

New Zealand: 2001 Article IV Consultation—Staff Report; Staff Statement; Public Information Notice on the Executive Board Discussion; and Statement by the Executive Director for New Zealand

Under Article IV of the IMF's Articles of Agreement, the IMF holds bilateral discussions with members, usually every year. In the context of the 2001 Article IV consultation with New Zealand, the following documents have been released and are included in this package:

- the staff report for the 2001 Article IV consultation, prepared by a staff team of the IMF, following discussions that ended on **December, 10, 2001**, 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 February 14, 2002.** 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 of **March 22, 2002** updating information on recent developments.
- a Public Information Notice (PIN) summarizing the **views of the Executive Board as expressed during its March, 22, 2002 discussion** of the staff report that concluded the Article IV consultation.
- a statement by the Executive Director for New Zealand.

The document listed below has been separately released.
Selected Issues Paper

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

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

Copies of this report are available to the public from

International Monetary Fund • Publication Services
700 19th Street, N.W. • Washington, D.C. 20431
Telephone: (202) 623-7430 • Telefax: (202) 623-7201
E-mail: publications@imf.org Internet: <http://www.imf.org>

Price: \$15.00 a copy

**International Monetary Fund
Washington, D.C.**

INTERNATIONAL MONETARY FUND

NEW ZEALAND

Staff Report for the 2001 Article IV Consultation

Prepared by the Staff Representatives for the 2001 Consultation with New Zealand

Approved by Steven Dunaway and Leslie Lipschitz

February 14, 2002

- The 2001 Article IV consultation discussions were held in Auckland and Wellington between November 29 and December 10, 2001.
- The mission team consisted of Ms. Kochhar (head), Messrs. Cerisola, Cardarelli, and Ueda (all APD). Mr. Di Maio (Assistant to the Executive Director) attended the meetings, and Mr. Dunaway (APD) joined the mission for the discussions held in Wellington.
- The mission met with Minister of Finance Michael Cullen; Treasury Secretary Alan Bollard; Reserve Bank Governor Don Brash; other senior government officials; and representatives of the private sector, labor unions, and academia.
- During the 2000 Article IV Consultation, Directors noted that large external imbalances and the fact that growth has not been enough to close more rapidly the gap with other advanced economies were key policy concerns. They stressed the need for further reforms, particularly in areas related to deregulating parts of the agricultural sector, while keeping labor and product markets flexible. Directors acknowledged that protection in trading partners limited the potential gains from some of these reforms. They also noted that New Zealand is well placed to absorb external shocks without undue economic and financial distress.
- 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, and is actively working to address outstanding issues that preclude subscription to the SDDS.
- The authorities have agreed to participate in the FSAP and are planning to undertake self-assessments in preparation for the mission that is expected in early 2003. The authorities have also agreed to publish the staff report for the 2001 Article IV Consultation.
- This report was drafted by Ms. Kochhar and Mr. Cerisola, with contributions from Messrs. Cardarelli and Ueda.

Contents

Page

I. Executive Summary.....	3
II. Introduction	4
III. Recent Economic Developments and Outlook	6
IV. Policy Discussions	12
A. Monetary Policy and the Exchange Rate	12
B. Fiscal Policy	15
C. Structural Policies	16
D. Economic Vulnerability	23
V. Staff Appraisal	25

Boxes

1. New Zealand and Australia—Divergent Growth Performance	5
2. Migration and Growth.....	8
3. The Exchange Rate Pass-Through in New Zealand	14
4. Proposals for Tax Reforms—The McLeod Tax Review	19

Figures

1. Selected Real Economic Indicators, 1996-2001	29
2. Labor Market and Inflation Indicators, 1996-2001.....	30
3. Balance of Payments and External Indicators, 1996-2001	31
4. Monetary and Financial Indicators, 1996-2001	32
5. Fiscal Indicators, 1995/96-2001/02	33

Tables

1. Selected Economic and Financial Indicators, 1997-2002.....	34
2. Balance of Payments and External Debt, 1996-2001	35
3. Central Government Budget, 1996/97-2001/02.....	36

Annexes

1. Medium-Term Scenario	37
2. Economic Vulnerability Assessment	39
3. Fund Relations	49
4. Statistical Issues	50

I. EXECUTIVE SUMMARY

1. **The performance of the New Zealand economy over most of the past two years has been relatively strong, underpinned by the sound macroeconomic framework in place.** Real GDP growth averaged almost 4 percent in 2000, before slowing to an estimated 2½ percent in 2001, owing to the weaker global environment. The unemployment rate declined to a 13-year low of around 5¼ percent in the second quarter of 2001, but rose modestly to nearly 5½ percent in late 2001. Inflationary pressures have been well contained, although price spikes (owing to one-off factors such as higher oil prices) pushed headline consumer price inflation for a time in late 2000 and early 2001 above the top end of the 0–3 percent official target range. Supported by strong commodity prices and a depreciating exchange rate, the current account deficit narrowed markedly from almost 7 percent of GDP in 1999 to an estimated 2¾ percent in 2001.
2. **The staff endorsed the current supportive stance of macroeconomic policies.** Economic growth, while expected to pick up during the course of 2002, would continue to be below potential, and inflationary pressures would remain subdued. However, significant downside risks to the external outlook continue to be an important concern. Monetary policy should be the main instrument geared toward supporting activity if economic prospects weaken. In that event, allowing the automatic stabilizers to work would be a sufficient fiscal policy response.
3. **The economic policy debate in New Zealand is centered around the objective of enhancing the economy’s growth potential.** The government has launched a wide-ranging review to assess the relative importance of size, scale, and location in New Zealand’s economic performance, how to reverse outward migration and foster high-skill immigration, and whether a more active role by the government could strengthen growth.
4. **The discussions focused on the need to preserve the current strong macroeconomic policy framework while furthering reforms to reduce disincentives to work, save, and invest productively.** In particular, the staff recommended aligning the top marginal personal income tax rate with the corporate rate; eliminating those aspects of the tax system that favor one form of saving/investment over another; and, as part of the comprehensive review of the social security system, reassessing the replacement rates and duration of benefits, along with consideration of “in-work” benefits, to enhance work incentives. The staff also expressed some concerns about recent reforms in labor and product markets that could add to business costs and hinder long-term growth prospects.
5. **New Zealand remains well placed to absorb external shocks.** Several important mitigating factors help to explain the deterioration in some economic vulnerability indicators, reflected by a rising share of debt in external liabilities, a shortening of maturities, and a decline in the share of New Zealand dollar-denominated debt. Nonetheless, these developments need to be carefully monitored.

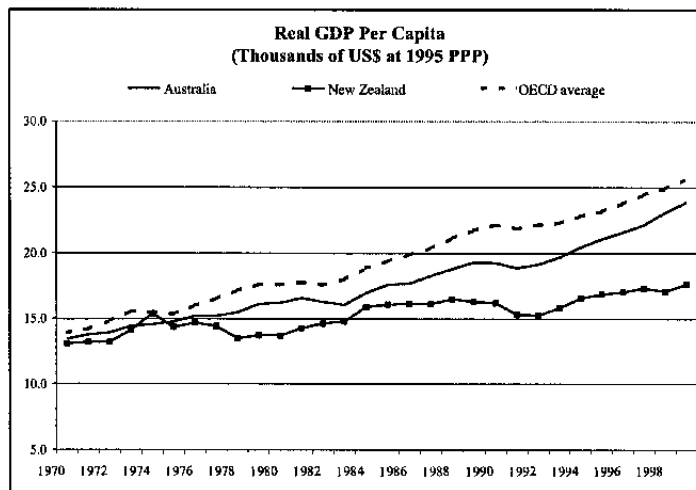
II. INTRODUCTION

6. **The resilience of the New Zealand economy to the global economic turbulence of recent years is testimony to the benefits of the economic reforms of the past 15 years.**

The relatively strong economic performance of most of the past two years was driven by a number of favorable conditions. These include a competitive exchange rate, strong prices and demand for New Zealand's exports, good agricultural growing conditions, and little evidence of imbalances in asset markets. The unemployment fell to a 13-year low of 5¼ percent in the second quarter of 2001 and rose to nearly 5½ percent in late 2001. The current account deficit narrowed sharply to about 3½ percent of GDP (annual rate) in the third quarter of 2001, and net external liabilities as a share of GDP, albeit still high, have declined markedly.

7. **Notwithstanding these positive developments, the central issue around which most of the policy debate is cast relates to New Zealand's relatively weak growth performance.** Despite wide-ranging structural and macroeconomic reforms implemented since the mid-1980s, growth in New Zealand has not been sufficiently fast to narrow the income gap with its OECD

counterparts, including its neighbor Australia (Box 1).¹ The staff's work during the last consultation discussed how the reforms have, with some delay, resulted in a pick-up in growth.² However, there remains an agenda of unfinished reforms necessary to enhance human capital development, liberalize product markets, and restructure the tax and public income support systems to reduce disincentives to productive investment, labor force participation, and productivity growth.



8. **The Government has launched an “Economic Transformation Agenda” which aims at bringing New Zealand's income per capita back into the top half of the OECD**

¹ The forthcoming selected issues paper will discuss the roles of factor accumulation, productivity, and structural factors in explaining New Zealand's growth performance relative to that of Australia.

² See “New Zealand's Growth Experience in Comparative Perspective,” in *New Zealand: Selected Issues*, IMF Staff Country Report No. 00/140, 2000.

Box 1. New Zealand and Australia—Divergent Growth Performance

In the past 15 years, the growth in New Zealand's per capita GDP has lagged that of Australia, owing to a relatively lower growth in labor productivity. The main factors explaining the productivity gap are both weaker total factor productivity and lower capital deepening. While this can be partly explained by structural differences between the two economies (size of domestic market and New Zealand's comparative advantage in agriculture) other factors that have constrained capital accumulation in New Zealand compared to Australia may have also been at play.

Since 1985, when far-reaching reforms were launched, New Zealand's real GDP growth has averaged around 2 percent per year, compared with an average of 3 percent in OECD countries. Meanwhile, with an annual average growth of around 3.7 over the past 15 years, Australia has been able to reduce the gap with the OECD average and to increase its GDP per capita to around 15 percent above that of New Zealand.

A proximate explanation for the observed divergence in GDP per capita between Australia and New Zealand can be found in the widening of the labor productivity gap between the two countries (Table 1). As for the possible drivers of the divergence in labor productivity, Table 1 shows that a key role was played by the gap in capital deepening (capital stock per hours worked) between the two countries. Over the past decade, the contribution of capital deepening to the level of labor productivity in New Zealand was only 86 percent of that in Australia. Table 2 shows that New Zealand has invested less than Australia in the period 1989-2000, and has still a larger share of total net capital stock comprising residential buildings.

Relative levels (AUS=1)	1988	1999	Average
Output per capita (Y/P) 1/	0.88	0.76	0.80
Labor productivity (Y/H) 2/	0.82	0.76	0.80
Labor utilization (H/P) 3/	1.08	0.99	1.01
Of which			
Hours worked per employed (H/E)	1.06	1.01	1.02
Employment rate (E/L)	1.02	1.01	1.01
Labor force participation (L/P)	0.99	0.97	0.97
Labor productivity (Y/H)			
Human capital	0.99	1.01	1.00
Capital intensity	0.85	0.83	0.86
Total factor productivity	0.97	0.86	0.93

Source: Staff estimates based on data from Statistics New Zealand, Australia Bureau of Statistics and OECD.

1/ Y=GDP at factor cost in SNZ 1995-96 prices.
2/ H=Total actual hours worked.
3/ P=Persons; E=Employed; L=Labor force.

While human capital accumulation contributed more to labor productivity in New Zealand than in Australia, owing to the process of skills upgrading of New Zealand's labor force (Table 2), differences in total factor productivity (TFP) also contributed to widen the labor productivity gap between the two countries. If it had the same capital intensity as Australia, New Zealand's labor productivity would still be around 15 percent lower than Australia's in 1999. Staff analysis also shows that, in contrast to Australia, New Zealand's TFP growth has not benefited from a reallocation of resources towards its most efficient sectors over the last decade.

	I. Investments and Capital Stock					
	Real Investments		Net Capital Stock			
	Average Rates of Growth 1989-2000		Current prices (replacement cost) share of total			
	NZ	AUS	NZ		AUS	
		1988	2000	1988	2000	
Residential Buildings	4.2%	5.5%	40.0%	46.0%	29.8%	35.2%
Plant and Machinery	5.6%	5.8%	16.4%	15.8%	21.2%	18.6%
Other buildings and structures	0.4%	1.0%	43.0%	37.5%	46.6%	43.4%
Intangible assets	8.8%	14.9%	0.7%	0.7%	2.4%	2.8%
Total capital	3.1%	4.5%	100%	100%	100%	100%

	II. Employment by Educational Attainment, Market Sector			
	New Zealand		Australia	
	1984	1996	1984	1996
Without qualifications	43.9%	30.2%	40.6%	39.0%
With school qualification	30.9%	30.7%	21.3%	20.8%
With postschool qualification	25.3%	39.1%	38.1%	40.2%
Higher degree and Postgraduate	1.9%	8.0%	-	1.4%
Bachelor Degree	2.0%	4.1%	-	6.4%
Diploma and Vocational qualifications	18.2%	21.4%	-	32.3%
Other post school qualifications	2.9%	5.5%	-	-

Source: Staff estimates based on data from Statistics New Zealand and Australia Bureau of Statistic.

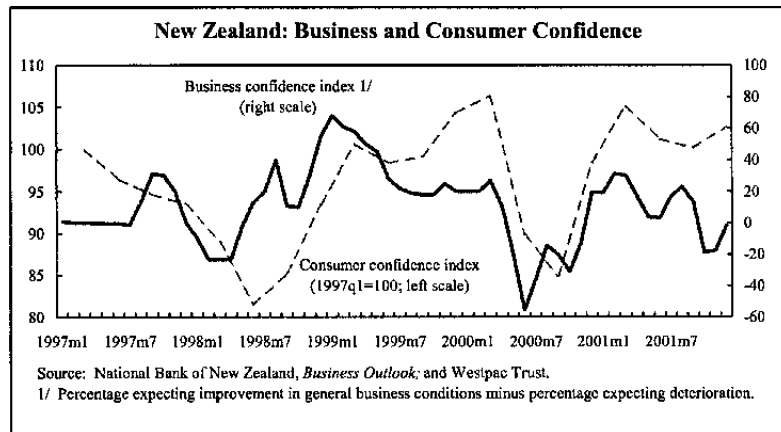
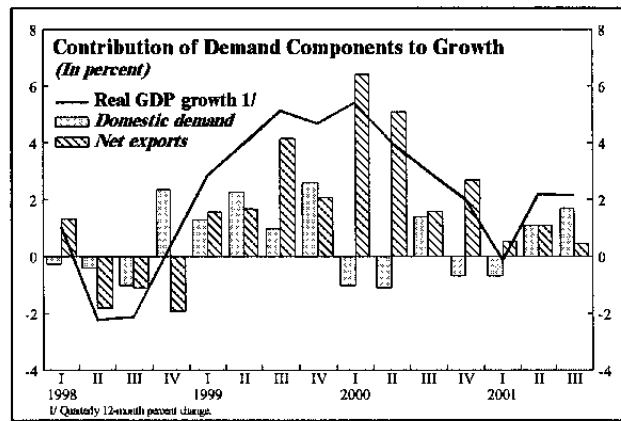
Both the lower capital intensity and the absence of allocative gains since the end of the 1990s are in principle consistent with the existence of structural disadvantages that may limit New Zealand's growth prospects, compared to those for Australia. In particular, the smaller domestic market may have prevented New Zealand from successfully diversifying away from primary production (where New Zealand has a strong comparative advantage) towards higher-growth manufacturing and service sectors.^{1/} However, other factors may have been at play in determining the divergence in GDP per capita between the two countries. In particular, the relatively higher cost of capital in New Zealand and the relatively larger share of New Zealand's net capital invested in residential housing may act as constraint on capital accumulation, while the relatively low capital intensity in agriculture seems to suggest that New Zealand has not fully exploited the potential for growth in the sector where it has a comparative advantage.

^{1/}Skilling D., 2001, "The Importance of Being Enormous :Towards An Understanding of the New Zealand Economy," New Zealand Treasury.

countries. The main objective is to examine the reforms undertaken to date and to assess additional reforms needed to enhance New Zealand's economic growth performance over the long-term. So far, policies have focused on promoting innovation and on fostering international linkages through trade, foreign direct investment, immigration, and knowledge. However, a broader debate is also underway arising from the view that simply relying on market signals may not have led to the best outcomes and that New Zealand's small size and location may warrant more proactive policies.

III. RECENT ECONOMIC DEVELOPMENTS AND OUTLOOK

9. Over the past two years, output growth has been driven mainly by strong export performance, whereas the performance of domestically oriented sectors has been more patchy. Net exports provided a significant stimulus to economic activity owing to the recovery in agricultural production from the severe droughts in 1999, favorable terms of trade, and the depreciated exchange rate. The uneven performance of domestic demand reflected wide swings in consumer and business confidence, triggered first by concerns about policy changes introduced by the new Labor government,³ then by the rise in rural incomes on the back of strong export performance, and most recently by the terrorist attacks in the United States. During the course of 2001, domestic demand rebounded and real GDP expanded at an average rate of 2¼ percent (y/y through the September quarter) (Table 1 and Figure 1). The output gap, which had been positive through most of 1999-2001, has been trending down more recently. However, capacity utilization rates remain quite high.

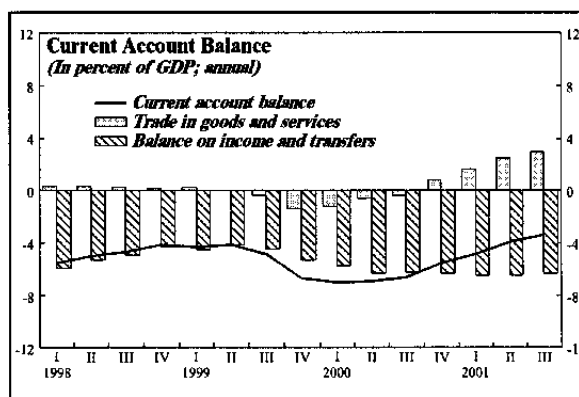


³ See *New Zealand: 2000 Article IV Consultation*, IMF Staff Country Report No. 00/138, 2000 and *New Zealand: Selected Issues*, IMF Staff Country Report No. 00/140, 2000 for details.

10. **Labor market conditions tightened markedly during 2000-01.** With rapid employment growth, the unemployment rate fell to 5¼ percent in the second quarter of 2001 (Figure 2), the lowest level since the second quarter of 1988. Despite relatively high participation rates, however, labor force growth did not keep pace with employment growth, largely due to a net migration outflow since mid-1997, which has only recently showed signs of reversal (Box 2),⁴ and which has contributed to the modest rise in unemployment to about 5½ percent at end-2001. Wage growth remained moderate, with the average hourly private earnings increasing by 3½ percent (y/y) in the third quarter of 2001, and unit labor costs rising by about 1 percent on average in the past two years.

11. **Inflation remains under control, despite higher resource utilization in most sectors of the economy.** Having remained comfortably within the 0-3 percent target range, inflation spiked briefly to 4 percent in the fourth quarter of 2000, remained slightly above 3 percent during the first half of 2001, and fell back to 2½ percent in the third quarter of 2001 and to 1¾ percent in the fourth quarter of 2001 (Figure 2). The inflation spike was due mainly to one-off factors, such as an increase in tobacco taxes and higher oil prices, as well as the depreciation of the exchange rate, a small part of which has been passed through to prices. Lower prices for oil, rents, and other commodities have contributed to its subsequent decline. Recent surveys point to inflation expectations around 2¼ percent in the year through November 2002, and trending downwards over the medium-term.

12. **A relatively consistent bright spot has been the strong performance of exports and the resultant narrowing of the current account deficit during 2000-01 to its lowest level since the early 1990s** (Table 2 and Figure 3). The most significant export gains occurred in the primary sector and in tourism. Both strong volume growth and buoyant prices explain the favorable performance of primary goods exports. Prices for the basket of commodities produced in New Zealand have remained strong, in part because of strong demand for dairy products from China and the United States and a reduction in subsidies paid to EU dairy exporters. Volume growth has also been boosted by drought in Australia and the outbreaks of BSE (“mad cow”) and foot and mouth disease in Europe. While slowing world growth took some steam out of external demand in 2001, there are a number of factors that are positive for New Zealand exports in the medium term. These include the recent admission of China into

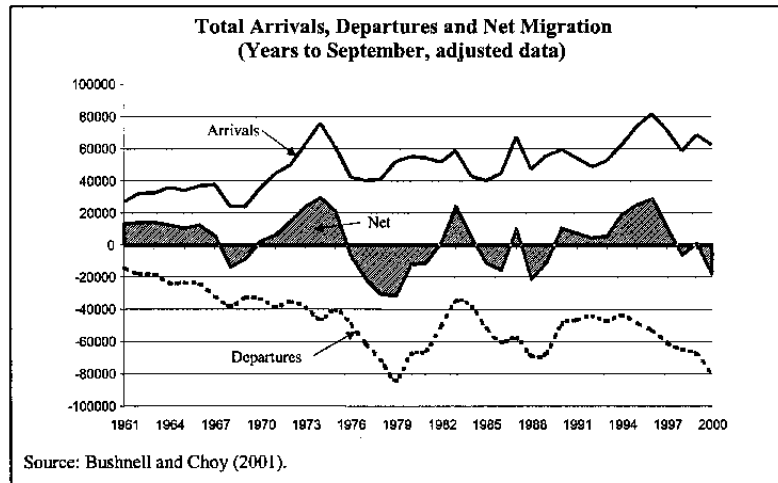


⁴ The forthcoming selected issues paper presents an analysis of developments in migration, their interaction with the tax and income support system, and the potential impact on growth in New Zealand.

