

New Zealand: 2003 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 Article IV consultation with New Zealand, the following documents have been released and are included in this package:

- the staff report for the 2003 Article IV consultation, prepared by a staff team of the IMF, following discussions that ended on **February 7, 2003**, 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 March 27, 2003.** 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 **April 28, 2003** updating information on recent developments.
- a Public Information Notice (PIN) summarizing the **views of the Executive Board as expressed during its April 30, 2003 discussion** of the staff report that concluded the Article IV consultation.
- a statement by the Executive Director for New Zealand.

The document(s) listed below have been or will be separately released.

Selected Issues Paper

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

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NEW ZEALAND

Staff Report for the 2003 Article IV Consultation

Prepared by the Staff Representatives for
the 2003 Consultation with New Zealand

Approved by David Burton and Leslie Lipschitz

March 27, 2003

- The 2003 Article IV consultation discussions were held in Auckland and Wellington between January 29 and February 7, 2003.
- The staff team comprised Messrs. Nolan (head), Parrado, Senhadji, and Ms. Ramakrishnan (all APD). Mr. Dunaway (APD) and Mr. Callaghan (Executive Director) joined the mission for the discussions held in Wellington.
- The mission met with the Minister of Finance Michael Cullen; Reserve Bank Governor Alan Bollard; Acting Treasury Secretary John Whitehead; other senior government officials; and representatives of the private sector, labor unions, and academia.
- New Zealand has accepted the obligations of Article VIII, Sections 2, 3, and 4, and maintains an exchange system that is free of restrictions on the making of payments and transfers for current international transactions. New Zealand has accepted the Fourth Amendment of the Articles of Agreement.
- New Zealand publishes an array of high-quality statistics, and the authorities are actively working to address outstanding issues that preclude subscription to the SDDS.
- New Zealand has agreed to participate in the FSAP. The FSAP report is expected to be discussed during the 2004 Article IV consultation.

Contents	Page
Executive Summary	3
I. Recent Economic Developments and Outlook	4
A. Macroeconomic Developments.....	4
B. Economic Outlook	9
II. Policy Discussions	10
A. Monetary Policy and the Exchange Rate	11
B. Fiscal Policy	12
C. Promoting Economic Growth	14
D. Economic Vulnerability	19
III. Staff Appraisal	20
 Boxes	
1. External Economic Influences on the New Zealand Economy.....	5
2. The Growth Debate.....	15
3. Savings, Investment, and Growth	18
 Figures	
1. Selected Real Economic Indicators.....	24
2. Balance of Payments and External Indicators.....	25
3. Inflation and Labor Market Indicators	26
4. Monetary and Financial Indicators	27
 Tables	
1. Selected Economic and Financial Indicators.	28
2. Balance of Payments and External Debt.....	29
3. Summary of Central Government Budget	30
4. Medium-Term Scenario	31
5. External Sustainability Framework.....	32
 Annexes	
I. Economic Vulnerability Assessment	33
II. Fund Relations	41
III. Core Statistical Indicators	42
IV. Public Information Notice (PIN).....	43

EXECUTIVE SUMMARY

Economic Setting

New Zealand's economy has performed strongly over the past three years, underpinned by sound macroeconomic policies and aided by favorable commodity prices and a competitive exchange rate. Real GDP is estimated to have risen by some 4 percent in 2002, following increases of 3.9 percent and 2.4 percent in 2000 and 2001, respectively. Strong demand conditions have contributed to pushing capacity utilization rates to high levels and reducing unemployment to 4.9 percent in the December 2002 quarter. Pressures on resources have kept inflation toward the top end of the official 1–3 percent target range. The current account deficit began to rise again during 2002, as commodity prices fell and the New Zealand dollar appreciated; however, at just under 3 percent of GDP in the year ending September 2002, the deficit was below its average level over the past decade. Since end-2001, the currency has appreciated by 33 percent against the U.S. dollar and 22 percent on a trade-weighted basis.

Growth is expected to slow during 2003, given the soft external environment, the sizable appreciation of the exchange rate, and some signs of easing domestic demand. Staff projections see growth at 2¾ percent in 2003, with inflation easing to around 2 percent. A more sluggish global recovery is the major downside risk to the outlook. On the upside, there is a risk that, with consumer confidence remaining high, near-term domestic demand growth could prove stronger than expected. New Zealand's medium-term economic prospects are favorable, with growth rising over the medium term to rates in line with estimates of the economy's potential of around 3 percent.

Policy Discussions

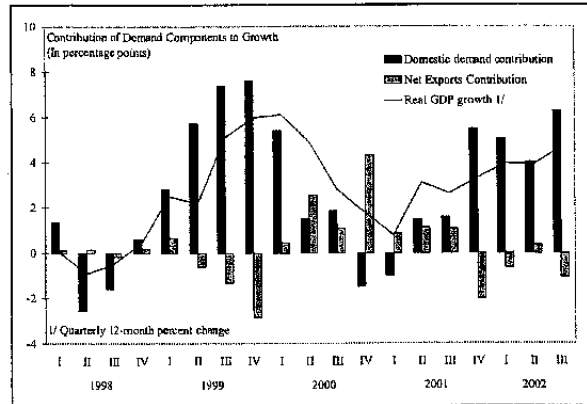
- **The authorities and the Fund staff broadly agreed on macroeconomic policy settings.** The staff supported the current monetary policy stance, and agreed that, although recent currency appreciation may have shifted the balance of risks, any cut in interest rates should be conditional on the emergence of clear signs that inflation looks set to return toward the middle of the target range over the medium term.
- **Fiscal prospects over the medium term are favorable, but are subject to significant risks.** Deferring decisions on new initiatives to the 2004 budget is prudent, and consideration will also have to be given to how the approach to fiscal management can be broadened to reflect longer-term spending pressures associated with the aging of the population.
- **Raising New Zealand's trend growth rate remains a key objective.** The Government's Growth and Innovation Framework could contribute to enhancing growth, but care would have to be taken to limit interventions in the economy and the program's budgetary costs. Increasing labor force participation by reforming the income support system and making complementary changes in the tax system was seen by the staff as an important way growth might be boosted.

I. RECENT ECONOMIC DEVELOPMENTS AND OUTLOOK

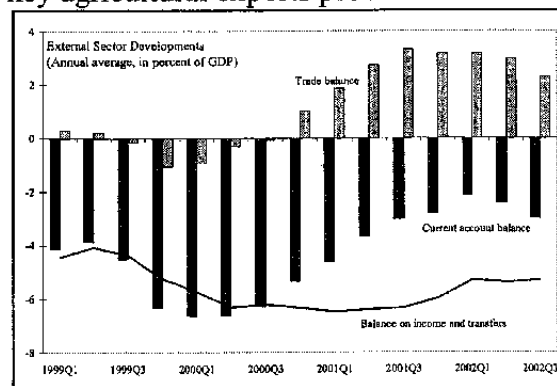
A. Macroeconomic Developments

1. New Zealand has maintained a strong pace of economic growth over the past three years, despite slowdowns in activity in some of its major overseas markets (Figure 1, Table 1, and Box 1). The economy's performance reflects its enhanced flexibility, stemming from the structural reforms of the 1980s and 1990s, and sound macroeconomic

policies. Favorable commodity price developments and a competitive exchange rate provided a strong stimulus to exports, raising growth sharply initially during this period. Subsequently, the impact of the increase in exports on incomes in the farm sector filtered through the rest of the economy, and domestic demand surged, led by private consumption and housing investment. Unusually strong net immigration inflows (some 1 percent of population in the past year) have also provided a stimulus to demand (notably residential investment) and have added to the economy's supply potential. Real GDP increased by around 4 percent in the year through September 2002, with continued strength in retail sales and the housing sector suggesting this pace has been sustained through the fourth quarter.



2. The sharp pick-up in export growth provided the basis for a sizable improvement in the external current account position from mid-2000, with the deficit declining from 6¼ percent of GDP in 1999 to nearly 3 percent in the year through September 2002 (Figure 2 and Table 2). Favorable price developments for key agricultural exports provided the main stimulus to exports, assisted by rising tourism receipts that suffered only a limited effect from the post-9/11 fall in travel. Rising imports of consumer goods (on the back of the pick-up in domestic demand), combined with weaker export prices in 2002, have eroded some of the improvement in the trade balance, but strong service receipts and falling factor outlays (aided by global interest rate declines) continue to provide support to the current account balance.¹ With the relatively strong current account position, net capital inflows have eased during the past two years.

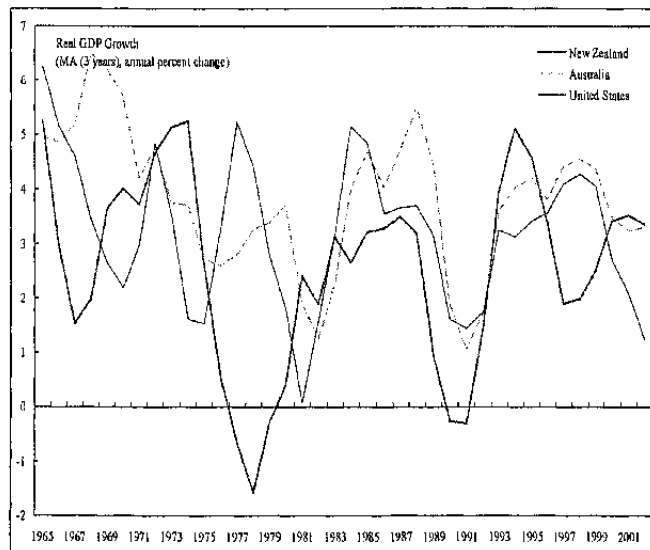


¹ Dairy prices have returned to trend levels; prices for wool, lamb, and some forestry products remain close to peak levels aided by market-specific (and likely temporary) factors.

Box 1. New Zealand: External Economic Influences on the New Zealand Economy

New Zealand's dependence on trade and its high degree of integration into international financial markets leave the country's growth prospects vulnerable to economic performance in key markets. Research by New Zealand Treasury using a structural vector autoregressive model concludes that international variables, particularly world output, world equity prices, and world interest rates have been the key sources of volatility in New Zealand real GDP.¹ The analysis also suggests that domestic climatic conditions have been important, particularly in periods such as the 1998 recession when New Zealand suffered two consecutive droughts in the midst of the Asian Crisis. Contrary to the conventional wisdom, results suggest that shocks from the exchange rate have been relatively unimportant.

Broad correlations reveal a high degree of synchronization between fluctuations in the New Zealand economy and business cycles in Australia and the United States over the last two decades. Staff analysis indicates that during the 1980s and the first half of the 1990s, changes in output in New Zealand and Australia were closely correlated, and developments in both countries' economies were highly correlated with movements in the U.S. economy. From 1995 onward, however, the behavior of real GDP in New Zealand has differed. In particular, during the Asian crisis, economic activity in New Zealand slowed significantly (owing in part to the effects of droughts), while it remained strong in Australia and the United States. After the U.S. economy began to slow in 2000, activity in New Zealand and Australia began to pick up and remained strong through 2002.



Empirical work by the staff to identify the geographical sources of the external shocks that influenced the New Zealand business cycle during the 1990s suggests that economic activity in Australia had a significant impact.² The direct effect of U.S. economic developments had substantially less effect on New Zealand, but indirect effects were still significant since economic activity in Australia was heavily influenced by that in the United States. Financial linkages were important as well. In particular, the analysis suggests that volatility in Australian interest rates (which, to some extent, also reflects U.S. developments) is an important source of fluctuations in New Zealand real GDP. Movements in U.S. equity prices also have played an important role in explaining business cycle developments.

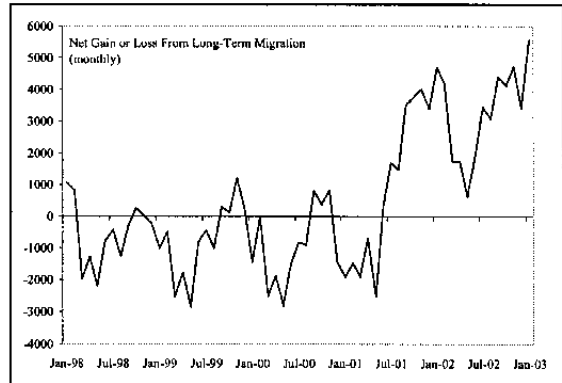
¹ Robert A. Buckle, et al, "A Structural VAR Model of the New Zealand Business Cycle," New Zealand Treasury Working Paper 02/26, December 2002.

² See the forthcoming *Selected Issues* paper for a more complete description of this work.

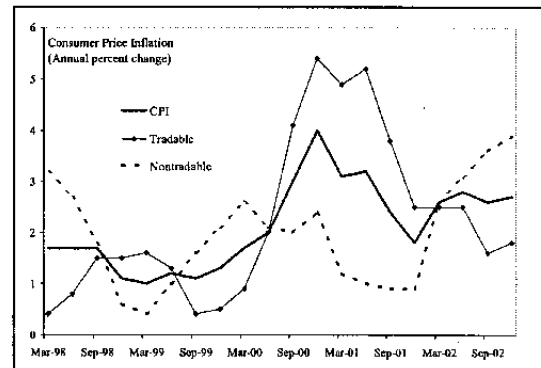
New Zealand's net external liabilities amounted to some 82 percent of GDP in March 2002, up marginally from 2001 but down from a peak of 89 percent in March 1998.

3. **Strong demand conditions have put considerable pressure on resources.** Capacity utilization rates are high and have been rising; moreover, a positive output gap has emerged since early-2002 (Figure 1, Panel 2). While the accuracy of such measures of resource utilization are subject to substantial uncertainty (partly owing to difficulties in gauging the size of a country's effective capital stock), it has been, nevertheless, somewhat surprising that private non-residential investment has not been stronger than its 5¼ percent growth in the year through September 2002. The slow pace of business investment outside agriculture has been attributed to the ongoing weakness in the global economic environment and expectations that the surge in domestic demand over the past year will run out of steam.

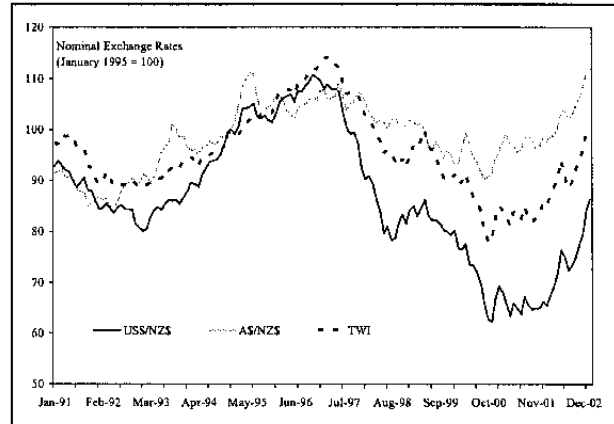
4. **Much of the increase in output supply is accounted for by strong employment growth.** Employment grew at an average annual rate of 2½ percent over the period 2000-02, and the unemployment rate declined to 4.9 percent in the December 2002 quarter. Vigorous labor demand has been reflected in higher labor force participation rates and has contributed to the strong net immigration inflows (Figure 3). Despite these increases in the supply of labor, businesses report increasing difficulties in finding both skilled and unskilled workers. While wages in recent years have tended to follow movements in prices and wage measures have been relatively subdued, recent data suggest some possible pick-up in labor costs, reflecting the tightness of conditions in the market.



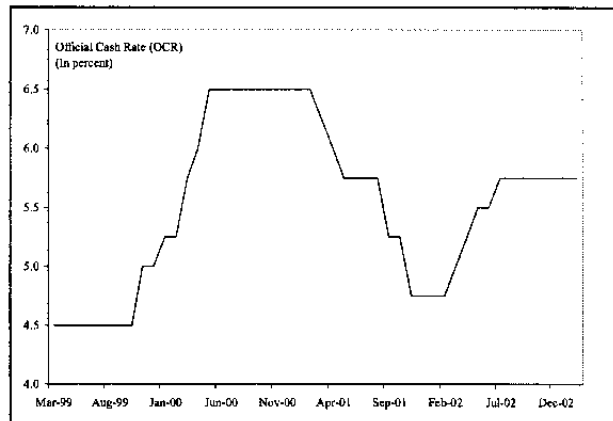
5. **Inflation has picked up slightly in 2002, but remained below the 3 percent upper bound of the official inflation target range.** During the year, CPI inflation rose slightly to 2¾ percent; however, the composition of inflation shifted markedly. Since mid-2001, the inflation rate of non-tradable goods and services rose sharply, but this pick-up in nontradables inflation was largely offset by a substantially slower rate of increase in the prices of tradables. The rise in nontradables inflation (particularly in such sectors as construction, housing, retailing, and other services) was consistent with the strength and composition of domestic demand. Slower tradables inflation appeared to reflect diminishing effects from the past sharp depreciation of the New Zealand dollar and the impact of its more recent appreciation, as well as an easing of world commodity prices. Measures of trend inflation show inflation as remaining relatively stable during 2002 (Figure 3). Surveys indicate that inflation expectations also remained relatively stable.



6. **After falling sharply in 1999 and 2000, the value of the New Zealand dollar stabilized during 2001 before appreciating substantially in 2002 and into early 2003 (Figure 4).** Since end-2001, the New Zealand dollar has risen by 33 percent vis-à-vis the U.S. dollar, 15 percent vis-à-vis the Australian dollar, and 22 percent on a trade-weighted basis. The currency's recent strength may reflect the resilience of economic activity in New Zealand compared to other developed countries and sizable interest rate differentials that favor investment in New Zealand assets. In February 2003, the value of the New Zealand dollar was 22 percent below its previous peak against the U.S. dollar in November 1996, before the Asian crisis, and 9½ percent below its trade-weighted value at that time.



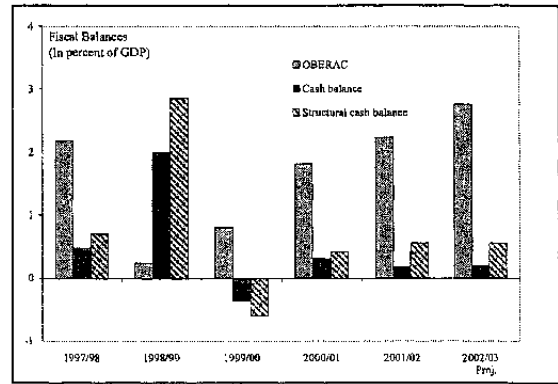
7. **With economic activity remaining significantly stronger than expected, the Reserve Bank of New Zealand (RBNZ) moved to tighten monetary policy in the first half of 2002, and the stance of policy has been unchanged subsequently.** In March to June 2002, the RBNZ raised the overnight cash rate (OCR) by a total of 100 basis points to 5.75 percent in 4 steps at its scheduled OCR reviews during the period.² At subsequent reviews in 2002, the RBNZ did not change rates, reflecting concerns about the deteriorating external environment and its implications for New Zealand. At its



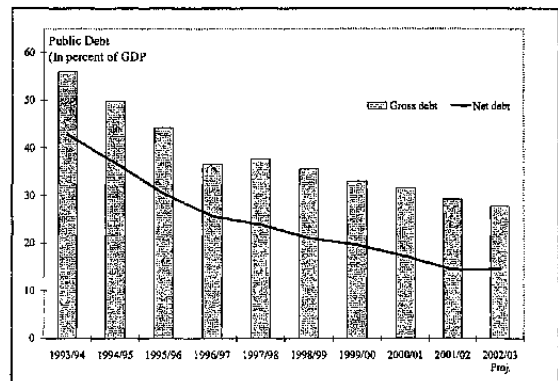
OCR reviews in January and March 2003, the RBNZ left the rate unchanged, but it suggested that the sharp appreciation of the currency may have shifted the balance of inflationary risks around the future path of interest rates. The RBNZ cautioned that any cut in interest rates, however, would be conditional on the emergence of clear signs of reduced pressures on resources and medium-term inflation. The March *Monetary Policy Statement* reiterated this stance.

