

Australia: 2000 Article IV Consultation—Staff Report; Staff Statement; and Public Information Notice on the Executive Board Discussion

Under Article IV of the IMF's Articles of Agreement, the IMF holds bilateral discussions with members, usually every year. In the context of the 2000 Article IV consultation with Australia, the following documents have been released and are included in this package:

- the staff report for the 2000 Article IV consultation, prepared by a staff team of the IMF, following discussions that ended on **December 11, 2000** 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 February 28, 2001.** The views expressed in the staff report are those of the staff team and do not necessarily reflect the views of the Executive Board of the IMF.
- a staff statement of **March 2, 2001**, updating information on recent economic developments.
- the Public Information Notice (PIN), which summarizes the **views of the Executive Board as expressed during its March 2, 2001, discussion** of the staff report that concluded the Article IV consultation.

The document listed below will be separately released.

- Selected Issues and Statistical Appendix

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INTERNATIONAL MONETARY FUND

AUSTRALIA

Staff Report for the 2000 Article IV Consultation

Prepared by the Staff Representatives for
the 2000 Consultation with Australia

Approved by Yusuke Horiguchi and Leslie Lipschitz

February 27, 2001

- The 2000 Article IV consultation discussions were held in Sydney, Melbourne and Canberra during November 29–December 11, 2000.
- The mission team consisted of Mr. Collyns (head), Ms. Kochhar, Messrs. Gruenwald and Cardarelli (all APD), and Mr. Dell' Ariccia (RES). Mr. Callaghan (Executive Director) attended the meetings in Canberra.
- The mission met with Treasurer Costello, Reserve Bank of Australia (RBA) Governor Macfarlane, Treasury Secretary Evans, other senior government officials, and representatives of labor unions, the business and financial sectors, and academia.
- Australia has accepted the obligations of Article VIII, Sections 2, 3, and 4, and maintains an exchange system that is free of restrictions on the making of payments and transfers for current international transactions. Australia has yet to accept the Fourth Amendment to the Articles of Agreement—the relevant legislation is due to be considered by Parliament in the February 2001 sitting.
- Australia publishes a wide array of high quality economic and financial statistics on a timely basis, and has subscribed to the Special Data Dissemination Standard (SDDS). The ambitious agenda of improvements to these statistics is described in Annex III.
- This report was drafted by Ms. Kochhar, with substantial contributions from Messrs. Gruenwald, Cardarelli, and Dell' Ariccia.

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I. INTRODUCTION

1. **Australia has entered the tenth year of an impressive economic expansion characterized by strong productivity growth and low inflation.** Since the current expansion began in the third quarter of 1991, growth has averaged 4¼ percent per annum, slightly higher than in the US and far outstripping that of the G7 and the OECD (Figure 1). This expansion has come on the back of broad-based productivity growth that compares favorably with other OECD countries, and annual inflation averaging around 2 percent.¹ However, the rate of unemployment has declined only slowly, the current account deficit has persisted at an average of 4½ percent of GDP in the 1990s, unchanged from the previous decade, and net external liabilities remain relatively high at over 60 percent of GDP.

Selected OECD Countries: Labor and Total Factor Productivity						
(Annual average percentage change)						
	Labour Productivity 1/			Total Factor Productivity 2/		
	1980-90	1990-98	1995-98	1980-90	1990-98	1995-98
Australia	1.2	2.0	2.3	0.8	2.1	2.1
US	1.1	1.7	1.9	0.8	1.1	1.1
Canada	1.0	1.1	1.1	0.3	0.7	0.7
Finland	2.4	2.9	2.8	2.2	3.1	3.5
Sweden	1.6	2.4	2.4	0.9	1.7	1.7
Norway	2.1	2.5	2.1	0.7	1.9	1.6
Ireland	3.5	3.2	3.2	3.4	3.5	3.2
UK	1.9	1.8	1.9	-	1.2	1.3
Germany	1.6	1.9	1.9	1.1	1.0	1.1

Source: OECD (Scarpetta, Bassanini, Pilat and Schreyer, Working Paper No. 248, 2000).

1/ Trend GDP per employee, total economy.
2/ Trend TFP, business sector, estimated as Solow residual with time varying factor shares.

2. **The creditable growth and inflation performance reflects in large part the comprehensive reforms undertaken since the mid-1980s, combined with sound macroeconomic management.** Australia's strong productivity performance is primarily the result of the reforms of the past 15 years and reflects in part a "catch-up" to the technology frontier.² During the first decade of reforms, the economy was opened up to external competition, key areas of the economy were liberalized, public entities were privatized or corporatized, and the process of fiscal consolidation was begun. Also, the Reserve Bank of Australia (RBA) shifted to an inflation targeting regime. More recent reforms have aimed at gradual labor market deregulation, competition reform, and tax reforms.

3. **In concluding the 1999 Article IV consultation in January 2000,** Executive Directors commended the authorities on the strong performance of the economy, which had

¹ A comprehensive review of Australia's recent performance appears in *The Australian Economy in the 1990s* (Reserve Bank of Australia, 2000).

² The level of TFP in Australia now stands at some 80 percent of that of the United States, up from around 77 percent in the mid-1980s and its TFP level is the highest amongst the OECD countries after the United States. See *Australia: Benefiting from Reform* (IMF, 1998), Salgado, R., (2000): "Productivity Growth and Structural Reform," IMF Staff Country Report 00/24, and Bean, C., (2000): *The Australian Economic Miracle: A View From the North*," in *The Australian Economy in the 1990s* (Reserve Bank of Australia, 2000).

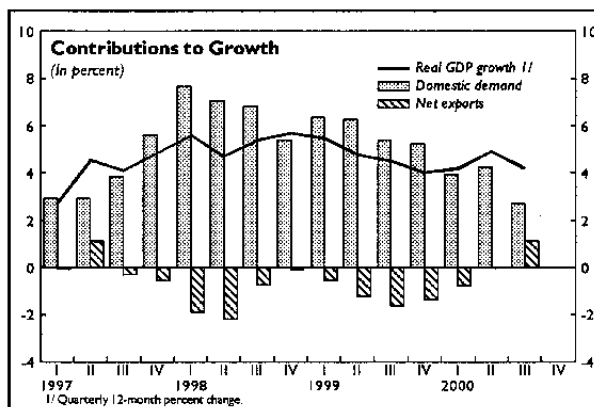
made a remarkably smooth passage through the Asian financial crisis. Directors considered that, in light of the sharp narrowing of the output gap, monetary policy management in the period ahead would need to focus on heading off inflation risks in a preemptive manner. Directors supported the mild fiscal stimulus in 2000/01, which they saw as a price worth paying for achieving the long-term benefits of the comprehensive tax reform, given the basically strong fiscal policy framework. Sustained implementation of the structural reform agenda—labor market reforms, reduction in welfare dependency, and trade reforms—was seen as essential to continuing strong productivity growth. Finally, the risks associated with external imbalances were considered manageable, provided the authorities continued to implement strong macroeconomic and structural policies and remained vigilant to maintaining a sound banking sector.

4. **The 2000 Article IV discussions focused on the challenge of sustaining output and productivity growth in the medium term while continuing to manage macroeconomic policies skillfully in the face of uncertain near-term indicators and a less favorable external environment.** The task of short-term monetary management is complicated by the unusual difficulty in reading the signals from economic indicators (created by changes in the tax system), the unexpected weakness of the Australian dollar, and more volatile external conditions. The challenge for fiscal policy is to maintain a strong overall position needed to underpin confidence in the face of the still large external imbalances, particularly given election year pressures (elections are expected to be held by October 2001). As for structural policies, the mission focused on two key issues. First, the weakness of the exchange rate has raised questions about Australia's long-term growth potential as the productivity "catch-up" process nears completion, particularly whether it is well positioned to take full advantage of the "new economy." Second, the persistence of relatively high unemployment and rising welfare dependency has prompted the government to give priority to labor market and welfare reforms.

II. RECENT ECONOMIC AND POLICY DEVELOPMENTS

5. **Growth was robust during most of 2000, but signs of a moderation began to**

emerge towards the end of the year. In the year through the September 2000 quarter, the economy grew by 4¼ percent, the fourteenth straight quarter with annual growth above 4 percent, supported by a strengthening of net exports. Growth in household consumption moderated to about 4 percent (y/y) in the third quarter from close to 5 percent (y/y) a year earlier, likely reflecting rising interest rates and some cooling in asset markets. As expected, private dwelling investment has been volatile, first surging by 21 percent (y/y) in the second quarter of 2000 as spending was brought forward in the year so as to avoid the less favorable tax treatment under the Goods and Services Tax (GST) launched in July 2000, then falling by nearly 22 percent (q/q) in the



September quarter (Box 1). Within business investment, machinery and equipment investment continued to exhibit strength, growing by 9 percent (y/y) in the September quarter (roughly the same pace as in 1999). However, spending on buildings and structures was much weaker, falling by about 15 percent in the September quarter, following the completion of several large mining projects. The slowing of private spending was partially offset by higher public spending, driven mainly by East-Timor related spending and capital spending by Telstra (Australia's largest majority public-owned telecommunications company).

6. The contribution made by net exports to growth has risen steadily since mid-1999, buoyed by the sharp fall in the currency (Table 1 and Figure 2). Exports of goods and services were up by 12½ percent for the year ending September, while import volumes grew by around 5½ percent. Consequently, the current account has improved more rapidly than projected. After peaking at over 6 percent of GDP in the second quarter of 1999, the current account deficit fell to 3⅓ percent of GDP in the September quarter of 2000 (Table 2 and Figure 4). Even correcting for the Olympics effect, the trend current account continues to improve strongly. Favorable terms of trade movements have also helped—terms of trade were up 6⅓ percent for the year ending September mainly on account of a pick-up in the prices of Australia's chief commodity exports. Australia runs a small net surplus on trade in oil and gas products and oil prices have only a negligible influence on the terms of trade.

7. Capital flows in the first three quarters of 2000 were characterized by a fall in equity flows and a rise in debt financed flows. As a result, net equity liabilities fell to around 18 percent of GDP from 21 percent of GDP at end-1999, and net debt liabilities rose to about 45½ percent of GDP from about 40 percent at end-1999 (Table 3). The end result of these movements was an increase in net foreign liabilities to 63½ percent of GDP in September 2000 from about 60 percent of GDP at end-1999. About half of the increase in net foreign liabilities resulted from transactions related to funding the current account deficit and the rest to valuation changes associated with equity price and exchange rate movements.

8. After a period of strong employment growth in 1999 and most of 2000, there are now signs of a softening in labor market trends. Mirroring the moderation in the pace of domestic activity in the third quarter, employment growth in the fourth quarter slowed to 2 percent (y/y)—close to the long-term trend employment growth rate—from the cyclical

Box 1. Impact of the Tax Reform and the Olympics

A. Tax Reform

Reform Measure	Effective Date	Impact on Prices	Impact on Activity	Impact on the Balance of Payments
GST: Replacement of wholesale tax on goods (ranging from 0-45 percent) with a 10 percent value added tax on goods and services	July 1, 2000	Originally estimated to add 3¾ percent to CPI in Q3, 2000, falling to 2¼ percent in longer run. Current estimated impact on CPI in Q3, 2000 is an addition of 3 percent.	In the aggregate, the GST is estimated to have brought forward some ¼ percent of spending from Q3 to Q2. There was a significant acceleration of housing investment, while spending on cars and computers was deferred until after the GST was introduced.	...
Reduction in personal income tax rates/increases in social security	July 1, 2000	Impact taken into account in estimating effect of TENTS.	Expected to support aggregate private spending	...
Company tax rate reduced from 36 percent to 34 percent	July 2000	--	May boost investment spending as a result of possible increase in aftertax profits	...
Company tax to be reduced from 34 percent to 30 percent	July 2001	--		...
Removal of accelerated depreciation tax concessions	July 2000	--	Short-term negative impact on mining and manufacturing sectors, which avail of this credit	...
Reductions in fuel excise for diesel and petrol for business use	July 2000	...	Positive for manufacturing and mining sectors, which are heavy fuel consumers.	...
New capital gains tax regime which effectively cuts the tax rate on capital gains in half	July 2000	--	No estimates made	...

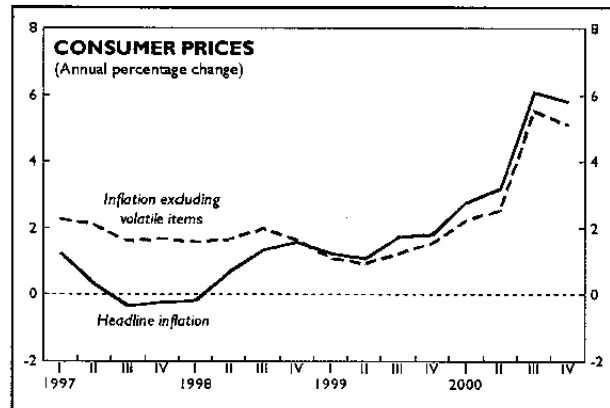
B. Olympics

Summer Olympics games	September 2000	...	Domestic construction activity related to Olympics completed in previous years. Expected to have had some impact on employment but no precise estimates available.	The estimated impact on the current account is \$A1.6 billion (or 1 percent of GDP on an annualized basis). Travel credits (tickets and spending by overseas visitors) were estimated at \$A0.6 billion in August-October. Credits associated with television broadcasting rights were estimated at \$A1 billion.
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high of 3¾ percent in mid-2000. The unemployment rate—which had fallen to 6⅓ percent in September 2000 from the peak of 11 percent in 1992—ticked up to around 6½ percent in December. Current levels fall within the range of estimates for the NAIRU (Figure 3).³

9. **At the same time, there are some signs of wage pressures.** The wage cost index—which abstracts from compositional effects—was up by about 3 percent (y/y) in the third quarter. However, the quarterly increase of 1.2 percent was the highest since September 1998. Moreover, in the year to September 2000, the average weekly ordinary time earnings index (which does not adjust for changes in the composition of employment towards higher paying service sector jobs) rose by 6 percent while wages under enterprise agreements rose by 4 percent. Although unit labor costs are still declining, the slowing of productivity growth—to ¾ percent in the year to September 2000, the slowest rate in five years—coupled with the risk of an intensification of wage pressures suggests that, looking ahead, competitiveness could come under pressure from this source.

10. **Underlying inflation—abstracting from the effects of the New Tax System (TNTS) and volatile items such as oil—rose only gradually through December 2000, while the introduction of the TNTS had less of a price impact than expected.** Both headline inflation (which the RBA targets at 2–3 percent over the medium term) and measures of underlying inflation increased steadily from 1 percent (y/y) in June 1999 to 3¼ percent and 2½ percent, respectively,



in June 2000. The increases reflected capacity constraints in the housing sector and other parts of industry, as well as increasing oil and gas prices.⁴ As a result of the introduction of TNTS,

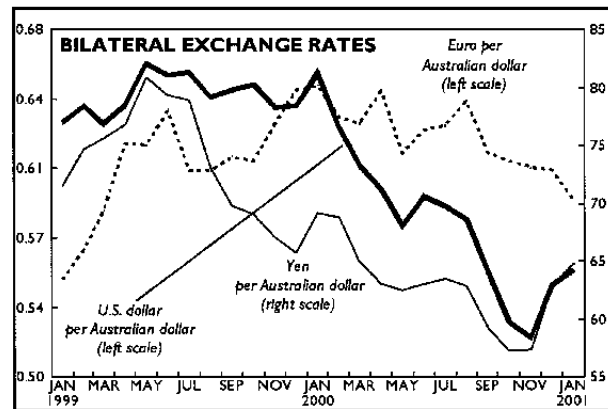
³ Estimates of the NAIRU in Australia vary widely. For example, recent work by the OECD (Richardson, et al., 2000, *The Concept, Policy Use and Measurement of Structural Unemployment: Estimating a Time Varying NAIRU Across 21 OECD Countries*, Economics Department Working Paper No. 250, ECO/WKP(2000)23) puts the NAIRU in the range of 7-7½ percent, while work by prominent Australian economists (Gruen, et al., 1999, *The Phillips Curve in Australia*, Research Discussion Paper, 1999-01) puts it in a range of 5½-7 percent.

⁴ Capacity utilization indicators (which do not cover services) are available only from early 1997 and contain limited information on long-term trends. Using an extended Hodrick-Prescott filter, the staff estimates that output gap was closed in early 1999, and output growth remained slightly above potential until mid-2000. With the slowing of growth in the third

(continued...)

headline inflation in the September quarter shot up to 6 percent (y/y); almost 3 percentage points of this increase is estimated to be directly attributable to TNTS, suggesting that underlying inflation was around 2½ percent.⁵ Inflation in the December quarter remained at around 6 percent (y/y), suggesting that underlying inflation is now close to the lower end of the RBA's target range. To date, the impact of TNTS was somewhat less than expected, possibly reflecting strong competition in domestic markets and effective monitoring of pricing behavior in the aftermath of the tax changes by the Australian Competition and Consumer Commission (ACCC). However, producer prices have been rising markedly across a range of components, and manufacturing output prices (excluding energy products) rose by 4½ percent (y/y) in the fourth quarter, and at the fastest quarterly growth rate since the early 1990s.

11. While the sharp weakening in the value of the \$A against the US\$ over the course of 2000 is difficult to explain, on a multilateral basis the current level of the \$A is only moderately below its medium-term equilibrium. Belying the strength of economic fundamentals, the Australian dollar fell by some 20 percent against the US dollar between January and November 2000 and by 9 percent in real effective terms. Responding to market developments, the RBA intervened, at times substantially, in the last four months of 2000.⁶ Since late November, the \$A has recovered some 10 percent of its value, apparently reflecting the worsening of economic prospects in the United States. Nevertheless, the \$A still remains around 15 percent below the most recent peak in mid-1999 and around 30 percent below its pre-Asian crisis value. Analysts cited an array of causes for the fall in the \$A, including the attraction of the US high-tech market, the lack of a production base for information technology in Australia, and concerns



quarter of 2000, the gap between actual and potential growth appears to have narrowed markedly (Figure 3).

⁵ The New Tax System was earlier forecast to add some 3¾ percent to CPI on impact; the estimated outturn has been somewhat smaller than expected. The move to the 14th series of the CPI also contributed to the smaller than expected impact, because the new series places a higher weight on items whose prices are likely to have declined as a result of the tax changes.

⁶ In addition, for most of 2000, the RBA supplied the foreign exchange needs of the government directly from its own reserves rather than from the market. Gross reserves at end-December stood at US\$18.8 billion, down from US\$22 billion at end-1999; net of forwards, reserves stand at US\$5 billion, down from about US\$7 billion at end-1999.

about the continued high level of external imbalances in Australia, but none of these is entirely convincing (Box 2). Looked at in terms of levels rather than changes, however, the current situation seems less anomalous as various indicators suggest that the currency is only modestly undervalued on a multilateral basis.⁷

12. **Other indicators of market perceptions were generally favorable.** In contrast to the behavior of the exchange rate, the Australian equity market performed better than in most other advanced countries in the region in local currency terms, recording a slight increase, while the others fell sharply. Moreover, spreads on long-term government bonds remained in the range of 0–50 basis points over comparable US Treasuries, while (swap) spreads on private sector debt have stayed broadly constant since the Asia crisis. Credit agencies continue to rate Australia favorably: S&P recently confirmed Australia’s AA+ sovereign long-term foreign currency debt rating, and noted, as in the past, that the high level of net foreign liabilities was the key reason for Australia remaining shy of the AAA rating.

