November 2012
IMF Country Report No. 12/305

Australia: 2012 Article IV Consultation—Staff Report; Public Information Notice on the Executive Board Discussion; and Statement by the Executive Director for Australia

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 2012 Article IV consultation with Australia, the following documents have been released and are included in this package:

- The staff report for the 2012 Article IV consultation, prepared by a staff team of the IMF, following discussions that ended on September 20, 2012, 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 October 29, 2012. The views expressed in the staff report are those of the staff team and do not necessarily reflect the views of the Executive Board of the IMF.

- A Public Information Notice (PIN) summarizing the views of the Executive Board as expressed during its November 12, 2012 discussion of the staff report that concluded the Article IV consultation.

- A statement by the Executive Director for Australia.

The documents listed below have been or will be separately released.

Financial System Stability Assessment
Report of Observance of Standards and Codes – Summary Assessments
Detailed Assessment Reports
Technical notes

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 2012 ARTICLE IV CONSULTATION

October 29, 2012

KEY ISSUES

Context. GDP growth is likely to remain strong, although narrowly driven by a mining investment boom, increasing the economy's vulnerability to terms of trade shocks. Outside the mining sector, growth is expected to be slow with still weak consumer confidence and a strong exchange rate weighing on business investment. The main risks are external, and include an intensification of the euro crisis and a sharper-than-expected slowdown in China.

Focus. Discussions centered on the policy-mix to maintain steady growth in the near term and the macro and structural policy options to make the most of the mining boom over the long run.

Near-term macroeconomic policy mix. The current macroeconomic policy mix is appropriate. With expected inflation within the target range, the strong Australian dollar, and the government's efforts to return the budget to surplus this year, monetary policy should remain accommodative, and should act as the first line of defense against near-term adverse shocks. The authorities' fiscal consolidation path strikes a balance between the benefits of reducing public debt and the need to contain any adverse impact on economic growth.

Financial stability. A Financial Sector Assessment Program update found the financial sector to be sound, and recommended that the authorities continue to emphasize intensive supervision and ensure that banks' liquidity and capital buffers are adequate given their reliance on offshore wholesale funding, exposure to highly indebted households, and the systemic importance of the large banks.

The challenge of economic and structural adjustment. The resources sector will remain a key driver of economic growth in the near term, with historically high mining sector investment projected over the next two years boosting Australia's export capacity. A key structural policy challenge is to facilitate the movement of resources across the economy, as well as to manage the increased vulnerability to terms of trade shocks.

Approved By
Masahiko Takeda and Tamim Bayoumi

Discussions took place in Sydney, Canberra, and Melbourne during September 6-20, 2012. The staff team comprised Messrs. Takeda (Head), Aitken, Ding, Jauregui, and Ms. Sheridan (all APD). Ms. Lim (MCM) also participated in part of the mission. Messrs. Basu and Schule (APD) contributed from headquarters. Ms. Luu (OED) participated in the discussions.

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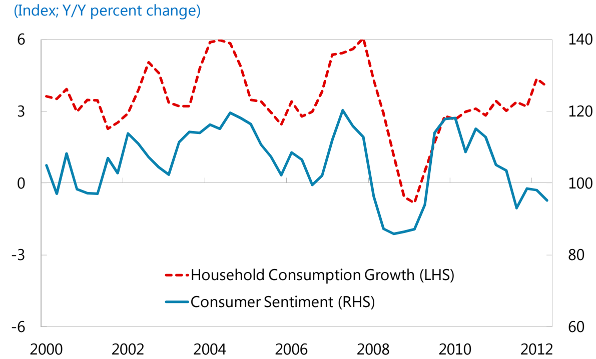
APPENDICES

RECENT ECONOMIC DEVELOPMENTS

1. **Growth.** The Australian economy has been growing faster than most advanced countries, benefiting from its trade linkages with Asia, particularly China. Growth accelerated from 2¾ percent in the second half of 2011 to 4 percent in the first half of 2012, driven by private domestic demand and exports (Figure 1, Table 1). However, growth has been uneven with mining-related sectors expanding strongly, in contrast with below-trend growth in other sectors. The high Australian dollar is weighing on trade-exposed manufacturing and tourism, which along with the uncertain global economic outlook is contributing to a broadly pessimistic mood. With cautious homebuyers and weak business confidence, investment growth outside the mining sector is weak.

2. **Household sector.** Although survey measures of consumer and business sentiment remained below their long-run averages, household consumption grew in line with solid household income growth (text figure). The household saving ratio seems to have stabilized at around 10 percent after increasing sharply at the onset of the global financial crisis. Household debt has been growing at around the same pace as disposable income, leaving the ratio of debt to income around 150 percent (Figure 2).

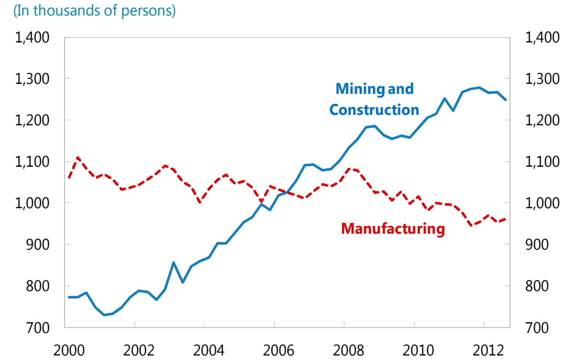
Consumer Sentiment and Consumption
(Index; Y/Y percent change)



Sources: ABS; Melbourne Institute.

3. **Labor Market.** The labor market has performed well in international comparison, with a low unemployment rate at below 5½ percent. Employment growth has slowed recently, with robust employment growth in mining and parts of the services sector offset by continued job-shedding in the manufacturing sector (text figure).

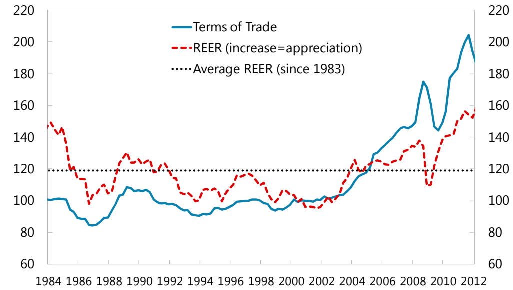
Employment by Industry
(In thousands of persons)



Sources: ABS; Australian Treasury.

4. Terms of trade and the exchange rate. Australia's terms of trade peaked in 2011, pushing up the real effective exchange rate further and narrowing the current account deficit to 2¼ percent of GDP. By the second quarter of 2012, the terms of trade had fallen by around 10 percent, driven by declines in spot prices for iron ore and coking coal of 25 and 30 percent respectively (text figure). In recent months, however, the Australian dollar has remained high despite lower export commodity prices and the weaker global outlook, in part related to portfolio reallocations of large reserve holders toward Australian government debt.

Australia: Real Effective Exchange Rate and Terms of Trade
(2000=100)



Sources: ABS; and IMF staff estimates.

5. Carbon price. Australia introduced a price on carbon in July 2012 with the objective of reducing carbon dioxide and other greenhouse gases to at least 5 percent below 2000 levels by 2020. The introduction of the carbon price is not expected to have any significant impact on economic growth but is expected to increase inflation by ¾ percentage points by end June 2013. Low- and middle-income households will be compensated through increases in the income tax free thresholds, and welfare beneficiaries will be compensated for cost of living increase associated with the scheme.[1]

6. Inflation. CPI inflation has eased with underlying measures of inflation remaining near the middle of the 2-3 percent target band, largely due to the declining tradable goods prices associated with the appreciation of the exchange rate (Figure 3). Wage growth is also moderate, just marginally above its 10 year average in June 2012 with private sector wage growth faster than in the public sector.

7. Monetary policy. The Reserve Bank of Australia (RBA) has lowered the policy rate by 150 basis points since November 2011, with the most recent cut in October 2012. Initially, when inflation moderated at the end 2011, the RBA moved to remove a mildly restrictive monetary policy stance. During 2012, as the outlook for the global economy deteriorated accompanied by a slightly weaker domestic outlook for 2013, and with projected inflation consistent with the target, the RBA shifted to an accommodative monetary policy stance. Interest rates for borrowers, a key indicator of the overall stance, are now slightly below their medium-term averages.

[1] See Box 3 in IMF Country Report No. 11/300.

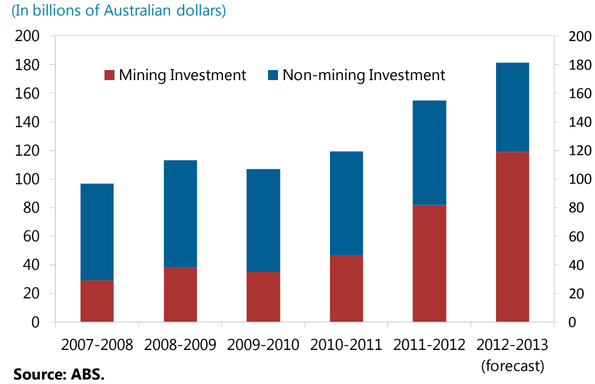
8. Fiscal policy. The 2011/12 underlying cash deficit came in at 3 percent of GDP, about 1½ percentage points higher than forecast in the 2011-12 Budget, due to both weaker receipts and higher expenditure. Structural factors have kept receipts as a percent of GDP below pre-crisis levels and have also contributed to receipts falling short of projections by 0.9 percent of GDP during 2011/12. High levels of mining sector investment and associated depreciation deductions have dampened growth in mining company tax receipts relative to profit growth. Changing consumer spending patterns away from the retail sector towards services have lowered retail company tax receipts. Furthermore, lower house and equity price growth rates, especially compared with pre-crisis rates, lowered capital gains tax receipts. Payments during 2011/12 exceeded forecasts by 0.6 percent of GDP mainly due to payments related to natural disasters and the accelerated transfer payments to households and businesses as compensation for higher energy costs following the introduction of carbon price.

OUTLOOK AND RISKS

9. Near-term outlook. The outlook for Australia remains favorable, buoyed by still-high growth in China accompanied by strong commodity demand which is supporting Australia's export earnings and driving a mining investment boom. We project growth of around 3¼ percent this year, broadly in line with trend. New natural resources-related investment, dominated by liquefied natural gas projects, is expected to reach a record level (text figure). On the other hand, with an appreciated Australian dollar, uncertain global environment, and sluggish housing construction, investment outside of the resources sector is likely to remain weak in the near term. The impact of the authorities' deficit reduction plan, discussed below, is expected to be buffered by strong mining-related growth. Inflation is projected to increase slightly as the effects of earlier currency appreciation decline and with the introduction of carbon pricing, yet is projected to remain consistent with the authorities' target band.

Total Private Capital Expenditure

(In billions of Australian dollars)



Source: ABS.

10. Vulnerabilities and risks. Fundamentals have improved since the global financial crisis; household and business balance sheets have strengthened and banks have reduced their use of foreign funding. Nevertheless, vulnerabilities remain. Risks are tilted to the downside (Appendix 1):

- The impact of a financial and economic fallout from an intensification of the European debt crisis and a hard landing in emerging Asia, especially China, could be compounded by a sharp decline in commodity prices.

- Turmoil in the international financial markets remains a concern as Australia's banks will continue to rely on overseas wholesale funding.

- Domestically, despite a recovery in the household savings rate and a recent softening of house prices, high household debt coupled with elevated house prices remains a vulnerability. A potential fall in commercial real estate prices is also a risk.

Many of the above risks are closely linked, and the importance of the resources sector to Australia's near-term outlook makes it vulnerable if a downside global scenario materializes. For example, a hard landing in China would reduce demand for Australian mineral exports, worsen terms of trade, reduce household income, and could trigger a fall in house prices. This in turn would weaken consumer demand and growth, and negatively affect banks' balance sheets.

11. Policy space to manage risks. The authorities have the monetary and fiscal policy space to respond to near-term shocks, with monetary policy serving as the first line of defense. The RBA has the scope to lower interest rates and loosen monetary conditions to help buffer against a downside scenario. As evident during the global financial crisis, the free-floating Australian dollar provides an additional cushion against external shocks, including disruptions to offshore funding and negative terms of trade shocks, with widespread hedging by banks insulating bank balance sheets from fluctuations in the exchange rate. The authorities would also be able to provide emergency liquidity support to banks, a measure which proved effective when wholesale markets shut down in the wake of the 2008 crisis. Moreover, Australia's modest public debt gives the authorities scope to delay their planned return to surplus in the event of a sharp deterioration in the economic outlook.

The Authorities' Views

12. The authorities broadly agreed with staff on the outlook and balance of risks, expecting the key growth drivers in the near term to be resources investment, related commodity exports, and household demand. They view the main risks to the economy as linked with external developments, including disruptions to European financial markets, the threat of sharp fiscal contraction in the United States, and a fall in Chinese growth momentum. A fall in commodity prices remains a vulnerability, but with many projects—of which approximately 70 percent are LNG and are associated with long-term supply contracts—already under construction or committed, the investment outlook is likely to be resilient to cyclical commodity price declines. They also pointed to relatively weak growth in some parts of the economy—the strong dollar is placing pressure on the non-mining traded sector and the uncertain external environment is weighing on domestic confidence—but noted that household demand remains robust and that the effects of earlier reductions in the cash rate were still working through the domestic economy. The authorities acknowledged that despite recent improvements related to rising incomes and softening in house prices, some metrics of housing affordability are still low by historical standards. They viewed this, however, as consistent with fundamentals reflecting both supply constraints in major cities and high demand from population growth on top of the one-off increase in equilibrium prices resulting from past disinflation. Given this, they do not see a major house-price correction as a stand-alone risk.

NEAR-TERM CHALLENGE: KEEPING THE ECONOMY ON AN EVEN KEEL

13. Monetary policy. Staff viewed the RBA's monetary policy stance as broadly appropriate, given the sizeable fiscal adjustment and the absence of inflation pressure, and factoring in higher bank funding costs, the appreciated exchange rate, and modest overall lending growth.[2] Analysis by staff suggests that the cash rate is compatible with inflation gradually rising to the mid-point of the RBA's 2–3 percent inflation target in 2013 (Figure 4). This projection is premised on wages rising broadly in line with productivity and the RBA's inflation target.

14. Fiscal policy. The government has made returning to surplus by 2012/13 a major policy priority. To reach this target, the government expects a rebound in receipts by 1½ percent of GDP and plans cuts in spending by about the same amount (Figure 5, Table 3). About 1 percent of the adjustment is achieved through expenditure restraint across a broad range of discretionary categories. Most of the adjustment in receipts will occur as receipts catch up with output growth (about ¾ percent of GDP), rather than changes in tax rates. Some of the other increases in receipts, such as those related to the introduction of minerals taxation (paragraph 19), are unlikely to affect investment decisions in the short run. These factors should help mitigate the impact of the planned deficit reduction on aggregate demand. In addition, unlike many other advanced economies, Australia's monetary policy space is still sizable and output is close to trend. These conditions suggest that the fiscal multiplier could be lower than in other countries undergoing fiscal consolidation, mitigating its negative impact on output. Given this and the nature of the fiscal

[2] See Appendix II for the main recommendations and policy actions related to last year's Article IV consultation.

adjustment, staff estimates that the contractionary impact of this budget will be less than would be suggested by the headline deficit reduction of 3 percent (Box 1).

15. Macroeconomic policy-mix. Staff supported the authorities' move toward a policy-mix that combines a tighter fiscal policy with an accommodative monetary policy stance, which will help ease pressure on the exchange rate. The fiscal consolidation is consistent with a policy setting where monetary policy plays the primary role in managing demand. The RBA's high degree of credibility and the rapid monetary policy transmission in Australia allows monetary policy to react quickly and flexibly to changing economic circumstances. Staff supported the authorities' strong commitment to a freely-floating exchange rate. The government's planned fiscal consolidation will produce a desirable reduction in net government debt.

The Authorities' Views

16. Monetary Policy. In its early October monetary policy announcement and, in discussions during the mission in September, the RBA noted that with inflation projected to remain consistent with their target and in light of a softening outlook for the global economy and slightly weaker domestic growth prospects, there was some scope for a more accommodative monetary policy stance. As a result of moves since late last year, interest rates for borrowers are a little below medium-term averages but the impact of these reductions has not, as yet, been fully felt.

17. Fiscal Policy. The authorities expressed the view that the impact on the economy of the return to surplus was significantly lower than the change in the headline fiscal position this year—subtracting ¾ to1½ percent from GDP growth—and in the context of an economy growing at around trend, and with adequate monetary policy space, did not present a policy challenge. Moreover, it is consistent with the government's medium-term fiscal framework. During the crisis they provided a strong fiscal impulse with the commitment to unwind fiscal support once the crisis was over and growth had returned to trend. Returning to surplus and maintaining fiscal discipline would therefore be important for sustaining investor confidence in the strength of Australia's public finances and signaling the government's commitment to maintaining its fiscal strategy. The authorities acknowledged a risk that achieving the surplus could be jeopardized if revenue were to fall short, in part if the economy underperformed relative to projections. If a major shock hits the economy, the authorities agree that they have the fiscal space to respond.

Box 1: Household Saving and Fiscal Multipliers

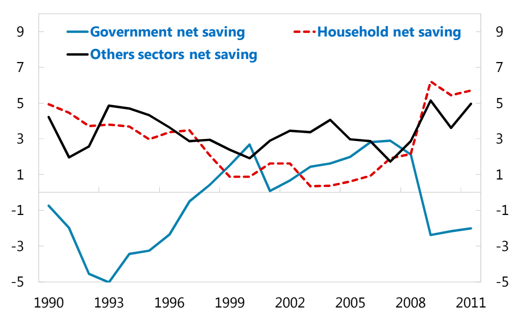
Australia's household saving as a share of GDP began increasing in 2005 and then increased sharply as the global financial crisis began to unfold. Household saving ratio (household savings to household disposable income) also rose by more than 5 percentage points in 2008-2009. Since then both ratios seem to have stabilized at levels above the pre-crisis averages.

The sharp increase in household saving in 2008-2009 reflected both slower growth in private consumption and a temporary boost to household income, with a significant contribution from the cash transfers paid to households as part of the government's fiscal stimulus package during the crisis (fiscal stimulus averaging about 2 percent of GDP a year in 2009-2011). Meanwhile household interest payments declined by more than 30% between the third quarter of 2008 and the first quarter of 2009, largely due to monetary policy easing. As Australia's economy was in a relatively strong position at the onset of the global financial crisis, the rapid deployment of fiscal and monetary stimulus measures helped buffer the negative impact of the crisis on household income and private demand.

As suggested in the IMF *Fiscal Monitor* (April 2012), the size of fiscal multipliers can vary significantly by the underlying state of the economy – the multipliers tend to be larger in downturns than in expansions as the crowding out effect between public and private spending is less applicable when there are excess capacities in the economy. Given that Australia's economy is close to potential, the contractionary impact of the current fiscal consolidation is likely to be smaller than in other countries undergoing similar fiscal adjustment but with large negative output gaps, and the impact could also be mitigated by Australia's still-sizable monetary policy space. These results are broadly in line with those suggested by the Global Integrated Monetary and Fiscal (GIMF) model simulations.

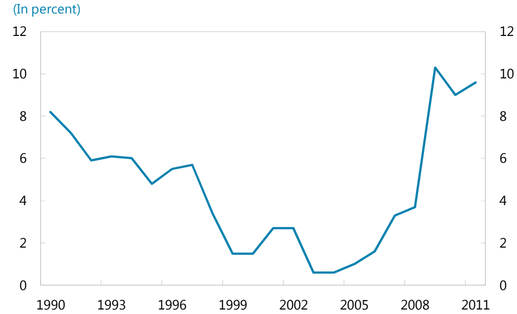
Going forward, Australia's household saving ratio is likely to decline modestly as interest rates normalize and household sentiment improves. But the saving ratio will remain above the pre-crisis levels as the persistently strong capital gains in household assets in the 1990s and 2000s, which allowed households to enjoy rising wealth with low rate of saving, are unlikely to be repeated in the near future.

