
Corporate behaviour and the balance of payments

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Balance of payments data are sometimes used to try to predict currency or financial crises. A high current account deficit relative to GDP, a large proportion of external debt relative to equity flows, and a large proportion of investment portfolio flows versus longer-term debt or direct investment have been considered “warning signals” of potential impending financial crises in some economies. Using balance of payments data for these purposes suggests the need for a careful understanding of what underlies the data.

This article aims to further our understanding of some of the elements in New Zealand’s balance of payments current account and financial account data so that we can make more insightful interpretations of developments in the balance of payments. It provides several examples of how corporate financing choices could affect measured flows. Because of legal arrangements, certain corporate transactions may result in the overstatement of one type of capital flow relative to another in economic terms. Therefore, analysis of capital flows at face value could be misleading when interpreting the flows from a macro-financial stability perspective.

1 Introduction

This article describes how various corporate financing decisions affect the balance of payments. Because of the way balance of payments statistics are compiled, they sometimes do not adequately capture the true economic nature of the transaction. Therefore, interpreting these statistics in a financial stability context requires care. Section 2 provides an overview of the balance of payments statistics and the relationship between the composition of capital flows and macro-financial stability. Section 3 describes several corporate financing possibilities and shows how financing decisions affect the balance of payments categories. Section 4 outlines three specific issues that could affect New Zealand’s balance of payments statistics. Section 5 concludes.

2 The balance of payments statistics and macro-financial stability

In the latter half of the 1990s, in response to several currency and financial crises, a large number of studies tested the ability of various economic variables to predict a financial crisis.² The maturity structure of debt was found to have some predictive power, where a high share of short-term debt relative to foreign currency reserves was an indicator of potential financial instability. The split between debt and equity also had implications for potential instability, where highly leveraged firms were seen to be more vulnerable than their unleveraged counterparts. Debt liabilities are prone to maturity or currency mismatch unless hedged, and hedging requires the existence of counterparties willing to hold the interest rate or currency risks. Equity, on the other hand, is repaid only after a full discharge of debt obligations, and dividends generally do not represent contractual obligations but are paid depending on the level of profit. Therefore, when looking at the composition of private capital inflows, a high level of debt versus equity, or debt versus foreign currency reserves, can be a warning sign. These indicators are only suggestive, often predicting crises that do not occur.

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² See Hawkesby (2000) and Woolford (2001) for a discussion of macro-prudential indicators.

Therefore, analysing capital flow data requires a case-by-case interpretation.

Data on capital flows, along with trade flows, are found in the balance of payments statistics. Data on the stock of international assets and liabilities are published in the international investment position statistics. The statistics are published by Statistics New Zealand on a quarterly basis. The balance of payments data are compiled on the basis of international standards for national accounts data and consist of three accounts: the current account, the capital account, and the financial account.³ The current account balance reflects "current expenditure" and is the sum of the balance on goods, services, income, and current transfers in a given period. The capital account primarily records cross-border capital transfers. The financial account records the financial transactions associated with the transactions in the current and capital accounts as per double entry accounting. Accordingly, the balance of payments accounts are structured, by definition, to sum to zero, as transactions in

the current and capital accounts have offsetting financial transactions.⁴ This article refers mainly to the financial account and the income portion of the current account. Data for the years ended March 2000 - 2002 for New Zealand are presented in table 1.⁵

Purchases and sales of financial assets of a foreign entity are recorded in the financial account and contribute to the stock of international assets and liabilities, which are recorded in the international investment position data. The income flows from the ownership of foreign assets are recorded in the income category of the current account (see figure 1). Each of these accounts is disaggregated into broad categories including direct investment, portfolio investment, and other investment. Further breakdowns within categories are available. For example, direct investment is broken down into equity capital and other capital, and portfolio investment is broken down into equity securities and debt securities.

