

**Australia: 2002 Article IV Consultation—Staff Report; Staff Statement; and Public Information Notice on the Executive Board Discussion**

Under Article IV of the IMF's Articles of Agreement, the IMF holds bilateral discussions with members, usually every year. In the context of the 2002 Article IV consultation with Australia, the following documents have been released and are included in this package:

- the staff report for the 2002 Article IV consultation, prepared by a staff team of the IMF, following discussions that ended on **June 18, 2002**, with the officials of Australia on economic developments and policies. **Based on information available at the time of these discussions, the staff report was completed on August 9, 2002.** The views expressed in the staff report are those of the staff team and do not necessarily reflect the views of the Executive Board of the IMF.
- a staff statement of **September 16, 2002** updating information on recent developments.
- a Public Information Notice (PIN) summarizing the **views of the Executive Board as expressed during its September 16, 2002 discussion** of the staff report that concluded the Article IV consultation.

The documents listed below will be separately released.

Selected Issues Paper

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

**To assist the IMF in evaluating the publication policy, reader comments are invited and may be sent by e-mail to [Publicationpolicy@imf.org](mailto:Publicationpolicy@imf.org).**

Copies of this report are available to the public from

International Monetary Fund • Publication Services  
700 19<sup>th</sup> Street, N.W. • Washington, D.C. 20431  
Telephone: (202) 623-7430 • Telefax: (202) 623-7201  
E-mail: [publications@imf.org](mailto:publications@imf.org) Internet: <http://www.imf.org>

Price: \$15.00 a copy

**International Monetary Fund  
Washington, D.C.**

# INTERNATIONAL MONETARY FUND

## AUSTRALIA

### **Staff Report for the 2002 Article IV Consultation**

Prepared by the Staff Representatives for  
the 2002 Consultation with Australia

Approved by Yusuke Horiguchi and G. Russell Kincaid

August 9, 2002

- The 2002 Article IV consultation discussions were held in Sydney, Melbourne, and Canberra during June 6-18, 2002.
- The mission team consisted of Mr. Dunaway (head), Mr. Cerisola, Mr. Cardarelli, Ms. Ramakrishnan (all APD), and Ms. Edison (RES). Mr. Callaghan (Executive Director) attended the meetings in Canberra. The mission met with Treasurer Costello, Treasury Secretary Henry, Reserve Bank of Australia Governor Macfarlane, other senior government officials, and representatives of labor unions, the business and financial sectors, and academia.
- During the 2000 Article IV consultation, Directors commended the authorities for their continued solid economic performance supported by prudent macroeconomic management and the sustained implementation of reforms. They noted that the policy framework and reforms have created an economy that was well-positioned to withstand shocks, but cautioned that the structural reform effort needed to be sustained, particularly in the area of industrial relations, where the benefits in terms of employment and growth were likely to be significant. They also welcomed steps to reduce disincentives to labor force participation and efforts to enhance the work incentives from the income support system.
- Over the past several years, the staff commended the authorities for their sound conduct of macroeconomic policies. The staff's advice on structural policies, designed to enhance economic efficiency and reduce unemployment, has focused on the tax, income support, and industrial relations systems, and measures planned by the authorities are broadly consistent with this advice.
- Australia has accepted the obligations of Article VIII, Sections 2, 3, and 4 and maintains an exchange system that is free of restrictions on the making of payments and transfers for current international transactions. Australia accepted the Fourth Amendment to the Articles of Agreement in June 2001.
- Australia publishes a wide array of high quality economic and financial statistics on a timely basis and has subscribed to the Special Data Dissemination Standard (SDDS).
- This report was drafted by Messrs. Dunaway and Cerisola.

Contents	Page
Executive Summary .....	3
I. Economic Developments and Outlook .....	4
A. Recent Developments .....	4
B. The Outlook.....	9
II. Policy Discussions.....	10
A. Monetary Policy and the Exchange Rate .....	10
B. Fiscal Policy .....	11
C. Structural Policies and Other Issues.....	15
III. Staff Appraisal.....	20
Boxes	
1. The Correlation Between Australian and United States Output .....	5
2. The InterGenerational Report .....	13
3. Income and Output Convergence Across Australian States .....	16
Figures	
1. Comparisons of Macroeconomic Performance, 1990–2001 .....	24
2. Selected Real Economic Indicators, 1995–2002.....	25
3. Inflation and Labor Market Indicators, 1995–2002 .....	26
4. Fiscal Indicators, 1997/98–2005/06.....	27
5. Selected Monetary Indicators, 1995–2002.....	28
6. Balance of Payments and External Liabilities, 1995–2002 .....	29
Tables	
1. Selected Economic and Financial Indicators, 1997–2003 .....	30
2. Selected Fiscal Indicators, 1997/98–2005/06 .....	31
3. Balance of Payments, 1997–2002.....	32
4. Medium-Term Scenario, 2002–07 .....	33
Annexes	
I. Economic Vulnerability Assessment .....	34
II. Fund Relations .....	38
III. Core Statistical Indicators Table.....	39

## EXECUTIVE SUMMARY

### Economic Setting:

- **The Australian economy has continued to grow strongly despite the global economic slowdown during 2001.** Since end-2000, real GDP has grown at an annual average rate of 4¼ percent, supported by macroeconomic policies. After some weakness during 2001, the labor market picked up slightly in 2002, with the unemployment rate at 6½ percent by mid-year. The sharp real depreciation of the exchange rate helped to narrow the current account deficit from about 4 percent of GDP in 2000 to 2½ percent in 2001. Inflation accelerated during 2001 largely owing to the impact of several sector-specific factors but it declined to within the official target range by the second quarter of 2002.
- **Growth is expected to remain at about 4 percent in 2002-03, and inflation should decline toward the mid-point of the target range.** Risks to the outlook appear to be primarily external, reflecting considerable uncertainty about the strength of the recovery in global activity. In addition, domestic demand could be weaker than expected if an anticipated slowdown in housing is not offset by a pick-up in business investment; consumption, however, could remain buoyant owing to wealth effects.

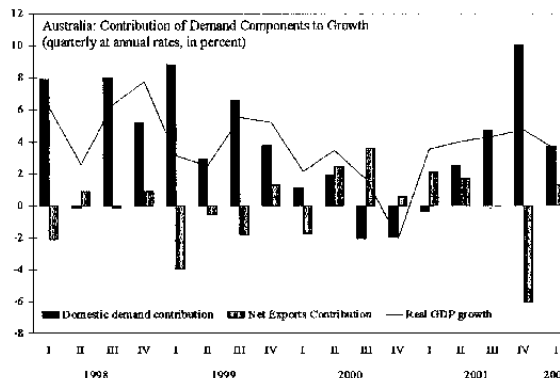
### Policy Discussions:

- **The authorities and the staff agreed that, if economic activity evolves as currently expected, a gradual further tightening of monetary policy will be required.** However, the timing and pace of further interest rate increases will depend on how economic prospects evolve in the period immediately ahead. Continued strong housing demand and rapid growth in these prices could create conditions for a more prompt policy tightening.
- **The fiscal position is sound and should remain that way given the authorities' medium-term objective of keeping the budget in balance over the business cycle.** Pressures on the budget from the health care system will grow over time, and envisaged reforms to the tax and income support systems could entail substantial demand for funding. Discipline over spending would need to continue and significant shifts in the allocation of budget resources could be required.
- **Comprehensive reforms of the tax, income support, and industrial relations systems will help to sustain relatively favorable growth prospects over the medium term and to ensure that all Australians partake in the benefits.** The staff suggested that consideration be given to lowering the top marginal personal income tax rate and increasing the threshold at which it applies; reducing the high effective marginal tax rates that income support recipients face when they go from welfare to work; tightening eligibility requirements and activity tests for some income support programs; establishing a single national labor relations system; and diminishing the role of the award system in setting minimum wages.

## I. ECONOMIC DEVELOPMENTS AND OUTLOOK

### A. Recent Developments

1. **Despite the synchronized slowdown in most of the rest of the world in 2001, the Australian economy has continued to post strong growth.** This performance reflected the absence of major imbalances in the economy, an aggressive easing of monetary policy, fiscal policy stimulus, and a competitive exchange rate.<sup>1</sup> Real GDP rose at an average rate of 4¼ percent from the fourth quarter of 2000 to the first quarter of 2002 (Table 1 and Figures 1 and 2).<sup>2</sup> Fiscal stimulus was provided by the introduction of the First Home Owners Scheme (FHOS), which combined with a decline in mortgage rates to their lowest levels in the 1990s, contributed to a major boost in housing investment.<sup>3</sup>



2. **Housing, accompanied by buoyant private consumption, led growth over the period.** Private consumption rose at an annual average of 4½ percent, supported by lower interest rates, gains in disposable income as income taxes declined, and by significant gains in household net wealth, the latter partly reflecting the sharp rise in housing prices in recent

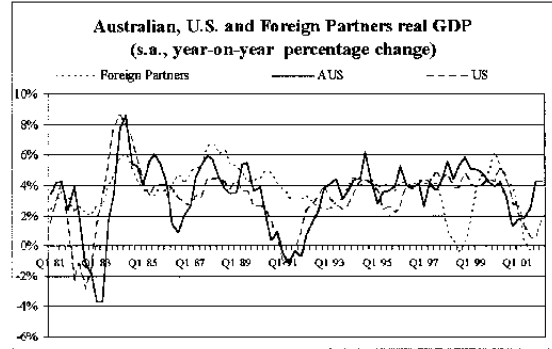
<sup>1</sup> The current expansion has lasted for 43 quarters (from the September 1991 quarter to the March 2002 quarter) and exceeds the duration of the expansions in the 1970s and 1980s, both of which lasted for approximately 30 quarters.

<sup>2</sup> Australia's real GDP growth was the third highest among (relatively large) advanced economies during 2001. It grew at an average annual rate of 2.6 percent, exceeding those of the G-7 economies, and was only surpassed by other advanced economies like Spain and Korea. Box 1 discusses the historically high correlation between Australian and U.S. business cycles, a topic which is further explored in the forthcoming selected issues paper.

<sup>3</sup> As part of the new tax system introduced in July 2000, the states and territories agreed with the Commonwealth government to fund and administer the FHOS to offset the impact of the GST on house purchases by first home buyers. The original grant amounted to \$A 7,000 for new and existing homes. An additional grant of \$A 7,000 fully funded by the Commonwealth government was made available on March 9, 2001 for contracts to build or purchase new homes entered into prior to January 1, 2002. In December 2001, the additional grant was extended until June 30, 2002 but at a lower amount of \$A 3,000. The grant reverted to its original \$A 7,000 on July 1 as scheduled.

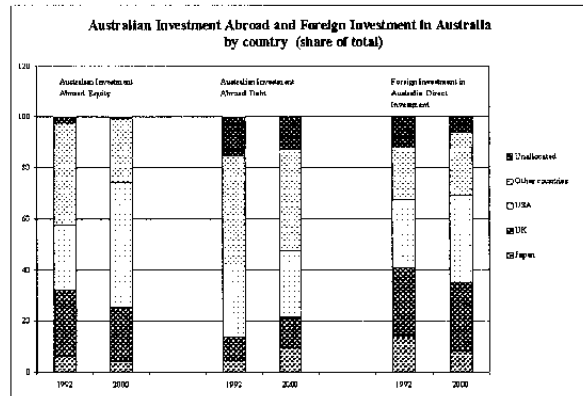
### Box 1. The Correlation Between Australian and United States Output

One of the most striking stylized facts about the Australian economy over the past two decades has been the strong correlation between the U.S. and Australian business cycles, which stands out when compared to that of Australia with its major trading partners. Explanations for the close correlation between the two countries' business cycles typically have relied on trade and financial transmission mechanisms.



Trade factors do not appear to play a major role in explaining the correlation. Since Australia's business cycle is better explained by U.S. activity rather than by activity in Australia's major foreign partners as a group (see table), it is arguably difficult that the transmission mechanism occurs mainly via exports. As for terms of trade effects, even if Australian commodity prices are highly dependent on the U.S. economy, the correlation between changes in U.S. output and changes in the Australian terms of trade index is relatively weak.

An important role may be played by financial linkages, as the degree of integration between Australian and U.S. financial markets has been increasing. The share of U.S. equity holdings by Australian residents has doubled during the 1990s. Also, the share of U.S. direct investments in Australia has increased by 30 percent, thus making the Australian corporate sector potentially more exposed to shocks in the United States.



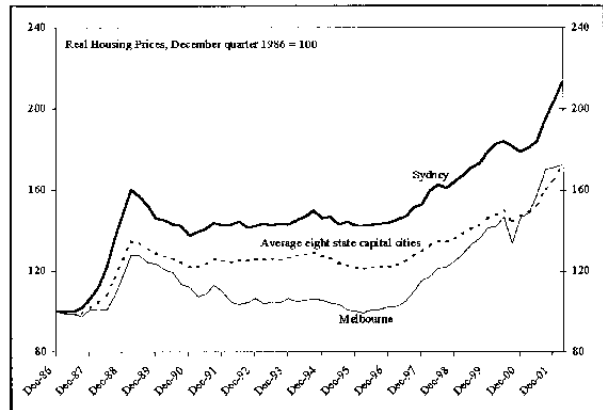
A high degree of financial interdependence between the United States and Australia may help explain the high correlation between the equity market returns in the two countries. This is likely to contribute to the high correlation between the two business cycles by affecting both investment and consumption. The correlation between the term structure of interest rates is also high.

The spread between corporate and government bonds in the two countries are also highly correlated and may contribute to the output comovement. Credit spreads contain useful information on the business cycle and risk premium (a widening credit spread may signal expectations of a future economic slowdown and higher costs for raising external finance, which in turn will induce firms to cut investment plans). Staff analysis suggests that financial linkages have played a significant role in transmitting shocks from the U.S. to the Australian economy since the mid-1990s.

Cross Correlations between Australian and foreign selected variables, 1981:Q1-2001:Q					
Lags	GDP 1/		Real Stock Market Return 3/	Term structure interest rates 4/	Corporate Bonds spread 5/
	USA	Foreign partners 2/			
0	0.64	0.24	0.63	0.41	0.42
1	0.70	0.18	0.52	0.32	0.26
2	0.71	0.12	0.44	0.19	0.16
3	0.60	0.05	0.25	0.17	0.05
4	0.44	0.00	0.00	0.08	-0.07
5	0.28	-0.02	-0.08	0.04	-0.14
6	0.09	-0.06	-0.13	-0.09	-0.21

1/ GDP: year-ended percentage change of real, seasonally adjusted, GDP.  
 2/ Foreign partners GDP is the weighted average of US, Japan, Taiwan, Hong Kong, Singapore, Korea, New Zealand and European Union percentage rates. Weights are export shares.  
 3/ Correlation with USA. Stock market return (year-ended change) is accumulation index ASX200 for Australia and S&P500 for US. Both are deflated using GDP deflators.  
 4/ Correlation with USA. Term structure is difference between yield of 10 years Treasury bonds and 3-months Treasury bills.  
 5/ Correlation with USA. Corporate Bond spread for Australia is difference between the redemption yield of UBSW corporate bond index, all maturities, and the redemption yield of UBSW Treasury bonds index, all maturities. For the U.S., the indexes are from Lehman Brothers (credit rating A). Only for this variable the cross correlations are calculated for the period 1996:Q4 - 2002:Q1

years.<sup>4</sup> Housing prices in real terms have risen at an average annual rate of about 7 percent since they began to pick up strongly in March 1997, with Sydney and Melbourne experiencing the largest increases among capital cities. Relative to their previous peak in March 1989, real housing prices are about 25 percent higher. The price rise was driven in part by an increase in household demand for housing arising from a decline in mortgage rates, which boosted the ability of



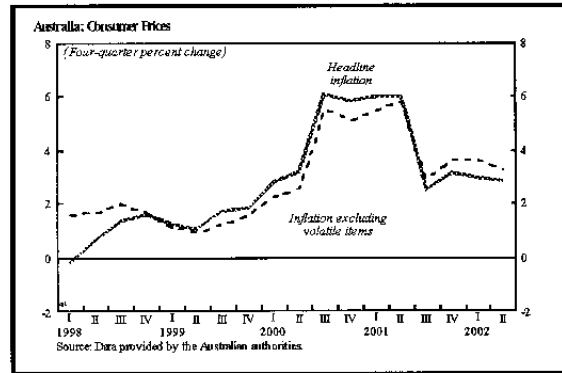
households to borrow, and from fiscal stimulus in the past two years. It also reflected some overseas demand for housing in Australia, which in part may have been motivated by the sharp depreciation of the Australian dollar. In turn, this marked increase in housing prices encouraged strong investor demand in the expectation of continuing large capital gains, driving prices up further. With rental prices softening, mortgage rates beginning to rise, and some withdrawal of fiscal stimulus to the housing sector in the second half of 2002, questions have arisen as to whether the level of prices can be sustained. Net exports, which had contributed to growth during much of 2000 and the first half of 2001, subtracted around 1½ percentage points of GDP in the second half of 2001, but contributed about ⅓ percentage points to GDP in the first quarter of 2002.