Box 2. New Zealand—Migration and Growth

New Zealand has experienced large migration flows in recent years, and taken together, all available data suggest, but far from conclusively, that there may have been some “brain drain” from New Zealand.

- During the 1990’s, in gross terms, more than 16 percent of the population left and a similar number entered the country. Gross emigration had an increasing trend in 1990’s, while gross immigration increased until the mid-90’s and has declined since then.
- Net bilateral migration flows between New Zealand and its four largest emigrant destinations—Australia, United States, United Kingdom, and Canada—are almost balanced except for Australia, where outflows outweigh inflows. Reported skill compositions (occupation based) are almost the same in bilateral flows between New Zealand and these four destination countries. But, the fact that the four countries pay higher wages, within the same occupation, may be a prima facie evidence that emigrants have higher skill levels.
- The largest net inflows come from Asian countries. Reported skill compositions of immigrants from these countries are skewed towards high levels. However, while about half of immigrants from Australia, United Kingdom, United States, and Canada reported their occupations, only about 30 percent of Asian immigrants reported them. Moreover, immigrants from developing countries face higher unemployment rates and lower wages compared to native born workers with the same qualifications. Thus the actual skill distribution of immigrants might be lower than what is reported.



Assessing the impact of migration on GDP growth is fraught with difficulties.

Quantity and price effect: As people migrate to higher wage countries, the labor force would decline, as would GDP, and domestic wages would eventually converge to destination country levels. Neither of these outcomes is readily observed.

Direct externality to productivity: If high skilled workers raise productivity of the economy, their emigration causes a loss. However, studies in other countries show mixed, if not weak, evidence.

Brain gain: When expected income in a foreign country is higher, emigration opportunities give people larger incentive to acquire skills. Hence human capital accumulation could be higher even for those who end up staying in New Zealand.

Regardless of the measured impact on migration flows, however, there is a need to ensure that the tax and social security systems do not create incentives for large emigration flows.

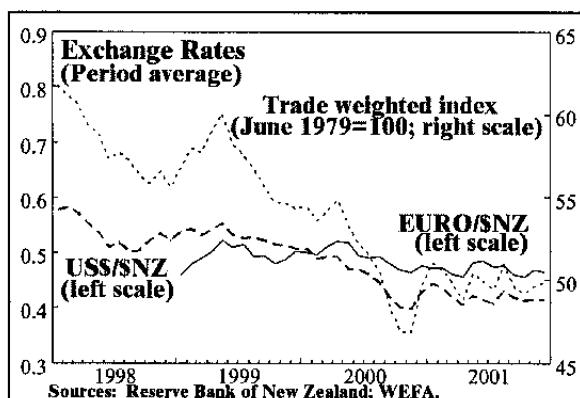
Income tax burden: Because of the high top income tax rate and the relatively low threshold at which it applies, the high skilled individuals have incentives to move to countries with lower income tax rate. This is reinforced by international competition supported by preferential tax treatment for high-skilled workers.

Free rider problem: Under the current superannuation scheme, New Zealanders have an incentive to work in foreign countries, where wages are high, when young, and to move back to New Zealand, when old. By doing this, they can avoid contributing to the social security system, while still receiving benefits. Available data suggest that many emigrants return to the country when they are middle-aged.

Cost of migration: Emigrants pay both monetary and non-monetary costs when they leave the country. Therefore, emigration induced by tax and social security system is true economic waste.

the WTO, an increase in Canada's import quotas for New Zealand beef, and the removal by the United States and Korea of restrictions on New Zealand lamb and beef products, following the ruling of the WTO's appellate body. Import volume growth has been relatively subdued, in part because of a slump in business investment spending and the weak \$NZ.

13. **Following a sharp depreciation in 2000, the \$NZ remained relatively stable during 2001.** Between end-1999 and November 2000, the \$NZ depreciated by about 11½ percent in real effective terms (based on relative CPIs) and by about 13 percent (based on relative unit labor costs in manufacturing), and by 21½ percent against the U.S. dollar (Figure 4). Since then, the currency has appreciated modestly, with its nominal value trading within a narrow range around \$0.43. The general weakness in the \$NZ since end-1999 has persisted despite strong prices for New Zealand's commodity exports, a favorable interest rate differential, a narrowing current account deficit, and the comparative cyclical strength of the New Zealand economy. Several factors may have contributed to the currency's persistent weakness, including the large stock of net external liabilities, the decline in non-resident holding of sovereign bonds and the shrinkage of the Eurokiwi bond market since 1998, low productivity gains in manufacturing relative to trading partners, and weaker medium-term growth prospects relative to the United States.



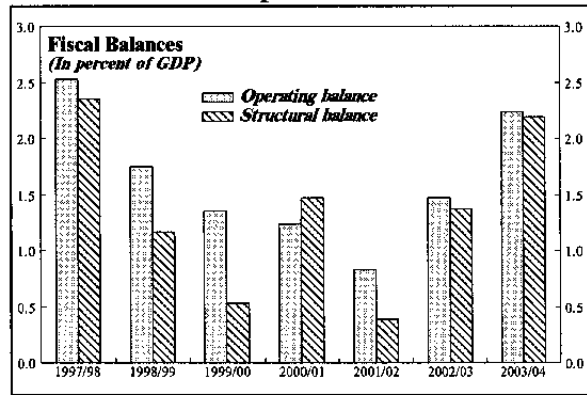
14. **Other indicators of market perceptions, however, remain generally favorable.** The New Zealand equity market, while not spectacular, outperformed most other major countries in 2001. Sovereign foreign currency debt ratings continue to be favorable and are similar to those for Australia. This suggests that the increase in 10-year government bond spreads relative to the United States in 2001 (a phenomenon also observed in Australia and, to a lesser extent, in Canada) most likely reflected the widening of spreads at the short-end of the yield curve—in turn reflecting the difference in cyclical positions of the New Zealand and U.S. economies—as well as some flight to quality in an extremely risk averse environment, rather than an increase in the New Zealand-specific risk premium, per se.

15. **Following a period through August 2001, during which the Reserve Bank of New Zealand (RBNZ) took a cautious approach to lowering interest rates, the pace of monetary policy easing was stepped up beginning in September.** In 2000, monetary policy was aimed at balancing the strength of the economy on the one hand and the deteriorating external outlook on the other. Even as the external environment began to weaken, the RBNZ held course on account of the upside risks to inflation from the positive output gap, the tight labor market, and the exchange rate depreciation. With mounting evidence of a marked global weakening in 2001, the RBNZ began to ease monetary policy, albeit by less than the United States and Australia, cutting rates by 75 basis points prior to September 11. Interest rates were cut on September 19 (between the regularly scheduled

official cash rate review dates) and on November 13 by a total of 100 basis points, reflecting concerns that the global economic slowdown was likely to be exacerbated by September 11 events. At its official cash rate review on January 23, 2002, the RBNZ left interest rates unchanged, noting that the decision reflected a balancing of the risks between a stronger-than-expected domestic economy and continuing weakness in the rest of the world.

16. **Following a strong performance through 2000/01 (July-June), the fiscal outlook has deteriorated considerably.** The operating surplus in 2000/01 was 1¼ percent of GDP, and the overall fiscal balance (cash basis) posted a modest surplus of ½ percent of GDP.⁵ Net Crown debt declined from 25¾ percent of GDP in 1996/97 to 17½ percent of GDP

in 2000/01, and remains well below the OECD average.⁶ The deterioration in the external environment since last September led to a downward revision in the fiscal projections in the December Economic and Fiscal Update (DEFU). The 2001/02 operating surplus is now projected at ¾ percent of GDP (down from 1¼ percent of GDP in the budget) reflecting lower tax revenues due to weaker growth, negative valuation effects from a higher net present value of Accident Compensation Corporation and Government-Employee Superannuation Fund liabilities, a higher deficit in District Health Boards, and additional one-off expenditures. The overall cash balance for 2001/02 is expected to shift to a deficit of 1¾ percent of GDP, owing to large capital expenditures associated with education and health and with the takeover of Air New Zealand.⁷



⁵ The overall balance on a cash basis is defined as current revenues less current expenditures and capital expenditures that command resources. The latter include net purchases of physical capital and the capital contingency provision (both excluding defense), student loans, and net capital contributions to SOEs and Crown entities.

⁶ New Zealand debt figures exclude local governments, and therefore, are not strictly comparable to those in the OECD, which refer to the general government. However, local government indebtedness (in relation to GDP) is very small in New Zealand.

⁷ The government has introduced a recapitalization package which consists of an equity investment by the Crown that increased its stake in the company to 82 percent. The Crown has agreed to invest \$585 million in shares, following a \$300 million loan granted in October 2001 that has been converted into shares. The Crown has also committed to provide up to \$150 million in further funding before June 2003.

17. **The impact of slower growth on fiscal balances is expected to be carried over into 2002/03.** Smaller operating fiscal surpluses projected over the next two years reflect, in addition to the ongoing effects of the deterioration of the economic assumptions in 2001/02–2002/03 relative to those budgeted, a modest increase from \$NZ 5.9 billion to \$NZ 6.1 billion in the three-year spending cap set by the government when it took office in 1999. However, the overall cash deficit will improve somewhat, declining to ½ percent of GDP in 2002/03 in line with lower capital expenditures. Over the medium-term, lower operating balances and additional capital expenditures associated with the recapitalization package for Air New Zealand, increased student loans, and funding for hospitals are expected to exert upward pressure on the financing requirement. Gross Crown debt is expected to reach 31½ percent of GDP in 2001/02, and peak at almost 32¼ percent of GDP in 2003/04. The ratio of net debt to GDP is also envisaged to increase to 18½ percent in 2001/02 and peak at 19¼ percent of GDP in 2003/04.

18. **New legislation establishing the New Zealand Superannuation Fund was enacted in October 2001, with the goal of partially prefunding future pension expenses.** Given the age profile of the population, spending on superannuation is projected to rise from 4 percent of GDP at present to over 9 percent in 2050. The government has decided to build up a fund that will help to smooth taxes in the transition to this higher level of pension expenditure. The required contributions will be calculated on the basis of a 40-year rolling horizon, and will be a function of both expected future pension payments and the return on the investments of the fund. The DEFU set the amount of capital contributions to the fund for the next five years at a cumulative \$NZ 7,850 million.⁸ An independent board will be appointed to administer the fund and determine its investment strategy. The legislation requires the board to pursue a prudent investment strategy and maximize return without undue risk.

19. **To ease demand pressures on health care services, the government announced additional health spending of \$NZ 2.4 billion for the next three years.** This spending is mainly targeted at supporting District Health Boards and the Government's "primary health care strategy," aimed at improving access to primary health facilities.⁹ The health package

⁸ Contributions to the New Zealand Superannuation Fund are treated as capital contributions and thus do not directly impact on the operating balance. The Fiscal Strategy Report contained in the Budget set a long-term upper limit of 35 percent of GDP for the sum of the operating expenses and contributions to the Fund.

⁹ District Health Boards are decentralized bodies charged with the provision of health care services in specific local communities. They are expected to better align the provision of services with needs and available funding. The previous system was based on a separation of the public funding of health care services, managed by the Health Funding Authority from the provision of services, managed by the Hospital and Health Services.

absorbs half of the fiscal provision left for next year (\$NZ 0.8 billion) and almost 40 percent of the indicative \$NZ 5.4 billion fiscal provision for the period between 2003 and 2006.

20. **In the short-term, the outlook for New Zealand faces significant downside risks arising from the external environment.** Even before September 11, it had become clear that the global economy had gone into a synchronized downturn, with all the potential engines of growth stalling simultaneously. In this environment, the major risks facing New Zealand are: a further softening in external demand; a further decline in commodity prices, which had held up relatively well until October 2001 but which declined by 6½ percent in U.S. dollar terms by early 2002; a sharp fall-off in tourism receipts as security concerns about airline travel exacerbate the overall fall in demand; and a decline in confidence triggered by persistent external weakness, which could, in turn, dampen domestic demand, especially for investment. Consumer spending is, however, likely to be buoyed by the strong employment situation and the fall in interest rates. With a recovery in U.S. and global confidence expected to begin in the second half of 2002, growth in New Zealand is forecast to slow to 2½ percent in 2001 and to around 2 percent in 2002. The current account deficit is expected to widen from 2¾ percent of GDP in 2001 to almost 4 percent of GDP in 2002, and inflation is expected to remain well within the official target range.

21. **Economic prospects in the medium term remain broadly favorable.** New Zealand's medium-term economic outlook (Annex I and Table 4) is consistent with the projections for partner country demand and world prices for New Zealand's exports and imports provided in the December 2001 interim World Economic Outlook. Following two years of slowing in 2001 and 2002, growth is projected to pick up to slightly above potential in 2003. The current account deficit would stabilize at around 3 percent of GDP by 2006-07, assuming a constant real effective value of the \$NZ, roughly at its depreciated late 2001 level.

IV. POLICY DISCUSSIONS

22. **The authorities and the staff broadly agreed on the course of macroeconomic policies in the period ahead.** The discussions centered on how macroeconomic policies should respond, in the context of the inflation targeting and the medium-term oriented fiscal policy framework, to prospective weakness in the economy; the role of macroeconomic and structural policies to enhance New Zealand's growth potential over the medium-term; and recent developments regarding New Zealand's economic vulnerability.

A. Monetary Policy and the Exchange Rate

23. **The authorities described the conduct of monetary policy over the past year as having been "appropriately preemptive."** RBNZ officials explained that the economy had maintained strong momentum during early 2001, and most measures of underlying inflation had pointed to a gradual upward drift towards the top-end of the target range. In such circumstances, the RBNZ's usual concern would have been that, with the economy near full capacity, the longer inflation was at or above the top-end of the range, the greater would be

the risks of spillovers into inflation expectations and the labor market. However, the RBNZ eased monetary policy cautiously in the first half of 2001, owing to the anticipated effects on New Zealand of a deteriorating world economy. The authorities noted that, given the deflationary nature of the September 11 shock, the fact that there has been limited pass-through from past changes in the exchange rate to prices (Box 3), and the absence of broad-based wage pressures, they had used monetary policy more actively to sustain the relatively favorable performance of the New Zealand economy.¹⁰ In late January, subsequent to the mission, the RBNZ left the official cash rate unchanged, noting that the decision reflected a balance of risks between a more buoyant than expected domestic economy and continuing weakness in the rest of the world. The authorities and the staff agreed that monetary policy should continue to be the main instrument in sustaining the relatively favorable conditions in New Zealand. Within the inflation targeting framework, monetary policy would be appropriately forward looking and would be eased if warranted by weaker prospects for the New Zealand economy.

24. **The authorities noted that, in response to recommendations made by an independent review of monetary policy commissioned by the New Zealand government, they would make some changes to strengthen what was seen as a sound framework for formulating and implementing policy.**¹¹ The report concluded that monetary policy in New Zealand is "...entirely consistent with the best international practice of flexible inflation targeting...." The authorities have decided to strengthen the RBNZ's governance and accountability for monetary policy decisions. In particular, the Governor will retain sole responsibility for monetary policy decisions. He will remain a member of the RBNZ Board of Directors, which has responsibility for monitoring the Governor's performance, but he will no longer serve as Board chairman. A panel of external advisors has been appointed by the Governor to provide additional perspectives on policy decisions, while foreign central bank officials have been invited to conduct informal peer reviews of different operational aspects of monetary policy. With regard to operational considerations, RBNZ officials explained that monetary policy will continue to aim at keeping inflation near the mid-point of the target range over the medium-term. The RBNZ is not indifferent between inflation rates within the target range, as they acknowledge some "increasing discomfort" when the inflation rate approaches the edges of the target range. The staff asked whether the Bank should adopt a single measure of "underlying" inflation rather than just a menu of measures. The staff thought that this would assist the RBNZ in communicating with the public its views on the persistence of the impact of shocks to prices, such as those stemming from the more volatile components of the CPI. The RBNZ officials said that in contrast to the practice in

¹⁰ The forthcoming selected issues paper presents an empirical analysis of the exchange rate pass-through in New Zealand and a comparison with Australia and Canada.

¹¹ See "Independent Review of the Operation of Monetary Policy in New Zealand: Report to the Minister of Finance" by Lars E. O. Svensson, February, 2001.

Box 3. The Exchange Rate Pass-Through in New Zealand

Over the past decade, most of the advanced economies have experienced a remarkable stabilization of inflation at very low rates despite wide fluctuations in exchange rates and import prices. Some explanations emphasize the role of transitory factors, such as favorable supply shocks or appreciating exchange rates, while others have pointed to more permanent effects on firms' "pricing power" stemming from information technology and inventory management, increased competitive pressures, and from the adoption of inflation targeting.

In New Zealand, the experience has been broadly similar to that of other advanced economies. Inflation has been subdued following the adoption of inflation targeting in 1989; however, the economy has been subject to significant exchange rate shocks—particularly since 1997—which seemed to have been primarily of an inflationary nature. For a small open economy like New Zealand, it is somewhat puzzling that the exchange rate shocks have not been passed on fully to domestic prices. According to the Reserve Bank of New Zealand (2001) "...while the first-stage of pass-through (from the exchange rate to import prices) was very much dampened between 1994 and 1999, it seems to have returned in the third and fourth quarter of 2000... At the second stage of pass-through (from import prices to consumer prices), the relationship is even less clear..."^{1/} Several factors may help to explain the lack of exchange rate pass-through in New Zealand:

- *Inflation targeting:* Taylor (1989)^{2/} argued that a low-inflation environment lowers the perceived persistence of changes in costs, and therefore, limits the pass-through of changes in costs associated with exchange rate fluctuations.
- *The business cycle and uncertainty in aggregate demand:* Mann (1986)^{3/} noted that firms may be reluctant to raise prices and prefer to adjust profit margins when the underlying strength in domestic demand is uncertain. Between 1991 and 1998, New Zealand experienced a significant increase in the volatility of the output gap—a proxy for the uncertainty in aggregate demand—which may have contributed to the low exchange rate pass-through.
- *Exchange rate volatility:* Large swings in the exchange rate and higher volatility may heighten the uncertainty about the underlying nature of the shocks driving it and increase price setters' reluctance to pass on exchange rate changes to domestic prices. The New Zealand dollar experienced wide swings and higher volatility during the 1990s—particularly during 1991-94 (possibly reflecting the effects of macroeconomic and structural reforms) and during 1997-99 (Asian crisis).
- *Increased competitive pressures and import penetration:* Import penetration increased in New Zealand, as the share of imports to aggregate demand rose from an average of 23 percent in 1987-1990 to almost 31 percent on average in 1997-2000. However, the rise in the share of imports has been accompanied by increased competitive pressures at the retail level, which may have helped to mute the exchange rate pass-through.
- *Strong productivity gains:* Growth in unit labor costs was relatively low between 1991 and 1999, providing increased room to absorb fluctuations in the exchange rate without affecting profit margins.

Staff analysis based on a mark-up error correction model suggests a decline in the short-term exchange rate pass-through to import and consumer prices during the 1990s. Part of this decline has been transitory in nature, possibly reflecting sequential and highly persistent shocks. The recent rise in the short-term pass-through appears to reflect a rebound to levels more consistent with those in the early 1990s. However, the degree of response of consumer prices (particularly nontradable goods) to permanent exchange rate shocks appears to have declined markedly during the 1990s and has remained relatively stable at very low levels.

^{1/} Reserve Bank of New Zealand, Monetary Policy Statement, May 2001.

^{2/} Taylor, J., 2000, "Low Inflation, Pass-Through, and the Pricing Power of Firms," *European Economic Review*, forthcoming.

^{3/} Mann, C., 1986, "Prices, Profit Margins, and Exchange Rates," *Federal Reserve Bulletin*.

other advanced economies, they preferred to rely on a menu rather than a single measure of underlying inflation, since their past experience with a single measure had proven to be difficult in terms of ensuring transparency and accountability.

25. **The authorities underscored the difficulty in fully understanding the sources behind the weakness of the New Zealand dollar.** RBNZ officials and market participants in general agreed that the weakness in the currency was more a reflection of persistent strength in the U.S. dollar, and that it was difficult to fully reconcile the weakness with traditional fundamentals, such as interest rate differentials and terms of trade movements. They assessed the \$NZ to be undervalued by about 10-20 percent against the U.S. dollar.¹² The authorities and the staff agreed that there were a number of factors, including the large net external liability position, that helped explain the trend decline in the \$NZ. The currency's relative weakness since the September 11 events might be explained by increased investor risk aversion worldwide, which adversely affected countries with large net external liabilities and by the expected deterioration in New Zealand's terms of trade. However, there was agreement that once risk aversion dissipated and overall market sentiment improved, the \$NZ should appreciate, but not to its pre-Asia crisis peak.

