

Economic *Roundup*

Spring 2004

© Commonwealth of Australia 2004

ISBN 0 642 74270 7

This work is copyright. Apart from any use as permitted under the *Copyright Act 1968*, no part may be reproduced by any process without prior written permission from the Commonwealth available from the Department of Communications, Information Technology and the Arts. Requests and inquiries concerning reproduction and rights should be addressed to:

The Commonwealth Copyright Administration
Intellectual Property Branch
Department of Communications, Information Technology and the Arts
GPO Box 2154
CANBERRA ACT 2601
Or posted at: <<http://www.dcita.gov.au/cca>>

The views expressed in the Economic Roundup are commentary only, and should not be considered as advice. You should not act in reliance upon the views expressed in the publication, but should seek independent professional advice in relation to these issues and any proposed actions.

The Commonwealth and the authors disclaim responsibility for loss or damage suffered by any person relying, directly or indirectly, on this publication, including in relation to negligence or any other default.

Copies of this publication may be purchased either as an annual subscription or a single issue.

Annual Subscriptions: \$47.30. (including postage and GST).

Rates shown include postage within Australia and surface postage overseas. Annual subscriptions are payable in advance and should be sent to:

NMM – The Treasury
National Mailing and Marketing Pty Ltd
PO Box 7077
Canberra BC, ACT 2610

For further information regarding subscriptions, contact Roundup Publications Officer, National Mailing and Marketing Pty Ltd, on 02 6269 1000.

Single Issue: \$19.00. Copies may be purchased through CanPrint Infoservices. Purchase details are as follows:

Over the counter at: 16 Nyrang St Fyshwick ACT.
CanPrint (Infoservices) Telesales: Toll Free 1300 889 873
CanPrint (Infoservices) Mail Order Sales, PO Box 7456 Canberra MC ACT 2610

A copy of this document appears on the Treasury Website:
<<http://www.treasury.gov.au>>

The Treasury website also contains data relating to Commonwealth Debt Management that meets the requirements of the IMF Special Data Dissemination Standards. Also in accordance with these standards, quarter-ahead notice of the approximate date of release of Commonwealth total gross outstanding debt data is given on the IMF's Data Dissemination Bulletin Board (<<http://dsbb.imf.org>>).

Printed by CanPrint Communications Pty Limited

CONTENTS

Foreign reserve accumulation in Asia: Can it be sustained?	1
International trends in company tax rates — implications for Australia's company income tax	23
Improving global frameworks for corporate regulation: an Australian perspective	49
2003-04 in review: continued expansion and world economic recovery	63
Key themes from the Treasury Business Liaison Program — July-August 2004	83
Sources of economic data	91
Past editions of Economic Roundup	93

Foreign reserve accumulation in Asia: Can it be sustained?

Phil Garton¹

Asian governments have been accumulating foreign reserves (largely United States securities) on a large scale, as a result of maintaining fixed exchange rates or attempting to limit currency appreciation in the face of a weakening US dollar. There has been considerable international discussion on Asia's capacity to maintain this approach and the implications for United States current account adjustment.

The effects on Asia to date appear relatively benign. More expansionary monetary conditions have helped some economies that were experiencing actual or near-deflation not long ago. Monetary authorities have been reasonably successful in maintaining monetary control through sterilisation operations without pushing up interest rates.

This situation is unlikely to be sustainable in the long term, as sterilisation on the recent scale cannot be maintained indefinitely. Ultimately, policy-makers cannot fix the real exchange rate. If economic fundamentals require a real appreciation, this will eventually occur through either nominal appreciation or higher inflation.

1 The author is from International Economy Division, Australian Treasury. This article has benefited from comments and suggestions provided by Gordon de Brouwer, David Gruen and Heather Smith, and from data assistance provided by Jennifer Chang. The views in the article are those of the author and not necessarily those of the Australian Treasury.

Introduction

Large-scale accumulation of foreign (largely US dollar) reserves by Asian economies has attracted considerable international attention over the past year or so. This accumulation is commonly attributed to Asian governments maintaining fixed exchange rates or trying to limit their currency's appreciation in the face of a depreciating US dollar.

This article examines the sustainability of this policy approach for Asia. Its primary focus is not on whether these policies have been optimal to date. Nor does it attempt to assess the implications for the rest of the world; in particular, for the sustainability of the United States current account. Instead, it starts from the premise that Asian policymakers have perceived benefits in resisting currency appreciation to date, and assesses whether they might continue to do so without imposing increasing costs on their economies. If the costs of maintaining the policy continually increase relative to the benefits, then policy can be expected to change at some point.

Foreign reserve accumulation in Asia: Key developments

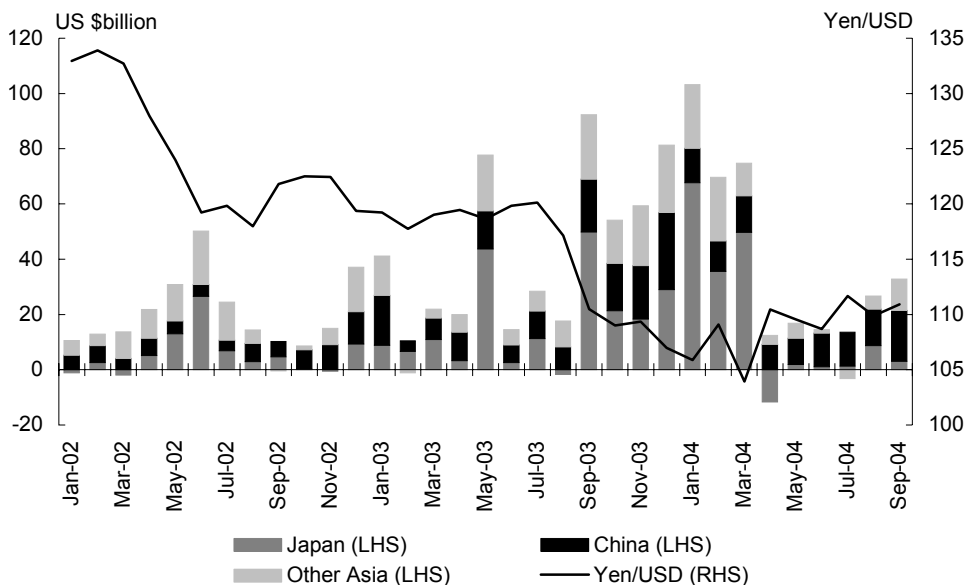
Drivers of Asian reserve accumulation

Total Asian foreign reserves have increased from US\$1.2 trillion at 31 December 2001 to US\$2.2 trillion at 30 September 2004. Monthly reserve accumulation peaked between September 2003 and March 2004, before easing from April (Chart 1).² Japan has been the largest contributor to the rise and subsequent slowing in reserve accumulation. China and the rest of Asia have also been significant, although the recent fall in Chinese accumulation has been less marked. A key factor underlying the recent fall appears to have been the partial recovery of the US dollar in recent months. This reduces the need to accumulate reserves to maintain a given exchange rate.

For economies pegged to a depreciating US dollar (China, Hong Kong and Malaysia), reserve accumulation has resulted automatically from the authorities' pledge to buy foreign exchange as necessary to maintain the fixed rate. For those with managed exchange rates, it reflects discretionary intervention in the foreign exchange market.

2 In order to present a more accurate picture of underlying trends, Chinese data in this article are adjusted for the allocation of US\$45 billion in foreign reserves to recapitalise Chinese banks in December 2003. This reduced measured changes in reserves and increased measured outflows of non-FDI capital in the relevant period.

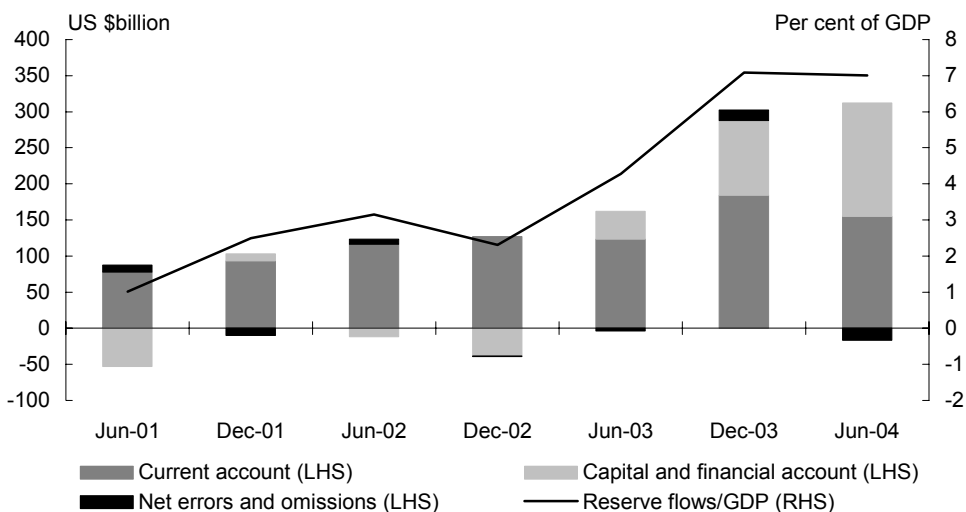
Chart 1: Monthly change in foreign reserves



Source: CEIC. Other Asia is the sum of flows for Korea, Taiwan, Hong Kong, India, Thailand, Malaysia, Singapore, Indonesia and the Philippines. Other Asia data for September 2004 does not include Indonesia.

Balance of payments (BoP) data, which exclude valuation effects, indicate flows into Asian reserves totalled around US\$460 billion in 2003 and US\$295 billion in the first half of 2004 (Chart 2). These flows correspond to surpluses on the overall balance of payments (the sum of current and capital accounts).

Chart 2: Contributions to Asian reserve flows



Source: CEIC. Total of flows for economies included in Chart 1. There is no data for Indonesia prior to March 2002.

Foreign reserve accumulation in Asia: Can it be sustained?

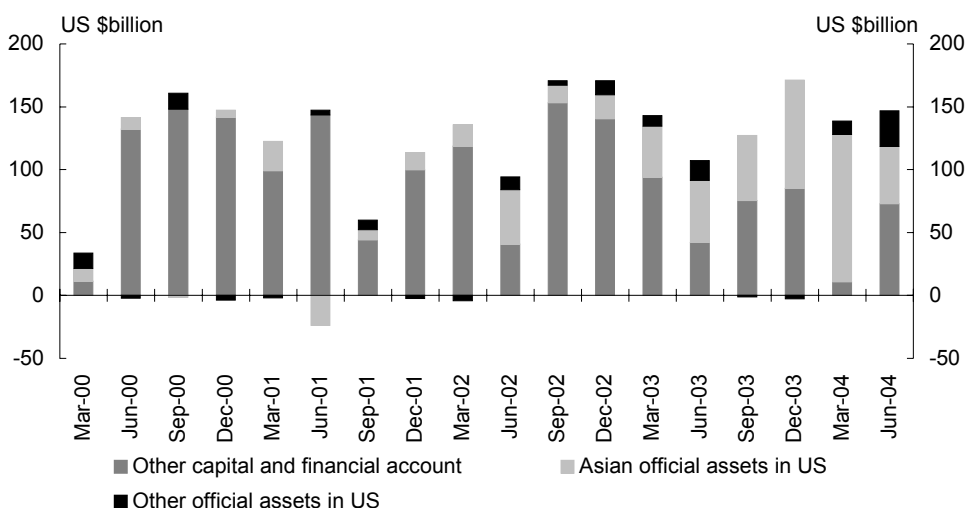
The main factor driving the increase in reserve flows up to the March quarter of 2004 was a turnaround from net outflows of non-FDI capital to net inflows, which reversed in the June quarter.

How large are Asian official purchases of United States assets?

The role of Asian central banks in financing the United States current account deficit has attracted a lot of attention. Data on currency composition of foreign reserves are not publicly available, but other data sources provide an indication of the extent of purchases of United States assets.

United States BoP data show that Asian official purchases of United States assets totalled US\$301 billion over the year to June 2004. These purchases have accounted for around half of net capital and financial account flows into the United States since the March quarter of 2003, offsetting most of the fall in net non-official flows over this period (Chart 3). In net flow terms, Asian official purchases have accounted for about 30 per cent of foreign purchases of United States assets in recent quarters.

Chart 3: Composition of United States net capital and financial account flows



Source: Bureau of Economic Analysis.

These data actually understate the importance of Asian official purchases, as they cover only purchases from United States residents. Hence, they do not capture purchases of United States securities in offshore secondary markets. The Asian BoP data suggest that Asian official purchases of United States assets may have totalled at least US\$410 billion in 2003, assuming at least 90 per cent of reserve purchases were

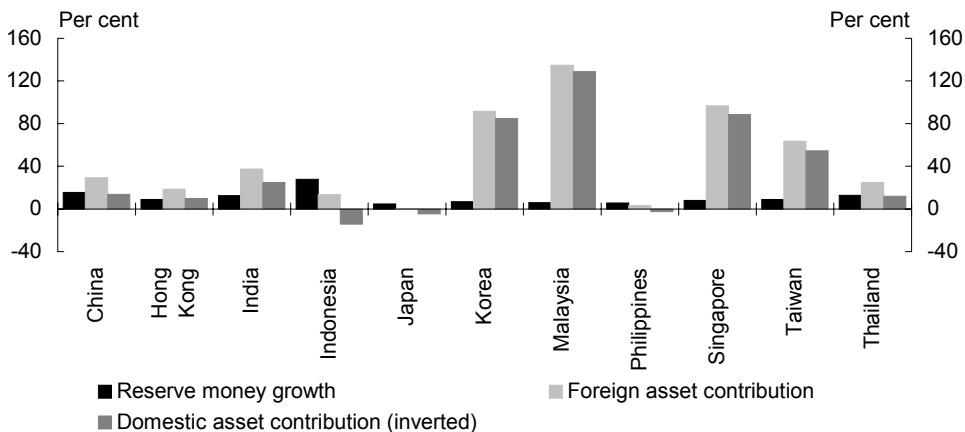
US dollar assets.³ This would imply that almost half of foreign purchases of United States assets in 2003 ended up in the hands of Asian central banks. In net flow terms, Asian official purchases may have amounted to around three-quarters of the United States current account deficit in 2003.

Has foreign reserve accumulation been sterilised?

Official purchases of foreign reserves increase the monetary base (currency held by the public plus deposits with the central bank), unless they are 'sterilised' by offsetting sales of government securities by the central bank. Prolonged unsterilised intervention is eventually likely to feed into higher inflation. This would mean a real appreciation, even if nominal exchange rates were unchanged.

We can gauge whether monetary effects of intervention have been offset by comparing growth in the monetary base (reserve money) with the contribution to growth implied by the change in net foreign assets held by monetary authorities. If the latter figure is higher this indicates a net withdrawal of liquidity through open market sales. Chart 4 suggests that most Asian economies have offset a substantial proportion of foreign asset contributions to monetary base growth over the past year.⁴

**Chart 4: Contributions to reserve money growth
(year to August 2004)**



Source: CEIC.

3 The BIS (2004) estimates that US dollar reserves accounted for 88 per cent of the change in world reserves (at constant exchange rates) in 2003. Asia accounted for 87 per cent of the change in world reserves (in SDR terms) in 2003.

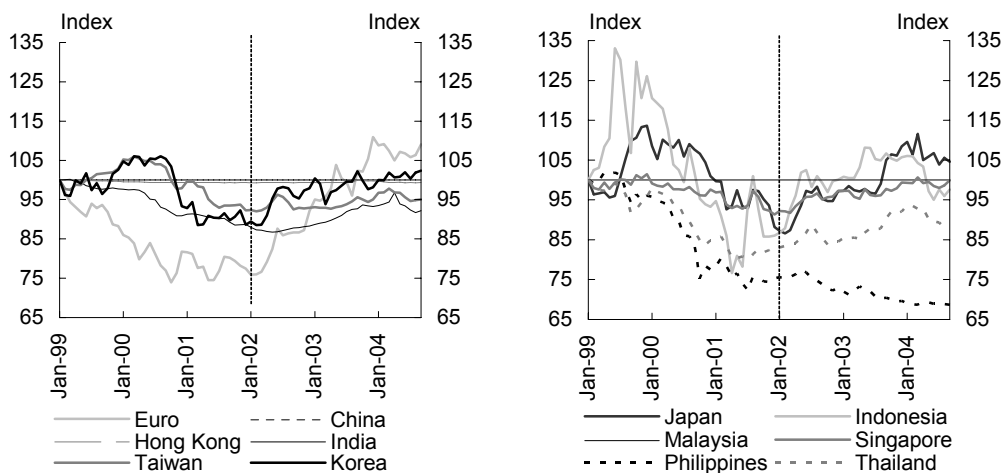
4 Japan's interventions are largely conducted through the Ministry of Finance's Special Account Fund, and do not automatically affect the monetary base. In the case of China, this approach does not capture the effects of increases in required reserve ratios from 6 to 7 per cent in September 2003, and again to 7.5 per cent (8 per cent for weak banks) in April 2004. These aim to prevent increases in the monetary base feeding through to broader monetary aggregates.

How has intervention affected exchange rates?

The scale of reserve accumulation and the limited recent appreciation of most Asian currencies against the US dollar appear to offer strong evidence that Asian governments have significantly influenced the values of their currencies.

In fact, the issue is less clear-cut than this. First, comparisons of currency movements depend critically on the choice of base date. Chart 5 shows that the euro depreciated much more than most Asian currencies in the period before January 2002 when the US dollar was appreciating. Hence, the choice of a base date when the euro was at a very low point exaggerates its relative rise in the recent period.

Chart 5: Exchange rates, USD/domestic currency (Jan-99 = 100)



Source: CEIC, OECD Main Economic Indicators. A downward movement represents a depreciation of the domestic currency against the USD.

Second, much of the recent intervention has been sterilised. While economists generally agree that unsterilised intervention (which changes monetary settings) should affect exchange rates, there is no consensus on the effectiveness of sterilised intervention.⁵

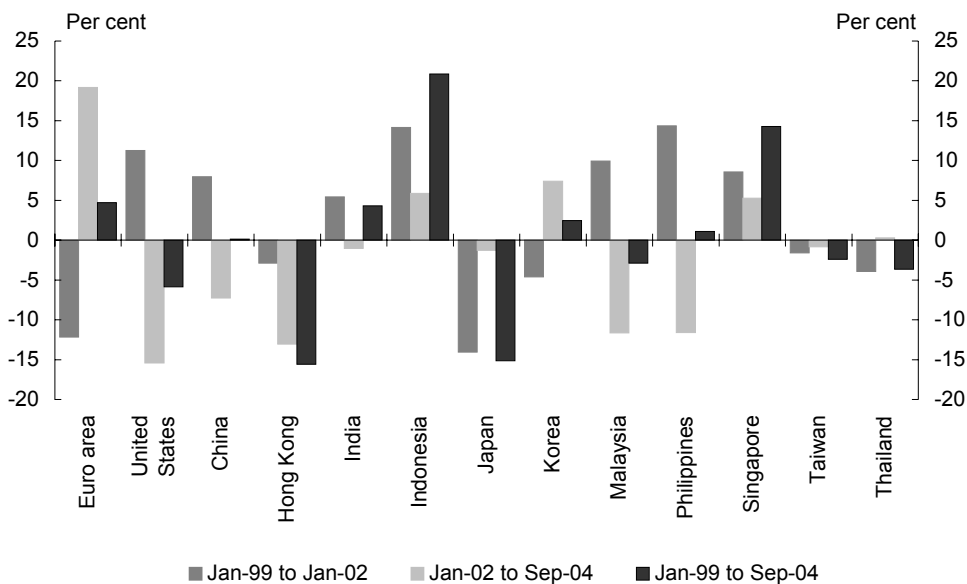
5 Sterilised intervention may affect the exchange rate through two main channels.

- (i) Portfolio balance channel. Sterilised intervention reduces the supply to the market of foreign bonds and increases the supply of domestic bonds. Where these assets are imperfect substitutes this increases the relative risk premium on domestic bonds, pushing the exchange rate down and the domestic interest rate up.
- (ii) Signalling channel. Intervention may be read by financial markets as a signal of future monetary policy intentions.

Where capital is mobile, the effects of sterilised intervention might conceivably be negated by the responses of other market participants, given no underlying fundamentals have changed.

That said, it is notable that most Asian economies have avoided significant real appreciations over the period since January 1999. This date is around the point at which Asian currencies stabilised following the 1997-98 financial crises (Chart 6).

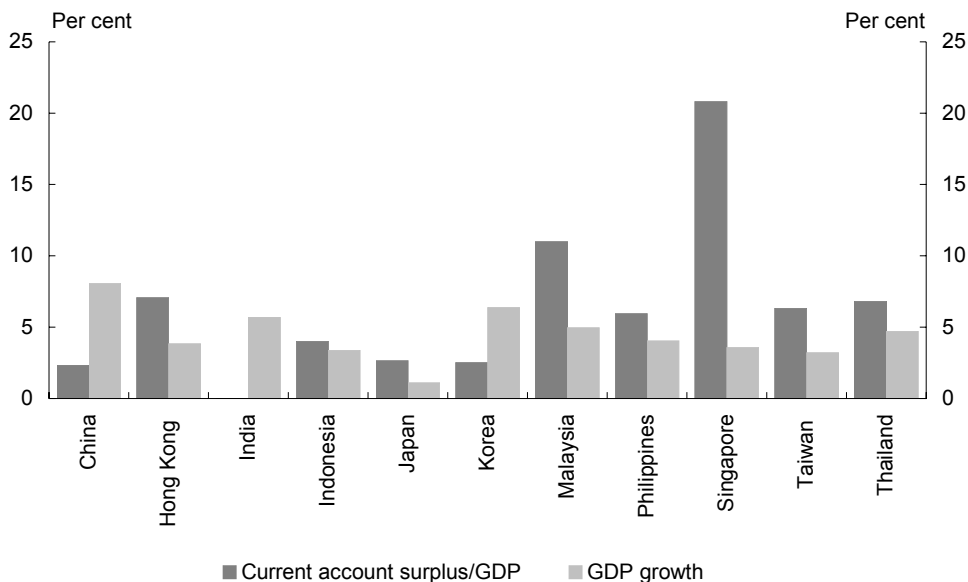
Chart 6: Real effective exchange rate changes



Source: Datastream (JP Morgan trade-weighted index, broad basis). Negative means depreciation.

This is despite the fact that most of these economies have been experiencing relatively strong GDP growth (with the notable exception of Japan) and accumulated current account surpluses over this period (Chart 7). These factors would normally imply a trend to real appreciation over time. In China's case, this may be at least partly offset by ongoing liberalisation of trade barriers, which tends to depreciate the real exchange rate by shifting domestic spending toward imports.

**Chart 7: Current accounts and GDP growth
(average 1999-2003)**



Source: CEIC.

