October 2003
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Australia: 2003 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 the2003 Article IV consultation with Australia, the following documents have been released and are included in this package:

- the staff report for the 2003 Article IV consultation, prepared by a staff team of the IMF, following discussions that ended on **June 30, 2003,** 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 September 3, 2003.** The views expressed in the staff report are those of the staff team and do not necessarily reflect the views of the Executive Board of the IMF.

- a staff statement of **October 22, 2003** updating information on recent developments.

- a Public Information Notice (PIN) summarizing the **views of the Executive Board as expressed during its October 22, 2003 discussion** of the staff report that concluded the Article IV consultation.

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

Selected Issues Paper

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

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

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INTERNATIONAL MONETARY FUND

AUSTRALIA

Staff Report for the 2003 Article IV Consultation

Prepared by the Staff Representatives for
the 2003 Consultation with Australia

Approved by David Burton and Leslie Lipschitz

September 3, 2003

- The 2003 Article IV consultation discussions were held in Sydney, Melbourne, and Canberra during June 19–30, 2003.

- The mission team consisted of Mr. Kronenberg (head), Mr. Senhadji, Ms. Ramakrishnan, and Mr. N'Diaye (all APD). Mr. Dunaway (APD) also participated in the discussions, and Mr. Callaghan (Executive Director) attended the meetings in Canberra. The mission met with Treasurer Costello, Reserve Bank of Australia Governor Macfarlane, Treasury Secretary Henry, other senior government officials, and representatives of labor unions, 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 accepted the Fourth Amendment to the Articles of Agreement in June 2001.

- 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).

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Executive Summary

Economic Background:

- **Australia's economy has continued to perform very well.** Despite the global slowdown and a severe drought, growth in 2002 was 3.6 percent, inflation remained low, the budget recorded a small surplus, and public sector net debt fell to below 10 percent of GDP.

- **Real GDP growth is expected to slow to 3.0 percent in 2003, given weaker domestic demand, the sluggish external environment, and the sizable appreciation of the exchange rate.** The short-term outlook is subject to considerable risks, including continued soft external demand, a resumption in the sharp appreciation of the Australian dollar, uncertainties about the recovery from the drought, and a rapid cooling off in the housing market.

Policy Discussions:

- **The authorities and staff generally agree on the appropriate macroeconomic policies for the short- to medium-term and on the key elements in the authorities' strategy to deal with Australia's longer-term policy challenges.**

- **The Reserve Bank of Australia has kept monetary policy on hold since June 2002.** The timing of a change in monetary policy is complicated by continued strong housing demand and rising prices. Nonetheless, interest rates should be lowered if indicators point to a marked deterioration in economic prospects.

- **The stance of fiscal policy remains fundamentally sound.** Owing to the strength of the economy and buoyancy of revenues, potential fiscal resources going forward were envisaged to be sufficient to meet the government's basic fiscal objective and to fund spending in the high priority areas of defense and health care and to cut personal income taxes.

- **While medium-term prospects remain generally favorable, policy actions will be needed to sustain strong economic performance over the longer term, especially in view of the pressures arising from an aging population.** The authorities' strategy focuses on policies to raise labor participation and maintaining productivity growth. This entails continuing sound and stable macroeconomic policies, maintaining competitive product markets, investing more in education, enhancing labor market flexibility, and reforming the tax and income support systems. Specific policy measures to enact this strategy and the fiscal measures required to fund them have not yet been identified.

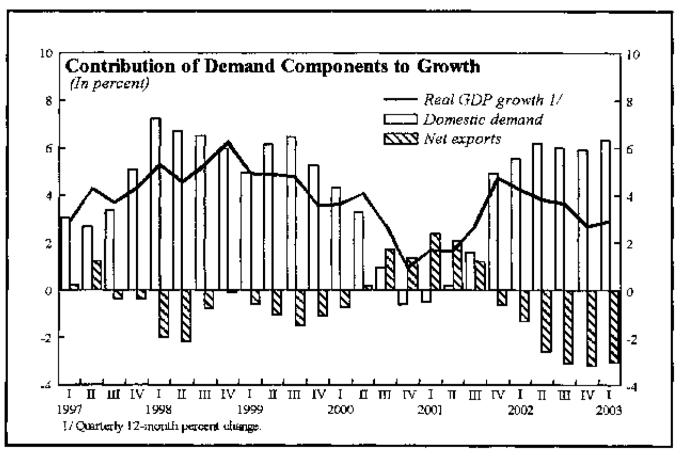
I. Economic Developments and Outlook

A. Introduction

1. **Australia's economy has outperformed most other advanced countries in recent years, reflecting adherence to a credible macroeconomic policy framework and continued progress in implementing structural reforms.** At the conclusion of the 2002 Article IV consultation on September 16, 2002, Executive Directors commended the authorities for the foundation that had been established by sound economic policies, including fiscal consolidation, the adoption of an inflation-targeting framework, and structural reforms. On fiscal policy, Directors considered that reforming the personal income tax system should be a major priority to enhance incentives to work, save, and invest. They also agreed that further reforms were needed to simplify the income support system and to enhance labor market flexibility. In general, there has been agreement between the authorities and the Fund on macroeconomic policies over the years. The authorities also have long recognized that continued progress in implementing structural reforms would be required to maintain and enhance Australia's growth performance, which would help in addressing Australia's longer-term challenges. In particular, they consider additional reforms of the industrial relations, income tax, and welfare systems to be among their top priorities, and they have actively pursued policy actions in all of these areas.

B. Recent Developments

2. **Real GDP growth picked up from 2¾ percent in 2001 to just over 3½ percent in 2002, as buoyant domestic demand more than offset a weaker external environment and the onset of a severe drought.**[1] The strength of domestic demand reflected an easing of monetary policy in 2001 (which was only partially reversed in 2002), further moderate fiscal stimulus during 2001/02, an improvement in the terms of trade, and a competitive exchange rate. Growth in household demand was particularly strong, with private consumption growth picking up from around 3 percent in 2001 to 4 percent in 2002. Low interest rates and government incentives to first-time homeowners contributed to a 25 percent rise in residential construction. Rapidly



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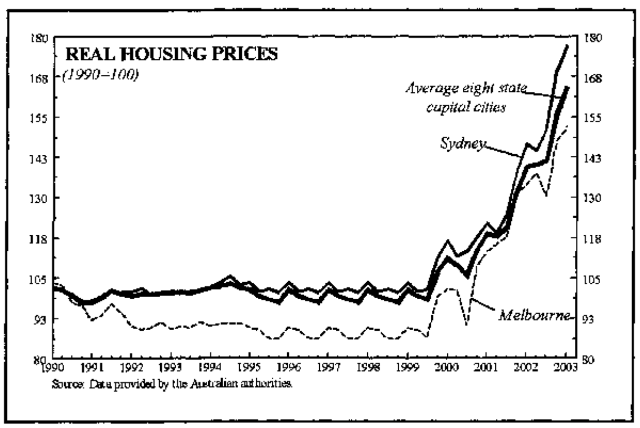
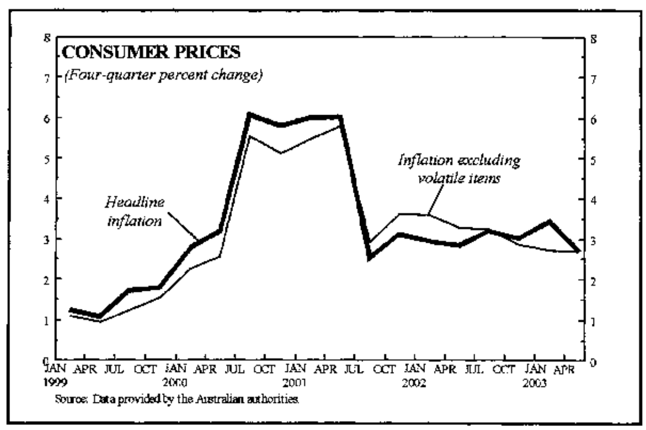
[1] The drought is considered to be the worst in the last century. It is estimated to have directly subtracted nearly 1 percentage point from GDP growth during fiscal year 2002/03 (year ending in June).

increasing real property prices may also have contributed to strong demand in the investor segment of the housing market. Business investment rebounded in 2002, led by a 24 percent increase in nonresidential construction and a 10 percent rise in equipment purchases. In contrast, net exports declined sharply due to the divergent cyclical positions in Australia and other major economies, and the impact of the 2002 drought. As a result, the external current account deficit widened from 2.4 percent of GDP in 2001 to 4.4 percent in 2002. Employment growth picked up, bringing the unemployment rate down from 6.8 percent at end-2001 to 6.1 percent at end-2002.

3. **GDP growth slowed to 2.7 percent in the first quarter of 2003, as weak foreign demand, appreciation of the currency, and the drought placed a substantial drag on exports and consumption softened.** Business investment continued to post strong gains, although it grew more slowly than in 2002. Subsequently, indicators of economic activity have been relatively mixed. Consumer confidence and retail sales, which dipped prior to the Iraq war, have recovered, and the unemployment rate, at 6.2 percent in July, remains close to its historical low; however, employment has declined in recent months. While lending to the housing sector has continued to expand at a rapid pace (21½ percent in June 2003 on a year-on-year basis), rental vacancy rates have risen, and rents and new construction approvals have fallen.

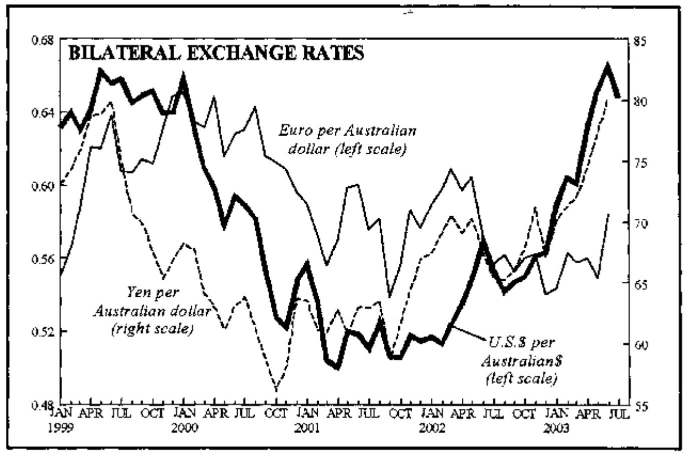
4. **Inflation has remained in check.** CPI inflation picked up to an annual rate of 3.4 percent in March 2003 reflecting a temporary run-up in petroleum prices and the drought-related food price increases, but it eased to 2¾ percent in June 2003, as oil prices subsided and the Australian dollar appreciated. Measures of core inflation have remained relatively stable within the Reserve Bank's 2–3 percent official target range. Housing prices have continued to post strong gains, with the index of real property prices in major cities rising by 18½ percent in 2002 and some 46 percent over the past three years (Box 1).[2]





[2] An analysis of the Australian housing market, including an empirical assessment of housing price developments, will be presented in the forthcoming *Selected Issues* paper.

5. **The Australian dollar, which weakened during 2000–01, has strengthened markedly over the past year and a half.** From its low of US¢ 50.7 in February 2002, the Australian dollar appreciated by 11¾ percent against the U.S. dollar and by 2½ percent on a real effective basis by end-2002. During the first half of 2003, it appreciated by an additional 17¾ percent against the U.S. dollar and by 9¾ percent on a real effective basis. During July, the Australian dollar moved off its recent high of US¢ 68.4, settling at around US¢ 65 in August. Currently, the exchange rate is about 1¼ percent higher on a real effective basis than its ten-year average and 7¼ percent lower than its previous peak in December 1996. Given the strength of the Australian currency over the past year, the Reserve Bank of Australia (RBA) purchased U.S. dollars. Official reserves, net of swaps commitments, were $A 11.2 billion in June 2003, up from $A 8 billion in April 2002.



6. **Monetary policy has been used effectively for countercyclical purposes.** In response to slowing growth, the RBA cut the short-term cash rate six times during 2001 to a post-war low of 4¼ percent. Monetary conditions also eased as a result of the depreciating Australian dollar. As domestic demand recovered, the RBA raised the cash rate by a total of 50 basis points in May–June 2002 to 4¾ percent, where it has remained. As the Australian dollar has appreciated against the currencies of the major trading partners, monetary conditions have tightened somewhat further over the past year.

7. **The May 2002 Budget was intended to withdraw some of the fiscal stimulus that had been injected in the previous two years.**[3] With the domestic and international economic environment expected to strengthen, the Commonwealth budget and the state and local government sector were projected to be in approximate balance in 2002/03. In the event, Australia's participation in the war in Iraq resulted in some unanticipated defense and security expenditures, while growth was slightly weaker than had been expected. Nevertheless, revenues proved to be surprisingly robust, and the Commonwealth budget is estimated to have recorded an underlying cash surplus of ½ percent of GDP in 2002/03.

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[3] A fiscal impulse of about 1 percent of GDP was injected in 2000/01 and 2001/02. In 2000/01, the fiscal stimulus arose principally from income tax cuts, while in 2001/02 a large part of the stimulus reflected the need to strengthen defense and domestic security expenditure. Despite the easing of fiscal policy, total net public sector debt declined further to around 10½ percent of GDP in 2001/02.

8. **The May 2003 Budget contains a combination of tax cuts and modest expenditure increases which would leave the Commonwealth budget balance with small underlying cash surpluses in 2003/04 (0.3 percent of GDP) and over the medium term.** On the spending side, the budget maintains a focus on upgrading defense and domestic security and addressing weaknesses in health care and higher education. In all, the expenditure measures in the budget are slated to cost $A 1.7 billion (0.2 percent of GDP) in 2003/04 and $A 4.3 billion over three years. On the revenue side, the new budget raises the thresholds for the three marginal personal income tax rates. These tax cuts and other smaller revenue measures are estimated to cost $A 2.5 billion (0.3 percent of GDP) in 2003/04 and $A 8.1 billion over three years.

C. The Outlook

9. **Real GDP growth is expected to slow to 3.0 percent in 2003, reflecting less buoyant domestic demand, subdued global demand, and the ongoing effects of the drought.** Private consumption growth and residential construction are expected to moderate from their very rapid pace in 2002. Rising vacancy rates and softness in rents, along with reduced fiscal incentives for first-time home owners should contribute to a cooling of price pressures in the housing markets, although to date there is little evidence of this occurring. Business investment would continue to rise, but at a slower rate, after a surge in mining sector construction in 2002 and as capacity pressures generally ease across the economy. Net exports would decline further, reflecting weak foreign demand, the effects of the drought, and the appreciation of the Australian dollar during the first half of the year. As a result, the current account deficit is projected to widen further to 5¼ percent of GDP in 2003. Softer demand and the strong exchange rate are expected to keep underlying inflation around the middle of the RBA's 2–3 percent official target range.

10. **The short-term outlook is subject to considerable uncertainty.** The international environment poses significant risks. Although there are some signs that growth in the major industrial countries may be picking up, if external demand does not rise as expected and/or the Australian dollar appreciates further, the decline in net exports could be exacerbated and contribute to a scaling back of business investment. Near-term prospects could also be adversely affected by a continuation of the drought. Moreover, a rapid decline in housing prices could have significant adverse effects across the economy (Box 2).[4] Booms in housing prices in Australia have historically been followed by periods of relatively stable nominal prices, instead of declining ones.[5] However, a key difference in the current price run-up is the

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[4] The forthcoming *Selected Issues* paper examines the potential impact on private consumption of changes in housing prices.

[5] While in real terms, prices have declined from quarter to quarter at the end of previous booms, nominal prices have been largely unchanged.

important role played by investor demand for housing, and it is not known whether investor behavior in a softening housing market could contribute to a sharp fall in housing prices.

11. **Medium-term prospects remain favorable.** The existence of transparent monetary and fiscal policy frameworks, the absence of fiscal imbalances, and the government's commitment to carry forward the program of structural reforms should enable Australia to sustain growth in line with the economy's currently estimated potential of around 3¾ percent per year over the medium term. This would be consistent with a further modest reduction in the unemployment rate to about 5½ percent. A post-drought recovery in agricultural production would boost exports and reduce the current account deficit to around 4 percent of GDP over the medium term.

II. Policy Discussions

12. **The authorities and the staff generally agreed on the appropriate settings for macroeconomic policies in the short-to-medium term and on the key elements in the authorities' strategy to deal with Australia's longer-term policy challenges.** The discussions centered on: (i) the uncertainties surrounding the economic outlook and implications for the near-term stance of monetary and fiscal policy; (ii) longer-term pressures on the economy and the budget arising from the aging of the populations; and (iii) implementation of the authorities' strategy to deal with these longer-term pressures and the fiscal resources that are likely to be required to finance it.

