IMF Country Report No. 17/42

AUSTRALIA

February 2017

2016 ARTICLE IV CONSULTATION—PRESS RELEASE; STAFF REPORT; STAFF STATEMENT; 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 2016 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 3, 2017 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 3, 2017, following discussions that ended on November, 15, 2016, 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 17, 2017.
- An **Informational Annex** prepared by the IMF staff.
- A **Staff Statement** updating information on recent developments.
- A **Statement by the Executive Director** for Australia.

The document listed below will be separately released.

Selected Issues

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.

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FOR IMMEDIATE RELEASE
February 9, 2017

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

IMF Executive Board Concludes 2016 Article IV Consultation with Australia

On February 3, the Executive Board of the International Monetary Fund (IMF) concluded the 2016 Article IV consultation with Australia.[1]

Australia has enjoyed robust growth despite the commodity price and mining investment bust. The moderate impact of the large shocks since 2011 highlights the resilience of the economy and strong policy frameworks. From mid-2015, the recovery advanced with a marked pickup in activity, although underlying demand growth remained close to trend. Nevertheless, Australia has not been immune to some elements of the "new mediocre." Wage and price pressures have been weak, underemployment has risen, and private business investment outside mining has been lackluster.

By some metrics, housing market conditions have cooled, in tandem with intensified prudential and regulatory steps, but risks related to house price and debt levels remain. In the continued low interest rate environment, house prices and household debt have risen further but house price growth has moderated. Intrinsic housing market risks are localized. Bank lending to household has slowed, especially in riskier loans, and banks have strengthened their balance sheets.

With inflation below the target range of 2-3 percent and a downshift in the path of inflation expectation in 2016, the Reserve Bank of Australia (RBA) lowered its policy rate by another 50 basis points to 1.5 percent. Core inflation has since stabilized at around 1.6 percent. Wage growth has remained weak, with nominal unit labor costs running at less than 0.5 percent on average, and cost pressures have been virtually absent suggesting that some economic slack is still present.

The federal government has recently aimed for substantial near-term fiscal consolidation but budget targets have not been met because of weaker nominal income. In the FY2016/17 budget, the government has projected a return to fiscal balance by FY2020/21. It has renewed its commitment to a federal government surplus of 1 percent of GDP over the business cycle as a medium-term fiscal anchor, which would imply a cumulative adjustment of up to 3.4 percent of

[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.

GDP. The Mid-Year Economic and Fiscal Outlook 2016-17 (MYEFO) foresees a cumulative adjustment of the fiscal balance of 2.1 percent of GDP by end of FY2019/20, primarily related to stronger personal income tax collection due to bracket creep.

Recent structural reforms have focused on fostering innovation. The National Innovation and Science Agenda (NISA) includes measures to boost innovation and entrepreneurship in the high-tech sector, including through tax breaks. Legislation is being prepared for key components of the Harper Review, which has identified a number of reforms to boost competition and productivity in the services sectors, and to strengthen competition policy broadly.

Executive Board Assessment[2]

Executive Directors noted that Australia's robust economic growth and low unemployment during the current terms-of-trade adjustment reflect the resilience of the economy and strong policy frameworks. While the balance of risks to the growth outlook has improved, there remain significant risks and uncertainties, notably weaker-than-expected domestic consumption, housing-related vulnerabilities, the rise in protectionist policies in the global economy, and a significant slowdown in Australia's main trading partners. Against this background, Directors stressed the importance of maintaining supportive macroeconomic policies, addressing macro-financial vulnerabilities, and boosting long-term potential growth.

Directors noted that continued demand support is needed to ensure a smooth transition to non-mining growth. They agreed that, with inflation below target, still elevated underemployment, and remaining economic slack, the monetary policy stance should remain accommodative. Directors welcomed the authorities' readiness to ease monetary policy further if warranted, and encouraged steps to improve policy communication.

Directors supported the government's plans to balance its budget over four years and make its expenditure composition more growth-friendly. Many Directors saw scope for using the available fiscal space to support aggregate demand and structural fiscal reforms, as well as increase infrastructure investment. Many other Directors viewed the authorities' front-loaded consolidation path as appropriately prudent under the current circumstances. Directors welcomed the intention to take a flexible approach if large downside risks materialize, noting that contingency plans would also be helpful. While the current medium-term fiscal framework has served the economy well, Directors recommended that the authorities continue to consider options to strengthen it further.

Directors commended the progress in enhancing prudential and regulatory measures to mitigate risks associated with the housing market, and in improving AML/CFT safeguards in the real estate sector. They encouraged the authorities to remain vigilant and continue to enhance the resilience of the banking system to shocks with macro-financial implications, including by encouraging banks to strengthen their capital position. Financial regulatory authorities would

[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.

need to stand ready to intensify targeted prudential measures, if lending or house price growth were to re-accelerate, while advancing the implementation of the regulatory reform agenda.

Directors welcomed the government's structural reform agenda to boost productivity through fostering innovation and strengthening competition, especially in the services sector. They commended the authorities for their commitment to an open economy in trade, foreign investment, and immigration.

Australia: Main Economic Indicators, 2012-2022
(Annual percent change, unless otherwise indicated)

	2012	2013	2014	2015	2016	2017	2018	2019	2020	2021	2022
					Projections						
NATIONAL ACCOUNTS											
Real GDP	3.6	2.1	2.8	2.4	2.3	2.6	3.0	3.0	2.9	2.9	2.9
Domestic demand	4.2	0.7	1.2	1.3	1.5	2.3	3.0	2.9	2.9	2.8	2.8
Private consumption	2.3	1.7	2.8	2.7	2.7	2.9	3.0	3.0	3.0	3.0	3.0
Public consumption	2.5	1.1	1.0	3.4	3.8	1.7	1.6	1.7	1.7	1.8	1.8
Investment	9.1	-1.5	-1.7	-3.2	-2.8	1.7	3.8	3.5	3.3	3.1	3.1
Public	6.7	-10.6	-2.1	-2.2	8.7	3.0	2.0	1.5	0.7	0.0	0.0
Private business	15.3	-0.8	-5.0	-8.8	-10.3	0.5	4.9	4.6	4.6	4.5	4.5
Dwelling	-6.3	2.3	6.8	10.0	8.1	3.5	3.3	2.9	2.7	2.4	2.4
Net exports (contribution to growth, percentage points)	-0.2	1.5	1.5	0.8	1.2	0.1	0.1	0.1	0.1	0.1	0.1
Gross domestic income	1.3	1.3	1.2	-0.1	2.0	2.2	2.0	2.7	2.8	2.8	2.9
Investment (percent of GDP)	29.0	27.6	26.9	26.3	25.1	25.1	25.4	25.5	25.6	25.6	25.6
Public	5.3	4.6	4.5	4.4	4.7	4.8	4.8	4.7	4.6	4.4	4.3
Private	23.3	23.0	22.4	21.9	20.3	20.3	20.7	20.9	21.0	21.2	21.3
Mining investment	8.4	8.5	7.2	5.5	4.0	3.0	2.3	2.3	2.3	2.3	2.3
Non-mining investment	14.9	14.5	15.2	16.4	16.3	17.3	18.4	18.6	18.8	18.9	19.0
Savings (gross, percent of GDP)	24.6	24.4	23.9	22.1	21.6	21.6	21.3	21.5	21.6	21.6	21.6
Potential output	2.9	2.8	3.0	2.5	2.6	2.6	2.6	2.6	2.6	2.6	2.6
Output gap (percent of potential)	-0.5	-1.1	-1.3	-1.4	-1.7	-1.7	-1.3	-1.0	-0.7	-0.4	-0.1
LABOR MARKET											
Employment	1.2	0.9	0.7	1.9	1.6	1.8	1.8	1.7	1.7	1.7	1.7
Unemployment (percent of labor force)	5.2	5.7	6.1	6.1	5.7	5.7	5.6	5.4	5.3	5.3	5.1
Wages (nominal percent change)	3.7	2.9	2.5	2.1	2.0	2.1	2.5	2.6	2.8	2.9	3.0
PRICES											
Terms of trade index (goods, avg)	121	117	107	94	92	91	86	86	85	85	85
% change	-12.3	-3.4	-8.1	-12.5	-2.0	-1.1	-4.9	-1.0	-0.3	0.0	0.0
Iron ore prices (index)	101	107	77	44	46	55	45	39	39	39	39
Coal prices (index)	109	95	79	65	74	83	75	72	72	72	72
LNG prices (index)	102	97	95	61	43	48	48	48	48	48	48
Crude prices (Brent; index)	103	100	91	48	40	52	52	52	52	52	53
Consumer prices (avg)	1.7	2.5	2.5	1.5	1.3	2.0	2.4	2.5	2.5	2.5	2.5
GDP deflator (avg)	-0.2	1.3	0.2	-0.6	1.0	1.9	1.8	2.2	2.4	2.4	2.5
FINANCIAL											
Reserve Bank of Australia cash rate (percent, avg)											
10-year treasury bond yield (percent, avg)	3.5	3.7	3.7	2.7	2.1	2.0	2.5	2.8	3.1	3.4	3.5
Mortgage lending rate (percent, avg)	7.0	6.2	6.0	5.6	5.4	5.4	5.7	6.0	6.3	6.6	6.6
MACRO-FINANCIAL											
Credit to the private sector	5.4	-1.7	7.4	8.1	6.5	5.0	5.2	4.7	4.4	4.2	4.1
House price index	102	113	120	131	138	145	152	158	164	169	174
% change	3.0	10.0	6.7	8.7	5.7	5.2	4.7	4.1	3.5	3.3	3.0
House price-to-income, capital cities	3.9	4.2	4.2	4.9	4.8	4.9	4.9	4.9	4.8	4.8	4.7
Interest payments (percent of disposable income)	9.8	8.8	8.8	8.6	7.8	8.5	9.1	9.6	10.0	10.1	10.2
Household savings (percent of disposable income)	8.0	8.3	8.1	6.4	6.1	6.2	5.9	5.6	5.4	5.2	5.0
Household debt (percent of disposable income) 1/	166	171	176	183	185	186	187	186	184	183.1	181.8
Non-financial corporate debt (percent of GDP)	49	48	49	51	52	51	52	52	52	52	52
GENERAL GOVERNMENT (percent of GDP) 2/											
Revenue	33.3	33.9	34.1	34.6	34.6	34.6	34.9	35.2	35.5	35.6	35.7
Expenditure	36.7	36.7	37.0	37.3	37.4	37.1	36.5	35.9	35.5	35.4	35.4
Net lending/borrowing	-3.5	-2.8	-2.9	-2.7	-2.8	-2.5	-1.6	-0.7	0.1	0.2	0.3
Operating balance	-2.0	-1.5	-1.6	-1.5	-1.4	-1.0	-0.2	0.5	1.0	1.2	1.3
Cyclically adjusted balance	-3.1	-2.3	-2.3	-2.0	-2.0	-1.8	-1.0	-0.2	0.4	0.4	0.3
Gross debt	27.8	30.7	34.2	37.6	41.3	43.6	43.8	42.8	41.0	39.2	37.2
Net debt	11.2	13.2	15.5	17.8	20.1	21.4	21.7	21.0	19.6	18.1	16.5
Net worth	52.2	53.9	52.3	47.5	46.8	50.2	49.8	49.7	49.3	48.3	47.3
BALANCE OF PAYMENTS											
Current account (percent of GDP)	-4.1	-3.2	-2.9	-4.8	-3.2	-3.5	-4.2	-4.1	-4.0	-4.0	-4.0
Export volume	5.7	5.8	6.9	6.1	6.6	4.2	4.1	4.1	4.0	4.0	4.0
Import volume	5.5	-2.2	-1.1	2.0	0.7	3.7	3.9	3.8	3.8	3.8	3.7
Net international investment position (percent of GDP)											
Gross official reserves (bn US$)	47	59	66	67	...	...	...	...	...	...	...
MEMORANDUM ITEMS											
Nominal GDP (bn A$)	1,507	1,559	1,606	1,634	1,688	1,766	1,851	1,948	2,052	2,162	2,281
Percent change	3.4	3.4	3.0	1.8	3.3	4.6	4.8	5.2	5.3	5.4	5.5
Real net national disposable income per capita (% change)											
Population (million)	22.9	23.3	23.6	23.9	24.3	24.6	25.0	25.3	25.7	26.1	26.4
Nominal effective exchange rate	110	105	99	92	...	...	...	...	...	...	...
Real effective exchange rate	110	105	100	93	93	...	...	...	...	...	...

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

1/ 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.

2/ Calendar year.

INTERNATIONAL MONETARY FUND

AUSTRALIA

STAFF REPORT FOR THE 2016 ARTICLE IV CONSULTATION

January 17, 2017

KEY ISSUES

Context. Australia has enjoyed a robust economic performance despite the commodity price and mining investment bust. The moderate impact of the large shocks since 2011 reflects prompt monetary easing, a flexible exchange rate acting as a shock absorber, export orientation to the dynamic Asia region, flexible labor markets, relatively high population growth, and strong institutions. Nevertheless, Australia has also been confronted with symptoms of the "new mediocre" since the Global Financial Crisis, including a downshift in average GDP growth. And with declining interest rates, already high house prices and household debt ratios have started to rise again.

Outlook and risks. After a slowdown due to one-off factors around mid- 2016, growth close to trend is expected to resume from 2017 onwards, with increasing contributions from so far lackluster private domestic demand. With a gradual return to full employment, inflation is expected to edge back up within its 2-3 percent target range. Macro-financial vulnerabilities are expected to stabilize as house prices align with broader price levels. A hard landing in China is a major external risk, while housing-related vulnerabilities remain the dominant domestic source of risk.

Policy recommendations. The policy priorities are to complete the transition to non-mining-based growth with adequate demand support amid mild symptoms of the "new mediocre", contain macro-financial risks, and upgrade the longer-term growth potential.

- **Demand support**. Under the baseline, the priority is to maintain monetary accommodation and to use Australia's fiscal space for a gradual fiscal consolidation while raising infrastructure spending and supporting structural reforms. If a large downside shock were to materialize, fiscal stimulus may be needed to support aggregate demand, considering that monetary policy could rapidly become constrained by the effective lower bound on nominal policy rates.
- **Macro-financial policies**. Policies should focus on further strengthening resilience to housing and other shocks with macro-financial implications—by maintaining robust bank capital positions, completing regulatory reform, and standing ready to tighten prudential regulation should house prices increases re-accelerate.
- **Raising productivity.** Reforms should focus on fostering innovation, raising competition and productivity in the services sectors, and reforming the tax system.

Approved By
Odd Per Brekk and Sanjaya Panth

Discussions were held in Canberra, Melbourne, and Sydney during November 2-15, 2016. The staff team comprised Thomas Helbling (head), Philippe Karam, Kyungsuk Lee, Adil Mohommad, Dirk Muir, and Siegfried Steinlein. Christine Barron and Chris Stewart (OED) joined the discussions. Ioana Hussiada and Nadine Dubost assisted from HQ.

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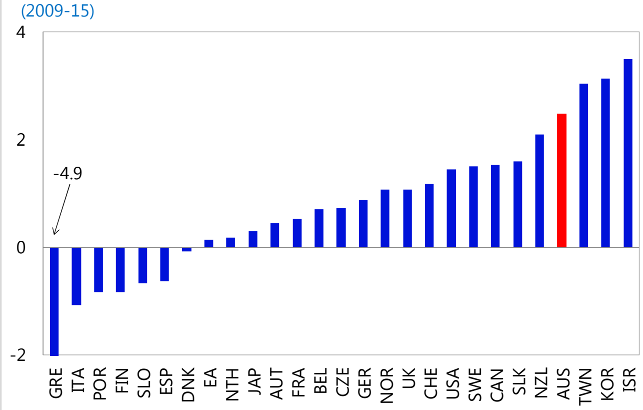
TABLES

ANNEXES

CONTEXT

1. **Australia's economic performance has been robust in comparison to other advanced economies despite the commodity price and mining investment bust.** Growth has remained above 2 percent (annual rate) and increases in unemployment have been small. The moderate impact of the large shocks since 2011 reflects prompt monetary easing, a flexible exchange rate acting as a shock absorber, export orientation to the dynamic Asia region, relatively high labor force and population growth, and flexible labor markets. Another reason is the relatively small size of the commodity sector and continued strong mining export performance (Annex I: "Four Years After the Bust …"). In this setting, Australia's long expansion without a recession has continued uninterrupted for 25 years.

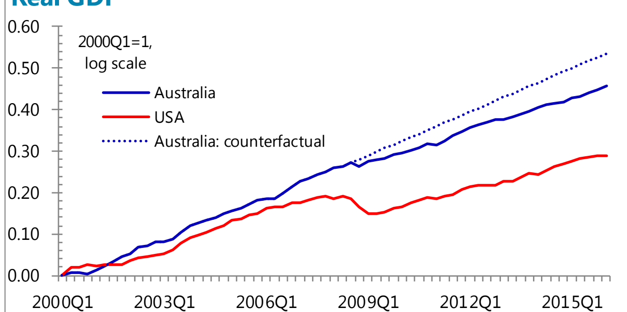
Average Annual Real GDP Growth
(2009-15)



Source: IMF, World Economic Outlook database.

2. **Still, Australia has been confronted with symptoms of the "new mediocre."** The economy has experienced a slowdown since the global financial crisis (GFC), with average GDP growth about 0.8 percent lower (annual rate), which is indicative of lower potential output growth. As elsewhere, the adjustment to the shocks has been drawn out, and growth has fallen short of expectations in 2014 and early 2015, partly from weaker-than-expected partner country growth and partly from domestic demand weakness. In particular, growth in non-mining business investment has been slow despite declines in real interest rates and real exchange rate depreciation. At the same time, underemployment and long-term unemployment have been higher, while nominal wage growth has been low and inflation has fallen below target.

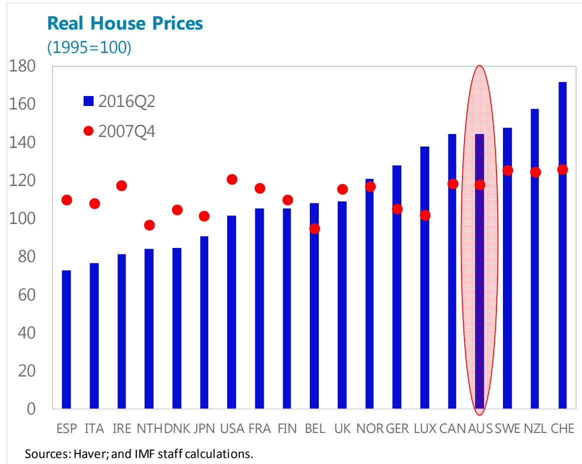
Real GDP



Sources: Haver Analytics and IMF staff calculations.
1/ Counterfactual is based on pre-GFC average growth (2003-07).

3. **Housing-related and external macro-financial vulnerabilities are a concern.** Real house prices and household debt ratios rose to high levels in tandem during the country's economic boom of the 1990s and 2000s. While stabilizing after the global financial crisis, both house prices and household debt ratios have picked up again recently. The main concern is the large housing

exposure (over 50 percent of total assets) of Australia's highly concentrated banking system. On the external side, Australia has had long-running current account deficits and a relatively large net external liability position. Much of the related risks focus on the funding of Australian banks because they rely heavily on international wholesale markets.

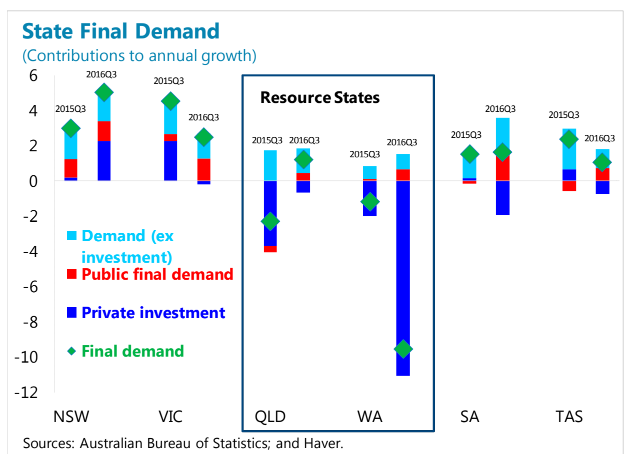


Real House Prices
(1995=100)
Sources: Haver; and IMF staff calculations.

RECENT DEVELOPMENTS, OUTLOOK AND RISKS

A. Developments over the Past Year

4. Australia's recovery advanced with a pickup in activity from mid-2015, but underlying demand growth remained closer to trend. Growth (at annual rates) increased to over 3 percent from mid-2015—above current potential output growth estimates of 2¾ percent—driven by higher government spending, LNG export capacity coming on stream, strong services export growth, and buoyant residential investment.[1] That said, private business investment outside mining has remained more subdued than expected. And with the growth rebalancing toward non-mining activity, activity in states where such activity dominates has been buoyant, and disparities in economic performance between non-mining and mining states have widened. With hindsight, some of the growth pickup in early 2016 reflected one-off level increases in demand, particularly in government spending. Consequently, real GDP unexpectedly contracted by 2 percent annualized in 2016Q3 when these level effects wore off, with temporary, weather-related weakness in residential investment spending also contributing. The strength of underlying growth in aggregate demand, however, does not appear to have changed.



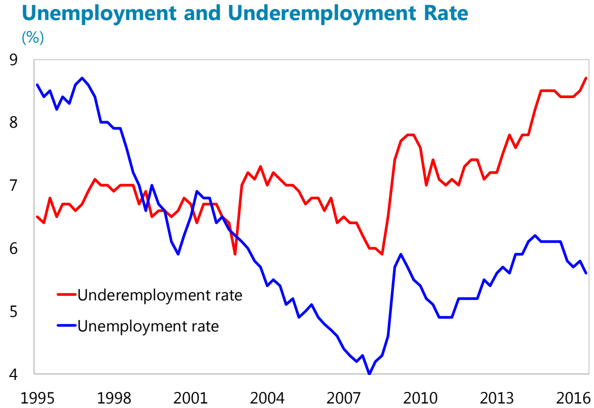
State Final Demand
(Contributions to annual growth)
Sources: Australian Bureau of Statistics; and Haver.

5. Labor market conditions have improved although the fall in the unemployment rate likely overstates the improvement in labor markets. Employment picked up with overall activity, and

[1] Background work for the 2015 Article IV consultation suggests that annual potential output growth in Australia has declined from about 3¼ percent before the global financial crisis to about 2¾ percent in recent years. See Mohommad, 2015, "Sustaining Income Growth in Australia", *Australia Selected Issues*, IMF Country Report No.15/275.

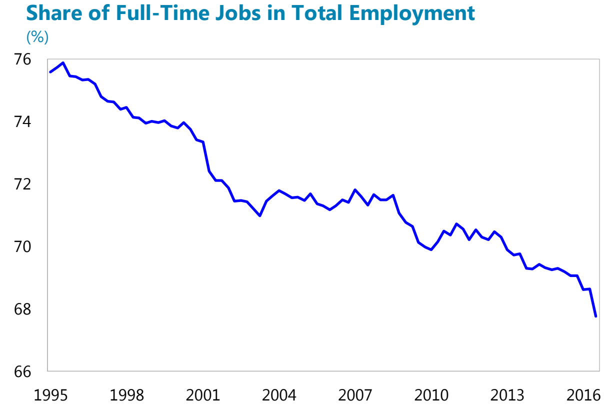
unemployment has decreased from its recent peak. Still, the underemployment rate—defined as the share of employed persons in the labor force seeking to work more hours—has remained almost 2 percentage points above average (7 percent of the active labor force over the past 20 years). Some 80 percent of the jobs created over the past year or so have been part-time jobs.[2] At the same time, the share of long-term unemployment has remained above average. As of mid-2016, IMF Staff estimates the output gap at 1.7 percent and the unemployment rate gap at 0.5 percent (about 1¼ percent at the peak).

Unemployment and Underemployment Rate



Source: Haver Analytics.

Share of Full-Time Jobs in Total Employment



Source: Haver Analytics.

6. Both headline and core inflation have been below the inflation target range of 2-3 percent in 2016, and the Reserve Bank of Australia (RBA) responded promptly to an unexpected downshift in the inflation path. Initially, the disinflation that began in late 2014 had been driven by the declines in the prices of oil and other commodities. Over the past 12 months, however, the declines have been due to non-tradables inflation, with the RBA pointing to the temporary inflation impact from lower margins due to increased competition in the retail and other sectors. After a noticeable, unexpected decline of core inflation in the first quarter of 2016, and a downshift in the path of expected inflation, the RBA has lowered the policy rate by another 50 basis points to 1.5 percent in 2016 in May and August. Core inflation has since stabilized at around 1.6 percent. Wage growth has remained weak, with nominal unit labor costs running at less than 0.5 percent on average, and cost pressures have been virtually absent.

