

The intermediation of international capital flows

Robert St. Clair, Christine Tether, and Bruce White, Economics Department

The extent of international investment in New Zealand, and of New Zealand's external debt, have been the subject of much discussion of late – against the backdrop of the large size of New Zealand's current account deficit, and the financial crisis that has occurred in a number of East Asian economies.

In the March *Bulletin*, an outline was provided of the balance of payments accounting framework used to record the **flows** of goods, services, and investment income across the border, and the counterpart **flows** of capital. This article takes the analysis of the capital account a step further, by:

- explaining how the capital account transactions are recorded in **stock**, or 'balance sheet' terms; and
- providing some background on the different forms that external capital takes, and on the different channels through which it is intermediated in and out of New Zealand.

1 Overview of the data and the accounting framework

The value of New Zealand residents' net foreign capital, at a particular point in time, is recorded in the International Investment Posi-

tion (IIP) statement compiled and published by Statistics New Zealand.¹

Table 1 summarises the main components of this statement for the last five years. As evi-

Table 1:
New Zealand residents' external obligations and claims
as at 31 March (\$ millions)

	<u>1993</u>	<u>1994</u>	<u>1995</u>	<u>1996</u>	<u>1997</u>
Residents' obligations to non-residents	92,644	99,789	103,485	114,430	120,205
Direct investment	37,682	44,201	47,574	57,540	64,276
Portfolio investment	10,236	14,803	16,732	19,405	20,835
Other investment	44,726	40,785	39,179	37,485	35,094
Less residents' claims on non-residents	28,752	32,452	32,424	44,801	47,886
Direct investment	17,720	18,158	19,246	23,713	25,209
Portfolio investment	1,564	2,407	2,612	8,078	8,923
Other investment	3,297	4,978	4,471	6,262	7,259
Official reserve assets	6,171	6,909	6,095	6,748	6,495
Net international investment obligations²	63,892	67,338	71,060	69,630	72,320

Source: Statistics New Zealand³

¹ New Zealand's official IIP is currently presented by Statistics New Zealand in two formats; a 'balance sheet' framework, and a 'balance of payments' framework (recommended by the International Monetary Fund (IMF)). For the purposes of this article, we have used the balance of payments approach but have adapted it so that all lending and borrowing within the direct investment category is shown on a gross basis. See Statistics New Zealand (1997) for details.

² The data in all tables in this article may not add to stated totals due to rounding.

³ The data in all tables in this article are sourced from the Statistics New Zealand release *International Investment Position* 31 March 1997 unless indicated otherwise.

denced by an excess of external obligations over claims, New Zealand is currently characterised as a 'net debtor'.

1.1 Foreign investment components

Direct investment

Direct investment, both inwards and outwards, relates to cross-border investment in businesses where there is a non-resident shareholding of 25 percent or more.⁴ Thus, for example, where an overseas party owns 25 percent or more of a New Zealand resident company, the overseas party is a direct investor **in New Zealand**. And where a New Zealand resident owns 25 percent or more of an overseas company, the investment is recorded as direct investment **by New Zealand** abroad.

Where the 25 percent threshold is met, the total amount of the investor's stake in the business, whether in the form of shareholders' funds (ie equity) or debt, is recorded as direct investment. The exception is in respect of short-term inter-bank funding (from overseas parents and subsidiaries), which is recorded in the 'other investment' category (see below).

Direct investment also captures New Zealand real estate that is owned directly by overseas investors.

Portfolio investment

Portfolio investment comprises cross-border **equity** holdings where an overseas shareholder owns less than 25 percent of an enterprise, and investment in marketable **long-term debt** securities (issued by both firms and governments). The principal elements of portfolio investment in New Zealand are overseas investment funds' holdings of listed shares (where the shareholding does not exceed 25 percent)

and government and corporate debt securities. New Zealand investment funds (such as unit trusts, life insurance funds, and superannuation funds) include similar overseas investments in their portfolios.

Official reserve assets

Official reserve assets comprise the holdings of liquid foreign currency assets held by the Reserve Bank and the Treasury. These assets mostly take the form of holdings of securities issued by highly rated foreign governments and financial institutions. Also counted is New Zealand's reserve position in the International Monetary Fund. Under IMF rules the portion of each member's subscription that has been paid, or subsequently called, in reserve currencies, can be withdrawn essentially on demand, and hence qualifies as a reserve asset.

Other investment

Investment not categorised as direct, portfolio, or official reserves, appears in the 'other' category. This category comprises mainly cross-border borrowing and lending in the form of **loans** by the New Zealand government and corporate sectors, as well as all short-term bank funding transactions. Additionally, other investment includes cross-border **trade debtors** and **trade creditors**, and cross-border inter-bank **deposits**.

