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FOR AGENDA

SM/10/104
Correction 1

May 7, 2010

To: Members of the Executive Board

From: The Secretary

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

The attached corrections to SM/10/104 (4/28/10) have been provided by the staff:

Mischaracterization of the Views of the Authorities

Page 21, para. 32, line 3: for "The authorities are considering the introduction of"
read "The authorities are researching the merits of…"

Factual Errors Not Affecting the Presentation of Staff's Analysis or Views

Page 8, para. 9, line 5: for "Although the Australian parent banks weathered the crisis well, their New Zealand subsidiaries faced some difficulties rolling over their sizable short-term funding when…"
read "New Zealand subsidiaries faced more difficulties rolling over their sizable short-term funding than their Australian parents when…"

Evident Ambiguity

Page 3, para. 1, last sentence: for "The latter created some funding difficulties for banks…"
read "The impairment of credit markets created some difficulties in rolling over short-term external debt…"

Page 13, para. 16, line 3: for "spending initiatives were permanent…"
read "spending initiatives, taken before the crisis hit, were permanent…"

Page 28, para. 46, line 1: for **"The strong fiscal position prior to the crisis enabled the authorities to deliver a sizable fiscal easing that…"**
read **"Reflecting a strong fiscal position prior to the crisis a sizable fiscal easing was already under way that…"**

Page 37, Background, 2nd para., last sentence: for "…fiscal stimulus, equivalent to…"
read "…fiscal easing that was in train prior to the crisis, equivalent to…"

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

This document will shortly be posted on the extranet, a secure website for Executive Directors and member country authorities.

Att: (6)

Other Distribution:
Department Heads

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 impairment of credit markets created some difficulties in rolling over short-term external debt 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.

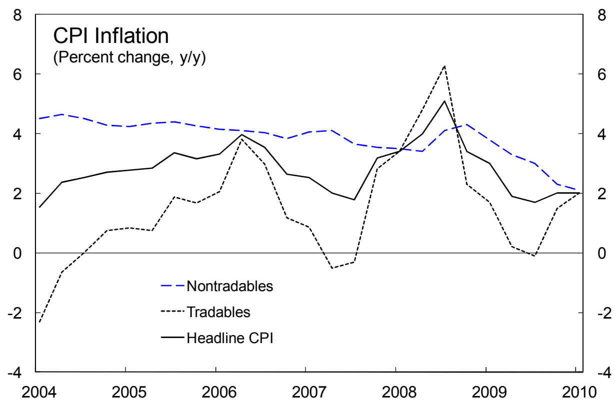
4. **Financial markets have regained some lost ground, as global sentiment improved and credit strains eased.** Money market spreads and bank CDS spreads have declined sharply from crisis highs, but the stock market is still about 25 percent below the 2007 peak (Figure 2). Sovereign bond spreads remain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

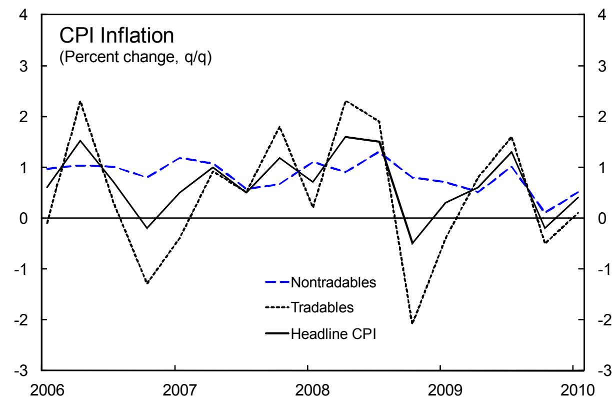
6. **Rising unemployment and a widening output gap contained growth in labor costs and eased inflationary pressures** (Figure 3). Headline and nontradables CPI inflation fell to about 2 percent y/y in March 2010, consistent with the inflation target of 1–3 percent and well below the peaks of 4–5 percent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

