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New Zealand: 2000 Article IV Consultation—Staff Report; Statement by Staff Representative; Public Information Notice Following Consultation; Statement by New Zealand's Representatives at the IMF

As required under Article IV of its Articles of Agreement, the International Monetary Fund conducts periodic consultations with its member countries. In the context of the 2000 Article IV consultation with New Zealand, the following documents have been released and are included in this package:

- the staff report for the 2000 Article IV consultation, prepared by a staff team of the IMF, following discussions that ended on **July 25, 2000,** 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 September 22, 2000.** 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 staff statement released the day of the Board discussion **of October 13, 2000**, updating information on recent economic developments.

- the Public Information Notice (PIN), which summarizes the **views of the Executive Board as expressed during the October 13, 2000, Executive Board discussion** of the staff report that concluded the Article IV consultation.

- a statement by the authorities of New Zealand.

Further background documentation prepared by IMF staff for the consultation will be published separately at a later date. The policy of publication of Article IV staff reports and PINS allows for the deletion of market-sensitive information.

The Article IV staff report is published—both in hard copy and on the IMF's website (http://www.imf.org)—as part of a pilot project.

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INTERNATIONAL MONETARY FUND

NEW ZEALAND

Staff Report for the 2000 Article IV Consultation

Prepared by Asia and Pacific Department
(In consultation with other departments)

Approved by Mario I. Blejer and Leslie Lipschitz

September 22, 2000

- The 2000 Article IV consultation discussions were held in Auckland and Wellington during July 17–25, 2000.
- The mission team consisted of Ms. Kochhar (head), Messrs. Gruenwald, Wade, and Cardarelli (all APD). Mr. Woolford (Advisor to the Executive Director) attended the meetings and Mr. Blejer (APD) joined the mission for the last three days of discussions.
- The mission met with Minister of Finance Michael Cullen, Treasury Secretary Alan Bollard, and Reserve Bank Governor Don Brash; other senior government officials; and representatives of the private sector and academia.
- New Zealand has accepted the obligations of Article VIII, Sections 2, 3 and 4 and maintains an exchange system that is free of restrictions on the making of payments and transfers for current international transactions. New Zealand has accepted the Fourth Amendment of the Articles of Agreement.
- New Zealand publishes an array of high–quality statistics. Substantial improvements in coverage, frequency and timeliness are underway in the financial accounts of the balance of payments.
- This report was drafted by Ms. Kochhar with substantial contributions from Messrs. Gruenwald, Wade and Cardarelli.

Contents

Page

I. EXECUTIVE SUMMARY

1. **The New Zealand economy came through the adverse shocks of the past 2-3 years smoothly, but is facing greater uncertainty in the period ahead.** Real GDP expanded by 3½ percent in 1999; and inflation remained low in 1999 and thus far in 2000, despite a tightening in input markets and a sharp depreciation of the currency. The current account deficit widened to 7 percent of GDP for the year through the first quarter of 2000; since then, however, export growth has been strong, largely reflecting the boost to competitiveness from the fall in the exchange rate and the improvement in farm output.

2. **Focusing on the fact that the payoff to the reforms of the past 15 years in terms of per capita growth has been disappointing, the left centrist government that took office late last year has signaled a shift in direction in several aspects of structural policies.** Broadly speaking, the shift is in the direction of tighter regulation of labor and product markets, a larger role for the government in industrial policies and increased emphasis on "closing the gaps" between the different segments of the population. The recent sharp weakening in business and consumer confidence, and the steep fall in the New Zealand dollar—attributed to the large external imbalances, relatively weak growth prospects as well as the direction of some of the policy changes being implemented in New Zealand—have clouded the economic outlook.

3. **The mission supported the authorities' management of macroeconomic policies to date.** Looking ahead, in light of the mixed picture for the outlook in different sectors of the economy, further tightening of monetary policy should be gradual and continually reassessed. The projected fiscal stance in 2000/01 and in the medium term is broadly appropriate, but the risks are predominantly on the downside, because of the potential for expenditure overruns and lower–than–forecast revenues.

4. **On growth, saving, and investment,** the discussions focused on areas where additional actions are necessary to boost saving and competitiveness, and areas where there is a risk of weakening the gains from earlier reforms. Specifically, the mission recommended more rapid deregulation of agricultural producer boards, and more emphasis on workforce training and R&D spending. The mission also suggested caution in the implementation of recent changes to the labor legislation which are intended to give greater power to the unions, and those under consideration to tighten regulations in certain sectors as these could undermine labor and product market flexibility.

5. **The evidence on external vulnerability indicators** and the experience of adjustment to shocks over the recent past supports the staff's earlier assessment that New Zealand is well placed to absorb shocks without undue economic and financial distress. However, New Zealand remains vulnerable to sharp adverse shifts in market sentiment.

II. INTRODUCTION

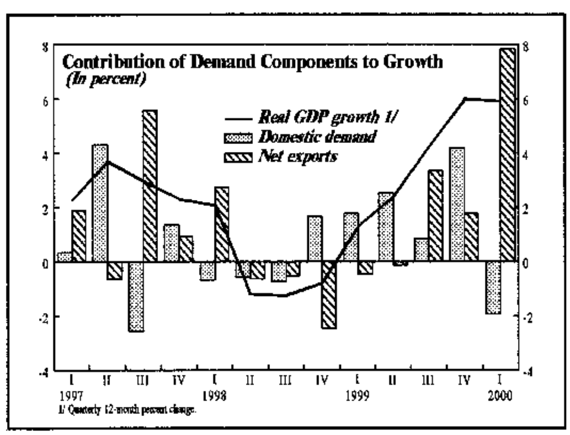
6. **The wide-ranging macroeconomic and structural reforms undertaken over the past 15 years have led to a marked improvement in economic management and in a number of aspects of economic performance**—fiscal consolidation and a sharp reduction in public debt, low and stable inflation, and an increase in output and employment growth. Two themes underlying the entire set of reforms—which began in the mid-1980s and continued through the mid-1990s—were the establishment of a legislative and institutional framework to improve public sector management, and a decisive move away from the pervasive controls and interventions that had characterized virtually all aspects of the economy. The key pillars were reforms of the monetary and fiscal policy frameworks through the Reserve Bank Act (1989), the Public Finance Act (1989), and the Fiscal Responsibility Act (1994), and the reform of labor markets through the Employment Contracts Act (1991).

7. **Notwithstanding these improvements, a central question in recent years is why the reforms have not succeeded in generating growth rates sufficient to close more rapidly the gap with other advanced economies (Box 1).** Closely related is the issue of the vulnerabilities associated with the sustained large external imbalances generated by the sizable current account deficit which has averaged over 5 percent of GDP since the mid-1970s. Key underlying structural weaknesses are the relatively inefficient investment of the past—which has resulted in relatively slow progress in the diversification of production and exports—and the low savings rate. In part, this reflects the fact that progress in deregulating the agricultural sector and reforming the social transfer system—superannuation, unemployment and other welfare benefits—has been relatively slow, leaving distortions to incentives to work, save, and invest.

8. **Questioning the effectiveness of the reforms in light of this disappointing growth performance, the Labor-Alliance coalition government that took office in November 1999 has signaled a shift in some policies and has launched reviews of others.** Broadly speaking, the shift is in the direction of tightening regulation of labor and product markets, and increasing the government's role in economic, social and industrial policies, in part, to "close the gaps" between various segments of the population (Box 2).

III. RECENT ECONOMIC AND POLICY DEVELOPMENTS AND SHORT-TERM OUTLOOK

9. **Economic activity recovered strongly in late 1999 and remained healthy through the first quarter of 2000.** The sharp acceleration in growth in the second half of 1999—at an annualized rate of 9 percent—resulted in an expansion in real GDP in 1999 of 3½ percent. A rebound in the agricultural sector following two



Box 1. New Zealand's Growth in Comparative Perspective 1/

New Zealand's macroeconomic, structural and institutional reforms since the mid–1980s were wide-ranging and, in many ways, are considered internationally unique. They opened the economy up to competitive pressure and market forces both domestically and internationally, and substantially improved the credibility of economic management. In recent years, an issue that has preoccupied policy makers and observers alike is why New Zealand's growth rate, albeit increasing in recent years, has remained consistently below the OECD average since the reforms began.

What are the facts about New Zealand's growth performance over time and across a small group of comparator countries? The table below starts in 1973, when the New Zealand economy experienced a sharp structural break at the time the U.K. joined the European Community. This event resulted in the loss of preferential access by New Zealand to its major export market. Also shown is the OECD average growth performance and that of a group of economies that are either structurally similar or that have performed very strongly in recent years. The year 1985 is treated as the first year of the reform period.

Annual Average Growth in Real GDP

	1973-99	1973-84	1985-99	1985-89	1990-94	1995-99
New Zealand	1.9	2.0	1.8	0.9	2.0	2.5
Australia	3.5	3.1	3.7	4.4	2.4	4.4
Canada	3.1	3.5	2.8	3.9	1.3	3.3
Finland	2.8	3.1	2.5	4.1	-1.1	4.5
Ireland	4.5	2.8	5.9	4.2	4.3	9.3
OECD	*2.9*	*3.0*	*2.9*	*3.6*	*2.1*	*2.9*

Source: WEO database

In light of the variability of New Zealand's growth rates, period averages tend to be a better representation of underlying trends in the economy. Several facts are noteworthy in the table above.

1. There is little difference in New Zealand's average annual growth rate between 1973-84 ("pre-reform") and 1985-99 ("post-reform").

2. A finer division of the "reform" period into five-year subperiods reveals that, after a period of low growth in the late 1980s, real GDP growth has been increasing. This is consistent with the findings of studies of the pattern of growth following structural adjustment, namely that there could be an initial period of adjustment costs during which output growth could slow.

3. A comparison with OECD averages during the 1973-84 and 1985-99 periods suggests that the gap with the OECD average growth rate has not changed in the two subperiods.

4. However, the comparative experience in the "post" reform period is more complex—New Zealand lost considerable ground vis-à-vis the OECD in the late 1980s immediately after the reforms were launched, but, in the 1990s, the difference in growth rates has narrowed markedly.

Recent evidence on TFP growth in New Zealand suggests that there has been a pick-up in productivity growth since the early 1990s.2/ Conway and Hunt (1998) use data through 1996 to show that the growth rate of trend TFP does exhibit an upward shift from end–1991. Likewise, Diewert and Lawrence (1999) find that trend TFP growth was about zero during 1984–93, but picked up to 1.5 percent during 1993–98. During the more cyclically–balanced period of the 1990s as a whole, TFP growth averaged 1.1 percent—about the median for industrial countries. However, Diewert and Lawrence are unable to find conclusive evidence to permit disentangling cyclical from structural reasons for the upward shift in TFP growth.

Regardless of how the stylized facts are interpreted, the reasons for the disappointing growth payoff to the reforms remain a live question. Examining cross-country differences in structural aspects of the economy reveals that the widest gaps are in the development of human resources in New Zealand, broadly defined to include technical and management skills.

1/ Further details can be found in the forthcoming Selected Issues paper.
2/ Conway, Paul and Ben Hunt, "Productivity Growth in New Zealand: Economic Reform and the Convergence Hypothesis," Reserve Bank of New Zealand Working Paper 98/2, June 1998, and Diewert, Erwin and Denis Lawrence "Measuring New Zealand's Productivity," New Zealand Treasury Working Paper 99/5, March 1999.

Box 2. New Zealand—Fiscal and Structural Initiatives Taken by the New Government

The following fiscal and structural policy changes have either been implemented or proposed by the Labour–Alliance government that came into power in November 1999.

Fiscal Policy

- Income tax cuts announced by the previous Government (increases in income thresholds) were cancelled, and the top marginal income tax rate was increased from 33 percent to 39 percent for incomes over $NZ 60,000 effective April 1, 2000.
- The fringe benefit tax was raised from 49 percent to 64 percent.
- The excise tax on tobacco was increased with effect from May 10, 2000.
- The revenues from the changes in tax policy will be used to fund various spending initiatives, including an increase in Superannuation payments (to ensure a minimum 65 percent pension benefit rate), and an increase in the income threshold to qualify for interest–free student loans.
- The Government will use a part of projected structural surpluses to partially pre–fund future superannuation costs.

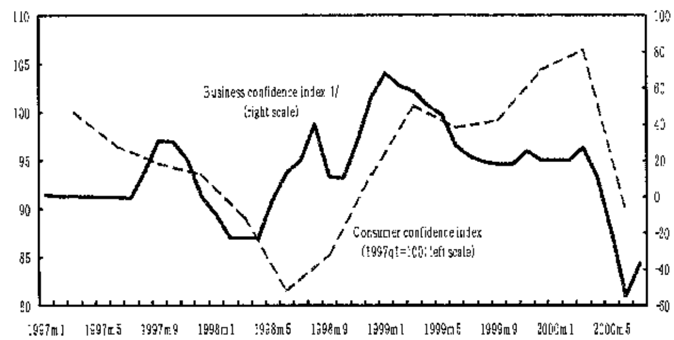
Structural Policy

- In August 2000, a new Employment Relations Act (ERA) was passed to replace the Employment Contracts Act (ECA) of 1991. The ERA seeks to rebalance employee and employer power in industrial relations by strengthening the role of labor unions. The draft Bill met with considerable opposition from the business community and was revised in some areas, but the basic thrust remained intact when it was passed. The law will be effective from October 2000.
- In March 2000, the adult minimum wage was raised from $NZ 7/hour to $NZ 7.55/hour. At the same time, the age threshold for eligibility for the adult minimum wage was lowered from 20 to 18. The government is currently considering raising the ratio of minimum wages that would apply to 16–17 year old youth from the current level of 60 percent of the adult minimum wage to somewhere between 60 percent and 100 percent; and to introduce a minimum wage for those on training contracts at a rate between 60 and 100 percent of the adult minimum wage.
- In April 2000, provisions for a competitive workplace accident insurance market, which had been introduced only in mid–1999, were reversed and the state–run company (ACC) was reinstated as the monopoly provider of such insurance.
- In April 2000, the Government cancelled the July 2000 tariff reductions planned by the previous government and announced that unilateral tariff reductions would be frozen until at least July 2005. The 1998 Tariff (Zero Duty) Amendment Act, which included the abolition of all tariffs by 2006—four years earlier than scheduled by the APEC Borgor Declaration of 1994—was abolished. Previously agreed tariff reductions in the context of bilateral or multilateral agreements will go ahead.
- In April 2000, the Commerce Act, which regulates the process of competition in New Zealand, was amended to: redefine the threshold for a ruling of anticompetitive behavior from the current "dominant position" criterion to a "having high market power" criterion; redefine commensurately the threshold for mergers and acquisitions; and strengthen the deterrents to anti–competitive behavior.
- The government has initiated reviews of the regulatory regimes for the telecommunications and electricity sectors to ensure that they are compatible with greater competition. Draft recommendations from both reviews are currently under consideration. In the telecommunications sector, the recommendations include the establishment of an industry–specific regulatory body with fairly wide–ranging powers.
- The government has announced a new, more activist industrial policy through the establishment of a new Crown entity—Industry New Zealand—which will target regional development, small and medium–sized enterprises, and provide assistance to exporters through export guarantees and credit financing.

successive droughts, and robust performance in sectors benefiting from strong external demand aided the recovery. The recovery was supported by accommodative macroeconomic policies and the depreciated exchange rate. The momentum of growth slowed to a more sustainable pace in the first quarter of 2000, while the composition shifted toward net exports, as domestic demand, which had led the recovery, slowed sharply (Figure 1).

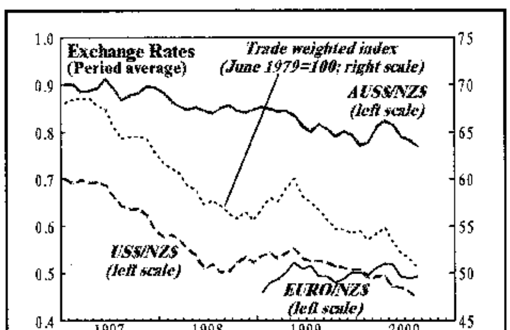
10. **However, there are signs that the momentum of growth weakened sharply in the second and third quarters of 2000**. Since April 2000, there has been a sharp fall in business and consumer confidence. Some observers attribute the fall in confidence to uncertainty about the direction of policies and the feeling that the economic environment is likely to become less business friendly, and others point to the increases in interest rates since November last year. The weakening of confidence has thus far been reflected in a fall in profit expectations, investment intentions and labor force participation rates. There are also indications of a softening in activity such as declining building consents, continued weak credit growth, and a moderation in retail sales, GST receipts, and capacity utilization rates.

New Zealand: Business and Consumer Confidence



Source: National Bank of New Zealand, *Business Outlook* and Westpac Trust.
1/ Percentage expecting improvement in general business conditions minus percentage expecting deterioration.

11. **After a short–lived strengthening in early 1999, the real effective exchange rate has weakened considerably since early 2000 and is now at an all–time low**. After depreciating by 18½ percent in real effective terms between mid–1997 and end–1998, the $NZ appreciated by some 7 percent through April 1999. Since then, however, the dollar has weakened steadily to a historical low at present, and recently, at a somewhat faster pace than the Australian dollar. The weakness of the dollar has been attributed to the large current account deficits, a reduction in the demand for $NZ denominated assets with the narrowing of interest rate differentials, a weakening of investor sentiment as a result of

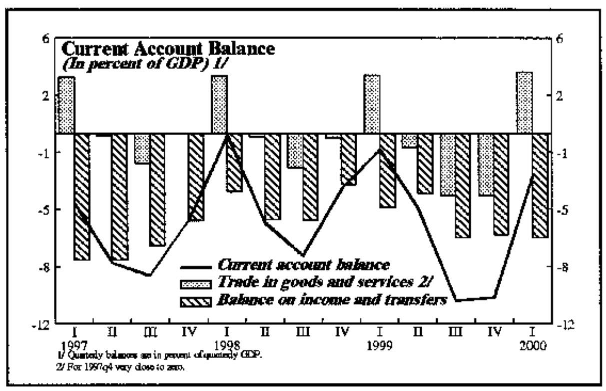


Sources: Bloomberg, Reserve Bank of New Zealand WEB, WEFA.

the direction of some of the new government's policies, [1] and the perception that New Zealand is relatively less well positioned to benefit from the productivity gains that have come to be associated with "new economy."[2]

12. **Inflation remained low during 1999 and thus far in 2000 despite a tightening in the labor market and in capacity utilization rates, but there are signs of pressures in the pipeline**. Through the first quarter of 2000, employment grew strongly—full time employment rose 3⅓ percent (y/y) in the first quarter of 2000—and the unemployment rate declined rapidly from a peak of 7¾ percent at end 1998 to 6⅓ percent at present—the lowest level since 1996 (Figure 2 and Table 1). Capacity utilization rates rose sharply and the output gap is estimated to have been eliminated by early 2000 (Figure 1). Wage growth has nevertheless been moderate and the target measure for inflation remained between 1 and 1¼ percent (y/y) during most of 1999, before moving to 1.8 percent in March 2000 and further to 2 percent in June. Much of the increase in the second quarter reflected higher fuel prices and tobacco and alcohol excises, suggesting that underlying inflation remains subdued. However, forward looking indicators such as inflation expectations, producer prices, and pricing intentions suggest upstream pressure on the CPI from sharply higher oil prices and a broadening of the pass–through of the exchange rate depreciation.

13. **The current account deficit widened to near 6¾ percent of GDP in 1999 from about 4¼ percent in 1998 but is likely to narrow in 2000**. The widening deficit was mainly due to a worsening of the trade balance. This resulted from rapid import growth in 1999, coupled with subdued export growth as the agricultural sector recovered from the droughts. Since

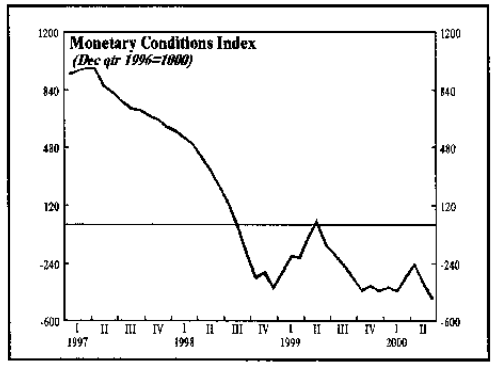


[1] The weakening in foreign investor sentiment in New Zealand has not been evidenced in interest rate spreads; rather it has taken the form of a decline in the proportion of government securities held by or on behalf of nonresidents from an average of over 50 percent in 1998 and early 1999 to around 32 percent in July 2000.

