INTERNATIONAL MONETARY FUND

IMF Country Report No. 11/102

New Zealand

2011 ARTICLE IV CONSULTATION

New Zealand: 2011 Article IV Consultation—Staff Report; Public Information Notice on the Executive Board Discussion; and Statement by the Executive Director for New Zealand

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 2011 Article IV consultation with New Zealand, the following documents have been released and are included in this package:

- The staff report for the 2011 Article IV consultation, prepared by a staff team of the IMF, following discussions that ended on March 22, 2011, 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 22, 2011. 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 May 9, 2011 discussion of the staff report that concluded the Article IV consultation.

- 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.

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INTERNATIONAL MONETARY FUND

NEW ZEALAND

STAFF REPORT FOR THE 2011 ARTICLE IV CONSULTATION

April 22, 2011

KEY ISSUES

Context: New Zealand's recovery has stalled since mid-2010, reflecting soft domestic demand and the adverse impact of two large earthquakes.

Growth prospects: In the near term, the earthquakes will slow activity, with real GDP growth projected at 1 percent in 2011. However, growth is forecast to rise to 4 percent in 2012, led by reconstruction. Risks are tilted to the downside, including a faltering of emerging Asia's rapidly growing demand for commodities and a possible rise in long-term interest rates.

Focus: The discussions centered on securing a sustainable and balanced recovery, safeguarding financial sector stability, and reducing external vulnerabilities.

Sustainable and balanced recovery: To contain inflationary pressure, monetary policy, which was eased in response to the earthquakes, will need to be tightened once it becomes clear that the recovery is underway. Staff recommended a return to fiscal surpluses by 2014/15 or earlier if feasible, despite the near-term cost of the earthquakes. In a downside scenario, there is scope to loosen monetary policy further, but limited space to delay the exit from budget deficits.

Financial stability: Banks' key vulnerabilities are their exposure to highly indebted households and farmers together with their sizable short-term offshore borrowing. The authorities should continue to strengthen their stress testing of banks and consider the merits of gradually raising bank capital to levels well above the Basel III requirements.

External vulnerability: Prudential measures and market pressures have led to a reduction in banks' sizable short-term wholesale borrowing. To further strengthen the resilience of the economy, the authorities could take additional measures aimed at encouraging banks to lengthen the maturity of borrowing further and increasing national saving, including through higher public saving and tax reform.

Approved By
Hoe Ee Khor and Tamim Bayoumi

Discussions took place in Auckland and Wellington during March 11–22, 2011. The staff team comprised Messrs. Brooks (head), Jang, Jauregui, and Ms. Sun (all APD). Mr. Di Maio (OED) participated in the discussions.

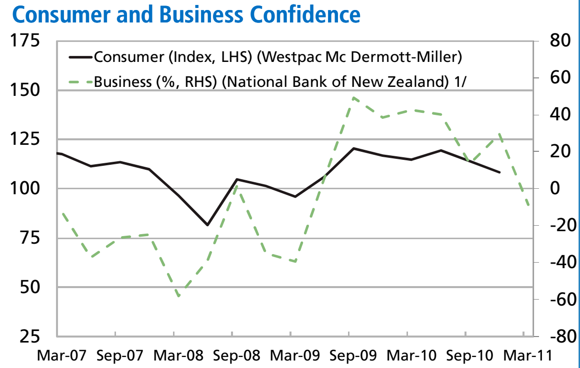
CONTENTS

Appendices

A BUMPY RECOVERY

1. **New Zealand's recovery has stalled since mid-2010.** Domestic demand has remained soft, as cautious households and businesses look to strengthen their balance sheets by slowing debt accumulation amid a weak housing market and an uncertain outlook (Figure 1, Table 1). Moreover, two earthquakes have caused substantial damage and hurt confidence (Box 1).

Consumer and Business Confidence



1/ Percentage expecting improvement in general business conditions minus percentage expecting deterioration.

2. **Spare capacity has helped contain inflation.** The unemployment rate hovered between 6–7 percent during 2010, limiting labor cost growth. An increase in the goods and services tax (GST) in late 2010 (from 12½ percent to 15 percent) and higher food and fuel prices pushed up headline inflation to 4 percent y/y at end-2010, above the 1–3 percent target band (Figure 2). However, inflation, excluding food, fuel, and government charges, remained below 3 percent.

3. **Following signs of recovery, the Reserve Bank of New Zealand (RBNZ) lifted its policy rate in two steps from a record low of 2.5 percent to 3 percent in mid-2010** (Figure 3). As the recovery softened, policy rate was kept on hold in late 2010 and early 2011. In mid-March 2011, the RBNZ reduced the policy rate by 50 bps to limit downside risks as a result of the February earthquake.

4. **The exchange rate appreciated and financial markets have largely recovered from the global financial crisis** (Figure 4). The nominal effective exchange rate appreciated by about 25 percent from the trough in early 2009 to February 2011, driven by higher commodity prices that pushed the terms of trade to 15 percent above the average of the past two decades. New Zealand's positive interest rate differential with other advanced economies and a recovery in global risk appetite also contributed to the appreciation.

5. **Fiscal easing supported activity.** Permanent income tax cuts and spending increases that were announced before the global financial crisis and introduced in late 2008 provided a stimulus, but worsened the fiscal outlook. The structural balance deteriorated from a surplus of 2 percent of GDP in 2007/08 to a deficit of 2¾ percent of GDP in 2009/10 (Figure 5, Table 2). Net government debt (core Crown) increased to 14 percent of GDP in mid-2010.

6. **The banking sector remains profitable and is dominated by four subsidiaries of Australian banks that performed well during the crisis.** Nonperforming loans have increased to 2 percent of total loans, still low by advanced

Box 1 The Economic Impact of the Canterbury Earthquakes

The Canterbury region, accounting for about 15 percent of New Zealand's economy, was struck by severe earthquakes in September 2010 and February 2011. About 180 lives were lost and residential and commercial buildings in Christchurch, New Zealand's second largest city, suffered extensive damage. Infrastructure and tourism assets were also damaged, but most of the manufacturing and agriculture sectors were largely unaffected. Estimates of the damage are still subject to considerable uncertainty, and staff assume the cost of reconstruction to be $NZ 15 billion or about 7½ percent of 2011 GDP, comprising residential buildings ($NZ 9 billion), commercial buildings ($NZ 3 billion), and infrastructure ($NZ 3 billion).

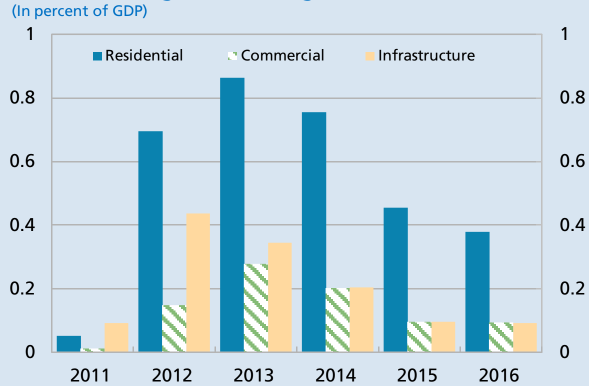
The cost of reconstruction is larger relative to GDP than for major earthquakes elsewhere. The 2010 earthquake in Chile and the 1995 earthquake in Kobe, Japan, inflicted damage of about 6½ percent and 2 percent of GDP, respectively. While the scale of damage from the recent Japan earthquake is still uncertain, it is likely to be less than the Canterbury earthquakes as a percent of GDP.

The Canterbury earthquakes have disrupted economic activity, reduced wealth, and weakened confidence. Staff marked down the growth projection for 2011 to about 1 percent from 3 percent projected in the WEO forecast of October 2010, largely because of the quakes. The earthquakes destroyed assets equal to about 2–3 percent of the nation's productive capital stock, and will have temporarily reduced potential output.

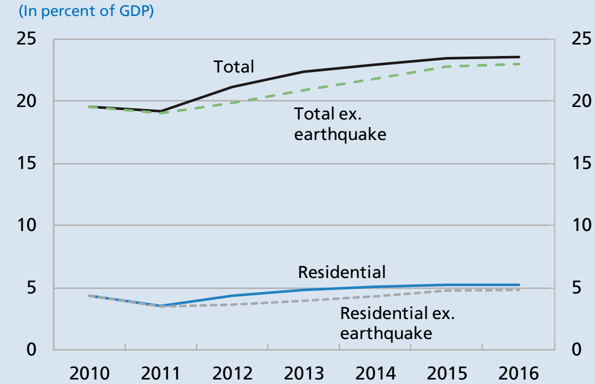
The earthquakes also had an impact on the financial sector. One insurance company, AMI Insurance, is facing significant financial uncertainty because it has ⅓ of the residential insurance market in Canterbury and has a concentration of risk in the region. The government has subscribed for called but unpaid preference shares in AMI of up to $NZ 500 million (¼ percent of GDP) to ensure that claims for damage are paid out in case AMI cannot, and to maintain confidence in the insurance sector. The authorities believe that the insurance sector in general is sound and has adequate resources, including offshore reinsurance arrangements, and that the impact of the earthquakes on the banking system is limited.

Over the medium term, reconstruction is expected to boost investment and aggregate demand. Aftershocks, demolition and land stabilization work suggest that reconstruction will not start until late 2011 or early 2012. Staff assumes that four-fifths of residential and infrastructure rebuilding will be completed by 2016, while commercial rebuilding continues beyond this.

Assumed Timing of Rebuilding (2011-16)
(In percent of GDP)



Fixed Investment
(In percent of GDP)



country standards, and sound regulation and supervision helped maintain stability. All banks currently meet the Basel III requirements for common equity, Tier 1 and total minimum capital ratios (Figure 6).

7. **The current account deficit narrowed to 2¼ percent of GDP in 2010, well below the levels of about 8 percent of GDP in 2005–08.** This reflects weak domestic demand, terms of trade gains, low world interest rates, and re-insurance inflows following the first earthquake (Figure 7, Tables 3 and 4). Net foreign liabilities have declined since 2008 but remained high at 82 percent of GDP at end-2010.

OUTLOOK AND RISKS

8. **Large uncertainty surrounds the economic outlook, particularly related to the size and timing of reconstruction from the earthquakes.** In the near term, the earthquakes will slow activity, with growth projected at 1 percent in 2011, supported by elevated terms of trade and the Rugby World Cup later this year. Assuming that the bulk of reconstruction takes place during 2012–16, staff projects growth to rise to 4 percent in 2012 and converge to the potential rate of 2⅓ percent in outer years (Table 5).

9. **Risks are tilted to the downside.**

- On the external front, a faltering of emerging Asia's rapidly growing demand for commodities could adversely affect exports, directly through lower commodity prices and indirectly through spillovers from Australia. Moreover, New Zealand's large net foreign liabilities expose it to a possible rise in long-term interest rates as a result of high funding requirements of banks and sovereigns in advanced economies. The Japan earthquake, unrest in the Middle East and North Africa, and volatile oil prices add uncertainty to the global outlook.
- Domestically, the recent earthquakes may have a greater-than-expected negative impact on confidence and growth. In addition, a sharp fall in house prices, which appear overvalued, would hit household balance sheets, likely depressing domestic demand and encouraging further deleveraging (Box 2). Similar falls in Australian house prices, which also appear moderately overvalued,[1] could spill over to New Zealand, given the strong links in the business cycle (see selected issues paper).
- Upside risks stem from a faster-than-expected recovery in major advanced economies pushing up commodity prices or stronger spillovers from Australia. Faster-than-expected reconstruction in Canterbury could create bottlenecks and push up inflation.

[1] See Tumbarello and Wang, 2010, *What Drives House Prices in Australia? A Cross-Country Approach*, IMF WP/10/291.

Box 2 Are House Prices Overvalued?

Real house prices rose by 150 percent in the fifteen years to 2007, one of the strongest increases among advanced countries. Real house prices have since fallen by more than 10 percent.

House prices appear overvalued by about 15–25 percent, using a combination of simple metrics and models. However, some of these measures have weaknesses which add to the uncertainty of the estimate.

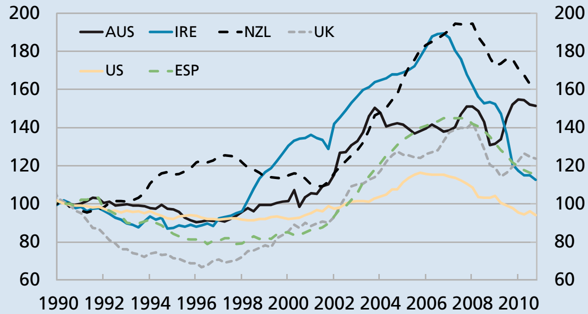
The OECD's house price-to-income ratio in September 2010 suggests an overvaluation of about 15 percent when compared with the average of the past twenty years. However, the income measure used by the OECD does not take account of Statistics New Zealand's recent upward revision to household income.

The OECD's price-to-rent ratio shows a much higher overvaluation relative to the past twenty years of 43 percent. However, the measure includes government subsidized rents which has pushed up the ratio over time as subsidized rents decreased, most noticeably in 2001. An alternative measure excluding subsidized housing suggests an overvaluation of 15–27 percent when compared with historical averages.

Model based estimates that take account of income, demographics and interest rates suggest an overvaluation of 15–25 percent. A model developed by Igan and Loungani (see forthcoming IMF working paper) shows an overvaluation in September 2010 of 20–25 percent. An alternative model that includes demographics, mortgage interest rates, and the terms of trade as a proxy for future income indicates that house prices are overvalued by about 15–20 percent, from a medium term perspective (based on Tumbarello and Wang, IMF WP/10/291).[1] The model, however, is sensitive to assumptions about the terms of trade (a proxy for future income) and interest rates. The models suggest that a 10 percent fall in the terms of trade could result in an 8 percent fall in house prices over the medium run.

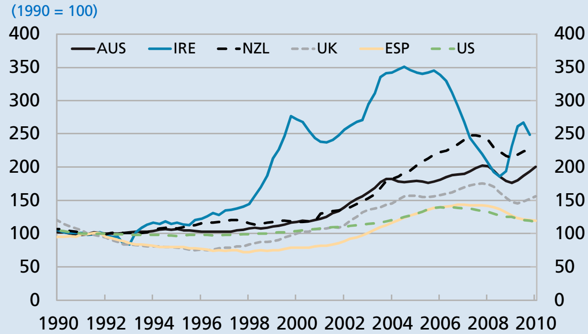
[1] Assuming real mortgage interest rates return to the average of the past 15 years.

House Price to Income Ratio
(1990 = 100)



Source: OECD database.

House Price to Rent Ratio
(1990 = 100)



Source: OECD database.

New Zealand Deviation of House Prices from Medium-Term Averages	
	Relative to 20-year average as of Sep. 2010
Price-to-income ratio	15.6
Price-to-rent ratio	43.1
Source: OECD.	

Authorities' Views

10. The authorities shared staff's assessment of the economic outlook and risks. They noted the difficulty in assessing the impact of the earthquakes and that confidence has deteriorated.

SECURING A SUSTAINABLE AND BALANCED RECOVERY

A. Monetary Policy

11. The weakening of the economic outlook gave scope for the recent reduction in the policy interest rate. Staff agreed that the reduction was appropriate given that the earthquake means that the output gap will likely remain about negative 2½–3 percent of GDP through mid 2012. Moreover, inflation expectations are below 3 percent, the upper end of the RBNZ's target band, despite a series of shocks to headline inflation including the increase in the GST and higher global oil and food prices.

12. Staff stressed, however, that monetary policy will need to be tightened once it becomes clear that the recovery is underway. Staff estimates that the output gap will close by around 2013/14 as reconstruction proceeds, putting upward pressure on inflation. Staff also noted that a shift toward floating rate mortgages in recent years and high household debt means that consumer demand is more sensitive to interest rate hikes. Therefore, the effect of monetary stimulus could be removed relatively quickly. Higher marginal bank funding costs relative to the policy rate imply a lower neutral policy rate of around 4½ percent compared to 5½–6 percent in the past. Moreover, with inflation projected to be in the upper range of the target band for several years, staff pointed out that the RBNZ needs to guard against medium-term inflation expectations becoming anchored at too high a level.

13. If growth falters or global financial markets are disrupted, staff noted that the RBNZ has scope to cut the policy rate and provide liquidity support for banks if necessary. This proved effective in the recent crisis. The flexible exchange rate also provides an important buffer.

Authorities' Views

14. As indicated in their own public statements, the RBNZ shared the view that monetary accommodation would need to be removed if the recovery proceeds as expected. They noted that the recent policy rate cut should be seen as an insurance measure designed to offset the negative economic effects of the earthquake until such time as rebuilding—and a recovery in the broader economy—act to draw on the economy's surplus resources. The mobilization of resources required to rebuild could have a persistent inflation impact which would likely require a material increase in the policy rate.

B. Fiscal Policy

15. **Reflecting the impact of the earthquakes and slower-than-expected economic recovery, staff projects the 2010/11 fiscal deficit to reach about 8 percent of GDP, much larger than budgeted.** The earthquakes could increase public expenditure in the current fiscal year by $NZ 5.5 billion (on accrual basis), including $NZ 3 billion funded by the Earthquake Commission.[2] The sharper-than-expected increase in the deficit is an unavoidable consequence of the earthquakes and will raise net government debt to 22 percent of GDP by June 2011.[3]

16. **Staff advised returning to fiscal surpluses as soon as feasible, if the economic recovery proceeds as expected.** Prior to the February earthquake, the Prime Minister announced the intention to return to a small surplus by 2014/15, one year ahead of the government's earlier plan (Figures 8 and 9). The earthquakes have worsened the deficit in the near term, but it would be desirable to return to surpluses by 2014/15 or earlier if feasible for the following reasons:

- Fiscal consolidation would create a buffer against future shocks.
- It would relieve pressure on monetary policy and thereby the exchange rate, helping rebalance the economy and contain the current account deficit over the medium term.
- Although government debt is projected to remain low by advanced country standards, New Zealand's large net foreign liabilities calls for fiscal prudence. If global interest rates rise, low government debt would help contain the rise in New Zealand's cost of funds.
- In a tail risk scenario where the asset quality of banks deteriorates sharply, bank liabilities present a potential fiscal liability that limits the extent to which public debt can be raised without hurting investor confidence.
- Reducing net government debt to below 20 percent of GDP over the next ten years would put the budget in a stronger position to deal with the fiscal costs of aging.

