April 8, 2020
Approval: 4/15/20

INTERNATIONAL MONETARY FUND

Minutes of Executive Board Meeting 19/9-2

11:40 a.m., February 4, 2019

2. Australia—2018 Article IV Consultation

Documents: SM/19/10 and Correction 1 ; SM/19/8; and Correction 1; SM/19/9 ; and Correction 1; and Correction 2; and Supplement 1

Staff: Helbling, APD; Jenkinson, MCM; Duttagupta, SPR

Length: 1 hour, 23minutes

Executive Board Attendance

T. Zhang, Acting Chair

Executive Directors	Alternate Executive Directors
D. Mahlinza (AE)	
M. Raghani (AF)	
	R. Morales (AG), Temporary
N. Ray (AP)	
A. Tombini (BR)	
	Y.Liu (CC), Temporary
	A. Del Cid-Bonilla (CE), Temporary
L. Levonian (CO)	
R. Kaya (EC)	
	A. Castets (FF)
S. Meyer (GR)	
S. Gokarn (IN)	
	M. Psalidopoulos (IT)
M. Kaizuka (JA)	
J. Mojarrad (MD)	
	P. Al-Riffai (MI), Temporary
	N. Jost (NE), Temporary
	J. Sigurgeirsson (NO)
	L. Palei (RU)
	R. Alkhareif (SA)
	P. Trabinski (SZ)
S. Riach (UK)	
	P. Pollard (US), Temporary

S. Bhatia, Acting Secretary
H. Malothra, Summing Up Officer
L. Briamonte, Board Operations Officer
M. McKenzie, Verbatim Reporting Officer

Also Present

Asia and Pacific Department: O. Brekk, T. Helbling, E. Loukoianova, D. Muir, M. Nozaki. Legal Department: S. Dawe. Monetary and Capital Markets Department: R. Awad, M. Cihak, C. Cohen, N. Jenkinson, T. Kapan, M. Kitonga, J. Morsink, M. Saiyid, N. Suryakumar. Strategy, Policy, and Review Department: R. Duttagupta, H. Lin.
Alternate Executive Director: G. Johnston (AP), H. Razafindramanana (AF). Senior Advisors to Executive Directors: M. Alle (AF), D. Hart (CO), G. Heim (SZ), T. Ozaki (JA), G. Preston

(AP), J. Shin (AP). Advisors to Executive Directors: E. Amor (AP), M. Bernatavicius (NO), S. David (AP), I. Fragin (GR), O. Haydon (UK), B. Jappah (AE), M. Kikiolo (AP), G. Kim (AP), W. Nakunyada (AE), Y. Naruse (JA), A. Park (AP), T. Persico (IT), F. Rawah (SA), S. Vitvitsky (US), S. Alavi (MD), K. Hennings (BR), K. Lok (CC), A. Sode (FF).

2. AUSTRALIA—2018 ARTICLE IV CONSULTATION

Mr. Ray, Ms. Preston and Ms. Park submitted the following statement:

Australia has just completed its 27th consecutive year of economic growth, with the adjustment to the largest terms of trade shock in our history and the associated huge mining investment boom running its course. The successful economic transition has occurred in the context of an open, diversified economy with a flexible exchange rate regime, liberalized capital account, flexible labor and product markets, supportive macroeconomic policies, strong institutional arrangements and robust regulatory frameworks. Economic growth is expected to be around potential in the near term. Authorities continue to pursue policies to boost potential growth, and remain firmly committed to open trade, investment and immigration. The 2018 Financial Sector Assessment Program (FSAP) underscores the strength and resilience of the Australian financial system. Stress tests highlight that Australian banks could withstand significant shocks, including the combination of a large slowdown in China with a severe correction in house prices.

Since the time of the 2018 IMF Article IV consultation in November 2018, the Australian economy has continued to perform strongly. The September quarter national accounts, despite showing softer growth than in previous quarters, reflected continued broad-based growth with household consumption, dwelling investment, net exports and new public final demand contributing to through-the-year real GDP growth of 2.8 percent. Notably, strong employment outcomes in the labor market continued in December 2018 with employment increasing by more than 21,000 and the unemployment rate falling to 5.0 percent, its equal lowest level since June 2011. Both underlying and headline inflation remain subdued, reflecting modest wage growth and continued strong retail competition and the impact of government child care policy initiatives. The Government released its Mid-Year Economic and Fiscal Outlook (MYEFO) update in December 2018, which forecast a smaller fiscal deficit in 2018-19 than in the Budget and a return to surplus in 2019-20. Most recently, after ratifying the Comprehensive and Progressive Agreement for Trans-Pacific Partnership (TPP-11) Australia joined Canada, Japan, Mexico, New Zealand and Singapore as part of the first group of countries where the TPP-11 entered into force on December 30, 2018.

Staff and authorities broadly agree on the outlook and risks for the Australian economy. Risks associated with Australia's exposure to China as a result of the significant trade linkages were examined by staff[1] in 2017. Results showed that spillovers to Australia in the event of a disorderly adjustment in China should be placed in the context of Australia’s relatively diversified economy and its willingness to accept the moderating influence of its flexible exchange rate and open economy. Staff also showed that Australia’s diversified economy is reliant on strongly established trading relations with the rest of Asia, both advanced and emerging countries, not just China alone, which mitigates the effects from a possible shock in China.

Labor market conditions are strong with robust employment growth, a historically high participation rate and the unemployment rate at its equal lowest level since June 2011, around the estimated level of the NAIRU. Continued strength in labor market outcomes is expected to support a gradual pick-up in wage and price growth. In Australia, as elsewhere in advanced economies, slower wages growth, inflation and inflation expectations have been a feature of the post-crisis era. In Australia’s case, the slow recovery in wages growth also reflects adjustments associated with the unwinding of high commodity prices following the terms of trade boom.

The authorities agree with staff that monetary and fiscal policy settings remain appropriate for the current economic conditions. Should an adverse external shock materialize, authorities have both conventional and unconventional monetary policy levers and significant fiscal space available to respond. The fully flexible exchange rate would also act as a buffer to certain adverse external shocks.

The accommodative stance of monetary policy is appropriately supporting stability and confidence in the Australian economy. It is also consistent with further progress towards full employment, including through reducing underemployment, and for inflation to return gradually toward the mid-point of the target. The current stance of monetary policy balances the need to support the economy in the final days of the transition to lower levels of mining investment against the risks stemming from current levels of household debt. Authorities note staff’s recommendation to provide clear guidance on the expected path of policy normalization. The Reserve Bank of Australia (RBA) will continue to ensure that the public understands its reaction function, allowing them to form their own views on the potential path

[1] The significant role of trade linkages between Australia and China were examined in Karam and Muir, 2018, “Australia’s Linkages with China: Prospects and Ramifications of China’s Economic Transition,” in Australia: Selected Issues, IMF Country Report No. 18/45 (also available as IMF Working Paper 18/119).

of interest rates. Australia's flexible inflation-targeting framework ensures that the RBA remains well-placed to respond to future developments.

Australia's current account deficit continues to reflect that Australia's strong investment outcomes are not able to be fully met by domestic savings, as is typical for resource endowed and sparsely populated countries. While Australia has a net foreign liability position, it has a net foreign currency asset position, because the bulk of Australia's foreign liabilities are issued in, or hedged back into, Australian dollars. The banking sector not only hedges its foreign currency liabilities but does so in a way that matches the duration of its hedges with the underlying liabilities. Additionally, over the past decade Australia has tended to issue debt with longer term maturities reducing risks associated with rollover or refinancing. For these reasons, Australia's net external liabilities have a relatively robust structure, minimizing exposure to exchange rate and other macro-financial risks, including risks associated with wholesale funding as identified in the FSAP. The current account deficit is expected to remain toward the low end of the range in which it has fluctuated over recent decades, and net foreign liabilities have been stable as a share of GDP over the past decade.

The Australian Government continues to maintain a responsible fiscal stance, while implementing its plan to lift potential growth by boosting productivity through lower taxes, targeted spending and investment in infrastructure. Consistent with the Government's commitment to responsible budget repair, the fiscal position is projected to return to surplus in 2019-20 and continued strong fiscal discipline will ensure that these surpluses exceed 1 percent of GDP in the medium term. The Government is focused on containing recurrent spending, with average real payments growth now the lowest in fifty years. Authorities take note of staff's suggestion of incorporating a medium-term debt anchor as a part of the fiscal strategy and will carefully weigh up this suggestion in the context of maintaining sufficient flexibility to respond to changes in economic conditions, alongside continued strengthening of the framework.

Australian authorities note staff's advice that further increases in infrastructure spending could be considered given the IMF's assessment of Australia's fiscal space. The quality of investment in infrastructure is also important to deliver a boost to potential growth. The Australian Government has processes in place to facilitate high quality investment in infrastructure. Infrastructure Australia works to prioritize and progress nationally significant infrastructure projects that are underpinned by robust business cases. At the current levels of investment in infrastructure by the Commonwealth, State and

Territory governments, some capacity constraints and skills shortages are emerging, which would potentially be amplified by a further lift in infrastructure spending. More broadly, Australian authorities consider that, given the current point in the cycle and as a small open economy, it is important to preserve fiscal space as a buffer to deal with significant adverse shocks should they materialize.

Australia remains firmly committed to open trade, investment and immigration. The authorities underscore their steadfast commitment to a cooperative multilateral trading framework that promotes openness over protectionism. The commencement of the TPP-11 from December 30, 2018 is Australia's first trade agreement with Canada and Mexico and offers important opportunities to both Australia and its trading partners. Australia remains well placed to benefit from its diversification and integration into Asia, and continues to benefit from recent FTAs with China, Japan and South Korea. Australia's free trade agreements cover 70 percent of its total two-way trade and will rise to 88 percent when current negotiations are completed.

The recent cooling of the housing market is welcome amid significant and sustained price increases in recent years and is helping to improve housing affordability. Recent falls in house prices in Australia's two largest cities have only partly unwound the strong growth recorded in those cities: capital city housing prices remain around 40 percent higher than in 2012. In this context, authorities expect the impact of the housing correction on consumption through the wealth effect to be relatively small. In addition, the correction to housing prices is occurring in the context of strong employment growth and labor market outcomes. Underlying demand is expected to remain strong, underpinned by population growth. On the supply side, the authorities agree that further reforms are needed to planning and zoning restrictions that impede supply with long lags.

Household debt is elevated relative to incomes and has been rising as moderate growth in debt has outpaced the low growth in household incomes in recent years. Downside risks from the housing market correction are a concern and vulnerabilities associated with household debt dynamics will be monitored closely. But, household balance sheets are generally strong, housing credit growth has not been unusually strong and many households have built significant mortgage buffers including through additional repayments and the use of offset accounts (mortgage buffers have doubled since 2008). Further, the distribution of debt is skewed towards high income households, with households in the top two income quintiles holding over 60 percent of Australian household debt. To the extent that higher income households are comprised of high skill workers that may be less vulnerable to unemployment shocks, this distribution enhances debt sustainability.

The authorities consider that staff's assessment that changes to tax policy would reduce structural incentives for leveraged investment by households represents a misunderstanding of how Australia's comprehensive income tax system works. The ability to offset costs incurred in earning income against all sources of income (negative gearing) is a fundamental element of such a system. In no way is it concessional. The authorities note that limiting such deductions would represent a move away from a comprehensive income tax system and would run the risk of introducing higher costs and distortions into the tax system.

Australian authorities welcome the FSAP recommendations and remain committed to continued improvement to regulatory frameworks and supervision practices. Australia's financial system remains fundamentally sound. Australian banks' capital ratios are around 50 percent higher than a decade earlier; banks have switched to more stable funding sources and increased their holdings of liquid assets and charges for bad debts are at historic lows. Stress testing shows that banks are resilient to significant shocks.

The Australian 2018 FSAP has taken place in the midst of a significant reform agenda for the financial sector, and against the backdrop of a Royal Commission into Misconduct in the Banking, Superannuation and Financial Services Industry. The FSAP recommendations will be considered in the context of the broader reforms to the financial system proposed by the 2014 Financial System Inquiry (FSI) and the Productivity Commission's review into 'Competition in the Australian Financial System.' A number of recommendations from the FSI have already been implemented including ensuring that banks have 'unquestionably strong' capital ratios, strengthening and testing the crisis management framework and moving to industry funding for Australia's corporate regulator, the Australian Securities and Investments Commission.

In a few places, the Australian authorities believe that the assessment and recommendations could have been better grounded within the context of Australia's governance structure and the nature of the systemic risks being faced. This would be consistent with the recent IEO evaluation that emphasized advice should be fully anchored in the local circumstances and not overly reliant on off-the-shelf "international best practice" more suited in other contexts.

In particular, Australian authorities are disappointed by the IMF's assessment of regulatory independence where staff's assessment does not appropriately take into account the operational context associated with Australia's system of government. Fundamental 'checks and balances' in Australia's system are designed to hold government agencies accountable to the Executive and Parliament, and ultimately to the public. These checks and balances should not be considered as compromising the operational independence of Australian regulators. The Australian authorities agree that financial sector supervisors should be equipped with the resources and powers that they need to perform their roles effectively. The Government announced additional funding for the Australian Securities and Investments Commission and Australian Prudential Regulation Authority in the 2nd half of 2018.

Australia's approach to managing financial risks involves a high degree of collaboration across key agencies that is coordinated through the non-statutory Council of Financial Regulators[2] (CFR). Individual agencies remain accountable for the policies they adopt and their operations. The transparency of CFR activities has recently been enhanced through the publication of a quarterly statement on its activities, modernization of the CFR website and expanded coverage of CFR activities in the RBA's Financial Stability Review.

On prudential policy, caps limiting investor and interest-only housing lending have been removed because they have met the objective of strengthening resilience across the financial system. This should not be seen as a loosening of prudential policy, but rather the removal of temporary speed limits as improved lending practices have become embedded. CFR agencies have worked together in recent years to reinforce sound residential mortgage lending practices in an environment of rising household indebtedness. A broad range of tools (including many used in other countries) were considered before arriving at the set of measures that CFR agencies agreed would best achieve policy objectives. The subsequent evidence suggests that the Australian approach has been successful in managing the financial stability risks faced.

The Australian authorities appreciated the opportunity to engage in an open and constructive dialogue with the AIV and FSAP mission teams on the Australian economy and financial system.

[2] The Council of Financial Regulators is the coordinating body for Australia's main financial regulatory agencies. It comprises the Reserve Bank of Australia, the Australian Prudential Regulation Authority, the Australian Securities and Investments Commission and The Treasury.

Mr. Beblawi and Ms. Al-Riffai submitted the following statement:

We thank staff for their set of reports. We also thank Mr. Ray, Ms. Preston and Ms. Park for their buff statement. Australia continues to adjust well to the end of the commodity price and mining investment booms by relying on a series of adaptive macroeconomic policies and strong institutions that have culminated in the current above-trend growth. Solid growth in employment, corporate profits, and public demand are expected to buoy the rest of the economy; however, the housing market correction, as well as lower growth in China and a tightening of the global financial environment, present some downside risks. We broadly concur with staff's analysis and make the following comments for emphasis.

With the economy moving toward full-employment, the authorities' medium-term fiscal strategy appropriately plans to reach a balanced budget by FY2019/20 and run surpluses onwards. The government is committed to reprioritizing spending towards infrastructure expenditure and stabilizing recurrent spending. We welcome the continued growth in public investment and the positive growth implications it is expected to have on the economy and productivity. Staff states that there is considerable fiscal space to further increase infrastructure spending; however, capacity constraints have held back implementation. The buff statement confirms that some capacity constraints and skills shortages are emerging, which would potentially be amplified by a further lift in infrastructure spending. We sympathize with the authorities' view that, given the current point in the cycle and as a small open economy, Australia needs to preserve fiscal space, as a buffer, to deal with adverse shocks should they materialize. Debt levels are currently low, and the authorities intend to use accumulated fiscal surpluses to bring down debt. Adverse shocks with protracted effects, however, may make it difficult to attain this objective. We, thus, see merit in staff's recommendation to introduce a more explicit link between debt levels and budget balance objectives with the former relying on numeric rather than on qualitative objectives.

Australia's financial sector is sound, its supervision conforms to international best practices, and recent stress tests indicate that the banks are resilient to significant shocks. Nonetheless, and though the authorities have taken steps to further strengthen banks' lending standards and resilience, vulnerabilities remain. The FSAP highlights that the still elevated household debt ratios and housing price overvaluation are a source of macrofinancial risk. Exposure to the residential real estate sector remains high, accounting for more than half of bank lending, one third of which are in higher-risk interest-only mortgages. Staff are concerned that in the event of a sharp real estate market correction, present macrofinancial linkages may send the economy into a loop of falling real estate valuations, higher NPLs, tighter bank credit, and weaker growth. The buff states, however, that many households have built significant mortgage buffers and that household debt is skewed towards high-income households where the top 2 quintiles hold over 60 percent of household debt. Staff comments are welcome. We positively note the steps the authorities have taken to strengthen bank lending standards and resilience, including the Australian Prudential Regulation Authority's request that banks pay closer attention to high-LTV loans and borrowers' DTI metrics in recent years, requiring enhanced reporting on the latter. We encourage the authorities to work towards improving the granularity and consistency of data collection and its provision for the sector. This would provide a crucial input to policy formulation, as well as to the timely analysis of systemic risks. To that end, we welcome the introduction of the Comprehensive Credit Reporting regime in 2018 and look forward to further improvement in the sector's data.

The authorities have implemented a range of demand and supply side policies aimed at promoting housing affordability, as well as safeguarding micro financial stability. As a result, the economy has witnessed a moderation in demand for residential housing by both domestic and foreign investors, greatly contributing to a smooth housing market correction. Nonetheless, high population growth in urban areas and robust economic growth will still likely place upward pressures on housing prices. On the supply-side, the authorities are putting in place policies to increase housing supply over time, including using City Deals - agreements across all levels of government - that integrate planning and infrastructure delivery for new developments and redevelopments. Since planning, zoning, and other supply side reforms may affect supply and prices with a long lag, and given that the current housing market downturn is taking place amidst a period of strong growth, high urban population growth, relatively low interest rates, and low unemployment (Box 2), we encourage the authorities to maintain their vigilance in monitoring the housing market developments.

Mr. Mahlinza and Mr. Nakunyada submitted the following statement:

We thank staff for a comprehensive report and Messrs. Ray, Preston, and Park for their helpful buff statement.

Australia's economic performance has gathered pace, benefitting from a strong macroeconomic policy stance, as well as growth in domestic demand.

Looking ahead, sustained recovery is subject to risks emanating from global economic developments and domestic macro-financial vulnerabilities. Against this background, policy priorities should focus on rebuilding fiscal buffers, continued implementation of prudent policies, containment of financial vulnerabilities, restoring housing affordability, and supportive structural reforms to uplift productivity. We broadly share staff's assessment and provide the following remarks for emphasis.

We commend the authorities for adopting an accommodative fiscal policy stance that has supported aggregate demand and stimulated growth. At the same time, we support government's medium-term strategy to achieve a budget balance and eventually generate surpluses that will be essential to rebuild buffers and preserve debt sustainability. The authorities should, however, stand ready to adjust the fiscal policy stance, as the economy progresses towards full employment. In addition, we underscore the need to utilize the available fiscal space to support well-sequenced and growth-enhancing public investment projects to meet the development needs of a growing population. While we agree on the need for medium term debt anchors to augment the medium-term fiscal strategies, we wonder if staff has conducted preliminary work on fiscal implications going forward. Staff comments are welcome.

Addressing structural vulnerabilities would be important to ensure financial stability. In this regard, the authorities should sustain efforts to reinforce sound lending practices including on mortgages and enhance capital buffers to strengthen banking sector resilience. The maintenance of stringent lending requirements will be necessary on the backdrop of accumulated debt vulnerabilities in the housing market and rising borrowing costs. We also welcome notable strides made to strengthen the AML/CFT framework to ensure the integrity of the financial system. That said, we encourage the authorities to expedite implementation of the 2018 FSAP recommendations to strengthen the systemic risk oversight and bolster supervisory and crisis management capacity. Furthermore, an enhanced macroprudential toolkit remains essential to increase responsiveness to financial stability risks.

