

The Economy of New Zealand: Overview

Introduction

New Zealand has a small export-dependent economy which operates on free market principles. It has sizable manufacturing and service sectors complementing a highly efficient agricultural sector. New Zealand is highly dependent on the primary sector with commodities accounting for around half of total exports. Exports of goods and services account for around one third of real expenditure GDP.

Background

New Zealand emerged from World War II with an expanding and successful agriculture-based economy. In the 1950s and 1960s, a period of sustained full employment, GDP grew at an average annual rate of 4%. Agricultural prices remained high, due in part to a boom in the wool industry during the Korean War. However, even during this period there were signs of weakness. In 1962, the Economic and Monetary Council advised the government that between 1949 and 1960 New Zealand's productivity growth had been one of the lowest amongst the world's highest earning economies.

In the late 1960s, faced with growing balance of payments problems, successive governments sought to maintain New Zealand's high standard of living with increased levels of overseas borrowing and increasingly protective economic policies.

Problems mounted for the New Zealand economy in the 1970s. Access to key world markets for agricultural commodities became increasingly difficult. The sharp rises in international oil prices in 1973 and 1974 coincided with falls in prices received for exports. As in many OECD countries, policies in New Zealand were principally aimed at maintaining a high level of economic activity and employment in the short term. High levels of protection of domestic industry had greatly undermined competitiveness and the economy's ability to adapt to the changing world environment. The combination of expansionary macro policies and industrial assistance led to macroeconomic imbalances, structural adjustment problems and a rapid rise in government indebtedness. After the next major shift in oil and commodity prices in 1979 and 1980, New Zealand's position deteriorated further.

From around 1984 onwards, the direction of economic policy in New Zealand turned away from intervention toward the elimination of many forms of government assistance. On the macroeconomic level, policies were aimed at achieving low inflation and a sound fiscal position while microeconomic reforms were introduced to open the economy to competitive pressures and world prices.

The reforms included the floating of the exchange rate, abolition of controls on capital movements, the ending of industry assistance, the removal of price controls, deregulation across a number of sectors of the economy, corporatisation and privatisation of state-owned assets, and labour market legislation aimed at facilitating more flexible patterns of wage bargaining.

After a period of weak growth during the late 1980s, New Zealand's economic performance improved significantly during the 1990s. From mid-1991, the economy grew strongly with particularly strong output from 1993 to 1996, with annual average growth in real GDP peaking at 6.8% in June 1994.

Growth slowed during 1997 and 1998 due to a slowdown in key Asian trading partners together with a drought that affected large parts of the country over the 1997/98 and 1998/99 summers.

After this period, the economy performed strongly with the exception of a short weaker period during 2001. However, the economy regained momentum, with a combination of two good agricultural seasons, relatively high world prices for New Zealand's export commodities, a low exchange rate and a robust labour market contributing to strong income flows throughout the economy.

Over 2002 to 2004, growth in GDP was generally in the 3.5% to 4.5% range, peaking at 5.2% annual average growth in December 2002. This period of strong growth included a period in which the economy was subject to several temporary negative events. These included travel disruptions and uncertainty due to the conflict in Iraq, the outbreak of SARS in Asia and the effects of dry weather on hydro-electricity production and farm output.

After 2004, growth eased as a result of high oil prices, interest-rate increases and weakness in the external sector, with the economy remaining flat in the second half of 2005. There was a recovery during 2006 as the exchange rate depreciated, but annual average growth of 1.7% for the year to December 2006 was well down from the recent peak of 4.4% in the year to 30 September 2004.

The current account deficit increased from the 2.7% to 4.1% range which had prevailed between 1990 and 1994, to 6.4% in 2000. The increase in the deficit was primarily caused by the international income deficit increasing, reflecting New Zealand's increased net international liability position. A depreciation of the exchange rate from 2000 saw the annual current account narrow to 2.8% of GDP in September 2001. A subsequent appreciation of the exchange rate saw the current account deficit reach 9.3% of GDP in the year to June 2006 as strong consumption and investment demand drove strong import growth.