17. **Staff encouraged the government to take concrete measures to control spending.** Even excluding earthquake-related expenses, government expenditure has risen significantly in recent years (up by 6 percent of GDP over the six years to 2010/11). Reducing expenditure relative to GDP would be needed to return to structural surpluses. To this end, there is considerable scope

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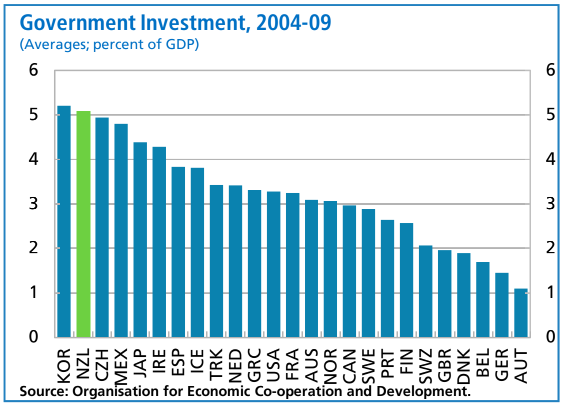
[2] The Earthquake Commission manages an insurance fund for residential property operated by the government with assets of $NZ 6 billion before the quakes.

[3] Net government debt refers to net core Crown debt excluding New Zealand Superannuation Fund and advances.

to trim transfers to middle-income households, rationalize capital spending (which is high by advanced country standards), and improve the efficiency of public service provision.



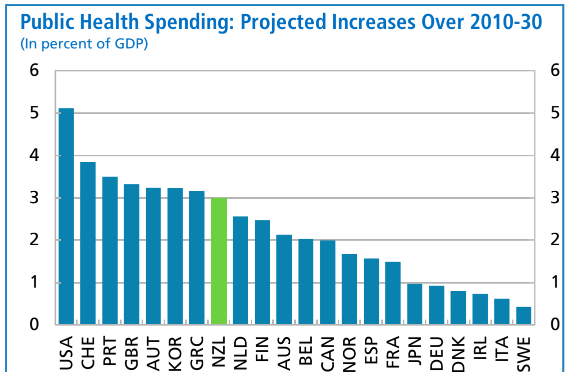
Source: Organisation for Economic Co-operation and Development.

18. The government plans to better manage its balance sheet and is considering selling a stake in state-owned enterprises. Staff noted that consideration should also be given to selling other assets, which would help reduce gross government debt and may limit the increase in New Zealand's borrowing costs.

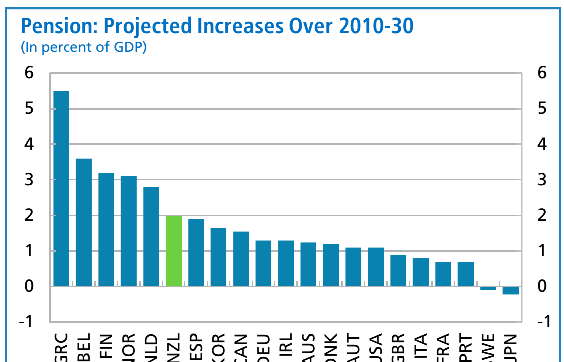
19. Staff supported the government's intention to save excess revenue. Higher-than-expected growth, possibly arising from higher commodity prices, could boost tax revenue. In a downside scenario of lower growth, there is some limited space to delay the exit from budget deficits, while taking credible measures to return to structural surpluses over the medium term.

20. Tax reforms announced in the 2010/11 budget should help boost growth and saving (WP/10/128). The package included increasing the GST rate, cutting personal and corporate income tax rates, and reducing tax incentives to invest in properties.

21. In the long term, the budget faces considerable pressure from aging and rising health care costs. To contain the public share of costs in these areas, policy action will be needed. Health care spending growth could be reduced by improving the efficiency of delivery and the public pension cost increases could be contained by raising the retirement age and moving away from full indexation of benefits to wage increases.



Source: IMF Fiscal Monitor database.



Source: IMF Fiscal Monitor database.

Authorities' Views

22. The authorities reiterated their intention to return to fiscal surpluses as soon as possible, despite the near-term cost of the earthquakes. They plan to reduce the Budget

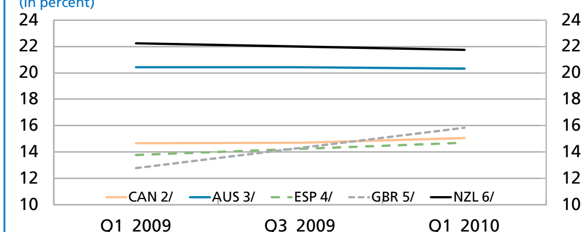
2011 allowance for spending on new initiatives with any increases in spending in areas like health and education offset by savings in other areas. They also plan to streamline government service provision and prioritize capital spending. A key aim is to cap government net debt at 30 percent of GDP over the medium term and reduce it to the publically stated long-term objective of no higher than 20 percent of GDP by the early 2020s. Consideration is being given to funding more of planned capital spending from the government's own balance sheet, including the partial sale of some state-owned enterprises, which would help limit the build-up in net debt.

MAINTAINING FINANCIAL STABILITY

23. Banks' key vulnerabilities are their exposure to highly indebted households and farmers together with their sizable short-term offshore borrowing. While household net wealth (mainly housing) exceeds 500 percent of disposable income, household debt exceeds 150 percent of disposable income (Figure 10). Residential house prices are estimated to be 15–25 percent overvalued, while a large fall in commodity prices would impair the quality of agricultural loans.

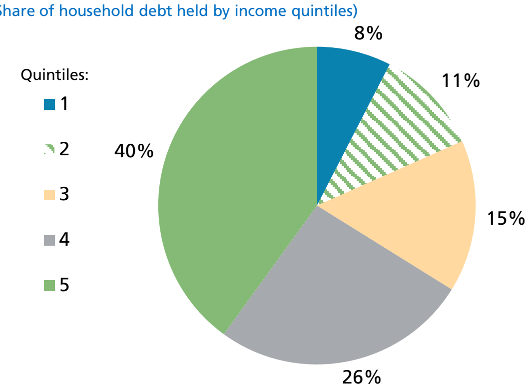
24. The potential risks associated with household lending are mitigated by a number of factors. In implementing the Basel II framework, the RBNZ required banks to assume higher rates of loss-given-default than in many other countries. At the same time, banks were relatively conservative. They limited their exposure to low-income earners, with less than one-fifth of bank loans to households in the lowest two income quintiles. Moreover, data from the *Household Economic Survey* for 2007 suggest that less than 5 percent of owner-occupied mortgages had loan-to-value ratios greater than 80 percent and debt-service ratios greater than 30 percent. The full recourse nature of mortgage lending also helped limit strategic loan defaults. Nonetheless, staff encouraged the RBNZ to review assumptions regarding probability-of-default and loss-given-default for mortgages and commercial lending in light of recent experience in countries where banks incurred large losses.

Loss Given Default on Residential Mortgages[1/]
(In percent)



Sources: Banks' disclosure statements and IMF staff estimates.
1/ Based on banks' assumed loss-given-default rates in their disclosure statements.
2/ Three largest banks.
3/ Four largest banks.
4/ Two largest banks. Reporting dates Q4 2008 and Q4 2009.
5/ Three banks. Reporting dates Q4 2008 and Q4 2009.
6/ Four largest banks. Reporting dates Q1 2009, Q3 2009, and Q3 2010.

Indebted Households, 2004
(Share of household debt held by income quintiles)



25. The sharp fall in agricultural commodity prices in 2009 exposed some weaknesses in banks' rural lending with a significant rise in nonperforming loans in the sector. With the recovery in commodity prices since then, banks have begun to work with farmers to reduce debt to more manageable levels. Moreover, the RBNZ recently reviewed capital adequacy associated with agricultural loans, which will require banks to set aside more capital for such lending.

26. The RBNZ has cooperated with the Australian authorities on stress testing. Last year's joint stress test results suggest that the Australian and New Zealand banks are resilient to sizable but plausible shocks.[4] Staff recommended that the results for New Zealand banks as a whole be published. Staff also noted that a more severe downside scenario of a sharp fall in commodity and house prices and a jump in global longer-term interest rates could hurt growth and raise unemployment for a substantially longer period than in the recent stress tests. Staff recommended explicitly including funding risk in future scenarios, encompassing a disruption to bank funding and a large increase in longer-term interest rates. The latter could come from a rise in global rates and an increase in New Zealand banks' risk premium.

27. Staff encouraged the authorities to consider the merits of raising bank capital gradually to levels significantly above the Basel III requirements for banks as a buffer against shocks. The four large banks comprise about 80 percent of the banking system and their assets amount to almost 160 percent of GDP. Given the banks' size, markets and ratings agencies perceive them as too big to fail and they pose a sizable contingent fiscal liability. While the RBNZ's proposed "open bank resolution" could help limit the fiscal costs of a bank failure, higher capital requirements could reduce the fiscal risk further.[5] In addition, higher capital buffers would limit the risk that a deterioration in bank asset quality could create offshore funding difficulties.

28. The RBNZ is analyzing the costs and benefits of macroprudential measures. The introduction of a core funding ratio for banks in April 2010 may help constrain excessive credit growth during upswings (Appendix 1). Some other measures such as countercyclical capital requirements and loan-to- value ratios could be introduced, depending on the specific conditions faced.

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[4] The Australian Prudential Regulation Authority (APRA) stress tests of Australian and New Zealand banks in early 2010 assessed resilience to a recession that included a rise in the unemployment rate to 11 percent, a fall in house prices of 25 percent, and a fall in commercial property prices of 45 percent.

[5] The proposed open bank resolution aims to resolve a bank failure quickly and provide for continuity of core banking services to retail customers and businesses, while placing the cost of a bank failure primarily on the bank's shareholders and creditors rather than the taxpayer.

29. Initiatives to improve crisis management are welcome. The planned Trans-Tasman crisis management exercise with Australia later this year is an important step to identify possible challenges in a banking crisis.

30. The RBNZ has continued to strengthen regulation and supervision of nonbanks. A number of finance companies failed in the past three years, because of poor risk management, including exposure to property developers.[6] The RBNZ has adopted a set of prudential requirements for nonbank deposit takers. Also, the 2010 Insurance Act empowered the RBNZ to regulate and supervise insurers.

Authorities' Views

31. The authorities stressed their conservative approach to bank supervision and the high quality of banks' capital. The authorities are considering publishing the aggregate results of last year's stress tests. They noted that they are analyzing the impact of the Basel III capital requirements and are likely to adopt many of them. They believed that a relatively small number of macroprudential tools could have a role to play.

[6] Under the retail deposit guarantee scheme introduced in October 2008 and closed in December 2010, the government paid $NZ 1.8 billion (0.9 percent of GDP) to depositors with failed nonbank financial institutions, mostly finance companies, by end-2010. The net fiscal costs are estimated to be about $NZ 1.2 billion (0.6 percent of GDP).

SAVING AND EXTERNAL VULNERABILITY

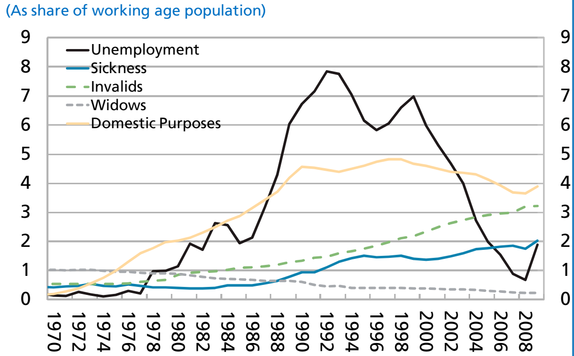
32. **Reflecting low national saving, New Zealand has run current account deficits for three and a half decades.** The result is high net foreign liabilities of about 82 percent of GDP (mostly debt) (Figure 11). In 2011, the current account is projected to be close to balance, largely reflecting weak domestic demand, terms of trade gains, and reinsurance flows related to the second earthquake. However, as the recovery gathers pace and world interest rates rise, staff projects the current account to deteriorate to a deficit of about 7 percent of GDP in 2016, which would raise net foreign liabilities to 85 percent of GDP.

33. **Raising national saving is key to containing the projected increase of the current account deficit.** In staff's view, fiscal consolidation is the surest way to raise national saving. Staff analysis suggests that a 1 percent of GDP increase in public saving would raise national saving by about ½–⅔ percent of GDP (see selected issues paper). Population aging over coming years will likely put downward pressure on the national saving ratio, as a growing share of the population begins to drawdown their savings to fund retirement while public expenditure on health care and pension benefits increases. This implies that a sizable increase in public saving may be needed to raise national saving in the medium term to prepare for the demographic transition.

34. **Staff supported the recommendations of the Savings Working Group on tax reform to raise saving and improve the efficiency of the tax system.** They include a further switch from income to consumption taxation over the medium term, while maintaining the broad base of the GST, and that interest income and expenses be indexed at a standard rate for tax purposes that reflects the rate of inflation (e.g., 2 percent per annum). Staff also advised continuing efforts to broaden the tax base by looking at capital gains tax settings and introducing a land tax to fund growth-enhancing tax rate reductions.

35. **Vulnerabilities related to external debt would be reduced by structural reforms to raise productivity and labor force participation, thereby lifting potential growth and export capacity.** Staff welcomed efforts to streamline regulation and improve government service provision. In addition, the recent report of the Welfare Working Group identified major deficiencies in the welfare system that have led to an increase in long-term benefit dependency. Staff supported the working group's recommendation to focus government support on encouraging beneficiaries to seek employment.

Social Welfare Beneficiaries, 1970-2009
(As share of working age population)



36. **The RBNZ's core funding ratio has contributed to a substantial decline in short-term external debt and enhanced stability of the banking sector.** However, short-term external debt remains high at 50 percent of GDP, exposing the economy to funding risks. Therefore, staff advised that the core funding ratio be increased more than planned to reduce short-term external debt further.

New Zealand: External Debt

(End of Period)	Dec-08	Dec-09	Dec-10
Gross external debt	251	241	248
(Expressed in NZ$ billions)			
Of which: Short term[1]	118	105	98
Gross external debt	145	174	191
(Expressed in US$ billions)			
Of which: Short-term[1]	68	76	75
Gross external debt/GDP	137%	130%	128%
Of which: Short term/GDP	64%	56%	50%
Short-term to gross external debt	47%	44%	39%
Net external liabilities/GDP	87%	86%	82%
Memorandum item:			
US$/NZ$ (end of period)	0.58	0.72	0.77

Sources: Statistics New Zealand and IMF staff estimates.

[1] Data on short-term external debt split between banks, corporates and the government on a residual maturity basis are not available.

37. **As evident during the crisis, the free-floating New Zealand dollar provides an important buffer against shocks, including disruptions to offshore funding.** In the event of a tightening of external funding, a large depreciation of the New Zealand dollar would reduce the U.S. dollar funding needed to meet banks' desired domestic funding as most debt is in New Zealand dollars or is hedged.

38. **Staff analysis suggests that the New Zealand dollar is overvalued by 5 to 20 percent relative to estimates of the equilibrium exchange rate** (Box 3). Part of the overvaluation reflects the large positive interest rate differential, which may dissipate with eventual tightening by major central banks.

Authorities' Views

39. **The authorities agreed that fiscal consolidation would help raise national saving.** On structural reforms, they are considering a range of changes to welfare in order to increase labor force participation, and taxation with a view to lifting potential growth, which would help limit external vulnerabilities. They noted that the exchange rate would probably need to be significantly lower for an extended period to reduce net foreign liabilities substantially. They expect some depreciation over the next few years as the advanced economies recover and interest rate differentials normalize, but not sufficient to prevent an increase in the current account deficit. A rebalancing of world demand and greater flexibility in exchange rates would assist rebalancing in New Zealand.

Box 3 Equilibrium Real Effective Exchange Rate

Staff estimates show an overvaluation of the New Zealand dollar of 5–20 percent, but the estimates are subject to considerable uncertainty, as indicated by the wide range of the confidence intervals. The estimates are based on the macroeconomic balance (MB) approach, the equilibrium real exchange rate (ERER) approach, and the external sustainability (ES) approach.

The MB approach estimates the current account deficit norm at 4¼ percent of GDP, based on a model including population growth, old-age dependency rates, income growth, the fiscal balance, and oil balance. New Zealand's relatively high population growth contributes about 1½ percent of GDP to the deficit norm. The projected current account deficit is above this norm, implying an overvaluation of about 14 percent.

The ERER estimates suggest a smaller overvaluation. The model explains the real effective exchange rate (REER) on the basis of the terms of trade, relative productivity, and relative government consumption. It suggests an overvaluation of about 5 percent, assuming that the terms of trade will remain well above the average of the past two decades over the medium term.

The ES approach implies an overvaluation of 16–20 percent. To decrease net foreign liabilities (NFL) from 82 percent of GDP at end 2010 to a more sustainable level of 75 percent of GDP over 15 years,[1/] the REER would need to depreciate by almost 20 percent. A depreciation of about 16 percent would be needed to stabilize NFL at end-2010 levels.

Exchange Rate Assessment: Baseline Results 1/

	CA/GDP		REER
	Norm	Projection 2/	Overvaluation
MB Approach: 3/			
Desk	-4.2	-7.0	13.6
ERER Approach: 4/			
Desk	…	…	4.5
ES Approach: 5/			
NFL constant at 82 percent of GDP	-3.8	-7.0	15.7
NFL decreasing from 82 to 75 percent of GDP by 2025	-3.2	-7.0	18.5

Source: IMF staff estimates.

1/ All results are expressed in percent. Detailed analysis is presented in the IMF Working Paper (WP/09/07).

