Abstract

This letter considers Ireland’s external debt by sector and compares Ireland to other euro area member states. External debt measures are important for assessing financial stability risks, but Irish headline external debt includes the internationally-traded financial services sector, which leads to a somewhat misleadingly high gross external debt to GDP ratio of over 1,000 per cent. Excluding IFSC entities, gross external debt was approximately 300 per cent of GDP in Q2 2012. Multinational corporations outside the IFSC contribute to this high external debt figure. Among domestic sectors, banks had large gross external debts before the crisis, while official sectors increased external borrowing after 2008. Excluding the IFSC, in Q2 2012, Ireland’s net international investment position, the broadest measure of the net external balance based on financial assets as well as liabilities, represented a liability of 98 per cent of GDP, while net external debt, a narrower measure, was 95 per cent of GDP. This is significantly below the gross figure, but exceeds the average for comparable euro area member states.

1 Introduction

This letter discusses recent data on Ireland’s external debt position. It describes the measurement concepts and compares Ireland to other countries.\footnote{The authors wish to thank Lars Frisell, Joe McNeill, Mary Cussen, Mary Everett and Philip Lane for very helpful comments and suggestions. The views expressed in this letter are those of the authors and do not necessarily reflect those of the Central Bank of Ireland or the ESCB.}

Due to the financial crisis, there is an increased focus on measures of external indebtedness. Commentary on Ireland’s external debt, from financial institutions and market participants, has frequently referred to an Irish gross external debt ratio of 1,000 per cent of GDP, far higher than among its peers. A careful analysis should disaggregate debt by sector to make like-for-like comparisons of Ireland and other countries, which are not always possible from headline figures.\footnote{Notable exceptions to this include Slok (2012) and International Monetary Fund (2012).}

An accurate assessment of financial stability depends on understanding external debt in Irish-oriented sectors of the economy, rather than entities resident in Ireland with more limited connections to the domestic economy. This can serve as a better basis for assessing the economic and financial stability risks of Ireland’s debt burden.

The broader context of this topic is the impact of external debt on public and private sector debt sustainability and, therefore, economic performance. The primary effect is on the ability of debtors to repay (credit risk). This is affected by a sector’s own circumstances, economic developments and market perceptions of the ability to service debt, i.e. debt sustainability. Related to this
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is creditors’ willingness to provide new funding on similar terms (rollover risk) in domestic or foreign currencies (foreign exchange risk). External debt may also affect economic growth through its impact on capital formation.

The next section reviews the literature on external debt measures and financial stability. This is followed by an overview of external debt concepts, important aspects of Irish external debt, and a comparison of Ireland to other countries.

2 Literature on external debt

An extensive literature addresses the relationship between debt and macroeconomic performance. Pattillo, Poirson and Ricci (2002) find a negative relationship in developing countries between economic growth and external debt figures above 40 per cent of GDP. The authors link high debt to low growth of total factor productivity and capital stocks (Pattillo, Poirson and Ricci, 2004).

High-income countries are more likely to have substantial asset portfolios which can offset external liabilities. Lane and Milesi-Ferretti (2007) note that many developed countries use external debt liabilities to finance foreign equity investments. These can contribute to debt sustainability, though they also entail international equity price risks. Brown and Lane (2012) note the relative stability of net equity positions of emerging European economies in 2007-09, and emphasise the stabilising role of equity-type liabilities, as their value declines with economic performance, though the benefits may accrue to foreign investors.

Krugman (1988) proposes a theory of debt overhangs to explain the effect of debt on growth. When external debt is high, expected transfers to creditors reduce the returns of growth and investment to residents. A survey of 87 developing economies by Imbs and Ranciere (2005) found that external debt values above 60 per cent of GDP have a negative effect on growth. Brown and Lane (2012) identify high private sector indebtedness in some sectors of emerging European economies.

Gros and Alcidi (2011) discuss high indebtedness in the euro area context. They argue that external debt is a necessary measure of fiscal sustainability within the euro area, in addition to other variables, as external debt crises imply a need for external adjustment. They argue that net external debt ratios are an important complement to gross figures, and suggest that Ireland’s high ratio of external assets to GDP is positive for debt sustainability. This depends on whether these assets are ultimately owned by Irish residents.

3 Measurement concepts

The concept of the external position or balance of an economy is useful in understanding certain official statistical measures, identifying the contribution of sectors to the economy’s overall position and comparing different economies. External debt describes one aspect of the external position, while other useful perspectives include sectoral decomposition and financial sector-specific data, such as BIS consolidated banking statistics. As this letter considers external debt at a relatively aggregated level, the focus is on aggregate gross and net external debt measures, as well as a broader measure of financial assets and liabilities called the international investment position (IIP).3

Gross external debt is a measure of debt owed by residents of a country to non-residents. This includes liabilities incurred by residents and owed to non-residents through loans, debt securities like bonds and money market instruments, trade credit owed to non-resident creditors, and bank deposits received by resident institutions from non-residents. Net external debt is gross external debt minus external debt assets owned by residents and held in other countries.

