



AUSTRALIA

2011 ARTICLE IV CONSULTATION

October 2011

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 2011 Article IV consultation with Australia, the following documents have been released and are included in this package:

- **Staff Report** for the 2011 Article IV consultation, prepared by a staff team of the IMF, following discussions that ended on August 2, 2011, with the officials of Australia on economic developments and policies. Based on information available at the time of these discussions, the staff report was completed on September 19, 2011. 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.
- **Informational Annex** prepared by the IMF.
- **Public Information Notice (PIN)** summarizing the views of the Executive Board as expressed during its October 5, 2011 discussion of the staff report that concluded the Article IV consultation.
- **Statement by the Executive Director** for Australia.

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.

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AUSTRALIA

STAFF REPORT FOR THE 2011 ARTICLE IV CONSULTATION

September 19, 2011

KEY ISSUES

Context. A mining boom is driving an economic recovery, as the terms of trade have risen to historic highs. The recovery is uneven, however, with those sectors not directly benefiting from high commodity prices coming under pressure from an elevated exchange rate. Inflation has begun to rise as the output gap closes.

Focus. Discussions centered on the economic policy mix to manage near-term risks and make the most of the mining boom over the medium term.

Near-term macroeconomic policy mix. While recent global financial market volatility has increased uncertainty about the outlook, further increases in the policy interest rate are likely to be needed to contain inflation if the recovery remains on track. An exit from budget deficits is needed to increase fiscal space and support monetary policy. Staff welcomed the authorities' commitment to return to a budget surplus by 2012/13, despite the negative impact of recent natural disasters.

Medium-term fiscal policy. The mining boom provides an opportunity to put Commonwealth government finances in a stronger position to deal with future shocks and long-term pressures from aging and rising health care costs. Therefore, staff recommended targeting a budget surplus of more than 1 percent of GDP, on average, for the period beyond 2013/14, while the mining boom continues to support growth.

Tax and structural reforms. Making the most of the mining boom will require reforms to increase labor supply and productivity. The authorities have taken a number of tax and other reform measures, but further steps are needed to remove inefficient taxes and improve work and investment incentives.

Financial stability. Staff emphasized the importance of continued intensive bank supervision to maintain financial stability. Staff also recommended considering the merits of higher capital requirements for the systematically important domestic banks and encouraging banks to reduce further their short-term external borrowing.

Approved By
Mahmood Pradhan
and Tamim Bayoumi

Discussions took place in Sydney and Canberra during July 22–August 2, 2011. The staff team comprised Messrs. Brooks (head), Basu, Jauregui, and Schule, and Ms. Tumbarello (all APD). Ms. Sheridan (APD) contributed from headquarters. Mr. Legg (OED) participated in the discussions.

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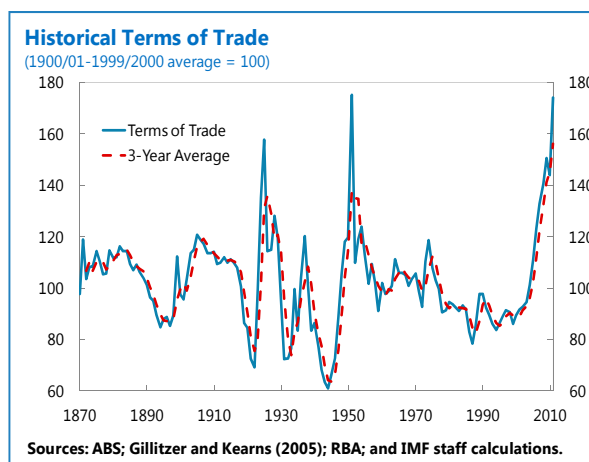
THE RECOVERY AND THE MINING BOOM

1. Australia's performance since the onset of the global financial crisis has been enviable. It was one of the few advanced economies to avoid a recession in recent years, reflecting its strong position at the onset of the crisis and a supportive macro policy response. The good performance can also be attributed to a healthy banking system, a flexible exchange rate, and robust demand for commodities from Asia, especially China.

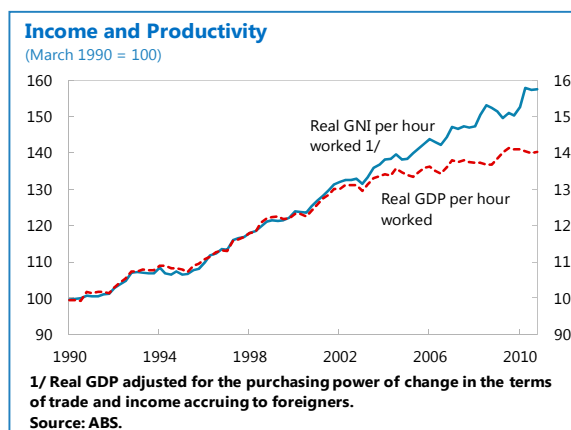
2. A recovery is now being driven by a mining boom. Real GDP growth picked up to 2¾ percent in 2010 with private demand and commodity exports beginning to take over from public demand as the main drivers (Table 1, Figure 1). Business profits have risen, especially in mining, as demand for commodities has pushed the terms of trade to 60 year highs (text figure).¹ In the first quarter of 2011, however, activity was disrupted by cyclones and floods in Queensland and Western Australia that reduced output, especially exports of coal and iron ore (which comprise about ⅓ of Australia's exports) (Figure 2). This contributed to a 0.9 percent fall in real GDP in the first quarter (seasonally adjusted, quarter-on-quarter). Real GDP

¹ The previous peak for the terms of trade in 1951 was short-lived and a three-year moving average of the terms of trade is currently at the highest level in 140 years.

growth rebounded in the second quarter by 1.2 percent (seasonally adjusted, quarter-on-quarter) but coal export volumes have not yet recovered fully.

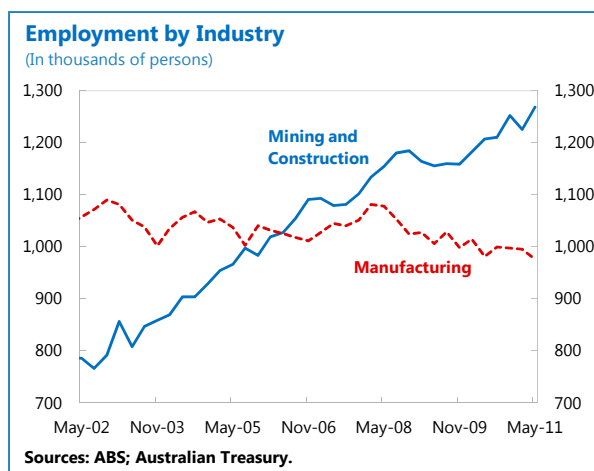


3. The exceptionally large rise in the terms of trade since 2002 has increased national income and improved the current account balance. Real national income per hour worked has increased by more than 3 percent per annum since 2002, while real GDP per hour worked grew at a much slower pace (text figure). The increase in income from commodity exports was a key factor behind the improvement in the current account deficit



to about 2½ percent of GDP in the first half of 2011, well below the average of 4½ percent of GDP for the past 15 years.

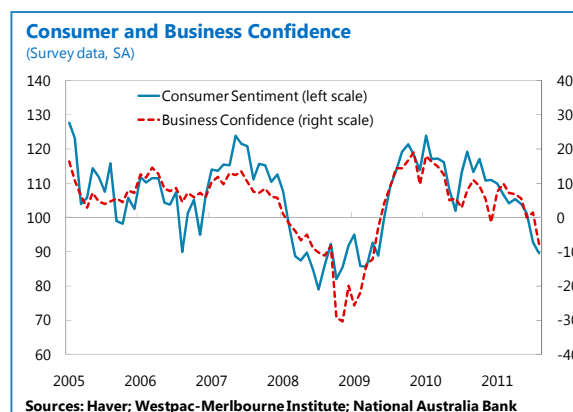
4. The unemployment rate has fallen to just over 5 percent, but job growth has slowed. Total employment has grown by more than 1 million since early 2007 (about 10 percent), despite the impact of the global crisis. Employment in mining and construction has grown rapidly (text figure). Some mining companies have reported that shortages of skilled labor have slowed construction of investment projects, partly because the projects are concentrated in remote areas of Queensland and Western Australia. Job growth, however, has been weak in manufacturing and some service sectors that are not benefiting from high commodity prices.



5. Inflation has increased as spare capacity has been used up. Headline inflation reached 3½ percent year-on-year in the second quarter, above the Reserve Bank of Australia’s (RBA) target band of 2–3 percent (over the medium-term). The increase was due in part to disruptions to food supply following the floods

in Queensland. However, underlying inflation has also risen, reaching 3 percent on an annualized rate in the first half of the year. Private sector wage growth has picked up to 4 percent year-on-year in the June quarter 2011, and is running well ahead of trend labor productivity growth of 0.9 percent over the same period (Figure 3).

6. Households remain cautious, however, as they rebuild their balance sheets. Household spending growth slowed since the crisis and saving rose to more than 10 percent of household disposable income in early 2011, the highest level in nearly 25 years. The jump in the saving rate appears to be attributable to households rebuilding their net worth after a decline during the global financial crisis. Households also appear to be offsetting part of the fall in government saving in recent years.² Consumer confidence has weakened as house prices have fallen, inflation has risen and employment growth has slowed (text figure). Household debt has stabilized at about 150 percent of disposable income.

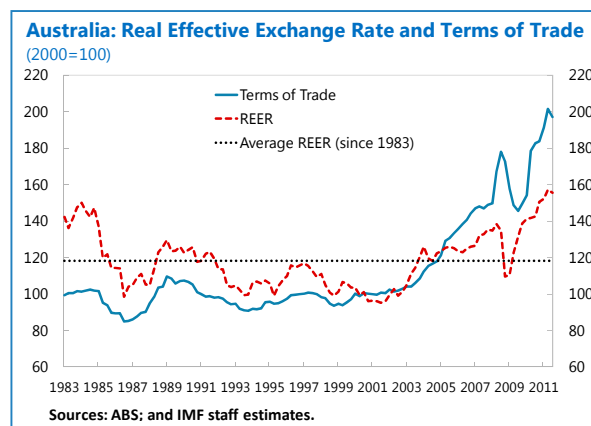


² See the Selected Issues paper by S. Basu, “Why Has Household Saving Increased So Sharply in Australia?”

7. Macroeconomic stimulus is being withdrawn. The RBA began to raise its policy rate in late 2009, earlier than central banks in other advanced economies. The policy rate has been held at 4¾ percent since November 2010, because of uncertainty regarding the global outlook and the impact of natural disasters on activity. Nonetheless, monetary conditions have tightened further with the appreciation of the exchange rate over the past year. The exit from fiscal stimulus began in 2010, as the recovery gained traction. However, fiscal consolidation has been complicated by natural disasters that contributed to a wider-than-expected budget deficit of 3½ percent of GDP in 2010/11.

8. Recent global financial market volatility has had some impact on Australian markets. The increase in global risk aversion in recent months has led to a depreciation of the Australian dollar by 5–6 percent in nominal effective terms from its recent peak in late July. However, the real effective exchange rate

remains just below the highest level since the Australian dollar was floated in 1983, supported by the strong terms of trade (text figure). Stock prices have fallen in recent months and credit default swap spreads have risen for Australian banks, but not as much as for U.S. and European banks (Figure 4). Financial markets are now expecting a cut in the RBA's policy rate over the next year as they have become more pessimistic about the global outlook, but a recent Reuters survey of local analysts suggests a small increase in the policy rate over the next year.



OUTLOOK, RISKS, AND SPILLOVERS

9. The economic outlook remains favorable, despite the global financial market volatility in recent months. Real GDP growth is projected at almost 2 percent for the calendar year 2011 and 3⅓ percent for 2012, on the back of strong demand for commodities and a sharp rise in private investment in mining. For 2013 and beyond,

real GDP growth is likely to be around the potential rate of around 3⅓ percent, supported by the positive outlook for fast-growing emerging Asia. The demand from Asia is reflected in the construction of several large iron ore and liquefied natural gas projects, which could raise private business investment to 50-year highs in coming years. The

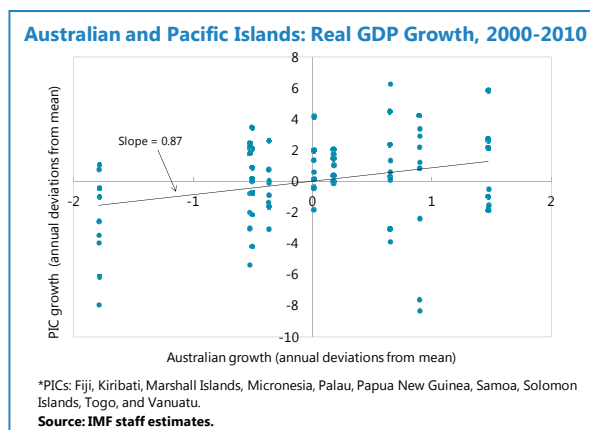
unemployment rate should continue to fall gradually to 4¾ percent by 2012. With capacity constraints emerging in the labor market and the output gap expected to close by year end, underlying inflation is likely to rise gradually. The external current account deficit is expected to narrow to 2¼ percent of GDP in 2011—due to the jump in the terms of trade—before progressively widening to about 6½ percent of GDP in the medium term, reflecting the increase in investment and a fall in saving. This assumes that the real effective exchange rate remains at its current level, even though staff project the terms of trade to decline by about 10 percent over the next five years.

10. The recent global financial market volatility has increased uncertainty about the near-term economic outlook, and the risks to staff’s growth projections are tilted to the downside:

- On the downside, a key risk is that the global recovery stalls or Asian growth falters in the near-term, impacting demand for commodities. Contagion from the euro area periphery and uncertainty about progress toward fiscal consolidation in the United States could also destabilize global funding markets. On the domestic front, a fall in house prices, which appear overvalued by 10–15 percent (Box 1), could hurt consumer confidence further and depress consumption growth.

- On the upside, investment in the resource sector could be larger than expected, boosting growth and pushing up wages and inflation. Also, households may become more confident as the boom progresses and reduce their current high level of saving.

11. The favorable Australian outlook should have positive spillovers for New Zealand and the Pacific Islands. Staff analysis suggests that economic shocks to Australia are transmitted almost “one-to-one” to New Zealand, given the strong trade and financial links.³ There is also a positive correlation between growth in Australia and the Pacific Islands given the links through trade, tourism, and remittances (text figure). In addition, the planned increase in Australia’s official development assistance to 0.5 percent of Gross National Income over the next few years is expected to support growth in the Pacific Islands.



³ Yan Sun, 2011, “From West to East: Estimating External Spillovers to Australia and New Zealand,” IMF WP/11/120.

Box 1. House Price Assessment

Real house prices rose by 130 percent in the last 20 years in Australia—faster than most comparators. However, unlike many comparators, Australia's house price increase growth has occurred in the context of strong growth in population and household income and relatively subdued growth in housing supply. As of June 2011, real house prices have fallen by 5 percent (year-on-year) since the peak in mid-2010.

House prices appear overvalued by about 10–15 percent as of June 2011, using a combination of simple metrics and models:

- **The price-to-income ratio** suggests an overvaluation of about 15 percent compared to its long-term average (text table and figure). This is based on the Australian Property Monitors data which include all residential property nationwide, including non-urban areas.¹
- **The price-to-rent ratio** also suggests an overvaluation of about 15 percent. This is based on data from the Real Estate Institute of Australia and RP Data Rismark, which includes houses and apartments.

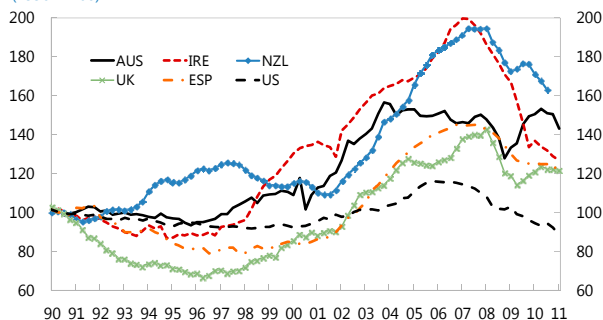
These simple ratios, however, have shortcomings in assessing misalignments. The ratios ignore structural changes such as the fall in nominal mortgage interest rates since the 1990s and do not take account of strong population growth or the increasing scarcity of land close to urban centers. Moreover, the 20-year average used as a benchmark is an imperfect proxy for the equilibrium house price.

Model-based estimates indicate that house prices are overvalued by about 10 percent, from a medium-term perspective.² The model uses a nationwide series that covers all residential properties (the RP Data Rismark) and takes into account demographics, mortgage interest rates, and the terms of trade as a proxy for future income, in line with Tumbarello and Wang (IMF WP/10/291).³ The model suggests that a 10 percent fall in the terms of trade could result in an 8 percent fall in real house prices over the medium term.

¹ The price-to-income and price-to-rent ratios, according to the OECD database, suggest a much larger overvaluation of 25–35 percent compared with the average for the past 20 years. However, these measures are based on the Australia Bureau of Statistics (ABS) series which has several shortcomings. The ABS house price series covers only detached houses in capital cities, where prices have increased faster than in non-urban areas, and excludes apartments and row houses. The ABS price-to-rent ratio series includes only rents for detached houses. A broader measure that includes apartments—which are a growing share of the housing market—shows much higher rental yields.

House Price-to-Income Ratio

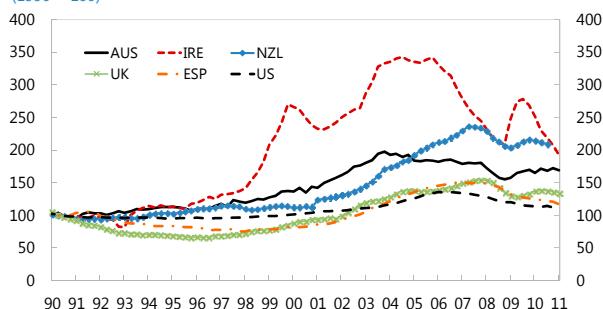
(1990 = 100)



Sources: OECD database. For Australia based on APM, ABS house price measure.

House Price-to-Rent Ratio

(1990 = 100)



Sources: OECD database. For Australia based on REIA and RP Data Rismark house price measure.

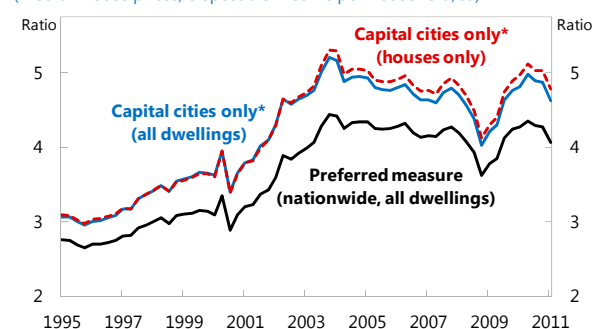
Australia: Deviation of House Prices from Long-term Average

	Relative to 20-year average as of June 2011
Price-to-income ratio	14.4
Price-to-rent ratio	15.2

Sources: RBA; Australian Property Monitor; REIA; and RP Data Rismark.

Australian Housing Price-to-Income Ratios

(Median house prices, disposable income per household, sa)



* Excludes Darwin and Hobart.

Sources: Reserve Bank of Australia; APM.

² Based on assumptions for the terms of trade, demographics, and mortgage rate through 2016.

³ The model does not take into account supply side factors, such as local government regulations on land use. Changes to these regulations would affect land prices.

The Authorities' Views

12. The authorities broadly agreed with staff on the outlook and balance of risks.

They were alert to the potential impact on the Australian economy from continued global uncertainty or a significant disruption to global growth. They pointed out that while the medium-term growth outlook for the

Australian economy remained strong, the substantial divergence across sectors was likely to persist. They noted that the extent and duration of adjustment to the high real exchange rate and cautious household spending behavior are key uncertainties. They also noted some upside risk to investment in the mining sector, given the conservative nature of their current projections.

THE NEAR-TERM MACROECONOMIC POLICY MIX

13. Staff agreed with the monetary policy stance taken over the past year, which has helped anchor medium-term inflation expectations. Financial conditions are mildly restrictive at present. Mortgage and business lending rates are above their average level for the past 15 years and the elevated exchange rate is helping contain inflation pressures (Figure 5). Moreover, credit and asset price growth remain subdued.

14. Staff advised that if the recovery remains on track, further increases in the policy rate are likely to be needed to contain inflation pressures from the impact of the mining boom on the wider economy. Staff analysis suggests that, in the absence of further tightening, underlying inflation would rise above the RBA's 2–3 percent inflation target band in 2012. Importantly, the RBA should guard against inflation expectations becoming anchored at too high a level.

15. On fiscal policy, the authorities remain committed to achieving a surplus by 2012/13 (Table 3, Figure 6). To this end, a temporary income tax levy and offsetting expenditure measures have been introduced to meet the costs of disaster relief and reconstruction in Queensland.⁴

16. Staff commended the authorities' commitment to consolidation to increase fiscal space and support monetary policy. The planned consolidation is faster than in many other advanced economies and is more ambitious than earlier envisaged, with an adjustment of about 3½ percent of GDP in the Commonwealth's cash balance over the next two years (Figure 7). If the growth outlook

⁴ Over six years, around \$A 6½ billion (or about 0.5 percent of GDP) is being provided for immediate relief and assistance, and to support rebuilding of affected communities.

improves, staff advised saving higher-than-expected tax revenue to avoid overheating and take pressure off the exchange rate.

