OECD Economic Surveys
NEW ZEALAND

APRIL 2011

OVERVIEW

Summary

Even before the latest severe earthquake in Christchurch, the expected gradual economic recovery in New Zealand was being held back by efforts by the private sector to reduce debt as well as by a persistently strong currency. Active monetary stimulus and a significant fiscal expansion resulting from decisions taken prior to the global downturn supported the economy through the recession, as has buoyancy in Australia and Asia and large terms-of-trade gains. Households, businesses and farmers are attempting to repair over-extended balance sheets in the aftermath of a property boom. The balance sheets of the non-financial private sector deteriorated markedly as the increase in property prices and perceived wealth prompted additional household spending. The associated widening in the current account deficit was largely financed by bank-intermediated foreign credit, adding to already high external debt. Weak business investment and low national saving have for some time contributed to poor growth performance. Achieving faster growth will require progress across a broad policy front. This includes bolder fiscal consolidation in the form of spending restraint, coupled with tax and pension reforms to boost national saving. These measures would allow interest rates to stay low for longer and create room for the exchange rate to ease, thereby facilitating the needed rebalancing of the economy, boosting output of tradable goods and services.

Favourable tax treatment of housing and inefficient regulatory constraints on supply should be removed. These distortions exaggerated the surge in house prices, giving rise to wider wealth inequalities and a heavy dependence of households' long-term financial positions on volatile property values. The shallowness of capital markets that results from low national saving also contributes to the attractiveness of housing as a savings vehicle relative to financial assets. Despite the slump in housing demand, property prices remain at high levels relative to rents and average incomes, keeping affordability low for less affluent households and intensifying pressures on the social housing sector. While the government has made progress in addressing some tax distortions and inefficiencies in social housing delivery, policy priorities should include further tax reforms to level the playing field for saving and investment decisions, while improving the efficiency of land-use policies and the overall urban planning system.

Regaining regulatory best practice and improving management of the government's considerable asset holdings could help boost productivity growth. OECD indicators suggest that New Zealand's long-standing front-runner status in product market regulation has been eroded away over the past decade or so. Regulatory quality has deteriorated somewhat, and government ownership of economic assets has increased, in contrast to OECD-wide trends. Consequently, New Zealand is falling further behind in its ambition to catch up with OECD living standards, in particular Australia's, by 2025. Encouragingly, the government has taken action to strengthen the regulatory management system, and a Regulatory Responsibility Bill designed to improve accountability and transparency is before Parliament. In addition, the government is considering, if re-elected, to partially privatise some key SOEs. Further steps should seek to fortify the regulatory governance framework in order to improve the overall investment environment. Continuing to enhance co-operation and regulatory harmonisation with Australian counterparts where appropriate would also reduce impediments to trade and competition.

Green growth would help to consolidate New Zealand's long-run growth potential. As an exporter of resource-based goods and services, notably dairy products and tourism, its "brand" relies on the environmental integrity of its output and policies. To this end, the country has begun to put in place one of the world's first and most comprehensive emissions trading schemes to fulfil its Kyoto obligations. However, mitigation possibilities are limited by the high share of hydro in its power generation and of agriculture in its overall GHG emissions. The carbon-price signal will need to be bolstered in order to encourage the greater uptake and discovery of clean technologies, although moves in this direction should be conditioned on progress towards a comprehensive international agreement. Market-based instruments to give natural assets a value should be used more broadly, notably to allocate water efficiently.

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Assessment and recommendations

The recovery stalled in 2010, despite record terms of trade

New Zealand's economic recovery began promisingly in mid-2009, supported by unprecedented policy stimulus. The economy has benefited from growing trade linkages to China and other emerging markets in Asia, which suffered less from the international financial crisis and have rebounded more vigorously. Dairy and other food prices have surged as rising living standards in such populous markets have boosted demand, and droughts in producer nations, including New Zealand, have been more frequent. The country has likewise gained from its high degree of economic integration with a robust Australia. Even so, private domestic demand has failed to bounce back as quickly as in most previous recoveries, and little or no rebalancing has occurred. Growth lost momentum by the second half of 2010 as the global economy slowed and households and firms remained cautious with their spending. This, together with the impact of a strong earthquake that struck the Canterbury region in September 2010, contributed to stagnation in activity in the second half of the year. A second, more damaging earthquake in late February 2011, largely centred on Christchurch, New Zealand's second largest city, will further retard the recovery in 2011and makes the outlook highly uncertain. The Rugby World Cup will provide a temporary boost to growth in the second half of the year and high commodity prices will also provide support, but previously expected earthquake reconstruction will be delayed and household spending will probably remain subdued for longer. Reconstruction (officially estimated at 8% of GDP) is projected to get fully underway in 2012 and provide a substantial boost to demand over a number of years. At the same time private investment and consumption should start to recover more surely, though needed fiscal consolidation will start to bite.

