

STATEMENT 3 — THE CURRENT ACCOUNT DEFICIT: STRUCTURAL IMPROVEMENTS

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STATEMENT 3 — THE CURRENT ACCOUNT DEFICIT: STRUCTURAL IMPROVEMENTS

INTRODUCTION

Australia's success in avoiding severe repercussions from the Asian financial crisis will see us grow more quickly than our trading partners in the period immediately ahead. The current account deficit will inevitably widen as growth in some of our trading partners turns down while domestic demand remains strong. This Statement compares expected developments in the current account with experiences in the 1980s and 1990s.

In the 1980s, the current account deficit came to be viewed as a constraint on Australia's economic growth — a recognition of the fact that the current account deficit itself reflected various structural weaknesses in the economy. Foremost among these was the trend deterioration in public sector finances, but there were also other factors at play which had the effect of distorting saving and investment decisions, especially in the private sector. Such structural weaknesses increased the risk of adverse sentiment among foreign investors on whom the financing of the current account deficit depended.

One of the Government's key objectives has been to reduce these risks and prevent the current account re-emerging as a constraint on sustained strong economic growth. This has not meant eliminating the current account deficit or maintaining it at some target level. Rather, the strategy has been to address the structural weaknesses that existed and ensure that the economic environment is such that the saving and investment decisions underpinning the current account deficit are soundly based. In turn, this should ensure that investor confidence is maintained and economic and employment growth is sustained.

As outlined in Budget Statement 2, the current account deficit is forecast to increase in 1998-99, largely as a result of cyclical influences on investment and saving decisions in the private sector. Continuing solid growth in private investment is expected, while saving rates will be affected by slower growth in export incomes, given the significant downturn in some of Australia's Asian export markets.

Despite the increase in prospect, the forecast current account deficit in 1998-99 in year average terms is not in the range of the three previous peaks (as a percentage of GDP) reached in the 1980s and mid-1990s. More importantly, the economic and policy environment in which the prospective rise in the current account deficit will occur has improved significantly compared with those past episodes, particularly those of the 1980s. Key improvements include a more soundly based and transparent macroeconomic policy framework aimed at achieving underlying budget surpluses following the extended period of negative public saving, the maintenance of low inflation, and an enhanced program of microeconomic and regulatory reform.

As a result of better policy and economic fundamentals, and the fact that policy is directed at their ongoing improvement, the prospective increase in the current account deficit should not place a constraint on economic growth.

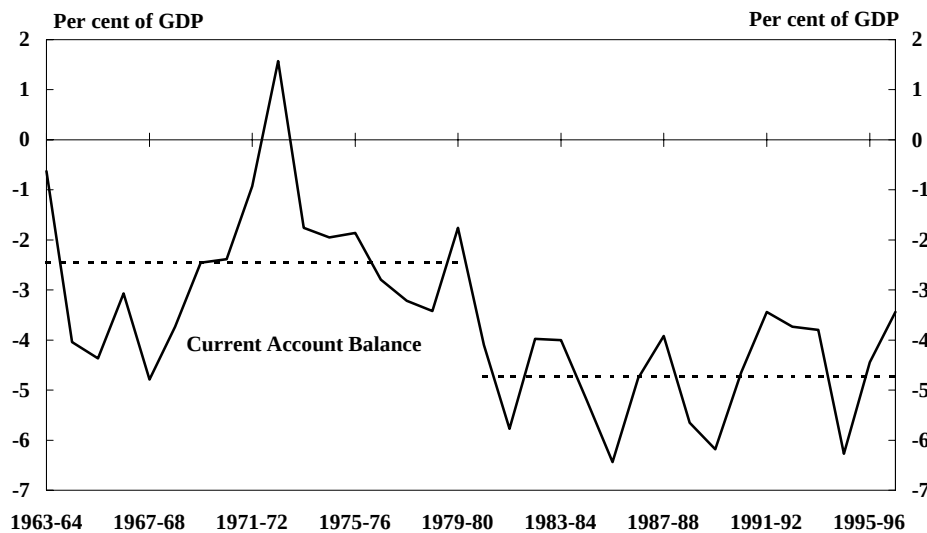
FACTORS UNDERLYING INCREASES IN THE CURRENT ACCOUNT DEFICIT

External and Domestic Influences

Australia has traditionally run a current account deficit, as investment opportunities have exceeded domestic saving. The deficit has also been quite volatile, reflecting cyclical influences on saving and investment. For example, changes in income stemming from swings in the terms of trade have mainly affected the level of saving as spending habits have been maintained. Investment cycles have also been a key driver of short term fluctuations in the current account deficit.

The level of the current account deficit increased markedly in the early 1980s and has averaged 4¾ per cent of GDP since then (Chart 1). The factors contributing to this structural increase in the current account deficit over the 1980s were discussed in the 1996-97 Budget Papers.¹

Chart 1: Long-term Movements in the Current Account Balance



Source: ABS Cat. No. 5302.0, 5206.0 and Treasury estimates.

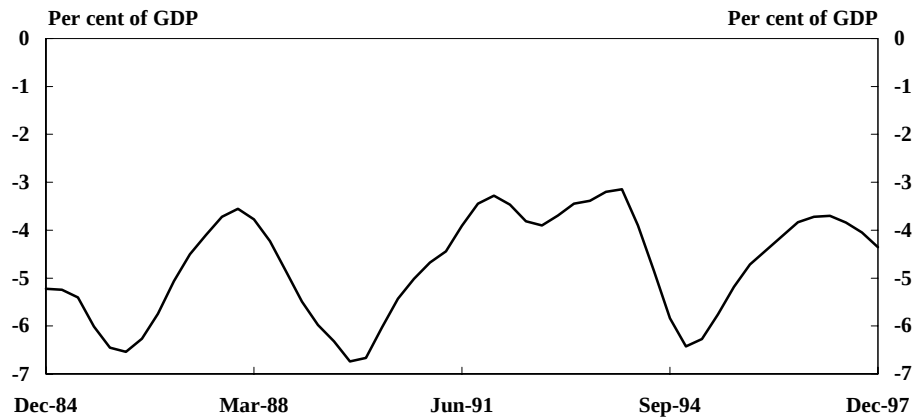
While there has been no obvious trend in the level of the current account deficit over the past decade and a half, there have been fluctuations around the average, with significant upswings in the mid-1980s, late 1980s and mid-1990s (Chart 2, Panel A).