3. **Despite the robust pace of economic activity, conditions in the labor market were relatively weak during 2001, before picking up a bit in 2002.** Employment growth slowed to 0.9 percent in 2001, compared to 2 percent growth in 2000; employment rose at an annual rate of 1¾ percent in the first half of 2002. With heightened business uncertainty during 2001, most of the gains were in part-time employment. The unemployment rate rose from 6.4 percent in December 2000 to 6¾ percent in late 2001 (Figure 3). Improved business conditions and confidence in Australia strengthened the demand for labor in early 2002, helping to bring the unemployment rate down to 6.3 percent between March and May. However, employment growth has continued to slow in recent months and the unemployment rate, which rose to 6½ percent in June, fell to 6¼ percent in July owing to a decline in labor force participation.

4. **Inflation drifted upward in 2001 primarily owing to the impact of several largely transitory factors, and it has come back down in line with the official 2-3 percent target during 2002.** Following the introduction of the GST, headline inflation spiked in the first half

<sup>4</sup> Higher prices for housing would likely affect consumption not only through higher asset values but also by enhancing the household's ability to increase its leverage. In general, changes in housing wealth tend to have a larger impact on consumption than changes in financial or equity wealth. See *World Economic Outlook—Prospects and Policy Issues*, Chapter 2, April 2002.

of 2001 to around 6 percent (change from same period preceding year); subsequently, it has fallen, coming down to around 2¾ percent in the second quarter of 2002 (four quarter change). Measures of underlying inflation rose from roughly 2 percent in 1999 to around 3¼ percent at end-2001, and some measures (such as the trimmed mean and weighted median) have declined to 2½ percent in the second quarter of 2002. However, inflation excluding volatile items has remained around



3¼ percent, partly reflecting sector-specific price developments, such as a boost in insurance costs—following the failure of HIH (one of Australia’s largest insurance companies)—and in air transportation due to the collapse of Ansett Airlines in late 2001. Other indicators suggest that inflationary pressures remain subdued. For example, the wage cost index rose by 3¼ percent in the year through the March 2002 quarter, slightly below the annual average of 3½ percent in the past two years. Nonfarm unit labor costs were up by ¾ percent in the year through March 2002, held down by the buoyant growth in labor productivity. The Reserve Bank of Australia’s (RBA) survey of inflation expectations of market economists shows that inflation is expected to come down from almost 3 percent in the year to June 2002 to about 2½ percent in the year to June 2003. Also, the yield differential between fixed-rate and inflation-indexed government bonds, has hovered around a narrow range of 250 basis points in 2002, suggesting that inflation expectations remain relatively well anchored.

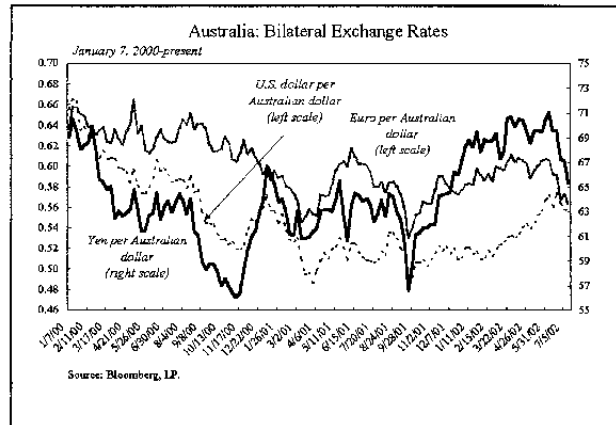
5. **With underlying inflationary pressures muted and uncertainty about the depth and duration of the global slowdown, monetary policy was highly supportive of growth during 2001 and early 2002.** Consistent with its inflation targeting framework, the RBA cut the official cash rate by 150 basis points in four steps between February and early September 2001. With a marked rise in global uncertainty in the wake of the September 11 terrorist attacks in the United States, the RBA eased monetary policy further, reducing the cash rate by 50 basis points in two steps between October and December 2001 to 4¼ percent. In the end, the economy did not slow as expected, and with generally favorable prospects, the RBA adopted a less accommodative policy stance and raised the cash rate by 25 basis points at both of its scheduled meetings in May and June 2002. At its July and August meetings, the RBA left the official cash rate unchanged.

6. **Fiscal policy was also eased significantly during 2001, providing additional stimulus to the economy.** In the May 2001/02 Budget (fiscal year July-June) and in the October 2001 Mid-Year Economic and Fiscal Outlook (MYEFO), the government implemented several tax and spending initiatives which were expected to shift the fiscal balance (on an accrual basis) from a surplus of about 1 percent of GDP in 2000/01 to a deficit of about ½ percent of GDP in 2001/02 (Table 2 and Figure 4). The underlying cash balance



would shift to a deficit of ¼ percent of GDP, the first cash deficit since 1996/97.<sup>5</sup> Important initiatives included a reduction of the corporate income tax rate,<sup>6</sup> the elimination of the financial institutions and stamp duties on quoted marketable securities; reforms to simplify and reduce the burden of compliance with the tax system for small businesses; changes in the welfare system; additional funding for promoting innovation, education, and health care; and increased spending on rural areas. The government also announced higher spending for defense (related to domestic security and to support the war on terrorism), the extension of the FHOS, and guarantees of staff entitlements related to the collapse of Ansett. The staff estimates that the fiscal impulse was about 1½ percent of GDP. The cumulative budget surpluses and significant privatization proceeds have reduced the Commonwealth net debt from 18¼ percent of GDP in 1996/97 to an estimated 5½ percent of GDP in 2001/02.

7. **Notwithstanding relatively favorable growth performance and the steady improvement in the terms of trade, the Australian dollar continued to depreciate during the first three quarters of 2001 before staging a strong comeback subsequently.** The value of the currency experienced wide swings that were partly related to market perceptions of a less favorable growth outlook for Australia relative to the United States in January–early April and to increased global risk aversion in July–September. As the economy regained its growth momentum and global risk aversion dissipated late in 2001, the Australian dollar began to appreciate. Between end-September 2001 and end-July 2002, the currency rose by about 11 percent against the U.S. dollar and about 9 percent on a real effective basis, reversing almost half of its decline against the U.S. dollar and about two-thirds of its real effective decline from its most recent peak in July 1999 (Figure 5).<sup>7</sup>



8. **The sharp real exchange rate depreciation in 2000 and 2001 and the marked recovery in Australia's terms of trade from its Asia-crisis lows helped to narrow the**

<sup>5</sup> The underlying cash balance is equal to the net cash flow from operating activities plus net cash flows from investments in nonfinancial assets minus assets acquired under financial leases or similar arrangements.

<sup>6</sup> The corporate tax rate in Australia was reduced from 34 percent to 30 percent. It is now similar to that in the United Kingdom, but lower than that in the United States (35 percent) and New Zealand (33 percent).

<sup>7</sup> See the forthcoming selected issues paper for an analysis of the fundamental factors that explain the fluctuations in the exchange rate.

**current account deficit from almost 6 percent of GDP in 1999 to 2½ percent in 2001.**

Most of the improvement was due to the sharp turnaround in the trade balance, which shifted from a deficit of 2½ percent of GDP to a surplus of roughly ½ percent of GDP (Table 3 and Figure 6). The terms of trade for goods and services increased by 1¾ percent on average in 2001. While the weak exchange rate and the favorable terms of trade helped to cushion the impact of the world slowdown, export volume growth decelerated markedly in late 2001. In the March 2002 quarter, the current account deficit was about 3 percent of GDP and net foreign liabilities were around 60 percent of GDP at end-March, about two thirds of which is comprised of net debt. Over the period since end-1999, net foreign liabilities have risen by about 4 percentage points of GDP. A rise in net debt more than accounted for this increase; as net foreign equity declined by about 3 percentage points of GDP.

## **B. The Outlook**

9. **The staff expects the Australian economy to grow by around 4 percent per year in 2002–03, slightly above its estimated long-term potential rate of 3¾ percent (Table 4).** Confidence has improved from the low point of last September, corporate profits have remained resilient, and employment growth rebounded in early 2002, all factors that bode well for private consumption and investment. Business investment, particularly in machinery and equipment, is poised for a strong recovery (led by mining), as evidenced by the strong spending in the fourth quarter of 2001, the rise in the share of profits in GDP, and by recent surveys of business' intentions. This pickup in business investment is expected to be only partially offset by a slowdown in housing investment, as FHOS grants are reduced and interest rates rise. The current account deficit is expected to increase to 3½ percent in 2002, reflecting increased domestic investment and the appreciation of the exchange rate since September 2001, but the deficit should resume its downward trend over the medium term reflecting a more favorable external environment and Australia's strong competitive position. Inflation is expected to decelerate from its current levels toward the mid-point of the target range, as the impact of "one-off" factors wanes.

10. **Risks to the short-term outlook appear to be primarily external.** There is considerable uncertainty about the strength of the recovery in global activity, especially regarding growth in the United States and the outlook for Japan. Weaker global prospects, coupled with the recent appreciation of the Australian dollar, would adversely affect exports, putting a damper on domestic activity. There is also some uncertainty about how the factors supporting domestic demand would unfold in the period ahead. The expected slowdown from housing may not be offset by a pick-up in business investment. However, consumption could prove to be more buoyant than currently expected owing to wealth effects, raising GDP growth.

11. **Medium-term prospects remain favorable.** The sound policy framework in place and the lack of imbalances have laid the foundation for sustainable high growth. The economy should expand at around its potential growth rate of 3¾ percent over the medium-term, consistent with a very gradual decline in the unemployment rate to around 5½ percent. The current account deficit is projected to trend down gradually to around 2½ percent of GDP,

assuming that the real exchange rate remains constant over the medium-term at its level of mid-2002. Net external liabilities should remain at slightly less than 60 percent of GDP by 2007.

## II. POLICY DISCUSSIONS

12. **The authorities and the staff generally agreed on the broad course of macroeconomic and structural policies in the period ahead.** The discussions centered on:

- The near-term response of monetary policy, in the context of the inflation targeting framework, to the potential risks to the outlook and to the rapid rise in housing prices.
- Continuing to achieve the authorities' fiscal objective of balancing the budget on average over the business cycle, while ensuring that sufficient budget resources are available to finance structural reforms.
- Comprehensive and coordinated reforms of the tax, income support, and industrial relations systems to further enhance incentives to work, save, and invest and to improve the flexibility of the labor market in order to enhance Australia's long-term growth prospects.

### A. Monetary Policy and the Exchange Rate

13. **With the expectation that the external environment would continue to improve and domestic economic activity would sustain considerable momentum, the authorities saw the need for monetary policy to be less accommodative to ensure that inflation remained within the target range.** The current level of interest rates was not seen as being sustainable, and therefore, they anticipated a gradual rise in rates back to a more "neutral" level. The two interest rate increases thus far in 2002 were initial steps in this process. The authorities and staff agreed that a key challenge was to gauge the point at which monetary conditions would be sufficiently tight to ensure that the rate of economic growth would not compromise the inflation target. Resource gaps in output and labor markets were not expected to close rapidly, and the appreciation of the Australian dollar had contributed to tightening monetary conditions. In these circumstances, the RBA would have time to determine the appropriate pace of interest rate increases based on a reappraisal of economic prospects as new information became available.

14. **In formulating monetary policy, the authorities noted that the rapid rise in housing prices represented a complicating factor.** It was difficult to determine whether housing prices had moved substantially out of line with their fundamental determinants, but the sharp increase in these prices raised concerns. In particular, investor demand for housing remained strong despite declining rental rates. Monetary policy was not viewed as being an effective instrument to deal with potential misalignments in these prices and other asset prices, and they were not directly a part of the policy objective. However, the behavior of asset prices could have significant macroeconomic implications through their impact on wealth and on the soundness of the financial sector balance sheets. The authorities and the staff agreed that

sustained strength in housing prices could raise aggregate demand growth and prospective inflationary pressures, prompting the need for a more rapid tightening of monetary policy.

15. **The weakness of the Australian dollar in 2000 and the first three quarters of 2001 was somewhat puzzling in that it did not reflect developments in those factors that were thought to be the traditional fundamental determinants of the exchange rate (such as commodity prices).** Instead, the depreciation was largely attributed to shifts in portfolio capital flows, as investor sentiment turned against Australian assets. The authorities noted that portfolio inflows began to strengthen markedly in mid-2001 and have continued to mount, possibly reflecting interest rate differentials, improved growth prospects in Australia relative to other major advanced economies, and a strengthening in Australia's main commodity prices. The authorities said that the real exchange rate remained somewhat below its 1992-2002 average on a multilateral basis, but that this average was not necessarily indicative of the currency's "equilibrium" value.

16. **RBA officials explained that the basic reasons for intervention in the foreign exchange market have not fundamentally changed.** They continue to intervene when markets appear to be driving the currency away from its "equilibrium" value; to calm disorderly markets; and to build reserves. The authorities emphasized that they did not attempt to achieve a particular exchange rate level. Since the early 1990s, the RBA's exchange market intervention has become less frequent, and in recent years, it has shifted more to supporting the Australian dollar, reflecting the currency's trend decline. When asked about the effectiveness of intervention, the authorities indicated that they had not conducted a comprehensive analysis of past interventions, but they thought that the fact that their intervention operations had been profitable provided some indication that the policy had had an effect.<sup>8</sup> The authorities and the staff agreed that intervention can be helpful to stabilize volatile market conditions and to signal concerns that the exchange rate may be moving out of line with fundamentals.

## B. Fiscal Policy

17. **The authorities assessed the current stance of fiscal policy as fundamentally sound.** The cautious fiscal strategy has been underpinned by the framework provided by the *Charter of Budget Honesty Act 1998*. The authorities' primary goal is to balance the budget on average over the course of the business cycle.<sup>9</sup> Consistent with this approach, the 2002/03 Budget envisages rough balance in the fiscal position on an accrual basis, but the underlying cash balance will swing into surplus by more than ¼ percent of GDP, representing a

---

<sup>8</sup> The forthcoming selected issues paper includes a more complete discussion of Australia's exchange market intervention policy and its implementation.

<sup>9</sup> The fiscal strategy has the supplementary objectives of maintaining surpluses when economic growth prospects remain sound, maintaining the overall tax burden below 1996-97 levels, and improving the Commonwealth government's net asset position over the medium to long term.

withdrawal of fiscal stimulus in 2002/03 equivalent to roughly ½ percent of GDP, of which 20 percent would be attributable to the reduction in FHOS grants. A more favorable than previously expected economic outlook significantly boosted revenue estimates. At the same time, the Budget introduced new spending initiatives, including further increases in spending on defense and domestic security; a rise in assistance to families; and higher expenditures for aged care. This is partly offset by spending reductions associated with additional welfare reforms to enhance work incentives, including tighter eligibility criteria for the Disability Support Pension (DSP), and increased user charges in the Pharmaceutical Benefits Scheme (PBS). Over the medium term, the fiscal surplus (on both an accrual and cash basis) is projected to rise from more than ¼ percent of GDP in 2003/04 to almost 1 percent of GDP in 2005/06. The Commonwealth government is expected to shift from a net debt position equivalent to roughly 4½ percent of GDP in 2002/03 to a net asset position of 2 percent of GDP in 2005/06.

18. **The staff pointed out that one-off factors and other small tax and spending initiatives have contributed to the shift of the budget into deficit in 2001/02 and reduced prospective surpluses in 2002/03 and over the medium term.** The authorities responded that the sound fiscal position achieved in recent years allowed them to implement a comprehensive reform of the tax system and take measures to support the economy during 2001. They explained that the path for fiscal policy outlined in the May 2002 Budget was a step in the right direction, as the fiscal position (on an accrual basis) will move back into balance in 2002/03 and will remain in surplus over the medium-term. Noting the strong opposition to the Budget's proposals for reforms to the PBS and DSP, the staff asked whether alternative measures would be introduced to achieve similar cost savings in the event these measures were not enacted. The authorities indicated that surplus estimates in the Budget were not specific targets. They reiterated that their primary objective remained keeping the budget on balance on average over the business cycle. The staff agreed that the prospective fiscal position was consistent with this objective.

