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# TREASURY TRENDS

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## A NEW WORLD ORDER

*Life is really simple, but we insist on making it complicated.* **Confucius**

### Ready to trade in renminbi?

The use of the Chinese renminbi for settlement is now topical with ongoing global developments pushing for trade in renminbi to grow. There has also been a move towards more companies requesting settlement in renminbi. Many local importers have begun experiencing this, with incentives such as favourable terms, discounts and access to newer markets on the Chinese mainland.

The renminbi is becoming an international currency due to China's emergence as the second largest economy in the world. China has significant reserves in US dollars, but these have continued to weaken, making trade in US dollars less attractive to Chinese exporters. China has also continued to support internationalisation of its currency with the number of 'mainland designated enterprises' that can settle in renminbi being allowed to grow to around 67,000. There are also 20 Chinese provinces that allow businesses based in those provinces to handle worldwide import and export trade, with about 95% of foreign trade within these provinces. In 2010 there was also the introduction of the Hong Kong based offshore deliverable market, referred to separately as CNH.

Local importers source a wide range of materials and products from China, normally priced in US dollars. Chinese suppliers appear to have built US dollar exchange risk into pricing, with little transparency. It is suggested that once settlement in renminbi can occur importers will be able to negotiate lower prices or longer payment terms as they have removed the currency exposure from the Chinese exporter. It should be noted that the importer will still have an FX exposure to manage.

China has three markets for renminbi trade, onshore ("CNY"), offshore non-deliverable ("NDF") and offshore deliverable in the Hong Kong market, the CNH. Settlement still involves official documentation and declarations although it will be less than for trade conducted in other currencies. Flow is generally limited to trade settlement and must be matched to goods or services. Businesses need to be aware that for hedging purposes the CNH differs from CNY in a number of subtle ways.

**Spot exchange rates.** The difference between spot CNH and CNY is a direct result of China's closed domestic currency market,

resulting in different market characteristics, and therefore different exchange rates. These characteristics, such as the fact that there is no intervention in the CNH exchange rate, mean that the offshore CNH has typically traded at a premium to the CNY.

**Forward curves.** Unlike the forward curves for the CNY and the NDF, the CNH forward curve is more normal as it is anchored to the interest rate curves. This is due to the lack of trading restrictions in the CNH market, compared to CNY and the resulting arbitrage opportunities that would arise.

**Options.** Onshore CNY options have been available in China since April 2011, but are still subject to regulation compared to offshore counterparts. This is to restrict speculative activity and companies are not able to sell currency options in the onshore market. As a result offshore options prices may be lower than onshore prices, as there will be fewer onshore sellers of volatility, and a restricted supply of written options.

All of the big banks have or are in the process of offering the ability to trade in renminbi. This will be new territory for most New Zealand businesses and we recommend that management begin the process of understanding the impact on trading in renminbi. This will include understanding the impact on product pricing, negotiation, future risk management, impact on existing hedges and changes to administrative processes.

### The future of the euro?

The emergence of the Chinese powerhouse may be coinciding with the death throes of another economic bloc. The long running European debt disaster has swirled from crisis to crisis since early 2010, when EU partners first outlined a plan to offer loan guarantees to troubled Eurozone members. The following months have provided a whirlwind of austerity plans, credit downgrades, riots and crisis meetings, jabbing an ever widening cluster of 'peripheral' nations. Massive bailout loans have been established for Greece, Portugal and Ireland, and a broadening reliance on the ECB has seen its open market operations expand into buying government and private debt securities.

Despite these unprecedented efforts, markets remain sceptical that the Eurozone can be maintained in its present form. These doubts have gained further credence this month as political rifts deepened

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# AUSTRALASIA ECONOMY & MARKETS

## The importance of China to Australia ...

Much has been made of the importance of China to the Australian economy with particular emphasis being placed on the export of minerals. Drilling down (no pun intended) into the merchandise trade data reinforces this belief but also shows up some other interesting facts. In 2008 Australia exported AUD32 billion of goods to China and imported AUD35 billion of goods. In 2009 the mix changed somewhat and exports exceeded imports by AUD6 billion. By 2010 the surplus was AUD19 billion (exports AUD58 billion, imports AUD39 billion).

Even more revealing are the percentages. In 2010 China accounted for 25.3% of Australia's exports and 22.1% of its imports, placing it first in both categories. Australia is China's 14th largest export destination and its 6th largest import source.