Although showing some common elements, the proximate causes of these three earlier upswings varied.

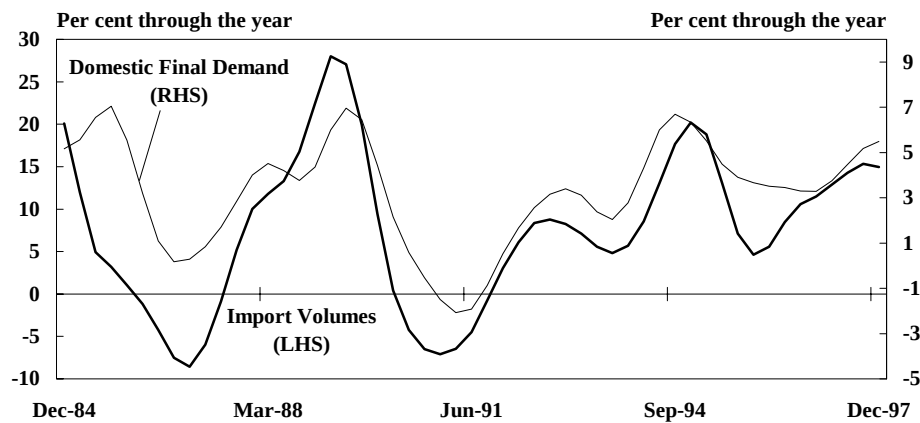
¹ See 1996-97 Budget Paper No. 1: Statement 2, pp 2-30 to 2-39.

Chart 2: Proximate Causes of Increases in the Current Account Deficit

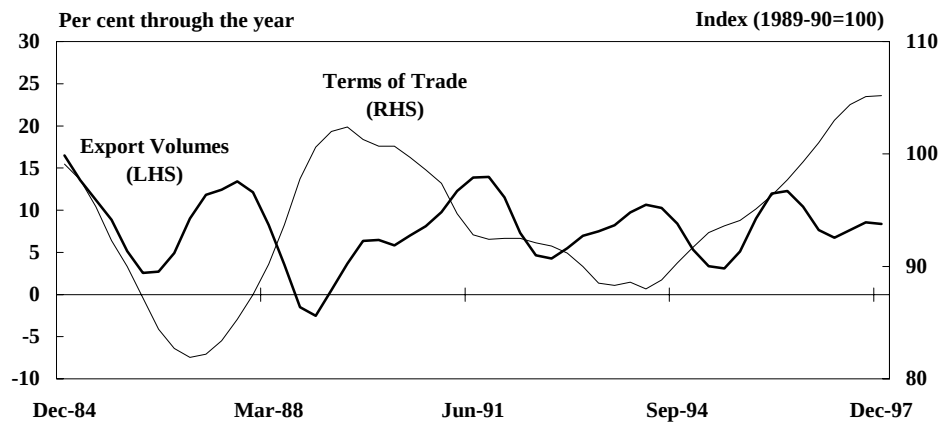
Panel A: Current Account Balance as a Proportion of GDP



Panel B: Domestic Final Demand and Import Volume Growth



Panel C: Terms of Trade and Export Volume Growth



Source: ABS Cat. Nos. 5302.0 and 5206.0 (trend data).

For example, the contribution of external factors to the rise in the current account deficit was dominant in the mid-1980s episode, with a large decline in the terms of trade and much slower growth in exports leading to a fall in domestic saving relative to investment and hence a deterioration in the trade balance (Chart 2, Panel C). While domestic demand was growing strongly at the beginning of the episode, import growth was weak reflecting the large amount of spare capacity in the economy following the recession of the early 1980s, and the progressive switching of demand towards domestic production as a result of the sharp depreciation of the exchange rate over 1985. In contrast, strong growth in import volumes fuelled by strong domestic demand growth was a major cause of the rise in the current account deficit in both the late 1980s and mid-1990s, with upswings in private sector investment figuring prominently (Chart 2, Panel B).² In these latter two episodes, the terms of trade was actually rising, although a slowing in export volume growth also played a role on each occasion (on the latter occasion drought reduced rural exports).

As outlined in Budget Statement 2, the current account deficit is forecast to rise to around 5¼ per cent of GDP in 1998-99 in year average terms, although the outcome for any particular quarter may be higher. This compares with 3.4 per cent of GDP in 1996-97 and an expected 4½ per cent of GDP in 1997-98. The relatively low 1996-97 outcome was due in part to one-off factors: abstracting from the Reserve Bank's sale of gold, the current account deficit in 1996-97 would have been around 3¾ per cent of GDP.

