

In a Sweat about Foreign Debt

Ritualistically when Australian politicians have little better to discuss, accusations are thrown about which side of politics is most to blame for the current level of Australia's foreign debt. There has even been trucks hired to drive around during election campaigns displaying the latest horror figure that Australians owe to foreigners.

Unfortunately, such an approach to economic debate provides little enlightenment for the electorate on this issue, and certainly fails to convey any sense that foreign debt may actually be part of a healthy and growing economy. For the rural sector, foreign debt has often been paraded as an evil that needs to be regulated and reduced, however, it has brought real benefits, and has forced Governments to adopt policies closely aligned to the needs of rural exporters.

The Commonwealth Parliament Hansard records the following exchange on August 30th:

Mr Crean - I ask a question of the Treasurer. I ask him whether he recalls saying on the World Today program on 30 August 1995 when referring to the foreign debt in nominal terms:

There is some very sobering news in today's national accounts, the worst net foreign debt position Australia has ever had, a jump to \$180 billion. That's \$10,000 for every man, woman and child ... in Australia.

Treasurer, doesn't today's \$228 billion foreign debt now mean, according to your formula, a debt of \$12,000 for every man, woman and child? Treasurer, if the foreign debt was important in 1995, why are you just trying to wish it away today?

Mr Costello - As I have said on numbers of occasions, debt servicing ratios were, firstly, higher, and secondly, let's have a guess: was the Government in the business of saving or borrowing in 1995? Let's all have a guess. What was the government doing in relation to debt in 1995?

Mr Crean - interjecting

Mr Costello - As I recall, in 1995 the budget surplus was...

Mr. Crean - Hypocrite!

Mr. Costello - The budget surplus, as I recall, in 1995 was minus \$17,000 million. I repeat, Mr Speaker, minus \$17,000 million.

Mr. Crean - Hypocrite!'

Such exchanges are relatively common between politicians, hence it is not surprising that radio talkback hosts also take the opportunity to stir up the foreign debt issue on slow news days, or when new statistics are released.

What is perhaps ironic is that both the politicians involved in the exchange would be fully aware that one of the consequences of opening up the Australian economy via the removal of trade barriers and foreign exchange controls – a policy that has had bi-partisan support - is precisely what has occurred – greater foreign investment in, and potential for foreign debt for Australia.

What is Defined as Australia's 'Foreign Debt'?

At the simplest level, Australia's foreign debt is the amount borrowed from non-residents of Australia by residents of Australia, irrespective of whether the residents are individuals, corporations or governments. Even such a simple concept has its complexities, for example the definition of a 'resident' includes Australian-registered branch offices of multi-national corporations, and also Australian multi-nationals like News Corporation, that appear to have the vast bulk of their operations located overseas.

Foreign debt is distinguished from equity investment (or foreign ownership) by the fact that debt entails an obligation to pay interest or repay the principal. Gross foreign debt is the total amount borrowed from overseas, whereas net foreign debt is gross debt, minus lending by Australians to overseas, and minus any Australian foreign reserves held overseas.

Not surprisingly, the definition becomes a little hazy when some of the more exotic debt/equity financial instruments are considered.

In addition, foreign equity in an Australian Company can be financed either by Australian or overseas-sourced borrowings, further complicating the foreign debt picture,

and the same applies to direct or portfolio investments by Australians in overseas companies.

Given these ever-increasing complications, it is not surprising that the Australian Bureau of Statistics urges caution in placing too much emphasis on a single set of quarterly statistics, and international comparisons of foreign debt have only become reasonably reliable in recent years.² As the ABS itself states, “care should be exercised in the use and interpretation of estimates ... The latest estimates are preliminary and subject to revision as more accurate data comes to hand.”

Reinforcing this caution, the median size of one-year revisions to one particular statistic, Foreign Investment in Australia, is around 20%, and further adjustments occur beyond one year.³ Adjustments to the initial estimates of other statistics, including the foreign debt statistic, can be just as large.

