

Assessment and recommendations

Global shocks have hit New Zealand's economy hard

Like its OECD counterparts, New Zealand's economy has been badly affected by the international economic crisis, but it also suffers from long standing domestic imbalances that were accentuated by the earlier period of excessive global liquidity and low risk aversion. In the early stages of the crisis, New Zealand seemed well positioned to escape its worst effects. Its banks had almost no exposure to sub-prime mortgages or other "toxic assets". When the recession began in early 2008 it could be attributed to domestic monetary tightening, the early stages of an overdue housing market correction and temporary drought conditions. As international turmoil intensified, however, it became clear that New Zealand would not escape a deeper recession, and in early 2009 macroeconomic indicators deteriorated significantly. New Zealanders had in fact been caught in much the same spiral of global excess liquidity, surging leverage, soaring asset prices and under-valuation of risks by lenders and borrowers that had taken hold globally. Households' indebtedness reached 160% of disposable income – and, in aggregate they cut their saving, possibly in the mistaken expectation that ever appreciating house prices would fulfil their future savings needs, notably for retirement. As already meagre personal saving fell further, and business borrowing increased strongly, even healthy corporate profits and steady government surpluses were insufficient to finance booming private consumption and housing investment. Hence, much of the financing came from abroad. The results were excess demand pressures, a widening in already unsustainable current account deficits and rising net foreign indebtedness (93% of GDP at end-2008).

The crisis has magnified the risks surrounding the high current account deficit

As a commodity exporter, New Zealand had enjoyed record gains in the terms-of-trade, especially late in the cycle, and these gains further nourished its asset-income-spending spiral. The inevitable bursting of the commodity-price bubble helped reverse this cycle. In addition, the global recession is shrinking exports – although less so than for many countries – intensifying the domestic downturn and reducing the economy's capacity to service its external debt (mostly denominated in NZ dollars). The largely foreign-owned banks remain well capitalised, although they are heavily reliant on short-term foreign wholesale funding. Heightened risk aversion and a global reduction in liquidity has led to a concern that banks may not be able to refinance foreign funding lines as they fall due. This underscores the country's vulnerability due to its large current account deficit and

high accumulated stock of foreign debt. Stabilising this debt in relation to GDP would require halving the current account deficit to 4-5% of GDP. Reducing it to a level that would lessen macroeconomic vulnerability would almost certainly require a larger adjustment.

The moment should be seized to confront the need to boost productivity

New Zealand is paradoxically at the forefront of the OECD in adopting policies in many areas that have been shown to lead to high per capita income, and yet it still ranks toward the bottom end of the OECD's productivity league. This performance has many natural and hence unavoidable causes, such as the economy's small size and geographical isolation. But the root of the problem is a structural deficiency in the capacity to produce tradable goods and services. Raising productivity growth therefore remains the greatest medium-term challenge. The new government has recognised this issue and pledged to catch up with Australian living standards by 2025. This would imply raising average annual per capita income growth to 3.3% from only 2.1% over the past decade, which in turn would require a much higher rate of productivity growth, given that labour input is already at very impressive levels by OECD standards. *The crisis should thus be seized as an opportunity to push forward the nation's productivity agenda.*

A deleveraging process is reducing demand

The global crisis is contributing to a needed deleveraging by households and firms. Demand for credit has dropped away very sharply, and lending terms have tightened somewhat. Overall bank credit is now shrinking, and falling house prices are impairing households' net worth. Steep declines in global commodity prices, potentially amplified by a revival of export subsidies in other countries, are hurting farm incomes and reducing the overvaluation of farm properties. Unlike most previous recessions, which tended to start in the business sector, this one is dominated by a drop in household demand. Balance-sheet adjustments imply reduced consumption for as long as it takes to unwind excessive leverage. A second stage of the cycle is now beginning, reinforced by the downturn in global trade. Lower corporate profitability, increased uncertainty about the business environment and financing difficulties are leading to declining business investment and hours worked. Weakness in labour-market outcomes and in household incomes could further aggravate the housing correction, intensify the drop in consumption and put further pressure on businesses.

