INTERNATIONAL MONETARY FUND

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NEW ZEALAND

2013 ARTICLE IV CONSULTATION

May 2013

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 2013 Article IV consultation with New Zealand, the following documents have been released and are included in this package:

- **Staff Report** for the 2013 Article IV consultation, prepared by a staff team of the IMF, following discussions that ended on March 18, 2013, with the officials of New Zealand on economic developments and policies. Based on information available at the time of these discussions, the staff report was completed on April 29, 2013. 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.
- **Informational Annex** prepared by the IMF.
- **Public Information Notice** (PIN) summarizing the views of the Executive Board as expressed during its May 13, 2013 discussion of the staff report that concluded the Article IV consultation.
- **Statement by the Executive Director** for New Zealand.

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

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INTERNATIONAL MONETARY FUND

NEW ZEALAND

STAFF REPORT FOR THE 2013 ARTICLE IV CONSULTATION

April 29, 2013

KEY ISSUES

Outlook and risks. The economy continues to grow at a rate below trend, in part reflecting the effects of the recent drought, and inflation pressures are subdued. Rising house prices, which are already elevated by standard metrics, are a growing concern, as they could lead to an increase in debt-financed household spending which would put pressure on aggregated demand, and increase the risk of an abrupt price correction. Other threats include the financial and economic fallout from an intensification of European sovereign debt problems and a slowdown in China, Australia, and other parts of Asia, although these events have receded somewhat as near term risks. The authorities have macroeconomic policy space to respond to adverse shocks, and the flexible exchange rate would serve as an important buffer.

Medium- and long-term challenges. New Zealand's external debt is high by international standards, making it desirable to raise the national savings rate. The ongoing fiscal deficit reduction contributes to this aim. The banks, although well-capitalized, face longstanding structural issues that will remain sources of financial sector risk over the medium term. Ample global liquidity is likely to keep the exchange rate elevated, which could keep the current account deficit high relative to its long-run sustainable level. Macroeconomic management will need to cope with large, sustained earthquake-related reconstruction spending, expected to peak sometime mid-decade.

Policy assessment. With expected inflation within the target range, the strong New Zealand dollar, and the government's efforts to reduce the budget deficit, monetary policy should remain accommodative, and act as the first line of defense against shocks. At the same time, the authorities should be prepared to apply stricter macro-prudential standards to prevent an acceleration of house price inflation.

Approved By
Isabelle Mateos y Lago and Tamim Bayoumi

Discussions took place in Auckland and Wellington during March 8-18, 2013. The staff team comprised Messrs. Aitken (head), Ding, Jauregui, and Saker (all APD). Ms. Hunter (OED) participated in the discussions.

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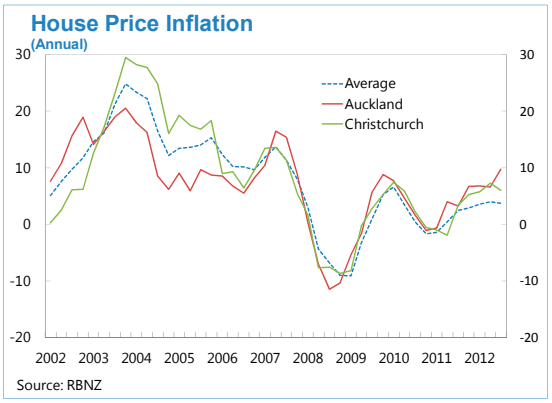
ANNEXES

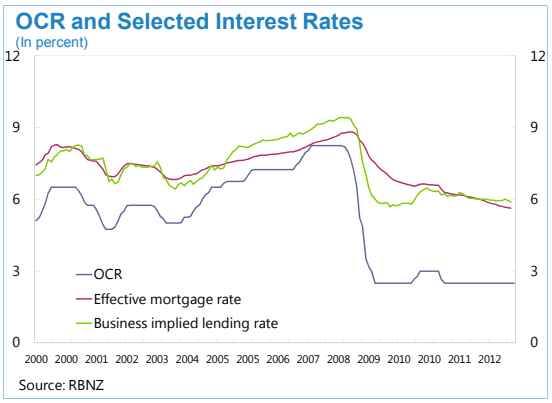
RECENT DEVELOPMENTS

1. Output. Growth appears to have strengthened in the last months of 2012 and is estimated at 2½ percent for the year, as subdued household consumption and business investment and budget deficit reduction have been offset by strong agriculture production and continued expansion in the construction sector. Earthquake related reconstruction is gathering pace.[1] Weather helped boost agricultural exports in 2012, while service exports were weighed down by the persistently strong exchange rate, brought about in part by the easing of global monetary conditions and more recently capital inflows related to a recovery in global risk appetite.

2. Inflation. Inflation remains subdued, with the exchange rate dampening tradable price inflation. Wage pressures are contained and by a range of measures the labor market remains soft. However pressures have emerged in the housing market, notably in Auckland where supply bottlenecks persist and in Christchurch where construction cost inflation has accelerated (figure). These two cities account for more than half of the housing wealth in New Zealand. Prices outside of these cities have been stable.



3. Monetary policy. The Reserve Bank of New Zealand (RBNZ) has kept the policy rate at 2½ percent for two years (figure) given uncertainty over the global outlook, soft domestic demand, benign inflationary expectations, and the strong New Zealand dollar. Favorable offshore borrowing conditions have reduced banks' funding costs and contributed to a further lowering of lending rates.



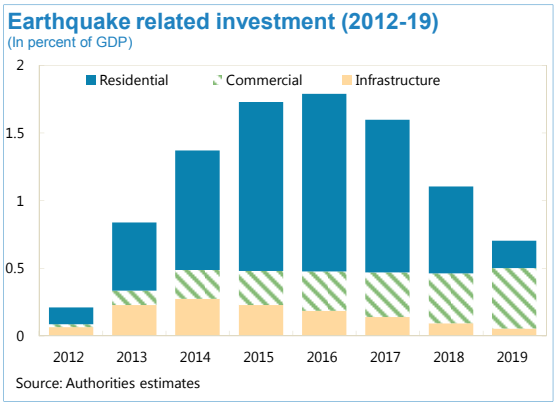
4. Fiscal developments. As a consequence of the crisis and two large earthquakes, net government debt grew from 5½ percent of GDP in 2008 to 20 percent in 2011. The government has since established a medium term deficit reduction plan which would reduce the structural budget deficit by about 6 percent of GDP over four years, mainly through spending restraint.

[1] The overall cost of reconstruction from the 2010 and 2011 earthquakes is estimated at about 15 percent of GDP. About one-half of the damage was to New Zealand's housing stock, limiting the negative impact on economic growth going forward. The public sector (the central government and Earthquake Commission) will finance around one-third of the reconstruction, with the bulk of the remaining costs financed from abroad through reinsurance, thereby buffering impact of the earthquake on New Zealand's overall balance of payments.

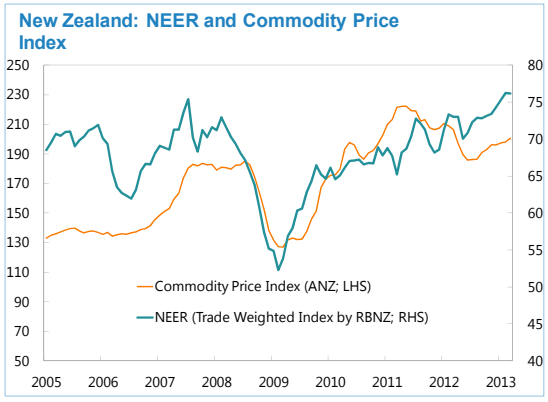
5. External sector. The current account deficit in 2012 widened somewhat to 5 percent of GDP, reflecting some terms of trade losses, although it is well below the 8 percent level in 2005-08. Net external liabilities remain high at 72 percent of GDP at end-2012.

OUTLOOK AND RISKS

6. Near-term outlook. The growth forecast for this year, currently at 2¼ percent, is subject to uncertainty. An increase in construction activity is offset by headwinds from budget deficit reduction, the strong dollar, and the recent severe drought, but at this stage the drought's impact on growth is difficult to project and could require changes to the outlook. Over the medium term, output growth should peak at 2¾-3 percent as reconstruction spending increases further (figure) before converging to a trend rate of about 2½ percent. Underlying inflation is expected to increase but remain modest.



7. External risks. Although these risks have recently receded somewhat, potential weaknesses in the global economy and a possible upheaval in the global financial system still pose risks to both the current and the financial accounts.[2] The main channels are:



- *Declining export demand causing a worsening of terms of trade.* A global slowdown would hit commodity prices and New Zealand's terms of trade, although in the past declines in commodity prices have often been offset by a weakening of the exchange rate (figure), buffering the impact on the economy.

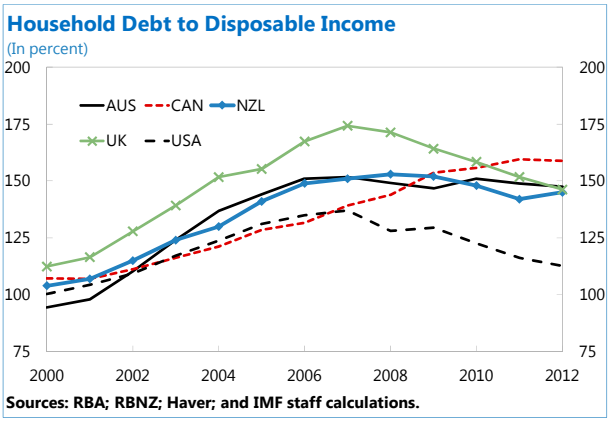
- *Increased cost of external funding and rollover risks.* Banks continue to rely heavily on offshore wholesale funding and a worsening of global financial conditions would raise funding costs.[3] Moreover, some of banks' total liabilities are short term external borrowings, leaving them exposed to the tail risk of a temporary shutdown of global funding markets. Banks are now less vulnerable than during the market disruption in late-2008, as the share of retail deposits and the average maturity of bank liabilities have been steadily increasing over the last two years and the source of funding is diversified across regions and products. Overall, with banks taking advantage of the relative calm in global markets to pre-finance

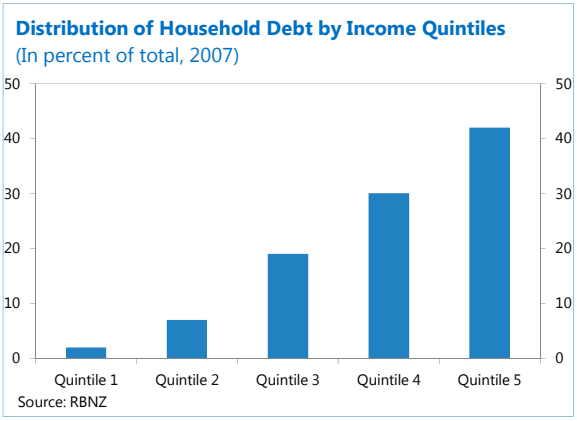
[2] The key risks are described in the attached risk assessment matrix (Box 1).

[3] Annex 1 discusses in more detail the structure of banking sector liabilities.

their upcoming funding needs at relatively low borrowing rates, the likelihood and potential impact of a shutdown in offshore funding markets has declined in recent months.

8. Housing sector risks. Household credit growth, housing market turnover, and house price inflation have all recently picked up, particularly in Auckland where supply bottlenecks persist, and prices remain elevated by most measures of affordability.[4] Recent developments also suggest some easing of mortgage lending standards. In these circumstances there is an emerging risk that sustained rapid price growth could give rise to expectations-driven, self-reinforcing demand dynamics and price overshooting. A shock to household incomes or to borrowing costs could cause a sudden price correction, reducing consumer confidence as a large share of wealth is in housing, worsening banks' balance sheets, and impacting overall economic activity. There are some mitigating factors, with a declining ratio of household debt to disposable income and low concentration of debt among low-income households likely limiting mortgage defaults and the impact of house price declines on the banks' balance sheets (figures).





9. Possible outward spillovers. Spillovers from potential problems in New Zealand are limited by its small size but could potentially affect Australia. This is largely because of the Australian banks' ownerships of most of the New Zealand banking system and the geographic and economic similarities of the two economies—both are commodity exporters with a generously priced housing sector involving significant bank exposures. However, these effects are mitigated by the fact that their direct credit exposure to New Zealand is fairly limited and recent stress tests suggest that the Australian banks are relatively resilient to external shocks.

[4] Housing market developments are discussed in more detail in Annex 2.

Box 1. New Zealand: Risk Assessment Matrix

Main Sources of Risks	Overall Level of Concern	
	Likelihood	**Expected Impact on Economy**
➢ **Stalled or incomplete delivery of Euro area policy commitments**	**Medium** Financial stress in the euro area re-emerges and bank-sovereign links re-intensify, combined with an intensification of the flight to safety in financial markets.	**Medium** The main direct impact would be through declining export demand and drying up of the European funding market. A sustained decline in growth caused by reduced exports, combined with a rise in unemployment, could exacerbate financial stresses in the banking sector. Banks' offshore funding cost could also increase, or in extreme cases, access to funding could be threatened. The free floating New Zealand dollar would help buffer the impact on the economy.
➢ **Fiscal policy shock in the US**	**Low** Delayed resolution of remaining issues of the U.S. fiscal cliff causes significant fiscal contractions in the U.S.	**Medium** The channels of transmission are similar as above. A fiscal contraction of the U.S. primary fiscal balance would reduce world demand for New Zealand exports and commodity prices.
➢ **Deeper than expected slowdown in the EMs**	**Low** A significant growth shock to Asia, especially China, would also affect growth in Australia.	**Medium** Australia and China are the top two destinations for New Zealand exports, leaving growth prospects vulnerable to their economic outlook.
➢ **Further buildup of house price inflation and a subsequent sharp fall in house prices**	**Low to medium** House price inflation has recently picked up, particularly in Auckland where supply bottlenecks persist, and prices remain elevated by most measures of affordability. Recent developments also suggest some easing of mortgage lending standards. In these circumstances, there is an emerging risk that sustained rapid price growth could give rise to expectations-driven, self-reinforcing demand dynamics and price overshooting.	**Medium to High** Price increases could give rise to an increase in debt-financed household consumption putting pressure on aggregate demand. A sudden price correction would dampen private consumption and reduce resident investment. It may also lead to an increase in default rates that would hurt banks' balance sheets. The risks are mitigated by a number of factors including banks' conservative lending practice and the high capital requirement for mortgages. Prudential polices are in place which could limit the likelihood that house prices accelerate to unsustainable levels.

10. Tail risks and downside scenarios. Many of the above risks are closely linked, and the importance of agricultural sector exports to New Zealand's near-term outlook makes the country vulnerable if a downside global scenario materializes. A combination of external shocks such as international financial turmoil and a slowdown in China and Australia could trigger a sudden decline in house and farm prices. This could in turn weaken consumer demand and negatively affect banks'

balance sheets and their willingness to lend. The downside macroeconomic impact in this scenario where shocks compound each other could be large. [5]

11. Authorities' views. The authorities shared staff's assessment of the economic outlook and risks. They noted that earthquake reconstruction would be a major driver of demand for many years but the precise timing and size of spending is still uncertain. They anticipate that the drought will have a sizeable negative effect on the growth outlook for this year. They are keenly aware that risks in the housing market, particularly for Auckland, have increased over the last year. They noted that the low level of residential construction activity in recent years has contributed to housing shortages, and that these shortages are unlikely to ease soon. They also see the recent decline in mortgage rates, reflecting banks' lower funding costs, as contributing to demand. Adding to this, credit has become easier to obtain, with banks competing aggressively to gain market share. The RBNZ is watching for signs that perceived increases in household wealth will lead to lower household saving, putting pressure on aggregate demand and increasing households' vulnerability to shocks such as increases in interest rates or unemployment.

NEAR-TERM MACROECONOMIC MANAGEMENT

12. Monetary policy stance. Given below trend growth and low inflation, the current accommodative monetary policy stance is appropriate. However, monetary policy is facing a growing tension between maintaining inflation in the target band in a soft economy and preventing an acceleration in house price inflation which could threaten financial stability. Going forward, the stance may need to change if house price and credit expansion begin to fuel excessive consumption spending and inflationary pressures. The RBNZ's credibility and the effective monetary transmission mechanism in New Zealand should allow for a nimble response should circumstances change.

13. Fiscal Policy. The deficit reduction plan underway would achieve a budget surplus by 2015. The 2013 deficit is expected to be about 2¾ percent of GDP.[6] The plan relies mainly on expenditure restraint by reprioritizing spending from lower-value to higher-value activities and reducing Budget operating allowances; reducing the cost of existing policies; and driving efficiency gains. The government designed an ambitious reform of many welfare programs to improve their efficiency and reduce spending by almost 2½ percent of GDP in the next two years. The cuts in spending are broad based with an almost 1 percent of GDP reduction in superannuation, social security and welfare expenses, ¾ percent in health and 0.6 percent of GDP in education. Revenue is expected to increase by almost ½ percent of GDP from 2013 to 2015. Under this plan, net debt would peak at about 30 percent of GDP in 2015 and return to 20 percent of GDP by 2021. The government also plans to sell stakes in several state-owned enterprises over the next four years amounting to about 3 percent of GDP and to use the proceeds to fund capital spending.

[5] The challenge, not unique to New Zealand, in assessing the impact of an adverse scenario is that it is unlikely that the risks identified would occur in isolation. Modeling tools aimed at identifying the impact of isolated, routine shocks are not well suited for multiple simultaneous shocks. Given these limitations, the report instead focuses on identifying where key vulnerabilities may lie, in this case through an assessment of how vulnerable banks are to a well-specified set of shocks including house price declines (see paragraph 8 of Annex 1).

[6] The budget year refers to the fiscal year ending in June.

14. Macroeconomic impact of fiscal policy. We regard the pace of deficit reduction as striking the right balance between sustaining aggregate demand and limiting public debt growth. The benefits of the plan are many. First, it withdraws fiscal stimulus at the right time by making room for the expected increases in private sector and earthquake-related reconstruction spending. Second, it has improved the macroeconomic policy mix by reducing pressure on monetary policy. Third, it creates fiscal space to help the country deal with aging and health care costs that are expected to increase over the long term and to cope with any negative shocks that may cause a sharp reduction in domestic economic activity or potential liabilities associated with the banking sector. Last, it could help raise national savings, reduce the current account deficit, and limit the increase in foreign liabilities.

