May 2007
IMF Country Report No. 07/150

New Zealand: 2007 Article IV Consultation—Staff Report; Public Information Notice; and Statement by Executive Director for New Zealand on the Executive Board Discussion

Under Article IV of the IMF's Articles of Agreement, the IMF holds bilateral discussions with members, usually every year. In the context of the 2007 Article IV consultation with New Zealand, the following documents have been released and are included in this package:

- the staff report for the 2007 Article IV consultation, prepared by a staff team of the IMF, following discussions that ended on February 21, 2007, with the officials of New Zealand on economic developments and policies. Based on information available at the time of these discussions, the staff report was completed on April 9, 2007. The views expressed in the staff report are those of the staff team and do not necessarily reflect the views of the Executive Board of the IMF;

- a Public Information Notice (PIN) summarizing the views of the Executive Board as expressed during its April 27, 2007 discussion of the staff report that concluded the Article IV consultation; and

- a statement by the Executive Director for New Zealand.

The document listed below has been or will be separately released.

Selected Issues Paper

The policy of publication of staff reports and other documents allows for the deletion of market-sensitive information.

To assist the IMF in evaluating the publication policy, reader comments are invited and may be sent by e-mail to publicationpolicy@imf.org.

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NEW ZEALAND

Staff Report for the 2007 Article IV Consultation

Prepared by the Staff Representatives for the 2007 Consultation with New Zealand

Approved by Steven Dunaway and Scott Brown

April 9, 2007

- **Dates**: February 12─21, 2007.
- **Team:** Messrs. Gordon (Head), Beaumont, Ms. Edison, and Mr. Rozhkov (all APD). Mr. Dunaway (APD) and Mr. Blazey (OED) also participated in the discussions.
- **New Zealand Representatives**. Included Minister of Finance Michael Cullen, Reserve Bank of New Zealand Governor Alan Bollard, Treasury Secretary John Whitehead, other senior officials, and representatives of the private sector and trade unions.
- **Focus:** The stance of macroeconomic policies; the risks arising from external and sectoral imbalances; and long-term fiscal challenges.
- **Context of past surveillance:** For a description of policy issues discussed in the 2006 Article IV consultation see: http://www.imf.org/external/np/sec/pn/2006/pn0650.htm.
- **Exchange system:** The New Zealand dollar floats independently and New Zealand maintains an exchange system that is free of restrictions on payments and transfers for current international transactions (Annex I).
- **AML/CFT:** The authorities are proposing a number of changes to strengthen the AML/CFT framework, including extending the Financial Transactions Reporting Act, 1996 (which predates the current FATF Standards) to include all entities that require supervision according to FATF standards.
- **Statistics:** New Zealand publishes an array of high-quality statistics (Annex II). The authorities are addressing issues that have precluded subscription to the Special Data Dissemination Standard.
- **Official development assistance:** New Zealand's ODA is focused on the Pacific and was 0.27 percent of national income in 2006.

Contents

Executive Summary

The cooling phase in New Zealand's cycle has proved to be short-lived and growth remains unbalanced. Domestic demand has strengthened with activity in the housing market particularly robust. However, there has been little easing of resource pressures, and capital inflows have kept the currency at a high level despite the uncomfortably large current account deficit. In this environment, the risk for a sharper correction remains, posing considerable challenges for macroeconomic policy making.

Monetary policy has been further tightened. The resurgence in domestic demand has raised inflation prospects over the medium-term horizon, even though oil prices have temporarily lowered headline inflation. The Reserve Bank of New Zealand (RBNZ) raised the official cash rate (OCR) by 25 basis points in March 2007 and retained a tightening bias, an appropriate response, in staff's view, to the renewed strength of domestic demand.

There is limited flexibility to make fiscal policy less expansionary in the near term. Although the fiscal position remains strong, the budget became stimulatory this year, mainly as a result of pre-announced spending decisions. In light of the current strength in private domestic demand, staff supports efforts to contain this stimulus, while recognizing that the medium-term fiscal framework limits the ability of fiscal policy to adjust in the short run.

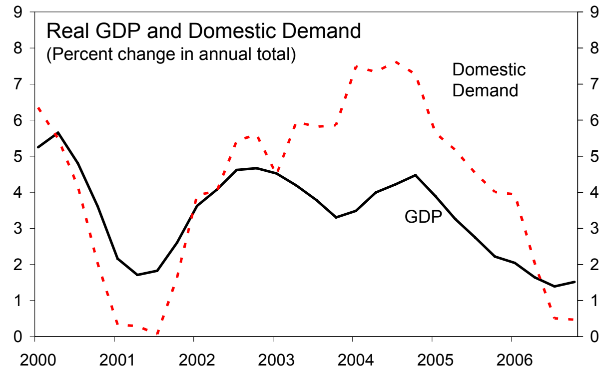
Tax policy changes next year could produce additional stimulus. In addition to planned new spending, possible tax measures that could be included in the May 2007 Budget include reducing the company tax rate from 33 percent to 30 percent (as in Australia) and introducing tax credits for R&D, training, and export marketing. Staff recommend shifting the mix of fiscal measures toward greater tax reductions and smaller expenditure increases should this be necessary to limit the effect on demand.

In light of the continued robust housing market, supplementary stabilization instruments are being reconsidered. In early 2006, various tax and prudential measures were considered by the authorities to ease pressures in the housing market. Given the continued housing boom, these options deserve further scrutiny. Nonetheless, staff welcomes the RBNZ's clear statement that the OCR will continue to be the primary instrument of monetary policy.

The government has released its first statement on the long-term fiscal position and will soon introduce the KiwiSaver scheme. The report on the long-term fiscal position indicates that the fiscal position will deteriorate as a result of demographic shifts, but should be manageable with early and sustained efforts. A work-based saving scheme, KiwiSaver, is set to be introduced in July, which may increase savings by some households, but is not expected to have a significant impact on national saving.

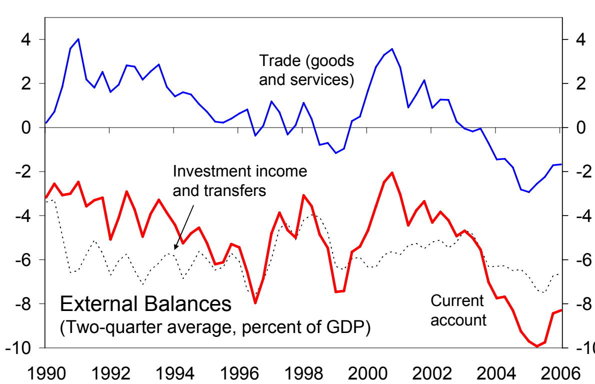
I. Background and Economic Developments

1. **An economic downturn commenced in late 2005.** New Zealand enjoyed a strong expansion during the early 2000's, with GDP growth well above potential. By the end of 2005, labor and capacity utilization had risen to historic highs, while inflation had edged up above the Reserve Bank of New Zealand (RBNZ)'s 1 to 3 percent target band (Table 1). The RBNZ responded by increasing the official cash rate (OCR) to 7¼ percent by end-2005. Meanwhile inward migration, an important driver of the boom, fell off sharply. By early 2006, the economy appeared to be cooling quickly, with quarterly growth dropping to zero and confidence and demand indicators deteriorating.

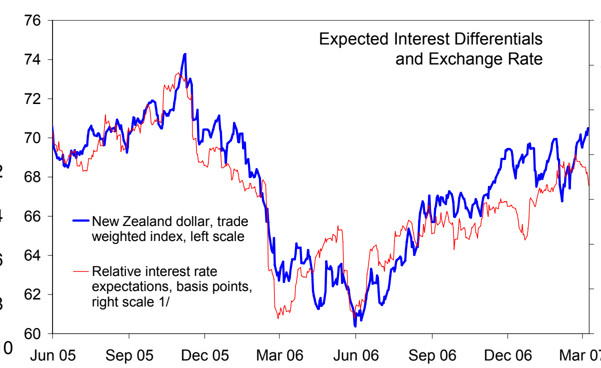


Source: New Zealand Time Series database and Fund staff estimates.

2. **Some rebalancing of the economy took place in 2006.** Net exports contributed negatively to growth in 2002-05 with the traded goods sector weighed down by record strength in the New Zealand dollar. Domestic demand, by contrast, powered ahead, underpinned by the strong labor and housing markets. The external current account deficit peaked at 9¾ percent of GDP in mid-2006, with net foreign liabilities approaching 90 percent of GDP (Table 2).[1] Nonetheless, the exchange rate continued to receive support from capital inflows and retail interest in New Zealand dollar denominated securities in Europe and Japan has remained strong.[2] In the first half of 2006, expectations for monetary easing were brought forward once growth began to falter and, in conjunction with signs that the global carry trade might unwind, the exchange rate fell by 15 percent. By the third



Source: Statistics New Zealand



Source: Reserve Bank of New Zealand
1/ Spread between bank bill futures rates in New Zealand and trade-weighted average of futures rates in the United States, Euro area, Australia, Japan, and United Kingdom.

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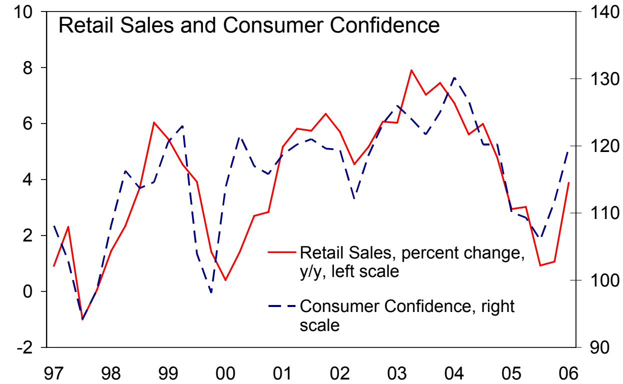
[1] Although foreign liabilities have continued to grow, liquidity and currency risks are contained given that borrowers are predominantly highly-rated banks and about 95 percent of external debt is either denominated in domestic currency or hedged. Chapter III of the Selected Issues paper provides a detailed assessment of New Zealand's external position and the financial soundness of key economic sectors.

[2] The external financing of banks through cross-currency foreign exchange swaps and the role of the Uridashi and Eurokiwi markets is discussed in Box 1 of IMF Country Report No. 06/160.

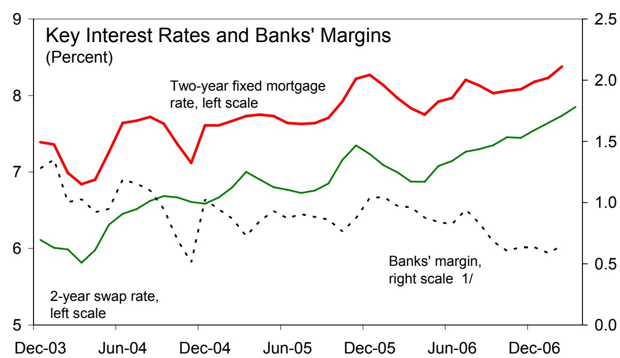
quarter of 2006, the trade balance was showing some improvement due to slower domestic demand, and a recovery in exports, albeit aided by a run-down of inventories. The current account deficit declined to 9 percent of GDP for 2006 as a whole.