19. **The 2002/03 Budget presented the first InterGenerational Report (IGR), which examines the sustainability of the government's finances over the next 40 years (Box 2).** In the absence of measures, a funding gap would emerge over the longer term equivalent to 5 percent of GDP by 2042, largely owing to rising health and aged care spending associated with advances in medical technology and an aging population. While noting the need for careful planning now to meet this future funding gap, the report does not recommend any specific policy measures. The authorities said that the IGR provided a useful basis to assess the long-term sustainability of current government policies and was intended to provide a

### **Box 2. The InterGenerational Report**

The *Charter of Budget Honesty Act, 1998* requires the government “to ensure that policy decisions have regard to their financial effects on future generations.” In the 2002/03 Budget, the government released the first InterGenerational Report (IGR), which presents a comprehensive analysis of the long-term implications for the budget of current policies. The IGR also assesses the impact of population aging on the public finances over the next 40 years.

Relative to other advanced economies, Australia appears to be well positioned to deal with the budgetary implications of population aging. The combination of a means-tested public pension system with a compulsory private (superannuation) system is expected to provide high replacement rates for the population and stimulate private savings. In addition, the comprehensive fiscal consolidation since 1996/97 has allowed Australia to significantly reduce public indebtedness.

Nonetheless, under current policies, significant pressures on public finances are likely to emerge. Assuming current trends in public spending and a constant ratio of revenues to GDP, spending is expected to exceed revenues in about 15 years, with the gap reaching about 5 percent of GDP around 2042. Given the nature of the exercise, the projections are subject to a high degree of uncertainty and are somewhat sensitive to the underlying assumptions, particularly those regarding demographic changes and their impact on spending and revenue.

The IGR shows that the main contributing factor to the fiscal gap is spending in health and aged care. The baseline projections show that public spending on health will rise from about 4 percent of GDP to 8¼ percent of GDP by 2042. About one-third of the growth in spending will be accounted for by population growth and aging, with the remainder coming from the demand for new technologies and treatments.

The IGR emphasizes that access to more expensive and new diagnostic procedures and medication will put considerable upward pressure on the Pharmaceutical Benefit Scheme (PBS). PBS spending is projected to increase from around ½ percent of GDP in 2001/02 to about 3½ percent by 2041/42.

backdrop for the debate over the medium-term course of fiscal policy. The staff agreed that the IGR was a very useful vehicle to begin such a dialogue. The staff noted, however, that the report might play down a bit the potential fiscal costs of health care because the changes to the PBS were assumed to be enacted as proposed in the Budget, which was now seen as uncertain, and population aging might have more of an impact than assumed, especially given the difficulties in predicting changes in medical technology and their implications for the cost of providing care for the elderly.

20. **Meeting health care costs already puts substantial pressure on public finances, and these pressures will grow over the long term if no further reforms are implemented.** The national health care system has undergone some major changes in the past decade, which aimed at fostering access to private health insurance.<sup>10</sup> The adjustments to the PBS included in the Budget were a useful step in controlling costs and encouraging efficient use of resources, but they faced strong opposition, and in the end, more would need to be done to deal with problems in this area. The staff argued that certain features of the current system appeared to contribute to substantial moral hazard. In particular, the staff thought it would be useful to cap the rebate for health insurance premiums and to limit the types of ancillary services qualifying for the rebate. The authorities indicated that it was still too early to assess the full impact of this reform and whether the recent rapid rise in spending reflected pent-up demand or a permanent increase in the use of health care services. The authorities and the staff agreed that a comprehensive solution needed to be found to the problems of the health care system so that a sufficient level of quality medical care could be provided to the Australian public at an affordable cost.

21. **An ambitious agenda of coordinated reforms in the tax, income support, and industrial relations systems would put additional demands on fiscal resources.** The availability of such resources, in turn, would dictate the pace of implementation of such reforms. The staff stressed that discipline over spending would have to be maintained and that continued efforts would have to be made to ensure that available resources were allocated to high priority areas.

22. **Both the gross and net debt of the Commonwealth government have declined markedly in recent years, with the government maintaining its intention to use the**

---

<sup>10</sup> The Australian health care system is based on the coexistence of universal public insurance, provided by Medicare, and a large private insurance industry. The public program covers public hospital care, with ambulatory, medical, and pharmaceutical services also available, and it is funded through general taxation and a Medicare levy surcharge imposed on “high” income individuals. Private health insurance covers access to those services not funded under Medicare, such as access to private hospitals and supplementary services, like dentistry. The main reforms were the introduction of a 30 percent rebate on private insurance premiums and changes which eliminate or establish limits on out-of-pocket expenses of patients (the so called “no” or “known gap” policies).

**proceeds from asset sales to reduce net debt.** As the gross debt has declined, questions have been raised regarding whether there are merits in maintaining a stock of government debt in order to facilitate the functioning and further development of the domestic bond market. The authorities felt that this was “a nice problem to have” and explained that the government has thus far maintained a large enough stock of debt to keep the government bond market liquid. With the prospect that the government will eliminate its net debt position in the next few years, the authorities have begun to consider whether they should continue to issue debt, which would prompt questions regarding the feasibility and/or desirability of investing public funds in private assets. Such an investment strategy would raise concerns about the vulnerability of these investments to political pressures and whether they would introduce distortions in capital allocations and reduce market efficiency. The authorities and the staff agreed that there was no immediate need for a decision, but that it was useful to begin to consider the issue.

### C. Structural Policies and Other Issues

23. **To sustain a high level of economic growth over time, the authorities want to encourage greater participation of all Australians in the economy.** To this end, the Government is continuing to evaluate the interlinkages between the tax, income support, and industrial relations systems with a view to developing a coordinated and comprehensive reform package that would substantially improve incentives to work, save, and invest. Some aspects of these interlinkages have contributed to disparities in output, income, and employment across states (Box 3). In the discussions, the staff focused on selected areas that it thought should be part of such a reform package.

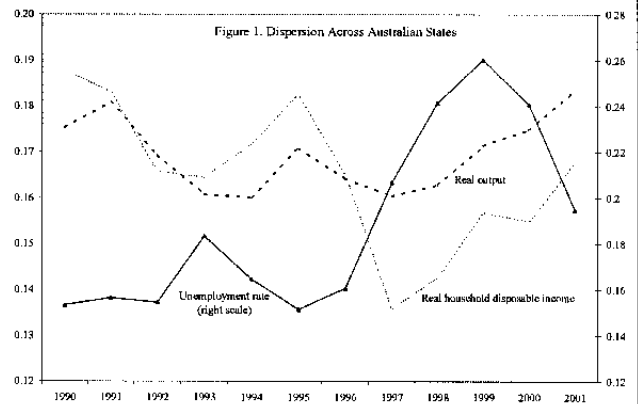
24. **In the tax system, a major priority will be reforms in the personal income tax.** In particular, the top marginal tax rate is 47 percent, and it is applied at a relatively low income level—one that is just two times median household income. The large difference between the top marginal rate in the personal income tax and the top corporate income tax rate, at 30 percent, also creates substantial incentives for tax avoidance, potentially reducing the economy’s efficiency by distorting economic decision making. The authorities and the staff agreed that the top marginal rate needed to be brought down over time and that the income threshold at which it applies should be substantially raised. The staff suggested that the top marginal rate should be brought down in line with the corporate tax rate. Lower personal income taxes would serve to boost work incentives and foster the development of a higher skilled work force by increasing returns to human capital. Sustaining Australia’s success in achieving a high rate of labor productivity growth will depend on continued rapid adoption of new technology, which will be aided by the presence of a good supply of skilled labor. Moreover, in an increasingly globalized economy, Australia will have to remain competitive to retain the services of its best and brightest people.

25. **Incentives to take up work should continue to be strengthened.** The authorities and the staff agreed that the withdrawal of income support benefits as individuals moved



### Box 3. Income and Output Convergence Across Australian States

Conventional measures of convergence suggest that neither output, income, or unemployment rates across Australian states have significantly converged during the 1990s (Figure 1). Analysis of the disparities in per capita real output and personal income suggests that Australian states and territories can be divided into two groups: one group in which the per capita real output and income are higher than the national average (including New South Wales, Victoria, Western Australia, and the two territories), and another group (comprising Queensland, South Australia, and Tasmania) with output and income levels below the national average. Considerable disparities also remain in regional unemployment rates and the median duration of unemployment.



Dispersions in output, income, and the unemployment rate across states have increased since 1997, after significant economic reforms began to take hold, with the dispersion in output far higher than that for disposable income. Additionally, unemployment rates are higher in the states with the higher income and output gaps where the median duration of unemployment is also longer.

Regional disparities may be explained by three factors:

**Labor market policies:** The continuing practice of some centralized wage bargaining may be a factor contributing to labor market rigidities in Australia across states and territories. Although the Workplace Relations Act of 1996 facilitated the transition to enterprise bargaining by restricting the role of awards to a safety net of minimum wages and other core conditions of employment, award-based wage setting is still sizeable—more so in the lower income regions, where about a third of wages are still set by awards only. In addition, the wage setting process does not sufficiently allow for productivity differentials among states to be considered, impeding labor market flexibility.

**Public transfers:** Public transfers have aided in reducing income disparities across Australia; however, it could be at the cost of creating disincentives to work. States with the relatively lowest output levels and highest dependence on social assistance are also the ones with the longest duration of unemployment. It is also likely that features of the income support system may constrain incentives for seeking work and migrating to higher growth regions. Further, the flat rate nature of unemployment benefits may lead to different replacement rates across states—with relatively higher rates occurring in lower-income regions—again creating disincentives to work and migration.

**Implementation of Reforms:** Another explanation could be that some states have made more progress in implementing reforms than others, and thus, are reaping the benefits in terms of higher output. The current federal-state funding arrangements are viewed by some as not providing the right incentives for sound economic policy. The incentives from the federal transfer system could partly contribute to delay or a slower pace in the implementation of reforms in the states with relatively lower income and output.

Staff analysis indicates that the wage setting process does not sufficiently allow for productivity differentials across states, impeding labor market flexibility and causing unemployment to be higher in regions with relatively lower productivity. There is also evidence that per capita real public transfers to households contribute to higher unemployment rates relative to the Australian average. However, empirical support is weak for the hypothesis that federal grants to the states adversely impact their relative output growth rates.

	Ratio to Australia		Unemployment	
	Per capita GDP	Per capita real disposable household income	Rate	Median duration in weeks
NS				
W	106.9	107.4	5.4	18.3
VIC	102.9	103.7	6.3	17.8
QLD	86.7	89.0	8.3	17.0
SA	83.4	88.7	7.2	25.0
WA	107.8	94.0	6.8	12.9
TAS	72.0	81.2	8.8	35.1
NT	119.1	97.0	6.8	11.1
ACT	125.9	135.1	4.9	15.0
AUS	100.0	100.0	6.7	18.0

Sources: ABS and staff estimates for 2001.

back into regular work created high effective marginal tax rates (EMTRs) and was a major barrier to greater labor force participation. The Government's introduction of the Working Credit as part of the *Australians Working Together* program in the 2001/02 Budget was a step in dealing with this problem; however, it effectively covers only income support recipients, who are willing to accept part-time, seasonal, or intermittent employment. The staff also noted that the transition back to work would be facilitated by the authorities' efforts to improve employment and job training services, and that extension of these and other supporting services (including child care and a phased reduction in the benefits provided through the Health Care Card program) needed to be considered to aid income support recipients, particularly older workers and parents, in their return to work.

26. **Eligibility requirements for income support programs and penalties for breach of obligations need to be rigorously applied and in some cases tightened.** The proposals in the 2002/03 Budget to tighten eligibility for the Disability Support Pension were seen as a good way to begin reducing the use of this program as a means of providing a pension to older workers who are not disabled but are having difficulties in finding new jobs. While the staff felt that these proposals should be implemented more quickly than planned, the authorities noted the strong opposition that they have encountered to the proposed phased implementation of the changes to the DSP. Nonetheless, they would continue to push for reform of the program. There also was general agreement between the authorities and the staff about the importance of maintaining and strictly enforcing strong activities tests and penalties for noncompliance with obligations for recipients of unemployment benefits to provide sufficient incentives for these individuals to return as quickly as possible back to employment. The staff noted that a requirement like the Mutual Obligation program (which requires unemployment recipients of 15 to 49 years of age to participate in job search and training activities in order to continue to receive benefits) provided proper incentives for individuals to take up employments. Such a program should be retained and extended to unemployment recipients of all ages.

27. **Efforts to bring people into the labor force would be assisted by further changes in the industrial relations system that would enhance the flexibility and efficiency of the labor market.** Reforms in recent years have allowed for a steady increase in enterprise bargaining and collective agreements, bringing the share of the workforce under the old awards system down from about two thirds in 1990 to slightly less than one quarter in 2000.<sup>11</sup> The awards system, however, continues to underpin a significant number of labor agreements and wage bargaining remains complicated by the overlapping jurisdiction of federal and state

---

<sup>11</sup> Major reforms include a reduction in the number of employment conditions covered by awards to a safety net consisting of basic wages and employment conditions; limiting the arbitration power of the Australian Industrial Relations Commission; and the streamlining of the approval process for individually negotiated Australian Workplace agreements.

frameworks.<sup>12</sup> Accordingly, the staff supported the authorities efforts to establish through legislation a national industrial relations system. The awards system also still plays an important part in setting minimum wages, which remain very high in Australia relative to other advanced economies. The authorities explained that, historically, the minimum wage has been used as a means of providing a “living wage”. They noted and the staff agreed that this function could be more effectively accomplished through the tax and the income support systems. Reducing the role of awards in setting minimum wages would enhance employment prospects for low-skilled workers.

**28. Representatives from the business sector and labor unions agreed in general that long-term unemployment remained an important problem and that further reforms were needed.** Business sector representatives welcomed recent measures in the budget to tighten requirements for and enhance assistance to the long-term unemployed but they were concerned by the share of such workers comprised by young males, which suggested that some reassessment of the education system might also be warranted. They also noted that fostering labor force growth, especially through immigration of skilled workers, should help sustain productivity and economic growth rates over the medium-term. Representatives from the Australian Council of Trade Unions (ACTU) felt that the current employment assistance system was not addressing the problem of long-term unemployment in an effective way. The ACTU suggested that wage subsidies for private sector employment or publicly funded job programs might be better alternatives.

**29. The banking sector in Australia remains financially very healthy despite some distress in the corporate and non-bank financial sectors.** The authorities did not envisage any systemic risk, even though, exposure of banks to the housing sector had increased significantly in the past couple of years. Banks have adopted cautious lending standards, have relatively low average loan-to-value ratios, and have increasingly relied on mortgage insurance. The collapse of HIH served to reinforce the need to tighten supervision and regulation of insurance companies. More important concerns, however, arise from difficulties in the insurance and superannuation industries, which have prompted steps to tighten the supervision and regulation of firms in these sectors. As part of a new prudential supervisory framework, the Australian Prudential Regulation Authority (APRA) has begun to relicense all non-life insurance companies, capital requirements have been increased on average by 50 percent and made more reflective of risks, and standards have been introduced for liability valuation, risk management, and reinsurance activities. Changes in the prudential regulatory framework for superannuation funds were also deemed important given their rapid growth in recent years and some concerns about governance in the wake of the failures of some small funds. APRA officials stressed the need in particular to expand licensing requirements to all APRA regulated funds, to introduce standards on outsourcing of administrative and

---

<sup>12</sup> The forthcoming selected issues paper explores some of the potential influences explaining regional disparities in unemployment, output, and income.

investment management services by funds, and to improve prudential information requirements.

30. **Australia remains well placed to absorb adverse economic shocks.** The staff agreed with the authorities that Australia's ability to adjust to adverse domestic and external shocks has been successfully tested over the past few years and that risks continue to be manageable. Household, corporate, and bank balance sheets remain sound and have been resilient to the sharp real depreciation of the exchange rate, wide swings in commodity prices, and the more recent episodes of distress in the corporate sector (Annex I). Nonetheless, the staff noted that recent trends warranted continued monitoring. External indebtedness has continued to grow at a rapid pace and its maturity structure has shortened somewhat. Net foreign liabilities remain high, with a rapid growth in debt financed liabilities, making Australia's position potentially vulnerable to marked shifts in investor sentiment. The staff agrees with the authorities that these risks are mitigated by the high degree of hedging, the significant share of gross foreign liabilities in Australian dollars, and by the marked decline in the ratio of net debt service to exports during the 1990s. In view of the inflation targeting framework and the floating exchange rate, the staff also would expect that, in the event of a sharp change in market sentiment, the economic effects will ultimately be borne by the domestic economy through changes in the exchange rate, interest rates, and economic activity.

