Asia Securities Forum Country Report

Country: New Zealand

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Date: 10 September, 2013

1. EXECUTIVE SUMMARY

The global outlook remains mixed with Europe's situation still uncertain while positive signs are emerging from the US and Japan. However global financial sentiment continues to be buoyant and the medium term outlook for New Zealand's main trading partners remains firm.

Growth in the New Zealand economy is picking up but remains uneven across sectors. Consumption is increasing and reconstruction in Canterbury continues to gather pace and will be reinforced by a broader national recovery in construction activity, particularly in Auckland. This will support aggregate activity and eventually help to ease the housing shortage.

In the meantime rapid house price inflation persists in Auckland and Canterbury. As previously noted, the Reserve Bank does not want to see financial or price stability compromised by housing demand getting too far ahead of the supply response.

Reflecting the balance of several forces, we expect annual GDP growth to accelerate to about 3.5 percent by the second half of 2014, and inflation to rise towards the midpoint of the 1 to 3 percent target band. Given this outlook, we expect to keep the OCR unchanged through the end of the year.

2. ECONOMIC PERFORMANCE AND PROJECTIONS

a. Introduction

New Zealand has a small, open economy that operates on free market principles. It has sizeable manufacturing and service sectors complementing a highly efficient export-oriented agricultural sector. New Zealand is highly dependent on the primary sector with commodities accounting for around half of total goods exports. Exports of goods and services account for around one-third of real expenditure GDP. New Zealand's high proportion of winter sunshine hours and considerable rainfall provide an ideal resource base for pastoral agriculture, forestry, horticulture and hydro-electricity generation. Hydro-electricity provides a relatively cheap source of energy and has allowed the development of energy-based industries such as aluminium refinement. New Zealand is also a popular overseas visitor destination and tourism is an important source of export income.

Over the last quarter of a century, the New Zealand economy has changed from being one of the most regulated in the OECD to one of the least regulated. The minority National Party Government elected in November 2008, and re-elected in November 2011, aims to lift the long-term performance of the economy through six key policy drivers: a growth-enhancing tax system; better public services; support for science, innovation and trade; better regulation, including regulation around natural resources; investment in infrastructure; and improved education and skills.

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b. Recent Economic Performance - Background

The New Zealand economy entered recession in early 2008, before the effects of the global financial crisis set in later in the year. A drought over the 2007/08 summers led to lower production of dairy products in the first half of 2008. Domestic activity slowed sharply as high fuel and food prices dampened domestic consumption, while high interest rates and falling house prices drove a rapid decline in residential investment. The outlook for the New Zealand economy deteriorated sharply following the intensification of the global financial crisis in September 2008. Similar to experiences across advanced economies, business and consumer confidence plummeted as uncertainty dominated the global financial and economic environment. In addition, local banks' access to funding in overseas markets was temporarily curtailed at the height of the crisis.

c. Response To Global Financial Crisis (GFC)

The Government and the Reserve Bank of New Zealand (RBNZ) responded to the crisis with a range of measures designed to alleviate its effects. The RBNZ lowered the Official Cash Rate (OCR) from its level of 8.25% over the year to July 2008 to a low of 2.5% at the end of April 2009. The Bank also introduced a range of facilities to ensure that adequate liquidity was available to the banking sector. The Government introduced retail and wholesale bank guarantees aimed at restoring confidence in the banking sector and providing banks with improved access to wholesale funding. The Labour-led Government proceeded with personal income tax cuts on 1 October 2008 and the new National-led Government, which came to power in November 2008, introduced further tax reductions effective from 1 April 2009. Other measures taken by the new Government in December 2008 were aimed more directly at alleviating the effects of the downturn, including infrastructure projects and a temporary relief package to assist small and medium-sized businesses.

d. Economic Growth

In total, New Zealand experienced six quarters of negative economic growth between the March quarter 2008 and the June quarter 2009, totaling 4.0% of real GDP. The relative shallowness of the recession compared favourably with other nations in the OECD, with New Zealand sixth least affected out of the 34 member nations.