Housing market reforms remain critical to restore housing affordability. In this regard, we support the authorities' efforts to increase housing supply in a coordinated manner, through City Deals. This notwithstanding, the strong housing demand from a rapidly growing urban population could render the on-going housing market correction insufficient and limit the effectiveness of City Deals. Against this background, we urge the authorities to accelerate housing supply reforms and streamline and consolidate the planning and zoning regulations. In addition, we urge the authorities to reconsider the discriminatory aspects of the housing policy, given the decline in real estate demand from non-residents. Further, changes to key tax parameters affecting housing demand and land use, including the introduction of broad-based land taxes, would help strengthen the supply response.

Implementation of structural policies would be important to provide impetus to growth prospects. To this end, we underscore the need for increased infrastructure investments to lift productivity and durable growth. We also underscore the need to increase infrastructure spending to bridge existing gaps, and support maintenance and rehabilitation of existing infrastructure. In addition, we emphasize the need for tax reforms to enhance efficiency and productivity through the shift from direct to indirect taxes, and the streamlining of tax concessions. That said, we welcome the progress made by the authorities on the energy policy as important to improve investor confidence.

Mr. Tombini, Mr. Saraiva and Ms. Florestal submitted the following statement:

We thank staff for a useful set of reports and particularly for the detailed analysis of Australia’s fiscal strategy and the Financial Sector Stability Assessment. We also thank Mr. Ray, Ms. Preston and Ms. Park for their enlightening buff statement.

We concur that the current macroeconomic policy stance is appropriate and should remain supportive, given existing fiscal space and subdued inflation. As underscored by Mr. Ray and colleagues, Australia’s strong institutional framework and proper macroeconomic policies have underpinned continuous economic growth in the past decades. In 2018, accommodative monetary policy and a supportive fiscal stance buttressed the acceleration of the Australian economy. That notwithstanding, inflation remains below target and the tepid increase of disposable income and wages dampened consumption growth, even as strong labor market conditions prevail. Sustained public infrastructure spending has been an important mainstay of aggregate demand and will help close the gap with other advanced economies over time, boosting productivity and potential growth.

We see merit in staff’s suggestion to complement the budget balance anchor with a debt anchor with a view to preventing large debt swings. The current fiscal framework is anchored around a balanced budget with no explicit reference to debt. Public debt remains low but has drifted up, pressed by shocks with protracted effects. The authorities' intent to carefully weigh up staff's suggestion is welcome. While the economy is projected to return to fiscal surpluses, the authorities should also consider staff's advice to avoid the potential inconsistency between a rigid application of the tax to GDP ceiling and running surpluses in the cyclical upswing.

Views converged on the need to keep monetary policy accommodative, however staff's call for the RBA to be clearer about which labor market conditions will determine policy normalization seems unpersuasive. Whilst the current and prospective conditions in the relevant time horizon clearly support an accommodative stance, communication should continue to help the agents' understanding of the factors shaping monetary policy over time. That said, monetary authorities are aware of the risks of tying themselves to a rigidly predefined course of action in an environment of uncertainty. Monetary policy should remain committed to inflation targets and responsive to economic developments, while the risks entailed by the voluminous household debt need to be properly weighed in. Moreover, the nexus of the high household debt with the channels of monetary policy transmission adds complexity to the normalization process and will require continuing judgment along the way. Could staff elaborate more on the findings of the forthcoming IMF Working Paper referred to in the report?

The Government's multi-pronged approach to housing sector imbalances and vulnerabilities have born fruits, but risks need to continue to be closely monitored. As noted in the staff report, "banks have strengthened their lending standards in response to the tightening of macro prudential measures". Nonetheless, concerns related to further abrupt correction in the housing market persist and may require further response from the authorities. Staff also reiterates the advice to reconsider measures that discriminate between residents and nonresidents arguing that "they may no longer be needed to address housing market imbalances". In our view, the reduction in housing starts and approvals underscored in the staff report may conceivably translate into increased gaps between supply and demand going forward. Hence, while we see room for the modification of key tax policy parameters affecting housing demand and land use, we wonder if it is not premature to remove existing policy measures including those that discriminate between resident and nonresident buyers. Staff's comments would be appreciated.

While external risks are clearly tilted to the downside, domestic risks seem more balanced, except for the risk of further sharp deterioration in the housing markets. We take note that staff attributes high probability to both rising protectionism and risks of fragmentation and security dislocation, with strong impact on Australia. It is also underscored that such impact would be exacerbated the larger the effect of trade tensions on China. As underscored in the buff statement Australia's openness and diversified trade partners should play a counterbalancing role. Nonetheless, the elevated number of external downside risks does not bode well. It is also notable that monetary easing is highlighted as the main policy reaction to every downside risk, which raises questions about the space for such response in case some of the risks materialize. Staff's comments would be appreciated.

The financial system remains robust and resilient, bolstered by new supervisory measures and the tightening of credit standards, which led to the origination of fewer loans with very high loan-to-value ratios and fewer interest-only loans, further reducing risks. An increase in earnings and profitability in the banking sector has been registered, whereas the data on the evolution of NPLs is not conclusive. Could staff elaborate on the sources of greater gains in the financial sector and if the asset quality of the system has strengthened? The reports, while acknowledging the strength of the financial system, underscore that vulnerabilities are still present and that there is room to reinforce oversight. In this regard, the authorities' continued commitment to improve regulatory frameworks and supervision practices reassures that the most critical FSAP's recommendations will be properly considered.

Mr. Lopetegui and Mr. Morales submitted the following statement:

We thank staff for their comprehensive staff report and Mr. Ray, Ms. Preston, and Ms. Park for their informative buff statement.

Australia maintains above-trend growth rates following a minor downturn, despite facing the largest terms of trade shock in their history, as explained by Mr. Ray, Ms. Preston, and Ms. Park in their buff statement. The economy is expected to reach full employment over the next few years, thanks to consistent macroeconomic policies, flexible markets, and strong institutional frameworks. As in other advanced economies, inflation remains below target and wages are not increasing in line with higher employment. Rising participation in the labor market and a pick-up in public and private investment should support higher wage and price growth that would sustain the proverbial dynamism of the Australian economy. Higher wages and lower unemployment and underemployment would also help mitigate emerging macro-financial risk arising from a housing market correction and still-high mortgage debt levels.

Macro-financial policies should aim at supporting growth, containing financial risks, and building buffers to address external shocks that may arise as the global economic environment weakens. In this regard, we broadly agree with the staff's recommendations on policy priorities, namely maintaining a supportive macroeconomic policy stance, strengthening macroprudential tools, and continuing efforts to raise potential growth. These policies would ensure a successful consolidation of the ongoing process of adjustment and rebalancing. In this regard, reducing the infrastructure gap would help Australia to address structural challenges related to its high exposure to China-related risks and rapid population growth. However, we agree with the Australian authorities that this effort should focus on high-quality investment, in line with well-established processes to prioritize key infrastructure projects based on robust business cases, and mindful of cyclical considerations and capacity and skills constraints, as explained by Mr. Ray, Ms. Preston, and Ms. Park.

Fiscal policies have remained appropriately growth-supportive following the end of the mining investment boom. We note that the government's medium-term fiscal strategy aims at a return to budget surpluses in FY 2019/20 as indicated by Mr. Ray, Ms. Preston and Ms. Park, consistent with the Charter of Budget Honesty Act. Given Australia's substantial fiscal space, this would still allow for higher spending on education, health care, and aged care, in addition to the infrastructure investment effort. In this regard, we agree with staff that the projected surpluses under the baseline outlook should not be cut short prematurely through tax-cuts and/or higher non-priority spending. By the same token, the authorities should stand ready to use fiscal space to address external shocks should they materialize. In this regard, the selected issues paper identifies some options to counteract political economy risks and rigidities in the existing framework, which may be more pressing in the future given limited conventional monetary policy space. However, we wonder if in the current juncture of very low public debt, adding a debt anchor to the existing framework, would introduce additional rigidities to fiscal policy in the event of an external shock. Staff's comments on what the appropriate conditions would be to introduce such modifications are welcome.

We concur with the authorities that the accommodative stance of monetary policy has supported the transition to rebalancing the economy. Inflation has remained subdued and is expected to return gradually toward the mid-point of the target. The transition to lower levels of mining investment is a significant structural change that fully justifies the current monetary policy stance. The flexible inflation-targeting framework and flexible exchange rate regime have contributed to minimize uncertainty throughout this process, and the expected gradual process of adjusting the policy rate to become positive in real terms appears prudent in light of the expected pick-up in inflation and wages.

The authorities should closely monitor the ongoing housing market correction. Strong population growth in some jurisdictions has translated into stable rental vacancy rates despite an increase in the housing supply and slower housing credit growth. Rising interest rates for new mortgages are still below those for existing mortgages despite new prudential measures and tightening of banks' lending standards. We agree with staff that any impact on bank asset quality should stay modest in the context of strong growth and higher participation in labor markets. To support this, macro-financial policies should aim at an orderly reduction of household debt ratios while house price overvaluation reverses. Gradual but decisive steps to reinforce the prudential framework would also help contain the risk of sharp swings in the event of a rapid tightening of global financial conditions spilling over into domestic financial markets and triggering sudden hikes in funding costs and a consequent reduction of debtors' disposable income, as highlighted by staff. While we understand the authorities concerns about an excessive reaction of commercial banks unduly reducing credit flows, we wonder why raising the cap on interest-only loans to 30 percent of new loans was necessary to "provide more flexibility in the pace of conversions of interest-only loans to principal-and-interest loans". Also, what is the share of interest-only loans in the loan portfolio? Staff's comments are welcome.

Australian banks show higher capitalization and profitability compared with international peers and have recently switched to more stable funding sources. We note that many FSAP recommendations are in line with the authorities' reform agenda, in particular on strengthening the crisis management framework. In this regard, we support the staff recommendation to integrate systemic risk analysis and stress testing into supervisory processes. Stress tests found that the ten largest banks are resilient to combined shocks, although vulnerabilities related to reliance on wholesale funding warrant monitoring. In this regard, we welcome the introduction of a net stable funding ratio and a timeline for the adoption of a minimum leverage ratio. Could staff elaborate on to what extent these regulations would reduce this vulnerability in the period ahead? We agree with staff that broadening the set of macroprudential tools would facilitate a timely response in the event of unexpected shocks, especially since their introduction would require a preparation period to gather the relevant data and ensure consistency of regulatory changes with the existing legal and regulatory framework. Some of the tools recommended by staff such as loan-to-value caps and loan/debt-to-income limits are increasingly used to this effect in comparable jurisdictions.

We commend the authorities for their commitment to a cooperative multilateral trading framework. The new TPP-11 provides an important framework to expand trade with key partners and would support Australia's efforts to diversify markets. Combining these efforts with progress on closing infrastructure gaps, narrowing gender inequality, enhancing R& D, upgrading energy policy, and expanding tax reform, would go a long way in ensuring higher productivity and higher potential growth in the medium term.

Finally, we encourage the authorities to expand the AML/CFT regime to cover non-financial institutions assessed as presenting higher risks in this area.

Mr. Mojarrad submitted the following statement:

We thank staff for the comprehensive set of papers, and Mr. Ray, Ms. Preston, and Ms. Park for their insightful buff statement.

Australia has continued to deliver a commendable economic performance, with above trend growth, low unemployment, and below-target low inflation. The fiscal position is in near balance, the external current account deficit is small and narrowing, and the financial sector is strong and well supervised. These achievements are the result of sound macroeconomic management and a strong policy framework, underpinned by the authorities' commitment to open trade and immigration policies, free capital movements, and a flexible exchange rate regime. With the transition toward a service-based economy well on track, policies will need to continue to address vulnerabilities associated with the housing market and household debt while raising potential growth through infrastructure investment, tax reform, and productivity-enhancing reforms. We agree that several risk factors, external and domestic, could weigh down on the medium-term growth outlook, while noting the availability of fiscal space and policy flexibility to mitigate their impact. We are in broad agreement with the staff appraisal and offer the following comments.

The macroeconomic policy mix is appropriate. We agree that monetary policy should remain accommodative in the absence of upward pressure on wages and prices, which would be the case if the slack in the labor market is reduced only gradually and inflation picks up slowly from its current low level. We trust that the Reserve Bank of Australia's communication strategy and its flexible inflation targeting framework would effectively respond to developments in these areas. Fiscal policy and the flexible exchange rate regime should provide the needed buffers against exogenous shocks or below-potential growth going forward.

Fiscal policy has been anchored on the principles outlined in the Medium-Term Fiscal Strategy (MTFS) and the Charter of Budget Honesty Act, including the principle of building budget surpluses in good times. We welcome the indication by Mr. Ray, Ms. Preston, and Ms. Park that the fiscal position will return to a surplus in 2019-20 which could possibly exceed 1 percent of GDP over the medium-term. Striking the right balance between supporting investment in infrastructure and productivity growth through lower taxes on the one hand and maintaining fiscal space to address exogenous shocks on the other is critical during the ongoing transition to the post commodity price and investment boom. The interesting SIP on Australia's fiscal framework usefully explores possible options to strengthen the MTFS as a fiscal anchor, including adding a medium-term debt anchor. While we note the authorities' willingness to consider these suggestions, as mentioned in the buff statement, we ask staff to comment on the political traction of such a policy advice given Australia's low debt relative to other advanced economies and the fact that the current fiscal framework seems to have worked well so far.

The financial system remains sound and resilient with well capitalized banks and low NPLs. We welcome the indication that the orderly housing market correction is continuing and its negative effects on banks' balance sheets remain modest. In the context of the high household debt, a faster correction in housing prices is a downside risk to the growth outlook that can be a source of concern. However, with demand still high, including from high population growth, we underscore the importance of strengthening the macroprudential policy toolkit to address potential risks to the financial sector from another house price boom, while also improving supply of housing units. We note the differences of views between staff and the authorities regarding the assessment of regulatory independence, as highlighted in the buff statement, and see merit in reaching common understanding taking into account Australia's specific conditions.

We support the authorities' structural reform agenda, which is appropriately geared toward reducing the infrastructure gap, promoting innovation through increased spending on research and development, and fostering productivity and inclusion through tax reform. We encourage sustained implementation of these reforms, together with energy policy reform to help raise potential growth over the medium term.

With these comments, we wish the authorities further success in their endeavors.

Mr. Jin and Ms. Lok submitted the following statement:

We thank staff for the set of reports and Mr. Ray, Ms. Preston, and Ms. Park for their useful buff statement. The Australian economy continues to perform strongly as it approaches the end of its adjustment, and growth is projected to stay above-trend in the near term. While growth momentum is expected to moderate against the background of a weaker global environment and downside risks to the outlook have increased, Australia's robust institutions, sound macroeconomic policy management, and diversified economy make it well-placed to weather through challenges. We broadly agree with staff's appraisal and would like to confine ourselves to the following comments.

We welcome the increase in infrastructure investment, which has provided support to aggregate demand and can help boost potential growth in the longer term. While staff viewed that consideration should be given to further increasing infrastructure spending, we believe this also needs to be balanced against the need to maintain fiscal buffers in an uncertain external environment, as well as capacity constraints. We therefore welcome the authorities' emphasis on quality of infrastructure investment, rather than quantity, and their prioritization of projects with sound business underpinnings.

As Australia's largest trading partner, we support the authorities' strong commitment to trade openness and promoting the global multilateral trading system. Given Australia's strong linkages with China, developments in China such as the ongoing trade tensions with the US and China's continued economic rebalancing would have implications for Australia's economic outlook. Staff's earlier analysis suggested that factors including Australia's diversified economy, exchange rate flexibility, and well-established trade relations in the region could help mitigate effects from a possible shock from China. Could staff share any latest estimates or analysis on the potential size of the impact of the China-US trade tensions on Australia? While trade tensions between China and the US could pose downside risks to Australia, we wonder if there are also potential upside effects from a reduction in trade between China and the US, such as diversion of agricultural and services (including education services) imports by China from the US to Australia? Staff's comments are welcome.

We take positive note of the significant steps by the Australian authorities to strengthen the financial system since the previous FSAP, which have significantly improved banks' resilience to shocks. We welcome the authorities' commitment to continue improving regulatory frameworks and supervision practices and look forward to positive outcomes of the broader reforms underway in the financial sector. In the meantime, continued vigilance is warranted in the face of vulnerabilities that could arise from elevated household debt and the housing market. We take some comfort, however, from the buff statement that household balance sheets are generally strong, and the distribution of debt is skewed towards high income households. Could staff explain a bit more on the relationship between household debt and offset accounts, and to what extent do these offset accounts could provide a buffer?

On systemic risk oversight, it appears the current institutional framework has served Australia well. APRA's efforts to consult other members of the Council of Financial Regulators (CFR) despite having no obligation to do so suggest a cooperative relationship across the agencies. The success of the mutually reinforcing efforts by APRA, ASIC, and the RBA in tackling the rapid growth of investor loans and interest-only loans also suggests effective coordination. We welcome the recent improvements in the transparency of CFR activities, and encourage the authorities to continue their close collaboration in monitoring and managing risks in the financial system.

While we recognize the importance of regulatory independence, we also see the need to appropriately balance independence with accountability. So far, it does not seem that APRA's operational independence has been undermined, and we wonder if removing checks and balances would necessarily improve the current framework in place. Meanwhile, we take positive note of the additional funding announced for ASIC and APRA in the second half of 2018.

With these remarks, we wish the authorities every success in their policy endeavors.

Mr. Sigurgeirsson and Mr. Bernatavicius submitted the following statement:

We thank staff for their informative reports and Mr. Ray, Ms. Preston, and Ms. Park for their useful buff statement. We broadly support the staff appraisal. Robust regulatory and fiscal frameworks, a strong banking sector, and flexible labor and product markets indicate that Australia is well paced to take on current challenges such as weak productivity growth, high household debt levels, and imbalances in the housing market. We urge the Australian authorities to promote lagging productivity growth by continuing to address infrastructure gaps, strengthening innovation and R&D capacity, and reducing the gender gap in the labor market.

Recent prudential policy measures have proved effective in dampening growth in high-risk lending and reinforced sound lending practices. We agree with staff's recommendation that further regulatory tightening may not be warranted at this stage. Nevertheless, we urge the authorities to closely monitor the situation and stand ready to activate further measures, if warranted. In addition to this, a broader set, including DTI/DSTI and LTV restrictions should be further explored to enable more flexible responses to financial stability risks in the future.

We broadly support staff's recommendations provided in the Financial System Stability Assessment, including the need to strengthen the independence of APRA and ASIC and enhance transparency of the CFR. We welcome the recent decision taken by the authorities to publish a statement following each of the regular quarterly meetings of the CFR.

While the housing market correction is helping housing affordability, it remains near all-time lows. As the underlying demand for housing is expected to remain strong due to high population growth and appropriately accommodative monetary policy, supply-side reforms should not be delayed. Staff notes the diminishing role of nonresidents in the housing market, which should provide the authorities an opportunity to ease discriminatory measures against foreign buyers in residential real estate markets, in line with the institutional view on capital flows (IV).

Household debt is one of the highest in AEs and major Australian banks have significant exposures to the real estate sector. Wholesale funding, although diminishing, remains around one-third of total banks' funding of which nearly two-thirds is from international sources, which may give cause for some concern. We take note of the useful information provided in the BUFF statement, which states that households from the top two income quintiles are responsible for about 60 percent of Australian household debt. While the level of debt remains a concern, as it is difficult to predict the impact of any potential downturn, we agree, that this distribution could enhance debt sustainability somewhat.

We welcome recent steps taken to enhance relatively weak productivity growth. Macro-critical gaps for infrastructure, gender equality, R&D, energy policy, and general tax reform are closing, but at an uneven pace. Higher female and old-age labor force participation and increased infrastructure spending, which has been a catalyst for the economic rebalancing, are the two most prominent examples of success. We see scope for additional measures in the other areas mentioned above.

We agree with staff's recommendation to consider placing more emphasis on a debt anchor in fiscal framework. While Australia's public public-debt-to-GDP ratio is relative low, recent experience demonstrates, that there can be a considerable upward drift in debt ratios from protracted shocks. Given the limited conventional monetary policy space and an environment in which discretionary fiscal stimulus might be needed more frequently, the role for a debt anchor in the fiscal framework might be considered. We also share staff's view that some of the recent revenue strength may well turn out to be more temporary than expected.

Mr. Meyer and Mr. Fragin submitted the following statement:

We thank staff for an informative and comprehensive set of reports and Mr. Ray, Ms. Preston, and Ms. Park for their helpful buff statement. The current macroeconomic environment and the short-term outlook are fairly comfortable, with an overall solid fiscal position and the labour market on a path to full employment. At the same time, the economic momentum is expected to level off in the medium term. The major domestic risk to the outlook stems from the real estate market that requires continued close monitoring. In addition, a weakening of the external environment, in particular in China, would have negative spillover effects due to Australia's high degree of international integration. In this context, we welcome the authorities' commitment to the promotion of an open and rules-based multilateral trading system.

