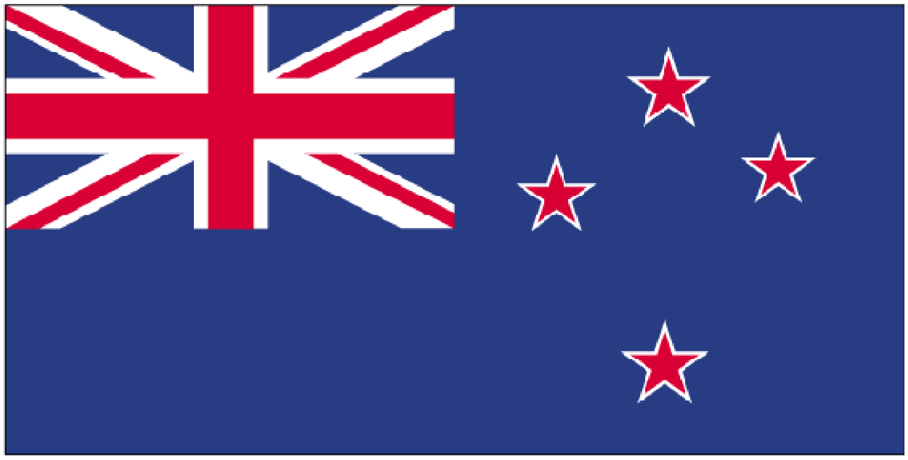
Country report

NEW ZEALAND



Summary

New Zealand prior to the crisis seems to have developed a social convention where the government does the saving, leaving spending to households and firms (making New Zealand the exact opposite of Japan in this regard). This convention has been changed by the impact of the crisis (and recent earthquakes) on the public balance, pushing it solidly into deficit. Hence fiscal consolidation is needed to relieve pressure on the external deficit and help rebalance New Zealand to at least stop the increase in international indebtedness.

Fortunately, significant measures have already been adopted to rebalance the economy (among which bank funding restrictions and a GST rate hike), whilst the more favourable external environment is expected to alleviate the economic pain of this adjustment. A failure to achieve structural adjustment in the public budget balance and/or significant (re-)widening in the current account deficit would make the economy vulnerable to future bouts of financial market nervousness.

Things to watch:

- The net international (short-term) debt position of the banking sector
- The extent of fiscal consolidation to relieve the external deficit
- The impact of monetary policy tightening on household mortgage rates

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New Zealand

National facts		
Type of government	Parliamentary democracy	
Capital	Wellington	
Surface area (thousand sq km)	267	
Population (millions)	4.3	
Main languages	English (91.2%)	
	Maori (3.9%)	
Main religions	Anglican (13.8%)	
	Roman Catholic (12.6%)	
	Reformed (10%)	
Head of State (president)	Anand Satyanand	
Head of Government (prime-minister)	John Key	
Monetary unit	NZD	

Economy		2010
Economic size	*bn USD*	*% world total*
Nominal GDP	140	0.23
Nominal GDP at PPP	120	0.16
Export value of goods and services	41	0.22
IMF quotum (in mln SDR)	895	0.41
Economic structure	*2010*	*5-year av.*
Real GDP growth	1.7	1.6
Agriculture (% of GDP)	5	5
Industry (% of GDP)	25	26
Services (% of GDP)	71	69
Standards of living	*USD*	*% world av.*
Nominal GDP per head	32014	325
Nominal GDP per head at PPP	27353	234
Real GDP per head	27117	339

Social and governance indicators	rank / total
Human Development Index (rank)	3 / 169
Ease of doing business (rank)	3 / 183
Economic freedom index (rank)	4 / 179
Corruption perceptions index (rank)	1 / 178
Press freedom index (rank)	8 / 178
Gini index (income distribution)	36.2
Population below $1.25 per day (PPP)	N/A

Foreign trade			2009
Main export partners (%)		*Main import partners (%)*	
Australia	23	Australia	18
Japan	10	China	15
US	9	US	11
China	7	Japan	7
Main export products (%)			
Dairy products			20
Meat products			13
Forestry products			6
Main import products (%)			
Mineral fuels			14
Machinery & electrical equipment			13
Transport equipment			10
Openness of the economy			2010
Export value of G&S (% of GDP)			29
Import value of G&S (% of GDP)			27
Inward FDI (% of GDP)			-0.4

