September 2007
IMF Country Report No. 07/314

Australia: 2007 Article IV Consultation—Staff Report; Staff Supplement; 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 2007 Article IV consultation with Australia, the following documents have been released and are included in this package:

- The staff report for the 2007 Article IV consultation, prepared by a staff team of the IMF, following discussions that ended on June 27, 2007, 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 2, 2007. The views expressed in the staff report are those of the staff team and do not necessarily reflect the views of the Executive Board of the IMF.

- A staff supplement of August 29, 2007 updating information on recent developments.

- A Public Information Notice (PIN) summarizing the views of the Executive Board as expressed during its August 31, 2007 discussion of the staff report that concluded the Article IV consultation.

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

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INTERNATIONAL MONETARY FUND

AUSTRALIA

Staff Report for the 2007 Article IV Consultation

Prepared by the Staff Representatives for the 2007 Consultation with Australia

Approved by Masahiko Takeda and Michael T. Hadjimichael

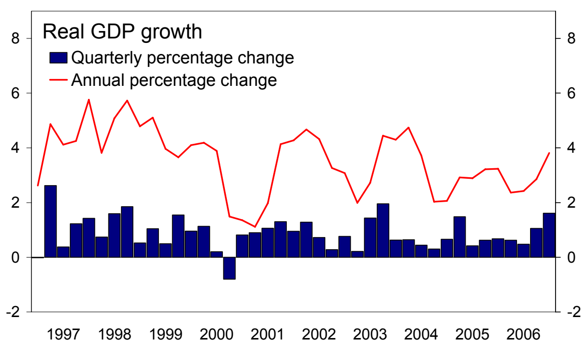
August 2, 2007

- **Dates:** June 18–27, 2007.
- **Team:** Mr. Takeda (Head), Ms. Edison, Mr. Rozhkov (all APD), Mr. Tressel (RES). Mr. Murray (OED) participated in discussions.
- **Counterparts:** Treasurer Peter Costello, RBA Governor Glenn Stevens, other senior officials, and representatives from academia, labor unions, financial and business sectors.
- **Past Surveillance**: For policy issues discussed in the 2006 Article IV consultation, see: http://www.imf.org/external/np/sec/pn/2006/pn06123.htm.
- **Exchange Rate:** Market determined. Australia maintains an exchange system that is free of restrictions on payments and transfers for current international transactions.
- **Official Development Assistance:** 0.3 percent of national income in 2006.

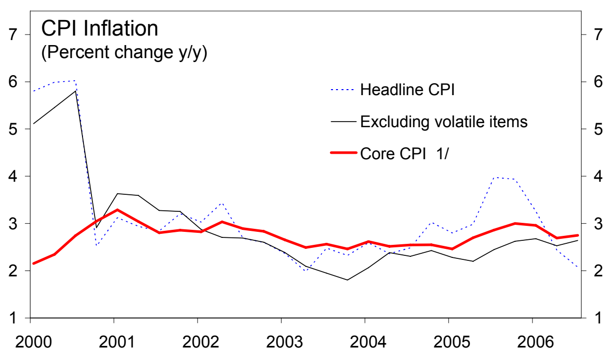
Contents Page

I. Economic Developments

1. **After a brief slowdown, Australia's real GDP expanded by 3¾ percent over the year to the first quarter of 2007, while inflationary pressures have moderated.** The pace of non-farm GDP growth accelerated, partly reflecting the surging terms of trade (TOT) driven by commodity prices. However, a severe drought sharply reduced output in the farm sector, subtracting about ¾ of a percentage point in GDP growth in 2006/07. Growth has been driven by domestic demand with consumer spending accelerating in the second half of the year, supported by rising employment and real wages (Table 1 and Figure 1). Australia's lengthy period of expansion has brought the economy to a position of high capacity utilization and tight labor markets. However, both headline and core inflation have eased recently reflecting in part temporary factors, particularly fuel and food prices (Figure 2).



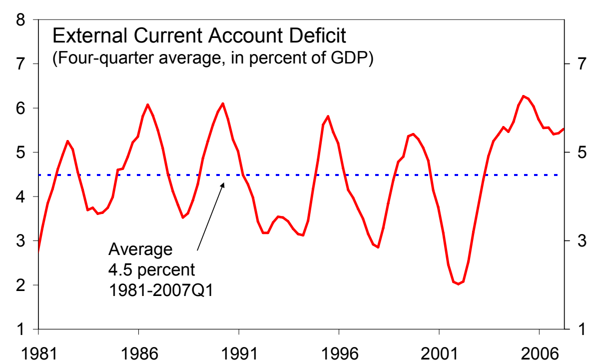
Source: Australian Bureau of Statistics.



Sources: Australian Bureau of Statistics and Reserve Bank of Australia

1/ Average of weighted median and trimmed mean inflation calculated by RBA.

2. **The current account deficit remained slightly above 5½ percent of GDP in 2006, reflecting high investment and a strong currency.** Historically, Australia has run on average a deficit of about 4½ percent of GDP. In 2006, the trade deficit narrowed, owing to higher export prices and a modest lift in volumes (Table 2 and Figure 3). However, the volume of imports rebounded recently, driven by firming growth in domestic demand, including strong imports of capital goods. The investment income balance continued to deteriorate, reflecting large net dividend payments particularly in the resource sector. Net foreign liabilities increased to over 60 percent of GDP. The private sector accounts for 99 percent of Australia's net external debt, with 78 percent intermediated by private financial institutions.



Source: Australian Bureau of Statistics

3. **Macroeconomic prospects remain favorable**. Staff project GDP growth to accelerate above 4 percent in 2007 and moderate slightly in 2008 (Table 3). Growth will continue to be broad based. The global environment is expected to remain supportive, driven

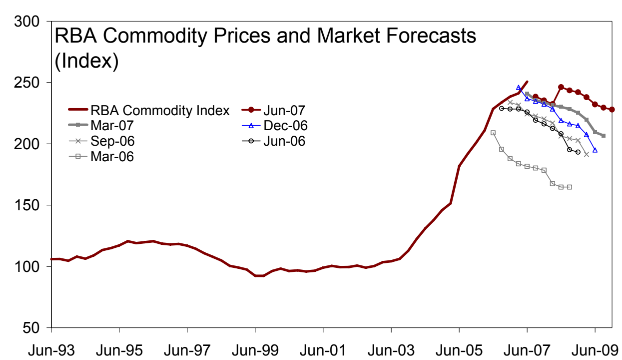
by strong growth in major trading partners. Exports are likely to increase as investment in the mining sector becomes productive. The current account deficit should remain stable in 2008 as the balance on goods and services improves, though the income deficit continues to create some drag. CPI inflation is expected to ease further in 2007 to slightly over 2 percent but recover to around 2¾ percent in 2008, within the Reserve Bank of Australia's (RBA) target band of 2-3 percent.

Australia: Medium-Term Scenario 2006–12

		Projections					
	2006	2007	2008	2009	2010	2011	2012
Real economic indicators (percent change)							
GDP	2.7	4.4	4.0	3.4	3.3	3.2	3.2
Total domestic demand	3.5	5.1	3.2	3.0	2.9	2.8	2.8
Exports of goods and services	3.4	6.1	9.0	6.8	6.1	6.1	6.1
Imports of goods and services	7.7	9.5	4.5	4.3	4.1	3.9	4.0
Inflation and unemployment							
CPI inflation	3.5	2.1	2.8	2.8	2.8	2.8	2.8
Unemployment rate	4.8	4.5	4.5	4.5	4.5	4.5	4.5
Balance of payments (percent of GDP)							
Balance on goods and services	-1.2	-1.1	-1.0	-1.2	-1.4	-1.4	-1.4
Balance on income and transfers	-4.3	-4.4	-4.6	-4.4	-4.5	-4.3	-4.4
Current account balance	-5.5	-5.6	-5.6	-5.6	-5.8	-5.7	-5.8

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

4. **The short-term risks to the outlook appear to be on the upside, while the medium-term risks are balanced.** A recent pickup in housing starts, recovery in rural income with the easing of the drought, and a lift in natural resource export volumes could lead to faster growth and pressure on inflation. The medium-term risks are evenly balanced and stem mainly from external developments, although risks from the recurrent droughts and household balance sheet consolidation remain. If the global economy slows significantly, for example owing to a possible financial turbulence, commodity prices could fall deeper and more rapidly than assumed, reducing exports, dampening investment, and slowing growth. On the other hand, commodity prices could continue to outperform expectations as they have for the past several years. This could present challenges including upward pressure on an already stretched economy.



Source: Reserve Bank of Australia and Access Economics

II. Policy Discussion

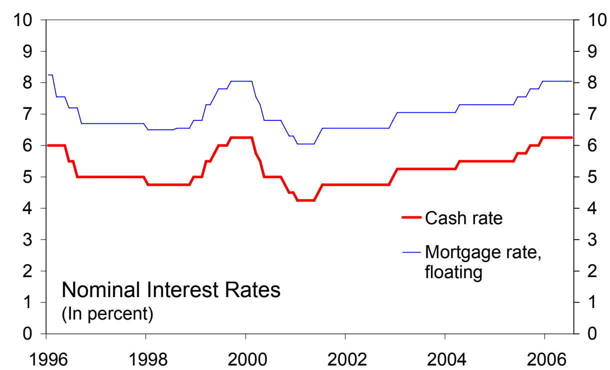
5. **In view of Australia's strong macroeconomic and policy performance, including external stability, this year's consultation discussions were streamlined.** The policy priorities remain to foster economic growth, maintain price stability, strengthen the financial

system, and enhance productivity through structural reforms. Given the robust fiscal position and the favorable outlook—partly because of the improvement in the TOT—there now exists an exceptional opportunity to achieve these goals. With the upcoming Federal election, however, it will be important to keep economic policy from deviating from its medium-term objectives. Discussions focused on the appropriate macroeconomic policies in light of limited spare capacity and the strategy to manage the long-term challenges related to growth.

A. Appropriate Policy Settings in a Full Employment Environment

6. **The challenge for policymakers in the near term is how to guard against upside risks.** Both fiscal and monetary policy are well-positioned to deal with downside risks, especially with a very strong fiscal position. The authorities need to be mindful, however, of upside risks by keeping aggregate spending in line with the economy's productive capacity without adding to inflationary pressures and by building capacity.

7. **Monetary policy has remained supportive of economic activity while ensuring low and stable inflation.** The RBA appropriately raised the official interest rate by 25 basis points three times last year to 6¼ percent, in view of the tight capacity utilization and a build-up of inflationary pressures (Figure 4). However, recently the RBA considered that the evidence from producer and consumer price indices indicated that inflation had moderated. Also, the surging value of the Australian dollar has helped dampen prices. In view of a relatively short policy effectiveness lag in Australia, staff concur with the RBA that this easing of inflationary pressures has allowed further time to assess the need for further tightening.

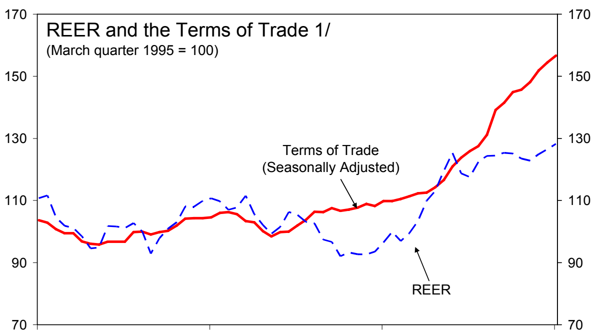


Source: Reserve Bank of Australia

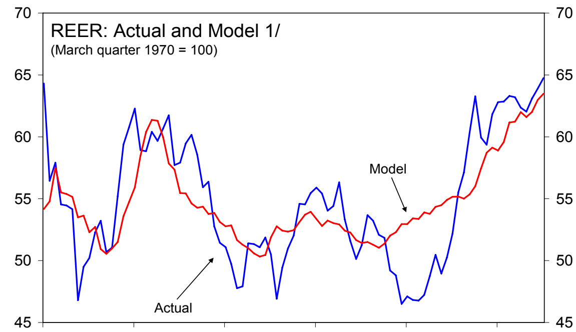
8. **However, if signs of inflationary pressure were to reemerge, this would call for a prompt policy action.** Key concerns to the inflation outlook relate to the ongoing strength in domestic activity, household credit, and wage outcomes. The RBA is monitoring these developments, and Governor Stevens has stated publicly that the political calendar would not influence the monetary policy decisions.