The fiscal framework in place has proven expedient to medium-term fiscal stability and sustainability. At the same time, as staff notes, a medium-term budget balance anchor runs the risk of surges in public debt levels during a shock, which are subsequently not reversed by corrective surpluses. We therefore see merits in staff's deliberations on a medium-term debt anchor as a complementary element to maintain prudent debt levels.

With regard to staff’s line of argument for expanding infrastructure investment to provide for a steady growth impetus, we would put greater emphasis on the quality of public investment. The desired public capital stock, in our view, should not be seen as a simplistic function of potential GDP but ultimately depends on more complex public welfare considerations. Furthermore, the assessment of infrastructure investment should consider technical and economic feasibility on a project-level to provide for best value for money, which is not fully ensured under a regime of targeting numerical ex-ante investment objectives. This is not to deny that infrastructure investment should play a crucial role in Australia’s fiscal and economic policy strategy, but should be seen as a pledge to take due considerations of quality instead narrowly focussing on quantities.

Although the correction in the housing market has not affected financial and economic stability, it is imperative to closely monitor developments, going forward. Compared with earlier episodes of downturns in the housing market, households are now on average burdened with higher debt levels and thus more vulnerable in the event of a major price correction. In this context, prudential measures have been put in place and contributed to stricter lending standards. For reasons of precaution, it might be advisable to keep further macroprudential measures readily available if macrofinancial risks become manifest. Moreover, to the extent that staff sees signs that the foreign capital inflow surge into housing has abated, we see merit in exploring effective alternatives to housing policy measures discriminating between residents and non-residents.

Notwithstanding the challenges arising from the above-mentioned accumulation of private indebtedness and the housing market, we take positive note that the financial system has been strengthened since the last FSAP. We appreciate the strong regulatory and supervisory framework and are encouraged by the authorities’ commitment to reinforce the framework with a view to improving systemic risk oversight and bolstering supervision and financial crisis management arrangements.

We broadly concur with staff’s assessment of areas for structural reforms to stimulate productivity growth. Given the importance of promoting R&D and private sector development in knowledge-intensive sectors, we would be grateful if staff could share some additional insights on the implemented recommendations drawn from the ‘2030 Strategic Plan for the Australian Innovation, Science, and Research System’.

The monetary policy stance seems appropriate at the current stage. We note that staff projects inflation to durably return to the midpoint of the RBA's target range in the coming years. We broadly agree with staff and the authorities that monetary normalization has to be pursued gradually. Nevertheless, vigilance is warranted as wages could rise after employment approaches supply constraints (unemployment seems fairly close to the estimated NAIRU and wage growth has been on an upward trend). Similarly, disinflationary effects from stronger retail competition could eventually diminish once markets have adjusted to the new competitive environment.

Ms. Levonian and Mr. Hart submitted the following statement:

We thank staff for their well-written reports and Mr. Ray, Ms. Preston, and Ms. Park for their useful buff.

Australia's economy continues to perform well, supported by strong institutions, policies, and regulatory frameworks that aim to minimize vulnerabilities and raise potential growth. Australia's openness to trade, investment, and immigration is commendable. This openness naturally comes with risks, but Australia's authorities have shown themselves to be adept at navigating this reality by building buffers and diversifying their economy. That said, longer-term challenges of raising productivity and adapting to the economy of the future should remain top priorities. We encourage the authorities to sustain their support for both higher and more inclusive growth, which will continue to serve Australia's economy and its citizens well.

Australia's current macroeconomic stance is about right. Fiscal policy is balancing a strong push for high-quality, growth-supporting infrastructure investment while still aiming to reduce public debt. The latter will help create additional fiscal space in the event of a negative shock. Monetary policy should remain accommodative until inflation and wage pressures firm up. External sector risks appear to be manageable, while the flexible exchange rate serves as an important buffer. Since the authorities share staff's assessment of the outlook and risks, we will focus our comments on a few specific points.

Managing housing market risks will require continued close monitoring and action along multiple fronts. Australia's elevated household debt, combined and domestic bank exposure to real estate, can amplify downside shocks, although strong household and bank balance sheets are mitigating factors. We are encouraged by indications that Australia's macroprudential measures (MPM) have helped to cool the housing market in a targeted way. This is taking place in otherwise favorable economic conditions, minimizing broader risks to economic growth. Nevertheless, ongoing vigilance is needed, and we note staff's recommendation to expand the MPM toolkit to deal with potential future risks. Further supply-side reforms are also needed to address housing affordability issues.

Structural reforms should focus on raising potential and inclusive growth. We welcome the focus on investing in quality infrastructure, as well as reforms to make the personal income tax system more progressive. We share staff's view that a greater focus on innovation, research and development, and education is warranted. Since fostering innovation is notoriously challenging, we encourage the authorities to experiment with a variety of approaches. We are also encouraged to see that the authorities' concerted efforts to reduce the gender gap in labor markets is bearing fruit in the form of higher rates of labor force participation by women (as well as older workers) in recent years. Do staff know whether higher female LFPR is contributing to a smaller gender pay gap (e.g., per annum/per hour)?

The FSAP confirms that Australia's financial sector is sound and well-supervised, although there is room for improvement. Good progress has been made since the 2012 FSAP and the banking sector is well-capitalized, profitable, and resilient to identifiable shocks. We welcome the authorities' intention to consider many of the FSAP's recommendations as part of their broader financial reform agenda. This should include strengthening (and applying) regulatory enforcement powers, fostering greater competition in the banking sector, and better integrating and coordinating bank resolution frameworks. However, we do not find that staff have provided a compelling case to increase the formality of the Council of Financial Regulators. Can staff elaborate on their claim that the current, more informal system creates a bias towards inaction? Can staff further elaborate on the potential costs, as well as the benefits, of moving to a more formal system? More generally, we would encourage staff to focus their advice on "best fit" over "best practice," particularly when proposing changes to a system that has served a member well.

Mr. Kaya and Mr. Hagara submitted the following statement:

We thank staff for the comprehensive set of reports and Mr. Ray, Ms. Preston and Ms. Park for their informative buff statement. Navigated by prudent policies and strong institutions, Australia continues its impressive long period of uninterrupted economic growth, extending it to 27 years. We broadly agree with the staff appraisal and would like to add the following comments for emphasis.

Close attention to housing market related vulnerabilities remains key in the short to medium term. We take positive note of the recent decline in housing price growth due to lower demand, higher supply as well as tighter lending requirements. The decline of interest-only loans is welcome, and we encourage the authorities re-introduce the cap on interest-only loans should this downward trend reverse. Nevertheless, given the vulnerabilities accumulated over the period of dynamic house prices growth, including high household debt and banks' exposure to real estate, further actions should be carefully balanced to avoid a disorderly correction in the housing market. At the current stage, we commend the authorities' progress with using City Deals and encourage them to continue with supply-side measures to address the longer-term housing needs of a growing population. We also see merit in preparatory work to extend the authorities' macroprudential toolkit to borrower-based instruments.

We encourage the authorities to address the FSAP recommendations. Australian banks are profitable and, reflecting more conservative capital adequacy requirements, well capitalized and resilient to shocks. Nevertheless, while the progress in reducing banks' dependency on external wholesale funding is welcome, the remaining vulnerabilities should be monitored. The authorities are well-advised to strengthen the supervision and resolution frameworks, while the systemic risk analysis needs to be supported by improved data collection and better integrated into supervisory processes.

While the unemployment rate continued to decline, the underemployment rate points to a continued slack in the labor market. Headline inflation hovers around the lower end of the Reserve Bank of Australia's target range. Against that backdrop, the current accommodative monetary policy stance seems warranted. At the same time, Australia's strong trade linkages to China brought benefits in terms of growth, but the authorities will need to be vigilant about potential risks. The flexible exchange rate has served Australia well and could serve as a tool to absorb external shocks.

The authorities stay the course of a responsible fiscal policy and are on track to reach their medium-term balanced budget objective. The fiscal deficit in FY2017/18 is projected to be lower than budgeted on the account of stronger revenues. In turn, while allowing for higher spending in priority areas, the authorities now aim to reach a balanced budget in FY2019/20, one year earlier than planned during the 2017 Article IV Consultations. In view of the rapidly growing population, rebalancing the expenditure mix away from recurrent spending towards more well-targeted infrastructure expenditures, seems warranted. We would welcome staff's more detailed comments on the strategy and measures through which the authorities plan to achieve the reduction of recurrent spending, including the wage bill.

Mr. De Lannoy and Mr. Jost submitted the following statement:

We thank staff for the comprehensive set of papers regarding both the Article IV consultation and the FSAP, and Mr. Ray, Ms. Preston, and Ms. Park for their informative buff statement. We welcome the strong performance of the Australian economy in recent years, including the robust employment data. Sound and predictable economic and fiscal policies, including relatively low public and stable debt levels, have contributed to this success. We welcome the authorities' awareness of downside risks and their commitment and strategies to address them. Overall, we broadly agree with staff's key recommendations.

While we agree with staff that infrastructure investment is necessary to continue adapting the Australian economy to the challenges that lie ahead, it will also be vital to monitor the quality of public investment, as highlighted by Mr. Ray in his buff statement. In this sense, we welcome the authorities' plans to maintain appropriate levels of quality investment, including in infrastructure, and their efforts to address capacity constraints. We support the authorities' commitment to responsible fiscal policies. Indeed, as an open economy, and as the RAM illustrates, Australia is exposed to a number of external risks, including those posed by trade tensions. Keeping fiscal room for maneuver should be part of the risk management strategy, also in light of financial market vulnerabilities that continue to exist on the national level. In that sense, we see merit in staff's recommendation to upgrade the fiscal framework by including medium-term debt anchors. We also agree with staff that continuing to increase female participation rates, fostering R&D and updating energy policies will likely contribute to a continuation of the economic success Australia has known in the past.

We share staff's view that the current accommodative monetary policy stance has allowed Australia to advance in its economic rebalancing after the end of the mining boom, strengthening the domestic economy by encouraging business investment and accommodating the structural change in labor and product markets. At the same time, we would like to caution against further policy rate reductions as financial stability risks might be larger than risks of low inflation. We agree with staff that normalization of monetary policy should be gradual.

We welcome the authorities' commitment to addressing financial market vulnerabilities, that continue to exist -in particular in the real estate market- in line with FSAP recommendations and would like to use this opportunity to offer a few comments.3, 4, 5

In light of the current high household debt levels, the ongoing housing market correction and the funding vulnerabilities identified in the banking sector, we believe that efforts remain necessary to limit liquidity risk in the banking sector from spreading to the rest of the financial system. Conducting additional analysis that aims to capture systemic liquidity risk in addition to monitoring liquidity risks at the institution level, might be useful. We would also like to encourage the authorities to strengthen the macroprudential toolkit, especially with regard to housing.

Encouraging Australian banks to lower their reliance on wholesale funding is a positive step towards reducing liquidity risk in the banking sector. Additional monitoring may be needed to ensure that banks follow suit. The authorities should closely monitor LCR and NSFR ratios varying the weights applied on short-term wholesale funding. Stricter measures (through Pillar 2) could be taken if banks violate the LCR requirement.

We see merits in carrying out a liquidity analysis at the system level, rather than solely bank by bank. The largest Australian banks are major liquidity providers, and liquidity problems in one bank can spread to other banks and financial institutions. Future liquidity analyses could incorporate both direct and indirect interconnections between banks (and non-banks) looking both at first and second round effects.

It could be useful to extend the current banking sector interconnectedness analysis shown in the stress-testing technical note beyond the 10 largest banks (including non-banks). An analysis of systemic liquidity could be carried out to see how different shocks that affect market liquidity could affect funding liquidity and vice-versa. While performing the

[3] ECB (2018). Systemic liquidity concept, measurement and macroprudential instruments. Occasional Paper Series No 214.
[4] ECB (2016). Lenders on the storm of wholesale funding shocks: saved by the central bank? Working Paper Series No 1884.
[5] Bank of Japan (2015). The interaction between funding liquidity and market liquidity: Evidence from subprime and European Crises. Discussion Paper No. 2015-E.

assessments, keeping in mind that liquidity metrics might be overly optimistic due to the current accommodative monetary policy environment could be relevant. Upcoming monetary policy normalization might trigger a correction that evaporates liquidity in the balance sheet of banks (and non-banks).

The authorities could also consider monitoring indicators including banks' contractual and behavioral cash-flow data, as well as the length of the re-hypothecation chain, the level of haircuts in repo transactions, margin calls on derivatives exposures and the spreads of bank funding in unsecured markets. Paying special attention to developments in the United States and United Kingdom is warranted, since Australia's largest banks are particularly exposed to financial institutions in these two countries.

Mr. Agung and Mr. Srisongkram submitted the following statement:

We thank staff for the set of reports and Mr. Ray, Ms. Preston, and Ms. Park for their informative buff. The continued strong performance of the Australian economy reflects the success of its economic rebalancing efforts and strong track record of sound macroeconomic management. Like other open economies, Australia faces many downside risks externally, particularly those relating to trade frictions and tightening global financial conditions. Against this backdrop, we commend the authorities for their commitment to global economic integration and their participation in the CPTPP as well as other trade negotiations with Asian economies. Domestically, risks pertaining to high household debt and overvaluation in the housing market remain. We agree with the broad thrust of the report and see merit in staff's recommendations to further augment the authorities' already-sound policy framework. In this regard, we note that it is important to focus on the substance of the policy advice and offer the following comments for emphasis.

Monetary policy should remain accommodative to further support domestic demand and return to the inflation target. Given remaining labor market slack and headwinds to private consumption and investment, we agree that a tightening cycle may be premature at this point. On staff's recommendation for more explicit RBA guidance on when labor market conditions would warrant policy normalization, the authorities' approach outlined in the buff appears to sensibly balance communication and flexibility objectives. In staff's view, are there specific areas in the RBA's current communication strategy that would benefit from further guidance?

The supportive fiscal stance remains appropriate. The authorities' commitment to budget repair and fiscal discipline has yielded substantial fiscal space. This should be managed responsibly, particularly given the potential downside risks to the economy. In this regard, we agree that infrastructure investment is an important avenue to boost growth potential, provided that the investments are judiciously channeled toward productive projects. We are encouraged by the authorities' focus on quality infrastructure investments and support their emphasis on conserving fiscal buffers at the current juncture. In the same vein, we appreciate staff's proposal to adopt, in addition to other improvements to the fiscal framework and MTFS, a medium-term debt anchor to contain upward drift in public debt. On balance, this will need to be considered in the broader context of maintaining policy flexibility as rightly noted by the authorities.

The financial sector remains sound, but risks pertaining to elevated household debt and overvaluation of house prices warrant continued vigilance. We welcome the authorities' continued efforts to strengthen the regulatory framework and note positively that stress tests affirm the soundness of the banking system. Meanwhile, high levels of gross household debt warrant continued close monitoring even as household balance sheets remain generally strong. Hence, we agree with staff that the authorities need to consider expanding their macro-prudential toolkit (e.g. debt-to-income ratio) so that they can act swiftly to reinforce lending standards should circumstances warrant. On the staff's assessment of regulatory independence, we share the authorities' view that well-designed check-and-balances with the government and parliament can foster transparency and accountability without impeding the regulatory agencies' operational independence.

The authorities' structural policy agenda is conducive to securing long-term growth. We agree with staff that further progress in closing the gaps in various key areas, especially for infrastructure and R&D, will pave the way for productivity growth. The ongoing pursuit of energy reforms and commitment to free-trade would also strengthen Australia's resilience against the negative impacts of volatile commodity prices and trade tensions.

Mr. Mouminah, Mr. Alkhareif and Mr. Keshava submitted the following statement:

We thank staff for the well-written set of reports and Mr. Ray, Ms. Preston, and Ms. Park for their insightful buff statement. We are in broad agreement with staff's analysis and policy recommendations and would limit our remarks to a few issues.

We agree that continued supportive macroeconomic policy stance is essential to help further rebalance the Australian economy amid below-target inflation and low wage growth. In particular, the current monetary policy is accommodative and should remain so for inflation to return to the target range. We also concur that higher infrastructure investment has provided support to aggregate demand and further increase should help raise productivity and support longer-term growth. In this regard, we take note of staff's recommendation that Australia could consider further increases in infrastructure investment given substantial fiscal space. Here, we would welcome staff elaboration on possible measures to address emerging capacity constraints and skills shortages and promote additional infrastructure investment.

We take positive note of the aim under the government's medium-term fiscal strategy to reach a balanced budget by FY2019/20 and run budget surpluses thereafter without undermining infrastructure investment programs. In this connection, we see merit in staff's recommendation to consider a role for medium-term debt anchors as a complementary element in medium-term fiscal strategies to mitigate any upward drift in the public debt from shocks with protracted effects. Here, we take note of recent press reports that the government will soon outline a plan to eliminate Australia's net debt within a decade to reach a "debt-free day". We would welcome staff elaboration on their recommendation on debt anchors whether these should include both gross and net debt?

The 2018 FSAP confirms the proactive measures taken by the authorities to further strengthen the financial system since the previous FSAP. These include increasing bank capital, reducing banks' dependency on wholesale funding, addressing rapid growth in riskier segments of the mortgage market, and enhancing financial supervision and systemic risk oversight. At the same time, the FSAP has brought attention to a number of challenges and we welcome the indication that the authorities will consider the FSAP recommendations in the context of the broader reforms to the financial system. On bolstering the independence and resourcing of the regulatory agencies, we are reassured by elaboration in the buff statement on the operational independence of Australian regulators. As regards the housing market, the authorities should remain vigilant to risks arising from the ongoing correction to housing prices and vulnerabilities associated with household debt dynamics.

With these remarks, we wish the authorities continued success.

Mr. Psalidopoulos and Ms. Lopes submitted the following statement:

We thank staff for the very insightful set of reports as well as Mr. Ray, Ms. Preston, and Ms. Park for the helpful buff statement. Australia has been having, for more than two decades, a remarkable economic performance; solid institutions and adequate macroeconomic policies implemented by the authorities played a key role for this outcome.

The current macroeconomic stance is adequate.

We fully share staff's advice on the need to continue with policy support for the completion of the rebalancing of the economy. Monetary policy should remain accommodative and public investment should continue to contribute to short term as well as medium term growth. We note that Australia has substantial fiscal space; in an event of a materialization of downside risks, authorities should proactively use this space as a countercyclical tool.

While risks loom, financial sector resilience should allow banks to weather shocks well.

The most significant downside risks to the Australian economy are a possible severe downturn in China as well as a disorderly adjustment of housing prices. In this context, the FSAP's stress tests is both insightful and reassuring. While a very severe shock is modeled to include the materialization of these events, the examined banks would still be meeting the minimum regulatory capital requirements.

Housing prices have started to correct, but affordability continues to be an issue.

We note that prices have started to cool-off also following the macroprudential measures implemented. While a disorderly price adjustment could pose significant risks, due to high household indebtedness and significant exposure of the banking sector to mortgage lending, we note that there is no evidence of oversupply and that strong growth and employment outcomes should mitigate possible wealth effects. Actually, the problem at this stage still continues to be affordability and the need to ensure adequate housing supply in urban areas.

Given the difficulty of assessing the structural fiscal position, structural decreases in revenues should be thoughtfully considered.

We note the introduction of a 23.9 percent of GDP cap (or speed limit, as the authorities describe it) on tax revenues; this can be a risk to achieving the medium-term fiscal objective. As staff, we encourage the authorities to look at this cap flexibly, and to carefully consider taking any measures with a permanent nature on the basis of an outcome that can be (unexpectedly) of a cyclical nature. Additionally, we would like to ask staff whether there are experiences in other countries where a similar rule has been introduced.

Mr. Trabinski and Mr. Heim submitted the following statement:

We thank staff for the insightful set of reports and Mr. Ray, Ms. Preston, and Ms. Park for their informative buff statement. The Australian economy remains in good shape and economic rebalancing after the commodity boom years has further advanced. The supportive macroeconomic stance, including the accommodative monetary policy and the boost of infrastructure investments, supported growth in 2018. In addition, labor market conditions have continued to improve, and inflation remains contained. Over the mid-term, the economy is expected to adjust gradually toward potential growth.

