New Zealand: A Macroeconomic Review

Public Policy 556
Macroeconomics

Kyle Browning
Adrienne Fernandes
Overview
New Zealand was a world leader in economic growth and per capita GDP from 1940 to the 1970s. Over that forty-year period, the country developed a highly diversified but uncompetitive industrial structure. By the early 1980s New Zealand faced a series of economic obstacles, including the oil crisis and rising inflation. To offset reductions in per capita GDP, the country abolished all controls over interest rates, floated the currency, and adopted stable macroeconomic policies, which together, broadly explain the improved performance of the New Zealand economy over the past decade. New Zealand’s success story, however, may soon come to an end. Low households savings, a growing current account deficit, and inefficient investment in education and skill building will likely hinder the very long-term growth of the island nation.

Recent Macroeconomic Performance

Gross Domestic Product
Since 1993, New Zealand’s real gross domestic product (GDP) has increased from 91.6 billion to 133.8 billion New Zealand dollars. The rate of GDP growth has averaged four percent during the last eight years, resulting in the country’s longest period of expansion in the past 25 years (see Figure 1). Though New Zealand suffered a two-quarter recession during the 1997 Asian crisis, the economy has since recovered and now outperforms many of the OECD’s advanced industrialized economies: from 2000 to 2004 real GDP growth averaged four percent from in New Zealand, two percent in Australia, and three percent in the United States.

The country’s population increased by approximately 340,000 from 1993 to 2004, due in part to net migration. GDP growth has outpaced this population inflow, averaging $111.5 billion dollars over the past decade. In turn, the standard of living for New Zealanders has increased. While per capita GDP continues to rise, it is among the lowest of the highly developed economies. In 2004, per capita GDP in New Zealand was $24,100 in U.S. dollars, compared to $28,800 in Australia, and $36,400 in the United States.

Consumption, Investment, and Government Spending
Consumption and investment have stimulated expansions in the New Zealand economy. Household consumption has comprised the largest share of GDP – 46 percent and upwards – since 1993 (see Figure 2). Low unemployment, coupled with a surge in net migration starting in 2001, has added to domestic demand, reflected in a booming housing market.

Relatively high interest rates have spurred investment, the second largest component of GDP. Foreign direct investment has increased nearly ever year over the past decade, though it has since slowed. Investment has grown at an average rate of seven percent, despite setbacks during the Asian crisis. Similarly, government spending has increased in real terms every year since 2002, but continues to make up less than 20 percent of GDP.

Exports and the Trade Balance
New Zealand is an open economy with a floating exchange rate, adopted in 1985 with the explicit objective to reduce inflation. The country has generally enjoyed a trade surplus, with principal exports comprised of dairy products, meat, forestry products, and fish. A weak exchange rate and a favorable investment environment spurred the growth in exports from 2000 to 2001. Despite the strengthening of the exchange rate from 2001 from 2002, rising world commodity prices offset any expected declines for certain exporting industries. Exporters benefited from rising global demand and tight global supplies for beef, lamb, and dairy goods. While the country has traditionally exported more than it imported, a reverse in this trend is underway. The negative trade balance in the past two years – between $456 million and $1.4 billion in U.S. dollars – has now fallen to a deficit of one percent of GDP. In turn, the current account deficit has increased (see Figures 3 and 4).
Unemployment

Full employment was the main priority of New Zealand government economic policies from after the Second World War until the mid-1980s. Accordingly, New Zealand maintained policies of protectionism and “insulationism” longer than most other developed nations. Indeed, full employment lasted until the 1970s, when oil shocks and other economic turmoil, along with an inflexible economic structure, disrupted the Kiwi economy. By the early 1980s, it was apparent to policymakers that change was needed. Reform of the labor market began in 1984, and was pushed further in 1991. After a lengthy time lag, the economic reforms helped reduce unemployment, especially after the recession of the early 1990s (see Figure 5 on this relationship between GDP growth and unemployment). Unemployment has continued to fall, averaging 7.9 percent in the 1990s and just 5.2 percent in the decade to date. New Zealand now has the second-lowest unemployment rate in the OECD, at 3.9 percent, less than half of what it was in the early 1990s.