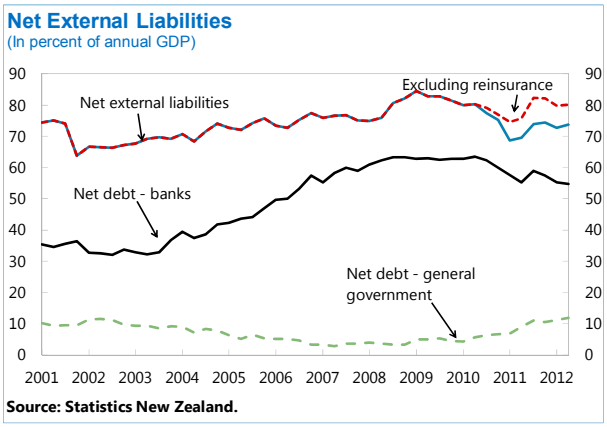
15. Policy space to manage risks. The authorities have monetary and fiscal policy space to respond to near-term shocks, with monetary policy serving as the first line of defense. The RBNZ has scope to lower interest rates and loosen monetary conditions to help buffer against a downside scenario. As evident during the global financial crisis, the free-floating New Zealand dollar provides an additional cushion against external shocks, including disruptions to offshore funding and negative terms of trade shocks, with widespread hedging by banks and businesses insulating their balance sheets from fluctuations in the exchange rate. The authorities would be able to provide emergency liquidity support to banks which proved effective when wholesale markets shut down in the wake of the 2008 crisis. New Zealand's modest public debt gives the authorities scope to delay their planned deficit reduction path in the event of a sharp deterioration in the economic outlook. To limit the risks in the housing market, the new macro-prudential tools under consideration (discussed in paragraph 22) could improve the RBNZ's ability to guard against a loosening of bank lending standards that would contribute to an unsustainable acceleration in house price inflation. These measures are untested, however, and there are questions about how effective they will be given possibilities of evasion and arbitrage.

16. Authorities' views. The RBNZ regards the currently accommodative monetary stance as consistent with keeping inflation in its targeted range of 1 to 3 percent. They agreed, however, that their flat interest rate outlook would need to be revisited if a housing-related credit boom added to underlying inflation pressures. To address housing risks, the RBNZ is currently consulting on a potential increase in bank capital requirements against high loan-to-value lending, and expects that the new macro-prudential policy framework could be used to increase resilience in the banking system against a future housing downturn while having a moderating influence on credit expansion to the housing sector. They also pointed to longer-term measures to address housing supply constraints, which could play an important role in containing price pressures and increasing affordability.

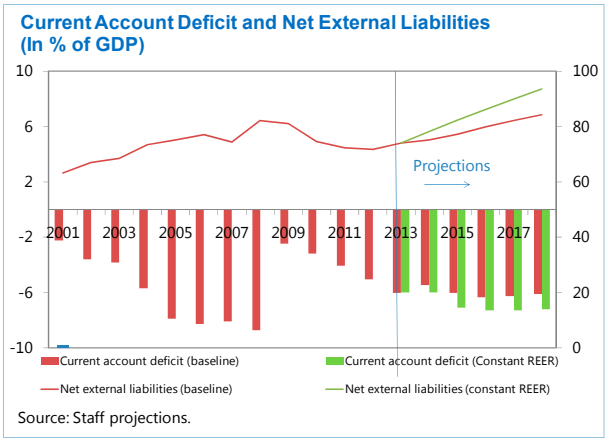
EXTERNAL STABILITY

17. Current account. New Zealand's persistently large current account deficits appear to reflect structural savings – investment imbalances, with low household savings playing a key role (see Annex 3). The deficit is expected to widen this year despite relatively strong terms of trade as

earthquake related reconstruction gathers pace. Meeting the country's investment needs given low savings has required capital inflows motivated by higher domestic interest rates. The result has been a strong exchange rate over an extended number of years and a buildup of the country's stock of net external debt (figure). Reducing pressure on the exchange rate and limiting current account deficits in a lasting way will therefore require addressing the reasons for low savings, rather than being the task of short-term macroeconomic management. The government's Savings Working Group presented recommendations in February 2011, suggesting raising national saving by 2–3 percent of GDP primarily through an increase in public saving and tax policy changes. They include a further switch from income to consumption taxation over the medium term while maintaining the broad base of the GST, and indexing interest income and expenses at a standard rate for tax purposes that reflects the rate of inflation. Budget deficit reduction would also contribute to this end, as would further household balance sheet repair. In this regard much will depend on whether the post-crisis increase in the household savings rate represents a structural break from past behavior.



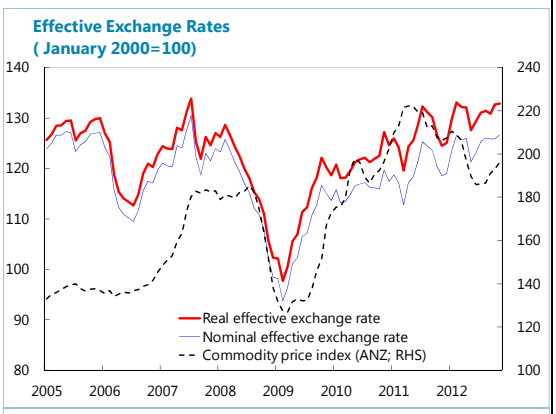
18. Exchange rate assessment. Aside from these structural factors, there are a number of short-term factors contributing to the currently overvalued exchange rate, including a continuing gap between domestic and foreign interest rates and more recently, increased portfolio flows into New Zealand (Box 2). If global monetary conditions were to become less stimulatory, the exchange rate would likely depreciate over time, reducing the current account deficit over the medium term—in staff's baseline scenario where the exchange rate depreciates by 10 percent over the next two years, perhaps the result of lower capital inflows and a tighter fiscal policy stance, the current account deficit would gradually decline to around 6 percent of GDP when the earthquake reconstruction comes off its peak. Stabilizing net foreign liabilities at around 80 percent of GDP would require a trade surplus of around 2 percent of GDP more than in the baseline scenario, which could be achieved through further adjustment to the exchange rate and/or a shift in public and private savings behavior. A worsening of the terms of trade would likely be accompanied by additional depreciation relative to the baseline scenario, which should help buffer the impact on the current account.

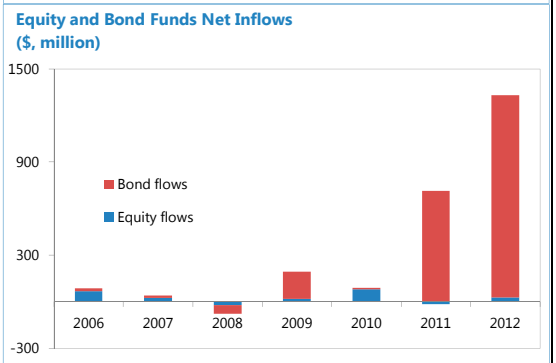


19. Authorities' views. The authorities agreed that the persistent strength of the New Zealand dollar is mainly the result of structural savings – investment imbalances, and not short-term

Box 2. Exchange Rate Assessment [1/]

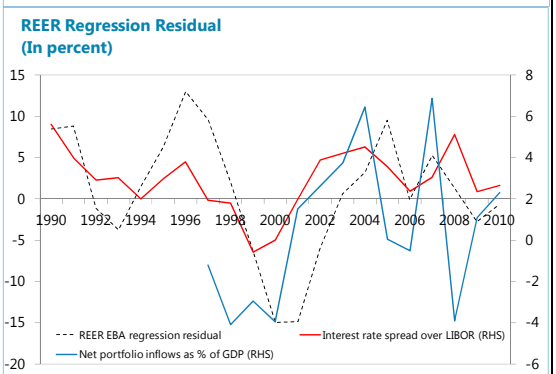
New Zealand's real effective exchange rate remains elevated in 2012 despite some decline in commodity prices, reflecting strengthening of the nominal effective exchange rate. The relatively strong dollar continues to weigh on tradable sector competitiveness and limit demand for net exports. The current account deficit widened from 4 percent of GDP in 2011 to 5 percent in 2012.





Source: EPFR database.

Aside from the structural savings-investment imbalance that contributes to the persistently strong exchange rate (see Annex 3), there are a number of short-term factors associated with its current level, including the gap between domestic and foreign interest rates, the recovery in global risk appetite, and increased portfolio and official flows into New Zealand.



Source: Staff estimates based on the Pilot External Balance Assessment

Model-based approaches, consistent with those of the authorities[2/] suggest that New Zealand's real exchange rate is 10-15 percent above the level that would be consistent with medium term fundamentals. The IMF's amended real exchange rate regression approach attempts to identify the policy-related (both domestic and international) drivers of the deviation of each country's real exchange rate from its fundamentals-based fitted value. Applied to New Zealand, this yields an estimate of 10 percent overvaluation. The unexplained residuals in the regression, i.e., the exchange rate gap not explained by medium term fundamentals and policy drivers, seem to be positively correlated with interest rate differentials and net portfolio inflows. These estimates are, however, subject to considerable uncertainty.

A second approach suggests that stabilizing net external liabilities at the 2011 level of around 80 percent of GDP (excluding reinsurances) would require the current account deficit falling to about 3¾ percent of GDP. Given the trade elasticities estimated by CGER, this would need the New Zealand dollar to be about 15 percent weaker than its current level.

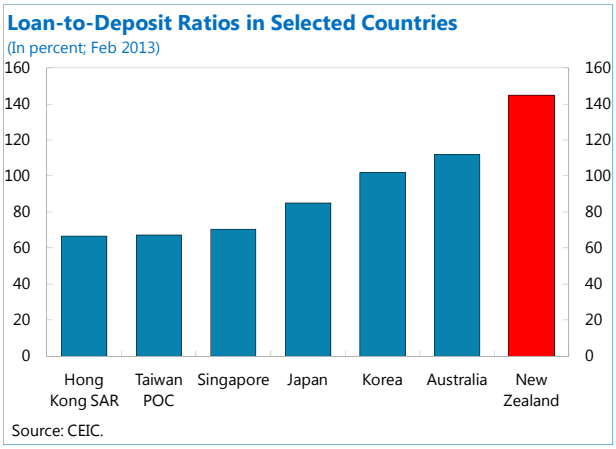
1/ This box is based in part on preliminary results from the pilot External Balance Assessment (See http://www.imf.org/external/np/res/eba/data.htm).

2/ Extending the Reserve Bank's macroeconomic balance model of the exchange rate (RBNZ *Analytical Note* 2012/08).

monetary policy management. They recognize the long-standing risk posed by the country's relatively large external debt position, and view the planned increase in public savings as the most effective policy action to reduce this risk. They noted the increase in household saving that had occurred in the past few years but agreed that there was some uncertainty about how much of the increase represented a structural shift. They emphasized the key role the integrity and credibility of the RBNZ's monetary policy framework, including the free floating exchange rate, has played in delivering macroeconomic stability and enhancing the resilience of the New Zealand economy. They agreed that part of the currency's current strength may dissipate with eventual tightening by major central banks, but underscored their concern that weak global growth and persistent European financial turmoil could delay this tightening for some time, adding to future current account deficits.

SAFEGUARDING FINANCIAL SECTOR STABILITY

20. Financial developments. New Zealand's banking sector has strengthened in the aftermath of the global crisis (see Annex 1). Asset quality remains good, the ratio of nonperforming loans to total assets is low and continues to decline from its peak, and return-on-assets is in line with the pre-crisis average. Capital adequacy has improved and is well above the Basel III capital requirements which the RBNZ began to put in place in January. Banks have shifted toward more stable funding sources facilitated by a combination of strong deposit growth and slower credit growth. Reliance on offshore wholesale funding has been reduced and is of longer maturity, and deposits now meet around half of banks' funding requirements. Nevertheless, vulnerabilities remain. The four major banks are systemic with broadly similar business models, and their reliance on wholesale offshore funding (as reflected in high loan-to-deposit ratios), although lower than pre-crisis levels, still represents a risk. Residential mortgages and agricultural lending account for a large part of banks' assets, sectors which are vulnerable to price fluctuations and where leverage is still high. These are longstanding structural issues that will remain sources of risk over the medium term.



21. Capital requirements. The RBNZ's conservative risk weights, capital eligibility, and deduction rules give New Zealand banks higher quality capital than their advanced country peers. At the same time, banking sector vulnerabilities should be assessed on an ongoing basis to minimize the risk that systemically important banks pose to the economy, taking into account the currently evolving international standards.

22. Revisions to the macro-prudential framework. The announcement of a number of macro-prudential tools (available to use in circumstances such as periods of excessive credit growth) sends

a strong signal to the market of the authorities' intention to safeguard financial system stability. The new tools are expected to include countercyclical capital buffers, overlays to sectoral capital requirements, cyclical variation in the Core Funding Ratio, and loan-to-value restrictions. The intention is to have the RBNZ apply these measures after consultation with the Minister of Finance, and a memorandum of understanding outlining the process will be signed soon. The framework is expected to be in place by the second half of the year. As noted in paragraph 15, these new measures could help dampen credit cycles, strengthen macroeconomic management, and guard against an acceleration of house price inflation.

23. Financial sector resilience. Consistent with staff simulations, the authorities' recent stress tests, based on both single and combined shocks, show that the major banks would be able to withstand a sizeable shock to output, terms of trade, commodity prices, rising unemployment, and a fall in house, farm, and commercial property prices.[7] However, a severe shock that combines an adverse global scenario with sectoral downturns would make major inroads into these banks' capital buffers requiring recapitalization efforts. Banks would also likely require RBNZ help to withstand an extreme funding shock.

24. Authorities' views. The authorities emphasized their conservative approach to bank regulation and supervision. Given this together with New Zealand banks' high capital quality, they did not see a need at present to raise the minimum capital requirements for the four systemically important banks above the Basel III requirements. The authorities agreed with staff that the new set of macro-prudential tools should be viewed as a complement to and not substitute for macroeconomic and micro-prudential measures. They stressed their intention to use these tools judiciously, and as experience with such instruments is limited, with caution, with the primary objective of limiting the periodic buildup of system-wide risk. Measures have been taken to further strengthen the AML/CFT regime, particularly to ensure adequate transparency of legal persons and arrangements.

STAFF APPRAISAL

25. Outlook and risks. Growth this year is likely to remain modest, with an increase in construction activity being offset by headwinds from budget deficit reduction, the strong dollar, and the recent severe drought. Spare capacity and a soft labor market will contain inflation pressures in the near term. Rising house prices, which are already elevated by standard metrics, are a growing concern, as they could lead to an increase in debt-financed household spending which would put pressure on aggregated demand, and increase the risk of an abrupt price correction. Other threats include the financial and economic fallout from an intensification of European sovereign debt problems and a slowdown in China, Australia, and other parts of Asia.

[7] Annex 1 discusses the assumptions of the stress test exercise.

26. Monetary policy. The current accommodative monetary policy stance is appropriate, but may need to change if house price and credit expansion begin to fuel excessive consumption spending and inflationary pressures. The RBNZ's credibility and the effective monetary transmission mechanism in New Zealand should allow for a nimble response should circumstances change.

27. Fiscal policy. The planned pace of deficit reduction strikes the right balance between sustaining aggregate demand and limiting public debt growth. It withdraws fiscal stimulus at the right time by making room for the expected increases in private sector and earthquake-related reconstruction spending, it has improved the macroeconomic policy mix by reducing pressure on monetary policy, it creates fiscal space to help deal with future spending pressures and cope with any negative shocks, and could help raise national savings. New Zealand's relatively modest public debt gives the authorities some scope to delay their planned deficit reduction path in the event of a sharp deterioration in the economic outlook.

28. External vulnerabilities and the exchange rate. New Zealand's large net liabilities are a longstanding source of external risk, and reflect historically low household savings rates. Given a structural savings-investment imbalance, reducing pressure on the exchange rate and limiting current account deficits in a lasting way will require addressing the reasons for low savings, rather than being the task of short-term macroeconomic management. Aside from these structural factors, there are a number of short-term factors contributing to the currently overvalued exchange rate, including a continuing gap between domestic and foreign interest rates and more recently, increased portfolio flows into New Zealand. If global monetary conditions were to become less stimulatory, the exchange rate would likely depreciate over time, reducing the current account deficit over the medium term.

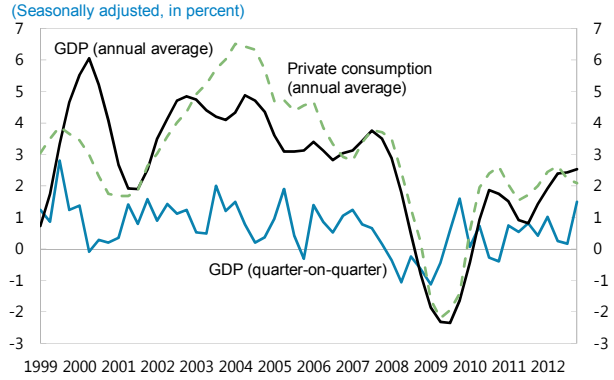
29. Financial sector issues. Banks remain sound, and recent stress tests show that the major banks would be able to withstand a sizeable shock to output, terms of trade, rising unemployment, and a fall in property prices. The banks remain exposed, however, to highly leveraged households and farmers and rollover risks associated with large short-term offshore funding needs. To limit the risks in the housing market, the new macro-prudential tools under consideration could improve the RBNZ's ability to guard against a loosening of bank lending standards that would contribute to an unsustainable acceleration in house price inflation. These tools should be viewed as a complement to macroeconomic and micro-prudential measures. They should be used infrequently, and as experience with such instruments is limited, with caution, with the primary objective of limiting the periodic buildup of system-wide risk.

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

Figure 1. A Modest Growth Rate

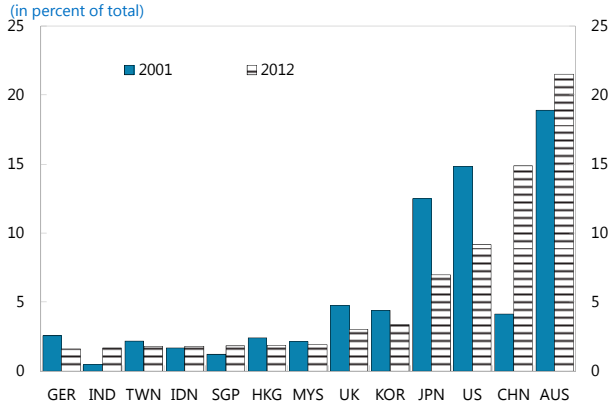
Modest growth continued in 2012…

Real Growth
(Seasonally adjusted, in percent)



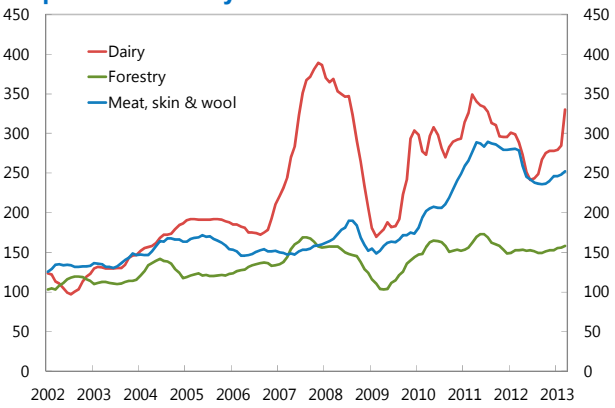
…with Australia and China as main export destinations…

Export by Destination
(in percent of total)



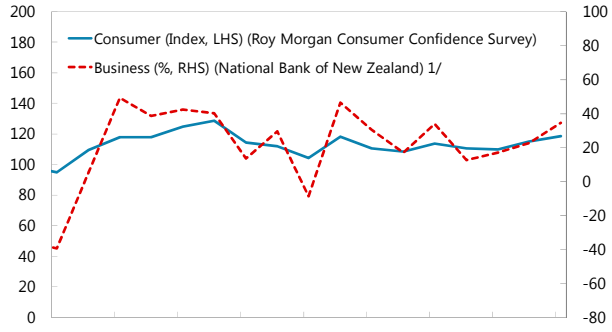
…and favored by high export prices.