External risks have increased, while domestic risks primarily relate to the housing market. On the external side, risks to growth have increased notably owing to (i) the ongoing trade dispute between China and the United States; (ii) China's slowing growth, and (iii) a possible tightening of global financial conditions. Domestically, risks stem from the ongoing housing market correction that may worsen in case of larger negative shocks, such as an excessive moderation in credit flows or an unexpected reaction by market participants. While downside risks dominate, staff also mentions upside risks to growth, e.g. a stronger pickup in the non-mining sector, or spillovers from public infrastructure investment and in case of a larger currency depreciation. Could staff elaborate on such a positive scenario?

Monetary and fiscal policies should remain supportive. We concur with staff and the authorities that the supportive macroeconomic policy stance should continue as long as downside risks prevail. Monetary policy should remain accommodative, in particular as upward pressure on wages and prices are unlikely to materialize soon. Substantial fiscal space allows for further public infrastructure investments. These investments seem to be well overseen by "Infrastructure Australia". Moreover, even with ambitious infrastructure investments, the government's medium-term fiscal strategy would be feasible under the baseline scenario.

The financial sector is robust, but high household debt and banks' wholesale funding require further vigilance. Despite the expected soft landing of the housing sector, the risk of a stronger market correction remains substantial. Macro-financial vulnerabilities related to high household debt and low housing affordability are elevated, as commercial banks' exposure to residential real estate remains an issue. Against this backdrop, we take good note of the banking sector's tightening of lending standards in response to the royal banking commission's recommendations. These measures have already led to a slowdown in mortgage credit growth and a cooling of the housing market. Hence, we agree that additional tightening measures are not warranted at this juncture. However, in light of increased competition, maintaining improved lending standards and strengthening the financial sector's capital adequacy framework is essential. Broadening the set of policy tools could enhance flexibility to address systemic risk and structural vulnerabilities. Where possible, non-discriminatory measures should be preferred. Moreover, reducing banks' use of wholesale funding would help decrease vulnerability to external funding risks. Have measures recently been introduced, or are additional measures foreseen, to reduce banks' dependency on foreign wholesale funding?

Housing affordability should be further improved by demand and supply-side reforms. The ongoing price correction provides some temporary relief for housing affordability, but structural issues, i.e., a growing urban population, remain a constant source for housing imbalances, high property prices and related high household debt. Reforms for real estate investment, including broad-based land taxes to incentivize efficient land use, should be considered. In addition, planning and zoning reforms should be accelerated. In this context, we take note that the authorities expect housing investment to slow by 2020. Could staff elaborate on this?

Ms. Riach and Mr. Haydon submitted the following statement:

We thank staff for an interesting set of papers, and Mr. Ray, Ms. Preston and Ms. Park for their informative buff statement.

Australia has a strong economic track record, and has just completed its 27th consecutive year of economic growth. Mr. Ray, Ms. Preston and Ms. Park are right to highlight the role that strong institutional arrangements, a flexible exchange rate regime, a liberalized capital account, and flexible labor and product markets have played in this prolonged period of growth and adjustment. We welcome staff's comments underlining their support for

Australia’s commitment to free trade and its work to actively engage with international partners to promote the global multilateral trading system.

Staff helpfully discuss Australia’s unique exposure to China’s economy via commodity linkages, amid ongoing trade tensions. While this primarily focuses on trade, Australia is also one of the largest recipients of Chinese investment. Given the economic benefits of infrastructure investment, staff may want to consider in addition the size of Chinese investment flows to Australian infrastructure and the implications of developments in the Chinese economy on these. In addition, it would also be helpful to get staff’s view on the trajectory of Australia’s trade elsewhere, including whether there are likely to be positive benefits accrued from involvement in CPTPP and if this could help balance Australia’s exposure to China.

We read staff’s paper on Australia’s fiscal strategy with interest, and broadly agree with its conclusions. It makes sense to introduce a link between debt and deficits into the fiscal framework. As the paper outlines, there are several options for achieving this, including a debt anchor. This type of constraint should be set at a sensible level which balances the need to keep debt on a sustainable trajectory while ensuring that the path this implies for the deficit is realistic and achievable. It is important to note, however, that debt levels can be affected by factors outside of the government’s control. Therefore, any new rule or anchor should recognise this and be designed in a way that reduces the risk of sharp – potentially procyclical – adjustments to fiscal policy close to the target date.

The housing market is identified as a key risk to Australia’s economy, and we welcome the update from staff. We felt the paper could have done a little more to capture the impact of the wider policy response to the housing affordability debate, where measures to dampen demand were not confined to non-resident buyers of property in Australia. For instance, reductions in the allowable tax deductions on depreciation and expenses were squarely aimed at domestic investors. We would be interested if staff could expand their position on the outlook for housing demand, which they expect to remain strong, despite some conflicting signs.

We welcome the Financial System Stability Assessment (FSAP) and its set of sensible recommendations. In particular, we recognise the significant progress Australia has made to enhance the resilience of its financial sector since its last FSAP. We support the inclusion of analysis on cross-border contagion and spillovers within the report, given the importance of global network effects in potential future shocks – this type of analysis is a valuable component of FSAPs. The full, timely and consistent implementation of the G20 financial regulatory reforms is essential in building resilience and facilitating openness in the financial sector. Therefore, we welcome the assessment that Australia has a high level of compliance against the Basel Core Principles, and the recommendation for completion of a resolution policy framework. Finally, given the forthcoming final report from the Royal Commission into Misconduct in the Banking, Superannuation and Financial Services Industry, we note that this may provide further inputs into staff's judgment on the strength and stability of the Australian banking sector in future surveillance.

Mr. Palei and Mr. Tolstikov submitted the following statement:

We thank staff for a set of well-written reports and Mr. Ray, Ms. Preston and Ms. Park for their informative buff statement. Australia's economic performance remains robust, with above-trend growth in 2018 underpinned by solid private and public consumption, stabilization in mining investment and pick-up in residential and public investment. The adjustment to the commodity price shock was relatively smooth, facilitated by supportive macroeconomic policies in the context of flexible exchange rate regime, liberalized capital account and a strong institutional and regulatory framework. At the same time, inflation remains below the target range, wage growth is weak, and there are signs of slack in the labor market. Resource exports are constrained by capacity, while high household debt and declining house prices weigh on private consumption growth.

Going forward, growth is expected to return to potential, while risks are tilted to the downside. Australia's economy remains exposed to substantial external shocks, including rising protectionism geopolitical risks, and possible slowdown in key trade partners. Domestically, housing market downturn could also have a substantial impact on the economy. In this context, we agree with staff that supportive macroeconomic policy stance remains pertinent, while the financial sector should be further strengthened. The structural reform agenda should focus on housing supply reforms, as well as the measures aimed at boosting productivity and potential growth.

The accommodative monetary policy stance appears appropriate given labor market slack and subdued inflation. The authorities are expected to maintain supportive policy until restoring full employment and reaching inflation target. In case of stronger demand growth and strengthening labor market conditions, policy normalization should be gradual, taking into account a high share of households with high debt-to-income ratios.

We commend the authorities for maintaining fiscal prudence. The government's plan to reach a balanced budget by FY2019/20 and running the budget surplus thereafter is in line with the authorities' commitments. At the same time, if return to full employment and inflation target is delayed, and/or in case of an adverse shock, the authorities have fiscal room for supporting measures. We note also that the increase of public infrastructure investment is deemed to be a key component of higher growth going forward. Taking into account considerable potential need for additional expenditures, we agree with staff that measures that can weaken fiscal revenues should be avoided.

The FSAP confirms that Australia's financial sector remains healthy and stable, notwithstanding the risks related to stretched real estate valuations and high household leverage. Good progress has been made in strengthening the financial system since the previous 2012 FSAP. We broadly support the FSAP recommendations aimed at further enhancing systemic risk oversight and strengthening financial supervision and crisis management.

We take positive note of the recent cooling of the housing market, but vulnerabilities remain high. Tightening lending standards and easing investor demand brought some decline in prices, improving housing affordability. At the same time, the underlying fundamentals for high housing demand remain in place, including high population growth and expected robust growth of the economy. In this regard, the authorities are well advised to go ahead with their supply-side reforms to alleviate supply constraints, complemented by targeted tax reforms to optimize housing and land use. We also tend to agree with staff that there is no compelling need for using capital account restrictions in the form of discriminating housing policy measures aimed at non-resident buyers.

Finally, we welcome the authorities' commitment to open trade, investment, and immigration. The implementation of the TPP-11 and other free trade agreements will help Australia to benefit from the needed diversification of the economy and further integration into global markets. On the other side, we note high risks from rising protectionism and retreat from multilateralism, as well as risks from adverse developments in the context of the U.S.-China economic disputes. Australia can play a role in mitigating these risks through consistent support for free trade and investment.

Ms. Pollard and Mr. Vitvitsky submitted the following statement:

We thank Fund staff for the comprehensive Article IV and Financial System Stability Assessment (FSSA). Australia's economic rebalancing has continued in 2018 amid improving labor market conditions and a – so far –

modest housing market correction. The financial sector appears resilient to shocks, supported by strong capital adequacy and liquidity. Still, there are major risks to the economic outlook, including an economic slowdown in China and a sharper correction in the housing market. We broadly agree with staff's appraisal and that the authorities have policy space to respond should downside risks materialize.

The Article IV appeared sanguine on risks from the housing market, noting that the "correction should be mild and short-lived." Cooling prices are welcome and so far, the correction has been orderly, but the potential for a sharper and protracted decline should not be dismissed. The significant rise in household debt relative to income is concerning, and if the housing values fall more-than-expected, household net worth could quickly decline with corresponding effects on private consumption. Staff comments would be welcome, including whether wealth effects are considered. Additionally, risks of China slowdown are only lightly addressed in the report, although last year's Selected Issues Paper had a comprehensive chapter on China-Australia economic and financial risks. We appreciate Mr. Ray, Ms. Preston, and Ms. Park's statement that risks are mitigated by the flexible exchange rate and diversified open economy.

Despite these risks, we agree with staff that the authorities have fiscal space and even some limited conventional monetary policy space to respond to shocks. The Australian authorities have long maintained fiscal prudence, with relatively low gross debt-to-GDP and even lower net debt-to-GDP. We also concur that the current accommodative monetary policy stance appears appropriate with inflation below the target range, but the authorities should remain vigilant with growth deemed to be above or close to potential and the possibility for upward pressure on wages and prices.

Regarding the FSAP, we welcome the apparent strong capitalization and liquidity of the banking sector. Capital requirements are higher than required by Basel III, and the banking sector complies fully with the Basel standards for LCR and NSFR. We are also pleased that the 10 largest banks met the minimum capital requirements under stress tests that had a variety of harsh scenarios.

Still, liquidity risk seemed more concerning, especially in a wholesale stress scenario. Banks' use of wholesale funding has declined, and many have extended the duration of their wholesale funding and hedging out currency risk. However, staff acknowledge that wholesale funding use remains high at about a third of the system's liabilities, of which nearly two-thirds is from international sources. We agree with staff's recommendation for banks to continue to extend the duration of their wholesale funding to minimize liquidity risks during a stress scenario

Mr. de Villeroché, Mr. Castets and Mr. Sode submitted the following statement:

We thank staff for the quality of their reports and Mr. Ray, Ms. Preston, and Ms. Park for their insightful buff statement. Australia's economic performances continue to be dynamic, supported by well calibrated monetary and fiscal policies. We commend the authorities for the measures taken to reduce financial risks linked to the housing sector boom. In the meantime, Australia continues to face external and domestic risks for which it should prepare. Going forward, Australia's good performances could be leveraged to further enhance social inclusion and ensure an environmentally-sustainable and decarbonized economic model, two issues that could have been covered in more detail in this Article IV. While we broadly agree with staff analysis and recommendations, we would like to make the following comments for emphasis:

We concur with staff that the current monetary and fiscal stance is appropriate, and we welcome the authorities' choice to increase infrastructure spending in view of the substantial existing fiscal space. This infrastructure push should continue in the coming years to accommodate the country growing needs. Good projects planning and implementation will be key to extract the highest benefits from these public spending. Could staff elaborate on the quality of public investment management in Australia and what are its recommendation in this field?

Regarding the housing sector, we agree with staff that macroprudential policy should hold the course on implementation of stricter lending standards for households and that measures targeted to increase the supply of housing are needed to improve housing affordability. We also agree with staff that authorities should broaden their prudential toolkit to include borrower-based restrictions, income-based ratios, as well as refined debt-serviceability requirements. On the supply side, we notably encourage the authorities to pursue their efforts to improve urban large-scale development projects. Given rising housing prices, we wonder what type of policies Australia has designed to improve housing conditions of the poorest households and how staff assess them.

We broadly agree with the recommendations made in the FSSA and encourage the authorities to swiftly implement the measures identified as priority reforms by staff. Given existing vulnerabilities to domestic and external risks, the authorities should notably encourage further maturity extension and lower use of overseas wholesale funding as well as strengthen financial crisis management and safety nets.

Concerning the climate footprint of Australia's economic activity, we are concerned by the fact that, as stated by staff "there is no agreement on nationally integrated policies needed to meet Australia's commitment to reducing greenhouse gas emissions under the Paris Agreement". Australia remains one of the very top advanced economy in terms of Co2 emissions per capita and recent policy choices – notably concerning coal production – could worsen the environmental sustainability of its economic model. Could staff elaborate further on the current state of discussion at the authorities' level on how to design and implement growth-friendly climate policies compatible with Australia's commitments under the Paris agreement. Given the macrocriticality of this issue, we strongly encourage staff to increase its policy dialogue on this topic in future Article IV.

Mr. Kaizuka and Mr. Naruse submitted the following statement:

We thank staff for the comprehensive reports and Mr. Ray, Ms. Preston, and Ms. Park for their informative statement. We commend Australia's 27th consecutive year of economic growth. We welcome a pick-up in growth in 2018, supported by private and public consumption. Also, it is encouraging that the economic momentum has resulted in improvements in labor market conditions, with the declining unemployment rate. However, the country faces challenges, such as low wage growth and high household debt. In this context, the authorities are expected to continue prudent policies, address macro-financial vulnerabilities, and raise potential growth. As we broadly agree with the staff's appraisal, we would like to make a few comments as follows:

Fiscal Policy and Monetary Policy

We agree with the staff's view that macroeconomic policy support should remain in place until full employment and inflation targets are firmly within reach. We note that the output gap is still negative, and the economy has not reached full employment. Also, we note that wage growth remains weak, and inflation has hovered around the floor of the Reserve Bank of Australia's target range of 2-3 percent. Against this background, we support the authorities' fiscal policy stance with the boost to high quality investment in infrastructure, which is a key for boosting Australia's productivity growth.

As staff point out, we are concerned about capacity constraints in infrastructure spending, so we agree with the staff's view that the appropriate sequencing of projects between levels of government and regions will be important. Regarding monetary policy, we support the staff's appraisal that monetary policy remains appropriately accommodative. Also, its normalization should depend on firmer upward trends on prices and further progress towards full employment.

Financial Sector Policy

We encourage the authorities to continue their efforts to further strengthen the financial oversight based on the FSAP recommendations. We welcome the fact that Australian banks are well capitalized and profitable. Also, it is encouraging that FSAP stress test results found banks' solvency and liquidity to be relatively resilient to stress. Regarding regulatory independence, we note the divergence of views between staff and the authorities. Staff assess that the Minister's written direction could limit Australian Prudential Regulation Authority (APRA)'s independence. However, one could reasonably assume that guiding the public agency's policy direction is the important role of the Minister, which does not necessarily undermine the APRA's independence.

Household Debt

We take note of the staff's analysis that high household debt has become one of major concerns in Australia. Regarding a tax reform, the authorities consider that the staff's recommendation (gradual lowering of capital gains discounts and limits on negative gearing for investors) would represent a move away from a comprehensive income tax system and would run the risk of introducing higher costs and distortions into the tax system. Could staff elaborate more on what kind of discussions staff and the authorities made (especially, on what points staff and the authorities diverged their views) about a tax policy to reduce structural incentives for leveraged investment by households, and how do staff think the authorities' stance?

With a cooling housing market, we note that the authorities removed caps on limiting investor and interest-only housing lending because the measures have reached their goals. On the other hand, in an environment of high household debt, staff recommend the Australian banks to maintain stringent lending standards. Taking note of the authorities' statement that the distribution of debt is skewed towards high income households, we wonder if the authorities might be able to consider easing lending standards. How do staff think the negative consequences on the Australian economy by maintaining stringent lending standards and limiting credit to the real economy?

Housing Market

We positively note that the housing market has been cooling. According to the staff's explanation, foreign and domestic investor demand has moderated. Also, progress has been made in the housing supply, including through City Deals. Having said that, we note that Western Australia and Tasmania have announced foreign purchaser duty surcharges since the last Article IV Consultation. We would like to hear the staff's view on the appropriateness of foreign purchaser duty surcharges. Does the role of foreign buyers in Western Australia and Tasmania remain larger than that of domestic buyers? If not, do staff think that non-discriminatory measures could alternately attain the policy objectives of these surcharges? Last but not least, how have the authorities reacted to the staff's recommendation?

Structural Policy

We welcome the authorities' continued efforts to raise potential growth. We agree with the staff's call to close a notable infrastructure gap compared to other advanced economies. Therefore, we support the latest budget which reduces the gaps in the near term. In addition, we agree with the staff's view that sustaining structural policy efforts, such as encouraging innovation and reducing the gender gap in labor force participation, would strengthen productivity growth. Lastly, we welcome the authorities' continued commitment to promote the global multilateral trading system. It is also encouraging that Australia has ratified the TPP-11, and the TPP-11 entered into force last December. We hope that there will be further progress in the negotiations of the RCEP. Our authorities stand ready to work together with Australia's authorities to harness open and rule-based international trade system.

Mr. Gokarn and Ms. Dhillon submitted the following statement:

We thank staff for the excellent report and Mr. Ray, Ms. Preston, and Ms. Park for their candid buff statement.

The Australian economy's consistently robust performance record is laudable. Solid job creation, subdued inflation and a narrowing current account deficit have been accomplished in an open and diversified economy with supportive macroeconomic policies and strong institutional arrangements. Going forward, growth is expected to strengthen. Nonetheless, external and domestic vulnerabilities, including the economy's exposure to China, global conditions, housing risks and household income dynamics could be challenging for the outlook. We broadly agree with the staff assessment and would like to emphasize the following points on macroeconomic policy, housing and financial sector and the structural reform agenda.

Overall, we concur with staff that macroeconomic policy support should remain in place until full employment and inflation objectives are attained. Inflation remains below target and the current policy rate has been on hold at 1.5 percent since August 2016. Continued labor market slack, including the underemployment rate and weak wage growth could suppress private consumption growth. Against this backdrop, on monetary policy, we share the authorities' view that the accommodative stance of monetary policy is appropriately supporting stability. We are appreciative of the current stance to balance transition to lower levels of mining investment against the risks of household debt. Going forward, we would advise clear guidance on the expected path of policy normalization as suggested by Staff and further, even an active response to evolving developments.

On fiscal policy, Australia's fiscal space and projected budget surpluses from FY2019/20 make it well positioned to expand the spending portfolio. Taking advantage of Australia's comparatively low public debt, a fiscal stimulus package targeting infrastructure investment, innovation and structural reforms could further elevate potential growth and enhance productivity. Given the large medium-term swings in net public-debt-to-GDP ratios, staff has suggested a debt anchor in the fiscal framework. Could staff offer more details on the drivers for the swings and when the debt anchor proposed is necessitated, bearing in mind the broader productivity enhancement agenda?

We take positive note of the well-capitalized and profitable Australian banks and the sound financial sector. Even so, we would caution that the authorities remain vigilant to household debt risks and ensure prudent lending standards. We note that the authorities have welcomed the FSAP recommendations but expressed disappointment at the staff's assessment of the operational context and related advice. In this context, we would like to hear staff views on the balance adopted for anchoring FSAP recommendations (considering the local governance structure and related systemic risks) vis a vis international best practices. Could staff elaborate? Beyond this, we would urge the authorities to remain committed to continued improvement to regulatory frameworks and supervision practices.

It is encouraging to see results emanating from the authorities' multipronged approach to manage the imbalances and vulnerabilities in the household sector. The risks to domestic financial stability have been addressed through prudential measures, including the tightening of bank lending standards. We will be interested to hear more details on the impact of the tax policy changes proposed in addressing housing sector pressures, given the standpoint mentioned in the buff, countering its effectiveness. Staff comments are welcome. Separately, we agree with staff that the authorities should step up efforts to expand housing supply and address legacy supply-demand imbalances.

