

**FOR
AGENDA**

SM/10/104

April 28, 2010

To: Members of the Executive Board

From: The Secretary

Subject: **New Zealand—Staff Report for the 2010 Article IV Consultation**

Attached for consideration by the Executive Directors is the staff report for the 2010 Article IV consultation with New Zealand, which is tentatively scheduled for discussion on **Wednesday, May 12, 2010**. At the time of circulation of this paper to the Board, the authorities of New Zealand have indicated that they need more time to consider whether they will consent to the Fund's publication of this paper. Any requests for modifications for publication must be received two days before the Board concludes its consideration.

Questions may be referred to Mr. Schule (ext. 34563) and Mr. Brooks (ext. 34454) in APD.

Unless the Documents Section (ext. 36760) is otherwise notified, the document will be transmitted, in accordance with the procedures approved by the Executive Board and with the appropriate deletions, to the WTO Secretariat on Thursday, May 6, 2010; and to the Organisation for Economic Cooperation and Development, following its consideration by the Executive Board.

This document, together with a supplement providing an informational annex, will shortly be posted on the extranet, a secure website for Executive Directors and member country authorities. The supplement, which is not being distributed in hard copy, will also be available in the Institutional Repository; a link can be found in the daily list (<http://www-int.imf.org/depts/sec/services/eb/dailydocumentsfull.htm>) for the issuance date shown above.

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INTERNATIONAL MONETARY FUND

NEW ZEALAND

Staff Report for the 2010 Article IV Consultation

Prepared by the Staff Representatives for the 2010 Consultation with New Zealand
(In consultation with other departments)

Approved by Mahmood Pradhan and Martin Mühleisen

April 27, 2010

- **Discussions:** March 19–29, 2010, with Minister of Finance Bill English, Governor of the Reserve Bank Alan Bollard, Treasury Secretary John Whitehead, and other senior officials and representatives of the private sector and trade unions.
- **Team:** Mr. Brooks (head), Mr. Schule, Mr. Jang, and Ms. Sun (all APD). Mr. di Maio (OED) also participated in the meetings.
- **Focus:** The macroeconomic policy mix to secure the recovery, reduce vulnerabilities, and preserve financial stability.
- **Past Fund Advice:** For a description of policy issues discussed in the 2009 Article IV consultation, see <http://www.imf.org/external/pubs/cat/longres.cfm?sk=22933.0> and Appendix I.
- **Exchange System:** New Zealand has accepted the obligations of Article VIII, Sections 2, 3, and 4. The exchange rate is free of restrictions on the making of payments and transfers for current international transactions other than restrictions notified to the Fund in accordance with Decision No. 144-(52/51). The de facto exchange rate arrangement is free floating.
- **Official Development Assistance:** 0.3 percent of national income for ODA in 2009/10, focused on the Pacific.

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EXECUTIVE SUMMARY

New Zealand rode out the crisis better than most advanced economies and a gradual economic recovery is underway. The outlook, however, is subject to a number of downside risks mainly related to the pace of the global recovery. The authorities are more optimistic than staff concerning the near-term outlook, given the economy's growing links to Asia and Australia. Two key macro-financial vulnerabilities persist—high household debt and high external debt. The latter created some funding difficulties for banks during the crisis.

The strong fiscal position prior to the global crisis enabled the authorities to deliver a sizable fiscal easing that helped cushion the impact of the crisis. However, the medium-term fiscal outlook has worsened because income tax cuts and many of the spending initiatives were permanent and revenue projections have been revised down.

Staff welcomed the government's commitment to limit the increase in public debt, but advised faster consolidation. A shift in the macroeconomic policy mix toward faster fiscal consolidation would relieve pressure on monetary policy and thereby the exchange rate, and limit the increase in the current account deficit. Faster consolidation would also create fiscal space to deal with future shocks, and reduce the likelihood of an increase in the risk premium related to New Zealand's high external debt. The authorities had considered the merits of faster fiscal consolidation, but decided that their planned pace of consolidation was appropriate.

Staff noted that the current accommodative monetary stance is appropriate and the RBNZ should gradually return to a neutral stance once the recovery is well established. The inflation-targeting framework served New Zealand well during the global crisis and there are no clear net benefits to increasing the inflation target.

Banks remain sound, but staff advised continued vigilance as banks are exposed to households and house prices appear overvalued. Staff welcomed closer collaboration with Australian authorities on crisis management and stress tests, and recommended that banks' capital and provisioning be strengthened if these tests suggest the need for additional buffers.

While uncertain, staff estimates suggest that the exchange rate is overvalued by 10–25 percent. If this overvaluation proves to be temporary, it may limit the expected widening of the current account deficit. But even if the current account returns to the estimated norm of almost 5 percent of GDP, net foreign liabilities would remain high at 90 percent of GDP.

Staff supported prudential and structural reforms that would help reduce external vulnerability. The introduction of the prudential liquidity policy, including a core funding ratio, should reduce banks' reliance on short-term external funding. The core funding ratio could be raised further than planned if needed to help reduce short-term external debt. Structural reforms to raise productivity and labor force participation, including tax and benefit reforms, would lift potential growth and export capacity.

I. BACKGROUND

1. **New Zealand experienced a relatively shallow recession during 2008–09.** The end of a housing boom in response to tight monetary policy slowed domestic demand, which combined with a drought pushed the economy into a recession in early 2008, ahead of many other countries. Subsequently, the downturn was exacerbated by the global financial crisis. Real GDP contracted by about 1½ percent in 2009, compared to an average contraction of 3 percent for other advanced economies.

2. **The global crisis has not hit New Zealand as hard as many other advanced countries.** This was because of demand from fast-growing Asian markets and the robust Australian economy, a flexible exchange rate, and the absence of a banking crisis (Figure 1). In addition, a sound macroeconomic framework and a strong pre-crisis fiscal position allowed significant monetary and fiscal policy easing that cushioned the blow from the global crisis. Nevertheless, the crisis highlighted long-standing vulnerabilities due to high household and high external debt.

II. ON THE ROAD TO RECOVERY

3. **The economy emerged from the recession in mid-2009.** Domestic demand is driving the recovery, supported by fiscal stimulus, low mortgage rates, and improved world commodity prices (Table 1). The unemployment rate (7.3 percent at end-2009) has not risen as sharply as elsewhere, which has helped underpin confidence.

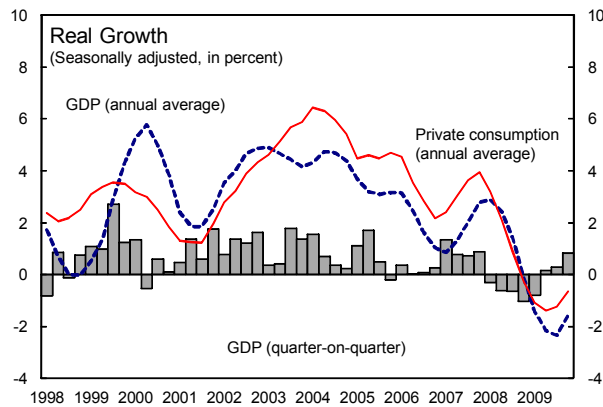
4. **Financial markets have regained some lost ground, as global sentiment improved and credit strains eased.** Money market spreads and bank CDS spreads have declined sharply from crisis highs, but the stock market is still about 25 percent below the 2007 peak (Figure 2). Sovereign bond spreads remain about 70–80 basis points above the average of the past 15 years.

5. **The exchange rate depreciated sharply at the onset of the crisis, but has appreciated since early 2009.** In the year to February 2009, the nominal effective exchange rate depreciated by 30 percent, as the Reserve Bank of New Zealand (RBNZ) eased monetary policy and the global crisis hit commodity prices and heightened risk aversion. Since then, the nominal effective exchange rate has appreciated by about 20 percent, reflecting a recovery in commodity prices and global risk appetite, and a widening of interest rate differentials.

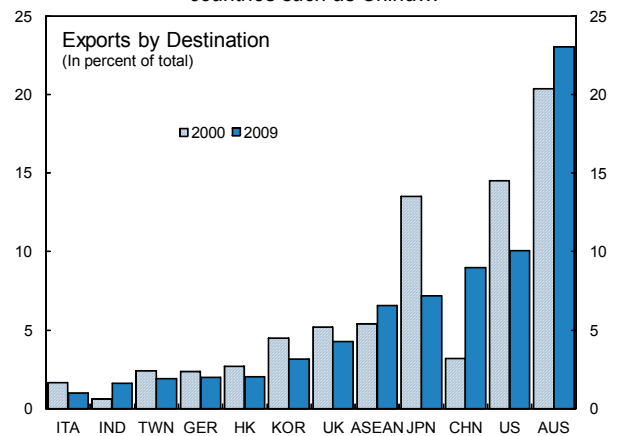
6. **Rising unemployment and a widening output gap contained growth in labor costs and eased inflationary pressures** (Figure 3). Headline and nontradables CPI inflation fell to about 2 percent y/y in March 2010, consistent with the inflation target of 1–3 percent and well below the peaks of 4–5 percent in 2008.

Figure 1. New Zealand: Recovery from Recession

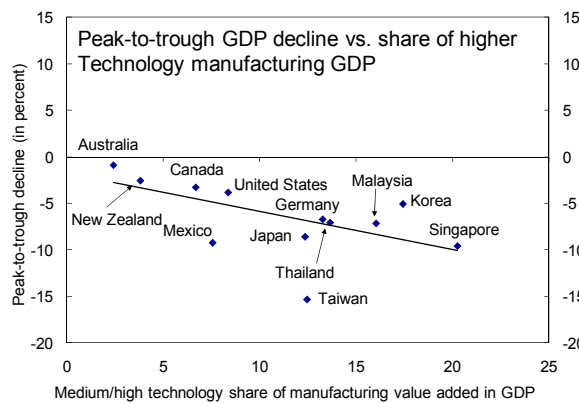
The economy began to emerge from recession in 2009 Q2...



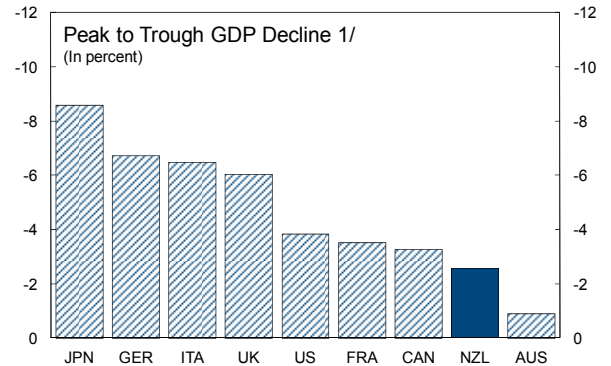
...helped by increasing ties with Australia and faster growing countries such as China...



...and a relatively low share of high-tech manufacturing in GDP.

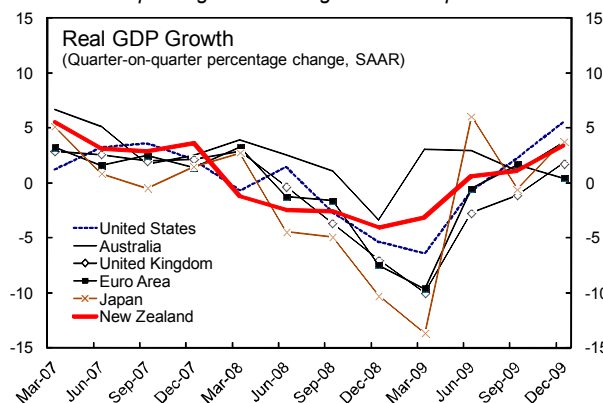


Consequently, the recession was not as severe as in many other countries.

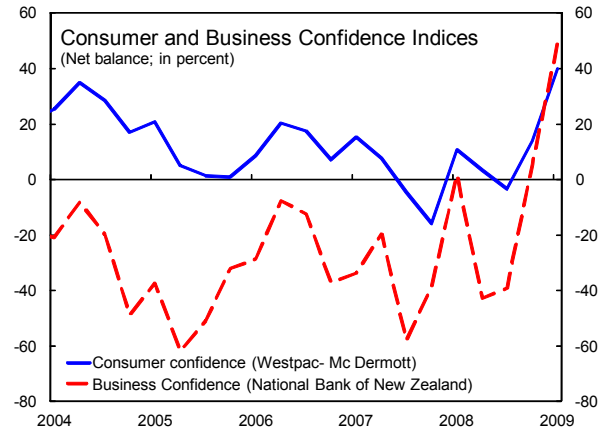


1/ For Japan, France and Germany, 2008Q1-09Q1. For Italy and United Kingdom, 2008Q1-09Q3. For United States, 2008Q2-09Q2. For Canada, 2008Q1-09Q2. For Australia, 2008Q3-08Q4. For New Zealand, 2007Q4-09Q1.

The recovery has been subdued so far, but near-term prospects are improving in line with global developments...

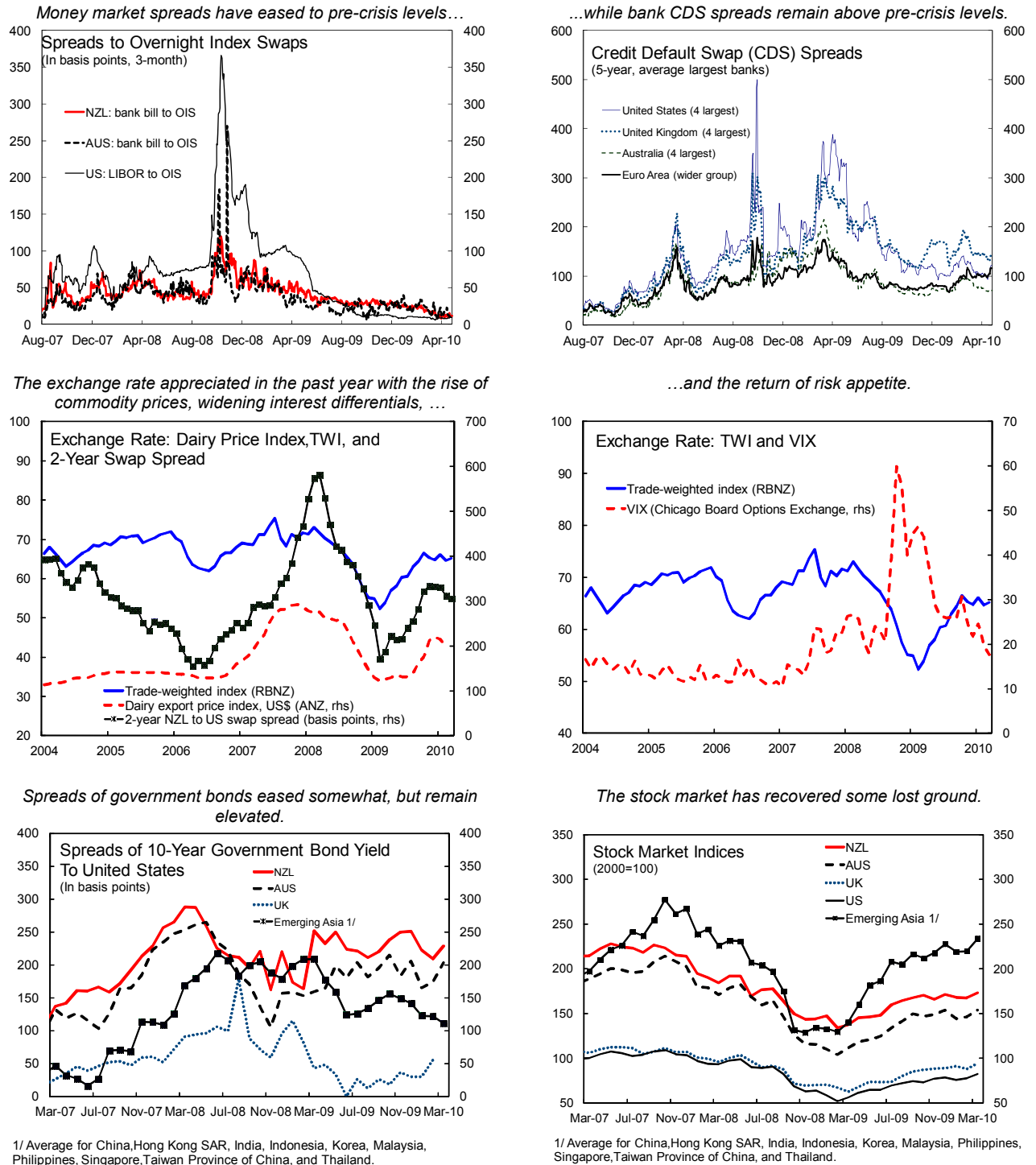


...and a rebound in confidence.