The recession has highlighted the need for structural reforms

Lacklustre growth reflects structural shortcomings of the NZ economy. As the 2000s progressed, the main sources of rising prosperity increasingly became commodity-based terms-of-trade improvements, credit-fuelled capital gains on property and rising government spending, rather than more enduring productivity increases based on investment and production in the traded-goods sectors. The economy now faces the challenge of a combination of high external deficits and international debt, an overvalued exchange rate, a heavy cost of capital and unbalanced growth. Following sharp setbacks in housing and farmland markets, an inevitable period of deleveraging began. Thus, the crisis may have long-lasting macroeconomic repercussions, but it is to be hoped that this will spur structural reforms and behavioural changes that can secure a stronger foundation for sustainable long-run growth.

In that regard, the 2011 OECD *Going for Growth* cites the need to: ease barriers to competition in network industries and to foreign direct investment; reduce regulatory opacity; reverse educational under-achievement among the Māori and Pacific Islander populations; raise the effectiveness of public R&D support; and improve efficiency in the health-care sector. This *Survey* focuses on ways to improve product market regulation and competition (health-care reform was covered in the last *Survey*). It also has a detailed look at the housing sector, which is subject to inefficiencies in many OECD countries, and at environmental policy, where the government is making special efforts to assure long-term sustainability at minimum cost.

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Recent interest-rate cuts will have to be reversed as resource pressures build

The Reserve Bank began to raise the official cash rate (OCR) in mid-2010 based on a relatively favourable economic outlook at that time, but it then appropriately paused as the recovery faltered. It also signalled that normalisation of the OCR would likely be more gradual and its end point would be lower than in previous tightening cycles. Following the second earthquake the Bank decided to lower the official rate by ½ percentage point as a precautionary move to limit the risk of a nation-wide decline in private confidence. While the scale and timing of the rebuilding effort remains highly uncertain, *the Reserve Bank will have to reverse that reduction as reconstruction activity gathers momentum, and further increases are likely to be necessary as resource constraints take hold.* In accordance with its mandate, the Bank will continue to "look through" high headline inflation caused by exceptional factors: consumption tax increases, the entry of industrial and energy sectors into the Emissions Trading Scheme (ETS), resurgent global commodity prices and items like insurance cost increases in the wake of the earthquakes. There are several potential sources of higher inflation pressures. Wage demands could respond to higher prices, especially if the labour market were to tighten unexpectedly. Estimates of potential output may be especially subject to uncertainty post-crisis. Indeed, with a recent history of relatively strong inflation, expectations have again been tending toward the upper range of the 1-3% official target band, even though underlying inflation remains subdued. *The Bank should remain vigilant to inflation risks and proactive in deterring them, as it clearly intends to be. It should also continue to explore the possibilities for countercyclical approaches to prudential regulation, consistent with Basel/G20 discussions, and consider applying maximum bank leverage ratios to mitigate financial-sector vulnerabilities.*

Macroeconomic imbalances reflect too little saving

The widening of the external deficit over the past decade reflects to a large extent the additional demand pressures associated with a boom in property and farmland markets. The boom, which was partly caused by strong inflows of migrants and rising commodity prices, was financed by accelerated private borrowing from abroad through the banking system. New Zealand's banks are well capitalised, but their continued, albeit somewhat reduced reliance on relatively short-term wholesale funding leaves them vulnerable to any shift in investor sentiment – including those about the New Zealand banks themselves, or their Australian parent banks. Persistent saving-investment imbalances appear to reflect primarily national saving that has been well below OECD averages. At the same time New Zealand has long had to pay comparatively high real interest rates, which have driven up the cost of capital and deterred business investment. To the extent that such high interest rates reflect domestic demand pressures, rather than a risk premium, they may also contribute to a persistent overvaluation of the exchange rate, resulting in the decline in the share of domestic output for tradable goods and services experienced since the mid-2000s. Finally, high interest rates exacerbate negative dynamics on the external debt, with net investment income payments averaging some 6% of annual GDP. The persistence of low national saving also impedes the deepening of financial markets, which thereby limits the country's ability to mobilise and allocate capital efficiently and may perpetuate the lack of savings.

Sluggish productivity performance adds to vulnerabilities

New Zealand's living standards have for some time tracked persistently below the OECD average, as well as Australia's, despite robust terms-of-trade gains, mainly because of poor labour productivity performance. In part, this reflects a low rate of business investment and hence capital intensity per worker. Total factor productivity growth has also been low (and occasionally falling) as well. The country's small size and remoteness from key export

