September 2005
IMF Country Report No. 05/331

Australia: 2005 Article IV Consultation—Staff Report and Public Information Notice on the Executive Board Discussion

Under Article IV of the IMF's Articles of Agreement, the IMF holds bilateral discussions with members, usually every year. In the context of the 2005 Article IV consultation with Australia, the following documents have been released and are included in this package:

- the staff report for the 2005 Article IV consultation, prepared by a staff team of the IMF, following discussions that ended on June 17, 2005, with the officials of Australia on economic developments and policies. Based on information available at the time of these discussions, the staff report was completed on August 24, 2005. 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 Public Information Notice (PIN) summarizing the views of the Executive Board as expressed during its August 29, 2005 discussion of the staff report that concluded the Article IV consultation.

The document listed below has 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 2005 Article IV Consultation

Prepared by the Staff Representatives
for the 2005 Consultation with Australia

Approved by David T. Coe and Carlo Cottarelli

August 24, 2005

- The 2005 Article IV consultation discussions were held in Sydney, Melbourne, and Canberra during June 8–17, 2005.
- The staff team consisted of Messrs. Coe (Head), Beaumont, Mercereau, Ms. Cui, (all APD), and Mr. Ouliaris (RES). Mr. Murray (Alternate Executive Director) attended the meetings in Canberra.
- The mission met with Treasurer Peter Costello, RBA Governor Ian Macfarlane, Treasury Secretary Ken Henry, Productivity Commission Chairman Gary Banks, other senior officials, academics, and financial, business, and labor representatives.
- Macroeconomic and structural policies are sound and are consistent with Fund advice. To address the challenge of increasing healthcare costs and population ageing, the authorities have taken measures to enhance the sustainability of health spending, and a Future Fund will be established to cover unfunded public service pension liabilities. The 2005 budget has announced reforms of welfare policies and the government has also proposed reforms of industrial relations in order to promote labor force participation and productivity growth. The authorities continue to monitor private sector balance sheets closely, and are refining the prudential regulation of household lending. These policies are consistent with Executive Director's recommendations at the conclusion of the 2004 Article IV consultation on October 27, 2004 (*IMF Country Report No. 04/353*, http://www.imf.org/external/np/sec/pn/2004/pn04124.htm).
- The Australian dollar is independently floating and Australia maintains an exchange system free of restrictions. It has accepted the obligations of Article VIII (Annex II).
- Australia publishes high quality economic and financial data on a timely basis and subscribes to the Special Data Dissemination Standard (Annex III).

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Executive Summary

Economic Background

- **Economic activity slowed during 2004 as domestic demand growth eased owing to a welcomed cooling of the housing market.** The appreciation of the exchange rate in recent years also contributed to the slowing by boosting imports. While the current account deficit widened, unemployment reached a 28-year low of 5 percent, inflation remained subdued, and strong revenues lifted the fiscal surplus.

- **Prospects for the Australian economy remain strong.** Growth is expected to rise from 2¼ percent in 2005 to about 3½ percent in the medium term as high investment boosts capacity, particularly in the export sector. Domestic demand growth will remain moderate as stimulus from the housing market fades, with large terms of trade gains also leading to a declining current account deficit. Underlying inflation may edge up in the near term, but upside risks have diminished.

Policy Issues

- **Macroeconomic policies are on track.** Monetary policy is in a wait-and-see stance for the time being, as is appropriate following the moderation in domestic demand. Fiscal policy has responded prudently to rising export commodity prices, while the mild fiscal stimulus from the budget may have helped cushion the slowing in activity.

- **Risks to the economic outlook are tempered by flexibility in macroeconomic policies and in the exchange rate.** The risk of a hard landing in the housing market appears to have eased, but terms of trade gains could be reversed rapidly if global growth slowed.

- **There is now an exceptional opportunity to implement further reforms to sustain and improve Australia's strong economic performance.** In particular, employment and productivity can be improved by implementing proposed reforms of labor markets and welfare policies. Productivity can also be increased by improving price signals in infrastructure, especially for water, land transport, and electricity, to encourage more efficient use and stimulate timely investments to expand infrastructure capacity.

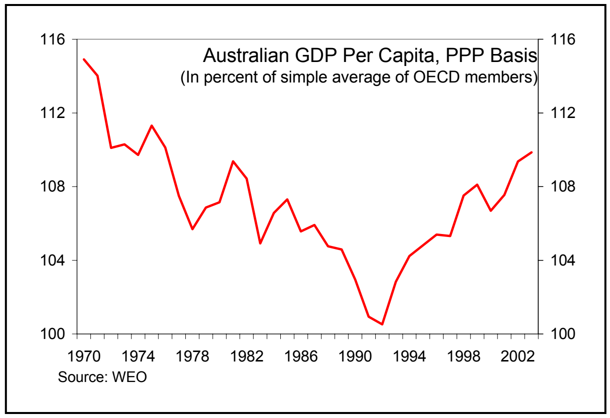
- **The authorities' strategy is to address Australia's long-term fiscal challenges through ongoing structural reforms on a broad front.** Recent steps to enhance the sustainability of health spending are welcome, and reforms to strengthen incentives for cost effectiveness in the health system could have large cumulative benefits by boosting productivity growth in this key sector. Following best practices in asset management and transparency will help ensure that the proposed Future Fund makes the greatest contribution to strengthening the government's balance sheet.

- **Financial regulation will need ongoing refinement in order to best preserve the financial health of the private sector, and hence the resilience of the economy.** Recent steps in response to the emergence of nonstandard household lending are prudent.

I. REFORMS HAVE PAID LARGE DIVIDENDS

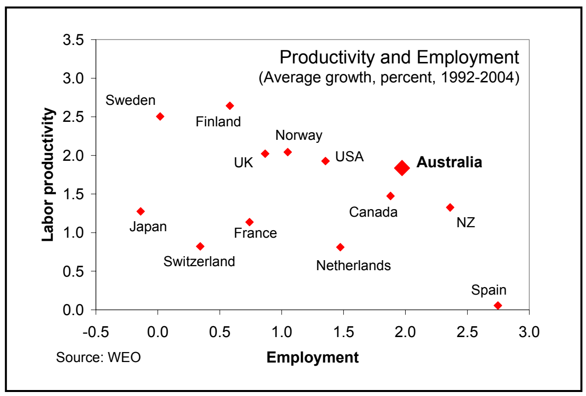
Australia has implemented wide-ranging structural reforms and strengthened the frameworks for monetary and fiscal policies over the past two decades. These efforts have yielded rapidly rising incomes through strong job creation and high productivity growth. Inflation has remained low and net public debt has been virtually eliminated—all in the context of an increasingly stable and resilient economy.

1. **Australians' incomes have turned around decisively.** In the 1950s, Australian living standards were among the highest in the world, but by 1990 per capita incomes (PPP basis) had declined to close to the OECD simple average and ranked in the bottom third of the OECD membership. Since 1992, however, Australia's real GDP has grown at an average annual rate of 3¾ percent, lifting per capita incomes to almost 10 percent above the OECD average by 2003.

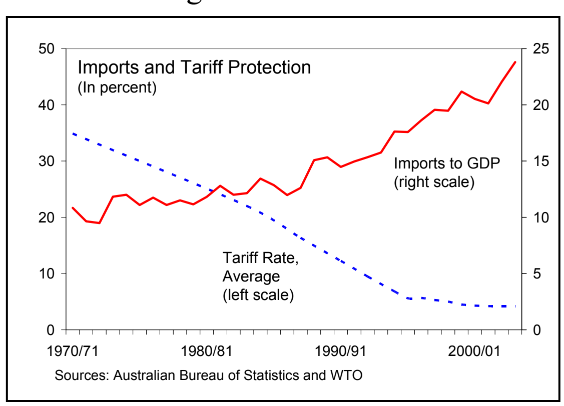


2. **Employment and productivity gains were both strong,** reflecting the benefits of the wide-ranging structural reforms implemented over the past two decades:

- **The unemployment rate has fallen by 6 percentage points since 1992, supported by more flexible labor markets and welfare reforms.** Labor market arrangements had historically been centralized and rigid. A series of reforms progressively decentralized bargaining toward the enterprise and individual level, with the wages of only one-fifth of employees set by centralized awards in 2002, compared with two-thirds in 1990. Among other reforms of the welfare system, the *Mutual Obligation Initiative* introduced in 1996 increased incentives for the unemployed to take jobs or participate in programs to enhance their employability.



- **Increased competition, both domestic and external, has promoted productivity growth.** Financial market deregulation and the reform or privatization of government businesses were part of the initial wave of reforms in the 1980s. The National Competition Policy (NCP), agreed to in 1995, reduced legal barriers to competition in some industries, ensured competitive neutrality for government businesses, enhanced third-party access to infrastructure, and reformed the transport, electricity, gas, and water sectors. Together with major reductions in trade barriers, adopted largely on a unilateral basis, these reforms raised productivity by improving efficiency at the microeconomic



level—it is estimated that productivity and price changes in key infrastructure sectors in the 1990s to which the NCP contributed raised GDP by 2½ percent.[1]

- **Fiscal measures helped to overcome barriers to reform.** Many aspects of the NCP are in the jurisdiction of the State governments. The challenge of coordinating these reforms was partly overcome by recycling to the States the projected federal revenue gains from reforms in the form of competition payments.

3. **Australia's economy has also become more stable, owing in part to reforms of the macroeconomic policy frameworks.** The economic expansion that began in 1992 is now in its 14th year, with the economy shrugging off the impact of the Asian crisis in 1997–98, the global IT slump in 2000–01, and a severe drought in 2002–03. Despite these shocks, the severity of Australia's economic fluctuations has declined: the standard deviation in the annual rate of GDP growth was 0.9 percent in 1992–2004, well below the 2.3 percent in the previous three decades. The greater resilience of the economy reflects increased flexibility at the microeconomic level as well as reforms to the frameworks for macroeconomic policy:

- **The floating exchange rate has been a key economic shock absorber.** The Australian dollar was floated in 1983. By moving broadly in accordance with the fluctuations in external demand and commodity prices, the exchange rate has tempered the impact of these fluctuations on Australian economic activity.[2]

- **Monetary policy has preserved low inflation in a flexible manner.** The Reserve Bank of Australia (RBA) adopted inflation targeting in 1993, and was made fully independent in 1996. CPI inflation has averaged 2½ percent since 1993, right in the center of the inflation target of 2 to 3 percent. Importantly, this target is to be achieved on average over the cycle, allowing flexibility for monetary policy to take into account implications for employment and economic activity.

- **Fiscal policy has been prudent.** In 1998, the *Charter of Budget Honesty Act* laid out principles of sound fiscal management, within which the government set the objective of maintaining budget balance, on average, over the cycle. When economic growth prospects remain sound, the government also aims to maintain a budget surplus on the forward estimates. This framework has locked in the gains from fiscal consolidation in the mid-1990s, with fiscal surpluses achieved in six of the past seven years. Government net worth rose by 9 percentage points of GDP as a result, and net debt is expected to be less than 1 percent of GDP by the end of 2005/06.

4. **Private investment and growth have been supported by external financing on a sustained basis within this economic framework.** The external current account deficit has averaged 4½ percent of GDP since 1990, lifting net external debt from 35 percent of GDP to 50 percent by end 2004. Almost all net external debt—97 percent—is owed by the private sector, with four-fifths being intermediated by financial institutions. Although debt has risen, investment

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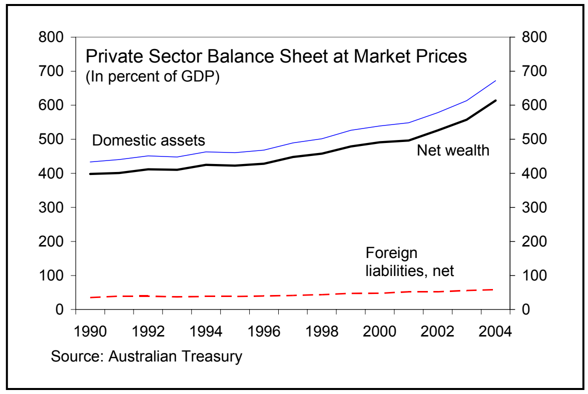
[1] *Review of National Competition Policy Reforms*, Productivity Commission, February 2005.

[2] Australia's adaptation to a flexible exchange rate is discussed in Chapter I of the forthcoming Selected Issues paper.

and valuation gains have raised the private sector's domestic assets by even more, increasing private sector net wealth from 400 percent of GDP in 1990 to over 600 percent of GDP in 2004. As a result, net external liabilities have remained less than one-tenth of the domestic assets of the private sector.

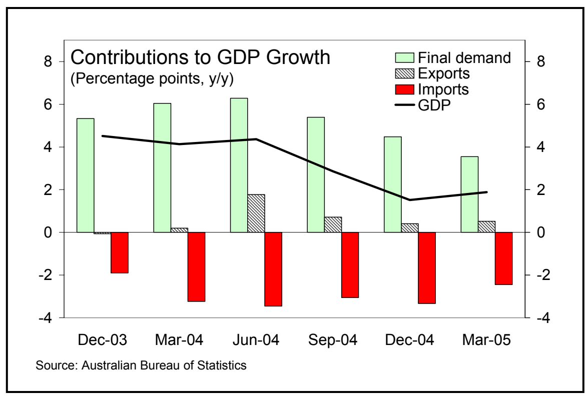


5. **The government now has an exceptional opportunity to implement further reforms.** The Liberal-National party coalition was elected to its fourth consecutive term in October 2004, and from July 2005 the government has a majority in the Senate, which had previously blocked key reforms. There appears to be widespread recognition of the lasting benefits from past reforms and increasing acceptance of the need for further reforms.

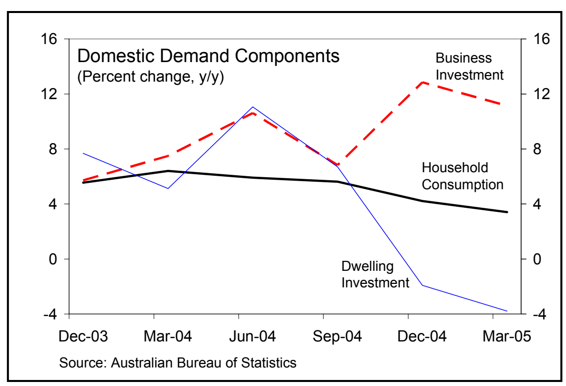
II. Why did the Economy Slow Recently?

Activity slowed in the second half of 2004 largely reflecting a welcomed cooling of the housing market and the rise in the Australian dollar in recent years. The external current account deficit widened but strong job creation continued and inflation remained low.

6. **Growth averaged 3¼ percent (y/y) in 2004, but slowed to 2 percent (Q1/Q1) by the first quarter of 2005** (Table 1). Economic activity was particularly weak in the second half of 2004, with growth running at an annualized rate of only 1 percent. Most analysts were surprised by the extent of this slowdown, which partly reflected a sharp fall in inventory investment that was reversed in the first quarter of 2005, boosting quarterly growth (Q1/Q4) to an annualized rate of 2¾ percent.

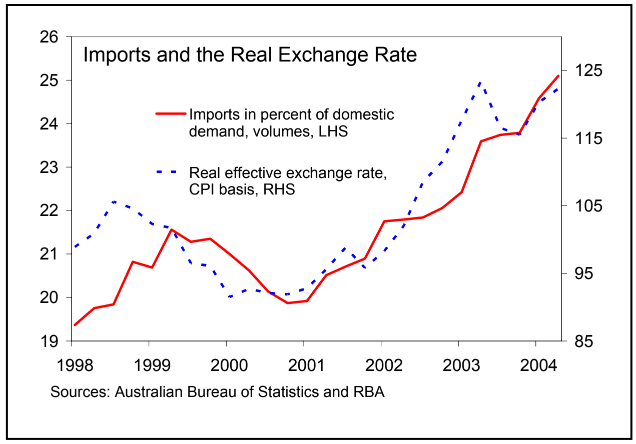


7. **Decelerating domestic demand was the main factor slowing growth, following a welcomed cooling of the housing market.** Having risen at an annual pace of 17½ percent in 2001–03, national housing prices were flat in the year to March 2005, with modest declines in Sydney, Melbourne, and Canberra.[3] Consumption growth moderated and dwelling investment fell as a result, so growth in final domestic demand eased to 3½ percent (y/y) in the first quarter of 2005 from 6 percent a year earlier. Business investment remained buoyant, reflecting high levels of profitability and capacity utilization.

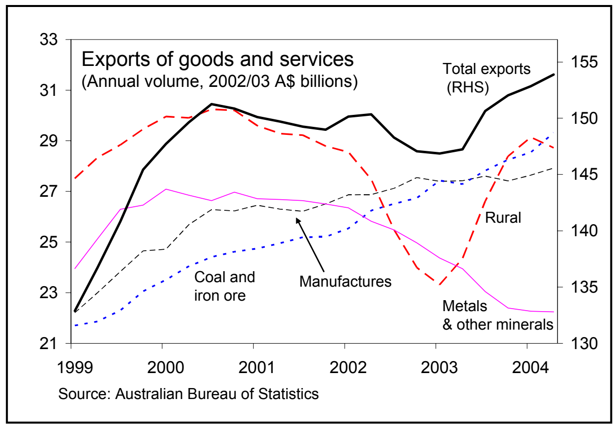


[3] Box 1 in IMF Country Report No. 04/353 discusses the Australian house price surge in more detail.

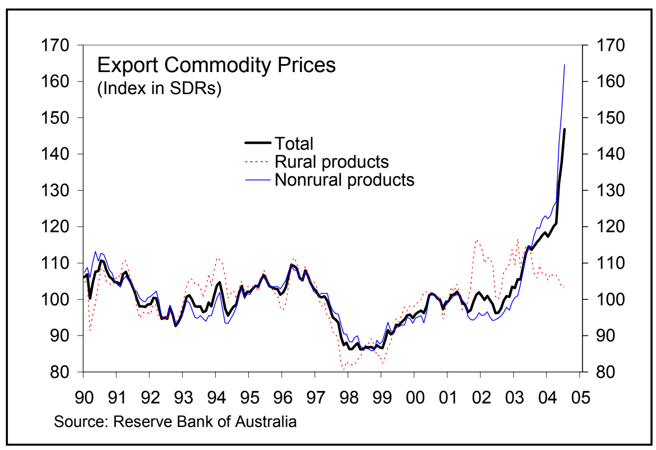
8. **The appreciation of the Australian dollar in recent years also restrained output growth in 2004.** Imports rose rapidly, responding to the 27 percent appreciation of the real exchange rate in 2002-03, and met three-quarters of the rise in final domestic demand during 2004. In the first quarter of 2005 the real effective exchange rate was 16 percent above its average level since 1990—reflecting a combination of U.S. dollar weakness, strong commodity prices, and relatively high Australian interest rates. Official reserves net of swap commitments were US$20 billion (3¼ percent of GDP) in June 2005, up from US$17 billion a year earlier.