A. Monetary Policy and the Exchange Rate

13. **The Reserve Bank of Australia has kept monetary policy on hold since June 2002.** Initially, despite strong domestic demand growth, concerns about the weak international economic environment and the drought influenced the RBA's decision. In early 2003, the situation changed as signs of slowing domestic demand emerged and monetary conditions tightened with the sharp appreciation of the Australian dollar. In June 2003, the RBA indicated publicly that it was considering lowering interest rates. The Bank, however, remained concerned about continued strong housing demand and rapid growth in housing prices and the effects a cut in interest rates might have on this market. The authorities and the staff agreed that, while the timing of a decision to lower interest rates was uncertain and complicated by the situation in the housing market, the Bank should move to ease monetary policy if indicators pointed to a marked deterioration in economic prospects. Subsequent to the mission, the RBA left policy unchanged at its regular reviews of the short-term cash rate in July and August as momentum in the economy held up, housing demand remained strong, and the exchange rate eased off of its late June high. In the *August 2003 Monetary Policy Statement*, the RBA indicated that, while the situation is still subject to considerable uncertainty, the external risks to the economy have receded, at least for the time being, with global prospects looking slightly better and the exchange rate no longer rising as quickly as it had in the first half of the year. At the same time, the risks posed by developments in credit and asset markets have not diminished. Given these considerations, and the current assessment of the economic outlook, the case for an easing was judged to have weakened since June 2003.

14. **In general, the authorities and the staff agreed that the sharp increase in housing prices in recent years appears to have been largely driven by fundamental factors.** A significant decline in long-term interest rates, robust employment and immigration, and increased availability of financing were all important contributing factors. The sharp rise in household mortgage debt resulting from the housing boom was not seen by the authorities as potentially posing significant balance sheet risks for the financial sector. The authorities, nonetheless, were generally concerned about the unsustainable rate at which housing prices were rising and were particularly concerned by the behavior of individuals purchasing housing for investment purposes. Further changes in fundamental determinants were not seen as supporting continued rapid increase in housing prices. The rapid rise in housing prices, coupled with low returns on alternative investments and the fact that housing in the past has tended to hold its value in market slumps, prompted a sharp rise in investor demand. Moreover, investor housing demand in the major cities has remained very strong, despite declining rents and rising vacancy rates. Since investors had not previously played as large a role in the housing market, the authorities were unsure how investors would behave if the rise in housing prices slowed appreciably or prices began to decline. Clearly, however, increased selling in a slowing housing market could precipitate and perpetuate a fall in prices. Hence, the authorities expressed some reluctance to reduce rates at this time to avoid fueling additional housing demand and a further substantial run-up in prices, which could simply set the stage for a sharp correction in housing prices and in economic activity in the future. As events have unfolded, the RBA's caution in reducing interest rate appears to have been justified.

15. **The appreciation of the Australian dollar over the past year appears to have been primarily linked to portfolio capital flows attracted by the relative strength of the Australian economy, interest rate differentials that favor investment in Australian dollar securities, and recent upgrades of Australia's credit ratings.** In part, the widening interest rate differential reflected the fact that, while monetary policy in Australia has been on hold, policies in other major economies have been eased. The authorities noted that the level of the real effective exchange rate in mid-2003 was basically in line with its ten-year average.[6] The sharp rise in the currency's value was one factor contributing to a growing external current account deficit. This was not expected to be a major problem if the exchange rate stabilized. However, if it appreciated substantially further, the near-term outlook for the economy could be materially worse. In the discussions, both the authorities and private sector representatives pointed out that the historically close relationship between the terms of trade and the real effective exchange value of the Australian dollar appears to have broken down in recent years. This was seen as suggesting that the Australian economy had become more balanced and might be less subject to cyclical shocks from the rest of the world via commodity prices than it had been in the past.

[6] The Consultative Group on Exchange Rates (CGER) assessment in August 2003 finds that the value of the Australian dollar is not significantly out of line with its estimated medium-term equilibrium value on a real effective basis.

B. Financial Issues

16. **Australia's banking system remains financially very healthy, with high levels of profitability and capital adequacy.** The authorities did not envisage any systemic risks in the sector, even though bank exposure to the housing sector had increased significantly in recent years. Mortgage debt was still viewed favorably by the banks, since the delinquency rate on mortgage loans remains very low (below 1 percent), and such debt represents about one-third of bank assets. Given the relative importance of mortgage debt, the Australian Prudential Regulation Authority (APRA) is conducting stress tests to ascertain how individual banks could weather a sharp decline in housing prices. Preliminary results of these tests suggest that, while a fall in housing prices could significantly affect the net income of individual institutions, bank capital was viewed as sufficiently robust and that this would not pose a serious risk of failure by any major institution. APRA representatives also indicated that close supervision of the banks' lending standards would have to be maintained.

17. **The nonbank segments of the financial sector also are generally sound, although some individual firms have faced difficulties; however, in light of recent developments, supervision is being strengthened.** APRA has already taken steps to improve supervision of the insurance industry and to strengthen its risk management practices, capital adequacy, and corporate governance, and it will implement other key recommendations of the Royal Commission investigating the failure of the insurance company HIH. In the superannuation industry, the Treasury and APRA are working on draft legislation that will further enhance the safety of the industry, based on the key recommendations of the Superannuation Working Group.[7] In particular, licensing would be required to ensure that all superannuation trustees have the capacity, competency, and means to look after the interests of superannuation fund members.[8] Trustees will also be required to provide to APRA a Risk Management Strategy as part of the trustee's application. In addition, a proposed standard will deal with the fitness and propriety of trustees.

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[7] In October 2001, in response to public concerns about the prudential framework governing superannuation, the government established the Superannuation Working Group (SWG), which reported its recommendations on 28 March 2002. The SWG and the Productivity Commission found that the superannuation regulatory regime, while generally effective, needed preventative maintenance to reflect modern prudential practices.

[8] Once the *Superannuation Safety Amendment Bill 2003* is passed, there will be a two year transition period that is expected to commence from 1 January 2004.

18. **Australia's vulnerability to adverse external shocks is considered to be low (Annex I).**[9] Although net foreign liabilities remain high, their level has broadly stabilized. Foreign debt has become more concentrated in private financial corporations, and its maturity has shortened, reflecting increased intermediation of flows by banks. The foreign currency component of external debt has risen, although the associated currency risk is mitigated through substantial hedging. Corporate and banking sector balance sheets remain strong, and they have proven in the recent past to be resilient to swings in exchange and interest rates. Household balance sheets also are reasonably sound, and they, too, have been resilient to past interest rate swings. Housing debt, which has risen rapidly in the last few years, is the sector's major liability and the largest single component of bank lending. Although the value of housing assets has increased more rapidly than housing debt due to the run-up in prices in recent few years, household balance sheets would weaken in the event of a major price reversal (especially in the investor housing segment of the market). This, alone, is unlikely to threaten bank solvency, given the banks' income positions and high capitalization, unless it was also accompanied by significant increases in both interest rates and unemployment.

19. **Australia is in full compliance with the recommendations of the FATF on money laundering, following the passage of the Suppression of the Financing of Terrorism Act 2002.** Australia has also ratified and implemented the OECD Convention on Combating the Bribery of foreign officials in international transactions.

C. Fiscal Policy

20. **The stance of fiscal policy as laid out in the May 2003 Budget remains fundamentally sound.** It is consistent with the authorities' primary goal of balancing the

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[9] Stress tests using the external sustainability framework template also do not suggest major concerns (Table 5). A large exchange rate depreciation produces (in a relatively static fashion) a sizable jump in the external debt to GDP ratio. However, no allowance is made for adjustments in response to the change in the exchange rate that would mitigate its effects over time. In particular, current account deficits and the build-up in foreign debt would be lower and GDP higher. These effects are illustrated by Australia's recent experience. From April 1997 to March 2000, the Australian dollar depreciated by 39 percent against the U.S. dollar, while the ratio of external debt to GDP rose by only 11½ percentage points. Moreover, in the event of a substantial depreciation, the mitigating influence of having foreign currency debt positions that are predominantly hedged (either by natural hedges or by financial derivatives) is not captured in the framework (for a discussion of Australia's substantial degree of hedging of foreign currency liabilities, see Annex I). Hedging instruments are not included in a country's international investment position because they are not financial assets in the case of natural hedges or they represent contingent claims in the case of financial derivatives.

budget on average over the course of the business cycle.[10] Pursuit of this objective provides the authorities with flexibility to deal with a possible deterioration in economic prospects by allowing the automatic fiscal stabilizers to function. Moreover, Australia's very sound budgetary position affords the scope to take discretionary fiscal policy actions if need be, and the policy framework—as embodied in the *Charter of Budget Honesty Act*—would help to ensure that such a discretionary response would be appropriate in size and duration. The authorities noted that the Australian public was wary of budget deficits, now that budget surpluses were viewed as the norm, and that they would be reluctant to take discretionary actions except in very special circumstances. If discretionary measures were taken, they would favor "high quality" ones, measures that would make a more lasting contribution to raising output rather than providing just a temporary boost to demand.

21. **Owing to the strength of the economy and buoyancy of revenues at the time that the May 2003 Budget was prepared, potential fiscal surpluses going forward were envisaged to be greater than required to meet the government's fiscal objective.** Accordingly, the Budget allocated part of these fiscal resources to meet high priorities in the areas of defense and health care. Part also were directed at the government's objective of raising the growth performance of the economy further over time by improving human capital through an increase in funds allocated to education and by enhancing incentives to work, save, and invest through cuts in personal income taxes by raising the income thresholds at which marginal tax rates apply.

22. **Over the medium to long term, Australia—like most of the advanced economies—faces significant fiscal pressures and major challenges in trying to maintain a satisfactory pace of economic growth, owing in part to the aging of the population.** The InterGenerational Report published as part of the May 2002 Budget sought to identify the sources and potential magnitude of fiscal pressures.[11] Statement 4 in the May 2003 Budget lays out a strategy to try to compensate for the negative effects of an aging population on economic growth and to help close prospective long-term fiscal gaps through measures to raise labor force participation and sustain strong productivity growth (Box 3). The strategy involves

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[10] The fiscal strategy has the supplementary objectives of maintaining surpluses when economic growth prospects remain sound, maintaining the overall tax burden below 1996/97 levels, and improving the Commonwealth government's net asset position over the medium to long term.

[11] It concluded that, under current demographic and long-term productivity trends and in the absence of measures, the fiscal gap could reach 5 percent of GDP by 2042, largely owing to rising health and aged care spending. Pensions are not expected to be a major source of fiscal pressure, owing to the nature of the system. Mandatory participation in private superannuation schemes will provide a growing source of retirement income. Public provision of pensions is limited to a means-tested safety net age-pension.

the continuation of sound and stable macroeconomic policies, further improvements in labor market flexibility, the maintenance of competitive product markets, more investment in education and training, personal income tax reductions to provide greater returns to working and to maintain an internationally competitive personal income tax system, and reforms in the income support system to remove impediments and encourage recipients of income assistance to take up work. The staff commended the authorities for this well-conceived and comprehensive strategy.

23. **Health care already is exerting substantial pressure on government spending and this pressure will intensify over time.** In assessing the situation, the authorities indicated that they thought that the basic structure of the health care system with its public and private elements was appropriate, and they were focused on dealing with sources of cost pressures. Adjustments to the Pharmaceutical Benefits Scheme (PBS) proposed in the May 2002 Budget would be useful steps in controlling costs and encouraging more efficient use of resources in an area of health spending which was growing very rapidly. Although, this proposal has run into strong opposition and has not yet passed the upper house of Parliament, the authorities indicated that they would continue to press strongly for its passage. At the same time, steps have been taken to tighten up on the types of ancillary services offered as part of health insurance policies that qualify for the health insurance premium rebate. Improvements were also made in the delivery of health care services by the public sector. As a key first step, the government was requiring significant improvements in the reporting on the performance of the public hospitals in the context of a new funding agreement with the states. In addition, consideration was being given to a range of other measures to make compensation to doctors more equitable, to provide incentives for preventative care, and provide an ample supply of doctors in areas facing shortages.

24. **To meet its health care obligations and to implement its longer-term strategy to raise labor force participation and maintain strong productivity growth, the government will need significant fiscal resources.** In turn, the size and availability of these resources will be an important factor in dictating the design and timing of policy actions to implement the strategy. Over the past few years (including the May 2003 Budget), the authorities have used potential fiscal resources going forward that were expected to be greater than those required to meet the basic fiscal objective of a balanced budget over the cycle to fund a number of relatively small tax and spending initiatives. Use of these resources for some of these tax and spending initiatives has precluded the possibility of building-up a larger stock of fiscal resources that could be used to finance more comprehensive reforms in line with the government's longer-term strategy. To obtain sufficient resources to fund this strategy, discipline over spending will have to be maintained, efforts will need to be made to pare expenditures and to limit tax reductions in lesser priority areas, and the government may have to run larger budget surpluses for longer periods of time (rather than quickly using potential surpluses in excess of those needed to meet the primary fiscal objective to satisfy more immediate needs). The next step in the reform process is to identify the specific policy measures to be taken in all of the key areas identified in the government's strategy.

D. Structural Policies

25. **Far-reaching structural reforms over roughly the past decade and a half have significantly improved Australia's resilience to shocks and have contributed to the economy's solid growth and productivity performance.** Nevertheless, the authorities as part of their longer-term economic policy strategy recognize that there remains a number of areas—including the personal income tax system, the income support system, and the industrial relations system—where reforms need to be pushed further to strengthen incentives to work, save, and invest. Additional support and reforms are also needed in the education system, and the competitiveness of product markets needs to be expanded both domestically and internationally. The next step in the reform process is to identify the specific policy measures to be taken in all of the key areas identified in the government strategy.

26. **The authorities stressed that additional changes in the personal income tax system are needed to strengthen incentives to work and to maintain an internationally competitive tax system.** In particular, the top marginal income tax rates are applied at relatively low income levels. Measures introduced in the May 2003 Budget modestly raised the income thresholds at which marginal tax rates apply, and the authorities noted that they were prepared to take further measures to cut personal income taxes, if the fiscal position allows.[12] The staff suggested that additional increases in income thresholds be implemented and that it would be useful in time to bring down the top marginal tax rates to enhance incentives to work and to acquire skills and to reduce distortions created by opportunities for high-income individuals to exploit the difference between personal and corporate income tax rates. The authorities pointed out that reductions in personal income taxes also might be necessary to ensure that Australia has an internationally competitive tax system so as to retain its best and brightest workers.

27. **The government is seeking to simplify the income support system in order to provide stronger incentives for participation in the labor force and to better tailor assistance to individual needs.**[13] The authorities recognize that the income support system

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[12] Prior to the May 2003 budget, personal income was taxed at 17 percent in the \$A 6001–\$A 20,000 range, 30 percent in the \$A 20,001–\$A 50,000, 42 percent in the \$A 50,001–\$A 60,000 range, and 47 percent for incomes above \$A 60,001. With the new budget, the tax rates remain the same but the tax thresholds have increased to \$A 21,600, \$A 52,000, and \$A 62,500, respectively. Thus, despite the increases in the tax thresholds in the current budget, the top marginal rate still applies at a relatively low income threshold (\$A 62,501 or about two times median income).

[13] The reform agenda reflects the recommendations of the McClure Report, published in July 2000. Some reforms already introduced include simplification of family assistance and better work incentives introduced in the New Tax System, the *Australian Working Together* package announced in the May 2001 Budget to expand and improve employment and other

(continued...)

has evolved over time in an *ad hoc* fashion. The result is a system that is complex, costly, and structured in ways that may discourage movement from income support to work. The government has just concluded a public consultation process on overhauling the system based on the December 2002 discussion paper, *Building a Simpler System to Help Jobless Families and Individuals*, and recommendations on the next steps in the process are expected by the end of 2003. In formulating reform proposals, the staff stressed the importance of finding means of significantly reducing the high effective marginal tax rates that income recipients tend to face when they move from welfare to work. It also stressed the importance of tightening eligibility for income support programs, like the May 2002 Budget's proposals to tighten eligibility for the Disability Support Pension, and uniformly applying to all recipients of unemployment benefits strong activity tests and penalties for breach of obligations. At the same time, more could be done to provide support services for income support recipients (including employment, job training, and child care services) and that longer phase outs (tapers) could be applied to the withdrawal of some income support benefits, like assistance with health care expenses, to strengthen incentives to enter the labor force. The authorities indicated that all of these possibilities would be explored in putting together a comprehensive reform plan.