Inflation

The 1970s and 1980s taught New Zealand that high and variable inflation has adverse consequences for both welfare and growth. The policymakers who instituted economic reforms in 1984 recognized this lesson, and price stability became a legislated goal of Kiwi economy policy with the 1989 Reserve Bank Act. This act gave the central bank operational autonomy, while making the Reserve Bank of New Zealand the first central bank in the world to explicitly focus on the achievement and maintenance of price stability rather than other macroeconomic objectives. An evolving inflation targeting regime thus became the focus of economic policy, with the target band moving from zero to two percent to its current range of one to three percent. After some initial turbulence, inflation was corrallled and reduced to the low single digits by the early 1990s (see Figure 6). After two decades of double-digit price rises, New Zealand’s inflation rate averaged below two percent in the 1990s.

Monetary policy has served as a stimulant to growth as well as inflation. The monetary base has been expanded in real terms since 1993 by the Reserve Bank, which, as predicted by the quantity theory of money, has put upward pressures on prices and wages. The bank has generally worked to alleviate this pressure through its indirect control of interest rates.

Interest Rates

Following the 1984 economic reforms, tight monetary policy and financial deregulation led to rising interest rates. Since by law New Zealand’s central bank must contain inflation within a low, narrow band, it has generally kept interest rates high in order to stave off inflationary pressures. In fact, the Reserve Bank has been accused of stifling economic growth by raising interest rates too aggressively to ensure inflation remains within the limit. The volatility in interest rates, however, has reduced in the last five years (see Figure 7).

Vulnerabilities in the New Zealand Economy

Current Account Deficit

New Zealand’s current account has grown steadily since 2000 and nearly doubled from $3.1 to $5.6 billion dollars over the past two years. The current account as a percentage of GDP is over eight percent, the highest figure since 1986 and very marked by OECD standards (see Figure 3). The negative trade imbalance is one of the primary reasons for increases in the current account deficit. Strong domestic demand for imports has outstripped international demand for New Zealand products, due in part to a favorable exchange rate that has caused imports to be relatively cheaper than domestic goods. The U.S.-New Zealand exchange rate has increased each year since 2001, currently standing at 72 cents on the US dollar; in 2001, the exchange rate was 44 cents on the dollar.

The current account deficit is financed primarily through the financial account. The financial account almost tripled in size between 2003 and 2004, increasing from $3.2 billion to $8.1 billion in real terms. Growing financial capital has flowed into New Zealand because of the country’s high interest rates, which provide...
strong returns to foreign investment. The country’s interest rate of 6.5 percent exceeds the world interest rate of 4.0 percent. The account is composed of three types of foreign investment: net direct foreign investment, net portfolio investment, and net other investment (see Figure 8). Direct foreign investment is the ownership or control of 10 percent, or more, of a Kiwi business or asset by a foreign entity. These investments tend to be long-term. Most foreign investment in New Zealand is portfolio investment, comprised of financial assets, including stocks, bonds, deposits and currencies. Foreigner portfolio investors own or control less than 10 percent of a business or asset. These investments are easier to unload during a financial downturn.

Despite a surplus in the financial account as of 2004, initial indicators suggest that the current account deficit cannot be sustained. Foreign direct investment plunged from $127 million in the final quarter of 2004 to a deficit of $772 million in early 2005, signaling that investors may be losing confidence in the economy. Similarly, portfolio investments decreased from $3.6 billion to a deficit of $1.6 billion over the same period. Though the current account grew smaller at the same time, the financial account did not cover the deficit. Recently published data confirms a declining confidence in the current business environment. The National Bank of New Zealand’s Business Outlook shows confidence dropping to a 17-year low in November 2005, and the closely followed index of New Zealand companies’ own activity expectations touched a five-year low. The consequence of lower investment and reduced confidence in the New Zealand business environment is diminished economic growth.

