percent)

	2012	2013	2014	2015	2016	2017	2018Q3
Capital Adequacy							
Regulatory capital to risk-weighted assets	12.1	11.8	12.4	13.9	13.8	14.7	14.7
Regulatory Tier I capital to risk-weighted assets	10.8	10.4	10.7	11.9	11.6	12.5	12.7
Capital to assets	6.1	6.0	5.9	6.0	6.6	6.9	7.0
Large exposures to capital	73.7	72.2	76.0	82.0	82.3	76.5	75.8
Nonperforming loans net of loan-loss provisions to capital	16.3	13.2	9.8	7.9	7.8	7.3	7.8
Asset Quality							
Nonperforming loans to total gross loans	1.8	1.5	1.1	0.9	1.0	0.9	0.9
Sectoral distribution of loans to total loans							
Residents	94.9	94.1	92.9	90.5	92.2	93.3	93.1
Deposit-takes	0.1	0.1	0.1	0.1	0.1	0.2	0.1
Central bank	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Other financial corporations	2.6	2.7	2.8	3.1	3.3	3.4	3.7
General government	0.3	0.3	0.3	0.3	0.3	0.2	0.2
Non-financial corporations	24.1	23.4	23.2	22.7	23.0	23.0	22.9
Other domestic sectors	67.8	67.7	66.6	64.3	65.5	66.6	66.2
Nonresidents	5.1	5.9	7.1	9.5	7.8	6.7	6.9
Earnings and Profitability							
Return on assets	1.1	1.2	1.2	1.4	0.8	1.2	1.4
Return on equity	17.7	20.1	20.8	23.8	12.1	16.7	19.7
Interest margin to gross income	68.0	67.3	66.9	59.4	82.5	71.3	63.9
Noninterest expenses as a percentage of gross income	49.8	47.4	47.9	42.8	53.8	47.5	44.9
Liquidity							
Liquid assets to total assets	16.9	17.0	16.4	17.0	17.6	17.8	17.2
Liquid assets to short-term liabilities	42.8	42.0	40.2	39.7	41.2	40.1	40.4

Sources: APRA and IMF, Financial Soundness Indicators (FSI) database.

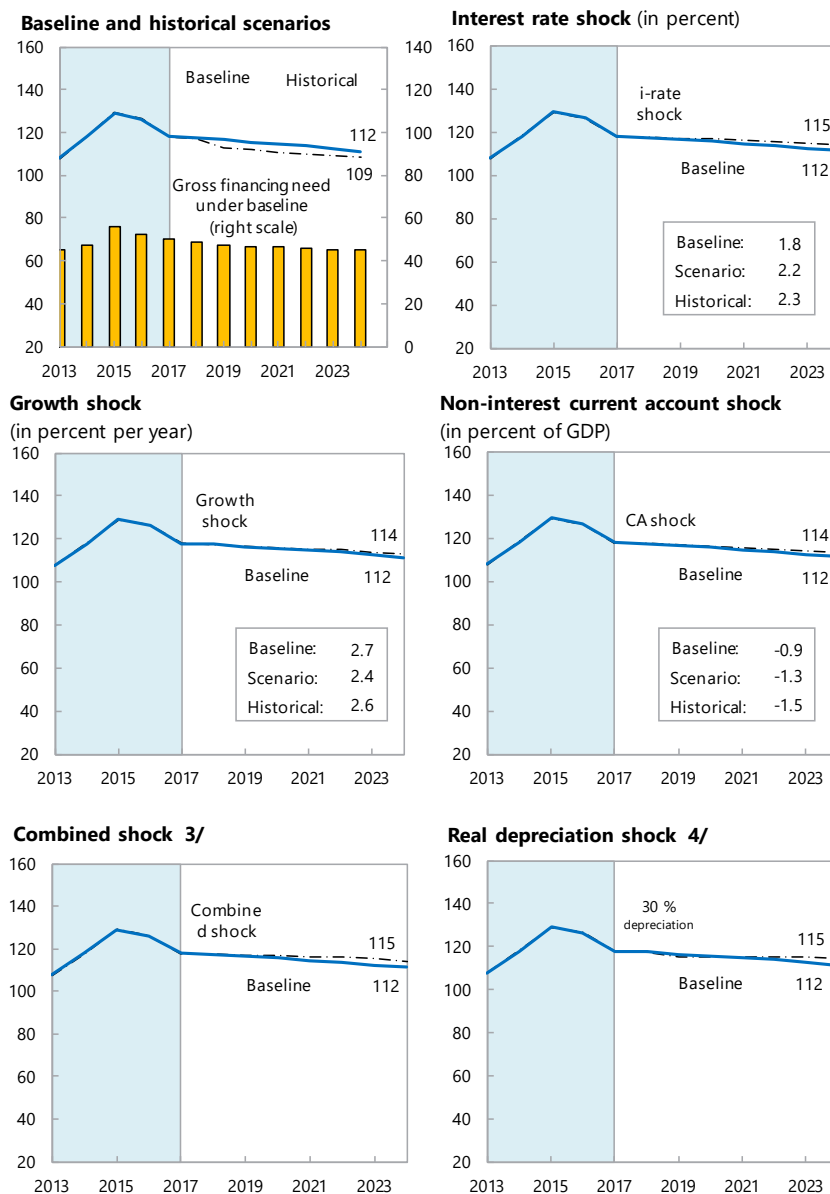
	Australia											Overall Assessment												
Foreign asset and liability position and trajectory	<p>Background. Australia has a large negative net international investment position (NIIP), reaching -54 percent of GDP at the end of 2017. Liabilities are largely denominated in Australian dollars, while assets are in foreign currency. Foreign liabilities are composed of around one quarter of FDI, one half of portfolio investment (principally banks borrowing abroad and foreign holdings of government bonds), and one quarter of other investment and derivatives. The NIIP improved in 2017 (by 3 percent of GDP relative to 2016), partly driven by a narrowing of the current account deficit and partly by strong nominal economic growth. The NIIP to GDP ratio is expected to remain around -53 percent of GDP over the medium term.</p> <p>Assessment. The NIIP level and trajectory are sustainable. The External Stability (ES) approach suggests that the NIIP would be stabilized at around current levels over the medium term with a CA deficit between 2¾-3 percent. The structure of Australia's external balance sheet reduces the vulnerability associated with its high negative NIIP. Since Australia's external liabilities are mainly in Australian dollars and there is a net foreign currency asset position, a nominal depreciation tends to strengthen the external balance sheet, all else equal. The banking sector's net foreign currency liability position is hedged. The maturity of banks' external funding has improved since the Global Financial Crisis, and even in a tail risk event where domestic banks suffer a major loss, the government's strong balance sheet position allows it to offer credible support.</p>											<p>Overall Assessment: <i>The external position of Australia in 2018 is projected to be broadly consistent with medium-term fundamentals and desirable policies, although the Australian dollar remains somewhat overvalued.</i> The CA deficit in 2018 is projected to shrink slightly to 2.4 percent of GDP. Some REER-based models suggest continued overvaluation.</p> <p>Potential policy responses: The Australian dollar remains moderately overvalued, and if growth was on the weak side, or commodity prices fell again, further monetary accommodation would be warranted.</p>												
Current account	<p>Background. Australia has run CA deficits for most of its history, reflecting a structural saving-investment imbalance with very high private investment relative to a private saving rate that is already high by advanced country standards. Since the early 1980s, deficits have averaged around 4 percent of GDP. The CA deficit in 2017 narrowed to 2.6 percent of GDP primarily reflecting stronger terms of trade, because of higher coal and iron ore prices in response to measures restricting domestic supply in China, and a ramp-up in new resource exports. The CA deficit is expected to shrink slightly to 2.4 percent of GDP in 2018, as strong terms of trade and the ramp-up in new resource exports continued, offsetting the negative impact of drought on rural exports. Over the medium term, the CA deficit is expected at a level lower than the historical average of around 4 percent, given the end of the prolonged import intensive mining investment boom and a lower interest differential on Australian bonds relative to foreign bonds compared to longer-term averages. With over half of Australia's exports going to emerging Asia, a key risk is a sharper than expected slowdown in China resulting in a further sharp decline in commodities prices.</p> <p>Assessment. Preliminary estimates from the 2018 EBA model suggest a CA norm of -0.6 percent of GDP. Taking the relative output gaps and the cyclical component of the commodity terms of trade into account, the cyclically adjusted CA for 2018 is estimated to be around -2.6 percent of GDP, indicating a CA gap of around -2.0 percent of GDP. However, in staff's view, the CA norm of Australia is closer to -1.6 percent of GDP, reflecting traditionally large investment needs due to its size, low population density, and initial conditions. Therefore, the adjusted 2018 CA gap for Australia is assessed to be in the range of -0.5 to -1.5 percent of GDP.</p> <table border="1"> <tr> <td>Projected CA</td> <td>-2.4</td> <td>Cycl. Adj. CA</td> <td>-2.6</td> <td>EBA CA Norm</td> <td>-0.6</td> <td>EBA CA Gap</td> <td>-2.0</td> <td>Staff Adj.</td> <td>-1.0</td> <td>Staff CA Gap</td> <td>-1.0</td> </tr> </table>												Projected CA	-2.4	Cycl. Adj. CA	-2.6	EBA CA Norm	-0.6	EBA CA Gap	-2.0	Staff Adj.	-1.0	Staff CA Gap	-1.0
Projected CA	-2.4	Cycl. Adj. CA	-2.6	EBA CA Norm	-0.6	EBA CA Gap	-2.0	Staff Adj.	-1.0	Staff CA Gap	-1.0													
CA Assessment 2018 projection																								
Real exchange rate	<p>Background. In 2017, Australia's REER appreciated by 2.9 percent relative to the 2016 average. As of December 2017, the REER was some 11 percent above its thirty-year average, consistent with the strengthening of the terms of trade in that period. Estimates up to November 2018 show that the REER depreciated by 4.8 percent relative to the 2017 average.</p> <p>Assessment. Considering estimates of the staff-assessed CA gap, the estimated REER gaps, and the gaps implied by the ES approach, staff assesses the 2017 REER to be 0 to 17 percent above the level implied by medium-term fundamentals and desirable policy settings. Real depreciation in 2018 have narrowed the range of overvaluation to 0 to 13 percent. 1/</p>																							
Capital and financial accounts: flows and policy measures	<p>Background. The mining investment boom has been funded predominantly offshore. Net FDI inflows into this sector have partially offset the reduced need for the banking sector to borrow abroad. As investment in new mining projects winds down, related demand for imports will decrease, buffering the impact on the overall balance of payments. Australia also received large inflows in recent years into bond markets. The weighted average maturity of government bonds is 6.6 years, and has lengthened over time, with 90 percent of the issue maturing by 2027.</p> <p>Assessment. Credible commitment to a floating exchange rate and a strong fiscal position limit the vulnerabilities.</p>																							
FX intervention and reserves level	<p>Background. A free-floater since 1983. The central bank undertook brief but large intervention in 2007-08 when the market for Australian dollars became illiquid (bid-ask spreads widened) following banking sector disruptions in the U.S. The authorities are strongly committed to a floating regime, which reduces the need for reserve holding.</p> <p>Assessment. Although domestic banks' external liabilities are sizable, they are either in local currency or hedged, so reserve needs for prudential reasons are also limited.</p>																							
Technical Background Notes	1/ For 2018, the REER index and level models imply an overvaluation of 2 and 13 percent respectively, while the CA gap is consistent with an overvaluation of 5 percent (applying an estimated elasticity of 0.2) and the ES approach suggests the REER is broadly in line.																							