28. **While the authorities have taken significant steps over the past several years to address labor market rigidities, further reforms are needed to improve the market's flexibility and to promote greater labor force participation.** In particular, the wage bargaining system should be simplified by reducing the overlap of the federal and state awards systems, and the role of the award system in setting minimum wages should be diminished in order to reduce barriers to employment for low-skilled workers. The government favors a faster pace of labor market reform. While it has secured passage of some new industrial relations legislation, much of the reform agenda has encountered substantial political resistance, with a number of proposals still pending before Parliament.[14]

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services, and changes to the eligibility for the Disability Support Pension announced in the May 2002 Budget (which has since been vetoed by the Senate). The government is also trying to improve the administration of the unemployment assistance program, including through the *Active Participation Model* introduced in the latest round of Job Network employment services contracts that is designed to improve the interface between income support programs and the Job Network.

[14] The government has secured passage of the *Workplace Relations Amendment (Genuine Bargaining) Act 2002* and *Workplace Relations Amendment (Prohibition of Compulsory Union Fees) Act* 2003. The WRA (Genuine Bargaining) Act 2002 empowers the Australian Industrial Relations Commission to end strikes by suspending or terminating bargaining periods if the Commission believes that a party is not genuinely trying to reach an agreement. The WRA (Prohibition of Compulsory Union Fees) Act 2003 nullifies clauses in certified agreements requiring payment of bargaining services fees. Other Workplace Relations Amendment bills awaiting parliamentary approval include the *Termination of Employment*

(continued…)

29. **The government is implementing reforms in education as part of its longer-term strategy to enhance economic performance.** The May 2003 Budget included a \$A 1½ billion increase in support to universities over four years, steps to allow the universities greater flexibility in setting fees, and additional financial support to students. The government also is seeking significant improvements in governance and workplace relations within the sector, as well as improvements in courses and curricula to make university training more responsive to the economy's needs for skilled workers.

30. **The authorities have taken a pragmatic, multi-tracked approach to trade liberalization aimed at strengthening the competitiveness and efficiency of domestic industries, while improving market access opportunities for Australian exporters.**[15] Agriculture is Australia's highest priority in the Doha Round, and the authorities stressed the importance of achieving progress in this area for the success of the round. The authorities have concurrently pursued bilateral negotiations, where possible, to achieve faster market openings. Australia signed a free-trade agreement with Singapore in February 2003, which eliminates tariffs on all goods and significantly liberalizes trade in services through the use of a short negative list. Negotiations on free-trade agreements with Thailand and the United States and preliminary research on an economic and trade agreement with Japan are under way. The authorities are also continuing to implement structural adjustment programs in the passenger motor vehicles (PMV) and the textiles, clothing, and footwear (TCF) sectors, which remain the more heavily protected sectors in Australia's economy. Tariffs in the PMV sector will be reduced through 2010, with government assistance declining progressively over this period. Tariffs in the TCF sector will be reduced through 2005, with post-2005 tariff arrangements to be considered shortly. In addition, to foster economic development in the poorest countries, Australia unilaterally granted tariff- and quota-free access on all products to the least developed countries effective July 2003.

III. Staff Appraisal

31. **Australia's economy has continued to perform remarkably well over the past year, despite encountering major adverse shocks, including persistent weakness in the global economic environment and a sustained, severe drought at home.** Australia's ability to generate strong growth outcomes in an increasingly inhospitable environment is testimony to the economy's enhanced resilience stemming from the implementation of stable macroeconomic policies within transparent frameworks and the continued implementation of structural reforms.

Bill, the *Secret Ballots for Protected Action Bill,* the *Compliance with Court Tribunal Orders Bill,* and the *Protecting the Low Paid Bill.*

[15] Australia has a rating of one (the least restrictive) on the IMF's ten-point index of trade restrictiveness.

32. **As regards monetary policy, the significant appreciation of the Australian dollar over the past year has tightened monetary conditions and bolstered expectations that underlying inflation will decline in the period ahead.** Consistent with its policy framework, the Reserve Bank of Australia has indicated that it would consider lowering interest rates. The RBA remains concerned, however, that lower rates might fuel a further, sharp rise in housing prices. While such considerations could complicate a decision on the precise timing of a cut in interest rates, the Bank would be expected to ease monetary policy should there be clear indications of a deterioration in economic prospects.

33. **In such circumstances, fiscal policy, with its objective of maintaining a balanced budget over the cycle, would allow the automatic stabilizers to work to support the economy.** If need be, Australia's sound fiscal position would provide scope for discretionary policy action, and the policy framework would help to ensure that such a discretionary response would be appropriate in size and duration. However, the staff supports the authorities' cautious view that such discretionary actions should be taken only in exceptional circumstances and that measures enacted should attempt to make a more lasting contribution to raising output rather than providing just a temporary boost to demand.

34. **Notwithstanding the impressive economic performance of the past decade, the authorities are fully aware that over the medium to longer term they are likely to face significant fiscal pressures and daunting challenges in trying to maintain a satisfactory pace of economic growth, owing in part to the aging of the population.** The staff supports the well-conceived, comprehensive strategy to raise labor force participation and sustain strong productivity growth that the authorities have adopted to deal with this situation. The strategy includes the continuation of sound and stable macroeconomic policies, further improvements in labor market flexibility, the maintenance of competitive product markets, more investment in education and training, personal income tax reductions to provide greater returns to working and to maintain an internationally competitive tax system, and reforms in the income support system to remove impediments and encourage recipients of income support to take up work.

35. **Maintaining a sound and stable macroeconomic environment is essential.** Doing so will help to ensure that relative prices provide clear information about where scarce resources can be put to their most productive uses and that the fruits of today's labors can be safely saved and invested for future consumption. The fiscal and monetary policy frameworks currently in place should provide this environment if they continue to be prudently implemented.

36. **Further reforms of the personal income tax system also are critical elements of the government's strategy.** Additional reductions in income taxes would improve incentives. In particular, the income thresholds at which different marginal tax rates apply should be raised further. Moreover, it would be useful over time to bring down the top marginal tax rates and to reduce a distortion in the tax system created by arbitrage opportunities for high-income individuals between the top marginal rate and the corporate tax rate. Reductions in personal income taxes may be needed as well to maintain an internationally competitive system.

37. **A comprehensive reform of the complex system of income support payments would provide stronger incentives for labor force participation.** The interplay of the current income support system and the personal income tax system creates high effective marginal tax rates when individuals move from welfare to work; finding means of significantly reducing these rates is an important consideration in formulating reform proposals. The transition to work also would be facilitated by continuing efforts to improve employment and job training services and the provision of other supporting services, such as child care and a tapered (phased) reduction in health care assistance. Tightening eligibility for some income support programs and maintaining strong activity tests and penalties for breach of obligations for unemployment benefits and applying them uniformly to all recipients would provide stronger incentives to return to employment.

38. **The government continues to push for changes in the industrial relations system that will increase labor market flexibility.** The staff believes that further simplification of the award and wage bargaining system is needed to bring the unemployment rate over time significantly below 6 percent and to raise the economy's potential output on a sustainable basis. Simplification of the awards system is needed to reduce the overlap of federal and state awards and the multiplicity of awards in the same workplace. In addition, the role of the award system in setting minimum wages should be diminished in order to reduce what could be a significant barrier to the entry of low-skilled individuals into employment.

39. **Investment in education and training also is important in raising productivity and participation levels throughout the economy.** In turn, the demand for education and training can be enhanced by improving the return on individuals' investment in acquiring skills through changes in the personal income tax system.

40. **Implementation of the government's strategy to raise labor force participation and sustain strong productivity growth could entail significant initial fiscal costs.** The availability of fiscal resources will be an important factor in determining both the design and pace of policy actions. The process of raising public awareness of the long-term challenges facing Australia and building political consensus to address them started with the InterGenerational Report and was extended by Budget Statement 4. In the period ahead, efforts will need to be directed at exploring specific options for reforms to implement the government's strategy, their fiscal costs, tradeoffs in establishing priorities for reforms, and how resources might be raised to finance them such that the burden is equitably shared across generations. To obtain needed fiscal resources, expenditure discipline has to be maintained and budget priorities set strictly in line with the government's strategy. It is also likely to entail the government running larger budget surpluses to build up a sufficient stock of fiscal resources to finance comprehensive reforms, particularly in the areas of the personal income tax and the income support systems.

41. **Maintenance of competitive product markets will contribute to faster innovation and productivity and income growth.** Accordingly, given the relatively small size of Australia's domestic market, the authorities have long recognized the importance of an open

international trade regime in promoting a competitive economy. The staff fully supports their approach to trade liberalization based on strict adherence to a rules-based multilateral framework and their efforts to improve market access through the Doha Round. The staff recognizes the importance of achieving a significant reduction in agricultural trade barriers in these negotiations. Australia's pursuit of bilateral free trade agreements are seen as being consistent and supportive of the country's multilateral efforts. These agreements may provide helpful opportunities to promote trade liberalization. In order to minimize trade diversion, however, partners in these agreements should avoid raising barriers to other countries and at the same time ensure comprehensive product coverage. In addition, the staff commends the authorities for the recent unilateral decision to provide least developed countries with complete duty- and quota-free access to the Australian market.

42. **The financial system is generally sound. The staff welcomes the steps already taken, as well as measures that are under consideration, to strengthen the supervision of the system.** The banking system as a whole has a high level of profitability and capital adequacy, making it highly resilient to shocks. While the system's large exposure to the housing market has prompted some concerns, the preliminary results of APRA's comprehensive stress test exercise suggest that the banks could manage a sharp decline in housing prices without endangering the safety of system, although bank profitability and capital would be adversely affected. Nevertheless, the staff agrees with the authorities that close supervision of the banks' lending standards and systems will need to be maintained. Steps that APRA has already taken, along with implementation of the key HIH Royal Commission recommendations, should strengthen supervision and risk management practices, capital adequacy, and corporate governance in the insurance industry. In addition, efforts to improve corporate governance in the management of superannuation funds are welcomed.

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

Box 1. Australia: Developments in the Property Market

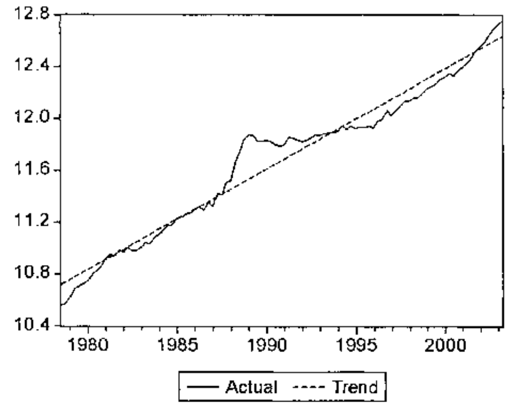
Property price inflation has accelerated during the last few years, propelled by low mortgage rates, poor returns from alternative investments, strong employment and immigration, and tax incentives. Low interest rates and the First Home Owners grant reduced the cost of housing for owner-occupiers. Investor demand has also driven housing prices, particularly in the central business districts of the major cities, as increased expected returns on housing far outstripped returns on other assets. Consequently, by the end of 2002, investor housing accounted for 30 percent of the stock of housing loans, compared to 18 percent a decade ago.

Table 1. Property Price Inflation

	1Y		2Y		3Y		5Y	
	Nominal	Real	Nominal	Real	Nominal	Real	Nominal	Real
Brisbane	16.1	13.7	37.1	30.4	45.1	30.2	48.8	28.3
Melbourne	11.6	9.3	32.0	25.6	46.6	31.6	84.8	59.3
Sydney	17.0	14.6	40.5	33.6	47.1	32.0	75.9	51.7
Average of 8 capital cities	14.1	11.7	33.9	27.4	43.2	28.5	65.9	43.1

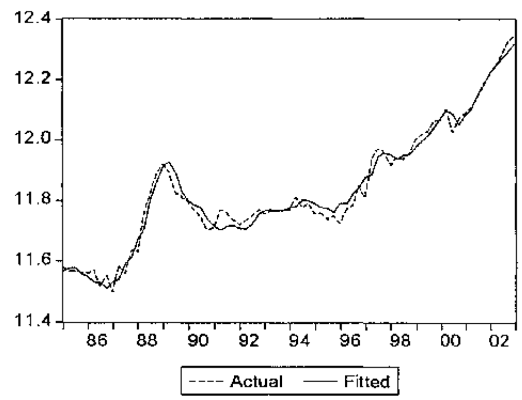
Source: Australian Bureau of Statistics.

Figure 1. Median Price of New and Established Houses (in log)



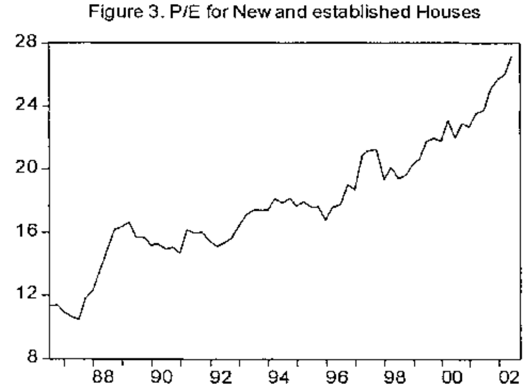
The recent run-up in housing prices is largely explained by economic fundamentals. While housing prices have increased rapidly during the last 5 years, they have not deviated significantly from their long term trend (Figure 1). Furthermore, the estimation results of an econometric model show that movements in real Australian housing prices over the last two decades are well explained by movements in real mortgage interest rates, real disposable income, real returns on equities, and population growth (Figure 2). In particular, the real mortgage rate decline of 4½ percentage points during the last five years alone accounted for about 30 percent of the increase in real property prices during the period.

Figure 2. Median Price for New and Established Houses Deflated by the CPI (in log)



The recent rapid rate of housing price increases does not, however, seem sustainable. The fact that property prices are well explained by economic fundamentals suggests that there may be no speculative bubble in the overall market at present. Nevertheless, the absence of a bubble does not imply that the current rapid rise in housing prices will continue. Further changes in fundamentals would not appear to support additional sharp increases in prices. In particular, mortgage rates are not expected to decline significantly. Moreover, in the investment segment of the market, the sharp rise in housing prices over the past 5 years and more recent indications of declining rents have led to a large increase in the price/earning ratio for new and established houses—computed as the ratio of the median price for new and established houses to the yearly rent for similar type of housing—although some of the increase reflects declining mortgage interest rates (Figure 3).[1] Signs of over-supply of rental housing are beginning to emerge. For example, in Sydney, the vacancy rate increased from 1.2 percent in mid-1999 to 4.4 percent in the fourth quarter of 2002.

Figure 3. P/E for New and established Houses

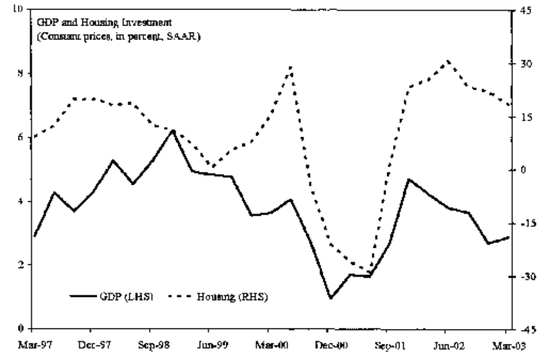


Source: Australian Bureau of Statistics, Real Estate Institute of Australia, and staff calculations.

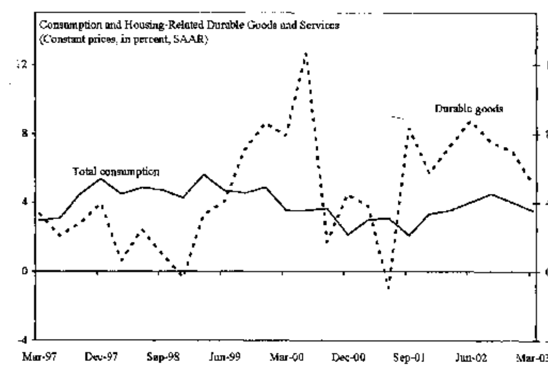
[1] For an explanation for why the ratio of housing price to the yearly rent can be interpreted as the "P/E" ratio for real estate assets, see Edward Leamer, June 2002, "Bubble Trouble? Your Home Has a P/E Ratio Too", *UCLA Anderson Forecast*.

Box 2. Australia: Housing, Consumption, and Output

In recent years, housing investment has made an important contribution to swings in economic activity in Australia. Strong GDP growth in 1999 reflected a surge in housing investment in advance of the introduction of the goods and services tax; GDP slowed sharply in 2000 as this investment plunged after the tax was imposed (first figure). However, after the government introduced the First Home Owners Scheme, the resulting boost to housing investment contributed to a pick up in GDP growth in Australia and to maintaining growth at a high level since 2000, even as economic activity in other advanced economies softened.



Housing activity also has had a strong influence on consumption. Directly, the rise in housing investment has affected consumption of housing-related durable goods and services (see figure). The consumption of these goods and services is highly correlated with housing investment , and they have made a significant contribution to the growth in consumption since 2000.



