



The Kiwi that had to fly:

Path dependence and evolutionary niches among international finance centres

Why should small countries like Australia, New Zealand and Singapore bat well out of their league in international capital markets? In the case of New Zealand, this has been primarily due to structural features of the economy that project the NZ dollar on capital account well beyond its merits on the trade account, with a smaller contribution from time zone advantages. Derivatives have been an essential part of this story, especially cross currency interest rate swaps, which in turn feed off the popularity of offshore NZ eurodollar and uridashi issues among unrelated parties. NZ debt instruments and equities contribute market completion benefits to the APEC capital market as a whole. Associated funding and risk management demands have generated a body of human capital that could likewise be considered a regional resource.

New Zealand has:

- 4.2 million people, the size of a middle-ranked Chinese city

We also have:

- 40 million sheep
- 5¼ million dairy cows



- But these are not known to trade financial products

Nevertheless...

- We are a very open economy, for all the right reasons
- We are an important financial centre, for all the wrong reasons

Background

NZ is a reasonably complete capital market, even if some sectors are small

Equity market

- NZ Stock Exchange (NZX) capitalised at about NZD\$ 75 billion, 300 listed companies on main board (NZSX), averages \$120 million worth of daily trades
 - NZX also trades equity derivatives, debt (NZDX) , hybrids, smaller equity (NZAX)
 - Fully electronic trading
 - Securities Markets Act 1988 gives it monopoly status.
 - Supervised by NZ Securities Commission
 - NZ companies stylised as high dividend cash cows rather than growth stocks

Generalised private equity more important as source of wealth:

- Mainly real estate, especially houses & farms
- Private equity companies and funds becoming more important, if less so than in US or Europe.

Local debt market

- Short: Treasury bills, 'bank bills' (now actually CD's), commercial bill
- Govt bonds:
 - Most volume in 3yr, 10 yr. No long dated govts.
 - Govt net debt now positive so shortage of debt volume, much is held by institutions
 - Liquidity of futures markets an issuing consideration though most issuance recently around 10 yr.
- Debentures
- Derivatives
 - Exchange-traded via Sydney Futures Exchange, mainly bank bill futures.
 - OTC
 - ❖ Bond options
 - ❖ FRA's
 - ❖ Swaps the biggest

