FOR AGENDA

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October 26, 1983

To: Members of the Executive Board

From: The Secretary

Subject: Australia - Staff Report for the 1983 Article IV Consultation

Attached for consideration by the Executive Directors is the staff report for the 1983 Article IV consultation with Australia, which has been tentatively scheduled for discussion on Wednesday, November 23, 1983.

If Executive Directors have technical or factual questions relating to this paper prior to the Board discussion, they should contact Mr. Thakur, ext. 73381.

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INTERNATIONAL MONETARY FUND

AUSTRALIA

Staff Report for the 1983 Article IV Consultation

Prepared by the Staff Representatives for the 1983 Article IV Consultation with Australia

Approved by L.A. Whittome and Subimal Mookerjee

October 26, 1983

I. Introduction

Article IV consultation discussions were held in Canberra and Sydney from September 1 to 12, 1983. The Australian representatives included the Secretary of the Treasury, Mr. J.O. Stone; the Governor of the Reserve Bank of Australia, Mr. R.A. Johnston; and officials from various Commonwealth departments and from the Reserve Bank of Australia. The head of mission also had a meeting with the Treasurer, the Honorable P.J. Keating. Mr. A.R.G. Prowse, Executive Director, attended this and some of the other meetings as an observer. The staff team consisted of Messrs. de Fontenay (EUR), Thakur (EUR), Folkerts-Landau (RES), Van't dack (EUR), and Miss Daniels (EUR).

Australia has accepted the obligations of Article VIII, Sections 2, 3, and 4, of the Fund Articles of Agreement as of July 1, 1965 .

II. Report of the Mission

1. The end of the boom

By the end of 1981, the Australian economy had experienced three years of rapid growth. Policies aimed at improving business profitability, and the favorable prospects for the energy and mineral resources sector associated with rising energy and commodity prices had combined to fuel a strong expansion of private investment. Employment rose and, despite some increase in participation rates, unemployment edged downward until the second quarter of 1981. By then the Australian economy was clearly out of step with the rest of the world which had already moved into recession for some time (Chart 1).

Nonfarm GDP (constituting about 95 percent of total GDP) peaked in the second half of 1981, and during 1982 and the first half of 1983 the economy underwent a pronounced downturn. By the second quarter of 1983, nonfarm GDP had fallen by 3 1/2 percent from its pre-recession peak and industrial production by 13 percent. Overall, the fall in total output in 1982/83 1/ was the most pronounced in 35 years. The recession was accompanied by an unusually severe shake-out of labor: full-time employment declined by almost 5 1/2 percent from its peak and although there was an increase in part-time work and a decline in participation, the unemployment rate climbed to 10.3 percent by the second quarter of 1983 (compared with a low of 5.5 percent in the second quarter of 1981).

The main causes of the recession seem clear. They include the direct and indirect effects of the world recession, particularly the fall in commodity and energy prices, which led to the postponement or cancellation of investment projects in the resources sector; the high level of interest rates, both in Australia and abroad; and soaring labor costs which drove the share of profits down to near historically low levels in 1981/82 and 1982/83. Together, these factors were largely responsible for the 20 percent fall in business fixed investment over the course of 1982/83. In addition, Australia experienced in 1982 one of the worst droughts in its history, which slashed farm incomes as farm output fell by 18 percent in in 1982/83.

Special mention must be made of the role played by wage developments in precipitating the downturn. Wage rates rose rapidly during the boom and the early stages of the recession. Average weekly earnings increased by about 14 percent in nominal terms and 4 percent in real terms in both 1980/81 and 1981/82, and did not decelerate significantly until a wage-freeze was imposed at the end of 1982. Labor market pressures and over-optimistic expectations by both employers and employees in the climate of euphoria that accompanied the expansion of the resources sector contributed to the wage explosion. However, institutional changes in the wage determination system also played a part. After the decision of the Arbitration Commission 2/ in July 1981 to abandon the system of indexation of wages in National Wage Cases, the centralized system of wage fixation, though weakened, remained in place. The Commission went on to ratify the spill-over to other sectors of the key Metal Trades Agreement of December 1981 after the onset of the recession. 3/ The spreading of wage increases obtained by strong unions might have taken place as well under conditions of free collective bargaining, in view of Australia's tradition of rigid wage relativities, but it was probably facilitated by the centralized system of wage determination. At any rate, wage developments go a long way in explaining why labor shedding was more severe in this recession than in the previous ones and why those sectors most affected by it were also those where labor costs had risen fastest.

1/ Australian economic and financial statistics are presented on a fiscal year (July 1 to June 30) basis. In most cases, the same practice is followed in this report.

2/ For a description of the role of the Commission in the wage determination system, see RED paper.

3/ This agreement, which covered about 350,000 workers, provided for wage increases and for a shortening of the work week to 38 hours. It is estimated to have raised wage costs in the industry by 20-25 percent over 12 months.

Australia: Output, Unemployment, and Wages

	1979/80	1980/81	1981/82	1982/83	1982/83 1st half	1982/83 2nd half
	Percentage changes					
Average weekly earnings	9.9	13.5	13.6	11.2	10.5	6.0
Real average earnings	-0.2	3.8	3.9	-0.1	-1.8	-3.4
Nonfarm GDP	2.2	4.7	1.7	-1.0	1.5	-3.9
Employment (full time)	2.0	2.2	1.2	-2.6	-1.6	-3.6
Unemployment rate (monthly averages)	6.1	5.9	6.2	9.0	7.9	10.0

Since the end of 1981 Australia's inflation rate has been above the industrial countries' average and by mid-1983 it was more than twice that average (Chart 2). The still relatively high current rate of inflation (11 percent in the second quarter of 1983), to some extent reflects temporary factors, notably the impact on meat prices of the breaking of the drought and of the 10 percent devaluation of the Australian dollar in March, but the trend has been downward since the end of 1982.

Australia's balance of payments followed a fairly normal cyclical pattern: the current account deficit widened during the boom, reaching $A9 billion in 1981/82 (equivalent to 6 percent of GDP), then narrowed to about 4 percent of GDP the following year as the collapse of private investment was reflected in lower imports which more than offset a decline in rural exports (Chart 3). The recent shrinking of the trade deficit also reflects some improvement in competitiveness associated with the depreciation of the exchange rate since the second half of 1981 and the March devaluation (Chart 4). Capital inflows fluctuated widely during the past two years--there was a large outflow in the first quarter of 1983 prior to the devaluation--but in general they more than covered the current account deficit and official reserves rose by $A 5 billion in the two years to June 1983. During the two years to September 1983 the Australian dollar depreciated by 14 percent in effective terms. The real depreciation, based on unit labor costs, was more modest.

2. Policies to March 1983

Unlike the situation in a number of other countries, anti-inflationary policies have had little to do with the onset of the recession. Indeed, it was the failure to temper the wage explosion that carried the seed of the cyclical reversal. The previous government, which had been in office since 1975, had stressed the need for sound financial policies designed to reduce inflation, make room for private sector demand and restore the profit position of enterprises. This strategy met with some success--

inflation decelerated markedly between 1975 and 1978 and profits and private investment recovered--but there were some serious slippages toward the end of the Government's term in office.

Until 1981/82 the Commonwealth Government had by and large succeeded in its goal of reducing the budget deficit and limiting the relative size of the public sector. Although States and local authorities were in fact increasing their borrowing, the public sector borrowing requirement (PSBR) was on a downward trend (Chart 5). In the three years 1979/80 to 1981/82 both the Commonwealth budget deficit and the PSBR had a restrictive impact on the economy, though, as the staff argued in the 1981 consultation report, it was probably insufficient in view of the strength of private demand and the developing labor market pressures. In 1982/83, a sharp shift in fiscal policy took place. The PSBR doubled to the equivalent of 6.4 percent of GDP, largely on account of an increase in the Commonwealth budget deficit. Although the latter reflected the impact of the recession and of drought relief expenditures, it also resulted from sizable discretionary increases in expenditures and reductions in taxes. Budget outlays, in particular, grew by 18.5 percent or more than 6 percent in real terms. Most of the fiscal stimulus came in the first half of 1983 when the budget deficit was running at annual rate twice as high as for 1982/83 as a whole. The deficit was financed largely through sales of securities to the nonbank public, but in spite of the large increase in government borrowing, interest rates declined in response to the fall in overseas interest rates and to the reduction in borrowing by the corporate sector.

Monetary aggregates decelerated sharply between 1975 and 1978 but since 1979 monetary expansion has been fairly stable (around 11-13 percent for broad money, M3) particularly when account is taken of shifts between aggregates due to financial innovation and phases of disintermediation-reintermediation induced by shifts in relative interest rates. The Australian representatives agreed that in view of the lack of further deceleration in monetary growth, the stubborn reluctance of the rate of inflation to decline below 10 percent was hardly surprising (Chart 6). Although the authorities have set objectives for the growth of M3 since 1976/77, these have been regularly exceeded since 1978/79.