Direct investment is defined as the purchase of 10 per cent or more of a firm's outstanding shares and implies a lasting

Table 1
New Zealand's balance of payments, NZD billions

March years	Current account balance	Financial account balance	Capital account balance	Net international investment position
2000	-7.1	4.2	-0.4	-87.1
2001	-5.3	5.4	-0.2	-85.0
2002	-2.7	5.0	1.4	-92.3

Source: Statistics New Zealand

Figure 1



³ See St Clair, Tether, and White (1998) for a detailed overview of the balance of payments statistics.

⁴ In practice, through a combination of misreporting, measurement difficulties, and the like, the accounts will not sum exactly to zero and usually include reconciliation terms (known as "errors and omissions").

⁵ See Collins, Nadal de Simone, and Hargreaves (1998) for an overview of the factors affecting New Zealand's current account.

interest in the firm and a degree of management control. All subsequent transactions between the direct investor and direct investee are also included under direct investment.⁶ Portfolio investment includes equities and debt securities. Portfolio equity transactions are those that represent less than 10 per cent of a firm's outstanding shares (and that do not result in a firm reaching the 10 per cent ownership threshold). Portfolio debt investment includes both long-term (bonds and notes) and short-term (money market instruments) issues by the banking sector, other corporates, and the government. The government is usually the largest contributor to New Zealand's portfolio debt liabilities. The "other investment" category includes loans, deposits, trade credits, and other liabilities.

3 Corporate financing decisions and the composition of capital flows

The balance of payments statistics are compiled according to internationally recognised standards. Balance of payments data, in combination with data on external assets and liabilities, provide a useful framework for assessing aspects of an economy's economic wellbeing, including the extent to which the residents of a country are collectively earning more or less than they are spending, the level of debt owed by residents to non-residents, the risk profile associated with that debt, and the capacity to service the debt. However, the data need to be interpreted with considerable caution, especially given the - at times - arbitrary dividing line between "resident" and "non-resident", measurement difficulties, and, increasingly, the conceptual difficulties in drawing clear boundaries on financial transactions between people and entities in different countries, given the increasing extent of globalisation, and the ease with which people, entities and assets and liabilities can move across national borders.

⁶ For the banking sector, Statistics New Zealand distinguishes between permanent debt, which represents the long-term investment in the New Zealand subsidiary, and funds used for bank funding. The former is categorised as direct investment while the latter is recorded under portfolio or other investment.

In this context, using the balance of payment statistics to make economic inferences can provide misleading results in some situations. For example, some capital flows categorised as debt because of accounting standards⁷ and legal issues may, from a financial stability perspective, behave more like equity. This section describes various corporate funding arrangements⁸ and how these arrangements are recorded in the balance of payments, with an emphasis on how the resulting composition of flows appears from a financial stability perspective.

Holding companies

A foreign entity wishing to make a direct investment in New Zealand will sometimes set up a holding company in New Zealand. It will issue debt to the holding company, which will then proceed to purchase shares in a New Zealand entity. There are various reasons why firms would want to do this - one of which is tax minimisation. This practice is understood to have been widespread in New Zealand until a change in the tax law ("Thin Capitalisation Rules" contained in Part FG of the Income Tax Act 1994) removed the incentive to organise businesses in that way.

The establishment of the holding company would be recorded as a small foreign direct investment inflow under the equity category in the financial account. The subsequent debt issue would be recorded in the debt category of direct investment in the financial account for the amount of the loan. When the holding company purchases shares in the New Zealand entity with the funds from the debt issue, the transaction does not appear in the balance of payments statistics, as it is not a cross-border transaction. The income that accrues to this arrangement will be recorded under "income from debt" in the direct investment category of the income portion of the current account. If the parent had purchased the New Zealand entity by directly purchasing shares, the transaction would have been recorded in the equity component of direct investment in the financial account. Therefore, the economic substance of these flows

⁷ Statistics New Zealand compiles the balance of payments statistics according to internationally recognised standards.

⁸ Throughout this paper the corporate sector includes the banking sector as well as non-bank financial institutions.

is equity, but the legal form is debt. Balance of payments and international investment position statistics are organised on a legal form basis. From an economic standpoint, therefore, they have probably overstated the share of debt in the international investment position and in the associated income in the current account, particularly in the early 1990s.