Monetary/banking system

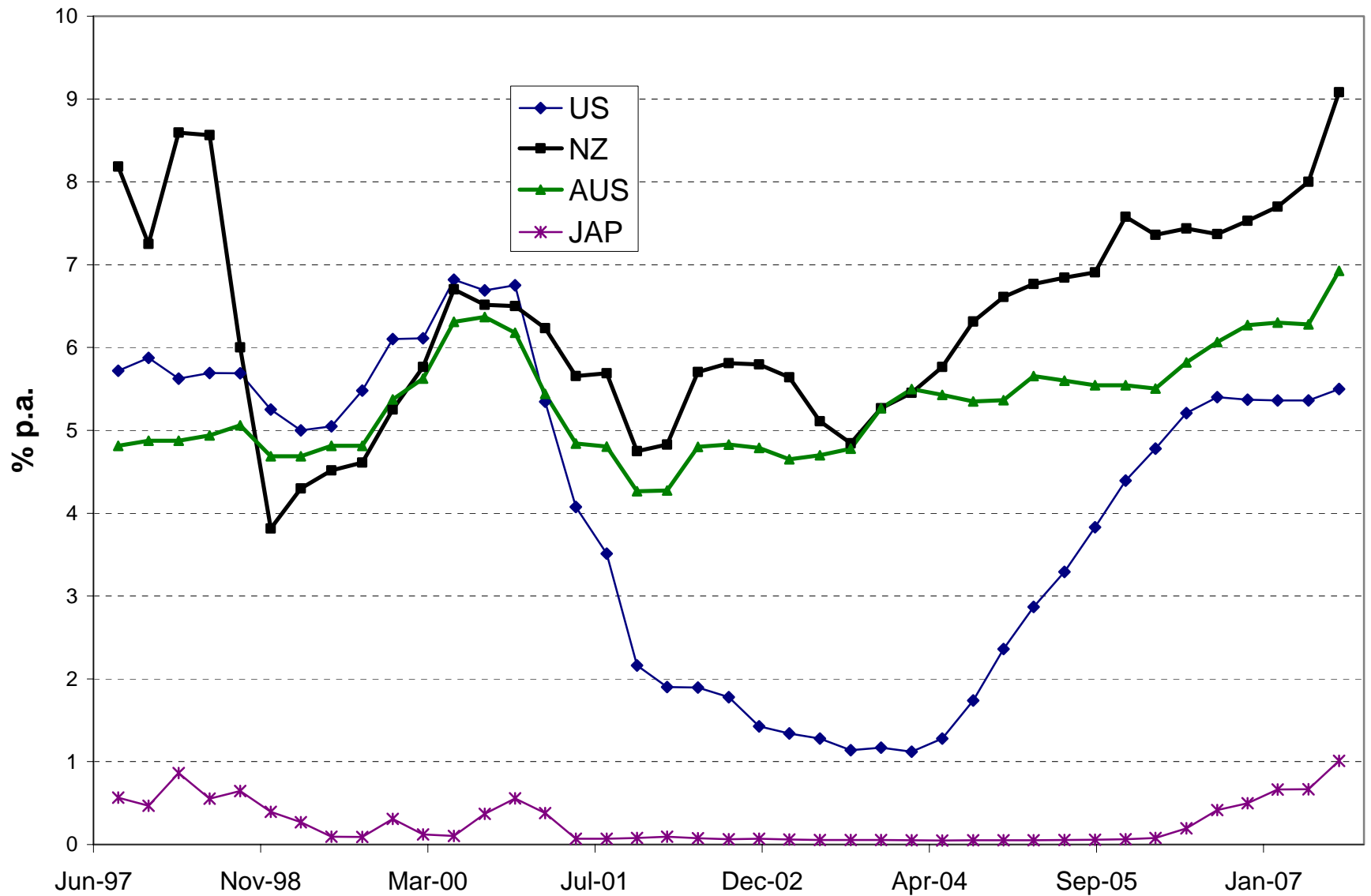
Reserve Bank of New Zealand

- Clearing system
 - No official reserve ratio
 - Official Cash Rate (OCR) is rediscount rate for end of day deficits
 - Acceptable instruments are T- bills and FX swaps
- Supervisory role for banks, soon other financial institutions as well
- Monetary policy

Monetary policy

- Inflation targeting band
- Control instrument is OCR announced normally third Thursday of each month
- No M^* targets. More attention paid to direct economic activity indicators
- Formally independent of Government
 - Bad side is fiscal ~ monetary policy dislocation

