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When yields go up, move down under
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Tough fiscal and monetary policies have helped balance New Zealand's budget and enhance the rating of its bonds, which are the fifth best performing in the world this year. Given the turbulence elsewhere, investors will soon be casting a glance down under, suggests Tim Blue.

In the aftermath of the international bond martket's meltdown, investors could do worse than to look at New Zealand where fixed-interest instruments have been performing particularly well of late. In the two months from the beginning of May, the yield on new Zealand 10-year government bonds rose from 7.61% to 8.15%, a comparatively low negative return of 11.5% which, because of turbulence elsewhere, elevated the bonds into fifth position worldwide.

In the same period, the New Zealand dollar appreciated from 56.42 to 57.10 in its trade-weighted index, representing an annual gain of 7% - "probably the best currency performance in the world," says Brian McTaggart, a principal and fixed-interest manager with investment bankers Buttle Wilson in Auckland. Against the US dollar, the story is even better. Many US investors have unhedged currency positions on those asset holdings, and have picked up substantial currency gains," says McTaggart.

With real returns of 6.75% on long bonds, foreign investors have been doing rather well in New Zealand. They have poured nearly NZ$10 billion ($5.9 billion) into financial securities in the past two years, and now hold an estimated 30% of New Zealand's bond market, and about 45% of short-term treasury bills. And this flow shows no signs of abating – direct net investment inflow in the year to the end of March reached NZ$4.7 billion, more than twice the levels of the previous 12 months.

The capital inflows are the fruits of 10 years of rough fiscal policies – which in June produced the country's first genuine budget surplus in 25 years – combined with firm central banking from New Zealand Reserve Bank governor Don Brash.

Investors will be heartened by Brash's independence, which was evident within a few days of the June 30 budget. In an appearance before a preliminary finance and expenditures select committee, he declined to endorse tax cuts with had been proposed by the ruling National Party. Brash neither approved nor disapproved, saying he could not make sensible comments about cuts when nobody could know the state of the economy in three years.

"Any change in fiscal policy which has an implication for the inflation rate, prompts some kind of monetary policy reaction," he told *Euromoney*. "We cannot foreshadow our response now when any cuts are still more than two years away."

The budgetary situation is also encouraging. Booming government revenues, helped by the working out of corporate tax losses, enabled the finance minister, Bill Birch, to present a budget surplus of NZ$527 in 1993-94, and project a surplus the year after of NZ$730 million about 1% of GDP. Moreover, most private-sector economists found the budget credible and even conservative. According to Bank of New Zealand chief economist Donal Curtin, it represented "a realistic view of the outlook for the economy."

All this is having a knock-on political effect. Strong growth and the prospect of tax cuts drew a 57% approval rating in the first poll after the budget, and bolstered ratings for the National Party government, which has a narrow two-seat majority – by four points to 36%. Labour was steady at 29%, while the left-leaning Alliance drifted three points to 24%. Approval for the Prime Minister, Mr Jim Bolger, however, was down 1% to 13%, well behind the 26% approval rating for the Alliance Party leader, Mr Jim Anderton.

Tackling public debt

Asked what the government should do with its budget surplus, the first preference of 62% of New Zealanders was for the government to "get on with the job of getting the debt down." At NZ$35.6 billion, public debt is still 42.1% of GDP, albeit well down on a peak of 51% of GDP in early 1992. According to Graeme Wheeler, treasurer of the New Zealand Debt Management Office (DMO) which administers the country's hefty net public debt: "There is common agreement to cut the government's debt burden."

The government has adopted a policy of fiscal rectitude and a new Fiscal Responsibility Act became law only a few days before the budget. The legislation obliges the government to spell out its fiscal intentions over the next three years as well as its long-term fiscal objectives, but it stops short of demanding hard number targets.

Public debt is projected to fall to NZ$35.3 billion in 1994-95, NZ$32.7 billion in 1995-96 and NZ$28.1 billion in 1996-97. Relative to GDP, the debt will fall from 39.6% in 1994-95, to 35.1% in June 1996 and 28.7% in June 1997. The prime target will be the gross debt of NZ$17 billion in foreign currencies. Gross domestic currency debt stands at NZ$29 billion.

