

Geoff Bertram

The Banks, the Current Account, the Financial Crisis and the Outlook

Some years back I wrote two papers (Bertram, 2001, 2002) about the current account, the exchange rate and the banks. Here I pick up the threads of my earlier analysis as the backdrop to some remarks about the recent decision of the New Zealand government to provide a wholesale deposit guarantee to this country's New Zealand-incorporated – but mainly Australian-owned – banking sector.

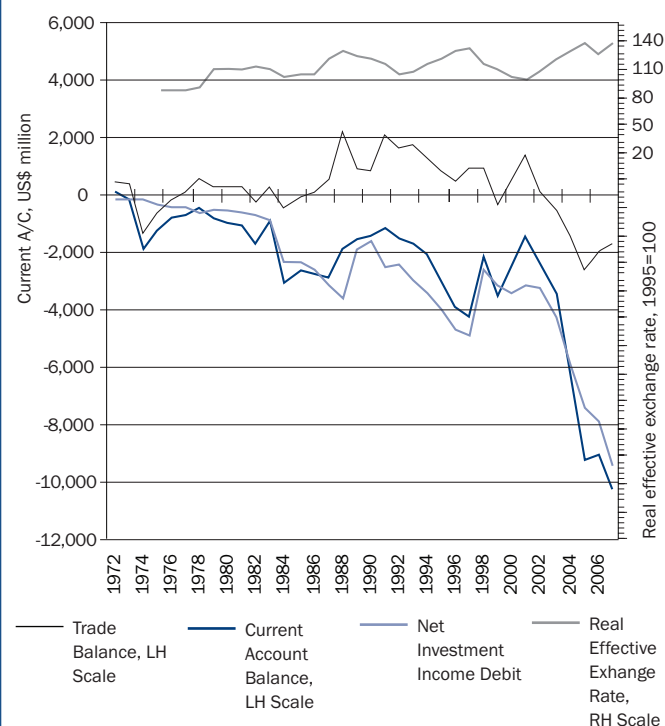
The first paper was subtitled 'Might New Zealand face a transfer problem?' The issue as I saw it was that continuing high current account deficits must necessarily imply a run-up of overseas debt, whether in the form of offshore ownership of assets in New Zealand or via portfolio flows to fund borrowing by New Zealand residents. This debt would have to be serviced, which would mean a growing outflow on the investment-income account of the balance of payments. This in turn would require a growing stream of foreign currency funding to meet those obligations, which could be secured either by improved net export performance or by further offshore borrowing.

The second paper (Bertram, 2002) focused on my realisation that, following the Asia crisis of 1997–98 and the accompanying sharp downturn in foreign direct investment flows into New Zealand, the hole in the New Zealand balance of payments had been filled (and the exchange rate of the New Zealand dollar kept afloat) by an extraordinary inflow of foreign currency deposits into the New Zealand banks from their overseas owners.

This paper brings the data and the story up to date as of late 2008. I find that in the decade following the Asian crisis, the banks' offshore funding activities have dominated the continuing rise in New Zealand's external debt, sustaining in the process a high exchange rate and large current account deficit. The global credit crunch reached New Zealand initially as a bank funding issue; the bulk of the economy's net external indebtedness sits on the banking sector's balance sheets; and the first big fiscal policy move in response to the crisis was a taxpayer guarantee of deposit funding for the banks.

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Figure 1: The current account, the trade balance (goods and services) and the real exchange rate, 1972–2007 calendar years



Sources: IMF, *International Financial Statistics*; Statistics New Zealand data; Tripe (2004), Table 2; updated data from David Tripe

Figure 1 shows that since the 1970s the real exchange rate has trended up while the current account of the balance of payments has trended downwards – precipitously since 2002. The widening current account deficit has been effectively identical with the rising cost of servicing offshore investors’ stake in the New Zealand economy (the ‘investment income deficit’) and has been funded by incurring further international liabilities. The proportion of that net outflow of investment income attributable to the banks rose from one third in 1997 to about 70% by 2008.