The short interest rate consequences

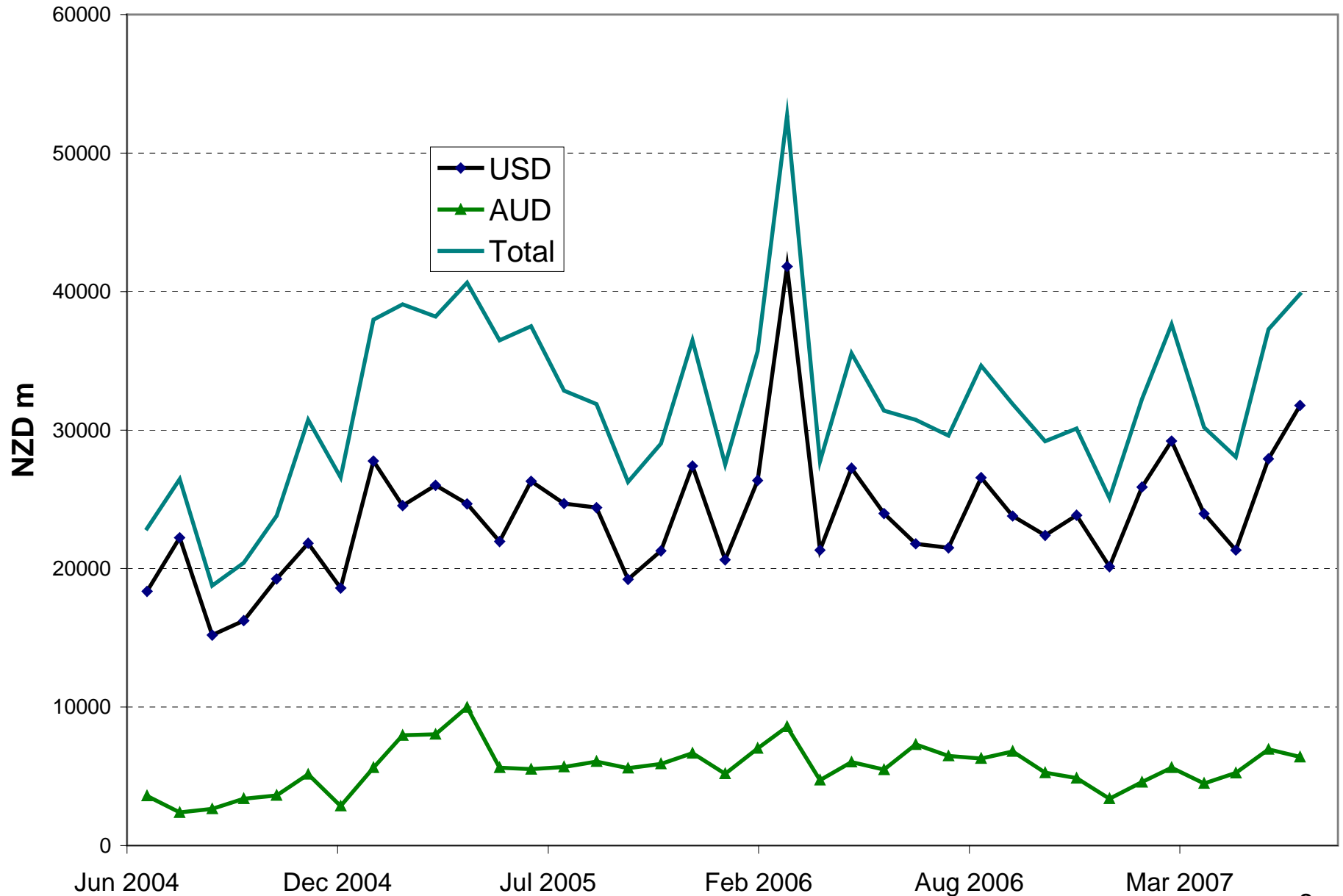


Spot foreign exchange market

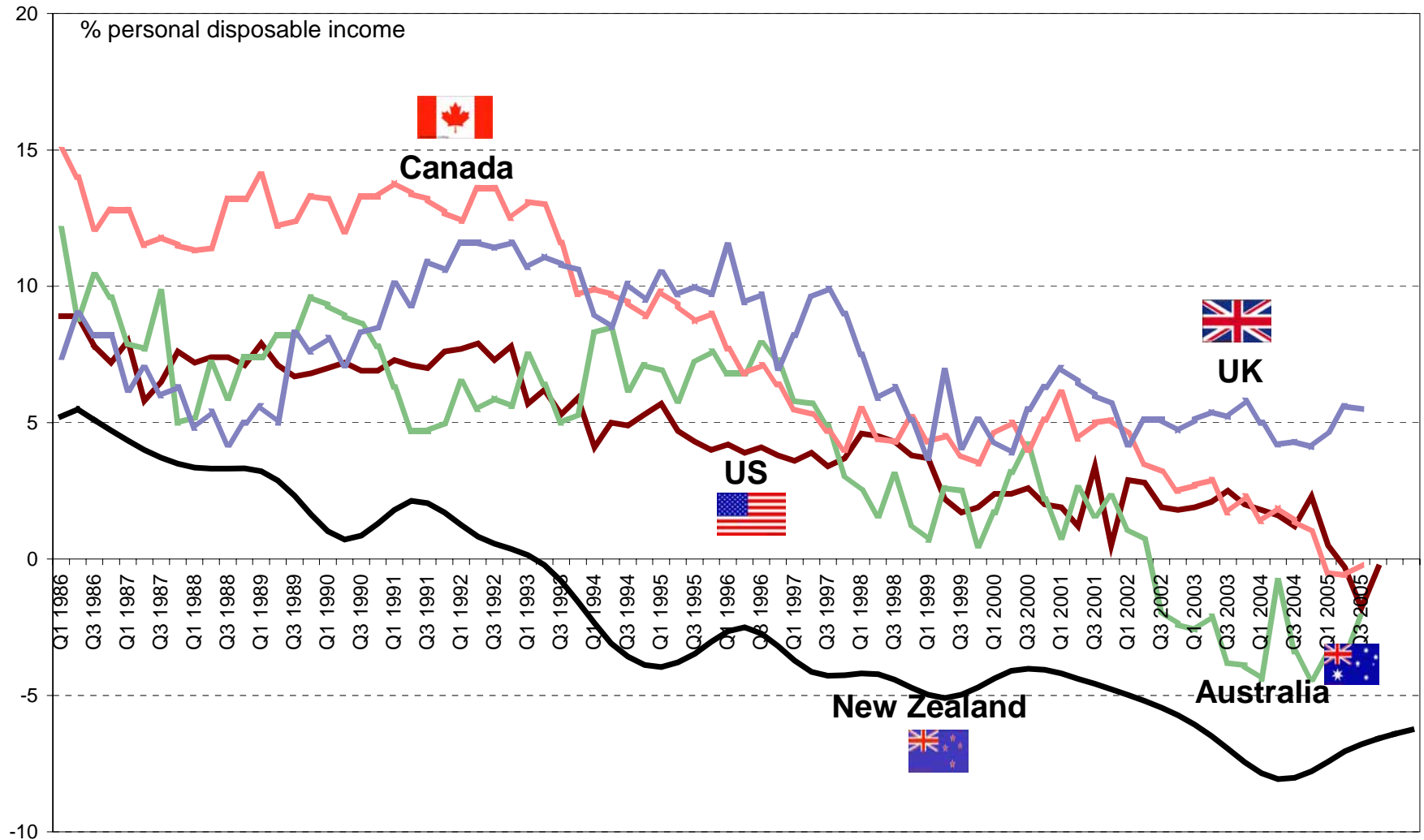
Up until this year, very free system.

- RBNZ intervened in June to try to cap rise of Kiwi.
- Limitations of the OCR as an economic policy instrument generates short term rates persistently higher than rest of world.
- Cash and carry trade very influential in response to this
- Further spot transactions generated by the NZD uridashi and euro markets (q.v.)
- USD major counterparty currency
- Fair volume of third party (non NZD) crosses, especially against USD as terms currency, e.g. JPY/USD.