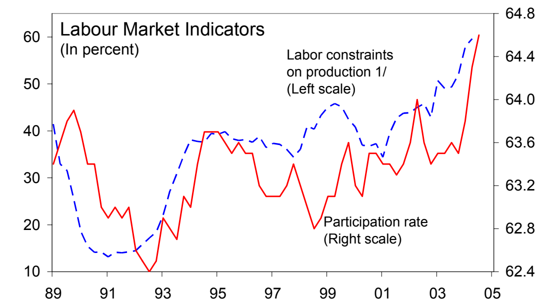
9. **Exports supported growth in spite of some supply-side constraints.** The volume of exports rose 4 percent in 2004 mainly because of a 25 percent rebound in rural exports from the 2002–03 drought. Owing to constraints on mine capacity and on rail and port infrastructure in some areas, the expansion of coal and iron ore exports was limited to 4 percent in 2004, even as global demand, especially from China, rose strongly. Mine closures and refinery shutdowns led to a further decline in metals exports, and slow growth in exports of manufactures continued, reflecting the combined effects of the high exchange rate and more intense global competition.



10. **Though the terms of trade rose to levels not seen for three decades, the current account deficit widened.** This mainly reflected an increase in payments to foreign investors, largely owing to high mining sector profits. Export commodity prices in SDR terms rose to almost 50 percent above their 2001–03 average in June 2005, led by sharp increases in coal and iron ore prices. As a result of a 10 percent rise in the terms of trade, the trade balance was stable in 2004 despite the large rise in import volumes (Table 2). The current account deficit widened to 6½ percent of GDP, being financed mainly through external debt issues by financial institutions, with net external liabilities rising to 65 percent of GDP.

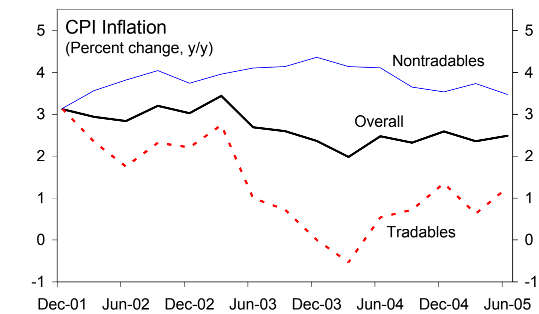


11. **Unemployment has fallen to a 28-year low of 5 percent, but aggregate wage growth has risen little.** Employment growth has remained strong, at 3 to 4 percent (y/y) in 2005, possibly because real unit labor costs are below historical average levels. With labor participation rising to new highs, indicators of the difficulty of finding suitable labor have increased. Nevertheless, average wage rises have edged up only slightly to 4 percent, despite robust wage increases in sectors such as construction and mining.



Sources: Australian Bureau of Statistics and National Australia Bank
1/ Share of firms reporting that availability of suitable labor is a constraint on production.

12. **CPI inflation has been steady at about 2½ percent (y/y).** Nontradable inflation eased slightly to 3½ percent in June 2005, partly reflecting less rapid rises in the housing component as dwelling investment declined. Meanwhile, tradables inflation has picked up as the dampening effects of the 2002–03 exchange rate appreciation have waned.[4]



Source: Australian Bureau of Statistics

13. **The RBA tightened the stance of monetary policy in March 2005 to lean against a prospective rise in inflation.** Having kept interest rates on hold since late 2003, the RBA raised target cash rate by 25 basis points to 5½ percent in March 2005. In its February 2005 *Statement on Monetary Policy* the RBA projected that inflation would rise to about 3 percent by the end of 2006, as prospects for domestic demand remained solid while signs of capacity constraints were emerging, and 2004 PPI data suggested inflation pressure in the pipeline.

14. **The fiscal surplus for 2004/05 is projected to be substantially higher than previously expected.** In the 2005 Budget released in May, the government projects the underlying cash balance to reach 1.1 percent of GDP in 2004/05 (the fiscal year ends in June), compared with the surplus of 0.3 percent of GDP projected in the 2004 Budget (Table 3). Revenue is projected to be almost 1 percent of GDP higher than before, with company taxes particularly buoyant, partly reflecting the boost in profits from rising export commodity prices.

III. Where Is the Economy Heading?

A rebalancing of economic growth is expected over the medium term as exports strengthen while domestic demand moderates, an outlook shared by the authorities, the mission, and most economic analysts. Housing market risks appear to have eased somewhat, but external risks remain, although overall prospects are underpinned by flexibility in the economy and macroeconomic policies.

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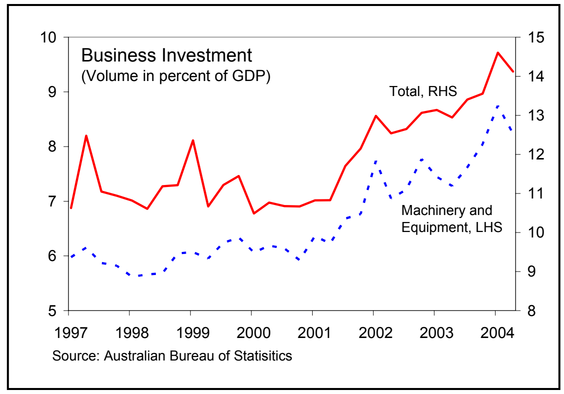
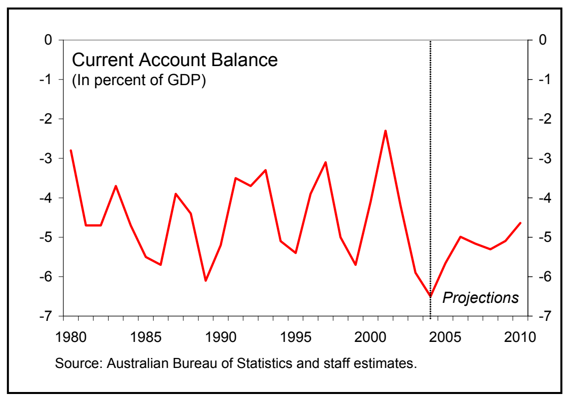
[4] The RBA has noted that the impact on inflation from the appreciation in 2002–03 has been smaller than expected. The role of increasing goods market competitiveness in accounting for declining exchange rate pass-through is analyzed in a forthcoming Working Paper.

15. **Growth is expected to steady in 2005.** Real GDP growth is projected to continue at about 2¾ percent during the remainder of 2005, with year-on-year growth of 2¼ percent as a result of carry-over effects from slow growth in the second half of 2004. Domestic demand growth will likely further ease as households respond to lower housing price rises and slightly higher interest rates. A more rapid slowing is unlikely, as investment intentions remain positive and consumer confidence is underpinned by strong employment growth, income tax reductions, and the broad based 25 percent rise in equity prices in 2004. The rising terms of trade will also support demand, although this effect is expected to be smaller than in the past (Box 1). Some resource projects are coming on-stream in 2005, but total export growth may be restrained by weakness in agricultural production. The current account deficit is expected to narrow to about 5¾ percent of GDP due to terms of trade gains—the trade balance increased notably in the second quarter as export prices rose steeply. While headline inflation may approach 3 percent in 2005 owing to higher oil prices, underlying inflation is expected to edge up more modestly.



16. **Real GDP growth is projected to rise to about 3½ percent on average in the medium-term, with exports likely to play a greater role as a driver of growth** (Table 4). The expected strengthening of export growth reflects rising investment in the resource sector in recent years and substantial further investments planned in coming years.[5] Domestic demand growth is expected to remain moderate as the stimulus from the housing market fades and household saving is rebuilt over time. Hence the external current account deficit would decline back to its historical average of 4½ percent of GDP even as global commodity supply increases lead to some unwinding of recent export price gains in the medium term. Underlying inflation may remain in the upper half of the target range in 2006, before returning to about 2½ percent.

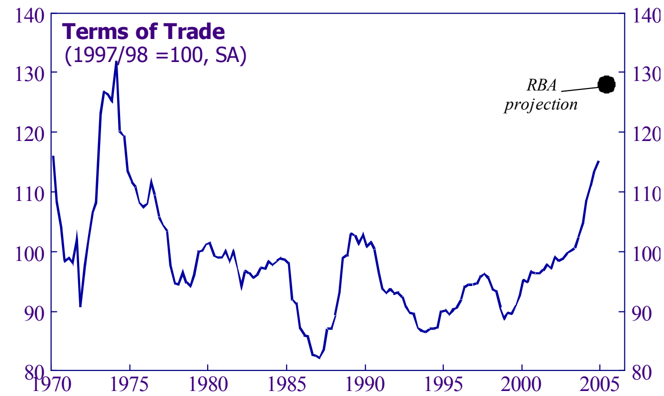


17. **After a year of stability in the housing market, potential risks appear to have eased.** Turnover in the housing market has continued with no sign of a sell-off by investors, and most observers consider that while house prices might decline further in some areas, a major exogenous shock would be required to interrupt a continued soft landing. Although investors play a growing role in the housing market relative to owner-occupiers—accounting for almost one-third of housing loans—they also have a relatively long investment horizon, which reduces

[5] Infrastructure is not expected to be a significant constraint on exports in the medium term, as State governments and private operators are boosting infrastructure spending, including in some of the facilities facing capacity limits recently (e.g., the port at Dalrymple Bay in Queensland). Moreover, most investments by large resource sector enterprises incorporate a dedicated infrastructure.

Box 1. The Terms of Trade Boom—Prospects and Macroeconomic Implications

Australia's terms of trade (TOT) are rising to historically high levels. Strong world demand, especially from China, has driven up the price of commodities of which Australia is a major exporter. Most recently, with effect from mid-2005, new contracts have locked in large price increases in U.S. dollar terms for some of Australia's key exports, e.g., a 70 percent rise for iron ore, and a 120 percent increase for hard coking coal. Moreover, a decline in the prices of Australia's manufactured goods imports has also contributed to the steady improvement in TOT. [1]

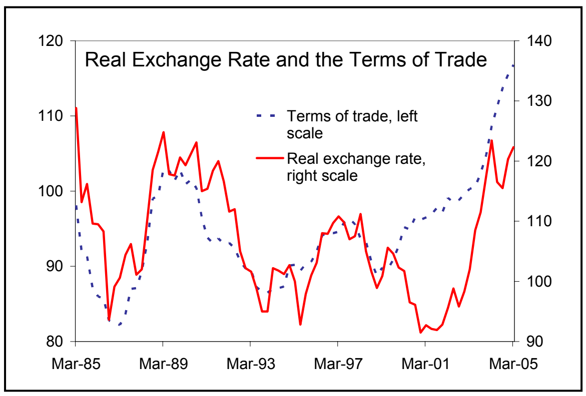


Source: Australian Bureau of Statistics and Reserve Bank of Australia.

These TOT gains are likely to reverse as global supply responds to higher commodity prices, but the timing is uncertain. Current high prices have triggered a surge in investment in several commodity sectors worldwide, which should place downward pressure on Australia's export prices over time. For example, world production of iron ore is expected to increase by around 20 percent in the next three years. But the continued strength of world demand makes the timing and extent of price adjustment difficult to predict. Recent research finds that half of past TOT gains were dissipated within two or three years on average.[2]

Domestic demand will be boosted by the TOT gains, but these effects may be smaller than usual because the gains are concentrated in the mining sector. The mining sector is 50 to 60 percent foreign owned and employment is a small share of the total. Hence, as a rule-of-thumb, about one-third of the rise in mining revenues will be received by State and Federal governments through higher royalties and tax receipts, one-third will accrue to foreign investors, leaving only one-third for the domestic private sector, largely reflected in higher stock prices for mining companies. In addition, the rise in mining investment is expected to be contained by expectations that commodity prices will decline, and the consolidation of the global mining sector in recent years may also serve to moderate the investment cycle.

Exchange rate flexibility will play a key role in shaping the macroeconomic effects of the TOT gains. Large increases in the terms of trade during the Korean War (leading to booming wool prices) and in the early 1970s (a more broadly based commodity price boom) led to sharp increases in domestic demand and inflation. However, since the float of the Australian dollar in 1983, the exchange rate has tended to fluctuate with movements in the terms of trade, such that the trade balance now plays a larger role in absorbing these shocks. According to earlier estimates, if the exchange rate appreciates by about one-third to one-half of the percentage rise in the TOT, the impact on inflation will be limited.[3] In the case of the current rise in commodity prices, the Australian dollar has risen substantially to date, thereby tending to moderate inflationary pressures.



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[1] China's growth also played an important role, see Box 3 in *IMF Country Report No. 04/353*.
[2] C. Gillitzer and J. Kearns, "Long-Term Patterns in Australia's Terms of Trade," *Reserve Bank of Australia Research Discussion Paper 2005-01*.
[3] D. Gruen and J. Dwyer, "Are Terms of Trade Rises Inflationary?," *Reserve Bank of Australia Research Discussion Paper 9508*.

downside risks to house prices. Some countries have experienced a slump in consumption after housing markets cooled, but an analysis of consumption behavior suggests this risk is modest in Australia (Box 2). Nonetheless, higher household indebtedness could make consumer spending more sensitive to shocks, particularly if they also affect interest rates.

18. **However, recent terms of trade gains could be reversed more rapidly than expected.** Demand for Australia's export commodities would fall if downside risks to global growth are realized—possibly reflecting a disorderly adjustment of global imbalances—especially if there were a hard landing in East Asian growth. There could be further downward pressure on commodity prices if the global supply of resource products increases more than expected owing to the substantial rise in global investment in the resource sector in recent years. A sharp fall in export commodity prices would lower incomes and domestic demand, but the impact would be significantly mitigated by risk-sharing with foreign investors in the traded goods sector,[6] time lags in investment responses, and the likely depreciation of the exchange rate—although this buffer would be less effective if the shock involved a large fall in the U.S. dollar.

19. **The economy remains well placed to manage both external and domestic risks.** Australia's relatively high and rising net external debt, just under one-half of which is short-term, would, on the face of it, appear to represent a source of vulnerability, as it does in other countries. On closer inspection, however, it is not clear that it significantly raises vulnerability to external shocks because private sector balance sheets are strong and currency and liquidity risks are well managed, with most external debt either denominated in Australian dollars or hedged (Annex I). While net foreign liabilities are expected to rise before stabilizing in the medium term, a depreciation of the exchange rate would facilitate an orderly decline in the external current account deficit if this rise in liabilities was to reduce the attractiveness of foreign investment in Australia. This is consistent with stress tests that do not suggest significant external vulnerabilities (Annex I, Figure I).[7] Considering the remaining housing market risks, the authorities' analysis finds that banking sector and household sectors are robust to substantial declines in house prices (Section IV.D and Annex I), thereby containing the potential impacts on domestic demand and foreign investor confidence. Experience during the Asian crisis underscores the resilience of the Australian economy to external shocks, and there is also ample scope for macroeconomic policies to help cushion the economy against either external or domestic shocks.

20. **Nonetheless, maintaining a high trend rate of economic growth will be a challenge.** Demographic changes are expected to slow growth in Australia's working age population from 1½ percent to about 1¼ percent in the medium term. With an unchanged rate of labor force participation, labor productivity growth would need to continue at the 2¼ percent pace achieved in the last 14 years, which, owing to past reforms, was above trend productivity growth in earlier decades. There is scope to raise labor participation but relatively high productivity growth will still be required to underpin the prospects for sustained strong growth in living standards.

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[6] The potential risk-sharing benefits of closer financial integration with the Asian region are explored in Chapter II of the forthcoming Selected Issues paper.

[7] To better capture the impact of a large fall in the exchange rate, the analysis presented in Figure 1 of Annex I allows for the high foreign currency hedging coverage of private external debt.

Box 2. Will Consumer Spending Slump as the Housing Market Cools?

The substantial rise in housing prices in many industrialized countries in recent years has lifted household wealth and expanded the scope for households to finance higher consumption. In some cases—notably Australia, Ireland, Spain, and the U.K.—prices have risen by 50 to 90 percent since 1999. The resulting rise in home equity has increased the collateral for borrowing, and relatively low nominal interest rates have encouraged households to leverage on this collateral to finance spending. To the extent that this spending is not on housing assets, i.e., housing construction including additions and alterations, the household sector's net equity in housing declines. Such "housing equity withdrawal" loans have grown significantly in recent years, especially in the U.S., the U.K., and Australia.[1]

Experience in the Netherlands suggests that housing equity withdrawals may slow quickly, with a negative impact on economic activity. [2] House prices in the Netherlands increased rapidly in the second half of the 1990s and household debt rose by two-fifths of the increase in the value of housing. In 1998-2000, annual GDP growth averaged 4 percent, with growth boosted by an estimated 1 percentage point on average each year as the result of housing equity withdrawals. But home equity withdrawals declined sharply as housing price increases slowed from mid-2000, reducing consumption growth by an estimated 1 percentage point in 2001 and 2002 and ½ percentage point in 2003, although the recession in the Euro area may also have played an important role in these developments.

With household credit growth slowing as the housing market cools in Australia, it is important to understand the sensitivity of household consumption to these developments. A life-cycle model of household consumption was estimated in which household's disposable income, net wealth (housing and financial), and the real interest rate influence consumption trends. Changes in the unemployment rate and household equity withdrawals were included as they could affect short-run movements in consumption. The model explains real household consumption from 1988 to 2004 quite well (standard error ½ percent).

Controlling for other variables, household equity withdrawals were found to have negligible effects on consumption. Disposable income, real interest rates, and net housing wealth are the key determinants of household consumption expenditure in Australia, with changes in net financial wealth having little effect. Overall, it appears that housing equity withdrawals are not a driving force for consumption in Australia, rather they are more a source of financing.[3]

Real Household Consumption, Australia, 1988:Q1-2004:Q4	Elasticity	
	One Year	Long-Run
Disposable Income	0.47**	0.81**
Net Housing Wealth	0.09**	0.15**
Net Financial Wealth	0.005	0.008
Real Interest Rate (25 bps)	-0.14**	-0.15**
Unemployment Rate (1 percent)	-0.001**	…
Household Equity Withdrawals	0	…

Staff estimates. ** Significant at the 5 percent level.

The cooling housing market in Australia might still affect consumption via net housing wealth, but interest rate flexibility could moderate the overall macroeconomic impact. If, for example, the household sector's net housing wealth declined by 5 percent, the model predicts that consumption would decline almost ½ percent after one year and by ¾ percent in the long run. However, Australia has the flexibility to cut interest rates if this is consistent with keeping inflation on-track in the medium term, thereby moderating the decline in consumption and boosting other spending.

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1 See "Housing Equity Withdrawal," *Reserve Bank of Australia Bulletin*, February 2003.

2 "Financial Behaviour of Dutch Households," de Nederlandsche Bank, *Quarterly Bulletin*, September 2003.

3 The RBA will release the results of a household survey later in 2005, which will include an examination of the links between housing equity withdrawals and household spending.

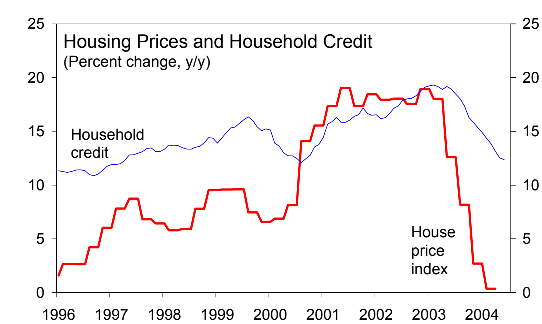
IV. How to Sustain Strong Economic Performance?