² The OCR is the RBNZ's main policy tool. It is formally reviewed eight times during the year.

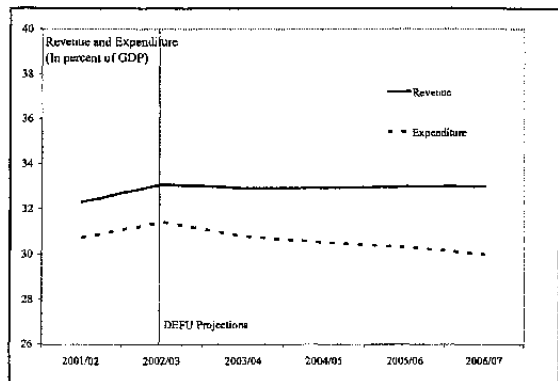
8. **The fiscal surplus continued to rise in 2001/02 (fiscal year ending June 30).** The operating surplus (OBERAC) rose by nearly ½ percentage point to 2¼ percent of GDP; measured on a cash basis, the surplus declined slightly to about ¼ percent of GDP (Table 3).³ The 2001/02 outturn was significantly better than expected primarily reflecting stronger tax revenues, owing to the strength of economic activity. Staff estimates of the structural cash balance suggest that the fiscal policy did not have an appreciable impact on economic activity in 2001/02. Gross government debt fell to nearly 29½ percent of GDP at the end of the fiscal year; net debt (excluding the assets of the New Zealand Superannuation Fund (NZS)) declined to 14½ percent.



9. **The fiscal balance is expected to strengthen further over the medium term.** Projections in the *December Economic and Fiscal Update 2002* (DEFU) show the OBERAC rising to 2¾ percent of GDP in 2002/03 and steadily increasing to nearly 4 percent in 2006/07; the cash balance surplus would rise from ¼ percent to around 1½ percent over this period. The operating surpluses in prospect are more than sufficient to meet funding needed for contributions to the NZS, additional capital expenditures envisaged, proposed advances for student loans, and other planned government investments. Accordingly, gross debt is expected to decline to around 23½ percent of GDP, and net debt would fall to 11 percent by end-2006/07.



10. **Over the forecast period, the total revenue-to-GDP ratio is projected to be reasonably stable, while the expenditure-to-GDP ratio would continue to slowly fall.** Tax revenue in the first four months of 2002/03 were running higher than expected, and this variance was assumed to hold over the remainder of the



³ Fiscal accounting is on an accrual-basis. OBERAC is defined as general government revenues less expenses, adjusted for revaluation movements and accounting policy changes. The cash balance, which is a measure derived by the Fund staff, is equal to the OBERAC plus capital expenditures that command additional resources (outlays on physical capital that increase the central government's asset base and net capital injections to state-owned and crown enterprises), advances (mainly student loans), and adjustments for accruals. It represents the Fund's standard concept of the fiscal balance.

fiscal year, pushing the tax-to-GDP ratio to 30¼ percent. This ratio is assumed to decline slightly over the forecast horizon to 30¼ percent in 2006/07. Restraint in government operating spending accounts for a projected decline in the expenditure-to-GDP ratio over the forecast period. Such spending is projected to rise at around a 4 percent annual rate, reflecting demand-driven factors (including health demographics, benefit indexation, and education enrolment growth) and additional operating spending provided for in the 2002 budget and planned to be introduced in the 2003 budget; operating spending in many areas is assumed to remain constant in nominal terms through 2006/07.

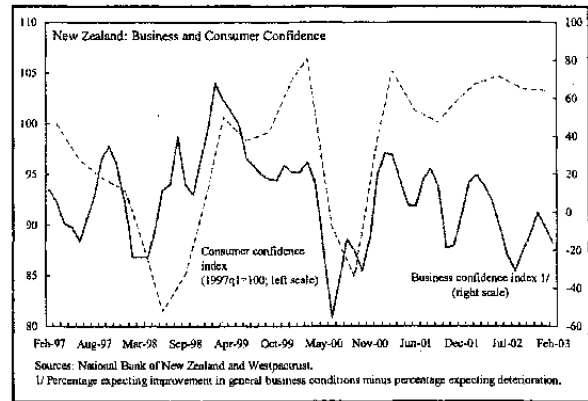
B. Economic Outlook

11. **The pace of economic growth is expected to ease during 2003, given the weak external environment, the fall in commodity prices, and the sizeable appreciation of the New Zealand dollar (Table 4).** The Fund staff and official forecasts see growth dropping from 4¼ percent in the year ending March 2003 to around 2½ percent in the March 2004 year. Private consumption would account for most of the slowdown in growth, reflecting weaker disposable income growth (particularly with a decline in farm revenues owing to lower commodity prices) and slower population growth. The pace of residential investment also would slacken. Pressures on resources would ease, and inflation would fall back to around 2 percent (the mid-point of the inflation target range); the tradables component of CPI inflation would fall faster, continuing recent trends, with an easing of nontradables inflation occurring more gradually. Private sector analysts offer a broadly similar view, although some expect a more extended consumption boom, and hence a milder GDP growth slowdown in the March 2004 year.

12. **In the near term, key downside risks to the economic outlook stem from the external environment.** Significantly weaker external demand, reflecting a further delay in the recovery of world growth and contributing to an additional decline in commodity prices, could lower GDP growth by about 1 percentage point in 2003. Such a slowdown could be worse if the New Zealand dollar were to continue to appreciate. Uncertainties with regard to the likely scope and duration of the military conflict in Iraq also cloud the picture for the near-term outlook. Fund staff analysis of a military conflict in Iraq of a limited scope and relatively short duration would reduce New Zealand's growth in 2003 by a little more than 1 percentage point relative to the baseline forecast, primarily owing to higher oil prices, the impact of adverse confidence effects on domestic demand, and more minor effects on exports of goods and tourist receipts.⁴

⁴ Agricultural exports are in many cases quota-constrained and typically have low income elasticities. Tourist receipts may be significantly affected during the period when military operations are taking place, but they are expected to recover quickly thereafter, and could be boosted by a perception of New Zealand being a "more secure" tourist destination.

13. **On the upside, there is a risk that near-term domestic demand growth could prove to be stronger than expected.** Confidence in the household sector remains very strong. A combination of the strength in income growth over the past several years, continued high levels of employment, and some increase in wealth from rising housing prices could serve to limit the expected slowdown in consumption spending and housing investment. This slowdown might be further limited if net migration inflows do not decline as envisaged. Moreover, particularly if uncertainties regarding the external environment diminish, business confidence and investment could rise rapidly, further boosting domestic demand and GDP growth. In such circumstances, short-term pressures on the economy's resources would be expected to increase significantly.



14. **New Zealand's medium-term economic prospects are favorable, with growth rising to rates over the medium term in line with estimates of the economy's potential.**⁵ The Fund staff's medium-term scenario assumes that GDP growth over the period 2004-07 will average around 3 percent per year.⁶ Inflation, at 2 percent per annum, is expected to remain around the middle of the official target range. Over the forecast period, current account deficits are expected to return to their average level of the 1990s of around 4½ percent of GDP. New Zealand's net foreign liability position and its external debt, however, would remain broadly unchanged in relation to GDP at around their current levels.

II. POLICY DISCUSSIONS

15. **In concluding the 2001 Article IV consultation, Executive Directors noted the pressures on the long-term fiscal position stemming from demographic trends and supported the policy of running fiscal surpluses to pre-fund future pension liabilities.** They also suggested that reforms in the public pension and health care systems would need to be considered in time to help contain outlays in the longer term. Major structural reforms had improved growth performance, but additional reforms of the tax and welfare systems could boost growth further by reducing disincentives to work, save, and invest. Directors viewed New Zealand as being well placed to absorb external shocks, notwithstanding high external debt levels, and they supported further efforts to assess the external liability position. The

⁵ New Zealand Treasury estimates of trend growth presented in the DEFU indicate that a variety of traditional statistical techniques yield estimates around 3.1 percent, similar to Fund staff estimates. An alternative method used by the Treasury (the "on-trend" method) suggests that trend growth during the period 1993-99 was higher at 3.4 percent.

⁶ The medium-term outlook in the DEFU assumes a similar average growth rate for GDP over the forecast period.

New Zealand authorities are well aware of the challenges that they face in all of these areas, and they continue to act to meet them.

16. The authorities and the Fund staff broadly agreed on the settings for macroeconomic policies in the period immediately ahead and over the medium term. The staff commended the authorities for an outstanding policy performance. The authorities stressed, however, that they would have to continue to work hard to ensure that appropriate monetary and fiscal policies were in place. The discussions focused on the management of monetary and fiscal policy and growth prospects for New Zealand over the medium term and how they might be enhanced. Economic vulnerability and the risks that New Zealand's net international liability position might entail were also discussed.

A. Monetary Policy and the Exchange Rate

17. A new Policy Targets Agreement (PTA) for conducting monetary policy as part of New Zealand's inflation targeting framework was signed in September 2002, following the appointment of the new RBNZ Governor, Dr. Alan Bollard. The key changes in the new PTA are that: (i) the floor of the target range for inflation has been raised from 0 to 1 percent, while the ceiling remains unchanged at 3 percent, and (ii) the target measure has been redefined to be future CPI inflation outcomes on average over the medium term. RBNZ officials noted that these changes provided some additional flexibility for monetary policy. In appropriate circumstances, the RBNZ now could be more gradual in adjusting policy, thereby helping to avoid some volatility in output, interest rates, and the exchange rate. The staff agreed that these changes in the PTA were a welcome enhancement to the inflation targeting framework.⁷

18. The monetary authorities made it clear that not all outcomes for inflation within the 1–3 percent official target range were viewed as equal. If projected inflation were close to either edge of the target range, there would be a risk that a minor unexpected shock could push inflation outside of the range. In these circumstances, a monetary policy adjustment would generally be made to ensure that inflation would fall comfortably inside the target range over the medium term, even allowing for a reasonable range of unexpected events. Conversely, this policy approach can be interpreted as suggesting that there would be a "comfort zone" around the middle of the target range, in which no monetary policy response would be necessary as long as projected inflation was expected to stay within that zone. While generally in agreement with this approach to implementing policy, the Fund staff thought that it might be useful at some point for the RBNZ to more firmly tie down inflation expectations by announcing a specific target within the official range for medium-term inflation outcomes at the range's mid-point.

⁷ Market analysts' assessments of the changes vary. Some saw little change from past practice, while others expected a modest increase (around ½ percentage point) in the trend inflation rate. All analysts agreed that the way in which things develop will depend on how the Governor chooses to interpret his mandate. Surveys of inflation expectation since the adoption of the PTA have shown no appreciable change.

19. **Despite actual inflation hanging up toward the high end of the official target range, the RBNZ has chosen to keep monetary policy unchanged since June 2002, with the expectation that price pressures would ease.** The relatively rapid appreciation of the New Zealand dollar at the end of 2002 and into early 2003 has been seen as shifting the balance of risks around the future path of short-term interest rates, as acknowledged in the RBNZ's statement released at the time of the January OCR review. The authorities and the staff agreed that the current stance of monetary policy is appropriate for the time being, owing to the considerable uncertainties regarding the near-term outlook for the New Zealand economy. There also was agreement that, in light of the recent appreciation of the currency, any policy easing would have to depend on clear signs of easing resource pressures and a reasonable expectation that inflation was set to return to a level comfortably within the target range over the medium term. Subsequent to the mission, the RBNZ reiterated this position in the statement released after the March OCR review and in the March *Monetary Policy Statement*.

20. **The floating exchange rate regime has served New Zealand well.** It provides New Zealand with the scope to pursue an independent monetary policy, while also facilitating adjustment to the structural changes that have taken place and buffering the economy from the effects of economic shocks. The Fund staff's analysis suggests that New Zealand is subject to different economic shocks than its major trading partners Australia and the United States, and that common shocks can have significantly different effects on the three countries (Box 1). Consequently, the staff sees an independently determined monetary policy and the floating exchange rate associated with it as providing New Zealand with substantial benefits.

21. **The recent appreciation of the New Zealand dollar was seen as a mixed blessing, especially by private sector representatives.** While it would dampen inflationary pressures, it would diminish the competitive edge that tradable-goods producers had enjoyed, and this was viewed by some as a worrisome development because a competitive exchange rate was one of the factors that had supported New Zealand's favorable economic performance over the past three years in the face of a slowdown in global growth. To some extent, this worry also reflected the New Zealand dollar's relatively rapid rise, especially against the Australian dollar, which complicated the adjustment process. Nevertheless, at its early 2003 level, the currency's trade-weighted value was around its long-term average level since the New Zealand dollar was floated, and it was seen as being reasonably well explained by the underlying fundamental determinants of its value.⁸

B. Fiscal Policy

22. **Fiscal policy in New Zealand is cast in a medium-term framework.** As part of its fiscal management approach, the Government has set its medium-term objectives as achieving an operating surplus on average over the economic cycle sufficient at least to meet the requirements for contributions to the NZS and keeping gross government debt below

⁸ The latest Consultative Group on Exchange Rates (CGER) assessment estimated that the current value of the New Zealand dollar is not significantly out of line with its medium-term equilibrium value on a real effective basis.

30 percent of GDP.⁹ Short-term operating and capital spending intentions will be set consistent with meeting these objectives, and they will be reviewed regularly and adjusted appropriately in line with changes in the economic and fiscal outlook. The Fund staff agreed with the authorities that this approach provided a sound framework to formulate fiscal policy, allowing for sufficient flexibility so that policy could adapt to changing cyclical conditions and shifting public investment needs. Moreover, it established simple and clear basic objectives for fiscal policy, and the consistency of short-term policy actions with them could be easily assessed over time.

23. **In the longer term, the budget faces growing pressures on spending arising from health and pension obligations owing to the aging of the population.** Empirical work done by the Treasury illustrates the potentially large estimated costs of meeting these obligations, but it also stresses the considerable uncertainties surrounding such projections.¹⁰ The estimated impact of demographic changes alone on government spending for pensions and health care is to increase such expenditures from 11 percent of GDP in 2002 to 19 percent in 2051. However, with varying cost assumptions, budgetary costs could rise as high as 34 percent of GDP by 2051. Owing to these uncertainties, the staff noted that delay until the budgetary costs are known with more certainty might be attractive. However, meeting these obligations needed to be factored into the fiscal policy framework, and consideration would have to be given at some not too distant point to possible reforms in these programs. Such policy actions would have to be adopted early enough to provide individuals with sufficient time to adapt their savings behavior accordingly.

24. **The DEFU projections paint a healthy picture regarding the fiscal position, but there are some significant uncertainties.** Operating surpluses over the next five years are expected to be more than sufficient to meet the fiscal objectives by a growing margin. The potential size of these additional budgetary resources, which could be used to fund new policy initiatives, is uncertain at this point for several reasons. As the alternative scenario in the DEFU illustrates, the existence and size of such resources is highly dependent on economic performance; if the recovery in global economic activity were further delayed, operating surpluses over the medium term would be significantly reduced. The DEFU's favorable fiscal projection also are heavily dependent on maintaining discipline over operating expenditures,

⁹ In the 2002 Budget, the Government replaced the three-year nominal cap for new spending initiatives (fiscal provisions) with a revised fiscal management approach which enables the Government to achieve the same fiscal objectives, but manage spending flexibly in a way that uses up-to-date information and judgment about the medium term. The revision implies greater focus on the operating balance and gross debt, and a regular review of the fiscal position. It is viewed as placing more focus on the medium term when setting short-term spending intentions.

¹⁰ See John Creedy and Grant M. Scobie, "Population Ageing and Social Expenditure in New Zealand: Stochastic Projections" New Zealand Treasury Working Paper No. 02/28, December 2002.

as reflected in the expected medium-term decline in the spending-to-GDP ratio, while the revenue-to-GDP ratio remains largely unchanged. Moreover, the ultimate size of the pool of resources available for new initiatives will depend on when such initiatives are adopted. Reflecting all of these factors, the authorities indicated that decisions on any new policy initiatives would be deferred to the 2004 budget. At that time, it was expected that some of the uncertainties at present, especially with regard to the economic outlook, would be resolved. The staff supported this cautious policy approach. It also suggested that the focus for new budgetary initiatives should be on measures that would help to achieve the Government's objective of raising the economy's trend growth rate.

25. **The New Zealand Superannuation Fund is set to accumulate and invest substantial amounts of funds over the next twenty years** (with the peak balance expected to reach roughly 44 percent of GDP around 2036) in order to partially pre-fund the future obligations of the public pension system. An independent board to manage the investment of these assets was appointed in August 2002. Guidelines for the fund's investment allocation decisions have not yet been formulated; budgetary contributions to the NZS to date have been held in an account at the Reserve Bank. The staff noted some of the pitfalls associated with investing public funds in private assets, particularly with a modest-sized domestic private capital market.¹¹ The authorities were well aware of these risks and felt that they could be effectively managed by the fund's independent investment board.

C. Promoting Economic Growth

26. **Raising the growth potential of New Zealand's economy is one of the Government's key objectives.** Although growth in per capita income has risen over the past few years to the average of other OECD countries, there remains a sizable gap between the level of per capita income in New Zealand and the average OECD level. The Government outlined its strategy for increasing trend GDP growth and closing the income gap in "Growing an Innovative New Zealand", released in February 2002 (Box 2). The authorities explained that an essential element in the strategy was maintaining a solid foundation for growth through continued sound macroeconomic policies and preserving the competitive and open market-based economy and well-developed legal and institutional frameworks that have been established. However, growth prospects could be enhanced by additional efforts aimed at strengthening the innovation system, building a more skilled labor force, and improving New Zealand's links to the global economy. Policy initiatives were seen as needed in these areas to help overcome disadvantages stemming from New Zealand's small size and distance from the main centers of global economic activity.

27. **While the staff agreed with the basic thrust of the Government's Growth and Innovation Framework (GIF), it cautioned about the risks associated with a more interventionist role in the economy for public policy.** It agreed that New Zealand's small size and distance from markets created significant challenges for the country's firms, but this

¹¹ The New Zealand approach is similar to that adopted in Canada and in Ireland. The policy issues associated with government investing in private assets are reviewed in *United States: Selected Issues*, IMF Country Report 01/149, pp. 70–85.

Box 2. New Zealand: The Growth Debate

New Zealand experienced a relative decline in living standards vis-à-vis the OECD average for most of the post-World War II period. Wide-ranging reforms to the economy initiated in the mid-1980s have delivered substantial efficiency gains and contributed to a significant improvement in growth performance in the 1990s, but the income gap vis-à-vis the OECD has not narrowed and the gap vis-à-vis Australia has widened over the past decade—a cause for particular concern, given the free movement of labor between the two countries.

There is now a large body of analysis seeking to explain New Zealand's growth record, although it has not revealed reasons for New Zealand's "sub-par" growth rate that could be easily dealt with by government policy actions. New Zealand's relatively small size and location far removed from the main clusters of global economic activity figure in most explanations of slower growth. The high trade barriers faced by New Zealand's agricultural exports is also seen as a serious growth impediment. Lower investment in New Zealand is seen as accounting for a significant share of the income differential vis-à-vis Australia; however, it is not clear why capital investment in New Zealand has been lower. In contrast, significant investment in human capital appears to have taken place in New Zealand in recent years, as evidenced by rising participation rates in tertiary education, although there are concerns about the effectiveness of the education system in producing the skills needed by business. Low levels of privately-funded research and development (R&D) in New Zealand and a failure to adequately exploit commercial opportunities arising from government-financed R&D have been cited as concerns. Nonetheless, evidence suggests that New Zealand firms have extensive access to information on technological innovations from abroad and do not face apparent barriers to adopting them.

