THE TREASURY
Kaitohutohu Kaupapa Rawa

Budget Report: 2010/2011 Domestic Debt Programme

Date:	6 May 2010	**Report No:**	BR2010/15

Action Sought

	Action Sought	Deadline
Minister of Finance (Hon Bill English)	**approve** the 2010/11 domestic bond programme of up to $12.5 billion; **approve** an increase in the maximum amount of outstanding treasury bills from $12 billion to $15 billion; **sign and date** the attached warrant giving effect to that increase; **approve** the briefing of Rating Agencies on the contents of the Budget on the morning of Budget day.	10 May 2010

Contact for Telephone Discussion (if required)

Name	Position	Telephone		1st Contact
Philip Combes	Deputy Secretary, Financial Operations and Head of NZDMO	***[Deleted – privacy]***	***[Deleted – privacy]***	✓
Andrew Turner	Head of Portfolio Management	***[Deleted – privacy]***	***[Deleted – privacy]***	

Minister of Finance's Office Actions (if required)

If the Minister of Finance agrees to the increase in the amount of treasury bills that can be outstanding ensure the attached warrant is signed, witnessed and dated and returned to Treasury Legal.

Enclosure: ***[Not relevant to release]***

6 May 2010 DE-3-1-8

Budget Report: 2010/2011 Domestic Debt Programme

Executive Summary

The New Zealand Debt Management Office (NZDMO) seeks your approval for a 2010/11 domestic bond programme of up to $12.5 billion. Up to ***[Deleted – to avoid prejudice or disadvantage in negotiations and commercial activities]*** of this may be raised through issuance of inflation-indexed bonds (IIBs).

Total bond issuance over the forecast period to 2013/14 is $51.5 billion, a reduction of $2 billion on total issuance forecast at the Half-Year Update. Average bond issuance remains at approximately $240 million a week over the period 2009/10 to 2012/13.

We also seek your approval for an increase in the maximum amount of treasury bills that can be outstanding from $12 billion to $15 billion. This provides flexibility to meet increased market demand or short-term funding requirements by increasing weekly issuance or changing the mix of maturities offered. Outstandings may be significantly higher than the $10 billion included in Budget forecasts, which is based on current weekly average issuance.

Although market feedback suggests that liquidity in the New Zealand Government bond market is improving, the cost of buying and selling our bonds remains of concern for investors. Given this, we are considering further measures to support market liquidity including participating directly in the secondary market, providing the option for bond switches and offering longer-term bond repurchase agreements.

The NZDMO will continue to undertake a range of marketing activities next year. ***[Deleted – under active consideration]***. In particular, they can be used to reinforce and reassure investors of the differences between New Zealand and those sovereigns currently experiencing significant fiscal difficulties. The timing of these visits will also provide the opportunity to reinforce the marketing activity associated with the launch of the proposed syndicated IIB.

In line with recent practice, we seek your approval to brief S&P, Moody’s and Fitch on the Budget highlights on the morning of 20 May. All three agencies are scheduled to visit New Zealand for their annual rating reviews in the three weeks following the Budget.

We will provide NZDMO’s draft media statement on the 2010/11 Domestic Debt programme to your staff prior to the Budget.

Recommended Action

We recommend that you:

a. **approve** the 2010/11 domestic bond programme of up to $12.5 billion;

agree/disagree

b. **note** that the 2010/11 bond programme may include issuance of up to ***[Deleted – to avoid prejudice or disadvantage in negotiations and commercial activities]*** of inflation-indexed bonds;

c. **note** the forecast bond programmes of:

	2009/10	***2010/11***	***2011/12***	***2012/13***	***2013/14***
$ billion	12.5	12.5	10.5	10.0	6.0

d. **note** that we will seek your approval for the introduction of a new nominal bond in the 2010/11 fiscal year**;**

e. **approve** an increase in the maximum amount of outstanding treasury bills from $12 billion to $15 billion;

agree/disagree

f. **sign** the enclosed warrant of appointment of borrowing agents to give effect to that increase;

g. **note** that we are investigating introducing additional market support measures to improve bond market liquidity;

h. **approve** the briefing of rating agencies on the highlights of the Budget on the morning of Budget day;

agree/disagree

i. **note** that we will provide NZDMO's draft media statement on the 2010/11 Domestic Debt programme to your staff prior to the Budget.

Philip Combes
Deputy Secretary, Financial Operations and Head of NZDMO
for Secretary to the Treasury

Hon Bill English
Minister of Finance

Budget Report: 2010/2011 Domestic Debt Programme

Purpose of Report

1. In this report we seek your approval for a 2010/11 domestic bond programme of up to $12.5 billion. Of this, up to ***[Deleted – to avoid prejudice or disadvantage in negotiations and commercial activities]*** may be raised through issuance of inflation-indexed bonds (IIBs). Updates to forecast bond programmes out to 2013/14 are provided.