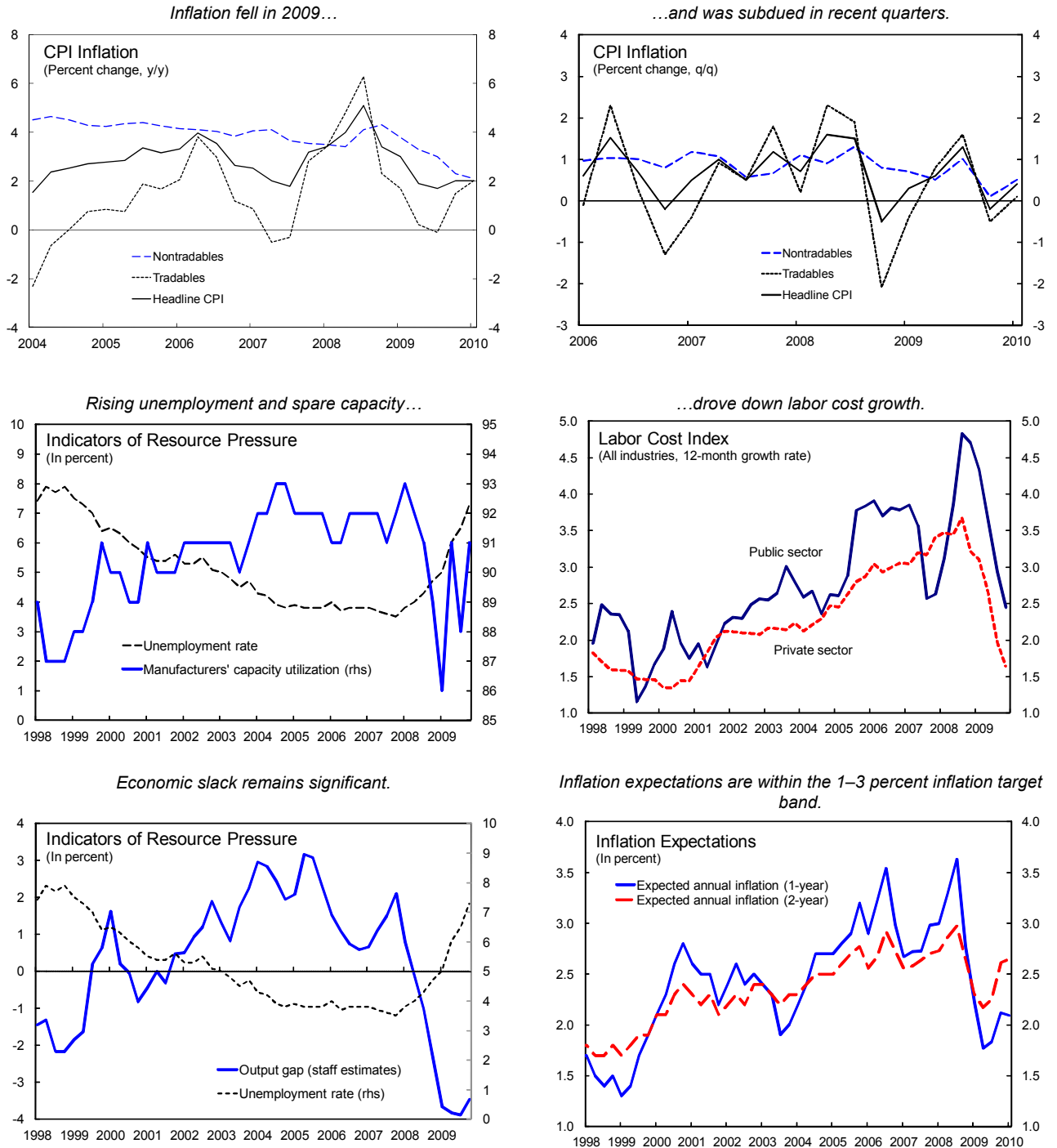
Sources: Statistics New Zealand; Reserve Bank of New Zealand; UNIDO database; Haver Analytics database; World Economic Outlook; and Fund staff estimates.

Figure 2. New Zealand: Financial Markets



Sources: Bloomberg; Haver Analytics database; International Financial Statistics database; APDCORE database; and Fund staff estimates.

Figure 3. New Zealand: Inflation



Sources: Reserve Bank of New Zealand; Statistics New Zealand; New Zealand Institute of Economic Research; Bloomberg; International Financial Statistics database.

7. **As the economic outlook weakened, the RBNZ cut its policy rate by 575 basis points from mid-2008 to early 2009 and then kept it at a historical low of 2½ percent** (Figure 4). Unlike some other advanced economies, the transmission of monetary policy remained effective, and the aggressive cuts in the policy rate were largely, but not fully, reflected in lower lending rates, which supported domestic demand.

8. **A sizable easing of fiscal policy also helped support activity.** The fiscal position was strong before the crisis hit, with a string of surpluses reducing net public debt to 6 percent of GDP by mid-2008 (Table 2). This enabled the authorities to deliver a large fiscal stimulus, equivalent to almost 6 percent of GDP spread over the two years to June 2010 (Figure 5).

9. **Banks remain sound but faced some funding difficulties during the crisis.** Four large Australian-owned banks dominate the financial sector and suffered an increase in nonperforming loans to 1½ percent of total loans, though still low by advanced country standards (Figure 6). They increased provisioning and raised additional capital from their parents and through retained earnings. Although the Australian parent banks weathered the crisis well, their New Zealand subsidiaries faced some difficulties rolling over their sizable short-term funding when international wholesale markets were severely impaired after the collapse of Lehmann Brothers. In response, the government introduced a wholesale funding guarantee that helped banks obtain term funding of about \$NZ 10 billion until they were able to access the market directly late last year.

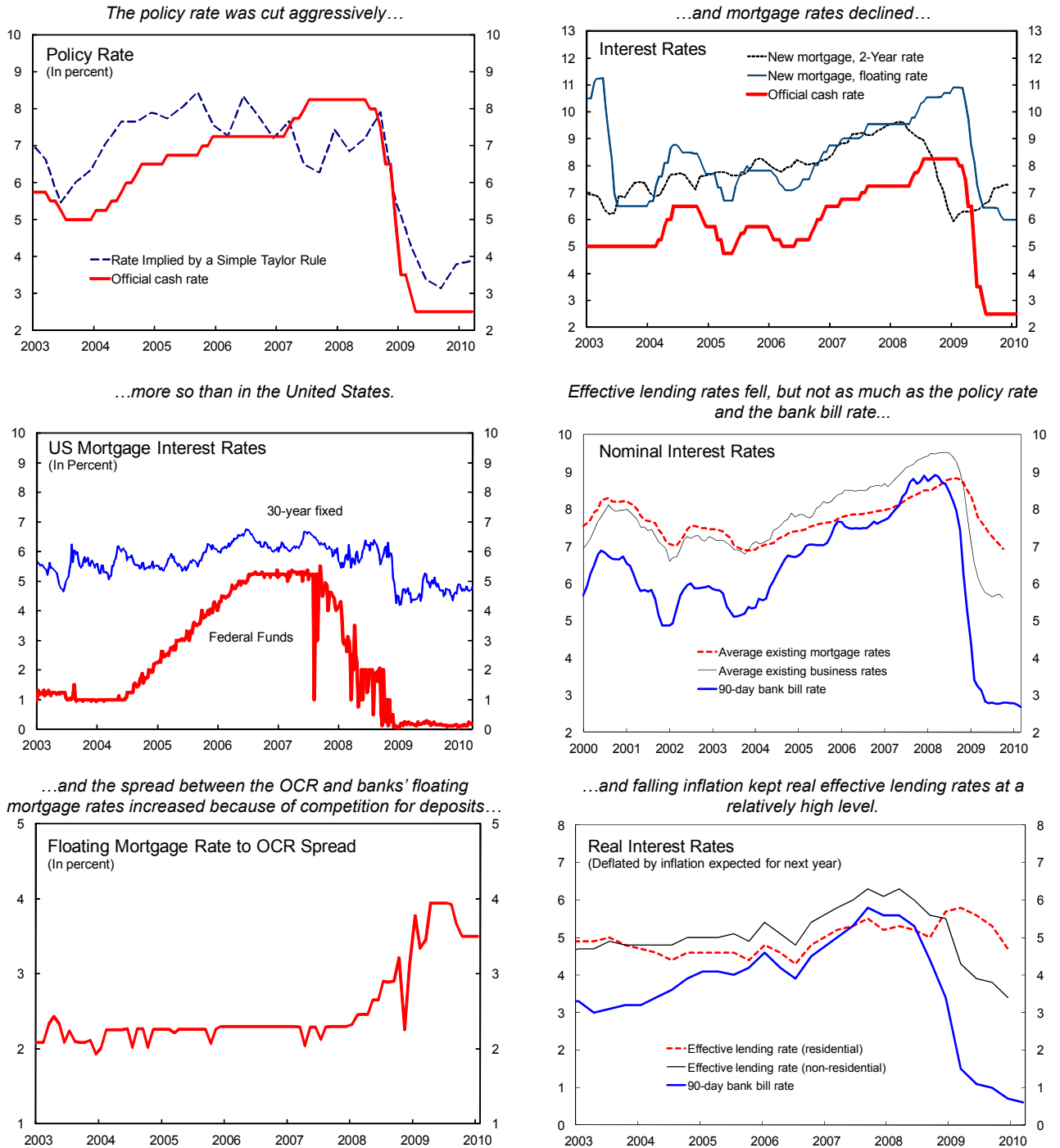
10. **The current account deficit narrowed sharply in 2009 to 3 percent of GDP, as both trade and income balances improved** (Figure 7, Table 3). While imports dropped sharply due to the recession, primary exports benefited from fast growing Asia markets and manufacturing and service receipts were helped by robust Australian demand and a depreciation of the \$NZ/\$A rate. In addition, lower interest and profit payments reduced the income deficit.

III. OUTLOOK AND RISKS

11. **In the near-term, a gradual economic recovery is expected.** Accommodative fiscal and monetary policies continue to support domestic demand and real GDP is projected to expand by about 3 percent in 2010 and 2011. The unemployment rate is forecast to lag the recovery and peak at 7½ percent in 2010.

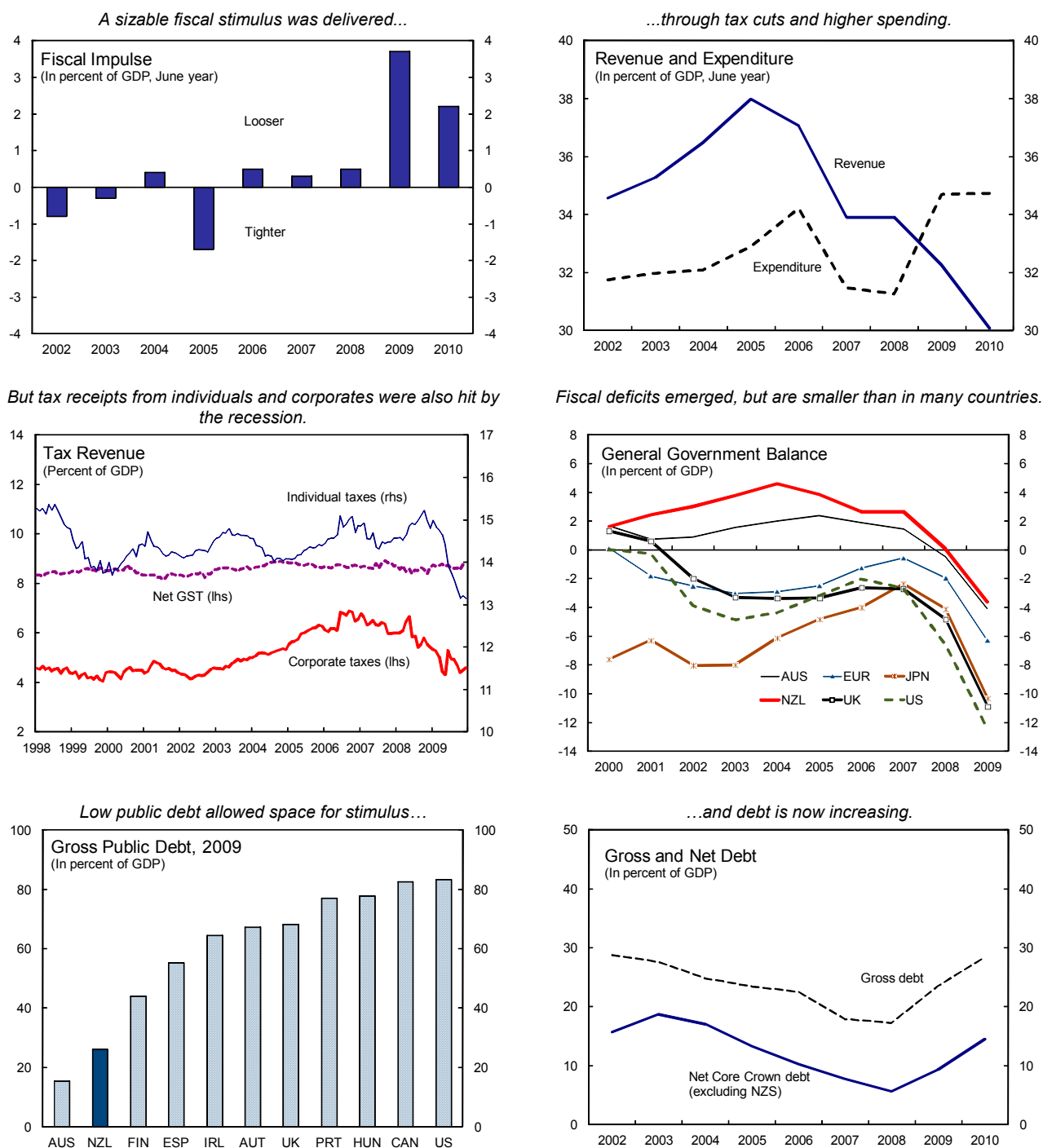
12. **Over the medium term, growth is projected to fall back to staff's estimate of potential of 2½ percent** (Table 4). High household debt and an expected increase in the cost of capital as a result of the global crisis are likely to weigh on the growth of private consumption and investment. Under the baseline assumption of a constant real effective exchange rate (REER), the contribution of net exports to growth will remain muted. The income deficit is expected to worsen as interest rates and profits rise, leading to a widening of the current account deficit.

Figure 4. New Zealand: Monetary Stimulus



Sources: Reserve Bank of New Zealand; Statistics New Zealand; Bloomberg; International Financial Statistics database.

