
New Zealand's imbalances in a cross-country context¹

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New Zealand's current account deficit is the counterpart of a low rate of national saving relative to domestic investment. Persistent current account deficits have led to the build-up of a large net international investment position (NIIP) financed largely through foreign debt with short maturity. Dependence on foreign capital makes New Zealand vulnerable to changes in the availability and cost of external financing, although New Zealand has not added to this vulnerability by taking on currency risk. Debt maturity has lengthened over the recent past in response to market pressure and the Reserve Bank's Prudential Liquidity Policy. Apart from New Zealand's financial vulnerability, high debt levels threaten to weigh on economic growth by raising interest rates and crowding out private investment. A strong fiscal position in the run-up to the global crisis served to allay concerns over New Zealand's credit worthiness, but the government's finances have deteriorated in the wake of the crisis. It would therefore be prudent to improve the fiscal position sooner rather than later. Faster fiscal consolidation would also contribute to the required rebalancing of the economy towards higher saving and exports. This article considers New Zealand's imbalances in a cross-country context in order to highlight sources of vulnerability.

1 Introduction

Over the past three decades, New Zealand has been running one of the largest and most persistent current account deficits relative to other advanced economies. The deficit has largely been funded using foreign borrowing. As a result, New Zealand is one of the more indebted nations in the OECD. The increase in New Zealand's overseas debt largely reflects private borrowing, much of which has been of short maturity.² This position makes New Zealand vulnerable to changes in investor sentiment and credit ratings that raise the cost of external financing or ultimately close off funding altogether. Currency risk is, however, very low, since almost all foreign currency borrowing is hedged back to local currency. The Reserve Bank can therefore provide local currency liquidity should funding risks spike unexpectedly.

New Zealand's economy has been relatively resilient through the recent global financial crisis. This has reflected, in part, a comparatively low level of public debt. However, in the aftermath of the global crisis, the government's finances have deteriorated. Much of the deterioration reflects a structural

increase in expenditure, not merely a cyclical reduction in revenue. A worsening fiscal position could have negative implications for borrowing costs and private sector access to capital. Faster fiscal consolidation would therefore be prudent. It would also contribute to the required rebalancing of the economy.

Domestic savings and investment behaviour are important features of New Zealand's external imbalances. The current account deficit is the counterpart of a gap between domestic saving and investment. While the investment rate is comparable to those of other OECD economies, the saving rate is comparatively low. A higher investment rate may reflect New Zealand's growing population and desired catch-up to income per capita levels of other advanced economies. But low national saving implies a dependence on inflows of foreign capital. Over time, this foreign borrowing requirement may weigh on growth by raising interest rates.

New Zealand's vulnerability to shocks can be reduced by gradual unwinding of its imbalances. Such rebalancing will likely require higher national saving, improved international competitiveness and fiscal consolidation. The recovery that is currently under way displays some important features of the required rebalancing, including higher household saving and debt consolidation. Over the longer term, such a rebalancing would enhance resilience and support higher and more sustainable growth.

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² Gross private overseas debt has risen from about 46 percent of GDP in 1989 to over 115 percent most recently. The government's gross overseas debt, on the other hand, fell from 26 percent of GDP to below 10 percent prior to the global crisis.

This article considers New Zealand's imbalances in a cross-country context in order to highlight sources of vulnerability. Section 2 compares New Zealand's external imbalances to those faced by other advanced countries. A discussion of internal imbalances is taken up in section 3, focusing on household saving and investment behaviour and public sector borrowing and creditworthiness. Section 4 considers the rebalancing process and the adjustment that the New Zealand economy must undergo. Section 5 concludes.

2 New Zealand's external imbalance

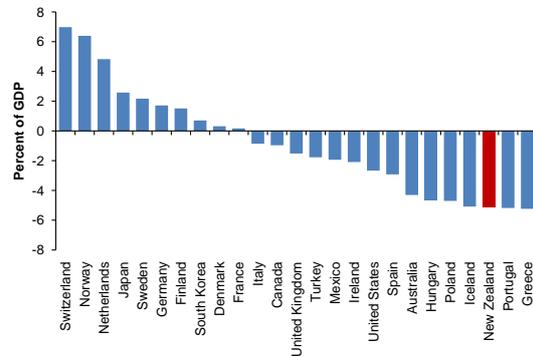
Large and persistent current account deficits

The current account reflects the difference between domestic saving and total investment. In an open economy, a part of domestic spending and investment can be financed from capital inflows from other countries. For developed economies, a current account deficit can be symptomatic of a lack of international competitiveness, leading to a trade deficit and need to borrow to finance consumption in excess of income.

New Zealand's large and persistent current account deficit, however, reflects a low national saving rate relative to domestic investment. The current account deficit has, on average, largely been the product of a deficit on the investment income account – the trade balance has been in surplus for much of the last two decades. As such, the deficit is strongly related to the country's high stock of foreign debt, low rates of return on foreign assets, and the relative attractiveness of New Zealand's financial assets.

New Zealand's current account deficit is large by OECD standards. Figure 1 below plots New Zealand's external balances against those in other OECD countries. New Zealand's current account deficit averaged over 5 percent per annum between 1980 and 2009 and over 8 percent in each year between 2005 and 2008. Australia and New Zealand have both been able to run large and persistent current account deficits over several decades without experiencing a sudden balance of payments reversal or a even a prolonged rebalancing.

Figure 1
Average current account balances for selected OECD economies (1980 - 2009)

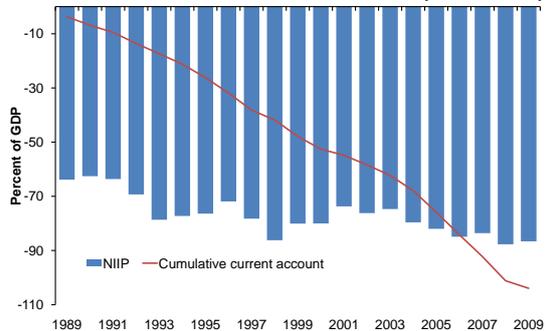


Source: IMF, Statistics NZ.