3. **Over the last few months, the cycle has turned again.** A range of indicators in late 2006 and early 2007 suggest that domestic demand has regained momentum. These include a resurgent housing market and improved business and consumer confidence. Initially, the pick up in activity was interpreted as temporary, reflecting the sharp decline in oil prices. Increasingly, however, the boost to demand is viewed as more enduring, despite the fact that resources remain stretched. Given the worsening medium-term prospects for inflation, the RBNZ adopted a progressively stronger tightening bias and the exchange rate has retraced its highs of late 2005, moving in tandem with other currencies linked to the global carry trade. As expected by financial markets, the OCR was raised again to 7½ percent in March 2007.



Source: Statistics New Zealand and Westpac McDermott-Miller.

4. **The resilient housing market has contributed to firming demand.** House sales rebounded unexpectedly during 2006, in part due to higher net immigration, while competition between banks and ready access to external funds served to dampen the rise in mortgage interest rates; effective mortgage rates have risen by about 110 basis points over the past three years, which is less than half the increase in the OCR over the same period. Competition in the mortgage market has been evident in reduced interest margins, more active use of "low doc" lending, and acceptance of higher debt service and loan-to-value (LTV) ratios.[3] Indeed, mortgage credit growth has slowed little and household debt-to-income ratios have become more extended. House price inflation was still at 9 percent through February 2007 (y/y). By a number of measures, the New Zealand housing market remains stronger than in Australia, the United Kingdom, and the United States (Figure).

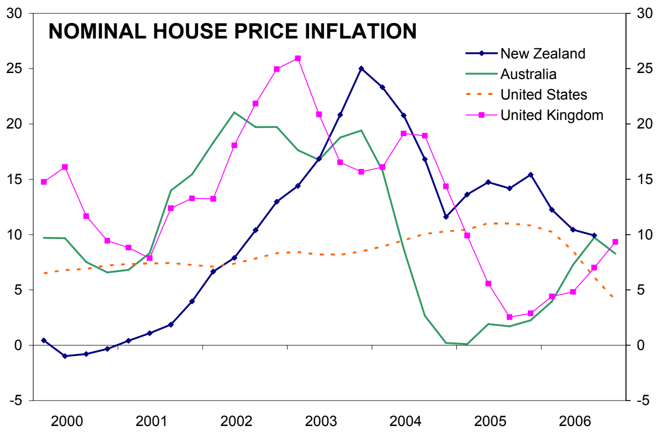


Source: Reserve Bank of New Zealand
1/ Two-year fixed mortgage rate less the 2-year swap rate.

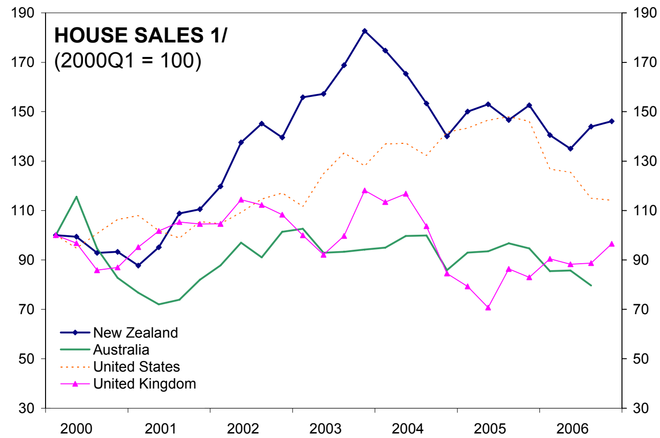
[3] Subprime lending, however, appears to be on a relatively limited scale with market estimates indicating that only 2-5 percent of mortgage loans outstanding are to subprime borrowers. Moreover, home ownership is on a declining trend in New Zealand, whereas the opposite might be expected with a boom in subprime lending.

New Zealand: Housing Market Compared to Other Countries, 2000-06

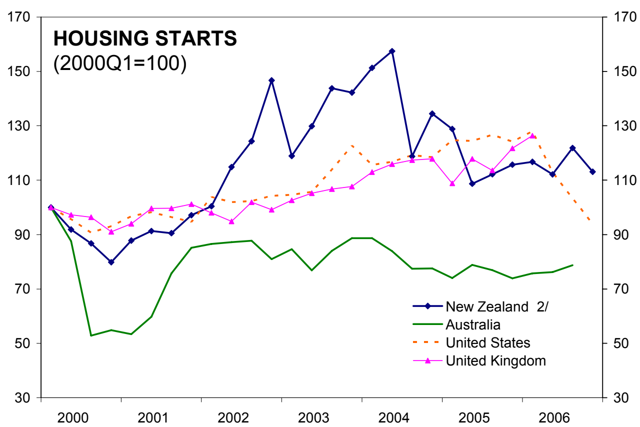
House price inflation remains rapid in New Zealand…



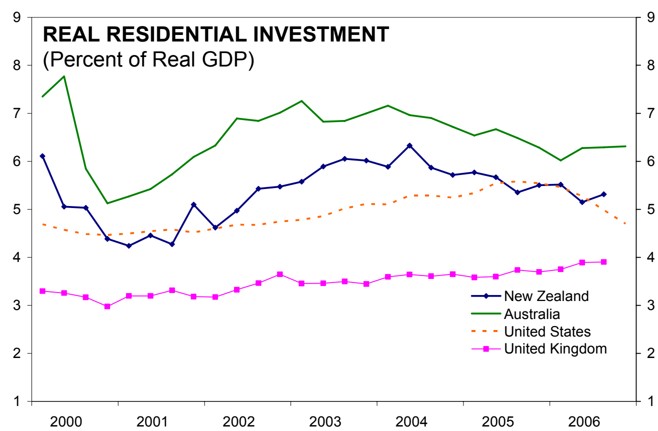
…with house sales having picked up again.



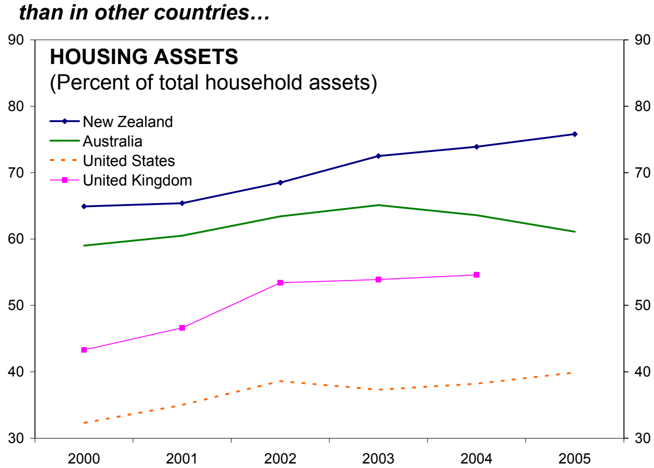
Housing starts are down from their peak, but remain robust…



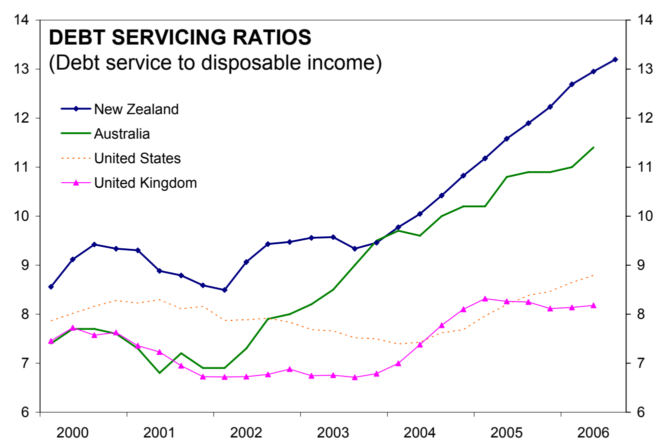
…while residential investment has been sustained.



The "Home Bias" in New Zealand asset portfolios is stronger than in other countries…



…and the debt service ratio has sharply increased during this cycle.

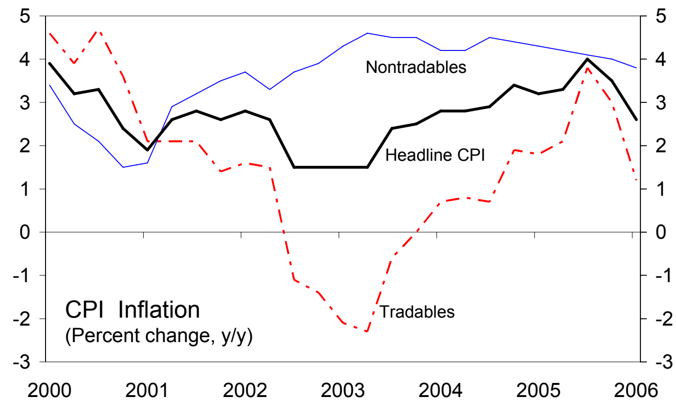


Sources: Reserve Bank of New Zealand, Haver Analytics and Fund staff estimates.

1/ REINZ Total House Sales (New Zealand); New Houses Completed (Australia); New 1-Family House Sales (U.S) and Total Property Sales (U.K).

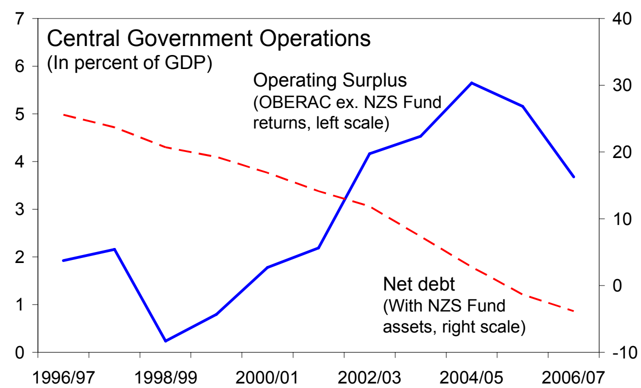
2/ New dwellings authorized.

5. **Headline CPI inflation has declined, but medium-term pressures remain.** During the first half of 2006, the RBNZ held good to its promise of looking through the one-off effects on inflation of the fall in the exchange rate and the rise in oil prices. These shocks combined with still-high nontradables inflation to lift headline CPI inflation to a peak of 4 percent in June. More recently, tradable goods prices have been subject to the opposite forces, lower oil prices and a stronger currency, and CPI inflation eased to 2¾ percent in December 2006. However, nontradables inflation has declined only gradually, and with resource pressures continuing, inflation is likely to pick up again once one-off effects recede.



Source: Statistics New Zealand

6. **The fiscal position has further strengthened.** Tax revenue growth in 2005/06 (fiscal year begins July 1) greatly exceeded budget projections, helping the government to record an operating surplus of 5 percent of GDP,[4] and to reach a positive net financial asset position for the first time (Table 3). The operating surplus was little changed from the previous fiscal year once write-downs of student loans are excluded, consistent with official estimates of a neutral fiscal impulse. The operating surplus is projected to decline to 3¾ percent of GDP in 2006/07, a goal which was on track through January. The budget has become stimulatory this year owing to pre-announced spending initiatives such as the *Working for Families* program.



Source: New Zealand Treasury

[4] Operating balance excluding revaluations, accounting changes and NZ Superannuation (NZS) Fund earnings.