2. The report also:
   - outlines our intention to introduce a new nominal bond in 2010/11;
   - seeks an increase in the amount of treasury bills that can be outstanding; and
   - summarises further measures we are considering to improve bond market liquidity.

2010/11 Domestic Bond Programme and Borrowing over the Forecast Horizon

3. We recommend a 2010/11 bond programme of $12.5 billion. As Table 1 shows, this is the same size as the current 2009/10 gross borrowing programme, but, with no maturity occurring, produces the largest forecast net bond issuance.

Table 1: Forecast Bond Programmes, Bond Maturities and Net Bond Issuance

$ billion	***2009/10***	***2010/11***	***2011/12***	***2012/13***	***2013/14***	***Cumulative***
Bond Programme						
2010 Budget	**12.5**	**12.5**	**10.5**	**10.0**	**6.0**	**51.5**
2009 Half-Year Update	10.5	10.5	12.5	12.5	7.5	53.5
Bond Maturities						
2010 Budget	**4.2**	**-**	**8.0**	**8.0**	**-**	**20.2**
2009 Half-Year Update	4.2	-	8.0	8.0	-	20.2
Net Bond Issuance						
2010 Budget	**8.3**	**12.5**	**2.5**	**2.0**	**6.0**	**31.3**
2009 Half-Year Update	6.3	10.5	4.5	4.5	7.5	33.3

4. Smaller gross borrowing programmes are forecast for each of the years beyond 2010/11. Total bond issuance over the five years to 2013/14 is $51.5 billion, a reduction of $2.0 billion on total issuance forecast at the Half-Year Update. This primarily reflects improvements in the fiscal position.

5. Average bond issuance is approximately $240 million a week over the period 2009/10 to 2012/13 and remains the same as the average weekly issuance estimate based on forecasts in the Half-Year Update. The average weekly issuance for the years 2010/11 to 2013/14 is $200 million.

Issuance of a new inflation-indexed bond

6. You recently agreed to include provision for issuance of a new IIB in the 2010/11 domestic bond programme [T2010/620 refers]. A provision of up to ***[Deleted – to avoid prejudice or disadvantage in negotiations and commercial activities]*** of IIB issuance would allow a combination of:

   - a relatively small volume of issuance via a possible initial "private placement" ***[Deleted – to avoid prejudice or disadvantage in negotiations and commercial activities]***;

   - ***[Deleted – to avoid prejudice or disadvantage in negotiations and commercial activities]*** for a syndicated launch of a new IIB to the market; and

   - post syndication, issuance of IIBs by tender over the remainder of the fiscal year ***[Deleted – to avoid prejudice or disadvantage in negotiations and commercial activities]***.

7. ***[Deleted – to avoid prejudice or disadvantage in negotiations and commercial activities]***.