Australia Private and Government Saving
(In percent of GDP)



Source: OECD.

Australia Household Saving Ratio
(In percent)



Source: ABS.

MEDIUM-TERM FISCAL POLICY

18. Fiscal Strategy. The government's fiscal strategy has remained unchanged since first developed in 2008-09. It 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 (23.7 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. This strategy is projected to yield small surpluses which gradually increase from ¼ percent of GDP in 2013/14 to 1 percent of GDP in 2015/16. As a result, net commonwealth debt, already low by international comparison (Figure 6), will fall from about 10 percent of GDP in 2012 to zero by 2020/21. Outside the Commonwealth budget, the States and Territories also anticipate a gradual reduction in expenditure over the medium term, in part through public sector wage control measures, to maintain their reputation among international bondholders for fiscal discipline in the face of lower projected GST revenues.

19. Tax Policy. Staff supports the recent tax initiatives. Following a comprehensive review of the Australian tax system in 2010 (*Australia's Future Tax System*), the authorities implemented on July 1, 2012 a number of tax reforms that include a minerals resource rent tax (MRRT), a broadening of the base of the petroleum resource rent tax (PRRT), and a carbon price with a transition to emissions trading over time. Staff welcomed the introduction of the MRRT and broadening of the base of the PRRT and continues to support the carbon price, which is well-designed along FAD recommendations and intended to be fiscally neutral.

20. Fiscal Policy Management. While monetary policy is expected to be the main demand management tool in the medium-term, fiscal policy can, nevertheless, play a role in responding to economic shocks. In this regard, staff recommended that the automatic stabilizers be allowed to move fully in both directions. Staff noted that the growing importance for the economy of mining exposes government revenue, more than in past years, to swings in commodity income.

21. Medium-term fiscal challenges. Over the medium-term, the authorities are facing an increase in expenditure commitments, primarily related to aging and health care costs, which together are estimated to increase public expenditure by over 3 percent of GDP by 2030. With revenue currently well below the government's cap of 23.7 percent of GDP—around 21.0 percent of GDP in 2011/12 —there is some room to accommodate the higher spending needs through increases in revenue. Even so a re-prioritization of spending would likely be needed to accommodate the additional commitments and produce budget surpluses if the revenue ceiling is maintained. A sustained shock to the terms of trade would add to these challenges.[3]

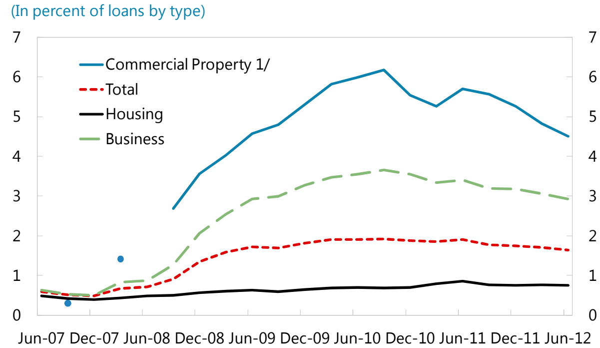
The Authorities' Views

22. The authorities agreed with staff on the role of automatic stabilizers in fiscal policy management. They acknowledged the medium-term budgetary challenges. They noted that the revenue ceiling is based on 2007-08 receipts and as such reflects temporary factors that contributed to unusually high receipts in the pre-crisis period, namely, high capital gains taxes boosted by surging asset prices, rapidly rising commodity prices, rapid credit growth and a low household savings rate. Moreover, structural changes to the tax base that have taken place during the recovery from the crisis, such as shifting consumption patterns, lower asset price growth and higher depreciation deductions, are likely to persist. As such, the authorities do not expect the revenue ceiling to be a binding constraint over the next several years if the current tax policy framework is maintained. The authorities' strategy for managing the public sector proceeds from increased mining exports does not envisage accumulating assets in an earmarked sovereign wealth fund—unlike other commodity producing countries with such funds, the share of Australia's mining sector in the economy (projected to increase to around 10 percent of GDP) and its contribution to public revenue will still remain limited even after the expansion, and minable resources are expected to be long-lasting rather than temporary. Instead, the authorities plan, in the first instance, is for the tax proceeds to contribute more generally to the gradual reduction in gross public sector debt, which provides for equivalent outcomes as a formal fund.

SAFEGUARDING FINANCIAL SECTOR STABILITY

23. Resilient financial system. Banks are highly profitable with a return-on-equity in line with the pre-crisis average (Figure 7). Asset quality remains good and the ratio of nonperforming loans to total assets continues to inch downward from the post-crisis peak (text figure). Although the Australian banks remain amongst the most highly rated globally, there were some rating actions in the last

Asset Quality: Non-performing Loans
(In percent of loans by type)



1/ Impaired assets.
Source: Reserve Bank of Australia.

[3] Previous staff estimates suggest that a sustained 30 percent decline in the terms of trade, partly offset by exchange rate depreciation, could worsen the budget balance by 2 percent of GDP.

12 months with S&P downgrading all four major banks in December 2011, a well-anticipated move that was driven by revised methodology. Fitch also downgraded three major banks earlier this year, citing risks posed by banks' reliance on offshore wholesale funding. Bank credit default swaps spreads are above pre-crisis levels yet below those for European banks (Figure 8).

24. Funding. Since the financial crisis, reflecting lessons learned and the changing regulatory environment, banks have shifted toward more stable funding sources facilitated by combination of strong overall deposit growth and slower credit growth. Reliance on wholesale funding has been reduced and deposits now currently meet more than 50 percent of banks' funding requirements. Much of the decline in wholesale funding has been driven by declines in domestic short-term debt further improving the stability of banks' funding—the share of short-term debt has fallen from a peak of over 30 percent to about 20 percent. Legislative changes in October 2011 permitted Australian banks to issue covered bonds and since then the major banks have used around one-quarter of their covered bond issuance capacity. So far this year, covered bonds accounted for about one-third of banks' bond issuance, with the remainder unsecured. The increased competition for deposits has pushed up the spread of deposit to money market rates, and, together with a move to more stable funding sources, contributed to higher funding costs.

25. Vulnerabilities. The banking system is large, highly concentrated, and interconnected. The four major banks are systemic, with broadly similar business models, and their reliance on wholesale and off-shore funding, although below pre-crisis levels, still represents a risk. Residential mortgages are the banks' single largest asset but household debt is high and house prices are elevated. These are long-standing structural issues that will remain key sources of risk over the medium-term. Stress testing indicates that the major banks are adequately capitalized and are likely to withstand severe macroeconomic shocks, but would require the assistance of the RBA to withstand an extreme funding shock. Net foreign liabilities of the banks amount to almost 25 percent of GDP. Although predominately in foreign currency, these positions are hedged and counterparty risk is limited. The banking sector faces the prospect of slower credit growth as businesses and households continue to deleverage, and could take on riskier strategies in an effort to return to pre-crisis credit and profit growth rates.

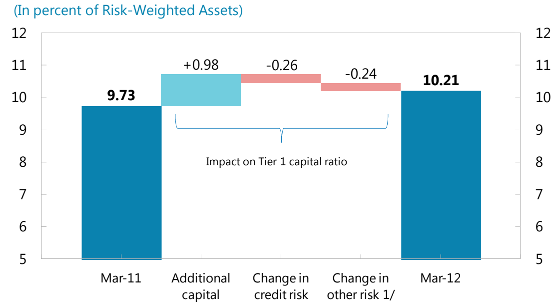
26. Financial sector reform. Capital ratios are increasing and the banks are well-placed to meet Basel III capital requirements and Australian Prudential Regulation Authority (APRA)'s accelerated timetable for implementation (Box 2). Total capital has increased, largely due to dividend reinvestment plans and higher retained earnings which boosted Tier 1 capital. Banks have shifted the composition of their portfolios towards assets with lower risk weights, such as mortgages and government

Box 2. Progress towards Implementing Basel III Reforms

Under APRA's accelerated schedule, Australian banks will be required to meet the minimum Basel III capital requirements from January 2013 and the Basel III capital conservation buffer beginning January 2016. Australian banks have made good progress and are well-positioned to meet these new requirements. Total capital ratios have improved, with a greater increase in Tier 1 capital ratios, as banks chose to run-off holdings of Tier 2 instruments no longer eligible under Basel III. Immediately following the global financial crisis, new equity issuance increased banks' capital. However, more recently, capital has been accumulated organically through retained earnings and dividend reinvestment plans. Relatively low asset growth and a slight shift toward lower-risk assets has also improved banks capital ratios.

Tier 1 Capital Ratio

(In percent of Risk-Weighted Assets)



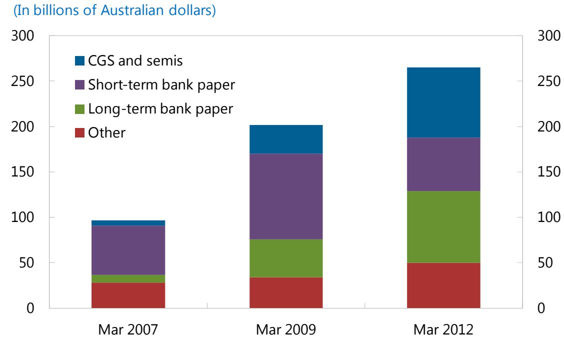
1/ Other risk includes market risk, operational risk, equity risk, interest rate risk in the banking book and other assets.

Sources: Banks' Disclosure statements; IMF staff calculations.

The liquidity of banks' balance sheets has steadily improved since the financial crisis: in March 2012 liquid assets were 10 percent of total assets up from 6 percent in March 2007 (text figure). The composition of the banks' liquid asset portfolios has also changed significantly. Banks have substituted holdings of short-term bank paper for Commonwealth Government Securities (CGS) and semi-government securities which are now one-third of liquid assets compared with 6 percent in March 2007.

Bank Liquid Assets

(In billions of Australian dollars)



Sources: ABS; APRA; RBA.

A key element of the Basel III liquidity reforms is the liquidity coverage ratio (LCR) which is designed to ensure that banks have adequate high-quality liquid assets—defined by APRA as cash, central-bank reserves, CGS and semi-government securities—to meet the outflows associated with a 30 day stress scenario. 1/

However, Australia faces a shortage of such high-quality liquid assets. In particular, a long-period of prudent fiscal policy has resulted in a low supply of CGS relative to the size and liquidity needs of the financial sector. In addition, overseas demand for CGSs is high with a sizeable share held by non-residents, including by institutional investors that tend to hold assets to maturity, further reducing the depth of the CGS market. Other Basel III reforms, such as collateral requirements for derivative contracts, are expected to further increase the demand for high quality liquid assets.

With some other countries also facing a shortage of high-quality liquid assets, the Basel III framework allows for alternative approaches. The RBA and APRA have adopted one of these approaches, a committed liquidity facility, where banks can establish a secure liquidity facility with the RBA, for which they are charged an ongoing fee. The facility is designed to cover any shortfall between a bank's holdings of high-quality liquid assets and the LCR requirement. However banks are required to hold more high-quality liquid assets and cannot solely rely on the facility to meet the LCR.

APRA intends to adopt the counter-cyclical capital buffer as part of its implementation of the Basel III reforms. However, it is likely to go beyond the Basel Committee on Banking Supervision (BCBS)'s proposed benchmark—the de-trended ratio of credit to GDP—as its guide to deploy the buffer. Any such decisions are likely be made in consultation with the Reserve Bank of Australia, be based on a wide array of data, and with additional capital serving as a complement to other prudential tools.

1/ Further draft revised liquidity standards are expected to be released by APRA at end 2012.

bonds. Holdings of liquid assets have increased as banks also prepare to meet Basel III liquidity requirements (Figure 7).

27. Financial Sector Assessment Program (FSAP). Staff reiterated the recommendations from an FSAP update conducted over the past months[4]. To further bolster financial system stability, higher loss absorbency for systemically important institutions may be desirable, as part of a multi-pronged approach, that includes supervision and recovery and resolution planning. The FSAP mission identified room for improvement in certain areas of supervision, recommending greater depth and intensity in APRA's supervision of liquidity risk through more time allocated to formal on-site review, and that Australia Securities and Investments Commission (ASIC) be given more resources and flexibility over its operational budget. The FSAP mission recommended that the RBA develop macro-financial stress tests which could enhance its ability to identify and monitor emerging systemic risks and APRA devote more resources to stress testing. To ensure that the banking industry bears at least part of the cost of bank failures, the FSAP mission recommended that the authorities re-evaluate the merits of an ex ante funded deposit insurance scheme. While banks are making efforts to change funding structure, the FSAP mission stressed the importance of encouraging banks to continue to lengthen the maturity of offshore funding and increase their domestic funding.

The Authorities' Views

28. The authorities broadly agreed with the staff assessment of financial sector vulnerabilities. They acknowledged that banks are heavily exposed to household debt and that house prices are high by historical standards but, as discussed above, they do not see a fall in house prices as a stand-alone risk and note that other kinds of bank lending have proven to be more important drivers of losses in many countries over recent years. Moreover, stringent under-writing standards, based on serviceability rather than collateral, improve the resiliency of bank balance sheets to declines in house prices, consistent with the results of recent stress testing. Significant prepayment buffers—funds that borrowers can draw on to stay current with their loan, amounting to over 10 percent of the outstanding stock of housing loans and equivalent to about 18 months payment—further mitigate the risk to the banking sector of significant stress in the housing market or a sharp increase in unemployment. Improvements in banks' funding profiles have reduced the macroeconomic vulnerability to bank funding stress that would arise if the global funding markets become closed to all banks, regardless of individual strength. Due to their relative strength

[4] See Australia: Financial Sector Stability Assessment (forthcoming).

compared with banks in other countries, Australian banks were able to take advantage of periods of relative financial market calm earlier this year to move ahead of their annual funding targets.

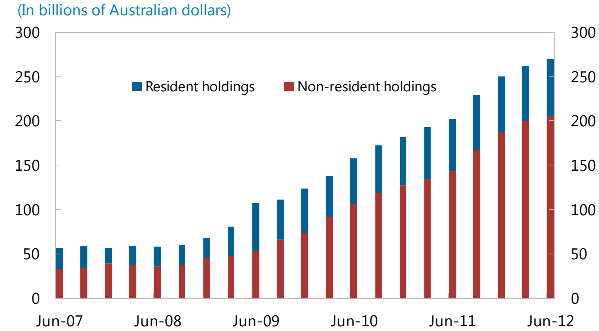
29. The authorities welcomed the main conclusions of the FSAP and noted that the process involved good, robust, and constructive discussions. Overall, they agreed with the assessment that the Australian financial system was resilient through the global financial crisis; the banks are well-capitalized, profitable, and well-positioned to implement Basel III capital reforms; and with the assessment of vulnerabilities, risks and mitigating factors identified during the FSAP process. In terms of the recommendations, the authorities emphasized the importance of intensive supervision as a tool for mitigating risks created by large, systemic banks. They will consider next steps on higher loss absorbency following G-20 endorsement of the Basel Committee's recommendations for domestic systemically important banks (D-SIBs).

ASSESSING EXTERNAL STABILITY

30. Current account. The current account deficit is projected to widen to 4 percent of GDP in 2012 as import volumes pick up, especially for capital goods (Figure 9, Table 5). Over the medium term, assuming a constant real exchange rate, the deficit is projected to reach 6 percent of GDP as investment in the resources sector reaches its peak, increasing mining-related imports by about 2 percent of GDP, and the terms of trade and interest rates on external borrowing normalize. The resources sector investment is financed by new foreign investment and retained earnings rather than through borrowing from domestic banks, and will expand export capacity in the future.

Non-resident Holdings of Commonwealth Government Securities, 2003-2012

(In billions of Australian dollars)

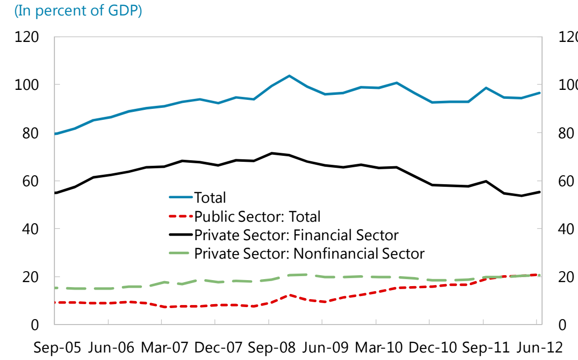


Sources: Australia Office of Financial Management

31. Capital flows. Over the past few years, net capital inflows have been largely directed towards the public sector, reflecting a heightened appetite by international investors for Australia government debt which, notwithstanding increases in availability of Commonwealth Government Securities, has increased the share held by non-residents to three-quarters of the total outstanding stock, an increase of over 15 percentage points compared with end-2009 (text figure). Over the past year, there have been net private sector equity inflow, including into the mining sector to finance investment, and net outflows of debt largely from the banking sector as existing debt matured.

32. Exchange rate assessment. Australia's free floating exchange rate will continue to provide the economy with an important buffer, particularly to fluctuations in global commodity demand. In addition, a strong Australian dollar plays a necessary role in reallocating domestic resources away from other tradable sectors, accelerating structural change. At the same time, staff estimates that the exchange rate is currently stronger than would be consistent with this adjustment, and at its current level, if continued, would likely result in an increase in banks' net foreign liabilities going forward (Box 3).[5] Although Australia's gross external debt is low by advanced country standards, net external liabilities remain relatively high (Figure 10). There are a number of factors contributing to the current high level of the Australian dollar, including the relative strength of the Australian economy, the gap between domestic and foreign interest rates and more recently, ongoing strong foreign demand for Commonwealth Government Securities. If these factors were to ease, the exchange rate would likely depreciate, reducing the current account deficit over the medium term and limiting the reliance of banks' borrowing abroad. The government's fiscal consolidation should also ease pressure on the exchange rate by boosting national saving, and additional steps to limit the projected decline in private saving, such as the planned increase in superannuation contributions, are appropriate.

Foreign Debt Level: Liabilities
(In percent of GDP)



Source: ABS.

The Authorities' Views

33. The authorities viewed much of the projected widening of the current account deficit as sustainable, related to major investment projects in mining financed by foreign investment, retained earnings, and long-term debt. As the investment phase of the mining boom comes to an end, mining sector export volumes are expected to increase and capital imports retreat, narrowing the current account deficit. The authorities reiterated their strong commitment to a freely-floating exchange rate, which should play a key role in containing external vulnerabilities. In contrast to past mining booms, the floating exchange rate has helped the economy to absorb a sharp increase in terms of trade without leading to an overheating domestic economy and a spike in inflation. They acknowledged staff's assessment that the exchange rate is modestly overvalued

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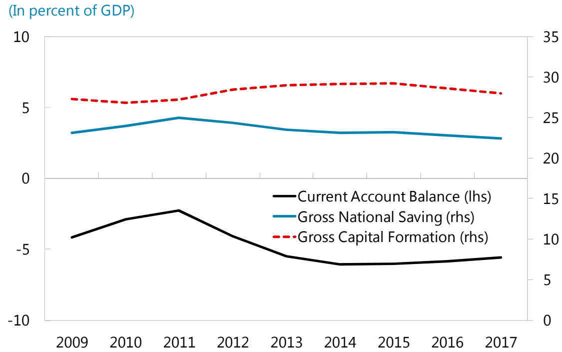
[5] Model-based approaches, while involving a high degree of uncertainty, suggest that the real exchange rate is 10-20 percent above the level predicted by Australia-specific factors. This assessment is sensitive to projections of saving behavior and the nature of the investment boom.