Housing also has influenced consumption indirectly through the effects of the rise in housing prices on net wealth of households. According to this "traditional" wealth effect, an increase in permanent wealth will induce households to consume more (save less) out of current income. Various studies of consumption and saving in Australia suggest that consumption expenditures rise (saving falls) by 3 to 5 cents for every dollar increase in net housing wealth. Over the period since 2000, housing wealth has risen by approximately $A 670 billion, suggesting that consumption could have been increased by as much as $A 33 billion, if households considered this rise in wealth to be permanent.

Beyond the traditional wealth effect, housing has played a role in stimulating consumption owing to innovations in credit markets which have allowed homeowners to more easily and less expensively borrow against the equity in their houses. The impact of this improvement in household access to credit may have had a more significant influence on consumption than the traditional wealth effect. During the period 2001 to March 2003, net housing equity withdrawals are estimated to have been around $A 165 billion. The proportion of these funds used to finance consumption or for other purposes is not known, but it is likely that a substantial part was used for consumption.

The rapid increase in housing prices in recent years has raised concerns about a bubble developing and the potential consequences for economic activity if a sharp correction in prices were to occur. In the event, housing investment would be expected to fall, and along with it, consumption of housing-related consumer durables and services. Traditional wealth effects would reduce consumption further. However, although net equity withdrawals (and the consumption they would have financed) would decline, households would not be expected to make substantial repayments of previous housing equity withdrawn which would lead to a further fall in consumption.

[1] A more detailed analysis of wealth effects associated with housing is provided in the forthcoming *Selected Issues* paper.

[2] According to an ABS survey, about 20 percent of borrowers used excess funds from home refinancing during 1997–99 to finance consumption, particularly purchases of cars.

Box 3. Australia: May 2003 Budget–Statement 4

***Budget Statement 4, Sustaining Growth in Australia's Living Standards,* lays out a strategy to compensate for the negative longer-term effects of an aging population and increasing health and aged care costs. The strategy focuses on the interaction between population, labor force participation, and productivity.** Various scenarios presented in the 2002 Intergenerational Report (IGR) showed population aging would slow growth in real GDP per person to about 1½ percent per annum by the next decade, if recent trend toward lower labor force participation continued and productivity growth fell back to the average of the last 30 years (about 1¾ percent). Not only would the economy grow more slowly than currently, public expenditures, primarily because of age-related spending, would raise sharply, opening up a budget gap that would reach about 5 percent of GDP in 2041–42 if government services are maintained at current levels.

To address this fiscal gap, one alternative that the government is considering is to increase GDP growth above the rate projected in the IGR. Drawing lessons from other countries' experiences and building on the policy reforms of the past years, the government suggests that stronger GDP growth could be attained by sustained efforts to remove obstacles or disincentives for individuals to participate in the labor force and to maximize productivity growth rates.

The basic types of policies that make up the government's strategy include:

- *Macroeconomic policies.* Stable and sound macroeconomic policies are a necessary backdrop. Australia's fiscal and monetary policy frameworks produce stable low inflation and contribute to stabilizing the business cycle. The certainty and credibility of these policies would contribute to an environment conducive to investment and innovation.

- *Education and training policy.* Improving education and training outcomes can increase productivity directly by increasing the skills and abilities of individual workers and indirectly by raising the flexibility of the labor force. It also could foster more rapid utilization and transmission of new skills and production technologies, having a dynamic effect in increasing productivity.

- *Labor market policy.* A flexible labor market can assist workers in avoiding periods of involuntary unemployment by making it easier for workers to change jobs and occupations, and facilitate the hiring of workers by (small) firms in areas of growth in the economy, thereby enhancing job creation, innovation, the deployment of new technologies, and productivity growth.

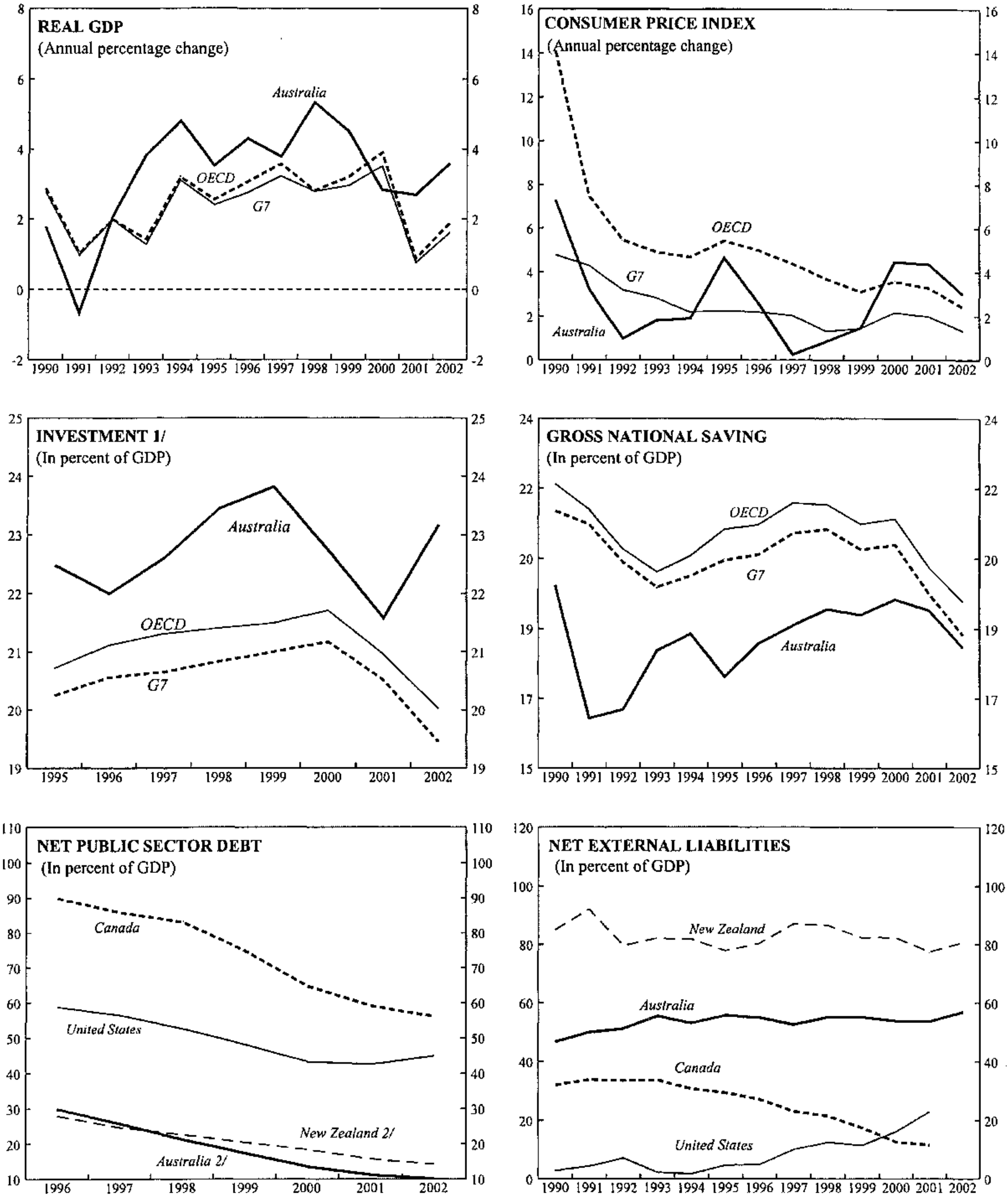
- *Maintaining competitive product markets.* Product market competition contributes to enhancing employment and productivity outcomes. It promotes higher investment in R&D, innovation, and creates incentives for workers to upgrade their skills.

- *Taxation policy.* Productivity and participation are affected by the level of taxation and the design of the taxation system. Taxes on returns to capital can affect savings and investment behavior, while taxes on returns to workers can affect labor force participation decisions. Maintaining internationally competitive personal income taxes arrangements also will be an important factor in Australia's ability to retain skilled workers in increasingly globalized markets for such individuals.

- *Welfare and health policy.* Australia's welfare system is highly targeted, providing a reliable safety net for those in need. However, different rates of assistance and means testing arrangements for various social security benefits for people of working age may discourage labor force participation and job search.

FIGURE 1: AUSTRALIA

COMPARISONS OF MACROECONOMIC PERFORMANCE, 1990-2002

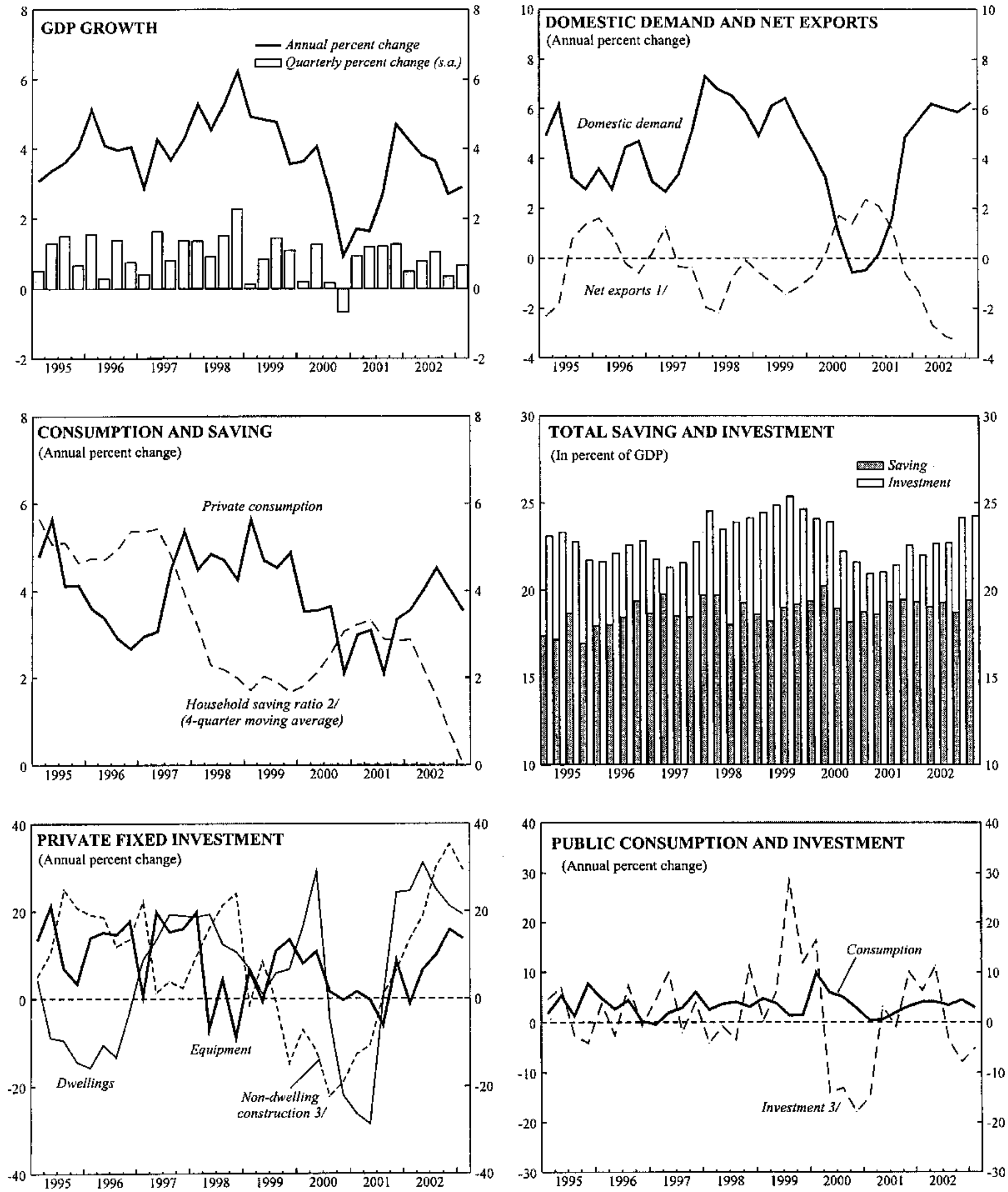


Sources: National authorities; IMF, International Financial Statistics and World Economic Outlook; OECD, Economic Outlook.

1/ Gross fixed capital formation.
2/ Fiscal year.

FIGURE 2: AUSTRALIA

SELECTED REAL ECONOMIC INDICATORS, 1995-2003

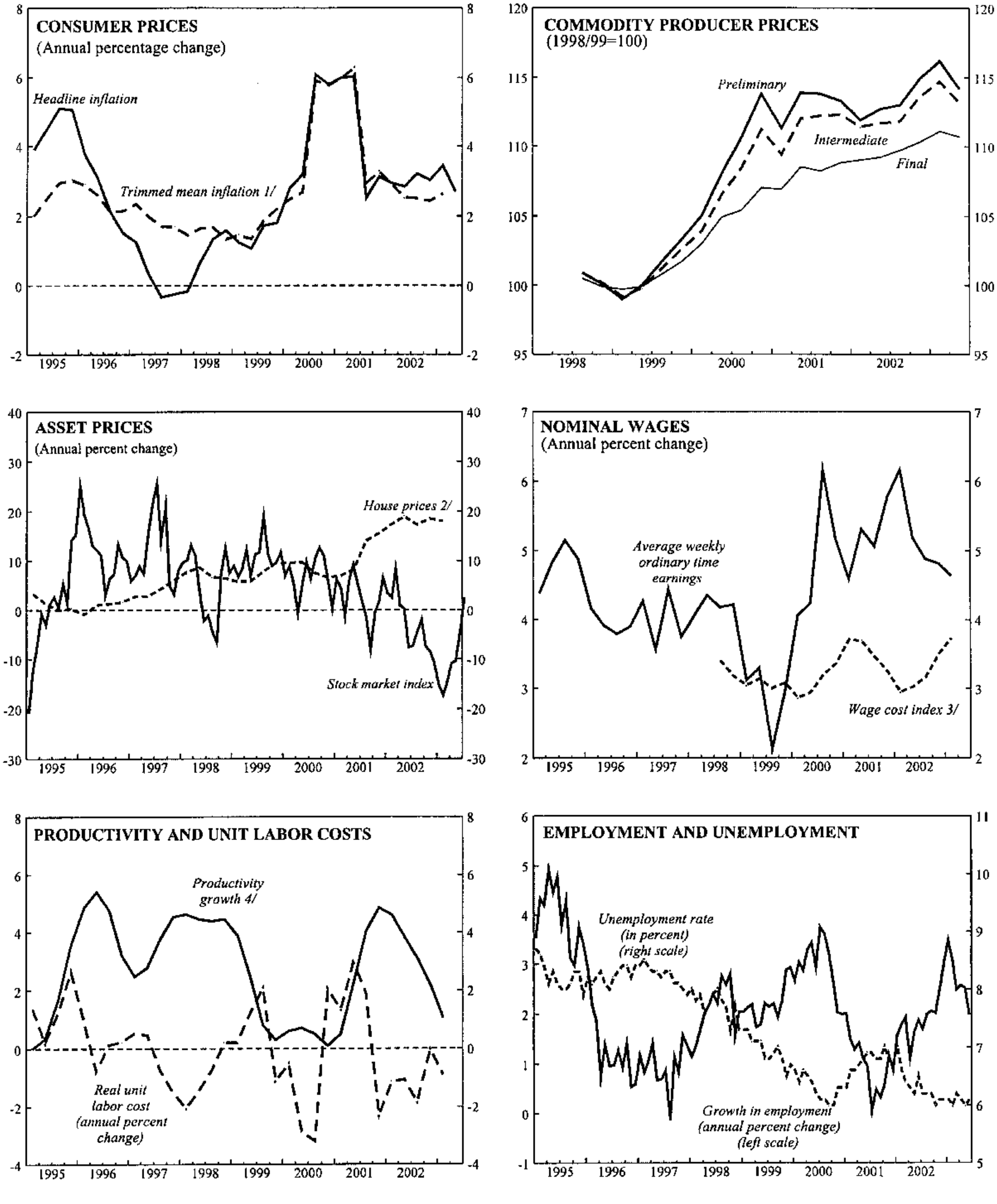


Source: Data provided by the Australian authorities.

