INTERNATIONAL MONETARY FUND

IMF Country Report No. 16/39

NEW ZEALAND

2015 ARTICLE IV CONSULTATION—PRESS RELEASE; STAFF REPORT; AND STATEMENT BY THE EXECUTIVE DIRECTOR FOR NEW ZEALAND

February 2016

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 2015 Article IV consultation with New Zealand, the following documents have been released and are included in this package:

- A **Press Release** summarizing the views of the Executive Board as expressed during its February 5, 2016 consideration of the staff report that concluded the Article IV consultation with New Zealand.
- The **Staff Report** prepared by a staff team of the IMF for the Executive Board's consideration on February 5, 2016, following discussions that ended on November 10, 2015, 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 January 21, 2016.
- An **Informational Annex** prepared by the IMF staff.
- A **Statement by the Executive Director** for New Zealand.

The document listed below will be separately released.

Selected Issues

The IMF's transparency policy allows for the deletion of market-sensitive information and premature disclosure of the authorities' policy intentions in published staff reports and other documents.

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INTERNATIONAL MONETARY FUND

COMMUNICATIONS DEPARTMENT

Press Release No. 16/47
FOR IMMEDIATE RELEASE
February 8, 2016

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

IMF Executive Board Concludes 2015 Article IV Consultation with New Zealand

On February 5, 2016, the Executive Board of the International Monetary Fund (IMF) concluded the Article IV consultation[1] with New Zealand.

The economy's strong growth after the global financial crisis has been supported by rising terms of trade and reconstruction activity after the 2010–11 Canterbury earthquakes, as well as high net immigration. Growth peaked at 3.5 percent year-on-year (y/y) in Q4 2014, bringing output slightly above potential. However, the tailwinds have recently waned. In 2014, dairy prices began to fall from historic highs, leading to a sharp drop in income growth after the positive effect of declining oil prices had worn off, and investment activity related to the Canterbury rebuild has reached a plateau. As a result, output growth is estimated to have slowed to 2.3 percent in 2015, despite resilient consumption. Meanwhile, unemployment has been edging up reaching 6 percent in Q3 2015. Due largely to the decline in oil prices, inflation has dropped to 0.3 percent (y/y) in Q3 2015. House price inflation in Auckland has remained high, driven fundamentally by supply shortages.

The exchange rate depreciation has cushioned some of the impact of the decline in dairy prices. The bilateral exchange rate against the U.S. dollar has depreciated as dairy prices fell and the Reserve Bank of New Zealand (RBNZ) eased monetary policy. The depreciation has mitigated the impact of the international dairy price decline on farmers' incomes, and supported exports of travel and education services.

With growth below potential, measures of core inflation around the lower half of the target band, and a still strong exchange rate, monetary policy has been eased since June and the Reserve Bank stands ready to reduce rates further if warranted.

To manage risks arising from house price inflation in Auckland, macroprudential measures were introduced in 2013, leading to a temporary slowdown in price hike. A package of additional

[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.

macroprudential regulations and tax measures was announced in May 2015, but having become fully effective only in November. The banking sector has increased capital and liquidity buffers, but reliance on offshore funding and a large share of mortgage lending remain sources of vulnerability.

Fiscal policy is also supportive of the economy in the short term, while consolidation is projected to resume in the medium-term. Automatic stabilizers have been allowed to work and public investment is being increased. Net debt is projected to decline further to around 5 percent of GDP in the medium term.[2]

With chronically low national saving, New Zealand's economy is dependent on borrowing from abroad. Its persistently negative savings-investment balance has led to the accumulation of a large net negative international investment position (IIP) which reached65 percent of GDP in 2014.

The short-term outlook is challenging with both external and domestic risks, the latter arising from rapid house price inflation in Auckland. However, New Zealand's flexible economy is resilient, and medium-term prospects remain positive. New Zealand's main exports—agricultural consumer products and tourism—should benefit from the ongoing shift to a more consumption-oriented growth model in China. Consumer demand in other Asian countries is also expected to grow. Overall, output growth is projected to recover to its estimated potential rate of 2.5 percent. With measures of core inflation around the lower end of the target range and expectations consistent with the band's midpoint, inflation is forecast to rise to within the RBNZ's target range of 1–3 percent in 2016.

Executive Board Assessment[3]

Executive Directors welcomed that New Zealand's economy continues to perform well despite the slowdown imposed by the fall in dairy prices, plateaued investment associated with the Canterbury rebuild, and slower growth in trading partners. Directors agreed that New Zealand's sound and flexible policy frameworks, including the important buffer provided by the flexible exchange rate, position the country well to weather the recent slowdown. Medium-term prospects remain positive, and Directors were encouraged by the authorities' alertness to the downside risks and challenges arising from real estate market pressures, a persistently low savings rate, and relatively low productivity.

[2] GFS Measure.

[3] 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.

Directors considered the current accommodative monetary stance to be appropriate and agreed that, if needed, the authorities should stand ready for further easing given low inflationary pressures and below potential output. With regard to fiscal policy, they agreed that the planned easing this year and next, including through an acceleration of public investment in infrastructure, combined with a resumption of gradual fiscal consolidation thereafter, is appropriate. These measures should support the economy in the short term and bolster the public sector balance sheet in the longer term.

Directors noted that the banking system is resilient and well-supervised. They commended the proactive prudential and tax measures being taken to address the risks stemming from the housing market. Noting that the underlying cause of the housing market boom in Auckland is a supply/demand mismatch, they encouraged the authorities to be ready to use additional prudential measures and consider steps to reduce the tax advantage of housing over other forms of investments, while continuing to address supply-side bottlenecks.

Directors agreed that raising national and in particular private saving is critical to reducing external vulnerabilities from the still heavy reliance on offshore funding. They noted that higher saving may also reduce capital costs by lowering the risk premium and thereby support productive investment and long-term growth. They encouraged the authorities to consider comprehensive policy measures to boost long-term financial savings, including through reform of retirement income policies, as this could also help deepen New Zealand's capital markets and broaden options for retirement planning.

Directors observed that, notwithstanding high living standards, New Zealand incomes lag those of other advanced economies, due to relatively low capital intensity and productivity. Acknowledging that the economy's small size and distance from markets likely limit gains from trade, they encouraged the authorities to build on the country's business-friendly environment to take steps to boost competition in key service sectors, leverage ICT more intensively, and address key infrastructure bottlenecks. They welcomed the focus of the government's Business Growth Agenda on these issues.

New Zealand: Main Economic Indicators, 2010-2020

(Annual percent change, unless otherwise indicated)

	2010	2011	2012	2013	2014	2015	2016	2017	2018	2019	2020
						Projections					
NATIONAL ACCOUNTS											
Real GDP (production)	1.5	2.0	2.6	2.4	3.7	2.3	2.0	2.6	2.5	2.3	2.3
Real GDP (expenditure)	2.0	1.8	2.8	1.7	3.0	2.7	1.8	2.7	2.5	2.3	2.3
Domestic demand	3.8	3.2	3.1	3.2	4.4	2.9	2.4	2.4	2.5	2.6	2.8
Private consumption	3.1	2.6	2.8	3.0	2.7	2.4	2.6	2.8	2.9	3.0	3.0
Public consumption	0.8	2.6	-0.4	1.6	2.7	2.4	1.3	1.1	1.2	1.2	1.2
Investment	8.4	5.3	7.4	5.4	10.8	3.7	2.7	2.4	2.7	2.7	3.4
Public	2.6	0.5	-5.2	0.4	7.2	8.1	3.3	1.1	1.4	0.5	0.3
Private	-0.3	9.1	12.3	6.8	12.3	3.1	2.1	2.9	3.2	3.5	3.9
Private business	-0.8	13.2	11.8	4.2	11.2	2.0	1.5	2.6	3.0	3.5	4.1
Dwelling	0.6	0.8	13.3	12.9	14.6	5.2	3.4	3.5	3.5	3.5	3.5
Inventories (contribution to growth, percent)	1.5	-0.2	0.1	0.1	0.0	-0.1	0.0	0.0	0.0	0.0	0.1
Net exports (contribution to growth, percent)	-1.9	-1.3	-0.3	-1.6	-1.6	-0.4	-0.4	0.2	-0.1	-0.4	-0.6
Real gross domestic income	3.9	2.7	0.9	4.4	5.0	0.8	0.2	3.1	3.3	3.0	2.8
Investment (percent of GDP)	20.2	20.3	21.2	21.4	22.5	22.8	22.9	22.5	22.1	21.7	21.5
Public	6.2	6.0	5.5	5.3	5.4	5.7	5.8	5.6	5.4	5.2	5.0
Private	13.4	14.0	15.3	15.6	16.7	16.8	16.8	16.6	16.4	16.2	16.1
Savings (gross, percent of GDP)	24.6	19.9	17.5	19.3	19.4	18.2	16.3	16.3	16.6	16.5	16.2
Public	-0.1	-0.3	0.6	0.2	-0.1	0.1	-0.6	-0.3	0.2	0.8	0.8
Private	24.7	20.2	16.9	19.1	19.5	18.0	16.9	16.7	16.4	15.7	15.4
Potential output	1.1	1.5	2.0	2.4	3.0	2.9	2.4	2.4	2.3	2.3	2.3
Output gap (percent of potential)	-1.3	-0.9	-0.3	-0.3	0.4	-0.1	-0.5	-0.4	-0.2	-0.1	0.0
LABOR MARKET											
Employment	0.5	1.5	0.2	1.6	3.5	2.1	1.4	1.3	1.2	1.0	1.0
Unemployment (percent of labor force)	6.6	6.5	6.9	6.2	5.8	5.9	5.9	5.8	5.8	5.7	5.5
Wages (nominal percent change)	1.2	2.9	3.0	2.4	2.5	2.1	2.0	2.3	2.3	2.3	2.4
PRICES											
Terms of trade index (goods, % change)	8.8	3.9	-6.3	8.5	5.7	-7.0	-5.4	1.1	2.3	2.0	1.4
Consumer prices (avg, % change)	2.3	4.0	1.1	1.1	1.2	0.3	1.7	1.9	2.0	2.0	2.0
GDP deflator (avg, % change)	3.5	2.8	0.0	2.2	1.4	0.0	0.2	1.8	1.8	2.2	2.2
MACRO-FINANCIAL											
Reserve Bank of New Zealand Policy Rate (percent,avg)	2.8	2.5	2.5	2.5	3.3	2.9	2.5	2.9	3.8	4.0	4.4
Credit to the private sector (percent change)	0.5	1.7	3.7	5.1	4.5	6.7	6.0	4.0	4.2	4.3	4.5
House prices (percent change, avg)	1.9	1.2	4.7	9.1	6.5	11.6	7.3	4.1	4.0	3.9	3.9
Interest payments (percent of disposable income)	10.3	9.5	8.9	8.7	9.2	9.1	9.5	9.8	10.1	10.4	10.5
Household savings (percent of disposable income)	4.1	3.7	2.8	2.8	2.8	2.8	2.8	2.8	2.8	2.8	2.8
Household debt (percent of disposable income)	155	151	151	155	154	158	157	156	155	154	153
CENTRAL GOVERNMENT (percent of GDP) 1/											
Revenue	34.0	33.9	33.9	33.9	34.1	35.1	35.6	35.4	35.3	35.4	35.5
Expenditure	40.5	40.1	36.4	35.5	34.3	35.0	36.2	35.7	35.1	34.6	34.8
Net lending/borrowing	-6.5	-6.1	-2.5	-1.5	-0.1	0.1	-0.6	-0.3	0.2	0.8	0.8
Operating balance	-4.9	-4.6	-1.5	-0.5	0.7	1.3	1.3	1.3	1.6	2.0	1.9
Cyclically adjusted balance	-5.6	-5.2	-1.6	-0.8	0.5	0.6	-0.1	0.2	0.7	1.2	1.2
Gross debt	26.9	31.5	32.0	30.8	30.8	30.8	31.3	30.6	28.3	27.0	26.1
Net debt	2.3	6.1	7.6	7.7	7.6	7.7	8.1	8.1	7.5	6.4	5.3
Net worth	41.8	32.0	28.3	30.5	33.4	35.5	36.1	35.9	35.6	35.8	36.1
BALANCE OF PAYMENTS											
Current account (percent of GDP)	-2.3	-2.8	-3.9	-3.2	-3.1	-4.8	-6.7	-6.2	-5.5	-5.3	-5.4
Export volume	3.3	2.6	1.9	0.8	3.0	5.5	2.2	3.0	3.0	2.4	2.4
Import volume	10.8	7.0	2.8	6.2	7.9	6.0	3.3	2.1	2.9	3.4	3.8
Net international investment position (percent of GDP)	-71.8	-69.1	-69.5	-64.5	-64.6	-65.4	-70.7	-73.9	-76.3	-78.2	-80.2
Gross official reserves (bn US$)	16.4	17.2	17.7	16.5	15.8	17.6	...	...	...	...	...
MEMORANDUM ITEMS											
Nominal GDP (bn NZ$)	202	211	217	227	238	244	249	260	272	284	297
Percent change	5.0	4.8	2.5	4.6	5.1	2.3	2.1	4.5	4.4	4.6	4.6
Nominal GDP per capita (US$)	33,227	37,976	39,659	41,541	43,458	36,780	35,081	36,209	37,160	38,405	39,705
Real gross national disposable income per capita (NZ$)	43,374	44,210	44,542	46,016	47,349	47,553	47,301	48,282	49,443	50,489	51,453
Percent change	2.6	1.9	0.8	3.3	2.9	0.4	-0.5	2.1	2.4	2.1	1.9
Population (million)	4.3	4.4	4.4	4.4	4.5	4.6	4.6	4.7	4.7	4.7	4.8
US$/NZ$ (average level)	0.6	0.7	0.8	0.8	0.8	...	...	...	...	...	...
Nominal effective exchange rate	100	103	108	112	117	...	...	...	...	...	...
Real effective exchange rate	100	104	108	111	115	...	...	...	...	...	...

Sources: Authorities' data and IMF staff estimates and projections.

1/ Calendar year.

INTERNATIONAL MONETARY FUND

NEW ZEALAND

STAFF REPORT FOR THE 2015 ARTICLE IV CONSULTATION

January 21, 2016

KEY ISSUES

Growth and outlook

- **Growth has moderated** as tailwinds have waned: dairy prices have fallen sharply from historic highs and investment activity related to the Canterbury rebuild has reached a plateau. **The short-term outlook is challenging** with both external and domestic risks, the latter arising from rapid house price inflation in Auckland. However, New Zealand's flexible economy is resilient, and **medium-term prospects remain positive.**

Policy agenda

- **Monetary policy** has been eased since June and the Reserve Bank stands ready to reduce rates further if warranted. Given the below-potential growth, measures of core inflation around the lower end of the target band, and a still strong exchange rate, the monetary policy stance is appropriate.
- **Fiscal policy** is also supportive of the economy in the short term, while consolidation is projected to resume in the medium term. Automatic stabilizers have been allowed to work and public investment is being increased. Given the current economy and with the strength of the public sector balance sheet key to sustain investor confidence, this fiscal path is broadly appropriate.
- For monetary policy to be able to focus on the real economic cycle, the **risks arising from house price inflation in Auckland** need to be managed through other tools, including prudential and tax measures.
- The **banking sector** has increased capital and liquidity buffers, but reliance on offshore funding and a large share of mortgage lending remain sources of vulnerability. Continuing to strengthen capital and moving toward more stable sources of funding is important.
- **Raising national saving** is key to reducing dependence on borrowing from abroad. Comprehensive measures to encourage private long-term financial saving should be considered, including through retirement income policies. Incentives to invest in real estate assets should be reduced.
- New Zealand's living standard is very high but incomes lag those of peers. The economy's small size and distance from markets limit gains from trade, but measures to boost competition in key sectors, strengthen skills and innovation, as well as investment in infrastructure, should help **improve productivity.**

Approved By
Kalpana Kochhar and Sanjaya Panth

Discussions were held in Auckland, Christchurch, and Wellington during October 28 – November 10, 2015. The staff team comprised Messrs. Sumi (head), Mohommad, Nyberg, and Pitt (all APD). Ms. Plater (OED) also participated. Ms. Hussiada and Ms. Dubost assisted from HQ.

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ANNEXES

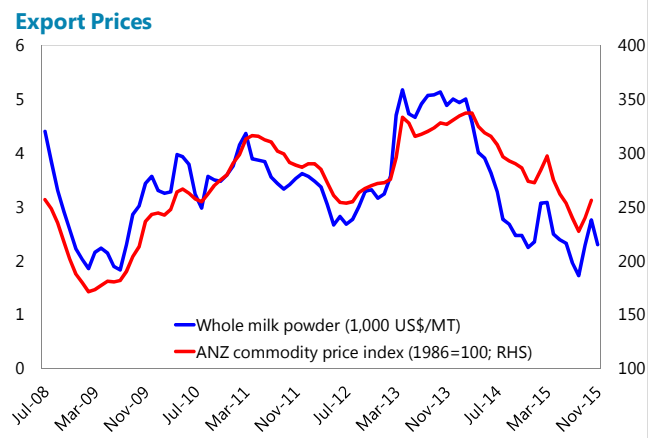
RECENT DEVELOPMENTS

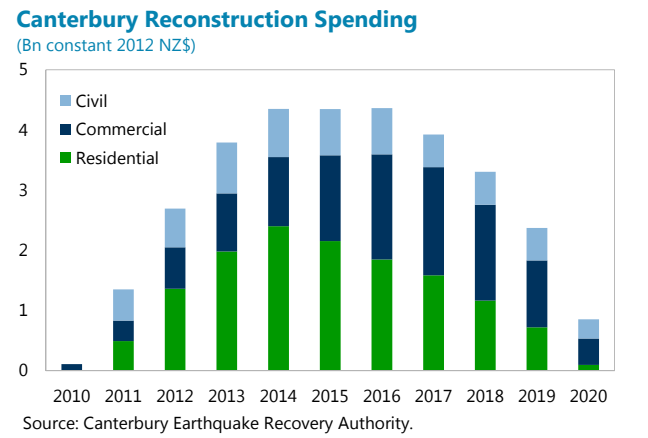
1. The economy's strong growth after the global financial crisis (GFC) has been supported by tailwinds: rising terms of trade (driven by high demand from China); and reconstruction activity after the 2010-11 Canterbury earthquakes. More recently, population growth driven by high net immigration also contributed, as the economy of Australia, New Zealand's common labor market partner, has slowed. Growth peaked at 3.5 percent y/y in Q4 2014, bringing output slightly above potential. Due largely to the decline in oil prices, inflation has dropped to 0.1 percent (y/y) in Q4 2015.