On structural reforms, the next round of Australian prosperity would come from reforms that spur both growth and equity. It will be essential to increase productivity by addressing infrastructure gaps, innovation, education reforms, greater female labor market participation, labor force skills and diversifying the sources of economic growth.

With these comments, we wish the authorities the best in their endeavors.

Mr. Villar and Mrs. Del Cid-Bonilla submitted the following statement:

We thank staff for a comprehensive set of reports and Mr, Ray, Ms. Preston and Ms. Park for their informative and insightful buff statement. Supported by strong institutions, sound macroeconomic policies, flexible labor markets and robust financial regulation, Australia has seen more than two decades of sustained economic growth, better than any other advanced country. We commend the authorities for the successful economic transition towards a more- diversified economy after the mining investment boom. The economic outlook is positive and monetary policy tools, along with significant fiscal space and a flexible exchange rate regime would provide substantial cushion should downside risks materialize.

Significant progress has been achieved to further strengthen the financial system, but important challenges remain. Banks capital requirements have been raised and applied more conservatively than minimum Basel standards, financial supervision and systemic risk oversight have been enhanced, and the authorities have taken successful policy action to address rapid growth in riskier segments of the mortgage market. However, macro financial vulnerabilities remain, in particular related to the elevated household debt and the banks' reliance on wholesale financing which still accounts for a third.

Authorities have been successful in tempering the housing market after a long boom, but close monitoring is warranted. Household debt (HD) has eased since mid-2017 due to the multipronged approach implemented by the authorities but, at 190 percent of disposable income, is one of the highest in the world; in addition, commercial banks' exposure to residential real estate remained at over 50 percent of total assets. We welcome the introduction of stronger lending standards in the banking system, but we wonder if other measures that had accompanied this, in particular the limits on interest-only mortgage lending, were not removed too soon, given that demand is expected to remain strong and supply-side measures can take some time to bear results. Staff comments on this are welcome, and on the feasibility to implement broad-based land taxes as part of a comprehensive approach.

Reinforcing financial crisis management arrangements and strengthening the macroprudential policy (MaPP) kit is also crucial. We welcome the progress in strengthening APRA's resolution powers and expanding banks' recovery planning to cover additional institutions; we encourage the authorities to follow FSAP recommendations to promptly complete the resolution policy framework and to better integrate banks' recovery planning into their risk management framework. Expanding the set of MaPP tools, along the lines recommended by staff to enhance flexibility to address systemic risks and structural vulnerabilities would also be worth considering.

Strengthening innovation and research, closing infrastructure gaps, tax reform and energy policy are crucial components of a comprehensive agenda aimed at fostering growth. We commend the authorities for the progress in energy reform, aimed to improve competition and reduce electricity prices, and in the implementation of recommendations from the 2030 Strategic Plan for Australian Innovation, Science and Research. We share the authorities' approach to close the investment gap combining new infrastructure investment with processes to ensure its quality and concur with their cautious approach to accelerate spending giving the current point in the cycle. This said, planning for additional spending over the coming years should be expedited. Can staff elaborate on options to address, within a broader perspective, the capacity constraints and skill shortages that have emerged?

Australia’s continued commitment to a cooperative multilateral trading framework that promotes openness over protectionism is invigorating. Australia’s highly open trade and investment regimes are commendable. The entering into force of the TPP-11 Agreement for Trans-Pacific partnership in December 2018, along with recent free trade agreements with China, Japan and South Korea, will open important opportunities for Australia and its trading partners

With these remarks, we wish the Australian authorities success with their future endeavors.

Mr. Raghani and Mr. Alle submitted the following statement:

We thank Staff for a comprehensive set of papers and Mr. Ray, Ms. Preston, and Ms. Park for their insightful buff statement.

The Australian economy exhibits strong fundamentals with a sound macroeconomic environment, solid growth and declining unemployment. The authorities should be commended for their supportive policies which help achieve these emboldening results. Their rebalancing and adjustment efforts have been instrumental in dampening the spillover effects of the slowdown in some trade partners. Going forward, stepped up actions are needed to address vulnerabilities including in the housing market. Moreover, the authorities should be encouraged to improve infrastructure investment with the view to boost potential growth.

Staff assessment of the outlook points to positive developments forward and risks that are manageable. We welcome the picking up in growth and the soft landing from recent commodity price and mining investment boom. We see merit in the authorities’ diversification strategy and smooth reorientation towards new trading partners. As regards risks related to the housing market, we note the authorities’ view that the correction in the sector has been orderly. Nevertheless, we encourage them to remain vigilant and address the remaining vulnerabilities along the lines recommended by staff.

We find the supportive fiscal policy appropriate to help the economic rebalancing. We commend the authorities for the enviable fiscal position and low debt level. This epitomizes the high level of fiscal discipline maintained over the years and gives room for maneuver in terms of public spending. In this context, we support the recommendation to boost infrastructure investment to close gaps in this area and increase productivity, while addressing capacity constraints voiced by the authorities. Nonetheless, spending plans should be balanced against the imperative of enhancing buffers to cope with potential shocks. In this regard, we share the view that the fiscal strategy consisting of running budget surpluses in good times should continue going forward.

The accommodative monetary stance has served the economy well and should continue to support the adjustment towards full employment. In view of the various objectives of growth, employment and inflation, monetary policy should fully contribute to the policy mix. We therefore share staff's recommendation to maintain the accommodative stance at this juncture. We however call on the authorities to stand ready to adjust the policy stance as required by inflation developments. Can staff elaborate on the first line of actions envisaged by the authorities in case inflation expectations turned less favorable?

We welcome the strong indicators displayed by the banking sector and support the authorities' steps to further enhance financial stability. The Financial System Stability Assessment report has highlighted an important number of measures taken by the authorities since the 2018 FSAP to strengthen the financial system. As a result of these efforts, banks appear well capitalized and liquid, and the 10 largest among them still meet regulatory minima, albeit with some pressure on capital as revealed by stress tests. While sharing Mr. Ray, Ms. Preston, and Ms. Park's concerns about the need for staff advice to be "fully anchored in the local circumstances", we encourage the authorities to step up actions to address the weaknesses of the sector. In particular, the linkages between the housing market and the banking sector should be closely monitored as should the exposure of the system to external liabilities.

Structural reforms are critical to support the diversification strategy and enhance long-term growth. We welcome the authorities' efforts to foster non-mining growth. In this regard, we encourage them to swiftly implement their policies laid out in recent national agendas, including on innovation and science.

The Acting Chair (Mr. Zhang) noted that Australia had experienced remarkable economic performance over the past two decades, underpinned by solid institutions and sound macroeconomic policies. The economy was facing risks from a weaker global economic environment, higher household debt, and developments in the housing market. The staff had suggested that the authorities continue to pursue supportive macroeconomic policies, implement macroprudential policies, and undertake a wide range of structural reforms.

Mr. Kaizuka made the following statement:

The economic performance of Australia, with 27 years of continuous growth, despite some financial crises, is quite remarkable. It is envious from the perspective of my own country, which experienced the lost two decades while Australia was growing.

One of the factors that supports this performance seems to be the population growth, partly due to the migration. The population bonus, itself, is a positive one, but we have to carefully recognize a future possible reversal of the trend; thus, Australia has to enhance its productivity. From this perspective, we completely agree with the need for further investments in quality infrastructure. I believe Australia could proceed with enhancing infrastructure governance, which would present good lessons to other countries. I hope the Australian efforts in this regard could be useful input to the current G20 discussion on quality infrastructure.

Secondly, on regulatory independence, I fully agree with the point raised in the buff statement on the checks and balances of the parliamentarian system. I take positive note of the staff's answers to the technical question, which says: "Staff considered very carefully the issue of 'best fit' in terms of the Australian framework and thus did not recommend any wholesale institutional reorganization or granting of independent authority to the Council of Financial Regulators, actions that could have been disruptive to a well-functioning system." This should be well respected.

Lastly, on the debt anchor, there is a question of whether the debt anchor should be on a gross or net basis. I took note of the staff's answer, stating that: "Choosing an anchor based on net debt is more sensible." This may be right in the context of the Australian case, where the assets could consist of those that have a high liquidity and could be sold, if necessary. However, the discussion should not be generalized, as there are certain country cases where assets are not so liquid or are already locked in for future obligations, including a pension payment. There should be a granular analysis of the characteristics and the nature of the assets when we discuss the net debt.

Finally, I wish the Australian authorities success.

Mr. Raghani made the following statement:

We issued a gray statement, and I would like to emphasize three points.

First, we commend the Australian authorities for their supportive macroeconomic policies, which help achieve impressive results. Staff reports have highlighted these achievements, including the strong pickup in growth and low unemployment. Owing to the authorities' export-orientation strategy, Australia has also been able to ring fence against the spillover effects of the slowdown in traditional trade partners.

Second, on fiscal policy, like many other Directors, we encourage the authorities to take advantage of fiscal surpluses to close infrastructure gaps. At the same time, we are cognizant of the need to enhance buffers against potential shocks. There is a balance to find between these apparently conflicting objectives. We trust the staff to continue to help the authorities in this regard.

Third, we welcome the authorities' commitment to pursuing accommodative policies. We share the view that this policy stance is still needed at this juncture to help the economic balancing.

With these comments, we wish the authorities all the success in their endeavors.

Mr. Trabinski made the following statement:

We commend the Australian authorities for their sound macroeconomic policies, and we welcome the sustained economic growth, which has already lasted for more than two decades. In this regard, Australia is better than Poland but only by a few years.

That being said, we note that the risks to the outlook are increasing, and we would like to add two comments to our gray statement.

First, the accommodative monetary policy and supportive fiscal stance has further underpinned the continued economic growth. In this context, we encourage the authorities to maintain responsible fiscal policy while implementing measures to boost productivity and address infrastructure gaps. The staff's advice regarding the further increase of infrastructure spending is appropriate at the current juncture. In this regard, we consider the authorities' Infrastructure Australia Plan, which focuses on prioritization and the quality of investment, as a step in the right direction to increase the potential growth in the long term.

Second, house prices that have kept falling recently bring nationwide property values back to the levels last reported in 2016. While a cooling of house prices is welcome—in particular, in the context of housing affordability—the households' high debt burden calls for vigilance.

Mr. Tombini made the following statement:

I concur with the overall positive assessment of the staff and the recommendation to maintain a supportive monetary and fiscal stance. The staff's assessment of risks is also most in line with the authorities. But naturally, there remain some divergent views, but my reading of the report is that there is overall support for the approach adopted by the authorities.

I would like to make four comments. First, I thank the staff for their answers to our questions on monetary policy, which shows that complexity and uncertainty have risen. Proper calibration may require an even more judicious analysis of data as they become available. I would like to reinforce the idea that the monetary authority should retain its options in dealing with such an uncertain macroeconomic environment. The importance of properly communicating policy steps and clearly explaining the factors underlying policy decisions cannot be overstated. That notwithstanding, we sympathize with the authorities' preference to preserve room for judgment in the policymaking process.

Second, the distinction between cyclical and structural rising revenue is important for the application of the revenue cap. As suggested by the staff, we see no reason for limiting revenue when the surge may be driven by cyclical factors. If revenue increases temporarily, it would be an opportunity for Australia to expand buffers or to boost its infrastructure investment. It will make sense for the Australian authorities to consider a more flexible way when applying a ceiling on revenue.

Third, I sympathize with the authorities when they feel that some of the assessments and recommendations of the Financial Sector Assessment Program (FSAP) could be better embedded in the specific institutional context of Australia. They point specifically to the assessment of regulatory independence and highlight the checks and balances that hold government accountable to the parliament and society. This complaint reminds me of the recent discussion of the Independent Evaluation Office's (IEO) evaluation of financial surveillance, which underscored the need to move away from off-the-shelf recommendations.

Finally, we appreciate Australia's main partners raising the issue of potential positive spillovers for Australia from a reduction in trade between China and the United States, driven by a diversion of trade in agriculture and services. In fact, this is an issue that was highlighted last year, and I want to hear the staff's comments on what is the latest in this area.

With this, I wish all the success to the Australian authorities in their future policy endeavors.

Ms. Levonian made the following statement:

We have issued a gray statement, so I will just raise two additional points.

First, on housing, generally, it is important to consider a range of measures to help contain risks related to housing markets while being mindful of their impact on sustainable and inclusive growth. This should be complemented by supply-side and other targeted measures to improve housing affordability. Canada faces similar challenges, and we appreciate the difficulty of the balancing act facing Australia's policymakers and regulators. We believe that they found a good balance thus far, but ongoing vigilance is always necessary.

Second, on financial regulatory oversight. We thank the staff for the answer to our question, in which we asked for an elaboration on the rationale for making more formal Australia's framework for financial and regulatory oversight, a system that has so far served Australia well. I should clarify that we support the staff's call for greater transparency and the need for better data on systemic risk, but those are not the costs we had actually referred to in our question. Rather, we remain to be convinced that a shift to a more formalized arrangement is inherently a better outcome. In fact, it may even diminish the system's overall effectiveness. It is admittedly hard to prove the counterfactual, but our bottom line is that the bar for changing a well-functioning institutional arrangement should be high.

With that, I wish the authorities well.

Mr. Morales made the following statement:

Australia's stellar record of steady growth reflects its strong fundamentals, a sound macroeconomic environment, and solid institutions. Its transition to a rebalanced economy has been successful so far, and the authorities' track record on prudent and flexible macro-financial policies gives confidence that, as the global economy softens, the main risks will be contained and spillover effects will be minimized.

The reports highlight areas where these policies could usefully focus going forward, which are the ones we want to emphasize. They include narrowing the infrastructure investment gap and addressing emerging vulnerabilities in the housing market. The former will be consistent with the supportive fiscal policy stance that is in place, keeping in mind the authorities' caveats regarding capacity constraints. Likewise, Australia has a well-capitalized financial system, thanks to consistent macroprudential policies over time which should contribute to continuing to maintain a proactive approach to minimize the risk of a disruptive impact of eventual shocks that may affect households' income.

Related to the latter, we welcome the introduction of stronger lending standards in the banking system, and we agree with the staff that the authorities should give high priority to policies to maintain high lending standards by banks, encourage banks to reduce their wholesale funding, and strengthen financial crisis management and safety nets. To complement this effort, additional binding prudential indicators could be introduced to Australia's arsenal of macroprudential tools to make the monitoring of systemic risks more effective and facilitate a timely policy reaction in the event of sudden changes in the risk profile of financial institutions, households, and firms.

With this, we wish the authorities success in their policy endeavors.

Mr. Just made the following statement:

We welcome the strong performance of the Australian economy in recent years, including the robust employment data. We believe that sound and predictable economic and fiscal policies have contributed to these developments, including the relatively low and stable public debt levels. When I read the authorities' views in the buff statement, there was discussion on risk management and the acknowledgement of the existing risks. I have an understanding that the authorities would like to keep fiscal buffers to deal with the external risks that they face.

While we agree with the importance of infrastructure investment, we also believe that it will be important to monitor the quality of these investments.

Given that we made many comments on the financial sector, I will not discuss this here.

One point we would like the authorities to consider is an update of their energy policies.

Mr. Meyer made the following statement:

We welcome the positive outlook of the Australian economy, and more broadly, the impressive resilience shown in the face of headwinds over the course of decades, as also depicted in the buff statement.

We welcome the authorities' commitment to the promotion of an open and rules-based multilateral trading system. We thank the staff for the detailed answer on the possible size of the impact of China-U.S. trade tensions on Australia.

A key domestic risk ahead seems to stem from the real estate market, in combination with high household debt. We welcome that the recent price correction has been orderly and encourage the authorities to remain vigilant going forward. In this context, macroprudential policies should continue to play a key role.

Furthermore, I would like to echo Mr. Kaizuka on the question of the debt anchor. In general, markets tend to focus on gross debt, so when looking on net debt, we need a special justification. Australia might be a case where assets are readily available, but in general, one should be careful whenever moving to the anchor on net debt.

Finally, we note that the staff advocates a top-down approach to derive public infrastructure investment targets from potential GDP in the selected issues paper. Like others, we would put a stronger emphasis on the quality of public investment, which a mechanistic approach targeting quantities risks compromising to some degree. We take note of the buff statement in this regard.

There are interesting parallels to the German case, as some capacity constraints are showing and there are shortages of skilled labor. This is something we also observe in the German case.

With this, let me wish the authorities all the best.

Mr. Agung made the following statement:

I commend the authorities for their successful economic rebalancing efforts and the sound macroeconomic management that kept the Australian economy in good stead, despite many recent shocks. The structural reform, the structural policy agenda and other long-term pursuits, including continued engagement with free trade with emerging Asia, will contribute positively to its resilience in the more adverse global environment.

Today I would just add two comments. First, maintaining policy flexibility is critical in these uncertain times. The supportive macroeconomic policy mix is appropriate, given the downside risks. We strongly welcome the authorities' preparedness to utilize the available monetary and fiscal policy tools, as needed, as well as their emphasis on maintaining sufficient room for maneuver to respond to the shocks. Some of the staff's recommendations will need to be balanced against the need to maintain flexibility in the current context.

On monetary policy communication, we view that the Reserve Bank of Australia's (RBA) current approach could effectively provide guidance without tying themselves unnecessarily, especially in the face of uncertainty.

On the fiscal front, we agree with the authorities that adopting a medium-term debt anchor must be carefully considered, given that it may constrain flexibility.

Meanwhile, the risks pertaining to high household debt and the housing market remain. Therefore, it is imperative that the authorities should remain vigilant and well equipped with the tools to respond, as needed.

Second, assessing regulatory independence should be based on the outcome more than form. We see merit in the staff's suggestion to close potential loopholes that could undermine Australian Prudential Regulation Authority's (APRA) independence, especially in the bad times. However, we share the view with other chairs that having checks and balances do not necessarily impede its operational independence, as noted in the statement by Mr. Ray and colleagues.

Mr. Beblawi made the following statement:

Australia continues to adjust solidly to the end of the commodity price and mining investment booms by relying on a series of adaptive macroeconomic policies and strong institutions that have culminated in the current above trend growth. We issued a gray statement, so we will limit our intervention to the following two issues.

First, on fiscal policy, debt levels are currently low, and the authorities intend to use accumulated fiscal surpluses to bring down debt. However, adverse shocks with protracted effects may make it difficult to attain such objective. We see merit in the staff's recommendation to introduce a more explicit link between the debt levels and balanced budget objective, relying instead on the numeric target for debt levels, rather than on qualitative objectives.

Second, on the financial sector, Australia's financial sector is sound. Its supervision conforms to the international best practices, and recent stress tests indicate that the banks are resilient to significant shocks. I would like to focus on two points. One, we take note of the buff statement's clarification on household debt being skewed toward high-income households. Nonetheless, following the staff's response to our question, we share staff's view that the still-elevated house debt ratios and housing price overvaluation can be a source of macro-financial risk, especially since the banks' exposure to the residential real estate sector is significant. Two, we welcome authorities' efforts to further improve the granularity and the consistency of data collection and its provision for the sector. This is a crucial input to policy formulation, as well as to a timely analysis of systemic risks.

In closing, we wish Australian authorities further success moving ahead.

Mr. Gokarn made the following statement:

We issued a gray statement, but we would like to raise a few issues.

The first is in relation to the housing price discussion. We recall last year's discussion on the Australian Article IV consultation. There was a fair amount of time spent on the capital flow measures (CFMs) that were introduced by the authorities to deal with what was seen as excessive pressure on housing prices. Now, we are seeing a very different situation in this Article IV consultation. Prices seem to have moderated; in fact, in some jurisdictions have gone below authorities' expectations. But there is not much discussion--or, in fact, no discussion or that I saw about the consequences. Do these reflect the consequences of those CFMs? Were they then an effective way of dealing with the immediate pressures? What does this mean for this whole debate? Are those measures still in place, for example? Or have they been removed? There is a need, more generally, for some continuity when these issues come up. In one Article IV consultation, there is a need to keep the discussion or at least keep some attention on them in the following year's documents. I would appreciate some feedback from the staff on this issue.