7. The current account balance has remained moderately weaker than its fundamental level and the Australian dollar has continued to be moderately overvalued. The commodity-currency adjustment mechanism that has come into play after the mining investment bust has supported the rebalancing of growth toward net exports, with investment weakness also weighing on imports. A renewed widening of the current account deficit in 2015 reflected temporary factors, including weather related export declines and exceptional imports, and the balance has since

[2] See Annex III for a summary of the forthcoming selected issues paper by Mohammad, 2016, "Labor Market Adjustment to Shocks in Australia," discussing labor market adjustment after the global financial crisis and after the commodity price bust and mining investment decline.

narrowed again. While currency depreciation in 2014-15 has reduced much of the overvaluation that had developed over the boom, the correction has stalled in recent months (Annex IV—External Sector Assessment). The latter has likely reflected the relative attractiveness of Australian assets, given their relatively high returns. Nonetheless, yields on longer-term Australian bonds have declined, and valuation effects from the resulting bond price increases, together with exchange rate appreciation, have contributed to a marked deterioration in the net external liability position over the past year, given the economy's sizeable net short position in that asset class (Annex II). That said, the underlying risk profile has improved further, adding to improvements since the global financial crisis, as the share of longer-term external funding of Australian banks has increased over the past year or so, while that of short-term external funding has decreased.

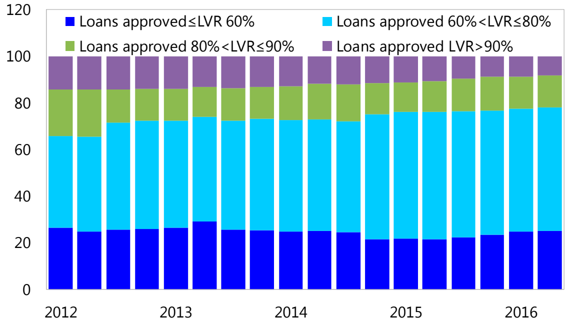
8. By some metrics, housing market conditions have cooled and credit growth to households has slowed, but risks related to house price and debt levels have not yet decreased.

- ***Real house price gains have moderated.*** Indicators of current conditions such as sales volumes and the rate of turnover in the housing stock have moderated. The extent of cooling has varied considerably across capital cities. The strongest price increases continue to be recorded in Sydney and Melbourne, where underlying demand for housing remains strong. With house prices still rising ahead of income, standard valuation metrics suggest somewhat higher house price overvaluation relative to the assessment in 2015 Article IV consultation.

- ***The flipside has been slowing growth in bank lending to households.*** APRA prudential guidance requiring tighter lending standards by banks, which was introduced in late 2014, has curtailed growth in riskier mortgage loans in particular and credit growth to household more broadly. At the same time, there has been some upward pressures on mortgage rates, as banks have increased capital ratios and prepared for a higher risk weight on mortgage lending. That said, household credit gaps have not yet reversed.

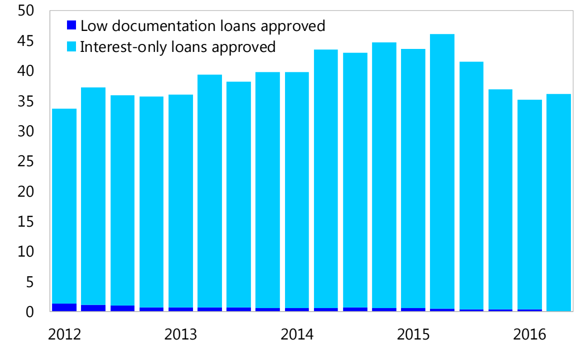
- ***On the supply side,*** residential investment has risen to some 0.5 percent of GDP above its long-term average (the ratio remains comparatively low given population and labor force growth). An above-average number of new apartments is expected to come on stream in the next year or so, mostly in the downtown areas of Brisbane, Melbourne, and, to a lesser extent, Sydney. Concerns about temporary oversupply have thus risen. But leading indicators, such as approvals of new houses and other dwellings or new residential construction starts, have started to level off after brisk increases in 2014-15. In commercial real estate, property price valuations have increased but are still within the usual range of variation over the cycle (Box 1).

New Residential Term Loan Approvals by Loan-to-Valuation Ratio (LVR)
(In percent of total new residential loans)



Source: APRA

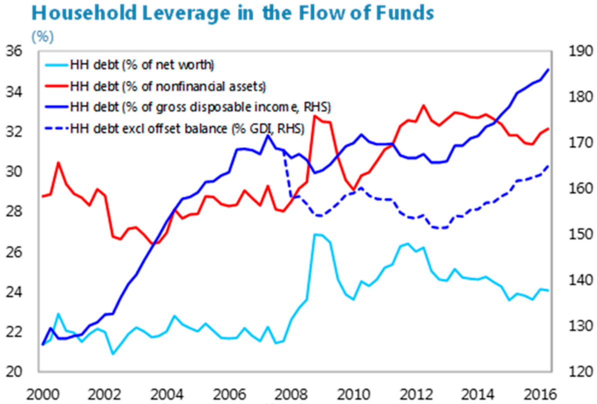
New Residential Term Loans to Households Approved
(In percent of total new residential loans)



Source: APRA

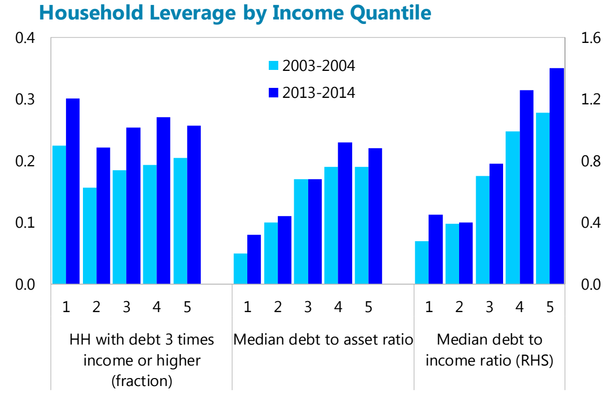
9. **Household sector leverage has been stable overall despite higher debt, and debt buffers have risen but not for all households.** The household debt ratio rose to 186 percent of gross disposable income over the past year, but underlying vulnerabilities have not increased to the same extent. Mortgage buffers—balances in related offset accounts and redraw facilities, which are held for tax and precautionary reasons—have also risen, to some 18 percent of outstanding mortgage loans by mid-2016—the equivalent of around 2½ years of scheduled debt payments at current interest rates. And household leverage (liabilities as a percent of net worth) has been stable and low at around 25 percent.[3] Yet there is considerable heterogeneity across households. With house values a rising multiple of income, first-time homebuyers and other new borrowers tend to have higher debt ratios and smaller buffers. Indeed, around 25 percent of all households in each income quintile had debt to income ratios above 3 in FY2013-14—the latest available year for income and wealth data across households. These households may well be liquidity-constrained in an economic downturn.

Household Leverage in the Flow of Funds
(%)



Sources: Haver Anaytics and IMF staff estimates.

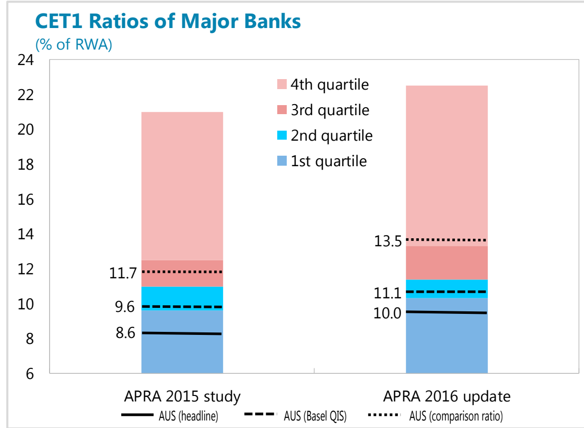
Household Leverage by Income Quantile



Source: ABS.

[3] The household saving ratio has remained relatively high since it rebounded in 2007-08 and household net lending (saving minus gross fixed capital formation) has been positive since then, implying that households continue to acquire financial assets. A good part of household financial assets is held in so-called superannuation funds, the mandatory second pension pillar.

10. Banks have further strengthened their balance sheets, responding to regulatory change and market pressure. The large Australian banks have raised the CET1 capital ratio from 8.6 of risk-weighted assets (RWA) in June 2014 to 10 percent at the end of 2015, partly through raising fresh capital, and the ratios are expected to have improved further in 2016. According to APRA studies, after adjusting for stricter requirements in capital and RWA calculations, these capital ratios have placed the banks at the low end of the top quartile internationally. Bank funding conditions have also improved, with foreign currency funding continuing to be fully hedged. Nonperforming loans (NPL) have remained largely unchanged.[4]



B. Outlook

11. The baseline outlook is for the resumption of growth close to trend, a gradual return of inflation into the target range, and a slow stabilization of macro-financial vulnerabilities.

- ***Growth is expected to be close to trend, with increasing contributions from domestic demand growth as the adjustment to the commodity and mining shocks advances further.*** With the contraction in 2016Q3 largely due to one-off factors, growth is expected to resume in the last quarter of 2016. Residential investment growth is expected to rebound, given a strong pipeline of building approvals and housing starts. The contribution of private business investment to growth should turn positive, as the correction in mining investment should run its course and non-mining investment should start to pick up. In addition, states that have experienced rapid growth in activity are expected to ramp up infrastructure spending in 2017-18. Private consumption should strengthen with the recovery continuing and labor markets improving further. On the export side, the rate of growth is expected to slow somewhat, as the initial boost from new mining capacity and new sources of demand (e.g., tourism from Asia) should moderate.

- ***The disinflation experienced in 2015-16 is expected to start reversing.*** With the rebound of oil prices in 2016, an important source of disinflation has already dissipated. Other sources are expected to weaken gradually. The output gap is projected to decline, and the inflation effects from downward pressure on producer price levels from increased competition in the retail sectors should wear off with no major new market entrants.

[4] The NPL ratio of loans to the agricultural sector from the banks' New Zealand subsidiaries has increased modestly since the beginning of 2016, but it remains low, at around 1 percent. The overall exposure to the sector is small—some 1½ percent of banks' consolidated assets.

- ***The macro-financial outlook is for a stabilization of housing-related vulnerabilities.*** The main driver is a realignment of house price inflation with broader measures of inflation and robust growth. Recent increases in residential investment should result in higher supply over the next two years, especially in market segments that have seen higher prices increases, and lower affordability should constrain demand. Credit gaps and debt ratios should thus stabilize or decline. On the external side, the accumulation of net external liabilities should slow in the absence of valuation effects. As banks prepare to meet net stable funding ratio requirements by 2018, related vulnerabilities should improve further.

C. Risks

12. The balance of risks has improved but is still to the downside. The interaction of external and domestic downside risks must remain the main policy concern. The momentum of the recovery could be stronger, as recent terms-of-trade improvements could boost business confidence and commodity production if they are more persistent than expected. On the downside, growth could be slower, as consumption growth could remain lackluster with continued low wage growth and high incidence of part-time work, and profits could remain under pressure for longer with increased competition and relatively persistent slack. On the external side, there are risks to global trade from rising populism and nationalism in large economies and from tighter and more volatile global financial conditions. A major concern for macro-financial risk management is that external risks could hit both traditionally exposed sectors (commodity prices and exports) and new sources of growth (e.g., services exports), for example, a sharper growth slowdown in China (Annex V—Risk Assessment Matrix). If such external risks materialized, they could interact with or even trigger domestic risks, especially a sharp housing market correction, also given that annual approvals for all non-residents applying to purchase residential property have substantially increased to around 20 percent of overall turnover value, and they could lead to external funding pressure for banks.

D. The Authorities' Views on Outlook and Risks

13. The authorities emphasized that the transition to non-mining-based growth after the boom was well advanced. They acknowledged that some elements of the "new mediocre" were present, including weak private business investment. But they saw these as a reflection of the drawn out adjustment of the economy to the decline in the terms of trade and the large fall in mining investment rather than a cause. While many of the new jobs were part-time ones, this partly reflected preferences in the labor force. The rise in underemployment as well as in long-term and youth unemployment had remained small in historical comparison, and growth in output had remained close to trend. And while trend growth was lower, the decline was small, about a quarter of a percentage point, partly reflecting lower population growth, not lower capital intensity or productivity growth.

14. Robust broad-based growth was expected to continue. The authorities noted that the unexpected decline in GDP in the September quarter of 2016 was partly a result of falling mining investment and a series of one-off factors including weather-related falls in non-residential construction and dwelling investment. Looking forward, economic growth would be supported by household consumption; another wave of LNG capacity was expected to ramp up, in 2017 as well as in 2018; public investment growth would rise as States' infrastructure spending was budgeted to increase further; residential dwelling investment growth, while moderating, would remain strong in the near term; and private business investment would no longer detract from growth in 2018 as the drag from mining investment would ease and non-mining investment would rise moderately. GDP growth would strengthen to around trend rates. The authorities indicated that the economy would thus return to full employment gradually, with underemployment declining and inflation moving back into the target range. While the balance of risks had improved, it remained tilted to the downside, with the possibility of a hard landing in China being a key medium-term concern.

15. The authorities noted that risks associated with high and rising household leverage had diminished. Tighter bank lending standards, encouraged by prudential measures, had led to slower mortgage credit growth, with improved risks profiles for new loans, and a moderation in housing price growth. Risks related to short-term demand-supply mismatches in housing markets were localized. There were some risks related to lending to real estate developers but those were being closely monitored. Households across all income brackets continue to accumulate deposits in offset accounts, implying that effective household debt was lower, and did not use mortgage borrowing to finance consumption. More resilient bank balance sheets were another factor contributing to diminished housing risks.

ECONOMIC POLICY PRIORITIES

16. Discussions focused on policy requirements to meet three broad objectives: Completing the economy's transition to non-mining growth; containing macro-financial vulnerabilities; and enhancing longer-term growth potential.

A. Supporting Aggregate Demand

Context

17. Australia's transition to non-mining-based growth has advanced significantly with monetary policy support but the process is not completed. The lack of significant price and wage pressures suggests that some economic slack is still present, which, if prolonged in what has already been a drawn-out adjustment process, risks hurting medium-term supply potential.

18. The RBA cut the policy rate promptly in response to the unexpected downshift in the expected inflation path in early 2016. The easing also helped to realign the policy rate with interest rates elsewhere, which had declined in some other major advanced economies through September 2016. Staff background work suggests that the equilibrium real interest rate has declined from about 3 percent in the early 1990s to close to 1 percent in the second quarter of 2016 compared to an actual real rate of 0.2 percent, although there is substantial uncertainty around such estimates.[5] Absent monetary easing, upward pressure on the Australian dollar would likely have been stronger, reinforcing the disinflationary impulse experienced early in the year.

19. Australia has substantial fiscal space. Standard metrics suggest that Australia has fiscal space under both the baseline and economic stress scenarios (Annex VI—External and Fiscal Debt Sustainability Analysis). For example, sovereign spreads over U.S. bonds have been relatively moderate in the past 12 months (at most 64 basis points); gross debt is still low at 40 percent of GDP compared with other major advanced economies.

20. The federal government has recently aimed for substantial near-term fiscal consolidation but budget targets have not been met because of weaker nominal income. Automatic stabilizers have been allowed to operate in response to weaker growth and lower inflation, and the fiscal stance in 2016 is estimated to have been broadly neutral. Against this backdrop, concerns about recent public debt increases and what they mean for Australia's top-ranked sovereign debt rating have dominated fiscal policy discussions.

21. In the FY2016/17 budget, the government has projected a return to fiscal balance by FY2020/21. It has also renewed its commitment to a federal government surplus of 1 percent of GDP over the business cycle as a medium-term fiscal anchor, which would imply a cumulative adjustment of up to 3.4 percent of GDP. The Mid-Year Economic and Fiscal Outlook 2016-17 (MYEFO), released on December 19, 2016 foresees a cumulative adjustment of the fiscal balance of 2.1 percent of GDP by end of FY2019/20, as revenues strengthen in line with the economy, primarily related to stronger personal income tax collection because of bracket creep.

Staff Views

22. The RBA's monetary policy stance should remain accommodative until the return of inflation to the mid-point of the target range is highly secured. Australia has not experienced the persistent low inflation problem of other advanced economies, and medium-term inflation expectations, while lower, have generally remained within the target range. But with economic slack expected to decline only gradually and taking into account downside risks, policy decisions should remain predicated on the possibility that the return of inflation back to target may take longer, consistent with recent international experience. And in current circumstances, there are asymmetric costs to inflation risks, given policy objectives. The risk of inflation rising faster than expected is less costly than risks of inflation being lower. Monetary policy can likely respond more effectively to positive surprises for some time, given that from current policy settings, policy rates may rapidly reach the effective lower bound if negative surprises reflect large shocks to demand.

23. The RBA could consider enhancing its policy communication given the inflation outlook and the risk of hitting the effective lower bound under a downside scenario. While increases of longer-term interest rates in advanced economies since October are suggestive of some

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[5] See Annex VII for a summary of the forthcoming selected issues paper by Helbling, Kamenik, Karam, Laxton, Wang, and Yao, 2016, "Inflation Targeting in Australia: Performance, Challenges and Strategy Going Forward."

increase in underlying equilibrium interest rates, policy rates in Australia may well stay low for some time. Under these conditions, risks of low inflation becoming entrenched could be reduced through clear guidance by the RBA on the horizon over which inflation is expected to return to the mid-point of the target range and on the likely policy measures should downside risks materialize. To lay the foundation, the RBA could consider lengthening the forecast horizon in its *Statements on Monetary Policy*. More clarity on the policy rate path, possibly through publication of the RBA's projected policy rate path, could also enhance the RBA's communication with markets and price setters.

24. The government should use its fiscal space for a gradual fiscal consolidation and structural fiscal reform. The conditions calling for more pro-active fiscal stimulus, including policy rates at the effective lower bound and impaired monetary policy transmission, are not present. Some fiscal consolidation remains desirable—not the least in view of a sizeable structural budget deficit and impending medium-term increases in ageing-related spending. However, Australia has the fiscal space to undertake budget repair gradually. Any remaining negative demand effects could be offset by continuing accommodative monetary policy, expenditure switching, and growth-friendly structural fiscal reform. In contrast, a front-loaded fiscal consolidation based on measures would pose too much of a risk to the on-going recovery. The MYEFO 2016-17 shows a fiscal improvement based on an economic recovery, broadly consistent with staff's views on growth in the coming years.

25. Structural fiscal reform should focus on supporting growth through increased spending on infrastructure, innovation, labor market integration, and tax reform.

- ***There is room for greater infrastructure investment.*** While general government spending on infrastructure has increased in FY2016/17, this increase primarily reflects higher spending by States, not the Commonwealth. Indeed, capital spending is expected to increase by ½ of a percentage point of GDP in the current budget year, but these efforts are not expected to be sustained as spending is projected to level off in the next fiscal year and to decline thereafter. A more sustained, multi-year increase in spending on efficient infrastructure also at the Commonwealth level would be desirable, considering that Australia has infrastructure needs and fiscal space and the funding environment is favorable.
- ***Reforms that support innovation and productivity should be strengthened.*** These would include an upgrade of the R&D tax credits put in place last year and active labor market policies, to lower risks of hysteresis in labor markets and support human capital formation in an environment of rapid structural change, increased part-time employment, and higher long-term unemployment.
- ***A tax shift, lowering corporate and household income taxes while increasing the goods and services tax (GST), could boost investment and lift GDP.*** Background work using the IMF's G20MOD suggests that in Australia, the long-term multipliers for a 1 percent of GDP shift from corporate income taxes to the GST is roughly 0.6 percent of GDP, while that of

labor income taxes to the GST is over 0.1 percent of GDP. A revenue-neutral tax shift should thus lead to a permanent increase in the level of real GDP. [6]

26. Should downside risks materialize, fiscal stimulus may be needed to boost aggregate demand, as monetary policy may rapidly be constrained by the effective lower bound. If the shock is large, an effective macroeconomic policy response may well require expansionary fiscal policy. In a China downside scenario, model-based scenario analysis in background work by staff illustrates how a combined monetary and fiscal policy response ensures a faster recovery (Box 2). With some high-impact downside risks to the near- and medium-term outlook present, contingency plans for expansionary fiscal policy should be prepared, given the implementation lags involved in undertaking fiscal stimulus. Such contingency plans should include a revolving pipeline of ready-to-implement infrastructure projects, with coordination between the Commonwealth and State governments.

27. An IMF staff review of the fiscal anchor and framework suggests that the authorities consider changing to a long-term debt anchor.[7] In 2010, the government raised the medium-term anchor from a zero balance to a surplus of 1 percent, with a view to reverse the recent debt accumulation. In staff's view, it is a strength of Australia's fiscal framework that it requires governments to report against a medium-term fiscal strategy based on "principles of sound fiscal management." But the authorities should consider replacing the current medium-term budget balance anchor with a longer-term debt anchor. The latter would provide certainty about debt and fiscal policy in the future. Once in place, the debt anchor would encourage the government to discuss the implication of unanticipated shocks on the fiscal position and the medium-term fiscal strategy. At the same time, if implemented over a 5- to 10-year horizon, the framework would remain sufficiently flexible to allow for countercyclical fiscal policy support if needed.

Authorities' Views

28. The RBA was concerned about the potential costs to financial stability from further monetary easing relative to the benefits of inflation returning to target faster. Against expectations of robust growth and improving labor markets, it considered risks of inflation becoming entrenched below target to be low. The undershooting of core inflation was recent. But the RBA was ready to ease further should the outlook for labor markets and inflation deteriorate materially. RBA officials saw costs and benefits to changing policy communication strategies. While RBA staff were working on extending the forecast horizon, they were concerned that conditional forecasts of the policy rate path could be misread as RBA commitment. RBA officials noted that they could use unconventional monetary policy measures should the need arise, with circumstances dictating the instruments to be used. However, they considered the risks of reaching the effective

[6] The benefits of a tax shift are discussed in Box 2 of the selected issues paper by Dizioli, Karam, Muir and Steinlein, 2016, "Australia's Fiscal Framework: Issues and Options for Reform." Tax reform options were discussed extensively in the 2015 Article IV Consultation and in Pitt, 2015, "Options for Tax Policy and Federal Fiscal Relations Reform", *Australia Selected Issues*, IMF Country Report No.15/275.

[7] See Annex VIII for a summary of the selected issues paper by Dizioli and others (2016).

lower bound for policy rates to be low, partly because the Australian dollar usually depreciated in the case of adverse external shocks. This, in turn, could ease the burden on monetary policy in responding to a downturn.

29. The authorities were less sanguine than staff about the extent of available fiscal space and did not think that current circumstances required its active use. They noted concerns by rating agencies about the sizeable and persistent budget deficits and emphasized that being a capital importing country, which generally runs current account deficits, requires greater fiscal prudence than otherwise. In their view, the economy could absorb the proposed path of fiscal consolidation, noting that much of the expected increase in revenue was through household income tax bracket creep, rather than measures with higher multipliers. However, they agreed that, in the face of negative economic shocks, such as a sharp slowdown in China, increased fiscal spending would need to be considered, as the effectiveness of monetary easing might be diminished. Concerns about a widening current account deficit could be mitigated if it is driven by fiscal spending that encourages stronger domestic investment instead of only weakening saving ratios.

30. The authorities felt that the composition of fiscal adjustment was as important as the pace of consolidation. In this respect, they noted that past spending increases often focused on recurrent spending. Some of the spending had not been productive, while other spending could be reduced while maintaining or improving outcomes through increased productivity in the delivery of services. Restraining recurrent spending would help in increasing productive spending, on infrastructure investment, nurturing innovation, and on measures encouraging private investment, real wages and incomes in the private sector. This in turn would help on the revenue side as well, particularly for healthy labor income tax revenues, which depend on growth to induce bracket creep.

B. Managing Macro-Financial Vulnerabilities

Context

31. Momentum in house prices and housing credit has moderated and bank balance sheets have strengthened with prudential and regulatory steps, but vulnerabilities have not yet decreased materially. Intrinsic housing market risks have become more localized. The escalation of APRA's supervisory intensity, including guidance on lending standards, over the past year and a half has contributed to lowering growth in new, higher risk lending (e.g., with loan-to-value ratios of more than 80 percent), while housing market conditions have cooled broadly. Nevertheless, risks of renewed price acceleration remain, as mortgage and interest rates more broadly are still low, while foreign investment interest in residential property in the major cities continues to be strong. And high household debt could still amplify the negative impact of large shocks. Regulatory steps under the Basel III framework have contributed to banks' stronger capital positions. As of January 2016, banks had to meet a capital conservation buffer of 2.5 percent of RWA, and a buffer for domestic systemically important institutions of 1 percent of RWA became effective. The counter-cyclical capital buffer is currently set at zero. In addition, in July 2016, a floor for mortgage risk weights for banks using the IRB approach took effect. Tighter prudential rules do not seem to have led to migration of credit activity to non-banks, and the shadow banking sector in Australia has remained relatively small over recent years.

Staff Views

32. With signs of a cooling housing market, the tightening of prudential measures should remain a contingency. Under the IMF staff's macro-financial baseline outlook, tighter loan restrictions could accelerate a cooling in housing market, which would be pro-cyclical. In markets where a house price correction has already begun—in the mining states, for example—they risk delaying the recovery from the commodity bust, including by hindering labor mobility. But with continued upside risks to house prices and housing lending growth, APRA should stand ready with targeted prudential measures. Minimum amortization requirements for new loans could also be considered to rein interest-only lending further.

33. Banks' should further strengthen their capital position, which would increase their resilience to housing and other macro-financial shocks. This approach would focus on strengthening banks' ability to absorb losses from a more significant housing market correction. For instance, APRA could consider adjustments to the level of required capital, dependent on banks' exposure to risky housing market segments and lending standards in those segments (pillar 2 adjustments). Alternatively, it could consider introducing higher minimum risk weights for some lending, notably higher-risk housing-related loans. With expectations of lower profitability in the sector, it will be important for banks to remain in a position to continue to generate sufficient internal capital to finance the growth of their balance sheets and maintain unquestionably strong capital ratios.

