Asia Securities Forum Country Report

Country: New Zealand

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1. **Economic Performance, Trends and Projections**
   a. **Economic Trends**

Over the last quarter of a century the New Zealand economy has changed from being one of the most regulated in the OECD to being currently one of the least regulated. The minority centre right National Party was elected in November 2008 and aims to continue developing New Zealand as a globally competitive economy.

From 1999 to 2008 the NZ economy has experienced its longest sustained period of economic growth in three decades peaking in the period 2002 to 2004 in a range of 3.4% to 5.2% driven by relatively high world commodity prices. More recently growth has eased as a result of high oil prices, increased interest rates and slowing immigration.

Growth contracted over the first three quarters of 2008 as high food and oil prices along with high interest rates led to a sharp fall in domestic demand. Growth is forecast to remain weak in the short term as households consolidate debt. Annual average growth for the year ending March 2009 was -2.7% which is expected to be the bottom of the range. Growth is expected to return to the economy in 2011 with trend levels of 3% driven by an export led recovery.

After a small rise in the short term the annual current account deficit is expected to narrow over the medium term from its Sept 2008 level of 8.6% of GDP. This narrowing is expected to be driven by slowing import growth and declines in the exchange rate in 2010.

Annual Consumer Price Index (CPI) inflation increased from 1.8% in September 2007 to 5.1% in September 2008, well outside the Reserve Bank's inflation target band of between 1% and 3% driven largely by higher food and fuel prices. Annual inflation has however fallen back to 1.9% as of June 2009, driven by falling fuel and other import prices as well as a general easing in domestic and external demand. Further falls are expected over 2009.

b. **Fiscal Outlook**

During the commentary relating to economic trends, I have not mentioned either the International Credit Crisis or the Global Recession, but these two recent events have had a significant impact on both the economic performance of all countries as well as playing a big role in the shaping of fiscal and monetary policy. The new government has announced a number of initiatives designed to mitigate the effects of these two events. These include:

i) A program of accelerated infrastructural spending spanning the housing, transport, education and energy sectors at an estimated cost of $500 million.

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ii) A small business relief package designed to assist small and medium sized businesses. These include tax relief, an expansion of the export credit scheme, business advice services and prompt payment requirements for government agencies.

iii) The introduction of a `Wholesale Funding and Retail Deposit Guarantees scheme. The primary objective of the opt-in wholesale funding guarantee facility was to facilitate access to international capital markets by NZ financial institutions in a global environment where investors were highly risk adverse. The government guarantees the financial institution and charges fee to that institution based on their credit rating.

    The primary objective of the opt-in retail guarantee scheme was to ensure public confidence in NZ financial institutions. A raft of recent failures by Finance Companies operating in NZ has severely impacted on investor confidence which also affected confidence in the banking sector. The scheme requires that bank and non bank deposit takers apply to participate and pay fees based on the amount of deposits guaranteed, growth in deposits and deposit taker rating.

Prior to discussing the implication of these and other measures on New Zealand's fiscal position, I wish to provide some background information. Following a prolonged period of fiscal deficits, New Zealand achieved surpluses in the 1993/94 year through until the 2007/08 financial year. During this period core Crown operating expenses have been reduced as a percentage of GDP from over 40% in 1992/93 to 31.7% in 2007/08. The 2007/08 operating balance was a surplus of $2.384 billion. For the year ending May 2009 the operating balance was $7.16 billion and forecasts for the 2009/10, 2010/11, 2011/12 and 2012/13 are for deficits of $5.729 billion, $7.111 billion, $7.115 billion and $5.773 billion respectively.

This significant turnaround from operating surpluses to deficits will increase the need for government borrowing. Prior to 1985, successive governments had borrowed under a fixed exchange rate regime to finance the balance of payments deficits. Since the adoption of a freely floating exchange rate, governments have undertaken new external borrowing only to rebuild the nation's external reserves and meet refinancing needs.

The new government has recently released a new set of fiscal objectives contained within the 2009 Fiscal Strategy Report (FSR). The FSR sets the wider context around Budget 2009. The FSR shows how the Government will balance the tasks of steering the economy through the recession, positioning New Zealand for recovery, delivering on our priorities and commitments and over time delivering a prudent fiscal position. The main decisions reported in this FSR are to:

- Re-specify the long-term debt objective in "net debt" terms, consistent with our intention to take a wider view of the Crown balance sheet. Gross debt will remain as a fiscal indicator.
- Reformulate the long-term debt objective to recognise that in the current economic crisis it is appropriate to have a temporary lift in net debt to buffer the economy. However, the revised net debt objective will ensure that we begin to rebuild net worth to provide a buffer for future economic shocks and the consequences of demographic change.
- Reduce the future operating allowances to a maximum of $1.1 billion from Budget 2010.
- Delay the second and third tranches of the planned tax cuts in 2010 and 2011 until economic and fiscal conditions allow reconsideration.
- Suspend required contributions to the New Zealand Superannuation Fund (NZS Fund) for the period until the operating balance returns to a sufficient surplus.
- Make a contribution to the NZS Fund of $250 million in 2009/10. This will assist in focusing investments towards New Zealand-based investments and is consistent with the Government's policy of having the Fund invest 40% of its assets within New Zealand.