Australia enjoys an exceptional opportunity to lay the foundations for sustained strong economic performance: the medium-term economic outlook is sound; the fiscal position is strong; and public attitudes to reforms are broadly supportive. Reforms of labor markets, welfare policies, and infrastructure are the main priorities to support high productivity growth and raise employment. Strong growth will help tackle the long-term fiscal challenges, but reforms to moderate growth in health spending are also important. In the meantime, protecting the financial soundness of the private sector will underpin the resilience of the economy, and macroeconomic policies should continue to respond flexibly to potential shocks.

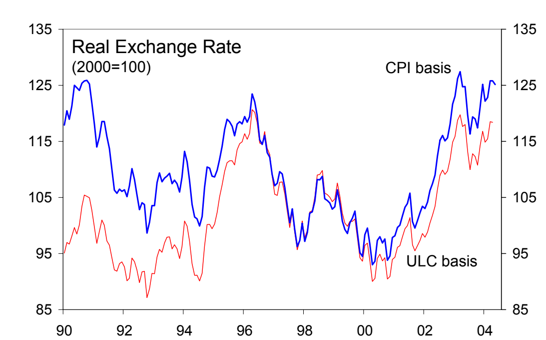
A. Maintaining Sound and Flexible Macroeconomic Policies

21. **The current broadly neutral monetary stance will remain appropriate if moderate demand growth is sustained.** The RBA noted that most recent indicators suggested some moderation in domestic demand growth, with underlying inflation expected to rise modestly in the medium term, to peak at around 3 percent in 2006. The authorities consider a wait-and-see attitude appropriate in view of the diminished upside risks to the inflation outlook. If there were shocks to external or domestic demand, monetary policy is well placed to respond in either direction to cushion the economy, which would be fully consistent with achieving the RBA's medium-term inflation objective.

22. **Although house prices have stabilized somewhat and household credit growth has eased, developments in the housing market and household finances still need to be monitored closely.** The authorities judged that the downside risks associated with the housing cycle have eased following the two interest rate hikes in late 2003. The rise in household leverage may partly be a response to greater macroeconomic stability, and households' high net worth would help moderate the impact of negative shocks on demand. The RBA considered, nonetheless, that it is appropriate for monetary policy to recognize that the interest sensitivity of spending may have increased due to higher household indebtedness.



Sources: Australian Bureau of Statistics and RBA



Source: Information Notice System, WEO database

23. **Australia's flexible exchange rate will continue to play a crucial role in buffering shocks.** Responding to fundamentals, in particular the historically high terms of trade, the exchange rate has remained at relatively high levels in 2004-05.[8] This appreciation contributed to a

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[8] Staff analysis finds the exchange rate is about 15 percent above its medium-term equilibrium using a macroeconomic balance approach (see P. Isard *et al*, 2001, *Methodology for Current Account and Exchange Rate Assessments*, IMF Occasional Paper No. 209), although this approach does not allow for changes in the terms of trade.

slowing in growth and a widening in the external current account balance in 2004, but it also played a valuable role by easing inflation pressures directly through lower import prices and indirectly by switching expenditure to imports. After the RBA rebuilt its foreign reserves to a more comfortable level during 2002–03, the accumulation of reserves has been modest more recently, with little effect on the foreign exchange market.

24. **Higher surpluses projected in the 2005 Budget are appropriate.** The budget included significant tax reductions along with modest expenditure increases partly linked to welfare reforms, suggesting a mildly expansionary fiscal stance.[9] Nonetheless, the underlying cash balance is projected to remain at close to 1 percent of GDP over the next four years, up from ¼ percent of GDP in the previous budget. This reflects expected revenue gains from higher export commodity prices, as well as a revised methodology for projecting revenues to correct the consistent under-prediction in recent years.[10] The authorities considered that the adjustments in taxes and expenditures in the 2005 budget were prudent as a significant portion of the higher revenue outlook had been saved in the form of higher surpluses. Moreover, the revenue projections allowed for a fall in export commodity prices to historical average levels by 2007/08. The mission agreed, and noted that the mildly expansionary stance of fiscal policy in the last two budgets may have cushioned the recent slowing in growth without placing undue stress on monetary policy or the public finances.

25. **The authorities stressed that fiscal policy will continue to manage uncertainty in the terms of trade outlook within the transparent medium-term framework.** The upswing in export commodity prices has so far boosted corporate profitability, and hence company tax revenue, with only a relatively modest impact on domestic demand. If there was a decline in export prices, allowing the full operation of the automatic fiscal stabilizers would be consistent with the objective of budget balance over the course of the cycle. In coming years, as the budget projections are updated the authorities will reevaluate the extent to which the recent terms of trade gains were a cyclical or permanent factor, and fiscal policies would be adjusted if necessary. The mission supported this forward-looking approach, noting that if room for further tax reforms emerged the authorities should focus on measures that would encourage labor force participation and productive investments.

B. Tackling Long-Term Fiscal Challenges

26. **Australia is aiming to tackle the challenges of rising healthcare costs and population ageing on a broad front.** Compared with other OECD countries, the ageing of Australia's population is more gradual. Nonetheless, the Productivity Commission estimates the long-term

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[9] Personal income taxes were cut most, with phased increases in the thresholds for the highest rates of personal income tax—which were low by OECD standards—and a reduction in the lowest income tax rate from 17 to 15 percent, with an annual cost of two-thirds of a percent of GDP from 2006/07. The fiscal stance is judged to be mildly stimulatory, even with a broadly stable fiscal balance, as revenues were supported by terms of trade gains.

[10] Following a review of the methodology, revenue projections have been made more responsive to changes in incomes, mostly affecting projections of income taxes from companies and "other individuals." As structural changes could partly account for the higher estimated income sensitivity, the new methodology is being applied cautiously as further analysis is carried out.

financing gap of the Commonwealth government at some 6½ percent of GDP by 2045, with rising healthcare costs being the main contributor. The risks around this outlook are significant given the difficulty of anticipating the effects of developments in medical technology such as pharmaceuticals (Box 3). To manage this challenge without excessive increases in tax rates or government debt, the authorities are acting on a number of fronts:

- **Lifting incomes and hence the revenue base.** Increases in labor force participation and labor productivity can significantly narrow the long-term fiscal gap.[11] Accordingly, the government has recently announced structural reforms of the labor market, welfare, and training (Section IV.C).

- **Enhancing the sustainability of health spending.** Recognizing that health spending will increase in the longer run, the government aims to moderate its growth while continuing to achieve high standards of healthcare.

- **Ensuring that government savings are available to meet long-term fiscal needs.** Fiscal surpluses are currently being deposited with the RBA as government debt is very low and the authorities have decided to retain a government debt market. To raise the expected return on these assets, and ensure that they are used to cover specific long-term liabilities, the government plans to establish a Future Fund by the end of 2005.

27. **To underpin the success of the Future Fund (FF), it will be critical to follow international best practices in its management and transparency.** [12] The FF will invest fiscal surpluses in order to cover the liability arising from those public service pensions which are not funded, currently standing at about 10½ percent of GDP. Inflows to the FF will come from future fiscal surpluses, privatization proceeds, and from its own investment income. To safeguard the assets of the FF, legislation will provide that outflows cannot begin until the unfunded liability is fully covered and that they then must be used to meet the pension payments covered by the FF, which are projected to average about 0.6 percent of GDP. The FF will be governed by an independent board, with members selected by the government based on their financial expertise; other key details, such as the nature of the investment mandate that would guide asset allocation, are expected to be clarified in the coming months.

28. **Far-sighted steps to enhance the sustainability of health spending are being taken, and ongoing reform efforts will be needed.** The government has announced increases in the safety net thresholds for Medicare, along with a phased increase in the thresholds for the Pharmaceutical Benefits Scheme (PBS). To further contain the rapid growth in pharmaceutical spending the PBS would seek to put downward pressure on pharmaceutical costs, and the government is also aiming to moderate growth in the cost of distributing pharmaceuticals to the

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[11] Raising participation rates to the top one-fifth of the OECD is estimated to close the long-term fiscal gap by 2 percent of GDP, with a similar effect from raising labor productivity growth by ½ percentage point so long as productivity growth in government services also increases. See D. Gruen and M. Garbutt, "The Long Term Fiscal Implications of Raising Australian Labor Force Participation or Productivity Growth," *Treasury Working Paper*, 2004-01.

[12] Arrangements for the Future Fund are compared with those in other countries in Chapter III of the forthcoming Selected Issues paper.

Box 3. Healthcare Costs are a Key Risk to Australia's Long-Term Fiscal Prospects

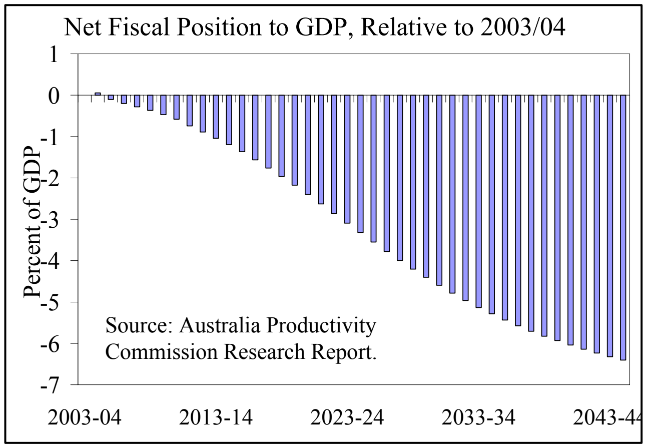
Rising healthcare costs are central to long-term fiscal pressures. The Productivity Commission projects government spending to rise by 6½ percent of GDP over the next four decades.[1] Health spending is projected to rise to 10.3 percent of GDP in 2044–45, up from 5.7 percent of GDP in 2002–03, accounting for two thirds of the total rise in spending.

Increases in Fiscal Spending
(Projected difference between 2003-04 and 2044-45, in percent of GDP)

Health Care	4.5
Aged Care & Carers	1.4
Age Pensions	1.7
Other Social Safey Nets	-0.6
Education	-0.5
Total	**6.5**

Source: Australia Productivity Commission.

In addition to population ageing, rising wealth and technological change are important contributors to rising healthcare spending. Ageing will increase health spending as expenditure on the aged is larger than on the young, with the Productivity Commission estimating that demographics alone account for about half of future increases in healthcare spending. The remaining increase comes from increasing utilization of services at any given age as people get wealthier, coupled with the rising cost of healthcare, as technological advances offer new and often more expensive treatments. In the past two decades, health spending has outpaced income, with pharmaceutical expenditure rising by 7¼ percent a year on a real per capita basis.



Small changes in the outlook for healthcare costs have large effects on health spending in the long run. Based on historical experience, the Productivity Commission estimates that healthcare costs may increase 0.3 to 0.9 percent faster than per capita GDP as a result of technology and other factors besides ageing. Health spending would rise to 11½ percent of GDP if the rise in costs was at the upper end of this range, while the increase would be 2½ percentage points of GDP smaller if the rise in costs was at the lower end. Changes in other factors, such as life expectancy, labor productivity, or migration would have a lesser impact. Moderating the rise in healthcare costs will therefore be a crucial element in addressing the long term fiscal challenge.

Historical Growth Rates in Real Health Spending Per Capita
(in percent)

Growth in GDP per capita	2.1-2.5
Growth related to age structure	0.4-0.6
Other growth	0.3-0.9
Total	**2.8-4.0**

Source: Australia Productivity Commission.

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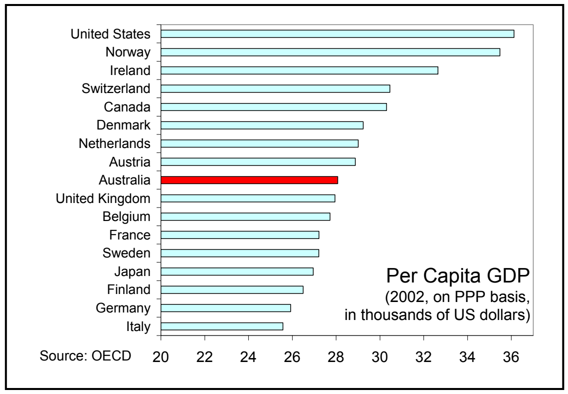
[1] *Economic Implications of an Ageing Australia,* Australian Productivity Commission, March 2005.

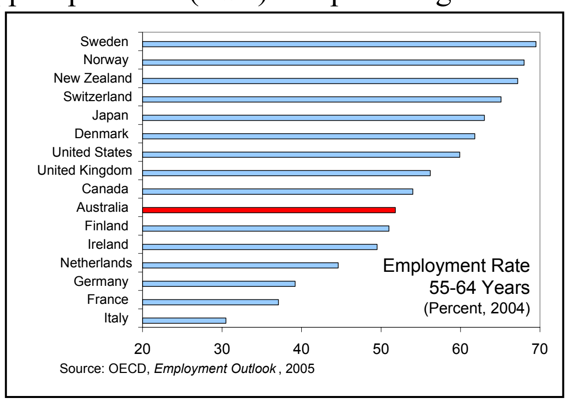
public. With healthcare services provided by different levels of government, the authorities have recognized the importance of reducing duplication and gaps in services by improving coordination. Looking ahead, one of the key challenges will be to make the most cost effective use of new medical technology.[13] The mission encouraged the authorities to find ways to make the incentives within the health system—including those faced by users and purchasers of technology—consistent with improved cost effectiveness in order to raise productivity growth in healthcare services. Past experience (e.g., the Hilmer Review that preceded the NCP) suggests that a comprehensive public review could help create a consensus for health reform.

C. Implementing Further Structural Reforms

29. **Australia has scope to further close the income gap with the leading economies.** Even with the gains made in the past 14 years, per capita incomes (PPP basis) remain some 20 percent below those in the United States, with only part of this gap accounted for by the effects of Australia's remoteness on productivity.[14] Structural reforms to raise productivity and employment levels would help close the income gap, and thereby also contribute to reducing the long-run fiscal shortfall.



30. **To raise labor participation, the 2005 Budget announced a package of reforms to encourage the transition from welfare to work.** The reforms are mutually reinforcing: work testing of welfare benefits is extended to disability support pensions (DSP) and parenting payments (PP) for single parents;[15] work incentives are improved by cutting the high effective marginal tax rates that recipients of benefits face on employment income; and assistance for people seeking to return to work is enhanced, including through increased childcare availability. With 11 percent of the workforce receiving the DSP or PP, the authorities estimate that the reforms will raise labor participation rates by about 1 percentage point in the medium term. The mission noted that these steps would help ease potential labor market pressures, and it urged continued efforts to increase Australia's employment rate, especially among persons aged 55 or older, which remains middling by international standards.



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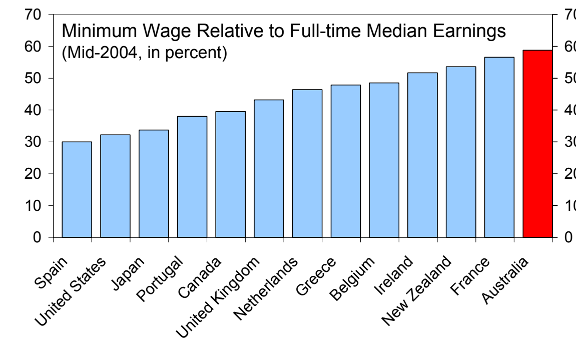
[13] *Impacts of Medical Technology in Australia*, Productivity Commission, March 2005.

[14] Recent research suggests that about two-fifths of the productivity gap with the U.S. may reflect Australia's remoteness from global markets and its relatively low population density, see J. Rahman, "Comparing Australian and United States Productivity," *Economic Roundup*, Autumn 2005.

[15] The work tests do not apply to current DSP recipients. New DSP applicants who are assessed as being able to work more than 15 hours per week will have an obligation to seek part-time work. A similar part-time work obligation will also apply to single parents with school age children.

31. **Further reforms of industrial relations are needed to expand labor demand and facilitate productivity gains.** Labor market reforms to date have substantially reduced rigidities, but centralized awards still set minimum working conditions in 20 areas through the requirement that conditions in collective and individual contracts not fall below those in awards—the "no disadvantage test"—and large employers face up to six different industrial relations systems at the Federal and State levels. Moreover, minimum wages are relatively high at almost 60 percent of median earnings of full-time male employees.[16] The government has proposed a comprehensive set of reforms to address these issues, including:[17]



Source: UK Low Pay Commission, *National Minimum Wage,* 2005

- **Transforming the determination of minimum wages** by establishing an Australian Fair Pay Commission, which will focus more on the implications for employment than the current adversarial system for setting minimum wages, while not reducing minimum wages from their current level;

- **Providing legislative protection of key working conditions**—annual leave, parental leave, personal leave, and maximum ordinary hours of work—to replace the no disadvantage test for employees with collective and individual employment contracts;

- **Scaling back employment protection** by limiting the coverage of unfair dismissal laws to enterprises with more than 100 employees, and by extending the qualification period for unfair dismissal coverage from 3 to 6 months, while retaining protection against unlawful termination for discrimination;

- **Unifying the Federal and State industrial relations systems** and streamlining the agreement making process to reduce costs and uncertainties.

These reforms face significant opposition from trade unions, which expressed concern that they will lead to a two-tier labor market; the authorities, on the other hand, did not view this as a major concern since strong social protections would remain in place for employees. The mission urged the implementation of this package of reforms to widen employment opportunities and raise productivity by enhancing flexibility in work arrangements. Training and education initiatives to support productivity growth were also announced recently in the budget and by the Council of Australian Governments.

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[16] The Commonwealth Government's submission for the 2005 Safety Net Review surveys ten papers estimating the relationship between wages and employment in Australia. All papers find a negative relationship, and the two papers focusing on minimum wages more specifically both find a negative elasticity of employment demand with respect to the minimum wage.

[17] "A New Workplace Relations System—A Plan for a Modern Workplace," May 26, 2005.

32. **Productivity gains can also be realized by improving the efficiency of key infrastructure sectors, where reform of pricing is essential.** A recent review proposed regulatory reforms to reduce the risk of infrastructure constraints on export performance, but important infrastructure reform challenges remain, especially in water, land transport, and electricity (Box 4). Reform programs to address some of these issues, such as the National Water Initiative, are already in place, and the recent meeting of the Council of Australian Governments agreed to renew the NCP reform agenda. With demand for infrastructure services likely to grow, the mission urged that the reform agenda be ambitious. In particular, improving the price signals in each of these sectors is a priority to encourage the efficient use of water, road and rail networks, and electricity. Such signals will also help stimulate appropriate and timely investments to meet growing demand. Given the positive role of competition payments in helping to coordinate past reform efforts, the mission noted that the government's strong fiscal position could facilitate measures to assist States in overcoming hurdles to reforms.