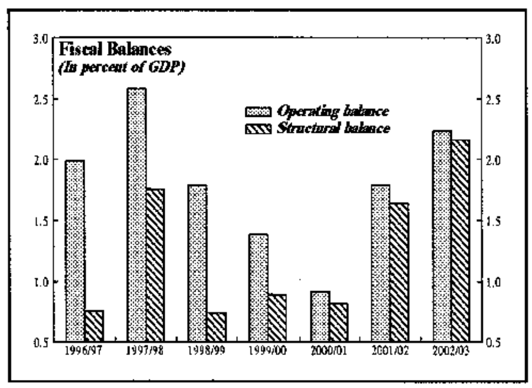
[2] There is little agreement amongst analysts about robust measures of the "new economy." On the one hand, measures such as labor productivity growth—which has picked up in the 1990s—and ICT expenditures (including IT hardware and software, and telecommunication services) as a share of GDP—which is considerably higher than the OECD average—would suggest some evidence of the "new economy." On the other hand, New Zealand's relatively low ranking on technical skills and other dimensions of technological and innovative capabilities would lead to doubts about its readiness to take advantage of the new economy.

early 2000, however, export growth has been strong—at 20 percent (y/y) in value terms in the three months through July 2000, largely reflecting the boost to competitiveness from the fall in the real effective exchange rate this year and the improvement in agricultural output. The deficit on the income account increased to around 6 percent of GDP, which, in turn, reflects New Zealand's high external indebtedness—net foreign liabilities stand at around 100 percent of GDP (Figure 3 and Table 2).

14. **Despite an increase in interest rates since November 1999, monetary conditions remain relatively easy due to the fall in the exchange rate**. The sharp fall in the trade–weighted exchange rate in 1997–98 and the decline in interest rates (90–day rates fell from 9 percent to 4½ percent during 1998) at the onset of the recession in early 1998 resulted in a substantial easing of monetary conditions—the monetary conditions index (MCI) fell from a level of 1000 in early 1997 to about –450 at end–1998.[3] In response to the unexpectedly rapid growth in the second half of 1999 and the resultant narrowing of the output gap, the RBNZ raised the OCR five times from 4½ percent to 6½ percent between November 1999 and May 2000. Nevertheless, monetary conditions remain relatively easy in view of the weakening exchange rate.



15. **The fiscal stance in 1999/2000 (July–June) was broadly unchanged from that of the previous year**. The operating surplus in 1999/2000 was 1.4 percent of GDP (compared with the budget target of a zero balance, and an estimate of 0.4 percent of GDP at mid–year). While this represents a decline of about ½ percent of GDP relative to the outturn in 1998/99, adjusted for valuation changes, the fiscal stance was broadly unchanged (Table 3).[4] Apart from favorable valuation changes, the larger–than–



[3] The MCI provides a summary measure of the monetary stance, capturing the influence of both interest rates and the exchange rate on economic activity 6-18 months ahead, with the weight assigned to changes in the former being twice that given to changes in the latter. An increase (decrease) in the MCI indicates tightening (easing) of monetary conditions.

[4] The operating surplus in 1998/99 was inflated by the net effects of the windfall profits from the sale of Contact Energy and valuation effects of the unfunded liabilities of the Accident Compensation Corporation (ACC). In 1999/2000, about 0.3 percent of GDP of the surplus is attributable to favorable valuation changes in the closed Government Superannuation Fund and the ACC.

budgeted surplus in 1999/2000 is a result of: higher revenues (reflecting the more rapid economic recovery and the part–year effect of the increase in income and excise taxes), which were not fully offset by increases in expenditure (arising from the part–year effect of the increase in the superannuation benefit rate from 60 percent to 65 percent of the average wage).

16. **The 2000/01 budget targets an operating surplus of 0.9 percent of GDP—consistent with a broadly unchanged fiscal policy stance—and increasing structural surpluses in the medium term.** Overall, both revenue and expenditure are projected to remain virtually unchanged in terms of GDP from last year in line with this government's longer term fiscal objectives. Revenue growth is expected to result mainly from the full–year effects of the tax increases implemented earlier in 2000. On the expenditure side, there is additional emphasis on social spending, particularly for education, health, welfare and industrial development policies. The government has reiterated its pre–budget commitment to adhere to a cap of $NZ 5.9 billion (equivalent on average to 1.7 percent of GDP per year) of new spending over the next three fiscal years, of which some two–thirds has already been committed. Net Crown debt is slated to fall marginally just above 20 percent of GDP in 2000/01. Over the medium term, operating surpluses are projected to rise steadily to 2½ percent of GDP by 2003/04, with a similar increase in the structural balance, and net debt is to fall to 16½ percent of GDP.

17. **The authorities have initiated plans to partially address the longer–term pressures on the budget arising from an aging population**, expected to begin around 2010 and to plateau in 2040. An important initiative is the proposal to partially prefund future pension liabilities—currently equal to about 4 percent of GDP and expected to rise to 9 percent by the second half of the century—by building a separate Superannuation Trust Fund (Box 3) with capital contributions of ½ percent of GDP in 2001/02, 1 percent of GDP in 2002/03, and 1½ percent of GDP in 2003/04. The plan would involve a move from the current system of funding pension costs from general revenues to one in which the government would pay in advance a part of the future costs, rather than relying solely on a PAYG system. The prefunding scheme is intended to smooth the transitional costs associated with the change in demographic structure, while preserving both the universal publicly funded pension and the link between pensions and the average wage. However, the authorities have not announced any details of how the fund will operate, except that the fund will be "ringfenced" from any other use and that it will be managed on a prudent commercial basis independently of the government, most likely in a Crown entity.

18. **The new government has launched a number of initiatives to review and change certain aspects of structural policies**. Key amongst these include modifications to the industrial relations framework aimed at strengthening the position of labor unions (Box 4); the removal of the provisions for a competitive insurance market for workplace

Box 3. New Zealand—A Recent Chronology of Key Public Pension Policy Developments

New Zealand Superannuation (NZS) is a universal, pay-as-you-go public pension system funded from general tax revenues—there is no payroll tax. All pensioners receive the same pension depending on their marital status, and the pension is based on the level of nationwide average wages.

- In 1977, the Government established New Zealand's first "pure" universal public pension. Benefits began at age 60, and were set at 80 percent of the average wage for couples (48 percent for singles). Qualifications were liberal: only 10 years of residence were required, and there were no income or asset tests. Government pension costs quickly doubled to 7 percent of GDP.

- To rein in costs, various Governments in the 1980s reduced the generosity of the system. In 1985, a surcharge was placed on other retirement income (effectively introducing means testing). In 1989, the 80 percent "replacement ratio" was suspended.

- Further reforms followed in the early 1990s: it was agreed to raise the retirement age to 61 immediately, and to 65 by 2001; pensions were indexed to prices alone; and the surcharge was increased and its base broadened. Pension expenditure fell to 5 percent of GDP by mid-decade.

- In 1993, an Accord on Retirement Income Policies was reached, which included: a transitional benefit to partially offset the effects of the increase in the retirement age; bounding a couple's combined pension in a band of 65-72½ percent of average wages; and commissioning of a six-yearly Periodic Group Report (from 1997) to look broadly at the effects of demographic changes on pension spending. Also, the Office of the Retirement Commission was established to publicize the need to increase private retirement savings, and the public pension system was renamed NZS.

- The National-New Zealand First coalition government posed a national referendum on superannuation in September 1997. A fully-funded, privately managed, defined contribution scheme with a government "top-up" was rejected by 92 percent of voters. Also, in April 1998, the surcharge on other retirement income was eliminated, returning New Zealand to a pure universal pension scheme.

- In December 1998, the minority National Government set up a Superannuation 2000 Task Force, charged with developing a pension policy consistent with long-term fiscal sustainability (and to report its findings in 2000). The floor on the pension benefit rate was reduced to 60 percent.

- In November 1999, a Labour-Alliance coalition government came into power and disbanded the Superannuation 2000 Task Force. In March 2000, the government announced the immediate restoration of the floor of the pension benefit rate to 65 percent, as well its plans to "pre-fund" future superannuation payments out of projected operating surpluses beginning in 2001/02. Cumulative contributions would be about 3 percent of GDP over the first three years.

- The 2000 Budget spelled out further details of the pre-funding scheme. Annual contributions would be determined using a rolling, 40-year tax smoothing model, which implies the existence of an investment fund into the 22nd century. Also, the fund would be run on a commercial basis through a Crown entity, and be subject to income taxes. The precise investment objectives and instruments (and the extent to which assets could be invested abroad) have yet to be finalized.

Box 4. New Zealand—Labor Market Arrangements

Background

New Zealand has a long history of strong central controls on the labor market and industrial relations dating from the late 19th century. For most of the 20th century, the labor market was characterized by the registration (and special legal status) of unions and the settlement of enforced agreements (awards) through mandatory, state-provided arbitration. The post-war labor market exhibited wage rigidities owing to compulsory union membership, "blanket" coverage for wage claims, government arbitration and, in the 1970s, generalized wage adjustments, all buttressed by external tariff barriers and a lack of domestic competition. While some attempts at reform took place in the 1980s (e.g., aimed at reducing state involvement in labor market outcomes), the labor market was largely excluded from the first wave of reforms.

Employment Contracts Act (ECA), 1991

- The ECA was a fundamental break with past labor market arrangements as it gave primacy to agreements between freely contracting individuals ("freedom of association").
- Multi-enterprise bargains could only come about through mutual agreement.
- Compulsory and monopoly union powers were abolished, government registration of unions was terminated and "incorporated societies" lost their tax exempt status.
- The right to strike or lock out was retained, but such actions were only possible after the expiry of a contract. If employers had agreed to a multi-enterprise contract, then strike action involving employees of other enterprises was legal after the expiration of the contract.
- Protection against unjustified dismissal was retained, as were (under separate legislation) minimum wage laws, a minimum code of employment rights such as holidays, sick leave, and occupational hazards, etc.
- All parties had the right to enforce their employment contract through an Employment Court and Employment Tribunal.
- Employees had access to the Employment Court to have a contract set aside if it contained or was entered into under harsh or oppressive conditions. Government courts were restructured to provide quick and inexpensive means of mutual resolution of disputes.

Employment Relations Act (ERA), 2000

- The ERA is based on the premise that there is an "inherent inequality of bargaining power in employment relationships," and specifies that such relationships must be built on "good faith." General principles of good faith bargaining are built into the legislation, but a code of good faith bargaining is to be developed by a tripartite committee for approval by the Ministry of Labor.
- All collective bargaining must be undertaken through unions (which will be a signatory to any such employment contract) and only union members can be covered by a collective bargaining agreement.
- The ERA retains the voluntary nature of union membership while protecting freedom of association. The ERA prohibits any preference or undue influence in decisions on union membership.
- The legislation allows unions to have access to workplaces to recruit members, discuss union business, and to deal with any matters related to the terms and conditions of employment of union members.
- The legislation establishes a collectively allocated right for those covered by collective agreements to take leave for training in employment relations, at the employers' expense. The union allocates the use of this right to eligible employees who must be union members covered by the relevant agreement.
- New institutions will be set up to promote resolution of problems: an independent (publicly staffed) Mediation Service as the first step of dispute resolution, and a new Employment Relations Authority (an independent statutory body) to investigate problems that have not been solved through mediation. The Employment Court will continue to exist to hear matters referred to it by the Employment Relations Authority.

accidents that had been introduced only in 1999; an amendment of the Commerce Act to redefine the threshold for a ruling of anti–competitive behavior; freezing unilateral tariff reductions planned by the previous government, until at least mid–2005; the launching of a review of the monetary policy framework (Box 5); and the establishment of a new entity—Industry New Zealand—charged with the implementation of industrial policies focused on regional development.

19. **Assessing the near- and medium-term outlook has been significantly complicated by the sharp fall in domestic confidence and international investor sentiment since April 2000.** With signs that growth in the second and third quarters of 2000 slowed sharply, the staff's projections are for output growth of about 3¾ percent in calendar year 2000, falling to around 3¼ percent in 2001 and to 2½–3 percent over the medium term (Annex I). Given the strong trading partner outlook and the marked boost to competitiveness from the large real effective depreciation of the exchange rate, export growth is expected to remain strong. Imports are expected to be affected by higher interest rates and falling confidence which are expected to act as a dampener of domestic demand; higher oil prices which will boost the nominal import bill. All told, the current account deficit is expected to narrow to about 6 percent of GDP in calendar 2000, before tapering off gradually to around 4 percent by 2005. With little prospect of a strengthening of the New Zealand dollar in the near future, rising oil prices, and the long period of tightening margins, the pass–through to inflation of higher import prices should broaden, making it likely that inflation will get close to or even breach the upper band of the target range by the end of 2000. For the year as a whole, CPI inflation is forecast to be around 2½ percent in 2000 and 2001, and slightly above the mid–point of the target range over the medium term.

20. **At this stage, the staff sees mostly downside risks to the growth outlook.** Although the forecasts build in a weakening in domestic demand, the fall in confidence, if it persists, could foreshadow an even sharper slowing in the domestic economy. The lack of buoyancy in domestic activity would make growth—which is expected to be driven by exports—especially vulnerable to a weakening in global economic conditions.

IV. Policy Discussions

21. **Discussions focused on demand management and the policy mix, structural policies to raise saving and growth, operational elements of monetary policy and on the degree of external vulnerability facing New Zealand.** During the last Article IV consultation, Directors recommended structural reforms of the agricultural producer boards and of education to raise potential growth. They saw the need to address fiscal pressures from population aging, and to remove disincentives to household saving in the tax, welfare and pension schemes. Directors' view was that although New Zealand was well–positioned to cope with shocks, the high current account deficit and net external liabilities left the economy vulnerable to adverse shifts in investor sentiment.

Box 5. New Zealand—Recent Developments in Monetary Policy Operations

The second half of the 1990s saw some important changes in New Zealand's approach to inflation targeting, all broadly aimed at moving to greater flexibility and efficiency in the framework.

- In December 1996, the inflation target band was widened from 0-2 percent to 0-3 percent;
- From March 1999, the Reserve Bank of New Zealand (RBNZ) began to use the Official Cash Rate (OCR) as its primary policy instrument, replacing the previous, more complicated, modus operandi when policy was conducted through periodic announcements about the desired level of the Monetary Condition Index (MCI);
- At the same time as the switch to the OCR, the RBNZ extended its policy horizon (from 12-14 to 18-24 months);
- The RBNZ has shifted from a "mark up" approach to projecting inflationary pressures (based on cost pressures and margins and, thus, on the direct effect of the exchange rate) to an "output gap" approach, that emphasizes the indirect effect of the exchange rate (via aggregate demand).

The most recent change was the revision of the Policy Targets Agreement (PTA) in December 1999 following the change in government in November 1999. The new PTA confirms the primacy of the price stability objective and the 0-3 percent inflation target, but now states that "*in pursuing its price stability objective, the bank shall implement monetary policy in a sustainable consistent and transparent manner and shall seek to avoid unnecessary instability in output, interest rates and the exchange rate*". This compares with the previous PTA, which stated that "*the Bank shall implement monetary policy in a sustainable, consistent and transparent manner*".

Another recent development has been the commissioning of a review of the operation of monetary policy. The goal of the review is to ensure that the monetary policy framework and the RBNZ's operations within that framework are appropriate to the characteristics of New Zealand's economy and best international practice. The primacy of the price stability objective and the RBNZ's autonomy in conducting monetary policy will not be subject to review. The review (which will be conducted by Lars Svensson and is due to be completed early next year) will consider the following issues:

- Whether the way the RBNZ interprets the PTA with a view to ensuring that achieving price stability is consistent with avoiding undesirable instability in output, interest rates and the exchange rate;
- Whether the RBNZ has an adequate range of instruments and is using them effectively in altering monetary conditions in the desired direction;
- The range of sources, availability, type and timeliness of data and the impact of these variables on forecasting and decision making;
- Whether the monetary policy decision making process and accountability structures promote the best outcomes possible;
- The coordination of monetary policy with other elements of the economic policy framework;
- Whether the RBNZ's decisions are explained to the public and markets in the simplest, clearest and most effective way possible.

A. Macroeconomic Policies

22. **The key challenge for near–term macroeconomic policy is to steer the economy pragmatically to support sustained growth while avoiding a build–up of inflationary pressures**. Given the large external imbalances, an adverse shift in investor sentiment could—as in the past few months—lead to unsettled financial market conditions, and thus complicate the task of macroeconomic management. Thus, the mission stressed the need to reassure investors and markets that the overall economic strategy is clearly consistent with raising New Zealand's productivity and that it is aimed at enhancing the economy's competitiveness and growth prospects.

Monetary Policy

23. **The mission supported the implementation of monetary policy to date**. The staff agreed with the authorities that the very rapid pace of expansion of the economy in the second half of 1999 and the stimulus being provided by the depreciating exchange rate warranted the increases in interest rates that have taken place thus far. The staff also supports the authorities' decision not to raise interest rates at the mid–August review, both because recent signs of slowing activity could suggest that the balance of risks may have shifted slightly away from a sustained build–up in inflationary pressures, and the possible salutary effects the pause in the tightening cycle may have on confidence.

24. **For the period ahead, the authorities are of two minds about the direction of monetary policy, but agreed that any tightening should be gradual and continually reassessed**. Indicators of activity paint a mixed picture of the strength of the economy going forward, with a marked difference in temperature across sectors. In these circumstances, the authorities' view is that there is a plausible scenario for inflationary pressures that would necessitate further tightening. In particular, it is unclear whether there is much prospect for a strengthening in the $NZ in the near future; indeed, the significant volume of Eurokiwi bonds that are maturing in the next few months, and the market's view that New Zealand is off global investors' radar screens suggests further downward pressure on the exchange rate in the near term. The authorities agreed with the staff's judgment that the decline in the New Zealand dollar could be a structural adjustment to the large current account deficits and that the currency may only be slightly below its medium–term equilibrium in real effective terms. On the other hand, there is also a plausible scenario which would call for no further tightening or even an easing of policy. The fall in confidence could be an early indicator of a sustained weakening in domestic demand. Moreover, in light of the high level of household indebtedness (estimated to be close to 110 percent of household disposable income), [5] domestic demand may now be more interest sensitive, implying that the increase in interest rates to date may be impacting the economy more than previously estimated.

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[5] Thorp, Clive and Bun Ung, "Trends in Household Assets and Liabilities since 1978," RBNZ Bulletin, Vol. 63, No. 2, 2000

Fiscal Policy

25. **The authorities explained that the overriding principle of this year's budget was one of restoring balance between economic and social objectives**. The key initiatives are aimed at strengthening the health and education sectors, promoting regional development, improving prospects for Maori and Pacific Islanders who make up some 20 percent of the population, and closing gaps between the rich and the poor, while still preserving a sustainable medium-term fiscal position. Specifically, the government's fiscal objectives are to maintain an operating surplus across the economic cycle to allow for prefunding pension costs associated with an aging population (discussed further below) and to reduce and maintain net debt below 20 percent of GDP.

26. **The mission took the view that the projected fiscal policy stance in 2000/01 and the medium–term is broadly appropriate but the risks are predominantly on the downside**. From the point of view of demand management and raising public saving, the planned operating surpluses for the next four years are appropriate. Also, the fiscal provision covering new discretionary spending provides an additional dimension of accountability. The authorities acknowledge that, because about two–thirds of the fiscal provision has already been allocated, they face a very tight constraint on discretionary spending for the rest of this government's term. In addition, the staff expressed concern that the revenue forecasts are based on optimistic growth projections. Thus, while the fiscal provision may be met, the baseline outcomes for revenues and expenditures may be worse than expected due to factors that may not be strictly exogenous, including negative macroeconomic effects of the policies of the new government. Given the recent shift in market sentiment and in light of the fact that a key driver of confidence is the market's perception of whether the government has the ability to control its finances and to reduce the burden of demand management on monetary policy, the mission suggested the need to keep a very close watch on expenditures together with the formulation of well–specified contingency plans to offset possible slippages in achieving the targeted surpluses.