The projection of 9-11 percent growth for M3 in 1982/83 was again exceeded as monetary expansion accelerated in the first half of 1983. The large budget deficits and continued capital inflows were making it difficult to check monetary expansion but the monetary authorities did not want to tighten financial conditions too much in view of the weakness of activity and thus to "chase the economy down." They were also influenced by the divergent behavior of monetary aggregates: M3 increased faster than the broader aggregates due to a reflow of deposits into the banking system, as lower interest rates made banks more competitive compared with other financial institutions such as money market corporations and finance companies.

Monetary and debt management policies have been made more effective in recent years as a result of changes in policy instruments, and in particular by progressive deregulation of the financial system, greater reliance on open market operations instead of direct controls on lending, and the introduction of a tender system for sales of government bonds (see RED). The recommendations of the Committee of Inquiry into the Australian Financial System (Campbell Committee) which called, inter alia, for complete deregulation of the financial system and the admission of foreign banks into Australia are being reviewed by a task group appointed by the present Government. The group is to address itself to these issues, bearing in mind considerations of economic efficiency as well as the Government's social and political objectives.

3. The new Government's economic program

The new Labor Government, elected in March 1983, has stated that, in contrast with what was perceived as the "fight inflation first" strategy of the previous government, its approach would be to attack unemployment and inflation simultaneously. An expansionary fiscal policy is to provide a stimulus to economic activity while inflation is to be checked by a prices and incomes policy supported by a monetary policy which accommodates the expected increase in real output plus what is regarded to be a "desirable and feasible" increase in prices. The Government has also stressed its commitment to seeking a broad consensus on the main economic issues through consultation with unions and business.

a. Prices and incomes policy

Prices and incomes policy is based on an Accord between the Labor Party and the Australian Council of Trade Unions (ACTU) which has been broadly endorsed by the Government. In accordance with the terms of the Accord, the Government has supported the return to centralized wage fixing and, for now, full indexation commencing with the CPI increase in the first half of 1983. The Arbitration Commission has ratified these proposals and decided that cost-of-living adjustments will be at half-year intervals. Other provisions of the Accord call for restructuring the income tax in favor of low and middle-income earners and an attempt to reduce indirect taxation. For their part, unions would refrain from pressing sectional wage claims beyond cost-of-living adjustments. Finally, a prices surveillance authority is to be set up to review pricing behavior in those sectors where prices have pervasive effects through the economy and where market discipline is lacking.

The Australian representatives agreed that unions probably could not have obtained the gains they secured for 1983 through the Accord under conditions of free collective bargaining, given the weakness of the labor market. However, the Government had obtained promises that the expected recovery of employment would not lead to another round of wage-price increases. The ACTU has accepted that in 1984 indexation would take place on the basis of the official CPI which will be reduced by about 2 1/2 percentage points as a result of changes in health cost-financing arrangements (see RED).

The combination of the expected recovery and attempts by some unions to recoup recent cuts in real disposable income is expected to put the

Accord under stress in 1984. The Government is determined to uphold it but there are obvious risks that the ACTU will not be able to keep individual unions in line and/or will insist on tax concessions. The Australian representatives were well aware that the fate of the incomes policy was linked to the setting of financial policies and that incomes policy alone could not be relied upon to bring inflation down permanently. If monetary policy, in particular, were not sufficiently firm, it would become very difficult to achieve the real wage moderation necessary to restore business profitability and bring about a recovery of employment.

b. Fiscal policy

Owing to the recession and decisions taken in 1982 and early 1983, the present Government was faced with the prospect of a budget deficit approaching $A10 billion in 1983/84 (5 1/2 percent of GDP). In order to make room for its own spending programs, notably for job creation and public housing, the Government had to make cuts in the spending and tax expenditure programs of the previous Government. The 1983/84 budget presented in August 1983 features a deficit of $8.4 billion (4.7 percent of GDP). Outlays are to increase by 16 percent (more than 7 percent in real terms), with heavy concentration on welfare-oriented expenditure. Some of the new programs will have their full effect in subsequent years. This is the case in particular for the new universal medical and hospital cost insurance scheme (Medicare) which is to be financed by a levy on personal incomes. With the deficit of the States and local authorities estimated to remain at about last year's level, as a percent of GDP, the PSBR could rise to the equivalent of 8 1/2 percent of GDP in 1983/84, compared with 6 1/2 percent in 1982/83.

Australia: Public Sector Finances

(As percent of GDP)

	1980/81	1981/82	1982/83	1983/84 1/
Commonwealth budget				
Revenue	26.9	27.6	27.7	27.0
Spending	27.7	28.0	30.5	31.7
Deficit	0.8	0.4	2.8	4.7
Cyclical component 2/	0.6	0.7	1.8	2.6
Structural component 2/	0.3	-0.3	1.0	2.1
Public sector				
Revenue	34.6	35.6	36.1	35.1
Spending	38.2	38.8	42.5	43.5
Deficit	3.6	3.2	6.4	8.4

1/ Projections.
2/ Official estimates.

rates as in 1982/83 will depend in part on the behavior of foreign interest rates which exert a strong influence on domestic rates (Chart 7), but there is also a risk that markets will become saturated and pressures on interest rates may develop which could stimulate capital inflows at a time when the current account deficit was diminishing. In this case, the monetary target could only be achieved if the exchange rate was allowed to appreciate sufficiently to curb any tendency for official reserves to increase. The Australian representatives noted that capital flows were responsive to a variety of factors and that an appreciation might lead to anticipations of further appreciation which could in turn attract foreign capital. An appreciation would, of course, impair the competitiveness of Australian producers. This form of "exchange rate crowding-out" was seen by the Australian representatives as one of the main risks involved in the Government's policy mix.

Australia: Contribution to Monetary Growth 1/

(In billions of Australian dollars)

	1980/81	1981/82	1982/83	1983/84 2/
Budget deficit	1.1	0.5	4.5	8.4
Balance of payments	1.2	1.0	1.9	...
Bank lending to private sector	4.1	4.6	5.4	...
Other factors	0.3	--	--	--
Less sales of government securities to nonbank sector	0.5	-0.2	4.1	...
Money supply growth	6.2	6.3	7.7	6.2-7.6
(Per cent increase)	(12.7)	(11.3)	(12.5)	(9-11)

1/ For a more disaggregated money formation table, see the RED paper.
2/ Official projection.

The exchange rate continues to be heavily managed. Exchange rate policy has aimed--and succeeded--at limiting exchange rate volatility, without moving against the fundamental trends. However, relative exchange rate stability may have had its counterpart in a higher degree of interest rate volatility. The Campbell Committee has recommended a move to a more market-determined system and the Australian representatives did not rule out some change in that direction.

The upward trend of the effective exchange rate for the Australian dollar was reversed after August 1981 in recognition of the exceptionally large current account deficit, together with less favorable prospects for its reduction and the worsening competitive position. The downward trend generally continued until March 1983 notwithstanding occasional

This represents a large fiscal stimulus, though one which the Government regards as appropriate in view of the expected continued weakness of private demand. The authorities recognize, however, that as the private sector recovers and its demands on financial markets begin to increase, the fiscal stimulus will need to be reined back. The magnitude of the task to be accomplished is suggested by the structural component of the PSBR which, for the Commonwealth budget alone, is estimated at more than 2 percent of GDP. The Australian representatives were skeptical as to the relevance of the concept of structural deficit when the economy was suffering not only from underutilization of real resources but from other problems such as high inflation and impaired profitability of enterprises. Furthermore, they agreed that it was the total deficit which was relevant in assessing the risks that it might put pressures on interest rates and on the exchange rate and prevent a recovery of investment and employment.

c. Monetary and exchange rate policies

The Government has stated its support for a monetary policy which accommodates the expected increase in output and the rise in wages and prices resulting from the operation of the Accord. It has set a projection range for the growth of M3 at 9-11 percent over the year to the second quarter of 1984. In view of the expected 14 percent increase in nominal GDP, this assumes a sharp recovery of velocity, which is not inconsistent with the experience of previous cycles and would be facilitated by the rapid monetary expansion in the first half of 1983. It is possible, however, that monetary aggregates will continue to be distorted as in 1982/83 by shifts of funds and the authorities intend to monitor a variety of indicators in assessing monetary developments and have provided for a mid-year review of monetary targets. The Australian representatives acknowledged that there is a risk that eclecticism in the choice of indicators, revisions of targets, and "base drift" (resulting from the targets being exceeded and the new targets making no attempt at correcting the excess money creation) could undermine the objective of keeping monetary growth on a stable path consistent with medium-term objectives for inflation and output.

