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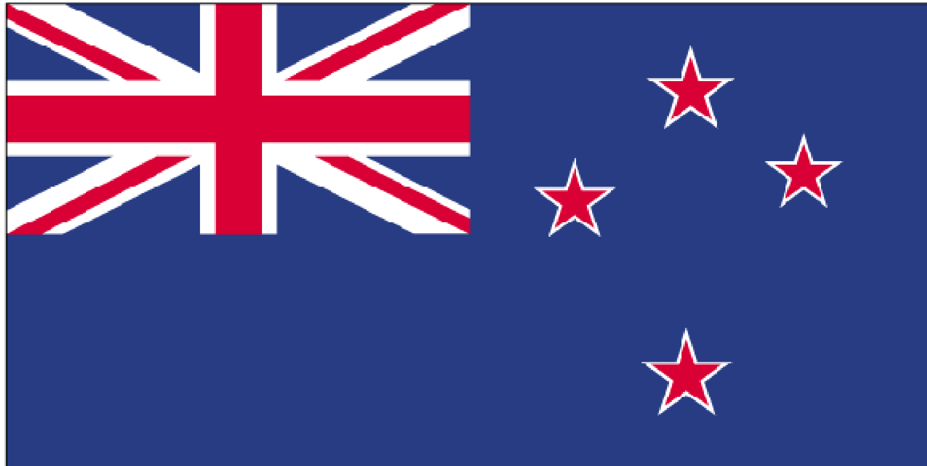
Country report **NEW ZEALAND**



Summary

Economic and financial developments in New Zealand have continued to be impacted by the aftershocks from the 4 September 2010 Canterbury earthquake. Absent further disruptions, rebuilding should support the economic recovery in the years to come. Economic growth has been supported by high commodity prices and export growth. This has pushed up the value of the exchange rate, making economic life harder for the non-commodity sectors. These specific developments are also at play in Australia. Both countries have become more dependent on demand from China both for its export volumes and for the level of commodity prices. This makes the economy more vulnerable to economic shocks in China or sharply falling commodity prices. Although still strong, the government finances have been weakened by the 2008/09 recession and the earthquakes. Together with an already rather low policy rate, this has lowered the room for policy to respond to any new economic shocks.

Things to watch:

- Budget deficit reduction from earthquake induced elevated levels
- High household debt and rising house prices
- Rising vulnerability to China demand and commodity price shocks

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New Zealand

National facts		
Type of government	Parliamentary democracy	
Capital	Wellington	
Surface area (thousand sq km)	268	
Population (millions)	4.5	
Main languages	English (91.2%)	
	Maori (3.9%)	
Main religions	Protestant (38.6%)	
	Roman Catholic (12.6%)	
	Maori Christian (1.6%)	
Head of State	Queen Elizabeth II	
Head of Government (prime-minister)	John Key	
Monetary unit	NZD	

Economy	2011	
Economic size	*bn USD*	*% world total*
Nominal GDP	160	0.23
Nominal GDP at PPP	133	0.17
Export value of goods and services	48	0.22
IMF quotum (in mln SDR)	895	0.41
Economic structure	*1905*	*5-year av.*
Real GDP growth	1.3	1.4
Agriculture (% of GDP)	5	5
Industry (% of GDP)	25	25
Services (% of GDP)	71	n.a.
Standards of living	*USD*	*% world av.*
Nominal GDP per head	36153	335
Nominal GDP per head at PPP	30072	244
Real GDP per head	27340	336

Social and governance indicators	rank / total
Human Development Index (rank)	5 / 187
Ease of Doing Business Index (rank)	3 / 183
Index of Economic Freedom (rank)	4 / 179
Corruption Perceptions Index (rank)	1 / 183
Press Freedom Index (rank)	13 / 178
Gini index (income distribution)	36.2
Population below $1.25 per day (PPP)	n.a.

Foreign trade			2010
Main export partners (%)		*Main import partners (%)*	
Australia	23	Australia	18
China	11	China	16
US	9	US	10
Japan	8	Japan	7
Main export products (%) (2011)			
Dairy products			24
Meat products			12
Forestry products			8
Wool			2
Main import products (%) (2011)			
Machinery & electrical equipment			21
Mineral fuels			15
Transport equipment			13
Openness of the economy (2011)			
Export value of G&S (% of GDP)			30
Import value of G&S (% of GDP)			29
Inward FDI (% of GDP)			1.3

Source: EIU, CIA World Factbook, UN, Heritage Foundation, Transparency International, Reporters Without Borders, World Bank.

