I. ECONOMIC ENVIRONMENT

(1) OVERVIEW

1. There is a high degree of transparency in the formulation and evaluation of Australia's economic policies in relation to their rationale, nature, and economic effects, thereby enhancing government accountability and public debate over the merits of these policies. Consequently, transparency has contributed greatly to the continual process of reform, which began in the 1980s, and in which trade liberalization, much of it unilateral, has played an integral part. The extent of structural reform in Australia is exemplified by the drop in the effective rate of assistance (ERA) for manufacturing during the past two decades[1], from 25% to 4.5% in 2003/04.[2] Structural reforms were accompanied by macroeconomic reforms, notably the floating of the exchange rate in the early 1980s, which facilitated subsequent adjustment to tariff reductions.[3] Structural reforms have been aimed at reducing, if not removing, distortions to competition in order to improve the functioning and therefore flexibility of markets for goods, services, labour, and capital, thereby accomplishing a more efficient use of domestic resources. The resulting rise in productivity and improved competitiveness of Australia's goods and services in world markets has enabled real GDP to grow at an average annual rate of about 3.5% during the past 15 years, which has raised per capita income to eighth place among OECD countries. Reform has also made the economy more flexible and resilient to external shocks, like the Asian financial crisis in the late 1990s and, more recently, the drought in 2006.[4]

2. Against the backdrop of continued wide-ranging structural reforms as well as sound macroeconomic policies since the previous Review of Australia (in 2002), real GDP has grown by an average annual rate of around 3.2%. One-quarter of the GDP growth is due to increases in total factor productivity (TFP), albeit not as strong as in the 1990s.[5] Inflation has remained, by and large, within the Central Bank's targeted range. Unemployment has reached its lowest level in 30 years, in great part due to reforms that have rendered the labour market more flexible.

3. Growth has been led by a global boom in demand for mineral products, of which Australia is a major exporter. The increased demand for resource-based products has revealed infrastructure constraints, which the Australian Government and the various state governments (responsible for most Australian ports) are trying to address. Other unfinished business under the competition reforms include reform of land transportation, electricity, and water services, as well as continued efforts to maintain labour market flexibility.

4. Rapid growth in the resource sector and the accompanying rise in private investment, including inward foreign direct investment (FDI), have in great part contributed to a widened current account deficit. The strength of the Australian dollar has put pressure on other sectors, particularly manufacturing, although, according to the authorities, this has not resulted in any significant domestic pressure for further protection from imports.

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[1] ERAs are a measure of the net assistance to a sector divided by the sector's unassisted value added. Sectors that have relatively high ERAs are more likely to attract resources away from those with lower rates.

[2] Banks (2005), and Productivity Commission (2004).

[3] Australia commenced its unilateral tariff reduction programme in 1988.

[4] The drought in 2006 caused a 20% fall in farm output, which is predicted to reduce GDP growth by half a percentage point (Reserve Bank of Australia, Statement on Monetary Policy, November 2006. Viewed at: http://www.rba.gov.au/PublicationsAndResearch/StatementsOnMonetaryPolicy/statement_on_monetary_1106.html [24 November 06]).

[5] Growth of total factor productivity averaged 2.1% annually between 1993/94 and 1998/99 (ABS document 5206.0, September 2005), but fell to 0.8% annually between 2001/02 and 2005/06.

(2) RECENT ECONOMIC PERFORMANCE

5. Australia's economic performance has continued to be impressive during the review period; its annual GDP growth averaged 3.2%, unemployment declined to 4.8% in August 2006, its lowest level since the 1970s, and inflation has, by and large, remained within the Reserve Bank's targeted range (2-3% on average over the economic cycle) (Table I.1).[6] Productivity growth continued, albeit more slowly than during the 1990s. In particular, TFP growth averaged 0.8% between 2001/02 and 2005/06 (turning negative in 2004/05), while capital productivity actually declined, suggesting the need for continuing the reform programme.[7]

Table I.1
Selected macroeconomic indicators, 2001-06

	2001/02	2002/03	2003/04	2004/05	2005/06
National accounts			*Percentage change*		
Real GDP (2004/05 prices)	3.8	3.2	4.1	2.7	2.9
Consumption	2.9	3.4	5.0	4.2	2.8
Private consumption	3.0	3.4	5.3	4.3	2.6
Government consumption	2.8	3.2	3.9	3.9	3.4
Gross fixed capital formation	9.7	14.4	8.3	6.0	8.9
Exports of goods and non-factor services	-1.0	-0.4	2.1	3.1	2.2
Imports of goods and non-factor services	1.5	13.1	13.0	12.1	7.3
Unemployment rate (%)	6.7	6.2	5.8	5.3	5.1
Productivity (2004/05=100)			*Percentage change*		
Labour productivity	3.6	1.8	3.2	-0.4	2.2
Capital productivity	0.8	-0.1	0.0	-2.0	-2.9
Total factor productivity	2.5	0.9	1.8	-1.1	0.0
Prices and interest rates			*Per cent*		
Inflation (CPI, percentage change)	2.9	3.1	2.4	2.4	3.2
90-day bank bill (end-period)	5.11	4.67	5.50	5.66	5.97
90-day bank bill (period average)	4.58	4.83	5.27	5.54	5.68
Government bond yield (10-years; end-period)	5.99	5.01	5.87	5.11	5.79
Government bond yield (10-years; period average)	5.89	5.37	5.65	5.42	5.39
Money credit (end period)			*Percentage change*		
M3 money supply[a]	6.1	13.6	10.2	8.9	10.2
Broad money supply[b]	-0.4	7.9	9.1	11.4	10.0
Credit to private sector	18.8	14.6	12.0	12.5	..
Exchange rate					
US$/$A (financial year-annual average)	0.5239	0.5847	0.7137	0.7529	0.7474
Real effective exchange rate (percentage change)	2.1	7.1	16.3	2.5	1.9
			Per cent of GDP, unless otherwise indicated		
Commonwealth fiscal balance					
Revenue	22.1	22.5	22.4	23.0	23.0
Tax revenue	20.5	21.0	20.9	21.7	21.4
Expenses	22.7	21.9	21.7	21.8	21.3