Annex II. Risk Assessment Matrix

	Source of risks	Likelihood	Time horizon	Impact	Policies to reduce impact
Domestic risks					
	Stronger recovery momentum	M	Short term	M Non-mining business investment could recover faster with higher public infrastructure investment, which would boost domestic demand and growth.	The Australian dollar would likely appreciate; monetary policy tightening if output gap closes faster than expected and inflation is above the target range mid-point.
	Slowing of economic recovery	M	Short to medium term	M Consumption growth could be weaker with continued low wage growth and a higher incidence of part-time work, leading to weaker growth and an economic downturn.	Monetary policy easing; combined with easier fiscal policy if policy interest rates approaches the zero lower bound.
	Severe Housing market downturn	L/M	Short to medium term	H A sharp housing market correction would lower residential investment and private consumption, and thereby growth. A negative feedback loop of declining house prices, higher non-performing loans, tighter bank credit, and lower activity could amplify the downturn.	Monetary policy easing; fiscal policy stimulus; measures to facilitate mortgage debt restructuring, including selected fiscal intervention.
External Risks					
	Weaker growth in China S-T disorderly deleveraging or M-T insufficient progress in rebalancing and deleveraging	L (disorderly deleveraging) / M (insufficient progress in deleveraging, rebalancing)	Short to medium term	H A disorderly deleveraging and insufficient progress in rebalancing in China resulting in large commodity price declines would lead to a downturn in Australia. Could be exacerbated by an acceleration in the trade dispute with the United States.	Combined monetary policy and fiscal policy easing if the policy interest rate approaches the zero lower bound; structural fiscal measures to facilitate adjustment in commodity sectors and regions, including active labor market policies.
	Weaker-than-expected global growth	M	Medium term	M Lower growth in these economies would result in lower commodity prices and commodity consumption, and thereby lead to a downturn in Australia.	Monetary policy easing; combined with easier fiscal policy if policy interest rate approaches the zero lower bound. Structural and fiscal reforms to raise productivity.
	Sharp tightening of global financial conditions	M	Short term	M Australia would be affected through direct asset price channels, their impact on international funding conditions of Australian banks, and spillovers from their broader effects on global growth and commodity prices. Much would depend on investor sentiment toward Australia.	The exchange rate would likely act as a shock absorber and dampen the impact; monetary policy easing as needed.
	Unsustainable macroeconomic policies	M	Short to medium term	M A sharp tightening of global financial conditions could spill over into internationally integrated domestic financial markets, raising funding costs and lowering disposable income of debtors, with the impact also depending on the response of the Australian dollar.	The exchange rate would likely act as a shock absorber and dampen the impact; monetary policy easing as needed.
	Rising protectionism and retreat from multilateralism	H	Short to medium term	H Australia would be negatively affected as a rise in protectionism in large economies would reverse trade liberalization and regional integration, reduce global growth and commodity prices and increase financial market volatility. If China faces a strong impact, it would work directly through trade in commodities, tourism and education services.	Monetary policy easing; combined with easier fiscal policy if policy interest rate approaches the zero lower bound. Continued pursuit of open market policies for trade.
	Intensification of the risks of fragmentation and security dislocation	H	Short to medium term	M Escalated tensions in parts of the Middle East, Africa, Asia, and Europe could lead to some small decrease in external demand for Australia. It could experience safe-haven capital, leading to a stronger Australian dollar, which could result in a slower pickup in economic activity and inflation.	Monetary policy easing; combined with easier fiscal policy if policy interest rate approaches the zero lower bound.
	Sizable deviations from baseline energy prices	M	Short to medium term	L If oil prices increase sharply due to steeper-than-anticipated export declines, real consumer income would be lower. Prices could drop significantly if downside global growth risks materialize or supply exceeds expectations. Coal and LNG sectors would be hurt, as would the coal mining states.	The exchange rate would likely act as a shock absorber and dampen the impact; monetary policy response if needed.

