What is Foreign Debt?

**Foreign Debt/ External Debt**
Foreign Debt is the borrowings of governments, govt trading enterprises and the private sector from overseas residents.

Most of Australia's debt is denominated in foreign currency.

**Gross Foreign Debt versus Net Foreign Debt**

- **Gross Foreign Debt** – total of Australia’s overseas borrowing.
- **Net Foreign Debt** – Gross foreign debt – Australian lending to overseas residents.

**Net Foreign Debt is the best indicator of Australia’s debt.**

**Net Foreign Debt is a Component of Net Foreign Liabilities.**

**Trend on Net Foreign Debt as a Component of Net Foreign Liabilities**

If you look at Figure 7:
- Net Foreign Debt is by far the largest component of Net Foreign Liabilities. In Sept 2009, debt represented approximately 5/6 (83%) of Net Foreign Liabilities as a % of GDP.
- Since 1989 Net Debt has increased from approximately 11% of GDP to reaching a peak in late 2008 of approximately 55% of GDP.
- The trend in Net Foreign Debt is reflected in the trend in Portfolio Investment.
Who is Responsible for the Borrowing?

The Government (Public) or the Private Sector?

Public Debt versus Private Debt

- **Public Debt** – Govt Debt (Official).
  Public Debt increases with Budget Deficits.
- **Private Debt** – private sector debt.

Trends in Public Sector and Private Sector Debt.

- Since 1993/94, Public Sector has fallen from 14% of GDP to approximately 4% of GDP in Sept 2009. This reflects the Federal Government mainly reducing budget deficits and running budget surpluses.
  Due to the GFC in 2008/9 the Federal Government ran a fiscal expansionary policy which has led to the Federal Government currently running a Budget Deficit increases public sector debt.

- Private Sector Debt is approx 96% of total debt. Private sector debt increased in the 90’s due to the deregulation of the financial sector, globalisation and the significant increase in mining production (requiring foreign savings). Due to the savings investment imbalance the private sector borrows from overseas (portfolio investment) which increases private sector debt.

Which is Preferable Private Sector or Public Sector Debt?

Private Sector debt is considered preferable to public sector debt.
Unlike Public Sector Debt, Private Sector Debt is linked to profit and should yield a higher return than the interest payable, therefore, increasing Australia’s productive capacity. This theory is called the “Pitchford Thesis” as it was popularised by Professor John Pitchford.

Federal Government Budgets

The Federal Government Budget is a fiscal policy tool.

A **Budget Deficit** is when the Federal government spends more that it earns in revenue or \( G > T \).
Normally a Budget Deficit is run by the Federal Government in an economic downturn or periods of relatively falling economic growth rates.

A **Budget Surplus** is when the Federal government spends less than it earns in revenue or \( G < T \).
Normally a Budget Surplus is run by the Federal Government in a boom or periods of strong economic growth.
Factors Affecting Foreign Debt

1. Financial Deregulation and the removal of exchange controls and regulations (FIRB and the ACCC) regarding overseas investment.

2. An imbalance between domestic savings (reflected in the CAD) leading to the borrowing from the private sector

3. Public sector budgets. Normally, a budget deficit increases foreign debt and a budget surplus reduces foreign debt.

4. Continual CAD’s (strong economic growth) due to Australia spending more than it earns.

5. Any factors that affect portfolio investment and interest payments on CAD (Net Income) will affect Foreign Debt. For example, interest rate differentials and the value of the $A. An appreciation of the Australian $ - reduces the amount we have to pay back as most of our debt is in US dollars. A depreciation of the Australian $ will increase the amount we have to pay back as most of our debt is in US dollars.

Is Australia’s Foreign Debt Manageable???

Measures or Criteria Used to Assess the Manageability of Australia’s Foreign Debt

Measurement One: Debt Servicing Ratio

Debt Servicing Ratio DSR (interest payments on the foreign debt as a proportion of export income)

$$\text{DSR} = \frac{\text{interest payable on foreign debt}}{\text{export income}} \times 100$$

If the debt servicing ratio is less than 10-12% of export income – this is considered manageable.

Higher DSR - the more difficulty Australia has in the debt servicing.

1991 DSR = 20%
2009 DSR = just over 10%. Australia’s debt is manageable according to this measure.

Measurement Two: Net Foreign Debt as a % of GDP

In 2009 Net Foreign Debt was approximately 52% of GDP whereas in 1984 it was 16% of GDP.

Is this a problem?
Economists argue measuring foreign debt (stock concept) in terms of GDP (flow concept) is inaccurate. The best measure of debt (stock concept) is in relation to Australia’s total wealth (stock concept) - Debt in terms of Liabilities and Assets. (Measurement Three).

**Measurement Three: Debt in terms of Liabilities and Assets**

Australia’s assets have increased at greater rate than liabilities. This increases Australia’s net wealth and real income levels; subsequently, increasing our ability to pay the debt. Therefore, the increase in foreign liabilities and foreign debt is not a problem using this measure.

Another Criteria Used to Assess the Manageability of Australia’s Foreign Debt: Private Sector Debt is more manageable than govt debt.

Unlike Public Sector Debt, Private Sector Debt is linked to profit and should yield a higher return than the interest payable, therefore, increasing Australia’s productive capacity. Most of Australia’s debt is private sector debt and this is considered preferable and more manageable.

Due to the global economic crisis, the public sector debt has increased but compared to international standards this level of public sector debt is very low.

**Costs and Benefits of Australia’s Foreign Debt**

Essentially the cost and benefits of Australia’s foreign debt are similar to the disadvantages and benefits of foreign investment and in particular portfolio investment.

The costs of Foreign Debt fundamentally depend on:

1. what we are spending the borrowed funds on.
2. the manageability of the debt.
3. economic growth in Australia and our trading partners’ economic growth rates.

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**Figure 9 Dubai Debt**

In the space of a few years the Dubai’s investment arm, Dubai World, accumulated $59 billion in debt, borrowing to build lavish developments like a giant island shaped like a palm tree to entice celebrities like Brad Pitt, and to invest in glittery properties like the MGM Grand Casino in Las Vegas. Analysts say the Dubai government has paid the price for a flamboyant economic model centred on foreign capital inflow in projects that are unable to generate the income required to service the debt.

Source: http://www.nicholsoncartoons.com.au
Conclusion

- Australia needs to borrow (insufficient savings) for investment.
- Investment increases living standards.
- Australia’s net overseas indebtedness has been growing in absolute terms, and relative to GDP but debt levels are still considered manageable.
- As a net borrower, Australia will be more affected by changes in the global economy.