Recent Developments and Outlook

A drought over the 2007/08 summer led to lower production of dairy products in the first half of 2008. Domestic activity slowed sharply as high fuel and food prices and the impact of past interest rate rises began dampening private consumption. High interest rates and falling house prices resulted in residential investment contracting sharply in the first half of 2008. The economy contracted 0.3% in the March quarter and again by 0.2% in the June quarter. Growth slipped by a further 0.4% in the September quarter on the back of lower investment and export volumes, taking annual average growth to 1.7% in the year to September 2008.

The appreciation of the New Zealand dollar during 2007, coupled with the re-acceleration of economic growth and continued capacity constraints, promoted a rebound in business investment. The resurgence in investment, coupled with the high exchange rate relative to the currencies of New Zealand's main trading partners, meant annual average import volume growth remained strong at 7.5% in the year ending September 2008. Slowing domestic activity and a falling exchange rate are expected to dampen import growth over at least the next three years.

The Trade Weighted Exchange Rate Index (TWI), which is based on a basket of rates for New Zealand's major trading partners, reached a record level of 75.42 in the middle of 2007. Despite the exchange rate remaining at historically high levels in the second half of 2007, export volumes continued to grow on the back of increased demand for agricultural products, particularly from Asia and oil-exporting countries. The currency began a swift period of downward adjustment, particularly against the US dollar, from early 2008 as the market assessed monetary policy in New Zealand shifting towards a loosening bias and a weaker outlook for growth. Annual average growth in exports slowed through 2008, increasing only 2.4% in the year to September 2008.

The terms of trade began increasing from December 2006, supporting export values (as well as private consumption) through 2007. The terms of trade reached a 33-year high in March 2008 and remained elevated in the September quarter due to record high commodity prices in late 2007 continuing to be reflected in export prices, particularly for dairy-related products. A sharp fall in oil prices is expected to result in the terms of trade peaking by year-end 2008 and gradually declining as export prices begin to fall. A declining exchange rate is expected to partly offset falling commodity prices and export volumes are expected to contract in the year to March 2009.

The current account deficit is expected to increase in the short term from the 8.6% of GDP reached in September 2008 given the surge in oil prices earlier in 2008 and the effects of the drought limiting some agricultural exports. The deficit is expected to increase from its September 2008 level of 8.6% of GDP in the short term but then to narrow over the next five years. Export price growth over 2008, along with declining imports, weak domestic demand and a pick-up in export volumes as global growth returns, is expected to contribute to the continued narrowing of the deficit.

Annual CPI inflation increased from 3.2% in September 2007 to 5.1% in September 2008, largely driven by higher petrol and food prices, before falling back to 3.4% in the December quarter. The September 2008 quarter's figure of 5.1% is expected to be the peak in the current inflation cycle as non-tradable inflation is expected to soften as resource pressures in the economy subside.

Annual growth is forecast to be just under zero in the year to March 2009 as domestic demand continues to slow. The slowdown has primarily been led by households, as private consumption and residential investment levels continue to fall. The anticipated reduction in private spending and residential construction is expected to assist in rebalancing the New Zealand economy, with the rate of household debt accumulation slowing and the household saving rate increasing. Growth is expected to pick up moderately in the year to March 2010 as domestic demand recovers in response to lower import prices and interest rates and as agricultural exports recover from drought-affected levels.

A large proportion of the risks and uncertainties around the outlook for New Zealand relate to the global economic outlook, especially around global financial markets and international commodity prices. If global growth continues to deteriorate and credit remains tight, businesses and households will be adversely affected. The degree to which the international situation deteriorates, and the extent of the impact on the real economy, is highly uncertain at this juncture. The path taken by the exchange rate and uncertainty around oil prices are additional risks to the outlook in the current economic climate.

Response to Recession and International Credit Crisis

Since taking office in November 2008, the new government has announced a number of initiatives aimed at mitigating the effects of the recession and the global credit crisis. These include:

- An accelerated package of 'ready-to-roll' infrastructure projects spanning the housing, transport, education and energy sectors at an estimated cost of almost \$500 million, of which around \$100 million worth of projects will start in the current financial year.
- A small business relief package designed to assist small and medium-sized businesses (which make up the largest proportion of New Zealand businesses) in order to reduce compliance and improve the business environment in the face of the crisis. The package includes the following elements:
 - a suite of 11 tax changes costing \$480 million over four years, with around \$270 million of extra cashflow remaining in businesses in the current financial year ending 30 June 2009;
 - an expansion to the export credit scheme;
 - extended jurisdiction for the Disputes (small claims) Tribunal to reduce the number of disputes going through lengthy court processes;
 - expansion of business advice services; and
 - a prompt-payment requirement for government agencies.
- Wholesale Funding and Retail Deposit Guarantees.