The second has to do with the financial sector—the inquiry commission, the Royal Commission that is referred to in the buff statement. I gathered from news reports that this report was published today. It is 1,000 pages long, so I would not expect the staff to have read it before the meeting. But many recommendations are made in relation to misconduct and so on. Given that the FSAP report has just been published and will go out into the public domain after this meeting, we would appreciate some feedback on whether the Royal Commission's diagnosis and recommendations come into conflict with any of the FSAP assessments. It is an important signaling issue, a messaging issue. If the two reports appear to be at odds with each other, there would be credibility issues that the FSAP would have to deal with. Tiven that this report has just been put out, does it have some implications for the publication schedule or the strategy that the Fund is considering for the FSAP report?

Mr. Alkhareif made the following statement:

As highlighted in our gray statement, we broadly agree with the staff's conclusions. Therefore, I will limit our remarks to a few issues.

First, we agree that the continued supportive macroeconomic policy stance is essential to help further rebalance the Australian economy. However, infrastructure investment is expected to further increase productivity and potential output. Therefore, we take positive note of the staff's recommendation that Australia could consider a further increase in infrastructure investments, given the substantial fiscal space.

Separately, we take positive note that the 2018 FSAP confirms the proactive measures taken by the authorities to further strengthen the financial system. Moreover, we are reassured by the elaboration in the buff statement on the operational independence of the Australian regulatory system.

As regards to the housing market, the authorities should remain vigilant to risks arising from ongoing corrections to the housing prices and the vulnerabilities associated with the household debt dynamics.

With these remarks, we wish the authorities continued success.

Ms. Pollard made the following statement:

I also want to commend the Australian authorities for their impressive track record of growth, which reflects both the sound macroeconomic policy, including their flexible exchange rate, and their strong institutions. Given the high degree of agreement between the authorities and the staff, I was not going to say anything but want to follow up on two points raised by others at the Board.

The first is this issue of net debt versus gross debt. This is an issue that this chair has pushed quite a bit, that the staff should take more of a look at net debt in countries. Although I do not have a view on whether net debt should be used as a fiscal anchor, this is an area that deserves more study. I take Mr. Kaizuka's point: Is this something that is appropriate for other countries? Do we need to look at the type of assets that the government holds? I would just encourage the staff to do more analysis on this issue.

On the question of the restrictions on the purchases of housing by non-residents, I want to add to Mr. Gokarn's point and ask the staff whether there were any unintended consequences from these measures. In a footnote in the staff report, it seems like two other provinces adopted measures. Did this reflect a shift in foreign purchases across provinces in Australia or did this have some effect on the decline in housing prices?

Mr. Castets made the following statement:

We published a gray statement, so I would like to react to one point that has been raised by Directors, which is the infrastructure investment needs in Australia.

As \recalled by Mr. Alkhareif, the fiscal space is substantial, and the infrastructure gap has been well detailed by the staff in the report. We definitely see a need for more investment; notably, to ensure that the economic model is more sustainable from an environmental point of view, and given the Paris Agreement targets that have been agreed on.

In this regard, we also noted that Mr. Ray mentioned in his buff statement some capacity constraints. We wonder whether the staff could elaborate on this since it is not that easy to identify what those constraints can be in such an advanced country as Australia, and maybe more precisely, whether there is a comprehensive plan to overcome those constraints.

Mr. Palei made the following statement:

Australia is interesting, particularly for our chair, as a commodity-exporting country and an inflation-targeting country and also a country that follows elaborate fiscal rules.

Recently, Mr. Gaspar of the Fiscal Affairs Department (FAD) compared Russia and Australia in terms of national savings. The point was that national savings in Australia have a somewhat better outlook because the retirement protection is relatively less in Australia, compared to Russia. But it is also well known that in Australia, retirement savings are compulsory. This superannuation fund is a very large pot of savings, one of the largest funds in the world. I would like staff to comment on the relative importance of retirement protection, as provided by the government, versus the scheme being mandatory, which is not usual for many countries. Australia's experience in this case is somewhat unique.

The staff representative from the Asia and Pacific Department (Mr. Helbling), in response to questions and comments from Executive Directors, made the following statement:[6]

I will start with one question we did not answer in the written responses to technical questions. That was the question about the traction of the background work. Let me make three points.

As a rule, we consult with the authorities on background work. The authorities, therefore, typically have had a strong interest in our work. This interest does not guarantee traction. There are two forces at work. On the one hand, with interest rates on public debt in Australia below the normal rates seen in the past and below the rate of nominal GDP growth, public debt dynamics are not an acute issue in Australia. In fact, staff has argued that Australia has substantial fiscal space. On the other hand, in Australia, there is a strong preference for low public debt and responsible fiscal policy. This preference is across party lines and public debt figures in the economic policy dialogue. We believe this preference is partly explained by a strong sense that

[6] Prior to the Board meeting, SEC circulated the staff's additional responses by email. For information, these are included in an annex to these missions.

low public debt has contributed to managing the potential vulnerabilities arising from a relatively large net foreign liability position.

On this background work, we hope that it stimulates a debate, a debate that may be picked up in Australia. With the low debt, there is time for a reconsideration of some of the notions of low and prudent debt implicit in the fiscal framework. On the other hand, prudence and carefully managing fiscal resources remain valuable goals. At an analytical level, we also believe there is value to considering feedback between debt and deficit in a fiscal framework and to have that feedback be part of regular evaluations.

On the question of, what will be the first line of defense if inflation expectations turned out to be less favorable, the Reserve Bank is an inflation-targeting central bank. If inflation expectations declined for some reason, this would mean that inflation forecasts, absent any policy measure, would experience a downshift. We would expect the RBA to ease monetary policy. The RBA still has conventional monetary policy space. One can look at 2016, when the RBA had to revise its inflation projections down after a number of surprises and it eased monetary policy, and that allowed it to ultimately keep the inflation forecast path unchanged.

Turning to the questions raised today. On trade, I would refer to our answer to question No. 1. We believe very little has changed. The modeling work shows that, through trade channels, the impact of the trade tensions on Australia is very small. That is because of trade diversion away from trade between the United States and China to other trading partners. Whether the modeling appropriately considers the special case of trade in agriculture, which is much more regulated, we have not looked at in any detail. But we would note that some of the products that the United States exports to China are not produced in Australia. In that sense, we believe our current work remains relevant.

On the empirical experience, the only question is, to what extent the imposition of tariffs as of January 1 has led to the advancing of some trade before that. Perhaps this could explain why we have not seen strong evidence of a negative effect of trade tensions in the trade data. We also note that we face an identification issue, a problem observational equivalence, so to speak. Australia has experienced a drought, which has also shown up in some of the trade data. That will need a more careful analysis with longer data.

Finally, turning to the CFMs, all the measures are still in place. In fact, two more states have introduced stamp duty surcharges, as noted in the report.

Price pressures have abated. However, we believe it is a bit premature to firmly conclude that the housing market is back in balance. Back-of-the-envelope calculations and drawing on regular work on house price assessments suggest that house prices are still a bit overvalued.

On the effectiveness of the measures, we would note that it is very difficult to evaluate them. With hindsight, some of the measures were in place more or less at the same time when price pressures started to abate, but the CFMs were not the only new measures. We also have seen a change in the global economic environment, certainly with the beginning of U.S. monetary policy normalizations, which probably set expectations that interest rates globally have bottomed out, changed the outlook for real assets, in general, and residential real estate, in particular. We would also note that other measures that have affected investor interest from Asia in residential real estate have also changed through domestic measures in these countries. At this point, and given a relatively small sample and relatively little variability across states, we have not found a convincing way to establish the effectiveness of the policies empirically.

Finally, we note that, as price pressures have abated, it is perhaps time to reconsider the measures. That is noted in the report.

The staff representative from the Monetary and Capital Markets Department (Mr. Jenkinson), in response to questions and comments from Executive Directors, made the following statement:

With respect to the FSAP, I will cover three points: first, the points on regulatory oversight and supervision; second, Ms. Levonian's comments on the systemic risk framework; and then I will respond to Mr. Gokarn's comments on the Royal Commission.

First, on the question of supervisory independence. In terms of FSAPs, the approach that the staff takes is to review financial supervision against international best practice standards, which are set collectively by national authorities through the international standard-setting bodies, such as the Basel Committee on Banking Supervision, the International Organization of Securities Commissions, the Financial Stability Board for resolution, et cetera. These standards are designed to be applicable across countries, to be applied or utilized on a proportionate basis, but they can be used as a consistent benchmark. Consequently, that is the approach that is followed, which the Board will be familiar with from the Standards and Codes Review. For example, in terms of banking supervision, since the start, staff have conducted some 280 assessments in over 150 countries, and we have undertaken more than 50 since 2012 with the new methodology for banking supervision.

I would just like to mention that we are now applying the 2012 standard, where standards were raised significantly and collectively by the national authorities and the standard-setters in light of the weaknesses and failures in supervision, which are one of the sources or are one of the proximate ingredients in the global financial crisis. The standards were raised, and this is a relatively tough bar which we use for the assessment.

Australia demonstrates a strong framework. There is a high degree of compliance with international best practice standards. There has been clear progress in strengthening the regulatory framework and the effectiveness of supervision since the previous FSAP; a strong conservative capital framework; unquestionably strong capital benchmark; Basel liquidity; reinforcing sound mortgage lending; strengthening crisis management and preparedness, although the latter is still a work in progress. But the assessment does identify some gaps in the arrangements and points that we have put forward to the Australian authorities for their consideration. Some of them are consistent with the comments that have come out in terms of the Royal Commission report. For example, the toughening of enforcement powers and a stronger application of that to support effective risk management and to mitigate future misconduct, strengthening the oversight of banks' governance and risk management through providing stronger in-depth and periodic reviews by the supervisor, and a number of other recommendations which are highlighted in the report.

But underpinning these actions, we do make suggestions to bolster the independence and the resourcing of the regulatory agencies. We do see some constraints in Australia on the exercise of powers and discretion by the regulatory authorities, which we believe jeopardizes their independence—for example, the power of ministers to issue directions about the policies that regulators should pursue, as well as to decide significant changes in bank ownership. There is no disclosure of reasons for the dismissal of an APRA Board member set in the legislation. None of these have actually been applied to date in practice, but they are all potential factors which can have an influence. In terms of the international best practice standards, then we are making some suggestions for strengthening the framework.

We also seek some constraints on the budgeting and resourcing of the regulatory agencies, which can affect their planning and ability to attract and retain skilled staff in certain areas. At present, the budget is set on an annual basis. APRA has to submit new proposals, which limits medium-term planning and certainty. The 2014 Financial System Inquiry in Australia recommended a three-year funding model to provide more stable funding for APRA and Australian Securities and Investments Commission. That recommendation is not yet enforced. It is still under consideration by the authorities.

We continue to suggest some recommendations in this particular area for consideration by the Australian authorities in terms of funding and independence. With respect to independence, I would just like to quote an assessment by APRA, which is a prudential regulator, in their submission to the Financial System Inquiry in 2014. They write in the executive summary: "APRA has substantial independence from government in most respects but, over time, constraints on its prudential, operational and financial flexibility have eroded its independence. As a consequence, Australia falls short of global standards in this area."

I wanted to provide that background to the Board for why we are making certain recommendations to the Australian authorities in this particular area.

Moving to Ms. Levonian's comments with respect to systemic risk oversight, we are suggesting an adaptation and improvement of the current framework. We are not suggesting a widespread change, but we are suggesting changes that would move in the direction of more formality, greater transparency, and accountability. We believe that would help to further strengthen what is already good collaboration between the regulatory authorities in Australia, would help them harness the collective resources. It will help them in terms of improving the data and analysis, as well as their preparedness and readiness to apply new tools. Our recommendations are working with the grain, rather than suggesting a radical change, which we do not believe is appropriate or would apply, given that the system is a well-functioning system.

Third, on Mr. Gokarn's comments on the Royal Commission, the staff have been up early this morning. I cannot claim to have read all 1,000 pages of the Royal Commission's report. But I would say that the Royal Commission's report is consistent with the thrust of the recommendations in the FSAP. In the FSAP, we are focusing much more on the prudential side. The Royal Commission is focusing much more on conduct. But as I have indicated, we are suggesting a strengthening of the regulatory and supervisory system; we are suggesting stronger enforcement. We are very pleased by the comments this morning by the Australian Government in terms of the resourcing of the regulatory authorities and providing additional funding in the budget, which we believe also works in the same direction. Subject to Mr. Ray's comments on that, I do not believe that there are any particular conflicts on this point.

Mr. Castets reiterated his question on the constraints preventing an increase in infrastructure investment and whether the authorities had a comprehensive plan in place to overcome those difficulties.

Mr. Palei noted that the authorities were interested in national savings, and there were many policy initiatives aimed at increasing national savings. He asked for the staff's view on the drivers of national savings in Australia. Was the fact that the superannuation scheme was compulsory an important contributor to national savings? Or was it driven by other factors, like the introduction of fiscal rules and other factors?

The staff representative from the Asia and Pacific Department (Mr. Helbling), in response to further questions and comments from Executive Directors, made the following additional statement:

On the infrastructure, the authorities, over the past few years, have strengthened infrastructure planning and execution, and in that process, have also built up a pipeline of infrastructure projects. In that sense, our assessment would be that the authorities are more ready to execute and implement and vary infrastructure spending in line with macroeconomic needs. At the moment, though, as noted in the staff report, constraints have emerged. The authorities have ramped up infrastructure spending, and capacity constraints have become an issue. That is perhaps one of the reasons why we would not, at the moment, push very hard on raising infrastructure spending. Clearly, coordination between different levels of government is becoming an issue, and the authorities have worked to improve the situation in that regard. In areas of overlap, city deals have provided a vehicle for coordination. With the ramping up of infrastructure spending, coordination between and within states has become an issue. If we then look at states further, they are also ramping up their planning and execution capacity.

On the national savings, we have not looked at that. There is a sense that compulsory saving schemes, everything else increase national savings, even if it were from myopia in the sense that households do not fully account for the fact that, on the other hand, the public pension system, in a sense, has been "downgraded" to more of a social safety net, although it is a very comfortable social safety net, given the public pension scheme.

Finally, in the background work on the fiscal anchor and the fiscal framework, we used net public debt because that is the main metric on the debt side in Australia's fiscal reporting, so we stuck with the country preferences.

Mr. Ray made the following concluding statement:

I thank Directors for their comments and observations. Many Directors have touched on a the issues I will discuss in my remarks.

Australia has been growing for 27 years without a recession. I wanted to talk about this in three parts. One part is luck. It is a bit of statistical luck to avoid a technical recession when there is a major shock that hits the economy hard, but it all fell in one-quarter. A degree of modesty about this is important. What is more important is how Australia was able to avoid significant real shocks throughout a series of big global events—the Asian financial crisis, the dot-com boom, and global financial crisis; but these all pale when looked at in terms of the terms of trade shock that we have been through. Between 2003 and 2011, our terms of trade doubled as a result of mainly positive shocks to global commodity prices. Import prices were also falling, but it was mainly on the export price side. The rise in the terms of trade prompted an unprecedented boom in mining investment. If one looks at investment, mining investment-to-GDP in Australia hovers around 2 to 3 percent; 3 percent is a boom. In this current cycle, mining investment went to 9 percent of GDP, so three times the size of any of the previous mining booms in recorded data. Australia is the world's largest exporter of iron ore, coal, and recently liquefied natural gas (LNG). It is also the second-largest producer of gold. Resource exports account for 56 percent of our total exports. But I wanted to put that in context. Our mining sector only accounts for 8 percent of value added, and it contributes less than 2 percent to employment. The services sector accounts for three-quarters of value added and more than that in employment.

The second thing to take away from Australia is that our diversified economy, diversified drivers of growth, particularly when the economy is open and subject to external shocks, are pretty important.

The third part has been the flexibility to adjust, due in no small part to a series of structural reforms that, in some ways, Australia took later than many other OECD countries, starting in the mid-1980s, particularly the floating of the currency and the reduction of trade barriers. Australia's longstanding and firm commitment to open trade and investment and immigration, as Mr. Kaizuka mentioned, has stood us in good stead. In that regard, I thank Directors for their support for a continued commitment to free trade, foreign investment, and immigration. It is not always easy politically, and it is important to have support from the Fund. It is important to bolster the political drive for this.

Australia is also a current account deficit country. Once upon a time, that was considered to be a problem. It reflects the fact that our strong investment demand is not able to be fully met by domestic savings, despite, as Mr. Palei says, relatively high levels of national saving. This is because we have a lot of resources and a sparsely populated country, and we need foreigners to come and give us the capital to dig them out and export them.

On immigration, nearly 30 percent of Australians were born overseas, and more than half of Australians were either born overseas or one or the other of their parents was born overseas. This is quite large, by world standards. Immigration has been an important source of labor supply for Australia since the 1980s. It has made the largest contribution to growth in Australia's working age population. Migrants, on average, are more educated. They are younger than the resident population. They tend, on average, to pay more tax and to draw fewer welfare benefits. All of this has helped Australia more than officials and politicians thought at the beginning of this century. The observation is that demography is not quite destiny, and there are active policy choices that can be made.

Turning to the housing market. The recent cooling in house prices is welcome amid significant and sustained price increases in recent years. It is helping to increase housing affordability, and it is probably helping to rebalance supply and demand. Recent falls in house prices in our two largest cities have only partly unwound the strong growth recorded in those cities. Capital city house prices, overall, remain about 40 percent higher than they were five years ago. Household debt is elevated, relative to incomes, but their household balance sheets are generally strong. Housing credit growth has not been unusually strong. Many households have built significant mortgage buffers. This housing cooling is unusual in Australia because it is occurring without the central bank lifting interest rates, and it is also occurring when the labor market is very strong.

As Directors have noted, Australia has got significant conventional and non-conventional monetary policy and fiscal policy space to help manage the impact of potential shocks on the economy, most of which are likely to come from overseas. In this sense, my authorities appreciate the support of

Directors who agreed that additional investment in infrastructure needs to be taken carefully, given the current moment, and have noted Australia's preference for quality projects and a desire to preserve fiscal space to respond to adverse external shocks.

As a small, open economy and importer of capital, maintaining a prudent fiscal stance is important. While we have got the exchange rate to adjust, fiscal policy needs to be carefully managed. In that regard, I agree with Mr. Kaizuka and others who talked about the need to look at whether net or gross debt is the right measure. Traditionally, in Australia, we have used net debt, but not all of the debt assets are liquid. Prudent management suggests that, when one look at these things, one should look at both, whether or not one chooses net debt as the target.

Notwithstanding all of this, Australia is not without its challenges. In recent years, progress on structural reform has been relatively slow, and that is unfortunate for the future. A few Directors noted energy policy, where the experience has been less than positive.

January of this year was Australia's hottest month since records began. We now have rain falling in meters in large urban centers on the Queensland coast. Dealing with these things is not easy, and it is something where the staff can help the authorities in the coming years.

I would like to turn to the FSAP. I brought with me the documentation. It is almost as long as the Royal Commission's report. It is all going to be published, and I do wonder whether we really need to have quite so much documentation. It is difficult for anybody to digest. That being said, my authorities are happy with the outcome and the assessment; most notably, that stress tests highlight that Australian banks could withstand significant shocks. The shocks included a combination of a large slowdown in our largest trading partner, China, along with a severe correction in house prices.

However, as has been discussed this morning, there are components of the assessment where my authorities—like the IEO—believe that the recommendations could have been better grounded in the local circumstances and not overly reliant on so-called international best practice. In particular, my authorities are disappointed by the staff's assessment of regulatory independence. My authorities do not believe it takes sufficient account of the operating context. We appreciate the support that Directors have given the authorities on this issue. Quite frankly, such recommendations strike at the very nature of systems of government. There are fundamental checks and balances in Australian parliamentary system that are designed to hold government agencies accountable to the executive and parliament and, ultimately, the public. They are very important to our system. My authorities do not believe that they should be considered as compromising operational independence.

A word on the budget; Australia budgets across four years. Regulatory agencies are funded out of taxes. Taxes, under the constitution, have to be paid into the Consolidated Revenue Fund, and the parliament has to appropriate money for spending. That is a basic system. It is not inappropriate for defense spending, and I do not believe it is inappropriate for regulators.

On macroprudential policy, the Australian authorities are open to exploring a range of tools. This is exactly what happened when they were considering what to do in the housing sector in recent years. A wide range of options was considered before arriving at the specific measures that the authorities believed were best targeted.

Looking ahead, my authorities will continue to explore a range of prudential tools, including in a liquidity context, which Mr. Just's colleagues noted in their gray statement.

