Global Trends by Martin Khor

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On the external debt situation

As the country's external debt has become a topic of debate and confusion, it is useful to review the situation

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Last week there was some confusion over the state of the country's external debt, but it was to some extent cleared up after an explanation by the Finance Ministry.

It is thus useful to clarify what is external debt, and have an informed discussion on how dependent or vulnerable the country is to external funds and changing conditions.

On 11 March the media reported that the Finance Minister, in a written reply to a Parliamentarian's question, said Malaysia's external debt had risen from RM196 bil in the final quarter of 2013 to RM740.7 bil in the third quarter of 2014.

The reply did say that the sharp increase was due to a new definition in debt reporting which now includes ringgit-denominated debt securities held by foreigners.

However this nuance was lost amidst the headlines that the country's external debt had tripled to RM740 bil, causing surprise and perhaps a tinge of alarm.

A day later the Finance Ministry issued a statement clarifying the new external debt figures were in line with debt reporting requirements of the IMF, and under the new definition, the external debt now includes holdings of debt securities, deposits and trade credits denominated in ringgit by non-residents, as well as the offshore borrowings by the government, public enterprises and the private sector.

The high level of non-residents' holdings of ringgit-denominated debt securities and deposits comprise over 40% of Malaysia's external debt, and "this is due to the wider depth, openness and attractiveness of the Malaysian financial market," added the statement.

This should give relief, that the external debt hasn't jumped three times after all. It was really, mainly, a re-definition issue.

While the jump isn't so high after all, this explanation does reveal that the country's external debt is really much higher than originally thought.

Under the old definition, Malaysia's external debt was RM328 bil in end-March 2014 or 30.5% of GDP. Using the broader new definition, the debt level had become higher at

RM700 bil or 65.2% of GDP at the same date, according to Bank Negara's explanation of the redefinition of external debt, in its Quarterly Bulletin of First Quarter 2014.

The ratio of short term external debt to exports also jumped from 15% to 39% using the redefined figures.

These figures show that the country is more vulnerable than previously thought, in terms of the share of foreigners in domestic loans and the exposure or risks to changes in conditions that affect foreigners' perceptions on whether to maintain the holdings of their credit to the country.

The newly-defined external debt has increased further to RM744.7 bil, or 69.6% of GDP, as at end-December 2014, according to Bank Negara data.

The redefinition exercise is a positive one. It puts the country's debt reporting in line with international standards, meeting the IMF's requirements.

It also provides a more realistic and accurate view of the true state of the country's external debt.

Previously, only the loans taken by government and private companies from abroad and denominated in US dollar and other foreign currencies were considered to be external debt.

Meanwhile, foreigners have been taking up billions of ringgits' worth of government and corporate bonds issued in Malaysia and denominated in ringgit. These had previously not been considered external debt.

By the end of 2014, non-residents' holdings of domestic debt securities were RM223 bil, and non-residents' deposits were RM88 bil, thus totaling RM311 billion of the total RM745 bil external debt. The remainder were offshore borrowings (RM367 bil) and trade credits and other items (RM67 bil).

On one hand, ringgit-denominated borrowings by Malaysia do not carry the same risks of exchange rate volatility that dollar-denominated loans have.

Thank goodness for that, because the recent depreciation of the ringgit means that more ringgit would have to be forked out to service and repay those external loans that Malaysia have taken in US dollars and other foreign currencies.

On the other hand, the increase in foreigners' holdings of Malaysian government securities and corporate bonds, although denominated in ringgit, also increases the country's exposure in terms of having to service the loans (including paying interest to foreigners, thus causing an outflow on the current account of the balance of payments) and of outflows of funds if and when the foreigners decide to withdraw the credit they provided.

Much of the public securities or private bonds that the foreigners took up can be sold back in the market and taken out of the country, and it is not unusual that buyers do not hold the financial asset until the maturity date.

If there is a change in market sentiment, prompted by either international or domestic conditions, then there can be a net outflow of foreign funds held in debt securities.

It is true that the build-up of foreign holdings of Malaysian securities and bonds is made possible by the increased openness and attractiveness of the Malaysian financial market, as explained by the Finance Ministry.

On top of the exposure to foreign ownership of loans, there is also significant foreign ownership of equity in the Stock Exchange (which is not counted in the figures on external debt).

The same openness that brought the capital inflows could also lead to capital outflows when conditions change.

The easy-money policies of the United States that included near zero interest and quantitative easing that pumped over a trillion dollars into the banking system, contributed to huge funds seeking higher yield in developing countries like Malaysia.

Since the end of quantitative easing in the US and with the increasing prospect that interest rates will rise, the same funds have begun to return to the US. It is not clear whether this will be offset by the new quantitative easing exercise which just started in Europe.

Malaysia is no exception to the countries facing a reversal of capital flows.

For the whole of 2014, there was a net outflow of RM37.9 bil of portfolio investment, and RM20 bil of that in the fourth quarter, according to Bank Negara data. This portfolio investment includes foreign holdings of debt and stock-market equity.

The outflow of portfolio funds together with outflows of direct and other investments, caused the financial account of the balance of payments to have a deficit of RM76.5 bil in 2014, thus contributing to the decline in the overall balance of payments by RM36 bil, according to Bank Negara data in its Quarterly Bulletin 4th Quarter 2014.

The international reserves correspondingly declined from RM441.9 bil in end-December 2013 to RM405.5 bil in end-December 2014 (according to Bank Negara Quarterly Bulletin) and to RM386 bil on 27 February 2015 (Bank Negara media statement 6 March).

The declines are significant but the current situation is manageable as high reserves were built up through the years, so that the country will not be caught again by the crisis conditions of 1997-99.

The redefinition of debt figures and the recent data on movements in portfolio investment and reserves show that a comprehensive overview of the debt situation enables a better picture of the country's exposure to different types of debt-related and portfolio investment flows.

Another conclusion is that borrowing through ringgit-denominated debt removes the risks associated with foreign-exchange changes, but still results in dependence on the foreign appetite or preferences in investment venue and thus to exposure to significant outflows when these preferences alter.

As global conditions, especially in the US and Europe change, it will be a challenge to manage the country's finances.