A further *a priori* reason for believing that recent Asian intervention has been at least somewhat effective is that capital mobility in most Asian economies is lower than in other regions. This reflects factors such as capital account restrictions, less developed financial markets and weaker policy credibility.

What has motivated reserve accumulation in Asia?

Maintaining export-led growth

Most observers see recent reserve accumulation as driven by a desire to maintain competitive exchange rates and, hence, economic growth.

In the short-term, foreign exchange market intervention may help support demand in circumstances where conventional instruments cannot be used effectively. This has been particularly relevant for Japan. Conventional monetary policy has been made ineffective by the zero interest bound and bad loan problems in the banking system, while fiscal policy is constrained by concerns about long-term sustainability.

In the longer term, growth benefits from an under-valued exchange rate depend on supply-side impacts. The thesis of Dooley et al (2003) assumes that a strategy of

deliberately under-valuing the exchange rate to promote exports can deliver long-run growth benefits.

Vines (2004) suggests that such a strategy might be justified in terms of an endogenous growth model. An under-valued exchange rate increases profitability in the 'modern' export sector, promoting investment in productivity-enhancing technologies that yield ongoing growth benefits. Sufficiently high rates of profit cannot be maintained in the domestic market alone because increased output would push down prices.

Vines notes, however, that sustaining such a strategy is likely to be difficult, requiring a combination of tight fiscal policy, effective capital controls and trade liberalisation measures to offset pressures for real appreciation. These options are discussed further below.

Eichengreen (2004) argues that the export-led growth model, while successful for Asia in the past, may have reached the point of diminishing returns for many Asian economies. First, traditional traded goods are no longer the sole source of knowledge spillovers. These increasingly come from areas like software development, back-office services and financial intermediation. This calls for balanced investment in both traded and non-traded sectors (including human capital).

Second, financial liberalisation has reduced scope to channel savings into investment in the export sector. This increases the risk that abundant credit (driven by reserve accumulation to hold down the exchange rate) spills over into excessive investment in the non-traded sector. Increasing financial openness also makes it harder to sustain under-valued exchange rates due to the difficulty of sterilising resultant capital inflows. This issue is also discussed further below.

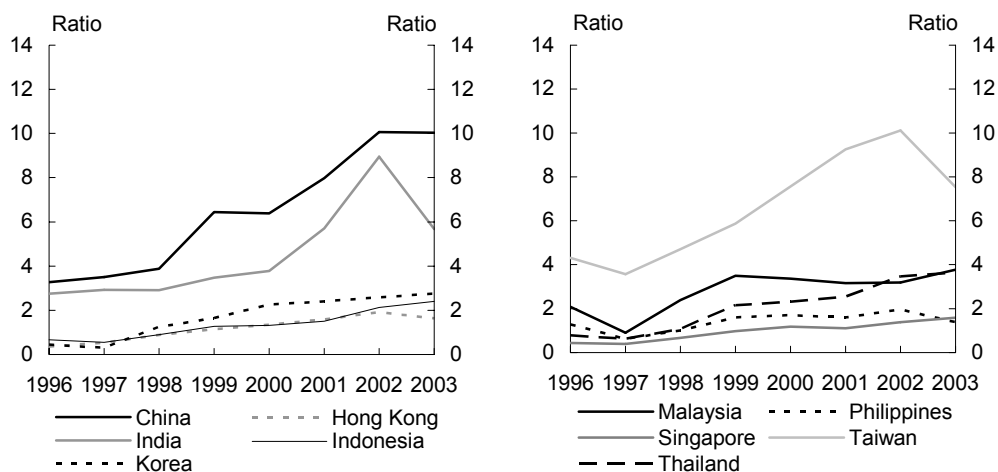
Reducing vulnerability to external shocks

Foreign reserves reduce vulnerability to external shocks, particularly for emerging market economies whose access to global financial markets tends to be uncertain and pro-cyclical. Capacity to draw on reserves can help smooth consumption in the face of external shocks and reduce vulnerability to creditor runs arising from currency and maturity mismatches.

The ratio of reserves to short-term external debt is the most widely-used indicator of emerging market vulnerability to capital flight. All emerging Asian economies comfortably meet the benchmark of at least 100 per cent coverage, in contrast to the situation at the time of the 1997-98 financial crises (Chart 8). Taiwan, India and China, in particular, have quite high ratios. This suggests that limiting vulnerability probably has not been the primary motive for recent reserve accumulation in most economies.

The IMF (2003) has developed a model that predicts reserve levels based on a range of factors including economic size, indicators of current and capital account vulnerability, exchange rate volatility and interest differentials. This model suggests that reserve build-up in Asian emerging economies from 1998 through to 2001 could be explained by normal economic factors, but accumulation since then appears unusual.

Chart 8: Ratios of reserves to short-term external debt (end of year)



Source: CEIC, Joint BIS-IMF-OECD-World Bank Statistics on External Debt. Debt due within one year.

Maintaining exchange rate pegs for stability

Reserve accumulation may result automatically from maintaining currency pegs to the US dollar for purposes of financial stability and monetary policy credibility. Pegs may be either 'hard' (as for China, Hong Kong and Malaysia) or 'soft' (allowing fluctuation within a limited range).

The 'fear of floating' hypothesis suggests that emerging economies tend to be reluctant to allow their currencies to fluctuate (Calvo and Reinhart, 2000). This is said to reflect concerns about price stability and financial vulnerabilities arising from 'original sin': that is, limited ability to borrow long-term domestically and in their own currencies externally.

McKinnon and Schnabl (2003) argue that East Asia has adopted hard or soft dollar pegs as a response to a large share of its trade being invoiced in US dollars and 'original sin' problems of capital market incompleteness that make hedging difficult. Pegging to the US dollar allows most remaining currency exposures to be hedged in the yen-dollar, euro-dollar and other well-developed markets.

Counter to this view is the argument that pegged or intermediate regimes are difficult to sustain where capital is mobile. Rogoff et al (2003) found that emerging market economies with pegged or intermediate regimes have been more prone to 'twin' banking and currency crises. Nor did such regimes appear to provide any significant gain on inflation or average growth for these economies.

On the other hand, developing economies that are less open to capital flows were found to have achieved fewer benefits from such regimes with little cost in terms of growth, volatility or incidence of crises. Hence, sustaining pegs may be easier for economies like China that have maintained capital controls. But this will become more difficult as they become more integrated into international financial markets.

What are the costs of reserve accumulation?

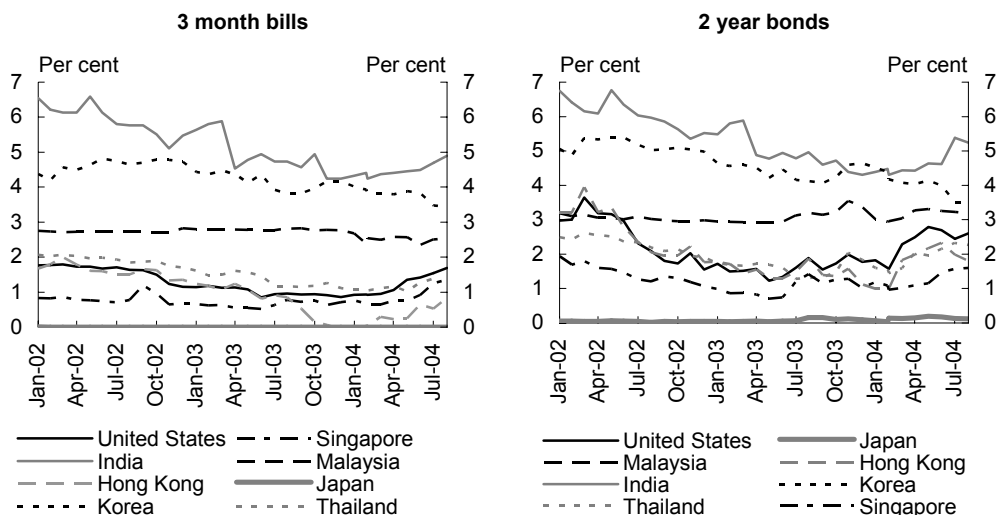
Fiscal costs

Reserve accumulation means higher gross public debt than otherwise. Where intervention is sterilised, debt held by the public is increased. Even if intervention is unsterilised, the monetary base thus created could have otherwise been used to purchase government debt. Fiscal costs will be incurred if the return on foreign reserve assets is less than the government's borrowing rate.

Chart 9 shows that bond yield differentials with the United States vary significantly across Asia. Some economies have yields close to or below United States yields, and hence would not incur net interest costs from holding reserves. Others have significant positive differentials with the United States: up to around 300 basis points for India.⁶

6 Foreign reserve assets are generally of shorter maturities, as are securities used by central banks for sterilisation operations. While data on shorter-term yields is not available for China, long-term yields during this period have generally been 150-200 basis points above US yields. Indonesia and the Philippines also have large interest rate differentials but are excluded as their recent accumulation of reserves has been much less significant.

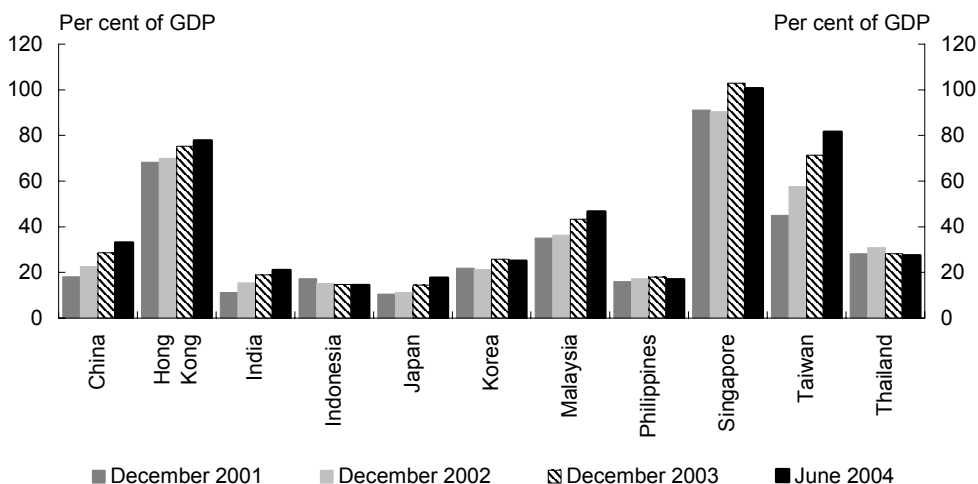
Chart 9: Government security yields



Source: CEIC, Datastream. '2 year' yields for India and Korea are 1 year.

Chart 10 shows foreign reserves held by Asian economies as a percentage of GDP. Net interest costs for economies with positive interest differentials (India, Korea and Malaysia) appear to be significant but not prohibitive (of the order of 0.4 to 0.6 per cent of GDP). Moreover, part of this would reflect normal prudent requirements, so the fiscal cost of 'excess' reserve accumulation would be substantially lower.

Chart 10: Foreign reserves as a percentage of GDP



Source: CEIC.

Fiscal costs may also arise from balance sheet exposures. As recent reserve asset accumulation has largely comprised United States securities, declines in either the US dollar or United States bond prices could generate losses.

Central banks whose currencies have appreciated against the US dollar already have unrealised losses on US dollar assets, although these are at least partly offset by gains on euro assets. Euro assets form a much lower share of reserves, but most Asian currencies have depreciated much more against the euro than they have appreciated against the US dollar.

Of course, central banks only recognise losses when assets are realised. They generally avoid losses by holding foreign currency assets until they are appreciating against the domestic currency. But losses will be more difficult to avoid if the long-term trend in the US dollar is downward. Even so, governments' currency exposures are hedged if they have offsetting US dollar debt exposures. But the biggest interveners – Japan, China, Taiwan, and Korea – have relatively low levels of external government debt.

Economic opportunity costs

In addition to fiscal costs, reserve accumulation may involve real resource costs. There are several aspects to this. First, 're-export' of capital inflows into foreign securities entails a real resource transfer to foreigners when risk-adjusted returns on these assets are lower than the risk-adjusted costs of external borrowing.

Second, domestic investment and consumption may be crowded out if intervention results in higher interest rates and/or a lower exchange rate than otherwise. Such crowding out necessarily occurs when the economy is at full capacity, but it is less likely to be a concern where the economy has spare capacity.

Third, resource misallocation costs can arise if the lower exchange rate is unsustainable, due to excess investment in tradable goods production capacity.

Loss of monetary policy autonomy

Another potential cost arises from the constraints of the 'impossible trinity'; that is, the impossibility of simultaneously maintaining both a fixed exchange rate and an independent monetary policy when capital is highly responsive to interest rate differentials. Exchange rate targeting must entail some loss of monetary policy autonomy unless capital mobility can be restricted.

Foreign reserve accumulation in Asia: Can it be sustained?

As noted earlier, purchase of reserve assets entails monetary expansion unless sterilised by offsetting sales of government debt. The critical issue is how long Asian governments could maintain control over their monetary policies through sterilisation. In general, the lower the capital mobility, the smaller the BoP surpluses that must be sterilised and hence the longer sterilised intervention can be sustained.

The difficulties of sterilisation, however, increase over time if sterilisation debt grows faster than the rate of liquidity growth consistent with monetary policy objectives. Higher interest rates would eventually be required to induce investors to hold an increasing relative supply of domestic government debt. Unless capital mobility can be restricted, this tends to attract further capital inflows. This can create a vicious circle where increasing sterilisation operations further increase interest rates and attract more capital inflows (including increasing speculative inflows).

In these circumstances, governments would eventually be faced with the choice of either letting their currencies appreciate or allowing monetary growth to increase. In the latter case, they could continue to hold down the nominal exchange rate, but real appreciation would eventually occur through higher inflation.

Are the costs of reserve accumulation increasing?

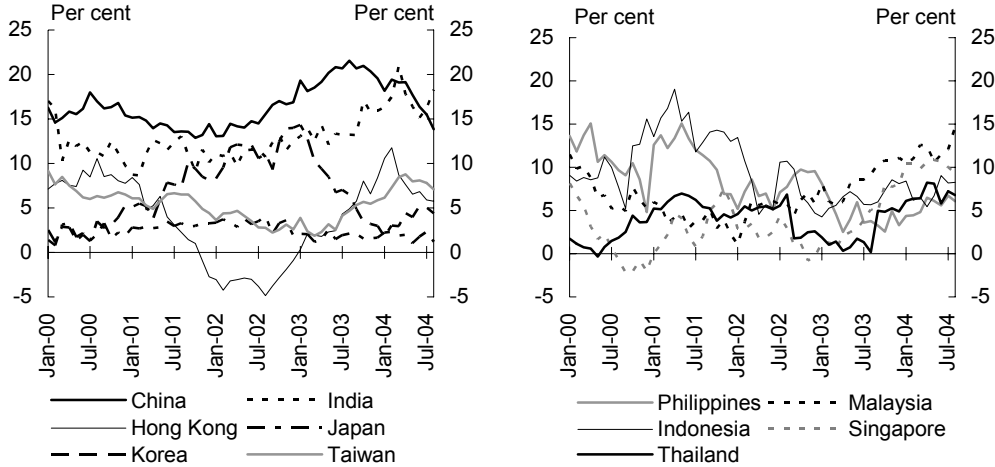
If accumulation of reserves were becoming more costly, this should be manifested in either rising interest rates (increasing fiscal and economic costs) or excessive monetary expansion and inflationary pressures.

At this stage there is no clear evidence of upward pressure on interest rates in Asia. Chart 9 showed that government bond yields have not significantly increased relative to United States yields. Indeed, real rates in many Asian economies have fallen as inflation rates have increased.

One reason for this may be that many Asian economies have until recently not seen much growth in domestic investment that would otherwise have absorbed liquidity. This may explain why there has been a ready appetite for government debt, avoiding the need for higher interest rates. While investment growth in China has been very strong, administrative controls over credit allocation may, until recently, have helped avoid interest rate increases.

Chart 11 shows that the rate of growth in broad money has increased in some Asian economies over the past 12-18 months, albeit from relatively low rates in some cases. Recent M2 growth has been especially strong in China (albeit slowing recently) and India and has also increased noticeably in Malaysia.

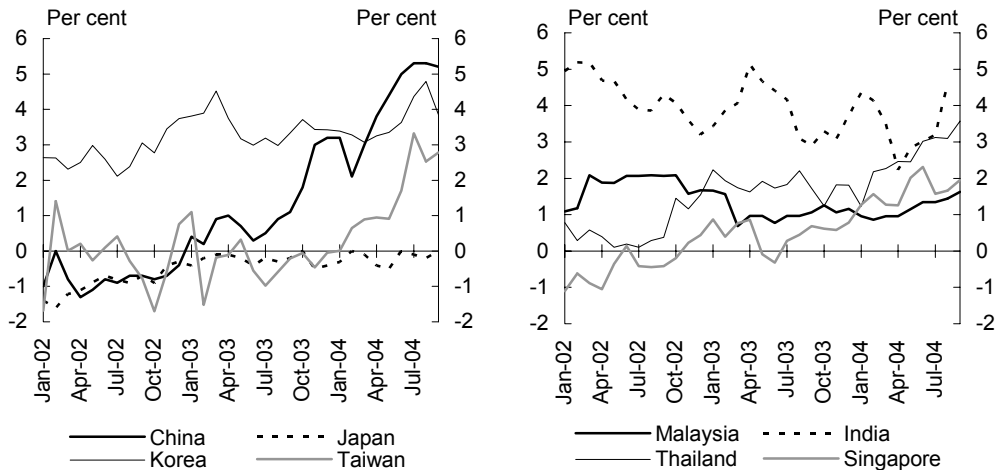
Chart 11: M2 growth (through the year)



Source: CEIC.

More expansionary monetary conditions have been associated with increasing inflation rates in many Asian economies (Chart 12). This has allowed a number of economies to emerge from an earlier period of actual or near-deflation. While inflation in China has risen to over 5 per cent through the year, this has been primarily driven by steep increases in food prices. That said, inflation may become more of a concern going forward and tighter monetary conditions may be needed in some economies.

Chart 12: CPI inflation rates (through the year)

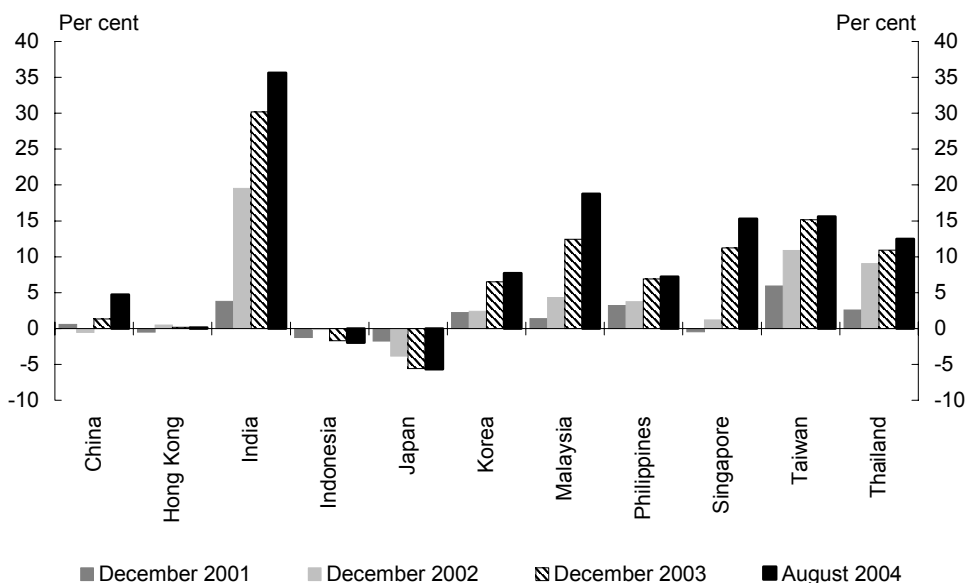


Source: CEIC.

Can recent policies be sustained without increasing costs?

Asian governments may find it more difficult to maintain appropriate monetary conditions in future if they continue to resist currency appreciation. Chart 13 shows that cumulative sterilization operations (based on the approach shown in Chart 4) have grown significantly as a share of broad money in a number of Asian economies. This suggests that recent rates of reserve accumulation in these economies cannot be sustained indefinitely. As economies continue to grow and excess capacity and liquidity are absorbed, continued sterilization on this scale would eventually push up interest rates, leading to the vicious circle process described above.

Chart 13: Cumulative sterilisation since January 2001 (per cent of M2)



Source: CEIC. Difference between change in net foreign assets and change in reserve money, cumulated from January 2001.

A notable exception has been Japan, which has been accumulating reserves on a large scale while injecting liquidity through open market operations. This reflects Japan’s ongoing deflationary conditions, which have meant that the authorities have not been concerned to limit monetary expansion. This is not likely to become an issue until there is a clear end to deflationary conditions.

Cumulative sterilisation in China is still relatively limited as a share of M2, albeit growing in recent months as the authorities increased efforts to rein in monetary growth. The sustainable rate of reserve accumulation is likely to be higher for a fast-growing economy like China, given liquidity needs will also be growing at a relatively fast pace. Moreover, a rapidly developing economy should be able to sustain

a somewhat higher rate of inflation without losing competitiveness.⁷ China's stated objective is to keep inflation under 5 per cent, which could encompass a higher rate of inflation than its trading partners.

Sustainability of US dollar pegs (or quasi-pegs) will depend substantially on the future value of the US dollar. Further dollar depreciation would depreciate effective exchange rates, promoting renewed speculative inflows and further increasing the task of sterilising BoP surpluses. It would also increase potential currency losses. Hence, a renewed decline in market confidence in the dollar would make it more costly for Asian policy-makers to continue to resist appreciation. A moderate US dollar appreciation, on the other hand, would relieve upward pressure on Asian currencies.

As noted earlier, pressures for real appreciation might be mitigated through some combination of:

- tightening capital controls to prevent capital inflows responding to interest rate differentials and expectations of appreciation; and
- tightening fiscal policy to push down interest rates and constrain domestic demand; and
- trade liberalisation to shift Asian spending toward imports.

How effective or feasible such measures might be is unclear. Capital controls tend to become less effective over time, particularly as financial markets become more sophisticated and openness to trade increases. Controls in place in China have become somewhat 'leaky', and gradual liberalisation will be desirable to assist financial development. While China is selectively reducing controls over foreign currency holdings, the fragility of Chinese banks constrains the pace of such liberalisation.

The impact of tighter fiscal policy may be ambiguous. While fiscal consolidation would be desirable for some Asian economies to ensure fiscal sustainability, a permanent fiscal tightening in these circumstances might boost confidence and put upward pressure on exchange rates. In any case, as the United States and Europe also need to undertake fiscal consolidation over the medium-term, this is likely to be at best a temporary means of avoiding appreciation.