B. Fiscal Policy

26. **A modest fiscal stimulus is already being provided in the current fiscal year, primarily through the automatic stabilizers, and the authorities and staff agreed that there was only a limited role for discretionary measures.** The authorities explained that fiscal policy was aimed at keeping a tight rein on expenditures and letting the automatic stabilizers run their course. They felt comfortable that the current stance of fiscal policy would provide reasonable support against the expected cyclical slowdown and did not see major benefits from a more proactive fiscal policy. In particular, most tax changes would take time to enact, while bringing forward capital expenditures (such as in health or social infrastructure) would most likely be ineffective due to the considerable lags in implementation, and increases in discretionary expenditure may prove too difficult to withdraw once the economy recovered, which could compromise medium-term fiscal objectives. The authorities emphasized that the large net external liability position and some concerns over the New Zealand's risk premium in the sovereign debt market also limited the scope for fiscal measures.

¹² The latest Consultative Group on Exchange Rate (CGER) assessment estimated that the NZ dollar was 10 percent below its medium-term equilibrium in real effective terms, and by at least 20 percent against the U.S. dollar. Similar assessments are derived from market analysts' long run "fair value" and PPP-based models. However, the CGER methodology probably overstates the potential for a real appreciation of the New Zealand dollar because it does not adequately account for the impact of commodity prices on the \$NZ value. Moreover, the medium-term value of the \$NZ will continue to be influenced by investors' willingness to hold \$NZ exposure.

27. **The authorities emphasized their commitment to holding the line on new spending initiatives.** They explained that substantial pressure on public spending stemmed from education and health. Demands for greater health-care expenditures have already taken up most of the fiscal provision left for the 2002 Budget and have been increasingly difficult to resist, as the spending has been targeted to deal with shortages of key skilled medical professionals and to assure the quality of health-care services. The staff noted that these pressures on health-care spending, the potential for further costs associated with the government's equity investment in Air New Zealand, and possible election-related spending initiatives raised the risk of significant slippage in the fiscal position. The authorities acknowledged the risk, but reiterated their commitment to containing expenditures to achieve the government's objective of keeping the ratio of gross debt to GDP around 30 percent.

28. **The staff noted the longer-term fiscal pressures arising from pensions, as well as health expenditures, with the aging of the population.** While supporting the authorities' plan to partially prefund future pension liabilities, the staff said that consideration might be given to parametric reform to reduce the generosity of the system, contain budgetary costs, and encourage national savings.¹³ The authorities explained that the partial prefunding of pension liabilities will be instrumental in "ring-fencing" part of the expected fiscal surpluses. Parametric reforms—such as increasing the retirement age, or even possibly, reinstating some form of means-testing for pensions—were not currently being considered. On health care, current pressures from rising costs are likely to intensify with population aging and, possibly, with the recent decentralization of health care service provision. The staff suggested that the authorities review the experience of other industrial countries for ways to improve the efficiency in delivering services and controlling costs, including through shifting part of the costs to the private sector. The authorities were skeptical about the potential benefits of increasing private sector participation and stressed their commitment to a publicly funded system. Alternatively, an ear-marked tax to pay for health care services might be introduced to enable people to better match their expectations and demands with the costs of maintaining a public health-care system. In any event, the authorities noted that the problems faced by New Zealand were not unique and, like in other advanced countries, would not be quickly resolved.

C. Structural Policies

29. **The discussion of structural policies was centered around the government's objective of enhancing New Zealand's growth potential.** This issue continues to dominate the debate in New Zealand, as evidenced by the government's "Economic Transformation Agenda." In particular, the main focus of the current debate is on how to strike a balance between more proactive government policies in some areas, while avoiding the mistakes of

¹³ See "New Zealand Superannuation—Possible Extensions to Full Funding" in *New Zealand: Selected Issues*, IMF Staff Country Report No. 00/140, October 2000 for a more detailed assessment of the macroeconomic impact of the prefunding of superannuation.

the past resulting from an interventionist government policy. A wide-ranging review has been launched to assess the relative importance of size, scale, and location in New Zealand's economic performance, how to reverse outward migration and foster high-skill immigration, and whether a more active role by the government could strengthen the growth strategy.

30. **The staff suggested that improving New Zealand's growth potential would require maintaining the strong macroeconomic framework and the key structural reforms that have been in place over the past decade and furthering reforms to reduce disincentives to work, save, and invest productively.** The reforms to date have significantly improved economic incentives and enhanced the economy's growth performance and its resilience to absorb adverse shocks. However, additional reforms to enhance prospects for investment, labor force growth, and productivity would be needed to foster the necessary conditions to raise the economy's growth potential in a sustainable way.

31. **The authorities noted that recent initiatives in the social security system (New Zealand's income support system) have been aimed at better addressing individual needs.** Applicants for unemployment benefits will have a "job seeker agreement" which will set out their work-test responsibilities. Applicants for domestic purposes benefits will have to complete a "working towards employment plan," setting out the beneficiaries' work-related goals and actions, and will no longer be subject to a work test. This "case management" approach was seen as providing positive incentives to move from welfare to work, in contrast to the negative incentives associated with the previous work test. More generally, the authorities noted that a broader overhaul of the social security system was underway, with the key objectives of building a simpler system, enhancing work incentives, supporting families and children, and ensuring that all segments of society have the capacity to participate in the economy.

32. **The staff agreed with the authorities' general approach to overhauling the social security system, stressing the need for simplification and improved work incentives.** The staff expressed concerns that the recent changes to work requirements risked exacerbating work disincentives. In response, the authorities noted that the previous work test for some benefits was not effective because mandated sanctions for lack of compliance and reviewing replacement rates were generally not being imposed. Duration limits on unemployment benefits were also seen by the staff as a means of increasing work incentives. In addition, the staff suggested that the experience of other industrial countries with introducing "in-work" benefits could elicit some useful lessons with regard to how workforce participation of household heads could be encouraged while providing an adequate social safety net for families and children. The authorities cautioned that, in overhauling the social security system, tradeoffs would have to be made between simplifying the system, enhancing incentives to work, and avoiding substantial additional fiscal costs.

33. The staff agreed with the authorities' focus on innovation and skill development.

The mission, in general, supported the government's efforts to raise educational achievement; encourage innovation and research and development; promote linkages between universities, businesses, and basic research institutes; facilitate the immigration of high skilled workers (e.g., the Talent Visa program which makes it easier for employers to hire skilled immigrants); and better integrate immigrants into society and the labor force. These programs in large part involved only small amounts of public funds targeted at facilitating or catalyzing activities in the private sector. A notable exception is the student loan program.¹⁴ While this program offers great promise by providing opportunities for all New Zealanders to acquire education and training, the staff cautioned that it needed to be monitored closely to guard against potentially large future losses when significant repayment on these loans begin to mature. The authorities acknowledged that they were aware of the experiences with similar programs in other countries. They expected some losses, and they would work to control them without overly compromising the basic objectives of the program.

34. The recent McLeod Tax Review (Box 4) concluded that the tax system is basically sound but that some changes could be made to improve its effectiveness.

The staff stressed the importance of several of the tax review's recommendations designed to reduce distortions in the current system.¹⁵ In response to the review, the government indicated that it was likely to adopt only the recommendations with respect to international taxation issues. In this regard, the staff cautioned against providing preferential treatment for new foreign direct investment, as the tax review had recommended, because it would risk opening up a variety of tax arbitrage opportunities. The staff suggested that attention should be paid to eliminating the wedge between the top marginal personal income tax rate and the corporate tax rate to reduce incentives for tax avoidance, encourage savings, and improve incentives for retention and inward migration of high-skilled labor. The staff also suggested that, as budgetary resources become available over time, consideration should be given to gradually aligning New Zealand's corporate income tax rate with those in neighboring countries. Moreover, the staff saw a need to take steps to level the playing field

¹⁴ The student loan program was established in 1992 to finance New Zealand's tertiary students' tuition fees and other education-related costs. Students are not required to repay the loan until they begin to earn sufficient income. Student loans include a provision for doubtful debts, which is currently 10 percent of loans disbursed. The value of these loans is projected to grow from around \$NZ 4 billion in 2001 to \$NZ 15 billion by the year 2015.

¹⁵ "Tax Review 2001, Final Report," October 2001.

Box 4. Proposals for Tax Reforms—The McLeod Tax Review

The government appointed a committee headed by Mr. Rob McLeod to review the tax system and formulate various proposals for its improvement. The review's main conclusion was that there was no need for major changes in the tax system. It made recommendations for a number of small changes to enhance the system effectiveness.

Taxation of Personal Income

The review proposes simplifying the personal income tax scale from the current 4-step system to a 2-step system. The main rationale is to eliminate the large gap between the middle rate (21 percent) and the two top rates (33 and 39 percent), and between the top rate and the flat company tax rate (33 percent). Both features create serious problems of tax avoidance and have encouraged various forms of income splitting (especially via family trusts). A two-step system with a higher bottom rate was seen as having only a limited impact on the disposable income of low-income earners, while it would encourage high-income New Zealanders to remain in New Zealand and strengthen incentives to save, work, and invest.

Taxation of Savings and Investment

The review does not recommend the introduction of a comprehensive capital gain tax, because of the difficulties in its implementations and the distortions in investor choices that would follow. The approach currently adopted in New Zealand consists in taxing only the income and capital gains from assets held for the purpose of resale. While it prefers this pragmatic approach to a comprehensive capital gain tax, the review recognizes that there are inconsistencies in the treatment of capital gains and that the New Zealand tax regime discriminates between different savings and investment vehicles. Particularly important is the case of investment in housing, which in New Zealand accounts for more than 70 percent of total household saving (compared with less than 50 percent in the average of OECD countries). While other countries tax both capital gains and the imputed rental from owner occupied homes (albeit at low rates and granting a series of deductions), New Zealand effectively subsidizes investment in owner-occupied housing, as this is not subject to any form of taxation, while other forms of savings are taxed.

As an alternative to a comprehensive capital gain tax, the review proposes that the Risk Free Return Method (RFRM) be applied to tax all forms of investment income. According to this method, all investment returns would be taxed as if capital had been invested in a risk-free government bond. Such a regime would allow a comprehensive treatment of capital gains while making investment choices less tax-driven.

The McLeod Tax Review does not propose introducing any form of tax incentives for savings, as any such measures are considered as entailing potentially large costs for uncertain gains. However, if the authorities were to consider savings incentives, a preference is expressed for reducing taxation on the returns from savings, rather than allowing for tax breaks on income saved.

Taxation of Nonresidents and of New Zealand Offshore Income

The review noted that increased levels of foreign direct investment are essential to significantly increase per capita GDP. It recommends that a company tax rate of 18 percent be imposed on direct investment by nonresidents to ensure that New Zealand "stands out from the crowd." As for the tax treatment of offshore investments by New Zealanders, the main proposal is to repeal current tax exemptions on investments in specific (preferred) countries, and to tax investments offshore either by introducing uniform tax credits or by applying RFRM to all form of portfolio investments, both offshore and domestic. In the case of uniform tax credits, a distinction should be made between passive and active investments, with only active investments being allowed tax credits, in order to minimize tax avoidance. Further, to attract high-skilled and high net-worth immigrants, the review proposes exempting non-New Zealanders from taxes on their world-wide income for the first seven years after they become resident, and imposing a cap of taxes that would be payable in New Zealand.

between housing and other instruments for savings and investment, as the level of financial assets in New Zealand remains well below the OECD average.¹⁶

35. **The authorities explained that the government raised the top marginal personal income tax rate during the start of its term in 1999, and given its objective of favoring some progressivity in the tax system, it was unlikely that tax rates would be realigned in the near term.** In addition, the authorities did not agree with the need for changing the tax treatment of housing. Aside from the serious tax administration issues that would arise from attempting to tax the rental income of owner-occupied housing, they felt that the allocation of a large portion of household wealth into housing was more a reflection of social preferences and past high returns to housing investment than a result of distortions in the tax system. As for the preferential treatment of foreign direct investment, the authorities shared some of the staff's skepticism regarding its effectiveness, but argued that lowering the tax rate on non-resident investment could help to lower the cost of capital and facilitate technology transfer. Furthermore, in response to a question about whether providing such preferences might be interpreted as creating harmful tax practices, the authorities reminded the staff that New Zealand would be following rather than leading other countries in adopting this practice.

36. **The mission also stressed the need to deepen competitive forces within the economy and raised concerns about the risks that some recently introduced measures could eventually prove detrimental to competitiveness and long-term growth prospects.**

- Although concerns relating to the impact of the **Employment Relations Act (ERA)** enacted in 2000 on labor market flexibility have not materialized to date, business groups, labor union representatives, and government officials agreed that the “jury was still out.”¹⁷ The staff noted that, in view of the strength of employment growth since its enactment, it could be argued that any potential for reduced labor market flexibility has not yet been tested.
- The establishment of **Fonterra Cooperative** will significantly affect New Zealand's long-term growth prospects, given the relative importance of the dairy industry in the economy.¹⁸ To stem concerns about the potential effects of the merger on the

¹⁶ Household financial assets accounted for 40 percent of total household assets in New Zealand by end-2000. Household net financial wealth (as percent of disposable income) was around 70 percent in 2000, compared with roughly 270 percent in Australia, 330 percent in the United States and the United Kingdom, and 250 percent in Italy.

¹⁷ For a further discussion of the Act and its potential implications, see “Toward Assessing the Impact of the Employment Relations Act,” in *New Zealand: Selected Issues*, IMF Staff Country Report No. 00/140, 2000.

¹⁸ The Dairy Industry Restructuring Bill was approved in September 2001 enabling the merger of the two largest dairy processors together with the Dairy Board to form the Fonterra
(continued...)

domestic market structure—as the new company would be a virtual monopsony in the market for raw milk—the government modified the regulatory framework to constrain Fonterra’s power. The new framework guarantees open entry and exit for farmers primarily by ensuring share prices in the cooperative that are set to reflect the value of the company and by allowing shareholders to supply raw milk to other processors. Fonterra is also no longer the sole designated exporter of dairy products (which the Dairy Board was); however, the company has exclusive transitional rights to export to tariff quota markets for seven years. The staff argued that while these changes could enhance the industry’s efficiency, the new structure entails significant risks, including the exposure of farmers to the business strategy of a single entity and the potential for moral hazard from “too big to fail” considerations associated with Fonterra’s size. Moreover, the firm’s structure continues to prevent investment from outside the dairy industry in a key sector of New Zealand’s economy.

- The **Accident Compensation Corporation (ACC)** as a government-sponsored monopoly provider for accident insurance raises some concerns that, with the absence of competitive pressures and ACC’s new mandate that it be fully self-funding, businesses and individuals could face significantly higher premiums over time. In particular, the staff suggested that experience-rated premiums for individuals and firms and more competition in this market should be introduced over time. The authorities pointed out that it was too early to draw any conclusions on the effects of the renationalization and an assessment of the experiences in the pre- and post-competitive market was underway, which they expected to finalize this year.¹⁹
- The staff noted concerns that provisions and implementation of the **Resource Management Act (RMA)** and the recently proposed amendments to the **Health and Safety in Employment Act (HSEA)** may significantly add to businesses costs. The RMA—intended to achieve environmental protection objectives—has been used in some cases by incumbent firms to deter competition, largely owing to the way the act has been enforced. The authorities said that improved coordination between the central and local governments was critical in ensuring the Act was implemented fairly. Business firms were especially concerned about a proposed amendment to the HSEA that would recognize stress and fatigue as workplace hazards and raise the cost of workplace accident insurance.

Cooperative. The new company will be the largest in New Zealand and the ninth largest dairy company in the world.

¹⁹ A competitive market for insurance for work-related injuries was created in July 1999, but in July 2000, the government reestablished the ACC as the sole provider of such insurance.

- The recent government takeover of **Air New Zealand** was seen as the only feasible solution to the company's failure, given the country's need for reliable air transport to support the tourism industry and the economy in general. Easing the foreign ownership restriction was not a viable option since the company's major shareholders were not prepared to increase their stake by putting up a significant amount of new capital. The government's takeover involved a potentially large open-ended commitment, but the authorities were confident that the injections of public funds would be limited. The government has indicated that it will retain a majority stake for the foreseeable future. Once the airline's business has stabilized, the government will consider selling a stake in the airline to a strategic partner, although no plan or timetable has been established in this regard.
- The staff reiterated its concern that the establishment of **Industry New Zealand** could be perceived as a step toward a more interventionist industrial policy and its recommendation that the department's activities be tightly circumscribed. The authorities indicated that Industry New Zealand's role has been limited to helping business start-ups, and small- to medium-size firms' access to managerial and financial resources primarily through the provision of management skill training and a brokerage service between investors and companies.
- Although the authorized capital of the **Kiwibank** and its scale of operations is small, this bank has the potential to become a relatively high-risk activity, which could also entail fiscal costs.²⁰ The authorities said that the bank would be run on a strictly commercial basis. They emphasized that the government does not provide any explicit guarantees to the bank or its main shareholder (NZ Post). Based on past experience with state-owned enterprises, the government would apply commercial criteria to any decisions regarding its future.
- The business community and other private sector groups expressed concerns that the government's intention to ratify the **Kyoto protocol** could entail significant costs to the economy. The authorities responded that ratification could result in some significant reallocation of resources between forestry, agriculture, and energy intensive sectors, but that the overall effects on the economy were still uncertain and would depend on how the protocol was implemented.

37. **The authorities stressed the importance of furthering trade liberalization.** Multilateral negotiations under the WTO and of bilateral trade agreements, such as those with Singapore and Hong Kong, were essential for New Zealand to fully exploit its competitive advantage and to mitigate the disadvantages of the country's small size and

²⁰ The government authorized its creation under the aegis of New Zealand Post (NZ Post), a Crown corporation, in November 2001, and agreed to contribute about \$NZ 80 million in capital. The bank intends to offer nationwide retail services in areas with relatively limited access to banking services.

distance from markets for growth. While welcoming the recent removal of restrictions on lamb and beef imports by the United States and Korea, they stressed the role played by protectionist barriers in industrial countries in hindering New Zealand's long-term growth prospects. The staff praised the authorities for their decision to grant duty- and quota-free access to all products from least developed countries, noting that they are the first advanced economy to have done so.

38. **The authorities have made significant progress in dealing with anti-bribery and money laundering initiatives.** The Crimes Amendment Act was enacted in June 2001, which fully implements the OECD Convention on Combating Bribery of Foreign Public Officials in International Business Transactions. The OECD Working Group on Bribery in International Business Transactions recently concluded that the legislation conformed with the convention and commended the authorities for adopting extra-territorial jurisdiction which would also allow the government to prosecute citizens, residents, and corporations for offences committed fully outside New Zealand. The authorities also explained that the Financial Transactions Reporting Act of 1996 and other recent legislative amendments have brought New Zealand in full compliance with the recommendations of the Financial Action Task Force (FATF) on money laundering. A self-assessment on terrorist financing has been conducted, and the government has introduced legislation to implement the United Nations International Convention for the Suppression of the Financing of Terrorism.

D. Economic Vulnerability

39. **New Zealand remains well placed to absorb adverse external shocks.**²¹ Increased foreign indebtedness has been accompanied by some concentration of exposures in the banking sector and a higher share of short-term financing, and a shift away from domestic currency financing.²² The level of capitalization in the banking system and degree of hedging of the foreign currency debt provide a high degree of comfort. The authorities and the staff agreed that New Zealand remains vulnerable to marked shifts in market sentiment, and there was a need to better understand the implications of recent developments for vulnerability, how exchange rate risk is passed on by domestic banks to the rest of the economy, and to identify the ultimate holder of exchange rate risk. To this end, the RBNZ has recently developed a set of macroprudential indicators on the banking, household, and corporate sectors that will assist them in monitoring the stability of the financial system and the

²¹ A more detailed assessment of New Zealand's economic vulnerability is provided in Annex II.

²² Some of the recent shifts in the composition of capital flows may be related to several changes to the balance of payments statistics introduced by Statistics New Zealand (SNZ). Due to differences in data collection between the previous and current definitions for foreign direct and portfolio investment, SNZ has not updated the series for the financial accounts and International Investment Position prior to 2001.

economy.²³ Statistics New Zealand is considering extending its hedging survey to enable the ultimate holders of the New Zealand dollar positions to be identified. In view of the inflation targeting regime, the policy on foreign exchange intervention, and the fiscal policy framework, the impact of a sharp change in market sentiment will ultimately be borne by the domestic economy.

40. **The authorities were somewhat uncertain about the implications for vulnerability of recent indicators.** The decline in the share of \$NZ denominated debt did not appear to represent a reassessment of risk by foreign investors, but rather, the combination of lower interest rate differentials and a structural shift in foreign investors' portfolios to emerging market sovereign debt. The authorities agreed that the high degree of hedging has been important in mitigating vulnerability to sharp exchange rate movements but noted that the shortening of debt-maturity and the relatively low liquidity in derivatives markets could increase the economy's exposure to rollover risk. At the same time, however, they pointed out that the market for currency swaps remains well diversified and the sound risk management practices of domestic financial institutions should continue to provide an important buffer.