Build-up of foreign liabilities

The flipside of the large current account deficit is a large offshore financing requirement. Continuous current account deficits since 1973 have therefore led to a build-up of foreign liabilities (figure 2).³ The country's NIIP, which reflects the balance of total assets held offshore and total liabilities owed to foreigners, has deteriorated to around 86 percent of GDP – one of the highest levels among OECD countries (figure 3). A high level of external liabilities increases a country's vulnerability. This is because creditors may become increasingly anxious about the possibility that the country will not be able to meet its debt service obligations, raising

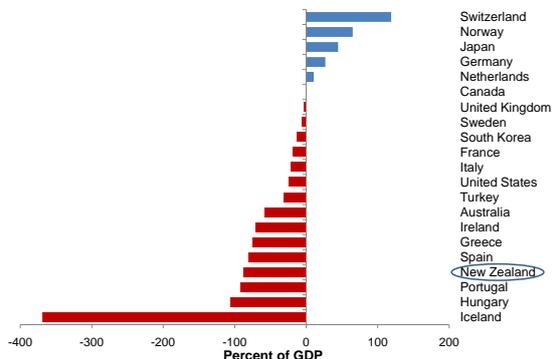
Figure 2
Cumulative current account and NIIP (% of GDP)



Source: Statistics NZ, author's calculations.

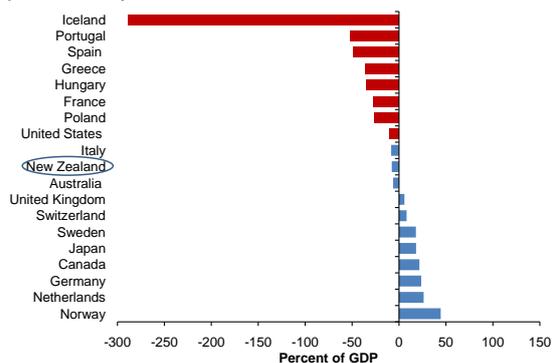
³ A country's NIIP in a given period will equal the current account deficit recorded in the previous period plus the NIIP from the previous period, adjusted for valuation changes. Valuation changes occur because of changes in the exchange rates and prices used to measure the values of the assets and liabilities that comprise the NIIP.

Figure 3
NIIP for OECD countries in 2008
(% of domestic GDP)



Source: IMF, Statistics NZ, author's calculations.

Figure 4
Change in NIIP between 2000 and 2008
(% of GDP)*

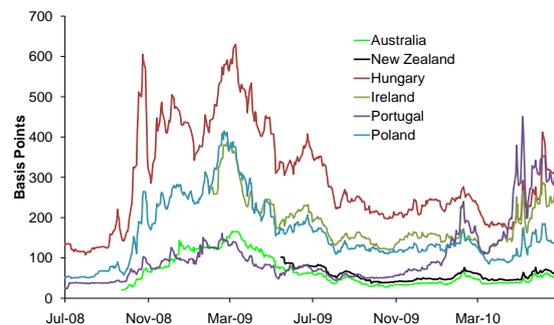


* A negative change reflects a deterioration in the NIIP.
Source: IMF, Statistics NZ, author's calculations.

borrowing costs and making the repayment of debt even more difficult. The recent experiences of Iceland, Greece, Spain, Portugal and Hungary demonstrate the vulnerability of countries with large net foreign liability positions (see figure 4).

Burgeoning current account deficits and dependence on foreign capital have been a major source of fragility for several other economies in the OECD. Greece, Hungary, Iceland, Ireland, Portugal and Poland have all seen the costs of their external borrowing rise as global risk aversion spiked during the crisis and market perceptions of public sector credit worthiness (figure 5) subsequently deteriorated. Factors that have distinguished New Zealand and Australia include relatively strong fiscal positions prior to the crisis, very low levels of currency exposure and floating exchange rates.

Figure 5
Sovereign credit default swap spreads for selected OECD countries*



* Credit default swaps measure the perceived riskiness of debt denominated in a given national currency.
Source: Bloomberg.

Despite the vulnerabilities associated with large external imbalances, New Zealand has been able to sustain a persistent current account deficit over recent decades. One possible reason why markets have been so sanguine about New Zealand's deficit could be that the risk of a sudden external adjustment has been quite low. A study by Edwards (2006) suggests that, while a high deficit raises the probability of an abrupt and costly external adjustment, the risk of a large adjustment nevertheless remains relatively low in New Zealand.⁴

Financial market confidence about New Zealand's ability or willingness to repay its external obligations may also reflect expectations of higher future incomes and economic growth. If the deficit reflects investment in the economy, inflows of foreign capital will raise the country's capital stock and growth potential.⁵ Provided that inflows are invested productively, inflows may be expected to generate sufficient additional income to service the country's additional foreign obligations. Even though New Zealand's growth performance over recent decades has been lower than the OECD average, research by the Treasury (Makin, Zhang and Scobie 2008) suggests that the returns to foreign capital have been sufficient to service the debts that have accompanied those inflows.

⁴ For a given debt level and a current account deficit of 3 percent, Edwards estimates that the probability of a 5 percent of GDP adjustment in the current account deficit is about 0.6 percent. Given a deficit of 9 percent of GDP, the probability rises to 5 percent.
⁵ See for example, Makin (2005), Kim, Hall and Buckle (2006), or Munro and Sethi (2006).

Composition of New Zealand's external balance sheet

The size and composition of the external balance sheet has important implications for the transmission of external shocks to its economy (Bedford 2008). The structure of the external balance sheet will also have an important bearing on the evolution of the country's external position. The gross value of international assets and liabilities will be impacted by movements in the exchange rate and domestic and foreign asset prices.⁶ Changes in the returns to different classes of foreign assets and liabilities will also impact cross-border income flows.