Box 3. External Sector Assessment 1/

Australia's real effective exchange rate has remained relatively high in 2012, while the current account is beginning to widen as capital imports grow and commodity prices fall. After appreciating by over 90 percent from 2003 to the third quarter of 2011, Australia's terms of trade has declined. The real exchange rate remains 32 percent above its 1983-2012 average, while the current account deficit widened from 2¼ percent of GDP in 2011 to 3¼ percent in the first half of 2012.

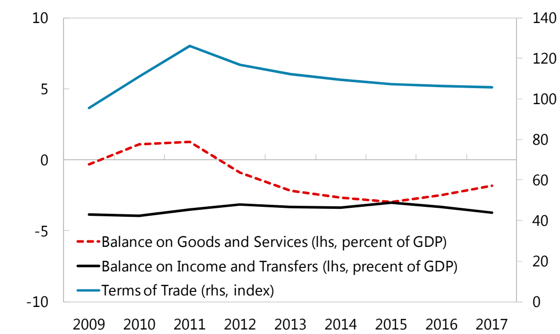
Model-based approaches, consistent with CGER and other approaches, suggest that Australia's real exchange rate is 10-20 percent above the level predicted by Australia-specific factors from a medium-term perspective. These estimates are, however, subject to considerable uncertainty. The IMF's amended real exchange rate regression approach attempts to identify the policy-related (both domestic and international) drivers of the deviation of each country's real exchange rate from its fundamentals-based fitted value. Applied to Australia, this yields an estimate of 20 percent overvaluation.

Saving-Investment Balance
(In percent of GDP)



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

External Balance Projection



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

Staff projects the current account to widen to 6 percent in the medium term, as the investment boom continues and the terms of trade and interest rates on external borrowing normalize (text figures). Investment is projected to peak at 29 percent of GDP in 2015 from 27 percent in 2011, and then to fall back to 28 percent of GDP in 2017. Over the same period, saving is projected to decline gradually from 25 to 22½ percent of GDP reflecting projected declines in currently high private sector corporate and household savings rates. If government saving does not follow its projected path of rising by 3 percent of GDP, the current account deficit would be correspondingly larger. The terms of trade is projected to decline by 15 percent between 2011 and 2017, and the riskless real interest rate is assumed to return to the pre-crisis average.

Staff assesses that the underlying current account deficit is 2 percent of GDP larger than the estimated medium-term norm of a deficit of 4 percent of GDP. The latter is close to the 4¼ percent of GDP average of the current account deficit since 1988, and is derived from a cross-country regression with a fixed effect.

Staff's assessment is sensitive to projections of saving behavior as well as the nature of the investment boom. Private saving may fall less quickly than projected if Australia's terms of trade falls more slowly (yielding higher retained profits), or if the deleveraging process is deeper than expected (pushing up household and corporate saving). The volume and timing of exports yielded by mining investments also affects the assessment.

[1/]This section is based in part on preliminary results from the Pilot External Sector Report (See http://www.imf.org/external/np/pp/eng/2012/070212.pdf).

relative to what might have been expected given the recent decline in the terms of trade. They noted, however, that there have been times in the past where the exchange rate has not moved closely in line with the terms of trade on a short term basis and that the recent strength of the exchange rate reflected positively on the relative attractiveness of Australia as an investment destination at the current juncture.

FACILITATING STRUCTURAL CHANGE

34. Structural change. A key structural policy challenge is to facilitate the movement of resources across the economy, as the mining sector moves rapidly through various stages from a phase of rapid commodity price growth to a period—currently underway and expected to peak in the next few years—of large scale investment, and to rapid growth in exports as investment projects are completed. Commodity prices have likely peaked, and although expected to remain at high levels, will no longer serve as a key driver of income growth. Strong demand from ongoing urbanization and industrialization in emerging Asia is fueling a surge in resources sector investment, which is projected to reach historic highs as a percent of GDP over the next two years. Ultimately, this investment will boost Australia's export capacity as projects come online.

35. Commodity price shocks. The increasing share of the mining sector in the economy implies that Australia will be more exposed to volatile commodity prices. Policies will also face the challenge of facilitating adjustment to shocks that affect different industries and regions within the country. Part of the adjustment to these asymmetric shocks can take place through the redistribution of income and taxation across regions achieved by Australia's federal fiscal system already in place. Our tentative estimates suggest that Australia's existing fiscal policy framework provides a fair amount of income insurance of this kind (Box 4).

36. Diversifying growth. Staff welcomed the government's efforts to formulate a policy strategy for dealing with the economy's longer-term structural transition, in particular making the most of the opportunities offered by the growth of Asian economies and addressing related challenges, as outlined in the recently released government White Paper on *Australia in the Asian Century*. To benefit from the Asian Century, Australia needs more than a mining sector success, not least to ensure that the economy has diversified enough growth drivers, such as services exports, health, education, tourism and professional services.[6]

[6] Staff organized a conference jointly with the Treasury and the RBA during the mission, in which the challenges and opportunities Australia faces in the Asian Century were extensively discussed.

Box 4. Federal Taxes and Transfers as Insurance for States in Australia

The Federal Fiscal System of Australia provides important insurance to households against idiosyncratic income shocks at the state level. Federal taxes change automatically in a countercyclical way with the level of income of households, providing insurance against negative shocks. Something similar happens with federal transfers.

Since states lack their own exchange rate, the insurance provided is particularly helpful to accommodate regional shocks. The shocks can be state specific, like natural disasters, or industry specific, like the mining boom, which affects states in an asymmetric way. The insurance provided by the federal fiscal system can be seen as the counterpart of the absent exchange rate flexibility for the states to react to shocks.

Staff estimates that about a quarter of the income lost in households is compensated by this insurance. The estimates are based on regression analysis of taxes and transfers paid or received by households as a function of income over the last two decades. Variables are measured in real per capita terms and relative to the national average. Several specifications produced similar results. Four fifths of the insurance comes from the tax side. These estimates are comparable to those for other countries, which vary between one tenth and one third for the total insurance effect.

Federal taxes decrease by approximately twenty cents per dollar lost in income. This is the combined effect of federal taxes on income, wealth, and other taxes when income in one state falls with respect to the national average. It includes all federal taxation on individuals. It excludes company taxes since the focus of the study is on the disposable income of households, not the support to the full economy.

Federal transfers increase by approximately five cents per dollar lost in income. The fact that transfers seem to provide less insurance than taxes could reflect non linearity in the amount received when compared to income, like receiving benefits only by belonging to groups defined by thresholds or other characteristics, for example, unemployment benefits that don't change when income is lower for the employed, transfers to families below certain income or belonging to a disadvantaged group like the disabled.

It is important to notice that this analysis aims to capture the countercyclical effect on income and not re-distributive policy. The previous discussion about the role of transfers makes clear that one thing is the stabilizing effect on income and the other redistribution to the poor or other disadvantaged groups in society.

The federal system also provides additional insurance to the state finances. The estimates above relate only to disposable household income, and do not include horizontal transfers between states and vertical transfers with the federal government. Of particular importance for state finances is the horizontal fiscal equalization mechanism by which goods and services sales tax revenues are re-distributed among states.

The total insurance to household incomes is larger than our estimates above, because of state taxes and transfers. The focus of the study was the federal system, as a counterpart to the absence of a floating exchange rate at the state level. The state fiscal system also provides some automatic stabilization of household income.

The Authorities' Views

37. Managing structural change. The authorities agreed that Australia is undergoing long-term structural change, shifting towards a services-oriented economy and responding to the rise of Asia, as reflected in current demand for non-rural commodities and the needs of the growing Asian middle class. The government's role is to facilitate change, which is best achieved through policies that increase the flexibility, capabilities, and stability of the economy. They emphasized the key role of exchange rate flexibility in adjusting to cycles in the terms of trade. They noted that although the current mining boom is larger than in the past, macroeconomic outcomes are better, with stable inflation and low unemployment. This can be, in part, explained by improvements to the institutional settings such as the introduction of a floating exchange rate regime, decentralized wage bargaining, inflation targeting and operational independence for the RBA, and product market reforms that enhance flexibility, such as removal of trade barriers. The authorities noted that as the investment phase of the current boom winds down, growth in other sectors of the economy such as residential construction would need to pick-up in order to maintain a steady pace of economic growth. They noted that early signs of this were already starting to occur, assisted by the significant monetary policy easing over the past year.

STAFF APPRAISAL

38. Outlook and risks. The outlook for the Australian economy remains favorable with strong commodity demand from China that is boosting export earnings and driving an investment boom in the mining sector. Outside the mining sector, growth is expected to be slow with still weak consumer confidence and a strong exchange rate weighing on business investment. The risks to the growth projections are tilted to the downside reflecting an uncertain global economy and the risk of disruptions to the global financial system. The flexible exchange rate would provide a buffer against shocks, particularly to fluctuations in global commodity demand.

39. Monetary Policy. The current accommodative monetary policy stance is broadly appropriate given expected inflation within the target range, the strong Australian dollar, and efforts to return the budget to surplus this year. The RBA's high degree of credibility and the rapid monetary policy transmission in Australia allows monetary policy to react quickly and flexibly to changing economic circumstances. If the global recovery stalls or international markets are disrupted, monetary policy should act as the first line of defense and the RBA has the scope to cut the policy rate and provide liquidity support for banks.

40. Fiscal Policy. The government's deficit reduction path strikes a balance between the benefit of reducing public debt and the need to contain any adverse impact on economic growth. Much of this year's adjustment reflects a catch up of revenue, which should help mitigate the impact of the planned deficit reduction on aggregate demand. The plan to maintain surpluses over the medium term should help relieve pressure on monetary policy and thereby the exchange rate, and put Australia in a better position to deal with future shocks and the long-term cost of aging. Australia's modest public debt gives the authorities scope to delay their planned return to surpluses in the event of a sharp deterioration in the economic outlook.

41. External vulnerabilities and the exchange rate. Australia's net foreign liabilities are large by international comparison. The current account deficit is projected to widen in the coming years as mining-related capital goods imports, mostly financed by direct investment, pick up. Although a strong Australian dollar plays a necessary role in reallocating resources toward mining and related sectors, it is stronger than would be consistent with this adjustment alone, and at its current level would likely lead to a build-up of bank foreign liabilities over the longer term. Increasing national saving, including through budget deficit reduction, would help reduce pressure on the current account.

42. Financial Sector. An FSAP Update was conducted in conjunction with the 2012 Article IV consultation and found Australia's financial system to be sound, resilient, and well-managed. Banks are making efforts to move to more stable funding sources and are hedged against exchange rate risk, but will continue to rely on wholesale funding for the foreseeable future exposing them to global market turmoil. Stress testing indicates that the major banks are adequately capitalized and are likely to withstand large macroeconomic shocks, but would require RBA liquidity support to withstand an extreme funding shock. The authorities should continue to emphasize intensive bank supervision and introduce higher loss absorbency for systematically important banks.

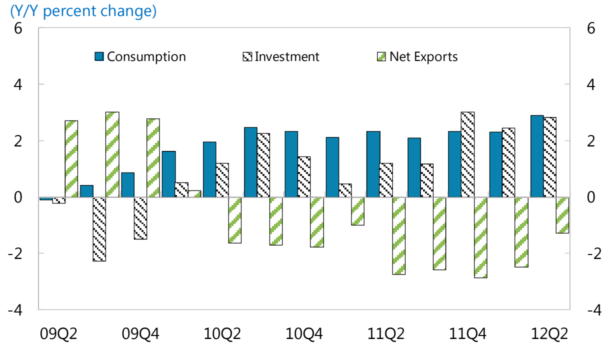
43. Facilitating structural change. A key structural policy challenge is to facilitate the movement of resources across the economy, as the mining sector moves through various stages: namely, a commodity price boom, the current large scale investment phase, and then the expected expansion in export capacity. Staff welcomed the government's efforts to formulate a policy strategy for dealing with the economy's longer-term structural transition, in particular making the most of the opportunities offered by the growth of Asian economies and addressing related challenges.

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

Figure 1. Australia: Growth Driven by Commodities

Australia's growth is strong...

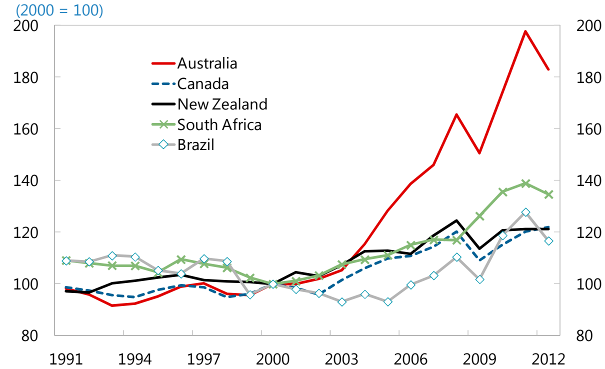
Contribution to Growth
(Y/Y percent change)



Source: Australian Bureau of Statistics.

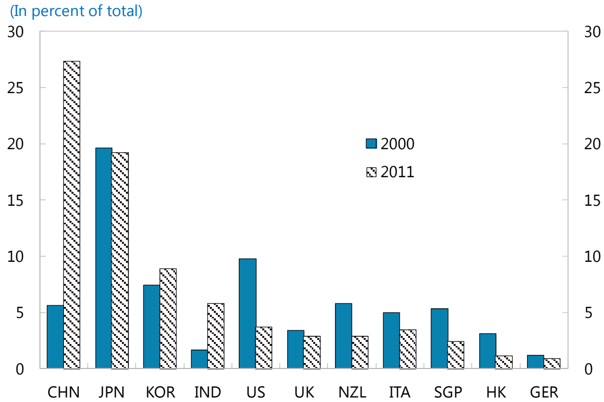
...driven by still-strong terms of trade...

Terms of Trade, Goods and Services
(2000 = 100)



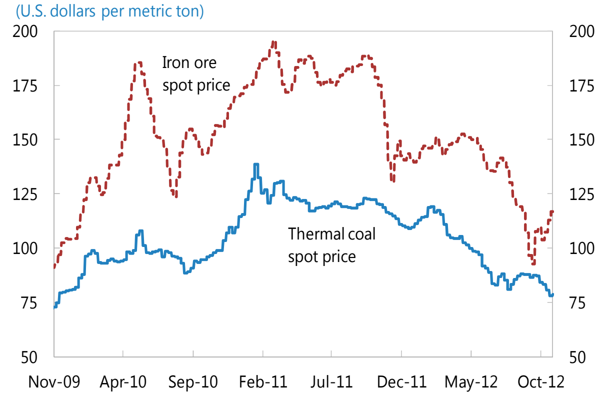
...and growing links to Asia, especially China, where demand for commodity remains strong...

Exports by Destination
(In percent of total)



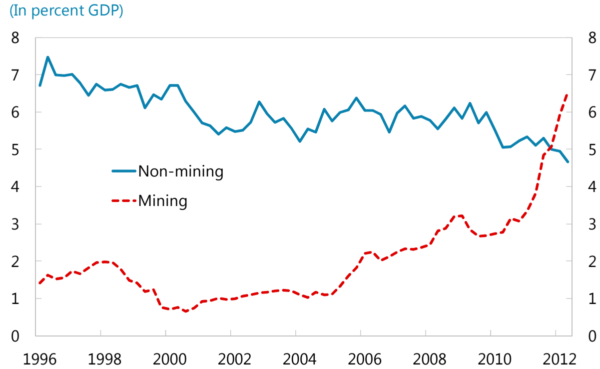
...despite the recent decline in Australia's commodity prices.

Commodity Prices
(U.S. dollars per metric ton)



The growth however appears to be narrowly-based, with stronger growth in mining sector investment...

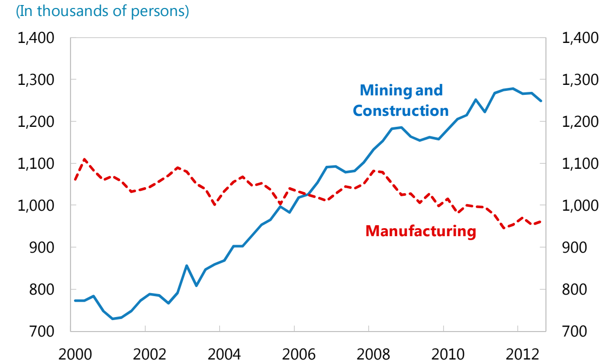
Capital Expenditure
(In percent GDP)



Source: Australian Bureau of Statistics.

...and employment.

Employment by Industry
(In thousands of persons)



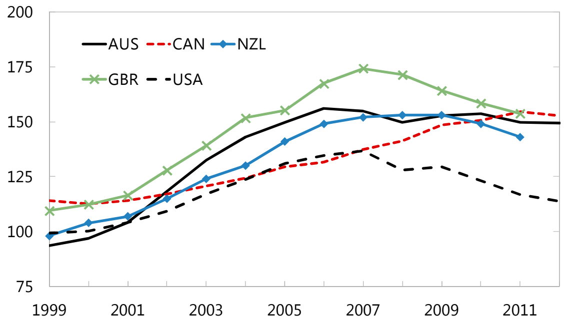
Sources: ABS; and Australian Treasury.

Figure 2. Australia: Household Vulnerabilities

Household debt declined marginally...

Household Debt to Disposable Income

(In percent)

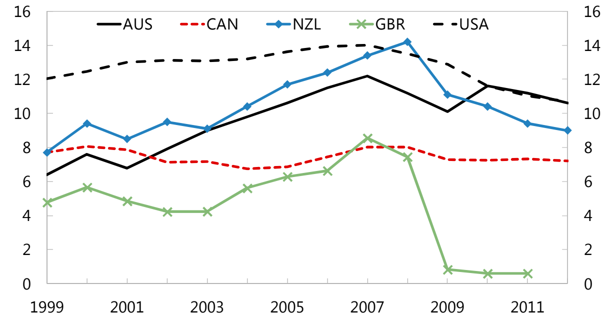


Sources: RBA; RBNZ; Eurostat; Haver; and IMF staff calculations.

...so have debt-servicing costs.

Household Interest Payments to Disposable Income

(In percent)

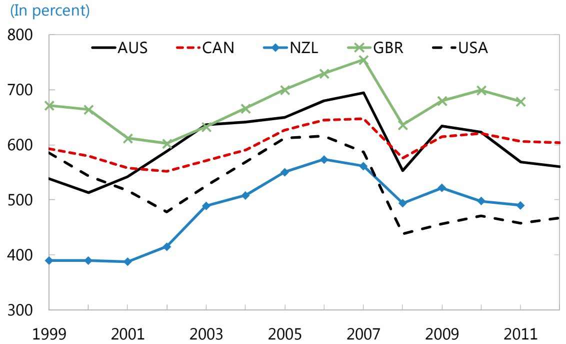


Sources: RBA; RBNZ; Eurostat; Haver; and IMF staff calculations.

Household net wealth has fallen since the crisis...

Net Wealth to Disposable Income

(In percent)

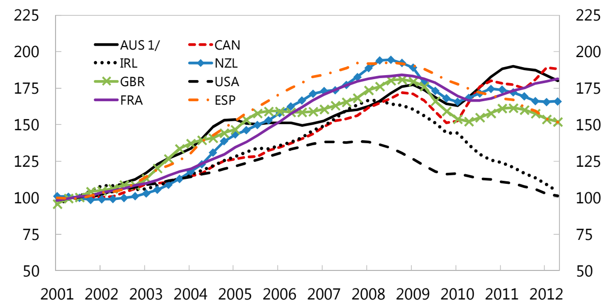


Sources: RBA; RBNZ; Eurostat; OECD; Haver; and IMF staff calculations.

...and households remain vulnerable to a possible unwinding of the large run-up in house price.