Annex III. Debt Sustainability Analysis

Figure 1. Australia: External Debt Sustainability: Bound Tests 1/ 2/
(External debt in percent of GDP)



Sources: International Monetary Fund, Country desk data, and staff estimates.
 1/ Shaded areas represent actual data. Individual shocks are permanent one-half standard deviation shocks. Figures in the boxes represent average projections for the respective variables in the baseline and scenario being presented. Ten-year historical average for the variable is also shown.
 2/ For historical scenarios, the historical averages are calculated over the ten-year period, and the information is used to project debt dynamics five years ahead.
 3/ Permanent 1/4 standard deviation shocks applied to real interest rate, growth rate, and current account balance.
 4/ One-time real depreciation of 30 percent occurs in 2018 and 80 percent of fx denominated external debts are assumed to be hedged to local currency.

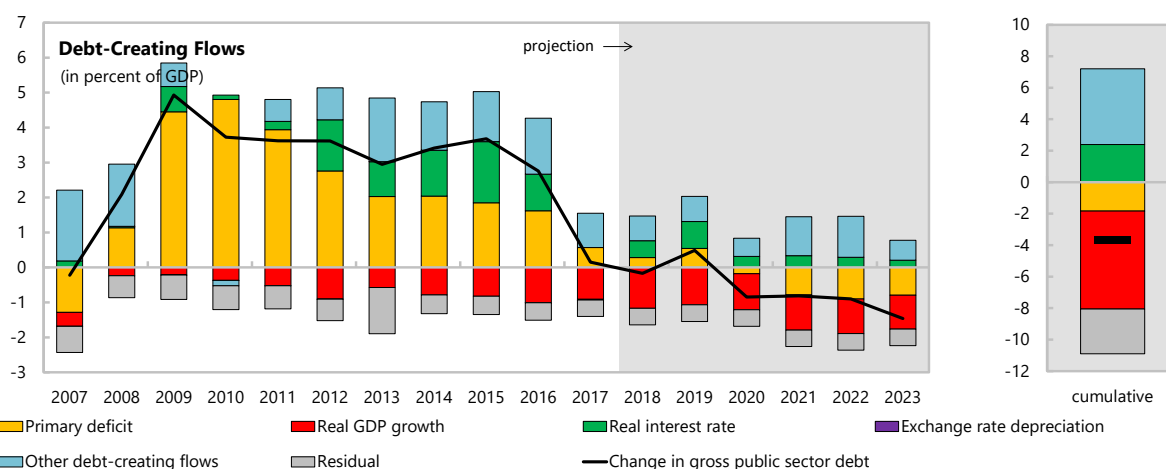
Figure 2. Australia: Public Sector Debt Sustainability Analysis (DSA) – Baseline Scenario
(In percent of GDP unless otherwise indicated)

Debt, Economic and Market Indicators^{1/}

	Actual			Projections						As of January 03, 2019		
	2007-2015 ^{2/}	2016	2017	2018	2019	2020	2021	2022	2023	Sovereign Spreads		
Nominal gross public debt	23.7	40.5	40.7	40.5	41.0	40.1	39.3	38.4	37.0	EMBIG (bp) 3/		-37
Public gross financing needs	2.9	2.6	1.6	3.6	3.7	3.2	2.9	2.6	3.3	5Y CDS (bp)		78
Real GDP growth (in percent)	2.8	2.8	2.4	3.0	2.7	2.6	2.6	2.6	2.6	Ratings	Foreign	Local
Inflation (GDP deflator, in percent)	2.4	1.0	3.6	1.7	1.0	2.1	2.1	2.3	2.6	Moody's	Aaa	Aaa
Nominal GDP growth (in percent)	5.3	3.9	6.1	4.8	3.7	4.8	4.8	5.0	5.3	S&P's	AAA	AAA
Effective interest rate (in percent) ^{4/}	5.9	3.9	3.6	3.0	3.0	3.0	3.0	3.1	3.2	Fitch	AAA	AAA

Contribution to Changes in Public Debt

	Actual			Projections						cumulative	debt-stabilizing primary balance ^{9/}
	2007-2015	2016	2017	2018	2019	2020	2021	2022	2023		
Change in gross public sector debt	3.1	2.8	0.1	-0.2	0.5	-0.8	-0.8	-0.9	-1.5	-3.7	
Identified debt-creating flows	3.8	3.3	0.6	0.3	1.0	-0.4	-0.3	-0.4	-1.0	-0.9	
Primary deficit	2.4	1.6	0.6	0.3	0.5	-0.2	-0.8	-0.9	-0.8	-1.8	
Primary (noninterest) revenue and grants	32.9	34.3	34.5	35.1	35.5	35.5	35.3	35.2	35.1	211.8	
Primary (noninterest) expenditure	35.4	35.9	35.0	35.4	36.1	35.3	34.5	34.3	34.3	209.9	
Automatic debt dynamics ^{5/}	0.2	0.0	-0.9	-0.7	-0.3	-0.7	-0.7	-0.7	-0.8	-3.8	
Interest rate/growth differential ^{6/}	0.2	0.0	-0.9	-0.7	-0.3	-0.7	-0.7	-0.7	-0.8	-3.8	
Of which: real interest rate	0.8	1.0	0.0	0.5	0.8	0.3	0.3	0.3	0.2	2.4	
Of which: real GDP growth	-0.5	-1.0	-0.9	-1.2	-1.1	-1.0	-1.0	-1.0	-1.0	-6.2	
Exchange rate depreciation ^{7/}	0.0	0.0	0.0	...	...	...	...	...	...	...
Other identified debt-creating flows	1.2	1.6	1.0	0.7	0.7	0.5	1.1	1.2	0.6	4.8	
Net privatization proceeds (negative)	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	
Contingent liabilities	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	
Stock-flow adjustment, incl. asset chang ^{8/}	1.2	1.6	1.0	0.7	0.7	0.5	1.1	1.2	0.6	4.8	
Residual, including asset changes ^{8/}	-0.7	-0.5	-0.5	-0.5	-0.5	-0.5	-0.5	-0.5	-0.5	-2.8	



Source: IMF staff.