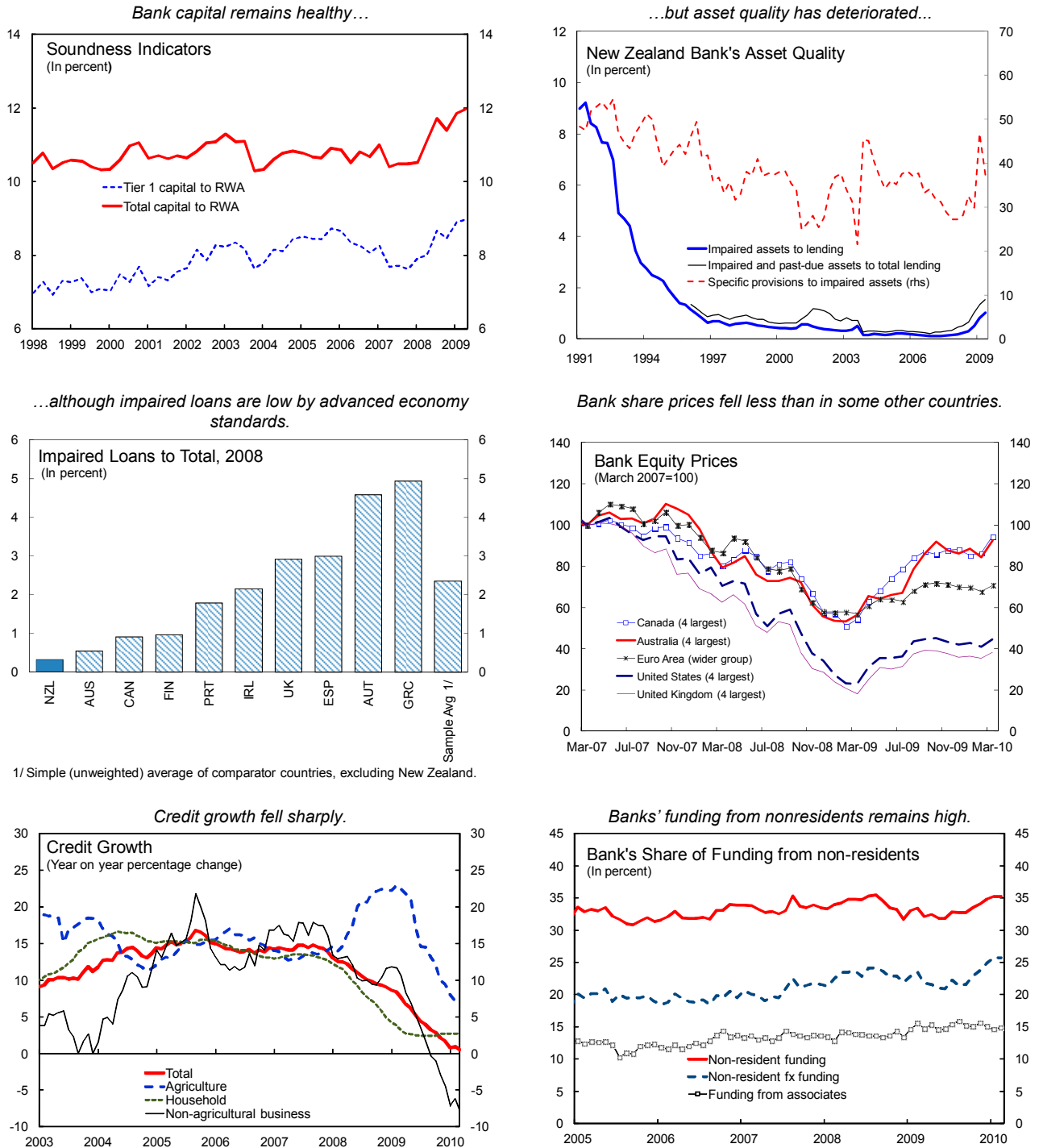
Figure 5. New Zealand: Fiscal Stimulus



Note: Fiscal years ending June 30.

Sources: The New Zealand Treasury; SNZ; World Economic Outlook; and Fund staff calculations and projections.

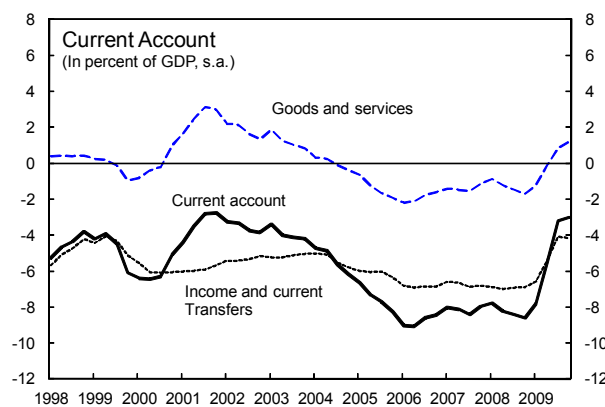
Figure 6. New Zealand: Domestic Banks



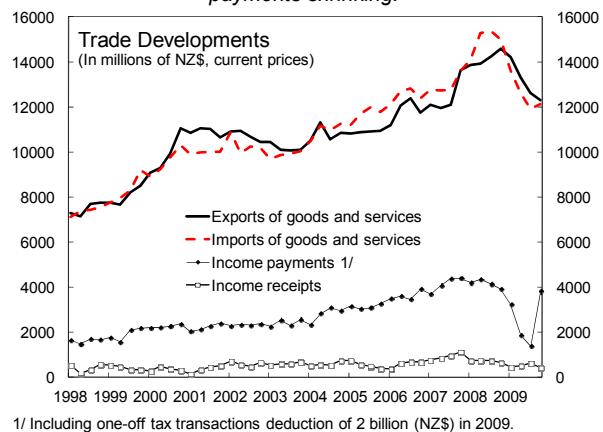
Sources: Reserve Bank of New Zealand; Bankscope; APRA; Haver Analytics database; and Fund staff estimates.

Figure 7. New Zealand: External Developments

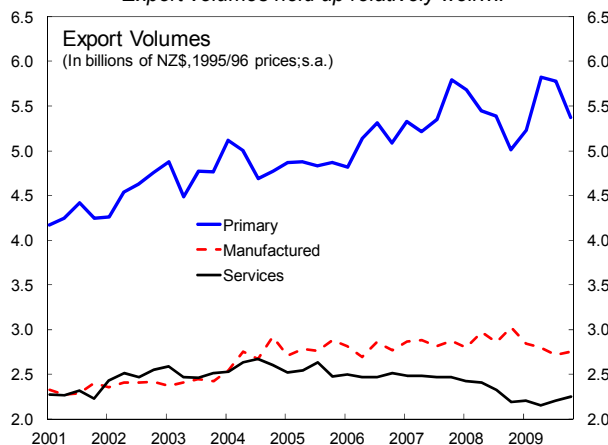
The current account deficit narrowed considerably in 2009...



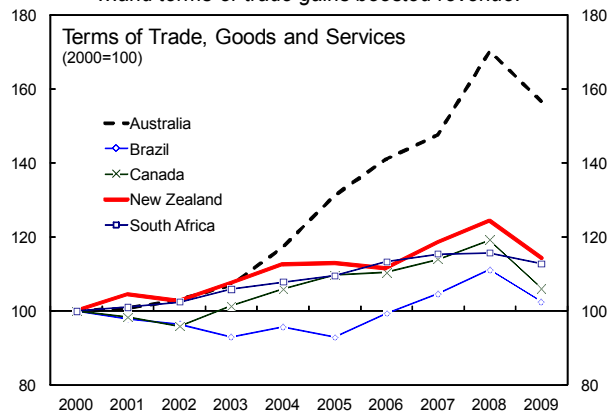
...with the trade balance shifting to surplus and income payments shrinking.



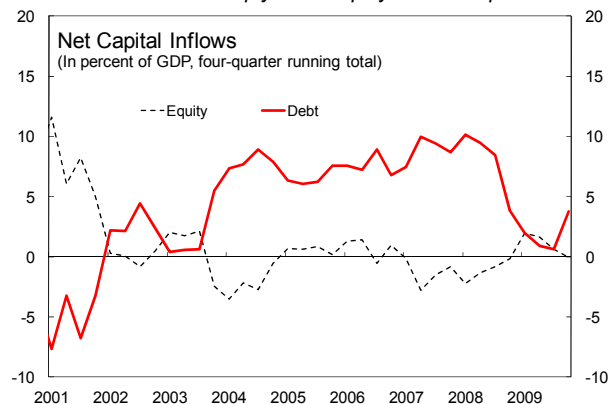
Export volumes held up relatively well...



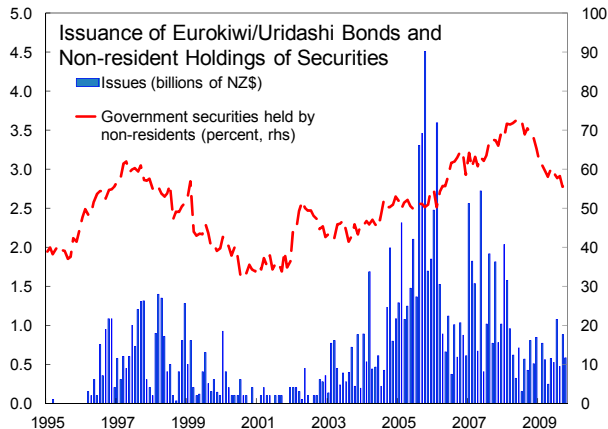
...and terms-of-trade gains boosted revenue.



Debt inflows fell sharply while equity inflows improved...



...as uridashi issuance fell.



Sources: Reserve Bank of New Zealand; SNZ; Haver Analytics database; World Economic Outlook; International Financial Statistics database; and Fund staff estimates.

13. **On the external front, risks are tilted to the downside as global activity remains dependent on highly accommodative macroeconomic policies.** The global recovery could stall and Chinese demand drop sharply, with negative spillovers for commodity prices. In addition, risk premiums could rise further for countries with high external debt, such as New Zealand, thereby constraining growth. However, an increase in global risk appetite is also possible, which may lead to a further appreciation of the exchange rate, making it difficult to rebalance growth toward the tradables sector.

14. **On the domestic front, a stronger-than-expected recovery may force an earlier tightening in monetary policy, putting upward pressure on the exchange rate.** However, faster-than-expected deleveraging by households and businesses may slow the recovery.

IV. POLICY DISCUSSIONS

15. Discussions focused on the macroeconomic policy mix needed to rebalance the economy toward the tradable sector and increase saving to address the vulnerabilities associated with high household and external debt.

A. Exit from Fiscal Stimulus

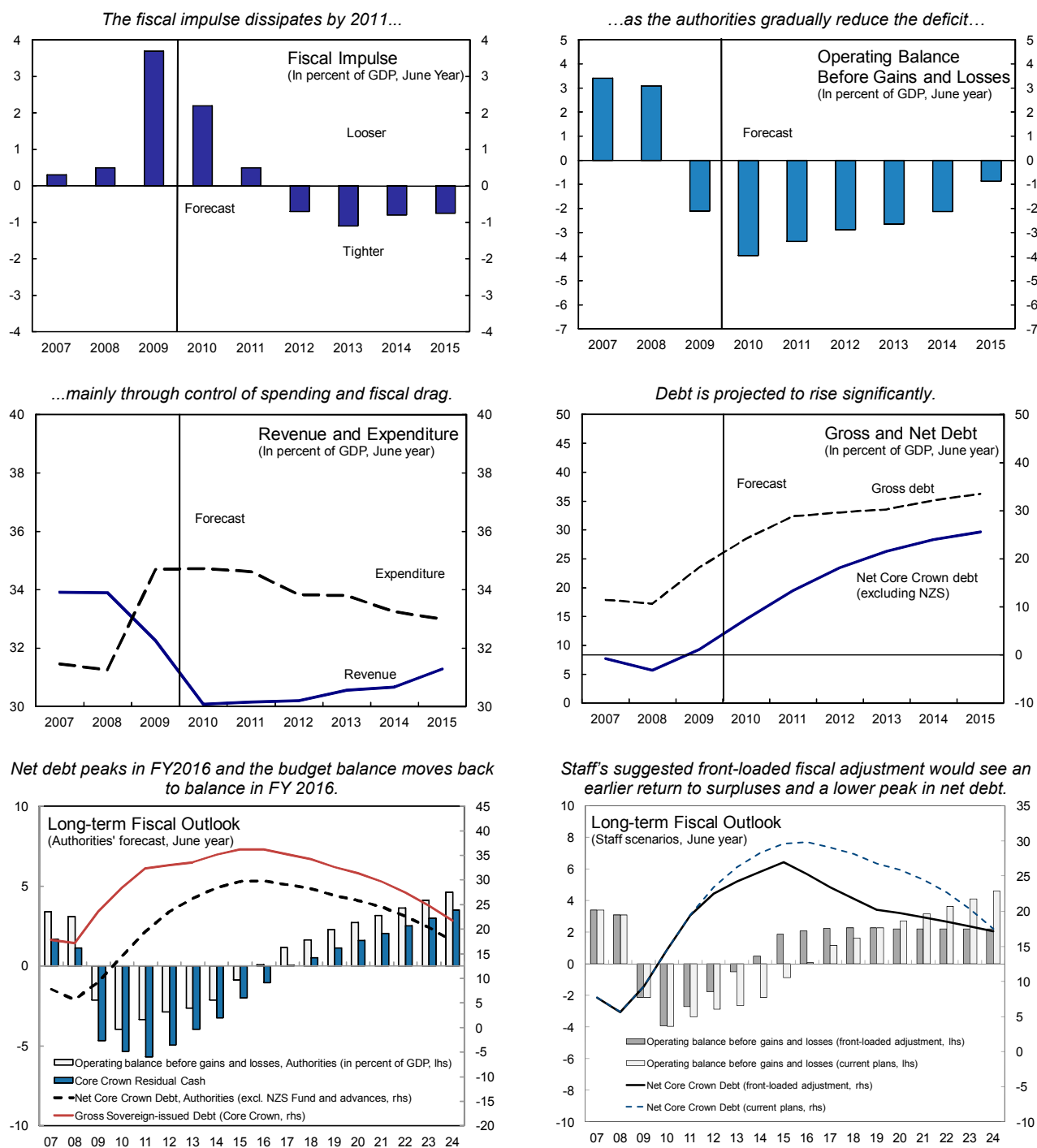
16. **The sizable fiscal easing in the past two years helped cushion the impact of the crisis, but worsened the medium-term fiscal outlook.** Income tax cuts and many of the spending initiatives were permanent and revenue projections have been revised down. As a result, budget deficits of about 2–4 percent of GDP on an accrual basis (operating balance before gains and losses) and 3–6 percent of GDP on a cash basis are projected over the next 4–5 years.¹

17. **Staff supported the fiscal stimulus through June 2010 and the government's long-term net public debt target of 20 percent of GDP.** The large stimulus helped buffer the economy from the impact of the crisis while the commitment to contain the long-term increase in debt should ensure fiscal sustainability.

18. **The government plans to reduce budget deficits gradually through expenditure restraint and fiscal drag, with a return to balance by 2016.** A fiscal impulse of more than 2 percent of GDP is being implemented for 2009/10, with a further small impulse of ½ percent of GDP planned for 2010/11 (Figure 8). On this basis, the authorities expect that net core crown debt would peak at 30 percent of GDP by 2016 and fall below 20 percent of GDP by 2024. While the stimulus was larger than in most advanced economies, the increase in public debt is expected to be smaller than average, as New Zealand had budget surpluses prior to the crisis (Figure 9).

¹ Cash deficits are larger partly because of a planned increase in capital spending, that is greater than depreciation included in the accrual measure of the deficit.