Drawing on this evidence from the growth debate, the Government has adopted a strategy for improving growth performance that has four principal components: (i) enhancing innovation, (ii) building a more skilled labor force, (iii) increasing linkages to the global economy, and (iv) focusing government resources on selected sectors.¹

- Innovation is being strengthened through increased budgetary allocations for research and development; greater emphasis on commercialization of public-sector sponsored research; improving capital market access for business start-ups through a state-financed Venture Investment Fund; and providing technical assistance and support through Industry New Zealand, the government's industrial development agency, to help small firms grow.
- Measures to improve labor skills include better alignment of labor skills "production" by the tertiary education system with labor market needs (which is to be facilitated by the establishment of a new Tertiary Education Commission in July 2002) and immigration measures introduced in April 2002 aimed at facilitating the entry of skilled workers into New Zealand.
- Policies to strengthen New Zealand's external linkages include assistance for export market development from Trade New Zealand; an expanded promotion effort to attract "green-field" inward foreign direct investment; and a broader promotion effort to improve New Zealand's "brand" image as a source of high-quality exports, a good location for direct foreign investment, and an attractive destination for internationally mobile high skilled workers.
- The government sees a case for giving priority in its programs to three broad industrial areas: biotechnology, information and communication technology, and creative industries. These areas are seen as having strong growth potential and high potential spillover effects for growth in other sectors of the economy.

¹Prime Minister's Statement to Parliament, February 12, 2002, "*Growing an Innovative New Zealand*".

fact alone did not offer a clear prescription in favor of policy activism. The staff suggested that the key issue for policy purposes was to identify market failures that could be effectively counteracted by well-designed government interventions. On this basis, some initiatives—such as making publicly funded research more open to market influences, encouraging the commercialization of such research, improving knowledge transfer to New Zealand firms, and active marketing of New Zealand as a destination for foreign investment—could be seen as addressing market failures or externalities. The rationale for some other initiatives—such as direct provision of advice and support to individual firms by government agencies and focusing government resources on specific industries—was less obvious. The authorities noted that they were mindful of the risks associated with interventionist policies. They indicated that they did not have as yet sufficient experience to assess the effectiveness of the new initiatives and that they saw merit in continuing to explore ways, as outlined in the GIF, through which the government could facilitate economic growth.

28. **To build a skilled and flexible labor force, government policies were aimed at encouraging movement from welfare to work, enhancing labor market regulation, improving education, and fostering high skilled immigration.** The staff supported the thrust of the education and immigration initiatives and stressed the importance of welfare reform as contributing to further raising labor force participation and potential growth. The authorities noted that they are currently conducting a review of the income support system to see how it might be simplified and how work incentives (including through the tax system) could be improved, primarily by providing benefits that would “pull” people into employment. “Push” factors, such as limits on the duration of some benefits (such as unemployment benefits) were not likely to be considered. The staff agreed that simplification of the system was needed, but stressed that a combination of pull factors (like providing some type of in-work tax benefits to ease incentive problems caused by high effective marginal tax rates arising when income support recipients consider returning to employment) and push factors (such as duration limits on some benefits) could be effective in reducing disincentives to work.

29. **Some measures already taken and others currently being considered raised concerns regarding the labor market and the business environment in New Zealand.** Business groups pointed to increases in the minimum wage, the scaling back of exemptions for young workers and apprentices, and changes in occupational safety and health requirements as potentially significantly raising labor costs. Concerns were also expressed about the potential outcome from the upcoming review of the Employment Relations Act (ERA) and new measures under consideration to protect workers in the event a business is sold or activities are contracted out and to ensure equity in pay across occupations. Union representatives, in particular, saw the ERA review as needed to further address an imbalance in bargaining power between employers and employees. The staff noted that a flexible labor market had served New Zealand very well over the past decade, contributing to rapid employment growth, and cautioned against initiatives that would unduly impair its functioning. The authorities acknowledged the importance of maintaining labor market flexibility and maintained that their intention was only to improve labor market outcomes. The Resource Management Act was also seen by business groups as creating impediments to investment. The authorities attributed these complaints largely to dissatisfaction with the way

the act has been administered, and they sought to address problems that had arisen with delays in investment project approvals.

30. **The adequacy of saving in New Zealand and its impact on growth have been extensively studied and debated (Box 3).** There generally is agreement that the link between saving and growth is weak given New Zealand's integration into international capital markets. Moreover, it is difficult to point to major distortions that adversely affect the level of private savings. The staff noted one possible exception, pointing to the expectation of households that the government would meet its pension and health care obligations without major changes in future taxation or benefits. This situation argued for the government to lay out its plans for dealing with the longer-term fiscal pressures that it faces in a timely manner to allow sufficient opportunity for households to adjust their behavior. Broad-based tax measures to encourage additional private savings are not seen as useful; such measures would tend to be costly to the public purse, have regressive income distributional effects, and do little to raise private or national saving. The authorities generally shared these views. They noted, however, that some tax changes to encourage savings might be advisable. For example, the tax treatment of employer superannuation contributions was not fully equitable since the tax rate imposed was not tied to the beneficiary's marginal tax rate. Also, the tax system currently treated all savings similarly. Hence, with income on retirement savings being taxed in the near term when it is earned (and expenditure pressures are weaker) and not in the future when it would be distributed (and expenditure pressures would be greater), the time profile of revenues might not be optimal, owing to New Zealand's demographic profile. This situation might argue for some change in the way retirement savings are taxed.

31. **The authorities noted that protectionism in the major industrial countries (most notably for agricultural products) had significantly hampered New Zealand's growth performance.**¹² They, therefore, attached great importance to multilateral trade liberalization, and were hopeful that the current Doha negotiations would yield solid progress, especially in agriculture. At the same time, bilateral trade arrangements were viewed as another means of trying to improve market access for New Zealand's goods and services. A comprehensive free trade agreement had been signed with Singapore in 2001, and negotiations on similar agreements were either underway or anticipated with Chile, Hong Kong, and Mexico. Efforts in pursuing a free trade agreement with the United States have increased over the past two years.

¹² Estimates of the average tariffs confronting New Zealand's basket of exports in major industrial countries range from 25 to 75 percent, as compared with an average OECD tariff level of 5 percent and an average New Zealand tariff level of 4 percent. A key contributor to these estimates is very high tariffs on out-of-quota agricultural products, especially dairy products; see Sandrey, Ron (2000) "The Relative Tariff Ratio Index", New Zealand Trade Consortium Working Paper No. 7, New Zealand Trade Consortium in association with NZIER. New Zealand's rating on the IMF's trade restrictiveness index is 4 (on a scale ranging from 1 to 10, 1 being the least restrictive), largely on the basis of nontariff barriers related to export market monopolies for certain agricultural products.

Box 3. New Zealand: Savings, Investment, and Growth

The persistence of current account deficits (averaging about 4½ percent of GDP over the past decade) and the unfavorable comparison of New Zealand's average national savings rate to the OECD average (15½ percent versus 21 percent) have prompted concerns that New Zealand has a "savings problem". With rising government saving over most of the last decade, the main culprit is alleged to be private savings, particularly household savings. In turn, "low" savings is seen as adversely affecting investment and growth. However, it is not clear whether savings in New Zealand can be characterized as "low" and whether higher savings would materially affect either investment or growth.

Is the Savings Rate "Low"?

Cross-country comparisons of savings rates can be misleading because such factors influencing savings as institutional arrangements, financial market development, and societal preferences (especially time preference) may vary sharply between countries. For example, in New Zealand, the public provision of pensions and health care serves to significantly reduce the need for savings. Also with well-developed financial markets providing households easy access to credit, major purchases (like houses and cars) can be financed, reducing saving. Therefore, the savings rate in New Zealand might be expected to be lower than in many other countries.

A better test of the existence of a "savings problem" would be whether private and household savings behavior can be adequately explained by their fundamental determinants. Analysis by the staff suggests that a trend decline in the household savings rate is reasonably well explained by such fundamentals as higher public saving (i.e., partial Richardian equivalence holds), higher government pension and income support transfers, increased household wealth, and improved access to credit.¹ The long-term behavior of the private savings rate is also relatively well explained by its fundamental determinants, including higher net private foreign liabilities.

These results suggest that there does not appear to be major distortions that would adversely affect the level of household and private savings in New Zealand. However, there still might be a "savings problem" if households were mistaken in their expectations that future pension and health care costs will be met without major increases in taxes or reductions in benefits.

Would Higher Savings Promote Higher Growth?

Given New Zealand's small size and close integration into external capital markets, the links from domestic savings to domestic investment and growth are relatively weak. Higher domestic savings would generally be expected to reduce external borrowing (the use of foreign savings) rather than significantly lower the cost of capital and raise domestic investment.

Higher domestic savings, however, could have secondary effects on investment and growth if: (i) less reliance on external debt resulted in a drop in New Zealand's risk premium (and hence interest rates) or (ii) market imperfections (e.g., in the supply of capital to small- and medium-sized firms) existed such that larger local pools of savings could yield higher investment. Nevertheless, these secondary effects are not likely to be large.

Empirical analysis (including by the staff) suggests that the risk premium on international borrowing by New Zealand is positively related to the level of New Zealand's external debt.¹ The size of the risk premium, however, has declined significantly over the last decade and is not very large at present, owing in large measure to the improvement in the fiscal position.

Anecdotal evidence suggests some imperfections in capital market access for small- and medium-sized firms, but government-sponsored studies do not point to major weaknesses in this regard. Moreover, higher pools of domestic savings would not automatically ensure that more resources would be available to credit-constrained small- and medium-sized firms.

¹ These analyses are discussed in greater detail in the forthcoming *Selected Issues* paper.

D. Economic Vulnerability

32. **New Zealand continues to be reasonably well placed to manage adverse economic shocks (Annex 1).**¹³ In regard to the external position, gross foreign debt has risen in recent years, with the portion of foreign indebtedness denominated in domestic currency generally declining since the mid-1990s, the debt becoming increasingly concentrated in the banking system, and its maturity shortening. The authorities indicated that there was some comfort in the fact that the rise in gross external debt had been roughly matched by an increase in foreign assets, leaving the net international liability position largely unchanged, and looking ahead, the net position might improve a bit with the appreciation of the currency. Nevertheless, the size of the net debt position left New Zealand potentially vulnerable to shifts in market sentiment, and the situation had to be carefully monitored.

33. **The sizable proportion of debt denominated in foreign currency does not raise major concerns.** A substantial portion of this debt is hedged, either through natural hedges or the use of currency swaps. While the ability of New Zealand banks and firms to continue to have access to hedging instruments was a risk that had to be considered, the authorities noted that the market for these derivatives appeared to be reasonably deep and that this market had proven to be rather resilient, given the large shifts in the value of the New Zealand dollar over the past several years. Access to the market would also depend to an important extent on the soundness of domestic financial institutions.

34. **Banks in New Zealand are profitable and well capitalized, with very low levels of impaired assets.** They rely heavily on short-term wholesale funds raised offshore to finance their domestic lending operations (both short- and long-term), and as such, they may be subject to significant rollover risk.¹⁴ The banks' ability to maintain access to offshore wholesale markets is dependent on not only their overall financial soundness but also that of

¹³ Stress tests using the external sustainability framework template also do not suggest major concerns (Table 5). A large exchange rate depreciation produces (in a relatively static and mechanical fashion) a sizable jump in the external debt to GDP ratio. However, recent experience underscores the flexibility of the New Zealand economy in handling such shocks without significant dislocation. From March 1997 to March 2000, the New Zealand dollar depreciated by 30 percent against the U.S. dollar, while the ratio of external debt to GDP rose by only 17 percentage points (debt data for this period are fully comparable). Moreover, the mitigating influence in the event of a substantial depreciation of having foreign currency debt positions that are predominantly hedged (either by natural hedges or by financial derivatives) is not captured in the framework. Hedging instruments are not included in a country's international investment position because they are not financial assets in the case of natural hedges or they represent contingent claims in the case of financial derivatives.

¹⁴ In connection with these operations, there are risks from the repricing of foreign exchange hedges for the wholesale funds denominated in foreign currencies, but these risks are reduced by the use of term currency swaps and the periodic repricing of loans financed by these funds.

their foreign parent banks (particularly those in Australia), in addition to other, New Zealand specific risk factors.¹⁵ While no major source of vulnerability was seen in the current situation, the nature of the foreign liability exposure and the structure of New Zealand's banks led the authorities to remain cautious and carefully monitor developments.

35. **New Zealand's participation in the FSAP during 2003 was seen by the authorities as contributing to improving the understanding of potential vulnerabilities in the financial system.** The FSAP could also help promote a better understanding outside of New Zealand for the country's distinctive approach to banking supervision, which emphasizes market-based supervision. In preparation for the FSAP, the authorities have organized, with the cooperation of the major banks, stress tests of the banking system based on risk factors specific to New Zealand. The authorities have conducted self-assessments of their compliance with bank supervisory codes and standards. They noted that these assessments had brought out some areas where practices in New Zealand could be improved, and measures were being considered. However, the assessments also had highlighted areas where New Zealand's approach to supervision with its emphasis on public disclosure of information on bank performance meant that conventional standards based on inspection and assessment of banks by trained examiners were less relevant. The authorities stressed that it was important to recognize the uniqueness of the New Zealand banking system, with its high concentration of foreign ownership, and the merits of the country's distinctive supervisory approach.

36. **New Zealand has made significant progress in dealing with anti-bribery and money laundering initiatives.** Following the passage of the Terrorism Suppression Act, New Zealand has moved toward full compliance with the recommendations of the FATF on money laundering. A full assessment of AML/CFT issues will be conducted during the FSAP. The Crimes (Bribery of Foreign Public Officials) Amendment Act 2001 came into effect in May 2001 to implement the OECD Convention on Combating Bribery of Foreign Public Officials in International Business Transactions.

III. STAFF APPRAISAL

37. **The wide-ranging structural reforms of the economy initiated in the mid-1980s and the continuing pursuit of sound macroeconomic policies have laid the foundation for New Zealand's impressive economic performance over the past three years.** New Zealand has maintained a strong rate of GDP growth despite a substantial slowdown in the global economy, with some support from favorable commodity price developments and a competitive exchange rate. However, it was the structural reforms adopted, which made the New Zealand economy more flexible, and continued pursuit of prudent macroeconomic policies that have put the economy in a position to benefit from favorable economic developments and to ride out the turbulence in the world economy.

¹⁵ Moody's Investor Services in February 2003 issued a report concluding that the ratings outlook for Australian banks was stable. The operating environment for the Australian banks was expected to remain relatively benign in a global context, and Australia's rated banks were judged to have sufficient resources to absorb likely levels of credit deterioration.

38. **The new Policy Targets Agreement represents a modest fine-tuning of the inflation targeting framework, providing the RBNZ with more flexibility in responding to shocks.** Under the new PTA, policy settings will be guided by an assessment that future inflation will fall comfortably within the official target range, an approach that the staff endorses. The staff also sees merit in considering whether it might be advantageous at some point to further ground inflationary expectations by explicitly defining the policy objective as seeking inflation outcomes over the medium-term around the 2 percent mid-point of the target range. In addition, New Zealand's floating exchange rate regime is an integral part of the inflation targeting framework. It has served the country well, allowing New Zealand to follow an independent monetary policy and playing an important role in facilitating the adjustment of the economy to structural reforms and economic shocks.

39. **With inflation toward the high end of the target range, an expected easing in price pressures this year is welcome.** The recent appreciation of the New Zealand dollar may have shifted the balance of risks, intensifying the anticipated slowdown in growth and easing of inflationary pressures, and thereby creating scope for monetary easing. Even so, the staff supports the current monetary policy stance, and concurs with the RBNZ's view that, given the considerable uncertainties in the economic situation at present, any cut in the overnight cash rate should be conditional on the emergence of clear signs that resource pressures are easing and price inflation looks set to settle at a level comfortably within the target band over the medium term.

40. **The Government's fiscal objectives of achieving an operating surplus on average over the economic cycle sufficient at least to meet the requirements for contributions to the New Zealand Superannuation Fund and keeping gross government debt below 30 percent of GDP provide a sound medium-term anchor for fiscal policy.** At the same time, the policy framework provides adequate flexibility to respond to cyclical pressures and to meet public investment needs, and it can be easily understood and monitored by the public. Consideration will need to be given to broadening the fiscal management approach to reflect the longer-term spending pressures that the budget faces, especially from growing pension and health care costs. Work at the Treasury points to the potentially large size of these expenditures, but it also highlights the sizable uncertainties surrounding such projections. While uncertainty favors delaying policy actions until the potential costs are more clearly defined, measures have to be adopted sufficiently early to smooth fiscal costs over time and allow individuals time to adapt their savings behavior appropriately.

41. **Fiscal projections for the coming five years suggest that budgetary resources may be available to fund some new policy initiatives.** The room for new measures is not large, with its ultimate size depending, in particular, on uncertain economic prospects and continued discipline in holding down the growth of operating expenditures. There is also uncertainty as to the relative importance of cyclical factors in explaining the recent strengthening of the operating balance. The staff endorses the authorities cautious approach of deferring decisions on new initiatives to the 2004 budget, by which time the underlying fiscal position may be clearer. The staff also recommends that in considering new initiatives, the focus should be on measures that would strengthen medium-term growth performance.

42. **The staff sees the labor market as one important area where policy changes could raise potential growth.** Previous policy actions have contributed to a sharp rise in New Zealand's labor force participation rate to one of the highest among OECD countries. Nevertheless, the participation rate could be raised further by reducing the disincentives to work created by New Zealand's rather complex income support system, and the anticipated additional budgetary resources might be used very profitably for this purpose. The authorities are currently conducting a review. In this context, the staff would recommend a major simplification of the income support system and accompanying changes in the tax system (including consolidating current credits into an earned income tax credit as a means of providing in-work benefits) that would provide additional incentives for individuals to move from welfare to work. The government's initiatives aimed at actively managing welfare cases may be useful in preventing abuse of the system and also aid recipients in taking up employment. But some additional measures to tighten benefit requirements (such as duration limits on some benefits) may be needed as another means of encouraging labor force participation.

43. **Certain regulatory initiatives being implemented or currently being considered pose potential risks to the efficient working of the labor market.** A flexible labor market has served New Zealand workers well in the past decade, providing rapid growth in employment. Measures to set wage levels (via minimum wage rates or pay equity proposals) or to impose new regulations could significantly impair labor market flexibility.

44. **Based on the Fund staff's analysis, there do not appear to be major impediments or distortions that would give rise to a "savings problem" in New Zealand, with the possible exception of unintended effects resulting from the public pension and health care programs.** Household savings decisions are based heavily on expectations that the government will meet its pension and health care obligations without major changes in benefits or in the future burden of taxation, underscoring the need for the government to lay out, in a timely manner, its plans to deal with longer-term fiscal pressures. Policymakers may still conclude that there is a need to raise personal savings in New Zealand. Using the tax system for broad-based savings promotion purposes is not advisable; such schemes tend to be expensive, are regressive, and yield little change in national saving. For equity reasons, however, a tightly focused measure such as aligning taxation of superannuation contributions to the beneficiary's marginal tax rate might be desirable, and it could add to savings.