27. **The authorities' view is that the contentious history of superannuation reform in New Zealand makes it critical to have a period of stability in the scheme**. One way to achieve this is to use part of fiscal surpluses to partially prefund future pension spending. The mission expressed broad support for the authorities' prefunding plans, and the staff's work on the macroeconomic impact of prefunding superannuation suggests that, relative to the counterfactual where superannuation expenses continue to be funded out of general revenues, there would be a small positive impact on national saving, and a net positive impact on labor supply and output.[6] In response to the suggestion to consider additional parametric reform to reduce the generosity of the system, lower pension costs, and encourage private saving, the authorities explained that the proposed scheme to partially prefund future pension costs has the flexibility to incorporate some parametric reform such as a gradual increase in the

[6] Further details can be found in the forthcoming Selected Issues paper.

retirement age. On the institutional arrangements, including the investment strategy, the mission recommended that consideration be given to running a tax-exempt fund using an index approach with both domestic and foreign investments. The authorities prefer to subject the superannuation fund to taxes on the grounds that this would be consistent with the tax treatment of all Crown entities. The authorities agreed that defining the institutional arrangements to safeguard the fund's assets were important, but believe that regardless of the chosen arrangement, once the fund rises to a critical level, it will become increasingly difficult for future governments to tamper with it.

28. **Finally, in addition to pension costs, the mission suggested that preparations be started to address health costs related to the aging population**—conservatively estimated to be of a similar order of magnitude as pension expenses. In this context, the mission suggested that the authorities review the experiences of other industrial countries with progressively shifting a part of the costs to the private sector.

B. Structural Policies

29. **As noted above, the new government's view is that the relatively weak growth payoff to New Zealand's reforms suggests the need for a "correction" in certain policies, while maintaining intact other aspects of the reforms.** The authorities stressed that they remain committed to the fiscal policy framework and to the fundamental elements of the monetary policy framework, and that the changes being implemented in other areas should be seen as attempts to bring New Zealand in line with regimes in Australia and other comparable industrial countries. The authorities also took the view that there is a need for a more active role for the government in the economy to ensure greater consistency between sectoral policies.

Growth

30. **The staff shares the authorities' concern that, although there have been improvements in growth and productivity in the 1990s, there has not been a significant narrowing of the gap in per capita incomes with comparable countries** (Box 1). The staff agreed with the authorities on the broad objectives of the growth strategy for New Zealand, namely (a) to leverage its traditional strengths in primary and commodity–based manufacturing; and (b) to put itself in a better position to take advantage of those aspects of globalization where physical remoteness may be of much less importance.[7] Acknowledging that the experience of other countries (e.g., Australia and the U.K.) suggests that the full effect of reforms takes several years, and that important reforms were implemented only in the first half of the 1990s, the discussions focused both on areas where there is scope for additional reforms and those where there could be a risk of weakening the gains that have already been achieved through earlier reforms.

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[7] These issues are presented in greater detail in the forthcoming Selected Issues paper.

31. **On the scope for further reforms:**

- First, the mission agreed with the authorities' focus on **upgrading human capital**. In particular, the mission endorsed initiatives such as the modern apprenticeship program to supplement the on–the–job training provided by Industry Training Organizations; skills–targeted immigration policies; and the provision of grants to encourage R&D. An additional issue relates to retaining skilled labor in New Zealand and stemming the "brain drain". In this context, the mission had some concern that measures such as the increase in the income tax on high-income earners could serve to exacerbate rather than alleviate the problem of emigration of skilled labor.

- Second, the mission saw considerable scope to improve agricultural sector performance through more rapid progress in **deregulating key primary sectors**. The mission welcomed the progress that has been made with the partial deregulation of the apple and pear, and kiwifruit boards and suggested that the authorities undertake an early review of experience with a view to further deregulation. As for the **dairy industry**, which accounts for 15–20 percent of New Zealand's exports, the authorities agreed that notwithstanding the limits to expansion arising from partner country protectionist barriers, there remains scope for innovation and for achieving greater access to new markets through dairy board reform, but noted that they strongly prefer that a solution be generated from within the industry. The mission suggested that, since the dairy industry had failed to deliver a restructuring plan before the deadline of September 1, 2000, the authorities now take a greater leadership role in its reform, including through the commissioning of an external review similar to one for the wool board.

32. **The mission also highlighted areas where there is a danger of weakening the gains that have already been achieved through earlier reforms.** In this context, the mission took the view that the impact on confidence of changes in policy direction that are accompanied by a lack of clarity in the underlying economic rationale could be severe. As already noted, the economy's increased resilience and flexibility in the face of shocks has largely been the result of labor and product market deregulation, which has improved competition and has significantly reduced the scope for rent–seeking activities. Thus, in the following areas, the mission suggested proceeding with caution and being prepared to change policies that prove detrimental to competitiveness and growth.

- The first of these areas is **the replacement of the Employment Contracts Act (ECA) by the Employment Relations Act (ERA)**. The ECA is widely acknowledged as having improved labor market flexibility and resulted in a much closer alignment of wages and productivity growth.[8] The authorities' view is that the ECA tipped the power balance in labor relations unduly in favor of employers and

[8] Labor market issues are covered in greater detail in the forthcoming Selected Issues paper.

that the ERA is aimed at achieving a better balance. Private sector representatives expressed the view that there was no compelling reason for a reform of the industrial relations framework, that labor relations had improved greatly under the ECA, and that the new legislation would add to the cost of doing business. Moreover, they noted that although a code of "good faith" in employment relationships is being drafted, actual practice will depend on the body of case law that will take time to be built up. The authorities countered that business' reaction is exaggerated and were confident that experience with the new legislation will show that business' fears are unfounded. The mission noted that the new framework does raise the possibility of weakening wage and labor market flexibility, and that the authorities should be prepared to be flexible and pragmatic in its implementation.

- The second is **the restoration of the ACC as the monopoly, public–sector owned provider of workplace accident insurance** after it was opened up for private sector participation only in mid–1999. Prior to the introduction of a competitive insurance market, the main concerns related to the scheme's increasing cost and relative generosity. Since the introduction of the competitive regime, businesses had experienced substantial cost saving. Nevertheless, the authorities were concerned first, that private insurers' focus on short–term profits would come at the expense of investment in injury prevention and rehabilitation; and second, that higher transactions and compliance costs associated with a multi–insurer environment would be transferred to employers and claimants. The mission noted that a competitive system could lead to greater incentives for employers to take preventive measures because of the link between firms' risk ratings and their premiums, and suggested that the authorities remain open to reintroducing competition in this market, especially if risks of rising fiscal costs reemerge.

- The third relates to **changes in product market regulation**. On the changes to the Commerce Act, the authorities explained that actual practice had tended to weaken the original intent of the legislation and that the amendments bring the legislation in New Zealand more closely in line with that in Australia. They also acknowledged that these amendments would be especially effective in the regulation of utilities. The staff was in broad support of these changes. However, in the telecommunications sector—where the authorities are considering the establishment of an industry–specific regulator with relatively far–reaching powers—the staff noted that this was a difficult area, and that there is no international consensus on "best practice." Indeed, New Zealand's current approach of relying on general competition law and industry self–regulation is, in many ways, an ideal. Moreover, there is evidence that competition in this sector has not been stifled in spite of light–handed regulation, and that costs have remained low, despite the disadvantages of low population density and lack of scale economies.[9] This suggests the need to proceed with caution, especially with the establishment of additional regulatory apparatus that could prove difficult to dismantle if deemed unsatisfactory.

- The fourth relates to **industrial policies**. The refocused and expanded role of the Ministry of Economic Development in coordinating, integrating and monitoring on–going economic and industry development programs is likely to be quite useful insofar as it minimizes duplication and could increase efficiency. On the role of the soon to be established entity Industry New Zealand, the mission acknowledged that only a small amount has been allocated for this purpose in the budget, but suggested that its role be carefully designed and tightly circumscribed from the start, so as to prevent drift into the type of activist industrial policy that characterized pre–reform New Zealand. In particular, caution is warranted in the use of public intervention in promoting regional development policies. First, these policies could restrict the benefits of agglomeration—critical in a country of New Zealand's size. Second, there is the risk of creating opportunities for rent seeking behavior and associated resource allocation distortions.

33. **On trade issues, the authorities stressed that protectionist barriers in industrial countries for its exports have had substantial detrimental effects on New Zealand's GDP**. Thus, while they remain committed to trade liberalization through the WTO, they are pursuing regional and bilateral agreements as second best options. The authorities made the point that the recent decision to freeze unilateral tariff reductions on textiles, footwear and clothing would make the regime no different from that in Australia. The vast majority (95 percent) of goods entering New Zealand are not subject to any tariffs, and New Zealand remains committed to APEC agreements to eliminate all tariffs by 2010 and to other bilateral trade agreements. The staff welcomed the authorities' commitment to trade liberalization but noted that the decision to freeze unilateral tariff reduction, because it reverses earlier plans, could have an adverse impact on confidence.

Saving

34. **In light of the steady decline in saving, the staff have, in the past, argued strongly in favor of policies that provide appropriate incentives for private saving**. With respect to private saving, the staff noted that some of the recent changes in the tax and social transfer systems could go in the wrong direction to this objective. First, the increase in the income tax rate on high income earners further increases the reliance on direct taxation which studies (both by the staff and the authorities) have found to be a significant disincentive to private saving. Second, the increase in the replacement ratio from New Zealand

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[9] Lew Evans, "*Size Matters, and So Does the Pace of Change*", and "*Being Certain about what you are regulating and why*" Competition and Regulation Times, New Zealand Institute for the Study of Competition and Regulation, June 2000.

Superannuation together with some of the welfare system reforms tend to increase the generosity of social transfers, which, in turn, could dull private saving incentives. In this context, the staff welcomed the comprehensive review of the tax system planned for 2001 and urged that priority be given to efforts to eliminating disincentives in the tax regime and in the social transfer and welfare system to private saving and productive investment. The authorities pointed out that the key reason for the low saving rate was the low rate of income growth rather than tax and transfer policies and thus the focus of policies should be on generating higher growth.

Household Saving Ratio

(In percent of disposable income)

	1975-85	1985-95	1995-99
New Zealand	9.7	4.5	1.0
Australia	14.5	7.3	3.8
United States	9.8	7.8	4.2
Canada	14.5	11.1	4.0
Ireland	16.0	10.7	10.7
OECD	11.9	10.2	9.0

Source: OECD.

C. Review of Monetary Policy Operations

35. **The government has implemented a change in the Policy Targets Agreement (PTA) and has commissioned a review of monetary policy operations to assess "its effectiveness in contributing to broader social and economic objectives" (Box 5).**[10] The authorities were of the view that the new PTA merely formalizes the changes that are already being implemented by the RBNZ since the mid-1990s as part of the move from a relatively strict to a more flexible inflation targeting framework. The staff agreed with this view, but made several points. First, in light of the favorable early assessment of the experience with the switch to the Official Cash Rate (OCR), the rationale for altering the PTA was not entirely clear.[11] Second, the inclusion of additional words and conditions in the PTA reduce the simplicity and clarity that were strong points of New Zealand's inflation targeting framework and could, over time, complicate monetary policy formulation. Third, there could now be a need for additional discussion of implementation issues to ensure that the public understands fully the rationale for monetary policy decisions and their likely implications for output, interest rate and exchange rate variability. Indeed, some of the gains in moving from the MCI to the OCR regime in terms of a reduction in the public's attention to implementation issues may be lost with the new PTA. Fourth, modifications to the PTA, particularly when coincident with the political cycle, could unduly politicize monetary policy implementation. In this context, any actual or perceived reduction in the instrument independence of the central bank could weaken policy credibility. The authorities stressed that there were sufficient checks and balances in the framework to ensure the independence of the central bank: the governor has the right to decline to sign the PTA which would

[10] The staff's work on this issue is at the authorities' request and is covered in greater detail in the forthcoming Selected Issues paper.

[11] See Brookes, A. and T. Hampton, "*The Official Cash Rate one year on*", RBNZ Bulletin, Vol. 63, No. 2, June 2000.

require the Treasurer to activate the "override" clause and begin dismissal procedures. Moreover, any change to the objectives of monetary policy would be a very open and public process and not one that would be entered into lightly.

36. **On the monetary policy review, the authorities emphasized that the terms of reference for the review clearly state that the goal of price stability and the operational autonomy of the RBNZ are not open to review.** Their view is that the time is right for a broad review of the operation of the monetary policy framework over the past ten years. The mission's discussions focused on the decision-making process and accountability structure used in New Zealand and whether these are likely to promote the best outcomes for monetary policy. Formally, the implementation of monetary policy rests in the sole hands of the governor, and he is solely accountable for inflation outcomes as specified in the contract embodied in the PTA. The performance of the governor in the implementation of monetary policy is assessed by the Board of Directors, of which the governor himself is a member.

- Notwithstanding theoretical arguments in favor of delegation of responsibility for monetary policy to a formal committee, the authorities cited the loss of parallels with the accountability structures in the rest of the public sector, the operational complexity arising from signing several individual contracts, and the shortage of potential candidates to constitute such a decision–making body as possible stumbling blocks to moving to a committee structure in New Zealand. Another factor is the possible adverse impact on monetary policy credibility as the new committee members establish their reputations and the market and the public learn how the committee will function. The mission agreed that there did not appear to be a compelling reason to move to a monetary policy committee structure at this time.

- However, regardless of whether changes are made to the current decision–making structure, the authorities agreed on the need to modify an element of the accountability structure, namely the board of directors which assesses the performance of the governor, either by replacing the governor as the chairman, or by dropping him from the board altogether.

D. External Vulnerability

37. **Indicators of external vulnerability and the adjustment to recent shocks supports the staff's earlier assessment that New Zealand is generally well placed to absorb shocks without undue economic or financial distress.**[12] As identified during the last Article IV consultation, key factors mitigating the vulnerability associated with the high external liabilities are the freely floating exchange rate; the near–complete natural or derivative based hedging of interest and exchange rate risks by banks and corporates; the

[12] A detailed assessment of external vulnerability is contained in Annex II.

38. sound financial position of banks with capital ratios well in excess of the Basle minimum standards and low levels of impaired assets;[13] the relatively low share of short–term external debt subject to rollover risk; and the high degree of policy transparency and accountability of policy makers. The series of adverse shocks over the past 2–3 years—the shift in market sentiment, volatility in commodity prices, and loss in external markets associated with the Asian crisis; the droughts; the weakness in housing and equity markets; and the recent renewed slide in the exchange rate—have, thus far, been absorbed quite smoothly. That said, the authorities agreed that the high degree of external exposure means that policy makers have to be especially mindful of the impact of their actions on confidence, and that the best course to reduce the economy's external vulnerability over the medium term is to implement policies that are clearly aimed at removing disincentives to saving and ensuring that investment is allocated more productively.

New Zealand--Key External Vulnerability Statistics

	1996	1997	1998	1999	2000
	(in percent of GDP at end-March)				
Current Account (annual)	-5.4	-6.3	-5.6	-4.4	-7.1
Net foreign liabilities	-77.5	-83.9	-90.9	-86.7	...
Gross external debt	82.5	85.4	101.1	103.4	105.0
Of which:					
Local currency denominated	43.5	46.8	54.1	48.7	45.4
Short-term (residual maturity)	40.3	40.2	41.7	44.1	52.1
Public sector	23.9	21.7	20.3	17.5	15.8
Related party	29.6	32.6	44.3	46.2	53.5
	(annual percentage growth at end-December) 1/				
Exports of goods and services (y-o-y volume)	3.4	2.9	2.5	5.1	5.5 2/
Imports of goods and services (y-o-y volume)	8.3	4.2	2.5	11.9	12.5 2/
Terms of trade (quarterly index)	-1.0	-1.6	0.9	-0.1	-1.0
Real effective exchange rate (1990=100)	112.2	104.5	89.1	87.8	85.1

Source: Statistics New Zealand.

1/ For 2000, data are for end-June.
2/ Goods only.

[13] At end–March 2000, capitalization ratios stood at above 10 percent, with about 7 percent in Tier–1 capital. The ratio of impaired assets to total lending was less than ½ percent. The authorities are also considering a number of steps, in consultation with major banks and their home country supervisors, to further strengthen the banking system by dealing with potential systemic risks arising from bank failures (Annex II).

V. Staff Appraisal

39. **The fact that the wide-ranging economic reforms have not yet brought strong rewards in terms of growth may be a legitimate reason to reexamine elements of the reform process**. However, in light of New Zealand's vulnerability to external investor sentiment, it is particularly important that the economic rationale for policy changes be well understood both domestically and internationally. Changes in policies that are undertaken in the absence of convincing evidence of the shortcomings of the existing regime could be interpreted by markets as a step backwards, with negative short- and medium-term consequences.

40. **The resilience displayed by the New Zealand economy through the turbulence of the past 2–3 years is clear testimony of the benefits of the economic reforms of the past 15 years**. Growth recovered strongly in 1999 and early 2000, owing to favorable weather conditions and appropriate macroeconomic management, while inflation remained relatively subdued. The widening of the current account deficit, in large part, reflected the effects of the drought on exports; in recent months, exports have picked up strongly and the current account deficit looks set to narrow despite the adverse impact of higher oil prices. The financial system has fully absorbed the impact of the adverse shocks and remains well capitalized with low levels of impaired assets.

41. **The key challenge for near–term macroeconomic policy is to steer the economy pragmatically to support sustained growth while avoiding a build–up of inflationary pressures.** In this context, in the absence of steps to reassure markets that the authorities' overall economic strategy is clearly aimed at enhancing competition and growth, the burden on macroeconomic policies in maintaining stability could be very high.

42. **The recent conduct of monetary policy has been appropriate but monetary management in the period ahead is likely to be challenging**. Although signs of slowing activity would suggest that the balance of risks may have shifted slightly away from a sustained build–up in inflationary pressures, there remain some indications of a need for further tightening of monetary policy over the coming year. However, any tightening should be gradual and continually reassessed in light of the uncertainty surrounding the sustainability of the economic expansion.

43. **The targeted near– and medium–term fiscal operating surpluses are appropriate from a demand management point of view and are reasonably ambitious, but the risks are mainly on the downside**. These risks arise from the fact that two–thirds of the fiscal provision has already been allocated leaving a very tight constraint on discretionary spending for the rest of this government's term. Moreover, at this stage, it is not clear that the optimistic growth forecasts underlying the revenue projections will be realized, in part because of the impact of the direction of government policies on confidence. With a key driver of sentiment being the market's perception about the government's ability to control public finances and to reduce the burden of demand management on monetary policy, the staff sees the need to keep a very close watch on expenditures together with the formulation

of well–specified contingency plans to offset possible slippages in achieving the targeted surpluses.

44. **The authorities' focus on New Zealand's growth performance is appropriate—the staff would suggest that, to increase the growth dividend, additional actions are necessary in some areas, while in others there is a need to avoid the risk of weakening the gains that have already been achieved through earlier reforms.** In this context, the authorities' focus on human capital development is appropriate, but there is concern that increase in tax rates on high income earners could exacerbate the "brain drain." The staff welcomes the reforms implemented to partially deregulate parts of the agricultural sector, and recommends more rapid progress in deregulating the dairy sector, where notwithstanding the limits to expansion arising from partner country protection in dairy products, there remains scope for innovation and higher value added.

45. **The mission also cautioned against reforms that could reduce labor and product market flexibility and suggested that the authorities be flexible and pragmatic in their implementation.** Chief amongst these are the ERA, the restoration of the ACC as the monopoly provider of workplace accident insurance, and the regulatory reforms of the hitherto lightly regulated telecommunications sector. Likewise, while efforts to coordinate and integrate ongoing economic and industry development programs are useful, the mission would recommend that the role of the soon to be created Industry New Zealand be tightly circumscribed from the start so as to prevent a drift into activist industrial and regional development policies.