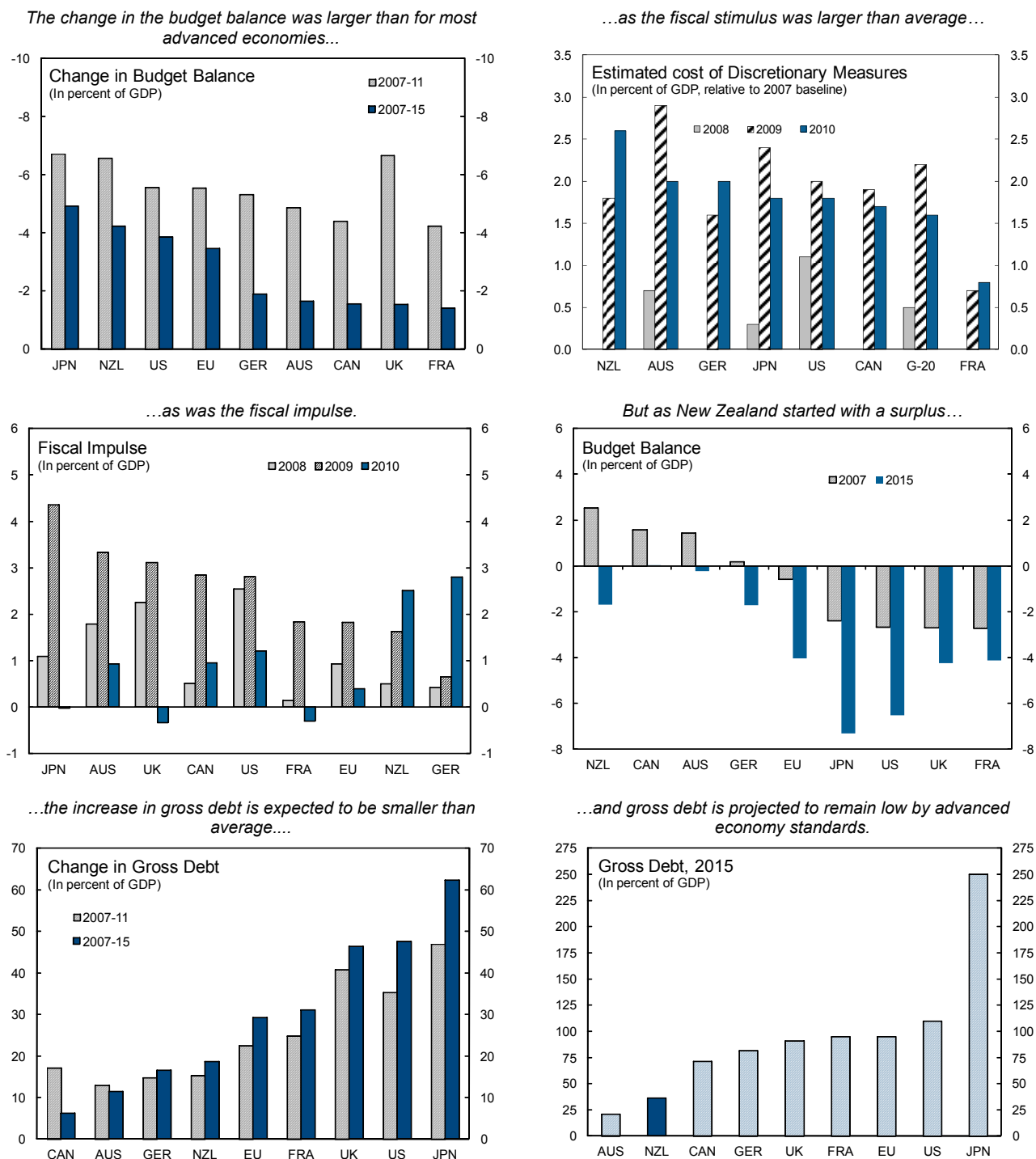
Figure 8. New Zealand: Exit from Fiscal Stimulus



Note: Fiscal years ending June 30.

Sources: The New Zealand Treasury; Statistics New Zealand; and Fund staff calculations and projections.

Figure 9. New Zealand: Comparison of Fiscal Outlook



Note: Fiscal years ending June 30.

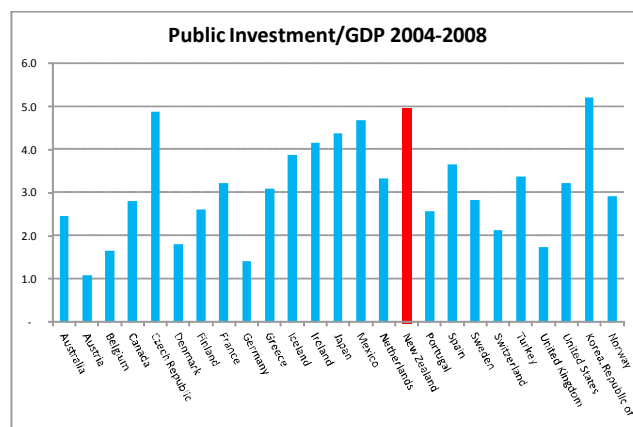
Sources: The New Zealand Treasury; SNZ; World Economic Outlook; and Fund staff calculations and projections.

19. **Nevertheless, staff advised further spending restraint to return to surpluses earlier than planned.** Faster consolidation over the next 3–4 years would take pressure off monetary policy and the exchange rate, thereby helping rebalance the economy toward the tradables sector and contain the current account deficit. The mission recommended returning the budget to surplus by 2014, unless the downside risks to growth materialize, based on the following:

- Upfront adjustment would create fiscal space as insurance against future shocks that may arise in coming years. A key lesson from the global financial crises is the desirability of fiscal space to run larger deficits when needed without raising market concerns about fiscal sustainability.
- Although public debt is projected to remain low by advanced country standards, New Zealand's large gross external debt (130 percent of GDP) calls for greater fiscal prudence. If global interest rates rise because of large sovereign and bank borrowing in advanced countries, low public debt would help contain the rise in New Zealand's cost of capital (see forthcoming working paper).
- Staff analysis with the Global Integrated Monetary and Fiscal (GIMF) model shows that faster fiscal consolidation would lead to a depreciation of the exchange rate, a smaller sovereign risk premium, and a lower current account deficit (see selected issues paper).
- While the probability is extremely low, the government may need to take on more external debt should the banks once again have difficulties in global markets. This limits the extent to which public debt can be increased without hurting investor confidence.
- Finally, reaching a lower level of debt earlier than planned would put the budget in a stronger position to deal with the fiscal costs of ageing.

20. **Staff recommended that concrete measures to control spending be introduced and that any positive revenue surprises be saved.** Expenditure is projected to remain high at 33 percent of GDP by 2015 compared with 31 percent of GDP in 2008, mainly because of higher social spending. The staff noted scope to better target transfers to households, improve the efficiency of public service provision, and rationalize capital spending, which is high by advanced economy standards.

The introduction of spending caps may also provide useful discipline.



Government Transfers to Households (In percent of GDP)			
	2005	2009	2014
NZ Superannuation	4.0	4.3	4.7
Unemployment benefit	0.5	0.3	0.4
Family and in-work tax credit	0.6	1.5	1.3
Other benefits	3.4	3.3	3.4
Total benefit expenses	8.8	9.6	10.0
Student loans	0.3	0.7	0.4
Kiwi Saver subsidy	0.0	0.7	0.5
Total transfers to households	9.0	11.1	10.9
Source: New Zealand Treasury, HYEPU December 2009.			

21. **Tax reforms could help raise potential growth.** Shifting the tax burden from income to consumption—as suggested by the Tax Working Group established by government—would raise incentives to work and invest. In addition, reducing tax incentives to invest in rental properties may help improve the allocation of capital. Staff analysis, suggests that a 1 percent of GDP shift of taxes from capital and labor to the goods and services tax could raise the level of real GDP by almost 1 percent after 5–6 years.

22. **To address longer-term pressures on the budget, the mission advised early steps to contain growth in health care and pensions costs.** Measures could include improving the efficiency of health care spending, raising the pension eligibility age, and linking it to life expectancy.

B. Exit from Monetary Stimulus

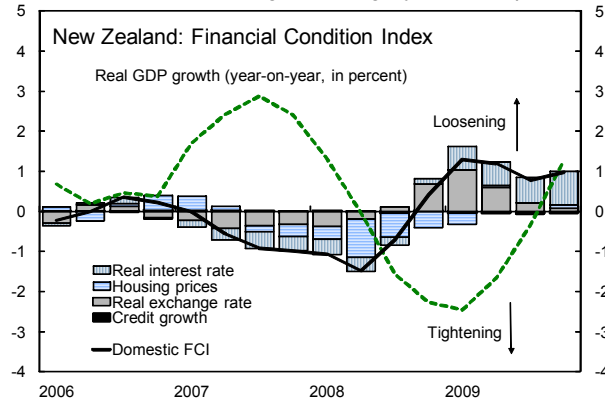
23. **The RBNZ announced last year that it would keep the policy rate on hold until mid-2010 and thereafter gradually return to a neutral rate.** Markets have priced in rate hikes of 150 basis points over the coming year. The authorities have started to unwind crisis-related measures by scaling back extraordinary liquidity support (Figure 10, Table 5).

24. **Staff supported the current accommodative monetary policy stance and the RBNZ's intention to gradually return to neutral rates once the recovery is well established.** Over the next few years, inflation is likely to stay within the RBNZ's 1–3 percent target, albeit toward the upper end of that range. Staff estimates that the output gap will not close before 2013. Inflation is also being limited by a tightening in monetary conditions over the past year with the appreciation of the currency, higher medium-term interest rates, and an increase in funding costs of banks, as they compete for retail deposits.

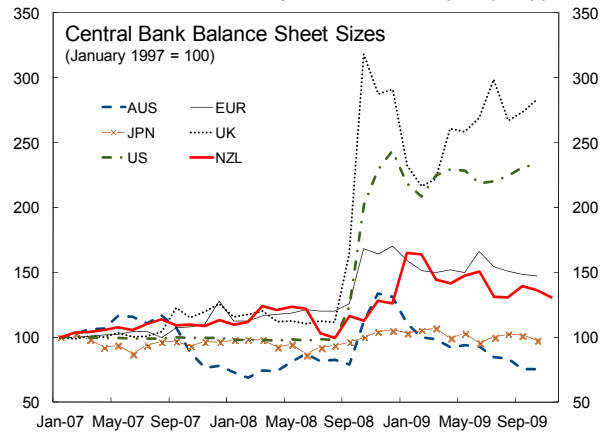
25. **The rising wedge between the policy rate and bank funding costs suggests that the neutral policy rate is likely to be lower than in the past.** Moreover, when the RBNZ begins to tighten, the transmission of the policy rate to mortgage rates should be relatively fast, as many households have refinanced mortgages at variable rates.

Figure 10. Financial Sector: Exit from Monetary Stimulus

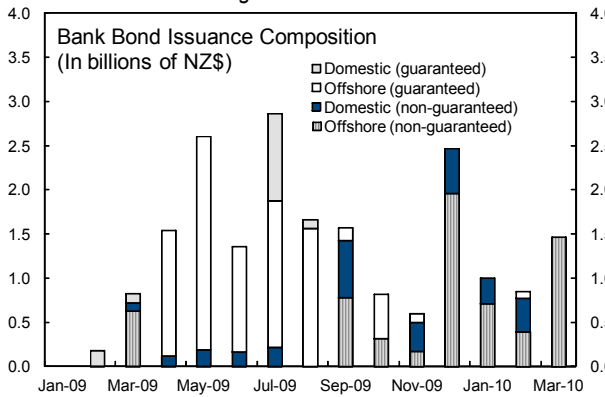
Financial conditions have tightened slightly in recent quarters...



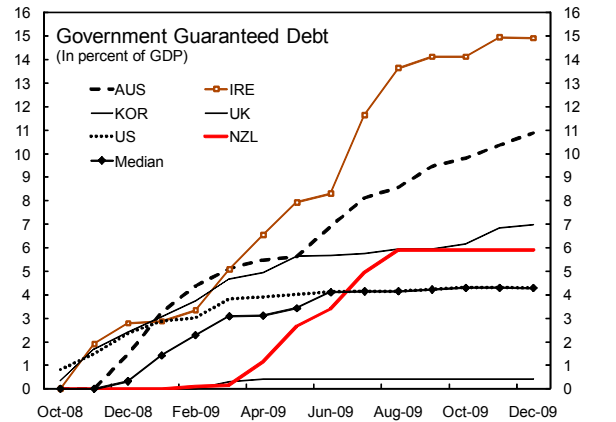
...and the Reserve Bank began to exit from liquidity support...



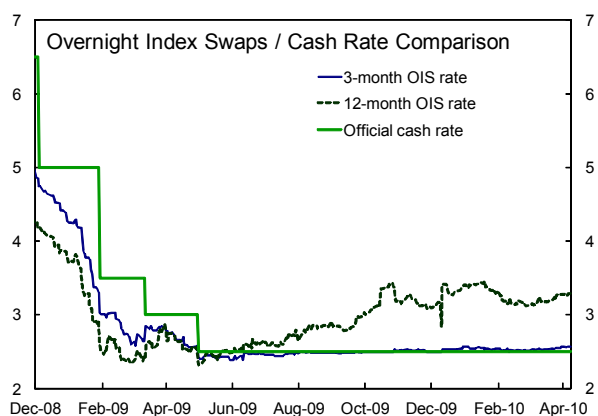
...and improved market conditions allowed banks to issue nonguaranteed bonds.



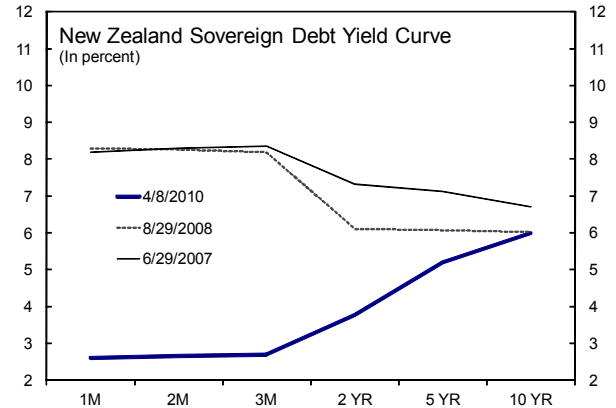
Appropriate pricing contained the size of debt guarantees.



Financial markets are pricing in an increase in the official cash rate,...



...which is also reflected in the yield curve.



Sources: Reserve Bank of New Zealand; Haver Analytics database; Bloomberg; World Economic Outlook.

26. **In a downside scenario, monetary policy still has room to be loosened.** Weaker-than-expected global growth and higher risk premia on New Zealand assets would spill over to the domestic economy through weaker commodity prices, growth, and inflation. In this scenario, the policy interest rate could be cut and any consequent weakening of the currency would ease financial conditions and cushion the impact on New Zealand.

27. **The inflation-targeting framework served New Zealand well during the global financial crisis.** The official cash rate (OCR) was high before the crisis, at 8¼ percent, because of monetary tightening in response to inflationary pressures in 2007/08 stemming from the housing boom. While the RBNZ does not directly target house prices, it takes account of the impact of changes in house prices on consumer spending. The framework was flexible enough to allow a substantial cut in the OCR to 2½ percent by early 2009. Importantly, the inflation target effectively anchored medium-term inflation expectations and was helpful in reducing the likelihood of deflation in the midst of the recession.

