DOCUMENT OF INTERNATIONAL MONETARY FUND AND NOT FOR PUBLIC USE

SM/83/219
Correction 1

CONTAINS CONFIDENTIAL INFORMATION

November 25, 1983

To: Members of the Executive Board

From: The Acting Secretary

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

The following corrections have been made in SM/83/219 (10/26/83):

Page 2, 1st full para., line 6: for "record low" read "near historically low"

line 8: for "in 1982/83" read "over the course of 1982/83."

Page 3, table, columns 5 and 6, line 4: for "-2.3" and "-3.3" read "-1.6" and "-3.6," respectively.

line 5: for "unemployment rate (end-period)" read "unemployment rate (monthly average)"

columns 5 and 6, line 5: for "8.7" and "10.3" read "7.9" and "10.0," respectively.

Page 4, 1st full para., line 2: for "the size" read "the relative size"

lines 3 and 4: for "less successful in reducing" read "in fact increasing."

Page 11, 1st full para., line 7: for "GSP rates" read "developing country preference rates."

Page 19, line 2, under "Area and population": for "Population (June 1981) 14,926,800" read "Population (December 1982) 15,276,100"

Corrected pages are attached.

Att: (5)

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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

However, it has affirmed that it would not interfere with the phasing down of assistance programs inititated 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

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.

	1979/80	1980/81	1981/82	1982/83
Public finance				
Commonwealth Government (annual percentage increase, in value terms)				
Outlays	9.1	14.6	13.9	18.5
Receipts	15.9	18.7	15.9	9.1
Budget deficit as percentage of GDP	1.8	0.9	0.4	2.8
Monetary data				
Domestic credit	11.9	12.4	9.8	...
Broad money (M3)	12.3	12.7	11.3	12.5
Short-term commercial bill rate (end of period, in percent)	13.9	16.0	18.8	...
Long-term government bond yields (end of period, in percent)	11.8	13.1	16.4	...
Balance of payments (In millions of $A)				
Exports	18,589	18,718	19,089	20,697
Imports	15,853	19,169	22,374	21,528
Trade balance	2,736	-451	-3,285	-831
Net invisibles	-4,857	-5,004	-5,575	-5,637
Current account balance	-2,121	-5,455	-8,860	-6,468
(In percent of GDP)	(-1.8)	(-4.2)	(-6.0)	(-4.0)
Capital account balance	1,821	6,604	10,214	8,903
Overall balance	-301	1,149	1,354	2,435
International reserves (end-period)				
IFS basis (in millions of SDRs)	1,646	2,796	4,099	6,011
Reserve Bank basis 2/ (in millions of $A)	5,681	5,709	6,517	...
Exchange rates (units of foreign currency per $A, end of period)				
U.S. dollar	1.1576	1.1480	1.0223	.8745
Trade-weighted basket (May 1970 = 100)	85.0	92.9	88.2	77.9

1/ End-period, percentage increase from one year earlier.
2/ Using market-related valuation of gold.