1/ Public sector is defined as general government.

2/ Based on available data.

3/ Long-term bond spread over U.S. bonds.

4/ Defined as interest payments divided by debt stock (excluding guarantees) at the end of previous year.

5/ Derived as $[(r - \pi(1+g) - g + ae(1+r))/(1+g+\pi+g\pi)]$ times previous period debt ratio, with r = interest rate; π = growth rate of GDP deflator; g = real GDP growth rate;

a = share of foreign-currency denominated debt; and e = nominal exchange rate depreciation (measured by increase in local currency value of U.S. dollar).

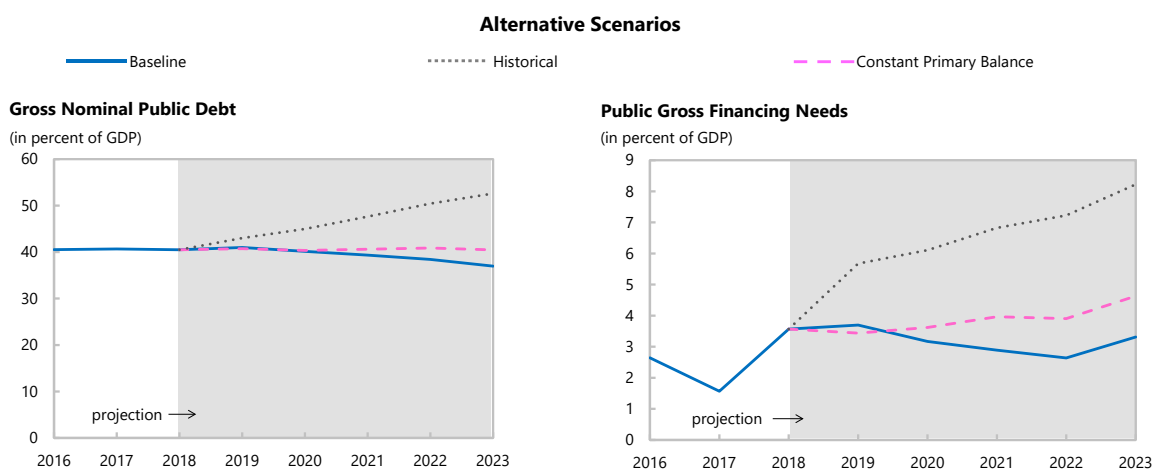
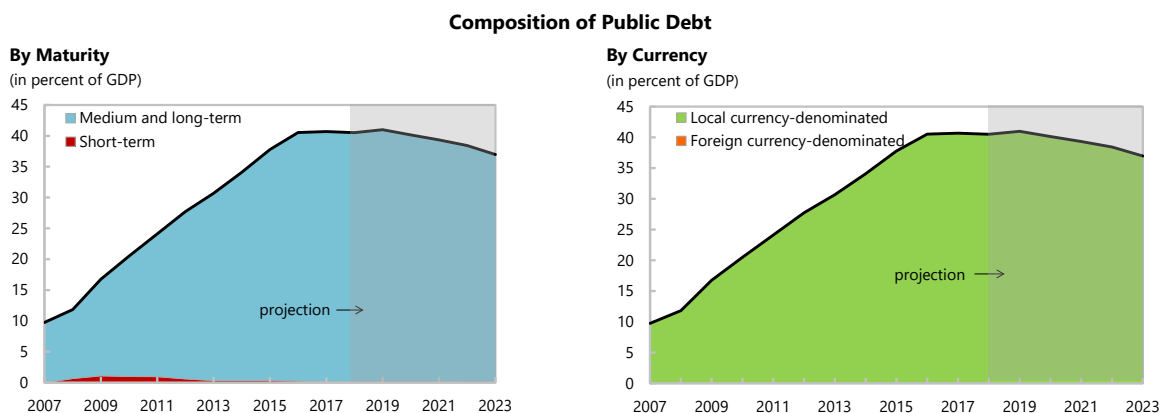
6/ The real interest rate contribution is derived from the numerator in footnote 5 as $r - \pi(1+g)$ and the real growth contribution as $-g$.

7/ The exchange rate contribution is derived from the numerator in footnote 5 as $ae(1+r)$.

8/ Includes asset changes and interest revenues (if any). For projections, includes exchange rate changes during the projection period.

9/ Assumes that key variables (real GDP growth, real interest rate, and other identified debt-creating flows) remain at the level of the last projection year.

Figure 3. Australia: Public DSA – Composition of Public Debt and Alternative Scenarios



Underlying Assumptions (in percent)

Scenario	2018	2019	2020	2021	2022	2023
Baseline Scenario						
Real GDP growth	3.0	2.7	2.6	2.6	2.6	2.6
Inflation	1.7	1.0	2.1	2.1	2.3	2.6
Primary Balance	-0.3	-0.5	0.2	0.8	0.9	0.8
Effective interest rate	3.0	3.0	3.0	3.0	3.1	3.2
Constant Primary Balance Scenario						
Real GDP growth	3.0	2.7	2.6	2.6	2.6	2.6
Inflation	1.7	1.0	2.1	2.1	2.3	2.6
Primary Balance	-0.3	-0.3	-0.3	-0.3	-0.3	-0.3
Effective interest rate	3.0	3.0	3.0	3.0	3.1	3.2
Historical Scenario						
Real GDP growth	3.0	2.6	2.6	2.6	2.6	2.6
Inflation	1.7	1.0	2.1	2.1	2.3	2.6
Primary Balance	-0.3	-2.5	-2.5	-2.5	-2.5	-2.5
Effective interest rate	3.0	3.0	3.3	3.6	4.0	4.3

Source: IMF staff.