Monetary policy is the first line of defence

Policy makers have moved aggressively to support demand and put a floor under a potentially vicious downward spiral. In this they have been helped by greater room for manoeuvre than in most other OECD countries, the result of relatively conservative monetary policy during the last phases of the boom and a very low level of gross public debt. The Reserve Bank has lowered its policy interest rate by 5.25 percentage points since July 2008, to 3% currently, and has facilitated access to bank liquidity through a series of other measures. New Zealand displays a structurally higher neutral rate of interest than most other developed OECD members, a reflection of its structural imbalances and

comparatively high inflation expectations. *The Reserve Bank still has room to go further in responding to deteriorating economic conditions.* Despite widening credit-risk spreads, borrowing costs for households and businesses are falling relatively sharply, and the currency has depreciated significantly, which will be critical for external adjustment. Falling core inflation and easing inflation expectations further increases monetary-policy leeway. This should help set the stage for an eventual recovery.

Further fiscal stimulus should be avoided

Fiscal measures can increase employment and demand fairly quickly by way of infrastructure projects and the like, provided they can be implemented in a timely fashion. Tax cuts are less potent as demand boosters but could bolster confidence and assist balance-sheet adjustments. Already, recent and planned tax cuts and accelerated infrastructure spending will provide a fiscal expansion equal to approximately 5% of GDP over the two financial years ending June 2010. The government has also helped shore up confidence in the banking sector by introducing an optional retail-deposit guarantee, providing explicit depositor protection for the first time in New Zealand's history. To help secure access to term funding the government also offered temporary opt-in insurance for wholesale bank funding. Such policy support will attenuate the downturn, but substantial downside risks remain. The banking system's ability to secure foreign funding is currently reliant on the government's wholesale guarantee. The effectiveness of this guarantee depends on the perceived creditworthiness of the government as guarantor. Heightened risk around the sovereign credit rating due to a projected sharp rise in indebtedness implies that, despite the public sector's net financial asset position and a still moderate budget deficit this year, *there is little room for further fiscal expansion.* If, however, any measures were to be undertaken, they should be carefully designed to provide timely support, while being easily reversible, with a path back to a fiscally sustainable position clearly laid out. In assessing the scope for any further policy stimulus, either fiscal or monetary, the authorities will need to be conscious of the risks of triggering a disorderly or severe exchange-rate adjustment.

Policy makers should be beginning to devise exit strategies

With the world's central banks pumping vast amounts of liquidity into money markets and many Treasuries flooding the international bond markets with new issues of sovereign debt, policy makers everywhere, including in New Zealand, need to begin to plan for a withdrawal of stimulus and other extraordinary measures when the recovery takes hold. While the financial shock is likely to shrink global potential GDP growth, at least for a time, a significant output gap is likely to open up. As it begins to close, the overall degree of stimulus will have to be reined in. Fiscal consolidation is likely to have to start first in light of the outlook for public finances. Although the OECD's projected low of 2% for the official cash rate would be exceedingly expansionary in normal times, it will be important to ensure that the eventual recovery is firmly established before material amounts of monetary stimulus are withdrawn. *The twin challenges will be to avoid moving too soon and stalling the recovery as against keeping the policy stance too loose for too long, leading to a strong pickup in inflation. Furthermore, once the financial crisis has passed, the wholesale and retail deposit*

guarantees should be removed. Consideration should then be given to implementing a well structured, self-financing retail deposit insurance scheme that minimises moral hazard.

Fiscal policy expansion in the short term needs to be embedded in a consolidation plan for the medium term

The recession, combined with current policy settings, ends 14 years of continuous surpluses. In December 2008 the Treasury projected, based on unchanged policies, a period of structural deficits, with gross debt rising to 57% of GDP by 2023. The new government has stated that such debt levels would be imprudent. As a first step it committed to reviewing the efficiency of all public outlays, eliminating unnecessary expenditures and cancelling any unfunded spending commitments of the previous government. A more substantive response will need to be set out in its first budget in May. This will be particularly challenging, given the deterioration in the economic outlook in the intervening months. *It is nevertheless vital to present a credible medium-term programme that will re-establish a structural surplus. Either this surplus would need to be sufficiently large to ensure significant net public-sector assets before demographic pressures intensify or else the government would need to begin to scale back future health and pension spending. Central government spending caps have been shown to be a particularly successful means of fiscal consolidation in OECD countries that have adopted them, and should therefore be considered by New Zealand. Adjusting the revenue baseline for terms-of-trade cycles would likewise help to prevent temporary revenue increases from translating into permanent spending obligations.*

