# Expanding Economic Relations between China and New Zealand: Direct Trading of the New Zealand Dollar in the Onshore Renminbi Market

**New Zealand Treasury**

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## Introduction

1. On 18 March 2014, direct trading between the New Zealand dollar and the Chinese renminbi was launched in the Chinese onshore foreign exchange market. In this note we provide an explanation of what direct trading is, and outline the current situation in the New Zealand dollar and renminbi markets. We also summarise the motivations for having direct trading of the New Zealand dollar with the renminbi. Finally, we provide a brief overview of the current economic relationship between New Zealand and China. Over time, direct trading should help increase the integration of Chinese and New Zealand financial markets, reduce transaction costs of converting currencies, and improve the efficiency of trade and cross-border capital flows.

## What is direct trading?

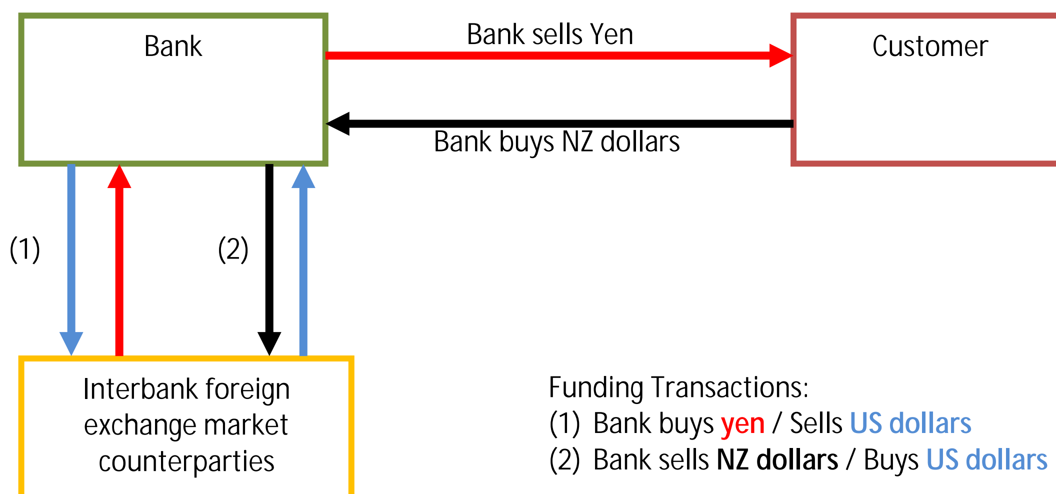
2. Banks quote exchange rates to clients who need to buy or sell foreign currency. The banks' transactions with clients need to be funded, which can be done through offsetting trades in the interbank foreign exchange market. For example, a bank which agrees to buy New Zealand dollars from a corporate client in exchange for US dollars has a "long" New Zealand dollar and "short" US dollar position. The bank could fund this position by selling New Zealand dollars / buying US dollars in the interbank market.

3. Although banks quote a wide range of exchange rates to clients, most "cross" exchange rates (ie, exchange rates that do not involve the US dollar) are not settled directly on the wholesale or interbank market. Rather, they are traded indirectly by converting through US dollars. This is because liquidity in markets for currencies against the US dollar is usually greater than in other currency pairs. As a result, bid-offer spreads (the difference between the exchange rates at which banks buy and sell foreign currency) are usually narrower in the US dollar markets.

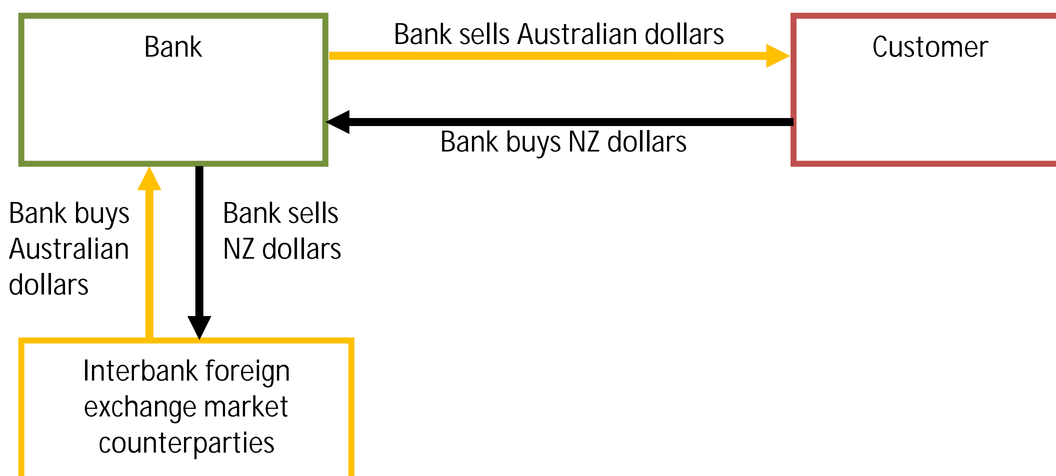
4. For example, if a bank sells Japanese yen / buys New Zealand dollars from a client, it can fund this position with offsetting transactions where it sells New Zealand dollars / buys US dollars and buys yen / sells US dollars. This eliminates the bank's exposure to exchange rate movements. This is illustrated in Figure 1(a) below. There are a few exceptions in the foreign exchange markets, in which currency pairs are traded directly. One exception is the Australian dollar-New Zealand dollar cross exchange rate. This is illustrated in Figure 1(b).