At any rate, the achievement of a rate of monetary growth within the projected range will not be an easy task, especially in view of the fact that the rate of monetary expansion through August 1983 was 13 percent, well above the top of the range. Given the projected growth of bank credit to the private sector, the achievement of the monetary objective will require very large sales of government securities to the nonbank public to finance the budget deficit and, in contrast with previous years, no contribution of the balance of payments to money creation. The latter condition may require some assistance from exchange rate policy, as well as a more determined effort to sterilize net purchases of foreign exchange by the monetary authorities.

Sales of government securities to the nonbank sector will need to be even larger than last year. Whether this can be done at declining interest unexpectedly large capital inflows. During 1982/83, considerations of competitiveness received some precedence over the achievement of monetary objectives in view of the rapid weakening of the economy. Since the 10 percent devaluation of March 1983, which was precipitated by large capital outflows around the time of the general elections, sizable and persistent capital inflows, as well as the strengthening of the current account have pushed up the exchange rate, and by end-September the devaluation had been almost completely offset.

4. Prospects

Although the provisional national accounts for the second quarter of 1983 showed a further decline in activity, the Australian representatives believed that the economy had already bottomed out: industrial production was on an uptrend and the employment situation was stabilizing. They expected the upswing to strengthen during 1983/84, supported by the recovery of farm income, a reversal of the stock cycle and stronger public and foreign demand offsetting a further decline in business investment. Nonfarm product was projected to grow by 2 percent in 1983/84 but this would imply a 5 percent growth rate over the course of the year (Table 1). The effects of the pickup in activity on the labor market were expected to be limited, as employment in manufacturing and services was unlikely to expand strongly until a clear and durable improvement in profitability could be observed. There would be gains in the housing and public sectors, however, and with the help of government job-creation schemes, employment would grow 1 1/2 percent over the course of 1983/84. This would be insufficient to prevent a further rise in unemployment.

Inflation is expected to abate in 1983/84 as the effect of the wage-freeze in the first half of 1983 would be reflected in a slowdown in the annual average increase of wage rates to about 7 percent. In through-the-year terms, however, wages would rise considerably faster, though not back to the rates of 1982/83. The CPI would decelerate to about 7 1/2 percent in 1983/84 but, as already noted, about 2 1/2 percentage points of the decline would be on account of the introduction of the Medicare scheme as of February 1, 1984.

A further improvement in the current account of the balance of payments is expected in 1983/84. The deficit could be reduced to about \$A 5 1/2 billion (3 percent of GDP). Exports should benefit from a recovery of farm exports (except meat) and from the impact of firmer foreign demand and commodity prices on other exports. Although reductions in contract prices for coal and iron ore exports will dampen export receipts in the short term, increased productive capacity will allow a strong growth in volume terms. Little change in the value of imports is projected for 1983/84 compared with the previous year; this forecast implies a further decline in volume terms due largely to the relative weakness of private sector demand, notably investment, and the lagged effect of the improvement in the competitive position of Australia in the past two years. A pickup in import volume is expected over the course of the year, however, as inventory accumulation resumes (Table 1).

The Australian representatives found it difficult to extend the forecast beyond the middle of 1984 in view of the uncertainties surrounding the setting of economic policies and their results. Besides the level of interest rates and the exchange rate, one major uncertainty was the effectiveness of the Government's incomes policies. If unions went along with the ACTU's acceptance of limiting wage increases in 1984 to cost-of-living adjustments based on the CPI, the sharp deceleration in consumer prices due to the introduction of Medicare would be passed on to labor costs and contribute to an improvement of profitability. The Accord, however, recognizes the legitimacy of the unions seeking "over time" a catch-up for the real wage cut due to the wage freeze. Some unions (in the building, petrochemical and food processing sectors) have already sought and obtained pay raises before the end of the freeze and others may not countenance a further cut in real wages. On the external side, the Australian representatives thought that one could reasonably expect the current account deficit to edge up in the second half of 1984 because the strengthening of domestic demand would push up imports while the recovery of farm exports would slow down.

The staff forecast for the second half of 1984 implies a continuation of the recovery at roughly the same pace as in the first half of 1984 with some strengthening of private sector demand offsetting a stabilization of public sector spending.

5. Trade and aid policies

Australia faces extensive restrictions against some of its main exports, in particular temperate agricultural products for which it has a comparative advantage. These trade barriers account in part for the decline in Australia's share of world exports over the past 15 years. The Australian representatives complained that these restrictions, particularly nontariff barriers, had intensified in recent years and that subsidization of agricultural exports by certain producers, notably the EC and the United States, had undermined Australia's ability to export to third markets. They also noted that protective measures against some of Australia's trading partners in the Pacific Basin adversely affected exports of commodities (e.g., coal and iron ore) used as inputs into those products which were being restricted.

Protection by Australia itself applies mainly to the manufacturing sector, dairy products and sugar (see RED paper). While this protection is extensive, it is also exceptionally transparent. An official body, the Industries' Assistance Commission (IAC) calculates the level of nominal and effective protection for the economy and by sectors, and reviews annually as well as on reference by the Government, the costs of protection and the arguments for phasing it down.

The average level of protection has changed little since 1973. The previous government did not seek to reduce it when the boom was putting pressure on resources and the present Government has indicated that it would not move to lower trade barriers until unemployment had been reduced.

However, it has affirmed that it would not interfere with the phasing down of assistance programs initiated by the previous Government, which cover about 3 percent of manufacturing output. It has also endorsed the Closer Economic Relations Agreement with New Zealand which became effective in January 1983 and which provides for the progressive elimination of trade barriers between the two countries.

On August 11, 1983, overriding an IAC recommendation that no additional assistance be granted, the Government announced a five-year assistance package for the steel industry, which included (1) subsidies on certain products produced and sold in the domestic market; (2) a "safety mechanism" which provides for a review of assistance needs if the industry's share of the domestic market in specified product categories falls below 80 percent or rises above 90 percent; (3) a limit on imports at developing country preference rates of duty set at the average volume over the five years ending June 1983. As part of the assistance package, the Government received from the industry and unions certain commitments relating to job security, wage and productivity movements and levels of investment. The Australian representatives noted that the form of assistance adopted, viz., subsidies, was less detrimental to steel-using sectors than tariffs or quotas and that the effect of the package on the average level of protection would depend on whether the market share guarantee came into play.

The present Government has not indicated any intention to depart from past practice of providing substantial budgetary assistance to industry and in particular to exports, although the existing export incentive scheme is being reviewed.

Australia's official development assistance in 1982/83 amounted to 0.47 percent of GNP, up from 0.45 percent in 1981/82. The 1983/84 budget provides for a 13 percent increase in commitments for overseas development assistance. Imports from developing countries represented 28 percent of total imports in 1982/83 (up from 26 percent in 1981/82).

6. External debt and foreign investment policy

Australia's gross external debt has increased rapidly in recent years (Chart 8). The increase has been offset to some extent by additions to foreign assets, but more important, it has been associated until 1982/83 with a strong increase in investment in the resources sector, which can be expected to generate over time the income and foreign exchange receipts necessary to service the debt. Meanwhile, the ratio of interest payments to exports of goods and services has shown a rapid rise, but it should diminish later as the export potential of the investments is fully realized.

Australia's external debt position remains strong and its credit rating among the highest. There have been, however, a few recent developments in the debt position which have received the authorities' attention. First, there has been a significant shortening of the maturity structure of private debt. Second, in 1982/83, in contrast with the previous years' experience, the net inflow of capital (in percent of GDP) declined by less than investment while domestic saving fell, indicating that some of the inflow went to finance consumption. While this development is not unexpected during a period of weak commodity prices and foreign demand, it would be a cause for concern if it proved persistent. Third, direct foreign investment has accounted for a declining share of the capital inflow, so that the ratio of debt to equity in Australia's external liabilities has been rising--albeit from a relatively low level. The Australian representatives noted in this context that foreign investment policy was under review but there had been no change so far except for some tightening of restrictions on real estate purchases by foreigners. They said that the recent high rate of rejection of foreign investors' applications was due to special non-recurring factors.

The staff has made projections of Australia's external debt and debt service payments through 1989 for illustrative purposes (Table 3). They are sensitive to assumptions made regarding foreign and domestic demand and real rates of interest, and are not meant to be interpreted as forecasts. They nevertheless suggest that Australia's debt service burden is likely to rise in the next couple of years, before tapering off as the recent large investment in the resources sector is translated into increased export earnings.

III. Staff Appraisal

At the time of the previous consultation in 1981, the Australian economy was growing rapidly, while most other industrial countries had already moved into recession. The main concern was then about the recrudescence of inflation and the growing pressures on the labor market. In his summing up at the conclusion of the 1981 consultation, the Acting Chairman noted that Directors had found that the acceleration of wage inflation, if unchecked, risked making the (then) current pace of economic activity unsustainable, had counseled greater fiscal restraint, and suggested more active labor market policies and a significant reduction in the level of protection.