A large, imperfectly understood prosperity gap remains, due in part to geography and to policy deficiencies

Whereas New Zealand had a higher living standard than the average OECD country in the early 1970s, relatively low labour productivity growth since then has opened up a large income gap relative to the OECD average and an even greater one with leading countries such as the United States. The poor productivity performance is explained to some extent by New Zealand's special geographic situation, which hinders the transfer of human, physical and technological capital from abroad, but also to sub-optimal policies in a number of areas. The country appeared to be on the right policy track with its earlier market-oriented reforms. But the policy focus on productivity and growth eroded during the years of economic buoyancy, while other countries advanced. Notably, a large amount of new regulation, at times poorly designed, co-ordinated and focused, was introduced. Such measures have increased the costs of doing business and sent bad signals to foreign investors. The incoming government has taken some steps to reverse this trend. *First*, it established a new ministerial portfolio of regulatory reform. *Second*, it is reviewing key regulations thought to have adverse effects on productivity. *Third*, it has set up a task force to develop the principles for future regulatory management.

Pursue greater international economic integration

Greater international economic integration can reduce the “effective distance” between New Zealand and its economic partners. To this end, the government should strive to create the region’s most attractive business environment. This requires structural policy changes in many areas, from lowering the costs of moving people, goods, capital and ideas between New Zealand and the rest of the world to ensuring domestic policy settings make it attractive to innovate, locate in or do business with New Zealand. Given that so much of New Zealand’s prosperity is due to its comparative advantage in commodity exports, it *should facilitate maritime trade to the greatest possible extent with the goal of reducing inbound and outbound shipping costs to meet the standards set by the OECD’s most efficient members, whose costs are some 25% lower.* Although the ports are corporatised, many have strong local-authority shareholding, with mixed agendas. *Ownership changes and consolidation around fewer port companies are likely to be integral to enhancing efficiency in this sector.* As well, capital investments can be encouraged by creating a welcoming environment for foreign direct investment. To do so *New Zealand should eliminate FDI screening requirements, or, at a minimum, shift the burden to the government to demonstrate harm to the economy before turning down an investment proposal.* Since taxes on capital income are comparatively high, it *should focus its tax-reform agenda, as fiscal conditions permit, on cutting its corporate tax rate at least enough to match the OECD average.* It *should also shrink gaps between the company, personal, trust and portfolio investment entity rates to reduce investment distortions and shift the tax base away from income and towards consumption and immobile factors, including housing.*

Improve public-sector efficiency and remove infrastructure bottlenecks

There should be a focus on raising public-sector efficiency by curbing growth in public expenditures and subjecting existing and new programmes to a rigorous cost-benefit test that takes into account the economic costs of raising tax revenue. Raising public-sector efficiency also means limiting government ownership and spending to core sectors and divesting assets in non-core sectors such as electricity generation and transport. Infrastructure bottlenecks, particularly in roads, electricity, and telecommunications may have discouraged investment and constrained productivity growth. In recent years, however, plenty of resources have been committed to infrastructure projects, many of which are now in the works, though it will take some time for the economic benefits to be apparent. A secure and reliable electricity generation and delivery system is crucial to today’s developed economy. Incentives for private investments in electricity generation and transmission could be sharpened by removing soft price caps, encouraging the creation of financial markets for hedging risks, and providing a clear and stable regulatory framework that takes into account dynamic competition effects. The demand-side response to market conditions could also be made more flexible through greater use of metering and time-of-day electricity charges. Besides expanding the infrastructure base to keep pace with the economy, it is also important to make good use of existing infrastructure. For instance, toll and congestion charges could help reduce road congestion and provide a market signal for the expansion of capacity.