Export Commodity Price Index



Consumer confidence stabilized in the last year while business confidence has recently improved…

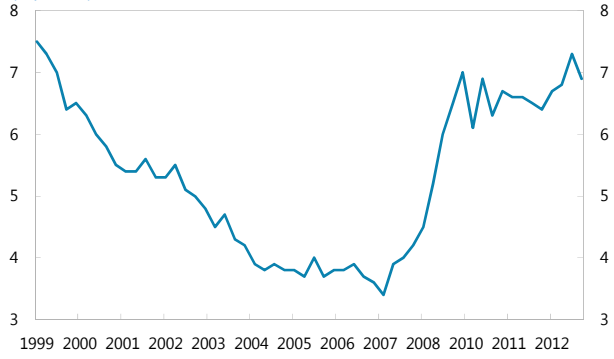
Consumer and Business Confidence



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

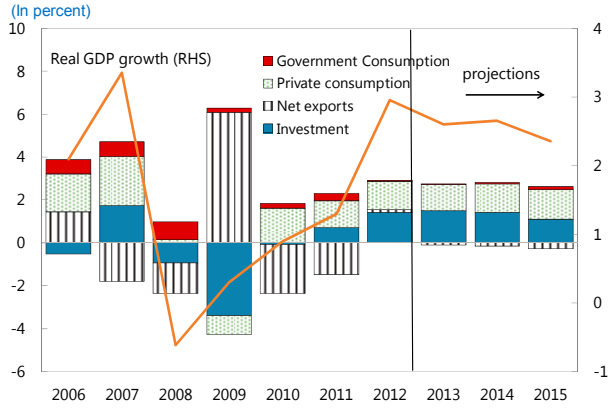
…however unemployment remains elevated.

Unemployment Rate
(In percent)



Reconstruction investment will support growth in the next few years.

Contribution to Annual GDP Growth
(In percent)

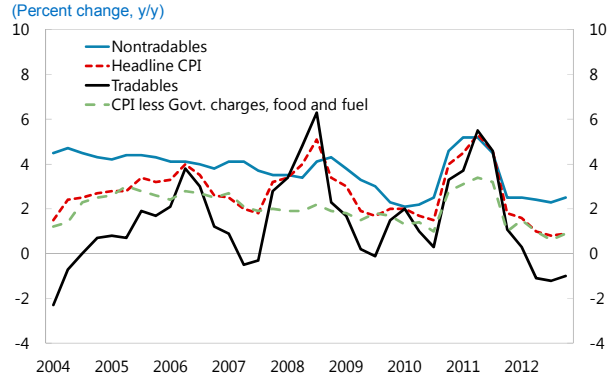


Sources: Statistics New Zealand; Reserve Bank of New Zealand; ANZ; Haver Analytics; World Economic Outlook; and Fund staff estimates.

Figure 2. An Accommodative Monetary Stance

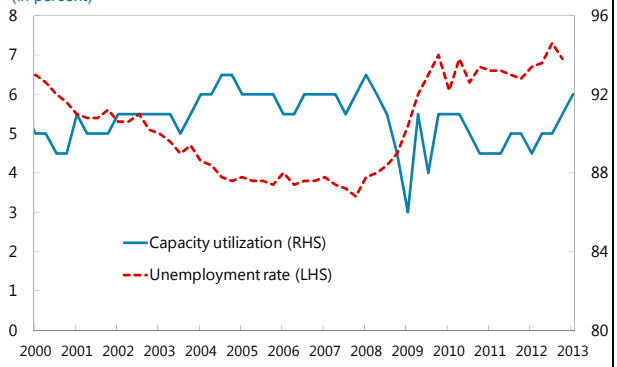
Inflation remains subdued mainly due to falling tradable prices…

CPI Inflation
(Percent change, y/y)



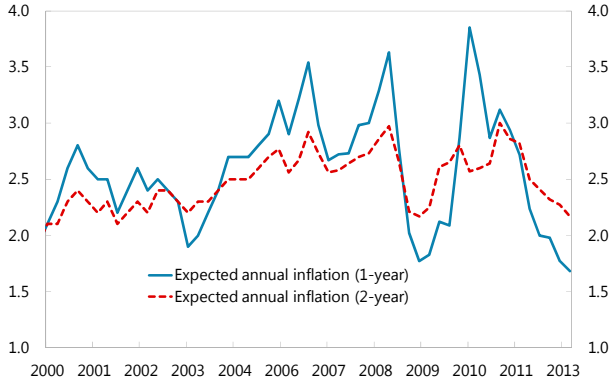
…with elevated unemployment and spare capacity.

Indicators of Resource Pressure
(In percent)



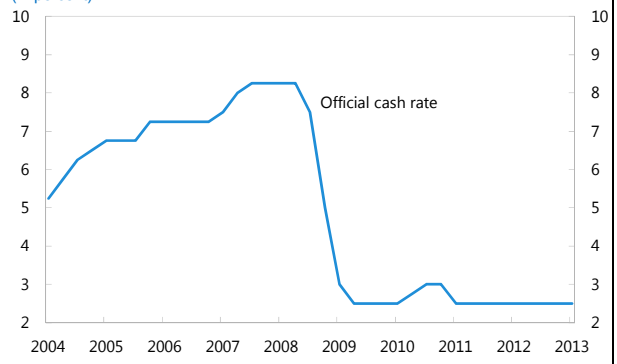
Inflation expectations are in the 1 to 3 percent target band...

Inflation Expectations
(In percent)



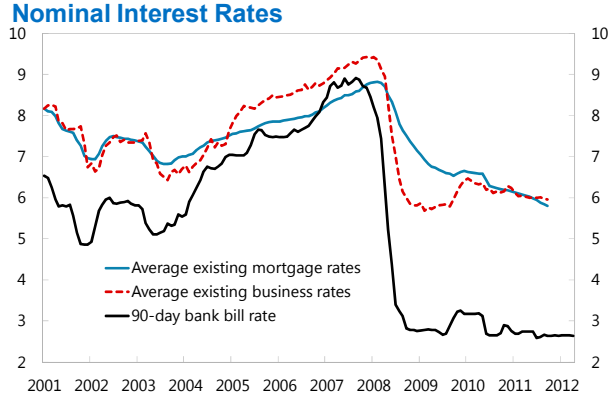
…and the policy rate remains low.

Policy Rate
(In percent)



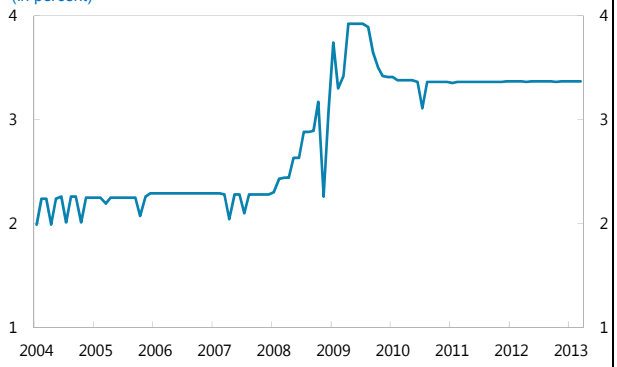
Interest rates are declining slowly...

Nominal Interest Rates



However, mortgage spreads are stable and high.

Floating Mortgage Rate to OCR Spread
(In percent)

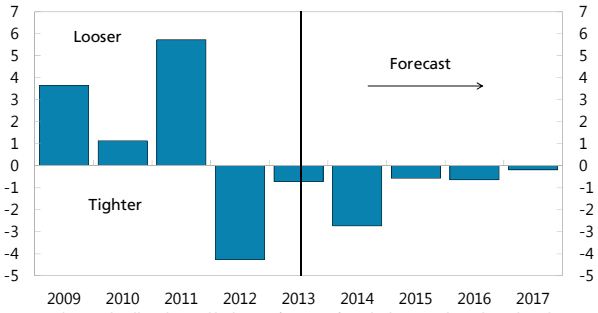


Sources: Reserve Bank of New Zealand; Statistics New Zealand; New Zealand Institute of Economic Research; Haver Analytics database; and Fund staff estimates.

Figure 3. The Government's Deficit Reduction Plan

The ongoing deficit reduction devised by the authorities…

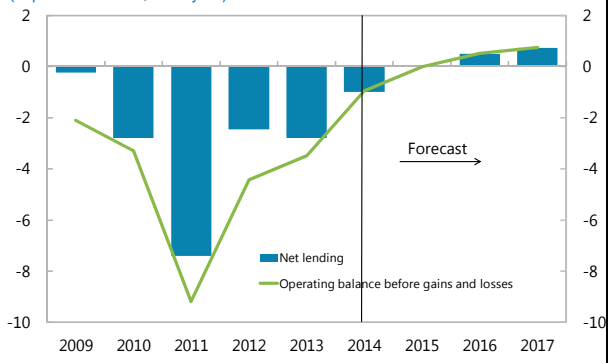
Fiscal Impulse[1/]
(In percent of GDP, fiscal year)



1/ Based on cyclically adjusted balances (OBEGAL), including earthquake-related spending.

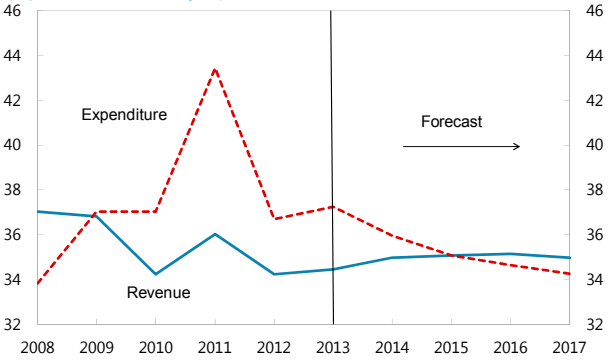
… will achieve operating surplus by 2015…

Fiscal Balance
(In percent of GDP, June year)



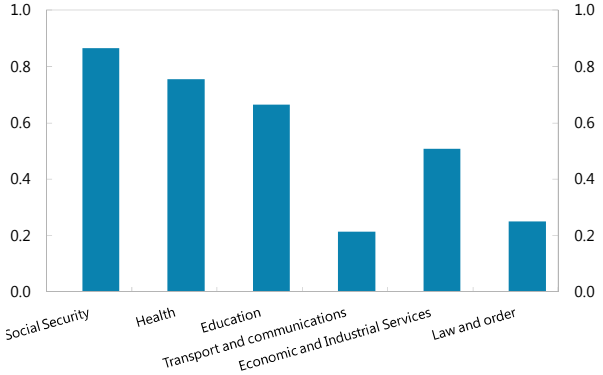
...mostly by expenditure restraint...

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



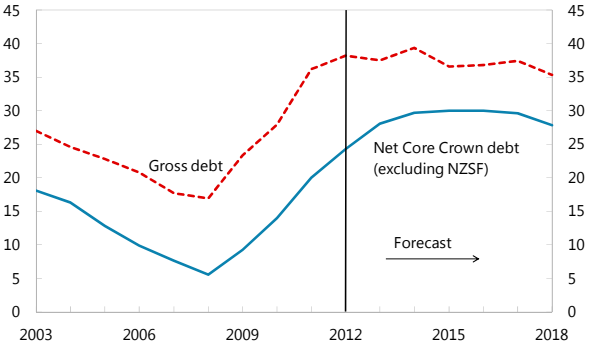
…applied broadly to services and programs.

Expenditure Reduction, 2011-2015
(In percent of GDP)



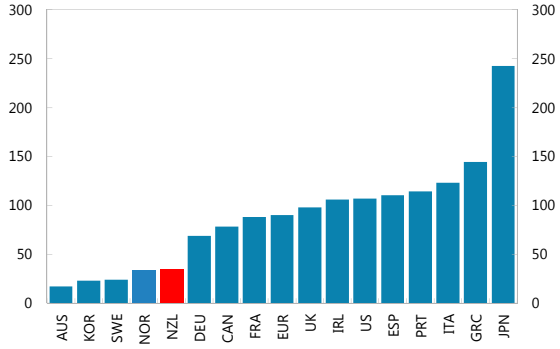
Net debt will peak at about 30 percent of GDP…

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



… and gross debt will continue to be among the lowest in advanced economies.

General Government Gross Debt, 2018
(In percent of GDP)



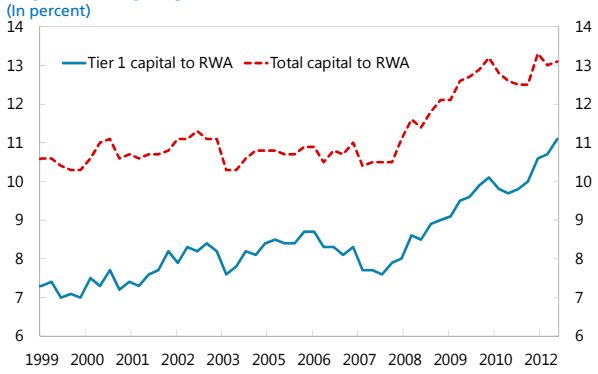
Sources: The New Zealand Treasury; Statistics New Zealand; World Economic Outlook database; and IMF staff calculations and projections.

Figure 4. Banking Sector Developments

Capital is increasing since 2007…

Capital Adequacy Ratios

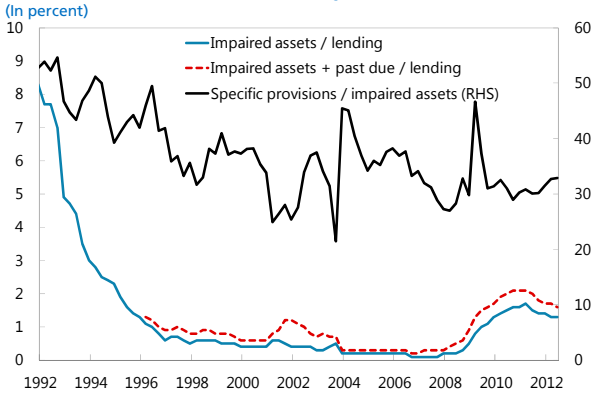
(In percent)



…and asset quality has improved in the last year...

New Zealand Banks Asset Quality

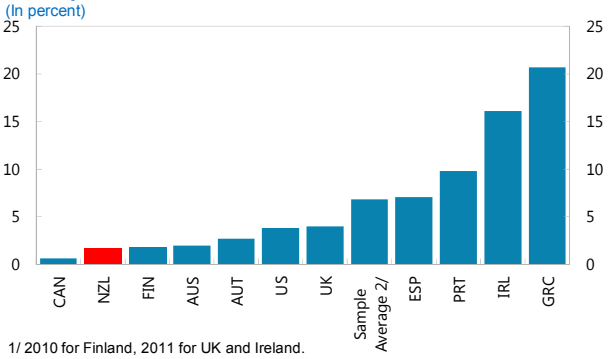
(In percent)



…with low non performing loans by advanced country standards.

Nonperforming Loans to Total Loans, latest available 2012 quarter 1/

(In percent)

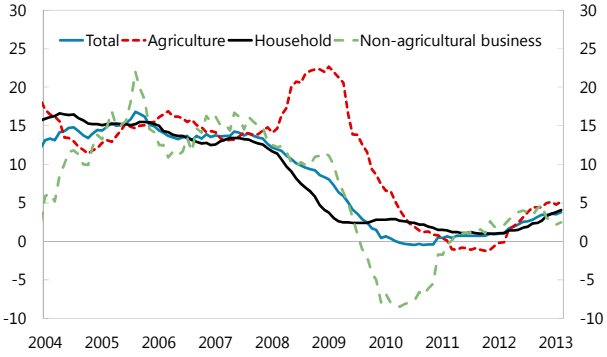


1/ 2010 for Finland, 2011 for UK and Ireland.
2/ Simple (unweighted) average of comparator countries, excluding New Zealand.

Credit growth has picked up in the last part of 2012.

Credit Growth

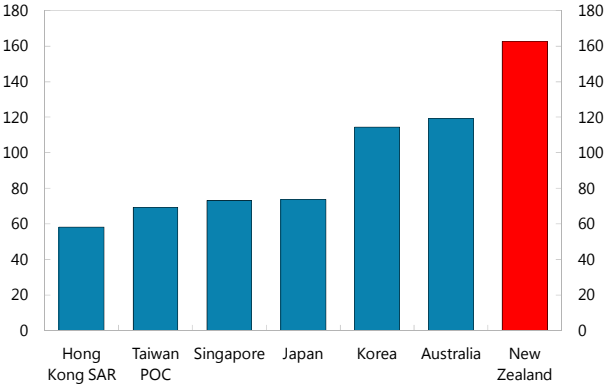
(Year on year percentage change)



Loan to deposit ratios are high in the region...

Loan-to-Deposit Ratios in Asian Countries

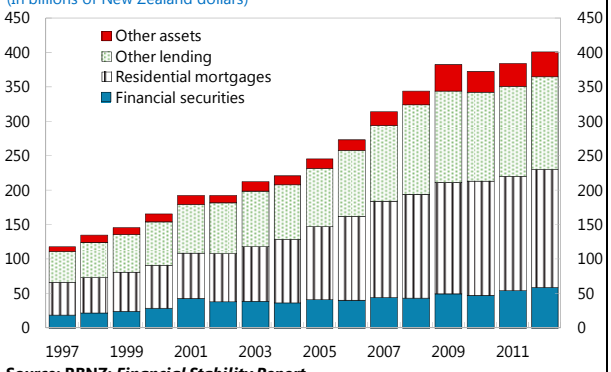
(In percent; 2007-Feb 2013 averages)



…with mortgages constituting a large proportion of the assets.