Failure to take corrective measures to deal with the emerging imbalances in the economy did contribute to the ensuing sharp recession, although other factors played an important part, notably the world recession and an exceptionally severe drought. Unlike the situation in a number of other countries, anti-inflationary policies were not a major cause of the downturn. At the trough of the recession, Australia's inflation rate was twice the average for all industrial countries, while it had been below it from 1979 to 1981.

The Government which took office in March 1983 was confronted with inflation and unemployment both in the double digit area, a large budget deficit due to the recession and to measures taken by the previous Government, a sizable current account deficit, and a massive outflow of capital which put pressure on the exchange rate. It moved quickly and decisively to restore domestic and foreign confidence in its policies, and to implement its own strategy to deal with the economy's problems. It devalued the Australian dollar, pared the prospective budget deficit to make room for its own programs, and initiated large sales of government bonds to avoid an excessive monetary financing of the deficit.

The main features of the Government's economic policy are an expansionary fiscal policy designed to prime a recovery of private sector activity, and an incomes policy which, together with monetary policy, would allow some progress in reducing inflation. The incomes policy would, if fully successful, achieve some reduction in real wages and labor costs and offset the deterioration of business profitability which took place over the past two years. The expansionary stance of fiscal policy results almost entirely from a rapid increase in spending, both for the Commonwealth budget and for the public sector for the second year in succession. In the view of the staff this strategy may yield positive results in the next 12 months but carries serious risks for the period beyond. In the short run the large fiscal stimulus from the previous and current budgets and rapid monetary expansion in the first eight months of 1983 are likely, together with the recovery of foreign demand, to support a strong cyclical upswing while the current account of the balance of payments continues to improve and the recorded rate of inflation decelerates markedly. But if either monetary policy stays off course and allows a new buildup of inflationary pressures, or the budget deficit is not reined in, thereby crowding out a revival of private activity, the basis for a sound and durable recovery will be lacking.

The staff supports the Australian authorities' view that it is the private sector which must eventually be counted on to provide employment opportunities and that such opportunities will in turn be strongly dependent on real wage developments. The reduction in real wages which is being sought will not be easy to achieve and safeguard, especially, in the Australian context of strong and independent unions. And the task would become even more formidable if expansionary financial policies were to put too much pressure on incomes policy.

The staff believes that a monetary policy firmly aimed at a progressive deceleration of inflation has a key role to play in the present circumstances. The Government will need to continue its policy of financing the budget deficit through sales of securities to the nonbank public and exchange rate policy will have to curb the contribution of the balance of payments to monetary growth. In recent years that contribution has increased steadily and the failure to offset it has been a factor behind the lack of success in meeting monetary targets. An appreciation of the exchange rate, if it became necessary, might impair Australia's competitive position in the short run, but over time competitiveness would be even more seriously affected by letting inflation accelerate. In view of the large differential between its rate of inflation and that of its trading partners, Australia should seek to improve its competitiveness through restraint on domestic costs and prices rather than through exchange rate depreciation. In this context, particular care would be needed to ensure that the proposed mid-term review of monetary projections toward the end of 1983 does not result in their relaxation.

The staff is concerned by the rapid increase in the PSBR--to an estimated 8 1/2 percent of GDP in 1983/84, up from 3 1/4 percent in 1981/82--and about the feasibility of financing it without pressure on interest rates and the exchange rate. It believes that the structural component of the fiscal deficit should be sharply reduced in the next budget in order to avoid private sector activity being crowded out by rising interest and exchange rates. Otherwise, the PSBR is likely to be reflected in a continuing current account deficit financed by foreign borrowing, thereby undermining Australia's present strong external debt position.

Finally, the staff sees ample scope for measures which over time would raise the efficiency of the Australian economy. By fostering competition and reducing distortions and rigidities in some segments of the economy, particularly the labor market, the authorities could achieve faster noninflationary growth. In particular, the staff's view is that full wage indexation, a major cause of real wage rigidity, should not become a permanent feature in national wage cases. Medium-term adjustment would also be facilitated by a reduction in the assistance given by the Government to many sectors of the economy, especially manufacturing. The staff regrets that Australia did not avail itself of the opportunity to reduce protection at the peak of the boom, as had been recommended during the previous consultation, in order to relieve some of the pressure on domestic resources, and that protection has recently been intensified in certain sectors such as steel products. While recognizing that the current high unemployment and the restrictions imposed by a number of countries against Australian exports make it more difficult to act now, the staff believes that it would be in Australia's own interest to start dismantling some of its trade barriers.

It is recommended that the next Article IV consultation with Australia be held on the standard cycle.

Table 1. Australia: Domestic Developments 1/

(Percentage change with respect to the preceding (half) year)

	1981/82	1982/83	1983/84 2/	1982/83 2nd half	1983/84 1st half	1983/84 2nd half	1984/85 2/ 1st half
Demand and output (volumes)							
Private consumption	3.6	0.8	1.1	-0.2	0.4	1.6	1.0
Public consumption	1.2	3.1	5.5	3.3	1.1	5.4	2.0
Gross fixed capital formation	7.4	-10.4	-5.7	-7.9	-2.1	0.8	1.9
Dwellings	-2.9	-25.4	3.0	-18.4	7.5	13.7	7.5
Business fixed investment	18.7	-15.9	-14.0	-10.8	-7.5	-6.6	--
Public investment	-4.1	9.4	3.0	0.8	3.0	4.1	1.6
Change in stocks 3/4/	0.4	-2.8	1.7	-1.7	...	...	...
Total domestic demand	4.6	-4.2	2.0	-3.1	2.1	3.1	2.3
Exports of goods and services	1.0	1.4	4.0	-7.5	3.0	9.3	4.0
Imports of goods and services	12.1	-10.3	-2.5	-10.6	--	6.1	1.5
Foreign balance 3/	-2.1	2.3	1.2	0.8	...	...	...
Gross domestic product	2.5	-2.0	3.2	-2.4	2.6	3.6	2.8
Of which:							
Nonfarm product	1.7	-1.0	2.3	-2.0	1.8	2.8	2.8
Farm product	16.1	-17.7	19.0	-9.7	...	...	...
Prices and incomes							
CPI	10.4	11.5	7.5	4.8	4.0	1.8	4.0
Average weekly earnings	13.6	11.2	7.0	0.7	3.3	4.4	2.5
Employment and unemployment							
Employment	1.2	-1.4	--	-1.5	0.4	0.9	1.0
Unemployment rate (in percent)	6.2	9.0	10.7	10.0	10.5	10.9	11.1

Sources: Australian Bureau of Statistics, Quarterly Estimates of National Income and Expenditure; Reserve Bank of Australia, Bulletin; and staff estimates.

1/ Year ending June.
2/ Staff estimates.
3/ Including statistical discrepancy.
4/ Changes expressed as percentage of GDP in the preceding (half) year.

Table 2. Balance of Payments, 1980/81-1983/84 1/

	1980/81			1981/82			1982/83			1983/84 2/
	1st half	2nd half	Year	1st half	2nd half	Year	1st half	2nd half	Year	Year
	(In billions of Australian dollars)									
Trade balance	-0.1	-0.4	-0.5	-1.7	-1.6	-3.3	-0.9	—	-0.8	1.1
Exports, f.o.b.	9.3	9.4	18.7	9.0	10.0	19.1	10.4	10.2	20.7	23.0
Imports, f.o.b.	-9.4	-9.8	19.2	-10.7	-11.6	-22.4	-11.3	-10.2	-21.5	-21.9
Net invisibles	-2.5	-2.6	-5.0	-2.6	-3.0	-5.6	-2.8	-2.8	-5.6	-6.5
Current balance	-2.5	-3.0	-5.5	-4.2	-4.6	-8.9	-3.7	-2.8	-6.5	-5.4
Private capital inflows	2.5	4.1	6.7	2.5	7.2	9.7	5.1	3.2	8.4	6.0
Government capital inflows	—	—	-0.1	0.4	0.1	0.5	0.8	0.2	0.5	0.5
Total capital inflows	2.5	4.1	6.6	2.9	7.3	10.2	5.9	3.0	8.9	6.5
Net official monetary movements	—	1.1	1.1	-1.3	2.7	1.3	2.2	0.2	2.4	1.1
	(As percent of GDP)									
Current balance	3.7	-4.7	-4.2	5.5	6.4	6.0	4.5	3.6	4.0	3.0
Total capital inflows	3.7	6.4	5.0	3.8	10.1	6.9	7.1	3.9	5.5	3.6
Net official monetary movements	--	1.7	0.8	-1.7	3.8	0.9	2.6	0.2	1.5	0.6

Source: Reserve Bank of Australia, Bulletin; IMF, International Financial Statistics.