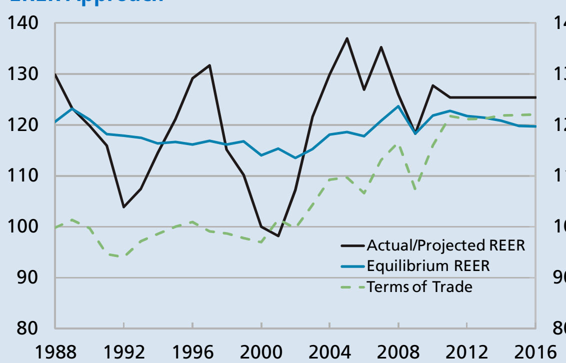
2/ Staff projection of the underlying CA/GDP in 2016.

3/ Based on a semi-elasticity of the CA/GDP with respect to the REER of –0.21.

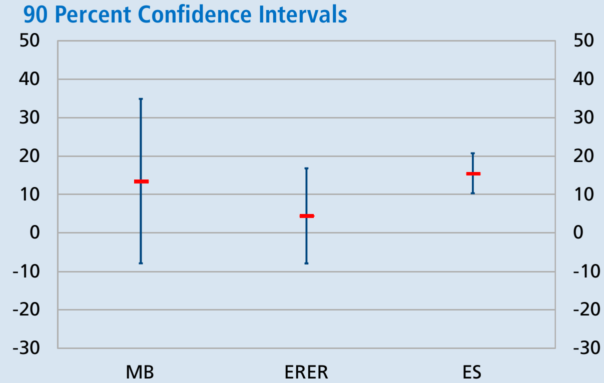
4/ Overvaluation is assessed relative to the average of February 2011.

5/ Based on nominal GDP growth rate of 5 percent.

ERER Approach



90 Percent Confidence Intervals



[1/] The 75 percent of GDP is about the average NFL over the pre-boom period of 2000–03.

STAFF APPRAISAL

40. **The recovery has stalled due to soft domestic demand and the adverse impact of the two large earthquakes.** Post-earthquake rebuilding and strong commodity prices bode well for a rebound in activity in 2012, but the timing and pace of the pickup is subject to considerable uncertainty. The outlook is also clouded by downside risks, notably those related to the global economy and New Zealand's large net foreign liabilities.

41. **The recent cut in the policy interest rate was appropriate but the RBNZ will need to tighten monetary policy once it becomes clear that the recovery is underway.** Importantly, the RBNZ should guard against a rise in medium-term inflation expectations as a result of higher food and oil prices, coupled with possible bottlenecks arising from reconstruction. In response to a downside scenario, the RBNZ has room to cut the policy rate and provide liquidity support for banks.

42. **The earthquakes have worsened the fiscal deficit in the near term, but returning to fiscal surpluses by 2014/15 or earlier is recommended.** Fiscal consolidation would build a buffer against future shocks and relieve pressure on monetary policy and thereby the exchange rate, helping rebalance the economy and contain the current account deficit over the medium term. It would also limit the impact of a rise in global interest rates and put the government in a better position to deal with the long-term costs of aging.

43. **The government should take concrete measures to control spending to strengthen the credibility of fiscal plans.** There is considerable scope to trim transfers to middle-income households, rationalize capital spending, and improve the efficiency of public service provision. Positive revenue surprises should also be saved to contain debt growth. The government's plan to better manage its balance sheet, including possible divestment of a stake in state-owned enterprises, is welcome. Moreover, policy action will need to be taken early to contain rising fiscal costs related to aging and health care.

44. **Banks remain profitable and capital adequacy has improved, but they are exposed to highly indebted households and farmers and rollover risks associated with short-term offshore borrowing.** Collaboration with the Australian authorities on stress tests and crisis management is welcome. However, future stress tests should include funding risks. Consideration should be given to raising bank capital gradually to levels well above the Basel III requirements to build a larger cushion against shocks.

45. **The RBNZ's continued work on the costs and benefits of macroprudential measures is welcome.** The core funding ratio has contributed to a substantial decline in short-term offshore borrowing and enhanced stability of the banking system. The ratio should be increased more than planned over time to reduce short-term external debt further.

46. New Zealand's large net foreign liabilities present a major risk. Despite recent improvements, the current account deficit is expected to widen to 7 percent of GDP over the medium term, as the economy recovers and interest rates normalize. Efforts to raise national saving and improve productivity, including through fiscal consolidation, tax and welfare reform, and streamlining regulation, would reduce external vulnerabilities.

47. The exchange rate is overvalued by 5–20 percent from a medium-term perspective. Part of the overvaluation is likely to be transitory, as the positive interest rate differential may dissipate with eventual monetary tightening by major central banks.

48. Staff recommends that the next Article IV consultation be held on the standard 12-month cycle.

Table 1 Selected Economic and Financial Indicators, 2006–12

Nominal GDP (2010): US$140.4 billion — GDP per capita (2010): US$31,915
Population (2010): 4.4 million — Quota: SDR 894.6 million

	2006	2007	2008	2009	2010	2011 Proj.	2012 Proj.
Real growth (percent change)							
GDP (production basis)	1.0	2.8	-0.2	-2.1	1.5	0.9	4.0
Final domestic demand	1.8	4.6	-0.1	-3.5	2.4	1.9	4.5
Private consumption	2.2	4.1	-0.3	-0.8	2.1	1.8	2.4
Government consumption	4.9	4.1	5.0	0.6	2.2	0.6	0.3
Fixed investment	-1.2	6.0	-3.0	-12.9	3.5	3.1	13.6
Inventories 1/	-0.8	0.3	0.4	-2.4	1.7	0.1	0.0
Exports of goods and services	1.7	3.9	-1.7	1.9	2.8	4.1	4.5
Imports of goods and services	-2.5	8.7	2.6	-14.9	10.0	6.8	6.1
Output gap	1.0	1.6	-0.3	-3.2	-3.1	-2.9	-1.3
Headline CPI inflation (percent change)	3.4	2.4	4.0	2.1	2.3	4.1	2.7
End of period (percent change)	2.7	3.2	3.4	2.0	4.0	2.8	2.5
Unemployment rate (period average, in percent)	3.8	3.7	4.2	6.2	6.5	6.7	6.2
Investment and saving (in percent of GDP)							
Investment	23.3	23.8	23.1	19.1	19.9	19.6	21.6
National saving 2/	15.2	15.6	15.2	16.3	17.7	19.4	17.3
Public finance (in percent of GDP) 3/							
Revenue	36.1	33.8	33.7	32.1	29.7	28.9	29.7
Expenditure	33.4	31.4	31.1	34.5	33.8	36.7	34.4
Operating balance 4/	4.1	3.8	2.1	-3.2	-3.7	-6.8	-4.0
Operating balance before gains and losses	4.5	3.4	3.1	-2.1	-3.3	-8.1	-3.8
Net Crown debt excluding $NZ Fund and advances	10.0	7.7	5.6	9.2	14.1	21.9	26.3
Money and credit (end of period)							
Resident M3 (percent change) 5/	12.3	12.0	9.1	1.9	3.9	5.0	…
Private domestic credit (percent change) 5/	12.8	13.4	8.3	1.7	0.5	0.8	…
Interest rates (period average)							
Interest rate (90-day, in percent) 6/	7.5	8.3	8.0	3.0	3.2	3.0	…
Government bond yield (10-year, in percent) 6/	5.8	6.3	6.1	5.5	5.5	5.6	…
Balance of payments (in percent of GDP)							
Current account	-8.2	-8.0	-8.7	-2.9	-2.2	-0.2	-4.3
(In billions of New Zealand dollars)	-13.7	-14.4	-16.1	-5.3	-4.3	-0.4	-9.2
Trade balance (goods)	-1.8	-1.3	-1.3	1.3	1.8	2.4	2.0
Terms of trade (percent change)	0.0	6.0	7.4	-10.1	10.3	4.4	-0.5
Foreign assets and liabilities ($NZ billion)							
Net international investment position	-140.8	-148.7	-161.0	-160.7	-159.0	-159.1	-167.8
(In percent of GDP)	-84.8	-83.3	-87.2	-86.5	-81.7	-77.9	-78.2
Official reserves 5/	19.9	22.3	19.1	21.6	21.7	24.0	…
Exchange rate (period average)							
U.S. dollar per New Zealand dollar 6/	0.65	0.74	0.71	0.64	0.72	0.76	…
Trade-weighted index (June 1979 = 100) 6/	65.4	70.9	65.7	60.0	64.6	67.2	…
Nominal effective exchange rate 7/	91.8	97.8	91.1	84.1	92.2	94.5	…
Real effective exchange rate 7/	92.7	98.7	92.0	86.4	94.2	95.5	…
GDP (in billions of New Zealand dollars)	166.1	178.6	184.5	185.7	194.6	204.2	214.6

Sources: Data provided by the New Zealand authorities; and IMF staff estimates and projections.
1/ Contribution in percent of GDP.
2/ Based on national accounts data.
3/ Fiscal years ending June 30.
4/ Equals revenue less expenditure plus net surplus of state-owned enterprises and Crown entities.
5/ Data for 2011 are for January.
6/ Data for 2011 are for January-March.
7/ IMF Information Notice System index (2000 = 100). Data for 2011 are for January.

Table 2 Summary of Central Government Budget, 2006/07–2011/12 [1]

	2006/07	2007/08	2008/09	2009/10	2010/11 Proj.	2011/12 Proj.
	(In billions of New Zealand dollars)					
Revenue (core Crown)	58.2	61.8	59.5	56.2	57.5	62.0
Tax revenue	53.5	56.7	54.7	50.7	51.7	55.9
Expenditure (core Crown)	54.0	57.0	64.0	64.0	73.1	71.9
Social security and welfare	16.8	17.9	19.4	21.2	22.1	22.8
Health	10.4	11.3	12.4	13.1	14.0	14.0
Education	9.3	9.6	11.5	11.7	12.0	12.0
Defense	1.5	1.6	1.8	1.8	2.0	1.9
Finance costs	2.3	2.5	2.4	2.3	3.1	3.8
Other	13.8	14.3	16.6	13.9	20.0	17.4
Of which: Earthquakes-related expenses	…	…	…	…	2.5	1.5
Revenue less expenditure (core Crown)	4.2	4.8	-4.5	-7.8	-15.6	-9.9
Operating balance (core Crown)[2]	6.5	3.9	-5.9	-7.0	-13.5	-8.4
Operating balance before gains and losses (total Crown)	5.9	5.6	-3.9	-6.3	-16.1	-7.9
Of which: Earthquakes-related expenses					5.5 [7]	1.5
Residual cash balance[3]	2.9	2.1	-8.6	-9.0	-17.1	-11.4
Gross sovereign-issued debt[4]	30.6	31.4	43.4	53.6	68.9	75.7
Net core Crown debt[5]	13.2	10.3	17.1	26.7	43.5	54.8
Net core Crown debt with NZ Superannuation Fund[6]	1.6	-2.7	5.6	12.5	27.8	37.7
Net worth (core Crown)[6]	50.8	57.0	53.1	44.7	33.1	25.0
	(In percent of GDP)					
Revenue (core Crown)	33.8	33.7	32.1	29.7	28.9	29.7
Tax revenue	31.1	30.9	29.5	26.8	26.0	26.8
Expenditure (core Crown)	31.4	31.1	34.5	33.8	36.7	34.4
Social security and welfare	9.7	9.7	10.5	11.2	11.1	10.9
Health	6.0	6.2	6.7	6.9	7.0	6.7
Education	5.4	5.2	6.2	6.2	6.1	5.8
Defense	0.9	0.9	0.9	1.0	1.0	0.9
Finance costs	1.4	1.3	1.3	1.2	1.5	1.8
Other	8.0	7.8	9.0	7.3	10.0	8.4
Of which: Earthquakes-related expenses	…	…	…	…	1.3	0.7
Revenue less expenditure	2.4	2.6	-2.4	-4.1	-7.8	-4.7
Operating balance[2]	3.8	2.1	-3.2	-3.7	-6.8	-4.0
Operating balance before gains and losses (total Crown)	3.4	3.1	-2.1	-3.3	-8.1	-3.8
Of which: Earthquakes-related expenses					2.8 [7]	0.7
Residual cash balance[3]	1.7	1.1	-4.7	-4.8	-8.6	-5.5
Gross sovereign-issued debt[4]	17.8	17.1	23.4	28.3	34.6	36.3
Net core Crown debt[5]	7.7	5.6	9.2	14.1	21.9	26.3
Net core Crown debt with NZ Superannuation Fund[6]	0.9	-1.5	3.0	6.6	13.9	18.1
Net worth (core Crown)[6]	29.5	31.1	28.6	23.6	16.6	12.0
Memorandum items (in billions of New Zealand dollars)						
Contributions to NZ Superannuation Fund	2.0	2.1	2.2	0.3	0.0	0.0
NZ Superannuation Fund balance	13.0	14.2	13.7	15.7	17.1	18.3

Sources: New Zealand Treasury; and Fund staff estimates and projections.

1/ Fiscal years ending June 30.

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

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

4/ Excluding Reserve Bank settlement cash.

5/ Excluding NZ Superannuation Fund and advances.

6/ Includes financial assets of NZ Superannuation Fund.

7/ Includes the Earthquake Commission's payments of $NZ 3 billion.

Table 3 Balance of Payments and External Debt, 2005–10
(In percent of GDP)

	2005	2006	2007	2008	2009	2010
Current account balance	-7.9	-8.2	-8.0	-8.7	-2.9	-2.2
Goods balance	-2.3	-1.8	-1.3	-1.3	1.3	1.8
Exports, f.o.b.	19.7	21.0	20.7	23.8	21.7	22.7
Imports, f.o.b.	-22.0	-22.8	-22.1	-25.1	-20.4	-20.9
Services balance	0.4	0.2	0.2	-0.4	0.0	-0.3
Receipts	7.8	7.5	7.2	7.0	6.8	6.2
Payments	-7.4	-7.3	-7.0	-7.4	-6.8	-6.5
Income balance	-6.2	-7.0	-7.3	-7.6	-4.1	-5.5
Receipts	3.1	3.2	3.6	2.9	3.1	3.3
Payments	-9.2	-10.2	-10.9	-10.5	-7.2	-8.8
Transfers balance	0.2	0.4	0.3	0.5	0.2	1.8
Receipts	1.1	1.2	1.1	1.3	1.0	0.7
Payments	-0.9	-0.8	-0.8	-0.8	-0.8	1.1
Capital and financial account balance	7.6	7.4	7.1	2.7	0.0	1.5
Capital account (net)	-0.2	-0.2	-0.4	-0.3	0.3	-0.2
Financial account (net)	7.8	7.6	7.5	3.1	-0.3	1.7
Direct investment (net)	2.7	4.0	-0.4	3.2	-0.8	0.1
Portfolio investment (net)	-0.1	-1.0	8.1	-5.9	1.7	2.3
Assets	-0.6	-0.9	-1.1	-0.2	-2.7	-1.1
Equity securities	-1.0	-0.7	-0.8	0.1	-1.3	-0.7
Debt securities	0.4	-0.2	-0.3	-0.3	-1.4	-0.4
Liabilities	0.5	-0.1	9.2	-5.7	4.4	3.3
Equity securities	-0.1	-0.4	0.2	0.2	0.8	-0.2
Debt securities	0.6	0.3	9.0	-5.9	3.6	3.5
Other investment (net)	5.1	4.6	-0.2	5.8	-1.2	-0.7
Assets	1.6	-5.3	-3.7	5.4	-3.8	-1.5
Liabilities	3.5	10.0	3.5	0.4	2.6	0.8
Net errors and omissions 1/	0.3	0.9	1.0	6.1	2.8	0.8
Overall balance	0.0	0.0	0.0	0.1	-0.1	0.0
	(Assets and liabilities as of end-December)					
Gross external debt	106.9	115.7	121.7	136.3	129.6	127.7
Short-term (less than one year on residual maturity basis)	56.2	60.1	66.8	63.8	56.5	50.1
Long-term	50.7	55.5	54.8	72.5	73.1	77.5
Gross external debt	106.9	115.7	121.7	136.3	129.6	127.7
Of which: Denominated in New Zealand dollars	55.7	63.1	62.6	68.0	63.5	64.8
Gross external debt	106.9	115.7	121.7	136.3	129.6	127.7
Public sector	11.2	8.9	9.7	10.2	12.5	16.7
Private sector	95.6	106.8	111.9	126.1	117.2	110.9
Net international investment position 2/	-81.8	-84.8	-83.3	-87.2	-86.5	-81.7
Net equity	-11.0	-10.1	-7.6	-2.6	-3.7	-2.8
Net debt	-70.9	-74.7	-75.7	-84.6	-82.8	-78.9
Gross official reserves	8.2	12.0	12.5	10.4	11.6	11.2
Gross reserves in months of future imports of g&s	5.2	8.2	8.2	8.4	9.4	8.8
Gross reserves as percent of short-term debt	14.7	19.9	18.7	16.2	20.6	22.2

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

1/ The large net errors and omissions in 2008 and 2009 mainly reflect financial account data issues, as extreme volatility in exchange rates and market prices during that period made it difficult to separate out valuation effects from financial account transaction.
A project is underway to investigate how balance of payments statistics can better capture transactions in financial derivatives.

2/ IIP balance sheet positions arise from transactions and valuation changes. The large net errors and omissions in 2008-09 do not lead to large under-estimation of net foreign liabilities.