31. **Australia remains committed to trade liberalization on a multilateral basis and has been an active participant in the WTO process.** At the same time, the country has sought to negotiate bilateral free trade agreements with Singapore and Thailand and has reached agreement on a framework for negotiating a free trade agreement with the United States. Other bilateral and regional initiatives are being considered. Such agreements are seen by the authorities as being consistent and supportive of multilateral efforts and offering Australia a second-best option for extending the benefits received from trade. Liberalization of trade in agricultural products remains a major area of interest for the authorities, and they expressed concerns about the near-term implications for Australia of the enactment of the new U.S. farm bill and the adverse effect that this legislation may have on reaching new international agreements on agricultural trade. With regard to access to Australian markets for the least developed countries, the authorities noted that about 93 percent of products from these countries entered Australia duty- and quota-free; remaining restrictions were being reviewed, and some of them could be removed in the near term.<sup>13</sup>

32. **The authorities have made significant progress in dealing with anti-bribery and money laundering initiatives.** The Criminal Code Amendment Bribery of Foreign Officials Act was enacted in December 1999 to implement the OECD Convention on Combating Bribery of Foreign Public Officials in International Business Transactions. The authorities have continued to make progress regarding the recommendations of the Financial Action Task

---

<sup>13</sup> Australia's rating on the IMF's trade restrictiveness index is 1 (on a scale ranging from 1 to 10, with 1 being the least restrictive).

Force (FATF) on money laundering. Their self-assessment indicates that they comply with the forty recommendations, with the exception of one owing to limitations on their ability to confiscate the financial instruments intended for use in money laundering offences, and legislation addressing this issue is currently before Parliament. The authorities expect that new legislation, which was enacted in late June, will facilitate their tracking down of terrorism financing by domestic institutions and bring Australia in line with FATF recommendations in this area.

### III. STAFF APPRAISAL

33. **Policy actions sustained over the past several years have significantly improved the domestic economic environment, helping to make the current expansion one of the longest on record.** Broad fiscal consolidation, implementation of a transparent framework for fiscal policy, adoption of inflation targeting, broad structural reforms in product and labor markets, and external trade liberalization have established a sound foundation for the Australian economy. This solid base combined with appropriate discretionary monetary and fiscal policy actions helped Australia to sustain strong economic growth despite the substantial external shocks stemming from the Asian financial crisis and the synchronized slowdown in the world economy during 2001. This has to be recognized as a major achievement because it represents a sharp departure from the economy's previous vulnerability to such shocks.

34. **The better-than-expected performance of the economy in 2001 and its continued favorable prospects prompted the Reserve Bank of Australia in May and June to begin to reduce some of the monetary stimulus put in place during 2001 after the onset of recession in the United States.** Monetary conditions have also been tightened by the appreciation of the exchange rate in 2002. With a rate of GDP growth envisaged over the next two years only slightly above potential, resource gaps in output and labor markets are not expected to close rapidly or spark a sudden rise in price pressures. In these circumstances, a gradual further tightening of monetary policy will be required, but the timing and pace of interest rate increases is not certain and will depend on how economic prospects evolve in the period immediately ahead. At the same time, the rapid rise in housing prices in recent years is a factor that presents an additional complication in formulating monetary policy. The authorities and the staff agree that monetary policy should not attempt to directly target asset prices, but consideration needs to be given to the impact that a possibly unsustainable run-up in asset prices could have on the real economy and inflation through wealth effects and potential financial market disruptions. Accordingly, continued strong household and investor demand for housing and rapid growth in these prices could create conditions that would call for a more prompt tightening of monetary policy.

35. **Overall, the fiscal position remains sound despite some easing in the policy stance in recent years, and the 2002/03 Budget proposes to bring the fiscal position back into surplus after a small deficit in 2001/02.** Nevertheless, one-off factors (such as the additional funding provided for the First Home Owners Scheme and for defense and border security) and other relatively small tax and spending initiatives over the last two fiscal years and in the current Budget have reduced the size of potential fiscal resources, contributing to

the shift of the budget into deficit in 2001/02 and reducing prospective surpluses in 2002/03 and over the medium term. Moreover, compromises that may be required to secure passage of some of the reforms proposed in the 2002/03 Budget, such as the changes to the Pharmaceutical Benefits Scheme and the Disability Support Pension, could entail additional budget costs, further eroding prospective fiscal resources.

**36. Pressures on the budget from the health care system have intensified and will continue to grow over the longer term, especially with the aging of the population.** This will increase the need for a reallocation of budget resources and reforms in this area to improve the efficiency of the delivery of medical services and to contain costs. As evidenced by the experiences of all advanced economies, dealing with rising health care costs is no easy task. While the reforms introduced in Australia in recent years have helped to increase the health-care coverage of the population markedly, they have also raised the demand for and costs of services, imposing a very heavy burden on public finances. As noted in the InterGenerational Report, these pressures will intensify in the future if no further reforms are implemented. Certain features of the current system in Australia appear to contribute to substantial moral hazard, and correcting them should help to contain cost pressures. The changes in the Pharmaceutical Benefits Scheme proposed in the Budget are modest steps in this direction. Consideration might also be given to placing limits on the rebate for insurance premiums and the types of ancillary services that receive the rebate. While short-term actions are needed to contain health-care costs, a dialogue also has to begin on finding more comprehensive solutions to the question of how to efficiently provide sufficient quality medical care at a reasonable cost. The InterGenerational Report provides a very useful vehicle to begin such a dialogue, and the IMF staff commends the authorities for their work.

**37. The current fiscal policy stance also is not likely to generate sufficient resources to finance further reforms that are needed over the medium term to allow the economy to sustain relatively rapid growth and to ensure that all Australians share in these gains.** In this regard, the authorities have indicated their interest in improving incentives and expanding opportunities for all segments of Australia's working-age population to increase their participation in the economy. To do this effectively will entail major changes in the tax, income support, and industrial relations systems. The staff agrees with the authorities that these measures should be considered as part of a comprehensive and coordinated package in order to maximize the economic benefits. This can be achieved by making the tax and income support systems work together more effectively and improving the flexibility and efficiency of the labor market. Substantial funding may be needed to meet the costs of these changes, and this could require significant shifts in the allocation of budget resources. Discipline over spending would need to be continued, and efforts made to pare expenditures and tax reductions in lesser priority areas.

**38. To enhance incentives to work, save, and invest, reform in the personal income tax system is a major priority.** In particular, the top marginal tax rate at 47 percent kicks in at a relatively low income level (one that is about two times median income) and is high relative to the corporate income tax rate, which has been reduced to 30 percent. This disparity has distorted economic behavior by creating substantial incentives for tax avoidance. The staff

recommends that efforts be made to bring the top marginal tax rate down over time to a level in line with the corporate income tax rate and that the income threshold at which it applies be raised substantially.

39. **Recent efforts towards overhauling the income support system began with the introduction of the *Australians Working Together* program in the 2001/02 Budget.** The program established the Working Credit and tightened activity tests for unemployment benefits recipients under the Mutual Obligation program, as steps in fostering labor force participation. However, as the authorities have noted, the income support system remains very complex and more comprehensive reforms are needed to simplify the system and the benefits provided, to strengthen incentives to move from income support to gainful employment, and to ensure that individuals and families receive and effectively use the assistance that they may need in making the transition to work. As part of a comprehensive reform, the staff suggests that consideration be given to:

- The introduction of a scheme that would reduce the high effective marginal tax rates that income support recipients face under the current system when they attempt to move from welfare to full-time employment. The transition to work would also be facilitated by efforts to improve employment and job training services and to provide other supporting services, such as child care and a phased reduction in public health care benefits.
- Tightening eligibility requirements for some income support programs. In particular, the proposals in the 2002/03 Budget to tighten eligibility for the Disability Support Pension are a good start toward ending the use of this program to pension off mature workers having difficulty in finding employment.
- Maintaining strong activities tests and penalties for breach of obligations for recipients of unemployment benefits. These activity tests and penalties should be imposed uniformly and consistently across all recipients in order to have their intended effect of providing a strong incentive to return to employment. It is important that a requirement like the Mutual Obligation program be retained and extended to all age groups in the labor force.

40. **To facilitate the entry of income support recipients into employment and to encourage others to participate in the labor force, the flexibility and efficiency of the labor market needs to be enhanced further.** While much has been done, additional reforms would help over time to bring the unemployment rate significantly below 6 percent and to raise the economy's potential growth rate on a sustainable basis. As part of such reforms, the award and wage bargaining systems need to be further simplified. It is important to move toward establishing a single national industrial relations system and move away from the complicated array of federal and state frameworks that may currently apply to different groups of employees in a single enterprise. In addition, the role of the award system in setting minimum wages should be diminished in order to reduce what may be a significant barrier to the entry of low-skilled individuals into employment. Historically, the minimum wage in Australia has been used as a vehicle to try to ensure a "living wage". However, it has to be

recognized that the wage determination system is a very blunt instrument to use for this purpose. Ensuring a minimum standard of living for all working Australians could be achieved more efficiently, with the creation of fewer economic distortions, by using the tax and/or income support systems.

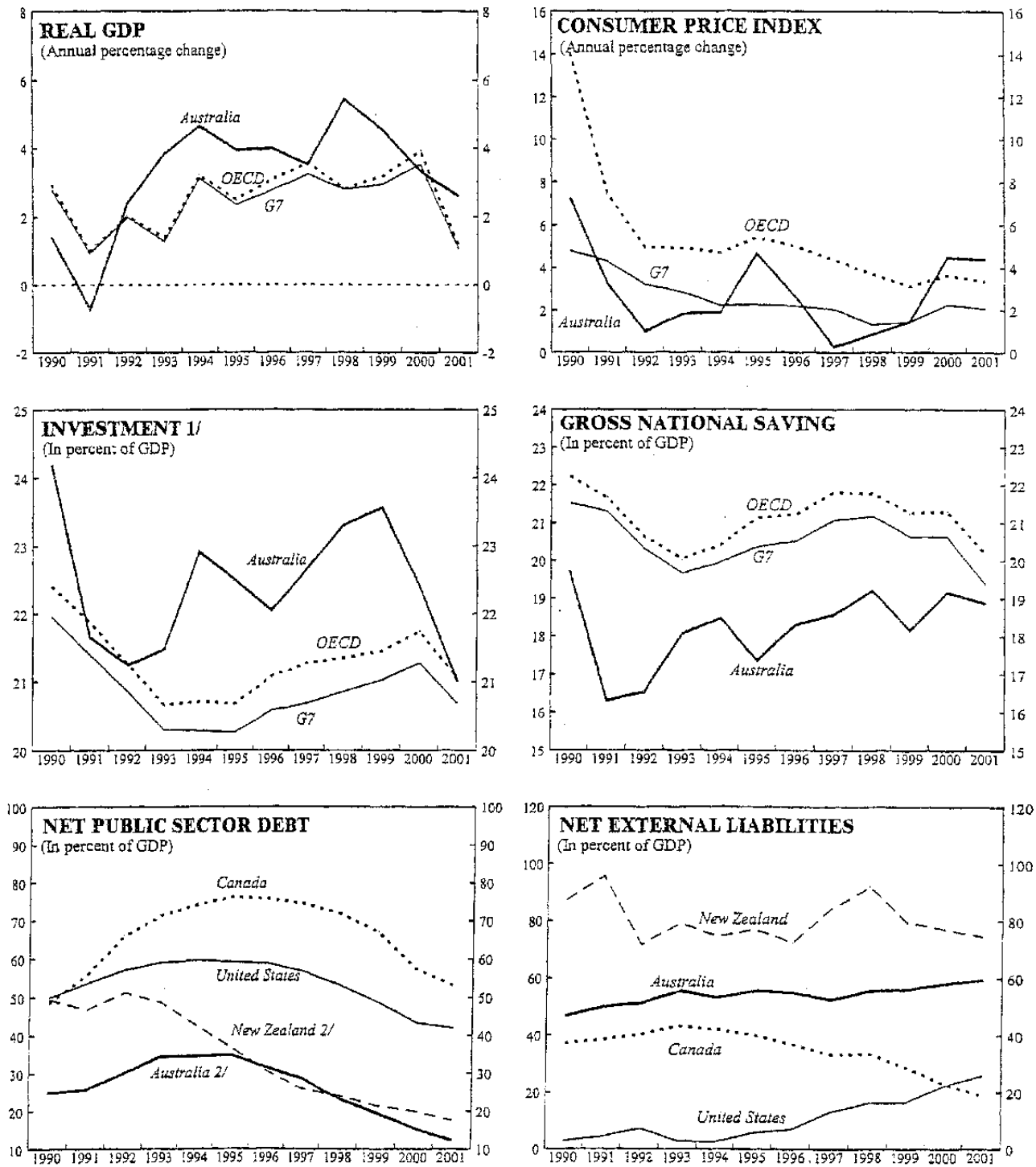
41. **The high profile of the collapses of several large corporations and firms in the financial sector in the past year has focused attention on the potential impacts of these failures on the financial system and has raised concerns about the regulatory and supervisory framework.** The staff agrees with the authorities' assessment that, given the exposures to the failed firms and the high levels of bank profitability and capital adequacy, the banking system would not be seriously affected by these events. It also agrees that, at present, banks' exposures in the housing market do not pose a systemic risk in the event of a significant decline in housing prices. Implementation of a new prudential supervisory framework for the non-life insurance sector is a welcome step to strengthen risk management practices, capital adequacy, and corporate governance in the industry. In addition, the growing importance of superannuation funds and recent difficulties encountered by some funds have appropriately prompted the authorities to examine ways of improving the prudential supervisory framework for these funds.

42. **Australia has successfully adjusted to adverse shocks over the past few years.** Household, corporate, and bank balance sheets remain basically sound, and all sectors have in general coped well with the sharp real depreciation of the exchange rate, the wide swings in commodity prices, and the more recent episodes of corporate distress. Some of these corporate failures appear to have been the result of inadequate hedging of exchange and market risk, and they have had no systemic implications for the economy. Nonetheless, the potential implications of some recent trends—the rapid pace of growth in external indebtedness, a shortening of the maturity structure, and increased exposure of the financial system to housing—should continue to be carefully assessed. The high degree of hedging in the economy provides some comfort. Moreover, in light of the inflation targeting framework and the floating exchange rate, preserving a sound fiscal position helps to minimize the impact on the domestic economy of a marked shift in market sentiment.