The New Zealand economy then grew for four consecutive quarters up to mid-2010, totaling 3.0% of real GDP. The recovery was led by exports, with strong demand from major trading partners, Australia and China. This was helped by historically high prices for New Zealand's commodity exports, which flowed through to a high terms of trade. The strength in the external sector was led by a boom in demand from China, which boosted dairy and log exports. However, in the second half of 2010, the New Zealand economy experienced a technical recession (two quarters of negative real GDP growth). Real GDP growth bounced back in 2011, growing 2.6% over the year despite a devastating earthquake in Canterbury in February. The lift in GDP growth was characterised by strong primary production and an improvement in services activity, offsetting the continued weakness in the construction sector.

The Rugby World Cup in September and October provided a positive contribution to growth in the second half of the year. Real GDP strengthened further at the beginning of 2012, growing 0.9% in the March quarter. The growth in activity was reasonably broad-based, including good pastoral growing conditions providing a boost to agricultural production and food processing. However, growth in the middle of 2012 was weaker with GDP growth of 0.5% across both the June and September quarters, supported by activity in the construction sector. The Canterbury rebuild is expected to be a main driver of growth in the coming year, gaining momentum in the first half of 2013.

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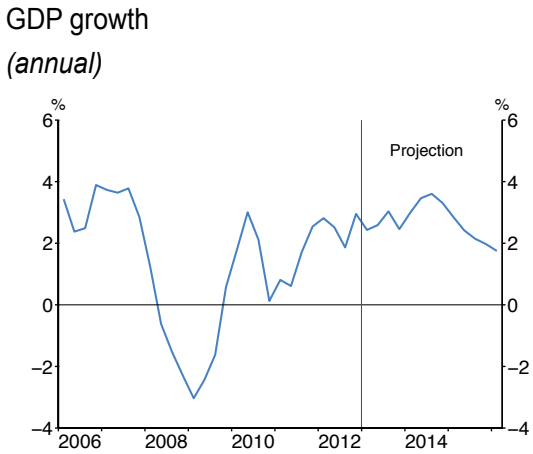

Source: Statistics New Zealand, RBNZ estimates.

e. Canterbury Earthquakes

On 22 February 2011, the Canterbury region on the east coast of the South Island experienced a devastating 6.3-magnitude earthquake. A total of 181 people were killed; the second deadliest natural disaster in New Zealand history. This followed a 7.1-magnitude earthquake on 4 September 2010, in which there had been no casualties. The earthquakes (including subsequent aftershocks) caused widespread damage to buildings and infrastructure, in particular to the Central Business District (CBD) and eastern parts of the city. The New Zealand Treasury estimates the damage from the earthquakes at around $30 billion (14% of GDP), much of which is covered by private insurance (reinsured through overseas insurance companies) and the government-owned Earthquake Commission (EQC).

Despite the significant amount of disruption caused by the earthquakes (in particular the February 2011 event), the cleanup and demolition operations helped minimize the immediate growth impact. Many businesses were able to relocate out of the badly damaged CBD and keep trading. Primary and manufacturing production in the region was not significantly affected. The Canterbury rebuild is expected to be a significant driver of economic growth over the next five to ten years with both the June and September 2012 quarter GDP outturns providing hard evidence of rebuilding activity. The pace of the rebuild over the medium term is uncertain, in part owing to uncertainty around capacity constraints.

f. Labour Market

The labour market has shown little improvement following the GFC with the unemployment rate sitting at 7.3% for the September quarter 2012. This follows a two-year period of volatility in the unemployment rate after it rose from a low of 3.5% in the December quarter 2007 to 6.9% in the December quarter 2009. The Canterbury earthquakes initially had a negative impact on the labour market, with employment falling 8.0% in the region in the year to September 2011. More recently, labour market statistics in Canterbury have strengthened with employment rising 2.9% in the year to September 2012. Excluding Canterbury, employment fell 0.4% over the same period, with the unemployment rate above the headline figure, at 7.6%.