Table 4 Balance of Payments and External Debt, 2005–10
(In billions of U.S. dollars)

	2005	2006	2007	2008	2009	2010
Current account balance	-8.8	-8.9	-10.6	-11.5	-3.4	-3.1
Goods balance	-2.6	-1.9	-1.7	-1.7	1.5	2.5
Exports, f.o.b.	22.0	22.6	27.3	31.4	25.6	31.9
Imports, f.o.b.	-24.6	-24.6	-29.0	-33.1	-24.1	-29.4
Services balance	0.5	0.2	0.3	-0.5	0.0	-0.4
Receipts	8.7	8.1	9.4	9.3	8.0	8.7
Payments	-8.2	-7.9	-9.2	-9.7	-8.0	-9.1
Income balance	-6.9	-7.5	-9.6	-10.0	-4.9	-7.8
Receipts	3.4	3.5	4.8	3.8	3.6	4.6
Payments	-10.3	-11.0	-14.4	-13.8	-8.5	-12.3
Transfers balance	0.2	0.4	0.4	0.7	0.3	2.6
Receipts	1.2	1.3	1.4	1.7	1.2	1.0
Payments	-1.0	-0.9	-1.0	-1.0	-0.9	1.6
Capital and financial account balance	8.5	8.0	9.3	3.6	-0.1	2.1
Capital account (net)	-0.2	-0.2	-0.6	-0.4	0.4	-0.2
Financial account (net)	8.7	8.2	9.9	4.0	-0.4	2.3
Direct investment (net)	3.1	4.4	-0.6	4.2	-1.0	0.1
Portfolio investment (net)	-0.1	-1.1	10.7	-7.8	2.0	3.2
Assets	-0.7	-1.0	-1.4	-0.2	-3.2	-1.5
Equity securities	-1.2	-0.8	-1.0	0.1	-1.6	-1.0
Debt securities	0.5	-0.2	-0.4	-0.4	-1.6	-0.5
Liabilities	0.6	-0.1	12.1	-7.6	5.1	4.7
Equity securities	-0.1	-0.4	0.3	0.2	0.9	-0.2
Debt securities	0.7	0.3	11.8	-7.8	4.2	4.9
Other investment (net)	5.7	5.0	-0.2	7.6	-1.4	-1.0
Assets	1.7	-5.7	-4.8	7.2	-4.5	-2.1
Liabilities	4.0	10.8	4.6	0.5	3.1	1.2
Net errors and omissions 1/	0.4	0.9	1.3	8.0	3.4	1.1
Overall balance	0.1	0.0	0.1	0.1	-0.1	0.1
	(Assets and liabilities as of end-December)					
Gross external debt	115.5	135.6	168.2	145.5	174.0	193.9
Short-term (less than one year on residual maturity basis)	60.7	70.5	92.4	68.1	75.8	76.1
Long-term	54.8	65.1	75.8	77.4	98.2	117.7
Gross external debt	115.5	135.6	168.2	145.5	174.0	193.9
Of which: denominated in New Zealand dollars	60.2	74.0	86.5	72.6	85.2	98.4
Gross external debt	115.5	135.6	168.2	145.5	174.0	193.9
Public sector	12.1	10.4	13.5	10.9	16.7	25.4
Private sector	103.4	125.2	154.7	134.6	157.3	168.5
Net international investment position 2/	-88.4	-99.4	-115.1	-93.1	-116.2	-124.1
Net equity	-11.8	-11.8	-10.4	-2.8	-5.0	-4.2
Net debt	-76.6	-87.6	-104.7	-90.3	-111.2	-119.9
Gross official reserves	8.9	14.1	17.2	11.1	15.6	16.9
RBNZ net short position in forex swaps	1.8	7.4	8.0	3.4	7.4	9.4
RBNZ net open foreign currency position	0.0	0.0	1.9	2.9	2.5	2.2
U.S./New Zealand exchange rate (e.o.p.)	0.7	0.7	0.8	0.6	0.7	0.8
U.S./New Zealand exchange rate (period average)	0.7	0.6	0.7	0.7	0.6	0.7

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

1/ The large net errors and omissions in 2008 and 2009 mainly reflect financial account data issues, as extreme volatility in exchange rates and market prices during that period made it difficult to separate out valuation effects from financial account transaction. A project is underway to investigate how balance of payments statistics can better capture transactions in financial derivatives.

2/ IIP balance sheet positions arise from transactions and valuation changes. The large net errors and omissions in 2008-09 do not lead to large under-estimation of net foreign liabilities.

Table 5 Medium-Term Scenario, 2008–16

	Average				Projections					
	1998-2007	2008	2009	2010	2011	2012	2013	2014	2015	2016
Real growth (percent change)										
GDP (production basis)	3.2	-0.2	-2.1	1.5	0.9	4.0	3.2	2.8	2.5	2.3
GDP (expenditure basis)	3.3	-1.2	0.1	1.8	0.9	4.0	3.2	2.8	2.5	2.3
Final domestic demand	4.0	-0.1	-3.5	2.4	1.9	4.5	3.6	2.9	2.9	2.5
Consumption	3.5	0.9	-0.5	2.1	1.5	1.9	1.9	1.9	2.1	2.2
Private consumption	3.6	-0.3	-0.8	2.1	1.8	2.4	2.4	2.4	2.6	2.7
Government consumption	3.2	5.0	0.6	2.2	0.6	0.3	0.4	0.5	0.6	0.6
Fixed investment	5.4	-3.0	-12.9	3.5	3.1	13.6	8.8	5.6	4.8	3.1
Private business	5.8	-1.1	-18.6	10.2	7.3	11.8	8.0	6.4	5.9	4.1
Private residential	3.1	-17.1	-19.3	2.8	-15.0	27.1	14.7	8.5	5.8	2.0
Public investment	7.9	4.9	7.5	-9.5	4.1	11.1	7.3	1.5	1.2	1.2
Changes in inventories 1/	0.0	0.4	-2.4	1.7	0.1	0.0	0.0	0.0	0.0	0.0
Exports of goods and services	4.0	-1.7	1.9	2.8	4.1	4.5	5.0	4.7	4.7	4.7
Imports of goods and services	6.0	2.6	-14.9	10.0	6.8	6.1	6.0	4.7	5.3	4.8
Net exports (contribution to growth)	-0.7	-1.5	6.2	-2.3	-1.0	-0.8	-0.6	-0.3	-0.5	-0.3
Saving and investment (percent of GDP)										
Gross capital formation	22.6	23.1	19.1	19.9	19.6	21.6	22.7	23.3	23.8	23.9
Fixed investment	21.7	22.1	20.1	19.5	19.2	21.2	22.3	22.9	23.4	23.5
Fixed investment excluding earthquakes	…	…	…	19.5	19.0	19.9	20.9	21.8	22.8	23.0
Changes in inventories	0.9	0.9	-1.0	0.3	0.4	0.4	0.4	0.4	0.4	0.4
National savings 2/	17.3	15.2	16.3	17.7	19.4	17.3	17.7	17.7	17.2	16.9
Private	11.6	10.2	14.3	19.4	21.2	16.8	15.6	14.3	13.1	12.0
Public	5.7	5.1	1.9	-1.8	-1.9	0.4	2.1	3.3	4.2	4.9
Inflation and unemployment (percent)										
Headline CPI inflation (period average)	2.2	4.0	2.1	2.3	4.1	2.7	2.4	2.4	2.3	2.1
Headline CPI inflation (end of period)	2.3	3.4	2.0	4.0	2.8	2.5	2.4	2.4	2.2	2.0
Unemployment rate	5.2	4.2	6.2	6.5	6.7	6.2	5.7	5.3	4.8	4.5
Output gap (staff estimate)	0.8	-0.3	-3.2	-3.1	-2.9	-1.3	-0.5	-0.2	-0.1	0.0
Government budget (percent of GDP) 3/										
Revenue	34.2	33.7	32.1	29.7	28.9	29.7	30.1	30.5	30.9	31.1
Expenditure	32.0	31.1	34.5	33.8	36.7	34.4	33.0	31.9	31.4	30.7
Operating balance 4/	2.8	2.1	-3.2	-3.7	-6.8	-4.0	-2.2	-0.6	0.3	1.1
Operating balance before gains and losses	2.6	3.1	-2.1	-3.3	-8.1	-3.8	-2.0	-0.5	0.3	1.2
Residual cash balance	0.9	1.1	-4.7	-4.8	-8.6	-5.5	-4.0	-2.1	-1.1	0.1
Gross Crown debt	27.6	17.1	23.4	28.3	34.6	36.3	35.6	37.3	34.7	32.6
Net Crown debt excluding NZS Fund and advances	18.3	5.6	9.2	14.1	21.9	26.3	28.6	29.3	29.0	27.1
Terms of trade (2002=100, goods and services)	104.5	121.2	110.6	120.6	124.2	123.3	124.0	124.4	124.6	124.9
Terms of trade (2002=100, goods)	103.7	123.4	111.0	122.4	127.8	127.1	127.6	127.7	127.5	127.4
Terms of trade (percent change, goods)	1.8	7.4	-10.1	10.3	4.4	-0.5	0.4	0.1	-0.2	-0.1
Export prices	2.4	19.6	-12.6	6.5	11.2	5.0	3.1	2.5	2.2	1.3
Import prices	0.6	11.4	-2.8	-3.4	6.5	5.6	2.7	2.5	2.3	1.4
Balance of payments (percent of GDP)										
Current account balance	-5.4	-8.7	-2.9	-2.2	-0.2	-4.3	-5.0	-5.7	-6.6	-7.0
Balance on goods and services	0.1	-1.7	1.3	1.5	1.7	1.1	1.0	1.1	1.0	1.0
Balance on income and transfers	-5.5	-7.0	-3.9	-3.7	-1.9	-5.4	-6.0	-6.8	-7.5	-8.0
Net foreign liabilities (percent of GDP) 5/	79.8	87.2	86.5	81.7	77.9	78.2	78.3	80.1	82.3	85.1
Gross external debt 5/	108.0	136.3	129.6	127.7	124.6	124.8	124.9	126.4	128.1	130.4
Nominal GDP (in billions of New Zealand dollars)	137.7	184.5	185.7	194.6	204.2	214.6	228.1	238.7	251.0	262.6
Partners' GDP growth	3.9	2.4	-0.5	4.5	3.8	3.9	3.8	3.9	3.8	3.7
Partners' import volume growth (goods and services)	7.4	5.4	-9.6	12.2	6.1	7.1	7.0	7.0	7.1	7.0
90-day bank bill rate	6.5	8.0	3.0	3.0	2.7	3.1	3.8	4.6	5.0	5.0
10-year bond rate	6.2	6.1	5.5	5.6	5.8	6.2	6.3	6.5	6.8	7.0

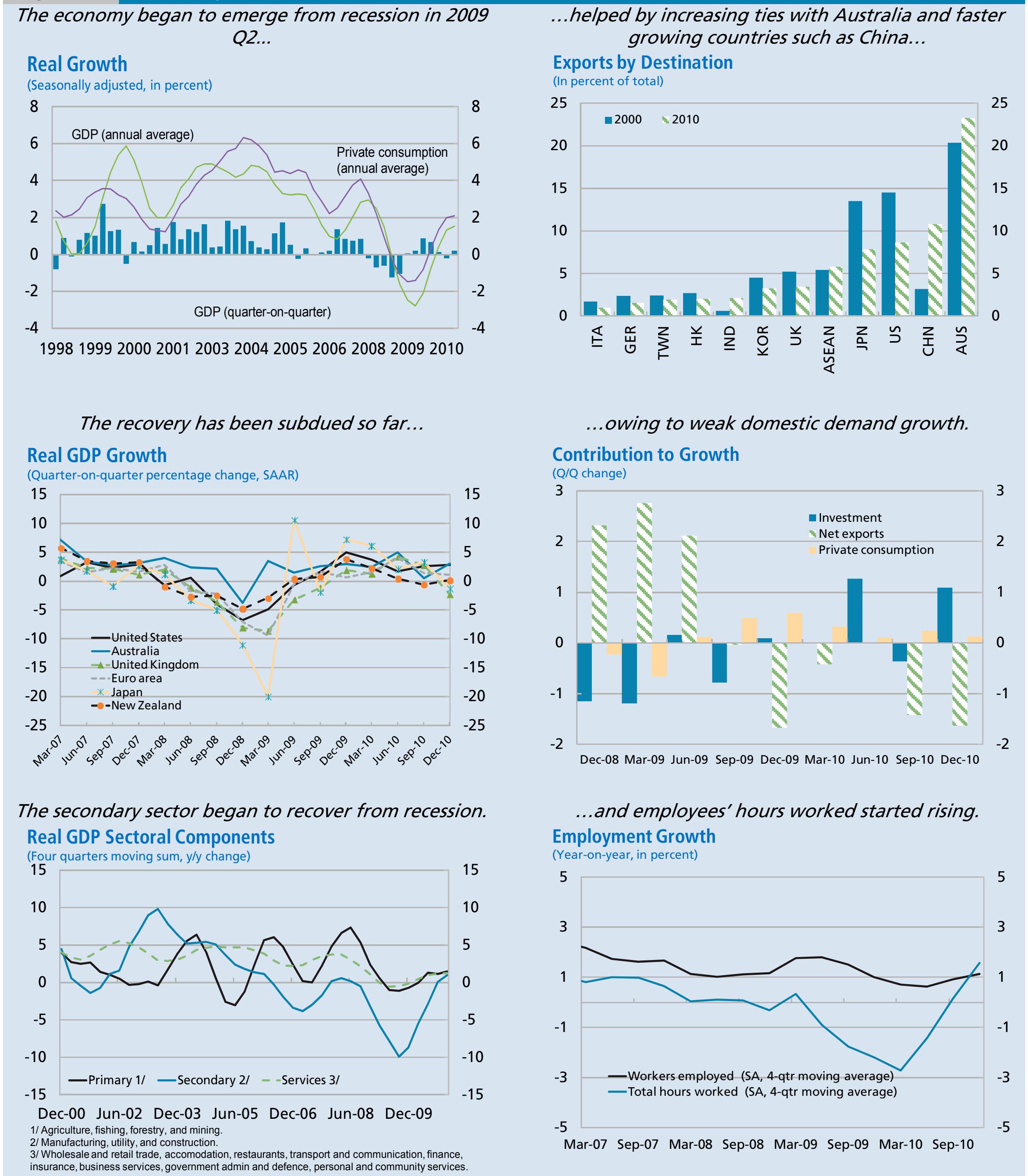
Sources: Data provided by the New Zealand authorities; and IMF staff estimates and projections.
1/ Contribution in percent of GDP.
2/ Converted from March year basis for historical data. Public saving covers general government.
3/ Fiscal years ending June 30.
4/ Equals revenue less expenditure plus net surplus of state-owned enterprises and Crown entities.
5/ Data for end-December.

Table 6 Indicators of External and Financial Vulnerability, 2005–10
(In percent of GDP, unless otherwise indicated)

	2005	2006	2007	2008	2009	2010
External indicators						
Real exports of goods and services (percent change)	-0.5	1.7	3.9	-1.7	1.9	2.8
Real imports of goods and services (percent change)	5.4	-2.5	8.7	2.6	-14.9	10.0
Terms of trade (goods; percent change)	1.1	0.0	6.0	7.4	-10.1	10.3
Current account balance	-7.9	-8.2	-8.0	-8.7	-2.9	-2.2
Capital and financial account balance	7.6	7.4	7.1	2.7	0.0	1.5
Of which:						
Net portfolio investment	-0.1	-1.0	8.1	-5.9	1.7	2.3
Net direct investment	2.7	4.0	-0.4	3.2	-0.8	0.1
Total reserves (in billions of New Zealand dollars)	13.1	19.9	22.3	19.1	21.6	21.7
In months of imports of goods and services	5.2	8.2	8.2	8.4	9.4	8.8
Net foreign liabilities	81.8	84.8	83.3	87.2	86.5	81.7
Of which:						
Net external public sector debt	1.5	-4.9	-4.8	-3.6	-3.1	-0.9
Net external private sector debt	69.4	79.6	80.4	88.5	85.8	79.8
Investment income balance to exports (in percent)	-22.4	-24.5	-26.2	-24.6	-14.5	-19.1
Nominal effective exchange rate (percent change)	4.6	-8.2	6.6	-6.8	-6.1	-3.7
Financial market indicators						
General government gross debt	10.9	8.7	9.4	9.7	12.1	16.2
Interest rates (percent end-year)						
3-month T-bill	7.1	7.5	8.3	8.0	3.0	3.0
3-month T-bill, real	4.0	4.0	5.8	3.9	0.9	0.7
3-month interest rate spread vis-à-vis U.S.	3.9	2.7	3.9	6.6	3.0	3.0
Stock market index (percent change, end-year)	10.0	20.3	-0.3	-32.8	6.6	9.7
Capital adequacy (in percent)						
Regulatory capital to risk-weighted assets	10.9	10.7	10.5	11.4	12.6	13.2
Tier I capital to risk-weighted assets	8.7	8.1	7.6	8.5	9.5	9.9
Asset quality (in percent)						
Nonperforming loans to total loans	0.3	0.2	0.3	0.9	1.7	2.1
Provisions to nonperforming loans	155.7	187.9	111.5	56.2	58.8	56.7
Asset composition (share of total)						
Agricultural	12.7	12.7	13.0	14.6	15.6	15.7
Business	25.4	26.1	26.2	27.0	24.7	24.0
Households	61.8	61.2	60.8	58.4	59.7	60.4
Of which: Housing	56.6	56.3	56.3	54.2	55.7	56.3

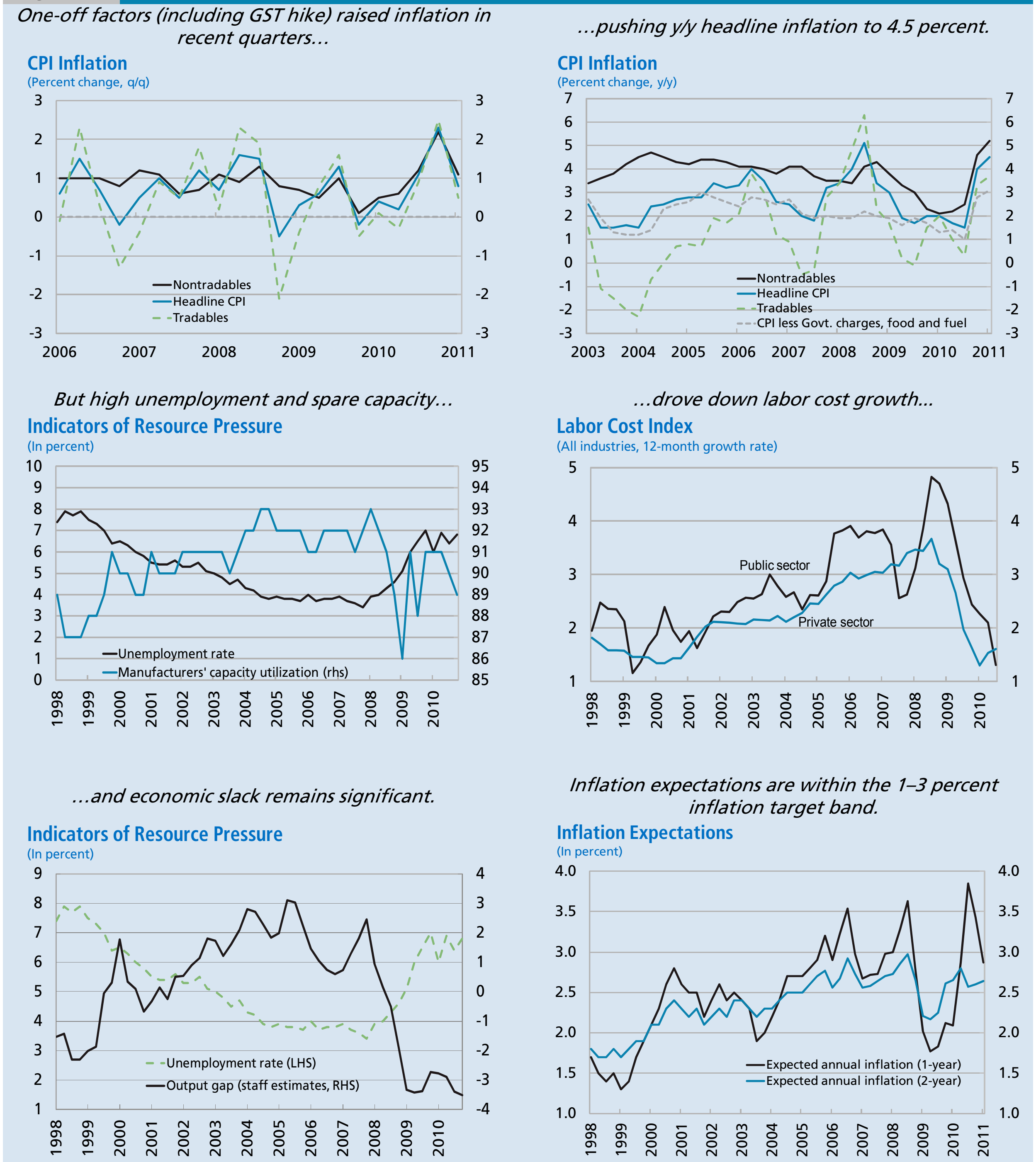
Sources: Data provided by the New Zealand authorities and IMF staff estimates.