45. **The staff supports the basic objectives of the Government's Growth and Innovation Framework.** Strengthening the innovation system, building a more skilled labor force, and enhancing New Zealand's links to the global economy could all contribute to raising growth over time. In pursuing these objectives, the government has to be mindful of the potential risks it runs by playing a more interventionist role in the economy. Policy decisions should be based on the traditional economic tests of "market failure" and "corrective nature of intervention". Accordingly, the case for direct assistance to individual firms and for targeting specific economic sectors is not fully convincing. There may be merit in further analysis in these areas, but the staff would caution against spending large amounts on experimental programs.

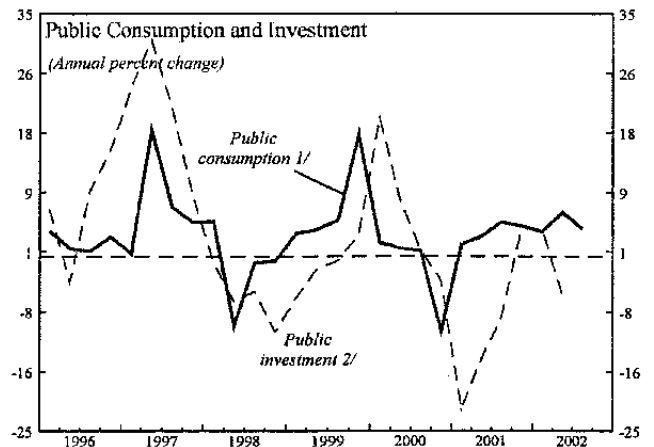
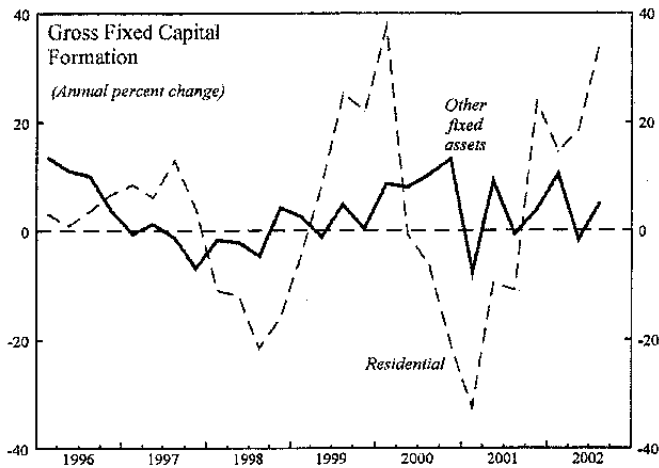
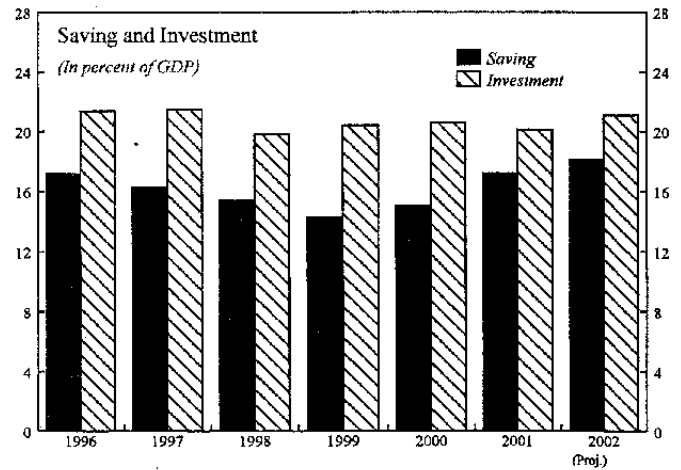
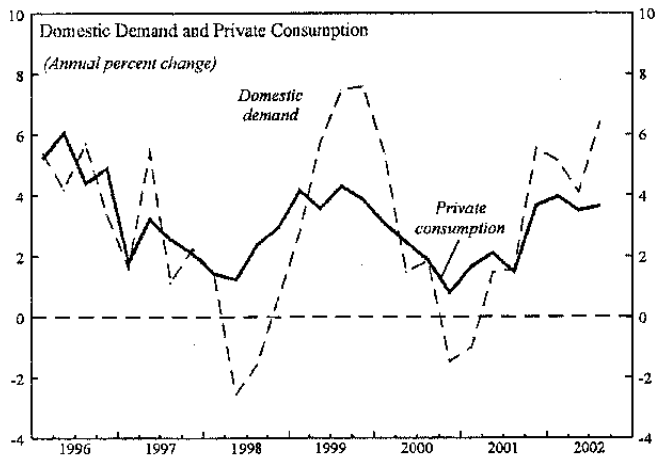
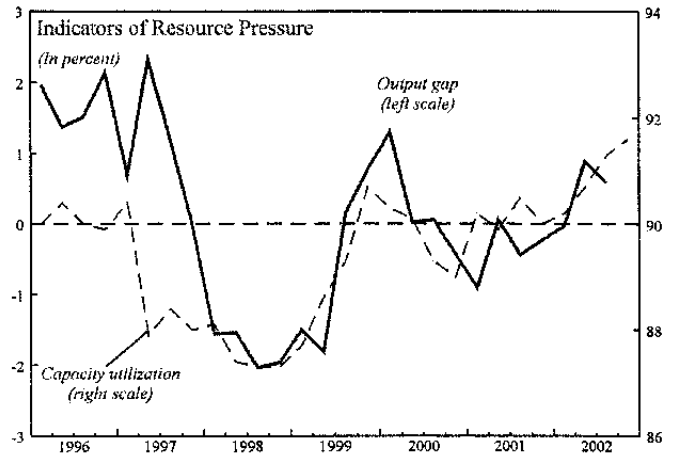
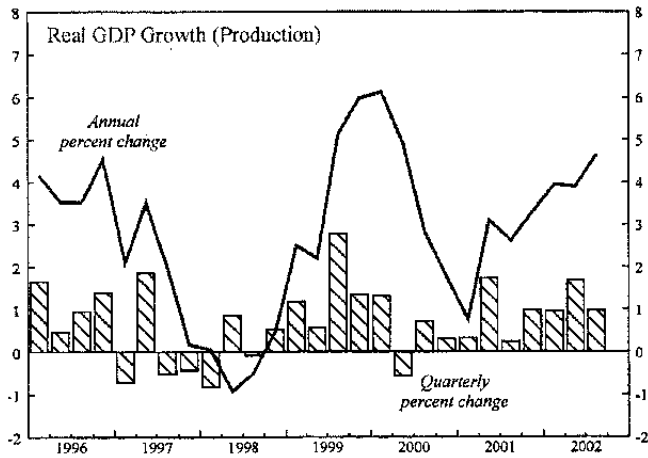
46. **New Zealand's small size and the composition of its production mean that trade policies play a central role in influencing growth performance.** Protectionism in major trading partners has imposed significant costs on New Zealand. Progress in multilateral trade negotiations, especially in agricultural products, could provide an important growth stimulus. Bilateral trade agreements can provide another avenue to expand market access, but they should be like the Closer Economic Relationship with Australia, comprehensive and nondiscriminatory, to minimize distortionary effects.

47. **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.

48. 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



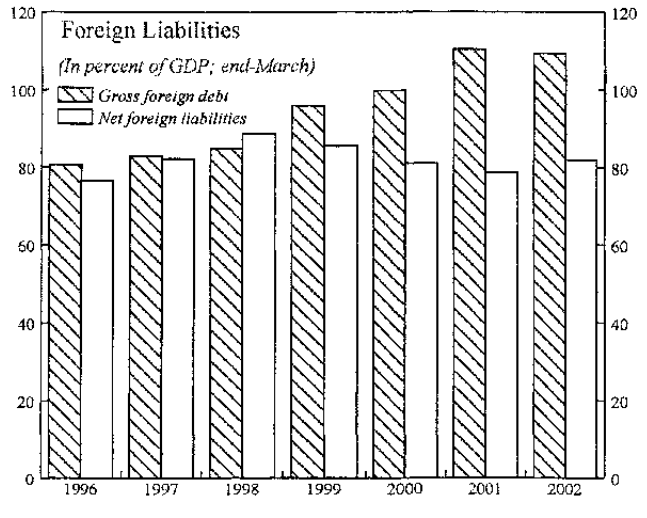
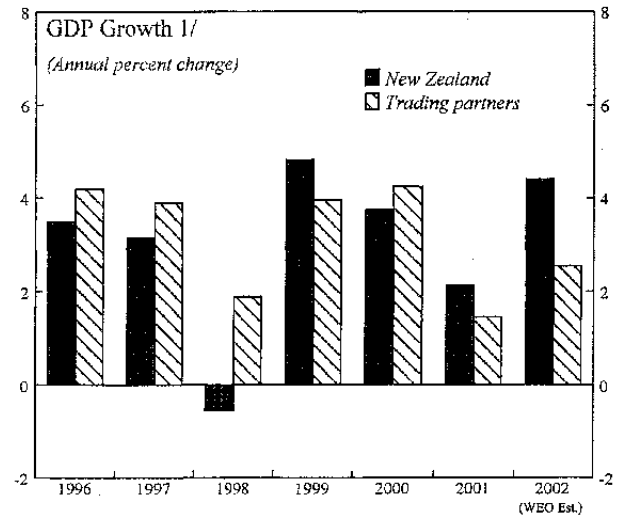
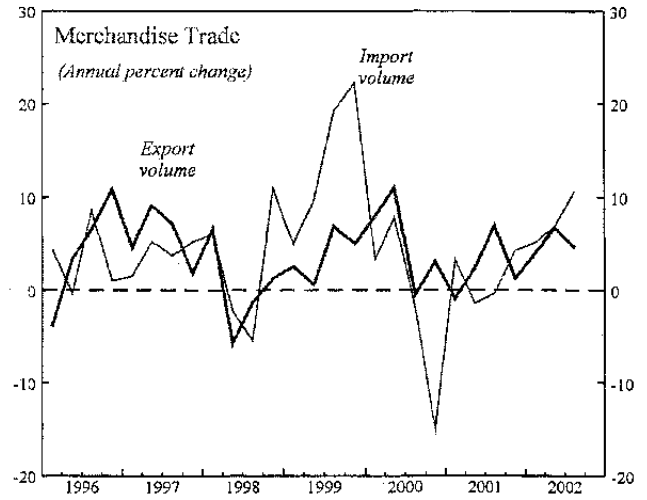
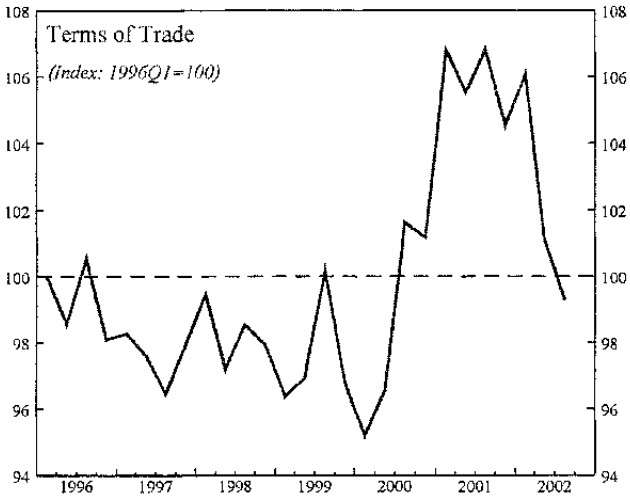
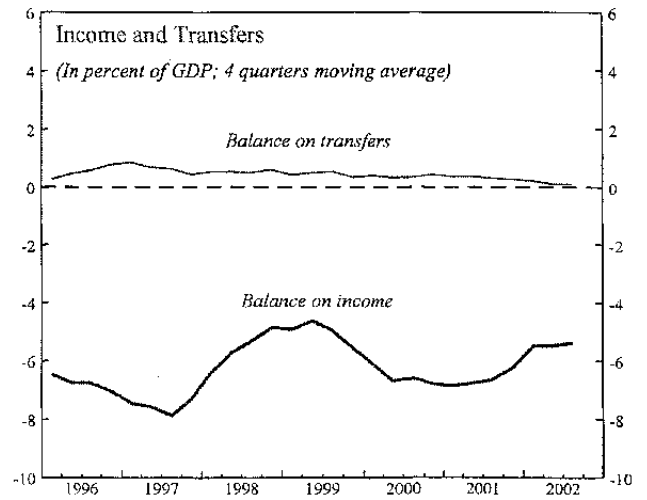
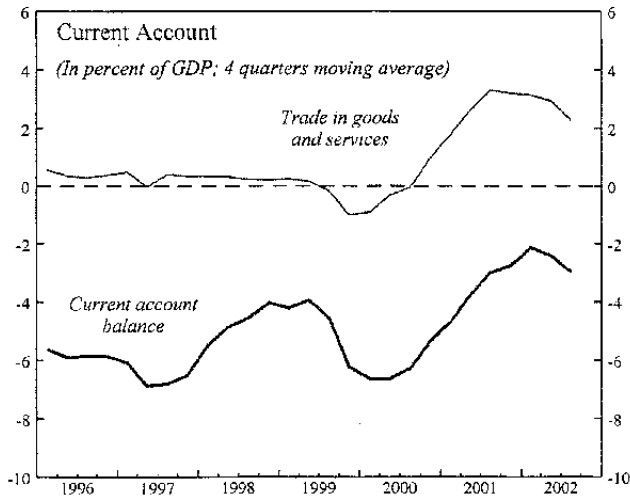
Sources: Statistics New Zealand; and staff estimates.

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

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

FIGURE 2
NEW ZEALAND

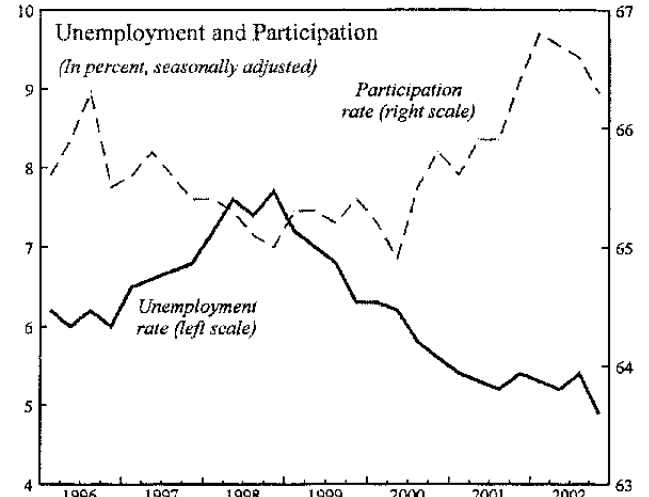
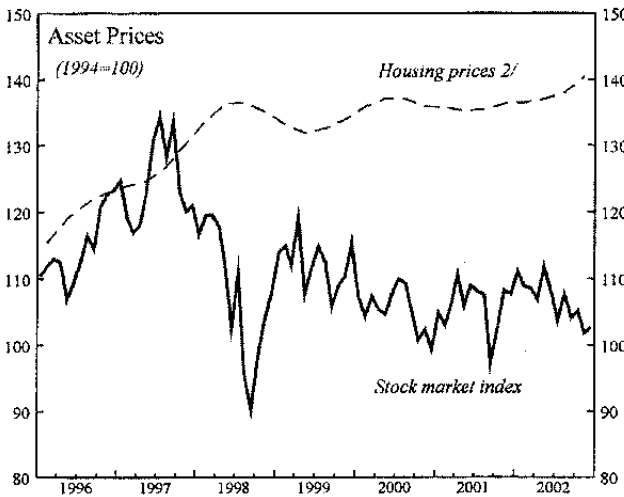
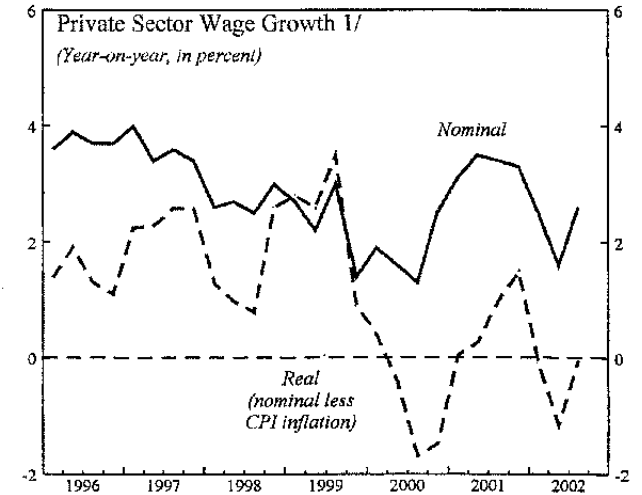
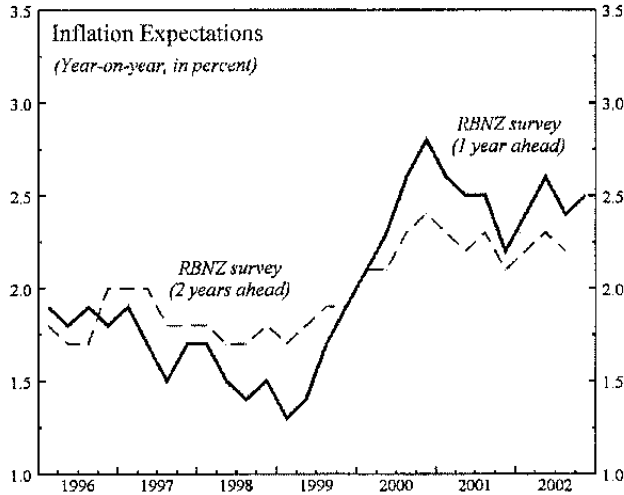
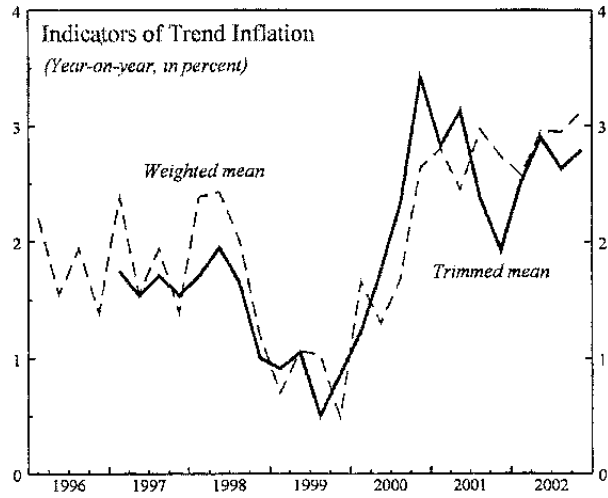
BALANCE OF PAYMENTS AND EXTERNAL INDICATORS



Sources: Statistics New Zealand, IMF, World Economic Outlook; and staff estimates.
1/ New Zealand data are expenditure based. Trading partner data are an export-weighted average based on data for partner countries that account for at least 95 percent of New Zealand's trade.