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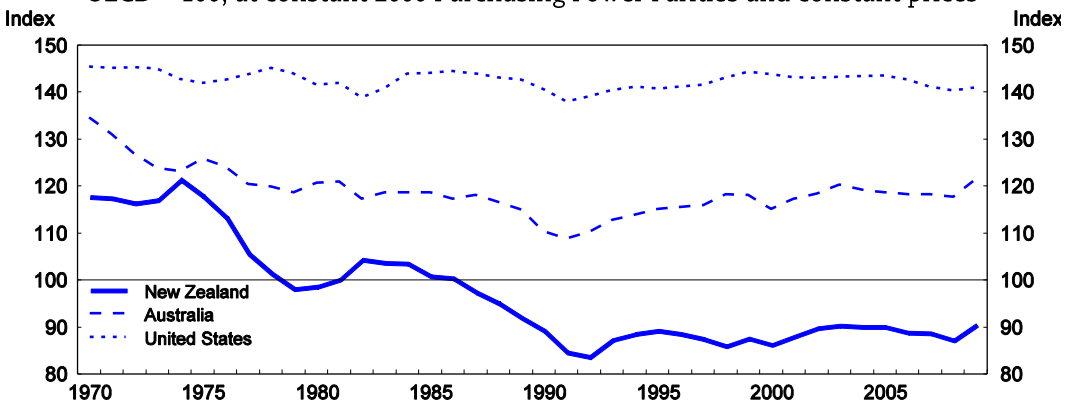
markets may shield domestic firms from competitive pressures to innovate and seek efficiencies, while also reducing specialisation and integration into global production systems. Comparatively large state holdings of commercial enterprises and social housing may further dull competitive forces. With a lack of profitable opportunities domestically, a real exchange rate that has not fallen in response to widening income and productivity differentials between New Zealand and its main trading partners, relatively high (albeit now much reduced) corporate tax rates and an elevated cost of capital, businesses may have seen few rewards to reinvesting their earnings.

Real GDP per person[1]

OECD = 100, at constant 2000 Purchasing Power Parities and constant prices



1. GDP per capita has been calculated in USD at constant prices and constant PPPs.

Source: OECD National Accounts database.

Fiscal consolidation is more urgent in view of external vulnerabilities

Prior to the recession, a main element of stability was a string of fiscal surpluses that helped to offset private-sector imbalances, at least in part. Even so, current spending grew relative to GDP by some five percentage points over a short period, as tax revenues surged in response to the decade-long period of growth. The fiscal position entering the crisis appeared strong, based on a low public debt-to-GDP ratio. Structural spending increases and tax cuts – decisions largely taken prior to the recession – provided a timely stimulus in 2009-10. However, this along with the automatic stabilisers, caused a shift to a substantial deficit of over 5% of GDP. Prior to the recent earthquake the government indicated it planned to return to surplus by fiscal year 2014/15, largely by means of spending restraint. This would have limited net public debt to less than 30% of GDP. The earthquakes will have a materially adverse short-term effect on the government's finances. Nonetheless, *returning to fiscal surplus as soon as possible should be a priority. To reduce the risk of pro-cyclical fiscal policy in the next upswing the government should consider whether further changes are needed to strengthen the existing fiscal framework. These might include adopting a more comprehensive public expenditure ceiling in a multi-year framework and an independent fiscal watchdog, as has been done in Sweden, for instance.*

More worrying is a long history of high current account deficits and large net external indebtedness (most recently some 85% of GDP) – among the highest in the OECD and close to that now found in some European countries that have experienced recent problems. Once the recovery takes firmer hold and the private sector starts to spend again, the likelihood is that the current account deficit, which fell from around 9% of GDP in 2008 to about 3% of GDP (abstracting from insurance-related transfers associated with the earthquake) more recently, will widen again. With markets now focusing closely on sovereign and national indebtedness, such a scenario is riskier than it was. *These*

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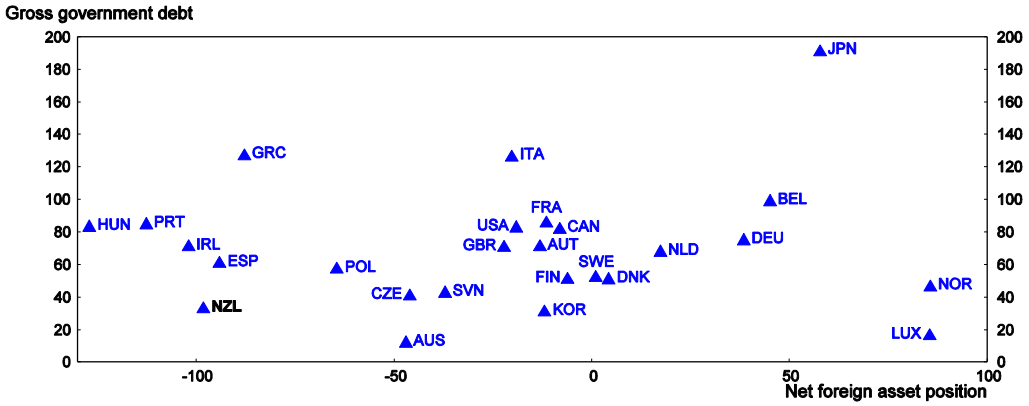
considerations suggest that it would be prudent for the government to aim for a larger medium-term surplus than the 2% of GDP in its December update. Larger fiscal surpluses would directly raise national savings and thereby cut into the negative net international investment position. A more ambitious target would also do more to prefund liabilities associated with foreseeable population ageing. Faster budgetary consolidation would also allow monetary policy to stay easier for longer, which in turn would reduce interest-rate differentials and lower the exchange rate, thereby supporting external adjustment.