Figure 1 Recovery From Recession



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

Figure 2 Inflation

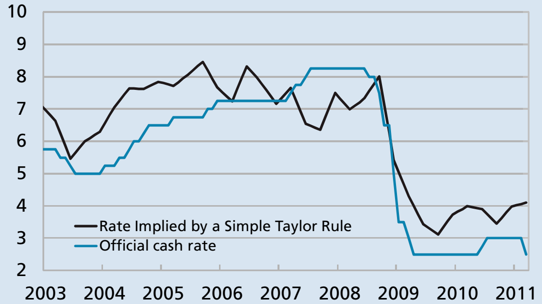


Sources: Reserve Bank of New Zealand; Statistics New Zealand; New Zealand Institute of Economic Research; Bloomberg; International Financial Statistics database.

Figure 3 Monetary Stimulus

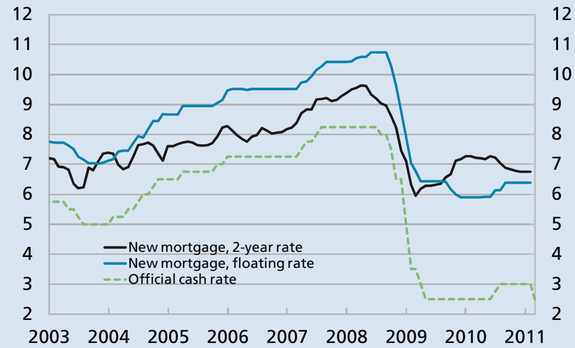
The policy rate was cut aggressively during the crisis…

Policy Rate
(In percent)



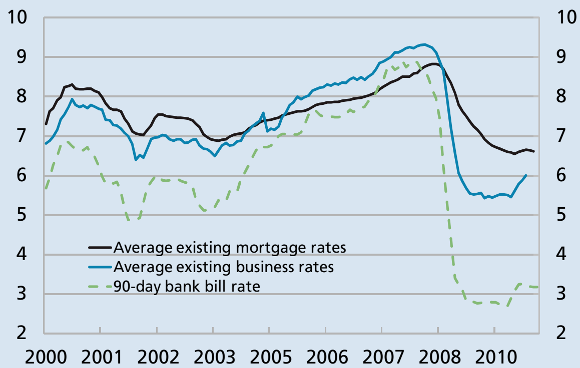
…and mortgage rates declined.

Interest Rates



Effective lending rates fell, but not as much as the policy rate and the bank bill rate…

Nominal Interest Rates

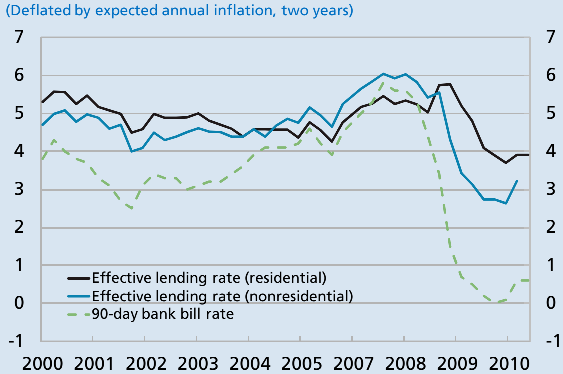


…and the spread between the OCR and banks' floating mortgage rates increased because of competition for deposits.

Floating Mortgage Rate to OCR Spread
(In percent)

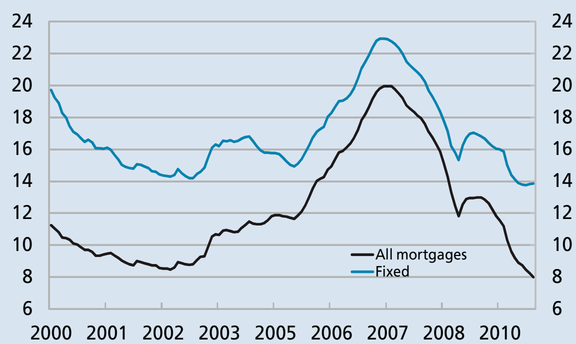
Real effective lending rates fell.

Real Interest Rates
(Deflated by expected annual inflation, two years)



The decline in mortgage duration suggests faster monetary transmission.

Average Mortgage Duration
(In months)

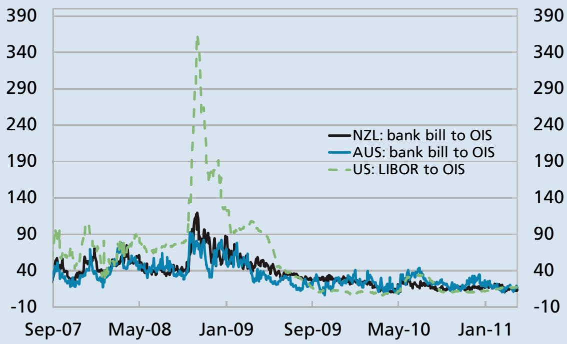


Sources: Reserve Bank of New Zealand; Statistics New Zealand; Bloomberg; International Financial Statistics database.

Figure 4 Recent Financial Market Developments

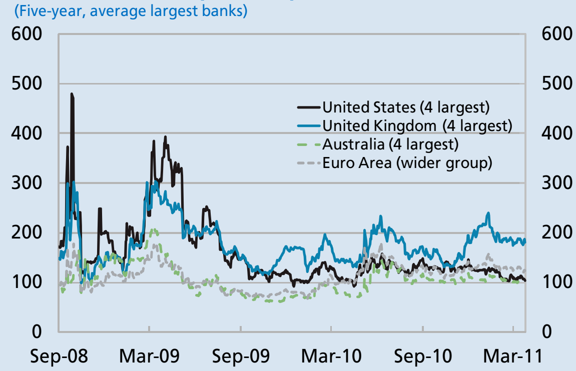
Money market spreads have eased to pre-crisis levels…

Spreads to Overnight Index Swaps
(In basis points, 3-month)



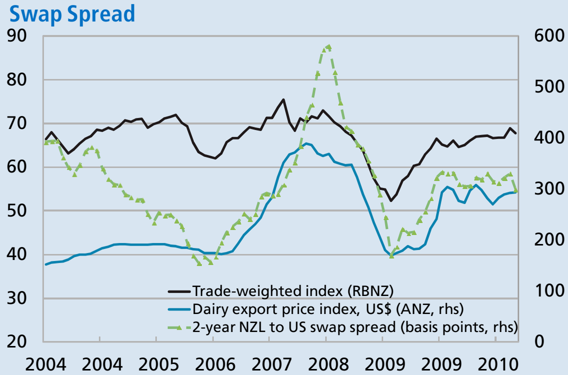
…while bank CDS spreads remain above pre-crisis levels.

Credit Default Swap (CDS) Spreads
(Five-year, average largest banks)



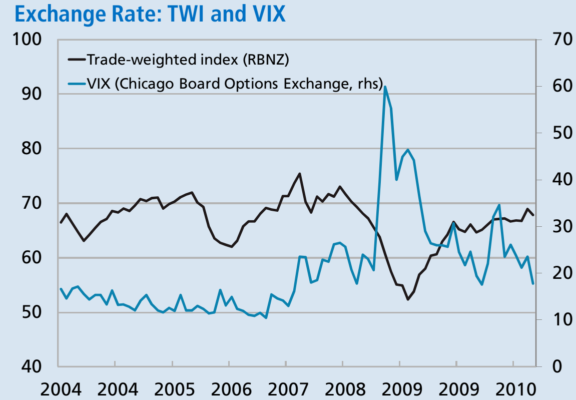
The exchange rate remains elevated, supported by commodity prices, interest differentials, …

Exchange Rate: Dairy Price Index, TWI, and Two-Year Swap Spread



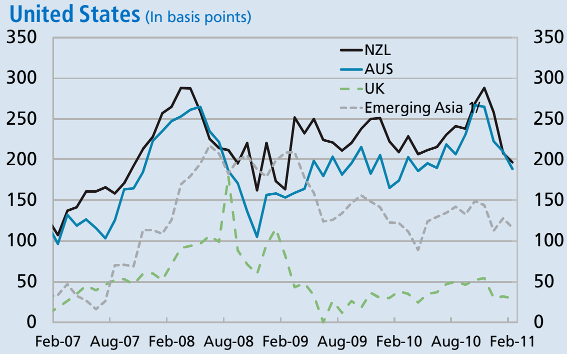
… and risk appetite.

Exchange Rate: TWI and VIX



Spreads of government bonds remain elevated.

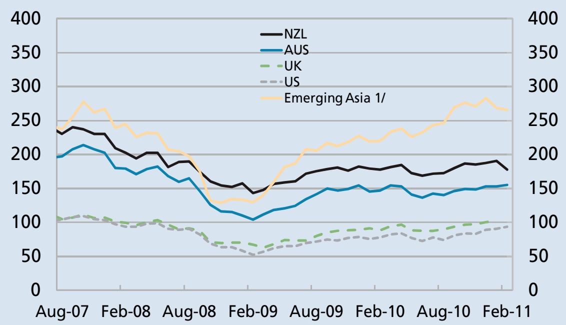
Spreads of 10-Year Government Bond Yield to United States (In basis points)



1/ Average for China, Hong Kong SAR, India, Indonesia, Korea, Malaysia, Philippines, Singapore, Taiwan Province of China, and Thailand.

The stock market has recovered some lost ground.

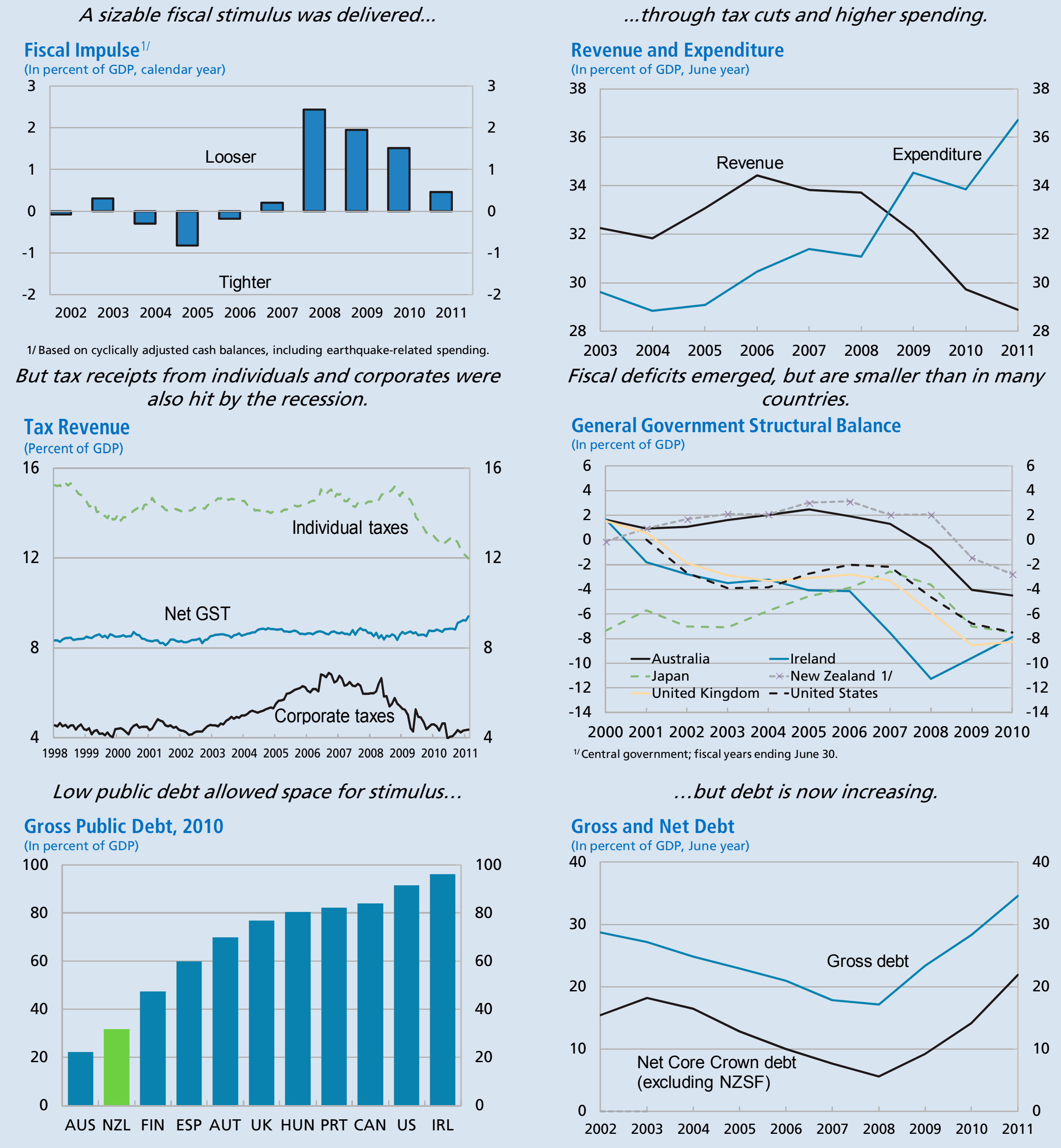
Stock Market Indices
(2000=100)



1/ Average for China, Hong Kong SAR, India, Indonesia, Korea, Malaysia, Philippines, Singapore, Taiwan Province of China, and Thailand.

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

Figure 5 Fiscal Stimulus

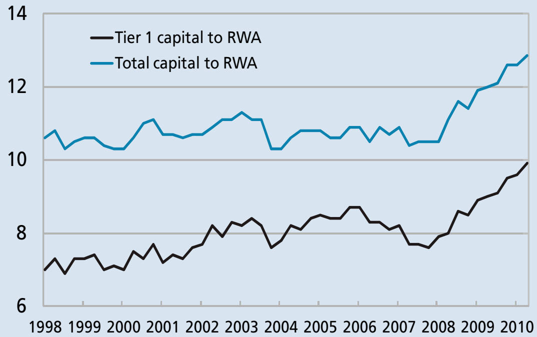


Sources: The New Zealand Treasury; Statistics New Zealand; *World Economic Outlook*; and IMF staff calculations and projections.

Figure 6 Domestic Banks

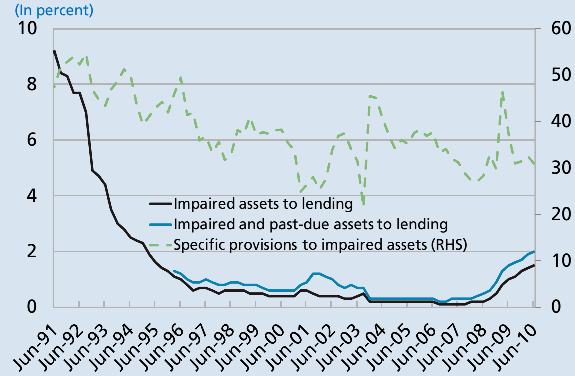
Bank capital remains healthy…

Soundness Indicator
(In percent)



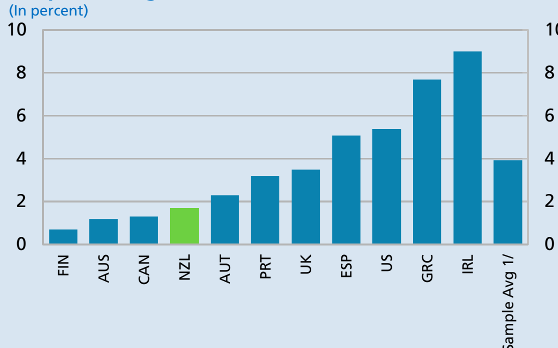
…but asset quality has deteriorated.