41. **The asset quality of New Zealand's banks was seen as critical in minimizing potential sources of vulnerability.** In light of the predominance of Australian-owned banks, the authorities acknowledged that the ability of domestic banks to secure foreign financing would continue to hinge mainly on the overall financial soundness of the Australian parents of New Zealand banks and their ability to preserve access to global capital markets. The authorities did not see any major difficulties in the current structure of the domestic financial system.²⁴

42. **The authorities' decision to participate in the FSAP in early 2003 should contribute to strengthen the understanding of issues surrounding New Zealand's vulnerability and improve the understanding of the country's approach to banking regulation and supervision.** RBNZ officials noted that it would be important for the FSAP to focus on vulnerability issues (such as stress testing the banking system), cross-border transactions in banking and insurance, bank failure management, and compliance with standards and codes. They planned to conduct self assessments of all standards and codes in preparation for the FSAP. They also felt that it was important for the FSAP to recognize the

²³ See "Macro-Financial Stability and Macprudential Analysis," *RBNZ Bulletin*, Vol. 64, No. 3, 2001.

²⁴ Recent assessments by Standard & Poor's (S&P) noted that Australian banks were expected to perform satisfactorily in the next year, but their credit risk was seen likely to deteriorate somewhat due to the weaker economic environment and increasing funding pressures. In late December 2001, S&P confirmed its credit ratings on the four major Australian banks; however, it downgraded the outlook for two banks, one of which has a relatively small presence in New Zealand.

uniqueness of the New Zealand banking system, with its high concentration of foreign ownership, and also to understand New Zealand's approach to banking supervision, which emphasizes disclosure and market-based mechanisms.

V. STAFF APPRAISAL

43. The sound macroeconomic policies and wide-ranging structural reforms of the past 15 years have clearly put New Zealand in a good position to weather the global economic turbulence of the past four years. The relatively strong economic performance of the two years, particularly in relation to the rest of the region and to other advanced economies, has also been underpinned by a number of favorable conditions—a competitive exchange rate, strong commodity prices, good agricultural growing conditions, and the absence of imbalances in asset markets. Unemployment remains close to a 13-year low, the current account deficit has narrowed markedly, and net external liabilities as a share of GDP, albeit still high, have declined.

44. **The staff endorses the current supportive stance of macroeconomic policies.** Given that inflation is now well within the target range, that growth is expected to continue to be below potential through most of 2002, and the downside risks to the external outlook, macroeconomic policies need to continue to be geared toward supporting activity.

45. **Monetary policy should continue to be the first line of defense.** Although domestic activity has remained stronger than expected and some signs of the expected rebound in world economic growth have begun to emerge, significant downside risks to the outlook continue to be an important concern. With inflationary pressures likely to remain subdued, there is scope for further easing. The Reserve Bank of New Zealand should use this room, within the context of its forward-looking inflation targeting framework, if economic prospects weaken.

46. **The modest fiscal impulse already in place is providing stimulus to the economy, and if growth is significantly weaker than currently envisaged, allowing the automatic stabilizers to work would be a sufficient fiscal policy response.** The scope for discretionary fiscal easing is limited by the large net external liability position, the concerns over the risk premium in debt markets, and the difficulty in calibrating a fiscal policy response in a manner that delivers the stimulus when it is most needed, while ensuring that medium-term fiscal policy objectives are not compromised. Even with regard to the use of automatic stabilizers, the staff sees a need for careful monitoring of the economic outlook and the evolution of the fiscal accounts so as not to confuse the impact of cyclical and non-cyclical factors.

47. **Potentially large pressures building on the fiscal front raise some concerns about the prospects for fiscal policy.** Larger-than-expected wage settlements for health workers, additional pressure on health spending (despite the substantial planned increase in allocations through 2004/05) to meet increasing demands, and the government's exposure to Air New Zealand are likely to take up most of the provision for new spending in the coming budgets.

Moreover, the staff sees a risk that the revision of the spending cap for 2002/03 could encourage additional spending demands, and urges the authorities to strictly adhere to the revised spending cap.

48. **There are also a number of areas where long-term fiscal pressures are likely to intensify.** On superannuation, the staff broadly support the plan to prefund a part of future pension liabilities, but given substantial prospective budgetary costs, consideration will need to be given to parametric reforms (raising the retirement age, lowering the replacement rate, or indexing payments to prices rather than wages). Rising health care costs associated with the commitment to a first-class public health care system in New Zealand are also a concern, and pressures will grow as the population ages. Thus, the staff urges the authorities to review the experience of other industrial countries to help in the design of appropriate incentives to increase the efficiency of the delivery of health services and to control costs.

49. **The structural reforms implemented to date—by eliminating major distortions, reducing inflation, strengthening public finances, deregulating goods and labor markets, and opening up the economy to foreign trade and capital—have improved economic incentives and enhanced the growth performance of the economy.** The staff's view is that lifting the economy to a higher sustainable growth trend is appropriately at the top of the Government's agenda. Doing so would require, first and foremost, maintaining the strong macroeconomic framework and key structural policy reforms that have already been put in place. Additional reforms aimed at enhancing growth in the basic components of productive capacity—the capital stock, the labor force, and their productivity would likely foster the necessary conditions for lifting New Zealand's growth potential.

50. **The authorities' focus on innovation and skill development, as well as on strengthening international linkages is appropriate.** The staff supports efforts to raise education and training; encourage innovation and research and development and its dissemination, and to attract and retain high-skilled workers. The focus on strengthening international trade linkages through multilateral negotiations and free trade agreements is appropriate. In this context, the staff commends New Zealand for its exemplary policy of providing duty- and quota-free access to the least developed countries for all goods and services.

51. **Reforms of the tax and income support systems aimed at significantly reducing disincentives to participate in the labor force and to save and invest productively in New Zealand are a priority.** The tax system is basically sound and a radical restructuring is not required, but several distortions need to be addressed. The recommendations of the recent McLeod Tax Review are a good place to start. Specifically, the staff supports aligning the top marginal personal income tax rate with the corporate tax rate and eliminating those aspects of the tax system that favor one form of saving/investment over another. The staff is skeptical about the effectiveness of lowering tax rates on new foreign investment since taxes are not the main drivers of where to locate investment, and to do so would open up a variety of tax arbitrage opportunities. Reforms of the welfare system also have an important bearing on incentives for labor force participation. In particular, replacement rates and the duration of

benefits need to be reassessed, and it would be useful to examine the experiences of other countries with “in-work” benefits in order to provide better incentives to household heads to work while ensuring an adequate safety net for families and children. While reforms of the tax and income-support system could impose additional net costs on the budget, any negative impact on market sentiment from such an increase in costs will likely be small, if the reforms are seen as part of a well-designed strategy aimed at improving investment and growth.

52. The recent consolidation of the dairy processing industry and merger with the export marketing agency to form the Fonterra Cooperative poses significant risks for the economy. Dairy producers are exposed to a single business strategy if no effective competition to Fonterra emerges. Important moral hazard issues also are created with an entity that could be seen as “too big to fail.” Moreover, the company’s structure does not allow investors outside the dairy industry to invest in Fonterra. The staff urges the authorities to keep the functioning of the new company under close review to ensure that effective competitive pressures are generated in the sector.

53. The government has taken on a potentially large, open-ended commitment with the takeover of Air New Zealand. The staff strongly supports the authorities’ intention to allow the company to operate as a commercial entity, with sound governance, strong management, and operational restructuring to contain costs. However, the staff recommends that the government divest its shares in Air New Zealand at the earliest opportunity.

54. The authorities should remain mindful of the risks of a more interventionist industrial policy. The role of Industry New Zealand should remain tightly circumscribed so as to prevent drift into activist industrial and regional development policies, with which most countries, including New Zealand, have not had satisfactory experiences. In addition, the Kiwibank has the potential to become a relatively high-risk activity, which could eventually entail fiscal costs. It is essential that the bank be run on a strictly commercial basis and kept under close scrutiny.

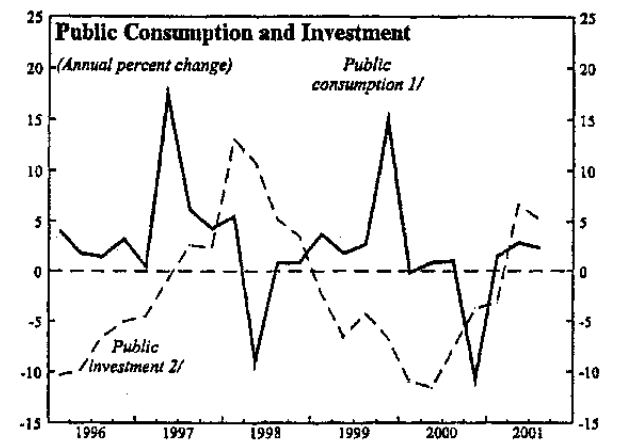
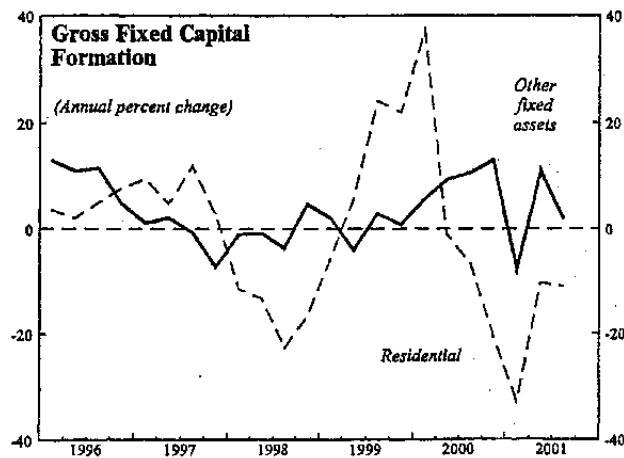
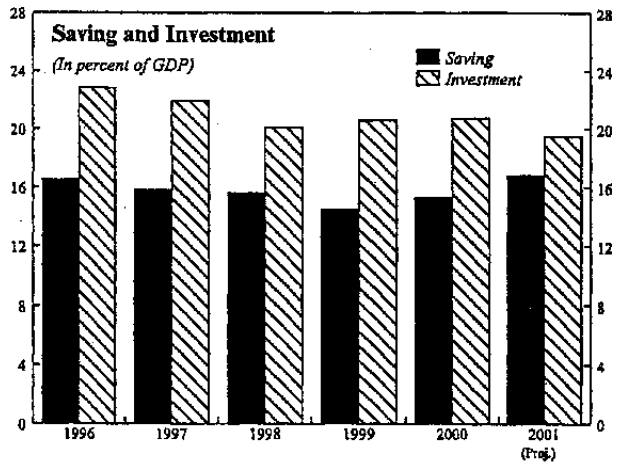
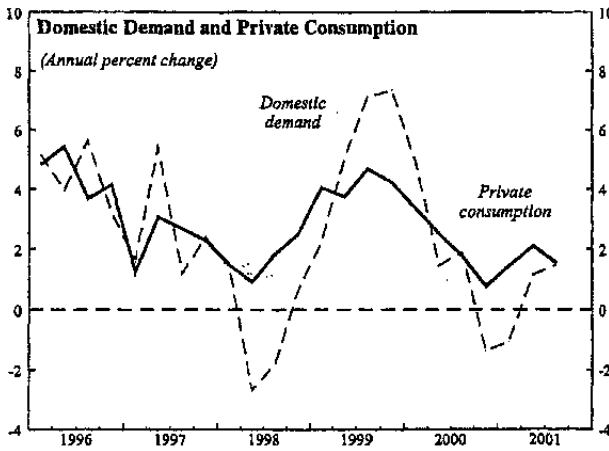
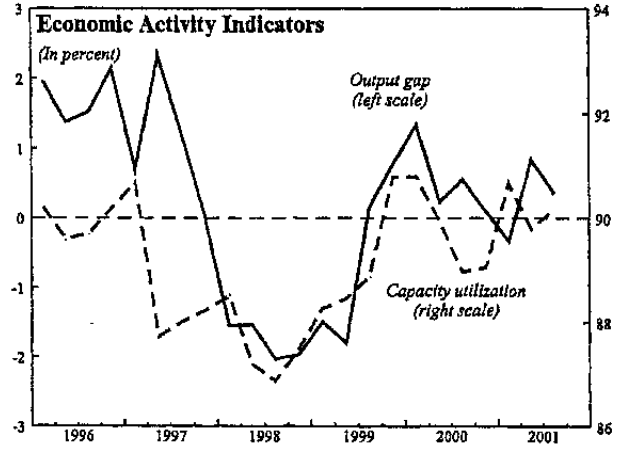
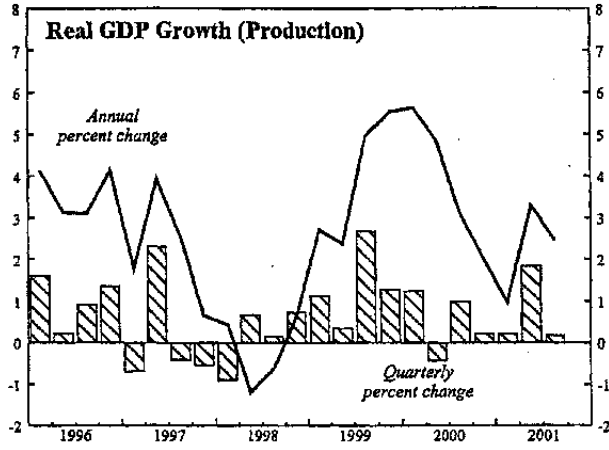
55. In spite of New Zealand’s high dependence on foreign capital, the resilience of the corporate and financial sectors to the experience of the past four years—which saw a fall in the currency by more than 30 percent vis-à-vis the U.S. dollar—continues to support the assessment that the economy is generally well-placed to absorb shocks. Credible and sound economic policies, the robustness of the financial sector, the strong risk management culture in New Zealand banks, the absence of corporate and household sector financial imbalances, and the high degree of hedging provide comfort in this regard. That said, some recent developments—the increase in debt as a share of external liabilities, potential rollover risks from the shortening of maturities, and the decline in the share of New Zealand dollar denominated debt—need to be carefully monitored. We support the authorities’ efforts to better understand these developments and their implications for the exchange rate and other asset prices. The authorities’ efforts to develop a wide range of macroprudential indicators of economic and financial vulnerability are also very useful, and the agreement to participate in the FSAP in 2003 is welcome.

56. **New Zealand publishes an array of high-quality economic and financial data that are adequate for surveillance.** The staff supports the authorities' ongoing efforts to improve the frequency, timeliness, and coverage of economic and financial statistics (Annex IV).

57. 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, 1996-2001



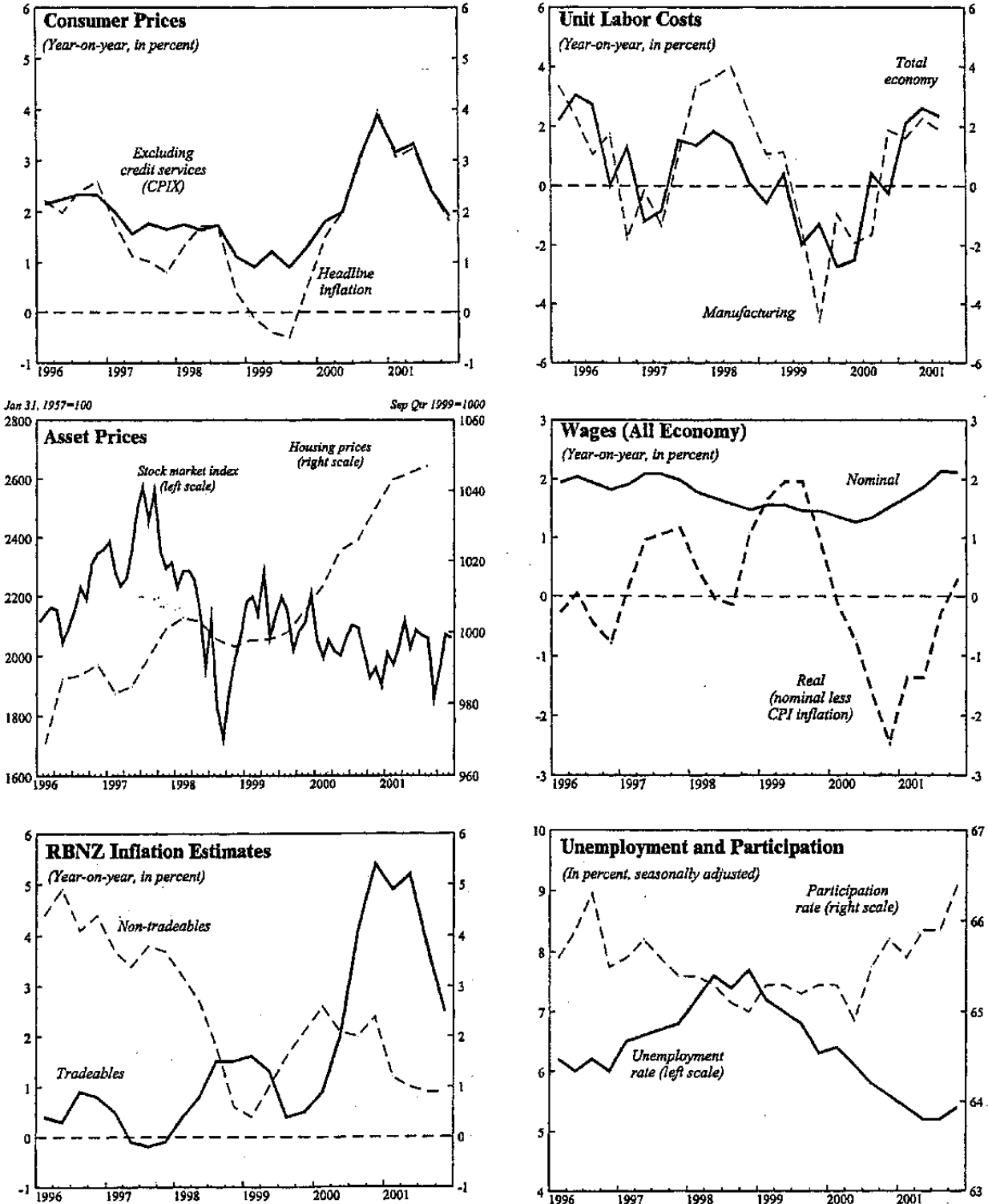
Sources: Statistics New Zealand; and staff estimates.

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

2/ Defined as total minus private investment. Private investment interpolated from annual data, which were calculated using March-year total investment deflator.

**FIGURE 2
NEW ZEALAND**

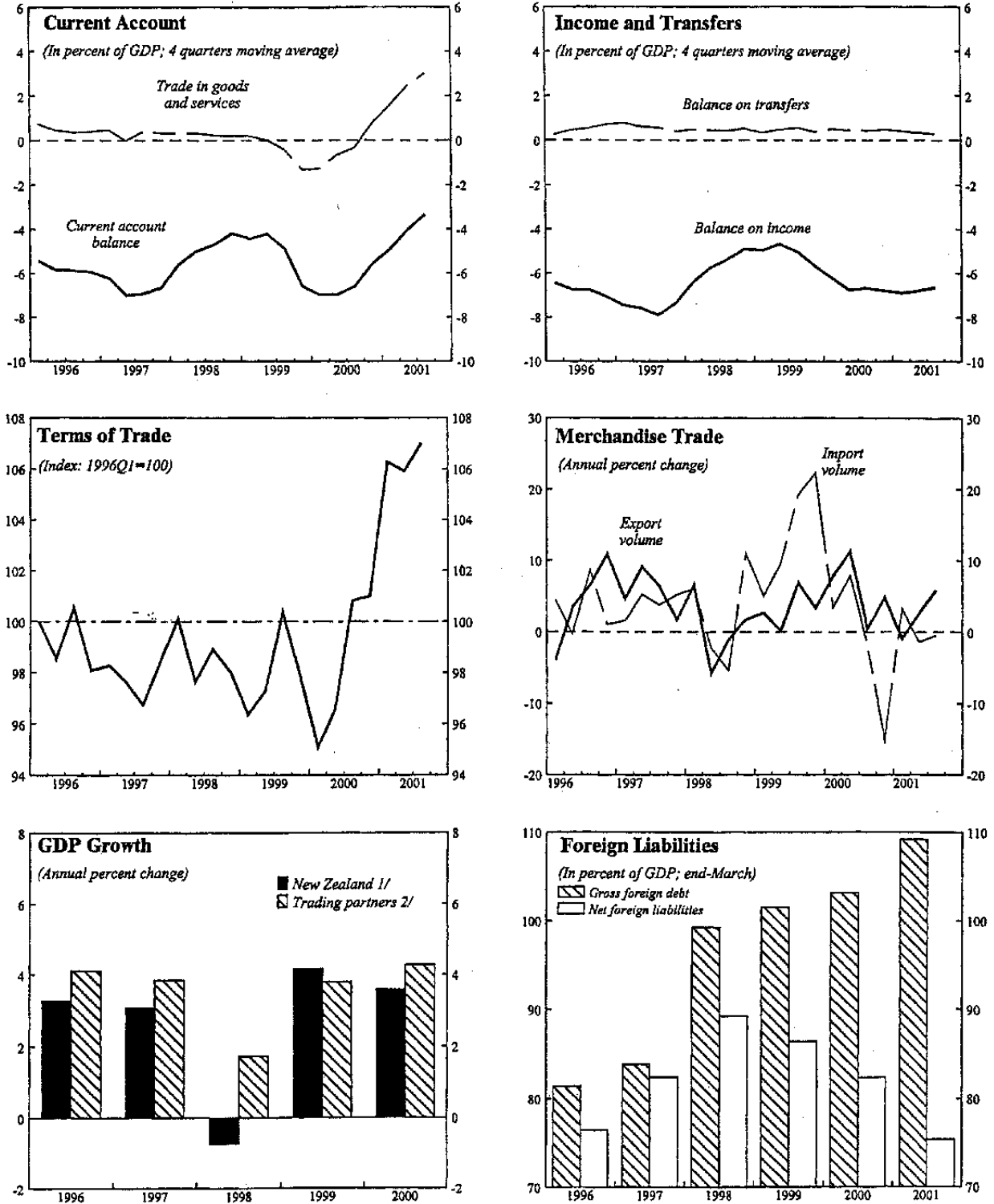
LABOR MARKET AND INFLATION INDICATORS, 1996-2001



Sources: Statistics New Zealand; and staff estimates.