Figure 3. New Zealand: Inflation

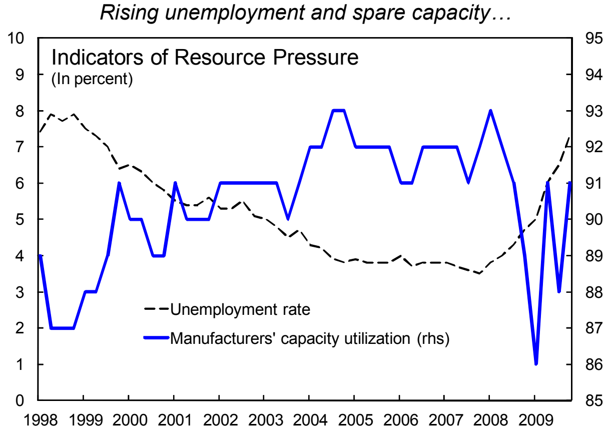
Inflation fell in 2009…



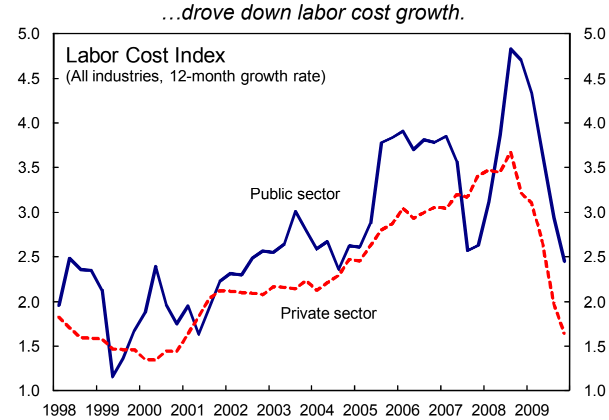
…and was subdued in recent quarters.



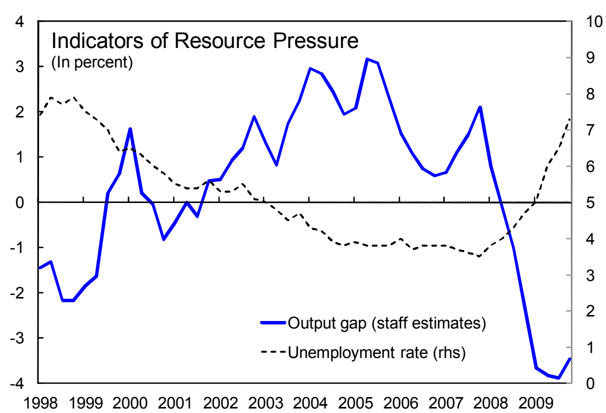
Rising unemployment and spare capacity…



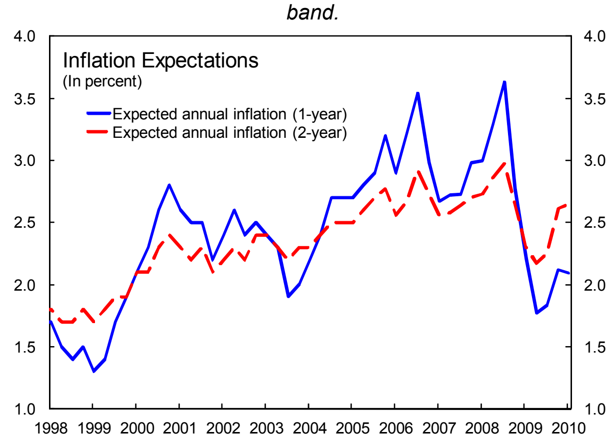
…drove down labor cost growth.



Economic slack remains significant.



Inflation expectations are within the 1–3 percent inflation target band.



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 authotities 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. New Zealand subsidiaries faced more difficulties rolling over their sizable short-term funding than their Australian parents 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 2⅓ 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.

