

Donald T Brash: An indebted people

Speech by Mr Donald T Brash, Governor of the Reserve Bank of New Zealand, to the Canterbury Employers' Chamber of Commerce, Canterbury, 25 January 2002.

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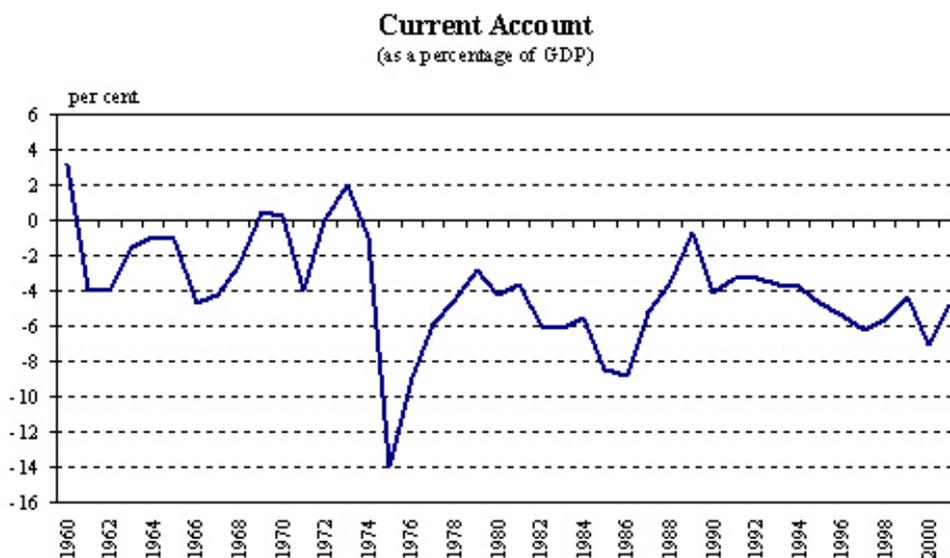
Mr Chairman, ladies and gentlemen

I am delighted to be here again for my ninth annual address to the Canterbury Employers' Chamber of Commerce. Last year I spoke to this audience about what goes on "behind the scenes" in formulating monetary policy at the Reserve Bank, and over the years I have addressed a wide range of topics. In 1998, I talked about New Zealand's balance of payments deficit and its relevance to policy-makers. The topic of that speech was "New Zealand's balance of payments deficit: does it matter?"¹

I want to return to this topic today, from a slightly different tack. As part of our brief to watch out for things to do with financial stability, we in the Reserve Bank have been doing some thinking recently about New Zealand's dependence on foreign capital and some of the risks that that exposes us to.² (As an aside, it seems fitting to be addressing this topic in Christchurch this year, as my own Masters thesis, submitted to the University of Canterbury forty years ago this year, was entitled "New Zealand's External Debt Servicing Capacity" - although I am bound to say my understanding of the issues has evolved considerably since that time!)

Just how dependent are we on foreign capital?

By international standards, and by our own historical standards, New Zealand is unusually dependent on foreign capital. Since the mid-1970s, New Zealand has consistently spent more on goods and services from abroad, including the income paid to the foreigners who have provided us with capital, than it has earned from exports. It has, in other words, consistently run a current account balance of payments deficit. Each of these deficits has had to be financed by capital inflows of one kind or another.



Source: Statistics New Zealand

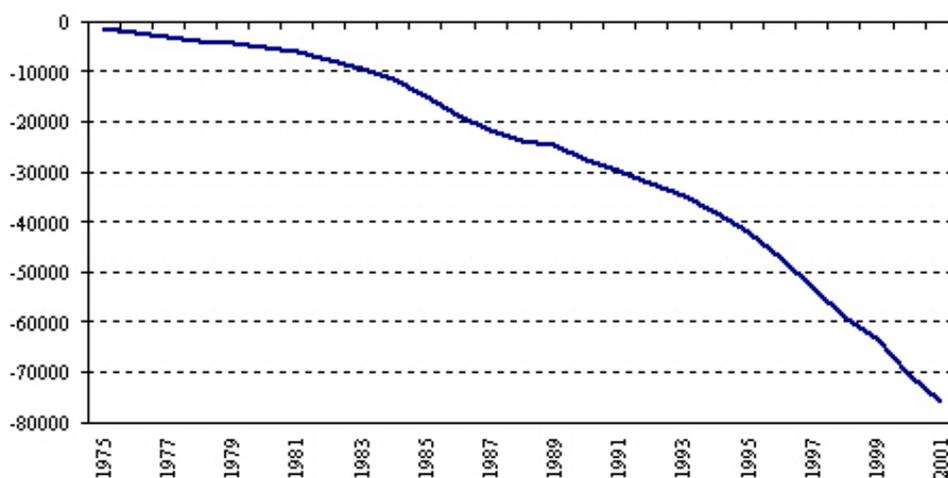
¹ Speech to Canterbury Employers' Chamber of Commerce, 30 January 1998.