2. However, the tailwinds have recently waned. In 2014, dairy prices began to fall from historic highs, leading to a sharp drop in income growth after the positive effect of declining oil prices had worn off, and post-earthquake rebuilding activity in Canterbury has reached a plateau.

- Prices for whole milk powder (WMP), one of New Zealand's key exports, declined from an average of around US$4,900/MT over 2013Q2-2014Q1 to US$1,700/MT in August 2015, partly on account of high inventories in China, decline in demand from Russia, and increased global milk supply after the European Union abolished its production quotas. Production cuts in New Zealand, which provides about 60 percent of global supply of WMP, have since supported a partial recovery of the price to just over US$2,300/MT in November 2015.

- Post-earthquake reconstruction investment in the Canterbury region ramped up quickly, from NZ$1½ billion in 2011 to NZ$4½ billion in 2014, but is forecast to plateau at about that level during 2015-17.



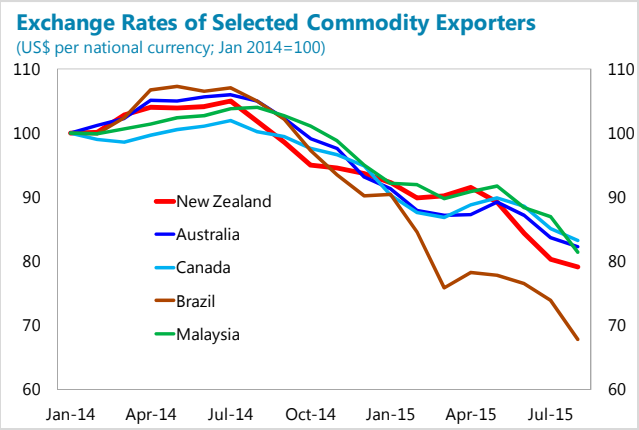


As a result, output growth began to slow in H1 2015, despite resilient consumption. Meanwhile, unemployment has been edging up, reaching 6 percent in Q3 2015 (well above pre-GFC levels) even as employment is growing, on account of stronger labor force growth.

3. Monetary policy has been eased. With inflation below target and the weakening outlook, the Reserve Bank of New Zealand (RBNZ) lowered its policy rate by a cumulative 100 bps since June

2015, to 2.5 percent, and has indicated its readiness to ease further if circumstances warrant in its December Monetary Policy Statement.

4. The exchange rate depreciation has cushioned some of the impact of the decline in dairy prices. The bilateral exchange rate against the U.S. dollar has depreciated as dairy prices fell and the RBNZ eased monetary policy. The depreciation has mitigated the impact of the international dairy price decline on farmers' incomes, and supported exports of travel and education services. The trade-weighted exchange rate depreciated by 12 percent since its peak in July 2014, which has brought the REER closer to fundamentals, though some overvaluation likely remains (Annex I).



5. House price inflation in Auckland has remained high. House prices in Auckland (where about one-third of the population lives) have continued their strong upward trend, rising by 22.5 percent (y/y) in December 2015, and the housing inventory available for sale remains low. Moreover, prices in neighboring areas are beginning to accelerate as buyers are priced out of the Auckland market. Supply shortages are a fundamental driver of house price inflation, exacerbated by high net immigration. On the demand side, macroprudential measures introduced in 2013 have led to a temporary slowdown in house price inflation. A package of additional macroprudential regulations and tax measures aimed at containing risks emanating from the Auckland housing market was announced in May 2015, but having become fully effective only in November, its effectiveness to cool rapid house price growth is yet to be seen (Box 1).

6. Fiscal consolidation is broadly on track. With significant expenditure control and solid revenue growth, an overall surplus of 0.8 percent of GDP was reached in 2014/15, well above the budget target (which had envisaged a deficit).[1] Net debt declined slightly to 7½ percent of GDP.

7. The authorities broadly agreed with the staff's policy advice in the last Article IV consultation. They have strengthened macroprudential policies to rein in risks from the housing market. Their flexible monetary policy has been supported by fiscal policy.

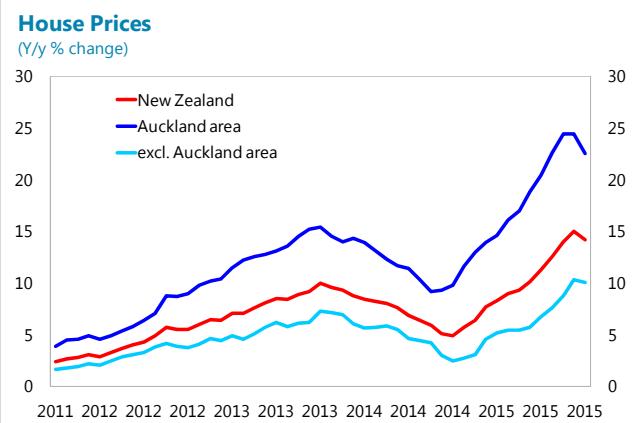
[1] GFS measure. The authorities' measure of net debt excludes, among others, assets of the New Zealand Superannuation Fund, which are projected to reach 12½ percent of GDP in 2015/16.

Box 1. Measures to Contain Auckland House Price Risks

To contain risks arising from rapidly rising house prices to the financial sector, the RBNZ has used macroprudential policy tools proactively.

First round (October 2013): The RBNZ placed a temporary 'speed limit' on high loan-to-value ratio (LVR) residential mortgage lending where banks must restrict new mortgages at LVRs over 80 percent to no more than 10 percent of their total residential mortgage lending. While house price inflation in Auckland initially moderated in response to the measures (and tighter monetary policy), it accelerated again during 2015.

Second round (May 2015): The RBNZ announced additional measures, which have taken effect in November 2015:



Sources: QV.co.nz and staff estimates.

- Residential property investors (though not owner-occupiers) in Auckland are required to have a deposit of at least 30 percent of the purchase price.
- The existing 10 percent speed limit for loans at LVRs of greater than 80 percent is retained in Auckland, while it is increased outside of Auckland from 10 to 15 percent, to reflect the more subdued housing market conditions there.
- A new asset class for loans to residential property investors has been established, which could attract a higher risk weighting than owner-occupier mortgages.

Tax measures announced in the 2015/16 budget presented in May also complemented the RBNZ's second round. They effectively apply income tax on profits from property sales for non-primary residences if the house is bought and sold within two years. The government also announced a tightening of reporting and taxation rules for foreign buyers.

OUTLOOK AND RISKS

New Zealand's flexible economy, underpinned by strong policy frameworks, is well-positioned to weather the recent slowdown and manage risks, including to financial stability. Over the medium term, raising saving remains critical to address long-standing issues associated with New Zealand's large net external liability position.

A. Outlook: Short-Term Challenges but Positive Medium-Term Prospects

8. The short-term outlook is challenging. The decline in dairy prices is still feeding through the economy, as investment and input decisions in the dairy sector continue to influence related sectors through the rest of the milk production season (until May 2016). While New Zealand's milk

production comprises less than 5 percent of GDP, its downstream and upstream footprint is estimated to be much larger.[2] On the investment side, the plateauing of reconstruction in Canterbury and a relatively slow pick-up in infrastructure and housing construction in Auckland imply that the contribution of investment demand to growth will be significantly reduced (Figure 1, panel 3). More broadly, New Zealand's main trading partners, China and Australia, have slowed, putting downward pressure on demand for and prices of New Zealand's exports.

9. House price inflation has not given rise to a general credit boom. Credit to the private sector has accelerated recently but remains moderate at 7.1 percent in the year to November, with both housing loans and business credit growing at similar rates (Figure 2, panel 6). Going forward, house price growth is projected to moderate, as the impact of tighter macroprudential and tax measures sets in. This should lead to a slowdown in housing loans and an eventual decline of the household debt-to-disposable income ratio (Box 2). At the same time, business credit is expected to pick up further as investment accelerates in the medium term, supported by accommodative monetary policy and a recovery in domestic-currency export prices.

10. Fiscal policy is supportive of the economy in the short term, while consolidation is projected to resume in the medium term. In 2015/16 and 2016/17, weaker revenue growth and higher public investment are expected to return the budget to deficit (of about ½ percent of GDP each year), providing significant stimulus to the economy. In the medium term, the authorities' fiscal plans envisage significant expenditure control through improvements in the efficiency of recurrent as well as capital spending, while maintaining revenue broadly constant as a share of GDP. In 2017/18, the budget is projected to be broadly in balance, and from 2018/19 in surplus which gradually increase to about 1 percent of GDP. Net debt is forecast to decline to about 5½ percent of GDP by 2019/20.

11. New Zealand's economy is resilient and its financial sector sound. Business and consumer confidence indicators have recently picked up again, and consumption remains solid and net immigration strong.

- *The flexible exchange rate provides an important buffer.* The depreciation of the NZ dollar is cushioning some of the impact of dairy price declines, and supports exports of education and tourism services, which constitute around one-fifth of total exports and continue to grow rapidly, as well as manufacturing.
- *In the agricultural sector,* farmers are well-experienced and can employ a range of measures (e.g., delaying capital expenditure, using cheaper feed, reducing labor costs, culling cows) to adapt to lower prices, and banks continue to support the sector, taking a medium-term approach to borrower's viability.

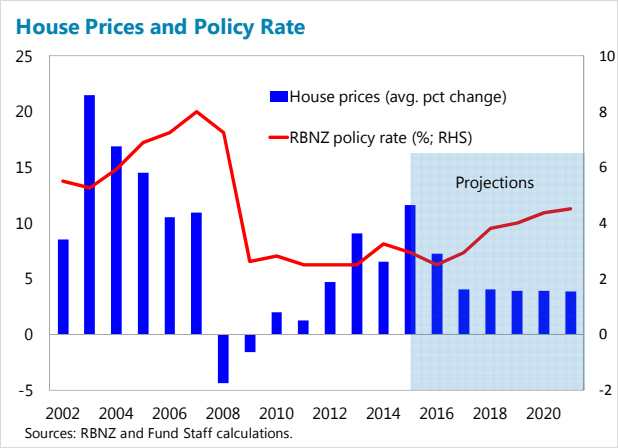
[2] 17 percent of GDP according to a BusinessNZ estimate.

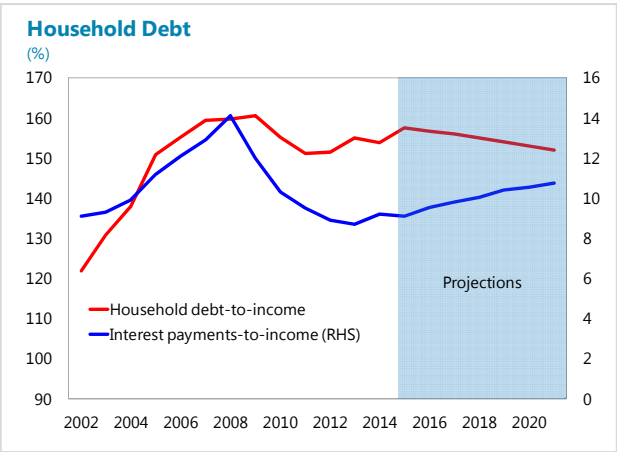
Box 2. Macro-Financial Outlook and Risks

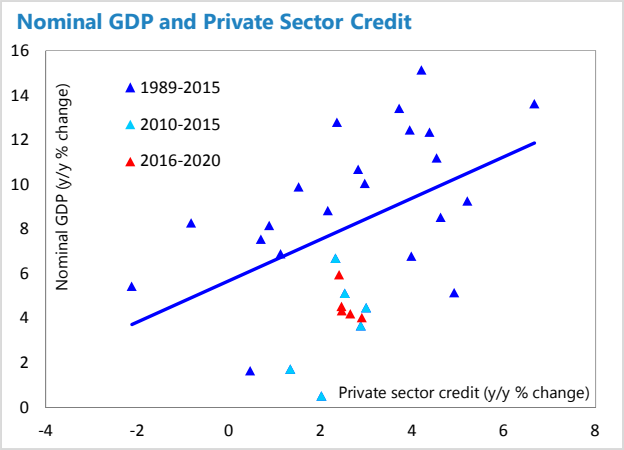
The housing sector is central in assessing New Zealand's outlook and risks, considering risks stemming from high price inflation in Auckland, high concentration of mortgage loans in banks' asset books, and high levels of household debt. Staff's analysis, using a model of house prices based on economic fundamentals, suggests that house prices and household debt are to moderate over the medium term, containing financial sector risks in the baseline scenario.

Banking sector assets are around 180 percent of GDP,household debt is high, and much of household wealth is in housing. However, based on medium-term fundamentals, house price growth is likely to moderate, along with mortgage credit growth and the level of household debt (see also Tables 1 and 4).

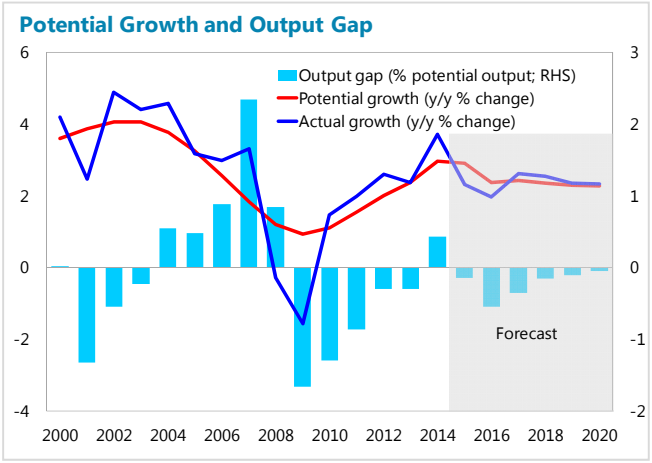
- *House prices.* The baseline projection is for a soft landing supported by effective macroprudential measures and tax policies, with house price inflation slowing to a sustainable 3-4 percent, based on medium-term fundamentals (interest rates, working-age population, and per capita income).
- *Household debt.* Projected increases in house prices would further raise nominal household debt, but income growth should gather pace, resulting in the debt-to-disposable income ratio—which stood at 154 percent in 2014—initially rising further before falling gradually.
- *Household interest payments.* The interest payments-to-income ratio is currently at historic lows. With RBNZ policy interest rates rising in the medium term, the household interest payment burden as a share of income is projected to rise, gradually approaching historical averages.
- *Credit to the private sector* is assumed to grow as a weighted average of house price increases and business investment (broadly in line with recent historical patterns). This results in slightly slowing growth, and overall credit should remain broadly stable as a ratio of GDP. However, combined with deposits staying broadly constant as a share of GDP, this results in no significant reduction in banks' use of wholesale funding.







- *Banks remain well capitalized* and stress tests indicate hat the sector can withstand a sizeable shock to house prices, the terms of trade, and economic activity (Box 3). They have also reduced their reliance on foreign sources of funding.



12. Medium-term prospects remain positive. Under the baseline scenario, dairy prices are expected to stabilize going forward at the current level. While the Chinese economy as a whole is expected to slow down, New Zealand's main exports—agricultural consumer products and tourism—should benefit from the ongoing shift to a more consumption-oriented growth model in China. Consumer demand in other Asian countries is also expected to grow along with their income levels, and net exports to benefit from the weaker exchange rate. Overall, while output growth is estimated to have slowed to 2¼ percent in 2015, slightly below potential, it is projected to recover to its estimated potential rate of 2½ percent, based on total factor productivity (TFP) and capital input growth in line with long run historical averages, and moderately declining growth of labor input consistent with the projected slowing of working age population growth (with migration fluctuating in line with historical experience). With inflation expectations consistent with the midpoint of the RBNZ's target range of 1-3 percent, inflation is forecast to rise to within the band in 2016, as the impact of the decline in oil prices drops out, the depreciation of the NZ dollar passes through, and fiscal stimulus is adding to demand, and then gradually converge to the center of the band.

B. Risks: Tilted to the Downside

13. While overall prospects are positive, risks are significant and tilted to the downside (Annex II).

- *Dairy prices.* A renewed decline in dairy prices could threaten some higher-cost dairy producers. While New Zealand's dairy sector as a whole has coped with significant price swings in the past, debt in the sector is concentrated among a relatively small group of farms. At the end of the 2013–14 season, 10 percent of farms accounted for around one-third of the total sectoral debt and these may constitute a pocket of vulnerability. The impact of this on financial stability, however, would likely be limited.
- *China spillovers.* A sharper-than-expected slowdown in China that significantly affects consumer spending could reduce New Zealand's exports and may lead to the exit of some farmers and attendant repercussions on the financial sector. In addition, it would also likely adversely affect Australia, New Zealand's second-largest destination for exports.

- *El Niño*. The El Niño weather pattern is well entrenched. While irrigation is spreading, some agricultural areas are reliant on rainfall. Should a drought occur there, agricultural output could be significantly affected.
- *House prices*. If the authorities' measures fail to cool house price inflation in Auckland, the housing market could be increasingly driven by self-reinforcing demand dynamics which could eventually lead to a sudden sharp correction in house prices, with adverse effects on the financial sector (residential mortgages represent about 50-60 percent of banks' assets) and the wider economy. High levels of household debt—with a large share of mortgages carrying adjustable rates—also imply that a rise in interest rates could strain their ability to service debts, squeeze disposable income and consumption, and trigger declines in house prices.
- *Financial market volatility*. U.S. monetary policy normalization may lead to unexpected bouts of higher global financial market volatility. This could lead to an abrupt depreciation, higher financing costs and/or a period of very poor liquidity in international financial markets.

14. There are also upside risks. A stronger-than-anticipated supply response to housing demand could pave the way for a smoother deceleration of house price inflation while supporting growth, and a recovery in dairy prices would boost incomes and investment. Continued high net immigration could pose challenges for short-term economic management, but in the longer run would boost growth.

15. There is ample policy space to respond. Should downside risks materialize, the RBNZ has scope to ease interest rates further. The low level of public debt would allow even more supportive fiscal policy if warranted. The flexible exchange rate provides an important buffer, and the financial system is less vulnerable than before the GFC. Broadly, financial system stress tests suggest it is able to withstand—at least in the short term—adverse developments related to China spillovers, dairy prices, and the housing market (Box 3), even though public support may be needed in an extreme scenario.

16. More broadly, with chronically low national saving, New Zealand's economy is dependent on borrowing from abroad. Its persistently negative saving-investment balance has led to the accumulation of a large net negative international investment (IIP) position (65 percent of GDP in 2014), and requires to a significant extent financing by bank borrowing from abroad. While the net IIP position has improved from a negative 85 percent of GDP in 2009—supported by the payouts from international reinsurers after the Canterbury earthquake as well as strong deposit growth—this still renders the economy susceptible to swings in international financial markets (even though foreign exchange exposures are mostly hedged or in domestic currency), and is estimated to lead to higher capital costs.

