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Urgent call for inflation linked bonds

Niko Kloeten

The government risks having to go cap in hand to the IMF unless it considers issuing inflation-linked bonds to diversify its portfolio, an investment industry leader has warned.

This dire scenario has become more of a possibility after the Crown financial accounts released on Wednesday showed government debt has ballooned since the recession began.

The government's operating deficit for the year was a massive \$10.5 billion, thanks to a combination of lower tax revenue, increased government spending and a nearly \$6 billion blow-out in claims liability at ACC.

Finance Minister Bill English said the government needed to borrow \$250 million a week and added that the effect of the recession on the government's accounts would be felt for 20 years.

NZ Funds Management chief investment officer Michael Lang has called on the New Zealand Debt Management Office to issue an inflation-linked bond for retail-oriented investors and institutions.

This, he said, would make government debt a more attractive proposition for local investors as it

would offer them protection in the event of high inflation.

According to Mr Lang, New Zealand's heavy reliance on foreign buyers for its government debt puts it at huge risk if an economic shock were to hit the country.

Reserve Bank figures show that in August 2009 foreign buyers held 58.3% of the total value of government securities (government bonds and treasury bills).

"The government is totally focused on getting as many Japanese to buy its bonds as possible," Mr Lang said.

But there could be a huge problem if an event like a foot and mouth outbreak hit New Zealand and foreign investors (including Japanese housewives) decided to sell their bonds all at once. Due to the relative illiquidity of New Zealand government bonds, this could push bond yields up to 10-15%, ruining local banks, Mr Lang said.

"We have the IMF as a backstop but what a terrible event that would be if New Zealand's government had to go there begging for help."

The inflation-indexed bonds were and last issued in 1999. While the government no longer issues these bonds they can still be on-sold by those who hold bonds that haven't matured yet.

A New Zealand inflation-indexed bond expiring in

2016 yields 3.285% today while a New Zealand normal bond expiring in 2017 yields 5.540%, indicating the "break-even" point is inflation of 2.55%.

Mr Lang said the government was reluctant to issue inflation-linked bonds because it was concerned about high inflation projections for the next few years.

But he said the reduction of sovereign risk would be well worth the higher cost.

nkloeten@mbr.co.nz