New Zealand's large stock of net foreign liabilities, together with a high average yield on New Zealand's liabilities relative to those on the country's assets, have been responsible for generating a large net deficit on the investment income account. The deficit averaged over 6 percent to GDP between 2000 and 2009. As mentioned earlier, a large deficit on the net international investment account has been a key contributor to the persistence of the current account deficit.

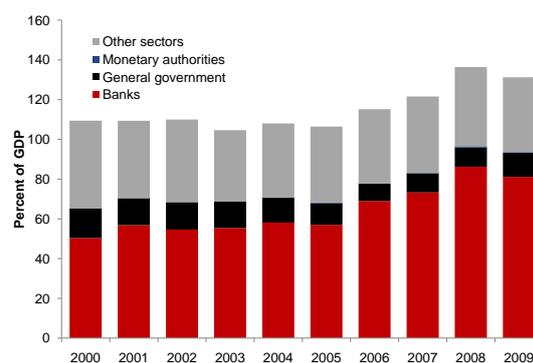
New Zealand's external deficit has been financed largely through debt inflows. As a result, gross liabilities comprise mostly debt. Over 80 percent of New Zealand's gross foreign liabilities are in the form of borrowing, while debt comprises over 90 percent of foreign liabilities on a net basis.

The vulnerabilities associated with foreign debt financing will depend on the composition, maturity structure and currency denomination of the stock of debt. New Zealand has a large stock of external debt, much of which reflects banking sector borrowing at relatively short maturities.

Gross foreign debt to GDP peaked at over 130 percent in 2008 (figure 6). Banks are responsible for more than 60 percent

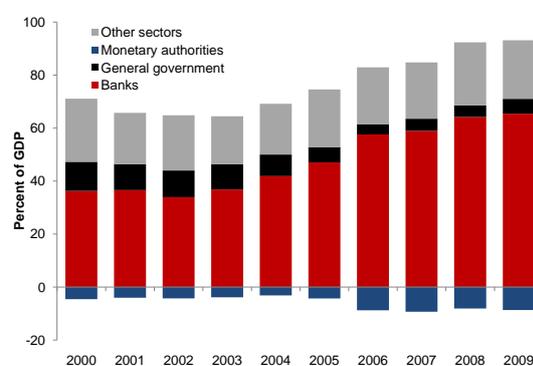
of total gross foreign debt, which is equivalent to around 80 percent of GDP. General government debt is a comparatively small portion of external debt. Since bottoming at the end of 2006 at 8.9 percent of GDP, gross public debt increased to about 13 percent by the first quarter of 2010. On a net basis, public external debt stands at 6.7 percent of GDP and overseas bank debt is 64 percent of GDP (figure 7).

Figure 6
New Zealand's total gross external debt (% of GDP)



Source: Statistics NZ, author's calculations

Figure 7
New Zealand's net external debt (% of GDP)



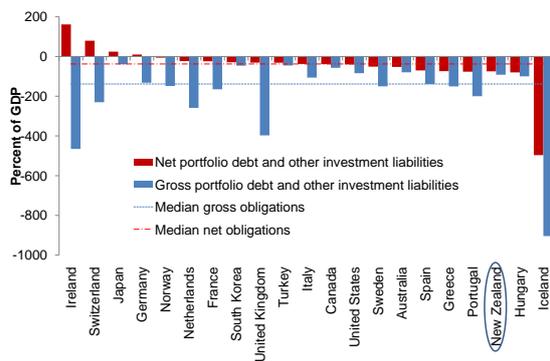
Source: Statistics NZ, author's calculations

While New Zealand is relatively highly indebted on a net basis, gross indebtedness is much lower compared to other OECD economies. In the absence of comparable figures for net external debt, cross-country debt figures are proxied using gross stocks of portfolio debt and other investment

⁶ It appears that periods of strong nominal GDP growth and favourable valuation changes have helped offset some of the deterioration in New Zealand's NIIP to GDP ratio from cumulative current account deficits (as in figure 2). Offsetting valuation changes are likely to reflect the fact that New Zealand's foreign assets are slightly skewed to equity that have delivered large valuation changes, while liabilities are skewed to debt, almost all of which is denominated in local currency or hedged. The latter implies that the liabilities side of New Zealand's balance sheet will be less subject to revaluation effects from exchange rate changes.

assets and liabilities (after subtracting financial derivatives).⁷ On this basis, Figure 8 shows that New Zealand's ratio of net foreign liabilities to GDP is higher than the median level for the OECD, at over 70 percent of GDP in 2008. New Zealand's gross position is, however, much lower in comparison to other OECD economies (depicted as the blue bars in figure 8). This means that New Zealand has not used its foreign borrowing to lend offshore.

Figure 8
Gross and Net external debt in 2008 (% of GDP)



Source: IMF, author's calculations.

Low currency risk

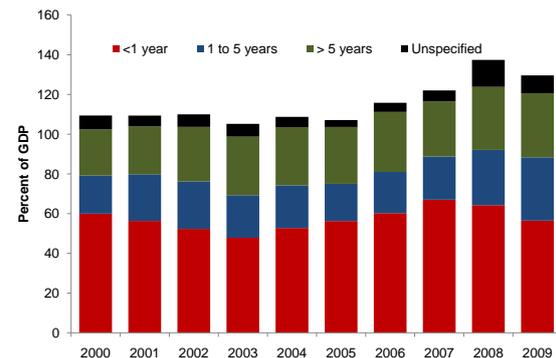
Debt funding implies exposure to changes in interest rates and roll-over risk as loans mature. Compared to other countries, currency risk is low in New Zealand. About half of New Zealand's gross foreign debt is denominated in local currency. Almost all of New Zealand's foreign currency debt (93 percent) is hedged, either using financial derivative contracts or by matching foreign currency exposures with foreign currency assets or expected foreign currency

revenues.⁸ This virtual absence of currency mismatch insulates domestic debtors against adverse exchange rate fluctuations, reducing the impact of expectations of currency depreciation on debt and debt service costs.