New Zealand Banks Asset Quality
(In percent)



….although nonperforming loans are low by advanced economy standards

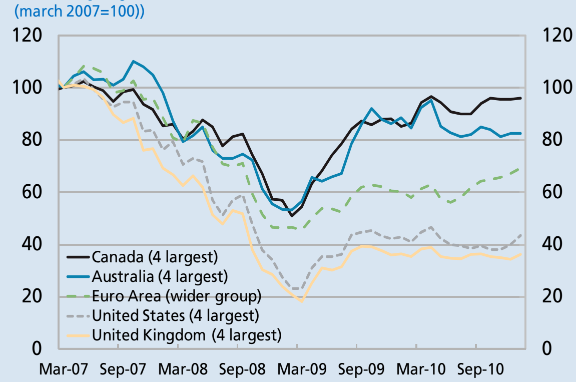
Nonperforming Loans to Total Loans, 2009
(In percent)



1/ Simple (unweighted) average of comparator countries, excluding New Zealand.

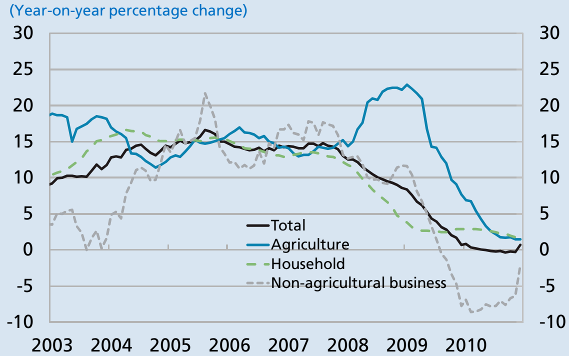
Bank share prices have recovered some lost ground.

Bank Equity Prices
(march 2007=100))



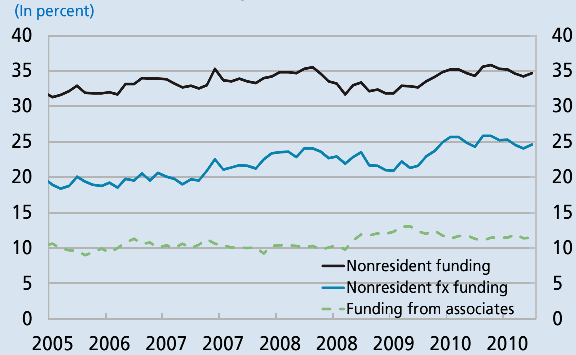
Credit growth fell sharply.

Credit Growth
(Year-on-year percentage change)



Banks' funding from nonresidents remains high.

Banks' Share of Funding From Nonresidents
(In percent)

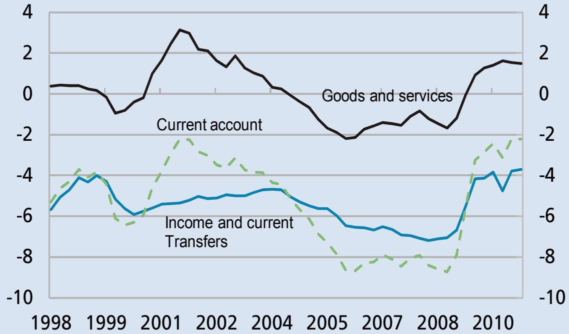


Sources: Reserve Bank of New Zealand; Bankscope; APRA; Haver Analytics database; and IMF staff estimates.

Figure 7 External Developments

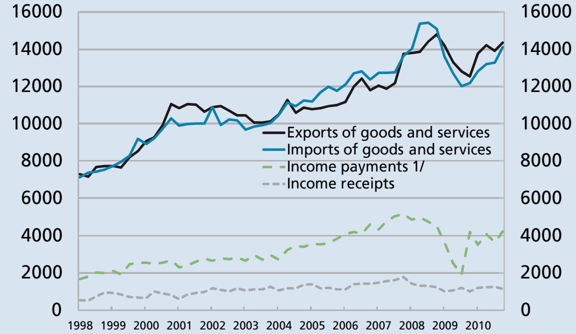
The current account deficit narrowed considerably since 2009…

Current Account
(In percent of GDP, s.a.)



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

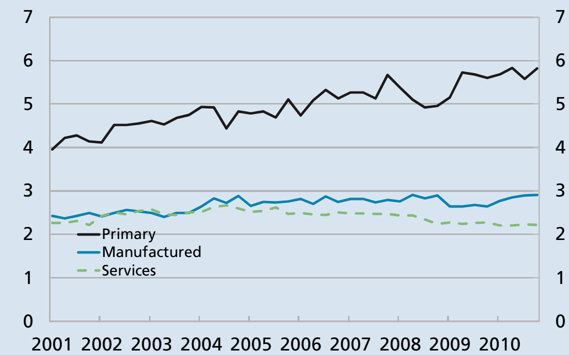
Trade Developments
(In millions of New Zealand dollars, current prices)



1/ Including one-off tax transactions deduction of 2 billion ($NZ) in 2009.

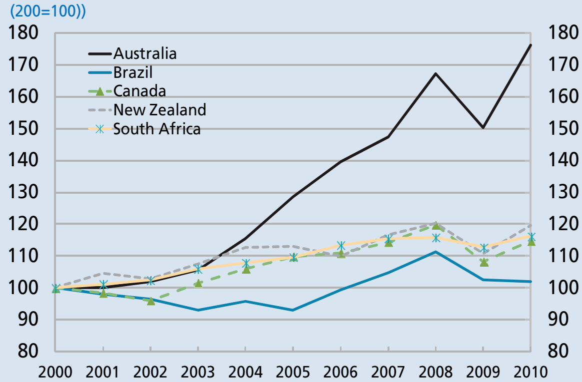
Export volumes held up relatively well….

Export Volumes
(In billions of New Zealand dollars, 1995/96 prices, s.a.)



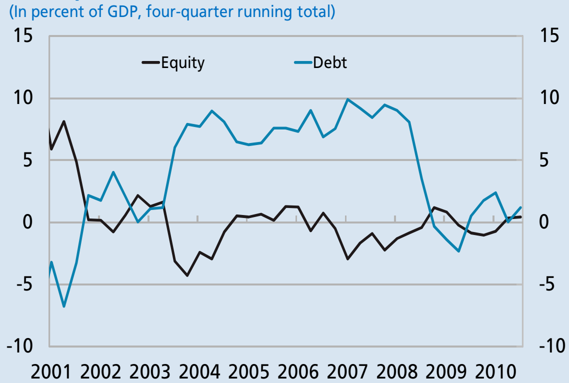
…and terms-of-trade gains boosted revenue.

Terms of Trade, Goods, and Services
(200=100))



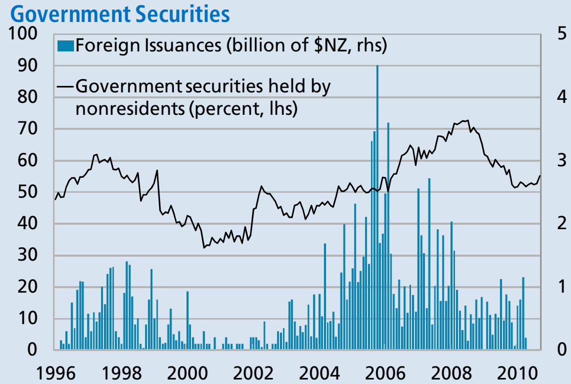
Debt inflows fell sharply while equity inflows were broadly stable…

Net Capital Inflows
(In percent of GDP, four-quarter running total)



…as Uridashi issuance fell.

Issuance of $NZ Securities and Nonresident Holdings of Government Securities

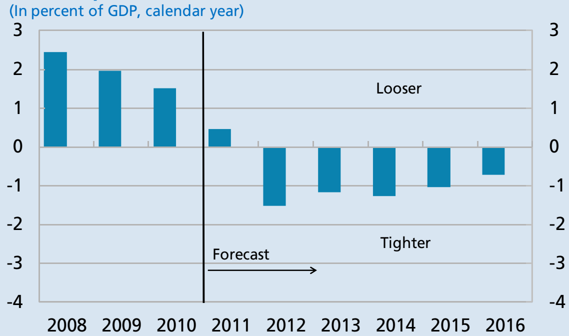


Sources: Reserve Bank of New Zealand; Statistics New Zealand; Haver Analytics database; *World Economic Outlook*; International Financial Statistics database; and IMF staff estimates.

Figure 8 Exit from Fiscal Stimulus

The fiscal impulse dissipates by 2011...

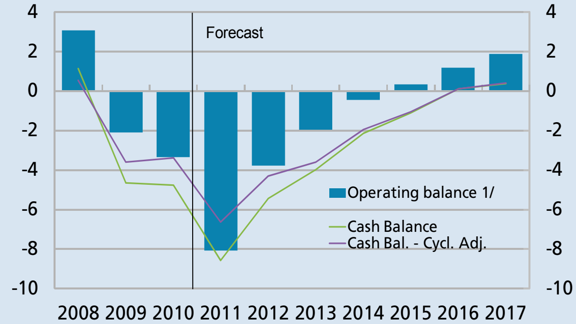
Fiscal Impulse 1/
(In percent of GDP, calendar year)



1/ Based on cyclically adjusted cash balances, including earthquake-related spending.

...as the authorities gradually reduce the deficit...

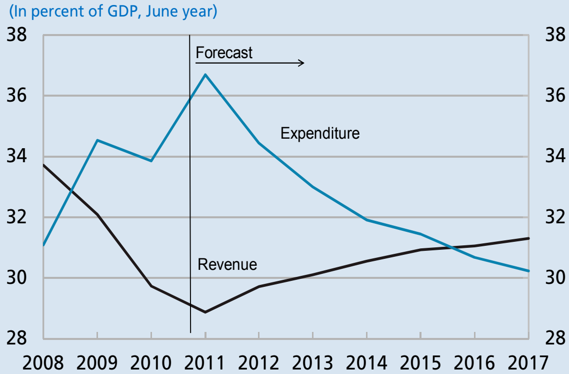
Fiscal Balance
(In percent of GDP, June year)



1/ Before Gains and Losses.

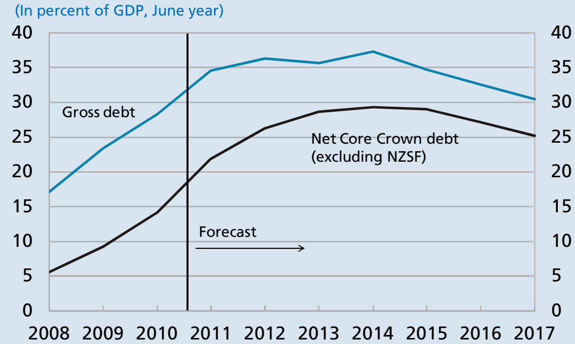
...mainly through control of spending and fiscal drag.

Revenue and Expenditure
(In percent of GDP, June year)



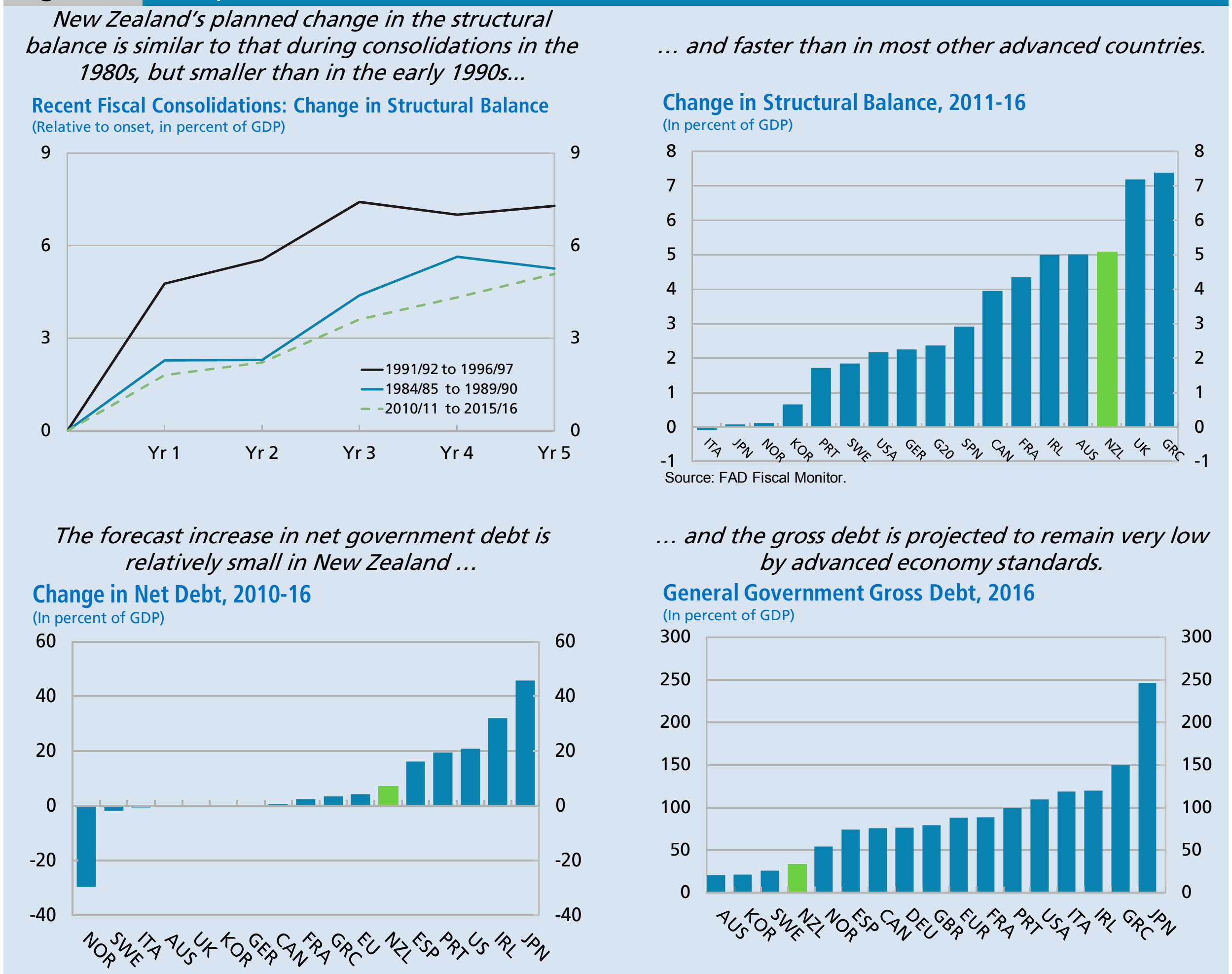
Net debt is projected to rise to almost 30 percent of GDP.

Gross and Net Debt
(In percent of GDP, June year)



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

Figure 9 Comparison of Fiscal Outlook

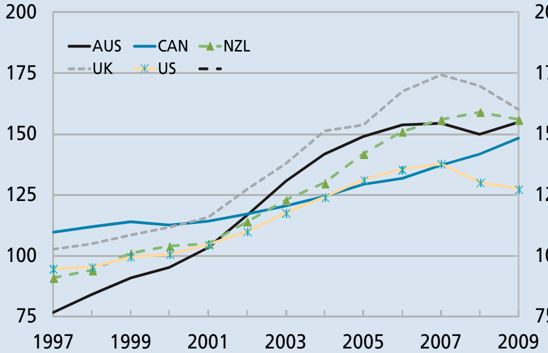


Sources: *World Economic Outlook*, IMF staff estimates.

Figure 10 Household Vulnerabilities

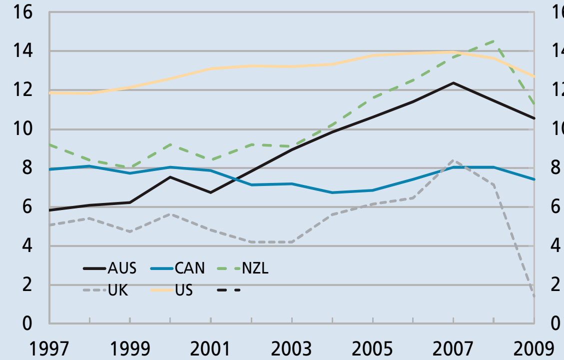
Household debt remains very high …

Household Debt to Disposable Income
(In percent)



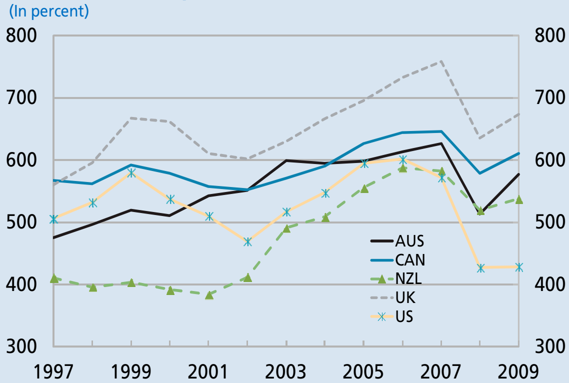
… although debt-servicing costs have declined during the global crisis.