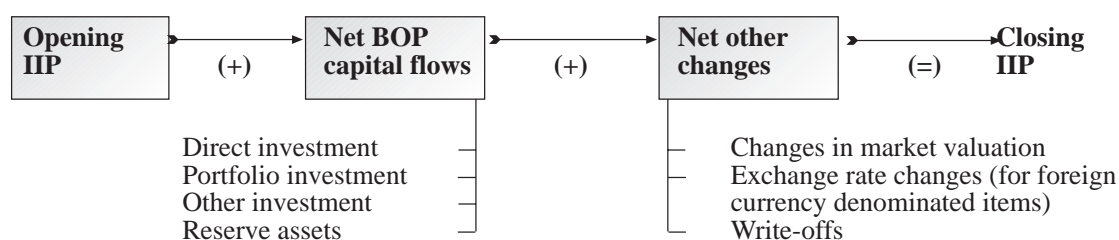
1.2 Changes in New Zealand's IIP

Figure 1 shows how New Zealand's net international investment position can change between two points in time. Two types of changes are identified; those arising from foreign financing/investment transactions and those due to 'non-transactions'.

⁴ Foreign direct investment by New Zealand arises where *at least one* New Zealand investor holds an equity interest of 25 percent or more in an overseas firm. In contrast, direct investment in New Zealand is recorded where *one or more* non-residents collectively own at least 25 percent of the equity of a New Zealand enterprise. Thus, if the share registry of a New Zealand firm shows 25 percent or more of its total shares on issue being owned by non-residents, then

the overseas investment is classified as direct investment, even though no individual overseas shareholder may have a 25 or greater percent shareholding. Upon adoption by Statistics New Zealand of the 5th edition of the IMF's Balance of Payments Manual, which is scheduled to be completed in 2001, these thresholds will both be reduced to 10 percent and will apply consistently on both sides (on an individual, rather than aggregated, shareholding basis).

Figure 1:
Changes in the value of New Zealand's IIP



Foreign financing/investment transactions, or capital flows, are recorded in the capital account of the balance of payments. These transactions show how a current account deficit has been financed, or surplus invested.

Changes in the IIP may also occur without any transaction taking place. These changes may reflect: unrealised capital gains or losses on a claim; changes in the value of foreign currency denominated items arising from movements in the New Zealand dollar against other currencies; or write-offs of unrecoverable debts. These are recorded (net) as a reconciliation item in the IIP statement.

1.3 Data sources and limitations

The primary data source for New Zealand's IIP is the Statistics New Zealand Annual Capital Accounts Survey (supplemented by an Annual Real Estate Survey). The Capital Accounts Survey collects information on the international financial liabilities and assets of New Zealand enterprises. The survey is sent to all New Zealand enterprises identified from Statistics New Zealand's Business Directory as undertaking capital transactions with non-residents. About 7,000 firms are surveyed, although the primary focus is on the 150 or so that have the largest foreign assets and liabilities.

Companies surveyed are asked to value foreign financial assets and liabilities at current market value, where possible. Where current market value is not available listed companies are asked to value shares according to their last sale price, or the mid point of the buy and sell quotes of the shares. Unlisted companies are

asked to estimate share values using either a recent transaction price, a director's valuation, or the net asset value (at current cost) from their consolidated company accounts.⁵

Other data sources include:

- (a) The Reserve Bank's monthly data on non-resident holdings of New Zealand Government Securities. This data is compiled primarily from the Reserve Bank registry of New Zealand government security holdings and from a survey of nominee companies conducted by the Bank. Nominee holdings on behalf of overseas investors in private and other public sector (local government and State Owned Enterprise (SOE)) debt securities are also surveyed, but equity securities are not.

Nominee companies are operated by New Zealand financial institutions and brokerage houses and provide custodial services to portfolio investors in respect of their New Zealand portfolio investments. One consequence, however, is that the securities in question are registered in the name of the nominee company, rather than in the name of the underlying, or beneficial, overseas owner. Data from the survey of nominee companies has been incorporated within IIP portfolio investment since 1992.

⁵ All equity stocks and transaction flows are sought on a March year basis. Some companies cannot provide valuations as at 31 March, having for example, a December, September, or June balance date. These companies are asked to report as at the balance date immediately prior to 31 March. For this reason, 31 March is only an indicative time point in the IIP statistics.

(b) The Reserve Bank's quarterly Managed Funds Survey. Data from this survey has been incorporated within the IIP statement since 1996 and provides information on the international investments of New Zealand fund managers – that is, the managers of unit trusts, superannuation funds, and life insurance funds. The value of New Zealand funds managed by Australian fund managers is also surveyed. Further details on these surveys can be found in Boaden (1996).

Fund managers' international investments in equity securities, property, and long-term interest bearing securities appear under portfolio investment. Their international investments in cash and deposits, short-term interest bearing securities, loans and mortgages, and other investments are categorised as 'other' investment.

