### INTERNATIONAL MONETARY FUND

**New Zealand**

2013 Article IV Consultation

Preliminary Concluding Statement

March 18, 2013

***Overview*.** The authorities’ current macroeconomic policy stance is appropriate, but a new set of challenges has emerged. With expected inflation within the target range, the strong New Zealand dollar, and efforts to reduce the budget deficit, monetary policy should remain accommodative, and should act as the first line of defense against adverse shocks. Policies will need to take into account a range of issues including price pressures from an acceleration of earthquake-related reconstruction, rising house prices, and the economic fallout from the ongoing drought. The authorities’ fiscal consolidation path – timely in view of the earthquake rebuild – strikes a balance between the need to limit both public and external debt increases while containing any adverse impact on economic growth. The financial sector is sound and well capitalized, and the authorities should continue to ensure that banks’ liquidity and capital buffers are adequate given banks’ usage of offshore wholesale funding, their exposure to highly indebted households and farmers, and the systemic importance of the top banks.

**Recent Developments**

***Developments*.** Growth appears to have strengthened in the last months of 2012 and is estimated at 2¼ percent for the year, as subdued household consumption and business investment and budget deficit reduction have been offset by strong agriculture production and continued expansion in the construction sector. Weather helped boost agricultural exports in 2012, while service exports were weighed down by the strong exchange rate. Earthquake-related reconstruction is gathering pace. Inflation remains subdued, with the persistently high exchange rate dampening tradable price inflation. Wage pressures are contained and by a range of measures the labor market remains soft. There are however signs that pressures are beginning to emerge in the housing market, notably in Auckland where supply bottlenecks persist, and in Christchurch where construction cost inflation has accelerated.

***Outlook.*** Growth this year is expected to increase subject to a number of risks, with an increase in construction activity offsetting headwinds from budget deficit reduction, the strong dollar, and the possibly protracted impact of the severe drought. Underlying inflation is expected to increase but remain modest. Output growth over the medium term is projected to converge to a trend rate of about 2½ percent.

**Macroeconomic Management**

***Monetary policy stance.*** The integrity and credibility of the RBNZ’s monetary policy framework has played a key role in delivering macroeconomic stability and enhancing the resilience of the New Zealand economy. We see the Reserve Bank of New Zealand’s (RBNZ) accommodative monetary policy stance as appropriate, with the cash rate compatible with underlying inflation gradually rising to the mid-point of the RBNZ’s inflation target band. The strong New Zealand dollar, brought about in part by the easing of global liquidity conditions and the recovery in risk appetite, is likely to continue to put downward pressure on tradable goods’ inflation. Going forward the RBNZ’s credibility and the effective monetary policy transmission in New Zealand should allow for a nimble policy response should growth circumstances change.

***Fiscal policy.*** We regardthe planned pace of budget deficit reduction as striking the right balance between sustaining output growth and limiting public debt growth, and consistent with a framework where monetary policy plays the primary role in managing aggregate demand. The benefits of the plan are many. First, it withdraws fiscal stimulus at the right time by making room for the expected increases in private sector and earthquake-related construction spending. Second, it has improved the macroeconomic policy mix by reducing pressure on monetary policy. Third, it creates fiscal space to help the country deal with aging and health care costs that are expected to increase over the long term and to cope with any negative shocks that may cause a sharp reduction in domestic economic activity. Last, it helps raise national savings, reduce the current account deficit, and limit the increase in New Zealand’s foreign liabilities.

**Managing Near-term Risks**

***External risks*.** New Zealand’s fundamentals have improved since the global financial crisis; household and business balance sheets have strengthened and banks have reduced their use of foreign funding and lengthened its maturity. Nevertheless, vulnerabilities remain. External risks have recently receded somewhat, but potential weaknesses in the world economy and a possible further upheaval in the global financial system are still concerns*.* A global slowdown would hit commodity prices and New Zealand’s terms of trade, and a worsening of financial conditions abroad would make it more difficult for New Zealand’s banks to secure needed offshore funding.

***Housing market risks.*** Household credit growth, housing market turnover, and house price inflation have all recently picked up, particularly in Auckland where supply bottlenecks persist, and prices remain elevated by most measures of affordability. Recent developments also suggest some easing of mortgage lending standards. In these circumstances there is an emerging risk that sustained rapid price growth could give rise to expectations-driven, self-reinforcing demand dynamics and price overshooting. A shock to household incomes or to borrowing costs could cause a sudden price correction, reducing consumer confidence, worsening banks’ balance sheets, and impacting overall economic activity.