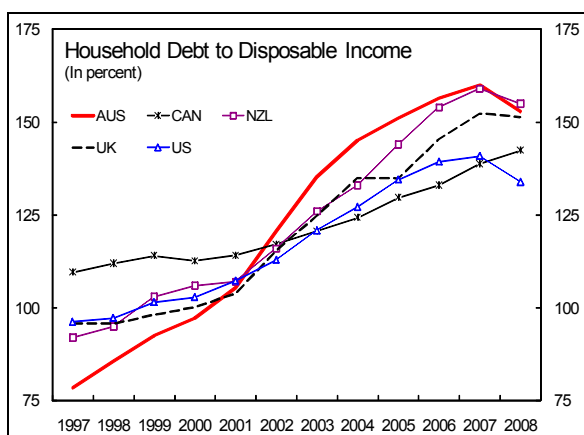
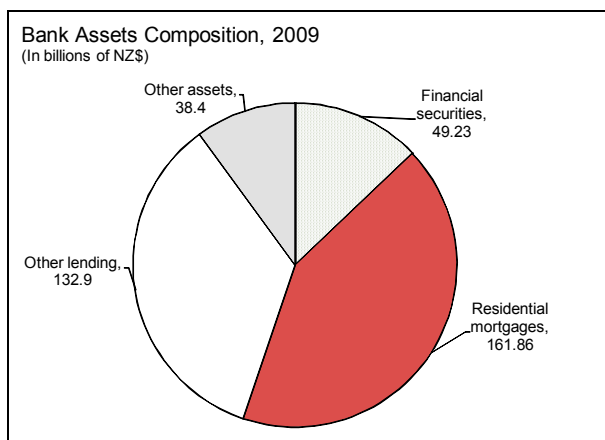
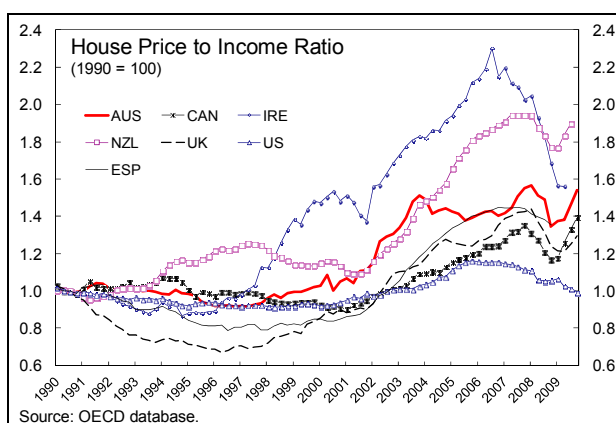
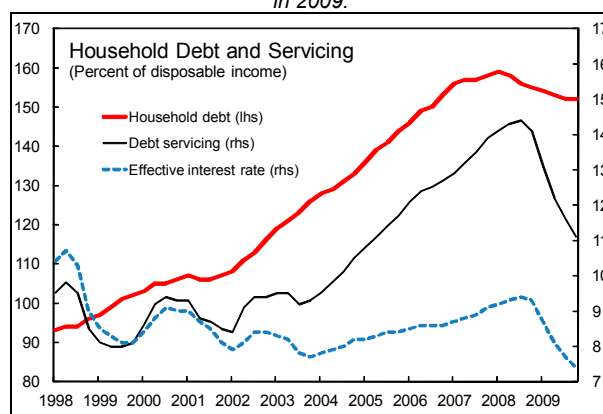
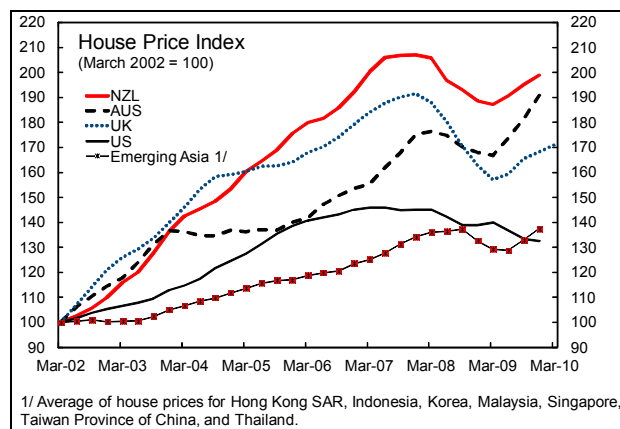
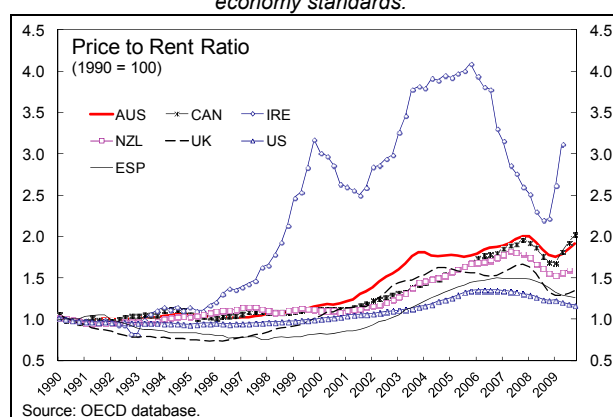
28. **Staff noted that the inflation target of “1–3 percent on average over the medium term” is appropriate and consistent with international best practice.** The government is not planning a revision to the target but there has been some debate in New Zealand recently on whether to raise the inflation target. In the staff's view, increasing the inflation target would provide no clear benefits and may entail a number of costs, including greater inflation uncertainty and reduced credibility of the authorities' commitment to price stability. In turn, this could lead to a higher cost of capital and lower potential growth given New Zealand's reliance on international capital markets to fund current account deficits and rollover sizable external debt.

C. Maintaining Financial Sector Stability

29. **The key domestic vulnerability is banks' exposure to household debt of just over 150 percent of disposable income** (Figure 11). However, this exposure proved to be relatively low risk in the recent recession. Factors mitigating the mortgage risks include the fall in mortgage rates, the absence of a sharp rise in unemployment, and only a 4 percent fall in house prices from the peak in 2007. Moreover, household debt has fallen from a peak of about 160 percent of disposable income in 2008. Nonetheless, risks remain. House prices are high relative to historical price-to-income ratios and debt-service burdens will rise with a return to neutral policy rates. In a downside scenario, a sharp decline in house prices and a jump in unemployment could lead to further deleveraging by households and an increase in banks' impaired assets. However, the risk to banks is mitigated by their limited exposure to high risk mortgages.² Other vulnerabilities include banks' substantial exposure to dairy farming (where world market prices are volatile), commercial property, and small and medium-sized enterprises.

² Less than 5 percent of owner-occupied mortgages had loan-to-value rates greater than 80 percent and debt service ratios greater than 30 percent. Moreover, previous staff analysis (WP/09/224) suggests that bank capital would be resilient to a sharp increase in mortgage defaults.

Figure 11. New Zealand: Household Vulnerabilities

Household debt is relatively high.*Banks are exposed to households.**House prices remain high relative to income....**The debt servicing burden rose sharply since 2002, but eased in 2009.**House prices fell from the peak in 2007 but are recovering.**...and the house price-to-rent ratio is also high by advanced economy standards.*

Sources: Reserve Bank of New Zealand; SNZ; Haver; Analytics Database; International Financial Statistics Database.

30. **A conservative approach to bank regulation and supervision helped banks weather the crisis.** As a result, banks had relatively low leverage and high capital adequacy, with Tier 1 ratios of 7–8 percent before the crisis hit. In implementing the Basel II framework, the authorities required banks to hold relatively high capital. For example, a 20 percent loss-given-default floor was adopted for residential mortgages, higher than the Basel II 10 percent floor (text table). Staff welcomed the Reserve Bank's current review of capital adequacy associated with agricultural loans.

Risk Weights for Banks' Internal Models Under the Basel II Capital Framework			
	New Zealand		Australia
	Initial bank position	Final position after RBNZ actions	
Housing loans:			
Loss given default 1/	10% and not sensitive to loan-to-value (LVR)	Just over 20% and sensitive to LVR	20% minimum
Long run portfolio probability of default	about 0.5%	1.25% minimum	0.8%
Average risk weight	10%	30%	15-20%
Rural loans:			
Average risk weight	50%	System average of 80-90%	...
Credit cards:			
Average risk weight	about 30%	80%	30-50%
Source: Reserve Bank of New Zealand			
1/ The Basel II framework specifies a minimum value of 10 percent for loss given default.			

31. **Staff supported closer collaboration with Australian authorities on regular stress tests and crisis management.** The tests use more extreme scenarios than in past exercises and staff advised that capital and provisioning be strengthened if these tests suggest the need for additional buffers. Staff welcomed the crisis management toolkit, developed with the Australian authorities, and the intention to undertake a Trans-Tasman crisis management exercise in 2011.

32. **The authorities intend to investigate the costs and benefits of potential macro-prudential policy tools, particularly some of the proposals coming out of the Basel Committee on Banking Supervision.** The authorities are considering the introduction of time varying capital overlays under Pillar 2 and time varying liquidity requirements. Staff noted that macro-prudential measures may be useful to manage risks arising from excessive bank credit growth during upswings.

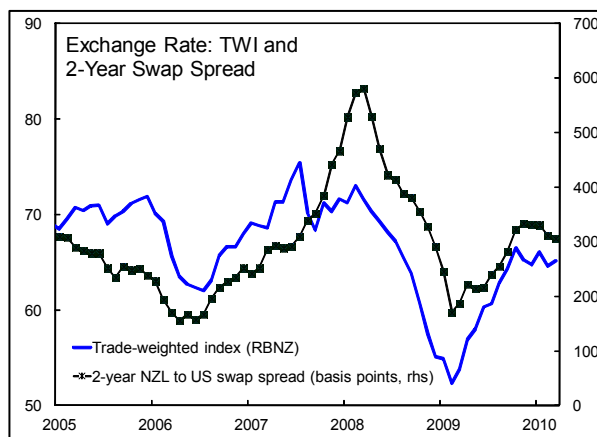
33. **Staff welcomed the announced closure of the wholesale government guarantee scheme by end-April 2010, given that funding conditions have improved.** The authorities are considering the costs and benefits of introducing a permanent retail deposit insurance scheme when the current government guarantee expires at end 2011. The RBNZ is also strengthening the nonbank prudential regulatory regime, including mandatory credit ratings from March 2010 and capital requirements.

D. Addressing External Vulnerability and Increasing Saving

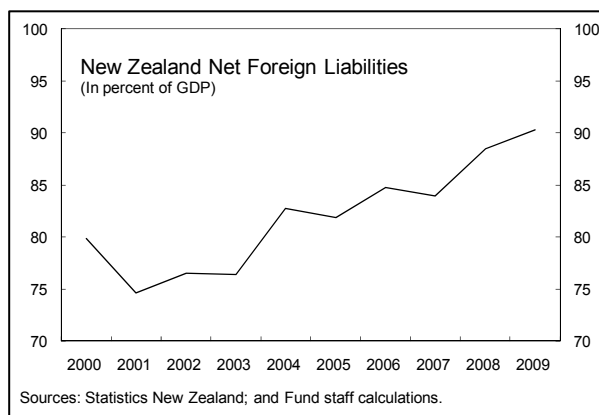
34. **The free-floating exchange rate regime remains appropriate, as it enables an independent monetary policy and provides a useful buffer against shocks.** Prior to the crisis, the RBNZ was able to increase the policy rate to contain inflationary pressures fuelled

by the housing boom. Moreover, the flexible exchange rate has moved with world commodity prices and thereby reduced the volatility of farm incomes in New Zealand.

35. **While there is uncertainty, staff estimates suggest the currency is overvalued by 10–25 percent** (Box 1). The overvaluation appears to be driven by a widening in interest differentials in the past year, given market expectations of an earlier tightening in monetary policy in New Zealand than in the United States (text figure). Therefore, part of the overvaluation may be temporary and the exchange rate may depreciate as the interest rate differential narrows with eventual tightening by the U.S. Federal Reserve.



36. **Assuming the exchange rate remains at present levels, staff projects the current account deficit to widen to over 8 percent of GDP by 2015.** The deficit may not widen as much if the present overvaluation of the real effective exchange rate proves to be temporary. But even at staff's estimated saving-investment norm (corresponding to a current account deficit of almost 5 percent of GDP), New Zealand's net foreign liabilities would remain high at 90 percent of GDP. A current account deficit of about 3 percent of GDP would be needed over the next 15 years to return net foreign liabilities to 75 percent of GDP, around the 2001–03 level, before the recent rise in external and household debt.



37. **Low household saving is a fundamental factor behind large current account deficits and rising external debt in recent years** (Box 2). Household saving fell to negative 10 percent of disposable income in 2008, although the actual rate may be higher than that given statistical problems. The current government is considering shifting the tax burden away from income to consumption to encourage saving. Staff simulations with the Fund's GIMF model illustrate that a 1 percent of GDP revenue-neutral shift to consumption taxation would permanently raise national saving to GDP ratio by about 0.3 percentage points.

BOX 1. NEW ZEALAND: EQUILIBRIUM REAL EFFECTIVE EXCHANGE RATE

Staff estimates suggest that the New Zealand dollar is overvalued by 10–25 percent. These estimates are based on the macroeconomic balance (MB), the equilibrium real exchange rate (ERER), and the external sustainability approach (ES).

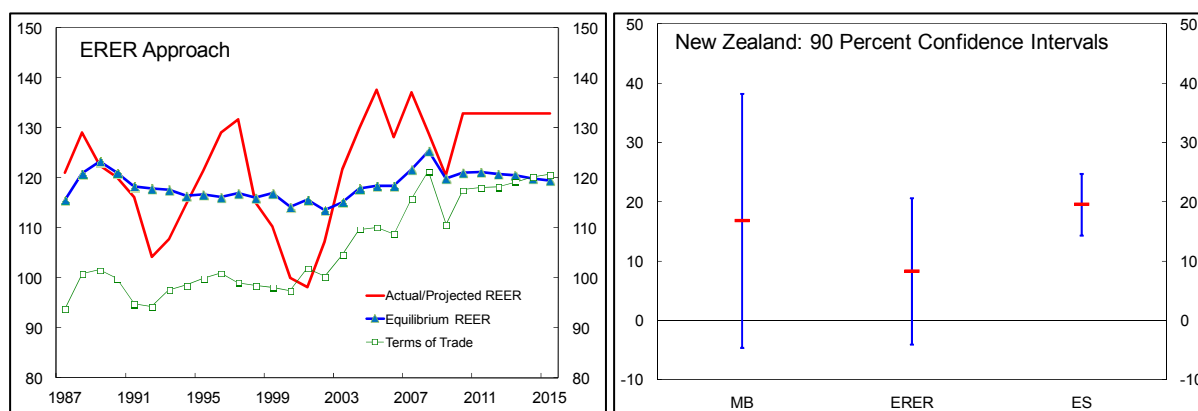
The MB estimates the current account deficit norm at 4.7 percent of GDP. To close the gap between this norm and staff's projected medium-term current account deficit of 8.2 percent of GDP, the real effective exchange rate (REER) would need to depreciate by 17 percent.

Exchange Rate Assessment: Baseline Results ¹			
	CA/GDP		REER
	Norm	Projection ²	Overvaluation
MB Approach: ³			
Desk	-4.7	-8.2	16.8
ERER Approach: ⁴			
Desk	8.3
ES Approach: ⁵			
NFL constant at 90 percent of GDP	-4.1	-8.2	19.6
NFL decreasing from 90 to 75 percent of GDP by 2025	-3.0	-8.2	25.3
Source: Fund staff estimates.			
1/ All results are expressed in percent. Detailed analysis is presented in the IMF Working Paper (WP/09/07).			
2/ Staff projection of the underlying CA/GDP in 2015.			
3/ Based on a semi-elasticity of the CA/GDP with respect to the REER of -0.21.			
4/ Overvaluation is assessed relative to the latest month of March 2010.			
5/ Based on nominal GDP growth rate of about 5 percent.			

The ERER estimates suggest a smaller overvaluation. This approach explains the REER with terms-of-trade, relative productivity, and relative government consumption. It suggests an overvaluation of almost 10 percent, assuming some strengthening of the terms of trade over the medium-term.

The ES approach implies a larger overvaluation. To stabilize foreign liabilities (NFL) at their end-2009 level of 90 percent of GDP, the REER would need to depreciate by 20 percent. However, to reduce NFL to a more sustainable level of 75 percent of GDP over fifteen years, the REER would need to depreciate by 25 percent.

The estimates are subject to considerable uncertainty, as shown by the wide range of the confidence intervals.



38. **High short-term external debt remains a key vulnerability.** Gross external debt exceeded 130 percent of GDP in 2009, about 44 percent of which is short-term, mostly held by banks (Figure 12). While short-term external debt has fallen and market conditions have improved in the past year, rollover risks remain as short-term external debt is high by advanced economy standards.

New Zealand: External Debt			
(End of Period)	Jun-08	Dec-08	Dec-09
Gross external debt (Expressed in NZ\$ billions)	227	250	243
Of which: Short term	117	119	108
Gross external debt (Expressed in US\$ billions)	173	144	176
Of which: Short-term	89	69	78
Gross external debt to GDP	124%	136%	131%
Of which: Short term to GDP	64%	65%	58%
Short-term to gross external debt	51%	48%	44%
Memorandum item: US\$/NZ\$ (end of period)	0.76	0.58	0.72
Sources: Statistics New Zealand and Fund staff estimates.			

39. **Staff welcomed the introduction by the RBNZ of a prudential liquidity policy, including a core funding ratio that should reduce banks'**

reliance on short-term external funding (Box 3). Planned increases in the core funding ratio over the next two years will further reduce this vulnerability and could, if needed, be increased more than planned to reduce short-term external debt.

40. **Vulnerabilities related to external debt would also be reduced by structural reforms to raise productivity and labor force participation, thereby lifting export capacity.** The government is considering a number of reforms with this aim, including tax and benefit reforms, streamlining regulation, and establishing a Productivity Commission.

E. Authorities' Views on Staff Advice³

41. **The authorities were more upbeat than staff on the near-term economic outlook.** They project real GDP growth to pick up slightly quicker in the near term and reach almost 3½ percent in March year 2012, about ¼ percent stronger than staff projections. While they acknowledged the risks raised by staff, they were more optimistic about the near-term upside risks, given the economy's growing links to Asia and Australia.

³ Prepared in co-operation with the authorities.