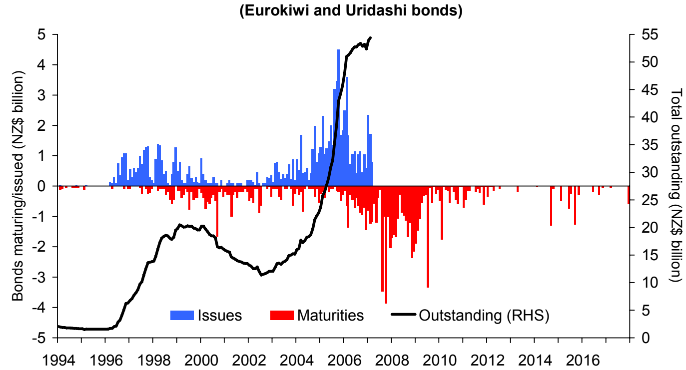
II. Report on the Discussions

7. **Macroeconomic management has operated within a well-established framework for many years.** Monetary policy, through pursuit of the inflation target, has shouldered the primary burden of macroeconomic stabilization. Fiscal policy, by contrast, has been framed in a medium-term setting with fiscal goals and spending plans set well in advance: as a result, fiscal policy has limited flexibility to adjust in the short run. Prudential policy has tended to be light-handed with an emphasis on disclosure and market discipline. Past Fund surveillance has endorsed New Zealand's policy framework, emphasizing the clear design and steadfast implementation of inflation targeting, the advantages from stable and predictable fiscal policy, and the important steps taken by the authorities to promote financial stability.

8. **Recent events, however, have brought this framework under scrutiny.** During the current cycle, a combination of factors–abundant global liquidity, a more competitive banking sector, and longer transmission lags owing to enhanced risk management by households and firms–have served to dilute the effects of monetary tightening. High interest rates have, nonetheless, attracted global investors hungry for yield, keeping the exchange rate at an appreciated level. The high exchange rate has created pressures on the tradable goods sector, the most likely source of productivity gains, and caused large and unsustainable imbalances to persist, accentuating the risks of a hard landing. Against this backdrop, the authorities have been critically examining the macroeconomic policy framework (Box 1). The question they have asked is whether fiscal policy, and alternative, possibly non-conventional, policy tools might also be used to moderate the cycle. The discussions during the consultation reflected these concerns, focusing on the source of the problem, and possible measures that could be adopted.

Offshore New Zealand dollar denominated bond issuance

(Eurokiwi and Uridashi bonds)



Sources: Reserve Bank of New Zealand, Bloomberg and Fund staff estimates.

A. Outlook and Risks

9. **Staff's baseline forecast is for growth to pick up in 2007, but to remain below potential until 2009.** GDP growth is projected to rise to about 2½ percent in 2007, from 1½ percent in 2006 (Table 4). The primary driver is higher private consumption growth, with household incomes benefiting from the tight labor market and increased income support from government. Investment activity is expected to remain sluggish until 2008, and, while the recent rebound in commodity prices provides some offset, exports should grow only modestly given the high exchange rate. A period of growth below the economy's potential will gradually help alleviate the resource pressures that have accumulated in recent years, putting downward pressure on inflation and aiding the narrowing of the current account.

New Zealand: Medium-Term Scenario, 2006–12

	Est.	Projections					
	2006	2007	2008	2009	2010	2011	2012
Real growth (percent change)							
GDP (production basis)	1.5	2.4	2.6	2.7	2.9	3.0	3.0
Final domestic demand	1.2	1.9	2.0	2.5	2.8	3.0	3.3
Exports of goods and services	2.0	2.6	3.8	4.6	5.0	4.7	4.3
Imports of goods and services	-2.4	1.0	2.1	3.8	4.2	4.5	5.0
Inflation and unemployment							
Headline CPI inflation	3.4	2.3	2.6	2.4	2.2	2.1	2.0
Unemployment rate	3.8	4.1	4.4	4.5	4.5	4.5	4.5
Balance of payments (percent of GDP)							
Current account balance	-9.0	-8.6	-7.8	-7.4	-7.4	-7.7	-8.2
Balance on goods and services	-1.9	-1.3	-0.9	-0.6	-0.3	-0.4	-0.8
Balance on income and transfers	-7.0	-7.2	-6.9	-6.9	-7.0	-7.2	-7.4

Sources: Data provided by the New Zealand authorities; and Fund staff estimates and projections.
1/ Fund staff estimates; calculated as residual from gross national investment and external current account balance.

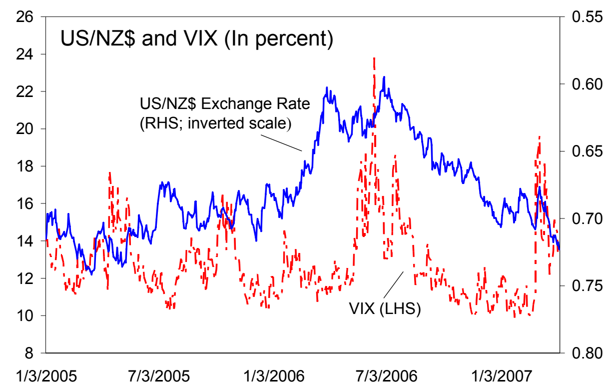
10. **The discussions reviewed the risks around this forecast.** The authorities shared the view that the economy was strengthening before rebalancing had proceeded as far as was desirable. Indeed, growth could be stronger than currently expected, in which case engineering a soft landing for the economy would be even more challenging. The common view in the discussions was that the current account deficit remained unsustainably large and under the most likely scenario would improve only gradually. New Zealand was thus particularly vulnerable to a global event such as a sharp unwinding of the carry trade that could trigger a large fall in the currency, an upward spike in interest rates, and perhaps a significant decline in asset prices. Given the strong correlation between house prices and private consumption, the result might be an abrupt slowing of growth. While the flexibility of the economy and the robust health of the banks and corporate sector would limit the depth and duration of a potential slowdown, the economy might be in for an uncomfortable period. The important question was whether current policies were doing enough to minimize the risks.

B. Macroeconomic Policies

11. **Monetary policy has remained vigilant against inflation pressures.** The resurgence in domestic demand has raised inflation prospects over the medium-term horizon, even though lower oil prices are likely to temporarily bring down headline inflation this year. In recent months, the RBNZ has expressed particular concern over the risks to the medium-term inflation outlook arising from the strength in the housing market and from the potential for additional fiscal stimulus beyond that projected at the time of the 2006 Budget in May. Staff concurred with this diagnosis and considered that further monetary tightening was warranted, consistent with the RBNZ's subsequent decision to raise the OCR in March and to retain a tightening bias.

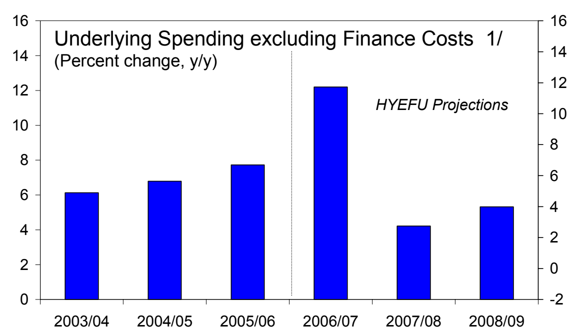
12. **The exchange rate continues to float freely.** Large capital inflows have driven the New Zealand dollar out of line with medium-term fundamentals. Staff estimates the New Zealand dollar to be 10-15 percent above the medium term equilibrium level based on the equilibrium real exchange rate approach under the CGER. This is somewhat lower than the level implied by the authorities' assumption that the currency will depreciate by about 20 percent over the medium term. The continued strength of the currency has prompted RBNZ Governor Bollard to describe the exchange rate as exceptionally and, in some respects, unjustifiably high. However, the authorities indicated that they did not view current conditions as meeting the other criteria they have specified to justify intervention.[5]

13. **The immediate path of the New Zealand dollar hinges on the carry trade.** The global search for yield has targeted New Zealand dollar-denominated assets because of the large interest differentials, which looked likely to persist. Staff noted that even though the Bank of Japan had begun to tighten, the domestic returns available to *Uridashi* investors and the funding cost for leveraged investors in Japan would rise only gradually. With regard to interest rates in New Zealand, the critical issue was when markets expected tightening to end. In early March, there was some unwinding of carry trades, causing the New Zealand dollar to weaken. However, the exchange rate has since re-strengthened.[6]



Source: Bloomberg and Fund staff estimates.

14. **The fiscal surplus has risen to levels well above that required within the medium-term fiscal framework.** The government's medium-term fiscal objectives are that the operating surplus covers contributions to the New Zealand Superannuation (NZS) Fund and part of capital spending, such that gross debt remains around 20 percent of GDP. Surpluses beyond those needed to meet these objectives have contributed to political pressures to increase spending



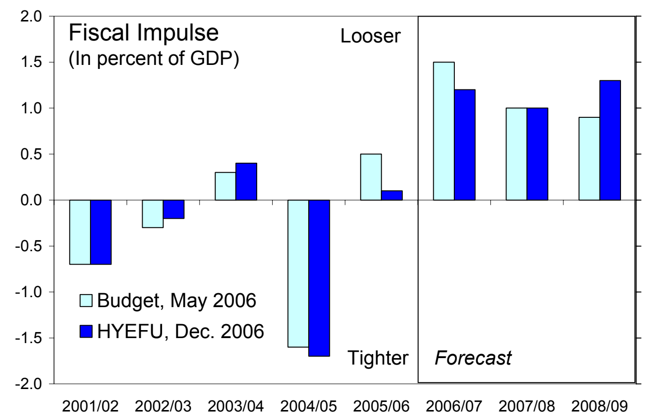
Sources: New Zealand Treasury and staff calculations.
1/ Excludes foreign exchange and pension liability revaluations, GSF pension expenses, asset and loan write-offs, and other accounting or one-off items.

[5] In March 2004, the authorities specified the following criteria to justify intervention: the exchange rate is exceptionally high (or low); the exchange rate is unjustified by economic fundamentals; intervention is consistent with monetary policy objectives; and intervention is likely to be effective. There has been no intervention since then (in fact, since 1985) and the RBNZ has continued to maintain a zero net open foreign exchange position, with the recent increase in gross reserves largely explained by changes in swap positions in conjunction with major changes implemented during 2006 in the RBNZ's domestic liquidity management operations.

[6] Chapter I of the forthcoming Selected Issues paper studies the impact of the carry trade and finds that swings in the New Zealand dollar largely reflect the favorable interest rate spreads, as well as foreign investor risk appetite, which has been generally very strong in recent years.

and/or cut taxes. The authorities' plans, as outlined in the December *Half Year Economic and Fiscal Update* (HYEFU), are to reduce the surplus to a projected 2¼ percent of GDP in the medium term, with expenditure on welfare and social services rising as announced in previous budgets, while revenues decline to more normal levels relative to GDP. These projections are consistent with achieving the medium-term fiscal objectives.

