THE IMPORTANCE OF INTERNATIONAL FINANCE TO NEW ZEALAND IN THE 1980'S

This article is based on an address given by Mr R. W. R. White, Governor, Reserve Bank of New Zealand to the Wellington Branch of the N.Z. Society of Accountants on 27 March, 1980.

New Zealand's need to raise money overseas arises in part from structural current account deficits which have their origins in the events of the 1970's and in part from the increase in import payments which will result from the large development projects scheduled for later in the 1980's. The threshold of a new decade, with its tradition of being the occasion for the assessment of past performance as well as for the survey of future prospects, is therefore an appropriate time to examine the international financial system as it affects New Zealand.

STRUCTURAL FOREIGN EXCHANGE CURRENT ACCOUNT DEFICIT

The term structural is used in describing the current account deficit because long standing patterns of production and spending have to be changed before our foreign exchange receipts and payments can be brought reasonably near to balance.

Although the remedy for the deficits lies in a structural change which will take time to affect the balance of payments, the causes were much more immediate in their impact. As always, the causes were many and varied but can be summarised by the statement that as a nation we have not been prepared to reduce our spending, including spending on both consumption and investment, to match the reduction in our real incomes which occurred when the price of oil was increased in 1973/74. Unfortunately, neither were we prepared to increase production from our own resources to make up for this loss of income.

Fiscal policy, monetary policy and, at times, incomes policy have been used to reduce people's ability to live up to their over-optimistic expectations about consumption and investment spending. This is evidenced by the small growth in economic activity in real terms over the last four years. Nevertheless, the foreign exchange deficits have continued albeit at a diminishing rate. This is shown by the following figures.

Year Ended March	*O.E.T. Current Account Deficit ($m)*	*Current Account Deficit as Percentage of Estimated G.N.P.*
1975	992.6	9.9
1976	814.5	7.1
1977.	590.5	4.3
1978	509.5	3.4
1979	426.4	2.5
1980	481.8	2.4

Success cannot be claimed notwithstanding the improvement in the foreign exchange position. The restraint of demand dictated by the balance of payments has generated a lack-luctre economy which cannot be tolerated for long. Therefore, means must be found to change the ratio of exports to imports so that growth can be resumed without a further deterioration of the balance of payments. To achieve this change we must undertake additional investment in export and import substitution industries; investment which often take some time to come to fruition. The policies, in the form of flexible exchange rates, meat and wool minimum price guarantees and revised export incentives, have been put in place to encourage this investment and the recent performance of farmers and manufacturers suggests that they are responding. However, the further hike in the price of oil which we have just suffered will generate a reversal of the more favourable trend in the foreign exchange deficit we might have expected from the restructuring policies. Thus the deficit of $482 million for the year ended March 1980 is likely to deteriorate by another two to three hundred million dollars in 1980.

The financing of the current account deficit has been the main reason for official overseas borrowing in recent years. Regrettably, because of the relatively long lags before the New Zealand economy responds to policies aimed at improving the ratio of exports to imports and because of the probability that import prices will climb more quickly than export prices in the near future, we will continue to have occasion to borrow overseas for balance of payments purposes in the next year or two at least.

FINANCING OF LARGE SCALE DEVELOPMENT PROJECTS

Further into the 1980's the development of projects to be based on Maui gas and other major undertakings will add to our import bill and the need for overseas funds. The New Zealand Planning Council's report 'Implications of New Energy Developments' (1) estimated that projects associated with the reduction of our dependence on imported fuels to about half the country's requirements by 1989 would need overseas expenditure of about $773 million. An alternative strategy providing for about 80 per cent of the country's fuel requirements by the same date would involve overseas expenditure of about $2,222 million. These projects are expected to be net savers of foreign exchange over their economic life-time but this net benefit will not be very apparent until well into the 1980's and the full impact will not be felt until the 1990's.

The need to arrange overseas finance for these projects does not arise entirely because of the foreign exchange cost of imports. The capital required is of such magnitude that the direction of this demand for funds to the small New Zealand capital market would be severely distorting. Recourse to overseas markets to finance very large projects is therefore almost inevitable quite apart from the balance of payments aspects.