Authorities' Views

17. The authorities broadly concurred with the staff's assessment of the outlook and risks, though they viewed risks as more balanced. They emphasized that at the current juncture the

degree of uncertainty, including with regard to dairy prices, immigration, and the impact of El Niño was unusually high.

- *Dairy prices:* the authorities noted that dairy markets had a history of volatility. They stressed, however, that the dairy industry has gone through rounds of structural changes coping with the volatility, and has become more competitive and resilient, with increasingly professional management and new investment.
- *Immigration:* they noted that the current situation, in which net emigration to Australia was at an all-time low, was unusual, and that they expected it to pick up as growth in Australia rebounds. However, should high net immigration continue, this would support growth in the longer run even if it posed challenges—notably by increasing pressure in the housing market—in the short run.
- *El Niño:* the authorities indicated that the El Niño weather pattern was well established, but its impact as yet uncertain. The spread of irrigation had reduced the risk associated with drought.

Box 3. Stress Testing the New Zealand Financial Sector

Over the past years, the RBNZ has conducted regular stress tests of the New Zealand banking system, focused on housing price busts, interest rate spikes and a protracted decline in dairy prices. The Australian Prudential Regulatory Authority collaborated on the subsidiaries of Australian banks, which play dominant roles in New Zealand.

House price bust and interest rate spike. In the house price decline scenario, a sharp slowdown in economic growth in China triggers a severe double-dip recession. Real GDP declines by around 4 percent, and unemployment peaks at just over 13 percent. House prices decline by 40 percent nationally, with a more marked fall in Auckland. The agricultural sector is also hit by a combination of a 40 percent fall in land prices and a 33 percent fall in commodity prices. The RBNZ also considered a scenario where the interest rate is sharply higher, resulting in increased unemployment and higher borrowing costs.

In these scenarios banks face higher funding costs and credit losses, with a significant adverse impact on profitability and capital ratios. Losses on residential mortgages account for around one-third of total credit losses. The aggregate Common Equity Tier 1 (CET1) ratio falls by around 3 percentage points though all banks remain above the minimum CET1 capital requirement of 4.5 percent. Losses are greater than the capital held for housing for the internal ratings based risk weight banks and almost all banks would use capital conservation buffers and face constraints on dividend and bonus payouts. Even though CET1 requirements are not breached, it is unlikely that New Zealand would have a fully-functioning banking system as banks with substantially reduced capital ratios would be severely constrained in their ability to raise funding (both in availability and pricing), and hence in their ability to advance credit. In such a scenario, the lower credit extended by banks would also have an adverse impact on real GDP growth and would likely lead to higher fiscal deficits.

Low dairy prices. In the stress scenarios, milk prices are substantially below recent averages and farm gate prices are assumed to fall by around 40 percent by 2018-19. This will result in higher loss rates, estimated around 2-14 percent of all dairy lending. The banks would incur losses amounting to 2-18 percent of pre-tax profits, highlighting the need for increased provisioning, but the impact would be manageable from a financial stability perspective.

- *House prices:* they pointed to stress tests that suggested banks would be able to withstand a severe shock to house prices, output, and dairy prices, but noted that in a severe scenario credit supply could become constrained.
- *Financial market volatility:* while acknowledging the risks, the authorities noted that New Zealand's banking system had weathered the GFC relatively well, and stressed that capital ratios have improved and the use of wholesale funding was significantly reduced since then.

18. The authorities broadly shared the staff's assessment of longer-term vulnerabilities and higher capital costs arising from low saving. While they pointed out that this is a long-standing feature of the economy and that net external liabilities had been reduced substantially after the GFC, they shared the staff's concerns and indicated that they would consider measures to raise savings.

POLICIES

Monetary and fiscal policy settings are broadly appropriate. Automatic stabilizers have been allowed to operate, and public investment is accelerated where possible. Prudential and tax measures should be used to increase the maneuvering room for monetary policy. In the medium term, steps to raise national savings, boost productive investment, and further strengthen the financial sector should be considered.

A. Short-Term Macroeconomic and Risk Management

19. A strong public sector balance sheet ultimately underpins confidence in New Zealand's economy. In this regard, while public debt is already low (Annex III), the authorities' planned medium-term fiscal consolidation path is broadly appropriate, envisaging an improvement of the cyclically adjusted balance by about 1/3 percent of GDP annually from 2016/17 onward over the next few years. However, in the short run, with the economy below potential and ample fiscal policy space, the authorities' planned fiscal stimulus through automatic stabilizers and increased public investment is timely. In particular, investments to support a boost in housing supply in Auckland, and infrastructure improvements to address bottlenecks would also help ease house price inflation, and improve the productivity of the economy. This should be facilitated by the recently completed national 30-year infrastructure investment plan, which provides a strategic framework for infrastructure investment decisions.

20. Monetary policy should focus on price stability while paying due regard to economic growth. With the below-potential growth, measures of core inflation around the lower end of the target band, and a still strong exchange rate, the RBNZ's recent easing and its continued readiness to ease further are appropriate. Using monetary policy to 'lean against the wind' could be considered as part of a broader strategy to rein in financial stability risks only if financial stability risks become broad based and prudential policy is insufficient to contain them. Even in this case, the benefits would need to be weighed against the output costs and the risk of policy reversals, though further prudential and tax measures to reduce incentives to invest in housing could ease these trade-offs.

21. For monetary policy to be able to focus on the real economic cycle, the risks arising from further house price inflation in Auckland need to be managed through other policy measures. The underlying issue is a supply/demand mismatch. Intensifying efforts already underway to boost higher-density housing, and increase the supply of land and infrastructure in the city would be welcome, including through better local/central government coordination and measures to discourage land hoarding (which could include higher land taxes), but even then the supply response will be slow. Therefore, in the interim, to buy time, other measures can usefully be employed:

- *Prudential measures:* Housing market risks are serious, and need to be proactively addressed. While the impact of the newly introduced macroprudential and tax measures will need to be evaluated, the authorities should prepare further steps in advance, should they be needed. This could include targeted higher risk weights on housing loans, higher down payments, and a formal debt serviceability test, as deployed in other advanced economies in the Asia-Pacific region that have experienced rapid house price growth.

- *Tax measures:* The newly introduced measures to deter speculative investment are welcome, and further steps in this direction (e.g., by widening the scope within which a resale of real estate is deemed for a business purpose and the proceeds taxable) could be envisaged. In addition, the incentives for buying real estate increase when real estate investors can write off interest payments against their other taxable income. This 'negative gearing' encourages investment that would otherwise be loss making, and thereby acts as an amplifier of price movements in the real estate market. Ring-fencing housing losses to within real estate earnings would therefore weaken an important price driver.

22. The financial system has markedly improved its capital and liquidity buffers since the GFC, but challenges remain. The major banks have a large proportion of their assets in residential mortgages and rely on broadly similar business models. Banks have continued to reduce their reliance on short-term offshore funding markets, resulting in a rise in the core funding ratio from 78 percent in 2010 to 86 percent in 2015, mainly through increased deposit funding. With regard to capitalization, all banks currently exceed Basel III capital requirements, with strong profitability. Stress tests indicate that even under very adverse scenarios, banks' CET1 capital remains above the minimum requirement. Nonetheless, a reduction in collateral values and loss absorbing capital could prompt banks to rebuild buffers, leading to reduced credit provision to the economy. To improve the resilience of the sector and reduce vulnerabilities stemming from the reliance on offshore funding, it is important to continue strengthening capital buffers and moving toward more stable sources of funding. Staff welcomes the planned review of financial sector capital levels in 2016. Moreover, the planned FSAP in 2016 will also assess financial sector resilience. Even after the recent growth in size and depth, New Zealand's capital markets remains small by international standards and the banking system continues to dominate funding for firms. Further development of both equity and bond markets, including retirement products, should remain a policy priority.

23. Should any of the risks outlined above materialize, macroeconomic policy responses would need to be adjusted. A sharp slowdown in the economy driven by key export markets could

warrant a monetary and, if severe enough, a coordinated fiscal policy response. A severe downturn in the housing market may also call for supportive demand policies. Similarly, a period of extremely low liquidity in financial markets or an excessive risk premium required by international investors could call for both monetary and fiscal support.

Authorities' Views

24. The authorities emphasized their commitment to reducing net debt. While low compared to other advanced economies, they felt that a small open economy like New Zealand needed particularly strong buffers and that the government has an important role to play given the economy's net external liabilities. While keeping its fiscal strategy unchanged, the government has updated some of its short-term intentions and long-term objectives to provide scope for the fiscal position to fluctuate in response to changing economic circumstances. The intention is to reduce net debt in national definition to around 20 percent of GDP by 2020, and to within a range of 0 to 20 percent of GDP over a longer time horizon. The authorities also emphasized their efforts to enhance the efficiency of both capital and current spending, the latter through a 'social investment' approach which takes into account costs and benefits of social policy interventions over a 20-year horizon. The authorities were ready to let automatic stabilizers—which largely work on the revenue side—operate fully, and have announced an additional NZ$1 billion of capital spending given the pipeline of high-quality investment priorities. This could help alleviate housing market and infrastructure pressures in Auckland.

25. The RBNZ reaffirmed its accommodative stance. While they expect interest rates to now be on hold for some time, they stand ready to ease further should circumstances warrant. They confirmed that monetary policy was focused on price stability, with due regard to output growth, but at the same time, they pointed to the limits of monetary policy in fine-tuning the economy. With regard to house price inflation, they indicated that they were strengthening their collection of data to enhance analysis of mortgage lending, and suggested that they would need to assess the impact of the most recent macroprudential and tax measures on the housing market and mortgage lending before deciding on possible additional measures. While pointing to stress tests indicating that banks can withstand a sizeable shock to house prices, the terms of trade, and economic activity, the authorities agreed on the importance of maintaining strong capital and stable sources of funding buffers.

B. Medium-Term Policies: Increasing Resilience and Raising Incomes

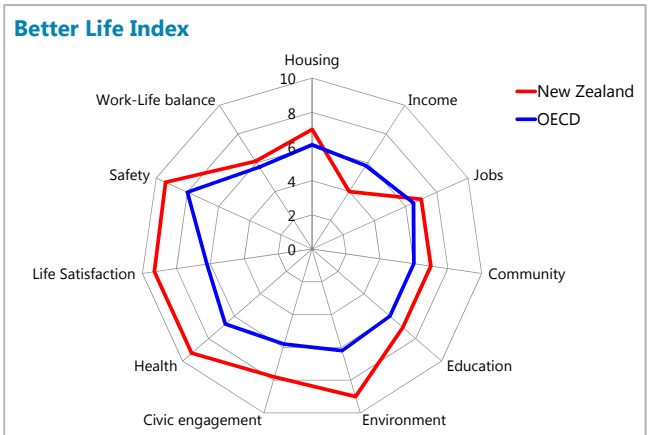
26. Raising national saving is key to reducing external vulnerabilities and raising potential growth. With government saving broadly adequate and higher than those of peers, policy measures would need to concentrate on raising private savings. Higher savings would, through lower capital costs, raise potential growth over time due to higher productive capital investment and increased TFP, and would improve the IIP, rendering the economy less susceptible to external developments.

27. Comprehensive measures to encourage long-term private financial saving should be considered. Such measures would need to be embedded in the current tax system, which

epitomizes the principle of 'broad-base low-rate' taxation, but need not be confined to tax measures. A key instrument could be modifications to the Kiwisaver scheme, which was introduced in 2007. Options include broadening coverage, changing default settings to nudge participants toward higher contributions, restricting access to funds before retirement (including for buying a first home), raising employer contributions, raising the minimum level of employee contributions, reduce taxation of contributions or returns, and promote a wider variety of financial investment options. This could also help deepen New Zealand's capital markets and broaden options for retirement planning. In addition to changes to the Kiwisaver scheme, modifications to the universal pension system could also be considered, including the introduction of a means test.

28. Incentives to invest in real estate assets should be reduced. The tax-preferred treatment of housing diverts savings into real estate assets, increasing costs for business investment. In this regard, the measures outlined above to reduce the tax advantage of real estate investment (reducing the scope for 'negative gearing' and widening the scope of applicability of income taxation on profits from property sales for non-primary residences) would also help promote financial savings.

29. New Zealand's living standard is very high but incomes lag those of other advanced economies. Its income per capita remains at the low end of advanced OECD economies. While New Zealand's small size and distance from markets likely play a role in limiting gains from trade (Box 4), there is some room to alter other structural factors to increase investment in productive capital, thereby increasing the currently low capital intensity and TFP.



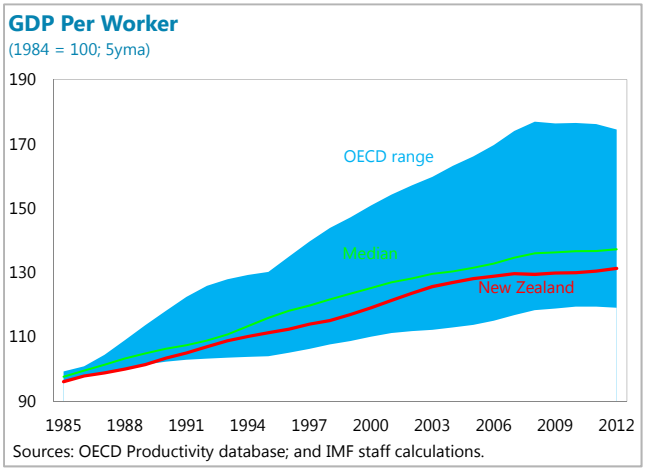
Source: OECD Better Life Index.

30. Despite the implementation of successful structural reforms in the 1980s, productivity levels have remained low compared to OECD peers. To raise productivity, the government's Business Growth Agenda has identified a number of policy priorities. Specifically, the Productivity Commission has highlighted the need to raise productivity in the services sector (which comprises 70 percent of GDP). Measures include boosting competition in key sectors such as finance, real estate, retail, and business and other professional services; and leveraging ICT technology more intensively, including by enhancing skills. With New Zealand ranked 2nd in the World Bank's 2016 Doing Business report, there is limited scope for simple measures to boost productivity, but the authorities' focus on the services sector as well as on ICT as a means to reduce the costs of distance is appropriate. Higher saving (see above) may also boost long-term growth by lowering capital costs for businesses, thus supporting higher productive investment. This would be reinforced if incentives for investing in real estate were to be reduced and options for financial savings broadened.

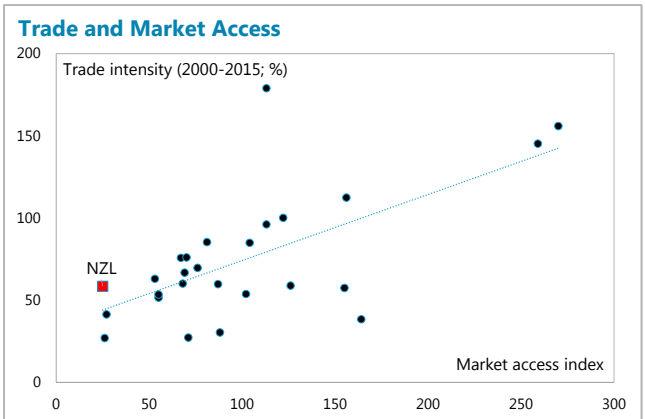
Box 4. The Impact of Distance

New Zealand's distance from markets has limited productivity, resulting in below-OECD average incomes, even though its sound institutions and policies could have made it a top performer Enhanced efforts would be needed to overcome this handicap.

From the 2000s, New Zealand has lagged behind top OECD countries in output per worker by 20–25 percent. This gap can be explained by both substantial productivity gaps and lower levels of capital. While the latter may be partly influenced by the low savings rate (and higher interest rates), the productivity gap is striking, particularly when taking into account New Zealand's sound institutional and policy settings: New Zealand's per capita should be 20 percent above the OECD average based on structural policy settings, not 20 percent below (NZPC, April 2014).1/



Sources: OECD Productivity database; and IMF staff calculations.



Sources: Baulhol and de Serres (2010) for index of market access; IMF WEO database; and IMF staff calculations. Trade intensity is defined as sum of exports and imports over nominal GDP in percent.

New Zealand's distance from markets appears to be a key factor. It could affect productivity through limits on the potential to exploit scale economies and agglomeration effects, higher transport costs, and by reducing trade intensity. These factors may explain more than half of New Zealand's productivity gap compared to 20 selected OECD countries and is estimated to cost around 12 percent of GDP relative to other developed countries (Boulhol and de Serres, 2010). 2/

Overcoming the disadvantages of distance may require enhanced efforts. Integration into global value chains in industries and services with fast-paced innovation, particularly in high-value added (and less location-dependent) aspects such as design and R&D would be required. Further easing telecom and air transport regulation may help reduce the distance disadvantage, including for service exports, for which New Zealand is relatively well positioned.

1/ New Zealand Productivity Commission: An International Perspective on the New Zealand Productivity Paradox, Working Paper 2014/01.

2/ "Have countries escaped the curse of distance?" Journal of Economic Geography 2010 (1).

Authorities' Views

32. The authorities agreed that raising national saving was an important policy objective. They indicated that they had explored this issue in depth, and would consider measures to boost private saving—without jeopardizing their solid fiscal position—in the future. They also pointed to measures already taken to reduce incentives for investing in real estate, and indicated that consideration could be given to expanding these. At the same time, they were keen to protect the integrity, simplicity and 'broad base, low rates' approach of the tax system, and were skeptical about the effectiveness of fiscal incentives. They were also concerned about transitional issues and the distributional impact of changes to the tax system, but agreed that such issues could at least partially be addressed through a comprehensive approach to reform. Moreover, they pointed out that key tax measures to significantly disincentivize investment in housing were politically difficult.

33. They concurred that raising productivity was critical. With New Zealand among the most business-friendly economies in the world, they saw little scope for 'big bang' reforms, but explained that they were advancing a broad-based Business Growth Agenda to strengthen skills and innovation, as well as investment and infrastructure, while using natural resources sustainably. They also aimed to boost exports, as a means to foster competitiveness. The authorities also saw improvements in the efficiency of both recurrent and capital public spending as a key tool to contain fiscal costs while improving outcomes.

STAFF APPRAISAL

34. Outlook. As tailwinds wane, the short-term outlook is challenging. Dairy prices have fallen from historic highs and the investment associated with the Canterbury rebuild is plateauing, while trading partner growth has slowed. However, New Zealand's resilient and flexible economy is well positioned to weather the recent slowdown. The flexible exchange rate is an important buffer to help the economy adjust. Underpinned by strong policy frameworks, medium-term prospects remain positive.