² See, for example, the article "International capital flows, external debt, and New Zealand financial stability" in the December 2001 issue of the Reserve Bank's Bulletin.

Four years ago when I talked about the current account, the deficit stood at 6.4 per cent of GDP, then one of the largest deficits in the world relative to GDP. In fact, the deficit deteriorated further, peaking at 7.0 per cent of GDP in the year to March 2000. The latest information we have is for the year to September 2001, when the current account deficit was 3.4 per cent of GDP. That is low by recent New Zealand standards. But what matters is not any particular year's current account deficit - whether the 14 per cent peak deficit in 1975, when the terms of trade collapsed, or the rather lower deficit of the last year, helped by good commodity prices and an unusually low exchange rate. What matters, when we think about financial stability, is the *accumulation* of deficits: the stock of debt and equity finance which foreign investors have provided to this economy over the years, and the relationship of that stock to our wealth and income.

Capital inflows match (and fund) a current account deficit. Capital inflows can take the form of debt (foreigners lending to us) or equity (foreign investors buying property and shares in other productive assets in New Zealand). But each inflow adds to the stock of foreign debt and foreign ownership. The numbers involved are large. If we add together all the current account deficits since 1975, they total almost \$80 billion, and of course there were substantial amounts of foreign debt and foreign ownership prior to that date.

Cumulative Current Account Deficit, 1975-2001
(NZ dollar millions)



Source: Statistics New Zealand

I have no doubt that foreign investment in New Zealand has been very beneficial to the New Zealand economy and to most New Zealanders, and that is especially true since we abolished the subsidies which we used to extend to some foreign investors through our protection of internationally uncompetitive industries.³

Of course, there is nothing inherently wrong with borrowing or debt either. I differ, for example, from a strict interpretation of the sentiment Mr Micawber expressed in Charles Dickens's "David Copperfield":

"Annual income twenty pounds, annual expenditure nineteen pounds nineteen shillings and sixpence, result happiness. Annual income twenty pounds, annual expenditure twenty pounds ought and sixpence, result misery."

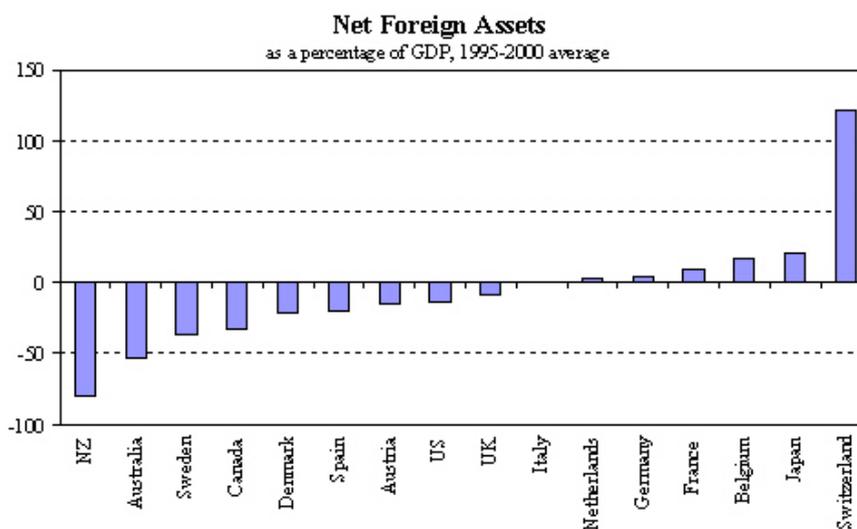
Taking on debt permits spending and investment earlier than would otherwise be possible. It can provide a buffer when income is temporarily low, and help finance profitable investment opportunities. This applies both to individuals and to nations. Much of the initial infrastructure of this country was financed by foreign borrowing from the United Kingdom in the nineteenth century.

However, the more indebted a country is the more vulnerable it is to things going wrong. In many ways, the story is the same for a country as for a highly indebted individual - everything is fine as long

³ "Foreign investment in New Zealand: Does it threaten our prosperity or our sovereignty?", speech to the Wellington Rotary Club, 20 November 1995.

as there is the willingness and the ability to service the debt. But the higher the level of debt, the more exposed the individual is if, say, he or she is made redundant or faces unexpected expenses.

I mentioned a moment ago that we have run current account deficits totalling around \$80 billion since 1975. The best official measure of how reliant we are on foreign capital is Statistics New Zealand's International Investment Position data. That shows that our total net use of foreign capital - allowing for the best estimates of New Zealanders' holdings of foreign assets - is around \$88 billion, or nearly 80 per cent of GDP. Moreover, the gross numbers matter too - the total amount of capital which foreigners have provided to New Zealand is around \$170 billion. There is a mix of debt and equity: the distinction between the two isn't always clear cut,⁴ but in the official data approximately \$120 billion of the total takes the form of debt.