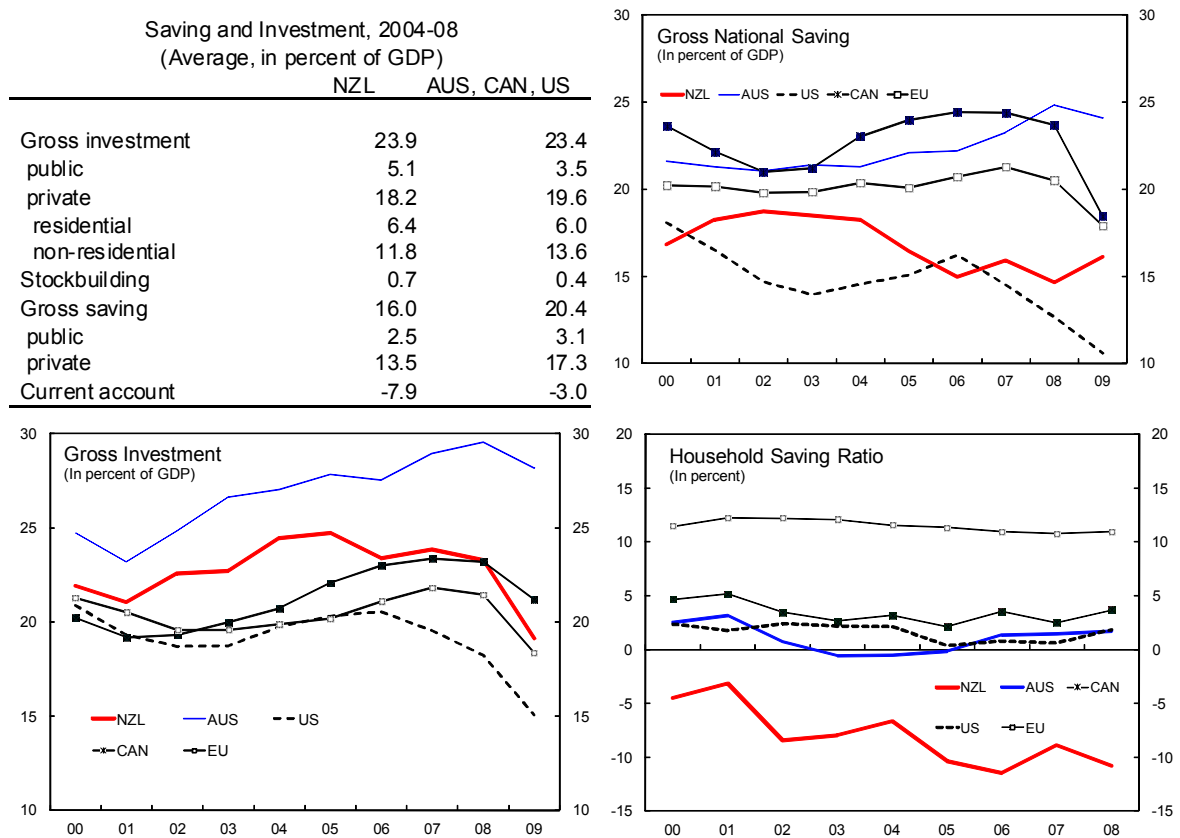
BOX 2: NEW ZEALAND: SAVING AND INVESTMENT

A fundamental factor behind high current account deficits in New Zealand is low national saving. Gross national saving was about 4 percent of GDP lower than the average for Australia, Canada and the U.S. for 2004–08, while gross investment was only ½ percent of GDP higher. Private saving, especially household saving, appears low by advanced country standards. Experimental data published by Statistics New Zealand suggest that household saving fell from negative 5 percent of disposable income in 2000/01 to negative 10 percent of disposable income in 2008, although this is likely to be an underestimate due to deficiencies in sector statistics.

Previous staff analysis has shown that the long-term behavior of households' saving in New Zealand is explained by wealth, the pension and income support from government, the fiscal balance, and ease of access to credit (*IMF Country Report No. 03/122* (Chapter 2)). With lower house prices, tighter credit conditions and fiscal deficits, household saving is expected to rise, relative to 2008 levels.

To raise household saving, the previous government introduced in 2007 an opt-out savings scheme (KiwiSaver). Incentives to participate include a \$NZ 1,000 kick start payment from the government and tax incentives. By September 2009, more than half of the labor force had joined the scheme. Despite KiwiSaver's success in terms of participation, it remains to be seen whether it will have a lasting impact on aggregate household saving.

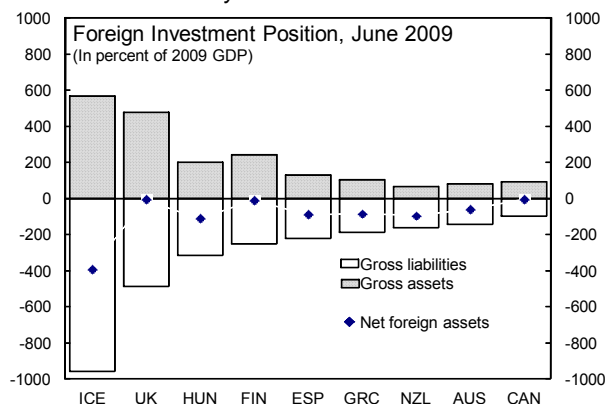
While gross investment was comparable with other countries, public investment was high, and private non-residential investment was low. From 2004–08 public investment was 1½ percent of GDP higher than in Australia, Canada, and the U.S. However, there is uncertainty about whether public investment is materially higher in New Zealand, given the use of public-private partnerships in other countries.



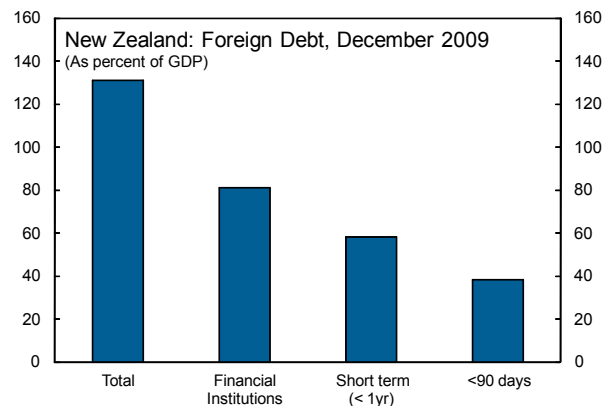
Sources: SNZ; World Economic Outlook; and Fund staff calculations.

Figure 12. New Zealand: External Vulnerabilities

While net foreign liabilities are high, gross liabilities are lower than in many other advanced economies.



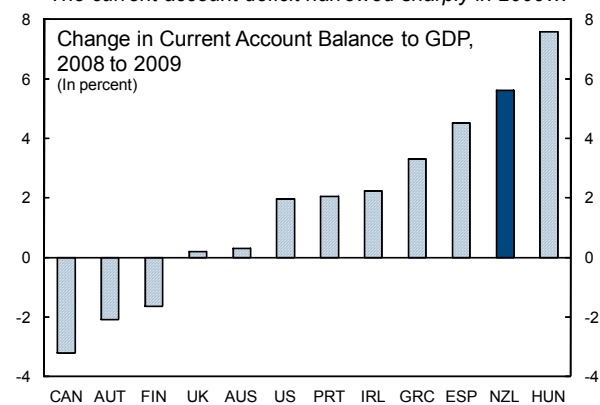
Most foreign debt is with banks and is short term.



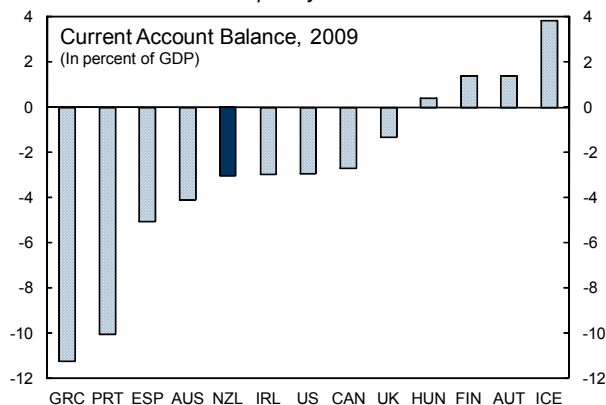
Short-term debt is high by advanced economy standards.



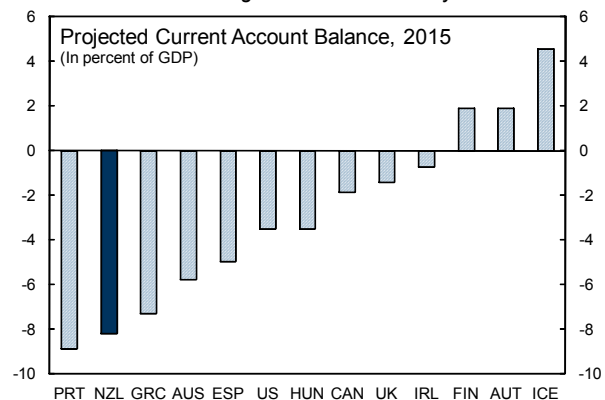
The current account deficit narrowed sharply in 2009...



...to about 2 percent of GDP because of cyclical and other temporary factors.



But staff project the deficit to widen over the medium term, worsening external vulnerability.



Sources: Reserve Bank of New Zealand; SNZ; Haver; Analytics database; World Economic Outlook database; International Financial Statistics database; and Fund staff estimates.

BOX 3. NEW ZEALAND: NEW LIQUIDITY POLICY

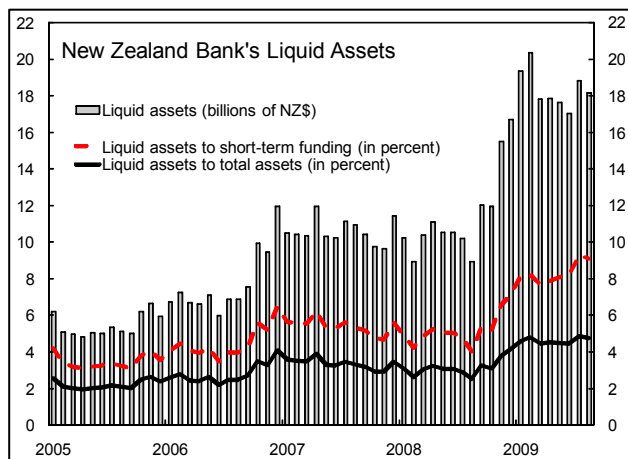
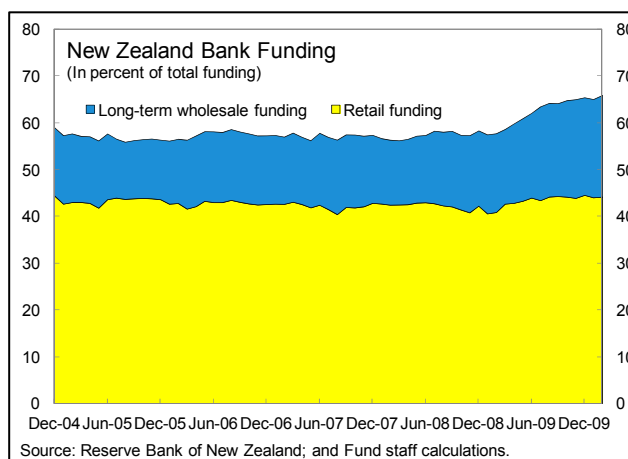
The global financial crisis highlighted the need for banks to have adequate liquidity to safeguard financial stability. Given New Zealand banks' significant use of short-term offshore funding, the RBNZ moved ahead of other countries to implement a new liquidity policy for banks.

The new quantitative requirements (which are broadly consistent with the Basel Committee's proposals in December 2009) have two components—one aimed at short-term funding horizons, and one for the longer-term funding profile.

- **Liquidity mismatch ratios** set minimum 'zero' requirements for one-week and one-month each business day. The mismatch ratios compare a bank's likely cash inflows with its likely cash outflows.
- **A minimum core funding ratio (CFR)** aims to ensure that banks hold sufficient retail and longer-dated wholesale funding. The minimum CFR has been set at 65 percent from April 2010, increasing to 70 percent from July 2011 and to 75 percent from July 2012.

Since 2008, banks have almost doubled their holdings of liquid assets and increased retail and long-term wholesale funding. The new policy implies that banks may have to shift more than 10 percent of GDP of funding from short-term funding to longer-term maturities or to retail deposits, over the next two years. In turn, this should help reduce short-term external debt.

The new policy may also constrain the ability of banks to increase lending during cyclical upturns, when banks tend to resort to short-term offshore markets for additional funding.



42. **The authorities had considered the merits of faster fiscal consolidation, but decided that the current planned consolidation was appropriate.** They share many of the considerations outlined by the staff, particularly the conclusion that a low level of net public debt is essential to keep the cost of capital low in the face of high external private debt. This assessment is reflected in their target for net public debt of 20 percent of GDP and the expectation to return the budget to balance in 2016, only two years after the staff's proposal. Current settings also allow for positive revenue surprises to be used to reduce the fiscal deficit. They consider that this path will restore New Zealand's ability to withstand potential future shocks and allows more time to develop sustained improvements in the quality of public spending. Their judgment is that while fiscal consolidation may help at the margin to rebalance the economy towards higher exports and savings, the impact on the current account deficit and growth is likely to be small and subject to a high degree of uncertainty.

43. **The authorities agree that the exchange rate will need to be significantly lower for an extended period to get the net foreign liability position back to where it was five years ago.** They expect a depreciation over the next few years as the world economy recovers and interest rate differentials normalize, but not to a level sufficient to prevent a projected widening of the current account deficit to 7½ percent of GDP by 2014 and an increase in net foreign liabilities.

44. **The authorities are following the international discussion of macro-prudential measures closely.** However, they were cautious about the effectiveness of a number of the measures being discussed internationally and emphasized the scope for financial markets to work around some measures.

V. STAFF APPRAISAL

45. **A gradual economic recovery is expected to continue, helped by timely and significant macroeconomic stimulus.** But the outlook is subject to a number of downside risks mainly related to the pace of the global recovery. Moreover, two key macro-financial vulnerabilities persist—high household debt and high external debt.

46. **The strong fiscal position prior to the crisis enabled the authorities to deliver a sizable fiscal easing that helped cushion the impact of the crisis.** However, the medium-term fiscal outlook has worsened because income tax cuts and many of the spending initiatives were permanent and revenue projections have been revised down. As a result, cash budget deficits of about 3–6 percent of GDP are projected over the next 4–5 years.

47. **The fiscal stimulus through June 2010 is appropriate, but meeting the government's commitment to limit the increase in public debt will be key to ensuring fiscal sustainability.** The authorities' plans imply that net core Crown debt would peak at 30 percent of GDP in 2016 and fall below 20 percent of GDP by 2024.

48. **A shift in the macroeconomic policy mix toward faster fiscal consolidation would reduce the risk of a recurrence of external funding problems.** Faster consolidation would relieve pressure on monetary policy and thereby the exchange rate, and limit the increase in the current account deficit. Faster consolidation would also create fiscal space to deal with future shocks, and reduce the likelihood of an increase in the risk premium related to New Zealand's high external debt.
49. **Consolidation should focus on spending restraint to return to budget surpluses earlier than planned, unless the downside risks to growth materialize.** There is scope to better target transfers to households and improve the efficiency of public service provision and capital spending. In addition, long-term pressures on the budget from rising health and pension costs should be addressed early. Any positive revenue surprises should be saved and the introduction of spending caps may provide useful discipline.
50. **The current accommodative monetary stance is appropriate and the RBNZ should gradually return to neutral once the recovery is well established.** Inflation is likely to stay within the 1–3 percent target over the next few years, as the output gap is not expected to close before 2013. In a downside scenario, monetary policy has room to be loosened. The inflation-targeting framework served New Zealand well during the global crisis and there are no clear net benefits to increasing the inflation target.
51. **Banks remain sound, but the authorities should continue to be vigilant as banks are exposed to households and house prices appear overvalued.** Closer collaboration with Australian authorities on crisis management and stress tests is welcome, and banks' capital and provisioning should be strengthened if these tests suggest the need for additional buffers.
52. **The exchange rate is overvalued by 10–25 percent from a medium-term perspective.** If this proves to be temporary, it may limit the increase in the current account deficit. But even if the current account returns to the estimated norm of almost 5 percent of GDP, net foreign liabilities would remain high at 90 percent of GDP.
53. **Prudential and structural reforms would help reduce external vulnerability.** The introduction of the prudential liquidity policy, including a core funding ratio, should reduce banks' reliance on short-term external funding. The core funding ratio could be raised further than planned if needed to help reduce short-term external debt. Further structural reforms to raise productivity and labor force participation, including tax and benefit reforms, would lift potential growth and export capacity.
54. Staff recommends that the next Article IV consultation be held on the standard 12-month cycle.