These debt measures include loans between corporate subsidiaries based in Ireland and other subsidiaries or the parent entity. Non-debt liabilities are excluded, such as financial derivatives and equity, including shares in foreign-owned multinational corporations based in Ireland.

External debt has a sectoral composition, including general government, the monetary authority (i.e. the central bank), monetary financial institutions (MFIs, like banks), foreign direct investment enterprises, and other sectors, including other financial intermediaries (OFIs, like mutual funds, insurance corporations, or pension funds)

3Gross external debt figures are taken from the CSO. It is also possible to measure external debt from annual or quarterly financial accounts data, by adding securities other than shares and loans from the “rest of the world” sector. However, these entries may be residuals from other calculations.
External debt is part of the international investment position, which is a more complete description of the external position, including equity and financial derivatives. The net international investment position (NIIP) equals foreign financial assets held by residents minus liabilities owed to non-residents. When the NIIP is negative, external liabilities surpass external financial assets, i.e. a negative NIIP signifies a net external liability. Gross external debt is an IIP liability, while net external debt is the overall position across IIP debt assets and liabilities. Figure 1 shows a stylised IIP breakdown, including gross and net external debt.

As noted by Lane (forthcoming), the large, internationally-trading financial services sector significantly affects Ireland’s external debt and NIIP positions. Irish statistics include the assets and liabilities of International Financial Services Centre (IFSC) entities, such as financial vehicle corporations and special purpose vehicles (FVCs/SPVs), international banks, treasury operations, investment funds and money market funds domiciled in Ireland. In accordance with the ESA 95 system of accounts, IFSC entities are treated as Irish residents. However, their activities are somewhat removed from the rest of the economy, and the ultimate owners of assets and bearers of risks are mostly resident outside Ireland. Figure 2 illustrates Ireland’s external debt structure.

4 Stylised facts for Ireland

It is useful to isolate the impact of the IFSC on external debt data, because this highlights the position of sectors more tied to the domestic economy, though other multinational financing structures remain in the data. Figure 3 shows a wide range of external debt comparisons.

Regarding the Irish external debt data, there are several distinctive features. First, the IFSC has a substantial impact. Ireland’s total external debt, including IFSC entities, is 1,047 per cent of GDP as of Q2 2012. IFSC-related external debt, mainly in OFIs and MFIs, is 737 per cent of GDP, over 70 per cent of the Irish total.

A large share of IFSC OFI debt is due to financial vehicle corporations (FVCs), which accounted for 44 per cent of total OFI debt in Q2 2012. Though this sub-sector includes the National Asset Management Agency (NAMA), and creditor residency is not available for FVC external debt, they are mostly IFSC entities, and most of their liabilities are not thought to be held by Irish residents.

Many IFSC MFIs and OFIs hold large, offsetting external debt assets, and non-residents hold most of these sub-sector’s debts. Therefore, gross external debt excluding IFSC entities may be more relevant to Irish debt sustainability. This amounted to 309 per cent of GDP in Q2 2012. Though much lower than total gross external debt, this is one of the highest figures among euro area countries.

Net external debt and the NIIP can supplement gross external debt in international comparisons. The NIIP is, in theory, a more comprehensive measure. One potential drawback is that the behaviour of Ireland’s NIIP is complex. Changes in NIIP may be due to timing, valuation changes and other issues (Lane, forthcoming). In Q2 2012, excluding the IFSC, Ireland’s NIIP was −98 per cent of GDP, a considerably larger liability than in most euro area member states. The NIIP is close to the net external debt figure, ex-IFSC, which was 95 per cent of GDP in Q2 2012. This is mostly owed by the government and monetary authority sectors.

Second, multinational non-financial corporations have sizeable external debts, which may include debts owed to affiliated entities and intra-group financing. These are mainly classified as “direct investment”, as defined in the Annex. The importance of non-bank lending also appears in Ireland’s Quarterly Financial Accounts (Central Bank of Ireland, 2012), as shown in Figure 3f. These topics are further explored in CSO (2012a).

The impact of direct investment on external debt includes treasury and banking activities. Depending on the location of headquarters of entities within groups, banks associated with foreign direct investment activities could be categorised as MFIs within the Irish economy, and treasury operations could be included in “other sectors”. Therefore,

4 Households may have external debt if they borrow from banks located in other countries, but this is uncommon in most euro area member states.