35. Risks. There are significant downside risks, including a renewed decline in dairy prices, spillovers from a sharper-than-anticipated slowdown in China, the impact of El Niño on agriculture, a sharp correction in house prices, and financial market volatility related to monetary policy normalization in the U.S. However, the well capitalized banking system, under strong RBNZ supervision, is assessed to be able to withstand severe stress scenarios, although it continues to face long-standing structural issues related to reliance on offshore funding and a large share of mortgage lending. Moreover, there is ample monetary and fiscal policy space to respond, should it become necessary.

36. Macroeconomic management. Given low inflationary pressures, output below potential, and unemployment edging up, the RBNZ' accommodative monetary stance, including its readiness to ease further if warranted, is appropriate. With regard to fiscal policy, continued strengthening of the public sector balance sheet with a firm commitment to the medium-term objective of reducing debt further should help underpin confidence in New Zealand's economy. The authorities' fiscal easing this year and next, including through an acceleration of public investment in infrastructure,

combined with a resumption of a gradual fiscal consolidation path thereafter, is broadly appropriate to support the economy in the short term while bolstering the public sector balance sheet in the longer term. If risks were to materialize, macroeconomic policies would need to be adjusted: a sharp slowdown in the economy could warrant a monetary and, if severe enough, a coordinated fiscal policy response.

37. Financial stability. Risks stemming from the housing market are serious, and staff welcomes the proactive macroprudential measures to address them. While the underlying cause of the housing market boom in Auckland is a supply/demand mismatch, self-reinforcing price dynamics may emerge and eventually lead to a sudden sharp correction in house prices, with adverse effects on the financial sector. Intensifying efforts to boost housing and the supply of land and infra-structure in the city is therefore critical. But since such measures, even if accelerated, will take time, other policy steps are needed for monetary policy to be able to focus on the real economic cycle.

- *Prudential:* While some time will be needed to fully assess the impact of the recent macroprudential and tax measures, additional steps should be prepared in advance, in case they are needed.
- *Tax measures:* The newly announced measures to strengthen the applicability of income taxation on profits from property sales are welcome, but more comprehensive steps to reduce the tax advantage of housing over other forms of investments should be considered, including by reducing the scope for 'negative gearing' and increasing taxation of land.

38. Saving and investment. Raising national saving is critical to reducing external vulnerabilities. In particular, higher private and especially household saving (which are low compared to peers) would improve the IIP. At the same time, higher saving may also reduce capital costs by lowering the risk premium and thereby support productive investment and long-term growth. Comprehensive policy measures to encourage private long-term financial saving should be actively considered, including through reform of retirement income policies. Options include changing the parameters of the Kiwisaver scheme—e.g., default settings, access to funds, contributions, and taxation—to increase coverage and contributions while containing fiscal costs, and adjustment of parameters of the public pension system. This could also help deepen New Zealand's capital markets and broaden options for retirement planning.

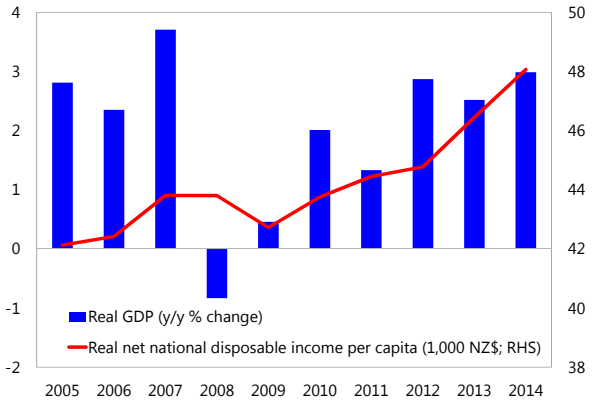
39. Productivity. Notwithstanding high living standards, New Zealand incomes lag those of other advanced economies, due to relatively low capital intensity and TFP. The economy's small size and distance from markets likely limit gains from trade, but leveraging ICT technology more intensively, including by enhancing skills, could mitigate the impact of this handicap. Moreover, measures to boost competition in key sectors such as finance, real estate, retail, and business and other professional services should help raise productivity and incomes. In addition, public investment to address key infrastructure bottlenecks should help improve productivity. These steps should effectively supplement the macro-economic measures to reduce the longstanding saving-investment imbalance described above.

40. It is recommended that the next Article IV consultation be held on the standard 12-month cycle.

Figure 1. Output and Prices

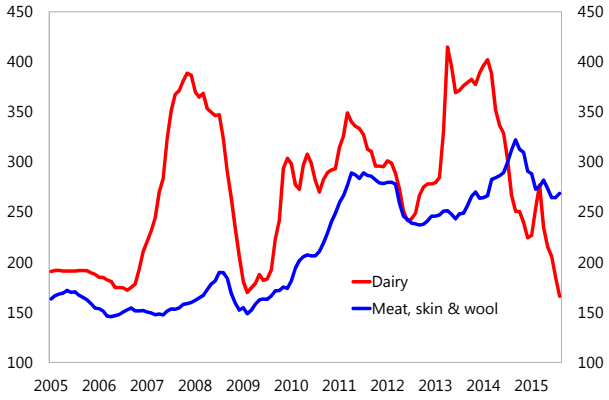
Growth has rebounded quickly after the GFC …

Growth Performance



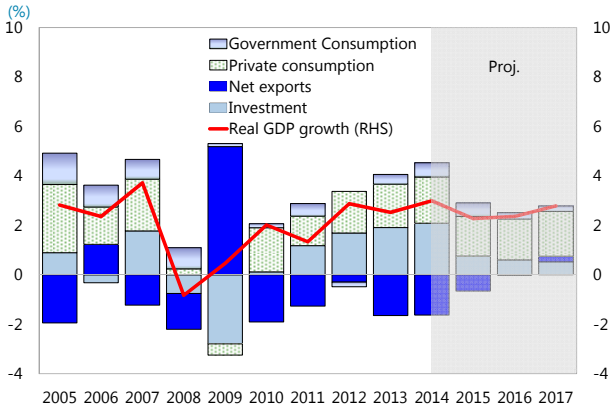
… supported by rising commodity prices …

Export Commodity Price Indices



… and reconstruction spending.

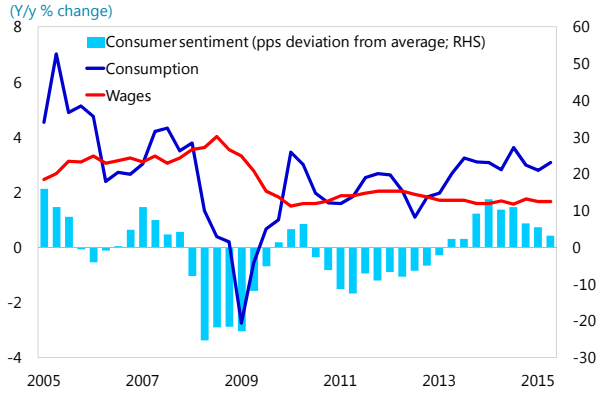
Contribution to Growth



But wage growth and consumer sentiment have declined …

Consumption and Wages

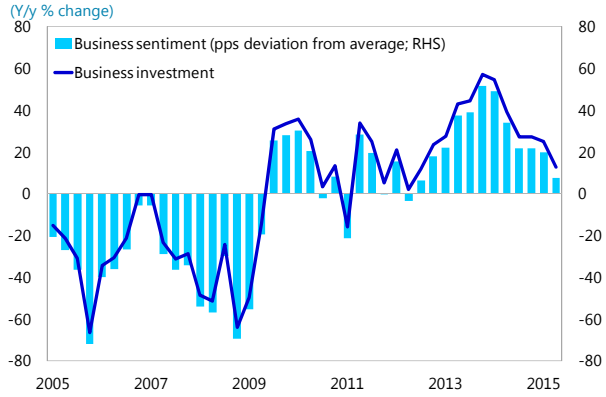
(Y/y % change)



… as has business investment …

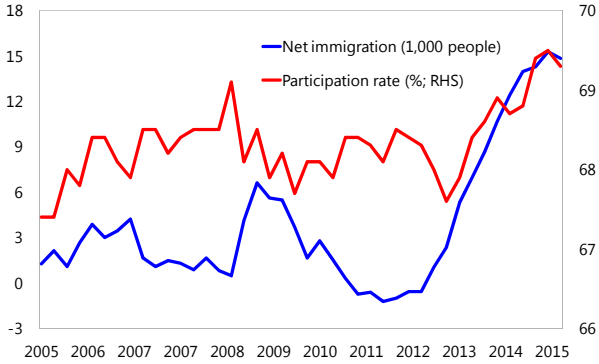
Business Sentiment and Investment

(Y/y % change)



… and labor participation and immigration are peaking.

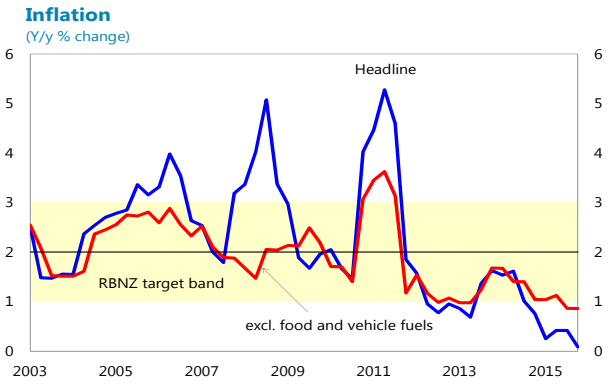
Labor Market Indicators



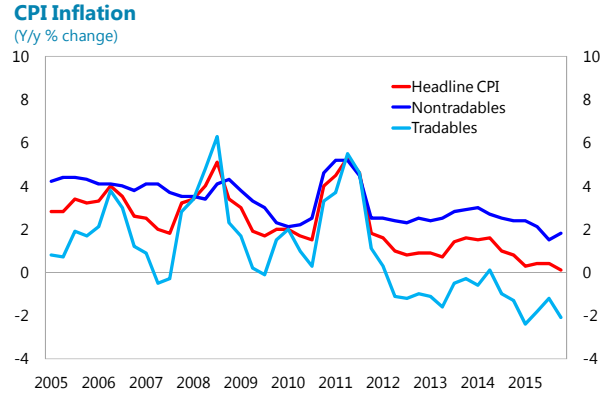
Source: Haver Analytics.

Figure 2. Considerations for Monetary Policy

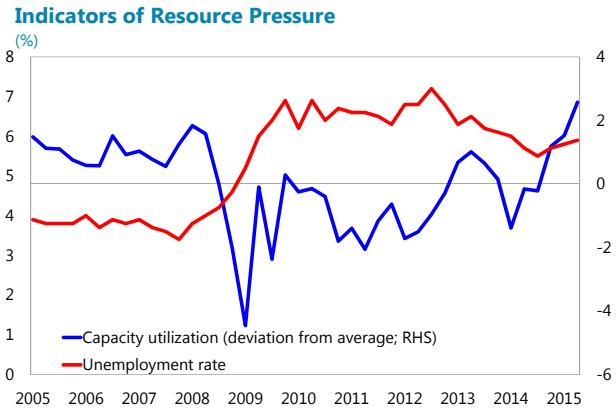
Inflation has slowed …



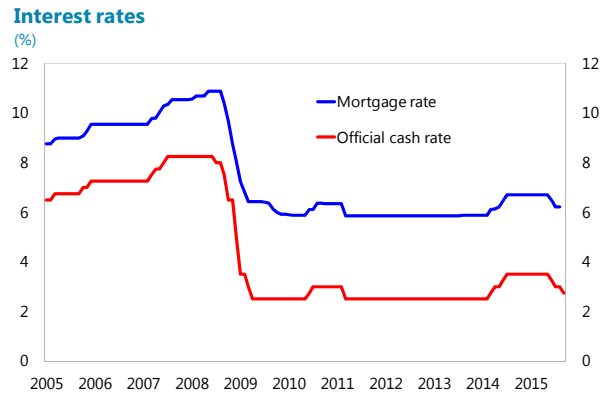
… on account of both tradables and non-tradables.



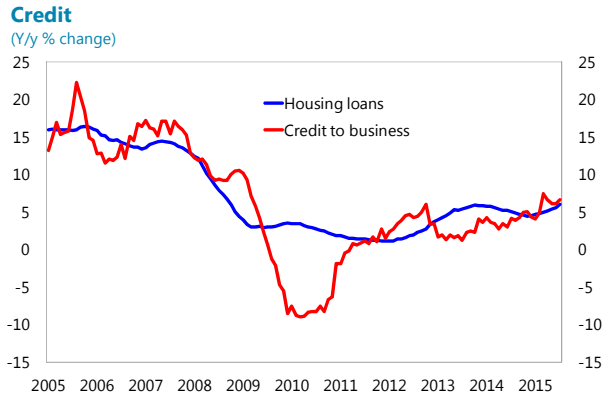
While capacity utilization is still high, unemployment is edging up …



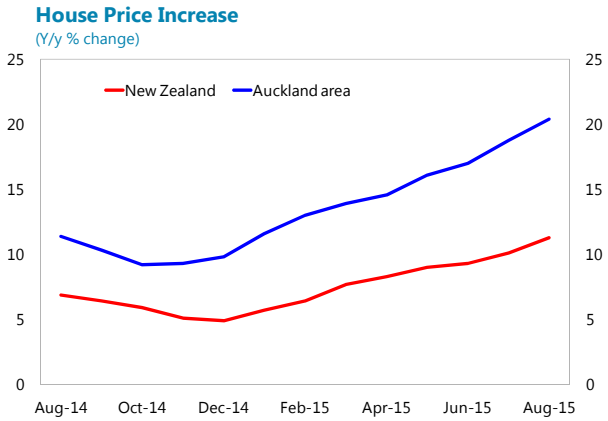
The RBNZ's easing has led to lower mortgage rates …



… while credit is picking up gradually …



… helping to fuel house price inflation in Auckland.

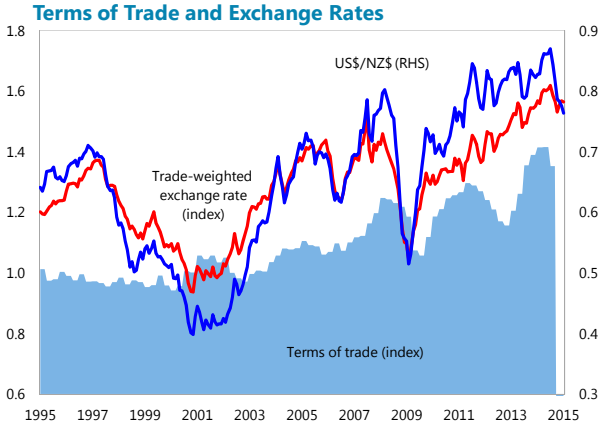


Sources: Reserve Bank of New Zealand; Haver Analytics; CoreLogic; and IMF staff estimates.

Figure 3. External Developments

The terms of trade and the exchange rate have come off their highs …

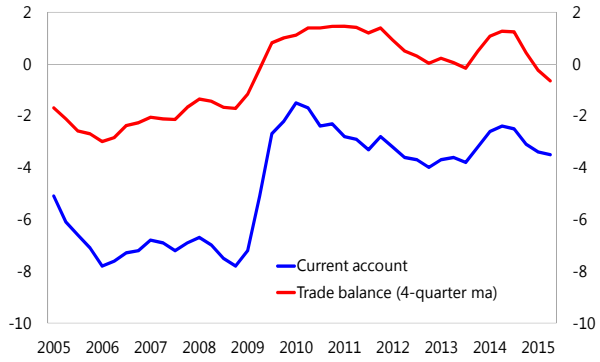
Terms of Trade and Exchange Rates



… and the current account is widening again …

Current Account

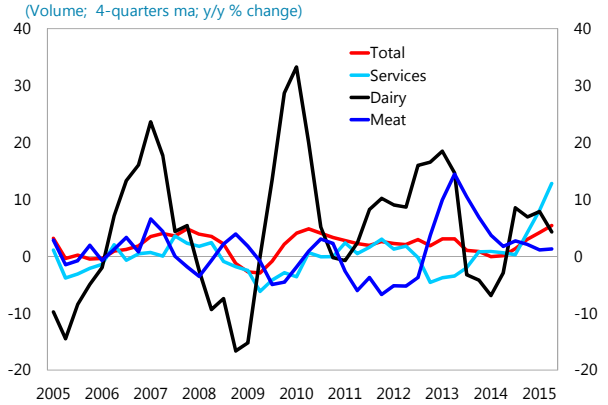
(% GDP)



… despite a sharp rise in services exports…

Export Composition

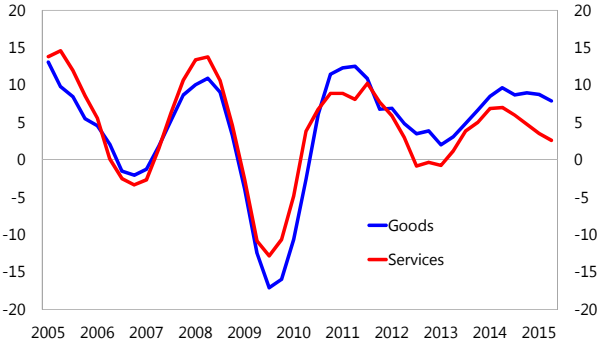
(Volume; 4-quarters ma; y/y % change)



… and a gradual slowing of imports.

Import Volume

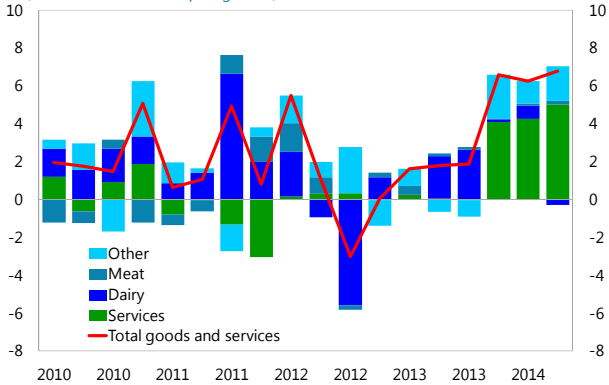
(4-quarters ma; y/y % change)



Dairy exports are highly volatile, but services are gaining in importance …

Export Composition

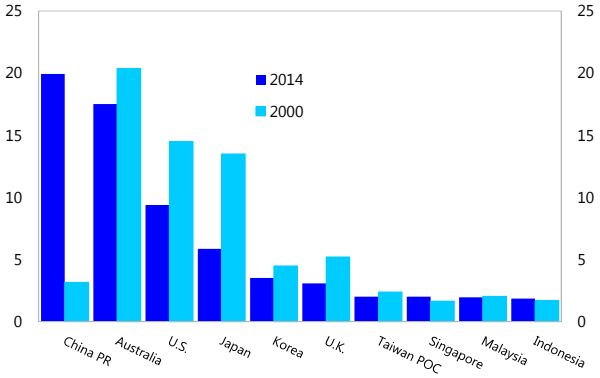
(Contribution to real export growth)



… and China has become New Zealand's largest export destination.