OTHER PRIVATE CAPITAL INFLOWS

New Zealand businesses have borrowed quite substantial amounts in overseas capital markets in some years in the recent past in order to assist their New Zealand funds position. In addition, overseas investors taking a direct interest in New Zealand companies sometimes remit cash into the country in order to acquire an equity holding. To the extent that the private sector, in this instance including the statutory corporations, raise money overseas either by borowing or by way of equity participation in New Zealand enterprises, the need for the Government to borrow or to reduce the official reserves in order to cover a current account deficit and capital repayments is reduced. This is illustrated by the Reserve Bank statistics of overseas exchange transactions for the five years to March 1979.

	$ Million
Cumulative Foreign Exchange Current Account Deficit (April 1974 — March 1979)	3,333.5
Financed by(1):—	
Net Government Borrowing	1,525.0
Net Other Official Borrowing	240.1
Net Private Capital Inflow	842.0
Net Funding from the IMF	376.3
Reserves valuation adjustment, etc	383.6
	3,367.0
Change in reserves	33.5

(1) All expressed net of repayments

CONSTRAINTS ON NEW ZEALAND BORROWING OVERSEAS

The increase in our overseas debt in one form or another has been substantial during recent years and the question is sometimes asked as to how long the country can continue to borrow at this rate. This question has two elements. First, how long will overseas investors continue to lend to us and, secondly, can we afford to commit an increasing percentage of our future export income to the meeting of overseas debt servicing costs to the detriment of the production and consumption standards of New Zealanders at that time.

New Zealand's credit rating with overseas investors is undoubtedly high in relation to that of other borrowers in the market. Factors involved in this are:—

(i) Our relatively late entry into the international capital market with the consequence that we had only $1,081 million of official overseas debt outstanding on 1st April 1975. Thus, even now, the amount of New Zealand debt in the portfolios of large international investors is relatively small.

(ii) Interest on our official overseas debt as a percentage of annual foreign exchange income from current transactions (4.9 percent in calendar year 1979) is not high by international standards.

(iii) Our reputation for political stability.

(iv) Our reputation as a people who will honour their debts.

(v) The fact that, in the last few years at any rate, demand management and exchange rate policies have been of the kind to achieve ultimately a structural shift which will reduce the borrowing requirement.

(vi) Our newly recognised riches in the field of energy resources.

There is little doubt that we will continue to be able to raise money on overseas markets.

The answer to the second question about the degree to which we should mortgage the future is not so easy. The borrowings could be said to be justified if they enable policies to be followed — both in the Government and private sectors — which result in increases in production of sufficient amount to enable the debt to be serviced while leaving New Zealanders at that time no worse off than they would have been had the borrowing not taken place. No one will ever know whether or not this criterion has been met so the policy must be to keep the debt servicing cost down to a level which will never be a serious constraint on future production and at the same time to increase the productivity of labour and capital by every available means.

The foreign exchange statistics show that we are already remitting about $300 million each year to pay the interest on Government overseas debt while just over another $200 million is absorbed in the payment of interest, profits and dividends due to non-residents on account of equity and loan investments with the New Zealand private sector. In addition, maturing debt will have to be refinanced. It should be borne in mind that part of the maturing debt can be refinanced without an approach to the capital market being involved but the fact remains that the servicing costs of debt incurred to pay for past imports of goods and services is already a constraint on our current ability to import and, therefore, on our ability to expand production and consumption.

Further borrowing is inevitable in the short term but it is clear that we should reduce the amount we have to borrow for normal balance of payments reasons as quickly as possible. Further curtailment of demand would be one way of achieving a reduction in the deficit but, in view of the present state of employment and business activity, few people would want to see this happen unless all else fails. The other answer, in fact the only satisfactory answer, is to increase production by New Zealanders using New Zealand resources and at the same time achieve the necessary change in the export-import ratio. Finding a way to achieve the first part of this solution, difficult though it may be, becomes more important day by day.