17. If global financial markets become severely disrupted or world growth falters, macroeconomic policy is well positioned to respond. The exchange rate would likely depreciate, limiting the fall in commodity prices in Australian dollars and providing stimulus to the noncommodity tradable sector. The RBA has ample scope to cut the policy interest rate and provide liquidity support to banks, which proved effective in the global financial crisis. There is also fiscal space to delay the return to surplus and, if needed, to take temporary discretionary measures, given the low level of Commonwealth government net debt (6 percent of GDP).

The Authorities' Views

18. In discussions with the mission in late July and in its two subsequent post-Board statements, the RBA said that it remained concerned about the medium-

term outlook for inflation. It emphasized that monetary policy was exerting a degree of restraint, including through the exchange rate. The Board considered in August whether the outlook warranted further policy tightening. On balance, it judged that it was prudent to maintain the current setting of monetary policy, particularly in view of the acute sense of uncertainty in global financial markets. In discussions with the mission, the RBA agreed that there is considerable policy space to react to a downside scenario.

19. The authorities reiterated their commitment to fiscal consolidation. The Budget forecasts a return to surplus in 2012–13, despite the impact of the natural disasters earlier in the year. The emphasis on expenditure control was key to achieving this goal and they pointed out that the pace of consolidation was faster than in previous episodes. They agreed with staff that the fiscal position was strong enough to accommodate a sharp downturn in global growth.

HOW TO MAKE THE MOST OF THE MINING BOOM OVER THE MEDIUM TERM?

20. The mining boom is expected to be long lasting, given the favorable prospects for sustained growth in emerging Asia. However, there could be bumps along the road. A key policy challenge for economic policy is to facilitate the movement of

resources to mining and related service sectors in order to raise household incomes, while containing economy-wide wage pressures. Moreover, the greater importance of mining may amplify the business cycle and raise the economy's exposure to swings in commodity

prices. To make the most of the boom, reforms should enhance the flexibility of the economy

so that it can adjust to the structural changes taking place.

A. Medium-Term Fiscal Policy

21. The government's fiscal strategy envisages three pillars: achieving budget surpluses, on average, over the medium term; keeping taxation as a share of GDP below the 2007–08 level on average (23½ percent of GDP); and improving the government's net financial worth over the medium term. To achieve this aim, the government is committed to limiting spending growth. In particular, while the economy is growing at or above trend, real spending growth, on average, will be capped at 2 percent annually until surpluses are at least 1 percent of GDP.

22. The mining boom provides an opportunity to put Commonwealth government finances in a stronger position to deal with future shocks by reducing debt and building funds for a rainy day.

Therefore, staff advised targeting a budget surplus of more than 1 percent of GDP, on average, for the period beyond 2013/14, while the mining boom continues to support growth. Although Australia's public debt is relatively low, larger fiscal buffers would give greater scope to spend during a downturn to support income and jobs. Staff noted that lack of scope for fiscal and monetary policy to react in other countries may mean that a global downturn would have a sizable impact on Australia, implying a need for larger buffers than in the

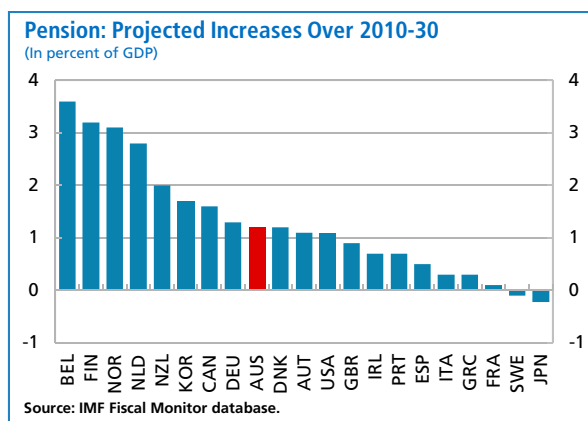
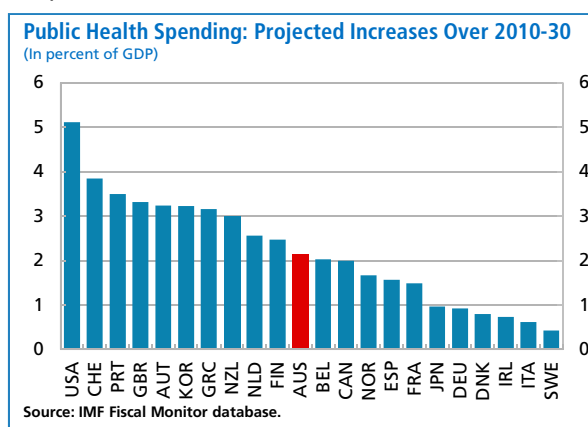
past.⁵ Moreover, a further strengthening of the Commonwealth government balance sheet should continue to contain economy-wide debt-servicing costs. This will be important given the likely upward pressure on global interest rates from sizable sovereign borrowing by other advanced economies in coming years.

23. Staff recommended allowing the automatic stabilizers to operate fully in both directions. The growing importance for the economy of mining exposes government revenue to swings in commodity income. This would motivate running sizable surpluses during upswings to avoid overheating. These surpluses should be larger than in past upswings when they were limited to about 1¾ percent of GDP. Conversely in a downturn, sizable but temporary deficits would be appropriate. The impact of a large fall in commodity income on the budget could be presented to the public to build support for running sizable surpluses during good times. Staff estimates suggest that a permanent fall in the terms of trade of 30 percent could reduce nominal GDP by 6 percent relative to the

⁵ See the Selected Issues paper by J. Jauregui and W. Schule, "External Downside Scenarios for Australia and Emerging Asia Using GIMF."

baseline (assuming that the exchange rate depreciates by 15 percent) and worsen the budget balance by 2 percent of GDP.

24. Stronger fiscal consolidation would also put the budget on a firmer footing to deal with some of the long-term pressures from aging and rising health care costs (text figures). Staff welcomed the reform agenda of the Council of Australian Governments to improve coordination and efficiency in the health care sector, including the development of nationally consistent performance indicators for patient care.



25. While budget institutions are operating well, the quality of the

institutional arrangements could be improved further. The proposed

establishment of a Parliamentary Budget Office is welcome, and steps to ensure that a greater share of expenditure is covered in the annual budget process would enhance the quality of spending decisions (Box 2).

The Authorities' Views

26. The authorities agreed with the need to improve the fiscal position over the medium term, noting that the budget is forecast to return to surplus in 2012–13 and real spending growth will be limited to 2 percent a year, on average, until surpluses are at least 1 percent of GDP. However, they considered that revenue improvements from the mining boom could not be expected to contribute to building surpluses at the same rate as previous occasions. They noted that revenues are not expected to grow as strongly as in the 2003–04 to 2007–08 mining boom, given the already very high level of commodity prices. If revenues surprise on the upside, they would allow these revenue improvements to flow through to improve the budget position, consistent with the government's fiscal strategy. While larger buffers would help cushion against commodity income shocks, achieving these buffers would limit the scope for reducing taxes and thereby addressing the associated deadweight losses for the economy.

Box 2. Budgetary Institutions Supporting Fiscal Consolidation¹

Australia's strong budgetary institutions have operated successfully both in times of fiscal strength and stress.

Australia is an international pioneer in many areas of budgetary reform including: the development of three-year forward estimates, the Expenditure Review Committee which reviews expenditure proposals, the introduction of accrual accounting and outcome frameworks, and the publication of an *Intergenerational Report*. This Box discusses some enhancements to the quality of existing institutions that would support fiscal consolidation.

Staff welcomes the proposal to create a Parliamentary Budget Office (PBO).

Comparable institutions have been established in Canada and the United Kingdom with the objectives of improving fiscal transparency and providing an independent view on the government's fiscal policy. The Australian PBO's proposed functions include costing political parties' election commitments and providing independent analysis to parliament on fiscal policy and the financial implications of policy proposals. While most of the focus has been on its role in costing election commitments, it is equally important that the PBO develop its capacity to provide independent fiscal analysis.

A significant portion of the Australian Government budget is subject to a greater degree of lock-in, making fiscal consolidation potentially more difficult.

Up to 30 percent of expenditure is approved by the parliament each year through the annual budget process. The remainder is subject to "special" or standing appropriations where authority for expenditure continues beyond the three-year estimates period until it is annulled or amended by the parliament. This includes most entitlements and benefits programs, such as pensions, but also some other discretionary spending. The balance between "special" and "annual" appropriations should be reviewed, with the aim of reducing the share of expenditure under "special" appropriations.

Budget decisions should be focused on the annual budget to uphold fiscal discipline.

The government has also taken decisions on spending and saving proposals outside the annual budget process. While this approach provides flexibility and helps maintain discipline, it does not improve the government's ability to make strategic decisions, including on trade offs and reallocations across departments. This is best achieved when decisions are made in the context of the annual budget.

¹ Prepared by Ms. Curristine, FAD, following a staff visit to Australia in July 2011.

B. Tax and Structural Reforms

27. Tax and structural reforms will play a key role in allowing Australians to take full advantage of the mining boom. Labor force participation has risen in recent years, in part reflecting government initiatives, but the mining boom is increasing the demand for labor. Meeting this demand will require not only raising labor supply, but also facilitating the movement of labor across industries and regions.⁶ Productivity growth in Australia has slowed over the past decade, and the elevated level of the real exchange rate is generating pressure for efficiency improvements in the nonmining tradable sector.

28. The review of the tax system released in May 2010 provides a blueprint for tax reform. Staff welcomed the progress already made in adopting many of its recommendations, which include reducing the company tax rate, taxing some mineral resource rents, taking steps to reduce effective marginal tax rates for low-income earners, and reducing the complexity of the tax system. Staff supported the proposed introduction of a carbon price as a transition to a permits trading system to mitigate greenhouse gas emissions (Box 3). Part of the revenue raised from the tax will be used to assist low- and middle-income households by increasing the

⁶ See Selected Issues paper by Y. Sun “The Impact of the Mining Boom on the Australian Labor Market.”

tax-free threshold to \$A 18,200. This should boost labor force participation and relieve an extra 1 million Australians from the need to lodge an income tax return.

29. Going forward, staff recommended continued tax reform. A priority should be to remove inefficient taxes such as state stamp duties (including on home sales that discourage worker mobility) and insurance taxes. Moreover, there is scope to improve work incentives by further reducing effective marginal tax rates and to encourage investment by reforms to business tax. While tax reform entails difficult political choices, options to replace the lost revenue from these reforms include more reliance on a consumption-based tax,⁷ reforming land taxes,⁸ and broadening the coverage of the minerals resource rent tax beyond coal and iron ore.

30. On broader structural reforms, staff welcomed the steps taken to raise labor participation and invest in skills training, which should help workers improve their

⁷ The existing goods and services tax rate is currently 10 percent, relatively low by advanced economy standards, and the base excludes a number of food items and health and education services.

⁸ Owner-occupied housing is exempt from existing land taxes.

Box 3. Carbon Pricing and the Emissions Trading Scheme

Australia plans to introduce a price on carbon in July 2012. An Emissions Trading Scheme (ETS) will be established to progressively reduce carbon dioxide (CO₂) and other greenhouse gases to at least 5 percent below year 2000 levels by 2020. Around 500 large emitting companies will be required to purchase and surrender a permit for each metric ton of emissions produced.

Initially the permit price will be fixed at \$A 23 per metric ton of CO₂ equivalent, but after July 2015 will be determined by market trading. Permits will be allocated for free to emissions-intensive and trade-exposed industries and electricity generators to help them transition to carbon pricing by assisting them to meet part of their liability.

The ETS has a number of attractive features. Pricing policies (emissions trading and emissions taxes) are the most effective and cost-effective policies for reducing emissions. The ETS is comprehensive, covering major industrial sources such as power generators and gas producers. Emissions from fuel used in light passenger-vehicles are not covered. However, an effective carbon price will be levied on fuel used in aviation, off-road, and by some businesses through the fuel excise system.

The majority of emissions allowances will be auctioned. Estimates by the Australian Treasury suggest that the sale of permits and application of a carbon price will raise receipts of \$A 18.2 billion over the three years to 2014/15 (about 0.3 percent of annual GDP on average for the three years). Treasury modeling shows that the scheme would increase the level of the Consumer Price Index by about 0.7 of a percentage point in late 2012.

Low- and middle-income households will be compensated through income tax cuts and transfer payments. The tax free threshold will be increased and welfare beneficiaries will be assisted with the increase in the cost of living associated with the scheme. Further assistance will be given to businesses affected by the scheme and to encourage investment in green technology. Overall, the compensation exceeds the revenue generated from the scheme. As a result, an increase in the cash budget deficit of about \$A 4.1 billion is projected by the Australian Treasury for the four years to 2014/15, which is less than about 0.1 percent of annual GDP (on average for the four years).

mobility and income prospects. The 2011/12 budget introduced several measures to increase labor supply. These include reducing marginal tax rates for single parents, phasing out tax breaks for dependent spouses under forty years old, and increasing childcare support. Work requirements and wage subsidies are being expanded for disability beneficiaries and the long-term unemployed, while pensioners will be able to work more hours without losing income support. Further steps in this direction could raise labor participation. Vocational training is also being expanded. In other areas, the current favorable economic outlook provides a window of opportunity to push ahead with the Council of Australian Governments' reform agenda, including in the areas of education, infrastructure, and harmonization of business regulations. In addition, the government should resist pressures to prop up declining industries.

The Authorities' Views

31. The authorities noted that a number of important tax and structural reforms are

being implemented. They emphasized that they have been working toward reducing effective marginal tax rates, including through tripling the tax free threshold from \$A 6,000 to \$A 18,200, reducing income support payment withdrawal rates, and increasing income support free areas. The authorities added that further progress in this area generally involves a fiscal cost. The authorities pointed to the significant number of other tax reform measures that also build on recommendations from the tax review, including cutting company tax and providing tax relief and simplification for small business. Measures will also reduce complexity in the system, through a higher tax-free threshold, optional standard personal tax deductions, and simpler depreciation for small business. They noted the discussion of the inefficiency of state taxes such as stamp duties. The government is opposed to the option of raising consumption taxes. On structural reforms, the government's tax reforms are designed to get a better return for Australia's nonrenewable resources and reinvest this in business tax cuts, infrastructure, and superannuation savings to enhance the competitiveness of the broader economy.

HOW TO SAFEGUARD FINANCIAL SECTOR STABILITY?

32. Banks were resilient to the global crisis, mainly because of sound regulation and supervision. Prudential rules, often

tighter than the minimum international standards, such as higher loss-given-default assumptions, together with a pro-active

approach to supervision, helped maintain a healthy and stable financial sector. Moreover, the Council of Financial Regulators played a key role in coordinating the response to the global crisis. Staff welcomed the government's confirmation that the Financial Claims Scheme will be a permanent feature of the financial system. The scheme currently guarantees deposits with banks and other deposit-taking institutions of up to \$A 1 million. The cap is being reduced to \$A 250,000 in February 2012, but will still cover around 99 percent of deposit accounts in full.

33. Banks have remained sound. Bank profits have recovered and the return on equity for the major banks is now around pre-crisis levels (Figure 8). Capital adequacy has improved, driven both by increases in capital and declines in risk-weighted assets. Common equity as a share of tangible assets has also risen to nearly 5 percent for the four large banks. The ratio of nonperforming loans to total assets has decreased slightly from a peak of 1.7 percent in March 2010. Banks have made significant changes to the structure of their funding. Their loans-to-deposits ratio has fallen by more than 10 percentage points since early 2007 to less than 120 percent in mid-2011, and their share of funding from short-term debt has fallen to just over 20 percent (on an original maturity basis).

34. Challenges remain, however. Banks may be tempted to take on riskier strategies in an environment of structurally lower credit growth. Household debt remains high (150 percent of disposable income, Figure 9) and a downside scenario of slower growth and a fall in the terms of trade, could lead to an increase in bad loans, although current arrears are modest. In addition, concentration in the banking sector has increased in the wake of the crisis with the assets of the four large banks now comprising about three-quarters of total bank assets. The government recently introduced a package to encourage competition among financial institutions. This included the removal of exit fees on bank mortgages, which has contributed to an increase in mortgage refinancing.

35. The Australian Prudential Regulation Authority (APRA)'s sound supervisory and regulatory approach has been commendable, but continued vigilance is needed to maintain financial stability. The government should ensure that APRA's capacity keeps pace with emerging risks and the evolving international norms. APRA's proposed early implementation of Basel III is welcome. In a recent discussion paper, APRA proposed that banks will be required to hold a minimum 4.5 percent Common Equity Tier 1 ratio and a 6 percent Tier 1 capital ratio from January 2013. APRA

has also proposed introducing a capital conservation buffer of 2.5 percent from January 2016. Moreover, APRA will maintain its current conservative requirements for determining risk-weighted assets.

36. Staff supported APRA's plan to undertake more comprehensive stress tests of banks than in 2009/10, including stress tests incorporating a disruption to funding markets.⁹ Staff also welcomed progress on contingency planning for liquidity and solvency problems at systemically important banks, including for the New Zealand subsidiaries. The Trans-Tasman crisis management exercise with New Zealand should help identify possible challenges in a banking crisis.

37. While continued strong bank supervision is the key to maintaining financial stability, staff also encouraged the

⁹ The 2009/10 tests assumed a global economic downturn that results in a 3 percent contraction of real GDP in Australia in the first year, followed by a V-shaped recovery. The scenario also assumed a rise in the unemployment rate to 11 percent, a fall in house prices of 25 percent, and a fall in commercial property prices of 45 percent. The results suggested that none of the banks would have breached the 4 percent minimum Tier 1 capital requirement of the Basel II framework.

authorities to consider higher capital requirements on banks that are systemically important in the domestic market, taking into account the currently evolving international standards. The large market share of the four banks in the domestic market implies that they are perceived as too big to fail and pose a potential fiscal risk (Box 4). Analysis of the appropriate capital requirements could be undertaken over the next year (including using stress tests) in the context of discussions in the Financial Stability Board and the 2012 update of the Financial Sector Stability Assessment with the IMF. More robust capital levels for systemically important banks would be beneficial, particularly in times of market uncertainty.

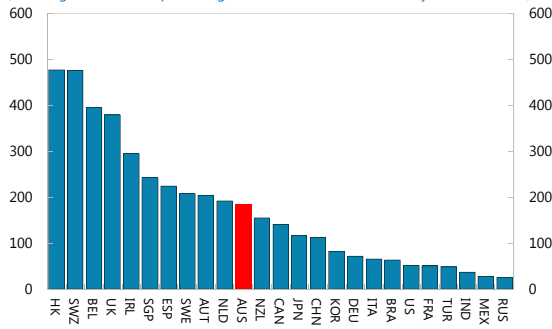
38. Macro-prudential oversight has played a role in maintaining financial stability. The Council of Financial Regulators (CFR), comprising representatives from the RBA, APRA, the Treasury, and the Australian Securities and Investments Commission, has maintained a focus on systemic risks as part of financial sector regulation. For example, in 2004, APRA raised capital requirements on some types of mortgage lending in response to weakened credit standards in the sector. Looking ahead the authorities see a potential role for a countercyclical buffer, in line with international proposals.

Box 4. Australia's Large Banks

Australia's four large banks account for about 75 percent of total banking sector assets and more than 80 percent of mortgage lending. Banking concentration increased in the wake of the global financial crisis, as the RMBS market became dislocated making it harder for nonbank lenders to compete, two smaller banks were taken over by two of the larger banks in 2008 (both approved by Australia's competition regulator), and several foreign-owned banks exited the Australian markets.

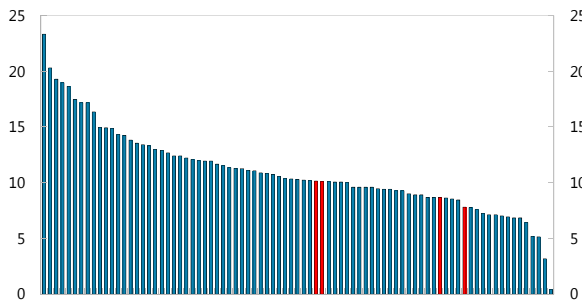
The assets of the four large banks comprise about 180 percent of GDP, around the average for a selection of advanced and emerging market economies (text figure). Subsidiaries and branches of the four major banks also control 90 percent of the assets of New Zealand's banking sector. Given their size, any distress among these banks could have a sizable impact on the financial sector and the real economy in both countries. Moreover, they may be perceived by the markets as too big to fail, which implies they could pose a potential fiscal liability.

Banking Sector Assets for Selected Countries
(Four largest banks as a percentage of these banks' home-country GDP, end 2010)



Basel III will require banks to hold more and higher-quality capital and introduces global liquidity and funding standards. The Australian banks are making good progress toward meeting these new requirements. Capital adequacy has improved, and the quality of bank capital in Australia is high, as it is mainly common equity. While the headline ratio of common equity to risk-weighted assets is lower than for other large banks, the risk-weighted assets numbers are not directly comparable across countries (text figure). APRA's requirements for computing risk-weighted assets likely imply that risk-weighted assets are higher than for comparable banks in other countries. For example, staff estimates suggest that if the Australian banks applied a loss given default assumption for residential mortgages of 10 percent (the Basel II minimum), rather than the 20 percent minimum required by APRA, their common equity to risk-weighted assets ratio would rise by almost 1 percentage point. APRA also makes other conservative assumptions that increase risk-weighted assets.