13. **The interest rate tightening cycle launched in late 1999 in response to signs of rising price pressures ended in mid-2000, and monetary policy began to be eased in early 2001.** Between November 1999 and August 2000, the RBA raised the cash rate five times by a total of 150 basis points (Figure 5). Until late 2000, financial markets were expecting a further small increase in rates over the next 12 months, but with increasing evidence of a global downturn and with inflation remaining under control, official interest rates were lowered by 50 basis points in February 2001. Markets appear to be pricing in a further cut of 50 basis points by end 2001. Recent data suggest that private sector credit growth has slowed markedly from the high point of 13½ percent (y/y) in August 2000 to about 12 percent in January 2001. As expected housing credit has slowed since July as the GST-related housing boom has tapered off; in recent months, however, growth in other personal credits has also slowed from its mid-year peak of 17½ percent to around 14¼ percent in December.

14. **The degree of fiscal policy easing in 2000/01 is likely to be smaller than originally anticipated.**⁸ The 2000/01 budget released in May 2000 contained only modest new

⁷ The staff’s latest estimates using the CGER methodology suggest that the underlying current account deficit is around 2¾ percent of GDP, slightly below the medium-term saving–investment norm of 3¼ percent of GDP, suggesting a modest undervaluation of up to 10 percent. A similar assessment is suggested by a comparison of the real effective exchange rate at end-2000 with its trend value and by market analysts’ estimates of the “fair value” of the \$A.

⁸ The fiscal year runs from July to June.

Box 2. Australia: Recent Exchange Rate Developments

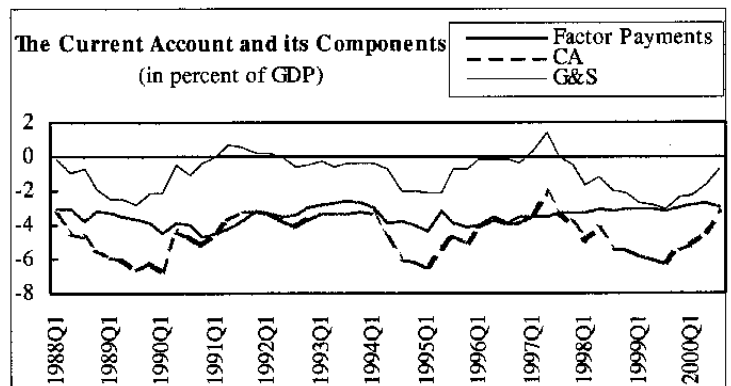
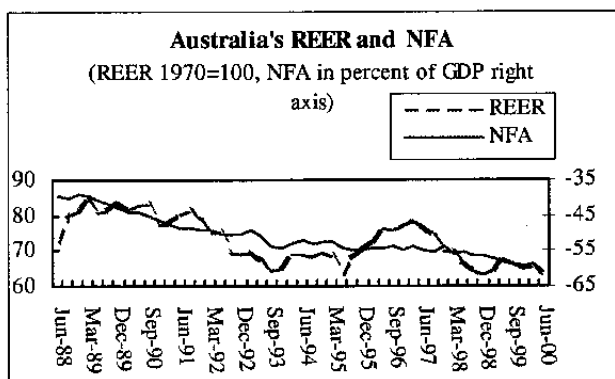
A development that has preoccupied observers of the Australian economy in 2000 has been the sharp weakening of the Australian dollar (\$A), especially vis-à-vis the U.S. dollar. The \$A dropped from around US\$0.65 at end-1999 to around US\$0.50 at mid-November; since then it has come off its lows reaching US\$0.56 in mid-January 2001. Against a background of strong growth, generally sound fundamentals, and relatively favorable economic prospects, the recent fall in the exchange rate has confounded policy makers and market analysts alike. In particular, the variables believed to be the main driving forces of the \$A in the past—commodity prices, the current account deficit and associated external imbalances, and interest rate differentials—do not help explain the recent movement of the currency.

A number of alternative explanations have emerged among market analysts. The first contends that the weakness of the Australian dollar is closely linked to the technology divide: Australia has a smaller share of its economy involved in the development and production of ICT products and services relative to the U.S. and has therefore failed to attract equity capital. However, this explanation is at odds with the fact that the depreciation of the \$A in the second half of 2000 coincided with a sharp correction in U.S. technology stocks.

A second related story suggests that the gap in relative medium-term growth prospects between the U.S. and Australia is the chief driving force behind recent exchange rate movements. According to this thesis, downward revisions of expectations of Australia's output growth relative to the U.S. were at the root of the sharp exchange rate depreciation at the beginning of the year. The relative performance of the Australian and American stock markets is consistent with this view, with Australian stocks underperforming the S&P500 index by about 7.5 percent in U.S. dollar terms in 2000. Likewise, the recent appreciation, reflecting downward revisions of expectations about the U.S. economy, is also consistent with this theory although it is difficult to disentangle changing views about cyclical and longer-term expectations of the \$A.

A third view which cannot explain the short-term behavior of the \$A, but may be relevant for the medium and long run, links the real exchange rate to the net foreign asset position of the country. According to this view, in equilibrium, larger net foreign liabilities requires a relatively more depreciated real exchange rate to generate a larger surplus on goods and services to meet net factor payments. However, this view has not found much support in the data. Indeed, while Australia's real effective exchange rate and its net foreign liabilities both have followed downward trends, regression analysis suggests that net foreign liabilities do not significantly affect the real exchange rate after interest rate differentials and the terms of trade are taken into account. In addition, the income deficit increased only moderately since 1980 and has remained roughly constant in more recent years.

These issues are examined in greater detail in the forthcoming Selected Issues paper. The paper estimates a structural vector autoregression model of the real effective exchange rate, trade-weighted relative output growth and relative CPI, and the terms of trade. The estimation confirms the importance of terms of trade shocks for the determination of the real exchange rate. In addition, it suggests that the compression in interest rate spreads—possibly reflecting the fiscal consolidation of the 1990s—has contributed to the downward pressure on the \$A during this period.



initiatives—extra spending on health and families and communities assistance and a scrapping of the previously planned “Timor tax” (each of which had an impact of 0.1 percent of GDP). However, the major overhaul of the tax system that came into effect on July 1 implied a significant net revenue loss (Box 3). As a result, the accrual surplus was envisaged to decline to 0.8 percent of GDP in 2000/01 from an estimated surplus of 1.5 percent of GDP in 1999/2000.⁹ However, the mid-year review of the budget and economic outlook announced in November raised the projected surplus for the current fiscal year to 1.2 percent of GDP, and increased the projected surplus for 2001/02 from 0.2 percent of GDP to ½ percent of GDP (Table 4). This stronger fiscal outlook reflects both one-off factors that will boost GST revenue in 2000/01¹⁰ as well as higher-than-expected income tax and petroleum tax revenues resulting from stronger economic and employment growth and the run up in crude oil prices. The higher revenues are expected to be only partially offset by higher expenditures—associated with higher than expected spending on one-time savings bonuses for some retirees and on private health insurance rebates, as well as new discretionary measures. Based on the current projections, the staff estimates that the Commonwealth government’s structural surplus in 2000/01 would be about ½ percent of GDP, some 1 percent of GDP lower than 1999/00 (Figure 6).

III. NEAR- AND MEDIUM-TERM OUTLOOK

15. The pace of growth is expected to continue to moderate over the year ahead. Partial indicators of activity and confidence surveys suggest that private consumption growth is likely to have slowed further in the fourth quarter of 2000, and that the slowing trend will continue in 2001. The dampening effect of the recent official interest rate hikes, oil price increases, and the subdued performance of the stock market are likely to be only partially offset by the tax cuts and benefit increases under the New Tax System. Dwelling investment is expected to remain weak, although activity in this sector is showing signs of bottoming out. Serving as a limit to the deceleration, non-dwelling construction growth is projected to recover somewhat, ending the decline of the past two years, while favorable factors such as high profit shares, the post-GST drop in capital goods prices, and relatively low real borrowing rates suggest that investment in machinery and equipment will continue to grow at a healthy pace (Annex I). Likewise export growth is expected to continue to be robust in 2001 (after adjusting for the effects of the Olympics), notwithstanding an expected

⁹ In the event, the surplus in 1999/00 turned out to be 2.1 percent of GDP reflecting stronger than expected growth.

¹⁰ Because all GST proceeds accrue to the states, a change in GST revenue does not directly affect the Commonwealth’s budget. However, during the transition period, it does affect the Commonwealth budget through variations in the budget balancing assistance that is to be paid to States in the event of shortfalls in GST collections compared to the guaranteed minimum amount (the funding benchmark under the New Tax System).

Box 3. Australia: An Overview of Ongoing Tax Reform 1/

A 10 percent goods and services tax (GST) was introduced on July 1, 2000. The GST is broad-based, covering most goods and services except basic food, education, health, and childcare. It replaces a number of selective taxes on goods, most notably the Wholesale Sales Tax (which carried rates of up to 45 percent). State governments will receive all GST revenue, which is expected to fully compensate for the loss of income from the removal of some indirect taxes and the abolition of grants from the Commonwealth, and give States a more reliable source of revenue.

As compensation for the cost of living increase stemming from the GST, personal income tax rates were cut and social welfare benefits raised, so that most low and middle-income families are expected to benefit from an increase in real disposable income after adjusting for the GST.

The Commonwealth has guaranteed that in each of the transitional years following the introduction of the GST, each State's budgetary position will be no worse off than had the taxation reforms not been implemented. While the cost of this guarantee was projected at ½ percent of GDP per year at the time of the Budget, higher than anticipated GST collection has reduced this amount to almost zero in the current fiscal year and less than ¼ percent of GDP in 2001/02.

A two-stage, revenue neutral, reform of the business taxation regime was announced in September 1999, which aims at optimizing growth, promoting equity and reducing complexity.

The first stage of the reform included:

- reducing the company tax rate from 36 percent to 30 percent over the next two years;
- removing most accelerated depreciation allowances;
- simplifying the system of capital gains taxation by doing away with indexation and subjecting only one-half of realized long-term nominal capital gains to taxation; and
- simplifying company tax payments by moving to a unified "pay-as-you go" system.

The second stage of the reform, most of which will take effect from July 2001, will include:

- subjecting most trusts to a company tax regime (discretionary trusts would be most affected);
- tightening the regulations on personal services income; and
- other "integrity" measures to simplify the tax code and limit the scope for avoidance.

1/ For more details, see SM/99/306, *Australia: Staff Report for the 1999 Article IV Consultation* and IMF Country Report 99/01, *Australia: Selected Issues and Statistical Appendix*.

deceleration in partner country demand. Overall, the staff expects growth to moderate from 4¼ percent in 2000 to 3¼ percent in 2001. Consistent with this projection, the unemployment rate is expected to decline gradually to below 6½ percent by end-2001 and the current account deficit is expected to remain at around 4¼ percent of GDP. Underlying inflation is expected to rise to the top of the 2–3 percent range by mid-2001 as cost increases already in the pipeline feed through, and decline modestly thereafter. These projections are broadly in line with market consensus; the authorities' official forecasts for growth—made in October before the downward revision to the global outlook—are somewhat more optimistic (4 percent for 2000/01).

16. **The greatest concerns for the near-term outlook arise from: (i) the heightened likelihood of a more abrupt weakening of the external environment and (ii) possible inflation pressures still in the pipeline.** The main downside risk is of a hard landing in the U.S. and a sharp slowdown in Australia's main export markets—the likelihood of this development has increased since the mission—although the decline in global interest rates that is following the slowdown in the U.S. and the competitive Australian dollar are likely to be mitigating factors. However, even as the economy slows, a stronger rise in inflation from cost-push pressures cannot conclusively be ruled out. While underlying inflation remains subdued, there are still upside risks from a number of sources: rising wage pressures in tight labor markets coupled with falling labor productivity growth; a possible unwinding of margin compression; rising manufacturing output and producer prices; and the pass-through of the depreciation of the \$A.¹¹

17. **Medium-term prospects are generally favorable.** Assuming a continuation of structural reforms already in train, growth is expected to rise to its estimated potential range of 3½-3¾ percent over the medium-term, consistent with a continued gradual decline in the unemployment rate to around 6 percent. The current account deficit is projected to trend down to around 2½ percent of GDP, implying a slight reduction in net external liabilities from 63½ percent at end-2000 to about 60 percent of GDP by 2005. The public finances are expected to strengthen on current plans (which assumes the sale of the remaining share of Telstra), and net Commonwealth debt is expected to be eliminated by the mid-2000s.

IV. POLICY DISCUSSIONS

A. Monetary Policy

18. **During the mission, the team agreed with the RBA's view that upside and downside risks facing the economy were finely balanced and endorsed their "wait and**

¹¹ Unlike during the Asian crisis, when foreign suppliers were discounting their prices and there was slack in domestic markets, there is, at present, a greater risk of pass-through from the depreciated exchange rate to consumer prices.

see” approach to monetary policy until the direction of activity and inflation became clearer. While emphasizing the difficulty in reading signals about the strength of activity, the authorities pointed to the slowing of growth in private consumption, credit, and employment as indications that interest rate hikes had succeeded in moderating the pace of activity, making it increasingly possible that no further rate increases would be needed to contain inflation within the target range.¹² They also were concerned that the outlook could turn out to be much less buoyant than forecast, both because of domestic and external factors. The mission acknowledged these concerns, but underlined that there were nevertheless still some risks on the inflation front, including from the pass-through of the exchange rate depreciation and from intensifying wage pressures in the context of tight labor markets. The authorities responded that they were alert to these risks and would be prepared to act preemptively to head off a build up of inflationary pressure, if necessary.

19. **Responding to developments since the mission, the authorities have reached the judgment that the balance of risks facing Australia has shifted sufficiently to warrant an easing of policy.** In announcing the 50 basis point reduction in interest rates in early February 2001, the Governor of the RBA pointed to the sharper than expected slowing in the U.S. economy and the resultant weakening in global demand, coupled with the fact that consumer price inflation, labor cost growth, and inflationary expectations remained low, as justifying policy settings more supportive of domestic demand. At the same time, the Governor emphasized that the economy still exhibited considerable resilience, with fiscal policy continuing to exert an expansionary influence, and that the overall outlook in Australia remained strong.

20. **In the policy discussions, the authorities stressed that monetary policy has responded pragmatically to downward pressure on the \$A.** RBA officials observed that in the first seven months of 2000, the progressive weakening of the \$A seemed to have been associated with market perceptions of Australia’s short-term growth outlook relative to the U.S. and thus for short-term interest rate differentials, although, in their view, the market’s pessimism had been overdone. However, the continued weakness of the \$A between August and early December was more difficult to explain in any consistent manner. In line with the inflation targeting framework, the monetary policy response to the downward pressure on the exchange rate had been calibrated on an assessment of how shifts in the exchange rate affected the balance of inflation risks rather than trying to defend any specific rate. The mission endorsed this approach, and noted that while the decline of the \$A against the U.S. dollar had been sharp, the staff’s assessment is that its current level was moderately undervalued on a multilateral basis. Put another way, the more depreciated rate was facilitating a welcome

¹² The authorities considered that the then prevailing real cash rate was consistent with a neutral monetary policy stance but acknowledged that monetary conditions remained expansionary owing to the depreciated exchange rate.

narrowing of the current account deficit that was broadly consistent with the improved national saving picture implied by a stronger fiscal position.

21. **RBA officials pointed out that their interventions in the foreign exchange market in 2000 had been limited to occasions when they felt that official action could usefully affect market conditions.** The RBA's stated policy is to intervene when, in their view: (i) the exchange rate is overshooting, that is, has deviated significantly from fundamentals; and (ii) when market conditions are unsettled. During the second half of the year, the authorities had felt that market behavior was driven by an irrational element, and had taken the opportunity to try to counteract the market through small and well-timed interventions. More generally, however, they believed that since the downward pressure on the \$A was more a reflection of international market trends rather than of markets' views on the Australian economy per se, the scope for independent, large-scale action by the RBA to avert its fall was rather limited.

22. **On transparency, RBA officials noted that the operation of monetary policy is generally well understood by markets.** At present, announcements are made only when the cash rate is changed, and the staff suggested that transparency could be further enhanced by issuing at least brief statements after all board meetings, including when the decision is not to move rates. The authorities countered that there have been few occasions on which the authorities' actions have deviated from market expectations. They saw little value-added—and indeed potential for greater confusion—from trying to concoct a statement when there was little new to say. The authorities emphasized their commitment to transparent monetary policy operations, noting the planned shift from semi-annual to quarterly statements on monetary policy.

B. Fiscal Policy

23. **The authorities considered the conduct of fiscal policy in 1999/00 and thus far in 2000/01 to be fully consistent with their cautious fiscal strategy.**¹³ The primary objective of the strategy is to maintain fiscal balance over the cycle, with the supplementary objectives being to run surpluses when growth is sound; to ensure that there is no increase in the tax burden from the 1996/97 level; and to continue to improve the Commonwealth net asset position. The much stronger than budgeted surplus in 1999/00 (2.1 percent of GDP versus the 0.9 percent of GDP originally budgeted) was a reflection of a much stronger growth and profits outcome than envisaged when the budget was formulated. Even in 2000/01, when a significant reduction in the surplus from the previous year was planned as the “price” of the

¹³ The authorities do not make their own estimates of the structural balance, but agreed that the staff's estimate of a modest structural surplus of between ½ and ¾ percent of GDP in 2000–01 and 2001–02 seemed reasonable.

tax reform, a larger surplus than originally envisaged is now expected, both on account of stronger growth and of a structural improvement in revenue collections resulting from the tax reforms.¹⁴

24. **For the period ahead, the authorities are committed to preserving modest surpluses as long as growth remains healthy.** The staff raised the concern that political pressures in a pre-election period could imply large new spending initiatives which could erode the fiscal surplus, and reiterated the need for fiscal policy to be focused on underpinning investor confidence in light of Australia's still large external imbalances. The authorities responded by noting that the government had strongly resisted calls for tax cuts, especially in 2000 when world oil prices were rising rapidly, and reassured the mission that new spending initiatives (approved or in train) would be modest and well-targeted, with priority areas for new spending being defense, roads and rural development, innovation policy and welfare reforms. The authorities also emphasized the institutional constraints on rash pre-election spending promises implied by the *Charter of Budget Honesty* which encourages election platforms to be costed by the Treasury or the Department of Finance and to be made public.