How Large is Australia's Foreign Debt?

For that reason alone, political protagonists like Mr Costello and Mr Crean should perhaps refrain from exchanges about just-released statistics. However, there are perhaps much more compelling reasons why a fixation on the evils of foreign debt is no longer appropriate.

Figure 1 shows Australia's foreign debt over the last twenty years, both as a dollar figure, and also as a percent of the national GDP. It shows a steady increase in the amount of foreign debt, but it also shows that foreign debt as a percent of GDP has actually stabilised since the early 1990's.



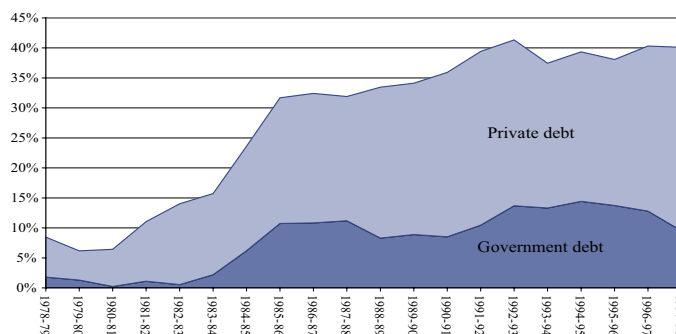
Figure 1 also highlights the significance of the decision to float the Australian dollar, and to remove some other capital controls in December 1983. In effect, from that time Australian banks were genuinely exposed to the potential of international competition, and overseas financial institutions were better able to compete in Australian finance markets, as an element of risk (that of the Government intervening in the \$A exchange rate) was virtually removed. This also reduced the reliance Australian banks had on domestic savings as a base to provide finance for lending.

What occurred in a general sense is precisely what would be expected when increased competition is introduced into a previously comfortable market – the new competitor (foreign-sourced finance) secured an increasing share of Australia's debt market.

Debt, however, cannot be considered in isolation. What is important for a nation or a company is the size of the business that secures that debt.

The information displayed in Figure 2 puts this debt in context with the ‘business’ called Australia. It shows Australia's foreign debt as a percentage of GDP, and segments the debt into Government (or public debt) and private (or debt repayable by individuals and corporations).

Fig. 2. Australian Public and Private foreign debt as a % of GDP



This reveals that apart from a period during the mid 1980's - again the floating of the \$A in December 1993 appears a significant date - when there was a significant increase in public sector foreign debt as a proportion of GDP, the bulk of the growth in Australia's foreign debt is attributed to the private sector. In fact, Government sector foreign debt has actually decreased significantly in percentage of GDP terms since the mid 1990s.

This confirms that, far from Australia's net foreign debt equalling about \$12,000 for every man, woman and child, only about one quarter of that amount is actually ‘public’ debt that could notionally be shared by all Australians. The rest is foreign debt that is repayable by individuals or companies.

While a default on a significant portion of this private debt may affect international market's assessments of the creditworthiness of Australia as a place to lend money, there would be no direct call on Australians as a whole to repay the money, or even service this debt. Responsibility for managing the bulk of this debt rests with the boardmembers and managers of corporations that have incurred it, in the same way that they are responsible for managing any ‘Australian’ debt that their organisations may have.

The benefits of access to this foreign debt flow through to average Australians in a very direct way. For example, it is reported that mortgage originators such as RAMS and Aussie Home Loans have, in recent years, been amongst the largest Australian borrowers in international capital markets.⁴ They in turn have passed on the benefits to average Australians in lower interest rates for mortgage finance, which has a flow-on effect in general business finance rates.

It is interesting to note that in 1991, 47% of non-government foreign debt was attributed to financial corporations such as banks. By 1998, this had increased to 69% of non-government foreign debt, indicating that banks

and other financial corporations are increasingly sourcing funds offshore.

How Does Australia Rank Internationally?