Bank Asset Composition

(In billions of New Zealand dollars)



Source: RBNZ: *Financial Stability Report.*

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

Table 1. New Zealand: Selected Economic and Financial Indicators, 2008–13

Nominal GDP (2012): US$169.7 billion | GDP per capita (2012): US$38,111
Population (2012): 4.4 million | Quota: SDR 894.6 million

	2008	2009	2010	2011	2012	2013 Proj.
Real growth (percent change)						
GDP (production basis)	-0.8	-1.6	1.8	1.4	2.5	2.2
Final domestic demand	0.0	-3.9	1.7	2.3	2.7	2.3
Private consumption	0.2	-1.4	2.6	2.0	2.1	1.7
Government consumption	5.0	1.1	1.3	2.0	0.3	0.1
Fixed investment	-3.7	-13.6	-0.4	3.3	6.6	5.9
Inventories 1/	0.8	-2.8	2.6	-0.4	0.1	0.0
Exports of goods and services	-1.1	2.4	3.6	2.7	2.1	2.1
Imports of goods and services	3.1	-14.3	10.7	6.7	1.5	2.6
Output gap	0.7	-1.8	-1.0	-0.9	-0.1	-0.2
Headline CPI inflation (percent change)	4.0	2.1	2.3	4.0	1.1	1.4
End of period (percent change)	3.4	2.0	4.0	1.8	0.9	2.2
Unemployment rate (period average, in percent)	4.2	6.1	6.5	6.5	6.9	6.7
Investment and saving (in percent of GDP)						
Investment	22.9	18.5	19.3	18.7	19.6	20.1
National saving 2/	14.5	16.0	16.1	14.6	14.5	14.0
Public finance (in percent of GDP) 3/						
Revenue	37.0	36.8	34.2	36.0	34.2	34.6
Expenditure	33.8	37.0	37.0	43.4	36.7	37.4
Net lending (+)/borrowing (–)	3.2	-0.2	-2.8	-7.4	-2.5	-2.8
Operating balance before gains and losses	3.0	-2.1	-3.3	-9.2	-4.4	-3.5
Gross debt	16.9	23.4	27.9	36.2	38.2	37.7
Net debt (financial assets excl. NZS Fund & Advances)	5.5	9.2	13.9	20.0	24.3	28.2
Stuctural balance (percent of potential GDP)	2.3	0.3	-2.2	-5.8	-1.5	-1.9
Cyclically adjusted balance (percent of potential GDP)	2.3	0.3	-2.2	-6.6	-2.2	-2.7
Money and credit (end of period)						
Resident M3 (percent change) 4/	9.1	1.8	4.8	6.9	8.0	...
Private domestic credit (percent change) 4/	8.3	1.7	0.5	1.7	3.6	...
Interest rates (period average)						
Interest rate (90-day, in percent)	8.0	3.0	3.0	2.8	2.7	...
Government bond yield (10-year, in percent)	6.1	5.5	5.6	4.9	3.7	...
Balance of payments (in percent of GDP)						
Current account	-8.7	-2.5	-3.2	-4.1	-5.0	-6.0
(In billions of New Zealand dollars)	-16.3	-4.6	-6.3	-8.3	-10.5	-13.2
Trade balance (goods)	-1.3	1.3	1.7	1.7	0.5	-0.3
Terms of trade (percent change)	7.4	-10.1	10.3	4.6	-6.8	-1.9
Foreign assets and liabilities ($NZ billion)						
Net international investment position	-152.8	-151.8	-146.9	-147.9	-150.0	-162.0
(In percent of GDP)	-82.1	-81.1	-74.6	-72.3	-71.7	-74.1
Official reserves	19.1	21.6	21.7	22.1	21.4	...
Exchange rate (period average)						
U.S. dollar per New Zealand dollar	0.71	0.63	0.72	0.79	0.81	...
Trade-weighted index (June 1979 = 100)	65.7	60.0	66.7	69.3	72.6	...
Nominal effective exchange rate 4/	91.1	84.3	92.2	95.1	99.5	...
Real effective exchange rate 4/	92.0	86.7	94.9	98.7	102.3	...
GDP (in billions of New Zealand dollars)	186.2	187.3	196.9	204.6	209.3	218.7

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

1/ Contribution in percent of GDP.

2/ Based on national accounts data.

3/ Fiscal years ending June 30.

4/ IMF Information Notice System index (2000 = 100).

Table 2a. New Zealand: Statement of Operations of Budgetary Central Government, 2008/09-2013/14 1/
(In billions of New Zealand dollars)

	2008/09	2009/10	2010/11	2011/12	2012/13 Proj.	2013/14 Proj.
Revenue	68.3	65.6	72.1	71.3	73.6	78.4
Taxes	57.8	54.3	55.8	59.2	61.3	65.9
Other revenue	10.4	11.3	16.4	12.1	12.3	12.5
Property income	2.2	3.1	3.0	2.4	3.1	3.3
Sales of goods and services and other revenues	8.2	8.3	13.4	9.7	9.2	9.3
Expenditure	68.7	71.0	87.0	76.5	79.5	80.6
Expense	67.8	69.1	86.1	75.0	77.6	77.7
Compensation of employees	17.9	18.4	18.8	19.2	19.7	19.6
Consumption of fixed capital	3.2	3.0	3.4	3.2	3.2	3.3
Interest	1.4	2.0	2.7	3.0	3.3	3.2
Grants and subsidies	4.0	3.9	4.7	4.2	5.2	5.1
Social benefits	19.5	20.8	21.7	21.8	22.5	23.1
Other expense 2/	21.8	21.0	34.7	23.6	23.6	23.3
Net acquisition of nonfinancial assets	0.9	1.9	0.9	1.5	1.9	3.0
Gross Operating Balance	3.7	-0.4	-10.5	-0.5	-0.8	4.0
Net Operating Balance	0.4	-3.5	-13.9	-3.7	-4.0	0.8
Net lending (+)/borrowing (–)	-0.4	-5.4	-14.8	-5.1	-5.9	-2.2
Net financial transactions	-0.4	-5.4	-14.8	-5.1	-5.9	-2.2
Net acquisition of financial assets	7.9	4.8	19.4	0.7	-9.8	3.2
Domestic	7.9	4.8	19.4	0.7	-9.8	3.2
Debt securities 3/	0.8	1.3	8.1	-1.2	-8.0	3.0
Loans	1.7	3.4	1.6	1.2	1.2	1.4
Other accounts receivable	5.4	0.2	9.8	0.6	-3.0	-1.2
Net incurrence of liabilities	8.3	10.2	34.3	5.8	-3.8	5.4
Domestic	8.3	10.2	34.3	5.8	-3.8	5.4
Debt securities	6.8	8.9	20.8	7.3	0.0	9.5
Other accounts payable	1.5	1.3	13.4	-1.5	-3.9	-4.1
Memorandum items:						
Cash receipts from operating activities	64.7	64.9	66.0	71.5	76.0	76.0
Cash payments from operating activities	63.5	65.8	71.7	78.6	78.4	78.4
Net cash inflow (outflow) from operating activities	1.2	-0.9	-5.7	-7.1	-2.4	-2.4
Cash surplus (deficit)	-2.8	-5.4	-10.1	-12.4	-7.2	-7.2
Operating balance before gains and losses (total Crown)	-3.9	-6.3	-18.4	-9.2	-7.4	-2.1
Earthquake expenses (core Crown)			1.6	1.3	1.7	0.7
Cyclically adjusted balance	0.6	-4.3	-13.4	-4.5	-5.8	-1.6
Stuctural balance	0.6	-4.3	-11.9	-3.2	-4.0	-0.9
Structural residual cash balance (core Crown)	0.6	-4.3	-11.9	-3.2	-4.0	-0.9
Gross sovereign-issued debt 4/	43.4	53.6	72.4	79.6	80.1	88.4
Net core Crown debt 5/	17.1	26.7	40.1	50.7	59.9	66.7
Net worth (Core Crown) 6/	53.1	44.7	34.9	23.4	18.5	17.6
Nominal GDP	185.5	191.7	200.3	208.4	212.7	224.4
Interest revenue	2.2	3.1	3.0	2.4	3.1	3.3

Source: New Zealand Treasury. The data on cyclically adjusted balance, structural balance and structural residual cash balance in this table are based on the IMF's Staff calculations and methodology.
1/ Fiscal year ending June 30. Includes core Crown (excluding RBNZ) and Crown entities.
2/ Includes use of goods and services.
3/ Includes currency, deposits and equities.
4/ Excluding Reserve Bank Settlement cash.
5/ Excluding NZ Superannuation Fund and advances.
6/ Includes financial assets of NZ Superannuation Fund.

Table 2b. New Zealand: Statement of Operations of Budgetary Central Government, 2008/09-2013/14 1/

(In percentage of GDP)

	2008/09	2009/10	2010/11	2011/12	2012/13 Proj.	2013/14 Proj.
Revenue	36.8	34.2	36.0	34.2	34.6	34.9
Taxes	31.2	28.3	27.8	28.4	28.8	29.4
Other revenue	5.6	5.9	8.2	5.8	5.8	5.6
Property income	1.2	1.6	1.5	1.1	1.4	1.5
Sales of goods and services and other revenues	4.4	4.3	6.7	4.7	4.3	4.1
Expenditure	37.0	37.0	43.4	36.7	37.4	35.9
Expense	36.6	36.0	43.0	36.0	36.5	34.6
Compensation of employees	9.6	9.6	9.4	9.2	9.3	8.8
Consumption of fixed capital	1.7	1.6	1.7	1.5	1.5	1.5
Interest	0.8	1.1	1.4	1.5	1.6	1.4
Grants and subsidies	2.1	2.0	2.3	2.0	2.5	2.3
Social benefits	10.5	10.8	10.8	10.5	10.6	10.3
Other expense 2/	11.8	10.9	17.3	11.3	11.1	10.4
Net acquisition of nonfinancial assets	0.5	1.0	0.5	0.7	0.9	1.3
Gross Operating Balance	2.0	-0.2	-5.3	-0.2	-0.4	1.8
Net Operating Balance	0.2	-1.8	-6.9	-1.8	-1.9	0.3
Net lending (+)/borrowing (–)	-0.2	-2.8	-7.4	-2.5	-2.8	-1.0
Net financial transactions	-0.2	-2.8	-7.4	-2.5	-2.8	-1.0
Net acquisition of financial assets	4.3	2.5	9.7	0.3	-4.6	1.4
Domestic	4.3	2.5	9.7	0.3	-4.6	1.4
Debt securities 3/	0.5	0.7	4.1	-0.6	-3.8	1.3
Loans	0.9	1.7	0.8	0.6	0.6	0.6
Other accounts receivable	2.9	0.1	4.9	0.3	-1.4	-0.6
Net incurrence of liabilities	4.5	5.3	17.1	2.8	-1.8	2.4
Domestic	4.5	5.3	17.1	2.8	-1.8	2.4
Debt securities	3.7	4.6	10.4	3.5	0.0	4.2
Other accounts payable	0.8	0.7	6.7	-0.7	-1.8	-1.8
Memorandum items:						
Cash receipts from operating activities	34.9	33.8	33.0	34.3	35.7	33.9
Cash payments from operating activities	34.2	34.3	35.8	37.7	36.9	34.9
Net cash inflow (outflow) from operating activities	0.6	-0.5	-2.8	-3.4	-1.1	-1.1
Cash surplus (deficit)	-1.5	-2.8	-5.0	-6.0	-3.4	-3.2
Operating balance before gains and losses (total Crown)	-2.1	-3.3	-9.2	-4.4	-3.5	-0.9
Earthquake expenses (core Crown)			0.8	0.6	0.8	0.3
Residual cash balance (core Crown)	-4.7	-4.7	-6.7	-6.2	-4.6	-2.8
Cyclically adjusted balance (percent of potential GDP)	0.3	-2.2	-6.6	-2.2	-2.7	-0.7
Stuctural balance (percent of potential GDP)	0.3	-2.2	-5.8	-1.5	-1.9	-0.4
Gross sovereign-issued debt 4/	23.4	27.9	36.2	38.2	37.7	39.4
Net core Crown debt 5/	9.2	13.9	20.0	24.3	28.2	29.7
Net worth (Core Crown) 6/	28.6	23.3	17.4	11.2	8.7	7.8
Nominal GDP (in billions of NZ dollars)	185.5	191.7	200.3	208.4	212.7	224.4

Source: New Zealand Treasury. The data on cyclically adjusted balance, structural balance and structural residual cash balance in this table are based on the IMF's Staff calculations and methodology.

1/ Fiscal year ending June 30. Includes core Crown (excluding RBNZ) and Crown entities.

2/ Includes use of goods and services.

3/ Includes currency, deposits and equities.

4/ Excluding Reserve Bank Settlement cash.

5/ Excluding NZ Superannuation Fund and advances.

6/ Includes financial assets of NZ Superannuation Fund.

Table 2c. New Zealand: Central Government Balance Sheet, 2008/09-2013/14

(In billions of New Zealand dollars)

	2008/09	2009/10	2010/11	2011/12	2012/13 Proj.	2013/14 Proj.
Net worth	102.3	95.8	91.8	77.8	57.0	53.7
Nonfinancial assets	77.3	82.7	84.5	84.8	86.3	88.5
Net Financial Worth	25.0	13.1	7.3	-7.0	-29.3	-34.9
Financial Assets	93.4	98.6	102.7	122.1	114.4	104.8
Currency and deposits	10.2	13.2	12.7	20.5	16.5	14.7
Debt securities	18.3	17.9	20.2	21.3	25.3	19.4
Equity and inv. fund shares	43.6	45.1	45.7	48.2	39.8	41.1
Loans	7.9	8.1	10.5	11.4	12.1	12.5
Other financial assets	13.3	14.3	13.7	20.8	20.7	17.2
Liabilities	68.4	85.5	95.4	129.0	143.8	139.7
Currency and deposits	3.8	5.0	5.4	7.4	6.8	6.7
Debt securities and loans	26.1	36.4	44.0	62.6	70.6	70.1
Insurance and pension liabilities	8.3	9.0	9.9	10.2	13.5	13.0
Other liabilities	30.3	35.1	36.0	48.9	52.8	50.0
Memorandum items:						
Net financial worth (in % of GDP)	13.5	6.8	3.7	-3.3	-13.8	-15.5
Financial assets (in % of GDP)	50.4	51.4	51.3	58.6	53.8	46.7
Liabilities (in % of GDP)	36.9	44.6	47.6	61.9	67.6	62.3
Nominal GDP	185.5	191.7	200.3	208.4	212.7	224.4

Source: New Zealand Treasury. The data in this table are based on the IMF's Staff calculations, methodology, and coverage for the central government.

Table 3. New Zealand: Balance of Payments and External Debt, 2008–12

(In percent of GDP)

	2008	2009	2010	2011	2012
Current account balance	-8.7	-2.5	-3.2	-4.1	-5.0
Goods balance	-1.3	1.3	1.7	1.7	0.5
Exports, f.o.b.	23.6	21.5	22.5	23.7	22.3
Imports, f.o.b.	-24.9	-20.3	-20.7	-22.0	-21.8
Services balance	-0.3	0.2	-0.2	-0.4	-0.5
Receipts	7.4	7.4	6.9	6.9	6.6
Payments	-7.7	-7.2	-7.1	-7.3	-7.1
Income balance	-7.6	-3.7	-4.8	-5.3	-4.8
Receipts	3.0	3.4	3.6	3.4	3.4
Payments	-10.6	-7.1	-8.4	-8.9	-8.3
Transfers balance	0.5	0.2	0.0	-0.1	-0.2
Receipts	1.3	1.0	0.7	0.6	0.6
Payments	-0.8	-0.8	-0.7	-0.7	-0.8
Capital and financial account balance	4.4	0.5	3.4	6.1	2.8
Capital account (net)	-0.3	0.3	2.3	6.2	-0.2
Financial account (net)	4.7	0.2	1.1	-0.2	3.0
Direct investment (net)	3.0	0.2	-0.1	1.1	2.0
Outward	-0.3	0.9	-0.4	-1.6	0.3
Inward	3.3	-0.7	0.3	2.7	1.7
Portfolio investment (net)	-3.9	1.1	2.3	2.2	2.5
Assets	1.7	-3.2	-1.0	-0.4	-2.9
Equity securities	2.1	-1.9	-0.8	0.6	-1.0
Debt securities	-0.3	-1.4	-0.2	-0.9	-2.0
Liabilities	-5.7	4.3	3.3	2.6	5.5
Equity securities	0.2	0.8	-0.2	1.0	0.3
Debt securities	-5.8	3.6	3.5	1.5	5.2
Other investment (net)	5.6	-1.0	-1.1	-3.5	-1.5
Assets	5.1	-3.5	-2.1	-3.2	1.1
Liabilities	0.5	2.4	1.0	-0.3	-2.6
Net errors and omissions 1/	4.4	1.9	-0.2	-2.0	2.2
Overall balance	0.1	-0.1	0.0	0.0	0.0
(Assets and liabilities as of end-December)					
Gross external debt	136.1	129.2	127.5	125.5	120.7
Short-term (less than one year on residual maturity basis)	66.1	58.7	51.6	50.9	49.3
Long-term	69.9	70.5	75.9	74.6	71.3
Gross external debt	136.1	129.2	127.5	125.5	120.7
Of which: Denominated in New Zealand dollars	67.8	63.2	65.5	70.2	70.5
Gross external debt	136.1	129.2	127.5	125.5	120.7
Public sector	10.1	12.4	16.6	17.7	19.5
Private sector	125.9	116.8	110.9	107.8	101.2
Net international investment position 2/	-82.1	-81.1	-74.6	-72.3	-71.7
Net equity	0.2	-0.2	1.7	-2.2	-3.7
Net debt	-82.3	-80.9	-76.3	-70.1	-67.9
Gross official reserves	10.3	11.5	11.0	11.7	11.2
Gross reserves in months of future imports of g&s	8.3	9.3	8.9	9.9	9.9
Gross reserves as percent of short-term debt	15.5	19.6	21.4	23.0	22.7

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

1/ The large net errors and omissions in 2008 and 2009 mainly reflect financial account data issues, as extreme volatility i exchange rates and market prices during that period made it difficult to separate out valuation effects from financial account transaction.