Intercompany loans

There are several ways that firms can lend money to their subsidiaries in foreign countries, and the particular form of the funding arrangements evolves according to the specific situation. One type of loan arrangement is a parallel loan, which is best described by way of an example. Suppose corporation A is domiciled in country A and corporation B is a country B entity. With a parallel loan, corporation A will make a loan to corporation B's subsidiary in country A and corporation B would make a comparable loan to A's subsidiary in country B. These types of loans tend to be made to circumvent exchange controls, (which is not applicable in New Zealand's case, given the absence of exchange controls), avoid exchange rate risk, or to achieve favourable interest rates. This type of arrangement will not be recorded in balance of payments statistics, as both parties to the loan are domestic residents in each country. This does not affect the net figures; if the loans were recorded, the inflow would equal the outflow, resulting in a zero net flow. What does result is a reduction in the gross flows in the financial account as well as the interest payments on both sides of the current account. However, given that this type of arrangement is not thought to be common in New Zealand, it would not materially affect recent New Zealand balance of payments statistics.

Flows through New Zealand

The operations of a company, and the location of the parent and its subsidiaries, can have an impact on a country's balance of payments statistics. Consider a New Zealand-based parent that borrows internationally (from an unrelated party) on behalf of its subsidiary located abroad. The initial debt from abroad would be recorded as a financial inflow in the "portfolio" or "other" categories of the financial account (depending on the type of borrowing undertaken). When the parent lends the money to its subsidiary, it would be an

outflow in the "direct investment" category of the financial account. Thus, net flows in the financial account are not affected; the outflow exactly offsets the inflow. However, the levels of the flows in the financial account are inflated; if the subsidiary had borrowed on its own, there would not have been an inflow or an outflow. In addition to the inflation of the levels, there is an effect on the composition of the financial account. This arrangement will increase the share in total of foreign investment from abroad in the "portfolio" or "other" categories as well as increase the direct investment share in the New Zealand investment abroad category.

This arrangement has a similar effect on the income balance of the current account. If the subsidiary had arranged for the financing itself, there would be no entries in New Zealand's current account. With this arrangement, the interest on debt from the subsidiary is classified as "income from investment abroad – direct investment" in the current account, and the interest payments to the outside lender would be in the "income from foreign investment in New Zealand – 'other' or 'portfolio'" in the current account. The amounts should be offsetting so that the net effect on the current account would be zero. Similarly, principal repayments are included in the financial account and will be offsetting. Flows through New Zealand are likely to be relatively less important now than when large corporates with extensive international operations, such as Brierley Investments and Lion Nathan, were headquartered here, and Fletcher Challenge operated as a New Zealand conglomerate.

Some New Zealand entities borrow from their overseas parents. When this occurs, the initial debt transaction results in a capital inflow in the "direct investment" portion of the financial account. The subsequent interest payments are recorded in the "income from foreign investment in New Zealand (direct investment)" portion of the current account and the principal repayments are recorded in the "direct investment outflows" portion of the financial account. To the extent that the New Zealand entity needed to borrow abroad, the fact that the funding is from the parent entity does not affect the level of the current account, only the category the obligation is recorded in. The result is an increase in the share of inward direct investment at the expense of inward investment in the "portfolio" or "other" categories in the financial account.

4 Some numbers for New Zealand

This section provides an analysis of three aspects of the composition of New Zealand's financial and current accounts. First, New Zealand has high foreign direct investment relative to gross domestic product as compared with other countries. Second, as recorded in the balance of payments, New Zealand's returns from investment abroad are significantly lower than the returns to foreigners investing in New Zealand. Third, a significant portion of New Zealand's external debt is owed to related parties. Foreign bank ownership plays a significant role in this regard, given that any funding that the bank subsidiaries are receiving from their parents, as well as any debt relating to the initial purchase of the New Zealand banks, will be categorised as "debt due to related entities". Each of these issues is discussed in turn, with an emphasis on the implications for financial stability.

