EXTERNAL DEBT ISSUES

How and why an economy builds up external debt; what determines the sustainability of overseas borrowing; and the relevance of whether the government or the private sector does the borrowing, are among the issues discussed in this article.

Introduction

New Zealand's gross overseas debt has grown rapidly since the early 1970s, both in absolute terms and relative to the size of the economy. Total reported overseas debt amounted to \$650 million or 9.5 per cent of GDP at the end of March 1972, but had risen to \$32,900 million (70 per cent of GDP) by the end of December 1986. There has not only been a rapid increase in reported overseas debt, but also a marked shift in the composition of that debt, with the official (government and Reserve Bank) component falling from almost 100 per cent to under two thirds of the total in that time.

In an open economy such as New Zealand, the level and composition of overseas debt are important economic indicators. However, the purpose of this article is not to focus on these statistics, or to undertake a detailed explanation of the specific factors underlying the debt accumulation process in this country.[1] Rather, the principal focus is on the broad conceptual issues that are relevant to an assessment and interpretation of the significance of New Zealand's overseas debt position.

The first section of the paper outlines in general theoretical terms how and why overseas debt is accumulated. The next section provides a qualified rationale for the accumulation of overseas debt. The paper then goes on to summarise the basic conditions required if debt servicing difficulties are to be avoided, and discusses debt indicators and how these should be interpreted. It concludes by applying this framework to New Zealand.

Conceptual Framework

The process which underpins the accumulation of overseas debt is quite simple. In a closed economy (one where there is no trade with the rest of the world) external imbalances cannot, by definition, occur. Individual households, firms or the government can spend more than they earn by borrowing from one of the other sectors, but in aggregate, domestic income must equal expenditure. In an open economy, though, this equality need not hold. Domestic expenditure can exceed domestic income and, when this occurs, a country's external current account will move into deficit. In order to finance that deficit, residents (including the government) must either borrow overseas or draw down overseas assets. The imbalance between domestic income and expenditure therefore appears as a current account imbalance, which must be equivalent to the change in a country's net stock of overseas debt (its overseas liabilities less any overseas assets). The level of net overseas debt is then simply the sum of all prior current account imbalances (adjusted for exchange rate revaluations).

Another way to present the process involved is by highlighting the link between domestic savings and investment, and the overseas current account outcome. When a country records a current account deficit it is 'dissaving', i.e. borrowing overseas or running down existing overseas assets to finance the excess of expenditure over income. This imbalance (i.e. the current account deficit) can be expressed as the difference between private sector investment and savings, plus the fiscal deficit. In order to prevent a persistent current account deficit from causing overseas debt to rise at an unsustainable rate, a country must therefore limit the shortfall of domestic savings relative to the level of investment and the fiscal deficit. If the level of investment is desired to be maintained, then domestic savings must rise and/or the fiscal deficit must fall.

The Rationale for Incurring Overseas Debt

Although a persistently large current account deficit implies a significant domestic income/expenditure imbalance, it does not necessarily follow that this outcome is inappropriate or that there are deficiencies in domestic economic policies. There are a range of circumstances in which it may be appropriate for a country to operate a current account deficit.

Firstly, short term external borrowing has a natural place in an open economy. Overseas borrowing (and its counterpart, the current account deficit) enables the level of domestic expenditure and activity to be stabilised in the face of transient adverse changes in income. These changes may follow from domestic developments (such as a temporary fall in agricultural production) or external influences like seasonal variations in export receipts. Access to foreign funds allows these transient income disturbances to be absorbed, thus limiting fluctuations in domestic expenditure and the associated distortionary or destabilising effects that this can have on resource allocation and economic growth. Current account deficits arising from this source should of course be offset by current account surpluses arising from temporary increases in national income relative to national expenditure, unless an ongoing accumulation of debt is warranted for other reasons.