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

Table 4. New Zealand: Balance of Payments and External Debt, 2008–12

(In billions of U.S. dollars)

	2008	2009	2010	2011	2012
Current account balance	-11.6	-2.9	-4.5	-6.6	-8.5
Goods balance	-1.7	1.5	2.5	2.8	0.8
Exports, f.o.b.	31.4	25.6	31.9	38.4	37.9
Imports, f.o.b.	-33.1	-24.1	-29.4	-35.6	-37.1
Services balance	-0.4	0.2	-0.3	-0.6	-0.9
Receipts	9.9	8.8	9.8	11.2	11.1
Payments	-10.3	-8.6	-10.0	-11.8	-12.0
Income balance	-10.1	-4.4	-6.8	-8.6	-8.1
Receipts	4.0	4.0	5.2	5.5	5.8
Payments	-14.1	-8.4	-12.0	-14.5	-14.0
Transfers balance	0.6	0.2	0.0	-0.2	-0.4
Receipts	1.7	1.2	1.0	1.0	1.0
Payments	-1.1	-1.0	-1.0	-1.2	-1.4
Capital and financial account balance	5.9	0.6	4.8	9.8	4.7
Capital account (net)	-0.4	0.4	3.2	10.1	-0.4
Financial account (net)	6.3	0.2	1.6	-0.3	5.1
Direct investment (net)	4.0	0.2	-0.1	1.8	3.4
Outward	-0.4	1.1	-0.5	-2.5	0.5
Inward	4.4	-0.8	0.4	4.3	2.9
Portfolio investment (net)	-5.2	1.3	3.3	3.6	4.3
Assets	2.3	-3.9	-1.4	-0.6	-5.0
Equity securities	2.8	-2.2	-1.1	0.9	-1.6
Debt securities	-0.4	-1.6	-0.3	-1.5	-3.4
Liabilities	-7.5	5.1	4.7	4.2	9.3
Equity securities	0.2	0.9	-0.3	1.7	0.4
Debt securities	-7.8	4.2	5.0	2.5	8.9
Other investment (net)	7.5	-1.2	-1.6	-5.6	-2.6
Assets	6.8	-4.1	-2.9	-5.1	1.8
Liabilities	0.7	2.9	1.4	-0.5	-4.4
Net errors and omissions 1/	5.9	2.2	-0.3	-3.3	3.8
Overall balance	0.1	-0.1	0.0	-0.1	0.0
(Assets and liabilities as of end-December)					
Gross external debt	146.6	174.6	193.4	195.8	209.0
Short-term (less than one year on residual maturity basis	71.2	79.3	78.3	79.4	85.5
Long-term	75.3	95.3	115.1	116.4	123.5
Gross external debt	146.6	174.6	193.4	195.8	209.0
Of which: denominated in New Zealand dollars	73.0	85.4	99.4	109.6	122.1
Gross external debt	146.6	174.6	193.4	195.8	209.0
Public sector	10.9	16.7	25.2	27.6	33.7
Private sector	135.7	157.9	168.2	168.3	175.2
Net international investment position 2/	-88.4	-109.6	-113.2	-112.8	-124.1
Net equity	0.2	-0.2	2.6	-3.5	-6.5
Net debt	-88.6	-109.4	-115.8	-109.3	-117.7
Gross official reserves	11.1	15.6	16.7	18.3	19.4
RBNZ net short position in forex swaps	3.4	7.4	9.3	10.3	0.0
RBNZ net open foreign currency position	2.9	2.5	2.1	1.7	0.0
U.S./New Zealand exchange rate (e.o.p.)	0.6	0.7	0.8	0.8	0.8
U.S./New Zealand exchange rate (period average)	0.7	0.6	0.7	0.8	0.8

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

1/ The large net errors and omissions in 2008 and 2009 mainly reflect financial account data issues, as extreme volatility in exchange rates and market prices during that period made it difficult to separate out valuation effects from financial account transaction.

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

Table 5. New Zealand: Medium-Term Scenario, 2010–18

	Average				Projections					
	2001-11	2010	2011	2012	2013	2014	2015	2016	2017	2018
Real growth (percent change)										
GDP (production basis)	2.4	1.8	1.4	2.5	2.2	2.3	2.7	2.5	2.4	2.5
GDP (expenditure basis)	2.4	0.9	1.3	3.0	2.1	2.4	2.6	2.5	2.4	2.5
Final domestic demand	2.9	1.7	2.3	2.7	2.3	2.6	2.5	2.2	2.0	2.0
Consumption	3.1	2.3	2.0	1.7	1.3	1.6	1.9	1.8	1.9	1.9
Private consumption	3.0	2.6	2.0	2.1	1.7	1.9	2.2	2.1	2.2	2.2
Government consumption	3.3	1.3	2.0	0.3	0.1	0.6	0.8	0.6	0.5	0.6
Fixed investment	2.6	-0.4	3.3	6.6	5.9	5.7	4.6	3.5	2.4	2.2
Changes in inventories 1/	0.0	2.6	-0.4	0.1	0.0	0.0	0.0	0.0	0.0	0.0
Exports of goods and services	2.9	3.6	2.7	2.1	2.1	2.4	2.6	3.0	3.1	3.3
Imports of goods and services	4.9	10.7	6.7	1.5	2.6	2.7	2.3	2.1	2.0	1.8
Net exports (contribution to growth)	-0.6	-2.3	-1.5	0.1	-0.3	-0.2	0.0	0.2	0.3	0.5
Saving and investment (percent of GDP)										
Gross capital formation	21.9	19.3	18.7	19.6	20.1	20.6	21.0	21.3	21.3	21.3
Fixed investment	21.3	18.5	18.1	18.9	19.6	20.1	20.5	20.8	20.8	20.8
Fixed investment excluding earthquakes	22.2	...	...	18.6	18.7	18.7	18.8	19.0	19.3	19.8
Changes in inventories	0.6	0.8	0.5	0.7	0.5	0.5	0.5	0.5	0.5	0.5
National saving 2/	16.8	16.1	14.6	14.5	14.0	15.1	14.9	14.9	15.0	15.2
Private	11.9	15.6	15.1	14.7	12.0	11.3	10.4	9.8	9.6	10.2
Public	4.9	0.4	-0.6	-0.2	2.1	3.7	4.5	5.1	5.4	5.0
Inflation and unemployment (percent)										
Headline CPI inflation (period average)	2.8	2.3	4.0	1.1	1.4	2.2	2.2	2.1	2.0	2.0
Headline CPI inflation (end of period)	2.6	4.0	1.8	0.9	2.2	2.2	2.2	2.0	2.0	2.0
CPIX inflation	2.8	2.4	4.1	1.0	1.4	2.2	2.2	2.1	2.0	2.0
Unemployment rate	4.9	6.5	6.5	6.9	6.7	6.1	5.5	5.3	5.5	5.3
Output gap (staff estimate)	-0.1	-1.0	-0.9	-0.1	-0.2	0.0	0.1	0.0	0.0	0.0
Central government budget (percent of GDP) 3/										
Revenue	36.6	34.2	36.0	34.2	34.6	34.9	35.0	34.9	34.9	34.9
Expenditure	35.3	37.0	43.4	36.7	37.4	35.9	35.0	34.4	34.2	34.2
Net lending (+)/borrowing (–)	1.3	-2.8	-7.4	-2.5	-2.8	-1.0	0.0	0.5	0.7	0.7
Operating balance before gains and losses	1.0	-3.3	-9.2	-4.4	-3.5	-0.9	0.0	0.5	0.8	0.8
Gross debt	25.1	27.9	36.2	38.2	37.7	39.4	36.5	36.5	37.3	35.1
Net debt (financial assets excl. NZS Fund & Advances)	14.0	13.9	20.0	24.3	28.2	29.7	29.9	29.8	29.5	27.6
Stuctural balance (percent of potential GDP)	-0.6	-2.2	-5.8	-1.5	-1.9	-0.4	-0.1	0.5	0.7	0.7
Cyclically adjusted balance (percent of potential GDP)	-0.8	-2.2	-6.6	-2.2	-2.7	-0.7	-0.1	0.5	0.7	0.7
Terms of trade (2002=100, goods and services)	110.5	119.2	123.9	117.4	116.3	119.2	118.2	117.0	116.3	115.4
Terms of trade (2002=100, goods)	111.8	122.4	128.0	119.3	117.1	120.4	119.8	118.6	117.9	117.0
Terms of trade (percent change, goods)	2.6	10.3	4.6	-6.8	-1.9	2.8	-0.5	-1.0	-0.6	-0.8
Balance of payments (percent of GDP)										
Current account balance	-5.3	-3.2	-4.1	-5.0	-6.0	-5.5	-6.0	-6.3	-6.3	-6.1
(Current account balance under constant REER)					-6.0	-6.1	-6.9	-7.1	-7.1	-7.1
Balance on goods and services	0.3	1.6	1.4	-0.1	-0.9	-0.3	-0.5	-0.5	-0.4	-0.1
Balance on income and transfers	-5.6	-4.8	-5.4	-5.0	-5.1	-5.2	-5.6	-5.8	-5.9	-6.0
Net foreign liabilities (percent of GDP) 4/	73.5	74.6	72.3	71.7	74.1	75.2	77.3	79.8	82.2	84.3
Gross external debt (percent of GDP) 4/	117.2	127.5	125.5	120.7	122.5	123.4	125.0	127.0	128.9	130.5
Nominal GDP (in billions of New Zealand dollars)	166.5	196.9	204.6	209.3	218.7	230.6	241.2	251.4	261.8	272.9
Partners' GDP growth	4.0	5.0	3.6	3.5	3.4	3.9	4.0	4.0	4.0	3.9

Sources: Data provided by the New Zealand authorities; and IMF staff estimates and projections.
1/ Contribution in percent of GDP.
2/ Converted from March year basis for historical data. Public saving covers general government.
3/ Fiscal years ending June 30.
4/ Data for end-December.

Table 6. New Zealand: Indicators of External and Financial Vulnerability, 2008–12

(In percent of GDP, unless otherwise indicated)

	2008	2009	2010	2011	2012
External indicators					
Real exports of goods and services (percent change)	-1.1	2.4	3.6	2.7	2.1
Real imports of goods and services (percent change)	3.1	-14.3	10.7	6.7	1.5
Terms of trade (goods; percent change)	7.4	-10.1	10.3	4.6	-6.8
Current account balance	-8.7	-2.5	-3.2	-4.1	-5.0
Capital and financial account balance	4.4	0.5	3.4	6.1	2.8
Of which:					
Net portfolio investment	-3.9	1.1	2.3	2.2	2.5
Net direct investment	3.0	0.2	-0.1	1.1	2.0
Total reserves (in billions of New Zealand dollars)	19.1	21.6	21.7	22.1	21.4
In months of imports of goods and services	8.3	9.3	8.9	9.1	9.1
Net foreign liabilities	82.1	81.1	74.6	72.3	71.7
Net foreign equity liabilities	-0.2	0.2	-1.7	2.2	3.7
Net foreign debt liabilities	82.3	80.9	76.3	70.1	67.9
Of which:					
Net external public sector debt	-4.6	-4.1	-2.0	1.7	5.1
Net external private sector debt	86.9	85.0	78.4	68.4	62.8
Investment income balance to exports (in percent)	-24.4	-12.9	-16.3	-17.2	-16.6
Nominal effective exchange rate (percent change)	-6.8	-7.5	9.3	3.1	4.6
Financial market indicators					
General government gross debt	9.6	12.0	16.0	20.5	24.4
Interest rates (percent end-year)					
3-month T-bill	8.0	3.0	5.8	2.8	2.7
3-month T-bill, real	3.9	0.9	3.5	-1.2	1.6
Stock market index (percent change, end-year)	-32.8	6.6	2.4	-1.6	24.9
Capital adequacy (in percent)					
Regulatory capital to risk-weighted assets 1/	10.5	11.4	12.6	13.2	13.1
Tier I capital to risk-weighted assets 1/	8.5	9.5	9.8	9.8	11.1
Asset quality (in percent)					
Nonperforming loans to total loans 1/	0.9	1.7	2.1	1.7	1.6
Provisions to impaired assets 1/	29.8	31.4	30.3	31.5	32.9
Asset composition (share of total)					
Agricultural	14.6	15.6	15.7	15.5	15.6
Business	27.0	24.7	24.0	24.1	24.7
Households	58.4	59.7	60.4	60.4	59.7
Of which: Housing	54.2	55.7	56.3	56.6	55.6

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

1/ Data for 2012 are for end-June.

Annex 1. The Resilience of New Zealand's Banking Sector[1]

1. The banking sector in New Zealand weathered the global financial crisis well and has emerged in a stronger position and better placed to withstand another possible global banking shock. This resilience was despite a number of pre-crisis structural vulnerabilities. These included the limited deposit mobilization and a high reliance on short term foreign borrowing, and the consequences of sustained credit expansion with high exposures to highly indebted household and dairy sectors and a notable expansion in mortgage lending. The core institutions – the top four banks that are subsidiaries of leading Australian banks – did not need to access on a sustained basis the support mechanisms that were temporarily put in place by the government and the Reserve Bank of New Zealand (RBNZ) and they were unscathed by the shakeout of peripheral non bank financial institutions (NBFIs) that occurred during the crisis.

2. In response to the vulnerabilities that the crisis exposed, a number of steps have been taken to improve banks' resilience. Bank's balance sheets are more resilient, and the regulatory structure has been strengthened.

3. The liability structure has improved with banks borrowing less in international wholesale markets and at longer maturities. Conversely, the proportion of funding from the local deposit base has increased (chart 1). The RBNZ has steadily tightened requirements regarding how the banks are funded, requiring greater stability and reducing liquidity mismatches. Banks now have a higher core funding ratio (CFR) than required by the RBNZ and than under similar Basel III standards (chart 2). System-wide CFR—which includes customer deposits, longer-term wholesale borrowing, and bank capital—rose from a little under 70 percent in October 2008 to 85 percent at end 2012 as banks have taken advantage of relative calm in global financial markets and low rates to prefund their current needs and have also started to use covered bonds to borrow at lower rates. Banks are also fully compliant with the new requirements that the liquidity mismatch ratios should not be less than zero (chart 3).

4. The banks generally do not borrow directly from their parent institutions, limiting direct contagion fears, but borrow in the international wholesale markets. Their borrowings in the global wholesale markets are fully hedged against currency risk. About half of bank borrowings are denominated in New Zealand dollars so there is no exchange rate risk. Of the remainder, hedges are typically undertaken through exchange rate swaps with nonresident investors who have New Zealand dollar denominated liabilities they would also like to hedge. These investors are mainly globally systemic institutions and this limits counterparty risk. Credit risks are also minimized as banks generally do not lend in foreign exchange and households do not typically borrow internationally but via the domestic banks. Fonterra, the largest dairy exporter, also hedges export proceeds, thus limiting the volatility in farmers' incomes. This is important as loans to farmers represent a significant share of the banks' loan books.

[1] Prepared by Neil Saker.

5. The quality of banks' assets has improved. The relatively limited rise in non-performing loans that peaked at around 2 percent in 2011 has reversed and the increase was low in international terms (chart 4). Although the rate of credit growth fell during the global crisis, credit growth still remained positive and banks are in stronger position to provide credit to support the recovery (chart 5).

6. Capital adequacy has remained strong by both historic and international standards and banks already exceed the full Basel III requirements with a high proportion of equity capital. As a buffer, banks are required to use conservative accounting guidelines that ensure higher risk weights on potentially risky assets. Staff research suggests that if banks followed the more standard approaches used by comparator countries, the capital adequacy ratio in New Zealand would be about 100 to 200 basis points higher than presently measured.[2] In addition, capital adequacy dynamics are favorable as profitability has returned to the pre-crisis average, boosting own funds.

7. The regulatory framework is being strengthened particularly to deal with the impact of any future banking crisis. The top banks now conduct their mainstream operations through subsidiaries rather than being branches of their Australian based parents and directors have a fiduciary duty to safeguard the interest of New Zealand-based depositors. This limits the possibility of funds being diverted in the unlikely case of problems at the parent bank. An Open Bank Resolution framework is being introduced that aims to provide the government with an alternative to a taxpayer bailout or liquidation, by maintaining access to a bank's core transactional functions while enabling losses to be borne by creditors, once shareholders' funds have been extinguished. The regulatory net has been widened to include deposit-taking NBFIs thus limiting contagion and regulatory arbitrage possibilities and a number of stronger NBFIs have converted into banks enhancing system-wide stability and efficiency by increasing competition.

8. The relative robustness of the system to potential risks is validated by the results of the recent stress tests, conducted in conjunction with the Australian Prudential Regulation Authority (APRA). The stress tests applied a number of single factor tests and scenarios to model the impact. The most severe scenario was based on an adverse international environment that impacted the real economy and financial markets—a 40 percent fall in the world price of New Zealand's commodity exports, a six-month freeze on wholesale debt markets, a cumulative output loss of four percent, a rise in unemployment to 11½ percent, and a fall in house, farm and commercial property prices of about 30 percent. Estimates of default rates and loss given defaults (LGDs) were based on detailed but standardized estimates for each type of loan provided by APRA—exposures at default averaged 4 percent for the banks, with a range of 3.1 to 5 percent. Overall, impaired asset expenses over the course of the three-year scenario rose to 5.5 percent of total loans. In this scenario capital adequacy ratios fell sharply as banks reported losses (chart 6). Nevertheless, the test indicated that

[2] For example, New Zealand's four largest banks have an estimated weighted average risk weight on housing loans of about 29 percent in 2011, compared with an estimated 17 percent for the four largest banks in Australia, 10 percent in Canada, and 19 percent in the U.K. See New Zealand Banks' Vulnerabilities and Capital Adequacy, Byung Kyoon Jang and Masahiko Kataoka, 2013, IMF Working Paper WP/13/7.

banks complied with the minimum Tier 1 capital adequacy ratio that was in place at that time (at 4 percent)[3], although two banks fall by 1 percentage point below the minimum total capital ratio of 8 percent. The RBNZ intends to conduct such tests on a more frequent basis and widen their scope to include all domestic banks and to include a broader range of risks to the financial system.

9. These tests indicated that the banks need to replenish capital buffers. This would need to be done primarily through the raising of new capital as the scope for internally generated funds would be limited by the inherently weak profitability in the recession. These findings and conclusions were similar to stress tests undertaken by Fund staff. This analysis was based on a substantial fall in asset quality, especially of residential mortgages similar to what was experienced in Ireland. Under this scenario, the probability of default rose sharply and estimated losses were larger than provisions Consequently, banks' Tier 1 capital ratio fell by about 1 percentage point. A test of the impact of corporate distress showed a similar result. Under a more severe scenario that looked at combined shocks including adverse international developments, Tier 1 capital ratios fell from over 10 percent to around 6 percent.

[3] The Tier 1 capital ratio was raised to 6 percent in 2013.

New Zealand. Financial Sector Developments

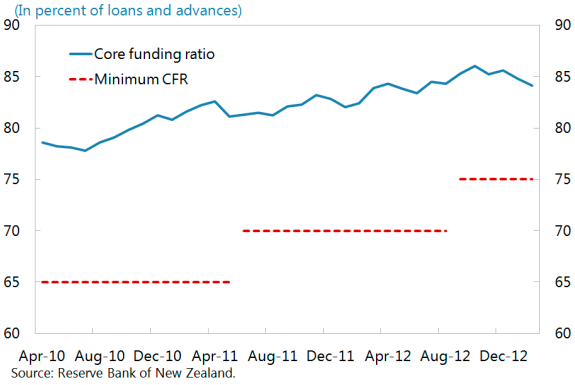
Deposits rising as overseas borrowing falls

Chart 1. Change in Liability Structure
(Domestic deposits as a share of foreign borrowing)

Source: Reserve Bank of New Zealand, *Financial Stability Report*.