33. **Trade liberalization is part of Australia's growth strategy.** Multilateral trade liberalization under the Doha round is a priority for the authorities, as this is the only avenue to secure progress on key issues for Australia such as trade in agricultural products. To ensure complementarity with the multilateral process, the authorities have negotiated bilateral free trade agreements (FTA) with comprehensive coverage. FTAs with Thailand and the U.S. came into force in January 2005; separate FTA negotiations with China, ASEAN, Malaysia, and the U.A.E. began during 2005; and a feasibility study of an FTA with Japan is planned. The few remaining high tariff rates continue to be cut—in January 2005, tariff rates on textiles were reduced from 25 to 17.5 percent, and the rate on automobiles was reduced from 15 to 10 percent, with these rates to reach 5 percent by 2015 and 2010, respectively.

34. **Australia is increasing its official development assistance (ODA).** To assist in recovery and reconstruction following the Indian Ocean Tsunami, Australia has increased assistance to Indonesia by A$1 billion over a five year period. Commitments to promote stability and growth in Papua New Guinea, the Solomon Islands, and other Pacific Island countries have also been increased substantially.[18] The budget for 2005/06 allocates 0.28 percent of national income for ODA, up from 0.25 percent in 2004; Australia remains committed to achieving the United Nations target of 0.7 percent.

D. Protecting the Private Sector's Financial Health

35. **Microeconomic analysis of households' balance sheets indicates that household sector vulnerability is more limited than suggested by aggregate indicators.** The financial and corporate sectors remain in strong financial health, but a rise in aggregate household interest payment burdens in recent years could signal increased household financial vulnerability.[19] However, based on a survey of over 7,000 households, the RBA reports that household debt is concentrated on high income groups, who have relatively low debt-service burdens and

[18] A more extensive discussion of Australia's external assistance policy is available in *IMF Country Report No. 04/353*, and Box 5 in particular.

[19] The decline in unemployment and the rise in household net worth in Australia in recent years will tend to offset the effect of a higher interest burden on household financial distress, see J. Whitely *et al,* "An empirical model of household arrears," *Bank of England Working Paper*, 2004, No. 214.

Box 4. Averting Infrastructure Constraints—Getting the Pricing Right is Crucial

Recent transportation bottlenecks have raised concerns that Australia's infrastructure could become a constraint on growth. Long queues of ships outside two of the major coal ports on the east coast—Dalrymple Bay and Newcastle—indicated that port and rail facilities were limiting exporters' ability to meet rapidly expanding demand for coal, especially from China.

Improved regulatory arrangements can lower the risk of infrastructure constraints on exports. Infrastructure is typically the responsibility of the States in Australia, with some infrastructure being privately managed but subject to state level regulation. In Dalrymple Bay, for example, the private port operator is subject to regulation by the Queensland Competition Authority, which covers issues like changes in user charges. A taskforce commissioned by the Prime Minister found that there was a need for greater regulatory certainty.[1] It proposed the option of referring a dispute between infrastructure providers and users to a federal agency, the Australian Competition and Consumer Commission, in cases where State regulators could not resolve an issue within six months.

Even with a better regulatory system, notable challenges remain in key infrastructure sectors:

- **Water:** citizens in many of Australia's major cities face restrictions on their water use. This rationing is partly a symptom of prices that are low compared with European countries, encouraging relatively high water usage. Agriculture uses about two-thirds of Australia's water, but some estimates suggest that up to one-third of irrigation water is wasted, and much water may not be put to its best use—88 percent of water is used to produce only ½ of agricultural output.

- **Land transport:** the share of freight carried between Australia's capital cities by rail has fallen from 70 to 30 percent in the past three decades, as weak rail profitability is reflected in low investment and poor service levels. A significant part of this decline reflects low road access charges for heavy long-distance trucks, which do not include a return on the capital invested in roads. The Bureau of Transport and Regional Economics calculates that road access charges would need to roughly double to achieve neutrality with rail.

- **Electricity:** retail prices for electricity vary significantly across States as the development of a competitive nationwide electricity market has been hindered by retail price controls and regulatory complexity. Uncertainties about potential carbon charges have also delayed some investment.

Better pricing of infrastructure services can promote the best use of these services while also stimulating appropriate investments. State governments are planning large increases in infrastructure spending, but simply increasing the quantity of infrastructure is not an efficient strategy. In the case of water, appropriate prices would not only moderate demand by discouraging waste and inefficient uses of water, it would also enhance supply by making investments (e.g., in dams, pipe repairs, and recycling facilities) more economic. A well functioning market in rural water rights is therefore needed. Similarly, removing the implicit subsidy to heavy road users through higher access charges would stimulate the use of rail transport and reduce the cost of maintaining and expanding roads. Appropriate price signals would also promote the large investments in electricity generation and transmission needed in coming years.

Preliminary estimates of the productivity gains from infrastructure reforms are substantial.[2] A comprehensive infrastructure reform agenda is estimated to raise GDP by 2 percent, with rural and urban water reforms contributing almost half of these gains.

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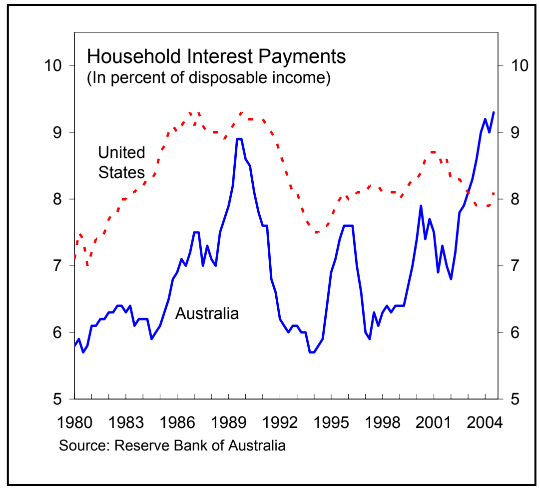
[1] *Australia's Export Infrastructure*, Report of the Exports and Infrastructure Taskforce, May 2005.
[2] *Reforming and Restoring Australia's Infrastructure*, Report by Port Jackson Partners Ltd, March 2005.



and significant financial assets.[20] Only a few percent of households were considered to be in a vulnerable position due to high loan-to-value (LVR) or debt-service ratios. These survey data are from 2002, and while middle-income households became more active housing investors during 2002-03, the authorities considered that the likely increase in vulnerability was modest.

36. **Nonetheless, the authorities are continuing to refine the regulation of financial institutions' exposures to the household sector.** The Australian Prudential Regulatory Authority (APRA) noted that even in the face of slowing credit growth and increased pressure on margins from non-bank lenders, banks had shown no enthusiasm for lending to subprime debtors. This contrasts with developments in the second half of the 1980s, reflecting more sophisticated management of credit risk. To meet the needs of self-employed persons there has been an increase in lending with more limited verification of creditor income information—so called "low doc" loans. Although these loans are typically less than 1 percent of bank portfolios, and their default rates are similar to standard loans, APRA had taken the precaution of tightening the LVR requirements for "low doc" loans to qualify for a risk weight of 50 percent.[21] APRA has also raised capital requirements for mortgage insurance companies effective from the start of 2006, although the two major companies were already well capitalized. Moreover, as part of its Basel II related reforms, APRA plans to adopt a tiering of risk weights for housing loans based on the LVR of households, in order to make capital requirements more consistent with the underlying risk of the loan portfolio.

37. **The authorities are participating in an FSAP during 2005–06 with the aim of identifying and prioritizing improvements in financial regulation.** Issues likely to be addressed during the FSAP include the effectiveness of the newly integrated structure of supervision, implications from the dominance of the major financial conglomerates, and vulnerabilities linked to the housing sector and foreign borrowing. Preparations are well advanced, with the authorities working on the appropriate design of stress tests and detailed self assessments of the relevant standards and codes.

V. Staff Appraisal

38. **Australia's implementation of wide-ranging reforms in the past two decades has paid dividends in many dimensions.** Structural reforms in the labor market, trade policy, the financial sector, public enterprises, and infrastructure were complemented by the adoption of a floating exchange rate and medium-term frameworks for both monetary and fiscal policies. Concrete returns on these efforts have included rising incomes owing to high productivity

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[20] Reserve Bank of Australia, *Financial Stability Review*, March 2005.

[21] For standard housing loans to qualify for risk weight of 50 percent rather than 100 percent, the loan must have mortgage insurance if the LVR is above 80 percent. From September 2004, to qualify for a 50 percent risk weight, "low doc" loans need mortgage insurance if the LVR exceeds 60 percent.

growth, strong job creation reducing unemployment to a three-decade low of 5 percent, low and stable inflation, and the near elimination of net public debt—all in the context of an increasingly stable and resilient economy.

39. **Prospects for the Australian economy remain strong notwithstanding the slowdown in 2004.** This slowdown largely reflected a welcomed cooling of the housing market, which was itself a reflection of astute and timely actions by policymakers, along with the strength of imports owing to the appreciation of the Australian dollar. With job creation, business investment, and consumer confidence remaining robust, the healthy growth that resumed in early 2005 is expected to continue. Exports are expected to play a greater role in driving growth in the medium term, which together with sharp rises in Australia's export commodity prices will tend to narrow the external current account deficit over time. Enhanced labor market flexibility has enabled the economy to cope with excess demand in specific labor markets without generalized wage pressures. While headline inflation may approach 3 percent in 2005 because of higher oil prices, underlying inflation is expected to edge up only modestly before declining again toward the middle of the target range.

40. **Macroeconomic policies are on track.** The stance of monetary policy is now broadly neutral, and a wait-and-see attitude is appropriate given the slowing of activity over the past year and the associated decline in upside risks to inflation. The stance of fiscal policy is mildly expansionary largely owing to prospective tax reductions, helping to cushion the slowdown in growth without placing undue stress on monetary policy or public finances. Indeed, the projection for the underlying cash balance surplus has been revised up to almost 1 percent of GDP over each of the next four years, reflecting the government's prudent commitment to ongoing surpluses while the economy remains strong. The transparent medium-term fiscal framework has again proven its value, with the authorities making appropriate allowance for the likelihood that export commodity prices will decline in coming years.

41. **Risks to the outlook are cushioned by flexibility in macroeconomic policies and in the exchange rate.** Australia's recent large terms of trade gains could be reversed more rapidly than expected if a disorderly adjustment of global imbalances weakened export demand, especially if there was a sharp slowdown in east Asia. However, the flexible exchange rate has helped buffer such shocks in the past, and the economy has proven resilient to substantial exchange rate fluctuations, partly reflecting the extensive hedging of the foreign currency component of external debt. Potential risks to domestic demand appear to have eased after a year of stability in housing prices and a smooth deceleration in household credit, although continued monitoring of the housing market is clearly warranted. Monetary policy stands ready to respond to external or domestic shocks in either direction, and the strong fiscal position means that the automatic stabilizers are also free to operate.

42. **As in many countries, Australia faces the medium-term challenge of addressing the economic consequences of an ageing population and rising healthcare costs.** Because Australia's ageing is more gradual than in most other industrial countries, the authorities are in the enviable position of being able to focus on further structural reforms to boost medium-term growth, and hence, the revenue base, complemented by measures to enhance the sustainability of government expenditure. Australia's strong track record of successful implementation of structural reforms to improve supply-side efficiency makes this strategy credible. Moreover, there appears to be widespread recognition of the lasting benefits from past reforms and increasing acceptance of the need for further reform. Together with the robust fiscal position,

there now exists an exceptional opportunity to implement additional far-reaching structural reforms. If this opportunity is seized, Australia should continue to have one of the strongest performing economies among the economically advanced countries. If, however, the structural reform effort falters, economic growth is likely to decline as the population ages, and future generations will be faced with a substantial fiscal shortfall.

43. **Employment and productivity can be lifted by implementing labor market and welfare reforms.** The authorities are adopting a mutually reinforcing set of welfare and industrial relations reforms to encourage the transition from welfare to work and increase labor market flexibility. By supporting productivity growth and widening the opportunities for employment, the implementation of these reforms would have substantial medium-term growth benefits. Looking ahead, further progress in raising labor force participation among the population aged over 55 will be needed in order to moderate the impact of population ageing on employment.

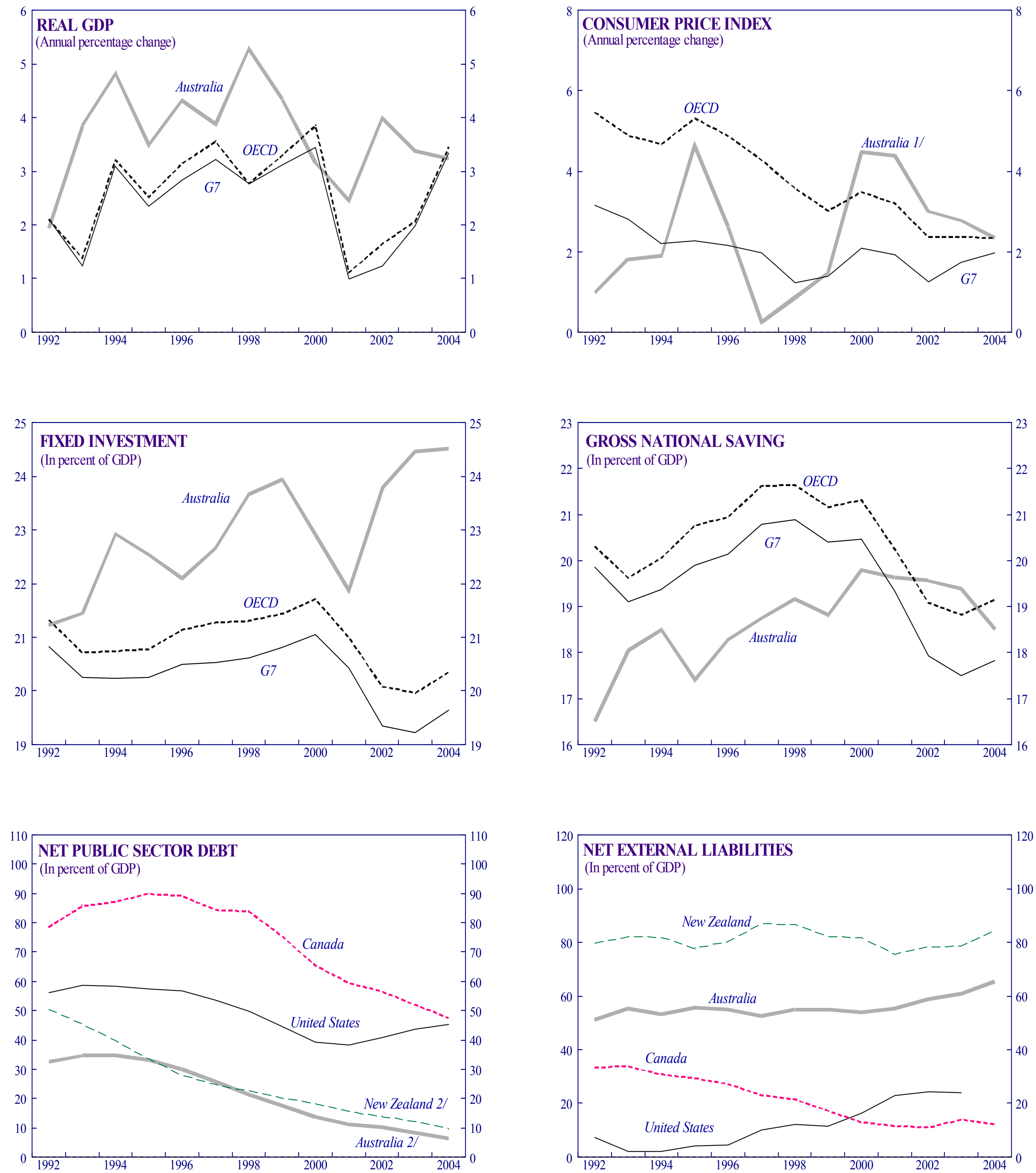
44. **Infrastructure reforms, including a more efficient regulatory system, would also boost productivity and real incomes.** Simply increasing the quantity of infrastructure is not likely to address issues in the water, land transport, and electricity sectors in a sustainable or efficient manner. The key is to price these infrastructure services correctly so as to reflect capital and scarcity costs, and as appropriate, externalities. An ambitious new reform agenda is therefore needed in each of these areas to create incentives for the efficient utilization of infrastructure and also for appropriate and timely infrastructure investments. The government's strong fiscal position could facilitate measures to assist States in overcoming hurdles to the implementation of reforms.

45. **Enhancing the sustainability of health spending can make a major contribution to tackling Australia's long-term fiscal challenges.** Recent changes to the Pharmaceutical Benefit Scheme and Medicare, coupled with planned reforms of pharmaceutical distribution, are important steps to moderate the growth in health spending. But there are other fundamental challenges to sustainability, such as making the most appropriate use of advances in medical technology, which may require some strengthening of the incentives for cost effectiveness facing both users and providers of healthcare services. By covering unfunded public service pension liabilities, the Future Fund can also play a valuable role in meeting long-term fiscal challenges. The proposed governance framework of the Future Fund is sound, and decisions on the investment mandate and transparency arrangements will benefit from assessing best practices among funds in other countries.

46. **Efforts to enhance financial regulation must continue to help preserve the resilience of the economy.** While banks are demonstrating more sophisticated credit risk management in this cycle, the authorities have responded prudently to the emergence of nonstandard household lending. The well advanced state of preparations for the FSAP in 2005-06 is welcome, as is the authorities' commitment to using the FSAP to help refine their regulatory framework.