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



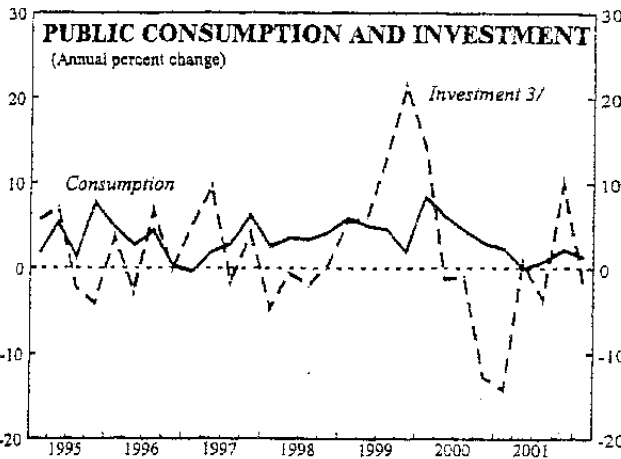
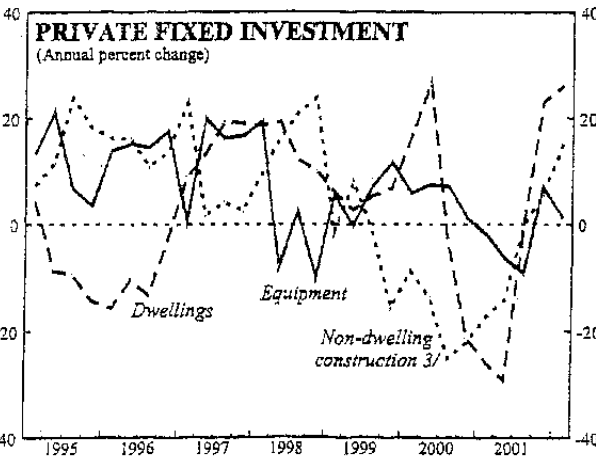
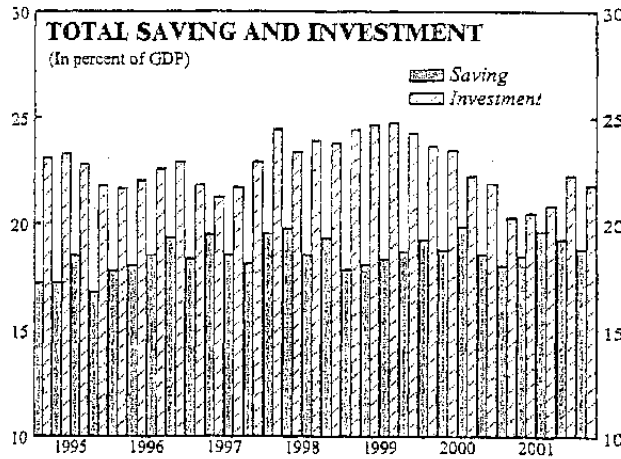
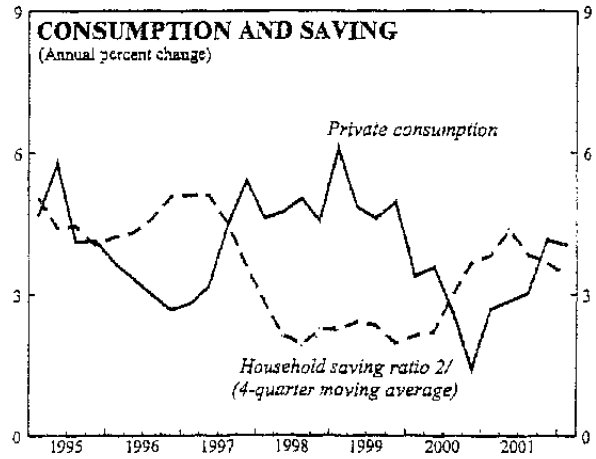
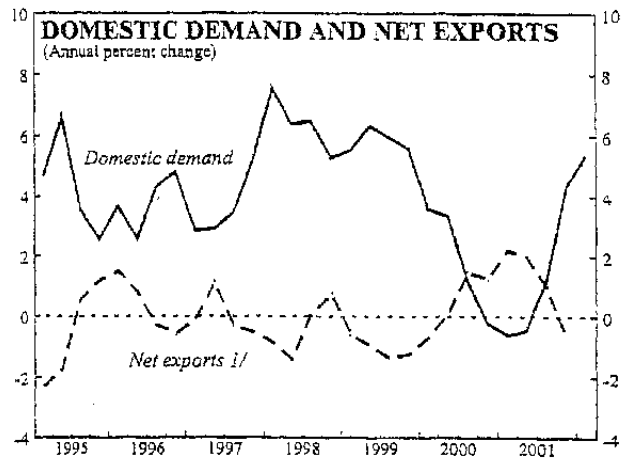
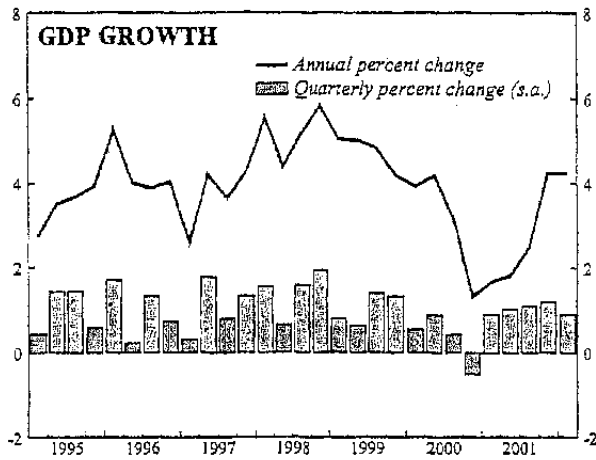
**FIGURE 1**  
**AUSTRALIA**  
**COMPARISONS OF MACROECONOMIC PERFORMANCE, 1990-2001**



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

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

**FIGURE 2**  
**AUSTRALIA**  
**SELECTED REAL ECONOMIC INDICATORS, 1995-2002**



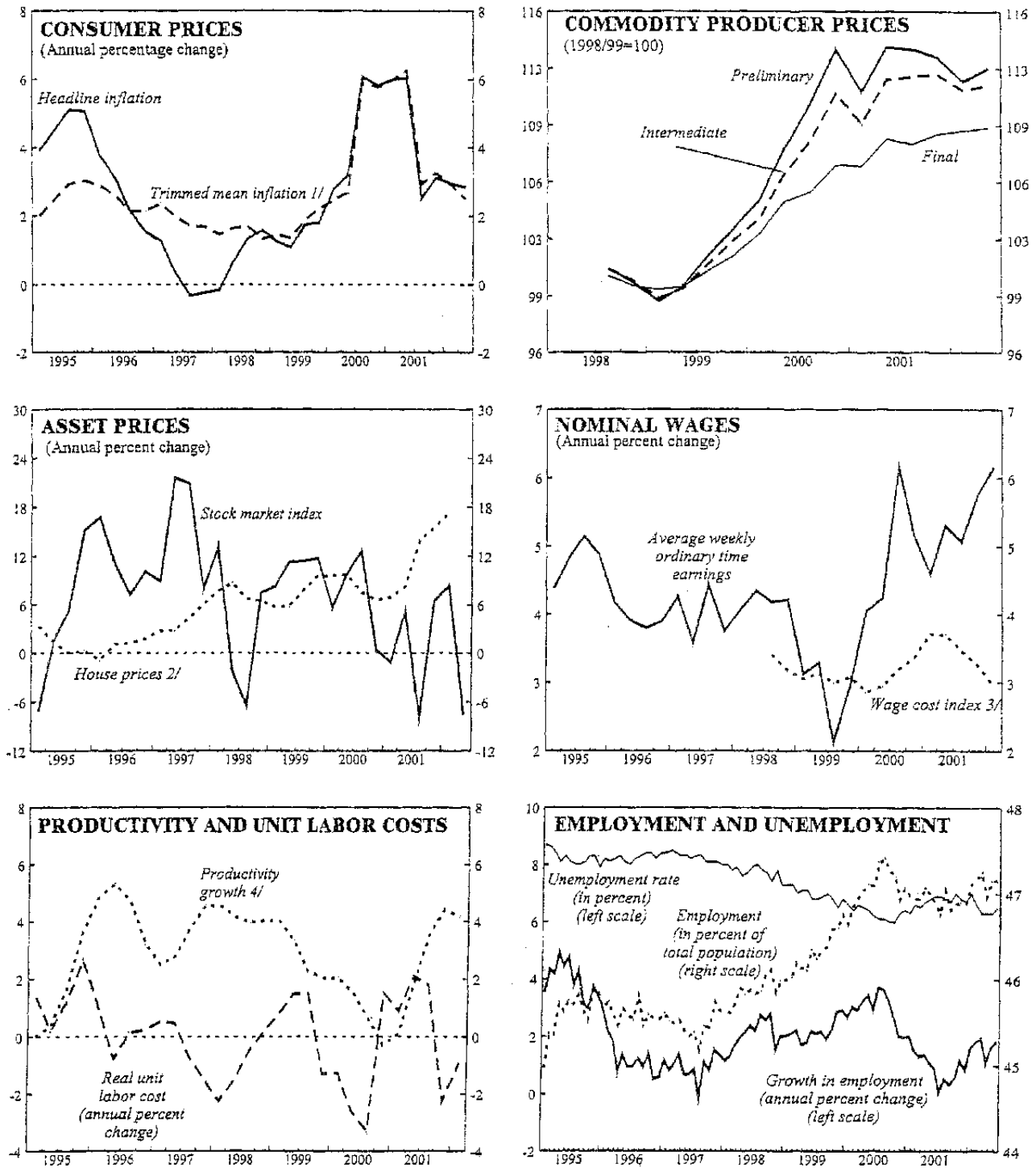
Source: Data provided by the Australian authorities.

1/ Contribution to GDP growth.

2/ Net household saving as a percent of household disposable income.

3/ Adjusted for sale of second hand assets between sectors.

**FIGURE 3**  
**AUSTRALIA**  
**INFLATION AND LABOR MARKET INDICATORS, 1995-2002**



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

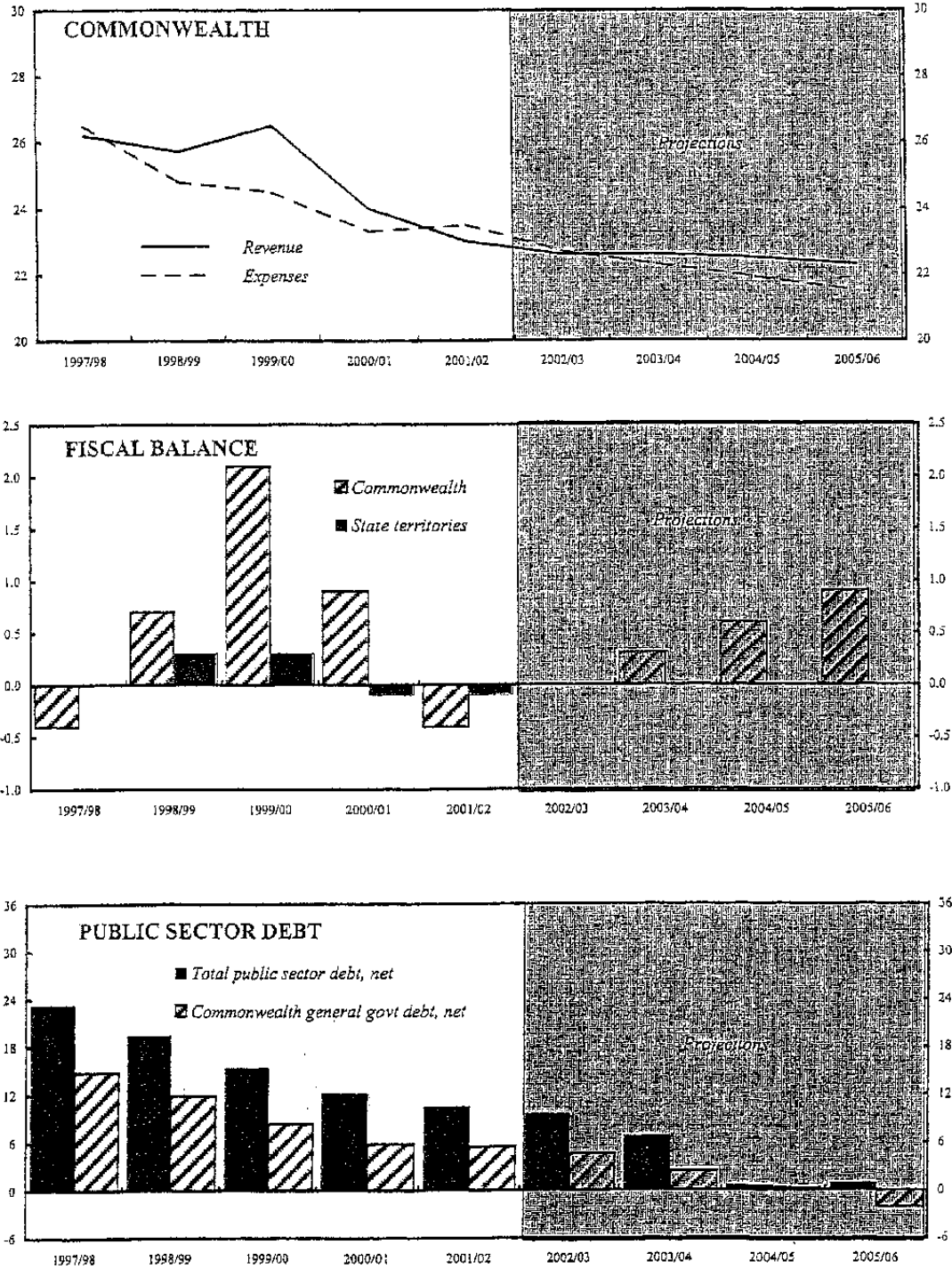
1/ The "Trimmed mean" is calculated as the weighted mean of the central 70 per cent of the quarterly price change distribution of all CPI components, with the annual rates based on quarterly calculations.

2/ Weighted average of 8 capital cities; established houses.

3/ The Wage Cost Index is only available from September 1997.

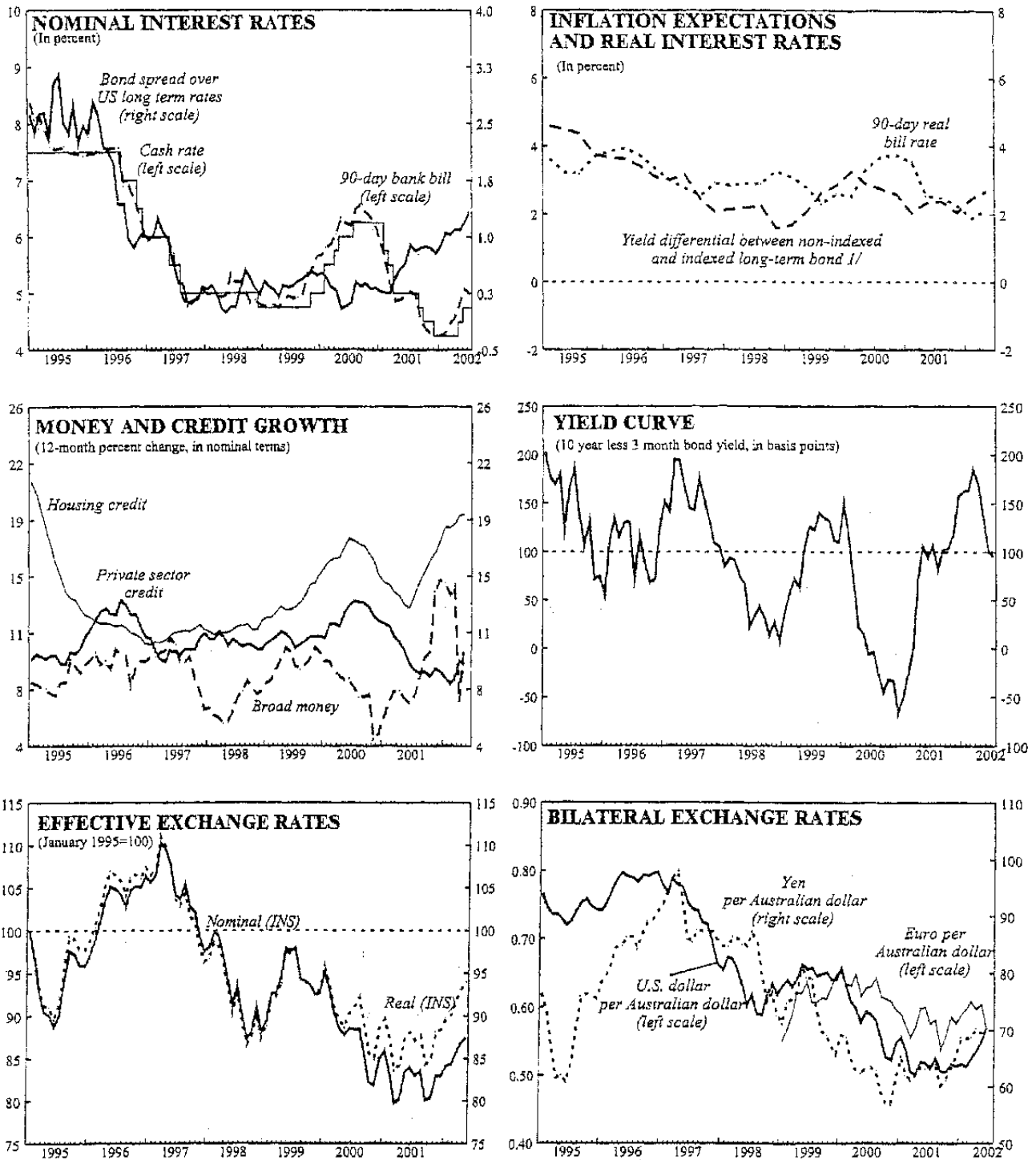
4/ Output per hour worked; non-farm market sector.