The DMO was formed by the Treasury in 1987 to administer New Zealand's foreign and domestic debt and to limit interest and exchange-rate risk. It appears to be doing its job well. Market sources estimate that in the past year the office has saved the country about 20 to 30 basis points on borrowings – or as much as NZ$100 million, a figure the DMO will neither confirm nor deny. Its management task has been bolstered by a government intent on polishing its balance sheet, helped by booming revenues, no signs of slackening growth and no ballooning imports.

A total of NZ$46.4 billion worth of debt is administered by the DMO, in what Wheeler describes as a conservative style. Traders are able to take some views within approved position loss limits. The DMO is also New Zealand's largest trader in foreign currencies. "We have what we regard as a low risk portfolio configuration, measured against a benchmark portfolio, weighted 50% against the US dollar, 25% yen and 25% European currencies," says its head of portfolio management, Alex Jurshevski.

Jurshevski oversees five business units in the trading room – cash management, foreign exchange, medium-term funding, domestic funding and liquidity management – the performance of each of which is measured against a relevant benchmark. Liquidity management amounts to a money market operation in six offshore currencies, in a style similar to a large commercial bank, and duration benchmarks in each currency basket are measured against JP Morgan bond indices. Some market participants suggest the introduction of a tender panel might help the DMO's sales efforts. Wheeler says though that while the issue has been explored, it is not under active consideration.

The bright outlook on debt is mirrored by economic growth prospects. The latest March quarter economic growth figure of 1.5% took the 12-month figure to 5.3% - up in the top ranks of OECD growth performance. And across the Tasman Sea, is also picking up in its biggest trading partner, Australia.

Moving to a budget surplus appears to pose no threat to this growth. :The Keynesian view that a budget surplus will slow the economy so far has not eventuated in New Zealand," says merchant bank Buttle Wilson director John Zohrab. "The Repatriation of overseas debt at worst has had a pretty transient and small effect on domestic interest rates."

Since 1987, the government has used the proceeds of privatization mainly to retire foreigh currency debt, which amounts to NZ$11 billion. About NZ$3 billion of foreign currency debt was dispatched in the past year. Receipts from the introduction of a one-year treasury bill also helped, so that domestic overfunding at a projected NZ$2 billion deficit became a NZ$527 million surplus.

Overfunding maintains foreign investor interest in New Zealand, while guaranteeing liquidity in the domestic market and instilling confidence in the ratings agencies through lower foreign exchange risk. The government cannot effectively hedge its NZ$17 billion foreign-currency debt, hence its policy of reducing its foreign currency exposure by retiring the debt through asset sales or by overfunding.

NZ Post and NZ Electricity are obvious candidates for future privatizations but lately the government has gone quiet on further asset sales. Analysts say this is because of domestic political sensitivities, but according to finance minister Bill Birch: "We simply don't need to sell off more."

New Zealand's debt reduction programme has so far won some approval from the rating agencies. Since the budget, Standard & Poor's has maintained New Zealand's AA rating on long-term debt, but changed the rating outlook to positive from stable. It notes that "evidence of broadening political support for the current fiscal strategy could lead to an upgrade as the next election, due by November 1996 approaches."

This follows an uncertain decade for the Republic's debt rating. From triple A in 1981, New Zealand fell to double-A, under the influence of a sharp recession, large fiscal and current account deficits and 11% plus unemployment. Standard & Poor's then declared a double-downgrade in late 1991, which would have taken New Zealand to A+. Only a flying visit to present new evidence and discuss policy settings by the then finance minister Ruth Richardson, Wheeler and others, persuaded the agency to revise to AA minus. Moody's also downgraded New Zealand, and now assigns it Aaa after an upgrade earlier this year.

But whatever the views of the ratings agencies, the market has spoken. The DMO completed a US$1 billion floating rate note issue in February, an action probably not possible a few years ago, says Jurshevski. “In January 1993 we could have done a FRN issue of up to US$500 million at Libor plus 20 points, in a marker which saw about US$45 billion raised in FRNs in the Euromarkets. When we did our transaction in January this year, the price was Libor minus 7.5 points, a narrowing of 28 basis points and a sign that investors accept that NZ credit is improving. At the time, the rate was slightly better than that achieved by the more highly-rated Sweden, and performance during the year has been exemplary,” he says.