Saving and Consumption
Though the current account deficit partly reflects strong investment in New Zealand’s resources, it underscores the unprecedented dissaving by Kiwi households, representing the largest sector of the economy. New Zealanders are borrowing primarily to support consumption expenditures rather than to build infrastructure or grow the capital base. In 2000, dissavings were about one percent of disposable income, compared to the current dissaving rate of nearly 12 percent, very low by OECD standards (see Figure 9). At current levels, the ratio of household debt to income (excluding student loans) is similar to those found in the U.S., Australia, and the U.K. According to the Ricardian equivalence, consumers should base their spending on their current and future income, which is dependent, in part, on the rate of government savings. The New Zealand government has traditionally run a budget surplus, suggesting that consumers are employing Ricardian logic.

Like in the United States, dissaving is due in part to trends in the housing market. Nearly 90 percent of household debt is housing debt, at an average rate of 7.5 percent of disposable income. As cheaper capital and more accessible mortgages have become available, the household sector has boomed, characterized by first-time home buying, home upgrades and additions, and the purchase of second homes, investor homes, and rural property. The housing boom has driven expenditures that accompany home buying, including appliances and cars. With rising home values, New Zealanders feel wealthy and in turn spend money on big-ticket items like entertainment and travel. Such a low saving rate restricts long term economic growth and forces New Zealand to become ever more dependent on foreign investment.

New Inflation Worries
Despite its apparent success in combating inflation, a consequence of New Zealand’s recent low unemployment and real GDP growth has been new inflationary pressures, particularly with the non-tradable sector. A booming housing sector has added to demand pressures, as will any future fiscal expansions. Moreover, high oil prices are another risk to the inflation outlook. Some central bankers, including those in New Zealand, “have said publicly that monetary policy needs to take account of asset prices [such as houses and shares] and that sometimes interest rates may need to rise by more than if the sole objective were to keep consumer-price inflation within target.” While New Zealand’s prices may be under control, inflation may simply be taking a different form. Evidence of this can be found in the fact that inflation has recently exceeded the Reserve Bank’s target band. Higher gasoline prices helped to push up consumer prices up in the last year, putting the 12-month Consumer Price Index figure ending in September 2005 at 3.4 percent,
surpassing the target band for the first time since the June quarter of 2001.\textsuperscript{16} This conflation of circumstances likely means there is no prospect of a reduction in interest rates in the foreseeable future.

\textit{Additional Limitations on Very Long-Term Growth}

A net positive migration has helped fuel New Zealand’s recent growth in real GDP. While this result is to be expected, the economy’s growth has actually outpaced the population increase, raising the average standard of living. Output per worker, though, remains among the lowest of the highly developed economies. Bringing GDP per capita up to the level of other developed economies, as opposed to simply fueling cyclical economic upturns that will affect welfare only over the short run, is hindered by fundamental structural problems.

Beyond the challenges of dissaving and the current account deficit discussed above, education and skills among the domestic workforce remains a significant dilemma. New Zealand’s economic system is inefficient and generally fails to prepare its workers. Kiwi students perform poorly on international tests despite the fact that public expenditure on education, as a percentage of GDP, is higher than in the U.S. and Australia.\textsuperscript{17} There is also a wide consensus that New Zealand’s labor productivity has remained very low for the last two decades despite the market-oriented reforms of the 1980s. Investment in education and skills is thought to be a driving force behind economic growth, as increasing the human capital stock creates growth through encouraging the workforce to develop, implement, and adopt new technologies. New Zealand’s inefficient investment in these critical elements of very long-term growth continues to be a challenge.