Source: IMF

In isolation, these figures don't mean very much; and, after all, many of us have had mortgages well in excess of one year's income. International comparisons can help us gain a better perspective. Most mature and highly developed economies in Europe and North America are either net lenders to the rest of the world, or have financing from abroad equivalent to only 20-30 per cent of GDP. Even Australia, with its own history of persistent current account deficits, is only about half as dependent on foreign capital as we are.

It is not easy to draw strong conclusions from international comparisons, as there are measurement difficulties in comparing data from different countries. However, it does seem that New Zealand is now much more dependent on foreign capital than any of the developed countries we like to compare ourselves with. One exception is the tiny - but much wealthier - country of Iceland, which is in about the same position. Looking back over history, the data are not as reliable, but it is not obvious that any developed country in the post-war era has been more dependent on foreign capital than we are now⁵ - and certainly none since the general liberalisation of private capital flows over the last few decades.

As I suggested earlier, a heavy dependence on foreign capital - whether of debt or of equity - need not be a problem. What matters is how that capital is used, and what is happening to the incomes and assets of those raising the finance. I have noted on many occasions that Singapore ran very large current account deficits, averaging around 11 per cent of GDP, for a long period in the 1970s. As any businessperson knows, borrowing or raising outside equity makes a lot of sense if there are profitable investment opportunities available. At a national level, an unusually high degree of dependence on foreign capital (especially debt) makes a lot of sense if there are opportunities that mean it is reasonable to expect the rate of economic growth to take a big step up, and to move ahead of the average.

⁴ Tax considerations often encourage foreign parent companies to finance their local subsidiaries in the form of debt rather than equity, and some instruments are designed to be equity for some purposes and debt for tax purposes.

⁵ Ireland may have been an exception in the late 1970s and early 1980s (the data do not allow a direct comparison).

Singapore got that sort of pay-off. That country graduated from being a low-income developing country in the 1950s to the point where it now has per capita incomes higher than our own.

Unfortunately, we haven't achieved a similarly dramatic transformation. Yes, our GDP growth performance has been better in the 1990s, but on most measures (eg growth in output per hour or per person employed) it has still not been as good as those of other, much less indebted, developed nations. Australia's picture looks better: although our trans-Tasman cousins have also run relatively large current account deficits, and are therefore also relatively quite heavily dependent on foreign capital, they achieved growth rates among the highest in the developed world during the 1990s.

But even that does not get to the crux of the issue for New Zealand. Gross domestic product is a measure of the income generated within New Zealand, and New Zealand's growth in GDP was not too bad during the 1990s. But because we have become increasingly reliant on finance from foreign savers, an increasing share of the income this economy generates goes (in interest and dividends) to those who financed us. Gross national product is a measure of the income generated by New Zealanders' own resources. Unfortunately, GNP per capita in New Zealand barely increased at all during that time. In other words, because we have been such heavy users of capital from foreign savers - so reluctant to save enough to provide our own investment capital - much of the growth in the New Zealand economy in recent years has accrued to those foreign savers.

This is not a speech about why our growth performance has been disappointing. I have spoken on that and related issues on other occasions, including to this audience two years ago.⁶ Instead, I want to devote the rest of this speech to looking briefly at how we came to be so dependent on foreign capital, and then turn to outlining some of the risks that that dependence may expose New Zealand to.

How did we get into this situation?

I don't think there are too many easy answers to the question of *why* we became so dependent on foreign capital. I think it is clear, however, that the current situation is more a reflection of private sector choices over a number of years than of government decisions, though of course to the extent that government policies have *influenced* private sector choices those government policies must share some of the responsibility.

At the heart of the issue, countries run up obligations to foreign investors when, in total, they are spending (consuming or investing) more than they are earning.

Let me stress that government borrowing is not the issue today. When we first ran large current account deficits in the 1970s, and through to 1984, government fiscal deficits accounted for much of the excess spending that gave rise to the current account deficits, and government borrowing abroad financed those deficits. As late as the early 1990s, New Zealand's total government debt was relatively high by international standards - though never anywhere nearly as high as the public debt of countries like Ireland, Belgium and Italy, or indeed Japan today. But a decade or more of prudent fiscal management means that our net public debt is now among the lowest in the developed world. Good comparative data are hard to come by, but it seems likely that the New Zealand government's overall net asset position is today at least as good as the average for developed countries.