25. **With net Commonwealth debt expected to be eliminated over the next 3-4 years, the authorities are now considering approaches to maintain a well functioning domestic debt market.**¹⁵ With budget surpluses projected to rise to 1½ percent of GDP by 2003/04, net Commonwealth debt—which now stands at around 7 percent of GDP—is projected to be reduced to zero within a few years. The mission discussed a range of approaches including issuing bonds at a broad range of maturities and volumes, and investing the receipts abroad in fixed income assets at the highest end of the credit quality spectrum (foreign government bonds and other assets rated AAA or AA+), and borrowing to fund future public pension liabilities. The staff noted that this was an issue being faced elsewhere—notably in the United States—and that two key questions that needed to be addressed were (i) the extent to which substitutes for government debt could emerge to underpin capital markets, and (ii) how to ensure appropriate governance for any government investment fund. Officials expressed their interest in being kept abreast of the Fund's work in this area.

26. **The authorities considered that Australia was well placed to deal with long-term budgetary pressures arising from the aging of the population.** Key factors supporting this assessment are Australia's younger population and favorable demographics relative to other advanced economies; its low public debt and projected fiscal surpluses; the mandatory private pension (superannuation) scheme which limits the pressure on the public purse; and measures

¹⁴ The introduction of the Australian Business Number and the integrated administration of GST, business and income taxes has likely resulted in a widening of the tax net.

¹⁵ The authorities are of the view that gross liabilities of \$A 50-60 billion (8-9 percent of GDP) would be sufficient to maintain a liquid government bond market.

to increase participation in private health insurance schemes and to contain per capita health care costs. With these factors acting to contain the prospective burden on the budget, the authorities continue to believe that there is little need to run larger fiscal surpluses now to build a war-chest for future strains.

27. Australia is especially well-placed to deal with projected pension costs in the years ahead. The combination of flat-rate, means tested public pension system and a sizable (albeit still maturing) compulsory private system (with a 91 percent participation rate) is estimated to be able to provide replacement rates of 70 percent and 75 percent respectively, after 30 years and 40 years of contributions, although replacement rates will be lower until the system is fully mature. Key remaining concerns for the mission relate to the complexity of the taxation of superannuation and to ensuring sufficient tax incentives for voluntary private saving over and above superannuation. The authorities responded that they were aware of these issues, but noted that time would need to be given to allow the recent wide-ranging tax reforms to be absorbed before embarking on further major adjustments to the system.

28. However, pressures arising from health-related spending are a more serious concern over the longer term. Total health spending has risen by 4½ percent of GDP over the past 40 years to around 8½ percent of GDP (the public sector accounts for three-quarters of this amount, and the Commonwealth funds about two-thirds of the public sector share), which is above the OECD average in spite of Australia's relatively young population. The authorities project that total health costs could rise to 15 percent of GDP by 2041.¹⁶ The mission noted that experience of other countries that are further along the demographic transition suggests that it can become increasingly difficult to control costs as the age profile steepens against the background of technology-driven increases in health care expenses. The authorities made the point that the hybrid public-private system has been successful in recent years in maintaining very high quality services while containing costs pressures. Nevertheless, in light of the potential intensification of cost pressures, the mission suggested exploring alternative mechanisms to provide a buffer against future financing pressures. Such mechanisms could range from simply investing fiscal surpluses into an account dedicated for future public health expenditures (similar to what New Zealand is undertaking for pensions) to the funding of individual-based accounts—such as those, for example, currently in use in Singapore and South Africa—designed to mobilize current resources for anticipated future increases in health expenditures.

¹⁶ These projections assume a 2 percent per annum increase in real per capita health spending and a 1½ percent per annum growth in productivity. If it is assumed that the largest costs are incurred in the last 1½-2 years of life, then the impact on total projected health expenditures is considerably lower.

C. External Vulnerability

29. **The evolution of a range of indicators and Australia's adjustment to shocks over the recent past supports the Fund's assessment that external risks remain manageable.**

The narrowing of the current account deficit by some 1½ percent of GDP this year and the generally strong household, corporate and bank balance sheets, and solid financial sector indicators all support this view.

- The **household sector** is where the largest risks lie—household debt has now risen to over 100 percent of disposable income. The authorities noted, however, that three key factors are likely to mitigate the risks. First, despite the increases in interest rates, debt service as a share of disposable income—at around 8 percent has fallen by one-third since the beginning of 1990s. Second, despite the long period of strong growth there is no evidence of serious imbalances in the economy or of “bubbles” in equity and property prices. Third, property lending constitutes about 10 percent of banks’ portfolios and stress tests indicate that the system could withstand as much as a 300 basis point increase in interest rates with few problems.

End-June	1991	1997	1998	1999	2000
Total assets	532	649	707	736	788
Dwellings	318	374	420	435	472
Financial assets 1/	177	240	252	267	281
Other tangible assets	36	35	35	35	34
Total liabilities	53	81	89	94	103
Net worth	478	568	619	642	685
Debt and interest payments 2/	10.8	5.7	6.3	6.2	7.8

Source: RBA and Australian Bureau of Statistics.
1/ Excludes unfunded superannuation claims.
2/ Datum for 2000 corresponds to end-September.

- The degree of gearing in the **nonfinancial corporate sector** has been on a steady decline and the debt service burden stands at 12 percent of gross operating surpluses, well below the late-1980s level of around 35 percent. The authorities’ indicated that the high degree of hedging by corporates has meant that they have been able to absorb the sharp fall in the exchange rate with little difficulty.

End-June	1991	1997	1998	1999	2000
Equity	216	523	573	681	751
Debt	341	386	424	436	471
Total liabilities	557	909	997	1117	1222
Debt equity ratio (in percent)	158	74	74	64	63
Net interest payments/gross operating surplus (in percent)	35	14	12	12	12

Source: Australian Bureau of Statistics.

- Finally, the **financial sector** remains robust. In September 2000, banks’ impaired assets stood at around ½ percent of total assets (down from 1 percent at end-1996), and banks have maintained a strong record on provisioning and capital adequacy. The risk-weighted capital adequacy ratio was 10 percent, of which some 7½ percent was Tier 1 capital. Also, the largest banks have reported strong growth in profits in the 2000 financial year,

propelled by tight cost controls, strong lending growth, and a modest recovery of margins between lending and deposit rates. Finally, S&P recently affirmed the double-A ratings of the four major Australian banks, citing their strong financial profiles, asset quality, profitability, capitalization and risk monitoring and management techniques.

30. **Nonetheless, the authorities agreed that the experience of the past year had underlined potential risks from shifts in investor sentiment.**

Although Australia is a net creditor in foreign currency denominated claims, and the debt-service ratio remains below 10 percent, the ratio to GDP of net foreign liabilities is still high, while the share of debt-financed liabilities has risen sharply. Moreover, the net reserve

Financial Corporations—Selected Statistics					
End-June 1/	1991	1997	1998	1999	2000
Capital ratios 2/					
Tier 1	6.4	7.9	7.1	7.9	7.4
Total	10.1	10.3	9.8	10.5	10.1
Impaired Assets 3/					
	5.6	0.7	0.7	0.7	0.6
Housing credit (share of total credit) 4/					
	23.9	38.7	38.4	38.8	41.5
Ratio of private sector credit outstanding to GDP					
	0.77	0.91	0.96	0.99	1.06
Bank stock prices, end-period (percent change)					
	13.7	32.3	16.9	13.1	19.8
Overall stock prices, end-period (percent change)					
	14.0	21.6	-2.1	11.3	14.5
Sources: RBA and Australian Prudential Regulation Authority.					
1/ Data for 2000 correspond to end-September.					
2/ As a percentage of risk-weighted assets.					
3/ As a percentage of total assets. Datum for 1991 is "non-performing loans."					
4/ Total credit includes loans and advances by financial intermediaries to the private sector plus total bank bills outstanding.					

coverage of short-term foreign currency debt has fallen this year—net reserves fell from 11 percent of short-term foreign currency denominated debt at end-1999 to 9½ percent at end-June 2000 (Table 3). In this context, however, the authorities cautioned against mechanically using reserve-based indicators that are designed for emerging market countries that could lose market access and much less relevant in the context of an advanced country that can issue debt in its own currency and operates a floating exchange rate regime. They strongly refuted views expressed by some market analysts that in light of recent interventions by the RBA in the foreign exchange market, reserve based indicators take on added importance in assessing vulnerability. The mission broadly agreed with this view but stressed that shifts in investor sentiment can impact the economy strongly through the exchange rate, and underlined the importance of continued prudent macroeconomic management and a strong fiscal position.

D. Structural Policies

31. **The discussion of structural policy issues focused on (i) policies to strengthen innovation, and (ii) reforms of the welfare system.** Australia's impressive recent productivity performance is largely a result of the far-reaching structural reforms of the past 15 years, and it is likely that the productivity payoff from these reforms will continue to flow for some time. Nevertheless, the authorities recognize that there remain a number of areas where the reform agenda needs to be pushed ahead. With the tax reform largely completed, efforts are now underway to complete competition reform, and implement further labor market reforms. Key new initiatives include a comprehensive reform of the welfare system, and measures to encourage technological excellence and the "new economy" in Australia.

Policies to Encourage Innovation and the “New Economy”

32. **Recent global capital movements have brought to the fore the issue of how well placed Australia is to benefit from the productivity gains associated with the “new economy.”** Discussions of this issue within Australia have focused on the one hand on measuring the impact of the “new economy” and on the other on broader questions relating to the suitability of existing institutions for encouraging innovation and entrepreneurship. Assessing Australia’s “new economy” credentials is not easy, since it ranks very low as an ICT producer but ranks very high in the ICT usage category. Some market commentators have taken the view that, because of the small production base, Australia is unlikely to be in a position to gain the same benefits from the “new economy” as technology leaders such as the US (Box 4). However, the authorities believe that the benefits of the “new economy” for Australia are most likely to accrue not from a shift to high-tech industries where Australia is unlikely to have a strong comparative advantage, but from capital deepening based on ICT usage aimed at improving labor productivity throughout the economy.

33. **The Government recognizes that, in a broad sense, technological innovation is essential to ensure that Australia remains competitive, and has already signaled that policy measures in this area are a key policy priority.** Early in 2000, the Government, jointly with the business community, sponsored a National Innovation Summit to discuss the central issues, and subsequently established the Innovation Summit Implementation Group to come up with policy recommendations. The Group’s recommendations focused on measures to build Australia’s research capabilities, including through government funding and providing appropriate incentives for business R&D. To ensure successful commercialization of ideas, the Group also recommended fostering closer links between research organizations and business and ensuring the availability of funding for start-up firms.

34. **An issue that received particular emphasis in the report is how to strengthen Australia’s research infrastructure and capability.** In this context, there has been considerable debate about the implications of the sharp decline in business R&D spending since the reduction in the tax concession for this activity in 1996. Critics of the cuts in the tax concession contend that the fall in R&D spending does not bode well for Australia’s prospects for being an innovative and competitive economy, while others have expressed doubts about the quality and relevance of what was classified as business R&D spending prior to the tax concession reductions and have questioned the strength of the link between R&D spending and productivity growth. The Group recommended raising the rate of R&D tax concession and restructuring the R&D tax concession to focus on “additionality” by allowing further concessional tax treatment for R&D expenditures above some base level.

35. **The authorities agreed that it was important to provide adequate incentives for R&D, but are mindful of the need to contain the costs to the budget of these incentives.** Accordingly, in January 2001 the government announced a \$A 3 billion package of initiatives (to be implemented over the next five years) based on these recommendations. Key amongst

Box 4. The “New Economy” in Australia 1/

Over the last decade, Australia’s growth performance has been quite remarkable. GDP per capita has grown faster than in the 1980s, with increases in both labor participation and labor productivity. Moreover, the second half of the 1990s has witnessed a sharp acceleration of labor productivity growth (Chart A). The changing nature of the growth process in Australia during the 1990s is reflected by the different contribution that the capital/labor ratio and total factor productivity (TFP) have made to labor productivity growth. Following the slowdown in the 1980s, TFP has increased significantly in the 1990s, especially in the second half, and is now growing well above its historical average (Chart B). At the industry level, total factor productivity has grown in almost all sectors of the economy, with a notable acceleration in communication services, agriculture, wholesale trade and communication and finance sectors (Chart C).

Studies suggest that this impressive productivity performance is mainly the product of the structural reforms implemented in Australia over the last two decades. In particular, wholesale trade and agriculture, two relatively labor-intensive sectors, are likely to have benefited from labor market reforms, while the acceleration of TFP in the utility sector during the first half of the 1990 is largely attributed to product market reforms and privatization. The recent acceleration of TFP in the communication and finance sectors, on the other hand, seems to suggest that the diffusion of information and communication technologies (ICT) may also have played an important role in the productivity growth story.

The contribution of the “new economy” to productivity growth has been identified to occur essentially through 3 channels—greater efficiency in the ICT producing sector itself; capital deepening through investments in ICT throughout the economy; and spillovers from ICT usage. An evaluation of these channels in Australia presents a mixed picture:

- 1) **Production of ICT:** Around one-third of the increase in TFP in the United States can be attributed to greater efficiency achieved in the computer producing sector.^{2/} The weight of the ICT sector in Australia, however, is only about half that in the United States (Table A). This warrants some skepticism on the direct contribution of this sector to the above mentioned acceleration of labor productivity growth.
- 2) **Investment in ICT as a capital good:** Investment in ICT equipment (computers and peripherals and software) has grown very rapidly in Australia over the last 15 years (second only to the US in 1990-1996), and Australia is now ahead of many other advanced countries in terms of the ICT share of total non-construction investments (Table B). The acceleration of investment in highly productive ICT capital in the second half of the 1990s is reflected in the fact that a quality adjusted measure of the capital stock (i.e., the supply of services from capital, shown in Chart D) has grown at a faster pace than the unadjusted capital stock. As a result of such sustained accumulation, ICT capital accounted for about 60 percent of total capital deepening over the last decade
- 3) **Spillovers from ICT usage:** Network externalities and spillovers effects associated with the usage of new technologies may bring about an upward shift of the aggregate production function. Whether ICT is producing significant spillover effects in Australia remains uncertain largely because of measurement problems. Key measures of new technology infrastructure, penetration and activity show that Australia ranks quite high compared to Japan and many European countries, but is still behind the US and Nordic countries (Table). That said, the contribution of such spillovers seems to have been quite small so far even in the United States.

Hence, while the low weight of its ICT sector indicates that Australia has a relative disadvantage in gaining production benefits from new technologies, the recent acceleration of investments in ICT capital and the industry-wide acceleration of TFP growth may well be a sign of the start of a new phase of growth in Australia.

1/A detailed study can be found in the forthcoming Selected Issues Paper.

2/ Oliner, Stephen and Daniel Sichel, “*The Resurgence of Growth in the Late 1990s: Is Information Technology the Story?*” FRB Finance and Economic Discussion Paper, n.20, 2000.

Box 4. The "New Economy" in Australia (Concluded)

Table A. Indicators of the "New Economy"

	Shares of ICT Sector in Business Sector (s) 1/		Internet Users 2/ (% of pop.)	Internet Cost 3/ (OECD=100)	Percentage of Households With Access to PCs 4/	Spending on IT (% of GDP) 5/
	Value Added	R&D				
Australia	4.1	26.8	23.4	73.3	45.9	8.5
New Zealand	-	17.7	18.0	89.5	27.6	8.7
Canada	6.5	43.7	21.2	83.6	36.0	7.7
Finland	8.3	51.0	30.5	61.3	42.0	6.2
Ireland	-	47.7	7.2	96.2	-	5.9
Sweden	9.3	27.9	29.0	70.5	68.0	8.4
US	8.4	38.0	28.3	77.1	42.1	7.7
UK	8.7	21.8	13.7	92.0	58.0	7.8
Japan	5.8	40.4	-	81.8	25.8	7.6
European Union	6.4	23.6	8.6	-	-	6.3

1/ Measuring the ICT sector, OECD, 2000. Data refer to 1997.

2/ Internet Software Consortium (ISC). Data refer to 1998.

3/ OECD. The figures refer to the cost of access to Internet for 20 hours including VAT.

4/ Computer Industry Almanac. Data refer to 1997.

5/ WITSA/IDC database. Data refer to 1997.

Table B. Investments in ICT Equipment 1/

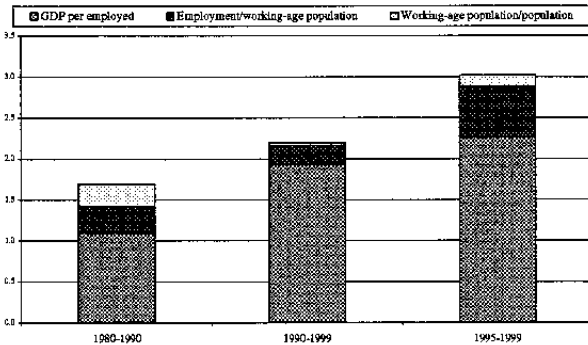
	Australia	USA	UK	Japan	Germany	France	Canada	Italy
ICT equipment as a share of non-building gross fixed capital formation 2/								
1985	1.9	8.3	5.2	3.4	3.4	6.1	6.9	3.4
1990	3.5	8.7	7.5	3.8	3.5	5.0	7.3	4.1
1995	6.9	13.4	11.7	4.6	6.1	8.0	10.1	4.2
Average annual rate of growth of constant price investment in ICT equipment								
1985-1990	45.5	18.6	25.5	23.5	18.8	16.2	17.2	20.8
1990-1995	35.1	23.8	17.6	14.5	18.6	11.0	17.6	12.9

Source: Australia, ABS. Other countries, OECD (Schreyer, 2000).

1/ ICT equipment is Computers and Peripherals.

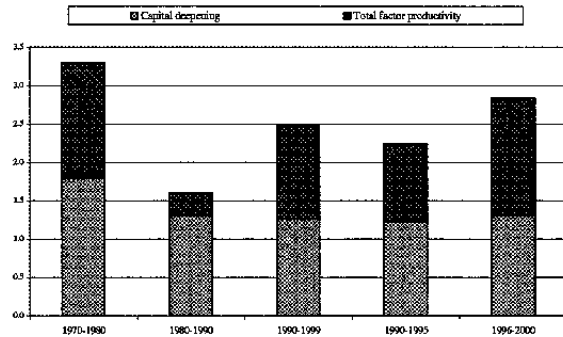
2/ For Australia, non-building Gross Fixed Capital Formation (GFCF) is total GFCF less GFCF in Dwellings and in Other Buildings and Structures. All shares are in current prices.

Chart A. Sources of Trend GDP per Capita Growth, Average Annual Percent Change



Source: OECD.

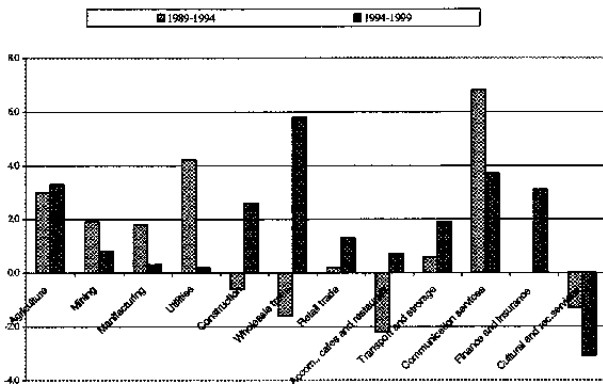
Chart B. Sources of Trend Labor Productivity Growth, Average Annual Percent Change



Source: ABS.