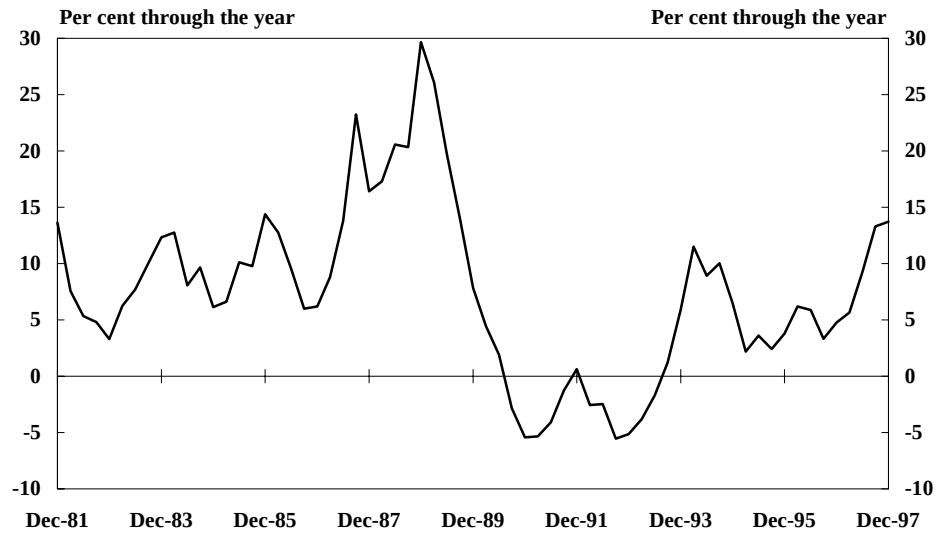
The rise in the current account deficit in prospect is the result of a combination of both domestic and external influences. Strong growth in domestic demand in 1998-99 will lead to substantial growth in import volumes, although both domestic demand and import growth are forecast to be somewhat lower than was the case in the late 1980s and mid-1990s episodes. External factors are also expected to figure prominently, although again there are some differences with the mid-1980s experience: in particular, the deterioration in external conditions is not expected to be reflected in a sharp fall in the terms of trade. The expected impact of the downturn in some of Australia's trading partners on export prices and volumes, along with other factors influencing the terms of trade, are outlined in Budget Statement 2.

Domestic Demand Growth and Inflationary Pressure

A rising current account deficit is a source of concern if it signals internal imbalances in the economy and in particular rising inflationary pressure. This has been true from time to time in Australia. In the late 1980s and in the mid-1990s strong growth in domestic demand spilled over into imports (Chart 2, Panel B) and led to a build up in domestic inflationary pressures.

2 Declining relative import prices, as a result of exchange rate appreciation, also contributed to import demand in each of these episodes.

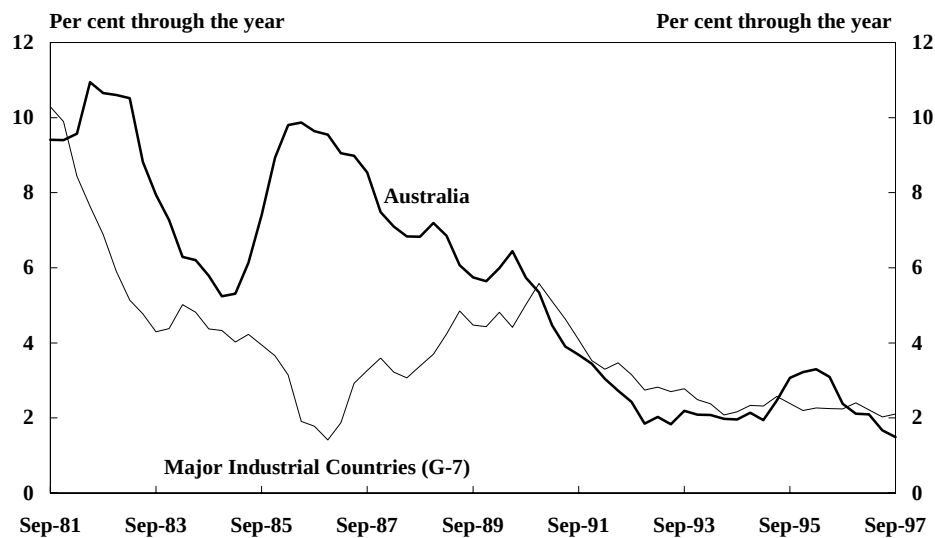
Chart 3: Asset Price Increases



Source: Treasury estimates.

In the late 1980s, these inflationary pressures became evident in particularly high rates of asset price inflation: total asset prices rose by around 55 per cent between the March quarter 1987 and September quarter 1989 (Chart 3). The build up in inflationary pressures took place against the background of an inflation rate persistently high by international standards (Chart 4).

Chart 4: Comparative Inflation Performance^(a)



(a) G-7 inflation is the change in the All Items CPI. For Australia, the Treasury measure of underlying inflation is used.
Source: OECD Main Economic Indicators database and ABS Cat. No. 6401.0.

In the mid-1990s, in the face of accelerating demand growth and wage increases, inflationary pressures built up but from a low and internationally comparable rate of inflation (Chart 4). There was also no accompanying surge in asset prices like that experienced in the late 1980s.

The current outlook for inflation is more favourable than in these earlier episodes, especially the late 1980s. The current inflation rate is very low by historical and international standards, and the data on inflationary expectations in financial markets and amongst consumers suggest low inflation is well entrenched.

The more favourable inflation outlook partly reflects the absence of excessive demand pressures. While domestic demand is forecast to grow relatively strongly in the period ahead, it will increase at a somewhat lower rate than experienced in the late 1980s and mid-1990s. More moderate domestic demand growth and rising import prices are also expected to lead to slower import growth than in the late 1980s and mid-1990s. For example, domestic demand growth in the year to the December quarter 1997 was 5.3 per cent, and import growth was 12.8 per cent; these are forecast to moderate to 3½ per cent and 8 per cent respectively in the year to the June quarter 1999. This compares with growth in domestic demand and imports of 7.7 per cent and 30 per cent respectively in the year to the June quarter 1989, and growth of 6.8 per cent and 20.6 per cent in the year to the December quarter 1994.

As discussed in Budget Statement 2, inflation is forecast to rise only gradually in 1998-99 and remain within the Reserve Bank's target band. Wages and selling margins are expected to exert little upward pressure on inflation, with rises in import prices in late 1997 and early 1998 being the main contributor to the rise in inflation in 1998-99.

A particularly important distinguishing feature of the current situation is the improvement in the monetary policy framework which gives far greater confidence in Australia's capacity to maintain low inflation. Monetary policy is now clearly focussed on maintaining low inflation and is operated in a more transparent manner. In contrast, in the 1980s there was no clearly articulated or credible inflation target as an anchor for monetary policy and financial markets remained uncertain about the goals of policy.