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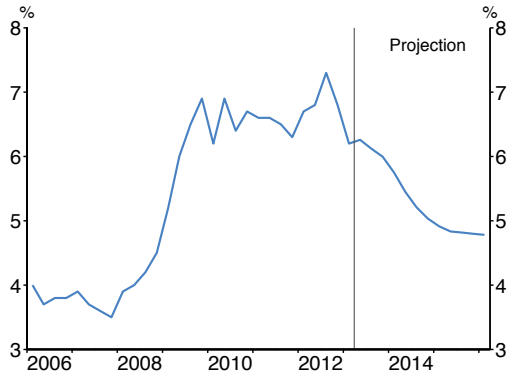
Unemployment rate

(seasonally adjusted)



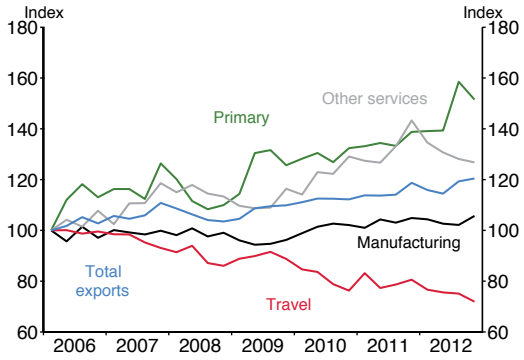
Source: Statistics New Zealand, RBNZ estimates.

g. External Trade

The prices of the commodities that New Zealand exports were at record high levels in early 2011, after more than recovering the significant falls experienced during the GFC. The high commodity prices were widespread, including dairy products, meat and logs, owing to surging demand from China. The high commodity prices flowed through to a historically high terms of trade, as export prices rose much faster than import prices. The strong terms of trade have provided an offset to the weaker real economy, helping to boost nominal GDP. Since early 2011, global conditions have deteriorated; the terms of trade eased off their peak in the September quarter 2011, and continued to do so in the first half of 2012. Further moderation is expected to have occurred in the second half of 2012 but improvement is expected in 2013 as higher spot prices flow through to export prices.

Export volumes

(seasonally adjusted, 2006 Q1=100)



Source: Statistics New Zealand.

h. Balance of Payments

External strength and a subdued domestic economy resulted in the current account and the net international investment position improving during the recovery from the GFC. The annual current account deficit fell from 8.8% of GDP in the December quarter 2008 to a low of 1.8% in the March quarter 2010. The narrowing of the current account deficit was helped by a positive balance on the goods account since the start of 2010, with goods exports outpacing goods imports. Net international liabilities fell from 84.6% of GDP in March 2009 to 66.7% in March 2011, owing to the smaller current account deficits, valuation changes and outstanding reinsurance claims related to the Canterbury earthquakes.

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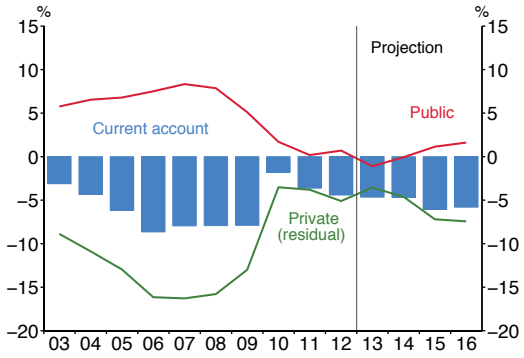
After the low of 1.8% in March 2010, the current account deficit widened to 4.7% in the September 2012 quarter, as the goods and investment income balances deteriorated, partly reflecting falling commodity prices and higher profit outflows from the banking sector. The current account deficit is expected to widen further over the medium term owing to increased imports for the Canterbury rebuild, as well as increasing debt servicing costs and higher profit outflows. New Zealand's net international liabilities increased from a trough of 66.7% of GDP in the March quarter 2011 to 71.2% of GDP in the September quarter and are expected to gradually rise further.

Private and public contributions to the current account balance

(annual, share of nominal GDP)

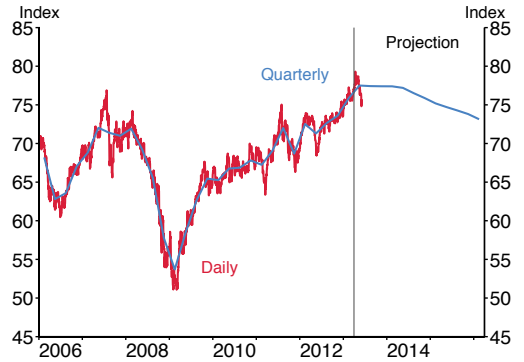


Source: Statistics New Zealand, RBNZ estimates.