Some refinancing risk

Reliance on short-term foreign borrowing makes a country vulnerable to funding problems in the event of changes in the availability of foreign lending. New Zealand does have a reasonably high proportion of short-term debt to total foreign borrowing, at about 40 percent (see figure 9). But by OECD standards, New Zealand's short-term foreign indebtedness does not appear to stand out. Available data suggest that the value of New Zealand's outstanding short-term debt securities are not high on a comparative basis, both as a percentage of GDP or as a share of total gross external debt in issue (figures 10 and 11).⁹ Both ratios have also dropped in recent years relative to those in peer OECD countries. Figure 12 shows that New Zealand's foreign exchange reserves cover a relatively large portion of the country's short-term external debt, even though the gross level of foreign reserves remains reasonably low relative to some other OECD countries.

Figure 9
Maturity composition of foreign liabilities



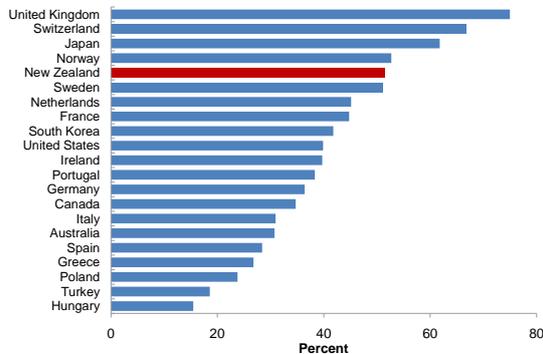
Source: Statistics New Zealand

⁷ Figure 8 uses a balance of payments presentation to compare New Zealand's external position to other countries. This approach nets out cross-border inter-company borrowing and lending and excludes financial derivatives. Note that the foreign debt figures presented in figures 6 and 7, on the other hand, are based on a balance sheet approach. In the balance sheet presentation of the external position, all forms of lending are classified as assets and all forms of borrowing are classified as liabilities. The balance sheet and balance of payments presentations provide the same NIIP, equity positions and reserve asset balances. But gross estimates of the foreign debt will differ depending on the composition of individual assets and liabilities. See Statistics New Zealand's 'Balance of Payments and International Investment Position' reports, available from their website, for more detail.

⁸ See Statistics New Zealand's annual hedging survey. Results are available in their 'Balance of Payments and International Investment Position' reports published on their website.

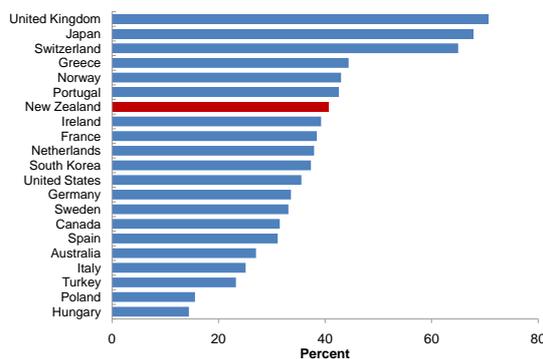
⁹ External debt should be calculated as borrowing to non-residents less financial derivatives. Because a breakdown of financial derivatives by maturity is not published, New Zealand's short-term external debt is proxied using short-term external borrowing only, whereas gross external debt is total external borrowing less total financial derivatives. New Zealand's short-term debt figures will therefore be slightly overstated in figures 10-14.

Figure 10
Short-term external debt (by maturity) as a proportion of total gross external debt
(June 2008)



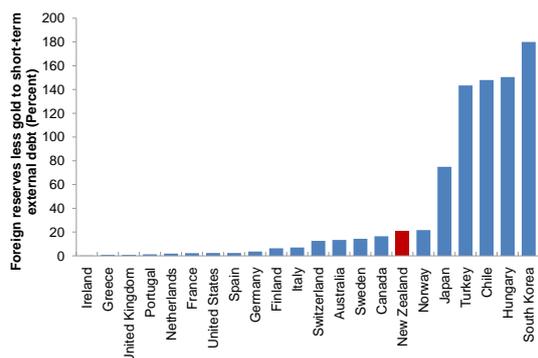
Source: World Bank, Statistics New Zealand, author's calculations.

Figure 11
Short-term external debt (by maturity) as a proportion of total gross external debt
(June 2010)



Source: World Bank, Statistics New Zealand, author's calculations.

Figure 12
Total foreign reserves to short-term external debt
(December 2009)



Source: IMF, BIS, Statistics NZ, author's calculations.

The banking sector remains exposed to liquidity and refinancing risk should domestic conditions deteriorate or external events cause global interest rates to spike or liquidity to dry up. Over 40 percent of New Zealand's domestic bank lending is funded via offshore borrowing and over 50 percent of this is short term. Domestic on-lending by banks is, however, focused on longer-term advances such as mortgage loans. Housing debt owed to registered banks totals over 90 percent of household lending from banks.

Several factors offset these risks. New Zealand banks' hedging activities largely reduce interest rate risk. Banks have tended to reduce funding costs by borrowing in foreign currency in foreign wholesale markets and then using swap contracts to convert the proceeds into New Zealand dollars. This transforms foreign short-term borrowing into local currency borrowing that is only subject to longer term re-pricing.¹⁰ Government guarantees and the Reserve Bank's liquidity operations also played a key role in maintaining the supply of funding during the crisis. The introduction of the Crown wholesale guarantee scheme in November 2008 buttressed confidence in the market for New Zealand debt and helped secure bank sector funding.¹¹ The lack of currency exposure on external debt means that the Reserve Bank can provide New Zealand dollar liquidity should local borrowers face stress in external funding markets. Access to external financing is also supported by the linkages between Australian parents and domestic banks.

In response to market pressures, domestic banks have lengthened the maturity of funding to reduce their refinancing risk. The Reserve Bank's Prudential Liquidity Policy also underpinned this development, by requiring a larger proportion of long-term wholesale financing and retail deposits.¹² Bank funding with a maturity of more than 1 year has increased from about 34 percent of total in mid-2008 to 44 percent.

¹⁰ See Craigie and Munro (2010) for more detail.