34. In the longer term, the macro-financial resilience of the economy to housing market shocks could be enhanced through tax reform. The Commonwealth tax system provides households with incentives for leveraged real estate investment that likely amplifies housing cycles. The incentives arise from the combination of tax concessions on capital gains and the possibility to apply losses from negative gearing to income from other sources. Reforms of capital gain tax concessions would need to be undertaken in a broader context, to avoid introducing new distortions in the taxation of different assets.

35. Broader progress in implementing the regulatory reform agenda would also help in lowering and managing financial sector risks. APRA's efforts to develop an operational framework to assess whether Australian banks are "unquestionable strong" in international comparison will further reduce bank-related financial stability risks. Another priority are reforms recommended in the 2014 Financial Sector Inquiry for increasing the resilience of the banking system, such as the implementation of a framework for loss absorbing and recapitalization capacity and the introduction of a leverage ratio, in the context of international regulatory developments.

36. The authorities are taking steps to address the lack of adequate AML/CFT safeguards in the real estate sector. In 2015, the Mutual Evaluation Report of Australia's AML/CFT regime by the Financial Action Task Force found that the real estate sector is exposed to significant money laundering risk and should be subject to AML/CFT safeguards in line with the international standards. In response, Australia has recently completed a statutory review of its AML/CFT regime and initiated a consultation process about regulating real estate professionals under the AML/CFT Act. The cost-benefit analysis of different regulatory models is expected to be completed by July 2017.

37. Remittance flows from Australia have remained broadly stable while regional correspondent banking relationships with Australian banks have continued. AUSTRAC's tracking of international funds flowing through financial intermediaries registered in Australia suggests no significant change in patterns or magnitudes of remittance flows. That said, money transfer operators have been subject to structural change, given evolving financial technology, and regulatory change. While some operators have had their bank accounts closed, this has only affected a subset among them. However, money transfer operators have faced increased costs and complexities of doing business. At this stage, there is no evidence that Australian banks have stopped correspondent banking and other business with neighboring Pacific Islands. Nevertheless, recognizing the potential for negative spillovers, the authorities have formed a high-level interdepartmental committee to coordinate policies, intensified consultation with the industry, provided neighboring countries with technical assistance to deal with AML/CFT challenges, and actively engaged in the G20 Global Partnership for Financial Inclusion.

Authorities' Views

38. The authorities concurred that policies should focus on further strengthening resilience to housing market and other shocks with macro-financial implication. Regarding "unquestionably strong" capital ratio of banks, APRA stressed that a top quartile positioning relative to international peers is only one guidepost and that other benchmarks would be used as well. For example, capital positions against rating agency measures of capital strength would be assessed and the result of stress tests can also be informative. In terms of timing, APRA did not expect that final standards on unquestionably strong capital ratio would be released soon, given that 2017 will be a year of consultation. The standards would be unlikely to take effect until at least a year after that to facilitate an orderly build-up of capital. APRA indicated openness to the use of a range of prudential measures in case they are needed.

39. The Treasury continues its efforts to introduce new legislation to deliver on the Government's financial system agenda. In its response to the recommendations of the Financial System Inquiry (FSI), the government announced 48 measures, including on the crisis management toolkit, banks resolution, and consumer protection, which require legislation to be prepared and worked through the legislative process.

C. Keeping Up Productivity Growth

40. Maintaining high productivity growth rates may be challenging. Aggregate labor productivity growth in Australia has remained stable over the past decade and a half, increasing at an annual average rate of around 1.5 percent. More recently, however, labor productivity growth has slowed, with weaker multifactor productivity especially in the services sectors, which have accounted for most of the growth in employment since the end of the mining boom. At the same time, weak non-mining investment has likely resulted in less capital deepening.

41. Moving ahead with a range of smaller reforms may nevertheless boost productivity. After a wave of reforms in the early 1990s, there are few low-hanging fruit in terms of large-scale structural policies. Australia generally ranks favorably compared to other OECD countries in key "ease of doing business" areas, although its relatively favorable position has eroded over time as other countries have also improved and progress on reforms in Australia has slowed. Policy priorities have been identified in commissioned expert Reviews and Inquiries, while the Productivity Commission provides the government with research and analysis. The reform agenda, including on the tax side, has been shaped by the 2015 *Competition Policy Review* ("Harper Review") and the 2014 *Financial System Inquiry* ("Murray Inquiry").

Staff Views

42. Recent structural reforms have appropriately focused on fostering innovation. Innovation is key to factor productivity growth, but there are sizeable gaps relative to the frontier in this dimension. Investment in knowledge capital is relatively low in Australia, partly reflecting low R&D spending relative to other advanced economies. The government's National Innovation and Science Agenda (NISA) allocates $1.1 billion (less than 0.1 percent of GDP) over four years to boost innovation and entrepreneurship in the high-tech sector, including through tax breaks. Recognizing the difficulties in fostering innovation through policies, the authorities are closely monitoring outcomes to ensure policy effectiveness. The government plans to continue and expand the program if it proves to be effective.

43. Product market reforms can be expanded in targeted areas. The Harper Review has identified a number of reforms to boost competition and productivity in the services sectors, and to strengthen competition policy broadly. Some of the major benefits from the proposed measures arise from reforms to increase competition in the delivery of human services on behalf of governments, and in other markets including construction, retail trade, and transport. A number of these reforms will have to be implemented at the state level, which will require complex coordination between the Commonwealth and State governments, in legislation and through intergovernmental agreements. Legislation for key components are still under preparation, and efforts to expedite implementation of the Harper Review would be beneficial. In addition, efforts to increase competition in the financial sector, including through implementation of measures identified in the Murray Inquiry, should continue.

44. Trade liberalization is another means to increase competition and Australia intends to continue efforts towards further liberalization in regional and multilateral fora. Aside from benefiting from traditional lines of exports, Australia would also stand to gain from enhanced access to service export markets, which would also serve to strengthen service sector productivity in Australia. At the same time, active labor market policies and the social safety net would help to mitigate the cost to those who would bear the burden of adjustment.

45. Tax reforms appear challenging in the current political environment. The government managed to achieve passage of a tax cut for small business in the current Budget, but has yet to introduce similar measures for larger firms. Such a measure should be part of a package of broader reforms that remains to be accomplished, including reducing tax concessions, and the shift in the tax mix discussed above as part of structural fiscal reforms. Such reforms could enhance productivity.

46. Labor markets have performed well. The flexible labor market settings have contributed to a smooth adjustment from the mining boom with low unemployment. However, the elevated rate of underemployment, and persistent youth unemployment could lead to diminished incentives to accumulate human capital if not addressed. While the gradual elimination of economic slack should help to ease some of the potential for problems, the authorities should remain vigilant to prevent deepening skill mismatches and labor market hysteresis. In this context, the government's $840 million Youth Employment Package, which seeks to increase employability of youth mainly through wage subsidies, is a welcome step.

Authorities' Views

47. The authorities agreed that the productivity growth environment is challenging. While labor productivity growth has been stable, it is expected to grow at a somewhat slower rate over the next few years. Moreover, half the aggregate labor productivity growth recorded recently was contributed by the mining sector, which has moved to the less labor-intensive production phase after a long investment phase.

48. The authorities aimed to improve productivity through targeted steps, with legislative steps under preparation. With key economy-wide reforms already implemented, future productivity gains would require specific measures, which include increasing contestability in markets for services, and boosting innovation capacity and absorption. Reforms identified in the Harper Review would primarily have to be implemented at the state level, and would require close coordination between the Commonwealth and State governments. The government is finalizing intergovernmental agreements and National Partnerships detailing funding for measures taken at the state level. These Partnerships are expected to be formed by mid-2017 to mid-2018. Other reforms proposed in the Harper Review can be implemented by the Commonwealth government and may be introduced as early as mid-2017.

49. Innovation was emphasized as a priority. The government's NISA would help to boost innovation capacity by seeking to encourage entrepreneurship, and to enhance industry-science collaboration. Future waves of NISA would envisage building science capability in niche areas such as health or data analytics, encouraging private sector investment in innovation and making it easier for business to interact with Government.

50. The authorities were pressing ahead with trade liberalization. They were committed to the passage of the TPP. Even if it were not to come into force because some other signatories may not pass it, the authorities were committed to implementing as many of its provisions as possible by other means such as bilateral agreements – for example, the recent expansion of its 2003 free trade agreement with Singapore. They were also interested in continuing negotiations for the RCEP (Regional Comprehensive Economic Partnership), which includes China and the Asia-Pacific TPP signatories.

STAFF APPRAISAL

51. Context. Australia has experienced robust growth and low unemployment during the drawn-out adjustment to the commodity price and mining investment bust, highlighting the resilience of the economy and strong policy frameworks. But it has not been immune to symptoms of the "new mediocre." Wage and price pressures have been weak, underemployment has risen, and private business investment outside mining has been lackluster.

52. Outlook and risks. After a growth pickup from mid-2015, real GDP unexpectedly contracted in 2016Q3, largely on account of one-off factors, so growth close to trend is expected to resume. The balance of risks to the growth outlook improved in 2016 but remains tilted to the downside. While recent terms-of-trade improvements provide for some upside, domestic demand could remain lackluster with continued weak wage growth and underemployment. A major concern is that high-impact external risks could interact with or even trigger domestic risks, especially a housing correction.

53. On the macro-financial side, prudential policies have contributed to a tentative stabilization of housing-related and external vulnerabilities. APRA's prudential measures introduced in late 2014 have improved the risk profile of new loans. While household debt has remained high, risks to banks and to household balance sheets have been mitigated by the strong growth in mortgage buffers. The macro-financial risk outlook has also improved as banks' balance sheets have become more resilient with higher capital ratios and a higher share of stable funding.

54. The economic policy agenda should center on three priorities: Demand support to ensure completion of the transition to non-mining-based growth; further reductions in macro-financial vulnerabilities, and reforms to enhance the longer-term growth potential.

55. The monetary policy stance should remain accommodative. Australia's low inflation is more recent, but policy decisions should remain predicated on the possibility that inflation may return into the target range later than expected, given international experience. Prudential measures to address housing-related risks have mitigated risks to balance sheets and financial stability from lower policy rates.

56. Australia still has substantial fiscal space despite recent public debt increases, which allows for a gradual approach to fiscal consolidation and higher growth-friendly spending.

- ***The government appropriately plans to balance the budget over four years, while making the expenditure composition more growth-friendly.*** Efforts focus on supporting longer-term inclusive growth, including by boosting innovation and tax reform.
- ***The envisaged fiscal consolidation risks being too front-loaded.*** Over the next two years, the budget targets reductions in the structural budget deficit of close to 1½ percent. This

ambitious pace risks being counterproductive in the current phase of the recovery, especially if it does not provide for the increases in productive spending needed to support longer-term growth.

- ***A more sustained public investment effort.*** A multi-year increase in spending on efficient infrastructure beyond the planned current short-lived increase would be desirable, considering that Australia has infrastructure needs and fiscal space.

57. If high-impact downside risks were to materialize, fiscal policy should support aggregate demand, as monetary policy could be constrained by the effective lower bound. Developing contingency plans and a pipeline of infrastructure projects would help reduce implementation lags in undertaking fiscal stimulus.

58. With more acute risks concentrated in a few specific housing market segments, policies should focus on further strengthening resilience to housing market and other shocks with macro-financial implications.

- With continued upside risks to house prices, APRA should stand ready to intensify targeted prudential measures, if lending or house price growth were to re-accelerate.
- APRA should continue to actively encourage banks' efforts to robustly anchor their capital position in "unquestionably strong" territory, given a highly concentrated banking sector where banks have similar business models.
- Treasury's preparation of new legislation to further the regulatory reform agenda should continue to complete the implementation of the FSI recommendations. APRA should continue in its effort to implement prudential steps to strengthen the loss absorbing and recapitalization capacity of banks and introduce leverage ratios, in line with the international agenda.

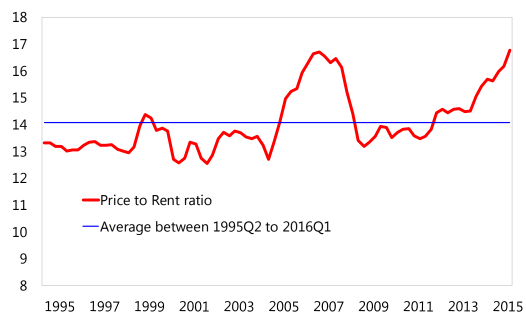
59. The government's structural reform agenda appropriately focuses on fostering innovation and strengthening competition, and the intention to push for trade liberalization is welcome. The NISA, is an important step forward. The efforts should continue, as currently envisaged, and, if effective, be expanded. The measures recommended by the Harper Review would strengthen services sector competition and productivity, but implementation will require determined effort. Expanding access to service export markets could also strengthen services sector productivity in Australia and elsewhere, while the social safety net and active labor market policies could mitigate the cost to those who bear the burden of adjustment.

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

Box 1. Developments in Australia's Commercial Real Estate Market

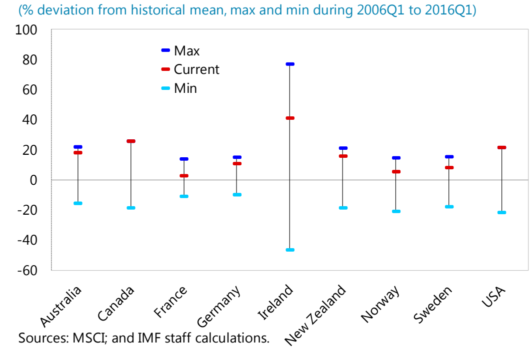
Signs of commercial real estate overvaluation have emerged. Commercial real estate (CRE) prices in Australia have increased rapidly since mid-2014. Rents have not followed at the same pace, and the price-to-rent (PR) ratio is now above average. Whether the latter is a good metric of fair value is difficult to assess. But the deviations from average are now close to levels last seen before the global financial crisis. Shortly thereafter, there was a sharp correction in CRE prices in the context of the crisis. Internationally, Australia's CRE PR ratio is closer to the pre-crisis maximum than in almost all other countries for which data are available, with the notable exception of the United States and Canada. The valuation increases may in part reflect the strong interest of foreign investors in Australian CRE assets.

Price to Rent Ratio
(%)



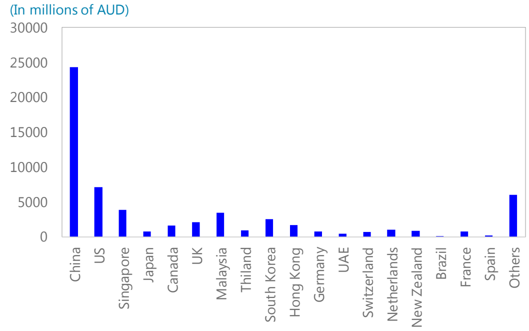
Sources: MSCI; and IMF staff calculations.

Price to Rent Ratio
(% deviation from historical mean, max and min during 2006Q1 to 2016Q1)



Sources: MSCI; and IMF staff calculations.

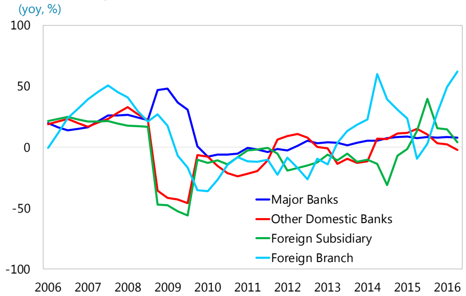
Approvals by Country of Investor on Real Estate in 2014-2015
(In millions of AUD)



Risks to financial stability from any potential CRE overvaluation appear manageable. The share of CRE lending in commercial banks' total assets decreased in the past few years and has now stabilized at around 5 percent. Even so, banks' lending growth to CRE has been rising recently, with increased contribution by Australian branches of foreign banks. The share of impaired CRE assets over total CRE assets has declined and the impaired assets are almost fully provisioned. While a downturn in the CRE market would likely not pose a major financial stability risk, it may still have important macroeconomic effects as Australia's CRE capital expenditures as a percent of GDP are relatively high in comparison.

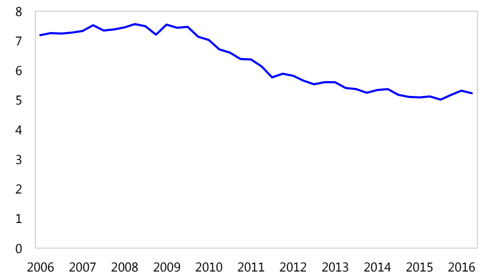
Box 1. Developments in Australia's Commercial Real Estate Market (concluded)

CRE Lending Growth Rate
(yoy, %)



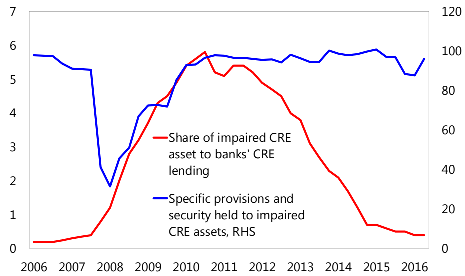
Source: APRA.

Share of CRE
(% of Banks' Total Asset)



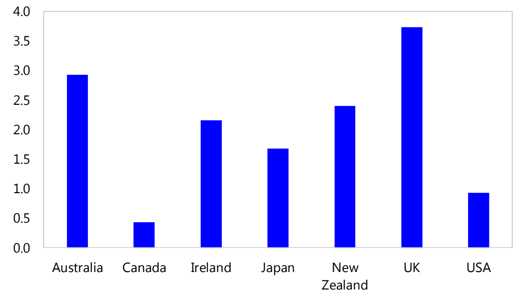
Source: APRA.

Impaired CRE Assets and Special Provisions
(%)



Source: APRA.

Share of CRE Related Capital Expenditure
(% of GDP)



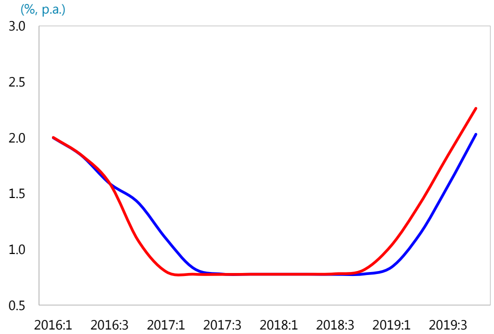
Sources: MSCI; Haver Analytics; and IMF staff calculations.

Box 2. A China Downside Scenario with Monetary and Fiscal Policy Responses

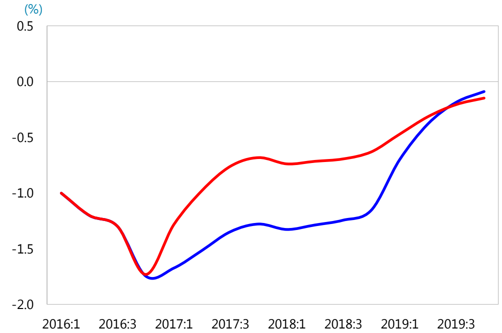
Disappointing external environment may require a 'low for longer' strategy for monetary policy. We consider alternative simulations where China's economic growth surprises on the downside. This has significant spillover effects on the rest of the world and a sizable impact on commodity prices. This downside scenario implies an opening up of the effective foreign output gap relevant for the Australian economy (defined as export-weighted output gaps for Australia's main trading partners). Specifically, the effective foreign output gap is 2.3 percentage points lower and metal prices are 5.3 percent lower at the trough compared to the baseline. Under the *blue line*, in anticipation of the negative shocks, the policy rate declines to the effective lower bound (assumed to be 0.75 percent) and stays there for 2 years. This results in a further depreciation in the Australian dollar that helps support the economy. However, a sizable negative output gap remains for the Australian economy as largely dominated by the magnitude of the negative shock. Headline inflation slightly overshoots the 2.5 percent mid-point of the RBA's 2-3 percent inflation target range.

A combined monetary-fiscal policy would provide a much-needed shot in the arm for the Australian economy if the downside shocks were to materialize. Under this case, a direct fiscal stimulus is used to help deal with the negative external shocks hitting the Australian economy. The direct effects of the fiscal stimulus are equal to 0.25 percent of GDP for 2017-18. Monetary policy provides the 'supporting role' to a much-welcomed fiscal expansion by cutting the policy rate aggressively to its lower bound faster than under the previous case. This helps raise inflation and generate a modest overshoot of inflation above the upper bound of the 2-3 percent target range over the medium term. This planned overshoot of inflation raises inflation expectations and reduces the real interest rates, which combined with more depreciated exchange rate helps close the output gap much faster. A faster recovery of the economy under this more accommodative strategy allows monetary policy to renormalize earlier than under the previous case.

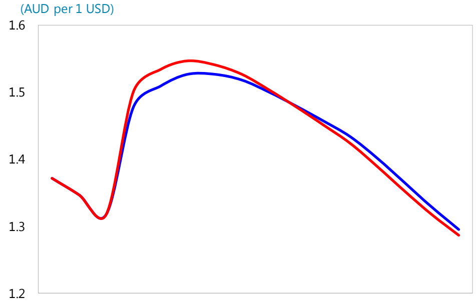
Policy Rate
(%, p.a.)



Output Gap
(%)



Exchange Rate
(AUD per 1 USD)



Headline Inflation
(%, Y/Y)

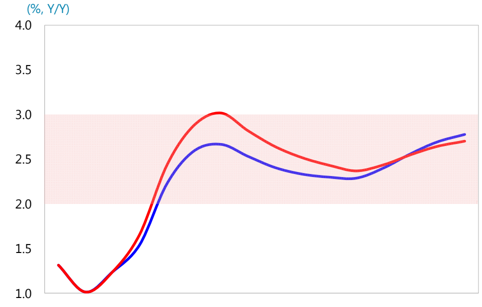
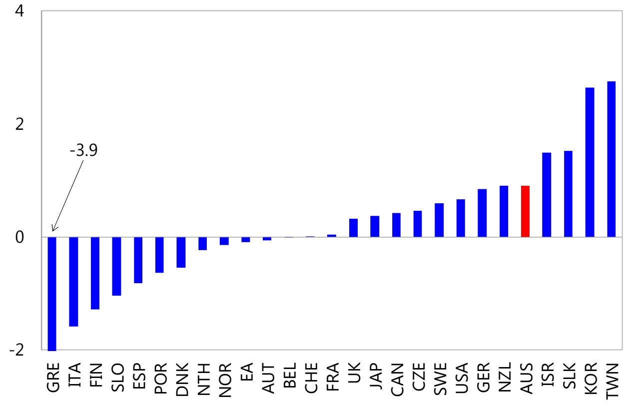


Figure 1. Australia in International Comparison

Australia has enjoyed high growth in per capita terms

Average Annual Per Capita Real Growth

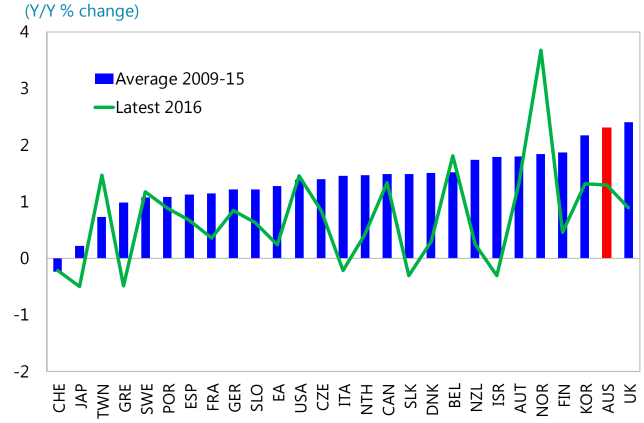
(2009-15, % change)



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

Consumer Price Index

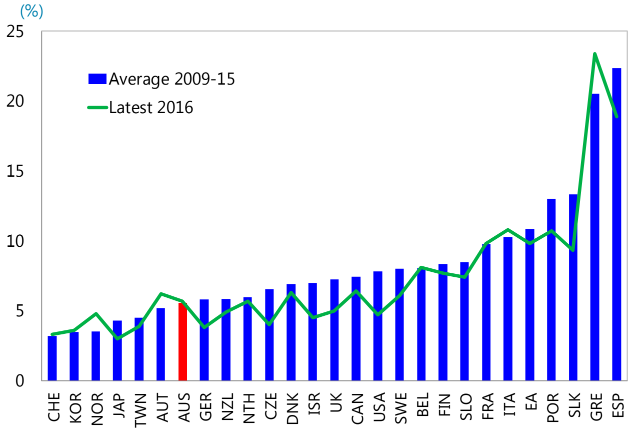
(Y/Y % change)



Unemployment is relatively low

Unemployment Rate

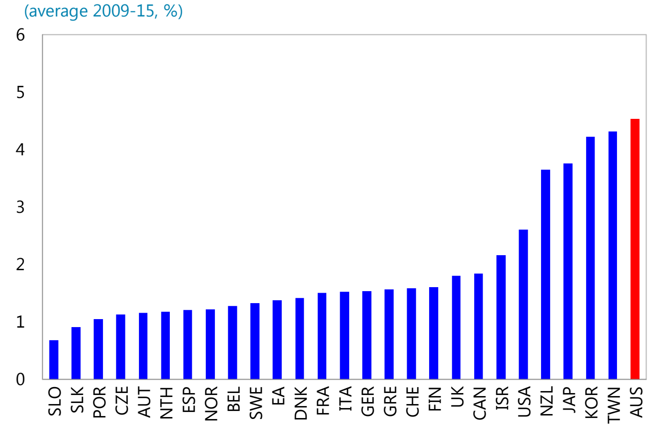
(%)