(c) Official overseas reserves and borrowing data are provided by the Reserve Bank and the Treasury.

As for all data sourced from surveys, the quality of data in the IIP statement is dependent on two things: survey coverage, and the accuracy of the information obtained. Currently, Statistics New Zealand acknowledges that some or all of the following foreign assets and liabilities are omitted from the IIP statement:

- New Zealand currency held overseas;
- international assets and liabilities of individuals. For example, New Zealand individuals' direct holdings of shares in overseas companies or direct ownership of foreign real estate are not captured. Also, migrants' claims on and liabilities to residents in their 'home', or other countries, will not be captured;
- the ownership of various non-financial intangible assets, eg patents and franchising rights;

- net assets of branches/sales offices (although these will be captured to the extent they are reported as borrowings from head office); and
- gains and losses on derivative contracts with non-resident counterparties.

Equity investment in New Zealand listed companies by foreign investors, via nominees will also be understated (because this is not covered by the survey of nominee companies).

Another principal area of difficulty in compiling the data is obtaining consistent valuations. To some extent the figures reported are inevitably a mixture of current market values, estimated market values, and book values (some of which might be quite out of date relative to what a current market value would be).

2 Details of international capital flows

This section examines in more detail the individual components of New Zealand's IIP.

2.1 Direct investment

As a rule, direct investment (either undertaken in New Zealand by non-residents or by New Zealanders overseas) is thought to be fairly stable. Typically, direct investors seek to gain substantial voting rights so that they can exercise direct control over the business with a view to maximising value over the long term. Moreover, exiting a large, or controlling, shareholding when market conditions are adverse can be difficult to achieve quickly, at least without the market value of the investment being forced down, against the interests of the seller. Withdrawal by a direct investor, therefore, tends to be something that is carefully stage managed, and generally will be motivated by long-term strategic considerations, rather than concern about short-term price volatility.

Although the distinction between direct and portfolio investment is drawn in terms of a shareholding threshold, this does not mean that

Table 2
Direct investment components⁷
as at 31 March (\$ millions)

	<u>1993</u>	<u>1994</u>	<u>1995</u>	<u>1996</u>	<u>1997</u>
Direct investment in New Zealand	37,682	44,201	47,574	57,540	64,276
Equity investment	21,244	27,220	31,966	38,745	41,555
Debt investment:					
Borrowing by a NZ company from a foreign:					
parent	8,326	10,396	10,060	10,287	11,126
subsidiary	8,112	6,585	5,548	8,508	11,595
Less New Zealand direct investment abroad	17,720	18,158	19,246	23,713	25,209
Equity investment	14,123	14,421	15,428	19,047	21,277
Debt investment:					
Lending by a NZ company to a foreign:					
parent	1,732	2,362	1,950	1,958	1,906
subsidiary	1,865	1,375	1,868	2,708	2,026
Net international direct investment obligations	19,962	26,043	28,328	33,827	39,067

all direct investment comprises equity investment. Borrowing and lending transactions between enterprises which have a direct investment relationship are also classified as direct investment.⁶

The components of direct investment are presented in table 2. Over the last few years foreign direct investment in New Zealand as a proportion of total international investment liabilities has climbed quite sharply.

Direct equity investment ***(a) in New Zealand***

The bulk of direct investment in New Zealand is in the form of equity capital, which includes direct investment in real estate outside of corporate structures, eg where a foreign party buys a property directly, as distinct from a company that owns property. There has been an increasing preference for equity capital instead of long-term capital borrowing, as equity capital as a share of total direct investment in New Zealand has increased since 1993. This likely stems

in part from changes to tax and company legislation in recent years.

New Zealand has had a long history of substantial inward direct investment. Much of New Zealand's early economic development was associated with overseas companies establishing a presence here, for example, in the meat processing industry, transport (particularly in the oil and vehicle assembly industries), banking and insurance, and in manufacturing. And in recent years, there has been a new wave of foreign direct investment. The recent developments have been closely associated with the restructuring of the New Zealand economy, including the privatisation of government trading enterprises, which has seen overseas owners acquire significant stakes in a number of those businesses (for example, in Telecom, Tranz

⁷ This table is presented in a format which differs from the official Statistics New Zealand presentation, which shows borrowing by New Zealand companies from foreign subsidiaries as negative lending, and lending by New Zealand companies to their foreign parents as negative borrowing. See Statistics New Zealand (1997) for details. In table 2, lending and borrowing are shown in gross terms.

⁶ Except short-term intra-group funding by banks.