Funding is more stable

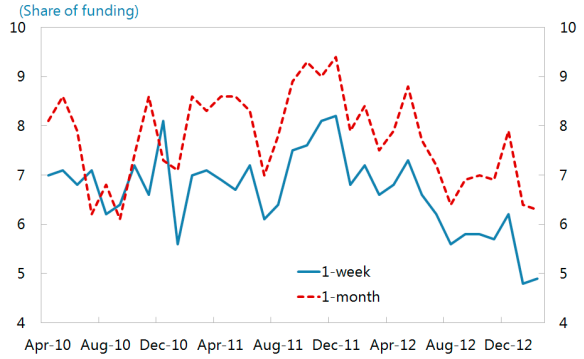
Chart 2. Core Funding Ratio
(In percent of loans and advances)



Source: Reserve Bank of New Zealand.

Liquidity remains adequate

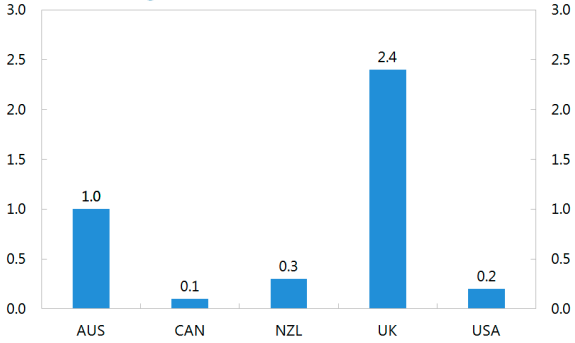
Chart 3. Mismatch Ratios
(Share of funding)



Source: Reserve Bank of New Zealand.

Limited deterioration in asset quality

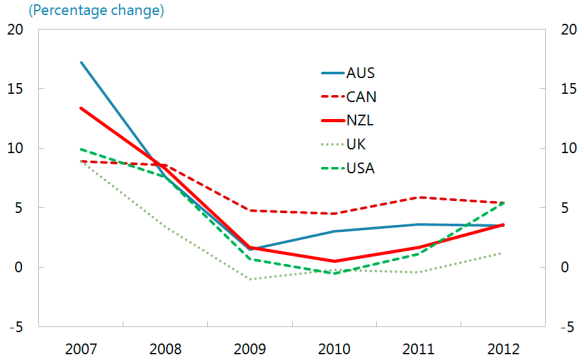
Chart 4. Change in NPLs



Sources: Reserve Bank of New Zealand, *Financial Stability Report;* and IMF, Financial Soundness Indicators. Number refers to absolute level in terms of gross loans.

Deleveraging was only temporary

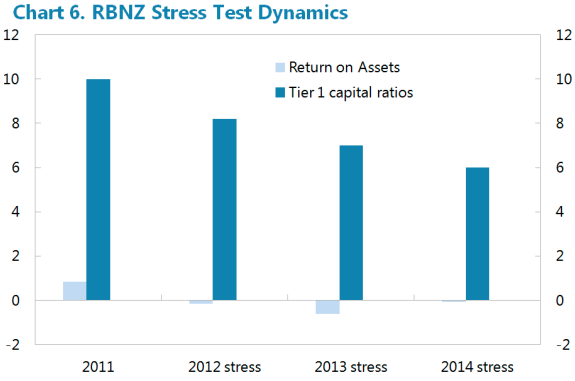
Chart 5. Credit Growth
(Percentage change)



Source: Haver Analytics.

Stress tests results show that losses impact CAR

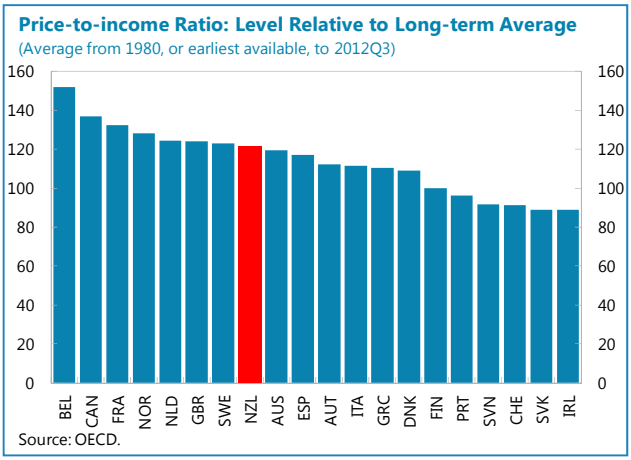
Chart 6. RBNZ Stress Test Dynamics

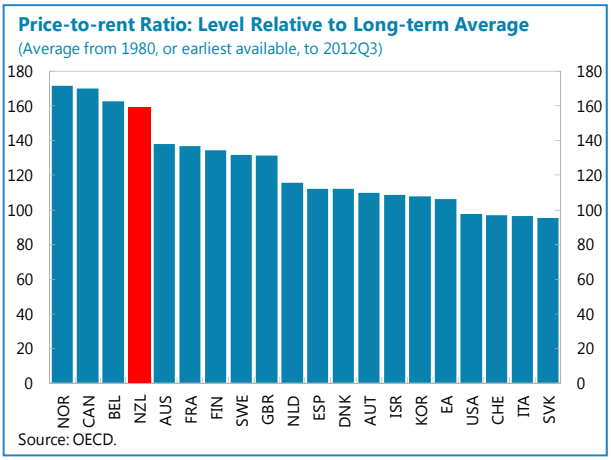


Source: RBNZ. 2011 is actual data and other years are based on stress test results

Annex 2. Housing Market in New Zealand[1]

1. House prices are high in New Zealand. Although affordability metrics are difficult to interpret, most show a significant deterioration in the last two decades. The median house to income ratio rose from 3 in 2000 to about 5 in 2007, before declining to about 4½ in the last five years as incomes outpaced nominal house price growth.[2] This ratio is somewhat higher than that of several peer countries. Despite the recent decline, various measures still point to overvalued house prices. Model based analysis suggests an overvaluation of about 25 percent.[3] Price income ratios are 20 percent higher than the average of the last three decades. Price to rent ratios, which also rose significantly during last boom, show an even larger overvaluation, although rent values in New Zealand are distorted by the large stock of public housing, which serves about 5 percent of the population.





2. From this high base, house prices are beginning to rise again, particularly in Auckland and Christchurch. Real house prices post-2008 had been relatively stable until recent months, when nation-wide annual house price inflation picked up to over 5 percent.[4] Auckland has had price increases of almost 12 percent for some months.[5] The recent price pick up creates the risk of speculative demand that could induce price overshooting. Supply response will take time, and increased demand is likely to continue.

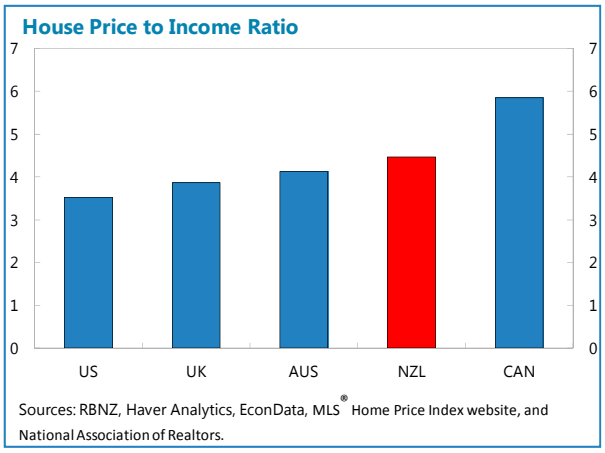
[1] Prepared by Juan Jauregui.

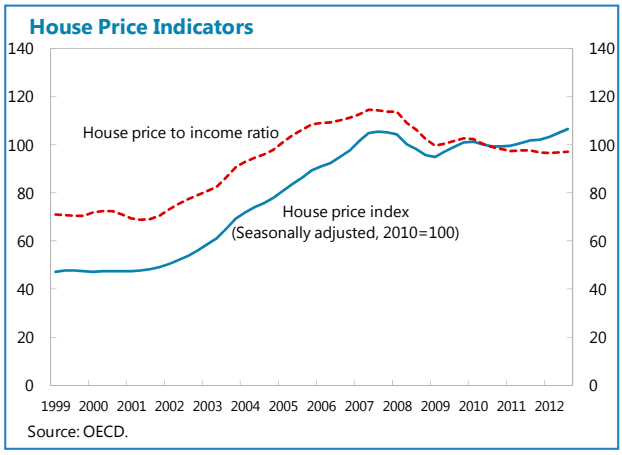
[2] Reserve Bank of New Zealand, Financial Stability Report, November 2012. The price income ratios are very sensitive to different definitions of prices and incomes.

[3] IMF Research Department, Macro-Financial Unit, Housing Module.

[4] Real Estate Institute of New Zealand.

[5] Quotable Value Ltd., New Zealand.





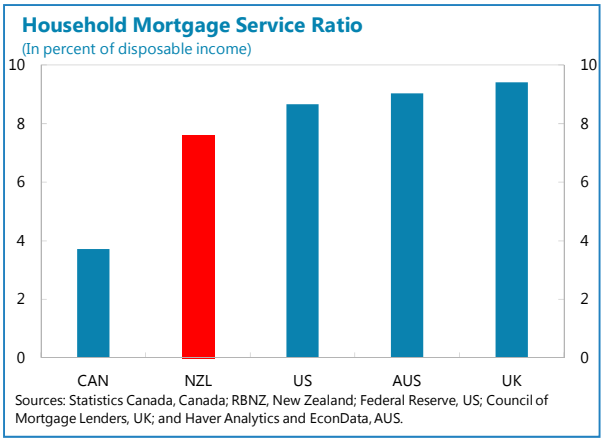
3. There are several underlying supply and demand pressures contributing to high and rising house prices in New Zealand

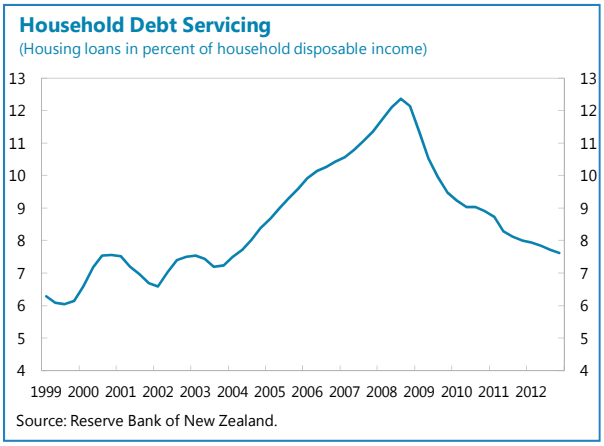
- Population growth and household formation
- Low housing investment
- Supply constraints
- Low interest rates
- High building costs

4. Population growth and household formation. New Zealand has one of the highest rates of growth for working age population among OECD countries—over the last 30 years New Zealand has experienced population growth well above the OECD mean.[6] Since 1971, population growth has resulted in roughly 450,000 new households and the decrease in average household size has created an additional 350,000. Between 2001 and 2006 an average of 22,000 additional households were formed each year. Looking to the future, in nearly all parts of the country the average household size is likely to continue to fall, implying increased housing demand. The government's Productivity Commission expects New Zealand's population to continue to grow strongly. Much of this growth will occur in the Auckland region, putting pressure on the regional housing market. It is currently projecting a shortfall of 90,500 dwellings in Auckland alone over the next 20 years.

5. Low housing investment. Housing investment fell sharply in the wake of the global crisis and has been below 4 percent of GDP in the last five years, the lowest level in 40 years and relatively low when compared to other countries. Meanwhile, net migration continued to be positive over those years increasing demand.

[6] New Zealand Productivity Commission Inquiry into Housing Affordability.





6. Low interest rates. Low inflation and high global liquidity has pushed mortgage interest rates to their lowest level in 40 years. The fall in mortgage rates in recent years has helped offset the effect of higher house prices on mortgage debt service, and has allowed households to take on more debt despite already high debt-to-income ratios. Household mortgage service ratios are in line with those in a set of comparator countries.

7. Supply constraints in Auckland.[7] Auckland has accounted for roughly 40 percent of New Zealand's net household formation over the last 10 years. This city is New Zealand's largest city, with about 1½ million people accounting for a third of the population of the country. It is projected that there will be 200,000 more households by 2031, a 40 percent increase with respect to 2011. Increasingly smaller households add to the increase in demand, as couples without children are expected to increase by 55 percent and single person households by 67 percent.

8. Regulatory constraints on supply. Additionally, supply of housing is constrained in Auckland for regulatory reasons. Land availability is cited as a major constraint, with the price of vacant land more than tripling in the last 10 years.[8] The slow pace at which land for housing is planned, zoned and released contributes to the high price of sections and thereby house prices. Also compliance costs for development and construction are high and the associated delays are a significant burden.[9]

9. Supply constraints in Christchurch. The market of Christchurch, the second largest city with a population of about 400,000 people, is undersupplied as a consequence of earthquakes that damaged 150,000 houses, 30,000 of which seriously. The reconstruction cost of residential buildings is estimated at 14.7 billion New Zealand dollars, or almost 7 percent of GDP. Reconstruction is under

[7] Statistics New Zealand, Demographic Projections.

[8] Quotable Value Ltd., New Zealand.

[9] New Zealand Productivity Commission Inquiry into Housing Affordability.

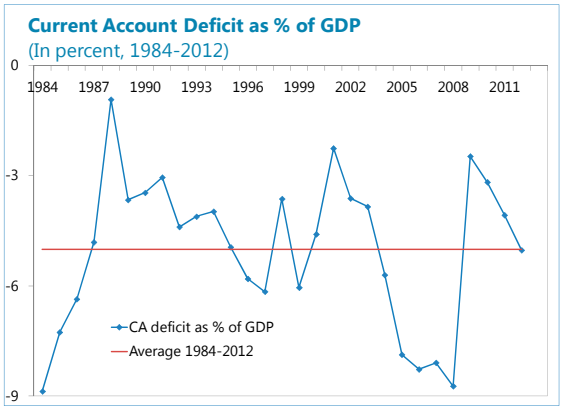
way and projected to peak in the next three years, which should relieve pressure on house prices in that city.

10. Building costs.[10] During the last construction boom, the cost of building a standard house has increased at a greater rate than inflation adding upward pressure on prices. Currently, the cost of both building materials and building a standard house is substantially higher than in Australia, a comparable market. Industry productivity is flat-lining, and this is reflected in growing building costs and evidence of poor building quality. Evidence suggests that the productivity performance of the construction industry over the past thirty years has been poor relative to other New Zealand industries, and relative to other countries. In particular, the lack of scale in the residential construction industry presents a significant barrier to productivity growth.

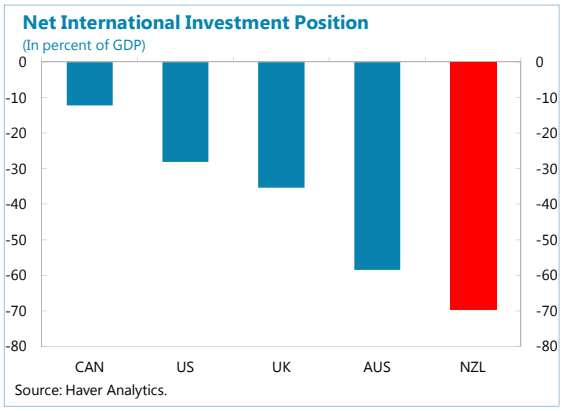
[10] New Zealand Productivity Commission Inquiry into Housing Affordability.

Annex 3. Household Savings and the Current Account in New Zealand[1]

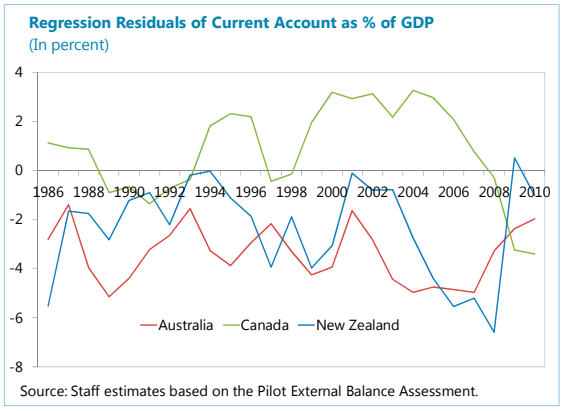
1. Overview. New Zealand has run persistent current account deficits. It is not entirely clear why this is the case, but it most likely reflects structurally low household savings, possibly related to the structure of New Zealand's tax, social security, and welfare systems. Meeting the country's investment needs given low savings has required capital inflows motivated by higher domestic interest rates. The result has been a strong exchange rate over an extended number of years and a buildup of the country's stock of net external debt.



2. New Zealand's current account deficit has averaged about 5 percent of GDP over the last 30 years. Net external debt has remained high at around 70 percent of GDP, significantly higher than New Zealand's peers. Reflecting in part a relatively small domestic deposit base associated with low savings (discussed below), this debt mostly takes the form of banks' offshore wholesale borrowing.



3. These current account deficits have been larger than can be explained by observable fundamentals. One can attempt to explain the current account by regressing it using cross-country data on a set of factors theoretically expected to affect a country's savings and investment.[2] Such factors, or fundamentals, include per capita income, population growth, age dependency ratio, terms of trade, expected income, social insurance, the budget balance, and others. In the case of New Zealand these regressions produce large, one-sided residuals, implying that the current account deficit has been larger than would be predicted by these fundamentals for the length of the sample period.

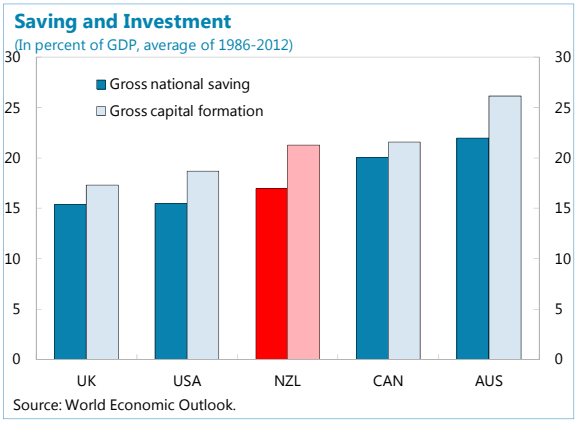


[1] Prepared by Brian Aitken and Ding Ding.

