FOR AGENDA

SM/97/257
Correction 1

CONTAINS CONFIDENTIAL
INFORMATION

October 31, 1997

To: Members of the Executive Board

From: The Secretary

Subject: **New Zealand—Staff Report for the 1997 Article IV Consultation**

The following correction has been made in SM/97/257 (10/17/97):

Page 7, footnote 10: for "See Stone,...forthcoming."
read "This estimate...(SM/97/252)."

A corrected page is attached.

Att: (1)

Other Distribution:
Department Heads

sector and the current account. In contrast, if fiscal policy were tightened, then monetary policy could be further relaxed, allowing competitiveness to be restored through an orderly decline in the nominal exchange rate.

15. **The mission team observed that fiscal tightening would be desirable for budgetary reasons, as well**. It noted that the measures in the past two budgets had already reduced the structural balance to levels where there was little fiscal buffer against the cyclical downturn. This margin could narrow further if unexpected costs materialize, such as those which helped reduce the projected 1997/98 surplus by 1½ percent of GDP in the three months between the Budget Policy Outlook and the June budget. In these circumstances, next year's planned spending increases and tax reductions could well push the budget into deficit.

16. **If this occurred, there could be a significant impact on economic confidence**. A significant surplus has been the symbol of macroeconomic rigor in New Zealand, and of the authorities' determination to adhere to the spirit of the Fiscal Responsibility Act. It has formed the foundation of the authorities' framework, underpinning the feasibility of the tight inflation target, the objective of reducing government net debt to 20 percent of GDP, and the goal of receiving a credit upgrade from the current AA+ rating. Moreover, while any deficit would likely be cyclical, it would be difficult for financial markets to confirm this; there were many examples of countries where the authorities believed they had structural surpluses, based policies on this assumption, and incurred large and prolonged deficits as a result.

17. **A loss of the fiscal surplus could also increase the risks attached to the widening current account deficit**. The team noted that even the 4 percent of GDP deficits projected over the medium term seemed too large to be consistent with long-term equilibrium.[9] Such deficits were likely to generate continuing increases in New Zealand's net foreign liabilities ratio which, at over 80 percent of GDP, was already the highest in the industrialized world, by a wide margin (Chart 3, bottom panel). They also implied that private sector investment would exceed private saving by 7 percent of GDP (based on the current public sector position) which, the team's work suggested, would be much larger than could be expected, even considering the country's relatively young population and low income level, compared to other advanced countries. Overall, the team estimated that the equilibrium deficit was closer to 2½ percent of GDP.[10]

18. **Accordingly, some reduction in the current account deficit seems to be inevitable**. There is the possibility that this reduction could take place slowly, and without a policy correction, since the widening of the deficit had been matched by a rise in private investment,

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[9]There was also a risk that the deficits may prove wider than forecast, especially if the rate of return on a foreigner's equity holdings continued to remain at high levels.

[10]This estimate is based on the approach in *A Methodology for Exchange Rate Assessment and its Application in Fund Surveillance over Major Industrial Countries* (SM/97/252).

attracted by economic liberalization, which had outpaced a public sector-led rise in national saving.

19. **Nevertheless, given the deficit's high level, there was a risk of a disruptive, market-led, adjustment**. This risk would be particularly significant if the government was pressing ahead with the planned tax cuts, at the same time as the fiscal situation was deteriorating. Further, New Zealand was also vulnerable to terms-of-trade shocks, because it depends on primary products for over one-half of its exports. Should a fiscal or other shock occur, investor sentiment could shift, causing the exchange rate to fall sharply and forcing the Bank to tighten its policy stance to protect the inflation target—and possibly sending the economy into a recession.

20. **In these circumstances, the team believed that it would be advisable to scale back the medium-term fiscal plans**. They noted there was scope to limit the planned expenditure increases, since only one-half of the 2½ percent of GDP in new spending had been specified in the 1997 budget, with the rest being included under "provisions for policy initiatives." In addition, consideration could also be given to reducing the planned income tax cuts.

21. **The authorities agreed that a prospective loss of the budget surplus would be a matter of considerable concern, given their fiscal framework**. Accordingly, if clear signs of an impending deficit emerged, prompt action would be taken. Already, a review was under way to examine the scope for expenditure reduction in next year's budget, the size of which would depend on the fiscal needs. They would be reluctant to change their tax plans, however, as this could harm economic prospects. Last year, when the tax cuts were postponed, households who had already spent in anticipation of the tax cut were forced to correct their consumption spending, thereby aggravating the overall slowdown.

IV. Addressing the Fiscal Impact of the Aging Population

22. *In the decades ahead, New Zealand's population will age rapidly. New Zealand's forward-looking fiscal framework has already focused attention on this issue, leading the new government to propose replacing state-provided pensions with a "Chilean-style" compulsory private pension scheme. In September, however—after the IMF mission's departure—this plan was rejected in a referendum, by a large majority. Why? What are the alternatives? And what is the authorities' broader long-term fiscal strategy?*

23. **By 2040, there are likely to be less than 3 persons of working age for each person over 64, compared with more than 5 persons at present**. As a result, government expenditures on pensions and health care are expected to increase—by an estimated 12 percentage points of GDP by 2050, if current benefits remain unchanged (Chart 4).[11]

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[11]Government pension expenses would increase from 5 percent of GDP in 2000 to 10 percent (continued...)