Table I.1 (cont'd)

[6] The Australian financial year starts on 1 July and ends on 30 June.

[7] According to the authorities, lower productivity growth in recent years reflected partly the cyclical downturn; however, the low measured productivity may also reflect the time lag between investment and output growth. The authorities state that, mining investment and employment, for example, have grown significantly, with output expected to pick up in the coming years.

	2001/02	2002/03	2003/04	2004/05	2005/06
Net operating balance	-0.5	0.6	0.7	1.2	1.6
Commonwealth government debt	5.2	3.8	2.8	1.3	-0.6
Saving and investment					
Gross national savings	20.4	20.1	20.7	20.1	21.0
Gross domestic investment	22.9	24.8	25.4	25.8	26.5
Savings-investment gap	-2.5	-4.7	-4.7	-5.7	-5.5
External sector					
Current account balance	-2.5	-4.9	-5.5	-6.2	-5.6
Net merchandise trade	-0.1	-2.4	-2.8	-2.6	-1.6
Value of exports	16.4	14.8	13.0	14.3	16.0
Value of imports	16.6	17.2	15.8	16.8	17.6
Services balance	0.3	0.3	0.2	0.0	0.1
Capital account balance	0.1	0.1	0.1	0.1	0.1
Financial account balance	2.6	4.8	5.3	6.0	5.4
Direct investment	0.2	1.4	-1.9	5.0	-1.0
Terms of trade, (2004/05=100)	83.5	85.3	91.0	100.0	110.9
Merchandise exports (percentage change)	0.6	-4.2	-5.5	16.8	20.7
Merchandise imports (percentage change)	1.2	10.1	-0.9	13.4	12.5
Service exports (percentage change)	-2.1	2.3	4.9	5.2	5.7
Service imports (percentage change)	-2.0	1.0	6.7	10.1	4.6
Foreign exchange reserves[c] ($A billion)	32.8	36.0	46.1	52.7	60.6
Net external debt ($A million; end-period)	324,147.0	356,995.0	390,565.0	431,941.0	493,828.0
Net external debt (US$ million; end-period)	169,820.6	208,735.0	278,746.2	325,208.4	369,087.0
Debt service ratio[d] (end-period)	8.8	7.9	8.7	9.4	..

.. Not available.

a M3 is defined as currency plus bank current depositis of the private non-bank sector.
b Broad money is defined as M3 plus borrowings from the private sector by non-bank financial institutions (NBFIs), less the latter's holdings of currency and bank deposits.
c Excluding gold and SDRs (Special Drawing Rights) and reserve position in IMF.
d Net interest payments to exports.

Source: Australian Bureau of Statistics documents 1301.0, 1350.0, 5204.0, 5206.0, 5302.0; Reserve Bank of Australia, *Bulletin Statistical Tables,* November 2006; and Australian Government, *Final Budget Outcome,* various issues.

6. In terms of value added by sector, the mining and quarrying sector slowed in 2005/06, after growing at 5% in 2004/05; manufacturing also slowed (Table I.2). On the other hand, construction and services have been growing during the review period. The mining and quarrying sector has been one of the major driving forces behind Australia's recent economic growth, accounting for 48.4% of total merchandise exports in 2005. The global boom in mineral commodities, of which Australia is a major exporter, boosted its terms of trade by 30% from 2002/03 to 2005/06. This has raised tax revenue, as the surge in commodity prices increased the profitability not only of mining companies, but also of other enterprises, such as construction and retail companies.

7. Australia's prudent macroeconomic policies have helped to strengthen the economy's resilience to shocks, and thereby to sustain economic growth. The inflation target enables the Reserve Bank to keep inflation moderate in a flexible manner, and the floating exchange rate helps to ease inflation pressure. On the fiscal side, both the Australian Commonwealth and state governments have achieved fiscal surpluses, and the net government debt has been eliminated. However, with the economy at almost full capacity, the predicted fall in fiscal surplus as the result of tax reform, in connection with the rising interest rates due to inflationary pressure, raises the question of whether the present mix of monetary and fiscal policies is appropriate. According to the authorities, changes in

the fiscal position of less than 1% of GDP should not cause problems for monetary policy; thus, the Australian Government's fiscal change in the current Budget, reducing the fiscal surplus by around 0.5% of GDP between 2005/06 and 2006/07, is within the limit.