Still coping with the quakes

Economic developments in New Zealand have continued to be impacted by the aftershocks from the 4 September 2010 Canterbury earthquake. The 22 February 2011 quake had a devastating impact on Christchurch, the country's third city and the biggest city on the South Island. The September and February events led to a fall in economic activity and a sharp slowdown in economic growth respectively. Further large aftershocks followed on June 13 and December 23 of 2011, hampering the rebuilding effort. Even so, real GDP growth for 2011 strengthened somewhat relative to 2010, to 1.4% from 1.2%, continuing the modest recovery from the 2008/09 recession. In the last quarter of 2011, the level of GDP had almost regained the pre-recession peak of late 2007. The unemployment rate averaged 6.5% in 2011, the same rate as 2010. That may be low from an international perspective, but it is much higher than the sub 4% readings in the years before the 2008/09 recession and the sub 6% readings since 2000. In the absence of further disruptive aftershocks, the rebuilding effort should support economic activity this year and in the years to come. Growth will also be supported by accelerating growth in main export destination Australia, which also saw its economy negatively affected by natural disaster last year. As such, we expect GDP growth in New Zealand to accelerate this year, which should lead to a gradual fall in the unemployment rate. We also expect to see the construction industry and manufacturing, which have suffered the biggest output losses since 2007 and the least recovery, to strengthen.

The flipside of high commodity prices and increased export concentration
New Zealand exports are largely reliant on agricultural products. Dairy and meat products alone made up 36% of goods exports in 2010. High agriculture prices have pushed up the terms of trade, which helped raise national income. In volume terms, agriculture contributed 15% to real GDP growth in 2011, although the sector comprises only 5% of the economy. Exports are also rather concentrated geographically, with Australia and China accounting for 34% of exports in 2010, up from 23% in 2000. Concentration in products that have seen sharp price increases and to economies that have been performing very well over the past few years has been a mixed blessing. It has supported economic growth. But at the same time, relatively robust growth, high demand for its commodities and being a safe haven with relatively high interest rates has pushed up the exchange value of the New Zealand dollar. This is making it harder for non-agricultural sectors to recover from recession. And if agricultural prices fall sharply, either on their own or due to a sharp slowdown of growth in China and the rest of Asia, it can quickly turn into a liability. Australia has an even larger trade reliance on China and high commodity prices have been very important in its recent economic development. A crisis in China – which we are not expecting, but cannot be excluded either - would have the double impact of lowering demand for Australian and New Zealand exports at the same time as commodity prices would most likely fall sharply. As a result, both directly and through its main trading partner, New Zealand export volumes and values have become very vulnerable to external developments. The possible adverse economic consequences that this would have might well be reinforced by existing interconnected vulnerabilities, such as high household debt, elevated house prices and a large reliance of banks on foreign wholesale funding.

Large net international debtor position a key vulnerability
Years of relatively high current account deficits have pushed up net international liabilities of New Zealand to over 100% of GDP. Corporates and banks have been dependent on foreign financing due to very low saving rates of households, which were even negative in the years before the crisis. Foreign financing has been forthcoming despite financial market tensions arising from the European debt crisis. But in a crisis scenario centering on Asia, the likelihood of a disruption of foreign finance becomes much more serious. A domestic return to recession might well lead to falling house prices, which appear to be overvalued. The IMF puts the extent of overvaluation between 15% and 25%. Having fallen almost 8% during 2008, house prices have recovered since. A sharp rise in the second half of 2011 put the house price index published by the central bank almost back at par with the previous peak. With positive inflation and income growth, real house prices and the house price to income ratio are probably still lower than the former peak. But in a crisis scenario, a sharp downward correction might well occur. Coupled with rising unemployment and high household debt, this may spook investors and disrupt foreign financing of the banks or at least lead to much higher interest rates. The same mechanism might well be at work in Australia, where house prices are also deemed overvalued, households have high debt loads too and banks are also reliant on foreign funding. Note that the banking system in New Zealand is dominated by subsidiaries of the four big Australian banks. A simultaneous shock to both economies will put pressure on the same banking groups in their main markets at the same time. On the other hand, as in Australia, bank capitalization in New Zealand is strong and strengthened in international perspective by conservative risk weighting demanded by regulators. Also, reliance on short-term foreign funding has been reduced somewhat over the past years. And Moody's reports that mortgages have an average loan to value ratio of only 60%-70% at origination. Moreover, unlike in countries such as Ireland and Spain, high house prices have not resulted in a commercial property boom in New Zealand and Australia. It is exactly commercial real estate that has been wreaking

havoc on the former countries' banking systems. As such, the Australia/New Zealand banks seem to be in a better position to cope with a potential sharp fall in house prices. Also, banks have been ordered to set aside more capital for agricultural loans to provide for higher buffers in case of a sharp fall in agricultural prices. The central bank has some more room to cushion negative shocks by lowering interest rates, although at 2.5% since the February quake the policy rate is already relatively close to zero when compared to Australia and other countries in the Asia-Pacific. Apart from monetary stimulus, the central bank has proven willing and able to act as a lender of last resort to the banking system. Also, low government debt in both Australia and New Zealand provides budgetary room to support the banks. In all then, although the external financial position, the high household debt ratio, overvalued house prices and the increased sensitivity to movements in commodity prices and developments in China pose clear risks to New Zealand economic and financial stability, there are meaningful mitigating factors that somewhat contain our concerns.