FIGURE 4  
 AUSTRALIA  
 FISCAL INDICATORS, 1997/1998-2005/2006  
 (In percent of GDP)



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

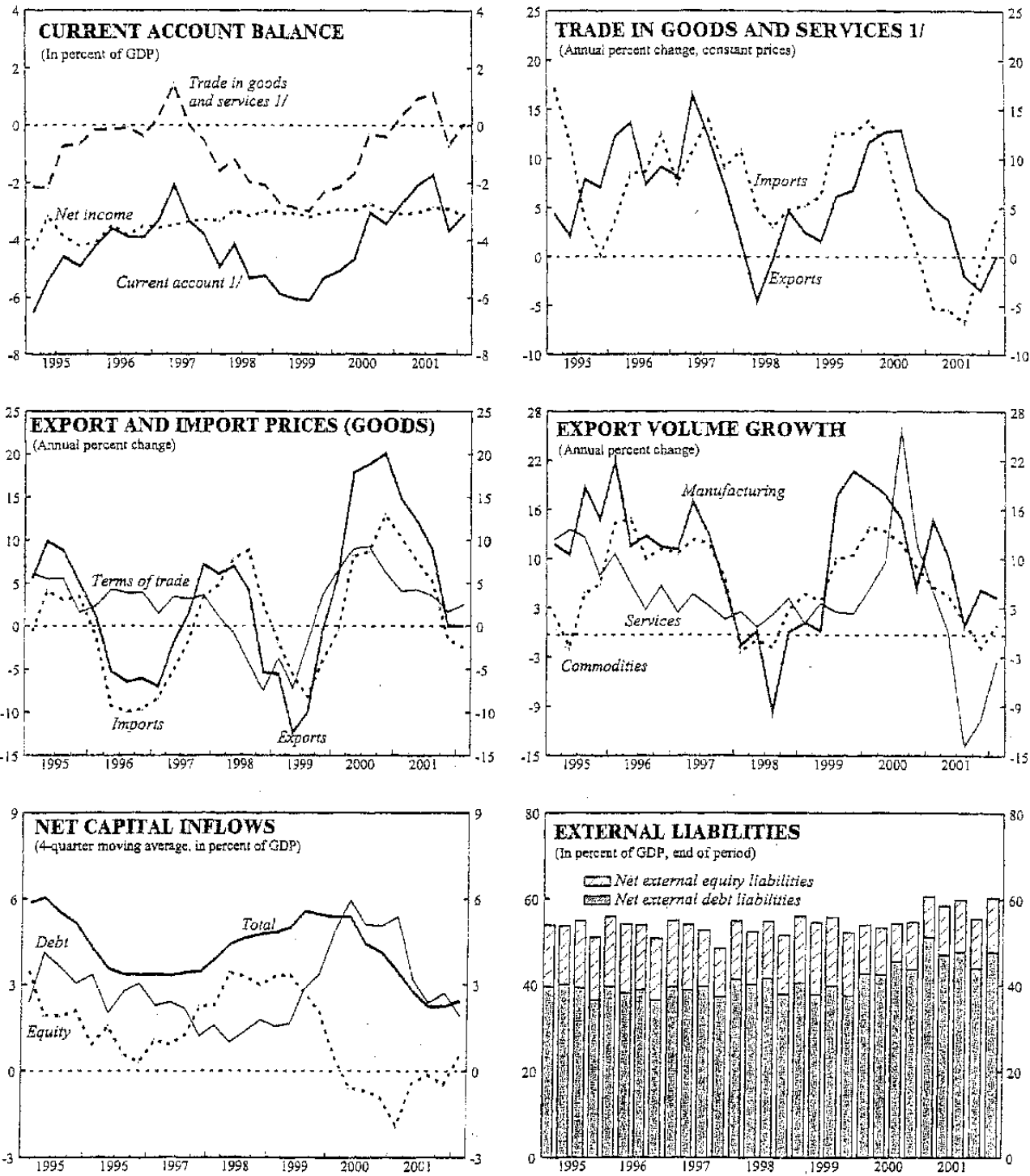
**FIGURE 5**  
**AUSTRALIA**  
**SELECTED MONETARY INDICATORS, 1995-2002**



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

1/ Calculated as the spread between long-term non-indexed and indexed government bonds.

**FIGURE 6**  
**AUSTRALIA**  
**BALANCE OF PAYMENTS AND EXTERNAL LIABILITIES, 1995-2002**



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

1/ June 1997 exports includes the sale of gold by the Reserve Bank equivalent to 1 1/2 percent of June 1997 quarter GDP.

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

	1997					Projections	
	1997	1998	1999	2000	2001	2002	2003
Nominal GDP (2001):	\$A92 billion (US\$ 358 billion)						
Population (June 2001):	19.56 million						
GDP per capita (2001):	US\$ 18,302						
Quota:	SDR 3,236						
<b>Output and demand (percent change)</b>							
Real GDP	3.7	5.2	4.8	3.1	2.6	4.0	3.8
Total domestic demand	3.6	6.4	5.8	1.9	1.1	5.2	4.2
Private consumption	4.0	4.7	5.1	2.7	3.2	4.2	3.2
Fixed investment	10.2	6.9	7.2	0.5	-3.4	8.5	10.1
Exports of goods and services	11.1	0.2	4.3	10.9	0.8	3.1	6.5
Imports of goods and services	10.5	5.9	9.1	7.4	-4.5	7.3	7.9
<b>Inflation and unemployment (in percent)</b>							
CPI inflation	0.3	0.9	1.5	4.5	4.4	2.8	2.5
Unemployment rate	8.3	7.7	7.0	6.3	6.7	6.3	6.0
<b>Saving and investment (in percent of GDP)</b>							
Gross national saving	18.6	18.9	18.1	19.2	18.9	18.0	18.4
General government saving	2.1	3.9	4.2	2.6	2.6	2.1	2.7
Private saving 1/	16.5	15.0	13.9	16.6	16.3	15.8	15.7
Gross capital formation	21.8	23.8	24.5	22.8	20.2	21.6	22.2
<b>Fiscal indicators (in percent of GDP) 2/</b>							
Commonwealth budget							
Revenue	24.5	24.2	24.8	26.4	23.9 3/	23.1	23.0
Underlying expenditure 4/	25.5	24.0	24.1	24.3	23.1 3/	23.3	22.7
Underlying balance 4/	-1.0	0.2	0.7	2.0	0.8	-0.2	0.3
Fiscal balance (accrual basis)	-0.8	-0.4	0.7	2.1	0.9 5/	-0.4	0.0
<b>Money and credit (end of period)</b>							
M1 (percent change)	13.3	6.1	9.7	9.4	21.3	-1.9 6/	...
M3 (percent change)	7.2	6.8	9.4	5.1	14.9	14.9 7/	...
Private domestic credit (percent change)	11.3	10.3	11.1	12.0	8.8	9.0 7/	...
Interest rate (90-day bill, in percent)	5.1	4.8	5.7	6.2	4.2	5.1 8/	...
Government bond yield (10-year, in percent)	6.0	5.0	7.0	5.5	6.0	6.1 8/	...
<b>Balance of payments (in percent of GDP)</b>							
Current account	-3.1	-4.9	-5.8	-4.0	-2.6	-3.6	-3.9
of which: Trade balance	0.4	-1.4	-2.5	-1.2	0.6	-0.4	-0.5
<b>Terms of trade (percent change)</b>	2.0	-4.1	-0.9	5.4	1.6 9/	...	...
<b>External assets and liabilities (in percent of GDP)</b>							
Net external liabilities	52.5	55.5	55.9	58.1	59.5	...	...
Gross short-term external debt	27.7	30.9	33.9	42.8	41.4 10/	...	...
Net short-term external debt	14.8	18.0	18.1	25.5	25.2 10/	...	...
Gross official reserves	4.8	4.3	5.5	5.2	5.3	...	...
<b>Exchange rate (end of period)</b>							
US\$/A\$	0.653	0.614	0.654	0.554	0.509	0.565 8/	...
Trade-weighted index	58.4	53.3	56.4	51.7	50.2	52.3 8/	...
Nominal effective exchange rate 11/	105.5	95.3	100.3	92.0	89.8	94.1 6/	...
Real effective exchange rate 11/	86.2	78.3	83.3	79.3	79.2	83.4 6/	...

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

1/ Includes public trading enterprises.

2/ Fiscal year ending June 30. Data up to 1998/99 are on cash terms, while those for 1999/00 and 2000/01 are cash proxies derived from the accrual framework.

3/ The sharp drop in 2001 reflects tax reform, including income tax cuts, the removal of the Wholesale Sales Tax, and the reduction in grants to States.

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

5/ The fiscal surplus exceeds the underlying cash surplus in 2000/01 due to abnormally high tax liabilities from the move to a pay-as-you-go system for company tax.

6/ April 2002.

7/ May 2002.

8/ June 2002.

9/ Based on latest WEO assumptions.

10/ December 2001.

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

Table 2. Australia: Selected Fiscal Indicators, 1997/98-2005/06 1/  
(In percent of GDP)

	1997/98	1998/99	1999/00	2000/01	2001/02 Prel.	Projections 2/			
						2002/03	2003/04	2004/05	2005/06
Fiscal accounts (accrual basis) 3/									
Commonwealth government									
Revenue	26.2	25.7	26.5	24.0 5/	23.0	22.6	22.6	22.5	22.3
Tax	...	...	24.2	22.5	21.2	21.1	21.2	21.1	21.0
Income tax	...	...	18.2	18.0	17.0	17.0	17.2	17.3	17.3
Individuals and other withholding	...	...	13.4	11.6	12.3	12.4	12.6	12.7	12.8
Indirect and other tax	...	...	6.0	4.5	4.3	4.1	4.0	3.8	3.7
Non-tax	...	...	2.2	1.5	1.7	1.5	1.4	1.3	1.3
Expenses	26.5	24.8	24.5	23.3 5/	23.5	22.7	22.3	21.9	21.5
Salaries and wages	...	...	...	1.4	1.4	1.5	1.4	1.4	1.3
Payments for supply of goods and services	...	...	...	4.9	4.9	4.9	4.9	4.9	4.8
Current transfers	...	...	...	14.1	14.4	13.9	13.8	13.6	13.5
Other expenses	...	...	...	2.9	2.7	2.4	2.2	2.0	1.9
Net capital investment	0.0	0.2	-0.2	-0.2	-0.1	-0.1	-0.1	-0.1	0.0
Fiscal Balance 4/	-0.4	0.7	2.1	0.9	-0.4	0.0	0.3	0.6	0.9
State, Territory, and local government balance	...	0.3	0.3	-0.1	-0.1	...	...	...	...
Public Non-financial corporations balance	...	-0.6	0.5	0.1	0.2	...	...	...	...
Non-Financial Public sector balance 6/	...	0.4	3.0	0.8	-0.3	...	...	...	...
Fiscal Accounts (cash basis) 7/									
Commonwealth government									
Revenue	24.2	24.8	26.4	23.9 5/	23.1	23.0	22.8	22.6	22.4
Underlying expenditure	24.0	24.1	24.3	23.1 5/	23.3	22.7	22.3	22.1	21.6
Underlying cash balance 8/	0.2	0.7	2.0	0.8 9/	-0.2	0.3	0.5	0.6	0.8
Memorandum items:									
Commonwealth structural balance (accrual basis) 10/	...	...	1.6	0.9	-0.3	0.1	0.3	0.6	0.8
General government structural balance (accrual basis)	...	...	1.0	0.5	0.1	0.4	0.6	0.6	0.9
Commonwealth government net debt 11/	14.8	11.9	8.4	5.8	5.5	4.6	2.4	0.2	-2.1
Commonwealth government net worth 11/12/	-12.2	-12.9	-5.7	-6.1	-6.0	-5.8	-5.3	-4.6	-3.7

Sources: Commonwealth of Australia: *Budget Strategy and Outlook, 2002/03*; *Final Budget Outcome, 2000/01*.

1/ Fiscal year ends June 30.

2/ Projections as presented in the *Budget Strategy and Outlook, 2002/03*.

3/ Accrual data are reported on a consistent basis with Government Financial Statistics (GFS). GST related transactions are excluded since the Commonwealth government conducts them on behalf of states and territories.

4/ The fiscal balance is equal to revenue less expenses less net capital investment and measures the government's net lending.

5/ The drop in 2000/01 reflects tax reform, including income tax cuts, the removal of the Wholesale Sales Tax, and the reduction in grants to States.

6/ The Commonwealth, state, and public enterprise balances may not add up to the public sector balance due to the effect of consolidation.

7/ Due to a break in the series following the introduction of the new accrual accounting standards, cash receipts and payments data from 1999/00 are not directly comparable with earlier years.

8/ The cash equivalent of the fiscal balance.

9/ The fiscal surplus exceeds the underlying cash surplus in 2000/01 due to abnormally high tax liabilities from the move to a pay-as-you-go system for company tax.

10/ Staff estimate; adjusted to exclude the above-normal dividend from the RBA in 1999/2000.

11/ Assumes the sale of the government's remaining shareholding in Telstra.

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



Table 3. Australia: Balance of Payments, 1997-2002  
(In percent of GDP)

	1997	1998	1999	2000	2001	2002 Proj.
Current account balance	-3.1	-4.9	-5.8	-4.0	-2.6	-3.6
Trade balance	0.4	-1.4	-2.5	-1.2	0.6	-0.4
Exports	16.0	15.5	14.2	17.0	17.8	16.6
Imports	-15.6	-16.9	-16.7	-18.2	-17.2	-16.9
Net services	-0.1	-0.3	-0.2	0.1	-0.2	0.0
Total credits	4.5	4.5	4.4	4.9	4.5	4.3
Total debits	-4.7	-4.8	-4.7	-4.8	-4.7	-4.4
Net income	-3.4	-3.1	-3.1	-2.9	-3.0	-3.2
Receipts	1.8	1.8	1.8	2.3	2.2	2.0
Payments	-5.2	-4.9	-4.9	-5.2	-5.1	-5.2
Net transfers	0.0	-0.1	0.0	0.0	0.0	0.0
Capital and financial account	3.7	4.9	5.6	4.2	2.4	...
Capital account	0.2	0.2	0.2	0.2	0.2	...
Financial account	3.5	4.8	5.4	4.1	2.3	...
Direct investment transactions: net	0.3	0.8	2.2	1.8	-2.0	...
Equity (net)	-0.1	0.5	1.0	0.1	-1.1	...
Debt (net)	0.4	0.2	1.2	1.7	-0.9	...
Portfolio investment transactions: net	3.3	1.0	2.8	2.6	2.8	...
Equity (net)	2.1	2.2	0.6	-1.2	0.8	...
Debt (net)	1.2	-1.2	2.2	3.8	2.1	...
Financial derivatives (net)	0.2	-0.3	0.3	-0.2	0.1	...
Other transactions (net)	-0.3	3.3	0.1	-0.2	1.3	...
Net errors and omissions	-0.6	0.1	0.2	-0.2	0.2	...

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

Table 4. Australia: Medium-Term Scenario 2002-07

	1990-1999 Average	2000	2001	Projections					
				2002	2003	2004	2005	2006	2007
Real economic indicators (percent change)									
GDP	3.3	3.1	2.6	4.0	3.8	3.8	3.8	3.8	3.8
Total domestic demand	3.2	1.9	1.1	5.2	4.2	3.9	3.5	3.5	3.6
Private consumption	3.3	2.7	3.2	4.2	3.2	3.1	3.0	3.1	3.1
Total investment	3.6	0.5	-3.4	8.5	10.1	7.0	5.2	4.8	5.1
CPI inflation	2.5	4.5	4.4	2.8	2.5	2.5	2.5	2.5	2.5
Unemployment rate	8.6	6.3	6.7	6.3	6.0	5.7	5.7	5.5	5.5
Saving and investment (percent of GDP)									
Gross national saving	18.0	19.2	18.9	18.0	18.4	18.8	19.2	19.5	19.7
General government saving	0.4	2.6	2.6	2.1	2.7	2.9	3.0	3.1	3.1
Private saving 1/	17.6	16.6	16.3	15.8	15.7	15.9	16.1	16.3	16.6
Gross capital formation	22.7	22.8	20.2	21.6	22.2	22.4	22.4	22.2	22.2
Fiscal indicators (percent of GDP) 2/									
Commonwealth Budget									
Revenue	23.9	25.0	23.5	22.8	22.7	22.4	22.2	22.2	22.2
Underlying expenditure	25.2	23.6	23.2	22.8	22.3	21.9	21.6	21.4	21.4
Underlying balance (cash basis)	-1.3	1.4	0.3	0.1	0.4	0.5	0.7	0.8	0.8
Fiscal balance (accrual basis)	...	1.5	0.2	-0.2	0.2	0.5	0.7	0.8	0.9
Public sector net debt 3/	28.2	13.5	11.2	10.1	8.3	5.8	3.5	1.3	-0.8
Balance of payments (percent of GDP)									
Balance on goods and services	-0.8	-1.1	0.4	-0.4	-0.7	-0.4	0.1	0.5	0.7
Balance on income and transfers	-3.6	-2.9	-3.0	-3.2	-3.2	-3.2	-3.3	-3.2	-3.2
Current account balance	-4.4	-4.0	-2.6	-3.6	-3.9	-3.6	-3.2	-2.7	-2.5
Trade in goods and services (percent change)									
Export volume	7.4	10.9	0.8	3.1	6.5	10.0	8.6	8.9	8.3
Import volume	6.0	7.4	-4.5	7.3	7.9	10.2	6.9	7.3	7.4
Terms of trade	-1.1	5.4	1.6	0.3	0.3	1.7	0.8	0.0	0.0
Export price	-0.6	13.3	9.1	-4.6	2.7	3.8	2.2	1.2	1.0
Import price	0.7	6.9	6.2	-4.2	2.4	2.0	1.5	1.2	1.0
External liabilities (percent of GDP)									
Net external liabilities	53.1	58.1	59.5	60.0	60.6	60.5	60.2	59.6	58.8

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

1/ Includes public trading enterprises.