7 This reflects the so-called Balassa-Samuelson effect. Productivity catch-up in the traded goods sector tends to drive real appreciation as economies develop. This can occur through nominal appreciation or, if this is prevented, through higher inflation relative to trading partners. Higher traded sector productivity pushes up wages across the economy, increasing unit labour costs in the non-traded sector relative to the traded sector.

Further trade liberalisation would only be effective if Asia's trade barriers to the rest of the world were reduced. With the notable exception of China and compared with past experience, Asian economies generally appear to have little appetite for comprehensive unilateral liberalisation. Indeed, as the aim would be to reduce trade surpluses it would only be attractive if policymakers were concerned with export competitiveness *per se* rather than with *net* exports.

Conclusions

Notwithstanding the scale of foreign reserve accumulation by Asian governments over the past two years or so, the costs of this policy so far do not appear high. Asian economies have been able to maintain relatively competitive exchange rates without experiencing significant economic pressures in the form of either rising interest rates or high inflation. This has reflected factors such as existing spare capacity and subdued domestic investment in many economies. More expansionary monetary conditions appear to have been beneficial in boosting growth and combating deflation in the region.

Continued reserve accumulation on the recent scale is unlikely to be sustainable indefinitely. The need to sterilise monetary effects of reserve accumulation would eventually put upward pressure on interest rates. This would induce further capital inflows, leading to an increasingly large and costly sterilisation requirement. If reserve accumulation feeds into monetary growth, competitiveness benefits from holding down the nominal exchange rate would eventually be offset through higher inflation.

When such pressures might arise is uncertain, and depends on factors such as: movements of the US dollar; the balance between excess capacity, demand and supply growth in each economy; and the balance between the sterilisation task required to meet monetary policy objectives and available liquidity. In general, there appears to be no urgency for Asian economies to change their foreign reserve accumulation policy in the immediate future, although a further depreciation of the US dollar against other currencies would tend to increase pressures on the current approach.

Policy objectives of Asian governments may also be influenced by the evolution of their economies and by external political pressures from the United States and Europe, although it is difficult to predict how these factors might play out.

Japan may be less concerned about yen appreciation if the current recovery consolidates and deflationary conditions come to an end. The costs of continuing to resist appreciation may then loom larger in policy calculations. But whether the recent

Foreign reserve accumulation in Asia: Can it be sustained?

fall in Japan's foreign exchange market intervention presages such a policy shift will only be tested if the US dollar starts to depreciate again.

China has signalled its intention to move to a more flexible exchange rate regime over time, which could see it reduce its accumulation of reserves.

References

Bank for International Settlements 2004, *Annual Report 2003-04*.

Calvo, Guillermo and Reinhardt, Carmen 2000, 'Fear of Floating', *National Bureau of Economic Research Working Paper 7993*.

Dooley, Michael, Folkerts-Landau, David and Garber, Peter 2003, 'An Essay on the Revived Bretton Woods System', *National Bureau of Economic Research Working Paper 9971*.

Dooley, Michael, Folkerts-Landau, David and Garber, Peter 2004a, 'The Revived Bretton Woods System: The Effects of Periphery Intervention and Reserve Management on Interest Rates and Exchange Rates in Centre Countries', *National Bureau of Economic Research Working Paper 10332*.

Dooley, Michael, Folkerts-Landau, David and Garber, Peter 2004b, 'Revived Bretton Woods End Game: Direct Investment, Rising Real Wages and the Absorption of Excess Labour in the Periphery', Prepared for IMF Conference in Honour of Guillermo Calvo, Washington DC, April 15-16.

Eichengreen, Barry 2004a, 'Chinese Currency Controversies', paper presented to the Asian Economic Panel, Hong Kong, 12-13 April.

Eichengreen, Barry 2004b, 'Global Imbalances and the Lessons of Bretton Woods', *National Bureau of Economic Research Working Paper 10497*.

Fatum, Rasmus and Hutchison, Michael 2003, 'Effectiveness of Official Daily Foreign Exchange Market Intervention Operations in Japan', *National Bureau of Economic Research Working Paper No. 9648*.

International Monetary Fund 2003, 'Are Foreign Exchange Reserves in Asia Too High?', Chapter II, *World Economic Outlook September 2003*.

Ito, Takatoshi 2002, 'Is Foreign Exchange Intervention Effective? The Japanese Experiences in the 1990s', *National Bureau of Economic Research Working Paper 8914*.

McKinnon, Ronald and Schnabl, Gunther 2003, 'The East Asian Dollar Standard, Fear of Floating and Original Sin', <http://www.stanford.edu/~mckinnon/papers.htm>.

Ramaswamy, Ramana and Samiei, Hossein 2000, 'The Yen-Dollar Rate: Have Interventions Mattered?', *IMF Working paper WP/00/95*.

Rogoff, Kenneth; Husain, Aasim; Mody, Ashoka; Brooks, Robin and Oomes, Nienke 2003, 'Evolution and Performance of Exchange Rate Regimes', *IMF Working Paper WP/03/243*.

Vines, David 2004, 'Pegged Exchange Rates, Export-led Growth and Capital Controls: Managing a Revived Bretton Woods System in the Asia Pacific Region', presented to a conference on 'Practical Steps Towards East Asian Integration', Tokyo, 25-26 March.

International trends in company tax rates — implications for Australia’s company income tax

James Kelly and Robert Graziani¹

Worldwide statutory company tax rates have been declining. The choice of Australia's statutory company tax rate is a balancing act, as Australia's company income tax system has two basic roles. The first, to tax the income of Australian residents, is not affected directly by the international trend. The second, to tax the Australian source income of foreign investors, may be affected by that trend. Reducing Australia's company tax rate (to reduce tax on foreign investors) could, but may not, improve national welfare by increasing foreign investment in Australia. Australia's current statutory company tax rate is around the OECD average and is less than or equal to the rates in our major sources and destinations of foreign investment.

1 The authors are from the International Tax and Treaties Division, Australian Treasury. This article has benefited from comments and suggestions provided by Peter Mullins, Paul McMahon, Ann Duffy and Jyoti Rahman. The views expressed are those of the authors and not necessarily those of the Australian Treasury.

Introduction

A striking feature of recent decades is the marked decline in countries' statutory company tax rates. The OECD average top (federal) statutory company tax rate fell from 44 per cent in 1985 to 31 per cent in 2004, on a GDP-weighted basis.² Australia's statutory company tax rate fell even more, from 46 per cent to 30 per cent over the same period.

The decline in statutory company tax rates and other developments (such as the decline in cross-border withholding tax rates) raises concerns for some – optimism for others – that competition between countries to attract investment will limit countries' capacity to tax capital income.³ Then, total tax revenue would decline or additional reliance would be placed on less mobile tax bases such as labour, consumption or land.⁴

This article briefly surveys international trends and outlines some of the policy considerations and empirical evidence relevant to determining an appropriate statutory company tax rate in light of those trends. It considers:

- international trends in statutory and (taking account of other features of the tax system) effective company tax rates and how Australia compares;
- two basic roles of company income tax – taxing the income of residents and (of primary interest here) taxing foreigners on their Australian source income;
- the pros and cons of reducing the tax foreigners pay on their Australian source income, including relevant empirical evidence; and
- observations on the implications of recent trends.

2 Estimated using the OECD Tax Database; the GDP weights are based on nominal GDP of the OECD countries in US\$ at market exchange rates.

3 The appropriateness of capital income taxation is controversial, even for a closed economy. The benefits of a broader base and distributional outcomes must be measured against the efficiency costs of distorting saving and investment decisions. For an open economy, cross-border capital flows may make investment relatively more tax sensitive. This would argue for a lower rate of tax on capital income than other income from an efficiency perspective. See Zee (2002, pp. 1185-87) for a brief overview.

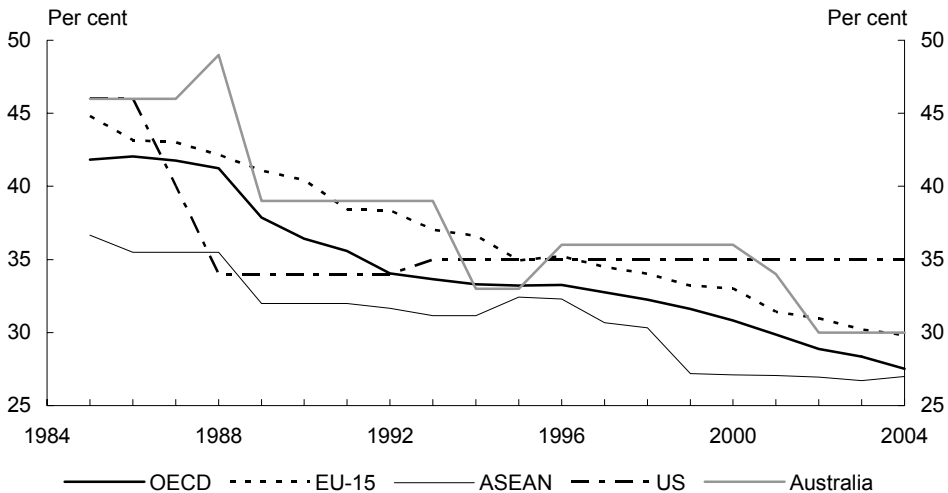
4 That is not to say that all these tax bases are immobile. The mobility of skilled labour and consumption has probably increased in recent decades.

International trends and comparisons

Trends in statutory company tax rates

Statutory company tax rates clearly have fallen, particularly in developed nations (Chart 1).

Chart 1: Historical trends in statutory company tax rates^(a)



(a) Rates are top federal statutory company tax rates. Averages are unweighted.
Source: OECD Tax Database; KPMG (various years).

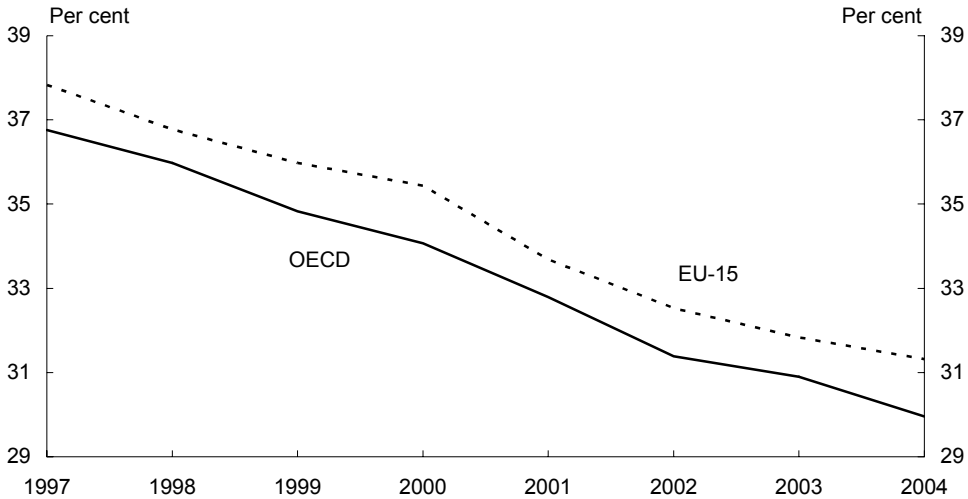
Accompanying the decline has been a convergence of statutory company tax rates, with the average rates for the OECD, European Union, ASEAN and other less-developed countries moving closer together over time.

These movements in group averages can, however, hide significant differences within the various groupings or regions. For example, within the European Union rates range from 0 per cent on reinvested earnings (Estonia) to around 38 per cent (Germany).⁵

The rate of decline in recent years also appears relatively constant, if changes in the unweighted averages of OECD and European Union countries are a guide (Chart 2).

⁵ Low statutory company tax rates adopted by many other small European Union economies (Ireland 12.5 per cent; Latvia, Lithuania and Cyprus 15 per cent; Poland and Slovakia 19 per cent) have led France and Germany to push (unsuccessfully so far) for minimum European Union statutory company tax rates. See Tax Notes International (2004, p. 1001).

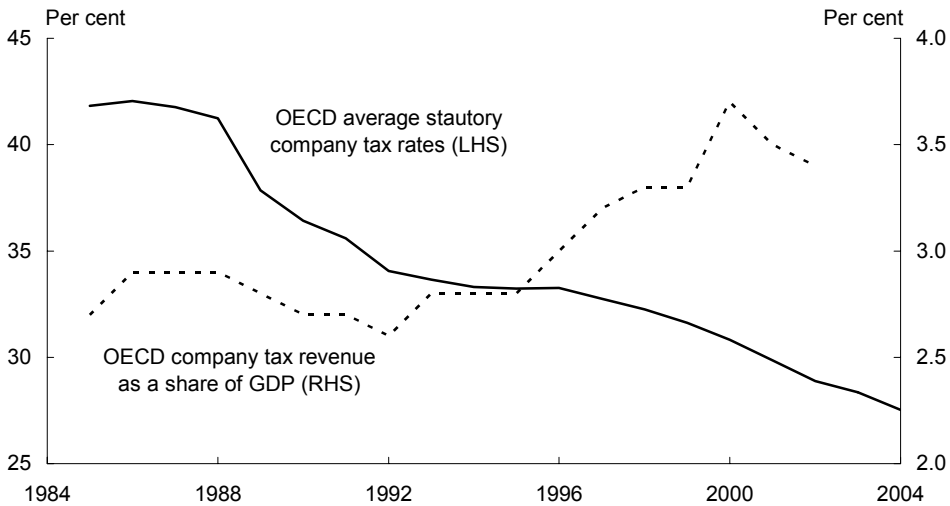
Chart 2: OECD and European Union statutory company tax rates^(a)



(a) Rates also include surtaxes and sub-national taxes on company income. Averages are unweighted. Source: KPMG (2004, Table 2, p. 2).

However, Zee (2004, p. 356) claims the pace of decline since 2000 is slower than between the mid-80s and mid-90s. Either way, such past trends are not a sure guide to the future and the current consensus appears to be that statutory company tax rates are not inexorably heading to zero.

Chart 3: Historical trends in OECD statutory company tax rates and company tax revenue^(a)



(a) Rates are top federal statutory company tax rates. Averages are unweighted. Source: OECD Tax Database; KPMG (various years); OECD (2004).

Significantly, to date, declining statutory company tax rates have not reduced company tax collections as a share of GDP (Chart 3). This is because declining statutory company tax rates often are accompanied by tax base broadening, as well as growth of the corporate sector and its improved profitability over the relevant period (Zee 2002, p. 1196).

While international tax competition possibly forced the decline in statutory company tax rates, alternatively, policy makers or electorates may have adopted what appears to be a successful policy implemented by other countries.⁶ Domestic considerations also may have been relevant. In Australia, the benefit of removing economic distortions by broadening the company income tax base was a significant policy influence.⁷

How Australia's statutory company tax rate compares

Australia's 30 per cent statutory company tax rate is close to or below average.

Looking at top federal statutory company tax rates alone, Australia's 30 per cent rate lies in between the GDP-weighted OECD average (31 per cent) and the unweighted OECD average (28 per cent).⁸ The higher weighted average largely reflects the relatively high rate levied in the United States.

Taking account of surtaxes and sub-national taxes that many countries (but not Australia) levy on company income, the comparison is even more favourable. Australia's rate is considerably below the GDP-weighted OECD average (37 per cent) and only slightly above the unweighted OECD average (29.96 per cent).⁹

A 30 per cent statutory rate or thereabouts is commonplace, even in the Asia-Pacific region (Chart 4). Chile at 17 per cent, Hong Kong at 17.5 per cent, Singapore at 22 per cent and Chinese Taipei at 25 per cent, are significant exceptions.

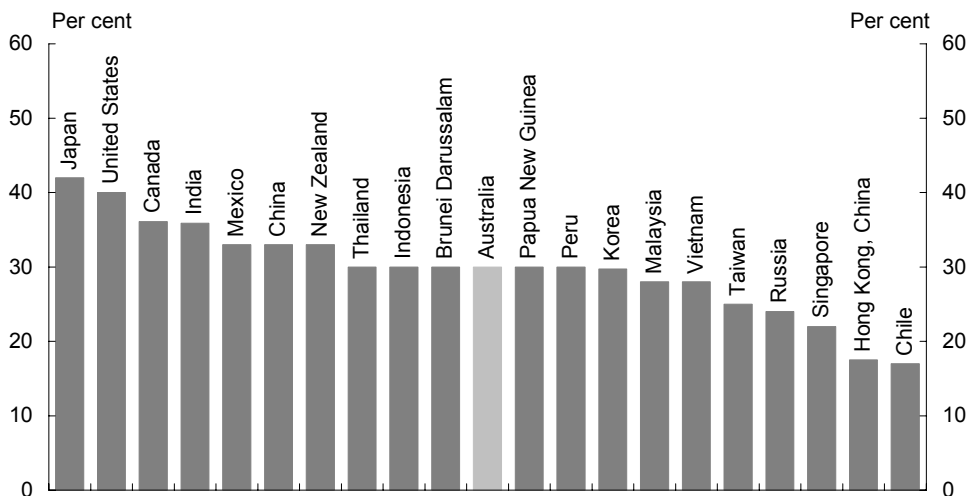
6 Devereux et al (2003) consider whether the decline is driven by *tax competition* to attract the mobile element of the company income tax base, or *yardstick competition* where voters in one country compare themselves with other countries, or whether a *common intellectual trend* influences policy-makers in one country to institute reforms of another country. They tentatively conclude tax competition is the best explanation.

7 For other (domestic) factors that may influence statutory company tax rate trends, see Slemrod (2004). He finds a strong association between the top personal income tax rate and the statutory company tax rate.

8 Estimated using the OECD Tax Database. The GDP weights are based on nominal GDP of the OECD countries in US\$ at market exchange rates.

9 Estimated using the statutory company tax rates, including surtaxes and sub-national taxes, from KPMG (2004).

Chart 4: Australia’s company tax rate relative to Asia-Pacific economies^(a)



(a) Rates also include surtaxes and sub-national taxes on company income.
Source: KPMG (2004).

Australia’s 30 per cent rate is also comparable with the rates of the immediate sources of foreign direct investment (FDI) in Australia (Table 1), and of the major destinations of Australian FDI overseas (United States, United Kingdom and New Zealand).

Table 1: Major sources of FDI in Australia, 2003

Country	Share of total FDI in Australia (%)	Company tax rate ^(a)
United States	29.1	40(b)
United Kingdom	21.6	30(b)
Japan	7.5	42(b)
Netherlands	4.4	34.5
Germany	3.5	38.3

(a) Rates (as at 1 January 2004) also include surtaxes and sub-national taxes on company income.

(b) Country has foreign tax credit system for taxing foreign source income from offshore subsidiaries and branches.

Source: ABS (2004a); KPMG (2004).

Trends in effective company tax rates

So far this article has focussed on statutory company tax rates. However, actual tax paid can differ significantly from what the statutory rate alone would suggest. It is important therefore to consider trends in effective company tax rates.

What are effective company tax rates?

An effective tax rate looks at actual tax payable (historical or hypothetical) against actual income (historical or assumed). An effective rate can differ from the statutory

rate because of taxable income differing from actual income (due, for example, to accelerated depreciation), other features of the tax law (such as tax offsets), or non-compliance.

Unlike statutory rates, effective tax rates are not readily observable. Researchers use various methods to measure representative effective company tax rates.¹⁰ In making international comparisons, a country's international ranking can vary considerably depending on the effective tax rate measure adopted.

Unfortunately, all effective tax rate measures have significant methodological and/or data problems. For effective tax rate measures using historical data, inadequate data complicate comparisons of rates over time and between countries. Hence, robust estimates are difficult to find.¹¹ Effective tax rates for hypothetical investments are highly stylised and cannot capture all relevant aspects of a tax system.

Effective tax rate trends

Yoo (2003) compares effective marginal tax rates and effective average tax rates.¹² He calculates the rates for hypothetical investments applying to cross-border investments between pairs of OECD countries. The estimates take account of the home tax system (where the investment is financed from) and host tax system (where the investment is made).¹³

Yoo estimates effective marginal and average tax rates declined for inbound FDI from 1991 to 2001. Effective marginal tax rates fell on average by around 9 percentage points between 1991 and 2001, and effective average tax rates by around 4 percentage points between 1996 and 2001. There was some convergence in effective rates between countries, especially effective average tax rates (Chart 5).

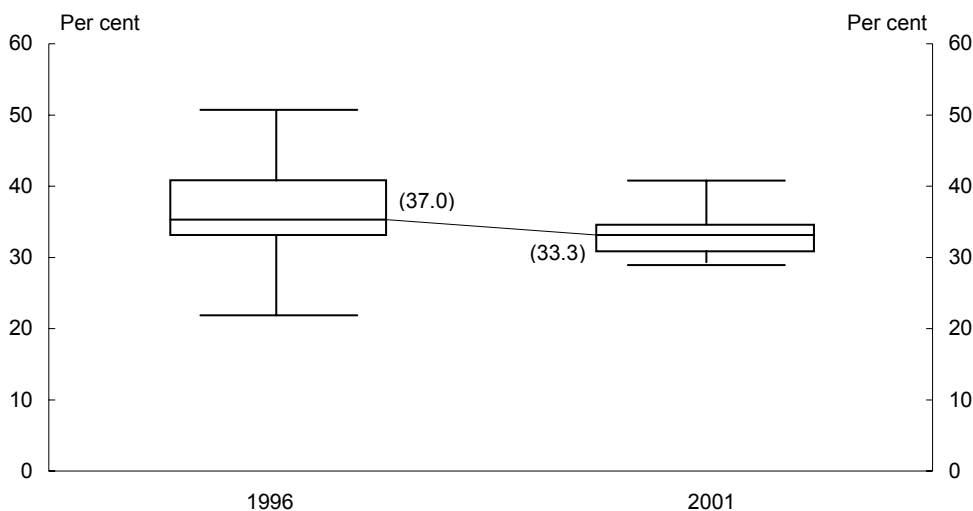
10 OECD (2000) provides a general overview of tax burden measures. See also Devereux and Griffith (2003).

11 OECD (2001b, pp. 31-32, and Tables 17 and 21 at pp. 56-57, 67-69) provides estimates comparing aggregates of relevant tax collections and a measure of corporate operating surplus derived from national accounts statistics for some OECD countries from 1965 to 1996, including Australia. However, the authors note significant problems with them.

12 An effective marginal tax rate is the rate that applies to an investment that earns just enough to break even with a company's cost of capital (the minimum return a company must offer investors, whether shareholders or lenders, for them to invest or retain their investment in the company). An effective average tax rate is the rate of tax on investments earning returns greater than a company's cost of capital. See Devereux and Griffith (2003).

13 The estimates provide an upper bound estimate only as they do not account for many of the tax minimisation strategies available to multinationals.