- Consider on an annual basis whether to make any further contributions to the NZ Superannuation Fund, before the required rates of contribution are resumed.

2. Capital Markets Performance, Trends and Projections

a. Government Bond Market

The return to fiscal deficits has necessitated an increase in government debt issuance by The Treasury's New Zealand Debt Management Office (DMO). The previous period of sustained surpluses reduced gross sovereign issued debt to GDP to around 17% as at June 2008.

Forecast gross bond issuance is projected to be in excess of $50 billion over the next four years. This issuance will add a significant amount of depth to what has been a relatively illiquid market where there has been reluctance by market participants to `price make' and resulting lack of investor appetite to enter and exit the market. Outstanding bonds will increase from $23 billion to $57 billion over this period.

As a result gross sovereign-issued debt is forecast to increase to around 39% of GDP by June 2013, a level that remains relatively low by global standards.

Recently the DMO has taken a number of steps to improve liquidity and promote participation in the bond market. These steps include:

i) The establishment of a Bond Market Working Group chaired by the NZ Financial Markets Association with participation from the DMO and market participants. The objective of this group is primarily to explore ideas designed to improve market participation and liquidity.
ii) The establishment of a new benchmark`long bond'.
iii) The establishment of tap and reverse tap tenders.
iv) Offering larger tenders.

b. The Kauri Bond Market

The Kauri bond market first appeared as a feature of the New Zealand Capital Markets in 2004. The market has grown rapidly in recent times partially due to the Reserve Bank's decision to accept AAA rated Kauri bonds as security in its operations. A Kauri bond is a New Zealand dollar denominated security, registered in New Zealand and issued by a foreign issuer. Settlement takes place in New Zealand initially after which the security can be held in other depositories around the world. Issuers occasionally are funding New Zealand dollar positions but are more likely to be funding programmes in Euro or US dollars.

This market has become popular with issuers and borrowers alike who previously issued/invested in New Zealand dollar instruments via the Euro-kiwi and to a lesser extent, Uridashi markets. Similar markets have developed in Australia (Kangaroo), Canada (Maple), and the USA (Yankee), to name a few. A sharp spike in issuance occurred following the Reserve Bank's announcement in July 2007 to accept AAA rated Kauri bonds as security in domestic operations. Just less than 5 billion was issued by AAA issuers during the remainder of that year and 1.86 billion issued in 2008.

c. Other Debt Capital Markets

The current Debt Capital Markets environment continues to see Credit re-priced across all asset classes. The difficult conditions that have existed in the global credit markets have highlighted the need for liquidity and diversified sources of funding. While many other markets went through a lengthy period of operating in a `dysfunctional' manner, the NZ domestic retail investor market remains a viable source of funding for good quality Credits.

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Repeated collapses of finance companies last year refocused investors' minds on the need to balance high-yielding high-risk investments with lower yielding higher rated senior debt instruments. Continued investor dissatisfaction with the performance of managed funds and the equity markets has resulted in a strong trend towards senior fixed income investments. A decreasing number of players in the wholesale institutional markets has seen issuers turn to the retail investor market for liquidity reasons.

The Retail Government Guarantee Scheme implemented late last year has distorted issuance as those with the benefit of the guarantee look to exploit the opportunity before it expires in October 2010 and those without the guarantee issue longer dated paper. As a result retail issuance has grown from 26% of total issuance in 2007 to 56% of total issuance so far in 2009.

In terms of market developments, the Government is working with local body representatives to investigate the feasibility of setting up a `bond bank' to help councils finance up to $35 billion of planning infrastructure over the next decade. The establishment of the so-called bond bank to reduce councils' cost of borrowing was one of the initiatives that came out of the Government initiated `Jobs Summit' designed to enhance employment growth in a recessionary environment. A study will look at whether combining councils' borrowing needs would result in lower interest rates and transaction costs, this arrangement being common overseas. The study will also investigate options for how such an organisation could be run. A joint Government and Local Government New Zealand steering group set up to look at the proposal expects to receive the study around mid August. Decisions about whether such a vehicle is feasible, and if so, how it will operate is yet to follow.