Table 1. New Zealand: Selected Economic and Financial Indicators, 2005–11

Nominal GDP (2009): US\$117.7 billion
Population (2009): 4.3 million

GDP per capita (2009): US\$27,127
Quota: SDR 894.6 million

	2005	2006	2007	2008	2009	2010 Proj.	2011 Proj.
Real growth (percent change)							
GDP (production basis)	3.2	1.0	2.8	-0.1	-1.6	2.9	3.2
Final domestic demand	4.7	1.9	4.3	0.0	-3.4	3.0	3.7
Private consumption	4.7	2.2	3.9	-0.3	-0.6	2.0	2.5
Government consumption	3.9	5.3	4.1	4.8	1.5	1.9	2.0
Fixed investment	5.2	-1.0	5.5	-2.6	-13.5	6.9	8.2
Inventories 1/	-0.1	-0.8	0.4	0.4	-2.5	2.0	0.0
Exports of goods and services	-0.4	1.7	3.8	-1.4	0.0	2.1	5.9
Imports of goods and services	5.5	-2.5	8.7	2.5	-15.2	8.7	7.0
Output gap	2.7	1.0	1.3	-0.7	-3.7	-2.9	-1.8
Headline CPI inflation (percent change)	3.0	3.4	2.4	4.0	2.1	2.1	2.5
End of period (percent change)	3.2	2.7	3.2	3.4	2.0	2.3	2.8
Unemployment rate (period average, in percent)	3.8	3.8	3.7	4.2	6.2	7.2	6.6
Investment and saving (in percent of GDP)							
Investment	24.7	23.4	23.9	23.3	19.2	20.9	22.0
National saving 2/	16.4	14.9	15.9	14.6	16.1	16.3	16.3
Public finance (in percent of GDP) 3/							
Revenue	38.0	37.0	33.9	33.9	32.2	30.1	30.2
Expenditure	32.9	34.2	31.5	31.2	34.7	34.7	34.6
Operating balance 4/	5.4	4.2	3.8	2.1	-3.2	-3.7	-3.9
Operating balance before gains and losses	4.8	4.6	3.4	3.1	-2.1	-4.0	-3.4
Net Crown debt excluding NZS Fund	13.3	10.2	7.7	5.6	9.3	14.5	19.5
Money and credit (end of period)							
Resident M3 (percent change) 5/	9.4	11.3	11.1	10.4	-0.6	-3.6	...
Private domestic credit (percent change) 5/	10.2	12.4	12.8	7.4	0.9	0.2	...
Interest rates (period average)							
Interest rate (90-day, in percent) 6/	7.1	7.5	8.3	8.0	3.0	2.7	...
Government bond yield (10-year, in percent) 6/	5.9	5.8	6.3	6.1	5.5	5.9	...
Balance of payments (in percent of GDP)							
Current account	-8.3	-8.4	-8.0	-8.6	-3.0	-4.6	-5.7
(In billions of New Zealand dollars)	-13.1	-14.0	-14.2	-15.8	-5.6	-9.0	-11.6
Trade balance (goods)	-2.3	-1.8	-1.3	-1.2	1.3	1.6	1.6
Terms of trade (percent change)	1.1	0.0	6.0	7.4	-10.1	8.5	0.7
Foreign assets and liabilities (NZ\$ billion)							
Net international investment position	-129.6	-140.5	-149.3	-162.3	-167.5	-176.7	-188.7
(In percent of GDP)	-81.9	-84.8	-83.9	-88.5	-90.3	-90.8	-92.4
Official reserves 5/	13.1	19.9	22.3	19.1	21.6	24.0	...
Exchange rate (period average)							
U.S. dollar per New Zealand dollar 6/	0.70	0.65	0.74	0.71	0.63	0.71	...
Trade-weighted index (June 1979 = 100) 6/	70.4	65.4	70.9	65.7	60.2	64.8	...
Nominal effective exchange rate 7/	134.3	123.8	133.0	124.1	113.6	123.1	...
Real effective exchange rate 7/	137.6	128.2	137.8	128.9	120.5	130.9	...
GDP (in billions of New Zealand dollars)	158.3	165.8	177.9	183.4	185.5	194.7	204.2

Sources: Data provided by the New Zealand authorities; and Fund staff estimates and projections.

1/ Contribution in percent of GDP.

2/ Based on national accounts data.

3/ Fiscal years ending June 30.

4/ Equals revenue less expenditure plus net surplus of state-owned enterprises and Crown entities.

5/ Data for 2010 are for February.

6/ Data for 2010 are for January-March.

7/ IMF Information Notice System index (2000 = 100). Data for 2010 are as of February.

Table 2. New Zealand: Summary of Central Government Budget, 2006/07–2010/11 1/

	2006/07	2007/08	2008/09	2009/10 Proj.	2010/11 Proj.
(In billions of New Zealand dollars)					
Revenue	58.2	61.8	59.5	56.8	60.0
Tax revenue	53.5	56.7	54.7	51.2	54.3
Expenditure	54.0	57.0	64.0	65.5	68.9
Social security and welfare	16.8	17.9	19.4	21.2	22.2
Health	10.4	11.3	12.4	13.4	13.5
Education	9.3	9.6	11.5	11.6	11.8
Defense	1.5	1.6	1.8	1.8	1.9
Finance costs	2.2	2.3	2.7	2.9	3.7
Other	13.9	14.4	16.3	14.5	15.9
Revenue less expenditure (core Crown)	4.2	4.8	-4.5	-8.8	-8.9
Net surplus from SOEs and Crown entities	0.4	0.9	1.5	1.3	1.8
Operating balance (Core Crown) 2/	6.5	3.9	-5.9	-6.9	-7.7
Operating balance before gains and losses (total Crown)	5.9	5.6	-3.9	-7.5	-6.7
Residual cash balance 3/	2.9	2.1	-8.6	-10.1	-11.3
Gross sovereign-issued debt 4/	30.6	31.4	43.4	53.7	64.4
Net core Crown debt 5/	13.2	10.3	17.1	27.4	38.8
Net core Crown debt with NZ Superannuation Fund	-7.5	-13.0	-4.8	1.5	11.4
Net worth 6/	96.8	105.5	99.5	94.8	89.7
(In percent of GDP)					
Revenue	33.9	33.9	32.2	30.1	30.2
Tax revenue	31.2	31.1	29.6	27.2	27.3
Expenditure	31.5	31.2	34.7	34.7	34.6
Social security and welfare	9.8	9.8	10.5	11.2	11.2
Health	6.0	6.2	6.7	7.1	6.8
Education	5.4	5.2	6.2	6.2	5.9
Defense	0.9	0.9	1.0	1.0	0.9
Finance costs	1.3	1.2	1.5	1.5	1.9
Other	8.1	7.9	8.9	7.7	8.0
Net surplus from SOEs and Crown entities	0.2	0.5	0.8	0.7	0.9
Operating balance 2/	3.8	2.1	-3.2	-3.7	-3.9
Operating balance before gains and losses	3.4	3.1	-2.1	-4.0	-3.4
Residual cash balance 3/	1.7	1.1	-4.7	-5.3	-5.7
Gross sovereign-issued debt 4/	17.9	17.2	23.5	28.4	32.3
Net core Crown debt 5/	7.7	5.6	9.3	14.5	19.5
Net core Crown debt with NZ Superannuation Fund	-4.3	-7.1	-2.6	0.8	5.7
Net worth 6/	56.4	57.8	54.0	50.3	45.0
<i>Memorandum items</i> (in billions of NZ dollars)					
Contributions to NZ Superannuation Fund	2.0	2.1	2.2	0.3	0.0
NZ Superannuation Fund balance	7.6	7.8	7.4	8.3	8.3

Sources: New Zealand Treasury; Economic and Fiscal Forecasts, December 2009; and Fund staff estimates and projections.

1/ Fiscal years ending June 30.

2/ Equals revenue less expenditure plus net surplus of state-owned enterprises and Crown entities.

3/ Net core Crown cashflow from operations after contributions to NZS Fund, purchases of physical assets, and advances and capital injections.

4/ Excluding Reserve Bank settlement cash.

5/ Excluding NZ Superannuation Fund and advances.

6/ Includes financial assets of the NZS Fund.

Table 3. New Zealand: Balance of Payments and External Debt, 2004–10

	2004	2005	2006	2007	2008	2009	2010 Proj.
(In percent of GDP)							
Current account balance	-6.2	-8.3	-8.4	-8.0	-8.6	-3.0	-4.6
Goods balance	-1.4	-2.3	-1.8	-1.3	-1.2	1.3	1.6
Exports, f.o.b.	20.5	19.7	21.0	20.8	23.9	21.7	23.0
Imports, f.o.b.	-22.0	-22.1	-22.8	-22.1	-25.2	-20.4	-21.3
Services balance	1.0	0.4	0.2	0.2	-0.5	-0.2	-0.6
Receipts	8.3	7.8	7.6	7.2	6.9	6.5	6.3
Payments	-7.2	-7.4	-7.3	-7.0	-7.4	-6.7	-6.9
Income balance	-6.0	-6.5	-7.2	-7.3	-7.5	-4.5	-5.9
Receipts	1.6	1.4	1.4	2.1	1.6	1.6	1.2
Payments	-7.6	-7.9	-8.7	-9.4	-9.1	-6.6	-7.0
Transfers balance	0.1	0.2	0.4	0.4	0.6	0.3	0.3
Inflows	0.9	1.1	1.2	1.1	1.3	1.0	1.0
Outflows	0.6	0.6	0.6	0.6	0.6	0.6	0.5
Capital and financial account balance	7.5	7.6	7.5	7.4	3.3	3.5	...
Capital account (net)	0.2	-0.2	-0.2	-0.4	-0.3	-0.2	...
Financial account (net)	7.4	7.8	7.7	7.9	3.7	3.7	...
Direct investment (net)	2.9	2.7	4.2	-0.2	4.1	0.7	...
Portfolio investment (net)	6.1	-0.1	-1.1	8.2	-6.0	3.8	...
Equity securities (net)	-1.5	-1.1	-1.1	-0.5	0.3	-0.7	...
Debt securities (net)	7.6	1.1	0.0	8.7	-6.3	4.5	...
Other investment (net)	-1.7	5.1	4.6	-0.1	5.6	-0.7	...
Assets	-0.2	1.6	-5.3	-3.7	5.3	-3.9	...
Liabilities	-1.5	3.5	10.0	3.5	0.3	3.2	...
Net errors and omissions	-1.3	0.8	0.9	0.6	5.4	-0.6	...
Overall balance	0.0	0.0	0.0	0.0	0.1	-0.1	...
(Assets and liabilities as of end-December)							
Total external debt	108.0	106.4	115.2	121.7	136.1	131.1	131.4
Short-term	52.8	56.3	60.3	67.1	64.7	58.2	...
Long-term	55.2	50.1	55.0	54.5	71.4	72.9	...
Net international investment position	-82.7	-81.9	-84.8	-83.9	-88.5	-90.3	-90.8
Net equity	-16.8	-11.7	-10.7	-8.3	-3.9	-6.0	...
Net debt	-65.9	-70.2	-74.0	-75.6	-84.6	-84.3	...
(In billions of New Zealand dollars)							
Gross official reserves 1/	9.7	13.1	19.9	22.3	19.1	21.6	24.0
RBNZ net short position in forex swaps 1/	1.5	2.7	10.5	10.3	5.8	10.2	12.1
RBNZ net open foreign currency position 1/	0.0	0.0	-0.1	2.5	5.0	3.5	3.3
Gross reserves in months of future imports of g&s	3.9	5.2	8.2	8.2	8.5	9.2	9.6
Gross reserves as percent of short-term debt	12.2	14.7	19.9	18.6	16.1	20.0	22.0

Sources: Data provided by the New Zealand authorities; and Fund staff estimates and projections.

1/ For 2010, actual number for February.

Table 4. New Zealand: Medium-Term Scenario, 2008–15

	Average	2008	2009	Projections					
	1998-2007			2010	2011	2012	2013	2014	2015
Real growth (percent change)									
GDP (production basis)	3.1	-0.1	-1.6	2.9	3.2	3.0	2.8	2.7	2.4
GDP (expenditure basis)	3.3	-1.0	-0.3	2.9	3.2	3.0	2.8	2.7	2.4
Final domestic demand	3.9	0.0	-3.4	3.0	3.7	3.5	3.1	2.9	2.8
Consumption	3.5	0.8	-0.2	2.0	2.4	2.7	2.4	2.4	2.3
Private consumption	3.6	-0.3	-0.6	2.0	2.5	2.9	2.7	2.7	2.5
Government consumption	3.2	4.8	1.5	1.9	2.0	2.0	1.6	1.6	1.6
Fixed investment	5.4	-2.6	-13.5	6.9	8.2	6.0	5.2	4.3	4.3
Private business	5.8	2.2	-17.8	7.4	11.0	7.4	6.9	5.4	5.4
Private residential	3.1	-16.3	-18.7	7.8	8.5	7.1	4.1	4.1	4.1
Public investment	8.0	-3.2	4.0	4.9	0.9	1.2	1.2	1.2	1.2
Changes in inventories 1/	0.0	0.4	-2.5	2.0	0.0	0.0	0.0	0.0	0.0
Exports of goods and services	4.0	-1.4	0.0	2.1	5.9	5.7	4.9	5.0	4.4
Imports of goods and services	6.1	2.5	-15.2	8.7	7.0	6.7	5.5	5.1	5.2
Net exports (contribution to growth)	-0.7	-1.4	5.8	-2.2	-0.6	-0.6	-0.4	-0.3	-0.5
Saving and investment (percent of GDP)									
Gross capital formation	22.6	23.3	19.2	20.9	22.0	22.6	23.0	23.2	23.5
Fixed investment	21.8	22.4	20.1	20.5	21.6	22.2	22.6	22.9	23.2
Changes in inventories	0.9	0.9	-0.9	0.4	0.3	0.3	0.3	0.3	0.3
National savings 2/	17.0	14.6	16.1	16.3	16.3	15.5	15.0	15.1	15.3
Private	14.2	16.6	19.7	19.9	19.5	18.1	17.0	16.1	15.9
Public	2.7	-2.0	-3.6	-3.6	-3.2	-2.6	-2.0	-1.0	-0.5
Inflation and unemployment (percent)									
Headline CPI inflation (period average)	2.2	4.0	2.1	2.1	2.5	2.7	2.7	2.3	2.0
Headline CPI inflation (end of period)	2.3	3.4	2.0	2.3	2.8	2.6	2.5	2.1	2.0
Unemployment rate	5.2	4.2	6.2	7.2	6.6	5.9	5.4	4.7	4.4
Output gap (staff estimate)	0.8	-0.7	-3.7	-2.9	-1.8	-1.0	-0.4	0.0	0.1
Government budget (percent of GDP) 3/									
Revenue	34.2	33.9	32.2	30.1	30.2	30.2	30.6	30.7	31.3
Expenditure	32.0	31.2	34.7	34.7	34.6	33.8	33.8	33.2	33.0
SOE and Crown entity surplus (net)	0.7	0.5	0.8	0.7	0.9	0.9	0.9	0.8	0.9
Operating balance 4/	2.8	2.1	-3.2	-3.7	-3.9	-3.1	-2.7	-2.0	-1.1
Operating balance before gains and losses	2.6	3.1	-2.1	-4.0	-3.4	-2.9	-2.6	-2.1	-0.9
Residual cash balance	0.9	1.1	-4.7	-5.3	-5.7	-5.0	-4.0	-3.2	-2.0
Gross Crown debt	27.6	17.2	23.5	28.4	32.3	33.0	33.5	35.1	36.3
Net Crown debt excluding NZS Fund	18.3	5.6	9.3	14.5	19.5	23.5	26.3	28.3	29.6
Terms of trade (2002=100, goods & services)	104.5	121.4	110.7	117.7	118.1	118.2	119.2	120.2	120.7
Terms of trade (2002=100, goods)	103.7	123.4	111.0	120.4	121.3	121.5	122.3	123.2	123.4
Terms of trade (percent change, goods)	1.8	7.4	-10.1	8.5	0.7	0.2	0.6	0.7	0.1
Export prices	2.4	19.6	-12.6	10.7	5.1	3.9	3.3	3.0	2.5
Import prices	0.6	11.4	-2.8	2.0	4.3	3.7	2.7	2.3	2.4
Balance of payments (percent of GDP)									
Current account balance	-5.7	-8.6	-3.0	-4.6	-5.7	-7.1	-8.0	-8.1	-8.2
Balance on goods and services	0.0	-1.7	1.2	1.0	0.8	0.6	0.7	1.0	0.9
Balance on income and transfers	-5.7	-6.9	-4.2	-5.6	-6.5	-7.7	-8.7	-9.1	-9.1
Net foreign liabilities (percent of GDP) 5/	80.5	88.5	90.3	90.8	92.4	95.9	98.9	103.7	106.8
Gross external debt 5/	107.9	136.1	131.1	131.4	132.8	135.5	137.8	141.6	144.1
Partners' GDP growth	3.7	2.3	-0.7	3.5	3.8	3.8	3.7	3.7	3.6
Partners' import volume growth (goods and services)	7.1	5.0	-10.8	6.6	6.4	6.5	6.2	6.0	5.9
90-day Bank Bill Rate	6.5	8.0	3.0	3.4	5.1	5.5	5.5	5.5	5.5
10-year Bond Rate	6.2	6.1	5.5	6.3	6.6	6.6	6.6	6.6	6.6

Sources: Data provided by the New Zealand authorities; and Fund staff estimates and projections.