It is also worth noting that the New Zealand government now has no net foreign currency debt. The small amount of foreign currency government debt still outstanding is fully matched by foreign currency assets held by the Treasury and the Reserve Bank. The limited net amount of debt still owed by the government to foreigners is in the form of locally-issued New Zealand dollar bonds that foreign investors have bought on the local bond market.

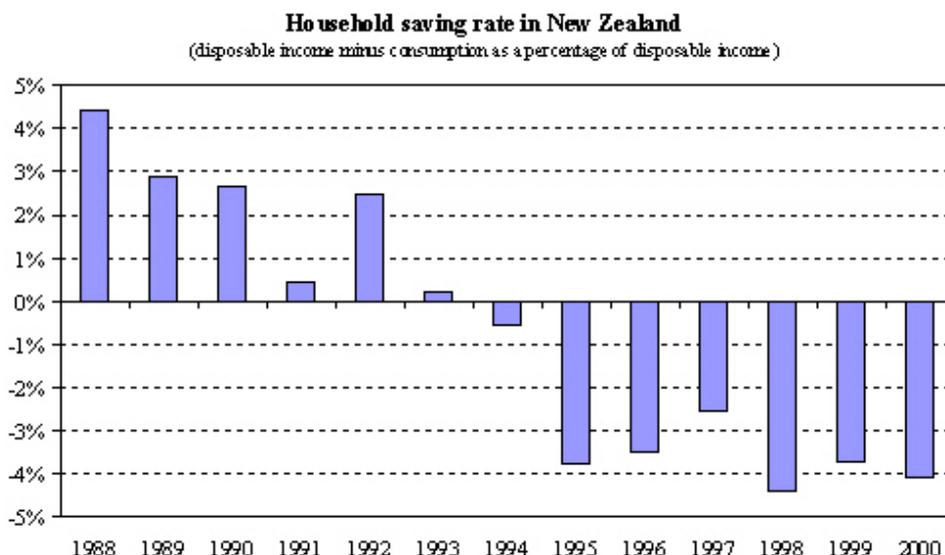
Nor is privatisation to blame. Many of the formerly government-owned assets that have been sold have ended up owned by foreign investors. But selling the assets didn't change the spending habits of New Zealanders. The deficits needed to be financed: selling assets (whether privately owned or publicly owned) has been one way of doing that, and if we hadn't sold such assets, we would have had to finance those deficits by going even further into debt. As I said a moment ago, current account deficits need to be financed, and that financing can take the form of either equity or debt. If not equity, then debt; if not debt, then equity.

⁶ "The building blocks of economic growth", speech to the Canterbury Employers' Chamber of Commerce, 26 January 2000. See also "Faster growth? If we want it", a speech to the Catching the Knowledge Wave conference, 2 August 2001.

Who then is behind the spending that has made us so reliant on foreign savings?

The "culprit" has been the private sector - and New Zealand households in particular. The share of their incomes that New Zealand households are saving has fallen away very markedly. Household savings rates fell in a number of developed countries over the last ten years or so. But, while some caution is needed because of cross-country measurement difficulties, New Zealand's record looks particularly poor.

Fifteen years ago, our household saving rate was not too bad by developed country standards. But by 2000, we had slipped down to the bottom of the OECD developed-country class. By that year, our households were, in aggregate, spending more than their income. The OECD average saving rate that year was 8.4 per cent.



Source: Statistics New Zealand

The sharp fall in the household savings rate has not been sufficiently offset by increased savings in other sectors of the economy, so that now our overall national savings rate also appears to be the lowest among the developed OECD countries. If we, as New Zealanders, are not saving very much, somebody else - somebody overseas - has to finance the ongoing investment the economy needs. Our level of investment is not unusually high, but our savings rate is unusually low.

Why are we, on average, saving so little of our incomes?

I have, from time to time, suggested that we are poor savers because we have been effectively told by successive governments for more than half a century that we do not need to save for the things that people in many other countries save for. We have been reassured that government will care for us if we get sick; that government will pay for the primary, secondary, and tertiary education of our children; that government will care for us in old age. "You don't need to save" has been the message. And successive governments have also effectively told us, by their behaviour during the seventies and eighties at least, that if we nevertheless do save we would lose our savings through high inflation, and strongly negative after-tax real interest rates.

But while there may be something in that explanation, it does not really explain either why our savings performance is so much inferior to that in, for example, most European countries (where the social welfare net is at least as generous as it is in New Zealand), or why our savings performance has actually deteriorated in recent years, as government's commitment in health, education, and retirement income has become a little less generous, as inflation has been largely eliminated and as real after-tax interest rates on savings have become positive.