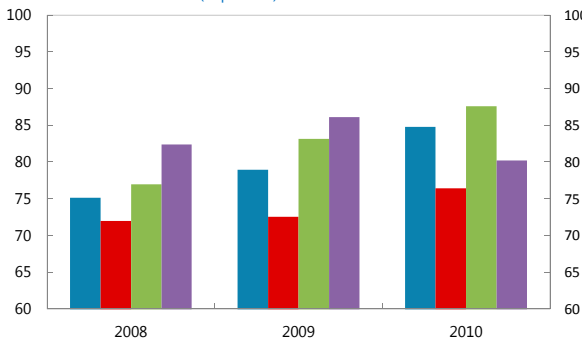
Tangible Common Equity to Risk-Weighted Assets, 2010¹
(Four largest banks, in selected countries)



Sources: Bankscope, IMF staff calculations.
¹ Red bars represent the four large Australian banks (Australia and New Zealand Bank, Westpac, Commonwealth Bank, and National Australia Bank).

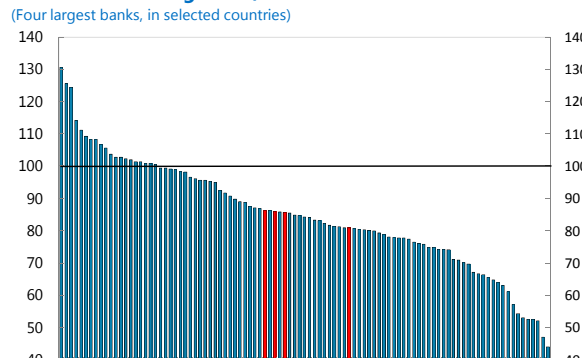
The structure of the funding of Australian Banks has further improved, with a higher share of retail deposits and long-term wholesale funding as well as a reduced share of offshore funding. Staff estimates suggest that the Net Stable Funding Ratio (NSFR) has improved for three of the four large banks over the past three years. By end 2010, staff estimates show that Australian banks were at or just below the average level for a selection of large banks.

Where the Four Large Australian Banks Stand vis-à-vis the NSFR (in percent)



Sources: Bankscope; Banks' Annual Reports; and IMF staff estimates.

Net Stable Funding Ratio, 2010



Sources: Bankscope, IMF staff calculations.

The Authorities' Views

39. The authorities agreed on the importance of continued rigorous supervision including ongoing stress-testing. They emphasized that intensive supervision and close cooperation between regulators are keys to maintaining financial stability. The authorities noted that their proposed Basel III minimum capital requirements are stronger than the global minimum. International standard-setters are yet to finalize additional loss absorbency

requirements for global systemically important banks and no decision has been taken on whether these will apply to a broader group of systemically important banks, and if so, how this will occur. Hence, the authorities' view is that it is premature to consider any extension of these requirements to any Australian banks at this stage. The authorities are also well advanced in their development of proposals to implement the Basel III liquidity requirements.

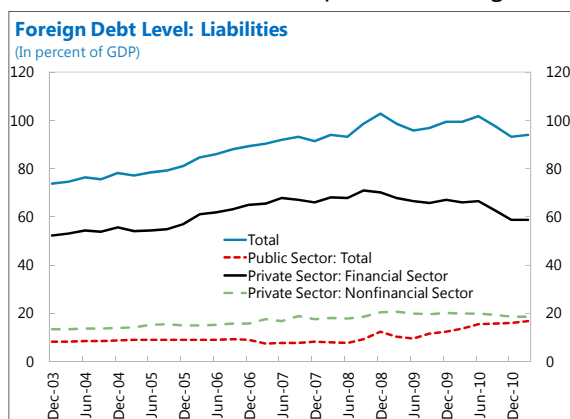
ASSESSING EXTERNAL VULNERABILITY

40. Relatively high net external liabilities and a projected widening of the current account deficit are vulnerabilities.

Net external liabilities fell from a peak of 62 percent of GDP in 2009 to about 57 percent of GDP in mid-2011, largely because of a fall in gross external debt (text figure). Most of this fall was due to lower private sector gross external debt, and an increase in private sector assets held abroad. The latter reflects, in part, an increase in retained earnings in the mining sector. At the same time, public sector gross

external debt has risen as a result of budget deficits. Although gross external debt is low by advanced country standards, net external liabilities remain relatively high (Figure 10). Moreover, staff project net external liabilities to increase to 68 percent of GDP in 2016, as the current account widens to 6½ percent of GDP by 2016.

41. The projected widening of the current account deficit should be manageable as it is driven in large part by investment to increase export capacity. For instance, investment in large LNG projects is expected to treble to 3 percent of GDP in 2013–14 and boost total exports by 3–4 percent. Much of the investment in the mining sector is expected to be financed through foreign direct investment, retained earnings, and long-term debt.



42. The expected increase in the current account deficit also reflects a projected decline in the national saving rate. Staff analysis suggests that demographics would put downward pressure on private saving over time, as a growing share of the population would draw on its savings to fund retirement. This underlines the need for fiscal consolidation to raise public saving, as well as tax reform to remove distortions to saving and investment decisions (as outlined in the recent tax review).¹⁰ The planned gradual increase in the compulsory superannuation contribution paid by employers, from 9 percent to 12 percent by 2019/20, is welcome as it may help raise national saving, with some studies showing its effectiveness in that regard over the past 15 years.¹¹

43. While financial institutions (mainly banks) have reduced their external borrowing, disruptions in global capital markets could still put pressure on their funding. Financial institutions external borrowing has fallen from a peak of 70 percent of GDP in 2008, to less than 60 percent of GDP

¹⁰ Recommendations of the review include reducing the tax on bank deposits and moving toward more tax neutral treatment of equity and debt financing.

¹¹ See the Selected Issues paper by S. Basu, "Why Has Household Saving Increased So Sharply in Australia?"

in mid-2011 (Tables 6 and 7). Short-term debt (mostly issued by banks) has also declined, but remains sizable at 42 percent of GDP (on a residual maturity basis). Funding from European banks was just over US\$300 billion at end 2010, about ¼ of gross external debt. If offshore funding markets were disrupted, the cost of bank funding would likely rise.

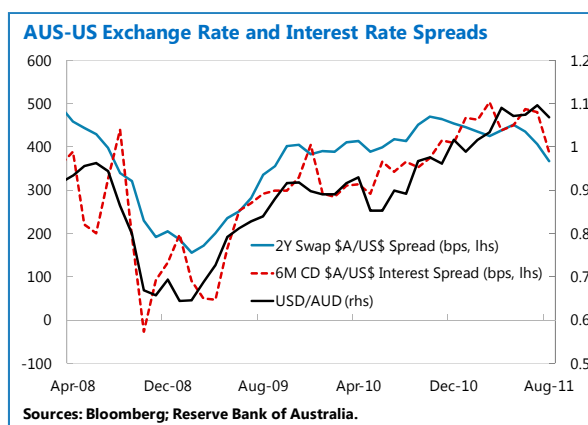
44. The flexible exchange rate, however, would provide a buffer to a funding shock. The Australian dollar would likely depreciate in response to such a shock which would provide a stimulus to the tradables sector and reduce the foreign exchange funding required to meet banks' desired Australian dollar funding.¹² Also, the relatively small foreign currency-denominated assets of the Australian banks means they have limited need for foreign currency funding. Widespread hedging mitigates the impact of a depreciation on bank balance sheets, with 44 percent of external debt denominated in Australian dollars and much of the remaining debt hedged. While the hedging involves counterparty risk, there were

¹²For example, if an Australian bank borrowed US\$100 million for three months and swapped it into Australian dollars at parity to achieve its desired funding in Australian dollars, a depreciation of the currency would reduce the amount it needed to borrow in U.S. dollar terms to rollover the loan. If the exchange rate depreciated by 10 percent, it would only need to borrow US\$90 million to achieve its desired Australian dollar funding of \$A 100 million.

no sizable problems in settling contracts during the market turmoil in 2008/09.

45. Despite the factors mitigating the risks, staff recommended that the authorities encourage banks to reduce further their exposure to short-term external debt. APRA could consider the merits of introducing measures along the lines of the Net Stable Funding Ratio requirement ahead of the 2018 schedule being discussed by the Basel Committee. In addition, the proposed legislation to allow Australian banks to issue covered bonds would help increase the share of long-term funding.

46. The Australian dollar is free-floating, but staff analysis suggests that it is overvalued by 10–20 percent, from a medium-term perspective (Box 5). However, these estimates are subject to substantial uncertainty. Part of the overvaluation reflects higher policy interest rates in Australia than elsewhere (text figure) and may dissipate over time with eventual tightening by major central banks. Consensus forecasts for the Australian dollar show a depreciation of



6½ percent against the U.S. dollar over the next two years, one of the largest depreciations expected for a major currency. Such a depreciation would reduce the widening of the current account deficit and the associated increase in net external liabilities.

The Authorities' views

47. The authorities noted that while the projected widening of the current account deficit reflects increased national investment, it is prudent to take measures to boost national savings. The planned improvement in public saving and the gradual increase in compulsory superannuation contributions should help on this front. In their view, future current account deficits should be sustainable, in part reflecting the fact that major investment projects in mining are being funded by multinationals with strong balance sheets and low debt/equity ratios. The authorities noted that banks had already reduced their exposure to short-term borrowing and are well positioned to weather any future turbulence in offshore funding. The authorities agreed on the importance of ensuring sustainability in relation to bank funding. As the Basel III Net Stable Funding Requirement remains under development within the Basel Committee on Banking Supervision and is subject to an extended observation period that will commence in 2012, the authorities consider it premature to commit to a particular implementation timetable at this stage.

Box 5. Australia’s Equilibrium Real Effective Exchange Rate

Staff estimates suggest an overvaluation of the Australian real effective exchange rate by 10–20 percent from a medium-term perspective. The estimates, however, are subject to considerable uncertainty, as shown by the wide range of the confidence intervals (text figure). They are based on the macroeconomic balance (MB) approach, the equilibrium real exchange rate (ERER) approach, and the external sustainability (ES) approach. The value of the currency has been boosted recently by cyclical influences that are reflected in unusually wide interest rate differentials between Australia and most other advanced economies.¹

The MB approach estimates the current account deficit norm at 4.6 percent of GDP. The projected current account deficit is above this norm, implying an overvaluation of about 11 percent.

The ERER estimates suggest an overvaluation slightly higher than the MB approach. The model estimates the equilibrium REER based on projections for the terms of trade, relative productivity, and relative government consumption. The equation suggests that in August 2011, the REER was overvalued by 16 percent.

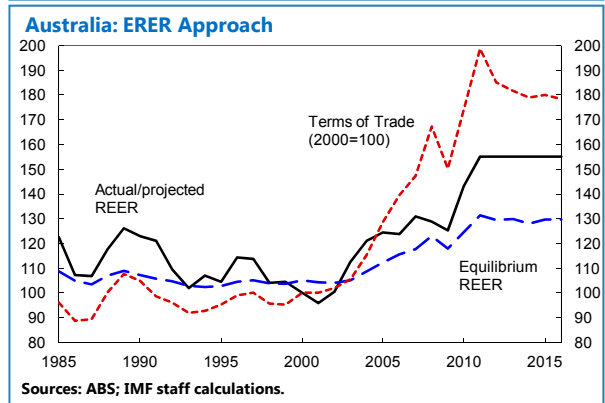
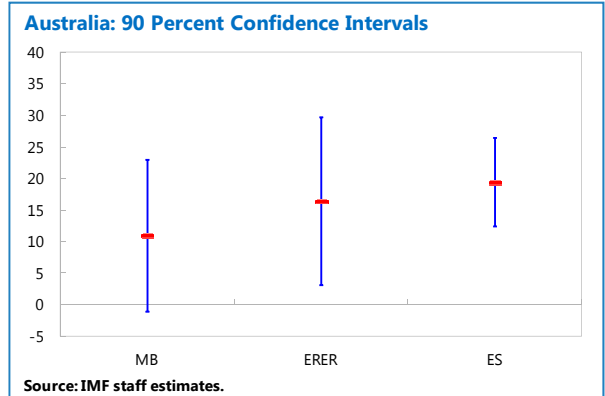
The ES approach implies an overvaluation in line with the ERER approach, assuming that net foreign liabilities (NFL) stabilize at the 10-year average of 55 percent of GDP.

¹ Interest rate differentials are not included in the estimates of the fundamentals.

Exchange Rate Assessment: Baseline Results (In percent)

	Current Account/GDP		REER
	Norm	Projection 1/	Overvaluation
Macroeconomic balance 2/	-4.6	-6.3	11.0
Equilibrium real exchange rate 3/	...	...	16.4
External sustainability 4/	-3.3	-6.3	19.4

Sources: IMF staff estimates.
 1/ Staff projection of the underlying CA/GDP in 2016.
 2/ Based on semi-elasticity of CA/GDP with respect to the REER of -0.16.
 3/ Overvaluation is assessed relative to August 2011.
 4/ NFL stabilizing at 55 percent of GDP, assuming a nominal GDP growth rate of 5.7 percent and that a 10 percent depreciation would decrease NFL by 3 percent through valuation effects.



STAFF APPRAISAL

48. Although recent global market volatility has increased uncertainty about the economic outlook, strong commodity demand from emerging Asia underpins Australia's favorable economic prospects.

While the mining boom is expected to be long-lasting, there may be large swings in commodity demand that will require a macroeconomic policy response. The risks to the staff's growth projections are tilted to the downside because of concerns about the global outlook. In addition, a fall in house prices could hurt consumer confidence. On the upside, the mining boom may have a larger-than-expected impact on growth and inflation.

49. Macroeconomic stimulus is being appropriately removed as the recovery continues. The RBA has paced monetary policy tightening well, which has helped anchor medium-term inflation expectations. Inflation pressures are emerging, however, as capacity constraints are being reached. If the recovery remains on track, a further tightening of monetary policy is likely to be required to contain inflation. The government's commitment to return the Commonwealth budget back to surplus in 2012/13 is welcome as it will strengthen fiscal buffers and should take some pressure off monetary policy and the exchange rate.

50. If global financial markets become severely disrupted or world growth falters,

macroeconomic policy is well positioned to respond. The free-floating exchange rate provides an important buffer to external shocks and the RBA has ample scope to cut policy interest rates. There is also fiscal space to delay the return to a surplus and, if needed, to take temporary discretionary measures, given the low level of government net debt.

51. Over the medium term, the government should grasp the opportunity provided by the mining boom to strengthen fiscal buffers further. A budget surplus of more than 1 percent of GDP should be targeted, on average, for the period beyond 2013/14, while the mining boom supports growth. A reduction in government debt and build up of public funds would give fiscal policy the flexibility needed to respond to larger shocks and deal with the long-term pressures from aging and rising health care costs.

52. Tax and structural reforms are required to make the most of the mining boom. Reforms should build a more flexible economy that encourages labor force participation and facilitates the movement of labor and capital across industries and regions. Inefficient taxes such as state stamp duties on house sales, that discourage worker mobility, should be eliminated. Also, further steps are needed to reduce effective marginal income tax rates to improve work incentives. Business

tax reform would also encourage investment. Options to raise revenue to fund these reforms include greater reliance on consumption and land taxes, and a broadening of the proposed minerals resource rent tax. Other reforms, including in the areas of education, infrastructure, and business regulation would enhance the economy's capacity to adjust to the structural changes taking place.

53. While banks remain sound, the authorities should continue to emphasize intensive supervision, as banks may be tempted to take on riskier strategies in an environment of structurally lower credit growth. We support APRA's plans to undertake stress tests incorporating disruptions to funding markets. The authorities should also consider the merits of higher capital requirements in the context of discussions in the Financial Stability Board and encourage

banks to reduce further their short-term external debt.

54. The projected widening of the current account deficit presents some risks.

Deficits, however, should be manageable as they reflect, in large part, an increase in private investment in the export sector. A projected decline in national saving also contributes to the widening of the deficit, which underlines the need for fiscal consolidation.

55. The exchange rate is overvalued by 10–20 percent, from a medium-term perspective. However, part of the overvaluation may dissipate over time with the eventual tightening of policy rates by major central banks.

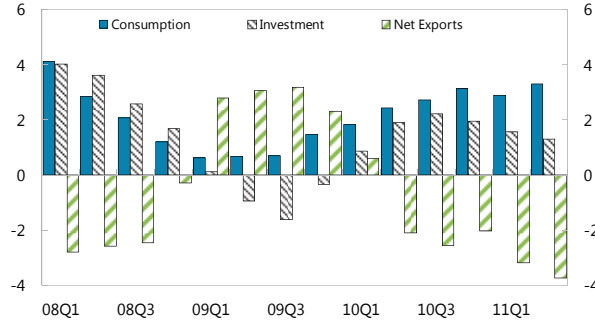
56. Staff recommends that the next Article IV consultation be held on the standard 12-month cycle.

Figure 1. Australia: A Recovery Driven by Commodities

Australia's recovery is on a solid footing...

Contribution to Growth

(Y/Y percent change)

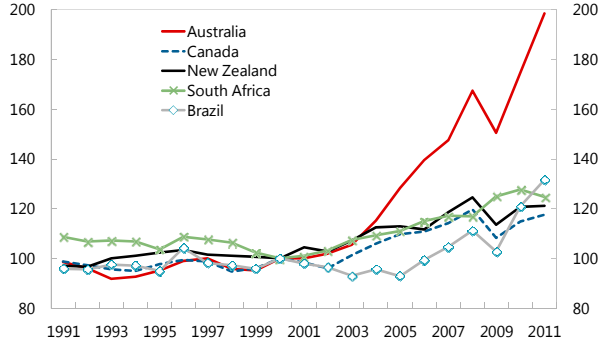


Source: Australian Bureau of Statistics.

...driven by exceptionally strong terms of trade...

Terms of Trade, Goods and Services

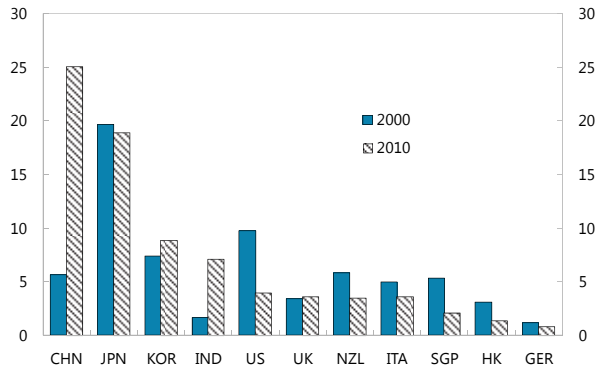
(2000 = 100)



...and growing links to Asia, especially China, where demand for commodities is strong.

Exports by Destination

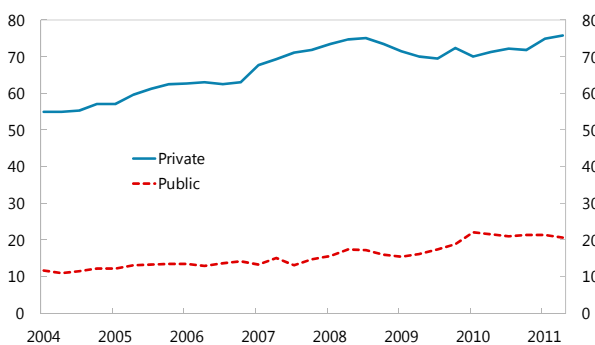
(In percent of total)



Private investment is picking up...

Capital Expenditure

(In billions of Australian dollars, SA)

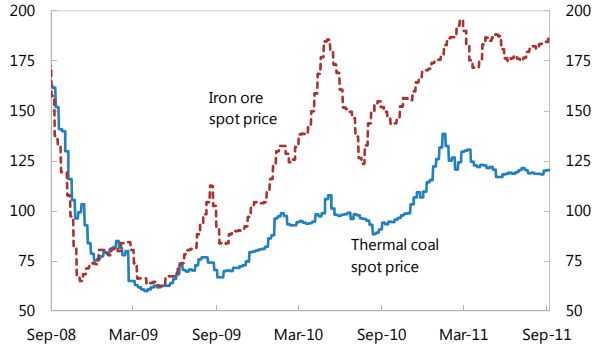


Source: Australian Bureau of Statistics.

Demand for Australia's two key commodity exports is driving price movements.

Commodity Prices

(U.S. dollar per ton)



...and companies in the mining sector are enjoying an increase in profits.