46. **On saving, the mission noted that recent proposals and changes in the tax and social transfer systems may not go far enough to have a significant impact on saving or, in some cases, may actually reduce saving.** The staff expressed broad support for the authorities' plan to prefund a part of future pension liabilities through the building up of a separate trust fund, and would suggest that consideration also be given to parametric reforms to lower pension costs. The staff also suggests that more rapid progress be made with defining the institutional arrangements and the investment strategy to safeguard the fund's assets. As for private saving, the staff's view is that recent increases in top income tax rates and in the replacement rate for superannuation are likely to lower private saving; the staff would therefore suggest that the forthcoming comprehensive review of the tax and transfer regimes focus on removing disincentives to private saving and to productive investment.

47. **On recent reforms and the forthcoming review of monetary policy operations,** the staff agrees that a review of monetary policy operations may be timely and welcomes the fact that the primacy of the price stability objective and the autonomy of the RBNZ are not subject to review. However, the inclusion of additional conditions in the contract could reduce the clarity of the framework and, over time, could complicate monetary policy formulation. Moreover, the changes imply a need for monetary policy announcements to focus on implementation issues. Finally, the staff would caution against actions that could unduly politicize monetary policy implementation and could undermine the actual or perceived instrument independence of the RBNZ.

48. **The mission's assessment of New Zealand's external vulnerability is that the country is generally well placed to absorb shocks without undue economic or financial distress.** While the extent of external imbalances remains very large, suggesting a high degree of vulnerability to sudden changes in investor sentiment, mitigating factors including the high degree of hedging and the experience of adjustment to shocks over the recent past support this assessment. The staff, however, stressed that the large degree of external exposure means that policy makers have to be especially mindful of their actions on confidence, with the focus being on policies that are clearly aimed at reducing disincentives to saving and productive investment so as to narrow the current account deficit over the medium term to more sustainable levels.

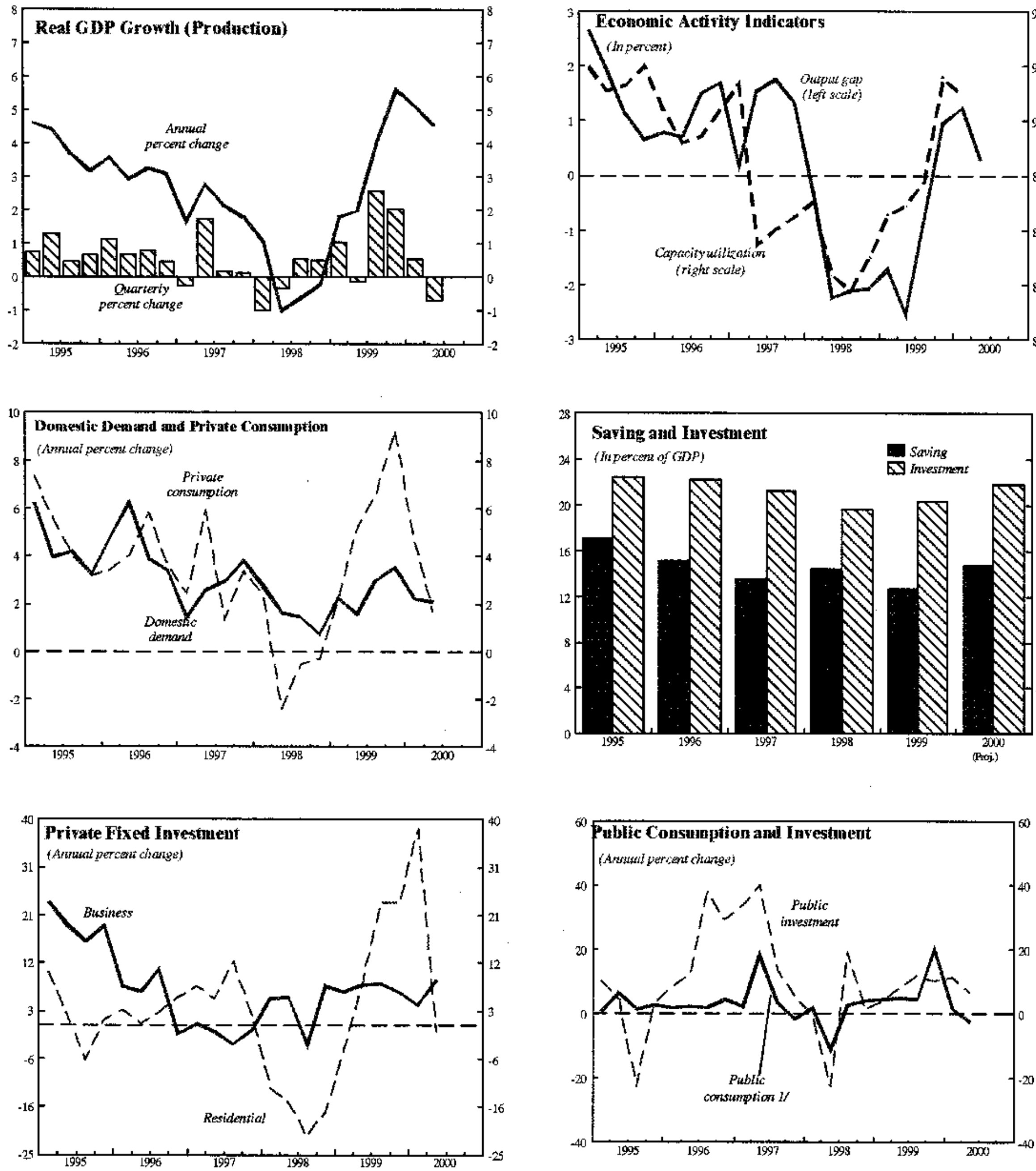
49. **New Zealand publishes an array of high–quality economic and financial statistics that are adequate for surveillance.** The staff welcomes the authorities' efforts to improve the frequency, timeliness and coverage of these statistics (Annex IV).

50. **The staff would encourage the authorities to give favorable consideration to requesting an FSAP.** The authorities have tentatively indicated that if they do, it will be in 2001, after the completion of the on-going monetary policy review.

51. It is proposed that the next Article IV consultation with New Zealand take place on the standard 12–month consultation cycle.

FIGURE 1
NEW ZEALAND

SELECTED REAL ECONOMIC INDICATORS, 1995-2000



Sources: Statistics New Zealand; and staff estimates.

1/ 1999q4 excludes the purchase of a navy frigate equivalent to 0.6 percent of GDP.

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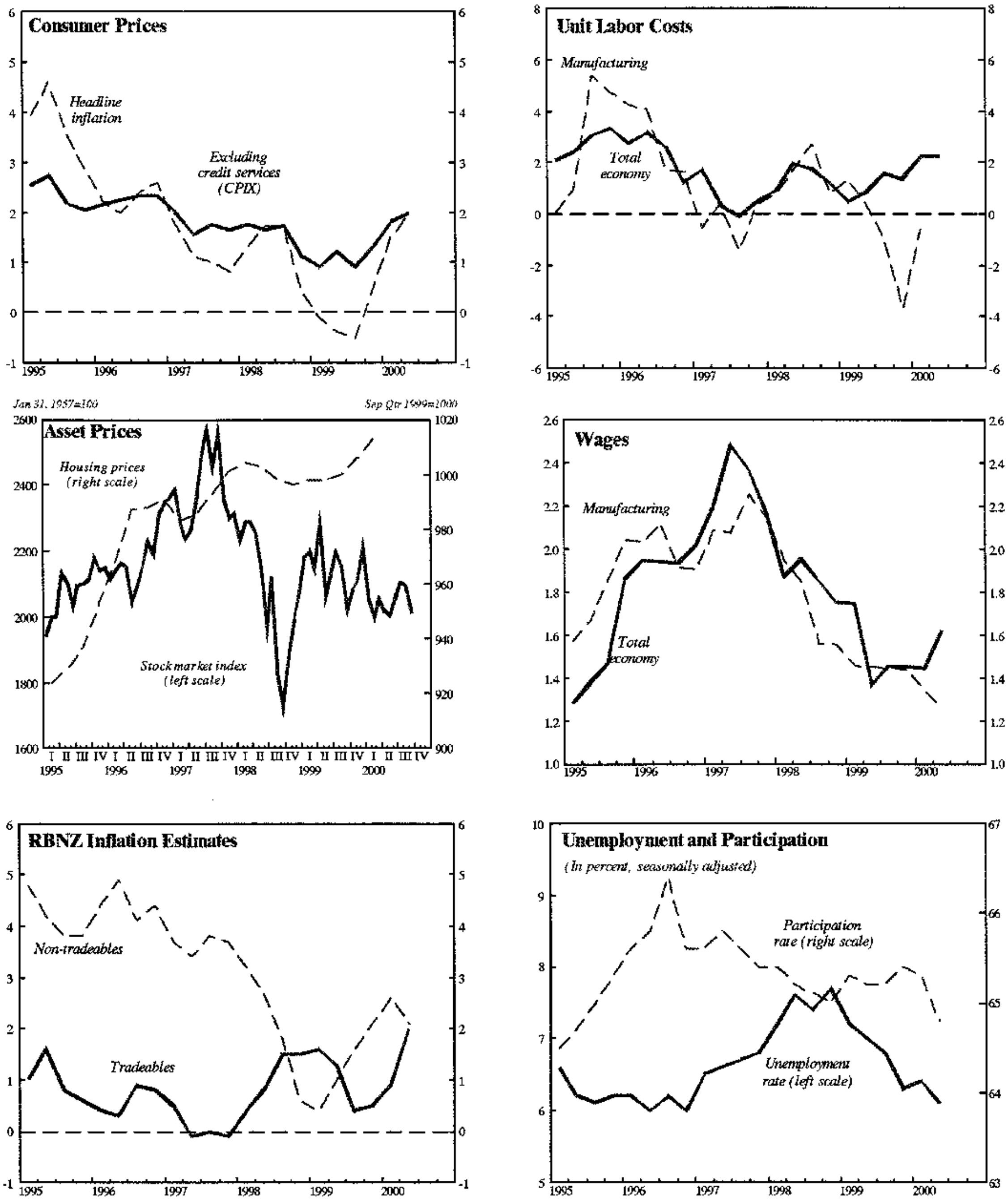
FIGURE 2
NEW ZEALAND

LABOR MARKET AND INFLATION INDICATORS, 1995-2000

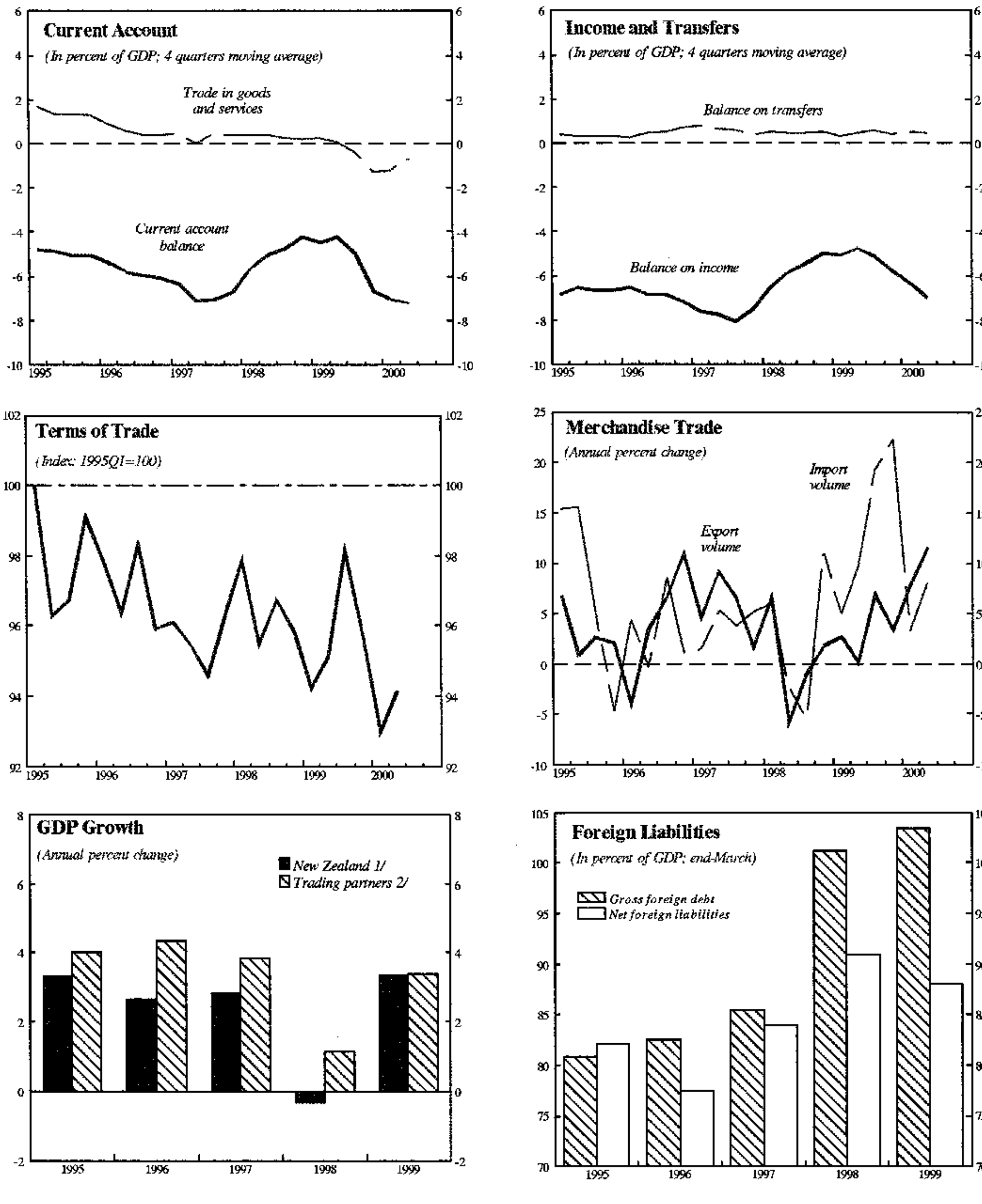


q:\data\nzl\charts\s00\nzlsrcht.cmd

Sources: Statistics New Zealand; and staff estimates.

FIGURE 2
NEW ZEALAND

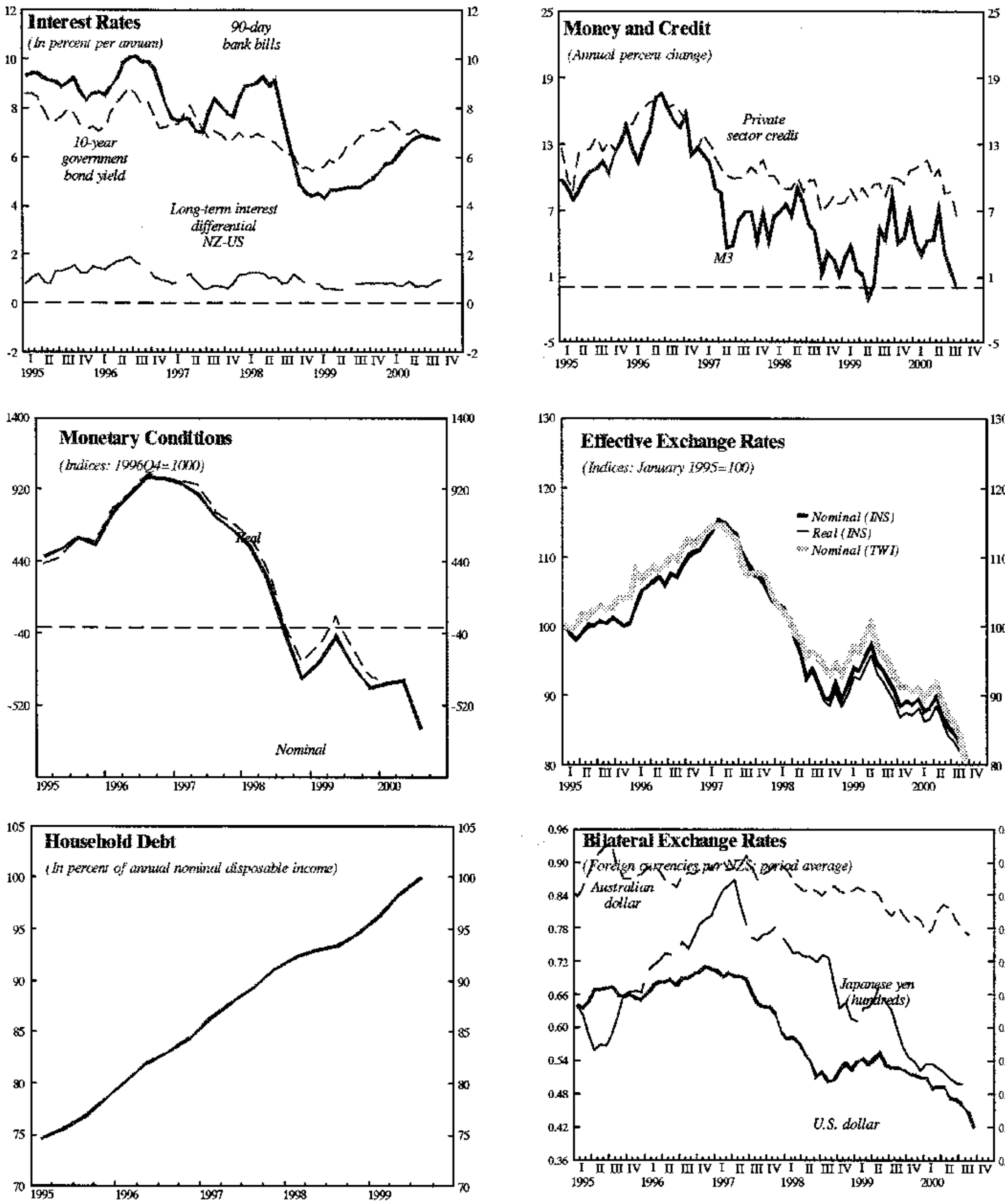
BALANCE OF PAYMENTS AND EXTERNAL INDICATORS, 1995-2000



Sources: Statistics New Zealand; IMF, World Economic Outlook; and staff estimates.
1/ Expenditure based.
2/ Exported-weighted average based on data for partner countries that account for at least 95 percent of trade of New Zealand.

FIGURE 4
NEW ZEALAND

MONETARY AND FINANCIAL INDICATORS, 1995-2000



Sources: Reserve Bank of New Zealand; and IMF, International Financial Statistics.