The monetary policy framework has been strengthened in recent years. The joint statement by the Treasurer and Governor of the Reserve Bank in August 1996 formalised the target of achieving 2 to 3 per cent underlying inflation on average over the medium term. It also provided for greater public accountability on the part of the Bank, increasing transparency in the conduct of monetary policy. This framework, along with the consistently good inflation performance in recent years, has resulted in falls in inflationary expectations in financial markets and, most notably, in the large narrowing of the differential between Australian and US bond rates in the last two years. Improvements are also evident in measures of consumer and business inflation expectations.

National Saving

For a modern market based economy with strong competitive forces, a current account deficit has traditionally been of most concern when associated with a poor, or deteriorating, public sector fiscal position: large and growing public sector deficits raise

concerns as to whether foreign savings are being used sufficiently well to generate the income necessary to meet the servicing costs involved. Markets are also becoming more discerning, and recognise that private sector investments can entail contingent risks to public finances, particularly when budget processes are not transparent and accountability is poor.

The 1996-97 Budget Papers discussed in detail the rationale for the Government's fiscal consolidation strategy. It was noted that the increase in the current account deficit since the 1970s had been associated with a structural deterioration in the Commonwealth's fiscal position. The aim of the fiscal consolidation strategy has been to reverse this structural deterioration and to place fiscal policy in a clear medium-term framework to ensure that the structural improvement is sustained. A guiding objective of the strategy is that the Commonwealth Budget should be in underlying balance, on average, over the course of the economic cycle. That is, the Commonwealth should not draw, on average, on the saving available to fund investment elsewhere in the economy.

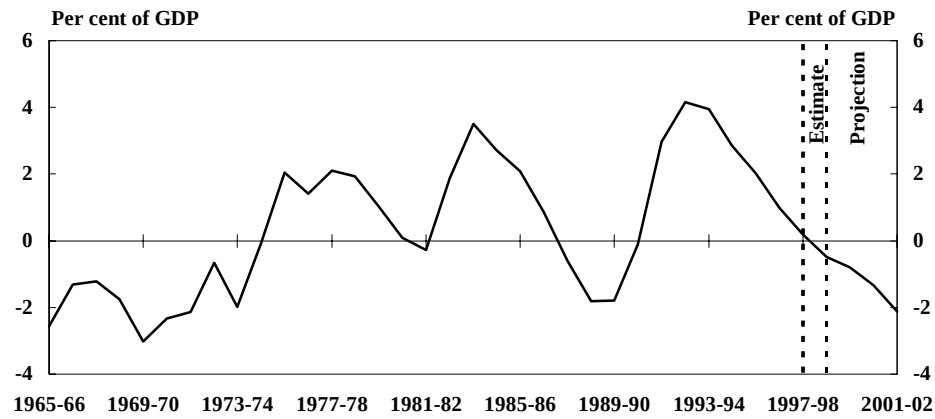
The fiscal consolidation strategy is set within the context of the Charter of Budget Honesty, which has increased the transparency and accountability of fiscal policy through improved disclosure of fiscal policy intentions and information on fiscal developments. The Charter will impose discipline on governments to maintain a responsible fiscal policy over the medium to longer term. The framework represented by this Charter is recognised as international best practice and sets standards that the International Monetary Fund is advocating for member countries.

As a result of the Commonwealth's fiscal consolidation program, the cyclical rise in the current account deficit in prospect is taking place against the background of a significant improvement in Commonwealth finances. With State and Local Government underlying fiscal positions remaining broadly in balance, the turnaround in the Commonwealth underlying budget position to surplus is being reflected in a reduction in the public sector's call on national saving of a similar magnitude (Chart 5). Importantly, a significant proportion of the improvement in Commonwealth finances is structural; that is, it is the result of discretionary measures, rather than simply being the result of rises in economic activity or the price level.

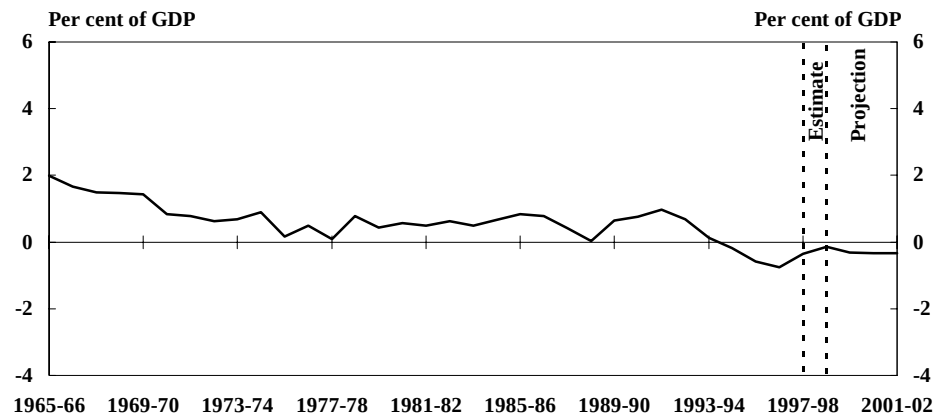
From a saving and investment perspective, the forecast rise in the current account deficit in 1998-99 reflects a deterioration in private net lending (that is, private saving minus private investment) which is more than offsetting improvements in the public net lending position. The fall in private net lending is the result of both a rise in investment, at least part of which is cyclical, and a decline in the private saving rate due in part to households and firms maintaining spending at desired levels in the face of slower income growth resulting from weaker export returns. As these cyclical influences on private net lending unwind, the ongoing improvement in public sector finances should exert downward pressure on the current account deficit.