Export Destination

(% total)

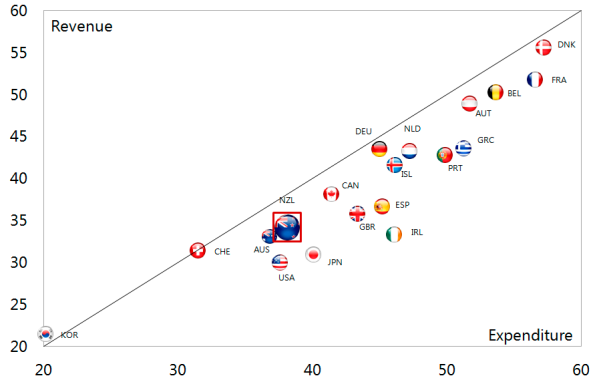


Sources: The Reserve Bank of New Zealand; Haver Analytics; and IMF staff calculations and projections.

Figure 4. Fiscal Developments

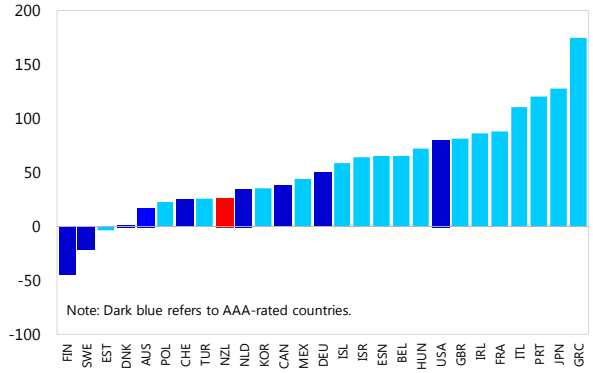
New Zealand has a relatively small government …

Revenue and Expenditure
(% GDP; average 2010-14)



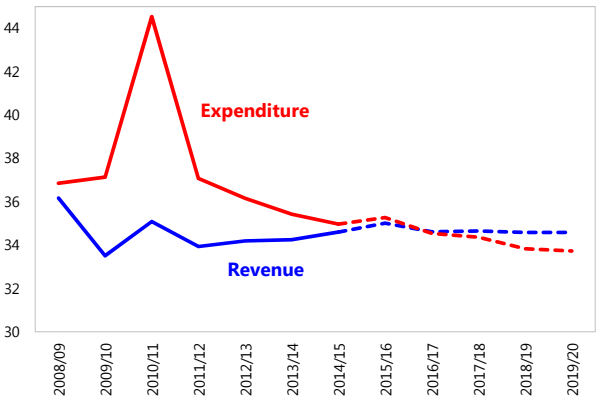
… and a low level of public debt.

Net Public Debt
(% GDP; 2014)



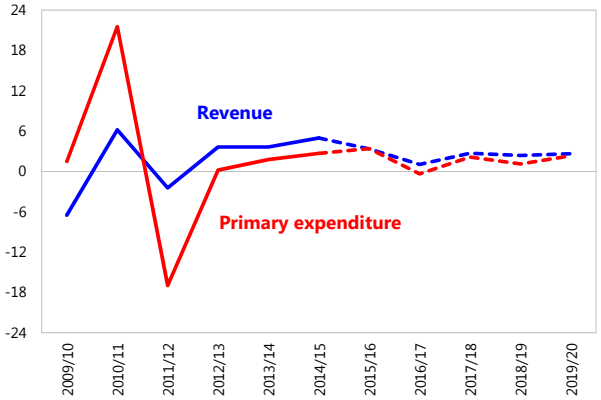
Expenditure restraint, …

Central Government Revenue and Expenditure
(% GDP)



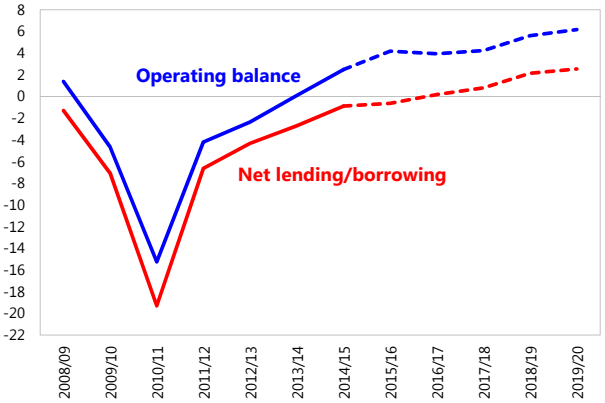
… aided by low borrowing costs…

Real Revenue and Real Primary Expenditure
(Y/y % change)



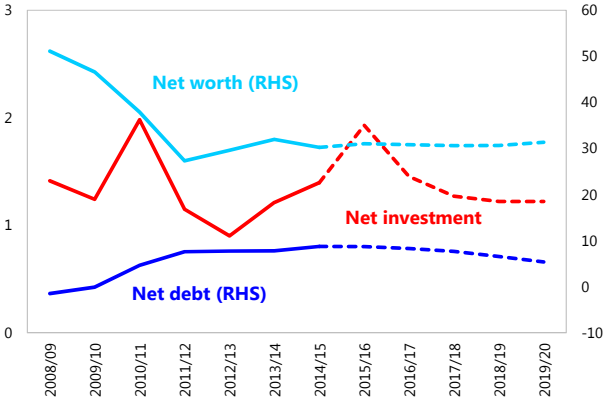
… delivers a gradual consolidation path …

Overall and Operating Balance
(% GDP)



… and a stable balance sheet.

Central Government Balance Sheet
(% GDP)



Sources: The Treasury, Budget 2015; and IMF staff estimates.

Table 1. New Zealand: Main Economic Indicators, 2010-2020

(Annual percent change, unless otherwise indicated)

	2010	2011	2012	2013	2014	2015	2016	2017	2018	2019	2020
						Projections					
NATIONAL ACCOUNTS											
Real GDP (production)	1.5	2.0	2.6	2.4	3.7	2.3	2.0	2.6	2.5	2.3	2.3
Real GDP (expenditure)	2.0	1.8	2.8	1.7	3.0	2.7	1.8	2.7	2.5	2.3	2.3
Domestic demand	3.8	3.2	3.1	3.2	4.4	2.9	2.4	2.4	2.5	2.6	2.8
Private consumption	3.1	2.6	2.8	3.0	2.7	2.4	2.6	2.8	2.9	3.0	3.0
Public consumption	0.8	2.6	-0.4	1.6	2.7	2.4	1.3	1.1	1.2	1.2	1.2
Investment	8.4	5.3	7.4	5.4	10.8	3.7	2.7	2.4	2.7	2.7	3.4
Public	2.6	0.5	-5.2	0.4	7.2	8.1	3.3	1.1	1.4	0.5	0.3
Private	-0.3	9.1	12.3	6.8	12.3	3.1	2.1	2.9	3.2	3.5	3.9
Private business	-0.8	13.2	11.8	4.2	11.2	2.0	1.5	2.6	3.0	3.5	4.1
Dwelling	0.6	0.8	13.3	12.9	14.6	5.2	3.4	3.5	3.5	3.5	3.5
Inventories (contribution to growth, percent)	1.5	-0.2	0.1	0.1	0.0	-0.1	0.0	0.0	0.0	0.0	0.1
Net exports (contribution to growth, percent)	-1.9	-1.3	-0.3	-1.6	-1.6	-0.4	-0.4	0.2	-0.1	-0.4	-0.6
Real gross domestic income	3.9	2.7	0.9	4.4	5.0	0.8	0.2	3.1	3.3	3.0	2.8
Investment (percent of GDP)	20.2	20.3	21.2	21.4	22.5	22.8	22.9	22.5	22.1	21.7	21.5
Public	6.2	6.0	5.5	5.3	5.4	5.7	5.8	5.6	5.4	5.2	5.0
Private	13.4	14.0	15.3	15.6	16.7	16.8	16.8	16.6	16.4	16.2	16.1
Savings (gross, percent of GDP)	24.6	19.9	17.5	19.3	19.4	18.2	16.3	16.3	16.6	16.5	16.2
Public	-0.1	-0.3	0.6	0.2	-0.1	0.1	-0.6	-0.3	0.2	0.8	0.8
Private	24.7	20.2	16.9	19.1	19.5	18.0	16.9	16.7	16.4	15.7	15.4
Potential output	1.1	1.5	2.0	2.4	3.0	2.9	2.4	2.4	2.3	2.3	2.3
Output gap (percent of potential)	-1.3	-0.9	-0.3	-0.3	0.4	-0.1	-0.5	-0.4	-0.2	-0.1	0.0
LABOR MARKET											
Employment	0.5	1.5	0.2	1.6	3.5	2.1	1.4	1.3	1.2	1.0	1.0
Unemployment (percent of labor force)	6.6	6.5	6.9	6.2	5.8	5.9	5.9	5.8	5.8	5.7	5.5
Wages (nominal percent change)	1.2	2.9	3.0	2.4	2.5	2.1	2.0	2.3	2.3	2.3	2.4
PRICES											
Terms of trade index (goods, % change)	8.8	3.9	-6.3	8.5	5.7	-7.0	-5.4	1.1	2.3	2.0	1.4
Consumer prices (avg, % change)	2.3	4.0	1.1	1.1	1.2	0.3	1.7	1.9	2.0	2.0	2.0
GDP deflator (avg, % change)	3.5	2.8	0.0	2.2	1.4	0.0	0.2	1.8	1.8	2.2	2.2
MACRO-FINANCIAL											
Reserve Bank of New Zealand Policy Rate (percent, avg)	2.8	2.5	2.5	2.5	3.3	2.9	2.5	2.9	3.8	4.0	4.4
Credit to the private sector (percent change)	0.5	1.7	3.7	5.1	4.5	6.7	6.0	4.0	4.2	4.3	4.5
House prices (percent change, avg)	1.9	1.2	4.7	9.1	6.5	11.6	7.3	4.1	4.0	3.9	3.9
Interest payments (percent of disposable income)	10.3	9.5	8.9	8.7	9.2	9.1	9.5	9.8	10.1	10.4	10.5
Household savings (percent of disposable income)	4.1	3.7	2.8	2.8	2.8	2.8	2.8	2.8	2.8	2.8	2.8
Household debt (percent of disposable income)	155	151	151	155	154	158	157	156	155	154	153
CENTRAL GOVERNMENT (percent of GDP) 1/											
Revenue	34.0	33.9	33.9	33.9	34.1	35.1	35.6	35.4	35.3	35.4	35.5
Expenditure	40.5	40.1	36.4	35.5	34.3	35.0	36.2	35.7	35.1	34.6	34.8
Net lending/borrowing	-6.5	-6.1	-2.5	-1.5	-0.1	0.1	-0.6	-0.3	0.2	0.8	0.8
Operating balance	-4.9	-4.6	-1.5	-0.5	0.7	1.3	1.3	1.3	1.6	2.0	1.9
Cyclically adjusted balance	-5.6	-5.2	-1.6	-0.8	0.5	0.6	-0.1	0.2	0.7	1.2	1.2
Gross debt	26.9	31.5	32.0	30.8	30.8	30.8	31.3	30.6	28.3	27.0	26.1
Net debt	2.3	6.1	7.6	7.7	7.6	7.7	8.1	8.1	7.5	6.4	5.3
Net worth	41.8	32.0	28.3	30.5	33.4	35.5	36.1	35.9	35.6	35.8	36.1
BALANCE OF PAYMENTS											
Current account (percent of GDP)	-2.3	-2.8	-3.9	-3.2	-3.1	-4.8	-6.7	-6.2	-5.5	-5.3	-5.4
Export volume	3.3	2.6	1.9	0.8	3.0	5.5	2.2	3.0	3.0	2.4	2.4
Import volume	10.8	7.0	2.8	6.2	7.9	6.0	3.3	2.1	2.9	3.4	3.8
Net international investment position (percent of GDP)	-71.8	-69.1	-69.5	-64.5	-64.6	-65.4	-70.7	-73.9	-76.3	-78.2	-80.2
Gross official reserves (bn US$)	16.4	17.2	17.7	16.5	15.8	17.6	...	...	...	...	...
MEMORANDUM ITEMS											
Nominal GDP (bn NZ$)	202	211	217	227	238	244	249	260	272	284	297
Percent change	5.0	4.8	2.5	4.6	5.1	2.3	2.1	4.5	4.4	4.6	4.6
Nominal GDP per capita (US$)	33,227	37,976	39,659	41,541	43,458	36,780	35,081	36,209	37,160	38,405	39,705
Real gross national disposable income per capita (NZ$)	43,374	44,210	44,542	46,016	47,349	47,553	47,301	48,282	49,443	50,489	51,453
Percent change	2.6	1.9	0.8	3.3	2.9	0.4	-0.5	2.1	2.4	2.1	1.9
Population (million)	4.3	4.4	4.4	4.4	4.5	4.6	4.6	4.7	4.7	4.7	4.8
US$/NZ$ (average level)	0.6	0.7	0.8	0.8	0.8	...	...	...	...	...	...
Nominal effective exchange rate	100	103	108	112	117	...	...	...	...	...	...
Real effective exchange rate	100	104	108	111	115	...	...	...	...	...	...

Sources: Authorities' data and IMF staff estimates and projections.

1/ Calendar year.

Table 2. New Zealand: Fiscal Accounts, 2009/10 – 2019/20

In percent of GDP, unless otherwise indicated)

	2009/10	2010/11	2011/12	2012/13	2013/14	2014/15	2015/16	2016/17	2017/18	2018/19	2019/20
							Projections				
CENTRAL GOVERNMENT 2/											
Revenue	**33.5**	**35.1**	**33.9**	**34.2**	**34.3**	**34.9**	**35.1**	**35.0**	**34.7**	**34.7**	**34.9**
Tax revenue	26.9	26.4	27.4	28.0	28.0	28.8	28.8	29.0	28.9	29.1	29.4
Direct taxes	17.3	16.1	16.8	17.4	17.4	18.6	18.5	18.5	18.6	18.9	19.2
Individual and withholding	13.1	11.9	11.9	12.3	12.4	13.1	13.1	13.2	13.0	13.1	13.2
Corporate	4.2	4.1	4.8	5.1	5.0	5.5	5.4	5.4	5.6	5.9	6.0
Indirect taxes	9.6	10.3	10.6	10.5	10.6	10.2	10.4	10.5	10.3	10.2	10.1
Of which: GST	6.2	6.9	7.2	7.2	7.2	7.6	7.7	7.8	7.7	7.7	7.7
Non-tax revenue	6.6	8.6	6.5	6.2	6.3	6.2	6.3	6.0	5.8	5.6	5.5
Expenditure	**37.1**	**44.5**	**37.1**	**36.2**	**35.4**	**34.1**	**35.7**	**35.5**	**34.8**	**34.2**	**33.9**
Expense	35.9	42.6	35.9	35.3	34.2	33.5	33.8	33.7	33.4	32.9	32.8
Employee expenses	9.2	9.1	9.1	8.9	8.7	8.6	8.8	8.5	8.1	7.8	7.5
Other operating expenses (excl. depreciation)	4.2	4.2	4.1	4.3	4.2	4.2	4.2	4.2	4.2	4.3	4.3
Social benefits	15.8	15.7	15.3	14.8	14.5	14.2	14.3	14.5	14.3	14.2	14.2
Other transfers	4.1	10.6	4.5	4.4	4.0	2.9	3.0	3.0	3.0	2.9	2.9
Interest	1.3	1.6	1.7	1.7	1.5	1.5	1.4	1.5	1.5	1.5	1.4
Other	1.3	1.4	1.3	1.2	1.2	2.1	2.1	2.0	2.3	2.3	2.4
Net acquisition of nonfinancial assets	1.2	2.0	1.1	0.9	1.2	0.6	1.8	1.8	1.4	1.3	1.1
Of which: Gross fixed capital formation	2.5	3.0	2.2	2.0	2.1	1.5	2.9	2.5	2.1	1.9	1.7
Operating balance	-2.4	-7.5	-2.0	-1.1	0.0	1.4	1.3	1.3	1.3	1.8	2.1
Primary balance	-2.3	-7.9	-1.4	-0.3	0.4	2.3	0.8	1.0	1.4	2.0	2.4
Net lending (+)/borrowing (-)	**-3.6**	**-9.5**	**-3.1**	**-2.0**	**-1.2**	**0.8**	**-0.6**	**-0.5**	**-0.1**	**0.6**	**1.0**
CENTRAL GOVERNMENT BALANCE SHEET 2/											
Liabilities	**50**	**64**	**68**	**63**	**60**	**59**	**57**	**56**	**53**	**51**	**49**
Gross debt	23	31	33	31	31	31	30	31	29	27	26
Other liabilities	27	33	35	32	29	28	27	25	24	24	23
Assets	**97**	**102**	**95**	**92**	**92**	**95**	**92**	**92**	**88**	**86**	**85**
Financial assets	60	66	60	58	56	58	55	55	51	49	48
Debt relevant	23	26	26	23	23	24	22	23	21	20	21
Other	36	40	34	34	33	35	33	31	30	29	28
Other assets	37	36	35	35	36	37	37	38	37	37	36
Net financial worth	**9.4**	**2.0**	**-8.2**	**-5.3**	**-3.7**	**-1.0**	**-2.0**	**-2.0**	**-2.3**	**-2.1**	**-1.1**
Net debt	**0**	**4.7**	**7.6**	**7.7**	**7.8**	**7.5**	**7.9**	**8.1**	**7.8**	**6.9**	**5.6**
Net worth	**46**	**38**	**27**	**30**	**32**	**36**	**35**	**36**	**35**	**35**	**35**
MEMORANDUM ITEMS											
Cyclically adjusted balance (percent of potential GDP)	-3.0	-8.8	-2.9	-1.8	-0.7	0.8	-0.4	-0.3	0.0	0.6	1.0
Change in real revenue (percent)	-6.5	6.2	-2.5	3.6	3.6	6.0	2.7	2.0	1.7	2.7	3.1
Change in real primary expenditure (percent)	1.5	21.5	-17.0	0.2	1.8	0.0	7.4	1.5	0.6	0.7	1.9
New Zealand Superannuation Fund											
Budget transfers (+ = receipts)	0	0	0	0	0	0	0	0	0	0	0
Net assets	8	9	9	10	11	12	12	13	13	13	13
Contributed capital	8	7	7	7	6	6	6	6	6	5	5
Local governments											
Revenue	4.2	4.1	4.2	4.1	4.1	4.1	4.2	4.2	4.2	4.2	4.2
Expenditure	4.6	4.4	4.4	4.6	4.6	4.4	4.3	4.2	4.2	4.2	4.2
Net lending (+)/borrowing (-)	-0.5	-0.4	-0.2	-0.5	-0.5	-0.3	-0.1	0.0	0.0	0.0	0.0
Net debt	2	2	3	3	3	3	3	3	3	3	3
Net worth	48	48	47	46	45	43	43	42	40	39	38
GDP (in billion NZ$)	**197**	**206**	**214**	**222**	**230**	**241**	**246**	**255**	**266**	**278**	**291**

Sources: Authorities' data and IMF staff estimates and projections.