**Figure 1: Bank funding of foreign exchange positions – direct vs. indirect**

a. *Bank funding NZD /Yen position through US dollar exchange rates (**most common practice in foreign exchange market**)*




b. *Bank funding NZD/AUD position through directly quoted exchange rate (**less common practice in foreign exchange market**)*




5. In China, trade in the onshore interbank renminbi foreign exchange market occurs via the China Foreign Exchange Trade System (CFETS). The only currencies which can currently be traded in CFETS against the renminbi are the New Zealand dollar, US dollar, Japanese yen, Australian dollar, Malaysian ringgit, and Russian rouble, which are traded directly, as well as the euro, pound, Hong Kong dollar, and Canadian dollar, which are traded indirectly through the US dollar.

6. Prior to the launch of direct trading, the New Zealand dollar could not be traded on CFETS, either directly or indirectly. The meant that if a bank wanted to trade the New Zealand dollar against the renminbi, it would need to trade it indirectly in two legs through the US dollar. It would trade the US dollar / renminbi leg through CFETS and trade the US dollar / New Zealand dollar leg in the overseas foreign

exchange market. The recent agreement has made the New Zealand dollar the sixth directly traded currency in CFETS.

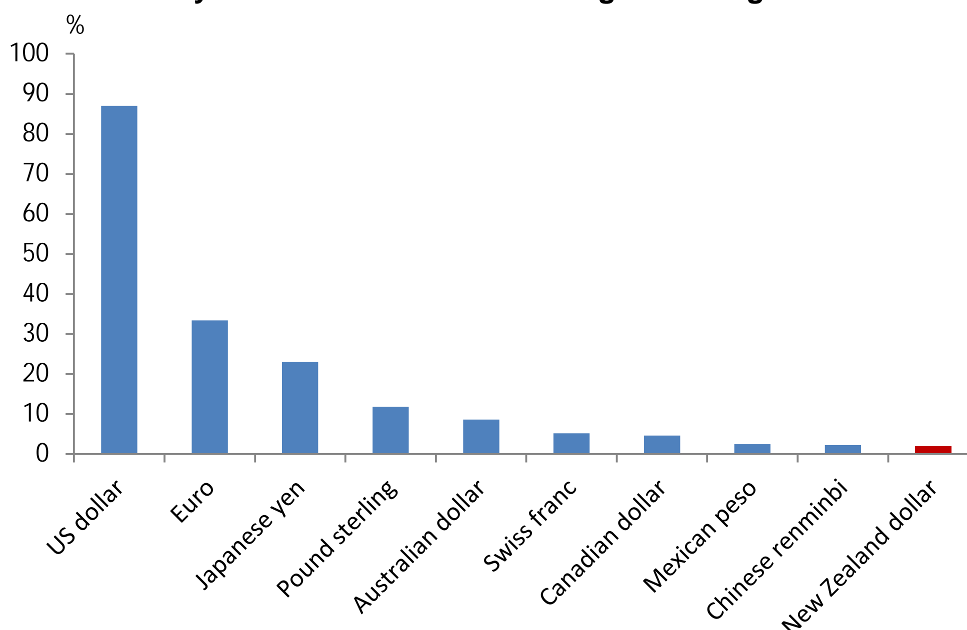
7. As in other countries, Chinese banks can quote a range of exchange rates to clients and fund their positions in the interbank market. Certain banks are licensed by the PBOC to act as "market makers" (ie, institutions which are committed to quoting bid and offer prices) in the directly traded currency pairs in CFETS.

8. For other currency pairs, such as the euro-renminbi, banks which want to buy or sell renminbi against those currencies have to convert funds into US dollars and convert those US dollars into the currency they require. This typically increases transaction costs, leading to wider spreads between bid and offer rates quoted in the interbank market, and wider spreads quoted to clients.

**The New Zealand dollar and Chinese renminbi in the foreign exchange market**

9. The New Zealand dollar floats freely against all other currencies. The New Zealand current account and capital account are fully convertible, and transactions can be carried out without restrictions or controls. Despite the relatively small size of the New Zealand economy, the New Zealand dollar is very actively traded in the global foreign exchange market. Statistics published by the Bank for International Settlements (BIS) indicate the New Zealand dollar was the 10th most actively traded currency in April 2013 (Figure 2). The relatively high level of trading of the New Zealand dollar reflects several factors. First, the real rate of return on New Zealand assets has historically been higher than in many comparable economies. Second, there are relatively few regulatory barriers to capital flows. Finally, the Reserve Bank of New Zealand has openly intervened only infrequently in recent years in the foreign exchange market.