GLOBAL DEMAND FOR FOREIGN FINANCING

Turning now to the international environment within which New Zealand will be competing to satisfy its needs for capital, the price of oil has more than doubled since the beginning of 1979, causing a dramatic change in the global pattern of current account imbalances. After being in near balance in 1978 the current account surplus of OPEC countries has been estimated to rise to perhaps US$110 billion in 1980.(2) The inevitable counterpart to this is that there will be a huge rise in the current account deficits of other countries. After being in net surplus in 1978 the current account deficits of OECD members are expected to be about US$60 billion in 1980 while the combined deficit of the non-oil exporting developing countries may rise to US$50 billion.

Although it is difficult to look too far ahead, the OPEC surplus may not decline as quickly in the next few years as it did after the first oil crisis in 1973/74. Oil producers are more aware of the effects of inflation on their oil revenues and the Iranian revolution has shown the sensitivity of the oil price to small changes in supply. Currency instability has caused oil exporters to consider alternatives to expressing the price of oil in terms of the US dollar and to consider the idea of denominating the price in terms of a unit of account based on a basket of major currencies. These developments suggest that the real price of oil will be maintained in future years.

Thus it is likely that continuing surpluses by oil exporting countries will place great strains on the international monetary system. The difficulty which some deficit countries are likely to experience in borrowing the very large amounts involved and undertaking the commitment to service these loans is likely to inhibit growth and lower the demand for internationally traded goods.

STRUCTURE OF THE INTERNATIONAL CAPITAL MARKET

The private sector of the international market must meet the bulk of expanding international financing needs for there is no other source for the magnitude of money which will be required. In effect this means substantial reliance on the Euromarkets which are the major source of international finance.

Eurocurrency markets have arisen out of the operations of international commercial banks. A Eurodollar deposit is a deposit denominated in US dollars with a bank operating outside the United States, including foreign branches of United States banks. Similarly, other Eurocurrencies are created by deposits of deutschmarks, yen, sterling, Swiss francs and other currencies with banks outside the country issuing the currency. Corresponding to these liabilities, Eurocurrency loans, or credits as they are called, are advanced by banks out of currencies held by them outside the country of their issue. The attraction of these deposits and credits is that they are not subject to many of the legal controls and restrictions which would apply to them if they were made in national financial markets. The term Euromarkets is used loosely in a geographical sense as it includes financial centres in the United States, the Caribbean and elsewhere. The Asian dollar market, based in Singapore, operates with the US dollar on the same lines as the Eurodollar market. Eurodeposits are usually short term — one year or less — whereas Eurocurrency credits are generally medium term with most having maturities betwen five and ten years. Because of this discrepancy in maturity, credits have a variable interest rate which is normally tied to the short term rates quoted on the London market. Credits are made at a spread or margin over the London interbank offered rate or 'libor' as it is usually called.

It is difficult to determine the size of the Eurocurrency market. The Bank for International Settlements compiles the most comprehensive statistics available and these show that at the end of September 1979 the gross external liabilities of international banks reporting to it were US$1,035 billion. Gross external assets were US$1,042 billion.(3) After eliminating double counting resulting from interbank deposits, credit outstanding to final borrowers was probably in excess of US$500 billion. To place this amount in perspective, total credit outstanding from the International Monetary Fund at that time was only US$10.5 billion.(4) The total volume of syndicated Euro-credits made during 1979 was US$77 billion.(5)

It has also been estimated that the US dollar comprises 80 per cent of the total size of the Eurocurrency market. This is a major contributing factor to currency instability as at times 'unwilling' dollar holders have endeavoured to diversify their assets, i.e., they have tried to sell dollars in exchange for other currencies and, perhaps, gold.

Quite distinct from the Eurocurrency operations of the international banks is the Eurobond market. A Eurobond is one sold outside the country in whose currency the bond is denominated. In this market borrowers can raise funds directly from investors without the intermediation of banks by issuing medium or long term negotiable bonds with a fixed rate of interest. Because of the direct reliance by the investor on the creditworthiness of the issuer of a bond, this market is only open to prime borrowers. Variable interest rate bonds, known as Floating Rate Notes, which have grown in significance recently, are usually issued by banks to fund Eurocurrency credits. The total volume of Eurobonds registered in 1979 was slightly over US$18 billion.(6) Foreign bonds are those issued in domestic bond markets to non-residents of the country. In 1978 the sale of foreign bonds provided US$20.2 billion in new funds to international borrowers.