Ensure environmental policies do not put the brakes on growth

New Zealand is to be commended for taking its Kyoto Protocol commitment seriously, including by being the first country to introduce an all-gas, all-sector emissions trading scheme. However, because of the importance of export-oriented, emissions-intensive industries, firms and citizens at large are unlikely to accept and continue to support environmental policies that are perceived to unfairly hurt their prosperity, unless similar efforts are made in other countries. To reduce the impact of pricing greenhouse gas emissions, the trading scheme gives temporary free allocations to the most affected industries. However, it still creates uncertainty because investment is long-lived and the price of emissions when these free allocations expire is impossible to predict. The new government has announced a full review of climate-change policy, which is expected to be followed by amendments to the emissions trading scheme and other relevant policies. To increase certainty for potential investors, *the scheme could make greenhouse gas reduction targets explicitly contingent on other countries adopting similar policies and targets, or it could include a cap on the price of emission permits, as a safety valve. Care would have to be taken to avoid setting the cap too low, which could entail a significant budgetary risk.* Also, once a carbon pricing system is fully in place, *the cost of achieving a given emissions target can be minimised by eliminating emissions-reduction programmes that are not justified by an externality other than climate change.*

Improve processes around the Resource Management Act

The Resource Management Act (RMA) was an innovative piece of legislation whose basic principles – pulling together all planning/regulatory issues related to environmental authorisation for new projects while eliminating jurisdictional overlap – remain uncontested. However, its management and application need to evolve along with the problems New Zealand is facing in some areas, notably the scarcity of water and its deteriorating quality. First, *the consenting process, which appears to be mainly driven by the courts, should be streamlined, and the scope for commercial interests to use objections under the Act as an anti-competitive tool should be narrowed. The ability for competitors to disguise trade competition objections as environmental objections should be curtailed, and “security of costs” required before proceeding with appeals of regional council decisions. Limiting such appeals to points of law would also reduce the number of spurious objections.* Second, the lack of mechanisms to determine water use or pollution rights among competing users gives rise to an inefficient allocation of this crucial resource. Because water management is under their authority, *regional councils must take the lead in establishing local provisions for water trading and for measuring and consenting nutrient flows so that trading can be established.* However, because such councils do not have all the knowledge and expertise required to set limits on such flows or to design markets, *the national government should provide guidance and resources to regional councils as needed.* A bill has been introduced in parliament to amend the Act to deal with a number of these issues.

Control of health-care costs is the most pressing fiscal challenge

As in most OECD countries, health spending has been the fastest growing component of public expenditure for several decades. This has reflected health-care technology and demand pressures, the latter exacerbated by the fact that individuals do not typically pay directly for the services they receive, while suppliers have enormous influence over demand. Ongoing medical advances and rising expectations by the public of their entitlements imply that such pressures will only keep growing. In addition, demographic ageing is set to push up demand, especially for disability and long-term-care services. Official projections show that, even with policy reforms, by 2050 public health spending as a share of GDP could double, driving up the public debt by 80 percentage points of GDP over the 30 years to 2050. *This implies the need for early policy action to contain health-care cost pressures. It also underlines the urgency of averting the earlier scenario of surging gross debt over the medium term.*

Recent trends in the health-care system are disquieting

New Zealand achieves relatively good health outcomes for comparatively modest health-care outlays. Since around 2001, however, public health-care spending has grown at more than double the pace of GDP. Health-care institutions have at the same time been completely transformed: the prior market-oriented reforms in the hospital sector were reversed, and a radical reform of primary care was inaugurated. Most of the increased funding went to pay for wage awards to hospital nurses and doctors and for capitation payments to primary-care physicians. But there is scant evidence as yet of much higher output or quality achieved. Indeed, waiting lists and shortages have grown, and measured hospital efficiency has declined. While many of the objectives of the reforms were sound, mistakes were made in design and implementation. Few tools were provided to achieve their goals: purchasers' autonomy was restricted, duties were not always clarified, incentives to seek efficiencies were largely lacking, and yet substantial new funding was distributed in the hope that it would all be well used. *The new government's stated commitment to address these shortcomings within the present structure is welcome.*

The reorganised hospital sector faces inadequate efficiency incentives

The 2001 reform reorganised the hospital sector, then consisting of the corporatised public hospitals and an arms-length national purchaser, into 21 District Health Boards (DHBs) that simultaneously own the public hospitals and purchase most health-care services for their districts. The diminished emphasis on competition and profitability, together with a greater appeal to responsibility and co-operation to achieve results, were popular with both the public and health professionals. Yet the new arrangements probably went too far in downplaying incentives. *Some adjustment to enhance their role now appears necessary.*