Secondly, a more prolonged period of current account deficits may result when an economy experiences a permanent adverse shift in its ability to generate income. This may occur for instance as a result of the loss of domestic productive potential, a lasting decline in the terms of trade, or the loss of access to key markets. It is essential that structural economic changes occur in response. Overseas borrowing provides a means by which the adjustment

(1) These factors have been covered in some detail in two earlier articles in the *Bulletin* (in August 1980 and March 1983). See also the New Zealand Planning Council's 1983 publication *Foreign Exchange Constraints*, 'Export Growth and Overseas Debt'.

process can occur at a more orderly pace, without the abrupt and possibly large falls in domestic economic activity which would otherwise follow. The use of foreign funds allows the cost of the permanent 'shock' to be spread out over time, while prices adjust and resources are reallocated as required in the altered economic environment. As overseas borrowing also imposes real costs, the use of foreigners' savings does not represent a sustainable way of avoiding adjustment to permanent adverse shifts in growth potential.

A third broad possibility is that a capital inflow and associated current account deficit are generated by a large increase in desired domestic investment. Such an increase, which may be in response to a change in underlying economic conditions (or in the policy framework) which increases the availability of profitable investment opportunities, may not be capable of being financed from domestic savings alone without substantially depressing domestic consumption. Foreign funds provide the necessary supplement to domestic savings to make possible an increase in capital formation. They allow the full potential for growth in the domestic economy to be realised, and while this process is underway, a persistent current account deficit may be recorded.

Rising overseas debt may therefore be fully consistent with sound economic management, but overseas debt must be managed with care if the servicing flows are not to pose future problems for the economy and economic policy.

In general, for a particular rate of debt accumulation to be 'sustainable' the economy must expand at a rate sufficient to provide both the funds needed to service the external debt and the investment funds necessary to sustain the growth process. In other words, the economy's ability to earn foreign exchange (by raising the rate of growth in exports and/or reducing dependence on imports) must improve over the medium term in line with the increase in overseas debt.

This implies that as domestic income grows, aggregate domestic saving at some point will need to exceed domestic investment by an amount sufficient to meet the interest payments on external debt. In other words, the rate of growth in domestic consumption expenditure (including government consumption expenditure) in the long term must be constrained to a level that ensures sufficient domestic savings are generated to fund both domestic investment and service the debt. Clearly, the more rapidly the economy is growing, the less severe these constraints will be.

Debt Indicators

The previous sections have provided an economic perspective on debt accumulation, but the question of how much debt is appropriate or sustainable in a particular case is difficult to answer in practical terms. A starting point is provided by an examination of external debt indicators.

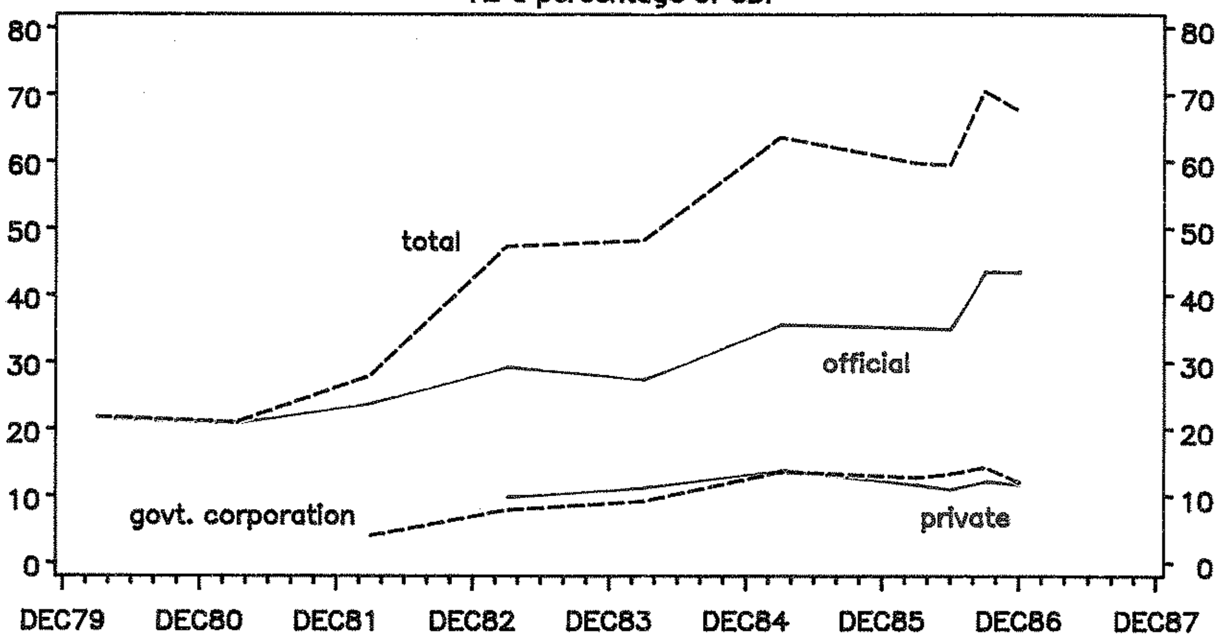
Although a range of statistical indicators have been formulated, for many countries (including New Zealand) sufficiently detailed and comprehensive statistics are often not available on a timely basis to provide a fully satisfactory basis for assessment. In practice, attention is usually confined to a limited range of indicators.