Annex IV. Selected Key Macroprudential Policy Measures, 2014-18

Date	Authority	Measures
Dec 2014	APRA	<ul style="list-style-type: none"> • Speed limit curtailing annual growth in a bank's investor housing lending to 10 percent; • Serviceability assessments for new mortgage lending to include interest rate buffers of at least 2 percentage points above the effective variable rate applied for the term of the loan, and a minimum floor assessment rate of at least 7 percent to allow borrowers to accommodate future increases in interest rates; and • Supervisors would be alert to high levels of higher-risk mortgage lending with: <ul style="list-style-type: none"> ○ high LVR and/or loan-to-income ratio ○ owner-occupier loans with lengthy interest-only periods
Dec 2014	ASIC	A review of interest-only home loan was undertaken to determine whether lenders' lending practices complied with responsible lending obligations.
2015	APRA	<p>To assess and compare lending standards across ADIs, in early 2015, APRA request a number of the larger ADIs to complete a Hypothetical Borrower Exercise (HBE), providing serviceability assessments for four hypothetical mortgage borrowers — two owner-occupiers and two investors — using their policies in place as at December 31, 2014.</p> <p>In a second HBE conducted in late 2015, ADIs that were the least conservative in December 2014 generally reported a significant drop in calculated net income surplus using their September 2015 policies.</p>
Jul 2015	APRA	<p>Announced an increase in capital adequacy requirements for residential mortgage exposures for ADIs accredited to use the internal ratings-based (IRB) approach to credit risk, effective from July 1, 2016.</p> <p>This change requires an increase of average risk weights to at least 25 percent from about 16 percent, equivalent of increasing minimum capital requirements for major banks by approximately 80 basis points.</p>
Jan 2016	APRA	Countercyclical capital buffer (Basel III) was incorporated into the capital standards for locally incorporated ADIs. APRA has determined that the Australian jurisdictional countercyclical capital buffer applying from January 1, 2016 will be zero percent of risk-weighted assets. This rate will remain in force until APRA determines otherwise.
Oct 2016	APRA	Released for consultation a revised draft of Prudential Practice Guide APG 223 Residential Mortgage Lending to incorporate measures announced or communicated to ADIs since 2014.
2016	APRA	Conducted a thematic review of commercial property lending over 2016.

Date	Authority	Measures
2016	ASIC	Reviewed the lending practices of 11 large mortgage brokers to promote responsible lending and consumer confidence in the credit industry.
Mar 2017	APRA	<ul style="list-style-type: none"> • Limit the flow of new interest-only lending to 30 percent of new residential mortgage lending¹, and within that: <ul style="list-style-type: none"> ○ Strict internal limits on the volume of interest-only lending at loan-to-valuation ratios (LVRs) above 80 percent; and ○ Strong scrutiny and justification of any instances of interest-only lending at an LVR above 90 percent; and • Restraint on lending growth in higher risk segments of the portfolio, e.g. high LTI loans, high LVR loans and very long-term loans.
Apr 2018	APRA	<p>The 10 percent investment lending growth benchmark will no longer apply from July 1, 2018 where an ADI has been operating below it for at least the past 6 months, and the ADI's Board has provided the required assurance to APRA on both lending policies and practices:</p> <ul style="list-style-type: none"> • Interest rate buffers above 2 percentage points over the loan product rate, and interest rate floors above 7 percent; • application of these interest rate buffers and floors to both a borrower's new and existing debt commitments; • discounts on uncertain and variable income, with haircuts of at least 20 percent for most types of non-salary income and expected rental income; • for interest-only loans, an assessment of serviceability for the period over which the principal and interest repayments apply; • prudently managing overrides to lending policies, with risk tolerances set by the Board on the extent of exceptions to serviceability policy (negative serviceability) and serviceability verification waivers; and • developing internal risk appetite limits on the proportion of new lending at very high debt to income levels (where debt is greater than 6 times a borrower's income), and policy limits on maximum debt to income levels for individual borrowers.
Dec 2018	APRA	<p>For ADIs that have provided the necessary assurances on their lending standards and are no longer subject to the investor loan growth benchmark of 10 percent, the interest-only benchmark will also no longer apply, effective from January 1, 2019.</p> <p>For other ADIs, it will be removed concurrently with the removal of the investor loan growth benchmark.</p>
<p>¹ADIs with levels of interest-only loans below the benchmark are expected to remain below it and not increase the share of new interest-only loans materially from current levels.</p>		

Annex V. Key FSAP Recommendations

Recommendations and Authority Responsible for Implementation	Time¹
Banking and Insurance Supervision	
Strengthen the independence of APRA and ASIC, by removing constraints on policy making powers and providing greater budgetary and funding autonomy; strengthen ASICs enforcement powers and expand their use to mitigate misconduct (Treasury, APRA, ASIC).	ST
Enhance APRA's supervisory approach by carrying out periodic in-depth reviews of governance and risk management (APRA).	ST
Strengthen the integration of systemic risk analysis and stress testing into supervisory processes (APRA, RBA).	I
Financial Stability Analysis	
Commission and implement results of a comprehensive forward-looking review of potential data needs. Improve the quantity, quality, granularity and consistency of data available to the CFR agencies to support financial supervision, systemic risk oversight and policy formulation (CFR agencies).	MT
Enhance the authorities' monitoring, modeling and stress testing framework for assessing solvency, liquidity and contagion risk. Draw on the results to inform policy formulation and evaluation (CFR agencies).	ST
Encourage further maturity extension and lower use of overseas wholesale funding (APRA).	I
Systemic Risk Oversight and Macprudential Policy	
Raise formalization and transparency of the CFR and accountability of its member agencies through publishing meeting records as well as publication and presentation of an Annual Report to Parliament by CFR agency Heads (CFR agencies).	I
Undertake a CFR review of the readiness to apply an expanded set of policies to address systemic risks, including data and legal/regulatory requirements; and address impediments to their deployment (CFR agencies).	I
Commission analysis by the CFR member agencies on relevant financial stability policy issues, including: policies affecting household leverage; as well as factors affecting international investment flows and their implications for real estate markets (CFR agencies).	MT
Financial Crisis Management and Safety Nets	
Complete the resolution policy framework and expedite development of resolution plans for large and mid-sized banks and financial conglomerates, and subject them to annual supervisory review (APRA, Treasury).	ST
Extend resolution funding options by expanding loss-absorption capacity for large and mid-sized banks and introduce statutory powers (APRA, Treasury).	ST
Advance mutual understanding between the Australia and New Zealand resolution authorities on cross-border bank resolution modalities, through the Trans-Tasman Banking Council (CFR agencies).	ST
Financial Market Infrastructures	
Strengthen independence of RBA and ASIC for supervisory oversight, enhance enforcement powers and promote compliance with regulatory requirements (RBA, ASIC, Treasury).	I
Finalize the resolution regime for FMIs in line with the FSB Key Attributes (RBA, ASIC, Treasury).	ST
Anti-Money Laundering / Countering the Financing of Terrorism (AML/CFT)	
Expand the AML/CFT regime to cover all designated non-financial businesses and professions (DNFBPs), and strengthen AML/CFT supervision by: improving data collection and risk analysis; increasing oversight of controls and compliance; and undertaking more formal enforcement action in the event of breaches (Department of Home Affairs, Treasury, AUSTRAC).	I
¹ I Immediate (within 1 year); ST Short term (within 1-2 years); MT Medium term (within 3-5 years).	