Chart 5: Effective average tax rates on FDI between OECD countries, 1996 and 2001^(a)



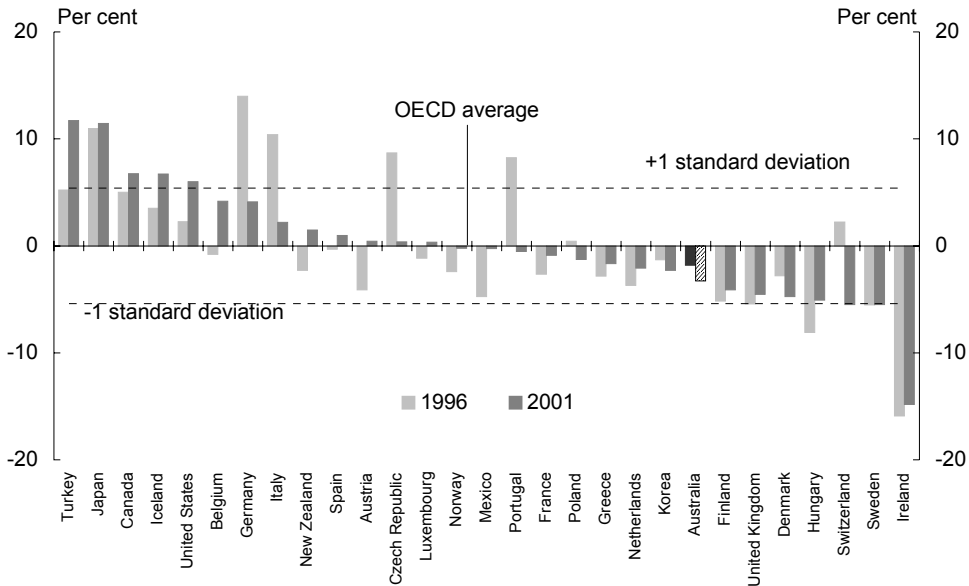
(a) The box plot shows, in each year, the median OECD value of the effective *average* tax rate imposed on inward FDI (the horizontal line in the box), the third and second quartiles of the cross-country distribution (the edges of each box) and the extreme values (the horizontal lines above and below each box). Averages are provided in parentheses.

Source: Yoo (2003, Figure 1, Panel B).

Effective average tax rates may better measure the tax incentives a multinational may face in choosing a country in which to locate a large, discrete, investment project. Effective marginal tax rates, which relate to a project’s break even point, may be more relevant for deciding a project’s scope once the country location choice is made.¹⁴ In Yoo’s estimates for 1996 and (even more so) for 2001, Australia’s effective average tax rate on inbound FDI was moderately below the OECD average (Chart 6).

14 For further discussion see Devereux and Griffith (2003). Devereux et al (2002) found that effective marginal tax rates have not declined significantly since the early 1980s whereas effective average tax rates have. This is unsurprising given that the latter are more closely correlated to statutory rates than the former (for which the company tax base is relatively more important), and statutory rates have declined while the company tax base has broadened.

Chart 6: Difference in country effective average tax rate on inbound FDI from OECD average, 1996 and 2001



Source: Yoo (2003, Figure 4, Panel B).

Other measures of tax burden

Other measures are often used to consider tax trends and international tax competitiveness. These include the ratios of total tax revenue collected to GDP, company tax collected to GDP, and company tax collected to total tax revenue.

For OECD countries, total tax revenue to GDP ratios have risen consistently since the 1960s, though the pace has slowed. In very recent years, the rise has stalled and partially reversed in some countries. This could reflect cyclical factors and may not last. On a total tax revenue to GDP basis, Australia is below the OECD average.¹⁵

Company tax revenues to GDP have been fairly steady (Chart 3). Since 1980, the weighted OECD average has been steady, but moving in line with the economic cycle. However, the unweighted average has increased, possibly because of profit shifting to small, low tax rate, OECD countries (Griffith and Klemm 2004, pp. 16-17).

By OECD standards, Australia's company tax to GDP ratio is high, 5.3 per cent in 2002 against an unweighted OECD average of 3.4 per cent. A high ratio can reflect non-tax

15 See OECD (2004), the source for figures on the other measures of tax burden referred to in this section.

factors such as a high proportion of businesses being incorporated, a relatively profitable corporate sector, and differences in revenue data and GDP estimates.¹⁶

Finally, for OECD countries the weighted average of company tax as a proportion of total tax revenue has declined since 1965. However, since the 1980s they have remained fairly stable (Griffith and Klemm 2004, pp. 17-18). These trends reflect total tax revenue to GDP increasing over time while company tax to GDP has remained steady.

Australia's high company tax to GDP ratio, and low total tax revenue to GDP ratio, means Australia has a high company tax to total tax revenue ratio – 16.8 per cent in 2002 against an unweighted OECD average of 9.3 per cent. These ratios are heavily influenced by taxes completely unrelated to company and capital income, and so have limited value.

Note that ratios of both company tax to GDP and company tax to total tax revenue typically do not take account of company and personal income tax integration. For example, they do not adjust for the tax benefit an imputation system provides to resident shareholders for company tax paid.

Two basic roles for company income tax

Australia's company income tax applies to Australian resident companies and Australian branches of foreign companies.¹⁷ For 2003-04, total company tax revenue (on a cash basis) was \$36.1 billion, or 21 per cent of total Australian Government tax revenue.¹⁸

In theory, company income tax is *not* a necessary part of a comprehensive income tax system. That is, if unrealised gains were subject to accruals taxation, or if a company's income was fully attributed to its underlying shareholders (like the treatment of partners in general partnerships), then company income tax would be unnecessary.

16 For example, OECD revenue statistics treat tax collected on superannuation funds' contributions and earnings (but not the superannuation surcharge) as part of total Australian company tax revenue.

17 A company is resident in Australia if incorporated in Australia, or if it carries on a business in Australia and has either its central management and control in Australia or its voting power controlled by resident shareholders.

18 Australian Government (2004a, Table C3). Australian Government (2004b, pp. 5-10, 5-11), discusses the recent strength of Australian company tax revenues.

For various reasons neither alternative is feasible.¹⁹ Hence, Australia's company income tax system fulfils two basic roles:

- a (withholding) tax on the income earned by Australian residents through an Australian resident company;²⁰ and
- a tax on (Australian source) income earned by foreigners through an Australian company or the Australian branch of a foreign company.

Other reasons are sometimes given for company income tax. These include: companies having a separate legal identity; a user charge for the limited liability status of companies; a user charge for public goods such as an educated workforce and public infrastructure; and ease of tax collection. These are, at best, of secondary importance.²¹

Taxing residents

Company income tax helps to ensure that residents are appropriately taxed on their income.²² Without company income tax, a resident could accumulate income tax-free in a company. Tax would be deferred until the resident sells the shares in the company or receives a dividend.

In Australia, resident shareholders are taxed on dividends received but are credited for Australian company income tax on the profits from which the dividends are paid. Hence, company income tax in Australia effectively acts as a withholding tax on income residents earn through a company. Given imputation, there are some benefits in aligning the company and top personal tax rate.²³

While company income tax generally taxes income from capital, it also effectively taxes the labour income of the incorporated self-employed or contractors. Hence, the residents' tax role is relevant to both capital and labour income.

19 Examples include valuation difficulties and compliance costs in allocating taxable income to underlying shareholders, especially where ownership changes during a year.

20 The 'controlled foreign companies' and 'foreign investment fund' rules perform a similar policy function for income derived by Australian residents through foreign companies.

21 For example, the limited liability status argument would only justify a low company tax rate, while the public goods provided to companies and a profit based company tax are not directly connected. For further discussion of the rationales for company income taxes, see Bird (1996), Mintz (1996) and Slemrod (2004).

22 See Gordon and MacKie-Mason (1994) for a discussion.

23 Such an alignment may not fully remove the incentives to earn income through a company, as it ignores possible differences in personal and company income tax bases, income-splitting benefits, and higher effective personal income tax rates arising from the means-testing of benefits.

Taxing foreigners on Australian source income

Australia taxes capital income earned by foreigners investing in Australia principally through company income tax. It applies to investments through an Australian subsidiary, or a non-controlling (portfolio) shareholding in an Australian company, or through an Australian branch of a foreign company.

Foreigners owned around 30 per cent of equity issued by Australian enterprises as at 30 June 2003 (ABS 2004b). Given total company tax revenue was \$36.1 billion in 2003-04, and certain simplifying assumptions, this implies company tax revenue from taxing foreigners' Australian source income is around \$11 billion per annum.

To determine the appropriate statutory company tax rate for this role, government must weigh up the benefits of raising revenue from foreigners against the potential costs of deterring investment into Australia. International company tax rates can affect these assessments. The remaining sections focus on these benefits and costs.

Balancing the two roles

While the focus of this article is on the role of company income tax in taxing foreigners, the residents' tax role is also important. The choice of a single statutory company tax rate must balance both. Hence, Australia's statutory company tax rate is likely to lie somewhere between the rates that each role would suggest.

Fairly recent history illustrates the tension between the two roles. After imputation was introduced in the late 1980s, the statutory company tax rate was briefly aligned with the top (statutory) personal income tax rate, at 49 per cent.²⁴ A reason given for alignment was eliminating opportunities to defer tax by accumulating income in a company – consistent with the residents' tax role (Keating 1985, p. 4). However, the statutory company tax rate was soon lowered to 39 per cent. That drop was justified partly to boost international competitiveness.²⁵

Company income tax and attracting foreign investment

Lowering company income tax on foreigners who invest in Australia could help Australia compete for more foreign investment. Attracting FDI in particular is the primary goal of many who advocate reductions in statutory company tax rates.

24 Alignment was achieved by increasing the statutory company tax rate while reducing the top statutory personal income tax rate.

25 The related broadening of the company income tax base would also reduce distortions in respect of the investment decisions of companies. See Keating (1988, pp. 6-7).

FDI measures foreigners' investments in Australian companies they control or Australian branches. It measures financial interests, not investment in new factories, services and business. Hence, an increase in FDI does not directly translate into increased real investment in Australia.²⁶

Even assuming a statutory company tax rate reduction has a positive impact on inbound FDI (the evidence on this is discussed below), doing so will not necessarily improve Australians' wellbeing.

Potential benefits to Australia of greater FDI include:

- if Australia's capital stock increases, greater labour income through increased productivity and possibly employment; and
- positive externalities or spill-overs associated with FDI which improve labour and capital productivity, and hence labour and (residents') capital income.²⁷

Capital income from any net increase in Australia's capital stock accrues to the foreign investors, without direct benefit to Australia other than source tax revenue (see below). If increased inbound FDI simply displaces Australian ownership of Australia's capital stock, offset by increased ownership of assets overseas by Australians, the net capital income of Australian residents will not necessarily change.

26 FDI may be associated directly with a new real investment in Australia, although this may crowd out an investment that would otherwise have been made. FDI may reflect the acquisition of an existing business, although vendors may use the sale proceeds to undertake additional real investment. FDI may arise if an amount is invested in an Australian subsidiary (inbound FDI), which in turn invests in a subsidiary of its own in a third country (outbound FDI).

27 Potential positive externalities or spill-overs include Australians learning new business methods and skills, developing overseas contacts, benefiting from technology transfer, and increasing competition in domestic markets. Lipsey (2002) reviews evidence of home and host country effects of FDI on exports, wages, and productivity.

The costs for Australia arise primarily from the reduced revenue collections from foreigners due to the lower company tax rate. More precisely:

- reduced revenue from existing FDI in Australia (a transfer of wealth to foreigners from Australians), offset by revenue on capital income arising from any net increase in the capital stock and revenue accruing from reduced incentives to shift profits out of Australia;²⁸
- negative externalities (for example, FDI could reduce domestic competition in specific cases); and
- further compromising the effectiveness of company income tax in its role of taxing residents.

A national accounts measure of national income would capture most of the above benefits and costs. Therefore, gross national income better measures the net benefits than observing responses in inbound FDI. Even then, other consequences of the change need to be factored in to assess the change in wellbeing of Australians.

A reduced statutory company tax rate, irrespective of the impact of inbound FDI, also may encourage Australian companies to invest domestically rather than overseas.

On the other hand, government may need to increase taxes elsewhere (or reduce them by less than they otherwise would) to maintain total revenue. The economic costs associated with these offsetting tax changes also need to be taken into account. Such 'revenue constrained' tax policy choices are the focus of 'optimal tax' analysis. A well-known optimisation argument is directly relevant to the discussion above.

Optimal tax arrangements for a small capital importing country

For a small capital importing country, if capital is perfectly mobile between countries but labour (the other factor of production) is immobile, a tax on the income derived by the foreign capital that it imports is sub-optimal.

Taxing the domestic source capital income of foreigners causes them to reduce their investment in the country until the marginal post-tax rate of return equals the (unchanged) returns available from investing elsewhere. Foreigners' after-tax returns are therefore unaffected, so they do not bear the cost of the tax. However, by reducing

28 Ireland appears an example of a case where the offsetting revenue gains appear to have been greater than the upfront cost. Additional revenue also may be collected if labour income and capital income accruing to Australians increases. However, as these (gross) income effects already were identified as benefits, further identifying any associated revenue gains would involve double counting.

their total investment, the country's capital stock declines. The decline reduces domestic labour productivity and hence income.

Domestic labour, not foreign investors, therefore bear the real cost of taxing the domestic source capital income of foreigners. To raise revenue, a direct tax on labour income would be optimal: the incidence of the tax would still be on labour, but it avoids the efficiency costs from a smaller capital stock.

This encapsulates the basic argument for reducing company tax rates to attract more foreign investment.²⁹ However, even if accepted, some factors would still justify taxing such income:

- the home country of a foreign investor also may tax the investor's Australian source income, but credit the Australian tax paid. Most FDI into Australia is from countries that operate such foreign tax credit systems (Table 1).³⁰ However, credits are effectively not provided on a one-for-one basis;³¹
- economic rents (returns above the cost of capital) may be available only from investing in Australia (for example, investments in natural resources or a non-tradable sector like construction). If foreigners only realise these 'extraordinary' profits by investing in Australia, some tax on these rents will not deter investment;³² and
- existing investments may be locked in (or 'sunk').

All three factors suggest reasons why, even if capital is otherwise mobile, foreign investment into Australia may be insensitive to the present level of Australian tax. The next step, therefore, is to consider the evidence on the tax responsiveness of cross-border investments.

29 For consideration of how the optimal tax outcome may differ if alternative assumptions are made, see Devereux (2003).

30 Other countries, including Australia, generally exempt the income from outbound FDI.

31 Countries limit credits for foreign tax to the amount of domestic tax payable; countries do not in general tax (and hence credit) Australian source income on an accruals basis, diminishing the present value of the credits; and credits for Australian tax paid on Australian income are typically pooled with credits for other income.

32 On the other hand, economic rents may arise from firm-specific factors that can be realised regardless of the country in which an investment is made (for example, a factory that produces for export, for which any above-normal profits are attributable to the intellectual property of the firm). Such investments can be highly mobile, and are arguably the focus of tax competition between countries; see Devereux and Griffith (2003).

Cross-border investments and profit shifting and company income tax

Cross-border investments

Company income tax is only one factor affecting the level and allocation of cross-border investments. Other taxes, such as tariffs and withholding taxes may feature. More important still are non-tax factors such as closeness to final markets, availability of inputs to production, labour market conditions, well-developed property rights, and political and economic stability.³³

Considerable research has been undertaken on the responsiveness of cross-border investments – principally FDI, but also related concepts, such as property, plant and equipment, or new capital investment. The studies are not definitive as they suffer from problems with data and in disentangling tax effects from other influences. Results also vary considerably between studies.

However, some conclusions that can be drawn from the research are that:

- cross-border investments are significantly influenced by company tax, though this is difficult to quantify, and this influence is increasing over time;
- company tax is more significant in determining the allocation of investment within, rather than between, regions;
- company tax is a more significant factor for some investments than others (for example, location of intra-group service providers);
- new investments are sensitive to tax rates while acquisitions of existing businesses (mergers and acquisitions) are not;³⁴
- effective tax rates are more important than statutory tax rates;
- certainty and transparency of tax treatment are important; and
- investments sourced from countries with a foreign tax credit (as opposed to exemption) system may be relatively less sensitive to host country company tax rates, but evidence of this is not conclusive.

33 Unsurprisingly, the sensitivity of cross-border investments to company income tax may depend on interaction with non-tax factors. Grubert and Mutti (2000) found the sensitivity of the real capital investments of US multinationals to host country average effective tax rates was significantly greater for countries with an open, rather than closed, trade regime.

34 Mergers and acquisitions typically represent a major part of inbound FDI.

Some general surveys of relevant econometric (statistical) studies have estimated the average quantitative response found by the underlying studies.

Hines Jr (1999) found statistically significant and important tax impacts on both the level and allocation of FDI. He found the studies suggested a tax elasticity of FDI of -0.6 per cent. That is, a 1 per cent reduction in the relevant tax rate (for example, from 30.0 to 29.7 per cent) increases inbound foreign investment by 0.6 per cent.

Reviewing 25 studies, de Mooij and Ederveen (2001) estimated that they showed a semi-elasticity of -3.3 per cent. That is, a 1 percentage point reduction in the modelled tax rate (30 to 29 per cent) is associated with a 3.3 per cent increase in inbound investment.

The policy usefulness of these averages (and specific estimates) is questionable given differences in investment measures, tax rate measures, and other aspects of the studies.³⁵ Further, they may not be relevant to Australia and they say nothing directly about net additions to a country's aggregate capital stock.

Profit shifting between countries

To minimise tax paid worldwide, multinational groups may artificially shift profits from a high-tax country to a low-tax country by:³⁶

- allocating proportionally more debt to group companies in high-tax countries than in low-tax countries (thin capitalisation);
- having group companies in high-tax countries undercharge for sales, or overpay for purchases, to or from group companies in low-tax countries (transfer pricing); or
- paying royalties from group companies in high-tax countries to group companies in low-tax countries for the use of intangibles such as brand names.

These practices principally create a benefit that is a function of differences in statutory company tax rates in the relevant countries.

35 See Devereux and Griffith (2002) for a sceptical view of these estimated averages.

36 High and low-tax are relative terms. Hong Kong is seen as a low-tax jurisdiction but has acted to guard against transfer pricing. Even between OECD nations profit shifting appears significant, see Bartelsman and Beetsma (2003).

While high-tax countries typically guard against such practices, profit shifting nonetheless occurs.³⁷ Differences in statutory company tax rates significantly affect the allocation of debt within multinationals, levels and direction of royalty payments, and location of reported profits (firms in tax havens typically are more profitable).

However, Australia appears relatively unaffected by such practices.³⁸ This may reflect stronger protective measures and stricter enforcement than in other countries. Australian multinationals also have an incentive to shift profits to Australia to pay Australian rather than foreign company income tax.

By paying Australian company income tax, even where statutory rates are the same, an Australian multinational generates tax credits for its resident shareholders. A move away from imputation would remove this incentive to shift profits here and pay Australian rather than foreign tax.

The importance of statutory company tax rates in profit shifting suggests that, for a given effective tax rate, a low rate/broad base is preferable to a high rate/narrow base. Unsurprisingly, a switch to the former has been evident worldwide in recent years. Hence, declining statutory company tax rates coupled with base broadening may be due partly to company tax revenue protection rather than tax competition.³⁹

Profit shifting behaviour also means the revenue cost to a country from lowering its statutory company tax rate (or gain from increasing it), may not be as significant as tax collection data suggest. More than 65 per cent of additional revenue from a unilateral company tax increase could be lost (Bartelsman and Beetsma 2003). For Australia, the empirical evidence and the countervailing influence of imputation suggest this effect would be much less pronounced.

Observations on the implications of recent trends

The links between international and Australia's statutory company tax rates

As discussed, optimal tax theory provides an argument for small capital importing countries to avoid taxing the income of foreign capital. The logic of this argument is true *regardless* of company tax rates overseas or movements in those rates. It is often

37 See, for example, Kinney and Lawrence (2000), Swenson (2001), Gordon and Hines Jr (2002, pp. 49-58), Bartelsman and Beetsma (2003), Grubert (2003) and Mills and Newberry (2004).

38 See Bartelsman and Beetsma (2003) and Sullivan (2004).

39 Separately from Devereux et al (2003) (see footnote 6), Devereux et al (2002) tested these two explanations and could not conclude in favour of the tax competition explanation.

assumed that lower company tax rates overseas mean that Australia's rate needs to be lower, without explanation of the causal links that make this so.

A relationship does exist between Australia's statutory company tax rate and those in countries with foreign tax credit systems. In 2003, at least 60 per cent of the stock of inbound FDI was from countries with a foreign tax credit system whose own statutory company tax rate equalled or exceeded Australia's.⁴⁰

Lower statutory tax rates in these countries could directly affect Australia. However, evidence of a relationship between the tax responsiveness of FDI and the presence of a foreign tax credit or exemption system in the home country is not strong.

This may not be true of the specific case of investment in Australia or it may reflect some of the underlying problems with the empirical studies. Bénassy-Quéré et al (2003) found asymmetries in the responsiveness of FDI to tax rates. The sensitivity of FDI to tax rates was much higher where a country's tax rate was significantly higher than average. Where a country's tax rate (as Australia's is) was around or below average, the FDI response to a change in the rate was much reduced. Such outcomes are consistent with the operation of foreign tax credit systems.

A second direct link between Australia's statutory company tax rate and those overseas occurs with profit shifting. The difference between Australia's statutory rate and those overseas will influence the degree and direction of profit shifting.

Alternative approaches

Even if lowering Australia's statutory company tax rate to attract greater FDI would have net benefits, the implications for the taxing of residents would need consideration. Satisfying two goals using a single rate is difficult; some countries have considered broad-ranging reforms to overcome this constraint.⁴¹

New Zealand's split company tax rate proposal

New Zealand considered the most direct alternative following a recent tax review (McLeod et al 2001). The approach was to apply a lower statutory company tax rate (18 per cent) *to the extent* a New Zealand company was owned by foreigners. For ownership by New Zealanders, the standard (33 per cent) rate was to apply.

40 Relative statutory tax rates are important as foreign tax credit systems do not provide a credit for foreign tax paid above the domestic tax payable.

41 For an overview of the merits of reducing statutory company tax rates versus more specific investment incentives (for example, tax holidays and capital allowances) see OECD (2001a).

International trends in company tax rates

This approach was intended to improve New Zealand's competitiveness in attracting FDI. Apart from reducing effective rates, it was also thought there would be direct benefits from a low 'headline' rate.

Assuming a split rate system could be implemented without residents accessing some of the benefits, a lower rate for foreign owners would not have directly affected the taxing of income earned by New Zealanders through New Zealand companies.