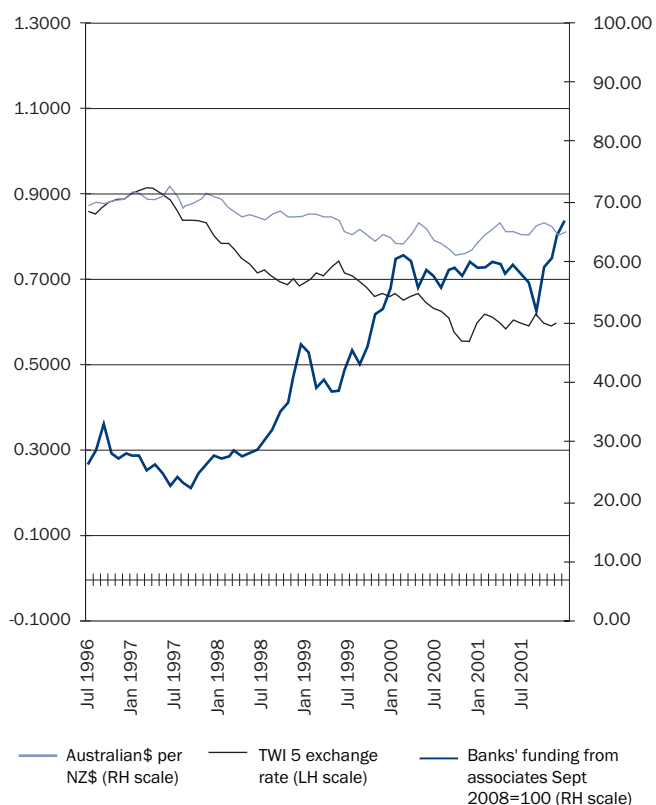
Figure 2 shows the arrival of the banks as a major force in the balance of payments in the late 1990s. The onset of a downward trend in the New Zealand dollar exchange rate in mid-1997 was quickly followed by the injection of \$22 billion dollars of deposits into the New Zealand banks by their offshore associates (parents) between June 1997 and December 2001. The effect of this boost in the supply of foreign currency to the foreign exchange market was to check the fall in the TWI exchange rate and nearly stabilise

Table 1: Current account flows and bank outflows of accruing profits and interest: \$ billion

	Current account balance	Investment income debit	Outflows attributable to the banks	Banks’ share of income debit
1988	-2.3	-4.5		
1989	-0.5	-3.9		
1990	-2.9	-5.0		
1991	-2.3	-4.7		
1992	-2.3	-5.5		
1993	-2.7	-4.4		
1994	-3.0	-5.7		
1995	-4.0	-7.0		
1996	-5.0	-8.0		
1997	-5.8	-8.5	-2.8	33
1998	-5.4	-8.5	-3.1	37
1999	-4.4	-8.2	-2.8	34
2000	-7.0	-9.5	-3.8	40
2001	-5.1	-9.0	-4.6	51
2002	-3.9	-9.3	-4.8	52
2003	-4.5	-9.6	-4.9	51
2004	-6.7	-10.0	-4.6	46
2005	-10.3	-12.3	-6.0	49
2006	-14.6	-13.3	-7.8	59
2007	-13.8	-14.7	-9.1	62
2008	-14.2	-17.1	-11.7	69

Sources: Current account data from INFOS; banking sector data from David Tripe

Figure 2: Offshore bank funding and two exchange rates



Source: Reserve Bank of New Zealand data

the New Zealand–Australia cross exchange rate (that is, the rate that determined whether the Australian parent banks suffered capital losses on the New Zealand dollar lending of their New Zealand affiliates).

Bertram (2002) showed that the New Zealand banks continued to expand their local economy lending at a steady pace between 1997 and 2002 despite a drying up of New Zealand resident funding, with the gap filled by the inflow of funds from offshore. The relevant chart is reproduced as Figure 3.

The conclusion I reached was that ‘in the absence of this large-scale extension of short-term credit by overseas parents to their New Zealand bank affiliates, the nominal exchange rate would have been under far greater downward pressure during 1999. Indeed, one might speculate that, without this private-sector substitute for an activist central bank, the economy might have faced a classic financial and exchange-rate crisis in the wake of the Asian meltdown’ (Bertram, 2002, p.195).