Government debt and net foreign asset position

Percentage of GDP, 2009 [1]



1. 2008 for Australia; the 2009 gross debt data for Japan and Luxembourg is the OECD EO88 projections.

Source: IMF, International financial Statistics database.

Tax and benefit policy reforms may contribute to rebalancing growth

Generous universal public pension and student-loan schemes may reduce the incentive for households to save, while non-neutralities in the taxation system bias investment decisions by distorting market signals. NZ Superannuation provides relatively high benefits compared to first-pillar pension systems in other OECD countries. While the fiscal cost of the scheme remains low, relative to the OECD average, it is projected to escalate as the population ages. *Improving the fiscal sustainability of NZ Superannuation through raising the retirement age, while slowing the pace of growth in benefit payments by, for example, a switch from full wage to partial price indexation could simultaneously provide large fiscal savings, increase potential output and boost household saving rates.* The expansion of tax-preferred investment vehicles such as KiwiSaver has the potential to raise the overall level of savings and deepen capital markets, but its success in achieving such objectives is currently limited by unfocused government subsidies. *A reform to KiwiSaver that would generate higher national savings by raising government saving is to remove subsidies, especially to high-income members who are most likely to have shifted their savings from other sources. Participation could be further expanded by broadening the automatic enrolment programme to all employees, rather than just new hires.* The 2010-11 budget introduced some reforms to address low saving and growth, but *further tax reforms – either by aligning top corporate, capital and labour income tax rates at lower levels or adopting a dual income tax approach – could further stimulate growth and saving.*

Housing market imbalances remain daunting

The boom in NZ housing markets that got underway in the early 2000s reflected two demand-side factors – easy credit financed from abroad and strong net migratory inflows – and was exacerbated by long-standing structural features of the economy. These include

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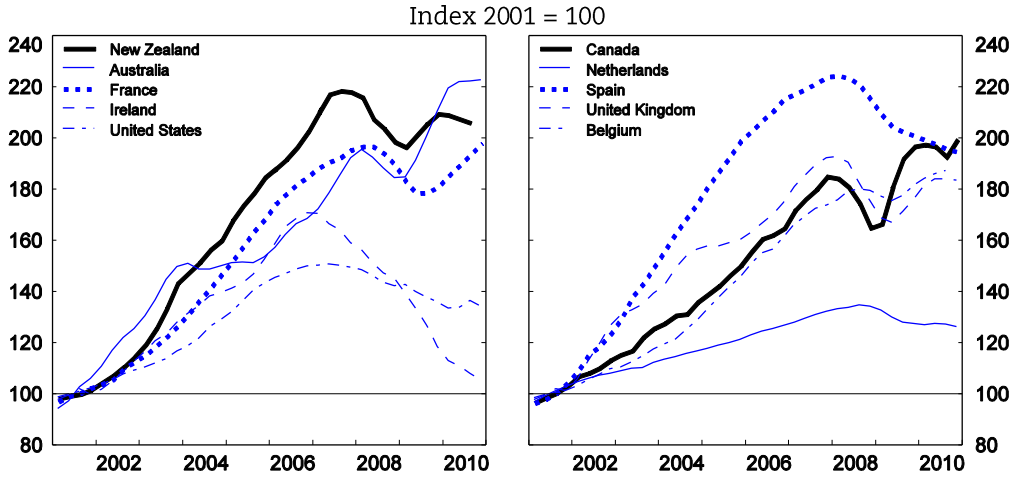
tight restrictions on new housing supply and regressive tax advantages to purchases of rental properties. As a result, the increase in house prices was larger than in most other OECD countries. Although there has been some modest adjustment since mid-2007, prices remain historically very high relative to incomes and rents. Wealth gains have accrued primarily to property owners, whereas the proportion of households unable to afford to buy a home grew significantly. Aggregate household wealth appears to be more heavily concentrated in property and land assets than in most other advanced economies. Households seem to favour property in their portfolio allocation decisions in part because unrealistic capital gains expectations raise the perceived returns to real estate investment relative to alternative assets for long-term wealth creation. International experience has shown, however, that real estate returns are highly variable over time, and thus the long-term financial positions of NZ households are subject to substantial undiversified risk. An obstacle to expanding portfolio diversification is the lack of capital market depth, which limits the availability of alternative investments.