The types of goods Australia exports to China provide few surprises. The biggest category in 2010 was 'iron ore and concentrates' which totalled AUD34 billion and 59% of total exports to China. Coal came second at AUD5.19 billion, while crude petroleum was third at AUD1.66 billion. Australia's largest import category from China was clothing at AUD4.16 billion, computers next at AUD3.95 billion and telecommunications equipment 3rd at AUD3.85 billion.

## ... and to New Zealand

Based on figures for 2010, China is only New Zealand's second largest export destination, receiving 11% of our exports with a total value of NZD4.8 billion. Australia tops the ranking at NZD10.0 billion, equating to 23% of New Zealand's total exports. But between 2008 and 2010 the exports to China had increased by 90%, and 91% of them were primary products. Over the same period New Zealand's exports to Australia increased by only 2.3%, and the value of imports from its closest neighbour actually declined slightly. New Zealand's biggest export category to China is milk powder, the total value increasing by a whopping 343% from the end of 2008 to the end of 2010, to reach NZD1.57 billion, i.e. 32.5% of exports to that country.

As for New Zealand's imports, China is again second at 16%, (computers first and telephone equipment second) just behind Australia which is at 18%.

New Zealand traditionally thinks of the UK as being its biggest export destination, perhaps remembering the days when frozen lamb carcasses were exported in large numbers. The UK now ranks more lowly, as New Zealand's fifth largest export destination with sheep meat first, wine second and wool third.

## The conclusions

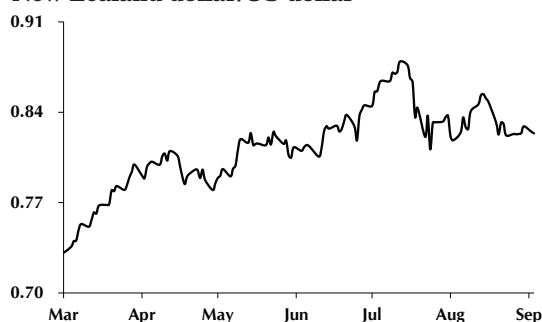
The widely held belief that China and the health of its economy is of considerable importance to Australasia is certainly reinforced by the trade figures. Australia is probably more reliant on China than New Zealand is, in that China is Australia's largest trading partner whereas for New Zealand China comes in second behind Australia. But with New Zealand being so reliant on Australia, New Zealand has an indirectly greater reliance on China than the headline trade figures portray.

The figures also show the decline in New Zealand's trade with its traditional trading partners such as the United Kingdom and the United States. Lamb and beef used to provide the backbone of New Zealand's exports, but these are being overtaken by dairy and China plays a key role in that.

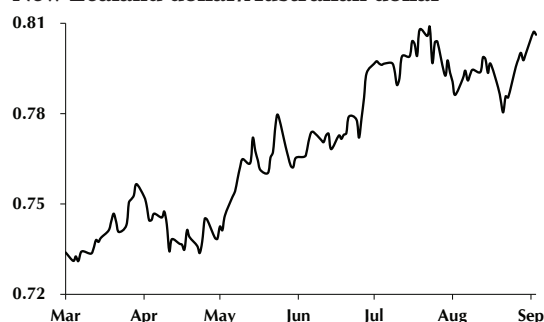
The role of technology in helping to drive economic growth is well known. China has a pivotal role here as well, in that both Australia and New Zealand import considerable quantities of computers and telephone equipment. The overriding conclusion is that as China grows both Australia's and New Zealand's economic growth will be more inextricably tied to developments in that part of the world, with the amount of trade conducted only set to grow even more. Will it continue to grow at the same pace as in recent years?

A bigger strategic question, perhaps, is whether we are doing enough to develop markets elsewhere to reduce this growing dependence on China. For example, Brazil is the world's seventh largest economy, but it ranks only 50th on New Zealand's bilateral trade totals.