1/ The fiscal year runs from July to June.

2/ Accrual basis; GFS. Comprises Core Crown (excl. Reserve Bank of New Zealand) and Crown entities. Includes New Zealand Superannuation Fund.

Table 3. New Zealand: Balance of Payments, 2010-2020

(In percent of GDP, unless otherwise indicated)

	2010	2011	2012	2013	2014	2015	2016	2017	2018	2019	2020
						Projections					
BALANCE OF PAYMENTS											
(% GDP)											
Current account	-2.3	-2.8	-3.9	-3.2	-3.1	-4.8	-6.7	-6.2	-5.5	-5.3	-5.4
Balance on goods and services	2.3	2.1	0.5	1.0	1.1	-0.9	-2.9	-2.2	-1.4	-1.0	-1.0
Exports of goods and services	29.8	30.8	28.9	28.6	28.5	28.3	29.0	28.9	28.8	28.2	27.6
Exports of goods	21.8	22.8	21.5	21.4	21.2	19.9	20.3	20.4	20.5	20.1	19.7
Of which: Dairy											
Exports of services	8.0	8.0	7.5	7.2	7.3	8.4	8.6	8.5	8.3	8.1	7.8
Imports of goods and services	27.4	28.7	28.5	27.6	27.4	29.2	31.8	31.0	30.1	29.2	28.6
Imports of goods	20.4	21.5	21.4	20.8	20.8	22.0	24.0	23.4	22.7	22.0	21.5
Imports of services	7.0	7.3	7.1	6.8	6.7	7.2	7.9	7.7	7.4	7.2	7.1
Primary income, net	-4.6	-4.7	-4.1	-3.9	-4.0	-3.7	-3.5	-3.8	-3.9	-4.0	-4.1
Inflows	2.9	2.9	3.1	3.1	3.2	3.5	4.4	4.9	4.9	4.9	4.9
Outflows	7.5	7.6	7.2	7.0	7.1	7.2	7.9	8.7	8.9	9.0	9.1
Secondary income, net	0.0	-0.1	-0.2	-0.2	-0.2	-0.2	-0.2	-0.2	-0.2	-0.2	-0.2
Inflows	0.7	0.6	0.6	0.6	0.7	0.8	0.5	0.6	0.5	0.5	0.5
Outflows	0.7	0.7	0.8	0.7	0.9	1.0	0.7	0.8	0.8	0.7	0.7
Capital and financial account											
Capital account, net	3.0	6.8	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Financial account, net	0.6	0.8	-3.4	0.2	-1.7	-3.5	-6.7	-6.2	-5.5	-5.3	-5.4
Direct investment	0.7	-0.2	-0.1	-0.8	0.5	0.0	0.3	0.6	0.6	0.7	0.7
Equity	0.3	-0.1	-0.1	0.5	0.0	0.2	0.2	0.4	0.4	0.4	0.4
Debt	0.4	0.0	0.0	-1.3	0.5	-0.2	0.1	0.3	0.3	0.3	0.3
Portfolio investment	1.5	0.6	2.0	3.7	5.1	1.7	1.0	2.0	2.0	2.1	2.1
Equity	1.3	-0.3	0.2	2.3	1.9	0.2	0.6	1.2	1.2	1.3	1.3
Debt	0.2	0.9	1.7	1.3	3.2	1.4	0.4	0.8	0.8	0.8	0.8
Financial derivatives	0.1	0.1	0.2	-0.3	-1.0	-0.9	0.2	0.5	0.5	0.5	0.5
Other investment	1.5	2.0	-2.2	-1.5	-1.4	1.0	0.3	0.5	0.5	0.6	0.6
Reserve assets	0.6	0.2	0.3	-0.5	-0.2	...	...	...	...	...	...
Net errors and omissions	-0.2	-3.2	0.6	3.4	1.4	1.3	0.0	0.0	0.0	0.0	0.0
BALANCE SHEET											
Net international investment position	-71.8	-69.1	-69.5	-64.5	-64.6	-65.4	-70.7	-73.9	-76.3	-78.2	-80.2
Equity, net	4.0	-0.1	-1.7	-2.0	-4.7	-3.1	-4.4	-5.2	-5.8	-6.3	-6.8
Assets	32.0	28.4	29.4	31.8	33.8	37.2	37.2	37.2	37.2	37.2	37.2
Liabilities	28.0	28.5	31.1	33.8	38.5	40.4	41.7	42.5	43.1	43.5	44.0
Debt, net	-109.7	-106.7	-101.5	-91.2	-86.5	-73.2	-77.2	-79.6	-81.4	-82.8	-84.3
Assets	17.1	17.1	18.7	18.1	22.6	48.3	48.3	48.3	48.3	48.3	48.3
Liabilities	126.8	123.8	120.2	109.3	109.1	121.5	125.5	127.9	129.7	131.1	132.6
External assets (gross)	83.1	83.2	81.8	78.6	83.1	96.5	96.5	96.5	96.5	96.5	96.5
Equity	32.0	28.4	29.4	31.8	33.8	37.2	37.2	37.2	37.2	37.2	37.2
Debt	17.1	17.1	18.7	18.1	22.6	48.3	48.3	48.3	48.3	48.3	48.3
External liabilities (gross)	154.9	152.3	151.3	143.1	147.7	161.9	167.2	170.3	172.8	174.7	176.6
Equity	28.0	28.5	31.1	33.8	38.5	40.4	41.7	42.5	43.1	43.5	44.0
Debt	126.8	123.8	120.2	109.3	109.1	121.5	125.5	127.9	129.7	131.1	132.6
Of which: NZ$ denominated	62.6	64.6	67.2	68.3	61.1	65.4	70.1	71.1	72.5	73.3	74.1
FX denominated	60.9	57.7	51.1	45.7	43.3	45.7	49.4	50.1	51.0	51.6	52.2
Short-term	49.7	48.5	47.4	40.0	35.5	39.9	41.3	42.0	42.6	43.1	43.6
MEMORANDUM ITEMS											
Gross official reserves (bn NZ$)	16.4	17.2	17.7	16.5	15.8	...	...	...	...	...	...
In months of prospective imports	4.3	4.3	4.1	3.7	3.4	...	...	...	...	...	...
In percent of short-term external debt	21.7	21.5	20.9	22.0	23.9	...	...	...	...	...	...

Sources: Authorities' data and IMF staff estimates and projections.

Table 4. New Zealand: Monetary and Financial Sector, 2014-2020

(In billion NZ$, unless otherwise indicated)

	2014	2015	2016	2017	2018	2019	2020
		Projections					
BANKING SYSTEM (M3 Institutions)							
Assets	427	443	461	481	503	526	551
Government securities and cash	23	24	24	26	27	28	29
NZ Government bonds and Treasury bills	13	14	14	15	16	16	17
NZ notes and coin	1	1	1	1	1	1	1
Claims on the Reserve Bank	9	9	9	10	10	10	11
NZL dollar claims	365	390	413	430	448	467	489
M3	14	15	16	17	18	18	19
Non-M3	341	363	385	401	417	436	455
Non-resident	10	11	12	12	13	13	14
Foreign currency claims	11	11	11	12	13	13	14
NZ resident	4	4	4	4	4	4	5
Non-resident	7	7	8	8	8	9	9
Other assets	28	29	30	31	33	34	36
Liabilities	427	443	461	481	503	526	551
Capital and reserves	32	32	34	35	37	39	40
NZL dollar funding	295	308	324	339	354	371	388
Resident	262	275	289	303	316	331	347
Non-resident	33	34	35	36	38	40	42
Foreign currency funding	74	74	75	76	80	83	87
Resident	8	8	8	9	9	9	10
Non-resident	66	66	66	67	70	74	77
Other liabilities	27	28	29	31	32	33	35
MEMORANDUM ITEMS							
Private sector credit (percent of GDP)	148	153	159	159	158	158	158
Private sector credit (percent change)	4.5	6.7	6.0	4.0	4.2	4.3	4.5
Mortgage lending	194	212	228	237	246	256	266
Mortgage lending (percent change)	4.4	9.3	7.3	4.1	4.0	3.9	3.9
Loan-to-deposit ratio (percent)	140	142	143	142	142	141	141
Nonresident funding (percent of total liabilities)	15.5	14.9	14.4	14.0	14.0	14.0	14.0
Nominal GDP	238	244	249	260	272	284	297

Sources: RBNZ and IMF staff calculations.

Table 5. New Zealand: Financial Sector Indicators, 2009-2014
(In percent of GDP, unless otherwise indicated)

	2009	2010	2011	2012	2013	2014
Interest rates (percent end-year)						
3-month T-bill	3.0	3.0	2.8	2.7	2.7	3.4
3-month T-bill, real	0.9	0.7	-1.2	1.6	1.5	2.2
Stock market index (percent change, end-year)	18.9	2.4	-1.6	24.9	16.5	17.5
Capital adequacy (in percent)						
Regulatory capital to risk-weighted assets	12.6	12.8	13.3	13.1	12.5	12.4
Tier I capital to risk-weighted assets	9.5	9.8	10.6	11.5	11.4	11.4
Asset quality (in percent)						
Nonperforming loans to total loans 1/	1.7	2.1	1.7	1.4	1.0	0.9
Asset composition (share of total)						
Agricultural	15.7	15.8	15.5	15.7	15.5	15.5
Business	24.8	24.2	24.4	24.3	24.0	24.0
Households	59.5	60.0	60.1	60.0	60.5	60.6
Of which: Housing	55.0	55.6	55.8	55.7	56.3	56.2
Profit Ratios (%)						
Return on assets	1.1	0.8	1.2	0.9	1.1	1.1
Return on equity	12.2	11.2	16.1	11.4	13.9	14.1
Net interest margin	2.0	2.2	2.3	2.2	2.2	2.4

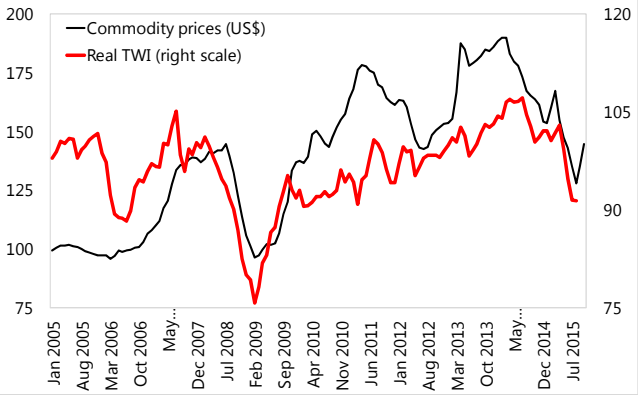
Sources: Data provided by the New Zealand authorities and IMF staff estimates.

1/ Data for 2014 are for end-June.

Annex I. New Zealand: Exchange Rate Assessment

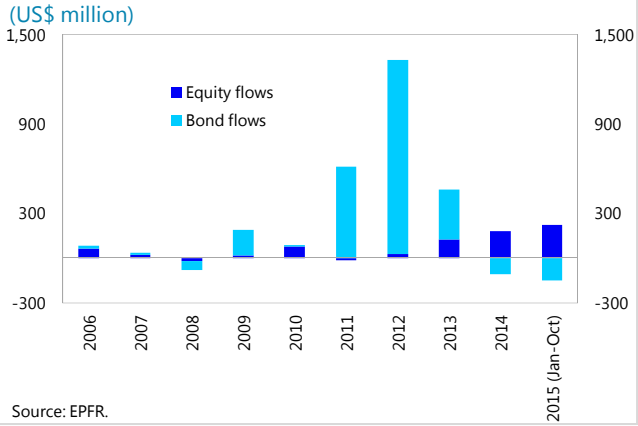
Historically, New Zealand's real exchange rate has tended to reflect movements in prices of its key commodity exports. For instance, over the commodity price cycles between February 2009 and January 2015, commodity prices rose nearly 60 percent, and the real exchange rate appreciated by 35 percent over the same period. This relationship can also be observed prior to the GFC, where the run-up in commodity prices over July 2006 – July 2007 by 35 percent, and subsequent unwinding over July 2008 – Feb 2009, was accompanied by a nearly 20 percent exchange rate appreciation, and subsequent depreciation of similar magnitude as commodity prices declined.

Exchange rate depreciation reflects sharply weaker commodity prices
(Index; 2005 = 100)



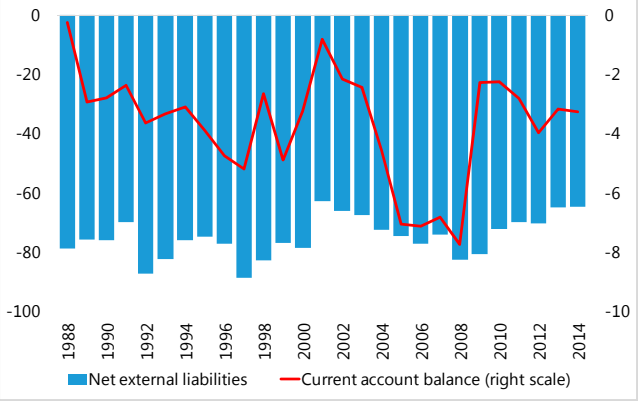
More recently, by December 2015 commodity prices, including dairy, had declined by 23 percent relative to the 2014 average, and by 20 percent since the recent peak in March 2015. Concurrently, by August 2015 the trade-weighted real exchange rate had depreciated by 13 percent compared to the 2014 average, and by 10 percent since March 2015. Among other short term factors influencing the exchange rate, equity and bond funds net inflows appear to have recovered year-to-date in 2015, after falling sharply off the peak in 2012.

Equity and Bond Funds Net Inflows
(US$ million)



Source: EPFR.

External liabilities reflect persistent current account deficits (% GDP)



New Zealand has historically had a large negative IIP position and run persistent current account deficits. This reflects a long standing structural savings-investment imbalance, with a relatively low savings rate compared to other advanced economies. The current account has been gradually widening since 2010, and hit 3¼ percent of GDP in 2014. The deficit is projected to widen to 4.8 percent of GDP in 2015 as sharply lower commodity prices weaken the goods balance. As a result, the net

foreign liabilities to GDP are expected to widen slightly from just under 65 percent in 2014 to nearly 66 percent in 2015.

Against this backdrop, the IMF's model based approaches that attempt to relate the REER to macro fundamentals and policy gaps from desired policy settings suggest that the gap between current REER level and the level implied by fundamentals may have narrowed compared to assessments of overvaluation in the range of 5-15 percent prior to the recent declines in commodity prices and exchange rates, now more in the range of 0-10 percent, though there are uncertainties around these estimates.

- The REER index regression that directly relates the REER index to medium term fundamentals and policy gaps suggests that in September 2015, the exchange rate is still about 5 percent above the value implied by fundamentals and desired policy settings. 3 percent of the gap was attributed to policy gaps, and 2 percent to regression residuals. Compared to the 2014 assessment, this shows a narrowing of the REER gap.

Table 1. EBA Exchange Rate Assessments

	2013	2014	Latest 1/
REER index regression	13%	14%	6%
Current account regression 2	5%	2%	10%
External sustainability 3/	10%	12%	7%
Commodity price index 4/	152	177	145
% change	17	-1	-17
REER index 4/	77	80	70
% change	3	3	-13

Note: figures show % deviation from level implied by fundamentals and desired policy settings. + sign indicates actual REER is stronger than the predicated level.
1/ As of September 2015.
2/ Assuming CA/GDP to REER elasticity of - 0.2.
3/ Staff estimate for 2015.
4/ Year average in 2013, 2014; latest available month in 2015.

- Similar to the REER index regression, the current account regression approach attempts to model a current account norm implied by medium term fundamentals and desired policy settings, This approach suggests the REER was above levels implied by fundamentals by between 0-10 percent[1] given a projected current account deficit wider than the estimated current account norm by around ¼ – 2¼ percent in 2015.[2]

- Finally, stabilizing net external liabilities at the projected level of 65.8 percent of GDP in 2015 would require current account deficits to average around 3¼ percent of GDP over the medium term. This suggests that the real exchange rate would have to depreciate further by about 7 percent.

Overall, the external position is assessed to be moderately weaker than the level consistent with medium term fundamentals and desirable policy settings.

[1] Based on an EBA estimate of the elasticity of the current account to the REER of -0.2 (consistent with a recent Treasury estimate in Treasury Working Paper 14/12), and a mean estimate of -0.4 as suggested by RBNZ Analytical Note AN 2012/08.

[2] The EBA estimated current account norm (deficit) in September 2015 is 1¾ percent of GDP, which appears to be low given that New Zealand has historically run current account deficits averaging 3¾ percent of GDP. A norm closer to the historical average would imply a smaller current account gap relative to the projected 2015 deficit, and a less overvalued exchange rate.