In principle, another possibility is that the savings rate (from current income) might be falling because households own assets that have risen in value, making people feel that there is less need to save

from current income. This seems to have been the story in the United States - which has also become much more dependent on foreign savings in recent years. Ten years ago, US household saving rates were around 8 or 9 per cent, but by the end of the decade (at the end of the longest and strongest equity market expansion of the twentieth century), the US savings rate had dropped to just 1 per cent. One might question just how robust those high asset prices will prove - on most longer-term metrics, US share prices still look to me to be rather considerably overvalued. But, if people believe the wealth gains will last, it does make sense for them to increase spending and reduce savings in response.

We, by contrast, have not seen soaring asset prices of that sort - indeed, the data suggest that real household wealth has been falling for several years. There are very real data difficulties in comparing wealth in different countries, but New Zealand stands out in the data we do have: we have a low ratio of wealth to income, indeed the lowest of the developed countries we've looked at. Our numbers are likely to be understated - in particular, farms are not included in the data, and farms make up a larger percentage of wealth here than in most other developed countries. But even if adjustments were made for these factors, it seems unlikely to change the overall picture materially. And our relative position in those league tables looks much worse than it did a decade ago.

It is worth highlighting a few numbers. Financial assets and liabilities are easier than most to get a good fix on. New Zealand households' net financial wealth (deposits, shares, unit trusts, pension funds, etc less household debt) is estimated to be only around 70 per cent of our annual disposable income. In the bigger developed countries, that ratio averages around 270 per cent - even after the fall in international share prices last year. Even allowing for the inevitable problems in putting together such cross-country comparisons, and for the possibility that international share prices still have some further adjustment to do, that is a large - and sobering - difference. Put another way, the debt of the household sector in New Zealand is very much higher, relative to the sector's financial assets, than in many other developed countries.

Household net financial wealth to income ratios

Per cent	1990	1995	2001	1990-2001 change	1995-2001 change
US	261.8	304.7	333.0	71.2	28.3
Japan	260.3	283.8	356.9	96.6	73.1
Germany	130.8	140.4	150.0	19.2	9.6
France	130.6	184.7	264.4	133.8	79.7
UK	211.8	291.2	333.2	121.4	42.0
Italy	196.3	217.1	250.0	53.7	32.9
G6	198.6	237.0	281.3	82.7	44.3
Australia	253.0	218.4	266.0	13.0	47.6
New Zealand	102.7	108.6	70.4	- 32.3	- 38.1

Source: OECD, national sources, and UBS Warburg. 2001 data are forecast, except for NZ, which are 2000 actuals.

Household debt to household financial assets ratios

Per cent	1990	1995	2001	1990-2001 change	1995-2001 change
US	25.0	23.6	23.8	- 1.2	0.2
Japan	3.4	32.7	27.1	- 6.3	- 5.6
Germany	34.9	42.5	41.1	6.2	- 1.4
France	40.3	25.8	17.3	- 23.0	- 8.5
UK	35.6	24.9	24.4	- 11.2	- 0.5
Italy	12.9	12.9	12.9	0.0	0.4
G6	30.4	27.0	24.4	- 5.9	- 2.6
Australia	30.8	36.7	40.4	9.6	3.7
New Zealand	39.1	47.3	64.5	25.4	17.2

Source: OECD, national sources, and UBS Warburg. 2001 data are latest estimates based on monthly or quarterly figures, except for NZ, which are 2000 actuals.

Unlike most developed countries, in New Zealand houses make up the overwhelming bulk of our relatively modest net wealth. Of course, we all have to live somewhere, but especially in a low inflation environment, houses do not offer a high investment return - either to most of us as owner-occupiers or to those holding investment properties (although I acknowledge the incentives created by the present tax regime). It is perhaps worth noting that New Zealand home ownership is no longer particularly high by developed world standards and, although getting consistent data over time is not easy, may even be slipping down the international rankings. I suspect this may surprise some people, as we tend to see ourselves as a nation of home-owners tending the quarter acre plot. It isn't obvious that we are building a disproportionate number of houses either, but perhaps - by default as much as by design - we are rather too keen on having a house as the principal asset in our investment portfolios. What we haven't done is built up or maintained holdings of other income-earning assets.

Later this year, the Retirement Commissioner will release a report based on a fairly comprehensive survey of New Zealand household wealth. While I have not seen the report of course, it will undoubtedly add a great deal to our understanding of household balance sheets. I suspect that underlying the aggregate figures - and by that I mean the household sector as a whole - some disturbing figures could emerge about just how low the wealth and savings of even the middle-aged middle income sections of our society are.

What still isn't so clear is why we have cut our savings rate to such a low level.