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, 1995-2003



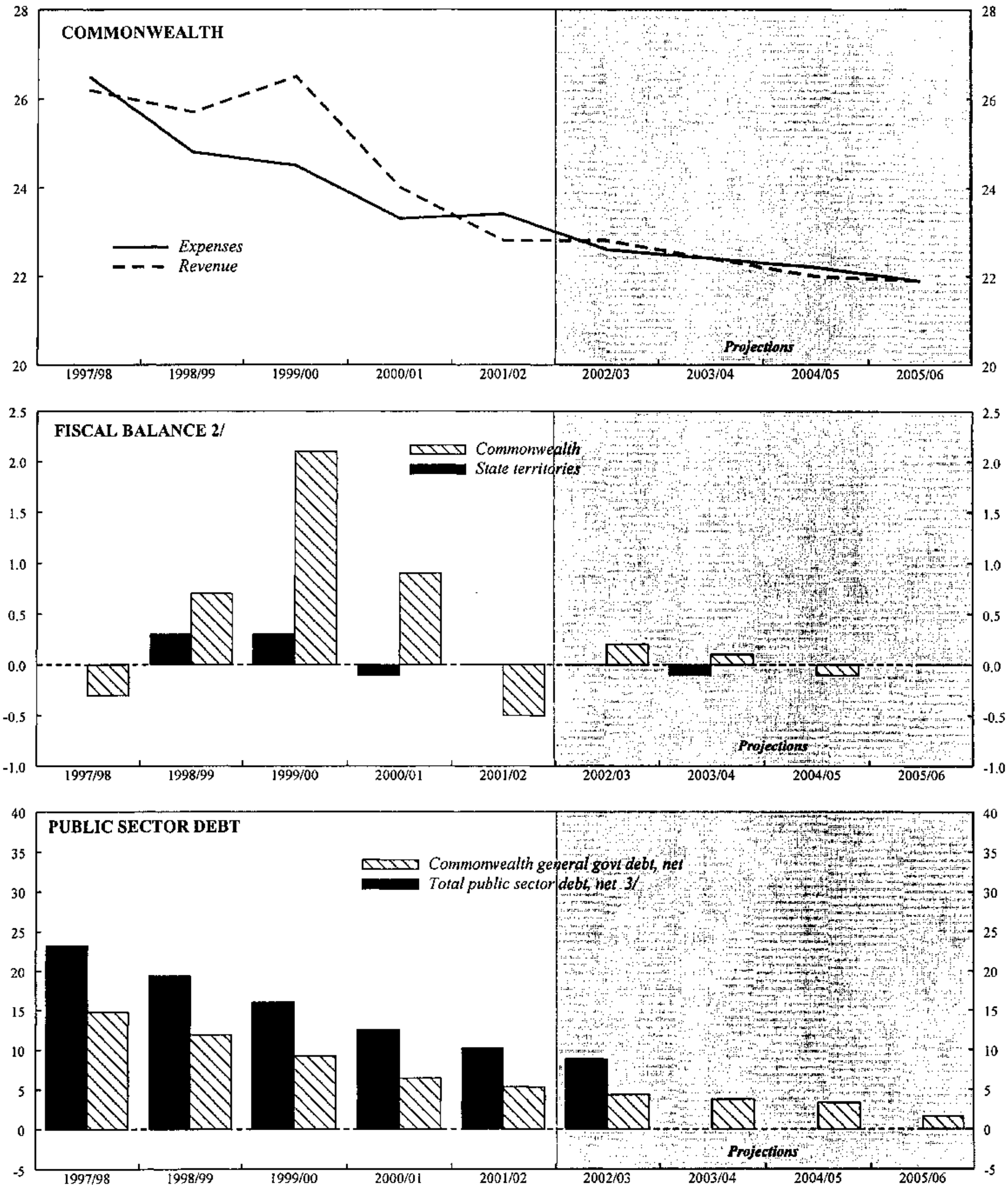
Sources: Australian Bureau of Statistics; and Fund staff estimates.

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

FISCAL INDICATORS, 1994/95-2005/06 1/

(In percent of GDP)

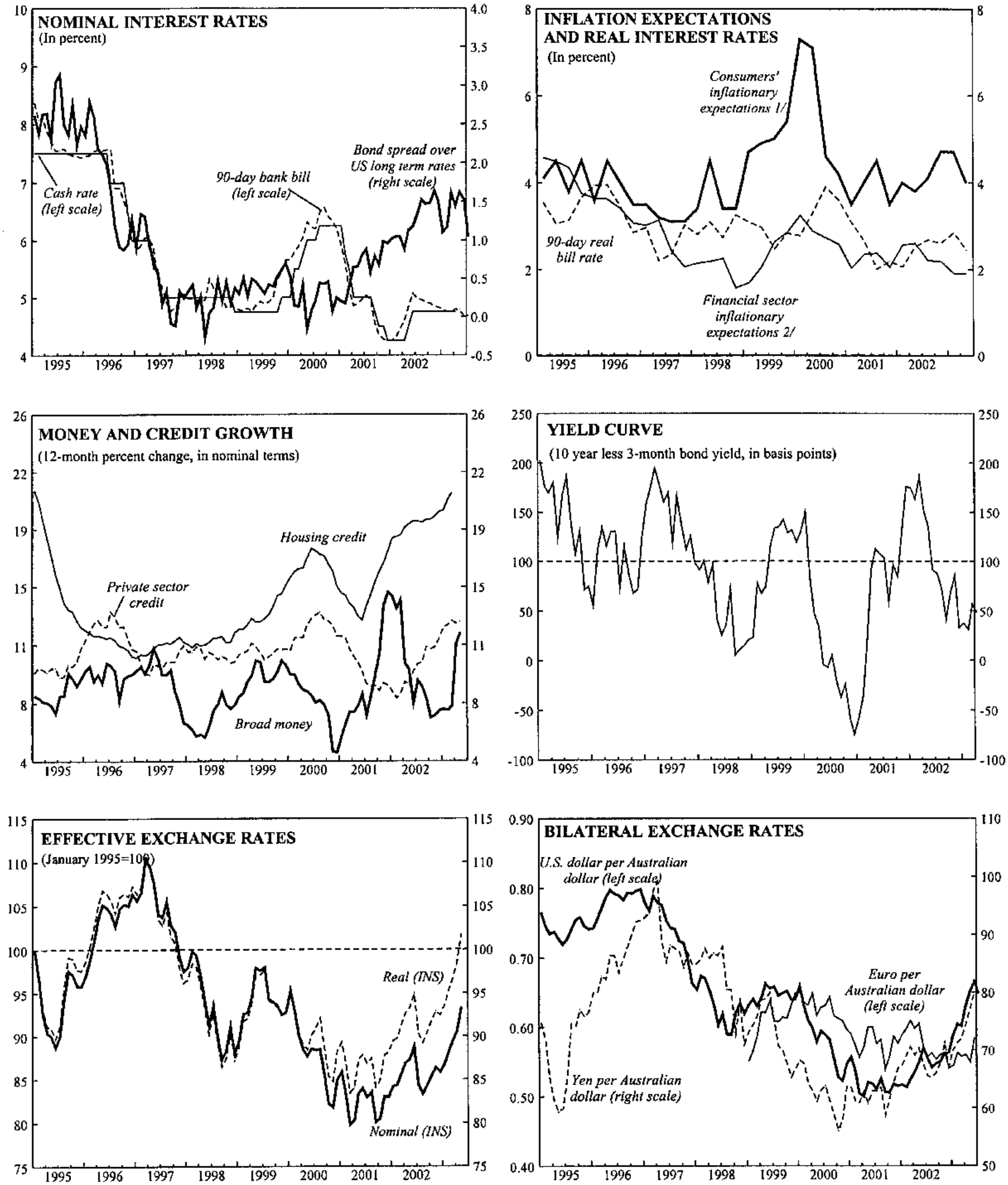


Source: Data provided by the Australian authorities.

1/ Revenue, expenses, and fiscal balance are on accrual basis.
2/ Fiscal balance is equal to revenue less expenses less net capital investment.
3/ Data only available to 2002/03.

FIGURE 5: AUSTRALIA

SELECTED MONETARY INDICATORS, 1995-2003

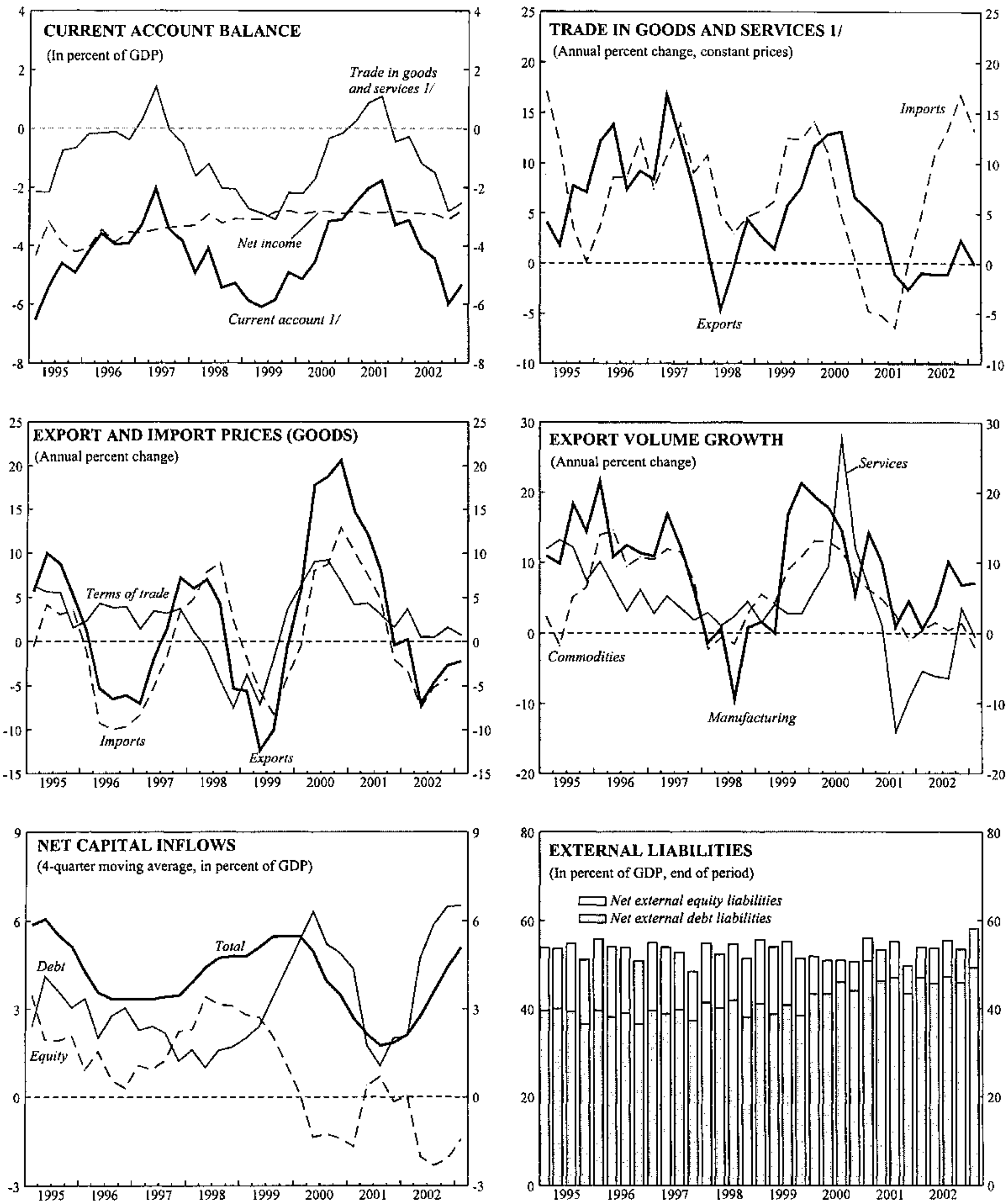


Sources: Australian Bureau of Statistics; Reserve Bank of Australia; and staff estimates.

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.

FIGURE 6: AUSTRALIA

BALANCE OF PAYMENTS AND EXTERNAL LIABILITIES, 1995-2003



Sources: Australian Bureau of Statitics; and Reserve Bankd 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.

Table 1. Australia: Selected Economic and Financial Indicators, 1997-2003

Nominal GDP (2002):	$A734 billion (US$399 billion)
Population (Sep 2002):	19.73 million
GDP per capita (2002):	US$ 20,223
Quota (in millions):	SDR 3,236

	1997	1998	1999	2000	2001	2002	Proj. 2003
Output and demand (percent change)							
Real GDP	3.8	5.3	4.5	2.8	2.7	3.6	3.0
Total domestic demand	3.6	6.6	5.7	1.9	1.5	5.9	4.5
Private consumption	4.0	4.6	4.9	3.2	2.9	4.0	2.9
Fixed investment	9.9	8.2	7.7	-0.1	-1.2	13.0	8.7
Exports of goods and services	11.1	0.1	4.4	11.0	1.3	-0.2	4.0
Imports of goods and services	10.5	5.9	9.1	7.4	-4.1	11.4	9.0
Inflation and unemployment (in percent)							
CPI inflation	0.3	0.9	1.5	4.5	4.4	3.0	2.9
Unemployment rate (annual average)	8.2	7.7	7.0	6.3	6.7	6.3	6.1
Saving and investment (in percent of GDP)							
Gross national saving	18.7	19.0	18.9	19.3	19.1	18.1	18.5
General government saving	1.8	3.9	4.5	2.8	3.0	2.8	2.8
Private saving 1/	16.8	15.1	14.5	16.5	16.1	15.3	15.7
Gross capital formation	21.8	23.9	24.8	23.0	20.6	22.5	23.7
Fiscal Indicators (in percent of GDP) 2/							
Commonwealth budget							
Revenue	24.5	24.2	24.7	26.4	24.0 3/	22.8	23.0
Underlying expenditure 4/	25.5	24.0	24.0	24.3	23.1 3/	22.9	22.5
Underlying balance 4/	-1.0	0.2	0.7	2.1	0.9	-0.1	0.5
Commonwealth government net debt	18.2	14.8	11.9	9.2	6.4	5.3	4.3
Money and credit (end of period)							
M1 (percent change)	13.3	6.1	9.7	9.4	21.3	-9.3	4.7 5/
M3 (percent change)	7.1	7.0	9.6	4.8	14.8	10.4	10.6 6/
Private domestic credit (percent change)	11.3	10.3	11.1	11.9	8.8	11.8	12.8 6/
Interest rate (90-day bill, in percent)	5.1	4.8	5.7	6.2	4.2	4.8	4.7 7/
Government bond yield (10-year, in percent)	6.0	5.0	7.0	5.5	6.0	5.5	5.4 7/
Balance of payments (in percent of GDP)							
Current account	-3.1	-4.9	-5.7	-4.0	-2.4	-4.4	-5.2
of which: Trade balance	0.4	-1.4	-2.5	-1.2	0.5	-1.3	-2.1
Terms of trade (percent change)	2.0	-4.1	-0.9	5.5	1.5	2.2	...
External assets and liabilities (in percent of GDP)							
Net external liabilities	52.5	55.1	55.0	53.8	53.6	56.9	...
Gross short-term external debt	27.7	30.6	33.1	40.1	39.9	40.9	...
Net short-term external debt	14.8	17.4	17.2	22.5	23.8	22.9	...
Gross official reserves	4.8	4.3	5.5	5.2	5.3	5.2	...
Exchange rate (end of period)							
US$/$A	0.653	0.614	0.654	0.554	0.508	0.566	0.648 7/
Trade-weighted index	58.4	53.3	56.4	51.7	50.2	52.0	58.3 7/
Nominal effective exchange rate 8/	105.5	95.3	100.3	92.0	89.8	92.9	101.0 5/
Real effective exchange rate 8/	85.9	78.0	82.9	78.9	78.7	82.6	90.9 5/

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

1/ Includes public trading enterprises.
2/ Fiscal year ending June 30.
3/ The sharp drop in 2001 reflects tax reform, including income tax cuts, the removal of the Wholesale Sales Tax, and the reduction in grants to States.
4/ Underlying expenditure and balance exclude asset sales and other one-off factors; cash basis.
5/ May 2003.
6/ March 2003.
7/ July 2003.
8/ IMF, Information Notice System index (1990 = 100).