Table I.2
Basic economic indicators, 2001-06

	2001/02	2002/03	2003/04	2004/05	2005/06
Real GDP ($A million, 2004/05 prices)	813,542.0	839,187.0	873,197.0	896,568.0	922,385.0
Real GDP (US$ million, 2004/05 prices)	426,214.7	490,672.6	623,200.7	675,026.0	689,390.5
Current GDP at market price ($A million)	735,714.0	781,675.0	840,285.0	896,568.0	966,036.0
Current GDP at market price (US$ billion)	385,440.6	457,045.4	599,711.4	675,026.0	722,015.3
Current GDP at factor cost ($A million)	651,512.0	688,913.0	740,980.0	794,590.0	858,559.0
Current GDP at factor cost price (US$ billion)	341,327.1	402,807.4	528,837.4	598,246.8	641,687.0
GDP per capita at current market price ($A)	37,677.0	39,574.0	42,057.0	44,376.0	47,185.0
GDP per capita at current market price (US$)	19,739.0	23,138.9	30,016.1	33,410.7	35,266.1
			Annual percentage change		
GDP by economic activity at 2004/05 real prices[a]					
Agriculture, forestry and fishing	3.2	-23.5	31.4	-0.7	3.6
Mining and quarrying	0.1	-0.3	-3.6	5.0	-2.4
Manufacturing	2.1	3.6	0.9	-1.1	-0.4
Electricity, gas and water	-0.8	0.9	0.7	0.7	1.6
Construction	11.9	16.4	6.6	4.8	9.4
Services	3.8	3.6	3.8	3.2	3.5
Wholesale and retail trade	4.0	4.7	5.0	3.9	2.0
Accommodation, cafés and restaurants	-0.0	3.4	5.6	4.7	3.0
Transport, storage and communication	3.4	7.5	4.6	4.0	4.3
Finance and insurance	3.3	2.1	4.7	2.0	4.8
Real estate and business	5.1	3.4	3.6	1.3	3.5
Government administration and defence	4.3	-1.2	1.6	3.5	2.4
Education	1.8	1.6	1.3	1.4	1.8
Health and community	5.4	4.3	3.5	4.8	4.2
Cultural and recreational	0.5	3.7	5.8	5.8	3.7
Personal and other services	4.0	2.1	1.3	1.3	5.4
Ownership of dwellings	3.8	4.0	3.9	4.3	3.9
			Per cent		
Share of sectors in GDP at current prices[b]					
Agriculture, forestry and fishing	4.4	3.3	3.5	3.3	3.1
Mining and quarrying	5.3	5.0	4.3	5.6	7.5
Manufacturing	12.1	12.5	12.4	11.7	11.0
Electricity, gas and water	2.5	2.6	2.5	2.5	2.5
Construction	5.9	6.3	6.8	6.9	7.0
Services	69.8	70.4	70.4	69.9	68.9
Wholesale and retail trade	11.7	12.1	12.1	11.7	11.3
Accommodation, cafés and restaurants	2.4	2.3	2.3	2.4	2.2
Transport, storage and communication	7.9	7.9	7.9	7.9	7.5
Finance and insurance	7.5	7.4	7.6	7.6	7.8
Real estate and business	12.6	12.9	12.9	12.8	12.4
Government administration and defence	4.2	4.2	4.2	4.2	4.2
Education	4.7	4.7	4.7	4.6	4.7
Health and community	6.2	6.3	6.4	6.5	6.7

Table I.2 (cont'd)

	2001/02	2002/03	2003/04	2004/05	2005/06
Cultural and recreational	1.5	1.6	1.6	1.6	1.6
Personal and other services	2.1	2.0	2.0	2.0	2.0
Ownership of dwellings	9.0	8.9	8.7	8.6	8.5
Share of sectors in total employment					
Agriculture, forestry and fishery	4.9	4.0	3.9	3.7	3.5
Mining and quarrying	0.9	0.9	1.0	1.1	1.3
Manufacturing	11.8	11.9	11.2	11.1	10.6
Electricity, gas and water	0.7	0.8	0.8	0.8	0.9
Construction	7.6	7.7	8.2	8.5	8.7
Services	74.1	74.7	74.9	74.8	75.0
Wholesale and retail trade	19.8	20.1	19.8	19.7	19.3
Accommodation, cafés and restaurants	5.0	4.8	4.9	5.1	4.8
Transport, storage and communication	6.3	6.2	6.4	6.5	6.4
Finance and insurance	3.8	3.7	3.6	3.7	3.7
Property and business	11.3	11.6	11.8	11.5	11.9
Government administration and defence	4.3	4.6	4.7	4.6	4.6
Education	7.1	7.1	7.3	6.9	7.2
Health and community services	9.9	10.0	10.0	10.2	10.4
Cultural and recreational services	2.5	2.6	2.5	2.7	2.7
Personal and other services	4.0	4.1	3.9	4.0	4.0

a Based on chain volume measures.
b Percentage of gross value added at basic prices.

Source: Australian Bureau of Statistics documents, 1350.0, 5204.0, and 5206.0.