The primary objective of the two-year opt-in retail deposit guarantee scheme is to ensure public confidence in New Zealand's financial system given the international financial market turbulence. Bank and non-bank deposit-takers must apply to the Treasury for approval to participate in the scheme and, in certain cases, pay fees to the New Zealand Government based on amount of deposits guaranteed, growth in deposits and deposit-taker rating.

The primary objective of the opt-in wholesale funding guarantee facility is to facilitate access to international markets by New Zealand financial institutions in a global environment where international investors remain highly risk averse and where many other governments have offered guarantees on domestic banks' wholesale debt. The New Zealand Government receives a fee from each participating institution based on the institution's credit rating and the term and amount of guaranteed debt issued.

Fiscal Policy

Prudent Fiscal Management: The Public Finance Act 1989

In 1994, the Government enacted the Fiscal Responsibility Act. The Act was intended to assist in achieving consistent, good quality fiscal management over time, which would enable the Government to make a major contribution to the economic health of the country and be better positioned to provide a range of services on a sustained basis. This Act has now been repealed but its provisions have largely been incorporated into Part 2 of the Public Finance Act 1989.

Part 2 requires the Crown's financial reporting to be in accordance with New Zealand Generally Accepted Accounting Practice. The primary fiscal indicators are the operating balance, debt and net worth.

Part 2 requires the Government to pursue its policy objectives in accordance with the principles of responsible fiscal management set out in the Act. These include:

- reducing debt to prudent levels to provide a buffer against future adverse events;
- maintaining, on average, operating balance once prudent debt levels are reached i.e., the Government is to live within its means over time, with some scope for flexibility through the business cycle;
- achieving and maintaining levels of net worth to provide a buffer against adverse events;
- managing the risks facing the Crown; and
- pursuing policies that are consistent with a reasonable degree of predictability about the level and stability of future tax rates.

Key Fiscal Indicators

Operating Balance: Following a prolonged period of fiscal deficits, New Zealand achieved surpluses in 1993/94 and remained in surplus until 2007/08.

Core Crown operating expenses have been reduced as a percentage of GDP from over 40% in 1992/93 to 31.7% in 2007/08. Expenses have been controlled with output budgeting, accrual reporting and decentralised cost management.

In 2007/08, the operating balance was a surplus of \$2.384 billion. The December 2008 Update (main scenario) forecasts for 2008/09, 2009/10, 2010/11, 2011/12 and 2012/13 are for deficits of \$4.329 billion, \$1.990 billion, \$3.598 billion, \$3.609 billion and \$3.333 billion respectively.

Net debt: Net debt has fallen from 49% of GDP in 1992/93 to 0% in 2007/2008. Debt repayments have been financed from operating surpluses, and asset sales proceeds pre 1999.

Net worth: Net worth increased from \$96.8 billion in 2006/07 to \$105.5 billion in 2007/08. This improvement reflects the ongoing operating surplus plus revaluations of physical assets.

The January Financial Statements of the Government released on 6 March 2009 reported that both the operating balance and net worth were tracking lower than expected against the December Update. The variance was mainly driven by valuation changes in the liability of the Accident Compensation Corporation (ACC). The lower than forecast operating balance has limited impact on the cash position as the majority of the weaker investment returns are valuation changes and so are non-cash.

Both tax revenue and expenses were tracking close to expectation.

Losses arose in the New Zealand Superannuation Fund (NZSF) as a result of the sharp downturn of the financial markets (equity, commodities and property markets) during the period for September 2008 to January 2009. Weakness in the New Zealand dollar relative to foreign currencies also contributed to the losses in the NZSF.