Australia has not been alone in adopting policies aimed at opening up financial and other markets to international participation, and for that reason it is useful to examine external debt levels internationally. Unfortunately, international external debt statistics have only recently become routinely available; hence they are somewhat patchy, and subject to some variation in their definition.

Table 1: Net external debt in developed economies.⁵

Country	Net external debt as a % of GDP		
	1984	1993	1996
Ireland	63.0	44.1	29.8
Iceland	60.5	60.6	-
Greece	45.1	40.1	33.3*
Canada	24.8	44.4	44.8
Sweden	23.1	58.9	45.2
Norway	16.7	7.1	3.7*
Australia	15.9	41.5	40.2
New Zealand	-	61.6	64.2
USA	2.8	16.3	20.2
Germany	-6.8	-7.4	-2.1*
France	-7.5	-0.1	-2.8*

* Denotes closest year statistic available.

Table 1 shows that Australia is certainly amongst a group of countries that have relatively high net external debt levels as a proportion of GDP, although countries such as Canada, Sweden and New Zealand have relatively higher levels of net external debt.

It is also important to remember that these are net figures, and unlike many other countries, both Australia and New Zealand have relatively low levels of external lending to offset gross external debts. Australia's gross external debt, at around 56% of GDP, ranks well behind that of many other developed countries, such as Canada (77%), Sweden (101%), Netherlands (88%) and Switzerland (96%)

In terms of servicing Australia's external debt, net external interest payments amounted to around 0.5% of GDP in 1992-3, and this figure has remained relatively unchanged since that time, amounting to about 0.4% in the December '98 quarter. One other way of examining this question is to compare net external interest payments with the value of exports. Net external interest payments exceeded 20% of the value of goods and service exports in the late 1980s, but declined to around 11% by 1993, and the last official estimates put this figure at 9.1% for the June 99 quarter.⁶ A growth in exports and a fall in global interest rates have both contributed to this reduction. These figures appear to indicate that Australia can adequately service its foreign debt.

Policy Implications for Australia

The opening up of the Australian economy, and the resulting increased enmeshment of Australian businesses internationally has brought with it the opportunity for higher rates of economic growth and competitiveness, a higher level of national prosperity, and access to larger markets. However, with the resulting increased exposure to international financial markets also comes a range of risks. A recent IMF policy discussion paper⁷ categorised these cross-border finance risks into three main areas;

- **Credit risk:**
This refers to the normal risks associated with all credit arrangements, but these are heightened in cross-border financial arrangements. Examples of additional risks include the risk that the borrower will not be able to obtain sufficient required currency to meet obligations; the settlement risk that arises because of time-zone differences; and country risks associated with the economic, social and political environment in the borrowers or lenders country.
- **Market risk:**
This includes; movements in the market prices of securing assets or traded product; foreign exchange risk in either the borrowers or lenders country; interest rate changes in either country; basis risks arising from imperfect matching of hedging facilities; and risks inherent in some of the more sophisticated derivatives used in international financial markets.
- **Liquidity risk:**
This potentially arises if a bank encounters liquidity problems, and is unable to accommodate sudden changes in asset or market values, through for example, a mismatch in the maturity of asset and liability facilities.

Some of these are obviously risks that are present in any normal domestic financial arrangement, but the fact that these arrangements cross international borders adds an extra element to those risk.

Recent events in Asia have highlighted that these risks are further magnified by the herding behaviour evident in international finance markets, especially where the bulk of transactions in those markets are speculative, rather than linked to a need for trade or other finance.

The authors of the research paper looked at the experiences of a sample of countries, some of which had been adversely affected by international financial crises, and some of which had not. The result was some preferred policy approaches to enable nations to best manage the risks associated cross-border capital flows. The main aspects of that policy are as follows:

Consistent monetary and exchange rate policy seems to be important in determining whether a country will be badly affected by sudden flows of capital. The authors noted that countries that focussed on achieving a domestic interest rate target while allowing their exchange rate to adjust appear to have avoided severe

capital flow reversals. On the other hand, countries that tried to manage exchange rates and interest rates simultaneously created incentives for capital flows, and were exposed to greater risk. It was also found that monetary and exchange rate policy needed to be consistent over time – sudden changes to announced policy reduced credibility in the markets, making a nation more susceptible to attack.