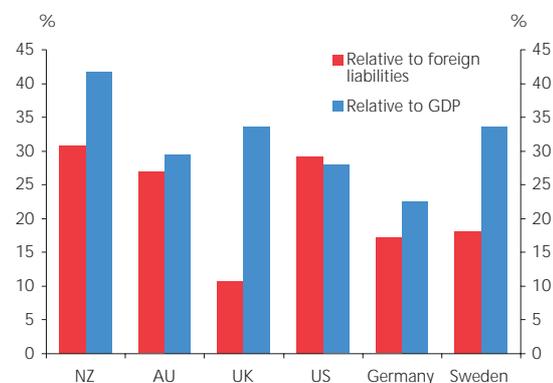
Foreign direct investment

Foreign direct investment (FDI) represents just over 30 per cent of the stock of foreign financing in New Zealand. This is a little higher than the norm for advanced economies (and, of course, in total, New Zealand is more dependent on foreign financing than other developed countries). On the face of it, New Zealand's higher level of inward FDI is a positive feature from a financial stability perspective, given the presumed stability of FDI in periods of economic difficulty (relative to short-term debt). Cross-country comparisons of this data can be misleading however, without taking into account country-specific circumstances. The United Kingdom provides a good example of this. The data indicate that a very low share of foreign liabilities is in the form of direct investment which, if FDI were considered a "safer" form of financing from a macro-financial stability perspective, would indicate that the United Kingdom is more vulnerable than some other advanced countries.⁹ In reality, the United Kingdom serves as a global financial centre; many foreign banks are established in the United Kingdom. As a result,

⁹ FDI represents a lasting interest in an entity and FDI flows are generally less volatile than portfolio flows. Therefore, FDI is not as likely to experience the sudden reversals that short-term portfolios have exhibited in certain situations such as in the South East Asian countries in 1997/98.

many capital flows into the United Kingdom do not represent foreign investment in the United Kingdom *per se*, but investment into various European firms. The result is that the recorded share of direct investment is lower than it would otherwise be. Because of the large volume of capital flows into and out of the country, the United Kingdom has a very large stock of gross foreign liabilities relative to GDP, compared to other countries.¹⁰ Therefore, FDI relative to gross domestic product gives a better indication of the degree of foreign ownership of firms.

Figure 2
Share of foreign direct investment, 2000



Source: IMF, Datastream

Returns to investment

Table 1 showed that New Zealand has been running a current account deficit over recent years (and indeed, for most of New Zealand's history) and has a negative net international investment position. A large part of the current account deficit can be attributed to the balance on income. As New Zealand is a net debtor, it is not surprising that the income balance is negative. However, an important question is how the returns to New Zealand investment abroad compare with returns to foreigners investing in New Zealand.

Table 2 shows that overall returns to New Zealand investment abroad have been significantly lower than returns to foreign investors in New Zealand over most of the 1990s. Generally these numbers reflect the fact that New Zealand investment

¹⁰ This can be seen in figure 2 by comparing the difference in the two columns for the United Kingdom. If total liabilities were equal to GDP, the columns would be of equal height. Because gross liabilities are three times GDP, FDI to liabilities is much lower than FDI to GDP.

Table 2
Returns to investment (annual returns (%))

	New Zealand investment abroad	Foreign investment in New Zealand
1993	3.9	5.3
1994	2.7	7.9
1995	5.8	7.9
1996	1.6	7.1
1997	1.7	6.7
1998	4.6	5.1
1999	4.3	6.0
2000	2.4	5.9
2001	1.4	5.4
2002	2.4	5.0

Source: IMF, Statistics New Zealand, and RBNZ calculations

abroad has not been as profitable as foreign investment in New Zealand. A significant proportion of net foreign financing takes the form of debt and, of course, interest rates in New Zealand have generally been higher than interest rates abroad. However, there are measurement issues that can also affect the comparability of these numbers. As an example, consider the returns to portfolio equity investment. Dividend income is the only type of income reported in the equity portion of portfolio investment income,¹¹ so differences in dividend payouts across countries may explain the return differential to some extent.¹²

As at March 2002, 38 per cent of New Zealand's portfolio investment abroad was into the United States, 14 per cent

was to the United Kingdom, and 13 per cent was to Australia. To give some perspective on relative dividend payout rates, the second column of table 3 shows the percentage of firms in the associated index that pay dividends. The third and fourth columns show the 12-month average and median dividend yield of those firms that pay dividends. Columns five and six show the 12-month average and median dividend yields of all firms in the index.