8. In 2005/06, the current account deficit reached 5.6% of GDP (compared with 2.6% in 2001/02), and external debt was 51.1% of GDP (up from 44.1% in 2001/02). This reflected the widened gap between gross domestic investment and national savings, mainly owing to strong growth in the former, driven initially by the real estate sector, but more recently by the commodity price boom and the consequent increase in business investment. With savings insufficient to finance higher investment, FDI flows into Australia increased to a record high in 2004[8], resulting in an appreciation of the Australian dollar. By contrast, national savings' share of GDP remained broadly stable during the period under review, at around 20% (Table I.1).[9]

9. The current account deficit reflected private sector's savings and investment decisions, as general government net debt was eliminated and the general government budget was in modest surplus. Around 99% of all net external debt was owned by the private sector in 2005.[10] Australia's foreign reserves increased from $A 32.8 billion in 2001/02 to $A 60.6 billion in 2005/06. Import coverage also changed from two and a half to three and a half months (for goods and non-factor services).

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[8] FDI inflows reached a record US$43 billion in 2004, up from US$15.6 billion in 2002 and US$7 billion in 2003 (UNCTAD, 2005).

[9] The conventional way to measure savings is by subtracting consumption and depreciation from household disposable income. However, in Australia, the composition of household savings has shifted from bank deposits and fixed income to equity holdings. Thus, the authorities consider it more appropriate to measure savings as the change in household net financial wealth, defined as household financial assets (bank deposits, bonds, equities, and unit trusts) less non-housing debt. The authorities indicate that in countries with low household savings (using conventional measures), households usually hold a greater proportion of their savings in equities (Reserve Bank of Australia, Statement on Monetary Policy, May 2006). The authorities state that, taking into account financial wealth, the share of savings to GDP is much higher.

[10] IMF (2006).

(3) MACROECONOMIC POLICIES

(i) Monetary and exchange rate policies

10. The Reserve Bank of Australia (RBA) is responsible for formulating and implementing monetary policy; the principal aim is to achieve an inflation rate of 2-3% on average over the economic cycle. As the inflation target is defined as a medium-term average, the RBA considers it allows flexibility in forecasting, and allows for uncertainties and lags in the effects of monetary policy on the economy.[11]

11. Since its previous Review, the RBA has, by and large, kept inflation within this targeted range; in September 2006, core CPI inflation, which excludes volatile items such as fresh food and petrol, was 2.6%.[12] However, headline inflation (including all items) was 3.9%. As a result of increased inflationary pressure (owing to rises in energy and commodity prices), the RBA has been tightening monetary policy. The cash rate was increased from 4.25% at the beginning of May 2002, to 5.25% by the end of 2003. The rate was increased by a further 25 basis points in March 2005, May 2006, August 2006, and again in November 2006, following which it has been maintained at 6.25%.[13]

12. Australia maintains a floating exchange rate system (introduced in 1983), with the RBA intervening in the foreign exchange market from time to time in order to prevent misalignment of the exchange rate.[14] The real effective exchange rate of the Australian dollar has been rising during the period under review although it has been relatively stable since 2004, mainly due to narrowing interests rate differentials and an expected slowdown in the commodity boom (Table I.1).[15]

(ii) Fiscal policy

13. The primary objective of the Government's fiscal policy is to maintain the budget in balance, on average, over the economic cycle.[16] Since its previous Review, fiscal policy has in general been effective in this regard, with the general government (Commonwealth and state) fiscal balance being in modest surplus; as a result, net government debt was eliminated.[17] The improvement in the fiscal balance is mainly attributed to the increase in tax revenues; at the same time, the share of expenditure in GDP has been kept relatively stable. An important source of the increase in tax revenue has been corporate taxes, attributed to, *inter alia*, the surge in commodity prices and the resulting boost in corporate profitability and the sustained economic expansion, which has reduced the stock of losses carried-forward.

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[11] RBA, "Third Statement on the Conduct of Monetary Policy". Viewed at: http://www.rba.gov.au/MonetaryPolicy/third_statement_on_the_conduct_of_monetary_policy_2006.html [23 November 2006]

[12] RBA Table H1. Viewed at: http://www.rba.gov.au/Statistics/Bulletin/G01hist.xls [23 November2006].

[13] The RBA targets a publicly announced overnight cash (interest) rate determined by the Reserve Bank Board to act pre-emptively against inflationary pressures (WTO, 2003).

[14] RBA online information. Viewed at: http://www.rba.gov.au/MarketOperations/International/ex_rate_rba_role_fxm.html [6 October2006].

[15] According to the IMF, in July 2006 the dollar was 11% above its 20-year average in real effective terms, although relatively stable in spite of the commodity boom (IMF, 2006).

[16] There are also a number of secondary objectives, including maintaining budget surpluses over the immediate two-year projection period, given sound growth prospects; and not increasing the overall tax burden from 1996/97 levels (Budget, 2006). Also, in Australia, there is "no attempt to precisely date the economic cycle" (OECD, 2006b).

[17] Federal government net debt was eliminated in early 2006, and aggregate state governments' net debt was eliminated a few years earlier.