i. Exchange Rate

The Trade Weighted Index (TWI), a basket of exchange rates for New Zealand's major trading partners, began retreating from historically high levels in March 2008 as the market assessed monetary policy in New Zealand, shifting towards a loosening bias and a weaker outlook for growth. The TWI fell 28% between February 2008 and February 2009, cushioning the economy from the global downturn. As the outlook for global growth became more optimistic, the US dollar weakened and demand for commodities improved. As a result, the TWI appreciated rapidly from early 2009, rising from 52.3 in February to 66.5 in October, a 27% increase. High commodity prices, as well as a relatively strong economy, resulted in further increases in the TWI to 72.1 in August 2011, before retreating to around 68 in December as global risk aversion increased and commodity prices eased. The TWI appreciated again in 2012, rising to 73.0 by April 2012, before declining to around 70.0 in the middle of the year as risks around the euro debt crisis escalated. Recently, commodity prices for New Zealand exports have started to recover and euro zone risks recede slightly, which saw the TWI appreciate to 74.3 in December 2012.

New Zealand dollar TWI



Source: RBNZ estimates.

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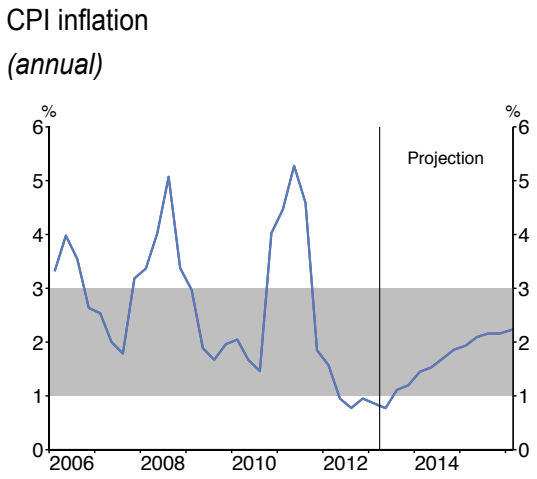
j. Inflation

Annual Consumer Price Index (CPI) inflation was comfortably within the Reserve Bank of New Zealand's (RBNZ) 1% to 3% target band in the two years following the GFC. Inflation increased significantly in the December quarter 2010 as an increase in the rate of goods and services tax (GST) from 12.5% to 15% on 1 October 2010 was passed on to consumers. The CPI rose 2.3% in the quarter, taking annual inflation to 4.0%, well above the target range. Inflation increased further during 2011, rising to 5.3% on an annual basis in June before falling to 1.8% in the year to December 2011 as the effect of the GST rate rise fell out of the calculation. Over 2012, CPI inflation continued to ease, falling 0.2% in the December 2012 quarter, which brought annual inflation down to 0.9%, a reflection of the strong New Zealand Dollar and falling commodity prices which have depressed tradables prices.



Source: Statistics New Zealand, RBNZ estimates.

k. Outlook

In the December 2012 Half Year Economic and Fiscal Update (HYEFU), the New Zealand Treasury expected annual average growth in the economy to be 2.3% in the March 2013 year and 2.9% in the March 2014 year, driven mainly by the Canterbury rebuild and recovery in domestic demand. Recovering world demand, as well as still high commodity prices, should also assist export growth, although this is dependent on the global outlook. The performance of the global economy exceeded expectations in 2010 but then slowed significantly as public stimulus measures faded, natural disasters in Japan and Australia caused disruption and Europe sovereign-debt issues re-emerged. However, New Zealand's increasing exposure to the faster growing areas of the world, in particular Australia and Asia excluding Japan, resulted in exports holding up better than otherwise would have been expected.

New Zealand trading partner growth is expected to have increased slightly in 2012, to hold up in 2013, and to pick up again in 2014. While private consumption is expected to pick up, spending is likely to remain subdued as households remain cautious. Investment is expected to grow strongly as the earthquake rebuild gets underway. The stimulus from the rebuild is expected to offset the impact of fiscal consolidation over the forecast period.

l. Monetary Policy

The focus of monetary policy is to maintain price stability. A Policy Targets Agreement between the Governor of the RBNZ and the Minister of Finance sets out the specific targets for maintaining price stability, while seeking to avoid unnecessary instability in output, interest rates and the exchange rate. The current Policy Targets Agreement, which was signed in September 2012 on the appointment of a new