Real House Prices

(2000 = 100)

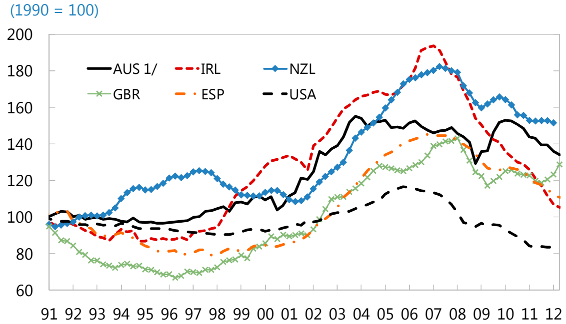


1/ Based on ABS house price measure.
Source: OECD database.

However, housing has become more affordable...

House Price-to-Income Ratio

(1990 = 100)

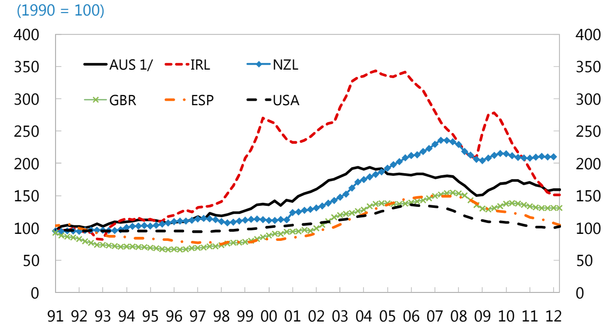


1/ Based on APM and ABS house price measures.
Sources: OECD database.

...and the house price-to-rent ratio has improved.

House Price-to-Rent Ratio

(1990 = 100)

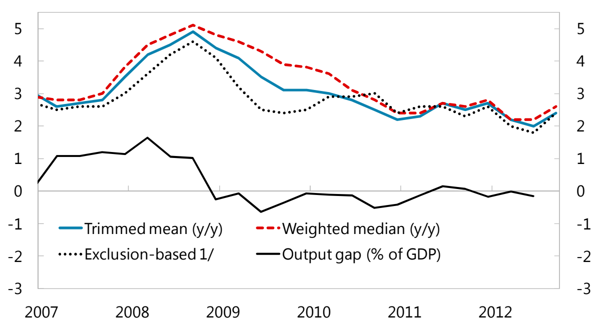


1/ Based on REIA and RP Data Rismark house price measures.
Sources: OECD database.

Figure 3. Australia: Inflationary Pressures Eased

Underlying inflation has been falling...

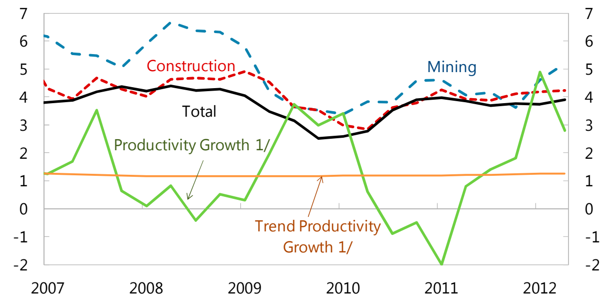
Underlying Inflation and Output Gap
(In percentage points)



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

....as wages grew roughly in line with trend productivity and the RBA's inflation target.

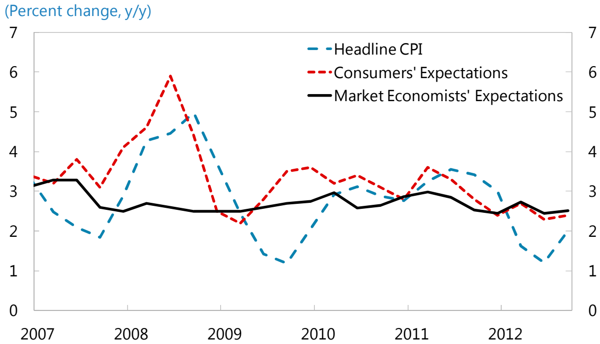
Private Sector Wages and Productivity
(Percent change, y/y)



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

Inflation expectations remain stable around 2½ percent ...

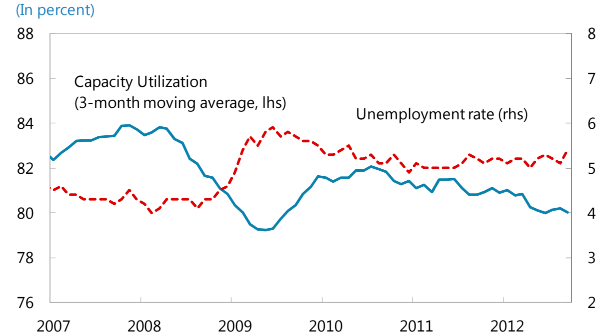
CPI Inflation
(Percent change, y/y)



Sources: RBA; ABS; and Melbourne Institute.

...and there seems to be spare capacity in the economy.

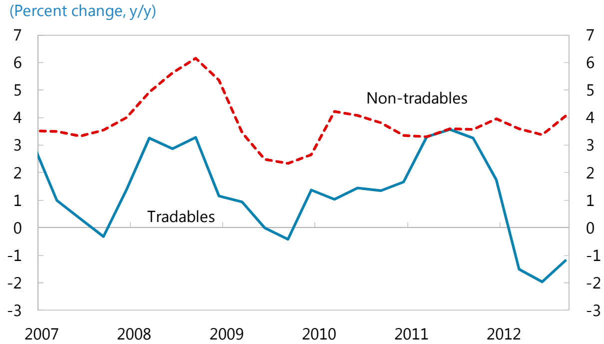
Indicators of Resource Pressure
(In percent)



Sources: ABS; and National Australia Bank.

Exchange rate pass through has lowered tradable prices...

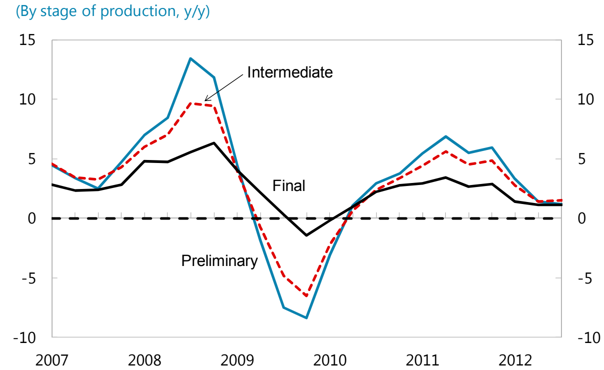
CPI Inflation
(Percent change, y/y)



Source: Australian Bureau of Statistics.

...while producer price inflation has declined.

Producer Price Inflation
(By stage of production, y/y)



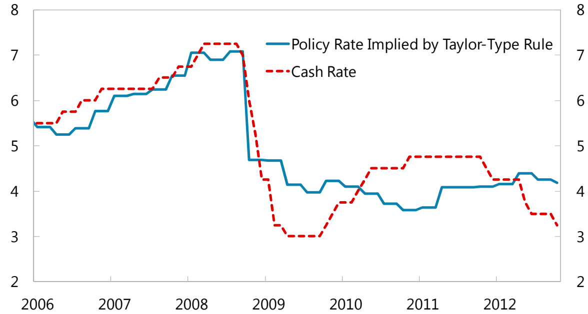
Source: Reserve Bank of Australia.

Figure 4. Australia: Monetary Stance

The policy rate is close to that implied by a Taylor rule…

Policy Rates

(In percent)

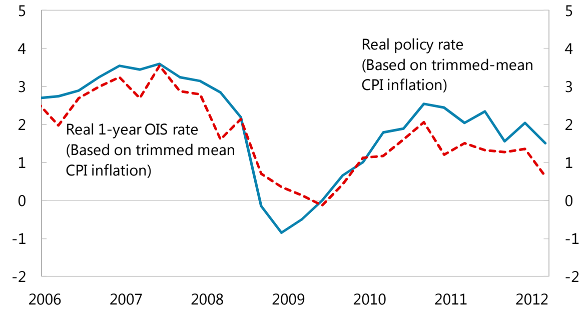


Sources: Reserve Bank of Australia; and IMF staff estimates.

…and the real policy rate has stabilized below its recent average.

Real Interest Rates

(In percent)

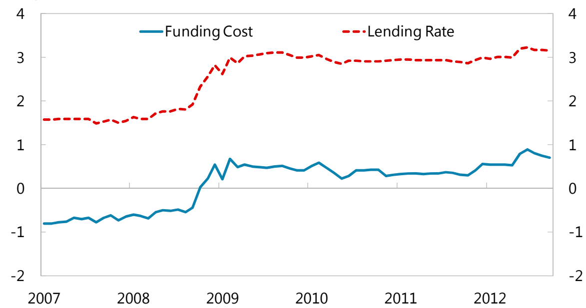


Source: Haver Analytics.

Bank funding costs have remained elevated…

Major Banks' Lending Rates and Funding Costs Spread to Cash Rate

(In percent)

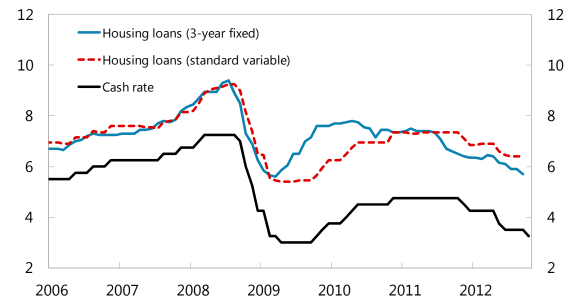


Source: Reserve Bank of Australia.

…while mortgage rates followed the cash rate.

Mortgage Interest Rates

(In percent)

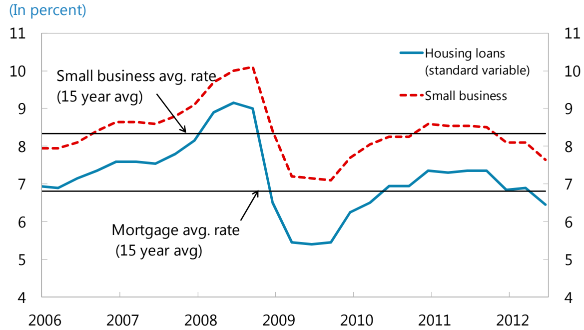


Source: Reserve Bank of Australia.

Market lending rates are close to historical averages…

Mortgages and Business Lending Rates

(In percent)

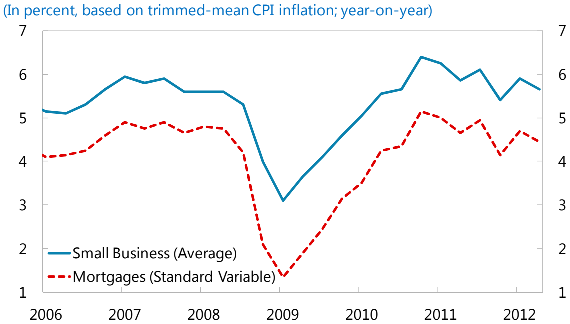


Source: Reserve Bank of Australia.

…and so are real lending rates.

Real Lending Interest Rate

(In percent, based on trimmed-mean CPI inflation; year-on-year)



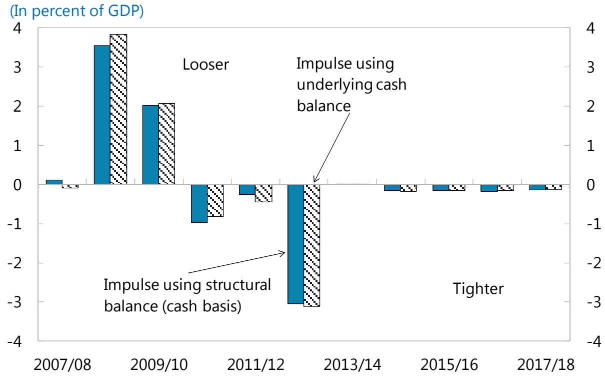
Source: Reserve Bank of Australia.

Figure 5. Australia: Fiscal Stance

An ambitious consolidation...

Commonwealth Government Fiscal Impulse

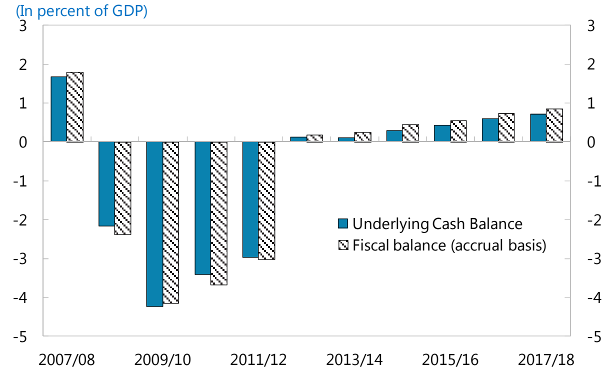
(In percent of GDP)



...will return the budget to surplus this fiscal year...

Commonwealth Government

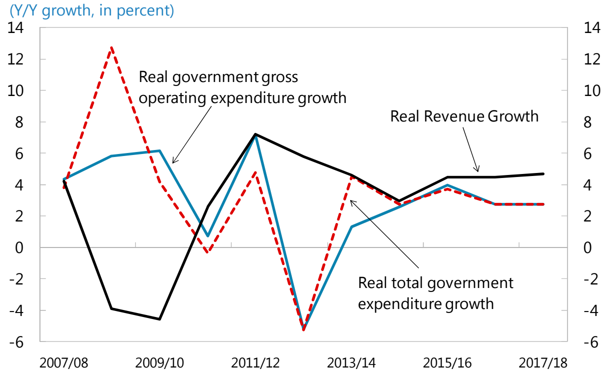
(In percent of GDP)



...through restraint in expenditure and revenue growth.

Commonwealth Revenue and Expenditure

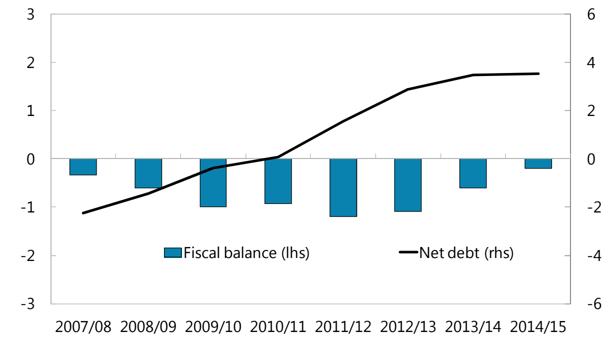
(Y/Y growth, in percent)



States are also consolidating gradually their budgets.

State/Local Governments

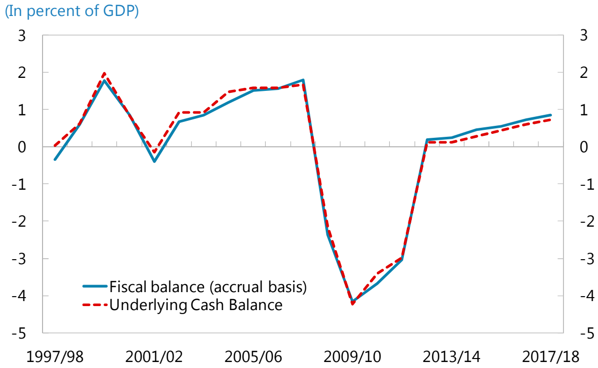
(In percent of GDP)



The budget surplus is projected to increase to about 1 percent of GDP over the medium term...

Commonwealth Government - Balance

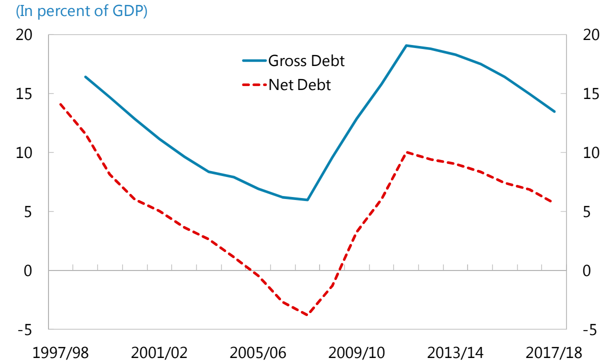
(In percent of GDP)



...while net debt is projected to peak at almost 10 percent in 2011/12.

Commonwealth Government - Debt

(In percent of GDP)



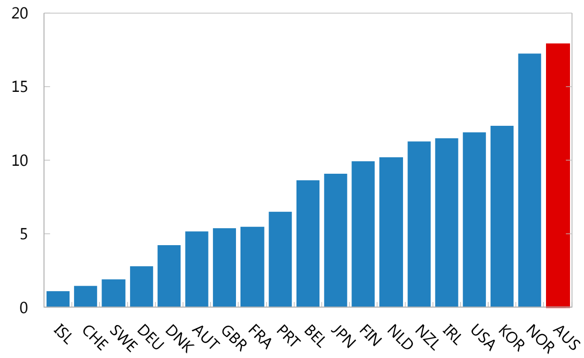
Sources: Australian Bureau of Statistics; and IMF staff estimates and projections.

Figure 6. Australia: Comparison of Fiscal Outlook

After a period of high real expenditure growth…

Change in Real Expenditure Per Capita, 2006-11

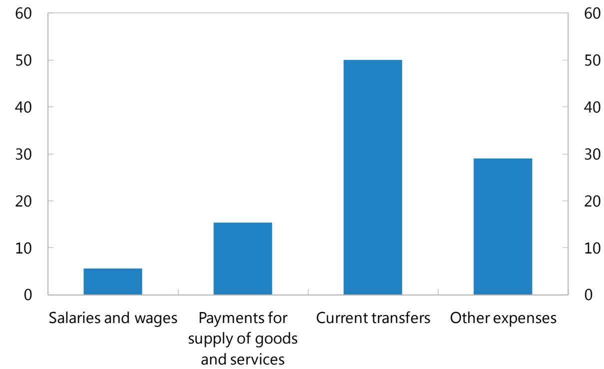
(In percent; general government)



…driven mainly by current transfers…

Contribution to Expenditure Growth, 2006-2011

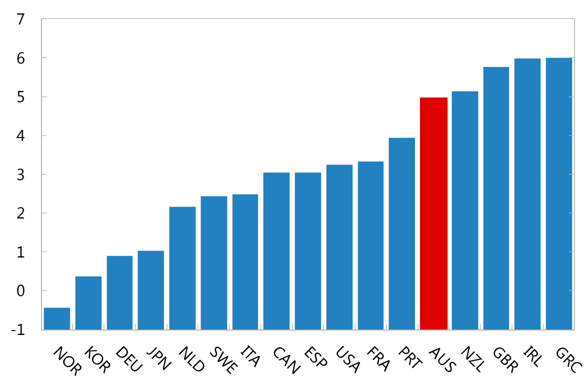
(In percent)



…consolidation is now faster than in most advanced countries…

Change in Structural Balance, 2011-2017

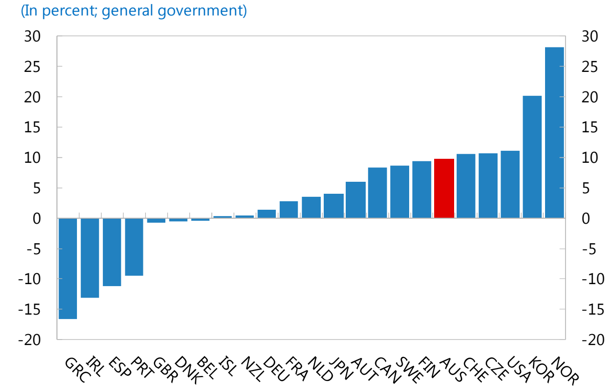
(In percent of GDP; general government)



…many of which have higher expenditure growth…

Change in Real Expenditure, 2011-2017

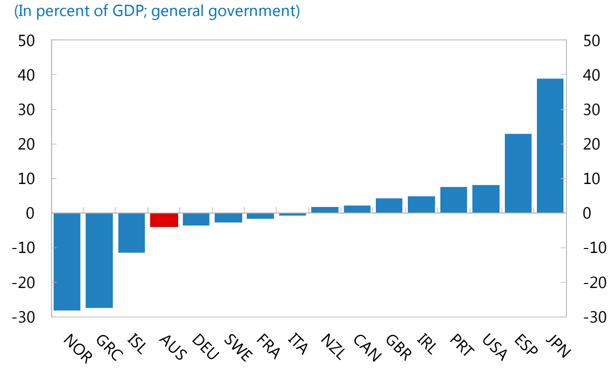
(In percent; general government)



General government net debt is forecast to fall over the medium term…

Change in Net Debt, 2011-17

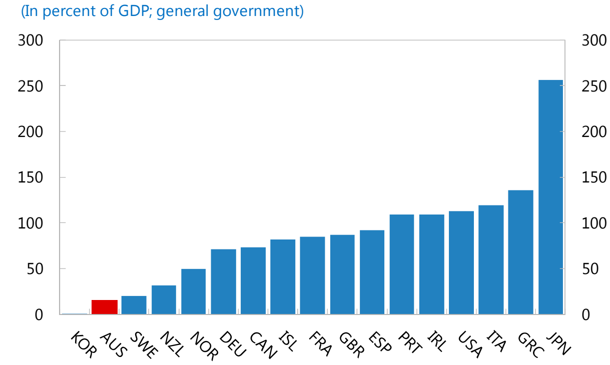
(In percent of GDP; general government)



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

General Government Gross Debt, 2017

(In percent of GDP; general government)

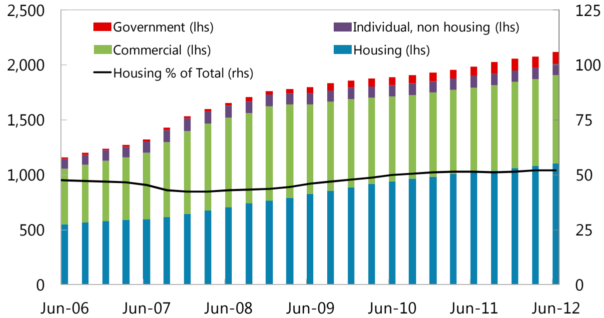


Sources: Australian Bureau of Statistics; and IMF staff estimates and projections.