Business Profits

(In percent of GDP)

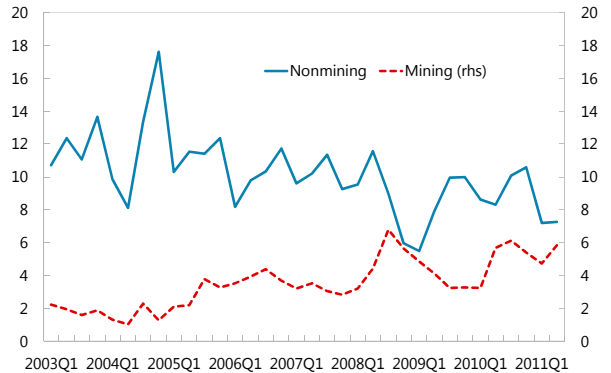
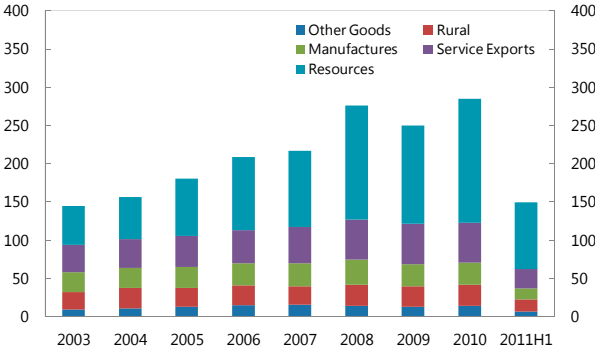


Figure 2. Australia: Trade and the Balance of Payments

The resources sector accounts for a rising share of exports...

Composition of Exports

(In billions of Australian dollars)

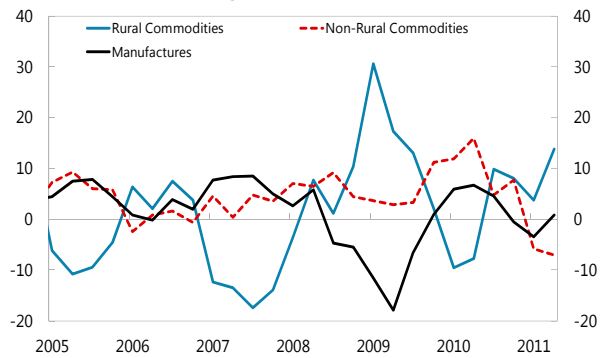


Sources: Australian Bureau of Statistics; Reserve Bank of Australia.

...despite a slowdown in mineral export volumes in early 2011...

Exports of Goods

(In real terms, Y/Y percent change)

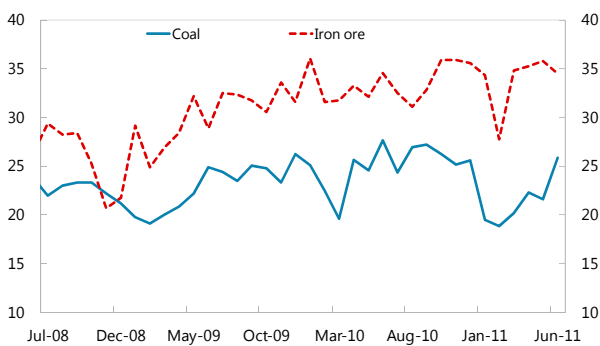


Source: Australian Bureau of Statistics.

... because of the impact of natural disasters on coal and iron ore exports.

Exports of Coal and Iron Ore

(In millions of tons)

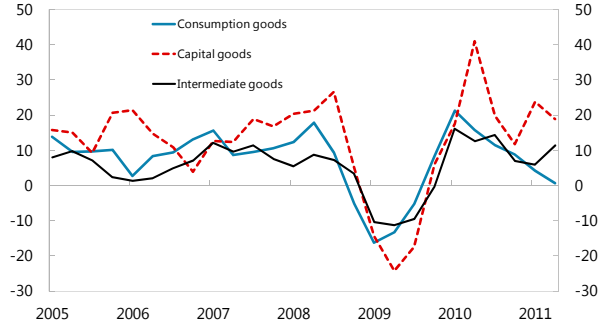


Source: Australian Bureau of Statistics.

Imports, especially of capital goods, have rebounded since the crisis.

Imports of Goods

(In real terms, Y/Y percent change)



Source: Australian Bureau of Statistics.

The current account deficit has narrowed...

Current Account Balance

(In percent of GDP)

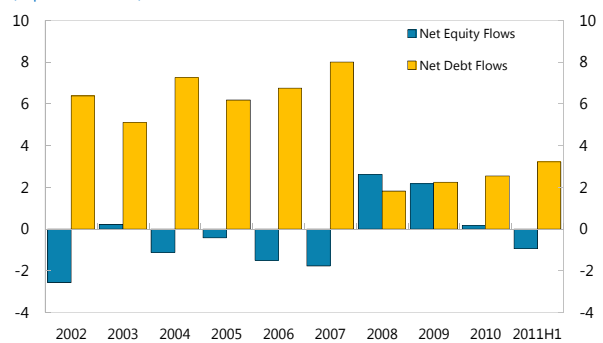


Sources: Australian Bureau of Statistics; and IMF staff estimates.

...while debt and equity inflows have slowed.

Net Capital Inflows

(In percent of GDP)



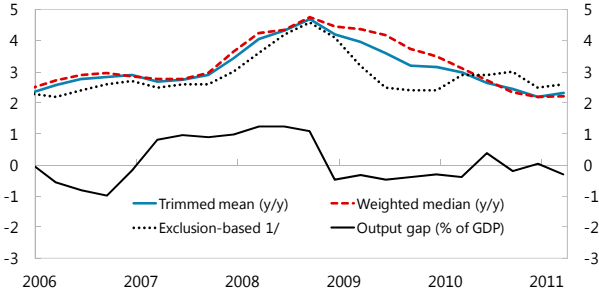
Source: Australian Bureau of Statistics.

Figure 3. Australia: Rising Inflationary Pressures

Underlying inflation has bottomed out with little spare capacity left...

Underlying Inflation and Output Gap

(In percentage points)

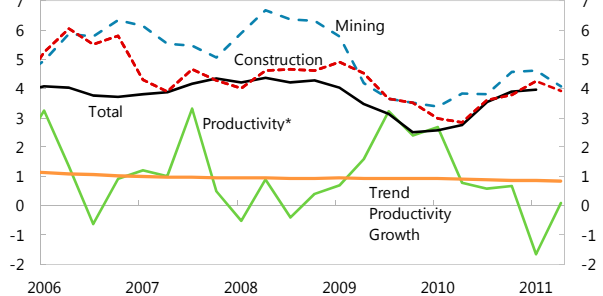


1/ Excludes fruit, vegetables, automotive fuel, and deposit & loan facilities.
Sources: Reserve Bank of Australia; IMF staff estimates.

...and wage growth is picking up.

Private Sector Wages and Productivity

(Percent change, y/y)

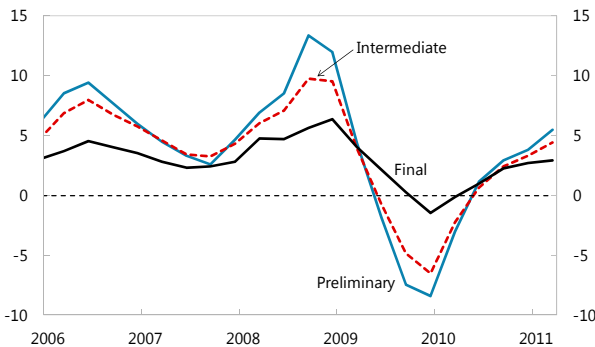


*Output per hour worked, market sector
Source: Australian Bureau of Statistics.

Producer price inflation is rising...

Producer Price Inflation

(By stage of production, y/y)

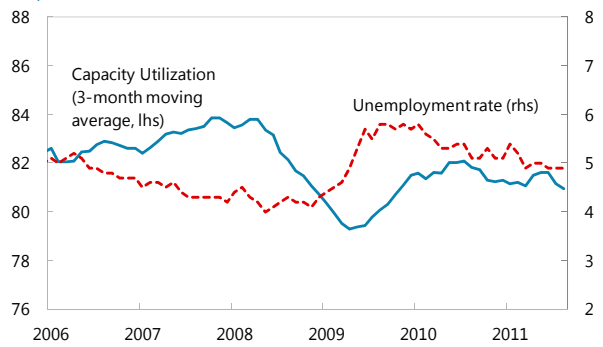


Source: Reserve Bank of Australia.

...and labor markets are tightening.

Indicators of Resource Pressure

(In percent)

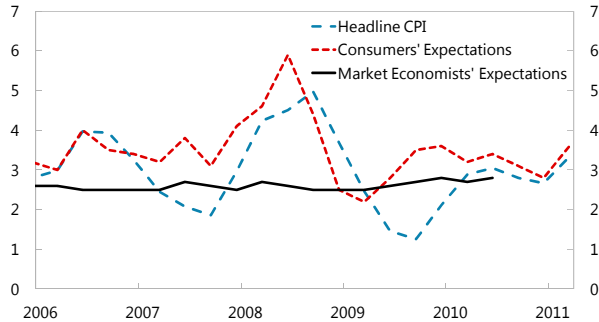


Sources: ABS and National Australia Bank.

Headline and expected inflation rose...

CPI Inflation

(Percent change, y/y)

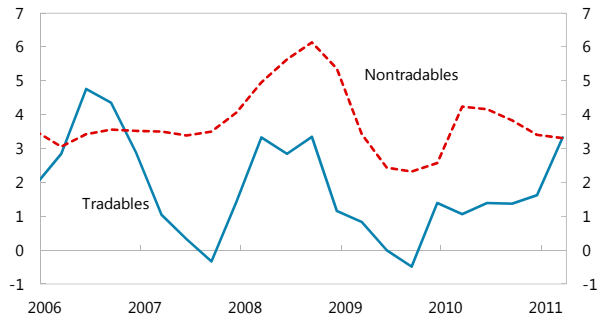


Sources: RBA; ABS; Melbourne Institute.

...as tradables and nontradables inflation increased.

CPI Inflation

(Percent change, y/y)

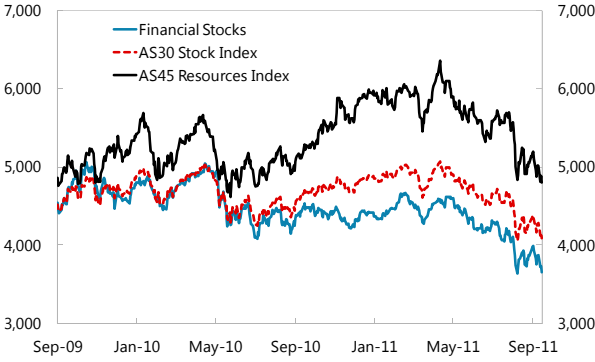


Sources: Australian Bureau of Statistics.

Figure 4. Australia: Financial Market Indicators

Stock market indices have fallen in recent months.

Stock Market Indices

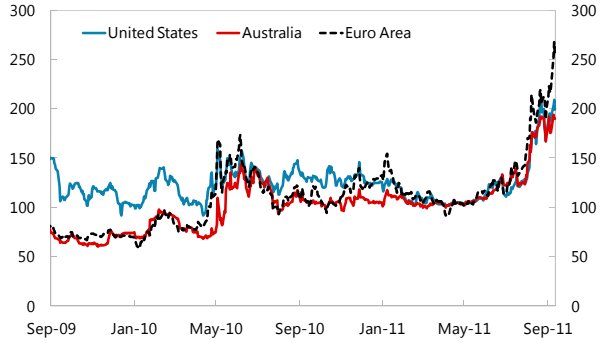


Source: Bloomberg.

Bank credit default swap spreads have risen, in line with the US and Europe.

Credit Default Swap (CDS) Spreads

(Five-year; average of four largest banks)

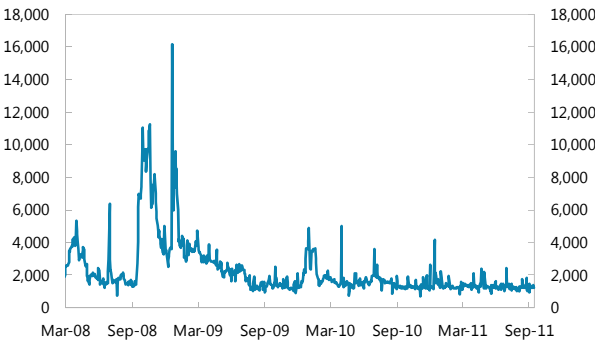


Sources: Reserve Bank of Australia; Bloomberg.

Exchange settlement balances at the RBA, an indicator of bank demand for cash, remains much lower than in early 2009.

Exchange Settlement Balances

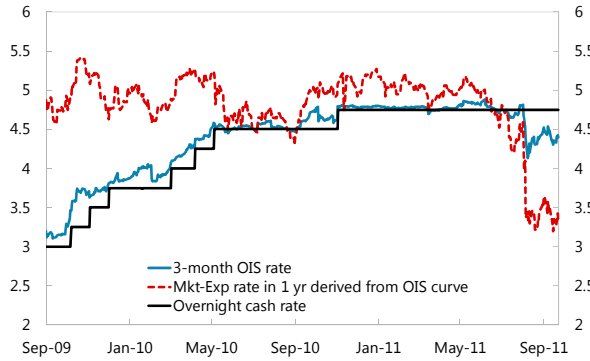
(In millions of Australian dollars)



Source: Reserve Bank of Australia.

The overnight index swap market expects a cut in the policy rate over the next year.

OIS, Cash Rate, and Market Expectations

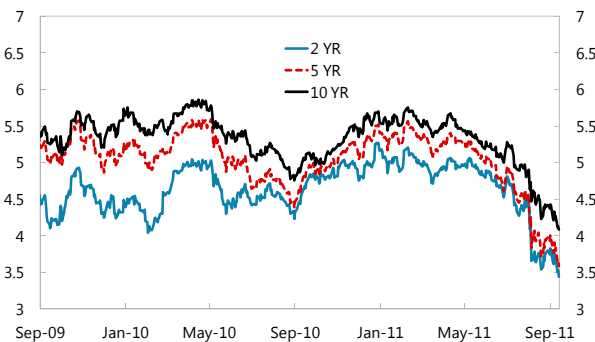


Sources: Bloomberg; and Credit Suisse.

Australian Commonwealth bond yields have fallen in recent months...

Australia Commonwealth Debt Yields

(In percent)

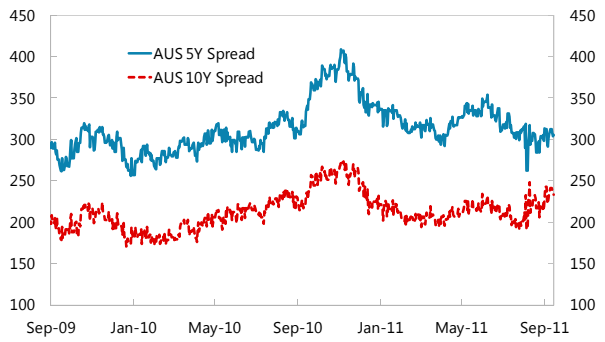


Source: Bloomberg.

...and Australian Commonwealth bond spreads have narrowed since the end of last year relative to U.S. yields.

Australia Sovereign Spreads

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

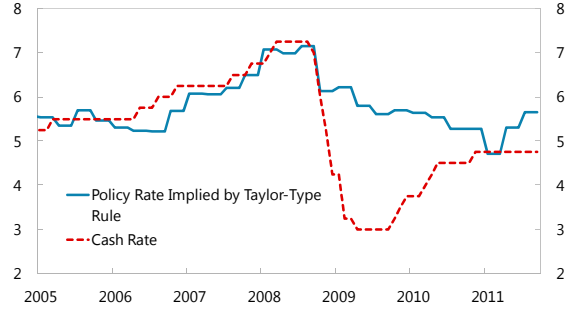


Source: Bloomberg.

Figure 5. Australia: A Mildly Restrictive Monetary Stance

The policy rate is close to that implied by a Taylor Rule.

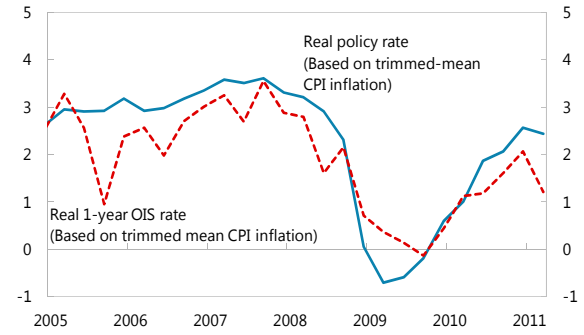
Policy Rates
(In percent)



Sources: Reserve Bank of Australia; IMF staff estimates.

The real policy rate stabilized below its historical average.

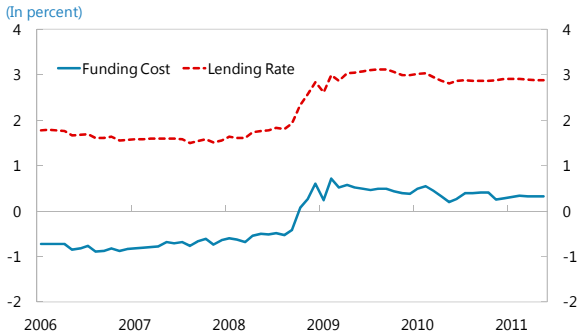
Real Interest Rates
(In percent)



Sources: RBA; Melbourne Institute; Bloomberg; and IMF staff estimates.

However, higher bank funding costs (relative to the policy rate) have pushed up lending rates.

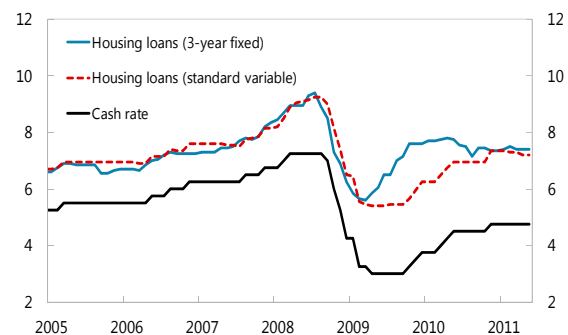
Major Banks' Lending Rates and Funding Costs Spread to Cash Rate
(In percent)



Source: Reserve Bank of Australia.

Mortgage rates have risen with the policy rate.

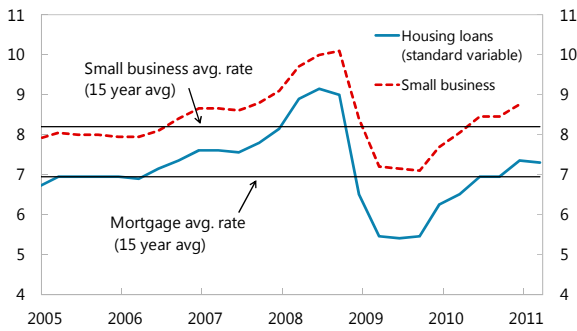
Mortgage Interest Rates
(In percent)



Source: Reserve Bank of Australia.

Lending rates moved above historical averages...

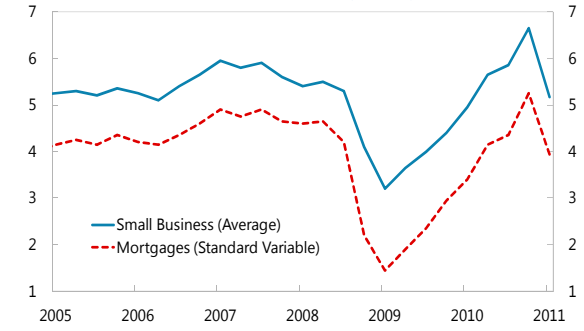
Mortgages and Business Lending Rates
(In percent)



Source: Reserve Bank of Australia.

...as have real lending rates.

Real Lending Interest Rate
(In percent, based on trimmed-mean CPI inflation; year-on-year)



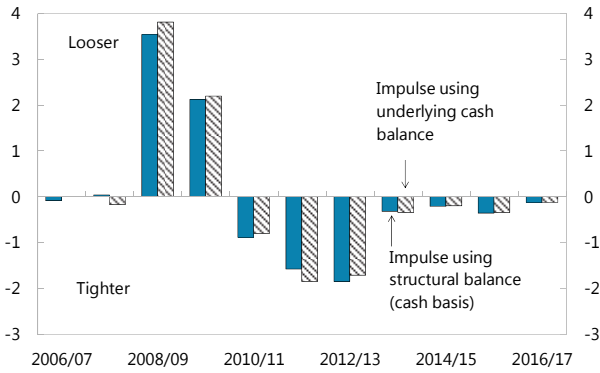
Source: Reserve Bank of Australia.

Figure 6. Australia: On the Path to Consolidation

Three consecutive years of fiscal consolidation...

Commonwealth Government Fiscal Impulse

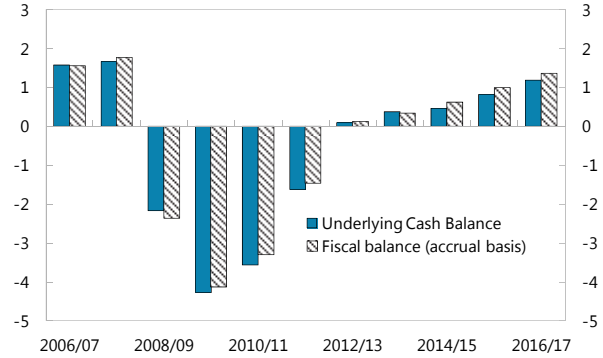
(In percent of GDP)



...is expected to return the budget to surplus in 2012/13...