Prudential supervision of the financial sector was also observed to be very important. Cross-border capital movements involve different risks to those associated with purely domestic transactions. Those countries that implement regulations such as imposing balance sheet ratios, incorporating foreign exchange risk into loan classification, provisioning and capital adequacy rules, and also enhance disclosure and reporting requirements for the banking sector have generally avoided major crises. This approach seems preferable to the alternative, which is imposing restrictions on capital movements, although it was noted that in some cases capital controls have been successfully used to supplement enhanced reporting and disclosure requirements.

Central bank management of national foreign exchange assets and liabilities was a key lesson to emerge from the Asian crisis. Nations that had systems to accurately monitor foreign currency exposures and the liquidity of their foreign currency positions were better able to weather a sudden ‘attack’ by financial markets. Having access to diverse sources of reserves, and contingency credit arrangements with predetermined interest costs were all-important, as was disseminating comprehensive information on these reserves and arrangements.

The existence of a sound domestic banking sector was observed to be a critical base that was essential for a nation to successfully engage in international capital markets. Opening up to international markets increased competition on the domestic banking sector, and exposed weaker domestic banks to greater risk of failure. Deep and liquid financial markets within a country were also very important, as they lessened the risk that banks would not be able to price and manage risk and liquidity.

In many ways there are no great surprises in these findings, but they do reinforce the need for countries like Australia, which have a relatively high exposure to international financial markets, to revisit those areas of financial sector supervision that may have been considered adequate in the past. The fact that Australia escaped the Asian crisis relatively unscathed perhaps adds to the dangers, in that smugness appears to be a consistent precondition for a financial crisis.

For a predominantly export-oriented sector such as agriculture that has previously experienced major competitive disadvantages in international markets as a result of high domestic interest and inflation rates, the

increased engagement of Australia in international finance markets brings with it some positives. Prime amongst these is the need for prudent, disciplined and consistent Government economic policy, something that the rural sector and other export sectors have long argued for.

Perhaps it has not yet dawned on some of our politicians, but the flip side of Australia’s relative high exposure to external borrowings is a reduction in the flexibility of national governments to pursue short-term expediency in managing the economy.

In many ways, the international financial marketplace is much less forgiving of ill-advised economic policies, and is much better than any lobby group could ever hope to be in making sure national Governments pursue disciplined economic policies. These include keeping inflation in check, and not maintaining artificially high exchange rates. Interestingly, high inflation, high interest rates and an overvalued \$A are all factors that have severely damaged the international competitiveness of Australia’s rural sector in the recent past.

While anything in excess creates problems, reasonable levels of foreign debt provide some pretty significant benefits for Australia’s rural producers, and at the same time reduce the need to lobby Governments about sensible economic policies!

(Footnotes)

- 1 House of Representatives Hansard, August 30th, 1999.
- 2 Rider, M (1994) External debt and liabilities of industrial countries. Reserve Bank of Australia., Research paper 9405.
- 3 ABS 5342.0 (1996) Quality of Australian Balance of Payment Statistics.
- 4 Bryan & Rafferty (1999) The Global Economy in Australia. Allen & Unwin.
- 5 Rider, op cit also Mcfarlane, Reserve Bank Bulletin, April 1998
- 6 Reserve Bank (1999) Reserve Bank Bulletin, September 1999.
- 7 Johnston & Okter-Robe (1999) IMF Policy Discussion paper 99/6

COMMENTS CONTAINED IN THIS DOCUMENT ARE BASED ON INFORMATION AVAILABLE AT TIME OF PUBLICATION.

This paper originally appeared as an edition of the Primary Report published by NSW Farmers’ Association. Re-published in 2004 by the Australian Farm Institute.