All in all, Australia's financial system remains fundamentally sound. Australia's banks' capital ratios are around 50 percent higher than a decade earlier. Banks have switched to more stable funding source and increased their holdings of liquid assets.

A number of Directors urged caution in regards to the use of wholesale funding by Australian banks. This is a longstanding issue. Because we run a current account deficit in Australia, we need to import capital somehow. Banks are relatively efficient at doing it. In particular, global money markets provide the Australian banks with a much deeper market, with a wider investment base than the relatively small domestic market. The banks manage the risks of borrowing in that market by borrowing from overseas investments effectively in Australian dollars and fully hedging both the exchange rate and interest rate exposures on the day that they borrow at relatively low cost. If it was not relatively low cost, they would not do it.

Lastly, I would like to thank both teams, ably led by Mr. Helbling and Mr. Jenkinson. Both reports are extremely useful, and they are an informed contribution to the policy discourse in Australia. I just wanted to add a personal note, that in Australia, what the Fund says gets published on the front page of the paper. Therefore, my political masters take notice of what the Fund says. That trickles down so that the engagement that the officials have with the Fund in Australia can be robust but are valued by my colleagues greatly. I would like to, again, thank the two mission chiefs for conducting the excellent missions to Australia last year.

The Acting Chair (Mr. Zhang) noted that Australia is an Article VIII member, and no decision was proposed.

The following summing up was issued:

Executive Directors agreed with the thrust of the staff appraisal. They commended the authorities for their sound macroeconomic management and strong policy framework which have contributed to over two decades of robust and resilient economic performance. Directors noted that although growth is expected to remain above trend in the near term, a weaker global economic environment, high household debt, and vulnerabilities in the housing sector could weigh on medium-term growth. Against this background, they highlighted the importance of maintaining supportive macroeconomic policies to secure stronger demand momentum, address macrofinancial risks, and boost long-term productivity and potential growth.

Directors agreed that continued macroeconomic policy support is essential until full employment and the inflation target are firmly within reach. They considered monetary policy to be appropriately accommodative in the current circumstances and advised that policy normalization should depend on firmer upward pressures on prices.

Directors welcomed the supportive fiscal policy stance. They commended Australia's infrastructure investment boost as a critical source of demand in the near term. Directors also welcomed the authorities' prudent medium-term fiscal plans, targeting budget surpluses from FY2019/20. The principle of running budget surpluses in good times has been an important anchor for fiscal discipline in Australia. Directors generally considered that a medium-term debt anchor could further help strengthen the medium-term fiscal strategy. Noting the uncertainty about the recent strength in revenues, Directors encouraged the authorities to exercise prudence in approving permanent tax cuts or expenditure increases.

Directors agreed that the macroeconomic policy response needs to be flexible. They noted that given limited conventional monetary policy space, discretionary fiscal stimulus may need to complement monetary easing in the event downside risks materialize. Most Directors noted that Australia’s substantial fiscal space could be utilized for further increases in high-quality infrastructure spending to boost potential growth. At the same time, a number of Directors noted that the fiscal space could be preserved as a buffer to deal with shocks.

Directors welcomed the authorities’ macroprudential interventions to reduce credit risk and reinforce sound lending standards. They concurred that, with high prices for residential real estate along with elevated household debt, macroprudential policies should hold the course on the improved lending standards and further strengthen bank resilience by refining the capital adequacy framework. Directors also saw merit in expanding and strengthening the macroprudential toolkit to allow for more flexible responses to financial stability risks.

Directors welcomed that Australia’s financial system remains fundamentally sound. They supported the FSAP recommendations to strengthen systemic risk oversight of the financial sector. They generally noted that the quality of supervision would be further bolstered by strengthening enforcement powers to support effective risk management and by making additional investment in data and analytical tools. Directors encouraged the authorities to strengthen the integration of systemic risk analysis and stress testing with supervisory processes, complete the resolution framework, and expedite the development of bank-specific resolution plans.

Directors underscored the need to remain vigilant about housing market developments. They noted that while the housing market correction is helping housing affordability, continued housing supply reforms remain critical for broad affordability and to reduce macrofinancial vulnerabilities. Directors generally encouraged the authorities to explore, where possible, alternative and effective non-discriminatory measures for buyers.

Directors stressed that to lift productivity and longer-term growth, sustained structural policy efforts will be needed. These should focus on continuing to close macro-critical gaps in infrastructure, greater female labor force participation, research and development, sustainability of energy policy, as well as broad tax reform. Directors welcomed the authorities’ commitment to openness and trade and their participation in the Comprehensive and Progressive Agreement for Trans-Pacific Partnership.

It is expected that the next Article IV consultation with Australia will be held on the standard 12-month cycle.

APPROVAL: April 15, 2020

JIANHAI LIN
Secretary

Annex

The staff circulated the following written answers, in response to technical and factual questions from Executive Directors, prior to the Executive Board meeting:

Outlook and Risks

1. ***Could staff share any latest estimates or analysis on the potential size of the impact of the China-US trade tensions on Australia? While trade tensions between China and the US could pose downside risks to Australia, we wonder if there are also potential upside effects from a reduction in trade between China and the US, such as diversion of agricultural and services (including education services) imports by China from the US to Australia? Staff's comments are welcome.***

- Recent scenario analysis for the October 2018 Asia-Pacific Regional Economic Outlook on trade tensions and trade liberalization, which was presented at the IMF 2018 Annual Meetings in Bali (available online at https://www.imf.org/en/Publications/REO/APAC/Issues/2018/10/05/areo1012 using the link "Background Papers") speaks to the issue. The tariff increase scenario in this work remains relevant, as it still reflects the current situation for tariffs between China and the United States, as well as the views of the IMF's China team (broadly).
- In the scenario, Australia would see a loss from trade tensions of less than 0.1 percent of GDP by 2020 through the trade channel (assuming only the current tariffs in place), with some offset from exchange rate effects. However, if the tariff increases also involved financial market disruption and lower business confidence, the loss in GDP could amount to almost 0.5 percent of GDP by 2020.
- There could be some potential upside from trade tensions for Australia, but it would depend on the effects in China.
- Without any fiscal response by China, the Chinese economy would be worse off relative to a scenario without trade tensions, and Australia would be worse off in its trade with China; any gains from an exchange rate depreciation would come from other trading partners.
- Even if China were to engage in offsetting fiscal stimulus, relative to a scenario without trade tensions, the engine of growth would likely be infrastructure investment, and consumption would still be lower than otherwise. This would be negative for China's imports of services and agricultural goods.
- However, Australia would then maintain, or perhaps experience a positive impact on, its commodity sector, given it is the China's main foreign supplier of inputs for steel used in infrastructure investment (namely, iron ore and coking coal).
- Australia might even experience somewhat of an appreciation, which would then reduce the positive spillovers from higher services exports to other countries.

2. ***While downside risks dominate, staff also mentions upside risks to growth, e.g. a stronger pickup in the non-mining sector, or spillovers from public infrastructure investment and in case of a larger currency depreciation. Could staff elaborate on such a positive scenario?***

- A stronger pick-up in the non-mining sector or higher spillovers from public infrastructure investment would further enhance productivity, most likely economy-wide, thereby having
- supply effects - encouraging investment; encouraging further exports of goods, perhaps high-technology goods; lowering production costs which further stimulates demand for capital (and thereby investment) and labor (employment, perhaps even pushing up wages, especially since real wages would be less because of higher productivity from the firms' perspective)
- demand effects – lowering prices (pass-through from lower production costs) allowing for higher real consumption for a given nominal income; increasing consumption because of wealth and income effects from increased employment (a supply-side effect above).
- A larger depreciation would serve to stimulate exports (goods and services) and production. While the cost of imports would rise, this would only mute the export effects, and could still be offset by the effects of higher productivity mentioned above.
- The depreciation itself could be a consequence of the higher productivity described above if it is broad-based in both tradable and non-tradable sectors.

Fiscal Policy

3. ***While we agree on the need for medium term debt anchors to augment the medium-term fiscal strategies, we wonder if staff has conducted preliminary work on fiscal implications going forward. Staff comments are welcome.***

- This issue was addressed in an earlier SIP from the 2016 Article IV Consultation (issued as IMF Working Paper 17/286, Dizioli, Karam, Muir and Steinlein, "Australia's Fiscal Framework: Revisiting Options for a Fiscal Anchor.").
- While IMF WP/17/286 does not suggest a desired level for a debt target (this is a decision for the Australian authorities), it considers what type of longer-term fiscal anchor would be most resilient in the face of three common shocks in Australia – a positive demand shock, a negative terms of trade shock, and a negative productivity shock.
- The paper finds that the economic impact would be smallest with a medium-term debt anchor. Such an anchor would return debt most quickly to its desired level conditional on minimizing the cumulative effects on, and producing the least variability of, real GDP relative to other tested anchors.

4. ***We wonder if in the current juncture of very low public debt, adding a debt anchor to the existing framework, would introduce additional rigidities to fiscal policy in the event of an external shock. Staff's comments on what the appropriate conditions would be to introduce such modifications are welcome.***

- The rationale for using a longer-term debt anchor would be to provide for sufficient flexibility in responding to economic fluctuations while anchoring debt in the long-term. Fluctuations in debt ratios would generally be larger with the current short-term to medium-term budget balance anchor.
- The only conditions under which it would be inappropriate to replace a medium-term budget balance anchor with a longer-term debt anchor would be in the depths of a large shock, such as during the sustained plunge in commodity prices in 2011, or the GFC.
- That said, introducing a target during a time of stability when actual output is expected to remain close to potential output would make it easier to establish credibility for a long-term debt anchor quickly compared to a time of instability when fiscal policy might have to focus on output stabilization, with some temporary debt drift.

5. ***The interesting SIP on Australia's fiscal framework usefully explores possible options to strengthen the MTFS as a fiscal anchor, including adding a medium-term debt anchor. While we note the authorities' willingness to consider these suggestions, as mentioned in the buff statement, we ask staff to comment on the political traction of such a policy advice given Australia's low debt relative to other advanced economies and the fact that the current fiscal framework seems to have worked well so far.***

- Staff will respond to this question during the Board meeting.

6. ***Could staff offer more details on the drivers for the swings and when the debt anchor proposed is necessitated, bearing in mind the broader productivity enhancement agenda?***

- Using only a deficit anchor means that each time the target level is missed, the effect on the debt level is not explicitly unwound.
- In an environment with small deficit deviations, and/or short-lived deviations, all which average to zero over time, then debt, while still following a random walk, is also less likely to experience drift.
- However, the current environment seems to be more volatile and experience longer-lived shocks, such as the GFC or the end of the terms-of-trade / mining investment boom in Australia. Current risks in the international environment point to

a high degree of likelihood that an environment of large shocks or highly persistent shocks will continue, in which case a debt anchor would provide an additional stabilizing influence that encourages private sector activity unimpeded by fiscal issues, as originally intended by the principles of Australia's *Charter of Budget Honesty Act*.

- This is the broad motivation provided in both the accompanying Selected Issues Paper, Muir, "Evaluating and Reinforcing the Commonwealth of Australia's Fiscal Strategy," and previous work from the 2016 Article IV published as IMF Working Paper 17/286, Dizioli, Karam, Muir and Steinlein, "Australia's Fiscal Framework: Revisiting Options for a Fiscal Anchor."

7. ***We take note of recent press reports that the government will soon outline a plan to eliminate Australia's net debt within a decade to reach a "debt-free day". We would welcome staff elaboration on their recommendation on debt anchors whether these should include both gross and net debt?***

- The level of the debt anchor should be the choice of the Australian authorities. Choosing an anchor based on net debt is more sensible, since a gross debt anchor would not acknowledge the assets held by the government that are available to cover part of their debt obligations.

8. ***We would welcome staff's more detailed comments on the strategy and measures through which the authorities plan to achieve the reduction of recurrent spending, including the wage bill.***

- The Commonwealth government has focused on improving delivery of services as well as better targeting and ensuring better compliance for certain social expenditures such as family assistance.
- Delivery of services are being improved by pursuing technology solutions and avoiding duplication with other levels of government (or at least ensuring better coordination between governments).
- Improved delivery of services can also allow for a reduction in the government workforce over time. There is no explicit target, but natural attrition will be the primary driver for reductions.
- Spending is being better administered during Budget 2017-18 and/or Budget 2018-19 also through:
- Revising down the discount rate of the future costs of pension obligations, recognizing that the neutral real rate of interest is most likely lower post GFC.
- Strengthening administration and regulation of income support for people with disabilities.
- Strengthening administration and regulation of vocational training programs and unemployment insurance.

- Better targeting payments related to the revised R&D tax incentive program.

9. ***We take note of staff's recommendation that Australia could consider further increases in infrastructure investment given substantial fiscal space. Here, we would welcome staff elaboration on possible measures to address emerging capacity constraints and skills shortages and promote additional infrastructure investment.***

- For infrastructure investment, there are still gaps in some areas of the country that could be filled. While the major cities have strong pipelines (Sydney, Melbourne, Brisbane, Perth) there is always scope for more transportation-related projects, upgrades to social infrastructure (especially as technology continues to increase its role in education, health care and aged care), and infrastructure to increase and sustain the housing stock. Australia is not unique in this regard, especially for social infrastructure.

10. ***We note the introduction of a 23.9 percent of GDP cap (or speed limit, as the authorities describe it) on tax revenues; this can be a risk to achieving the medium-term fiscal objective. As staff, we encourage the authorities to look at this cap flexibly, and to carefully consider taking any measures with a permanent nature on the basis of an outcome that can be (unexpectedly) of a cyclical nature. Additionally, we would like to ask staff whether there are experiences in other countries where a similar rule has been introduced.***

- The closest comparable example has been Denmark's "tax freeze," from 2001 to 2011, where direct and indirect taxes could not be raised unless it was for environmental reasons or to fulfill Denmark's EU obligations and if extra revenue was used to reduce other taxes, at all levels of government.
- Its motivation was that by clearly restricting the level of tax revenues available, government spending would have to fall in line to prevent large or rapid or persistent increases in debt.
- However, it proved to be restrictive in face of certain spending demands and was removed in face of the unexpected effects of the GFC, when automatic spending obligations pushed up government debt rapidly (by over 20 percentage points of GDP). Reducing the resulting debt load would have required very large spending cuts without the mitigating impact that was allowed for by removing the tax freeze and allowing tax increases to bear part of the adjustment process.

11. ***Could staff elaborate on the quality of public investment management in Australia and what are its recommendation in this field?***

- Australia at both Commonwealth and State/Territorial levels has consistently issued and improved regulations for tendering and procurement processes, which have encouraged strong public investment management processes, and public-private partnerships have been strongly supported at State/Territorial levels by government units, especially in New South Wales, Victoria and Queensland, with further developments in other States and Territories.

- Ex-ante benefit-cost analysis has been strong, thanks to the presence of the Commonwealth's arm's-length agency, Infrastructure Australia, with strong independent State and Territorial equivalents, especially in New South Wales, Victoria and Queensland.
- Staff is of the view that the public investment management process is robust in Australia, and a leading example for other countries.

Monetary and Exchange Rate Policies

12. ***The nexus of the high household debt with the channels of monetary policy transmission adds complexity to the normalization process and will require continuing judgment along the way. Could staff elaborate more on the findings of the forthcoming IMF Working Paper referred to in the report?***

- The empirical analysis in the forthcoming working paper examines the response of households with various level of household debt (grouped by debt-to-net -worth quartiles) to a contractionary monetary policy shock, as well as potential impact on monetary policy transmission.
- The paper finds that current consumption and durable expenditures of households with high and medium debt levels would decline in response to a contractionary monetary policy shock. In contrast, households with low debt levels may not respond or may even increase their consumption, suggesting that in this case the income effect dominates the intertemporal substitution effect.
- The results of the analysis suggest that with a larger share of households with high debt and given their responsiveness to a monetary policy shock, it may take a smaller increase in the cash rate for the RBA to achieve its policy objectives, compared with past episodes of policy rate adjustment.

13. ***It is also notable that monetary easing is highlighted as the main policy reaction to every downside risk, which raises questions about the space for such response in case some of the risks materialize. Staff's comments would be appreciated.***

- While the conduct of monetary policy by the Reserve Bank of Australia (RBA) has limited conventional policy space, there is nothing preventing the RBA from resorting to unconventional monetary policy instruments if necessary. Moreover, fiscal policy is also often suggested as a complement to monetary policy in response to many of the risks listed. The Staff Report notes that fiscal policy may have to be a larger role relative to monetary policy in a broader downturn, given limited conventional monetary policy space.

14. ***On staff's recommendation for more explicit RBA guidance on when labor market conditions would warrant policy normalization, the authorities' approach outlined in the buff appears to sensibly balance communication and flexibility objectives. In staff's view, are there specific areas in the RBA's current communication strategy that would benefit from further guidance?***

- This is a general recommendation. With the concept of full employment becoming more multi-dimensional than in the past, private sector counterparts might find it difficult to assess the monetary policy stance based on past experience. Continued labor market assessments will thus remain critical.

Financial Sector

15. ***An increase in earnings and profitability in the banking sector has been registered, whereas the data on the evolution of NPLs is not conclusive. Could staff elaborate on the sources of greater gains in the financial sector and if the asset quality of the system has strengthened?***

- Banks' asset quality has been stable for a number of years, and NPLs are low at slightly less than 1 percent of total loans. NPLs are also mostly secured mortgage loans so the proportion of impaired loans is quite small. The authorities have taken steps to strengthen banks' capital ratios, which are now at 14.6 percent CAR, as of 2018Q3.
- Banks' lending standards have also improved because of tighter regulation. The introduction of a requirement on banks to test the debt-servicing ability of borrowers at 2 percentage points over the current interest rate has provided borrowers with a buffer against repayment difficulty at higher interest rates. In the past, the authorities also introduced caps on banks' origination of interest-only loans, which helped to lower the proportion of riskier loans in the system.
- Nevertheless, a high proportion of the stock of mortgage loans are still interest-only loans. Such loans tend to have higher outstanding balances and some borrowers could face repayment difficulties at the expiration of interest-only periods especially if rates were to rise sharply.

16. ***While we understand the authorities concerns about an excessive reaction of commercial banks unduly reducing credit flows, we wonder why raising the cap on interest-only loans to 30 percent of new loans was necessary to "provide more flexibility in the pace of conversions of interest-only loans to principal-and-interest***

***loans". Also, what is the share of interest-only loans in the loan portfolio? Staff's comments are welcome*.**

- The share of interest-only (IO) loans in banks' combined loan portfolios is about 27 percent of the total (as of September 2018). Staff considers that the decline in the share of interest-only loans is a welcome development because borrowers who take out IO loans tend to be more exposed to adverse shocks than those with conventional principal and interest (P&I) loans as they tend to carry higher loan balances. In this context, the removal of the cap on IO loans from 30 percent of new loans provides banks with some flexibility in refinancing IO loans.

17. ***Stress tests found that the ten largest banks are resilient to combined shocks, although vulnerabilities related to reliance on wholesale funding warrant monitoring. In this regard, we welcome the introduction of a net stable funding ratio and a timeline for the adoption of a minimum leverage ratio. Could staff elaborate on to what extent these regulations would reduce this vulnerability in the period ahead?***

- Australian banks have reduced their reliance on wholesale funding significantly since the GFC, from around 50 percent of all (non-equity liabilities) before the GFC to about one-third recently. The adoption of the NSFR (as of January 1, 2018) contributed to the decline of the share of wholesale funding in recent years. Going forward, staff considers that banks' use of wholesale funding is unlikely to drop further due to NSFR regulation, as the larger banks are already compliant.
- Staff also considers that the adoption of a leverage ratio would have negligible impact on banks' portfolios since the top 10 banks by assets already have leverage ratios well above the Basel minimum requirement of 3 percent. At the same time, however, the announced implementation of the leverage ratio will place a backstop to the risk-based capital framework and will thus be a welcome addition to Australia's prudential toolbox.

18. ***We take some comfort, however, from the buff statement that household balance sheets are generally strong, and the distribution of debt is skewed towards high income households. Could staff explain a bit more on the relationship between household debt and offset accounts, and to what extent do these offset accounts could provide a buffer?***

- Most of the debt of Australian households is secured against some collateral (typically real estate) and most is comprised of mortgage debt (see, figure 17 top left-hand panel in the FSSA, for instance).
- Offset accounts are one of a number of buffers that Australian households have in relation to mortgage debt. An offset account acts like an at-call deposit account, in

which funds in the account are netted against the borrower's outstanding mortgage balance for the purposes of calculating interest on the mortgage loan. Net household debt, calculated by netting out offset balances, is about 13 percent lower than gross household debt, as of September 2018.