Chart 5: General Government Underlying Deficit

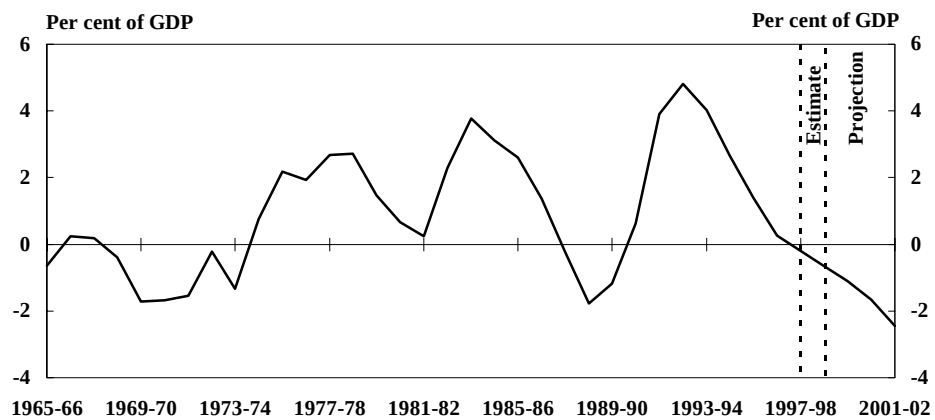
Panel A: Commonwealth



Panel B: State, Territory and Local Government



Panel C: Total General Government Sector



Source: Treasury estimates.

Another way of viewing developments in net lending is that, if there had been no improvement in public net lending, the expected deterioration in private net lending would have led to an even larger current account deficit than forecast. Alternatively, some of the private investment in prospect would have been 'crowded out', lowering growth prospects. Either way, the strengthening of the Commonwealth's fiscal position is providing a sounder and more stable growth environment for Australia in the face of considerable regional economic disruption.

There is also the prospect that the improvement in public saving at the Commonwealth level will be complemented by structural increases in private saving over the medium term.

A number of factors suggest an improved outlook for private saving.

- Low and predictable rates of inflation provide a more favourable environment for saving by encouraging long-term planning, and reducing distortions in after-tax real rates of return, other factors unchanged.
- The Superannuation Guarantee, which is scheduled to increase to 9 per cent of qualifying employee earnings by 2002-03, is estimated to add around 2.1 percentage points to private saving as a share of GDP over the next decade.³
- The savings rebate, which comes into effect in 1998-99, will enhance the incentive to save across a range of savings vehicles. More generally, the tax reform now in prospect has the potential to enhance private saving.
- Finally, quite apart from these policy influences, demographic change over the next decade or so is likely to see a rise in the proportion of the population in age groups which historically have been high savers and a decline in younger, low-saving age cohorts.

In summary, the prospective rise in the current account deficit will be taking place against the background of a structural improvement in public sector finances. This improvement should be accompanied by structural increases in private saving, helping to reduce pressures on the current account deficit over time. However, the current account outcomes will also depend importantly on structural developments in the level (and by implication quality) of investment.

The Quality of National Investment

The willingness of foreign investors to finance a current account deficit is likely to be closely related to perceptions about the quality of investment being undertaken in the economy, and whether it is expected to produce a return sufficient to meet its financing costs. The Asian economic crisis underlines this point. In the affected countries, the loss of foreign investor confidence stemmed to an important extent from the accumulation of

3 See Gallagher, P, 1997, 'Assessing the National Saving Effects of the Government's Superannuation Policies', RIM Conference Paper 97/3.

evidence that investment decisions were systematically distorted and corporate balance sheets were weak, and not supported by robust financial systems.

Concerns about the quality of investment decisions in Australia, while of a significantly lesser magnitude than those discussed above, probably added to financial market concerns during previous upswings in the current account deficit, particularly in the late 1980s. Some aspects of that earlier experience are outlined below, and contrasts are drawn with current circumstances.

The Property Price Boom in the Late 1980s

Concerns as to whether private sector investment decisions are soundly based are likely to especially arise in circumstances of a speculative property boom. In this situation, the prices of property assets far outstrip levels likely to be justified by future economic returns, leading to a temporary and unsustainable over-investment in property assets (followed by a sharp correction in prices and a collapse in investment). The rise in the current account deficit in the late 1980s was fuelled by a very strong investment boom, especially in the property sector. Property investment reached historical highs (Chart 6, Panel A), driven by rapid rises in office prices (Chart 6, Panel B).⁴ The subsequent sharp rise in vacancy rates and the associated fall in rents and office prices meant that much of this investment did not generate the level of returns which may have been anticipated at the time the investment decisions were made. At a national level, income generated by these investments was not sufficient to meet the servicing costs of the related domestic and external financing obligations.

A related concern with regard to speculative property booms is that property investment is often highly leveraged, leaving domestic investors exposed to cash flow difficulties when the inevitable correction occurs. This was true of the property investment boom in the late 1980s, which came at a time when corporate gearing levels in general were rising to reasonably high levels — corporate gearing rose from 50 per cent in the early 1980s to around 70 per cent in the late 1980s.⁵ In the latter part of this period, the rise in average gearing reflected the fact that a number of firms which were already highly leveraged continued to increase their gearing ratios. These circumstances can have an impact on the financial system. For example, the combination of highly leveraged firms and sharp falls in asset prices was one of the contributors to the relatively high level of non-performing loans recorded in the early 1990s — these were around 6 per cent of total bank assets in the March quarter 1992.

None of the factors which were evident in the late 1980s is significant in current circumstances. While there are localised pressures (in particular, in the Sydney CBD), office investment overall is currently at moderate levels and office price inflation remains relatively subdued (Chart 6, Panels A and B). In addition, corporate finances are strong.