Household Interest Payments to Disposable Income
(In percent)



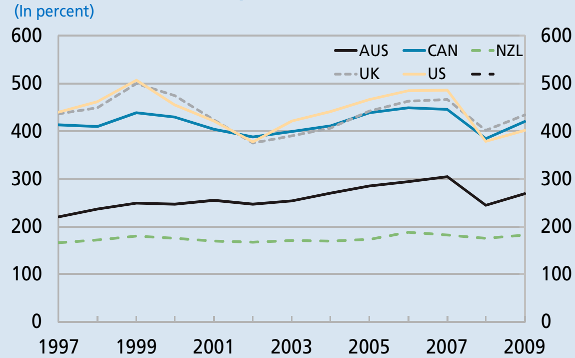
Household net wealth position has improved over the last decade…

Net Wealth to Disposable Income
(In percent)



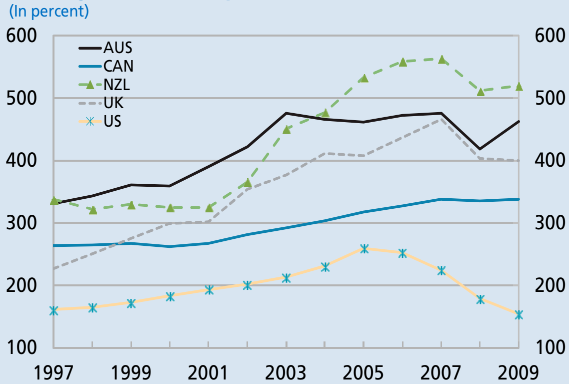
…with financial wealth accounting for a relatively low share…

Financial Wealth to Disposable Income
(In percent)



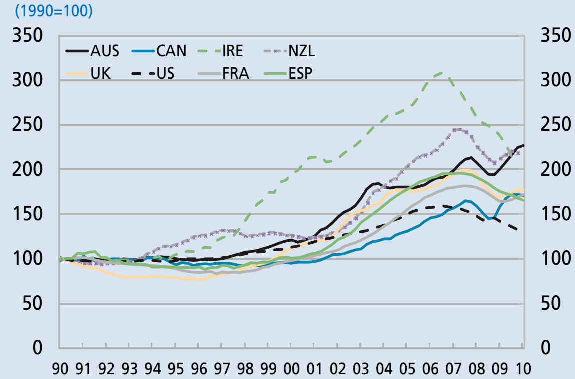
… and housing wealth for a large share.

Housing Wealth to Disposable Income
(In percent)



This leaves New Zealand households vulnerable to a possible unwinding of the large run-up in house prices.

Real House Prices
(1990=100)

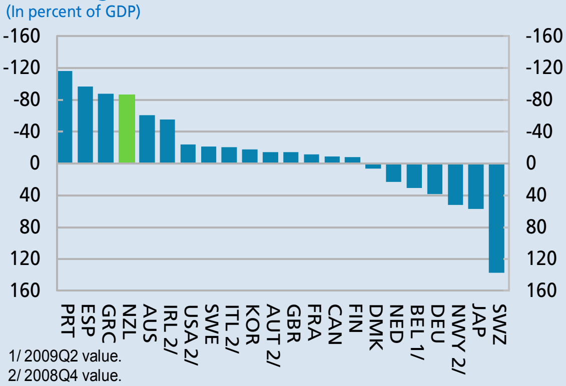


Sources: Reserve Bank of Australia; Reserve Bank of New Zealand; Eurostat; OECD; Haver; and IMF staff calculations.

Figure 11 External Vulnerability

New Zealand's net foreign liabilities are high ...

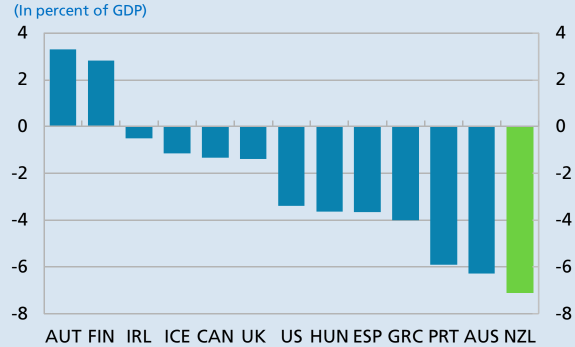
Net Foreign Investment Position, 2010
(In percent of GDP)



1/ 2009Q2 value.
2/ 2008Q4 value.

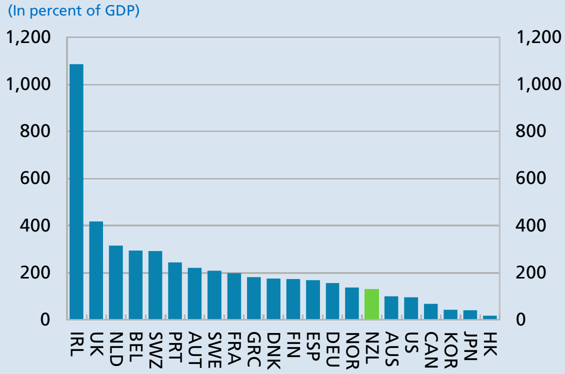
... and its current account deficit is forecast to be larger than most advanced countries ...

Current Account Balance, 2016
(In percent of GDP)



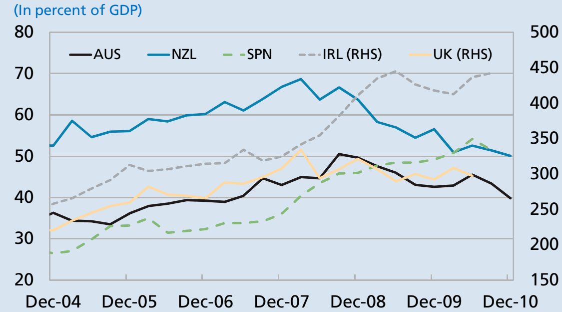
... but gross external debt is lower than in most other advanced countries.

Gross External Debt, 2010
(In percent of GDP)



Despite recent declines, short-term debt remains high at 50 percent of GDP...

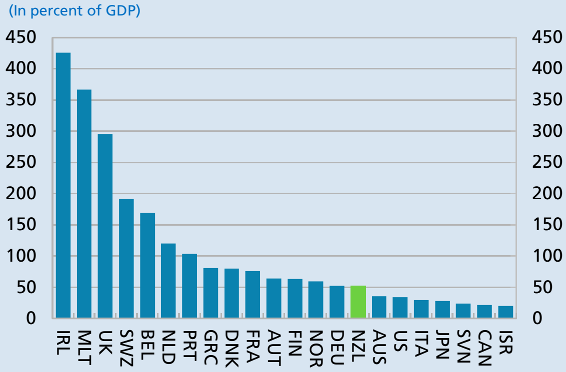
Total Short-Term External Debt 1/
(In percent of GDP)



1/ Short-term debt is on a residual maturity basis for Australia and New Zealand and on an original maturity for other countries.
Sources: ABS, EconData, WB JEDH, and IMF staff estimates.

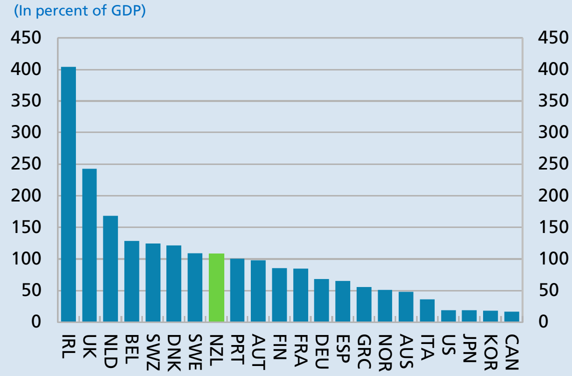
... but is less than in most other advanced countries, as a share of GDP.

Total Short-Term External Debt, 2010
(In percent of GDP)



Bank debt is relatively high among advanced economies.

Bank Gross External Debt, 2010
(In percent of GDP)



Sources: IFS, *World Economic Outlook*, Haver Analytics, EconData, WB-IMF-BIS-OECD Joint External Debt Hub, and IMF staff estimates.

Appendix 1 New Liquidity Rules: Will It Work as a Macroprudential Policy Tool?

The global financial crisis highlighted the need for banks to have adequate liquidity to safeguard financial stability and the Basel Committee proposed new liquidity standards in December 2009. Given New Zealand banks' dependence on short-term offshore funding, the authorities moved ahead of other countries to implement new liquidity rules from April 2010.

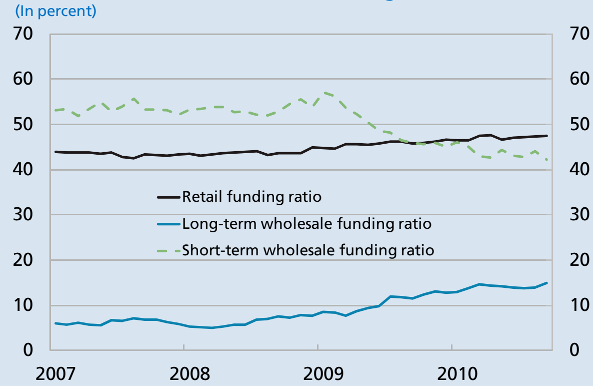
The new quantitative requirements have two components—liquidity mismatch ratios and a core funding ratio (CFR)—which have considerable similarities to the Basel Committee's proposed liquidity standards—the liquidity coverage ratio and net stable funding ratio. The liquidity mismatch ratios compare a bank's likely cash inflows with its likely cash outflows. The CFR aims to ensure that banks hold sufficient retail and longer-dated wholesale funding. The minimum CFR has been set at 65 percent of total loans and advances from April 2010.

Since the onset of the global financial crisis in 2008, New Zealand banks have improved their funding structures. They have significantly increased their retail and long-term wholesale funding so banks' reliance on short-term wholesale funding declined from 53 percent of total funding in 2007 to 42 percent in late 2010. The four major banks' CFR is currently high at above 75 percent.

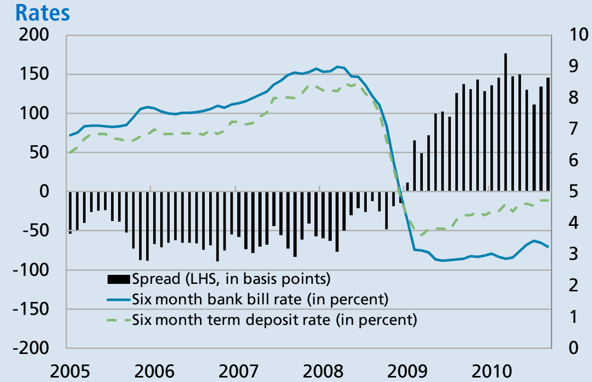
The shift to more stable funding in New Zealand has increased bank funding costs. Both the experience of the crisis and the introduction of the liquidity rules in New Zealand have made banks willing to pay more to attract retail deposits. In addition, a widening in funding spreads since the crisis along with greater use of long-term wholesale funding has seen bank funding costs relative to the policy rate have increased substantially, which is equivalent to tightening of policy rates of about 100–150 basis points.

The impact of New Zealand's new liquidity policy may be stronger during cyclical upturns, when banks tend to resort to short-term offshore funding markets to support credit expansion. To satisfy growing credit demand, banks will need to find funding mostly from customer deposits and longer-term markets. Aside from ensuring that credit growth is funded from more stable sources, this may put some upward pressure on bank funding costs, potentially reducing to some extent the need for the RBNZ to raise the policy rate. Through this channel, the CFR has the potential to play a role in assisting monetary policy.

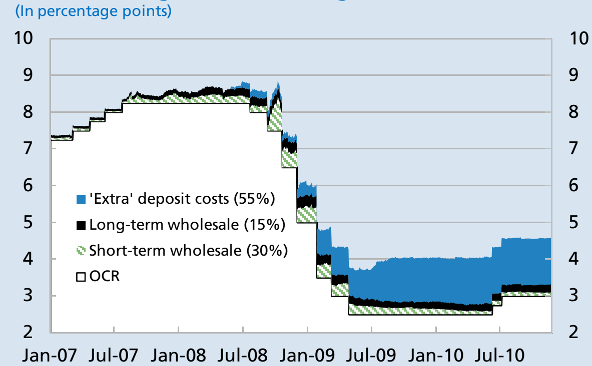
Sources of New Zealand Bank Funding
(In percent)



New Zealand Term Deposit and Wholesale Interest Rates



Indicative Marginal Bank Funding Costs Relative to OCR
(In percentage points)

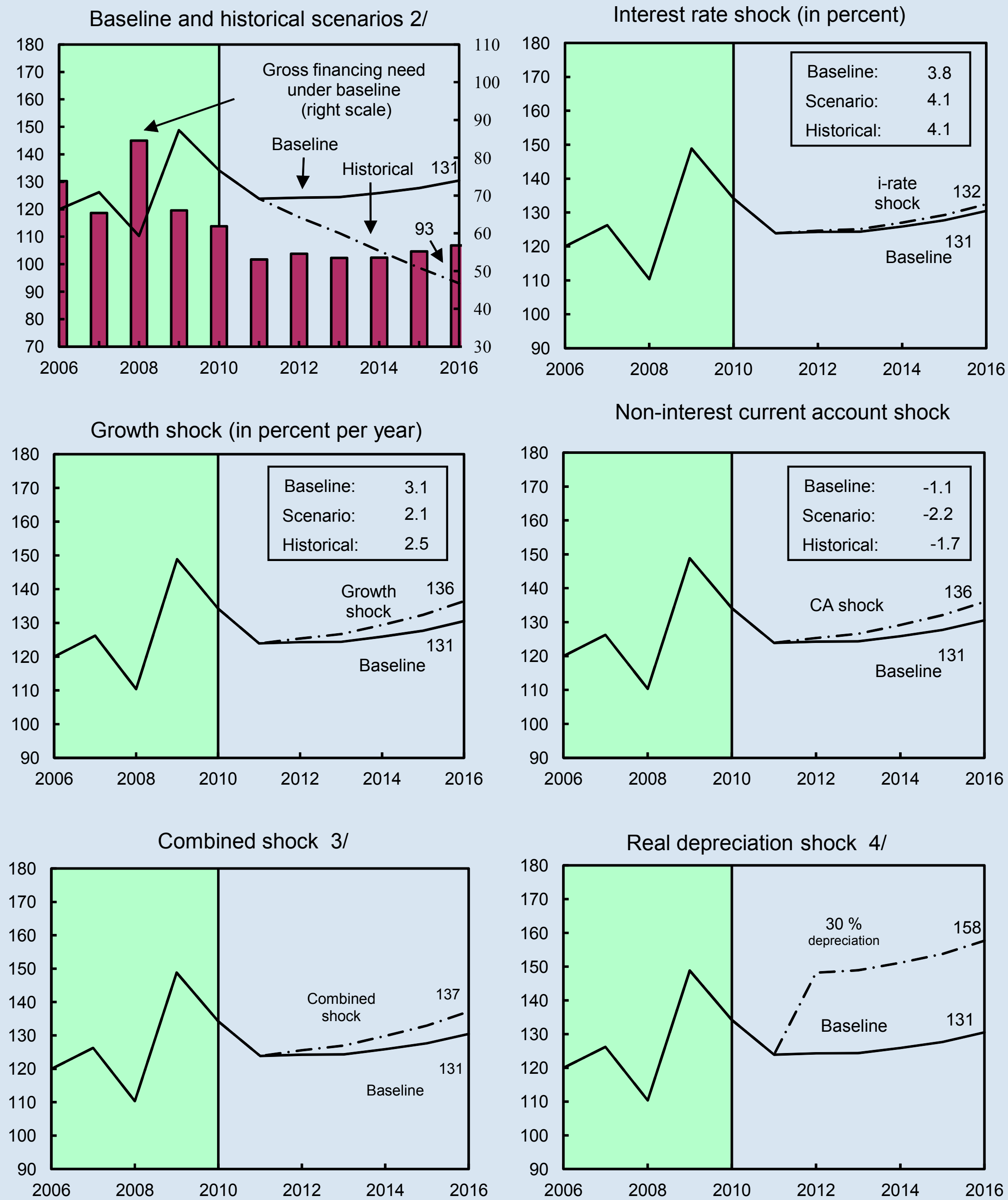


Sources: RBNZ estimates.

Appendix 2 Main Recommendations of the 2010 Article IV Consultation

Fund Recommendations	Policy Actions
Fiscal policy: Staff advised returning the budget to surplus by 2014, two years earlier than planned. Faster fiscal consolidation would take pressure off monetary policy and thereby the exchange rate, and limit the increase in the current account deficit. Staff recommended that concrete measures to control spending be introduced and that any positive revenue surprises be saved.	The 2010/11 budget called for a return to a small budget surplus by 2016, but early this year the Prime Minister announced the intention to return to a small surplus by 2014/15.
Monetary policy: Staff supported the current accommodative monetary policy stance and advised that the RBNZ gradually return to a neutral stance once the recovery is well established.	Following signs of recovery, the RBNZ lifted its policy rate in two steps from a record low of 2.5 percent to 3 percent in mid-2010. The RBNZ then reduced the policy rate to 2.5 percent following the February earthquake.
Financial sector policy: Staff supported the planned introduction of a prudential liquidity policy for banks, including a core funding ratio, and advised that banks' capital and provisioning be strengthened if stress tests suggest the need for additional buffers.	The authorities introduced a core funding ratio for banks in April 2010, which reduced banks' reliance on short-term funding and may help constrain excessive credit growth during upswings. Joint stress-testing with the Australian authorities was conducted in 2010 and the test results suggest banks' resilience to sizable but plausible shocks. The RBNZ recently reviewed capital adequacy associated with agricultural loans, which will require banks to set aside more capital for such lending.

Appendix 3 External Debt Sustainability: Bound Tests[1] (External debt in percent of GDP)



Sources: International Monetary Fund, country desk data, and IMF 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/ The historical scenario assumes that real GDP growth, inflation, current account deficit, and nominal interest rate are equal to 10-year averages from 2010 onward.
3/Permanent 1/4 standard deviation shocks applied to real interest rate, growth rate, and current account balance.
4/ One-time real depreciation of 30 percent occurs in 2012.

NEW ZEALAND

STAFF REPORT FOR THE 2011 ARTICLE IV CONSULTATION—INFORMATIONAL ANNEX

April 22, 2011

Prepared By

The Asia and Pacific Department
(In Consultation with Other Departments)

CONTENTS

ANNEX I. FUND RELATIONS

(As of March 31, 2011)

Membership Status

Joined: August 31, 1961; Article VIII

General Resources Account

	SDR Million	Percent Quota
Quota	894.60	100.00
Fund holdings of currency	662.36	74.04
Reserve position in Fund	232.26	25.96

SDR Department

	SDR Million	Percent Allocation
Net cumulative allocation	853.76	100.00
Holdings	855.06	100.15

Outstanding Purchases and Loans

None

Financial Arrangements

None

Projected Obligations to Fund:

None

Exchange Arrangement

New Zealand accepted the obligations of Article VIII on August 5, 1982. The New Zealand dollar has floated independently since March 1985 and the de facto exchange rate arrangement is free floating. New Zealand maintains an exchange system that is free of restrictions on the making of payments and transfers for current international transactions, other than restrictions notified to the Fund in accordance with Decision No. 144-(52/51).