Rail, PostBank, and Bank of New Zealand). But large scale inward direct investment has not been limited to the former government trading enterprise sector: there has also been significant overseas direct investment in other sectors, for example in the forestry sector (International Paper having invested in Carter Holt Harvey), the media (Independent Press in Wilson and Horton), and food processing (Heinz in what used to be Watties). And the direct investment flow has not all been one way: the motor vehicle assembly industry is one example of a sector where economic restructuring is leading to lower levels of direct investment in the New Zealand economy. But, overall the trend in recent years has been for increases in inward direct investment substantially to exceed any outflows.

(b) by New Zealand

Equity capital is the most significant component of New Zealand's direct investment abroad, growing by around 11 percent per annum on average over the last four years. The transactions that add to New Zealand's stock of direct investment equity assets abroad are those that involve a New Zealand resident firm acquiring a 25 percent or greater shareholding in an overseas firm.

Examples include: Brierley Investment Limited's shareholding in Thistle plc (a United Kingdom hotel operating company); Fletcher Challenge Limited's shareholding in Fletcher Challenge Canada Limited and joint venture investment with Jasra International Petroleum Sendirian Berhad in Brunei; and Carter Holt Harvey's Chilean investment in Copec.⁸

Direct debt investment

(a) in New Zealand

To some extent, direct debt capital is analogous to direct equity investment. Funding provided by an overseas owner to its New Zealand enterprise in the form of loans rather than equity capital is counted as direct investment in New

Zealand. Often this funding, while legally debt, will, in substance, be equity. Traditionally, overseas owners of New Zealand subsidiaries have preferred that a portion of the capital of the New Zealand business be in the form of debt rather than equity for two principal reasons: debt funding has been more flexible, particularly if the owner wished to withdraw capital, and debt funding has been more tax efficient.

However, there have been important legislative changes in New Zealand during the last few years in the direction of making for a more neutral environment. First, the Companies Act (1993) introduced a more flexible regime by which companies wishing to retire capital can do so (without going through the High Court procedure generally required under the Companies Act 1955).

Second, the Foreign Investor Tax Credit (FITC) regime, which was introduced in respect of foreign portfolio investment in September 1993, and extended to all categories of overseas equity investment in December 1995, provides a mechanism by which double taxation of dividends paid to overseas shareholders can be avoided. In effect, the FITC regime extends to non-resident shareholders the benefit of the New Zealand imputation system which enables recipients of dividends to claim income tax that has already been paid by the company as a credit against their own assessable income. Previously the benefits of this regime had been available only to New Zealand resident shareholders.

Third, a "thin capitalisation" rule for taxing foreign-owned companies was introduced in 1996. This has the effect of limiting the amount of interest expense that can be claimed as a tax-deduction where the company is "thinly capitalised", ie where the capital provided by its overseas parents is in the form of debt to an abnormal extent.

A notable feature of table 2 is the large amount that New Zealand enterprises have **borrowed from overseas enterprises they own** (ie from their overseas branches or subsidiaries). In-

⁸ Note that the same company, in this case Carter Holt Harvey, can appear on both sides of the balance sheet, both as an overseas owned company and itself as an overseas investor.

deed, perhaps somewhat surprisingly, in 1997 New Zealand firms' borrowings outstanding to their overseas branches and subsidiaries was as much as was outstanding to overseas parents.

The explanation for this position is that a number of New Zealand institutions and corporates have established subsidiaries (or branches) abroad as vehicles for accessing overseas capital markets. Basically, the subsidiary issues securities, generally under commercial paper or medium-term note programmes, to overseas investors and flows the proceeds back to New Zealand.⁹ Often these subsidiaries or branches of New Zealand firms carry on virtually no other business in the overseas market where they are located – which typically will be offshore financial centres like Hong Kong, Singapore, Cayman Islands and Netherlands Antilles. These elements of direct investment in New Zealand are, in economic substance, no different from the other borrowings raised by New Zealand firms in overseas capital markets and recorded as either 'portfolio investment' or 'other investment'.

(b) by New Zealand

Direct debt investment by New Zealand firms in overseas enterprises is substantially less than the amount of borrowing from the same category (discussed immediately above). This reflects both the relatively smaller overall amount of direct investment by New Zealand firms compared with that in New Zealand firms, and also that New Zealand is not a financial

centre from which overseas firms access international capital markets.

The data for direct debt investment (lending) by New Zealand firms in overseas parent companies will likely represent surplus funds that have been temporarily invested with an overseas parent, or flowed back by way of loans rather than dividends.¹⁰ And the direct debt investment in overseas subsidiaries is likely to comprise mostly instances where the New Zealand firm has chosen to capitalise its subsidiary partly, or mainly, with debt rather than equity.

2.2 Portfolio investment

Portfolio investment, either in New Zealand by foreigners, or by New Zealand residents in overseas markets, comprises corporate **equities** and **long-term debt securities** where there is **no direct investment relationship** between the issuer and the holder.