- Another buffer is a redraw facility, which allows a borrower to reduce future mortgage balances and interest payments by making higher-than-scheduled repayments, but with the ability to reborrow the 'overpayment'.
- Finally, an additional buffer protecting households from payment shortfall against debt is the existence of large savings in the form of superannuation accounts. While these accounts are segregated and may not be drawn until retirement, households are able to borrow against them to alleviate a temporary cashflow shortage in extenuating circumstances.
- While these different types of buffers have been rising over the past few years, the RBA notes that while one-third of outstanding owner-occupier mortgages had at least two years' buffer, around one-quarter had less than one month (RBA Speech, 2018).

19. ***We do not find that staff have provided a compelling case to increase the formality of the Council of Financial Regulators. Can staff elaborate on their claim that the current, more informal system creates a bias towards inaction? Can staff further elaborate on the potential costs, as well as the benefits, of moving to a more formal system?***

- Staff note that while the Australian authorities, through APRA, have certainly taken significant action to address the buildup of housing-related risks from the viewpoint of institutional safety and soundness, they have not (of their own admission) focused particularly on the systemic risk perspective. Despite a buildup of risks, the authorities did not take any macroprudential measures until December 2014 and, for example, have chosen not to activate a countercyclical capital buffer for banks, which could be unwound at the turn of the cycle, and have preferred to rely on raising the (prudential) capital standard. Household debt levels and asset price valuations do not enter directly into APRA's regulatory framework. While of course the regulator is aware of the macrofinancial backcloth and risks, it is natural that the prudential regulator focuses somewhat less on these issues, particularly when it is separate from the Central Bank which has the mandate for and expertise in financial stability. But this is why, despite regulatory actions having been effective, and that the arrangements have worked well historically in terms of flexibility and cooperation, staff would submit that the current arrangements may lead to a bias towards inaction on the systemic risk side, and why the FSAP recommends reinforcement of the framework through greater formalization and transparency of the work of the CFR to strengthen accountability.
- Staff considered very carefully the issue of "best fit" in terms of the Australian framework and thus did not recommend any wholesale institutional reorganization or

granting of independent authority to the CFR, actions that could have been disruptive to a well-functioning system. Rather staff recommended that the authorities increase transparency, accountability, and coordination across the regulatory agencies on systemic issues, and also invest in data and analytics that would facilitate deeper assessment of systemic risks and enable the use of macroprudential tools in the future. While these may have costs in terms of resource allocation, they also deliver significant contingent benefits in terms of regulatory flexibility and enhanced tools to deal with future systemic risks.

- The Australian authorities have recently (December 2018 - after the concluding mission of the FSAP) taken positive steps that move in the direction of FSAP recommendations, in particular by providing greater transparency through the publication of a statement following each of their quarterly meetings. This initiative is very welcome.

20. ***Reducing banks' use of wholesale funding would help decrease vulnerability to external funding risks. Have measures recently been introduced, or are additional measures foreseen, to reduce banks' dependency on foreign wholesale funding?***

- In recent years, the Australian authorities introduced the Basel regulatory standards for liquidity, the LCR and NSFR, which actively encourage banks to rely on more stable sources of funding and reduce their reliance on wholesale funding. Additionally, APRA has strengthened supervisory standards and guidelines for managing broader liquidity risk (standard APS 210 and guideline APG 210) and enhanced its supervisory work as described in the Detailed Assessment Report on Banking Supervision accompanying the FSAP.
- In relation specifically to liquidity risks in foreign currency, APS 210 sets out that ADIs active in multiple currencies should maintain liquid assets consistent with the distribution of liquidity needs by currency. In conducting reviews, supervisors look for adequate policies, procedure and frameworks to manage foreign exchange risks, in particular, the ability to raise funds in foreign currency markets, the ability to transfer a liquidity surplus from one currency to another and across jurisdictions and legal entities, the likely convertibility of currencies in which the ADI is active (including the potential for impairment or closure of foreign exchange markets for particular currency pairs), and the capacity to manage risks arising from currency mismatches, including from risks of sudden changes in exchange rates or market liquidity, or both, that could materially affect liquidity mismatches and the effectiveness of foreign currency hedges. ADIs' liquidity strategies are expected to take into account a variety of operational restrictions in their ability to liquidate assets in a time of stress, as well as time zone differences. ADIs are also expected to undertake stress tests capturing risks including their funding and foreign exchange mismatch risks in domestic and offshore locations.

21. ***We would like to hear staff views on the balance adopted for anchoring FSAP recommendations (considering the local governance structure and related systemic risks) vis a vis international best practices. Could staff elaborate?***

- FSAPs provide a comprehensive and in-depth analysis of a country's financial sector. To assess stability, staff examine the resilience of the banking and non-bank financial sectors; conduct stress tests and analyze systemic risks, including linkages among banks and nonbanks and domestic and cross-border spillovers; examine microprudential and macroprudential frameworks; review the quality of bank and nonbank supervision and financial market infrastructure oversight; and evaluate the ability of central banks, regulators and supervisors, policymakers, backstops and financial safety nets to respond effectively in case of systemic stress. Such assessments and the resulting recommendations are focused on the risks and policy frameworks applying in each member country. To support the assessments, where relevant and appropriate. and in agreement with the authorities, staff draw on international standards, codes and best practices that have been agreed collectively by national authorities through international standard setting bodies such as the BCBS, FSB, IOSCO, IAIS, CPMI etc. Under the FSB Charter, member countries commit to implement such international financial standards. The assessments undertaken as part of FSAPs thus provide authorities with a comparable, independent benchmark of the consistency of their national policy framework with international standards in highlighted areas, based on an extensive and detailed review that is anchored by the local approach. Policy recommendations are provided to the authorities for their consideration that take full account of national circumstances.
- In the case of Australia, which is an active member of international standard setting bodies, the IMF's assessment of financial supervision was based on an extensive review of the existing legal and regulatory structure in Australia and the related supervisory practices and processes. It was also informed by extensive discussions with APRA teams and other stakeholders. In the assessment, staff has taken into consideration the local governance structure and reviewed the extent to which it allows APRA to fulfill its mandate and be in compliance with international standards. The FSAP has recognized that various aspects of the local governance structure enhance the accountability of APRA to the Executive, Parliament, and ultimately the general public. However, it also found that some aspects of the current framework may undermine APRA's operational independence (including in relation to budgeting and staffing and its prudential policy making powers), as stipulated in international standards. Many of these issues were highlighted in the previous FSAP and have also been noted in local documents, including the 2014 FSI inquiry and APRA's submission to this inquiry.

Housing Markets

22. ***Staff are concerned that in the event of a sharp real estate market correction, present macrofinancial linkages may send the economy into a loop of falling real estate valuations, higher NPLs, tighter bank credit, and weaker growth. The buff states, however, that many households have built significant mortgage buffers and that household debt is skewed towards high-income households where the top 2 quintiles hold over 60 percent of household debt. Staff comments are welcome.***

- Staff would agree that from a risk perspective, it is better for a greater share of total household debt to be held by wealthier households than low-income households. Nevertheless, household debt ratios have increased across all income quintiles, and if a significant share of household becomes more cash- or finance-constrained, the impact of many negative shocks could be amplified by high household debt.
- Moreover, staff considers that it might be more relevant to assess financial stability risks based on the debt-servicing ability of households in relation to disposable income or household assets.
- Using such metrics, a survey conducted by the Australian Bureau of Statistics found that nearly 30 percent of households had debt of 3 or more times disposable income, or 75 percent of the value of their assets, suggesting a sizeable share of households with potential debt servicing issues.
- See also the answer to question 18.

23. ***The reduction in housing starts and approvals underscored in the staff report may conceivably translate into increased gaps between supply and demand going forward. Hence, while we see room for the modification of key tax policy parameters affecting housing demand and land use, we wonder if it is not premature to remove existing policy measures including those that discriminate between resident and nonresident buyers. Staff's comments would be appreciated.***

- The broad principles from the institutional view emphasize that when capital flow management measures (CFMs) are adopted they should generally be temporary and be reconsidered when capital inflow pressures abate. While certain CFMs may be maintained over the longer term under exceptional circumstances (provided that they are imposed for reasons other than BOP purposes, such as financial stability or national security), these conditions are not relevant here.
- Against this backdrop and given that the role of foreign investors in residential real estate markets seems to have declined in the past 2 years and with the ongoing correction in housing markets, staff encourages the authorities to start reconsidering the CFMs, as other measures (including less discriminatory measures) have likely become sufficient to address housing market imbalances. The underlying housing shortages should ultimately be addressed through housing supply measures.

24. ***We take note that the authorities expect housing investment to slow by 2020. Could staff elaborate on this?***

- As the housing market correction is assumed to continue over the next year or so, staff's baseline projections incorporate a decline in private dwelling investment growth in 2019-20 on a quarterly basis.

25. ***We would be interested if staff could expand their position on the outlook for housing demand, which they expect to remain strong, despite some conflicting signs.***

- The underlying demand for housing is expected to hold up with robust population growth from immigration and migration to urban areas, continuing solid growth and improving employment conditions. Also, the housing market correction would decrease house price overvaluation, helping to improve housing affordability, thereby providing more opportunities for first-time home buyers.

26. ***The significant rise in household debt relative to income is concerning, and if the housing values fall more-than-expected, household net worth could quickly decline with corresponding effects on private consumption. Staff comments would be welcome, including whether wealth effects are considered.***

- Household debt to household net worth has remained stable (see the chart on page 7 of the Staff Report). The staff's baseline projection assumes private consumption growth to be supported by employment growth and gradual increase in wages, with a small negative wealth effect from anticipated house price declines on household spending.
- The magnitude of the wealth effect is somewhat uncertain. The RBA have long argued that there is little evidence of an impact on consumer spending of house prices during the period of large price increases (2013 to 2017), and therefore, do not anticipate a significant impact on spending as prices fall. There are also observations that, unlike in earlier booms during which rising house prices led to higher spending, this time round, households have been building mortgage buffers or amortizing their mortgages ahead of schedule.

27. ***Given rising housing prices, we wonder what type of policies Australia has designed to improve housing conditions of the poorest households and how staff assess them?***

- The Australian Housing and Urban Research Institute (AHURI) has estimated that while 384,700 households (4.4 percent of all households) were housed in social housing in 2016, Australia is facing a shortfall of 433,000 social housing units (5 percent of all households).

- To improve the housing condition of the poorest/poorer households, the Commonwealth government is introducing a new National Housing and Homelessness Agreement (NHHA) with the States and Territories. Under the agreement, it will maintain the Commonwealth's current funding of over $1.3 billion a year, with a requirement for concrete outcomes to build more homes and ensure improved housing outcomes across the housing spectrum. The Commonwealth Treasury noted that further reforms will include focus on improving outcomes in social housing and homelessness by providing $375 million over three years from FY2018/19 to make homelessness funding permanent and give funding certainty to providers of homelessness services under the NHHA. Staff welcomes these initiatives and looks forward to further discussions on this front.

28. ***Could staff elaborate more on what kind of discussions staff and the authorities made (especially, on what points staff and the authorities diverged their views) about a tax policy to reduce structural incentives for leveraged investment by households, and how do staff think the authorities' stance?***

- In this year's Article IV Consultation, the discussions focused on whether Australian tax settings were the primary factor favoring leveraged real estate investment by households or whether the tax settings were interacting with other factors, such as financial frictions (or "distortions"). There was broad agreement that the tax system was not the primary factor since the settings apply equally to all assets, including, for example, equity. However, effectively, because of financial frictions, notably the need for lending collateral, differences in lenders' risk tolerance across asset classes (and differences in capital requirements), leveraged investment by households is more prominent in real estate than in other asset classes.
- There was also broad agreement that, with the decline in inflation rates over the past two decades, the capital gains tax discount of 50 percent now seems too high. The discount was established in the late 1990s to compensate investor for inflation-related losses on real asset values, as the intention is to tax real capital gains.
- Disagreements have long centered around the role of negative gearing (the tax deductibility of losses from total income when owning an asset for which holding costs exceed the income stream) in supporting leveraged real estate investment. This feature of the Australian personal income tax system reflects the principle of universal income taxation and is only applied in a few other advanced economies. In staff's view, this setting favors leveraged real estate investment in booms and should be reconsidered or limited. While some officials acknowledge the issue, the authorities' general view is that that the economic benefits from having a personal income tax system based on the universal income concept outweigh costs. They see

considerable efficiency gains in having a system that does not discriminate between different asset classes.

29. ***How do staff think the negative consequences on the Australian economy by maintaining stringent lending standards and limiting credit to the real economy?***

- Staff welcomes the improvement in lending standards, which has further strengthened banks' resilience.
- The move to sounder lending standards should not have any negative impact on growth on a risk-adjusted basis.
- That said, undue increases in risk aversion by lenders, including, for example, because of uncertainty about changes in the lending standard regime could limit credit provision and have a negative impact on growth.

30. ***We would like to hear the staff's view on the appropriateness of foreign purchaser duty surcharges. Does the role of foreign buyers in Western Australia and Tasmania remain larger than that of domestic buyers? If not, do staff think that non-discriminatory measures could alternately attain the policy objectives of these surcharges? Last but not least, how have the authorities reacted to the staff's recommendation?***

- The authorities of Western Australia noted that they had introduced the stamp duty surcharges on foreign buyers to align their tax system with that of other states.
- In staff's assessment, Western Australia are not experiencing a capital inflow surge into their local real estate markets, and the surcharges are, therefore, not appropriate under the IMF's Institutional View on capital flows and should be reconsidered.
- The authorities remain of the view that these measures are capital flow management measures in form but not in terms of substance and macro-criticality.

31. ***We will be interested to hear more details on the impact of the tax policy changes proposed in addressing housing sector pressures, given the standpoint mentioned in the buff, countering its effectiveness. Staff comments are welcome.***

- With the on-going housing market correction, the tax policy changes proposed by staff are less urgent and should best be considered in the context of a broad tax reform.
- Any change in housing-related tax policy settings would need to be gradual to avoid a disruptive impact on housing markets (e.g., through a greater incidence of fire sales by housing investors).

32. ***We wonder if other measures that had accompanied this, in particular the limits on interest-only mortgage lending, were not removed too soon, given that demand is***

expected to remain strong and supply-side measures can take some time to bear results. Staff comments on this are welcome, and on the feasibility to implement broad-based land taxes as part of a comprehensive approach.

- Staff's view is that the strong decline (from 40 percent in 2015 to 26.8 percent in September 2018) in the stock of interest-only loans is a welcome development and should be maintained, as interest-only (IO) loans are more exposed to adverse shocks given the higher loan balances. However, the removal of a hard limit on the flow of IO loans is likely to be helpful at this point, given softening of housing market conditions, and considering that the removal is conditional on improved lending standards. The main benefit is that with the removal, a bunching in the rollover of the large current cohort of existing IO loans into principal and interest (P&I) loans can be avoided. However, staff has emphasized that that lending conditions should be closely monitored and that the authorities need to continue using macroprudential tools proactively.
- The political economy of a change to a broad-based land tax is challenging, and any transition would need to be gradual to avoid undue hardship on current owners.

Structural Reforms

33. ***Given the importance of promoting R&D and private sector development in knowledge-intensive sectors, we would be grateful if staff could share some additional insights on the implemented recommendations drawn from the '2030 Strategic Plan for the Australian Innovation, Science, and Research System'.***

- The 2030 Strategic Plan focused on 5 "imperatives," with responses by the Commonwealth government.
- Education: Respond to the changing nature of work by equipping all Australians with skills relevant to 2030 (Recommendations 1 to 5).
- The Commonwealth government supports these recommendations, but it has already engaged in reforms of the vocational education system (both funding and outcomes) and introduced in 2015 a "National STEM School Education Strategy 2016-26." It is more interested in following its existing programs at this stage, and only takes note of some of these recommendations.
- Industry: Ensure Australia's ongoing prosperity by stimulating high-growth firms and improving productivity (Recommendations 6 to 10).
- The government feels this is already supported by the National Innovation and Science Agenda (NISA), but supports recommendations in new areas, such as the digital economy, and improving the intake of skilled immigrants.
- Government: Become a catalyst for innovation and be recognized as a global leader in innovative service delivery (Recommendations 11 to 18).

- Most of these recommendations are consistent with new or ongoing initiatives by the Commonwealth government, such as an independent review of the public service (expected to finish in 2019), a Digital Transformation Agenda, and increased collaboration with the States and Territories through the components of the Council of Australian Governments (COAG) such as the Transport and Infrastructure Council, and the Industry and Skills Council.
- Research and Development: Improve research and development effectiveness by increasing translation and commercialization of research (Recommendations 19 to 26).
- Budget 2018-19 already has introduced funding for a National Health and Medical Industry Growth Plan, plus they have overhauled the R&D tax incentive system (although staff suggests and recommends further action on this front in the Staff Report).
- Culture and Ambition: Enhance the national culture of innovation by launching ambitious National Missions (Recommendations 27 to 30).
- The government generally supports identifying and evaluating national missions, although this has not yet moved on this, outside of an existing health initiative it can identify as a "National Mission."
- The government does have evaluation tools already developed for general uses.

34. ***We are also encouraged to see that the authorities' concerted efforts to reduce the gender gap in labor markets is bearing fruit in the form of higher rates of labor force participation by women (as well as older workers) in recent years. Do staff know whether higher female LFPR is contributing to a smaller gender pay gap (e.g., per annum/per hour)?***

- Staff has not undertaken research in this area.
- According to the Workplace Gender Equality Agency of the Australian government, the gender pay gap—the difference between women's and men's average weekly full-time equivalent earnings, expressed as a percentage of men's earnings—decreased from 24.7 percent in 2013-14 to 21.3 percent in 2017-18.
- While this declined coincided with greater female LFPR, establishing a causal effect would require additional econometric analysis.

35. ***It would also be helpful to get staff's view on the trajectory of Australia's trade elsewhere, including whether there are likely to be positive benefits accrued from involvement in CPTPP and if this could help balance Australia's exposure to China.***

- There should be some benefits from the CPTPP (given its preponderance of Asian members), plus Australia has continued to pursue other avenues, such as the recent FTA with Indonesia.

- Australia does have a large exposure to China – roughly 32 percent of non-service exports went to China in 2016. But, they have a diversified trading base, where the share of Asia for non-service exports is over 40 percent, and the rest mostly goes to Europe and North America. There is less of a dependence on China for service exports
- However, the recent trajectory has been an increasing share for China, so there has been a limited drive towards other countries, but again, the relationships outside of China are fairly diverse. Iron ore and coking coal are also mostly going to China.

36. ***Could staff elaborate further on the current state of discussion at the authorities' level on how to design and implement growth-friendly climate policies compatible with Australia's commitments under the Paris agreement?***

- State and Territorial governments (especially the larger States) continue to pursue renewable energy targets, developing renewable sources, and installing battery storage systems to enhance reliability (and hence the attractiveness of more variable renewable sources such as wind and solar power). The Commonwealth government has committed to large investment in hydroelectric power with the Snowy Hydro 2.0 project.
- As stated in the Staff Report, efforts to ensure an integrated nationwide policy have stalled with the suspension of the National Energy Guarantee. But existing mechanisms remain in place, and States and Territories continue to pursue their own policies, some of which are more ambitious (such as in South Australia).
- All major political parties at the Commonwealth level remain committed to achieving the emission reductions agreed to under the Paris Agreement, and the government will be required to review policies in 2020 when the national emission targets need to be extended.

37. ***We share the authorities' approach to close the investment gap combining new infrastructure investment with processes to ensure its quality and concur with their cautious approach to accelerate spending giving the current point in the cycle. This said, planning for additional spending over the coming years should be expedited. Can staff elaborate on options to address, within a broader perspective, the capacity constraints and skill shortages that have emerged?***

- Capacity constraints and skills shortages can be difficult to address in the short term.
- Among the options are to allow for increases in skilled immigration or using foreign contractors in areas with acute shortages (as occurred during the mining investment boom).
- Also, the use of equipment and labor in projects with similar equipment and labor needs could be better coordinated. In a federation such as Australia, such coordination would need to involve state governments, as they are responsible for most

infrastructure investment. Coordination between public and private construction projects would also help.

- Relying on market-based provision is more likely to be efficient, provided coordination issues are addressed. This can be another reason for encouraging public-private partnerships.