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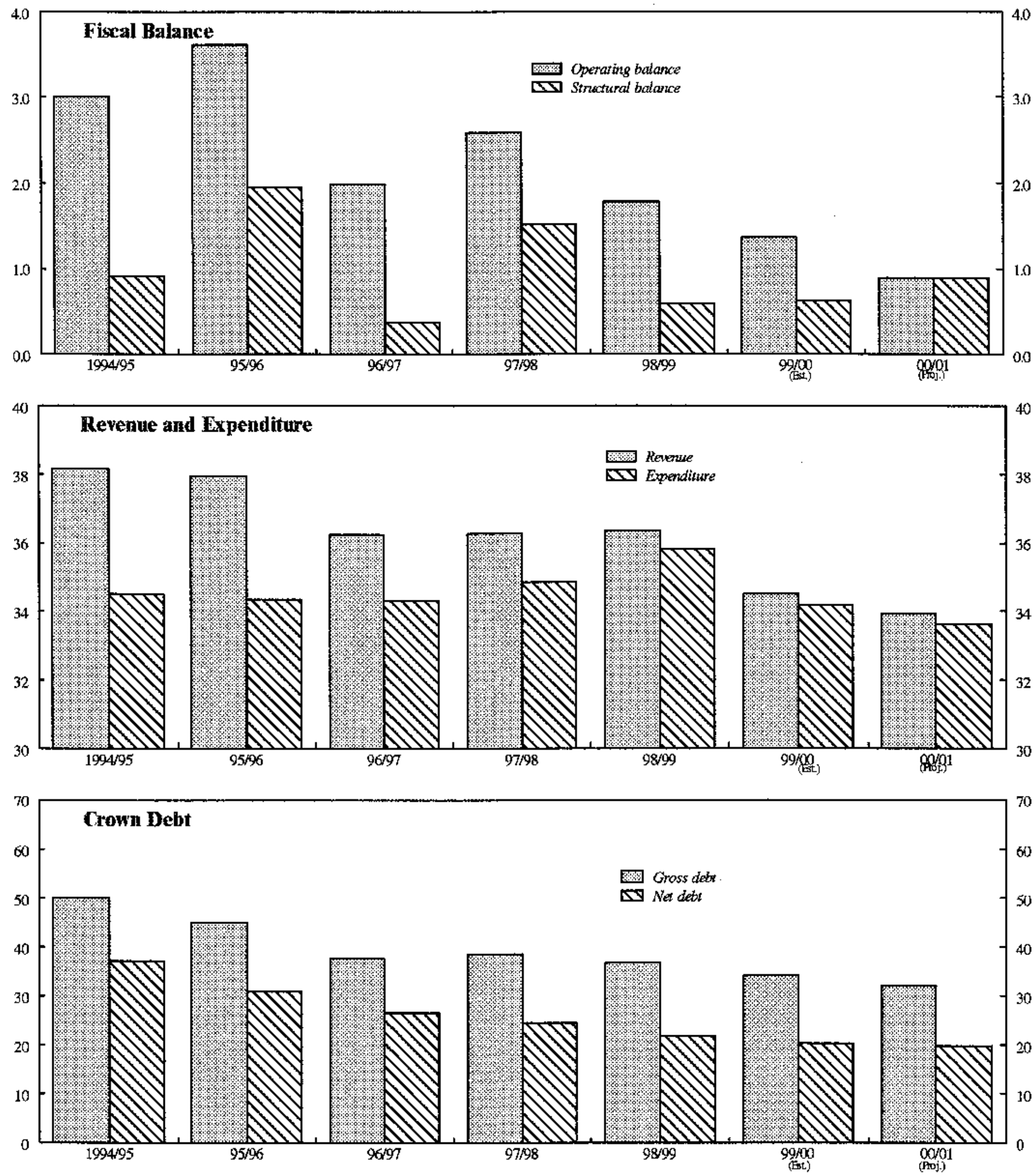
FIGURE 5
NEW ZEALAND

FISCAL INDICATORS, 1994/1995-2000/01
(In percent of GDP)



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

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Table 1. New Zealand: Selected Economic and Financial Indicators, 1996-2001

Nominal GDP (1999):	US$ 53.9 billion
Population (1999):	3.8 million
GDP per capita (1999):	US$ 14,140
Quota:	SDR 894.6 million

					Proj.	
	1996	1997	1998	1999	2000	2001
Real growth (percent change)						
GDP (production basis)	3.2	2.1	-0.2	3.4	3.8	3.2
Domestic demand	4.2	3.3	-0.2	5.8	3.4	3.1
Private consumption	4.6	2.7	1.7	2.8	2.7	2.5
Fixed investment	7.0	3.8	-1.9	8.3	7.9	5.6
Exports of goods and services	3.4	2.9	2.5	5.1	9.1	8.0
Imports of goods and services	8.3	4.2	2.5	11.9	6.8	7.3
CPI excluding credit services (percent change)	2.3	1.7	1.6	1.1	2.5	2.5
Unemployment rate (in percent)	6.1	6.7	7.5	6.8	6.4	6.4
Investment and saving (in percent of GDP)						
Investment	22.2	21.2	19.6	20.4	21.8	22.2
National saving 1/	15.1	13.6	14.4	12.7	14.8	16.1
Private saving	9.0	8.4	9.3	7.6	9.5	10.8
Public saving	6.1	5.3	5.1	5.1	5.3	5.3
Public finance (in percent of GDP) 2/						
Revenue	38.0	36.2	36.3	36.4	34.5	33.9
Expenditure	34.4	34.3	34.9	35.8	34.2	33.6
Operating balance 3/	3.6	2.0	2.6	1.8	1.4	0.9
Estimated structural balance 4/	1.9	0.4	1.5	0.6	0.6	0.9
Net public debt	31.0	26.4	24.5	21.7	20.2	19.7
Money and credit (end of period)						
M3 (percent change)	12.7	4.2	1.1	6.9	-0.1 5/	...
Private domestic credit (percent change)	12.5	10.1	7.6	10.6	6.1 5/	...
Interest rate (90-day, in percent)	8.1	8.3	4.4	5.7	6.7 6/	...
Government bond yield (10-year, in percent)	7.2	7.0	5.4	7.2	6.8 6/	...
Balance of payments ($NZ billion)						
Current account	-5.7	-6.5	-4.1	-6.9	-6.6	-6.1
(in percent of GDP)	-(6.1)	-(6.7)	-(4.2)	-(6.7)	-(6.0)	-(5.2)
Trade balance (goods)	0.8	1.3	1.7	-0.9	0.9	1.4
Exports	20.8	21.5	22.9	23.8	29.3	32.3
Imports	-20.1	-20.2	-21.2	-24.7	-28.4	-30.9
Terms of trade (percent change)	-1.0	-1.6	0.9	0.0	0.9	0.5
Foreign assets and liabilities ($NZ billion) 7/						
Net international investment position 8/	-70.9	-79.9	-89.3	-87.1	-87.1	...
(in percent of GDP)	-(77.5)	-(83.9)	-(90.9)	-(88.0)	-(83.9)	...
Gross short-term external debt 9/	36.9	38.2	40.9	43.7	54.1	...
Gross foreign currency denominated debt	32.8	33.5	43.6	48.7	57.9	...
Official reserves	8.4	7.7	8.0	8.6	7.1 10/	...
Exchange rate (end of period)						
US$/$NZ	0.71	0.58	0.53	0.51	0.40 6/	...
TWI 11/	67.5	62.2	55.4	54.3	46.8 6/	...
Nominal effective exchange rate 12/	116.9	109.6	94.1	93.3	89.0 10/	...
Real effective exchange rate 12/	112.2	104.5	89.1	87.8	84.1 10/	...

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

1/ Estimate of national saving equals investment plus current account balance excluding migrants' transfers.
2/ Fiscal year ending June 30.
3/ Equals revenue less expenditure plus net surplus attributable to state-owned and Crown entities.
4/ Staff estimates; equals operating balance net of cyclical effects, revaluations and changes in accounting rules.
5/ August 2000.
6/ October 6, 2000.
7/ Data for end-March of each year.
8/ Data based on International Investment Position statistics.
9/ Residual maturity of less than one year; data based on Total Overseas Debt statistics.
10/ July 2000.
11/ Trade-weighted index (June 1979 = 100).
12/ IMF Information Notice System index (1990 = 100).

Table 2. New Zealand: Balance of Payments and External Debt, 1995-2000

(In percent of GDP)

	1995	1996	1997	1998	Est. 1999	Proj. 2000
Current account balance	-5.0	-6.1	-6.7	-4.2	-6.7	-6.0
Trade balance	1.6	0.8	1.3	1.7	-0.9	0.8
Exports, f.o.b.	22.8	22.0	22.1	23.2	23.4	26.9
Imports, f.o.b.	-21.2	-21.2	-20.8	-21.5	-24.2	-26.1
Services balance	-0.3	-0.4	-1.0	-1.5	-0.5	-0.6
Receipts	7.6	7.1	6.7	7.1	8.0	8.5
Payments	-7.9	-7.5	-7.6	-8.6	-8.5	-9.0
Income balance	-6.7	-7.2	-7.5	-5.0	-5.8	-6.7
Receipts	1.6	0.6	0.7	1.7	1.7	1.2
Payments	-8.2	-7.8	-8.1	-6.6	-7.5	-7.9
Transfers balance	0.3	0.7	0.4	0.5	0.4	0.4
Inflows	0.9	1.4	1.1	1.3	1.2	1.2
Outflows	-0.6	-0.6	-0.7	-0.8	-0.8	-0.8
Capital and financial account balance 1/	2.1	7.5	6.6	1.7	4.1	...
Capital account (net)	2.1	2.1	0.4	0.1	0.0	...
Financial account (net)	7.8	5.5	6.3	1.6	4.1	...
Direct investment (net)	6.7	5.8	4.1	0.0	3.3	...
Portfolio investment (net)	-0.3	-0.8	-1.9	-0.8	-1.0	...
Equity securities (net)	-0.5	-0.3	-1.3	-0.4	0.1	...
Debt securities (net)	0.2	-0.6	-0.6	-0.4	-0.4	...
Other investment (net)	1.4	0.5	4.0	2.4	1.8	...
Net errors and omissions 2/	3.6	1.3	-2.1	1.6	2.2	...
Overall balance 3/	0.6	2.7	-2.2	-0.9	-0.4	...
(assets and liabilities as of end-March)						
Total external debt 4/	80.8	82.5	85.4	101.1	103.4	105.0
Short-term 5/	38.5	40.3	40.2	41.7	44.1	52.1
Long-term	40.2	39.1	41.8	56.8	53.8	49.0
Unallocated estimate	2.2	3.0	3.5	2.6	5.5	3.9
Net international investment position 6/	-82.1	-77.5	-83.9	-90.9	-88.0	-83.9
Net equity	-19.6	-17.1	-19.7	-23.5	-12.6	-6.5
Net debt	-62.5	-60.4	-64.2	-67.4	-82.7	-85.0
Official reserves	6.8	8.4	7.7	8.0	8.6	7.8
(in months of future imports of g&s)	(2.9)	(3.0)	(2.8)	(3.0)	(2.5)	(2.4)
(as percent of short-term debt 5/)	(17.5)	(20.9)	(19.1)	(19.1)	(19.4)	(14.9)

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

1/ Based on IFS data; The figure for 1999 represents first quarter at annual rate.
2/ Calculated as a residual.
3/ Based on IFS data.
4/ Data based on Total Overseas Debt statistics.
5/ Residual maturity of less than one year.
6/ Data for end-March of each year, based on the International Investment Position statistics.

Table 3. New Zealand: Central Government Budget, 1994/95-2000/01 1/

	1994/95	1995/96	1996/97	1997/98	1998/99	1999/00	2000/01 Budget
	(In billions of New Zealand dollars)						
Revenue	33.6	35.1	34.8	35.6	36.4	36.5	38.4
Tax revenue	30.2	32.3	31.9	33.0	32.2	34.0	36.2
Direct taxation	19.8	21.3	20.2	21.3	20.3	21.5	23.2
Indirect taxation	10.4	11.0	11.8	11.7	11.9	12.5	12.9
Non-tax revenue	3.4	2.8	2.9	2.6	4.2	2.5	2.2
Expenditure	30.4	31.7	33.0	34.2	35.8	36.2	38.1
Social security and welfare	11.7	11.2	11.9	12.5	12.9	12.9	13.7
NZ Superannuation	5.2	5.3	5.3	5.4	5.1	5.1	5.3
Other	6.6	6.0	6.5	7.1	7.8	7.8	8.5
Health	4.9	5.2	5.6	6.0	6.6	6.9	7.2
Education	4.8	4.9	5.3	5.7	5.9	6.3	6.8
Defense	1.0	1.0	0.9	1.1	1.0	1.2	1.1
Finance costs	3.8	3.7	3.1	2.8	2.5	2.4	2.5
Other	4.2	5.7	6.1	6.1	6.9	6.5	6.7
Revenue less expenses	3.2	3.3	1.8	1.4	0.5	0.4	0.3
Net surplus from SOEs and Crown entities	-0.6	0.0	0.1	1.2	1.2	1.1	0.7
Operating balance 2/	2.6	3.3	1.9	2.5	1.8	1.4	1.0
Gross Crown debt	44.1	41.5	36.0	37.9	36.7	36.0	36.1
Net Crown debt	32.6	28.6	25.3	24.1	21.7	21.4	22.3
Memorandum item: GDP	88.1	92.4	96.0	98.1	100.0	105.9	113.1
	(In percent of GDP)						
Revenue	38.2	38.0	36.2	36.3	36.4	34.5	33.9
Tax revenue	34.3	34.9	33.2	33.6	32.2	32.1	32.0
Direct taxation	22.5	23.0	21.0	21.7	20.3	20.3	20.5
Indirect taxation	11.8	11.9	12.3	11.9	11.9	11.8	11.4
Non-tax revenue	3.9	3.0	3.0	2.6	4.2	2.4	2.0
Expenditure	34.5	34.4	34.3	34.9	35.8	34.2	33.6
Social security and welfare	13.3	12.2	12.4	12.7	12.9	12.2	12.1
NZ Superannuation	5.9	5.7	5.6	5.5	5.1	4.8	4.6
Other	7.5	6.5	6.8	7.3	7.8	7.4	7.5
Health	5.5	5.7	5.9	6.1	6.6	6.5	6.4
Education	5.5	5.4	5.6	5.8	5.9	6.0	6.0
Defense	1.2	1.0	1.0	1.1	1.0	1.2	1.0
Finance costs	4.3	4.0	3.2	2.9	2.5	2.2	2.2
Other	4.8	6.1	6.3	6.2	6.9	6.1	5.9
Revenue less expenses	3.7	3.6	1.9	1.4	0.5	0.3	0.3
Net surplus from SOEs and Crown entities	-0.6	0.0	0.1	1.2	1.2	1.0	0.6
Operating balance 2/	3.0	3.6	2.0	2.6	1.8	1.4 /4	0.9
Estimated structural balance 3/	0.9	1.9	0.4	1.5	0.6	0.6	0.9
Crown debt							
Gross	50.1	44.9	37.5	38.6	36.7	34.0	31.9
Net	37.0	31.0	26.4	24.5	21.7	20.2	19.7

Sources: New Zealand Treasury, Budget Economic and Fiscal Update; financial statements of the Government of New Zealand for the year ended 30 June 2000; and staff estimates and projections.

1/ Fiscal year ending June 30.
2/ Equals revenue less expenditure plus net surplus attributable to state-owned and Crown entities.
3/ Staff estimates; equals operating balance net of cyclical effects, revaluations and changes in accounting rules.
4/ Includes $NZ519 million corresponding to movements in ACC valuations.

New Zealand—Medium-Term Scenario

Background

This scenario illustrates the medium-term dynamics of key economic variables such as growth, inflation, and the current account. In particular, it takes into account the impact of the authorities' medium-term fiscal consolidation plans and the real effective depreciation of the New Zealand dollar since 1997 on the dynamics of the current account deficit and net external liabilities.

Given the strong dependence of the New Zealand economy on the external environment, the economic outlook is largely conditioned by future regional and global developments. The scenario presented here is consistent with the latest global WEO projections of partner-country demand and world prices for New Zealand's exports and imports.

Near-term outlook

- Following the sharp acceleration of growth in the second half of 1999, activity weakened in the first half of 2000 with a slowdown in domestic demand.

- Relatively sharp differences have recently emerged between the domestically-oriented sectors and the external sector. Domestic demand growth and the urban, nontradeables sector are slowing as a result of successive interest rate hikes, the generally moribund stock market, and a sharp fall in business confidence, related in part to government policy changes which is reflected in lower investment intentions. On the other hand, the rural sector and exporting industries have been buoyed by a recovery from 2 years of drought, the very competitive exchange rate as well as strong demand in key export markets. Consequently, the composition of growth has shifted sharply toward net exports and away from domestic demand.

- Growth is projected at 3¾ percent in 2000, with the quarterly growth momentum is projected to slow sharply through the year. The annual average growth rate reflects the carryover effect of the rapid growth in the second half of 1999.

- The current account deficit is projected to narrow to 6 percent of GDP in 2000, down from 6¾ percent of GDP (adjusted for a large one-off defense-related import item) in 1999.

- Inflation in 2000 is expected to get close to and could even breach the 0–3 percent target band at end-2000, with increasing pass-through of the exchange rate depreciation but will remain at 2½ percent on average.

Medium-term outlook

- Growth is projected to fall to 3¼ percent in 2001 and then gradually slow to its medium-term potential rate of about 2½ percent.

- The current account deficit is projected to fall steadily (reaching about 4 percent of GDP in 2005), mainly due to a sustained improvement in the trade balance. This is based on a projected firm recovery in import demand in trading partners, and the lagged impact of stronger competitiveness as a result of the large real effective depreciation of the New Zealand dollar.

- Net foreign liabilities are projected to stabilize at about 99 percent of GDP in 2000.

- Inflation is projected to remain above 2 percent over the next two years with the negative output gap having been closed in 2000 while gradually approaching the midpoint of the authorities' 0-3 percent target band. Further out in the medium term it is projected to remain close to the midpoint of the band.

Saving-Investment balance

- The improvement in the current account is projected to occur as a result of higher national saving, which more than offsets the cyclical recovery in investment rates from their depressed levels in 1998-99.

- Higher national saving rates are expected due to increases of roughly the same magnitude of both public saving (in line with the authorities' medium-term fiscal projections) and private saving.

- The projected increase in private saving reflects both the impact of high household debt levels and the leveling-off of household net worth since 1997, following sizable increases during the 1990s.

Sensitivity analysis

The staff has conducted sensitivity analysis of the illustrative baseline scenario to examine the impact of :

- **A 100 basis point increase in the risk premium on foreign liabilities**.

- **A deterioration of terms of trade by five percent through higher import prices**. In both these scenarios, the current account adjustment is much smaller with the deficit remaining above or at about 6 percent of GDP through 2005—the end of the projection period—when net foreign liabilities would increase to 107 percent of GDP.

- **A 2 percentage point drop in external demand.** The reduction in the current account deficit is again slower than in the central scenario, reaching 5 percent of GDP by 2005. Net foreign liabilities would increase gradually over the period projection to 104 percent of GDP.

- **A 10 percent depreciation of the trade weighted exchange rate from its level in Q3, 2000.** By the end of the projection period the current account deficit would fall to 2¾ percent of GDP and net foreign liabilities would decline to 88 percent of GDP.

- **Lower growth caused by weak domestic demand.** The reduction in the current account deficit would be faster than in the baseline scenario, reaching 3 percent of GDP by 2005 while net foreign liabilities would decline to 96 percent of GDP.

Each scenario assumes a single shock. It is, of course, possible to envisage a situation where more than one of these shocks take place at the same time. In these circumstances, in some cases (e.g., if there is a deterioration in the terms of trade coupled with an increase in the risk premium), external imbalances could deteriorate significantly. In other cases, (e.g., a further depreciation of the exchange rate coupled with weaker domestic demand), there could be a substantial improvement in external balances.