15. **Nonetheless, fiscal stimulus is being added to a still over-heated economy.** Staff questioned whether there was any scope for delaying the current stimulus, perhaps by slowing the timing of current spending plans. The authorities drew a distinction between the "fiscal space" that was available owing to the strength of the overall budget and the "macroeconomic space" provided by the cyclical position of the economy. The lower surpluses envisaged in the HYEFU took account of the fiscal space, recognizing that continued large surpluses were not required by the medium-term objectives and would encounter political pressure. Nonetheless, the authorities indicated that fiscal policy would continue to try to avoid complicating the task of monetary policy and that fiscal expansion would be contained to the extent possible. In particular, should revenues overperform, as they have in recent years, the 2006/07 surplus would be allowed to increase as an automatic stabilizer. In case of further positive revenue surprises, staff encouraged the authorities to limit new initiatives in the 2007 Budget (covering 2007/08) to the pre-announced allowance. Consideration should also be given to limiting the pre-commitment of the allowance in the 2008 Budget to create more fiscal flexibility next year.



Source: New Zealand Treasury

16. **The 2007 Budget is expected to announce tax cuts.** Possible measures that could be part of a tax cut package include reducing the company tax rate from 33 to 30 percent (making it the same as in Australia), and introducing tax credits for R&D, training, and export marketing. Along with planned increases in spending, these tax cuts could provide additional fiscal stimulus in 2008 ahead of a significant easing in resource pressures in the economy. Staff recommended that, if necessary, the authorities could contain the size of such a stimulus by shifting the mix of fiscal measures toward greater tax reductions and smaller expenditure increases. Staff observed that the proposed tax credits were an abrupt deviation from New Zealand's previous very clean tax system. The authorities fully recognized that these measures were "second best" solutions, especially as there would be pressure for additional tax credit measures. They also noted that R&D was already being encouraged through grants from the budget, although there were doubts whether this spending was fully effective.

C. Supplementary Stabilization Instruments

17. **The authorities are taking a second look at supplementary stabilization instruments (SSI).** In early 2006, various tax and prudential reforms were considered by the authorities as possible ancillary measures with direct bearing on the housing market that might complement monetary policy in managing inflation pressures.[7] At the time, there were doubts about the effectiveness of these measures. However, the continued housing boom has caused the authorities to reassess these options, and the March 2007 *Monetary Policy Statement* indicates that consideration is being given to alternative measures that might help support the OCR. The RBNZ has nonetheless clearly emphasized that the OCR would remain the primary instrument of monetary policy.

18. **Some tax measures might be warranted.** Staff offered cautious support for options such as eliminating the ability to deduct losses on housing-related investments from other income, and more active enforcement of current laws on the taxation of capital gains on properties purchased with the intention of resale. These measures, which are more in the way of tightening existing tax laws rather than introducing new distortions, could act as a signal that might dampen enthusiasm with respect to property investments.[8] However, the authorities indicated that they did not expect that such measures would do much to moderate the housing cycle.

19. **The financial sector remains very sound, but a tightening of prudential and lending standards could be useful to lean against housing market risks.** The authorities agreed that it might be useful to raise banks' awareness of the risks of "low-doc" and high LTV mortgages, particularly in light of current concerns about lapses in underwriting standards in the U.S. subprime market. Staff stressed that banks should be especially careful about lending for investments in housing and farms where properties were expected to generate negative cash flows. Under the Standardized Approach to Basel II, one option would be to tailor risk weights on mortgages according to the LTV ratio and to whether or not there was mortgage insurance. Non-bank financial institutions have been active in the property market, and staff supported the proposed structure for the supervision of non-bank deposit takers, which appeared to strike a sensible balance between enhancing depositor information and containing the costs of regulation.

D. Other Issues

20. **KiwiSaver, a work-based saving scheme, will begin to operate in July.** Under the scheme, employees can contribute 4 or 8 percent of earnings to approved savings products. Employers can contribute part or all of the employees share and receive tax incentives on contributions up to 4 percent (Box 2). The scheme may facilitate increased

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[7] The February 2006 report on SSI can be found at: http://www.rbnz.govt.nz/news/2006/2504934.html.

[8] Housing accounts for about three-quarters of household assets. Chapter II of the forthcoming Selected Issues paper discusses the "home bias" of New Zealand households and analyzes the incentives created by the current tax system to invest in real estate.

savings in some households, but, at least initially, the authorities do not expect the effect on national savings to be substantial. Since KiwiSaver will provide a subsidy to first-home buyers saving for a deposit, staff inquired whether this might provide a further boost to the housing market. The authorities considered the potential boost to be limited given that the subsidy would be targeted based on income. They agreed, however, that it would be appropriate to keep the scheme's performance under review to assess whether any parameters needed to be modified. Coupled with the launch of the KiwiSaver, reforms of the taxation of managed funds and international portfolio investments are also underway. Staff proposed that a broader review of the taxation of savings vehicles might be warranted at some point to place these various initiatives within an integrated framework.

21. **The government has released its first statement on the long-term fiscal position.** In tackling long-term fiscal issues, the authorities considered that most progress had been made with regards to superannuation. Even so, staff questioned whether gradual changes might be warranted to key parameters of the superannuation system such as the replacement rate and eligibility age. The report on the long-term fiscal position concludes that considerable challenges remain in other areas such as health spending, although these should be manageable with early and sustained efforts (Box 3). Improving productivity in the health care system is likely to be particularly important given the political difficulty of setting limits on health spending. The authorities noted that social welfare benefits and education spending could also pose a challenge for fiscal sustainability. A key decision was whether it would be possible to continue indexing welfare benefits to the CPI. The alternative of wage indexation would significantly increase expenditure over time.

22. **Progress has been made on a number of banking issues.** In November 2006, an Australian-owned bank operating locally as a branch registered as a New Zealand incorporated subsidiary of the Australian parent. This achieved the RBNZ's goal that all systemically important banks be locally incorporated so as to reap the benefits of a local board and facilitate crisis management. Progress has also been achieved in enhancing cooperation and information sharing between Australian and New Zealand regulators. Recent legislative changes formalized a requirement on regulators in the two countries to be alert to each others' interests in times of stress. With legislation in place, the work of the Trans-Tasman Council on Banking Supervision will now focus more on the practical aspects of coordination in crisis management.

III. Staff Appraisal

23. **Economic growth has recovered, but remains unbalanced.** After a brief pause, GDP growth is picking up. Domestic demand has strengthened with activity in the housing market particularly robust. Exports, by contrast, are battling against the high exchange rate, which is receiving support from the global search for yield. Moreover, the recent slowdown was too short in duration to alleviate the economy's significant imbalances. With the upturn characterized by a still large current account deficit, high household indebtedness, and a continued tight labor market, the risk for a sharper correction remains.

24. **Given elevated medium-term inflation risks, monetary policy appropriately retains a tightening bias.** In light of still-stretched resource utilization, inflation prospects have risen over the medium-term horizon, even though lower oil prices may temporarily bring down headline inflation this year. The RBNZ responded to the renewed strength of domestic demand by raising the OCR by 25 basis points in March 2007. Further rate hikes cannot be ruled out.

25. **The exchange rate rightly remains flexible.** The freely-floating exchange rate continues to provide a valuable shock absorber to the economy and underpins the inflation targeting regime. Nonetheless, the real exchange rate is currently well above its historical average. Given the large current account deficit, a correction in the exchange rate is warranted, but this is being delayed by continuing capital inflows.

26. **Fiscal plans are largely predetermined, especially in the near term.** Although the fiscal position remains strong, the budget became stimulatory in 2006/07, mainly as a result of pre-announced spending decisions. The resurgence in private demand raises the question of whether such stimulus is appropriate. The authorities, however, face growing pressure to reduce budget surpluses over time to bring them in line with medium-term fiscal objectives. There is also limited flexibility in the short run to roll back new spending that has been pre-announced within the medium-term fiscal framework. However, if resource pressures were to persist, the authorities should scale back the still more-malleable fiscal plans for 2007/08 to support monetary policy.

27. **Tax policy changes in the 2007 budget could produce additional stimulus**. Depending on developments, the tax package proposed for mid-2008, in conjunction with new spending, could provide a further unwelcome boost to demand. Staff therefore welcomes the authorities' willingness to consider containing the stimulus by shifting the mix of fiscal measures toward greater tax reductions and a smaller increase in expenditures. Possible tax credits for R&D, training, and export marketing represent a significant step away from the current very clean tax arrangements, and should be used cautiously. There may also be scope for expenditure savings for the budget in areas that are to be targeted by tax credits.

28. **In light of the continued buoyancy in the housing market, supplementary stabilization instruments are back on the table.** Staff thinking about these instruments has evolved since last year when the assessment was that they were not needed. Given the booming housing market, tax measures that might make the housing sector less procyclical merit scrutiny. In particular, limiting the ability to deduct losses on housing-related investments from other income combined with more active enforcement of current tax laws might help to discourage property speculation.

29. **Some tightening of prudential regulation might also be useful.** The RBNZ should advise banks to maintain risk management and underwriting standards by carefully managing high LTV loans and loans for investments in housing, particularly in circumstances where properties are expected to generate negative cash flows. Banks should also be advised to obtain adequate documentation on new loans. The current

experience in the U.S. market with losses arising from subprime loans provides a salutary warning on these issues. Under the standardized approach to Basel II, staff encourage the RBNZ to apply varying risk weights on mortgages according to the LTV ratio and the presence of mortgage insurance.

30. **KiwiSaver is set to be launched in July.** KiwiSaver may help to increase savings in some households, although the effect on national savings is likely to be limited. Reforms of the taxation of managed funds and international portfolio investments are also underway. A broad review of taxation of savings vehicles should be undertaken to place these various initiatives within an integrated framework.

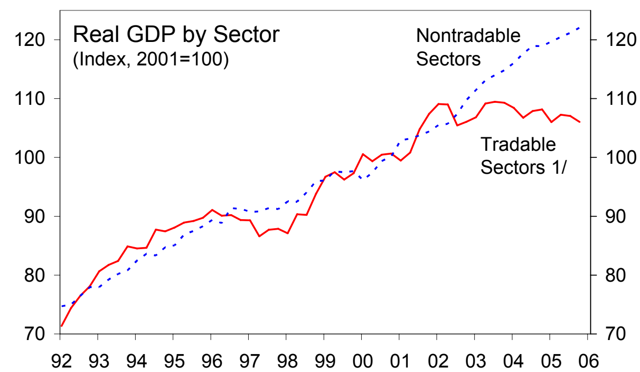
31. **New Zealand faces a significant long-term fiscal challenge, which should be manageable with early and sustained efforts.** The staff welcomes the release of the first report on the long-term fiscal position, which clearly articulates the significant long-term challenges that rising health care costs and population aging will pose for fiscal policy. Improving productivity in the health care system is likely to be particularly important given the difficult challenge to limit health spending. On superannuation, going forward, some consideration might be given to a gradual decline in the replacement rate and a gradual increase in the eligibility age as life expectancy rises.

32. **It is proposed that the next Article IV consultation with New Zealand be streamlined and take place on the standard 12-month cycle.**

Box 1. Macroeconomic Stabilization Challenges in a Small Open Economy

New Zealand has been at the frontier of developments in macroeconomic policy frameworks. By the early 1990s, New Zealand had established a framework consisting of a freely-floating exchange rate, an inflation-targeting monetary policy and a medium-term oriented fiscal policy, with a high degree of transparency in both monetary and fiscal policies. Together with deep structural reforms, this macroeconomic framework has contributed to much improved economic performance in the past 15 years.