However, New Zealand eventually decided against the proposal. The benefit of a likely increase in inbound FDI was not enough to outweigh the revenue cost (and loss to New Zealand's national income) from a reduced rate on existing as well as future foreign investment (Lynch and Peters 2003).

Such an outcome reflects the observation that where pre-existing investments of foreigners are locked-in, taxing the income of foreign investment is more readily justified. New Zealand considered only applying the lower rate to 'new' investments, but felt that distinguishing between existing and new investments on a permanent basis would be impractical.

Scandinavian dual income taxes

In the early 1990s, Norway, Finland, Denmark and Sweden introduced (to varying degrees) dual income tax systems. Under a dual income tax, capital income is taxed at a relatively low flat rate (in practice, around 30 per cent). Labour income remains subject to tax against a (higher tax) progressive rate schedule.⁴²

The move to dual income taxes was partly a response to international tax competition for capital. Deficiencies in the capital income tax bases of these countries meant previous arrangements had also not collected significant revenue from capital income. The move therefore was accompanied by considerable base broadening.

A dual income tax responds to international tax competition to attract (and retain) capital while retaining a domestic policy focus for less mobile (labour) income. To ensure that labour income cannot benefit from the lower rate of tax on capital income, a dual income tax system taxes the implicit labour income of the self-employed (whether incorporated or unincorporated) against the progressive rate schedule.

The difficulty (and increased importance) of distinguishing between labour and capital income is a significant challenge for dual income taxes.

⁴² For an overview, see Zee (2002).

Future US developments

The United States has not participated in the trend of declining statutory company tax rates for nearly two decades. It has not reduced its (Federal) statutory rate since 1986, when it was cut from 46 to 34 per cent. Instead, the United States increased its rate slightly in 1993 to 35 per cent. It also maintains a foreign tax credit system for taxing repatriated foreign source income.

In international tax policy, other countries often follow US leads. If the United States substantially cuts its statutory company tax rate, this is likely to have significant flow-on effects internationally. If the United States moved away from providing foreign tax credits for earnings repatriated from offshore subsidiaries, this could also have widespread international ramifications.

Conclusions

Statutory company tax rates around the world have declined significantly in recent decades. This is likely to continue in the short-term at least, although the rate of decline may be diminishing and convergence (rather than a headlong fall to zero rates) taking place.⁴³ Effective company tax rates also have declined, but not as much as statutory rates. Australia's experience reflects these trends.

There is a link between the level and allocation of cross-border investments and company tax. The sensitivity of cross-border investments to tax also appears to be increasing.

If reducing company tax to attract more foreign investment was thought justified, lowering the statutory company tax rate would generally be preferable to narrowing the company tax base because:

- a broader base minimises distortions in the allocation of capital within Australia;
- a lower statutory rate provides a better outcome in respect of profit shifting;
- if competition between countries is primarily for discrete high profit investments, then reducing the statutory rate is a better targeted response; and
- a statutory company tax rate reduction is more visible and may provide a positive 'headline' effect for any given effective tax rate.

⁴³ Countries that have already foreshadowed future statutory company tax rate cuts include: Austria (34 to 25 per cent); France (removal of 3 per cent company surtax); Netherlands (34.5 to 30 per cent) Romania (25 to 19 per cent); and Singapore (22 to 20 per cent).

International trends in company tax rates

The benefits of increased foreign investment from cutting the statutory company tax rate must, however, be weighed against the costs (largely revenue) and implications for taxing residents. Moreover, it is not clear that there are significant competitiveness problems with Australia's current statutory company tax rate, which is around the OECD average. It is also less than or equal to our major sources (and destinations) of FDI, and the most important of these sources provide a credit (albeit imperfectly) for Australian company tax paid.

References

Australian Bureau of Statistics (ABS) 2004a, Cat. No. 5352.0, *International Investment Position, Australia: Supplementary Country Statistics*, Australia, 2004.

Australian Bureau of Statistics (ABS) 2004b, Cat. No. 1301.0, *Year Book Australia*, Australia, 2004.

Australian Government 2004a, *Final Budget Outcome 2003-04*, Australia, 2004.

Australian Government 2004b, *Budget Paper No. 1 Budget Strategy and Outlook 2004-05*, Australia, 2004.

Bartelsman, EJ and Beetsma, MWJ 2003, 'Why pay more? Corporate tax avoidance through transfer pricing in OECD countries', *Journal of Public Economics*, 87, pp. 2225-2252.

Bénassy-Quéré, A Fontagné, L and Lahrèche-Révil, A 2003, 'Tax Competition and Foreign Direct Investment', *Working Paper No. 2003*, 17 December, CEPII, Paris.

Bird, RM 1996, 'Why Tax Corporations?', *Working Paper 96-2* prepared for the Technical Committee on Business Taxation, Department of Finance, Ottawa.

Devereux, MP 2003, 'Some Optimal Tax Rules for International Portfolio and Direct Investment', August 2003, available from <http://www2.warwick.ac.uk/fac/soc/economics/staff/faculty/devereux/publications/>, accessed 5 October 2004.

Devereux, MP and Griffith, R 2002, 'The impact of corporate taxation on the location of capital: A review', *Swedish Economic Policy Review*, 9, pp. 11-33.

Devereux, MP and Griffith, R 2003, 'Evaluating tax policy for location decisions', *International Tax and Public Finance*, 10, pp. 107-126.

Devereux, MP Griffith, R and Klemm, A 2002, 'Corporate income tax reforms and tax competition', *Economic Policy*, 35, pp. 451-495.

Devereux, MP Lockwood, B and Redoano, M 2003, 'Is there a 'Race to the Bottom' in Corporate Taxes?' *An Overview of Recent Research*, May 2003, available from http://www2.warwick.ac.uk/fac/soc/csgr/research/keytopic/race/Lockwood_Overview_May03.pdf/, accessed 6 October 2004.

International trends in company tax rates

Gordon, RH and Hines, Jr JR 2002, 'International Taxation', *National Bureau of Economic Research Working Paper No. 8854*.

Gordon, RH and MacKie-Mason, JK 1994, 'Why is there corporate taxation in a small open economy? The role of transfer pricing and income shifting', *National Bureau of Economic Research Working Paper No. 4690*.

Griffith, R and Klemm, A 2004, 'What has been the tax competition experience of the last 20 years?', *Working Paper 04/05*, The Institute for Fiscal Studies, London.

Grubert, H 2003, 'Intangible Income, Intercompany Transactions, Income Shifting, and the Choice of Location', *National Tax Journal*, 56(1, part 2), pp. 221-242.

Grubert, H and Mutti, J 2000, 'Do Taxes Influence Where U.S. Corporations Invest?', *National Tax Journal*, 53(4, part 1), pp. 825-840.

Hines, Jr JR 1999, 'Lessons from Behavioral Responses to International Taxation', *National Tax Journal*, 52(2), pp. 305-322.

Keating, P 1985, *Reform of the Australian Taxation System*, September 1985, Australian Government Publishing Service, Canberra.

Keating, P 1988, *Economic Statement May 1988*, Australian Government Publishing Service, Canberra.

Kinney, M and Lawrence, J 2000, 'An Analysis of the Relative U.S. Tax Burden of U.S. Corporations having Substantial Foreign Ownership', *National Tax Journal*, 53(1), pp. 9-22.

KPMG (various years), *KPMG's Corporate Tax Rates Survey*, KPMG, available from http://www.us.kpmg.com/microsite/global_tax/ctr_survey/, accessed on 30 September 2004.

Lipsey, RE 2002, 'Home and Host Country Effects of FDI', *National Bureau of Economic Research Working Paper No. 9293*.

Lynch, R and Peters, C 2003, *Taxing Inbound Investment*, New Zealand Departments of the Treasury and Inland Revenue, 10 September 2003, available from <http://taxpolicy.ird.govt.nz/publications/files/fdireport.pdf>, accessed on 30 September 2004.

McLeod, R Patterson, D Jones, S Chatterjee, S and Sieper, E 2001, *Tax Review 2001 – Final Report*, 24 October 2001, available from

<http://www.treasury.govt.nz/taxreview2001/finalreport/index.html>,
accessed on 30 September 2004.

Mills, LF and Newberry, KJ 2004, 'Do Foreign Multinationals' Tax Incentives Influence Their U.S. Income Reporting and Debt Policy?', *National Tax Journal*, 57(1), pp. 89-107.

Mintz, J 1996 'Corporation Tax: A Survey', *Fiscal Studies*, 16(4), pp. 23-68.

de Mooij, RA and Ederveen, S 2001, 'Taxation and foreign direct investment: a synthesis of empirical research', *Discussion Paper 3*, CPB Netherlands Bureau for Economic Policy Analysis, The Hague.

OECD 2000, 'Tax Burdens: Alternative Measures', *OECD Tax Policy Studies No. 2*, OECD, Paris.

OECD 2001a, 'Corporate Tax Incentives for Foreign Direct Investment', *OECD Tax Policy Studies No. 4*, OECD, Paris.

OECD 2001b, 'Tax Ratios: A Critical Survey', *OECD Tax Policy Studies No. 5*, OECD, Paris.

OECD 2004, *Revenue Statistics 1965-2003*, OECD, Paris.

Slemrod, J 2004, 'Are corporate tax rates, or countries, converging?', *Journal of Public Economics*, 88, pp. 1169-1186.

Sullivan, MA 2004, 'Data Show U.S. Companies Shifting Profits to Tax Havens', *Tax Notes International*, 20 September 2004, pp. 1035-1046.

Swenson, DL 2001, 'Tax Reforms and Evidence of Transfer Pricing', *National Tax Journal*, 54(1), pp. 7-26.

Tax Notes International 2004, 'Germany, France Again Call for Minimum EU Corporate Rates', *Tax Notes International*, 7 June 2004, p. 1001.

Yoo, K 2003, 'Corporate Taxation of Foreign Direct Investment Income 1991-2001', *Economics Department Working Papers No. 365*, OECD, Paris.

Zee, H 2002, 'Taxing Capital Income in a Globalized World', *Tax Notes International*, 2 September 2002, pp. 1185-1211.

Zee, H 2004, 'World Trends in Tax Policy: An Economic Perspective', *Intertax*, 32(8/9), pp. 352-364.

Improving global frameworks for corporate regulation: an Australian perspective

Conan Brownbill, Matthew Crooke and Andrew Sellars¹

Through most of the latter half of the 20th century, forums for economic cooperation among nations were primarily focused on removing artificial barriers to free trade and investment across borders. With the growing recognition that the opportunities created by globalisation, particularly liberalisation of capital markets, carry significant risk, the agenda of organisations pursuing international economic development is increasingly directed at improving domestic standards of business regulation in areas such as corporate governance, insolvency frameworks and financial systems.

This article describes some efforts to improve the global corporate regulatory landscape in which the Australian Treasury has been involved, and makes some observations about the merit of engaging in such activities in light of Australia's international trade and investment relationships. It concludes that although there are significant challenges ahead, the potential benefits from improving corporate regulatory systems warrant Australia's ongoing involvement.

1 The authors are officers of Markets Group, Australian Treasury. The views expressed in this article are those of the authors and not necessarily those of the Australian Treasury.

Australia's international trade and investment relationships

An ongoing commitment to opening product, services and capital markets both in Australia and overseas continues to change the patterns of trade and capital flows between Australia and the rest of the world.

Most Australian trade currently occurs with Japan, the United States and China (see Table 1). The clear majority of Australia's trade (71 per cent of exports and 70 per cent of imports) occurs with countries within the Asia-Pacific region.

Table 1: Australia's trade relationships

2003–04 (\$m)

	Top 5					Group				
	Japan	China	USA	Korea	NZ	ASEAN	EU	APEC	OECD	All
Exports										
Value	19,811	9,936	9,479	8,484	8,091	12,268	12,932	77,797	61,373	108,993
Percentage	18.2	9.1	8.7	7.8	7.4	11.3	11.9	71.4	56.3	100.0
Imports										
	Top 5					Group				
	USA	Japan	China	Germany	UK	ASEAN	EU	APEC	OECD	All
Value	19,945	16,101	15,338	7,986	5,430	20,558	31,502	91,096	81,860	131,022
Percentage	15.2	12.3	11.7	6.1	4.1	15.7	24.0	69.5	62.5	100.0

In contrast to Australia's trade relationships, Australia's investment relationships are deepest with the United States and the United Kingdom (Table 2). Future investment trends may involve a shift towards emerging market economies within the region, particularly those with whom Australia continues to strengthen its trade relationships (for example, China and emerging Asia-Pacific Economic Cooperation (APEC) economies).

Australian outward investment has traditionally been directed towards the United States and the United Kingdom. The relationship with the United States remains the predominant one, as reflected by the significant investment stocks and strong flows in Table 2. In recent times, trans-Tasman market integration has progressed at a significant pace, with Australian investment in New Zealand (and vice versa) increasing rapidly. A significant proportion of outward investment has been in the New Zealand banking sector.

**Table 2: Australia's investment relationships
stock at 31 December 2003 (\$m)**

	Top 5							Group		
	USA	UK	NZ	Japan	Netherlands	ASEAN	EU	APEC	OECD	All
Outward										
Value	211,004	82,644	37,088	21,873	12,702	16,340	148,418	309,964	432,584	508,218
Percentage	41.5	16.3	7.3	4.3	2.5	3.2	29.2	61.0	85.1	100.0
Inward										
Value	297,311	258,792	88,743	44,771	32,692	30,715	340,733	438,505	731,848	978,135
Percentage	30.4	26.5	9.1	4.6	3.3	3.1	34.8	44.8	74.8	100.0

	Top 5							Group		
	USA	UK	NZ	Japan	Hong Kong	ASEAN	EU	APEC	OECD	All
flows in year to 31 December 2003 (\$m)										
Outward										
Value	26,846	3,776	6,918	1,746	493	-1,060	11,079	35,406	47,577	51,987
Percentage	51.6	7.3	13.3	3.4	0.9	-2.04	21.3	68.1	91.5	100.0
Inward(b)										
Value	47,946	14,375	21,674	479	-12,719	-5,241	17,620	32,161	67,686	96,715
Percentage	49.6	14.9	22.4	0.5	-13.15	-5.42	18.2	33.3	70.0	100.0

(a) International Capital Markets

(b) Negative figures in this table represent a net withdrawal of investment

Source: Australian Bureau of Statistics, *International Investment Position*, Supplementary Country Statistics, Cat. No. 5352.0, Canberra, 2004.

As the United States and the United Kingdom are the world's largest funds management centres, significant investment flows between Australia and other countries are likely to be channelled through funds managers based in those jurisdictions. This could obscure the ultimate ownership of these investments.

Increasingly, Australia's capital needs are being sourced from international capital markets, where securities might be offered to investors in a number of countries simultaneously. The growth in offshore issues of residential mortgage backed securities (home loan securitisation) is a key example. The regulatory framework required to underpin such activity is one that must increasingly be suited to commercial practice within international capital markets, rather than that of any given country.

Implications for Australia's regulatory framework

Australia's interest in comparing its own regulatory framework with those of other economies, particularly its trade and investment partners, is linked to its increasingly outward orientation.

An important influence on whether foreign interests are willing to engage commercially with Australia is its regulatory policy. As a relatively small and remote player on the global stage, Australia must be concerned with the consistency of its regulatory architecture with those in other countries.²

To the extent that business regulatory frameworks in Australia and its economic partners can be further aligned, trade and investment opportunities may be enhanced.

Corporate regulation and international economic cooperation

Forums committed to international economic cooperation, including the Organisation for Economic Cooperation and Development (OECD), APEC, the World Bank, the International Monetary Fund (IMF) and a range of similar institutions, devote significant efforts to promoting reform of the global corporate regulation landscape. These activities followed the recognition of sound corporate regulation as a facilitator of foreign investment, and a key tool in the prevention and mitigation of the risks associated with cross-border capital flows.

2 A more detailed discussion of the relative cost disadvantages Australia faces in international engagement is contained in Department of Treasury (2003).

Role in crisis prevention and mitigation

Since the Second World War, the prevailing view of economic policy makers in most nations, including Australia, has been that physical trade between countries without artificial barriers is in the interests of all participants.

Along with free trade, liberalisation of capital markets is viewed by many as a key to increasing the potential economic growth of a country. Open markets for foreign capital can expand the range of available investment opportunities, allow for greater diversification of risk, provide channels for the dissemination of knowledge and new technologies, and improve the cost and accessibility of capital for business.

On the other hand, some commentators are not convinced that free flows of global capital (other than foreign direct equity investment³) necessarily result in benefits for all.⁴ There has been an association between high levels of international capital flows and financial crises.⁵ These risks are higher in emerging economies, where capital flows are more volatile, offshore borrowing is largely foreign currency-denominated and markets for hedging currency risk tend to be under-developed. In the Asian financial crisis, economies that had become reliant upon foreign sources of capital, particularly in the form of bank lending and portfolio investments, found themselves vulnerable to a reversal in flows. In the three year period 1994-1996 following substantial liberalisation of capital accounts, private capital inflows to Malaysia, Indonesia, the Philippines, South Korea and Thailand amounted to US\$220 billion. In 1997, at the height of the Asian financial crisis, US\$100 billion flowed out of those countries. Allowing the free flow of investment funds increases the risk that a sudden reversal in market confidence may spread panic and quickly cause an economy-wide crisis.⁶

Despite the risks, however, it is highly unlikely that the trend toward more cross-border capital flows will reverse to any significant extent. Expansion of world trade has historically been accompanied by expansion of cross-border capital flows as production tends to shift closer to end markets.⁷ Technological innovations in recent years, along with other developments such as innovations in financial instruments, have greatly increased the volume and speed of cross-border capital flows – including into developing countries.⁸

3 See subheading 'Role in attracting foreign investment' below.

4 The debate is canvassed in McLean and Shrestha (2002).

5 Eichengreen (2003), p. 5.

6 Sakakibara (1999), p. 182.

7 Eichengreen (2003), p. 15.

8 Marr (1997).

While capital controls may play a transitional role, the real issue in the longer term is not whether the cross-border capital flows should be restricted, but rather how the risks associated with them can be managed. In the wake of the Asian financial crisis there were a range of suggestions about measures to prevent excess volatility in capital markets from causing financial crises. There is now a general recognition that emerging economies need to be careful to sequence capital account liberalisation with other reforms in order to limit vulnerability. The solutions are not straight-forward, and draw on a range of coordinated initiatives. However, it has often been noted that one means of reducing the risks associated with capital account liberalisation is to have well-developed financial and corporate legal infrastructure, which includes robust regulatory standards in areas such as corporate governance and insolvency procedures.⁹

Role in attracting foreign investment

Attracting significant foreign investment was a key objective of some affected economies following the Asian financial crisis to mitigate the impact of the sudden reversal of capital flows. A particular target was direct equity investment, which is seen as a more stable form of capital than bank lending or corporate debt.

Effective corporate regulation has been identified as a factor in attracting foreign investment. It increases certainty and transparency for investors, potentially reducing the costs of international exchange and encouraging further international economic integration. As mentioned above, the benefits of foreign investment also include reducing financial constraints on economic growth and assisting development of expertise and technologies.

The attraction of all forms of capital is facilitated by well-developed legal and judicial systems, strong frameworks of governance, accurate and timely provision of information, and an appropriate degree of regulatory oversight and sanction. Well-informed markets, based upon transparent disclosure of information and relative certainty in property rights, help to avoid the social, economic and political costs of financial instability. An institutional investor opinion survey, conducted by McKinsey and Company in cooperation with the World Bank in 2000, found that corporate governance was considered just as important a factor when making investment decisions as reported financial performance.¹⁰

9 Eichengreen (2003), p. 303.

10 McKinsey & Company (2000).

Similarly, insolvency systems that are properly designed and implemented can boost confidence, thereby encouraging investment.¹¹

Treasury's involvement in initiatives to improve the global framework for corporate regulation

The Australian Treasury has been involved in a number of international projects to improve the global frameworks for corporate regulation and, in some cases, has instigated or led those efforts. Some recent examples follow.

Revision of the OECD Principles of Corporate Governance

The OECD comprises 30 economies of the developed world committed to democratic government and the market economy. It plays an important role in the facilitation of good governance in the public and corporate sectors of member and non-member economies.

An officer of Australian Treasury currently chairs the OECD Steering Group on Corporate Governance, which coordinates the OECD's corporate governance initiatives.

Recently the Steering Group has reviewed the OECD Principles of Corporate Governance. The Principles were first published in 1999 and have become widely accepted as the leading international benchmark on corporate governance issues. They became one of the Financial Stability Forum's twelve Key Standards for International Financial Stability.

The Steering Group's review of the Principles was commissioned in 2002 by OECD Ministers to ensure the Principles were sufficiently robust and up-to-date after a series of high-profile corporate collapses in member economies.

As part of the revision process, the Steering Group sought and received comments from individuals plus national and international organisations. The OECD Ministerial Council endorsed the revised Principles as recommended by the Steering Group in May 2004 and they have been published.¹² The key changes to the Principles are:

- greater emphasis on transparency and director responsibility through improved related party transaction disclosure and 'whistle-blower' protections;
- auditors being made explicitly accountable to shareholders;

11 Hagan (2000), p. 50.

12 OECD (2004).

- new principles on shareholder access to information and ability to influence the board membership and remuneration commensurate with their voting share;
- requiring the disclosure of institutional investor voting policy and how they manage conflicts of interest;
- a new focus on the role of analysts and brokers in the governance system, including a requirement for the disclosure of conflicts of interest; and
- revision of the preamble and annotations to reflect changes in the corporate governance environment and to assist with implementation of the Principles.

The OECD Principles are a valuable tool in facilitating dialogue and improving corporate governance systems in both developed and developing economies. Their revision represents a significant milestone for the OECD in its efforts to strengthen corporate governance standards around the world. This will, in turn, facilitate economic growth and financial stability given the valuable contribution that good corporate governance makes in these areas.¹³

United Nations Commission on International Trade Law (UNCITRAL) Legislative Guide on Insolvency Law

In October 1998, following the Asian financial crisis, the Prime Minister commissioned a task force, chaired by the Treasurer, to advise on ways that Australia could assist international financial reform. That task force's report, published later in 1998, recommended that Australia propose, and actively encourage, an international guide on insolvency law by the United Nations Commission on International Trade Law (UNCITRAL).

This recommendation arose from statements in reports of Group of 22 working groups that strong national insolvency regimes were essential to address corporate financial difficulties early, before they accumulated and caused economy-wide crises. Strong insolvency systems were deemed an important component of crisis prevention, but also a significant element of orderly and cooperative crisis management.

Although there were some statements of principle regarding effective and efficient insolvency systems at the time of the recommendation, no detailed guidance on legislative frameworks had been developed. The task force report suggested that given its recent experience preparing a model law on cross-border insolvency and its broad constituency and expert contacts, UNCITRAL would be a suitable body to prepare a model legislative framework for national insolvency laws for use in a range of different legal systems and commercial environments.