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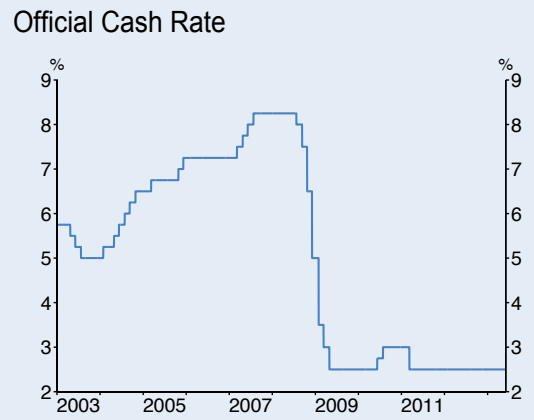
governor, requires the Bank to maintain inflation in the range of 1% to 3% on average over the medium term, but with the additional requirement to "focus on keeping future average inflation near the 2% target midpoint".

Following the lowering of the OCR from 8.25% in mid-2008 to 2.5% in April 2009 in response to the international credit crisis, the RBNZ began increasing the OCR again as the economy began to recover. The OCR was increased to 3.0% in July 2010, before a cut of 50 basis points back to 2.5% as an "insurance cut" following the February 2011 Canterbury earthquake. Since then, a deteriorating global outlook has meant that interest rates have remained at 2.5%, with increases not expected until late 2013 as the Canterbury rebuild gets underway, creating some inflationary pressures.



Source: RBNZ.

m. Fiscal Policy

In 1994, the Government enacted the Fiscal Responsibility Act. The Act was intended to assist in achieving consistent good quality fiscal management over time. Good quality fiscal management should enable the Government to make a major contribution to the economic health of the country and be better positioned to provide a range of services on a sustained basis. This Act has now been repealed but its provisions have largely been incorporated into Part 2 of the Public Finance Act 1989. Part 2 requires the Crown's financial reporting to be in accordance with New Zealand Generally Accepted Accounting Practice (NZGAAP). The primary fiscal indicators are the operating balance, debt and net worth. Part 2 requires the Government to pursue its policy objectives in accordance with the principles of responsible fiscal management set out in the Act. These include:

- Reducing debt to prudent levels to provide a buffer against future adverse events;
- Maintaining prudent debt levels by ensuring that, on average, total operating expenses do not exceed total operating revenues (i.e., the Government is to live within its means over time, with some scope for flexibility through the business cycle);
- Achieving and maintaining levels of net worth to provide a buffer against adverse events;
- Managing the risks facing the Crown; and
- Pursuing policies that are consistent with a reasonable degree of predictability about the level and stability of future tax rates.

n. Key Fiscal Indicators

An extended period of growth led to a strong fiscal position for the Government in the 2007/08-year. However, the recession that began in the first quarter of 2008 resulted in a decrease in revenues and expenditure increases which weakened the fiscal position in 2008/09 and subsequent years.

Operating balance: Following a prolonged period of fiscal deficits, New Zealand achieved surpluses in

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1993/94 and remained in surplus until 2007/08. In 2011/12, the operating balance was a deficit of $14.90 billion. The December 2012 HYEFU forecasts for the operating balance for 2012/13, 2013/14, 2014/15, 2015/16 and 2016/17 are for a deficit of $3.28 billion and surpluses of $0.05 billion, $2.10 billion, $3.55 billion and $4.39 billion respectively. Core Crown operating expenses as a percentage of GDP decreased to 33.8% in 2011/12, down from 35.6% in 2010/11. Expenses are controlled through output budgeting, accrual reporting and decentralised cost management.

Net debt: Net debt increased to 24.8% of GDP in 2011/12 as a result of the additional borrowing undertaken to offset the Government's operating deficits.

Net worth: After a prolonged period of increases, net worth has been decreasing since 2007/08 and stood at $59.3 billion as at 30 June 2012. The decreases have arisen as a result of the operating deficits, partly offset by asset revaluations.

o. Fiscal Objectives

The Government's long-term fiscal objectives were set out 2012 Fiscal Strategy Report published with the 2012 Budget and reconfirmed in the 2013 Budget Policy Statement in December 2012. The long-term fiscal objectives include objectives for debt, operating balance, operating expenses and revenue, and net worth. The long-term debt objective requires net debt to remain consistently below 35% of GDP, and to be brought back to no higher than 20% of GDP by 2020. Consistent with this, the objective for the operating balance is to return to an operating surplus sufficient to meet the Government's net capital requirement, including contributions to the New Zealand Superannuation Fund. The current short-term fiscal intention is for the operating balance (excluding gains and losses) to be returned to surplus as soon as possible and no later than 2014/15, subject to any significant shocks. Current forecasts are for net core Crown debt to peak below 30% of GDP in 2016/17.