¹¹ See *Financial Stability Report* November 2010.

¹² At the time of writing, domestic banks' core funding levels exceed the current minimum ratio (65 percent) as well as the level that the ratio is expected to be raised to over the next two years (75 percent). Banks' liquid asset positions also remain well above the minimum required level.

Government guarantees and liquidity operations can transfer some private credit risk to the public sector. Banking sector stresses and interbank freezes can feed through to sovereign liquidity and solvency risk.¹³ The recent Irish experience offers an important warning about the potential impact of government bank bailouts on the solvency of the public sector.

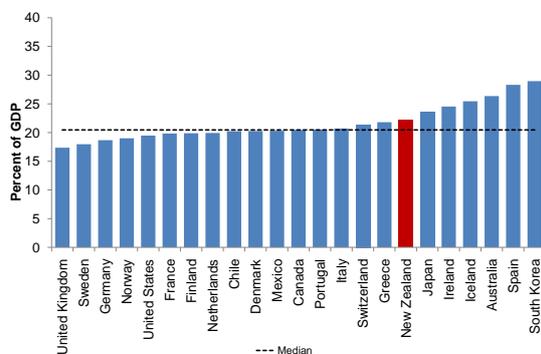
3 Domestic imbalances

Low national saving rate

New Zealand's external imbalances are inextricably linked to domestic imbalances. A low national saving rate relative to investment manifests as a large and persistent current account deficit. Higher levels of public and private debt make the economy vulnerable to shocks and weigh on New Zealand's growth potential by raising interest rates and crowding out private investment. It also reduces the scope for counter-cyclical fiscal responses to shocks.

The national saving rate has fallen slightly over recent years, while the investment rate has remained largely stable. The decline in national saving has seen a widening in the gap between New Zealand's saving and investment rates. While the investment rate has been just above the median for OECD countries (figure 13), New Zealand's saving rate has been low by OECD standards (figure 14).

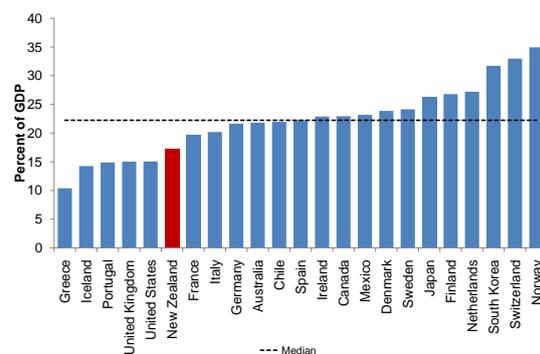
Figure 13
Gross Fixed Capital Formation (average 2000 to 2007 % of GDP)



Source: IMF.

¹³ By impairing Government's perceived creditworthiness, a banking crisis could set off a sudden stop in capital inflows. See André (2010) for a description of plausible scenarios of a sudden adjustment, in the context of recent international experiences.

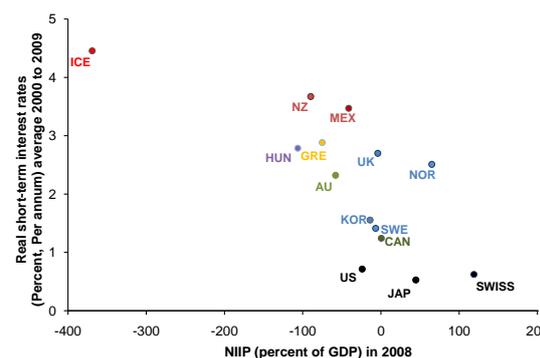
Figure 14
Gross national saving (average 2000 to 2007 % of GDP)



Source: OECD.

A low saving rate has important implications for macro-stability and future growth prospects.¹⁴ Low national saving implies a dependence on inflows of foreign capital, which over time increases debt service costs. Servicing the foreign borrowing requirement may weigh on the performance of the economy if higher levels of debt lead to higher interest rates and lower capital accumulation. Figures 15 to 16 compare interest rates in OECD countries and demonstrate that New Zealand's interest rates have been relatively high.

Figure 15
Comparative real short-term interest rates* and NIIP

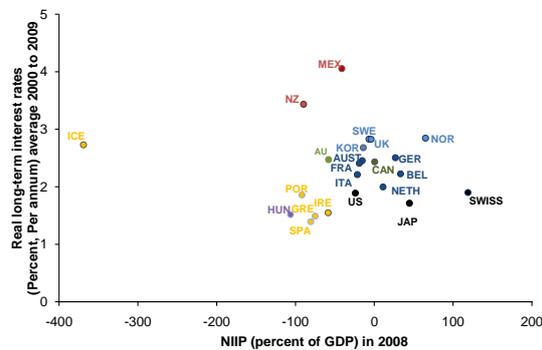


* Annual average nominal interest rates less average annual consumer prices.

Source: OECD, IMF, author's calculations.

¹⁴ See New Zealand Treasury (2010) for a detailed discussion.

Figure 16
Comparative real long-term interest rates* and NIIP



* Annual average nominal interest rates less average annual consumer prices.
Source: OECD, IMF, author's calculations.

Higher interest rates could reflect higher risk premia associated with New Zealand's external debt. Monetary policy may also increase interest rates in response to the inflationary consequences of low saving and debt-financed consumption.¹⁵ The latter explanation for high interest rates in New Zealand appears to be particularly applicable in the decade preceding the crisis, as it was characterised by abundant global liquidity and compression of country risk premia.

Prior to the global crisis, relatively high interest rates also tended to attract yield-seeking inflows, strengthening the currency. A strong currency has tended to reinforce the current account deficit by lowering returns to exports and lowering the cost of imported goods. Over time, this has produced a divergence between the fortunes of the traded and non-traded sectors in New Zealand, creating considerable demand for imports and reducing the economy's capacity to expand exports and unwind the imbalances.