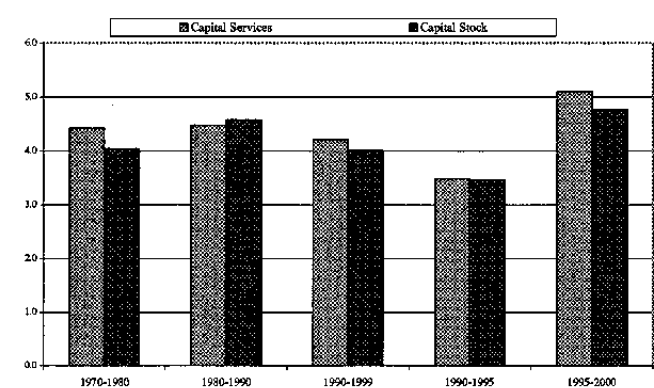
1/ Labor productivity is GDP per hours worked.

Chart C. Growth in TFP by Industry Sector, Average Annual Percent Change



Source: Productivity Commission.

Chart D. Changes in Capital Stock, Average Annual Percent Change



Source: ABS.

the new initiatives are: a new premium R&D tax concession rate of 175 percent for additional R&D and an equivalent tax rebate to help small companies in tax loss; an increase in funds for publicly funded research; and additional places for university curricula focused on ICT, mathematics, and science.

36. The mission also discussed other issues beyond those raised by the Innovation Summit that are relevant to enhancing and retaining high quality human capital in Australia. These include labor market reforms (see paragraph 40 below), the education system, and the personal income taxation regime.

- The authorities were of the view that, overall, Australia's publicly funded education system had responded well to the demand for skills generated by the movement up the technology ladder, while also ensuring broad access to higher education. The mission noted that the authorities may need to give consideration to increase further the rewards to strong performance with a view to encouraging a performance culture and creating centers of global excellence, which would help to ensure the continued high quality of human capital in Australia.
- The staff pointed out that the top marginal personal income tax rate (47 percent) and the relatively low threshold (recently raised from \$A 50,000 to \$A 60,000) at which it starts to apply could act as a deterrent to attract and retain entrepreneurial and technological skills. The authorities recognize the potential for such disincentive effects but also noted the importance of balancing equity with efficiency considerations.

Welfare Reforms

37. The authorities see modernizing the welfare system as an important part of the wider reform process but have stressed that reforms are complex and sensitive and will take time to design and implement. Key problems with the welfare system have been identified as its complexity; high effective marginal tax rates (EMTRs) which act as a serious disincentive to work; and regional pockets of long-term unemployment (Box 5). Thus the broad objectives of welfare reform are to reduce dependency and increase participation rates, and over time, increase income and saving. Some progress was made under the New Tax System towards the objective of enhancing work incentives by lowering EMTRs and improving in-work benefits. Recognizing that more remains to be done, in late 1999 the government established a reference group to guide the development of comprehensive welfare reforms. The group's report (the McClure report) was presented to the government in July 2000. A number of the recommendations were focused on providing greater financial and other incentives to participate in the labor force and to move off income support.

Box 5. Australia: Welfare Reform and Links to the Labor Market

Australia is set to embark on a comprehensive reform of the welfare system.^{1/} This box sets out the current state of play in the welfare system, the main recommendations of the McClure Report and the Government's response, and the key links between welfare reform and the labor market.

Current System

- *The current welfare system is rooted in an era of low unemployment and nuclear families; as the social and demographic trends changed, the system has become very complex.* In an effort to address rises in unemployment and broadening social objectives since the 1970s, successive governments sought to increase the scope of the system while maintaining a lid on costs, resulting in a relatively complex system with extensively means tested benefits and high effective marginal tax rates (EMTRs).
- *Welfare rolls have risen sharply since the mid-1960s.* Between 1965 and 1998, the proportion of the workforce receiving income support rose from 5 percent to 22 percent, outstripping the rise in the proportion unemployed. Moreover, the ongoing economic expansion has not reduced this trend.
- *Within recipients of welfare, there is heavy reliance on income support.* Data from 1997-98 show that 14 percent of those of workforce age receives over 90 percent of its income from Government transfers. Those most likely to be heavily reliant on income support are sole parents, people over the age of 55, and single people without children.
- *As a result, spending on income support has risen sharply.* Expenditure on income support has increased from 0.6 percent of GDP in 1970 to 3.3 percent of GDP in 1998. Although this ratio is still below the OECD average, with the current higher incidence of income support among older groups, there are concerns that this trend will continue.
- *Joblessness has become concentrated across families, suggesting a danger of persistent income support.* Families have become increasingly divided between two-job and zero-job families, with the latter more likely to receive income support. Moreover, research suggests that young people from income support families are 2½ times more likely to be on income support themselves.

McClure Report and the Government's Response

- *The Report outlined five features of a "Participation Support System:"* (i) individualized service delivery to emphasize prevention and improve self-reliance; (ii) a simpler, integrated system for the delivery of the various forms of income support to deal with people's changing circumstances over the life cycle; (iii) increased incentives and financial assistance to encourage labor force participation; (iv) an expanded definition of mutual obligations which focuses on participation as a criterion for support; and (v) social partnerships to build local capacity to increase participation (community development and micro-businesses).
- *The Government endorsed the broad recommendations of the McClure Report, emphasizing the need for substantial upfront funding.* Moreover, the Government noted that welfare reform will be a medium- to long-term undertaking. Specific ideas now being considered include a "transition bank" which would allow income support recipients with intermittent (seasonal) work to be treated similarly under the income test as those with regular, part-time work; and an increase in participation requirements for parents with school age children.

Potential Links to the Labor Market

- *Incentive effects could be expected to increase the supply of labor.* These could include lowering EMTRs through lowering taper rates, raising in-work benefits and enacting a transition bank, to reward participation.
- *Employment may be stimulated through several channels.* First, increased search intensity could be expected to improve the matching of supply and demand, resulting in a more efficient labor market and higher employment. Second, the lower pressure on wages resulting from welfare reform could be expected to increase employment. Finally, the higher product demand from the increase in employment from the first two factors could, in turn, increase the demand for labor.
- *While the effect of welfare reform on the unemployment rate would be ambiguous, the effect on joblessness would be favorable.* Thus, the success of welfare reform should be measured primarily by a rise in the employment ratio and labor force participation, as well as the effects on jobless families and communities rather than by changes in the unemployment rate or spending on income support.

^{1/} A more detailed study can be found in the forthcoming Selected Issues paper.

38. **In its initial response to the McClure Report in December 2000, the government indicated its commitment to the broad direction of the recommendations and identified welfare reform as one of the highest funding priorities in the 2001/02 budget.** Key elements of the reform strategy are long-term prevention; early intervention; active assistance to move people off income support; and building partnerships between the community and business. In addition, the government has identified a number of specific areas in which it is disposed to take some early action: further developing the idea of a “transition bank” aimed at improving financial incentives for income support recipients to take up part-time and casual work; increasing participation requirements for certain categories of social assistance recipients; and launching a campaign to publicize and clarify existing incentives and assistance so as to reduce “model uncertainty.”

39. **The authorities acknowledged that completion of the welfare reform agenda was likely to be a lengthy process.** The staff expressed concern that there could be some tension among multiple objectives, including the commitment to improve incentives to work, while making no group materially worse off and limiting the fiscal cost of the reform. The mission’s suggestions to alleviate some of the tensions included de-linking pension and disability payments from wage growth at an early stage, substantially increasing participation requirements for welfare recipients (going beyond the McClure report’s recommendations in this area), and considering a shift to in-work benefits such as an earned income tax credit (EITC). The authorities made the following points in response. They stressed that in light of the high value placed on social cohesion in Australia, the country would be willing to pay some price to ensure a strong safety net for the poor and the disadvantaged, and saw little scope for a radical approach to cutting welfare benefits or eligibility. They noted that the relevant benchmark when examining potential costs is the welfare expenditure profile under current policies, which are projected to rise from \$A 21 billion in 2000/01 to \$A 24 billion in 2003/04. While welfare reforms would have a net cost up front, the expectation is that the reforms would mitigate the need for additional welfare spending in the medium term. In this context, while they agreed that an EITC system could work to increase participation rates, it could become very expensive. Moreover, the existing system in Australia where benefits have taper rates can be used to replicate the effects of an EITC.

Other Structural Issues

40. **Despite growing political opposition, the Government remains committed to pursuing further labor market reforms.** The authorities pointed to the gains in real wage and productivity growth that have been observed from the reforms already implemented under the Workplace Relations Act of 1996. Nevertheless, they acknowledge that labor market flexibility continues to be hampered by the operation of unfair dismissal legislation and the still important position occupied by industrial relations commissions and tribunals. The government has also stated that it sees labor market reform as a critical complement to reforms aimed at strengthening innovation and the “new economy.” Following the defeat in the Senate

in late 1999 of legislation to implement the “second wave” of labor market reforms, the Government introduced, in June 2000, four bills to implement separate parts of the reform package. These are aimed at reducing the number of employment conditions covered by awards to a safety net of basic minimum wages and employment conditions, limiting the arbitration power of the Australian Industrial Relations Commission, streamlining the approval process for Australian Workplace Agreements (individually negotiated agreements) and addressing the difficulty presented by the “unfair dismissal” provisions of the existing law.

41. **Progress continues to be made in the implementation of the National Competition Policy, but the review of legislation is likely to be delayed somewhat from the original timetable.** Australia has come a long way from the time when the economy was characterized by heavy regulation and limited competition by pursuing an ambitious agenda of competition reform, which aims at reducing distortions between different sectors of the economy and at achieving competitive neutrality between public and private enterprises, and between states. The National Competition Policy has provided a vehicle for the federal government to promote reform at the state level. An important element of the agenda is the on-going comprehensive review of all Commonwealth and State legislation which may restrict competition and which may be costly to business. The guiding principle of the review is that legislation should not restrict competition unless the benefits of such restriction outweigh the costs and the objectives of the legislation can only be achieved by restricting competition. The review involves nearly 1700 pieces of legislation and was originally scheduled to be completed by end-2000. The authorities noted that the large number of laws to be reviewed has resulted in some delay in the timetable, but reiterated their commitment to a thorough and careful review of all legislation.

42. **On the future direction of trade reforms, the authorities stated that they remain strongly committed to maintaining an outward-oriented economy.** Australia reduced tariffs significantly in the 1980s and 1990s, which contributed significantly to increased competitiveness and to growth. At present, tariffs remain on passenger motor vehicles (PMV) at 15 percent, textile, clothing and footwear (TCF) at 15–25 percent, while about 40 percent of trade is duty free and a further 40 percent is subject to tariffs between 1 and 5 percent. The mission supported the recent recommendations made by the Productivity Commission to eliminate the general tariffs before 2010 and also suggested making more concrete the commitments on PMV and TCF tariffs. In December 2000, the authorities announced their decision to retain tariffs of between 1 and 5 percent and the business import duty concession at 3 percent. They stressed that Australia is committed to the APEC goal of “free and open trade” by 2010, and that its strong record of trade liberalization give it a powerful bargaining position in future trade negotiations.

43. **The mission also discussed the impact of trade barriers facing Australia.** The authorities cited a recent study which estimates the welfare gain to Australia from a 50 percent reduction in trading partner tariffs in the areas of agriculture and services to be on the order of

US\$5 billion (1¼ percent of GDP) per year.¹⁷ In this context, the authorities noted that they remain committed to the WTO process but intend to pursue other bilateral and regional initiatives to maximize benefits to Australia as second-best options.

V. STAFF APPRAISAL

44. **Since the last consultation with the Fund, the Australian economy has turned in another impressive performance, notching up its tenth year of economic growth,** although there are now signs of a moderation in domestic demand. Particularly remarkable is the fact that this expansion has been characterized by strong, broad-based productivity increases and average annual inflation of 2 percent. This creditable record is clear testimony of the benefits both of the comprehensive reforms begun in the mid-1980s and of skillful and disciplined macroeconomic management.

45. **Notwithstanding some recent strengthening, a striking development of the past year has been the weakness of the exchange rate.** The continuing downward pressure on the \$A during much of 2000—at a time when short-term influences would generally have implied a strengthening—was hard to explain. That said, the present level of the real exchange rate is only moderately depreciated relative to medium-term fundamentals, and it is welcome that the strengthening fiscal position has boosted national saving and made possible a sustained reduction in the current account deficit.

46. **As the balance of risks has shifted in recent months towards a sharper slowing of the world economy, and with inflation in Australia remaining under control, the authorities have appropriately moved to ease the stance of monetary policy.** Further interest rate cuts are now generally anticipated by the market during the course of 2001, consistent with the view that activity in Australia will continue to moderate. That said, with tax cuts delivering some fiscal support to the economy and the still highly competitive \$A, the overall macroeconomic environment remains favorable to growth. In view of this assessment, and given some lingering inflation concerns in Australia, the scope for interest rate cuts is likely to be less than in the United States, and the staff would recommend a continued cautious approach to interest rate reductions.

47. **The RBA has generally taken a pragmatic approach to coping with the downward pressure on the currency,** taking account of the inflation implications in setting monetary policy but not seeking to suppress market forces. The staff agrees with the RBA that while some intervention can be helpful to stabilize foreign exchange market conditions and to signal concern that the exchange rate is moving out of line with fundamentals, even large scale intervention would be futile in the face of sustained market pressures.

¹⁷ “*Global Trade Reform: Gaining Momentum,*” Department of Foreign Affairs and Trade, Canberra, 1999.

48. **The RBA enjoys a high degree of credibility and the operation of monetary policy is generally well understood.** The planned shift to quarterly statements on monetary policy will reinforce the transparency of the framework. Consideration could be given to going further in this direction by issuing at least brief statements after policy board meetings including when the decision is not to move rates. This could enhance market understanding further, particularly when the decision is different from expectations.

49. **Although the mid-year budget review painted a healthy picture of the public finances, it remains important to keep a lid on public spending,** since maintaining a strong fiscal position continues to be a key support for investor confidence in Australia, notwithstanding the recent improvement in the current account deficit. The staff therefore welcomes the authorities' assurances that the fiscal initiatives now being planned to meet the Government's policy priorities in the pre-election period will contain only limited, well-targeted increases in spending, consistent with the policy of maintaining fiscal surpluses in periods of healthy growth.

50. **Although Australia is better positioned to handle fiscal pressures from an aging population than other industrialized countries, rises in health care costs may prove challenging.** The means-tested publicly provided age pension, the mandatory private superannuation scheme, and the tax incentives for additional voluntary saving provide a suitable framework for retirement income support over the longer term, while limiting the burden on the government accounts. Rising health care costs are, however, a greater concern. Given the commitment to a strong public health care system in Australia, the staff continues to feel that it would be prudent to run modest fiscal surpluses over the cycle or to develop other mechanisms (such as medical savings accounts) to provide a buffer against future fiscal pressures from this source.

51. **The evolution of external vulnerability indicators and the experience of adjustment to shocks over the recent past supports the Fund's earlier assessment that external risks are manageable and that Australia is well placed to absorb shocks without undue economic or financial distress.** The narrowing of the current account deficit, the apparently limited impact of the sharp drop in the exchange rate on balance sheets (reflecting the high degree of hedging), and the continued generally strong financial sector indicators all support this view. More generally, it bears repeating that the high degree of external exposure (notwithstanding the recent improvement in the current account) underlines the importance of continued prudent fiscal policy and firm regulatory oversight of the financial system.

52. **Despite the impressive productivity growth of the recent past, there is no room for complacency.** While the reforms of the past 15 years will continue to bring dividends, the reform effort must be sustained if Australia is to retain its place amongst the leaders in productivity growth. The staff is therefore encouraged by indications that the Commonwealth Government remains strongly committed to moving its reform agenda forward across a range of fronts—the welfare system, policies to encourage innovation and the “new economy,” and labor market reforms.

53. **In fostering the “new economy,” Australia is most likely to maximize its growth potential by focusing on policies that would permit playing to its strengths in the adoption and application of high technology rather than attempting to foster production at a potentially sizable resource cost.** As emphasized by the recent Innovation Summit, the key will be to provide appropriate incentives to encourage innovation, R&D, and entrepreneurial activity and to avoid such stumbling blocks to more rapid technology diffusion as gaps in telecommunication infrastructure and skills and financing shortages. More broadly, the staff would suggest steps to strengthen excellence in the higher education system as well as lowering the top marginal tax rate in order to bolster Australia’s capacity to develop and retain technical skills and entrepreneurship at the highest level.

54. **Another avenue to enhance Australia’s future growth prospects is moving ahead with the remaining elements of industrial relations reform.** While acknowledging the inherent political difficulties with reforms in this area, the staff feels that the potential payoff is likely to be significant, as it has been with the labor market reforms implemented to date, and welcomes the authorities’ commitment to pursuing further reforms. Thus, the staff supports the introduction of legislation to streamline the awards system further, aimed at reorienting the system more as a safety net than a device for setting wages and working conditions, and to reduce impediments to labor market flexibility from the current restrictive dismissal laws.

55. **Efficient use of labor is also affected by a welfare system that is cost effective and tightly targeted but also implies high EMTRs which act as serious disincentives to workforce participation.** The staff welcomes the steps being taken to address these issues, and endorses the McClure report’s view that the welfare system should provide greater incentives to move people from welfare to work while continuing to offer a secure “safety net” of income support. The biggest challenge will be to achieve these objectives in a manner that is consistent with the government’s overall commitment to fiscal prudence, while also satisfying the commitment to leave no group materially worse off. While recognizing that time will be needed to achieve the reform objectives in full, the staff would caution against an excessively “softly softly” approach. Key to balancing the various, potentially conflicting objectives is to take early action to delink pension and disability payments from wage growth, while substantially increasing participation requirements for welfare recipients.

56. **Finally, the strong link that has already been observed between structural policies and potential growth argues for persevering with the reform agenda more broadly.** Sustained implementation of the National Competition Policy remains a priority, and the staff particularly welcomes the continuing review of legislation that restricts competition. On trade reform, the current strength of the Australian economy presents a good opportunity to move swiftly to eliminate general tariffs of under 5 percent and to make more concrete the timetable for the elimination of tariffs in the key PMV and TCF sectors by 2010.