FIGURE 3
NEW ZEALAND

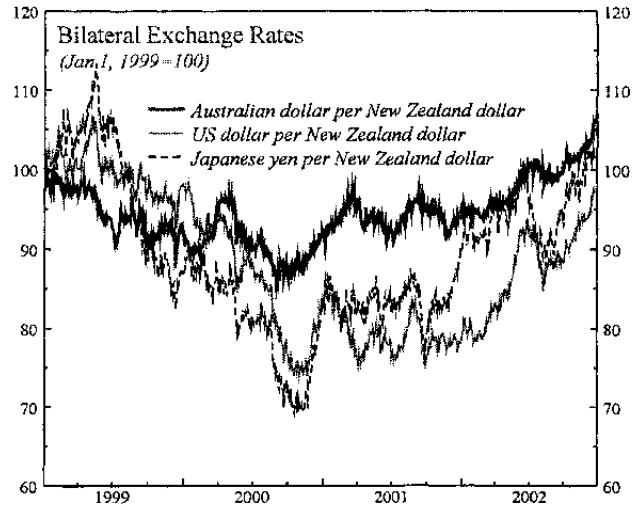
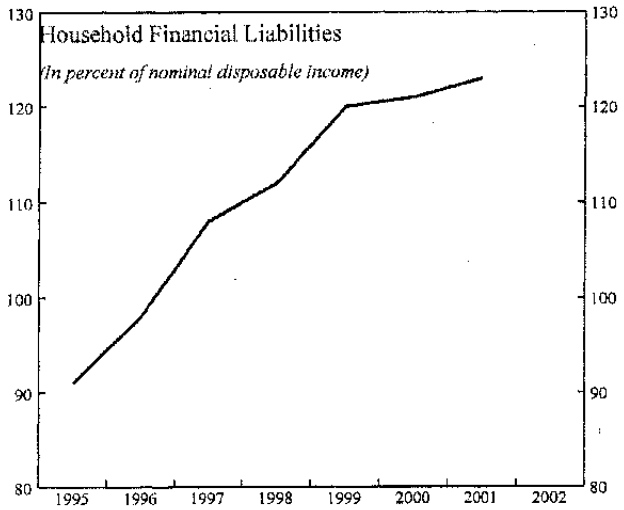
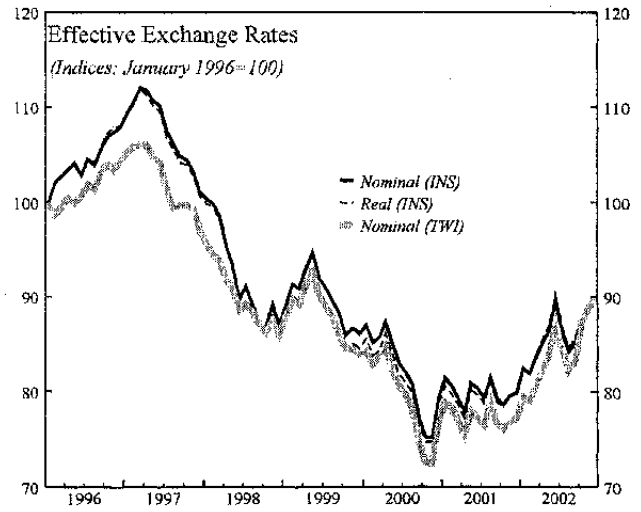
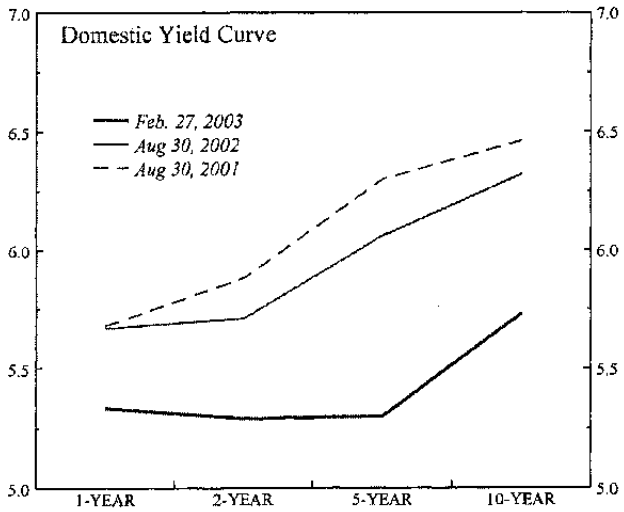
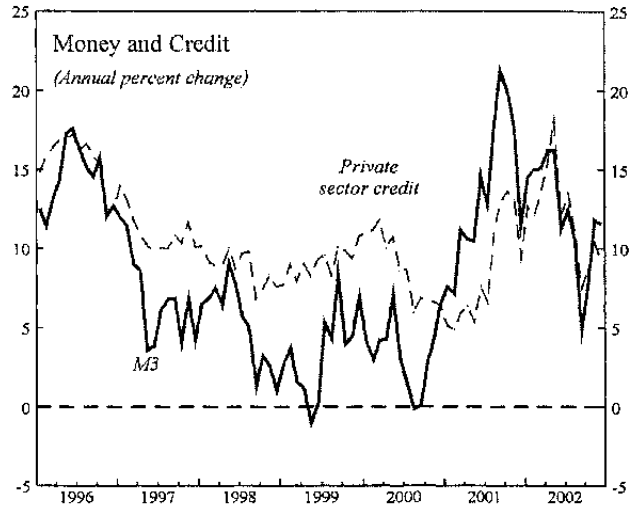
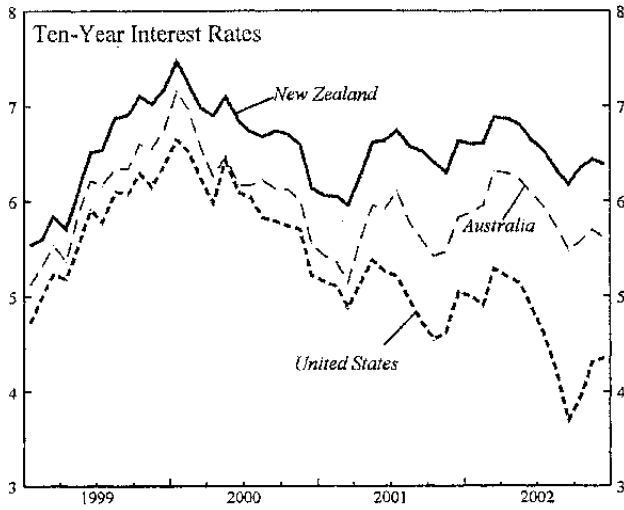
INFLATION AND LABOR MARKET INDICATORS



Sources: Statistics New Zealand; RBNZ; and staff estimates.
1/ Based on Quarterly Employment Survey (QES).
2/ Home ownership component of CPI in real terms.

FIGURE 4
NEW ZEALAND

MONETARY AND FINANCIAL INDICATORS



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

Table 1. New Zealand: Selected Economic and Financial Indicators

Nominal GDP (2001): US\$ 50.3 billion
 Population (2001): 4.0 million
 GDP per capita (2001): US\$ 12,667
 Quota: SDR 894.6 million

	1998	1999	2000	2001	Est. 2002	Proj. 2003
Real growth (percent change)						
GDP (production basis)	-0.2	4.0	3.9	2.4	4.2	2.7
Domestic demand	-0.5	5.9	1.8	1.9	4.9	3.3
Private consumption	2.0	4.0	2.0	2.2	3.5	2.8
Fixed investment	-4.8	4.6	7.7	-2.0	7.4	6.9
Exports of goods and services	1.6	8.2	6.8	2.1	5.9	4.5
Imports of goods and services	1.3	11.8	0.2	1.4	7.2	6.7
Headline CPI inflation (percent change)	1.3	-0.1	2.6	2.6	2.7	2.0
CPI excluding credit services (percent change)	1.6	1.1	2.7	2.7	2.7	1.9
Unemployment rate (in percent)	7.5	6.8	6.0	5.3	5.2	5.4
Investment and saving (in percent of GDP)						
Investment	19.8	20.4	20.7	20.0	20.5	21.0
National saving 1/	15.4	14.3	15.0	17.2	17.2	16.5
Private saving	10.2	9.8	10.7	12.9	12.2	11.0
Public saving	5.2	4.5	4.3	4.3	4.9	5.5
Public finance (in percent of GDP) 2/						
Revenue	35.4	35.3	33.5	34.0	32.3 2/	33.1
Expenditure	34.0	34.8	33.2	32.8	30.7 2/	31.4
Operating balance 3/	2.5	1.7	1.3	1.2	1.9	2.0
OBERAC 4/	2.2	0.2	0.8	1.8	2.2	2.8
Estimated structural balance 5/	2.3	1.2	0.6	1.7	2.0	2.6
Net public debt	23.9	21.1	19.6	17.2	14.4	14.6
Money and credit (end of period)						
M3 (percent change)	1.1	6.9	6.5	11.4	11.5	...
Private domestic credit (percent change)	7.6	10.8	6.4	9.5	9.1	...
Interest rate (90-day, in percent)	4.4	5.7	6.7	4.9	5.9	...
Government bond yield (10-year, in percent)	5.4	7.2	6.1	6.6	6.4	...
Balance of payments (\$NZ billion)						
Current account	-3.9	-6.6	-5.9	-3.4	-4.3	-6.0
(in percent of GDP)	-(3.9)	-(6.2)	-(5.2)	-(2.8)	-(3.4)	-(4.5)
Trade balance (goods)	1.7	-0.7	1.5	3.5	0.8	-1.6
Exports	22.9	23.9	29.8	33.1	30.8	27.7
Imports	-21.2	-24.6	-28.3	-29.6	-30.0	-29.3
Terms of trade (percent change)	0.7	-0.8	1.3	7.2	-5.7	-4.6
Foreign assets and liabilities (\$NZ billion) 6/						
Net international investment position 7/	-89.3	-87.1	-87.1	-89.8	-99.3	-91.7
(in percent of GDP)	-(88.7)	-(85.5)	-(81.0)	-(78.8)	-(81.2)	-(71.1)
Gross short-term external debt 8/	40.9	43.7	54.1	65.1	73.1	...
Gross foreign currency denominated debt 9/	46.2	54.1	61.9	79.2	75.6	...
Official reserves	7.6	7.3	7.9	8.6	7.7	9.4 10/
Exchange rate (end of period)						
US\$/NZ\$	0.53	0.52	0.44	0.42	0.53	...
Trade-weighted index (June 1979 = 100)	55.6	54.3	49.7	49.9	58.1	...
Nominal effective exchange rate 11/	94.13	93.29	85.9	86.5	94.8 12/	...
Real effective exchange rate 11/	89.00	87.83	81.8	83.0	91.5 12/	...

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

1/ Based on national accounts data.

2/ Fiscal years ending June 30. Significant changes have been made to fiscal data compilation. Thus, revenue and expenditure estimates for 2002 and 2003 are not directly comparable with those for previous years.

3/ Equals revenue less expenditure plus net surplus attributable to state-owned and Crown entities.

4/ Operating balance net of revaluations and accounting changes.

5/ Fund staff estimates; equals operating balance net of cyclical effects, revaluations and changes in accounting rules.

6/ Data for end-March of each year. Data from 2001 are not directly comparable with the historical data due to methodology changes to comply with BPM5.

7/ Data based on International Investment Position statistics.

8/ Residual maturity of less than one year. Data based on Total Overseas Debt until 2000, and on the International Investment Position thereafter.

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

10/ As of December 2002.

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

12/ October 2002.

Table 2. New Zealand: Balance of Payments and External Debt

	1996	1997	1998	1999	2000	2001	Est. 2002
(In percent of GDP)							
Current account balance	-5.9	-6.5	-3.9	-6.2	-5.2	-2.8	-3.4
Trade balance	0.7	1.3	1.7	-0.6	1.3	2.9	0.6
Exports, f.o.b.	21.5	21.5	22.6	22.6	26.5	27.6	24.3
Imports, f.o.b.	-20.8	-20.2	-20.9	-23.3	-25.1	-24.6	-23.7
Services balance	-0.4	-1.0	-1.4	-0.3	-0.2	0.2	0.8
Receipts	7.0	6.4	6.9	7.8	8.6	8.6	8.8
Payments	-7.4	-7.4	-8.3	-8.2	-8.8	-8.4	-8.0
Income balance	-7.2	-7.3	-4.9	-5.6	-6.8	-6.2	-5.1
Receipts	0.6	0.6	1.6	1.6	1.2	1.1	1.1
Payments	-7.8	-7.9	-6.5	-7.3	-7.9	-7.3	-6.2
Transfers balance	0.7	0.4	0.5	0.4	0.5	0.2	0.3
Inflows	1.3	1.1	1.3	1.1	1.3	1.2	1.2
Outflows	-0.6	-0.7	-0.7	-0.7	-0.8	-0.8	-0.8
Capital and financial account balance 1/	7.4	6.5	2.6	3.1	6.0	4.7	...
Capital account (net)	2.0	0.4	-0.3	-0.4	-0.4	0.9	...
Financial account (net)	5.4	6.1	2.9	3.5	6.4	3.8	...
Direct investment (net)	5.7	4.0	0.5	1.1	4.7	2.8	...
Portfolio investment (net)	-0.8	-1.8	-0.1	-5.3	-0.5	-3.0	...
Equity securities (net)	-0.2	-1.3	0.3	-1.3	-4.2	-1.4	...
Debt securities (net)	-0.6	-0.6	-0.3	-4.0	3.7	-1.6	...
Other investment (net)	0.5	3.9	2.5	7.7	2.2	3.9	...
Net errors and omissions 2/	1.2	-2.1	0.4	3.4	-1.1	-2.3	...
Overall balance	2.7	-2.2	-0.9	0.3	-0.3	-0.4	...
(Assets and liabilities as of end-March) 3/							
Total external debt 4/	80.7	83.0	84.9	96.0	99.8	110.5	108.3
Short-term 5/	39.5	39.0	35.0	40.9	49.5	57.1	59.8
Long-term	38.2	40.6	47.7	49.9	46.6	45.7	42.6
Unallocated estimate	3.0	3.5	2.2	5.1	3.7	7.7	5.9
Net international investment position	-76.5	-82.1	-88.7	-85.5	-81.0	-78.8	-81.2
Net equity	-16.9	-19.3	-22.9	-12.2	-6.2	-19.1	-19.7
Net debt	-59.6	-62.9	-65.7	-80.4	-82.1	-59.7	-61.5
Official reserves (billions of NZ dollars)	6.8	6.5	7.6	7.3	7.9	8.6	7.7
(In months of future imports of g&s)	(3.0)	(2.8)	(3.0)	(2.5)	(2.4)	(2.6)	(2.3)
(As percent of short-term debt)	(17.1)	(16.7)	(21.6)	(17.7)	(20.2)	(24.5)	(18.9)

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

1/ Based on IPS data.

2/ Calculated as a residual.

3/ Data from 2001 are not fully comparable with the historical data due to methodology changes to comply with BPM5.

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

5/ Residual maturity of less than one year.

Table 3. New Zealand: Summary of Central Government Budget 1/

	1998/99	1999/00	2000/01	2001/02	2002/03	2003/04
	DEFU					
	(In billions of New Zealand dollars)					
Revenue	36.4	36.5	39.5	39.9	42.2	44.0
Tax revenue	32.2	34.0	36.7	36.5	39.2	40.7
Direct taxation	20.3	21.5	23.9	24.5	26.4	27.6
Nontax revenue	4.2	2.5	2.8	3.5	3.1	3.3
Expenditure	35.8	36.2	38.2	38.0	40.1	41.2
Social security and welfare	12.9	12.9	13.2	13.5	13.9	14.4
New Zealand Superannuation	5.1	5.1	5.3	5.5	5.6	5.9
Other	7.8	7.8	7.9	8.0	8.3	8.5
Health	6.6	6.9	7.3	7.0	7.6	8.2
Education	5.9	6.3	6.7	6.5	6.9	7.2
Finance costs	2.5	2.4	2.5	2.1	2.1	2.2
Other	7.9	7.7	8.5	8.9	9.5	9.3
Revenue less expenses	0.5	0.4	1.3	1.9	2.1	2.9
Net surplus from SOEs and Crown entities 2/	1.2	1.1	0.1	0.5	0.4	1.0
Operating balance 3/	1.8	1.4	1.4	2.4	2.5	3.8
OBERAC 4/	0.2	0.9	2.1	2.8	3.5	3.8
Cash balance 5/	2.0	-0.4	0.3	0.2	0.3	-0.2
Capital investment 6/	-1.7	1.3	1.6	3.6	3.4	4.1
Gross Crown debt	36.7	36.0	36.8	36.2	35.5	35.9
Net Crown debt	21.7	21.4	20.0	17.8	18.6	19.1
Net worth 7/	6.0	8.6	11.5	18.7	21.2	25.1
	(In percent of GDP)					
Revenue	35.3	33.5	34.0	32.3	33.1	32.9
Tax revenue	31.2	31.2	31.6	29.5	30.7	30.5
Direct taxation	19.7	19.7	20.5	19.8	20.7	20.6
Nontax revenue	4.1	2.3	2.4	2.8	2.4	2.5
Expenditure	34.8	33.2	32.8	30.7	31.4	30.8
Social security and welfare	12.5	11.8	11.4	10.9	10.9	10.8
New Zealand superannuation	4.9	4.6	4.5	4.4	4.4	4.4
Other	7.6	7.2	6.8	6.5	6.5	6.4
Health	6.4	6.3	6.3	5.7	6.0	6.1
Education	5.7	5.8	5.8	5.2	5.4	5.3
Finance costs	2.4	2.2	2.1	1.7	1.7	1.6
Other	7.7	7.1	7.3	7.2	7.5	6.9
Revenue less expenditure	0.5	0.3	1.1	1.6	1.7	2.1
Net surplus from SOEs and Crown entities	1.2	1.0	0.1	0.4	0.3	0.7
Operating balance 3/	1.7	1.3	1.2	1.9	2.0	2.9
OBERAC 4/	0.2	0.8	1.8	2.1	2.8	2.9
Cash balance 5/	2.0	-0.4	0.3	0.2	0.2	-0.1
Capital investment 6/	-1.6	1.2	1.4	2.9	2.7	3.0
Structural cash balance 8/	2.8	-0.6	0.4	0.6	0.5	0.6
Gross Crown debt	35.6	33.1	31.6	29.3	27.8	26.9
Net Crown debt	21.1	19.6	17.2	14.4	14.6	14.3
Net worth 7/	5.8	7.9	9.9	15.2	16.6	18.8

Sources: New Zealand Treasury; DEFU (December Economic and Fiscal Update) 2002 and Fund staff estimates.

1/ Fiscal year ending June 30. Changes have been made to the compilation of fiscal data starting in 2001/02; data prior to that date are not fully comparable.

2/ The value for 1999/00 includes \$NZ 0.519 billion corresponding to movements in ACC valuations.

3/ Equals revenue less expenditure plus net surplus attributable to state-owned and Crown entities.

4/ Operating balance net of revaluations and changes in accounting rules.

5/ Fund staff estimate; equals cash flows from operations less cash flows on investment.

6/ Excludes contribution to the New Zealand Superannuation Fund.

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

8/ Fund staff estimate; equals overall cash balance net of cyclical effects as a percent of potential GDP.