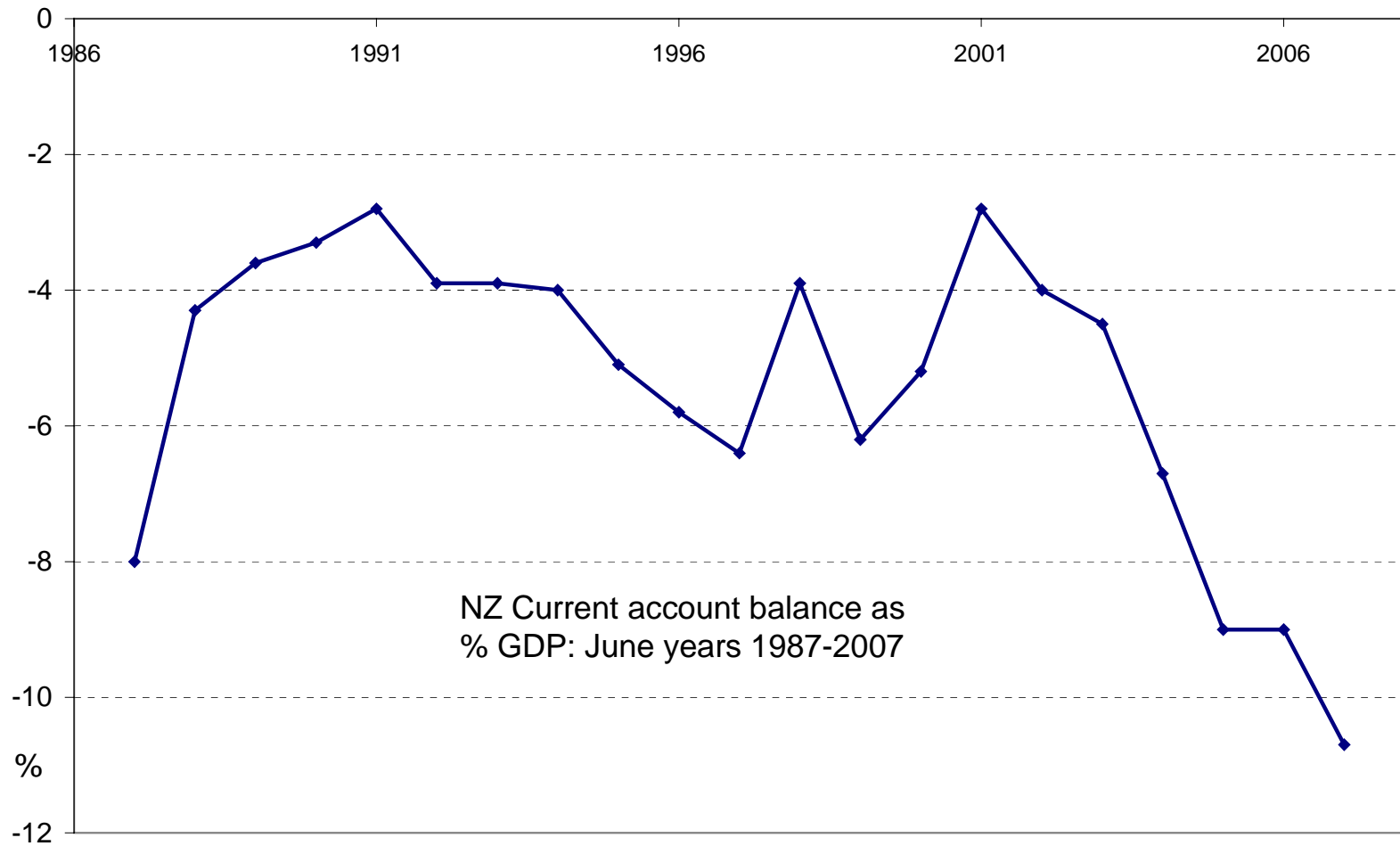
Figure 1a: Monthly spot FX trading volume with NZD as terms or commodity