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

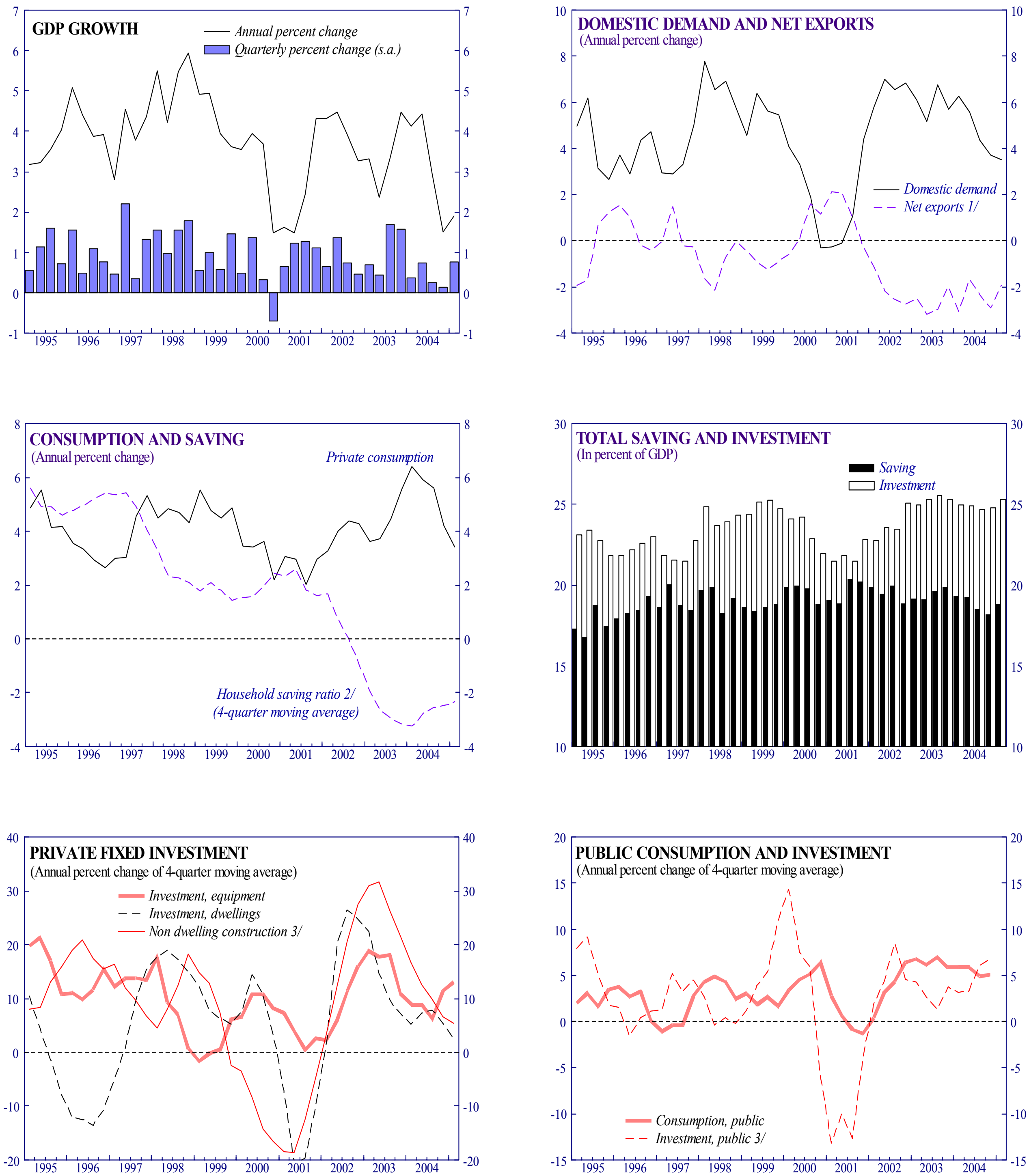
Figure 1. Australia: Comparisons of Macroeconomic Performance, 1992–2004



Sources: Data provided by the Australian authorities; IMF; IFS; WEO; and OECD.

1/ The higher inflation rate in 2000 and 2001 is due to the introduction of the Goods and Services Tax.
2/ Fiscal year.

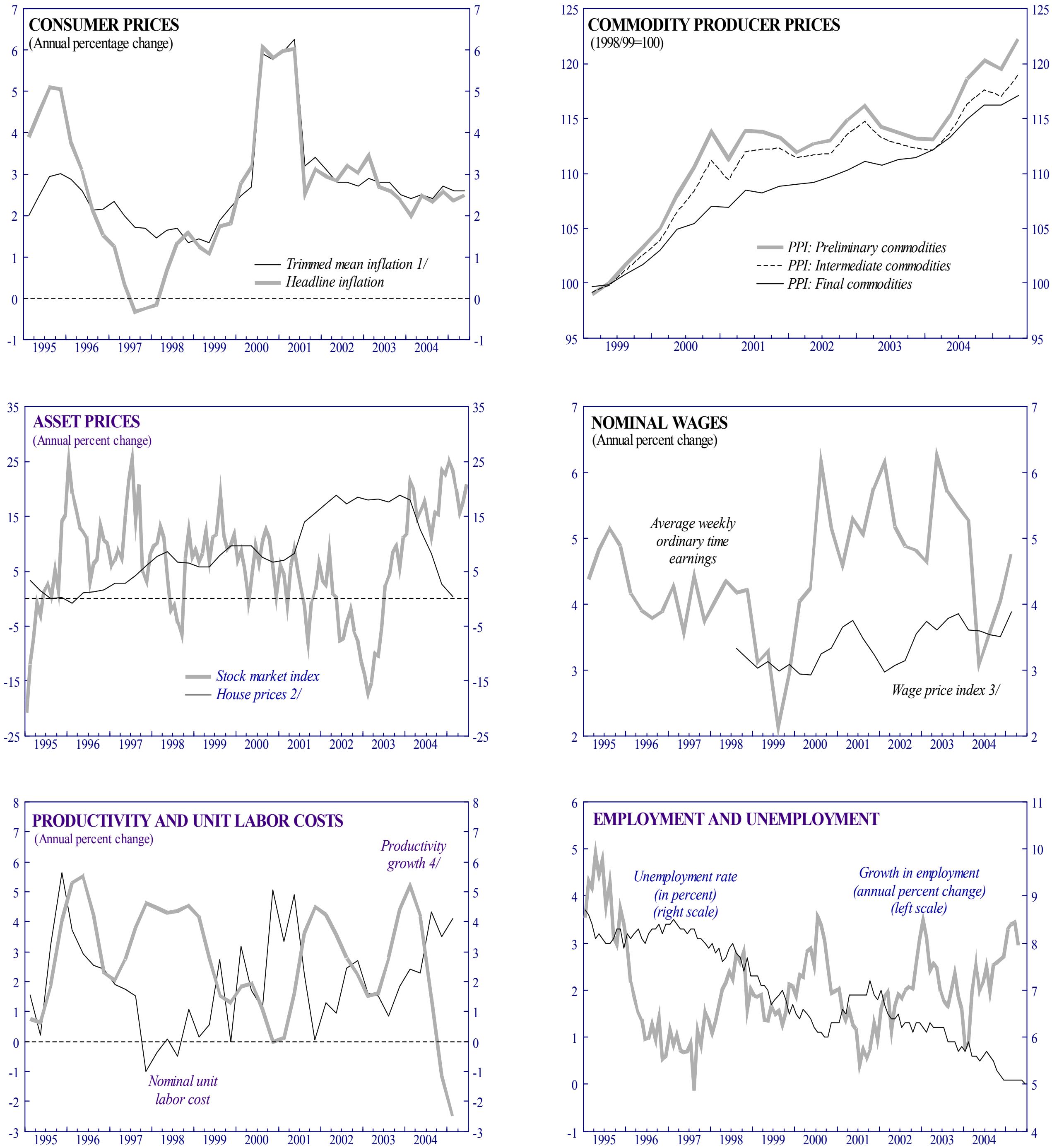
Figure 2. Australia: Real Economic Indicators, 1995–2005



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.

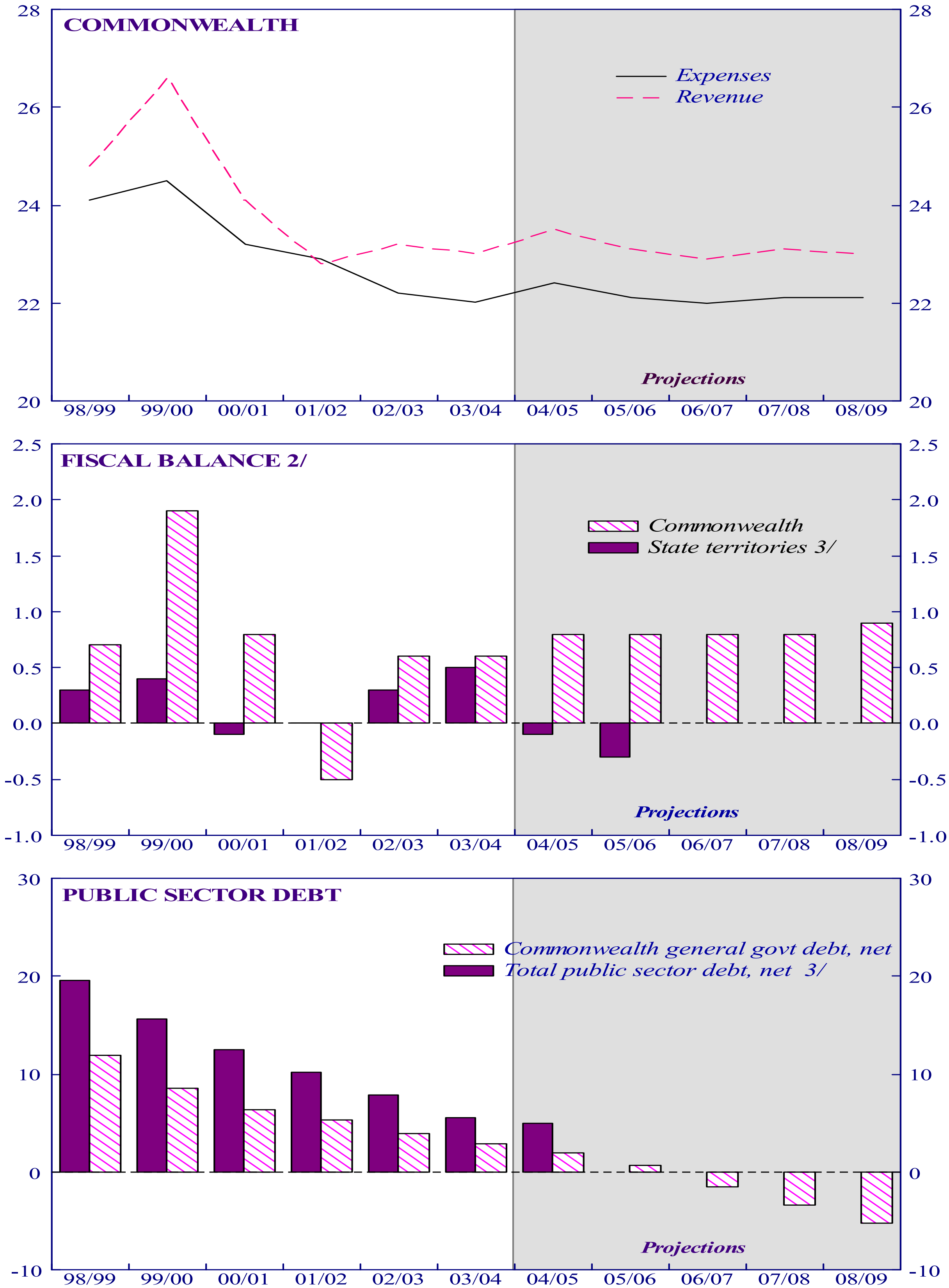
Figure 3. Australia: Inflation and Labor Market Indicators, 1995–2005



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

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

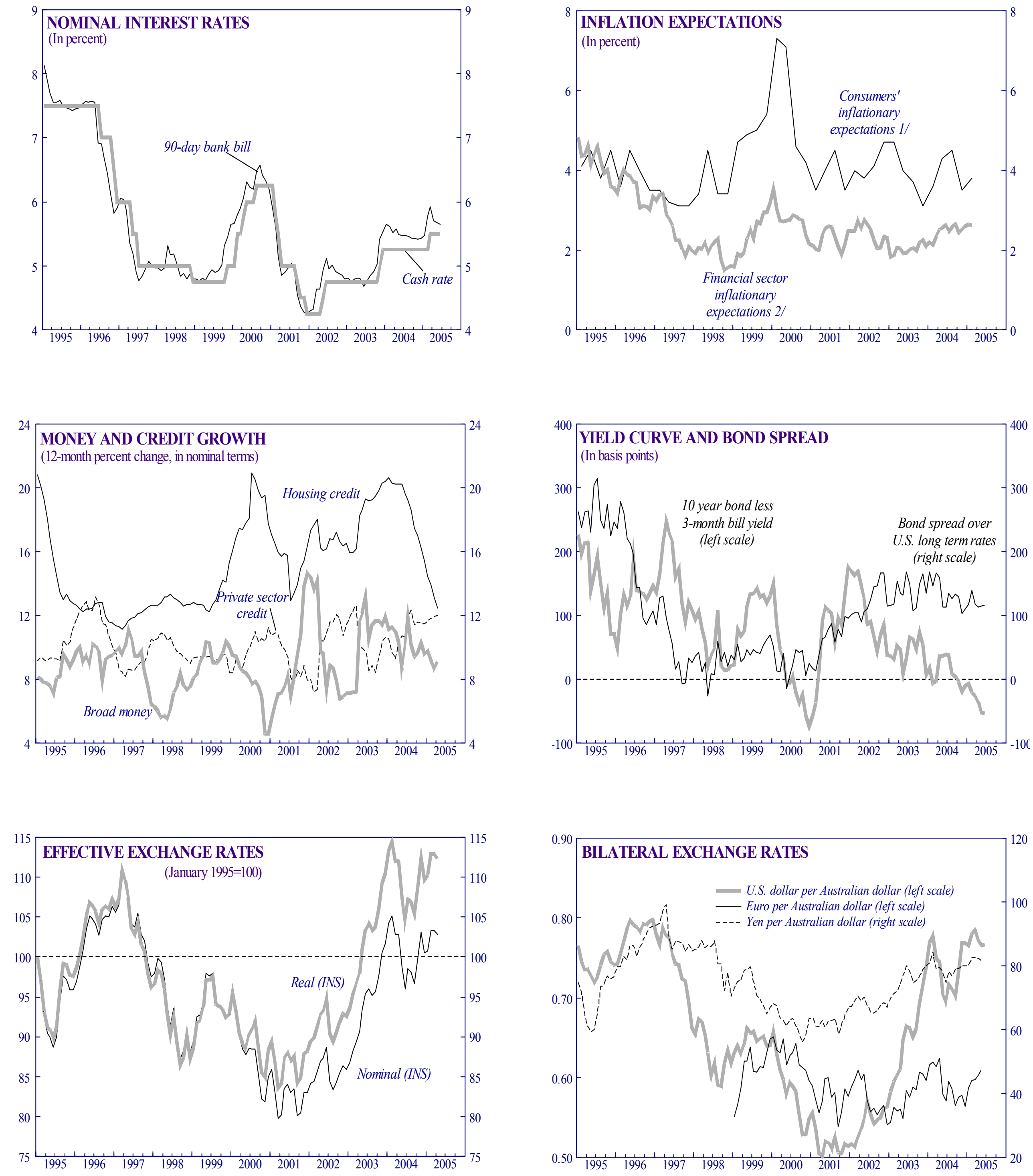
Figure 4. Australia: Fiscal Indicators, 1998/99–2008/09 1/
(In percent of GDP)



Source: Australian budget for 2004/05.

1/ Revenue, expenses, and fiscal balance are on accrual basis.
2/ Fiscal balance is equal to revenue less expenses less net capital expenses.
3/ Data for fiscal balance of state territories are available to 2005/06, and data for total public sector debt are available to 2004/05.

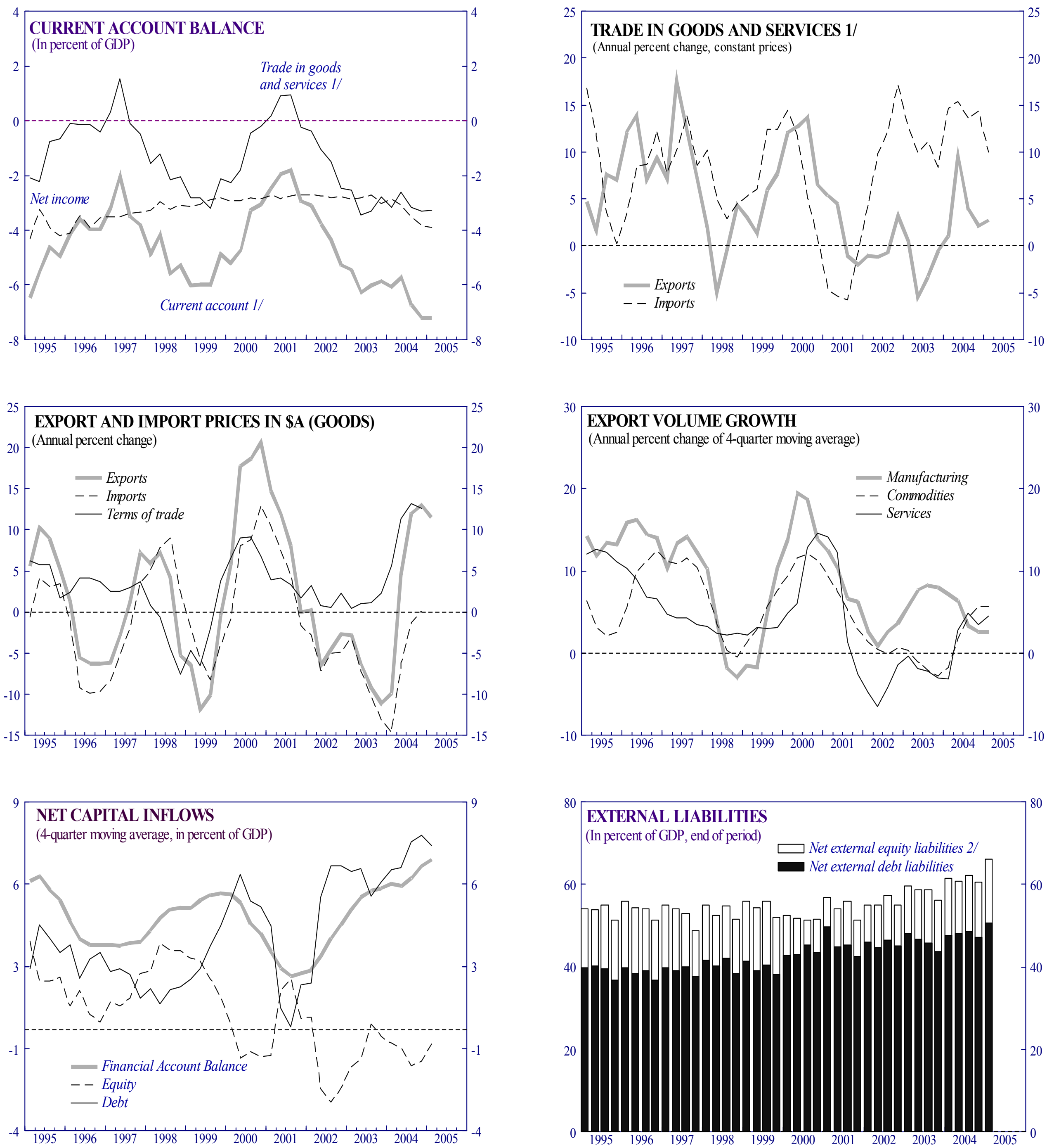
Figure 5. Australia: Monetary Indicators, 1995–2005



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

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

Figure 6. Australia: Balance of Payments and External Liabilities, 1995–2005



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

1/ June 1997 exports includes the sale of gold by the Reserve Bank equivalent to 1.5 percent of 1997QII GDP.
2/ Net external equity liabilities are nonresident holdings of Australian equities net of Australian holdings of foreign equity.