Ratios of *external debt to GDP* and *external debt to exports* provide a measure of the magnitude of overseas indebtedness, relative to the size of the economy and trade flows respectively. External debt as a proportion of export receipts measures the 'liquidity' dimension of the debt or debt servicing burden, since it essentially indicates the relative size of the foreign exchange earnings available in relation to the external debt to be serviced or repaid. The ratio of debt to the overall size of the economy (GDP) provides some indication of the 'sustainability' of the debt (i.e. of the medium to long term significance of debt and debt servicing), which is determined by the overall ability of the economy to generate income. However, as the issue of sustainability is more directly related to the size of the real debt servicing burden relative to the growth rate of the economy, the debt to GDP ratio must be supplemented with other information. In the short run, moreover, these ratios may vary considerably, making them an even less satisfactory basis for making inter-country comparisons.

The *debt service ratio* (defined as interest plus principal repayments as a proportion of goods and services export receipts) is another important statistic. It indicates (usually on an annual basis) how much of a country's export receipts would be absorbed by debt service payments, and is therefore a measure of the 'debt burden' in relation to the country's current foreign currency earning capacity. It can be regarded as a liquidity measure similar to cash flow indicators for a firm — a debtor's ability to cover debt servicing obligations declines as the ratio increases. Although widely quoted, this indicator obscures an important practical point. Debt service obligations rarely have to be met entirely from export earnings. In normal circumstances a large proportion of scheduled principal repayments is rolled over — i.e. covered by new gross foreign borrowing. Provided that the rate of return on new investment exceeds the cost of borrowed funds (and the other conditions outlined above are met), refinancing may make economic and commercial sense. In these circumstances, another key indicator, the *ratio of interest payments to export receipts* provides a more useful measure of the debt burden. However, where a country's debt ratios approach a point at which overseas investor confidence begins to wane, the more conservative debt service ratio gives better insight into its ability to weather a period when rollover of maturing debt may not be possible.

In assessing what is an appropriate debt level, it is important to retain a primary focus on basic debt and debt servicing statistics. The indicators above highlight the key conditions which must hold over time if the debt

Figure 1
Gross External Debt
As a percentage of GDP



is to be sustainable. For instance, external debt cannot consistently grow more rapidly than GDP without obvious implications for the ability of the economy to shift resources into the tradeable goods sector and thus continue to service that debt. Similarly, a sustained increase in the ratio of debt servicing payments to exports will inevitably bring 'liquidity' problems. In this case, the economy will experience increased difficulty in generating foreign exchange to meet debt servicing commitments while also maintaining economic growth.

Although the financial flows associated with current account deficits and debt servicing may be manageable or sustainable from an analysis of the various indicators, it is also important to monitor access to international capital markets. A sustained large scale financing requirement can, over a period of years, run counter to overseas lenders' portfolio considerations. Even though the overseas lenders remain confident that the domestic authorities are responding effectively to an external imbalance, they may be unwilling to continue increasing their exposure to the country concerned at the rate implied by trends in the current account deficit. Ultimately there is a limit to investors' willingness to absorb financial claims against any one country. In the medium to long term the debt profile may be sustainable but, from a more practical standpoint, in the short term, the magnitude of the required financial inflow must be consistent with current and prospective conditions in international capital markets.