Australia has benefited from growth in dynamic Asian partners

Trading Partner Growth

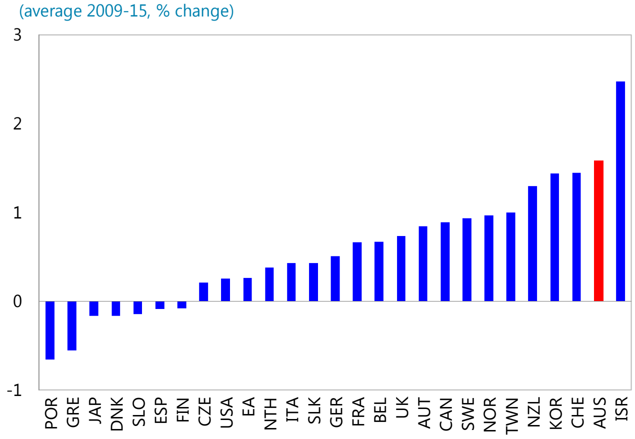
(average 2009-15, %)



Labor force growth has contributed to growth momentum

Labor Force Growth

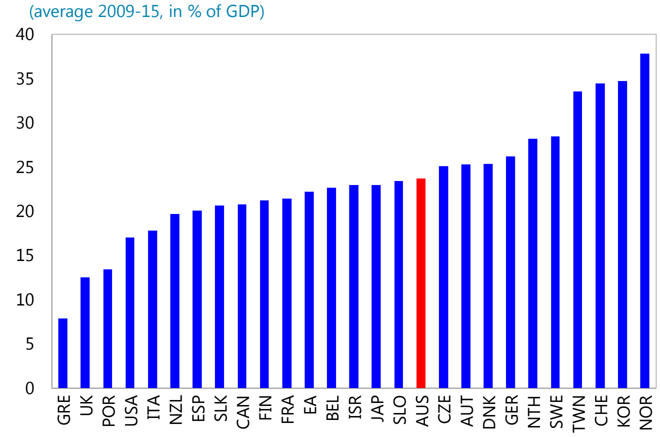
(average 2009-15, % change)



Australia's national saving ratio is close to average

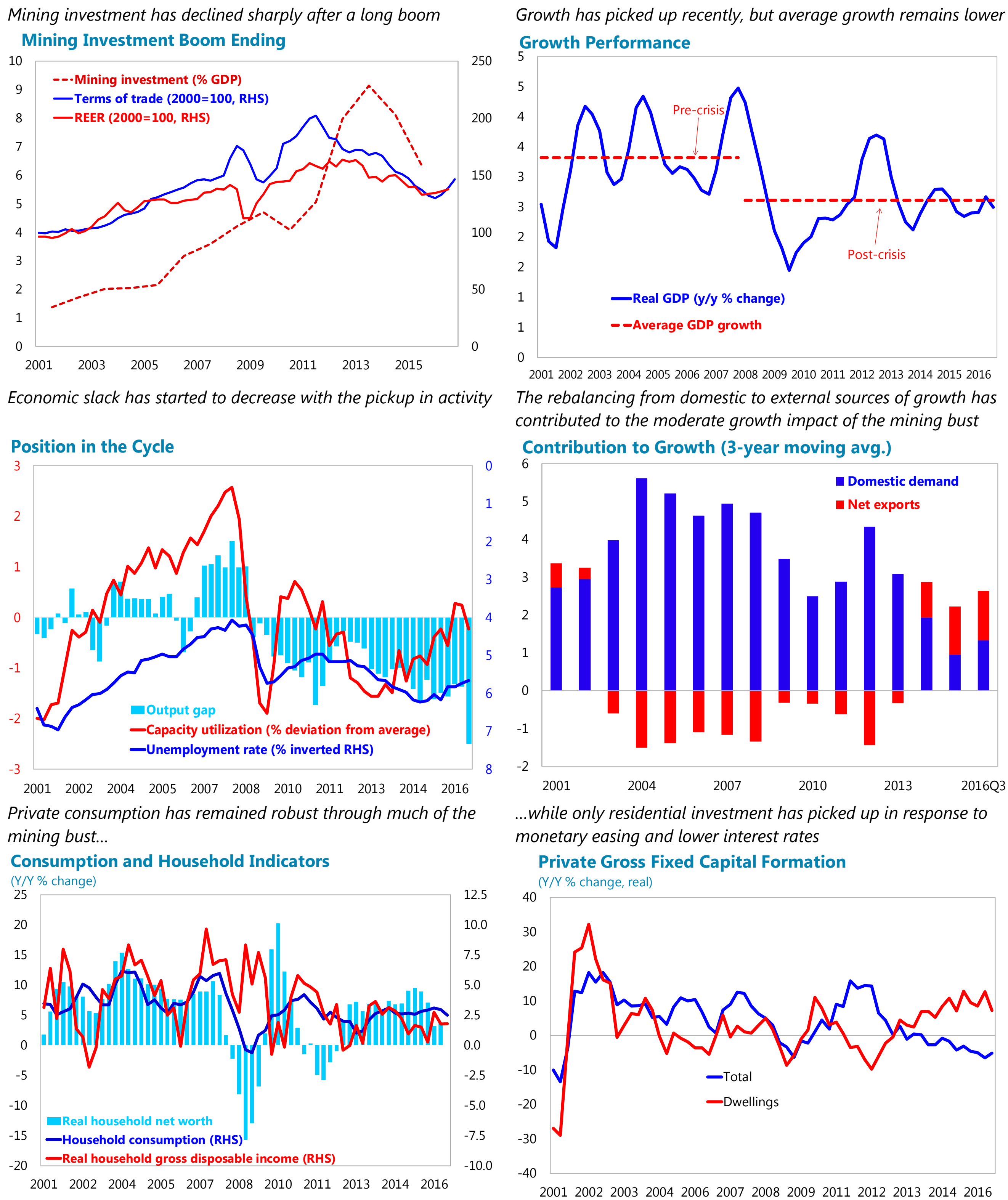
Gross National Savings

(average 2009-15, in % of GDP)



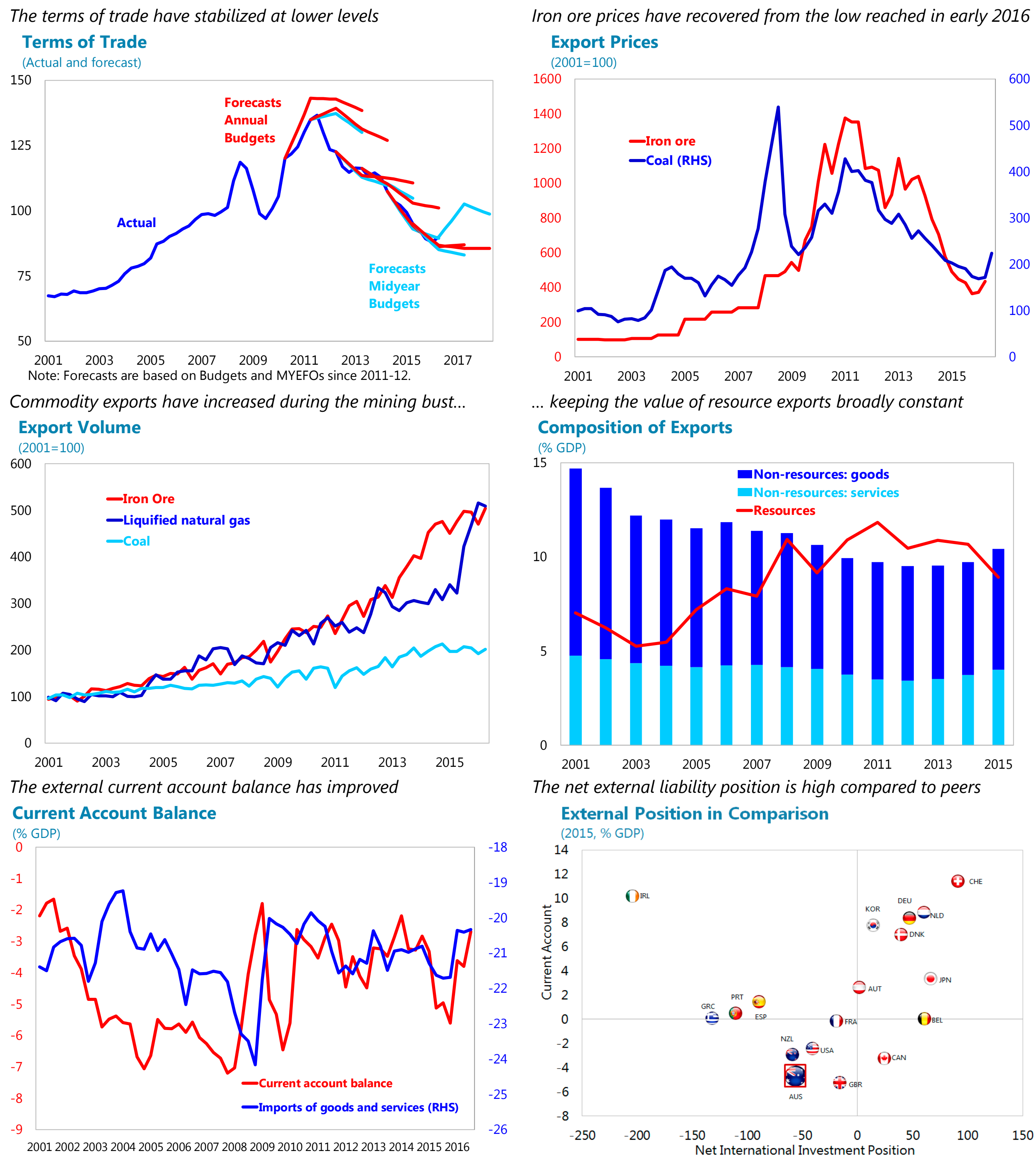
Source: IMF, World Economic Outlook database.

Figure 2. Strong Advances in the Recovery from the Mining Bust



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

Figure 3. Current Account Improving After Rebalancing Toward Net Exports



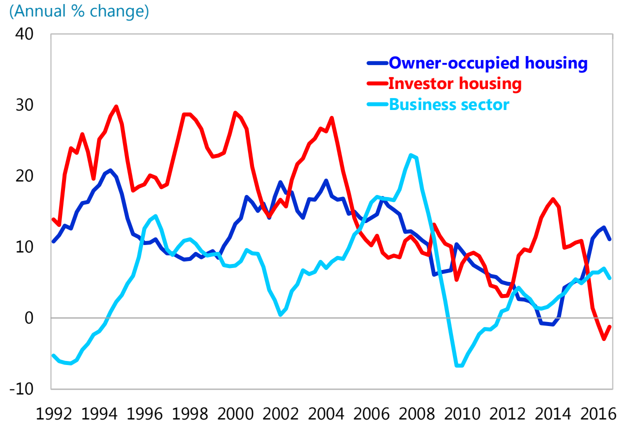
Sources: Haver; IMF, *World Economic Outlook*; ABS; RBA; and IMF staff calculations.

Figure 4. Housing Risks Remain

Credit growth for investor housing sharply decreased while credit growth for owner-occupied housing picked up moderately

Credit

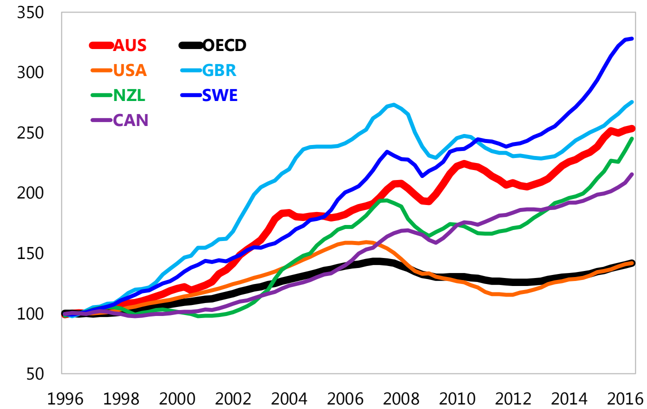
(Annual % change)



House price dynamics are similar to other buoyant markets...

Real House Prices vs OECD

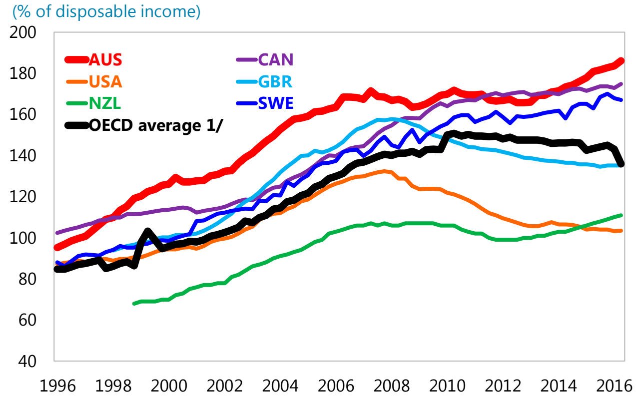
(1996=100)



...and have been an important driver of high household debt

Household Debt

(% of disposable income)

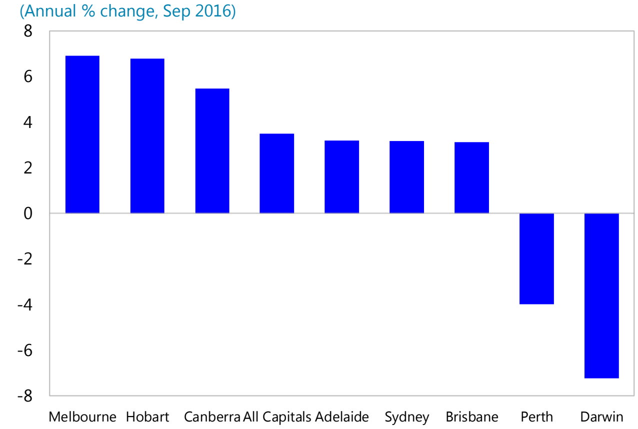


1/ Based on a limited number of countries due to lack of data.

House price inflation varies greatly across regions

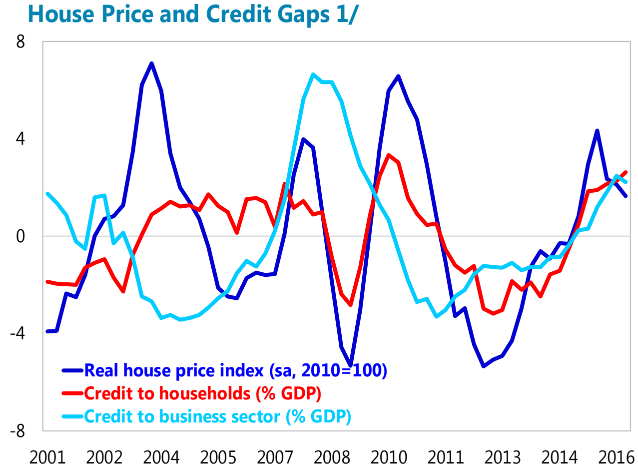
House Prices Across Capitals

(Annual % change, Sep 2016)



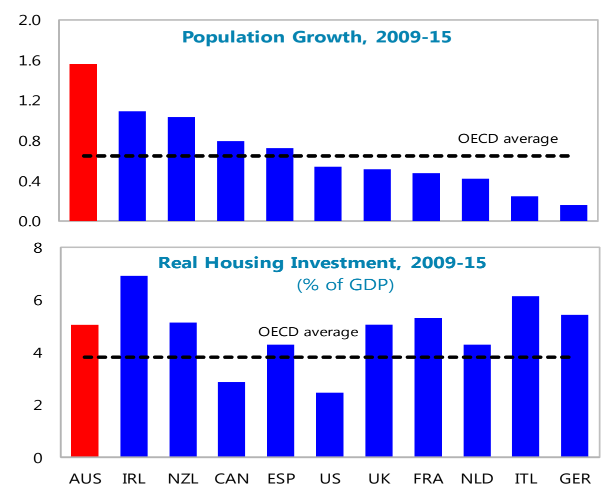
House price appreciation and credit growth show tentative signs of stabilization

House Price and Credit Gaps 1/



1/ Gap is the difference from HP filter trend.

Demographics partly explain strong housing demand in Australia

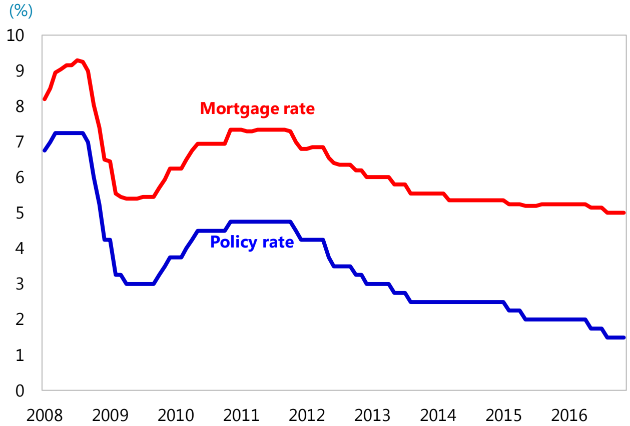


Sources: OECD; RBA; APRA; RBNZ; Corelogic; BIS; Haver Analytics; and IMF staff calculations.

Figure 5. Monetary Policy Faces a Disinflationary Impulse

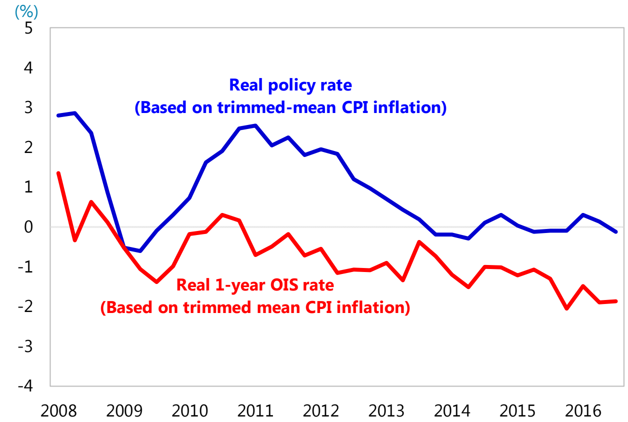
There have been two additional policy rate cuts in 2016...

Policy Rate and Mortgage Rate



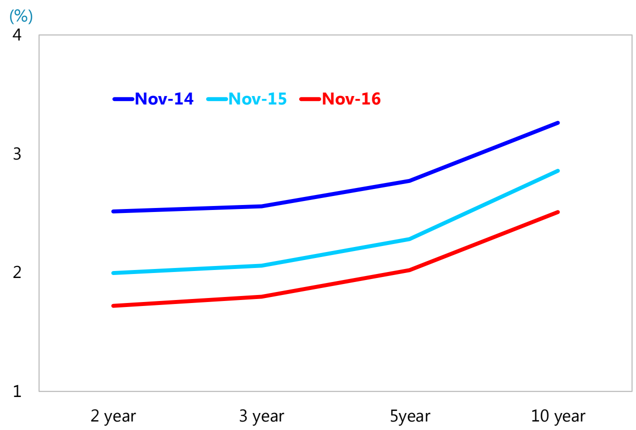
...and real policy rates are around zero

Real Interest Rates



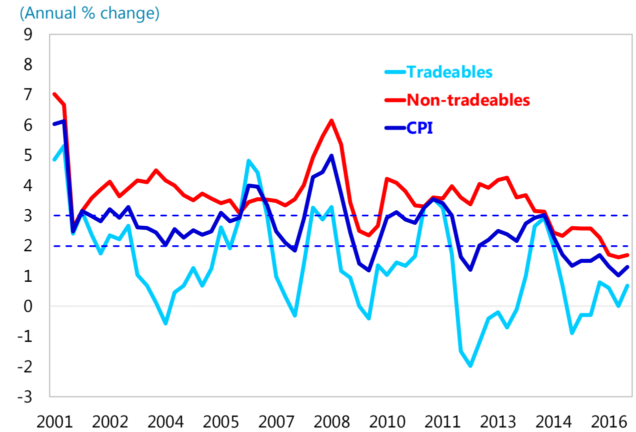
And, as elsewhere, the yield curves had shifted down

Australia Commonwealth Yield Curves



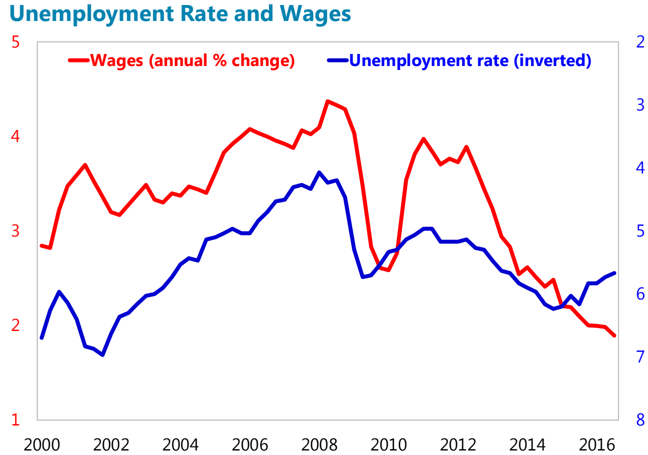
Both headline and core inflation are below the RBA's target range

Price Pressures, Inflation



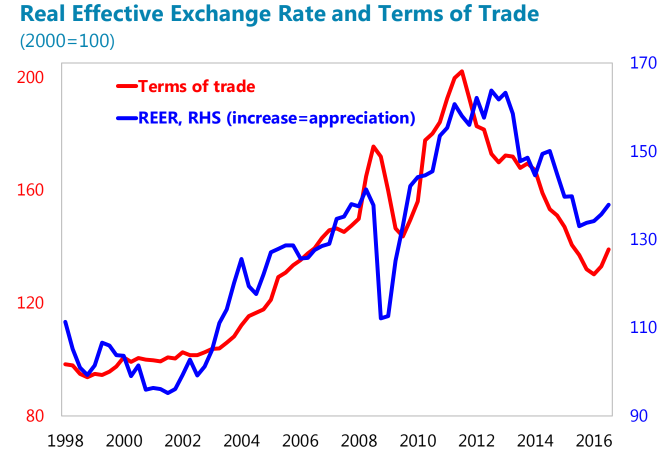
Wage growth is subdued even though unemployment has declined

Unemployment Rate and Wages



The downturn in the terms of trade looks not to have been fully reflected in the exchange rate level

Real Effective Exchange Rate and Terms of Trade

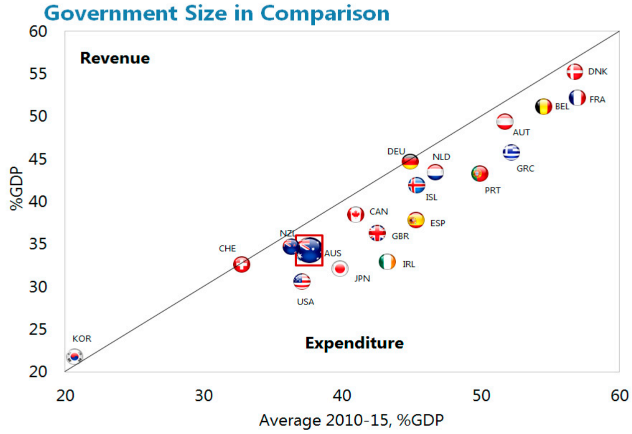


Sources: RBA; Haver Analytics; and IMF staff estimates.