Table 1. Australia: Selected Economic Indicators, 2000–05

Nominal GDP (2004): $A 839 billion (US$ 618 billion) GDP per capita (2004): US$ 30,697
Population (2004): 20.1 million Quota (in millions): SDR 3,236

	2000	2001	2002	2003	2004	Proj. 2005
Output and demand (percent change)						
Real GDP	3.2	2.5	4.0	3.3	3.2	2.2
Total domestic demand	2.2	1.3	6.6	5.9	5.0	3.2
Private consumption	3.2	2.7	4.0	4.3	5.6	2.7
Total investment	1.2	-0.7	16.1	8.2	6.3	2.9
Exports of goods and services	11.2	1.7	0.1	-2.2	4.1	3.4
Imports of goods and services	7.9	-4.2	11.1	10.5	14.5	7.8
Inflation and unemployment (in percent)						
CPI inflation	4.5	4.4	3.0	2.8	2.3	2.6
Unemployment rate	6.3	6.8	6.4	6.0	5.5	5.1
Saving and investment (in percent of GDP)						
Gross national saving	19.2	19.6	19.6	19.4	18.4	19.0
General government saving	2.9	2.6	3.0	3.4	3.0	2.7
Private saving 1/	16.3	17.1	16.6	15.9	15.4	16.3
Gross capital formation	23.2	21.9	23.7	25.3	24.8	24.7
Fiscal indicators (in percent of GDP) 2/						
Receipts 3/	26.6	24.1	22.8	23.2	23.0	23.5
Payments 3/ 4/	24.5	23.2	22.9	22.2	22.0	22.4
Underlying balance 4/	2.1	0.9	-0.1	1.0	1.0	1.1
Public debt, net	8.6	6.4	5.3	3.9	2.9	1.9
Money and credit (end of period)						
Interest rate (90-day bill, in percent) 5/	6.2	4.2	4.8	5.5	5.4	5.7
Treasury bond yield (10-year, in percent) 5/	5.5	6.0	5.2	5.6	5.3	5.1
M3 (percent change) 6/	4.6	14.7	7.1	11.9	9.6	8.8
Private domestic credit (percent change) 6/	11.2	7.9	11.4	10.6	11.5	11.9
Balance of payments (in percent of GDP)						
Current account	-4.1	-2.3	-4.1	-5.9	-6.4	-5.7
of which: Trade balance	-1.2	0.5	-1.3	-3.0	-2.9	-1.9
Foreign direct investment, net	2.9	-2.1	1.9	-1.6	4.3	...
Terms of trade (percent change)	5.5	1.5	2.0	3.1	10.0	10.7
External assets and liabilities (in percent of GDP)						
Net external liabilities	54.8	55.2	58.6	60.8	64.5	65.9
Net external debt	46.1	45.8	48.0	47.1	50.2	…
Gross official reserves 6/	5.2	5.3	5.2	5.6	5.6	6.3
Exchange rate (period average)						
US$/$A 5/	0.554	0.511	0.566	0.750	0.769	0.767
Trade-weighted index 5/	51.6	50.2	51.7	63.0	62.8	64.3
Real effective exchange rate 7/	79.3	79.2	83.1	99.2	98.3	100.6

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

1/ Includes public trading enterprises.
2/ Fiscal year ending June 30, Commonwealth Budget.
3/ The sharp drop in 2001 reflects tax reform, including income tax cuts and removal of the Wholesale Sales Tax, and a cut in grants to States
4/ Excludes asset sales and other one-off factors; cash basis.
5/ Data for 2005 are for June 2005.
6/ Data for 2005 are for May 2005.
7/ IMF, Information Notice System index (1990 = 100). Data for 2005 are for April 2005.

Table 2. Australia: Balance of Payments, 2000–05

(In percent of GDP)

	2000	2001	2002	2003	2004	Proj. 2005
Current account balance	-4.1	-2.3	-4.1	-5.9	-6.4	-5.7
Trade balance	-1.2	0.5	-1.3	-3.0	-2.9	-1.9
Exports	17.1	17.8	16.2	13.8	14.1	15.4
Imports	-18.3	-17.3	-17.5	-16.8	-17.0	-17.3
Net services	0.1	-0.1	0.0	-0.1	-0.1	-0.1
Total credits	5.0	4.7	4.5	4.1	4.1	4.3
Total debits	-4.9	-4.7	-4.5	-4.2	-4.2	-4.4
Net income	-2.8	-2.7	-2.7	-2.8	-3.3	-3.6
Receipts	2.4	2.3	2.1	2.0	2.2	2.1
Payments	-5.3	-5.0	-4.9	-4.8	-5.5	-5.8
Net transfers	0.0	0.0	0.0	0.0	0.0	-0.1
Capital and financial account	3.9	2.4	4.3	5.7	6.6	…
Capital account	0.2	0.2	0.1	0.1	0.1	…
Financial account	3.8	2.2	4.2	5.6	6.5	…
Direct investment transactions: net	2.9	-2.1	1.9	-1.6	4.3	…
Equity (net)	0.8	-1.2	0.2	-1.9	4.1	…
Debt (net)	2.0	-0.9	1.7	0.3	0.2	…
Portfolio investment transactions: net	1.1	3.1	0.4	7.8	2.9	…
Equity (net)	-2.0	1.9	-2.7	1.3	-5.8	…
Debt (net)	3.2	1.2	3.1	6.5	8.7	…
Financial derivatives (net)	-0.2	0.2	0.1	0.1	0.0	…
Other transactions (net)	0.0	1.1	1.8	-0.7	-0.7	…
Net errors and omissions	0.1	-0.1	-0.1	0.1	-0.1	…
		(Assets and liabilities at end-period)				
Net external liabilities	54.8	55.2	58.6	60.8	64.5	65.9
Net external equity liabilities	8.7	9.4	10.6	13.7	14.3	…
Foreign equity investment in Australia	49.4	52.9	48.6	51.3	57.6	…
Australian equity investment abroad	-40.7	-43.5	-38.0	-37.6	-43.3	…
Net external debt	46.1	45.8	48.0	47.1	50.2	…
Net public sector	2.3	1.6	2.2	1.1	1.7	…
Net private sector	43.8	44.2	45.8	46.0	48.5	…
Gross external debt	72.8	73.8	77.5	77.4	82.8	…
of which: $A denominated	26.7	25.2	27.0	27.0	29.9	…
Gross external lending	-26.7	-28.0	-29.5	-30.3	-32.6	…
Short-term net external debt (residual maturity basis)	22.2	23.9	23.1	18.5	19.1	…
Short-term gross external debt	40.3	40.2	41.1	37.3	39.0	…
Short-term gross external lending	-18.1	-16.3	-18.0	-18.8	-19.9	…
Memorandum items:						
Gross official reserves (in $A billion)	34.0	36.5	38.1	44.3	47.4	…
RBA outstanding forward contracts (in $A billion)	24.9	29.5	25.0	26.4	22.4	…
Gross reserves in months of imports	2.7	2.7	2.8	3.0	2.9	…
Gross reserves to ST FX denominated debt (percent)	18.9	19.3	18.5	21.8	21.5	…
Net reserves to ST FX denominated debt (percent)	5.0	3.7	6.4	8.8	11.3	…

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

Table 3. Australia: Fiscal Accounts, 2000/01–2008/09 1/

					Projections 2/				
	2000/01	2001/02	2002/03	2003/04	2004/05	2005/06	2006/07	2007/08	2008/09
Fiscal accounts on an accrual basis 3/					(In percent of GDP)				
Commonwealth government									
Revenue	24.2	22.8	23.1	23.1	23.5	23.1	23.0	23.2	23.1
Tax	22.7	21.0	21.5	21.5	22.0	21.7	21.6	21.7	21.7
Income tax	18.1	16.7	17.3	17.5	18.1	18.0	18.0	18.2	18.3
Individuals and other withholdings	11.7	12.1	12.0	12.1	12.5	12.0	12.1	12.4	12.6
Indirect and other tax	4.6	4.4	4.2	4.1	3.9	3.7	3.6	3.5	3.4
Non-tax	1.5	1.8	1.6	1.5	1.4	1.4	1.4	1.4	1.4
Expenses	23.5	23.3	22.5	22.4	22.6	22.2	22.2	22.4	22.3
Salaries and wages	1.4	1.4	1.4	1.4	1.4	1.4	1.3	1.3	1.3
Goods and services	4.9	4.8	4.8	4.8	5.2	5.2	5.2	5.2	5.1
Current transfers	14.2	14.3	13.5	13.8	13.7	13.4	13.5	13.7	13.9
Other expenses	2.9	2.8	2.6	2.3	2.3	2.2	2.1	2.1	2.0
Net capital investment	-0.2	-0.1	0.0	0.1	0.1	0.1	0.1	0.0	0.0
Fiscal Balance 4/	0.8	-0.5	0.6	0.6	0.8	0.8	0.8	0.8	0.9
State, Territory, and local government balance	-0.1	0.0	0.3	0.5	0.2	-0.4	…	…	…
									…
Public Non-financial corporations balance 5/	0.1	-0.1	-0.1	0.0	-0.4	…	…	…	…
									…
Non-Financial Public sector balance 5/	0.7	-0.5	0.9	1.2	0.7	…	…	…	…
Fiscal accounts on a cash basis									
Commonwealth government									
Receipts	24.1	22.8	23.2	23.0	23.5	23.1	22.9	23.1	23.0
Payments	23.2	22.9	22.2	22.0	22.4	22.1	22.0	22.1	22.1
Future Fund Earnings						0.0	0.1	0.1	0.1
Underlying cash balance 6/	0.9	-0.1	1.0	1.0	1.1	1.0	0.8	0.8	0.9
Memorandum items:									
Commonwealth government net debt 7/	6.4	5.3	3.9	2.9	1.9	0.7	-1.5	-3.4	-5.3
Commonwealth government net worth 7/8/	-6.5	-6.8	-7.0	-4.9	-4.0	-3.0	-2.1	-1.4	-0.6

Sources: Commonwealth of Australia: *Budget Strategy and Outlook, 2005-06.*

1/ Fiscal year ends June 30.
2/ Projections as presented in the *Budget Strategy and Outlook , 2005-06* .
3/ Accrual data are reported on a consistent basis with Government Financial Statistics (GFS).
4/ The fiscal balance is equal to revenue less expenses less net capital investment.
5/ The consolidated commonwealth, state and local governments.
6/ Underlying cash balance is equal to receipts less payments less expected Future Fund earnings.
7/ Assumes the sale of the government's remaining shareholding in Telstra.
8/ Includes financial and non-financial assets and liabilities, including unfunded superannuation liabilities to public employees.

Table 4. Australia: Medium-Term Scenario 2004–10

	Average 1994-2003	2004	Projections 2005	2006	2007	2008	2009	2010
Real economic indicators (percent change)								
GDP	3.9	3.2	2.2	3.2	3.5	3.5	3.5	3.5
Total domestic demand	4.5	5.0	3.2	2.9	3.0	3.1	3.1	3.1
Private consumption	3.9	5.5	2.9	2.5	2.8	3.0	3.0	3.0
Total investment	7.2	6.3	2.9	3.3	3.3	3.4	3.3	3.5
Business	11.2	9.5	7.7	6.3	4.8	4.5	4.1	4.1
Dwelling	5.5	5.1	-5.4	-4.3	-1.5	0.0	0.6	1.6
CPI inflation	2.6	2.3	2.6	2.7	2.6	2.5	2.5	2.5
Unemployment rate	7.4	5.5	5.1	5.1	5.2	5.2	5.2	5.2
Saving and investment (percent of GDP)								
Gross national saving	18.9	18.4	19.0	19.2	18.9	18.7	18.8	19.1
General government saving	2.0	3.0	2.7	2.6	2.6	2.9	2.9	2.8
Private saving 1/	16.9	15.4	16.3	16.6	16.3	15.9	15.9	16.3
o/w Household	10.8	7.1	8.2	9.4	9.5	9.5	9.2	9.3
Gross capital formation	23.3	24.8	24.7	24.2	24.1	24.1	23.9	23.7
o/w Private fixed investment	19.0	20.8	20.4	20.1	19.9	19.9	19.7	19.5
Fiscal indicators (percent of GDP) 2/								
Commonwealth Budget								
Receipts	24.0	23.0	23.5	23.1	22.9	23.1	23.0	22.9
Payments	24.5	22.0	22.4	22.1	22.0	22.1	22.1	22.0
Underlying balance (cash basis) 3/	-0.5	1.0	1.1	1.0	0.8	0.8	0.9	0.8
Fiscal balance (accrual basis)	…	0.6	0.8	0.8	0.8	0.8	0.9	1.0
Public sector net debt 4/	12.2	2.9	1.9	0.7	-1.5	-3.4	-5.3	-7.2
Balance of payments (percent of GDP)								
Balance on goods and services	-1.2	-3.1	-2.0	-1.5	-1.6	-1.8	-1.7	-1.2
Balance on income and transfers	-3.2	-3.4	-3.7	-3.5	-3.6	-3.5	-3.4	-3.4
Current account balance	-4.5	-6.4	-5.7	-5.0	-5.2	-5.3	-5.1	-4.6
Trade in goods and services (percent change)								
Export volume	5.1	4.1	3.4	5.0	5.8	5.5	5.0	4.8
Import volume	8.0	14.5	7.8	3.2	3.3	3.2	3.1	3.0
Terms of trade	1.6	10.0	10.7	0.7	-2.8	-3.7	-1.5	0.7
Export price	0.9	4.0	11.9	1.1	-2.8	-3.6	-1.3	0.8
Import price	-0.6	-5.5	1.1	0.4	0.0	0.1	0.1	0.1
External liabilities (percent of GDP)								
Net external liabilities	55.7	64.5	65.9	67.2	69.0	70.9	72.1	72.6

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

1/ Includes public trading enterprises.
2/ Fiscal year basis ending June 30.
3/ The projected underlying cash balances do not include Future Fund earnings.
4/ Assuming the sale of the government's remaining shareholding in Telstra.

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.[22] Net foreign liabilities remain high relative to other advanced economies, mainly reflecting private sector borrowing, and the external debt has become more concentrated in private financial corporations due to increased intermediation of flows by banks. Despite the large share of foreign currency denominated debt, the currency risk is mitigated through extensive 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 years. Housing prices have risen substantially in recent years, but analyses using microeconomic data indicate that a relatively small share of households are potentially vulnerable to a significant fall in housing prices, and the banks are sufficiently well capitalized to withstand a substantial housing market correction.

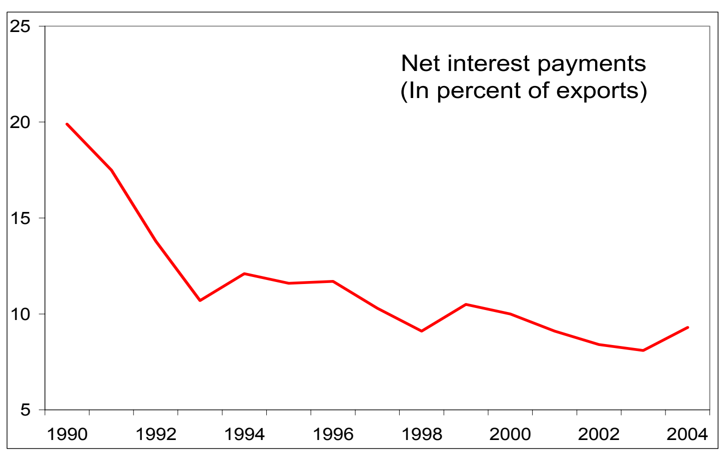
A. External Position

2. **Net external liabilities have increased from 55 to 65 percent of GDP over the last five years, driven by private sector borrowings intermediated by financial corporations** (Table 1). The composition of liabilities shifted more toward debt. The private sector now accounts for 88 percent of total external debt, including more than 70 percent borrowed by financial corporations, while non-resident claims on the public sector have declined in recent years as the total public debt has fallen.

Australia: External Debt Statistics
(In percent of GDP unless otherwise noted)

	End-December 1999	2000	2001	2002	2003	2004
Gross external debt	64.4	72.9	73.7	77.6	77.4	82.4
Public sector	11.4	10.4	9.8	9.7	8.7	9.5
Private sector	52.9	62.5	63.9	67.9	68.7	72.9
of which: Financial corporations	40.9	46.8	49.8	53.2	55.1	59.5
Foreign currency-denominated (in percent of total debt)	62.8	63.4	65.8	65.2	65.1	64.0
Short term (in percent of total debt)	51.8	55.4	54.5	53.0	48.1	47.3
of which: Foreign currency-denominated (in percent of total debt)	37.6	38.1	37.2	36.0	33.5	31.9

Sources: Australian Bureau of Statistics and RBA.

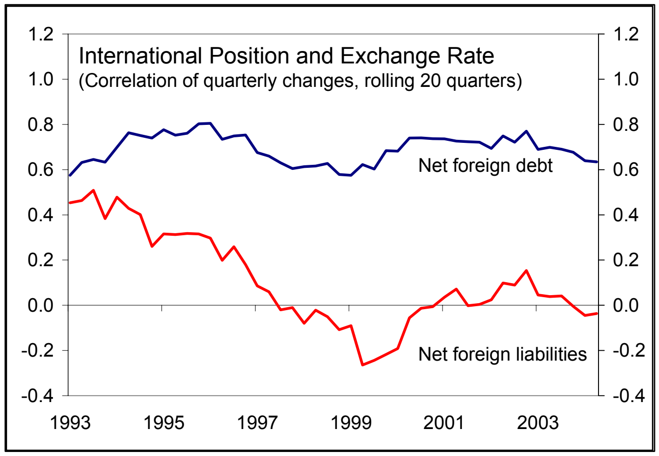


3. **Net interest payments rose modestly relative to exports in 2004 but remained low by historical standards.** The ratio has declined in recent years due to low

[22] This annex updates the vulnerability assessment provided in Australia: 2004 Article IV Consultation, *IMF Staff Country Report* No. 04/353, 2004. That assessment concluded that there were no major vulnerability concerns.

global and Australian interest rates, and is considerably lower than the level reached in the early 1990s.

4. **Foreign currency risks are limited by extensive hedging.** The share of gross debt denominated in foreign currency is around 65 percent. Nevertheless, a survey by the Australian Bureau of Statistics (ABS) showed that foreign currency assets of Australian entities exceeded foreign currency liabilities at end-June 2001, with a net long foreign currency position of $149 billion.[23] In particular, private corporations appeared to have relatively minimal direct exposure to exchange risk; a significant portion of their overseas borrowing was hedged naturally. While banks have borrowed substantially in foreign currencies, they have made extensive use of derivatives to hedge the exposure. Around 65 percent of these derivative contracts are taken with non-residents, including the entities that have borrowed in Australian dollars and are seeking to swap their liability back to their home currencies. Most of the remainder of the derivative positions—27 percent of the total—were swap transactions with the Reserve Bank, which undertakes such transactions for domestic liquidity management purposes. One indication of the effectiveness of the banks' hedging is the limited variation in the sector's earnings in the face of the sharp movements of the Australia dollar in recent years.[24] Taking into account foreign currency hedging, the country's international investment position has been little affected by the movements of the exchange rate.[25]



5. **Although half of the external debt has a maturity of less than a year, the refunding risks are limited by the banks' active liquidity management.** The maturity profile of the external debt primary reflects the borrowing patterns of the financial sector. Over the last year, however, banks have lengthened the maturity profile of their external borrowings, in light of the historically low yield in the global capital market. Banks also increased their holdings of liquid assets to 12 percent of the total assets from 8 percent in 2000. Perhaps more important than these simple ratios is the fact that the financial innovation and the availability of funding facilities have

[23] The survey captures around 90 percent of total foreign currency assets and liabilities. See "Australia' foreign currency exposure and hedging practices", Reserve Bank of Australia, August 2002. An updated survey is expected to become available by the end of 2005.