**FIGURE 3
NEW ZEALAND**

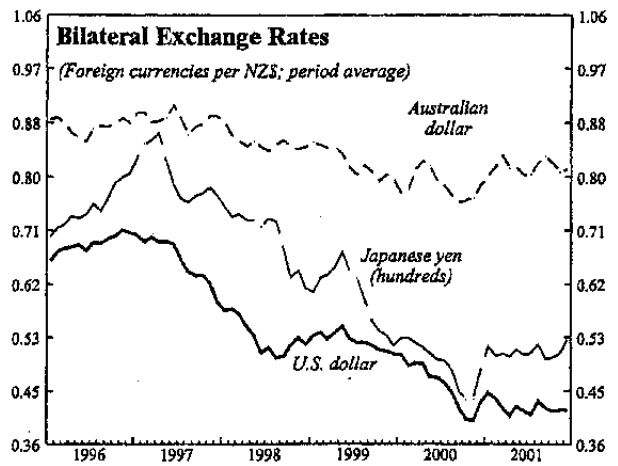
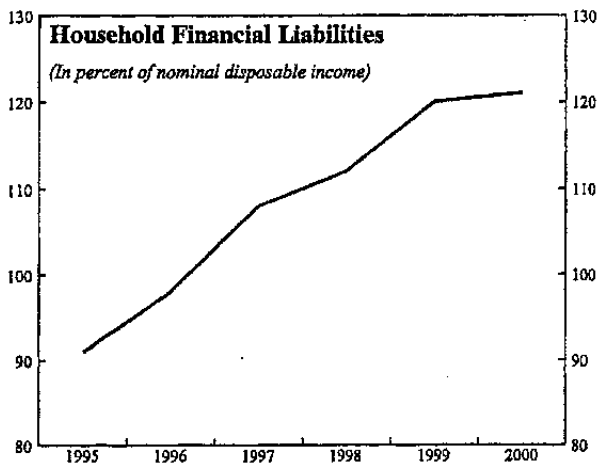
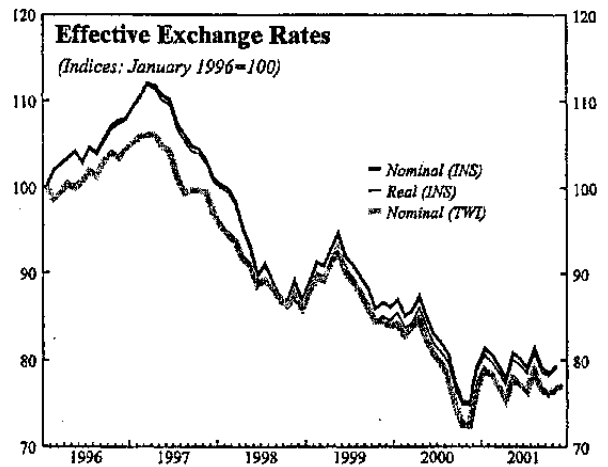
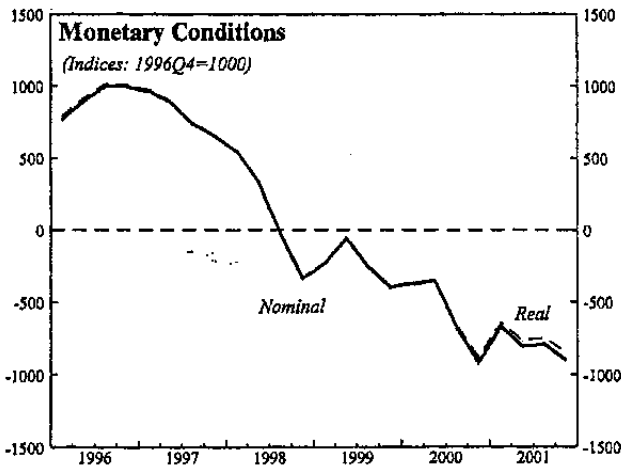
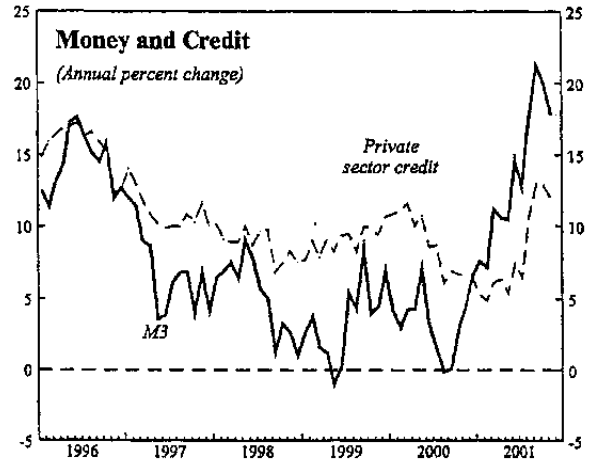
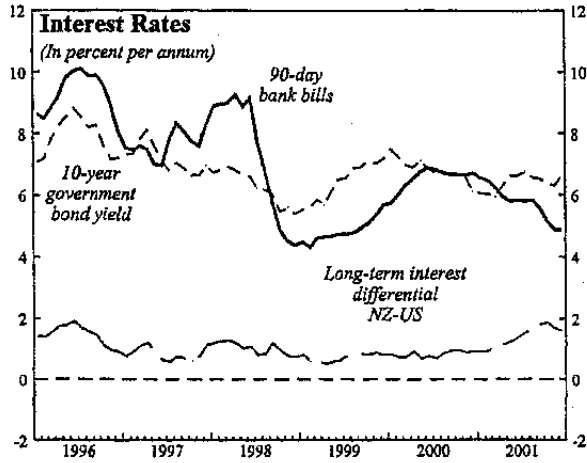
BALANCE OF PAYMENTS AND EXTERNAL INDICATORS, 1996-2001



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**

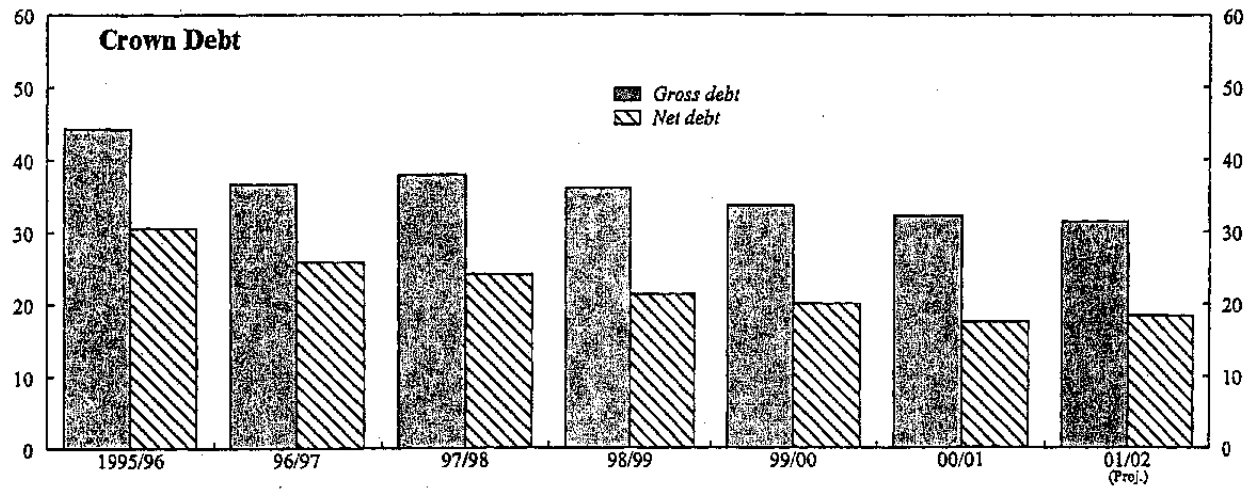
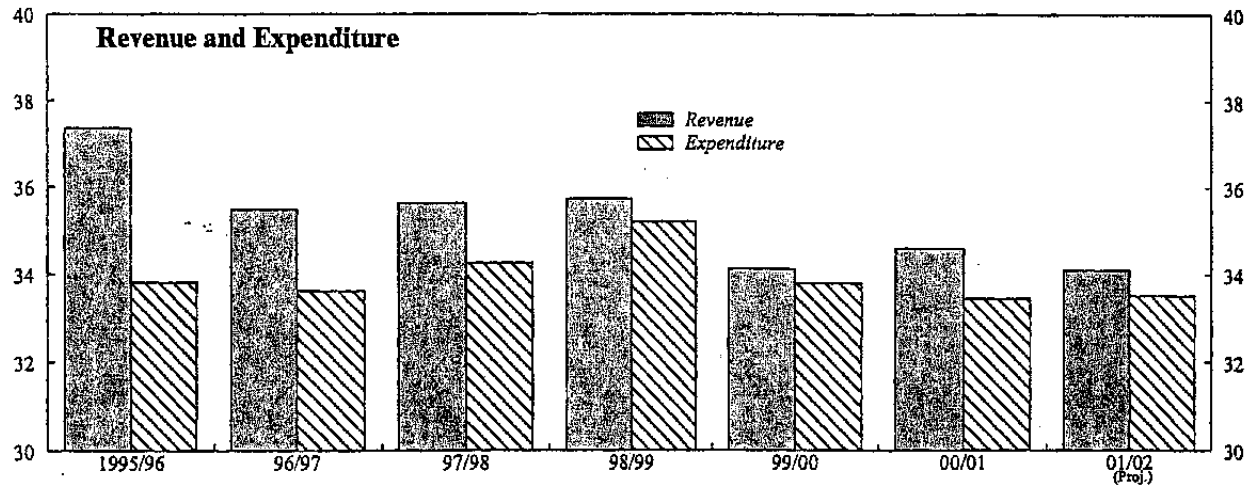
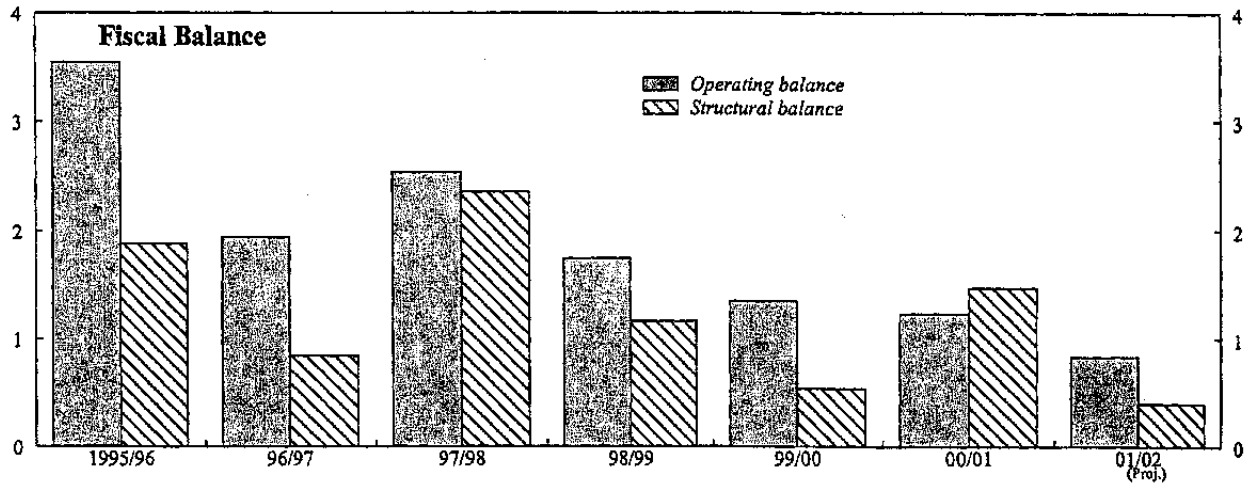
MONETARY AND FINANCIAL INDICATORS, 1996-2001



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

FIGURE 5
NEW ZEALAND

FISCAL INDICATORS, 1995/1996-2001/02
(In percent of GDP)



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

Table I. New Zealand: Selected Economic and Financial Indicators, 1997-2002

Nominal GDP (2000): US\$ 49.9 billion
 Population (2000): 3.8 million
 GDP per capita (2000): US\$ 13,131
 Quota: SDR 894.6 million

	1997	1998	1999	2000	Proj.	
					2001	2002
Real growth (percent change)						
GDP (production basis)	2.2	-0.2	3.9	3.9	2.4	1.9
Domestic demand	2.6	-0.6	5.4	1.7	1.1	2.0
Private consumption	2.3	1.7	4.2	2.1	1.9	1.8
Fixed investment	1.1	-4.5	2.9	7.2	-2.6	4.4
Exports of goods and services	3.7	1.2	7.1	7.6	2.9	1.6
Imports of goods and services	2.4	1.4	11.7	1.1	1.1	1.5
CPI excluding credit services (percent change)	1.7	1.6	1.1	2.7	2.7	1.9
Unemployment rate (in percent)	6.7	7.5	6.8	6.0	5.3	5.5
Investment and saving (in percent of GDP)						
Investment	21.9	20.1	20.6	20.7	19.5	19.9
National saving 1/	15.8	15.6	14.5	15.3	16.8	16.1
Private saving	11.2	11.2	10.8	11.8	13.7	12.7
Public saving	4.6	4.4	3.7	3.5	3.1	3.4
Public finance (in percent of GDP) 2/						
Revenue	35.5	35.6	35.7	34.1	34.6	34.2
Expenditure	33.6	34.3	35.2	33.8	33.5	33.6
Operating balance 3/	1.9	2.5	1.7	1.4	1.2	0.8
Estimated structural balance 4/	0.8	2.4	1.2	0.5	1.5	0.4
Net public debt	25.8	24.1	21.3	20.0	17.5	18.4
Money and credit (end of period)						
M3 (percent change)	4.2	1.1	6.9	6.5	17.8 5/	...
Private domestic credit (percent change)	10.1	7.6	10.6	6.5	11.9 5/	...
Interest rate (90-day, in percent)	8.3	4.4	5.7	6.7	4.9 6/	...
Government bond yield (10-year, in percent)	7.0	5.4	7.2	6.1	6.6 6/	...
Balance of payments (\$NZ billion)						
Current account	-6.6	-4.1	-6.9	-6.1	-3.2	-4.5
(in percent of GDP)	-(6.6)	-(4.1)	-(6.7)	-(5.6)	-(2.7)	-(3.8)
Trade balance (goods)	1.3	1.7	-0.9	1.3	3.5	1.3
Exports	21.5	22.9	23.8	29.7	33.0	31.7
Imports	-20.2	-21.2	-24.7	-28.4	-29.5	-30.4
Terms of trade (percent change)	-1.6	0.9	-0.8	0.6	7.2	-5.0
Foreign assets and liabilities (\$NZ billion) 7/						
Net international investment position 8/	-79.9	-89.3	-87.1	-87.1	-86.8	...
(in percent of GDP)	-(82.4)	-(89.3)	-(86.4)	-(82.4)	-(75.4)	...
Gross short-term external debt 9/	38.2	40.9	43.7	54.1	62.1	...
Gross foreign currency denominated debt 10/	36.8	46.2	54.1	61.9	78.4	...
Official reserves	7.7	8.0	8.6	7.6	7.3 12/	...
Exchange rate (end of period)						
US\$/NZ\$	0.58	0.53	0.52	0.44	0.42 6/	...
TWI 11/	62.8	55.6	54.3	49.7	49.9 6/	...
Nominal effective exchange rate 12/	109.6	94.13	93.29	85.9	86.1 13/	...
Real effective exchange rate 12/	104.5	89.06	87.83	81.8	82.2 13/	...

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

1/ Projections 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/ November 2001.

6/ December, 2001.

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 until 2000, and on the International Investment Position thereafter.

10/ Includes debt that is unallocated in terms of foreign currency denomination.

11/ Trade-weighted index (June 1979 = 100).

12/ IMF Information Notice System index (1990 = 100).

13/ November, 2001.

Table 2. New Zealand: Balance of Payments and External Debt, 1996-2001

	1996	1997	1998	1999	2000	Proj. 2001
	(In percent of GDP)					
Current account balance	-6.0	-6.6	-4.1	-6.7	-5.6	-2.7
Trade balance	0.8	1.3	1.7	-0.8	1.2	3.0
Exports, f.o.b.	21.6	21.6	22.8	22.9	26.9	28.2
Imports, f.o.b.	-20.8	-20.3	-21.1	-23.7	-25.7	-25.2
Services balance	-0.4	-1.0	-1.5	-0.5	-0.4	0.2
Receipts	7.0	6.5	6.9	7.8	8.6	8.7
Payments	-7.4	-7.5	-8.4	-8.3	-9.0	-8.5
Income balance	-7.1	-7.3	-4.9	-5.7	-6.8	-6.2
Receipts	0.6	0.6	1.6	1.7	1.2	1.1
Payments	-7.7	-8.0	-6.5	-7.4	-8.0	-7.4
Transfers balance	0.7	0.4	0.5	0.4	0.5	0.3
Inflows	1.3	1.1	1.3	1.1	1.3	1.2
Outflows	-0.6	-0.7	-0.7	-0.8	-0.8	-0.9
Capital and financial account balance 1/	7.4	6.5	2.6	3.2	6.2	...
Capital account (net)	2.0	0.4	-0.3	-0.4	-0.4	...
Financial account (net)	5.4	6.1	2.9	3.6	6.6	...
Direct investment (net)	5.7	4.0	0.5	1.1	4.4	...
Portfolio investment (net)	-0.8	-1.8	-0.1	-5.4	0.2	...
Equity securities (net)	-0.2	-1.3	0.3	-1.3	-4.3	...
Debt securities (net)	-0.6	-0.6	-0.3	-4.1	4.4	...
Other investment (net)	0.5	3.9	2.5	7.8	2.0	...
Net errors and omissions 2/	1.2	-2.0	0.6	3.8	-1.0	...
Overall balance	2.7	-2.2	-0.9	0.3	-0.3	...
	(Assets and liabilities as of end-March)					
Total external debt 3/	81.4	83.9	99.3	101.6	103.2	109.2
Short-term 4/	39.8	39.4	40.9	43.3	51.2	55.5
Long-term	38.6	41.0	55.8	52.8	48.2	53.7
Unallocated estimate	3.0	3.5	2.6	5.4	3.8	...
Net international investment position	-76.5	-82.4	-89.3	-86.4	-82.4	-75.4
Net equity	-16.9	-19.4	-23.1	-12.3	-6.3	-17.0
Net debt	-59.6	-63.1	-66.2	-81.3	-83.5	-58.4
Official reserves	6.8	6.5	7.6	7.3	7.8	7.3
(in months of future imports of g&s)	(3.0)	(2.8)	(3.0)	(2.5)	(2.4)	(2.2)
(as percent of short-term debt)	(17.0)	(16.5)	(18.5)	(16.8)	(15.2)	(13.2)

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

1/ Based on IFS data.

2/ Calculated as a residual.

3/ Data based on Total Overseas Debt statistics until 2000, and on the International Investment Position thereafter.

4/ Residual maturity of less than one year.

