Box C

Foreign Currency Exposure and Hedging in Australia

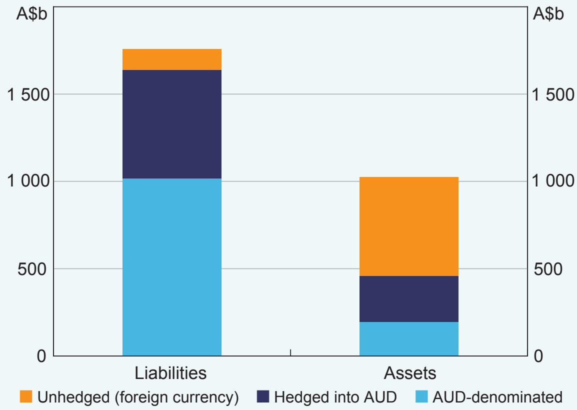
A recent survey by the Australian Bureau of Statistics, conducted on behalf of the Reserve Bank, confirms that Australian entities are well hedged against the risk of sharp movements in the exchange rate.[1] In particular the survey indicates that the foreign currency liabilities of the banking sector are almost entirely hedged against the risk of exchange rate movements using derivative instruments.

The survey collected information on the foreign currency exposures and hedging practices of resident entities. The implications of these exposures and hedging behaviour for the economy as a whole are best understood in the context of Australia's overall external position (Graph C1). Of Australian entities' $1.7 trillion in foreign liabilities, less than half are denominated in foreign currency. The majority of the liabilities that are denominated in foreign currency are hedged using derivative instruments, leaving only a small unhedged liability exposure. In contrast, the majority of Australian entities' $1 trillion in foreign assets are denominated in foreign currency and, as only about a third of these are hedged, the unhedged foreign currency asset position is relatively large. Thus, while Australian entities' foreign assets fall short of foreign liabilities by around $700 billion, the effective foreign *currency* assets of Australian entities exceed their foreign *currency* obligations by around $400 billion. One implication of this is that, in aggregate, the valuation effect of an exchange rate depreciation on Australia's external position is actually positive.

Graph C1

Currency Composition of Australia's External Position

As at 31 March 2009



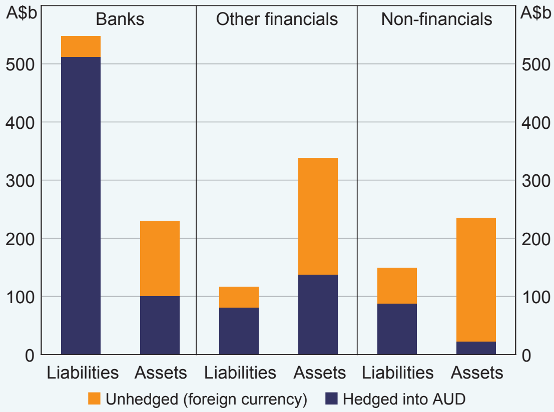
Sources: ABS; RBA

The survey provides information on the distribution of foreign currency exposures and hedging across the main sectors of the economy. In line with the overall finding, the survey indicates that all sectors hedge their liability exposures more than their asset exposures (Graph C2). The banking sector accounts for the bulk of Australian entities' foreign currency liabilities. These exposures are almost entirely hedged back into Australian dollar obligations using derivative instruments – the hedge ratio for the banking sector's liabilities is around 95 per cent. Non-bank financial corporations and non-financial corporations also hold extensive derivative hedges against their foreign currency liabilities – with average hedge ratios of 70 per cent and 60 per cent respectively – although in aggregate these exposures are relatively small.

On the asset side, the non-bank financial sector holds the largest foreign currency asset exposure before hedging. These exposures primarily reflect superannuation funds' holdings of foreign asssets on behalf of Australian households. Around 40 per cent

1 For a full discussion of the results of the survey see D'Arcy P, M Shah Idil and T Davis (2009), 'Foreign Currency Exposure and Hedging in Australia', RBA *Bulletin*, December, pp 1–10.

Graph C2
Foreign Currency Exposure and Hedging
By sector and instrument



Sources: ABS; RBA

of the foreign currency exposure in these portfolios is hedged, leaving an unhedged exposure of around $200 billion. This exposure is likely to be deliberately held for diversification purposes and represents only a relatively small share – about 10 per cent – of the sector's total assets. Non-financial firms typically do not hedge their foreign currency assets and so have the largest foreign currency asset exposure after hedging. These assets represent about 10 per cent of non-financials' total assets and are mainly in the form of long-term foreign direct equity investments. Although in some cases these exposures are 'naturally hedged' with matching foreign currency liabilities, they are typically left unhedged for diversification reasons. The banking sector's foreign currency assets are hedged at around 50 per cent, meaning that it also has a small net foreign currency asset position after hedging.

The fact that Australian residents hedge a larger amount of foreign currency liabilities than assets means that, on balance, non-residents must be acting as counterparties to Australians hedging foreign currency liabilities. The survey data on derivative counterparties confirm that this is the case, with Australian residents holding a net long foreign currency position in derivative contracts with foreigners of just under $300 billion (Table C1). This represents Australian residents' net demand for hedging liability exposures after the netting of offsetting liability and asset exposures among residents. It also indicates that in addition to the Australian dollar exposure non-residents hold through direct holdings of Australian dollar assets, which amounts to $700 billion in total, they are willing to hold nearly half this amount again in Australian dollar exposure through the derivatives market. While this is significant in underpinning the market for Australian firms hedging the exchange rate risk on foreign borrowings, it is a relatively small exposure in the context of global investors' total portfolios.

Table C1: Residents' Gross Outstanding Foreign Exchange Derivative Positions
By counterparty, notional value, A$ billion, as at 31 March 2009[(a)]

Counterparty	Long foreign currency/short AUD positions	Short foreign currency/long AUD positions	Net positions
Resident	554	–554	0
Non-resident	991	–703	288
Total	**1 545**	**–1 257**	**288**

(a) Positive values represent derivative positions under which the holder will receive foreign currency in exchange for Australian dollars at a predetermined exchange rate (that is, a long foreign currency/short AUD position). Negative values represent derivative positions under which the holder will receive Australian dollars in exchange for foreign currency at a predetermined exchange rate (that is, a short foreign currency/long AUD position).
Source: ABS