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

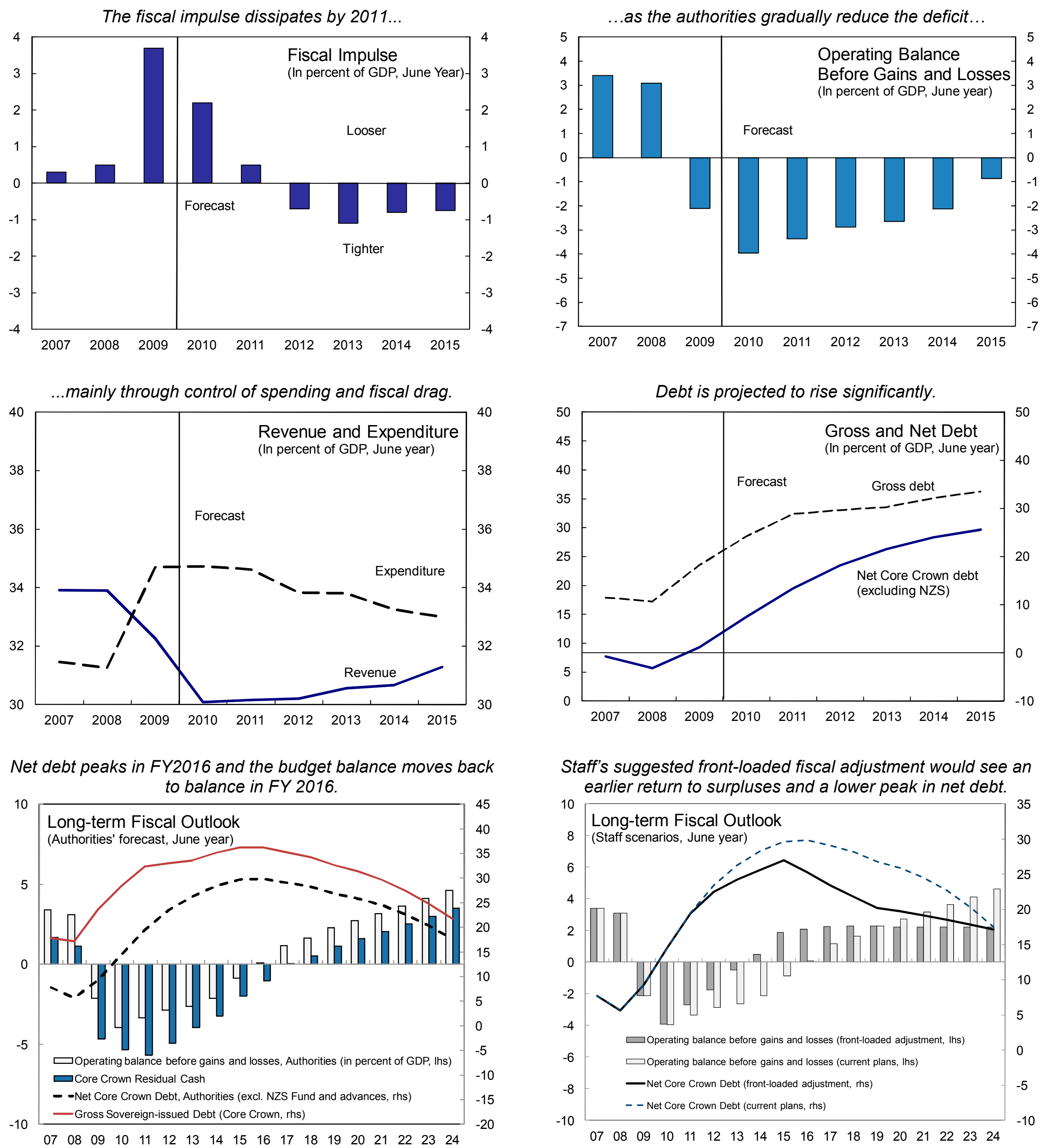
16. **The sizable fiscal easing in the past two years helped cushion the impact of the crisis, but worsened the medium-term fiscal outlook.** Income tax cuts and many of the spending initiatives, taken before the crisis hit, were permanent and revenue projections have been revised down. As a result, 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.

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 researching the merits 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.