14. In 2005 and the first half of 2006, a number of measures were adopted to further the reform of Australia's tax system. Measures considered by the authorities to have a significant impact on revenue included, increases in the thresholds of personal income tax and reduced rates, the abolition of the surcharge on superannuation contributions, and changes to depreciation arrangements. In addition, tariffs on certain imports were reduced and the tariff applying to imported business inputs under the tariff concession system was removed.[18] Partly due to these reforms, the Government has predicted a fall in the fiscal surplus from 1.3% of GDP in 2005/06 to 0.5% in 2006/07 (for all levels of government), which, with interest rates rising, raises the question as to whether fiscal policy remains sufficiently prudent and the mix of monetary and fiscal policies appropriate for the future. The rise in interest rates could counteract the effects of tax cuts and could pose a potential threat to the sustainability of an economy, especially as the economy is operating at almost full capacity (in August 2006, when the unemployment rate was 4.8% at the national level, it fell below 3% in the resource-rich state of Western Australia).

(4) MAIN STRUCTURAL REFORM ISSUES

15. Australia's strong economic performance has been the result of two decades of structural reforms, of which trade liberalization has been an integral part. Since its previous Review, Australia has continued its pursuit of these reforms, which, by promoting competition, increasing labour market flexibility and supply, and boosting productivity, should help Australia to rise to a number of challenges. These include, in particular, the possible end to the commodity price boom and an aging population.

(i) Tariff and tax reforms

16. In 2005, Australia unilaterally reduced tariffs on passenger motor vehicles (PMV), as well as on textiles, clothing and footwear (TCF) products (Chapter III(2)(ii)(a)). Consequently, the overall simple average applied MFN tariff rate fell from 4.5% in 2002 to 3.8% in 2006. In addition, on 11 May 2005, the 3% tariff on business inputs under the tariff concession system was removed. As a result, all goods covered by a tariff concession order (TCO) can be imported duty free (Chapter III(2)(ii)(b)).[19]

17. Tax reforms have continued since the introduction of the New Tax System (including the introduction of the goods and services tax) in 2000. Reforms for business taxes have been conducted to reduce their complexity and thus compliance costs, encourage investment, and support small business development (Chapter III(4)(i)). In addition, the corporate income tax rate was reduced from 34% to 30% as a result of tax reform in 2001, and has been maintained at this rate; while the present rate is higher than in some country in the region, it is not out of line with rates in OECD countries. By contrast, personal income tax rates were reduced and thresholds increased, with the result that in 2006 more than 80% of taxpayers face a marginal income tax rate of 30% or less, and the top income tax rate has been reduced to 45% (from 47%). As income tax rates may affect people's decisions on how much and where to work, the reduction in the top tax rates and the higher thresholds tend to enhance Australia's international competitiveness, as well as to reduce the tax disincentive for people to save.

[18] Although tariffs are a source of government revenue, they are not formally considered part of taxation policy in Australia.

[19] Before 11 May 2005, under the tariff concession scheme, a tariff concession order (TCO) had allowed duty-free entry for consumption goods, and a minimum 3% duty had been charged for goods identified as business inputs.

(ii) Labour-market reforms

18. Although the unemployment rate has fallen to its lowest level since the 1970s, further labour market reforms are required, particularly to deal with the aging population and the high reliance on income support. Therefore, "Welfare to Work" reforms were commenced in July 2006, to increase workforce participation. These involved changes to income support, such as the tightening of the eligibility criteria for new claimants of disability support pensions (DSP). As of 1 July 2006, applicants who are able to work 15 hours or more per week are no longer eligible for DSP; instead, they receive a "new start" allowance.

19. Other reforms intended to increase labour market flexibility include the implementation of the Work Choices Act in March 2006. The Fair Pay Commission, a new independent body, was established under the Act to, *inter alia,* set and adjust minimum wages according to criteria that include considering the impact of any decision on the employment prospects of the unemployed and the low paid. The new system also streamlines the process of making workplace agreements, and promotes bargaining at the workplace level.

20. The Government believes that a healthy, skilled, and motivated population is critical to workforce participation and productivity. Thus, under the New National Reform Agenda launched by the Council of Australian Governments (COAG) in February 2006, reform in human capital includes health promotion, education and training, as well as labour-market reforms to encourage workforce participation.

(iii) The National Competition Policy, government trading enterprises (GTEs), and deregulation

21. Since the formulation of the National Competition Policy (NCP) in 1995, competition legislation has been extended to all business activities, including government businesses. Public monopolies have undergone reforms, such as separation of their regulatory function from commercial operations, ensuring third-party access to certain infrastructure services, and preventing overcharging by monopoly service providers. The corporatization and/or privatization of government trading enterprises (GTEs) have also continued. For example, Sydney Airport was privatized in June 2002; the Australian Dairy Corporation was privatized into Dairy Australia in July 2003; and in August 2005, the Government announced the divestment of its majority stake in Telstra.

22. One innovation of the NCP was the annual competition payments provided by the Commonwealth Government to state and territory governments for their implementation of the NCP reform. The final round of payments under the NCP was made in December 2005; before then, where there was lack of progress on NCP-related reform, the Government could reduce payments, upon recommendations from the National Competition Council (NCC).[20] Furthermore, the NCP includes a legislative review process under which governments are committed to reviewing and changing legislation that may restrict competition. Accordingly, several pieces of competition related legislation have been revised (Chapter III(4)(iii)).