In particular, the amalgamation of the functions of purchase and provision of services may have distorted incentives, with DHBs tending to direct business to their own hospitals, to

the detriment of private entry. This discourages potential efficiency-raising competition and exacerbates supply shortages. Though top-down budget controls have reduced DHB deficits, some hospitals remain in chronic deficit. Compounding these problems is a lack of autonomy by DHBs to spend budgets as they see fit. Perhaps because of weak internalised incentives in the first place, there is excessive emphasis on negotiating annual plans with the Ministry of Health and preparing detailed reports to demonstrate progress in achieving a multitude of objectives. The Ministry also allocates a high proportion of the DHB budgets centrally, overturning the principle of local accountability which is the DHBs' very *raison d'être*. The DHB system is also too fragmented to make capital investment decisions, where more cross-district rationalisation and specialisation may be needed to preserve clinical viability in such a small country.

Some spontaneous steps in this direction have been taken: for example, DHBs are co-ordinating their hospital planning and managements regionally. *The existing momentum towards greater DHB collaboration may lead to some mergers and increased specialisation, which should, in principle, be accompanied by greater internal contestability among hospitals. If this fails to secure improved purchasing and service delivery, then a next step would be to instil stronger incentives for efficiency through a formal separation of hospitals from DHB funders. It would be important to build public understanding and support for such an institutional change. DHB flexibility and accountability need to be strengthened. This goal would usefully be served by allowing each DHB to negotiate its own hospital wages, rather than through multi-employer agreements. There would also be benefits from paying hospitals on the basis of prospective costs and volumes within a budget-holding approach. The Ministry needs to more actively monitor performance while devolving its purchase function to the DHBs. Bureaucratic reporting burdens should be radically cut. The Ministry can also help by developing user-friendly databases of best practices, performance benchmarks, public health programmes of national scope and strategic planning.*

Primary-care reform ambitions have not yet been achieved

The 2001 Primary Health Care Strategy envisaged a primary-care system that would: i) close existing social gaps in health outcomes by improved access to care, particularly among the substantial Maori and Pacific Islander minorities; ii) engage in more preventive care to maintain population health proactively; and iii) develop integrated, community-based models of care able to better meet minority and immigrant needs and more efficiently manage the increasing burden of chronic care. Two instruments were created: Primary Health Organisations (PHOs); and a switch in method of paying GPs from fee-for-service to capitation payments based on patient lists. Practices were to sign up with a PHO in order to obtain capitation payments. Once-substantial co-payments fell across the board, though by less than doctors' capitation payments grew, and consultations increased, although apparently less so for the targeted groups. Primary-care physicians' incomes also trended up, and the subsequent closing of many PHO patient lists may suggest the existence of cherry-picking to discourage sicker patients and prevent new practices from entering. The PHOs' effectiveness as agents of change was highly variable, while the new models of care generally failed to take hold. *To achieve the laudable objectives of the strategy, further changes will be required. Practices should have access to capitation payments directly from the DHBs to avoid restrictions to competition by PHO "club membership" obligations. The PHOs should be either eliminated as an unnecessary new bureaucratic layer or else their role and*

obligations must be more clearly defined, particularly as regards facilitating the development of the new clinical models, with the DHBs using part of their funding to the PHOs as a lever. Fees should be better regulated by the DHBs but balanced sufficiently with capitation payments in order to maintain doctors' intrinsic motivation to exert effort. The appropriate balance may need to be tailored to the needs of particular groups.