AUSTRALIA

STAFF REPORT FOR THE 2018 ARTICLE IV CONSULTATION—INFORMATIONAL ANNEX

January 18, 2019

Prepared By

Asia and Pacific Department

CONTENTS

FUND RELATIONS	2
STATISTICAL ISSUES	4

FUND RELATIONS

(As of December 31, 2018)

Membership Status: Joined: August 5, 1947; Article VIII

General Resources Account:

	<u>SDR Million</u>	<u>Percent Quota</u>
Quota	6,572.40	100.00
Fund holdings of currency (exchange rate)	5791.43	88.12
Reserve tranche position	781.33	11.89
Lending to the Fund		
New Arrangements to Borrow	186.57	

SDR Department:

	<u>SDR Million</u>	<u>Percent Allocation</u>
Net cumulative allocation	3,083.17	100.00
Holdings	3,109.70	100.86

Outstanding Purchases and Loans: None

Financial Arrangements: None

Type	Date of Arrangement	Expiration Date	Amount Approved (SDR Million)	Amount Drawn (SDR Million)
Stand-By	May 01, 1961	Sep 05, 1961	100.00	0.00

Projected Obligations to Fund¹

(SDR million; based on existing use of resources and present holdings of SDRs):

	<u>Forthcoming</u>				
	<u>2019</u>	<u>2020</u>	<u>2021</u>	<u>2022</u>	<u>2023</u>
Principal					
Charges/interest	0.05	0.05	0.05	0.05	0.05
Total	0.05	0.05	0.05	0.05	0.05

¹ When a member has overdue financial obligations outstanding for more than three months, the amount of such arrears will be shown in this section.

Exchange Rate Arrangement. Australia has accepted the obligations of Article VIII, Sections 2, 3, and 4 of the Articles of Agreement, and maintains an exchange system that is free from restrictions

on the making of payments and transfers for current international transactions, except for exchange restrictions that are maintained solely for the preservation of national or international security and which have been notified to the Fund pursuant to Executive Board Decision No. 144-(52/51). The exchange rate is free floating, but the Reserve Bank of Australia retains discretionary power to intervene. There are no taxes or subsidies on purchases or sales of foreign exchange.

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.

Article IV Consultation. Australia is on the 12-month consultation cycle. The 2018 Article IV consultation discussions were held during November 7-20, 2018; the Executive Board discussed the staff report and concluded the consultation on February 4, 2019.

FSAP. The 2018 FSAP missions were held during June 6-26 and August 29- September 14, 2018. The findings were discussed with the authorities during the Article IV consultation discussions in November 2018 and were presented to the Executive Board for discussion alongside the Article IV staff report on February 4, 2019. The previous FSAP Update was discussed by the Executive Board on November 12, 2012 (IMF Country Report No. 12/308).

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

STATISTICAL ISSUES

Data provision is adequate for surveillance. Australia has subscribed to the Special Data Dissemination Standard (SDDS) since April 1996, and its metadata are posted on the Fund's Dissemination Standards Bulletin Board (DSBB). Australia implemented all the recommendations of the first phase of the G-20 Data Gaps Initiative (DGI), with the exception of semi-annual reporting of Coordinated Portfolio Investment Survey (CPIS) data. Australia also participates in the second phase of the DGI but has no plans to adhere to the SDDS Plus. In recent years, the Australian Bureau of Statistics (ABS) has taken several initiatives to further improve the quality of the data, such as issues relating to seasonal adjustment of unemployment and employment statistics. Adding monthly inflation data to the suite of statistics would assist surveillance.

I. Assessment of Data Adequacy for Surveillance

Real Sector. GDP is compiled on a quarterly basis and timely published in the first week of the third month after the end of a quarter. Based on the 2008 SNA, GDP is derived by income, expenditure, and production approaches, with their estimates aligned annually based on supply and use tables, which are incorporated in published quarterly estimates 17 months after the reference period. Seasonal and trend estimates are also published. According to the ABS, Australia's implementation of the 2008 SNA standards reflect local conditions and requirements, with departures from the standards relatively minor and not affecting the cross-country comparability of national accounts information. The compiling methodology and the departures from 2008 SNA recommendations are disseminated to the public in detail. The Consumer Price Index (CPI) is published quarterly in the month following the end of a quarter, based on almost 900,000 separate price quotations collected each quarter, together with a breakdown by categories and geographical locations, as well as various analytical series.

Fiscal Sector. The ABS provides annual data (operating statement, balance sheet, government expenses by function, taxation revenue and non-financial assets reconciliation) on the general government and its Commonwealth (central), state/territorial and local government subsectors following the Government Finance Statistics Manual 2014 (GFSM 2014) recommendations, publishing data from 10 years back (with or without revision) on a fiscal year (July-June) basis. It is published roughly 10 months following the fiscal year end, preceded by data on a provisional basis at the time of the budget (usually in May, based on data from 3 months prior to fiscal year end).

The Commonwealth, State and Territorial governments also provide data on a timely basis for their respective public sectors that complies with the ABS implementation of the GFS on an accrual basis and the Australian Accounting Standards (AAS). They are presented using the Uniform Presentation Framework to enhance comparability among states and territories, and with the Commonwealth. They are provided on a monthly basis (with a one-month lag), with an annual statement published within 4 months of the fiscal year end, and are also part of the budgets and mid-year reviews of their respective governments

The provided data enable adequate assessment of the impact of fiscal policy measures on Australia's economic performance.

Monetary and Financial Sectors.

The Reserve Bank of Australia (RBA) publishes monthly and quarterly data on a broad range of financial variables for financial institutions, the payments system, money and credit statistics, and household and business finances. Most data are monthly, quarterly for banking lending, and weekly or daily series for open market operations, exchange and interest rates.

Monetary and Financial Statistics: The RBA reports monthly monetary and financial statistics (MFS) to the IMF Statistics department based on the standardized report forms. While MFS for Australia are broadly in line with the concepts and definitions of the *IMF's Monetary and Financial Statistics Manual* (2000), the scope of the other financial corporations' sector data could be improved by also including insurance corporations, pension funds, and other financial institutions. The ABS, the Australian Prudential Regulation Authority, and the RBA are reviewing some of their MFS reporting forms with the aim to increase the quality and granularity of source data and to meet the G-20 Data Gaps Initiative (DGI-2) recommendations.

Financial Sector Surveillance: The RBA reports all core financial soundness indicators (FSI) for deposit takers except for the FSIs on the "net open position in foreign exchange to capital" and 21 of the 28 encouraged FSIs for other sectors on a quarterly basis.

External Sector. The ABS publishes the Balance of Payment (BOP) and International Investment Position (IIP) statistics based on the IMF's Balance of Payments and International Investment Position Manual, Sixth Edition (BPM6). Comprehensive data reporting systems support the accuracy and reliability of the external sector statistics. The statistics are disseminated quarterly and timely published in the first week of the third month after the end of the reference quarter. The BOP and IIP data are consistent and reconcilable with national accounts, monetary, financial and external debt statistics. Historical time series date back to 1959, facilitating researchers to analyze long-term economic issues such as the terms of trade.