23. The National Reform Agenda endorsed by the COAG on 10 February 2006 includes measures to facilitate investment in energy, transport, and other export-oriented infrastructure, aimed at achieving efficient use of infrastructure by improving pricing and investment signals and establishing competitive markets. Reform to reduce regulatory burden is also being pursued. These measures

[20] Total funding of $A 5.7 billion was allocated for competition payments over the period 1997/98 to 2005/06. This funding level, estimated by the Industry Commission in 1995, represents the benefits of implementing the reform programme. (Productivity Commission, 2005c)

would help to address issues such as infrastructure bottlenecks, the reduction of which could increase exports (particularly of mineral resources).[21] The COAG also agreed to establish a COAG Reform Council (CRC) to replace the National Competition Council (NCC). The CRC is to report to the COAG on reform progress, and when the COAG considers reform proposals, to undertake independent cost-benefit analysis.

(5) DEVELOPMENTS IN TRADE AND FOREIGN DIRECT INVESTMENT

(i) Merchandise trade

24. The share of mining in total merchandise exports increased from 40% in 2002, to 48.4% in 2005 (Chart I.1). The shares of manufacturing and agriculture fell (Table AI.1). Unlike the export structure, manufacturing accounted for around 80% of total merchandise imports; the share of imported automotive products increased from 12.3% in 2002 to 12.8% in 2005, perhaps reflecting tariff reductions in PMVs (Table AI.2). Nonetheless, the share of textiles and clothing fell from 4.8% in 2002 to 4.1% in 2005, notwithstanding the tariff reductions on 1 January 2005. Imports by the mining sector increased, from 8.4% in 2002 to 12.1% in 2005; the authorities state that import levels reflect strong business investment in capital goods, as well as increased demand for imported inputs, or intermediate goods.

25. Australia's trade with Asia continues to increase (Chart I.2). The Asia-Pacific Economic Cooperation (APEC) forum also plays a key role; 73.6% of Australia's merchandise exports and 70.1% of its imports are with APEC countries (Table AI.3 and AI.4).

26. Japan remains Australia's largest export market (20.4% in 2005), and the EC25 continues to account for the largest share of Australia's total imports (23.2%). The proportion of trade with both Singapore and Thailand has increased, possibly owing to the trade creating effects of RTAs. Another notable trade partner is China, whose share in total exports increased from 7.0% in 2002 to 11.6% in 2005, and in total imports from 10.1% to 13.7%. However, the proportion of trade with the United States fell.[22]

(ii) Trade in services

27. Trade in services is an important component of Australia's total trade (Chapter IV(5)(i)). Exports of services rose by 5.7% and imports by 4.6% in 2005/06, the services trade surplus reached $A 828 million, up from $A 380 million in 2004/05.

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[21] Allegedly, queuing of ships at some coal ports reflected infrastructure bottlenecks for exports of raw materials. An Exports and Infrastructure Taskforce was established in 2005 to identify infrastructure bottlenecks. The taskforce found evidence of capacity constraints, with the greatest impediment to infrastructure development being the regulatory framework. Responding to the taskforce's conclusions, the COAG agreed to a "simple and consistent national system of regulation for ports and export-related infrastructure", and to include the issue in its new National Reform Agenda.

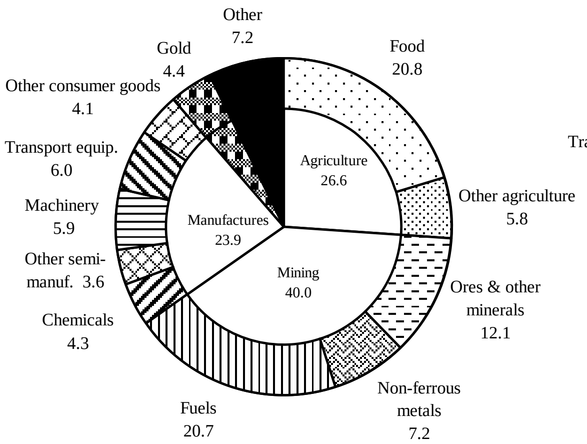
[22] Analysis by DFAT indicates that the decline in exports to the United States in 2005 was unrelated to the AUSFTA; reasons for the decline included the diversification of beef and oil exports to other markets, and a higher average exchange rate (DFAT, 2006c).

Chart I.1
Product composition of merchandise trade, 2002 and 2005

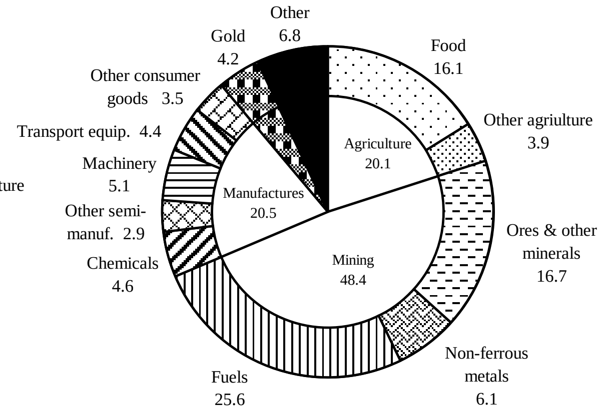
Per cent

2002 **2005**

(a) Exports (f.o.b.)