9. **The Australian dollar has been appreciating substantially over the past few years, but does not appear misaligned once the recent TOT gains are taken into account, especially if these gains are permanent.** The recent appreciation partly reflects the surge in the TOT (40 percent in the last 4 years) and strong capital inflows, encouraged by the differentials on interest rates along with the perception that these differentials

are likely to persist for some time.[1] The available estimates for the overvaluation of Australian dollar's real effective exchange rate (REER) range from 1 percent according to an RBA model (which is based on the TOT changes so far) to 9 percent according to two of the CGER estimates that take into account the projected partial reversal of the TOT gains over the medium term.[2] Based on this, the staff believes that there is no significant misalignment of the exchange rate.

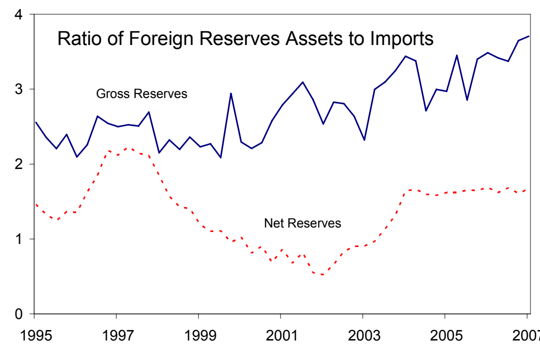


Source: Authorities and Fund Staff estimates.
1/ REER using RBA trade weights.



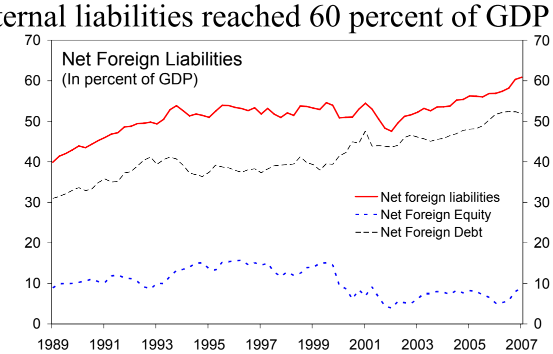
Source: Reserve Bank of Australia
1/ REER using RBA trade weights.

10. **The RBA's general approach is to let market forces determine the exchange rate.** They noted that the currency appreciation has played a valuable role in easing inflation pressures directly through lower import prices, and indirectly by switching expenditure to imports when capacity utilization was high. The RBA has taken advantage of the relatively high Australian dollar to accumulate a modest amount of additional reserves, with negligible effect on the foreign exchange market.



Source: Reserve Bank of Australia

11. **External debt continues to rise.** Net external liabilities reached 60 percent of GDP in 2006, and are projected to increase further as high current account deficits are expected to persist over the medium term (Figure 5). The high deficits are primarily due to high domestic investment, which reflects attractive investment opportunities in Australia, including vast reserves of natural resources. There is little



Source: ABS Times Series Database

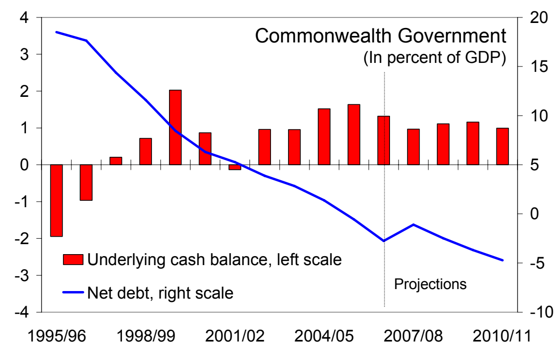
[1] Unlike New Zealand, the carry trade is small relative to aggregate capital flows in the Australian market. So the risk from an unwinding of carry trade is negligible.

[2] For a description of an RBA exchange rate model see Stone, et al (2005), "A Small Model of the Australian Macroeconomy: An Update," RBA RDP 2005-11. The CGER estimates of overvaluation are 9 percent (equilibrium real exchange rate), 9 percent (macroeconomic balance approach), and 18 percent (external sustainability approach).

reason to believe that a sudden reversal of the current account balance is bound to occur in the future. Nevertheless, staff raised questions about external stability implications of high and rising external debt.[3]

12. **The RBA argued that the growth in foreign liabilities was not a threat to external stability as liquidity and currency risks are contained.** In particular, borrowers are predominantly highly-rated banks, and survey evidence shows that a significant portion of this external debt is either denominated in domestic currency or hedged, while foreign currency assets exceed foreign currency liabilities. Also, Australia has a number of features that tend to make it relatively resilient to external shocks, including deep financial markets that are open and transparent attracting foreign participation. Furthermore, the RBA argued that the projected rise in net foreign liabilities over the medium term need not indicate an exchange rate misalignment as it is partly driven by high expected returns on investments, especially in the resource sector. Staff concurred with the RBA's assessment, but cautioned that debt sustainability also depended critically on the sound macroeconomic framework and sustained implementation of structural reform, which are underpinning Australia's very favorable investment climate.

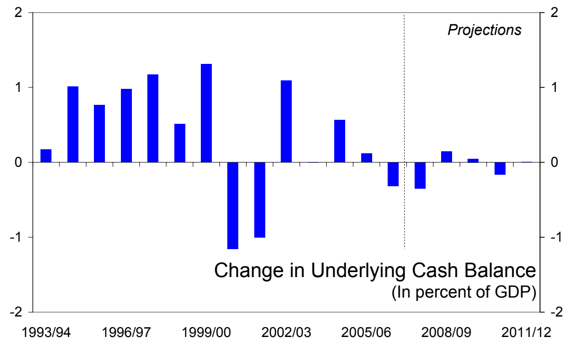
13. **The fiscal position of the Commonwealth is strong and Australia is well placed to deal with the long term fiscal challenges.** The Commonwealth government has recorded surpluses in 9 of the last 10 years, and net government debt was eliminated in 2006. Like in most OECD countries the major long-term fiscal challenge relates to pressure from impending demographics. However, Australia is relatively well prepared for an aging population as it has a flat rate and means-tested public pension, an increasing share of elderly relying on occupational pensions, and has established a "Future Fund" to build up assets to pay for future pension liabilities of government workers.



Source: Australian Treasury

[3] Potential vulnerabilities stemming from Australia's current account deficit were extensively discussed in *IMF Country Report 06/373*, which concluded that the deficit appears to be sustainable although risks from the resulting debt require careful monitoring and management.

14. **The fiscal position remains strong this year.** The underlying cash surplus for 2006/07 (fiscal year ending June) is estimated at 1.3 percent of GDP, higher than budgeted, partly reflecting revenue gains from rising TOT and a solid labor market. The 2007/08 Budget targets continued surpluses, despite further personal income tax cuts and a number of new spending initiatives. The underlying surplus is projected to decline slightly to 1 percent of GDP, and to remain at that level in the medium term (Table 4 and Figure 6). The budget appears supportive of long-term objectives, as many of the new initiatives are focused on increasing labor participation and boosting productivity. This fiscal stance is also consistent with the objectives of Australia's medium-term fiscal strategy to maintain budget balance over the course of the economic cycle and to maintain budget surpluses when growth prospects are sound.



Source: Australian Treasury

15. **Although, the government's management of additional revenue resulting from the TOT boom has been prudent, the main concern in the near term is to avoid the additional stimulus to the economy.** Recent surpluses were used to repay government debt or saved through the Future Fund. Lately, as some of the TOT gains began to appear permanent, the argument for spending part of the increased revenue became more convincing. In addition, with Australia's fiscal position already very strong, running large budget surpluses has become more difficult to explain to the public. In light of this, the government has used part of the increased revenue for needed expenditures and tax cuts, thereby transferring part of the stimulus from the boost in the TOT to other parts of the economy. The staff recognized that increases in spending and/or reductions in taxes have been done in a manner consistent with the government's medium-term objective of raising potential growth, but considered it important to balance this against short-term implications for aggregate demand. Staff suggested that this year's expenditure be kept to the current budget plan, even if revenues run ahead of projections.

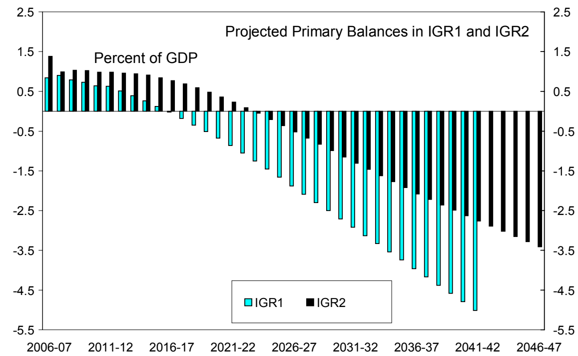
16. **Another stimulus that raises concern comes from the States.** The States are collectively forecasting a fiscal deficit of around ½ percent of GDP in 2007/08. This constitutes a reversal of the surplus position that the States have been in until 2005/06 (Table 4).[4] The States point to the need for infrastructure improvements as the main reason for the recent deterioration in their budgets. The catch up in infrastructure spending comes at a time when there is already strong competition for human and capital resources from the

[4] In aggregate, the States eliminated net debt in 2001/02 and up to 2005/06 had run fiscal surpluses in five of the previous seven years. The strong fiscal performance at the state level was partly due to the widespread adoption of medium-term fiscal policy frameworks.

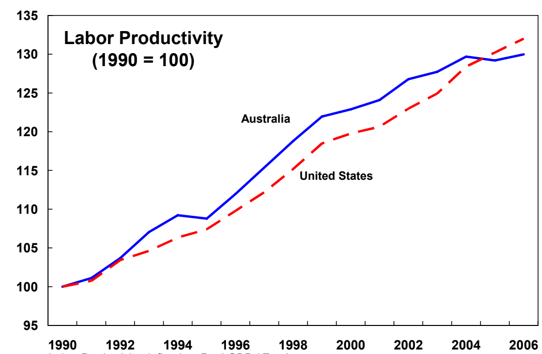
private sector. As a result, this is putting more pressure on resources and could begin to bid up prices.

B. Australia's Challenge: Making the Good Times Last

17. **Long-term fiscal sustainability has improved, reflecting reform efforts**. The second Intergenerational Report (IGR) published in April 2007 shows that the fiscal position has improved since 2002, mainly by accumulating surpluses, eliminating net debt and establishing the Future Fund to provide for unfunded liabilities. Nevertheless, the long-term financing gap is forecast to reach 3½ percent of GDP by 2047. The projected rise in healthcare cost is the predominant contributor to the gap. A range of measures have been put in place to better control spending on health, such as the Pharmaceutical Benefit scheme, but further efforts will be needed. Continued attention to the efficiency and effectiveness of spending will be key to preserving long-term fiscal sustainability.



18. **Australia has shown that comprehensive market reforms can have a large payoff in terms of macroeconomic performance.** The staff agrees with the authorities that this is the right time to push forward with the implementation of additional measures needed to spur efficiency and further enhance productivity and income growth. It is important to make progress on the National Reform Agenda (NRA), which was adopted last year as a follow-on to the earlier successful National Competition Policy reform program. The NRA aims at boosting competition in the areas of transport, energy, and infrastructure; reducing the regulatory burden imposed by the three levels of government; and improving human capital. The greater focus on human capital and competition and regulatory reform is consistent with staff research on productivity, which shows that Australia's strong productivity performance over the past 16 years was aided by the wide range of labor and product market reforms (Tables 5 and 6).



Labor Productivity defined as Real GDP / Employment
Source: World Economic Outlook 2007

19. **Maintaining the environment is important for current and future growth.** The government is reducing the greenhouse emissions signature of the Australian economy and plans to introduce a new emissions trading system. Given the increasing scarcity of water, the authorities are appropriately investing funds in a comprehensive plan to increase water use efficiency and address overallocation of water entitlements to provide greater water security for communities, industry, and the environment.

20. **Sustained growth requires a sound financial system.** Australia's financial system is healthy, profitable, and well placed to cope with shocks. Supervisory authorities are alert to potential vulnerabilities, including heavy reliance on international capital and wholesale markets for funding, cross-border vulnerabilities with the banking system in New Zealand, and large exposure of banks and other lenders to households. With household debt and debt servicing approaching 160 and 12 percent of disposable income and house prices picking up again, household finances need to be closely monitored (Table 7).[5] So far, however, the incidence of defaults on mortgage loans remains low. The sub-prime loan market in Australia is very small, and is dominated by specialized non-bank institutions. Nevertheless, given the experience of other countries, the Australian Prudential Regulation Authority (APRA) is appropriately maintaining supervisory efforts to ensure banks' awareness of the risks arising from "low doc" and high loan-to-value ratio loans.