Macroeconomic imbalance - I



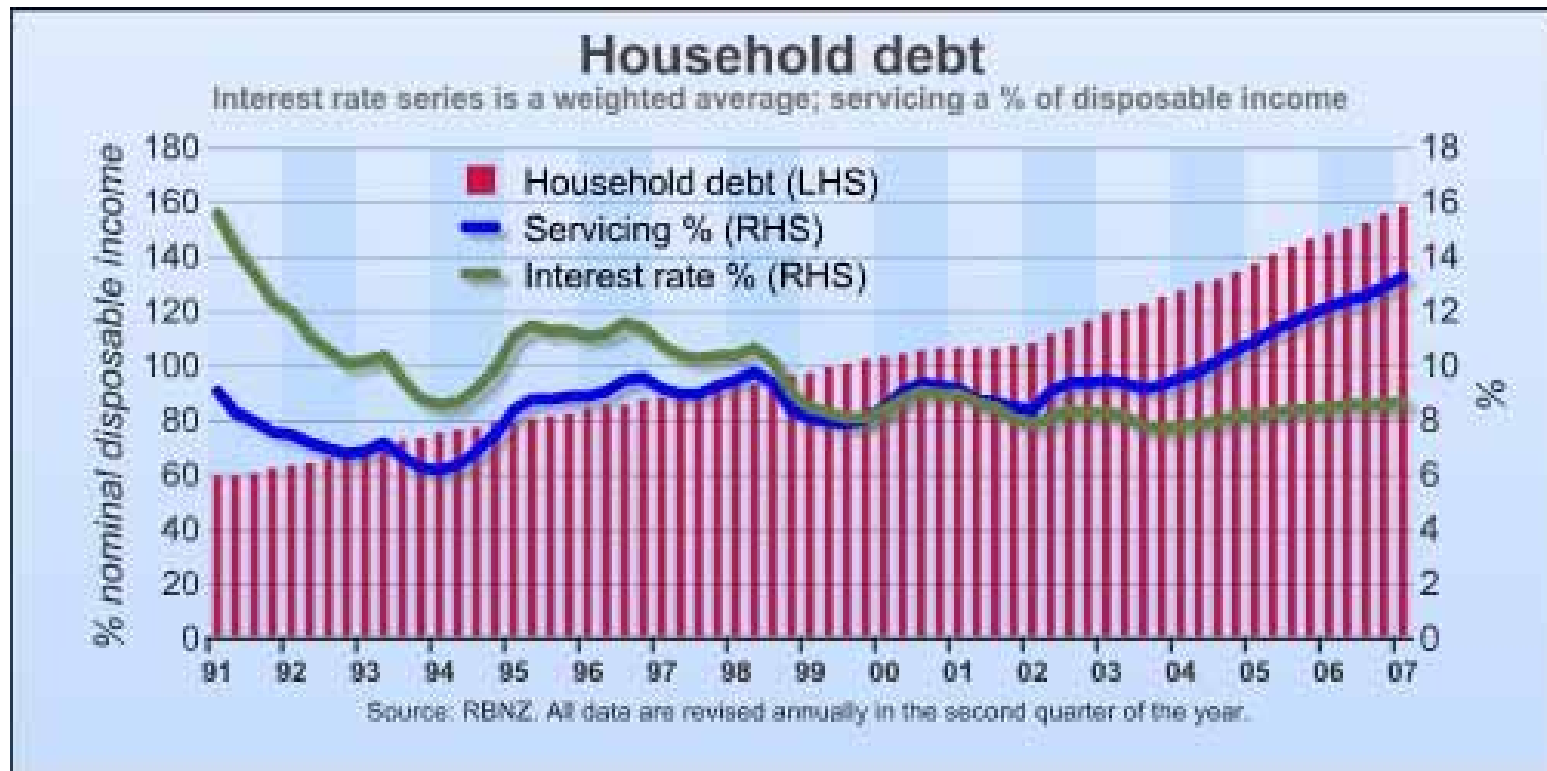
Macroeconomic imbalance - II



Funding the BoP deficit: Uridashis, eurokiwi and the housing market

Much of the accumulated BoP deficits represent liabilities of the banks, which in turn fund the great Kiwi obsession with real estate.

Fundamentally, it is this that puts us on the world map of financial market centres