Figure 7. Australia: Banking System Developments

Over half of total lending is to housing.

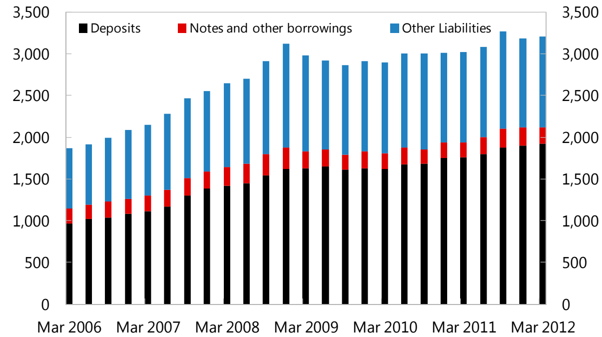
Banks' Lending Structure
(In billions of Australian dollars)



Source: Reserve Bank of Australia.

Deposits are an increasing share of banks' liabilities but wholesale funding remains sizeable.

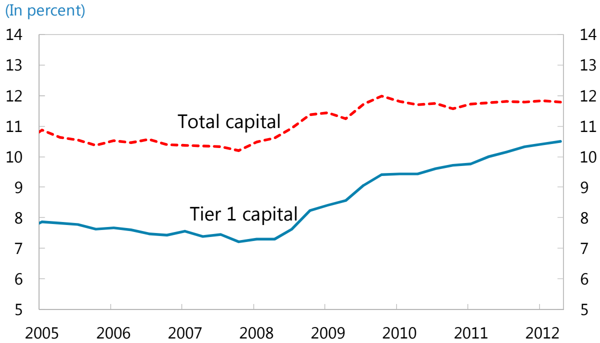
Banks' Liabilities Composition
(In billions of Australian dollars)



Source: Australia Prudential Regulation Authority.

Banks' Tier 1 capital ratio continues to increase as banks move towards meeting Basel III requirement.

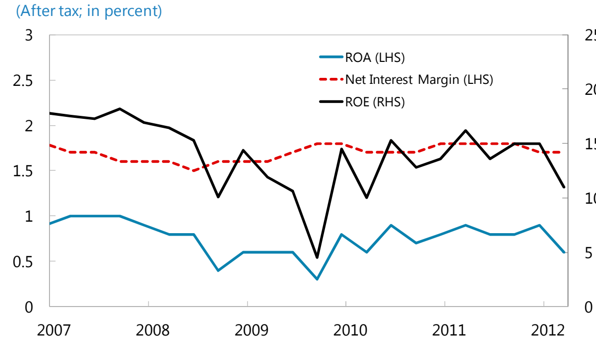
Capital Adequacy Ratios
(In percent)



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

Banks are profitable...

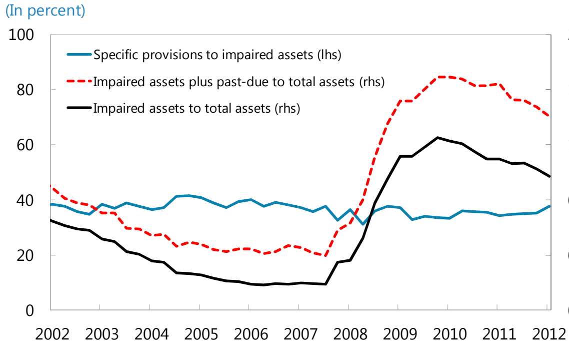
Profitability
(After tax; in percent)



Source: Australia Prudential Regulation Authority.

...and asset quality is good, although impaired assets remain above pre-crisis levels.

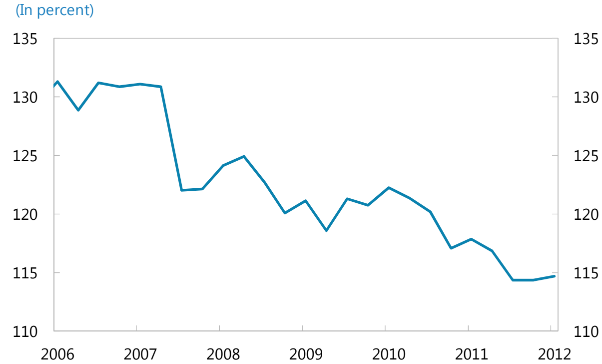
Asset Quality
(In percent)



Source: Reserve Bank of Australia.

With rapid deposit growth and more modest growth in credit, banks' loans to deposit ratio continues to fall.

Banks' Loans to Deposits Ratio
(In percent)

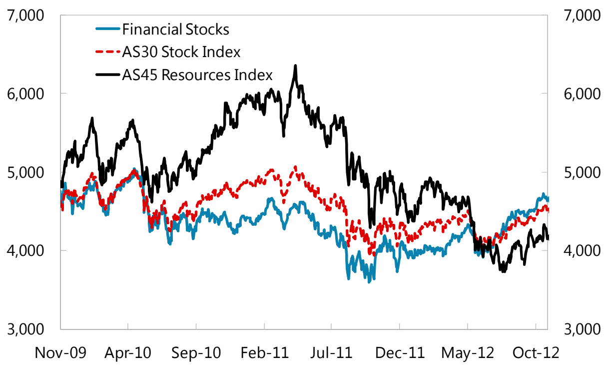


Source: Australia Prudential Regulation Authority.

Figure 8. Australia: Financial Market Indicators

The stock market index is broadly unchanged over the year but financial stocks have gained while the resources index has fallen sharply.

Stock Market Indices

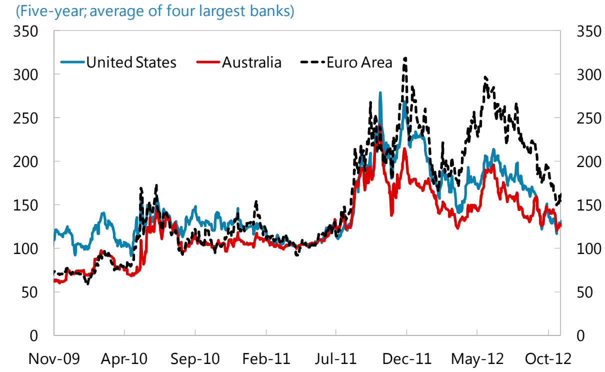


Source: Bloomberg.

Bank credit default swaps spreads are above crisis levels yet below those for European and U.S. banks.

Credit Default Swap (CDS) Spreads

(Five-year; average of four largest banks)

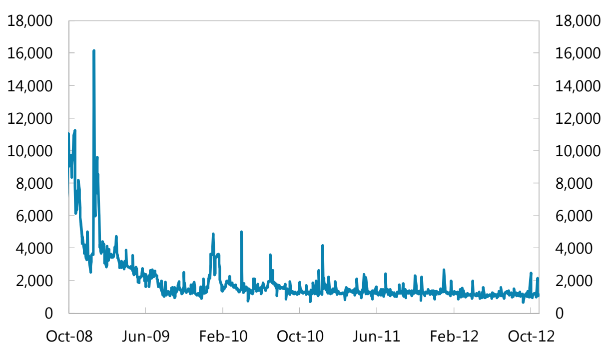


Sources: Reserve Bank of Australia; and Bloomberg.

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

Exchange Settlement Balances

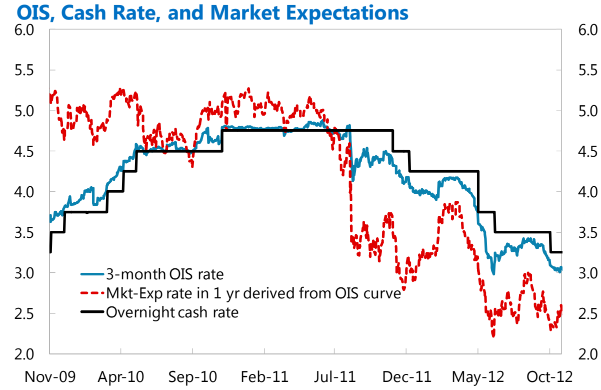
(In millions of Australian dollars)



Source: Reserve Bank of Australia.

Market expectations derived from the overnight swap market point to further cuts in the policy rate over the next year.

OIS, Cash Rate, and Market Expectations

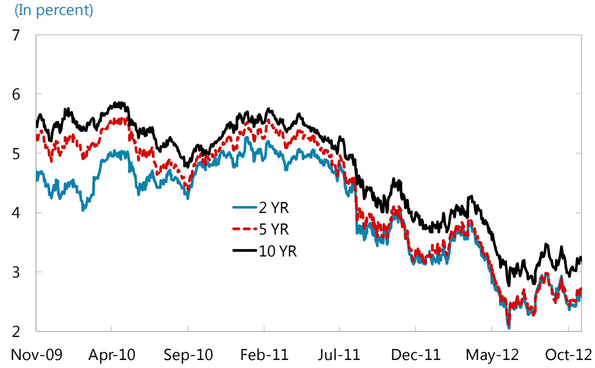


Sources: Bloomberg; and Credit Suisse.

Australian Commonwealth bond yields fell to historic lows during the year...

Australia Commonwealth Debt Yields

(In percent)

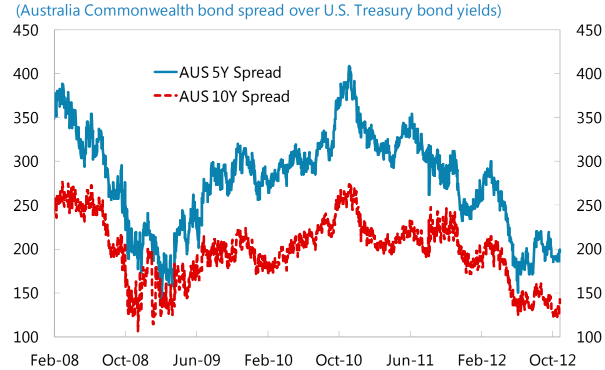


Source: Bloomberg.

...as Australian Commonwealth bond spreads continue to narrow relative to U.S. yields.

Australia Sovereign Spreads

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



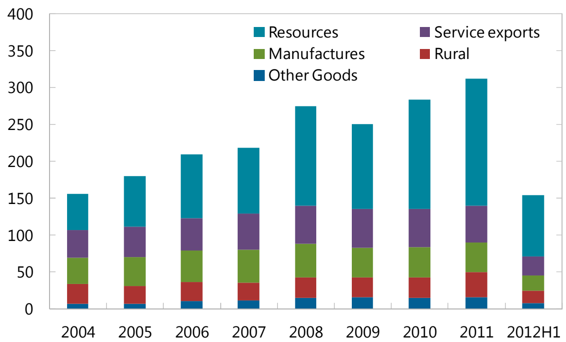
Source: Bloomberg.

Figure 9. Australia: Trade and the Balance of Payments

The resource sector accounts for a rising share of exports…

Composition of Exports

(In billions of Australian dollars)

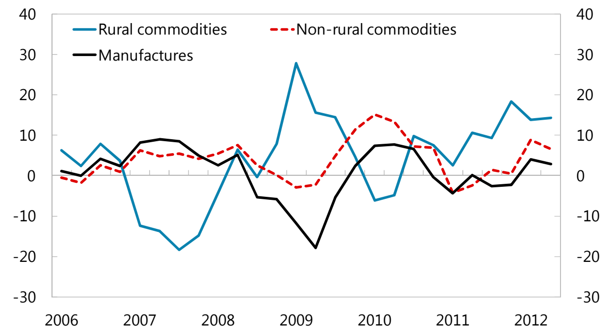


Sources: Australian Bureau of Statistics; and Reserve Bank of Australia.

…and has recovered from the natural disasters in 2011.

Exports of Goods

(In real terms, Y/Y percent change)

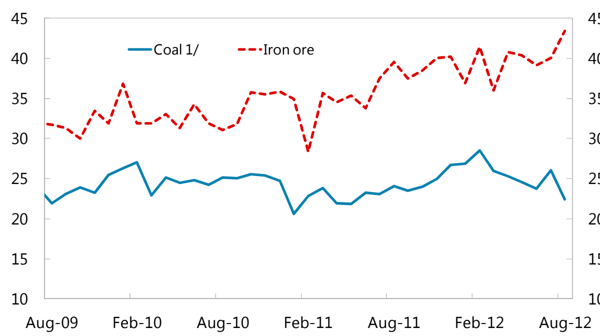


Source: Australian Bureau of Statistics.

Exports of coal and iron ore remain strong.

Exports of Coal and Iron Ore

(In millions of tons)

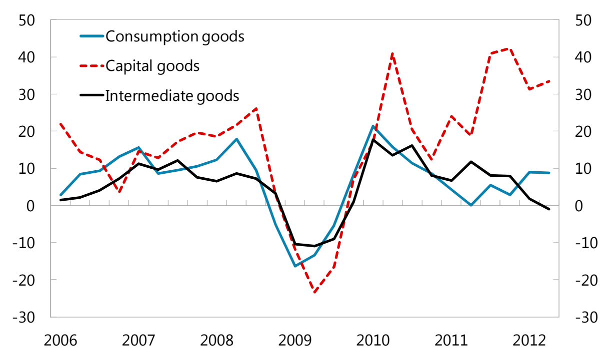


1/ Seasonally adjusted.
Sources: ABS; and RBA.

Imports of capital and consumption goods rebounded…

Imports of Goods

(In real terms, Y/Y percent change)



Source: Australian Bureau of Statistics.

…contributing to a widening current account deficit…

Current Account Balance

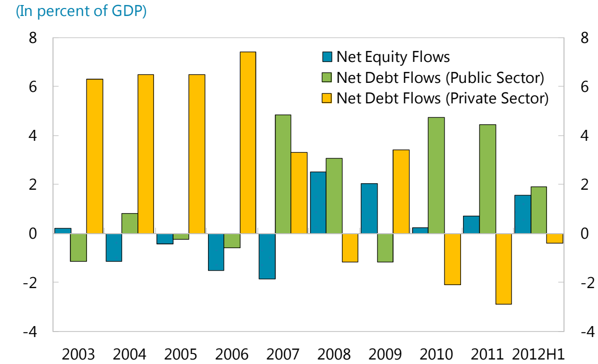
(In percent of GDP)

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

…which is increasingly financed by equity flows and debt flows to the public sector.

Net Capital Inflows

(In percent of GDP)



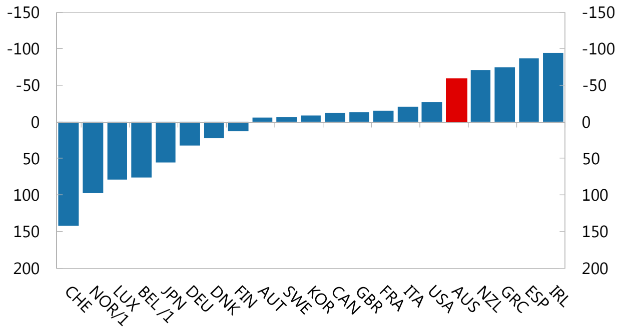
Source: Australian Bureau of Statistics.

Figure 10. Australia: External Vulnerability

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

Net Foreign Investment Position, 2011

(In percent of GDP)

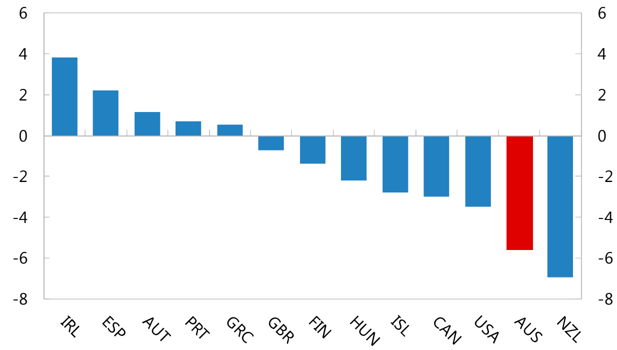


1/ 2010Q4 value

...and its current account deficit is projected to be larger than most advanced economies...

Current Account Balance, 2017

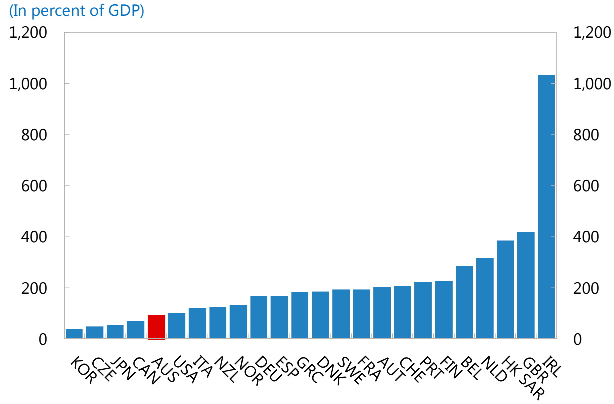
(In percent of GDP)



...but gross external debt is low compared to other countries.

Total External Debt, 2012Q1

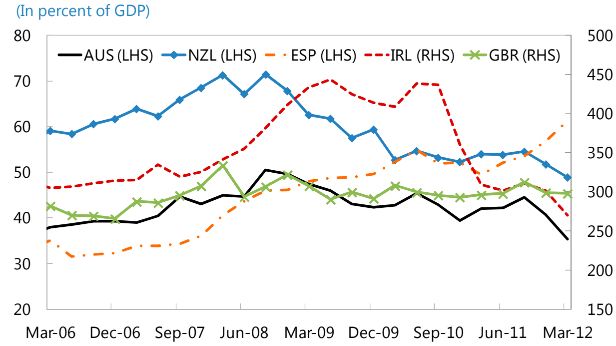
(In percent of GDP)



Short term debt declined somewhat from its pre-crisis peak...

