Asia Securities Forum Country Report

Country: New Zealand

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Date: 15th October 2012

INTRODUCTION

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

ECONOMIC PERFORMANCE AND PROJECTIONS

a. Economic Background

Domestically the economy continues to recover slowly from the 2008/09 recessions. While this recovery is encouraging some spare capacity exists and **inflation** is low. This has been driven by falls in food prices and annual headline inflation declined to 1.0 per cent in the June quarter 2012. Inflation is expected to settle near the middle of the target range over the medium term.

New Zealand's GDP growth has been sluggish over recent years. Aggregate GDP has taken time to recover from pre-recession levels and at a much slower rate than post 1990/91 and 1997/98 recessions and the unemployment rate has been near its recessionary highs. Despite the stimulus of low interest rates, underlying inflation recently moved below 2 per cent.

Despite the weak general conditions there has been some recent positive developments. Specifically export commodity prices appear to have stabilised, reflecting the severe drought in the US and its impact on international grain prices. March quarter GDP growth was stronger than expected reflecting favourable climatic conditions for farming. Housing market and retail sales data have also picked up since the previous release. Repairs and rebuilding in Canterbury are expected to substantially boost construction sector activity and will become more apparent in the economic data.

Headwinds for the economy are still evident with the outlook for most of our trading partners being weak. Many euro area economies are in recession and Chinese growth continues to slow. Domestically the unemployment rate remains elevated and the high New Zealand dollar continues to undermine export earnings and encourage substitution towards imported goods and services.

Consistent with recent developments the 90-day interest rate continues to be projected to remain low over the medium term.

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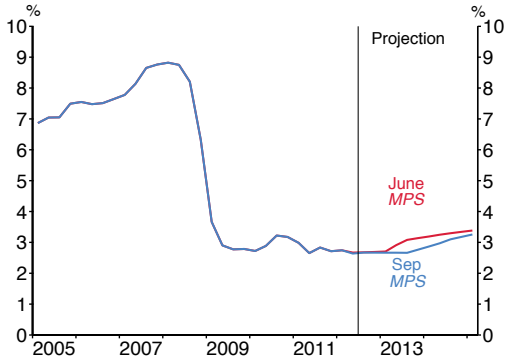
Figure 2.1

90-day interest rate



Source: RBNZ estimates.

New Zealand being highly dependent on its trading partners is facing below consensus global growth. The cost of bank funding relative to the 90-day interest rate is expected to remain elevated due to on-going strains on overseas funding markets. In the euro area it is by no means clear that the risk of significant economic deterioration has been eliminated.

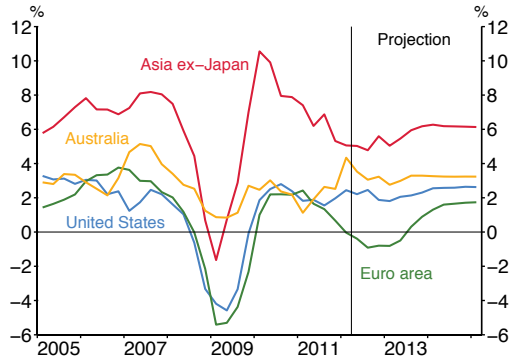
In the US economic growth remains modest and the near term outlook is subject to considerable uncertainty and downside risk due to substantial fiscal tightening that is legislated to occur at the start of next year.

In China economic data continues to soften with GDP growth expected to slow even further. Falling Investment growth has reduced global demand for industrial commodities with Australia's terms of trade suffering as a result.

Figure 2.2

Trading partner growth

(annual)



Source: Haver Analytics, RBNZ estimates.
Note: Asia ex-Japan includes China, Hong Kong, India, Indonesia, Malaysia, The Philippines, Singapore, South Korea, Taiwan and Thailand.

Despite increasing risk appetite, government bond yields in the major markets remain near historical lows. New Zealand's government bond market has followed international trends with yields remaining low, given the widely held view that any tightening in monetary policy is a long time away.

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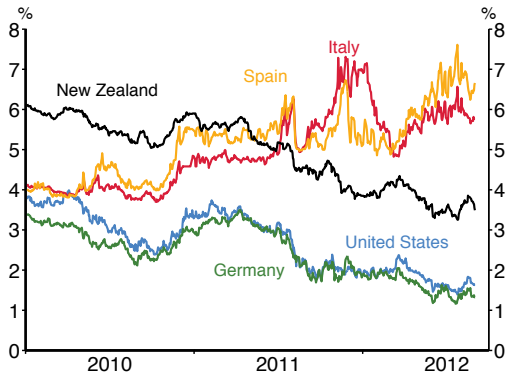
Figure 3.4

Selected 10-year government bond rates



Source: Reuters.