New Zealand: Medium-Term Scenario, 1996-2005

	1996	1997	1998	1999	2000	2001	2002	2003	2004	2005
					Proj.					
Real growth (percent change)										
GDP	3.2	2.1	-0.2	3.4	3.8	3.2	3.0	2.7	2.7	2.6
Domestic demand	4.2	3.3	-0.2	5.8	3.4	3.1	3.0	2.8	2.8	2.7
Consumption	4.2	3.2	1.1	3.7	2.6	2.2	2.2	2.2	2.2	2.1
Private consumption	4.6	2.7	1.7	2.8	2.7	2.5	2.4	2.2	2.3	2.2
Fixed Investment	7.0	3.8	-1.9	8.3	7.9	5.6	5.6	4.6	4.5	4.5
Exports of goods and services	3.4	2.9	2.5	5.1	9.1	8.0	7.3	6.9	6.5	6.4
(Imports in trading partners)	(10.6)	(8.5)	(8.4)	(0.6)	6.8	10.2	8.2	7.3	7.2	6.9
Imports of goods and services	8.3	4.2	2.5	11.9	6.8	7.3	7.0	6.6	6.4	6.4
Saving and investment (percent of GDP)										
Gross capital formation	22.2	21.2	19.6	20.4	21.8	22.2	22.5	22.7	22.8	23.0
Fixed investment	21.2	20.5	19.4	19.3	20.8	21.2	21.5	21.6	21.8	22.0
Increase in stocks	0.9	0.7	0.2	1.1	1.0	1.1	1.1	1.0	1.0	1.0
National saving 1/	15.1	13.6	14.4	12.7	14.8	16.1	16.8	17.3	17.7	18.1
Private	9.0	8.4	9.3	7.6	9.5	10.8	11.5	12.0	12.4	12.9
Public	6.1	5.3	5.1	5.1	5.3	5.3	5.3	5.3	5.3	5.3
Inflation and unemployment										
CPIX inflation	2.3	1.7	1.6	1.1	2.5	2.5	1.9	1.9	1.8	1.6
Unemployment rate	6.1	6.7	7.5	6.8	6.4	6.4	6.2	6.1	6.0	5.9
Output gap	1.2	1.2	-1.7	-1.0	0.0	0.2	0.3	0.1	0.0	-0.1
Government budget (percent of GDP) 2/										
Revenue	38.0	36.2	36.3	36.4	34.5	33.9	33.5	33.3	33.1	33.1
Expenditure	34.4	34.3	34.9	35.8	34.2	33.6	32.3	31.8	31.3	30.9
Net surplus from SOEs and Crown entities	0.0	0.1	1.2	1.2	1.0	0.6	0.5	0.6	0.6	0.6
Operating balance	3.6	2.0	2.6	1.8	1.4	0.9	1.7	2.2	2.4	2.8
Estimated structural balance 3/	1.9	0.4	1.5	0.6	0.6	0.9	1.5	2.0	2.2	2.6
Net Crown debt	31.0	26.4	24.5	21.7	20.2	19.7	18.1	16.8	15.7	13.1
Terms of trade (percent change, goods)	-1.0	-1.6	0.9	0.0	0.9	0.5	0.3	0.2	0.1	0.1
Balance of payments (percent of GDP)										
Current account balance	-6.1	-6.7	-4.2	-6.7	-6.0	-5.2	-4.8	-4.4	-4.2	-3.9
Balance on goods and services	0.4	0.4	0.2	-1.3	0.2	1.0	1.5	1.9	2.1	2.3
Balance on goods	0.8	1.3	1.7	-0.9	0.8	1.2	1.4	1.6	1.7	1.8
Balance on services	-0.4	-1.0	-1.5	-0.5	-0.6	-0.2	0.1	0.3	0.4	0.6
Balance on income and transfers	-6.5	-7.1	-4.4	-5.4	-6.3	-6.2	-6.2	-6.3	-6.3	-6.3
Balance on income	-7.2	-7.5	-5.0	-5.8	-6.7	-6.6	-6.6	-6.6	-6.6	-6.6
Balance on transfers	0.7	0.4	0.5	0.4	0.4	0.4	0.4	0.4	0.4	0.4
Net foreign liabilities (percent of GDP) 4/	82.0	89.4	96.4	100.2	100.7	99.5	99.7	99.7	99.4	99.0

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

1/ Staff estimates; based on national accounts data.
2/ Fiscal years ending June 30.
3/ Staff estimates; equals operating balance net of cyclical effects, revaluations and changes in accounting rules.
4/ End of calendar year.

New Zealand—External Vulnerability Assessment

This Annex updates the staff's assessment of New Zealand's external vulnerability provided in SM/99/196 (August 3, 1999). On the whole, the assessment remains broadly unchanged. That is, while the extent of external imbalances remains very large, suggesting a high degree of external vulnerability to sudden changes in investor sentiment, several mitigating factors, including evidence from recent large movements in the exchange rate, lead the staff to conclude that the external risks remain manageable. However, the staff notes that some of the mitigating factors—such as the relatively benign currency and maturity composition of the debt—have deteriorated somewhat since the previous Article IV consultation, but that others—such as increases in debt to related parties—have helped to offset this somewhat.

The Annex is structured as follows: Section A decomposes New Zealand's gross external debt along sectoral, currency denomination, maturity and related party lines. Section B reports on the extent to which external exposures are hedged. Section C looks at the balance sheets of the household, banking and government sectors. Section D covers some remaining factors that come into play in assessing New Zealand's external vulnerability. Section E concludes.

A. Decomposition of External Debt[1]

New Zealand's gross external debt remains very high, and continues to rise rapidly. At end–March 2000, external debt totaled $NZ 109 billion, equivalent to 105 percent of GDP, up from 101 percent of GDP two years ago and 82 percent of GDP at end–March 1996 (Table 1).[2]

However, a decomposition of this debt paints a somewhat less alarming picture:

- *Official government sector external debt continues to fall.* This class of debt constituted 15 percent of total external debt at end–March 2000, down from 29 percent of external debt four years earlier. In nominal terms, official sector external debt fell from $NZ 22 billion at end–March 1996 to $NZ 16 billion at end–March 2000.

- *Most of the nominal increase in private sector debt corresponds to banks.* External debt of registered banks rose from $NZ 22 billion in 1996 to $NZ 51 billion at end-March 2000 while other corporate sector external debt rose from $NZ 32 billion to

[1] The bulk of the material in this section comes from "New Zealand's Total Overseas Debt, March 31, 2000," (Statistics New Zealand, June 2000).

[2] Net external liabilities at end-March 2000 were estimated at 102 percent of GDP, up from 75 percent of GDP four years earlier. Net equity as a share of net external liabilities has remained broadly constant over this period at about one quarter.

$NZ 42 billion over the same period. In relative terms, the external debt of registered banks rose from 24 percent of GDP at end–March 1996 to 33 percent of GDP at end-March 1998 and 49 percent at end-March 2000.

- *The local currency component of external debt remains relatively high, although it has dropped in the past two years.* New Zealand dollar denominated external debt as a share of total external debt stood at 43 percent at end–March 2000, down from 53 percent at both end–March 1996 and end–March 1998. In nominal terms, local currency denominated debt rose from $NZ 40 billion four years ago to $NZ 53 billion at end–March 1998 before falling to $NZ 47 billion at end–March 2000.

- *The maturity structure of the debt has moved somewhat toward the short end.* Short–term external debt (measured on a residual maturity basis) rose to 50 percent of total external debt at end–March 2000, as against 41 percent two years earlier and 49 percent at end-March 1996. Over 90 percent of the external short–term debt stock reflects original short–term maturities. Long–term external debt (defined here as having a maturity of over five years on a residual basis), which stood at 25 percent of total external debt at end–March 1996, fell to 21 percent of GDP at end–March 1998 and 15 percent at end–March 2000.

- *External debt owed to related parties (i.e., those non–resident creditors with a greater than 25 percent equity interest in the debtor) continues to rise sharply.* This class of debt constituted 60 percent of private sector debt at end–March 2000, up from 55 percent in 1998 and 51 percent in 1996. Alternatively put, 73 percent of the increase in corporate sector external debt over the past four years has been to related parties.

B. Hedging of Foreign Currency Exposures

An estimated 97 percent of New Zealand's foreign currency denominated external debt at end–March 2000 was hedged in some way.[3] This compares with 97 percent in 1999 and 95 percent in 1998. This ratio applies broadly for the three major foreign currency denominations (US dollar, Japanese Yen and Australian dollar).

About two thirds of the foreign currency external debt is hedged using financial derivatives, with about one third having natural hedges. The share of debt hedged with financial derivatives has increased from 54 percent in 1998.

Banks tend to hedge their foreign currency debt with derivatives; non–banks and the official sector tend to use natural hedges. Banks (which account for two thirds of the debt in the hedging supplement) hedged 81 percent of their foreign currency denominated

[3] Hedging information was collected as a supplement to the external debt survey beginning in 1999. The supplement covers an estimated 81 percent of external debt at end-March 2000.

debt using financial derivatives at end–March 2000, up from 73 percent in 1998. Conversely, non–banks and official entities hedged only 31 percent of their foreign currency debt at end–March 2000 using financial derivatives, down from 36 percent in 1998.

C. Balance Sheets

Household balance sheets have strengthened somewhat over the past decade, although New Zealand continues to lag behind the rest of the OECD. Net wealth in terms of personal disposable income rose from 339 percent in 1990 to 364 percent in 1999.[4] This level is below the OECD average, owing to New Zealand's low levels of net financial household wealth.[5] Net non–financial household wealth in New Zealand is broadly on a par with the rest of the OCED—net housing wealth accounts for over three–quarters of net wealth in New Zealand.

Household debt exceeded 110 percent of disposable income at end–1999, up from 61 percent in 1990. Moreover, households bear interest rate risk given the floating rate structure of mortgages in New Zealand. Also, since one–half of the households are reportedly debt free, the aggregate figures mask the extent of leverage in the other half of the household sector. Nevertheless, default rates have been historically low in New Zealand, even in times of high nominal interest rates and implied negative equity. The authorities explained that, unlike the United States, New Zealand does not have a default culture, and were of the view that mortgages would continue to be serviced even if net equity turned negative, provided that doing so was feasible on a flow basis. Also of note, there has been little or no margin borrowing on the part of households due to flat asset prices over the past few years.

Bank balance sheets appear to be very strong

- The capital adequacy ratio of locally incorporated banks in the recent past has consistently exceeded 10 percent of risk weighted assets, while tier 1 capital has exceeded 6 percent of such assets.

- Impaired assets of registered banks have held steady at around ½ of 1 percent of total lending since 1997, down from around 10 percent early last decade.

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[4] The Reserve Bank of New Zealand recently published a 20-year time series of household assets and liabilities (RBNZ Bulletin, Vol. 63, No. 2).

[5] This should be treated with some caution as it could reflect, inter alia, the tradition of (relatively generous) state provided pension and other benefits in New Zealand, which would tend to dampen the need for households to hold assets against these types of expenditures on their balance sheet. Looking ahead, any build-up of assets by the Government to pre-fund future superannuation expenditures may also have the effect of dampening net financial household assets.

- Stiff competition among banks is evident from interest margins below 2½ percent even though the sector is highly concentrated (see below).

- Profitability is high, exceeding 1 percent of assets. The return on equity ranges across major banks from 18 percent to 25 percent.

The public sector balance sheet is strong. Reflecting a period of fiscal operating surpluses, Crown net debt has fallen from over 30 percent of GDP in the mid–1990s to 22 percent in the most recent fiscal year, while Crown net worth has turned positive and now stands at 6 percent of GDP. Overall, the strength of public sector balance sheets is buttressed by the transparent accounting framework.

Contingent liabilities are minimal. For the public sector, this reflects the Fiscal Responsibility Act, which forces the government to bring such items into its reporting framework. Regarding the private sector, the authorities were of the view that contingent liabilities do not pose a major risk.

D. Other Factors

Spreads on New Zealand sovereign debt have remained broadly stable despite a widening of the current account deficit. The current account deficit increased from 5 percent of GDP in 1995 (and 1998) to 8 percent of GDP in the March quarter of 2000. Nevertheless, the spread on the 10–year New Zealand government bond has remained broadly unchanged since late 1996, averaging less than 100 basis points over comparable US Treasuries.

External pressures have manifested themselves in the exchange rate, which has depreciated sharply since the onset of the Asian crisis. The New Zealand dollar dropped by 20 percent in real effective terms from end–1996 to end–1998, and by an additional 3 percent in the second quarter of 2000. This has provided a test of the resilience of the financial system, which, as noted above, continues to have very strong balance sheets. It has also instilled a large investment in risk management techniques on the part of banks.

Both sovereign and commercial bank credit ratings continue to be favorable. Moody's rates New Zealand sovereign long–term foreign currency debt at Aa2, while S&P's current rating for such debt is AA+. Moody's downgraded New Zealand by one notch in September 1998 for this class of debt, while S&P upgraded New Zealand by one notch in January 1996. Australia, Canada, Sweden and Spain enjoy similar credit ratings for their sovereign long–term, foreign currency debt. In the banking sector, all but one small bank are rated A- or above by S&P.

The banking system is highly concentrated, with a heavy foreign presence. At end-1999, the five largest banks in New Zealand accounted for over 85 percent of total assets. Of these five bank, four are majority owned and controlled by major Australian banks.

The RBNZ has frequent contact with the supervisory authorities in Australia and other countries whose major banks operate in New Zealand.

The authorities have begun to consider a number of steps to further strengthen the banking system by dealing with the potential systemic risks arising from failures of foreign banks. By statute, the RBNZ has the power to put a failed bank under statutory management. In light of the practical difficulties in applying this approach to a branch (in terms of quickly ascertaining the branch's net asset position), the RBNZ is considering requiring systemically important banks to incorporate locally. Consultations have also begun with banks on the feasibility of applying a "haircut" to a failed bank's liabilities—which would effectively amount to freezing part of the liabilities to recapitalize the bank and allowing it to resume normal banking functions after only a few days—as well as on other failure management options.

E. Conclusion

Although several key vulnerability indicators—most notably gross external debt and the current account deficit—appear to be "blinking red," suggesting a significant degree of external vulnerability, a closer look leads to a more nuanced assessment.[6]

- An important share of the gross external debt is local currency denominated.
- Most of the recent increase in foreign currency debt has been to related parties (usually between banks), and therefore has "equity–like" characteristics.
- Although the maturity structure of external debt has been shortening somewhat of late, New Zealand continues to have a lower share of short–term external debt to total external debt than Australia.[7]
- Almost all of the exposure arising from external foreign currency-denominated debt has been hedged—this holds across sectors.
- New Zealand's floating exchange rate regime and transparent policy framework serves to bring any necessary exchange rate adjustments forward. The RBNZ has not intervened in the foreign currency market since 1985, and therefore provides no reason for markets to believe that there exist any "one-sided" bets regarding the exchange rate.

[6] Reserve-related indicators (which are not mentioned in this Annex) are not meaningful in New Zealand since the RBNZ has not intervened in the foreign exchange market since 1985 and holds few foreign assets.

[7] Cross country comparisons of this variable are difficult owing to the paucity of data.

- Balance sheets remain strong, particularly in the banking sector. Partly as a result of the floating exchange rate system, economic agents, and banks in particular, have made the adjustment to a culture of state of the art risk assessment and management. The degree of hedging in the economy attests to the extent of this culture beyond the banking system.

Table 1. New Zealand--Decomposition of Gross External Debt 1/

	End-March				
	1996	1997	1998	1999	2000
	(in billions of New Zealand dollars)				
Total gross external debt	75.4	81.3	99.3	102.4	109.1
By sector					
Official government	21.9	20.6	20.0	17.4	16.4
Corporate sector	53.5	60.7	79.4	85.0	92.7
By sub-sector					
Banks	21.9	24.4	32.9	39.5	51.0
Other corporate	31.7	36.2	46.5	45.5	41.7
By relation					
Related party	27.1	31.0	43.6	45.8	55.5
Non-related party	26.4	29.6	35.8	39.2	37.1
By currency					
New Zealand dollar	39.8	44.5	53.1	48.3	47.2
Foreign currency	32.8	33.5	43.6	48.7	57.9
US dollar	19.6	20.5	28.0	33.0	38.6
Japanese yen	4.7	4.1	4.9	5.5	8.2
Australian dollar	3.7	3.1	3.7	4.3	5.1
Other	4.8	5.8	7.0	5.9	5.9
Unallocated	2.8	3.3	2.6	5.4	4.0
By (residual) maturity					
Short-term (under 1 year)	36.9	38.2	40.9	43.7	54.1
Medium-term (1-5 years)	17.2	21.1	35.1	30.6	34.3
Long-term (over 5 years)	18.6	18.7	20.8	22.7	16.6
Unallocated	2.8	3.3	2.6	5.4	4.0

Table 1 (Continued). New Zealand--Decomposition of Gross External Debt 1/

	End-March				
	1996	1997	1998	1999	2000
	(in percent of GDP)				
Total gross external debt	82.5	85.4	101.1	103.4	105.0
By sector					
Official government	23.9	21.7	20.3	17.5	15.8
Corporate sector	58.5	63.7	80.8	85.8	89.3
By sub-sector					
Banks	23.9	25.7	33.5	39.9	49.1
Other corporate	34.6	38.1	47.3	46.0	40.2
By relation					
Related party	29.6	32.6	44.3	46.2	53.5
Non-related party	28.9	31.1	36.4	39.6	35.8
By currency					
New Zealand dollar	43.5	46.8	54.1	48.7	45.4
Foreign currency	35.9	35.2	44.4	49.1	55.7
US dollar	21.4	21.5	28.5	33.3	37.2
Japanese yen	5.2	4.3	5.0	5.5	7.9
Australian dollar	4.1	3.3	3.8	4.4	4.9
Other	5.2	6.1	7.1	5.9	5.7
Unallocated	3.0	3.5	2.6	5.5	3.9
By (residual) maturity					
Short-term (under 1 year)	40.3	40.2	41.7	44.1	52.1
Medium-term (1-5 years)	18.8	22.1	35.7	30.8	33.0
Long-term (over 5 years)	20.3	19.6	21.1	22.9	16.0
Unallocated	3.0	3.5	2.6	5.5	3.9

Table 1 (Concluded). New Zealand--Decomposition of Gross External Debt 1/

	End-March				
	1996	1997	1998	1999	2000
	(in percent of total gross external debt)				
Total gross external debt	100.0	100.0	100.0	100.0	100.0
By sector					
Official government	29.0	25.4	20.1	17.0	15.0
Corporate sector	71.0	74.6	79.9	83.0	85.0
By sub-sector					
Banks	29.0	30.1	33.1	38.6	46.7
Other corporate	42.0	44.5	46.8	44.5	38.3
By relation					
Related party	35.9	38.2	43.9	44.7	50.9
Non-related party	35.0	36.4	36.0	38.3	34.1
By currency					
New Zealand dollar	52.8	54.7	53.5	47.2	43.3
Foreign currency	43.5	41.2	43.9	47.5	53.0
US dollar	26.0	25.2	28.2	32.2	35.4
Japanese yen	6.2	5.0	5.0	5.3	7.5
Australian dollar	4.9	3.8	3.8	4.2	4.7
Other	6.3	7.2	7.0	5.8	5.4
Unallocated	3.7	4.1	2.6	5.3	3.7
By (residual) maturity					
Short-term (under 1 year)	48.9	47.0	41.2	42.7	49.6
Medium-term (1-5 years)	22.8	25.9	35.3	29.8	31.5
Long-term (over 5 years)	24.6	23.0	20.9	22.2	15.2
Unallocated	3.7	4.1	2.6	5.3	3.7

Source: Statistics New Zealand; and Fund staff estimates.

1/ Based on an "Overseas Debt Survey" comprising all official organizations known to have external debt, and corporate enterprises with external debt greater than $NZ 50 million.

Table 2. New Zealand--Hedging of Foreign Currency Denominated External Debt

	End-March		
	1998	1999	2000
	(in billions of New Zealand dollars)		
Foreign currency external debt (from Table 1)	43.6	48.7	57.9
Of which: covered by SNZ hedging supplement 1/	32.4	38.0	47.0
Coverage of supplement (in percent)	74.3	78.1	81.2
Type of hedge			
Hedged	30.8	36.9	45.4
Financial derivatives	17.6	24.5	30.6
Naturally hedged	13.2	12.4	14.8
Unhedged	1.7	1.1	1.6
Type of hedge (as a percentage of total debt in the Supplement)			
Hedged	94.9	97.2	96.6
Financial derivatives	54.1	64.5	65.1
Naturally hedged	40.7	32.7	31.5
Unhedged	5.1	2.8	3.4
By sector			
Banks	15.9	23.8	31.9
Financial derivatives	11.6	19.3	26.0
Naturally hedged	4.3	4.4	5.3
Unhedged	0.1	0.0	0.6
Non-banks and official	16.5	14.2	15.0
Financial derivatives	6.0	5.2	4.6
Naturally hedged	9.0	8.0	9.5
Unhedged	1.6	1.0	1.0
By sector (as a percentage of sectoral debt)			
Banks	100.0	100.0	100.0
Financial derivatives	72.8	81.3	81.4
Naturally hedged	26.8	18.5	16.6
Unhedged	0.4	0.2	2.0
Non-banks and official	100.0	100.0	100.0
Financial derivatives	36.2	36.3	30.6
Naturally hedged	54.1	56.4	63.0
Unhedged	9.7	7.3	6.4

Source: Statistics New Zealand.

1/ Hedging data were collected from a selection of respondents to the Overseas Debt Survey, and are intended to provide indicative information about the extent of hedging.