Portfolio investment is often thought to be less stable than direct investment. One reason is that, as the name suggests, portfolio investment is largely held in the portfolios of investment funds, for example, mutual funds and hedge funds¹¹ in the United States, and unit trusts, life insurance funds, and superannuation funds in New Zealand. These investment vehicles typically maintain diversified portfolios. This enables them both to spread their risk and also to enter and exit particular investments, without so much risk of moving the market against themselves. As such, portfolio investment tends to be more mobile than direct investment.

Portfolio investment, therefore, is generally thought of as funds that can be transferred quickly in the event of a crisis or sharp correction in financial markets. However, the mobility of portfolio investment should not be overstated. If many portfolio investors seek to sell at the same time, they too will move the market against themselves. For example, if

⁹ A commercial paper programme is a facility under which the issuer can issue short-term securities as required, provided that the total amount on issue does not exceed the facility limit. Typically the facility will be for 2-3 years, and the paper will be for terms between 30 and 180 days. A facility may, or may not be underwritten by a lending or investment institution. A medium-term note facility is similar, except that the notes issued will generally be for longer, say, 2-3 year terms. Generally, commercial paper and medium-term notes will require a rating by a credit rating agency to achieve investor acceptance. In turn, to obtain a satisfactory credit rating, they will generally be supported by a credit enhancement (guarantee) from the issuer's parent company and possibly a stand-by facility provided by a lending or investment institution.

¹⁰ The motivation for repatriating profits this way will have reduced following the FITC regime being extended to direct investors in December 1995.

¹¹ Hedge funds raise their capital mainly from high net worth investors. These investors are more willing to take leveraged and speculative positions.

Table 3:
Portfolio investment components
as at 31 March (\$ millions)

	<u>1993</u>	<u>1994</u>	<u>1995</u>	<u>1996</u>	<u>1997</u>
Portfolio investment in New Zealand	10,236	14,803	16,732	19,405	20,835
Equity securities	2,473	1,451	2,283	1,732	1,426
Debt securities	7,763	13,352	14,448	17,673	19,409
Less portfolio investment abroad	1,564	2,407	2,612	8,078	8,923
Equity securities	1,129	1,482	1,888	6,326	6,952
Debt securities	435	925	724	1,751	1,971
Net international portfolio investment obligations	8,672	12,396	14,120	11,327	11,912

sentiment changes against New Zealand securities as a class, and many overseas investors seek to sell at about the same time, they will drive down the prices of those securities, which has the effect of increasing the yield or percentage rate of return, for those who remain invested. Similarly, if they seek to sell the New Zealand dollar (\$NZ) proceeds realised from selling their \$NZ securities, they will tend to drive down the exchange rate, resulting in their receiving, for example, less \$US for their \$NZ investment. Both factors tend to act to moderate capital flows – although, perhaps not where the circumstances are so adverse that there is an incentive to ‘get out regardless of the cost’. For these sorts of reasons, it is easy to infer too much from the distinction between direct investment and portfolio investment. Also, of course, the 25 percent of voting rights threshold for distinguishing between direct and portfolio investment is essentially arbitrary.¹²

Table 3 details the value of portfolio investment over the last five years. Over this time New Zealand has consistently received more portfolio funds from non-residents than it has invested overseas.

Portfolio equity investment

Portfolio **equity** investment mostly comprises shares held in listed companies. In contrast to direct investors who are usually interested in gaining an ‘effective voice’ in an enterprise, portfolio equity investors generally play no direct role in the affairs of a company.

Over 1993-95 the levels of foreign portfolio equity investment in and by New Zealand were broadly comparable. However, there was a large jump in New Zealand portfolio investment abroad in 1996. This reflects the inclusion of stock data from the Reserve Bank’s Managed Funds Survey as well as the substantial increase in equity values in overseas sharemarkets, at a time when the New Zealand equity market has been relatively subdued.

Portfolio debt securities

Portfolio **debt** securities consist of long-term bills and bonds issued by corporates, SOEs, local authorities, and the government.

In recent years, investment by non-residents in New Zealand government securities has accounted for most of the overseas portfolio investment in New Zealand. From early 1993 to mid 1997, the proportion of New Zealand government securities on issue held by non-residents increased from less than 20 percent (NZ \$3.5 billion) to 60 percent (NZ \$15 billion). More recently, the trend has reversed a little,

¹² Lowering the threshold from 25 percent to 10 percent will further blur the distinction between portfolio and foreign direct investment. See footnote 4.