Table 4. New Zealand: Medium-Term Scenario

	1999	2000	2001	Est.	Proj.					
				2002	2003	2004	2005	2006	2007	2008
Real growth (percent change)										
GDP	4.0	3.9	2.4	4.2	2.7	3.0	3.0	3.0	3.0	3.0
Domestic demand	5.9	1.8	1.9	4.9	3.3	2.8	2.6	2.8	2.8	2.7
Consumption	4.8	1.1	2.5	4.0	3.3	2.6	2.5	2.6	2.6	2.6
Private consumption	4.0	2.0	2.2	3.5	2.8	2.8	2.7	2.7	2.7	2.8
Fixed Investment	4.6	7.7	-2.0	7.4	6.9	4.8	3.3	3.4	3.3	3.3
Exports of goods and services	8.2	6.8	2.1	5.9	4.5	5.4	5.8	5.4	5.4	5.4
(Imports in trading partners)	(7.6)	(12.2)	-(1.8)	(5.1)	(6.0)	(6.5)	(7.1)	(6.9)	(6.8)	(6.8)
Imports of goods and services	11.8	0.2	1.4	7.2	6.7	5.0	4.7	4.6	4.7	4.7
Saving and investment (percent of GDP)										
Gross capital formation	20.4	20.7	20.0	20.5	21.0	21.2	21.4	21.4	21.4	21.5
Fixed investment	19.2	19.8	18.8	19.2	20.5	20.9	21.3	21.3	21.3	21.4
Increase in stocks	1.3	0.9	1.2	1.3	0.5	0.3	0.2	0.1	0.1	0.1
National saving 1/	14.3	15.0	17.2	17.2	16.5	16.8	17.1	17.1	17.3	17.7
Private	9.8	10.7	12.9	12.2	11.0	10.6	10.7	10.4	10.4	10.5
Public	4.5	4.3	4.3	4.9	5.5	6.2	6.4	6.7	6.9	7.2
Inflation and unemployment										
Headline CPI inflation	-0.1	2.6	2.6	2.7	2.0	2.0	2.0	2.0	2.0	2.0
Unemployment rate	6.8	6.0	5.3	5.2	5.4	5.3	5.2	5.2	5.2	5.2
Output gap	-0.7	0.2	-0.4	0.5	-0.2	0.0	0.0	0.0	0.0	0.0
Government budget (percent of GDP) 2/										
Revenue	35.3	33.5	34.0	32.3	33.1	32.9	32.9	33.0	33.0	33.0
Expenditure	34.8	33.2	32.8	30.7	31.4	30.8	30.5	30.3	30.0	29.7
Net surplus from SOEs and Crown entities	1.2	1.0	0.1	0.4	0.3	0.7	0.8	0.9	0.8	0.8
Operating balance 3/	1.7	1.3	1.2	1.9	2.0	2.9	3.2	3.5	3.9	4.2
OBERAC 4/	0.2	0.8	1.8	2.2	2.8	2.9	3.2	3.5	3.9	4.2
Cash balance 5/	2.0	-0.4	0.3	0.2	0.2	-0.1	1.2	1.5	1.6	1.9
Gross Crown debt	35.6	33.1	31.6	29.3	27.8	26.9	25.5	24.5	23.5	22.6
Net Crown debt	21.1	19.6	17.2	14.4	14.6	14.3	13.3	12.1	11.0	9.9
Net Worth 6/	5.8	7.9	9.9	15.2	16.6	18.8	21.1	23.6	26.4	29.6
Terms of trade (percent change, goods)	-0.8	1.3	7.2	-5.7	-4.6	1.6	1.8	1.2	0.6	0.0
Balance of payments (percent of GDP)										
Current account balance	-6.2	-5.2	-2.8	-3.4	-4.5	-4.5	-4.3	-4.3	-4.1	-3.8
Balance on goods and services	-1.0	1.1	3.2	1.4	-0.8	-0.3	0.6	1.0	1.2	1.5
Balance on goods	-0.6	1.3	2.9	0.6	-1.2	-1.0	-0.5	-0.2	0.0	0.1
Balance on services	-0.3	-0.2	0.2	0.8	0.4	0.8	1.1	1.1	1.2	1.3
Balance on income and transfers	-5.3	-6.3	-5.9	-4.9	-3.7	-4.2	-4.9	-5.2	-5.3	-5.3
Balance on income	-5.6	-6.8	-6.2	-5.1	-4.0	-4.5	-5.2	-5.6	-5.6	-5.7
Balance on transfers	0.4	0.5	0.2	0.3	0.4	0.4	0.3	0.3	0.4	0.4
Net foreign liabilities (percent of GDP) 7/	85.6	81.0	78.8	81.2	71.1	72.8	74.5	74.8	75.5	75.6
Gross external debt	96.0	99.8	110.5	108.3	97.6	100.3	101.5	102.0	102.7	102.8

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

1/ Fund staff estimates; based on national accounts data.

2/ Fiscal years ending June 30. Significant changes have been made to fiscal data compilation. Thus, figures from 2002 are not directly comparable with the historical data.

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

4/ Operating balance net of revaluations and accounting changes.

5/ Fund staff estimates; equals cash flows from operations less cash flows on investment.

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

7/ Data for end-March of each year. Data from 2001 are not directly comparable with the prior data due to methodology changes to comply with BPM5.

Table 5. New Zealand: External Sustainability Framework
(End-March data in percent of GDP, unless otherwise indicated)

	Actual				Projections						
	1998/99	1999/00	2000/01	2001/02	2002/03	2003/04	2004/05	2005/06	2006/07	2007/08	
1. Baseline Medium-Term Projections											
External debt	96.0	99.8	110.5	108.3	97.6	100.3	101.5	102.0	102.7	102.8	
Change in external debt	11.1	3.8	10.8	-2.2	-10.7	2.7	1.2	0.5	0.7	0.1	
Identified external debt-creating flows	6.1	3.3	0.4	-8.2	-10.8	0.2	-0.3	-1.8	-1.3	-1.9	
Current account deficit, excluding interest payments	-2.4	-0.9	-0.7	-3.0	-1.2	-1.2	-1.2	-1.6	-1.7	-2.2	
Deficit in balance of goods and services	-0.3	0.9	-1.9	-3.1	-0.1	0.6	0.3	-0.8	-1.1	-1.6	
Exports	29.9	31.1	36.3	35.6	30.7	28.7	29.3	30.8	31.6	32.4	
Imports	29.6	32.0	34.4	32.5	30.7	29.3	29.6	30.0	30.5	30.8	
Net non-debt creating capital inflows (negative)	-0.2	-2.3	-8.3	-1.2	2.2	0.0	-1.5	-1.3	-1.2	-1.4	
Net foreign direct investment, equity	-0.2	1.5	6.9	-0.1	-2.0	-0.1	1.3	1.1	1.0	1.1	
Net portfolio investment, equity	0.4	0.8	1.4	1.3	-0.2	0.2	0.1	0.3	0.2	0.3	
Automatic debt dynamics 1/	8.7	6.4	9.4	-4.0	-11.8	1.4	2.4	1.1	1.7	1.7	
Denominator: 1+g+p+g _o	0.9	1.0	0.9	1.1	1.3	1.1	1.0	1.0	1.0	1.0	
Contribution from nominal interest rate	6.5	7.5	5.3	5.1	5.8	6.0	6.1	6.1	6.1	6.1	
Contribution from real GDP growth	-0.3	-4.8	-2.8	-3.2	-3.2	-2.5	-2.8	-3.0	-2.9	-3.2	
Contribution from price and exchange rate changes 2/	2.5	3.7	6.8	-5.9	-14.4	-2.1	-0.8	-1.9	-1.6	-1.1	
Residual, incl. change in gross foreign assets	5.0	0.5	10.4	6.0	0.1	2.6	1.4	2.3	2.0	1.9	
External debt-to-exports ratio (in percent)	321.1	320.5	304.9	304.0	317.6	349.7	346.8	331.4	325.0	316.8	
Gross external financing need (in billions of US dollars) 3/ in percent of GDP	27.5 50.7	33.2 62.8	30.3 63.3	33.4 63.2	39.6 55.5	43.8 58.4	47.0 60.8	48.8 60.4	51.1 60.9	53.0 60.8	
Key Macroeconomic and External Assumptions											
Real GDP growth (in percent)	0.4	4.9	2.5	3.2	4.0	2.7	2.9	3.1	2.9	3.3	
GDP deflator in US dollars (change in percent)	-6.5	-7.1	-11.5	6.9	29.8	2.4	0.2	1.4	1.0	0.5	
Nominal external interest rate (in percent)	7.2	7.6	4.9	5.1	7.2	6.4	6.2	6.3	6.2	6.2	
Growth of exports (U.S. dollar terms, in percent)	-0.9	1.5	5.6	8.5	16.4	-1.8	5.2	9.9	6.7	6.6	
Growth of imports (U.S. dollar terms, in percent)	-0.8	5.5	-2.6	4.3	27.3	0.4	4.3	5.9	5.6	4.9	
II. Stress Tests for External Debt Ratio											
1. Real GDP growth, nominal interest rate, dollar deflator, non-interest current account, and non-debt inflows are at historical average in 2002/03-2007/08	121.3	123.9	124.5	126.0	127.3	128.5					
2. Nominal interest rate is at historical average plus two standard deviations in 2002/03 and 2003/04	103.5	113.6	115.1	115.7	116.6	116.9					
3. Real GDP growth is at historical average minus two standard deviations in 2002/03 and 2003/04	103.2	110.8	112.3	112.9	113.8	114.0					
4. Change in US dollar GDP deflator is at historical average minus two standard deviations in 2002/03 and 2003/04	158.2	207.2	211.0	212.7	215.3	217.3					
5. Non-interest current account is at historical average minus two standard deviations in 2002/03 and 2003/04	98.6	102.4	103.6	104.1	104.9	105.0					
6. Combination of 2-5 using one standard deviation shocks	149.9	185.4	188.6	190.1	192.2	193.9					
7. One time 30 percent nominal depreciation in 2002/03	137.9	141.3	143.4	144.4	145.8	146.6					
Other Shocks											
8. Real GDP growth is at the same level registered in the worst year (-1.3% in 1991/92) in 2002/03 and 2003/04 and then recover to 6% in 2004/05	102.7	109.8	107.9	108.5	109.3	109.5					
9. Nominal interest rate is at historical average plus one standard deviation in 2002/03 and 2003/04	103.0	110.3	110.5	110.5	111.0	111.2					
10. One time 30 percent nominal depreciation in 2002/03 (over the baseline projection)	112.5	115.5	117.0	117.7	118.7	119.0					
III. Historical Statistics for Key Variables (1991/92 - 2001/02)											
	Historical Average	Standard Deviation	Worst Case	Baseline Average	Standard Deviation						
Current account deficit, excluding interest payments 4/		-1.9	0.9	-0.7	-1.4	0.3					
Net non-debt creating capital inflows		3.7	3.2	8.3	0.4	1.5					
Nominal interest rate (in percent)		6.8	3.5	11.3	6.5	0.4					
Real GDP growth (in percent)		2.9	2.3	-1.3	3.1	0.5					
GDP deflator in US dollars (change in percent)		-0.6	9.8	-16.2	6.9	12.8					

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

1/ Derived as $[r - g - p(1+g) + \alpha(1+r)]/(1+g+p+g_o)$ times previous period debt stock, with r = nominal effective interest rate on external debt, g = change in domestic GDP deflator in US dollar terms, g = real GDP growth rate, β = nominal appreciation (increase in dollar value of domestic currency), and α = share of domestic-currency denominated debt in total external debt.

2/ The contribution from price and exchange rate changes is defined as $\beta(1+g) + \alpha(1+r)/(1+g+p+g_o)$ times previous period debt stock. p increases with an appreciating domestic currency ($\beta > 0$) and rising inflation (based on GDP deflator).

3/ Defined as non-interest current account deficit, plus interest and amortization on medium- and long-term debt, plus short-term debt at end of previous period.

4/ The historical average is from 1995/96 onwards because of lack of data on interest payments for the prior years.

New Zealand—Economic Vulnerability Assessment

1. **The basic assessment of New Zealand's economic vulnerability remains unchanged.**¹ The country does not appear to face major economic vulnerabilities and remains well placed to manage adverse economic shocks. Although gross foreign debt has risen sharply in recent years, it has been more than matched by a rise in assets, and the rate of increase in external indebtedness has slowed markedly over the past year. Foreign debt has become more concentrated in the banking sector and its maturity has shortened, reflecting increased intermediation of flows by banks. The foreign currency composition of the debt has also risen, but the associated currency risk is largely hedged. Corporate and banking sector balance sheets continue to look strong, and they have proven to be resilient to large swings in exchange and interest rates in the recent past. Household balance sheets and finances also look to be reasonably sound, and they too have been resilient to past interest swings. Housing remains the main household asset, and mortgage debt, which has risen rapidly in the last few years, is the major household liability and a major asset of the banking system. With higher indebtedness, households might be subject to somewhat more stress now in the event of a substantial increase in interest rates; however, they are likely to be resilient to such a change provided employment is not significantly affected. In addition, households could be at some risk from a sharp drop in housing prices, which would have spillover effects on the banking system. While housing prices have posted some gains since 1998, there does not appear to be a substantial risk of a major correction in these prices.

A. External Position

2. **The pace of New Zealand's external borrowing has slowed substantially.** At end-March 2002 (the most recent period for which full data are available), gross external debt was roughly unchanged in relation to GDP at around 110 percent, but substantially higher than at end-March 1998 (Table 1).² Net external liabilities, however, have declined over the period since

New Zealand: Key External Vulnerability Statistics						
	1997	1998	1999	2000	2001	2002
	(In percent of GDP at end-March)					
Current account (annual)	-6.1	-5.5	-4.1	-6.6	-4.6	-2.1
Net foreign liabilities	82.1	88.7	85.6	81.0	78.8	81.2
Gross external debt	83.0	84.9	96.0	99.8	110.5	108.3
Of which:						
Local currency denominated	45.4	45.4	45.2	43.2	41.1	46.5
Short-term (residual maturity)	39.0	35.0	40.9	49.5	57.1	59.8
Official government	21.2	20.1	17.1	16.5	14.9	15.5
Foreign-currency denominated debt (in SNZ billions)	...	46.2	54.1	61.9	79.2	75.6
Total Hedging (in percent of total debt)	...	94.9	97.2	96.6	99.8	94.2
Of which: with financial derivatives	...	54.1	64.5	65.1	62.6	63.7
naturally hedged	...	40.7	32.7	31.5	37.2	36.5
	(Annual percentage growth at end-December) 1/					
Exports of goods and services (y-o-y volume)	3.9	1.6	8.2	6.8	2.1	5.9
Imports of goods and services (y-o-y volume)	2.2	1.3	11.8	0.2	1.4	7.2
Terms of trade (quarterly index)	-0.6	-0.5	-1.6	0.5	5.6	-2.0
Real effective exchange rate (1990=100)	104.5	89.0	87.8	81.8	83.0	91.5 2/

Source: Statistics New Zealand.
1/ For 2002, data are for June quarter.
2/ Data for October 2002.

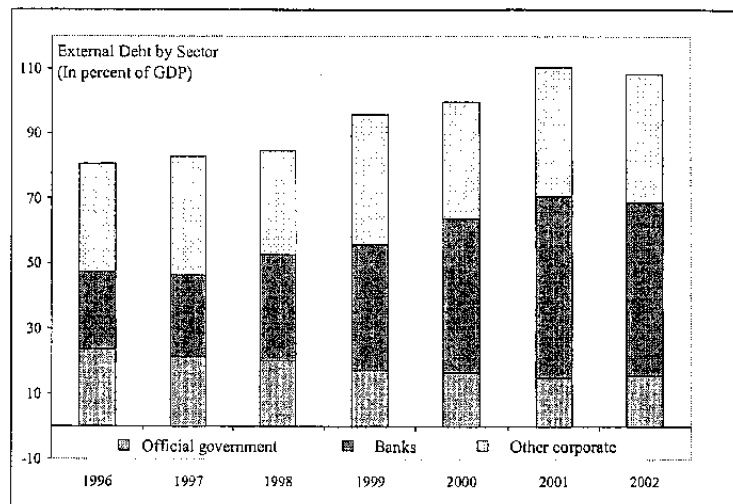
¹This annex updates the vulnerability assessment provided in *New Zealand: 2001 Article IV Consultation*, IMF Staff Country Report No. 02/49, 2002. That assessment concluded that there were no major vulnerability concerns.

²Data for end-March 2001 and 2002 are not fully comparable to earlier data due to methodology changes in the New Zealand balance of payments accounts.

end-March 1998 to about 82 percent of GDP. With a further moderate increase in foreign debt and an appreciation of the New Zealand dollar, the net foreign liability position would be expected to have declined further during 2002.

3. The increase in New Zealand's gross external indebtedness and a shortening of the maturity of the debt has been primarily related to activities of the banking sector.

External debt of the banks has more than doubled since end-March 1998, rising to 54 percent of GDP at end-March 2002, and accounting for about 50 percent of total gross external debt. In contrast, foreigners' holdings of New Zealand government debt



have declined and represented only 15 percent of total debt at end-March 2002. Short-term debt (residual maturity less than one year) accounts for 55 percent of the gross debt stock at end-March 2002, a share that has increased sharply since end-March 1998; long-term debt (residual maturity over 5 years) has been declining in importance, representing only a little more than 16 percent of the total at end-March 2002.

4. While a substantial share of gross foreign indebtedness is denominated in New Zealand dollars, slightly more than half of the debt is now foreign currency denominated. At end-March 2002, New Zealand dollar denominated debt was 43 percent of total gross external debt and foreign currency debt was nearly 55 percent of the total, compared to 53½ percent and 46½ percent, respectively, at end-March 1998. U.S. dollar denominated debt continues to account for the major share (roughly two-thirds at end-March 2002) of foreign currency debt. Survey data indicate that exchange rate risk for most of the foreign currency debt is hedged (Table 2).³ For the debt covered by the survey, more than 95 percent has been hedged, either through natural hedges or the use of financial derivatives. Dependence on financial derivatives for hedging has increased sharply since end-March 1998. The market for these instruments appears to be reasonably deep and has proven to be rather resilient, given the large swings in the value of the New Zealand dollar since the 1997 Asian crisis.

³ Hedging information is collected by Statistics New Zealand from a survey of corporations. In 2002, the survey covers more than 80 percent of foreign currency debt.

B. Sectoral Balance Sheets

Banks

5. **New Zealand's banking sector performance remains very strong.** With a robust domestic economy, New Zealand banks remained solidly profitable in 2002; return on total assets for the banking system was

New Zealand: Banks' Balance Sheet Indicators							
	1996	1997	1998	1999	2000	2001	2002 1/
Net profits / total assets	0.86	0.86	0.87	1.03	1.08	1.15	1.30
Net interest income / total assets	...	2.4	2.3	2.1	2.1	2.1	2.4
Return on average equity 2/	18.8	19.4	17.6	23.0	23.6	25.1	29.9
Capital adequacy 3/	10.5	10.5	10.5	10.3	11.1	10.8	11.1
Tier one	6.8	6.9	7.3	7.1	7.7	7.6	7.9
Impaired assets (in percent of total assets)	0.9	0.6	0.6	0.5	0.4	0.4	0.2

Sources: RBNZ: "Macro-financial stability and macroprudential analysis," RBNZ Bulletin (2001), "Developments in the New Zealand banking industry", RBNZ Bulletin (2002), and Bankscope.
 1/ As of September 2002; ratios for the four largest locally incorporated banks.
 2/ For the four largest locally incorporated banks; for 2002, NBNZ also excluded.
 3/ Capital as a percentage of risk-weighted exposure. Figures are as of December.

1¼ percent and return on equity was nearly 30 percent. The banks are also well capitalized, maintaining total capital of 11 percent and tier-one capital of around 8 percent of risk-weighted assets.⁴ The overall asset quality of the banking system remains very high, with the ratio of impaired assets to total assets at about ¼ percent, a historic low and well below levels in other developed countries. The overall strength of the banks in New Zealand is reflected in their ratings by the independent credit rating agencies.⁵ All of the major banks have strong ratings; the five largest banks, which account for 85 percent of total assets, have credit ratings of AA- or better.