2/ Calendar year basis.

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

## AUSTRALIA—ECONOMIC VULNERABILITY ASSESSMENT

1. The staff's assessment continues to be that Australia has been able to successfully adjust to adverse domestic and external shocks over the past few years and that risks continue to be manageable.

Household, corporate, and bank balance sheets remain sound and have been resilient to the sharp real depreciation of the exchange rate, wide swings in commodity prices, and the more recent episodes of distress in the corporate sector. Recent trends show that external indebtedness has continued to grow at a rapid pace, its maturity structure has gradually shifted towards short-term, and banks' exposure to housing has risen (Table 1). Net foreign liabilities remain high, with a relatively rapid growth in debt financed liabilities, making Australia's position somewhat vulnerable to marked shifts in investor sentiment.

	End-December					
	1990	1997	1998	1999	2000	2001
Current Account 1/	-5.2	-5.0	-5.0	-5.9	-4.0	-2.6
Net foreign liabilities	46.6	52.5	55.5	55.9	58.2	59.5
Equity	10.7	12.9	14.7	15.7	15.7	12.4
Debt	35.9	40.4	40.8	40.2	46.5	47.2
Gross external debt	30.1	61.4	62.2	62.9	71.3	72.8
Public sector	18.7	17.4	14.8	11.3	10.3	10.2
Private sector	31.4	44.0	47.5	51.5	60.9	62.6
Private financial corporations	14.0	31.5	34.8	39.3	45.3	48.6
Australian dollar-denominated	...	25.7	23.4	23.8	26.7	25.5
Foreign currency-denominated	...	35.7	38.3	39.1	44.5	47.4
Short term	...	27.7	30.9	33.8	42.8	41.5
Australian dollar-denominated	...	8.3	8.1	9.2	13.8	13.2
Foreign currency-denominated	...	19.4	22.9	24.8	29.0	28.3
Net interest payment in exports	19.9	10.3	9.0	10.1	9.6	9.4
Gross official reserves (in SA billions)	25.0	26.2	25.0	33.6	34.0	36.5
RBA outstanding forward contracts (in SA billions)	2.0	5.6	10.1	22.5	24.9	28.7
Gross official reserves in months of imports	4.4	2.5	2.3	2.7	2.7	2.7
Gross official reserves to short-term foreign currency denominated debt (percent)	...	24.7	19.1	22.3	17.9	16.2

Sources: Australian Bureau of Statistics and RBA.  
1/ Annual (sum of four quarters)

2. Notwithstanding these recent trends, several factors help to mitigate potential risks:

- Australia's resilience to the sharp real depreciation of the exchange rate in 2000 and early 2001 has been underpinned by the high degree of hedging in the economy. A recent survey by the Australian Bureau of Statistics indicates that as of mid-June 2001, residents had a net foreign currency asset position of about \$A150 billion.<sup>1</sup> Banks were the only sector with a substantial net foreign debt position; however, this was more than offset by hedging through financial derivatives. Private corporations appeared to have relatively minimal direct exposure to exchange rate risk. A significant portion of their overseas borrowing was hedged naturally; however, they still face some risks from their offshore equity investments. In

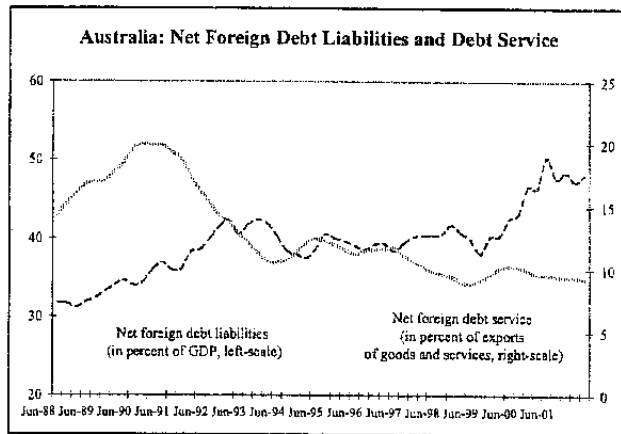
	Net foreign currency debt	Net position on foreign currency derivatives		Foreign currency exposure
		Foreign equity assets		
Banks	117	31	109	23
Other financial corporations	28	84	8	64
Official sector				
RBA	-36	0	-29	7
General government	-1	0	-9	-7
CBA	8	0	9	1
Other corporations	50	114	-3	61
Total economy	165	225	85	149

Source: Australian Bureau of Statistics.

<sup>1</sup> The survey was based on data as of end-June 2001, covered 323 resident enterprises with significant foreign currency exposure, and comprised around 90 percent of total foreign currency assets and liabilities identified in the Survey on International Investment (SII).

addition, the data could mask significant differences in the degree of hedging across financial institutions.

- Banks account for most of the increase in gross foreign liabilities over the past three years.** A significant proportion of liabilities continues to be denominated in Australian dollars. Over the period, the Australian dollar denominated debt has remained relatively constant around 25 percent of GDP. However, the share of foreign currency denominated debt has risen from 35 percent of GDP by end-1998 to about 48 percent of GDP as of end-2001. The increase in foreign currency denominated debt partly reflects the increased importance of Australian banks in funding their operations offshore and their intention of diversifying geographically and across different sources of funding. The growing share of banks in these liabilities has also contributed to a shift towards shorter maturities; short-term foreign currency debt has risen from 23 percent of GDP at end-1998 to 28 percent of GDP at end-2001.
- Australia's debt service ratio to exports has declined markedly during the 1990s and remains below 10 percent.** Over this period, net foreign debt service has declined steadily from about 20 percent of exports of goods and services to less than 10 percent in 2001. The rise in net foreign liabilities, and in particular, debt liabilities, has not been reflected in a steady rise in debt servicing requirements, as export growth has been particularly strong, suggesting that the economy's capacity to service its debt remains sound.



3. **Household balance sheets remain basically sound.** The share of household debt to disposable income has risen rapidly and stabilized at around 115 percent in 2001. Interest payments increased to 7¼ percent of disposable income in 2001, still well below levels in the early 1990s. Household net worth remains high but has become more exposed to adverse movements in asset prices. Housing is the major asset holding of the sector, and house prices have risen sharply in recent years. However, historically, these prices have not been subject to a major downward correction after periods of very rapid increases. Standard & Poor's (S&P) has recently noted that households may be vulnerable to sharp increases in interest rates, but emphasized that sound macroeconomic fundamentals and lower unemployment would help to mitigate such risk.

	End-June					
	1990	1997	1998	1999	2000	2001
Total assets	502	563	582	598	616	608
Non-financial assets	318	315	324	329	337	334
Dwellings and land	268	276	284	290	299	299
Financial assets	184	248	257	269	278	273
Deposits	67	57	59	58	57	57
Shares	38	37	41	49	51	56
Pension funds	94	92	100	106	120	115
Other	68	55	52	49	48	44
Total liabilities	68	90	99	103	113	113
Net worth	434	473	483	494	503	495
Interest payments	11.8	6.1	6.1	6.1	6.6	7.1
Household net savings	9.2	5.4	2.3	2.8	2.3	4.0

Source: RBA  
Note: 1990 data refer to 1995 for deposits, shares, pension funds and other financial assets. Pension funds include life insurance.

**4. Balance sheet indicators for the non-financial corporate sector remain healthy despite the distress experienced by a number of companies during 2001.**

Several high-profile corporations collapsed in different sectors of the economy, notably against a backdrop of a long period of strong growth. The reasons behind these failures do not suggest systemic problems. While the levels of leveraging, debt service burden, and profitability in the nonfinancial corporate sector have worsened in 2001, they remain sound and significantly better than the levels experienced in the early 1990s.

	End-December					
	1991	1997	1998	1999	2000	2001
Total liabilities	557	909	994	1129	1245	1317
Equity	216	523	583	689	757	771
Debt	341	386	411	440	488	546
Debt/equity ratio (%)	158	74	71	64	64	71
Net interest payments/gross operating surplus (%)	37.2	15.0	12.5	12.4	12.3	13.9
Profits/ODP (%) 1/	aver. 1990s 5.5	7.2	7.9	7.2	7.5	6.7

Source: Australian Bureau of Statistics.  
1/ Profits defined as gross operating surplus less interest less depreciation.

**5. Notwithstanding the rise in corporate failures, the asset quality, profitability, and capitalization levels of the banking system remain strong.** Banks' impaired assets stood at around 3/4 percent of total assets in early 2002, up from 1/2 percent at June 2001. The risk-weighted capital adequacy ratios exceeded regulatory benchmarks, and total provisions were above 100 percent of impaired assets. During the 1990s, banks have shifted their exposure toward the retail sector markedly. The exposure of banks' lending to housing is similar to the business sector, as the share of housing financing has increased markedly, well above the level at the start of the 1990s. While housing loans to individuals absorbed around half of total bank loans in 2001, the increase in loans to investors has also been strong, with the share in total housing loans rising to 31 percent in 2001.<sup>2</sup> A recent report by KPMG notes that the financial condition of Australia's 5 major banks remains outstanding despite recent difficult global economic conditions and concerns related to the corporate sector.<sup>3</sup>

	End-June						
	1990	1997	1998	1999	2000	2001	2002 1/
Loans	63.4	68.7	68.9	70.6	70.6	69.2	71.1
of which:							
Loans to persons	28.3	38.2	39.3	39.5	40.3	40.5	42.0
of which: Housing loans	19.2	32.1	32.9	32.9	33.6	34.7	36.6
Commercial loans	9.4	25.1	25.5	26.6	26.2	25.5	25.4
Housing loans to persons							
share of total loans	29.4	46.8	47.8	46.7	47.6	50.2	51.4
share of total loans to persons	67.8	84.0	83.8	83.4	83.3	85.7	85.8
Capital adequacy ratios 1/:							
Tier 1 capital	7.0	7.9	7.1	7.9	7.4	7.6	7.9
Total capital	10.2	10.3	9.8	10.1	9.9	10.4	10.6
Impaired assets	5.6	0.7	0.7	0.7	0.6	0.5	0.7
Net foreign currency liabilities 2/	6.5	7.8	3.0	8.0	9.9	12.3	11.1

Source: Australian Prudential Regulation Authority  
1/ Percentages of risk-weighted assets  
2/ 2002 datum is for the year ended March 2002.

	2002	2001	1997-2001
	Half Year	Half Year	Average 2/
Capital Adequacy Ratio	10.3	9.8	10.2
Operating Expenses to Operating Income	50.9	53.2	58.4
Operating Profit After tax (in percent of weighted average net assets)	16.6	16.9	14.6
Net non-accrual loans to total assets	0.3	0.3	...
Net impaired assets to shareholders' equity	4.6	4.8	...

Source: KPMG.  
1/ The 5 major banks are: ANZ, CBA, NAB, Westpac, and St. George.  
2/ Unweighted average.

<sup>2</sup> *Recent Developments in Housing: Prices, Finance and Investor Attitude*, Reserve Bank of Australia Bulletin, July 2002.

<sup>3</sup> *The Majors: Commentary for the first half year of 2002*, KPMG, May.

Table 1. Australia: External Debt and Reserve Indicators, 1997-2001  
(In percent of GDP)

	1997	1998	1999	2000	2001
	(Assets and liabilities at end-period)				
Net external liabilities	52.5	55.5	55.9	58.1	59.5
Net external equity liabilities	12.1	14.7	15.7	11.7	12.3
Foreign equity investment in Australia	41.4	46.8	50.7	47.4	50.8
Australian equity investment abroad	-29.3	-32.0	-35.0	-35.7	-38.4
Net external debt	40.4	40.8	40.3	46.4	47.1
Net public sector	9.6	7.4	2.8	2.0	1.7
Net private sector	30.8	33.5	37.5	44.4	45.5
Gross external debt	61.4	62.3	63.0	71.2	72.7
Gross external lending	-21.0	-21.5	-22.8	-24.8	-25.6
Short-term net external debt (residual maturity basis)	14.8	18.0	18.1	25.5	25.2
Short-term gross external debt	27.7	30.9	33.9	42.8	41.4
Short-term gross external lending	-13.0	-13.0	-15.8	-17.3	-16.2
Memorandum items:					
Gross official reserves (in \$A billion)	26.2	25.0	33.6	34.0	36.7
RBA outstanding forward contracts (in \$A billion) 1/	5.6	10.1	22.6	24.9	29.5
Net official reserves (in \$A billion)	20.6	14.9	10.9	9.1	7.2
Gross official reserves in months of imports	2.5	2.3	2.7	2.7	2.8
Gross official reserves to ST foreign currency denominated debt (percent)	24.7	19.1	22.3	17.9	18.7
Net official reserves to ST foreign currency denominated debt (percent)	19.4	11.4	7.3	4.8	3.7

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

1/ The forward obligations of the RBA represent the second leg of foreign currency swap transactions. With the drop in the stock of Commonwealth debt in recent years, the RBA has increasingly utilized foreign currency swaps for domestic liquidity management.

**AUSTRALIA—FUND RELATIONS**  
(As of June 30, 2002)

**A. Financial Relations**

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

<b>II. General Resources Account:</b>	<b>SDR Million</b>	<b>Percent Quota</b>
Quota	3,236.40	100.0
Fund holdings of currency	1,956.65	60.5
Reserve position in Fund	1,279.72	39.5
Financial Transaction Plan transfers (net)	189.00	

<b>III. SDR Department:</b>	<b>SDR Million</b>	<b>Percent Allocation</b>
Net cumulative allocation	470.55	100.00
Holdings	92.43	19.64
Designation plan	0.00	

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

**V. Financial Arrangements:** None

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

**B. Nonfinancial Relations**

**VII. Exchange Rate Arrangement.** Australia accepted the obligations of Article VIII, Sections 2, 3, and 4 on July 1, 1965 and maintains an exchange system that is free of restrictions on payments and transfers for current international transactions. Exchange rates are market determined, but the Reserve Bank of Australia retains discretionary power to intervene. On June 28, 2002, the U.S. dollar/Australian dollar exchange rate was US\$0.565=\$A 1.00. There are no taxes or subsidies on purchases or sales of foreign exchange. Australia has notified the Fund under Decision 144 of the imposition of exchange restrictions vis-à-vis Iraq, the Federal Republic of Yugoslavia and the Socialist People's Libyan Arab Jamahiriya. In late 1999, Australia imposed restrictions on financial transactions with the Taliban (the Islamic State of Afghanistan), and the UNITA movement in Angola.

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

**IX. Last Article IV Consultation, and Consultation Cycle.** Discussions for the 2000 Article IV consultation were held in Melbourne, Sydney, and Canberra from November 29 to December 11. The 2000 consultation (SM/01/42) was completed by the Executive Board on February 28, 2001 (SUR/01/24). Australia is on the standard 12-month consultation cycle.

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

**Australia: Core Statistical Indicators**  
(As of July 26, 2002)

	Exchange Rates	Official Reserves	Reserve/ Base Money	Central Bank Balance Sheet	Broad Money	Interest Rates	Consumer Price Index	Exports/ Imports	Current Account Balance	Overall Govt Balance	GDP/ GNP	External Liabilities
Date of latest observation	07/11/02	06/02	06/02	06/02	05/31/02	07/11/02	03/02	05/02	03/02	03/02	03/02	12/01
Date received	07/11/02	07/05/02	07/14/02	07/14/02	06/30/02	07/11/02	04/24/02	07/02/02	05/31/02	05/21/02	06/05/02	05/31/02
Frequency of data 1/	D	M	M	W	M	D	Q	M	Q	M	Q	Q
Frequency of Reporting 1/	D	M	M	W	M	D	Q	M	Q	M	Q	Q
Source of data 2/	C	N 5/	A	A	N 5/	C	N 5/	N 5/	N 5/	N 5/	N 5/	N 5/
Mode of reporting 3/	E	E	E	E	E	E	E	E	E	E	E	E
Confidentiality 4/	C	C	C	C	C	C	C	C	C	C	C	C
Frequency of publication	D	M	M	W	M	D	Q	M	Q	Q	Q	Q

1/ D-daily; W-weekly; M-monthly; Q-quarterly; or A-annually.