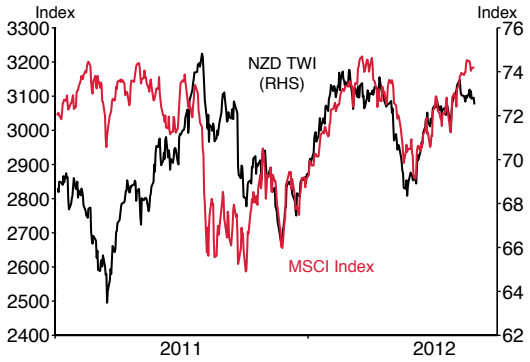
New Zealand banks have found it easier to issue long-term senior debt this year. The total cost of this debt has been declining in line with the credit default swap spreads. Investors have been attracted to non-European issues and the elevated spreads that were on offer earlier in the year. NZ Banks have also experienced strong deposit growth given the risk factors involved with alternative investments and good rates being offered by banks in order to meet revised regulatory funding requirements.

With better access to offshore market funding recently there has been less need to aggressively seek retail deposits. As such term deposit spreads to wholesale rates have receded from the top end of their range.

The improvement in market sentiment has put upward pressure on the New Zealand dollar. On a Trade Weighted Index (TWI) basis the NZD has appreciated by about 2 per cent. Over 2012 the NZD has closely followed market sentiment with a "risk on" environment putting upward pressure on the currency and a "risk off" environment having an opposing impact as seen with Figure 3.6. Other factors contributing to a strong NZD include rising high interest rate differentials between New Zealand and the five countries that make up the TWI and upward pressure on Commodity prices.

Figure 3.6

New Zealand dollar versus global equities



Source: Bloomberg.

b. Current Economic Conditions

The New Zealand economy continues to recover slowly form the 2008/09 recessions, with quarterly GDP growth estimated to have averaged 0.6 per cent over the past year. Domestic demand continues to strengthen with the housing market recovering further and household spending picking up. Offsetting this,

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slowing global growth has weighed on export commodity prices, and the elevated New Zealand dollar continues to erode export earnings and encourage substitution toward imports.

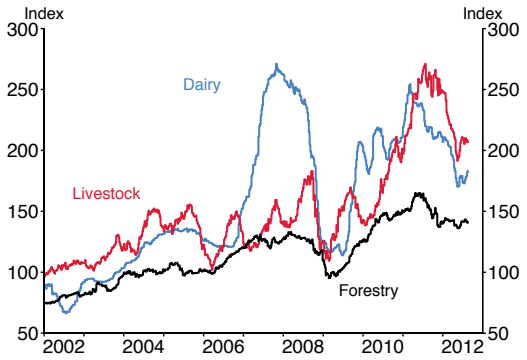
Inflationary pressures in the economy are currently modest with annual CPI inflation at 1.0 per cent. Falls in commodity prices and lingering strength in the New Zealand dollar have resulted in subdued tradable inflation. Consistent with some degree of spare capacity, non-tradable inflation is currently below its historical average.

Economic growth in New Zealand's trading partners has slowed over the past year. With the exception of Australia, GDP growth in the majority of trading partner economies is currently below average rates.

Moderate global growth and spare capacity in the United States and Europe continue to contribute to modest inflationary pressures in New Zealand's trading partner economies. As a result, manufactured import prices remain subdued. Slowing global growth and deterioration in financial markets drove sharp falls in commodity prices in the first half of the year – contributing to further softness in import price inflation.

Global growth in agricultural production was boosted in the early part of the year by favourable climatic conditions in New Zealand and abroad. This compounded the downward pressure on the prices of some of New Zealand's key exports, with dairy and lamb prices moderating from their elevated 2011 levels. In recent months, an easing in growth of global milk production has contributed to stabilization in dairy prices (figures 4.3). Concerns about drought in the United States, the worst since the 1950's, are also underpinning global dairy and beef prices. The drought has severely hampered prospects for the US grains harvest, driving a significant increase in the price of key grains such as corn and wheat. As a consequence, feed prices will increase sharply and this is likely to restrain the growth of US cattle herd numbers and dairy milk production (due to the heavy reliance on grain feed) leading to upward pressure on international beef and dairy prices.