[24] "International Banking Statistics for Australia," Reserve Bank of Australia, July 2004.

[25] Given the extensive hedging of the foreign currency exposure, the impact of a one time large depreciation on the country's external debt ratio is relatively modest (Figure 1).

strengthened the banks' capacity to meet their short term liquidity needs. For instance, the rapid development of asset backed security market has enabled the banks to treat their residential mortgage loans as a potential source of liquidity. Indeed, analysis by the Australian Prudential Regulation Authority (APRA) indicates that liquidity is comfortable under a range of scenarios. In addition, in case of a temporary loss of access to offshore funding, the banks could also tap onshore sources of liquidity (such as the Interbank Deposit Agreement for the four large banks), with borrowing costs contained as the RBA determines the short end of the yield curve through the official cash rate.

B. Sectoral Balance Sheets

Corporate Sector

6. **The nonfinancial corporate sector in Australia is in strong financial position**. The debt-to-equity ratio in the non-financial corporate sector declined in the past two years to 66 percent at the end of 2004. Debt has also declined relative to the operating surpluses since 2001, resulting in a large improvement in debt servicing ratios. Operating margins have improved, and the return on equity has remained at double-digit levels.

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

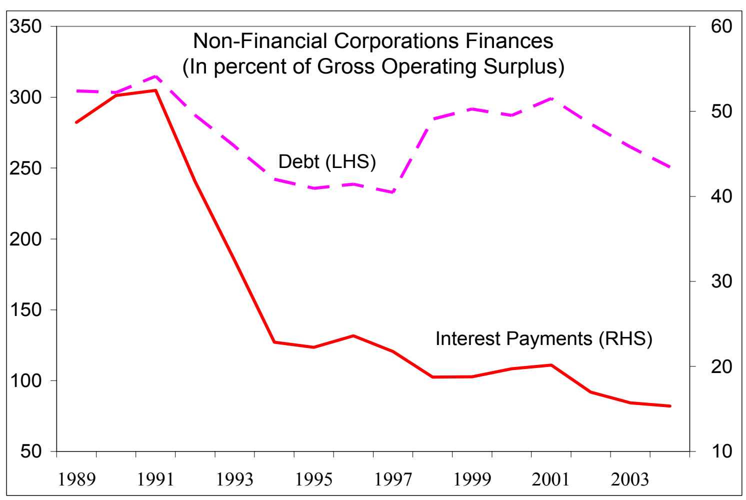
	1999	2000	2001	2002	2003	2004
Balance sheet indicators (end-Deember)						
Debt-equity ratio	62.3	73.7	71.8	81.3	73.5	66.2
Debt (in percent of GDP)	76.4	82.3	78.9	79.8	75.6	75.1
Profitability and liquidity indicators 1/						
Return to equity	17.2	21.8	18.0	15.8	14.2	19.6
Cash flow in percent of sales	24.3	25.4	22.1	21.8	22.5	24.3
EBIT Interest coverage ratio	9.4	9.3	5.5	4.9	7.5	11.3

Sources: Australian Bureau of Statistics, Thomson One Banker Analytics, and Fund staff estimates

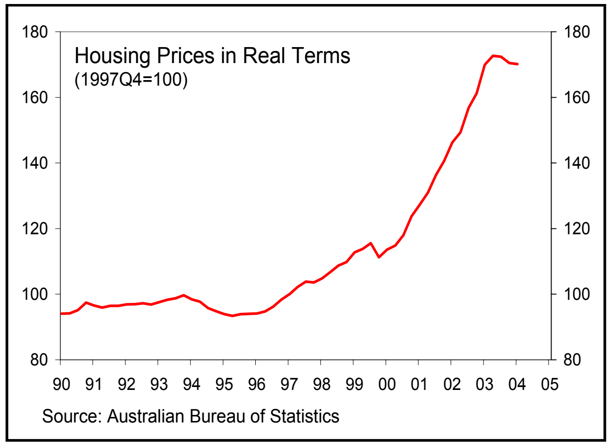
1/ Weighted average of data for companies accounting for more than 80 perecnt of total marekt capitalzation.

Households

7. **Household net worth declined relative to disposable income in 2004, but it remains high by historical standards.** The value of households' assets declined slightly relative to disposable income in 2004, driven by the subdued 3 percent rise in housing prices, which was partly offset by the strong gains on financial assets on the back of a buoyant equity market.



Household debt continued to rise, primarily driven by a 15 percent increase in housing financing.[26]



8. **Household interest payments rose to 8½ percent of disposable income in 2004**. The ratio increased further in 2005 following the increase of the official cash rate in March, and given the continued growth in credit to households.

9. **Nevertheless, there have been few signs of financial stress in the household sector.** For instance, despite the increase in debt and interest payments, the default rate on credit cards (viewed as an early indicator of financial stress) has remained below 1 percent. Default rates on housing loans are only 0.2 percent, which is very low by international standards. The strong employment growth and the increase in real disposable income imply that most households are in a good financial position to service their debt. Many households also have significant equity buffers in the housing assets, given the inclination for early repayment of the housing loans and the sizeable housing price increases in recent years. Moreover, the RBA reports that household debt is concentrated on high income groups who have relatively low debt service burdens and significant financial assets.[27] Only 2 percent of households were considered to be in a vulnerable position due to debt service ratios over 50 percent of after-tax income, and only 4 percent of households had loan-to-value ratios exceeding 75 percent.

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

	End-December						
	1998	1999	2000	2001	2002	2003	2004
Net worth	528	552	542	572	596	670	650
Total assets	630	661	655	692	729	818	807
Non-financial assets	370	389	388	422	465	538	511
Dwellings	339	359	359	393	436	509	483
Financial assets 1/	260	272	267	270	264	280	296
Deposits	60	58	56	59	63	66	67
Shares	49	53	52	53	49	50	55
Pension funds	102	115	115	114	108	116	127
Other	49	46	44	44	45	49	47
Total liabilities	102	109	113	119	133	148	157
Housing debt	64	70	76	83	93	108	116
Interest payments	6.3	6.4	7.3	6.6	6.7	7.7	8.6
Dwellings	4.2	4.3	5.0	4.7	4.9	5.8	6.6
Household net savings	1.8	1.4	2.5	1.7	-1.1	-3.1	-2.6

1/ Includes unincorporated enterprises
Source: Reserve Bank of Australia.

[26] The rapid increase of household debt was driven by households' easier access to credit and the relatively lower interest rate environment. As a result, the total household debt rose from a low level by international standards to levels comparable to those in the United Kingdom, and slightly higher than in the United States, although the overall gearing ratio (ratio of liabilities to assets) is still relatively low. See "Household Debt: What the Data Show", Reserve Bank of Australia *Bulletin*, March 2003.

[27] Reserve Bank of Australia, *Financial Stability Review*, March 2005.

Banks

10. **Australia's banking sector performance remains very strong**. With a robust domestic economy, Australian banks remained solidly profitable in 2004; the return on assets for the four major banks was over 1 percent and the return on equity rose to 18 percent.[28] The banking system is also adequately capitalized, maintaining total capital of 10½ percent and tier-one capital of 7½ percent of risk-weighted assets.[29] The overall asset quality of the banking system remains very high, with impaired assets of only 0.3 percent of total assets, and provisions increased to more than 170 percent of impaired assets. The strength of the Australian banks is reflected in their ratings by independent credit rating agencies—all of the four major banks have a credit rating of AA- or better.

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

	End-December					
	1999	2000	2001	2002	2003	2004
Loans	71.0	69.5	69.7	69.5	66.9	67.7
Loans to persons	39.3	41.2	42.2	41.3	41.9	42.0
Housing loans	32.8	35.2	36.3	35.0	35.7	35.8
Commercial loans	26.7	25.1	24.6	25.6	23.4	24.2
Profitability measures 1/						
Net interest margin 2/	2.7	2.5	2.3	2.2	2.2	2.2
Return on average assets	1.2	1.3	1.0	1.2	1.1	1.2
Return on average equity	18.0	19.4	15.6	18.2	16.4	18.2
Capital adequacy ratios 3/						
Tier 1 capital	7.8	7.1	7.7	7.7	7.6	7.6
Total capital	10.1	9.8	10.5	9.9	10.1	10.5
Impaired assets	0.6	0.5	0.7	0.6	0.4	0.3
General and specific provisions 4/	120.2	132.1	107.1	106.3	131.8	175.7
Housing loans past due 5/						
Net foreign currency liabilities	9.6	11.9	11.7	10.5	9.6	11.1

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

11. **The banking sector is robust to shocks, in particular, to a relatively sharp correction in the housing market**. Housing loans comprise about half of total bank loans, hence a major correction to housing prices could have some spillover effects on the banking system. Nonetheless, official stress tests have shown that the banking system is sufficiently well capitalized to withstand a substantial housing market correction.[30]

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

[29] While well above the 8 percent minimum, the capital adequacy ratio of Australia's banking system is somewhat below the level in many advanced economies. However, financial markets and ratings agencies recognize that the balance sheets of the Australian banks are less risky than implied by the standard risk-weighted assets measure, partly owing to the relatively high share of housing loans—it is notable that the Basel II standards will lower the risk weight on housing loans.

[30] APRA considered the impact of a 30 percent fall of real property prices on the authorized deposit-taking institutions (ADI), with the latter including banks, building societies, and credit unions. This stress test found that the strong capital positions enjoyed by ADIs as a group will not be substantially affected by such a shock. The aggregate default ratio will be around 3.5 percent, and over 90 percent of ADIs would survive such losses without breaching the minimum regulatory capital requirement. See "Stress testing housing loan portfolios," *APRA Insight*, 3rd Quarter/4th Quarter 2003.

Table 1. Australia: External Liability and Reserve Indicators
(In percent of GDP or otherwise noted)

	End-December						
	1998	1999	2000	2001	2002	2003	2004
Net external liabilities	55.2	55.5	54.8	55.2	58.7	60.9	65.4
Net external equity liabilities	14.3	14.9	8.7	9.4	10.6	13.7	15.1
Foreign equity investment in Australia	46.8	52.4	49.4	52.9	48.6	51.3	56.7
Australian equity investment abroad	-32.5	-37.4	-40.7	-43.4	-38.0	-37.6	-41.6
Net external debt	40.9	40.5	46.2	45.8	48.0	47.2	50.3
Net public debt	7.4	3.0	2.3	1.6	2.2	1.1	1.8
Net private debt	33.5	37.6	43.8	44.2	45.9	46.1	48.5
Gross external debt	63.0	64.4	72.9	73.7	77.6	77.4	82.4
Gross external lending	-22.1	-23.8	-26.7	-27.9	-29.5	-30.3	-32.1
Short-term net external debt (residual maturity basis)	17.5	17.0	22.3	23.9	23.1	18.5	19.5
Short-term gross external debt	30.7	33.4	40.4	40.2	41.1	37.3	39.0
Short-term gross external lending	-13.2	-16.3	-18.1	-16.3	-18.0	-18.8	-19.5
Memorandum items:							
Net income payments to exports (percent)	15.7	15.8	13.0	12.3	13.3	15.8	18.2
of which: Net interest payment to exports (percent)	9.1	10.5	10.0	9.1	8.4	8.1	9.3
Gross official reserves (in $A billion)	25.0	33.6	34.0	36.5	38.1	44.3	47.4
RBA outstanding forward contracts (in $A billion)	10.1	22.6	24.9	29.5	25.0	26.4	22.4
Net official reserves (in $A billion)	14.9	10.9	9.1	7.0	13.1	17.9	25.0
Gross official reserves (in months of imports)	2.3	2.7	2.7	2.7	2.8	3.0	3.0
Gross official reserves to short-term foreign currency denominated debt (percent)	19.5	23.0	18.9	19.3	18.5	21.7	21.5

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

Table 2. Australia: External Debt Sustainability Framework, 2000-2010
(In percent of GDP, unless otherwise indicated)

	Actual					Projections						
	2000	2001	2002	2003	2004	2005	2006	2007	2008	2009	2010	Debt-stabilizing non-interest current account 6/
Baseline: External debt	72.8	73.8	77.5	77.4	82.8	**83.7**	**85.4**	**87.6**	**90.0**	**91.6**	**92.2**	**-1.6**
Change in external debt	8.4	1.0	3.7	-0.1	5.4	0.9	1.6	2.3	2.3	1.6	0.6	
Identified external debt-creating flows (4+8+9)	4.9	2.7	-0.4	-5.5	-2.0	3.9	2.3	2.2	2.2	2.0	1.5	
Current account deficit, excluding interest payments	1.2	-0.3	1.7	3.8	4.1	2.5	1.5	1.6	1.7	1.4	0.9	
Deficit in balance of goods and services	1.2	-0.4	1.4	3.0	3.1	2.0	1.4	1.6	1.8	1.7	1.2	
Exports	21.9	22.5	20.7	17.9	18.2	19.7	19.7	19.2	18.5	18.1	18.0	
Imports	23.1	22.1	22.1	21.0	21.2	21.6	21.2	20.8	20.4	19.8	19.3	
Net non-debt creating capital inflows (negative)	1.2	-0.7	2.5	0.6	1.7	-0.1	-0.1	-0.1	-0.1	-0.1	-0.1	
Automatic debt dynamics 1/	2.5	3.7	-4.6	-9.9	-7.8	1.6	0.9	0.7	0.6	0.7	0.7	
Contribution from nominal interest rate	2.9	2.6	2.4	2.1	2.3	3.2	3.4	3.5	3.6	3.7	3.7	
Contribution from real GDP growth	-2.1	-1.9	-2.6	-2.0	-2.1	-1.6	-2.5	-2.8	-3.0	-3.0	-3.0	
Contribution from price and exchange rate changes 2/	1.7	2.9	-4.3	-10.0	-8.1	...	...	...	...	...	...	
Residual, incl. change in gross foreign assets (2-3) 3/	3.4	-1.7	4.1	5.4	7.4	-3.0	-0.7	0.1	0.2	-0.4	-0.9	
External debt-to-exports ratio (in percent)	332.1	327.4	374.6	431.5	455.7	425.8	432.9	457.0	485.2	505.0	511.2	
Gross external financing need (in billions of US dollars) 4/	160.1	165.4	171.4	219.4	282.1	348.3	382.6	409.7	440.6	471.1	500.1	
in percent of GDP	42.4	46.3	42.8	42.9	45.6	50.6	53.0	54.2	55.7	56.5	56.7	
Scenario with key variables at their historical averages 5/						**83.7**	**84.2**	**85.0**	**85.8**	**86.7**	**87.4**	**-2.5**
Key Macroeconomic Assumptions Underlying Baseline												
Real GDP growth (in percent)	3.2	2.5	4.0	3.3	3.2	2.2	3.2	3.5	3.5	3.5	3.5	
GDP deflator in US dollars (change in percent)	-6.3	-7.5	8.0	22.9	17.7	8.9	1.7	1.2	1.2	1.8	2.3	
Nominal external interest rate (in percent)	4.3	3.4	3.7	3.4	3.6	4.3	4.3	4.3	4.3	4.3	4.3	
Growth of exports (US dollar terms, in percent)	12.8	-2.8	3.0	10.7	22.4	20.4	5.2	1.8	1.3	3.0	5.2	
Growth of imports (US dollar terms, in percent)	3.9	-9.7	12.1	21.3	22.4	13.4	2.6	2.7	2.7	2.6	2.7	
Current account balance, excluding interest payments	-1.2	0.3	-1.7	-3.8	-4.1	-2.5	-1.5	-1.6	-1.7	-1.4	-0.9	
Net non-debt creating capital inflows	-1.2	0.7	-2.5	-0.6	-1.7	0.1	0.1	0.1	0.1	0.1	0.1	

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 rat
ε = nominal appreciation (increase in dollar value of domestic currency), and α = 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).

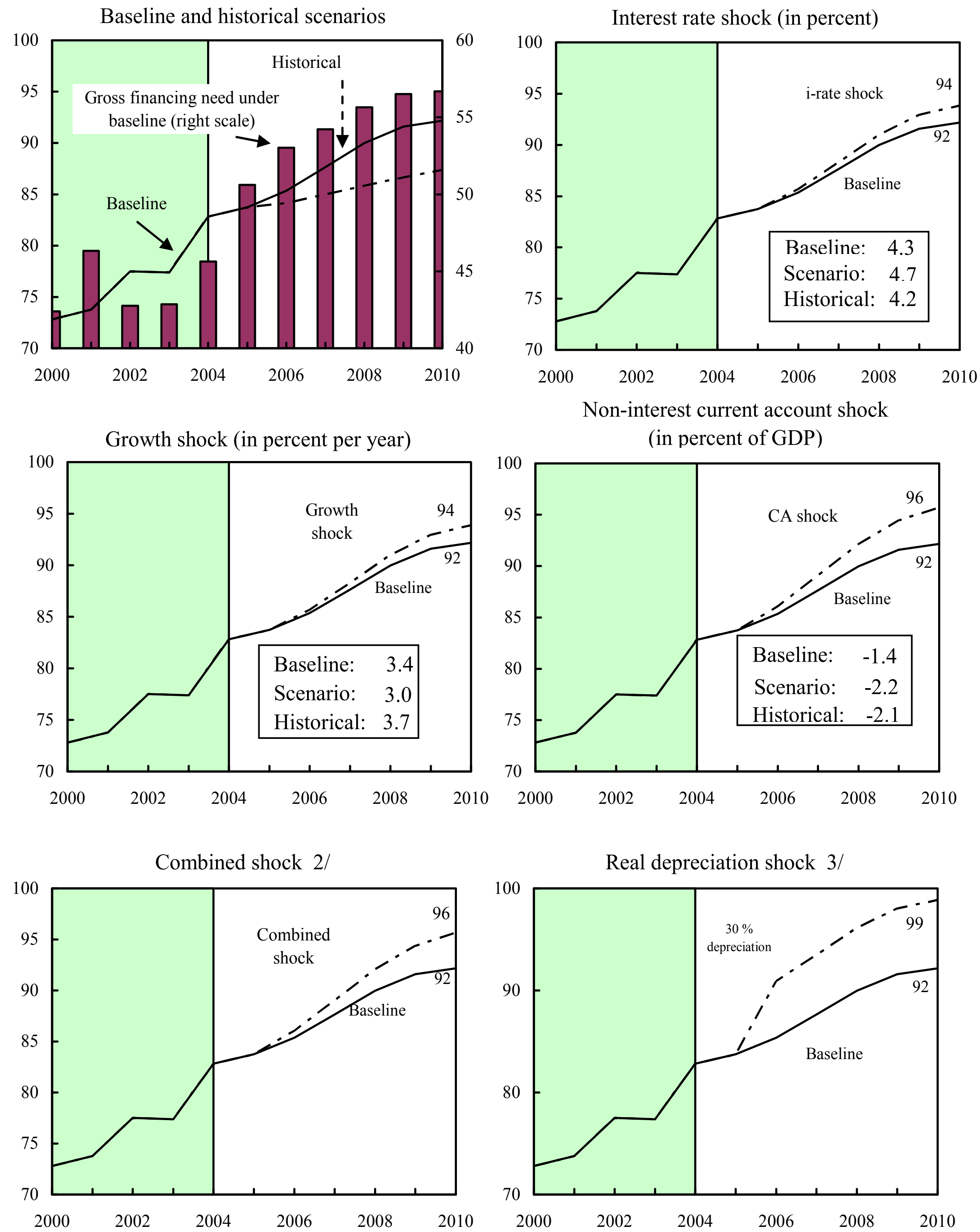
3/ For projection, line includes the impact of price and exchange rate changes.