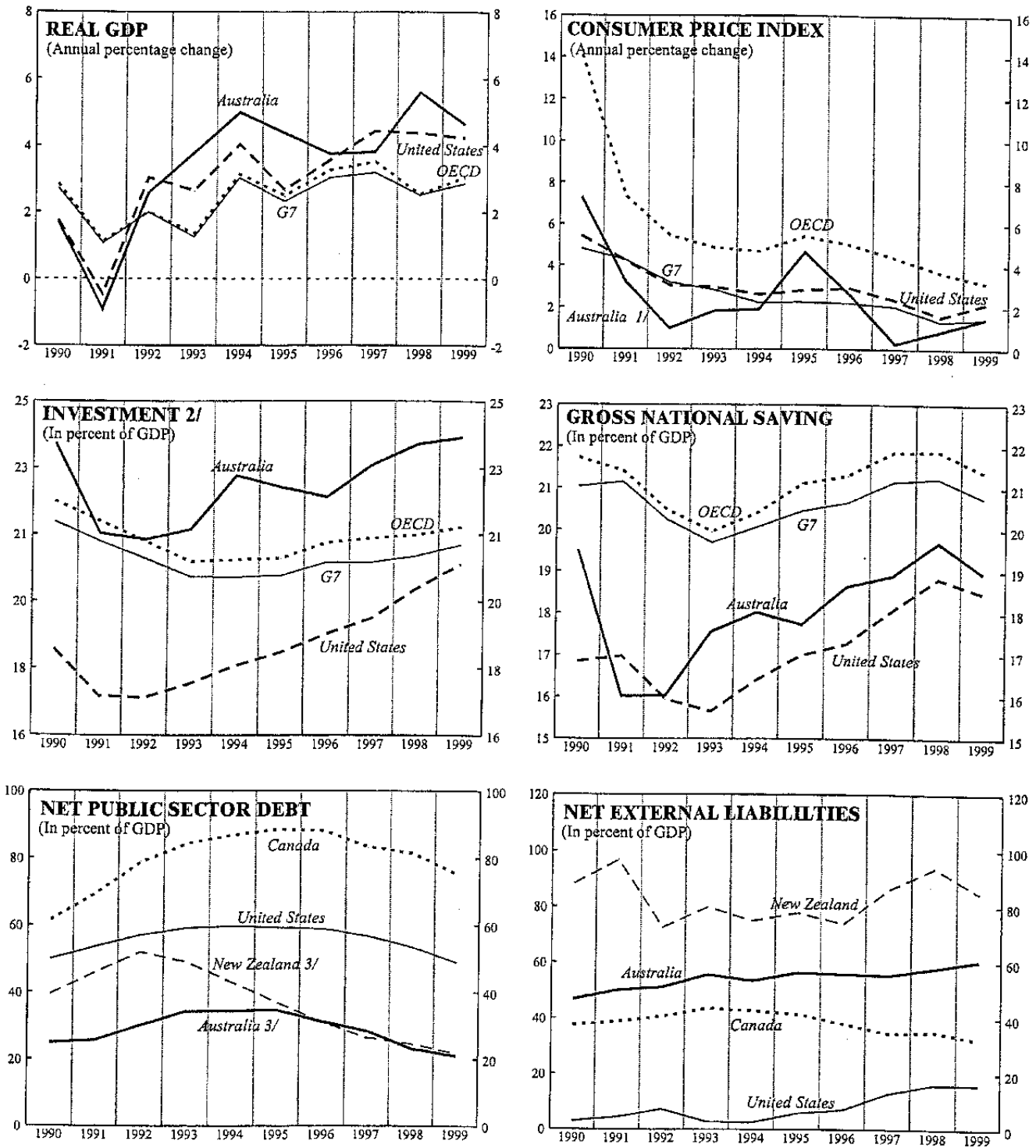
57. **In many respects, Australia is at the forefront of the production and dissemination of high quality economic and financial statistics (Annex III).** The staff welcomes the ongoing efforts to improve measures of inflation, productive capital stock, and

ICT usage; and to introduce an economy-wide quarterly survey to make more coherent the data currently collected in a number of quarterly surveys.

58. **The authorities have shown a continued commitment to official development assistance (ODA), particularly to support development in the East Asia and Pacific region.** Australia's ODA budget for 1999–2000 has been maintained in real terms from the previous fiscal year and stands at 0.25 percent of GNP, somewhat above the average for donor countries.

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

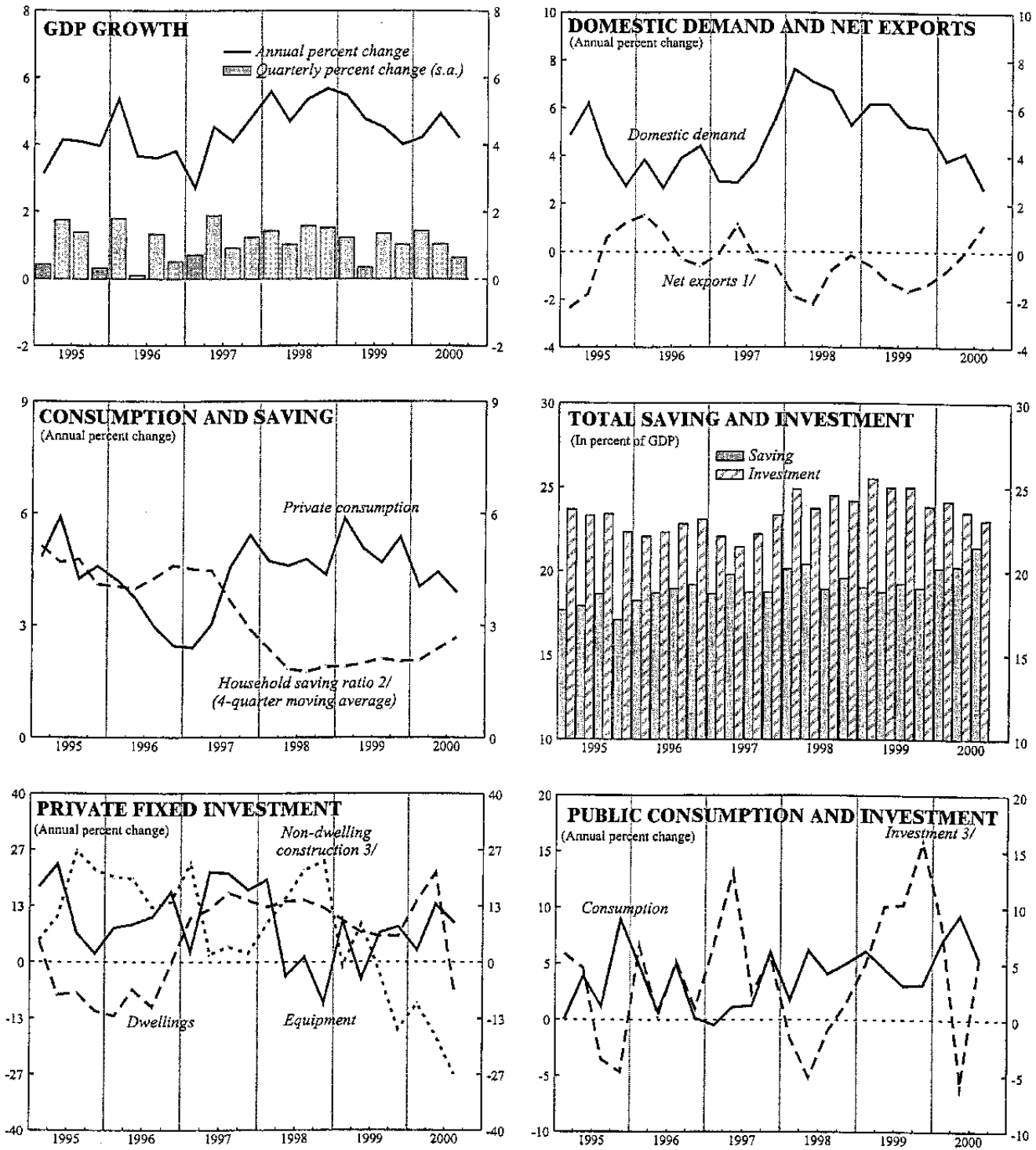
FIGURE 1
AUSTRALIA
COMPARISONS OF MACROECONOMIC PERFORMANCE, 1990-99



Sources: National authorities; IMF, International Financial Statistics and World Economic Outlook; OECD, Economic Outlook.

1/ Underlying inflation.
 2/ Gross fixed capital formation.
 3/ Fiscal year.

FIGURE 2
AUSTRALIA
SELECTED REAL ECONOMIC INDICATORS, 1995-2000



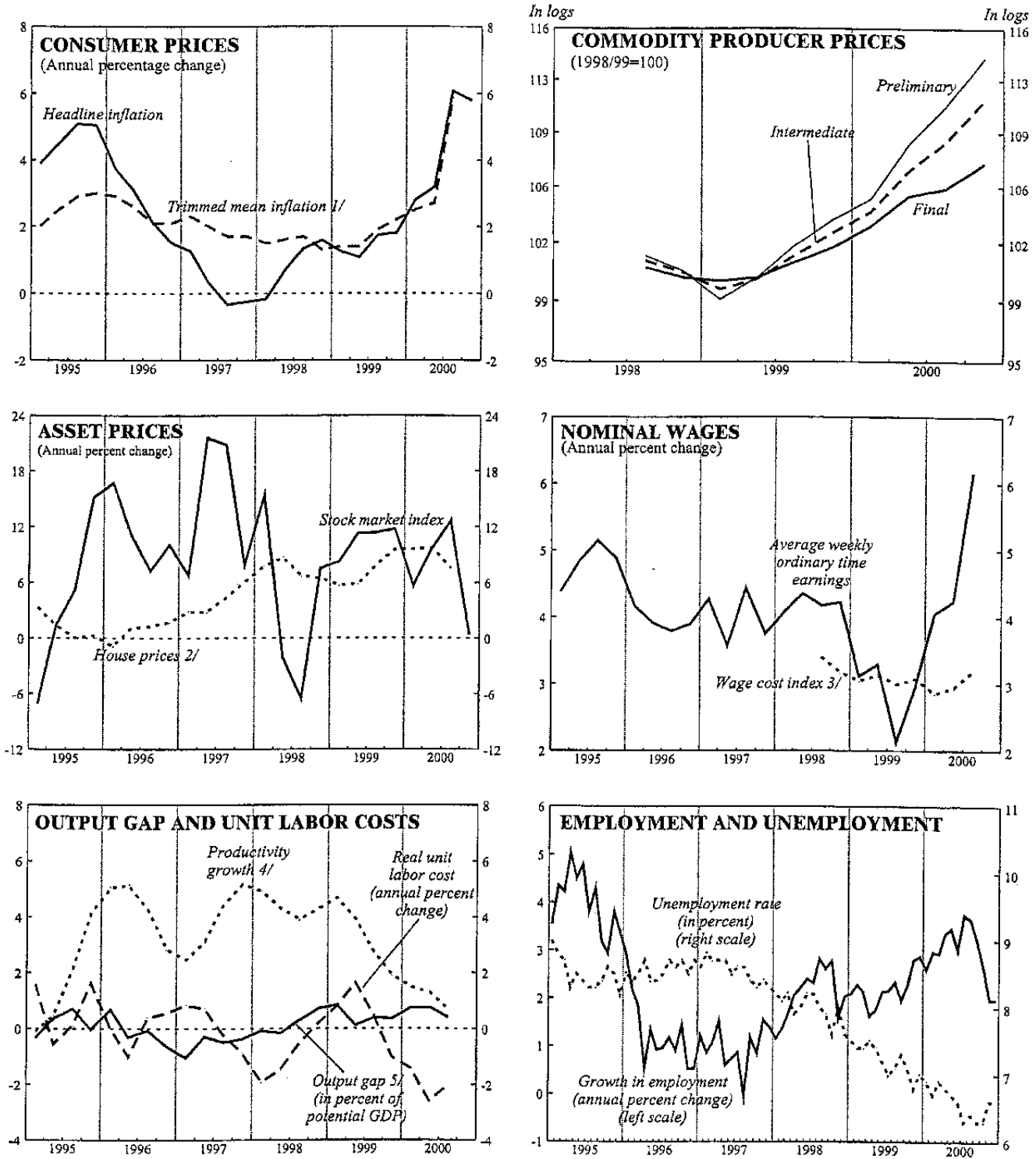
Source: Data provided by the Australian authorities.

1/ Contribution to GDP growth.

2/ Net household saving as a percent of household disposable income.

3/ Adjusted for sale of second hand assets between sectors.

FIGURE 3
AUSTRALIA
INFLATION AND LABOR MARKET INDICATORS, 1995-2000



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

1/ The "Trimmed mean" is calculated as the weighted mean of the central 70 per cent of the quarterly price change distribution of all CPI components, with the annual rates based on quarterly calculations.

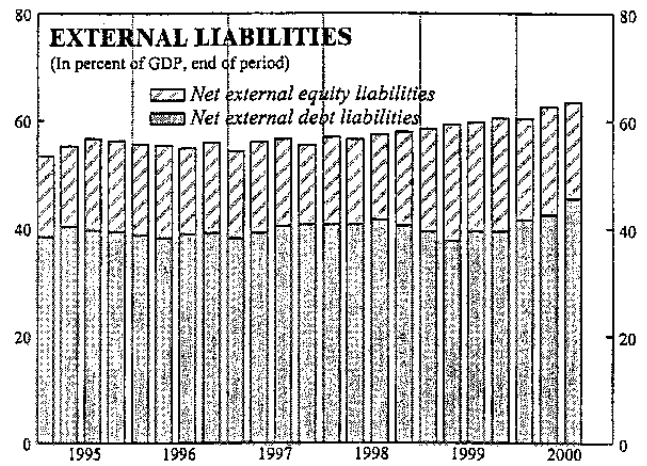
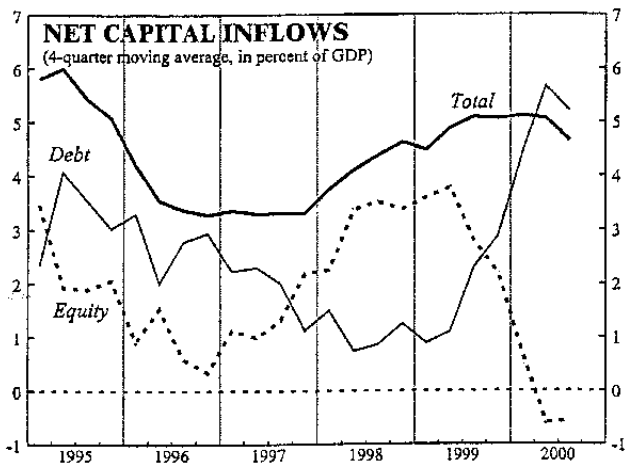
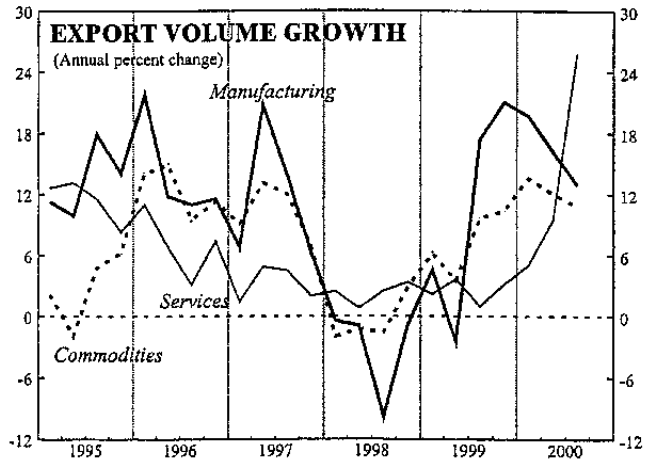
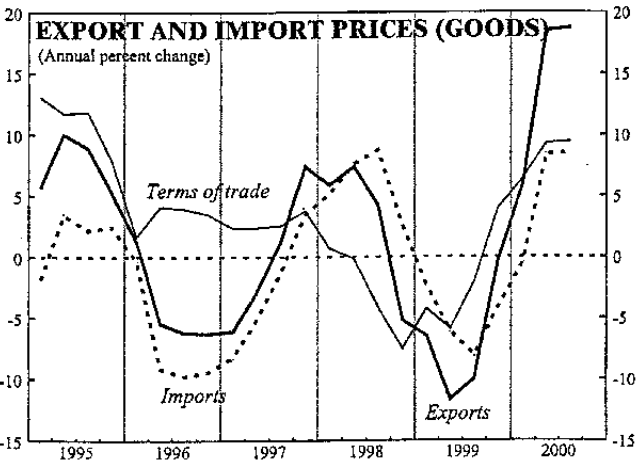
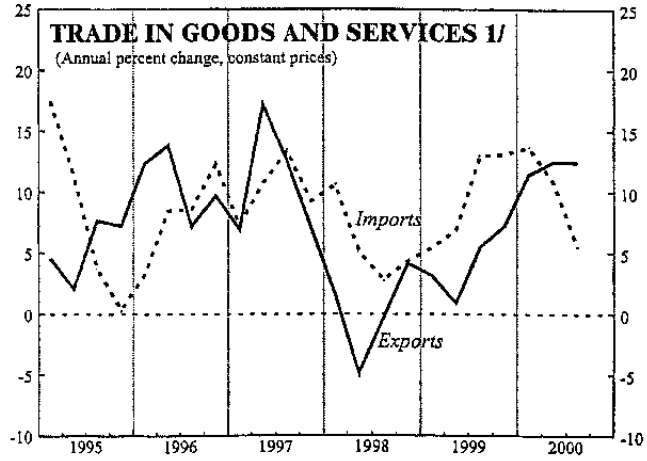
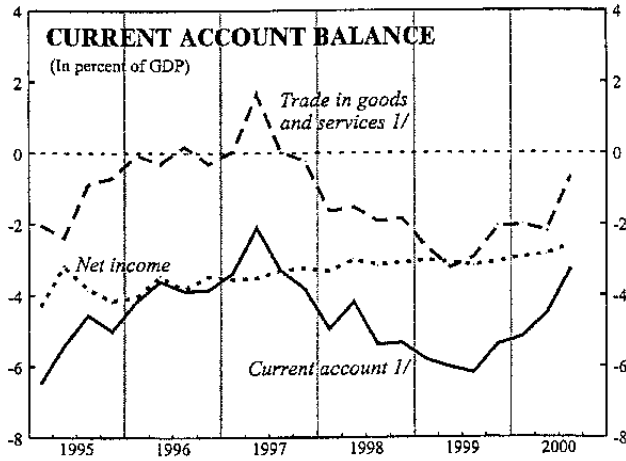
2/ Weighted average of 8 capital cities; established houses.

3/ The Wage Cost Index is only available from September 1997.

4/ Output per hour worked; non-farm market sector.

5/ Staff estimates.