Figure 6. Strong but Deteriorating Public Finances

Australia has a relatively small government…

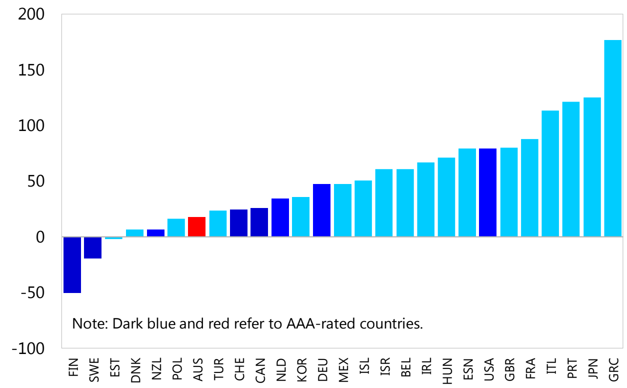
Government Size in Comparison



…and a low level of public debt

Net Public Debt

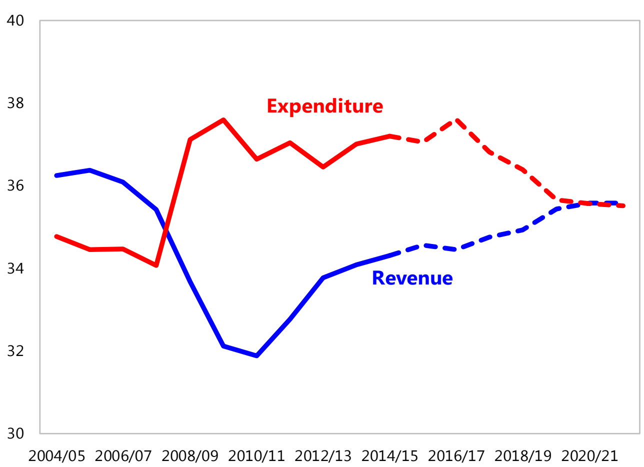
(% GDP; 2015)



But the deficit has not decreased as much as set out in the budget

Consolidated General Government Revenue and Expenditure

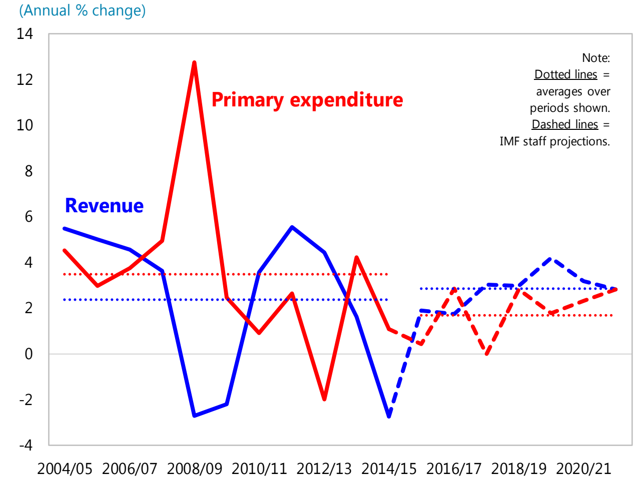
(% GDP)



The government seeks to achieve consolidation partly through lower real expenditure growth, which will be challenging

Real Revenue and Real Primary Expenditure

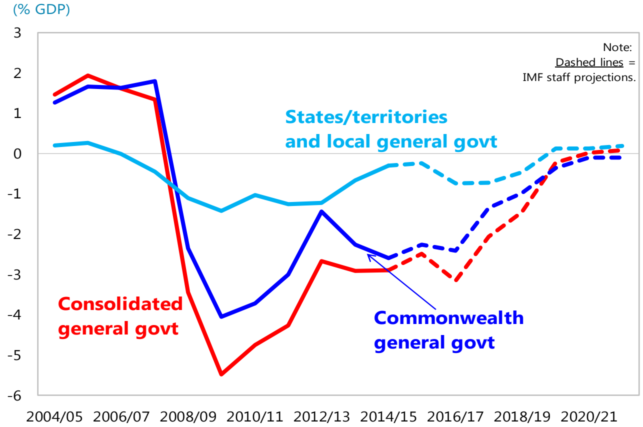
(Annual % change)



The states are also consolidating…

Fiscal Balances

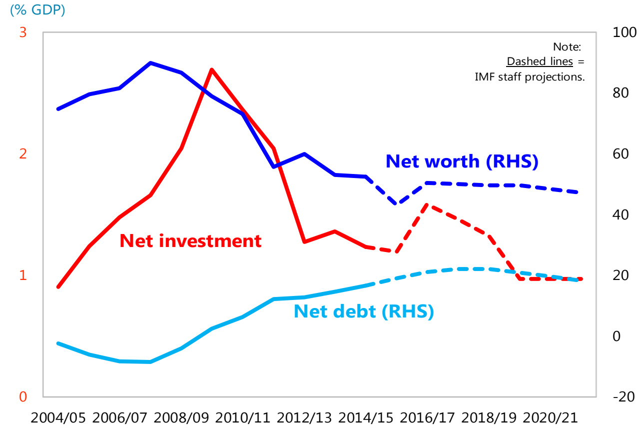
(% GDP)



…and public investment will only increase temporarily

Consolidated General Government Balance Sheet

(% GDP)



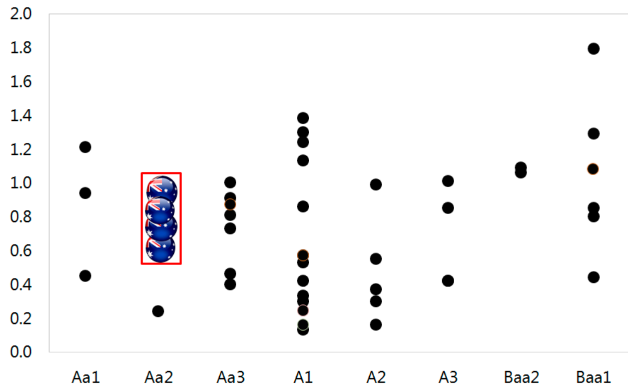
Sources: Commonwealth and State/Territory Treasuries; 2016-17 Budget; IMF, *World Economic Outlook*; and IMF staff estimates and projections.

Figure 7. Banking System Remains Strong

Australian major banks are highly rated...

Bank Ratings

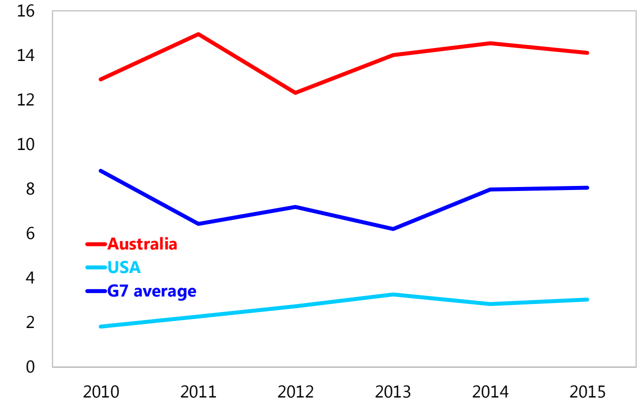
Return on assets



...and profitable

Return on Equity

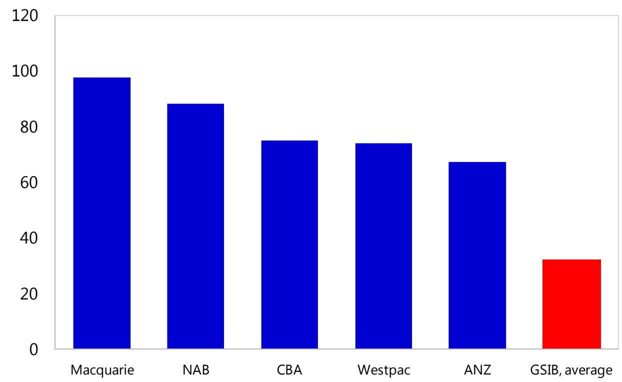
(%)



Pay out ratios are high

Australian Banks and GSIBs: Dividend Payout Ratio, 2014

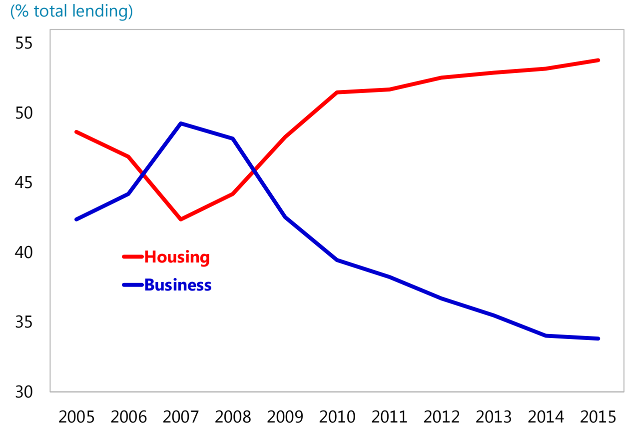
(% net income)



Bank lending is concentrated in housing

Banks' Lending Structure

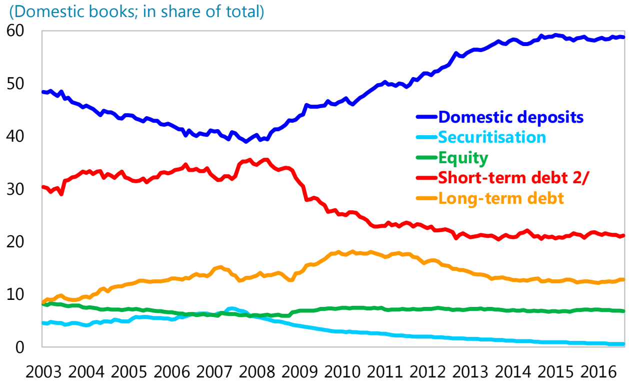
(% total lending)



Banks have reduced the share of short-term offshore wholesale funding

Banks' Funding 1/

(Domestic books; in share of total)



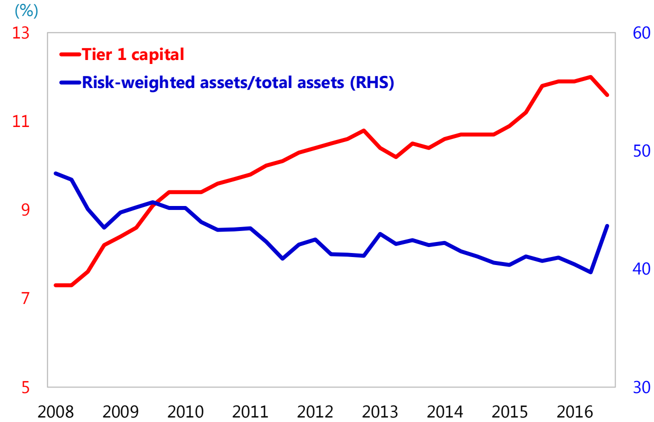
1/ Adjusted for movements in foreign exchange rates.

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

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

Capital Adequacy Ratios

(%)



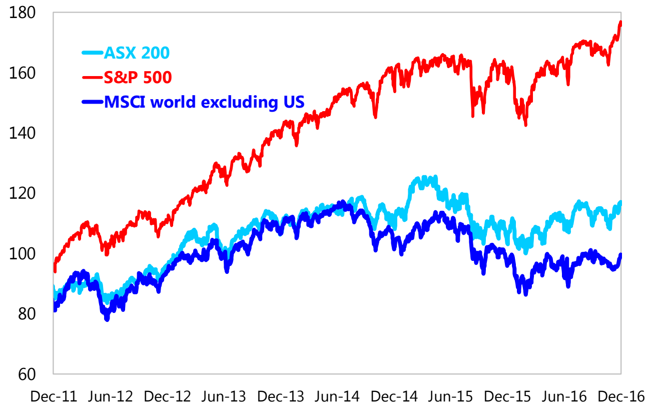
Sources: Bankscope; RBA; APRA; Financial Soundness Indicators; and IMF staff calculations.

Figure 8. Financial Market Indicators: New Lows for Yields and Spreads

Australian equity has moved sideways recently

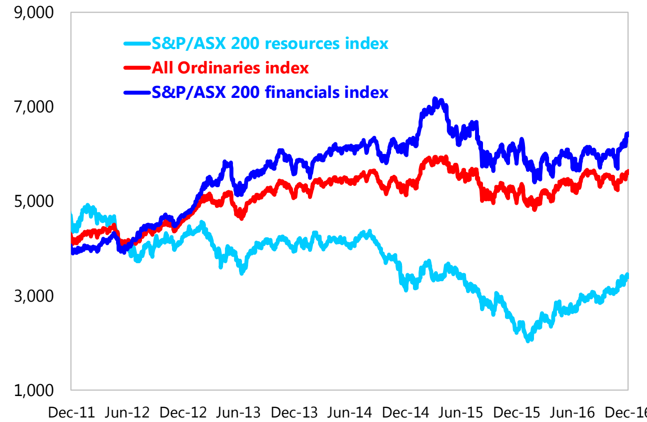
Stock Market Indices

(Jan 2011=100)



The resources sector has improved, but financials have eased

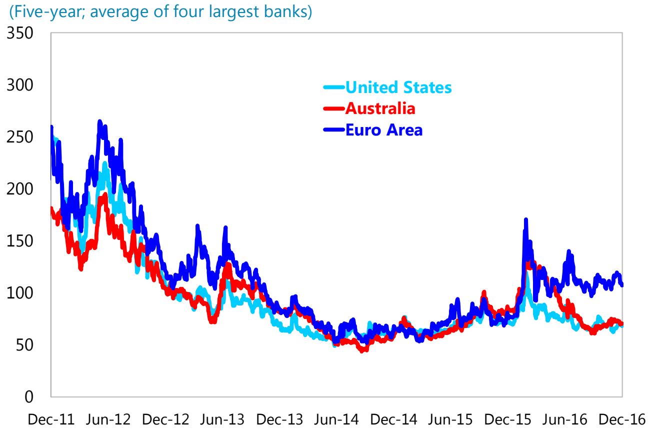
Stock Market Indices



Bank risk spreads are low

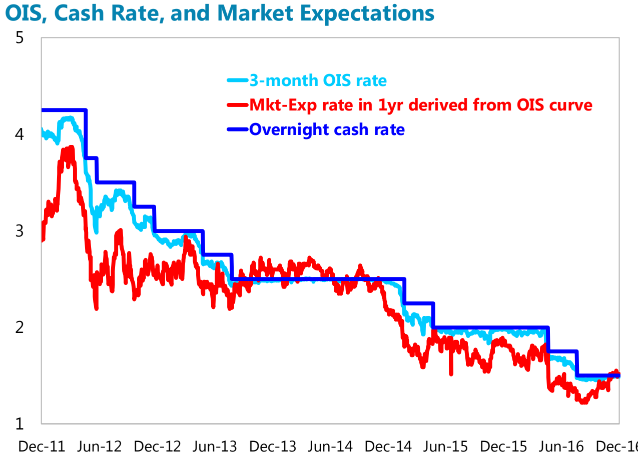
Credit Default Swap (CDS) Spreads

(Five-year; average of four largest banks)



Markets expect rates to remain on hold

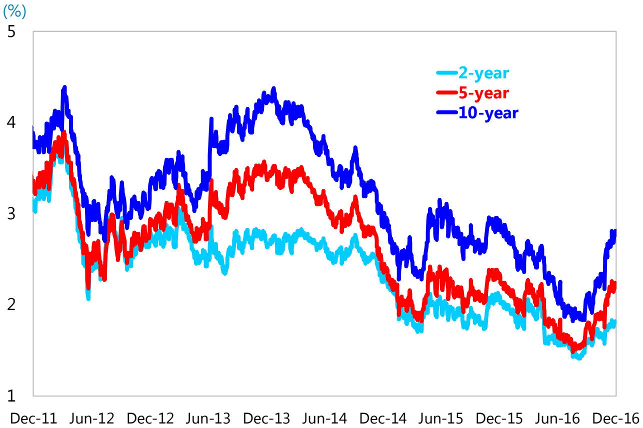
OIS, Cash Rate, and Market Expectations



Government bond yields and spreads have reached new lows in 2016, although yields are rebounding

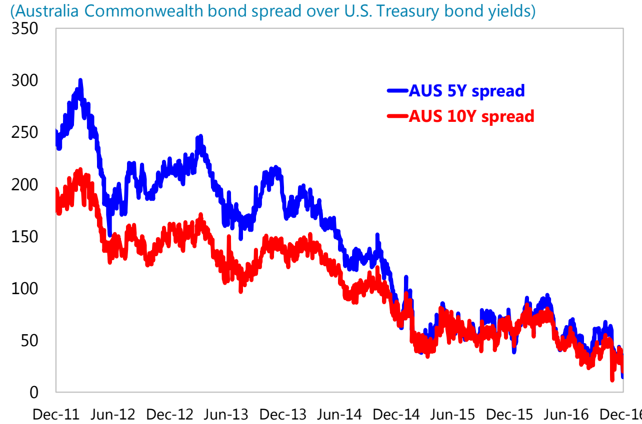
Australia Commonwealth Debt Yields

(%)



Australia Sovereign Spreads

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

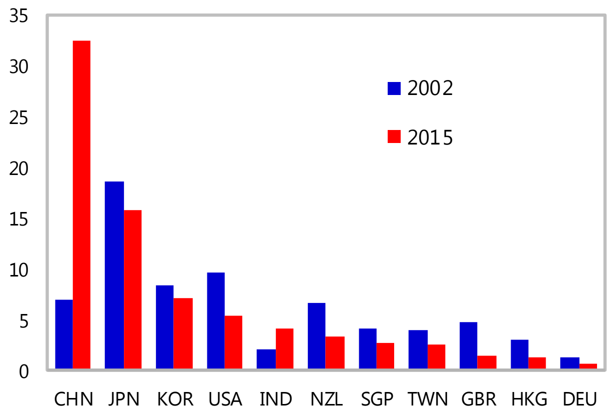


Sources: Bloomberg; RBA; and IMF staff calculations.

Figure 9. Interconnections and Spillovers

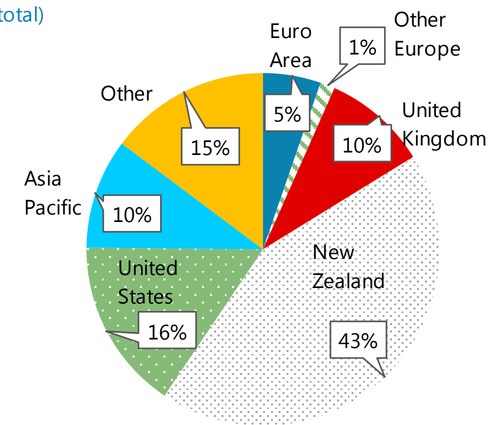
Trade links are mainly with China with exposure to commodity price shocks…

Exports by Destination
(% total)



…while financial links are with New Zealand, US, and UK.

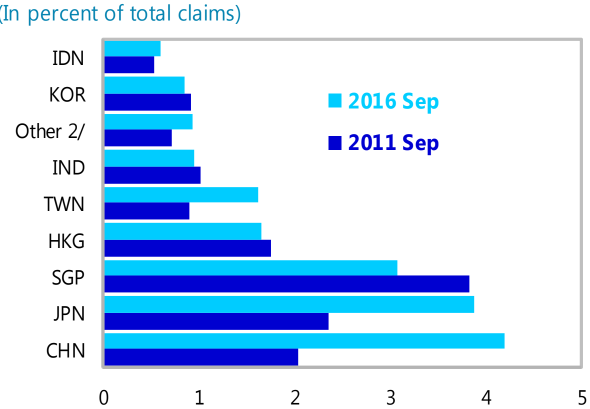
Foreign Claims of Australian Banks, 2016Q3 1/
(% total)



1/ Measured on a consolidated, ultimate risk basis.

Financial links with Asia are increasing from a low base

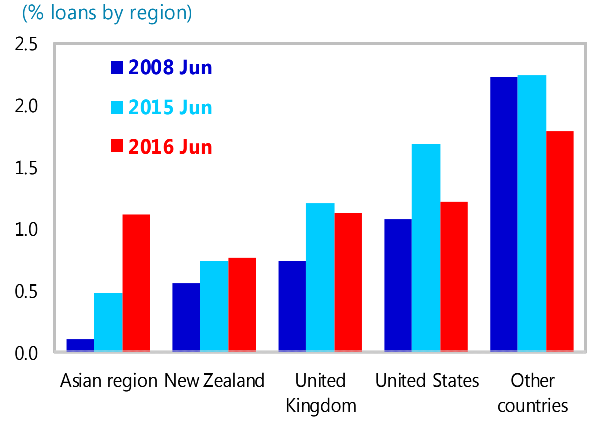
Australian-owned Banks' Claims on Asia 1/
(In percent of total claims)



1/ Measured on a consolidated, ultimate risk basis.
2/ Includes Cambodia, Lao PDR, Malaysia, Philippines, Thailand and Vietnam.

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.

Table 1. Australia: Main Economic Indicators, 2012-2022
(Annual percent change, unless otherwise indicated)

	2012	2013	2014	2015	2016	2017	2018	2019	2020	2021	2022
					Projections						
NATIONAL ACCOUNTS											
Real GDP	3.6	2.1	2.8	2.4	2.3	2.6	3.0	3.0	2.9	2.9	2.9
Domestic demand	4.2	0.7	1.2	1.3	1.5	2.3	3.0	2.9	2.9	2.8	2.8
Private consumption	2.3	1.7	2.8	2.7	2.7	2.9	3.0	3.0	3.0	3.0	3.0
Public consumption	2.5	1.1	1.0	3.4	3.8	1.7	1.6	1.7	1.7	1.8	1.8
Investment	9.1	-1.5	-1.7	-3.2	-2.8	1.7	3.8	3.5	3.3	3.1	3.1
Public	6.7	-10.6	-2.1	-2.2	8.7	3.0	2.0	1.5	0.7	0.0	0.0
Private business	15.3	-0.8	-5.0	-8.8	-10.3	0.5	4.9	4.6	4.6	4.5	4.5
Dwelling	-6.3	2.3	6.8	10.0	8.1	3.5	3.3	2.9	2.7	2.4	2.4
Net exports (contribution to growth, percentage points)	-0.2	1.5	1.5	0.8	1.2	0.1	0.1	0.1	0.1	0.1	0.1
Gross domestic income	1.3	1.3	1.2	-0.1	2.0	2.2	2.0	2.7	2.8	2.8	2.9
Investment (percent of GDP)	29.0	27.6	26.9	26.3	25.1	25.1	25.4	25.5	25.6	25.6	25.6
Public	5.3	4.6	4.5	4.4	4.7	4.8	4.8	4.7	4.6	4.4	4.3
Private	23.3	23.0	22.4	21.9	20.3	20.3	20.7	20.9	21.0	21.2	21.3
Mining investment	8.4	8.5	7.2	5.5	4.0	3.0	2.3	2.3	2.3	2.3	2.3
Non-mining investment	14.9	14.5	15.2	16.4	16.3	17.3	18.4	18.6	18.8	18.9	19.0
Savings (gross, percent of GDP)	24.6	24.4	23.9	22.1	21.6	21.6	21.3	21.5	21.6	21.6	21.6
Potential output	2.9	2.8	3.0	2.5	2.6	2.6	2.6	2.6	2.6	2.6	2.6
Output gap (percent of potential)	-0.5	-1.1	-1.3	-1.4	-1.7	-1.7	-1.3	-1.0	-0.7	-0.4	-0.1
LABOR MARKET											
Employment	1.2	0.9	0.7	1.9	1.6	1.8	1.8	1.7	1.7	1.7	1.7
Unemployment (percent of labor force)	5.2	5.7	6.1	6.1	5.7	5.7	5.6	5.4	5.3	5.3	5.1
Wages (nominal percent change)	3.7	2.9	2.5	2.1	2.0	2.1	2.5	2.6	2.8	2.9	3.0
PRICES											
Terms of trade index (goods, avg)	121	117	107	94	92	91	86	86	85	85	85
% change	-12.3	-3.4	-8.1	-12.5	-2.0	-1.1	-4.9	-1.0	-0.3	0.0	0.0
Iron ore prices (index)	101	107	77	44	46	55	45	39	39	39	39
Coal prices (index)	109	95	79	65	74	83	75	72	72	72	72
LNG prices (index)	102	97	95	61	43	48	48	48	48	48	48
Crude prices (Brent; index)	103	100	91	48	40	52	52	52	52	52	53
Consumer prices (avg)	1.7	2.5	2.5	1.5	1.3	2.0	2.4	2.5	2.5	2.5	2.5
GDP deflator (avg)	-0.2	1.3	0.2	-0.6	1.0	1.9	1.8	2.2	2.4	2.4	2.5
FINANCIAL											
Reserve Bank of Australia cash rate (percent, avg)	3.7	2.7	2.5	2.1	1.7	1.7	2.0	2.3	2.6	2.9	2.9
10-year treasury bond yield (percent, avg)	3.5	3.7	3.7	2.7	2.1	2.0	2.5	2.8	3.1	3.4	3.5
Mortgage lending rate (percent, avg)	7.0	6.2	6.0	5.6	5.4	5.4	5.7	6.0	6.3	6.6	6.6
MACRO-FINANCIAL											
Credit to the private sector	5.4	-1.7	7.4	8.1	6.5	5.0	5.2	4.7	4.4	4.2	4.1
House price index	102	113	120	131	138	145	152	158	164	169	174
% change	3.0	10.0	6.7	8.7	5.7	5.2	4.7	4.1	3.5	3.3	3.0
House price-to-income, capital cities	3.9	4.2	4.2	4.9	4.8	4.9	4.9	4.9	4.8	4.8	4.7
Interest payments (percent of disposable income)	9.8	8.8	8.8	8.6	7.8	8.5	9.1	9.6	10.0	10.1	10.2
Household savings (percent of disposable income)	8.0	8.3	8.1	6.4	6.1	6.2	5.9	5.6	5.4	5.2	5.0
Household debt (percent of disposable income) 1/	166	171	176	183	185	186	187	186	184	183.1	181.8
Non-financial corporate debt (percent of GDP)	49	48	49	51	52	51	52	52	52	52	52
GENERAL GOVERNMENT (percent of GDP) 2/											
Revenue	33.3	33.9	34.1	34.6	34.6	34.6	34.9	35.2	35.5	35.6	35.7
Expenditure	36.7	36.7	37.0	37.3	37.4	37.1	36.5	35.9	35.5	35.4	35.4
Net lending/borrowing	-3.5	-2.8	-2.9	-2.7	-2.8	-2.5	-1.6	-0.7	0.1	0.2	0.3
Operating balance	-2.0	-1.5	-1.6	-1.5	-1.4	-1.0	-0.2	0.5	1.0	1.2	1.3
Cyclically adjusted balance	-3.1	-2.3	-2.3	-2.0	-2.0	-1.8	-1.0	-0.2	0.4	0.4	0.3
Gross debt	27.8	30.7	34.2	37.6	41.3	43.6	43.8	42.8	41.0	39.2	37.2
Net debt	11.2	13.2	15.5	17.8	20.1	21.4	21.7	21.0	19.6	18.1	16.5
Net worth	52.2	53.9	52.3	47.5	46.8	50.2	49.8	49.7	49.3	48.3	47.3
BALANCE OF PAYMENTS											
Current account (percent of GDP)	-4.1	-3.2	-2.9	-4.8	-3.2	-3.5	-4.2	-4.1	-4.0	-4.0	-4.0
Export volume	5.7	5.8	6.9	6.1	6.6	4.2	4.1	4.1	4.0	4.0	4.0
Import volume	5.5	-2.2	-1.1	2.0	0.7	3.7	3.9	3.8	3.8	3.8	3.7
Net international investment position (percent of GDP)	-55	-54	-55	-59	-63	-63	-65	-65	-66	-67	-67
Gross official reserves (bn US$)	47	59	66	67	...	...	...	...	...	...	...
MEMORANDUM ITEMS											
Nominal GDP (bn A$)	1,507	1,559	1,606	1,634	1,688	1,766	1,851	1,948	2,052	2,162	2,281
Percent change	3.4	3.4	3.0	1.8	3.3	4.6	4.8	5.2	5.3	5.4	5.5
Real net national disposable income per capita (% change)	0.2	-1.0	-0.5	-2.4	1.0	-0.1	0.1	1.0	0.8	0.7	0.7
Population (million)	22.9	23.3	23.6	23.9	24.3	24.6	25.0	25.3	25.7	26.1	26.4
Nominal effective exchange rate	110	105	99	92	...	...	...	...	...	...	...
Real effective exchange rate	110	105	100	93	93	...	...	...	...	...	...