13 de Brouwer (2003), p. 1.

Australian representatives put the proposal to UNCITRAL in 1999, which accepted its merits. The Commission provided its working group on insolvency law with a mandate to develop a comprehensive statement of key objectives and core features for a strong insolvency regime and a detailed legislative guide. The working group held a number of meetings at which many developed, developing and transition economies were represented. Expert observers from a range of non-government organisations also attended. Australia was represented by an officer from Australian Treasury.

In June 2004, UNCITRAL adopted the draft Legislative Guide on Insolvency Law prepared by the working group. It contains comprehensive commentary and recommendations about the legislative framework for insolvency of commercial enterprises, including liquidation and reorganisations.¹⁴

Australian involvement in international insolvency projects was recently considered by the Parliamentary Joint Committee on Corporations and Financial Services in its report on Australia's insolvency laws. The Committee noted that Australian cooperation in international efforts to build credible and effective insolvency systems benefited Australian businesses trading overseas and gave reassurance to Australians and Australian institutions whose funds were at risk with cross-border operations.¹⁵

APEC Corporate Governance Pathfinder Initiative

Australia has been involved in a number of initiatives in APEC on corporate governance and related issues.¹⁶ Most recent is the APEC Pathfinder Initiative on Corporate Governance (Pathfinder Initiative) which arose from a recommendation in the 1999 APEC report on strengthening corporate governance.

14 The text of the Guide is available at:

www.uncitral.org/english/texts/insolven/insolvencyindex.htm.

15 Parliamentary Joint Committee on Corporations and Securities (2004), para. 13.12.

16 In 1998, the APEC Core Group on Corporate Governance was formed, led by Malaysia and also comprising Australia, the United States, the World Bank and the Asian Development Bank. In 2001, the Core Group delivered a report '*Strengthening Corporate Governance in the APEC region*' setting out measures that can be adopted by economies wishing to strengthen their corporate governance systems, with particular emphasis on developing member economies. The report includes an annex on the outcomes of a Corporate Governance Symposium hosted by Australia in November 1998, which brought together senior business people from member economies to identify priorities for corporate governance reform. The report is available at:

http://www.apecsec.org.sg/apec/apec_groups/other_apec_groups/finance_ministers_process.downloadlinks.0005.LinkURL.Download.ver5.1.9.

In 2000 and 2001, Australian Treasury provided the Chair and Secretariat for the APEC Task Force on Company Accounting and Financial Reporting. The Task Force promoted the use of high-quality, internationally acceptable standards of accounting, disclosure and auditing practices by business enterprises, taking into account the needs and diversity of developing member economies.

The Pathfinder Initiative was designed to gather information on corporate governance regimes and to highlight areas of strength and concern. It was intended to promote continued policy dialogue on corporate governance among APEC members and with other organisations such as the OECD, the World Bank and the Asian Development Bank. It was also hoped that the Pathfinder Initiative would encourage members to undertake the World Bank's Report on the Observance of Standards and Codes (ROSC) process on corporate governance.

Governments in Australia, Korea, Malaysia, Mexico, New Zealand and Singapore completed the survey drafted by Australian Treasury. The Treasury coordinated the evaluation of the surveys, chaired a working group of participating economies and prepared a final report for APEC Finance Ministers in September 2004.¹⁷

The Pathfinder Initiative will contribute to encouraging continuing dialogue and promote use of the ROSC process on corporate governance issues. It will also add momentum to improving corporate governance standards in APEC economies.

Looking ahead

The initiatives mentioned above, among others, have contributed to improving the global corporate regulatory framework in recent years. Although progress has been made, there are still significant challenges ahead.

Key to the effectiveness of efforts to improve the global regulatory framework is ensuring that the recommended regulatory reforms can be adapted and applied in economies having a range of different commercial and legal systems.

Another major task going forward is development by emerging markets of the necessary institutional infrastructure for effective and efficient implementation and enforcement of modern market regulations. It is likely that, in future, more assistance efforts will be directed toward this regulatory infrastructure rather than substantive regulations.

Overcoming such challenges will require ongoing work, but has potential benefits for Australia. Improving the global corporate regulatory systems, particularly those in emerging markets in the Asian region, will contribute to making the investment climate more attractive for foreign investors. This will facilitate growth and increase regional trade and investment opportunities.

¹⁷ Department of Treasury (2004).

Improving corporate regulatory systems also helps to manage the risks associated with high reliance on foreign capital in situations where market confidence is threatened.

Aside from those factors, Australia needs to be mindful of the consistency of its own regulatory framework with international benchmarks. Accordingly, it could often be in Australia's interests to have its policy perspective represented in the process of developing standards of international best practice.

Efforts to improve the international corporate regulatory framework on a global scale complement Australia's efforts to improve access to financial services markets through its negotiation of free trade agreements. A key element of this strategy is the pursuit of mutual recognition of regulatory standards for investor protection. For example, the Australia-United States Free Trade Agreement provides for the establishment of a Financial Services Committee (FSC). The primary goal of the FSC is to reduce regulatory barriers to the greater integration of the financial services markets between the two countries, particularly in terms of providing improved access for United States investors to Australian securities and collective investment schemes. Australian Treasury will be leading Australia's participation in the FSC.

Australia is also involved in promoting cross-border trade and investment on a bilateral basis through better coordination of business law between Australia and New Zealand. This undertaking includes closer cooperation between competition regulators; closer integration of competition and consumer protection regimes; mutual recognition of offer documents for securities and collective investment schemes; common accounting standards; enhanced insolvency frameworks; better access to details about trans-Tasman companies; and closer integration of banking regulation.

Australian Treasury is one of a number of areas in the Australian government that has been involved in initiatives directed to improvement of global corporate regulatory systems. Australia's long-term economic interest is served by continuing to engage in those efforts as part of a strategy to promote and facilitate cross-border trade and investment for the benefit of all participants.

Reference List

APEC Secretariat 2001, 'APEC economies; breaking down the barriers', APEC, Singapore.

APEC Secretariat 2002, 'Strengthening corporate governance in the financial sector', APEC, Singapore.

Australian Bureau of Statistics 2004, 'International Trade in Goods and Services', Cat. No. 5368.0, ABS, Canberra.

Australian Bureau of Statistics 2004, 'International Investment Position, Supplementary Country Statistics', Cat. No. 5352.0, ABS, Canberra.

Baum, H 2000, 'Globalising Capital Markets and Possible Regulatory Responses' in *Legal Aspects of Globalisation; Conflict of Laws, Internet, Capital Markets and Insolvency in a Global Economy*, eds J. Basedow and T. Kono, Kluwer Law, The Hague.

de Brouwer, G 2003, 'Macroeconomics and Governance', *Treasury Working Paper* <http://www.treasury.gov.au/documents/773/PDF/Macroeconomics%20and%20Governance.pdf>.

Department of Treasury 2003, 'Sustaining Growth in Australia's Living Standards' *Budget Paper No. 1, Budget Strategy and Outlook 2003-04, Statement 4*, <http://www.budget.gov.au/2003-04/bp1/html/bst4.htm>.

Department of Treasury 2004, 'APEC Corporate Governance Pathfinder Report', AGPS, Canberra, <http://www.treasury.gov.au/contentitem.asp?NavId=&ContentID=877>.

Eichengreen, B 2003, 'Capital flows and crises', Massachusetts Institute of Technology, London.

Hagan, S 2000, 'Promoting orderly and effective insolvency procedures', *Finance and Development*, vol 37, No. 1, pp. 50-52.

Marr, A 1997, 'Foreign direct investment flows to low-income countries: a review of the evidence', *Overseas Development Institute (UK) Briefing Paper*, (3) September, Overseas Development Institute (UK) http://www.odi.org.uk/publications/briefing/3_97.html.

McKinsey & Co. 2000, 'Investor opinion survey on corporate governance', <http://www.gcgf.org/docs/72CGBrochure.PDF>.

McLean, B and Shrestha, S 2002. 'International financial liberalisation and economic growth', *Reserve Bank of Australia Research Discussion Paper 2002-03* <http://www.rba.gov.au/rdp/RDP2002-03.pdf>.

Parliamentary Joint Committee on Corporations and Securities 2004, 'Corporate Insolvency Laws: A Stocktake' (Sen G Chapman, Chairman), AGPS, Canberra.

OECD 2004, 'OECD principles of corporate governance', OECD Publications Service, Paris, <http://www.oecd.org/dataoecd/32/18/31557724.pdf>.

Sakakibara, E 1999, 'From the Washington consensus to the new financial architecture', in *Capital Flows and the International Financial System*, eds D. Gruen and L. Gower, Reserve Bank of Australia Conference, Sydney.

Sundararajan, V, Ariyoshi, A and Otter-Robe, I 2002, 'International Capital Mobility and Domestic Financial System Stability: A Survey of Issues' in *Financial Risks, Stability and Globalisation*, ed. OEG Johnson, IMF, Washington.

Task Force on International Financial Reform 1998, *Report*, AGPS, Canberra <http://www.treasury.gov.au/contentitem.asp?NavId=&ContentID=189>.

United Nations Committee on International Trade Law (UNCITRAL) 2004, *UNCITRAL 'Legislative Guide on Insolvency Law' (Provisional Final Edition)* <http://www.uncitral.org/english/texts/insolven/insolvencyindex.htm>.

2003-04 in review: continued expansion and world economic recovery¹

The Australian economy grew strongly in 2003-04, following solid growth in 2002-03. Growth was driven by household consumption, reflecting high levels of consumer confidence and increases in household wealth and incomes. Farm production rebounded while business investment continued to grow solidly.

In contrast, Australia's export volumes were weak, due in part to a record rise in the exchange rate and domestic supply constraints. Nevertheless, the world economic recovery saw demand for Australia's commodity exports rise in 2003-04, with substantial increases in commodity prices. Underpinned by these price rises, the terms of trade rose to its highest level in around 30 years, underwriting some of the strong corporate profitability seen in 2003-04.

Fuelled by strong domestic demand and low prices, imports grew strongly in 2003-04. As a result, net exports registered a larger than expected subtraction from GDP growth, with the current account deficit widening.

Employment continued to grow solidly with the unemployment rate falling below 6 per cent.

Despite the ongoing strength of the economy, wages growth was contained, while inflation remained comfortably within the 2 to 3 per cent target band in 2003-04.

1 Based on June 2004 National Accounts data.

Overview

The Australian economy grew strongly in 2003-04, growing by 3.6 per cent in year average terms. This outcome was above the 2003-04 Budget forecast but broadly in line with the Mid-Year Economic and Fiscal Outlook (MYEFO) forecast.

The world also grew strongly in 2003-04, with many of Australia's major trading partners experiencing a resurgence. Global economic activity was driven by the United States and China, although Japan and the rest of East Asia also showed unexpected strength. The recovery in world activity was supported by highly expansionary monetary and fiscal policy settings in many parts of the world and an easing of some near-term downside risks. Nevertheless, large imbalances, in both current accounts and fiscal positions, persisted throughout 2003-04.

While the outcome for Australia's GDP growth represents a solid economic performance over 2003-04 as a whole, the composition of growth differed from initial expectations.

Household consumption grew at a 30-year record rate in 2003-04, with rising petrol prices and two increases in interest rates helping to moderate growth in the first half of 2004. Dwelling investment also demonstrated unexpected resilience, with the anticipated decline in medium-density housing activity failing to materialise.

In contrast, exports, due in part to the sharp appreciation in the exchange rate and domestic supply constraints, were unable to capitalise on the recovery in the world economy. Coupled with a boost to imports from strong domestic demand, net exports subtracted a larger than expected 2.7 percentage points from economic growth in 2003-04.

While unable to achieve the anticipated growth in export volumes, strong world demand saw prices for Australia's commodities rise sharply in 2003-04, with the terms of trade rising to its highest level in almost 30 years. This provided a boost to national income, while also underpinning some of the strong corporate profitability seen in 2003-04. Despite the strong growth in the terms of trade, the current account deficit (CAD) widened to 5.8 per cent of GDP.

Outcomes for other sectors of the economy were broadly consistent with expectations. Farm production rebounded in 2003-04 following widespread rainfall through much of Australia's grain belt over winter while private business investment moderated from the boom conditions experienced in the previous year.

Employment grew by 1.8 per cent in 2003-04 following very strong growth the year before. By June 2004 the unemployment rate had declined to 5.6 per cent from

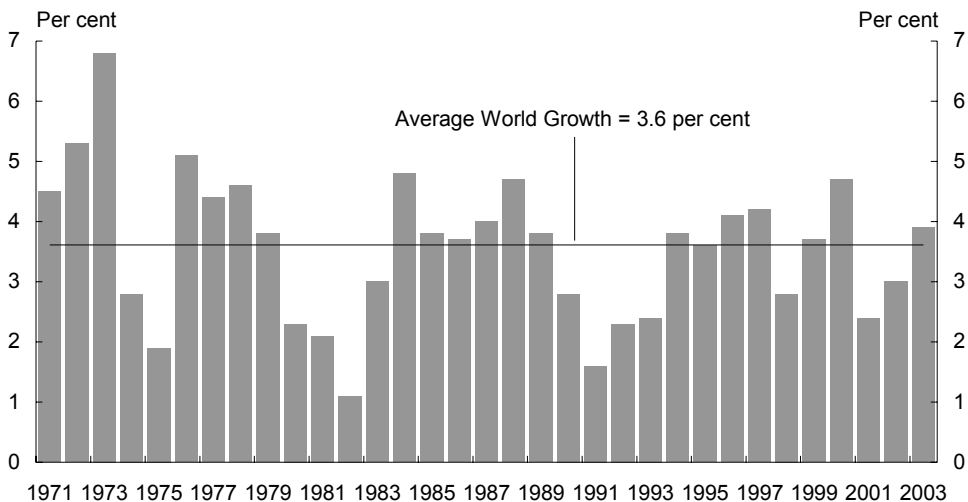
6.2 per cent a year earlier. The average unemployment rate through 2003-04 was 5.8 per cent, the lowest since 1976-77.

Despite the unemployment rate falling throughout 2003-04, wages remained contained. Inflation was 2.4 per cent in 2003-04, in line with the 2 to 3 per cent medium-term inflation target band. The inflation outcome indicates a lack of systemic price pressures in the economy, although this result was also supported by falling import prices.

The world economy

The world economy grew by 3.9 per cent in 2003, after expanding by 3 per cent in 2002 (Chart 1). This outcome exceeded both the 2003-04 Budget forecast of 3 per cent and the MYEFO forecast of 3½ per cent.

Chart 1: World growth^(a)



(a) World GDP growth rates are calculated using GDP weights based on purchasing power parity. Source: International Monetary Fund.

At the time of the 2003-04 Budget global economic growth was expected to be subdued, with the world economy struggling to gain traction in a highly uncertain environment. Instead, the world experienced a strong economic recovery.

The rapid growth experienced in the September and December quarters of 2003 was driven by very supportive monetary and fiscal policy settings in large parts of the world. The United States and China were the main engines of the global recovery, but the recoveries in Japan and the rest of East Asia were also stronger than expected.

The pace of growth eased slightly in the second half of 2003-04 as the persistence of high oil prices and an easing of growth in the United States and Japan dampened global activity. The impact of high oil prices is explored in Box 1. While growth has eased slightly, global economic activity has broadened. The softening of growth in the June quarter 2004 suggests that the peak of the upturn may have been reached and that GDP growth has started to ease towards more sustainable levels.

In the United States, GDP grew by 4.4 per cent in 2003-04, underpinned by private consumption and, increasingly, business investment. United States employment growth was subdued at the start of 2003-04, rising by an average of just 29,000 per month between June and December 2003 before picking up to a more healthy pace, growing at an average of 204,000 per month between January and June 2004. While monetary and fiscal policies in the United States remained expansionary over the course of 2003-04, the degree of monetary policy stimulus was reduced on 30 June when interest rates were raised by $\frac{1}{4}$ of a percentage point.

One of the key risks identified in the 2003-04 Budget was the existence of large global imbalances. The imbalances in the economy, represented by the large fiscal and current account deficits, persisted throughout the year, with the United States CAD rising to a record high of 5.6 per cent of GDP in the June quarter of 2004.

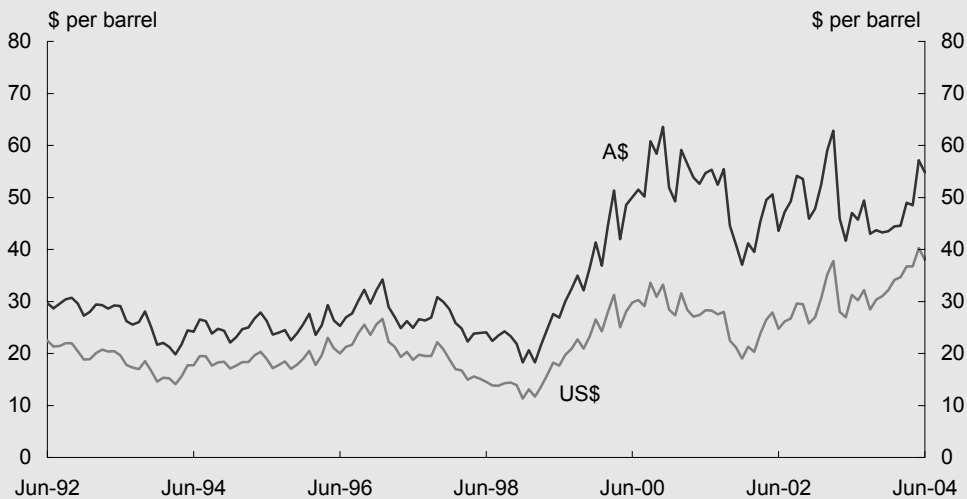
The Japanese economic recovery was unexpectedly strong, with growth of 3.7 per cent in 2003-04, the highest rate of growth since 1990-91. Growth was underpinned by strong exports growth and a rebound in business investment, and more surprisingly consumption. Japanese exports to China were especially strong over 2003-04, growing by 27 per cent over the period.

China's GDP grew by 9.7 per cent in 2003-04. Strong investment growth of 23 per cent in 2003 was the main component of GDP growth. Signs of overheating in a number of sectors prompted the government to impose tighter controls on credit in late 2003. By the end of 2003-04 there were signs that these measures were having some success in dampening credit and investment growth, with both easing in the June quarter 2004. Still, there remains uncertainty about the extent of the slowing.

Box 1: Oil prices

In 2003-04, the price of West Texas Intermediate oil (WTI) averaged US\$34 per barrel, 13 per cent higher than in 2002-03. This outcome was substantially higher than the 2003-04 Budget oil price assumption for a gradual fall to around US\$25 per barrel by the end of June 2004. However, over this period the appreciation of the Australian dollar against the US dollar cushioned the impact of higher oil prices on the Australian economy. On average the 2003-04 Australian dollar oil price was 7 per cent below the 2002-03 price (Chart A).

Chart A: United States and Australian dollar oil prices
(West Texas Intermediate)



Source: Datastream.

During 2003-04, oil prices continued on the upward path that commenced in 2002, reaching a 21 year high of over US\$41 per barrel in June 2004 before falling moderately towards the end of the financial year.

Higher oil prices were driven by strong global demand as well as tight oil supply conditions and concerns over possible supply disruptions. Increased participation of speculators in the oil market also contributed to higher prices.

- Oil demand accelerated more than expected in 2003-04, especially in the United States and China, reflecting the stronger world economic recovery. Of the 2.8 million barrel increase in world oil demand over this period, the United States and China were responsible for around 47 per cent.
- World oil production also accelerated in response to higher oil prices, reducing OPEC's spare capacity to around 1-2 per cent of world oil consumption. In this environment the oil market has become increasingly concerned over possible oil supply disruptions following attacks on oil infrastructure in the Middle East and civil unrest in Venezuela and Nigeria.

The rest of East Asia² grew by 6.5 per cent in 2003-04. The up-tick in world demand assisted East Asia's large export sector. As East Asia's recovery progressed, domestic demand started to make a larger contribution to growth. The exception was Korea where the economy remained almost entirely reliant on external demand with the fallout from the end of the household credit boom suppressing consumption growth.

Euro area GDP grew by 1.1 per cent in 2003-04. Exports growth was the key component of euro area GDP growth, despite a 23 per cent appreciation of the euro against the US dollar since June 2002 (11 per cent on a trade weighted index basis). High oil prices and high unemployment kept consumer confidence weak and constrained a stronger contribution from consumption. Monetary policy remained accommodative over the year with official interest rates held at 2 per cent since June 2003.

The United Kingdom economy outperformed that of the euro area with United Kingdom GDP growing by 3 per cent in 2003-04. United Kingdom GDP growth was more balanced than in the euro area with both domestic demand and net exports contributing to growth. The continued strong growth and rising inflationary pressures prompted the Bank of England to raise interest rates by 100 basis points over the year, to 4.5 per cent by June 2004.

Domestic economy

Table 1 compares the actual outcomes for the domestic economy in 2003-04 with both the 2003-04 Budget and the MYEFO forecasts.

At the time of the 2003-04 Budget, the Australian economy was showing resilience and continuing to grow solidly in the face of a sluggish world economy and the negative influence of the drought. The 2003-04 Budget forecasts were prepared on the basis of a rebound in farm production from a return to average seasonal conditions and a gradual improvement in world growth. These were expected to more than offset a moderation in domestic demand.

Slower wealth accumulation, driven by more temperate increases in house prices and subdued equity prices, was expected to contribute to an easing in household consumption growth in 2003-04 with a concomitant slowing in import growth. Underpinned by the improving world economy and a rebound in rural exports, export growth was expected to pick up over 2003-04.

2 The rest of East Asia comprises Hong Kong, Indonesia, Korea, Malaysia, the Philippines, Singapore, Taiwan and Thailand.