Nonetheless, recent economic imbalances have been greater than in the past cycles, which has raised some concerns. Activity in the tradable sectors has been flat since 2003, with all economic growth occurring in the nontradable sectors. Relatedly, net exports have declined substantially more than in past cycles, and, in late 2005, the real exchange rate peaked at a post-float high. Concerns about a possible "hard landing" have been prompted by the very high external current account deficit, the large rise in house prices and household debt, and the extended duration of the high real exchange rate. There is also the possibility that the resource shifts between tradable and nontradable sectors associated with large exchange rate cycles may undermine investment and productivity growth.[1]



Source: Statistics New Zealand
1/ Manufacturing, agriculture, forestry&fishing, and exports of services.

The authorities have been exploring whether any policy changes would be appropriate to moderate potential imbalances in future cycles. Monetary policy is already implemented flexibly, with scope to "avoid unnecessary instability in output, interest rates, and the exchange rate" in pursuing inflation of 1 to 3 percent over a medium term horizon. The authorities have therefore focused on:

- **Formalizing the framework for foreign exchange intervention.** In March 2004, the RBNZ set out the criteria that would be required to justify intervention in the foreign exchange market, and in December 2005 it stated that the exchange rate was "exceptionally and unjustifiably high" (one of the criteria) but no intervention has yet occurred.[2]

- **Evaluating whether supplementary stabilization instruments would be useful.** With the housing boom driving domestic demand, the authorities launched a review of a range of possible prudential and taxation measures targeted at the housing market in late 2005. The review concluded that further work was needed on areas such as improving the responsiveness of housing supply, but that introducing new discretionary instruments—a levy on mortgage interest, for example—would be subject to significant problems.[3]

- **Appraising the scope for improvement in the broader macroeconomic framework.** The Macroeconomic Policy Forum in June 2006, with participation from foreign academics and international organizations, found no "silver bullet" but concluded that further work would be useful on the stabilization role of fiscal policy, exchange rate volatility, and structural policies related to residential investment.

[1] See proceedings of Macroeconomic Policy Forum, June 2006 at: http://www.rbnz.govt.nz/research/workshops/12jun06/2837468.html
[2] Details on the criteria are at: http://www.rbnz.govt.nz/finmarkets/foreignreserves/intervention/index.html
[3] The report is available at: http://www.rbnz.govt.nz/news/2006/2504934.html

BOX 2. HOW WILL KIWISAVER WORK?

KiwiSaver is a voluntary scheme to aid retirement saving that will begin operating in July 2007. The scheme is work-based with employees contributing either 4 percent or 8 percent of their incomes. Membership is voluntary, with only people entering new jobs being automatically enrolled, although they can opt out within 8 weeks. Incentives to join include a $NZ 1,000 tax-free contribution from the government and assistance for first home buyers, while employers can add to employees contributions tax-free up to 4 percent of income. Funds cannot be withdrawn until age 65, except in case of hardship or ill health, or for a deposit on a first home. Nonetheless, up to half of employees' own contributions can be diverted to repayment of the mortgage on their residence.

By reducing the costs and complexity of saving, the scheme aims to help people get into the habit of saving. Costs are reduced through subsidized investment management fees and by having the Inland Revenue Department, rather than employers, transfer the contributions to investment funds. Complexity is reduced by giving employees only two options for their contribution rate, and by having a set of default investment managers for those employees who do not make a selection. Recent research finds that simplifying enrollment in savings plans can significantly increase participation.[1]

The fiscal costs of KiwiSaver are expected to be modest. Official projections assume that about 25 percent of working age New Zealanders will have opened a KiwiSaver account by 2013/14. Combining the cost of savings incentives, subsidies for management fees, and tax exemptions, the New Zealand Treasury estimates the annual cost of KiwiSaver at about 0.15 percent of GDP.

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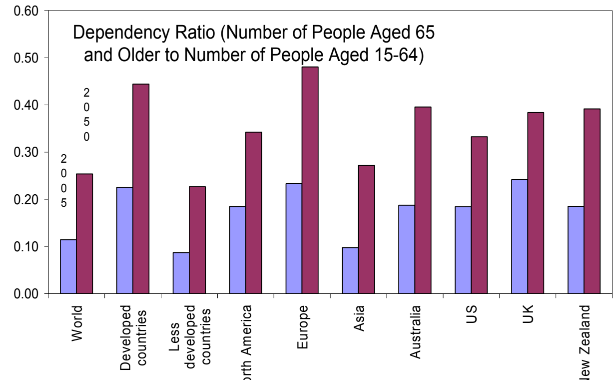
[1] Beshears, Choi, Laibson and Madrian, 2006, "Simplification and Saving," NBER Working Paper 12659.

Box 3. New Zealand's Long-Term Fiscal Position

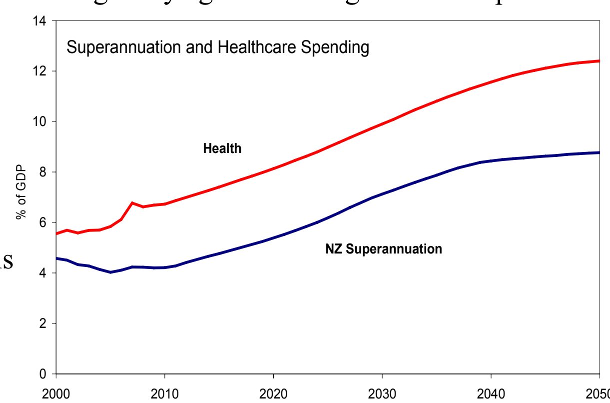
New Zealand recently released its first statement on the long-term fiscal position.[1] The report—which is to be produced at least every 4 years—assesses the fiscal situation over the next 40 years, the key factors driving the outlook, and the main areas of uncertainty. While New Zealand's current fiscal position is strong, and it is expected to remain strong in the next one or two decades, a significant deterioration is likely thereafter.

The outlook for population aging in New Zealand is typical for OECD countries. The transition to lower fertility rates and longer life expectancies will increase the share of older people in the population dramatically over the next decades. By 2050, New Zealand's old age dependency ratio is expected to double to 40 percent, close to Australia and the U.K., and slightly below the average for European countries.

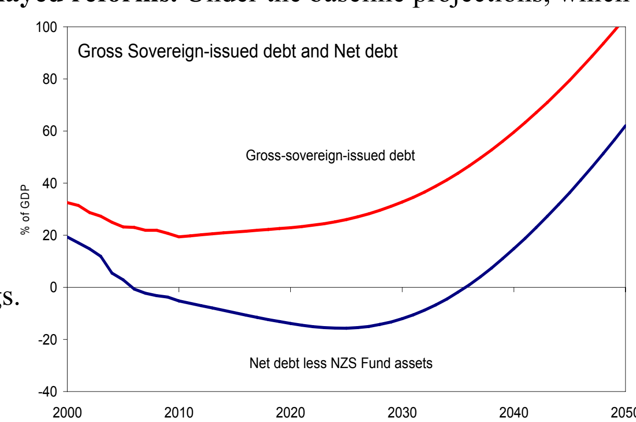


Source: United Nations (2005)

These demographic changes will raise spending significantly, especially on pensions and healthcare. Pension (superannuation) payments, of 4 percent of GDP currently, are projected to rise to 9 percent of GDP by 2050 assuming that the eligibility age is unchanged and that pensions continue to grow in line with after-tax wages. Health spending is also affected by demographic trends, but the rising relative price of healthcare and policy decisions on the coverage of services are also expected to be important factors driving health spending, which could double to 12½ percent of GDP. However, there is significant uncertainty in this baseline projection; for example, a continuation of past cost trends would raise spending even further to 15½ percent of GDP.

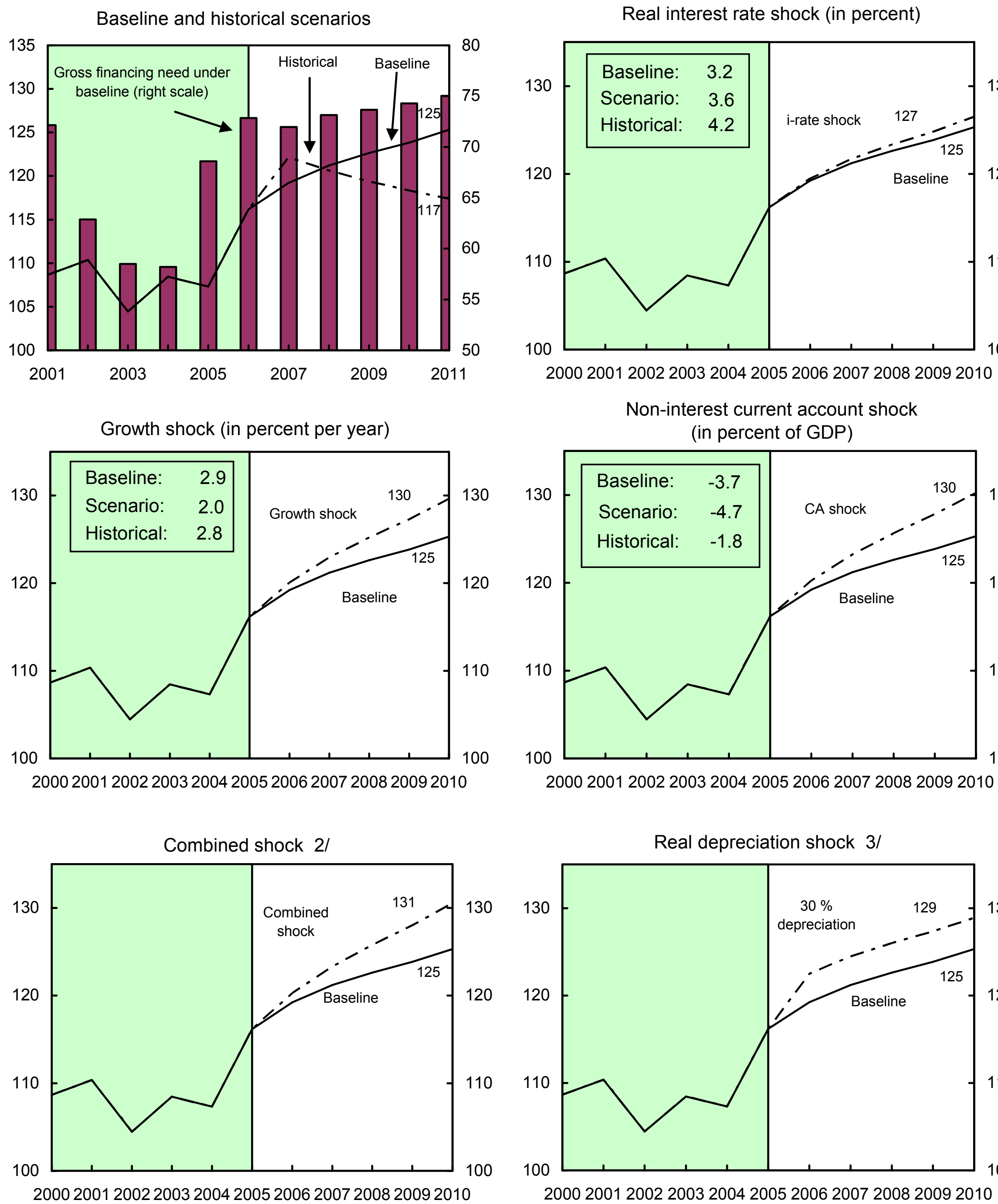


Policy changes will be needed to ensure fiscal sustainability, and early and sustained adjustments are more manageable than delayed reforms. Under the baseline projections, which assume tax revenue is broadly stable relative to GDP, the primary fiscal balance would begin to decline in the 2020s and go into deficit in the 2030s, leading to a rapid debt accumulation. Nonetheless, debt could be stabilized with gradual reduction in spending relative to the baseline that reached 4½ percent of GDP by 2050. Some revenue increases would moderate the required savings. By contrast, delaying the adjustment until the 2030s would require a sharp 6 percent of GDP reduction in spending, or larger revenue increases, in order to preserve debt stability.