Private funding and provision are underutilised

Though the proportion of the population holding supplementary private insurance is relatively high, it is typically used to circumvent elective surgery waiting lists, to pay for services not covered by public insurance or to reimburse primary-care co-payments. As the latter have now been sharply reduced, the contribution of private funding to health-care costs has dwindled for rich and poor alike. This in turn has increased demand for heavily subsidised primary care, perhaps particularly by the “worried well”, harming equity and boding poorly for the ability of the system to contain taxpayer costs in the future. The emergence of large, non-transparent deficits in the Accident Compensation Corporation (ACC) suggests a weakening of cost control in recent years under public monopoly insurance. *In the interests of both fiscal sustainability and health-care market competition, the authorities should consider a greater, well-regulated role for private insurance. To improve burden sharing, the recent move to extend eligibility for lower co-payments to wealthier people could be rolled back. The contestable parts of ACC should once again be exposed to competition from private insurers for accident insurance contracts. Private hospitals and auxiliary-service provision should be encouraged in parallel with the above DHB reforms.*

Severe health workforce shortages are looming

New Zealand is quite constrained in how much it can control medical professionals' wage costs because of its open market for their skills. A high proportion of locally trained doctors and nurses emigrate, while around half of all practicing doctors and nurses in New Zealand are foreign-trained immigrants. Heavy turnover of immigrant professionals implies large recruitment and training costs, however, along with greater risks of shortages. Imminent ageing of the doctor and nurse populations implies a scarcity of future capacity, against which sharply rising demands on the system would greatly increase cost inflation. *The number of slots for medical studies should be increased, and more foreign students should be accepted in the hope that many will stay on after graduation. To the extent that New Zealand cannot offer international-level specialist wages, it should work harder to create a satisfying and innovative clinical environment, giving doctors a high degree of autonomy and interaction with other professionals in the new collaborative-care settings.*

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This Survey is published on the responsibility of the Economic and Development Review Committee of the OECD, which is charged with the examination of the economic situation of member countries.

The economic situation and policies of New Zealand were reviewed by the Committee on 10 March 2009. The draft report was then revised in the light of the discussions and given final approval as the agreed report of the whole Committee on 25 March 2009.

The Secretariat's draft report was prepared for the Committee by Alexandra Bibbee and Yvan Guillemette under the supervision of Peter Jarrett. Research assistance was provided by Françoise Correia.

The previous Survey of New Zealand was issued in April 2007.

This book has...



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BASIC STATISTICS OF NEW ZEALAND

THE LAND

Area (1 000 km ²)	268.0	Urban population,* percentage of total	
Percentage of total pasture and arable land, 2003	51.3	(30 June 2008)	78.2
		Population of major urban areas	
		(30 June 2008, 1 000 persons):	
		Auckland	1 313.1
		Wellington	381.9
		Christchurch	282.2

THE PEOPLE

Resident population, 31 December 2008 (1 000)	4 291.9	Civilian employment, 2008 (1 000)	2 168.2
Inhabitant per sq. km	16.0	of which:	
		Agriculture, forestry and fishing	150.7
		Manufacturing	273.8
		Trade (wholesale and retail)	487.2
		Education, health and community services	377.1

PARLIAMENT AND GOVERNMENT

Present composition of Parliament:		Present Government: National Party-led	
National Party	58	Next general election: November 2011	
Labour Party	43		
Green Party	9		
ACT New Zealand	5		
Maori Party	5		
Jim Anderson's Progressive	1		
United Future	1		

PRODUCTION (2008)

Gross Domestic Production (NZD millions)	180 444	GDP per capita (NZD)	42 268
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FOREIGN TRADE (2008)

Main exports (percentage of total):		Main imports (percentage of total):	
Dairy products	22.1	Machinery and transport equipment	34.6
Meat and edible offal	12.0	Manufactures	16.3
Forest, wood and paper products	7.9	Mineral, chemicals, plastic materials	33.5
Machinery and equipment	5.8	of which:	
		Mineral fuels, lubricants, etc.	17.8

THE CURRENCY

Monetary unit: New Zealand dollar		Currency units per US dollar, average of daily figures:	
		Year 2008	1.4255
		March 2009	1.8808

* Defined as the population in the 30 main and secondary urban areas.



From:
OECD Economic Surveys: New Zealand 2009

Access the complete publication at:
https://doi.org/10.1787/eco_surveys-nzl-2009-en

Please cite this chapter as:

OECD (2009), "Assessment and recommendations", in *OECD Economic Surveys: New Zealand 2009*, OECD Publishing, Paris.

DOI: https://doi.org/10.1787/eco_surveys-nzl-2009-2-en

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