\textbf{Policy Recommendations}

\textit{Addressing the Current Account Deficit Challenge}

A current account deficit could mean that a country is living “beyond its means,” or is an oasis of prosperity, attracting foreign investment because of high returns.\textsuperscript{18} While New Zealand’s high interest rates have yielded strong profits for foreign investors, indicators signal that New Zealand may become financially overextended. Since the current account deficit threatens to slow economic growth in the long term, New Zealand could take steps to reduce the deficit:

- \textit{Encourage depreciation of the exchange rate by cutting interest rates or reducing the money base.} Decreasing the New Zealand interest rate below the world interest rate would discourage investment from foreigners due to appreciably lower returns. Depreciation of the exchange rate would make foreign goods relatively more expensive than domestic goods, spurring spending on New Zealand goods by residents and foreigners. This recommendation, however, is limited by the country’s inflation targeting regime. The Reserve Bank is averse to slashing interest rates because the economy is growing and such inflationary pressures are becoming more acute.

- \textit{Adopt measures to promote New Zealand exports, such as beef and dairy.} Increasing exports would reduce the current account deficit since the deficit is funded primarily through net imports. To increase exports, the government could subsidize certain exporting industries or they might tax imports to encourage New Zealanders to buy relatively less expensive domestic-made goods and services. However, the cost of subsidizing the industries might be passed on to Kiwi consumers, who might then look to cheaper imports, further exacerbating the trade imbalance. Import taxes could also spur retaliatory taxes on New Zealand exports. Import taxes have become increasingly unpopular, and the World Trade Organization has attempted to minimize them.

\textit{Addressing the Consumption and Dissaving Challenge}

The low level of saving in New Zealand hinders the replacement of depreciating capital by restricting the amount of domestic money that can be used for investment. This low saving rate creates increasing dependence on foreign investment to fuel economic growth. To increase the saving rate, New Zealand could take the following steps:
Increase mortgage rates to reduce demand. The Reserve Bank identified the housing boom as a concern several years ago and has repeatedly increased interest rates (through the Official Cash Rate) in order to curb excess demand. These interest rate hikes have slowed housing price growth somewhat. In addition to attempting to reduce the effective mortgage rate through interest rate hikes, the Reserve Bank can continue to speak out about the need for home-owners to diversify their savings, as saving only through property creates great risks since home prices cannot continue to rise forever. The limitation of this recommendation is that it conflicts with another goal: the need to reduce the current account deficit. As described above, one way to reverse the deep current account deficit is to encourage depreciation of the exchange rate by cutting interest rates.

Increase consumption taxes to encourage savings. New Zealand introduced a type of value-added tax in 1986. Increasing this consumption tax rate could help shift some income from consumption into savings. The problems associated with such an increase include the fact that consumption taxes tend to be regressive, penalizing the poor more than the rich. Additionally, too high of an increase could reduce consumption to the point that economic growth will be stifled.

Addressing the Labor Productivity Growth Challenge

New Zealand’s inefficient investment in the education and skills of its workforce continues to be a challenge for economic growth. Though labor productivity growth has shown more recent improvement, the Reserve Bank has argued for increasing “labor productivity growth to around two percent per annum (comparable to Australia and the U.S.) to continue to achieve continuing economic growth much over three percent per annum.”

To increase labor productivity, New Zealand can:

Increase net migration. Increasing net migration can raise the quantity of labor if migrants are more productive, or possess a higher skill level, than the domestic population. New Zealand requires that foreigners without highly valued skills (i.e., medicine, construction) possess at least $1,500,000 for investment in the country to be eligible for residency. Lowering the minimum asset requirement could encourage more immigrants to move to the country. Even if such reforms are put into place, higher migration may actually lower GDP per capita if the migrants are low skilled. To attract the most industrious residents, New Zealand would need to maintain a relatively high investment requirement.