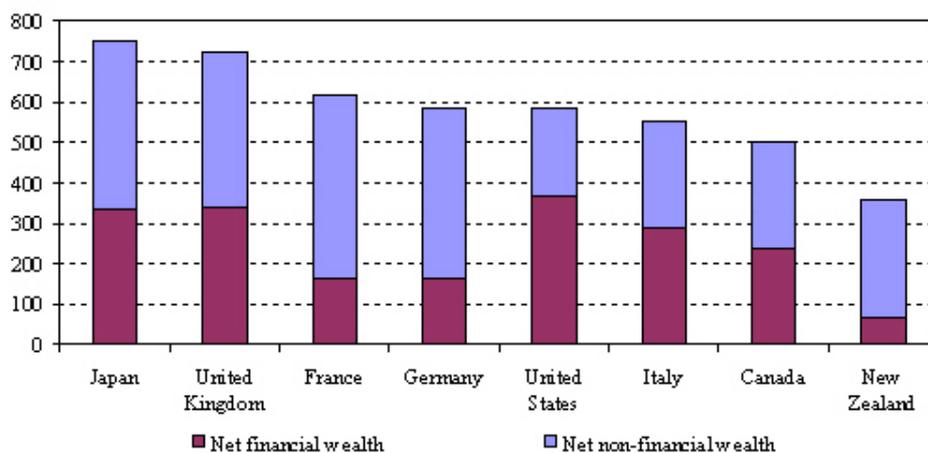
Part of it, of course, is simply that we could. In many developed countries following financial deregulation, households have run debt levels up quite substantially. Refinancing, and drawing down the equity in one's house, has become much easier - with revolving mortgage facilities, people can and do now "put the groceries on the mortgage". Banks have, at times, marketed this opportunity aggressively. I can recall one innovative television advertisement that encouraged home-owners to "put the boat on the house", and illustrated the message by depicting a boat balanced on the roof of the house. The wisdom of following their advice literally, or financially, was for the householder to determine! But whatever the wisdom, households went on a borrowing spree - we estimate that household borrowing increased by \$45 billion during the 1990s alone, from 57 per cent of disposable income in 1990 to 110 per cent in 2000, and that despite loud complaints from some about the high real interest rates on such borrowing.

Perhaps a little paradoxically, lower inflation also facilitated the increase in debt. When inflation was high, high nominal interest rates meant that bank limits on debt servicing as a share of income cut in very quickly. Given the way mortgages are structured, lower inflation, and the lower interest rates which come with it, have allowed individuals to borrow more than they could in high inflation periods.

As we've highlighted in a number of our *Monetary Policy Statements*, household debt-to-income ratios now seem to be fairly similar to those in, say, the United States and the United Kingdom. But post-deregulation adjustment to international norms isn't enough of an explanation. The difference between

New Zealand and most other developed countries is that we do not have as many assets as householders in other developed countries do. Basically, we have borrowed to finance consumption or relatively unproductive investments.

Household net wealth as a percentage of disposable income
(2000 data, 1999 for Japan and Italy)



Source: OECD and Reserve Bank of New Zealand

More work is needed in this area, but my own sense of what has gone on is relatively prosaic. Our incomes haven't been growing as rapidly as those in other comparable countries. But the range of goods and services available to us has increased dramatically, as we have liberalised and as other countries have grown - indeed, it is often commented just how good the services available in New Zealand now are. If our tastes (our demand for goods and services) are increasing faster than our income, savings inevitably fall. We were able to finance the difference between our low level of savings and our average level of investment expenditure by accessing the savings which foreigners made. Over the years, those differences have added up to large numbers.

Average investment as a percentage of GDP 1988-1999

Country	Residential Investment %	Investment excluding residential %
Finland	5.0	15.9
Netherlands	5.8	15.8
Denmark	3.9	15.2
US	4.0	14.6
Italy	5.0	14.5
New Zealand	4.9	14.3
UK	3.4	14.4
Australia	4.9	18.3
Canada	5.6	13.5
Average	4.7	15.2

Source: OECD Quarterly National Accounts

What does it all mean?

What should we make of all this?

As I noted at the outset, the more indebted we are - as individuals and in aggregate - the less resilient to adverse economic shocks we are, and the higher the potential vulnerability. Without automatically presuming that there are problems, central bankers thinking about potential risks to financial stability should be prodding and probing when financing patterns in the economy look very different from international norms, or when structures and stocks change rapidly in a relatively short space of time. The changes in New Zealand debt levels over the last 15 years have been very marked and have taken us increasingly away from international norms.

In recent years, and particularly following the Asian crisis, the Reserve Bank has been devoting more attention to thinking about potential risks, both economic and financial. Internationally, we have seen numerous financial crises over the last decade or so. Part of our work in this area has highlighted the encouraging features that differentiate New Zealand from the crisis countries, a point I will come back to in a moment.

It is worth noting that, since capital account liberalisation 18 years ago, the country's increasingly large external financing requirement has been met remarkably smoothly through a variety of international crises and changing domestic economic and financial conditions. But the perennial question concerns what sort of shocks or emerging points of vulnerability should we be alert to. If things turned against us, where might the pressure points in the economy and the financial system be?