Debt sustainability is thus ultimately determined by two factors — the ability of an economy to generate the additional income needed to service its debt, and a willingness by foreign creditors to maintain the level of credit extended. Creditors are concerned not only with solvency or the current position of the domestic economy and its ability to meet its debt servicing commitments, but also with the degree of risk perceived to be attached to investment in that country. The recent experience of some developing countries has been that debt crises need not involve debt levels reaching critical points, but can turn upon short term liquidity problems. Without consistent credible economic policies, these difficulties can be taken to foreshadow a more permanent underlying problem, and thus spark a sharp contraction in capital availability or withdrawal of credit previously extended.

Relevant indicators of the perception of international capital markets of the risk of lending to a country are the credit ratings used by most creditors as guides to country risk, and the rates of interest charged on loans or sought on investments denominated in the debtor country's currency. Again, neither of these indicators are perfect. For example, although worsening perceptions of risk will tend to show up in the interest rate margins (relative to a normal international interest rate) facing borrowers from debtor countries, at some point interest rates may become meaningless as creditors refuse to extend further credit, no matter what the interest rate offered.

In summary, there is no clear relationship between basic measures of the relative size or burden of overseas debt and the sustainability of that debt position. Relatively high debt servicing and related ratios can and have been managed successfully, while conversely some countries have found that even moderate ratios are no guarantee that serious difficulties will not be encountered. A 'rule of thumb' approach often used is that a debt service ratio below 10 per cent should pose no difficulties but a ratio above 20 per cent can be potentially problematic. The IMF notes, however, that many countries have had debt servicing ratios of between 20 per cent and 70 per cent without encountering debt servicing difficulties or losing access to international capital markets, while there have been other countries with ratios of well below 20 per cent which have had to reschedule their external debt obligations. What matters most is how well the funds have been used, not simply how large the capital flows have been in absolute or relative terms.

This implies that a broader perspective than just focussing on simple ratios is needed when examining the issue of sustainability. The indicators above must be placed in perspective against the broad features of a country's economic structure and the nature of its external linkages. These include the extent to which exports and export markets are diversified, historical and prospective trends in export prices and the terms of trade, the nature of its links with international financial markets, and the general stance of economic policies.

New Zealand's Overseas Debt

Before applying the foregoing discussion to New Zealand's debt position, some comments on definitions and data availability need to be made.

The definition of overseas debt adopted by international agencies such as the International Monetary Fund and the World Bank is that overseas debt includes all liabilities of residents to nonresidents for which there is a contractual obligation to repay (i.e. there is a distinction drawn between liabilities to nonresidents and overseas debt). The principal implication of this is that direct investment inflows (for instance the purchase of shares in domestic institutions or of real assets by nonresidents) are excluded. This, in turn, means that a current account deficit can be financed by a net direct investment inflow, without an increase in net overseas debt.

In terms of the above criteria, the data available on New Zealand's overseas debt is incomplete in some important respects. In particular, no data is available on short term overseas debt (defined as debt with a maturity of less than one year). Although in the past most of this debt would have been the counterpart to trade flows, and therefore repaid as transactions were completed or cyclical changes in trade receipts were reversed, this is no longer necessarily the case. Although some details can be inferred from international bank lending statistics, there are considerable gaps in the coverage, and it is questionable as to whether this data presents a sufficiently accurate indication to be of any analytical usefulness.

As noted earlier, the net overseas debt position (i.e. overseas liabilities less overseas assets) may be of more relevance for the economy and economic policy than the gross debt position. Changes in gross official overseas debt may reflect only changes in official foreign reserves. Similarly, a change in gross private overseas debt by itself may be of little economic significance, if it is the product of portfolio shifts which see an offsetting rise in overseas assets. In either case, net debt may remain unchanged while gross debt increases.

The issue of the categories of assets (public or private sector, financial assets or direct investment) to be included in deriving a country's net overseas debt position remains one for debate. From a medium term perspective, since real assets can be utilised to service external debt if the need arises, a broad based measure may be most appropriate. On the practical grounds that private sector overseas assets may be difficult to mobilise (or indeed identify) in the event of debt servicing difficulties, a more restrictive measure may be necessary. One approach adopted by the International Monetary Fund is to include only official overseas reserves and the overseas assets of domestic financial institutions in the definition of external assets. This approach is not necessarily the most appropriate for New Zealand, but more comprehensive reliable data on residents' holdings of overseas assets is not as yet available.