Table 3. New Zealand: Central Government Budget, 1996/97-2001/02 1/

	1996/97	1997/98	1998/99	1999/00	2000/01	2001/02 DEFU
(In billions of New Zealand dollars)						
Revenue	34.8	35.6	36.4	36.5	39.5	40.3
Tax revenue	31.9	33.0	32.2	34.0	36.7	35.6
Direct taxation	20.2	21.3	20.3	21.5	23.9	24.2
Indirect taxation	11.8	11.7	11.9	12.5	12.9	13.3
Non-tax revenue	2.9	2.6	4.2	2.5	2.8	2.7
Expenditure	33.0	34.2	35.8	36.2	38.2	39.6
Social security and welfare	11.9	12.5	12.9	12.9	13.2	13.6
NZ Superannuation	5.3	5.4	5.1	5.1	5.3	5.5
Other	6.5	7.1	7.8	7.8	7.9	8.1
Health	5.6	6.0	6.6	6.9	7.3	7.8
Education	5.3	5.7	5.9	6.3	6.7	7.0
Defense	0.9	1.1	1.0	1.2	1.3	1.2
Finance costs	3.1	2.8	2.5	2.4	2.5	2.3
Other	6.1	6.1	6.9	6.5	7.2	7.6
Revenue less expenses	1.8	1.4	0.5	0.4	1.3	0.7
Net surplus from SOEs and Crown entities	0.1	1.2	1.2	1.1	0.1	0.3
Operating balance 2/	1.9	2.5	1.8	1.4	1.4	1.0
OBERAC 3/	1.9	2.2	0.2	0.9	2.1	1.2
Structural operating balance	0.8	2.4	1.2	0.6	1.7	0.5
Cash balance 4/	3.0	0.6	1.9	-0.4	0.6	-2.0
Fiscal impulse 5/	-2.3	1.9	-1.9	3.2	-0.8	2.1
Gross Crown debt	36.0	37.9	36.7	36.0	36.8	37.1
Net Crown debt	25.3	24.1	21.7	21.4	20.0	21.7
Crown balance (net worth) 6/	7.5	9.9	6.0	8.6	11.5	12.4
(In percent of GDP)						
Revenue	35.5	35.6	35.7	34.1	34.6	34.2
Tax revenue	32.6	33.0	31.6	31.8	32.2	30.2
Direct taxation	20.6	21.3	19.9	20.1	20.9	20.6
Indirect taxation	12.0	11.7	11.7	11.7	11.3	11.3
Non-tax revenue	2.9	2.6	4.1	2.3	2.4	2.3
Expenditure	33.6	34.3	35.2	33.8	33.5	33.6
Social security and welfare	12.1	12.5	12.7	12.1	11.6	11.6
NZ Superannuation	5.4	5.4	5.0	4.7	4.6	4.7
Other	6.7	7.2	7.7	7.3	7.0	6.9
Health	5.7	6.0	6.5	6.4	6.4	6.6
Education	5.4	5.7	5.8	5.9	5.9	6.0
Defense	1.0	1.1	1.0	1.2	1.1	1.0
Finance costs	3.1	2.8	2.5	2.2	2.2	2.0
Other	6.2	6.1	6.8	6.0	6.3	6.5
Revenue less expenses	1.9	1.4	0.5	0.3	1.1	0.6
Net surplus from SOEs and Crown entities	0.1	1.2	1.2	1.0	0.1	0.3
Operating balance 2/	1.9	2.5	1.7	1.4	1.2	0.8
OBERAC 3/	1.9	2.2	0.2	0.8	1.8	1.0
Structural operating balance	0.8	2.4	1.2	0.5	1.5	0.4
Cash balance 4/	3.0	0.6	1.9	-0.4	0.5	-1.7
Gross Crown debt	36.7	37.9	36.1	33.7	32.2	31.5
Net Crown debt	25.8	24.1	21.3	20.0	17.5	18.4
Crown balance (Net Worth) 6/	7.6	9.9	5.9	8.0	10.0	10.6

Sources: New Zealand Treasury, Budget and DEFU (December Economic and Fiscal Update); 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/ Equals operating balance net of revaluations and changes in accounting rules.

4/ Staff estimates; equals cash flows from operating activities less cash flows on investing activities that entail a claim on current resources.

5/ Based on the cash balance, as defined in footnote 4. A negative number implies a tightening of the fiscal stance.

6/ Includes the financial assets of the New Zealand Superannuation Fund, which are excluded from net debt.

NEW ZEALAND: MEDIUM-TERM SCENARIO

This scenario illustrates the medium-term dynamics of key economic variables assuming the continued implementation of policies announced by the authorities. The medium-term outlook is largely dependent on global developments, and is based on the latest global WEO assumptions and projections of partner-country demand and world prices for New Zealand's exports and imports.

Real GDP growth is envisaged to decelerate to around 2½ percent in 2001, owing to a slowdown in export growth following the marked declines in New Zealand's trading partner demand and commodity prices. Private investment would also slow, partly reflecting the deterioration in business confidence experienced in 2000 (Table I.1). Growth is expected to slow further to 2 percent in 2002, in line with a weaker world economy during the first half of 2002. With a recovery in external conditions expected in the second half of 2002, domestic economy would likely accelerate in 2003, when GDP is projected to grow at 3 percent. Over the medium-term, growth is projected to return to its potential rate of about 2½–2¾ percent, as consumption growth stabilizes around its long-term trend, investment growth continues to be supported by improved business confidence and sound macroeconomic fundamentals, and a more favorable external environment. The unemployment rate is expected to remain close to its present level, rising modestly towards 5½ percent in the next two years, as growth slows. Inflation is expected to fall toward the middle of the 0-3 percent target band over the medium-term, in line with the authorities inflation targeting framework.

The current account deficit is projected to narrow sharply to around 2¾ percent of GDP in 2001, down from 5½ percent of GDP in 2000, mainly as a result of a weak exchange rate and the exceptional performance of world prices for New Zealand's main export commodities. In 2002, however, the current account is projected to return to around 3¾ of GDP as the world economy slowdown affects export volumes. Further, as the buoyancy of commodity prices comes to an end, most of gains in the terms of trade experienced in 2001 are expected to be reversed. Beyond 2002, the current account is expected to improve again and converge towards 3 percent of GDP, owing to the positive contribution of net exports, as the real exchange rate is expected to remain broadly unchanged from its current level. The ratio of net external liabilities to GDP is projected to remain broadly unchanged from its current level of 76 percent of GDP.

National savings would most likely contribute to the narrowing of the current account deficit. Much of the improvement in national savings would result from higher public savings, supported by a sound medium-term fiscal outlook. This is in line with the authorities' long-term objective, as stated in the Fiscal Strategy, to achieve operating surpluses (on average over the cycle) sufficient to fund New Zealand Superannuation (NZS) and leave gross (net) debt at below 30 (20) percent of GDP. Private savings are expected to peak in 2001 and decline modestly over the medium-term, depending on the relative magnitude of two effects. Household savings would tend to rise as the rapid debt accumulation and deterioration in net worth experienced since 1997 levels off. However, the establishment of NZS is expected to reduce the amount of precautionary savings for retirement by households.

Table I.1. New Zealand: Medium-Term Scenario, 1998-2007

	1998	1999	2000	Proj.						
				2001	2002	2003	2004	2005	2006	2007
Real growth (percent change)										
GDP	-0.2	3.9	3.9	2.4	1.9	3.0	2.8	2.7	2.6	2.6
Domestic demand	-0.6	5.4	1.7	1.1	2.0	2.8	2.6	2.5	2.4	2.4
Consumption	1.1	4.5	1.0	2.0	1.8	2.5	2.4	2.4	2.3	2.2
Private consumption	1.7	4.2	2.1	1.9	1.8	2.6	2.4	2.5	2.3	2.2
Fixed Investment	-4.5	2.9	7.2	-2.6	4.4	2.9	3.2	3.3	3.3	3.2
Exports of goods and services	1.2	7.1	7.6	2.9	1.6	5.7	5.6	5.7	5.6	5.6
(Imports in trading partners)	(1.4)	(7.2)	(11.9)	-(0.3)	(2.0)	(7.1)	(7.3)	(7.5)	(7.5)	(7.5)
Imports of goods and services	1.4	11.7	1.1	1.1	1.5	5.3	5.2	5.2	5.3	5.3
Saving and investment (percent of GDP)										
Gross capital formation	20.1	20.6	20.7	19.5	19.9	20.0	20.2	20.3	20.4	20.6
Fixed investment	20.0	19.4	19.9	18.9	19.5	19.5	19.7	19.9	20.1	20.3
Increase in stocks	0.1	1.2	0.8	0.6	0.4	0.5	0.5	0.4	0.3	0.3
National saving 1/	15.6	14.5	15.3	16.8	16.1	16.6	16.9	17.2	17.5	17.8
Private	11.2	10.8	11.8	13.7	12.7	12.5	12.2	12.3	12.6	12.9
Public	4.4	3.7	3.5	3.1	3.4	4.1	4.7	4.9	5.0	5.0
Inflation and unemployment										
CPIX inflation	1.6	1.1	2.7	2.7	1.9	1.7	1.7	1.6	1.7	1.5
Unemployment rate	7.5	6.8	6.0	5.3	5.5	5.6	5.7	5.6	5.6	5.6
Output gap	-1.8	-0.6	0.6	0.3	-0.5	-0.1	0.0	0.0	0.0	0.0
Government budget (percent of GDP) 2/										
Revenue	35.6	35.7	34.1	34.6	34.2	33.9	34.5	34.8	34.7	34.7
Expenditure	34.3	35.2	33.8	33.5	33.6	33.1	33.0	32.7	32.6	32.6
Net surplus from SOEs and Crown entities	1.2	1.2	1.0	0.1	0.3	0.7	0.7	0.7	0.7	0.7
Operating balance	2.5	1.7	1.4	1.2	0.8	1.5	2.3	2.7	2.8	2.8
Structural operating balance 3/	2.4	1.2	0.5	1.5	0.4	1.4	2.2	2.7	2.7	2.7
Cash balance 4/	0.6	1.9	-0.4	0.5	-1.7	-0.6	0.3	1.2	1.0	1.0
Gross Crown debt	37.9	36.1	33.7	32.2	31.5	31.6	32.3	31.6	31.0	30.6
Net Crown debt	24.1	21.3	20.0	17.5	18.4	19.0	19.2	18.4	17.8	17.5
Crown Balance (Net Worth) 5/	9.9	5.9	8.0	10.0	10.6	11.6	13.4	15.6	17.6	20.0
Terms of trade (percent change, goods)	0.9	-0.8	0.6	7.2	-5.0	0.6	0.3	0.0	0.1	0.0
Balance of payments (percent of GDP)										
Current account balance	-4.1	-6.7	-5.6	-2.7	-3.8	-3.5	-3.3	-3.1	-2.9	-2.8
Balance on goods and services	0.2	-1.4	0.8	3.2	1.6	1.9	2.1	2.3	2.5	2.6
Balance on goods	1.7	-0.8	1.2	3.0	1.1	1.4	1.6	1.8	2.0	2.1
Balance on services	-1.5	-0.5	-0.4	0.2	0.5	0.5	0.5	0.5	0.5	0.5
Balance on income and transfers	-4.3	-5.3	-6.3	-5.9	-5.4	-5.4	-5.4	-5.4	-5.4	-5.4
Balance on income	-4.9	-5.7	-6.8	-6.2	-5.7	-5.6	-5.7	-5.6	-5.6	-5.6
Balance on transfers	0.5	0.4	0.5	0.3	0.3	0.3	0.3	0.3	0.3	0.3
Net foreign liabilities (percent of GDP) 6/	87.3	83.6	79.9	76.1	78.5	78.2	78.0	77.7	77.4	77.1

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/ Staff estimates; equals cash flows from operating activities less cash flows on investing activities that entail a claim on current resources.

5/ Includes the financial assets of the New Zealand Superannuation Fund, which are excluded from net debt.

6/ End of calendar year.

NEW ZEALAND—ECONOMIC VULNERABILITY ASSESSMENT

This Annex updates the staff's assessment of New Zealand's external vulnerability provided in last year's Article IV consultation.¹ On the whole, the assessment remains broadly unchanged. The rapid growth in external debt and the shift in its currency composition to foreign currencies and a shortening of its maturity structure might suggest that the country's external vulnerability has increased. However, there are important mitigating factors which support the view that New Zealand remains well placed to absorb adverse external shocks.² These factors include:

- The share of local currency denominated debt in gross external debt remains large despite the shift in the composition of new flows.
- While external indebtedness is becoming increasingly concentrated in the financial sector, most of the increased exposure is to related parties.
- Hedging of foreign exchange rate risk from external foreign currency-denominated debt remains high across sectors, and "natural" hedging has risen markedly in 2001.
- Corporate and bank balance sheets remain strong and have been resilient to the sharp depreciation of the exchange rate. The increased focus by economic agents on market and credit risk management is a reflection of the floating exchange rate system in New Zealand.

New Zealand—Key External Vulnerability Statistics					
	1997	1998	1999	2000	2001
	(In percent of GDP at end-March)				
Current account (annual)	-6.2	-5.6	-4.4	-7.0	-4.8
Net foreign liabilities	82.4	89.3	86.5	82.4	75.4
Gross external debt	83.9	99.3	101.6	103.2	109.2
Of which:					
Local currency denominated	45.9	53.1	47.9	44.6	39.1
Short-term (residual maturity)	39.4	40.9	43.3	51.2	55.5
Official government	21.3	20.0	17.2	15.5	15.1
Foreign currency denominated debt (in \$NZ billions)	...	43.6	48.7	57.9	78.4
Total Hedging (in percent of total debt)	...	94.9	97.2	96.6	99.8
of which: with financial derivatives	...	54.1	64.5	65.1	62.6
naturally hedged	...	40.7	32.7	31.5	37.2
	(Annual percentage growth at end-December) 1/				
Exports of goods and services (y-o-y volume)	3.7	1.2	7.1	7.6	2.9
Imports of goods and services (y-o-y volume)	2.4	1.4	11.7	1.1	1.1
Terms of trade (quarterly index)	0.2	-0.4	-3.7	2.9	5.8
Real effective exchange rate (1990=100)	104.5	89.1	87.8	81.8	81.1 2/

Source: Statistics New Zealand.
 1/ For 2001, data are for June quarter.
 2/ Data for October 2001.

¹ See *New Zealand: 2000 Article IV Consultation*, IMF Staff Country Report No. 00/138, 2000.

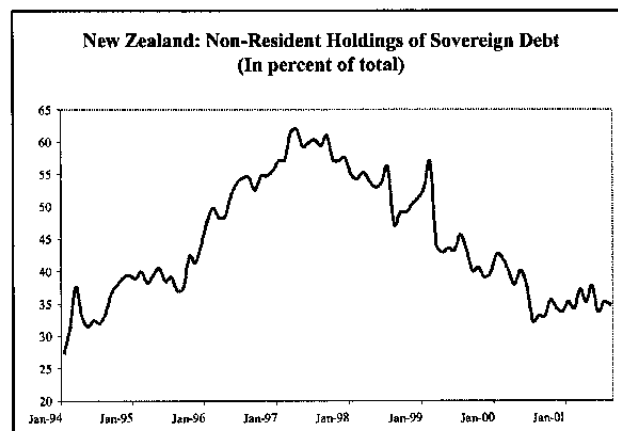
² Reserve-related indicators (which are not mentioned in this Annex) are not meaningful in New Zealand since the RBNZ has not intervened in the foreign exchange market since 1985 and holds few foreign assets.

A. Decomposition of Gross External Debt

1. **The rapid pace of New Zealand’s external borrowing observed in past years has continued.** As of end-March 2001, gross external debt amounted to \$NZ 122 billion (almost 110 percent of GDP), roughly 12 percent higher than end-March 2000. In the five years to end-March 2001, gross external indebtedness has increased by almost 30 percentage points of GDP (Table II.1). However, net external liabilities have declined to about 75 percent of GDP in March 2001 from a recent high of nearly 90 percent of GDP.

2. **New Zealand’s increased gross external indebtedness is primarily a financial sector phenomenon.** Since end-March 1996, gross private sector debt has increased from 58 percent of GDP to 95 percent of GDP by end-March 2001, while official government debt has declined markedly, from 23½ percent of GDP to 15¼ percent of GDP, largely reflecting the ambitious fiscal consolidation. Registered banks accounted for the bulk of private sector borrowing, as other corporate indebtedness remained largely unchanged relative to GDP. Since end-March 1996, banks foreign indebtedness has more than doubled, rising from 23½ percent of GDP to 57½ percent in 2001.

3. **The currency composition of New Zealand’s external debt continued to shift away from domestic to foreign currencies.** After peaking at 54¾ percent in end-March 1997, the share of NZ dollar-denominated debt has declined markedly over the past three years, reaching 35¾ percent in end-March 2001. NZ dollar-denominated debt declined in the past year to \$NZ 43 billion by end-March 2001, although it is estimated to have increased to \$NZ 47½ billion in September 2001. All the external borrowing denominated in domestic currency is done mainly by banks and the government. Banks fund themselves in other Asian markets, primarily through related parties. Also, non-residents holdings of New Zealand government debt has declined from a peak of 62 percent of total government debt in April 1997 to about 35 percent in August 2001.



4. **The share of short-term debt has risen since 1999, but the implications for the overall maturity structure of the total external debt are less evident, as the share of long-term debt increased markedly as of end-March 2001.** The share of short-term external debt was 51 percent of total external debt and 55 percent of GDP at end-March 2001, above the levels observed prior to the Asian crisis.³ However, the share of long-

³ End-March 2001 data are not strictly comparable to previous years due to a change in the presentation by Statistics New Zealand (SNZ). Short-term liabilities are now classified up to

(continued)

term debt has increased to 19½ percent of total debt in 2001 from a low of 15¼ percent in 2000.

B. Hedging of Foreign Currency–Denominated Debt

5. **The degree of hedging of New Zealand’s foreign currency denominated debt has been quite high over the past three years.**⁴ As of end–March 2001, New Zealand’s foreign currency denominated external debt was almost fully hedged (99.8 percent), up from 97 percent in 2000, and 95 percent in 1998 (Table II.2). Banks’ and official sector’s debt were fully hedged as of end–March 2001.

6. **While about two thirds of the hedging has been arranged through financial derivatives since 1999, the share of “natural hedging” (i.e., mainly against cash flows or assets) increased markedly in 2001, to about 37 percent of debt.** Even though banks continue to rely primarily on financial derivatives for hedging foreign–currency debt, they have been more recently able to book liabilities in \$NZ terms, either through loans from related parties or deposits. Banks’ reliance on natural sources of hedging accounted for roughly 50 percent of total natural hedging in New Zealand in 2001, up from 35 percent in 2000.

C. Balance Sheets

7. **Over the past 15 years, household balance sheets have been significantly influenced by economic restructuring and financial liberalization in New Zealand.** Household indebtedness doubled in the 1990s, from 64 percent of disposable income in 1990 to 120 percent in 2000, as stronger economic growth, enhanced access to credit, and significant net immigration in the early 1990s boosted borrowing and investment in housing. By end-2000, about 80 percent of

	1990	1995	1996	1997	1998	1999	2000
Net wealth:	358	401	408	415	390	386	356
Of which net financial wealth:							
Assets	165	193	194	195	194	199	187
Liabilities	64	91	98	108	112	120	121
Other assets (housing)	257	299	312	328	307	307	289
Debt servicing costs 2/ (in percent of disposable income)	9.2	9.1	9.9	9.9	8.9	8.5	9.6
Savings rate 3/	2.7	-3.4	-3.1	-2.2	-4.5	-4.1	-4.2

Source: Thorp and Ung, RBNZ Bulletin June 2001; Statistics New Zealand.

1/ In percent of disposable income.
2/ Figures are as of December quarter.
3/ Figures refer to year ending in March.

and including one year instead of under one year of maturity. SNZ has not yet released historical data prior to March 2000. Also, the breakdown of external debt by related and non-related party has not been published as of end–March 2001.

⁴ Hedging information was collected from a survey of corporations in New Zealand by SNZ. It comprised about 74 percent of the total foreign currency–denominated debt in New Zealand as of end–March 2001.

households' liabilities and 60 percent of households' assets were related to housing. Notwithstanding the sharp rise in indebtedness, net wealth remained high. After peaking at 415 percent in 1997, net wealth declined steadily to 360 percent of disposable income in 2000, due to lower equity and housing prices, and to the real depreciation of the exchange rate. Net financial wealth declined during most of the past decade, and its share in total net wealth is low relative to comparable OECD countries.⁵

8. **Increased indebtedness and a negative saving rate might normally suggest that the household sector could be vulnerable to sudden changes in the economic outlook but this does not appear to be the case.** Mortgage debt in New Zealand is largely structured at fixed rates with short maturities, or floating rates. With a decline in interest rates and rising incomes due to strong employment growth, household interest payments, which peaked at 10½ percent of disposable income in mid-1998, have declined to 9½ percent by end-2000 and to 8¾ percent by September 2001. Household balance sheets also remain sound, as net wealth remains high and in line with OECD levels. The household saving rate, which has been negative since 1993, stood at -3 percent of disposable income in March 2001. Possible factors underlying its deterioration include the fiscal consolidation and disincentives associated with the structure of taxes on social security and public transfers, as well as methodological issues which tend to bias the estimate of savings downwards.⁶

	Operating income		ROPC		EBITDA		FFO to Debt		Total Debt to Capital	
	to Sales									
	1999	2000	1999	2000	1999	2000	1999	2000	1999	2000
New Zealand companies										
Median	38.5	29.4	9.5	10.1	4.2	5.0	21.7	26.0	36.1	37.3
Air New Zealand	18.6	-1.4	7.2	-7.1	4.8	...	14.5	9.8	97.2	77.3
Total survey population										
Median	22.9	24.5	9.7	10.4	5.2	5.0	24.8	24.6	42.1	41.6

Source: Australia & New Zealand Credit Stats 2001, Standard & Poor's.

1/ Figures in percent, except EBITDA. ROPC means return on permanent capital; EBITDA means earnings before interest, tax, depreciation, and amortization interest cover; and FFO means funds from operations.

9. **Recent balance sheet indicators suggest that the corporate sector in New Zealand remains sound.** According to S&P, the positive performance of New

⁵ A recent study by the RBNZ (Thorp and Ung, *RBNZ Bulletin*, Vol. 64, No. 2, June 2001) suggests that the relatively low share of net financial wealth could reflect the lack of attractive opportunities to invest in domestic capital markets and the expectation by investors of high returns to housing investment, especially following the attractive returns during the high-inflation period in the 1970s and 1980s.

⁶ The household saving rate is derived as a residual in the national accounts, and therefore, subject to significant measurement problems. Also, spending on durable goods and education bias the level of savings downwards. A recent study shows that about 30 percent of households report negative saving rates, that a significant portion of household saving comes from a small number of high-income households, and that the tax and transfers system has affected cohorts differently, inducing low saving rates. See "Household Saving Behaviour in New Zealand: A Cohort Analysis" by J. Gibson and G. Scobie, Treasury Working Paper 2001/18.