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

New Zealand suffered a recession that was protracted yet mild by international standards with a 0.9% contraction of GDP in 2008 and stagnant activity in 2009. In 2010, growth resumed (+1.8%) and the recovery is expected to continue into 2011 and 2012. Growth is being supported by the large shares of exports to Australia and Asia as well as by the global surge in food prices since mid-2010. Nevertheless, the outlook for 2011 growth is rather less favourable. Economic growth almost came to an abrupt halt in 10H2 (+0.1% compared to 10H1) and GDP contracted in 11Q1, partly owing to the Canterbury earthquake in February (the Canterbury region accounts for 15% of GDP and the city of Christchurch for about 12% of total population). An 11H2 expansion is likely as overall activity normalises and is even stimulated by reconstruction activity (the IMF estimates the damage done by the earthquake to be around 7½%-GDP). The RBNZ has lowered policy rates to 2½% (from 3%) to mitigate economic risks stemming from the earthquake, which reverses the rate hikes implemented during 2010.

In terms of the composition of growth going forward, export surveys at the start of 2011 point to a pickup in exports growth, partly due to the strong performance of the agricultural sector, which remains a dominant component of New Zealand's exports, and partly due to the strong growth profile in Australia and Asia which constitute the major export markets of New Zealand. Perversely, the Kiwi dollar has softened some 5% in trade-weighted terms following the Canterbury earthquake on expectations of weaker economic performance.
Household spending was already set to slow. Consumer confidence softened in 10H2 and the earthquake delivered a further blow to sentiment, pushing confidence back down to levels normally

seen only in the midst of recessions. The unemployment rate (6.5%), while looking sanguine by European standards, remains elevated compared to New Zealand's history and employment is only now bottoming out. So the domestic backdrop remains a drag on consumer expenditure which is not necessarily bad news given the need for the economy to rebalance towards more sustainable (i.e. lower) domestic demand and improved export performance.

International investment position

New Zealand still features a number of structural weaknesses that policy has now only started to address. Most prominently, its net international investment position (the difference between international assets and liabilities) stood at about 100%-GDP in 2009, making it about as heavily indebted as the likes of Greece and Spain. The trade balance is positive, but the significant negative income balance is sufficient to pull the overall current account balance 'comfortably' into deficit territory (average 8%-GDP in the 2005-08 period). The recession has pushed the current account deficit back to 3%-GDP in 2009-10 and the recent weakening of activity combined with the agricultural boost to exports has the potential to push it back even further in the short term (with earthquake reconstruction imports a potential offset). Obviously, when push comes to shove, New Zealand has the less painful option to structurally adjust through nominal depreciation of its floating exchange rate, rather than being forced to go through painful years of internal devaluation, as is the case in European periphery countries. A risk amplifier is the fact that New Zealand's negative net international investment position consists almost entirely of debt, half of which is short-term and predominantly reflects the banking sector's net international debtor position. In this regard, New Zealand is building up a substantial financial vulnerability, with its banks borrowing short-term in international markets to extend credit domestically.

Rebalancing

This also makes the rebalancing of the economy a prominent policy challenge. For the banking sector, a core funding ratio has been introduced that aims to ensure that banks hold a sufficient funding share of retail and longer-term wholesale funding (to 75% of total funding in 2012, from 65% in 2009). Regarding household consumption, a tax reform has been implemented that hiked the goods and services tax (GST) to 15% from 12½% (October 2010), whilst cutting income and business taxes. Another policy channel through which domestic demand may be curtailed is monetary policy normalisation. Once the RBZN starts tightening, the impact on the wider economy (or transmission mechanism) should be relatively fast as many households have refinanced mortgages at variable rates, leaving themselves relatively sensitive to interest rate increases. The impact on credit quality should be limited due to the low rate of unemployment, the low level of mortgage rates that we start from, and the sustainability of government income support (i.e. unemployment and other types of welfare) given the healthiness of public finances.