Figure 4.3
Export commodity prices
(US dollar terms)



Source: ASB Bank.

Lingering strength in the New Zealand dollar continues to erode export receipt and hamper the competitiveness of the tradable sector more generally. While total export volumes continue to grow, largely supported by strength in primary sector exports, exports of travel services remain weak (figure 4.4). In part, this is due to the strong New Zealand dollar eroding the spending power of tourists. Subdued global activity and disruption to South Island tourism caused by the Canterbury earthquakes have also contributed to the weakness.

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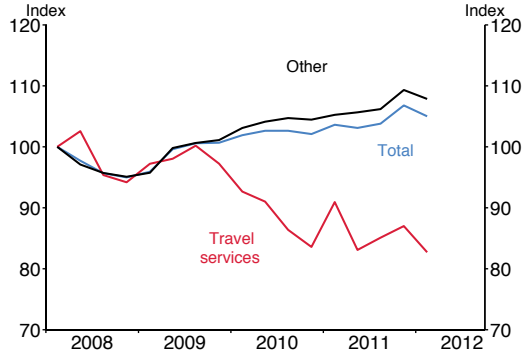
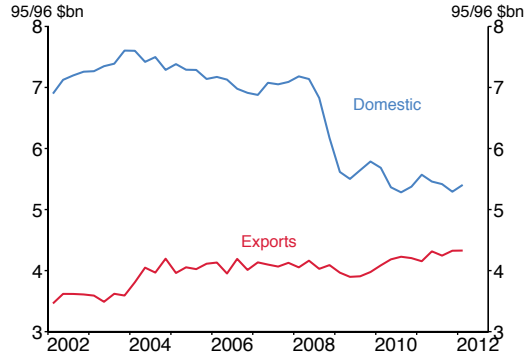
Figure 4.4
Export volumes
(seasonally adjusted, 2008Q1=100)



Source: Statistics New Zealand.

At the same time, the high New Zealand dollar is encouraging continued substitution to imports as it lowers the price of imports relative to domestically produced goods and services. Indeed, import-competing manufacturers who sell into the domestic market have seen their sales volumes decline markedly over the past four years, while manufactured export volumes have held up (figure 4.5). While prolonged weakness in the New Zealand construction sector will have contributed significantly to this divergence, it also appears that the high New Zealand dollar is negatively affecting import-competing firms to a greater extent than exporters. Overall, imports are currently elevated as a share of trend GDP. Persistent strength in the New Zealand dollar and strengthening domestic demand will continue to support imports over the remainder of 2012.

Figure 4.5
Quarterly manufacturing sales volumes
(seasonally adjusted)



Source: Statistics New Zealand, RBNZ estimates.

The New Zealand economy is estimated to have expanded 2.4 percent in the year to the September quarter 2012. Agriculture and primary manufacturing were key sources of growth, reflecting favourable climatic conditions. While the contribution to growth from these sectors is expected to wane over the coming year, domestic demand continues to strengthen. Service sector activity continues to expand and construction activity is expected to increase, albeit from a low base.

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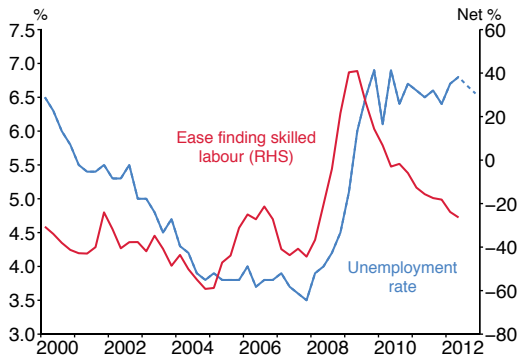
The housing market continues to recover. House sales and building consent issuances have increased strongly across the country since the beginning of the year, indicating an increase in residential construction over 2012. Consent issuance in the Canterbury region has increased sharply over the past year, consistent with a pick-up in repairs and building. That said, the current level of reconstruction activity remains low relative to the total rebuilding required. House price inflation has lifted across most regions, though remains modest to date. While there has been some divergence in house price inflation nationally, with house prices increasing faster in Auckland and Canterbury than in the rest of the country, these divergences are currently not significant relative to history.