Zealand firms during 2000 was underpinned by a recovery in Asian export markets, rising commodity prices, as well as by their efforts to restructure and cut costs.⁷ Operating margins deteriorated in 2000, but remained high relative to those for Australian corporations. Returns on capital improved markedly, but remained somewhat below those of Australian corporations. Prudential indicators, such as cash flow protection and leverage, have improved markedly and suggest that New Zealand corporations remain less leveraged than those in Australia. S&P noted that rating downgrades were very high in 2000 and continued to exceed upgrades, although, the ratio of downgrades to upgrades fell in contrast to global trends, reflecting the predominance of investment-grade ratings among New Zealand's and Australia's firm. Other private sector analysts agreed that, except for Air New Zealand, the corporate sector was healthy.

10. **The profitability, asset quality, and capitalization levels of New Zealand banks has been quite high in recent years.** During 2000, banks registered in New Zealand were quite profitable, with returns on assets and equity averaging about 1¼ percent and 23¾ percent, respectively, well above traditional benchmarks for international banks.⁸ Asset quality remained very sound, as the share of impaired assets was around 0.4 percent in 2000. In addition, banks appear to have provisioned a significant proportion of their lending, with total provision averaging about 35 percent of nonperforming loans. Capital levels also exceed regulatory benchmarks, with tier one capital rising to almost 8 percent of assets in 2000, and total capital increasing to 11 percent. Off-balance sheet exposures have been growing quite rapidly in the past few years, but still represented only 9 percent of risk-weighted assets by end-2000.

New Zealand: Banks' Balance Sheet Indicators					
	1996	1997	1998	1999	2000
Net profits (in percent of total assets)	0.86	0.86	0.87	1.03	0.99
Capital adequacy 1/	10.5	10.5	10.5	10.3	11.1
Tier one	6.8	6.9	7.3	7.1	7.7
Impaired assets (in percent of total assets)	0.9	0.6	0.6	0.5	0.4

Source: "Macro-financial stability and macroprudential analysis," Reserve Bank Bulletin (2001).
1/ Capital as a percentage of risk-weighted exposure. Figures are as of December.

D. Other Factors

11. **Recent developments in sovereign and commercial banks' credit ratings confirm the sound overall financial**

⁷ S&P conducts an annual survey of New Zealand and Australian corporations. The 2001 survey comprised 266 firms, of which 38 were from New Zealand. The median credit rating for all firms was A-, well above the BB- median rating for U.S. industrial companies.

⁸ There were 18 banks registered in New Zealand as of end-2000. Since then, two banks have closed operations. Registered banks in New Zealand must maintain a tier one capital ratio of 4 percent of risk-weighted assets and a total capital ratio of 8 percent. While capital requirements for banks operating in New Zealand as branches of overseas banks are not mandatory, the RBNZ has asked those banks—deemed as systemically important and with retail deposits exceeding \$NZ 200 million—to incorporate locally.

condition in New Zealand. Sovereign foreign currency debt continued to be favorably rated by the main international rating agencies, and ratings are similar to those of Australia. Ratings for long-term debt by Moody's and S&P remained unchanged at Aa2 and AA+, respectively, while ratings for short-term debt were also unchanged at P1 and A1, respectively. Ten banks had a credit rating of AA- or above as of end-2000, two more than in the previous year, suggesting that domestic banks capacity to repay debt remained very strong.

12. **While spreads on New Zealand sovereign bond debt have increased during 2001, this rise does not represent a fundamental reassessment of risk for the New Zealand economy.** The yield spread on the New Zealand ten-year government bond (relative to an equivalent U.S. bond yield) rose from an average of 95 basis points in 1994-2000 to a peak of 180 basis points in October 2001. It has declined to about 150 basis points in December, averaging 140 basis points in 2001. However, the yield spreads for other advanced economies, such as Australia and Canada, have followed similar trends in 2001, possibly reflecting investors' concerns on global economic conditions rather than on the New Zealand economy.

Table II.1. New Zealand: Decomposition of Gross External Debt ^{1/}

	End-March					
	1996	1997	1998	1999	2000	2001
(In billions of New Zealand dollars)						
Total gross external debt	75.4	81.3	99.3	102.4	109.1	122.2
<i>By sector</i>						
Official government	21.9	20.6	20.0	17.4	16.4	16.9
Corporate sector	53.5	60.7	79.4	85.0	92.7	105.2
<i>By sub-sector</i>						
Banks	21.9	24.4	32.9	39.5	51.0	63.7
Other corporate	31.7	36.2	46.5	45.5	41.7	41.5
<i>By relation</i>						
Related party	27.1	31.0	43.6	45.8	55.5	0.0
Non-related party	26.4	29.6	35.8	39.2	37.1	0.0
<i>By currency</i>						
New Zealand dollar	39.8	44.5	53.1	48.3	47.2	43.7
Foreign currency	32.8	33.5	43.6	48.7	57.9	74.0
U.S. dollar	19.6	20.5	28.0	33.0	38.6	51.8
Japanese yen	4.7	4.1	4.9	5.5	8.2	10.3
Australian dollar	3.7	3.1	3.7	4.3	5.1	7.2
Other	4.8	5.8	7.0	5.9	5.9	4.7
Unallocated	2.8	3.3	2.6	5.4	4.0	4.4
<i>By (residual) maturity</i>						
Short-term (under 1 year)	36.9	38.2	40.9	43.7	54.1	62.1
Medium-term (1-5 years)	17.2	21.1	35.1	30.6	34.3	27.3
Long-term (over 5 years)	18.6	18.7	20.8	22.7	16.6	24.0
Unallocated	2.8	3.3	2.6	5.4	4.0	8.8
Nominal GDP (in \$NZ)	92.7	96.9	100.1	100.8	105.7	111.9

Source: Statistics New Zealand; and Fund staff estimates.

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

Table II.1 (Continued). New Zealand: Decomposition of Gross External Debt

	End-March					
	1996	1997	1998	1999	2000	2001
	(In percent of GDP)					
Total gross external debt	81.4	83.9	99.3	101.6	103.2	109.2
<i>By sector</i>						
Official government	23.6	21.3	20.0	17.2	15.5	15.1
Corporate sector	57.8	62.6	79.3	84.3	87.7	94.0
<i>By sub-sector</i>						
Banks	23.6	25.2	32.9	39.2	48.2	56.9
Other corporate	34.2	37.4	46.4	45.2	39.5	37.1
<i>By relation^{1/}</i>						
Related party	29.3	32.0	43.5	45.4	52.6	...
Non-related party	28.5	30.6	35.8	38.9	35.1	...
<i>By currency</i>						
New Zealand dollar	43.0	45.9	53.1	47.9	44.6	39.1
Foreign currency	35.4	34.5	43.6	48.3	54.7	66.1
U.S. dollar	21.2	21.1	28.0	32.7	36.6	46.3
Japanese yen	5.1	4.2	4.9	5.4	7.7	9.2
Australian dollar	4.0	3.2	3.7	4.3	4.8	6.4
Other	5.1	6.0	7.0	5.8	5.6	4.2
Unallocated	3.0	3.5	2.6	5.4	3.8	3.9
<i>By (residual) maturity</i>						
Short-term (under 1 year)	39.8	39.4	40.9	43.3	51.2	55.5
Medium-term (1-5 years)	18.5	21.7	35.0	30.3	32.5	24.4
Long-term (over 5 years)	20.0	19.3	20.7	22.5	15.7	21.4
Unallocated	3.0	3.5	2.6	5.4	3.8	7.8

Source: Statistics New Zealand; and Fund staff estimates.

1/ Statistics New Zealand's has not updated the series for 2001.

Table II.1 (Concluded). New Zealand: Decomposition of Gross External Debt

	End-March					
	1996	1997	1998	1999	2000	2001
(In percent of total gross external debt)						
Total gross external debt	100.0	100.0	100.0	100.0	100.0	100.0
<i>By sector</i>						
Official government	29.0	25.4	20.1	17.0	15.0	13.9
Corporate sector	71.0	74.6	79.9	83.0	85.0	86.1
<i>By sub-sector</i>						
Banks	29.0	30.1	33.1	38.6	46.7	52.1
Other corporate	42.0	44.5	46.8	44.5	38.3	34.0
<i>By relation</i>						
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	...
<i>By currency</i>						
New Zealand dollar	52.8	54.7	53.5	47.2	43.3	35.8
Foreign currency	43.5	41.2	43.9	47.5	53.0	60.6
U.S. dollar	26.0	25.2	28.2	32.2	35.4	42.4
Japanese yen	6.2	5.0	5.0	5.3	7.5	8.4
Australian dollar	4.9	3.8	3.8	4.2	4.7	5.9
Other	6.3	7.2	7.0	5.8	5.4	3.9
Unallocated	3.7	4.1	2.6	5.3	3.7	3.6
<i>By (residual) maturity</i>						
Short-term (under 1 year)	48.9	47.0	41.2	42.7	49.6	50.8
Medium-term (1-5 years)	22.8	25.9	35.3	29.8	31.5	22.4
Long-term (over 5 years)	24.6	23.0	20.9	22.2	15.2	19.6
Unallocated	3.7	4.1	2.6	5.3	3.7	7.2

Source: Statistics New Zealand; and Fund staff estimates.

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

	End-March			
	1998	1999	2000	2001
(In billions of New Zealand dollars)				
Foreign currency external debt (from Table II.1) 1/	43.6	48.7	57.9	78.4
Of which: covered by SNZ hedging supplement 2/	32.4	38.0	47.0	56.5
Coverage of supplement (percent)	74.3	78.1	81.2	72.0
<i>Type of hedge</i>				
Financial derivatives	17.6	24.5	30.6	35.4
Naturally hedged (against assets/receipts)	13.2	12.4	14.8	21.0
Unhedged	1.7	1.1	1.6	0.1
<i>By sector</i>				
Banks	15.9	23.8	31.9	37.7
Financial derivatives	11.6	19.3	26.0	27.3
Naturally hedged (against assets/receipts)	4.3	4.4	5.3	10.4
Unhedged	0.1	0.0	0.6	...
Non-banks and official	16.5	14.2	15.0	18.8
Financial derivatives	6.0	5.2	4.6	8.1
Naturally hedged (against assets/receipts)	9.0	8.0	9.5	10.6
Unhedged	1.6	1.0	1.0	0.1

Source: Statistics New Zealand.

1/ Estimates for March 2001 include data where currency is unknown.

2/ 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 January 31, 2002)

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	572.81	64.03
	Reserve position in Fund	321.79	35.97
III.	SDR Department:	SDR Million	Percent Allocation
	Net cumulative allocation	141.32	100.0
	Holdings	12.82	9.07
IV.	Outstanding Purchases and Loans:	None	
V.	Financial Arrangements:	None	
VI.	Projected Obligations to Fund:	None	
VII.	Exchange Arrangement:		
	<p>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), the UNITA movement in Angola, Libya, and Taliban. These were all notified to the Fund pursuant to Decision No. 144.</p>		
VIII.	Article IV Consultation:		
	<p>New Zealand is on the 12-month consultation cycle. The 2000 Article IV consultation discussions were held during July 17-25, 2000, the Executive Board discussed the staff report (SM/00/211, 9/22/00) and concluded the consultation on October 23, 2000. The 2001 Article IV consultation should have been concluded by October 13, 2001, or at least by January 13, 2002, allowing for the three-month grace period beyond the end of the specified interval. The reason for delay in concluding the consultation is that the New Zealand authorities requested that the Fund mission be postponed from July 2001 to November-December 2001 to coincide with the release of the December Economic and Fiscal Update and to precede an OECD mission, allowing them to streamline their efforts in preparing for the two missions.</p>		
IX.	FSAP Participation and ROSCs:	FSAP scheduled for 2003	
X.	Technical Assistance:	None	
XI.	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.

SDDS Subscription

New Zealand is interested in subscribing to the SDDS and is currently completing work on the metadata templates. Given difficulties in calculating a meaningful monthly indicator of economic activity, SNZ will take advantage of the flexibility provisions within SDDS and will compile a quarterly manufacturing index using the quarterly series on manufacturing sales, which is currently disseminated. Another area in which SNZ will take advantage of the SDDS flexibility on timeliness is on the consumer price index and the producer price index as SNZ will continue to disseminate quarterly indices. New Zealand views modifications to the periodicity and timeliness requirements of the fiscal sector data category as important for subscription eligibility.¹

Balance of Payments

Based on SDDS requirements and the fifth edition of the Balance of Payments Manual (BOP), SNZ released BOP financial account and International Investment Position (IIP) statistics on a quarterly basis since the June quarter 2000. An important change was made to the definition for foreign direct investment (FDI) when in accordance with the fifth edition of the BOP manual the threshold for FDI was modified from 25 percent to 10 percent of total share. At the same time, the previous treatment in New Zealand balance of payments statistics of aggregating small holdings of related foreign investors to determine whether an investment was FDI was changed to conform with BOP. On balance, these two measures have induced a shift in capital flows from FDI to portfolio investment. Due to the differences in data collection between the previous and current definitions, SNZ has not attempted to update the series for the financial accounts and IIP prior to 2001. In addition, reinvested earnings (or losses) are now recorded in the current account under investment income and in the financial account under direct investment.

¹ For SDDS subscribers implementing accrual accounting systems for fiscal data, periodicity, and timeliness are on a “best efforts” basis until June 2002. During this period, the staff is reviewing ‘subscribers’ experiences and their impact on data dissemination practices with the aim of making specific recommendations, as needed, for modifications of the SDDS by the end of this period.

National Accounts

To comply with the System of National Accounts 1993 (1993 SNA), some changes will be introduced next year. The most important ones are the inclusion of livestock in the productive capital stock, and an improvement in the treatment of bank service charges. At present, this notional charge is not specifically allocated to the users of bank services but appears as a separate entry (as intermediate consumption of a notional industry, thus reducing GDP). Beginning in 2002, the financial intermediation services indirectly measured (FISIM) will be specifically allocated to the depositors and borrowers who consume the services, and thus be treated as intermediate consumption, final consumption expenditure, or as exports (FISIM imports will also be recorded). These changes would increase the level of GDP, as it would reflect the size of the bank services now consumed by final users.

Labor Market Data

Recent changes were made to hours worked reported by the Household Labor Force Survey (HLFS) to adjust for a misalignment between the HLFS quarter and calendar quarter and thus account for the missed or extra holidays. The Quarterly Employment Survey was also modified to correct problems related to the lack of a more frequent update of the number of businesses included in the survey, which was done only once a year. An adjustment has been introduced to smooth the increase of the number of businesses across several quarters.

New Zealand: Core Statistical Indicators

(As of January 31, 2002)

	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	1/31/2002	Dec. 2001	Dec. 2001	Dec. 2001	Dec. 2001	1/31/2002	Dec. 2001	Nov. 2001	Sept. 2001	Nov. 2001	Sept. 2001	Sept. 2001
Date received	1/31/2002	1/30/2002	1/14/2002	1/14/2002	1/29/2002	1/31/2002	1/17/2002	1/22/2002	12/20/2001	1/18/2002	12/20/2001	12/21/2001
Frequency of data	Daily	Monthly	Monthly	Monthly	Monthly	Daily	Quarterly	Monthly	Quarterly	Monthly	Quarterly	Quarterly
Frequency of reporting	Daily	Monthly	Monthly	Monthly	Monthly	Daily	Quarterly	Monthly	Quarterly	Monthly	Quarterly	Quarterly
Source of data	Reuters	RBNZ	RBNZ	RBNZ	RBNZ	Reuters	SNZ	SNZ	SNZ	Treasury	RBNZ	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	Monthly	Monthly	Monthly	Daily	Quarterly	Monthly	Quarterly	Monthly	Quarterly	Quarterly

Statement by the IMF Staff Representative
March 22, 2002

1. This statement contains information that has become available since the Staff Report (SM/02/49) was circulated to the Executive Board on February 14, 2002. The information does not alter the general thrust of the staff appraisal.

Recent Economic Developments and Outlook

2. **During the last quarter of 2001, economic activity proved stronger than expected at the time of the mission.** Data released for the December quarter showed that employment growth continued to be robust, the tourism industry recovered from the post-September 11 slowdown, and net migration inflows increased. Together with the low interest rates and the higher incomes associated with the agricultural export boom in 2000/01, these factors underpinned solid household spending and boosted the housing market. In contrast, both export volumes and the terms of trade deteriorated, as sales and prices of key New Zealand products were undermined not only by the weak global environment but also by some increases in export subsidies (e.g., European Union dairy subsidies).

3. **Robust consumption and construction activity are expected to sustain economic activity in the first half of 2002.** Consumer and business surveys indicate that confidence has improved in early 2002. On the business front, signs of recovery of the United States and global economy, high capacity utilization rates, and rising corporate profitability all point to an improvement in the outlook for investment. Although uncertainties still remain about the global economy and New Zealand's export sector, the strength of the domestic economy has led to an upward revision of the consensus growth forecast for 2002, from 2 percent to about 2½ percent. Despite the upswing in domestic economy, inflationary pressures have remained subdued, with stronger net migration inflows helping to ease wage inflation associated with skill shortages.

4. **Spurred by the more upbeat prospects for global growth, the New Zealand dollar has reached a six-month high in March.** Since the beginning of the year, the \$NZ has gained 5 percent against the U.S. dollar (3 percent in trade-weighted terms), and it is now back to its pre-September 11 levels.

Recent Policy Developments

5. **The Reserve Bank of New Zealand decided to raise the Official Cash Rate (OCR) by 25 bps to 5 percent at their scheduled review on March 20.** The main rationale for the decision was to withdraw some of the monetary stimulus that was introduced at the end of 2001 as an insurance against the deflationary risks arising from a significant slowdown in the world economy. Thanks to the strong domestic demand and the quicker than

expected recovery of the global economy, the RBNZ now sees greater risks of inflationary pressures arising from an economy operating at close to full capacity according to its measure of potential output. The annual inflation rate is projected to return to the top of the target range (0–3 percent) in March.

6. **The fiscal operating balance came in stronger reflecting the better than expected growth.** In the first seven months of the fiscal year (June 2001–January 2002), the operating balance was \$NZ 1.5 billion, some \$NZ 385 million larger than projected in the December Economic and Fiscal Update, mainly because of higher than expected revenues.

7. **The government released a report on the Economic Transformation agenda unveiling new initiatives to strengthen New Zealand’s economic growth prospects.** The report, *Growing an Innovative New Zealand*, presents initiatives directed at enhancing the innovation system, improving tertiary education, attracting foreign talents and quality investments, and fostering development in the areas of biotechnology, and information and communications technology.



INTERNATIONAL MONETARY FUND

Public Information Notice

EXTERNAL
RELATIONS
DEPARTMENT

Public Information Notice (PIN) No. 02/35
FOR IMMEDIATE RELEASE
March 27, 2002

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

IMF Concludes 2001 Article IV Consultation with New Zealand

On March 22, 2002, the Executive Board of the International Monetary Fund (IMF) concluded the Article IV consultation with New Zealand.¹

Background

Between late 1999 and early 2001, the performance of the New Zealand economy was very strong, with real GDP expanding at almost a 4 percent annual rate. Net exports provided a significant stimulus to the economy, reflecting favorable prices for New Zealand's main exports, a recovery in agricultural production from droughts in 1999, and increased competitiveness from a depreciating exchange rate. The contribution from domestic demand during this period was more uneven, owing to large swings in business and consumer confidence that were triggered by initial concerns about the policy changes introduced by the Labor government and the rise in rural incomes on the back of strong export performance. Since early 2001, domestic demand growth has recovered and contributed to sustain GDP growth in the wake of weaker net exports, owing to the economic slowdown in the rest of the world. Low interest rates, strong net inflows of migrants, increased employment, and higher incomes associated with the surge of agricultural export over the last two years all contributed to consumption and bolstered the housing market in 2001. An improvement in business and consumer confidence in the first months of 2002 suggests that domestic demand is likely to maintain its momentum in the first half of the year.

¹ Under Article IV of the IMF's Articles of Agreement, the IMF holds bilateral discussions with members, usually every year. A staff team visits the country, collects economic and financial information, and discusses with officials the country's economic developments and policies. On return to headquarters, the staff prepares a report, which forms the basis for discussion by the Executive Board. At the conclusion of the discussion, the Managing Director, as Chairman of the Board, summarizes the views of Executive Directors, and this summary is transmitted to the country's authorities.

The sharp rise in economic activity pushed the economy to a high level of resource use, as capacity utilization rates rose markedly in 2001. Conditions in the labor market also tightened considerably, and the unemployment rate, which declined to a 13-year low of around 5¼ percent in the second quarter 2001, but rose slightly to nearly 5½ percent in late 2001 owing to higher labor force participation.

Inflation has remained relatively well contained despite the increases in resource utilization and the depreciation of the exchange rate. Following a brief spike to 4 percent in the fourth quarter of 2000, inflation decelerated to about 3 percent in the first half of 2001 and declined further to 1¾ percent in the fourth quarter of 2001, near the mid-point of the official target range of 0–3 percent. After the sharp depreciation in 2000, the New Zealand dollar remained relatively stable during most of 2001. Spurred by more upbeat prospects for global growth, the value of the currency appreciated by about 5 percent against the U.S. dollar in early 2002, reaching a six-month high in March, and it is now back to its pre-September 11 level.