Fiscal Objectives

The new government has announced it will set new fiscal objectives in the 2009 Fiscal Strategy Report to be published on 28 May 2009 in conjunction with the 2009 Budget. The government's focus will be on ensuring a stable economic environment, underpinned by a plan to set revised objectives, and taking credible and achievable steps to stop debt rising and eventually reduce debt and maintain net worth. Achieving this will mean a focus on influencing the fiscal aggregates, such as debt and net worth measures, over a long time period, lifting growth in the economy and constraining expenditure. The government's objective is to lift growth through reducing regulation, lowering taxes and lifting productivity. A public service that delivers quality services and better value for money will be an important component of achieving the fiscal objectives.

Direct Public Debt

Prior to March 1985, successive governments had borrowed under a fixed exchange-rate regime to finance the balance of payments deficit. Since the adoption of a freely floating exchange-rate regime, governments have undertaken new external borrowing only to rebuild the nation's external reserves and to meet refinancing needs.

Direct public debt increased by a net amount of \$702 million including swaps between 1 July 2007 and 30 June 2008. This increase was due to a net increase in internal debt of \$702 million. There was no change in external debt.

Government gross direct debt amounted of 17.7% of GDP in the year ended June 2008, down from 18.9% the previous year.

National Accounts

In the year to September 2008, the New Zealand economy recorded annual average annual GDP growth of 1.7%. Growth in the September quarter was -0.4% following growth of -0.2% in the June quarter and -0.3% in the March quarter. Growth is expected to be near zero in 2009/10 and to resume during the 2010/11 year.

Gross Domestic Product and Gross National Expenditure(1)

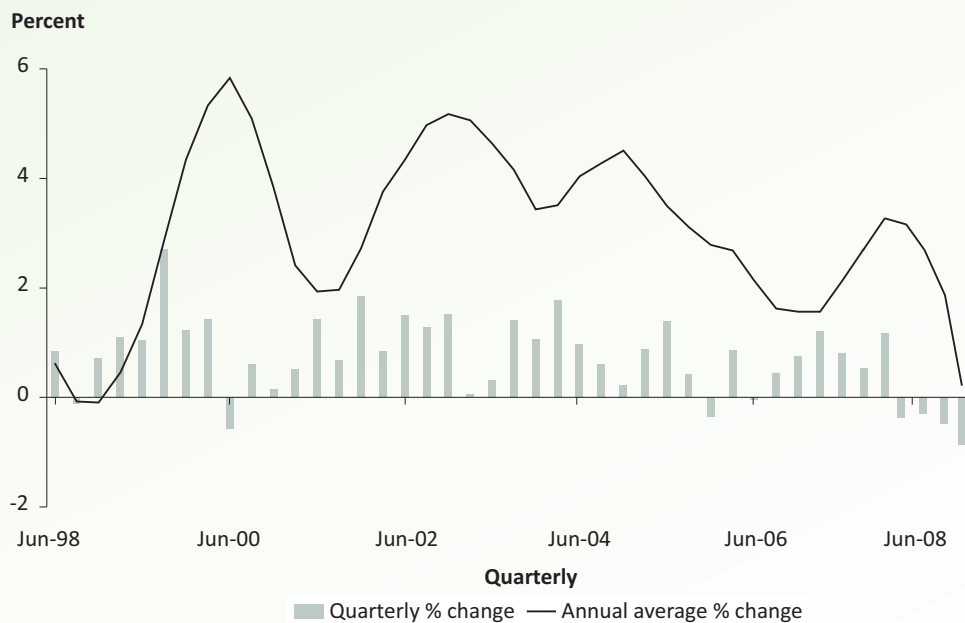
The following table shows Gross Domestic Product and Gross National Expenditure in nominal terms for the last five March years:

	Year ended 31 March				
	2004	2005	2006	2007	2008
	(dollar amounts in millions)				
Compensation of Employees	59,500	64,237	68,920	73,803	78,242
Net Operating Surplus	44,046	46,741	47,207	47,507	52,071
Consumption of Fixed Capital	18,902	20,315	21,858	23,595	25,082
Indirect Taxes	17,932	19,146	20,451	21,594	22,688
Less Subsidies	442	491	581	596	612
Gross Domestic Product	139,939	149,949	157,855	165,903	177,472
Final Consumption Expenditure					
General Government	24,383	26,347	28,521	30,843	33,304
Private	82,218	87,580	93,314	98,544	103,497
Physical Increase in Stocks	1,259	1,646	1,110	251	1,395
Gross Fixed Capital Formation	31,676	35,571	38,096	39,057	41,418
Gross National Expenditure	139,536	151,144	161,041	168,695	179,614
Exports of Goods and Services	40,658	43,337	43,808	48,202	51,390
Less Imports of Goods and Services	40,254	44,533	47,514	50,653	52,946
Expenditure on Gross Domestic Product	139,939	149,948	157,335	166,244	178,058

(1) 2008 data estimated. Prior years data revised.

Real Gross Domestic Product

Source: Statistics New Zealand



Gross Domestic Product by Production Group(1)

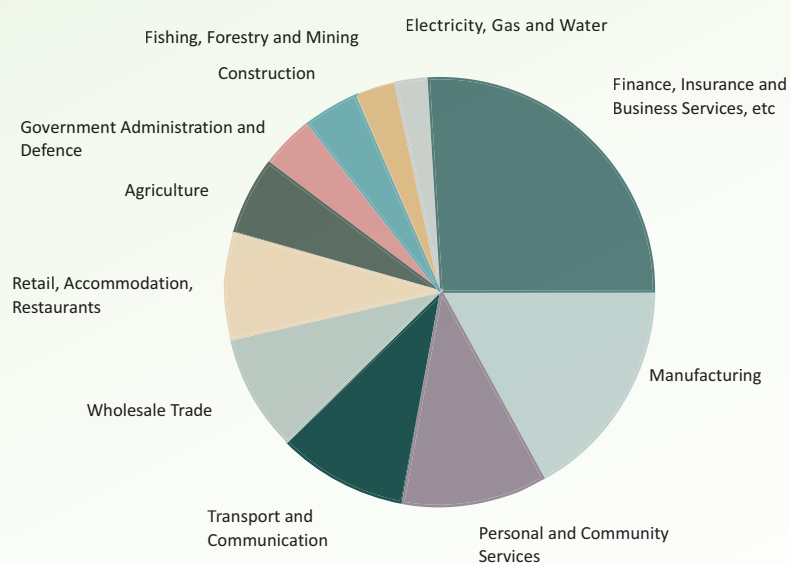
The following table shows Gross Domestic Product by major industries at constant 1995/96 prices:

	2004	2005	Year ended 31 March		2008	2008 % of Total
			2006	2007		
			(dollar amounts in millions)			
Finance Insurance & Business Services, etc	30,418	31,558	33,245	34,532	35,867	26.5%
Manufacturing	19,054	19,638	19,351	18,970	19,166	14.1%
Personal & Community Services	14,568	14,904	15,247	15,669	16,037	11.8%
Transport & Communication	12,124	12,868	13,228	13,516	14,214	10.5%
Wholesale Trade	9,195	9,823	10,077	10,081	10,508	7.8%
Retail, Accommodation, Restaurants	8,866	9,406	9,825	10,098	10,412	7.7%
Agriculture	6,300	6,090	6,485	6,505	6,372	4.7%
Construction	5,715	6,097	6,367	6,251	6,527	4.8%
Govt Administration & Defence	4,887	5,183	5,489	5,925	6,246	4.6%
Fishing, Forestry, Mining	2,740	2,633	2,597	2,567	3,193	2.4%
Electricity Gas & Water	2,395	2,525	2,414	2,485	2,379	1.8%
Gross Domestic Product	120,813	125,365	129,081	131,449	135,506	100.0%
Annual Average % change	4.3%	3.8%	3.0%	1.8%	3.1%	
Primary Industries	9,127	8,811	9,194	9,188	9,618	7.1%
Goods Producing Industries	27,173	28,299	28,170	27,783	28,122	20.8%
Service Industries	79,785	83,377	86,814	89,615	92,995	68.6%

(1) 2008 data estimated. Prior years data revised.

Gross Domestic Product by Industry Group

Source: Statistics New Zealand



Prices and Costs

New Zealand experienced a substantial improvement in inflation performance during the 1990s relative to previous decades. Since September 1991, inflation has averaged 2.2% per annum.