Table 4:
Other investment components
as at 31 March (\$ millions)

	<u>1993</u>	<u>1994</u>	<u>1995</u>	<u>1996</u>	<u>1997</u>
Other investment in New Zealand	44,726	40,785	39,179	37,485	35,094
Official sector	19,456	17,010	13,663	9,704	5,600
Deposit money banks	291	354	390	449	453
Other sectors	24,979	23,420	25,126	27,333	29,041
Less other investment abroad	3,297	4,978	4,471	6,262	7,259
Official sector	307	432	571	717	858
Deposit money banks	204	285	153	199	728
Other sectors	2,786	4,262	3,748	5,346	5,673
Net other capital investment obligations	41,429	35,807	34,708	31,223	27,835

with non-resident holdings as at April 1998 being NZ \$13 billion (54 percent of total government securities on issue).¹³

Smaller amounts of portfolio debt securities are held in longer-term notes issued by New Zealand corporates.

2.3 Official reserves

Overseas reserves are held by the Treasury and the Reserve Bank.

New Zealand's foreign currency reserves are held essentially to match the remaining balance of the Crown's foreign currency debt and to enable the Reserve Bank to intervene in the foreign exchange market, should circumstances arise where that is considered necessary. In

the latter regard, the policy since 1985, when the New Zealand dollar was floated, has been to intervene in the foreign exchange market only to restore orderly trading in the foreign exchange market should disorderly conditions occur. There has been no intervention in the foreign exchange market since the currency was floated in 1985.

2.4 Other capital investment

The other capital investment category records cross border financial claims and obligations which are not already classified as 'direct investment', 'portfolio investment' or 'reserve assets'. Other financial investments take the form of loans, currency, deposits, short-term bills and bonds, and trade credits.

Table 4 details the other investment components over the last five years.

Official sector

The official government sector comprises the Reserve Bank and central government.

The level of government overseas debt, in the form of foreign borrowings (as distinct from government securities issued in New Zealand), has been trending down in recent years. These borrowings now comprise only those which cannot be re-paid early, at least not without incurring significant penalties. In substance,

¹³ The non-resident government securities data will be distorted where securities are bought or sold in a repurchase contract. When a security is sold subject to a contractual repurchase obligation, the accounting convention is that the seller records the transaction as a borrowing and the buyer as a loan (rather than as the sale and purchase of the security). Thus, the overseas investment in New Zealand will likely be double counted: once as a reported **borrowing** from abroad by the New Zealand institution that sold the security, and secondly as an increase in non-resident **holdings of government securities** (this data being based on who is the actual holder of the security according to Reserve Bank surveys). The converse applies where a New Zealand institution buys a government security from a non-resident in a repurchase agreement. In this case, the New Zealand buyer will report a loan to an overseas party, and the Reserve Bank data will show a reduction in non-resident holdings of government securities.

however, these loans have been repaid. As already mentioned, the Reserve Bank and Treasury's holdings of reserve assets match the remaining overseas borrowings, and are structured to generate the cash flow required to service the debt and provide for repayment on maturity. In this sense New Zealand's foreign borrowing attributable to the official sector is nil in net terms.

The New Zealand government generally does not 'lend' abroad. The data shown for this category mainly comprises future payment obligations in respect of defence assets (ie frigates). Also, for example, any drawings under the loan facility that New Zealand offered to South Korea in December 1997, will likely be recorded here as an official investment.

Deposit money banks

These items comprise banks' nostro and vostro account balances, that is, the accounts that New Zealand banks hold with overseas banks and the accounts that overseas banks hold with New Zealand banks. They are used mainly for settling foreign exchange transactions.

Other sectors

The other sectors consist of the private sector and SOEs. The former include financial institutions, corporates, and producer boards.

Collectively these account for a substantial share of New Zealand's overseas borrowing.

(a) Financial sector lending and borrowing

New Zealand banks do little lending abroad. However, they have been active in raising funds abroad, mostly via short-term loans from their overseas parent, or offshore branches or subsidiaries.

Other principal channels by which New Zealand banks raise funds from non-residents are: raising short-term funds in the international inter-bank money market; the taking of \$NZ deposits in foreign markets; and by way of repurchase agreements (repos) in short-term government securities. Raising funds by selling government securities in a repurchase agreement can be thought of as being equivalent to borrowing, with the government bond (which for the term of the transaction is held by the buyer, or lender) serving as collateral. The accounting convention is for repos to be recorded as a borrowing (by the seller) and a loan (by the buyer).¹⁴

The fact that banks raise funding from abroad through a variety of structures, and with different funding instruments, means that the overall role of the banking sector in intermediating capital flows in and out of the economy is not readily discernible from the IIP data. However, a picture of bank intermediation can be

Table 5:
New Zealand banks' external obligations and claims
as at 31 March (NZ\$ million)

	<u>1993</u>	<u>1994</u>	<u>1995</u>	<u>1996</u>	<u>1997</u>
M3 institutions' external obligations	18,050	19,966	20,296	20,622	24,212
Non-resident NZ dollar funding	10,010	8,542	9,454	11,161	11,897
Non-resident foreign currency funding	8,040	11,424	10,842	9,461	12,315
Less M3 institutions' external claims	1,590	4,204	2,236	2,047	2,774
Non-resident NZ dollar claims	945	3,073	923	1,529	2,562
Non-resident foreign currency claims	645	1,131	1,313	518	212
Net M3 institutions' external obligations	16,460	15,762	18,060	18,575	21,438

Source: Reserve Bank of New Zealand

¹⁴ See footnote 13.

obtained from the Reserve Bank's money and credit aggregates statistical framework, (see table 5). This data shows that some 20 percent of the total gross amount of capital provided to New Zealand from abroad has been intermediated through the New Zealand banking system.