1/ Fiscal year, July 1 to June 30.
2/ Staff estimates.

Table 3. Australia: Illustrative Medium-Term Debt Scenario

	1982/83	1983/84	1984/85	1985/86	1986/87	1987/88	1988/89
Current Account (in percent of GDP)	-4	-3	-4 1/2	-5 1/4	-4 3/4	-4 1/2	-4 1/4
Gross total debt (in percent of GDP)	21	21 3/4	22 3/4	24 1/4	26	27 1/2	28 1/2
Net total debt (in percent of GDP)	13 1/2	15 1/4	16 3/4	18 1/4	20 1/4	22	24
Debt service, gross, as a per cent of exports of goods and nonfactor services 1/	17 1/4	18 1/2	19 1/2	21 1/2	22 1/2	23 1/4	23 1/4
Debt service, net as a per cent of exports of goods and nonfactor services 2/	15 1/2	16 1/4	17	18 3/4	20 1/4	20 1/2	20 1/2

Source: Staff estimates.

1/ Interest payments on total (private plus public) debt plus amortization on medium- and long-term debt.

2/ Interest payments on total debt net of interest receipts on total assets (including official reserves) plus amortization on medium- and long-term debt.

Note: The main assumptions behind this scenario are as follows: for 1983/84, the projections contained in the latest WEO paper for industrial countries' growth and inflation have been adopted. For 1984/85 through 1988/89, the scenario assumes growth in the industrial countries of 3 percent and a rate of inflation of 6 percent. Australia's domestic demand is assumed to grow at the same rate as foreign demand. Australia's competitive position is assumed to remain unchanged. The development of the resources sector in recent years is assumed to be followed by an "export phase" beginning in 1985/86. Short-term debt of the private sector is assumed to be 50 percent of total private debt. Details regarding Australia's external private and public liabilities and their breakdown into debt and equity are provided in the RED paper.

Fund Relations with Australia

Quota:	SDR 1,185 million.
Proposed quota under Eighth Review:	SDR 1,619.2 million.
Fund position:	Australia purchased SDR 32.5 million in November 1982 under the Buffer Stock Financing Facility. Fund holdings of Australian dollars at end-September 1983 were equivalent to 102.7 percent of quota. SDR holdings were SDR 115 million or 24.4 percent of net cumulative allocation.
Exchange system:	The Australian authorities do not maintain margins in respect of exchange transactions. The exchange rate of the Australian dollar is determined by reference to a trade-weighted basket of currencies. In practice, a mid-rate for the Australian dollar (the intervention currency) is announced each day by the Reserve Bank. The Australian dollar was devalued by 10 percent on March 7, 1983 from 81.5 to 73.3 on the trade-weighted index scale (May 1970 = 100). Subsequently, it was allowed to appreciate, and on September 30, 1983, the trade-weighted index stood at 80.4. The middle rate for the U.S. dollar was \$A = US\$0.8965. Exchange rates for other currencies are not officially posted. There are no taxes or subsidies on purchases or sales of foreign exchange.
Last consultation:	The consultation discussions took place in March 1981 and the staff report (SM/81/107, 5/11/81) was discussed by the Executive Board on May 29, 1981.

Australia - Basic Data

Area and population

Area	7,682,300 square kilometers
Population (December 1982)	15,276,100
Labor force (June 1983)	6,985,000

National accounts

	1982/83	1979/80	1980/81	1981/82	1982/83
	In millions of $A	Percentage change in volume terms			
Private consumption	100,249	1.8	3.4	3.6	0.8
Public consumption	28,742	2.2	5.5	1.2	3.1
Private investment 1/	24,602	1.3	17.6	12.7	-18.1
Public investment 1/	13,432	-3.3	2.1	-4.1	9.4
Change in stocks (including statistical discrepancy) 2/	-2,716	-1.5	0.7	0.4	-2.8
Total domestic demand	164,309	-0.1	6.3	4.6	-4.2
Exports of goods and services	24,559	7.6	-5.5	1.0	1.4
Imports of goods and services	27,976	0.1	9.1	12.1	-10.3
Gross domestic product	160,892	1.2	3.6	2.5	-2.0
Of which: Gross nonfarm product	155,281	2.2	4.7	1.7	-1.0

Gross domestic product per capita in 1982/83 SDR 9,187

Prices, incomes, and unemployment
(Annual percentage increase)

	1979/80	1980/81	1981/82	1982/83
GDP deflator (nonfarm)	9.6	10.2	11.8	11.4
Consumer price index	10.1	9.4	10.4	11.5
Real household disposable income	0.1	3.7	4.0	0.1
Average weekly earnings	9.9	13.5	13.6	11.2
Unemployment rate	6.2	5.8	6.2	9.0

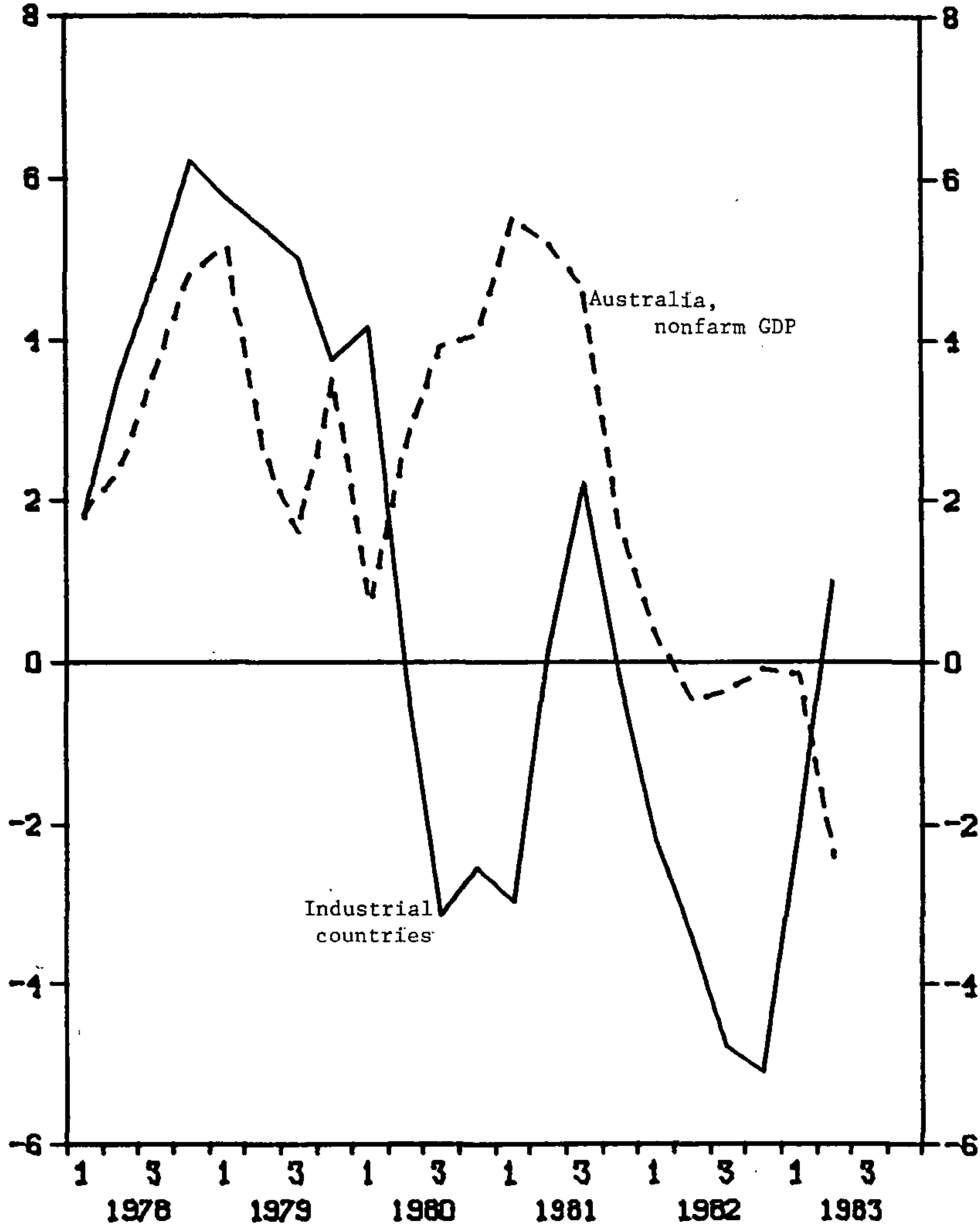
1/ Abstracting from the effects of sale-lease back transactions between the private and public sectors.
2/ Changes expressed as percentage of GDP in the previous period.