Commonwealth Government

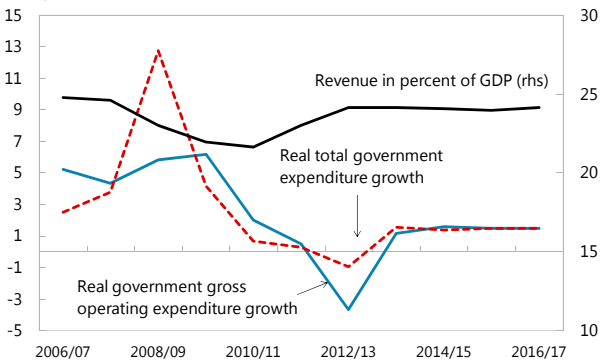
(In percent of GDP)



...mainly through restraint in expenditure growth and fiscal drag.

Commonwealth Revenue and Expenditure

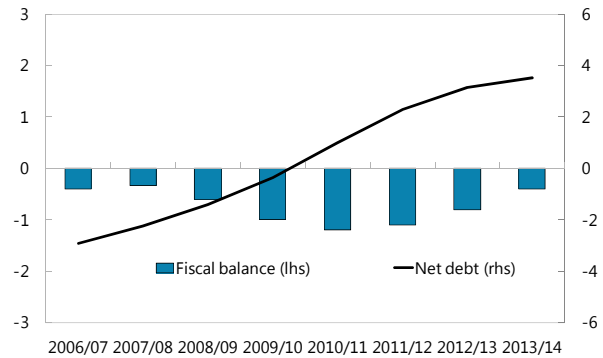
(Y/Y growth, in percent)



State deficits are projected to decrease in the next few years.

State/Local Governments

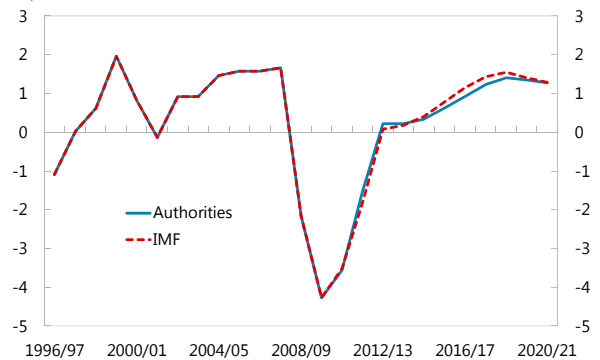
(In percent of GDP)



Budget surpluses are projected to increase gradually to about 1 percent of GDP over the medium term...

Underlying Cash Balance - Commonwealth Government

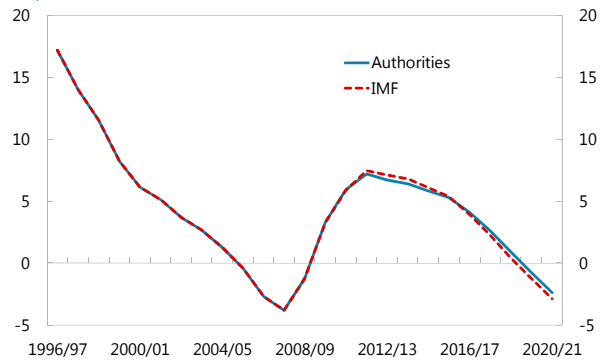
(In percent of GDP)



...while net debt is projected to peak at about 7 percent in 2011/12.

Net Debt - Commonwealth Government

(In percent of GDP)



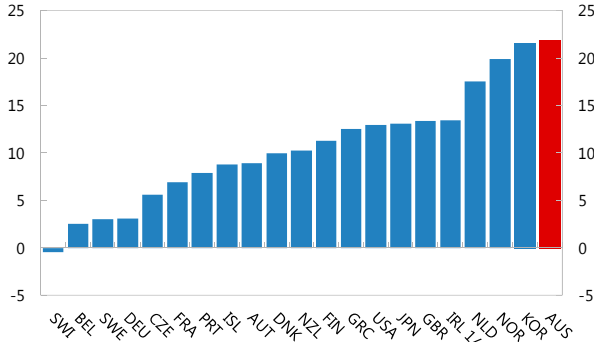
Sources: Australian Bureau of Statistics; and IMF staff estimates and projections.

Figure 7. Australia: Comparison of Fiscal Outlook

After a period of high real expenditure growth...

Change in Real Expenditure Per Capita, 2005-10

(In percent; general government)

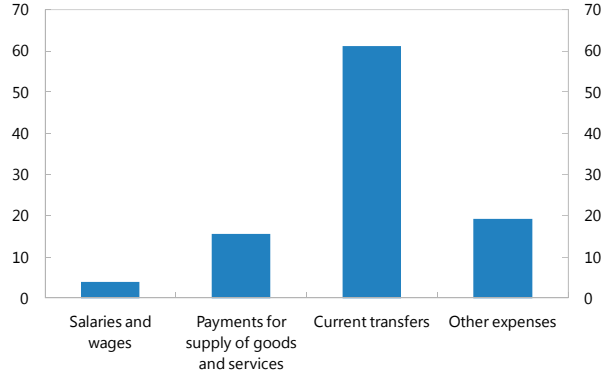


1/ Excluding bank support.

...driven mainly by current transfers...

Contribution to Expenditure Growth, 2005-2010

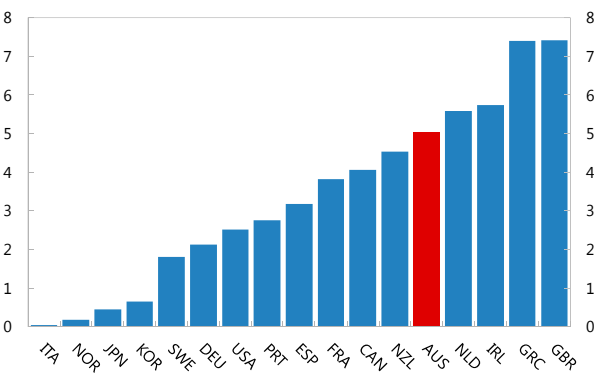
(In percent)



...consolidation is now faster than in most other advanced countries...

Change in Structural Balance, 2010-2016

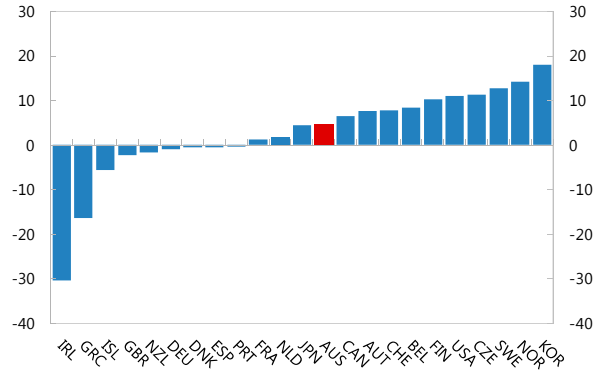
(In percent of GDP; general government)



...many of which will have higher expenditure growth...

Change in Real Expenditure, 2010-15

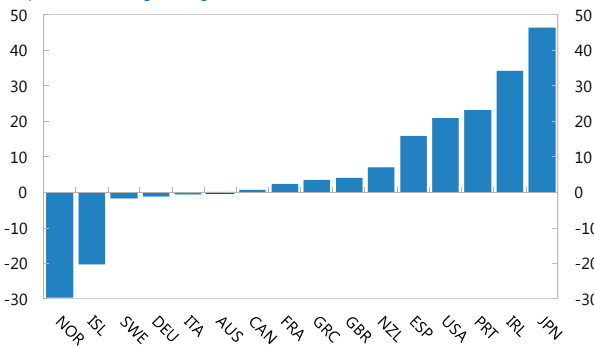
(In percent; general government)



General government net debt is forecast to remain stable over the medium term...

Change in Net Debt, 2010-16

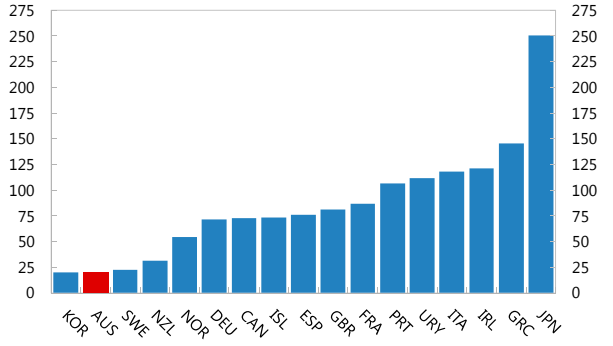
(In percent of GDP; general government)



...and gross debt is projected to continue to be among the lowest in advanced economies.

General Government Gross Debt, 2016

(In percent of GDP; general government)



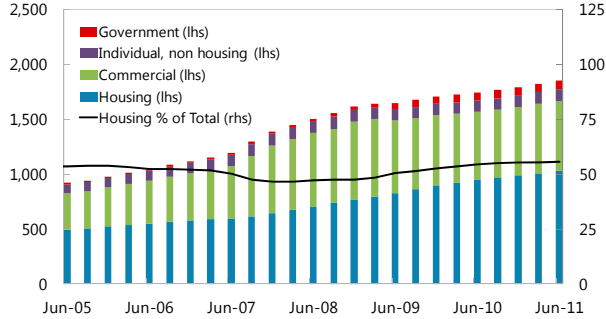
Sources: Australian Bureau of Statistics; and IMF staff estimates and projections.

Figure 8. Australia: Banking System Developments

Banks' assets consist predominantly of credit, with mortgage loans accounting for over half of total lending.

Banks' Lending Structure

(In billions of Australian dollars)

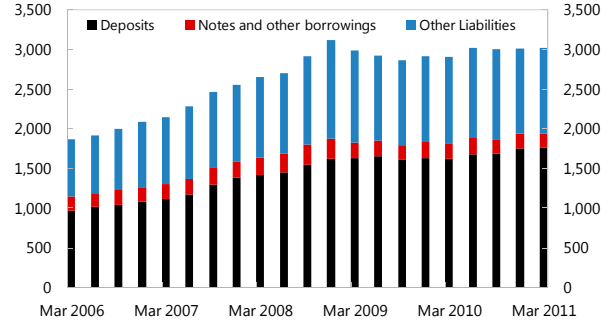


Source: Reserve Bank of Australia.

Banks' liabilities are mainly domestic deposits but wholesale funding remains sizable.

Banks' Liabilities Composition

(In billions of Australian dollars)

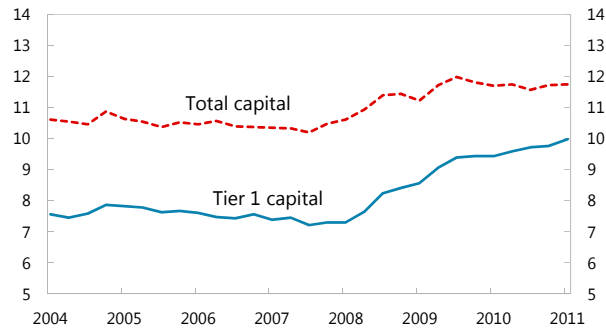


Source: Australia Prudential Regulation Authority.

Banks' Tier 1 capital has increased...

Capital Adequacy Ratios

(In percent)

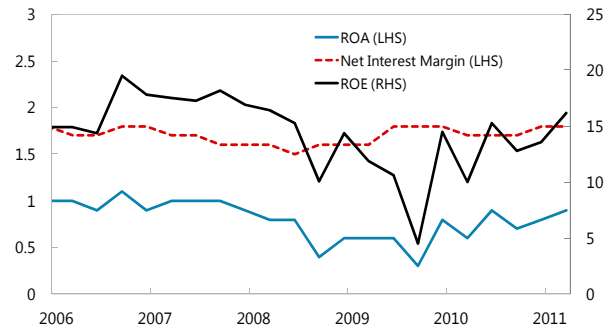


Sources: Reserve Bank of Australia; and Australia Prudential Regulation.

...profitability remains healthy...

Profitability

(After tax; in percent)

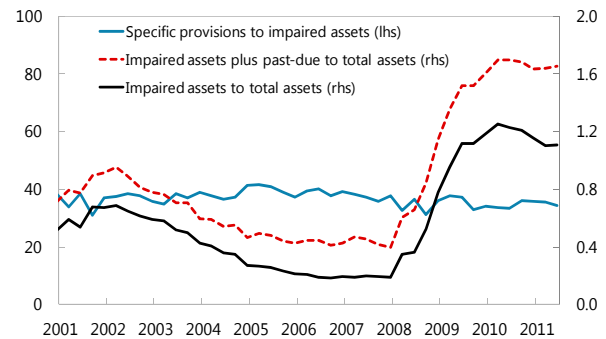


Source: Australia Prudential Regulation Authority.

...and impaired assets are low by international standards and appear to have peaked.

Asset Quality

(In percent)



Source: Reserve Bank of Australia.

With deposits growing faster than credit, banks' loans to deposit ratio fell.

Banks' Loans to Deposits Ratio

(In percent)

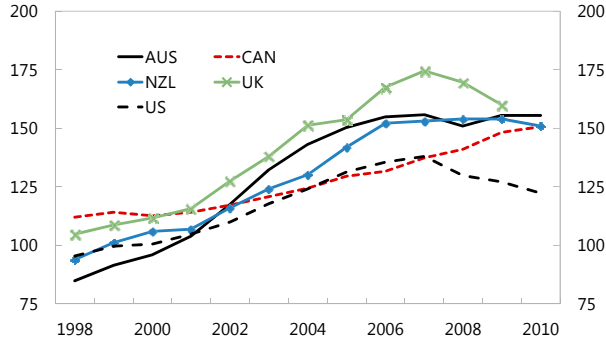


Source: Australia Prudential Regulation Authority.

Figure 9. Australia: Household Vulnerabilities

Household debt remains high...

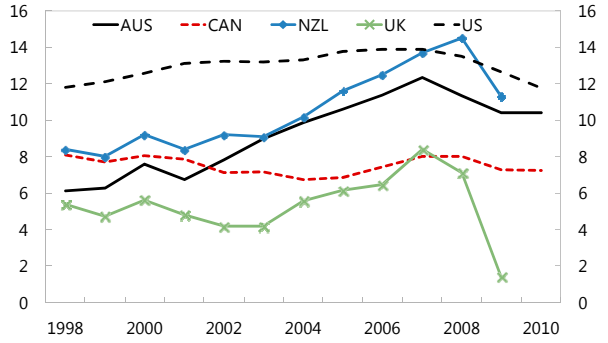
Household Debt to Disposable Income
(In percent)



Sources: RBA; RBNZ; Eurostat; Haver; and IMF staff calculations.

...although debt-servicing costs have declined during the global crisis.

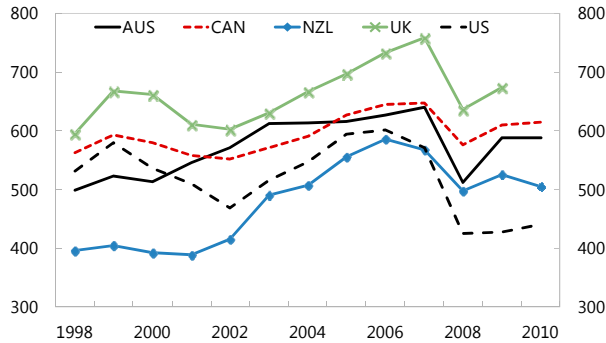
Household Interest Payments to Disposable Income
(In percent)



Sources: RBA; RBNZ; Eurostat; Haver; and IMF staff calculations.

Household net wealth has fallen since the crisis...

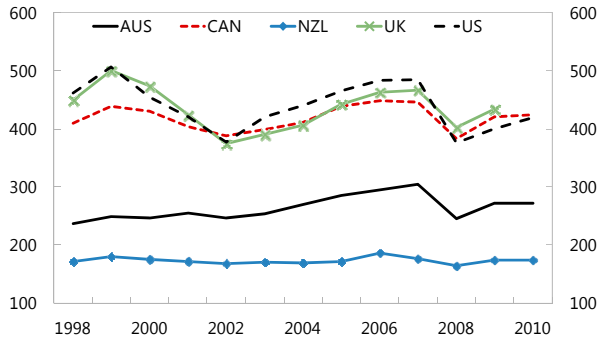
Net Wealth to Disposable Income
(In percent)



Sources: RBA; RBNZ; Eurostat; OECD; Haver; and IMF staff calculations.

...with financial wealth accounting for a relatively low share...

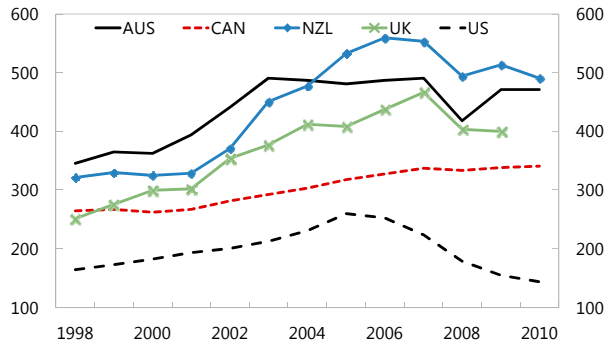
Financial Wealth to Disposable Income
(In percent)



Sources: RBA; RBNZ; Eurostat; Haver; and IMF staff calculations.

...and housing wealth for a large share.

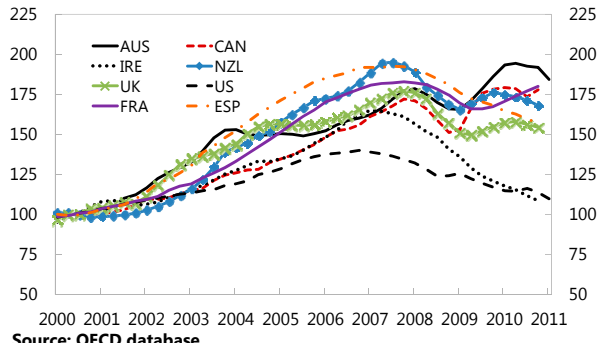
Housing Wealth to Disposable Income
(In percent)



Sources: RBA; RBNZ; Eurostat; OECD; Haver; and IMF staff calculations.

This leaves Australian households vulnerable to a possible unwinding of the large run-up in house prices.

Real House Prices
(2000 = 100)



Source: OECD database.

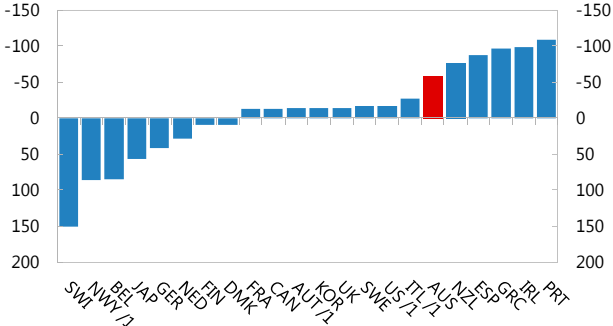
Note: For Australia, based on ABS house price measure.

Figure 10. Australia: External Vulnerability

Australia's net foreign liabilities are relatively high...

Net Foreign Investment Position, 2010

(In percent of GDP)

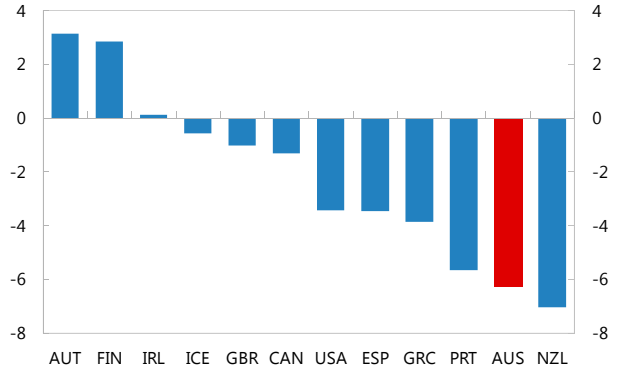


1/ 2009Q4 value.

...and its current account deficit is forecast to be larger than most advanced countries ...

Current Account Balance, 2016

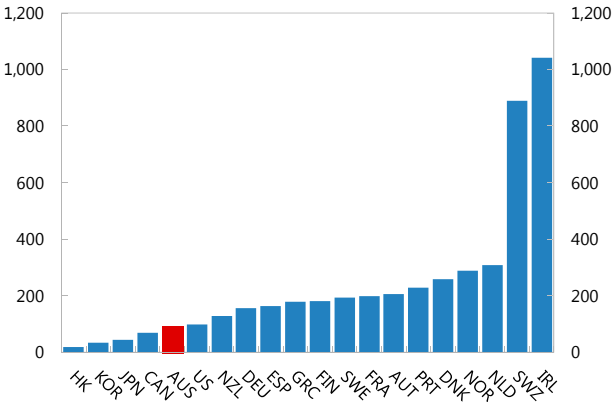
(In percent of GDP)



...but gross external debt is lower than in most other advanced countries.