21. **Prudential supervision by the APRA and market conduct supervision by the Australian Securities and Investments Commission are well established.** Supervisory authorities have endorsed the key recommendations of the Financial Sector Assessment Program (FSAP) (Table 8). It is especially encouraging that the authorities are working on formalizing the framework for failure resolution and crisis management despite the favorable financial environment. The proposed Financial Claims Compensation Scheme is a useful element of this framework.

III. Staff Appraisal

22. **The strong recent performance of the Australian economy is likely to continue with short-term risks tilted on the upside**. Staff project that growth will accelerate above 4 percent in 2007 and that core inflation will stay around 2½ percent, well within the target band. The main risk is the possibility that growth could surprise further on the upside, owing to the recovery of rural income with the easing of the drought and a pickup in resource export volumes.

23. **The RBA has ably balanced growth and inflation risks, including by keeping rates on hold since November.** The staff support this "wait-and-see" policy, as recent data suggest there is little urgency to raise interest rates, and welcome the RBA stance that the political calendar will not have any bearing on the bank's decision to move interest rates.

24. **Fiscal policy is appropriately focused on medium- and long-term objectives.** Australia's fiscal position is strong and the 2007/08 budget targets continued surpluses, even with further personal income tax cuts and a number of spending initiatives. The main concern is fittingly dealing with possible additional revenues stemming from further terms of trade

[5] Stress tests performed during the FSAP indicated that banks are highly resilient to changes in interest rates.

gains. Given the current economic situation and prospects staff urge the government to continue exercising fiscal restraint.

25. **The market-oriented exchange rate policy is appropriate.** While the Australian dollar has appreciated substantially over the past few years, the exchange rate does not appear to be misaligned once the recent surge in the terms of trade is taken into account. The currency appreciation has played a valuable role in easing inflation pressures directly through lower import prices, and indirectly by switching expenditure to imports when capacity utilization was high.

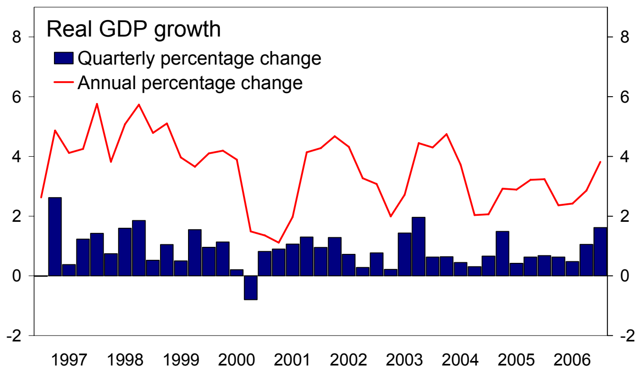
26. **The authorities are pushing forward with the implementation of additional measures needed to spur efficiency to enhance productivity and income growth, thus preparing Australia to face the challenges of population aging.** The National Reform Agenda, which was adopted last year, aims at boosting competition in the areas of transport, energy, and infrastructure; reducing the regulatory burden imposed by the three levels of government; and improving human capital.

27. **The financial sector is well positioned to cope with shocks and support sustained growth.** Australian banks are well capitalized, and asset quality remains high by any standards. At the same time there are a number of potential risks, including heavy exposure of banks to highly indebted households, which warrant close monitoring of household finances. Staff welcome the proposed Financial Claims Compensation Scheme as a useful element of the failure resolution framework.

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

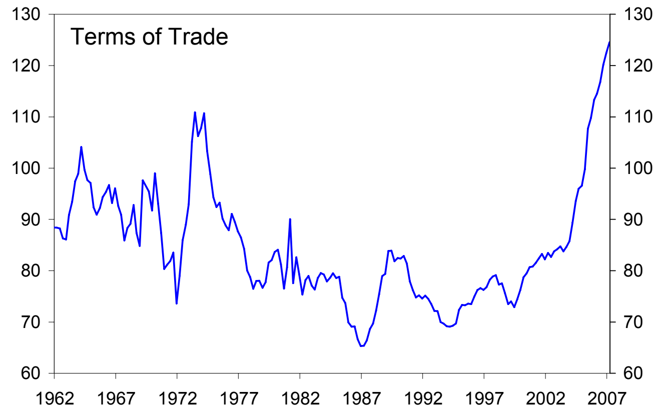
Figure 1. Australia: Real Economic Indicators

Australia has experienced more than 15 years of growth.



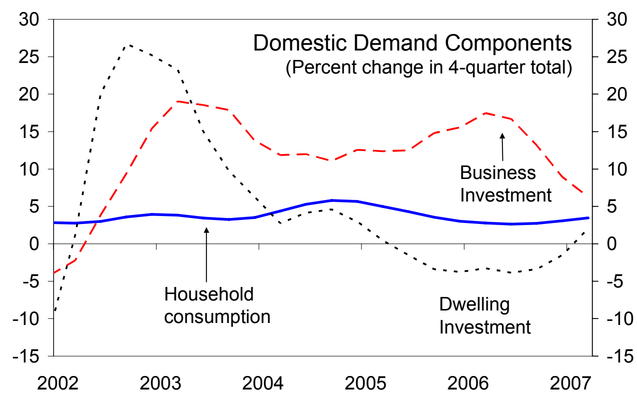
Source: Australian Bureau of Statistics.

The commodity boom is a driving force of economic activity with terms of trade rising to 50-year highs.



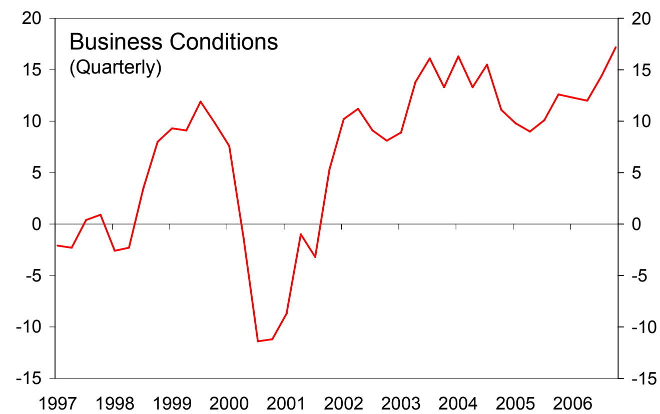
Source: Australian Bureau of Statistics.

Business investment appears to have peaked after several years of exceptional growth.



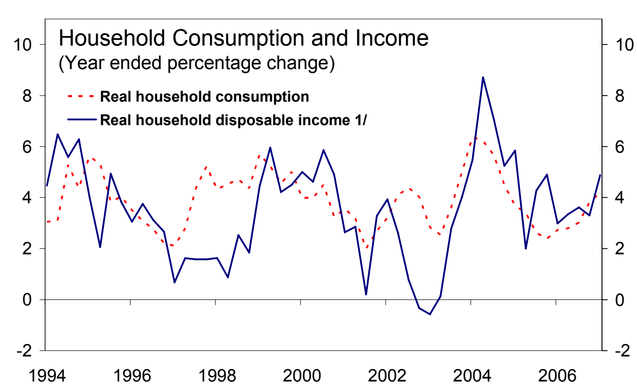
Source: Australian Bureau of Statistics.

Favorable business conditions should support continued growth.



Source: National Australian Bank.

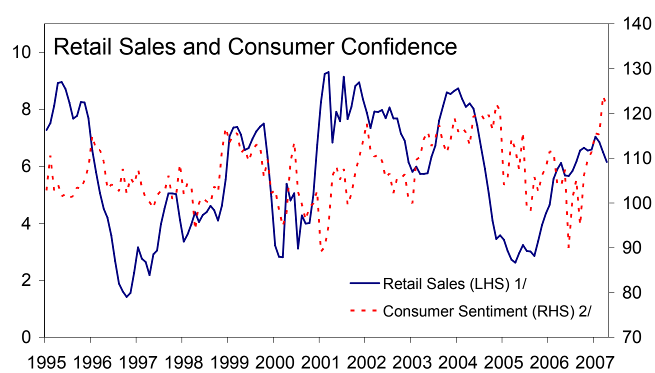
Household consumption has picked up again...



1/ Using consumption deflator.

Source: Australian Bureau of Statistics.

... and consumer confidence is strong with retail sales growing.

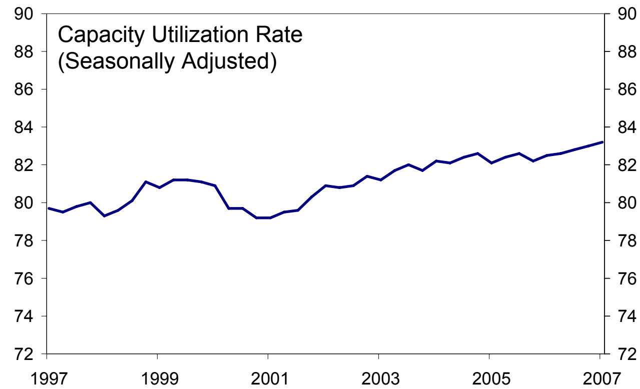


1/ Year on year percentage change of three month moving average.
2/ Index Number.

Source: Australian Bureau of Statistics.

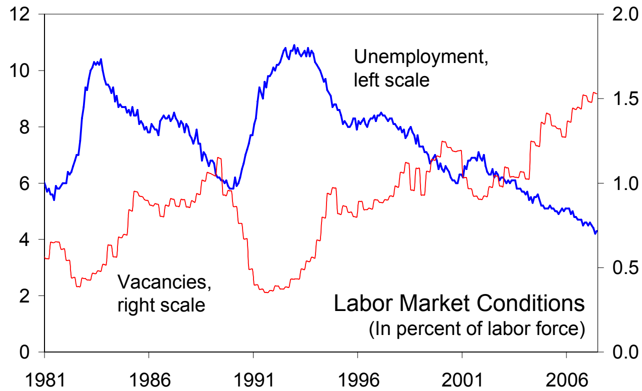
Figure 2. Australia: Inflation and Labor Market Indicators

The Australian economy is bumping up against capacity contraints.



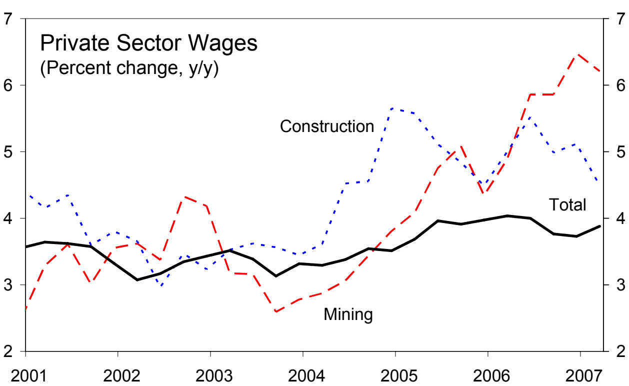
Source: National Australia Bank

Labor market conditions are tight...



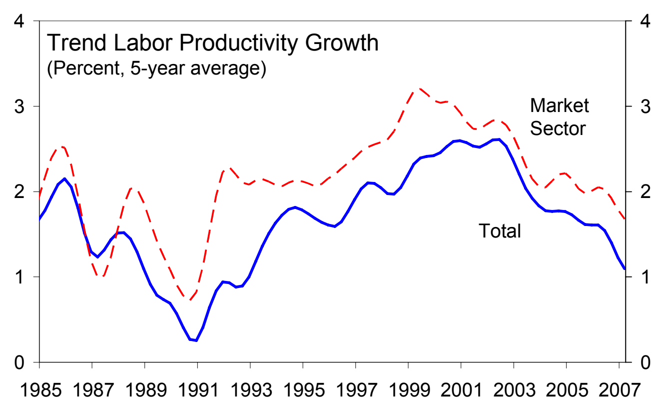
Source: Australian Bureau of Statistics

...however overall wage movements have been reasonably restrained.



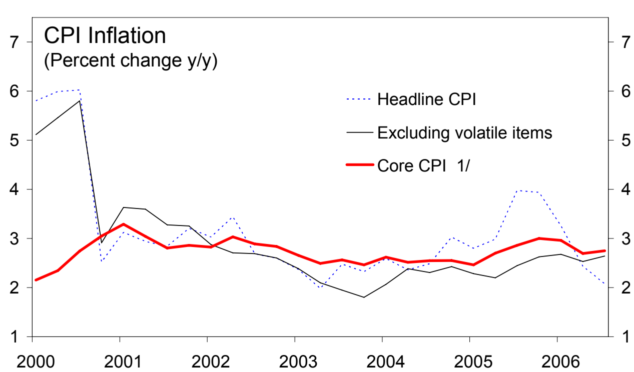
Source: Australian Bureau of Statistics

Productivity growth has lost ground.