Annual inflation reached 4.0% in June 2006 as increases in international oil prices flowed through to higher petrol prices. Inflation then moderated, with lower petrol prices and increased government subsidies for childcare and healthcare helping to reduce annual inflation to 1.8% in September 2007. Rising petrol and food prices then led to inflation increasing for four consecutive quarters to 5.1% in the year to September 2008 before falling to 3.4% in the year to December. Inflation is expected to decline further to around 1% by the end of 2009, driven by lower import prices and a general easing in pricing pressures in the economy due to weaker domestic and external demand, partly as a result of the international financial crisis.

Patterns of inflation vary between internationally tradable and non-tradable goods and services. Continued strength in the housing market, and high energy and electricity costs, along with stretched productive resources, contributed to non-tradable inflation averaging 4.3% from 2004 to 2007. Tradable inflation was generally low through to the end of 2007 due to the high dollar relative to historical levels. The rapid rise in oil prices over the first half of 2008, coupled with increased food prices, resulted in higher tradable inflation through until September 2008, when it reached 6.3%.

Wage growth has increased over recent years, reflecting a tight labour market and high inflation. Growth in the index of salary and ordinary-time wage rates averaged around 2.3% per annum in 2003 and 2004 but has been above 3% since September 2005, with a record 3.6% increase in the year to September 2008. Growth rates are expected to soften with lower inflation and easing employment over the period 2009/10.

Producer price inflation for inputs was negative for most of the period from the second half of 2002 until the first quarter of 2004, with the appreciating exchange rate an important contributor. Producer price inflation turned positive in the year to June 2004 and rose to an annual rate of 8.0% in the June 2006 quarter before declining sharply to 1.3% in June 2007, as a result of the higher New Zealand dollar. Record high price increases for oil and oil-related products resulted in producer price inflation reaching 13.6% in the year to June 2008, a figure expected to unwind rapidly as oil prices decline.

The following table shows on a quarterly basis the Terms of Trade Index, the Producers Price Index, the Consumers Price Index, and the Labour Cost Index and, in each case, the percentage change over the same quarter of the previous year.

Prices and Costs

		Terms of Trade Index(1)		Producers Price Index(2)		Consumers Price Index(3)		Labour Cost Index(4)	
2004	March	1,057	6.1%	1,143	(0.3%)	928	1.5%	1,062	2.2%
	June	1,080	7.2%	1,165	2.1%	935	2.4%	1,068	2.3%
	September	1,077	7.3%	1,176	2.5%	941	2.5%	1,075	2.2%
	December	1,081	4.4%	1,186	3.3%	949	2.7%	1,083	2.5%
2005	March	1,105	4.5%	1,185	3.7%	953	2.8%	1,089	2.5%
	June	1,091	1.0%	1,210	3.9%	962	2.8%	1,096	2.6%
	September	1,087	0.9%	1,240	5.4%	973	3.4%	1,108	3.1%
	December	1,060	(1.9%)	1,251	5.5%	979	3.2%	1,117	3.1%
2006	March	1,069	(3.3%)	1,264	6.7%	985	3.3%	1,124	3.2%
	June	1,097	0.5%	1,301	7.5%	1,000	4.0%	1,132	3.3%
	September	1,073	(1.3%)	1,319	6.4%	1,007	3.5%	1,143	3.2%
	December	1,100	3.8%	1,305	4.3%	1,005	2.6%	1,153	3.2%
2007	March	1,117	4.5%	1,296	2.5%	1,010	2.5%	1,160	3.2%
	June	1,122	2.3%	1,312	0.8%	1,020	2.0%	1,167	3.1%
	September	1,163	8.4%	1,344	1.9%	1,025	1.8%	1,179	3.1%
	December	1,197	8.8%	1,361	4.3%	1,037	3.2%	1,191	3.3%
2008	March	1,247	11.6%	1,390	7.3%	1,044	3.4%	1,200	3.4%
	June	1,242	10.7%	1,473	12.3%	1,061	4.0%	1,208	3.5%
	September	1,214	4.4%	1,527	13.6%	1,077	5.1%	1,222	3.6%
	December	NA	NA	1,493	9.7%	1,072	3.4%	1,230	3.3%

(1) Base: June quarter 2002 = 1,000.