Total External Debt, 2010

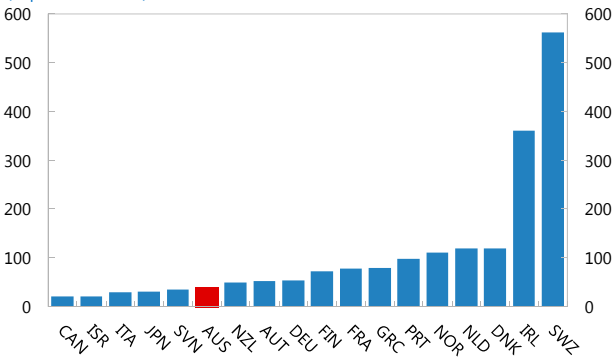
(In percent of GDP)



...and is less than in most other advanced countries, as a share of GDP...

Total Short-Term External Debt, 2010 1/

(In percent of GDP)

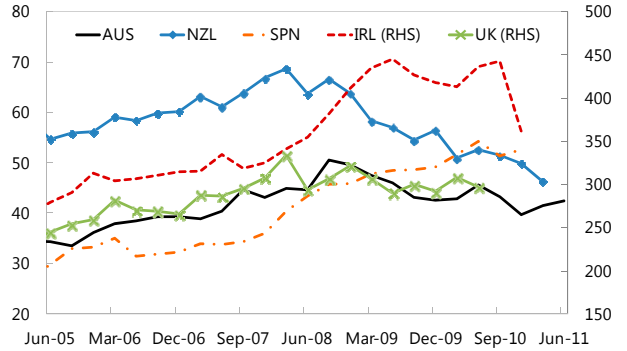


1/ Short-term debt is on a residual maturity basis for Australia and New Zealand and on an original maturity basis for other countries.

Short-term debt declined from its precrisis peak...

Total Short-Term External Debt 1/

(In percent of GDP)

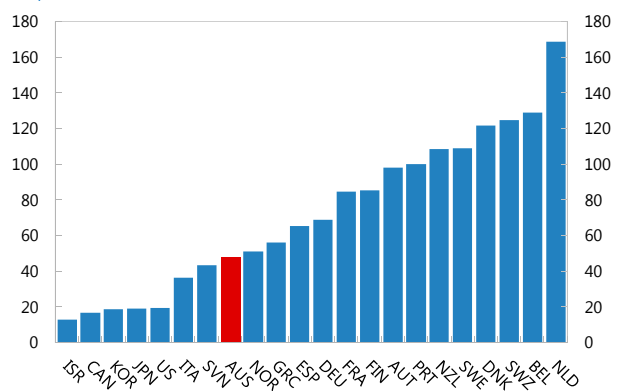


1/ Short-term debt is on a residual maturity basis for Australia and New Zealand and on an original maturity basis for other countries.

...and bank debt is lower than in most other advanced economies.

Bank Gross External Debt, 2010

(In percent of GDP)



Sources: ABS; IFS; WEO; Haver Analytics; EconData; WB-IMF-BIS-OECD Joint External Debt Hub; and IMF staff estimates.

Table 1. Australia: Selected Economic Indicators, 2008–12

Nominal GDP (2010): \$A 1,346 billion
 GDP per capita (2010): US\$55,332
 Unemployment rate (August 2011): 5.3 percent
 Main exports: Metal ores and minerals; tourism, coal and coke (fuel)
 ODA (2009-10): 0.3 percent of GDP

Quota (in millions): SDR 3,236.40
 Population (2010) December: 22.5 million

	2008	2009	2010	2011	2012
				Proj	
Output and demand (percent change)					
Real GDP	2.6	1.4	2.7	1.8	3.3
Total domestic demand	3.5	-0.7	4.2	4.4	3.9
Private consumption	1.9	1.0	2.8	3.1	2.3
Total investment	7.9	-3.2	5.8	5.6	9.0
Net exports 1/	-1.5	2.7	-1.6	-2.8	-0.7
Inflation and unemployment (in percent)					
CPI inflation	4.4	1.8	2.8	3.5	3.3
Unemployment rate	4.3	5.6	5.2	5.0	4.8
Saving and investment (in percent of GDP)					
Gross national saving	25.1	23.6	24.9	25.7	24.7
General government saving	3.6	-0.7	-0.3	2.3	3.7
Private saving 2/	21.5	24.4	25.2	23.4	20.9
Gross capital formation	29.5	27.9	27.6	27.9	29.3
Fiscal indicators (cash basis, in percent of GDP) 3/					
Receipts	24.6	23.0	22.0	21.6	23.0
Payments	22.9	25.2	26.2	25.1	24.8
Underlying cash balance	1.7	-2.2	-4.3	-3.5	-1.8
Net debt	-3.8	-1.3	3.3	5.9	7.5
Money and credit (end of period)					
Interest rate (90-day bill, in percent) 4/	4.1	4.2	5.0	5.0	...
Treasury bond yield (10-year, in percent) 4/	4.0	5.6	5.5	4.8	...
M3 (percent change) 4/	14.8	5.8	10.3	11.3	...
Private domestic credit (percent change) 4/	7.6	1.1	2.8	3.3	...
Balance of payments (in percent of GDP)					
Current account	-4.5	-4.2	-2.7	-2.2	-4.7
Terms of trade (percent change)					
	13.0	-9.9	16.3	13.6	-6.8
External assets and liabilities (in percent of GDP)					
Net external liabilities	56.9	61.9	57.0	55.6	57.9
Net external debt	55.5	52.7	47.9	47.7	49.4
Gross official reserves 4/	3.8	3.7	3.1	2.8	...
Net official reserves 4/	3.9	3.7	3.1	2.8	...
Exchange rate (period average) 4/					
Exchange rate regime					
U.S. dollar/Australian dollar	0.85	0.79	0.92	1.08	...
Trade-weighted index	66.3	63.2	70.9	77.7	...
Nominal effective exchange rate 5/	102.5	98.1	111.6	119.7	...
Real effective exchange rate 5/	103.6	100.7	115.3	123.8	...
Memorandum Item:					
Nominal GDP (in billions of Australian dollar)	1,240	1,247	1,346	1,438	1,501

Sources: Data provided by the Australian authorities; and IMF staff estimates and projections, including the estimated impact of the *Clean Energy Future* package from 2011/12.

1/ Contribution to growth.

2/ Includes public trading enterprises.

3/ Fiscal year ending June 30, Commonwealth Budget. For example, 2011 refers to fiscal year July 1, 2010 to June 30, 2011 which the Australian Government's budget papers denote as budget year 2010.

4/ Data for 2011 are for latest available month.

5/ IMF, Information Notice System index (2005 = 100).

Table 2. Australia: Medium-Term Scenario, 2008–16

	Average	2008	2009	2010	Projections					
	1998–2007				2011	2012	2013	2014	2015	2016
Real economic indicators (percent change)										
GDP	3.7	2.6	1.4	2.7	1.8	3.3	3.4	3.3	3.3	3.3
Total domestic demand	4.8	3.5	-0.7	4.2	4.4	3.9	3.7	3.2	3.3	3.3
Private consumption	4.2	1.9	1.0	2.8	3.1	2.3	2.8	2.9	2.8	2.8
Government consumption	3.2	3.2	1.6	3.6	3.2	0.3	1.3	1.3	1.7	1.6
Total investment	6.5	7.9	-3.2	5.8	5.6	9.0	6.7	4.8	5.0	4.9
Private sector	11.5	5.9	-4.4	0.7	8.3	11.5	8.8	6.2	5.8	5.7
Business	8.7	9.7	-5.2	0.0	11.8	15.3	10.7	7.0	6.5	6.4
Dwelling	3.9	2.1	-4.2	4.2	2.7	2.5	3.5	3.4	3.3	3.4
Stockbuilding	0.7	-0.3	-0.4	0.4	0.6	0.0	0.0	0.0	0.0	0.0
Public sector	3.6	17.8	2.4	27.0	-3.2	-0.4	-1.9	-1.3	1.2	0.9
Net exports 1/	-0.7	-1.5	2.7	-1.6	-2.8	-0.7	-0.4	0.0	-0.1	-0.1
Potential growth	3.5	2.7	2.6	2.5	1.8	3.0	3.5	3.4	3.3	3.3
Output gap	0.1	0.8	-0.3	-0.2	-0.2	0.1	0.1	0.0	-0.1	0.0
CPI inflation	2.8	4.4	1.8	2.8	3.5	3.3	3.5	3.0	2.9	2.6
Unemployment rate (percent)	6.0	4.3	5.6	5.2	5.0	4.8	4.8	4.7	4.7	4.7
Saving and investment (percent of GDP)										
Gross national saving	21.6	25.1	23.6	24.9	25.7	24.7	24.4	24.1	23.6	23.6
General government saving	4.1	3.6	-0.7	-0.3	2.3	3.7	5.3	5.1	5.1	5.3
Private saving 2/	17.5	21.5	24.4	25.2	23.4	20.9	19.1	19.0	18.5	18.2
Of which: Household	6.4	8.6	11.5	10.8	11.7	10.4	9.9	9.0	8.5	7.8
Gross capital formation	26.3	29.5	27.9	27.6	27.9	29.3	29.8	29.8	29.8	29.9
Of which: Private fixed investment	21.4	24.7	23.2	21.1	21.3	23.0	23.8	24.1	24.4	24.6
Commonwealth budget (percent of GDP) 3/										
Receipts (cash basis)	25.0	24.6	23.0	22.0	21.6	23.0	24.1	24.2	24.1	24.0
Payments (cash basis)	24.0	22.9	25.2	26.2	25.1	24.8	24.1	24.0	23.7	23.2
Underlying cash balance 4/	1.0	1.7	-2.2	-4.3	-3.5	-1.8	0.1	0.2	0.4	0.8
Net debt	5.0	-3.8	-1.3	3.3	5.9	7.5	7.1	6.8	6.1	5.4
Balance of payments (percent of GDP)										
Balance on goods and services	-1.6	-0.7	-0.3	1.2	1.6	-0.4	-0.9	-1.1	-1.0	-1.1
Balance on income and transfers	-3.2	-3.8	-3.9	-3.9	-3.7	-4.3	-4.5	-4.5	-5.2	-5.2
Current account balance	-4.8	-4.5	-4.2	-2.7	-2.2	-4.7	-5.4	-5.7	-6.1	-6.3
Trade in goods and services (percent change)										
Export volume	2.9	4.7	2.7	5.6	-1.9	7.7	6.6	6.8	6.7	6.6
Import volume	8.3	11.5	-9.1	13.8	9.9	9.5	7.2	6.0	6.1	6.1
Terms of trade (level)	68.8	101.5	91.4	106.3	120.8	112.5	110.4	108.9	109.5	108.5
Terms of trade	4.1	13.0	-9.9	16.3	13.6	-6.8	-1.9	-1.4	0.5	-0.9
External liabilities										
Net external liabilities (percent of GDP)	52.2	56.9	61.9	57.0	55.6	57.9	60.0	62.3	64.9	67.7
Net external interest (percent of exports)	9.7	10.4	11.5	9.3	8.8	10.9	11.9	11.3	12.5	13.0
Net foreign debt	43.8	55.5	52.7	47.9	47.7	49.4	50.9	52.7	54.7	56.9
Memorandum items:										
Nominal GDP (in billions of Australian dollar)	833	1,240	1,247	1,346	1,438	1,501	1,593	1,688	1,790	1,892
Partner country GDP growth	4.5	2.9	-0.1	6.2	4.1	4.7	4.7	4.7	4.7	4.5
Real effective exchange rate (period average) 5/	89.6	103.6	100.7	115.3	123.8	...	...	...	...	...
U.S. dollar/Australian dollar	0.67	0.85	0.79	0.92	1.05	...	...	...	...	...
10-year government bond yield	5.7	5.5	5.2	5.3	4.9	6.2	6.5	6.5	6.5	6.5
90-day Aus rates (average)	5.5	6.7	3.5	4.8	5.0	5.3	5.3	5.3	5.3	5.3

Sources: Data provided by the Australian authorities; and IMF staff estimates and projections, including the estimated impact of the *Clean Energy Future* package from 2011/12.

1/ Contribution to growth.

2/ Includes public trading enterprises.

3/ Fiscal year basis ending June 30. For example, 2012 refers to fiscal year July 1, 2011 to June 30, 2012 which the Australian Government's budget papers denote as budget year 2011.

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

5/ Data for 2011 are for latest available month.

Table 3. Australia: Fiscal Accounts, 2007/08–2014/15 1/
(In percent of GDP)

	2007/08	2008/09	2009/10	Projections				
				2010/11	2011/12	2012/13	2013/14	2014/15
Statement of Operations 2/ (Fiscal accounts on an accrual basis)								
Commonwealth government								
Revenue	25.6	23.8	22.8	22.4	23.7	24.9	25.0	25.0
Taxes	24.1	22.2	20.9	20.9	22.3	23.5	23.7	23.8
Income tax	17.6	16.0	14.6	14.8	16.3	17.2	17.4	17.5
Individuals and other withholdings	10.6	9.3	9.6	9.8	10.2	10.7	11.0	11.2
Indirect and other tax	6.5	6.2	6.3	6.1	6.0	6.3	6.3	6.3
Of which: Carbon price	...	...	...	...	0.0	0.3	0.4	0.4
Nontax	1.5	1.6	1.9	1.5	1.4	1.4	1.3	1.2
Expenditure	23.8	26.2	26.9	25.6	25.4	24.7	24.9	24.5
Expense	23.6	25.9	26.4	25.2	25.1	24.8	24.8	24.3
Compensation of employees	1.3	1.3	1.2	1.3	1.3	1.2	1.2	1.1
Use of goods and services	4.4	4.6	4.9	4.8	4.8	4.5	4.5	4.5
Current transfers	15.5	16.7	17.1	15.7	15.9	16.0	16.2	16.2
Of which: Carbon price	...	...	...	...	0.2	0.2	0.5	0.4
Other expenses	2.5	3.3	3.1	3.4	3.2	3.0	2.9	2.5
Net acquisition of nonfinancial assets	0.2	0.3	0.5	0.4	0.3	-0.1	0.2	0.2
Operating balance	2.0	-2.1	-3.6	-2.8	-1.4	0.1	0.3	0.7
Net lending (+) / borrowing (-) 3/	1.8	-2.4	-4.1	-3.2	-1.7	0.2	0.1	0.5
State, territory, and local government balance	-0.3	-0.6	-1.0	-1.2	-1.1	-0.8	-0.4	...
Public nonfinancial corporations balance 4/	-1.1	-1.6	-1.2	-1.1	-1.2	...	...	...
Nonfinancial public sector balance	0.3	-5.0	-6.5	-6.0	-4.1	...	...	...
Statement of Source and Uses of Cash (Fiscal accounts on a cash basis)								
Commonwealth government								
Receipts 5/	24.6	23.0	22.0	21.6	23.0	24.1	24.2	24.1
Of which: Taxes	23.5	21.7	20.3	20.8	22.1	22.6	22.9	22.9
Of which: Carbon price related	...	...	...	0.0	0.0	0.1	0.2	0.2
Payments	22.9	25.2	26.2	25.1	24.8	24.1	24.0	23.7
Of which: Carbon price related	...	...	...	0.0	0.2	0.1	0.3	0.2
Future Fund earnings	0.3	0.3	0.2	0.2	0.2	0.2	0.2	0.2
Underlying cash balance 6/	1.7	-2.2	-4.3	-3.5	-1.8	0.1	0.2	0.4
Consolidated general government (Commonwealth and States/Local)								
Receipts 5/	34.8	33.3	32.7	32.1	33.7	34.7	34.2	34.1
Payments	33.5	36.1	37.9	36.9	36.8	35.4	34.5	34.2
Future Fund earnings	0.3	0.3	0.2	0.2	0.2	0.2	0.2	0.2
Underlying cash balance 6/	1.4	-2.8	-5.2	-4.7	-3.1	-0.7	-0.3	0.0
Memorandum items:								
Commonwealth government net debt 7/	-3.8	-1.3	3.3	5.9	7.5	7.1	6.8	6.1
Consolidated general government net debt	-7.3	-3.5	2.3	6.3	9.1	9.5	9.2	8.3
Consolidated general government gross debt	9.7	14.0	19.2	21.9	23.8	23.5	22.4	20.9
Nominal GDP (in billions of Australian dollars)	1,186	1,255	1,285	1,391	1,471	1,549	1,642	1,735

Sources: Commonwealth of Australia 2011-12 Budget; and IMF staff estimates and projections, including the estimated impact of the *Clean Energy Future* package from 2011/12.

1/ Fiscal year ending June 30.

2/ Accrual data are reported on a consistent basis with *Government Finance Statistics (GFS)*.

3/ Net lending (+) / borrowing (-), i.e. the fiscal balance, is equal to revenue less expenditure.

4/ The consolidated Commonwealth, state, and local governments.

5/ Receipts exclude earnings of the Future Fund.

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

7/ Includes Future Fund assets that are kept in cash and debt instruments.

Table 4. Australia: Balance of Payments in U.S. Dollars, 2006–16
(In billions of U.S. dollars)

	2006	2007	2008	2009	2010	Projections					
						2011	2012	2013	2014	2015	2016
Current account balance	-41.6	-58.9	-47.3	-41.8	-33.1	-32.8	-73.5	-88.4	-96.0	-107.7	-114.0
Goods balance	-9.8	-17.3	-3.0	-2.7	18.1	33.0	5.8	-2.4	-6.7	-3.9	-6.6
Exports	124.5	142.5	191.2	156.3	213.6	277.1	291.4	285.6	311.9	319.3	332.1
Imports	-134.3	-159.8	-194.2	-159.0	-195.4	-244.0	-285.6	-288.0	-318.6	-323.2	-338.8
Net services	0.4	-0.6	-4.4	-0.4	-3.3	-9.4	-11.7	-12.7	-12.7	-12.8	-12.9
Total credits	32.8	39.7	44.7	41.7	48.2	54.7	61.0	65.5	70.4	75.5	81.0
Total debits	-32.4	-40.3	-49.1	-42.1	-51.5	-64.1	-72.7	-78.3	-83.1	-88.3	-93.9
Net income	-31.7	-40.9	-39.6	-37.7	-46.3	-54.8	-67.3	-73.0	-76.4	-90.7	-94.3
Of which: Net interest payments	-16.4	-22.4	-24.5	-22.8	-24.5	-29.1	-38.5	-41.7	-43.2	-49.3	-53.8
Of which: Net equity income	-14.8	-17.4	-13.8	-13.8	-20.3	-24.3	-28.9	-31.3	-33.3	-41.4	-40.5
Net transfers	-0.5	-0.1	-0.3	-1.0	-1.6	-1.7	-0.2	-0.2	-0.2	-0.2	-0.2
Capital and financial account	41.4	59.2	46.6	43.1	33.2	29.5	73.5	88.4	96.0	107.7	114.0
Capital account	0.2	-0.2	-0.4	-0.3	-0.3	-0.3	-0.4	-0.4	-0.4	-0.4	-0.4
Financial account	41.2	59.4	46.9	43.5	33.5	29.8	73.8	88.7	96.4	108.0	114.4
Direct investment transactions (net)	5.6	28.7	13.5	9.9	7.7	35.4	24.9	29.3	28.4	28.8	29.1
Equity (net)	-1.2	18.3	-1.4	20.4	10.2	...	...	...	...	...	...
Debt (net)	6.8	10.4	14.9	-10.4	-2.6	...	...	...	...	...	...
Portfolio investment transactions (net)	53.1	-20.8	29.5	78.4	70.5	19.0	50.4	53.8	50.0	54.2	52.4
Equity (net)	-10.7	-35.2	29.1	1.0	-8.2	...	...	...	...	...	...
Debt (net)	63.8	14.4	0.4	77.4	78.7	...	...	...	...	...	...
Financial derivatives (net)	0.7	-10.9	0.8	-5.2	-1.6	-17.4	-13.3	-14.3	-14.4	-14.4	-14.6
Other transactions (net)	-18.3	62.4	3.2	-39.6	-43.1	-7.2	11.7	19.9	32.4	39.4	47.5
Net errors and omissions	0.1	0.0	0.9	-1.1	-0.2	0.3	0.0	0.0	0.0	0.0	0.0
	(Assets and liabilities at end-period)										
Net external liabilities	460.8	560.9	488.5	692.6	780.6	846.6	901.6	969.6	1044.9	1126.7	1213.9
Net external equity liabilities	46.7	42.3	11.4	102.9	124.9	121.0	132.3	145.8	160.7	176.7	193.7
Foreign equity investment in Australia	463.3	600.4	367.8	628.8	761.1	840.1	863.2	896.8	934.9	981.3	1035.5
Australian equity investment abroad	-416.6	-558.1	-356.3	-526.0	-636.2	-719.1	-730.9	-751.0	-774.2	-804.6	-841.8
Net external debt	414.1	518.6	477.1	589.7	655.7	725.6	769.3	823.7	884.2	950.0	1020.2
Net public sector	3.0	36.8	55.8	63.6	131.1	...	...	...	...	...	...
Net private sector	411.0	481.8	421.3	526.2	524.6	...	...	...	...	...	...
Gross external debt	737.6	917.2	883.8	1111.7	1271.7	1412.8	1467.7	1541.3	1624.1	1719.0	1824.6
Of which: Australian dollar-denominated	268.1	359.0	329.6	487.1	561.9	...	...	...	...	...	...
Gross external lending	-323.5	-398.7	-406.7	-522.0	-616.0	-687.2	-698.4	-717.6	-739.8	-768.9	-804.4
Short-term net external debt (residual maturity basis)	147.9	232.9	203.5	176.8	195.3	...	...	...	...	...	...
Short-term gross external debt	323.6	432.0	426.3	476.3	542.8	...	...	...	...	...	...
Short-term gross external lending	-175.7	-199.1	-222.8	-299.6	-347.4	...	...	...	...	...	...