Chart 1

Australia

Industrial Production, Australia versus Industrial Countries

(Percentage change with respect to the same quarter of the previous year)



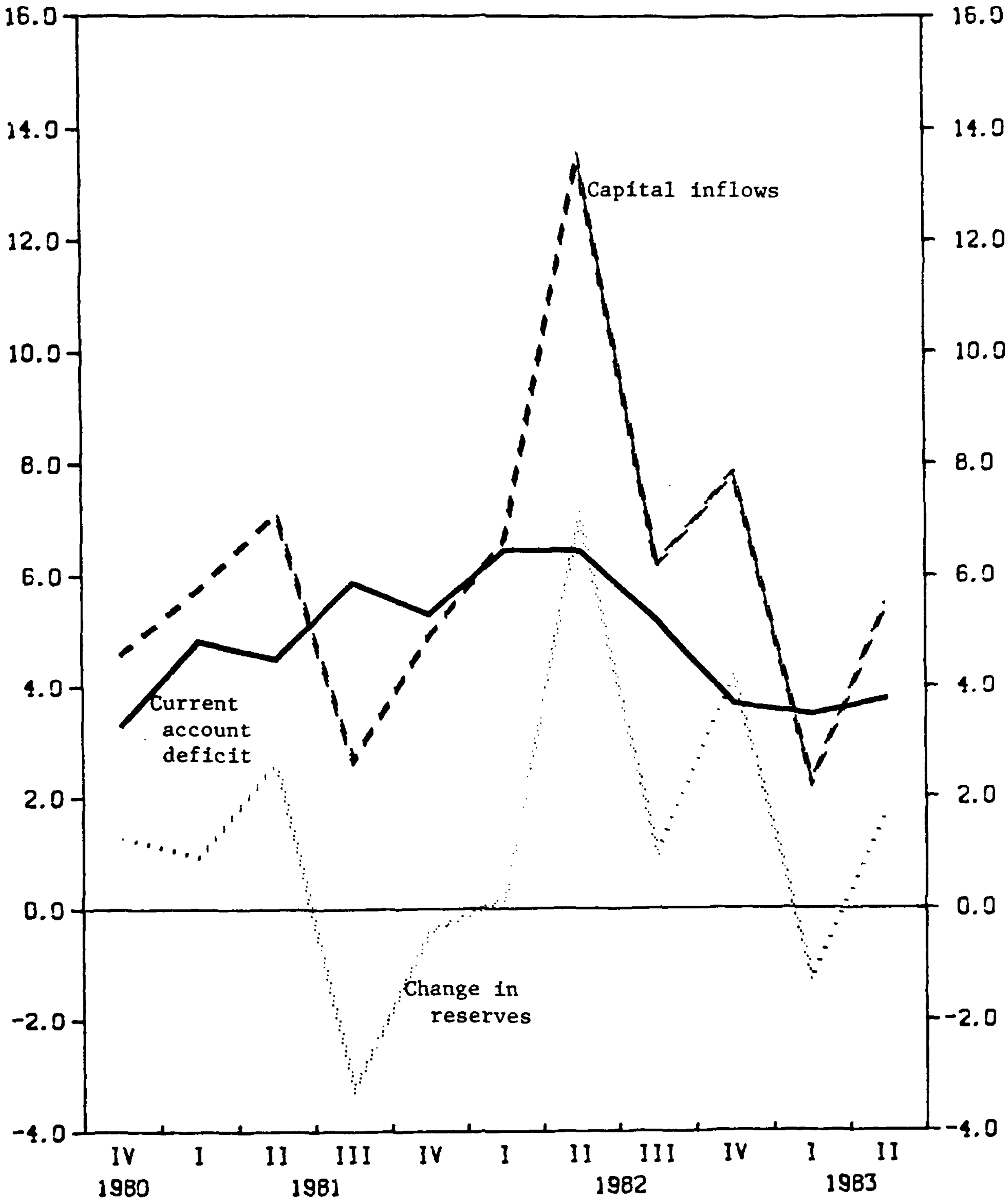
Sources: IMF, International Financial Statistics; and Australian Bureau of Statistics, Quarterly Estimates of National Income and Expenditures.

Chart 3

Australia

Balance of Payments Developments

(As percent of GDP, quarterly data)

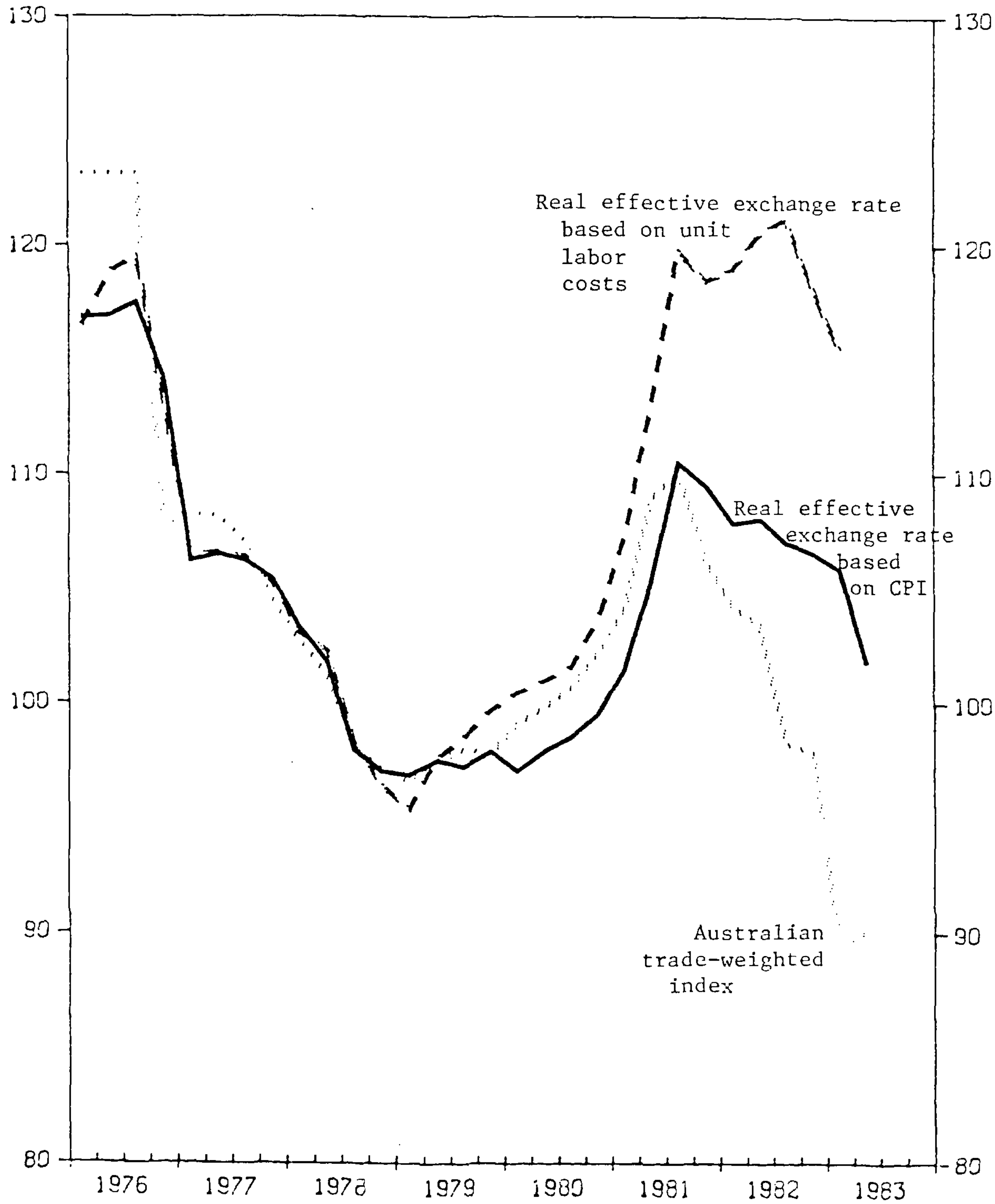


Source: Reserve Bank of Australia, Bulletin.