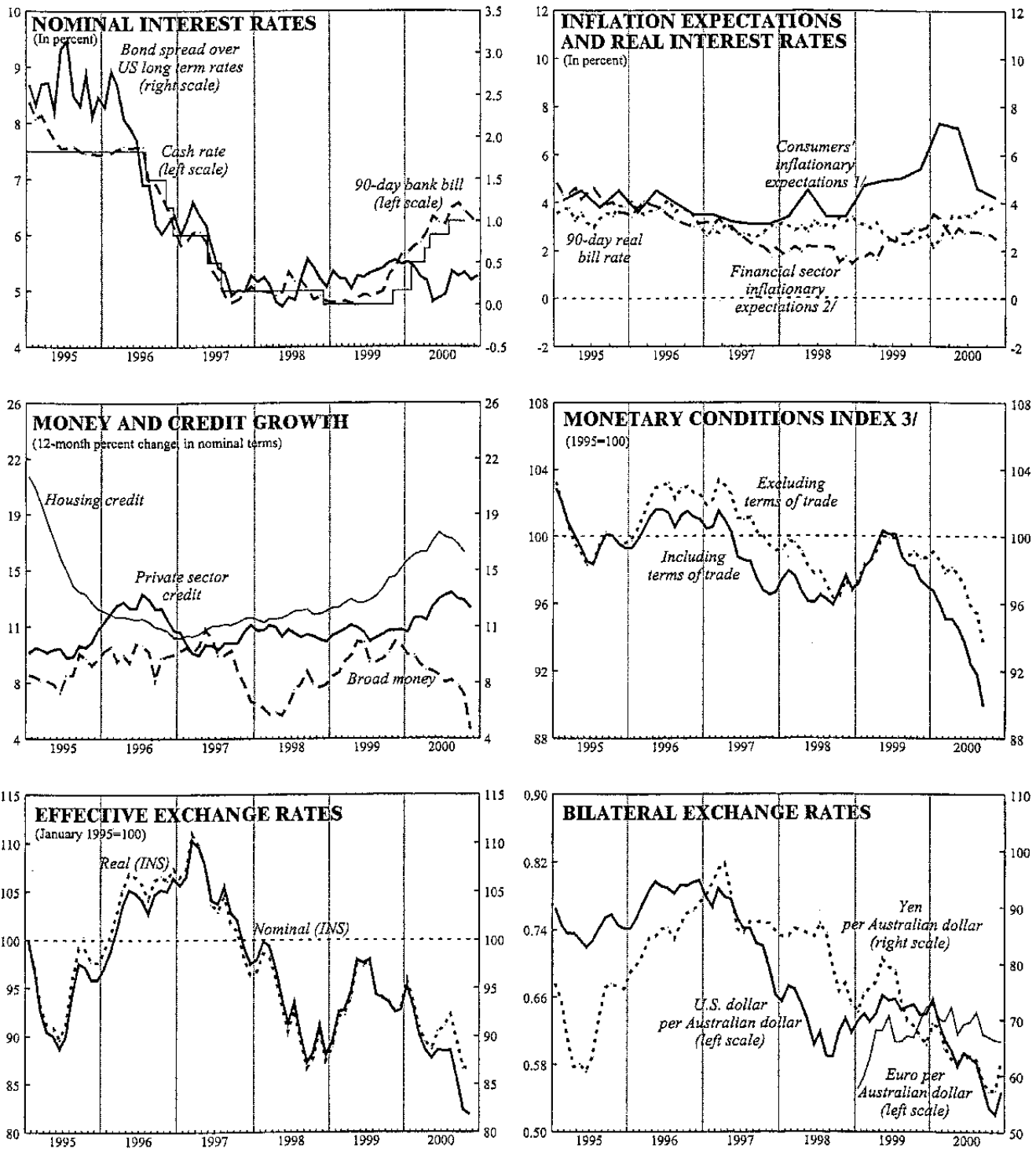
FIGURE 4
AUSTRALIA
BALANCE OF PAYMENTS AND EXTERNAL LIABILITIES, 1995-2000



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

1/ June 1997 exports includes the sale of gold by the Reserve Bank equivalent to 1 1/2 percent of June 1997 quarter GDP.

FIGURE 5
AUSTRALIA
SELECTED MONETARY INDICATORS, 1995-2000



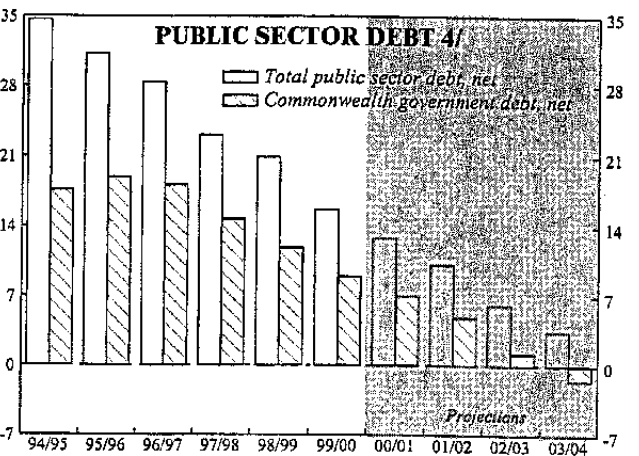
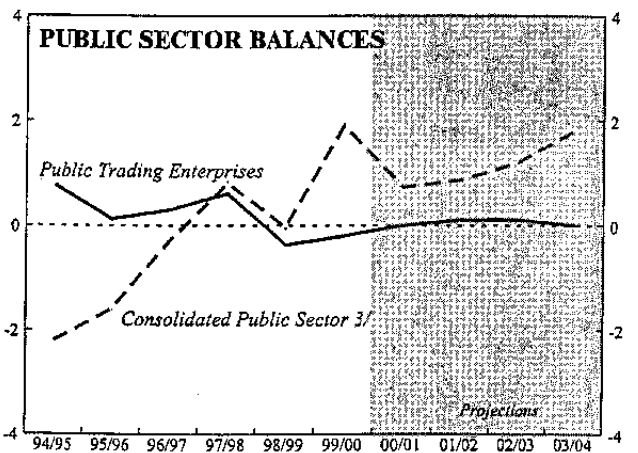
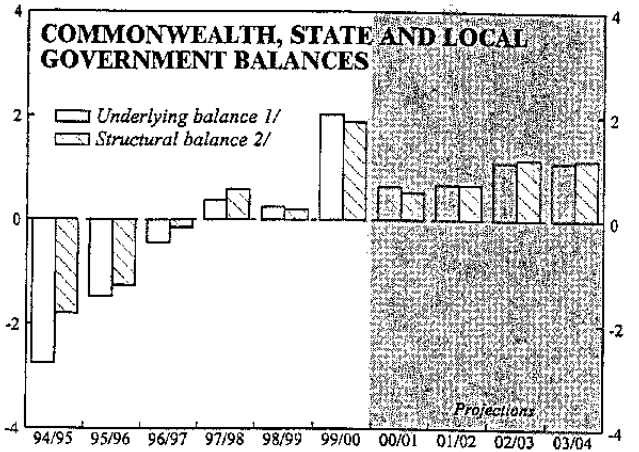
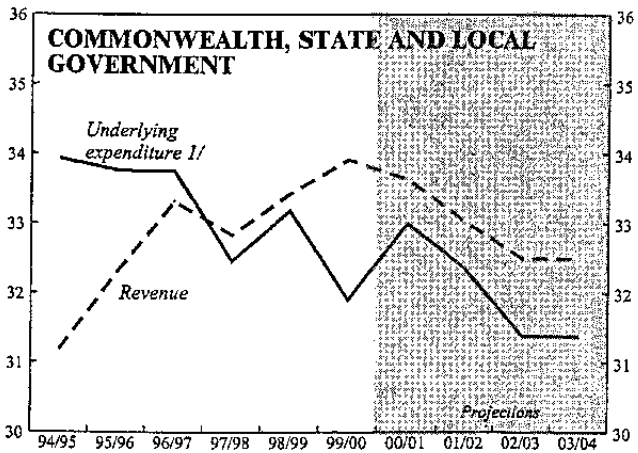
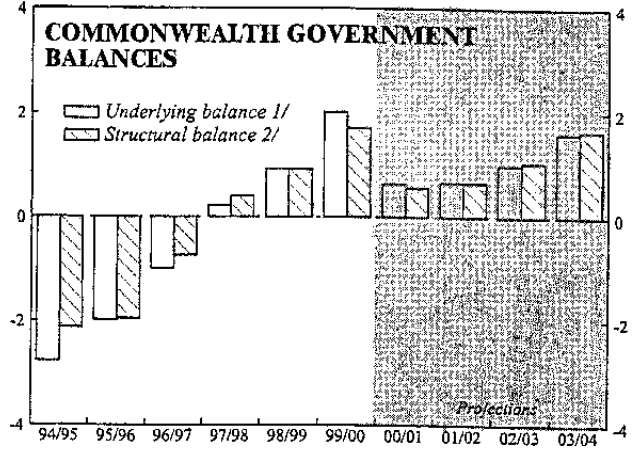
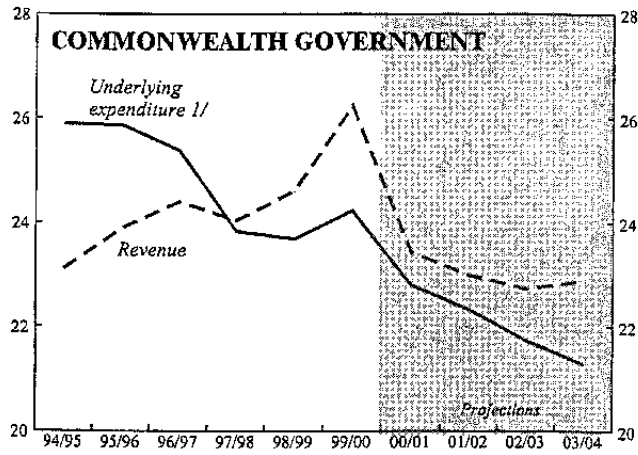
Sources: Australian Bureau of Statistics; Reserve Bank of Australia; and staff estimates.

1/ Melbourne Institute Survey, expectation of inflation over next year (median response).

2/ Calculated as the spread between long-term non-indexed and indexed government bonds.

3/ Calculated as a weighted sum of the change in the real 90-day bank bill rate (r), the real effective exchange rate (e), and the terms of trade on goods and services (tot) from February 1987. Both the real bill rate and real effective exchange rate are calculated using consumer prices. Based on Reserve Bank of Australia equation: $MCI = 1.0r + 0.26e - 0.31tot$. A fall in the index indicates an easing in monetary conditions.

FIGURE 6
AUSTRALIA
FISCAL INDICATORS, 1994/95-2003/04
(In percent of GDP)



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

1/ The underlying balance excludes asset sales and other one-off factors, on a cash basis.

2/ The structural balance is on a cash basis and is adjusted to exclude the abnormally high RBA dividend in 1999/00.

3/ The Commonwealth, state, and public enterprise balances may not add up to the public sector balance due to the effect of consolidation.

4/ Assuming the sale of the government's remaining shareholding in Telstra.

Table I. Australia: Selected Economic and Financial Indicators, 1996-2001

	1996	1997	1998	1999	Est. 2000	Proj. 2001
Nominal GDP (1999):	\$A612 billion (US\$395 billion)					
Population (June 1999):	18.97million					
GDP per capita (1999):	US\$ 20,695					
Quota:	SDR 3,236 million					
<hr/>						
Output and demand (percent change)						
Real GDP	3.7	3.8	5.6	4.6	4.3	3.2
Total domestic demand	3.3	3.5	7.0	5.6	3.6	3.8
Private consumption	3.3	3.9	4.6	5.2	3.9	3.6
Fixed investment	5.5	11.1	7.3	6.4	3.1	4.1
Exports of goods and services	10.6	11.5	-0.3	4.2	11.1	6.1
Imports of goods and services	8.2	10.3	5.9	9.6	8.7	5.7
Inflation and unemployment (in percent)						
CPI inflation	2.6	0.3	0.9	1.5	4.6	3.7
CPI inflation (excl. GST)	...	...	...	...	3.2	3.1
Unemployment rate	8.6	8.6	8.0	7.2	6.5	6.3
Saving and investment (in percent of GDP)						
Gross national saving	18.6	18.9	19.3	18.9	18.4	18.5
General government saving	0.5	2.3	4.0	3.6	3.6	2.9
Private saving 1/	18.1	16.6	15.3	15.4	14.9	15.6
Gross capital formation	22.5	22.2	24.3	24.8	22.8	22.8
Fiscal Indicators (in percent of GDP) 2/						
Commonwealth budget (cash basis)						
Revenue	23.9	24.4	24.0	24.6	26.2	23.3 3/
Underlying expenditure 4/	25.9	25.4	23.8	23.7	24.2	22.6 3/
Underlying balance 4/	-2.0	-1.0	0.2	0.7	2.0	0.6
Fiscal balance (accrual basis)	...	...	-0.3	0.6	2.1	1.2 5/
Public sector underlying balance 4/	-1.4	-0.1	1.1	-0.2	2.1	0.2
Money and credit (end of period)						
M1 (percent change)	13.8	13.3	6.1	9.7	9.7 6/	...
M3 (percent change)	9.5	6.4	7.5	10.1	4.6 6/	...
Private domestic credit (percent change)	11.1	11.4	10.3	11.1	12.5 6/	...
Interest rate (90-day bill, in percent)	5.9	5.1	4.8	5.7	6.2	...
Government bond yield (10-year, in percent)	7.6	6.1	5.0	7.0	5.5	...
Balance of payments (in percent of GDP)						
Current account	-3.9	-3.1	-5.0	-5.9	-4.3	-4.3
of which: Trade balance	-0.2	0.4	-1.4	-2.5	-1.4	-0.6
Terms of trade (percent change)	3.7	1.9	-4.2	-0.6	5.7	2.2
External assets and liabilities (in percent of GDP)						
Net external liabilities	55.8	55.3	57.9	60.5	63.4	63.9
Gross short-term external debt	25.4	27.3	30.2	31.1	...	...
Net short-term external debt	14.3	14.4	17.4	17.5	...	...
Gross official reserves	4.2	4.8	4.3	5.5	5.4	...
Exchange rate (end of period)						
US\$/A\$	0.788	0.653	0.610	0.654	0.554	...
Trade-weighted index	58.6	58.4	53.3	56.4	51.7	...
Nominal effective exchange rate 7/	115.1	105.5	95.3	100.3	88.5 6/	...
Real effective exchange rate 7/	96.1	86.2	78.3	83.3	77.5 6/	...

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

1/ Includes public trading enterprises.

2/ For fiscal year ending June 30.

3/ The sharp drop in 2001 reflects tax reform, including income tax cuts, the removal of the Wholesale Sales Tax, and the reduction in grants to States.

4/ Underlying expenditure and balance exclude asset sales and other one-off factors; cash basis.

5/ The fiscal surplus exceeds the underlying cash surplus in 2000/01 due to abnormally high tax liabilities from the move to a pay-as-you-go system for company tax.

6/ November 2000.

7/ IMF, Information Notice System index (1990 = 100).

Table 2. Australia: Balance of Payments, 1996-2001

(In percent of GDP)

	1996	1997	1998	1999	Est. 2000	Proj. 2001
Current account balance	-3.9	-3.1	-5.0	-5.9	-4.3	-4.3
Trade balance	-0.2	0.4	-1.4	-2.5	-1.4	-0.6
Exports	14.8	15.9	15.4	14.2	17.0	18.1
Imports	-15.0	-15.5	-16.8	-16.6	-18.4	-18.7
Net services	0.0	-0.1	-0.3	-0.3	0.0	-0.4
Total credits	4.5	4.5	4.4	4.4	4.8	4.6
Total debits	-4.6	-4.6	-4.7	-4.7	-4.8	-4.9
Net income	-3.7	-3.4	-3.1	-3.1	-2.9	-3.2
Receipts	1.5	1.8	1.8	1.7	2.2	2.3
Payments	-5.2	-5.2	-4.9	-4.8	-5.1	-5.5
Net transfers	0.0	-0.1	-0.1	0.0	0.0	0.0
Capital and financial account	3.5	3.5	4.9	5.3	4.3	...
Capital account	0.2	0.2	0.2	0.2	0.1	...
Financial account	3.3	3.3	4.6	5.1	4.2	...
Direct investment transactions (net)	-0.2	0.3	0.8	2.4	1.2	...
Equity (net)	0.0	-0.1	0.6	1.3	0.4	...
Debt (net)	-0.2	0.4	0.2	1.1	0.8	...
Portfolio investment transactions (net)	4.9	3.1	1.2	2.4	1.7	...
Equity (net)	-0.1	2.0	2.4	0.5	-0.9	...
Debt (net)	5.0	1.1	-1.3	1.9	2.6	...
Financial derivatives (net)	0.1	0.2	-0.3	0.2	0.1	...
Other transactions (net)	-1.5	-0.3	2.9	0.0	1.2	...
Net errors and omissions	-0.4	0.4	-0.2	-0.6	0.0	...

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

Table 3. Australia: Vulnerability Indicators, 1996-2000

(In percent of GDP unless otherwise indicated)

	1996	1997	1998	1999	Est. 2000
Net external liabilities	55.8	55.3	57.9	60.5	63.4 2/
Net external equity liabilities	16.7	14.7	17.4	21.0	17.8 2/
Foreign equity investment in Australia	39.0	41.0	46.3	50.0	...
Australian equity investment abroad	-22.4	-26.3	-28.9	-29.0	...
Net external debt liabilities	39.2	40.6	40.5	39.5	45.6 2/
Net public sector	13.5	10.2	7.9	3.4	...
Net private sector	25.7	30.5	32.6	36.0	...
Gross external debt	56.2	60.9	61.2	61.5	...
of which: \$A denominated	...	25.3	23.1	22.6	...
Short-term net external debt (residual maturity basis)	14.3	14.4	17.4	17.5	19.5 3/
Short-term gross external debt	25.4	27.3	30.2	31.1	31.9 3/
Short-term gross external lending	-11.1	-12.9	-12.9	-13.6	-12.4 3/
Net external debt payments (as percent of exports of goods and services)	11.7	10.3	9.0	10.1	9.8 2/
Reserve-based indicators					
Gross official reserves (in \$A billion)	22.1	26.2	25.2	33.6	34.0
RBA outstanding forward contracts (in \$A billion) 1/	3.1	5.6	10.1	22.6	24.9
Net official reserves (in \$A billion)	19.0	20.6	15.1	11.0	9.1
Gross official reserves (in months of imports)	2.4	2.5	2.3	2.6	2.5
Gross official reserves to short-term foreign currency denominated debt (percent)	24.4	28.5	25.3	33.4	25.6 3/
Net official reserves to short-term foreign currency denominated debt (percent)	21.0	22.4	15.2	10.9	9.4 3/

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

1/ The forward obligations of the RBA represent the second leg of foreign currency swap transactions. With the decline in the stock of Commonwealth debt in recent years, the RBA has increasingly utilized foreign currency swaps for domestic liquidity management operations.

2/ End-September 2000.

3/ End-June 2000.