Business indicators point to a gradual improvement in business investment from its current subdued level. An increase in capital imports and a sharp pick-up in commercial vehicle registrations in the first half of the year indicate some increase in firms' capital and transport investment. Surveyed investment intentions, which sit near historic norms, also point to higher capital investment.

Survey measures of capacity pressure indicate a continued elimination of spare capacity in the economy. Firms have reported increasing difficulty in finding staff with suitable skills, despite the unemployment rate remaining elevated (figure 4.8). Consistent with these developments, annual wage inflation has lifted to around average levels in recent quarters.

Annual headline CPI inflation declined to 1.0 per cent in the June quarter 2012. This low level of inflation was driven by sharp declines in imported commodity prices over the past year, especially food and fuel. Lingering strength in the New Zealand dollar and soft global conditions has further dampened tradable pressures. These factors will contribute to low inflation through the second half of 2012, though the dampening impact from fuel and food are expected to dissipate.

Figure 4.8
Unemployment rate and QSBO ease in finding skilled labour



Source: Statistics New Zealand, NZIER, RBNZ estimates.

Looking through commodity price volatility, underlying inflationary pressures, while modest, are not as low as headline CPI suggests. Core inflation measures remain around or below 2 percent in annual terms (figure 4.9), consistent with some degree of spare capacity in the economy.

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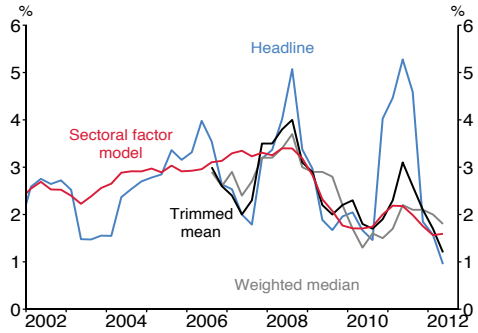
Figure 4.9
CPI inflation
(annual, excluding GST)



Source: Statistics New Zealand, RBNZ.

Consistent with recent low inflation outcomes and the gradual pace of economic growth, firms' pricing intentions have eased. In addition, surveyed inflation expectations have continued to moderate and have fallen considerably over the past year.

Although inflationary pressures are currently modest, there are signs that pressures are building in some parts of the economy. In particular, construction cost inflation has picked up, albeit from low rates, as housing market activity continues to increase.

c. Domestic Economic Projections

The subdued global outlook is expected to weigh on domestic activity through a number of channels. While our direct trade exposure to Europe is relatively small, indirect trade effects through our larger trading partners will put downward pressure on export earnings abroad. Weaker international incomes will also dampen tourist expenditure. Uncertainty regarding the global outlook is likely to dampen domestic confidence, potentially restraining business investment and hiring. Global uncertainty is also likely to see funding margins for New Zealand banks remain elevated.

Over the medium term, New Zealand's export prices are expected to increase gradually, supported by continued demand from Asia. This, coupled with a gradual increase in import prices, will see the terms of trade remain elevated over the projection horizon (figure 5.2). Over this period, the New Zealand dollar TWI is assumed to depreciate gradually (figure 5.3).

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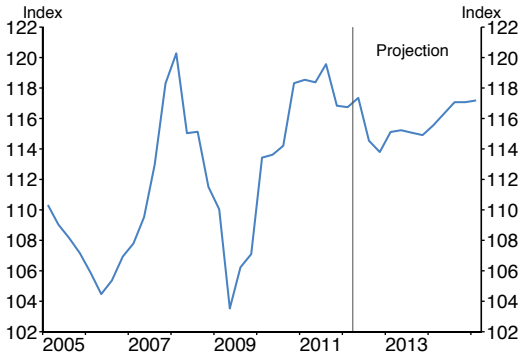
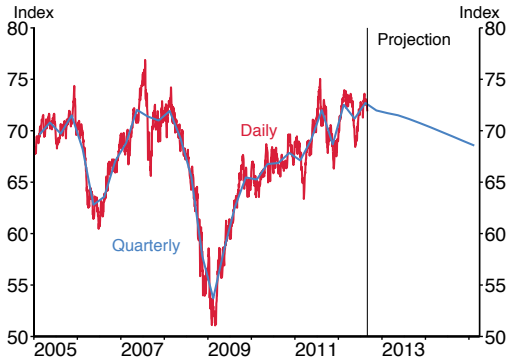
Figure 5.2
SNA terms of trade
(seasonally adjusted)



Source: Statistics New Zealand, RBNZ estimates.