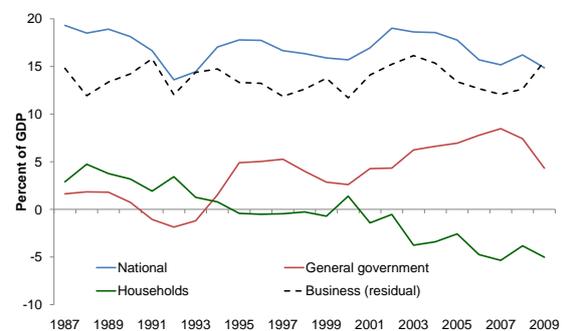
The economy could be burdened with substantially higher debt service costs should global investors increase the rates of return they require for lending to New Zealand residents. In the aftermath of the global financial crisis and stress in the sovereign debt markets elsewhere, global credit markets remain cautious about markets and sovereigns that appear risky.

¹⁵ See Labuschagne and Vowles (2010).

Low household saving

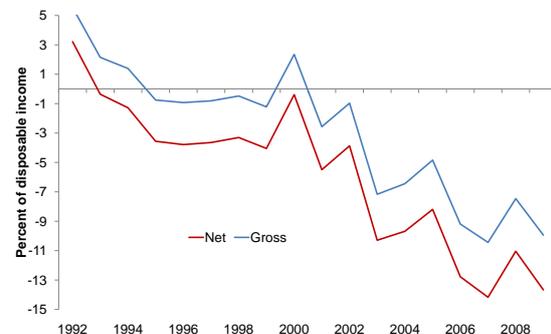
Official data suggest that households in New Zealand have been dis-saving, in effect financing consumption out of accumulated saving, borrowing or increases in wealth from rising asset prices. Households displayed a high propensity to finance consumption using debt in pre-crisis years – reacting to strong growth in house prices by withdrawing housing equity.¹⁶ The household saving rate has trended down since 1989 and has been negative for much of the recent decade (figures 17 and 18).

Figure 17
Gross saving by sector



Source: Statistics New Zealand

Figure 18
Saving rate by households in New Zealand



Source: Statistics New Zealand

Erratum: This online version uses the corrected figure.

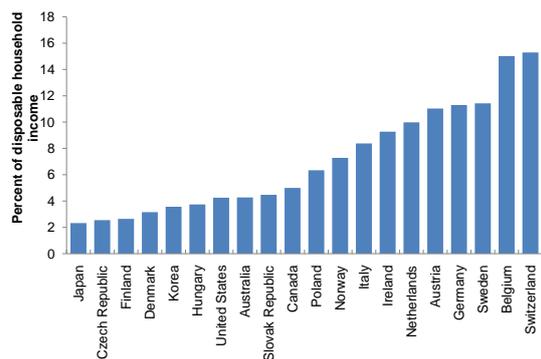
There are measurement problems associated with household sector income and balance sheet estimates in New Zealand.¹⁷ These measurement issues makes accurate

¹⁶ See Briggs (2008).

¹⁷ A full set of institutional sector accounts is not currently produced in New Zealand. There is likely to be substantial under-coverage of the cross-holdings of assets and income sharing between households and businesses in New Zealand in the existing estimates. Several papers have highlighted problems with different measures of saving in New Zealand (see for example Claus and Scobie (2002), Bascand, Cope and Ramsay (2006) or Scobie and Henderson (2009)).

comparison of New Zealand's household saving rate with other countries difficult.¹⁸ Nevertheless, the official figures are the best estimates of the economy's historical saving performance and suggest that New Zealand has the lowest household saving rate in the OECD (figure 19), albeit with the aforementioned caveat.¹⁹

Figure 19
Net household saving by selected OECD countries (2009)



Source: OECD

The current account deficit and low national saving need to be viewed against a global backdrop of historically low global long-term real interest rates. Prior to the crisis, easing borrowing constraints, associated with abundant liquidity, encouraged debt accumulation and discouraged saving in countries with open financial markets.²⁰ For example, in the US, Canada, UK and Australia, self-reinforcing cycles of credit growth, asset price growth and rising indebtedness emerged

¹⁸ The paucity of data also prevents accurate analysis of whether the deterioration in household saving in the country prior to the crisis reflected a partial offset to rising government saving pre-crisis or 'piercing of the corporate veil' via offsetting changes in business saving. This problem can be addressed by analysing the saving behaviour of the private sector as a whole. On this basis, business saving (measured as a residual) has remained relatively stable, averaging 14 percent between 2000 and 2009.

¹⁹ Note that household saving rates may not be directly comparable. Reasons include, for example, the calculation of depreciation in estimating net saving from the gross figures, the treatment of unincorporated businesses and non-profit organisations in the national accounts or whether pension benefits and contributions are included in disposable income.

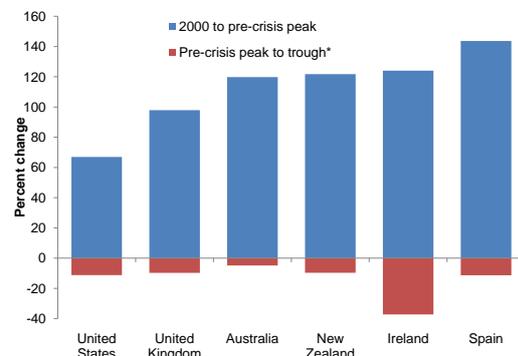
²⁰ This owed, in part, to structural surpluses in oil producers and fast-growing Asian economies, as well as reserve accumulation by developing countries seeking to amass the resources required to intervene in foreign exchange markets and self-insure against 'sudden stops' in the availability of foreign capital.

during the run-up to the global crisis, as rapidly growing credit inflated asset price booms that facilitated even more credit extension. Rising housing equity collateralised growth in credit extension and higher levels of debt, weighing on disposable income despite lower interest rates. There is evidence that New Zealand's strong consumption pre-crisis was related to a rise in household wealth.²¹

Households are exposed to property prices

A significant portion of New Zealand households' wealth is stored in the form of housing.²² The concentration of household wealth in property has meant that wealth is dependent on trends in property prices. New Zealand house prices grew very rapidly prior to the global crisis (figure 20). This contributed to a considerable increase in household net wealth between 2001 and 2006, in turn enabling debt accumulation via stronger household balance sheets.