Table of Common Indicators Required for Surveillance
(As of January 2, 2019)

	Date of Latest Observation	Date Received	Frequency of Data ⁷	Frequency of Reporting ⁷	Frequency of Publication ⁷
Exchange Rates	1/2/19	1/2/19	D	D	D
International Reserve Assets and Reserve Liabilities of the Monetary Authorities ¹	11/18	12/31/18	M	M	M
Reserve/Base Money	11/18	12/31/18	M	M	M
Broad Money	11/18	12/31/18	M	M	M
Central Bank Balance Sheet	12/26/18	12/28/18	W	W	W
Consolidated Balance Sheet of the Banking System	11/18	12/31/18	M	M	M
Interest Rates ²	1/2/18	1/2/18	D	D	D
Consumer Price Index	Q3 2018	10/30/18	Q	Q	Q
Revenue, Expenditure, and Balance – General Government ³	09/18	12/07/18	Q	Q	Q
Revenue, Expenditure, and Balance – Central Government	09/18	12/03/18	Q	Q	Q
Composition of Financing ⁴ – General Government ⁴	09/18	12/03/18	Q	Q	Q
Composition of Financing ⁴ – Central Government	11/18	12/20/18	M	M	M
External Current Account Balance	Q3 2018	12/03/18	Q	Q	Q
Exports and Imports of Goods and Services	10/18	12/05/18	M	M	M
GDP/GNP	Q3 2018	12/04/18	Q	Q	Q
Gross External Debt ⁵	Q3 2018	12/03/18	Q	Q	Q
International Investment Position ⁶	Q3 2018	12/03/18	Q	Q	Q
<p>¹Any reserve assets that are pledged or otherwise encumbered should be specified separately. Also, data should comprise short-term liabilities linked to a foreign currency but settled by other means as well as the notional values of financial derivatives to pay and to receive foreign currency, including those linked to a foreign currency but settled by other means.</p> <p>²Both market-based and officially determined, including discount rates, money market rates, rates on treasury bills, notes, and bonds.</p> <p>³Consists of the central government (including budgetary, extra budgetary, and social security funds) and state and local governments.</p> <p>⁴Foreign, domestic bank, and domestic nonbank financing.</p> <p>⁵Including currency and maturity composition.</p> <p>⁶Includes external gross financial asset and liability positions vis-à-vis nonresidents.</p> <p>⁷Daily (D), Weekly (W), Monthly (M), Quarterly (Q), Annually (A), Irregular (I); Not Available (NA).</p>					

**Statement by Nigel Ray, Executive Director for Australia
and Gemma Preston, Senior Advisor to Executive Director,
and Anna Park, Advisor to Executive Director
February 4, 2019**

Australia has just completed its 27th consecutive year of economic growth, with the adjustment to the largest terms of trade shock in our history and the associated huge mining investment boom running its course. The successful economic transition has occurred in the context of an open, diversified economy with a flexible exchange rate regime, liberalized capital account, flexible labor and product markets, supportive macroeconomic policies, strong institutional arrangements and robust regulatory frameworks. Economic growth is expected to be around potential in the near term. Authorities continue to pursue policies to boost potential growth, and remain firmly committed to open trade, investment and immigration. The 2018 Financial Sector Assessment Program (FSAP) underscores the strength and resilience of the Australian financial system. Stress tests highlight that Australian banks could withstand significant shocks, including the combination of a large slowdown in China with a severe correction in house prices.

Since the time of the 2018 IMF Article IV consultation in November 2018, the Australian economy has continued to perform strongly. The September quarter national accounts, despite showing softer growth than in previous quarters, reflected continued broad-based growth with household consumption, dwelling investment, net exports and new public final demand contributing to through-the-year real GDP growth of 2.8 percent. Notably, strong employment outcomes in the labor market continued in December 2018 with employment increasing by more than 21,000 and the unemployment rate falling to 5.0 percent, its equal lowest level since June 2011. Both underlying and headline inflation remain subdued, reflecting modest wage growth and continued strong retail competition and the impact of government child care policy initiatives. The Government released its Mid-Year Economic and Fiscal Outlook (MYEFO) update in December 2018, which forecast a smaller fiscal deficit in 2018-19 than in the Budget and a return to surplus in 2019-20. Most recently, after ratifying the Comprehensive and Progressive Agreement for Trans-Pacific Partnership (TPP-11) Australia joined Canada, Japan, Mexico, New Zealand and Singapore as part of the first group of countries where the TPP-11 entered into force on December 30, 2018.

Staff and authorities broadly agree on the outlook and risks for the Australian economy. Risks associated with Australia's exposure to China as a result of the significant trade linkages were examined by staff¹ in 2017. Results showed that spillovers to Australia in the event of a disorderly adjustment in China should be placed in the context of Australia's relatively diversified economy and its willingness to accept the moderating influence of its flexible exchange rate and open economy. Staff also showed that Australia's diversified economy is reliant on strongly established trading relations with the rest of Asia, both

¹ The significant role of trade linkages between Australia and China were examined in Karam and Muir, 2018, "Australia's Linkages with China: Prospects and Ramifications of China's Economic Transition," in *Australia: Selected Issues*, IMF Country Report No. 18/45 (also available as IMF Working Paper 18/119).

advanced and emerging countries, not just China alone, which mitigates the effects from a possible shock in China.

Labor market conditions are strong with robust employment growth, a historically high participation rate and the unemployment rate at its equal lowest level since June 2011, around the estimated level of the NAIRU. Continued strength in labor market outcomes is expected to support a gradual pick-up in wage and price growth. In Australia, as elsewhere in advanced economies, slower wages growth, inflation and inflation expectations have been a feature of the post-crisis era. In Australia's case, the slow recovery in wages growth also reflects adjustments associated with the unwinding of high commodity prices following the terms of trade boom.

The authorities agree with staff that monetary and fiscal policy settings remain appropriate for the current economic conditions. Should an adverse external shock materialize, authorities have both conventional and unconventional monetary policy levers and significant fiscal space available to respond. The fully flexible exchange rate would also act as a buffer to certain adverse external shocks.

The accommodative stance of monetary policy is appropriately supporting stability and confidence in the Australian economy. It is also consistent with further progress towards full employment, including through reducing underemployment, and for inflation to return gradually toward the mid-point of the target. The current stance of monetary policy balances the need to support the economy in the final days of the transition to lower levels of mining investment against the risks stemming from current levels of household debt. Authorities note staff's recommendation to provide clear guidance on the expected path of policy normalization. The Reserve Bank of Australia (RBA) will continue to ensure that the public understands its reaction function, allowing them to form their own views on the potential path of interest rates. Australia's flexible inflation-targeting framework ensures that the RBA remains well-placed to respond to future developments.

Australia's current account deficit continues to reflect that Australia's strong investment outcomes are not able to be fully met by domestic savings, as is typical for resource endowed and sparsely populated countries. While Australia has a net foreign liability position, it has a net foreign currency asset position, because the bulk of Australia's foreign liabilities are issued in, or hedged back into, Australian dollars. The banking sector not only hedges its foreign currency liabilities but does so in a way that matches the duration of its hedges with the underlying liabilities. Additionally, over the past decade Australia has tended to issue debt with longer term maturities reducing risks associated with rollover or refinancing. For these reasons, Australia's net external liabilities have a relatively robust structure, minimizing exposure to exchange rate and other macro-financial risks, including risks associated with wholesale funding as identified in the FSAP. The current account deficit is expected to remain toward the low end of the range in which it has fluctuated over recent decades, and net foreign liabilities have been stable as a share of GDP over the past decade.