Source: Australian Bureau of Statistics

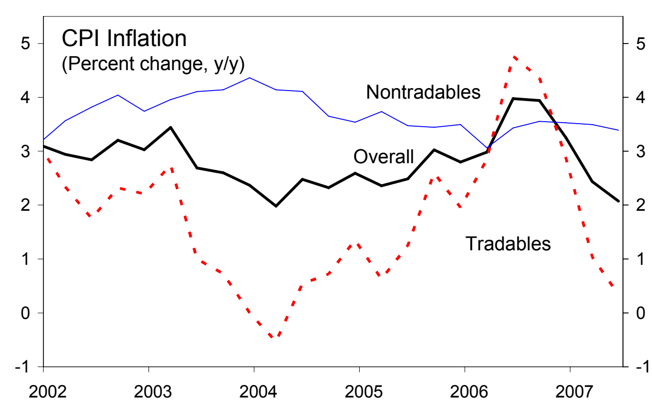
Despite high levels of capacity utilization, headline inflation has fallen...



Sources: Australian Bureau of Statistics and Reserve Bank of Australia

1/ Average of weighted median and trimmed mean inflation calculated by RBA.

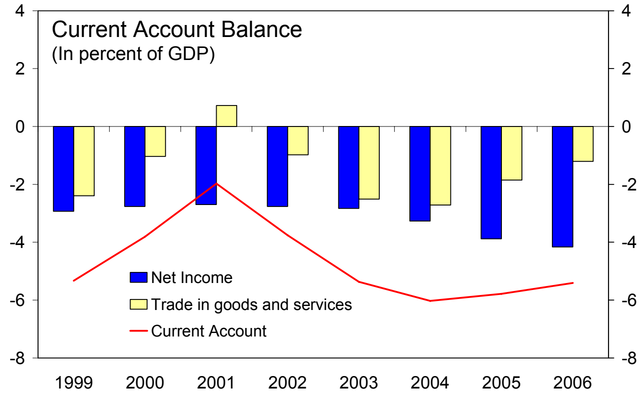
... with tradable prices leading the decline driven by lower oil prices and one-off food price effects.



Source: Australian Bureau of Statistics

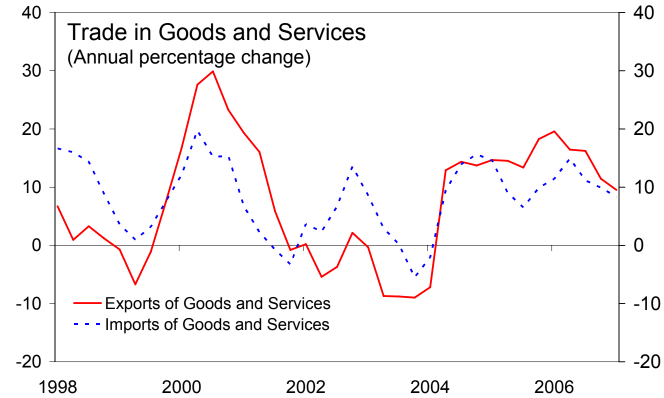
Figure 3. Australia: External Developments

The current account deficit is being driven by net investment income.



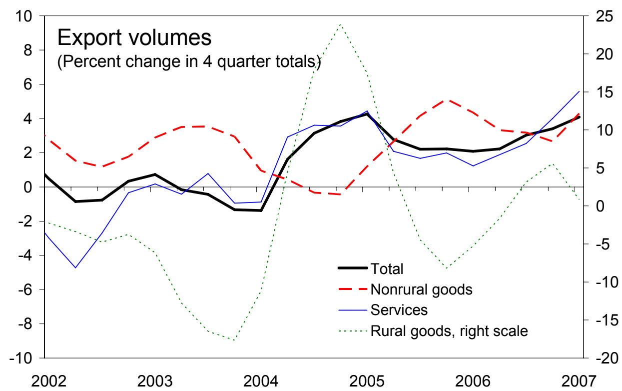
Source: ABS Times Series database and IMF staff estimates.

Export growth has been held back by the slow expansion of mining supply capacity and by the drought.



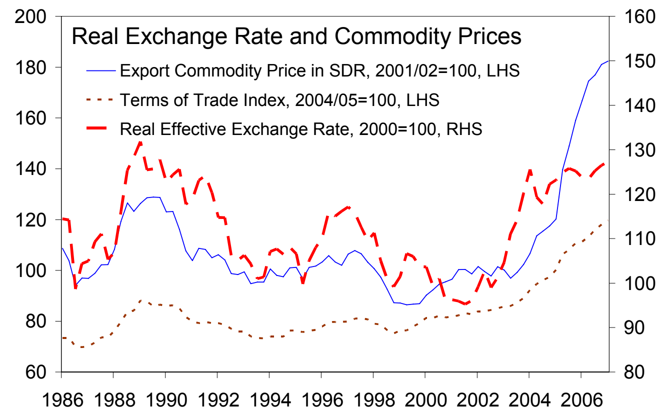
Source: ABS Time Series Database and fund staff calculations

Manufacturing and service exports are growing at a firm pace, while rural exports have been weighed down by the drought.



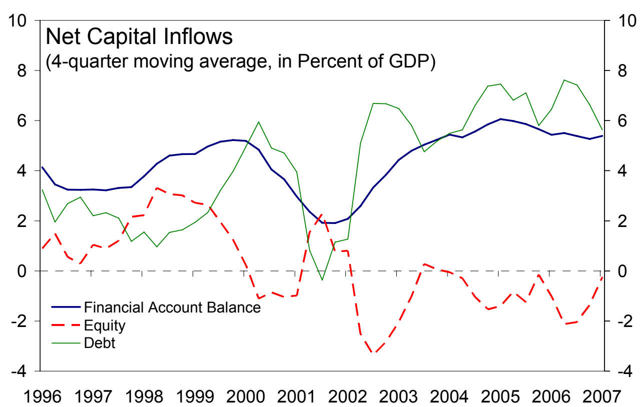
Source: Australian Bureau of Statistics

Commodity prices are booming, the terms of trade are up, and the real exchange rate has appreciated.



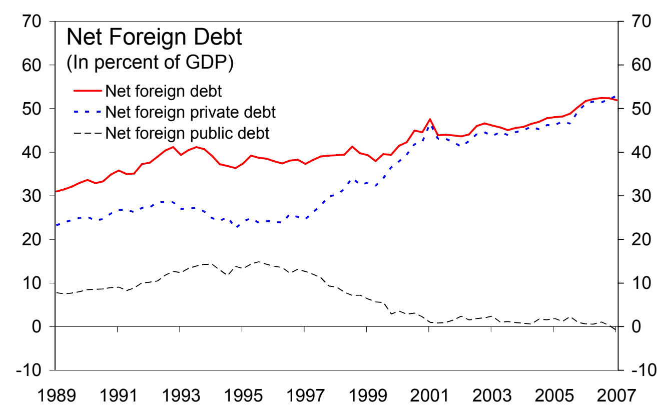
Sources: Reserve Bank of Australia and Information Notice System

Capital inflows into Australia remain strong.



Source: Australian Bureau of Statistics.

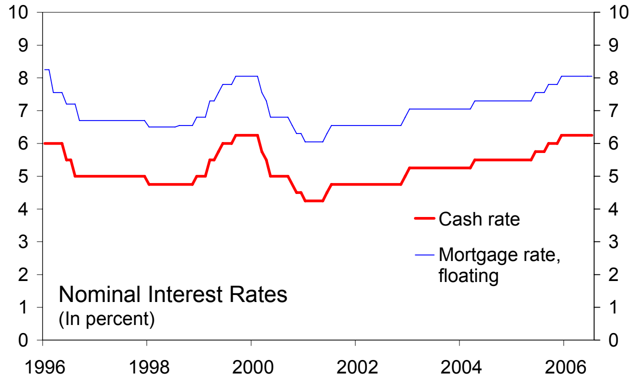
Net foreign debt has increased, all on the account of the private sector.



Source: ABS Times Series Database

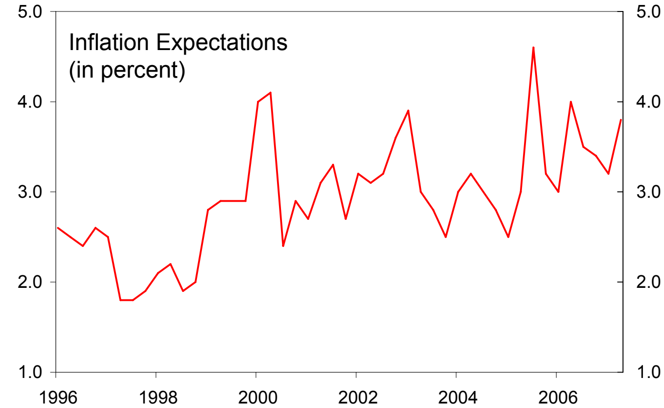
Figure 4. Australia: Financial Market Indicators

RBA raised rates 3 times in 2006 and mortgage rates adjusted accordingly.



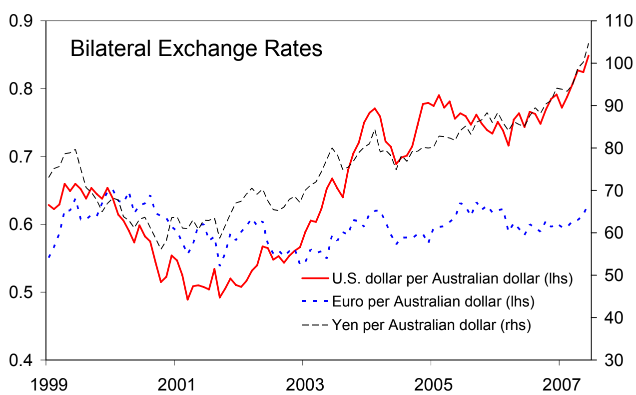
Source: Reserve Bank of Australia

Inflation expectations moderated in late 2006 but have begun to pick up.



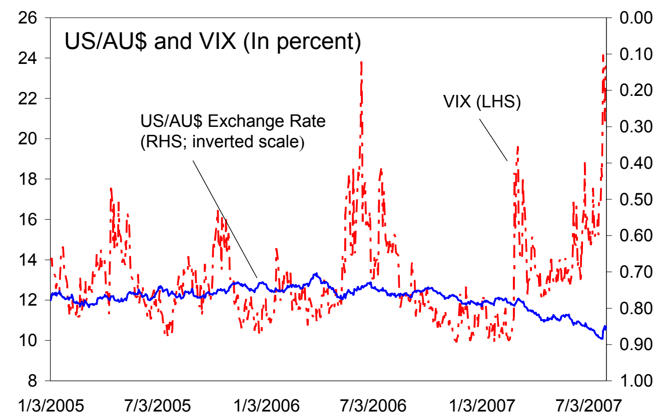
Source: Reserve Bank of Australia and Melbourne Institute.

The Australian dollar has appreciated against the U.S. dollar and the Japanese yen and held steady against the euro.



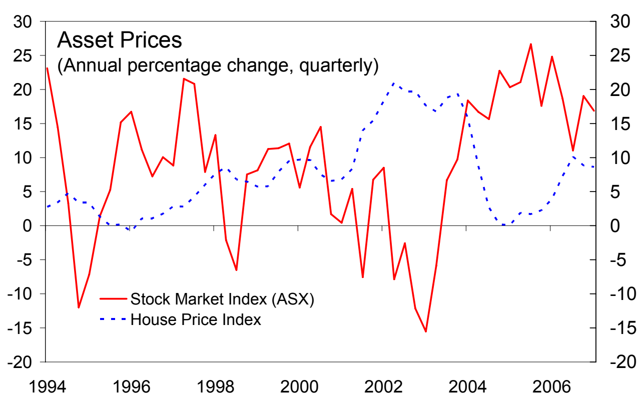
Source: Reserve Bank of Australia

High relative yields and low volatility have played a role in the AUD strength



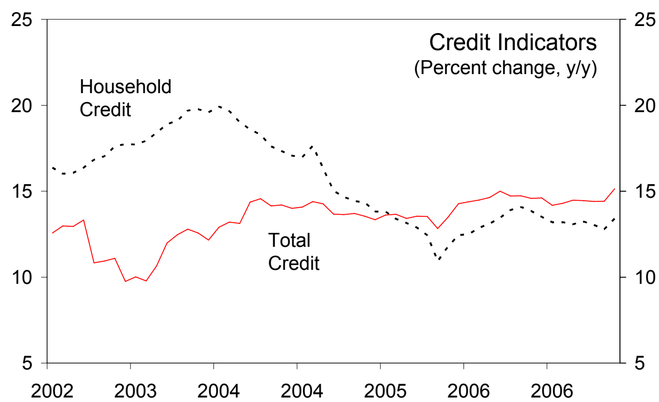
Source: Bloomberg and Fund staff estimates.