p. Public Debt

Prior to March 1985, successive governments had borrowed under a fixed exchange-rate regime to finance the balance of payments deficit. Since the adoption of a freely floating exchange-rate regime, governments have undertaken new external borrowing only to rebuild the nation's external reserves and to meet refinancing needs. Direct public debt increased by a net amount of $5,719 million including swaps between 1 July 2011 and 30 June 2012. This increase was owing to a net increase in internal debt of $6,241 million and a decrease of $522 million in external debt. Government gross direct debt amounted to 38.9% of GDP in the year ending the 30th of June 2012, up 36.6% year on year.

3. THE SECURITIES MARKET – MAJOR DEVELOPMENTS & PROSPECTS

a. Capital Markets Overview

In late April, New Zealand's 10-year government bond rate reached 60-year lows of just under 3.2 percent. Yields have since risen, driven by the rebound in global rates. Demand for New Zealand government bonds has been strong from overseas investors, as demand for high- yielding assets has increased. In early May the spread to United States 10-year Treasuries fell to as low as 140 basis points, the lowest since 2007 (figure 3.5). Offshore holdings of New Zealand government securities rose to 69 percent in April, the highest level since late 2009 and above the average of the last 15 years of 60 percent.

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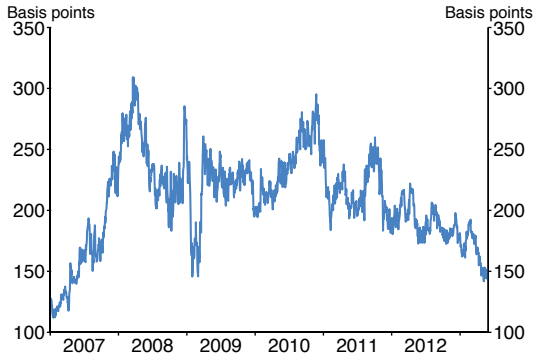
NZ-US 10-year government bond spread



Source: Bloomberg.

Issuance of Kauri bonds (New Zealand dollar denominated bonds issued in New Zealand by foreign issuers) has lifted during 2013, with around $4 billion of new issues in the five months ending May compared to $2.3 billion over calendar year 2012. The increased issuance has been driven by strong demand for New Zealand dollar assets and limited supply of New Zealand government bonds. In addition, a narrowing of interest rate spread between Australia and New Zealand supported this demand.

Domestic banks are currently well funded. Annual deposit growth is around 10 percent and the major banks are finding it relatively easy to obtain additional long- term funding from offshore markets. Since March, the four major banks have issued more than $2.3 billion of senior unsecured long-term (more than three years maturity) debt in various markets. The weighted average price of these deals when swapped back into New Zealand dollar floating rates was about 115 basis points over the reference rate (BKBM), approximately 75 basis points below year-ago levels.

Increased Kauri issuance has helped reduce the cost for New Zealand banks of hedging offshore debt issuance. The NZD-USD 5-year basis swap has trended lower this year and is about 20 basis points lower than mid-2012.

With banks able to raise term funding abroad more cheaply, the pressure on retail deposit rates has been downward over recent months. The average six-month term deposit rate for the four major banks is down 15 basis points to 3.81.

The New Zealand equity market has continued to perform well. The NZX-50 Index rose by 2.0 percent over April and May, following the 8.8 percent gain in the March quarter, although it has not increased by as much as the MSCI world index this year.

There has been no significant domestic non-financial corporate bond issuance this year. The search for yield has helped to further reduce corporate bond spreads to swap rates. In the secondary market, the average spread to swap of senior bank debt (of at least three years residual maturity) has fallen from 130 bps at the beginning of the year to 90 bps.

The short end of the interest rate market has been underpinned by steady monetary policy and expectations of this continuing over the near term. The 90-day bank bill rate has hovered around 2.65 percent. The OIS market is currently pricing in little chance of the OCR changing over the next few months and about 6 basis points of tightening has been priced in by year-end. Over the next 12 months, the OIS market has priced in about 23 basis points of tightening.