Chart 4

Australia: Real Effective Exchange Rates

(Index: 1978 = 100)



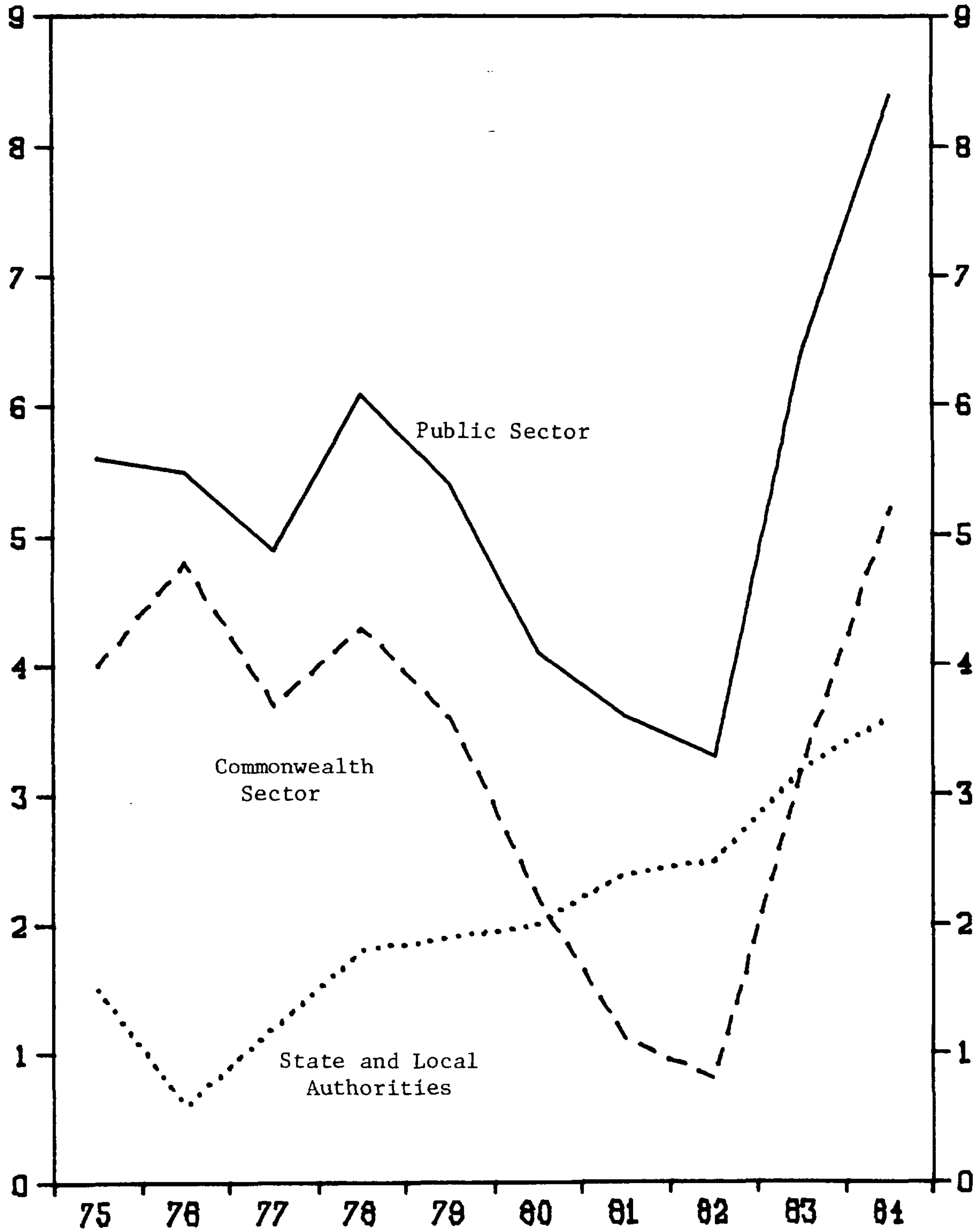
Source: Reserve Bank of Australia, Bulletin and staff calculations.

Chart 5

Australia

Public Sector Borrowing Requirement 1/

(In percent of GDP)



Source: 1983/84 budget statements.

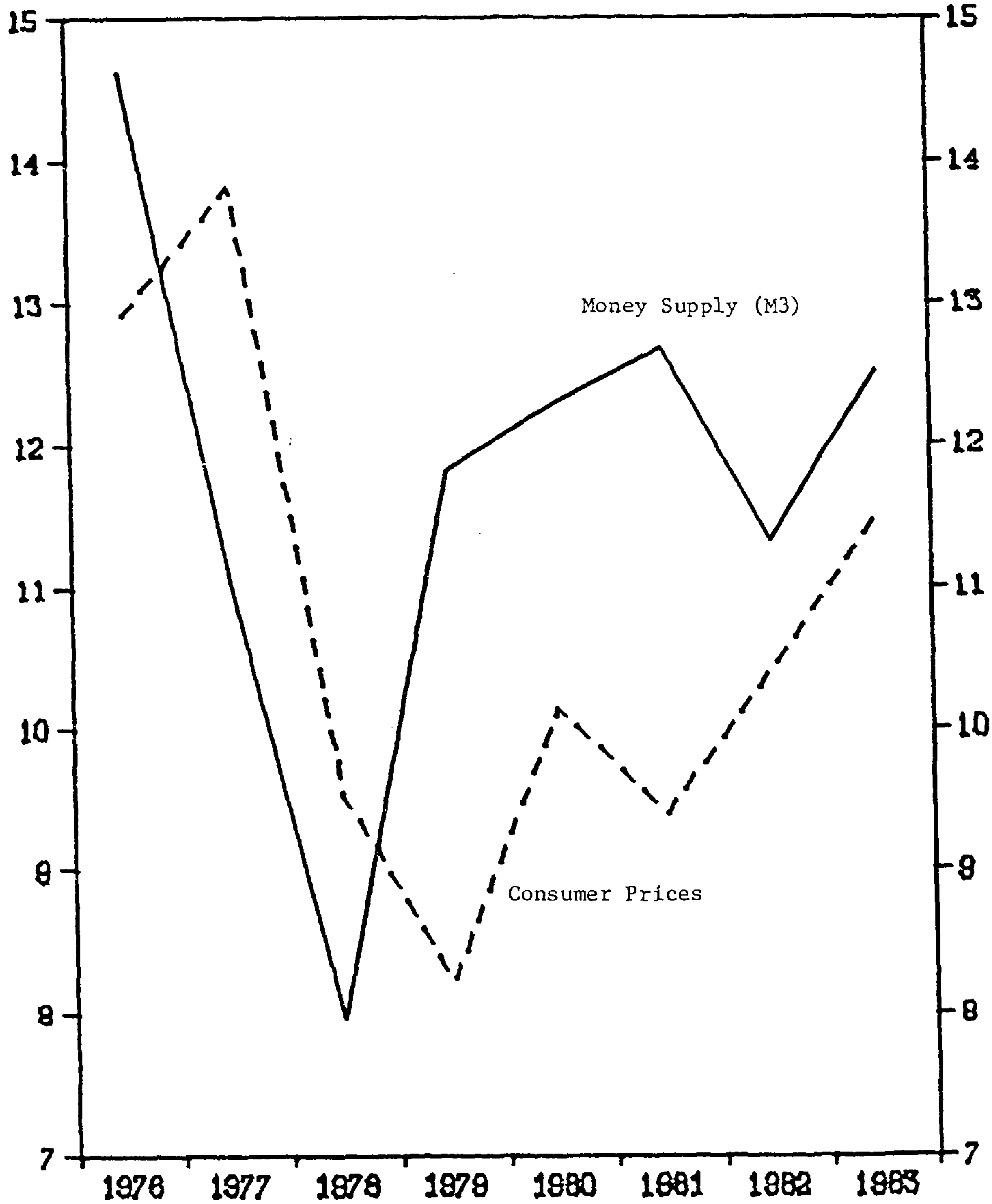
1/ The Commonwealth sector is defined as the Commonwealth budget plus Commonwealth nonbudget authorities. Figures for 1983/84 are official projections.

Chart 6

Australia

Monetary Growth and Inflation: 1975/76-1982/83

(Percent changes)



