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Statement by Mr. Loyo and Mr. Mori on Australia
(Preliminary)
Executive Board Meeting
August 29, 2005

1. We wish to thank staff for a well-written set of papers and Messrs. Murray and Francis for their informative Buff statement.

2. Australia is always an interesting case to analyze in light of its outstanding macroeconomic performance and track record of implementing a number of fundamental structural reforms. This is certainly a distinguishing feature among advanced economies. A particularly interesting aspect is the ability of the Australian economy to maintain a sequence of high current account deficits and rising external liabilities without any major disruption. The private sector in Australia seems to enjoy unlimited access to external credit. This is also a distinguishing feature.

3. External accounts like Australia's (Table 1) would be a motive for concern if observed elsewhere, especially in developing economies. The current account deficit remains large – at 5.9 percent of GDP in 2003 and 6.4 percent of GDP in 2004, and an average of 4 ½ percent of GDP since 1990. The most recent increase in the current account deficit happened despite some cooling down of domestic demand and extraordinarily favorable terms of trade. Gross external debt grew from 64.4 percent of GDP in 1999 to 82.4 percent in 2004, with an increasing share of banks' debt – which jumped from 40.9 percent of GDP to 59.5 percent of GDP in the same period, half of which being short term.

4. Despite such numbers, Australia has withstood well the sequence of external shocks verified since the 1990s, as its access to external financing has been preserved. In Australia, changes in liquidity conditions in the global markets have been reflected basically in variations in the exchange rate, in the maturity structure of the debt, as well as in the Reserve Bank's position in foreign currency swaps. Staff appears not to be particularly concerned with the deteriorating trend in external debt, as no mention of this fact is included in its appraisal – and so it seems that there are, after all, cases in which risks related to widening current account deficits and rising external debt can be largely neglected.

5. In other parts of the paper, staff does argue that the high and rising net external debt would not be a source of vulnerability to external shocks, as it would in other countries. This conclusion is based on the strong balance sheet of private sector, well-managed currency and

liquidity risks, and external debt either hedged against foreign currency risk or denominated in Australian dollars. We are, however, not entirely persuaded by these arguments.

6. Staff mentions, for instance, that the domestic assets of the private sector have grown by more than the increment in the external debt, thanks to investment and valuation gains. As a result, the net wealth of the private sector would be around 600 percent of GDP in 2004, and domestic assets ten times larger than net foreign liabilities. Unless some special assurance is provided with regard to the international tradeability of the income streams expected from those domestic assets, the comfortable balance sheet position does not necessarily dismiss concerns with the adjustments needed to transfer resources abroad in order to honor foreign debt. If it did, we imagine that the exercise of comparing external debt with domestic assets would probably have become a more standard component in the assessment of vulnerabilities of indebted economies in general.

7. Resilience to shocks is also explained by the extensive use of hedging instruments. But part of the risk associated with currency mismatches remains in domestic balance sheets, since the Reserve Bank is reported to respond for 27 percent of the short position in foreign currency derivatives, while 65 percent are taken by non-residents. Exporters are a source of natural hedge but it seems that they demand much of that hedge themselves in order to cover their own foreign currency liabilities. Furthermore, the supply of currency risk hedging instruments tends to fluctuate in tandem with the availability of external financing. Markets for such hedging instruments tend to work well in normal circumstances; in extreme events, however, if the external credit dries out, it is no surprise that the same should tend to happen with the supply of hedge. Because liquid markets for hedging instruments are often concentrated in relatively short maturities, there is no guarantee that domestic agents will be able to renew their insurance against currency risk – particularly, the insurance they place abroad – in adverse external financing scenarios.

8. Hence, there seem to be other factors explaining Australia's unlimited access to external credit even in unfavorable circumstances. Perhaps, it has to do with the very well-established track record of sound macroeconomic and structural policies, which is understood to prevent the economy from going through major disruptions. The benefits from the track record seem to be enough not only to ensure more resilient access to external financing but also to allow already for greater flexibility in policy implementation itself. The authorities make good use of such flexibility to follow "astute actions". Based on solid institutions and a well-designed macroeconomic framework, the outcome has been impressive, with GDP growth in a continued expansionary path since 1992, despite external and domestic shocks in this period. Inflation is under control, with rates remaining on average at the center of the target range. Fiscal surpluses continue to be recorded with the Government enjoying an almost negligible net public debt level, which in turn facilitates the conduct of monetary policy. Unemployment rates continue to fall, reaching a 28-year low.

9. The progress achieved over the years in the area of structural reforms is also impressive, and even more so the fact that, after all that has been accomplished, the authorities continue to pursue an ambitious agenda going forward. The main challenges are now to narrow further the income gap with respect to the more advanced industrial countries and to address the

issues posed by an ageing population. Given the comfort provided by years of sound fiscal policy and the reforms already in place, Australia has room to plan well in advance a strategy to cope with these challenges. One example of such a forward-looking policy is the way the authorities are addressing the problem of unfunded public service pensions, with the creation of the Future Fund. We follow with interest the implementation of that scheme. Policies to enhance long-run gains in productivity are also key, and will require particular attention to deficiencies in infrastructure. A more detailed assessment of potential benefits of improved regulatory and pricing frameworks for infrastructure services – or other strategies to overcome infrastructure bottlenecks – would be most welcome by occasion of the 2006 Article IV consultations.