2/ A-direct reporting by central bank, ministry of finance, or other official agency; N-official publication or press release; P-commercial publication; C-commercial electronic data provider; or E-EIS.

3/ E-electronic data transfer; C-cable or facsimile; T-telephone; M-mail; or V-staff visits.

4/ A-for use by the staff only; B-for use by the staff and the Executive Board; C-unrestricted use; or D-embargoed for a specific period and thereafter for unrestricted use.

5/ A less detailed breakdown of these items is obtained from Reuters before the official publication is received.



**Statement by the IMF Staff Representative  
September 16, 2002**

1. This statement contains information that has become available since the Staff Report (SM/02/254) was circulated to the Executive Board on August 12, 2002. This information does not alter the thrust of the staff appraisal.
2. New data indicate that the pace of economic activity slowed in the first half of 2002. Real GDP grew by 2½ percent (seasonally adjusted annual rate) in the second quarter, compared to 3 percent in the first quarter and an average annual rate of more than 4 percent during 2001. Housing, along with private consumption, remained buoyant, and business investment picked up, reflecting a sharp rise in new engineering construction. However, government spending, particularly for investment, slowed in the first half of the year, and net exports registered a large decline in the second quarter. Accordingly, the current account deficit rose from less than 3 percent of GDP in the first quarter to about 4 percent in the second quarter.
3. Crop conditions in some of Australia's major agricultural producing regions have deteriorated substantially in recent weeks owing to drought. Recent estimates suggest that there is likely to be a substantial reduction in farm production and incomes, with significant knock-on effects potentially slowing growth in the rest of the economy.
4. Employment rose in August, led by a sharp increase in full-time employment. The unemployment rate, however, remained at 6¼ percent as the participation rate also increased. Reflecting some softening of the labor market conditions during the first half of the year, the wage cost inflation slowed to just over 3 percent in the year to the June 2002 quarter, and unit labor costs increased modestly by 1¼ percent, as labor productivity increased by 3 percent.
5. The Reserve Bank of Australia (RBA) released its quarterly *Statement on Monetary Policy* on August 12. As set out in previous *Statements*, the RBA expects underlying inflation to remain around the middle of the 2–3 percent target band in the second half of 2002; however, a continuation of the economy's recent pace of growth was seen as possibly contributing to increased wage and price pressures over the course of 2003. The outlook for Australia's economy is predicated on a modest recovery in global economic activity. In these circumstances, the RBA envisages that interest rates would have to be increased further. While the RBA sees this as the most likely scenario, it recognizes the possibility that recent turmoil in world financial markets may have a dampening effect on the global economy. Given the uncertainties, the RBA Board judged at its July and August meetings that it was prudent to leave the cash rate unchanged. Subsequently, at its meeting in September, the Board again left the cash rate unchanged.



INTERNATIONAL MONETARY FUND

*Public Information Notice*

EXTERNAL  
RELATIONS  
DEPARTMENT

Public Information Notice (PIN) No. 02/103  
FOR IMMEDIATE RELEASE  
September 18, 2002

International Monetary Fund  
700 19<sup>th</sup> Street, NW  
Washington, D. C. 20431 USA

## **IMF Concludes 2002 Article IV Consultation with Australia**

On September 16, 2002, the Executive Board of the International Monetary Fund (IMF) concluded the Article IV consultation with Australia.<sup>1</sup>

### **Background**

Despite the synchronized slowdown in the rest of the world in 2001, the Australian economy has continued to grow strongly. This performance reflected the absence of major imbalances in the economy, an aggressive easing of monetary policy, fiscal policy stimulus, and a competitive exchange rate. Real GDP has risen at an average annual rate of 3¾ percent since end-2000. Buoyant private consumption and the housing sector led growth over the period, supported by lower interest rates, a rise in disposable income as income taxes declined, and significant gains in household net wealth, the latter partly reflecting the sharp rise in housing prices in recent years. In addition, the fiscal stimulus provided by the introduction of the First Home Owners Scheme (FHOS) contributed to a major boost in housing investment. Conditions in the labor market were relatively weak during 2001, before employment growth picked up in early 2002. The unemployment rate at around 6¼ percent in July and August 2002 generally drifted down from its higher level in late 2001. Inflation rose in 2001 primarily owing to the impact of several largely transitory factors, and it has come back down in line with the official 2-3 percent target during 2002.

With underlying inflationary pressures muted and the uncertainty about the depth and duration of the global slowdown, monetary policy was highly supportive of growth.

---

<sup>1</sup> 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.

Consistent with its inflation targeting framework, the Reserve Bank of Australia (RBA) cut the official cash rate by 150 basis points in four steps between February and early September 2001. With a marked rise in global uncertainty following the September 11 terrorist attacks, the RBA eased policy further by reducing the cash rate by 50 basis points in two steps between October and December 2001. In the event, the Australian economy did not slow as expected and with generally favorable prospects in early 2002, the RBA adopted a less accommodative policy stance and raised the cash rate by 25 basis points at both of its scheduled meetings in May and June. Subsequently, at its July, August, and September meetings, the RBA left the rate unchanged.

Fiscal policy was also eased significantly during 2001, providing additional stimulus to the economy. In the May 2001/02 Budget (fiscal year July-June) and in the October 2001 Mid-Year Economic and Fiscal Outlook (MYEFO), the government implemented several tax and spending initiatives which were expected to shift the fiscal balance (on an accrual basis) from a surplus of about 1 percent of GDP in 2000/01 to a deficit of about ½ percent of GDP in 2001/02. The underlying cash balance is expected to shift to a deficit of ¼ percent of GDP, the first cash deficit since 1996/97. Cumulative budget surpluses and significant privatization proceeds, have reduced the Commonwealth net debt from 18¼ percent of GDP in 1996/97 to an estimated 5½ percent of GDP in 2001/02.

A sharp real exchange rate depreciation in 2000 and 2001 and a recovery in Australia's terms of trade from its Asia-crisis lows helped to narrow the current account deficit from almost 6 percent of GDP in 1999 to 2½ percent in 2001. Most of the improvement was due to a sharp turnaround in the trade balance, which shifted from a deficit of 2½ percent of GDP to a surplus of roughly ½ percent of GDP. While the weak exchange rate and the favorable terms of trade helped to cushion the impact of the world slowdown, export volume growth decelerated markedly in late 2001. In the March 2002 quarter, the current account deficit was about 3 percent of GDP; however, as net exports registered a large decline in the June quarter, the current account deficit rose to 4 percent of GDP.

### **Executive Board Assessment**

Executive Directors welcomed the continued impressive performance of the economy, despite the major external shocks that Australia has faced, and attributed this success to the authorities' skillful economic management. In particular, Directors commended the foundation established by the sound economic policies sustained over the past several years—including fiscal consolidation, adoption of an inflation targeting framework, structural reforms in the product and labor markets, and trade liberalization, aided by appropriate discretionary monetary and fiscal policy actions.

Looking ahead, Directors considered that the sound policy framework and the absence of imbalances suggest that the conditions for sustained high growth are in place, and that the Australian economy will continue to perform well. While favorable growth would suggest a need for further monetary tightening, Directors considered that near-term prospects now appear less certain, this mainly reflects changes in the outlook for the global economy and associated risks—although they also noted other uncertainties, relating to drought and the housing market in Australia. In these circumstances, Directors thought that the timing and pace of further monetary tightening was uncertain

and would depend on how economic prospects evolve in the period immediately ahead. They agreed that the rapid rise in housing prices needed to be carefully assessed. Although monetary policy should not attempt to directly target asset prices, consideration would have to be given to the impact that a possibly unsustainable run-up in asset prices could have on growth and inflation. The supervisory authorities also would have to carefully consider the potential impact on the soundness of financial institutions.

Executive Directors viewed the stance of fiscal policy as fundamentally strong, supported by a sound framework and objectives for the public finances. They endorsed the authorities' policy approach, which has enabled them to act flexibly when needed.

This flexibility allowed policy to provide a fiscal stimulus to the economy during 2001, with one-off factors and modest policy initiatives reducing fiscal resources—contributing to a shift of the 2001-02 budget into a small deficit, along with reducing prospective surpluses over the medium term. Looking ahead, pressures on the budget, particularly from health care, are rising and are likely to intensify as the population ages. While agreeing that Australia is well placed as it turns to address the challenge of rising health care expenditure, Directors considered that certain features of the system appear to contribute to substantial moral hazard, pushing up costs. Short-term actions—like the changes to the Pharmaceutical Benefits Scheme proposed in the budget—are needed to contain costs, but a dialogue also has to begin on more comprehensive solutions. In this regard, Directors welcomed the InterGenerational Report released with the budget, which provides a very useful vehicle to begin a dialogue on the medium-term fiscal problems that Australia faces. Several Directors considered that Australia's example could offer useful lessons for other countries.

Directors also cautioned that, over the medium term, fiscal policy must generate sufficient resources to finance the further reforms needed to sustain high growth and to ensure that all Australians share in these gains. Directors agreed that changes in the tax, income support, and industrial relations systems should be considered as part of a comprehensive and coordinated package—with the aim of improving incentives, expanding opportunities for participation in the economy, and enhancing the flexibility and efficiency of the labor market. Substantial resources may be needed to finance these reforms, calling for continued discipline over spending and for a reallocation of budgetary resources to higher priority areas. Directors encouraged the authorities to garner the necessary broad support for these and other reforms, noting that successful implementation would require careful preparation of the ground.

Directors noted that reforming the personal income tax system should be a major priority to enhance incentives to work, save, and invest. In particular, the top marginal tax rate takes effect at a relatively low income level (one that is about twice the median income) and is high in relation to the corporate income tax rate. Directors generally encouraged the authorities to bring down the top marginal tax rate over time to a level more in line with the corporate income tax rate, and to apply it at a higher income threshold.

Directors welcomed the authorities' efforts to overhaul the income support system. They also agreed that further reforms would be needed to simplify the system and the benefits provided, to strengthen incentives to move to gainful employment, and to ensure that support is effectively used to help in the transition to work. As part of a

comprehensive reform, Directors suggested that consideration be given to reducing the high effective marginal tax rates faced by income support recipients when they go back to full-time work; tightening eligibility requirements for some income support programs; and maintaining strong activity tests, and penalties for breach of obligations by recipients of unemployment benefits, and enforcing them consistently and uniformly across all recipients.

Directors recognized that considerable progress has been achieved in reforming the labor market. However, they considered that labor market flexibility and efficiency could be enhanced further. In particular, award and wage bargaining systems could be further simplified by establishing a single national industrial relations system—moving away from the complicated array of federal and state frameworks that may currently apply to different groups of employees in a single enterprise. In addition, the role of the award system in setting minimum wages should be diminished in order to reduce what may be a significant barrier to the entry of low-skilled individuals into employment. Historically, the minimum wage in Australia has been used as a vehicle to try to ensure a “living wage”. Directors noted that this goal could be achieved more efficiently, with the creation of fewer economic distortions, by using the tax and/or income support systems.

The collapse of several large firms in the last year has focused attention on the potential fallout for the financial system and has raised concerns about the supervisory and regulatory framework. Directors agreed that exposures to the failed firms are unlikely to seriously affect the banking system, given high levels of profitability and capital adequacy. They also commented favorably on the steps being taken to strengthen the prudential frameworks for the non-life insurance sector and superannuation funds.

Directors pointed out that Australia has an impressive track record in adjusting to adverse shocks in recent years. Household, corporate, and bank balance sheets remain basically sound; and all sectors have coped well with the sharp real depreciation of the exchange rate, the wide swings in commodity prices, and the more recent episodes of corporate distress. Nevertheless, they noted that the potential implications of some recent trends—such as the rapid pace of growth in external indebtedness and a shortening in its maturity structure, and the sharp rise in house prices—should continue to be carefully assessed. Directors also noted that developments in the rest of the world in recent years have led to substantial fluctuations in the value of the Australian dollar, and generally considered that exchange market intervention had played a useful role in helping to maintain orderly market conditions.

Directors commended the authorities' commitment to trade liberalization. They welcomed the steps Australia has taken to provide duty- and quota-free access to most products from least developed countries, and encouraged the authorities to remove any remaining restrictions. In this spirit, Directors also encouraged the authorities to raise the level of ODA from its present level of 0.3 percent of GNP. Directors also commended the authorities on the significant progress made in dealing with anti-bribery and money laundering initiatives.

**Public Information Notices (PINs)** are issued, (i) at the request of a member country, following the conclusion of the Article IV consultation for countries seeking to make known the views of the IMF to the public. This action is intended to strengthen IMF surveillance over the economic policies of member countries by increasing the transparency of the IMF's assessment of these policies; and (ii) following policy discussions in the Executive Board at the decision of the Board. The Staff Report for the 2002 Article IV Consultation with Australia is also available.

## Australia: Selected Economic and Financial Indicators, 1997-2001

	1997	1998	1999	2000	2001	
Output and demand (percent change)						
Real GDP	3.7	5.2	4.8	3.1	2.6	
Total domestic demand	3.6	6.4	5.8	1.9	1.1	
Private consumption	4.0	4.7	5.1	2.7	3.2	
Fixed investment	10.2	6.9	7.2	0.5	-3.4	
Exports of goods and services	11.1	0.2	4.3	10.9	0.8	
Imports of goods and services	10.5	5.9	9.1	7.4	-4.5	
Inflation and unemployment (in percent)						
CPI inflation	0.3	0.9	1.5	4.5	4.4	
Unemployment rate	8.3	7.7	7.0	6.3	6.7	
Saving and investment (in percent of GDP)						
Gross national saving	18.6	18.9	18.1	19.2	18.9	
General government saving	2.1	3.9	4.2	2.6	2.6	
Private saving 1/	16.5	15.0	13.9	16.6	16.3	
Gross capital formation	21.8	23.8	24.5	22.8	20.2	
Fiscal Indicators (in percent of GDP) 2/						
Commonwealth budget						
Revenue	24.5	24.2	24.8	26.4	23.9	3/
Underlying expenditure 4/	25.5	24.0	24.1	24.3	23.1	3/
Underlying balance 4/	-1.0	0.2	0.7	2.0	0.8	
Fiscal balance (accrual basis)	-0.8	-0.4	0.7	2.1	0.9	5/
Money and credit (end of period)						
M1 (percent change)	13.3	6.1	9.7	9.4	21.3	
M3 (percent change)	7.2	6.8	9.4	5.1	14.9	
Private domestic credit (percent change)	11.3	10.3	11.1	12.0	8.8	
Interest rate (90-day bill, in percent)	5.1	4.8	5.7	6.2	4.2	
Government bond yield (10-year, in percent)	6.0	5.0	7.0	5.5	6.0	
Balance of payments (in percent of GDP)						
Current account	-3.1	-4.9	-5.8	-4.0	-2.6	
of which: Trade balance	0.4	-1.4	-2.5	-1.2	0.6	
Terms of trade (percent change)	2.0	-4.1	-0.9	5.4	1.6	
External assets and liabilities (in percent of GDP)						
Net external liabilities	52.5	55.5	55.9	58.1	59.5	
Gross short-term external debt	27.7	30.9	33.9	42.8	41.4	6/
Net short-term external debt	14.8	18.0	18.1	25.5	25.2	6/
Gross official reserves	4.8	4.3	5.5	5.2	5.3	
Exchange rate (end of period)						
US\$/A\$	0.653	0.614	0.654	0.554	0.509	
Trade-weighted index	58.4	53.3	56.4	51.7	50.2	
Nominal effective exchange rate 7/	105.5	95.3	100.3	92.0	89.8	
Real effective exchange rate 7/	86.2	78.3	83.3	79.3	79.2	

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

1/ Includes public trading enterprises.

2/ Fiscal year ending June 30. Data up to 1998/99 are on cash terms, while those for 1999/00 and 2000/01 are cash proxies derived from the accrual framework.

3/ The sharp drop in 2001 reflects tax reform, including income tax cuts, the removal of the Wholesale Sales Tax, and the reduction in grants to States.

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

5/ The fiscal surplus exceeds the underlying cash surplus in 2000/01 due to abnormally high tax liabilities from the move to a pay-as-you-go system for company tax.

6/ December 2001.

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