A strong performance in exports contributed to a substantial narrowing of the current account deficit. The current account deficit declined from almost 7 percent of GDP in 1999 to around 3½ percent of GDP in the third quarter of 2001. Export growth has been remarkably strong since early 2000, particularly in the primary sector and tourism, reflecting favorable terms of trade, a recovery in farm output from the effects of the 1999 drought, and a boost to competitiveness from the fall in the real effective exchange rate. However, export volumes and the terms of trade deteriorated in late 2001, largely on account of the weak global economic environment and some increases in export subsidies by other industrialized countries on key New Zealand's commodities.

With mounting evidence in 2001 of a marked weakening of global demand, the Reserve Bank of New Zealand (RBNZ) eased monetary policy cautiously, reducing its Official Cash Rate (OCR) by a total of 75 basis points between March and August 2001. Following events of September 11, the pace of monetary policy easing was stepped up, with the OCR cut in two steps by a total of 100 basis points to 4¾ percent in November 2001 to help arrest the deflationary risks stemming from a weak world economy. With the pace of domestic economic activity remaining strong in late 2001 and into 2002 and the external environment appearing more favorable, the RBNZ decided to raise the OCR by 25 basis points to 5 percent at its scheduled review in March 2002.

Following a strong performance through 2000/01 (July–June), the short-term fiscal outlook was marked down considerably in late 2001. The operating surplus was 1¼ percent of GDP in 2000/01, and the overall cash balance posted a surplus of ½ percent of GDP. An anticipated deterioration in the external outlook, especially after the events of September 11, prompted the government to revise downwards the fiscal projections in the December Economic and Fiscal Update. At that time, the operating surplus in 2001/02 was projected to be ¾ percent of GDP, while the overall balance is expected to be in deficit by 1¾ percent of GDP, mainly reflecting the government's investment in Air New Zealand and increased capital spending on health and education. Nonetheless, in the first seven months of the fiscal year (June 2001–January 2002),

the operating surplus was larger than projected in the December Economic and Fiscal Update, mainly as a result of higher than expected revenues.

Over the medium-term, operating and overall surpluses are projected to rise steadily to 2¾ percent and 1 percent of GDP, respectively, in 2006/07. The ratio of gross government debt to GDP is expected to fall slightly from 32¼ percent in 2000/01 to 30¾ percent in 2006/07, and the net debt ratio would be unchanged at 17½ percent of GDP.

As for the near- and medium-term outlook, the staff's projections are for output growth of about 2 percent in 2002 and of 2½-3 percent over the medium term. However, in light of the continued buoyancy of domestic demand over the last few months and the recently improved prospects for a marked turnaround in global economic activity, there appears to be scope for an upward revision of New Zealand's growth forecast for 2002. Following some deterioration in 2002, the current account deficit is expected to stabilize at around 3 percent of GDP over the medium-term, assuming that the real effective value of the New Zealand dollar remains near its depreciated level in late 2001. CPI inflation in 2002 is expected to be slightly above the mid-point of the target range and to remain around the mid-point over the medium-term.

Executive Board Assessment

Executive Directors agreed with the thrust of the staff appraisal. They complimented the New Zealand authorities for persisting with comprehensive structural reforms over the past 15 years and a sound macroeconomic policy framework, which have increased the economy's resilience to economic shocks and allowed it to perform relatively strongly despite the slowdown in world economic growth since 2001. Directors acknowledged that buoyant export prices, good agricultural conditions, and the absence of imbalances in asset markets also have been important factors underpinning the favorable economic performance during the current slowdown in world economic growth.

Directors endorsed the supportive stance of macroeconomic policies during 2001. They agreed that monetary policy should be the main line of defense against inflation and economic slowdown. Thus, with inflation well within the official target range, Directors endorsed the easing of monetary policy during 2001 to help support economic activity. In light of the recent forecast of a quicker-than-expected global economic recovery in 2002, and the strong growth of domestic demand in recent months, Directors supported the central bank's move to tighten monetary policy in March 2002.

Directors praised the skillful conduct of monetary policy in New Zealand and considered that the inflation targeting framework has served the country well. They welcomed the conclusions of the independent review of monetary policy and the authorities' decision to further strengthen the central bank's decision-making and governance structures.

Directors agreed that the modest fiscal support provided to the economy in the short run through the full play of automatic stabilizers is sufficient in the present circumstances. In any event, they noted the scope for a more proactive fiscal policy is limited by the country's net

external liability position, the difficulty of timing the fiscal stimulus so that it is effective, and the need to ensure that medium-term fiscal objectives are not compromised.

Directors noted that potentially large pressures on the budget have been building up, and that those associated with pension and health care expenditures are likely to intensify over the long term. In line with the authorities' intentions, they emphasized that expenditure restraint will be important, if the medium-term objective of maintaining a fiscal surplus over the business cycle to prefund the future pension liabilities and contain the size of the public debt is to be achieved. While welcoming the plan to prefund part of future pension liabilities, Directors noted the need for reforms in the public pension system, including raising the retirement age, lowering the replacement rate, and changing the indexation of pensions to prices from wages. They stressed also the need for health care reform to improve the efficiency of the delivery of services and to control costs. Given New Zealand's good track record of prudent fiscal management, Directors expressed confidence in the authorities' ability to meet the challenges in the period ahead.

Directors agreed that New Zealand remains well placed to absorb adverse external shocks, as demonstrated by the economy's ability to absorb these shocks over the past few years without undue economic or financial distress. While the rapid growth of foreign currency-denominated external debt and the shortening of its maturity structure might suggest an increase in New Zealand's external vulnerability, Directors acknowledged that several factors mitigate the foreign exposure risk to the financial system, including the credibility and soundness of economic policies, the robustness of the banking sector, the absence of corporate and household sector financial imbalances, and the high degree of hedging. At the same time, Directors supported the authorities' efforts to better understand the implications of recent developments for the exchange rate and other asset prices, and to identify the ultimate holders of risk. They also welcomed the efforts to develop a set of macroprudential indicators and the decision to participate in the Financial Sector Assessment Program in 2003.

Directors pointed to a number of structural reforms that have enhanced economic incentives and improved the growth performance of the economy, including fiscal reform, the elimination of major distortions in the economy, the deregulation of product and labor markets, and the opening up of the economy to foreign trade and capital. They emphasized that, to create conditions conducive to lifting New Zealand's growth potential, additional reforms will be required to reduce disincentives to work, save, and invest, while building the social consensus necessary to ensure their success.

Directors welcomed the authorities' focus on innovation and skill development, and on efforts to attract high-skilled workers and strengthen New Zealand's international trade linkages through multilateral trade agreements. In this context, Directors commended New Zealand for its exemplary policy of providing quota- and duty-free access to all products from least developed countries. Some Directors also noted that trade restrictions imposed by partner countries continue to significantly hamper growth in New Zealand.

While acknowledging that the tax system is basically sound, Directors accorded high priority to certain changes that could spur labor force participation, saving, and productive investment.

These include aligning the top marginal personal income tax rate with the corporate rate, reducing the tax bias in favor of residential investment, and reassessing replacement rates and the duration of social benefits. Directors raised doubts about the long-term effectiveness of lowering tax rates in attracting foreign investment and cautioned that such a measure would likely create new opportunities for tax arbitrage.

Directors urged the authorities to closely monitor the operations of the newly-established dairy cooperative, Fonterra, to ensure that it remains subject to effective competition domestically. Similarly, they welcomed the authorities' intention to allow Air New Zealand to operate on a commercial basis, but recommended that the company be privatized at the earliest opportunity. Directors also welcomed the authorities' intention to run Kiwibank on a strictly commercial basis and recommended that the bank's activities be kept under close scrutiny. In addition, they advised that the role of Industry New Zealand be tightly circumscribed so as to prevent drift into activist industrial and regional development policies.

Directors welcomed the significant progress made in dealing with anti-money laundering initiatives and the introduction of legislation to suppress the financing of terrorism.

It is expected that the next Article IV consultation with New Zealand will be held on the standard 12-month cycle.

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. The Staff Report for the 2001 Article IV Consultation with New Zealand is also available.

New Zealand: Selected Economic and Financial Indicators

	1997	1998	1999	2000	Est. 2001
	(Percent change)				
Real economy					
Real GDP	2.2	-0.2	3.9	3.9	2.4
Real domestic demand	2.6	-0.6	5.4	1.7	1.1
Real exports	3.7	1.2	7.1	7.6	2.9
Real imports	2.4	1.4	11.7	1.1	1.1
Inflation (CPI excluding credit services)	1.7	1.6	1.1	2.7	2.7
Unemployment rate (in percent)	6.7	7.5	7.2	7.2	5.3
Gross national saving (annual percent of GDP) 1/	15.8	15.6	14.5	15.3	16.8
Gross capital formation (annual percent of GDP)	21.9	20.1	20.6	20.7	19.5
	(Percent of GDP, years ending June 30)				
Government budget					
Revenue	35.5	35.6	35.7	34.1	34.6
Expenditure	33.6	34.3	35.2	33.8	33.5
Operating balance	1.9	2.5	1.7	1.4	1.2
Estimated structural balance 2/	0.8	2.4	1.2	0.5	1.5
Net public debt	25.8	24.1	21.3	20.0	17.5
	(End of period)				
Money and credit					
M3 (change in percent)	4.2	1.1	6.9	6.5	14.4 3/
Private domestic credit (change in percent)	10.1	7.6	10.6	6.5	11.3 3/
Interest rate (90-day, in percent)	8.3	4.4	5.7	6.7	5.6 4/
Government bond yield (10-year, in percent)	7.0	5.4	7.2	6.1	7.0 4/
	(Percent of GDP)				
Balance of payments					
Current account balance	-6.6	-4.1	-6.7	-5.6	-2.7
Capital and financial account	6.5	2.6	3.2	6.2	...
	(Percent of GDP, years ending March 31)				
External assets and liabilities					
Official reserves	6.5	7.6	7.3	7.8	7.3
Gross external debt	83.9	99.3	101.6	103.2	109.2
Net external liabilities	82.4	89.3	86.4	82.4	75.4
	(End of period)				
Exchange rate					
US\$/NZ\$	0.582	0.527	0.521	0.440	0.416 3/
Nominal effective exchange rate 5/	109.6	94.1	93.3	85.9	86.3 6/
Real effective exchange rate 5/	104.5	89.1	87.9	81.8	82.8 6/

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

1/ Projections of national saving equals investment plus current account balance excluding migrants' transfers.

2/ Staff estimates; equals operating balance net of cyclical effects, revaluations and changes in accounting rules.

3/ February 2002.

4/ March 25, 2002.

5/ IMF Information Notice System index (1990 = 100).

6/ December 2001.

**Statement by Michael J. Callaghan, Executive Director and Mario G. di Maio,
Assistant to the Executive Director for New Zealand
March 22, 2002**

Key Points

- New Zealand's sound macroeconomic framework and structural policies have been central to its relatively strong performance over the past two years and resilience to external economic shocks.
- Recent indicators suggest somewhat stronger activity than envisaged when the staff report was prepared.
- The current macroeconomic settings are appropriate in light of the economic outlook.
- Within the forward-looking inflation-targeting framework, monetary policy will continue to be the main instrument in responding to changes in the economic outlook.
- Fiscal policy is appropriately focused on medium-term objectives, with the automatic stabilizers providing modest support for activity in the near term.
- The staff report overplays the risks of a slippage in fiscal policy given New Zealand's consistent record of responsible fiscal management.
- The authorities recognize that meeting their fiscal objectives will require careful management of longer-term fiscal pressures, and these are being addressed as evidenced by the pre-funding of superannuation costs.
- Enhancing the growth and productivity of the capital stock and labor force will be critical to achieving the Government's goal of improving New Zealand's growth potential.
- New Zealand remains well placed to absorb external shocks.

Short-Term Economic Outlook

1. Recent economic developments suggest that the balance of risks has shifted somewhat from those embodied in the outlook presented in the staff report. At the time the report was written, the key risks to the short-term outlook for the New Zealand economy included a further softening in external demand, declining commodity prices and a sharp decline in tourism receipts – and that these would lead to a negative confidence shock with consequent slower domestic activity. The risks to the international outlook have subsequently become more balanced as outlined in the draft World Economic Outlook. There are tentative signs of an earlier than expected rebound in tourism flows and a consolidation of commodity prices. On the domestic front, recent indicators are consistent with somewhat stronger activity than that envisaged at the end of 2001 – both consumer and

business confidence have rebounded. In addition, household spending and firm investment and hiring decisions are tracking higher than expected, and in recent months there has been a sharp turnaround in net migration.

Monetary Policy

2. The Reserve Bank of New Zealand will continue to conduct monetary policy in a pre-emptive fashion, with the focus on ensuring that inflation remains within the target range. As to the short-term outlook, monetary policy will be influenced by the balance of risks between a domestic economy that seems rather more buoyant than expected at the end of 2001 and early in 2002, and continuing risks around the world economy.

3. On March 20th, the Reserve Bank increased the Official Cash Rate from 4.75 per cent to 5 per cent. The Governor noted that even after this decision, monetary conditions remain stimulatory and that the decision simply represents some withdrawal of monetary stimulus, much of which was put in place as insurance against risks which have now receded.

4. New Zealand has been well-served by its current monetary policy framework, as evidenced by the report of the independent review of monetary policy. The author of the report, Professor Lars Svensson, concluded that: "monetary policy in New Zealand is currently entirely consistent with the best international practice of flexible inflation targeting".

5. Notwithstanding the very positive overall report, Professor Svensson did recommend some refinements, mainly in relation to the Reserve Bank's decision-making and governance structures. One of his principal recommendations was that responsibility for monetary policy decision-making should be vested in a committee, comprising the Governor and senior Reserve Bank staff, rather than the Governor alone. The Government did not accept that recommendation, but some other refinements are planned. The Bank's Board of Directors will be reconfigured, by making a non-executive director the Chair (currently the Governor) and by removing the deputy governor(s) from the Board. This change is being made to more closely align the structure of the Board with its role, which, primarily, is to monitor the performance of the Governor. Separately, the Governor has decided to increase the level of external input to the monetary policy decision-making process. He has appointed two external members to the (previously entirely internal) panel that advises on interest rate decisions, and has instituted a program of external peer review, by foreign central bank officials, of the monetary policy decision-making process.

Fiscal Policy

6. Any consideration of the fiscal outlook must be set against the background of New Zealand's sound underlying fiscal position, with public debt to GDP ratio well below the OECD average. With the projected 2001/02 surplus, the operating balance has now been in surplus for eight years. While this strong fiscal position has allowed the operation of the automatic stabilizers to provide modest support for activity in the short-term, the authorities

will look through the current short-term downturn and focus on their key medium-term objectives of:

- maintaining an operating surplus on average over the cycle sufficient to make contributions to the New Zealand Superfund; and
- ensuring consistency with the objective of reducing gross debt below 30 percent of GDP over the economic cycle.

7. Discretionary fiscal measures are unnecessary in the current circumstances. The slowing of the New Zealand economy during the current world down-turn has been much less pronounced than in other developed countries. In addition, the usual arguments against discretionary fiscal policy apply in New Zealand, most notably the difficulty of timing any stimulus effectively and the uncertainty regarding the magnitude of a fiscal impulse in a small open economy. Recent changes to the balance of risks surrounding the economic outlook adds further weight to these arguments.

8. The authorities consider that the staff report overplays the risks of slippage in the short-term fiscal position. The pressures on public spending are acknowledged, however, New Zealand has a consistent record of responsible fiscal management and meeting fiscal objectives. Fiscal developments since the Government's mid-year update suggest that the outturns for the current year are likely to exceed expectations. Furthermore, as previously noted, recent indicators are pointing towards somewhat stronger domestic activity over the remaining half of the fiscal year than was expected at the end of 2001.

9. Longer-term fiscal strategy is based on expenditure restraint, with the expenditure to GDP ratio declining slightly over the period to 2006 as contributions to the pre-funding of superannuation expenses increase. The authorities recognize that longer-term fiscal pressures will require careful management, and note that the pre-funding of superannuation costs represents a substantial contribution to managing the costs from an aging population.

10. New Zealand, like other developed countries, faces increasing demand for health care related to lengthening life expectancy, an aging population, and the pace of technological change. In addition, there is strong competition from other countries for its skilled health care workforce. The Government has announced a substantial funding package over three years aimed at managing these pressures. The package will provide a more certain financial basis for planning. The overall funding envelope provides a framework within which trade-offs can be made among competing demands, and increases the incentives for the sector to manage costs, including wage costs.

Enhancing New Zealand's Growth Potential

11. The Government remains committed to the key strengths of New Zealand's policy framework – macroeconomic stability, based on prudent fiscal policy and a monetary policy framework focused on delivering price stability, and an open and competitive micro-economy.

12. Building on these strengths is the current Government's priority. To this end, the Prime Minister recently announced a growth and innovation framework with the objective of returning New Zealand's per capita income to the top half of the OECD rankings over time. The strategy focuses on enhancing the innovation framework, developing skills and talents, and strengthening New Zealand's international linkages.

13. Progress has also been made in several of the key areas Directors identified in the 2000 Article IV consultation, notably:

- deregulation of the dairy sector;
- flexible and pragmatic implementation of labor and product market changes; and
- the passage of legislation that includes strong institutional arrangements to safeguard the New Zealand Superannuation Fund's resources, including an independent board to administer the fund and determine its investment strategy.

14. The authorities consider that the structural policy changes highlighted in the staff report, notably to the tax and welfare systems, are not of a sufficient magnitude to explain New Zealand's relative growth performance. Moreover, the authorities believe it is essential to pursue a strategy of incremental structural change which builds the necessary consensus for the required reforms.

15. The *Final Report of the Tax Review* concluded that the broad architecture of New Zealand's tax system is sound. The current system of broad-based taxes and lower tax rates is the result of significant changes made during the 1980s. As a result, the review concluded that from a national welfare perspective, many of the gains from earlier tax reforms have already been realized, while the problems that remain defy easy solution. Work is now focused on assessing the review's recommendations regarding international taxation, where the aim is to ensure that taxes do not reduce the quality or quantity of inward or outward investment.

16. The authorities acknowledge that the welfare system could be improved to ensure there is a better connection of beneficiaries with the workforce, including through more intensive case-management and improved training opportunities. As the report notes, a number of initiatives have already been launched in this area. There is also a work program underway which aims to explore options for simplifying the welfare regime and its interaction with the tax system. However, the complexity of the regime is partly a function of ensuring that the system is equitable, responsive to individual circumstances, and is provided at an acceptable cost. There are very few easy gains to be made in balancing these trade-offs. The current benefit system provides a safety net rather than functioning as an insurance scheme. As a result, replacement rates are relatively low when compared internationally and the gains from limiting the duration of benefits may be limited.

17. The authorities agree with staff that the dairy industry reforms should enhance the industry's efficiency. On the other hand, the new structure exposes dairy farmers to the risks of a single business strategy, although under the previous structure these risks were also very centralized. The background to the changes in industry structure is important. In particular, the owners of the industry themselves, the dairy farmers, decided the future structure of their industry. The authorities believe that farmers' direct control of this process goes a long way to mitigating the moral hazard risk that a business of Fronterra's size may pose.

18. We would also like to draw attention to the role of protectionist policies in New Zealand's trading partners in limiting the country's growth potential. These policies are particularly damaging because the barriers are highest in sectors where New Zealand possesses a comparative advantage and are directly detrimental to New Zealand's growth potential. The authorities will continue to work with our trading partners through multilateral and bilateral initiatives to eliminate these barriers.

19. The Government's investment in Air New Zealand and KiwiBank will be subject to commercial discipline. In the case of Air New Zealand, which will remain a publicly listed company, public support was predicated on the significant externalities from the maintenance of a national carrier given New Zealand's remoteness, and concerns regarding a lack of regional competition. The immediate focus is on stabilizing the financial situation of the company and restoring its profitability. The Government is not actively seeking a strategic partner at this time, nor have any specific proposals been received. At a time when the Government is seeking to sell to a strategic partner, it would expect Air New Zealand to conduct a search process and make recommendations to the Government. The Reserve Bank's banking registration and supervisory regime applies in its entirety to KiwiBank. As staff notes, the scale of its operations are small and the risk profile of its banking activities is low.

External Vulnerability

20. The authorities agree that New Zealand remains well placed to absorb external shocks. The experience of the past four years provides tangible support for this conclusion. Significant contributions to preserving New Zealand's resilience to external shocks will be made by the maintenance of strong and credible macroeconomic policies, and a strong financial system (through which much of the external debt is intermediated).

21. While a superficial glance at some traditional indicators may indicate heightened external vulnerability, the staff's analysis does a good job of painting the more complex picture that underlies these indicators. The financial system remains well capitalized and profitable, the level of non-performing loans is low and well provisioned, and exposures to currency fluctuations are almost fully hedged. Household and corporate balance sheets underlying the financial system remain sound despite the volatility of financial conditions since the Asian crisis.

22. At the same time, New Zealand is deeply integrated with international trade and financial markets and will remain, like countries in a similar position, vulnerable to marked

shifts in market sentiment. The authorities are not complacent and continue to work on deepening their understanding of vulnerability issues. The RBNZ has recently devoted attention to developing and analyzing Financial Soundness Indicators. The authorities also look forward to the contribution that the FSAP process can make in this regard during 2003.

23. To conclude, we would like to record our authorities' appreciation for the staff's balanced contribution to the economic policy debate in New Zealand.