New Zealand firms tend to have, on average, a higher dividend yield than do their foreign counterparts. A caveat, however, is that 2001 was a difficult year for corporates in North America and Europe and will be reflected in lower dividend payouts to some extent. Differences in tax policies

Table 3
Dividend payouts – as at June 2002

(1)	Share (2)	12 month avg yield (3)	12 month median yield (4)	12 month avg yield* (5)	12 month median yield* (6)
NZSE40	82.6	5.4	5.4	4.4	4.4
AORD30	67.0	5.6	5.2	3.8	3.5
S&P500	71.4	1.9	1.6	1.4	1.0
Bloomberg Euro 500	86.0	2.8	2.5	2.4	2.3

* all companies

Source: Bloomberg and RBNZ calculations

¹¹ See Barrow and Bray (2001) for a detailed discussion on this issue.

¹² Both dividend income and retained earnings are recorded in the current account under "income from foreign direct investment" reflecting the fact that having a degree of ownership control allows the investor to influence dividend policy.

might explain why New Zealand entities are willing to invest abroad in firms with low dividend yields and why New Zealand firms might have a higher dividend payout rate. New Zealand does not double tax dividends, so the tax incentive to avoid issuing dividends is not present for firms. New Zealand does not generally tax capital gains but does tax dividend income so New Zealand entities might seek to invest in equities that do not pay dividends but realise large capital gains, in order to lower tax bills.

Because capital gains are not included in income, total returns (dividends plus capital gains) will not be fully reflected in the current account.¹³ Portfolio equity investment represents approximately 20 per cent of the stock of New Zealand assets abroad and is the largest single category after foreign direct investment, so this accounting issue could significantly impact the measured current account deficit during years when capital gains are large. A rough calculation¹⁴ shows that, on average over the 1997-1999 period, if capital gains were included in portfolio equity investment income, the current account deficit would have declined by just over 1 per cent of GDP each year. Of course, this was a period of large gains in overseas equity markets, and this issue could work in reverse in the current period of equity market declines around the world. It is important to stress that international investment position statistics are not susceptible to the measurement problem associated with capital gains or losses because they take into account revaluations.

Debt to related entities

Foreign ownership of firms in New Zealand, as well as other short and long-term borrowing, contributes significantly to New Zealand's external debt. Table 4 shows the breakdown of external debt to parents, subsidiaries and external parties. Debt to non-resident related entities was almost \$49 billion as at March 2002. Total external debt as at March 2002 was \$132.5 billion, so that the debt due to related entities represented 37 per cent of total external debt. The banking sector accounts for a large part of this. As at December 2001, the five largest banks in New Zealand owed approximately \$21.5 billion to non-resident related entities, accounting for almost 44 per cent of New Zealand's debt to related entities.

Debt due to related entities could be considered "safer" than debt due to unrelated entities from a macro-financial stability perspective for two reasons. Firstly, debt due to related entities may really function as equity, as in the holding company example discussed earlier. Equity earnings are a residual claim and cannot be defaulted on. Secondly, should a subsidiary get into difficulties, the parent company will normally have an incentive to renegotiate debt payments, roll over debt contracts, and even provide new funds in order to help the subsidiary. It is plausible to assume that unrelated external parties, not having the same level of interest in the subsidiary, would not react in the same way. While, for the reasons noted above, debt to related entities is, on balance, 'safer', there is one way in which over-reliance on this source of funding can lead to potential vulnerability. If the parent

Table 4
Composition of external debt as at March 2002

	NZD millions	Share in total*
Debt to overseas investor (parent or owning enterprise)	25,425	19%
Debt to overseas investee (subsidiary)	23,500	18%
Debt to unrelated overseas entities	64,722	49%
Total for banks and other sectors	113,647	86%
Official sector	18,925	15%
Total overseas debt	132,572	

* Does not sum to 100 per cent because of rounding.