Stock and house prices have been strong.



Source: HAVER analytics

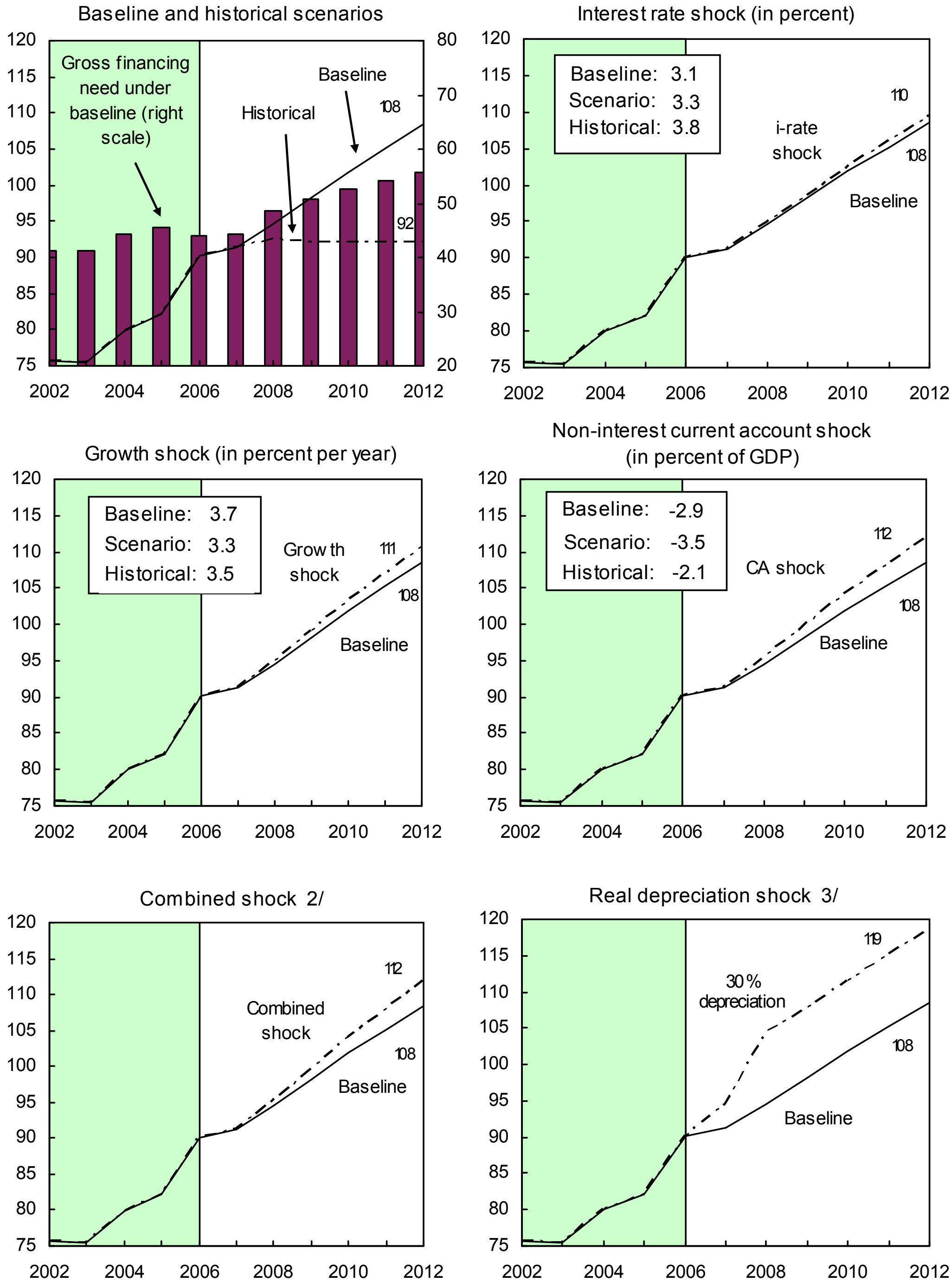
Credit growth has picked up modestly from an already high level.



Source: Reserve Bank of Australia and fund staff calculations.

Figure 5. Australia: External Debt Sustainability: Bound Tests [1/]

(Gross external debt in percent of GDP)

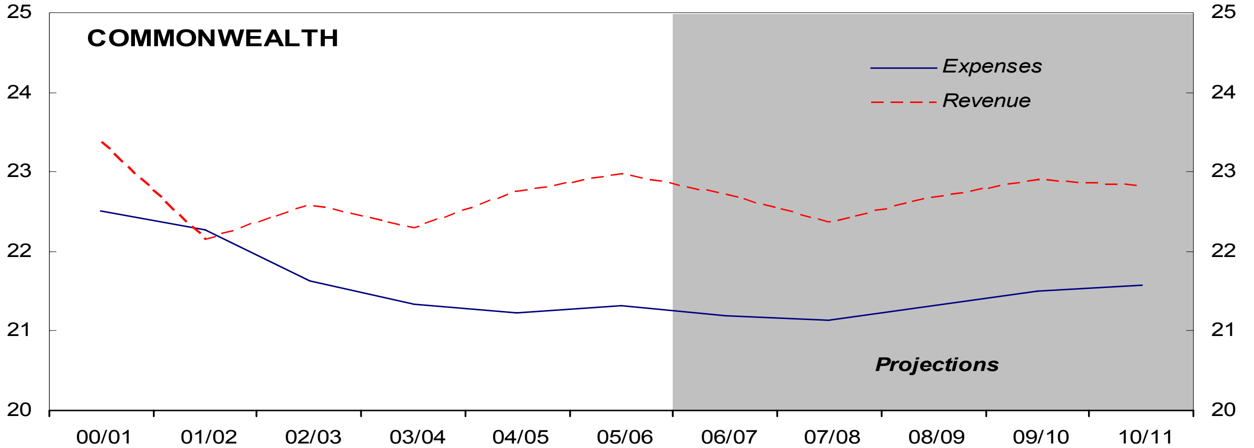


Sources: International Monetary Fund, Country desk data, and staff estimates.

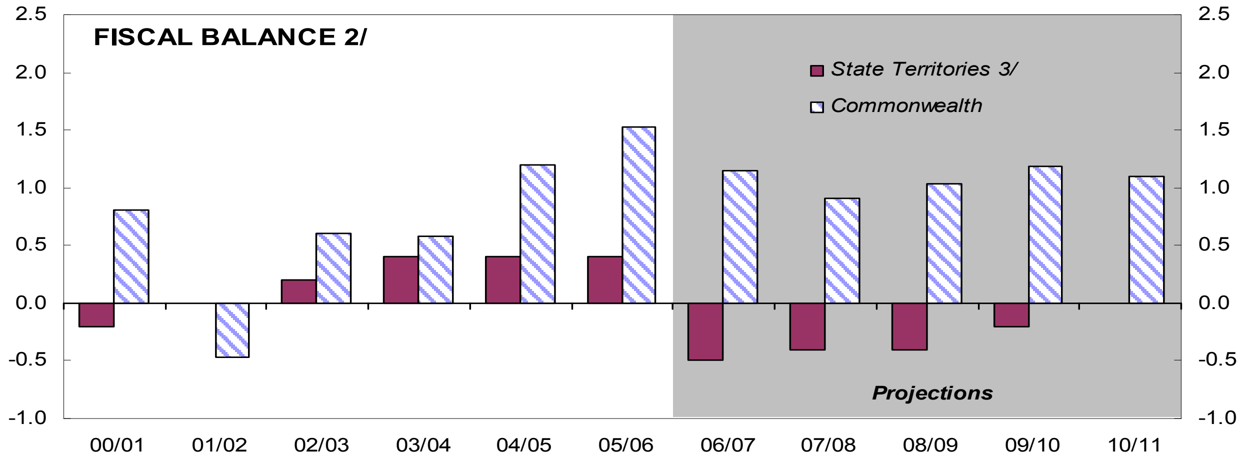
1/ Shaded areas represent actual data. Individual shocks are permanent one-half standard deviation shocks. Figures in the boxes represent average projections for the respective variables in the baseline and scenario being presented. Ten-year historical average for the variable is also shown.
2/ Permanent 1/4 standard deviation shocks applied to real interest rate, growth rate, and current account balance.
3/ One-time real depreciation of 30 percent occurs in 2007. This scenario assumes foreign exchange hedging covers 79 percent of foreign currency debt, consistent with the findings of a survey by the Australian Bureau of Statistics, as reported in "Australia's Foreign Currency Exposure and Hedging Practices," RBA Bulletin, December 2005.

Figure 6. Australia: Fiscal Indicators 1/
(In percent of GDP)

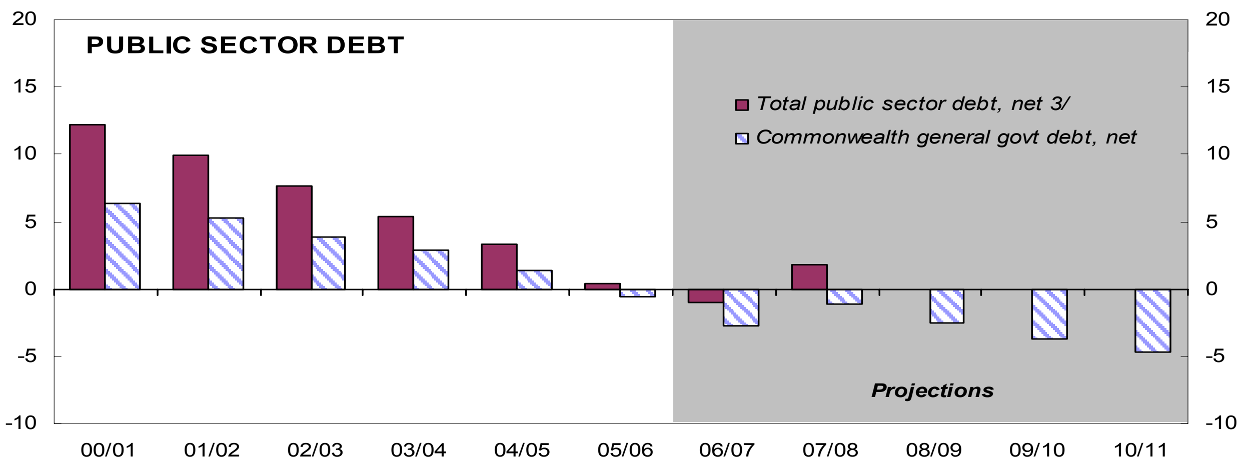
Fiscal position remains strong, reflecting in part strong revenue growth resulting from rising terms of trade in recent years.



Fiscal balance declines slightly in 2006/07 and 2007/08, but remains around 1 percent of GDP in the medium term.



Aided by fiscal surpluses, net debt of the Commonwealth government was eliminated in 2006.



Source: Australian budget for 2006/07.

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 and total public sector debt are available to 2009/10 and 2007/08; respectively.