Corporations

6. **Overall financial indicators for the corporate sector in New Zealand remain sound.** The ratio of operating income to sales, return on capital, and return on equity all have eroded a

New Zealand: Corporate Sector's Balance Sheet Indicators 1/												
	Operating Income to Sales			ROPC			EBITDA (interest cover)			Total Debt to Capital		
	1999	2000	2001	1999	2000	2001	1999	2000	2001	1999	2000	2001
New Zealand companies												
Median	38.5	29.4	28.4	9.5	10.1	9.8	4.2	5.0	4.4	36.1	37.3	42.6
Total survey population												
Median	22.9	24.5	25	9.7	10.4	9.1	5.2	5.0	4.7	42.1	41.6	41.6

Source: Australia & New Zealand Credit Stats various issues, Standard & Poor's.
 1/ Figures in percent, except EBITDA (earnings before interest, tax, depreciation and amortization). ROPC means return on permanent capital.

bit in the past few years, but they continue to be relatively strong, especially in comparison to companies in Australia. The decline in these indicators of profitability reflects the pressure

⁴ Registered banks in New Zealand are required to maintain a minimum tier-one capital ratio of 4 percent and a total capital ratio of 8 percent of risk-weighted assets. While capital requirements for branches of overseas banks operating in New Zealand are not mandatory, the RBNZ has requested that branches, which are deemed as systemically important and with retail deposits exceeding \$NZ 200 million, incorporate domestically.

⁵ All New Zealand banks are required to have credit ratings independent of their foreign parents.

that firms have operated under with the deterioration in global economic environment. Leverage ratios for New Zealand firms are in line with comparators in Australia; a big rise in the debt to capital ratio in 2001 was accounted for by large, debt-funded acquisitions and valuation adjustments to foreign currency denominated debt. Net interest expense has generally been small in relation to operating surplus, even prior to the decline of global interest rates in 2001.

New Zealand: Business Indicators 1/			
(In percent)			
	1999	2000	2001
Operating surplus before tax/GDP	29.7	27.6	25.7
Net interest expense/operating surplus 2/	6.8	7.0	-1.8
Current assets/current liabilities	80.1	80.9	91.8
Return on equity	9.5	9.3	9.1
Return on total assets	4.0	3.7	3.5

Source: Statistics New Zealand.
 1/ Includes finance and insurance industries.
 2/ Includes donations and interest income includes dividends.

Households

7. **Household net wealth has fallen in relation to disposable income in recent years, but remains at a relatively high level.** Net financial wealth has declined relative to disposable income primarily due to declining equity prices. Net housing wealth also has declined, as growth in housing prices was slower than that in disposable income and mortgage debt rose.

New Zealand: Household Sector Balance Sheet Indicators						
(Percent of annual disposable income)						
	1996	1997	1998	1999	2000	2001
Household net wealth	412	418	392	391	364	352
Net financial wealth	179	178	179	182	174	169
Assets	197	197	198	205	196	191
Liabilities	18	19	19	23	22	22
Net housing wealth	233	239	213	210	190	184
Housing value	313	328	306	307	289	285
Housing loan	80	89	93	97	99	101
Debt-servicing costs 1/	7.5	8.6	9.1	8.4	7.5	7.7
Savings rate 1/	-3.5	-2.5	-4.6	-4.2	-5.2	-3.7

Sources: Thorp and Ung, RBNZ Bulletin June 2002, Statistics New Zealand, and Fund staff estimates.
 1/ Figures refer to year ending in March.

8. **Housing figures very heavily in New Zealand household balance sheets and finances.** It accounts for about 60 percent of households' gross assets and about 80 percent of financial liabilities. Household finances could be affected by a surge in interest rates or a sharp fall in housing prices. Mortgage debt generally has floating interest rates, and with declining rates and strong income growth, debt servicing costs have declined to 7¾ percent of disposable income, down from the previous peak of more than 9 percent in 1998. Provided that there is no major correction in employment, households are likely to be resilient to a major rise in interest rates, as they have been in the past. Moreover, despite some additional pick-up in prices during 2002, housing prices in real terms have not posted sustained strong increases over the past several years, and there would not appear to be a substantial risk that these prices could decline sharply.

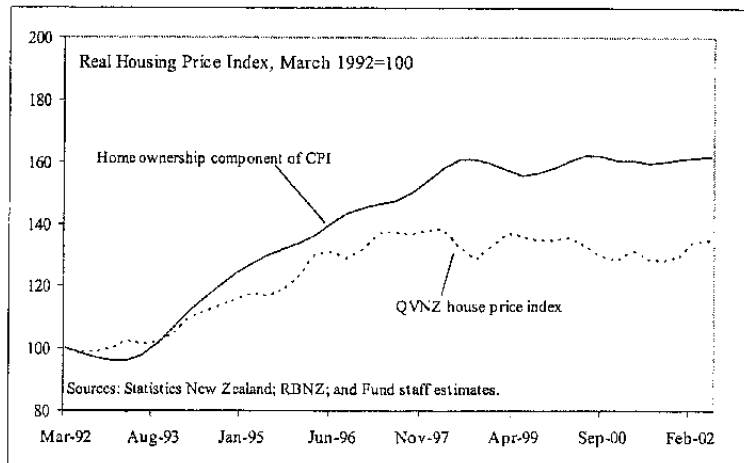


Table 1. New Zealand: Decomposition of Gross External Debt 1/

(In billions of New Zealand dollars)

	End-March						
	1996	1997	1998	1999	2000	2001	2002
Total gross external debt	74.8	80.7	85.6	97.7	107.3	126.0	132.6
<i>By sector</i>							
Official government	21.9	20.6	20.2	17.4	17.7	16.9	18.9
Corporate sector	52.9	60.1	65.3	80.3	89.6	109.1	113.6
<i>By sub-sector</i>							
Banks	21.9	24.4	32.9	39.5	51.0	63.7	65.4
Other corporate	31.0	35.6	32.4	40.8	38.6	45.4	48.2
<i>By relation 2/</i>							
Related party	27.1	31.0	43.6	45.8	55.5	...	...
Nonrelated party	25.8	29.0	21.8	34.5	34.0	...	...
<i>By currency 3/</i>							
New Zealand dollar	39.5	44.2	45.8	46.1	46.4	46.8	56.9
Foreign currency	35.3	36.5	39.8	51.6	60.9	79.2	75.6
U.S. dollar	19.4	20.3	24.1	31.5	38.0	52.9	49.5
Japanese yen	4.7	4.0	4.3	5.2	8.0	10.4	7.2
Australian dollar	3.7	3.1	3.2	4.1	5.0	7.9	9.4
Other	4.7	5.8	6.0	5.6	5.8	4.9	6.6
Unallocated	2.8	3.3	2.2	5.2	4.0	3.1	2.9
<i>By (residual) maturity 3/</i>							
Short term (under 1 year) 4/	36.6	37.9	35.3	41.7	53.3	65.1	73.1
Medium term (1-5 years)	17.0	20.9	30.2	29.2	33.8	28.3	30.6
Long term (over 5 years)	18.4	18.5	17.9	21.7	16.3	23.8	21.6
Unallocated	2.8	3.3	2.2	5.2	4.0	8.8	7.2
Nominal GDP (in \$NZ)	92.7	97.2	100.7	102.0	107.6	114.0	122.4

Sources: 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 corporates with external debt greater than \$NZ 50 million.

2/ Data not available for 2001 and 2002.

3/ Breakdown unavailable for data published in the International Investment Position of March 2000. Thus, ratios to total debt from the Overseas Debt Survey of March 2000 are applied to the revised total debt data.

4/ From 2001, short-term maturity data reclassified to include debt maturing in one year.

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

(In percent of GDP)

	End-March						
	1996	1997	1998	1999	2000	2001	2002
Total gross external debt	80.7	83.0	84.9	95.9	99.8	110.6	108.3
<i>By sector</i>							
Official government	23.6	21.2	20.1	17.1	16.5	14.9	15.5
Corporate sector	57.0	61.8	64.9	78.8	83.3	95.7	92.9
<i>By sub-sector</i>							
Banks	23.6	25.1	32.7	38.7	47.4	55.9	53.4
Other corporate	33.5	36.6	32.2	40.0	35.9	39.8	39.4
<i>By relation</i>							
Related party	29.3	31.9	43.3	44.9	51.6	...	...
Nonrelated party	27.8	29.9	21.6	33.8	31.6	...	...
<i>By currency</i>							
New Zealand dollar	42.6	45.4	45.4	45.2	43.2	41.1	46.5
Foreign currency	38.1	37.6	39.5	50.7	56.6	69.5	61.8
U.S. dollar	21.0	20.9	23.9	30.9	35.4	46.4	40.4
Japanese yen	5.0	4.1	4.2	5.1	7.5	9.1	5.9
Australian dollar	4.0	3.2	3.2	4.1	4.7	6.9	7.7
Other	5.1	5.9	6.0	5.5	5.4	4.3	5.4
Unallocated	3.0	3.4	2.2	5.1	3.7	2.7	2.4
<i>By (residual) maturity</i>							
Short term (under 1 year)	39.5	39.0	35.0	40.9	49.5	57.1	59.8
Medium term (1-5 years)	18.4	21.5	30.0	28.6	31.4	24.8	25.0
Long term (over 5 years)	19.9	19.1	17.7	21.3	15.2	20.9	17.7
Unallocated	3.0	3.4	2.2	5.1	3.7	7.7	5.9

Sources: Statistics New Zealand; and Fund staff estimates.

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

(In percent of total gross external debt)

	End-March						
	1996	1997	1998	1999	2000	2001	2002
Total gross external debt	100.0	100.0	100.0	100.0	100.0	100.0	100.0
<i>By sector</i>							
Official government	29.3	25.6	23.6	17.8	16.5	13.4	14.3
Corporate sector	70.7	74.4	76.4	82.2	83.5	86.6	85.7
<i>By sub-sector</i>							
Banks	29.2	30.3	38.5	40.4	47.5	50.5	49.3
Other corporate	41.5	44.1	37.9	41.7	36.0	36.0	36.4
<i>By relation</i>							
Related party	36.3	38.5	50.9	46.9	51.8	...	...
Nonrelated party	34.4	36.0	25.4	35.3	31.7	...	...
<i>By currency</i>							
New Zealand dollar	52.8	54.7	53.5	47.2	43.3	37.2	43.0
Foreign currency	47.2	45.3	46.5	52.8	56.7	62.8	57.0
U.S. dollar	26.0	25.2	28.2	32.2	35.4	42.0	37.3
Japanese yen	6.2	5.0	5.0	5.3	7.5	8.3	5.5
Australian dollar	4.9	3.8	3.8	4.2	4.7	6.3	7.1
Other	6.3	7.2	7.0	5.8	5.4	3.9	5.0
Unallocated	3.7	4.1	2.6	5.3	3.7	2.4	2.2
<i>By (residual) maturity</i>							
Short term (under 1 year)	48.9	47.0	41.2	42.7	49.6	51.7	55.2
Medium term (1-5 years)	22.8	25.9	35.3	29.8	31.5	22.5	23.0
Long term (over 5 years)	24.6	23.0	20.9	22.2	15.2	18.9	16.3
Unallocated	3.7	4.1	2.6	5.3	3.7	7.0	5.5

Sources: Statistics New Zealand; and Fund staff estimates.

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

(In billions of New Zealand dollars)

	End-March				
	1998	1999	2000	2001	2002
Foreign currency external debt	39.8	51.6	60.9	79.2	75.6
<i>Of which</i> : covered by SNZ hedging supplement 1/	32.4	38.0	47.0	56.5	61.9
Coverage of supplement (percent)	81.5	73.6	77.2	71.3	81.8
<i>Type of hedge</i>					
Financial derivatives	17.6	24.5	30.6	35.4	39.5
Naturally hedged (against assets/receipts)	13.2	12.4	14.8	21.0	18.9
Unhedged	1.7	1.1	1.6	0.1	3.5
<i>By sector</i>					
Banks	15.9	23.8	31.9	37.7	39.7
Financial derivatives	11.6	19.3	26.0	27.3	27.4
Naturally hedged (against assets/receipts)	4.3	4.4	5.3	10.4	...
Unhedged	0.1	0.0	0.6	0.0	...
Nonbanks and official	16.5	14.2	15.0	18.8	22.2
Financial derivatives	6.0	5.2	4.6	8.1	12.1
Naturally hedged (against assets/receipts)	9.0	8.0	9.5	10.6	...
Unhedged	1.6	1.0	1.0	0.1	...

Sources: Statistics New Zealand; Fund staff estimates.

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

NEW ZEALAND—FUND RELATIONS

(As of February 28, 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	558.26	62.40
	Reserve position in Fund	336.36	37.60
III.	SDR Department:	SDR Million	Percent Allocation
	Net cumulative allocation	141.32	100.0
	Holdings	16.62	1.76
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 2001 Article IV consultation discussions were held during November 29–December 10, 2001, the Executive Board discussed the staff report (SM/02/49, 02/14/02) and concluded the consultation on March 22, 2002.</p>		
IX.	FSAP Participation and ROSCs:	FSAP scheduled for 2003	
X.	Technical Assistance:	None	
XI.	Resident Representative/Advisor:	None	

New Zealand: Core Statistical Indicators

(As of February 28, 2003)

	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	2/28/2003	Jan. 2003	Jan. 2003	Jan. 2003	Jan. 2003	2/28/2003	Dec. 2002	Jan. 2002	Sept. 2002	Jan. 2003	Jan. 2003	Sept. 2002
Date received	2/28/2003	2/26/2003	2/26/2003	2/17/2003	2/26/2003	2/28/2003	1/17/2003	2/28/2003	12/19/2002	3/14/2003	3/14/2003	12/20/2002
Frequency of data	Daily	Monthly	Monthly	Monthly	Monthly	Daily	Quarterly	Monthly	Quarterly	Monthly	Monthly	Quarterly
Frequency of reporting	Daily	Monthly	Monthly	Monthly	Monthly	Daily	Quarterly	Monthly	Quarterly	Monthly	Monthly	Quarterly
Source of data	Reuters	RBNZ	RBNZ	RBNZ	RBNZ	Reuters	SNZ	SNZ	SNZ	Treasury	Treasury	SNZ
Mode of reporting	Electronic	Electronic	Electronic	Electronic	Electronic	Electronic	Electronic	Electronic	Electronic	Electronic	Electronic	Electronic
Confidentiality	Public	Public	Public	Public	Public	Public	Public	Public	Public	Public	Public	Public
Frequency of publication	Daily	Monthly	Monthly	Monthly	Monthly	Daily	Quarterly	Monthly	Quarterly	Monthly	Quarterly	Quarterly

**Statement by the IMF Staff Representative
April 28, 2003**

1. This statement contains information that has become available since the Staff Report (SM/03/107) was circulated to the Executive Board on March 28, 2003. This information does not alter the thrust of the staff appraisal.

2. New data indicate that the pace of economic activity was stronger than expected in the December 2002 quarter; real GDP grew by 0.8 percent, raising the annual average growth rate in 2002 to 4.4 percent. Growth in the quarter was driven by strong consumer spending and increased business investment. Housing investment, which had been an important contributor to growth in previous quarters, slowed sharply. The current account deficit widened further in the December 2002 quarter reaching 4½ percent of GDP; for the year 2002, the deficit rose to over 3 percent of GDP from around 2¾ percent in 2001.

3. Recent economic indicators generally have been consistent with an expected slowdown in the pace of economic activity in 2003. Consumer and business confidence has declined; new residential building consents have fallen; retail sales growth has eased; and advertised job vacancies have declined. The outlook for GDP growth in 2003 remains broadly unchanged at 2¾ percent. Although uncertainties associated with the military conflict in Iraq have diminished, some additional downside risks have emerged, including the impact on trade and tourism of the outbreak in Asia of Severe Acute Respiratory Syndrome and recent dry weather conditions in some parts of New Zealand, which could have adverse implications for agricultural and hydroelectric power production.

4. Inflation declined slightly in the March 2003 quarter, with consumer prices rising at a 2½ percent rate (year-on-year), compared to nearly a 2¾ percent rate in the December 2002 quarter. Both tradables and nontradables inflation declined. In late April 2003, the New Zealand dollar was largely unchanged from its level at end-February against the U.S. dollar and only slightly lower on a trade-weighted basis.

5. Following its scheduled review of the overnight cash rate (OCR) on April 23, the Reserve Bank of New Zealand (RBNZ) announced a rate cut of 25 basis points to 5½ percent. In the announcement, the RBNZ's Governor noted that conditions set in January 2003 for a cut in the OCR (the exchange rate remaining unchanged or appreciating further and evidence of reduced pressures on resources and medium-term inflation) had been met. Available data suggested that growth in the New Zealand economy was slowing as the RBNZ expected, and the Bank was more confident that inflationary pressures would ease. The Governor stated that the new Policy Targets Agreement requires the Bank to avoid unnecessary instability in output, interest rates, and the exchange rate. Accordingly, the RBNZ had been prepared to adjust interest rates a little faster in response to the evidence of a slowdown. However, any further easings in monetary policy would depend on evidence continuing to suggest that inflation would settle comfortably within the official target range over the medium term.



INTERNATIONAL MONETARY FUND

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May 2, 2003

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

IMF Concludes 2003 Article IV Consultation with New Zealand

On April 30, 2003, the Executive Board of the International Monetary Fund (IMF) concluded the Article IV consultation with New Zealand.¹

Background

Despite significant slowdowns in activity in some major overseas markets, New Zealand has maintained a strong pace of economic growth over the past three years. The economy's performance reflected its enhanced flexibility, stemming from the structural reforms of the 1980s and 1990s, and the prudence of macroeconomic policies. Favorable commodity price developments and a competitive exchange rate provided a strong stimulus to exports, raising growth sharply initially during this period. Subsequently, the impact of the increase in exports on incomes in the farm sector filtered through the rest of the economy, and domestic demand surged, led by private consumption and housing investment. Unusually strong net immigration inflows also provided a stimulus to demand. The annual average real GDP growth was 4.4 percent in 2002. Strong demand conditions contributed to pushing capacity utilization rates to high levels and reducing unemployment to 4.9 percent in the December 2002 quarter. Pressures on resources kept inflation towards the top end of the official 1–3 percent target range in 2002, but the rate declined to 2½ percent in the March 2003 quarter.

After falling sharply in 1999 and 2000, the value of the New Zealand dollar stabilized during 2001, before appreciating substantially in 2002 and into early 2003. Since end-2001, the

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.

New Zealand dollar has risen by 34 percent vis-à-vis the U.S. dollar and 21 percent on a trade-weighted basis. The earlier depreciation, in combination with favorable commodity prices, led to strong export growth which helped to narrow the external current account deficit from 6¼ percent of GDP in 1999 to around 3 percent in 2002. Rising imports of consumer goods (on the back of the pick-up in domestic demand) and weaker export prices in 2002 eroded some of the improvement in the trade balance over the course of the year, but rising service receipts and falling factor income outlays have provided some offset. With the relatively strong current account position, net capital inflows have eased during the past two years which has helped to reduce New Zealand's net external liabilities from 89 percent of GDP at end-March 1998 to 82 percent at end-March 2002.

Better-than-expected economic activity prompted the Reserve Bank of New Zealand (RBNZ) to tighten monetary policy in the first half of 2002. In March to June, the RBNZ raised the overnight cash rate (OCR) by a total of 100 basis points to 5.75 percent in four steps. At subsequent reviews in 2002, the RBNZ left rates unchanged, reflecting concerns about a deteriorating external environment and its implications for New Zealand. At the January and March 2003 OCR reviews, the OCR also was left unchanged, but the RBNZ suggested that the sharp appreciation of the currency may have shifted the balance of risks around the future path of interest rates. However, the RBNZ cautioned that any cut in the interest rates would be conditional on the emergence of clear signs of reduced resource pressures and medium-term inflation. At its scheduled review on April 23, the RBNZ cut the OCR by 25 basis points noting that these conditions had been met. Available data suggested that growth in the New Zealand economy was slowing as the RBNZ had expected, and the Bank was more confident that inflationary pressures would ease.