Housing price indexes across countries



Tax incentives have distorted saving and portfolio allocation decisions in favour of housing

The exclusion of imputed rents and capital gains from the NZ tax base contributes to diverting household portfolios towards housing. Because nominal interest income and dividends are taxed, the absence of a capital gains tax raises the relative returns to assets with good prospects for price appreciation, which tends to favour property and farm investments, given their greater leverage possibilities and a thin domestic equity market. In addition, rental property investments benefited from generous tax provisions that led to increasing losses claimed by investors against their other income in order to reduce overall tax liabilities. The tax advantages helped to prolong the housing boom, further inflating property values. They are also regressive in that they benefit high-income investors more, at least to the extent that losses can be deducted at the marginal tax rate, and low earners are priced out of the market. The government addressed some of these distortions in the 2010-11 budget. *Introducing a comprehensive realisation-based tax on capital gains would further reduce the bias towards housing investment relative to other assets. Excluding primary residences from taxation would diminish the effectiveness of such a tax, but partial exemption or rollover relief could act as a "second best" solution so as to facilitate public acceptance.* The government has so far refrained from introducing a capital gains tax. In such circumstances, it should consider other alternatives including *reducing the taxation of alternative savings to level the investment playing field and further limiting the extent to which property investment losses can be deducted for tax purposes. Such measures should*

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be accompanied by higher property or land taxes that could be designed to achieve the same objectives as a tax on imputed rent.

The recession has increased pressures on social housing

Inflexibility in the supply of social housing has resulted in lengthening high-priority waiting lists in certain regions, in contrast with an oversupply of social housing in others with low demand. A tradition of providing long-term tenancies with no re-assessment has also constrained the ability to match household needs with the available public housing supply, leading to a significant share of Housing New Zealand Corporation (HNZC, the public provider of social housing) dwelling units that are either underutilised or overcrowded. The government's plans to introduce reviewable tenancies for all new tenants and expand the participation of third-party suppliers should improve supply flexibility and efficiency, increasing the provision of state housing to those most in need, in line with HNZC's mandate. *Extending regular needs reassessments to all existing tenants could further enhance the capacity for social housing to match household requirements. This should be accompanied by greater efforts to actively assist occupants to transition towards self-sufficiency. Finally, HNZC's financial viability could be improved by terminating water-rate subsidies to tenants able to afford market rents and by divesting non-core activities.*

Easing supply constraints will require more efficient planning policies

Supply constraints have also contributed to the sustained increase in house prices. They arise in part from increasingly restrictive land-use regulations, which have driven up land values in several regions and largely reflect local government attempts to devise growth strategies that incorporate wider environmental objectives. These strategies have commonly taken the form of designating boundaries to promote high-density urban development within confined areas, thereby protecting the surrounding environment. There are indications that these restrictions have contributed to inflated land prices within such containment areas, without any clear net environmental benefit. Furthermore, residential densification has been stymied in certain areas by inconsistent district zoning plans and a lack of coordinated infrastructure provision, which raise uncertainties and risks for developers and discourage housing construction. This has added to upward pressures on property prices.

The government plays an important role in urban planning, given the environmental and societal externalities generated by land development. *Efficient planning policies should aim to capture such externalities through pricing mechanisms that assign socially optimal values to land, based on cost-benefit analyses of alternative land uses considering the location of housing, job opportunities and public transit.* This could be implemented through more systematic use of "financial contributions" (currently levied on developers to capture the environmental cost of land release), which would influence the location of development more efficiently than imposing urban growth boundaries. *These policies should also include consistent pricing signals for urban road use, congestion and parking, combined with better mass transit service to reduce carbon emissions and other pollutants from automobile exhaust more efficiently. Efforts should proceed to develop spatial planning systems that align land-use policies with infrastructure investment decisions, while improving co-operative engagement among various levels of government, private developers and infrastructure providers.* The current design of "development contributions" (charged to developers to fund the cost of additional infrastructure) may increase the price of new housing construction disproportionately, while subsidising existing residents. *The funding of infrastructure development could be more evenly distributed by charging higher user fees to all residents expected to benefit from the services provided.* Where it is impractical for pricing mechanisms to fully capture social and environmental costs, zoning may still be required.

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Regulatory quality has lost ground and regulatory governance should be further fortified

Wide-ranging reforms in the 1990s liberalised the economy and significantly reduced competitive restrictions, putting New Zealand at the forefront in terms of regulatory practice. Since then, however, the reform momentum has waned, and policy has even occasionally moved in the direction of discouraging competition. At the same time, other countries have been making progress, and, as a result, regulatory quality now appears average relative to other OECD countries. It needs to move again to the forefront to promote sustained growth. Regulatory uncertainty resulting from sudden policy changes arising from too much ministerial discretion, along with inconsistency in the extent to which policies are designed to support competition may be suppressing entrepreneurship and investment. This underlines the *need for further embedding, and more disciplined use, of the system of regulatory governance, along with more rigorous use of quantified regulatory impact analysis to justify policy changes.* The establishment of a Regulatory Quality Team within the Treasury to assess regulatory proposals, co-ordinate and recommend improvements to the regulatory management system and help the government set a prioritised regulatory review programme is a welcome step. But more work and political will is required to instil a culture of continuous improvement within the public bureaucracy, supported by evidence-based decision-making. *Productivity could be fostered by requiring clear net public benefits to justify regulatory restrictions on competition and establishing transparent quality benchmarks by passing a suitably refined Regulatory Responsibility Bill.*