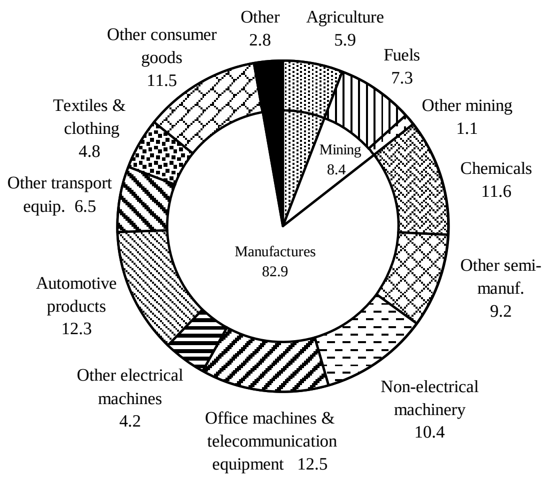


Total: US$65.0 billion

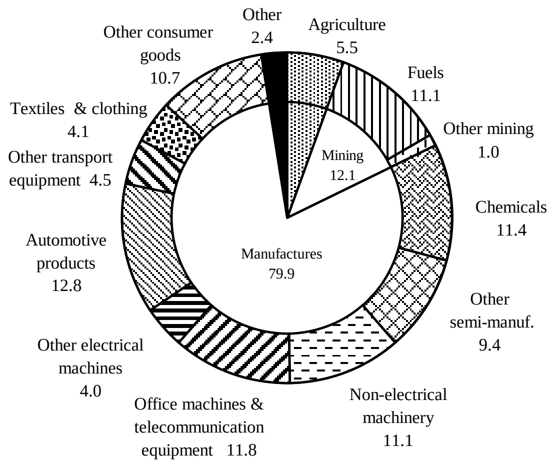


Total: US$105.8 billion

(b) Imports (f.o.b.)



Total: US$69.2 billion



Total: US$118.9 billion

Note: Subtotals for 2002 export data do not add up to 100%.

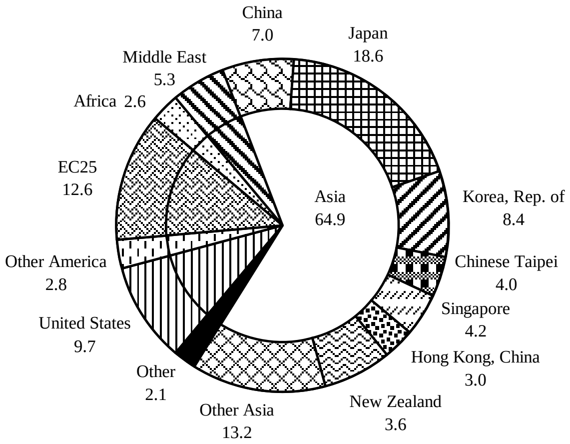
***Source*: UNSD, Comtrade database (SITC Rev.3).**

Chart I.2
Direction of merchandise trade, 2002 and 2005

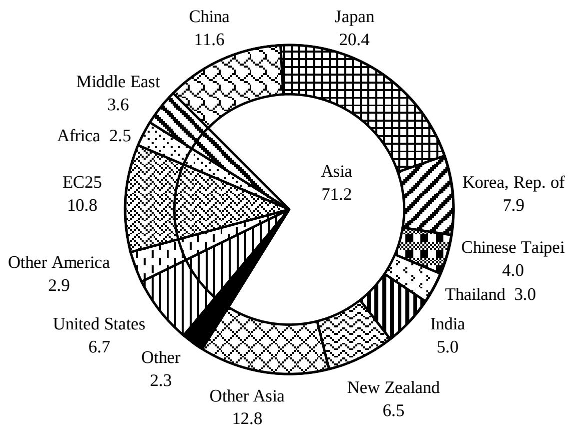
Per cent

2002 **2005**

(a) Exports (f.o.b.)

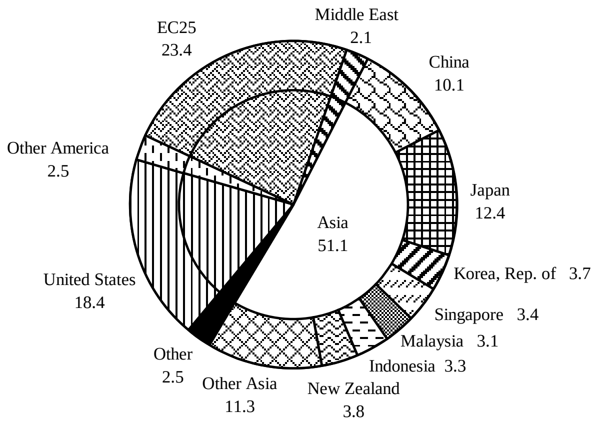


Total: US$65.0 billion

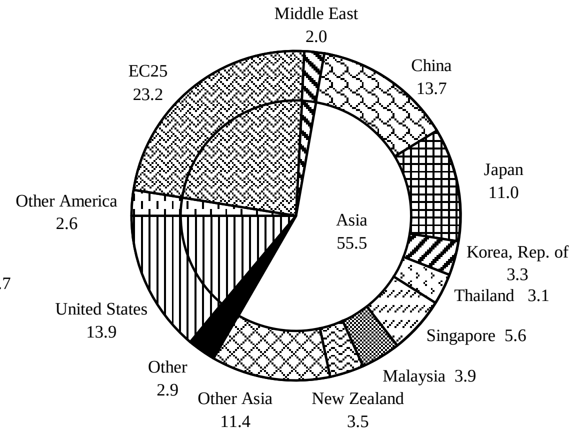


Total: US$105.8 billion

(b) Imports (f.o.b.)