By early 2002 the New Zealand dollar liabilities of the banks had accelerated to catch up with New Zealand dollar assets, suggesting that the shortfall of local currency funding from 1997 to 2001 had been a one-off aberration, and there I left the matter in 2002.

Extending the series to September 2008, as in Figure 4 below, shows that in the past six years the offshore funding of their balance sheets with which the banks experimented in the late 1990s has returned with a vengeance and become something of an addiction. By September 2008 the gap had widened to a \$58 billion shortfall of New Zealand dollar funding relative to New Zealand dollar assets, and a \$98 billion dollar shortfall of New Zealand dollar funding from New Zealand residents on the liabilities side, relative to the banks’ \$278 billion of outstanding New Zealand dollar claims on New Zealand residents on the assets side. The banks have moved to offshore funding on a grand scale to finance domestic credit expansion within New Zealand, much of which went to fund speculative activity in the housing and property markets.

The Reserve Bank of New Zealand’s recent Financial Stability Report (Reserve Bank of New Zealand, 2008, p.27, Figure 8) confirms that this flow of offshore funding has matched the current account deficit, enabling the economy to maintain its import levels without running into a foreign exchange constraint. Over the decade from March 1998 to June 2008 the cumulative current account deficit was \$88.42 billion, while the cumulative increase in the banks’ net foreign liabilities was \$79.69 billion. To a first approximation, the current account deficit has been fully funded by the banks’ offshore borrowing. More dramatic still, over the five years from June 2003 to June 2008 the cumulative current account deficit was \$62.14 billion and the increase in the banks’ net foreign liabilities was \$71.97 billion, which means that New Zealanders were investing (net) overseas to the tune of a cumulative \$10 billion, with the banks fully funding this as well as the current account deficit.

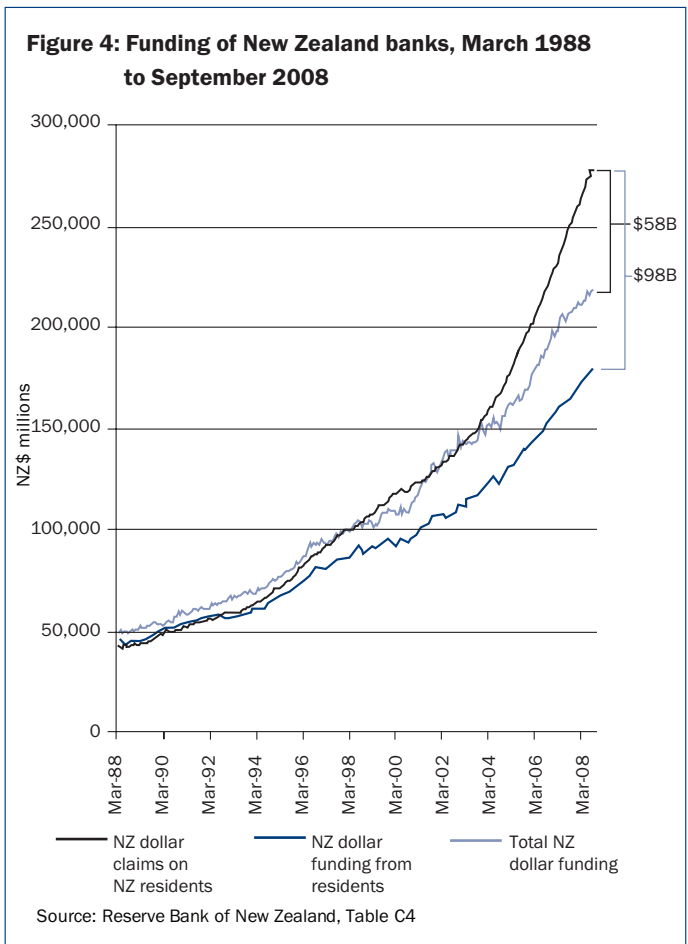
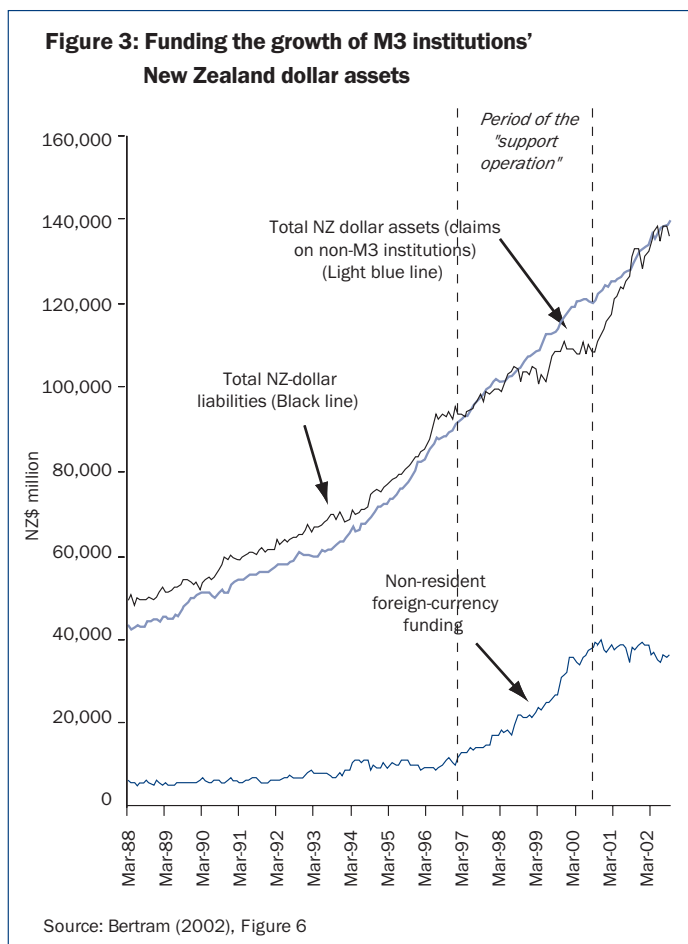