Table 1: 2003-04 Budget and MYEFO forecasts and outcomes^(a)

	Outcomes(b) 2002-03	2003-04 Budget Forecasts	2003-04 MYEFO Forecasts	Outcomes(b) 2003-04
	Year Average	Year Average	Year Average	Year Average
Panel A - Demand and output(c)				
Household consumption	3.8	3 1/4	4 1/2	5.6
Private investment				
Dwellings	15.4	-5	3	7.7
Total business investment(d)	17.4	7	7	8.3
Other buildings and structures(d)	32.0	14	11	12.0
Machinery and equipment(d)	16.7	4	5	6.0
Private final demand(d)	6.5	3	5	6.0
Public final demand(d)	4.7	3 1/4	2 3/4	3.5
Total final demand	6.2	3	4 1/2	5.4
Change in inventories(e)				
Private non-farm	0.0	0	- 1/4	0.6
Farm and public authorities	-0.1	1/2	1/2	0.0
Gross national expenditure	6.2	3 1/2	4 3/4	6.0
Exports of goods and services	-0.5	6	3	0.9
Imports of goods and services	13.5	6	9	13.1
Net exports(e)	-2.8	- 1/4	-1 1/2	-2.7
Gross domestic product	3.1	3 1/4	3 3/4	3.6
Non-farm product	4.1	2 3/4	3	3.0
Farm product	-24.7	25	27	26.8
Panel B - Other selected economic measures				
Prices and wages				
Consumer Price Index	3.1	2 3/4	2 1/4	2.4
Gross non-farm product deflator	2.9	2 1/4	2 3/4	3.9
Average earnings(f)	3.5	4	3 3/4	3.6
Labour market				
Employment (Labour Force Survey basis)	2.5	1 3/4	1 1/2	1.8
Unemployment rate (per cent)(g)	6.2	6	5 3/4	5.6
Participation rate (per cent)	63.7	64	63 3/4	63.5
External accounts				
Terms of trade	2.2	1 3/4	3 1/4	8.0
Current account balance				
\$ billion	-40.3	-42 3/4	-46	-47.4
Percentage of GDP	-5.3	-5 1/4	-5 3/4	-5.8

(a) Calculated using original data, except average earnings and the labour market measures which are calculated using seasonally adjusted data.

(b) Percentage change on preceding year unless otherwise indicated.

(c) Chain volume measure.

(d) Excluding transfers of second-hand asset sales from the public sector to the private sector.

(e) Percentage point contribution to growth in GDP.

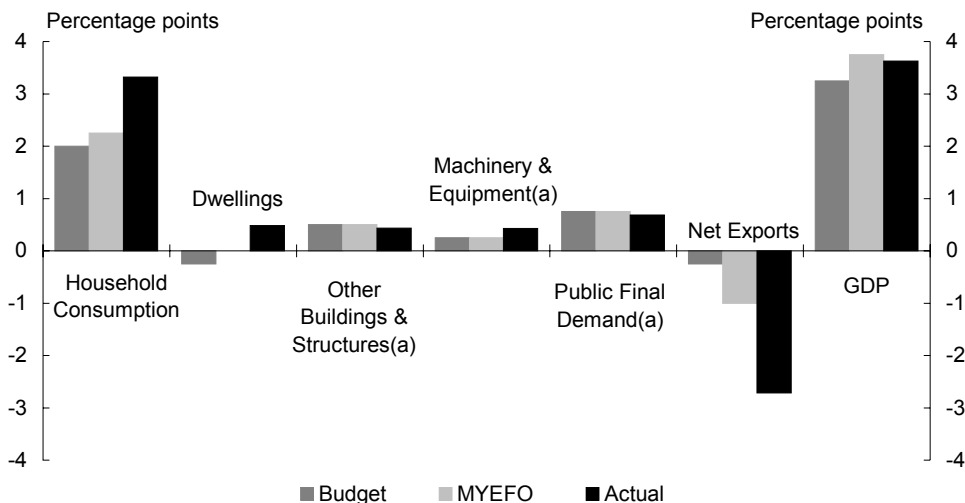
(f) Average non-farm compensation of employees (national accounts basis).

(g) The rate in the June quarter of each year.

A significant improvement in the global economic outlook, buoyant consumer activity and a persistent rise in dwelling investment saw the economic growth forecast revised up at MYEFO. However, the sharp appreciation of the exchange rate prompted a downward revision in forecast export growth which, when combined with more robust import growth in response to rising consumer demand, saw a forecast deterioration in Australia’s net export position.

As it turned out, aggregate GDP growth in 2003-04 was broadly consistent with the MYEFO forecast (Chart 2). Farm production was very close to expectations, as was business investment. Net exports subtracted more from growth than forecast with slower than anticipated growth in exports and strong domestic demand, particularly in household consumption, driving imports.

Chart 2: Contributions to GDP growth in 2003-04



(a) Excluding transfers of second-hand asset sales from the public sector to the private sector.
Source: ABS Cat. No. 5206.0.

Domestic demand

Household consumption

Once again, household consumption was a key driver of economic growth, rising by 5.6 per cent in 2003-04, a 30-year record. This was substantially above both the Budget forecast of 3¼ per cent and the MYEFO forecast of 4½ per cent.

At the time of the 2003-04 Budget, there was an expectation that the elevated levels of spending and household debt could not be sustained, with households expected to consolidate their balance sheets and increase saving. The increased financial exposure of households also raised the concern that a deterioration in labour market conditions

or a sharp correction in the housing market could cause consumption to slow significantly.

While house prices eased in the first half of 2004, this was not the sharp correction feared by many, with households apparently deferring consolidation of their balance sheets. In addition, employment growth was slightly stronger than forecast. Combined with a recovery in the stock market from its 2002 slump, household incomes and wealth were higher than anticipated. These gains offset rising petrol prices and a 50 basis point increase in interest rates in late 2003 to have consumption grow much more strongly than expected.

Household consumption was also boosted by the appreciation of the exchange rate, with the price of many consumption items being lower than expected. This allowed more goods and services to be purchased for the same income.

The strongest consumption category was recreation and culture as Australians took advantage of favourable exchange rates to travel overseas, realising several years of pent-up demand in this sector. Reflecting buoyant consumer confidence, consumption growth was also strong across a number of other consumption categories, most notably household furnishings and equipment, purchases of vehicles, and hotels, cafes and restaurants.

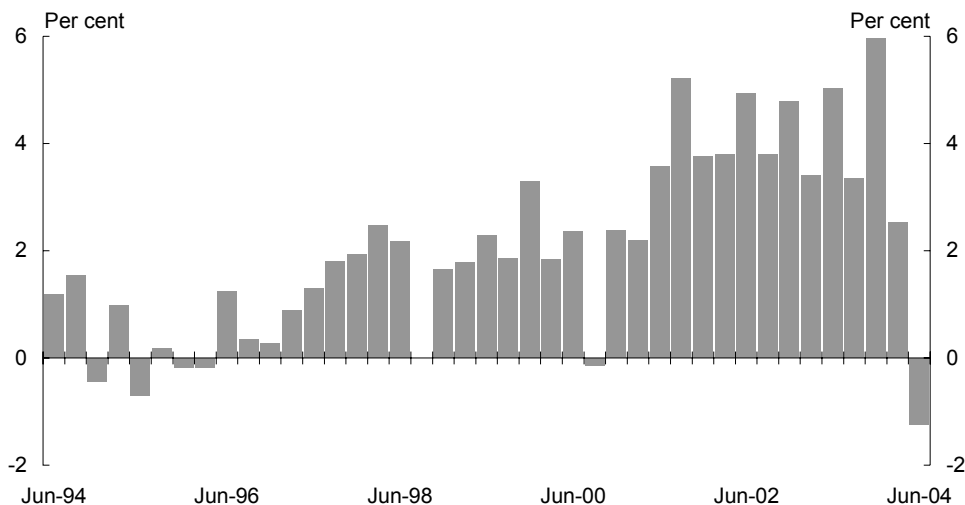
Consumption spending continued to grow faster than disposable income throughout 2003-04, with the household saving ratio remaining negative.

Dwelling investment

In contrast to the contraction forecast at Budget, dwelling investment continued to grow strongly in 2003-04, rising by 7.7 per cent. Dwelling investment contributed around 0.5 percentage points to GDP growth.

At Budget there were widely held concerns about the high levels of investor participation in the dwelling sector, whose involvement was potentially driving inflated prices. Oversupply was also a significant concern, particularly in the multi-unit sector. Combined with easing expectations of capital gains, demand for dwellings was expected to turn sharply.

However, the market appears to have behaved somewhat differently compared with previous peaks. Although dwelling investment grew strongly in 2003-04, house prices appear to have moderated, consistent with a slow correction in the market (Chart 3). In addition, sales growth appears to have softened. This slowdown is likely to have been assisted by the interest rate increases in late 2003.

Chart 3: Quarterly growth in established house prices

Source: ABS Cat. No. 6416.0.

Despite slowing in 2004, growth in alterations and additions also remained strong, outstripping the pace of activity in the new dwellings sector.

Business investment

After experiencing a boom in engineering construction in 2002-03, growth in private new business investment moderated to 8.3 per cent in 2003-04, down from its rapid 17.4 per cent expansion the year before. This was broadly in line with the 2003-04 Budget and MYEFO forecasts. Unlike some other sectors of the economy, the forecasts for private new business investment were not heavily influenced by the rapid appreciation in the exchange rate, reflecting that investment plans are often 'locked in' before actual purchases occur and the existence of favourable economic conditions, including low domestic interest rates, increasing corporate profitability and a strong world economy.

New investment in other buildings and structures increased by 12 per cent in 2003-04, following very strong growth the previous year. Growth was strong in both the non-residential building and engineering construction components, the latter underpinned by investment in large mining and infrastructure projects stimulated by the strong demand and rising prices for Australia's commodity exports.

Investment in new machinery and equipment increased by 6 per cent in 2003-04, following strong growth the year before. The increase in machinery and equipment investment was led by the mining sector, while investment in civil aircraft slowed following two years of exceptionally high growth.

Public final demand

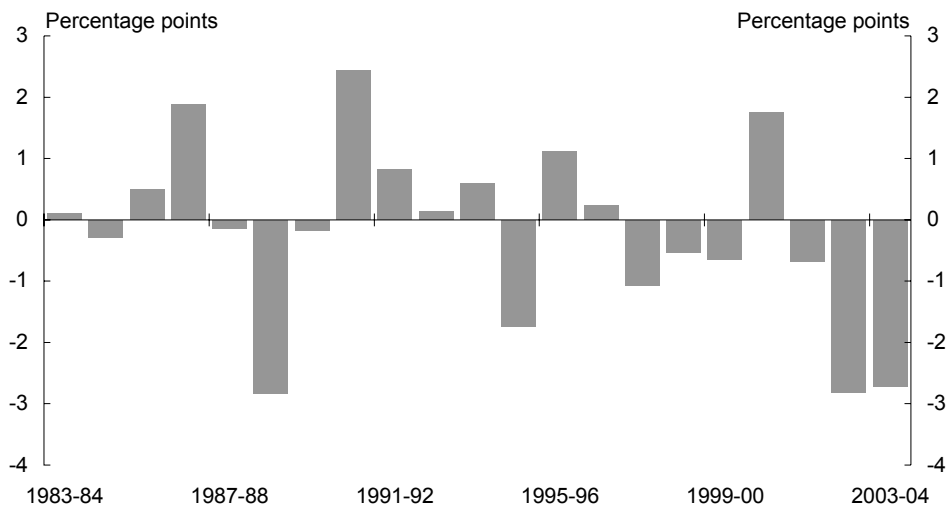
In 2003-04, public final demand grew by 3.5 per cent, broadly in line with the Budget forecast but above the forecast presented at MYEFO. Both government consumption and investment growth were above recent average rates. Consumption was driven by strong public sector employment growth in 2003-04, while investment by public trading enterprises continued to rebound from the lower levels experienced between 1999 and 2001.

Public final demand grew for Commonwealth and state and local governments, although growth in state and local government spending was marginally below recent average rates.

External sector

Despite the strong world economic recovery, net exports subtracted 2.7 percentage points from GDP growth in 2003-04, a much greater subtraction than expected at the 2003-04 Budget and MYEFO. Australia has now experienced two consecutive years of large net export subtractions from GDP growth (Chart 4).

**Chart 4: Net exports contribution to GDP growth
(year average)**

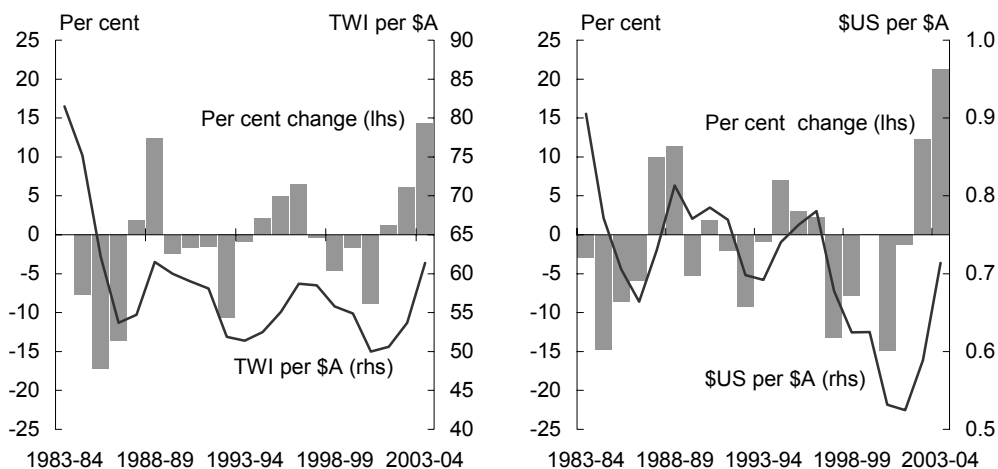


Source: ABS Cat. No. 6416.0.

The drivers of these net export subtractions have been quite different. In 2002-03 the severe drought, a tepid world economy, geopolitical uncertainties, Severe Acute Respiratory Syndrome (SARS) and a business investment boom combined to subtract 2.8 percentage points from GDP growth. In contrast, the 2003-04 subtraction was, at least partly, driven by domestic supply constraints and the sharp appreciation of the

Australian dollar, which rose by a record 22 per cent against the US dollar and 15 per cent against the Trade Weighted Index in 2003-04, in year average terms (Chart 5).

Chart 5: The Trade Weighted Index and US dollar exchange rates — levels and percentage change (year average)



Source: RBA Bulletin.

Export volumes of goods and services grew by a modest 0.9 per cent in 2003-04. This outcome was well below the expected 6 per cent increase in exports forecast in the 2003-04 Budget and the 3 per cent increase forecast at MYEFO.

Non-rural commodity exports declined in 2003-04, largely due to temporary plant shut-downs in the second half of the fiscal year, coal supply-chain constraints around Newcastle and the trend decline in oil field production. Exports of elaborately transformed manufactures grew by a modest 1 per cent in 2003-04, as the benefits of stronger world growth were offset by the higher exchange rate and more competitive world markets.

Rural production recovered in line with expectations; however, rural exports growth was slower to rebound.

Services exports increased by 2.3 per cent in 2003-04, with tourism buoyed by Australia's hosting of the Rugby World Cup. However, the potential rebound in tourism flowing from the pick-up in world growth and the waning of adverse shocks, such as the outbreak of SARS and the war in Iraq, was undermined by the appreciation in the Australian dollar.

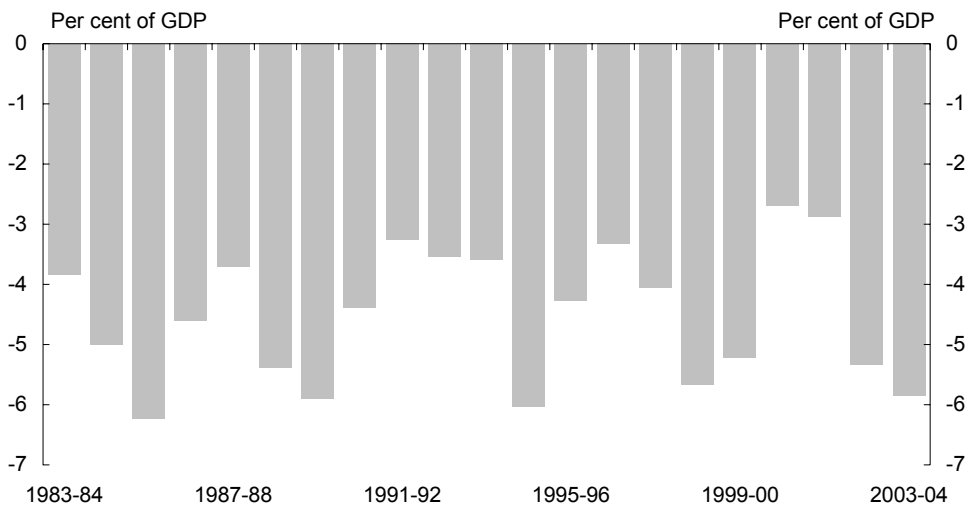
Import volumes grew strongly in 2003-04, registering a substantial 13.1 per cent year-average increase. This was greater than the 6 per cent 2003-04 Budget and 9 per cent MYEFO forecasts. The strong growth in imports stemmed largely from stronger than expected domestic demand. The aviation industry's upgrading of its fleet of civil aircraft also contributed to this outcome, although the contribution was smaller than in previous years.

While unable to achieve the anticipated growth in export volumes, strong world demand saw prices for Australia's commodities rise sharply. This underpinned a 8.0 per cent rise in the terms of trade in 2003-04, raising the terms of trade to its highest level in almost 30 years (Box 2).

Export prices fell by 4.5 per cent in 2003-04, as the appreciation of the exchange rate more than offset strong rises in world commodity prices. In addition, import prices fell by 11.4 per cent, largely driven by the rise in the Australian dollar and the trend decline in Information and Communication Technology (ICT) import prices.

The CAD widened from 5.3 per cent of GDP in 2002-03 to 5.8 per cent of GDP in 2003-04 (Chart 6), with the increase in the terms of trade more than offset by the deterioration in net export volumes. This was larger than the CAD forecast prepared at Budget but broadly in line with the MYEFO forecast. Relatively low world interest rates helped hold the Net Income Deficit steady at 2.9 per cent of GDP.

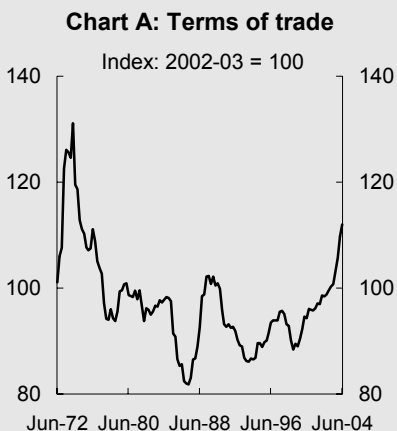
**Chart 6: Australia's current account balance as a share of GDP
(year average)**



Source: ABS Cat. No. 5302.0 and 5206.0.

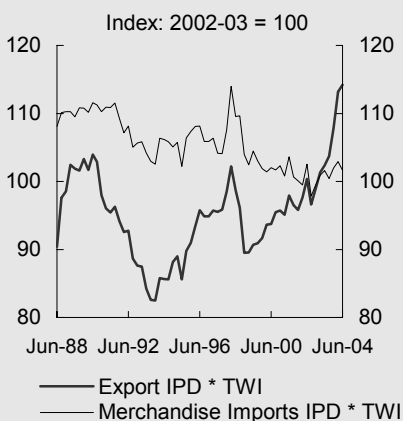
Box 2: The terms of trade in 2003-04

In 2003-04, Australia's terms of trade reached levels unseen since the mid-1970s commodities boom (Chart A).



This outcome was the result of several key developments, in particular the sharp increase in commodity prices and the trend decline in manufactured goods prices (Chart B).

Chart B: Foreign currency prices of exports and imports



Strong world demand drove up commodity prices in 2003-04. Through the year to June 2004 coal prices increased by 18 per cent, iron ore

prices by 26 per cent and oil prices by 19 per cent, in SDR terms.

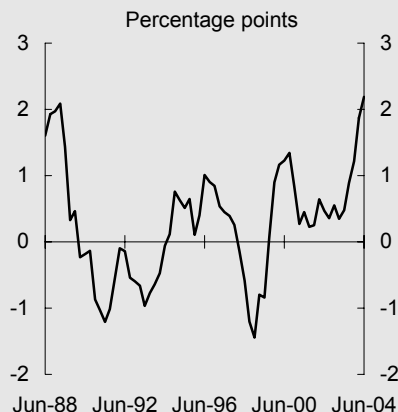
Global manufacturing prices have been trending downwards over recent years, partly due to the increased production of manufactured goods by low-cost economies such as China. Notably, the fall in the global prices of ICT goods has contributed, on average, around 1.0 percentage point to growth in the terms of trade over the past five years.

The appreciation of the exchange rate in 2003-04 was also a major factor, as it was largely responsible for around a 15 per cent rise in the services terms of trade.

The rise in the terms of trade has had a substantial impact on the Australian economy, which is receiving more income for the same volume of exports, and paying less for the same volume of imports, thereby improving national income and domestic living standards.

Considered in isolation from other effects, the rise in the terms of trade contributed over 2 percentage points to growth in national income through the year to June 2004 (Chart C).

Chart C: Contribution of the terms of trade to national income^(a)



(a) Real Gross Domestic Income.

Labour market

Employment continued its solid and steady expansion. Employment grew by 1.8 per cent, or 165,000 persons, in 2003-04, following growth of 2.5 per cent in 2002-03. This result was consistent with the 2003-04 Budget forecast of 1¾ per cent but above the MYEFO forecast of 1½ per cent.

The unemployment rate declined from an average of 6.2 per cent in 2002-03 to an average of 5.8 per cent in 2003-04, the lowest average rate since 1976-77. By the June quarter 2004, the unemployment rate had reached 5.6 per cent, below both the 2003-04 Budget and MYEFO forecasts.

Of the major employing industries, construction, education and property and business services showed strong year average employment growth, whereas retail trade, wholesale trade and manufacturing employment declined.

Despite the rebound in farm production, rural and regional employment did not experience the sharp pick-up anticipated at MYEFO, due in part to the rebound being concentrated in capital-intensive cereal crops.

In 2003-04 the recent trend to part-time work was somewhat reversed, with full-time employment growth higher than part-time employment growth. The growth in full-time employment suggests that labour demand is being met, at least partially, by part-time workers shifting to full time employment (Box 3).

Wages and prices

Wages growth in 2003-04 was solid but remained well contained. The Wage Cost Index increased by 3.6 per cent in 2003-04, the highest result in the six-year history of the series, although only a slight increase on that recorded in 2002-03. The National Accounts measure of wages – average non-farm compensation of employees (AENA) – increased by 3.6 per cent, below the 4 per cent increase forecast at Budget but broadly in line with the 3¾ per cent MYEFO forecast.

Taken together, these results suggest a moderate increase in wage inflation in 2003-04, broadly in line with that forecast at MYEFO.

At the industry level, wages growth was particularly strong in the construction and government administration and defence industries. In contrast, wages growth was subdued in the hospitality and wholesale trade industries. Most notable were the wage increases in the public sector, with the Wage Cost Index increasing by 4.5 per cent in the public sector in 2003-04 compared with 3.4 per cent in the private sector (Chart 7).

Box 3: Behaviour of the labour market

The labour market has enjoyed a sustained period of strong growth in recent years. Despite the unemployment rate falling, and remaining, below 6 per cent, there is little evidence of emerging wage pressures.