The trend of borrowers moving from floating to fixed rate mortgages has continued through 2013. The percentage of mortgages that are on fixed rates has increased to around 50 percent currently, whereas 37 percent of mortgages were on fixed rates a year ago. However, most of the increase in fixed rate

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mortgages is at six-month to two-year terms, the cheapest part of the curve, so for many mortgage holders re-pricing risk remains over the short term. The average time to re-price fixed rate mortgages has fallen slightly from 14.3 months in December to 13.8 months in April.

b. Regulatory Developments

During recent times there has been a wealth of regulatory change implemented in New Zealand that has been driven from both offshore and locally. The most important local developments in the regulatory environment are as follows:

Financial Markets Conduct Bill – This Bill replaces the Securities Act & Securities Market Act and was designed to improve financial markets conduct and restore investor confidence in New Zealand's financial markets. It centres on the requirement to have one comprehensive product disclosure document, the requirement that all derivative issuers are licensed, and stricter requirements for managed investment schemes.

Financial Service Provider Registration Regime – This regime is designed to provide comprehensive information on all service providers plus access to a free dispute resolution scheme.

Financial Reporting Bill – This Bill is intended to make wide-ranging changes to the financial reporting requirements.

Anti-Money Laundering – The Anti-Money Laundering and Counter Financing of Terrorism Act is designed to detect, manage and mitigate the possibility of money laundering and terrorism financing.

Cartel Criminalisation – The government has proposed to criminalise "hard core" cartel behaviours in New Zealand.

Covered Bonds – The Government has introduced a Bill setting out a regulatory framework for covered bonds, including mandatory registration requirements and independent monitoring.

Non-bank Deposit Takers Bill – NBDT's became subject to prudential oversight by the Reserve Bank in 2010. The Bill will implement the second phase, which includes the introduction of licensing & suitability tests for directors and officers.

Consumer Law Reform – The government has introduced a bill to modernise, amend and consolidate various consumer laws, including the Consumer Guarantees Act 1993, Fair Trading Act 1986 and Sale of Goods Act 1908. It also attempts to harmonise our law with Australia.

Financial Advisers – Subsequent to the recent discovery of our own Ponzi scheme, the Ministry intends to implement a more onerous reporting requirement for Financial Advisers who provide discretionary investment management services.

NZX Listing Rule changes – The NZX has introduced a consultation memorandum that proposes changes to content in annual reports, offer documents, independent directors and corporate governance etc.

In addition there has been a significant degree of compliance to regulation originating from the Basel Committee and the Dodd Frank Act.

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c. Prospects for the Securities Industry

Prospects for the NZ Securities Industry look positive. Forbes rated New Zealand first in their 2012 Best Countries for Business. With our economy that is closely linked to Australia's, we have performed better than most during the global financial crisis with the only downside being an appreciating currency. The Country's benchmark stock index, the NZX 50 rose 25% in 2012 outpacing Wall Street and Australia. By June 2013 we have reported our best year since 2004.

Our economic recovery since the GFC has been lead by exports, with strong demand from our major trading partners Australia and China who have been less affected by the crisis. Relatively strong Government accounts and a well-capitalised banking system have provided a stable base for the economy. These positives together with continued strong terms of trade and the boost to GDP from the Christchurch rebuild have led to solid underlying growth.

A range of measures makes New Zealand an attractive destination for investment, these being:

- A relatively strong fiscal position and a commitment to reduce debt to 20 percent of GDP by the early 2020's.
- Legislative requirements are in place to maintain public debt at prudent levels.
- The kiwi dollar was amongst Standard & Poors top rated sovereign currencies in the world as at 31st of December 2012.
- New Zealand's economy is forecast to grow 2 to 3% per year over the next four years.

The Government has embarked on a program of state owned asset sales retaining 51 percent crown investment. This will provide a significant boost to our equity market adding to the growing number of capital raisings achieved over recent times. Most recently the government has signaled its intention to sell down up to 49% of its shareholding in Meridian Energy, Genesis Energy and Solid Energy and to reduce its shareholding in Air New Zealand to 51%. Meridian Energy will be the second SOE to be offered for partial sale. The sale process has begun with the sale of Mighty River Power in the first half of 2013.

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Source:
New Zealand Treasury
Reserve Bank of New Zealand
Buddle Findlay