Table 1. Australia: Selected Economic Indicators, 2003–08

Nominal GDP (2006): $A 1,003 billion (US$ 756 billion) — Quota (in millions): SDR 3,236
GDP per capita (2006): US$ 35,583 — Population (September 2006): 20.6 million

	2003	2004	2005	2006	2007 Proj.	2008 Proj.
Output and demand (percent change)						
Real GDP	3.1	3.7	2.8	2.7	4.4	4.0
Total domestic demand	5.7	5.6	4.3	3.5	5.1	3.2
Private consumption	3.6	5.7	3.0	3.1	4.5	3.8
Total investment	9.1	7.6	7.7	6.5	5.7	3.3
Business	13.8	12.6	15.6	8.9	9.5	3.5
Dwelling	6.3	3.0	-3.8	-1.5	6.2	3.0
Exports of goods and services	-1.2	4.3	2.3	3.4	6.1	9.0
Imports of goods and services	11.1	15.0	8.9	7.6	9.5	4.5
Inflation and unemployment (in percent)						
CPI inflation	2.8	2.3	2.7	3.5	2.1	2.8
Unemployment rate	5.9	5.4	5.1	4.8	4.5	4.5
Saving and investment (in percent of GDP)						
Gross national saving	20.6	20.1	20.8	20.6	21.7	21.0
General government saving	4.0	3.4	3.8	3.9	2.7	2.8
Private saving 1/	16.6	16.6	16.9	16.8	19.0	18.2
Gross capital formation	25.9	26.0	26.7	26.6	27.2	26.6
Fiscal indicators (in percent of GDP) 2/						
Receipts 3/	22.6	22.3	22.7	23.0	22.7	22.4
Payments 3/	21.6	21.3	21.2	21.3	21.2	21.1
Underlying balance 3/	1.0	1.0	1.5	1.6	1.3	1.0
Net debt	3.9	2.8	1.4	-0.6	-2.8	-1.1
Money and credit (end of period)						
Interest rate (90-day bill, in percent) 4/	5.5	5.4	5.6	6.4	6.4	…
Treasury bond yield (10-year, in percent) 4/	5.6	5.3	5.2	5.9	6.3	…
M3 (percent change) 4/	11.7	9.0	8.2	13.1	16.1	…
Private domestic credit (percent change) 4/	12.5	14.1	13.5	14.2	14.5	…
Balance of payments (in percent of GDP)						
Current account	-5.4	-6.0	-5.8	-5.5	-5.6	-5.6
of which: Trade balance	-2.9	-2.8	-1.9	-1.3	-1.5	-1.6
Foreign direct investment, net	-1.6	3.9	-0.3	0.2	-0.4	0.0
Terms of trade (percent change)	3.2	9.3	11.7	7.8	3.5	-3.7
External assets and liabilities (in percent of GDP)						
Net external liabilities	53.5	55.4	56.9	60.3	61.6	63.8
Net external debt	45.5	47.7	50.3	52.4	52.6	54.5
Gross official reserves 4/	5.5	5.5	6.3	6.9	7.8	...
Exchange rate (period average)						
US$/$A 4/	0.65	0.74	0.76	0.75	0.82	…
Trade-weighted index 4/	57.8	62.3	63.9	63.0	66.6	…
Real effective exchange rate 5/	112.6	121.2	124.8	124.7	128.9	…

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/ Excludes asset sales and other one-off factors; cash basis.
4/ Data for 2007 are for latest available month.
5/ IMF, Information Notice System index (1990 = 100). Data for 2007 are for latest available month.

Table 2. Australia: Balance of Payments, 2003-2008

(In percent of GDP)

	2003	2004	2005	2006	Proj. 2007	Proj. 2008
Current account balance	-5.4	-6.0	-5.8	-5.5	-5.6	-5.6
Goods balance	-2.9	-2.8	-1.9	-1.3	-1.5	-1.6
Exports	13.4	13.6	15.0	16.5	15.3	14.7
Imports	-16.3	-16.4	-16.9	-17.8	-16.8	-16.3
Net services	0.3	0.1	0.1	0.1	0.3	0.6
Total credits	4.5	4.4	4.4	4.4	4.3	4.5
Total debits	-4.2	-4.4	-4.3	-4.3	-4.0	-3.9
Net income	-2.8	-3.3	-3.9	-4.2	-4.4	-4.6
o/w Net interest payments	-1.4	-1.6	-1.7	-2.2	-2.3	-2.2
o/w Net equity income	-1.3	-1.5	-2.1	-1.9	-2.1	-2.4
Net transfers	0.0	0.0	-0.1	0.0	0.0	0.0
Capital and financial account	5.4	6.0	5.8	5.5	5.6	5.6
Capital account	0.1	0.1	0.1	0.2	0.2	0.2
Financial account	5.3	5.9	5.6	5.3	5.4	5.4
Direct investment transactions: net	-1.6	3.9	-0.3	0.2	-0.4	0.0
Equity (net)	-2.0	3.6	-1.0	-0.5	-0.7	-0.5
Debt (net)	0.4	0.4	0.7	0.7	0.3	0.5
Portfolio investment transactions: net	7.5	2.4	5.3	7.0	4.6	3.2
Equity (net)	1.6	-5.6	-0.1	-1.3	-0.1	-0.7
Debt (net)	5.9	8.0	5.4	8.3	4.6	3.9
Financial derivatives (net)	-0.1	0.1	0.0	0.3	0.0	0.2
Other transactions (net)	-0.6	-0.6	0.6	-2.3	1.3	2.1
Net errors and omissions	0.0	0.1	0.0	0.0	0.0	0.0
(Assets and liabilities at end-period)						
Net external liabilities	53.5	55.4	56.9	60.3	61.6	63.8
Net external equity liabilities	8.0	7.6	6.5	8.0	…	…
Foreign equity investment in Australia	50.0	54.6	50.5	56.0	…	…
Australian equity investment abroad	-42.0	-47.0	-44.0	-48.1	…	…
Net external debt	45.5	47.7	50.3	52.4	52.6	54.5
Net public sector	0.9	1.6	1.0	0.2	…	…
Net private sector	44.6	46.2	49.3	52.1	…	…
Gross external debt	75.5	79.9	82.3	90.4	…	…
of which: $A denominated	26.5	28.5	30.1	33.6	…	…
Gross external lending	-29.9	-32.2	-32.0	-38.0	…	…
Short-term net external debt (residual maturity basis)	17.8	17.8	19.3	19.3	…	…
Short-term gross external debt	35.9	37.0	37.1	40.3	…	…
Short-term gross external lending	-18.1	-19.1	-17.8	-20.9	…	…
Memorandum items:						
Gross official reserves (in $A billion)	44.3	47.4	59.0	69.6	…	…
RBA outstanding forward contracts (in $A billion)	26.4	22.4	30.4	38.9	…	…
Net official reserves (in $A billion)	17.9	25.0	28.6	30.7	…	…
Gross reserves in months of imports	2.9	2.9	3.2	3.7	…	…
Gross reserves to ST FX denominated debt (percent)	21.9	21.5	24.7	23.9	…	…
Net interest payments to exports (percent)	7.9	9.1	8.9	10.4	11.5	11.5

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

Table 3. Australia: Medium-Term Scenario 2006–12

	Average 1996-2005	2006	Projections 2007	2008	2009	2010	2011	2012
Real economic indicators (percent change)								
GDP	3.7	2.7	4.4	4.0	3.4	3.3	3.2	3.2
Total domestic demand	4.5	3.5	5.1	3.2	3.0	2.9	2.8	2.8
Private consumption	3.9	3.1	4.5	3.8	3.5	3.0	2.7	2.7
Total investment	6.6	6.5	5.7	3.3	3.0	2.8	2.8	2.9
Business	9.4	8.9	9.5	3.5	3.0	2.7	2.7	2.8
Dwelling	4.5	-1.5	6.2	3.0	2.8	2.8	2.8	2.8
CPI inflation	2.5	3.5	2.1	2.8	2.8	2.8	2.8	2.8
Unemployment rate	6.7	4.8	4.5	4.5	4.5	4.5	4.5	4.5
Saving and investment (percent of GDP)								
Gross national saving	20.0	20.6	21.7	21.0	20.4	19.9	19.7	19.3
General government saving	3.2	3.9	2.7	2.8	2.9	2.8	2.7	2.6
Private saving 1/	16.9	16.8	19.0	18.2	17.5	17.1	17.0	16.6
o/w Household	6.4	5.3	5.4	5.5	5.3	5.4	5.6	5.7
Gross capital formation	24.4	26.6	27.2	26.6	26.0	25.7	25.4	25.1
o/w Private fixed investment	20.5	22.5	23.0	22.7	22.5	22.2	21.9	21.7
Commonwealth Budget (percent of GDP) 2/								
Receipts	23.4	23.0	22.7	22.4	22.7	22.9	22.8	22.8
Payments	22.9	21.3	21.2	21.1	21.3	21.5	21.6	21.6
Underlying balance (cash basis) 3/	0.4	1.6	1.3	1.0	1.1	1.2	1.0	1.0
Fiscal balance (accrual basis)	0.5	1.5	1.2	0.9	1.0	1.2	1.1	1.1
Net debt 4/	9.0	-0.6	-2.8	-1.1	-2.5	-3.7	-4.7	-5.7
Balance of payments (percent of GDP)								
Balance on goods and services	-1.2	-1.2	-1.1	-1.0	-1.2	-1.4	-1.4	-1.4
Balance on income and transfers	-3.1	-4.3	-4.4	-4.6	-4.4	-4.5	-4.3	-4.4
Current account balance	-4.3	-5.5	-5.6	-5.6	-5.6	-5.8	-5.7	-5.8
Trade in goods and services (percent change)								
Export volume	4.5	3.4	6.1	9.0	6.8	6.1	6.1	6.1
Import volume	8.2	7.6	9.5	4.5	4.3	4.1	3.9	4.0
Terms of trade	3.5	7.8	3.5	-3.7	-3.5	-2.7	-2.4	-2.2
Export price	2.4	12.0	-3.7	-5.2	-3.6	-2.7	-2.7	-2.7
Import price	-0.9	4.0	-7.0	-1.6	-0.1	-0.1	-0.3	-0.4
External liabilities								
Net external liabilities (percent of GDP)	53.0	60.3	61.6	63.8	66.3	68.7	71.0	73.2
Net external interest (percent of exports	9.4	10.4	11.5	11.5	11.2	11.8	12.5	13.2

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/ Underlying cash balance equals receipts less payments, and excludes Future Fund earnings.

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

Table 4. Australia: Fiscal Accounts, 2003/04–2010/11 1/

(In percent of GDP)

				Est.	Projections 2/			
	2003/04	2004/05	2005/06	2006/07	2007/08	2008/09	2009/10	2010/11
Fiscal accounts on an accrual basis 3/								
Commonwealth government								
Revenue	22.4	23.0	23.0	22.8	22.5	22.8	23.1	22.9
Tax	20.9	21.7	21.4	21.3	21.1	21.3	21.5	21.3
Income tax	17.3	18.2	18.2	18.3	18.1	18.4	18.7	18.6
Individuals and other withholdings	11.8	12.1	11.8	11.4	10.9	11.0	11.3	11.5
Indirect and other tax	3.6	3.5	3.2	3.1	3.0	2.9	2.8	2.7
Non-tax	1.4	1.4	1.6	1.5	1.4	1.5	1.5	1.6
Expenses	21.7	21.8	21.3	21.5	21.5	21.6	21.8	21.8
Salaries and wages	1.3	1.3	1.3	1.3	1.3	1.3	1.3	1.2
Goods and services	4.6	5.1	5.0	4.9	5.1	5.1	5.2	5.2
Current transfers	13.4	13.1	12.8	12.9	12.7	12.9	13.1	13.1
Other expenses	2.3	2.3	2.2	2.2	2.3	2.3	2.3	2.2
Net capital investment	0.1	0.0	0.1	0.2	0.1	0.1	0.1	0.1
Fiscal Balance 4/	0.6	1.2	1.5	1.2	0.9	1.0	1.2	1.1
State, Territory, and Local government balance 5/	0.4	0.4	0.4	-0.5	-0.4	-0.4	-0.2	…
						…	…	…
Public Non-financial Corporations balance 6/	0.0	-0.3	-1.0	-1.1	-1.1	…	…	…
						…	…	…
Non-Financial Public Sector balance 6/	1.1	1.3	1.0	-0.4	-0.5	…	…	…
Fiscal accounts on a cash basis								
Commonwealth government								
Receipts	22.3	22.7	23.0	22.7	22.4	22.7	22.9	22.8
Payments	21.3	21.2	21.3	21.2	21.1	21.3	21.5	21.6
Future Fund earnings	…	…	0.0	0.2	0.3	0.2	0.2	0.2
Underlying cash balance 7/	1.0	1.5	1.6	1.3	1.0	1.1	1.2	1.0
Memorandum items:								
Commonwealth government net debt	2.8	1.4	-0.6	-2.8	-1.1	-2.5	-3.7	-4.7
Commonwealth government net worth 8/	-4.7	-3.4	-2.4	-1.1	-0.1	1.2	2.4	3.5

Sources: Commonwealth of Australia: *Budget Strategy and Outlook, 2007-08.*

1/ Fiscal year ends June 30.

2/ Projections as presented in the *Budget Strategy and Outlook, 2007-08.*

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 2006/07 balance includes a A$ 5.6 billion deposit by the New South Wales government into their Liability Management Fund to meet future superannuation contributions. Excluding this transaction, the aggregate state/local cash deficit for 2006/07 is 0.1 percent.

6/ The consolidated commonwealth, state and local governments.