According to Moody's there are no significant problems in the banking sector, although offshore funding was a potential risk that materialised during the crisis (for only a brief period, though). Fiscal and monetary policy responses helped out here. There remains ample space available for fiscal and monetary policy to do so again in the unlikely event that offshore funding evaporates yet again. The government budget balance nevertheless deteriorated from a large surplus position prior to the crisis (average surplus of 3½%-GDP in 2000-07) to a 5.5%-GDP deficit in 2010 as a result of the impact of the Great Recession (in the wake of the Canterbury earthquake this may yet deteriorate further to 9%). Therefore, the fiscal stimulus during the recession was partly paid out of the pre-crisis budget surpluses, and the low level of initial gross debt (17%-GDP in 2008) makes these deficits highly affordable. Government policy is aiming to let gross government debt peak at about 45%-GDP by 2016, which in net terms (i.e. corrected for government's financial assets) equals about 30%-GDP.

New Zealand

Selection of economic indicators	2006	2007	2008	2009	2010	2011e	2012f
Key country risk indicators							
GDP (% real change pa)	2.1	3.5	-0.9	0.1	2.3	1.0	3.0
Consumer prices (average % change pa)	3.4	2.4	4.0	2.1	2.3	4.8	3.0
Current account balance (% of GDP)	-8.3	-8.1	-8.8	-3.1	-3.3	0.2	-2.2
Economic growth							
GDP (% real change pa)	2.1	3.5	-0.9	0.1	2.3	1.0	3.0
Gross fixed investment (% real change pa)	-0.9	5.5	-1.3	-11.4	3.3	1.5	7.9
Private consumption (real % change pa)	2.2	4.1	-0.3	-0.8	2.1	1.0	1.5
Government consumption (% real change pa)	4.9	4.1	5.0	0.6	2.2	1.5	5.7
Exports of G&S (% real change pa)	1.7	3.9	-1.7	1.9	2.8	4.9	5.3
Imports of G&S (% real change pa)	-2.5	8.7	2.6	-14.9	10.0	7.0	8.4
Economic policy							
Budget balance (% of GDP)	5.3	4.1	0.4	-3.7	-5.6	-6.8	-5.9
Public debt (% of GDP)	21	17	17	22	27	31	35
Money market interest rate (%)	7.3	8.3	5.0	2.5	2.8	2.6	3.7
M2 growth (% change pa)	11	11	10	-1	2	2	3
Consumer prices (average % change pa)	3.4	2.4	4.0	2.1	2.3	4.8	3.0
Exchange rate LCU to USD (average)	1.5	1.4	1.4	1.6	1.4	1.4	1.5
Recorded unemployment (%)	3.8	3.7	4.2	6.2	6.5	6.9	6.5
Balance of payments (mln USD)							
Current account balance	-8933	-10706	-11425	-3625	-4632	300	-3280
Trade balance	-1997	-1790	-1705	1315	1496	4650	2040
Export value of goods	22576	27288	31192	25336	31421	38640	38160
Import value of goods	24572	29077	32896	24021	29925	33990	36110
Services balance	278	218	-429	-58	-171	-390	-830
Income balance	-7623	-9540	-10003	-5150	-7247	-7200	-6220
Transfer balance	410	404	711	267	1291	3240	1720
Net direct investment flows	4403	-564	4148	-647	-1229	-680	420
Net portfolio investment flows	-952	10671	-6397	2701	3220	3950	4410
External position (mln USD)							
Total foreign exchange reserves	14069	17247	11052	15594	16723	17110	18120
International investment position	-99402	-115091	-93119	-115995	N/A	N/A	N/A
Total assets	73304	92082	74187	90249	N/A	N/A	N/A
Total liabilities	172706	207173	167306	206244	N/A	N/A	N/A
Key ratios for balance of payments, external solvency and external liquidity							
Trade balance (% of GDP)	-1.9	-1.4	-1.3	1.1	1.1	1.7	1.3
Current account balance (% of GDP)	-8.3	-8.1	-8.8	-3.1	-2.5	-1.9	-2.2
Inward FDI (% of GDP)	4.2	2.3	4.0	-1.1	-0.5	1.0	1.7
International investment position (% of GDP)	-92.3	-87.6	-72.0	-99.8	N/A	N/A	N/A

Source: EIU, Rabobank