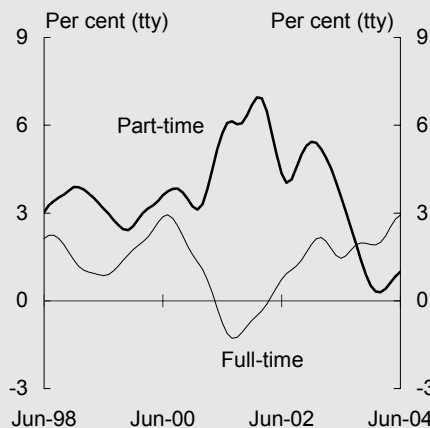
One possible explanation for this favourable employment and wage outcome is the more flexible labour market environment operating in Australia, with the majority of workers now employed under agreements negotiated at the level of the individual or the firm.

A manifestation of this has been the way employment – in response to changes in labour demand – has shifted between traditional full-time employment and more flexible working arrangements, such as part-time employment.

Chart A shows that part-time employment grew strongly over 2001 and 2002, significantly increasing the pool of part-time workers in the labour force. Survey data suggests that around a quarter of these part-time workers are willing to work more hours, including moving to full-time employment. As a result, aggregate measures of unemployment may underestimate the capacity of the labour force to meet increased labour demand.

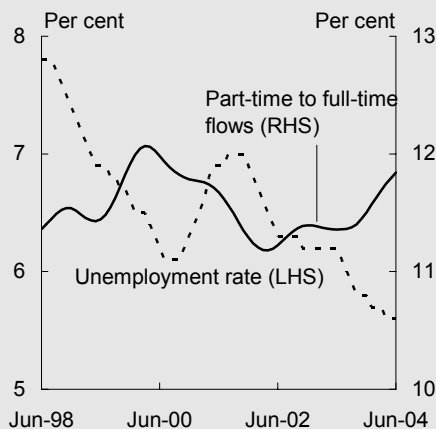
Over the past year, tighter labour market conditions have led to strong growth in full-time employment, and to a lesser extent part-time employment, with part-time workers flowing onto full-time employment.

Chart A: Full-time and part-time employment growth



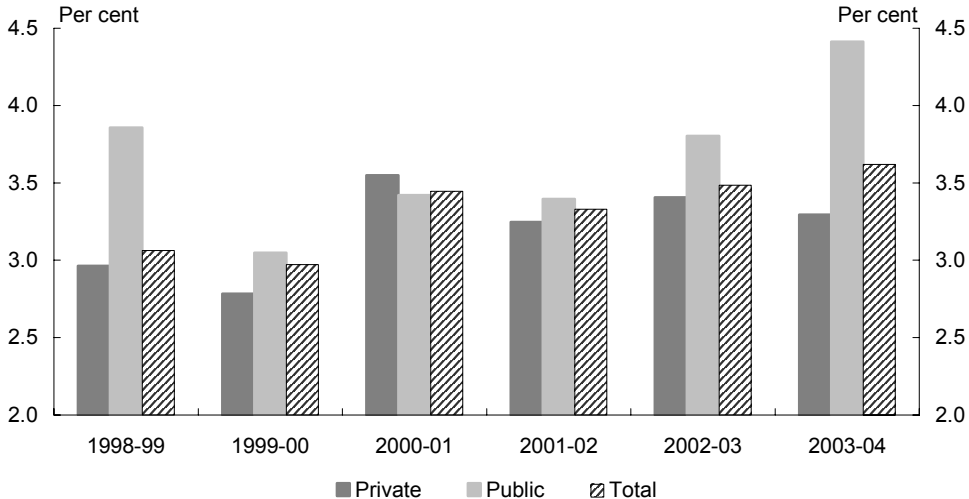
Indeed, the flow of workers from part-time to full-time employment (as a share of total part-time employment) is currently at a near-record high, drawing on the large pool of available part-time workers as the unemployment rate declines (Chart B).

Chart B: Flow of part-time to full-time employment



The public sector wage outcome largely reflected an increase in the NSW Crown employees award which covers a substantial part of the NSW public sector.

Chart 7: Year-average growth in the Wage Cost Index private, public and total



Source: ABS Cat. No. 6345.0.

The headline CPI increased by 2.4 per cent in 2003-04, compared with the forecasts of 2¾ per cent at Budget and 2¼ at MYEFO.

Increases in housing and fuel prices were the major contributors to inflation in 2003-04, reflecting ongoing rises in labour and materials costs and the impact of world oil prices. Food prices were also a significant contributor, the result of continued dry conditions and the impact of some localised severe weather events. In contrast, recreation subtracted from inflation, primarily driven by price declines for audio, visual and computing products, as well as overseas travel and accommodation.

Consistent with the appreciation in the exchange rate, tradables prices increased by only 0.2 per cent in 2003-04, while non-tradables prices increased by 4.3 per cent.

Fiscal policy

During 2003-04, the Government continued to meet its objective of budget balance, on average, over the course of the economic cycle. The Australian general government sector recorded an underlying cash surplus in 2003-04 of \$8.0 billion (1.0 per cent of GDP). The fiscal surplus in 2003-04 was \$5.6 billion (0.7 per cent of GDP). Australian general government net debt was reduced from 3.9 per cent of GDP in 2002-03 to 2.9 per cent of GDP in 2003-04.

Monetary policy

In late 2003 the Reserve Bank of Australia (RBA) increased official interest rates on two occasions, by a total of 50 basis points, to 5.25 per cent. The move to a less accommodative monetary policy setting was made in the light of a stronger global economy and a strengthening in domestic demand. A further consideration was the risk to the economy posed by the build-up in household debt and the associated increases in house prices.

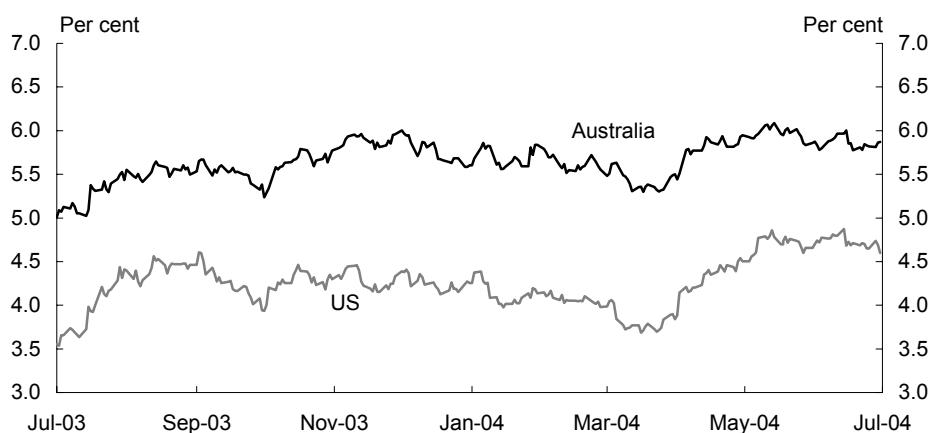
In July 2003 the *Statement on the Conduct of Monetary Policy* between the Treasurer and RBA Governor was reaffirmed and updated. The statement maintains the commitment by the RBA Board to hold consumer price inflation to between 2 and 3 per cent, on average, over the course of the economic cycle.

Bond market

Australian and United States 10 year bond yields moved broadly in line with each other over the course of 2003-04. Australian yields rose from around 5.0 per cent at the start of the period to around 5.9 per cent at the end of the period. United States yields rose from around 3.5 per cent at the start of the period to 4.6 per cent at the end of the period (Chart 8).

The spread between Australian and United States 10 year bond yields averaged around 140 basis points over 2003-04, ranging from around 100 to 180 basis points. Spreads at the lower end of this range occurred in July and August 2003 and then again from May 2004 after two episodes where bond yields rose more quickly in the United States than Australia.

**Chart 8: 10 year bond yields in Australia and the United States
2003-04**

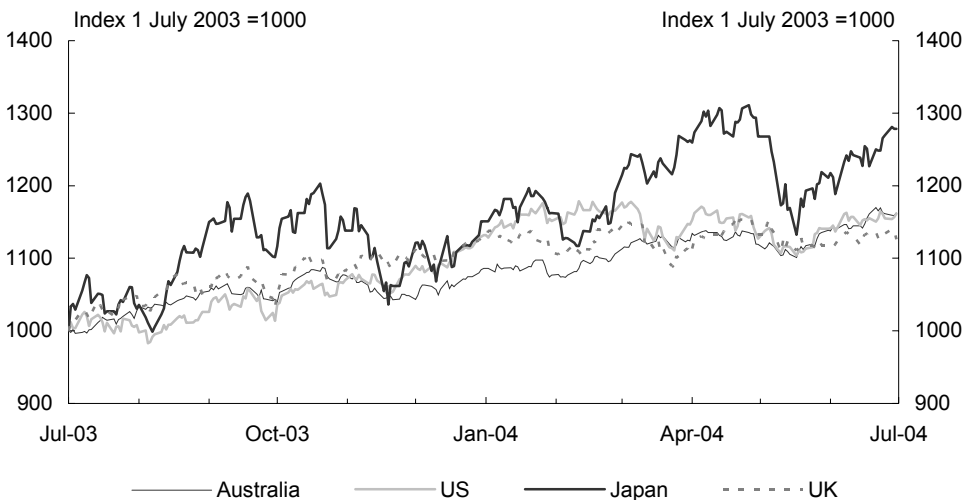


Source: Reuters.

Equity prices

Australian equity prices, as measured by the ASX 200 index, rose by around 17 per cent over 2003-04. Major stock indices around the world also rose (Chart 9). In the US, the S&P 500 index increased by around 17 per cent, while Japan's Nikkei index rose about 31 per cent. In Europe, the Euro STOXX broad euro zone index added around 19 per cent, while the FTSE index of United Kingdom stocks rose about 11 per cent.

**Chart 9: Equity prices — movements in major indices
2003-04**



Source: Reuters.

Exchange rates

In year average terms the Australian dollar appreciated by 22 per cent against the US dollar and 15 per cent against the Trade Weighted Index in 2003-04.

The broad movements in the exchange rate over the year were an appreciation up to February 2004 followed by a depreciation to the end of the year. By the end of 2003-04 the Australian dollar was broadly unchanged in trade weighted terms, depreciating by just ½ per cent. The Australian dollar appreciated by around 4 per cent against the US dollar and depreciated against the yen and euro by about 6 per cent and 2 per cent respectively.

Key themes from the Treasury Business Liaison Program — July-August 2004

The following article is a summary of findings from the Treasury Business Liaison Program conducted in July-August 2004.¹

The general view of businesses on economic conditions remains positive. Domestic demand is holding up well and firms expect this to continue. Construction activity is expected to slow gradually. Investment plans in the resources sector remain very strong. Firms report labour cost pressures as generally contained, and inflation pressures appear subdued.

Treasury greatly appreciates the commitment of time and effort made by the Australian businesses and industry associations that participate in this program.²

1 A detailed explanation of the Treasury Business Liaison Program is provided in the Treasury *Economic Roundup Spring 2001*.

2 This summary of business conditions reported in liaison meetings reflects the views and opinions of participants. It is provided for the information of readers. While Treasury's evaluation of the economic outlook is informed by findings from business liaison, a much wider range of information and data is utilised to ensure a rigorous assessment of the Australian economy.

Overview

The latest business liaison round comprised meetings in Sydney, Melbourne, Brisbane, Perth, Adelaide and Newcastle. The discussions took place in July and August, prior to the recent run-up in global oil prices. While the meetings are a limited sample of business opinion, they do offer a useful window on developments and expectations in the economy. Given that the feedback from interviewees was generally informed by experience in their own businesses, views may conflict with the aggregated summaries of the economy presented in macroeconomic forecasts and more widely based surveys.

There was an overall optimistic tone in the interviews, consistent with more recent published surveys of business sentiment. Firms reported domestic demand as resilient and they expected this to continue. While construction was expected to slow gradually, there are many large projects starting up in the resources sector. This healthy outlook for activity was also reflected in many firms' expectations for increased employment.

As noted in the *Pre-Election Economic and Fiscal Outlook 2004* (PEFO), while rising household debt, and particularly the rising proportion of highly geared households, is rendering the household sector increasingly vulnerable to shocks, there is no evidence of immediate problems. This view was supported by financial intermediaries, which generally did not report any increase in delays in repayments.

Retail activity was reported as particularly strong in Queensland, largely attributed to migration from the southern states. The housing sector was also reportedly stronger in Queensland. The West Australian economy was also doing particularly well, buoyed by the strength of the mining sector. This pattern is consistent with recent ABS data on retail sales.

As in previous rounds, some skill shortages were evident, but it was reported that so far this has not led to an acceleration in wages. Many businesses emphasised their lack of pricing power, adding support to the PEFO forecast that inflation will remain within its medium-term target band despite higher oil prices.

Consumer spending

Consumer spending was envisaged in the Budget to remain robust but ease as flat house prices no longer generate large increases in wealth. Firms interviewed generally agreed with this scenario. Some contacts reported that the payments to families announced in the Budget had led to a surge in sales in the week the payments were received, while others had experienced a more gradual increase. This contrasts with the retail sales statistics in recent months.

Retailers were generally confident that underlying demand would remain robust. This accords with the results from consumer surveys which found sentiment around ten-year highs. Some retailers expected consumer durable sales to ease in line with reduced activity in the housing market (see below). The motor vehicle industry had achieved strong sales, with buyers thought to be attracted by additional features being added to cars with no increases in prices.

Housing sector

In most capitals, the liaison participants reported falling inner city apartment prices and flat suburban prices. This was occurring despite higher building costs. Reports of modest overall falls in house prices are consistent with published house price indices, and the Budget forecasts of a marked slowing in household wealth.

Lenders outside Sydney and Melbourne reported little decrease in demand from owner occupiers. However, some have noticed a cooling off by individual investors. At the same time, some lenders were becoming less willing to finance investors, particularly for inner-city apartments. Sales of apartments were said to have peaked in late 2003.

There is still considerable building activity underway, and some builders are turning away work. In many cases, contacts said that shortages of skilled workers, or of materials, were delaying construction. The many projects still in the pipeline should support activity for some time, but fewer new projects are being started by developers.

Commercial construction

Construction companies said that office building has been slower to come off than they had expected although commencements peaked some time ago. There have been large rises in steel prices, which have increased costs and may lead to the cancellation of some projects.

Other types of building – hotels, factories and warehouse construction – remain generally strong. Engineering works, such as facilities for the 2006 Commonwealth Games in Victoria and roadworks in Sydney, are also supporting activity.

Manufacturing

A common comment by manufacturers interviewed was that competition from China, and to some extent other Asian countries, is becoming more intense and now extends to more sophisticated goods. Contacts also referred to the Chinese firms becoming more savvy in their design and marketing.

The automotive industry noted that the exports of cars are the highest they have been for many years, with the Middle East being a particularly important market. But component manufacturers were under pressure as the domestic car producers are increasingly sourcing from overseas. Higher oil prices had not yet had a significant impact on demand for cars and related products.

Some niche manufacturers are thriving. Interviewees in this liaison round referred to successful manufacturers of such diverse products as specialist gases, hyperbaric chambers, electrical substations and electronic ticketing systems. Many of these had found export markets.

Commodity exports

Rural exports have recovered since the drought. The recovery has been more rapid for crops than for livestock, as pastoralists rebuild their flocks and herds. This is one reason why rural employment is lagging the recovery in rural production; but in some cases farmers wanting to expand employment said they had found it hard to attract back workers who moved to mining areas or the cities during the drought.³ Grain harvests were expected to be strong in southern and western Australia, but there were concerns that prices may soften due to large global harvests. In contrast, some parts of New South Wales and Queensland were still very dry.

Resource demand continues to be very strong, with demand from China a driving force. While there were suggestions of the Chinese economy slowing in recent months, exporters report no noticeable effect to date.

Ports and shipping companies generally reported higher business. There has been some progress made in alleviating the supply chain constraints that have been limiting commodity exports. Notably, the queue of ships off Newcastle had come down from around 50 to more normal levels in the single digits.

Resource companies have a large number of investment projects underway, with the aim of increasing production capacity in order to take advantage of strong international demand, particularly for iron ore, coal and base metals. Some of these projects will provide a 40 per cent increase in production capacity, but in many cases the peak production will not be reached for another two to four years. For some projects the output of the mines has already been sold through long-term contracts.

3 For further information, see 'The impact of the 2002-03 drought on the economy and agricultural employment' in the *Economic Roundup Autumn 2004*.

Exports of services

Increasingly, an important component of Australia's export income comes from services. The two most important service exports are tourism and education.

Tourism suffered from traveller wariness following the terrorist attacks in the United States in September 2001 and Bali in October 2002, and the outbreak of SARS in the first half of 2003. As these concerns moderated, hotels and airlines reported higher occupancy rates. The Chinese government recently made it easier for tourists from China to visit Australia and with large numbers of Chinese households reaching income levels at which foreign holidays are affordable, this has been a significant source of new arrivals. As well as tourism, hotels reported good business from international meetings and conferences.

Academic contacts stated that foreign, fee-paying students now make up 10-20 per cent of students at many Australian universities. Computing and MBA courses are especially popular with overseas students. Asian students (mostly from China, Hong Kong, Malaysia and Singapore) generally come to do their whole degree in Australia, but US and European students often come just for a semester. While being located in a 'safe' part of the world makes Australian universities more attractive, contacts mentioned that the appreciation of the Australian dollar had caused some slowing in foreign enrolments. As well as teaching foreign students on domestic campuses, some Australian universities have been establishing arrangements to teach in other countries, sometimes as part of joint ventures.

Labour market

With demand expected to keep growing robustly, firms anticipated employment growth continuing at a healthy rate. This supports the forecast in the *Pre-Election Economic and Fiscal Outlook 2004* that unemployment would remain below 6 per cent.

There was increased concern this round about a shortage of skilled labour in certain regions and occupations. Some of the shortages, such as for draftsmen and bricklayers, were in the construction sector, and might be expected to ease as activity in that sector slows. But interviewees thought that other shortages would persist. Respondents noted that some kinds of engineers, mechanics, specialist drivers and certain skilled tradespersons were in short supply. Some contacts also considered that the trend towards earlier retirement may be worsening the problem.

The skill shortage was partly attributed to a lack of apprentices. Respondents suggested that the number of apprenticeships on offer had declined. Moreover, the pay rates for apprentices contributed to a 'stigma'. Respondents felt that apprenticeships were perceived as inferior to full-time tertiary education.

Unsurprisingly with the unemployment rate falling, some firms reported it harder to find quality staff even where there were plenty of applicants with the basic qualifications. This applied especially to accountants, although there were also references made to shortages of high quality managers, salespersons and programmers.

These observations are consistent with the increases in vacancies reported in the ANZ and Department of Employment and Workplace Relations (DEWR) surveys. It also accords with the Sensis Business Index, which has been reporting small and medium size enterprises citing skill shortages as their primary or secondary concern in recent surveys, and similar results from the July 2004 Australian Chamber of Commerce and Industry survey. The DEWR's 2004 Skill Shortage Lists identified national skill shortages for child care workers, accountants, nurses and health specialists.

Wages pressures were becoming evident in some areas of acute skill shortages. But overall wages were only strengthening marginally despite historically low rates of unemployment. This suggests that inflationary expectations are now well anchored within the 2-3 per cent band agreed between the Treasurer and the Reserve Bank as the medium-term target. It also gives support to the ideas advanced in Statement 4, *Maintaining Low Unemployment in Australia in Budget Paper No. 1, Budget Strategy and Outlook 2004-05* that unemployment can stay below 6 per cent.

Inflation

Few firms reported having much pricing power. As noted above, component suppliers in particular said that large companies were increasingly comparing prices around the world and sourcing supplies where they were cheapest. Communication and computing costs were continuing to fall. Car manufacturers suggested price competition could become more intense as the January 2005 drop in tariffs draws nearer.

The exchange rate stabilised in the June quarter, after a brief depreciation ended a prolonged period of appreciation. Some of these earlier exchange rate rises were yet to be fully reflected in prices so, on balance, firms expected the exchange rate to restrain prices.

The main inflationary impetus during recent months was the sharp rise in global oil prices. As well as the direct effect on petrol prices, this was feeding into higher prices for electricity, plastics and transport. Some airlines passed on the oil price rise in ticket costs. Most respondents were assuming the oil price would fall over coming months unless there were a major supply disruption in the Middle East. In the event that this

assumption is incorrect it suggests firms may face tighter margins going forward. Sharp rises were also reported in steel and cement prices.

As mentioned above, wage pressures were reported as contained. With the ongoing productivity improvements companies are achieving, unit labour costs are consistent with inflation remaining within the medium term target range.

Sources of economic data

The following table provides sources for key economic data. Australian Bureau of Statistics (ABS) data can be obtained over the internet at <http://www.abs.gov.au>. The Reserve Bank of Australia information is available at <http://www.rba.gov.au>. Similarly, OECD information is available at <http://www.oecd.org>. Information on individual economies is also available via the IMF at <http://www.imf.org>.

International economy

Output, current account balance and interest rates	OECD Main Economic Indicators
Consumer price inflation	ABS cat. no. 6401.0

National accounts

Components of GDP, contributions to change in GDP	ABS cat. no. 5206.0
---	---------------------

Incomes, costs and prices

Real household income	ABS cat. nos. 5204.0 and 5206.0
Wages, labour costs and company income	ABS cat. nos. 5204.0, 5206.0 and 6302.0
Prices	ABS cat. nos. 6401.0 and 5206.0
Labour market	ABS cat. no. 6202.0

External sector

Australia's current account, external liabilities and income flows	ABS cat. nos. 5368.0, 5302.0 and 5206.0
--	---

Past editions of Economic Roundup

Details of articles published in the past two editions of the Economic Roundup are listed below:

Autumn 2004

- A review of compositional developments in the Australian labour market
- The impact of the 2002-03 drought on the economy and agricultural employment
- Developments in the United States labour market
- The Japanese economy and future growth prospects
- The Review of Aspects of Income Tax Self Assessment
- Key themes from the Treasury Business Liaison Program – February 2004

Summer 2003-04

- First home buyers in Australia
- Recent developments in the Australian housing market
- Australian net private wealth
- Globalisation: the role of institution building in the financial sector
- Key themes from the Treasury Business Liaison Program – November 2003

Copies of these articles are available from the Treasury. Written requests should be sent to Manager, Domestic Economy Division, The Treasury, Langton Crescent, Parkes, ACT, 2600. Telephone requests should be directed to Ms Susan O'Shea on (02) 6263 3797. They may also be downloaded from the Treasury web site.

The Treasury website, at <http://www.treasury.gov.au>, provides a comprehensive list of press releases, speeches, publications, annual reports, legislation, discussion papers, submissions and articles released by the Department. Information on the Treasury website can be downloaded in PDF and RTF formats, or read online.