7/ Underlying cash balance equals receipts less payments, and excludes earnings of the Future Fund.

8/ Includes financial and non-financial assets and liabilities, including unfunded superannuation liabilities to public employees.

Table 5. Productivity Performance of Australian Industries

Multi-Factor Productivity Levels (in percent of U.S. MFP levels)				
Selected Industries	**1980**	**1990**	**2000**	**2003**
Agriculture	86.93	69.91	57.17	64.32
Mining	93.57	110.49	107.03	102.89
Total Manufacturing	89.31	72.88	52.12	48.39
Electricity, gas & water supply	89.79	117.13	135.69	123.10
Construction	75.84	71.20	88.17	113.34
Wholesale & retrail trade	71.76	69.95	71.25	72.45
Transport & Storage	163.40	103.06	89.25	85.77
Business services	109.79	100.39	86.21	92.66

Source: Thierry Tressel (2007), "Does Technological Diffusion Explain Australia's Productivity Performance?" Forthcoming IMF Working Paper.

Table 6. The Impact of Structural Reforms on Australia's Productivity Performance

Main Structural Reforms

Labor Market		**Product Market**	
1991	Introduction of enterprise bargaining agreements.	Late 1980s-1995	Infrastructure reforms: (i) deregulation in transport, telecommunications; (ii) commercialization , corporatization and privatization of state-owned firms.
1996	Coalition Government reforms introduced the possibility of individual contracts, and expanded the use of enterprise bargaining agreements.	1995-2000	National Competition Policy further reduced anti-competitive regulations, and reformed government businesses and the transport and utilities sectors.
2006	"Workchoices" further liberalized workplace agreements, created a national industrial relations system, liberalized unfair dismissal rules, and created the Fair Pay and Conditions Standard in legislation.	Mid-1980s-2000	Trade liberalization (phased reductions in tariffs across most industries).
		2007 -	National Reform Agenda: (i) reducing anti-competitive barriers (energy, transport, infrastructure); (ii) simplifying regulations; (iii) enhancing human capital.

Impact of Past Reforms on MFP [1/]

	Labor Market	**Product Market**
Average all industries	Positive, large	Positive, small
ICT-using industries [2/]	Positive, large	Positive, large
ICT-producing [3/]	Positive, not significant	No significant effect
Traditional industries [4/]	Positive, large	No significant effect

Source: Thierry Tressel (2007), "Does Technological Diffusion Explain Australia's Productivity Performance?" Forthcoming IMF Working Paper.

1/ The impact of structural reforms on MFP is estimated in a panel of OECD countries over the period 1980-2003.

2/ Industries that use Information and Communication Technology (ICT) intensively are: paper & publishing, machinery & equipment N.E.C., manufacturing N.E.C., wholesale and retail trade, financial intermediation and business services

3/ Industries that produce ICT goods are electrical & optical equipment, and post & telecommunications

4/ Traditional industries include agriculture, mining, a subset of manufacturing industries, transport, utilities, construction, and hotels & restaurants

Table 7. Australia: Indicators of External and Financial Vulnerability, 2002–06
(In percent of GDP, unless otherwise indicated)

	2002	2003	2004	2005	2006
External indicators					
Real exports of goods (percent change)	0.5	-1.5	3.9	2.3	3.2
Real imports of goods (percent change)	13.7	12.3	14.3	9.8	8.7
Terms of trade (percent change)	2.2	3.2	9.3	11.7	7.8
Current account balance	-3.8	-5.4	-6.0	-5.8	-5.5
Capital and financial account balance	4.0	5.4	6.0	5.8	5.5
Of which:					
Net portfolio investment	0.1	7.5	2.4	5.3	7.0
Net direct investment	2.2	-1.6	3.9	-0.3	0.2
Total reserves (US$ billion)	21.6	33.3	36.9	43.3	55.1
In months of imports of goods and services	2.8	2.9	2.9	3.2	3.7
Total net reserves (US$ billion)	7.4	13.5	19.5	21.0	24.3
Net international investment position	-51.6	-53.5	-55.4	-56.9	-60.3
Of which:					
Net external public sector debt	2.0	0.9	1.6	1.0	0.2
Net external private sector debt	44.5	44.6	46.2	49.3	52.1
Net interest payments to exports (in percent)	8.3	7.9	9.1	8.9	10.4
Nominal effective exchange rate (percent change)	3.1	10.8	7.5	2.5	-1.2
Financial market indicators					
General government gross debt	14.3	12.5	11.3	10.4	9.4
Interest rates (percent end-year)					
3-month T-bill	4.8	5.5	5.4	5.6	6.4
3-month T-bill, real	1.7	2.7	3.0	2.9	2.8
3-month interest rate spread vis-à-vis US	3.2	4.5	4.0	2.4	1.6
Stock market index (ASX, percent change, end-year)	-11.4	11.1	22.6	16.2	19.9
Capital adequacy					
Regulatory capital to risk-weighted assets	9.8	10.1	10.5	10.4	10.4
Tier I capital to risk-weighted assets 1/	7.7	7.5	7.6	7.6	7.4
Asset quality					
Impaired assets to total assets	0.6	0.4	0.3	0.2	0.2
Specific provisions to impaired assets	35.3	38.9	41.4	37.0	37.4
Loans composition (share of total)					
Public sector	3.6	2.5	2.2	1.5	1.4
Individuals	59.4	62.5	62.1	62.3	60.4
Housing loans	50.8	53.9	53.6	53.8	51.9
Investor housing	15.9	18.2	18.4	18.2	17.2
Commercial lending	37.0	35.0	35.7	36.3	38.2
Financial intermediaries	7.0	6.4	7.8	7.5	8.8
Non-financial sector	30.0	28.6	27.9	28.8	29.4

Sources: Authorities data and Fund staff estimates.

1/ Tier I capital includes issued and fully paid common equity and perpetual non-cumulative preference shares, and disclosed reserves.

Table 8. Financial Sector Assessment Program: Key Recommendations and Update on the Progress of Implementation[1]

Issue	Key Recommendations	Progress of Implementation
Banking	Continue to ensure strong risk management practices, including through regular stress testing.	The Basel II framework is scheduled to be implemented in January 2008, with regular stress testing forming an important element of the framework. The four largest banks are expected to adopt the advanced approach with respect to credit risk, and supervisors have appropriately put safeguards in place to ensure that the reduction in banks' capital is phased in.
Failure Resolution and Crisis Management	Continue to develop a formal process to manage the failure of individual institutions and more widespread crises.	The proposed Financial Claims Compensation Scheme is intended to provide depositors in a failed authorized deposit-taking institution (ADI) with a timely access to at least some of their funds, and policyholders of a failed general insurer with a right to have claims met. A number of changes to the design of the scheme as originally proposed have been suggested, and the amended scheme is now under consideration by the government.
Supervisory Capacity	Ensure that the supervisory agencies have adequate resources and flexibility.	In 2007, the government allocated additional funding to support the Australian Securities and Investments Commission (ASIC), in particular to fund a better regulation initiative program, and to streamline the corporate register. The government also allocated additional funding for the development of the ASIC's information technology systems over the next four years. In addition, in the 2007/08 Budget, APRA received additional funding to assist it to retain high quality staff.
Cooperation with New Zealand Regulators	Build on the progress made within the Trans-Tasman Council on Banking Supervision to improve coordination in crisis management.	Recent legislative changes formalized a requirement on regulators in the two countries to be alert to each others' interests in times of stress. These changes came into force in both countries in December 2006. With legislation in place, the work of the Trans-Tasman Council will now focus more on the practical aspects of coordination in crisis management.
AML/CFT	Give high priority to make the appropriate legislative and operational arrangements in the AML/CFT area	The AML/CFT Act was adopted in December 2006. This first tranche of reforms covers the activities of financial service providers, gambling services and bullion dealers. Implementation is proceeding in line with the adopted 24-month schedule. Work is underway on developing legislation for the second tranche of legislative and regulatory reforms intended to capture designated non-financial businesses and professionals.

Source: IMF Staff.

[1] A detailed discussion and a full list of recommendations can be found in the Financial System Stability Assessment (*IMF Country Report No. 06/372*).

INTERNATIONAL MONETARY FUND

AUSTRALIA

Staff Report for the 2007 Article IV Consultation—Informational Annex

Prepared by the Staff Representatives for the 2007 Consultation with Australia

(In Consultation with Other Departments)

August 2, 2007

Contents Page

ANNEX I. AUSTRALIA—FUND RELATIONS
(As of June 30, 2007)

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

II. **General Resources Account**:	**SDR Million**	**Percent Quota**
Quota	3,236.40	100.0
Fund holdings of currency	2,990.75	92.41
Reserve position in Fund	246.03	7.60

III. **SDR Department**:	**SDR Million**	**Percent Allocation**
Net cumulative allocation	470.55	100.00
Holdings	127.70	27.14

IV. Outstanding Purchases and Loans: None

V. Financial Arrangements: None

VI. Projected Obligations to Fund: None

VII. Exchange Rate Arrangement. Australia has accepted the obligations of Article VIII, Sections 2, 3 and 4 of the Articles of Agreement, and maintains an exchange system that is free from restrictions on the making of payments and transfers for current international transactions, except for exchange restrictions that are maintained solely for the preservation of national or international security and which have been notified to the Fund pursuant to Executive Board Decision No. 144-(52/51). The exchange rate is independently floating, but the Reserve Bank of Australia retains discretionary power to intervene**.** There are no taxes or subsidies on purchases or sales of foreign exchange.

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. Article IV Consultation. Australia is on the 12–month consultation cycle. The 2006 Article IV consultation discussions were held during June 1-9, 2006, the Executive Board discussed the staff report (IMF Country Report No. 06/374) and concluded the consultation on October 11, 2006.

X. FSAP Participation. The FSAP missions took place during November 30-December 14, 2005, and March 26-April 12, 2006. The FSSA (including financial sector ROSCs), the Detailed Assessment of Observance of Standards and Codes, and the Technical Note on Investor Protection, Disclosure, and Financial Literacy, were published as Country Reports No. 06/372, No. 06/415, and No. 06/437, respectively.

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

ANNEX II. AUSTRALIA: STATISTICAL ISSUES

Australia publishes a wide array of economic and financial data, which are considered adequate for surveillance purposes. Australia subscribed to the Special Data Dissemination Standard (SDDS) and its metadata are posted on the Fund's Dissemination Standards Bulletin Board (DSBB). In recent years, the Australian Bureau of Statistics has taken several initiatives to further improve the quality of the data, such as including the prices of financial services in the CPI and developing new measures of labor underutilization.

In September 2006, STA met with officials from the Australian Bureau of Statistics, the Australian Prudential Regulation Authority, and the Reserve Bank of Australia to encourage the reporting of monetary data using the standardized report forms (SRFs) introduced in October 2004. The SRFs provide for accounting data to be broken down by instrument, sector, and currency.

Table of Common Indicators Required for Surveillance
(As of July 23, 2007)

	Date of Latest Observation	Date Received	Frequency of Data[6]	Frequency of Reporting[6]	Frequency of Publication[6]
Exchange Rates	07/23/07	07/23/07	D	D	D
International Reserve Assets and Reserve Liabilities of the Monetary Authorities[1]	05/07	06/29/07	M	M	M
Reserve/Base Money	06/07	07/14/07	M	M	M
Broad Money	05/07	06/29/07	M	M	M
Central Bank Balance Sheet	06/07	07/16/07	M	M	M
Consolidated Balance Sheet of the Banking System	05/07	07/18/07	M	M	M
Interest Rates[2]	07/23/07	07/23/07	D	D	D
Consumer Price Index	Q1 2007	04/24/07	Q	Q	Q
Revenue, Expenditure, Balance and Composition of Financing[3] – General Government[4]	2005/06	10/06	A	A	A
Revenue, Expenditure, Balance and Composition of Financing[3]– Central Government	04/07	06/19/07	M	M	M
Stocks of Central Government and Central Government-Guaranteed Debt[5]	04/07	06/19/07	M	M	M
External Current Account Balance	Q1 2007	06/05/07	Q	Q	Q
Exports and Imports of Goods and Services	05/07	07/04/07	M	M	M
GDP/GNP	Q1 2007	06/06/07	Q	Q	Q
Gross External Debt	Q1 2007	06/05/07	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

AUSTRALIA

Staff Report for the 2007 Article IV Consultation
Supplementary Information

Prepared by Asia and Pacific Department

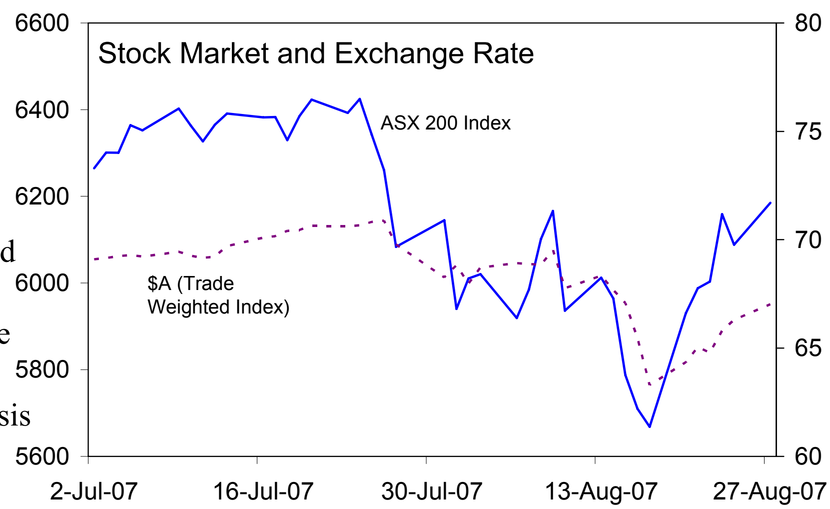
Approved by Masahiko Takeda and Carlo Cottarelli

August 29, 2007

1. This supplement to the staff report summarizes the main developments since the staff report was issued on August 2, 2007.