Figure 5.3
New Zealand dollar TWI



Source: Statistics New Zealand, RBNZ estimates.

GDP growth is expected to remain near its current annual pace over the projection (figure 5.4). An important driver of domestic activity is a substantial rise in residential investment over the forecast horizon, from currently low levels. Population growth, a gradual improvement in the labour market and regular maintenance of housing are expected to drive a recovery in nationwide residential investment.

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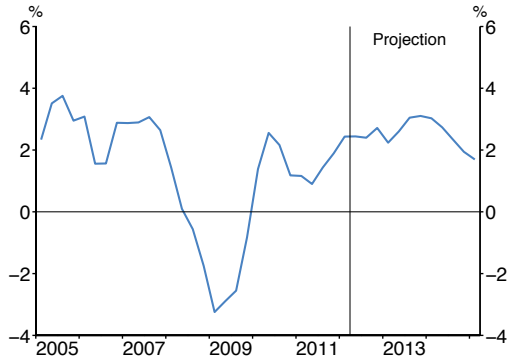
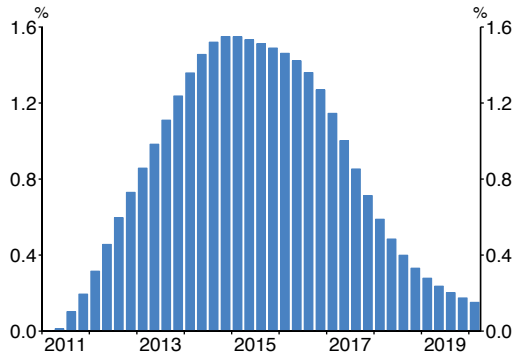
Figure 5.4
GDP growth
(annual)



Source: Statistics New Zealand, RBNZ estimates.

In addition, reconstruction activity in Canterbury will boost both residential and business investment over the projection. It is assumed that about $20 billion (in 2011 dollars) of assets damaged in the earthquakes will be repaired or replaced, with reconstruction peaking in 2014 (figure 5.6).

Figure 5.6
Canterbury rebuild profile
(seasonally adjusted, share of potential GDP)



Source: RBNZ estimates.

The eventual cost of reconstruction may be higher than the $20 billion currently assumed. Some assets, even those outside of Canterbury, will be repaired or built to a higher standard to meet higher earthquake-strengthening requirements. There may also be discretionary improvements when assets are replaced.

Weak house price inflation is expected to see consumption growth remain modest (figure 5.8). Households are also expected to remain relatively cautious in their spending, given their relatively high debt levels and a highly uncertain external environment.

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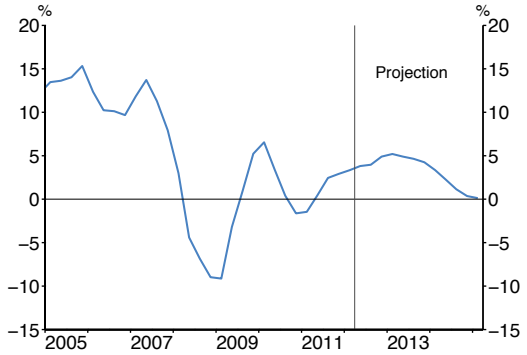
Figure 5.8
House price inflation
(annual)

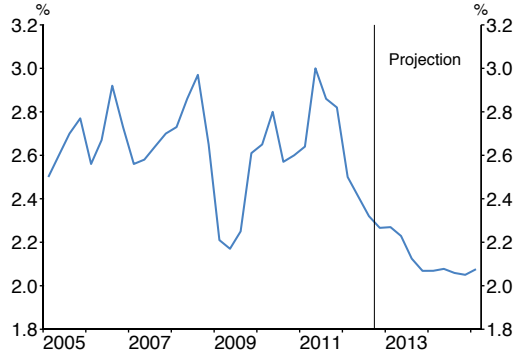


Source: Property IQ, RBNZ estimates.

Private consumption growth will also be limited by fiscal consolidation. The Government aims to return to surplus by the 2014/15 fiscal year, through a combination of reduced spending growth and an increase in revenues. The latter is expected to occur through a pick-up in domestic activity and higher indirect taxes. These taxes increase the price level, and will therefore also reduce consumers' real disposable incomes.