In the network sectors, the government's increasing interventions have reduced market transparency and stability, distorting competition and increasing risks to investors. Examples include the Ultra Fast Broadband Initiative, which was never subjected to a full cost/benefit analysis, and the government's "Kiwi share" in Telecom, which may constrain competition and *should be eliminated. While regulators should be accorded more autonomy, they should also be subject to strengthened accountability mechanisms through periodic independent assessments of their decisions.*

Competition policy should continue to move toward global best practice

Because of its size and remoteness, regulation of competition in New Zealand is perhaps more complex since in certain cases achieving scale economies is more difficult than in larger countries but may generate efficiency gains that justify restricting competition. As a result, enforcement of competition law has become a subjective process, creating lengthy delays in the finalisation of decisions. While recent restructuring efforts should expedite matters, *allowing a wider range of interventions could engender further efficiency gains, and regular* ex post *evaluations of mergers and acquisitions could act as an audit on Commerce Commission decisions. Anti-monopoly law could be made more effective through amendments to allow greater flexibility, in line with Australian legislation or OECD best practice.*

State ownership has increased, and barriers to FDI have tightened

While the government has commendably sought to reap the benefits of greater openness to foreign trade by seeking out and signing new free trade agreements, public ownership of commercial enterprises has increased over the past decade, which has likely restrained aggregate productivity by reducing competitive pressures and risk-taking, while discouraging FDI. Compared internationally, New Zealand's SOEs seem to perform better than many others', but there is room for improvement. These asset holdings are substantial, and moving towards public listing of state-controlled commercial assets and full or even partial privatisation would strengthen market discipline and transparency through securities listing requirements and legislation protecting minority shareholders. If the government proceeds with partial privatisation of state-owned electricity generators,

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then entrepreneurship, corporate governance and market transparency would be enhanced, but continued progress towards full privatisation will be needed to reap the full productivity benefits. The screening regime for FDI has become less transparent with regard to investments in "sensitive land". Greater clarity needs to be provided, notably by removing ministerial veto powers, to avoid discouraging foreign investment that could enhance overall productivity. Meanwhile, continued integration, where appropriate, through policy harmonisation, mutual recognition of standards or, at least, co-operation with Australian and other counterparts would mitigate the relatively high cost of regulatory governance and competition-law enforcement, yielding important business-sector efficiencies.

Green growth would be a key advantage

The NZ government has long promoted the principles of sustainable development. For example, the 1991 Resource Management Act (RMA) synthesised all previous environmental legislation into one law that attempted to integrate environmental costs and objectives into private resource-use decisions. The 2009 Emissions Trading Scheme (ETS) for greenhouse gases (GHGs) was one of the OECD's first such measures. The nation's tangible wealth and human skills to a large extent derive from its abundant natural capital, implying strong interdependencies between the economy and the environment. New Zealand is the world's premier dairy exporter, demonstrating the efficiency of its agricultural sector under a complete absence of agricultural subsidies. Tourism, which is primarily nature-based, has been growing rapidly and now surpasses dairy as the nation's highest export earner. As a small and remote, resource-based economy, New Zealand has to overcome high hurdles to both sustain its "clean and green" image and raise its productivity by exporting more. Markets today are attuned to environmental values and economic efficiency alike. Policies to pursue inclusive economic growth with sound environmental effects are essential to secure New Zealand's natural advantages in international competition.

More efficient water and land management should be a priority

As in the majority of OECD countries, environmental policy has tended to be carried out by regulation rather than by market-based instruments (MBIs). *Greater recourse to environmental taxation should be seriously considered for both its efficiency- and revenue-raising benefits.* The implementation of the RMA, which was devolved to the regions, involves high costs. Regional resource "consents" (official approvals) required for urban and rural investment projects have tended to be lengthy and costly in terms of both administration and litigation. Water shortages have occurred in drought-prone areas where dairy farms have sprouted in response to price incentives, as legal restrictions discourage explicit markets for irrigated water, with also adverse consequences for water quality. Progress is being made, however. The RMA has been twice reformed to more clearly allow the use of MBIs and to make the consenting process more efficient. The government has created a Land and Water Forum to allow stakeholders to collaboratively identify options for reform of New Zealand's fresh water management, and has established an independent Environmental Protection Authority (EPA) to oversee policy implementation in areas of clear national interest. Some regions, faced with more severe resource constraints, have begun to experiment with trading in water irrigation and pollution rights. As intended by the RMA, *national environmental standards and policy statements should be established to better guide local decisions to make users of the environment more accountable, and regions should carry out cost-benefit analyses of proposed regulations in view of these guidelines. The new EPA should be assured of its independence and given broad leeway to pursue its objectives in the most economically efficient manner. Markets for water allocation and pollution rights, either formal or informal, should be encouraged by removing regional legal restrictions to trading. New dams to store water for irrigation could also help to make allocation more efficient and to increase absorptive capacity, but environmental side-effects (such as increased GHG emissions due to more dairying made possible by water storage) should be taken into account.*