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

1/ 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.

2/ Calendar year.

Table 2. Australia: Fiscal Account, 2012/13-2021/22
(In percent of GDP, unless otherwise indicated)

	2012/13	2013/14	2014/15	2015/16	2016/17	2017/18	2018/19	2019/20	2020/21	2021/22
				Est.			Projections			
CONSOLIDATED GENERAL GOVERNMENT OPERATIONS 1/										
Revenue	**33.8**	**34.1**	**34.3**	**34.6**	**34.4**	**34.7**	**34.9**	**35.5**	**35.6**	**35.6**
Tax revenue	27.2	27.5	27.5	27.9	28.1	28.4	28.9	29.0	29.2	29.2
Direct taxes	19.5	19.7	20.2	20.3	20.6	20.9	21.3	21.5	21.6	21.6
Individual and withholding	13.0	13.4	14.2	14.6	14.7	14.6	14.9	15.1	15.1	15.1
Corporate	6.5	6.2	6.0	5.7	5.9	6.3	6.4	6.4	6.5	6.5
Indirect taxes	7.6	7.9	7.4	7.6	7.5	7.5	7.6	7.5	7.6	7.6
Of which: GST	3.3	3.5	3.5	3.6	3.6	3.6	3.7	3.6	3.6	3.6
Non-tax revenue	6.6	6.5	6.8	6.6	6.3	6.3	6.1	6.4	6.4	6.4
Expenditure	**36.4**	**37.0**	**37.2**	**37.1**	**37.7**	**36.8**	**36.4**	**35.7**	**35.6**	**35.6**
Expense	35.3	35.6	36.0	35.9	36.1	35.4	35.1	34.8	34.7	34.6
Employee expenses	9.9	9.6	9.7	9.6	10.1	9.5	9.3	9.2	9.1	9.1
Other operating expenses (excl. depreciation)	9.4	9.4	9.7	10.1	10.3	10.0	9.9	9.7	9.7	9.7
Transfers	12.3	12.7	12.6	11.7	11.7	11.6	11.6	11.7	11.7	11.6
Interest (excl. superannuation)	1.3	1.4	1.5	1.5	1.5	1.5	1.5	1.5	1.5	1.5
Other	2.4	2.5	2.6	3.0	2.5	2.7	2.7	2.7	2.7	2.7
Net acquisition of nonfinancial assets	1.2	1.4	1.2	1.2	1.6	1.4	1.3	1.0	1.0	1.0
Of which: Gross fixed capital formation	3.0	2.9	2.9	3.0	3.7	3.5	3.1	2.9	2.9	2.9
Operating balance	-1.5	-1.6	-1.7	-1.4	-1.7	-0.7	-0.2	0.7	1.0	1.0
Primary balance	-1.3	-1.5	-1.4	-1.0	-1.8	-0.6	0.0	1.2	1.5	1.5
Net lending (+)/borrowing (-)	**-2.7**	**-2.9**	**-2.9**	**-2.6**	**-3.2**	**-2.1**	**-1.5**	**-0.3**	**0.0**	**0.0**
CONSOLIDATED GENERAL GOVERNMENT BALANCE SHEET										
Liabilities	**59**	**65**	**69**	**77**	**72**	**71**	**70**	**67**	**64**	**61**
Gross debt	29	33	36	39	43	44	44	43	41	39
Commonwealth	20	23	26	30	34	35	35	34	33	32
States, territories and local governments	9	9	9	9	9	9	9	9	8	7
Other liabilities	31	32	33	38	28	27	25	24	23	22
Assets	**114**	**118**	**121**	**120**	**122**	**121**	**119**	**116**	**112**	**108**
Financial assets	45	48	50	49	52	52	52	52	50	48
Other assets	69	69	72	71	70	69	67	64	62	60
Net financial worth	-14	-16	-20	-28	-20	-19	-17	-15	-14	-13
Net debt	**12**	**15**	**17**	**19**	**21**	**22**	**22**	**21**	**20**	**18**
Commonwealth 2/	10	13	15	18	20	20	20	19	19	18
States, territories and local governments	2	2	2	1	2	2	2	2	1	1
Net worth	**55**	**53**	**52**	**43**	**50**	**50**	**49**	**49**	**48**	**47**
Commonwealth	-13	-15	-18	-25	-18	-18	-18	-18	-17	-16
States, territories and local governments	68	67	70	68	68	68	68	67	65	62
MEMORANDUM ITEMS										
Cyclically adjusted balance (in percent of potential GDP)	-2.3	-2.4	-2.3	-1.8	-2.4	-1.4	-0.9	0.2	0.3	0.3
Change in real revenue (percent)	4.4	1.6	1.0	1.9	1.6	3.1	3.1	4.2	3.2	2.8
Change in real primary expenditure (percent)	-2.0	4.2	1.1	0.4	2.8	0.0	2.8	1.8	2.3	2.8
Commonwealth general government 3/										
Revenue	20.2	20.3	19.9	20.2	20.2	20.7	21.2	21.6	21.7	21.7
Expenditure	21.7	22.5	22.5	22.5	22.6	22.1	22.2	22.0	21.9	21.9
Net lending (+)/borrowing (-)	-1.4	-2.3	-2.6	-2.3	-2.4	-1.3	-1.0	-0.4	-0.1	-0.1
States, territories and local governments 4/										
Revenue	12.8	13.4	13.7	13.8	13.7	13.5	13.2	13.3	13.3	13.3
Expenditure	13.9	13.7	13.7	13.8	14.2	13.9	13.4	12.9	12.9	12.9
Net lending (+)/borrowing (-)	-1.1	-0.3	0.0	0.0	-0.5	-0.5	-0.2	0.4	0.4	0.4
Commonwealth transfers to subnational governments	6.0	6.2	6.4	6.4	6.7	6.7	6.5	6.2	6.2	6.2
Of which: General revenue assistance	3.4	3.4	3.6	3.6	3.6	3.6	3.6	3.6	3.6	3.6
Nonfinancial public sector capital stock	96	97	98	99	99	98	97	95	93	0
GDP (in billion A$)	1,533	1,582	1,620	1,661	1,724	1,801	1,890	1,991	2,097	2,210

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

1/ Accrual basis; GFS. Comprises the Commonwealth, and state, territory, and local goverments.
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, 2012-2022
(In percent of GDP, unless otherwise indicated)

	2012	2013	2014	2015	2016	2017	2018	2019	2020	2021	2022
							Projections				
BALANCE OF PAYMENTS											
(% GDP)											
Current account	-4.1	-3.2	-2.9	-4.8	-3.2	-3.6	-4.2	-4.0	-4.0	-4.0	-4.0
Balance on goods and services	-1.4	-0.5	-0.5	-2.2	-1.3	-1.5	-2.3	-2.4	-2.4	-2.4	-2.3
Exports of goods and services	20.0	20.4	20.4	19.3	19.1	19.4	18.8	18.6	18.6	18.6	18.6
Exports of goods	16.5	16.9	16.6	15.3	14.9	15.0	14.4	14.4	14.4	14.4	14.4
Of which: Resources	10.3	10.8	10.6	8.8	8.5	8.6	8.2	8.2	8.4	8.4	8.5
Exports of services	3.4	3.5	3.7	4.0	4.3	4.4	4.3	4.2	4.2	4.2	4.1
Imports of goods and service	21.3	20.9	20.9	21.6	20.4	20.9	21.1	21.0	21.0	21.0	20.9
Imports of goods	17.1	16.4	16.5	16.9	15.8	16.1	16.3	16.2	16.2	16.3	16.2
Imports of services	4.3	4.5	4.4	4.7	4.6	4.8	4.8	4.8	4.8	4.8	4.7
Primary income, net	-2.6	-2.6	-2.3	-2.4	-1.8	-2.0	-1.8	-1.6	-1.5	-1.5	-1.6
Interest payments	-1.4	-1.3	-1.3	-1.3	-1.2	-1.1	-1.2	-1.3	-1.2	-1.2	-1.2
Equity income	-0.9	-1.0	-0.6	-0.7	-0.2	-0.7	-0.6	-0.5	-0.5	-0.5	-0.6
Secondary income, net	-0.1	-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	4.7	3.7	2.9	4.4	3.5	3.6	4.2	4.1	4.0	4.1	4.0
Direct investment	3.3	3.6	2.8	3.1	3.0	3.0	2.8	2.7	2.5	2.4	2.3
Equity	1.9	1.3	2.2	0.8	1.5	1.2	1.2	1.1	1.0	1.0	0.9
Debt	1.4	2.3	0.6	2.3	1.5	1.8	1.6	1.6	1.5	1.5	1.4
Portfolio investment	0.8	3.7	1.6	3.8	-2.2	2.3	2.5	2.4	2.1	1.9	1.9
Equity	-0.3	0.1	-0.8	1.1	-0.3	-0.3	-0.1	-0.4	-0.3	-0.3	-0.2
Debt	1.1	3.6	2.4	2.7	-1.9	2.6	2.6	2.8	2.4	2.2	2.1
Financial derivatives	-0.5	-1.2	-0.2	-0.3	-0.8	-0.6	-0.7	-0.7	-0.7	-0.7	-0.7
Other investment	1.2	-2.1	-1.0	-2.4	3.5	-1.0	-0.4	-0.3	0.1	0.4	0.5
Reserve assets	-0.2	-0.4	-0.3	0.2	0.1	0.0	0.0	0.0	0.0	0.0	0.0
Net errors and omissions	-0.5	-0.4	0.1	0.4	-0.3	0.0	0.0	0.0	0.0	0.0	0.0
BALANCE SHEET											
Net international investment position	-55	-54	-55	-59	-63	-64	-65	-66	-66	-67	-68
Equity, net	-4	1	4	4	0	-1	-2	-2	-3	-3	-4
Assets	51	59	63	64	67	67	67	67	67	67	67
Liabilities	55	57	59	61	67	67	69	69	70	70	71
Debt, net	-51	-56	-59	-62	-63	-63	-63	-63	-63	-64	-64
Assets	47	52	60	67	65	65	65	65	65	65	65
Liabilities	98	108	118	129	128	128	128	129	128	129	129
External assets (gross)	98	111	123	131	133	131	132	132	132	132	132
Equity	51	59	63	64	67	67	67	67	67	67	67
Debt	47	52	60	67	65	65	65	65	65	65	65
External liabilities (gross)	153	166	177	190	195	195	197	198	198	199	200
Equity	55	57	59	61	67	67	69	69	70	70	71
Debt	98	108	118	129	128	128	128	129	128	129	129
Of which: foreign currency, hedged	30	37	40	52	43	43	43	43	43	43	43
A$-denominated	48	50	55	51	60	59	60	60	60	60	60
Short-term	33	37	40	41	42	41	42	42	42	42	42
MEMORANDUM ITEMS											
Gross official reserves (bn A$)	47	59	66	67	...	...	...	...	...	...	...
In months of prospective imports	1.7	2.1	2.2	2.3	...	...	...	...	...	...	...
In percent of short-term external debt	9.5	10.3	10.3	10.0	...	...	...	...	...	...	...
Net official reserves (bn A$)	44	50	53	58	...	...	...	...	...	...	...
Iron ore prices (index)	101	107	77	44	45	41	35	30	28	27	25
Coal prices (index)	109	95	79	65	75	88	80	79	78	77	76
Oil prices (Brent crude; index)	102	97	95	61	43	48	48	48	48	48	48

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

Table 4. Australia: Monetary and Financial Sector, 2013-22

	2013	2014	2015	2016	2017	2018	2019	2020	2021	2022
				Projections						
BALANCE SHEET				In billions of A$						
Total assets	3,340	3,719	4,023	4,218	4,400	4,602	4,846	5,105	5,376	5,672
Currency and deposits	202	273	275	307	320	334	352	371	391	412
Securities other than shares	513	566	607	623	650	680	716	755	795	838
Loans	2,390	2,609	2,894	3,064	3,204	3,368	3,532	3,694	3,858	4,028
Claims on government	12	12	12	13	13	14	14	15	16	17
Claims on MFI	304	345	381	412	430	450	474	499	526	555
Claims on non-MFIs	1900	2040	2,205	2,356	2,466	2,595	2,718	2,837	2,956	3,076
Claims on non-residents	174	213	295	283	295	309	325	343	361	381
Shares and other equity	64	59	56	49	51	54	56	59	63	66
Other	170	211	192	175	175	166	189	226	270	328
Total liabilities	3,340	3,719	4,023	4,218	4,400	4,602	4,846	5,105	5,376	5,672
Capital and reserves	212	224	256	271	282	295	311	328	345	364
Borrowing from RBA	59	73	73	81	85	89	93	98	103	109
Liabilities to other MFIs	593	673	759	797	832	870	916	965	1016	1072
Deposits of non-banks	1,954	2,166	2,359	2488	2,595	2,714	2,858	3,011	3,171	3,346
Debt Securities	358	381	385	406	424	443	467	491	518	546
Other liabilities	164	202	191	175	183	191	201	212	223	236
					In percent of GDP					
Total assets (w/o residual)	214	232	246	250	250	250	250	250	250	250
Loans	153	163	177	182	182	183	182	181	179	177
Claims on MFI	20	21	23	24	24	24	24	24	24	24
Claims on non-MFIs	122	127	135	140	140	141	140	139	137	136
				Percent change						
Credit non-bank private sector	-1.7	7.4	8.1	6.9	4.6	5.3	4.7	4.4	4.2	4.1
Housing credit	7.6	9.3	9.2	8.3	5.2	4.7	4.1	3.5	3.3	3.0
o/w investor housing	16.5	12.4	2.2	-2.1	5.2	4.7	4.1	3.5	3.3	3.0
Business credit	1.7	4.5	6.8	4.7	3.8	6.1	5.8	5.6	5.6	5.6

Sources: IFS (Other Depository Corporations, Table ODC2-SR) , RBA, APRA and IMF staff projections.

Table 5. Australia: Selected Financial Soundness Indicators of the Banking Sector, 2010-16
(Year end, in percent)

	2010	2011	2012	2013	2014	2015	2016 June
Capital Adequacy							
Regulatory capital to risk-weighted assets	11.6	11.8	12.1	11.8	12.4	13.9	14.0
Regulatory Tier I capital to risk-weighted assets	9.7	10.3	10.8	10.4	10.7	11.9	12.0
Capital to assets	6.3	6.1	6.1	6.0	5.9	6.3	6.2
Large exposures to capital	69.6	68.1	73.7	72.2	76.0	49.8	47.4
Nonperforming loans net of loan-loss provisions to capital	19.3	18.2	16.3	13.2	9.8	7.8	8.4
Asset Quality							
Nonperforming loans to total gross loans	2.1	2.0	1.8	1.5	1.1	1.0	1.0
Sectoral distribution of loans to total loans							
Residents	96.2	95.5	94.9	94.1	92.9	90.5	91.9
Deposit-takes	0.2	0.2	0.1	0.1	0.1	0.1	0.1
Central bank	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Other financial corporations	2.6	2.9	2.6	2.7	2.8	3.1	3.4
General government	0.7	0.3	0.3	0.3	0.3	0.3	0.3
Non-financial corporations	23.7	24.5	24.1	23.4	23.2	22.7	23.1
Other domestic sectors	68.9	67.6	67.8	67.7	66.6	64.3	65.2
Nonresidents	3.8	4.5	5.1	5.9	7.1	9.5	8.1
Earnings and Profitability							
Return on assets	1.1	1.2	1.1	1.2	1.2	1.2	...
Return on equity	17.7	19.7	17.7	20.1	20.8	18.6	...
Interest margin to gross income	59.1	68.3	68.0	67.3	66.9	67.0	...
Noninterest expenses as a percentage of gross income	54.7	48.7	49.8	47.4	47.9	48.4	...
Liquidity							
Liquid assets to total assets	14.9	15.3	16.9	17.0	16.4	16.9	16.8
Liquid assets to short-term liabilities	38.9	39.2	42.8	42.0	40.2	39.7	40.6

Source: IMF, Financial Soundness Indicators (FSI) database

Annex I. Four Years after the Bust….

The sizeable bust in commodity prices and rapid decline in mining investment has been weathered well by the Australian economy. The decline in investment has been partly offset by rising resource exports, supporting value addition and employment linked to the resource sector in other industries. Household real incomes have been shielded from the commodity price bust as profits have absorbed much of the decline.

This annex examines some of the factors limiting the negative impact of a historic boom-bust cycle in mining investment and commodity prices on the economy. Over the boom period, mining investment rose from its average of around 2 percent of GDP to over 9 percent by 2013, net terms of trade doubled, and resource exports rose from 6 percent of GDP to 11 percent. Expansion of mining also increased demand for other industries, and the value added share of the broadly defined "resource sector" including directly extractive industries and support industries in aggregate nominal gross value added rose from 4¼ percent over 1990-2004 to 14¼ percent in 2011/12.[1] The share of the resource sector in employment doubled from around 5 percent over 1990-2004 to just under 10 percent in 2011/12, mostly among support industries, while the employment share of the mining sector itself remained around 2 percent.

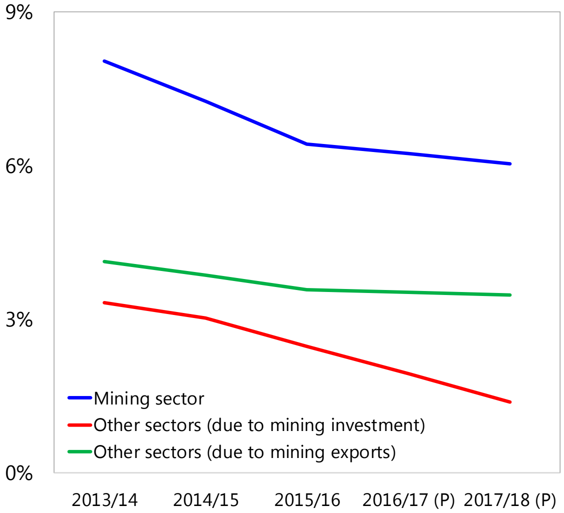
Four years into the bust, mining investment has declined sharply, but growing resource exports have dampened the negative impact of declining investment, and will continue to do so in the near term as new capacities ramp up and investment returns to more normal levels. Resource sector value added peaked at 15.5 percent of GDP in 2013/14, following the peak in mining investment. About half (8 percent of GDP) was value addition within the mining sector itself. The remainder was value addition in support sectors: 4 percent of GDP due to mining exports, and 3¼ percent of GDP due to investment (chart 1; table 1 lists the contribution of key support industries). Export-related value addition is expected to support a gradual decline in resource value added to around 11 percent of GDP by 2017/18.

Resource sector employment also peaked in 2013/14 at 10 percent of total employment (chart 2), of which only 2 percent was in direct mining activity and the rest was in support sectors. By 2015/16, resource employment declined only gradually, in line with the decline in resource sector value added. In addition, the investment decline has been cushioned by a strong housing sector, particularly for the construction sector which had a relatively higher exposure to mining investment.

The impact of the decline in commodity prices on household incomes has been mitigated by declining profits. Australia had experienced a so called "income recession" in late-2015 (adjusting GDP for the terms of trade decline), but real producer wages have in fact risen sharply since the end of the boom despite weaker nominal wage growth (chart 3), indicating that the impact of lower output prices has not been transferred entirely to wages. Producer wages stayed relatively low during the boom, and the share of profits in income was rising, whereas it has steadily declined since the 2011 peak in commodity prices. Moreover, consumer wages rose faster than producer wages during the boom, due in part to exchange rate appreciation. Estimates of exchange rate pass-through to CPI prices in Australia suggest that a 10 percent appreciation is linked with a 1 percent decline in consumer prices, which would imply a sizeable impact given the large real appreciation. On the downswing, depreciation has not translated into retail inflation as expected, which may be attributed to both weaker import prices (as manufacturing shifts globally to cheaper locations) and more domestic retail sector competition.

[1]Based on the" narrow measure" as described in Rayner and Bishop (2013). The analysis here extends their work, with the latest input-output table for 2013-14, and projected resource exports and investment. Resource sector value added estimates are broadly comparable to the "narrow measure" noted above. Resource related employment in an industry is assumed to be proportional to the share of resource sector related value added share in total industry value added.

Chart 1. Value Added Share of Resource Sector
(% GDP)



Notes: Chart shows impact of final demand for mining exports and investment in the mining sector on gross value added in aggregated industry groups as a share of GDP. Export demand is projected to grow in 2017 and 2018 at 5% each year in 2013/14 prices. Investment is projected to decline to 1.8% of GDP by 2018, and nominal values are inferred from desk forecasts of GDP.

Chart 2. Employment Share of Resource Sector
(% aggregate employment)

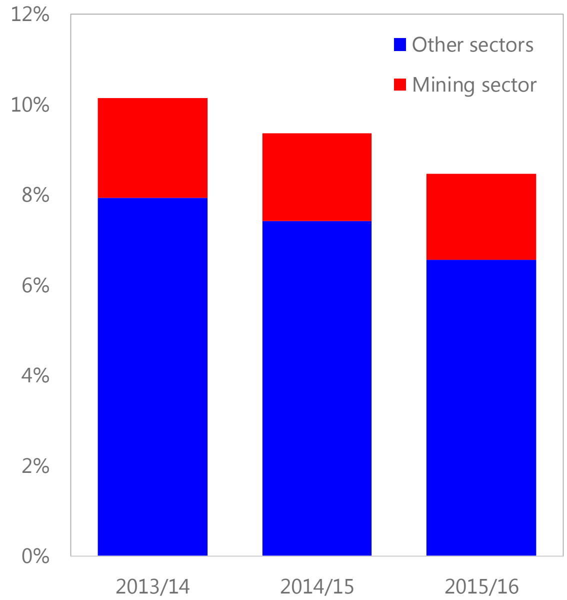
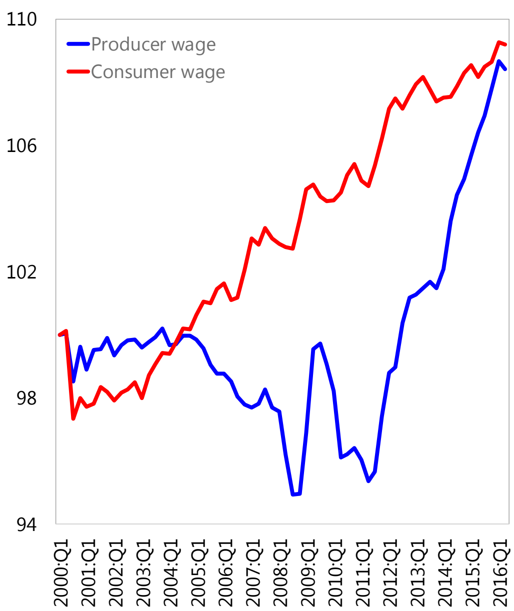


Chart 3. Real Wages
(Index; 2000Q1 = 100)



Source: Staff estimates.