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

Table 5. Australia: Balance of Payments, 2006–16
(In percent of GDP)

	2006	2007	2008	2009	2010	Projections					
						2011	2012	2013	2014	2015	2016
Current account balance	-5.3	-6.2	-4.5	-4.2	-2.7	-2.2	-4.7	-5.4	-5.7	-6.1	-6.3
Goods balance	-1.2	-1.8	-0.3	-0.3	1.5	2.2	0.4	-0.1	-0.4	-0.2	-0.4
Exports	15.9	14.9	18.0	15.8	17.3	18.4	18.5	17.5	18.4	18.2	18.4
Imports	-17.1	-16.8	-18.3	-16.1	-15.8	-16.2	-18.2	-17.6	-18.8	-18.4	-18.7
Net services	0.0	-0.1	-0.4	0.0	-0.3	-0.6	-0.7	-0.8	-0.7	-0.7	-0.7
Total credits	4.2	4.2	4.2	4.2	3.9	3.6	3.9	4.0	4.2	4.3	4.5
Total debits	-4.1	-4.2	-4.6	-4.3	-4.2	-4.3	-4.6	-4.8	-4.9	-5.0	-5.2
Net income	-4.0	-4.3	-3.7	-3.8	-3.7	-3.6	-4.3	-4.5	-4.5	-5.2	-5.2
Of which: Net interest payments	-2.1	-2.4	-2.3	-2.3	-2.0	-1.9	-2.4	-2.6	-2.5	-2.8	-3.0
Of which: Net equity income	-1.9	-1.8	-1.3	-1.4	-1.6	-1.6	-1.8	-1.9	-2.0	-2.4	-2.2
Net transfers	-0.1	0.0	0.0	-0.1	-0.1	-0.1	0.0	0.0	0.0	0.0	0.0
Capital and financial account	5.3	6.2	4.4	4.4	2.7	2.0	4.7	5.4	5.7	6.1	6.3
Capital account	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Financial account	5.2	6.2	4.4	4.4	2.7	2.0	4.7	5.4	5.7	6.2	6.3
Direct investment transactions (net)	0.7	3.0	1.3	1.0	0.6	2.3	1.6	1.8	1.7	1.6	1.6
Equity (net)	-0.1	1.9	-0.1	2.1	0.8	...	...	...	...	...	...
Debt (net)	0.9	1.1	1.4	-1.1	-0.2	...	...	...	...	...	...
Portfolio investment transactions (net)	6.8	-2.2	2.8	7.9	5.7	1.3	3.2	3.3	2.9	3.1	2.9
Equity (net)	-1.4	-3.7	2.7	0.1	-0.7	...	...	...	...	...	...
Debt (net)	8.1	1.5	0.0	7.8	6.4	...	...	...	...	...	...
Financial derivatives (net)	0.1	-1.1	0.1	-0.5	-0.1	-1.2	-0.8	-0.9	-0.9	-0.8	-0.8
Other transactions (net)	-2.3	6.5	0.3	-4.0	-3.5	-0.5	0.7	1.2	1.9	2.2	2.6
Net errors and omissions	0.0	0.0	0.1	-0.1	0.0	0.0	0.0	0.0	0.0	0.0	0.0
	(Assets and liabilities at end-period)										
Net external liabilities	55.8	55.9	56.9	61.9	57.0	55.6	57.9	60.0	62.3	64.9	67.7
Net external equity liabilities	5.7	4.2	1.3	9.2	9.1	7.9	8.5	9.0	9.6	10.2	10.8
Foreign equity investment in Australia	56.1	59.8	42.8	56.2	55.6	55.2	55.5	55.5	55.7	56.5	57.7
Australian equity investment abroad	-50.5	-55.6	-41.5	-47.0	-46.5	-47.2	-47.0	-46.4	-46.1	-46.3	-46.9
Net external debt	50.2	51.7	55.5	52.7	47.9	47.7	49.4	50.9	52.7	54.7	56.9
Net public sector	0.4	3.7	6.5	5.7	9.6	...	...	...	...	...	...
Net private sector	49.8	48.0	49.0	47.0	38.3	...	...	...	...	...	...
Gross external debt	89.4	91.4	102.9	99.4	92.9	92.8	94.3	95.3	96.8	99.0	101.7
Of which: Australian dollar-denominated	32.5	35.8	38.4	43.5	41.1	...	...	...	...	...	...
Gross external lending	-39.2	-39.7	-47.3	-46.7	-45.0	-45.1	-44.9	-44.4	-44.1	-44.3	-44.9
Short-term net external debt (residual maturity basis)	17.9	23.2	23.7	15.8	14.3	...	...	...	...	...	...
Short-term gross external debt	39.2	43.1	49.6	42.6	39.7	...	...	...	...	...	...
Short-term gross external lending	-21.3	-19.8	-25.9	-26.8	-25.4	...	...	...	...	...	...
Memorandum items:											
Gross external assets	-89.7	-95.3	-88.8	-93.7	-91.5	-92.4	-91.8	-90.8	-90.2	-90.6	-91.8
Gross external liabilities	145.5	151.2	145.7	155.6	148.6	148.0	149.8	150.8	152.5	155.5	159.5
Gross official reserves (in billions of Australian dollars)	69.6	30.5	47.5	46.5	41.6	...	...	...	...	...	...
Gross reserves in months of imports	3.8	1.5	2.0	2.2	1.7	...	...	...	...	...	...
Gross reserves to ST FX denominated debt (percent)	23.6	9.3	11.8	14.9	13.3	...	...	...	...	...	...
Net interest payments to exports (percent)	10.4	12.3	10.4	11.5	9.3	8.8	10.9	11.9	11.3	12.5	13.0

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

Table 6. Australia: Gross External Debt, 2007–11

	2007	2008	2009	2010	2011 June
(In billions of Australian dollars)					
Gross external debt	1,040	1,276	1,239	1,251	1,300
Of which: Public	92	153	154	213	234
Private - financial	749	870	835	790	809
Private - nonfinancial	199	253	250	248	256
Of which: Total short-term debt	490	615	531	534	589
0 - 90 days	360	423	399	372	408
90 days - 6 months	40	60	46	64	77
6 months - 1 year	90	132	86	98	104
Opening liabilities	932	1,040	1,276	1,239	1,251
Transactions during period	110	89	74	49	38
Valuation changes	-4	144	-112	-41	8
Other adjustments	2	2	2	4	2
Closing liabilities	1,040	1,276	1,239	1,251	1,300
(In billions of U.S. dollars)					
Gross external debt	917	884	1,112	1,272	1,396
Of which: Short term	432	426	476	543	633
(In percent of GDP)					
Gross external debt	91.4	102.9	99.4	92.9	93.4
Of which: Short term	43.1	49.6	42.6	39.7	42.4
Short-term to gross external debt	47.1	48.2	42.8	42.7	45.4
Memorandum items:					
Gross external debt denominated in \$A	407	476	543	553	566
US\$/A (end of period)	0.88	0.69	0.90	1.02	1.07
Nominal GDP (sum of last 4 quarters, \$A bn, SA)	1,138	1,240	1,247	1,346	1,391

Sources: Australian Bureau of Statistics and IMF staff estimates.

Table 7. Australia: Indicators of External and Financial Vulnerability, 2006–10
(In percent of GDP, unless otherwise indicated)

	2006	2007	2008	2009	2010
External indicators					
Real exports of goods (percent change)	1.4	1.3	4.2	3.8	7.4
Real imports of goods (percent change)	8.0	11.5	10.4	-9.9	13.3
Terms of trade (percent change)	8.6	5.8	13.0	-9.9	16.3
Current account balance	-5.3	-6.2	-4.5	-4.2	-2.7
Capital and financial account balance	5.3	6.2	4.4	4.4	2.7
Of which:					
Net portfolio investment	6.8	-2.2	2.8	7.9	5.7
Net direct investment	0.7	3.0	1.3	1.0	0.6
Total reserves (in billions of U.S. dollar)	55.1	26.9	32.9	41.7	41.9
In months of imports of goods and services	3.8	1.5	2.0	2.2	1.7
Total net reserves (in billions of U.S. dollar)	24.3	31.6	33.3	41.4	41.7
Net international investment position	-55.8	-55.9	-56.9	-61.9	-57.0
Of which:					
Net external public sector debt	0.4	3.7	6.5	5.7	9.6
Net external private sector debt	49.8	48.0	49.0	47.0	38.3
Net interest payments to exports (in percent)	10.4	12.3	10.4	11.5	9.3
Nominal effective exchange rate (percent change)	-1.6	6.1	-1.8	-4.3	13.7
Financial market indicators					
General government gross debt (percent of GDP)	9.9	9.6	11.7	16.9	20.5
Interest rates (percent)					
3-month T-bill	6.0	6.7	7.0	3.4	4.7
3-month interest rate spread vis-à-vis U.S.	1.3	2.3	5.6	3.3	4.5
10-year government bond	5.6	6.0	5.8	5.0	0.0
Capital adequacy					
Regulatory capital to risk-weighted assets	10.4	10.2	11.4	12.0	11.6
Tier I capital to risk-weighted assets 1/	7.4	7.2	8.2	9.4	9.7
Asset quality 2/					
Impaired assets to total assets	0.2	0.2	0.8	1.2	1.2
Specific provisions to impaired assets	39.1	37.6	36.0	34.2	35.4
Loans composition (share of total)					
Public sector	1.5	1.4	2.0	4.1	3.9
Individuals	60.6	54.2	53.9	58.9	61.5
Housing loans	52.1	46.5	47.6	52.9	55.6
Investor housing	17.2	15.3	15.3	16.2	17.1
Commercial lending	37.9	44.4	44.2	37.0	34.7
Financial intermediaries	8.1	13.0	14.0	9.6	8.9
Nonfinancial sector	29.7	31.4	30.2	27.3	25.8

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

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

2/ Q4 quarterly data.

**Appendix I. Australia: Financial Sector Assessment Program (FSAP):
Key Recommendations of the 2006 FSAP and Update on the Progress of Implementation¹**

Issue	Key Recommendations	Progress of Implementation
Banking	Continue to ensure strong risk management practices, including through regular stress testing.	<ul style="list-style-type: none"> The Basel II framework has been implemented since January 2008, with the four major banks (ANZ, Commonwealth Bank of Australia, Westpac, and National Australia Bank) and Macquarie Bank approved to adopt internal models for credit and operational risk. Stress testing is regularly carried out by banks as part of their Internal Capital Adequacy Assessment Process. As part of its supervisory activities, APRA thoroughly assesses banks' risk management practices and is proactive in integrating these assessments into its supervisory stance. Credit quality in home and commercial lending, and liquidity management, have been at the forefront of supervision activity. APRA has placed emphasis on banks having strong risk management practices in these areas. APRA has conducted periodic stress tests of the major authorized deposit-taking institutions (ADIs), with the most recent one being in 2010. These stress tests were undertaken to assess the resilience of the banks to a severe economic downturn and are part of an ongoing stress testing program.
Failure Resolution and Crisis Management	Continue to develop a formal process to manage the failure of individual institutions and more widespread crises.	<ul style="list-style-type: none"> In October 2008, the government introduced a Financial Claims Scheme (FCS), which provided protection for depositors of up to \$A 1 million in the event that an ADI failed. The cap will be reduced to \$A 250,000 per depositor, per institution, from February 2012 but will still cover 99 percent of deposit accounts in full. The FCS also protects policyholders of failed general insurers. The Council of Financial Regulators signed an MoU on financial distress management in 2008, formalizing what was already established in practice. It followed this with the development of comprehensive guidance for the resolution of a distressed ADI, covering a range of resolution options. This guidance is routinely updated to take into account developments, such as, the lessons the crisis management simulation exercise that was held in 2009 and the passage of legislation in 2010 to enhance APRA's crisis management powers in relation to distressed banks and general insurers. In a cross-border resolution context, the Council agencies and the Reserve Bank of New Zealand and the New Zealand Treasury have signed a Memorandum of Cooperation and developed guidance on how the distress of a trans-Tasman banking group may be managed.
Supervisory Capacity	Ensure that the supervisory agencies have adequate resources and flexibility.	<ul style="list-style-type: none"> In the 2007/08 Budget, APRA received additional funding over a four-year period to improve its staff capabilities. In October 2008, to manage issues associated with the global financial crisis, the government provided additional funding to APRA of \$A 45.5 million over four years. The government continues to monitor APRA's funding to ensure it remains adequately resourced. The government has also enhanced APRA's independence by removing the requirement to obtain ministerial consent before taking administrative actions. The Australian Securities and Investments Commission (ASIC) received funding of \$A 420.2 million in 2011–12 including additional funding of \$A 28.8 million to support ongoing GFC-related work and to support ASIC's operations.

Issue	Key Recommendations	Progress of Implementation
Cooperation with New Zealand Regulators	Build on the progress made within the Trans-Tasman Council on Banking Supervision to improve coordination in crisis management.	<ul style="list-style-type: none"> Legislative changes formalizing a requirement on regulators in the two countries to be alert to each other's interests in times of stress came into force in both countries in December 2006. The work of the Trans-Tasman Banking Council now focuses more on the practical aspects of coordination in crisis management with a protocol being agreed with the aim of establishing procedures to jointly deal with a regional banking crisis.
Insurance	Push ahead with Stage II reforms (e.g., capital management, reinsurance documentation, corporate government standards, and disclosure requirements).	<ul style="list-style-type: none"> The Stage II reforms have all been finalized and implemented. Subsequently, APRA has been consulting on a comprehensive update of its capital standards for general insurance and life insurance, aimed at making the standards more risk-sensitive and improving their alignment across regulated industries. In addition, from July 1, 2008, all Direct Offshore Foreign Insurers operating in Australia have had to be authorized by APRA and subject to Australia's prudential regime.
AML/CTF	Give high priority to make the appropriate legislative and operational arrangements in the AML/CTF area.	<ul style="list-style-type: none"> The AML/CTF Act, enacted in December 2006, established a regulatory regime to detect and deter money laundering and terrorism financing. The AML/CTF Act represents the first tranche of reforms and covers the activities of financial service providers, gambling services, bullion dealers and remittance dealers. The authorities report that the implementation is now complete. The second tranche of legislative and regulatory reforms, intended to capture a range of non-financial businesses and professionals is under consideration. Legislation has been implemented facilitating information exchange between the Australian Transaction Reports and Analysis Centre (AUSTRAC) and APRA. Information sharing arrangements at the executive and operational levels are now in place.

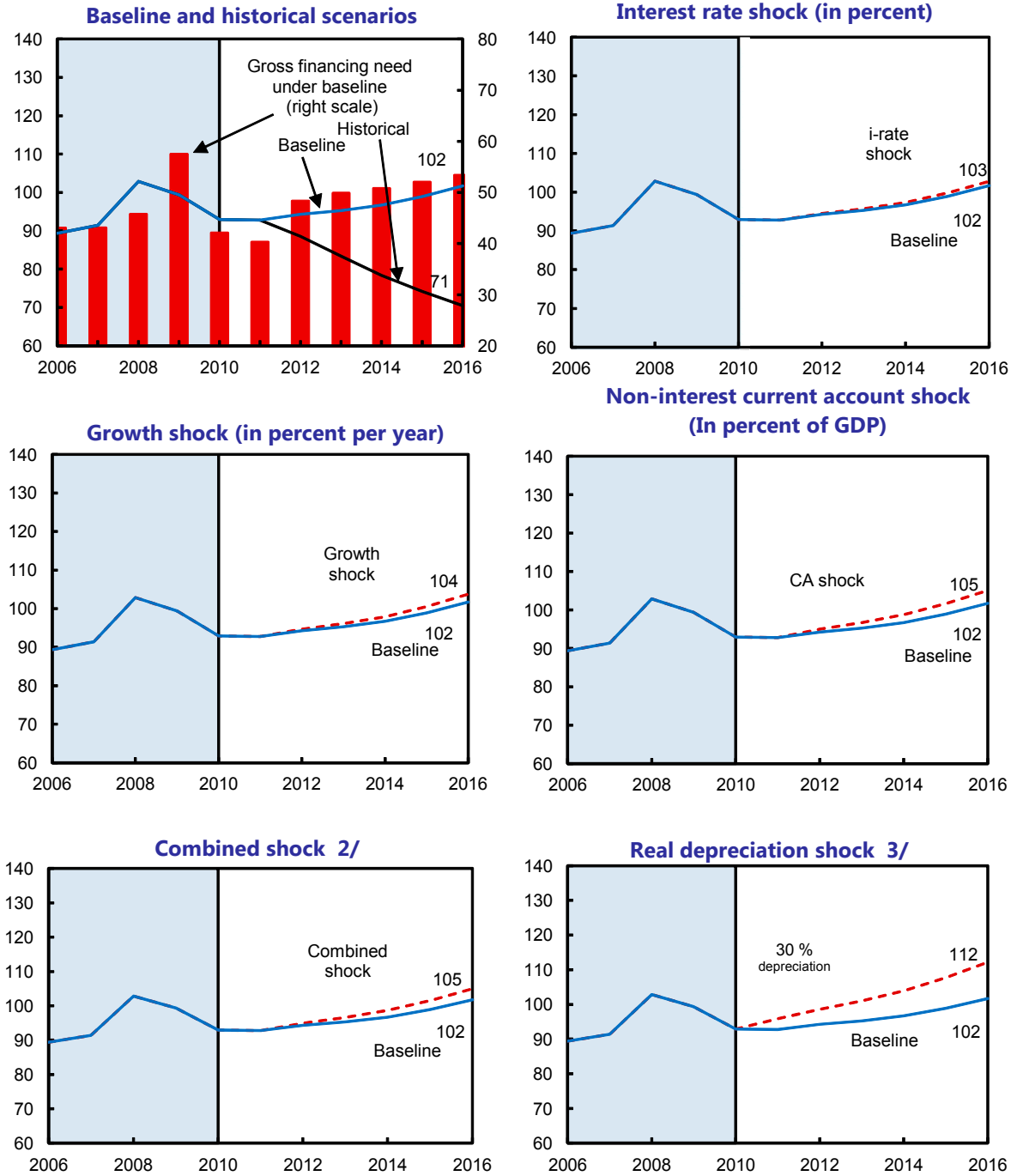
Source: IMF staff.

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).

Appendix II. Australia: Main Recommendations of the 2010 Article IV Consultation

Fund Recommendations	Policy Actions
<p>Fiscal policy: Staff agreed with the pace of exit from fiscal stimulus, assuming the recovery proceeded as expected. The authorities' plan for a return to surplus by 2012/13 should put Australia in a strong position to deal with future shocks. Staff noted that there was ample scope to slow the pace of exit or loosen fiscal policy in response to a downside scenario.</p>	<p>The authorities remain committed to returning to a budget surplus by 2012/13. Beyond that, the authorities plan to improve the fiscal position by limiting real spending growth while the economy is growing at or above trend to 2 percent a year, on average, until surpluses are at least 1 percent of GDP.</p>
<p>Staff emphasized that the automatic fiscal stabilizers should be allowed to operate fully, given that the growing dependence on mining may amplify the business cycle. This implies saving revenue windfalls and running larger budget surpluses during upswings than in the past to help avoid potential overheating and building a buffer against a sharp fall in commodity prices. Staff suggested that preparing a downside scenario for the budget in which commodity prices fall sharply may help build political support for running larger surpluses during the good times.</p>	<p>The government's strategy of achieving budget surpluses, on average, over the medium term and improving the government's net financial worth over the medium term is broadly consistent with allowing the automatic stabilizers to operate.</p>
<p>Monetary policy: Staff advised that if the recovery remains on track and downside risks dissipate, monetary policy will need to tighten further to contain inflation pressures generated by the mining boom. However, if the global recovery stalls or international capital markets come under severe stress, the RBA has ample scope to cut the policy rate and provide liquidity support for banks.</p>	<p>The RBA raised the policy rate to 4 percent in November 2010. Since then, the policy rate has been on hold but the appreciation of the exchange rate has tightened monetary conditions further.</p>
<p>Financial sector policy: The authorities should remain vigilant as banks could adopt riskier strategies. Staff welcomed APRA's regular stress testing and recommended explicitly including funding risk in future scenarios, given banks' sizable short-term external debt</p>	<p>APRA plans to undertake more comprehensive stress tests of banks than in 2009/10, including stress tests incorporating a disruption to funding markets. APRA has also made progress on contingency planning for liquidity and solvency problems at systemically important banks, including for the New Zealand subsidiaries.</p>

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



Sources: IMF country desk data and staff estimates.