Table 1 sets out the available data on New Zealand's gross external debt. As outlined in the introduction to this paper, in gross terms, overseas debt has risen rapidly since the early 1970s. The factors which have underpinned this process are well known, and will not be dealt with in detail here. In brief, much of the debt in the mid to late 1970s was incurred to support domestic economic activity in the wake of the first oil shock, while in the early 1980s an expanded borrowing programme was undertaken in relation to several large scale (import substituting) energy related projects. Over the period as a whole, however, only limited progress was made in achieving the basic structural economic adjustments needed for balance of payments equilibrium.

Recognition of the need for more rapid economic adjustment has been a key factor in shaping the economic policy framework in New Zealand in recent years. Despite marked changes in policies and some substantial structural shifts in the economy over recent years, though, there has not (until very recently) been the improvement in the current account imbalance and the slowing in the rate of accumulation in overseas debt that was initially looked for. The lack of detailed, comprehensive data on balance of payments capital account transactions means that it is not possible to draw any firm conclusions as to what specific factors have been at work, but the discussion in preceding sections does provide a basis on which to attempt an interpretation of developments.

First, it is clear that the growth in external debt over the past two years

Table 1
Gross Overseas Debt (NZ$m)

As at End March	Government	Reserve Bank	Official Debt	Government Corps	Private	TOTAL
1980	3567.5	729.3	4296.8	—	—	—
1981	4236.1	572.9	4809.0	—	—	—
1982	5460.0	1227.5	6687.5	1114.1	—	—
1983	7690.7	1486.9	9177.6	2469.0	3078.8	14725.4
1984	8174.9	1161.6	9336.5	3138.0	3885.3	16359.8
1985	12366.2	1550.1	13916.3	5249.0	5448.9	24614.2
1986	14462.3	1167.9	15595.0	5601.0	5228.0	26424.0
1986 June	14582.5	1493.5	16076.0	6092.0	5076.0	27244.0
Sept	19143.0	1604.0	20747.0	6780.0	5895.0	33421.0
Dec	19835.9	1484.1	21320.0	5864.0	5753.0	32938.0

has occurred through borrowing by the private sector and government corporations, rather than the official sector. This is because, under the floating exchange rate regime introduced in March 1985, the government has chosen not to borrow overseas to fund a current account deficit or finance its own activity.

A large proportion of the increase in non-official overseas debt in more recent years has been due to borrowing by public corporations, largely to fund expanded investment programmes. A broad range of indicators suggest that there has also been an increase in private investment in some sectors in response to economic deregulation and to other changes in the policy environment. Some part of this is likely to have been funded offshore. In both cases, investment decisions, including decisions on the use of overseas funds, are made in response to current and prospective market conditions; in short, on the basis of standard commercial criteria.

Similar disciplines govern other (portfolio related) borrowing by the private sector. Structural shifts in the economy and changes in the economic policy environment have resulted in changes in relative asset prices, and this in turn has generated shifts in the composition of private sector portfolios. The removal of exchange controls in 1984 allowed portfolio diversification to extend into external liabilities and assets. Other policy changes, for instance those which have encouraged competition and innovation in the financial markets, have provided further impetus to the process.[2] Other things being equal, these portfolio shifts represent 'one-off' adjustments, with an initial period of rapid growth in both gross inward and outward flows.

It also implies that some proportion of the rise in external liabilities is likely to be accounted for by the purchase of external assets. Statistics on the private sector's holdings of external assets are inadequate, with restricted measurement of foreign assets almost certainly leading to an undercounting of claims on foreigners, but this must be balanced against the likely understatement of private sector overseas debt (especially owing to the omission of short term debt) so that it is unclear whether the available statistics on gross overseas debt overstate or understate the increase in net overseas debt.