The fiscal surplus rose in 2001/02 and is expected to strengthen further over the medium term. In 2001/02, reflecting stronger tax revenues, the operating surplus (OBERAC) rose by nearly ½ percentage point to 2¼ percent of GDP. Medium-term projections in the December Economic and Fiscal Update 2002 suggest that the OBERAC could rise to 2¾ percent of GDP in 2002/03 and to nearly 4 percent by 2006/07. Projected operating surpluses are more than sufficient to meet the required contributions to the New Zealand Superannuation Fund, as well as additional capital expenditures and other planned government investments. Accordingly, gross debt is expected to decline to around 23½ percent of GDP, and net debt would fall to around 11 percent by 2006/07.

The pace of economic growth is expected to ease in 2003 to around 2¾ percent, given the weak external environment, the fall in commodity prices, and the sizeable currency appreciation. Private consumption would account for most of the slowdown in growth, reflecting weaker disposable income growth and slower population growth. Although uncertainties associated with military conflict in Iraq have diminished, uncertainty about the strength of external demand remains a major downside risk to the outlook. Some additional downside risks have emerged, including the impact on trade and tourism of the outbreak in Asia of Severe Acute Respiratory Syndrome and recent dry weather conditions in some parts of the country, which could have adverse implications for agricultural and hydroelectric power production. On the upside, there is a risk that with consumer confidence remaining high, near-term domestic demand growth could

prove stronger than expected. New Zealand's medium-term economic prospects are favorable, with growth expected to rise to a rate in line with estimates of the economy's potential of around 3 percent over the medium term. Inflation is expected to return to around the middle of the official target range in 2003 and remain there. The current account deficit is projected to return to its average level of the 1990s of around 4 to 4½ percent of GDP.

Executive Board Assessment

Executive Directors commended the New Zealand authorities for the performance of the economy. Directors attributed this success to the authorities' continued skillful management of macroeconomic policies and to the wide-ranging structural reforms undertaken since the mid-1980s, which have contributed to New Zealand's robust economic growth, made the economy more flexible, and increased its resilience to external shocks. Although growth prospects are expected to moderate over 2003, the strong institutional and macroeconomic frameworks should continue to serve the country well.

With regard to macroeconomic policies, Directors noted that New Zealand's inflation targeting framework has provided a sound and credible basis for formulating monetary policy. Modifications to the framework under the new Policy Targets Agreement (PTA) have been useful, as they provide some additional flexibility in conducting monetary policy. Directors were not convinced that, at some point in the future, it would be useful to modify the PTA to define the policy objective as seeking inflation outcomes over the medium term around the midpoint of the target range in order to further ground inflationary expectations, as the staff had suggested. Directors observed that the floating exchange rate regime is an integral part of the inflation targeting framework. It has served New Zealand well by allowing the country to conduct independent monetary policy and by providing flexibility in adjusting to structural reforms and economic shocks.

Directors generally supported the current monetary policy stance. Although a few Directors would have looked for further evidence of moderating inflation, most Directors welcomed the recent rate cut, in view of the anticipated slowdown in growth and expected easing in price pressures. Directors agreed with the Reserve Bank of New Zealand's view that, while the recent currency appreciation may have shifted the balance of risks, any further easing in monetary policy should be conditional on clear signs that resource pressures are easing and price inflation is set to remain comfortably within the target range over the medium term.

Directors viewed the Government's fiscal management approach as providing a solid medium-term anchor for fiscal policy. The objectives of running an operating surplus sufficient to meet the requirements for contributions to the New Zealand Superannuation Fund and keeping gross debt below 30 percent of GDP on average over the economic cycle provide adequate flexibility for fiscal policy to respond to cyclical pressures and should be easily understood and monitored by the public. Directors noted that over the longer term, the fiscal position faces substantial costs associated with the aging of the population. While acknowledging the significant uncertainties surrounding these projected costs, they suggested that measures to deal with

these costs should be adopted sufficiently early to allow smoothing of the fiscal burden over time and to enable households to adapt their savings behavior appropriately.

Directors welcomed the favorable budgetary position projected for the next five years, but they noted the significant uncertainties regarding the size of prospective fiscal surpluses. They supported the authorities' cautious approach of postponing any new policy initiatives to the 2004 budget, by which time the strength of the underlying fiscal position may be clearer.

Directors agreed with the authorities' focus on promoting economic growth, and pointed to the labor market as a key area where policy changes can raise potential growth. They suggested that reducing disincentives for moving from welfare to work should help to further raise the labor force participation rate—already one of the highest among OECD countries. In particular, Directors saw merit in simplifying the income support system and making accompanying changes in the incentives provided through the income tax system. A few Directors also suggested that measures to tighten benefit requirements might be useful in encouraging labor force participation. Additionally, Directors noted that labor market flexibility has served the country well, and advised caution with respect to the introduction of measures to set wage levels or of new regulations that might impair it.

Directors noted that private and personal saving levels in New Zealand are low relative to the averages for OECD countries. They agreed, however, that there appear to be no major impediments or distortions adversely affecting savings behavior, with one possible exception—namely, the general expectation that the government will meet its future pension and health care obligations without significant changes in benefits or in the future tax burden. This possibility reinforces the need for the government to suitably address longer-term fiscal pressures in a timely manner. Directors advised against using the tax system for broad-based savings promotion purposes, although they acknowledged that some tightly focused measures may be useful.

Directors supported the basic objectives of the Government's Growth and Innovation Framework as a way of expanding New Zealand's links with the global economy and contributing to higher growth over time. Directors underlined the importance of economic diversification and urged the authorities to continue on the path of market-based reforms to accelerate growth. They advised caution on a more general interventionist role for the government in the economy, for example through significant direct assistance targeted at individual firms or specific sectors.

Directors noted that owing to New Zealand's economic structure and small size, trade policies in other countries impose significant costs on New Zealand and adversely affect its growth performance. They considered that progress in multilateral trade negotiations, especially in agricultural products, will be crucial for providing an important stimulus to growth. Bilateral trade agreements aimed at improving New Zealand's access to foreign markets should be comprehensive and designed to operate in a nondiscriminatory manner to minimize distortionary effects.

On external vulnerability, Directors agreed that New Zealand continues to be well placed to manage adverse economic shocks. Although the growth of foreign currency-denominated external debt and the shortening of its maturity in recent years might suggest some cause for concern, Directors felt that several important factors mitigate the foreign exposure risk to the financial system, including the credibility and soundness of economic policies, the robustness of the banking sector and its integration into global capital markets, and the high degree of hedging. Against this background, Directors looked forward to New Zealand's participation in the Financial Sector Assessment Program (FSAP) during 2003, which should improve understanding of potential vulnerabilities in the financial system as well as of New Zealand's distinctive approach to banking supervision, which emphasizes market-based supervision. In this regard, they welcomed the authorities' work in preparing for the FSAP review, including stress testing of the banking system based on risk factors specific to New Zealand.

Directors welcomed the significant progress made in dealing with anti-money laundering and combating the financing of terrorism issues, and looked forward to a full assessment during the FSAP review.

Directors encouraged the authorities to continue their efforts to improve the frequency, timeliness, and coverage of economic and financial statistics.

Public Information Notices (PINs) are issued, (i) at the request of a member country, following the conclusion of the Article IV consultation for countries seeking to make known the views of the IMF to the public. This action is intended to strengthen IMF surveillance over the economic policies of member countries by increasing the transparency of the IMF's assessment of these policies; and (ii) following policy discussions in the Executive Board at the decision of the Board. The Staff Report for the 2003 Article IV Consultation with New Zealand is also available.

Table 1. New Zealand: Selected Economic Indicators

Nominal GDP (2001): US\$50.3 billion
 Population (2001): 4.0 million
 GDP per capita (2001): US\$12,667
 Quota: SDR 894.6 million

	1998	1999	2000	2001	Est. 2002
Real economy (percent change)					
GDP (production basis)	-0.2	4.0	3.9	2.4	4.4
Domestic demand	-0.5	5.9	1.8	1.9	5.0
Exports of goods and services	1.6	8.2	6.8	2.1	7.6
Imports of goods and services	1.3	11.8	0.2	1.4	8.8
Headline CPI inflation	1.3	-0.1	2.6	2.6	2.7
Unemployment rate (in percent)	7.5	6.8	6.0	5.3	5.2
Gross capital formation (in percent of GDP)	19.8	20.4	20.7	20.0	20.5
Gross national saving 1/	15.4	14.3	15.0	17.2	17.4
Public finance (in percent of GDP) 2/					
Revenue	35.4	35.3	33.5	34.0	32.3
Expenditure	34.0	34.8	33.2	32.8	30.7
OBERAC 3/	2.2	0.2	0.8	1.8	2.2
Estimated structural balance 4/	2.3	1.2	0.6	1.7	2.0
Net public debt	23.9	21.1	19.6	17.2	14.4
Money and credit (end of period)					
M3 (percent change)	1.1	6.9	6.5	11.4	11.5
Private domestic credit (percent change)	7.6	10.8	6.4	9.5	9.1
Government bond yield (10-year, in percent)	5.4	7.2	6.1	6.6	6.4
Balance of payments (\$NZ billion)					
Current account	-3.9	-6.6	-5.9	-3.4	-3.9
(in percent of GDP)	-(3.9)	-(6.2)	-(5.2)	-(2.8)	-(3.1)
Trade balance (goods)	1.7	-0.7	1.5	3.5	1.2
Foreign assets and liabilities (\$NZ billion) 5/					
Net international investment position	-89.3	-87.1	-87.1	-89.8	-99.3
(in percent of GDP)	-(88.7)	-(85.5)	-(81.0)	-(78.8)	-(81.1)
Gross short-term external debt	40.9	43.7	54.1	65.1	73.1
Official reserves	7.6	7.3	7.9	8.6	7.7
Exchange rate (end of period)					
US\$/NZ\$	0.53	0.52	0.44	0.42	0.53
Trade-weighted index (June 1979 = 100)	55.6	54.3	49.7	49.9	58.1
Nominal effective exchange rate 6/	94.13	93.29	85.9	86.5	98.5
Real effective exchange rate 6/	89.00	87.83	81.8	83.0	95.1

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

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

2/ Fiscal years ending June 30.

3/ Operating balance net of revaluations and accounting changes.

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

5/ Data for end-March of each year.

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

**Statement by Michael Reddell, Alternate Executive Director
for New Zealand
April 30, 2003**

Key Points

- Robust economic growth in recent years, but now beginning to slow.
- Modified inflation target allows a little more flexibility. Heightened focus on the midpoint, as proposed by staff, has little appeal.
- Low savings and heavy dependence on external capital remain a focus. Little near-term vulnerability, but longer-term questions remain.
- Raising medium-term economic growth is a key policy challenge. Progress on agricultural trade liberalisation should be a priority.
- Further rigorous cross-country analysis would be particularly welcome.

Recent economic developments

The New Zealand economy has performed robustly in recent years, at a time when growth throughout much of the world has been lackluster at best. Set against the backdrop of sound and robust fiscal and monetary policy frameworks, the recent outperformance has reflected the combination of several influences:

- a severely undervalued exchange rate (especially in 2000 and 2001);
- the surprisingly strong reversal in net migration flows from late 2001 (a factor often underestimated in external commentary on New Zealand);
- robust commodity prices; and
- the continued health of the Australian economy (New Zealand's largest trading partner, and itself benefiting from a low exchange rate).

Strong economic growth heightened the pressure on resources, raising core inflation. In response, the Official Cash Rate was raised by 100 basis points between March and July last year, and held at 5.75 per cent. Throughout 2002 economic activity held up surprisingly strongly.

But over 2002 and the first few weeks of 2003 the exchange rate has appreciated sharply. At a time when the US dollar was falling against almost all currencies, the New Zealand dollar rose particularly strongly. That was probably because of the combination of

New Zealand's strong economic growth and (not unrelatedly) its relatively high interest rates – high, that is, by current international standards, although still among the lowest seen in New Zealand for several decades. At present, the best estimates are that, in trade-weighted terms, the New Zealand dollar is just a little above fair value. Moving from a seriously undervalued level to more normal levels, at a time when world demand remains weak (with most OECD economies estimated to have materially negative output gaps and to be growing below potential), the change in the exchange rate should be expected to dampen demand and activity, especially when the outlook for world economic activity was weak. As ever, of course, these effects could only be expected to occur with a lag.

While the authorities had expected some slowing in 2003, and with it some easing in inflation pressures, at the time of the consultations in Wellington that slowdown was still a prospect rather than something tangible. In both its January and March reviews the Reserve Bank of New Zealand indicated that some reduction in the official cash rate was possible later in the year, if there were clear signs that inflation pressures would ease.

Over the last couple of months it has become clearer that the pace of economic growth is beginning to slow, and is more widely expected (by both the public and the business community) to slow. The world economy remains relatively weak. Locally, both business and consumer confidence have fallen away, quite sharply on some measures. Retail spending appears to have begun to ease back, job vacancy numbers are slipping and, despite the persistently strong net migration inflows, the housing market is also showing signs of peaking. The inflation rate is beginning to be influenced quite materially by the direct price effects of the marked rise in the exchange rate, while in the most recent inflation numbers, domestic non-tradeables inflation also showed signs of peaking. Against this backdrop, the Reserve Bank last week announced a 25 basis point cut in the OCR. In doing so, they noted that the cut was based not on a further worsening in the economic outlook, but on the increasing availability of indicators confirming that the expected slowing in activity, and with it reduced medium-term inflation pressures, was occurring.

Monetary policy framework

The monetary policy framework established in the late 1980s has served New Zealand well, something attested to in the independent review undertaken by Lars Svensson in 2001. The framework has provided disciplined arrangements for the day-to-day conduct of monetary policy, while allowing sufficient flexibility for the interpretation of the statutory goal of price stability to evolve over the years, with the agreement of the Governor and the Minister of Finance.

Upon the appointment of a new Governor last year, the Policy Targets Agreement was renegotiated. The floor of the target band was lifted to 1 per cent, setting a new target range of 1-3 per cent for future inflation outcomes, on average over the medium term. This change has generally been well-received, and has been regarded as allowing the Reserve Bank to operate a little more flexibly in some circumstances. My authorities welcome staff's endorsement of the changes. However, staff have also suggested that the Reserve Bank "more firmly tie down inflation expectations by announcing a specific target within the

official range ... at the range's midpoint. Of course, there is a variety of ways to handle the details of inflation targeting, but my authorities are not convinced that this suggestion has particular merit in the New Zealand context. The Governor has made it clear that not all inflation outcomes within the 1-3 per cent range are viewed as equal, and we consider that, with expectations already fairly well-anchored, there would be little to be gained by trying to specify the midpoint as a target. Indeed, it might risk sounding a little mechanical and spuriously precise, and would also be hard to give such a specification much operational meaning in view of the emphasis in the Policy Targets Agreement on **future** inflation outcomes **on average** over the **medium term**.

Fiscal policy

My authorities appreciate the staff's support for their fiscal management approach, as refined in the 2002 Budget. This approach continues to move the Government's budget focus further into a medium-term planning horizon and away from an emphasis on cyclical and short-term changes. The medium-term focus continues to contain specific fiscal goals while allowing increased flexibility in expenditure timing. The Government's fiscal goals, set out in the 2003 Budget Policy Statement, remain unchanged from the previous year. These goals include measures aimed at easing long-term fiscal pressures, including those noted by staff arising from an aging population. The Government is, of course, conscious of the risks that uncertainty in the economic outlook present to the fiscal outlook. The budgetary position appears healthy, but has been temporarily boosted by the surprisingly strong economic activity over the last year. Prudence dictates that my authorities will remain cautious in proceeding with new initiatives that would have a significant impact on the medium-term fiscal position.

Savings and external vulnerability

The Staff Report and Selected Issues papers rightly devote considerable space to issues surrounding New Zealand's savings performance and the economy's degree of dependence on foreign capital. These issues are the subject of continuing research and debate within official circles in Wellington, and we welcome the Fund's contribution to that dialogue. While there is probably a consensus that a relatively low savings rate is not a major component of the explanation of New Zealand's disappointing medium-term growth performance, there is rather less clarity on a number of points. These include how to explain the relatively low savings rate, what to make of the resulting high level of dependence on foreign capital (no developed economy is more dependent), and how to think about the relatively highly-g geared position of the household sector. We welcome the time Fund staff have spent on these issues and on understanding some of the institutional complexities, although we would also have welcomed a richer review of the issues in light of other countries' experiences. Indeed, it remains a real challenge for the Fund and other observers to better understand the consequences of the increasingly ready access to credit throughout much of the developed and emerging world in recent decades.

As staff note, from a policy perspective, it is highly reassuring that the net dependence on foreign capital has arisen out of private sector activity, rather than from any imbalances in the

Government's own balance sheet. And it is also reassuring that there are no obvious microeconomic distortions specific to New Zealand that appear to explain the pattern we observe. And, of course, the risks to financial institutions are not only well-managed and extensively-hedged, but are also widely disclosed as part of the supervisory regime. For these sorts of reasons my authorities welcome, and concur with, the staff's assessment that New Zealand remains relatively well-placed to meet and manage potential shocks.

My authorities nonetheless believe that it is important to remain vigilant in this area, and to improve their understanding of the issues and risks, whether financial or macroeconomic, in this area. As was the case with the equity market excesses of the 1990s in many other economies, that need for vigilance is real even though there may be little that policy measures could usefully do. My authorities fully recognise the importance of continuing to maintain a robust policy framework, providing savers and investors with confidence in economic and financial management in New Zealand.

My authorities look forward to the further exploration of some of these issues in the FSAP to be undertaken later this year.

Medium-term economic growth

New Zealand has experienced strong economic growth relative to the OECD average in recent years. However, a considerable gap still exists between where New Zealand currently lies on the OECD income ladder and where we would like to be. Indeed, as staff note, despite matching the OECD average growth rate, New Zealand's growth has continued to underperform Australia's impressive record, for reasons that are still insufficiently understood. Encouraging faster medium-term economic growth remains a key policy challenge for my authorities and lies at the heart of their Growth and Innovation Framework. However, it is also worth stressing that New Zealand still has a large, highly productive and increasingly sophisticated agricultural base and – as the staff note in their report – tariffs on agricultural goods remain significantly higher than those on non-agricultural goods. This directly reduces New Zealand incomes and welfare. Progress towards liberalising agricultural trade, with the attendant benefits for economic growth in New Zealand and throughout the world, remains a top policy priority for my authorities.

The Government fully recognises the importance of increasing both human and physical capital in raising growth and is committed to further developing human capital and encouraging investment. They are also committed to continuing to increase labour force participation from among those who have been dependent on the welfare system for long periods. While my authorities note the staff suggestions for increasing flexibility in the labour market, they would stress the flexibility displayed by existing labour market structures (in, for example, increasing numbers employed by 28 per cent since 1990). Those New Zealanders remaining out of work need innovative assistance to help them overcome their difficulties in obtaining and retaining employment. As the authorities advised the staff mission, however, further work is likely to focus on dealing with the complexities and high effective marginal tax rates apparent in parts of the current system that make it difficult for people to move from the benefit system into the workforce.

And finally

My authorities are appreciative of the manner in which staff conducted this review. They have found the team collegial and open. They particularly appreciated staff consultation with us on selected issues topics and their concern in ensuring these were in areas that were likely to be helpful and relevant to New Zealand. Ongoing dialogue between staff and New Zealand authorities will ensure that IMF research remains relevant to New Zealand's needs, as will – a consistent theme of this Chair – the increasing emphasis on disciplined cross-country comparative analysis noted as a priority in recent discussions on surveillance issues. This should be an area of real strength in the Fund's surveillance, and an area in which it can be of particular benefit to small countries like New Zealand.