Table 4. Australia: Selected Fiscal Indicators, 1995/96-2003/04 1/

(In percent of GDP)

	1995/96	1996/97	1997/98	1998/99	1999/00	Projections			
						2000/01	2001/02	2002/03	2003/04
Public sector underlying balance (cash basis) 2/ 3/	-1.4	-0.1	1.1	-0.2	2.1	0.2	0.7	0.9	1.6
Commonwealth underlying government balance	-2.0	-1.0	0.2	0.9	2.0	0.6	0.7	1.0	1.6
Commonwealth revenue	23.9	24.4	24.0	24.6	26.2	23.3	23.1	22.5	22.8
Commonwealth underlying expenditure	25.9	25.4	23.8	23.7	24.2	22.6	22.4	21.5	21.2
State, territory, and local government underlying balance 3/	0.7	0.8	0.7	-0.9	0.5	-0.2	0.2	0.1	0.0
Public trading enterprises balance	0.1	0.3	0.6	-0.4	-0.3	-0.6	-0.2	-0.2	0.0
Commonwealth Government (accrual basis) 4/									
Revenue	...	...	26.3	25.6	26.9	23.8 5/	23.0	22.5	22.9
Income tax revenue	...	...	16.2	17.9	18.0	17.1	16.7	16.4	16.8
Indirect and other tax revenue	...	...	7.4	6.2	6.1	4.6	4.4	4.3	4.2
Non-tax revenue	...	...	2.7	1.6	2.8	2.2	1.9	1.8	1.8
Expenses	...	...	27.4	25.0	25.4	23.0 5/	22.5	21.6	21.2
Employees	...	...	3.1	2.7	2.8	2.4	2.3	2.2	2.1
Personal benefits	...	...	10.3	10.0	9.7	10.2	10.1	9.9	10.0
Grants	...	...	7.2	7.3	7.1	4.5 5/	4.7	4.3	4.1
Interest and other financing costs	...	...	1.8	1.6	1.4	1.3	1.2	1.1	1.0
Other expenses	...	...	5.0	3.5	4.4	4.5	4.3	4.1	4.0
Operating result (revenue less expenses)	...	...	-1.2	0.6	1.5	0.9	0.5	1.0	1.8
Adjustment 6/	...	...	-0.8	0.0	-0.6	-0.4	0.0	0.1	0.2
Fiscal balance 7/	...	...	-0.3	0.6	2.1	1.2 8/	0.5	0.9	1.6
Memorandum items:									
Commonwealth structural balance (cash basis) 9/	-2.0	-0.7	0.4	0.9	1.7	0.6	0.7	1.0	1.6
Total public sector debt, net 10/	31.2	28.4	23.1	19.6	15.4	12.2	10.2	6.1	3.5
Commonwealth government net debt 10/	18.9	18.1	14.7	11.9	8.4	6.4	4.1	0.8	-1.7
Commonwealth government "net assets" 10/ 11/	...	...	...	-6.4	-1.8	-6.0	-4.9	-3.4	-1.4
Commonwealth gross assets	...	...	...	24.8	27.3	18.2	16.3	13.6	12.0
Commonwealth gross liabilities	...	...	...	31.2	29.1	24.2	21.3	17.0	13.4

Sources: Commonwealth of Australia: *Budget Strategy and Outlook, 2000/01*; *Final Budget Outcome, 1999/2000*; *Consolidated Financial Statements for the Year Ended 30 June 2000*; *Mid-year Economic and Fiscal Outlook, 2000/01*; and Fund staff estimates.

1/ Fiscal year ends June 30.

2/ The underlying balance excludes asset sales and other one-off factors, on a cash basis.

3/ The Commonwealth, state, and public enterprise balances may not add up to the public sector balance due to the effect of consolidation.

4/ Accrual data are reported on an Australian Accounting Standard 31 (AAS31) basis.

5/ The sharp drop in 2000/01 reflects tax reform, including income tax cuts, the removal of the Wholesale Sales Tax, and the reduction in grants to States.

6/ Excludes asset revaluations included in the operating result and replaces depreciation (included in expenses) with government investment.

7/ The accrual equivalent of the underlying cash balance, which measures the government's net lending. Defined as the operating result plus adjustment.

8/ The fiscal surplus exceeds the underlying cash surplus in 2000/01 due to abnormally high tax liabilities from the move to a pay-as-you-go system for company tax.

9/ Adjusted to exclude the above-normal dividend from the RBA in 1999/2000.

10/ Assuming the sale of the government's remaining shareholding in Telstra.

11/ Includes financial and non-financial assets and liabilities, including unfunded superannuation liabilities to public servants.

AUSTRALIA: MEDIUM-TERM SCENARIO

This scenario illustrates the medium-term dynamics of key economic variables assuming implementation of the authorities' announced macroeconomic and structural policies.

GDP growth is expected to slow to by one full percentage point to 3¼ percent in 2001, reflecting a continued moderation of private consumption—as the effects of recent interest rate hikes continue to feed through, accompanied by an expectation of subdued asset price growth—coupled with slower net export growth stemming from a softening of the global environment and base year effects (Table I.1). The effect on domestic demand of slower consumption will be offset by a modest pick-up in fixed investment, particularly the housing sector, where growth has been highly negative following the introduction of the GST in July 2000. Over the medium term, growth would pick up slightly to 3½–3¾ percent (in line with the staff's current estimate of potential growth) as consumption growth stabilizes around its long-term trend, investment growth remains healthy, and net exports make a modest, positive contribution to growth reflecting a relatively strong global environment and a continued improvement in the terms of trade. The unemployment rate is projected to decline steadily to below 6 percent by end-2005.

Average annual inflation is expected to fall from 4½ percent in 2000 to about 3¾ percent in 2001 reflecting the ongoing effects of the GST, which added almost 3 percent to the price level on impact. Excluding the effect of the GST, inflation is projected to be at or above the top of the RBA's 2–3 percent target band in the next few quarters reflecting some pass through of upstream price pressures from both the depreciated exchange rate and previous margin compression. Inflation is expected to fall toward 2½ percent over the medium-term, in line with the authorities inflation targeting framework.

On the external side, export volume growth (goods and services) is expected to weaken in 2001, reflecting base year effects (including the Olympics) following the double-digit growth in 2000 as well as the projected softening in the global environment faced by Australia, consistent with the Fund's WEO exercise. Reflecting the (temporary) slowdown in export growth, there will be a pause in 2001 in the improvement in the current account deficit, while over the medium term the current account deficit should fall steadily to around 2½ percent of GDP—this projection is based on a modest appreciation of the exchange rate. Correspondingly, net external liabilities would stabilize at close to the current level before declining to around 60 percent of GDP by the end of the projection period.

From a macroeconomic balance perspective, the narrowing of the current account deficit would come about largely through an increase in national saving. General government saving would remain broadly constant in terms of GDP (in line with the authorities' medium-term projections in the Commonwealth budget) while private saving would improve by 1½ percent of GDP, reflecting an increase in household saving as a result of the decline in the unemployment rate, a lower reliance on direct taxes (which the GST replaced), and an increase in the mandatory superannuation contribution rate.

Table I.1. Australia: Medium-Term Scenario 2001-05

	1990-1999 Average	Est. 2000	Projections				
			2001	2002	2003	2004	2005
Real economic indicators (percent change)							
GDP	3.4	4.3	3.2	3.6	3.6	3.6	3.6
Total domestic demand	3.3	3.6	3.8	3.5	3.5	3.6	3.6
Private consumption	3.4	3.9	3.6	3.6	3.6	3.6	3.6
Fixed investment	3.8	3.1	4.1	4.9	4.9	5.0	4.6
CPI inflation	2.5	4.6	3.7	2.5	2.5	2.4	2.4
CPI inflation (excl. GST effect)	...	3.2	3.1	2.5	2.5	2.4	2.4
Unemployment rate	8.9	6.5	6.3	6.2	6.1	6.0	6.0
Saving and investment (percent of GDP)							
Gross national saving	18.1	18.4	18.5	18.9	19.3	19.6	19.8
General government saving	0.4	3.6	2.9	2.8	2.9	3.0	2.9
Private saving 1/	17.6	14.9	15.6	16.1	16.4	16.6	16.8
Gross capital formation	22.8	22.8	22.8	22.6	22.4	22.3	22.1
Fiscal indicators (percent of GDP) 2/							
Commonwealth Budget (cash basis)							
Revenue	23.8	24.7	23.2	22.7	22.7	22.8	22.9
Underlying expenditure	25.1	23.4	22.5	21.9	21.4	21.2	21.3
Underlying balance	-1.3	1.3	0.6	0.8	1.3	1.6	1.6
Fiscal balance (accrual basis)	...	1.7	0.8	0.7	1.2	1.5	1.5
Public sector net debt 3/	28.2	14.1	11.4	8.0	4.7	2.5	0.8
Foreign trade (percent change)							
Export volume (goods and services)	7.4	11.1	6.1	6.9	7.2	7.1	7.0
Partner Country Imports (ex. Oil)	7.4	14.1	6.3	6.9	7.2	7.1	
Import volume (goods and services)	6.0	8.7	5.7	6.4	6.3	6.9	6.7
Terms of trade (goods and services)	-1.2	5.7	2.2	2.0	1.8	1.3	1.2
Export price (goods and services)	-0.6	13.9	4.2	0.6	0.8	0.4	1.4
Import price (goods and services)	0.7	7.4	2.0	-1.4	-0.9	-0.8	0.2
Balance of payments (percent of GDP)							
Balance on goods and services	-0.8	-1.4	-0.9	-0.4	0.2	0.5	0.8
Balance on income and transfers	-3.6	-3.0	-3.4	-3.3	-3.3	-3.2	-3.2
Current account balance	-4.4	-4.3	-4.3	-3.7	-3.1	-2.7	-2.4
External liabilities (percent of GDP)							
Net external liabilities	54.3	63.4	63.9	63.7	63.0	62.1	60.9

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

1/ Includes public trading enterprises.

2/ Calendar year basis.

3/ Assuming the sale of the government's remaining shareholding in Telstra.

AUSTRALIA—FUND RELATIONS

(As of January 31, 2001)

A. Financial Relations

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

II. General Resources Account:	SDR Million	Percent Quota
Quota	3,236.40	100.0
Fund holdings of currency	2,175.62	67.2
Reserve position in Fund	1,060.89	32.8
Financial Transaction Plan transfers (net)	91.00	

III. SDR Department:	SDR Million	Percent Allocation
Net cumulative allocation	470.55	100.0
Holdings	71.79	15.3
Designation plan	38.00	

IV. **Outstanding Purchases and Loans:** NoneV. **Financial Arrangements:** NoneVI. **Projected Obligations to Fund:** None

B. Nonfinancial Relations

VII. **Exchange Rate Arrangement.** Australia accepted the obligations of Article VIII, Sections 2, 3, and 4 on July 1, 1965 and maintains an exchange system that is free of restrictions on payments and transfers for current international transactions. Exchange rates are market determined, but the Reserve Bank of Australia retains discretionary power to intervene. On January 23, 2001, the U.S. dollar/Australian dollar exchange rate was US\$0.556=\$A 1.00. There are no taxes or subsidies on purchases or sales of foreign exchange. Australia has notified the Fund under Decision 144 of the imposition of exchange restrictions vis-à-vis Iraq, the Federal Republic of Yugoslavia and the Socialist People's Libyan Arab Jamahiriya. In late 1999, Australia imposed restrictions on financial transactions with the Taliban (the Islamic State of Afghanistan), and the UNITA movement in Angola.

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

IX. **Last Article IV Consultation, and Consultation Cycle.** Discussions for the 1999 Article IV consultation were held in Melbourne, Sydney and Canberra from October 15–26. The 1999 consultation (SM/99/306) was completed by the Executive Board on January 28, 2000 (EBM/00/9). Australia is on the standard 12-month consultation cycle.

X. **Fourth Amendment.** Australia has yet to accept the Fourth Amendment to the Articles of Agreement. The relevant legislation is scheduled to go before the Senate in February 2001.

STATISTICAL ISSUES

1. Australia publishes a wide array of economic and financial data. It has subscribed to the Special Data Dissemination Standard (SDDS) and its metadata are posted in the Dissemination Standards Bulletin Board (DSBB). The authorities are working toward the completion of a National Summary Data Page. It is expected that the NSDP will be linked to the DSBB soon. Australia began posting its international reserves and foreign currency liquidity data template in April 2000.

2. During the year 2000, the Australian Bureau of Statistics (ABS) undertook a wide-ranging agenda of projects and initiatives, such as: the evaluation of the impact of the New Tax System on price indexes and the National Accounts (NA) statistics; the evaluation of the impact of the Olympic games on statistical indicators; the continuation of the move from cash to accrual Government Financial Statistics; the introduction of a new series (the 14th series) of the CPI and a new, Stage of Production Producer Price Index; the publication of satellite accounts for the tourism sector; the publication of revised and still experimental figures for capital services and total factor productivity; and the launch of a series of new initiatives in the area of service industries, and financial and international statistics.

A. Real Sector

National Account

3. Substantial revisions have been made in 2000 to many aggregates of the National Accounts, mainly resulting from the incorporation of improved methodologies used to compile estimates of property income flows and financial intermediation services indirectly measured. These changes have contributed to revised growth rates for the finance and insurance industry and household consumption expenditure.

4. The ABS has been estimating the impact of the New Tax System (NTS) on the National Accounts (NA), which occurs through several channels. As for the direct impact, since it is a deductible tax, the GST is recorded only as being paid on final uses, in accordance with the net method of recording prescribed by the System of National Account 1993. As the GST raises more revenues than the taxes on production that it replaces, nominal GDP (under the income measure) will increase as a result of the introduction of the tax. However, it will have no effect on the chain volume measures of the GDP and other aggregates. Other indirect effects on the NA, through the changes in consumer and firm behavior, are more difficult to quantify. Due to this difficulty, it will not be possible to reflect the introduction of the NTS as a break in the trend for many NA time series, and the estimates of these trends will inevitably be affected.

5. Another important task for the ABS this year has been to assess the impact of the Olympic games on the Australian NA statistics. On the expenditure side of the GDP account, the impact from the Games has been mainly on net exports and household final consumption expenditure (recreation and culture). Consistent with the accrual accounting standard,

revenues from the television rights and ticket sales (totaling around \$A 1.6 billion) were recorded in the period in which the Games took place (Q3 2000), regardless of when the payments were made. On the other hand, revenues from sponsorships and merchandising (totaling around \$A 1 billion) were recorded when the payments were made. This has contributed to smoothing the impact of the Games over a relatively long period of time, together with the impact of economic activity associated with the lead-up to the Games (especially infrastructure construction). The positive impact on tourism is expected to have generated (and to generate in the future) significant additional economic activity, even if it is difficult to estimate the substitution effect (activity that would have taken place even without the Games).

6. From the 1997–1998 edition of the System of National Accounts (SNA), ABS publishes new estimates for the capital stock and multifactor productivity. Major changes include the inclusion of the finance and insurance sector and estimates of the “productive capital stock.” To obtain this series, a much more detailed set of capital assets is first identified, each with its own age–efficiency profile, and then aggregated with asset–specific user costs as weights. These estimates are still experimental and the 1998–1999 edition of the SNA contained significant revisions to capital estimates for earlier years. Three major initiatives are under way in this area: (i) the development of industry MFP estimates, obtained on a gross output basis (these estimates will not be available for a couple of years); (ii) the development of quality–adjusted labor input measures; and (iii) the development of hedonic prices indexes for different capital assets (at the moment, ABS uses hedonic prices estimated by the US Bureau of Labor Statistics only for computers and peripherals).

Prices

7. The ABS estimated the impact of the new Good and Service Tax (GST) on the CPI through a constant tax measure of the CPI (ignoring second and subsequent round effects). However, as the ABS notes, this measure suffers from two major limitations. First, assessing the exact amount of the wholesale sales tax (WST) implicit in the final prices would require additional price information (before and after the introduction of the WST), or the knowledge of margins between wholesale and final prices. As the ABS does not have this information, the WST is not captured correctly. Second, as the GST is levied at the retail price level, the constant tax rate measure tends to ignore the removal of embedded taxes. Due to these limitations the ABS estimate of the GST impact on the Q3 CPI turned out being implausibly low (1.7 percent), well below the 3¼ percent initially expected and the Treasury’s ex-post estimate of 2.8 percent. An adjusted measure (constructed by estimating the effective wholesale sale tax contained in alcohol prices using margin information) shows a total impact of 2.3 percent. In theory however, as the effects of the distortions (discussed above) go in opposite directions, it is difficult to say what the result would be if a constant fiscal take measure of the pre–GST CPI index was used. The ABS has thus decided not to publish estimates of the impact of GST for the subsequent quarters.

8. To ensure that the CPI continues to be a reliable measure of price inflation after the implementation of the new tax system, the Australian Bureau of Statistics (ABS) has

introduced the 14th series CPI. The new series reflects a change in the weights, which are taken from the most recent household expenditure survey (1998/99), replacing those derived from the 1993/94 edition of the survey. Another change in the series is the introduction of a new, utility-based classification of goods. The updated classification will assist in addressing possible substitution by consumers between commodities in response to relative price changes.

9. The ABS has started publishing in July 2000 a new quarterly price series, the Stage of Production (SOP) price index. This series brings together the existing range of producer price indexes and the newly developed ones relating to a range of service industries. While each of these indexes refers to a particular industry and is built on a net-sector basis (thus excluding transactions between establishments classified in the same sector), the SOP is an economy-wide index, based on an economic categorization of transactions according to their sequencing in the production chain, and allows for analyses of price change as commodities flow through the production process.

10. The ABS launched in April 2000 a new quarterly Producer Price Index for Selected Service Industries, containing price indices series for important freight transport industries, property services (such as real estate agents and the hire and lease of machinery and equipment), and a diverse range of business services (including surveying, computer services, accounting services, market research, etc.). In addition to the development of a service industry PPI, the quarterly survey of inventories and sales, which traditionally only collected sales from the manufacturing and wholesale industries, was extended to cover to service industries from March quarter 1999. Further, the Economic Activity Survey has been extended to provide a more detailed annual picture of financial data for the service sector. The second set of experimental series were released in December 1999 and the first production series was published in December 2000.

Other

11. With the introduction of the Australian Business Register (ABR), and the assignment of an Australian Business Number (ABN) that uniquely identifies all businesses operating in Australia with a turnover of at least \$A 50,000, a wealth of business taxation data is available for statistical purposes. Two examples of the future use of the ABN are: (i) a study that will try to specify how and to what extent Australian businesses are hedged against foreign currency exposure (the result of this project, partly funded by the RBA, will be available later in 2001);¹ and (ii) a study that will evaluate the profile of Australian importers and exporters of goods and services, including the services provided abroad by foreign branches and subsidiaries of Australian businesses.

¹ A pilot study of the foreign exchange exposures and hedging activities of the four major commercial banks was published by the RBA in the August 2000 *Bulletin*.

12. A notable new initiative is the preparation of a quarterly economy-wide survey (QEWS) that will bring together a number of current quarterly surveys, thereby improving the coherence and consistency of the data. The first phase of this project has involved large businesses, while smaller businesses will be inducted in the QEWS from March 2001.