New Zealand - Fund Relations
(As of August 31, 2000)

I. Membership Status: Joined: 08/31/1961; Article VIII

II. **General Resources Account:**	SDR Million	Percent Quota
Quota	894.60	100.0
Fund Holdings of Currency	644.74	72.1
Reserve position in Fund	249.88	27.9
Operational budget transfers(net)	-1.00	

III. **SDR Department:**	SDR Million	Percent Allocation
Net cumulative allocation	141.32	100.0
Holdings	9.27	6.6
Designation Plan	14.00	

IV. **Outstanding Purchases and Loans:** None

V. **Financial Arrangements:** None

VI. **Projected Obligations to Fund:** None

VII. **Exchange Arrangement**:

The New Zealand dollar has floated freely since March 1985. New Zealand maintains an exchange system that is free of restrictions on international payments and transfers for current and capital transactions, with the exceptions of restrictions maintained in accordance with relevant U.N. Security Council Resolutions against Iraq, the Federal Republic of Yugoslavia (Serbia/Montenegro), and Libya, and which were all notified to the Fund pursuant to Decision No. 144.

VIII. **Article IV Consultation**:

New Zealand is on the 12-month consultation cycle. The 1999 Article IV consultation discussions were held during May 31 – June 8, 1999; the Executive Board discussed the staff report (SM/99/196, 8/3/99) and concluded the consultation on August 30, 1999.

IX. **Technical Assistance**: None

X. **Resident Representative/Advisor**: None

STATISTICAL ISSUES

Core Statistical Indicators

New Zealand publishes a wide array of economic and financial statistics, and regularly provides to the Fund the core statistical indicators necessary for surveillance.

International Reserves and Foreign Currency Liquidity

New Zealand's reporting of international reserves was modified in March 2000 to conform to the Special Data Dissemination Standards (SDDS). The format for presentation of this data for SDDS purposes is prescribed by the IMF in a data template on international reserves and foreign currency liquidity. The Bank has amended the definitions and presentation of international reserves data to conform to the SDDS standards and mapped the presentation in its own tables to the SDDS template. This template is updated each month and disseminated on the Bank's website before the end of the following month.

Consumer Price Index

Statistics New Zealand (SNZ) concluded its 5-yearly review of the CPI in September 1999. The Consumer Price Index (CPI) has been rebased to the June 1999 quarter and the basket of goods and services has been updated to be more representative of current household expenditure patterns. In particular the new index excludes interest charges and the cost of residential land. (Home ownership is now represented by the purchase and construction of new dwellings—excluding land, expenses of dwelling purchase, local government rates and charges, house repairs and maintenance expenses and house insurance costs). The new index includes internet charges, bank charges, cell phones and telephone purchases. The September 1999 quarter CPI was the first data point of the new index.

Retail Sales

SNZ is improving methods for producing more reliable and timely indicators of economic activity within New Zealand. As part of this process from 20 April 2000, an early estimate of monthly retail sales, called the Retail Sales Indicator is being published two weeks in advance of the final numbers, on an experimental basis.

Balance of Payments

With the release of the BOP statistics for the June quarter 1999, SNZ introduced the bulk of the changes required to meet BPM5 (Balance of Payments Manual, 5th edition) guidelines in respect of the current and capital accounts. There is a significant BPM5 change that remains to be implemented, concerning the financial account component "direct investment", and the associated current account item, "direct investment income". The changes are to introduce symmetry in the definition of direct investor in respect of both inward and outwards direct investment, and in the threshold for defining the financial account component, direct investment. Currently, SNZ BOP statistics use a 25 percent threshold, versus the 10 percent recommendation of BPM5. SNZ has decided not to use the 10 percent threshold and definitional symmetry until the implementation of the comprehensive quarterly international investment survey, beginning operation in the June 2000 quarter.

National Accounts

Statistics New Zealand will be upgrading its National Accounts from November of this year. The accounts will incorporate new annual benchmarks based on a full inter-industry study for the 1995/96 year (the current accounts are based on a 1986/7 benchmark). The accounts will also incorporate new Capital Stock estimates, annual chain-linked volume indexes, an industry classification (ANZSIC) based on ISIC Rev 3, and most changes required to align with the 1993 SNA, including estimation of FISM and its allocation between final and intermediate consumption. Some further SNA93 changes, including treatment of breeding livestock and dairy herds as capital stock will be introduced in 2001.

Other national accounts development priorities for 2000/2001 include updating and coverage extensions of sub-annual financial surveys, extension of annual survey data to include commercial property leasing, collection new of benchmark data on farm production, upgrades of sector income and outlay accounts, improved methodologies for overseas trade indexes, new volume measures for non-market services and development of sector balance sheets, starting with the household sector.

An experimental Tourism Satellite Account has been produced for the 1995 year and will be updated to 1999/2000. Work is also being done on developing environmental accounts.

New Zealand: Core Statistical Indicators

(As of August 31, 2000)

	Exchange rates	International Reserves	Reserve/ base money	Central Bank balance sheet	Broad money	Interest rates	Consumer price index	Exports/ imports	Current account balance	Overall government balance	External public debt	GDP/GNP
Date of latest observation	8/31/2000	July 2000	Week ending 8/23/2000	July 2000	July 2000	8/31/2000	June 2000	July 2000	March 2000	May 2000	May 2000	March 2000
Date received	8/31/2000	8/31/2000	8/31/2000	8/25/2000	8/25/2000	8/31/2000	7/17/2000	8/24/2000	6/15/2000	7/7/2000	7/7/2000	6/26/2000
Frequency of data	Daily	Monthly	Weekly	Monthly	Monthly	Daily	Quarterly	Monthly	Quarterly	Monthly	Quarterly	Quarterly
Frequency of reporting	Daily	Monthly	Weekly	Monthly	Monthly	Daily	Quarterly	Monthly	Quarterly	Monthly	Quarterly	Quarterly
Source of data	Reuters	RBNZ	RBNZ	RBNZ	RBNZ	Reuters	SNZ	SNZ	SNZ	Treasury	Treasury	SNZ
Mode of reporting	Electronic	Electronic	Electronic	Electronic	Electronic	Electronic	Electronic	Electronic	Electronic	Electronic	Electronic	Electronic
Confidentiality	Public	Public	Public	Public	Public	Public	Public	Public	Public	Public	Public	Public
Frequency of publication	Daily	Monthly	Weekly	Monthly	Monthly	Daily	Quarterly	Monthly	Quarterly	Monthly	Quarterly	Quarterly

Statement by the IMF Staff Representative on New Zealand
October 13, 2000

1. This statement contains information that has become available since the Staff Report (SM/00/211) was circulated to the Executive Board on September 22, 2000. The information does not alter the general thrust of the staff appraisal.

Recent Economic Developments and Outlook

2. **Economic activity was somewhat weaker than expected in the second quarter of the year**. Updated information released in the last week of September shows that the economy recorded zero growth in the first half of the year (GDP contracted by 0.7 percent (q/q) in the second quarter, bringing growth to 4½ percent (y/y)). A sharp fall in construction and weaker activity in the agriculture and manufacturing sectors accounted for the outcome. On the expenditure side, a decline in residential investment and negative net exports, reflecting high import volumes, were the main contributors (Figure 1).

3. **Forward indicators suggest continued weakness in activity in the third quarter but confirm that the strength of activity is likely to be quite different across sectors**. Consumer and business confidence surveys indicate that confidence remained weak in the third quarter, and that there remains a dichotomy between externally– and domestically–oriented sectors of the economy—optimism about export prospects and consumer sentiment in rural areas has risen, while expectations of domestically oriented activity remain weak. On the inflation front, the outlook is likewise mixed. On the one hand, surveyed inflation expectations and the fall in the unemployment rate in the second quarter to close to 6 percent would suggest continued inflationary pressures; on the other, the weakness in activity in the second and third quarters suggests the reemergence of a negative output gap which is likely to dampen price pressures.

4. **The New Zealand dollar remains near an all–time low, although the interventions in late September to support the Euro and the Australian dollar appear to have slowed the pace of its decline**. Since the beginning of the year, the $NZ has lost some 22 percent of its value against the US dollar; in trade–weighted terms it has fallen by some 15 percent.

5. **The current account deficit remained at about 7 percent of GDP in the second quarter of 2000, but indications of strong export growth suggest that the deficit could narrow to about 6 percent of GDP for the year as a whole (Figure 2)**. Exports in the three months to August were nearly 24 percent higher than the same period a year ago, with an estimated 7-8 percent of the increase reflecting higher volumes. Imports in the three months to August were some 17 percent higher than the same period a year ago, with a sharp increase in oil imports dominating this growth.

Recent Policy Developments

6. **The authorities decided to leave the Official Cash Rate (OCR) unchanged at 6.5 percent at their October review**. The rationale for the decision is that the medium–term inflation outlook remains uncertain (as discussed above). The authorities noted that although there will be a sharp increase in the CPI in the coming months, most of the increase can be attributed to one–off factors. Abstracting from the effects of tobacco excises, world oil prices and the fall in the exchange rate, inflation will remain within the target range of 0–3 percent. The staff supports this decision.

7. **As for the outlook for monetary policy in the period ahead**, in addition to the two scenarios outlined by the authorities (and reported in SM/00/211), the governor described a third possibility—that of stagflationary conditions where confidence and growth are low, but there is pressure for higher wages and thus even higher inflation than currently expected. The authorities noted that, in such circumstances, interest rates would have to be increased even if such a move proves detrimental to growth in the near term.

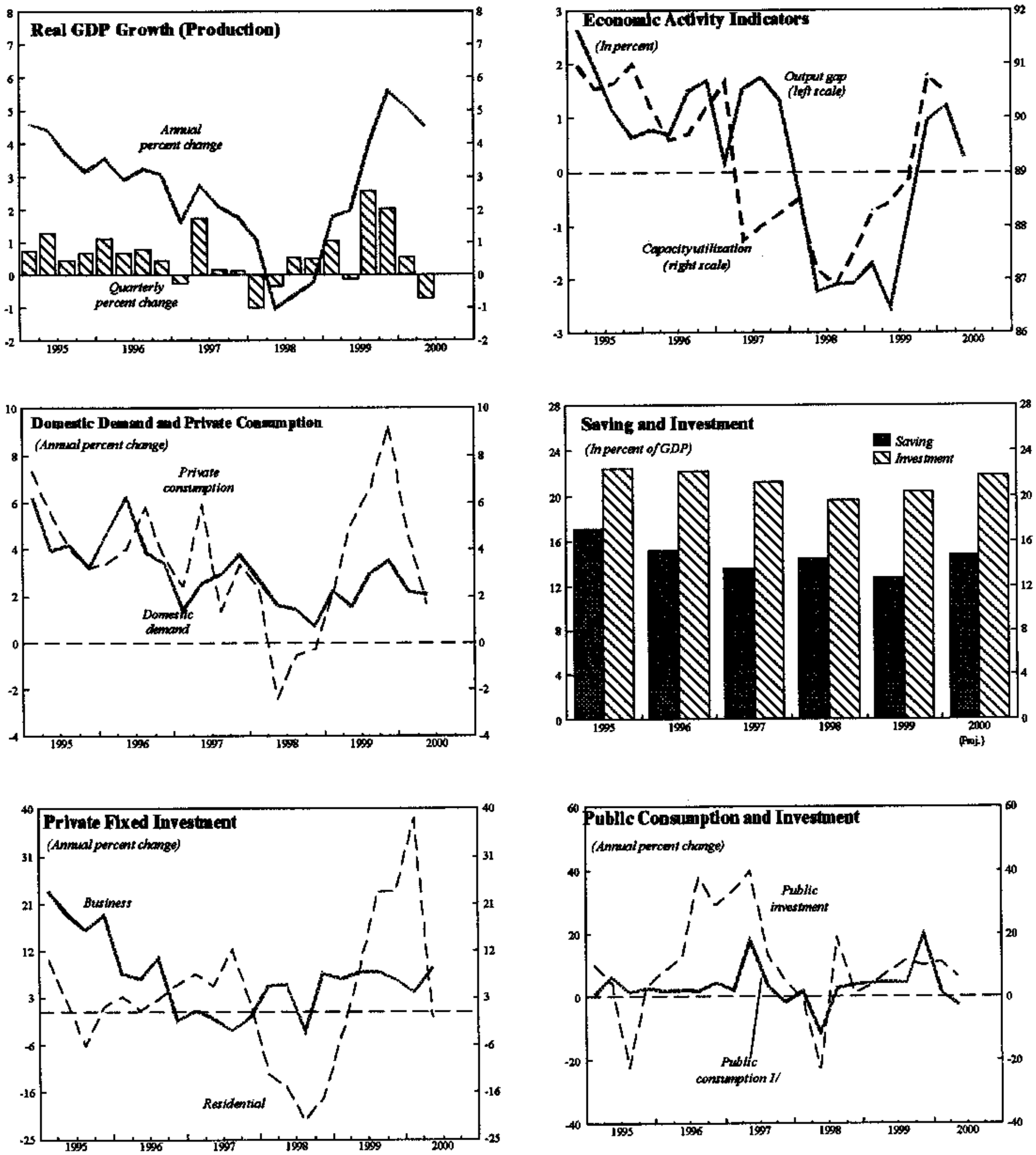
8. **At the invitation of the independent reviewer, the non–executive directors committee (NEDC) of the Board of the Reserve Bank recently presented their submission on the issues to be examined during the upcoming monetary policy review**. The main points of the NEDC submission include (a) that the existing single decision–maker model for monetary policy should be retained, due to "the strong accountability and the coherence in decision–making and policy communication that it makes possible"; (b) the Governor should cease to be the chair of the Board of the Bank, and this position should go to a non–executive member of the Board, who would be elected by the non–executive directors; and (c) a potential consequence of adding the clause in the PTA about avoiding unnecessary instability in financial markets and in the real economy could result in a blurring of the objective of, and accountabilities for, monetary policy.

9. **The RBNZ announced its intention to seek regulatory changes that will require overseas banks to establish locally incorporate subsidiaries instead of operating as branches**. Specifically, the changes would apply to banks in the following categories: (a) systemically important banks; (b) banks with significant retail deposits that are from countries where legislation gives home country depositors preferential claim if the bank is wound up—including the U.S. and Australia; and (c) banks with significant retail deposits which do not publish the information necessary for depositors to assess financial soundness.

10. **The Government formally unveiled on October 10 its plan to partially pre–fund future pension expenditures**. The thrust of the plan remains as described in the staff report. The draft legislation—which is to be introduced this year, with the aim of having the fund operational by July 1, 2001—consists of two parts, relating to entitlements and financing arrangements. The staff's assessment of the plan—namely that we are in broad support of plans to prepare for pressures on the budget from an aging population and would recommend consideration of parametric reforms of the public pension scheme—remains unchanged.

FIGURE 1
NEW ZEALAND

SELECTED REAL ECONOMIC INDICATORS, 1995-2000



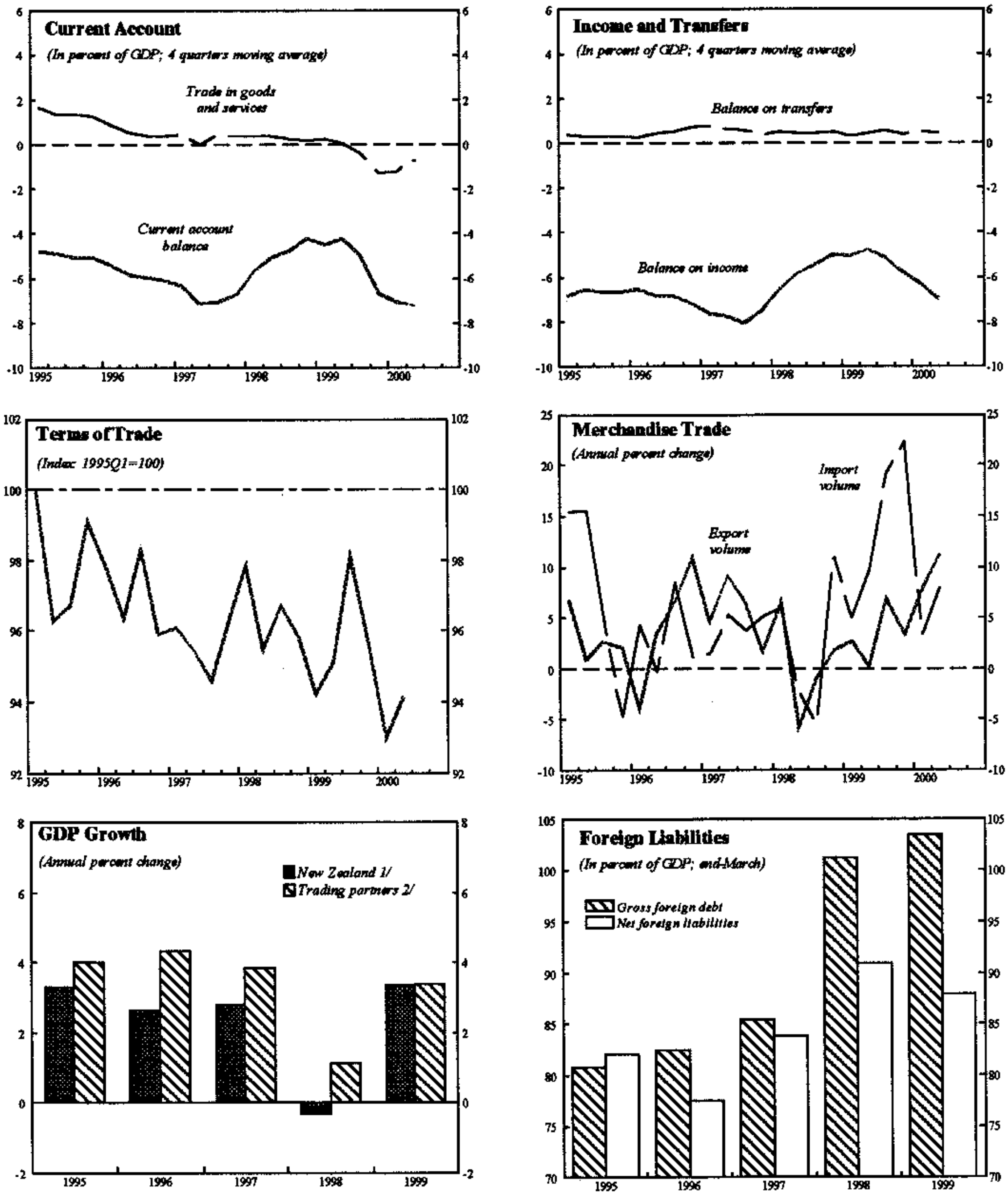
Sources: Statistics New Zealand; and staff estimates.

1/ 1999q4 excludes the purchase of a navy frigate equivalent to 0.6 percent of GDP.

q:\data\nzl\charts\sr00\nzlrcht.cmd

FIGURE 2
NEW ZEALAND

BALANCE OF PAYMENTS AND EXTERNAL INDICATORS, 1995-2000



Sources: Statistics New Zealand; IMF, World Economic Outlook; and staff estimates.
1/ Expenditure based.
2/ Exported-weighted average based on data for partner countries that account for at least 95 percent of trade of New Zealand.

INTERNATIONAL MONETARY FUND
Public Information Notice
EXTERNAL RELATIONS DEPARTMENT

Public Information Notice (PIN) No. 00/91
FOR IMMEDIATE RELEASE
October 27, 2000

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

IMF Concludes Article IV Consultation with New Zealand

On October 13, 2000, the Executive Board concluded the 2000 Article IV consultation with New Zealand.[1]

Background

Following the strong recovery in late 1999, growth in economic activity slowed markedly in the first half of 2000. A rebound in the agricultural sector following two successive droughts and strong domestic demand caused a sharp acceleration in growth in the second half of 1999, and resulted in an expansion in real GDP of 3½ percent for the year as a whole. Since the beginning of 2000, the composition of growth has shifted sharply toward net exports, and away from domestic demand. The recent decline in domestic business and consumer confidence and the fall in the $NZ to historical lows—attributed to large current account deficits, the perception that New Zealand is in a relatively weak position to benefit from the productivity gains of the "new" economy, as well as to some recent changes to government policies—has reinforced this shift. Forward indicators confirm that the strength of activity is likely to be different across sectors. Declining building consents, continued weak credit growth, and a moderation in retail sales and capacity utilization rates all point to slow domestic demand, but business confidence surveys indicate optimism about the outlook in externally oriented sectors.