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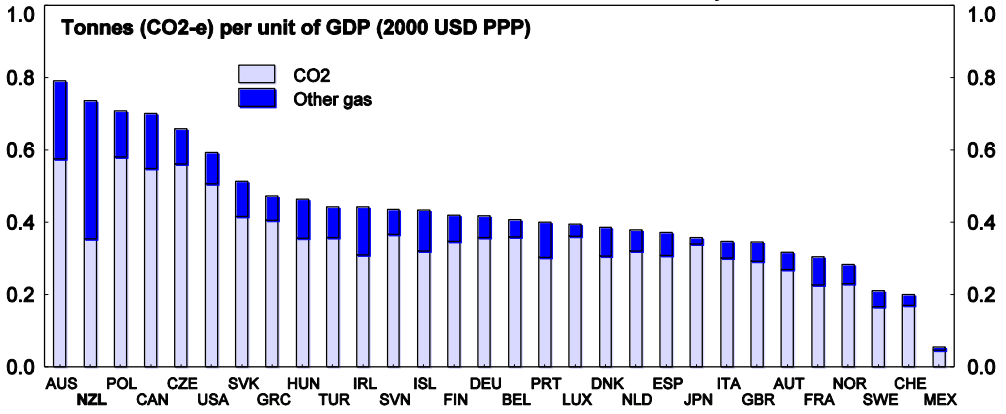
The emissions trading scheme is a major development

The 2009 ETS for GHGs was path-breaking in two main ways: it embodied New Zealand's faithfulness to turning Kyoto promises into policy actions, even after the global crisis had intervened and uncertainties were high, and even as other countries balked; and it incorporated all gases and sectors, including agriculture, as no other scheme (actual or planned) has done. New Zealand's Kyoto obligation is to bring GHG emissions back to 1990 levels by 2012. This will be challenging in several respects. As a commodity producer, it is the OECD's second highest GHG emitter in terms of production intensity, with roughly half coming from agriculture for which no known technology for significant mitigation of GHG emissions exists. A large proportion of electricity generation is already hydro-based, foreclosing that opportunity to reduce energy-sector emissions. Since 1990, gross emissions have grown by 23%, with the highest growth in the energy (transport) sector, reflecting a high rate of car ownership and an old car fleet.

GHG-emissions intensity excluding LULUCF[1]

Gross emissions, 2008 or latest available year



1. Land use, land-use change and forestry sector.

The ETS holds the promise of assuring least-cost mitigation, although New Zealand, as a high-marginal-cost abater, may have to purchase emissions permits abroad. The ETS is subject to a review this year, with the future of the international climate change framework being a key consideration. A number of transition measures have been introduced to moderate its initial impacts and enhance its political acceptability. These measures include uncapped, intensity-based free permit allocations to energy-intensive, trade-exposed industries based on current (rather than baseline year) production, standardised on sector-average intensity. There is thus no firm cap on allocations, while the price is fixed until the end of 2012. Foresters receive credits for plantings, and this will be a main way of meeting obligations under the first commitment period (2008-12), though corresponding liabilities will arise when many of these forests are felled starting around 2020. *Conditioning the extent to which the carbon price signal should be strengthened on progress towards a comprehensive international agreement on emissions reduction is an appropriate approach for the required 2011 review of the ETS.*

If progress is sufficient, ways of strengthening the price signal should include a binding cap on the allocation of permits that reflects New Zealand's international commitment. Auctioning permits would generate useful public revenues that could be used to support fiscal consolidation or to offset other distorting taxes. If free allocations are maintained, they should be distributed on a basis other than current intensity-based output, such as tax credits for emissions-reducing investment or input costs. New entrants into exposed industries, especially in heavily polluting sectors, should not receive free allocations. If, however, major trading partners were to fail to make progress commensurate with New Zealand's own carbon pricing policy for industry, free permit allocations should

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remain uncapped but their distribution should be better targeted as described above. In any case, the long-run fiscal costs, distributional impacts and risks of the ETS should be fully assessed and its risk management strengthened. Finally, New Zealand has led global efforts to measure and model agricultural emissions. *Publicly funded research efforts to find innovative technological solutions to agricultural methane and nitrogen emissions should press forward. Agriculture should enter the ETS as planned, but in the absence of its inclusion in other countries' schemes, the price signal should remain muted.*