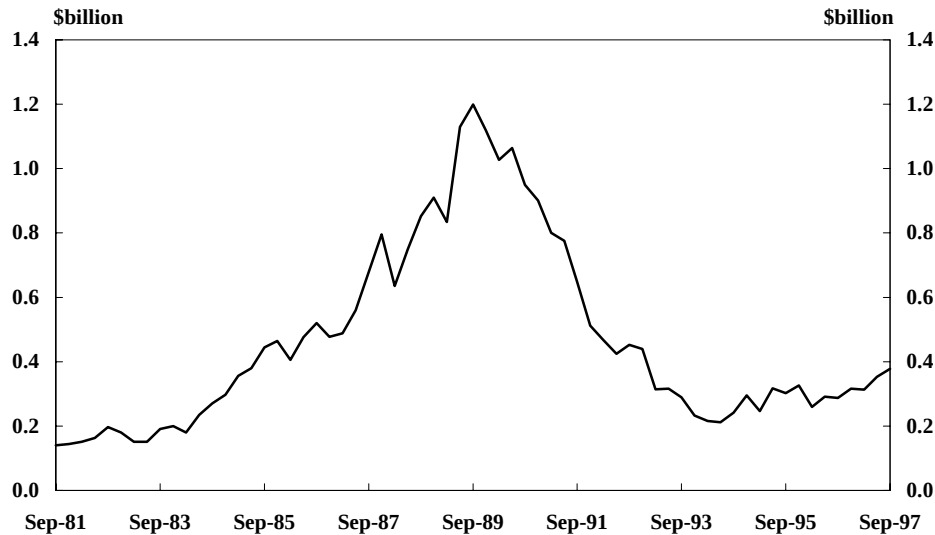
⁴ A high proportion of the increase in investment in the late-1980s was undertaken by 'real estate operators and developers', further suggesting speculative elements played a dominant role in the investment boom. See Kent, C. and Scott, P., 1991, *'The Direction of Australian Investment from 1985/86 to 1988/89'* Reserve Bank Research Discussion Paper 91/06.

⁵ As measured by the RBA series based on a sample of larger companies.

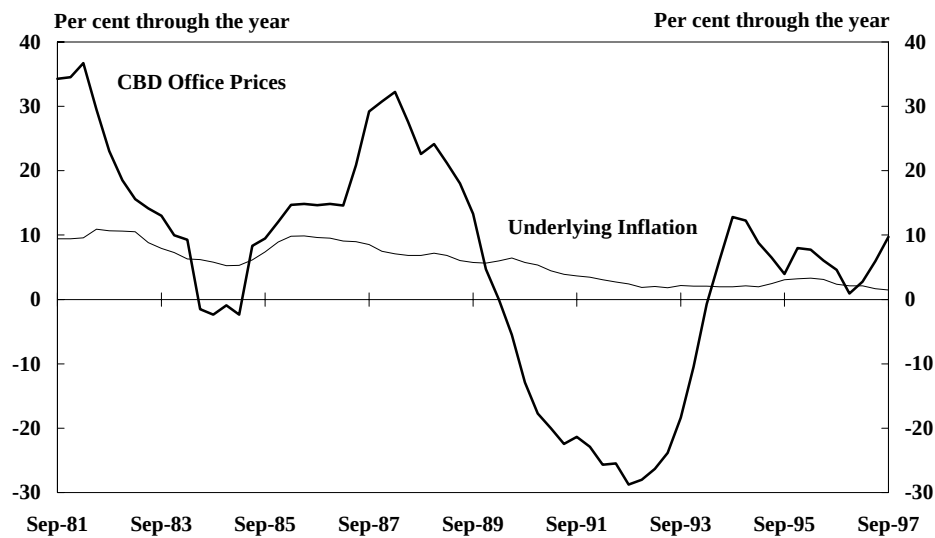
Gearing levels have fallen considerably since the late 1980s⁶ and interest cover — that is, profits divided by interest payments — is at much stronger levels than experienced in the late 1980s (Chart 7). The improvement in corporate financial positions suggests business lending has become less risky over time, adding to the soundness of the financial system. One reflection of this is that non-performing loans are now at very low levels, at around 0.6 per cent of total bank assets.

Chart 6: Office Investment and Prices

Panel A: Value of Office Construction



Panel B: Office Price Inflation



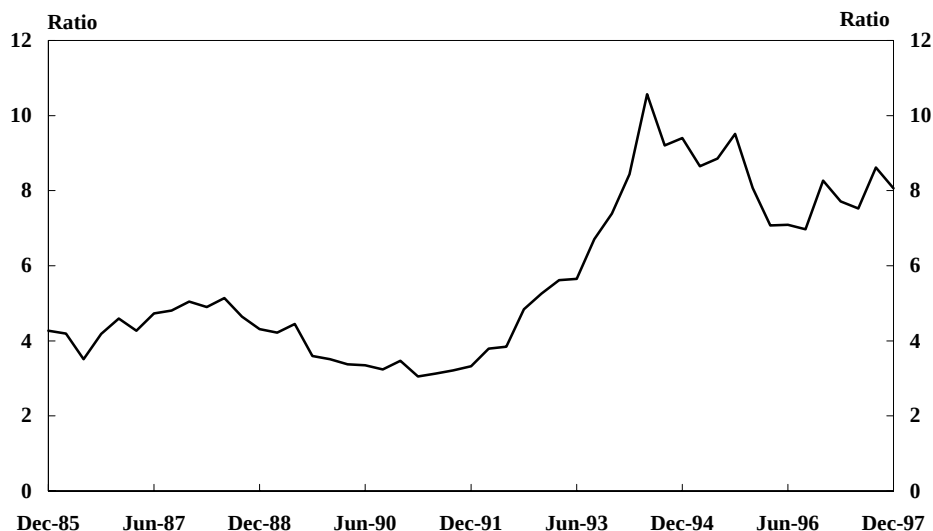
Source: ABS Cat. Nos. 8752.0 (for Panel A), RBA Bulletin (for Panel B).

⁶ Gearing had again fallen to 50 per cent by 1993-94. More recent data, while not directly comparable, suggests gearing has since remained broadly stable.

More broadly, overall asset price inflation is not occurring at rates that suggest speculative factors are dominant. Overall asset prices⁷ rose by 14 per cent in the year to the December quarter 1997, compared with a peak growth rate of 30 per cent in the year to the December quarter 1988.

These circumstances contrast strongly with those in the Asian economies in crisis, where the collapse of asset price booms has contributed to very high rates of non-performing loans, with severe consequences for financial and corporate balance sheets.

Chart 7: Interest Cover^(a)



(a) Interest cover is the ratio of gross profit to net interest paid.
Source: ABS Cat. Nos. 5651.0.

