

Uridashi and EuroKiwi

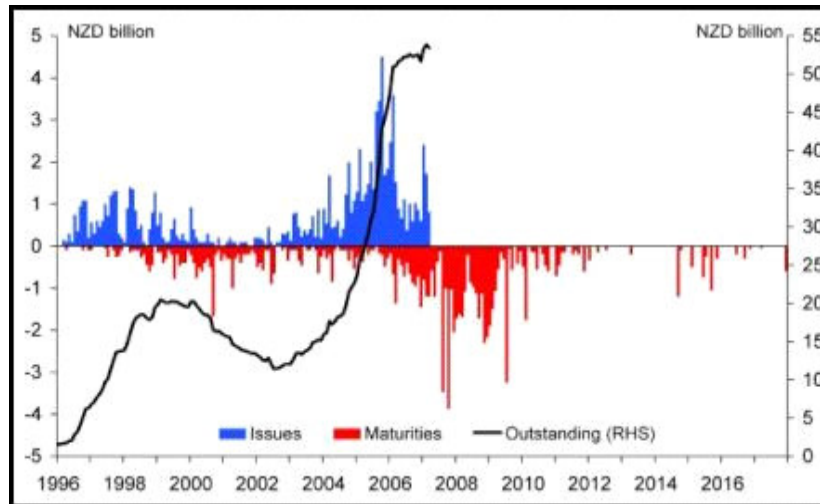
Clients may have heard of the term ‘carry trade’ that has had a large influence on New Zealand’s exchange rate over the last few years. This refers to funds moving across national borders in pursuit of profits created by interest rate differentials. Hedge fund managers together with ordinary savers domiciled in low interest rate economies are the key participants in this carry trade activity. Offshore residents can purchase New Zealand securities such as government stock directly. (Over 70% of NZ government bonds are estimated to be owned by overseas interests up from 50% in 2003).

Another mechanism is via the issue of New Zealand dollar denominated bonds often referred to as ‘Eurokiwi’ and ‘Uridashi’ bonds to European and Asian investors respectively. The value of these debt instruments has quadrupled in the past couple of years and now represents a mountain of debt at around NZ\$55 billion, which is more than New Zealand’s total annual economic output (measured as gross domestic product of just NZ\$39 billion).

Much of the funds raised by the Eurokiwi and Uridashi bond issues has channeled back into the domestic banking sector as funding for lower fixed rate mortgage rates. This is contributing to inflation in the housing sector, which in turn is a key driver for the Reserve Bank to raise the benchmark OCR. So at its most basic level there is a vicious cycle present to some degree. Other inflationary pressures influencing the OCR decision include demand driven by immigration, government fiscal policy, and wage increases arising from low unemployment.

The motivation behind the Eurokiwi and Uridashi debt issues was easy to understand. Using a simplistic example, here’s how it works: Funds borrowed in Japanese Yen at say 1% - 2% (where the Japan central bank’s equivalent of our OCR is just 0.5%) could be invested in New Zealand at 8.25% or more. The Japanese investor is happy, and the Kiwi borrower is content to mortgage assets they expect to appreciate faster than these perceived low rates. Further, the margins within the debt issue are sufficient to motivate the financial intermediaries.

The major risk for the lenders was the prospect of depreciation in the New Zealand dollar. This would reduce the value of Yen on repatriation of funds to the Japanese investor at maturity. This is why the future expectations for domestic interest rates and the flow on influence to the exchange rate is so important. The graph below exhibits the rising mountain of these debt securities on issue and the timetable for future maturities. The Eurokiwi and Uridashi market depends on confidence in the New Zealand economy. Should overseas investors elect en-masse not to roll these securities over on maturity, the NZD will decline rapidly – several years of cheap money and rising asset prices will be over suddenly, and those who are over extended will suffer the worst effects of tightening economic conditions.



Reuters; Bloomberg; Reserve Bank of NZ, Aug 2007

Back in August 2007 the first of the large maturities indicated by the red bars in the graph above, occurred with NZ\$3.65 billion maturing. Most of the maturing bonds were reinvested, demonstrating that the impact of the beginning of the turmoil in global equity and credit markets did not affect the appetite of the Uridashi and EuroKiwi investors for New Zealand.

However, since then the world's economies have been through a major recession. New Zealand's overnight cash rate now sits at 2.5% and its currency is trading much lower. What impact will the relatively low interest rates on offer have? Will funds move from NZ in what commentators are calling a "uridashi tsunami", to what some consider the stronger economy of Australia or will they be repatriated to their home countries until such time as economies improve globally?

Only time will tell. At the time of writing, it seems that the removal of the negative watch on NZ's credit rating by S&P back in May, has had the desired effect and that at least half of the maturities have been reinvested and it would appear that there is a renewed appetite for Uridashi and Eurokiwi issuances.