The Australian Government continues to maintain a responsible fiscal stance, while implementing its plan to lift potential growth by boosting productivity through lower taxes, targeted spending and investment in infrastructure. Consistent with the

Government's commitment to responsible budget repair, the fiscal position is projected to return to surplus in 2019-20 and continued strong fiscal discipline will ensure that these surpluses exceed 1 percent of GDP in the medium term. The Government is focused on containing recurrent spending, with average real payments growth now the lowest in fifty years. Authorities take note of staff's suggestion of incorporating a medium-term debt anchor as a part of the fiscal strategy and will carefully weigh up this suggestion in the context of maintaining sufficient flexibility to respond to changes in economic conditions, alongside continued strengthening of the framework.

Australian authorities note staff's advice that further increases in infrastructure spending could be considered given the IMF's assessment of Australia's fiscal space.

The quality of investment in infrastructure is also important to deliver a boost to potential growth. The Australian Government has processes in place to facilitate high quality investment in infrastructure. *Infrastructure Australia* works to prioritize and progress nationally significant infrastructure projects that are underpinned by robust business cases. At the current levels of investment in infrastructure by the Commonwealth, State and Territory governments, some capacity constraints and skills shortages are emerging, which would potentially be amplified by a further lift in infrastructure spending. More broadly, Australian authorities consider that, given the current point in the cycle and as a small open economy, it is important to preserve fiscal space as a buffer to deal with significant adverse shocks should they materialize.

Australia remains firmly committed to open trade, investment and immigration. The authorities underscore their steadfast commitment to a cooperative multilateral trading framework that promotes openness over protectionism. The commencement of the TPP-11 from December 30, 2018 is Australia's first trade agreement with Canada and Mexico and offers important opportunities to both Australia and its trading partners. Australia remains well placed to benefit from its diversification and integration into Asia, and continues to benefit from recent FTAs with China, Japan and South Korea. Australia's free trade agreements cover 70 percent of its total two-way trade and will rise to 88 percent when current negotiations are completed.

The recent cooling of the housing market is welcome amid significant and sustained price increases in recent years and is helping to improve housing affordability. Recent falls in house prices in Australia's two largest cities have only partly unwound the strong growth recorded in those cities: capital city housing prices remain around 40 percent higher than in 2012. In this context, authorities expect the impact of the housing correction on consumption through the wealth effect to be relatively small. In addition, the correction to housing prices is occurring in the context of strong employment growth and labor market outcomes. Underlying demand is expected to remain strong, underpinned by population growth. On the supply side, the authorities agree that further reforms are needed to planning and zoning restrictions that impede supply with long lags.

Household debt is elevated relative to incomes and has been rising as moderate growth in debt has outpaced the low growth in household incomes in recent years. Downside risks from the housing market correction are a concern and vulnerabilities associated with household debt dynamics will be monitored closely. But, household balance sheets are

generally strong, housing credit growth has not been unusually strong and many households have built significant mortgage buffers including through additional repayments and the use of offset accounts (mortgage buffers have doubled since 2008). Further, the distribution of debt is skewed towards high income households, with households in the top two income quintiles holding over 60 percent of Australian household debt. To the extent that higher income households are comprised of high skill workers that may be less vulnerable to unemployment shocks, this distribution enhances debt sustainability.

The authorities consider that staff's assessment that changes to tax policy would reduce structural incentives for leveraged investment by households represents a misunderstanding of how Australia's comprehensive income tax system works. The ability to offset costs incurred in earning income against all sources of income (negative gearing) is a fundamental element of such a system. In no way is it concessional. The authorities note that limiting such deductions would represent a move away from a comprehensive income tax system and would run the risk of introducing higher costs and distortions into the tax system.

Australian authorities welcome the FSAP recommendations and remain committed to continued improvement to regulatory frameworks and supervision practices. Australia's financial system remains fundamentally sound. Australian banks' capital ratios are around 50 percent higher than a decade earlier; banks have switched to more stable funding sources and increased their holdings of liquid assets and charges for bad debts are at historic lows. Stress testing shows that banks are resilient to significant shocks.

The Australian 2018 FSAP has taken place in the midst of a significant reform agenda for the financial sector, and against the backdrop of a Royal Commission into Misconduct in the Banking, Superannuation and Financial Services Industry. The FSAP recommendations will be considered in the context of the broader reforms to the financial system proposed by the 2014 Financial System Inquiry (FSI) and the Productivity Commission's review into 'Competition in the Australian Financial System.' A number of recommendations from the FSI have already been implemented including ensuring that banks have 'unquestionably strong' capital ratios, strengthening and testing the crisis management framework and moving to industry funding for Australia's corporate regulator, the Australian Securities and Investments Commission.

In a few places, the Australian authorities believe that the assessment and recommendations could have been better grounded within the context of Australia's governance structure and the nature of the systemic risks being faced. This would be consistent with the recent IEO evaluation that emphasized advice should be fully anchored in the local circumstances and not overly reliant on off-the-shelf "international best practice" more suited in other contexts.

In particular, Australian authorities are disappointed by the IMF's assessment of regulatory independence where staff's assessment does not appropriately take into account the operational context associated with Australia's system of government. Fundamental 'checks and balances' in Australia's system are designed to hold government agencies accountable to the Executive and Parliament, and ultimately to the public. These checks and balances should not be considered as compromising the operational independence of Australian regulators.

The Australian authorities agree that financial sector supervisors should be equipped with the resources and powers that they need to perform their roles effectively. The Government announced additional funding for the Australian Securities and Investments Commission and Australian Prudential Regulation Authority in the 2nd half of 2018.

Australia's approach to managing financial risks involves a high degree of collaboration across key agencies that is coordinated through the non-statutory Council of Financial Regulators² (CFR). Individual agencies remain accountable for the policies they adopt and their operations. The transparency of CFR activities has recently been enhanced through the publication of a quarterly statement on its activities, modernization of the CFR website and expanded coverage of CFR activities in the RBA's Financial Stability Review.

On prudential policy, caps limiting investor and interest-only housing lending have been removed because they have met the objective of strengthening resilience across the financial system. This should not be seen as a loosening of prudential policy, but rather the removal of temporary speed limits as improved lending practices have become embedded. CFR agencies have worked together in recent years to reinforce sound residential mortgage lending practices in an environment of rising household indebtedness. A broad range of tools (including many used in other countries) were considered before arriving at the set of measures that CFR agencies agreed would best achieve policy objectives. The subsequent evidence suggests that the Australian approach has been successful in managing the financial stability risks faced.

The Australian authorities appreciated the opportunity to engage in an open and constructive dialogue with the AIV and FSAP mission teams on the Australian economy and financial system.

² The Council of Financial Regulators is the coordinating body for Australia's main financial regulatory agencies. It comprises the Reserve Bank of Australia, the Australian Prudential Regulation Authority, the Australian Securities and Investments Commission and The Treasury.