Table 2: Consolidated banks balance sheet

	Liabilities, capital and reserves	Aug 08	Sept 08	Assets	Aug 08	Sept 08
	NZ dollar funding			NZ dollar claims		
1	NZ resident	177.6	179.6	NZ resident (Non M3)	277.2	277.9
2	Non-resident	40.0	39.0	Non-resident	7.6	9.0
3	Total 1+2	217.6	218.6	Subtotal to here	284.9	286.8
				NZ resident (M3 institutions)	15.0	15.1
				Total	299.9	302.0
	Foreign currency funding			Foreign currency claims		
4	NZ resident	10.2	9.9	NZ resident	4.0	4.2
5	Non-resident (?all wholesale?)	80.1	80.7	Non-resident	11.6	6.6
6	Total 4+5	90.3	90.7	Total	15.6	10.8
7	Capital and reserves	22.6	22.5	Foreign currency fixed assets and equity investment	0.1	0.1
8	Other liabilities	19.6	27.9	Shares in NZ companies	0.4	0.4
				Other assets	25.4	35.0
				NZ government bonds and Treasury bills	1.5	1.4
				NZ notes and coin	0.5	0.5
				Claims on the Reserve Bank	6.7	9.3
	Total liabilities	350.1	359.6	Total assets	350.1	359.6
	Memo items:			Memo items:		
9	funding from associates	50.7	50.4	financial claims on associates	7.1	6.6
#	total non-resident funding	120.1	119.7	total non-resident claims	19.2	15.6

Source: Reserve Bank of New Zealand

It remains an open question whether the driver for this process was a ‘hoover effect’, as rising local demand for credit sucked in funds from abroad, or a force-feeding exercise in which the banks aggressively expanded their local lending in order to lend out locally funds which they were able to raise more cheaply offshore. Probably the answer is a bit of both. The two key outcomes, however, are not in doubt:

- a banking system with large outstanding, often short-term, offshore debt liabilities and large longer-term assets in New Zealand dollars. This balance sheet structure as

at September is in Table 2. It presents no obvious risk of long-run insolvency, since the asset position is solid in local currency terms. There is, however, an obvious risk of a collapse on the liabilities side if access to offshore funding were to dry up, as it finally did in September 2008;

- a banking system which dominates both the investment income debits on the balance of payments current account and the liabilities side of the country’s international investment position (see Table 3 below).