Table 1. Value Added in Resource Sector
(% GDP, 2013/14)

Due to final demand for:	Mining exports	Mining Investment	Total
Resource sector	**11.6%**	**3.9%**	**15.5%**
Mining	**7.5%**	**0.6%**	**8.0%**
Other industries	**4.1%**	**3.3%**	**7.4%**
Business services	1.8%	0.9%	2.6%
Construction	0.3%	1.3%	1.6%
Manufacturing	0.6%	0.5%	1.2%
Transport	0.4%	0.2%	0.5%
Other industries	1.1%	0.5%	1.6%

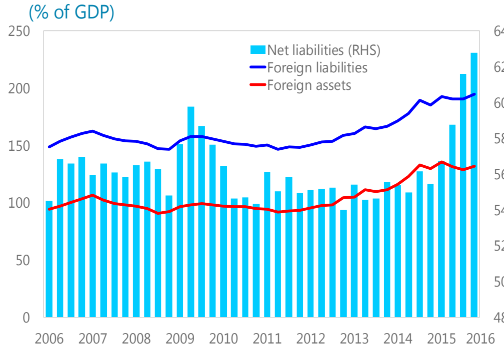
Note that this measure of value added generation considers only mining exports and investment in plant/machinery and construction in final demand. It excludes value added in the mining sector due to domestic demand for mining output. The results are broadly comparable to those of the "narrow measure" provided in Rayner and Bishop (2013), though the latter also exclude exports of manufactured resource exports in the narrow measure (while those are included in export demand here).

Annex II. Australia's External Balance Sheet: Developments and Risk Profile

Australia's net external liability position increased markedly over the past year. This annex documents that this increase largely reflected a set of atypical valuation effects and, for the ratio to GDP, exceptionally low nominal GDP growth that are atypical compared to usual patterns. The risk profile of Australia's net external position, however, has remained broadly stable.

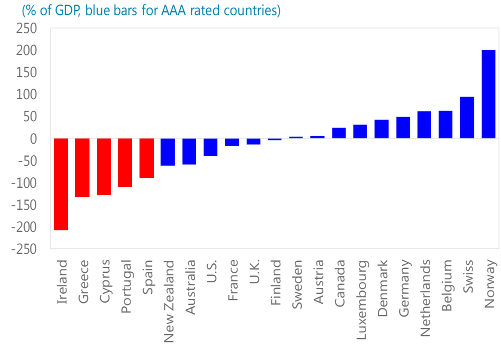
Net foreign liabilities amounted to 63 percent of GDP by the end of 2016Q3, about 7 percentage points higher than they were in mid-2015. This unusually steep increase occurred even though the current account deficit shrunk from around 5 percent of GDP to below 3 percent of GDP over the same period. Valuation effects—changes in the market value of external assets and liabilities—partly explain the contrasting behavior. Nominal GDP growth was exceptionally low because of sharply deteriorating terms of trade through the first half of 2016. Australia stands second to New Zealand among AAA-rated countries in relative size of net foreign liabilities to GDP.

Foreign Liabilities and Assets
(% of GDP)



Source: Haver Analytics.

Net International Investment Position
(% of GDP, blue bars for AAA rated countries)



Source: Haver Analytics.

Valuation effects have mitigated the impact of persistent current account deficits on Australia's net external liabilities. As of 2016Q3, the cumulated current account deficits since 1988Q3 (the period during which quarterly balance of payments statistics are available) amounted to about 72 percent of GDP. Offsetting this, valuation effects helped improve the net external liabilities by 10 percentage points of GDP over the same period. Analysis of the valuation effects following an approach reviewed by Gourinchas and Rey (2015) suggests that the return on external assets has been some half of a percentage point higher than that on external liabilities.[1] Despite external liabilities being substantially larger than external assets, the rate of return on the net external assets has still been positive. But it has been smaller than the rate of growth. Australia's debt-stabilizing current account deficit has thus been close to 4 percent of GDP.

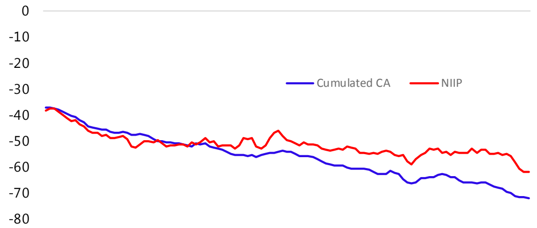
Over the past year, negative valuation effects, especially losses on Australia's equity assets, have resulted in a higher return on its net external liabilities. At the same time, the nominal GDP

[1] In this approach, the residual from the stock-flow reconciliation are considered to be mis-measured capital gains and are added to the valuation effects.

growth was exceptionally low because of the impact on the GDP deflator of the large terms-of-trade declines during the period. In the absence of valuation effects over the forecast horizon, the expected pickup in nominal GDP growth should result in a broadly stable net external liability position.

Net Foreign Liabilities

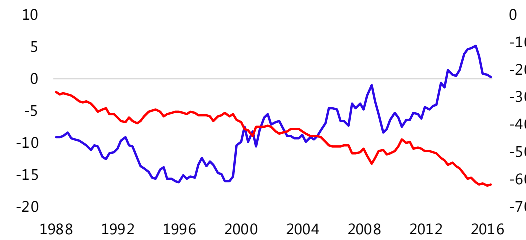
(% of GDP)



Source: Haver Analytics.
Note: Cumulated CA is calculated by adding cumulated CA balance to NIIP at the end of 1988Q2.

Net Equity and Net Debt

(% of GDP)

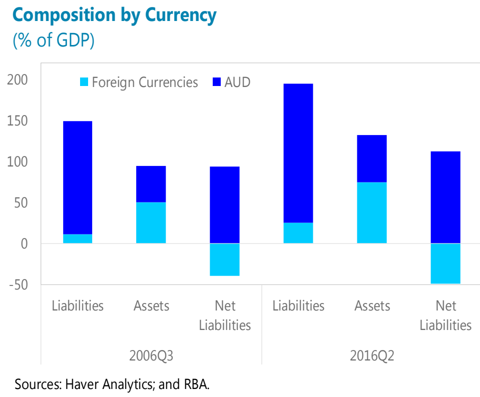


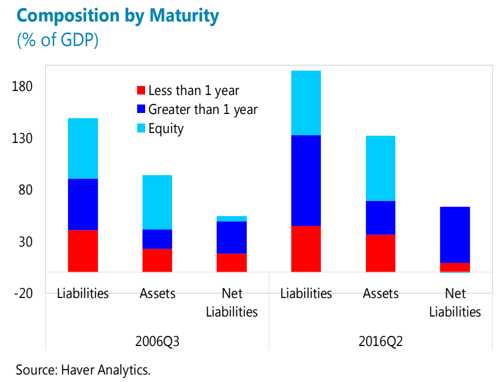
Source: Haver Analytics.

The structure of Australia's net external liabilities has remained broadly stable in terms of currency and asset composition, but its sectoral composition has changed.

- **Currency.** As of mid-2016, 87 percent of liabilities were denominated in domestic currency, while 56 percent of assets are in foreign currencies. On net, Australia thus had a long foreign currency position equals to 49 percent of GDP. The implication is that depreciation of the Australian dollar against the currencies in which its external assets are invested in leads to improvements in the external balance sheet. In the aggregate, depreciation does not come with the adverse balance sheet effects it would have with a net short foreign-currency position. For individual firms or households, however, there could still be negative effects. But banks' debt service obligations in foreign currency are fully hedged, while mining companies have natural hedges given commodity pricing standards.

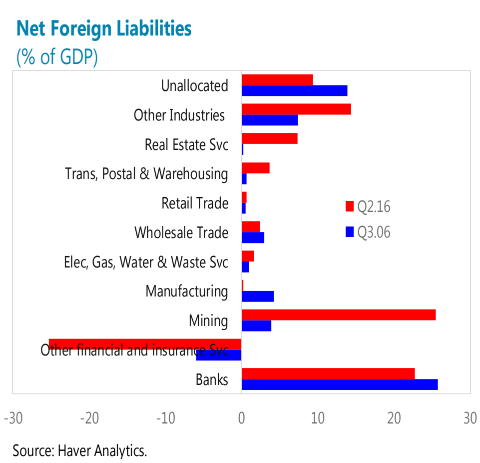
- **Maturity and Type.** At the end of 2016Q3, 87 percent of net liabilities are in long-term debt instruments (exceeding 1 year in maturity) and 14 percent in short-term debt, the net long position in equity is broadly balanced. The share of short-term external debt liabilities has decreased in recent years, partly because of banks increasing the share of more stable, longer-term debt in their wholesale funding.

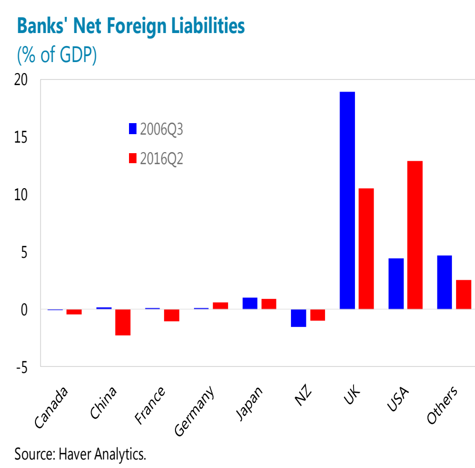




- **Sectors.**[2] With the mining investment boom, the mining sector's net external liabilities have increased by some 20 percentage points of GDP. At about 40 percent, the sector accounts for the largest share of total net external liabilities. Banks now account for some 36 percent. With greater emphasis on stable funding sources, their net external liabilities as a share of GDP have decreased by about 3 percentage points of GDP since the global financial crisis. With the housing boom, the real estate sector has also posted an increase in its net external liabilities, increasing from 0.4 to 11.7 percent of GDP between 2006 and 2016.[3] The other financial sector, which includes superannuation (the private second pension pillar), is the only private sector with a net foreign asset position. Its net position has increased by some 20 percentage points of GDP, reflecting the net accumulation of assets in the sector (contributions exceed withdrawals in the aggregate), some of which are invested abroad.

- **Banks' exposure by country.** Banks heavily rely on the UK and the US for funding, with a combined share in net liabilities of 103 percent. Banks have net assets with China, New Zealand and France.





[2] External liabilities calculated on the basis of monetary and balance of payments data.

[3] Data on the sectoral composition of external assets and liabilities are available for the period since 2006Q2.

Annex III. Summary – Labor Market Adjustment to Shocks in Australia

- **Australia's labor markets were relatively little disrupted by the global financial crisis, and are adjusting smoothly to the sizeable commodity price bust and mining investment decline.** Unemployment rose relatively little post-GFC compared to other advanced economies. After the commodity price bust, unemployment peaked at 6¼ percent in mid-2015 and has been declining since, and the unemployment gap is assessed to be small.
- **However, some labor market indicators suggest persistent weakness.** For instance, long-term unemployment remains elevated. Underemployment has also persisted above long run averages, and is a possible driver of weaker wage growth since the commodity price bust.
- **In this context, the paper conducts a more detailed assessment of the labor market impact of the adverse shocks.** It addresses the following key questions:
  - Has the commodity price bust and mining investment decline led to a worsening in skills mismatch and other frictions?
  - Have cyclical labor adjustment dynamics changed over time? What are the implications for assessment of labor market slack, and relatedly for wage growth?
  - Has changing sectoral allocation of labor had an impact in the transition?
  - What is the role played by migration in state level adjustment to shocks, particularly in the context of the commodity boom-bust cycle?
- **Salient findings for policy analysis consideration are as follows:**
  - Beveridge curve analysis suggests that the increase in long-term unemployment does not indicate any significant worsening in structural unemployment since the commodity price bust.
  - Average hours worked have adjusted more flexibly in downturns, with employment reductions smaller since the 2000s. However, rising part time employment and falling average hours worked are likely driving higher underemployment. A wage Phillips curve suggests that underemployment helps explain some of the recent weakness in wage growth.
  - Aggregate labor productivity growth has on average remained stable in the 2000s, but more recently, the expansion of services employment has contributed to the weakness in labor productivity growth.
  - At the state level, a VAR analysis suggests that changes in migration have played a key role in the supply side response to employment (demand) shocks, supporting a smooth adjustment particularly in the context of the mining boom-bust cycle.

Annex IV. External Sector Assessment

	Australia
Foreign asset and liability position and trajectory	**Background**. Australia has a high negative net international investment position (NIIP) of -63 percent of GDP (as of mid-2016). The ratio has varied in a range between -40 and -60 percent of GDP since 1988. 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. With the current account deficit expected to rise to its long run average of around 4 percent of GDP over the medium term, the NIIP to GDP ratio would rise to around 68 percent of GDP. **Assessment**. The NIIP level and trajectory are sustainable. The structure of Australia's external balance sheet reduces the vulnerability associated with its large negative NIIP. Since Australia's NIIP 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 has a net foreign currency liability position but it is fully 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.
Current account	**Background**. Australia has run current account (CA) deficits for most of its history. Since the early 1980s, deficits have averaged around 4 percent of GDP. In 2015, the deficit widened by 1¾ percentage points to 4.8 percent, reflecting an unusually large decline in the terms of trade (iron ore prices fell by over 40 percent in 2015), stronger domestic demand in Australia, and relatively weaker external demand. The current account deficit is expected to narrow in 2016, partly reflecting the lagged effects of currency depreciation in 2014/15, which has boosted services and non-resource exports, and new resource export capacity coming on stream. Over the medium term, the deficit is expected to be around 4 percent of GDP, with a moderately larger trade deficit. However, with over half of Australia's exports going to emerging Asia, a key risk is a sharper than expected slowdown in China which could result in a further sharp decline in commodities prices. **Assessment**. Australia's persistent CA deficits reflect a structural saving-investment imbalance with very high private investment relative to a saving rate which is already high by advanced country standards. After accounting for Australia-specific factors driving investment, the staff assessment is that the cyclically-adjusted current account is some 0-2 percent of GDP below the level implied by medium-term fundamentals and desirable policy settings in 2015. This assessment is subject to uncertainty given that it depends on how non-oil commodity prices evolve. 1/
Real exchange rate	**Background**. The real effective exchange rate (REER) depreciated 7 percent in 2015 relative to its 2014 average. As of June 2016, the REER depreciated by less than ½ percent compared to its 2015 averages. Compared to its thirty-year average, the REER is some 14 percent higher. Continued substantial capital inflows and favorable interest rate differentials may have contributed to the continued relative strength of the Australian dollar. Since mid-2015, the currency has been broadly stable in real effective terms. **Assessment**. Taking into account these factors including the attractiveness of highly rated Australian assets, staff assesses the REER to be 0 to15 percent above the level implied by medium-term fundamentals and desirable policy settings. 2/
Capital and financial accounts: flows and policy measures	**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 given its sound fiscal position relative to other advanced economies, and owing to relatively high interest rate differentials. **Assessment**. Credible commitment to a floating exchange rate and a strong fiscal position limit the vulnerabilities.
FX intervention and reserves level	**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. **Assessment**. Although domestic banks' external liabilities are sizable, they are either in local currency or hedged with little or no counterparty risks, so reserve needs for prudential reasons are also limited.
Technical Background Notes	1/ The EBA CA regression approach for 2016 estimates a CA norm of -1.0 percent of GDP and a CA gap of -1.9 percent of GDP. Using estimated elasticities, the current account approach would be consistent with an exchange rate overvaluation of around 11 percent in 2016. However, the estimates of the CA norm may not capture Australia-specific factors such as the attractiveness of Australian assets to overseas investors. If such factors were considered, the current account norm might be for a deficit larger than 1 percent of GDP. The NFA stabilizing deficit is closer to 2½-3 percent of GDP. Our assessment is therefore that the current account gap is in the range of -2 to 0 percent of GDP. 2/ The EBA REER regression approach, and the EBA REER level regression provide estimates of a gap encompassing a wide range from 5 to 15 percent in 2016.

Overall Assessment

Overall Assessment:

In 2016 the external position was assessed to be moderately weaker than the level consistent with medium term fundamentals and desirable policies. The widening of the current account deficit in 2015, notwithstanding substantial currency depreciation in 2014-15, was likely temporary, partly reflecting exceptionally large terms of trade declines in the context of commodity price declines and stronger-than-expected domestic demand growth in a weaker external environment. The Australian dollar has depreciated with the large deterioration in the terms of trade and supported expenditure switching, including by boosting services and non-resource exports. The depreciation in 2014-15 likely reduced the overvaluation of the Australian dollar, although the correction has stalled in recent months. Some remaining exchange rate overvaluation might be accounted for by the relative attractiveness of highly-rated Australian assets.

Potential policy responses:

If growth remains on the weak side, or commodity prices fall further driven by weaker global demand conditions, further monetary accommodation would be warranted.

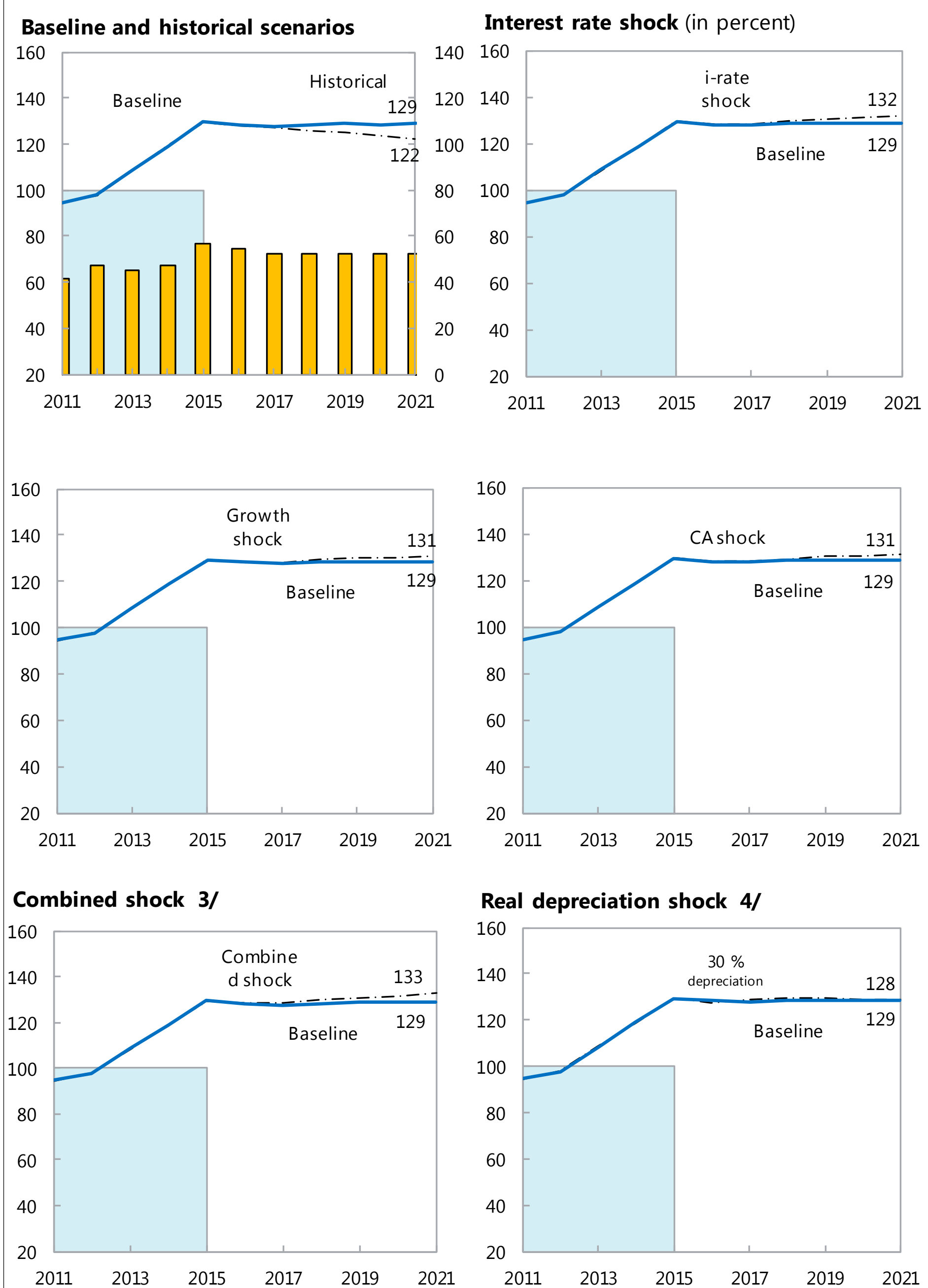
The government's planned gradual fiscal consolidation over the longer term should help improve the current account by boosting national savings.

Annex V. Australia: Risk Assessment Matrix

	Source of risks	Likelihood	Time horizon	Impact	Policies to reduce impact
				Domestic risks	
	Stronger recovery momentum	**M**	Short term	**M** Business investment could recover faster amid favorable financing conditions and stronger terms of trade.	The Australian dollar would likely appreciate; monetary policy tightening if needed.
	Slowing of economic recovery	**M**	Short to medium term	**M** Profits may remain under pressure for longer with external disinflation, while consumption growth could be weaker with continued low wage growth and a higher incidence of part-time work. Investment would remain weaker as a result, hurting medium-term growth prospects.	Monetary policy easing with minor slowing; combined monetary and fiscal policy easing if economy hits the zero lower bound.
	Housing market downturn	**L**	Short to medium term	**H** A sharp housing market correction would lower residential investment and private consumption. A vicious 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	
	Significant China slowdown	**L/M**	Short to medium term	**H** A hard landing in China would lead to lower growth and large commodity price declines would lead to a major downturn in Australia.	Combined monetary policy and fiscal policy easing as economy could reach the zero lower bound quickly; structural fiscal measures to facilitate adjustment in commodity sectors and regions, including active labor market policies
	Structurally weak growth in major advanced and emerging economies	**H/M**	Medium term	**M** Lower growth in these economies would result in lower commodity prices and commodity consumption, thereby lead to a major downturn in Australia.	For temporary easing: monetary policy easing; combined monetary and fiscal policy easing if economy hits the zero lower bound. Structural reforms, including fiscal ones, to raise productivity.
	Tighter and more volatile 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 how investor sentiment toward Australia changed.	Monetary policy easing; combined monetary and fiscal policy easing if economy hits the zero lower bound.
	Economic fallout from political fragmentation	**H**	Short to medium term	**M** As an open economy depending on trade, Australia would be negatively affected if a rise in populism and nationalism in large economies would reverse trade liberalization, reduce global growth and commodity prices, and exacerbate financial market volatility.	Monetary policy easing; combined monetary and fiscal policy easing if economy hits the zero lower bound. Continued pursuit of open market policies.
	Persistently lower energy prices	**L**	Medium term	**L** If fuel prices did not increase as expected, real incomes of consumers would be higher, but coal and LNG sectors would be hurt, as would the coal mining regions. The net effect on the economy would also depend on the global growth impact.	The exchange rate would likely act as a shock absorber and dampen the impact; monetary policy response if needed.

Annex VI. External and Fiscal 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 2010.