Inflation remained low during 1999 and early 2000, despite the fall in the exchange rate and the tightening in input markets, as competitive pressures in both manufacturing and retail

[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. In this PIN, the main features of the Board's discussion are described.

sectors have limited the pass through of higher costs onto final consumer prices, but there are now signs of pipeline price pressures. Through the first quarter of 2000, the unemployment rate declined rapidly to the lowest level since 1996, and capacity utilization rates rose sharply. The target measure for inflation, however, remained between 1 and 1¼ percent during most of 1999, before moving slightly above the mid-point of the band (0-3 percent) in March 2000 and to 2 percent in the June quarter (mainly because of one off-factors, such as higher fuel prices and tobacco and alcohol excises).

The current account deficit widened to 7 percent of GDP in the year to Q2, 2000 but is likely to narrow considerably in 2000. The widening deficit reflected rapid import growth in 1999 as well as the deficit on the income account - in turn, reflecting New Zealand's high external indebtedness (net foreign liabilities are around 100 percent of GDP). After subdued agricultural export growth in 1999, export growth has been strong since early 2000, largely because of the boost to competitiveness from the fall in the real effective exchange rate this year and the recovery in farm output from the effects of the drought.

With the unexpectedly sharp recovery in output since mid-1999 and the resultant narrowing of the output gap, the RBNZ launched a monetary policy tightening cycle in November 1999, raising the Official Cash Rate five times (from 4½ percent to 6½ percent) through May 2000. However, citing the uncertain outlook for the period ahead, the RBNZ left the OCR unchanged at its August review.

The 2000/01 budget targets an operating surplus of 0.9 percent of GDP – consistent with a broadly unchanged fiscal policy stance – and increasing structural surpluses in the medium term. On the expenditure side, the budget places additional emphasis on social spending and industrial policy, while revenue growth is expected to exceed GDP growth owing to the tax increases implemented earlier in 2000. The government has reiterated its pre-budget commitment to adhere to a cap for new spending initiatives of $NZ 5.9 billion over the next three fiscal years. However, some two-thirds of that amount has already been committed, leaving a very tight constraint on spending for the rest of the term. Over the medium-term, operating surpluses are projected to rise steadily to 2½ percent of GDP in 2003/04, with a similar increase in the structural balance, and net debt is to fall to 16½ percent of GDP.

The new government has launched a number of initiatives to review and revise some aspects of structural policies. Key amongst these include a change in the industrial relations framework through the replacement of the Employment Contracts Act (ECA) with the new Employment Relations Act (ERA) strengthening the role of labor unions; the removal of the provisions for a competitive insurance market for workplace accidents introduced only in 1999 and the reinstatement of the state-run ACC as the monopoly provider; a review of competition policy; the freezing of previously planned unilateral tariff reductions; a review of monetary policy operations; and the proposed introduction of partial prefunding of public pension costs to smooth the transition associated with demographic changes.

As for the near- and medium-term outlook, the staff's projections are for output growth of about 3¾ percent in calendar year 2000 and to 2½-3 percent over the medium term. There are, however, considerable downside risks to these growth projections. The strong trading partner outlook and the large real effective depreciation of the exchange rate are expected to continue to provide a boost to exports, while the higher interest rates and falling confidence are expected to act as a dampener of domestic demand. These trends are projected to result in a narrowing of the current account deficit to about 6 percent of GDP in 2000, before tapering off gradually to around 4 percent by 2005. With little prospect of a strengthening of the $NZ in the near future and the long period of tightening margins, the pass-through to inflation of higher import prices should broaden, making it very likely that inflation will breach the upper band of the target range by the end of 2000. For the year as a whole, CPI inflation is forecast to be around 2½ percent in 2000 and 2001, and slightly above the mid-point of the target range over the medium term.

Executive Board Assessment

Executive Directors considered the resilience displayed by the New Zealand economy through the turbulence of the past 2-3 years as being clear testimony of the benefits of the economic reforms of the past 15 years. Following a short-lived recession in 1998, growth recovered strongly in the second half of 1999, owing to appropriate macroeconomic management, favorable weather conditions, and the recovery in the region; inflation remains under control; the current account deficit—albeit still high—now looks set to narrow markedly; and the financial and corporate sectors have fully absorbed the impact of the adverse shocks of the past 2-3 years without distress.

Directors endorsed the recent conduct of monetary policy and noted that the key challenge for the period ahead is to steer the economy pragmatically to support growth while avoiding a buildup of inflationary pressures. Although slowing activity suggests that the balance of risks may have shifted away from a sustained increase in inflationary pressures, Directors considered that, if a further tightening of monetary policy over the coming year became necessary, such tightening should be gradual and continuously reassessed in light of the uncertainty surrounding the strength of economic activity.

Directors regarded the targeted near- and medium-term fiscal operating surpluses as being appropriate from a demand management point of view and from the point of view of contributing to reducing external imbalances. However, they saw mainly downside risks to the achievement of these objectives, both because of weaker revenues resulting from lower growth, as well as the tight constraint on discretionary spending for the rest of this government's term. Because a key driver of sentiment is the market's perception of the government's ability to control public finances, Directors urged the authorities to keep a close watch on expenditures and to formulate well-specified contingency plans to offset possible slippages in achieving the targeted surpluses.

Directors noted that the large external imbalances and the fact that growth in New Zealand has not been sufficient to close more rapidly the gap with other advanced economies remain key policy concerns. In this context, they took the view that the reexamination of elements of the reform process may be appropriate. However, in light of New Zealand's vulnerability to external investor sentiment, it is especially important that the economic rationale for policy changes be well understood lest they be seen by markets as a step backwards, with attendant negative effects on investor confidence. At the same time, Directors sympathized with the authorities' view that trade restrictions in partner countries are hampering growth.

Directors took the view that, to increase the growth dividend, additional actions are necessary in some areas, while in others there is a need to avoid the risk of weakening the gains that have already been achieved. They noted that the authorities' focus on human capital development is appropriate, but pointed out that the increase in tax rates on high-income earners could exacerbate the country's "brain drain." Directors welcomed the ongoing reforms to deregulate parts of the agricultural sector, and recommended more rapid progress in deregulating the dairy sector. It was noted, however, that limits to expansion of this sector arise from partner country protection.

Directors cautioned against undertaking reforms that could reduce labor and product market flexibility, and suggested that the authorities be flexible and pragmatic in implementing such measures. Chief among these are the Employment Relations Act and the restoration of the ACC as the monopoly provider of workplace accident insurance. In this regard, it was noted that the review of the telecommunications sector was intended to enhance competition. Directors noted that efforts to coordinate and integrate ongoing economic and industry development programs are useful, but suggested that the role of Industry New Zealand be tightly specified from the start so as to prevent a drift into activist industrial and regional development policies.

Directors commended the authorities for their proposals to address the longer-term pressures on public pension expenditure. They expressed broad support for the authorities' plans to pre-fund a part of future pension liabilities by building up a separate trust fund, and sought early progress in defining institutional arrangements and the investment strategy to safeguard the fund's assets. Directors also suggested that consideration be given to parametric reforms to lower future pension costs and encourage private saving.

As for private saving, Directors considered that the recent increases in top income tax rates and in the pension benefit rate could lower private saving, and suggested that the forthcoming comprehensive review of the tax and transfer regimes focus on clearly identifying and removing disincentives to private saving and to productive investment.

Directors welcomed the fact that the primacy of the price stability objective and the autonomy of the Reserve Bank of New Zealand are not subject to review in the upcoming monetary policy review. They observed, however, that the inclusion of additional clauses in the contract that governs the conduct of monetary policy could reduce the clarity of the framework and, over time, could complicate monetary policy formulation. Directors also cautioned against actions that could be perceived as weakening instrument independence of the Reserve Bank.

As for New Zealand's external vulnerability, Directors noted that the country continues to be well placed to absorb shocks without undue economic or financial distress, as evidenced by the experience of adjustment to shocks over the past few years. In particular, the high degree of hedging tends to mitigate the external vulnerability of New Zealand's economy. However, the large external imbalances imply that New Zealand remains vulnerable to sharp changes in investor sentiment. Thus, policymakers have to be especially mindful of the effects of their actions on confidence and focus on policies that are clearly aimed at reducing disincentives to saving, and improving the economy's competitiveness and medium-term growth prospects.

Directors commended the authorities for the high quality of economic and financial statistics and welcomed the efforts to improve the frequency, timeliness, and coverage of these statistics.

Public Information Notices (PINs) are issued, (i) at the request of a member country, following the conclusion of the Article IV consultation for countries seeking to make known the views of the IMF to the public. This action is intended to strengthen IMF surveillance over the economic policies of member countries by increasing the transparency of the IMF's assessment of these policies; and (ii) following policy discussions in the Executive Board at the decision of the Board. As part of a pilot project, the staff report for the 2000 Article IV consultation with New Zealand is also available.

New Zealand: Selected Economic and Financial Indicators, 1996-2000

	1996	1997	1998	1999	Proj 2000
	(Percent change)				
Real economy					
Real GDP	3.2	2.1	-0.2	3.4	3.8
Real domestic demand	4.2	3.3	-0.2	5.8	3.4
Real exports	3.4	2.9	2.5	5.1	9.1
Real imports	8.3	4.2	2.5	11.9	6.8
Inflation (CPI excluding credit services)	2.3	1.7	1.6	1.1	2.5
Unemployment rate (in percent)	6.1	6.7	7.5	6.8	6.4
Gross national saving (annual percent of GDP) 1/	15.1	13.6	14.4	12.7	14.8
Gross capital formation (annual percent of GDP)	22.2	21.2	19.6	20.4	21.8
	(Percent of GDP, years ending June)				
Government budget					
Revenue	38.0	36.2	36.3	36.4	34.5
Expenditure	34.4	34.3	34.9	35.8	34.2
Operating balance	3.6	2.0	2.6	1.8	1.4
Estimated structural balance 2/	1.9	0.4	1.5	0.6	0.6
Net public debt	31.0	26.4	24.5	21.7	20.2
	(End of period)				
Money and credit					
M3 (change in percent)	12.7	4.2	1.1	6.9	-0.1 3/
Private domestic credit (change in percent)	12.5	10.1	7.6	10.6	6.1 3/
Interest rate (90-day, in percent)	8.1	8.3	4.4	5.7	6.7 4/
Government bond yield (10-year, in percent)	7.2	7.0	5.4	7.2	6.8 4/
	(Percent of GDP)				
Balance of payments					
Current account balance	-6.1	-6.7	-4.2	-6.7	-6.0
Capital and financial account	7.5	6.6	1.7	4.1	...
	(Percent of GDP, years ending March)				
External assets and liabilities					
Official reserves	8.4	7.7	8.0	8.6	7.1
Gross external debt	82.5	85.4	101.1	103.4	105.0
Net external liabilities	77.5	83.9	90.9	88.0	83.9
	(End of period)				
Exchange rate					
US$/$NZ	0.71	0.58	0.53	0.51	0.40 3/
Nominal effective exchange rate 5/	116.9	109.6	94.1	93.3	89.0 6/
Real effective exchange rate 5/	112.2	104.5	89.1	87.8	84.1 6/

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

1/ Staff estimates; based on national accounts data.
2/ Staff estimates; equals operating balance net of cyclical effects, revaluations and changes in
3/ August 2000.
4/ October 6, 2000.
5/ IMF Information Notice System index (1990 = 100).
6/ July 2000.

**Statement by Gregory Taylor, Executive Director
and Ian Woolford, Advisor
for New Zealand
October 13, 2000**

Overall Assessment

The New Zealand authorities appreciate the balanced assessment in the Staff report. They are pleased that their position has, in the main, been clearly and accurately portrayed (although there are some points of clarification that we draw to the Directors' and Staff's attention).

My authorities endorse the Staff's views on the:

- importance of maintaining international investor confidence in light of New Zealand's large current account deficit and relatively high level of external debt;

- resilience of the economy in response to a difficult set of challenges over the past 2-3 years - this resilience being an important benefit of the economic reforms undertaken over the last 15 years;

- appropriateness of the recent conduct of monetary policy and the challenges that lie ahead;

- need to maintain confidence in the Government's fiscal strategy to support domestic confidence and the confidence of overseas investors;

- need to be pragmatic in the implementation of policy; and

- the desirability of removing private disincentives to save and encourage more productive investment.

Similarly, the short and medium-term macroeconomic outlook presented by the Staff is broadly consistent with the authorities' own assessment. Like staff, they see the key near-term macroeconomic policy challenge as being to successfully manage through the difficulties posed by a weak currency, rising oil prices and low domestic confidence to what are still good prospects for sustained economic growth in 2001 and 2002.

I. MACROECONOMIC POLICIES

The authorities agree with the Staff's assessment that the broad range of micro and macroeconomic reforms, including labour markets, product markets and financial and other capital markets, have increased the ability of the New Zealand economy to respond robustly to the wide-ranging nature of shocks over the past 2-3 years. Significant reforms have also occurred in tax and transfer policy over the last decade. Relative to other OECD countries, economic reform in New Zealand has been rapid and extensive.
Reflecting this, the economy came through the Asian crisis, adverse climatic conditions through 1997 and 1998 and a major slide in the currency relatively unscathed, and the financial system remains in good health.

The authorities recognise the difficulties for economic management posed by shifts in international investor sentiment and exchange rate changes. This is something that New Zealand has in common with many other economies at present, particularly smaller open economies. However, we believe that the Government's current macroeconomic strategy is appropriate. Monetary policy continues to be focused on maintaining price stability. Despite short-term volatility in the economy, the Government is maintaining a fiscal track that is consistent with surpluses over the course of the business cycle, falling official debt and a gradually reducing level of government spending as a proportion of GDP.

In addition, within this appropriate fiscal stance, the Government is investing additional resources in the development of both general education and advanced technical skills, promoting increased private sector research and development, and encouraging the development of more competitive export industries. Together, these policies will contribute to an improvement in New Zealand's growth performance, in the medium term.

II. MONETARY POLICY

The Government and the Reserve Bank remain committed to the goal of maintaining price stability. The period ahead poses many challenges for monetary policy, but the authorities have confidence that the Reserve Bank's operating framework and the Policy Targets Agreement (PTA)--the document that specifies the inflation target--have evolved in a way that will allow the Bank to work though these challenges to best effect.

The authorities would like to make it clear that there has been no change to the Act, nor to the PTA, that would have the effect of weakening the operational independence of the Reserve Bank or to change the price stability objective of monetary policy. And no changes are proposed to either of these core features of the New Zealand monetary policy framework.

We say this because, in paragraph 35 of the report, the Staff indicate that the "government has implemented a change in the Policy Targets Agreement ...". This wording may cause the reader to infer that the Government has unilaterally changed the PTA, which is not correct. Under the Act governing monetary policy, the Government has no power to unilaterally change the PTA (except where the formal over-ride is used to require the Reserve Bank to conduct monetary policy for a purpose other than price stability). Except where the formal override power is used, the PTA can only be modified by mutual agreement between the Government and the Reserve Bank. The present Government has made it very clear that it has absolutely no intention of using the over-ride facility of the Act - ie monetary policy will continue to be directed solely at price stability.

Moreover, in the Staff report, the changes to the PTA in December 1999, requiring the Bank to seek to avoid unnecessary instability in output, interest rates and the exchange rate, are characterised as being part of a move from a "relatively strict to a more flexible inflation targeting framework". This is not the way that either the Government or the Bank sees it. The Reserve Bank has always been mindful of the potential for monetary policy to influence variability in output, interest rates and the exchange rate. Subject to conducting monetary policy in a manner consistent with achieving and maintaining price stability, the Bank has always sought to minimize the potential for monetary policy to contribute to instability in these areas. The introduction of the requirement to seek to avoid unnecessary instability in output, interest rates and the exchange rate therefore largely formalises what is already the Reserve Bank's practice and implicit in the monetary policy framework.

The staff report also seems to suggest that the new PTA might be seen as a weakening of the Reserve Bank's operational independence. In fact, in the view of the Bank, the new PTA does not affect the Bank's "instrument independence". Under the new PTA, the Reserve Bank continues to have full autonomy in the formulation and implementation of monetary policy.

III. REVIEW OF MONETARY POLICY OPERATIONS

Ten years have passed since the Reserve Bank of New Zealand Act 1989 ("the Act") came into force on 1 February 1990. Having come through a period of transition to sustained price stability, the Government believes that it is now appropriate to review the way in which New Zealand's monetary policy is conducted and to assess its effectiveness in contributing to broader social and economic objectives. As noted by Staff, the goal of the review is to ensure that the monetary policy framework and the Reserve Bank's operations within that framework are appropriate to the characteristics of the New Zealand economy and best international practice. The fundamental principles underpinning the operation of monetary policy -- the sole objective of price stability and the operational independence of the Bank -- are not under review and will be preserved. The review is scheduled for completion at the end of February 2001. The review is being conducted by Professor Lars Svennson of Stockholm University.

IV. STRUCTURAL POLICIES

The Government has listened to market concerns about its policies and has made considerable effort to explain the Government's economic and social strategy. The authorities have been taking steps to reassure markets on the direction and substance of their policies, and recently have stepped up efforts in this area (with business and Government forums). The key objectives of the strategy, as set out in the March *Budget Policy Statement*, emphasize the importance of innovative business, effective government and strong communities together contributing to the well-being of New Zealanders. These objectives highlight the Government's focus on improving skills, enhancing the environment, strengthening national identity, and closing social and economic gaps between different sectors of the community.

The Government believes that some of the strengths of the reforms since the mid 1980s facilitated a vast improvement in the efficient allocation of resources, and an increase in transparency and accountability. They feel the economic direction they are now embarking on builds on the former reforms, by addressing some of the structural issues. However, they encourage staff to continue with their efforts to understand the role the reform process played in New Zealand's past and prospective growth performance.

It is important to note that from the economic viewpoint the Government's policies amount to no more than a modest rebalancing of policy. A number of measures are included - changes to the Commerce Act; reviews of whether competition in electricity and telecommunication markets can be enhanced; and the conclusion of a free trade agreement with Singapore – which the Government believes will strengthen competition and promote trade. The Government has also developed a program to lift performance in skills development and encourage the creation of an environment more sympathetic to the uptake of new technology.

Consistent with the Government's announced intentions to build a more participative and inclusive society, changes in employment law have been implemented. In this regard, it is important to be clear that the intention of the Employment Relations Act (which came into force on 1 October this year) is to restore fairness to the bargaining process rather than to increase union power *per se*. The government believes the new approach provides additional scope for improving productivity by promoting more cooperative solutions to employment issues and improved workforce morale.

While there is some scope for further innovation in the New Zealand dairy industry--primarily in the marketing of technology and development of higher value added products--the industry is already productive. While the staff focus on the need for the Government to exercise leadership, the New Zealand authorities would suggest that increasing leadership from trading partners in reducing protectionism would potentially have a greater impact on this sector's performance. More generally, we are disappointed that the appraisal has not pointed up more clearly to the deleterious effects on New Zealand's growth prospects from trade protectionism.

External Vulnerability

The authorities support the Staff's balanced and reasonable assessment of New Zealand's external vulnerability. As already noted, New Zealand has come through various economic shocks (including a substantial fall in the exchange rate, adverse climatic conditions and the Asian crisis) relatively smoothly. This reflects a number of factors, including the advantages associated with a floating exchange rate, sound and credible macroeconomic policy, high quality transparency arrangements, relatively flexible factor and product markets, relatively few distortions to relative prices and a robust financial sector.

In particular, the authorities note that the New Zealand financial system is almost fully hedged against currency risk, is strongly capitalized, has a very low level of non-performing loans, has relatively conservative exposure concentration and high quality and diversified overseas bank parentage. Similarly, the corporate sector in New Zealand is well hedged against currency risk and has been operating on relatively conservative leverage. These factors significantly reduce New Zealand's vulnerability to shifts in investor sentiment and other economic shocks.

V. FSAP

The proposal for an FSAP is under consideration by the authorities.