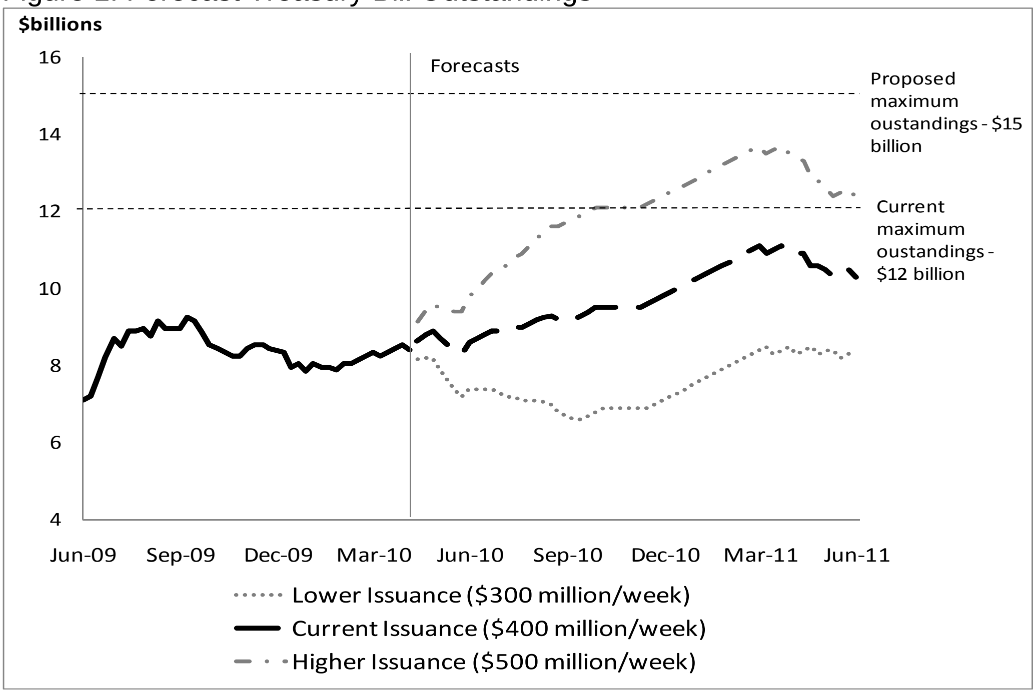
Issuance of a new nominal bond

8. We intend to seek your approval to introduce a new nominal bond during 2010/11, given the sizeable forecast bond programme and upcoming maturity of the November 2011 bond. The maturity of the new bond will depend on feedback from the market and the maturity profile of current debt on issue.

Treasury Bills

9. We seek your approval for an increase in the maximum amount of treasury bills that can be outstanding from $12 billion to $15 billion. This provides flexibility to meet increased market demand or short-term funding requirements by increasing weekly issuance or changing the mix of maturities offered. As Figure 1 illustrates, outstandings may be significantly higher than the $10 billion included in Budget forecasts, which is based on current weekly average issuance.

Figure 1: Forecast Treasury Bill Outstandings



10. Specifically, we expect outstandings to increase for two reasons. First, demand for treasury bills has increased as banks have increased their holdings of short-term, high quality, assets to meet Reserve Bank liquidity requirements. Secondly, in early April, a one-year treasury bill was reintroduced to complement the existing three- and six-month bills. The longer maturity of the new bill will naturally lead to higher outstandings.

11. If you agree to increase the maximum amount of treasury bills that can be outstanding to $15 billion, then you will need to sign the attached borrowing agents' warrant giving effect to that increase and revoking the existing warrant.

Foreign-Currency Issuance

12. Notwithstanding Recommendation 24 of the Capital Market Development Taskforce, ["*Encourage DMO to expand the range of government debt securities on offer, including longer-term debt, inflation-indexed bonds and foreign currency debt,"]* long-term foreign-currency funding remains unattractive on a cost basis compared to raising funds through the domestic bond programme. Similarly, short-term foreign-currency funding, such as European Commercial Paper, is also currently more expensive than domestic treasury bill issuance. We continue to monitor offshore markets for any improvements in relative pricing.

Liquidity and Market Support Measures

13. Feedback from market participants and our own observations suggest liquidity has improved in government securities markets. The cost of buying and selling our bonds, however, remains of concern for investors. Given this, we continue to look at ways we can improve liquidity and support the functioning of the market.

14. We believe that some of the measures briefly outlined in our report on reintroducing an inflation-indexed bond could be used to promote liquidity in the other securities we issue.

Table 2: Proposed Market Support Measures

Measure	***Description and rationale***	***Example of use***
Direct secondary market participation	The NZDMO would buy and sell Government bonds to help match demand and supply.	● When large amounts of bonds are sold back into the market to help prevent bond yields rising until investors can be found.
Bond switch facility	Providing investors a facility to switch between bonds would help promote liquidity in the market and therefore encourage investor participation.	● To move investors from the February 2016 IIB and our nominal bonds into a new IIB. ● Around the maturity of the November 2011 bond, to promote re-investment in other Government bonds.
Repurchase (repo) agreements	Lengthen the term that bonds can be borrowed from overnight to up to a month. Provide access to IIBs via repo.	● Assist banks to manage their portfolios during times of temporary mismatches in market supply and demand. ● To support IIB liquidity.

Marketing Activities

15. The NZDMO continues to undertake a range of marketing activities with banks and at international fora as opportunities arise. ***[Deleted – under active consideration***

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16. These visits will build on momentum from last year's visits, aim to consolidate existing relationships, and inform and capture new investors. In particular, the visits can be used to reinforce and reassure investors of the differences between New Zealand and those sovereigns currently experiencing significant fiscal difficulties. The timing of these visits will also provide the opportunity to reinforce the marketing activity associated with the launch of the proposed syndicated IIB. We will report to you in more detail after the Budget.

Rating Agency Briefings

17. In line with recent practice, we seek your approval to brief S&P, Moody's and Fitch on the Budget highlights on the morning of 20 May. Briefing the agencies enables them to give an informed response to media enquiries, which typically come soon after the end of the lock-up and before the agencies would have had time to digest the published documents.

18. We do not expect any immediate substantive announcement by the agencies. All three agencies are scheduled to visit New Zealand for their annual rating reviews in the three weeks following the Budget.

NZDMO Media Statement

19. As in past years, we plan to announce details of the 2010/11 domestic debt programme with the Budget. We will provide a draft media statement on the programme to your staff prior to Budget day. Market enquiries on the programme are most likely to be directed to NZDMO.