Pursue reforms and proactive policies related to education, research and skill development. In addition to improving the overall skill level of labor, increasing labor productivity growth to two percent a year will require an improved education system, continued strong investment, clever innovation, and good quality decision-making on business’s part. Such reforms are problematic in the sense that they are mainly the responsibility of the private sector. Improving education is a governmental obligation, but otherwise lifting labor productivity will rest on the shoulders of private initiative and industry.

Conclusion

New Zealand’s growth performance reaffirms the view that a low and stable inflation environment and sound macroeconomic policies are conducive to improved growth outcomes. As a small and relatively open economy by OECD standards, however, New Zealand’s economic performance is heavily circumscribed by developments outside of the country. Additionally, “even if New Zealand had the best economic policies in the world, its isolation would probably still constrain its growth rate.” On the domestic front, the country must encourage increased household saving and better prepare its workers to compete in a global economy in order to ensure long-term growth.
Figure 1: Changes in Real GDP and Real Per Capita GDP, 1993-2004
Source: IMF International Financial Statistics

Figure 2: Components of Real GDP, 2004
Source: IMF International Financial Statistics

- Real Consumption, 60%
- Real Net Exports, -0.08%
- Real Investment, 24.2%
- Real Government Spending, 16.6%
- Real Consumption, 60%
Figure 3: Trade and Current Account Deficit as Percentage of GDP, 1993-2004
Source: IMF International Financial Statistics

Figure 4: Balance of Payments, 1993-2004
Source: IMF International Financial Statistics
Figure 5: New Zealand and Okun’s Law, 1994-2004
source: IMF International Financial Statistics

Figure 6: New Zealand Inflation after the 1989 Reserve Bank Act
Inflation target ranges:
1989-1996 = 0-2%  1997-2002 = 0-3%  2002-present = 1-3%
source: Reserve Bank of New Zealand
Figure 7: New Zealand Interest Rate, 1985-2004
Source: IMF International Financial Statistics

Figure 8: Financial Account, 1993-2004
Source: IMF International Financial Statistics
Figure 9: Household Savings as a Percentage of GDP, 1990-2005

Source: Reserve Bank of New Zealand

Figure 10: New Zealand and the Phillips Curve, 1991-2004

Source: IMF International Financial Statistics
End Notes and Works Cited

1 All figures, except the household savings rate and inflation rate, were calculated from the IMF International Financial Statistics. The household savings rate and inflation rate were calculated using Reserve Bank of New Zealand data. All accompanying graphs are in New Zealand currency, unless otherwise noted.


4 Bollard and Hunt. 15 November 2005.

5 In the light of disappointing interwar experience, with the New Zealand economy suffering the Great Depression along with most of the world, there were doubts about the ability of the pastoral sector to provide sufficient work for New Zealand’s growing population. There was thus a desire to create more industrial jobs, even though there seemed no prospect of achieving scale economies within such a small country.


7 The Reserve Bank of New Zealand operates monetary policy within the confines of the Policy Targets Agreement (PTA). The PTA is a formal agreement between the Governor and the Minister of Finance that operationalizes the pursuit of price stability, as required by the 1989 act.


12 The Ricardian equivalence assumption may be unfounded. Government revenue and expenditure for New Zealand is available only through 2000. During the 1993 to 2000 period, the government, the government ran a surplus in all years, except in 2000. We might assume from the 2000 deficit that the government has continued to run deficits through the 2001 to 2005 period.


14 Bollard. 2 November 2005.

15 “America’s Monetary Policy is Off Target.” The Economist. 26 February 2005.

16 Reserve Bank of New Zealand. <http://www.rbnz.govt.nz/statistics/econind/a3/data.html> See also Figure 6.


20 The country has stringent residency requirements for all classes of immigrants. For instance, only applicants under the age of 54 may apply for the investment-based residency. See “New Zealand Permanent Residence.” Immigration Home. ENZ Immigration. 2 December 2005. <http://www.emigratenz.org/newzealandvisa.html>.

21 “Can the Kiwi Economy Fly?” The Economist. 30 November 2000.