Another key market development has been the extension of the retail deposit guarantee scheme. During August 2009, the Finance Minister announced the extension of the scheme out to 31st of December 2011 from 12 October 2010 previously. All entities will need to reapply when the current scheme expires. For an institution to obtain entry to the scheme, they will require a minimum credit rating of BB. A large proportion of those entities covered under the current scheme fall short of this criteria and it is questionable whether many will even be able to meet this new criteria by October next year. The other major change was that the guarantee level will be reduced from the current $1 million to $0.5 million for bank deposits and $0.25 million for eligible non-bank deposits per institution. This latter condition could limit the availability of a number of institutions to maintain current funding levels. In addition, Collective Investment Schemes (cash funds etc) will not be eligible under the new scheme. The government has also released a new fee structure for the scheme with the cost going up for all participants with the biggest increase being applied to the lower end of the investment spectrum.

In terms of pricing, weighted average yields for both Local Authority and Corporate issuance peaked late 2008 and early 2009. Yields have continued to trend downwards in recent months with the general increased confidence in the credit markets. Bank funding has improved significantly from a peak in June 2009 with yields across the funding curve falling. Short term bank funding is now being archived at 40 basis points over swap with longer term five year funding being achieved at 130 basis points over.

Capital Markets Development Taskforce

In response to `Global Credit Crisis' and Global Recession, the government initiated the establishment of a Capital Market Development Taskforce with the aim to develop and launch a blueprint to improve New Zealand's financial system for the benefit of the New Zealand economy and its businesses.

The objectives of the taskforce will be to identify key constraints and opportunities for development of NZ's financial system; to identify and debate options to improve the performance of New Zealand's financial system and to develop a blueprint for the development of New Zealand's financial system.

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This task force has been operating for just over twelve months and is due to present its blueprint and action plan at an industry event prior to year end.

3. Major Market and Regulatory Developments and Prospects for the Securities Industry

a. Regulatory Developments

The regulatory environment has seen significant change over the previous twelve month with the introduction of three pieces of legislation that impact on the New Zealand Securities Industry. Specifically these pieces of legislation are:

- The Financial Service Providers (Registration and Dispute Resolution) Act 2008 (FSPA).
- The Financial Advisers Act 2008 (FAA).
- The Reserve Bank of New Zealand Amendment Act 2008.

The most significant piece of legislation is the FAA. This Act affects any adviser who provides advice resulting in an individual making an investment decision. The Act is intended to capture advisers operating in both the retail and wholesale markets. The Act differentiates between complex and simpler products and requires that advisers providing advice in complex products are registered with the Securities Commission. Those individuals providing advice on simpler products are not required to be individually authorized by the Securities Commission but will need to be registered. Key components of the FAA are as follows:

- Disclosure – A requirement to provide a detailed set of disclosures at the time the advice is provided.
- Competence – Competence standards will be enforced for each class of advisers so as to prove both competence and knowledge. These requirements will need to be approved by a `Code Committee' and registered with the NZ Qualifications Authority.
- Be registered as a member of an approved Dispute Resolution Scheme or adopt the default scheme.

This legislation is viewed as being largely overdue. Its implementation is widely supported, however practical implementation of the FAA is the key to its success. Both the Ministry of Economic Development and the Securities Commission is consulting widely with the industry regarding its implementation.

The FSPA provides detailed components of the Dispute Resolution process. Because the function sits within another Ministry, the Ministry of Commerce, it is captured under a separate piece of legislation.

The Reserve Bank of New Zealand Amendment Act 2008 has seen significant changes to the regulatory authority of the central bank in response to the changing financial markets landscape in NZ. A key component of the amendment will be for deposit takers to obtain and maintain a credit rating from an approved Agency by 1 March 2010. Deposit takers will also have to comply with a range of other governance requirements including having a minimum of two independent directors, minimum capital requirements, capital ratio requirements, restrictions on related party exposures and liquidity requirements. Details surrounding these requirements will be contained within legislation to be passed at a future date yet to be confirmed.

On a final note, I have not provided a commentary on the NZ Equity Markets, which is an important component of the New Zealand Capital Markets. The reason being that the New Zealand Financial Markets Association membership base does not encompass equity market participants and as such I am not the best qualified to provide a detailed commentary on this market. Some relevant broad level comments are as follows:

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- The New Zealand domestic equity markets have declined relative to GDP over the last ten years.
- The average size of listed companies has remained constant, while companies in comparative countries have increased in size.
- The value of domestic equity turnover relative to GDP remains the smallest within comparable countries.
- Market liquidity is comparable to other countries but equity transactions per head of population remain relatively low.
- The New Zealand equity market has a much higher dividend yield comparable to other countries and this has grown.

New Zealand due to its geographic isolation, dependence on agriculture and relatively small population continues to provide challenges in terms of domestic equity market growth. Greater liquidity and investment diversity across the Tasman remain an attractive alternative to investors and capital raisers based in New Zealand.

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