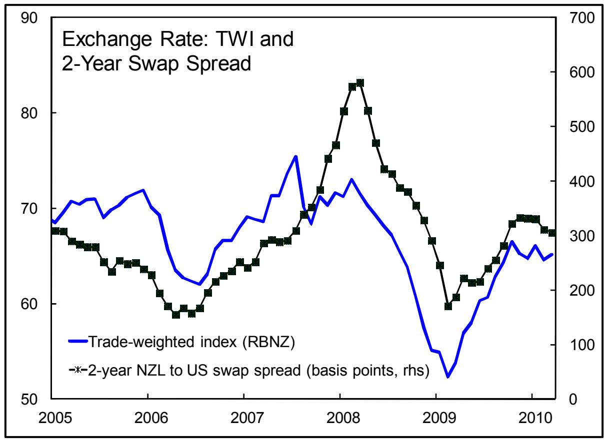
33. **Staff welcomed the announced closure of the wholesale government guarantee scheme by end-April 2010, given that funding conditions have improved.** The authorities are considering the costs and benefits of introducing a permanent retail deposit insurance scheme when the current government guarantee 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

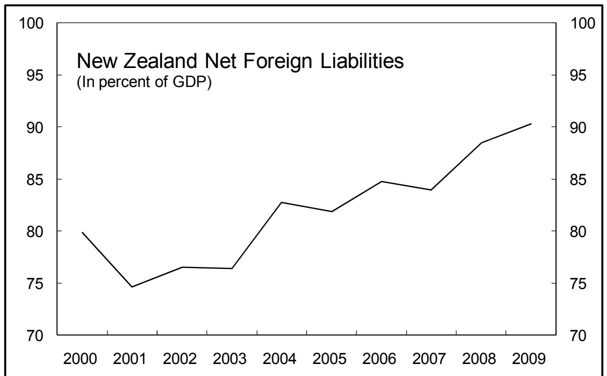
34. **The free-floating exchange rate regime remains appropriate, as it enables an independent monetary policy and provides a useful buffer against shocks.** Prior to the crisis, the RBNZ was able to increase the policy rate to contain inflationary pressures fuelled

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.



Sources: Statistics New Zealand; and Fund staff calculations.

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.

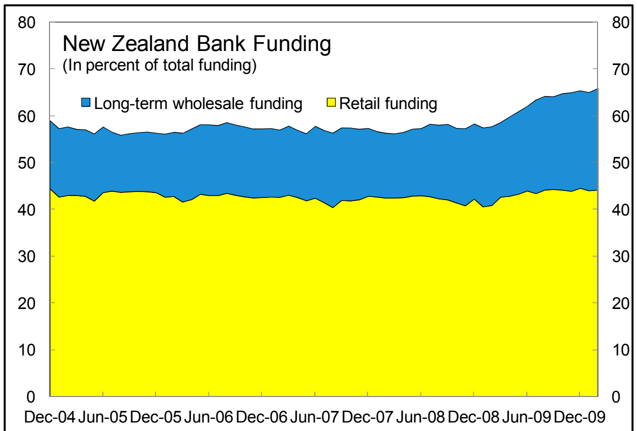
BOX 3. NEW ZEALAND: NEW LIQUIDITY POLICY

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.

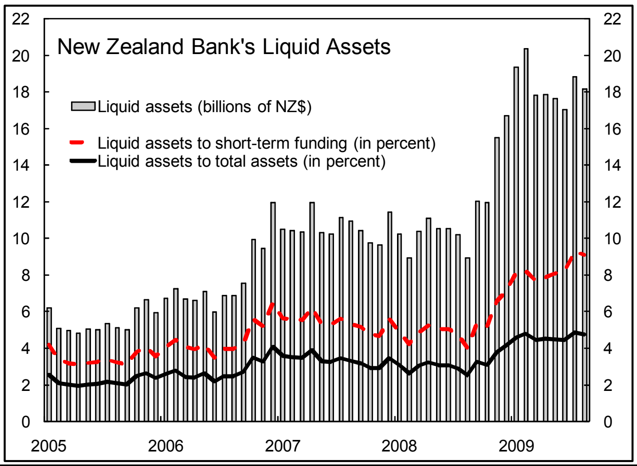
The new quantitative requirements (which are broadly consistent with the Basel Committee's proposals in December 2009) have two components—one aimed at short-term funding horizons, and one for the longer-term funding profile.

- **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.



Source: Reserve Bank of New Zealand; and Fund staff calculations.



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. **Reflecting a strong fiscal position prior to the crisis a sizable fiscal easing was already under way 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.

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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 easing that was in train prior to the crisis, 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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