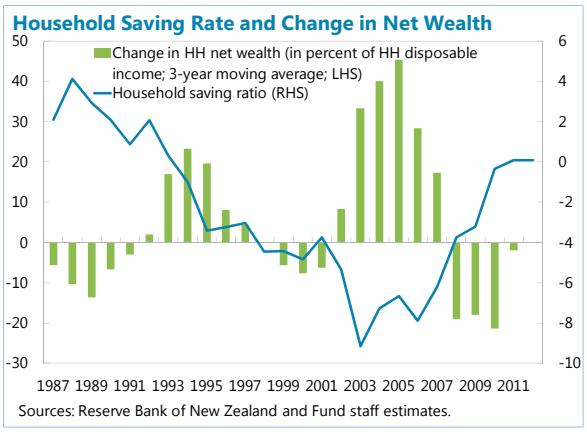
[2] This is one of the methods as part of the so-called IMF External Balance Assessment (EBA) approach, which uses a sample of 50 advanced and emerging economies for the period 1986-2010. http://imf.org/external/np/res/eba/data.htm.

This suggests New Zealand's savings – investment imbalance can be thought of as an enduring structural feature of the economy, shaped by other factors. Several caveats are in order, some of which may prove important in New Zealand's case. As in many cross-country panel regressions, heterogeneity in the country sample can weaken the fit and increase the errors. Uniform cross-country data on fundamentals is limited, and these regressions require imperfect empirical proxies—public health spending, for example, may be a weak proxy for overall social insurance in New Zealand's case.

4. Key to the imbalance is unusually low household savings rates in New Zealand.[3] Investment levels in New Zealand have been comparable to those of its peers, public savings rates have been relatively strong, and business savings remain positive over much of the last three decades.[4] Moreover, until the 2008 global crisis, the gap between New Zealand's household savings rate and those in other countries had widened. This suggests understanding household savings would be a good starting point for understanding the persistence of current account deficits and strong exchange rate.



5. Previous staff analysis suggests that house price inflation has been a significant driver of falling household savings rates.[5] Household savings rates should be associated with developments in net worth. In New Zealand, more than in many other countries, household net worth is dominated by house equity. This could make savings more sensitive to house prices. Indeed, changes in savings rates appear to be closely correlated with house prices, so rapid house price inflation in New Zealand could help explain the declining trend of the household saving rate.

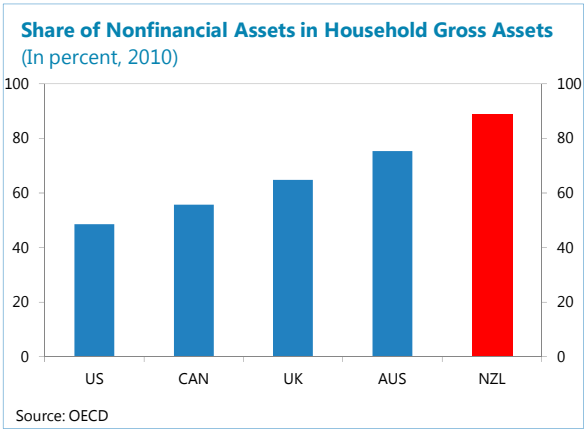


[3] There are uncertainties in measures of household savings in New Zealand, related to difficulties in distinguishing it from business savings. Nevertheless, overall private saving is low.

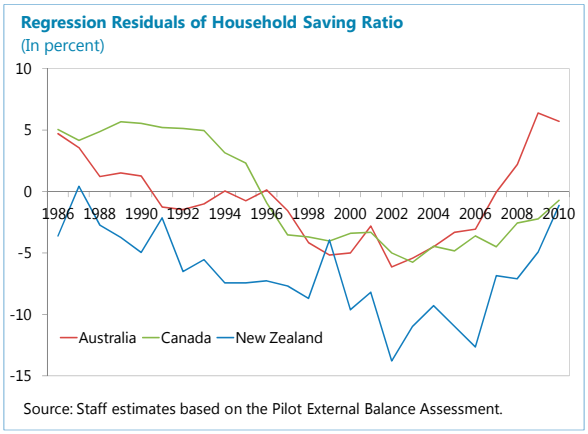
[4] Like New Zealand, Australia has historically faced unexplained structural savings – investment imbalances. In contrast, household savings rates in Australia have been comparable to its peers, but investment has been unusually high.

[5] See Selected Issues Paper Chapter I of the 2011 IMF Article IV Staff Report. Staff estimation suggests that the 50 percent rise in household's perceived net wealth in New Zealand from 1990 to 2009 is associated with a 5 percentage point fall in the net private saving rate, controlling for public savings and terms of trade.

6. Aside from the declining trend, the lower level of household savings throughout the last decades is perhaps more of a mystery. Some of it can be associated with the standard factors that influence household saving behavior. For instance, high public savings may play a role in a country's low private savings. The household saving rate could also be associated with the level of social benefits. Cross-country regressions show that at least public health spending is high in New Zealand for a country of its per capita income and demographics. But this can account for only part of the difference—if public health spending were as predicted by New Zealand's characteristics, the savings rate would only be 1.2 percentage points higher.



7. Observed fundamentals fail to explain fully this persistently low household savings rate. A cross-country panel regression of household savings on observed fundamentals shows persistent one-sided residuals similar to those of the current account regressions.[1] This suggests that a common set of structural factors may explain both the low household savings and current account balances in New Zealand. In contrast, the cross-country regressions on household savings seem to fit Australia better than the current account regressions, implying that Australia's unexplained current account deficit may be associated with its high investment rather than savings.



8. Other less-quantitative factors may be at play. New Zealand has some unique structural features which could play a role in reducing households' incentive to save. As indicated in the Savings Working Group Final Report[2] and a recent paper by Brook at the Treasury[3], New Zealand stands out as being one of the only OECD countries where individuals do not have access to any significantly tax-preferred saving vehicles other than property. New Zealand and Ireland are the only two OECD countries that do not have a tier-2 pension scheme – a compulsory private saving account or a mixture of defined benefit and defined contribution schemes and funding by social

[1] Using a comparable data set as with the EBA approach, but with the household savings ratio as the dependent variable.

[2] http://www.treasury.govt.nz/publications/reviews-consultation/savingsworkinggroup.

[3] http://www.rbnz.govt.nz/research/workshops/Mar2013/5200822.pdf.

security taxes. Previous staff analysis also points out that compared to some OECD countries, New Zealand relied more heavily on direct taxes[4], which may have had a role in reducing private savings.

9. Some factors could increase national savings going forward. Overall, at this point not-well-understood structurally low household saving is likely a major reason for the persistently strong exchange rate, current account deficits, and resulting stock of net external debt.[5] But the return to budget surplus should increase national savings. An incentivized retirement savings scheme, KiwiSaver, was launched in 2007 with automatic enrollment for new employees, and based on the past five years, future take-up is likely to be strong. A key question is whether the jump in the household savings rate post-2008 – of the sort seen in various other similar countries – is a structural break or whether rates will return to pre-crisis levels. Further household balance sheet repair could face an offsetting force of rising house prices in the coming years.

[4] Based on the IMF Fiscal Affairs Department's Tax Revenue Structure database for 2003-2007.

[5] Reddell of RBNZ argues that the persistent current account deficits (and high interest and exchange rate) could be related to high housing investment needs associated with the markedly increased and relatively rapid rate of population growth since around 1990. See his presentation at the March 2013 RBNZ Exchange Rate Policy Forum (http://www.rbnz.govt.nz/research/workshops/Mar2013/programme.html).

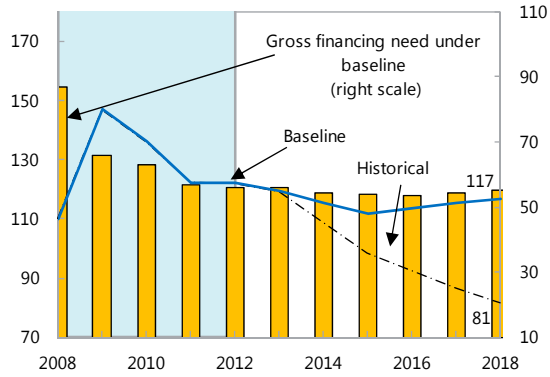
Annex 4. New Zealand: Main Recommendations of the 2012 Article IV Consultation

Fund Recommendations	Policy Actions
Fiscal policy: Staff advised to implement the current deficit reduction plan if the economic recovery proceeds as expected. The planned fiscal consolidation strikes the right balance between the need to contain both public and external debt while limiting any adverse impact on growth. It would also relieve pressure on monetary policy and thereby the exchange rate, helping contain the current account deficit over the medium term.	The 2012 Budget plans a return to surplus by fiscal year 2015. The authorities reiterated their commitment to this target. A plan of fiscal deficit reduction is under way, mainly through expenditure restraint and reprioritization. In the last two years, concrete expenditure measures been successful in gradually reducing the deficit. Also, the government is selling partial ownership of certain state owned enterprises.
Monetary policy: Staff supported the accommodative monetary stance. It recommended that the RBNZ tighten gradually to contain inflationary pressures if the recovery remained on track and downside risks dissipate.	The RBNZ kept its policy rate unchanged at 2.5 percent given uncertainty over the global outlook, soft domestic demand, benign inflationary expectations and the strong exchange rate.
Financial sector policy: Staff encouraged the authorities to assess on an ongoing basis the balance between banking sector vulnerability versus efficiency to minimize the risk that systemically important banks pose to the economy. Staff recommended the future stress tests to include funding risks and that the core funding ratio be increased more than planned over time. Also, staff suggested considering the merits of raising bank capital gradually to levels well above the Basel III requirements. Finally, Staff encouraged the authorities in their analysis of the cost and benefit of macroprudential measures.	The authorities conducted stress tests in coordination with the Australian authorities which showed the relative robustness of the financial sector. They included funding shocks, among others. Capital adequacy has improved and is well above Basel III requirements which the RBNZ began to put in place. Banks have shifted toward more stable funding sources. The authorities are revising the macro-prudential framework. In addition to the current floor on the core funding ratio new tools will include countercyclical capital buffers, overlays to sectoral capital requirements, and loan-to-value restrictions.

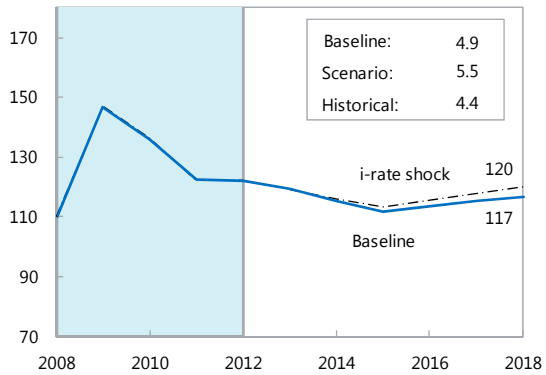
Annex 5. New Zealand: External Debt Sustainability: Bound Tests 1/ 2/

(External debt in percent of GDP)

Baseline and historical scenarios

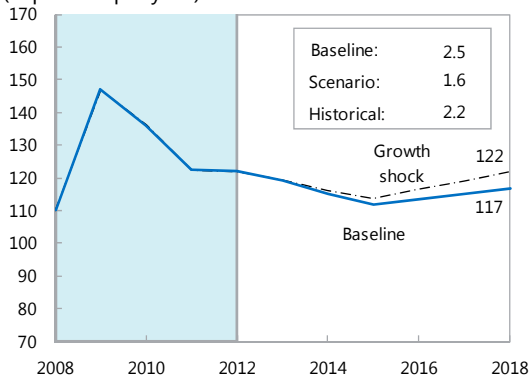


Interest rate shock (in percent)



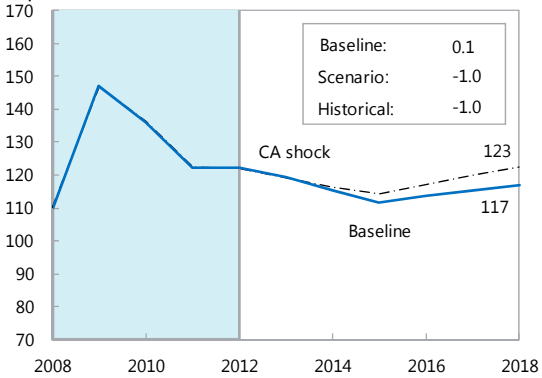
Growth shock

(in percent per year)

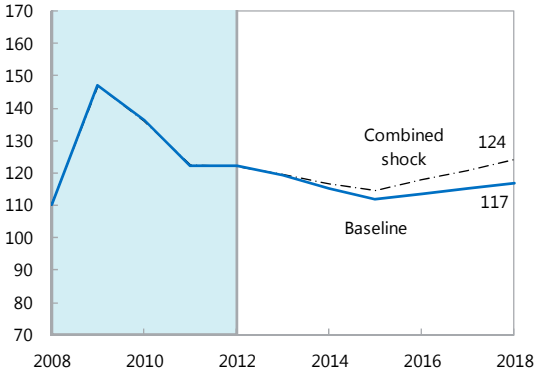


Non-interest current account shock

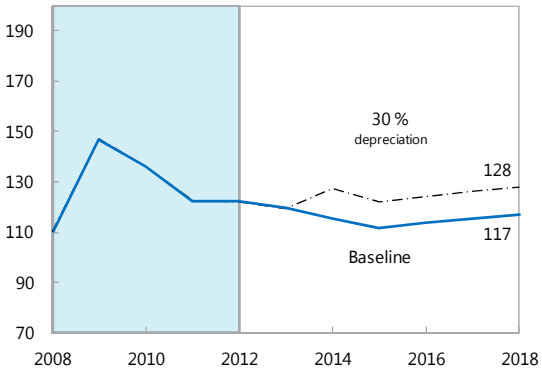
(in percent of GDP)



Combined shock 3/



Real depreciation shock 4/



Sources: International Monetary Fund, Country desk data, and staff estimates.

1/ Shaded areas represent actual data. Individual shocks are permanent one-half standard deviation shocks. Figures in the boxes represent average projections for the respective variables in the baseline and scenario being presented. Ten-year historical average for the variable is also shown.

2/ For historical scenarios, the historical averages are calculated over the ten-year period, and the information is used to project debt dynamics five years ahead.

3/ Permanent 1/4 standard deviation shocks applied to real interest rate, growth rate, and current account balance.

4/ One-time real depreciation of 30 percent occurs in 2013. This scenario assumes foreign exchange hedging effectively covers 90 percent of New Zealand's foreign currency-denominated debt, consistent with the findings of the RBNZ paper, "Sudden stops, external debt and the exchange rate" (RBNZ Bulletin Vol. 74 No.4, 2011).

INTERNATIONAL MONETARY FUND

NEW ZEALAND

STAFF REPORT FOR THE 2013 ARTICLE IV CONSULTATION—INFORMATIONAL ANNEX

April 29, 2013

Prepared By

Asia and Pacific Department
(In Consultation with Other Departments)

CONTENTS

FUND RELATIONS

(As of March 31, 2013)

Membership Status: Joined: August 31, 1961; Article VIII

General Resources Account:	SDR Million	Percent Quota
Quota	894.60	100.00
Fund Holdings of Currency	612.45	68.48
Reserve position in Fund	282.23	31.55
Lending to the Fund		
New Arrangements to Borrow	77.00	

SDR Department:	SDR Million	Percent Allocation
Net cumulative allocation	853.76	100.00
Holdings	791.20	92.67

Outstanding Purchases and Loans: None

Financial Arrangements: None

Projected Payments to Fund [1/]

	Forthcoming				
	2013	2014	2015	2016	2017
Principal					
Charges/Interest	0.05	0.06	0.06	0.06	0.06
Total	**0.05**	**0.06**	**0.06**	**0.06**	**0.06**

Exchange Arrangement:

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

Article IV Consultation:

New Zealand is on the 12-month consultation cycle. On June 6, 2012, the Executive board concluded the Article IV consultation with New Zealand and considered, and endorsed, the staff appraisal without meeting, on a lapse-of-time basis.

FSAP Participation and ROSCs:

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

Technical Assistance: None

STATISTICAL ISSUES

Data provision is adequate for surveillance. The authorities are continuing to enhance data quality and expand the range of data available, including a project led by the Reserve Bank of New Zealand to publish data consistent with the *Monetary and Financial Statistics Manual 2000 (MFSM 2000)*. Given New Zealand's high level of external indebtedness, the publication of up to date institutional sector and flow of funds accounts would be an important addition to the current suite of statistics. It is recommended that the authorities subscribe to the IMF's Special Data Dissemination Standard.

Table of Common Indicators Required for Surveillance
(As of April 22, 2013)

	Date of latest observation	Date received	Frequency of Data[7]	Frequency of Reporting[7]	Frequency of Publication[7]
Exchange Rates	4/22/13	4/22/13	D	D	D
International Reserve Assets and Reserve Liabilities of the Monetary Authorities[1]	2/13	3/15/13	M	M	M
Reserve/Base Money	2/13	3/30/13	M	M	M
Broad Money	2/13	3/30/13	M	M	M
Central Bank Balance Sheet	2/13	3/30/13	M	M	M
Consolidated Balance Sheet of the Banking System	2/13	3/30/13	M	M	M
Interest Rates[2]	4/22/13	4/22/13	D	D	D
Consumer Price Index	Q1 2013	4/17/13	Q	Q	Q
Revenue, Expenditure, Balance and Composition of Financing[3]—General Government[4]	Q4 2012	3/15/13	Q	Q	Q
Revenue, Expenditure, Balance and Composition of Financing[3]– Central Government	2/13	4/5/13	M	M	M
Stocks of Central Government and Central Government-Guaranteed Debt[5]	2/13	4/5/13	M	M	M
External Current Account Balance	Q4 2012	3/20/13	Q	Q	Q
Exports and Imports of Goods and Services	Q4 2012	3/20/13	Q	Q	Q
GDP/GNP	Q4 2012	3/21/13	Q	Q	Q
Gross External Debt	Q4 2012	3/21/13	Q	Q	Q
International Investment Position[6]	Q4 2012	3/20/13	Q	Q	Q

[1] Includes reserve assets pledged or otherwise encumbered as well as net derivative positions.
[2] Both market-based and officially determined, including discount rates, money market rates, rates on treasury bills, notes, and bonds.
[3] Foreign, domestic bank, and domestic non-bank financing.
[4] The general government consists of the central government (including budgetary, extra budgetary, and social security funds) and state and local governments.
[5] Including currency and maturity composition.
[6] Includes external gross financial asset and liability positions vis-à-vis nonresidents.
[7] Daily (D), Weekly (W), Monthly (M), Quarterly (Q), Annually (A), Irregular (I); Not Available (NA).