Figure 20
Nominal House Prices in selected economies



* At the time of writing, available data suggest that prices have not yet reached a trough in Spain, Ireland, the UK or the US.

Source: BIS, author's calculations.

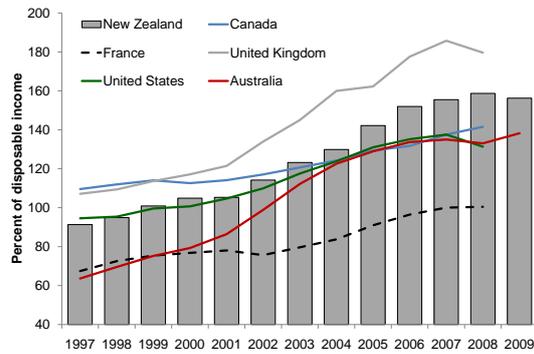
New Zealand households' debt-to-income ratio rose rapidly prior to the global crisis, tripling since the early 1990s. Though very high by New Zealand's own historic standards, this ratio is not dramatically higher than in OECD economies with liberalised financial markets (Figure 21). In the run-up to the crisis, credit growth was however lower in New Zealand

²¹ See De Veirman and Dunstan (2008) and (2010).

²² See New Zealand Treasury (2010) or Le, Gibson and Stillman (2010).

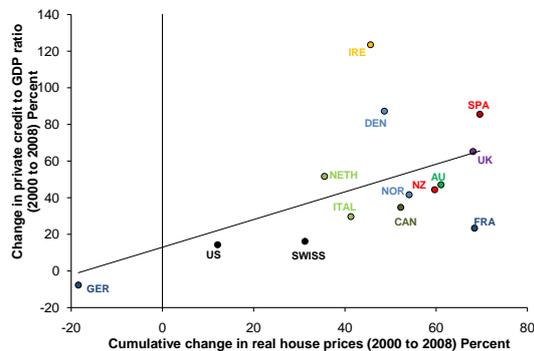
than in countries where the subsequent housing corrections have been particularly pronounced, such as Ireland and Spain (see figure 22).

Figure 21
Household debt as a proportion of disposable income for selected countries



Source: OECD, RBNZ, RBA.

Figure 22
Credit growth and house prices in selected OECD countries



Source: OECD, IMF.

The rebalancing has involved weaker credit growth as banks have faced stressed credit markets and weaker demand for credit as households and businesses have focused on repaying debt and reducing leverage. House prices have also declined in tandem with the reduction in credit and weak sentiment. House prices in New Zealand fell by over 10 percent from their peak to their trough, but the adjustment has been modest compared to some other OECD countries. Tighter credit conditions have placed further downward pressure on house prices, which has tended to raise effective leverage, as witnessed by the slight rise in the debt-to-housing -value ratio in New Zealand over the last year.

History suggests that debt ratios may be set to decline further in the coming years, particularly in economies that experienced banking crises. A recent Bank of International Settlements paper suggests that, on average, private sector debt to GDP tends to fall by 38 percent in the wake of financial crisis.²³

Homeowners in New Zealand appear to have an adequate buffer to absorb adverse shocks. Debt service costs rose in the run-up to the financial crisis as policy tightened, but subsequently declined as the policy rate was lowered and effective interest rates fell. At present, the ratio of non-performing loans remains relatively low (see *Financial Stability Report* November 2010). Moreover, the bulk of mortgage debt is held by higher-income households, who are more able to service their debt stocks.²⁴

Households' debt service capacity nevertheless remains vulnerable to shocks to income or interest rates. Any severe or persistent housing correction or tightening of lending conditions would also significantly drag on GDP growth as the deterioration of household balance sheets feeds through to confidence and consumption. By impacting the perceived credit worthiness of domestic banks and the government, weakening domestic fundamentals could lead to a larger premium for offshore funding. In this way, a reliance of foreign borrowing could amplify the impact of household sector stresses on the economy.

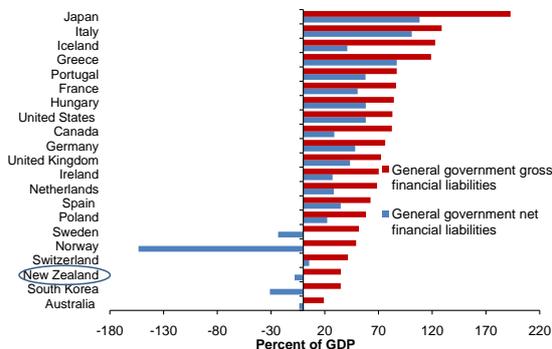
A strong initial fiscal position an important risk offset

While household saving fell significantly in the years prior to the crisis, government saving offset some of that decline. On a gross basis, government saving averaged over 5 percent of GDP between 1994 and 2009, with a return to consistent budget surplus from the mid-1990s. This allowed government to repay debt, which fell to below 30 percent of GDP at end 2006 on a gross basis. A low level of public debt and government surpluses in the run-up to the crisis meant that the Government had the fiscal space necessary to support the economy via expansive fiscal policy during the downturn. New Zealand's government debt remains low relative to other OECD economies (figure 23).

²³ See Tang and Upper (2010).

²⁴ See Kida (2009).

Figure 23
Comparative stocks of government liabilities in 2009

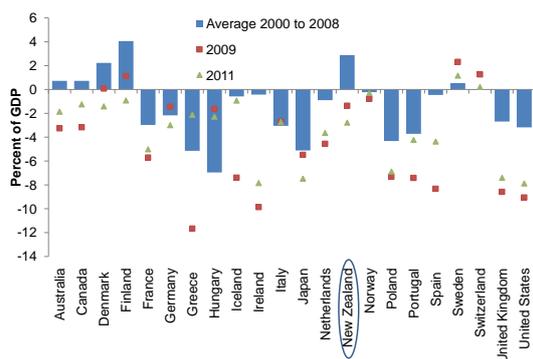


Source: OECD

But the strong fiscal position has reversed

In the aftermath of the crisis, the borrowing needs of most advanced economies have expanded rapidly. This is due to both the costs of fiscal stimulus, support for troubled institutions, as well as automatic stabilisers – expanding welfare payments and lower tax receipts brought on by the recession that the crisis produced. The reversal in New Zealand’s fiscal position since the recession has been significant by OECD standards (figure 24).