Annex II. New Zealand: Risk Assessment Matrix 1/

Source	Likelihood/ Direction	Time Horizon	Impact	Impact/Policy Response
EXTERNAL RISKS				
Sharp asset price adjustment and decompression of credit spreads				
Investors reassess underlying risk and respond to unanticipated changes in growth and financial fundamentals in large economies, Fed policy rate path, and increases in U.S. term premia, with poor market liquidity amplifying volatility.	Medium	Short term	Medium	Orderly tapering would likely beneficial for the economy, supporting a further depreciation of the exchange rate, even though the impact may be limited given asymmetric monetary policies. However, a bumpy exit from unconventional monetary policies and bouts of market volatility would likely raise the cost of New Zealand's offshore wholesale borrowing. Supportive fiscal and monetary policies may be needed.
El Niño				
El Niño-induced drought affects agricultural areas dependent on rainfall.	Medium	Short term	Low/Medium	Reduced dairy output would affect growth, though likely partially compensated by higher prices. Monetary support may be warranted
Sharper-than-expected global growth slowdown				
Structurally weak growth in key advanced and emerging economies. Easy global financial conditions coming to an end and insufficient reform progress undermine medium-term growth in emerging markets and suppress commodity prices (medium likelihood).	Medium	Medium term	Low/Medium	A broader slowdown in emerging markets, especially in the Asian region, would put pressure on New Zealand's terms of trade. However, the flexible exchange rate serves as a buffer against terms of trade shocks.
Significant China slowdown, triggered by corporate distress that propagates through shadow banks, precipitating deleveraging, uncertainty, and capital outflows. Weak domestic demand further suppresses commodity prices, roils global financial markets, and reduces global growth.	Low (short term); Medium (thereafter)	Short to medium term	Low/Medium	China is the top destination for New Zealand's exports, leaving growth prospects exposed to its economic outlook. While the effect on demand for consumer goods in China is likely limited as the economy continues to rebalance, a sharp slowdown in China would affect New Zealand directly through the terms of trade and indirectly through its impact on Australia, New Zealand's second-largest trade partner. However, the flexible exchange rate serves as a buffer against terms of trade shocks.
Upside: dairy price recovery				
A recovery in dairy prices would boost incomes.	Low	Short/Medium term	Medium	Monetary policymakers would need to carefully assess conditions before ending the current easing cycle.
DOMESTIC RISKS				
Sharp house price correction				
Self-reinforcing demand dynamics in the housing market could lead to a sudden price correction, affecting the financial system and the economy.	High	Short term	Medium/High	While there are underlying supply/demand factors that contribute to high house prices in New Zealand, a sudden price correction, especially in combination with a slowdown in the economy, could lead to a deterioration in households' ability to service mortgage debt, worsening banks' balance sheets and triggering a downward spiral of lower confidence, deteriorating balance sheets, and slowing activity. A further tightening of macroprudential and complemented by tax and supply measures would be needed to strengthen supply and rein in demand.
Upside: strong housing supply response				
Stronger administrative action leads to a decisive pickup of building consents and contruction in Auckland, leading to a gradual reduction of the supply shortage.	Low	Short/Medium term	Medium/High	Care will need to be taken not to generate a construction boom fueled by speculative behavior.

1/ The Risk Assessment Matrix (RAM) shows events that could materially alter the baseline path (the scenario most likely to materialize in the view of IMF staff). The relative likelihood is the staff's subjective assessment of the risks surrounding the baseline ("low" is meant to indicate a probability below 10 percent, "medium" a probability between 10 and 30 percent, and "high" a probability between 30 and 50 percent). The RAM reflects staff views on the source of risks and overall level of concern as of the time of discussions with the authorities. Non-mutually exclusive risks may interact and materialize jointly. "Short term" and "medium term" are meant to indicate that the risk could materialize within 1 year and 3 years, respectively.

Annex III. New Zealand: External and Fiscal Debt Sustainability Analyses

New Zealand Public Sector Debt Sustainability Analysis (DSA) - Baseline Scenario

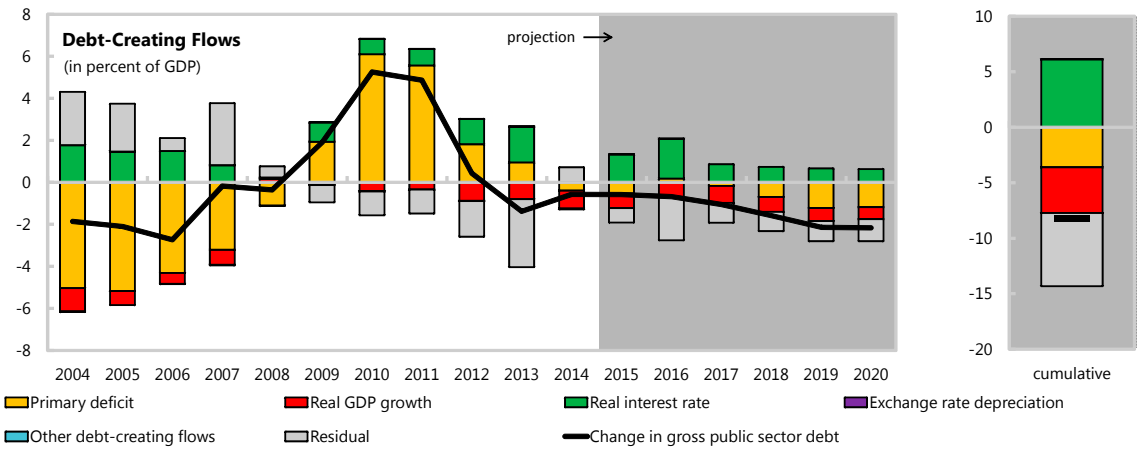
(In percent of GDP, unless otherwise indicated)

Debt, Economic and Market Indicators [1/]

	Actual			Projections						As of September 30, 2015		
	2004-2012 [2/]	2013	2014	2015	2016	2017	2018	2019	2020	Sovereign Spreads		
Nominal gross public debt	24.7	31.0	30.4	29.8	29.2	28.1	26.5	24.4	22.2	EMBIG (bp) 3/		122
Public gross financing needs	4.5	1.6	0.2	-0.1	0.5	0.4	-0.2	-0.8	-1.2	5Y CDS (bp)		121
Real GDP growth (in percent)	2.1	2.5	3.0	2.3	2.4	2.9	2.6	2.5	2.5	Ratings	Foreign	Local
Inflation (GDP deflator, in percent)	2.8	-0.1	5.1	0.4	-1.6	1.7	2.0	2.2	2.1	Moody's	Aaa	Aaa
Nominal GDP growth (in percent)	4.7	5.4	5.6	3.0	4.0	4.4	4.5	4.5	4.8	S&Ps	AA	AA+
Effective interest rate (in percent) [4/]	7.2	5.3	5.1	4.9	4.8	4.8	4.8	4.8	4.8	Fitch	AA	AA+

Contribution to Changes in Public Debt

	Actual			Projections							
	2004-2012	2013	2014	2015	2016	2017	2018	2019	2020	cumulative	debt-stabilizing primary balance [9/]
Change in gross public sector debt	0.6	-1.4	-0.6	-0.6	-0.7	-1.1	-1.6	-2.1	-2.2	-8.2	
Identified debt-creating flows	0.1	1.9	-1.3	0.1	1.4	-0.1	-0.7	-1.2	-1.1	-1.6	
Primary deficit	-0.4	0.9	-0.4	-0.5	0.2	-0.2	-0.7	-1.2	-1.2	-3.6	0.1
Primary (noninterest) revenue and grants	35.1	33.1	33.2	33.9	33.7	33.6	33.5	33.7	33.7	202.2	
Primary (noninterest) expenditure	34.7	34.1	32.9	33.4	33.9	33.4	32.9	32.5	32.6	198.6	
Automatic debt dynamics [5/]	0.5	0.9	-0.9	0.6	1.2	0.1	0.0	0.0	0.1	2.0	
Interest rate/growth differential [6/]	0.5	0.9	-0.9	0.6	1.2	0.1	0.0	0.0	0.1	2.0	
Of which: real interest rate	1.0	1.7	0.0	1.3	1.9	0.9	0.7	0.7	0.6	6.1	
Of which: real GDP growth	-0.5	-0.8	-0.9	-0.7	-0.7	-0.8	-0.7	-0.6	-0.6	-4.1	
Exchange rate depreciation [7/]	0.0	0.0	0.0	...	...	...	...	...	...	...	
Other identified debt-creating flows	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	
Net privatization proceeds (negative)	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	
Contingent liabilities	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	
Please specify (2) (e.g., ESM and Euro area loans)	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	
Residual, including asset changes [8/]	0.5	-3.2	0.7	-0.7	-2.0	-0.9	-0.9	-1.0	-1.1	-6.6	



Source: IMF staff.

1/ Public sector is defined as central government.

2/ Based on available data.

3/ Long-term bond spread over U.S. bonds.

4/ Defined as interest payments divided by debt stock (excluding guarantees) at the end of previous year.

5/ Derived as [(r - π(1+g) - g + ae(1+r)]/(1+g+π+gπ)) times previous period debt ratio, with r = interest rate; π = growth rate of GDP deflator; g = real GDP growth rate; a = share of foreign-currency denominated debt; and e = nominal exchange rate depreciation (measured by increase in local currency value of U.S. dollar).

6/ The real interest rate contribution is derived from the numerator in footnote 5 as r - π (1+g) and the real growth contribution as -g.

7/ The exchange rate contribution is derived from the numerator in footnote 5 as ae(1+r).

8/ Includes asset changes and interest revenues (if any). For projections, includes exchange rate changes during the projection period.

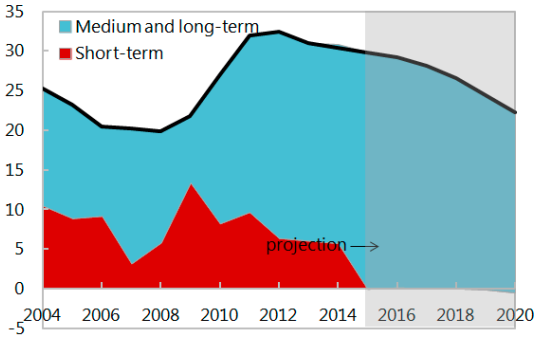
9/ Assumes that key variables (real GDP growth, real interest rate, and other identified debt-creating flows) remain at the level of the last projection year.

New Zealand Public DSA - Composition of Public Debt and Alternative Scenarios

Composition of Public Debt

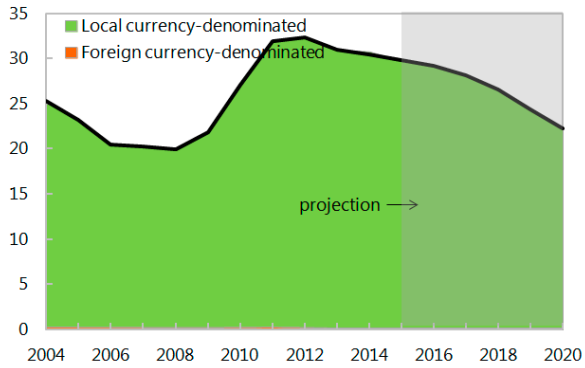
By Maturity

(in percent of GDP)



By Currency

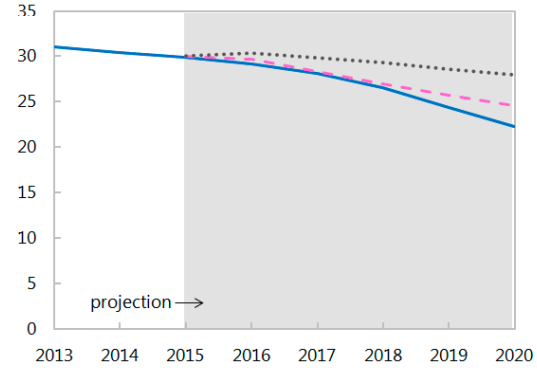
(in percent of GDP)



Alternative Scenarios

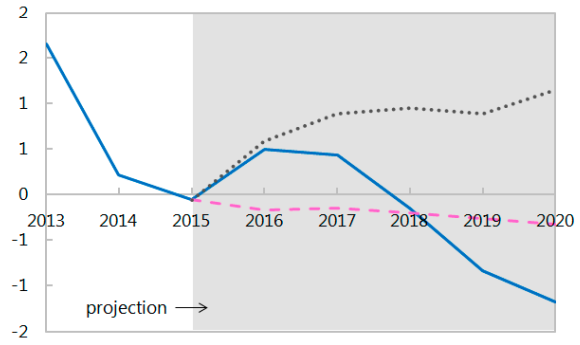
Gross Nominal Public Debt

(in percent of GDP)



Public Gross Financing Needs

(in percent of GDP)



Underlying Assumptions

(in percent)

Baseline Scenario	2015	2016	2017	2018	2019	2020
Real GDP growth	2.3	2.4	2.9	2.6	2.5	2.5
Inflation	0.4	-1.6	1.7	2.0	2.2	2.1
Primary Balance	0.5	-0.2	0.2	0.7	1.2	1.2
Effective interest rate	4.9	4.8	4.8	4.8	4.8	4.8
Constant Primary Balance Scenario						
Real GDP growth	2.3	2.4	2.9	2.6	2.5	2.5
Inflation	0.4	-1.6	1.7	2.0	2.2	2.1
Primary Balance	0.5	0.5	0.5	0.5	0.5	0.5
Effective interest rate	4.9	4.8	4.8	4.8	4.8	4.8

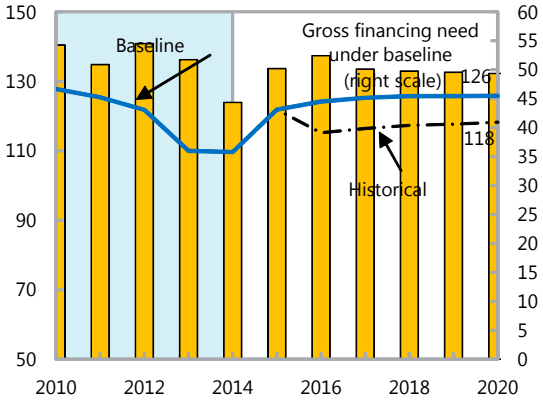
Historical Scenario	2015	2016	2017	2018	2019	2020
Real GDP growth	2.3	2.0	2.0	2.0	2.0	2.0
Inflation	0.4	-1.6	1.7	2.0	2.2	2.1
Primary Balance	0.5	-0.2	-0.2	-0.2	-0.2	-0.2
Effective interest rate	4.9	4.8	4.8	4.9	4.9	4.9

Source: IMF staff.

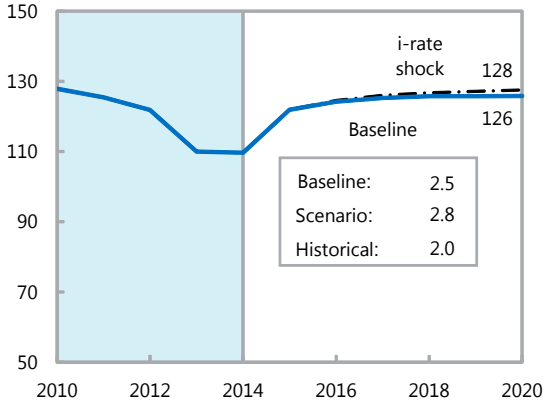
Figure 1. New Zealand: External Debt Sustainability: Bound Tests 1/ 2/

(External debt in percent of GDP)

Baseline and historical scenarios

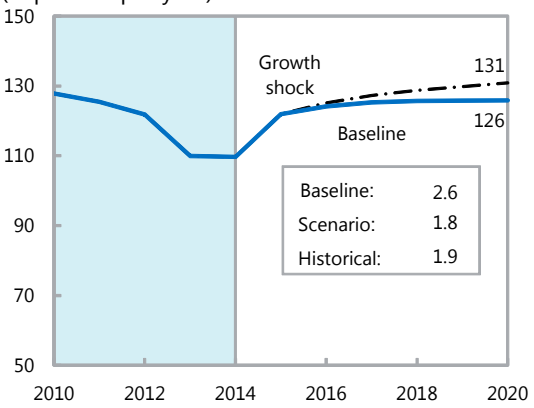


Interest rate shock (in percent)



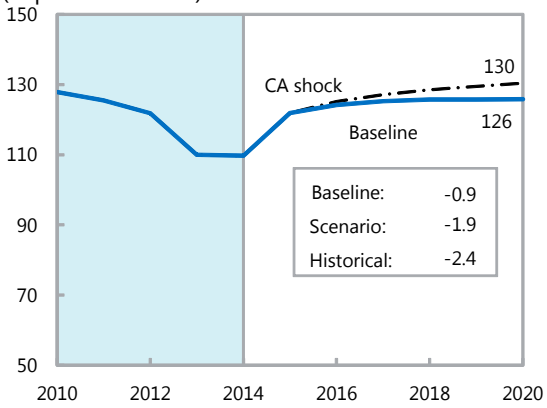
Growth shock

(in percent per year)

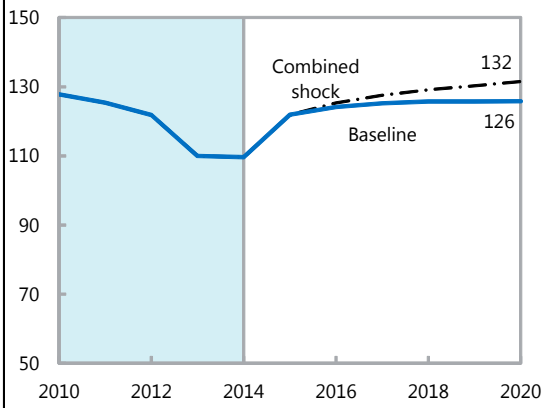


Non-interest current account shock

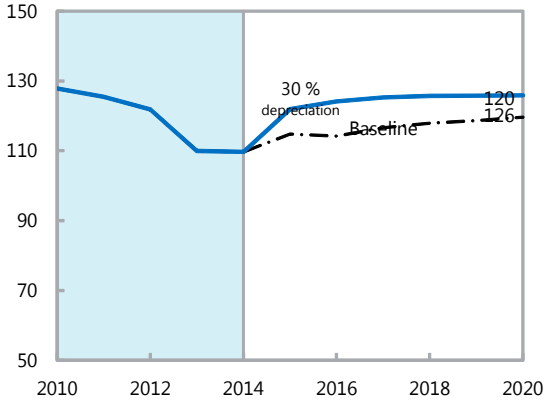
(in percent of GDP)



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 2010.