(b) Corporate borrowing and lending

New Zealand corporates too are generally not large scale lenders to overseas enterprises. And such lending that does occur – whether it is short or long term – will generally be classified in the context of a direct investment relationship. This occurs when a New Zealand corporate lends to its overseas subsidiaries.

On the borrowing side of the ledger, New Zealand corporates access overseas debt capital in three principal ways. Firstly, they issue commercial paper and medium-term notes in overseas markets. Where this happens via an overseas subsidiary or branch, the debt will be recorded as direct investment and is not included here (see Section 2.1).

Secondly, some New Zealand corporates borrow from international banks. Where companies resident in New Zealand borrow from overseas banks it will often result from a New Zealand subsidiary of a multinational group raising funds via the relationship that its overseas parent has with its principal overseas bankers. Additionally, sometimes New Zealand banks will 'syndicate' with overseas banks lending that would otherwise give rise to large sectoral exposures (to spread the risk). Where this happens, the share of the funding provided by the overseas bank will be included in the 'other overseas (inward) investment' category.

Thirdly, New Zealand firms involved in exporting and importing will generally give and receive payment terms (just as those in domestic trade do). Trade credit extended by exporters is recorded as an 'other investment' claim, and trade credit received by importers as an 'other investment' liability.

3 New Zealand's external debt

Table 6 replicates the data provided in earlier tables, in a way that enables a link to be made to the external debt data published by Statistics New Zealand, which are shown in table 7. The official external debt is published only on a gross basis, that is, includes only liabilities with no offset for claims on foreigners, and by definition includes only debt (not equity).

Because some of the external debt data is sourced from different surveys from those used by Statistics New Zealand for compiling the IIP, the gross external debt numbers do not correspond exactly with the debt numbers in the IIP. But, as shown from a comparison between tables 6 and 7, the differences are not all that material.

Using the IIP sources, as at 31 March 1997 New Zealand's gross debt obligations were \$77,224 million.¹⁵ The corresponding figure from table 7 is \$75,466 million. (In net terms, New Zealand's overseas debt was \$57,567.) This figure takes into account New Zealand's debt claims on foreigners of \$19,657.

The maturity classification of the debt data in table 7 is compiled according to the time to run (not original maturity) and also, according to the term of the drawing (not the term of the facility under which the drawing has been made). Thus, for example, where banks or corporates have established commercial paper facilities with a term of, say two or three years, under which drawings can be made for, say 90-day terms, those drawings will be mostly recorded in the 2-89 day band.

¹⁵ The gross external debt figure as at 31 March 1998 was released on 17 June 1998 at NZ\$98,998 million. The figure for 31 March 1997 was also revised to NZ\$79,593 million. It is not possible to relate this data to the more comprehensive IIP data as IIP data as at 31 March 1998 is not yet available.

Table 6:
New Zealand's external claims and obligations
as at 31 March (\$ millions)

	<u>1993</u>	<u>1994</u>	<u>1995</u>	<u>1996</u>	<u>1997</u>
New Zealand's obligations to non-residents	92,644	99,789	103,485	114,430	120,205
Direct investment:					
<i>Equity capital</i>	21,244	27,220	31,966	38,745	41,555
<i>Borrowing</i>	16,438	16,981	15,608	18,795	22,721
Portfolio investment:					
<i>Equity capital</i>	2,473	1,451	2,283	1,732	1,426
<i>Borrowing</i>	7,763	13,352	14,448	17,673	19,409
Other investment	44,726	40,785	39,179	37,485	35,094
Less New Zealand's claims on non-residents	28,752	32,452	32,424	44,801	47,886
Direct investment:					
<i>Equity capital</i>	14,123	14,421	15,428	19,047	21,277
<i>Lending</i>	3,597	3,737	3,818	4,666	3,932
Portfolio investment:					
<i>Equity capital</i>	1,129	1,482	1,888	6,326	6,952
<i>Lending</i>	435	925	724	1,751	1,971
Other investment	3,297	4,978	4,471	6,262	7,259
Official reserve assets	6,171	6,909	6,095	6,748	6,495
Net international investment obligations	63,892	67,338	71,060	69,630	72,320