***Tail risks and downside scenarios.*** Many of the above risks are closely linked, and the importance of agricultural sector exports to New Zealand’s near-term outlook makes the country vulnerable if a downside global scenario materializes. A combination of external shocks such as international financial turmoil and a slowdown in China and Australia would consequently reduce demand for New Zealand exports, worsen terms of trade, and could trigger a sudden decline in house and farm prices. This could in turn weaken consumer demand and negatively affect banks’ balance sheets and their willingness to lend. The downside macroeconomic impact in this scenario where shocks compound each other could be large.

***Managing risks.*** The authorities have monetary and fiscal policy space to respond to near-term shocks, with monetary policy serving as the first line of defense. The RBNZ has scope to lower interest rates and loosen monetary conditions to help buffer against a downside scenario. As evident during the global financial crisis, the free-floating New Zealand dollar provides an additional cushion against external shocks, including disruptions to offshore funding and negative terms of trade shocks, with widespread hedging by banks and businesses insulating their balance sheets from fluctuations in the exchange rate. The authorities would be able to provide emergency liquidity support to banks which proved effective when wholesale markets shut down in the wake of the 2008 crisis. New Zealand’s modest public debt gives the authorities scope to delay their planned deficit reduction path in the event of a sharp deterioration in the economic outlook. In terms of limiting risks in the housing market, the new macro-prudential tools under consideration could improve the RBNZ’s ability to safeguard financial stability, including guarding against a loosening of bank lending standards that would contribute to an unsustainable acceleration in house price inflation. As a longer term measure, policies to address housing supply constraints would play an important role in containing price pressures and increasing affordability.

**External stability**

***Current account.*** Reflecting low national savings relative to investment, New Zealand has run persistent current account deficits resulting in net external liabilities which are high by international standards.The deficit is expected to widen this year despite relatively strong terms of trade as earthquake related reconstruction gathers pace. Increasing national savings would be an important part of reducing external debt, and will depend in part on whether the recent increase in the household savings rate represents a structural break from the past. Fiscal deficit reduction would also contribute to raising national savings. The authorities’ efforts to identify ways of further increasing national savings are welcome.

***Exchange rate assessment.*** As part of the monetary policy framework, the free floating exchange rate regime should continue to provide an important buffer against external shocks or shifts in market sentiment. Staff estimates, as well as those of the authorities, suggest that the New Zealand dollar is currently stronger than would be consistent with medium term fundamentals, and on that basis appears to be overvalued. There are a number of factors contributing to the current level of the exchange rate, including the gap between domestic and foreign interest rates, and more recently, increased portfolio flows into New Zealand. If global monetary policy were to become less stimulatory, the exchange rate would likely depreciate over time, reducing the current account deficit over the medium term. The government’s deficit reduction plan also eases upward pressure on the exchange rate by boosting national saving. However, global liquidity could remain ample for some time, and New Zealand’s tradable sector will need to adapt by further increasing efficiency to remain competitive.

**Safeguarding Financial Sector Stability**

***Overview.*** New Zealand’s financial sector has strengthened in the aftermath of the global crisis. Asset quality remains good, the ratio of nonperforming loans to total assets is low and continues to decline from its peak, and return-on-assets is in line with the pre-crisis average. Capital adequacy has improved and is well above the Basel III capital requirements which the RBNZ began to put in place in January. Banks have shifted toward more stable funding sources facilitated by a combination of strong overall deposit growth and slower credit growth. Reliance on offshore wholesale funding has been reduced and is of longer maturity, and deposits now meet around half of banks’ funding requirements.

***Vulnerabilities.*** The four major banks are systemic with broadly similar business models, and their reliance on wholesale offshore funding, although lower than pre-crisis levels, still represents a risk. Residential mortgages and agricultural lending account for a large part of banks’ assets, sectors which are vulnerable to price fluctuations and where leverage is still high. These are longstanding structural issues that will remain sources of risk over the medium term. Staff simulations and the authorities’ recent stress tests suggest that the major banks could withstand a number of sizable shocks, but would make major inroads into their capital buffers. Banks would also likely require RBNZ help to withstand an extreme funding shock. We support the RBNZ’s plans to expand stress tests to include the smaller banks.

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

***Prudential measures.*** We support the authorities’ intention to establish a framework of macro-prudential tools to strengthen the resilience of the financial sector. Such tools include countercyclical capital buffers, core funding ratio, overlays to sectoral capital requirements, and loan-to-value restrictions, which could help dampen credit cycles, strengthen macroeconomic management, and guard against an acceleration in house price inflation. Such measures should be viewed as a complement to macroeconomic and micro-prudential tools. They should be used infrequently and (as experience with such instruments is limited) with caution, with the primary objective of limiting the periodic buildup of system-wide financial risk.