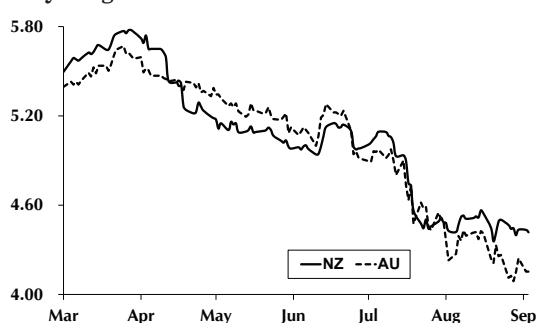
New Zealand dollar/US dollar



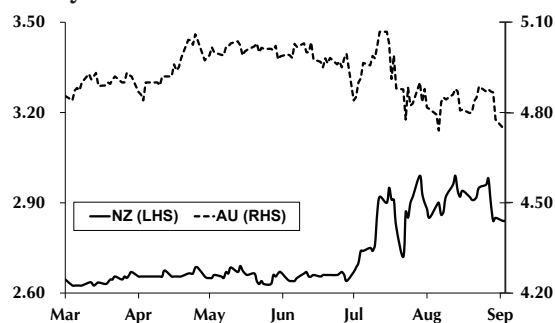
New Zealand dollar/Australian dollar



10 year government bonds



90 day bank bills



# WORLD ECONOMY & MARKETS

## Panic stations - Europe under attack

Europe is in financial strife – despite years of unsuccessful attempts to right the ship. One legacy of the GFC has been the movement of private debt to public debt from the implementation of bailouts and stimulus. And while that may have calmed markets and provided confidence in the banking sector at the time, it is now undermining the global economy as the public sector is forced to rein in spending to stabilise public debt. The current pressure on bank shares in France and Italy suggests that markets are worried about another tightening of credit and a banking crisis of confidence. The recent stress tests did not give much confidence in the ability of European banks to cope with a potential sovereign default.

The debt crisis has political implications for the Eurozone. The big question is whether it will pull through the crisis intact. Some think not, speculating that the euro's weaker members will ultimately leave the single currency, either by choice or at the urging of more creditworthy members. An alternative version of the 'breakup' hypothesis would see the stronger members, like Germany, leave the monetary union.

However, there are reasons to be optimistic about the ability of the EU and Eurozone hold together. Many commentators appear to have overlooked the range of existing EU and euro area institutions and arrangements that could be used to support sovereigns and banks. An enhanced EFSF – a quasi 'European Monetary Fund' – could be up and running relatively quickly, could pave the way to recapitalise banks, and enable it to lend directly to countries without the need for the involvement of the IMF. The ECB also has deep pockets and the capacity to act as lender of last resort and market maker for sovereigns and banks.

## When will it end?

Consumer and business sentiment has taken a significant hit from the Eurozone debt crisis, and there's still gridlock in debate over US fiscal policy. Governments, due to their indebtedness, have less room to manoeuvre relative to central banks and for this reason

there has been a marked step up in central bank intervention over recent times.

Both the IMF and OECD affirmed market fears over global growth prospects when both organisations revised down their respective outlooks in September. The OECD, recognising that the latest turmoil in global markets threatens another financial crisis, urged central banks to keep interest rates low and be ready to pursue other forms of easing. Whatever central bank actions emerge in the short term, the structural changes that many Governments need to make (to bring their balance sheets back into equilibrium) will likely result in a protracted period of below par growth.

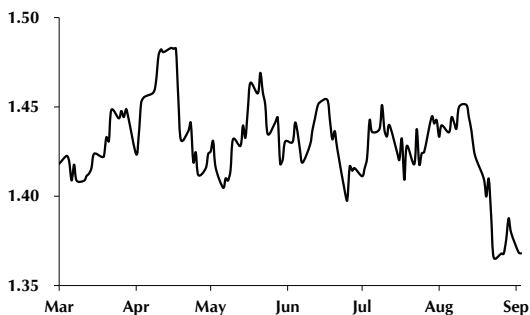
## Can Asia save global growth?

Renewed US and European recessions would likely have a material impact on the financial performance of Asian countries. While Asia is structurally decoupling from the western economies due to population demographics and potential high growth rates, it is still cyclically joined. During the GFC many countries in the region still experienced sharp slowdowns. Regional trade has increased but western economies still account for the majority of final demand for Asian exports. The smaller wide-open economies such as Hong Kong and Singapore are the most exposed to any export slowdown.

Asia also has room for fiscal stimulus, with public debt ratios much lower in Asia than in the industrialised economies. Exceptions are India and Sri Lanka where sovereign debt as a percentage of GDP is above 70%.

However, fiscal stimulus from China would probably be smaller this time round. Beijing's fiscal package during the GFC boosted GDP growth, but as it was focused on investment it delayed much needed internal rebalancing; the investment/GDP ratio has risen to an unsustainable 50% of GDP. The authorities are also battling asset price bubbles, inflation and non-performing loans – all hangovers from past stimulus. Another stimulus package would probably focus on consumption. In turn, its impact would be less immediate and provide less support for commodity prices than another investment focused stimulus package.