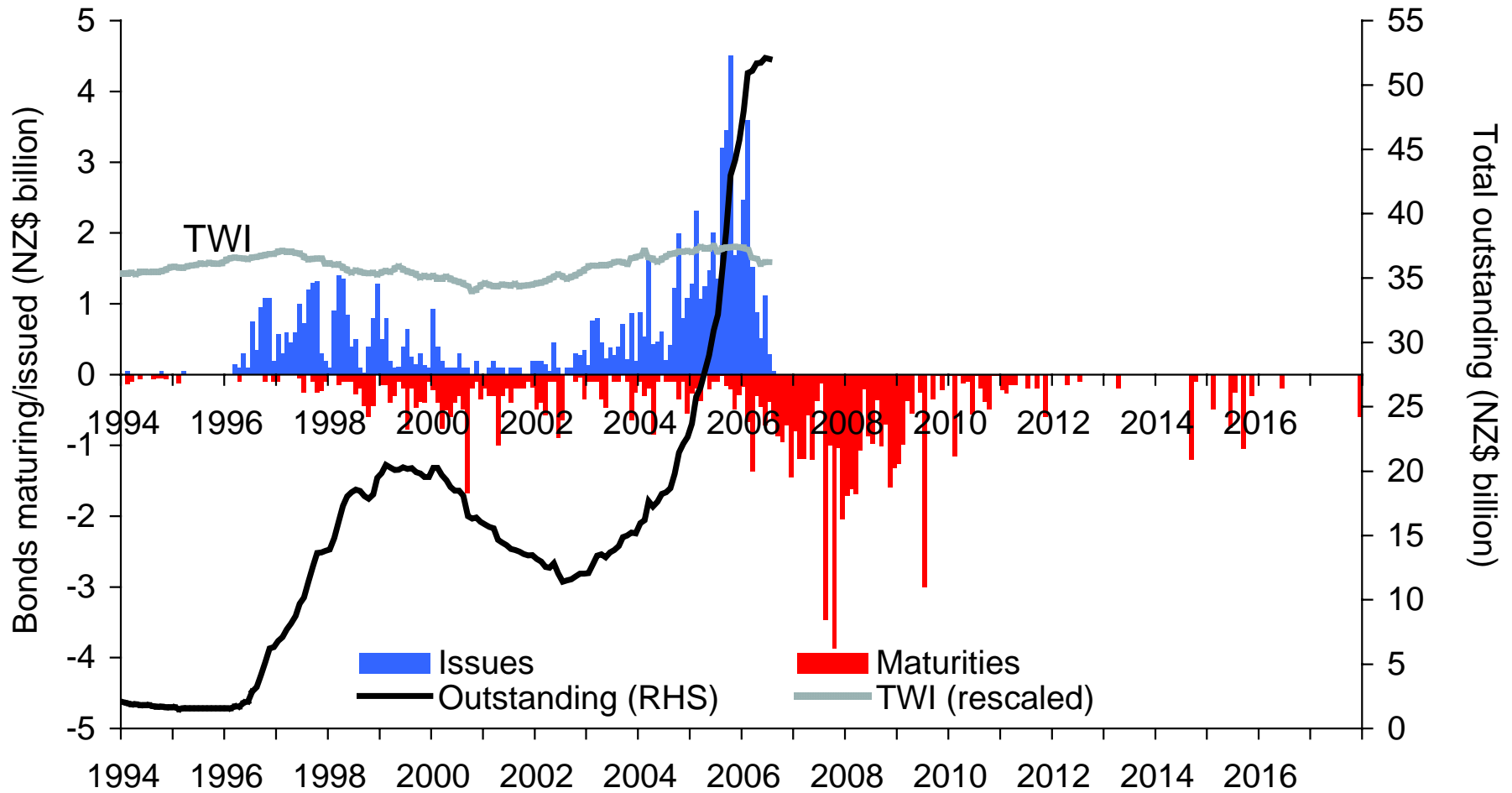
Sequencing

Typical transaction is multipart and involves a cross currency interest rate swap (CIRS)

- Offshore finance house raises NZD loan in Japan
- NZ bank raise USD funds, typically floating rate
- Offshore house and NZ bank do a cross currency interest rate swap, e.g. fixed NZD v floating USD interest rates
- NZ bank receives capital NZD amount and uses it to fund NZ home loans
- NZ bank remits NZD interest payments through to foreign finance house, who use it to pay coupon to 'Japanese housewife' –
- The FFH remits USD interest coupon or floating rate back to NZ bank
- At termination capital amounts reversed at original exchange rate
- Underwriting banks/brokers for uridashi and CIRS are happy too.

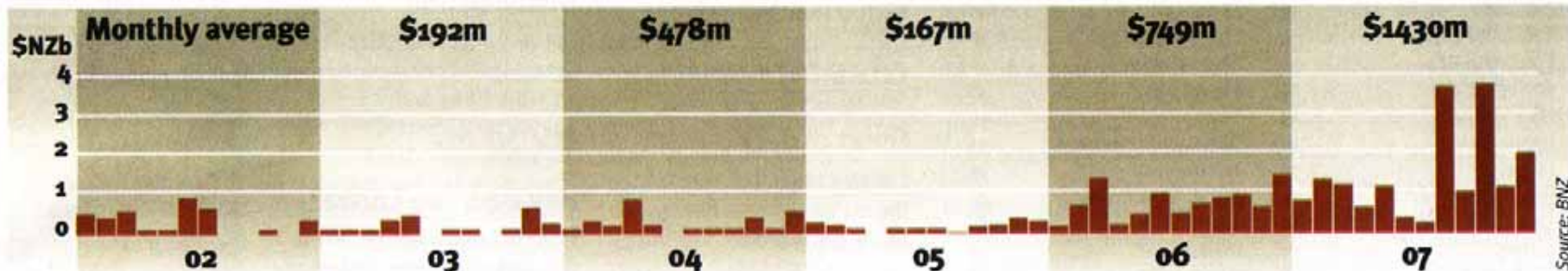
The tide of offshore NZD issuance

Offshore New Zealand dollar denominated bond issuance (Eurokiwi and Uridashi bonds)



EUROKIWI & NZD URIDASHI MATURITIES

(Indicative)



Uridashi tsunami imminent

The risks are high with euro issuance \$5 billion greater than Australia despite an economy six times smaller

Chris Bourke

The scourge of Finance Minister Michael Cullen is about to go on trial. Billions of dollars of uridashi bonds are set to mature over the next few weeks, marking the start of a long, volatile cycle that could see Japanese housewives decide the fate of the fragile New Zealand dollar.