A Sound Investment Climate

The above discussion suggests that investment is not being distorted by speculative factors, and that debt financing decisions appear — on the whole — to be well based. More broadly, the overall environment for investment in Australia has improved in recent years and this should support investor confidence.

A key aspect of this improvement is the achievement of low and stable rates of inflation. Low inflation has led to sharply lower nominal interest rates and has contributed to a reduction in real interest rates in recent years because, in periods of high and variable inflation, lenders tend to seek a real premium to compensate them for uncertain future returns. Low and stable inflation also contributes to a more efficient allocation of investment, providing more certainty for long-term investment planning and, in turn, better decision making. In addition, a number of provisions of the taxation system are set in nominal terms and, to the extent these are not offset by other measures, higher rates of

⁷ Treasury estimates based on an index combining equity, residential and commercial property prices.

inflation will distort investment and financing decisions.⁸ Inflation also tends to mask relative price signals and this, in turn, can distort investment decisions. Finally, the emphasis on transparency and predictability in setting monetary policy reduces the risk of sharp adjustments in policy, including by reducing the likelihood of asset price bubbles developing, with the additional concerns which can attach to these.

The range of microeconomic reforms introduced over a number of years has also reduced distortions in the economy, with the result that investment is now more likely to flow to areas of highest economic return. Key reforms in this regard include the elimination of import quotas and the sizeable reductions in tariffs which have occurred since the early 1980s. This brought about ongoing improvements in the distribution of investment between sectors of the economy, and had a major impact on the efficiency and dynamism of the formerly heavily protected manufacturing sector.

Competition policy reforms will extend this discipline to the non-tradables sector. Aspects of the competition policy reform will also reinforce the trend towards an increased commercial focus on the part of Public Trading Enterprises (PTEs). This trend has already resulted in strong improvements in capital and labour productivity in these enterprises, due in large part to the priority that all levels of government have placed on the commercialisation and privatisation of PTEs in a competitive market framework.

The shift towards enterprise bargaining is also likely to improve capital efficiency, via a range of improved work practices such as continuous shifts. The Workplace Relations Act (1996) is accelerating this shift towards enterprise bargaining, and enhancing the scope for innovative work practices to be introduced, which will further add to productivity.

The benefits of microeconomic reform in terms of enhancing the efficiency of the capital stock are most apparent in the performance of PTEs.⁹ This improved efficiency has been reflected in both falling prices to consumers and businesses¹⁰ and a strong increase in the net rate of return on capital: the latter has improved markedly over the past decade and is now at historically high levels (Chart 8).

At the aggregate level, evidence suggests that there has been a decisive pick-up in trend total factor productivity growth in the 1990s. Growth in total factor productivity is now above Australia's long-term average growth rate of 1.5 per cent a year and well above the average growth rate of 1 per cent recorded in the 1980s (Chart 9). Ongoing improvements in total factor productivity are likely to accrue, in part, in the form of increased returns to capital and should underpin confidence in the investment environment.

One possible outcome of increased investment returns is that investment rates may increase. An increase in investment in such circumstances would be a positive

8 During periods of high inflation, the concessional tax treatment of capital gains (where only real gains are taxed on realisation) and the ability of taxpayers to immediately deduct nominal interest, reduces the incentive to invest in assets earning recurrent income and increases the incentive to carry high levels of debt.

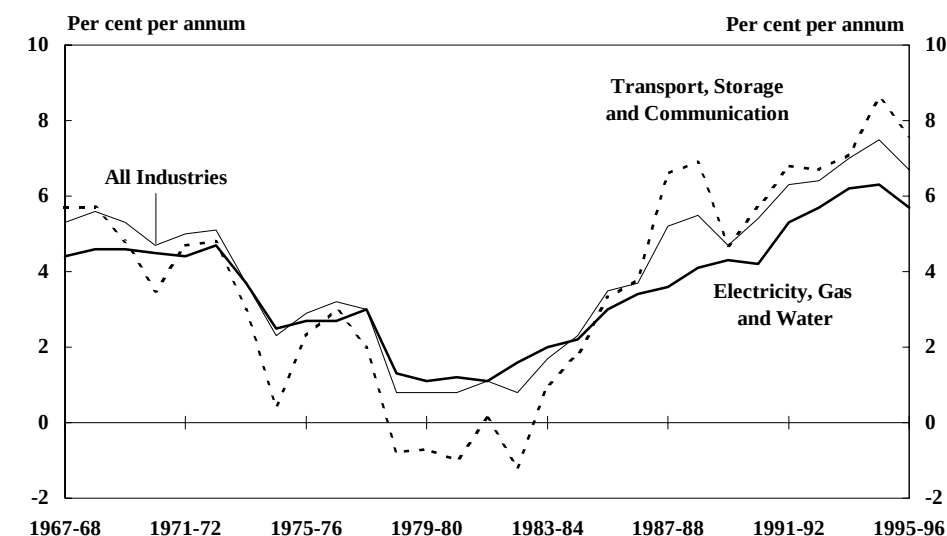
9 Industry Commission, 'Assessing Australia's Productivity Performance', AGPS, September 1997.

10 See pp 12-13 of Statement 3 of *Budget Paper No. 1* 1997-98.

development, and any resulting increase in the current account deficit would not be a cause for concern. Conversely, low investment rates arising as a result of a poor economic environment should be viewed in a different light despite the lower current account deficit which may result. Such a set of circumstances occurred in the middle to late 1970s, when a sustained weakening in private investment as a share of GDP masked for some time the effect on the current account deficit of a deterioration in public sector finances. In that period, lower productivity growth, a sharp increase in structural unemployment and an unstable macroeconomic environment all contributed to reduced investment levels.

While stronger productivity growth may lead to increased investment, it may also ultimately result in a lower investment share of GDP. International experience suggests that high rates of total factor productivity growth are associated with lower investment shares of GDP. In other words, a given amount of economic growth requires less investment.¹¹ Whatever the net impact on the investment share of GDP, an improved productivity performance enhances the capacity of the economy to service foreign liabilities.