[1] The Statement released in June 2006 can be found at www.treasury.govt.nz/longtermfiscalposition/

Figure 1. New Zealand: External Debt Sustainability: Bound Tests 1/
(External debt in percent of GDP)



Sources: International Monetary Fund, Country desk data, and staff estimates.
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/ Permanent 1/4 standard deviation shocks applied to interest rate, growth rate, and current account balance.
3/ 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. For a general discussion of balance sheet vulnerabilities, see Chapter III of the Selected Issues.

Table 1. New Zealand: Selected Economic and Financial Indicators, 2002–07

Nominal GDP (2006): US$ 104.0 billion — GDP per capita (2006): US$ 24,924
Population (2006): 4.2 million — Quota: SDR 894.6 million

	2002	2003	2004	2005	2006	2007 Proj.
Real growth (percent change)						
GDP (production basis)	4.7	3.3	4.5	2.2	1.5	2.4
Final domestic demand	5.3	6.2	7.1	4.3	1.2	1.9
Private consumption	4.3	5.8	6.0	4.6	1.9	2.2
Govt. consumption	1.8	2.4	5.7	4.1	4.5	3.5
Fixed investment	10.7	9.9	10.6	3.6	-2.7	-0.2
o/w Residential	18.7	19.4	5.1	-4.5	-2.6	0.2
o/w Business	-0.7	15.3	13.1	8.0	-6.4	-0.8
Inventories 1/	0.3	-0.3	0.3	-0.3	-0.8	0.7
Exports of goods and services	6.2	2.2	5.7	-0.5	2.0	2.6
Imports of goods and services	9.6	8.2	16.0	5.5	-2.4	1.0
Headline CPI inflation (percent change)	2.6	1.7	2.3	3.0	3.4	2.3
End of period (percent change)	2.7	1.5	2.7	3.2	2.7	2.8
Unemployment rate (in percent)	5.2	4.6	3.9	3.7	3.8	4.1
Investment and saving (in percent of GDP)						
Investment	22.8	23.1	24.5	24.5	22.8	22.3
National saving 2/	18.8	18.6	17.9	15.5	13.8	13.7
Public finance (in percent of GDP) 3/						
Revenue	31.7	33.0	33.0	34.6	37.8	36.3
Expenditure	30.2	31.5	29.3	30.7	31.9	33.2
Operating balance 4/	1.9	1.5	5.2	4.1	7.3	3.8
OBERAC 5/	2.2	4.2	4.5	5.6	5.2	3.7
Net Crown debt including NZS Fund	14.1	11.9	7.3	2.8	-1.4	-3.9
Money and credit (end of period)						
Resident M3 (percent change)	11.5	9.5	3.5	9.4	12.2	...
Private domestic credit (percent change)	9.1	8.2	12.2	10.2	13.2	...
Interest rate (90-day, in percent) 6/	5.9	5.3	6.8	7.7	7.7	7.9
Government bond yield (10-year, in percent) 6/	6.1	5.9	6.0	5.7	5.9	5.9
Balance of payments (in percent of GDP)						
Current account	-4.0	-4.5	-6.7	-9.0	-9.0	-8.6
($NZ billion)	-5.2	-6.1	-9.8	-13.9	-14.4	-14.5
Trade balance (goods)	0.2	-0.6	-1.4	-2.5	-2.0	-1.7
Terms of trade (percent change)	-4.5	0.9	6.3	1.1	0.0	-0.8
Foreign assets and liabilities ($NZ billion)						
Net international investment position	-100.2	-106.1	-124.2	-131.4	-143.2	-157.9
(in percent of GDP)	-77.6	-77.8	-84.5	-85.4	-89.4	-93.2
Official reserves	9.4	9.3	9.7	13.1	19.5	...
Exchange rate (end of period)						
US$/$NZ 6/	0.52	0.66	0.72	0.68	0.70	0.72
Trade-weighted index (June 1979 = 100) 6/	58.2	65.1	68.8	70.6	69.6	70.3
Nominal effective exchange rate 7/	112.3	126.0	132.3	135.9	128.3	...
Real effective exchange rate 7/	114.2	127.9	134.9	139.9	132.5	...

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 attributable to state-owned and Crown entities.
5/ Operating balance net of revaluations and changes in accounting rules (excluding net NZS Fund asset returns).
6/ Data for 2007 are as of April 5.
7/ IMF Information Notice System index (1990 = 100).

Table 2. New Zealand: Balance of Payments and External Debt, 2002–07

	2002	2003	2004	2005	2006	2007 Proj.
			(In percent of GDP)			
Current account balance	-4.0	-4.5	-6.7	-9.0	-9.0	-8.6
Goods balance	0.2	-0.6	-1.4	-2.5	-2.0	-1.7
Exports, f.o.b.	24.2	21.2	21.0	20.3	21.7	20.8
Imports, f.o.b.	-24.0	-21.8	-22.4	-22.7	-23.7	-22.5
Services balance	1.0	1.2	0.7	0.1	0.1	0.4
Receipts	8.9	8.4	8.1	7.7	7.6	7.6
Payments	-8.0	-7.2	-7.4	-7.6	-7.5	-7.1
Income balance	-5.4	-5.2	-6.1	-6.9	-7.5	-7.8
Receipts	1.9	1.8	1.6	1.3	1.4	1.6
Payments	-7.3	-7.0	-7.7	-8.2	-8.9	-9.4
Transfers balance	0.1	0.2	0.1	0.3	0.5	0.5
Inflows	1.1	1.1	0.9	1.1	1.2	1.3
Outflows	-0.9	-0.9	-0.8	-0.8	-0.8	-0.7
Capital and financial account balance	3.5	3.8	8.2	8.0	8.3	...
Capital account (net)	1.4	0.6	0.2	-0.2	-0.2	...
Financial account (net)	2.1	3.2	8.1	8.2	8.5	...
Direct investment (net)	2.3	2.4	3.8	2.6	6.6	...
Portfolio investment (net)	2.8	1.4	5.9	-0.2	-1.5	...
Equity securities (net)	-0.5	-0.2	-1.7	-1.2	-1.0	...
Debt securities (net)	3.2	1.6	7.6	1.0	-0.5	...
Other investment (net)	-2.9	-0.6	-1.6	5.7	3.5	...
Assets	-3.1	-1.2	-0.7	2.1	-5.0	...
Liabilities	0.2	0.6	-0.9	3.7	8.5	...
Net errors and omissions	0.5	0.6	-1.6	1.1	0.7	...
Overall balance	-0.1	0.0	0.0	0.0	0.0	...
			(Assets and liabilities as of end-December)			
Total external debt	110.4	104.4	108.5	107.1	116.7	119.4
Short-term	53.3	48.8	54.0	55.6	59.8	…
Long-term	57.1	55.6	54.5	51.5	56.9	…
Net international investment position	-77.6	-77.8	-84.5	-85.4	-89.4	-93.2
Net equity	-15.3	-16.0	-16.3	-12.3	-11.8	…
Net debt	-62.3	-61.9	-68.2	-73.0	-77.6	…
			(In billions of NZ dollars)			
Gross official reserves 1/	9.4	9.3	9.7	13.1	19.5	19.1
RBNZ net short position in forex swaps 1/	...	...	1.5	2.7	10.5	10.3
Gross reserves in months of future imports of g&s	3.9	3.7	3.8	5.0	7.9	7.9
Gross reserves as percent of short-term debt	13.7	14.0	12.2	15.2	20.3	18.4

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

1/ For 2007, actual number for end-January.

Table 3. New Zealand: Summary of Central Government Budget, 2001/02–2006/07 1/

	2001/02	2002/03	2003/04	2004/05	2005/06 2/	2006/07 HYEFU
	(In billions of New Zealand dollars)					
Revenue	39.9	43.6	46.9	52.1	59.2	59.0
Tax revenue	36.5	39.8	42.5	46.6	52.0	51.7
Direct taxation	24.5	26.8	28.6	32.0	36.7	36.2
Indirect taxation	12.0	13.0	14.0	14.0	14.7	15.2
Nontax revenue	3.5	3.8	4.4	5.4	7.2	7.3
Expenditure	38.0	41.7	41.6	46.2	49.9	54.0
Social security and welfare	13.5	13.9	14.3	14.3	14.7	15.6
New Zealand Superannuation	5.5	5.6	5.9	6.1	6.4	6.8
Other	8.0	8.3	8.4	8.2	8.3	8.8
Health	7.0	7.5	8.1	8.8	9.5	10.7
Education	6.5	7.0	7.6	7.6	7.9	9.9
Finance costs	2.1	2.4	2.3	2.3	2.4	2.5
Other	8.9	11.0	9.4	13.3	15.4	15.3
Net surplus from SOEs and Crown entities	0.5	0.1	2.1	0.4	2.2	1.2
Operating balance 3/	2.4	2.0	7.4	6.2	11.5	6.3
OBERAC 4/	2.7	5.5	6.4	8.5	8.1	6.0
Cash balance 5/	1.4	5.7	6.0	10.2	9.5	5.9
Capital investment 6/	2.3	2.0	3.0	2.0	2.6	3.5
Gross Sovereign-issued debt	36.2	36.1	34.7	35.0	35.5	37.9
Net Core Crown debt	17.8	17.6	14.4	10.8	7.7	6.4
Net Core Crown debt with NZS Fund	17.8	15.7	10.4	4.2	-2.1	-6.3
Net worth 7/	18.7	23.8	35.5	50.0	71.4	77.7
	(In percent of GDP)					
Revenue	31.7	33.0	33.0	34.6	37.8	36.3
Tax revenue	29.0	30.1	29.9	31.0	33.2	31.8
Expenditure	30.2	31.5	29.3	30.7	31.9	33.2
Social security and welfare	10.7	10.5	10.0	9.5	9.4	9.6
Health	5.6	5.7	5.7	5.9	6.1	6.6
Education	5.1	5.3	5.3	5.0	5.1	6.1
Finance costs	1.7	1.8	1.6	1.5	1.5	1.5
Other	7.0	8.3	6.6	8.8	9.8	9.4
Net surplus from SOEs and Crown entities	0.4	0.1	1.5	0.3	1.4	0.7
Operating balance 3/	1.9	1.5	5.2	4.1	7.3	3.8
OBERAC 4/	2.2	4.2	4.5	5.6	5.2	3.7
Cash balance 5/	1.1	4.3	4.3	6.8	6.1	3.6
Capital investment 6/	1.9	1.5	2.1	1.3	1.7	2.1
Gross Sovereign-issued debt	28.8	27.3	24.4	23.3	22.7	23.3
Net Core Crown debt	14.1	13.3	10.1	7.2	5.0	3.9
Net Core Crown debt with NZS Fund	14.1	11.9	7.3	2.8	-1.4	-3.9
Net worth 7/	14.9	18.0	25.0	33.2	45.7	47.8
Memorandum item (in billions of NZ dollars)						
Contributions to NZ Superannuation Fund	0.6	1.2	1.9	2.1	2.3	2.0

Sources: New Zealand Treasury; HYEFU (Half Year Economic and Fiscal Update, 2006).