Whether that debt matures or rolls over will test offshore appetite for New Zealand cash, and could add further selling pressure on the dollar over the year ahead.

tens of billions of Kiwi dollars dumped by foreign investors if they favour other countries' rates – or worry that currency risk will offset their gains.

"The way the currency is going, investors are going to be aware of the exchange rate risks around these instruments," Bank of New Zealand senior markets economist Craig Ebert said.

"Thinking of uridashi issuances three to six months ago, someone along the line has lost 10% on the deal. You suspect it's probably the

round of massive bond maturities, next year's is on course to double. And in late 2007, there will be \$2-3.8 billion of uridashi and eurokiwi bonds maturing – per month.

When uridashi bonds are issued in Japan, the issuer must buy New Zealand dollars as cover. Last year saw a record rate of dollar-buying and, as at December, around 67% of all New Zealand government bonds were held by foreigners.

That appeal is thought to be waning in Japan, where investors have been taking advantage of the

being accelerated by the Bank of Japan's decision to change its historically loose monetary policy, paving the way for gradual interest rate rises over the next 12 months. Although Japanese cash rates are still at zero, short-term bond rates have climbed to 1.7%.

Europe is also a concern. Last year's issuance of eurokiwi bonds was \$25 billion, while euro Aussie issuances totalled \$A20 billion. However, while both countries borrowed similar amounts, Australia's economy is around six times bigger than