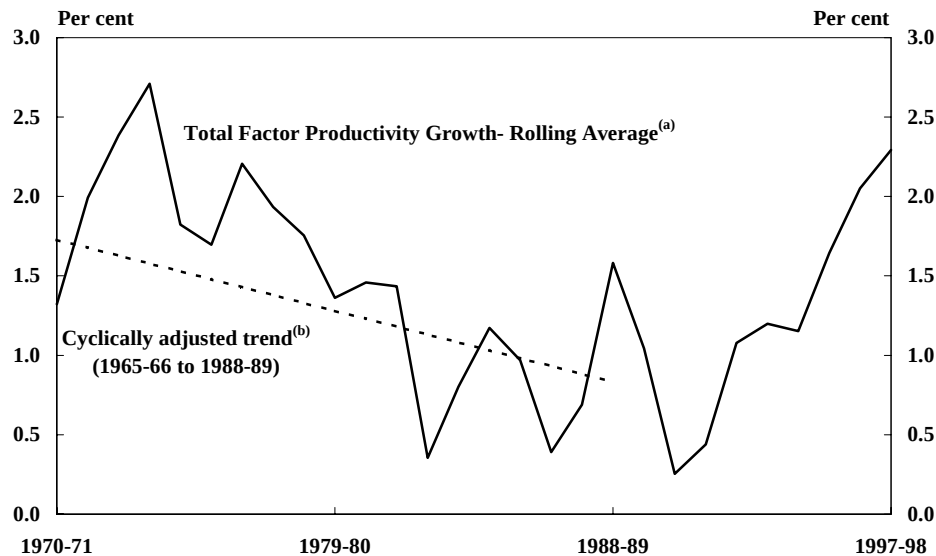
Chart 8: Net Rate of Return in Public Trading Enterprises



Source: ABS Cat. No. 5221.0.

¹¹ See EPAC, 1996, Tariff Reform and Economic Growth, Commission Paper No 10, and Ferry, N. 1996, Australia's Current Account Performance and Microeconomic Reform, Treasury Conference Paper No. 1996-02. Ferry discusses a range of possible reasons for this observed correlation, including the increase in the share of GDP generated in the less capital intensive service sectors as real per person incomes increase.

Chart 9: Trend Total Factor Productivity Growth
Non-Farm Market Sector



(a) Rolling average growth rates - six years to the year shown.

(b) The cyclically adjusted trend has been derived by regressing annual total factor productivity growth for the period shown against a cyclical indicator and a time trend.

Source: ABS Cat. Nos. 5206.0, 5231.0 and Treasury estimates.

Ongoing reform efforts will further improve the investment environment. For example, reforms to the financial system and the Corporate Law Economic Reform Program, which are in the process of being implemented, bear directly on the efficiency of investment. Following the recommendations of the Wallis Inquiry, the Government is implementing substantial financial sector reforms. These are designed to encourage greater competition and hence efficiencies in the provision of financial services. The reforms will also establish a regulatory system focussed on the underlying objective of ensuring confidence in the stability and safety of the financial system, as well as being able to respond to developments such as globalisation and technological change. Reforms undertaken in the course of the Corporate Law Economic Reform Program to the rules on directors' duties, fundraising and takeovers will also establish a more favourable climate for both investors and business.

Reform of the taxation system and further reform of the labour market will also be important in enhancing Australia's investment environment. A simpler taxation system with broader bases would reduce the distortions to investment behaviour produced by the current complex system. Further reform of the labour market, apart from bringing benefits in terms of lower unemployment and higher returns to labour, would open the way for more widespread adoption of innovative work practices with consequent benefits for capital productivity.

CONCLUSION

The forecast moderate rise in the current account deficit in 1998-99 will occur against a background of a substantial improvement in Australia's economic and policy environment compared with previous larger upswings in the current account deficit, particularly in the mid and late 1980s.

In assessing the implications of an increase in the current account deficit, the lesson from events in Asia is that investors are likely to focus on the underlying causes rather than the current account deficit *per se*. In particular, the overall stability of the macroeconomy, the quality of public and private saving and investment underpinning the current account deficit, and the transparency and predictability of the macroeconomic policy framework are very significant in investor assessments. The improvement in Australia's economic fundamentals means that the expected cyclical rise in the current account deficit in 1998-99 should not be a source of concern in financial markets and will be readily financed by foreign capital inflow. The key factors supporting this assessment are:

- Macroeconomic policy operates in a sound and transparent framework.
- The forecast increase in the current account deficit is not associated with internal imbalances in the economy, in particular inflationary pressures.
- A framework is in place to ensure monetary policy is applied in a consistent fashion and will maintain low inflation over the medium term.
- The Commonwealth Government's fiscal consolidation program has delivered a structural improvement in public saving, reflected in an underlying surplus in the 1998-99 Budget and the prospect of underlying surpluses in future years. Furthermore, legislation places an ongoing discipline on fiscal policy.
- The economic environment has improved such that investment is of a higher quality than in the past, and should generally produce returns that meet its financing costs. Important aspects in this regard include the entrenchment of low inflation; the accumulated benefits of ongoing microeconomic and regulatory reform; and the soundness of the financial and prudential supervision system in Australia and further reforms to strengthen these.

However, there is no room for complacency. It is critical that a sound policy framework be sustained and enhanced if investor confidence in Australia is to be maintained and the current account deficit not pose a threat to economic growth. In particular, the structural improvements in public saving must be sustained. Over time, this will contribute to a lower structural current account deficit, reinforcing the effects of policy initiatives and demographic factors which are likely to increase private sector saving rates over the medium to long term. The ongoing improvements in the Commonwealth's budgetary position detailed in this Budget contribute to such a result. It will also be important to proceed along the path of further microeconomic and regulatory reform, including taxation reform, to enhance the climate for investment in Australia and ensure that investment decisions are based on undistorted commercial criteria.