Table 2. Australia: Selected Fiscal Indicators, 1997/98-2006/07 1/
(In percent of GDP)

	1997/98	1998/99	1999/00	2000/01	2001/02	Estim. 2002/03	Projections 2/ 2003/04	2004/05	2005/06	2006/07
Fiscal accounts (accrual basis) 3/										
Commonwealth government										
Revenue	26.2	25.7	26.5	24.0 4/	22.8	22.8	22.4	22.0	21.9	21.9
Tax	...	...	24.3	22.6	21.0	21.2	20.9	20.7	20.6	20.6
Income tax	...	...	18.8	18.1	16.7	16.9	16.9	16.8	16.9	17.0
Individuals and other witholding	...	...	13.6	11.7	12.1	12.0	12.0	12.1	12.2	12.3
Indirect and other tax	...	...	5.5	4.5	4.3	4.2	4.0	3.9	3.7	3.6
Non-tax	...	...	2.2	1.5	1.8	1.6	1.5	1.3	1.3	1.2
Expenses	26.5	24.8	24.5	23.3 4/	23.4	22.6	22.4	22.2	21.9	21.6
Salaries and wages	...	...	...	1.4	1.4	1.4	1.4	1.4	1.3	1.2
Payments for supply of goods and services	...	...	...	4.9	4.8	4.9	4.9	4.8	4.7	4.7
Current transfers	...	...	16.0	14.4	14.3	13.7	13.7	13.7	13.7	13.6
Other expenses	...	...	...	2.6	2.9	2.6	2.4	2.3	2.1	2.1
Net capital investment	0.0	0.2	-0.2	-0.2	-0.1	0.0	-0.1	0.0	0.0	0.0
Fiscal Balance 5/	-0.3	0.7	2.1	0.9	-0.5	0.2	0.1	-0.1	0.0	0.3
State, Territory, and local government balance	...	0.3	0.3	-0.1	0.0	0.0	-0.1	...	...	...
Public Non-financial corporations balance	...	-0.6	0.5	0.1	-0.1	-0.3	...	...	...	...
Non-Financial Public sector balance 6/	...	0.3	3.0	0.8	-0.6	0.0	...	...	...	...
Fiscal Accounts (cash basis) 7/										
Commonwealth government										
Revenue	24.2	24.7	26.4	24.0 4/	22.8	23.0	22.5	22.3	22.0	21.9
Underlying expenditure	24.0	24.0	24.3	23.1 4/	22.9	22.5	22.2	22.1	21.8	21.4
Underlying cash balance 8/	0.2	0.7	2.1	0.9 9/	-0.1	0.5	0.3	0.2	0.1	0.5
Memorandum items:										
Commonwealth government net debt 10/	14.8	11.9	9.2	6.4	5.3	4.3	3.7	3.3	1.6	-0.2
Commonwealth government net worth 10/11/	-12.2	-12.9	-6.5	-6.7	-6.9	-6.3	-5.6	-5.7	-5.4	-4.9

Sources: Commonwealth of Australia: *Budget Strategy and Outlook, 2003/04; Final Budget Outcome, 2001/02.*

1/ Fiscal year ends June 30.
2/ Projections as presented in the *Budget Strategy and Outlook 2003/04*.
3/ Accrual data are reported on a consistent basis with Government Financial Statistics (GFS). GST related transactions are excluded since the Commonwealth government conducts them on behalf of states and territories.
4/ The drop in 2000/01 reflects tax reform, including income tax cuts, the removal of the Wholesale Sales Tax, and the reduction in grants to States.
5/ The fiscal balance is equal to revenue less expenses less net capital investment and measures the government's net lending.
6/ The Commonwealth, state, and public enterprise balances may not add up to the public sector balance due to the effect of consolidation.
7/ Due to a break in the series following the introduction of the new accrual accounting standards, cash receipts and payments data from 1999/00 are not directly comparable with earlier years.
8/ The cash equivalent of the fiscal balance.
9/ 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.
10/ Assumes 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 employees.

Table 3. Australia: Balance of Payments, 1997-2003
(In percent of GDP)

	1997	1998	1999	2000	2001	2002	Proj. 2003
Current account balance	-3.1	-4.9	-5.7	-4.0	-2.4	-4.4	-5.2
Trade balance	0.4	-1.4	-2.5	-1.2	0.5	-1.3	-2.1
Exports	16.0	15.4	14.3	17.0	17.8	16.3	15.5
Imports	-15.6	-16.9	-16.8	-18.2	-17.3	-17.6	-17.6
Net services	-0.1	-0.3	-0.2	0.1	-0.1	-0.2	0.0
Total credits	4.5	4.5	4.4	4.9	4.6	4.3	4.2
Total debits	-4.7	-4.8	-4.7	-4.8	-4.7	-4.5	-4.2
Net income	-3.4	-3.1	-2.9	-2.8	-2.8	-2.9	-3.0
Receipts	1.8	1.8	1.9	2.4	2.2	2.0	1.9
Payments	-5.2	-4.9	-4.8	-5.3	-5.1	-5.0	-4.9
Net transfers	0.0	-0.1	0.0	0.0	0.0	0.0	-0.1
Capital and financial account	3.7	5.0	5.7	3.6	2.0	4.6	...
Capital account	0.2	0.2	0.2	0.2	0.2	0.1	...
Financial account	3.5	4.8	5.5	3.5	1.9	4.4	...
Direct investment transactions: net	0.3	0.7	0.9	3.3	-2.0	1.8	...
Equity (net)	-0.1	0.5	0.0	1.3	-0.7	0.0	...
Debt (net)	0.4	0.2	0.9	2.0	-1.2	1.8	...
Portfolio investment transactions: net	3.3	0.8	3.1	0.7	2.8	0.8	...
Equity (net)	2.1	2.3	0.9	-2.8	0.8	-2.5	...
Debt (net)	1.2	-1.5	2.2	3.6	2.0	3.3	...
Financial derivatives (net)	0.2	-0.3	0.4	-0.2	0.1	0.1	...
Other transactions (net)	-0.3	3.5	1.1	-0.3	0.9	1.8	...
Net errors and omissions	-0.6	0.0	0.0	0.3	0.4	-0.1	...
	(Assets and liabilities at end-period)						
Net external liabilities	52.5	55.0	54.9	53.9	53.6	56.9	...
Net external equity liabilities	12.1	14.3	13.8	6.9	6.9	8.1	...
Foreign equity investment in Australia	41.4	46.6	51.0	47.5	50.7	46.6	...
Australian equity investment abroad	-29.3	-32.4	-37.2	-40.5	-43.8	-38.6	...
Net external debt	40.4	40.8	41.1	46.9	46.6	48.9	...
Net public sector	9.6	7.4	3.0	2.3	1.6	2.3	...
Net private sector	30.8	33.4	38.1	44.6	45.0	46.6	...
Gross external debt	61.4	62.8	64.7	73.1	73.5	76.8	...
of which: $A denominated	25.7	23.5	23.8	26.5	25.0	27.5	...
Gross external lending	-21.0	-22.1	-23.6	-26.1	-26.8	-27.9	...
Short-term net external debt (residual maturity basis)	14.8	17.4	17.2	22.5	23.8	23.0	...
Short-term gross external debt	27.7	30.6	33.1	40.1	39.9	40.9	...
Short-term gross external lending	-12.9	-13.2	-15.9	-17.6	-16.1	-18.0	...
Memorandum items:							
Gross official reserves (in $A billion)	26.2	25.0	33.6	34.0	36.5	38.1	...
RBA outstanding forward contracts (in $A billion)	5.6	10.1	22.6	24.9	29.5	25.8	...
Net official reserves (in $A billion)	20.6	14.9	10.9	9.1	7.0	12.2	...
Gross official reserves in months of imports	2.5	2.3	2.7	2.7	2.7	2.6	...
Gross official reserves to ST foreign currency denominated debt (percent)	24.7	19.5	23.1	18.9	19.4	19.6	...
Net official reserves to ST foreign currency denominated debt (percent)	19.4	11.6	7.5	5.1	3.8	3.7	...

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

Table 4. Australia: Medium-Term Scenario 2002-08

	1990-1999 Average	2000	2001	2002	Projections 2003	2004	2005	2006	2007	2008
Real economic indicators (percent change)										
GDP	3.3	2.8	2.7	3.6	3.0	3.5	3.7	3.8	3.8	3.8
Total domestic demand	3.2	1.9	1.5	5.9	4.5	3.0	3.3	3.4	3.4	3.8
Private consumption	3.3	3.2	2.9	4.0	3.0	3.1	3.2	3.1	3.1	3.4
Total investment	3.7	-0.1	-1.2	13.0	8.7	4.1	4.4	4.6	4.7	5.2
CPI inflation	2.5	4.5	4.4	3.0	2.9	2.3	2.5	2.5	2.5	2.5
Unemployment rate (annual average)	8.6	6.3	6.7	6.3	6.1	6.0	5.9	5.8	5.6	5.5
Saving and investment (percent of GDP)										
Gross national saving	18.1	19.3	19.1	18.1	18.5	18.5	18.4	18.6	18.7	18.7
General government saving	0.3	2.8	3.0	2.8	2.8	2.9	2.8	2.8	2.8	2.8
Private saving 1/	17.9	16.5	16.1	15.3	15.7	15.5	15.5	15.6	15.8	15.9
Gross capital formation	22.7	23.0	20.6	22.5	23.7	23.3	23.1	22.9	22.8	22.7
Fiscal indicators (percent of GDP) 2/										
Commonwealth Budget										
Revenue	23.9	26.4	24.0	22.8	23.0	22.5	22.3	22.0	21.9	22.0
Underlying expenditure	25.2	24.3	23.1	22.9	22.5	22.2	22.1	21.8	21.4	21.6
Underlying balance (cash basis)	-1.3	2.1	0.9	-0.1	0.5	0.3	0.2	0.1	0.5	0.4
Commonwealth government net debt 3/	12.7	9.2	6.4	5.3	4.3	3.7	3.3	1.6	-0.2	-1.7
Balance of payments (percent of GDP)										
Balance on goods and services	-0.8	-1.1	0.4	-1.5	-2.1	-1.5	-1.3	-0.9	-0.6	-0.6
Balance on income and transfers	-3.5	-2.9	-2.8	-3.0	-3.1	-3.3	-3.4	-3.4	-3.5	-3.5
Current account balance	-4.4	-4.0	-2.4	-4.4	-5.2	-4.8	-4.6	-4.3	-4.1	-4.0
Trade in goods and services (percent change)										
Export volume	7.5	11.0	1.3	-0.2	5.4	7.2	6.4	7.2	6.7	7.6
Import volume	6.0	7.4	-4.1	11.4	9.3	4.6	4.8	5.2	5.2	7.1
Terms of trade	-1.2	5.5	1.5	2.2	0.2	0.8	0.0	-0.2	0.1	-0.4
Export price	-0.5	13.0	8.6	-3.3	-4.4	2.9	1.2	0.7	0.7	0.4
Import price	0.7	6.8	6.0	-4.3	-4.2	2.2	1.2	0.9	0.6	0.8
External liabilities (percent of GDP)										
Net external liabilities	52.9	53.8	53.6	56.9	59.2	60.8	62.1	63.1	63.7	64.0

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

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

Table 5. Australia: External Debt Sustainability Framework, 1998-2008
(In percent of GDP, unless otherwise indicated)

	Actual					Projections					
	1998	1999	2000	2001	2002	2003	2004	2005	2006	2007	2008
					I. Baseline Medium-Term Projections						
External debt	62.9	64.8	72.9	73.6	76.7	75.4	77.6	79.4	80.5	81.3	77.9
Change in external debt	1.5	1.9	8.1	0.7	3.1	-1.3	2.2	1.8	1.1	0.8	-3.4
Identified external debt-creating flows (4+8+11)	3.3	-1.4	2.2	-0.6	-6.3	-9.2	-5.0	-5.2	-5.8	-5.9	-6.4
Current account deficit, excluding interest payments	2.6	3.2	1.1	-0.3	0.6	-0.3	-0.6	-0.9	-1.1	-1.3	-1.3
Deficit in balance of goods and services	1.7	2.7	1.1	-0.4	1.5	2.1	1.5	1.3	0.9	0.6	0.6
Exports	19.9	18.7	21.9	22.4	20.6	19.7	20.6	20.9	21.3	21.6	22.1
Imports	21.6	21.5	23.0	22.0	22.1	21.8	22.1	22.2	22.3	22.3	22.7
Net non-debt creating capital inflows (negative)	-4.3	-3.1	-1.3	-4.3	-4.3	-4.3	-4.3	-4.3	-4.3	-4.3	-4.3
Net foreign direct investment, equity	1.4	0.5	1.6	1.4	1.4	1.4	1.4	1.4	1.4	1.4	1.4
Net portfolio investment,equity	2.9	2.6	-0.3	2.9	2.9	2.9	2.9	2.9	2.9	2.9	2.9
Automatic debt dynamics 1/	5.0	-1.5	2.4	4.1	-2.6	-4.6	0.0	-0.1	-0.4	-0.4	-0.8
Contribution from nominal interest rate	2.4	2.5	2.9	2.7	3.8	3.7	3.8	3.9	4.0	4.0	3.9
Contribution from real GDP growth	-3.8	-2.6	-2.0	-2.1	-2.2	-2.0	-2.5	-2.6	-2.9	-2.9	-2.9
Contribution from price and exchange rate changes 2/	6.4	-1.4	1.5	3.5	-4.2	-6.3	-1.4	-1.4	-1.5	-1.6	-1.8
Residual, incl. change in gross foreign assets (2-3)	-1.8	3.3	5.9	1.3	9.4	7.9	7.2	7.0	6.9	6.8	3.0
External debt-to-exports ratio (in percent)	316.0	346.1	333.4	327.9	371.7	382.8	376.8	379.2	377.2	375.7	352.5
Gross external financing need (in billions of US dollars) 3/	19.3	24.2	17.2	10.6	19.3	19.1	19.3	19.6	19.9	20.2	20.2
in percent of GDP	5.3	6.2	4.5	3.0	4.8	4.1	4.0	3.8	3.6	3.5	3.3
Key Macroeconomic and External Assumptions											
Real GDP growth (in percent)	5.5	4.4	3.0	2.8	3.4	3.1	3.5	3.6	3.8	3.8	3.8
GDP deflator in US dollars (change in percent)	-15.2	3.3	-5.8	-8.4	7.9	13.1	1.8	1.7	1.9	2.0	2.2
Nominal external interest rate (in percent)	3.4	4.3	4.3	3.5	5.8	5.7	5.4	5.3	5.3	5.3	5.0
Growth of exports (US dollar terms, in percent)	-13.3	1.4	13.2	-3.4	2.6	11.3	10.2	7.0	7.9	7.3	8.4
Growth of imports (US dollar terms, in percent)	-4.3	6.9	3.7	-9.8	12.0	15.3	6.8	5.7	6.1	5.8	8.0
					II. Stress Tests for External Debt Ratio						
1. Real GDP growth, nominal interest rate, dollar deflator, non-interest current account, and non-debt inflows are at historical average in 2003-2008						87.3	94.3	101.3	108.4	115.5	119.0
2. Nominal interest rate is at historical average plus two standard deviations in 2003 and 2004						76.0	79.0	80.7	81.8	82.7	79.2
3. Real GDP growth is at historical average minus two standard deviations in 2003 and 2004						76.3	79.7	81.5	82.6	83.4	80.0
4. Change in US dollar GDP deflator is at historical average minus two standard deviations in 2003 and 2004						101.3	126.1	127.9	128.7	129.3	125.4
5. Non-interest current account is at historical average minus two standard deviations in 2003 and 2004						79.4	85.8	87.6	88.6	89.4	85.9
6. Combination of 2-5 using one standard deviation shocks						95.9	113.6	115.3	116.3	116.9	113.1
7. One time 30 percent nominal depreciation in 2003						101.2	103.4	105.2	106.1	106.8	103.2

Historical Statistics for Key Variables (past 10 years)	Historical Average	Standard Deviation	Average 2003-08
Current account deficit, excluding interest payments	1.4	1.1	-0.8
Net non-debt creating capital inflows	3.3	1.1	4.3
Nominal external interest rate (in percent)	4.8	0.9	5.4
Real GDP growth (in percent)	3.7	0.9	3.5
GDP deflator in US dollars (change in percent)	-1.2	7.8	4.1

1/ Derived as $[r - g - \rho(1+g) + \varepsilon\alpha(1+r)]/(1+g+\rho+g\rho)$ times previous period debt stock, with r = nominal effective interest rate on external debt; ρ = change in domestic GDP deflator in US dollar terms, g = real GDP growth rate, e = nominal appreciation (increase in dollar value of domestic currency), and a = share of domestic-currency denominated debt in total external debt.

2/ The contribution from price and exchange rate changes is defined as $[-\rho(1+g) + \varepsilon\alpha(1+r)]/(1+g+\rho+g\rho)$ times previous period debt stock. ρ increases with an appreciating domestic currency ($\varepsilon > 0$) and rising inflation (based on GDP deflator).

3/ Defined as current account deficit, plus amortization on medium- and long-term debt, plus short-term debt at end of previous period.