In essence, there is one big New Zealand imbalance that manifests itself in two - connected - ways. First, our household sector balance sheets appear to be very out of line with the international norm. And second, we are very dependent on foreign capital, with a large share of that in the form of debt finance. Let's remind ourselves of the connection.

Households do not, of course, typically borrow directly from overseas. Instead, they borrow from domestic banks. But that bank lending has to be financed somehow. Some of it is effectively financed by New Zealanders selling their holdings in New Zealand listed companies: we've seen a lot of that in the last 12-18 months as a low exchange rate has made many New Zealand companies appear very cheap to foreign buyers. But the household demand for credit has substantially exceeded the rise in the bank deposits of New Zealanders. As a result, much of the household borrowing has ultimately been financed by banks' borrowing from overseas. New Zealand banks now rely more heavily on overseas borrowing than banks in any other developed country - roughly a third of the total assets of the banking system are now funded by borrowing overseas, though not all of this funding is used to make loans to the household sector. Or measured another way, of the total increase in banks' balance sheets during the nineties, roughly a third has been financed from offshore. Of course, the average borrower isn't even aware of this (and need not be) - she goes to the bank on the corner and finances her house without realising from where the funds are sourced. Financial intermediaries do their job very well, bringing together domestic borrowers and often-foreign providers of funds.

Interestingly, individual loan-to-valuation ratios appear to be relatively conservative (and bank balance sheets are in very good shape in New Zealand), but I wonder how sustainable existing property prices would be if households ever decided to try to adjust their savings patterns, bringing their holdings of assets more into line with the international mainstream - looking to buy more shares, or to invest more in small and medium-sized businesses, for example.

Think, for example, of a large number of "baby boomers" realising that they really do not have enough income-generating assets to support a good lifestyle in retirement, and foregoing the next move up to a bigger house. In aggregate, the effects could be large. Think also of the impact on consumption spending, and the demand facing large parts of the business sector, if the household savings rate were to move back to 10 per cent of disposable income over a relatively short period of time. And of the possible implications then for the quality of bank loan books - built up at times when demand has been strong.

We all hope that the imbalances resolve themselves gradually and without undue disruption. And there are some encouraging signs. Having run up debt over the 1990s (in particular), credit growth rates are now much lower than they were in the mid-1990s. And the lack of house price inflation in recent years is a salutary reminder of what life should be like in a low inflation environment. Perhaps households may be beginning to stand back and consider their overall balance sheets. This certainly seems to be the sector of the economy that needs to think about how well placed it would be to absorb

a shock - a large drop in house prices, the loss of a job, and so on - and indeed the assets required to support a good quality of life in retirement.

Nonetheless, we cannot be complacent. Lending to households continues to grow faster than incomes are rising. And the current account position itself, although improving in the last couple of years, is not overly encouraging given the strength of New Zealand's export prices recently and the fact that most commentators, ourselves included, believe that our exchange rate is substantially undervalued. Unless the current account deficit stays below around 4 per cent of GDP or we achieve a rather faster rate of economic growth than we have managed in recent decades, the ratio of net foreign capital to GDP will continue to increase from already unusually high levels. Resolving imbalances, even "naturally" if borrowers voluntarily come to the conclusion that they are over-extended, can be painful, and it seems to be in the nature of life that adjustments of this sort don't always occur easily or smoothly. Often they seem to require some sort of external prompt or trigger.

Browsing in a second-hand bookshop recently, one of my colleagues came across the following salutary observation from a New Zealand commentator writing in 1886:

I fear it is of no use writing against excessive borrowing. The disease must run its course and no one will rejoice more than the writer if a certain cure is found for it. There are reckless lenders as well as reckless borrowers and the two must share the difficulties and troubles which may be in store for them in the future.⁷

One obvious area of risk is that those who are providing the finance from abroad may reassess their willingness to go on doing so. A sharply increased cost of overseas finance, for example, could dramatically alter the situation facing many New Zealand households.

The external finance we now use takes a variety of forms: some short-term and some long-term; some debt and some equity; some in New Zealand dollars and some in foreign currency. The conventional wisdom is that the risk of financial instability tends to increase as the proportion of short-term liabilities increases, as the proportion of debt increases relative to equity, and the greater the proportion of liabilities denominated in foreign currency.

Of course, these are simple rules of thumb not immutable laws of nature. They do not always hold. For example, it is clear that much of the apparently short-term debt owed by the New Zealand private sector is owed by foreign-owned subsidiaries to their overseas parents, and is quite unlikely to be called up at short notice.