1/ Contribution in percent of GDP.

2/ Fund staff estimates; calculated as residual from gross national investment and external current account balance.

3/ Fiscal years ending June 30.

4/ Equals revenue less expenditure plus net surplus of state-owned enterprises and Crown entities.

5/ Data for end-December.

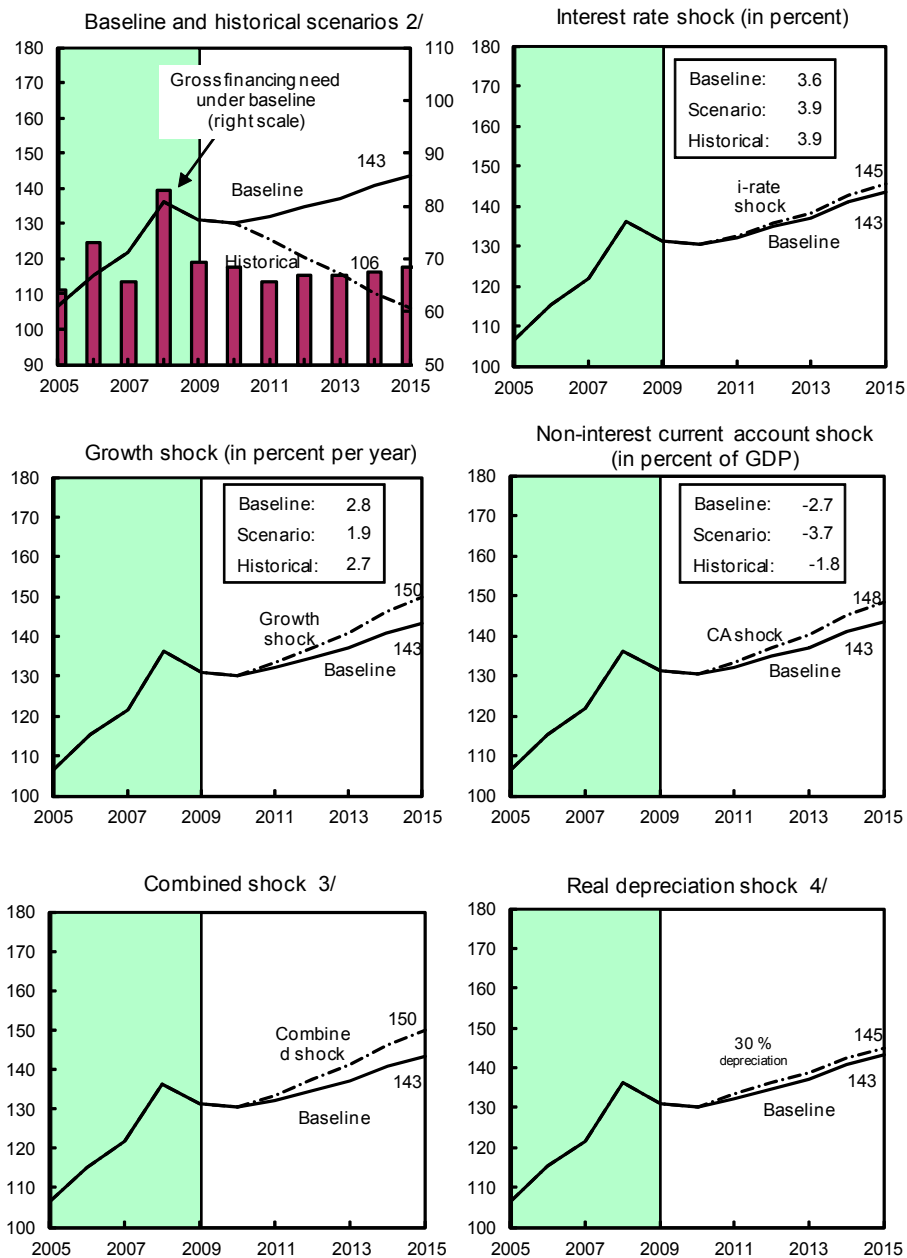
Table 5. New Zealand: Unwinding Crisis-Related Monetary Policy Measures

	Measures taken	Status of Unwinding
Monetary policy rate	The Official Cash Rate was reduced by 575 basis points since July 2008 to 2.50 percent in April 2009.	The Reserve Bank indicated its intention to begin removing policy stimulus around the middle of 2010.
Liquidity support	<p>In 2007–09, the Reserve Bank expanded eligible collateral for domestic Reserve Bank’s liquidity operations to include a broad range of government and private sector securities, including mortgage-backed, asset-backed, and corporate securities.</p> <p>In May 2008, the overnight reverse repo facility was extended from 1 day to a maximum of 30 days.</p> <p>In November 2008, the Reserve Bank introduced two new facilities to support bank liquidity: a term auction facility and weekly Reserve Bank bill tenders.</p>	<p>The Reserve Bank plans to rationalize the range of eligible securities by the third quarter of 2010.</p> <p>From November 2009 the maximum term was shortened to 1 day.</p> <p>From November 2009 the two facilities were removed.</p>
Foreign exchange swap arrangement	In October 2008, the Reserve Bank established a US\$15 billion swap line with the U.S. Fed, initially through April 2009 and later extended several times.	The swap line expired on February 1, 2010 and was never used.
Funding guarantees	<p>In October 2008, the Treasury introduced a retail deposit guarantee scheme (on an opt-in basis with a \$NZ 1 million cap on the coverage per depositor per institution) for two years. Participating institutions are charged fees, based on the guaranteed amount and their credit rating.</p> <p>In November 2008, a guarantee was offered on banks’ wholesale funding, on an opt-in basis (by institution and by instrument) for a fee differentiated by the risk of the issuer and the maturity of the security—e.g., 70–180 basis points per annum for foreign currency issues depending on issuers’ credit rating.</p>	<p>In August 2009, the Treasury announced an extended retail deposit guarantee scheme from October 2010 to end-2011, with higher fees and a lower coverage limit of \$NZ 0.5 million per depositor per bank and \$NZ 0.25 million per nonbank.</p> <p>The government will close the wholesale funding guarantee on April 30, 2010. About \$NZ 10 billion of debt (about 6 percent of GDP) was issued under this scheme by end-2009.</p>

Appendix I. New Zealand: Main Recommendations of the 2009 Article IV Consultation
(Consultation Discussions Ended on March 23, 2009)

Fund Recommendations	Policy Actions
<p>Fiscal policy: Staff advised that, to preserve investor confidence, concrete measures should be laid out in the May 2009 budget to stabilize gross public debt in the medium term and bring it back to around current levels (20–25 percent of GDP) in the longer term. The bulk of measures aimed at medium-term consolidation should have an impact in 2010/11 and beyond, when growth is projected to recover. The focus of fiscal consolidation should be on the expenditure side, although revenue measures are likely to be needed to close the gap.</p>	<p>The 2009/10 budget planned to reduce the deficits gradually through expenditure restraint and fiscal drag, with a return to surpluses projected by 2017. Net public debt is projected by the authorities to peak at 30 percent of GDP in 2015 and gradually decline to below 20 percent of GDP by 2024. Gross public debt is projected to fall to just over 20 percent of GDP by 2024. However, the adjustment is backloaded and concrete measures to reach the medium targets remain to be defined.</p>
<p>Monetary policy: Staff recommended that, given the weak outlook for growth and inflation, the RBNZ continue to reduce the official cash rate.</p>	<p>The official cash rate was cut further to 2.5 percent at end-April 2009 (the lowest since its introduction in 1999) and then kept unchanged as the economy emerged from recession in mid-2009.</p>
<p>Staff suggested that the authorities consider alternative instruments, such as quantitative easing, in the unlikely event that such measures are needed.</p>	<p>The economic situation improved, starting in mid-2009, so no further actions were taken in addition to the measures taken by early 2009, which broadened eligible collateral for the RBNZ's liquidity operations and introduced two new facilities to support bank liquidity.</p>
<p>Financial sector policy: Staff recommended that, given the downside risks to the outlook, banks be required to undertake extreme stress tests and increase their capital if needed, and supported the RBNZ's plan to press ahead with its proposed prudential liquidity rules to strengthen the liquidity of the banking system.</p>	<p>A joint stress-testing exercise with Australian supervisors is underway, and the banking sector has remained well capitalized. The RBNZ introduced two liquidity mismatch ratios and a core funding ratio (which came into force in April 2010) to increase banks' liquidity buffers and reduce reliance on short-term offshore funding.</p>

Appendix II. New Zealand: External Debt Sustainability: Bound Tests 1/ (Gross external debt in percent of GDP)



Sources: Fund staff estimates and projections.

1/ Shaded areas represent actual data. Individual shocks are permanent one-half standard deviation shocks. Figures in the boxes represent average projections for the respective variables in the baseline and scenario being presented. Ten-year historical average for the variable is also shown.

2/ The historical scenario assumes that real GDP growth, inflation, current account deficit, and nominal interest rate are equal to ten-year averages from 2010 onward.

3/ Permanent 1/4 standard deviation shocks applied to real interest rate, growth rate, and current account balance.

4/ This scenario assumes foreign exchange hedging covers 91 percent of foreign currency debt, consistent with the findings of hedging surveys conducted by Statistics New Zealand.



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FOR IMMEDIATE RELEASE
[May xx, 2010]

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APPENDIX III: IMF Executive Board Concludes 2010 Article IV Consultation with New Zealand

On [May 12, 2010], the Executive Board of the International Monetary Fund (IMF) concluded the Article IV consultation with New Zealand.¹

Background

New Zealand rode out the global crisis better than most advanced economies, thanks to strong demand from fast-growing Asian markets and the robust Australian economy, a flexible exchange rate, the absence of a banking crisis, and significant and effective policy easing. Nevertheless, the crisis highlighted long-standing vulnerabilities due to high household and external debt.

Led by domestic demand, the economy emerged from the recession in mid-2009. A large output gap contained growth in labor costs and eased inflationary pressures, with the annual CPI inflation falling from the peaks of 4–5 percent in 2008 to about 2 percent in early 2009. After cutting the official cash rate (OCR) by 575 basis points from mid-2008 to early 2009, the RBNZ has kept it at a historical low of 2½ percent. The strong pre-crisis fiscal position also enabled the delivery of a large fiscal stimulus, equivalent to almost 6 percent of GDP spread over the two years to June 2010.

¹ Under Article IV of the IMF's Articles of Agreement, the IMF holds bilateral discussions with members, usually every year. A staff team visits the country, collects economic and financial information, and discusses with officials the country's economic developments and policies. On return to headquarters, the staff prepares a report, which forms the basis for discussion by the Executive Board. At the conclusion of the discussion, the Managing Director, as Chairman of the Board, summarizes the views of Executive Directors, and this summary is transmitted to the country's authorities.

The current account deficit narrowed sharply in 2009 to 3 percent of GDP, as both trade and income balances improved. Private capital inflows continued to finance the deficit, and net foreign liabilities increased marginally to 90 percent of GDP. The exchange rate depreciated sharply at the onset of the crisis, but has appreciated by over 20 percent since early 2009, reflecting a recovery in commodity prices and global risk appetite, and a widening of interest rate differentials.

Banks remain sound but faced some funding difficulties during the crisis. In response, the government introduced a temporary wholesale funding guarantee that helped banks obtain term funding of about \$NZ 10 billion until they were able to access the market directly in late 2009. Banks remain exposed to highly-indebted households and house prices appear overvalued.

A gradual recovery is expected to continue, with growth projected at 3 percent in 2010–11. The outlook is subject to downside risks related to the pace of global recovery and borrowing cost for countries with high external debt, such as New Zealand.

Executive Board Assessment

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Public Information Notices (PINs) form part of the IMF's efforts to promote transparency of the IMF's views and analysis of economic developments and policies. With the consent of the country (or countries) concerned, PINs are issued after Executive Board discussions of Article IV consultations with member countries, of its surveillance of developments at the regional level, of post-program monitoring, and of ex post assessments of member countries with longer-term program engagements. PINs are also issued after Executive Board discussions of general policy matters, unless otherwise decided by the Executive Board in a particular case.

New Zealand: Selected Economic Indicators

	2006	2007	2008	2009	Proj. 2010	Proj. 2011
Real economy (percent change)						
GDP (production basis)	1.0	2.8	-0.1	-1.6	2.9	3.2
Final domestic demand	1.9	4.3	0.0	-3.4	3.0	3.7
Exports of goods and services	1.7	3.8	-1.4	0.0	2.1	5.9
Imports of goods and services	-2.5	8.7	2.5	-15.2	8.7	7.0
Headline CPI inflation (end of period)	2.7	3.2	3.4	2.0	2.3	2.8
Unemployment rate (in percent)	3.8	3.7	4.2	6.2	7.2	6.6
National saving (in percent of GDP) 1/	14.9	15.9	14.6	16.1	16.3	16.3
Investment (in percent of GDP)	23.4	23.9	23.3	19.2	20.9	22.0
Government budget (in percent of GDP) 2/						
Revenue	37.0	33.9	33.9	32.2	30.1	30.2
Expenditure	34.2	31.5	31.2	34.7	34.7	34.6
Operating balance before gains and losses	4.6	3.4	3.1	-2.1	-4.0	-3.4
Net Crown debt excluding NZS Fund	10.2	7.7	5.6	9.3	14.5	19.5
Interest rates (period average)						
Interest rate (90-day, in percent) 3/	7.5	8.3	8.0	3.0	2.7	...
Government bond yield (10-year, in percent) 3/	5.8	6.3	6.1	5.5	5.9	...
Money and credit (end of period)						
M3, resident (change in percent) 4/	11.3	11.1	10.4	-0.6	-3.6	...
Private domestic credit (change in percent) 4/	12.4	12.8	7.4	0.9	0.2	...
Balance of payments (in percent of GDP)						
Current account balance	-8.4	-8.0	-8.6	-3.0	-4.6	-5.7
Trade balance (goods)	-1.8	-1.3	-1.2	1.3	1.6	1.6
Terms of trade (change in percent)	0.0	6.0	7.4	-10.1	8.5	0.7
External assets and liabilities (in percent of GDP)						
Official reserves (NZ\$ billions) 4/	19.9	22.3	19.1	21.6	24.0	...
Gross external debt	115.2	121.7	136.1	131.1	131.4	132.8
Net international investment position	-84.8	-83.9	-88.5	-90.3	-90.8	-92.4
Exchange rate (period average)						
US\$/NZ\$ 3/	0.65	0.74	0.71	0.63	0.71	...
Trade-weighted index (June 1979 = 100) 3/	65.4	70.9	65.7	60.2	64.8	...
Nominal effective exchange rate 5/	123.8	133.0	124.1	113.6	123.1	...
Real effective exchange rate 5/	128.2	137.8	128.9	120.5	130.9	...

Sources: Data provided by the New Zealand authorities; and Fund staff estimates and projections.

1/ Based on national accounts data.

2/ Fiscal years ending June 30.

3/ Data for 2010 are for January-March.

4/ Data for 2010 are for February.

5/ IMF Information Notice System index (2000 = 100). Data for 2010 are as of February.