Credit market turmoil

2. **The turbulence in the credit markets has triggered large declines in Australian asset markets; however, asset prices have begun to show signs of recovery.** The re-pricing of risk in the global market has encouraged investors to reverse their carry trade bets, triggering a decline in the Australian dollar from the peak reached in late July. At the same time, the stock market index fell, and the short-term interest rates, such as the one-month bank bill swap rate used as a benchmark for variable rate loans, increased by about 50 basis points. However, more recently the stock market has started a recovery, driven by movements in the major global indices and strong earnings announcements by several large companies. As confidence in the financial system started to recover, default swaps on the large Australian banks fell, and the one-month bank bill swap rate decreased by about 10 basis points. Metal prices also fell during the turbulence, but more recently have partially rebounded. Market analysts and participants believe that metal prices will remain high on continuing demand in the near future.



Source: Reserve Bank of Australia and Australian Stock Exchange

3. **The direct impact of the U.S. credit market turbulence on Australia is modest.** Some Australian hedge funds have experienced losses in July, arising from their exposure to U.S. subprime loans. However, these funds are very small, with total funds under management equal to 0.03 percent of total assets of Australia's financial system. Australian banks' exposure to both U.S. and Australian subprime mortgage loans is low. Last week, Standard and Poor's stated that the credit quality of short-term debt sold by Australian banks will not be "adversely affected" by U.S. subprime losses, and that none of the companies set up by Australian banks to sell asset-backed commercial paper are exposed to U.S. residential mortgage assets. Fitch Ratings also noted the limited exposure to the U.S. subprime market, and commented that it does not anticipate the U.S. subprime issues to cause material problems for Australian banks. The Reserve Bank of Australia (RBA) injected significant amounts of liquidity into the market in August. However, more recently the level of liquidity has begun to return to more normal daily levels.

4. **Staff's macroeconomic projections remain broadly unchanged.** Given the need to ascertain global implications of the market turbulence, staff can make only a tentative estimate of its overall impact on the Australian economy. However, available indicators suggest that the impact on real economic activity is likely to be small. The cost of funding for the economy has increased, but strong profits, especially in mining, suggest that the investment is not likely to be significantly affected.

Monetary policy

5. **Inflation outcome for the June quarter, released in late July, showed a significant increase in inflation pressure.** The headline CPI rose by 1.2 percent in the second quarter, and by 2.1 percent in the year to June. Although the quarterly increase was boosted by increases in fuel and food prices, the strength of price increases was broad-based. The RBA's measure of underlying inflation increased by 0.9 percent in the quarter, higher than 0.5-0.6 percent in December and March quarters, and above RBA and market forecasts.

6. **On August 8, 2007, the RBA raised the official interest rate from 6¼ percent to 6½ percent.** The rate had been on hold since November 2006, as the evidence from producer and consumer price indices indicated that inflation had moderated. However, the RBA maintained a tightening bias during that period, as indicators of domestic demand remained consistently strong. The higher-than-expected CPI outcome for the June quarter indicated a deterioration in the near-term inflation outlook, and the RBA judged that "a somewhat more restrictive monetary policy setting was required in order to keep inflation consistent with the target in the medium term."

7. **Staff considers the rate decision to be appropriate, given the rise in medium-term inflation prospects.** Staff also concurs with the RBA that, despite the recent turbulence

of the credit markets, growth prospects remain strong, as high commodity prices continue to provide stimulus to Australia's national income and savings.

Fiscal policy

8. **Preliminary estimates indicate that the Commonwealth government recorded an underlying cash surplus of 1.7 percent of GDP in 2006–07 (fiscal year ending June).** The surplus is 0.4 percent of GDP higher than expected in May at the time of the 2007–08 Budget. Most of the surplus will be transferred to the Future Fund (0.7 percent of GDP) and the recently established Higher Education Endowment Fund (0.6 percent of GDP).

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September 12, 2007

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

IMF Executive Board Concludes 2007 Article IV Consultation with Australia

On August 31, 2007, the Executive Board of the International Monetary Fund (IMF) concluded the Article IV consultation with Australia.[1]

Background

Australia has experienced more than 15 years of continuous economic growth, benefiting recently from strong terms of trade gains. After a modest slowdown, growth expanded to 3¾ percent over the year to March 2007. The lengthy expansion has brought the economy to a position of near full employment. Inflation had eased in late 2006 and early 2007, but accelerated in the second quarter.

The current account deficit was 5½ percent of GDP in 2006, reflecting high business investment. The trade deficit narrowed, while the investment income balance continued to deteriorate, reflecting large net dividend payments. The Australian dollar has appreciated substantially over the past few years, but does not appear misaligned once the recent terms of trade gains are taken into account. Net foreign liabilities increased to over 60 percent of GDP, but survey evidence shows that there is limited exposure to foreign exchange risk.

After being kept on hold since November 2006, monetary policy was tightened in August, as signs of renewed inflation pressure began to emerge. The fiscal position

[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.

continues to be strong, with surpluses recorded in nine of the last ten years. The 2007/08 (July 2007-June 2008) budget projects the underlying cash surplus to decline from 1.7 to 1 percent of GDP, and to remain at that level in the medium term.

Staff project GDP growth to accelerate above 4 percent in 2007 and moderate in 2008. The current account deficit should remain stable as the balance on goods and services improves, while the income deficit continues to deteriorate. Headline CPI inflation is expected to be slightly over 2 percent in 2007, and to stay in the upper half of the Reserve Bank of Australia's target band thereafter.

Executive Board Assessment

Executive Directors commended the Australian authorities for their exemplary macroeconomic management, which is widely recognized as being at the forefront of international best practice. Sound fiscal, monetary, and structural policies, against a background of sizable terms of trade gains, have created the conditions for a continued expansion, supported by high employment levels. Directors expressed confidence that the authorities will continue to implement the reforms needed to spur efficiency in order to enhance productivity and income growth, and face long-term economic challenges, particularly related to population aging.

Directors praised Australia's very strong fiscal position, with fiscal policy firmly focused on medium- and long-term objectives. Additional revenues resulting from the terms of trade boom have been managed prudently, and the 2007/08 Budget continues appropriately to target budget surpluses. Directors recommended that, going forward, the surplus be allowed to exceed budget forecasts if growth and revenues are stronger than expected given the strength of economic activity. Directors agreed that State and Territory Governments would need to make prudent decisions on the timing and extent of infrastructure investments over the next few years.

Directors regarded the continuing flexibility of the exchange rate as a valuable shock absorber for the economy, and noted that the currency appreciation in the first half of 2007 helped to ease inflation pressures. While the Australian dollar has appreciated substantially over the past few years, Directors saw no clear signs of misalignment of the exchange rate, given the improvement in the terms of trade. Directors agreed that Australia's external deficit appears sustainable, although the resulting debt requires continued careful monitoring.

Directors considered the recent increase in the official interest rate to be appropriate in light of emerging inflation pressures. They commended the willingness of the Reserve Bank of Australia to take appropriate and timely action, noting that, in light of the recent global financial market turbulence, it will be desirable to maintain flexibility in the conduct of monetary policy.

Directors observed that the financial sector is stable and well-capitalized. Supervision is well-established and continues to be refined. At the same time, a number of potential vulnerabilities identified by the 2006 Financial Sector Assessment Program (FSAP) remain. In particular, it is important to continue to monitor the exposure of banks to developments in the household sector. Directors noted that Australian banks' exposure to U.S. subprime mortgage loans is low, and the direct impact of the recent credit market turbulence on Australia has been modest. Continued vigilant monitoring of evolving market developments is nevertheless warranted.

Directors supported the authorities' National Reform Agenda, and welcomed its focus on enhancing labor force participation and productivity as sources of future growth. Sustained progress on the agenda will prepare Australia to cope with the impact of population aging. While Australia is well-placed to deal with long-term fiscal challenges, continued attention will also need to be given to the efficiency of health-care spending. Directors welcomed the release of the second Intergenerational Report, which assesses the sustainability of government policies over the next 40 years. They emphasized that this report was an important further step in improving transparency of the government and increasing the government's ability to plan for the future, particularly by focusing debate on productivity and participation.

Directors welcomed the authorities' efforts in advancing multilateral trade negotiations, and their commitment to double Australia's official development assistance by 2010.

Australia: Selected Economic Indicators, 2003–07

	2003	2004	2005	2006	2007 Proj.
Output and demand (percent change)					
Real GDP	3.1	3.7	2.8	2.7	4.4
Total domestic demand	5.7	5.6	4.3	3.5	5.1
Private consumption	3.6	5.7	3.0	3.1	4.5
Total investment	9.1	7.6	7.7	6.5	5.7
Business	13.8	12.6	15.6	8.9	9.5
Dwelling	6.3	3.0	-3.8	-1.5	6.2
Exports of goods and services	-1.2	4.3	2.3	3.4	6.1
Imports of goods and services	11.1	15.0	8.9	7.6	9.5
Inflation and unemployment (in percent)					
CPI inflation	2.8	2.3	2.7	3.5	2.1
Unemployment rate	5.9	5.4	5.1	4.8	4.5
Saving and investment (in percent of GDP)					
Gross national saving	20.6	20.1	20.8	20.6	21.7
General government saving	4.0	3.4	3.8	3.9	2.7
Private saving 1/	16.6	16.6	16.9	16.8	19.0
Gross capital formation	25.9	26.0	26.7	26.6	27.2
Fiscal indicators (in percent of GDP) 2/					
Receipts 3/	22.6	22.3	22.7	23.0	22.7
Payments 3/	21.6	21.3	21.2	21.3	21.2
Underlying balance 3/	1.0	1.0	1.5	1.6	1.3
Net debt	3.9	2.8	1.4	-0.6	-2.8
Money and credit (end of period)					
Interest rate (90-day bill, in percent) 4/	5.5	5.4	5.6	6.4	6.9
Treasury bond yield (10-year, in percent) 4/	5.6	5.3	5.2	5.9	5.9
M3 (percent change) 4/	11.7	9.0	8.2	13.1	16.1
Private domestic credit (percent change) 4/	12.5	14.1	13.5	14.2	15.1
Balance of payments (in percent of GDP)					
Current account	-5.4	-6.0	-5.8	-5.5	-5.6
of which: Trade balance	-2.9	-2.8	-1.9	-1.3	-1.5
Foreign direct investment, net	-1.6	3.9	-0.3	0.2	-0.4
Terms of trade (percent change)	3.2	9.3	11.7	7.8	3.5
External assets and liabilities (in percent of GDP)					
Net external liabilities	53.5	55.4	56.9	60.3	61.6
Net external debt	45.5	47.7	50.3	52.4	52.6
Gross official reserves 4/	5.5	5.5	6.3	6.9	7.4
Exchange rate (period average)					
US$/$A 4/	0.65	0.74	0.76	0.75	0.82
Trade-weighted index 4/	57.8	62.3	63.9	63.0	66.6
Real effective exchange rate 5/	112.6	121.2	124.8	124.7	128.9

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/ Excludes asset sales and other one-off factors; cash basis.
4/ Data for 2007 are for latest available month.
5/ IMF, Information Notice System index (1990 = 100). Data for 2007 are for latest available month.