Article IV Consultation

New Zealand is on the 12-month consultation cycle. The 2010 Article IV consultation discussions were held during March 19–29, 2010; the Executive Board discussed the staff report (IMF Country Report No. 10/144) and concluded the consultation on May 12, 2010.

FSAP Participation and ROSCs

FSAP mission took place during October 30–November 18, 2003. The FSSA and the Detailed Assessments of Observance of IOSCO Objectives and Principles of Securities Regulation and FATF Recommendations for Anti-Money Laundering and Combating the Financing of Terrorism were published under Country Reports No. 04/126, No. 04/417, and No. 05/284, respectively.

Technical Assistance

None

ANNEX II. STATISTICAL ISSUES

Data provision is adequate for surveillance. The authorities are continuing to enhance data quality and to expand the range of data available, including the recent publication by Statistics New Zealand of institutional accounts that improved household and corporate saving data and a project led by the Reserve Bank of New Zealand to publish data consistent with the *Monetary and Financial Statistics Manual 2000.* Given New Zealand's high level of external indebtedness, the publication of up to date institutional sector and flow of funds accounts would be an important addition to the current suite of statistics. It is recommended that the authorities subscribe to the IMF's Special Data Dissemination Standard, which would require a production or services index, and present fiscal data in line with the *Government Finance Statistics Manual 2001*.

Table of Common Indicators Required for Surveillance

As of April 11, 2011

	Date of Latest Observation	Date Received	Frequency of Data[1]	Frequency of Reporting[1]	Frequency of Publication[1]
Exchange Rates	4/11/11	4/11/11	D	D	D
International Reserve Assets and Reserve Liabilities of the Monetary Authorities[2]	2/11	3/30/11	M	M	M
Reserve/Base Money	2/11	3/30/11	M	M	M
Broad Money	2/11	3/30/11	M	M	M
Central Bank Balance Sheet	2/11	3/30/11	M	M	M
Consolidated Balance Sheet of the Banking System	2/11	3/30/11	M	M	M
Interest Rates[3]	4/11/11	4/11/11	D	D	D
Consumer Price Index	Q4 2010	1/20/11	Q	Q	Q
Revenue, Expenditure, Balance and Composition of Financing[4]—General Government[5]	2009/10	12/14/10	A	A	A
Revenue, Expenditure, Balance and Composition of Financing[4]—Central Government	2/10	4/11/11	M	M	M
Stocks of Central Government and Central Government-Guaranteed Debt[6]	2/10	4/4/11	M	M	M
External Current Account Balance	Q4 2010	3/25/11	Q	Q	Q
Exports and Imports of Goods and Services	Q4 2010	3/23/11	Q	Q	Q
GDP/GNP	Q4 2010	3/24/11	Q	Q	Q
Gross External Debt	Q4 2010	3/23/11	Q	Q	Q
International Investment Position[7]	Q4 2010	3/23/11	Q	Q	Q

[1] Daily (D), Weekly (W), Monthly (M), Quarterly (Q), Annually (A), Irregular (I); and Not Available (N/A).

[2] Includes reserve assets pledged or otherwise encumbered as well as net derivative positions.

[3] Both market-based and officially determined, including discount rates, money market rates, rates on treasury bills, notes, and bonds.

[4] Foreign, domestic bank, and domestic nonbank financing.

[5] The general government consists of the central government (including budgetary, extra-budgetary, and social security funds) and state and local governments.

[6] Including currency and maturity composition.

[7] Includes external gross financial asset and liability positions vis-à-vis nonresidents.

Public Information Notice (PIN) No. 11/52
FOR IMMEDIATE RELEASE
May 9, 2011

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

IMF Executive Board Concludes 2011 Article IV Consultation with New Zealand

On May 9, 2011, the Executive Board of the International Monetary Fund (IMF) concluded the Article IV consultation with New Zealand.[1]

Background

New Zealand's recovery has stalled since mid-2010, reflecting soft domestic demand and the adverse impact of two large earthquakes. Domestic demand has remained soft, as cautious households and businesses look to strengthen their balance sheets by slowing debt accumulation amid a weak housing market and an uncertain outlook. Moreover, the earthquakes have caused substantial damage and hurt confidence. Spare capacity has helped contain inflation. The unemployment rate hovered between 6–7 percent over the past year, limiting labor cost growth.

Following signs of recovery, the Reserve Bank of New Zealand (RBNZ) lifted its policy rate from a record low of 2.5 percent to 3 percent in mid-2010. As the recovery softened, the policy rate

[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. An explanation of any qualifiers used in summings up can be found here: http://www.imf.org/external/np/sec/misc/qualifiers.htm.

was kept on hold in late 2010 and early 2011. In mid-March 2011, the RBNZ reduced the policy rate by 50 basis points to limit downside risks as a result of the February earthquake.

Permanent income tax cuts and spending increases that were announced before the global crisis and introduced in late 2008 provided a stimulus, but worsened the fiscal outlook. The fiscal deficit is projected to increase sharply to about 8 percent of GDP in 2010/11, reflecting the impact of the earthquakes and slower-than-expected economic recovery.

Banks remain profitable and capital adequacy has improved. Nonperforming loans have increased to 2 percent of total loans, still low by advanced country standards, and sound regulation and supervision helped maintain stability. Prudential measures and market pressures have led to a reduction in banks' sizable short-term wholesale borrowing.

The current account deficit narrowed to 2¼ percent of GDP in 2010, well below the levels of about 8 percent of GDP in 2005–08. This reflects weak domestic demand, terms of trade gains, and reinsurance inflows, following the first earthquake. Net foreign liabilities have declined since 2008 but remained high at 82 percent of GDP at end-2010. The trade-weighted exchange rate appreciated by about 30 percent from the trough in early 2009 to April 2011, driven by higher commodity prices.

Large uncertainty surrounds the economic outlook, particularly related to the size and timing of reconstruction from the earthquakes. In the near term, the earthquakes will slow activity, with real GDP growth projected at 1 percent in 2011. For 2012, growth is projected to rise to 4 percent, led by reconstruction. Risks are tilted to the downside, including a faltering of emerging Asia's rapidly growing demand for commodities and a possible rise in long-term interest rates.

Executive Board Assessment

Executive Directors expressed sympathy for the loss of life and extensive damage inflicted by two recent earthquakes. Despite the near-term disruption from the earthquakes, New Zealand's increasing ties with fast growing Asian economies and sound macroeconomic framework bode well for its economic prospects. Directors noted that continued policy efforts are needed to achieve sustained growth rates and reduce the vulnerabilities associated with low national saving and large net foreign liabilities.

Directors considered the current accommodative monetary policy stance appropriate. The cut in the policy interest rate in March 2011 has helped limit the negative economic impact of the second earthquake. Directors agreed that the RBNZ will have to balance the need to support the recovery with that of keeping medium-term inflation expectations well anchored. Directors concurred that, in case of a delayed recovery, the RBNZ would have room to cut the policy rate.

Although fiscal policy should remain supportive of growth and reconstruction efforts in the near term, Directors welcomed the authorities' intention to return to fiscal surpluses as soon as possible. Fiscal consolidation would build a buffer against future shocks, relieve pressure on monetary policy and the exchange rate, and contain the rise of the current account deficit. Directors encouraged the authorities to take concrete measures to strengthen the credibility of their fiscal plans. In particular, they saw scope to trim transfers to middle-income households, rationalize capital spending, and improve the efficiency of public service provision.

Directors observed that banks remain profitable and have strengthened their capital buffers, but are exposed to highly indebted households and farmers as well as rollover risks stemming from sizeable short-term offshore borrowing. They welcomed the adoption of a core funding ratio that has contributed to a substantial reduction in banks' short-term offshore borrowing and enhanced stability of the banking system. Directors encouraged the authorities to continue to be vigilant to financial sector risks, including through strengthening bank stress testing, and welcomed the continued collaboration with the Australian authorities. Most Directors encouraged the authorities to consider the merits of gradually raising bank capital to levels well above the Basel III requirements.

Directors noted the vulnerabilities arising from New Zealand's large net foreign liabilities and sizeable short-term external debt. They stressed the importance of policy measures to lift national saving and improve productivity, including through fiscal consolidation, tax and welfare reform, and streamlining regulation. Directors welcomed the RBNZ's continued work on macro-prudential measures.

Directors noted the staff's assessment that the exchange rate is moderately overvalued, while recognizing the uncertainty around those estimates. They concurred that the free-floating exchange rate has served New Zealand well by providing an effective buffer against shocks.

New Zealand: Selected Economic and Financial Indicators, 2007–12

	2007	2008	2009	2010	2011 Proj.	2012 Proj.
Real growth (percent change)						
GDP (production basis)	2.8	-0.2	-2.1	1.5	0.9	4.0
Final domestic demand	4.6	-0.1	-3.5	2.4	1.9	4.5
Inventories 1/	0.3	0.4	-2.4	1.7	0.1	0.0
Exports of goods and services	3.9	-1.7	1.9	2.8	4.1	4.5
Imports of goods and services	8.7	2.6	-14.9	10.0	6.8	6.1
Output gap	1.6	-0.3	-3.2	-3.1	-2.9	-1.3
Headline CPI inflation (percent change)	2.4	4.0	2.1	2.3	4.1	2.7
End of period (percent change)	3.2	3.4	2.0	4.0	2.8	2.5
Unemployment rate (period average, in percent)	3.7	4.2	6.2	6.5	6.7	6.2
Investment and saving (in percent of GDP)						
Investment	23.8	23.1	19.1	19.9	19.6	21.6
National saving 2/	15.6	15.2	16.3	17.7	19.4	17.3
Public finance (in percent of GDP) 3/						
Revenue	33.8	33.7	32.1	29.7	28.9	29.7
Expenditure	31.4	31.1	34.5	33.8	36.7	34.4
Operating balance 4/	3.8	2.1	-3.2	-3.7	-6.8	-4.0
Operating balance before gains and losses	3.4	3.1	-2.1	-3.3	-8.1	-3.8
Net Crown debt excluding $NZ Fund and advances	7.7	5.6	9.2	14.1	21.9	26.3
Money and credit (end of period)						
Resident M3 (percent change) 5/	12.0	9.1	1.9	3.9	6.2	...
Private domestic credit (percent change) 5/	13.4	8.3	1.7	0.5	1.6	...
Interest rates (period average)						
Interest rate (90-day, in percent) 6/	8.3	8.0	3.0	3.2	2.9	…
Government bond yield (10-year, in percent) 6/	6.3	6.1	5.5	5.5	5.6	…
Balance of payments (in percent of GDP)						
Current account	-8.0	-8.7	-2.9	-2.2	-0.2	-4.3
Trade balance (goods)	-1.3	-1.3	1.3	1.8	2.4	2.0
Terms of trade (percent change)	6.0	7.4	-10.1	10.3	4.4	-0.5
Foreign assets and liabilities ($NZ billion)						
Net international investment position	-148.7	-161.0	-160.7	-159.0	-159.1	-167.8
(In percent of GDP)	-83.3	-87.2	-86.5	-81.7	-77.9	-78.2
Official reserves 5/	22.3	19.1	21.6	21.7	24.7	…
Exchange rate (period average)						
U.S. dollar per New Zealand dollar 6/	0.74	0.71	0.64	0.72	0.76	…
Trade-weighted index (June 1979 = 100) 6/	70.9	65.7	60.0	64.6	67.5	…
Nominal effective exchange rate 7/	97.8	91.1	84.1	92.2	92.3	…
Real effective exchange rate 7/	98.7	92.0	86.4	94.2	96.9	…

Sources: Data provided by the New Zealand authorities; and IMF staff estimates and projections.
1/ Contribution in percent of GDP.
2/ Based on national accounts data.
3/ Fiscal years ending June 30.
4/ Equals revenue less expenditure plus net surplus of state-owned enterprises and Crown entities.
5/ Data for 2011 are for March.
6/ Data for 2011 are for January-April.
7/ IMF Information Notice System index (2000 = 100). Data for 2011 are for January–March.

Statement by Christopher Y. Legg, Executive Director for New Zealand; Mario Guiuseppe Di Maio, Senior Advisor; and Willy Chetwin, Advisor
May 9, 2011

Economic policies are focused on achieving higher, more sustainable growth. The Government is committed to returning to fiscal surplus as soon as possible and to restoring the pre-crisis strength of the government's balance sheet. The forthcoming Budget will outline a clear path for achieving this, notwithstanding the very substantial costs associated with recent devastating earthquakes.

Households and businesses remained very cautious through 2010, increasing their saving, resulting in weak growth in household demand and business investment, despite strong gains in the terms of trade. There were signs of a pick-up in growth in 2011 just prior to the second earthquake that hit Christchurch on 22 February 2011. The earthquakes caused widespread damage currently estimated at around NZD15 billion (8 percent of GDP; 2.5 per cent of the capital stock). The impact on the national balance sheet will be much more muted due to foreign reinsurance flows of around NZD10 billion. As a result, the economy and financial system has remained resilient.

Business and consumer confidence declined sharply following the earthquake, and in Canterbury consumer spending and tourism activity were badly affected. Confidence has since rebounded from post-quake lows and the disruption of economic activity is confined to the Canterbury region. At this stage, the disruption to the economy is expected to ease progressively over the next six months. Growth is expected to accelerate to more than 4 percent in 2012 as rebuilding takes place against the backdrop of strong commodity prices and robust trading-partner growth.

Monetary policy was eased in March as an insurance measure to limit the adverse impact of the earthquakes. The additional strengthening in activity expected from mid-2010, when monetary policy was tightened, failed to materialize. The negative output gap remains sizable and, outside of the direct effects of higher consumption taxes and increased oil prices, inflation outcomes are comfortably inside the 1 to 3 percent target range. Inflation expectations are similarly relatively well anchored. While current monetary settings are likely to remain appropriate for some time, the Reserve Bank expects to raise rates as the slack in the economy diminishes. Effective interest rates can be increased more quickly than in the past—with the average time to repricing of mortgage debt falling to around 7 months from a high of 20 months in the middle of 2007.

New Zealand's relative resilience to the shocks of the past few years highlights the high quality of its macroeconomic institutions. Nevertheless, the authorities recognize that high levels of external and private domestic debt leave New Zealand exposed to adverse changes in financial markets. The domestic demand that gave rise to those debt levels may also be increasing the cost of capital, which in turn probably inhibits desirable capital deepening.

Policies are being adapted to address these imbalances and manage the associated risks.

Fiscal consolidation will be brought forward. The Government has indicated it will reduce its future spending plans, meeting spending in priority areas by making savings elsewhere. Concrete measures will be announced in the 2011 Budget on 19 May. Despite the significant estimated NZD8.5 billion fiscal cost of earthquake-related rebuilding, the adjustment will see net debt peak only slightly above the figure of 28 percent of GDP forecast prior to the earthquakes. Including the financial assets of the New Zealand Superannuation Fund, the level of net debt is even lower at around 20 percent of GDP, making New Zealand's government balance sheet one of the strongest among advanced economies.

- **The fiscal adjustment plan will support rebalancing, rebuild fiscal buffers, and lift national saving.** The Budget will build on the tax changes announced in 2010 that increased consumption taxes and reduced taxes on investment and savings. As the economy recovers, a tighter fiscal stance will take the pressure off domestic resources, allow monetary policy to remain supportive for longer, and take some pressure off an exchange rate that appears overvalued. Eliminating the structural deficit and returning to surplus implies a structural improvement in the fiscal balance of around 5 percent of GDP. This will help raise national saving over the medium-term, perhaps by as much as 3¾ percent of GDP according to staff estimates.

- **Ministers are considering further changes that would lift national savings.** While there are theoretical benefits of fully indexing the tax system to adjust for inflation, the practical challenges are material – as suggested by the fact that no OECD country has such a system. There would also be a fiscal cost that would undermine fiscal consolidation objectives. A further increase in GST rates is not being considered given the rate was last increased by 2.5 percent only in October 2010. It might also prove undesirable if it reduces tax collection efficiency and support for the current broad GST tax base.

- **A further strengthening of financial stability is underway.** The cautious approach to banking sector regulation served New Zealand well through the crisis. Capital is already at the levels envisaged under Basel III and the authorities expect to adopt many of the Basel III improvements, tailored to New Zealand circumstances, ahead of the formal timetable. Domestic experience suggests that some proposals, for example a leverage ratio, may be counter-productive if they undermine a risk-based approach. Early introduction of liquidity regulations in New Zealand has led to a material lengthening of the maturity of bank funding. The appropriate future level of the Core Funding Ratio will depend on experience gained in New Zealand and the application of the Net Stable Funding Ratio to Australian banks.
- **A strong banking system is critical to intermediating significant foreign financing.** One approach, suggested by Fund staff, is to build additional capital buffers over and above international standards. The strategy to date in New Zealand has been to take a conservative approach to the quality of capital and risk weightings that reflect a genuine through-the-cycle philosophy towards the calibration of bank capital. For example, minimum loss-given default rates for mortgages are almost twice those of some comparator countries. Similarly, the Reserve Bank is currently finalizing its requirements for prudent minimum loss-given default rates for agriculture and the removal of the Basel II concessional SME treatment of risk weighting for agricultural loans.

In conclusion, the New Zealand economy has weathered a series of large shocks reasonably well. Strong regional growth, a rising terms of trade, sizable initial fiscal buffers, the sound banking system, the floating exchange rate, and a relatively flexible economy underpinned this resilience. However, the sustainable growth rate, currently estimated to be around 2 to 2½ percent, is lower than desired. High levels of private debt and domestic asset prices continue to pose questions about the evolution of the economy over the next few years. While the path of the needed macroeconomic adjustment is clear, a higher level of sustainable growth will depend on a wide range of better microeconomic policies. No "silver bullet" has been identified; rather progress across a broad front is required. In some aspects, such as a tax system that supports savings and investment, there has been progress. However, further improvements are needed in the regulatory environment and infrastructure to help deepen capital investment; create a more efficient public sector, including consideration of reducing state holdings in selected state-owned enterprises; and provide a better environment for investment in human capital and innovation.