Table 7:
New Zealand's gross external debt

<u>Maturity</u>	<u>1993</u>	<u>1994</u>	<u>1995</u>	<u>1996</u>	<u>1997</u>
Call	6,688	4,972	4,758	6,734	7,215
2-89 days	13,183	19,708	20,126	19,202	22,567
90 days and less than 1 year	9,799	9,881	8,436	10,918	8,100
1-5 years	17,996	16,258	17,011	16,219	15,466
Over 5 years	18,783	19,850	17,180	17,377	20,029
Unallocated estimate	1,850	1,876	1,883	1,943	2,089
Total	68,299	72,545	69,395	72,393	75,466

Source: Statistics New Zealand, overseas debt statistics (31 March 1997)

4 Some concluding observations

The aim of this article has been principally to provide a primer on how the stock of capital that New Zealand has borrowed from abroad, and invested abroad, is recorded, with a particular focus on the channels by which the intermediation has occurred. We have not set out to assess in any depth whether the large net amount of capital that New Zealand has borrowed provides a basis for confidence or is a cause for concern. Rather, we have provided an information framework for those who are interested in that question. Nonetheless, there are a few key points, based on New Zealand's **gross external investment** position as at March 1997, that stand out.

First, about 53 percent of New Zealand's gross external obligations (NZ\$64 billion out of NZ\$120 billion) comprise foreign **direct investment**. If borrowing from overseas (financing) subsidiaries is excluded from direct investment, then the percentage is 44 percent (NZ\$53 billion out of NZ\$120 billion). This investment is generally viewed as long term and as being relatively stable.

Of the balance (NZ\$67 billion), virtually all of which is debt, we estimate that:

- 36 percent (NZ\$24 billion) has been intermediated through the New Zealand banking system;
- 31 percent (NZ\$21 billion) comprises government debt (substantially in the form of non-residents' holdings of government securities issued in New Zealand);
- 33 percent (NZ\$22 billion) comprises funding that has been raised offshore by New Zealand corporations (many of which themselves are overseas owned).

Any qualitative assessment of the stability and soundness of these borrowings necessarily requires one to look at the credit standing and soundness of the institutions that have done the borrowing. That is beyond the scope of this article, although a review of the New Zealand

banking system in 1998 is provided in a separate article in this *Bulletin*.

Approximately half of the total amount of gross debt has a maturity of more than one year, and about a quarter with a maturity with more than five years. Of the shorter-term debt, most has an up to 90 day maturity (suggesting that it may substantially comprise commercial paper).

One aspect of New Zealand's external obligations that this article has not discussed is the currency of denomination of those obligations. This is mainly because the currency in which an obligation is denominated often will not reflect the currency to which the borrower is exposed. Also in the case of borrowing abroad by the New Zealand government (which in net terms now comprises only domestically issued government securities) the entire exposure is denominated in New Zealand dollars. Additionally, banks' disclosure statements show that New Zealand banks have very substantially hedged their balance sheets against exchange rate risk.

The available evidence also suggests that those corporates that have borrowed abroad in foreign currencies have either hedged the obligations into New Zealand dollars, or have 'natural hedges' (eg an exporter, with a revenue stream in foreign currency). This is not something on which we have quantitative data. Rather, the evidence comes from the fact that during the 1990s the exchange value of the \$NZ has moved through a 30 percent cycle in trade-weighted-index terms (initially upwards and more recently downwards), with little direct effect on the balance sheets of New Zealand institutions and corporates from exchange rate movements. This is consistent with market reports that corporates have generally hedged their foreign currency borrowings either in the currency derivatives markets, or by way of 'natural hedges' (from having export receipts in the currency in which they have borrowed).

Two more general points should also be borne in mind. First, the New Zealand financial system and capital markets nowadays are highly

integrated with international capital markets. In some respects, the capital market is these days borderless: those wishing to raise capital, or to invest capital, are not constrained to the New Zealand market, or to using New Zealand based institutions. This is highlighted by the development of the Eurokiwi market – an offshore market for borrowing and lending in New Zealand dollars – which is discussed in a separate article in this *Bulletin*.

Second, as has been underscored by developments in East Asia, maintenance of financial stability turns importantly on the ‘quality’ of the capital flows as well on the ‘quantities’. This brings the spotlight on to, amongst other things, the robustness of the commercial and financial entities through which capital is intermediated, and which provide the underpinnings for confidence in the capital markets. To be sure, large scale capital flows are often associated with low quality lending and investment – and in this sense quantitative and qualitative indicators of financial instability will often tell the same story. But equally, large scale capital flows can reflect solid fundamentals that are attracting capital.

So, it is necessary to go behind the aggregate numbers to develop a good sense of the extent to which high levels of external investment in, and borrowing by, an economy provide a basis for confidence, or create a cause for concern. This article, and companion contributions in this *Bulletin* which review developments in the New Zealand banking system, has aimed to provide a starting point for doing that.

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