1/ Shaded areas represent actual data. Individual shocks are permanent 1/2 standard deviation shocks. Figures represent average projections for the respective variables in the baseline and scenario being presented. Ten-year historical averages for key variables are 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 at the end of 2011. This scenario assumes foreign exchange hedging effectively covers 80 percent of foreign currency debt, consistent with the findings of the ABS survey, "Foreign Currency Exposure, Australia, March Quarter 2009." The scenario ignores the offsetting impact of a depreciation on partially hedged asset positions, and it does not incorporate any positive movement of the trade balance in response to the depreciation.



AUSTRALIA

STAFF REPORT FOR THE 2011 ARTICLE IV CONSULTATION—INFORMATIONAL ANNEX

September 19, 2011

Prepared By

Asia and Pacific Department

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ANNEX I. FUND RELATIONS

(As of August 31, 2011)

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

General Resources Account:

	SDR Million	Percent Quota
Quota	3,236.40	100.00
Fund holdings of currency (exchange rate)	2,229.84	68.90
Reserve tranche position	1,006.98	31.11
Lending to the Fund New Arrangements to Borrow	150.90	

SDR Department:

	SDR Million	Percent Allocation
Net cumulative allocation	3,083.17	100.00
Holdings	3,044.77	98.75

Outstanding Purchases and Loans:

None

Financial Arrangements:

None

Projected Obligations to Fund¹

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

	Forthcoming				
	2011	2012	2013	2014	2015
Principal					
Charges/interest	0.04	0.18	0.18	0.18	0.18
Total	0.04	0.18	0.18	0.18	0.18

¹ When a member has overdue financial obligations outstanding for more than three months, the amount of such arrears will be shown in this section.

Exchange Rate Arrangement. Australia has accepted the obligations of Article VIII, Sections 2, 3, and 4 of the Articles of Agreement, and maintains an exchange system that is free from restrictions on

the making of payments and transfers for current international transactions, except for exchange restrictions that are maintained solely for the preservation of national or international security and which have been notified to the Fund pursuant to Executive Board Decision No. 144-(52/51). The exchange rate is free floating, but the Reserve Bank of Australia retains discretionary power to intervene. There are no taxes or subsidies on purchases or sales of foreign exchange.

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

Article IV Consultation. Australia is on the 12-month consultation cycle. The 2010 Article IV consultation discussions were held during July 9–19, 2010; the Executive Board discussed the staff report (IMF Country Report No. 10/331) and concluded the consultation on October 27, 2010.

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.

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

ANNEX II. AUSTRALIA: STATISTICAL ISSUES

Data provision is adequate for surveillance. 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 (ABS) 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 ABS, 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. In March 2010, a STA mission took place in Sydney and Canberra to prepare the Data Module of the Report on the Observance of Standards and Codes (ROSC) assessment.

Table of Common Indicators Required for Surveillance
(As of August 25, 2011)

	Date of Latest Observation	Date Received	Frequency of Data ⁷	Frequency of Reporting ⁷	Frequency of Publication ⁷
Exchange Rates	8/25/11	8/25/11	D	D	D
International Reserve Assets and Reserve Liabilities of the Monetary Authorities ¹	07/10	08/8/11	M	M	M
Reserve/Base Money	07/11	08/30/11	M	M	M
Broad Money	07/11	08/30/11	M	M	M
Central Bank Balance Sheet	08/17/11	08/19/11	W	W	W
Consolidated Balance Sheet of the Banking System	07/11	08/30/11	M	M	M
Interest Rates ²	8/25/11	8/25/11	D	D	D
Consumer Price Index	Q2 2011	5/08/2011	Q	Q	Q
Revenue, Expenditure, Balance and Composition of Financing ³ – General Government ⁴	06/11	9/27/10	A	A	A
Revenue, Expenditure, Balance and Composition of Financing ³ – Central Government	05/11	07/22/11	M	M	M
External Current Account Balance	Q2 2011	08/31/11	Q	Q	Q
Exports and Imports of Goods and Services	07/11	08/30/11	M	M	M
GDP/GNP	Q2 2011	08/31/11	Q	Q	Q
Gross External Debt ⁵	Q1 2011	05/31/11	Q	Q	Q
International Investment Position ⁶	Q2 2011	08/31/11	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 nonbank financing.

⁴ 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 Includes external gross financial asset and liability positions vis à vis nonresidents.

⁷ Daily (D), Weekly (W), Monthly (M), Quarterly (Q), Annually (A), Irregular (I); Not Available (NA).



INTERNATIONAL MONETARY FUND

Public Information Notice

EXTERNAL
RELATIONS
DEPARTMENT

Public Information Notice (PIN) No. 11/126
FOR IMMEDIATE RELEASE
October 6, 2011

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

IMF Executive Board Concludes 2011 Article IV Consultation with Australia

On October 5, 2011, the Executive Board of the International Monetary Fund (IMF) concluded the Article IV consultation with Australia.¹

Background

Australia's performance since the onset of the global financial crisis has been enviable. It was one of the few advanced economies to avoid a recession in recent years, reflecting its strong position at the onset of the crisis and a supportive macro policy response. The good performance can also be attributed to a healthy banking system, a flexible exchange rate, and robust demand for commodities from Asia, especially China.

A recovery is now being driven by a mining boom. Real GDP growth picked up to 2¾ percent in 2010 with private demand and commodity exports beginning to take over from public demand as the main drivers. In the first quarter of 2011, however, activity was disrupted by cyclones and floods in Queensland and Western Australia that reduced output, especially exports of coal and iron ore (which comprise about ⅓ of Australia's exports). Real GDP growth rebounded in the second quarter but coal export volumes have not fully recovered.

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. An explanation of any qualifiers used in summings up can be found here: <http://www.imf.org/external/np/sec/misc/qualifiers.htm>.

The exceptionally large rise in the terms of trade since 2002 has increased national income and improved the current account balance to about 2½ percent of GDP in the first half of 2011. The improvement has contributed to an appreciation of the real effective exchange rate to near the highest level since the dollar was floated in 1983. The appreciation has put pressure on sectors not benefiting directly from higher commodity prices.

Macroeconomic stimulus is being withdrawn. The Reserve Bank of Australia began to raise its policy rate in late 2009, but the rate has been held at 4¾ percent since November 2010, because of uncertainty regarding the global outlook and the impact of natural disasters on activity. The exit from fiscal stimulus began in 2010, as the recovery gained traction. However, fiscal consolidation has been complicated by natural disasters that contributed to a wider-than-expected budget deficit of 3½ percent of GDP in 2010/11.

The economic outlook remains favorable, but the risks to growth are tilted to the downside. Real GDP growth is projected at almost 2 percent for the calendar year 2011 and 3⅓ percent for 2012, on the back of strong demand for commodities and a sharp rise in private investment in mining. Key downside risks are that the global recovery stalls or Asian growth falters, impacting demand for commodities. Funding markets could also be disrupted by concerns about sovereign debt in advanced economies. On the upside, investment in the resource sector could be larger than expected and households may become more confident as the boom progresses.

Executive Board Assessment

Executive Directors noted that although recent global market volatility has increased uncertainty about the economic outlook and tilted risks downward, strong commodity demand from emerging Asia underpins Australia's favorable economic prospects.

Directors agreed that the macroeconomic stimulus is being appropriately removed. They commended the Reserve Bank of Australia (RBA) for its well-paced monetary policy tightening, which has helped anchor medium-term inflation expectations. However, Directors observed that a further tightening of monetary policy could be warranted if the recovery remains on track, to counter the inflationary pressures from the unprecedented increase in mining investment. Directors welcomed the government's commitment to return the Commonwealth budget to surplus in 2012/13, as it would strengthen fiscal buffers and take some pressure off monetary policy and the exchange rate.

Directors agreed that in the event of severe adverse developments in global financial markets or world growth, macroeconomic policy is well positioned to respond. They noted that the free-floating exchange rate regime has cushioned external shocks, the RBA has ample scope to cut policy interest rates, and there is ample space for countercyclical fiscal support, given the low level of government net debt.

Directors stressed that, over the medium term, the government should grasp the opportunity provided by the mining boom to strengthen fiscal buffers further, recommending that a budget surplus of at least 1 percent of GDP be targeted for the period beyond 2013/14. In this regard, they emphasized the importance of tax and structural reforms. Directors underscored that inefficient taxes such as state stamp duties on house sales, that discourage worker mobility, be eliminated and that the effective marginal income tax rates be further reduced. Business tax reform would also encourage private investment. Options to raise revenue to fund these reforms include greater reliance on consumption and land taxes, and a broadening of the proposed minerals resource rent tax. More broadly, Directors considered that reforms in the areas of education, infrastructure, and business regulation would enhance the economy's capacity to adjust to structural changes.

Directors concurred that, while banks remain sound, continued intensive supervision remains critical. They welcomed the Australian Prudential Regulation Authority's plans to undertake stress tests incorporating disruptions to funding markets. Directors generally noted that higher capital requirements and a further reduction of banks' short-term external debt would reinforce financial stability, although a few Directors thought that any steps in this direction should await an international consensus on the appropriate norms.

Directors observed that the projected deterioration of the current account balance presents some risks, although future deficits should remain manageable as they reflect, in large part, an increase in private investment in the export sector. They pointed out that a projected decline in national saving also contributes to the widening of the deficit, which underlines the need for fiscal consolidation.

Directors took note of the staff's assessment that the Australian dollar may be somewhat stronger than the level implied by medium-term fundamentals. They noted, however, that the overvaluation is partly cyclical and may dissipate with the eventual tightening of policy rates by major central banks.

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](#) (use the free [Adobe Acrobat Reader](#) to view this pdf file) for the 2011 Article IV Consultation with Australia is also available.

Australia: Selected Economic Indicators, 2008–12

Nominal GDP (2010): \$A 1,346 billion

Quota (in millions): SDR 3,236.40

Unemployment rate (August 2011): 5.3 percent

	2008	2009	2010	Proj	
				2011	2012
Output and demand (percent change)					
Real GDP	2.6	1.4	2.7	1.8	3.3
Total domestic demand	3.5	-0.7	4.2	4.4	3.9
Private consumption	1.9	1.0	2.8	3.1	2.3
Total investment	7.9	-3.2	5.8	5.6	9.0
Net exports 1/	-1.5	2.7	-1.6	-2.8	-0.7
Inflation and unemployment (in percent)					
CPI inflation	4.4	1.8	2.8	3.5	3.3
Unemployment rate	4.3	5.6	5.2	5.0	4.8
Saving and investment (in percent of GDP)					
Gross national saving	25.1	23.6	24.9	25.7	24.7
General government saving	3.6	-0.7	-0.3	2.3	3.7
Private saving 2/	21.5	24.4	25.2	23.4	20.9
Gross capital formation	29.5	27.9	27.6	27.9	29.3
Fiscal indicators (cash basis, in percent of GDP) 3/					
Receipts	24.6	23.0	22.0	21.6	23.0
Payments	22.9	25.2	26.2	25.1	24.8
Underlying cash balance	1.7	-2.2	-4.3	-3.5	-1.8
Fiscal balance (accrual basis)	1.8	-2.4	-4.1	-3.2	-1.7
Net debt	-3.8	-1.3	3.3	5.9	7.5
Money and credit (end of period)					
Interest rate (90-day bill, in percent) 4/	4.1	4.2	5.0	5.0	...
Treasury bond yield (10-year, in percent) 4/	4.0	5.6	5.5	4.8	...
M3 (percent change) 4/	14.8	5.8	10.3	11.3	...
Private domestic credit (percent change) 4/	7.6	1.1	2.8	3.3	...
Balance of payments (in percent of GDP)					
Current account	-4.5	-4.2	-2.7	-2.2	-4.7
Of which: Trade balance (goods)	-0.3	-0.3	1.5	2.2	0.4
Terms of trade (percent change)	13.0	-9.9	16.3	13.6	-6.8
External assets and liabilities (in percent of GDP)					
Net external liabilities	56.9	61.9	57.0	55.6	57.9
Net external debt	55.5	52.7	47.9	47.7	49.4
Gross official reserves 4/	3.8	3.7	3.1	2.8	...
Exchange rate (period average) 4/					
U.S. dollar/Australian dollar	0.85	0.79	0.92	1.08	...
Trade-weighted index	66.3	63.2	70.9	77.7	...
Real effective exchange rate 5/	103.6	100.7	115.3	123.8	...

Sources: Data provided by the Australian authorities; and IMF staff estimates and projections, including the estimated impact of the *Clean Energy Future* package from 2011/12.

1/ Contribution to growth.

2/ Includes public trading enterprises.

3/ Fiscal year ending June 30, Commonwealth Budget. For example, 2011 refers to fiscal year July 1, 2010 to June 30, 2011 which the Australian Government's budget papers denote as budget year 2010.

4/ Data for 2011 are for latest available month.

5/ IMF, Information Notice System index (2005 = 100).

**Statement by Mr. Christopher Y. Legg, Executive Director, and Ms. Susan Bultitude,
Advisor to Executive Director, on Australia**

October 5, 2011

My authorities are monitoring closely the deteriorating external environment, very conscious of the prospect for a sustained period of global weakness and the downside risks this poses for the Australian economy. Heightened global financial volatility and uncertainty are compounding domestic pressures associated with a two speed economy, weighing on confidence in non-mining sectors. A significant increase in household saving – in many ways a positive development – is also constraining retail activity. Non-mining related growth is forecast to be weak, and we have witnessed a small upturn in unemployment in August, to 5.3 percent.

My authorities remain committed to preserve, and optimize, the considerable policy room they have available to respond to external instability. Recent improvements in both household and banking sector balance sheets will also help to buttress the domestic economy. More generally, a combination of factors continues to underpin the Australian economy's resilience: a continuing commitment to sound policy and regulatory frameworks; a proactive and cautious approach by the prudential regulator; the adaptability supported and fostered over many years by structural reform and exchange rate flexibility; as well as the advantages of close integration with a fast growing Asian region. After widespread damage and disruption associated with devastating floods and cyclones across wide areas of Australia earlier this year, GDP recovered strongly, by 1.2 percent, in the June quarter.

The benefits of proximity to emerging Asia are most obviously manifested in the unprecedented mining boom now driving growth. Australia's terms of trade are currently at 140 year highs. Mining investment is expected to reach record highs as a share of GDP over the next two years, rivaling that for the rest of the economy, notwithstanding the fact that mining production accounts for only around 9 percent of GDP. These developments are posing significant adjustment challenges for the Australian economy. However, the mining boom is a manifestation of a broader, long-term phenomenon, namely the transformation of Asia, with profound implications for the pattern of global production and consumption. The policy challenge in Australia is to maintain the right policy settings – both macroeconomic and structural – to ensure the economy benefits fully from the opportunities this transformation will bring.

Fiscal Policy

My authorities remain committed to returning the budget to surplus in 2012–13 and beyond, to re-build policy buffers and make room for the mining-related investment boom. The 2011-12 Budget projected that government net debt would peak at around 7 percent this year and decline to zero by 2019–20.

This involves a commitment to a significant adjustment effort, of the order of 4 percent of GDP in the space of 2 years. At the same time, revenue is likely to be less responsive to growth than during the first phase of the mining boom, from 2004 through 2007, including as a result of the impact of growing mining sector depreciation expenses as a proportion of mining sector profits and the sector's larger overall share of the economy. The Government's planned Minerals Resource Rent Tax will improve the sector's contribution to the budget. A Temporary Flood and Cyclone Reconstruction levy has also been imposed to help offset the costs of these natural disasters. But a significant part of the burden of this consolidation will necessarily fall on expenditures, and the 2011–12 Budget identified significant savings from reforms to a wide range of family benefits, income support including reforms to encourage greater participation, health, education, and defense programs. Real growth in spending is expected to average only 1 percent over the forward estimate period.

My authorities consider that the existing fiscal strategy – budget surpluses on average over the medium term, taxation as a share of GDP kept below the level for 2007–08, and a commitment to improve the government's net financial worth over the medium term – continues to provide a sound basis for sustainability. In operationalizing this strategy, the Government has committed to keep real expenditure growth below 2 percent per annum, once the budget returns to surplus and until the surpluses are at least 1 percent of GDP, while the economy is growing at or above trend. My authorities acknowledge Staff's recommendation regarding the desirability of allowing automatic stabilizers to operate fully in both directions, and note the arguments in favor of building larger fiscal buffers beyond the return to surplus. The need to manage the implications for aggregate saving of demographic trends is well understood. However, the benefits of greater insurance against cyclical risks in what may be a more volatile environment, would need to be weighed against the costs of significantly larger surpluses.

We welcome Staff's endorsement of Australia's strong budgetary institutions, its support for the establishment of a Parliamentary Budget Office, and the observations made regarding the scope for further fine tuning.

Monetary Policy

The Reserve Bank of Australia continues to assess carefully the outlook for growth and inflation. At its September meeting, the RBA Board judged that it was prudent to maintain the current stance of monetary policy, with the cash rate having been unchanged at 4.75 percent since November 2010. While the Board remained concerned about the medium-term outlook for inflation, most financial indicators suggested that monetary policy had been exerting a degree of restraint.

The headline consumer price index rose 3.6 percent through the year to the June quarter 2011, of which food prices (mostly fruit and vegetables) accounted for 1.0 percent. Inflation is expected to fall back below 3 percent in early 2012 as the effect of temporary weather-related events reverse.

The Exchange Rate and External Stability

The flexibility of the Australian dollar continues to be key to managing the impact of the mining boom alongside instability in global financial markets. The exchange rate has responded to heightened external risks, depreciating by around 12 percent in recent weeks. This follows a period of sustained appreciation through to July 2011, of around 24 percent since the last Article IV consultations and by more than 70 percent since the low following the collapse of Lehmans. Overall, the strength of the Australian dollar has helped to ease pressure on inflation and monetary policy while facilitating the re-allocation of resources to the mining sector. Nevertheless, recent adjustments in the exchange rate are relevant to the Staff's finding that the Australian dollar may have been overvalued, by the order of 10-20 percent, and market expectations of a depreciation (of around 6 ½ percent over two years) referred to by staff.

As the Staff Report notes, Australia's current account deficit (CAD) is expected to widen on the back of historic levels of investment associated with the mining boom. The authorities' commitment to fiscal consolidation, alongside measures further to increase private saving to address looming demographic pressures, such as the planned increase in the minimum superannuation contribution from 9 percent to 12 percent of salaries, will bolster domestic saving. Nonetheless, additional external resources will be required to take full advantage of the higher demand for Australia's commodities. The underlying policy imperative remains to improve the flexibility and allocative efficiency of the economy, to ensure that resources are being used productively.

Financial Sector and Household Balance Sheets

The Australian banking system continues to improve its financial position, with strong encouragement from the Australian Prudential Regulation Authority (APRA). As described in the Staff Report, banks have shifted away from short-term borrowing towards longer-term funding and deposits in recent years, and they hedge their foreign currency exposures.

APRA has a well-established stress testing program which it continues to develop. Upcoming projects include testing across a wider range of funding shocks, and working closely with the New Zealand authorities on trans-Tasman crisis management, under the auspices of the Trans-Tasman Council on Banking Supervision. APRA will also be working closely with the Monetary and Capital Markets Department over the coming year to conduct stress tests as part of Australia's FSAP.

APRA continues to adopt a conservative and robust approach to the application of Basel III in Australia. It is within this context that APRA has taken the view that it remains premature to increase the capital requirements for domestic systemically important financial institutions ahead of an international consensus being reached. Australia's experience has been that, at the margin, effective supervision and risk management, rather than additional regulatory capital per se, are the keys to maintaining a healthy financial system,

The financial position of Australia's household sector is also improving, with the household saving rate reaching 10½ percent of disposable income in June 2011 – a level on par with saving rates seen in the mid 1980s. This has been accompanied by a reduced appetite for most types of debt, an increase in debt repayments (including early repayments of scheduled debt) and an easing of household credit growth. These shifts in saving behavior partly reflect a return to more traditional patterns of saving and borrowing in recent years, after household spending had grown more quickly than income for a decade or so as nominal interest rates declined and credit became more widely available.

While the housing market remains in a position of undersupply, house prices have continued to soften, unwinding some of the strong growth experienced in recent years. However, the softening remains relatively modest, with house prices falling by around 2 to 2½ percent over the year to the June quarter. Taken together, the solid income growth and softening in house prices have contributed to an orderly decline in the ratio of prices to income, which is now consistent with the average level of the past decade.

Structural Reform

The long-term adjustment pressures associated with the emergence of Asia, and domestic demographic trends, underscore the importance of continuing efforts to lift workforce participation and – crucially – to enhance productivity. My authorities recognize the need to reverse the recent decline in multifactor productivity, and the 2011–12 Budget outlined a strategic approach to this challenge, building on a commitment to continued macroeconomic stability with a focus on enhancing flexibility and well targeted investments in skills and human capital, public and private infrastructure, and innovation. Legislation to establish a price for carbon, and transition towards an emissions trading scheme, has been introduced into Parliament, aiming to ensure the least cost means of adjusting to climate change. The compensation package for the introduction of a carbon price includes a number of significant tax reforms, while the Tax Forum, scheduled for October 4–5 in Canberra, will be an opportunity to build further momentum for significant tax reform, drawing on the broad ranging recommendations in the 2009 Report on “Australia's Future Tax System,” with the potential to improve resource allocation and labor mobility. And, there is an ambitious agenda of productivity reforms in the growing health and education sectors, in cooperation with the States.