Figure 8: Generalised currency swaps with NZD as one leg

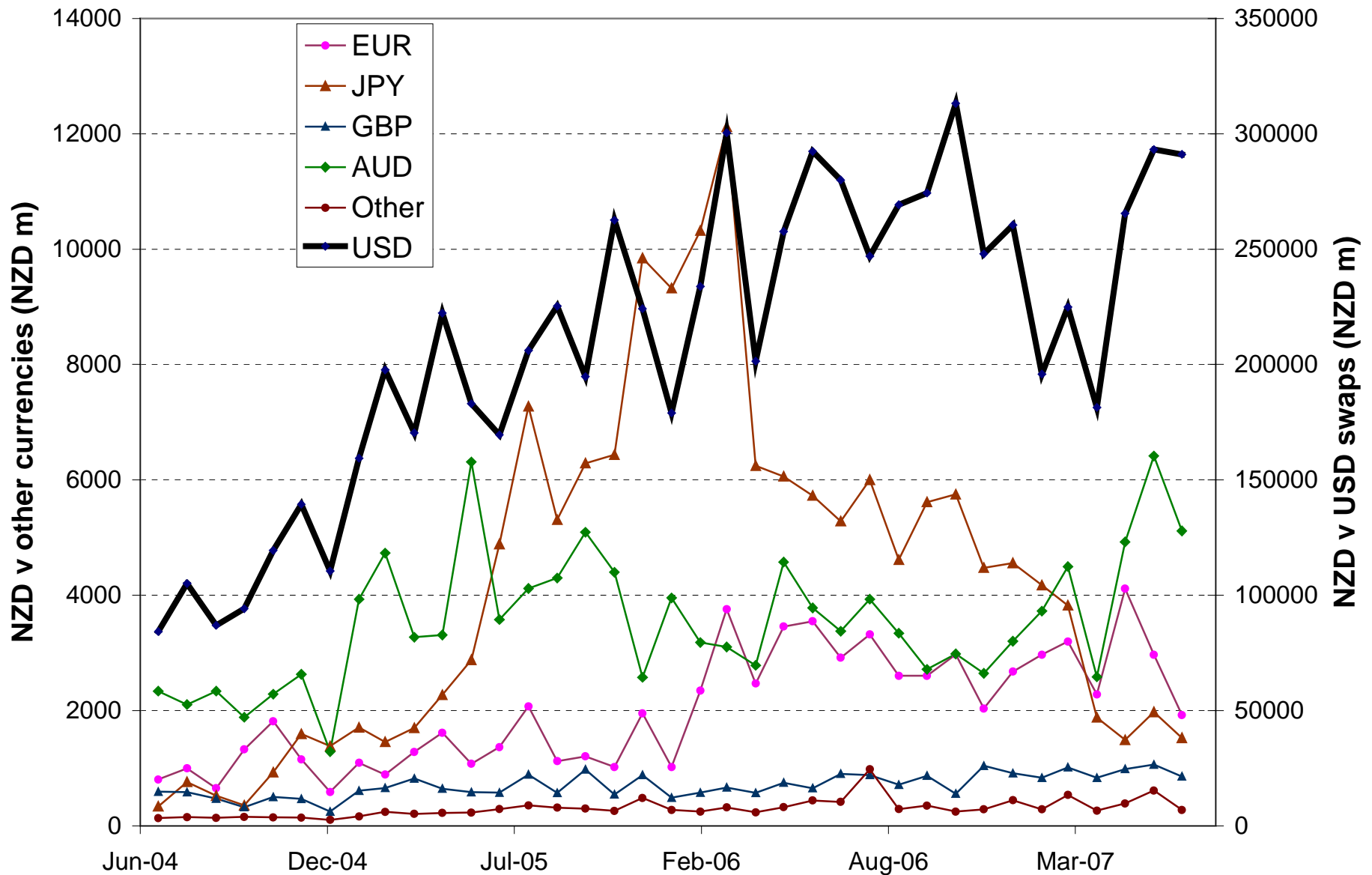
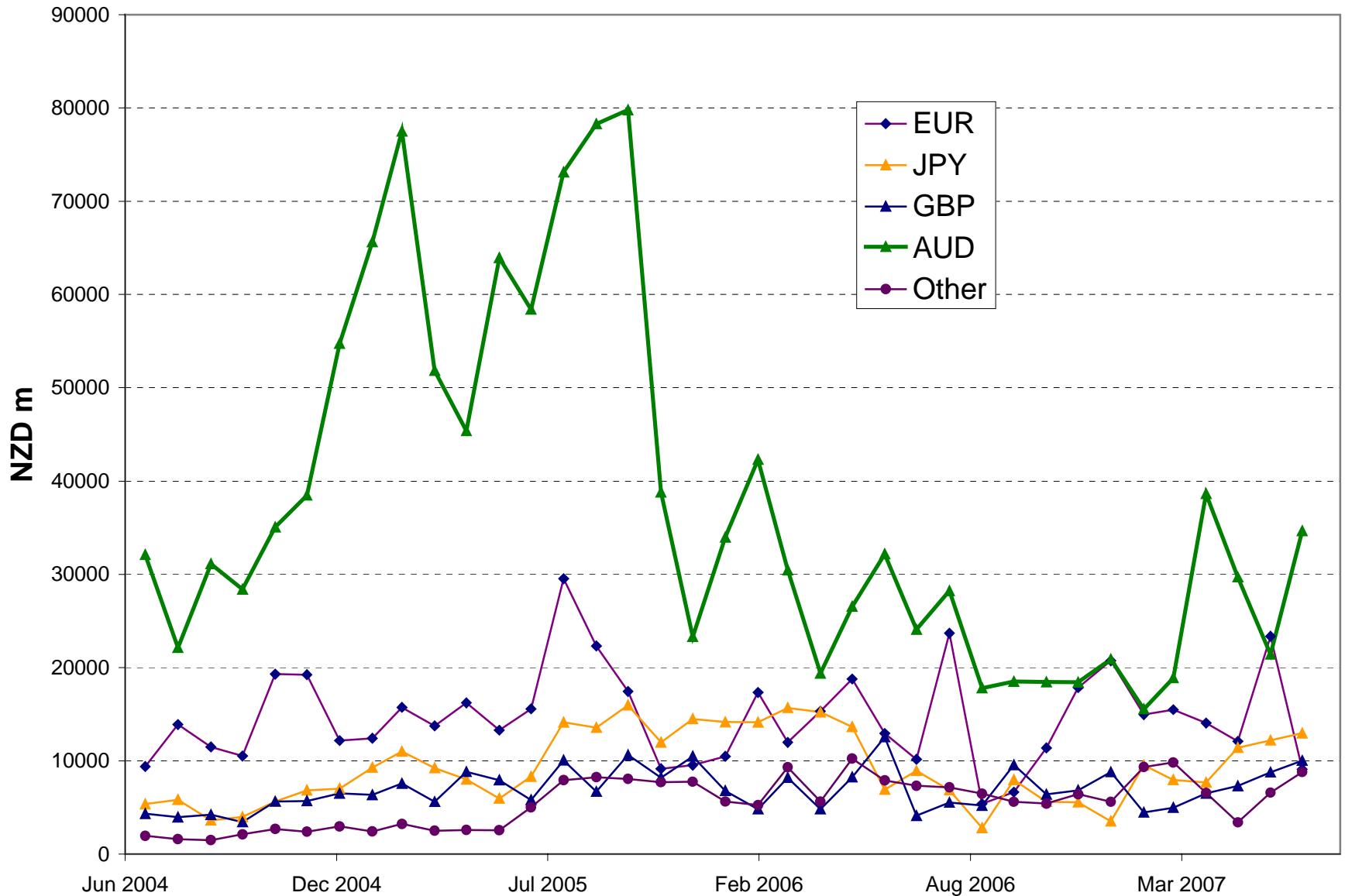


Figure 9: Third party generalised currency swaps



Concluding remarks

- NZ fills a specialist niche. Complementary rather than competing.
- NZ product mix provides useful market completion or high grade credit, high coupon fixed interest
 - Also for CIRS and related OTC derivative markets
- We have the world's wobbliest currency
- This makes us pay a lot of attention to FX risk management
- And a lot of attention to education in such aspects as treasury and portfolio risk management
- A source of human capital as a consequence