**Figure 2: Currency Distribution of Global Foreign Exchange Market Turnover***




*Percentage shares sum to 200%, as two currencies are involved in each transaction.
*Source: Bank for International Settlements (2013)*

10. Use of the Chinese renminbi is more restricted than the New Zealand dollar. The renminbi operates under a managed float regime against a basket of currencies.[1] While the Chinese current account is fully convertible, its capital account currently has restricted convertibility, with some controls on capital flows in and out of China. China is currently in the process of reducing the restrictions around its capital account, and has been actively promoting the internationalisation of the renminbi. This has resulted in a significant increase in international use of the renminbi. According to SWIFT, the renminbi has gone from being the 20th most used currency for international payments in January 2012 (with 0.25% activity share), to the seventh in February 2014 (with 1.39% activity share).[2] It is also now the second most used currency in trade finance, and amongst the ten most actively traded currencies overall. The significance of the renminbi in global currency markets will most likely continue to grow as China takes further steps to liberalise its capital account.

**Benefits of direct trading**

11. Direct trading represents a positive step for several reasons. First, there are potential economic benefits to increasing the integration of foreign exchange markets in China and New Zealand, in terms of reducing transactions costs of trade and capital flows. These benefits may not become apparent immediately, but may develop over the medium to long term as market liquidity develops. Direct trading may enhance moves towards renminbi pricing or settlement by New Zealand companies trading with China. As a result, small Chinese firms, which may find it difficult or expensive to hedge foreign exchange risk, could benefit from a move towards renminbi pricing. The Treasury holds regular discussions with New Zealand businesses, and is exploring their awareness of the possibility of renminbi pricing or settlement when trading with China. Direct trading could also lower the costs of capital flows between China and New Zealand, which are likely to increase as China moves to liberalise its capital account.

12. Second, direct trading will continue to expand the economic and financial relationship between China and New Zealand. This will carry on the process of increasing integration seen in recent years. The process of increased engagement has led to New Zealand achieving “four firsts”:

- The first Western country to conclude a bilateral agreement with China on its accession to the World Trade Organisation (August 1997)
- The first developed economy to recognise China’s status as a market economy (April 2004)
- The first developed country to enter into Free Trade Agreement (FTA) negotiations with China (announced November 2004)
- The first OECD country to sign a high quality, comprehensive and balanced FTA with China (April 2008).

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[1] See PBOC (2010) “A Managed Floating Exchange Rate Regime is an Established Policy”, available at http://www.pbc.gov.cn/publish/english/956/2010/20100727144152118668062/20100727144152118668062_.html

[2] Based on SWIFT’s RMB Monthly Trackers http://www.swift.com/products_services/renminbi_reports

13. Third, direct trading of the New Zealand dollar in the onshore renminbi market is consistent with the stated goal in the Chinese Government's 12th Five Year Plan to increase the international use of the renminbi. It builds on the existing currency swap agreement signed by the People's Bank of China and the Reserve Bank of New Zealand in April 2011, which contributes, along with swap agreements signed with other central banks, to boosting liquidity and increasing confidence in the renminbi markets. Since introducing direct trading in April 2013, trading between the Australian dollar and the renminbi has risen significantly.

**Trade and financial links between New Zealand and China**

14. China is New Zealand's largest market for exports of goods. Exports of goods are dominated by dairy, meat and forestry products. In addition, exports of tourism and educational services are also significant. In the year to December 2013, exports of goods from New Zealand to China were worth NZ$10.0bn. China is also New Zealand's largest source for imports.

15. Capital flows between New Zealand and China are also growing. New Zealand is open to cross-border capital flows, and has an open and transparent foreign investment screening regime. It has trade and investment treaties with both China and Hong Kong. While portfolio flows between the two countries are relatively small, the scale of Chinese Foreign Direct Investment (FDI) in New Zealand is more significant. China's stock of FDI in New Zealand stood at NZ$1,970m as at March 2013 (of which NZ$1,585m was from Hong Kong). This is equivalent to 1.9% of New Zealand's total FDI stock, and makes China New Zealand's 8th largest source of FDI.

16. New Zealand's stock of Overseas Direct Investment (ODI) in China was NZ$880m as at March 2013 (of which NZ$811m was in Hong Kong). This makes China New Zealand's 5th largest destination for ODI. ODI from New Zealand to China was equivalent to 3.9% of New Zealand's ODI stock. As the Chinese economy grows and the capital account is liberalised, there is likely to be scope for further expansion in capital flows between the two countries.