Because of the lack of data, it is not possible to discuss some of the major forces driving the composition and level of New Zealand's debt in recent years in anything other than conceptual terms. As noted previously, the key issue underpinning the question of the sustainability of an external debt position is the economic rate of return produced by the activities to which the borrowed funds are applied: in rough terms, borrowing is sustainable if the economic growth produced exceeds the associated real debt costs. Successful examination of whether this is in fact occurring depends heavily on data which indicates to what activity foreign borrowing is applied. Such data is not available in New Zealand. Consequently, all that one can say about the issue is that, in principle, the structural policy changes made in recent years enhance the chances that decisions to borrow, both domestically and abroad, are being made against the aforementioned commercial disciplines since, in general terms, these structural policy changes mean that the costs of using economic resources are more clearly borne by those taking the relevant decisions.

A major caveat is in order here though. Although the Government does not borrow directly from abroad under the current floating exchange rate regime, its deficit still affects the current account balance and hence increases the country's total overseas debt. As already discussed, a fiscal deficit that is not offset by net private sector savings necessarily induces a current account deficit. In effect, Government uses domestic private sector savings to finance its fiscal deficit, so that the private sector is increasingly forced into offshore borrowing to finance investment activity. This contrasts with the previous situation under a fixed exchange rate

(2) This process of portfolio diversification is quite different to that of 'capital flight'. Portfolio flows are driven by international investment opportunities whereas capital flight is generated when residents feel that the value of their savings (their assets) would be better preserved if held offshore, beyond the reach of the domestic authorities. Such sentiment is essentially the product of a lack of confidence in the soundness of current or expected future economic policies.

where Government tended to borrow offshore to finance its deficit so leaving domestic savings to finance domestic investment. For a given level of the fiscal deficit, the major effect of the Government choosing either to borrow domestically or offshore is therefore to change the composition, rather than the size of the country's total overseas debt.

The implication of this is that even though under the new policy approach the private sector does virtually all the direct overseas borrowing and in doing so faces the now-more-appropriate commercial incentives and disciplines needed to ensure decision-making consistent with sustainability, the overall rate of accumulation of external debt will still be heavily influenced by the fiscal position. It is equally important for sustainability of the external debt position that government borrowing decisions, both in New Zealand and overseas, are made in accordance with economic rate of return criteria. Over the last two or three decades, it is not at all clear that government borrowing has been for investment which has produced economic growth sufficient to outweigh the additional debt servicing burden.

In this light, it is important to note the recent moves made to expose greater areas of government activity to commercial rate of return criteria, particularly in the corporatisation strategy. However, it should also be noted that although significant progress has been made in reducing the relative size of the fiscal deficit it remains large both in historical terms and compared with other industrial countries. Apart from structural changes such as the corporatisation strategy referred to, the switch of Government borrowing to the domestic market can only reduce the current account deficit if it makes more obvious the costs of large, permanent fiscal deficits and thereby maintains a reduction in the fiscal deficit, or if it also increases domestic interest rates so inducing an increase in private savings and a reduction in expenditure (including investment). While this effect may in part be present, the negative effects on investment (and hence on growth) suggest that the major element in a programme designed to achieve a sustainable overseas debt level via a sustained improvement in the current account balance must be a reduction in the fiscal deficit.

Conclusion

This paper has outlined a range of factors which are central to the issue of New Zealand's overseas debt. There are no simple answers to the questions of how much debt may be appropriate or what rate of borrowing is likely to be sustainable, although in general terms, the key issue is the use which has been made of borrowed funds. However, this is not to imply that the only requirement is for the debt situation to be sustainable in a strict economic sense — creditors and potential creditors must share in this assessment and be willing to maintain or extend the flow of funds to the economy. The possibility of changes in the terms of access to external finance also needs to be accounted for in assessing an appropriate level of external debt.

The responsibility for ensuring that the rate of growth in the economy and in export receipts is consistent with the increases in debt, and that 'creditworthiness' is maintained, falls principally to economic policy. In this respect it is important to note that the liberalisation process has been designed to improve the efficiency and growth prospects of the economy. The fiscal deficit, while having fallen in real terms, still, however, constitutes a barrier to a sustained reduction in the current account deficit and so still acts as a major influence on the continued increase in the country's total overseas debt.