B. Fiscal Sector

13. The ABS has continued to move its government finance statistics from a cash to an accrual basis. All states are now reporting their fiscal data on an accrual basis, with the exception of Tasmania and the Northern Territory. Also, the majority of local government transactions report on an accrual basis. The shift to an accrual basis has not been without difficulties, as the fiscal numbers have shown a higher volatility and the seasonality patterns have changed, with a (temporary) negative effect on the quality of NA statistics. It is also likely that the original data for some aggregates will be subject to greater revision than has previously been the case, because it will take time for general government accounting systems to fully adjust to the new accrual system.

C. External Sector

14. Several changes have been introduced in the presentation of, and details available in, the financial account of the balance of payment (BoP) and the international investment position (IIP). In particular, financial derivatives are shown separately from portfolio investments in the financial account. Further, ABS announced that it would report financial derivatives separately from other securities within the reserve assets item in the IIP. A new table has also been added to the IIP reporting foreign debt by: (i) the currency in which assets and liabilities are likely to be repaid, and (ii) residual maturity. From the September quarter 2000, this table will allocate financial derivatives to the appropriately residual maturity categories.

D. Official Reserves and Debt

15. Timely data are publicly available on the aggregate level of foreign reserves and debt and the forward position of the Reserve Bank of Australia (RBA). Since April 2000, the RBA has started publishing greater details on holdings of official reserve assets, including monthly data on the currency composition and maturity profiles of reserves.

Australia: Core Statistical Indicators
(As of January 29, 2001)

	Exchange Rates	Official Reserves	Reserve/ Base Money	Central Bank Balance Sheet	Broad Money	Interest Rates	Consumer Price Index	Exports/ Imports	Current Account Balance	Overall Govt Balance	GDP/ GNP	External Liabilities
Date of latest observation	01/29/01	12/00	11/00	17/01/01	11/00	01/29/01	12/00	11/00	9/00	11/00	9/00	9/00
Date received	01/29/01	01/08/01	29/12/00	19/01/01	29/12/0	01/29/01	24/01/01	04/01/01	30/11/00	05/01/01	13/12/01	30/11/00
Frequency of data 1/	D	M	M	W	M	D	Q	M	Q	M	Q	Q
Frequency of Reporting 1/	D	M	M	W	M	D	Q	M	Q	M	Q	Q
Source of data 2/	C	N 5/	N	N	N 5/	C	N 5/	N 5/	N 5/	N 5/	N 5/	N 5/
Mode of reporting 3/	E	E	E	E	E	E	E	E	E	E	E	E
Confidentiality 4/	C	C	C	C	C	C	C	C	C	C	C	C
Frequency of publication	D	M	M	W	M	D	Q	M	Q	Q	Q	Q

1/ D-daily; W-weekly; M-monthly; Q-quarterly; or A-annually.

2/ A-direct reporting by central bank, ministry of finance, or other official agency; N-official publication or press release; P-commercial publication; C-commercial electronic data provider; or E-EIS.

3/ E-electronic data transfer; C-cable or facsimile; T-telephone; M-mail; or V-staff visits.

4/ A-for use by the staff only; B-for use by the staff and the Executive Board; C-unrestricted use; or D-embargoed for a specific period and thereafter for unrestricted use.

5/ A less detailed breakdown of these items is obtained from Reuters before the official publication is received.

**Statement by the IMF Staff Representative
March 2, 2001**

1. This buff contains information that has become available since the staff report (SM/01/42) was circulated to the Executive Board on February 8, 2001. This information does not affect the staff appraisal.

2. **Recent monthly indicators continue to point to slowing output growth.** Foremost amongst these are:

- the rise in the unemployment rate to 6¾ percent in January;
- the fall in company profits—below the cyclical peak reached in the first half of 2000;
- the decline in the business conditions index in January to its lowest level since December 1992, deteriorating consumer sentiment, and a decline in the leading index of economic activity;
- the 7 percent (m/m) decline in import values in January (lowering year-on-year growth to 4½ percent);
- and continued slow growth in credit, although there are signs of a recovery in lending to the housing sector.

3. **Recent data also indicate that wage and inflation pressures remain moderate.** The RBA's preferred Wage Cost Index rose by 0.8 percent in the December quarter (3.4 percent, y/y); while average weekly ordinary time earnings rose only 0.3 percent in the December quarter, taking the annual rate down to about 5 percent (from about 6 percent in the September quarter). Also, the index of consumer inflation expectations fell further to 3.7 percent in February, the lowest level since December 1998.

4. **In the financial markets, the recovery of the \$A that began at the end of 2000 has reversed,** reflecting both renewed strength of the US dollar, and increasing uncertainty about the course of the Australian economy. The \$A is now back near its November low, having lost 6 percent against the US dollar and about 4 percent in nominal effective terms since the start of the year. Long-term government bond yields remain at around 5¼ percent, 30 basis points above comparable US Treasuries.

5. **On the policy front, the government has made some changes to tax plans in response to political concerns, although the revenue impact of these changes is estimated to be small.** First, the plan to modify the taxation of trusts has been shelved in the face of opposition from rural land owners and farmers (who use trusts as a way of preserving their assets for future generations). Second, the government has cut the fuel tax by 1.5 cents a liter (a 4 percent reduction in the fuel excise level) and has put on hold the planned inflation-linked increases in the tax. It is estimated that these measures will reduce revenues by about 0.1 percent of GDP per year.



INTERNATIONAL MONETARY FUND

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Public Information Notice (PIN) No. 01/27
FOR IMMEDIATE RELEASE
March 21, 2001

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

IMF Concludes Article IV Consultation with Australia

On March 2, 2001, the Executive Board concluded the 2000 Article IV consultation with Australia.¹

Background

In 2000, Australia entered the tenth year of an impressive economic expansion characterized by strong productivity growth and low inflation. Since the current expansion began in the third quarter of 1991, growth has averaged 4¼ percent per annum. The comprehensive reforms undertaken since the mid-1980s have fostered a more competitive and outward-oriented economy, which, with sound and flexible macroeconomic policies, enabled Australia to make a remarkably smooth passage through the Asian financial crisis.

Growth was robust during most of 2000 but there are now signs of a moderation. Through September 2000, the economy grew at an annual rate of 4¼ percent supported by a strengthening of net exports. Although trends in domestic demand have been difficult to read owing primarily to the effects of the introduction of the New Tax System (TNTS) in July 2000 and the summer Olympic games in September 2000, there appears to have been a marked slowing in domestic demand the third quarter. Private dwelling investment, which surged in the first half of 2000 as spending was brought forward to avoid less favorable tax treatment under the GST, fell off sharply in the September quarter. As for business investment, machinery and equipment investment continued to exhibit strength, while spending on buildings and structures continued to be weak following the completion of several large mining projects and Olympics-related construction. Other signs of a softening in activity include the slowing of

¹Under 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. 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. This PIN summarizes the views of the Executive Board as expressed during the March 2, 2001 Executive Board discussion based on the staff report.

employment growth and the uptick in the unemployment rate from its low point of 6 $\frac{1}{3}$ percent in September 2000 to 6 $\frac{1}{2}$ percent in December.

Underlying inflation (abstracting from the impact of the TNTS and rising fuel prices) has remained within the RBA's 2-3 percent target band, but there are some signs of upstream price pressures. Headline inflation shot up to 6 percent (y/y) in the September and December quarters, but abstracting from the impact of TNTS (estimated to be about 3 percent) and excluding volatile items such as oil, underlying inflation is now close to the lower end of the RBA's target band. However, producer prices, manufacturing output prices and import prices have all been rising markedly across a range of components. As for wages, the wage cost index was up only about 3 $\frac{1}{2}$ percent (y/y) in the fourth quarter, and other measures of wage growth have also remained moderate.

A major event in 2000 was the sharp weakening in the value of the \$A over the course of the year, at the same time that other indicators of market perception remained generally favorable. Belying the strength of economic fundamentals, the \$A fell by about 20 percent against the U.S. dollar between January and November 2000, notwithstanding some foreign exchange market intervention in the last 4 months of the year. Following a modest rebound in December and January, the exchange rate has fallen again. However, other indicators of market sentiment toward Australia have remained favorable. The Australian equity market performed better than most countries in the region in local currency terms, and spreads on long-term government bonds and on private sector debt remained steady. Moreover, S&P recently confirmed Australia's AA+ rating, citing the high level of net external liabilities as the primary reason for Australia remaining shy of the AAA rating.

As a result of the exchange rate depreciation and favorable terms of trade movements, the current account improved markedly from a peak of over 6 percent of GDP in the second quarter of 1999 to 3 $\frac{1}{3}$ percent of GDP in the third quarter of 2000. Even abstracting from the effect of the Olympics, which boosted the third quarter outcome, the trend current account continues to improve strongly. Capital flows in the first three quarters of 2000 were characterized by a fall in equity flows and a rise in debt financed flows. Overall, net foreign liabilities increased to 63 $\frac{1}{2}$ percent of GDP in September 2000 from about 60 percent of GDP at end-1999.

The interest rate tightening cycle launched in November 1999 in response to signs of rising price pressures ended in mid-2000, and monetary policy began to be eased in early 2001, with the 50 basis point cut in rates. Recent data suggest that the increases in official interest rates—by 150 basis points between November 1999 and August 2000—have started to bite into private sector credit growth, which has begun to ease from the peak of 13 $\frac{1}{2}$ percent in August to 12 percent in January 2001, with growth in both housing and other personal credit recording a slowdown.

The degree of easing of fiscal policy in 2000/01 is likely to be smaller than originally anticipated. The 2000/01 Budget released in May 2000 contained only modest new initiatives in health and families and communities assistance, and a scrapping of the previously planned Timor tax. However, the major overhaul of the tax system that came into effect July 1, 2000,

implied a significant net revenue loss. As a result, the accrual surplus was envisaged to decline from 1.5 percent of GDP in 1999/00 to 0.8 percent of GDP in 2000/01. (In the event, the surplus in 1999/00 turned out to be 2.1 percent of GDP reflecting stronger than expected growth and profits). However, the mid-year review of the 2000/01 budget and economic outlook announced in November raised the projected surplus for 2000/01 to 1.2 percent of GDP. This stronger fiscal outlook reflects both one-off factors that will boost GST revenues in 2000/01 (which indirectly strengthens the Commonwealth's fiscal position) and higher revenues resulting from stronger income and profit growth, which will be only partially offset by higher expenditures.

The near-term outlook is for the pace of growth to continue to moderate over the year ahead. Recent indicators suggest continued slowing in consumption growth; dwelling investment is likely to remain weak, although activity in this sector is showing signs of bottoming out. Serving as a limit to the deceleration, business investment is likely to continue to grow. Overall, the staff forecasts that growth will slow from 4¼ percent in 2000 to 3¼ percent in 2001; the unemployment rate is expected to decline gradually to below 6¼ percent by end-2001 and the current account deficit is expected to remain at around 4¼ percent of GDP. Underlying inflation is expected to rise to the top of the 2-3 percent target range by mid-2001 and decline modestly thereafter. The main downside risk is of a hard landing in the U.S. and a sharp slowdown in Australia's main export markets, the likelihood of which has increased in recent weeks. However, even as the economy slows, a stronger rise in inflation from pressures still in the pipeline cannot be ruled out. Medium-term prospects remain generally favorable with growth projected to range from 3½-3¼ percent, the current account deficit to narrow to around 2½ percent of GDP, and net external liabilities to fall to around 60 percent of GDP.

Recent structural reforms efforts have focused on a continuation of labor market reforms aimed at further enhancing labor market flexibility; the launch of a gradual reform of the welfare system; measures to encourage innovation and entrepreneurship; and a comprehensive review of laws that restrict competition.

Executive Board Assessment

Executive Directors commended the authorities on the continued solid economic performance—characterized by robust economic growth during the past 10 years, broad-based productivity increases, and low inflation—which they attributed to prudent macroeconomic management and the sustained implementation of wide-ranging structural reforms since the mid-1980s.

Citing the moderation in economic growth since the latter part of 2000, the slowdown in world economic growth, and the absence of inflationary pressures, most Directors endorsed the recent cut in official interest rates. Nevertheless, Directors pointed out that, with tax cuts and increases in welfare benefits delivering some fiscal stimulus to the economy, and with the competitive exchange rate boosting net exports, economic growth prospects remained favorable. This assessment, and lingering concerns that inflationary pressures could emerge, led most Directors to recommend a cautious approach to further interest rate reductions.

Directors provided several comments on the methods used by the Reserve Bank of Australia to conduct the targeting of inflation, and broadly commended its pragmatic approach. Directors considered that the shift from semi-annual to quarterly policy statements will reinforce the already high degree of credibility and transparency of monetary policy, and some suggested that the issuance of brief statements after board policy meetings would further strengthen transparency.

Directors noted that the downward pressure on the Australian dollar during much of 2000, which occurred despite strong economic fundamentals, had made possible a marked reduction in the current account deficit. They supported the authorities' pragmatic approach to coping with the depreciation, which was concerned with addressing the inflationary consequences rather than with defending a specific exchange rate. Directors agreed that, while limited intervention can be helpful to stabilize the foreign exchange market, intervention would be futile in the face of sustained market pressure.

Although the mid-year budget review showed a strong fiscal position, Directors advised the authorities to keep public spending under close scrutiny to maintain investor confidence. They therefore welcomed the authorities' assurances that the fiscal initiatives being planned to meet the government's policy priorities in the pre-election period will contain only limited, well-targeted increases in spending, consistent with the policy of maintaining fiscal surpluses in periods of healthy growth.

Directors observed that the means-tested publicly provided age pension, the mandatory private superannuation scheme, and the tax incentives for additional voluntary saving provide a suitable framework for retirement income support over the longer term, while limiting the fiscal burden. They were more concerned about rising health care costs. Given the commitment to a strong public health care system, Directors considered that it would be prudent to run modest cyclical fiscal surpluses or develop other mechanisms to mobilize resources for future increases in health spending.

Directors noted that prudent economic management had created a dynamic, flexible economy that was well-positioned to withstand external shocks. They pointed to the narrowing of the current account deficit, the apparently limited impact of the sharp currency depreciation on balance sheets, and the generally strong financial sector indicators as evidence of this. In their view, these favorable external vulnerability indicators and the recent experience of adjustment to shocks indicated that external risks are manageable. Directors emphasized, however, that the high degree of external exposure underlines the importance of continued prudent fiscal policy and firm regulatory oversight of the financial system.

Directors cautioned that the structural reform effort must be sustained if Australia is to retain its place among the leaders in productivity growth. They felt that, in fostering the "new economy," Australia is most likely to maximize its growth potential by focusing on policies that promote innovation and technology absorption in industries and sectors in which it has a comparative advantage. They therefore welcomed recent initiatives to implement the recommendations of the Innovation Summit Implementation Group, including support for research and development and strengthened higher education, and encouraged the authorities to lower the top marginal

tax rate to bolster Australia's capacity to develop and retain technical and entrepreneurial skills.

Directors acknowledged the inherent political difficulties with industrial relations reforms, but noted that the potential payoff in terms of growth and employment is likely to be significant, and welcomed the authorities' commitment to pursuing further actions in this area. They supported the introduction of legislation to streamline the awards system, turning it more into a safety net than a device for setting wages and working conditions, and to increase labor market flexibility.

Directors welcomed the steps being taken to reduce disincentives to workforce participation and endorsed the view that the welfare system should provide greater incentives for people to move from welfare to work. They emphasized that the biggest challenge will be to achieve these objectives in a manner consistent with fiscal prudence and with the government's commitment to leave no group materially worse off.

Directors also welcomed the continuing review of legislation that restricts competition. They also encouraged the authorities to eliminate the remaining low tariffs, and to make more concrete the timetable for eliminating tariffs in the other items by 2010. Finally, several Directors encouraged the authorities to increase their official development assistance from its current level to the United Nations target and to increase its market access to developing countries.

Directors acknowledged that, in many respects, Australia is at the forefront of the production and dissemination of high quality economic and financial statistics, and welcomed the ongoing efforts to improve these statistics.

Public Information Notices (PINs) are issued, (i) at the request of a member country, following the conclusion of the Article IV consultation for countries seeking to make known the views of the IMF to the public. This action is intended to strengthen IMF surveillance over the economic policies of member countries by increasing the transparency of the IMF's assessment of these policies; and (ii) following policy discussions in the Executive Board at the decision of the Board.

Australia: Selected Economic and Financial Indicators 1/

	1995/96	1996/97	1997/98	1998/99	1999/2000
Real economy					
Real GDP	4.4	3.6	4.8	5.4	4.3
Real domestic final demand	3.8	3.8	5.7	5.3	5.2
Real exports	10.3	10.4	3.7	1.9	.9.4
Real imports	4.0	9.8	9.7	4.9	12.8
Headline CPI inflation	4.2	1.3	0.0	1.2	2.4
Underlying CPI inflation 2/	3.2	2.1	1.5	1.7	2.1
Unemployment rate (in percent)	8.4	8.6	8.3	7.6	6.9
Gross national saving (percent of GDP) 3/	18.2	19.0	19.5	19.1	19.4
Gross capital formation (percent of GDP)	22.5	22.4	23.6	24.8	24.1
Public finance					
Commonwealth budget					
Revenue	23.9	24.4	24.0	24.6	26.2
Underlying expenditure 4/	25.9	25.4	23.8	23.7	24.2
Underlying balance 4/	-2.0	-1.0	0.2	0.9	2.0
Headline balance	-1.0	0.4	2.9	1.9	2.7
Public sector underlying balance 4/	-1.4	-0.1	1.1	-0.2	2.1
Money and credit					
M1 (change in percent)	12.7	14.3	11.6	7.6	9.8
M3 (change in percent)	10.2	10.5	6.2	10.3	8.2
Private domestic credit (change in percent)	12.5	10.1	11.1	10.9	13.1
Interest rate (90-day, in percent)	7.6	5.4	5.3	4.8	6.2
Government bond yield (10-year, in percent)	8.9	7.1	5.6	6.3	6.2
Balance of payments					
Current account balance	-21.7	-17.8	-22.9	-33.7	-33.9
(In percent of GDP)	-(4.3)	-(3.3)	-(4.1)	-(5.7)	-(5.4)
Capital and financial account	19.0	18.7	24.4	30.3	32.9
Gross reserves (US\$ billions)	15.0	17.0	14.9	15.8	16.7
External liabilities					
Gross external debt	275.5	302.5	345.3	348.0	403.9
Net external liabilities	280.7	298.1	318.7	353.3	395.5
(In percent of GDP)	(55.4)	(56.0)	(56.4)	(59.3)	(62.6)
Exchange rate					
US\$/A\$	0.789	0.745	0.614	0.660	0.599
Nominal effective exchange rate 5/	113.4	112.7	98.8	105.6	95.8
Real effective exchange rate 5/	95.3	92.8	80.9	87.1	80.9

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

1/ Fiscal year ends June 30; some fiscal year aggregates are cumulated on seasonally adjusted quarterly data.

2/ The official series has been discontinued in 1999. The figure for 1999-2000 is a Fund staff estimate.

3/ National accounts basis, as measured by the authorities.

4/ Underlying expenditure and balance exclude asset sales and other one-off factors.

5/ IMF Information Notice System index (1990 = 100).