Total Short-Term External Debt 1/

(In percent of GDP)

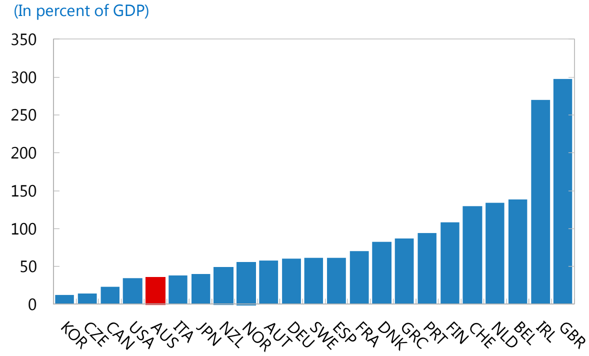


1/ Short-term debt is on a residual maturity basis for Australia and New Zealand and on an original maturity basis for other countries

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

Total Short-Term External Debt, 2012Q1 1/

(In percent of GDP)

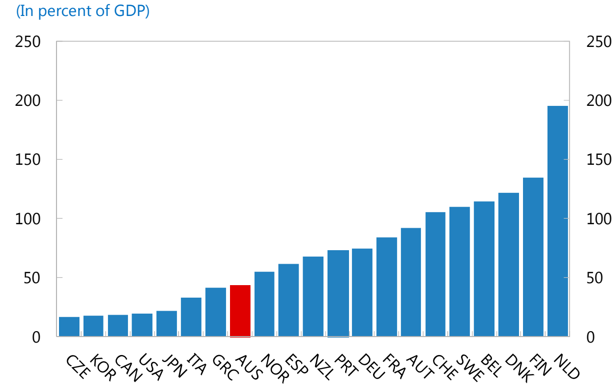


1/ Short-term debt is on a residual maturity basis for Australia and New Zealand and on an original maturity basis for other countries.

Bank debt is low relative to most other advanced countries.

Bank Gross External Debt, 2012Q1

(In percent of GDP)



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

Table 1. Australia: Selected Economic Indicators, 2009–13

Nominal GDP (2011): $A 1,44 billion — Quota (in millions): SDR 3,236
GDP per capita (2011): $A 63,576 — Population (September 2012): 22.7 million
Unemployment rate (September 2012): 5.4 percent
Main exports: Metal ores and minerals; tourism; coal and coke (fuel)

	2009	2010	2011	2012	2013
				Proj	
Output and demand (percent change)					
Real GDP	1.4	2.5	2.1	3.3	3.0
Total domestic demand	-0.8	4.1	4.6	4.7	3.6
Private consumption	1.0	2.9	3.3	3.7	3.4
Total investment	-3.0	4.9	7.1	8.2	5.5
Net exports 1/	2.2	-1.5	-2.7	-0.8	-0.7
Inflation and unemployment (in percent)					
CPI inflation	1.8	2.9	3.3	2.0	2.6
Unemployment rate	5.6	5.2	5.1	5.2	5.3
Saving and investment (in percent of GDP)					
Gross national saving	23.1	23.9	24.9	24.3	23.5
General government saving	-0.8	-0.1	-0.1	2.4	5.4
Private saving 2/	23.9	24.0	25.0	21.9	18.1
Gross capital formation	27.3	26.8	27.2	28.4	29.0
Fiscal indicators (cash basis, in percent of GDP) 3/					
Receipts	23.1	21.8	21.3	22.3	23.6
Payments	25.2	26.0	24.7	25.3	23.5
Underlying cash balance	-2.2	-4.2	-3.4	-3.0	0.1
Net debt	-1.3	3.3	6.0	10.0	9.4
Money and credit (end of period)					
Interest rate (90-day bill, in percent)	4.2	5.0	4.5	4.5	…
Treasury bond yield (10-year, in percent) 4/	5.6	5.5	3.7	2.8	…
M3 (percent change) 4/	4.1	10.4	8.0	9.1	…
Private domestic credit (percent change) 4/	1.3	3.0	3.5	4.6	…
Balance of payments (in percent of GDP)					
Current account	-4.2	-2.9	-2.3	-4.1	-5.5
Terms of trade (percent change)	-9.1	16.0	13.6	-7.4	-4.0
External assets and liabilities (in percent of GDP)					
Net external liabilities	61.7	57.3	59.5	61.4	64.1
Net external debt	52.6	47.9	50.8	52.5	54.1
Gross official reserves 4/	3.7	3.1	3.2	3.1	…
Net official reserves 4/	3.7	3.1	3.1	2.7	…
Exchange rate (period average)					
U.S. dollar/Australian dollar 4/	0.79	0.92	1.03	1.03	…
Trade-weighted index 4/	63.2	70.9	75.7	76.9	…
Nominal effective exchange rate 4/ 5/	98.1	111.6	119.5	125.7	…
Real effective exchange rate 4/ 5/	100.6	115.2	123.4	129.4	…
Memorandum Item:					
Nominal GDP (in billions of Australian dollar)	1,251	1,354	1,441	1,490	1,561

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

1/ Contribution to growth.
2/ Includes public trading enterprises.
3/ Fiscal year ending June 30, Commonwealth Budget. For example, 2012 refers to fiscal year July 1, 2011 to June 30, 2012.
4/ Data for 2012 are for latest available month.
5/ IMF, Information Notice System index (2005 = 100).

Table 2. Australia: Medium-Term Scenario, 2009–17

	Average				Projections					
	1998–2008	2009	2010	2011	2012	2013	2014	2015	2016	2017
Real economic indicators (percent change)										
GDP	3.5	1.4	2.5	2.1	3.3	3.0	3.2	3.3	3.2	3.2
Total domestic demand	4.7	-0.8	4.1	4.6	4.7	3.6	3.3	3.1	2.5	2.3
Private consumption	3.9	1.0	2.9	3.3	3.7	3.4	3.2	3.1	3.1	3.0
Government consumption	3.3	0.7	3.4	2.5	2.3	1.0	1.0	1.4	1.3	1.0
Total investment	6.7	-3.0	4.9	7.1	8.2	5.5	4.8	4.3	2.3	1.9
Private sector	8.3	-4.0	-0.3	11.4	9.7	6.6	5.8	5.1	2.7	2.2
Business	8.7	-4.6	-1.4	17.0	14.8	7.3	6.7	6.0	2.8	2.3
Dwelling	3.9	-4.4	4.1	1.3	-4.2	4.6	3.0	2.2	2.0	2.0
Stockbulding 1/	0.1	-0.8	0.4	0.4	0.0	0.0	0.0	0.0	0.0	0.0
Public sector	6.8	1.0	26.7	-6.8	2.0	0.7	0.3	0.4	0.4	0.4
Net exports 1/	-0.7	2.2	-1.5	-2.7	-0.8	-0.7	-0.2	0.0	0.5	0.7
Output gap	0.2	-0.3	-0.3	-0.6	0.0	0.1	0.1	0.0	0.0	0.0
CPI inflation	2.9	1.8	2.9	3.3	2.0	2.6	2.3	2.6	2.5	2.4
Unemployment rate (percent)	5.8	5.6	5.2	5.1	5.2	5.3	5.2	5.1	5.1	5.1
Saving and investment (percent of GDP)										
Gross national saving	21.8	23.1	23.9	24.9	24.3	23.5	23.1	23.2	22.8	22.4
General government saving	3.9	-0.8	-0.1	-0.1	2.4	5.4	5.2	5.2	5.1	5.1
Private saving 2/	17.9	23.9	24.0	25.0	21.9	18.1	17.9	18.0	17.6	17.3
Of which: Household	6.8	11.9	10.5	11.1	10.6	10.1	9.4	8.9	8.5	8.1
Gross capital formation	26.5	27.3	26.8	27.2	28.4	29.0	29.1	29.2	28.6	28.0
Of which: Private fixed investment	21.6	22.8	20.5	21.4	22.7	23.5	23.8	24.1	23.7	23.2
Commonwealth budget (percent of GDP) 3/										
Receipts (cash basis) 4/	25.1	23.1	21.8	21.3	22.3	23.6	23.8	23.8	24.0	24.2
Payments (cash basis)	24.1	25.2	26.0	24.7	25.3	23.5	23.7	23.5	23.5	23.6
Underlying cash balance 4/	1.0	-2.2	-4.2	-3.4	-3.0	0.1	0.1	0.3	0.4	0.6
Net debt	4.1	-1.3	3.3	6.0	10.0	9.4	9.0	8.4	7.4	6.8
Balance of payments (percent of GDP)										
Balance on goods and services	-1.5	-0.3	1.1	1.2	-0.9	-2.2	-2.7	-3.0	-2.5	-1.8
Balance on income and transfers	-3.3	-3.9	-4.0	-3.5	-3.2	-3.3	-3.4	-3.0	-3.3	-3.7
Current account balance	-4.8	-4.2	-2.9	-2.3	-4.1	-5.5	-6.1	-6.0	-5.9	-5.6
Trade in goods and services (percent change)										
Export volume	3.2	2.0	5.5	-1.2	4.3	3.9	5.4	5.3	7.3	7.2
Import volume	8.5	-8.6	14.2	11.4	7.1	6.1	5.4	4.3	3.7	3.1
Terms of trade (level)	74.9	95.7	111.0	126.1	116.7	112.1	109.5	107.2	106.2	105.6
Terms of trade	4.7	-9.1	16.0	13.6	-7.4	-4.0	-2.3	-2.1	-0.9	-0.5
External liabilities										
Net external liabilities (percent of GDP)	52.9	61.7	57.3	59.5	61.4	64.1	67.1	69.8	72.0	73.8
Net external interest (percent of exports)	10.0	11.5	9.3	7.9	8.1	8.9	9.1	7.2	8.1	9.2
Net foreign debt	45.1	52.6	47.9	50.8	52.5	54.1	56.4	58.2	59.5	60.6
Memorandum items:										
Nominal GDP (in billions of Australian dollar	…	1,251	1,354	1,441	1,490	1,561	1,640	1,725	1,821	1,921
Partner country GDP growth	4.7	0.5	6.6	3.9	3.9	4.3	4.5	4.6	4.5	4.6
Real effective exchange rate (period averag	91.0	100.6	115.2	123.4	…	…	…	…	…	…
U.S. dollar/Australian dollar	0.68	0.79	0.92	1.03	…	…	…	…	…	…

Sources: Data provided by the Australian authorities; and IMF staff estimates and projections
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
4/ Underlying cash balance equals receipts less payments, and payments exclude Future Fund earnings.

Table 3. Australia: Fiscal Accounts, 2009/10–2017/18 1/
(In percent of GDP)

				Projections					
	2009/10	2010/11	2011/12	2012/13	2013/14	2014/15	2015/16	2016/17	2017/18
Statement of Operations 2/									
(Fiscal accounts on an accrual basis)									
Commonwealth government									
Revenue	22.6	22.1	23.0	24.3	24.6	24.7	24.8	25.0	25.2
Taxes	20.7	20.7	21.6	22.8	23.3	23.4	23.5	23.8	23.9
Income tax	14.5	14.6	15.7	16.6	17.1	17.2	17.4	17.6	17.7
Individuals and other withholdings	9.5	9.8	10.2	10.5	10.9	11.1	11.2	11.3	11.4
Indirect and other tax	6.3	6.0	5.9	6.2	6.2	6.2	6.1	6.2	6.2
Nontax	1.9	1.5	1.5	1.4	1.3	1.3	1.3	1.3	1.3
Expenditure	26.8	25.8	26.0	24.1	24.4	24.2	24.3	24.3	24.4
Expense	26.3	25.5	25.7	24.2	24.3	24.2	24.2	24.2	24.3
Compensation of employees	1.2	1.3	1.2	1.3	1.2	1.1	1.1	1.1	1.1
Use of goods and services	5.0	4.7	4.9	4.7	4.6	4.7	4.7	4.7	4.6
Current transfers	17.0	15.6	15.9	15.8	16.1	16.2	16.3	16.1	16.0
Other expenses	3.1	3.8	3.6	3.0	3.0	2.8	2.6	2.6	2.6
Net acquisition of nonfinancial assets	0.5	0.4	0.3	-0.2	0.1	0.1	0.1	0.1	0.1
Operating balance	-3.7	-3.3	-2.7	0.0	0.3	0.5	0.6	0.8	0.9
Net lending (+) / borrowing (-) 3/	-4.2	-3.7	-3.0	0.2	0.2	0.4	0.5	0.7	0.9
State, territory, and local government balance	-1.0	-0.9	-1.2	-1.1	-0.6	-0.2	…	…	…
Public nonfinancial corporations balance 4/	-1.2	-1.0	-1.0	-1.2	…	…	…	…	…
Nonfinancial public sector balance 4/	-6.5	-6.0	-5.5	-2.6	…	…	…	…	…
Statement of Source and Uses of Cash									
(Fiscal accounts on a cash basis)									
Commonwealth government									
Receipts 5/	21.8	21.3	22.3	23.6	23.8	23.8	24.0	24.2	24.4
Of which: Taxes	20.2	20.1	21.1	22.1	22.7	22.7	22.9	23.1	23.3
Payments	26.0	24.7	25.3	23.5	23.7	23.5	23.5	23.6	23.6
Future Fund earnings	0.2	0.3	0.2	0.2	0.2	0.2	0.2	0.2	0.2
Underlying cash balance 6/	-4.2	-3.4	-3.0	0.1	0.1	0.3	0.4	0.6	0.7
Consolidated general government (Commonwealth and States/Local)									
Receipts 5/	32.6	31.5	32.7	34.2	34.4	34.5	34.6	34.9	35.0
Payments	37.8	35.9	37.1	35.4	35.2	34.4	34.4	34.5	34.6
Future Fund earnings	0.2	0.3	0.2	0.2	0.2	0.2	0.2	0.2	0.2
Underlying cash balance 6/	-5.2	-4.4	-4.4	-1.2	-0.8	0.0	0.2	0.3	0.5
Structural balance	-5.1	-4.1	-4.4	-1.3	-0.8	0.0	0.1	0.3	0.5
Memorandum items:									
Commonwealth government net debt 7/	3.3	6.0	10.0	9.4	9.0	8.4	7.4	6.8	5.7
Consolidated general government net debt	2.3	5.5	10.7	12.3	12.5	12.0	10.6	9.8	8.5
Consolidated general government gross debt	19.1	22.1	26.4	27.5	26.9	25.8	23.6	22.2	20.2
Nominal GDP (in billions of Australian dollars)	1,293	1,399	1,469	1,521	1,601	1,678	1,773	1,868	1,975

Sources: Commonwealth of Australia 2012-13 Budget and Mid-Year Economic and Fiscal Outlook; and IMF staff estimates and projections

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, 2007–17
(In billions of U.S. dollars)

						Projections					
	2007	2008	2009	2010	2011	2012	2013	2014	2015	2016	2017
Current account balance	-58.5	-46.3	-41.4	-35.7	-33.5	-63.0	-87.9	-99.6	-100.9	-101.3	-99.3
Goods balance	-17.7	-3.7	-2.4	17.1	27.5	-4.5	-23.3	-31.5	-37.0	-31.4	-21.7
Exports	142.5	190.5	156.9	213.1	271.2	260.7	256.2	263.8	272.6	291.5	313.3
of which nonrural commodity exports	89.3	137.1	106.1	152.5	198.4	182.3	174.0	178.8	186.7	203.2	220.7
Imports	-160.2	-194.1	-159.3	-195.9	-243.7	-265.2	-279.5	-295.3	-309.6	-322.9	-335.0
Net services	0.7	-4.0	-0.7	-3.5	-8.9	-9.6	-11.3	-12.5	-12.9	-12.0	-10.9
Total credits	41.1	45.0	41.5	47.7	51.7	52.5	53.8	56.3	59.2	63.2	67.1
Total debits	-40.4	-49.0	-42.2	-51.2	-60.6	-62.2	-65.1	-68.8	-72.1	-75.2	-78.0
Net income	-41.5	-38.5	-37.8	-48.5	-51.1	-46.3	-52.4	-54.7	-50.1	-57.1	-65.9
Of which: Net interest payments	-23.4	-24.8	-22.9	-24.1	-25.4	-25.3	-27.5	-29.3	-23.9	-28.9	-34.9
Of which: Net equity income	-17.0	-12.5	-14.0	-23.0	-24.2	-21.1	-24.9	-25.4	-26.3	-28.2	-31.0
Net transfers	-0.1	-0.1	-0.5	-0.8	-0.8	-1.0	-0.9	-0.9	-0.9	-0.8	-0.8
Capital and financial account	59.0	45.8	41.9	34.9	32.5	60.3	87.9	99.6	100.9	101.3	99.3
Capital account	-0.2	-0.4	-0.3	-0.4	-0.6	-0.6	-0.6	-0.6	-0.6	-0.6	-0.6
Financial account	59.2	46.2	42.3	35.3	33.1	60.9	88.6	100.2	101.5	101.9	100.0
Direct investment transactions (net)	28.7	13.9	10.0	6.9	51.2	44.9	51.7	49.6	51.1	51.1	51.7
Equity (net)	18.1	-1.2	20.4	10.3	41.2	…	…	…	…	…	…
Debt (net)	10.7	15.0	-10.3	-3.4	10.0	…	…	…	…	…	…
Portfolio investment transactions (net)	-21.2	28.5	77.7	73.1	33.2	29.5	53.0	49.0	53.1	51.1	50.0
Equity (net)	-35.7	27.7	-0.3	-7.5	-30.9	…	…	…	…	…	…
Debt (net)	14.5	0.9	78.0	80.6	64.1	…	…	…	…	…	…
Financial derivatives (net)	-10.3	1.0	-5.2	-1.6	-28.6	-21.0	-24.4	-23.5	-23.8	-24.0	-24.2
Other transactions (net)	61.9	2.8	-40.2	-43.1	-22.7	7.6	8.2	25.1	21.2	23.7	22.4
Net errors and omissions	-0.2	-0.1	0.4	0.4	0.6	0.5	0.0	0.0	0.0	0.0	0.0
	(Assets and liabilities at end-period)										
Net external liabilities	560.7	488.5	693.0	788.4	870.6	949.0	1013.4	1090.3	1163.0	1237.3	1309.2
Net external equity liabilities	41.7	10.4	102.1	129.3	126.6	138.0	158.3	173.9	193.9	214.1	234.6
Foreign equity investment in Australia	600.3	367.8	630.7	762.8	714.4	777.7	816.6	847.7	889.6	929.1	974.4
Australian equity investment abroad	-558.5	-357.4	-528.6	-633.5	-587.8	-639.6	-658.3	-673.8	-695.7	-715.1	-739.7
Net external debt	518.9	478.1	590.9	659.1	744.0	811.0	855.1	916.4	969.0	1023.2	1074.5
Net public sector	36.7	55.6	63.3	130.7	206.3	…	…	…	…	…	…
Net private sector	482.2	422.5	527.6	528.4	537.7	…	…	…	…	…	…
Gross external debt	917.0	884.0	1111.7	1271.5	1382.3	1503.7	1567.9	1646.1	1722.4	1797.6	1875.7
Of which: Australian dollar-denominated	358.8	329.8	487.1	561.9	640.8	…	…	…	…	…	…
Gross external lending	-398.1	-405.9	-520.8	-612.4	-638.3	-692.7	-712.9	-729.7	-753.4	-774.4	-801.1
Short-term net external debt (residual maturity basis)	233.3	204.5	177.9	198.8	226.7	…	…	…	…	…	…
Short-term gross external debt	431.8	426.5	476.4	542.6	595.8	…	…	…	…	…	…
Short-term gross external lending	-198.6	-222.0	-298.4	-343.9	-369.2	…	…	…	…	…	…