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Chapter summaries

Chapter 1. Adjusting towards a sustainable growth path

The 2008-09 recession was moderated by unprecedented policy stimulus and by relatively strong growth in Australia and Asia, New Zealand's largest trading partners, which also boosted the terms of trade. The subsequent recovery has been unexpectedly weak and patchy, however. A large debt overhang and increased risk aversion following the global crisis have led to a wish to deleverage by households, firms, banks and (soon) by government. This seems a necessary and desirable part of adjusting toward more sustainable long-run growth. The debt-fuelled property boom of the past decade drove down already structurally low household saving rates. Expansionary fiscal measures implemented prior to the recession, together with cyclical revenue shortfalls and major one-off earthquake costs, have now reduced government saving rates as well. With most of the growth in household, business and now government debt funded from abroad, for the private sector mainly through the banking system, net foreign liabilities have accumulated to levels that make the economy particularly vulnerable to sharp changes in investor sentiment. Persistently higher interest rates relative to other countries are symptomatic of low levels of national saving and have attracted significant capital inflows, placing upward pressure on the exchange rate and thereby shrinking the trade-exposed sector. Relatively high interest rates have also driven up the cost of capital, restraining domestic investment and hence longer-term growth prospects. The official objective of closing the productivity gap with Australia will require a re-balancing of the economy away from consumption towards more productive sources of growth. Fiscal consolidation, in particular through paring back public spending, will play an important role in reducing pressure on the exchange rate and improving the external position. This would allow price stability to be maintained at lower real and nominal interest rates. Public transfer cuts and capital divestments could, in a context of broader regulatory reforms to reduce policy distortions, serve to improve private incentives to work, save and invest, boosting potential growth..

Chapter 2. Policies to rebalance housing markets

A considerable housing boom has been a key feature of persistently large saving-investment imbalances in New Zealand over the past decade. Wealth is concentrated to a greater extent in property compared to most other OECD countries, leaving households and the banking system heavily exposed to a correction in land and housing markets. Supply rigidities and tax incentives that bias savings decisions towards property investment have amplified the increase in house prices, widening wealth inequalities in the form of larger homes for those who can afford them, but deteriorating affordability for the rest of the population. Substantial distortions via tax planning have been evident in rental property markets. Although the 2010-11 budget introduced measures to reduce some of these distortions, further reforms are needed to remove the significant tax bias favouring housing. The economic downturn has increased financial pressures on the social housing sector, with a shortage of public dwellings in areas of high demand. Regional supply constraints reflect inefficient land-use policies and long delays arising from an overly complex urban planning system. The adoption of spatial planning frameworks is a positive step forward, but they should include pricing mechanisms for land and road use that are aligned with broader policy objectives.

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Chapter 3. How to move product market regulation back towards the frontier

From the mid-1980s, New Zealand was widely considered to be a leader in liberalising product market regulation (PMR). However, the reform of PMR has lost momentum over recent years. Many areas of PMR are still consistent with best practice, but New Zealand is no longer assessed to be at the forefront of regulatory policy making. Although economic geography clearly offers a partial explanation for the relative underperformance of the NZ economy, restrictive policies in some areas are also likely to be constraining growth in GDP per capita. Indeed, it is likely that being small and distant exacerbates the negative impact of restrictive product market policies on New Zealand's economic performance. This implies a genuine need to shift the regulatory framework back towards the OECD frontier. Ongoing improvements in regulatory governance, minimising the government's influence in competitive markets and lowering barriers to trade and FDI, including ongoing policy harmonisation and mutual recognition with trading partners where appropriate, would all help in this regard..

Chapter 4. Green growth and climate change policies

New Zealand, as a resource-based economy anxious to protect and promote its clean-and-green image, appropriately sees green growth as a natural direction for future development. The country's environment is of high quality, and depletion of its abundant natural resources is for the most part not a problem. Nevertheless, there are challenges. With little pricing of water resources, water scarcity is being felt increasingly acutely in some dairy-intensive regions prone to drought. Water-quality degradation is linked to leakage from farming by-products. Agricultural activity also gives rise to nearly half the country's greenhouse gas (GHG) emissions, though electricity consumption and private transport are growing sources of pressure. New Zealand's GHG intensity of output is the second highest in the OECD (after Australia's), not surprising for a resource-rich country. Its unique emissions profile, however, makes for costly mitigation: an exceptionally high proportion of electricity generation is already renewable-based (mainly hydro), and no technology to significantly reduce methane from ruminant animals yet exists. New Zealand is a pioneer in implementing an emissions trading scheme (NZ ETS) covering all sectors and gases. Green growth could best be supported by the greater use of market mechanisms among a range of instruments in natural resource management and by strengthening price signals in the NZ ETS.

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The Secretariat's draft report was prepared for the Committee by Alexandra Bibbee, Calista Cheung and Paul Conway under the supervision of Peter Jarrett. Research assistance was provided by Françoise Correia.

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Further information

For further information regarding this overview, please *contact*:

Peter Jarrett, e-mail: peter.jarrett@oecd.org;
tel.: +33 1 45 24 86 97; or
Alexandra Bibbee, e-mail: alexandra.bibbee@oecd.org;
tel.: +33 1 45 24 76 14; or
Calista Cheung, e-mail: calista.cheung@oecd.org;
tel.: +33 1 45 24 87 01.

See also *http://www.oecd.org/eco/surveys/New Zealand*.

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