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

5/ The key variables include real GDP growth; nominal interest rate; dollar deflator growth; and both non-interest current account and non-debt inflows in percent of GDP.

6/ Long-run, constant balance that stabilizes the debt ratio assuming that key variables (real GDP growth, nominal interest rate, dollar deflator growth, and non-debt inflows in percent of GDP) remain at their levels of the last projection year.

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



Sources: International Monetary Fund, Country desk data, and staff estimates.
1/ Shaded areas represent actual data. Individual shocks are permanent one-half standard deviation shocks. Figures in the boxes represent average projections for the respective variables in the baseline and scenario being presented. Ten-year historical average for the variable is also shown.
2/ Permanent 1/4 standard deviation shocks applied to real interest rate, growth rate, and current account balance.
3/ This scenario assumes foreign exchange hedging covers 77 percent of foreign currency debt, consistent with the findings of a 2002 survey by the Australian Bureau of Statistics, as reported in "Australia's Foreign Currency Hedging Practices," RBA Bulletin, August 2002.

AUSTRALIA—FUND RELATIONS
(As of May 31, 2005)

A. Financial Relations

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

II. General Resources Account:	**SDR Million**	**Percent Quota**
Quota	3,236.40	100.0
Fund holdings of currency	2,290.77	70.78
Reserve position in Fund	945.77	29.22

III. SDR Department:	**SDR Million**	**Percent Allocation**
Net cumulative allocation	470.55	100.00
Holdings	131.46	27.94
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. The exchange rate is independently floating, but the Reserve Bank of Australia retains discretionary power to intervene**.** On May 31, 2005, the U.S. dollar/Australian dollar exchange rate was US$0.7557=$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, the Socialist People's Libyan Arab Jamahiriya, and Zimbabwe. In late 1999, Australia imposed restrictions on financial transactions with the Taliban (the Islamic State of Afghanistan).

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 2005 Article IV consultation were held in Sydney, Melbourne, and Canberra from June 8 to June 17, 2005. The 2004 consultation (IMF Country Report No. 04/354) was completed by the Executive Board on October 6, 2004. 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). Economic and financial data provided to the Fund are considered adequate for surveillance purposes.

C. Real Sector Statistics

National Accounts

2. In late 2005, the Australian Bureau of Statistics (ABS) will release new GDP estimates based on an updated set of supply-use tables. Work to date indicates that the level of GDP may be revised upwards, although such a revision is likely to have little effect on growth rates.

Prices

3. Over the next few years, the Australia Bureau of Statistics (ABS) plans to introduce indices measuring the change in the prices of financial services into the CPI. Since mid-2004, the ABS has released experimental price indices for financial services, covering both direct charges such as banking and real estate service fees, and indirect charges such as the interest rate margins. These indices are expected to be included into the headline CPI from the third quarter of 2005. In addition, with the 5-year review of the CPI, the weights in the CPI basket will be updated, based largely on the 2003–04 household expenditure survey.

4. The ABS released a new price measure—the Price Index of Domestic Final Purchases (DFP)—on an experimental basis since July 2001. The index reflects purchases of Australian residents (households, governments, and businesses), with import prices included and export prices excluded. 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.[31] The items and weights for this economy-wide measure of prices are derived from the 1994–95 input-output tables. The ABS plans to regularize the production of the DFP in the next few years, when the existing system for compiling price indexes is updated to accommodate this.

5. Beginning in November 2004, the ABS published new annual non-wage labor cost indices. These indices, covering superannuation, workers' compensation, annual leave, and payroll tax, will contribute to the development of indices of overall labor costs.

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

Labor

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 defined as 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 is expected to be available by October 2005.

6. Since July 2003 the ABS has also published experimental measures of volume based labor underutilization in terms of the number of hours of labor (rather than the number of people affected). The volume of underutilized labor in the labor force is derived as the number of hours of work sought by unemployed persons plus the number of additional hours of work offered by underemployed workers. The statistics are expected to be included in the official figures from late 2006.

D. Government Finance Statistics

7. The Australian Commonwealth (central) Government introduced accrual budgeting with the 1999/2000 Budget estimates that were released in May 1999. Consolidated Financial Statements for the Commonwealth and all State governments 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, in accordance with the *GFSM (2001)* methodology, are produced for the budget and mid-year updates of the estimates and the final budget outcomes publications. The ABS has been producing quarterly GFS estimates for many years as an input into the quarterly national accounts. In March 2004, the ABS published quarterly data on the operations of general government and nonfinancial public corporations, excluding data on financing. It is currently working with the Commonwealth and State governments to produce a harmonized set of GFS and accounting data, which is expected to commence with the 2006/07 budget.

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*.

E. Monetary and Financial Statistics

9. Data are reported to the Fund by the Reserve Bank of Australia (RBA) on a monthly basis and cover operations of the RBA and those of the trading and savings banks. The accounts

of other deposit-taking institutions are not included. To compile these data, the RBA uses several unpublished data sources, some of which are produced on a quarterly basis. Therefore, monthly data published in *IFS* are partly based on estimates. The RBA advised it was not at present in a position to submit the new Standardized Report Forms for monetary statistics.

F. External Sector Statistics

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

11. The ABS is currently conducting a survey on Australia's foreign currency exposure, an update to the 2001 survey. The purpose is to provide updated statistics on Australian enterprises' foreign currency exposure, the level of risks associated with that exposure due to adverse movements in the exchange rates, and the extent to which hedging is used to mitigate the risks. The results are expected to be published in October 2005. In future, it is expected that the foreign currency exposure survey will be updated every three years, subject to funding being available.

Australia: Table of Common Indicators Required for Surveillance

(As of July 18, 2005)

	Date of latest observation	Date received	Frequency of Data[6]	Frequency of Reporting[6]	Frequency of Publication[6]
Exchange Rates	7/18/05	7/18/05	D	D	D
International Reserve Assets and Reserve Liabilities of the Monetary Authorities[1]	05/05	06/30/05	M	M	M
Reserve/Base Money	06/05	07/14/05	M	M	M
Broad Money	05/05	06/30/05	M	M	M
Central Bank Balance Sheet	06/05	07/14/05	M	M	M
Consolidated Balance Sheet of the Banking System	05/05	06/16/05	M	M	M
Interest Rates[2]	7/18/05	7/18/05	D	D	D
Consumer Price Index	Q1 2005	04/27/05	Q	Q	Q
Revenue, Expenditure, Balance and Composition of Financing[3] – General Government[4]	2003/04	09/04	A	A	A
Revenue, Expenditure, Balance and Composition of Financing[3]– Central Government	05/05	07/08/05	M	M	M
Stocks of Central Government and Central Government-Guaranteed Debt[5]	05/05	07/08/05	M	M	M
External Current Account Balance	Q1 2005	05/31/05	Q	Q	Q
Exports and Imports of Goods and Services	05/05	07/04/05	M	M	M
GDP/GNP	Q1 2005	06/01/05	Q	Q	Q
Gross External Debt	Q1 2005	05/31/05	Q	Q	Q

[1] Includes reserve assets pledged or otherwise encumbered as well as net derivative positions.
[2] Both market-based and officially-determined, including discount rates, money market rates, rates on treasury bills, notes and bonds.
[3] Foreign, domestic bank, and domestic non-bank financing.
[4] The general government consists of the central government (including budgetary, extra budgetary, and social security funds) and state and local governments.
[5] Including currency and maturity composition.
[6] Daily (D), Weekly (W), Monthly (M), Quarterly (Q), Annually (A), Irregular (I); Not Available (NA)

INTERNATIONAL MONETARY FUND
Public Information Notice
EXTERNAL RELATIONS DEPARTMENT

Public Information Notice (PIN) No. 123
FOR IMMEDIATE RELEASE
September 12, 2005

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

IMF Executive Board Concludes 2005 Article IV Consultation with Australia

On August 29, 2005, the Executive Board of the International Monetary Fund (IMF) concluded the Article IV consultation with Australia.[1]

Background

Australia has implemented wide-ranging structural reforms and strengthened the frameworks for monetary and fiscal policies over the past two decades. As a result, Australia's economic expansion is now in its 14th year, with growth averaging 3¾ percent owing to a combination of strong job creation and high productivity growth. Inflation has remained low and the consistent fiscal surpluses in recent years have contributed to the elimination of net public debt.

Real GDP rose by 3¼ percent (y/y) in 2004, but growth slowed in the second half of 2004. The slowdown mostly reflected a deceleration of domestic demand following a welcomed cooling of the housing market, with housing prices slowing from an annual average growth of 17½ percent in 2001–03 to being largely flat in the year to March 2005. As a result, consumption growth moderated and dwelling investment fell. Business investment remained buoyant, reflecting high levels of profitability and capacity utilization. Employment has grown strongly, at 3 to 4 percent in 2005, reducing unemployment to a 28-year low of 5 percent, with no sign of generalized wage pressures.

[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.

The external current account deficit widened to 6½ percent of GDP in 2004 as payments to foreign investors rose owing to high mining sector profits. The trade balance was stable, with increases in the terms of trade to historically high levels offsetting the strong growth in imports following the large exchange rate appreciation in 2002-03. In the first quarter of 2005, the real exchange rate stood 16 percent above its average level since 1990. Export volume growth was limited to 4 percent despite the strong global demand for commodities, partly as a result of constraints on mine capacity and on transportation infrastructure in some areas. The current account was financed mainly through external debt issues by financial institutions, with net external liabilities rising to 65 percent of GDP.

CPI inflation has been steady at about 2½ percent, with a waning of the effects of the exchange rate appreciation on tradable goods prices balanced by a modest easing in the inflation rate of nontradable goods. Having kept interest rates on hold since late 2003, the Reserve Bank of Australia (RBA) raised the target cash rate by 25 basis points to 5½ percent in March 2005, to lean against a projected rise in inflation to about 3 percent by the end of 2006.

The fiscal position continued to be strong. In the 2005 budget released in May, the government projected the underlying cash balance to reach 1.1 percent of GDP in 2004/05, compared with the surplus of 0.3 percent of GDP projected in the 2004 budget. Revenue is projected to be almost 1 percent of GDP higher than budgeted, with company taxes particularly buoyant, partly reflecting the boost in profits from rising export commodity prices.

Growth is expected to rise from 2¼ percent in 2005 to about 3½ percent in the medium term, although this will require continued strong growth in productivity. Domestic demand growth will likely remain moderate as stimulus from the housing market fades, while exports are expected to strengthen as substantial investment in the export sector boosts capacity. As a result, the external current account deficit is expected to decline back to its historical average of about 4½ percent of GDP in the medium term even as part of recent terms of trade gains unwind owing to increases in the global supply of commodities. While headline inflation may approach 3 percent in 2005 because of higher oil prices, the recent easing in domestic demand growth suggests that underlying inflation will edge up only modestly before declining back towards the middle of the target range in the medium term.

Executive Board Assessment

Executive Directors commended the authorities for the sustained strength of Australia's economic performance, which they attributed to an exemplary setting of economic policies and institutions, supported by broad consensus on many issues. This includes wide-ranging structural reforms implemented over the past two decades, along with a prudent and flexible management of monetary and fiscal policies within transparent medium-term policy frameworks that has helped enhance the resilience of the economy. Going forward, Directors encouraged the authorities to continue with their structural reform efforts, in order to further raise productivity and labor force participation and address the fiscal impact of an ageing population.

Directors concurred that the outlook for the economy is favorable. While growth had slowed somewhat in the second half of 2004 owing to a welcome cooling of the housing market and the earlier appreciation of the Australian dollar, the resumption of growth in early 2005 is expected to continue, with demand underpinned by strong job creation and business investment. Medium-term prospects for stronger growth in exports supported by high investment in the resource sector, together with moderate growth in domestic demand, will tend to narrow the large external current account deficit.

Directors viewed the current wait-and-see monetary policy stance of the Reserve Bank of Australia as appropriate. While headline inflation may approach 3 percent in 2005 owing to higher oil prices, underlying inflation is likely to remain consistent with the authorities' targets over the medium term, given the moderation in domestic demand growth. Directors welcomed the stabilization of the housing market in 2004 and 2005, together with the easing in household credit growth, which partly reflected astute and timely policy actions. Nevertheless, close monitoring of the housing market and household sector finances will need to continue.

Against this background, Directors welcomed the continued improvement in risk management techniques by banks, and supported the timely refinements of prudential regulations in response to the emergence of nonstandard household lending. To preserve the soundness of Australia's financial sector, they encouraged continued efforts to enhance financial regulation, and welcomed the authorities' commitment to using the forthcoming FSAP to help identify reform priorities.

Directors agreed that Australia's medium-term fiscal position is robust, with the underlying fiscal surplus projected at almost 1 percent of GDP on average over the next four years, partly reflecting large increases in export commodity prices. Since not all of these gains may be lasting, Directors considered the allowance for a substantial decline in export prices in the medium-term revenue projections of the 2005 budget to be appropriately prudent. They also welcomed the tax reductions in the past two budgets, which, by contributing to a mildly expansionary fiscal stance, may have helped cushion the recent slowing in growth.

Directors considered that exchange rate flexibility will continue to play a key role in tempering the impact of possible shocks on growth, including those that might arise from a rapid reversal in recent terms of trade gains. They also supported the free operation of the automatic fiscal stabilizers and the readiness of monetary policy to respond flexibly to external or domestic shocks. Directors noted the role that extensive foreign currency hedging is playing in contributing to the resilience of the economy to substantial exchange rate fluctuations. At the same time, Directors concurred that the high level of private external debt, in the context of sustained current account deficits, requires continued close monitoring.

Directors considered that Australia's strong track record of successful implementation of structural reforms bodes well for addressing the significant economic challenges that lie ahead from an ageing population and rising healthcare costs. They endorsed the authorities' strategy to address those challenges through further reforms to boost medium-term growth, and hence the revenue base, complemented by measures to enhance the sustainability of expenditure. Directors observed that Australia's sound economic outlook and robust fiscal position create an exceptional opportunity to implement these reforms.

Directors accordingly welcomed the measures announced in the 2005 budget to expand labor force participation by encouraging the transition from welfare to work. They supported the proposed reforms of the industrial relations system aimed at further improvements in labor market flexibility that would facilitate additional gains in productivity and employment. The authorities should also continue efforts to raise labor force participation among the population aged over 55 to moderate the impact of population ageing on the outlook for employment and growth.

To further raise productivity and incomes toward those in the leading economies, Directors recommended the adoption of an ambitious new reform agenda in key infrastructure sectors. In particular, steps to improve the price signals for water, land transportation, and electricity would enhance incentives for their efficient use and stimulate timely investments to expand infrastructure capacity. The importance of stronger competition in the communications sector and increased research and development was also highlighted.

Directors welcomed the recent reforms of pharmaceutical benefits and Medicare as important steps to address rising healthcare costs, which are the main source of long-term fiscal pressures. Further efforts to enhance the sustainability of healthcare spending will nevertheless be needed, and Directors encouraged the authorities to explore how incentives in the health system could be strengthened to improve healthcare productivity growth. Directors agreed that the proposed Future Fund, by covering unfunded public service pension liabilities, and operating in accordance with international best practices, is also set to play a valuable role in meeting long-term fiscal challenges.

Directors commended Australia’s commitment to trade liberalization under the Doha Round, and the increase in official development assistance. They encouraged the authorities to continue to make progress toward the United Nations target.

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

Table 1. Australia: Selected Economic Indicators, 2000–05

	2000	2001	2002	2003	2004	Proj. 2005
Output and demand (percent change)						
Real GDP	3.2	2.5	4.0	3.3	3.2	2.2
Total domestic demand	2.2	1.3	6.6	5.9	5.0	3.2
Private consumption	3.2	2.7	4.0	4.3	5.6	2.7
Total investment	1.2	-0.7	16.1	8.2	6.3	2.9
Exports of goods and services	11.2	1.7	0.1	-2.2	4.1	3.4
Imports of goods and services	7.9	-4.2	11.1	10.5	14.5	7.8
Inflation and unemployment (in percent)						
CPI inflation	4.5	4.4	3.0	2.8	2.3	2.6
Unemployment rate	6.3	6.8	6.4	6.0	5.5	5.1
Saving and investment (in percent of GDP)						
Gross national saving	19.2	19.6	19.6	19.4	18.4	19.0
General government saving	2.9	2.6	3.0	3.4	3.0	2.7
Private saving 1/	16.3	17.1	16.6	15.9	15.4	16.3
Gross capital formation	23.2	21.9	23.7	25.3	24.8	24.7
Fiscal indicators (in percent of GDP) 2/						
Receipts 3/	26.6	24.1	22.8	23.2	23.0	23.5
Payments 3/ 4/	24.5	23.2	22.9	22.2	22.0	22.4
Underlying balance 4/	2.1	0.9	-0.1	1.0	1.0	1.1
Public debt, net	8.6	6.4	5.3	3.9	2.9	1.9
Money and credit (end of period)						
Interest rate (90-day bill, in percent)	6.2	4.2	4.8	5.5	5.4	…
Treasury bond yield (10-year, in percent)	5.5	6.0	5.2	5.6	5.3	…
M3 (percent change)	4.6	14.7	7.1	11.9	9.6	…
Private domestic credit (percent change)	11.2	7.9	11.4	10.6	11.5	…
Balance of payments (in percent of GDP)						
Current account	-4.1	-2.3	-4.1	-5.9	-6.4	-5.7
of which: Trade balance	-1.2	0.5	-1.3	-3.0	-2.9	-1.9
Foreign direct investment, net	2.9	-2.1	1.9	-1.6	4.3	...
Terms of trade (percent change)	5.5	1.5	2.0	3.1	10.0	10.7
External assets and liabilities (in percent of GDP)						
Net external liabilities	54.8	55.2	58.6	60.8	64.5	65.9
Net external debt	46.1	45.8	48.0	47.1	50.2	…
Gross official reserves	5.2	5.3	5.2	5.6	5.6	…
Exchange rate (period average)						
US$/$A	0.554	0.509	0.566	0.750	0.769	…
Trade-weighted index	51.6	50.2	51.7	63.0	62.8	…
Real effective exchange rate 5/	79.3	79.2	83.1	99.2	98.3	…

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

1/ Includes public trading enterprises.
2/ Fiscal year ending June 30, Commonwealth Budget.
3/ The sharp drop in 2001 reflects tax reform, including income tax cuts and removal of the Wholesale Sales Tax, and a cut in grants to States.
4/ Excludes asset sales and other one-off factors; cash basis.
5/ IMF, Information Notice System index (1990 = 100).