Fiscal consolidation will see government debt as a share of GDP stabilise over the medium term. In addition, only modest household spending growth will see the household saving rate increase. However, the large increase in residential (and, to a lesser extent, business) investment more than offsets these improvements, resulting in a current account deficit that widens to nearly 6 percent of nominal GDP in 2013.

Figure 5.11
2-year-ahead inflation expectations
(annual)



Source: RBNZ estimates.

Tradable inflation pressures are expected to increase as the New Zealand dollar TWI eases off its current highs over the projection. However, the soft outlook for global activity implies that the increase in tradable inflation will be modest. Headline CPI inflation is expected to settle near the middle of the target range over the medium term (figure 5.12).

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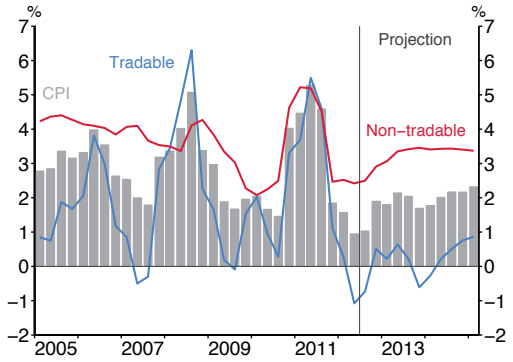
Figure 5.12
CPI, tradable and non-tradable inflation
(annual)



Source: Statistics New Zealand, RBNZ estimates.

THE SECURITIES MARKET

a. Capital Markets Overview

The NZ Capital Markets continue to operate in a global environment that is highly uncertain. Government bond issuance continues to increase as a result of the current account deficits being incurred by the current National Government. Demand for this issuance has been strong given the strong credit quality, relatively low public sector debt and relatively high yield.

The formation of the Local Government Funding Agency (LGFA) responsible for the issuance of debt instruments on behalf of New Zealand Local Authorities has seen both good supply and demand for this issuance.

Private sector debt issuance continues to be robust for well rated entities especially now that credit spreads have narrowed. Given the recent low prevailing interest rates for bank deposits there continues to be good demand for yield for well-rated entities.

With regard to the equity market, the worrying trends in this market have stabilised. On the supply side the significant de-equitsation that occurred from 1998-2005, primarily via offshore takeover activity, has been far less prominent. This in part reflects the high value of the NZD and the premium the NZ market trades at versus its global peers. On the demand side, the rise of local manager participation in the domestic market reflects the positive impact KiwiSaver has had on equity inflows.

One critical issue remains for the NZ equity market. When, and to what extent, will new equity supply come to the market? Well-publicised floats on the horizon would make an important impact. The NZ equity market remains a long way behind advanced economy peers as a proportion of the economy. In particular, while market capitalisation as a share of GDP remains below 50%, we believe a self-sustaining equity market will remain in question. The current run-rate of IPOs per annum is simply not enough to increase the relevance of the equity market in the broader economy.

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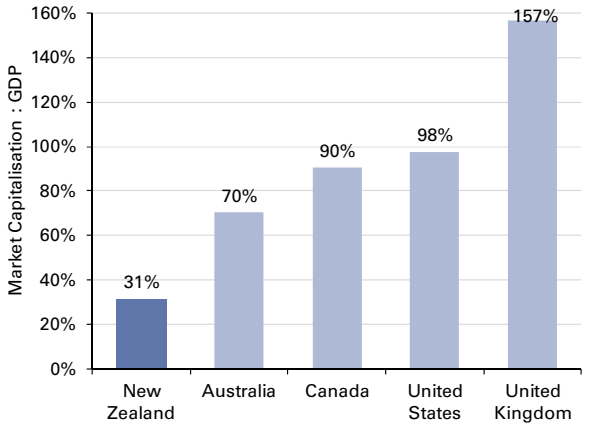
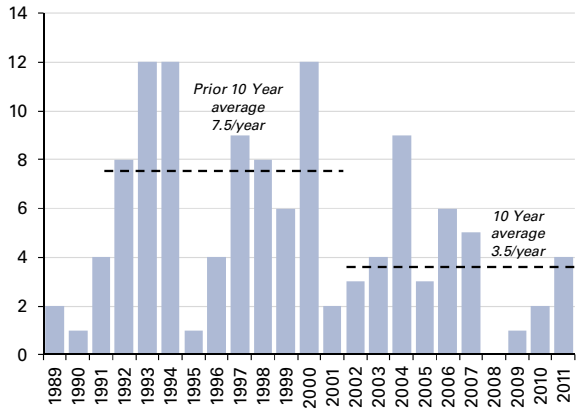
Exhibit 8: NZ equities play a small role in the economy
International market capitalisation vs. GDP



Source: Datastream, Goldman Sachs Research estimates.