(2) All industry inputs. Base: December quarter 1997 = 1,000.

(3) Base: June quarter 2006 = 1,000.

(4) All industry ordinary time salary and wage. Base: June quarter 2001 = 1,000.

Labour Markets

New Zealand has a decentralised labour market. Enterprise bargaining predominates in the negotiation of the terms and conditions of employment. The Employment Relations Act 2000 provides the statutory framework that supports the building of productive employment relationships. The legislation promotes collective bargaining in various ways, such as providing that only unions and employers can be parties to collective agreements, and giving employees the right to strike in pursuit of multi-employer contracts. It also requires the parties to employment relationships (unions, individual employees and employers) to deal with each other in good faith.

At the same time, individual choice is protected in terms of freedom of association and union membership, and the choice of collective and individual employment agreements. The legislation promotes mediation to assist in the early resolution of workplace disputes.

In 2004 and 2006, the government made amendments to strengthen the Act to ensure it is better able to achieve its key objectives of promoting good faith, collective bargaining and the effective resolution of employment relationship problems. The amendments also provide protective measures for employees affected by the sale, transfer or contracting out of businesses.

A set of minimum employment standards also underpins employment relationships and protects the more disadvantaged in the workforce. Legislation here includes the Minimum Wage Act, the Equal Pay Act, the Holidays Act and the Parental Leave and Employment Protection Act.

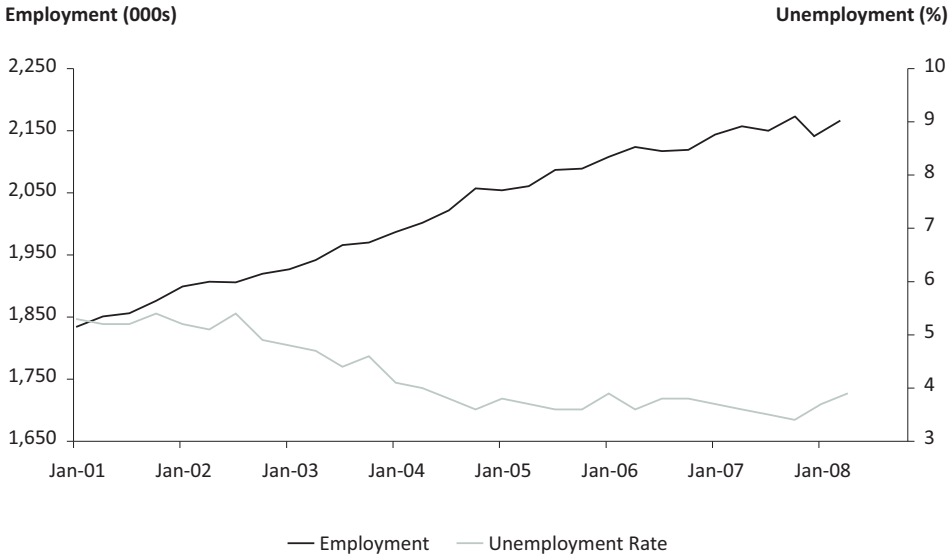
Employment growth has been strong recently, with annual growth averaging 2.4% over the four years to 2008 although it has since eased to 1.0%. The unemployment rate increased to 4.6% in December 2008, the highest rate in five years, although still low by historical standards. At the same time, the labour force participation rate was at an all time high of 68.8%.

Labour productivity grew through 2007 and peaked in the year to March 2008 at 3.3%. Productivity growth slipped to 2.7% in the year to June 2008 and is expected to continue to weaken in the near term as the economy cools.

New Zealand’s relatively high rate of job turnover and of firm creation and destruction suggests that there is a relatively low level of regulatory and institutional impediments to employment, disinvestment and innovation. Attention continues to be given to building up skill levels in the workforce and to addressing skill shortages.

Employment / Unemployment

Source: Statistics New Zealand





Summer wildflowers on the shores of Lake Hawea, Otago. *Andris Apse*



Prime grazing farmland, Southland. *Andris Apse*



Early morning frost on Canterbury farmland. *Andris Apse*