5 The European Commission (1996) describes the European System of National and Regional Accounts (ESA 95) as “an internationally compatible accounting framework for a systematic and detailed description of a total economy (that is a region, country or group of countries), its components and its relations with other total economies.” It is compatible with the United Nations System of National Accounts (1993 SNA).
the “direct investment” category is only part of the total impact of foreign direct investment on external debt. Furthermore, these firms tend to have external assets offsetting their liabilities.

Third, Irish households do not have large external debts. Instead, households borrow from resident banks that finance themselves with both domestic and external liabilities. Therefore, the link with the rest of the world is through the domestic banking sector. Rising external debts of MFIs before the crisis funded lending from the banking system to households and NFCs.

Fourth, the suspension of access to term debt market funding for the domestically-focused Irish banks from the onset of the domestic financial crisis until recently, and the repayment of outstanding bonds, led MFIs to replace this funding with shorter-term Eurosystem liquidity. The growing share of monetary authority external debt, from negligible levels before 2008, reflects liquidity provided to the domestic financial system.

5 Comparative analysis

Irish external debt can be considered along several dimensions. For instance, financial centres tend to have large external debts. This can be seen in Ireland and other financial centres, such as the United Kingdom, Luxembourg, Switzerland, Hong Kong and Singapore. Small open economies and euro area member states tend to have larger external debts than the average developed country.

However, other stressed euro area economies tend to have lower gross external debt ratios than the euro area as a whole. This is perhaps not surprising, as external financing could be more difficult to access during the crisis. Net debt is higher among stressed euro area economies, due to smaller external debt asset portfolios.

The majority of euro area government debt is typically held by foreign residents (Andritzky, 2012). However, this aggregate figure masks some important differences across countries. 78 per cent of Irish government bonds were held abroad at the end of 2011, compared to an average of 50 per cent in Greece, Italy, Portugal and Spain. As with other programme countries, Ireland’s external liabilities include loans owed to official creditors.

6 Conclusions

The analysis shows that Ireland’s gross external debt is high by international standards, but considerably lower than headline figures which includes IFSC entities. Excluding the IFSC, the NIIP liability and net external debt measures are also higher than in peer economies. Comparative analysis suggests that small open euro area economies tend to have higher levels of external debt than other economies. Before the crisis, in Ireland, external debt accumulated across the financial sector, particularly the domestic banking sector. In contrast, during the crisis, external debt expanded considerably in the official sector, including general government and the monetary authority, while MFI external debt fell significantly.

References

Annex

External debt definition

The IMF External Debt Manual defines external debt to be “a point in time statistical statement of the value and composition of the stock of an economy’s gross foreign financial liabilities to the rest of the world. The liabilities referred to cover those arising from Irish residents issuing debt securities such as bonds, notes and money market instruments to non-residents, as well as any loans received from and outstanding to non-residents, and any trade payables due to non-residents. In essence, external debt refers to financial obligations to non-residents other than those arising from transactions in equity or financial derivative contracts.” (CSO, 2012b)

Sectoral classification system for external debt

Following standards drawn up by the International Monetary Fund and applied internationally, external debt is classified across most economies in a standard manner. External debt is categorised by the institutional sector of the entity that owes the debt. Here, those sectors are presented, followed by their abbreviations in the figures and a summary of their constituent entities. The definitions of institutional sectors are based on CSO (2012b):

1. General government (Govt): Central and local government.
2. Monetary authority (MA): The national central bank; in Ireland, the Central Bank of Ireland.
3. Monetary financial institutions (MFIs): Institutions providing credit (e.g. banks) and money market funds.
4. Direct investment/intercompany lending (DI): Debt owed by a resident corporation to a foreign direct investor. This includes inter-affiliate loans, debt securities, trade credits and other debt liabilities, where the debtor and creditor are connected in a direct investment relationship involving equity ownership of 10 per cent or more.
5. Other sectors (Other): All other corporations and, implicitly, households. Included are: other financial intermediaries, i.e. investment funds, insurance companies and pension funds, asset finance companies, treasury companies, securities traders and other financial service companies; non-financial service and manufacturing companies; and other industrial enterprises; households and non-profit institutions serving households.

Categories used in cross-country analysis

All euro area averages exclude Ireland and Luxembourg. Gross external debt averages exclude Cyprus and Malta. Small open economies: All euro area member states except France, Germany, Italy and Spain.

Euro area core: Austria, Belgium, Finland, France, Germany, Netherlands.

Euro area periphery: Greece, Italy, Portugal, Spain.
Figure 1: Stylised international investment position and external debt

Figure 2: Stylised Irish external debt composition and sectoral linkages
Figure 3: Irish and euro area debt as a percentage of GDP