Exhibit 9: Weak IPO activity over the past decade
Number of IPOs in New Zealand



Source: Goldman Sachs Research estimates.

b. New Zealand Securities Markets

A key development in the New Zealand Securities Market is the Crown's intention to offer shares to the public in one or more of the publicly owned Companies including Genesis Power, Meridian Energy, Mighty River Power, Solid Energy and Air New Zealand. The Crown's intention however has been temporarily thwarted by an ownership claim on water as part of the Treaty of Waitangi. This has been caused by the uncertainty over ownership of water rights by Maori that may have a future cost implication for Energy Companies.

Equities - NZX

The market capitalisation of shares listed on the NZSX as at 30 September 2012 was $62.7 billion. This is an increase of 13% on last year's figures. The market capitalization of the smaller NZAX index increased to $900 million representing an increase year on year of 2%.

Debt - NZX

The NZDX is New Zealand's market for trading a range of investment securities, including corporate and government bonds, and fixed income securities. The value of the NZDX as at 30 September 2012 was $15.2 billion, a 2.0% decrease from the same time last year.

c. Regulatory Developments

The most important piece of legislation to impact on our securities market for some time is the Financial Markets Conduct Bill. This Bill overhauls New Zealand's securities law to improve financial market conduct and restore investor confidence in New Zealand's financial markets. The Bill repeals and replaces the Securities Act 1978, the Securities Markets Act 1988, and the Unit Trusts Act 1960, as well as making significant amendments to other related legislation.

A few key proposals include:

- Replacing the requirement for issuers to prepare both a prospectus and investment statement with a requirement to prepare a single product disclosure statement tailored to retail investors and place other information on a public register;

- Establishing licence regimes for fund managers, independent trustees of workplace superannuation schemes, derivative dealers, and peer-to-peer lenders;
- Introducing stricter requirements for managed investment schemes, including new duties on fund managers and supervisors and stronger governance requirements;
- Establishing an escalating system of liability, starting with basic infringement notices and ending with heavy criminal penalties.

The legislation is not expected to take effect until January 2014.

Another piece of proposed legislation affecting the securities market is the Financial Reporting Bill. This Bill is intended to improve the financial reporting system by aligning it with identified public policy objectives. Main impacts of the Bill will be to reduce compliance costs for smaller entities, grant more power to the External Reporting Board, and amend various inconsistencies with other legislation.

Also under consideration for further reform is in the area of Trans-Tasman Economic Integration. Specifically the Australian and New Zealand Productivity Commissions have been asked to jointly study the options for further reforms that would increase economic integration and improve economic outcomes. Particular proposals of note include:

- Aligning financial reporting and disclosure requirements to reduce the cost of issuing debt in trans-Tasman markets;
- Establishing a trans-Tasman PPSR;
- Removing barriers to the movement of capital between Australia and New Zealand;

A joint approach to banking supervision, including the alignment of the banking regulations frameworks in each jurisdiction to facilitate a joint banking market. In addition the Australian Treasury and New Zealand Ministry of Economic Development are working towards the implementation of a single economic market. Areas to be integrated include:

- Insolvency law;
- Financial reporting policy;
- Competition law;
- Personal property securities law;
- Consumer law;
- IP law;
- Insurance regulations; and
- Corporations law.

Another important piece of legislation that is currently in the consultation stage is the Anti-Money Laundering and Countering Financing of Terrorism Act 2009. The Ministry of Justice has issued a consultation document on proposed AML regulations.

Proposed regulations include:

- An annual reporting form to help financial institutions meet their reporting obligations;
- Information that must be included in suspicious transaction reports submitted to the Police;
- Exemptions for certain industries to clarify that they are outside the intended scope of the AML/CFT Act;
- Exemptions to simplify and remove duplication of customer due diligence requirements; and
- Enhancements to certain customer due diligence obligations, such as for international wire transfers.

The new regulations are expected to be in place by January 2013.

Ends

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