INTERNATIONAL MONETARY FUND
Public Information Notice
EXTERNAL
RELATIONS
DEPARTMENT

Public Information Notice (PIN) No. 13/51
FOR IMMEDIATE RELEASE
May 14, 2013

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

IMF Executive Board Concludes 2013 Article IV Consultation with New Zealand

On May 13, 2013, the Executive Board of the International Monetary Fund (IMF) concluded the Article IV consultation with New Zealand.[1]

Background

Growth appears to have strengthened in the last months of 2012 and is estimated at 2½ percent for the year, as subdued household consumption and business investment and budget deficit reduction have been offset by strong agriculture production and continued expansion in the construction sector. Earthquake-related reconstruction is gathering pace.

Inflation remains subdued, with the exchange rate dampening tradable price inflation. Wage pressures are contained and by a range of measures the labor market remains soft. However, pressures have emerged in the housing market, notably in Auckland where supply bottlenecks persist and in Christchurch where construction cost inflation has accelerated.

[1] Under Article IV of the IMF's Articles of Agreement, the IMF holds bilateral discussions with members, usually every year. A staff team visits the country, collects economic and financial information, and discusses with officials the country's economic developments and policies. On return to headquarters, the staff prepares a report, which forms the basis for discussion by the Executive Board. At the conclusion of the discussion, the Managing Director, as Chairman of the Board, summarizes the views of Executive Directors, and this summary is transmitted to the country's authorities. An explanation of any qualifiers used in summings up can be found here: http://www.imf.org/external/np/sec/misc/qualifiers.htm.

The Reserve Bank of New Zealand (RBNZ) has kept the policy rate at 2½ percent for two years given uncertainty over the global outlook, soft domestic demand, benign inflationary expectations, and the strong New Zealand dollar. Favorable offshore borrowing conditions have reduced banks' funding costs and contributed to a further lowering of lending rates. Net government debt grew from 5½ percent of GDP in 2008 to 20 percent in 2011, as a consequence of the policy response to the global financial crisis and the two earthquakes. The government has since established a medium term deficit reduction plan that aims to reduce the structural budget deficit by about 6 percent of GDP over four years, mainly through spending restraint.

The current account deficit in 2012 widened somewhat to 5 percent of GDP, reflecting some terms of trade losses, although it is well below the 8 percent level in 2005-08. Net external liabilities remain high at 72 percent of GDP at end-2012.

The banking sector remains sound. Asset quality remains good, the ratio of nonperforming loans to total assets is low and continues to decline from its peak, and return-on-assets is in line with the pre-crisis average. Capital adequacy has improved and is well above the Basel III capital requirements which the RBNZ began to put in place in January. Banks have shifted toward more stable funding sources facilitated by a combination of strong deposit growth and slower credit growth. Reliance on offshore wholesale funding has been reduced and is of longer maturity, and deposits now meet around half of banks' funding requirements. Banks' balance sheets are fully hedged against exchange rate risk.

The growth forecast for this year, currently at 2¼ percent, is subject to uncertainty. An increase in construction activity is offset by headwinds from budget deficit reduction, the strong dollar, and the recent severe drought. Over the medium term, output growth should peak at 2¾-3 percent as reconstruction spending increases further before converging to a trend rate of about 2½ percent. Underlying inflation is expected to increase but remain modest. Rising house prices, which are already elevated by standard metrics, are a growing concern, as they could lead to an increase in debt-financed household spending which would put pressure on aggregated demand, and increase the risk of an abrupt price correction. Other threats include the financial and economic fallout from an intensification of European sovereign debt problems and a slowdown in China, Australia, and other parts of Asia.

Executive Board Assessment

Executive Directors commended the authorities' strong track record of prudent macroeconomic management in the wake of the global economic downturn and devastating earthquakes. While a recovery is underway, growth this year is likely to remain modest, with an increase in construction activity offset by headwinds from budget deficit reduction, the strong dollar, and the recent severe drought. Risks arise from persistent low national savings and large external liabilities, and from high and rising house prices. Directors welcomed the authorities' continued efforts to reduce these vulnerabilities.

Directors agreed that the current accommodative monetary policy stance is appropriate, although a tightening may be warranted if house-price and credit expansion begin to fuel inflationary pressures. They were reassured that the reserve bank's credibility and the effective monetary transmission mechanism would allow a smooth response to changing circumstances. A few Directors pointed out that higher interest rates could lead to further exchange rate appreciation.

Directors welcomed the medium-term consolidation plan and its focus on expenditure restraint. The planned pace of deficit reduction strikes the right balance between sustaining aggregate demand and limiting public debt growth. It withdraws fiscal stimulus at the right time by making room for increases in reconstruction spending. It also reduces pressure on monetary policy, creates fiscal space, and could help to raise national savings. Directors considered that the relatively modest public debt provides some scope to delay the planned deficit reduction in the event of a sharp deterioration in the economic outlook.

Directors noted that New Zealand's large net liabilities reflect historically low household savings rates and a structural savings-investment imbalance. They agreed that the causes of low household savings will need to be addressed to reduce pressure on the exchange rate and limit current account deficits. In this context, Directors welcomed the shift in the composition of taxation from income to consumption taxes and looked forward to follow-up on the conclusions of the Savings Working Group. Directors further observed that other factors contributing to the overvalued exchange rate include a continuing gap between domestic and foreign interest rates and increased portfolio flows.

Directors agreed that banks remain sound, with recent stress tests showing that the major banks could withstand a variety of sizeable shocks. They observed, however, that banks remain exposed to highly leveraged borrowers and to rollover risks associated with large short-term offshore funding needs. Directors welcomed the reserve bank's consideration of using macroprudential tools in a judicious way to limit risks in the housing market, as a complement to macroeconomic and microprudential measures.

New Zealand: Selected Economic and Financial Indicators, 2008–13

Nominal GDP (2012): US$169.7 billion
Population (2012): 4.4 million
GDP per capita: (2012): US$38,111
Quota: SDR 894.6 million

	2008	2009	2010	2011	2012	2013 Proj.
Real growth (percent change)						
GDP (production basis)	-0.8	-1.6	1.8	1.4	2.5	2.2
Final domestic demand	0.0	-3.9	1.7	2.3	2.7	2.3
Private consumption	0.2	-1.4	2.6	2.0	2.1	1.7
Government consumption	5.0	1.1	1.3	2.0	0.3	0.1
Fixed investment	-3.7	-13.6	-0.4	3.3	6.6	5.9
Inventories 1/	0.8	-2.8	2.6	-0.4	0.1	0.0
Exports of goods and services	-1.1	2.4	3.6	2.7	2.1	2.1
Imports of goods and services	3.1	-14.3	10.7	6.7	1.5	2.6
Output gap	0.7	-1.8	-1.0	-0.9	-0.1	-0.2
Headline CPI inflation (percent change)	4.0	2.1	2.3	4.0	1.1	1.4
End of period (percent change)	3.4	2.0	4.0	1.8	0.9	2.2
Unemployment rate (period average, in percent)	4.2	6.1	6.5	6.5	6.9	6.7
Investment and saving (in percent of GDP)						
Investment	22.9	18.5	19.3	18.7	19.6	20.1
National saving 2/	14.5	16.0	16.1	14.6	14.5	14.0
Public finance (in percent of GDP) 3/						
Revenue	37.0	36.8	34.2	36.0	34.2	34.6
Expenditure	33.8	37.0	37.0	43.4	36.7	37.4
Net lending (+)/borrowing (–)	3.2	-0.2	-2.8	-7.4	-2.5	-2.8
Operating balance before gains and losses	3.0	-2.1	-3.3	-9.2	-4.4	-3.5
Gross debt	16.9	23.4	27.9	36.2	38.2	37.7
Net debt (financial assets excl. NZS Fund & Advances)	5.5	9.2	13.9	20.0	24.3	28.2
Stuctural balance (percent of potential GDP)	2.3	0.3	-2.2	-5.8	-1.5	-1.9
Cyclically adjusted balance (percent of potential GDP)	2.3	0.3	-2.2	-6.6	-2.2	-2.7
Money and credit (end of period)						
Resident M3 (percent change) 4/	9.1	1.8	4.8	6.9	8.0	...
Private domestic credit (percent change) 4/	8.3	1.7	0.5	1.7	3.6	...
Interest rates (period average)						
Interest rate (90-day, in percent)	8.0	3.0	3.0	2.8	2.7	...
Government bond yield (10-year, in percent)	6.1	5.5	5.6	4.9	3.7	...
Balance of payments (in percent of GDP)						
Current account	-8.7	-2.5	-3.2	-4.1	-5.0	-6.0
(In billions of New Zealand dollars)	-16.3	-4.6	-6.3	-8.3	-10.5	-13.2
Trade balance (goods)	-1.3	1.3	1.7	1.7	0.5	-0.3
Terms of trade (percent change)	7.4	-10.1	10.3	4.6	-6.8	-1.9
Foreign assets and liabilities ($NZ billion)						
Net international investment position	-152.8	-151.8	-146.9	-147.9	-150.0	-162.0
(In percent of GDP)	-82.1	-81.1	-74.6	-72.3	-71.7	-74.1
Official reserves	19.1	21.6	21.7	22.1	21.4	...
Exchange rate (period average)						
U.S. dollar per New Zealand dollar	0.71	0.63	0.72	0.79	0.81	...
Trade-weighted index (June 1979 = 100)	65.7	60.0	66.7	69.3	72.6	...
Nominal effective exchange rate 4/	91.1	84.3	92.2	95.1	99.5	...
Real effective exchange rate 4/	92.0	86.7	94.9	98.7	102.3	...
GDP (in billions of New Zealand dollars)	186.2	187.3	196.9	204.6	209.3	218.7

Sources: Data provided by the New Zealand authorities; and IMF staff estimates and projections.
1/ Contribution in percent of GDP.
2/ Based on national accounts data.
3/ Fiscal years ending June 30.
4/ IMF Information Notice System index (2000 = 100).

Statement by Jong-won Yoon, Executive Director for New Zealand
and Leni Hunter, Senior Advisor
May 13, 2012

The New Zealand economy continues to recover, with stronger growth in recent months. Expectations of further recovery are broadly in line with staff's estimates and are underpinned by accelerated construction activity and stronger household spending. The path of fiscal consolidation, the elevated exchange rate and global economic conditions are also important driving factors. New Zealand has also recently experienced a severe drought that will weigh on farm output, and is currently estimated to detract 0.7 percentage points from real GDP in calendar 2013.

The Canterbury earthquake reconstruction effort will provide a prolonged boost to growth. Earthquakes affecting the Canterbury region at the end of 2010 and the start of 2011 caused severe damage and loss of life. Hundreds of thousands of homes were damaged, with around ten thousand homes needing to be demolished. Rebuilding has been delayed by persistent aftershocks which have numbered in the thousands, many of which have been greater than magnitude 5. However, with reduced aftershocks and progress on insurance settlements, rebuilding is set to accelerate in 2013. Reconstruction is expected to take at least ten more years to complete, requiring investment spending in excess of 15 percent of GDP. The current estimate of the cost to taxpayers from the earthquakes is around $15 billion. As momentum around the rebuilding effort grows, the Government's focus is on removing roadblocks to ensuring the supply of workers and materials necessary to meet construction demands.

Supply constraints, including reducing housing stock in Christchurch, and low interest rates have led to resurgent house prices. House price growth has been particularly pronounced in Auckland and Christchurch. For the March quarter, annual house price inflation in Auckland and Canterbury was 13 percent and 10 percent respectively, with growth across the country at 8.6 percent. While housing demand has increased, market inventory is low and new supply remains limited given the slow pace of residential investment. Although house price pressure is expected to ease with increased construction, price escalation and renewed increases in private sector credit pose financial system risks. Like staff, the authorities view house prices as already elevated relative to fundamental metrics. A continuation of rapid increases in prices is likely to exacerbate the risk of a sharp correction in future, increasing risks to financial stability.

Stronger activity is yet to result in improved labor market data. The unemployment rate remains elevated at 6.9 percent, with firms displaying reluctance to take on additional employees. While there have been encouraging signs from business surveys, these are not yet suggestive of a strong near term recovery in employment growth.

The terms of trade have been supported by gains in dairy prices coupled with slower increases in import prices. Prices of New Zealand's export commodities have remained strong and improved from mid-2012 lows, reflecting improving global conditions (especially in Asia). In addition, slower growth in dairy supply and concerns about New Zealand's drought have supported dairy prices.

New Zealand remains sensitive to external developments, due to its small and open nature and the long-standing saving-investment gap. New Zealand has run persistent current account deficits, with high external debt high relative to GDP leaving the economy exposed, including to a downturn in offshore markets. Given the structural nature of the issues, the authorities consider a medium to long-term response as more appropriate than temporary or short-term policies. The authorities have focused on reducing vulnerabilities and bolstering economic resilience through deficit reduction, as well as structural reforms aimed at further improving economic flexibility and competitiveness.

The elevated New Zealand dollar continues to act as a headwind to growth. The strong New Zealand dollar in part reflects domestic data, and has some benefits for the economy through lower inflation and support for capital goods investment, a large amount of which is imported. However, the post-float highs in the currency are in excess of levels justified by economic fundamentals, particularly given external imbalances noted above. With New Zealand interest rates still quite high by international standards, stimulatory global monetary policy and quantitative easing, aimed to support other advanced economies, have been key factors behind the New Zealand dollar appreciation. Investor diversification – including from official sources – is also playing a role.

Monetary policy

Monetary policy remains accommodative, with the policy interest rate held at 2.5 percent since early 2011. Inflation expectations remain anchored and consistent with the Reserve Bank's medium-term inflation target band, although CPI inflation has hovered below the 1 to 3 percent band for two second consecutive quarters – with a CPI increase of 0.9 percent in the year to December 2012. Both tradable and non-tradable inflation has been low – due respectively to the exchange rate and spare capacity in the economy. However, non-tradable inflation is expected to rise in line with increasing construction costs and a closing output gap. Fiscal consolidation has provided some scope for monetary policy settings to remain more accommodative than otherwise and has, at the margin, reduced pressure on the New Zealand dollar.

The authorities currently expect to keep the Official Cash Rate unchanged through the end of this year, and to eventually raise the OCR as the recovery progresses and pressures on resources - particularly associated with the Christchurch rebuild - increase. If the momentum in house price growth continues and adds to inflationary pressures, a monetary

policy response would become more likely. There are both upside and downside risks to the outlook, but the authorities agree with staff that further reductions to the Official Cash Rate (OCR) would be possible as a first line of defense to negative shocks. The floating exchange rate would also act as a shock absorber. However the Reserve Bank has indicated that should further strong appreciation for reasons unrelated to fundamentals be experienced, a lower OCR may become warranted.

Fiscal policy

The Government is on track to return the operating balance to surplus in 2014/15, with further increases in the surpluses thereafter. This will support an increase in national savings and rebuild fiscal buffers. The government aims to reduce net core Crown debt to 20 percent of GDP by 2020, from an expected peak just below 30 percent. Figures released on May 6 for the government's fiscal deficit for the first 9 months of this year found the deficit 5 percent less than forecast, due to higher-than-expected tax receipts, and lower spending. The 2013 Budget will be delivered on 16 May.

Expenditure control is a key feature of the Government's fiscal plans. Spending restraint is being achieved in a number of ways, including: reprioritizing spending from lower-value to higher-value activities; reducing Budget operating allowances, including two Budgets in 2011 and 2012 that featured net-zero increases in discretionary spending; reducing the cost of existing policies; and driving efficiency gains from the public sector. Public sector capital spending over the next four years will be funded from the Crown's balance sheet and in particular from the proceeds of Government's share offer program. The asset sales reflect the Government's intent to more actively manage its assets to ensure the best returns and use of public resources.

Structural reform

Government has actively pursued a number of reforms to improve New Zealand's productivity and competitiveness. Over the past four years personal income and company tax rates have been lowered, while consumption tax and the effective tax on property investment have been raised. Labor market reform has included introduction of a 90-day trial period for new employees, and a "starting-out" youth minimum wage. Welfare system reform that was announced in the Budget 2012 is being progressed, with additional funding allocated to assist beneficiaries to return to work. Other reforms include changes to consent processes under the Resource Management Act, and an infrastructure program to improve roads, rail and broad-band access. In addition, Accident Compensation Corporation (accident insurance) levies have been reduced to lower costs to households and firms.

Financial sector

Bank profits have returned to near pre-crisis levels, in terms of return on assets. Banks have rebuilt interest margins, and have sought to grow lending. Competition for market share combined with weak loan demand has involved some relaxation of lending standards. As staff's report notes, high LVR lending has formed a larger share of new mortgage lending over recent times. Nevertheless, non-performing loans remain low at below 2 percent of lending, though with some concentration of risk in rural and business lending sectors. The authorities continue to closely monitor risks related to both residential mortgage and farm lending, and have performed stress tests in collaboration with the Australian Prudential Regulatory Authority.

New Zealand's banks have continued to build their liquidity and capital buffers. The banks increased their capital buffers in anticipation of the Basel III capital adequacy standards, which took effect from 1 January 2013. The counter-cyclical capital buffer framework will be available to be used from 1 January 2014. The Reserve Bank has also consulted on higher capital adequacy requirements for higher LVR lending, for banks using the internal models based approach, and announced increases in those requirements in its Financial Stability Report released earlier this week. The banks are comfortably meeting existing regulatory requirements for core funding, including the increase in the core funding ratio that came into effect on 1 January 2013. Reliance on wholesale funding has been reduced, with loan growth over the last couple of years matched by deposit growth from a recovery in private savings.

Consultation has recently taken place on a new macro-prudential framework and instruments, to assist the Reserve Bank to fulfill its legislative requirement to promote the maintenance of a sound and efficient financial system. Instruments will include a countercyclical capital buffer, and potentially adjustments to the core funding ratio, sectoral capital requirements, and restrictions on high LVR lending. Macro-prudential tools will help to manage risks associated with the credit cycle, including risks stemming from the recent resurgence in house prices and private credit growth discussed above. The authorities are realistic in their expectations of the efficacy of macro-prudential tools in attenuating the cycle, and share staff's view that the tools would be complementary to macroeconomic and micro-prudential measures.

The RBNZ is implementing a new prudential regime for the insurance sector, and is two-thirds of the way through the licensing of all insurers. All insurers are required to have a full license by September 2013. The earthquake has had a strong impact on the insurance industry, with the sector continuing to process claims. Claims of $13.4 billion have been paid to date, out of an expected total claims cost well in excess of $30 billion. Insurers are now rebuilding profitability, in part through rising premiums.

The RBNZ has continued consultation on its Open Bank Resolution (OBR) policy. OBR aims to provide Government with scope to very quickly reopen a bank after a failure event and an alternative option to a taxpayer bailout or liquidation. The resolution policy will preposition banks to enable losses to be borne by unsecured creditors, including depositors, once shareholders' funds have been extinguished. In the event of a bank failure, depositors will retain access to a non-frozen and government-guaranteed portion of their accounts, and customers will retain access to their bank's core transactional functions.