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

Table 5. Australia: Balance of Payments, 2007–17
(In percent of GDP)

	2007	2008	2009	2010	2011	2012	2013	2014	2015	2016	2017
						Projections					
Current account balance	-6.2	-4.4	-4.2	-2.9	-2.3	-4.1	-5.5	-6.1	-6.0	-5.9	-5.6
Goods balance	-1.9	-0.3	-0.2	1.4	1.8	-0.3	-1.5	-1.9	-2.2	-1.8	-1.2
Exports	15.1	18.1	15.8	17.1	18.2	16.9	16.0	16.1	16.2	16.8	17.5
Imports	-16.9	-18.4	-16.1	-15.7	-16.4	-17.2	-17.5	-18.0	-18.4	-18.6	-18.7
Net services	0.1	-0.4	-0.1	-0.3	-0.6	-0.6	-0.7	-0.8	-0.8	-0.7	-0.6
Total credits	4.3	4.3	4.2	3.8	3.5	3.4	3.4	3.4	3.5	3.7	3.8
Total debits	-4.3	-4.6	-4.2	-4.1	-4.1	-4.0	-4.1	-4.2	-4.3	-4.3	-4.4
Net income	-4.4	-3.7	-3.8	-3.9	-3.4	-3.0	-3.3	-3.3	-3.0	-3.3	-3.7
Of which: Net interest payments	-2.5	-2.4	-2.3	-1.9	-1.7	-1.6	-1.7	-1.8	-1.4	-1.7	-2.0
Of which: Net equity income	-1.8	-1.2	-1.4	-1.8	-1.6	-1.4	-1.6	-1.6	-1.6	-1.6	-1.7
Net transfers	0.0	0.0	-0.1	-0.1	-0.1	-0.1	-0.1	-0.1	-0.1	0.0	0.0
Capital and financial account	6.2	4.3	4.2	2.8	2.2	3.9	5.5	6.1	6.0	5.8	5.6
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	6.3	4.4	4.3	2.8	2.2	3.9	5.5	6.1	6.0	5.9	5.6
Direct investment transactions (net)	3.0	1.3	1.0	0.6	3.4	2.9	3.2	3.0	3.0	2.9	2.9
Equity (net)	1.9	-0.1	2.1	0.8	2.8	…	…	…	…	…	…
Debt (net)	1.1	1.4	-1.0	-0.3	0.7	…	…	…	…	…	…
Portfolio investment transactions (net)	-2.2	2.7	7.8	5.9	2.2	1.9	3.3	3.0	3.2	3.0	2.8
Equity (net)	-3.8	2.6	0.0	-0.6	-2.1	…	…	…	…	…	…
Debt (net)	1.5	0.1	7.9	6.5	4.3	…	…	…	…	…	…
Financial derivatives (net)	-1.1	0.1	-0.5	-0.1	-1.9	-1.4	-1.5	-1.4	-1.4	-1.4	-1.4
Other transactions (net)	6.5	0.3	-4.1	-3.5	-1.5	0.5	0.5	1.5	1.3	1.4	1.3
Net errors and omissions	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
				(Assets and liabilities at end-period)							
Net external liabilities	56.3	57.2	61.7	57.3	59.5	61.4	64.1	67.1	69.8	72.0	73.8
Net external equity liabilities	4.2	1.2	9.1	9.4	8.7	8.9	10.0	10.7	11.6	12.5	13.2
Foreign equity investment in Australia	60.3	43.1	56.2	55.4	48.8	50.4	51.7	52.2	53.4	54.1	54.9
Australian equity investment abroad	-56.1	-41.9	-47.1	-46.0	-40.2	-41.4	-41.7	-41.5	-41.8	-41.6	-41.7
Net external debt	52.1	56.0	52.6	47.9	50.8	52.5	54.1	56.4	58.2	59.5	60.6
Net public sector	3.7	6.5	5.6	9.5	14.1	…	…	…	…	…	…
Net private sector	48.4	49.5	47.0	38.4	36.7	…	…	…	…	…	…
Gross external debt	92.1	103.6	99.0	92.4	94.4	97.4	99.2	101.3	103.4	104.6	105.7
Of which: Australian dollar-denominated	36.0	38.6	43.4	40.8	43.8	…	…	…	…	…	…
Gross external lending	-40.0	-47.6	-46.4	-44.5	-43.6	-44.9	-45.1	-44.9	-45.2	-45.1	-45.2
Short-term net external debt (residual maturity basis)	23.4	24.0	15.9	14.4	15.5	…	…	…	…	…	…
Short-term gross external debt	43.4	50.0	42.4	39.4	40.7	…	…	…	…	…	…
Short-term gross external lending	-19.9	-26.0	-26.6	-25.0	-25.2	…	…	…	…	…	…
Memorandum items:											
Gross external assets	-96.1	-89.4	-93.5	-90.5	-83.8	-86.3	-86.8	-86.4	-87.0	-86.7	-86.8
Gross external liabilities	152.4	146.6	155.2	147.8	143.3	147.7	150.9	153.5	156.8	158.7	160.6
Gross official reserves (in billions of Australian dollars)	30.5	47.5	46.5	41.6	40.8	…	…	…	…	…	…
Gross reserves in months of imports	1.5	2.0	2.2	1.7	1.5	…	…	…	…	…	…
Gross reserves to ST FX denominated debt (percent)	9.3	11.8	14.9	13.3	12.1	…	…	…	…	…	…
Net interest payments to exports (percent)	12.7	10.5	11.5	9.3	7.9	8.1	8.9	9.1	7.2	8.1	9.2

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

Table 6. Australia: Gross External Debt, 2007–12

	2007	2008	2009	2010	2011	2012 June
	(In billions of Australian dollars)					
Gross external debt	1,040	1,276	1,240	1,251	1,361	1,413
Of which: Public	92	153	154	213	288	306
Private - financial	749	870	835	790	788	807
Private - nonfinancial	199	253	250	248	285	300
Of which: Total short-term debt	490	616	531	534	587	529
0 - 90 days	360	423	399	372	403	349
90 days - 6 months	40	60	46	64	99	84
6 months - 1 year	90	132	86	98	84	96
	(In billions of U.S. dollars)					
Gross external debt	917	884	1,112	1,272	1,382	1,440
Of which: Short term	432	426	476	543	596	539
	(In percent of GDP)					
Gross external debt	92.1	103.6	99.0	92.4	94.4	96.1
Of which: Short term	43.4	50.0	42.4	39.4	40.7	36.0
Short-term to gross external debt	47.1	48.2	42.8	42.7	43.1	37.4
Memorandum items:						
Gross external debt denominated in $A	407	476	543	553	631	714
US$/$A (end of period)	0.88	0.69	0.90	1.02	1.02	1.02
Nominal GDP (sum of last 4 quarters, $A bn, SA)	1,129	1,232	1,251	1,354	1,441	1,469

Sources: Australian Bureau of Statistics and IMF staff estimates.

Table 7. Australia: Indicators of External and Financial Vulnerability, 2007–11
(In percent of GDP, unless otherwise indicated)

	2007	2008	2009	2010	2011
External indicators					
Real exports of goods (percent change)	1.9	3.8	3.4	7.8	-0.1
Real imports of goods (percent change)	11.9	10.1	-9.3	13.9	11.6
Terms of trade (percent change)	5.4	12.9	-9.1	16.0	13.6
Current account balance	-6.2	-4.4	-4.2	-2.9	-2.3
Capital and financial account balance	6.2	4.3	4.2	2.8	2.2
Of which:					
Net portfolio investment	-2.2	2.7	7.8	5.9	2.2
Net direct investment	3.0	1.3	1.0	0.6	3.4
Total reserves (in billions of U.S. dollar)	26.9	32.9	41.7	41.9	46.8
In months of imports of goods and services	1.5	2.0	2.2	1.7	1.5
Total net reserves (in billions of U.S. dollar)	31.6	33.3	41.4	41.7	43.1
Net international investment position	-56.3	-57.2	-61.7	-57.3	-59.5
Of which:					
Net external public sector debt	3.7	6.5	5.6	9.5	14.1
Net external private sector debt	48.4	49.5	47.0	38.4	36.7
Net interest payments to exports (in percent)	12.7	10.5	11.5	9.3	7.9
Nominal effective exchange rate (percent change)	6.1	-1.8	-4.3	13.7	7.1
Financial market indicators					
General government gross debt (percent of GDP)	9.7	11.8	16.9	20.5	24.2
Interest rates (percent)					
3-month T-bill	6.7	7.0	3.4	4.7	4.8
3-month interest rate spread vis-à-vis U.S.	2.3	5.6	3.3	4.5	4.8
10-year government bond	6.0	5.8	5.0	5.6	4.6
Capital adequacy					
Regulatory capital to risk-weighted assets	10.2	11.4	12.0	11.6	11.8
Tier I capital to risk-weighted assets 1/	7.2	8.2	9.4	9.7	10.3
Asset quality 2/					
Impaired assets to total assets	0.2	0.8	1.2	1.2	1.1
Specific provisions to impaired assets	37.6	36.0	34.1	35.7	34.9
Loans composition (share of total)					
Public sector	1.3	1.8	3.6	3.7	5.3
Individuals	49.5	50.1	53.8	56.8	56.9
Housing loans	42.3	44.2	48.3	51.5	51.9
Investor housing	14.0	15.2	16.0	17.2	17.1
Commercial lending	49.2	48.1	42.5	39.5	37.9
Financial intermediaries	11.5	10.7	9.0	8.1	7.3
Nonfinancial sector	37.7	37.4	33.5	31.4	30.5

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 - Risk Assessment Matrix[1]

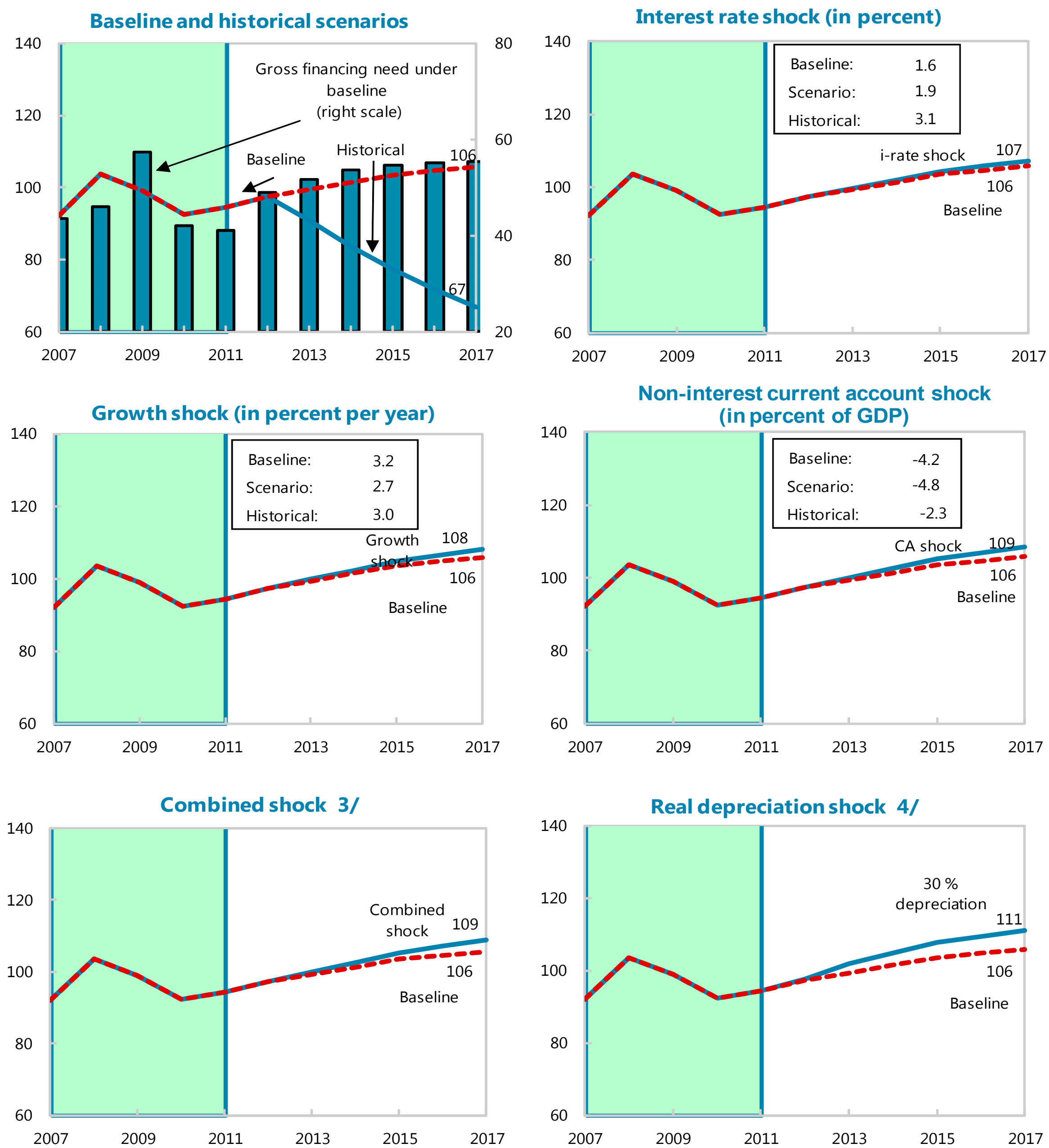
Nature/Source of Threats	Likelihood	Expected Impact on Economy
Strong intensification of the Euro area crisis	*Medium*	*Medium* The main direct impact would be through financial sector linkages, in particular if European funding markets would dry up. Moreover, declining export demand would reduce GDP growth. A sustained decline in GDP growth, together with a rise in unemployment, could exacerbate financial stresses in the banking sector.
Significant fall in non-oil commodity prices	*Medium*	*Medium* A significant fall in commodity prices would weaken Australia's terms of trade. The free-floating exchange rate would help buffer the impact on the economy, as declines in commodity prices can be offset to some extent by a weakening of the Australian dollar.
Hard landing in emerging Asia	*Low*	*High* One-third of Australia's exports go to emerging Asia, leaving growth prospects vulnerable to their economic outlook.
Volatility in wholesale and external funding	*Medium*	*Low* Banks' reliance on wholesale and external funding remains high. Their foreign liability positions are largely hedged and the explicit liquidity support from the RBA means that a reversal of capital flows would unlikely result in forced asset sales. Nevertheless, volatility in international funding markets could raise banks' funding costs.
Sharp fall in house and/or commercial real estate prices	*Low*	*Medium* House prices have declined gradually over the past year, but a collapse in house prices appears unlikely. A major construction boom has not accompanied the run-up in house prices, and supply remains quite tight in some areas. An average LTV ratio of around 50 percent on outstanding owner-occupied mortgages provides a buffer for the financial sector against a large decline in house prices. Nonetheless, there would likely be a negative wealth effect on consumption. Commercial real estate prices have seen a large correction since 2008 but still appear high in international comparison. Commercial real estate represents about 10 percent of banks' exposures, and a sharp fall in prices would likely impair banks' balance sheets.

[1] This matrix shows events that could materially alter the baseline path, the scenario most likely to materialize in the view of the staff.

Appendix II. Australia: Main Recommendations of the 2011 Article IV Consultation

Fund Recommendations	Policy Actions
Fiscal policy: Staff welcomed the authorities' commitment to return to a budget surplus by 2012/13, despite the negative impact of natural disasters. The deficit reduction 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.	The 2011/12 underlying cash deficit came in larger than planned. However, 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 to 2 per cent a year, on average, until surpluses are at least 1 per cent of GDP.
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.	The government's strategy of achieving budget surpluses, on average, over the medium term and improving the government's net financial worth is consistent with allowing the automatic stabilizers to operate.
Monetary policy: Staff agreed with the monetary policy stance, which has helped anchor medium-term inflation expectations. 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. However, if global financial markets become severely disrupted or world growth falters, Reserve Bank of Australia (RBA) has ample space to cut the policy rate.	The Reserve Bank of Australia (RBA) has lowered the policy rate by 150 basis points since November 2011, with the most recent cut in October 2012. Initially, when inflation moderated at the end 2011, the RBA moved to remove a mildly restrictive monetary policy stance. During 2012, as the outlook for the global economy deteriorated accompanied by a slightly weaker domestic outlook for 2013, and with projected inflation consistent with the target, the RBA shifted to an accommodative monetary policy stance.
Financial sector policy: 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.	The Australian Prudential Regulation Authority (APRA) undertook comprehensive stress tests of banks. With respect to capital requirements, the authorities will consider the next steps on higher loss absorbency following the G-20 endorsement of Basel recommendations for Domestic Systemically Important Banks (D-SIBs).

Appendix III. Australia: External Debt Sustainability: Bound Tests 1/ 2/
(External debt in percent of GDP)



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

1/ Shaded areas represent actual data. Individual shocks are permanent one-half standard deviation shocks. Figures in the boxes represent average projections for the respective variables in the baseline and scenario being presented. Ten-year historical average for the variable is also shown.

2/ For historical scenarios, the historical averages are calculated over the ten-year period, and the information is used to project debt dynamics five years ahead.

3/ Permanent 1/4 standard deviation shocks applied to real interest rate, growth rate, and current account balance.

4/ One-time real depreciation of 30 percent occurs at the end of 2012. 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.

INTERNATIONAL MONETARY FUND

AUSTRALIA

October 29, 2012

STAFF REPORT FOR THE 2012 ARTICLE IV CONSULTATION—INFORMATIONAL ANNEX

Prepared By | Asia and Pacific Department

CONTENTS

ANNEX I. AUSTRALIA: FUND RELATIONS

(As of September 30, 2012)

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

II. General Resources Account:

	SDR Million	Percent Quota
Quota	3,236.40	100.00
Fund holdings of currency (exchange rate)	2,135.66	65.99
Reserve tranche position	1,101.16	34.02
Lending to the Fund New Arrangements to Borrow	446.00	

III. SDR Department:

	SDR Million	Percent Allocation
Net cumulative allocation	3,083.17	100.00
Holdings	2,941.45	95.40

IV. Outstanding Purchases and Loans: None

V. Financial Arrangements: None

VI. Projected Obligations to Fund[1]

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

	Forthcoming				
	2012	2013	2014	2015	2016
Principal					
Charges/interest	0.03	0.15	0.15	0.15	0.15
Total	0.03	0.15	0.15	0.15	0.15

[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.

VII. Exchange Rate Arrangement. Australia has accepted the obligations of Article VIII, Sections 2, 3, and 4 of the Articles of Agreement, and maintains an exchange system that is free from restrictions on the making of payments and transfers for current international transactions, except for exchange restrictions that are maintained solely for the preservation of national or international security and which have been notified to the Fund pursuant to Executive Board Decision No. 144-(52/51). The exchange rate is 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.

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

IX. Article IV Consultation. Australia is on the 12-month consultation cycle. The 2011 Article IV consultation discussions were held during July 22–August 2, 2011; the Executive Board discussed the staff report (IMF Country Report No. 11/300) and concluded the consultation on October 5, 2011.

X. FSAP Participation. The last FSAP Update involved two missions: April 23-May 15 and July 9-24, 2012. The main findings are presented in the Financial System Sustainability Assessment.

