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The New Zealand Government should consider reducing its reliance on external funding of its debt and source funding from local retail and institutional investors by issuing inflation-linked bonds, says local investment manager, NZ Funds.

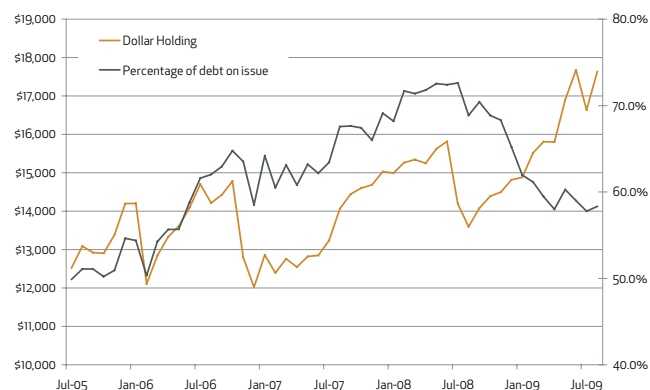
Michael Lang, Chief Investment Officer of NZ Funds says he is asking the NZ Debt Management Office ("NZDMO") to consider issuing more inflation-linked bonds for retail orientated investors and institutions as this would reduce the risks associated with the NZDMO's current reliance on external purchases of New Zealand Government debt.

Lang's call comes at a time when the NZDMO is being confronted with the need to more than double its Government bonds issuance to fund the New Zealand Government's rising fiscal deficit. Over the next three years debt issuance is projected to rise from \$7.5 billion in 2009/10 to \$15.9 billion in 2012/13.

"Recent global financial events show how integrated New Zealand's economy is with the global economy. It is no coincidence that New Zealand's banks were Government Guaranteed at the same time as the banks in the United States and United Kingdom. We are all citizens of a global economy," says Lang.

In order to survive in this environment where nations need to compete for international capital, and preserve domestic capital, Lang says New Zealand needs a vibrant and diversified investment market. "Currently the New Zealand Government predominately issues debt to institutional investors and it needs to diversify its bond buyers. As at August 2009, approximately 58% of our government debt is purchased by foreign investors, of which Japan is rumored to be the largest single buyer. In a crisis this could pose a risk to our future debt funding."

GOVERNMENT SECURITIES HELD FOR NON-RESIDENTS



Source: RBNZ.

Internationally government department offices have been courting the retail investor with inflation-linked bonds. Lang says the reason for this is retail investors are more stable when issues arise, for example in situations where external funders no longer want to buy New Zealand sovereign risk.

Locally, retail investors have significant funds available for investment says Lang. Reserve Bank money supply figures show that the M3 monetary aggregate amounted to \$212.4 billion in August 2009. M3 includes note and coins held by the public, checking account deposits and savings account deposits, time deposits plus New Zealand dollar funding minus inter-M3 institutional claims and minus central government deposits. "These figures highlight the prospect for a more reliable funding source for government debt."

New Zealand has the opportunity as a small developed nation to respond quickly to changes in international financial markets and retail investors' sentiment says Lang. "In fact, I would say it's a necessity for it to respond quickly, just look at the proactive approach taken by the Australian Government in announcing renewed issuance of inflation-linked bonds."

Inflation-linked bonds offer investors protection against inflation because the par value, and therefore interest

payments, on these instruments are adjusted for changes in the consumer price index. This makes them well suited to retail investors says Lang.

In Lang's opinion there are two classes of domestic investors who would benefit from the issuance of inflation-linked bonds. "Firstly, the retail investors who have fled to the security of bank deposits, but in doing so are not protecting themselves from unanticipated inflation, and secondly the significant community trust industry. These trusts have as their primary investment objective a level of return above inflation, but unfortunately as there is a scarcity of inflation-linked bonds, a large number of trusts have sought to generate returns by investing in global shares and commodities with mixed success."

The Australian Government recently launched its first offer of inflation-linked bonds since 2003 and analysts are expecting strong demand from local and international investors. Investors are likely to include both retail investors and large insurance companies that need to manage their inflation-linked liabilities.

New Zealand inflation-linked bonds were last issued in 1999.

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