AUSTRALIA—ECONOMIC VULNERABILITY ASSESSMENT

1. **Australia's vulnerability assessment remains broadly unchanged from the last assessment, and the economy remains well placed to manage adverse external shocks.**[1] Although net foreign liabilities remain high, their level has broadly stabilized. Foreign debt has become more concentrated in private financial corporations, and its maturity has shortened, reflecting increased intermediation of flows by banks. The foreign currency component of external debt has risen, although the associated currency risk is mitigated through substantial hedging. Corporate and banking sector balance sheets remain strong, and they have proven to be resilient to large swings in exchange and interest rates in the recent past. Household balance sheets also look to be reasonably sound, and they too have been resilient to past interest rate swings. However, housing remains the biggest household asset, and housing debt, which has risen rapidly in the last few years, is the major household liability and a major asset of the banking system. With higher indebtedness and given a rapid rise in housing prices over the past few years, households could be at risk to a major price correction (especially in the investor housing segment of the market), and there could be spillover effects on profitability and capital position of the banking system, although these effects are not expected to pose a systemic threat.

A. External Position

2. **Net external liabilities have remained largely unchanged at around 55 percent of GDP over the last five years, although their composition changed significantly in 2000, as net foreign holding of Australian assets shifted from equity to debt** (Table 1). Net external debt rose to 47 percent of GDP at end-2000 from around 41 percent during the previous three years, and subsequently, it has stayed at roughly that level. Financial corporations account for a growing proportion of both gross external debt and claims. Gross external debt increased from 61 percent of GDP in 1997 to 73 percent at end-2000 and has since risen more modestly to 76½ percent in 2002. The private sector accounts for 87 percent of total external debt, of which financial corporations are the biggest component. Public sector debt declined significantly between 1997 and 2000, and has since remained stable at 10 percent of GDP. The ratio of net interest payments to exports has declined steadily over the last few years, reflecting the relatively lower interest rate environment.

[1] This annex updates the vulnerability assessment provided in Australia: 2002 Article IV Consultation, *SM/02/254*, 2002. That assessment concluded that there were no major vulnerability concerns.

3. **The maturity profile of the external debt has been shortening, and there has been an increase in the foreign currency component.** As the financial sector raises most of its funds at shorter maturities than the government and corporate sectors, the rise in the share of the financial sector's external debt has caused a shortening in the maturity profile of Australia's external debt. At the same time, the share of gross debt denominated in foreign currency has risen slightly to around 64 percent in 2002. Australia's foreign currency exposure is mitigated by a high degree of hedging. A 2001 survey by the Australian Bureau of Statistics (ABS), showed that foreign currency assets of Australian entities exceeded foreign currency liabilities at end-June 2001.[2] Private corporations appear to have relatively minimal direct exposure to exchange risk; a significant portion of their overseas borrowing is hedged naturally. Banks, in contrast, made substantial use of derivatives to hedge their foreign currency exposure. The market for these instruments appears to be reasonably deep and has proven to be resilient given the large swings in the value of the Australian dollar over the past several years.

Australia: External Debt Statistics
(In percent of GDP)

	End-December					
	1997	1998	1999	2000	2001	2002
Gross external debt	61.4	62.8	64.7	73.1	73.5	76.6
Public sector	17.4	14.8	11.4	10.4	9.8	9.8
Private sector	44.0	48.1	53.4	62.7	63.7	66.8
of which: Private financial corporations	31.5	35.2	40.8	46.9	49.5	52.6
Australian dollar-denominated	25.7	23.5	23.8	26.6	24.9	27.4
Foreign currency-denominated	35.7	39.4	41.0	46.5	48.5	49.2
Short term	27.7	30.6	33.1	40.1	39.9	40.8
Australian dollar-denominated	8.3	8.4	9.2	12.6	12.5	13.1
Foreign currency-denominated	19.4	22.2	23.9	27.6	27.4	27.7

Sources: Australian Bureau of Statistics and RBA.

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

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

Source: Australian Bureau of Statistics.

B. Sectoral Balance Sheets

Corporate Sector

4. **Financial indicators suggest that the nonfinancial corporate sector in Australia remains sound**. The debt-to-equity ratio in the nonfinancial corporate sector has been gradually increasing over the last few years to nearly 80 percent in end-June 2002. While this increase raises some concerns, it is noteworthy that the ratio is about half its level in the early 1990s. Moreover, debt was reduced significantly in 2002. The operating margin remains sound and the interest cover ratio indicates a good position. The return on permanent capital has declined over the last two years primarily due to debt-funded acquisitions or investments.

[2] The survey captures around 90 percent of total foreign currency assets and liabilities. An updated survey for 2002 has not been published.

Households

5. **The recent boom in the property market has been associated with a significant increase in household debt.** Lower interest rates, lower inflation, and financial deregulation are the main factors behind the rise in household debt, which jumped from 90 percent of disposable income in 1997 to about 125 percent by the end of 2002, slightly higher now than the debt level in the United States, although the overall gearing ratio (ratio of liabilities to assets) is still relatively low.[3] At the same time, interest payments on mortgages declined to around 5½ percent of disposable income and principal repayments are estimated at about 2½ percent of disposable income.[4] The share of nonfinancial assets to disposable income increased as dwellings (mainly housing) and land increased in value. In contrast, financial assets declined as a share of the total and pension funds lost value. Household liabilities increased substantially with housing debt accounting for a large part of this increase.

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

	1997	1998	1999	2000	2001	2002
Balance sheet indicators (end-June)						
Debt-equity ratio	73.8	70.5	66.2	68.3	74.4	79.2
Debt (in percent of GDP)	72.8	73.2	76.8	82.0	84.8	79.0
Profitability indicators 1/						
Operating income/sales	...	25.3	26.0	26.0	24.6	25.1
Return on permanent capital	...	10.3	10.0	10.8	9.1	9.0
EBITDA interest cover (times)	...	5.1	5.3	5.7	4.8	5.0

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

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

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

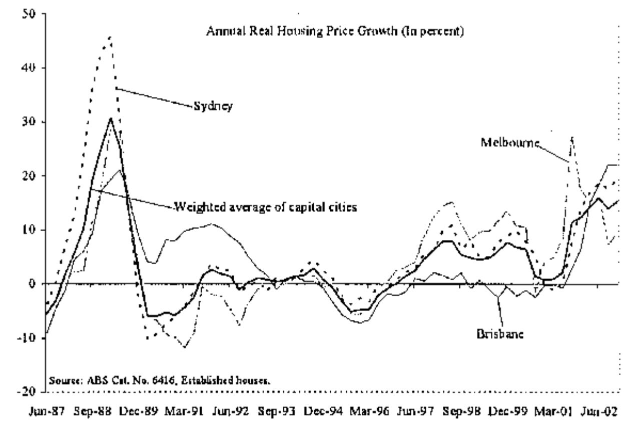
	End-June					
	1997	1998	1999	2000	2001	2002
Net worth	458	465	482	494	496	491
Total assets	549	566	587	607	609	616
Nonfinancial assets	313	321	327	335	339	352
Dwellings and land	273	281	288	296	302	316
Financial assets	236	245	259	272	271	264
Deposits	62	60	57	56	55	59
Shares	54	52	50	50	59	52
Pension funds	117	113	107	120	116	112
Other	3	19	46	46	41	42
Total liabilities	92	101	104	113	113	125
Housing debt	56	62	66	72	75	85
Interest payments	6.2	6.1	6.1	6.8	6.8	5.6
Household net savings	5.6	2.4	2.4	2.2	3.8	1.3

Source: Reserve Bank of Australia.

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

[4] However, estimates of *aggregate* servicing cost may mask much higher servicing costs for some households, given that only 28½ percent of households have a mortgage (the rest either own a home outright or rent).

6. **Housing prices have risen significantly since June 2001.** In real terms, the house price index (weighted average for the 8 capital cities) has risen by more than 30 percent since June 2001, and it increased by 15½ percent in 2002 alone—the highest annual increase since 1989. House price increases in some cities, such as Sydney and Brisbane, have been even higher. Historically, nominal housing prices have not been subject to major downward corrections after periods of very rapid increases. However, unlike the past, the current surge in prices is being driven to an important extent by demand for investment housing, which tends to be concentrated in the central business districts of the major cities and may be more at risk of a price correction. Spillover effects to other segments of the housing market from such a correction could significantly weaken household balance sheets.



Banks

7. **Australia's banking sector performance remains very strong**. With a robust domestic economy, Australian banks remained solidly profitable in 2002; return on assets for the four major banks was 1¼ percent and return on equity was 16 percent.[5] The banking system is also well capitalized, maintaining total capital of around 10 percent and tier-one capital of nearly 8 percent of risk-weighted assets. The overall asset quality of the banking system remains very high, with the ratio of impaired assets to total assets only about 0.6 percent. The strength of the Australian banks is reflected in their ratings by independent credit rating agencies—all of the four major banks have a credit rating of AA- or better. However, housing loans comprise roughly half of total bank loans. While a major correction to housing prices could have some spillover effects on the net income of banks, the banking system's capitalization is sufficiently robust that such a price correction would not pose a systemic threat.

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

	End-December					
	1997	1998	1999	2000	2001	2002
Loans	68.7	69.3	71.0	69.5	69.7	69.6
Loans to persons	38.6	39.0	39.3	41.2	42.2	41.4
Housing loans	32.3	32.6	32.8	35.2	36.3	35.1
Commercial loans	25.8	26.0	26.7	25.1	24.6	25.9
Profitability measures 1/						
Net interest margin 2/	3.0	2.7	2.9	2.4	2.4	2.6
Return on average assets	1.1	1.0	1.2	1.3	0.9	1.1
Return on average equity	15.1	14.0	16.9	18.3	12.7	15.8
Capital adequacy ratios 3/						
Tier 1 capital	7.5	7.6	7.8	7.1	7.7	7.8
Total capital	10.1	10.3	10.1	9.8	10.5	9.9
Impaired assets	0.6	0.7	0.6	0.5	0.7	0.6
Net foreign currency liabilities	7.7	8.0	9.6	11.9	11.7	10.6

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

[5] The four major banks accounted for around 80 percent of banking system loans and deposits at end-September 2002.

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

	End-December					
	1997	1998	1999	2000	2001	2002
Net external liabilities	52.5	55.0	54.9	53.9	53.6	56.9
Net external equity liabilities	12.0	14.3	13.8	7.0	6.9	8.1
Foreign equity investment in Australia	41.4	46.6	51.0	47.5	50.7	46.6
Australian equity investment abroad	-29.3	-32.4	-37.2	-40.5	-43.8	-38.6
Net external debt	40.4	40.8	41.1	46.9	46.6	48.9
Net public debt	9.6	7.4	3.0	2.3	1.6	2.3
Net private debt	30.8	33.4	38.1	44.6	45.0	46.6
Gross external debt	61.4	62.8	64.7	73.1	73.5	76.8
Gross external lending	-21.0	-22.1	-23.6	-26.1	-26.8	-27.9
Short-term net external debt (residual maturity basis)	14.8	17.4	17.2	22.5	23.8	23.0
Short-term gross external debt	27.7	30.6	33.1	40.1	39.9	40.9
Short-term gross external lending	-12.9	-13.2	-15.9	-17.6	-16.1	-18.0
Net interest payment to exports	10.3	9.1	10.4	10.0	9.4	8.7
Memorandum items:						
Gross official reserves (in $A billion)	26.2	25.0	33.6	34.0	36.5	38.1
RBA outstanding forward contracts (in $A billion)	5.6	10.1	22.6	24.9	29.5	25.8
Net official reserves (in $A billion)	20.6	14.9	10.9	9.1	7.0	12.2
Gross official reserves (in months of imports)	2.5	2.3	2.7	2.7	2.7	2.6
Gross official reserves to short-term foreign currency denominated debt (percent)	24.7	19.5	23.1	18.9	19.4	19.6

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

Australia—Fund Relations
(As of July 31, 2003)

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	1,828.35	56.49
Reserve position in Fund	1,408.16	43.51
Financial Transaction Plan transfers (net)	40.00	

III. **SDR Department**:	**SDR Million**	**Percent Allocation**
Net cumulative allocation	470.55	100.00
Holdings	107.55	22.86
Designation plan	0.00	

IV. **Outstanding Purchases and Loans**: None

V. **Financial Arrangements**: None

VI. **Projected Obligations to Fund:** None

B. Nonfinancial Relations

VII. Exchange Rate Arrangement. Australia accepted the obligations of Article VIII, Sections 2, 3, and 4 on July 1, 1965 and maintains an exchange system that is free of restrictions on payments and transfers for current international transactions. Exchange rates are market determined, but the Reserve Bank of Australia retains discretionary power to intervene. On July 31, 2003, the U.S. dollar/Australian dollar exchange rate was US$0.653=$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 2002 Article IV consultation were held in Melbourne, Sydney, and Canberra from June 6 to June 18, 2002. The 2002 consultation (SM/02/254) was completed by the Executive Board on September 16, 2002 (SUR/02/107). Australia is on the standard 12–month consultation cycle.

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

AUSTRALIA—STATISTICAL ISSUES

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).

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

A. Real Sector

Prices

3. The ABS released the experimental DFP in July 2001. The index reflects purchases of Australian residents (households, governments, and businesses), and includes import prices and excludes export prices. The series is confined to final market purchases, and, thus, avoids the issue of multiple counting of price impacts which would result if prices of intermediate stages of production were included.[1] The items and weights for this economy-wide measure of prices are derived from the 1994–95 input-output tables. The series is still in the consultative stage, and is not expected to be published on an ongoing basis until the second half of 2004 . Over the next few years, ABS' program includes introducing financial services and improved measures of telecommunication services in the CPI.

Labor

4. In February 2002, the ABS released two new measures of labor underutilization. In conjunction with existing unemployment statistics, the new measures provide a broad view of labor underutilization. The two new measures are: (i) the labor force underutilization rate, which is the unemployed plus the underemployed as a percentage of the labor force; and (ii) the extended labor force underutilization rate, which includes the unemployed, plus the underemployed, plus two groups that are marginally attached to the labor force—persons actively looking for work, who are not available to start work in the reference week but available to start work within four weeks, and discouraged job seekers—as a percentage of the 'extended' labor force (i.e. the labor force plus the two marginally attached groups). Currently, the new series are available on an annual basis back to 1994, but ABS is working to create a quarterly series for the labor force underutilization rate, which should be available by mid-2004.

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

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

Other

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

B. Fiscal Sector

7. The Australian Commonwealth (central) Government has introduced accrual budgeting with the 1999/2000 Budget estimates that were released in May 1999. Australia's Consolidated Financial Statements now contain a complete set of financial statements and various summary measures of government performance prepared on an accrual basis in accordance with applicable Australian Accounting Standards. Separate Government Finance Statistics (GFS) statements are produced for the budget and mid-year updates of the estimates and the final budget outcomes publications. There has been significant progress in the production of quarterly government finance statistics which are scheduled to be published by the end of 2003. The ABS has been producing quarterly GFS estimates for many years as an input into the quarterly national accounts. It is now working on separate publication of these quarterly data to commence with the December quarter 2003, which is scheduled for release in early March 2004.

8. Australia is a regular reporter of GFS data for publication in *IFS* and the *GFS Yearbook*. Cash data from the Department of Finance Monthly Financial Statements are used for publication in *IFS*. The detailed accrual data for 1999–2001 were published in the IMF's Supplement to the 2002 *GFS Yearbook*.

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

C. Financial Sector

9. Due to changes in legislation and new reporting arrangements for banks, the Australian Prudential Regulation Authority (APRA) suspended publication of the *Australian Banking Statistics* beyond March 2002. While APRA announced its intention to produce a similar publication in 2003, it was not able to provide - in response to STA inquiries - a specific date for the release of updated data. As a result, the most recent monetary survey data available in *IFS* are those for March 2002.

AUSTRALIA—CORE STATISTICAL INDICATORS
(As of August 19, 2003)

	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	07/31/03	05/03	06/03	06/30/03	04/03	07/31/03	03/03	05/03	Q1/03	01/03	Q1/03	3/03
Date received	07/31/03	06/06/03	07/10/03	07/10/03	06/13/03	07/31/03	04/28/03	06/13/03	06/06/03	03/22/03	04/01/03	05/30/03
Frequency of data 1/	D	M	M	W	M	D	Q	M	Q	M	Q	Q
Frequency of Reporting 1/	D	M	M	W	M	D	Q	M	Q	M	Q	Q
Source of data 2/	C	N 5/	N	N	N 5/	C	N 5/	N 5/	N 5/	N 5/	N 5/	N 5/
Mode of reporting 3/	E	E	E	E	E	E	E	E	E	E	E	E
Confidentiality 4/	C	C	C	C	C	C	C	C	C	C	C	C
Frequency of publication	D	M	M	W	M	D	Q	M	Q	Q	Q	Q

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

Statement by the IMF Staff Representative
October 22, 2003

1. This statement contains information that has become available since the Staff Report was circulated to the Executive Board on September 4, 2003. This information does not alter the thrust of the staff appraisal.