These markets have been of major significance to New Zealand. In the period 1975 to the first half of 1979 inclusive, publicised loans to New Zealand borrowers had a cumulative total of US$3.69 billion.(7) Thirty-six per cent of this amount was in the form of Eurocurrency credits, another 36 per cent was raised in the Eurobond market and the remaining 28 per cent came from the sale of foreign bonds.

FINANCING PROBLEMS IN THE 1980's

An important question for the 1980's is whether or not these markets can continue to cope with the financing demands which will be made upon them. The Eurocurrency markets have a demonstrated ability to attract funds from all over the world by offering attractive interest rates and this is likely to remain the case. Indications are that growing OPEC surpluses during the past year have already resulted in an increased flow of funds from these countries to the market either directly or indirectly through trustee accounts.(8) However, doubts are likely to arise over the capacity of the commercial banks to recycle OPEC funds as successfully as they did in the years following the 1973/74 oil crises.

One problem is the declining capital to loan ratios of international banks. Their capital base has not kept pace with the growth in their balance sheets and in some cases may not be adequate to support a large increase in their deposits and lending. This is particularly true of US banks. The capital to assets ratio of the nine United States banks with most international business deteriorated to 3.9 per cent by mid 1979 from 4.3 per cent in 1976.(9)

Another factor which may inhibit the growth of commercial bank lending is their growing perception of risk. The Iranian revolution and the invasion of Afghanistan have reminded them of the political risks of their lending. They are concerned also with the level of the indebtedness of some of the less developed countries commonly referred to as the LDC's. Regulatory authorities are concerned with the risk exposure of banks to particular countries. Lending to LDC's has tended to be concentrated amongst relatively few countries making a prudent spreading of country risk difficult for the banks to achieve. The growth of lending to LDC's by United States banks has already slowed but, so far, this has been compensated for by more aggressive lending by the banks of other countries.(10) However, in 1980 and beyond, there may possibly be an increasing reluctance to lend to LDC countries to whom a high level of lending has already been undertaken. The banks will probably prefer that these countries make greater use of the other sources of deficit financing available to them. This preference is likely to be expressed by higher spreads, shorter maturities and greater selectivity by lenders.

The prospects of a greater role for international bond markets in global financing do not appear good, at least in the short term. Since 1976 the bond markets have declined in relative significance compared to syndicated loans in the Eurocurrency market.(11) The longer term fixed interest rate nature of the bond markets makes them much more sensitive than the banking markets to interest rate and exchange rate developments and expectations. Their share of international borrowing is unlikely to increase until a lasting confidence in existing foreign exchange relationships returns to the market. While the trend of inflation and interest rates is upwards, investors will remain wary of fixed interest securities.

An increase in the role of the international financial agencies, primarily that of the World Bank and the International Monetary Fund, seems inevitable in these circumstances.

Members of the World Bank have recently agreed on a doubling of capital subscriptions which will enable real increases in lending to continue during the 1980's. The Bank's lending is confined to the less developed countries and disbursements on loans amounted to US$4.8 billion in the year to June 1979.(12)

THE ROLE OF THE IMF

The IMF may play a much greater role in external financing in the 1980's than has been the case in the recent past. It is now in a position to extend a much larger volume of credit and for a longer time than was the case in the early 1970's. The scope for drawings will be greatly increased by a 50 per cent increase in quotas which has been agreed upon and is currently awaiting ratification. As members pay in their quota increases, in effect subscribe extra capital, the usuable resources of the Fund will increase. Resources are available to members with a balance of payments need for terms of up to eight years. Substantial drawings are conditional upon agreement with the Fund on an economic programme to bring about adjustment to the external difficulties. During the 1970's this conditionality, together with easy access to international commercial bank credit, resulted in most LDC's avoiding heavy reliance on the Fund. Some countries came to the Fund only after their creditworthiness was exhausted and they were in a precarious financial position. In the 1980's higher deficits of LDC's harsher terms in international credit markets and the increased resources of the Fund, may make it a more attractive source of financing. Co-financing arrangements between commercial banks and the IMF may be desirable to encourage banks to maintain lending beyond their country limits and to make governments more willing to accept Fund conditionality.