Table 3: New Zealand international investment position at June 2008, \$ billion

New Zealand's international assets		
Equity assets	52.1	
Lending	77.7	
<i>Banks</i>		21.7 ←
<i>General government</i>		9.0
<i>Monetary authorities</i>		20.2
<i>Other sectors</i>		26.8
Total international assets		129.8
New Zealand's international liabilities		
Equity liabilities	63.1	
Borrowing	225.9	
<i>Banks</i>		138.9 ←
<i>General government</i>		17.6
<i>Monetary authorities</i>		0.3
<i>Other sectors</i>		69.1
Total international liabilities		289.0
New Zealand's net international asset position		
Net international equity		-11.0
Net international debt		-148,176
Net international asset position		-159,194

Source: Statistics New Zealand, *Hot Off the Press*

The banks, in summary, account for nearly 70% of investment income debits on the balance of payments, and for 74% of the economy's net overseas indebtedness.¹

A looming transfer problem?

Suppose that the availability of offshore credit for the New Zealand economy were to dry up while nothing else changed. In that case, unless the country were to default on its external debt, a transfer of domestic resources into export production and/or import substitution must occur, to an extent sufficient to create a trade surplus great enough to cover debt servicing. This is the 'transfer problem' which Keynes predicted in 1919 in the wake of the imposition on Germany of heavy reparation payments at Versailles. So long as the required domestic resource reallocation is feasible, there is no 'problem' – just downward pressure on home living standards as final output is diverted from local consumption and investment to overseas markets. If the required squeeze goes beyond feasible limits (or the political tolerance of the populace), then either default or offshore borrowing must follow, by the inexorable logic of the macro identities within which a national economy must operate.

Keynes conducted his analysis on the assumption that the reparations transfer would have to be entirely domestically funded, and calculated that the German economy would be unable to sustain the required level of production for export. In a famous debate with Keynes in 1929, Ohlin argued for offshore borrowing as the safety-valve. Germany indeed took that route in the late 1920s, as did New Zealand in the 1990s

and 2000s. By 2000, the New Zealand economy had built up net external indebtedness equivalent to 80% of its GDP.

Summing up, the stylised facts from the past couple of decades are:

1. New Zealand has since the 1970s financed a persistent current account deficit by borrowing offshore, in three successive waves.
 - a. The first, from 1975 to the late 1980s, was led by government borrowing which ran the total overseas debt up to 70% of GDP, of which the government accounted for about half.
 - b. The second, during the sell-off of state assets during the 1990s, saw the overseas debt privatised, as the government retreated to funding its financing needs by the issuing of New Zealand dollar-denominated debt. At the conclusion of this surge of inward equity investment, about 1997, the gross external debt stood at \$113 billion, of which half was direct private investment, and the net debt stood at \$86 billion, of which \$44 billion was direct investment.
 - c. The third saw the lead pass from direct investment to bank funding liabilities, over the period from 1997 to 2008.
 2. Looking forward, the era of massive bank funding inflows now appears to have come to an end, which leaves the economy once more confronting the age-old question of how the current account deficit is to be either funded, or covered by resource transfers into tradeables production. The fall in the New Zealand dollar exchange rate over the course of 2008 will have begun the transfer process, and the likely sharp drop in imports over coming months as recession bites will also help to bring the current account deficit down, as will the softening of the oil price, if and while it lasts. The immediate problem, however, is that the transmission of the economic downturn from the global economy to New Zealand will take place through the traditional channel of falling export earnings, not via the financial crisis, important as that is for domestic credit conditions.
 3. As was the case in 1997, the economy in 2009 faces two alternative options to deal with a latent transfer problem: borrow or trade its way through. The borrowing route will be feasible only if some new group of overseas investors becomes willing to finance New Zealanders' living standards on a large scale. The government may, of course, embark on large-scale foreign currency borrowing to fund infrastructure investment (which will have a high import content if politicians persist with their desire to build large showcase projects near big cities, rather than the dispersed, small-scale, labour-intensive infrastructure construction that could make intensive use of New Zealand resources and contribute directly to living standards across the country as a whole).
- So long as the massive inflow of offshore funding for the banks continued, and so long as that inflow continued to fully fund the current account deficit, the exchange rate was to

some extent relieved of the downward pressure that would have accompanied and driven a large-scale resource transfer into tradeables production. The banks' private pursuit of profitable opportunities to expand local lending by borrowing offshore at relatively low interest rates has had significant spillover consequences for the macro economy since 2002, by holding the real exchange rate higher than would otherwise have been the case, weakening in the process the profitability of tradeables producers and hence reducing the economy's structural capacity to confront a transfer problem.