2. Real GDP growth in the second quarter of 2003 slowed to about ½ percent (seasonally adjusted annualized rate), compared with growth of slightly more than 2¼ percent in the first quarter. Domestic demand continued to post very strong gains, rising by around 5¾ percent (4 percent in the first quarter). A deterioration in net exports was largely offsetting, reflecting a sharp drop in exports and a rise in imports. Consequently, the current account deficit rose from 5½ percent of GDP in the first quarter to 6¾ of GDP in the second. Recent indicators point to a rebound in GDP growth in the second half of 2003. Retail and motor vehicle sales have surged in the last few months, consumer and business confidence are high, and the unemployment rate fell to 5.8 percent in August, its lowest level in 13 years. Net exports are not anticipated to deteriorate further; indeed, exports are expected to recover as prospects improve for the agricultural sector with an easing in drought conditions. In the first half of 2003, housing prices continued to post rapid gains, rising at an annualized rate of 18 percent.

3. For 2003, GDP is still projected to grow by 3 percent, and it is expected to pick up to 3¾ percent a year over the medium term, in line with the economy's currently estimated potential growth. CPI inflation is expected to remain in the RBA's target range of 2–3 percent. Risks to the outlook have become more balanced, with upside risks becoming more prominent given the continued strength of domestic demand and recovery in agriculture from the drought. Although the Australian dollar resumed its appreciation against the U.S. dollar in September, reaching a value of 70 U.S. cents in October, its trade-weighted value has been largely unchanged. At its regularly scheduled meeting in early October, the Reserve Bank of Australia (RBA) decided to continue to leave the target for the cash rate unchanged at 4.75 percent.

4. Data on the budget outcome for 2002/03 released in September indicate that fiscal performance was significantly stronger than previously estimated. The Commonwealth budget recorded an underlying cash surplus of $A 7.5 billion, equivalent to 1 percent of GDP, which is ½ percentage point higher than estimated at the time of the 2003/04 Budget. Cash receipts were $A 2.2 billion higher than previously estimated, due mainly to stronger-than-anticipated company profits. Cash payments were $A 1.3 billion lower, reflecting lower take-up rates across a range of family and community services and education programs, along with some delays in contracted health expenditures. Net debt of the Commonwealth government declined to $A 29.7 billion (3.9 percent of GDP) at end-2002/03.

5. In an assessment of financial system stability published in September as part of its *2003 Annual Report*, the RBA concluded that the Australian financial system remains very

sound.[1] The financial soundness indicators monitored by the RBA—including asset quality, capitalization, profitability, and market valuation—continue to provide reassuring readings. Asset quality remains robust, with the ratio of impaired to total assets for the banks continuing at the low level of 0.5 percent. At the same time, lending standards—particularly for mortgages to finance investor purchases of housing—have been tightened. Strong lines of defense also are maintained against a deterioration in credit quality, as banks hold general provisions amounting to around 0.5 percent of total assets and aggregate capital of around 10 percent of risk-weighted assets; nonbank deposit-taking institutions have aggregate capital of 14–15 percent. The banks in particular have maintained high levels of profitability by enlarging their asset bases, containing costs, and diversifying income sources. In the period ahead, the RBA saw the main potential source of risk to financial stability as being a substantial correction in the housing market that could impact on the balance sheets of financial institutions through mortgage defaults. A flattening of, or modest reversal in, housing prices was not seen in itself as a cause for concern. The concern would be a sharp jump in mortgage default rates that would trigger a more substantial housing market correction, a scenario that was viewed as more likely to be associated with a deterioration in employment conditions or a sharp rise in interest rates.

6. In a September 8 address, the Chairman of the Australian Prudential Regulatory Authority (APRA) discussed his agency's stress tests of the housing loan portfolios of Australian deposit-taking institutions. APRA tested the resilience of each individual institution's mortgage portfolio to a 30 percent drop in housing prices over a one-year period and a probability of default on housing loans of around 3½ percent for deposit-taking institutions as a group, conditions which are far worse than Australia has experienced historically. The tests suggest that such a substantial correction in the housing market would not in itself be cause for undue alarm about the strength and stability of the sector. The capital position of these institutions as a group—though reduced—would not be materially affected, and over 90 percent of them would survive such a shock without breeching minimum regulatory capital requirements. Breeches of minimum capital requirements by a small number of institutions would not be large, and no institution would fail or come uncomfortably close to failing. The tests, nonetheless, drew APRA's attention to potential shortcomings in information systems and specific improvements that are needed to strengthen risk management policies and capital positions at some individual institutions, and APRA will be working with these institutions to achieve improvements. Where necessary, APRA would raise minimum capital ratios for institutions whose housing lending practices are judged as not being up to standard.

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[1] Although APRA is responsible for conducting the supervision of individual financial institutions, the RBA retains a mandate to monitor and assess the overall stability of the Australian financial system.

Public Information Notice (PIN) No. 03/129
FOR IMMEDIATE RELEASE
October 29, 2003

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

IMF Concludes 2003 Article IV Consultation with Australia

On October 22, 2003, the Executive Board of the International Monetary Fund (IMF) concluded the Article IV consultation with Australia.[1]

Background

Australia's economy has continued to perform remarkably well over the past year, despite encountering major adverse shocks, including persistent weakness in the global economic environment and a sustained, severe drought at home. Real GDP growth picked up from 2¾ percent in 2001 to just over 3½ percent in 2002, led by buoyant domestic demand. The strength of domestic demand reflected an easing of monetary policy in 2001 (which was only partially reversed in 2002), further moderate fiscal stimulus during 2001/02, an improvement in the terms of trade, and a competitive exchange rate. Continued strength in the housing sector—supported by a low interest rate environment, government incentives to first-time homeowners, and perceived high rates of return on property—and a robust rebound in business investment underpinned the growth momentum in 2002. In the first half of 2003, GDP growth slowed to 1.4 percent (seasonally adjusted annualized rate), as the drought, weak foreign demand, and appreciation of the Australian dollar placed a substantial drag on exports. Domestic demand also softened.

Employment growth picked up, bringing the unemployment rate down from 6.8 percent at end-2001 to 5.8 percent in August 2003. Inflation has remained in check. CPI inflation picked up in early March 2003 to an annual rate of 3.4 percent, reflecting a temporary rise in oil prices and drought-related food price increase; subsequently, it has come back down, easing to a 2.6 percent annual rate in September 2003. Measures of core CPI inflation have remained

[1] Under Article IV of the IMF's Articles of Agreement, the IMF holds bilateral discussions with members, usually every year. A staff team visits the country, collects economic and financial information, and discusses with officials the country's economic developments and policies. On return to headquarters, the staff prepares a report, which forms the basis for discussion by the Executive Board. 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.

relatively stable and within the Reserve Bank of Australia's (RBA's) 2–3 percent official target range. Housing prices continued to post strong gains, with an index of real property prices in major cities rising by 18½ percent in 2002 and some 46 percent over the past three years. After significant weakness in 2000–01, the Australian dollar has strengthened markedly over the past year and a half, appreciating by June 2003 by almost 30 percent against the U.S. dollar and by about 12 percent on a real effective basis since its low in early 2002. The external current account deficit has widened, increasing from about 2.4 percent of GDP in 2001 to 6.7 percent in June 2003.

In response to slowing growth in 2001, the RBA cut the short-term cash rate six times to a post-war low of 4¼ percent. Monetary conditions also eased as a result of the depreciating Australian dollar. As domestic demand recovered strongly, the RBA raised the cash rate by a total of 50 basis points in May–June 2002 to 4¾ percent. Subsequently, the cash rate has remained unchanged.

With the domestic and international economic environment expected to strengthen, the May 2002 Budget was intended to withdraw some of the fiscal stimulus that had been injected in the previous two years. The Commonwealth budget and the state and local government sector were projected to be in approximate balance in 2002/03. In the event, Australia's participation in the war in Iraq resulted in some unanticipated defense and security expenditures, while growth was slightly weaker than had been expected. Nevertheless, revenues proved to be surprisingly robust, and the Commonwealth budget recorded an underlying cash surplus of 1 percent of GDP in 2002/03. The May 2003 Budget forecasts small underlying cash surpluses in 2003/04 and over the medium term after the introduction of new measures including tax cuts and modest expenditure increases in the areas of defense and domestic security, health care, and higher education.

Real GDP growth is expected to slow to 3 percent in 2003 reflecting continued sluggish external demand growth, ongoing effects of the drought, and the appreciation of the exchange rate. Risks to the short-term outlook have become more balanced, with upside risks becoming more prominent given continuing strength in domestic demand and recovery in agriculture from the drought. Downside risks stem from the possibility of further weakness in external demand and/or appreciation of the Australian dollar. A sharp correction in housing prices also could have significant adverse effects across the economy.

Executive Board Assessment

Executive Directors commended the continued strong performance of the Australian economy in the face of persistent weakness in external demand and a severe drought at home. They attributed Australia's ability to generate robust economic growth with low inflation to the enhanced resilience of the economy, brought about, in turn, by steadfast pursuit of prudent macroeconomic policies and structural reforms within transparent policy frameworks.

Directors acknowledged that a number of risks cloud the economic outlook, including those generated by the uncertain outlook for external demand, the drought, rapidly rising property prices, and a sharp appreciation of the currency. However, they noted that Australia's economic fundamentals are strong, and that the authorities remain committed to sound macroeconomic management and structural reform. Overall, they judged Australia's near- and medium-term economic growth prospects to be favorable, and expected inflationary pressures to be held in check.

Directors noted that the inflation targeting framework has worked well. They considered the stance of monetary policy during the past year to have been generally appropriate, and recommended that the authorities continue to remain cautious and alert to signs of changing circumstances.

Directors considered that the rapid increase in housing prices poses a challenge for monetary policy in the near term, particularly in view of the appreciation of the Australian dollar. While agreeing that the increase in housing prices largely reflects economic fundamentals up to now, they cautioned that there may be speculative elements at work in some parts of the market, and that the authorities should continue to monitor housing market developments closely. Although monetary policy should not target asset prices, attention has to continue to be given to the impact that possibly unsustainable increases in housing prices could have on economic activity and inflation. Directors agreed that the appreciation of the Australian dollar is generally in line with its medium-term equilibrium value and is mostly due to the relative strength of the Australian economy.

Directors regarded Australia's fiscal position as fundamentally sound, reflecting the authorities' disciplined implementation of their policy framework. Directors endorsed the authorities' strategy of balancing the budget on average over the business cycle. They noted the authorities' preference to use discretionary fiscal policy in a manner that would make a lasting contribution to potential output rather than just temporarily boost demand. In this context, they noted that the very sound fiscal position provided scope for the full functioning of automatic stabilizers.

Directors noted the significant fiscal pressures that the authorities are likely to face over the longer term as a result of the aging in the population. They praised the authorities' strategy to cope with aging-related pressures. In particular, forward planning was considered preferable to delaying actions, which may lead to undesirable imbalances in the future. They also considered that the strategy outlined in the 2003/04 budget to tackle these challenges—which emphasizes raising labor force participation rates and sustaining strong productivity growth—is comprehensive and well conceived. Directors noted that the authorities are already implementing a range of measures in line with this strategy, as well as exploring other specific options for reforms. They agreed that the government may need to run somewhat larger budget surpluses than currently planned in order to build up a sufficient stock of resources to meet financing needs, particularly for comprehensive reforms in such areas as the personal income tax and the income support system.

Directors considered sound and stable macroeconomic policies and further reform of the personal income tax system to be essential elements of the authorities' strategy to strengthen growth. They concurred that, the fiscal position permitting, it would be desirable to raise further the income thresholds at which the different marginal tax rates apply, and to bring down over time the top marginal tax rate. Moreover, reductions in the personal income tax might be needed to maintain an internationally competitive tax system.

Directors agreed that a comprehensive reform of the complex system of income support would provide stronger incentives for labor force participation. They noted that the interplay between the current income support and the personal income tax system creates high effective marginal tax rates when individuals move from welfare to work. The transition to work would be facilitated by reducing these high effective marginal tax rates through further income tax reform, improved support services—including employment, job training, and child care services—and a more tapered reduction in assistance. Tightening eligibility for income support programs and instituting penalties for breach of obligations with regard to unemployment benefits would provide stronger incentives to return to employment. Directors noted that proposed changes to the industrial relations system and investment in education would also help raise labor market participation rates, enhance the flexibility of the labor market, and increase labor productivity. Directors also noted the authorities' efforts to reduce health care cost pressures, and urged the authorities to implement the announced changes to the Pharmaceutical Benefits Scheme.

Directors commended the authorities for their commitment to trade liberalization. With trade barriers to other countries not being raised, Australia's pursuit of bilateral free trade agreements was seen as supportive of the country's multilateral liberalization efforts. Directors commended the authorities for their recent unilateral decision to provide complete duty- and quota-free market access to the least developed countries. However, they encouraged Australia to further raise its level of official development assistance.

Directors noted the soundness of Australia's financial system, and they commended the authorities for the steps that have been taken to strengthen financial supervision. They welcomed the results of the recent stress tests of the housing loan portfolios of individual banks, which suggest that these institutions could safely manage a sharp decline in housing prices and avoid systemic disruptions. Directors agreed, however, that close supervision of the lending standards and information systems of financial institutions will need to be maintained. They also welcomed the steps that have been taken to strengthen supervision of the insurance industry, and they encouraged the authorities to proceed expeditiously with their planned reforms to strengthen the governance of superannuation funds. Directors commended the authorities for their efforts to combat money laundering and the financing of terrorism, noting that Australia is in full compliance with the recommendations of the Financial Action Task Force.

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. The Staff Report for the 2003 Article IV Consultation with Australia is also available.

Australia: Selected Economic and Financial Indicators, 1997-2002

	1997	1998	1999	2000		2001	2002
Output and demand (percent change)							
Real GDP	3.8	5.3	4.5	2.8		2.7	3.6
Total domestic demand	3.6	6.6	5.7	1.9		1.5	5.9
Private consumption	4.0	4.6	4.9	3.2		2.9	4.0
Fixed investment	9.9	8.2	7.7	-0.1		-1.2	13.0
Exports of goods and services	11.1	0.1	4.4	11.0		1.3	-0.2
Imports of goods and services	10.5	5.9	9.1	7.4		-4.1	11.4
Inflation and unemployment (in percent)							
CPI inflation	0.3	0.9	1.5	4.5		4.4	3.0
Unemployment rate (annual average)	8.2	7.7	7.0	6.3		6.7	6.3
Saving and investment (in percent of GDP)							
Gross national saving	18.7	19.0	18.9	19.3		19.1	18.1
General government saving	1.8	3.9	4.5	2.8		3.0	2.8
Private saving 1/	16.8	15.1	14.5	16.5		16.1	15.3
Gross capital formation	21.8	23.9	24.8	23.0		20.6	22.5
Fiscal Indicators (in percent of GDP) 2/							
Commonwealth budget							
Revenue	24.2	24.7	26.4	24.0	3/	22.8	23.4
Underlying expenditure 4/	24.0	24.0	24.3	23.1	3/	23.0	22.4
Underlying balance 4/	0.2	0.7	2.1	0.9		-0.1	1.0
Commonwealth government net debt	14.8	11.9	9.2	6.4		5.3	3.9
Money and credit (end of period)							
M1 (percent change)	13.3	6.1	9.7	9.4		21.3	-9.3
M3 (percent change)	7.1	7.0	9.6	4.8		14.8	10.4
Private domestic credit (percent change)	11.3	10.3	11.1	11.9		8.8	11.8
Interest rate (90-day bill, in percent)	5.1	4.8	5.7	6.2		4.2	4.8
Government bond yield (10-year, in percent)	6.0	5.0	7.0	5.5		6.0	5.5
Balance of payments (in percent of GDP)							
Current account	-3.1	-4.9	-5.7	-4.0		-2.4	-4.4
of which: Trade balance	0.4	-1.4	-2.5	-1.2		0.5	-1.3
Terms of trade (percent change)	2.0	-4.1	-0.9	5.5		1.5	2.2
External assets and liabilities (in percent of GDP)							
Net external liabilities	52.5	55.1	55.0	53.8		53.6	56.9
Gross short-term external debt	27.7	30.6	33.1	40.1		39.9	40.9
Net short-term external debt	14.8	17.4	17.2	22.5		23.8	22.9
Gross official reserves	4.8	4.3	5.5	5.2		5.3	5.2
Exchange rate (end of period)							
US$/$A	0.653	0.614	0.654	0.554		0.508	0.566
Trade-weighted index	58.4	53.3	56.4	51.7		50.2	52.0
Nominal effective exchange rate 5/	105.5	95.3	100.3	92.0		89.8	92.9
Real effective exchange rate 5/	85.9	78.0	82.9	78.9		78.7	82.6

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

1/ Includes public trading enterprises.

2/ Fiscal year ending June 30 of the following year.

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

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

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