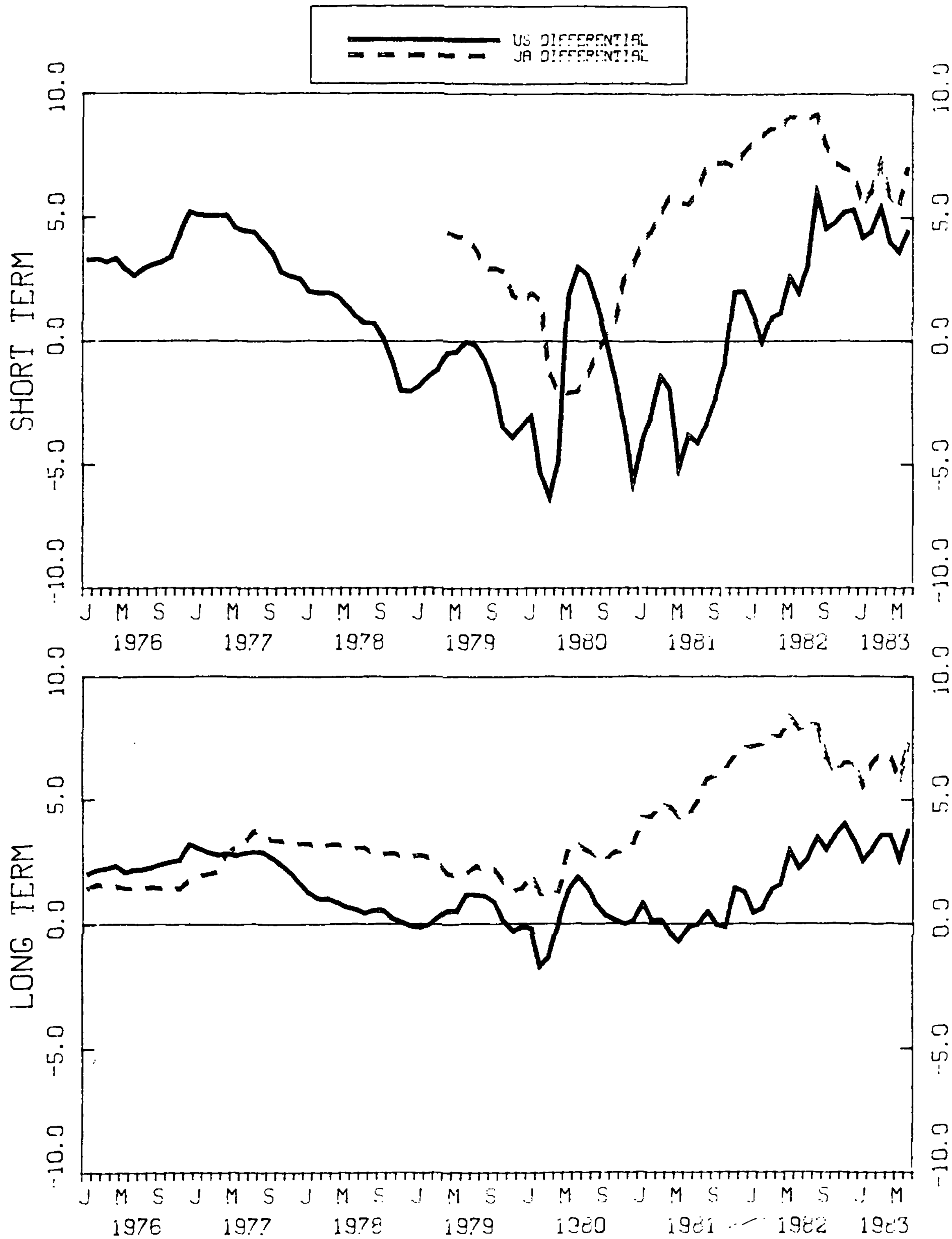
Source: Reserve Bank of Australia, Bulletin.

Chart 7

AUSTRALIA

NOMINAL SHORT TERM & LONG TERM INTEREST RATE DIFFERENTIALS 1/

(AUSTRALIA MINUS OTHER)



Source: Reserve Bank of Australia, Bulletin.

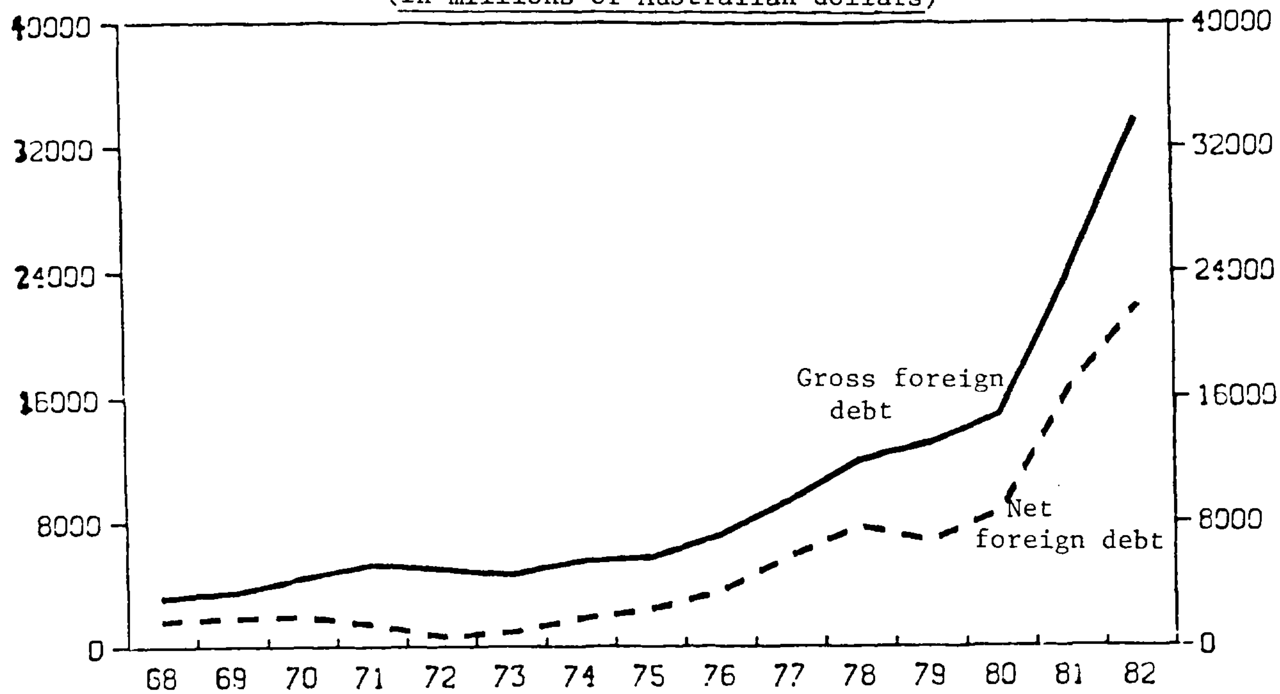
1/ US = United States, JA = Japan.

Chart 8

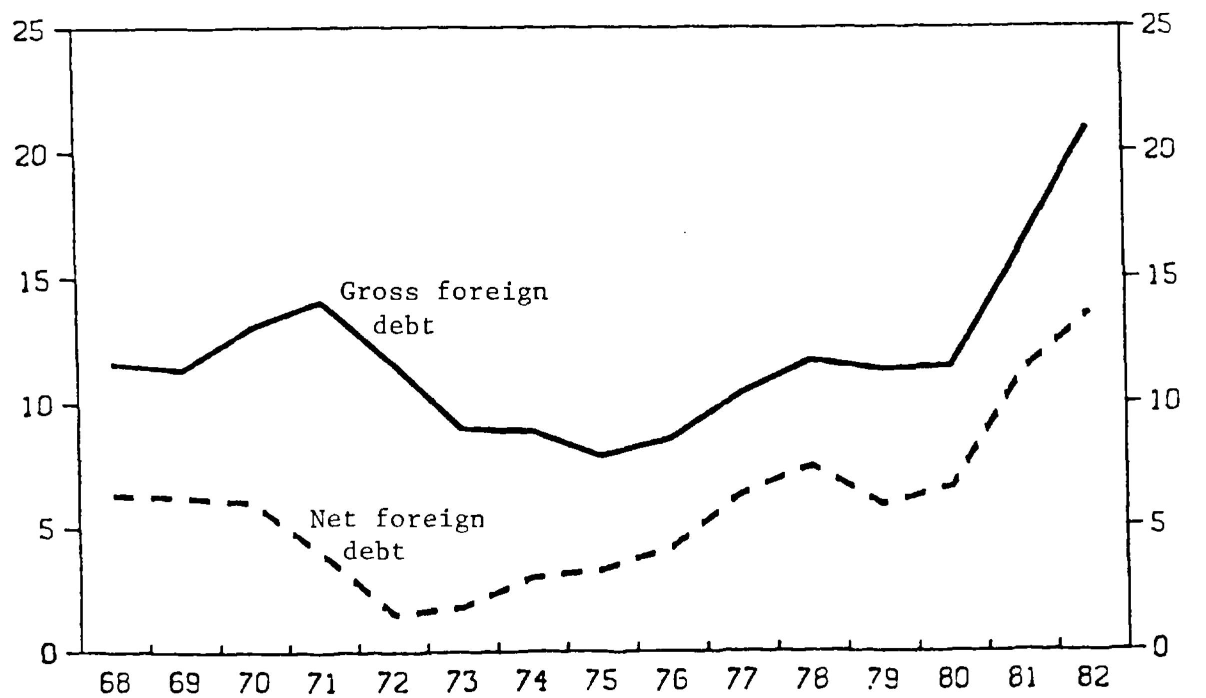
Australia

Foreign Debt 1/

(In millions of Australian dollars)



(In percent of GDP)



Sources: Government Securities on Issue at June 30, 1983 (1982-83 Budget Paper No. 8); Balance of Payments, Australia, June Quarter 1983; Quarterly Estimates of National Income and Expenditure, June Quarter 1983; Foreign Investment in Enterprises in Australia, March Quarter 1983; and Foreign Investment Australia, 1981-82.

1/ Fiscal years beginning July 1.