Because the expansion of lending had inflationary consequences domestically, driving up house prices and enabling non-tradeables suppliers to push their prices up without encountering stiff consumer resistance, it attracted a tightening monetary policy response from the Reserve Bank of New Zealand from 2003 to 2007 which widened the

Faced with the possibility of being unable to roll over maturing loans, the banks put pressure on the New Zealand government to copy its Australian counterpart and guarantee their offshore borrowing.

margin between offshore and domestic interest rates, setting up a positive-feedback loop which increased the head office pressure on local bank managers to lend more (subject to the obvious constraint that unwilling borrowers by definition do not have to borrow!).

The events of 2008 have exposed the limits on the Australian banking system, and hence on its New Zealand subsidiary, and hence on the prospects for continuing to fund our standard of living by bank credit. The housing slump and the fall in equities values have stopped the 'hoover effect' as credit demand slows; while the credit crunch has stopped the force-feeding mechanism of credit supply in its tracks. The outlook is for bank balance sheets to deflate as the economy slows, with causality running both ways.

The financial crisis

The vulnerability of the New Zealand banking system lies on the liability side of its collective balance sheet, which makes it quite different from the asset-side vulnerability of the banks in the United States and Europe. In the US, credit expansion was carried to extremely unsafe levels, with the result that a significant proportion of the banks' assets dropped in value as the housing market fell and defaults on mortgage loans spread. The resulting write-downs threatened the banks with actual insolvency, in the sense of having insufficient assets to meet all the claims of the banks' creditors.

The New Zealand (and Australian) banks in mid-2008 were well placed to cover all their existing liabilities, by liquidating assets if necessary, but with three vital qualifications:

1. *Exchange rate risk.* The liabilities had a far greater proportion denominated in foreign currencies than the assets, which meant that over time a falling exchange rate would progressively raise the New Zealand dollar value of a given volume of foreign currency liabilities.
2. *Exposure to a credit crunch.* In the event that offshore lenders became unwilling to make new loans to enable expiring loans to be rolled over, the funding for the banks' activities would be squeezed. The result would be illiquidity, not insolvency, so long as the assets of the banks (mainly loans to New Zealand residents) remain sound.
3. *Systemic risk related to the state of the real economy.* In the event that a very severe downturn in the New Zealand economy, and/or a crash of the housing market, were to force mortgage and other loans into default on a large scale, the assets side of the banks' balance sheets would weaken and the US scenario of the past year would become more relevant. On the whole there is adequate leeway in the condition of the 'typical' New Zealand households that are in debt to the banks (see Reserve Bank of New Zealand, 2008, p.20). More worrying is the high level of recent lending to agriculture (ibid., p.24), which has snowballed in the past six years to five times agriculture's value added, indicating that a significant segment of agriculture is very highly leveraged and so potentially seriously exposed to a world market downturn.

The wholesale guarantee

Whereas in 2000 the inflow of non-resident funding was dominated by deposits lodged by the Australian parents with their New Zealand subsidiaries, over the subsequent eight years the parents ran up against a regulatory constraint (Prudential Standard APS 222) imposed by the Australian regulator, the APRA, which limited the exposure the Australian banks were permitted to take to offshore affiliates relative to the size of their Tier 1 capital at home. The banks had therefore increasingly turned to offshore markets for commercial paper, taking on large liabilities to third parties which could be rolled over only so long as the relevant offshore markets remained liquid.