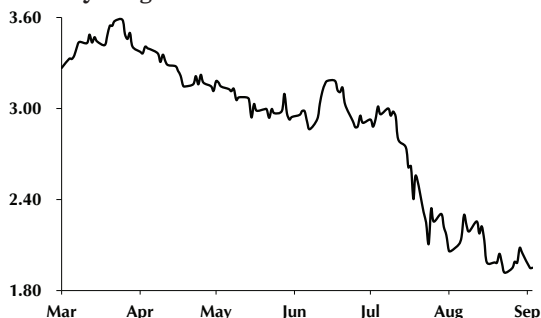
### Euro/US dollar



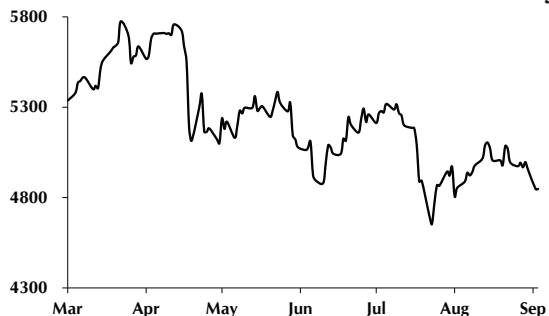
### US dollar/Japanese yen



### US 10 year government bond



### Standard & Poor's Goldman Sachs Commodity Index



# A NEW WORLD ORDER

and rumours circulated about Germany's commitment to keeping Greece within the fold. The heart of the Eurozone quickly responded to market pressure, with the German and French leaders publically reiterating their commitment to keeping Greece in the Eurozone. However there is much dissent, within Germany in particular. With all that has been going on, one would be naive to think that a 'Plan B' is not being worked on.

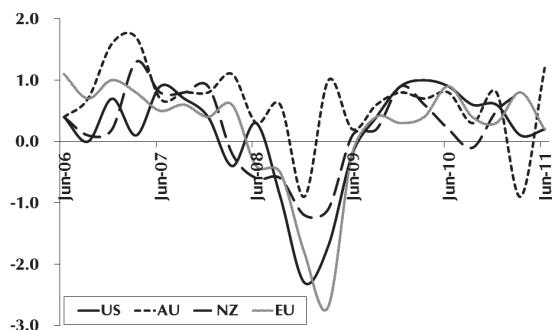
Financial reasoning may suggest that Greece should be left to face the wolves, although even this argument may be dubious given the large holdings of Greek debt held by predominantly French and German banks. If Germany was to give up on Greece, then it would still face significant costs in supporting its domestic banking sector. This may be a more palatable political solution but runs the risk of triggering a credit crunch similar to that seen in late 2008 as interbank markets lose sight of where the credit risks lie. The consequences would stretch well beyond European borders.

But rather than financial reasoning, it is politics that will determine the ultimate fate of Greece, a factor that makes it impossible to anticipate but may yet prove financial markets wrong. Many see some form of Greek default as inevitable but hope that an orderly scenario can be engineered. A default would not necessarily end Greek membership in the Eurozone but could result in other

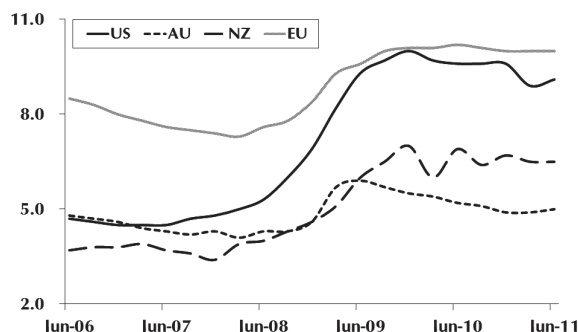
problematic Eurozone countries making similar moves. The technical difficulties of reintroducing a national currency alone would be enormous; it took three years to introduce the euro. The return of a (weakened) drachma would make Greek imports expensive and likely spark protectionist moves within Europe. Meanwhile, Greece would sink even deeper into its hole, having to pay back euro-denominated debt with a weak drachma.

Both scenarios are costly, but neither can be discounted. Whatever the outcome, unfortunately there will be no happy ending. While Australasian treasurers may feel removed from such events, European developments will continue to sway global currency and interest rate markets. Perhaps the sound of a kicked can is the best we can hope for.

**GDP growth (QoQ)**



**Unemployment rate**



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