Government finances losing some of their shine

The recession and costs related to the Canterbury earthquake have put somewhat of a dent in the strength of New Zealand's government finances. The budget balance for the fiscal year that ended in June 2011 deteriorated to 9.2% of GDP from 3.3% in the year before. This was somewhat higher than the 8.4% of GDP assumed as a starting point when the 2011-12 budget was presented in May 2011. The budget outcome for the 2011-12 fiscal year at 6% of GDP is expected to about 1%-point of GDP higher than previously planned. Even so, the National Party minority government, that was re-elected in November 2011, remained committed to the goal of balancing the budget by 2015 in its Budget Policy Statement February 2012. Gross sovereign issued debt is set to stabilize below 40%, up from less than 20% of GDP in 2007. Net government debt is set to peak below 30% of GDP. Barring any further economic shocks then, New Zealand's government finances will remain exceptionally strong when compared to other advanced economies. Of course, this strong position is countered on a national scale by the high household and corporate indebtedness that has resulted in the large net international debtor position for the country as a whole. An adverse economic shock may well push some of these private liabilities onto the government's balance sheet. In the medium term, although policy steps still have to be taken to prepare the public finances for ageing, the forecast rise in age related expenditure is relatively modest in an international context. Even though the fiscal position is still very strong, the sharp rise in government debt since 2007 makes public finances more vulnerable to possible adverse macro-economic scenario's than before. Given the fact that national income is currently supported by high commodity prices and the economy is expected to post relatively solid growth rates in the years to come, we think it is important that the government sticks to its goal of balancing the budget and bringing the debt level back down. This will ensure that the government remains well placed to absorb any adverse shocks to the economy or the financial system.

New Zealand

Selection of economic indicators	2007	2008	2009	2010	2011	2012e	2013f
Key country risk indicators							
GDP (% real change pa)	3.5	-0.8	-0.1	2.4	1.3	2.8	3.5
Consumer prices (average % change pa)	2.4	4.0	2.1	2.3	4.0	2.3	2.4
Current account balance (% of GDP)	-8.2	-8.9	-2.8	-3.5	-4.5	-5.8	-6.7
Economic growth							
GDP (% real change pa)	3.5	-0.8	-0.1	2.4	1.3	2.8	3.5
Gross fixed investment (% real change pa)	5.8	-1.2	-13.2	3.4	4.4	8.7	8.1
Private consumption (real % change pa)	4.1	-0.2	-0.9	2.3	2.3	2.4	2.1
Government consumption (% real change pa)	4.0	5.0	0.5	3.4	2.1	3.1	2.4
Exports of G&S (% real change pa)	4.0	-1.3	2.2	2.7	2.2	3.4	5.6
Imports of G&S (% real change pa)	8.9	3.0	-14.9	10.1	6.8	5.8	5.5
Economic policy							
Budget balance (% of GDP)	4.6	0.4	-2.6	-4.1	-8.8	-6.8	-2.7
Public debt (% of GDP)	17	17	23	27	36	41	41
Money market interest rate (%)	8.3	5.0	2.5	3.0	2.5	3.3	4.0
M2 growth (% change pa)	-3	7	0	1	5	5	5
Consumer prices (average % change pa)	2.4	4.0	2.1	2.3	4.0	2.3	2.4
Exchange rate LCU to USD (average)	1.4	1.4	1.6	1.4	1.3	1.3	1.4
Recorded unemployment (%)	3.7	4.2	6.1	6.5	6.5	5.9	5.6
Balance of payments (mln USD)							
Current account balance	-10825	-11567	-3247	-4994	-7183	-9050	-10500
Trade balance	-1825	-1731	1306	2344	2005	950	1120
Export value of goods	27288	31192	25336	31883	37575	36660	38630
Import value of goods	29112	32922	24030	29539	35570	35710	37510
Services balance	222	-394	99	-309	-788	-1500	-1960
Income balance	-9612	-10091	-4888	-6998	-8366	-8460	-9620
Transfer balance	389	648	234	-29	-33	-30	-30
Net direct investment flows	-451	3987	679	127	1185	-310	-340
External position (mln USD)							
International investment position	-103756	-88252	-109551	-113588	n.a.	n.a.	n.a.
Total assets	103452	79371	97059	113525	n.a.	n.a.	n.a.
Total liabilities	207208	167623	206610	227113	n.a.	n.a.	n.a.
Key ratios for balance of payments, external solvency and external liquidity							
Trade balance (% of GDP)	-1.4	-1.3	1.1	1.7	1.3	0.6	0.7
Current account balance (% of GDP)	-8.2	-8.9	-2.8	-3.5	-4.5	-5.8	-6.7
Inward FDI (% of GDP)	2.4	3.8	-0.6	0.5	1.3	1.4	1.4
International investment position (% of GDP)	-79.0	-68.2	-94.4	-80.7	n.a.	n.a.	n.a.

Source: EIU, Rabobank

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