As overseas financial markets seized up in September and October 2008, the banks' reliance on offshore funding became a looming issue. Faced with the possibility of being unable to roll over maturing loans, the banks put pressure on the New Zealand government to copy its Australian counterpart and guarantee their offshore borrowing. This involved a major change in fiscal strategy, which is in principle a matter for Parliament. The country was two weeks from a general election, with Parliament in recess. The minister of finance conceded that in the event of the guarantee being 'called' on a large scale, the contingent liability for the New

Zealand taxpayer could be \$150 billion – ten times the size of the ‘Cullen Fund’ laboriously built up over the previous years of fiscal surplus. Even on a probability-weighted basis the exposure was huge relative to the established fiscal strategy approved by Parliament earlier in the year. In underwriting the banks’ offshore borrowing, the New Zealand taxpayer would be in effect acting as an insurer/underwriter for risky private-sector financial transactions, in a setting where the usual protection a real insurer gains from diversity of risks was completely absent – in the event of a full-scale crisis offshore that brought the guarantee home to roost, it would be likely that several large guaranteed borrowers would go to the wall simultaneously. The privatisation of the country’s external indebtedness that was a centrepiece of the early 1990s would be reversed at a stroke. Considering the likely state of overseas financial markets in the bad state of the world, the New Zealand government’s own sovereign credit rating would probably count for relatively little, making the International Monetary Fund a potential lender of last resort.

The leader of the then Opposition came out strongly in favour of the guarantee, was briefly rebuffed by the then minister of finance, and the guarantee announcement was quietly slipped into place in the middle of the weekend of 1-2 November 2008. This was a dramatic change in the fiscal stance of the New Zealand government, undertaken without reference to Parliament and virtually without public debate on the important issues.

What arguments were there for the guarantee behind the scenes? Basically there appear to be five, none of them particularly compelling to my eye.

1. *The prospect of New Zealand dollar deposits over the \$1 million ceiling of the retail guarantee moving to Australia required a response.* This is far from self-evident. The deposits leaving the New Zealand banks (and reducing the liabilities side of their balance sheets in the process) would only be going to Australia to be parked in the parent banks, from where they would necessarily have to return to the New Zealand economy, which is where New Zealand dollar-denominated assets live. Part of the assets of the New Zealand banks would thus have shifted, along with the liabilities, from the local branch banks to the Australian parents. In the process the corset imposed by APS222 would be relaxed. It is far from obvious that New Zealand business would have been less able to secure working capital from the Australian parent than from the New Zealand subsidiary, let alone that the problem would have been serious enough to justify putting taxpayers’ money behind a guarantee.
2. *The banks would be better able to raise foreign currency loans if they had a guarantee, which would mean that instead of issuing their own paper in New York or London, they would in effect be issuing government paper by proxy.* Whether this is true or not I do not know, and I have seen no evidence to support the claim. The state of global

financial markets in late October 2008 was such that very little paper of any sort could be sold. The eventual test of the argument for a guarantee will be the extent to which non-guaranteed bank paper is in fact able to be placed with offshore financiers. I am sceptical that the guarantee will have any measurable effect on the ability of the New Zealand banks to raise funds offshore. I am in no doubt, however, that the transfer of the risks of offshore funding onto the shoulders of the taxpayers – effectively socialising the risks of Australian bank shareholders at the expense of New Zealand taxpayers – amounts to a significant subsidy, legislated without reference to Parliament and implemented largely behind closed doors.

3. *The taxpayer stands to make money on the charges for the guarantee.* The guarantees certainly bear significant penal charges, but it is probable that there is asymmetric information at

... where no rolling over of offshore funding was possible at all, the banks would be obliged to raise New Zealand dollar funding to pay down their foreign-currency debt.

work. New Zealand officials may well be more sanguine about where the overseas financial markets are heading in the next two years than the banks’ managements. Only after the event will we know whether a few billion dollars of fees is adequate compensation to taxpayers for the risk they are being obliged to bear.