Sometimes, long-term debt can create less vulnerability than equity: an investor's equity stake could be short-term in nature, while long-term debt holdings might be part of an overall relationship between highly-integrated foreign parent companies and local subsidiaries. Even if the underlying equity investment itself is a long-term one - and it can often be difficult to off-load large or controlling interests quickly - equity holders may move to hedge themselves against currency risk if they fear that the exchange rate is vulnerable to a fall. That sort of selling could exacerbate any pressures on the exchange rate.

Foreign currency borrowing is generally held to be much riskier than domestic currency borrowing, and most of the private sector's external debt is denominated in foreign currencies. But at the same time, the overwhelming majority of that foreign-currency debt is hedged back to New Zealand dollars (by contrast, most heavily indebted developing countries are unable to raise foreign funding in their own currencies). That meant that our banks and corporates got through the sharp fall in the exchange rate during the late 1990s - a fall which saw the New Zealand dollar fall against the US dollar by some 45 per cent from peak to trough - almost entirely unscathed.

But the very fact that so much of the debt is hedged raises further questions. If New Zealand residents are not directly exposed to foreign currency exchange rate risk, who is taking the risk? If we can effectively borrow from abroad in New Zealand dollars, someone must be willing to lend in New Zealand dollars - someone, most likely, without a strong "natural" interest in holding New Zealand dollar assets. Unfortunately, we cannot be sure who these holders are, what drives them, or what might make them reconsider their willingness to be exposed to a relatively small peripheral currency.

Financial systems and currencies can become illiquid quite quickly. Once investors begin to doubt the safety of the assets which they have tied up in a financial system or specific currency, they may want

⁷ C.R. Carter, *An Historical Sketch of New Zealand Loans and Other Matters Connected Therewith from 1853 to 1886*, London, 1886

to liquidate them quickly - the more so when, as in New Zealand's case, we feature in few of the international "benchmarks" that shape where portfolio managers place the bulk of their funds. There are considerable advantages in maintaining an independent currency and free movement of private capital, but it does mean that stability relies to an important extent on maintaining the confidence of market participants in the currency and the financial system.

An unusual feature of New Zealand's offshore financing is that such a large proportion of the financing now takes the form of hedged foreign currency financing undertaken by a relatively small number of banks. The ability of those banks to continue tapping the international markets, and to continue effectively hedging the foreign currency risks, is clearly a point of vulnerability. That is likely to be closely linked not only to their own financial health, but also to the financial health of the small number of overseas parents.

Under some circumstances, all this could become much more difficult. For example, even shocks outside the control of the borrowing bank or its overseas parent, such as a slip in New Zealand's credit rating (or indeed, in Australia's rating, given the dominant role of Australian banks in New Zealand), could trigger a reappraisal of the risks inherent in dealing in the New Zealand market. Below certain ratings thresholds it can be impossible to tap financial markets.

Concluding remarks

Clearly there are risks in being as heavily dependent on foreign savers as the New Zealand private sector has become. Heavy reliance on foreign capital is something New Zealand shares with many of the countries that have experienced exchange rate or banking system crises in recent years. But fortunately New Zealand differs from these countries in many respects, and our points of vulnerability - and it is no more than heightened vulnerability - appear to be rather specific to New Zealand.

We have had a floating exchange rate for 17 years. That has made borrowers appropriately cautious in ensuring that their borrowings are well hedged, and can help the economy adjust to adverse economic shocks. Unusually among heavily indebted countries, we are readily able to tap international capital markets in our own local currency. We have a sound macroeconomic policy framework, a government committed to running fiscal surpluses, and a relatively low level of government debt. We do not have a large bubble in asset prices just waiting to burst. Our banks are well-capitalised and well managed, and have very low levels of non-performing loans by international standards. There is a good level of high-quality disclosure about the financial position of banks and the government. And yet the very fact that imbalances of the sort I have highlighted in this speech can emerge, even against the backdrop of what appears to be such a sound well-designed policy framework, is part of what makes our situation quite unusual - and hard to know just how things will work out from here. Other countries have not been this way before.

Can I say unambiguously, however, that I am not predicting some sort of financial crisis for New Zealand. Yes, it appears that quite substantial adjustment in household balance sheets will be needed over time, and that will begin to reduce the levels of external indebtedness. We all hope that that adjustment will occur gradually, voluntarily, and against the background of favourable international circumstances. That seems by far the most likely outcome. But the message of this speech has been simply that when the ratios are as stretched as they have become in New Zealand, we are more vulnerable if things go wrong - and that is something which firms, households, the government, and a central bank focused on financial stability need to be aware of. All that underscores the importance of a sound macroeconomic framework for fiscal and monetary policy, and of robust and well-managed banks. For us at the Reserve Bank, it also highlights the need for continual monitoring of the nature of the risks and the ways in which demand for finance, and the terms on which it is available, are changing.

I have not devoted any time today to the question of what more public policy could or should do about this picture. Those are issues for another day.