Figure 24
General Government cyclically-adjusted budget balances



Source: OECD

The change in the cyclically adjusted budget balance between 2007 and 2009 was the third largest in the OECD, behind Spain and Ireland. Much of the deterioration in New Zealand’s fiscal position owes to rising spending and lower tax rates, rather than a cyclical falloff in revenue from weaker growth. Treasury forecasts, based on Government’s current

fiscal strategy, show that consolidating public finances will take several years. Net public debt is projected to reach over 26 percent of GDP by 2014, from 5.8 percent in 2008. Reducing net debt to the Treasury’s target of 20 percent of GDP is projected to take until 2022.

Financial markets and ratings agencies are continually reassessing country-specific credit risk, particularly for countries seeking to finance this borrowing externally. Although New Zealand’s sovereign debt remains relatively low, the country’s overall capacity to absorb future shocks through additional borrowing will be constrained as public debt rises.

The government’s finances are also vulnerable to changes in the availability of foreign capital or, at least, higher costs of external financing. In the context of impaired credit markets, higher public borrowing requirements are also more likely to crowd out more productive investment by competing with private borrowers for available funding. Crowding out could become more severe once the economy has recovered and growth is closer to its potential. Fiscal consolidation is, therefore, important for reducing pressure on interest rates and, therefore, the exchange rate, as well as for restoring the economy’s buffers against shocks.

4 The required rebalancing

A smooth rebalancing is required to maintain macroeconomic and financial stability in New Zealand.²⁵ There are four ways to stabilise and gradually reduce New Zealand’s ratio of net foreign liabilities to GDP. These include erosion of the real debt burden through higher inflation, a reduction in imports, higher exports or an improvement in the country’s growth performance. The first option – greater tolerance for inflation – would likely be costly and ineffective, since New Zealand’s debt is largely short-term and rising inflation expectations would therefore quickly translate into higher interest rates on existing and future issuances. The first option is also ruled out by the Reserve Bank’s inflation-targeting mandate and the Bank’s independence from Government.

Rebalancing the economy towards the tradeables sector would be supported by rebalancing of the global economy

²⁵ See Bollard (2005).

and a more competitive currency. Global imbalances reflect recurrent current account deficits in several major industrial countries and current account surpluses in a number of Asian economies and oil exporters. A gradual global adjustment is likely to require higher saving and exports in countries with current account deficits and domestic demand-led growth and currency appreciation in surplus economies.

There are indications of some unwinding of global imbalances in the wake of the global crisis. While some of this is a cyclical adjustment to lower trade growth, there is evidence that a large part of the reduction in global imbalances reflects a rebalancing of import and export growth (Freund 2010). This would tend to be more sustainable once global trade recovers because it is a manifestation of shifts in domestic saving and investment. Longer-term global rebalancing will require that these trends become entrenched as the recovery in the global economy takes deeper root.

There are also signs of internal rebalancing. Households in New Zealand and in many countries have made efforts to increase saving and reduce indebtedness. In the short term, lower consumption and credit growth is weighing on growth. While these shifts represent a natural cyclical adjustment to the past recession, it is important that they develop into a structural change in behaviour. This will support the long-run sustainability of domestic and global growth paths.

The increase in household saving has, however, been offset by the reduction in public saving. While fiscal policy is providing an important buffer at present, fiscal retrenchment over the longer term will be necessary to ensure that national saving rises in future and that government regains the flexibility to respond to any unexpected future shocks. Improved Government saving will also be crucial in preparing for increased spending pressures associated with the ageing population.

Given the drag on growth from internal rebalancing and withdrawal of fiscal stimulus over the medium term, an external rebalancing via stronger tradeables growth would significantly reduce the risk of an abrupt and disorderly rebalancing. Global factors are, however, expected to continue supporting the New Zealand dollar. Global interest

rate normalisation is unlikely over the short term, so that New Zealand financial assets are likely to remain attractive to yield-seeking investors.

5 Conclusion

New Zealand has, over the last several decades, run large and persistent current account deficits. As a result, New Zealand is one of the most indebted nations in the OECD on the basis of its net international investment position. The post-crisis world is characterised by cautious markets, studying data for signs of fundamental weakness and indications of adverse future debt dynamics.

New Zealand's high stock of foreign debt means that the country remains vulnerable to changes in the availability and cost of external financing. The country's banking institutions are exposed to refinancing risk because of their dependence on short-term, foreign wholesale funding. Bank balance sheets are also exposed to shocks to households' debt service capacity, such as higher borrowing costs, declines in house prices or income. Over time, a dependence on inflows of foreign capital may weigh on growth by raising interest rates.

Several factors, however, mitigate these risks. Foreign exchange risk is very low since New Zealand's foreign liabilities are largely denominated in local currency or hedged. As a result, the Reserve Bank can supply local currency liquidity should credit conditions deteriorate. The maturity structure of bank funding has lengthened owing to market pressure and the implementation of the Reserve Bank's Prudential Liquidity Policy, moderating roll-over risk.

The shift from debt-financed consumption to greater saving and investment is also expected to support the household sector's capacity to repay its debt. Continued rebalancing is desirable, but will face headwinds in the form of a strong currency, weak foreign demand and low global interest rates.

While a relatively favourable fiscal position differentiated New Zealand from most other OECD governments prior to the crisis, the deterioration of the fiscal balance reduces the

economy's capacity to respond flexibly to shocks. Faster fiscal consolidation would be a prudent approach to sustaining the required rebalancing over the long term.

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