1/ Fiscal year ending June 30. Accounts follow New Zealand Generally Accepted Accounting Practices (GAAP).
Changes have been made to the compilation of fiscal data starting in 2001/02; data prior to that date are not fully comparable.
2/ A write-down of student loans raises expenditure (other) by 1 percent of GDP, and reduces the OBERAC by 0.6 percent of GDP.
3/ Equals revenue less expenditure plus net surplus attributable to state-owned and Crown entities.
4/ Operating balance net of revaluations and changes in accounting rules, and excluding net NZS Fund asset returns.
5/ Fund staff estimate; equals cash flows from operations less cash flows on physical investment and advances.
6/ Excludes contribution to the New Zealand Superannuation Fund.
7/ Includes financial assets of the New Zealand Superannuation Fund, which are excluded from net core Crown debt.

Table 4. New Zealand: Medium-Term Scenario, 2006–12

	Average		Projections					
	1996-2005	2006	2007	2008	2009	2010	2011	2012
Real growth (percent change)								
GDP (production basis)	3.1	1.5	2.4	2.6	2.7	2.9	3.0	3.0
Final domestic demand	4.0	1.2	1.9	2.0	2.5	2.8	3.0	3.3
Consumption	3.7	2.5	2.5	2.5	2.6	2.9	2.9	3.0
Private consumption	3.8	1.9	2.2	2.3	2.5	2.8	2.9	3.0
Govt. consumption	3.1	4.5	3.5	3.1	3.0	3.0	3.0	3.1
Fixed investment	5.3	-2.7	-0.2	0.3	2.1	2.5	3.3	4.0
Inventories 1/	0.0	-0.8	0.7	0.2	0.0	0.0	0.0	0.0
Exports of goods and services	4.1	2.0	2.6	3.8	4.6	5.0	4.7	4.3
Imports of goods and services	6.4	-2.4	1.0	2.1	3.8	4.2	4.5	5.0
Saving and investment (percent of GDP)								
Gross capital formation	22.6	22.8	22.3	21.7	21.2	20.9	20.8	20.8
Fixed investment	21.7	23.0	21.9	21.2	20.8	20.5	20.4	20.4
Increase in stocks	0.9	-0.2	0.4	0.4	0.4	0.4	0.4	0.4
National saving 2/	17.2	13.8	13.7	13.9	13.8	13.5	13.1	12.6
Private	14.3	8.9	10.3	10.8	10.8	10.5	10.1	9.6
Public	2.9	4.9	3.4	3.1	3.0	3.0	3.0	3.0
Inflation and unemployment								
Headline CPI inflation	2.0	3.4	2.3	2.6	2.4	2.2	2.1	2.0
Unemployment rate	5.5	3.8	4.1	4.4	4.5	4.5	4.5	4.5
Government budget (percent of GDP) 3/								
Revenue	34.0	37.8	36.3	35.1	34.2	34.3	34.3	34.2
Expenditure	32.1	31.9	33.2	32.6	32.3	32.1	32.0	32.1
SOE and Crown entity surplus, net	0.6	1.4	0.7	1.0	1.0	0.9	0.8	0.8
Operating balance 4/	2.5	7.3	3.8	3.6	2.9	3.1	3.0	2.9
OBERAC 5/	…	5.2	3.7	3.1	2.3	2.4	2.3	2.2
Gross Crown debt	…	22.7	23.3	23.5	21.8	20.5	20.7	20.7
Net Crown debt including NZS Fund	…	-1.4	-3.9	-5.7	-6.6	-7.9	-9.7	-9.3
Net Worth 6/	…	45.6	47.8	49.1	49.5	50.2	50.9	51.6
Terms of trade (percent change, goods)	1.0	0.0	-0.8	-0.9	-0.7	-0.8	-1.9	-1.9
Export prices	0.8	8.8	-2.2	-0.8	-1.5	-1.4	-2.3	-2.4
Import prices	-0.2	8.9	-1.4	0.1	-0.8	-0.6	-0.5	-0.5
Balance of payments (percent of GDP)								
Current account balance	-5.4	-9.0	-8.6	-7.8	-7.4	-7.4	-7.7	-8.2
Balance on goods and services	0.3	-1.9	-1.3	-0.9	-0.6	-0.3	-0.4	-0.8
Balance on income and transfers	-5.7	-7.0	-7.2	-6.9	-6.9	-7.0	-7.2	-7.4
Net foreign liabilities (percent of GDP) 7/	79.5	89.4	93.2	96.7	99.8	102.5	105.7	109.3
Gross external debt	101.7	116.7	119.4	122.0	124.2	126.2	128.6	131.2

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 and Crown entities.
5/ Operating balance net of revaluations and changes in accounting rules (excluding net NZS Fund asset returns). In 2006, the OBERAC is reduced by $1024 million, or 0.6 percent of GDP, by accounting write downs of student loans.
6/ Includes the financial assets of the New Zealand Superannuation Fund, which are excluded from net Crown debt.
7/ Data for end-December. Data from 2001 comply with BPM5 and are not directly comparable with prior data.

Statement by Richard Murray, Executive Director for New Zealand and Yuong Thanh Ha, Advisor to the Executive Director April 27, 2007

Recent economic developments and outlook

The New Zealand economy has experienced an extended period of economic growth that has stretched capacity and resulted in medium-term inflation pressures. In response, the Reserve Bank of New Zealand (RBNZ) raised the Official Cash Rate (OCR) from 5.0 percent to 7.25 percent in a series of measured step over 2004 and 2005.

As the Staff Report highlights, over recent years, growth has been largely driven by domestic demand. There has been little or no growth in the tradables sector of the economy, despite relatively favourable commodity prices. The unemployment rate has remained under 4 percent for the past two years supporting strong growth in domestic incomes, government spending has risen, and the current boom in house prices is now the largest cyclical increase in recorded New Zealand history. Partly as a result, the current account deficit has widened substantially in recent years.

A year ago, it appeared that an economic slowdown was well underway: consumption growth was slowing, residential investment was declining and the momentum appeared to be coming out of the existing housing market, business confidence was weak, and capacity constraints showed tentative signs of beginning to ease. The exchange rate fell sharply in early 2006 and longer-term interest rates also fell as financial markets anticipated (prematurely) a shift to an easier stance of monetary policy.

However, since late 2006, a broad range of economic indicators have rebounded and forecasters have subsequently revised upwards the growth outlook for 2007. A rebound in growth to around 3 percent is possible. Significantly, the stronger growth outlook is concentrated in domestic demand, reflecting a resurgent housing market, and surprisingly robust labour income growth, reinforced by a recent sharp rise in dairy prices (dairy products represent around 20 percent of New Zealand’s total exports). Business and consumer confidence have rebounded strongly. This upswing in growth is occurring at a time when productive resources are already stretched and has lifted medium-term inflation pressures. As a result, the RBNZ raised the OCR to 7.5 percent at the time of the March Monetary Policy Statement, while noting that its medium-term inflation outlook remained subject to “considerable upside risk”. Inflation projections suggest that, even with a relatively firm stance of policy, core inflation will remain firmly in the upper part of the 1-3 percent target range for the foreseeable future.

Over recent months, market interest rates and the exchange rate have risen considerably – indeed, on a trade-weighted basis the exchange rate is now approaching the peaks last reached in December 2005. Against the US dollar, the exchange rate recorded a new post-float high in mid-April. Relatively easy global liquidity and a strong market appetite for risk would appear to have exacerbated the exchange rate cycle. Record dairy prices are providing some offset for that sector, but the persistently high exchange rate (it has now been above its long-term average for over three years) is placing portions of the export and import-competing sectors under considerable pressure. To date, the strong world economy has limited the adverse effects of the high exchange rate, thus a global slowdown remains a risk.

Macroeconomic policies

The New Zealand authorities recognise the challenges posed by the imbalances still present in the economy, as explored in the Staff Report. There are no easy ways through those imbalances. Possible supplementary measures are likely to make a difference only at the margin, and most of the burden of eliminating excess domestic demand pressures is likely to have to be borne by monetary policy.

In the context of exchange rates, my authorities acknowledge that while the global search for yield is a material factor, a range of currencies are also at, or near, their cyclical peaks. We agree with the staff assessment that market expectations of the end of the policy tightening cycle remains a critical issue for the New Zealand dollar. We would also would add that these expectations are closely tied to the medium-term inflation outlook (predominantly a domestic demand issue). Record high commodity prices are also a significant contributing factor to the high level of the New Zealand dollar. World dairy prices have increased by more than 40 percent since late 2006 and that even on a New Zealand dollar basis, commodity prices in aggregate have been rising.

The fiscal position remains very strong. Earlier last year New Zealand joined the very small group of countries in a net financial asset position. The government is running operating and cash surpluses and the latest information is showing both will come in ahead of the most recent forecasts. The forthcoming Budget (May 17) will show ongoing commitment to the medium-term fiscal objectives of achieving an operating surplus that covers the government's contributions to the New Zealand Superannuation Fund and gross debt remaining around 20 percent of GDP. As a result, net financial assets will continue to rise in advance of the ageing of the population. The Budget will also contain details of the business tax package scheduled to be implemented in 2008 that was signaled last December.

Government spending has been rising over recent years, reflecting a mix of ongoing spending growth in areas like health, major policy initiatives like Working for Families (that was covered in last year's Article IV report) and increased investment spending. While well signaled, this spending has contributed to short-term cyclical pressures, given the persistent strength of other components of domestic economy and tight capacity. However, government revenues have risen even faster and the fiscal balances have surprised on the upside. This means the government is already meeting its medium-term fiscal objectives. The authorities agree that substantial additional stimulus beyond that already planned would add to current macroeconomic challenges. The challenge in setting fiscal policy currently is therefore how to bring down the operating surplus to a level more consistent with medium-term objectives (rather than continuing to over-achieve and forgoing opportunities to advance policy objectives), all the while taking account of the macroeconomic situation. The fiscal authorities are of the view that the forthcoming Budget appropriately balances these considerations.

Supplementary instruments

Faced with persistent domestic demand pressures, and a prolonged period of exchange rate overvaluation, our authorities prudently took the opportunity to look afresh at the range of instruments available to them, to see whether there were measures which could usefully complement monetary policy by easing domestic demand pressures in a way that reduced any spillover into a higher exchange rate. As the Staff Report notes, there are several areas in which work is ongoing: these include work on improving the responsiveness of housing supply, more stringent enforcement of existing tax laws regarding capital gains made on properties that were bought with the intention of resale, and ensuring that in the implementation of Basel II any procyclical tendencies in the capital framework are avoided. There are no silver bullet solutions, and ultimately the OCR remains the principal instrument of demand management.