4. *The government will emerge whole because of swap arrangements.* The issue here is that when the banks raised foreign currency funding for their New Zealand dollar lending, they entered into swap arrangements to place the foreign currency proceeds of their commercial paper issues with offshore borrowers for terms longer than 90 days. Paying off the foreign currency liabilities with New Zealand dollar funding would leave the corresponding longer-dated foreign currency assets orphaned, while unnecessarily driving down the New Zealand dollar exchange rate. If the government guarantee succeeds in reopening access to 90-day credit, the assets component of the swap deals can then be unwound over time, leaving all parties whole. This is a complex argument, but relies ultimately on proposition two above to give it any validity as justification for the guarantee.
5. *‘Confidence’ will be restored.* The difficulty is to know whose confidence exactly, what the determinants of confidence are, and indeed what confidence itself may be. Appreciative and supportive statements from the banks who are the beneficiaries of this piece of taxpayer largesse do not, it seems to me, suffice to provide good evidence

that some relevant dimension of public psychology has been improved. Given the scale of the sums at stake, it would be good to have some substantial account of what this 'confidence' is, where it comes from, and exactly why it should be improved rather than scared by the sea change in fiscal strategy that has just happened.

Suppose that the wholesale guarantee had not been granted, or had been limited to New Zealand dollar funding only? In the worst case, where no rolling over of offshore funding was possible at all, the banks would be obliged to raise New Zealand dollar funding to pay down their foreign-currency debt. New Zealand dollar funding has been readily available from the Reserve Bank since May. The result would be a restructuring of the banks' balance sheets as their offshore debt was repatriated, accompanied presumably by a sharp depreciation of the exchange rate as the funds were transferred offshore. At the end of that process, more than half of the country's external debt would have disappeared and the current account would have moved most of the way back to balance, *ceteris paribus*.

Yes, there are downsides to this scenario, but none of them have been modelled and costed to my knowledge. Certainly they had not been modelled and costed at the point when the government and Opposition parties agreed to junk the prevailing fiscal strategy. The debate simply did not happen, so far as the public arena was concerned.

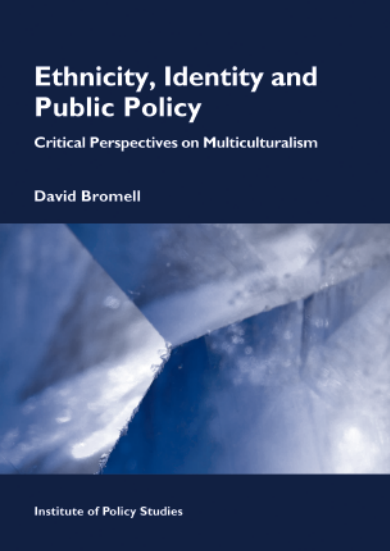
And yes, there are rigorous restrictions on the guarantee scheme that will undeniably reduce taxpayers' exposure very greatly; rather than \$150 billion, we may be faced with a worst-case contingent liability of, say, \$30 billion. That is still a lot of money, and it has been amazing to see how readily it was available to underwrite an offshore-owned banking system that was and is very far from insolvency and

which is arguably perfectly capable of looking after itself in difficult times. Think of the amount of future fiscal leeway to undertake social policies to ameliorate a major recession that may have been made hostage to the financial sector, just as that very recession looms over the horizon.

1 Calculation from Table 3: $(\$138.9 \text{ billion} - \$21.7 \text{ billion}) \div \$159.2 \text{ billion} = 74\%$.

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Ethnicity, Identity and Public Policy

Critical Perspectives on Multiculturalism

by David Bromell

Should government adopt multiculturalism as public policy? What is the role of the state in managing diversity? Are all cultures of equal value? And is ethnicity the difference that most matters?

In *Ethnicity, Identity and Public Policy*, David Bromell evaluates theory developed in other national contexts against challenges for public policy arising from ethno-cultural diversity in New Zealand. He concludes that this is a time to refine – and complicate – our thinking, and that the task of developing normative theory in relation to diversity and public life is still a work in progress.

In Bromell's view, New Zealand should endorse neither multiculturalism nor biculturalism as its official policy stance. Instead, he advocates safeguarding individual rights, which all share equally, and a restrained role for the state in 'managing' diversity. He argues that reducing inequalities ought to be a higher priority than recognising identities.

Overall, Bromell urges the cultivation of citizen participation in deliberative democracy and seeks to inform and stimulate debate about big ideas and difficult questions for public policy. This is a challenge for hearts as well as minds.

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