Table 1. New Zealand: External Debt Sustainability Framework, 2010-2020
(In percent of GDP, unless otherwise indicated)

	Actual							Projections						
	2010	2011	2012	2013	2014			2015	2016	2017	2018	2019	2020	Debt-stabilizing non-interest current account 6/
1 **Baseline: External debt**	127.8	125.4	121.8	110.0	109.7			**121.9**	**124.2**	**125.3**	**125.7**	**125.8**	**125.8**	**-14.9**
2 Change in external debt	-2.7	-2.4	-3.6	-11.9	-0.3			12.2	2.3	1.1	0.5	0.0	0.1	
3 Identified external debt-creating flows (4+8+9)	-16.6	-13.3	-7.2	-12.6	-14.5			-10.2	-10.2	-11.4	-12.1	-12.3	-12.2	
4 Current account deficit, excluding interest payments	0.3	0.7	2.1	1.5	1.5			2.7	2.4	1.4	0.5	0.1	0.1	
5 Deficit in balance of goods and services	-2.4	-2.1	-0.5	-1.0	-1.1			0.8	1.4	0.6	-0.3	-0.7	-0.7	
6 Exports	30.0	31.2	29.3	28.8	28.6			28.6	30.5	30.5	30.3	29.9	29.2	
7 Imports	27.7	29.1	28.9	27.8	27.6			29.4	31.9	31.1	30.0	29.2	28.5	
8 Net non-debt creating capital inflows (negative)	-6.0	-5.5	-6.7	-9.0	-11.7			-12.2	-12.4	-12.5	-12.5	-12.6	-12.6	
9 Automatic debt dynamics 1/	-11.0	-8.6	-2.6	-5.1	-4.3			-0.8	-0.3	-0.3	0.0	0.2	0.2	
10 Contribution from nominal interest rate	2.0	2.1	1.8	1.7	1.7			2.0	2.8	3.1	3.1	3.1	3.1	
11 Contribution from real GDP growth	-1.7	-2.0	-2.8	-2.6	-3.4			-2.8	-3.1	-3.4	-3.2	-3.0	-3.0	
12 Contribution from price and exchange rate changes 2/	-11.2	-8.6	-1.6	-4.3	-2.5			...	...	...	...	...	...	
13 Residual, incl. change in gross foreign assets (2-3) 3/	13.9	10.9	3.6	0.8	14.3			22.5	12.5	12.5	12.5	12.3	12.3	
External debt-to-exports ratio (in percent)	425.7	402.0	415.4	382.3	383.1			426.7	407.2	411.1	414.9	420.8	430.6	
Gross external financing need (in billions of US dollars) 4/	78.2	84.0	94.4	95.7	87.3			85.7	86.7	86.4	89.2	92.4	96.2	
in percent of GDP	54.3	50.9	54.5	51.8	44.4	10-Year	10-Year	50.2	52.5	50.1	49.8	49.5	49.4	
Scenario with key variables at their historical averages 5/								**121.9**	**115.2**	**116.4**	**117.3**	**117.6**	**118.2**	**-13.8**
Key Macroeconomic Assumptions Underlying Baseline						Historical Average	Standard Deviation							
Real GDP growth (in percent)	1.6	1.8	2.3	2.3	3.3	1.9	1.6	2.2	2.4	2.9	2.6	2.5	2.5	
GDP deflator in US dollars (change in percent)	17.7	12.3	2.6	4.3	3.1	5.2	9.1	-15.2	-5.6	1.3	1.4	1.5	2.0	
Nominal external interest rate (in percent)	1.8	1.9	1.5	1.5	1.6	2.0	0.6	1.6	2.2	2.6	2.6	2.6	2.6	
Growth of exports (US dollar terms, in percent)	21.1	18.9	-1.3	4.7	6.1	7.1	11.6	-13.5	3.2	4.2	3.5	2.5	2.2	
Growth of imports (US dollar terms, in percent)	21.1	20.3	4.1	2.8	5.7	7.2	13.7	-7.6	5.2	1.4	0.5	1.0	2.1	
Current account balance, excluding interest payments	-0.3	-0.7	-2.1	-1.5	-1.5	-2.4	1.9	-2.7	-2.4	-1.4	-0.5	-0.1	-0.1	
Net non-debt creating capital inflows	6.0	5.5	6.7	9.0	11.7	8.0	2.3	12.2	12.4	12.5	12.5	12.6	12.6	

1/ Derived as [r - g - r(1+g) + ea(1+r)]/(1+g+r+gr) times previous period debt stock, with r = nominal effective interest rate on external debt; r = change in domestic GDP deflator in US dollar terms, g = real GDP growth rate, e = nominal appreciation (increase in dollar value of domestic currency), and a = share of domestic-currency denominated debt in total external debt.

2/ The contribution from price and exchange rate changes is defined as [-r(1+g) + ea(1+r)]/(1+g+r+gr) times previous period debt stock. r increases with an appreciating domestic currency (e > 0) and rising inflation (based on GDP deflator).

3/ For projection, line includes the impact of price and exchange rate changes.

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

5/ The key variables include real GDP growth; nominal interest rate; dollar deflator growth; and both non-interest current account and non-debt inflows in percent of GDP.

6/ Long-run, constant balance that stabilizes the debt ratio assuming that key variables (real GDP growth, nominal interest rate, dollar deflator growth, and non-debt inflows in percent of GDP) remain at their levels of the last projection year.

INTERNATIONAL MONETARY FUND

NEW ZEALAND

STAFF REPORT FOR THE 2015 ARTICLE IV CONSULTATION—INFORMATIONAL ANNEX

January 21, 2016

Prepared By

Asia and Pacific Department
(In Consultation with Other Departments)

CONTENTS

FUND RELATIONS

(As of December 31, 2015)

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

General Resources Account:	SDR Million	Percent Quota
Quota	894.60	100.00
Fund Holdings of Currency	676.61	75.63
Reserve position in Fund	218.08	24.38
Lending to the Fund		
New Arrangements to Borrow	60.83	

SDR Department:	SDR Million	Percent Allocation
Net cumulative allocation	853.76	100.00
Holdings	872.47	102.19

Outstanding Purchases and Loans: None

Financial Arrangements: None

Projected Payments to Fund [1/]

	Forthcoming				
	2015	2016	2017	2018	2019
Principal					
Charges/Interest	0.01	0.01	0.01	0.01	0.01
Total	**0.01**	**0.01**	**0.01**	**0.01**	**0.01**

Exchange Arrangement:

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

Article IV Consultation:

New Zealand is on the 12-month consultation cycle. The 2014 Article IV consultation was concluded by the Executive Board on June 5, 2014.

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, and are making progress towards subscribing to the IMF's Special Data Dissemination Standard (SDDS).

Table of Common Indicators Required for Surveillance
(As of January 4, 2016)

	Date of latest observation	Date received	Frequency of Data[6]	Frequency of Reporting[6]	Frequency of Publication[6]
Exchange Rates	1/4/16	1/4/16	D	D	D
International Reserve Assets and Reserve Liabilities of the Monetary Authorities[1]	11/15	12/23/15	M	M	M
Reserve/Base Money	11/15	12/23/15	M	M	M
Broad Money	11/15	12/23/15	M	M	M
Central Bank Balance Sheet	11/15	12/23/15	M	M	M
Consolidated Balance Sheet of the Banking System	11/15	12/23/15	M	M	M
Interest Rates[2]	1/4/16	1/4/16	D	D	D
Consumer Price Index	Q3 2015	10/16/15	Q	Q	Q
Revenue, Expenditure, Balance and Composition of Financing[3]– Central Government	2014/15	12/15/15	A	A	A
Stocks of Central Government and Central Government-Guaranteed Debt[4]	2014/15	12/15/15	A	A	A
External Current Account Balance	Q3 2015	12/16/15	Q	Q	Q
Exports and Imports of Goods and Services	Q3 2015	12/16/15	Q	Q	Q
GDP/GNP	Q3 2015	12/17/15	Q	Q	Q
Gross External Debt	Q3 2015	12/16/15	Q	Q	Q
International Investment Position[5]	Q3 2015	12/16/15	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] Including currency and maturity composition.
[5] Includes external gross financial asset and liability positions vis-à-vis nonresidents.
[6] Daily (D), Weekly (W), Monthly (M), Quarterly (Q), Annually (A), Irregular (I); Not Available (NA).

Statement by Vicki Plater, Alternate Executive Director for New Zealand
February 5, 2016

The New Zealand economy is flexible and resilient and has continued to perform well in the face of shocks. As growth slowed during 2015, macroeconomic policy has responded to the changing outlook; as staff note, current policy settings are appropriate and provide room to move further if downside risks eventuate. The authorities note that it is a period of considerable uncertainty and they are alert to the array of risks that could eventuate, including potential upside risk. Stress testing indicates that the financial sector generally remains robust to potential risks, such as prolonged weak dairy prices or risks from the housing market, with macroprudential policies fulfilling their role in helping insulate the financial sector from risks to housing prices. Fundamentally, however, rapid house price growth reflects a shortage of supply. The authorities are strongly focused on lifting productivity and domestic savings. There are no simple policy levers to address these issues, and rather continuing to progress incremental reforms across a range of areas will be needed to help see a meaningful and sustainable lift in New Zealand's income levels over the medium-term.

I thank staff for a constructive mission and thorough Article IV report. My authorities value the Article IV process and the international experience and cross-country perspectives that the Fund can bring. The New Zealand authorities broadly concur with staff's outlook and analysis and generally agree with the recommendations put forward in the Article IV report.

Economic Outlook and Risks

While slowing in 2015, the economy remains resilient. New Zealand recorded its sixth year of consistent annual growth in 2015, albeit softening from 2014's above-potential 3.7 percent growth to slightly below potential (around 2.5 percent). Key factors are falling commodity export prices - most notably, the 65 percent drop in dairy prices in USD terms between February 2014 and August 2015 - and as the contribution to growth from the reconstruction activity in Christchurch begins to wane[1]. The economy is responding, supported by policy adjustments. The flexible exchange rate is acting as a buffer, having depreciated over 25 percent against the USD since June 2014. Farmers have lowered dairy production in response to the price signal. Strong growth in tourism has helped underpin services. While economic activity was subdued in the first half of 2015, indicators have turned more positive since August: international dairy prices have shown a modest if fragile recovery and consumer and business confidence have both improved. Continuing record levels of net migration demonstrate confidence in the economy. Employment growth has moderated in line with economic activity and unemployment had trended up slightly to

[1] The total cost of the 2010 and 2011 Canterbury earthquakes is estimated to be approximately 15 percent of GDP.

6.0 percent, in part reflecting strong labour force growth increasing spare capacity. The unemployment rate did drop back to 5.3 percent in December on the back of relatively strong employment growth and lower participation. Wage and price pressures are muted and inflation expectations are well-anchored.

Growth is expected to remain below potential at around 2-2.5 percent before picking up later in 2016. Accommodative monetary policy is expected to stimulate the domestic economy while exports – particularly of services – benefit from the depreciation of the New Zealand dollar. While the NZ dollar depreciation has not fully offset the fall in international dairy prices, it is a helpful fillip for exporters of a number of other commodities, manufacturing products and services (particularly to the US market) and import-competing firms. Global prices of agricultural-based commodities have fallen less than prices of energy and industrial commodities, and some agriculture sectors – such as horticulture and viticulture are performing well. Agriculture commodity prices are expected to recover modestly over time.

We concur with Staff that there are a number of risks and uncertainties to the economic outlook, although the New Zealand authorities see more potential for upside. Upside risks include the potential for net migration to run stronger for longer (forecasts assume that net migration will ease back from record levels as the relative performance of the Australian economy lifts, but outturns have persistently surprised); and domestic consumption could be stronger if households spend more freely on the back of recent house price gains. Downside risks could emerge from the current strong El Niño, weaker global growth and financial market volatility, while the near-term prospects for dairy prices remain a key factor in the outlook. While slower growth in China and other parts of emerging Asia would have an impact, including indirectly via Australia, New Zealand is well positioned to benefit from China's transition towards more consumption-oriented growth given New Zealand's export basket of predominantly consumer goods and services. That does not discount the potential that global transitions could be bumpy.

Domestically, high house prices represent a risk although macroprudential measures, and the clearer application of tax rules on property transactions, provide some space for the fundamental supply shortages to be addressed. As the tax measures (including the "bright line" test clarifying existing tax rules on taxation on gains from residential property sold within two years of purchase) only came into effect from 1 October 2015, and the changes to the RBNZ's macroprudential policies (including requiring residential property investors in Auckland to have a deposit of at least 30 percent) only took effect from 1 November 2015, it is too early to tell their impact. We are also conscious that macroprudential policy has limitations – it can buy time but cannot address the underlying challenge of a housing shortage in Auckland, which is further exacerbated by strong

migration.[2] The authorities are not immediately looking to develop additional macroprudential measures. A range of efforts are underway to help secure the housing supply response needed, including streamlining the approvals process to bring more land to market for housing developments, increasing the density of some Government social housing, and additional capital spending (see below) to address infrastructure bottlenecks. At the regional level a necessary element will be changes to zoning restrictions in Auckland City to enable higher density housing, decisions on which (in the proposed Auckland Unitary Plan) are due later in 2016. The Productivity Commission's inquiries on Using Land for Housing and Better Urban Planning are also relevant.

The authorities are alert to downside risks and potential volatility and have considerable policy space if required. The exchange rate remains an important buffer.

Monetary Policy

Monetary policy is supporting economic activity and remains appropriate, with the exchange rate depreciation also assisting the adjustment. In response to the weaker inflation and growth outlook, the Reserve Bank of New Zealand (RBNZ) lowered the policy interest rate by 100 basis points during 2015 to 2.5 percent. Interest rate settings will continue to be accommodative. At the end of January, the RBNZ stated that "some further policy easing may be required over the coming year to ensure that future average inflation settles near the middle of the (1 to 3 percent) target range". Although headline CPI was 0.1 percent in 2015, estimates of core inflation have centered around 1.5 percent and inflation expectations remain well-anchored – key given the RBNZ's forward looking focus for inflation. Nevertheless the RBNZ is monitoring conditions closely. The depreciation in the New Zealand dollar (over 25 percent against the USD to date although more modest on a trade weighted basis) is providing an important adjustment mechanism. The depreciation in the exchange rate has not fully reflected the falls seen in export prices.

Fiscal Policy

The government's fiscal stance is expected to be mildly expansionary in 2015/16. The Government has announced that it will allocate an additional NZ$1 billion towards infrastructure spending in the 2016 Budget than previously envisaged. Capital spending is expected to increase in 2016 and 2017, and discretionary fiscal policy will be supportive of economic activity in 2015/16. There is a solid pipeline of infrastructure projects (including to facilitate housing supply), although this will in part involve some bringing forward of capital expenditure already planned.

[2] Annual net migration continues to run at record levels, reaching 64,900, in December (1.8 percent of the working age population). While the relative strength of the New Zealand economy has been a key driver with fewer New Zealanders departing to Australia and arrivals of Australians and returning New Zealanders, there has also been a strong increase in student arrivals (particularly from India) and steady growth in arrivals on work visas.

The authorities recognize that prudent fiscal management is a necessary part of their economic management strategy. Having achieved its short-term target of a return to a fiscal surplus in 2014/2015,[3] the authorities refreshed the Government's short-term fiscal intentions in the 2016 Budget Policy Statement. The Government's overall fiscal strategy remains: to keep a tight rein on spending, focus on results from public services, starting to pay down debt, and looking to return any excess revenue on top of this to taxpayers. The revised short-term intentions provide scope for some short-term fluctuations in response to changing economic circumstances around the overall medium-term path for the Government's finances, thus mitigating the potential for fiscal policy reactions to exacerbate the cycle. Fiscal policy is expected to be broadly neutral on average over the next five years and Core Crown (recurrent) expenditure is expected to further narrow as a percentage of GDP, consistent with the Government's focus on improving public sector productivity and getting on top of the longer-term drivers of spending.

The authorities have also been placing an increasing focus on effective management of the overall government balance sheet and intend to strengthen the balance sheet as a buffer against future adverse shocks. Total net worth is expected to increase over the next five years, and by 2019/20 be similar to the level before the global financial crisis and Canterbury earthquakes. The authorities are seeking to strengthen incentives for government departments to better manage their balance sheet and investment projects. To help drive greater transparency and accountability on how well taxpayer-funded projects are progressing, new initiatives include the recent publication of the first annual "Managing Government Investment Projects" report and quarterly "Major Projects Performance Report". My authorities have appreciated the opportunity to share their experience with staff from Fiscal Affairs Department as we collectively strive to improve balance sheet performance measures and management.

Financial Sector

The financial system is sound and remains resilient to a range of shocks. The banking system maintains capital and funding buffers in excess of minimum requirements and profitability is strong. Stress tests indicate the financial system is well placed to withstand severe stresses that could emerge from the dairy sector and the housing market. The RBNZ's analysis of farm-level data shows that under a severe stress scenario (including a sharp decline in land values), losses for the banking system as a whole are manageable (approximately 18 percent of total before-tax profits of the five largest dairy lenders over a typical four year period). The RBNZ is currently completing stress tests with the largest dairy lenders. Risks to the financial sector from the housing market are being mitigated through macroprudential tools, which have reduced the proportion of low-deposit loans on the banks'

[3] New Zealand Operating Balance Excluding Gains and Losses (OBEGAL) measure.

balance sheets (LVR >80 percent) to 13.4 percent as at December 2015, thus improving resilience of the financial system to a housing market downturn.

Risks around the New Zealand banking system's reliance on global markets for funding have reduced. Strong and continuing deposit growth has meant that banks have had less need to issue debt in wholesale markets, leaving bank's reliance on wholesale funding much reduced from the time of the GFC. Wholesale funding has also shifted towards more longer-term instruments. These factors reduce the exposure to potential disruptions to offshore funding markets and short-term liquidity.

Strengthening financial regulation and supervision remains a focus to preserve financial stability and foster financial sector development and financial inclusion. The Reserve Bank continues to make progress on a number of regulatory initiatives, including carrying out a stocktake of banking regulations and consulting on the regulation of financial market infrastructures. The New Zealand authorities look forward to a high-quality FSAP to be undertaken later in 2016, and have already begun preparations for this.

Medium-term Structural Issues – Lifting Productivity and Savings

The authorities remain focused on lifting productivity and prosperity. As Staff usefully highlight, this challenge is compounded by distance and New Zealand's small size. Given New Zealand's strong relative performance in indicators of the business environment and regulation, to lift New Zealand's productivity requires incremental reforms across a broad range of areas. The Government's Business Growth Agenda (BGA) is working to build a more productive and competitive economy with a focus on six key inputs for businesses: skilled and safe workplaces; export markets; infrastructure; innovation; natural resources; and investment. Boosting productivity and international connections is key to bring scale, competition, investment and ideas. Amongst other things the Government is working to encourage and enable business-led innovation (especially through R&D) and to increase the impact of the Government's own R&D investment in public research organizations; and ensuring an education system that provides the skills that workers and businesses need, and equipping all people to participate and succeed. A sustainable lift in living standards will also require continued improvements in the management of New Zealand's natural resources. The Productivity Commission (established in 2011) also enhances the "system" to lift productivity. Recent inquiries have included the services sector, more effective social services, and regulatory institutions and practices, and the Commission is currently examining new models of tertiary education. The Commission's recommendations are feeding into programs of work.

The authorities concur that higher domestic savings and deeper financial markets could help lower the cost of capital and ultimately support higher productivity. New Zealand has had a continuous current account deficit for over 40 years as worthwhile investment opportunities have consistently exceeded the country's own capacity to fund them. While New Zealand's net international liability position is relatively high (61.9 percent of GDP) it is

well below its recent March 2009 peak of 84.0 percent and has been relatively stable. A long history of work (including the 2010/11 Savings Working Group) has sought to understand the factors that lie behind New Zealand's relatively low private savings. There is no one simple policy lever to address this, and some proposals are politically more challenging. We welcome Staff's suggestions and will continue to explore feasible policy options.

Conclusion

In summary, New Zealand's economic management has served us well. But we are not complacent to the risks and continue to seek ways to lift our economic performance. We thank Staff for their report as one of the ways that enables us to continue to assess results and make improvements, drawing also on other best practices.