Source: Statistics New Zealand

¹³ This is not to argue that capital gains should be included as income, but rather to note that capital gains (or losses) are a source of earnings on equity investments.

¹⁴ Capital gains were calculated by subtracting portfolio equity flows from the change in the stock of portfolio equity investment in a given period. This method will fail to control for errors and omissions.

experiences a credit downgrade or other form of credit deterioration, the cost of capital to the subsidiary will be affected as well. If the subsidiary maintains diverse funding sources, then it will have a better chance of securing credit based on its own credit rating. Moreover, large amounts of related party debt tend to increase the risk of intra-group contagion, increasing the risk of a parent entity's failure causing the failure of the New Zealand operation.

The role of the banks

Each of New Zealand's five major banks is foreign-owned; four are wholly owned subsidiaries of foreign banks and the fifth is a New Zealand branch of a foreign bank.¹⁵ Foreign bank ownership affects both the financial account and the current account of the balance of payments as well as the international investment position. The purchase of the New Zealand entity by a foreign entity would be recorded in the financial account during the quarter in which it occurred, as an inflow under the foreign direct investment category. This would occur whether the banks were New Zealand owned or otherwise. If they were purchased from a foreign entity and the foreign entity repatriated the funds, a corresponding outflow would be recorded as well.

During subsequent periods, foreign ownership appears in the income portion of the current account as the New Zealand entity services the parent's investment. The income recorded in the current account includes both dividends and retained earnings, as discussed above. In addition, the international investment position statistics reflect foreign ownership in the stock of foreign direct investment in New Zealand. Purchases of New Zealand entities add to the stock of New Zealand's international liabilities and changes in the market value of the New Zealand entity will be reflected in a change in the value of international liabilities.

It is important to stress that in a country with developed markets, such as those in New Zealand, foreign bank ownership in itself does not necessarily cause an increase in overseas funding; to the extent that domestic savings (as a source of funding) fall short of domestic investment needs, overseas funding will occur. What will change is the way in

which the funding is arranged and recorded. If no adjustments were made in the balance of payments statistics, funding from parents would appear in the direct investment category, whereas if the banks were domestically owned – or received funding from sources other than the parent – the funding would appear in either portfolio or other investment. In order to account for this, prior to June 2000, Statistics New Zealand categorised long-term debt as direct investment and short-term debt as portfolio or other investment depending on the type of flow. A more sophisticated approach has been undertaken since June 2000, where Statistics New Zealand distinguishes between permanent debt and other debt when categorising flows as direct investment.¹⁶ Permanent debt is the funding undertaken to establish or purchase the operations of a subsidiary. Financial flows undertaken to augment a subsidiary's funding is categorised as "portfolio debt" or "other investment" in the financial account, regardless of whether the funding comes from a parent or an unrelated entity. The new classification is an improvement, as it more accurately captures the economic underpinnings of the respective flows.

5 Conclusion

This article provides an outline of how a number of corporate transactions affect the balance of payments. Corporate overseas borrowing and lending, and corporate financing decisions, affect the level and composition of capital flows. Because of the difficulties in classifying some types of transactions, and the divergence between legal or accounting classifications of transactions and their economic substance, balance of payments data do not always reflect the true economic situation. For example, gross capital flows can be inflated when a parent company borrows on behalf of an overseas subsidiary. Similarly, the composition of FDI can be misleading, with the share of debt overstated, when holding companies borrow from overseas parents. Measurement issues also affect the income balance of the current account. Capital gains are not included in portfolio income flows so,

¹⁵ See Hull (2002) for a detailed discussion of foreign bank ownership and financial stability.

¹⁶ This breakdown is not published, but it is a conceptual change in how the balance of payments statistics are calculated.

for example, if a significant share of portfolio income derived from offshore comes from capital gains, income from abroad will be understated. These factors vary by country and change over time. Therefore, interpretation of these statistics in a macro-financial stability context requires caution and a sound understanding of institutional detail.

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