As well as its capacity for intermediation the IMF has a stabilisation role to play within the international monetary system. The establishment by the IMF of Special Drawing Rights (SDR's) has provided an international reserve asset and unit of account which is not dependent for its value on the economy of any one country. At times when an increase in international liquidity is deemed necessary, SDR's can be allocated directly to member countries to supplement their reserve assets. Total allocations made to date are equivalent to US$23.4 billion, of which New Zealand has received US$158 million. A further US$5.4 billion of SDR's will be allocated on 1st January 1981. By avoiding the instability of individual currencies, the SDR has attracted some use in private contracts as a unit of account. SDR denominated currency deposits are now accepted by the bank for International Settlements and several of the major commercial banks. In addition, bonds denominated in SDR's have been issued in the capital market.

To diminish pressures in the international currency markets and to enhance the role of the SDR as an alternative to the US dollar as an international reserve asset, the IMF is considering the establishment of a Substitution Account which would accept deposits of US dollars in exchange for claims on the Account denominated SDR's. At this stage it is invisaged that the US dollars received would be invested in United States government securities. The purpose of the Account is to provide a means for central banks to diversify their reserve holdings without causing the disruption to foreign exchange markets which occurs when people switch from one national currency to another. Some switching away from the US dollar has occurred since the resurgence of United States inflation, and instability of the dollar against other currencies has made it less attractive as a reserve asset. Another factor is a political one and is illustrated by the freezing on 14th November of official Iranian assets held in the United States or with the subsidiaries of United States banks in other countries. This was an unfortunate use of the international monetary system as a weapon for international political action.

The Substitution Account, if it eventuates, could provide an apolitical haven for central bank funds. Moreover, claims on the Substitution Account, if backed by the combined credit of member countries and if denominated in SDR's in order to reduce the risk of exchange losses, might compete successfully with gold and other real assets as an investment medium for surplus countries. It may thus have a role to play in avoiding the realisation of the very real fear that oil producers may see oil in the ground as a better investment than an increasing supply of a weakening US dollar. Unfortunately, it will be at least another two years before a Substitution Account is a reality.

CONCLUSION

New Zealand has a good standing in the world's capital markets, a standing which is confirmed by our formal credit rating and by the very competitive rates at which we can borrow. As with other borrowers, New Zealand will be affected by a tightening of terms but it is likely that, provided we operate our economy in a reasonable manner, we shall continue to have reasonable access to all branches of the overseas capital markets. Such access is essential if we are to gain time to enable us to match our production to our spending and to shift the export to import ratio still further towards exports. If we make these adjustments in good time we should have little difficulty in raising funds overseas to develop our natural resources.

REFERENCES

(1) *'Implications of New Energy Developments'* A report for the Minister of National Development and the New Zealand Planning Council, NZPC No. 13, October 1979, p.10.

(2) Statement by the United States Under-Secretary of the Treasury for Monetary Affairs, Anthony M. Solomon, before a sub-committee of the Committee on Banking, Finance and Urban Affairs of the House of Representatives on 4th February 1980. Reproduced as IMF document EBD/80/32.

(3) Reported in the *Financial Times*, 23rd February 1980, p.19.

(4) *International Financial Statistics*, December 1979, p.24.

(5) *BIS Press Reveiw*, No. 2, 3rd January 1980, P.4.

(6) See Reference (5).

(7) *Borrowing in International Capital Markets, Second Quarter 1979,* World Bank, October 1979, p.25.

(8) *Amex Bank Review*, Vol. 7, No. 1, 28th January 1980, p.2.

(9) *BIS Press Review*, No. 22, 31st January 1980, p.3. Remarks by Professor Henry Wallich at Conference in New York on Approaches to Managing Country Risk.

(10) See Reference (9).

(11) *Financial Times*, 18th February 1980, 'Euromarkets' Supplement, p.1. (graph).

(12) *World Bank Annual Report 1979.*