Other developments

<u>Kiwisaver</u>

Kiwisaver is a work-based savings scheme that comes into effect in July. The scheme complements other initiatives, such as the New Zealand Superannuation Fund (2001) and the Public-sector superannuation scheme (2004), aiming at encouraging household saving and preparing for the future impact of population ageing.

<u>Financial system and regulation</u>

The financial system coped well with the short-lived slowdown in economic growth over 2005/06 and the banking system as a whole appears to be in good shape, with strong balance sheet positions and strong profitability. However, as the RBNZ's Financial Stability Reviews have noted, the continued strong growth in housing lending and a sense that real house prices are above long-term sustainable levels mean that the challenges remain. As part of its ongoing supervisory responsibilities, the RBNZ has recently held senior-level consultations with major banks to discuss the sustainability of the recent rapid growth of mortgage lending and risks arising from stretched household balance sheets.

There has been significant progress on a number of banking and financial supervision issues. These developments allow the authorities to take advantage of the benefits and manage the risks, both in normal times and distress situations, that come with close trans-Tasman financial integration.

- The RBNZ requires systemically important banks to be locally incorporated, which provides for greater clarity of the separation between the interests and assets of the local bank operations and its Australian parent bank. The implementation of this local incorporation policy has now been completed with the registration of a locally incorporated subsidiary of Westpac in November 2006.

- There have been recent significant legislative changes in both New Zealand and Australia to provide greater assurance of cooperation between NZ and Australian regulators, particularly in a time of crisis, by imposing obligations on them to consult each other and to avoid actions that may have detrimental effects on financial stability in the other country. This represents a path breaking advance in home-host supervisory cooperation.

- Progress is also being made on the RBNZ's outsourcing policy and Basel II capital requirements.

Other developments in New Zealand's financial regulation include proposals for greater prudential regulation for non-bank deposit takers. These proposals allow the public to make better risk assessments of different institutions and encourage better risk management by deposit takers. In the area of AML/CFT, discussion continues on a proposed framework for monitoring and enforcing businesses' compliance with the FATF requirements.

INTERNATIONAL MONETARY FUND
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International Monetary Fund
700 19th Street, NW
Washington, D. C. 20431 USA

IMF Executive Board Concludes 2007 Article IV Consultation with New Zealand

On April 27, 2007, the Executive Board of the International Monetary Fund (IMF) concluded the Article IV consultation with New Zealand.[1]

Background

The economic downturn that commenced in 2005 has proved to be short-lived. In early 2006, the economy appeared to be cooling quickly, with quarterly growth dropping to zero and confidence and demand indicators deteriorating. Some needed rebalancing of the economy took place. Once growth began to falter in late 2005, expectations for monetary easing were brought forward, and, in conjunction with signs that the global carry trade might unwind, the exchange rate fell by 15 percent in the first half of 2006. By the second half of 2006, the trade balance was showing some improvement, as a result of slower domestic demand, and a recovery in exports, albeit aided by a run-down of inventories.

Over the last few months, the cycle has turned again. A range of indicators in late 2006 and early 2007 suggest that domestic demand has regained momentum. These include a resurgent housing market and improved business and consumer confidence. House sales rebounded during 2006, in part due to higher net immigration, while competition between banks and ready

[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 staff report (use the free Adobe Acrobat Reader to view this pdf file) for the 2007 Article IV Consultation with New Zealand is also available.

access to external funds served to dampen the rise in mortgage interest rates. While headline CPI inflation fell to 2¾ percent by end-2006, aided by lower oil prices, resources remain stretched and nontradables inflation has declined only gradually. With resource pressures continuing, inflation is likely to pick up again once one-off effects recede. The current account deficit remains uncomfortably large, at 9 percent of GDP at end-2006.

Given the worsening medium-term prospects for inflation, the RBNZ adopted a progressively stronger tightening bias, and raised the OCR in March and April 2007. Driven by strong tax revenues, the central government's operating surplus before revaluations and accounting changes (OBERAC) reached 5 percent of GDP in 2005/06 (fiscal year ending in June), and the government recorded a positive net financial asset position for the first time. The operating surplus is projected to decline to 3¾ percent of GDP in 2006/07, as the budget becomes stimulatory owing to pre-announced spending initiatives.

GDP growth is projected to rise to about 2½ percent in 2007, from 1½ percent in 2006, but to remain below potential until 2009. The primary driver is higher private consumption growth, with household incomes benefiting from the tight labor market and increased income support from government. Exports are expected to grow only modestly given the high exchange rate although increases in commodity prices are providing some offset. A period of growth below the economy's potential will gradually help alleviate the resource pressures that have accumulated in recent years, putting downward pressure on inflation and aiding the narrowing of the current account.

Executive Board Assessment

Executive Directors commended the New Zealand authorities on their continued implementation of sound macroeconomic policies anchored in a well-established framework in the face of a challenging environment. While economic growth has recently picked up, activity in the tradable sectors has remained flat and the housing market has yet to cool. There has been little easing of resource pressures, household debt ratios have further increased, and the current account deficit has remained unusually large with capital inflows keeping the exchange rate at a high level. Directors noted that many of these pressures reflect the exposure of the New Zealand economy to global and regional developments, and they called for continued vigilance to possible shocks. Some Directors suggested that these issues also be examined in a more integrated way, in the context of regional and global surveillance.

Directors considered the recent increases in the Official Cash Rate (OCR) to be appropriate in light of still-stretched resource utilization. They noted that while lower oil prices have temporarily lowered headline inflation, the resurgence in domestic demand has raised inflation prospects over the medium-term horizon. Directors broadly welcomed the readiness of the authorities to implement monetary tightening even though they recognized the risks of higher short-term capital flows.

Directors generally regarded the continuing flexibility of the exchange rate as a valuable shock absorber for the economy. Nonetheless, the exchange rate is well above its long-run average and is not supportive of an unwinding of the sustained, large current account deficit. Directors recognized that a correction might be delayed by continuing capital inflows, but also pointed to the risk of a sharper depreciation in case of a global event such as a sudden unwinding of the carry trade. In this context, they emphasized the robust health of the banks and the corporate sector as factors that would help limit the depth and duration of a subsequent slowdown.

Directors welcomed New Zealand's strong fiscal position and commended the authorities' continued adherence to a stable and transparent medium-term fiscal framework. They endorsed the authorities' goal that fiscal policy should avoid complicating the task of monetary policy, but questioned whether the current stimulatory fiscal stance would effectively help achieve this goal. Directors recognized that the stimulus mainly reflects pre-announced spending decisions and that the medium-term fiscal framework limits the ability to adjust fiscal policy in the short run. Nonetheless, they recommended that the automatic stabilizers continue to be allowed to work, and that fiscal stimulus be contained as much as possible in the period ahead. In particular, Directors advised shifting to the extent possible the mix of fiscal measures planned for 2007/08 toward greater tax reductions and smaller expenditure increases so as to moderate any expansionary effect. Several Directors also suggested exploring the scope for increasing the flexibility of the fiscal framework. Many Directors cautioned that tax credits for activities such as R&D would represent a step away from the current orderly tax arrangements, and could create distortions.

Directors observed that in light of the challenging macroeconomic policy environment, supplementary stabilization measures to limit buoyancy in the housing market deserve consideration. Directors broadly supported the view that limiting the ability to deduct losses on housing-related investments from other income, combined with more active enforcement of current tax laws, might help to discourage property speculation. Also, there might be merit in tightening prudential regulations. This could involve the application of varying risk weights on mortgages according to the loan-to-value (LTV) ratio and the presence of mortgage insurance, and raising banks' awareness of the risks associated with "low-doc" and high LTV mortgages. Overall, Directors nevertheless shared the authorities' view that these measures would not be a panacea given their likely limited impact, and that the OCR should remain the primary instrument of monetary policy.

Directors emphasized that early and sustained efforts would be essential to successfully manage the significant long-term fiscal issues facing New Zealand. They welcomed the release of the first report on the long-term fiscal position, which has raised awareness of the challenges ahead. Going forward, Directors stressed that improving productivity in the health care system is likely to be particularly important, as well as a review of pension arrangements. Directors welcomed the authorities' emphasis on increasing domestic savings, including through the introduction of the KiwiSaver scheme, and encouraged a broad review of the taxation of savings vehicles.

New Zealand: Selected Economic Indicators

	2002	2003	2004	2005	2006	Proj. 2007
Real economy (percent change)						
GDP (production basis)	4.7	3.3	4.5	2.2	1.5	2.4
Domestic demand	5.6	5.9	7.3	4.0	0.5	2.6
Exports of goods and services	6.2	2.2	5.7	-0.5	2.0	2.6
Imports of goods and services	9.6	8.2	16.0	5.5	-2.4	1.0
Headline CPI inflation (end of period)	2.7	1.5	2.7	3.2	2.7	2.8
Unemployment rate (in percent)	5.2	4.6	3.9	3.7	3.8	4.1
National saving (in percent of GDP) 1/	18.8	18.6	17.9	15.5	13.8	13.7
Investment (in percent of GDP)	22.8	23.1	24.5	24.5	22.8	22.3
Government budget (in percent of GDP) 2/						
Revenue	31.7	33.0	33.0	34.6	37.8	36.3
Expenditure	30.2	31.5	29.3	30.7	31.9	33.2
OBERAC 3/	2.2	4.2	4.5	5.6	5.2	3.7
Net Crown debt including NZS Fund	14.1	11.9	7.3	2.8	-1.4	-3.9
Money and credit (end of period)						
M3, resident (change in percent)	11.5	9.5	3.5	9.4	12.2	...
Private domestic credit (change in percent)	9.1	8.2	12.2	10.2	13.2	...
Interest rate (90-day, in percent) 4/	5.9	5.3	6.8	7.7	7.7	8.1
Government bond yield (10-year, in percent) 4/	6.1	5.9	6.0	5.7	5.9	6.1
Balance of payments (in percent of GDP)						
Current account balance	-4.0	-4.5	-6.7	-9.0	-9.0	-8.6
Trade balance	0.2	-0.6	-1.4	-2.5	-2.0	-1.7
External assets and liabilities (in percent of GDP)						
Official reserves	9.4	9.3	9.7	13.1	19.5	...
Gross external debt	110.4	104.4	108.5	107.1	116.7	119.4
Net external liabilities	77.6	77.8	84.5	85.4	89.4	93.2
Exchange rate (end of period)						
US$/$NZ 4/	0.52	0.66	0.72	0.68	0.70	0.74
Trade-weighted index (June 1979 = 100)4/	58.2	65.1	68.8	70.6	69.6	71.6
Nominal effective exchange rate 5/	112.3	126.0	132.3	135.9	128.3	...
Real effective exchange rate 5/	114.2	127.9	134.9	139.9	132.5	...

Sources: Data provided by the New Zealand authorities; and IMFstaff estimates and projections.
1/ Based on national accounts data.
2/ Fiscal years ending June 30.
3/ Operating balance net of revaluations and changes in accounting rules.
4/ Data for 2007 are as of May 3.
5/ IMF Information Notice System index (1990 = 100).