Total: US$69.2 billion



Total: US$118.9 billion

***Source*: UNSD, Comtrade database (SITC Rev.3).**

(iii) Foreign direct investment

28. Australia's stock of inward foreign direct investment (FDI) peaked in 2004 (Table I.3).[23] The United States continues to be the largest source of FDI in Australia, accounting for 24.6% of total FDI in 2005. Other major sources were the United Kingdom (18.3%), and Japan (8.5%).[24] It seems that Australia's recent regional trade agreements (with Singapore, Thailand, and the United States), which include investment-specific provisions, have not increased investment from its partner countries. The authorities consider it is too early to assess the impact of these RTAs on foreign investment flows as they are relatively new.

Table I.3
Foreign direct investment (FDI) in Australia by country and economic activity, 2001-05
($A million and per cent)

	2001	2002	2003	2004	2005
FDI inflow	16,058	31,296	12,301	48,885	-44,654
FDI stock	218,839	249,269	264,560	332,664	281,121
	FDI by origin (% of total FDI)				
United States	31.5	28.3	31.4	42.5	24.6
United Kingdom	22.0	22.2	17.2	13.0	18.3
Japan	7.4	6.7	6.9	5.6	8.5
Netherlands	4.8	4.8	4.5	4.9	6.8
Switzerland incl. Liechtenstein	2.4	3.9	4.1	3.6	5.1
	FDI from RTA partner countries ($A million)				
United States	68,840	70,646	82,955	141,411	69,065
New Zealand	5,444	4,158	5,512	6,382	5,889
Singapore	14,873	3,683	4,253	5,137	4,200
Thailand	-10	..[a]	..[a]	..[a]	52
	FDI by economic activity (% of total FDI)				
Mining	16.8	16.2	17.1	13.7	21.1
Manufacturing	30.2	26.5	27.9	38.9	19.3
Wholesale and retail trade	11.7	16.3	15.6	13.8	17.2
Finance and insurance	13.7	13.5	12.9	10.9	14.4
Transport and communication	10.2	9.4	9.9	7.8	9.4
Property and business services	7.7	8.4	7.7	5.8	6.9
Unallocated	1.1	1.0	0.6	3.4	4.7
Electricity, gas, and water	4.3	4.3	3.4	2.4	3.1
Construction	1.6	1.7	2.0	1.7	2.4
Other services	0.8	0.8	1.0	0.8	0.8

.. Not available.

a Included in totals where applicable but not available for publication, unless otherwise indicated.

Source: Australian Bureau of Statistics document 5352.0, 9 August 2006.

29. At the sectoral level, mining accounted for the largest proportion of FDI in 2005, as a consequence of increased demand for mineral resources. The shares of FDI received in some other sectors of the economy fell; the share of manufacturing declined from 38.9% in 2004 to 19.3% in 2005.

[23] The fall of FDI in 2005 is largely because the News Corporation moved its primary listing to the New York Stock Exchange (UNCTAD, 2006, p.85).

[24] Australian Bureau of Statistics document 5352.0, 9 August 2006.

30. Australia's outward investment has also been increasing: over the past 15 years, outward FDI stocks have grown faster than inward FDI stocks.[25] The Government considers that the benefits of outward FDI include improving efficiency and competitiveness of domestic firms by expanding their business beyond the potential constraints imposed by the limited size of the domestic market; providing growth opportunities to domestic shareholders by extending their market presence and permitting access to resources, expertise, and technology in other markets; and stimulating demand for goods and services provided by input suppliers.

(6) PROSPECTS

31. Australia's economic growth is expected to remain strong. The authorities are of the view that as a result of the ongoing and deepening structural reforms, the economy is now very resilient to external shocks. The major challenge in the short term is to maintain macroeconomic stability in the face of the high commodity prices. However, the authorities believe that the economy's vulnerability to an eventual end of the commodity price boom has been reduced owing to earlier reforms, such as the introduction of a floating exchange rate in the early 1980s and more flexible markets for goods, services, capital, and particularly labour. Nonetheless, in the face of the slowdown in total factor productivity in recent years, there also appears to be a need for continued reform, especially to key infrastructure-related services such as electricity, water, and transport. Despite certain evidence showing that increased investment in infrastructure has resulted in the mining sector overcoming some obstacles, such as infrastructure bottlenecks as well as labour and equipment shortages[26], there is a need to press ahead with reforms as outlined in the National Reform Agenda to raise productivity further. Increased productivity would also enable Australia to address the longer term challenge of an ageing population and the associated rise in health and social welfare costs and implications for the labour market.

[25] FIRB (2005), p. 42.
[26] *Financial Times*, "Australia on course to returning to trade surplus", 4 October 2006.