XI. 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.

Table of Common Indicators Required for Surveillance
(As of October 26, 2012)

	Date of Latest Observation	Date Received	Frequency of Data[7]	Frequency of Reporting[7]	Frequency of Publication[7]
Exchange Rates	10/26/12	10/26/12	D	D	D
International Reserve Assets and Reserve Liabilities of the Monetary Authorities[1]	09/12	10/08/12	M	M	M
Reserve/Base Money	08/12	09/28/12	M	M	M
Broad Money	08/12	09/28/12	M	M	M
Central Bank Balance Sheet	10/24/12	10/26/12	W	W	W
Consolidated Balance Sheet of the Banking System	08/12	10/02/12	M	M	M
Interest Rates[2]	10/26/12	10/26/12	D	D	D
Consumer Price Index	Q3 2012	10/23/12	Q	Q	Q
Revenue, Expenditure, Balance and Composition of Financing[3] – General Government[4]	06/12	09/04/12	A	A	A
Revenue, Expenditure, Balance and Composition of Financing[3]– Central Government	06/12	09/24/12	M	M	M
External Current Account Balance	Q2 2012	09/04/12	Q	Q	Q
Exports and Imports of Goods and Services	08/12	10/03/12	M	M	M
GDP/GNP	Q2 2012	09/05/12	Q	Q	Q
Gross External Debt[5]	Q2 2012	09/04/12	Q	Q	Q
International Investment Position[6]	Q2 2012	09/04/12	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. 12/xx
FOR IMMEDIATE RELEASE
November 12, 2012

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

IMF Executive Board Concludes 2012 Article IV Consultation with Australia

On November 12, 2012, the Executive Board of the International Monetary Fund (IMF) concluded the Article IV consultation with Australia.[1]

Background

The Australian economy has been growing faster than most advanced countries, benefiting from its trade linkages with Asia, particularly China. Growth accelerated from 2¾ percent in the second half of 2011 to 4 percent in the first half of 2012, driven by private domestic demand and exports. However, growth has been uneven with mining-related sectors expanding strongly, in contrast with below-trend growth in other sectors. The high Australian dollar is weighing on trade-exposed manufacturing and tourism, which along with the uncertain global economic outlook is contributing to a broadly pessimistic mood, and weak investment growth outside the mining sector. Although survey measures of consumer and business sentiment remained below their long-run averages, household consumption grew in line with solid household income growth.

Australia's terms of trade peaked in 2011, pushing up the real effective exchange rate further and narrowing the current account deficit to 2¼ percent of GDP. By the second quarter of 2012, the terms of trade had fallen by around 10 percent, driven by declines in spot prices for iron ore and coking coal of 25 and 30 percent respectively. In recent months, however, the Australian dollar has remained high despite lower export commodity prices and the weaker global outlook, in part related to portfolio reallocations of large reserve holders toward Australian government debt.

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[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.

CPI inflation has eased with underlying measures of inflation remaining near the middle of the 2-3 percent target band, largely due to the declining tradable goods prices associated with the appreciation of the exchange rate. Wage growth is also moderate, just marginally above its 10 year average in June 2012 with private sector wage growth faster than in the public sector. The labor market has performed well in international comparison, with a low unemployment rate at below 5½ percent.

The Reserve Bank of Australia (RBA) has lowered the policy rate by 150 basis points since November 2011, with the most recent cut in October 2012. Initially, when inflation moderated at the end 2011, the RBA moved to remove a mildly restrictive monetary policy stance. During 2012, as the outlook for the global economy deteriorated accompanied by a slightly weaker domestic outlook for 2013, and with projected inflation consistent with the target, the RBA shifted to an accommodative monetary policy stance. Interest rates for borrowers, a key indicator of the overall stance, are now slightly below their medium-term averages.

The 2011/12 underlying cash deficit came in at 3 percent of GDP, about 1½ percentage points higher than forecast during the 2011-12 Budget, due to both weaker receipts and higher expenditure. Structural factors have kept receipts as a percent of GDP below pre-crisis levels and have also contributed to receipts falling short of projections by 0.9 percent of GDP during 2011/12. High levels of mining sector investment and associated depreciation deductions have dampened growth in mining company tax receipts relative to profit growth. Changing consumer spending patterns away from the retail sector towards services have lowered retail company tax receipts. Furthermore, lower house and equity price growth rates, especially compared with pre-crisis rates, lowered capital gains tax receipts. Payments during 2011/12 exceeded forecasts by 0.6 percent of GDP mainly due to payments related to natural disasters and the accelerated transfer payments to households and businesses as compensation for higher energy costs following the introduction of carbon price.

Executive Board Assessment

Executive Directors commended the Australian authorities for their sound and prudent macroeconomic management, which had contributed to impressive growth, low unemployment, and subdued inflation. They noted that the economic outlook remains favorable, although risks are tilted to the downside, including a possible deterioration in external demand and elevated stress in the global financial market. Directors underscored the need to preserve adequate policy space to respond to adverse shocks and to persevere with structural adjustments aimed at facilitating more balanced growth.

Directors agreed that the current accommodative monetary stance is broadly appropriate. They also concurred that there is scope for further easing if warranted by economic circumstances. Policy effectiveness is supported by the central bank’s high degree of credibility and a well-functioning transmission mechanism.

Directors supported the government’s consolidation plans, which allow a reduction in public indebtedness without prejudice to growth through a combination of spending restraint and reprioritization, tax measures, as well as use of proceeds from mineral resources. They welcomed the intention to maintain budgetary surpluses over the medium term, thus strengthening fiscal buffers against future shocks and the long-term cost of population aging. Directors noted nevertheless that, in the event of a sharp deterioration in the economic outlook, and hence revenue underperformance, delaying the return to surpluses could be an option, given Australia’s modest debt-to-GDP ratio. Allowing automatic stabilizers to operate fully could also help relieve pressure on monetary policy.

Directors noted that Australia’s flexible exchange rate is a critically important element of the macroeconomic policy framework. They observed, however, that the Australian dollar, which remains moderately above its long-term average, has exerted pressure on non-mining tradable sectors, widening the current account deficit and net foreign liabilities. Raising national saving, including through budget deficit reduction and further incremental increases in employer provided pension contributions, would help narrow the current account deficit over time.

Directors welcomed the FSAP Update, which found Australia’s financial system to be sound, resilient, and well managed. They underscored the importance of continuing intensive bank supervision, providing liquidity support, and ensuring that systemically important banks have adequate capital buffers. Directors welcomed progress in increasing the competitiveness of the banking system, and encouraged further steps aimed at reducing banks’ short-term wholesale debt and broadening domestic funding sources. Close monitoring of developments in the housing market and household debt levels should continue to be priorities in the oversight of the financial sector.

Directors commended the government’s efforts to facilitate a structural transition toward a services-oriented economy. More specifically, they encouraged Australia to seize the opportunities offered by the growth of Asian economies, including by enhancing productivity and flexibility in the product and labor markets. They welcomed the government’s White Paper on Australia in the Asian Century, laying out a strategy for actively engaging with the region.

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.

Australia: Selected Economic Indicators, 2009–13

Nominal GDP (2011): $A 1,44 billion — Quota (in millions): SDR 3,236

GDP per capita (2011): $A 63,576 — Population (September 2012): 22.7 million

Unemployment rate (September 2012): 5.4 percent

Main exports: Metal ores and minerals; tourism; coal and coke (fuel)

	2009	2010	2011	2012	2013
				Proj	
Output and demand (percent change)					
Real GDP	1.4	2.5	2.1	3.3	3.0
Total domestic demand	-0.8	4.1	4.6	4.7	3.6
Private consumption	1.0	2.9	3.3	3.7	3.4
Total investment	-3.0	4.9	7.1	8.2	5.5
Net exports 1/	2.2	-1.5	-2.7	-0.8	-0.7
Inflation and unemployment (in percent)					
CPI inflation	1.8	2.9	3.3	2.0	2.6
Unemployment rate	5.6	5.2	5.1	5.2	5.3
Saving and investment (in percent of GDP)					
Gross national saving	23.1	23.9	24.9	24.3	23.5
General government saving	-0.8	-0.1	-0.1	2.4	5.4
Private saving 2/	23.9	24.0	25.0	21.9	18.1
Gross capital formation	27.3	26.8	27.2	28.4	29.0
Fiscal indicators (cash basis, in percent of GDP) 3/					
Receipts	23.1	21.8	21.3	22.3	23.6
Payments	25.2	26.0	24.7	25.3	23.5
Underlying cash balance	-2.2	-4.2	-3.4	-3.0	0.1
Net debt	-1.3	3.3	6.0	10.0	9.4
Money and credit (end of period)					
Interest rate (90-day bill, in percent)	4.2	5.0	4.5	4.5	…
Treasury bond yield (10-year, in percent) 4/	5.6	5.5	3.7	2.8	…
M3 (percent change) 4/	4.1	10.4	8.0	9.1	…
Private domestic credit (percent change) 4/	1.3	3.0	3.5	4.6	…
Balance of payments (in percent of GDP)					
Current account	-4.2	-2.9	-2.3	-4.1	-5.5
Terms of trade (percent change)	-9.1	16.0	13.6	-7.4	-4.0
External assets and liabilities (in percent of GDP)					
Net external liabilities	61.7	57.3	59.5	61.4	64.1
Net external debt	52.6	47.9	50.8	52.5	54.1
Gross official reserves 4/	3.7	3.1	3.2	3.1	…
Net official reserves 4/	3.7	3.1	3.1	2.7	…
Exchange rate (period average)					
U.S. dollar/Australian dollar 4/	0.79	0.92	1.03	1.03	…
Trade-weighted index 4/	63.2	70.9	75.7	76.9	…
Nominal effective exchange rate 4/ 5/	98.1	111.6	119.5	125.7	…
Real effective exchange rate 4/ 5/	100.6	115.2	123.4	129.4	…
Memorandum Item:					
Nominal GDP (in billions of Australian dollar)	1,251	1,354	1,441	1,490	1,561

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

1/ Contribution to growth.

2/ Includes public trading enterprises.

3/ Fiscal year ending June 30, Commonwealth Budget. For example, 2012 refers to fiscal year July 1, 2011 to June 30, 2012.

4/ Data for 2012 are for latest available month.

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

Statement by Ian Davidoff, Alternate Executive Director for Australia and Nghi Luu, Senior Advisor November 12, 2012

The Australian economy has continued to grow at trend pace, underpinned by strong economic fundamentals. In addition to solid growth, unemployment is low, inflation is contained and stable, monetary policy has room to ease further, and public finances are healthy with the budget due to return to surplus in 2012-13. The financial system is also strong and well-regulated, with our four major banks amongst the highest rated in the world.

While GDP is forecast to grow around its trend rate over the next two years - driven by strong growth in resources investment and exports, as well as solid growth in household consumption - the tepid nature of the global recovery will continue to weigh on Australia's growth prospects. In particular, developments in Europe and emerging Asian economies remain the key source of risks to the Australian economy, along with an unfavorable resolution of the fiscal cliff in the US. My authorities remain proactive and vigilant to any further deterioration in the world economy, and have long recognized the importance of preserving adequate policy space to respond to economic developments.

Australia is now entering the next phase of the mining boom, where the period of high commodity prices is likely to have passed, and mining investment reaches its peak. Whereas investment in iron ore and coal extraction has dominated recent resources investment, petroleum and LNG will dominate investment in the years to come. The investment pipeline for LNG is substantial, with many investment projects already committed or underway. The investment phase of the mining boom, which is likely to peak over the next two years, is expected to be followed by a production and export boom. The terms of trade will decline this year, due to recent falls in iron ore and coal prices, but remain elevated and high by historical standards owing to the ongoing process of urbanization and industrializing of the fast-growing Asian economies.

Australia will need to develop new sources of growth and the economy will continue to evolve in response to structural changes prompted by the re-emergence of Asia. As the middle-income class continues to grow rapidly in Asia, it will increasingly demand a diverse range of goods and services, from health and aged care, to education and financial services, as well as high-quality food products. My authorities are focused on lifting productivity and improving engagement in Asia, in order to seize and manage the growth opportunities presented by these changes.

Fiscal Policy

My authorities are committed to maintaining strict fiscal discipline through the medium-term fiscal strategy, which has remained unchanged since 2008-09. The recent release of the Mid-Year Economic and Fiscal Outlook shows that net debt peaked at 10 per cent of GDP in 2011-12 and that the budget is on track to return to a small surplus in 2012-13, followed by increasingly larger surpluses.

A return to surplus has been made more difficult with a weaker global economic outlook and falls in global commodity prices, underpinning a downward revision to tax receipts (mainly through company tax receipts and resources rent taxes). As noted by Staff, a range of other factors have also limited tax receipts, including reduced company tax collections due to depreciation deductions associated with mining sector investment, and lower capital gains tax receipts due to relatively subdued growth in housing and equity prices.

Notwithstanding these challenges, the forecast return to surplus will be achieved through a combination of natural increases in the tax receipts associated with a growing economy, as well as continued spending restraint, with government spending as a share of the economy remaining at 30-year historical lows (below 24 per cent of GDP). Due to the nature and timing of the savings measures put in place – for example, a delay in increases in overseas development assistance – the contractionary impact of the fiscal strategy is expected to be significantly lower (¾ to 1½ per cent of GDP) than the 3.1 per cent of GDP turnaround in the underlying cash balance.

Consistent with their commitment to retaining policy space, my authorities' judge that a return to surplus is appropriate given current economic conditions and other policy settings. The Australian economy is forecast to grow around trend (factoring in the planned fiscal contraction), with low unemployment, a low and stable inflation rate, scope for monetary policy to be eased and commodity prices expected to remain elevated. At the same time, my authorities note Staff's recommendation to allow the automatic stabilizers to operate, and will continue to judge the appropriate fiscal settings based on developments in the domestic and international economy.

Monetary Policy

Inflationary pressures remain contained, with both headline and underlying inflation remaining consistent with the medium term target of 2 to 3 per cent. The headline consumer price index increased by 1.4 per cent in the September quarter, to be 2 per cent over the year. The quarterly increase in headline CPI reflects a modest inflationary impact from the introduction of an explicit carbon price in July this year, as well as a number of seasonal and temporary factors.

Going forward, domestic prices are likely to remain subdued with the continuation of the recent increase in productivity growth and slower growth in wages. The high exchange rate, however, is expected to have less of a disinflationary impact than in the recent past due to the diminishing effects of the earlier appreciation in the Australian dollar.

Over the past year, monetary policy has become more accommodative, with the official interest rate lowered by 150 basis points to 3.25 per cent. This rate is near its recent historic low but still well clear of the zero bound. Interest rates for borrowers have declined to be clearly below their medium-term averages. Many households have taken advantage of the lower rates to pre-pay mortgage debt, rather than increase their consumption expenditure.

Exchange rate and external stability

The Australian dollar has stayed above its long-term average for an extended period of time, remaining near or above parity against the US dollar since October 2010. The relative strength of the Australian economy has increased the risk-adjusted return on Australian assets in relative terms, boosting global investors' demand (including central banks') for a range of Australian dollar denominated assets. The value of the currency has also been boosted by cyclical influences that are reflected in wide interest rate differentials between Australia and most other advanced economies.

The current account deficit (CAD) is expected to widen over the next two years, largely reflecting a fall in the terms of trade and an increase in capital imports. From a net lending perspective, the key driver of the rising current account deficit is the inflow of capital needed to finance the surge in resources investment, with the household sector and the Australian Government expected to be net lenders. This, together with the high level of foreign ownership of the resource sector, means that the current account is being largely funded by foreign investors. In the past, Australia's banking sector has intermediated much of the foreign borrowing associated with the CAD. However, in recent years resources investment has largely been internally funded out of the cashflow of investors. As resources investment is expected to drive the increase in Australia's capital requirements in the period ahead, we expect bank intermediation of the CAD to continue to decline.

My authorities remain committed to a floating exchange rate, given the benefits Australia has derived from having a flexible exchange rate regime. Notwithstanding the fact that movements in the Australian dollar have not mirrored the recent moderate decline in the terms of trade, the exchange rate has played a pivotal role in dampening the impact of economic shocks (including in 2009), and along with inflation-targeting monetary policy, has delivered macroeconomic stability over the past two decades.

The strength of the Australian dollar is inevitably exerting pressure on a number of non-mining trade exposed sectors, such as manufacturing and tourism. The structural change is resulting in a reallocation of resources across regions and sectors of the economy and improving productivity by moving resources to areas where their value is greatest. Notably, this recent wave of structural change has resulted in smaller variations in the labor market across the country compared with similar shocks in the past, reflecting the more flexible nature of Australia's product and labor markets.

Financial Sector and Household Balance Sheet

Significant steps have been taken in recent years to increase the competitiveness of the banking system and to ensure that the Australian financial system remains strong and secure. Banks are adapting to a slower credit growth environment but remain conservative in their lending practices. The Australian Prudential Regulation Authority (APRA) continues to take a proactive, risk-based approached to supervising its banks.

Australian banks continue to use offshore wholesale funding. However, banks have increased the liquidity of their balance sheets and have moved to a more stable funding structure by reducing their use of short term wholesale debt (from 33 to 18 per cent of all funding over the last four years) and replacing it with deposits and longer term wholesale debt.

While we acknowledge that the combination of high household debt and elevated house prices is a risk to banks' large mortgage portfolio and the economy more broadly, this risk is mitigated by a range of factors (as is noted in the FSAP). Households are in a significant net asset position, the average loan-to-valuation ratio is relatively low at 50 per cent, and mortgages with loan-to-valuation ratios above 80 per cent (about one-quarter of the total stock) are typically covered by lenders' mortgage insurance. Furthermore, most households are well ahead of their scheduled mortgage repayments (on average equivalent to 18 months of scheduled repayments), providing a significant buffer to draw down on during times of stress. Mortgages are full recourse loans, giving borrowers an incentive to continue making payment even under stress.

Financial Sector Assessment Program

My authorities agree with the FSAP assessment that our financial sector is sound, resilient and well managed and welcome the broad recommendations from the FSAP. Australia places a high priority on maintaining its track record of prudent economic management and strong supervision of the financial sector.

As the assessment notes, Australia's financial regulation framework has a high level of compliance with international standards, underpinned by strong systemic oversight, a sound crisis management framework and effective policy coordination arrangements. Our experience during the financial crisis has demonstrated the strength of our system, and stress testing by the IMF and APRA shows that our banking system is capable of withstanding severe shocks. As noted by Staff, Australia is also well on track to implement the Basel III capital and liquidity reforms.

My authorities would like to express their gratitude and appreciation to the assessment team, for their hard work, dedication and engagement with Australia and our FSAP team. They welcome the opportunity to address the IMF's recommendations, to strengthen our system where appropriate.

Structural Reform

The rise of emerging Asia and the shift in global economic weight towards Australia's region poses a defining challenge for Australia in managing and facilitating structural change. Australia has a good track record of managing structural adjustments, yet the scale of change and opportunities presented by the Asian century is unprecedented. A whole-of-Australia effort is required to manage the adjustment.

My authorities are aware that policy settings must be appropriately calibrated to not only ensure that we are well positioned to take advantage of the opportunities that lie in our region, but to ensure that the benefits are widely dispersed amongst the community.

Australia's success in the Asian century will be supported by lifting productivity through ongoing reform. Continued increases in productivity will ensure Australia can successfully meet Asia's demand for goods and services beyond mineral resources, by ultimately improving the flexibility of the Australian economy and therefore its ability to adjust to compositional change. Accordingly, my authorities are pursuing reforms and investments across five areas – skills and education, innovation, infrastructure (including telecommunications infrastructure), tax reform and regulatory reform.

The recent release of the Government's White Paper on *Australia in the Asian Century* builds on these steps and sets out an ambitious blueprint for Australia's navigation of the Asian century. It provides a comprehensive review of economic and strategic change in Asia and its implications for Australia. The White Paper assesses Australia's current policy settings and commits Australia to improve the way it understands and engages with the region. The approach includes improving language literacy, adapting business models so that they are better suited to the region, and continuing to attract highly skilled and talented people to live, study and work in Australia.

This strategy should help Australia to strengthen its platform for growth and secure its ongoing prosperity.