Australia Public Sector Debt Sustainability Analysis (DSA) - Baseline Scenario

(in percent of GDP unless otherwise indicated)

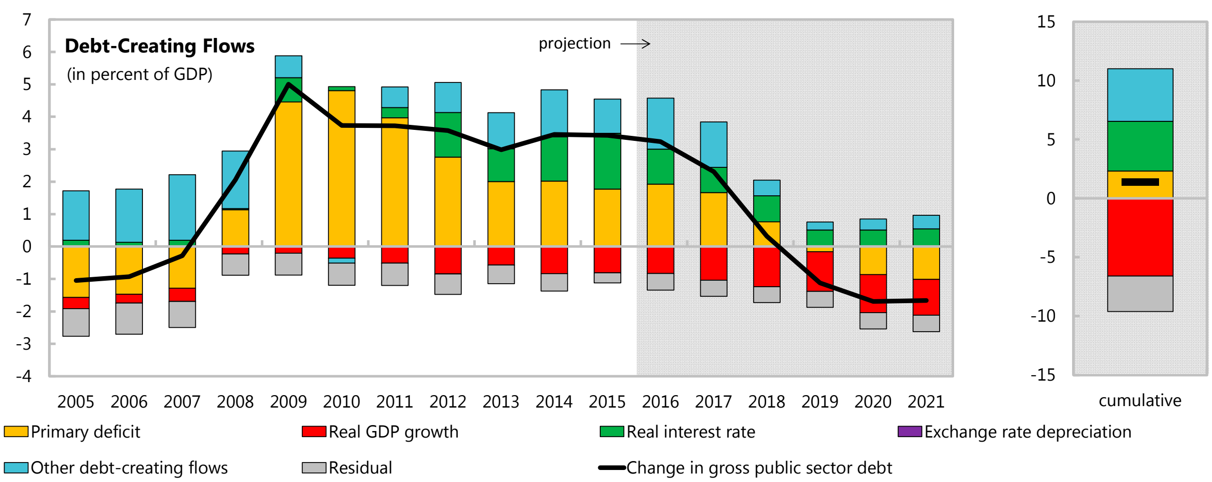
Debt, Economic and Market Indicators [1/]

	Actual			Projections					
	2005-2013 [2/]	2014	2015	2016	2017	2018	2019	2020	2021
Nominal gross public debt	18.0	34.2	37.6	40.9	43.2	43.5	42.4	40.7	39.0
Public gross financing needs	1.9	3.0	2.8	5.7	5.3	4.4	3.4	2.5	2.2
Real GDP growth (in percent)	2.8	2.8	2.4	2.3	2.6	3.0	3.0	2.9	2.9
Inflation (GDP deflator, in percent)	3.5	0.2	-0.6	1.0	1.6	1.5	2.3	2.4	2.4
Nominal GDP growth (in percent)	6.4	3.0	1.8	3.3	4.3	4.6	5.3	5.3	5.3
Effective interest rate (in percent) [4/]	6.3	4.8	4.5	4.0	3.7	3.5	3.6	3.7	3.9

As of December 14, 2016		
Sovereign Spreads		
EMBIG (bp) 3/		14
5Y CDS (bp)		68
Ratings	Foreign	Local
Moody's	Aaa	Aaa
S&Ps	AAA	AAA
Fitch	AAA	AAA

Contribution to Changes in Public Debt

	Actual			Projections							
	2005-2013	2014	2015	2016	2017	2018	2019	2020	2021	cumulative	debt-stabilizing primary balance [9/]
Change in gross public sector debt	2.1	3.5	3.4	3.2	2.3	0.3	-1.1	-1.7	-1.7	1.4	-0.1
Identified debt-creating flows	2.8	4.0	3.7	3.7	2.8	0.8	-0.6	-1.2	-1.2	4.4	
Primary deficit	1.6	2.0	1.8	1.9	1.7	0.8	-0.2	-0.9	-1.0	2.3	
Primary (noninterest) revenue and grants	33.4	33.6	34.0	34.1	34.1	34.4	34.7	35.0	35.1	207.5	
Primary (noninterest) expenditure	35.0	35.6	35.8	36.0	35.8	35.2	34.6	34.2	34.1	209.8	
Automatic debt dynamics [5/]	0.0	0.5	0.9	0.3	-0.3	-0.4	-0.7	-0.7	-0.6	-2.4	
Interest rate/growth differential [6/]	0.0	0.5	0.9	0.3	-0.3	-0.4	-0.7	-0.7	-0.6	-2.4	
Of which: real interest rate	0.5	1.4	1.7	1.1	0.8	0.8	0.5	0.5	0.5	4.2	
Of which: real GDP growth	-0.4	-0.8	-0.8	-0.8	-1.0	-1.2	-1.2	-1.2	-1.1	-6.6	
Exchange rate depreciation [7/]	0.0	0.0	0.0	…	…	…	…	…	…	…	
Other identified debt-creating flows	1.1	1.4	1.1	1.6	1.4	0.5	0.2	0.3	0.4	4.5	
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	
SFA, including asset changes	1.1	1.4	1.1	1.6	1.4	0.5	0.2	0.3	0.4	4.5	
Residual 8/	-0.7	-0.5	-0.3	-0.5	-0.5	-0.5	-0.5	-0.5	-0.5	-3.0	



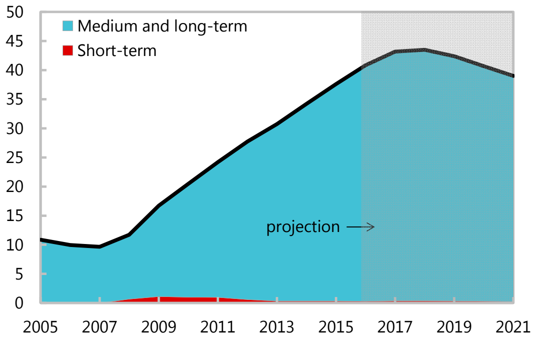
Source: IMF staff.
1/ Public sector is defined as general government.
2/ Based on available data.
3/ Long-term bond spread over U.S. bonds.
4/ Defined as interest payments divided by debt stock (excluding guarantees) at the end of previous year.
5/ Derived as [(r - π(1+g) - g + ae(1+r)]/(1+g+π+gπ)) times 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 - π (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 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.

Australia Public DSA - Composition of Public Debt and Alternative Scenarios

Composition of Public Debt

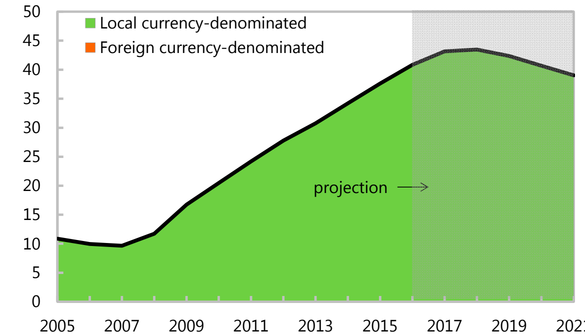
By Maturity

(in percent of GDP)



By Currency

(in percent of GDP)

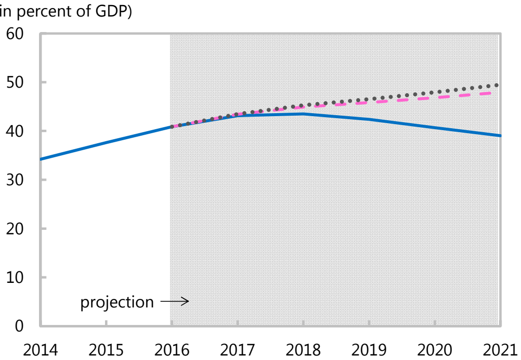


Alternative Scenarios

Baseline Historical Constant Primary Balance

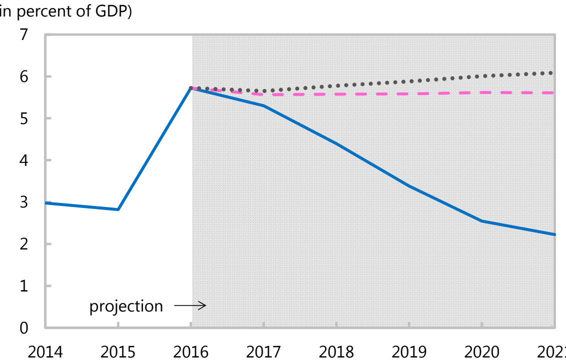
Gross Nominal Public Debt

(in percent of GDP)



Public Gross Financing Needs

(in percent of GDP)



Underlying Assumptions

(in percent)

Baseline Scenario	2016	2017	2018	2019	2020	2021
Real GDP growth	2.3	2.6	3.0	3.0	2.9	2.9
Inflation	1.0	1.6	1.5	2.3	2.4	2.4
Primary Balance	-1.9	-1.7	-0.8	0.2	0.9	1.0
Effective interest rate	4.0	3.7	3.5	3.6	3.7	3.9
Constant Primary Balance Scenario						
Real GDP growth	2.3	2.6	3.0	3.0	2.9	2.9
Inflation	1.0	1.6	1.5	2.3	2.4	2.4
Primary Balance	-1.9	-1.9	-1.9	-1.9	-1.9	-1.9
Effective interest rate	4.0	3.7	3.5	3.5	3.6	3.7

Historical Scenario	2016	2017	2018	2019	2020	2021
Real GDP growth	2.3	2.7	2.7	2.7	2.7	2.7
Inflation	1.0	1.6	1.5	2.3	2.4	2.4
Primary Balance	-1.9	-2.0	-2.0	-2.0	-2.0	-2.0
Effective interest rate	4.0	3.7	3.7	3.9	4.1	4.4

Source: IMF staff.

Annex VII. Summary – Inflation Targeting in Australia: Performance, Challenges and Strategy Going Forward

The Australian model of flexible inflation targeting has been a success, as evidenced by average inflation consistent with the target, and a substantial moderation in inflation and output volatility.

Belatedly, monetary policy in Australia has also faced some of the challenges that other central banks have faced after the global financial crisis, albeit not to the same extent.

- A slower-than-expected recovery, economic slack, and inflation declining below target in a difficult global economic environment.
- An increased probability of hitting the effective lower bound (ELB) on nominal policy rates, given declines in the real equilibrium interest rate (EIR) and some possibly large downside risks (e.g. China, European banks, geo-political uncertainty, etc.).
- Risk of more persistent deviations of inflation below target ("low inflation trap") and prolonged slack.

Staff estimates of the real EIR in Australia suggest that it has declined from around two percent in mid-2008 to around 1 percent over the past two years. The policy rate has been below the equilibrium throughout most of the post-GFC recovery, indicating that monetary policy has been in a 'loose' stance.

In the current situation, the prudent policy strategy would be a "low for longer" monetary policy stance while preparing for coordinated monetary and fiscal policy easing if downside risks were to materialize.

- Around the *current baseline outlook,* a 'prudent risk-management strategy' would be to respond more strongly to negative inflation and output surprises than to positive ones.
- To lower risks of *'dark corners'*, an effective policy response would call for both expansionary monetary and fiscal policies in the event that large negative shocks were to materialize (e.g., lower global growth and commodity prices).

Enhancing policy transparency

- A more forecast-oriented communication policy which could include more explicit discussion of how the RBA intends to use its policy instruments over time to bring inflation back to target.

Annex VIII. Summary – Australia's Fiscal Framework: Issues and Options for Reform

This paper reviews the Government of Australia's approach to framing fiscal policy.

- Trying to meet its objectives of stabilization, long-term sustainability, and support of intergenerational equity. It aims for a medium-term balance anchor of 1 percent of GDP budget surplus, on average, over the economic cycle and to control debt accumulation.
- Amid long-term spending pressures from demographics – pensions, health care, aged care.

The analysis is based upon the use of the IMF's model, G20MOD.

- Comprises the entire world, with a block specifically for Australia. It models households, firms, the government and the central bank, calibrated to match Australia's macroeconomic and fiscal characteristics.
- The fiscal sector is fairly rich, with eight tax and spending instruments. Since government debt levels help determine global interest rates, long-term net foreign asset holdings and real exchange rates, fiscal policy plays a key role in both the short and long term.

Propose options for fiscal rules best suited to Australia to anchor fiscal policy.

- Based on IMF work on fiscal rules (IMF, 2009, "Fiscal Rules – Anchoring Expectations for Sustainable Public Finances," IMF Staff Paper, December, 2009), with some of the methodology derived from the Canada 2014 Article IV paper (Kinda, 2014, "Anchoring Sustainable Fiscal Policy: A New Fiscal Rule in Canada," in *Canada: Selected Issues,* IMF Country Report No. 15/23)

Short-term budget repair to achieve the medium-term balance anchor. The analysis shows that the Government should be cautious about the pace of budget repair.

- There is uncertainty on the required magnitude for budget repair.
- Relies on rebalancing away from the domestic to external sector, which may not be a desirable choice of fiscal authorities at this juncture.
- It can be very costly under the primary risk of the "new mediocre."

Implement a long-term debt anchor to provide a stronger long-term fiscal framework.

- To achieve and maintain this, we propose an appropriate mix from three types of fiscal rules:
- An expenditure rule limiting spending growth from 2021-2030—quantifies existing government commitment to reduce the size of government and harks back to expenditure rules used in the past;
- Medium-term balance anchor (a flexible budget balance rule)—this is the target currently in force;

- Different configurations of debt rules – both strict and flexible, achieving a new debt target over either a 5- or 10-year horizon.

Compare strengths of the long-term debt anchor and the medium-term balance anchor.

- Both targets have to be met on average over the economic cycle (a degree of flexibility that is already present in the existing medium-term balance anchor) and communicated clearly through various vehicles such as the annual budget and the mid-year updates.
- A long-term debt anchor provides certainty about the level of the debt and its role in anchoring households' and firms' behavior.
- A long-term debt anchor provides greater stability for real GDP in both temporary and permanent shocks relative to a medium-term balance anchor.

The paper analyzes three different debt rules. It examines an example consolidation of 10 percent of debt under the benchmark scenario as well as a couple of possible alternatives – stronger aggregate demand and a boom-bust cycle driven by the terms of trade.

- A preferred mixed rule strategy combines an expenditure rule with the flexible debt rule aiming to reduce the debt over 10 years assessed against a number of stabilization and debt-control related indicators.
- The analysis also demonstrates that clear communications will ease the transition for the implementation of rule against the background of long-term spending pressures from demographics.

INTERNATIONAL MONETARY FUND

AUSTRALIA

STAFF REPORT FOR THE 2016 ARTICLE IV CONSULTATION—INFORMATIONAL ANNEX

January 17, 2017

Prepared By	Asia and Pacific Department

CONTENTS

FUND RELATIONS

(As of December 31, 2016)

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

General Resources Account:

	SDR Million	Percent Quota
Quota	6,572.40	100.00
Fund holdings of currency (exchange rate)	6,503.82	98.96
Reserve tranche position	68.97	1.05
Lending to the Fund New Arrangements to Borrow	388.61	

SDR Department:

	SDR Million	Percent Allocation
Net cumulative allocation	3,083.17	100.00
Holdings	2,857.15	92.67

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 Fund[1]

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

	Forthcoming				
	2017	2018	2019	2010	2021
Principal					
Charges/interest	0.66	0.65	0.65	0.65	0.65
Total	0.66	0.65	0.65	0.65	0.65

[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 2016 Article IV consultation discussions were held during November 2-15, 2016; the Executive Board discussed the staff report and concluded the consultation on February 3, 2017.

FSAP Participation. The last FSAP Update involved two missions: April 23-May 15 and July 9-24, 2012; the Executive Board discussed the assessment (IMF Country Report No. 12/308) on November 12, 2012.

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.

Table of Common Indicators Required for Surveillance
(As of January 5, 2017)

	Date of Latest Observation	Date Received	Frequency of Data[7]	Frequency of Reporting[7]	Frequency of Publication[7]
Exchange Rates	12/13/16	12/13/16	D	D	D
International Reserve Assets and Reserve Liabilities of the Monetary Authorities[1]	11/16	12/22/16	M	M	M
Reserve/Base Money	11/16	1/2/17	M	M	M
Broad Money	11/16	1/2/17	M	M	M
Central Bank Balance Sheet	12/07/16	12/09/16	W	W	W
Consolidated Balance Sheet of the Banking System	10/16	11/29/16	M	M	M
Interest Rates[2]	12/13/16	12/13/16	D	D	D
Consumer Price Index	Q3 2016	10/26/16	Q	Q	Q
Revenue, Expenditure, and Balance – General Government[4]	09/16	12/07/16	Q	Q	Q
Revenue, Expenditure, and Balance – Central Government	09/16	12/07/16	Q	Q	Q
Composition of Financing[3] – General Government[4]	10/16	11/29/16	M	M	M
Composition of Financing[3]– Central Government	10/16	11/29/16	M	M	M
External Current Account Balance	Q3 2016	12/06/16	Q	Q	Q
Exports and Imports of Goods and Services	10/16	12/08/16	M	M	M
GDP/GNP	Q3 2016	12/07/16	Q	Q	Q
Gross External Debt[5]	Q3 2016	12/06/16	Q	Q	Q
International Investment Position[6]	Q3 2016	12/06/16	Q	Q	Q

[1]Any 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.
[2] Both market-based and officially determined, including discount rates, money market rates, rates on treasury bills, notes, and bonds.
[3] Foreign, domestic bank, and domestic nonbank financing.
[4] Consists of the central government (including budgetary, extra budgetary, and social security funds) and state and local government
[5] Including currency and maturity composition.
[6] Includes external gross financial asset and liability positions vis-à-vis nonresidents.
[7] Daily (D), Weekly (W), Monthly (M), Quarterly (Q), Annually (A), Irregular (I); Not Available (NA).

Statement by the IMF Staff Representative on Australia
February 3, 2017

1. This supplement summarizes the main developments since the staff report was issued on January 18, 2017. The developments are consistent with the analysis and assessment presented in the staff report, and do not require a change in the staff appraisal.

2. Consumer price inflation was broadly unchanged in the fourth quarter of 2016. Headline CPI rose by 0.5 percent compared to the previous quarter, unchanged from the third quarter. On a year-on-year basis, it rose by 1.5 percent, up from 1.4 percent. Core CPI rose by 0.4 percent against the previous quarter and 1.6 percent compared to the same quarter a year ago, up from an annual rate of 1.5 percent in the previous quarter.

3. The unemployment rate increased to 5.8 percent in the last quarter of 2016, from 5.6 percent in the previous quarter. This increase reflected a combination of faster labor force growth and slightly lower employment growth compared to developments in the previous quarter.

4. The terms of trade improved by 19.0 percent against the previous quarter, compared to an expected improvement of 7.0 percent. The stronger outcome largely reflected stronger coal and iron prices. However, spot prices for these commodities have started to decline recently as expected, partly reflecting increased domestic supply in China.

Statement by Christine Barron, Alternate Executive Director for Australia and Christopher Stewart, Advisor to Executive Director

February 3, 2017

The Australian economy continues to perform well in the face of one of the largest terms of trade adjustments in its history. Despite global economic headwinds and the transition underway to broader sources of growth following the mining investment boom, the economy is expected to grow at around trend supported by a flexible exchange rate, adaptive macroeconomic policies and strong institutional arrangements. But challenges remain as Australia experiences some of the symptoms of the 'new mediocre', in particular low business investment. The authorities have introduced policies to support business investment and they remain committed to trade, foreign investment and immigration for future economic growth.

Recent developments and outlook

After 25 years of continuous growth, the economy is forecast to grow in line with potential, at about 2¾ per cent. This is a significant achievement given the challenges associated with adjusting to the size of both the terms of trade boom and subsequent decline and amid weak global growth. The unemployment rate has trended down over recent years to stand at 5.8 per cent, around only half a percentage point or so above the non-accelerating inflation rate of unemployment, while the authorities estimate the output gap to be of a similar magnitude. While GDP contracted by 0.5 per cent in the September quarter 2016, this was heavily influenced by a confluence of one-off factors and the economy is forecast by both the authorities and the IMF to continue to grow in 2017. Over the longer term, the authorities appreciate that productivity growth will be vital for improving living standards in the face of any decline in the terms of trade and modest wages growth.

The baseline outlook is for a continued gradual recovery as the economy transitions from a mining investment boom to broader sources of growth. The majority of the decline in mining investment has already occurred, and non-mining investment has begun to grow, albeit slowly. Resource exports are expected to contribute strongly to growth as mining production ramps up following a decade of strong mining investment. Tourism and education service exports are increasing in response to the depreciation in the exchange rate since the peak in the terms of trade in late 2011. Economic activity is also expected to be supported by an increase in public infrastructure investment at both federal and state levels of government. Strong growth in dwelling construction in response to lower interest rates and firm population growth is expected to taper off.

Underlying inflation has been running at about 1½ per cent and is forecast to gradually rise over the next 1-2 years. Longer-term inflation expectations appear well anchored.

Growth in wages appears to have stabilised, although at low rates, and is expected to pick up gradually over the next couple of years, in line with further improvements in the labour market.

The authorities largely agree with staff that while the balance of risks has improved, it is still tilted to the downside. A deterioration in the external sector resulting from adverse economic or political developments in larger economies is seen as a particular risk, but not one that the authorities can respond to in a more proactive manner than the policy settings already in place. Domestically, there remains uncertainty about the pace of the pick-up in non-mining business investment. Apparent risks in the housing market are currently manageable. While some segments of the overall market are experiencing rapid price gains, credit growth is not unusually strong, and the Australian household sector as a whole has built significant mortgage buffers. The authorities also agree that there is the potential for a large external shock to interact with, or even trigger, domestic risks.

Fiscal Policy

The authorities welcome the IMF's confirmation of the current timetable to return the budget to surplus and note only small differences in path profiles. The average annual pace of fiscal consolidation across the forward estimates is 0.5 per cent of GDP. To the extent that there have been weaker-than-planned budget outcomes over recent years, both staff and the authorities agree that these have reflected weaker-than-expected nominal growth leading to weaker-than-expected revenue, rather than a policy easing. Expenditure growth has slowed, consistent with the commitment to repair the budget by controlling expenditure.

Restraining recurrent spending creates room for productive spending. The authorities have a strong commitment to supporting jobs and growth through boosting infrastructure, innovation and investment while also rebuilding fiscal buffers. The Federal Government is, for example, investing a record $50 billion in national infrastructure, including in the National Broadband Network, the biggest infrastructure project in Australia's history. State Governments, which have predominant responsibility for infrastructure in Australia, have also increased infrastructure investment. Private investment will be encouraged through a lowering of the corporate tax rate – starting with tax reductions for small businesses – while average wage earners will remain in lower tax brackets longer through adjustments to the personal income tax thresholds.

If large downside risks materialize, the authorities will continue to take a flexible approach, prudently supporting the economy while also adhering to a longstanding medium-term fiscal framework of achieving budget surpluses, on average, over the cycle. The flexibility of the economy means that there is less benefit, and more room for error, in trying to 'fine tune' the economy through minor adjustments to fiscal settings. The authorities question the Staff's suggestion that infrastructure investment be used for short-term aggregate demand management, given the lags involved. Instead, the focus is on public and private investment in infrastructure to contribute to higher potential growth.

The authorities welcome the Staff's discussion of options for reform of Australia's fiscal framework and the suggestion that a long-term debt anchor could strengthen the current fiscal framework. Australia has benefited considerably from its longstanding commitment to maintain a budget surplus, on average, over the course of the economic cycle. Australia has also benefited from its regular Intergenerational Reports that assess long-term fiscal sustainability. The Commonwealth Government aims to stabilize and then reduce net debt over time – currently it is expected to peak at about 19 per cent of GDP in 2018-19 before declining to around 10 per cent in 2026-27 – although the uncertainties involved in policymaking mean that care is necessary to avoid policy becoming too constrained by using a rigid debt anchor. Together, the existing tools support a long-term disciplined approach towards fiscal policy that is necessary for a capital importing country which generally runs current account deficits.

Monetary Policy

Monetary policy remains accommodative and supportive of economic growth. The decline in inflation in Australia has been much more recent and much more modest than in other advanced economies and longer-term inflation expectations remain well anchored. As such, while the neutral cash rate has declined somewhat, monetary policy has ensured that finance remains readily available to creditworthy borrowers, supporting dwelling construction and providing a platform for business investment. The RBA's flexible inflation- targeting framework ensures that it remains well placed to respond to future developments.

The RBA will consider staff's suggestion of lengthening its forecast horizon in monetary policy statements to help clarify its projections for longer-term inflation. More generally, the 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.

Financial system

The Australian financial system remains in good shape in terms of both its resilience to shocks and its ability to support real economic activity. Resilience has increased over recent years. Banks have improved their capital buffers, with the weighted average CET-1 capital ratios of the four largest Australian banks moving into the upper quartile of international peers on a comparable basis (at about 13.5 per cent as at December 2015). Banks are expected to steadily accumulate further capital as the Australian Prudential Regulation Authority continues to finalise its assessment of what constitutes 'unquestionably strong' capital positions. The banks have also improved their liquidity profiles by increasing the share of stable funding, including by sourcing more funds from domestic deposits and longer-term debt. Indeed, of those authorized deposit-taking institutions that are subject to the net stable funding ratio (NSFR), most already appear to broadly meet the minimum requirements which come into effect in 2018. The banks are working to maintain their profitability through an increased focus on simplifying their businesses and cutting costs, with the major banks' return on equity currently about 14 per cent.

Lending standards will remain under scrutiny given APRA's intensive and risk-based approach towards supervision. There has been increased attention on reinforcing sound lending standards in response to developments in some segments of the property market. Furthermore, the riskiness of existing housing loans continues to be somewhat mitigated by the sizable mortgage buffers that borrowers have built by maintaining their debt repayments above required repayments as interest rates fell. More generally, the Council of Financial Regulators will continue to monitor potential risks and take additional steps if necessary.[1] In this regard, however, the motivation behind the authorities' actions is to improve the resilience of the economy, not to influence housing prices. They will also continue to carefully monitor commercial property lending and are working to finalize legislation to further improve their crisis management and bank resolution toolkit, in line with the recommendations of the Financial System Inquiry accepted by the Government.

The structure of Australia's net external liabilities largely mitigates any potential macro-financial vulnerability. Australia's current account deficit continues to reflect that Australia's strong investment outcomes are not able to be fully met by domestic savings. Furthermore, while Australia has a net foreign liability position, it has a net foreign currency asset position, given that the bulk of foreign liabilities are denominated in, or hedged back into, Australian dollars. Indeed, despite the cost, 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. Finally, the current account deficit is expected to remain towards 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.

Structural Reforms

The authorities appreciate the importance of further reforms to boost productivity growth. With the terms of trade unlikely to return to its previous highs, improvements in productivity are essential to invigorate growth in living standards. Further reform is also important to create the conditions for stronger private investment as the weakness in non-mining investment is an aspect of the "new mediocre" that is most evident in Australia.

[1] 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 Investment Commission, and The Treasury

The authorities welcome Staff's message that the reform agenda is appropriately focused on fostering innovation and competition. The National Innovation and Science Agenda will play a key role in supporting investment, innovation and enterprise, with its effectiveness underpinned by annual assessments. The first tranche included changing funding arrangements for some government services; the second tranche may focus on improving critical science capabilities and business investment in innovation. With regards to taxation reform, this was the focus of comprehensive analysis and national debate in 2015 and 2016, the outcome of which was a focus on lowering the corporate tax rate and adjustments to personal income tax brackets to ensure average wage earners remain in lower tax brackets for longer.

Heightened competition will be supported by the implementation of recommendations from the Harper Review into competition policy, including introducing competition, contestability and consumer choice in the provision of (largely publicly provided) human services. The Government has also initiated specific inquiries into the efficiency of the superannuation industry as well as competition in the financial system. This is on top of the changes to the financial system coming out of the Government accepting all but one of the recommendations from the Financial System Inquiry. More broadly, the Productivity Commission has been tasked with undertaking regular reviews of the nation's productivity performance.

Australia remains firmly committed to an open economy in trade, foreign investment and immigration. Australian policymakers understand that it is in Australia's national interest to stay the course and continue liberalizing trade. 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. In addition, Australia is developing new multilateral and bilateral free trade agreements with major trading partners.