

# The Extraordinary Decline in Australia's Net Foreign Liabilities



RESERVE BANK OF AUSTRALIA

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## Introduction

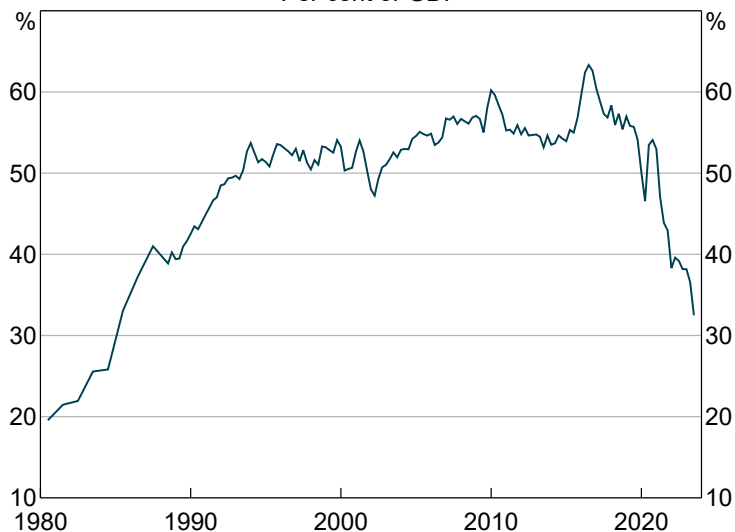
I would like to thank the CFA Societies Australia for the opportunity to speak this morning.

December 2023 will mark the 40th anniversary of the decision to float the Australian dollar and remove restrictions on capital flows. This reform has been one of the greatest success stories of Australian macroeconomic policy and is a key pillar of our monetary policy framework. A floating exchange rate buffers the economy from external shocks and allows monetary policy to focus on the goal of domestic price stability.

Capital controls were removed when the dollar was floated because they were no longer needed to maintain the fixed exchange rate. This has allowed investment in Australia's productive capacity to be unconstrained by the availability of domestic savings and enabled Australian households and businesses to diversify their portfolios and benefit from attractive investment opportunities overseas.

Australia is a country with a lot of profitable investment opportunities, so for almost all of our history since colonisation, foreigners have invested more in Australia than Australians have invested overseas and Australia has recorded current account deficits. This was true even when the exchange rate was fixed and when there were restrictions on capital flows. The result has been an accumulation of foreign debt and foreign ownership of Australian assets. When restrictions on capital flows were lifted, Australia's net foreign liabilities increased noticeably, and continued to trend higher to reach a peak of 63 per cent of GDP in 2016 (Graph 1).<sup>[1]</sup>

**Graph 1**  
**Net Foreign Liability Position\***  
 Per cent of GDP



\* Net foreign liability values from Foster (1996) used from June 1980 to June 1988; ABS data used from September 1988 onwards.

Sources: ABS; Foster (1996); RBA.

History has shown that persistent capital inflows and a build-up of foreign debt can be a source of vulnerability to ‘sudden stops’ that cause a collapse in external borrowing and aggregate demand. So it is understandable that Australia’s external debt has regularly been at the forefront of the national economic conversation, even though a floating exchange rate greatly diminishes the likelihood of sudden stops. At no time was this more apparent than in 1986 when the then Treasurer Paul Keating warned that Australia risked becoming a ‘Banana Republic’. Concerns since the dollar was floated have related to whether national saving is perhaps too low or whether foreign currency borrowing creates financial stability risks.

In recent years, something remarkable has occurred. Australia’s net foreign liabilities have fallen sharply to 32 per cent of GDP, which is the lowest level since the mid-1980s. This has largely flown under the radar given the significant challenges posed by the COVID-19 pandemic and its aftermath. In my remarks today I will discuss why this has occurred and what its economic significance might be.

In particular, as part of my discussion, I will provide two main reasons why net foreign liabilities have declined:

1. national saving has been higher than national investment resulting in capital outflows and current account surpluses for the first time since the 1970s.
2. valuation effects associated with higher interest rates have reduced the value of the existing stock of external debt, while higher US equity prices and a depreciation of the exchange rate have increased the value of external assets in Australian dollar terms.

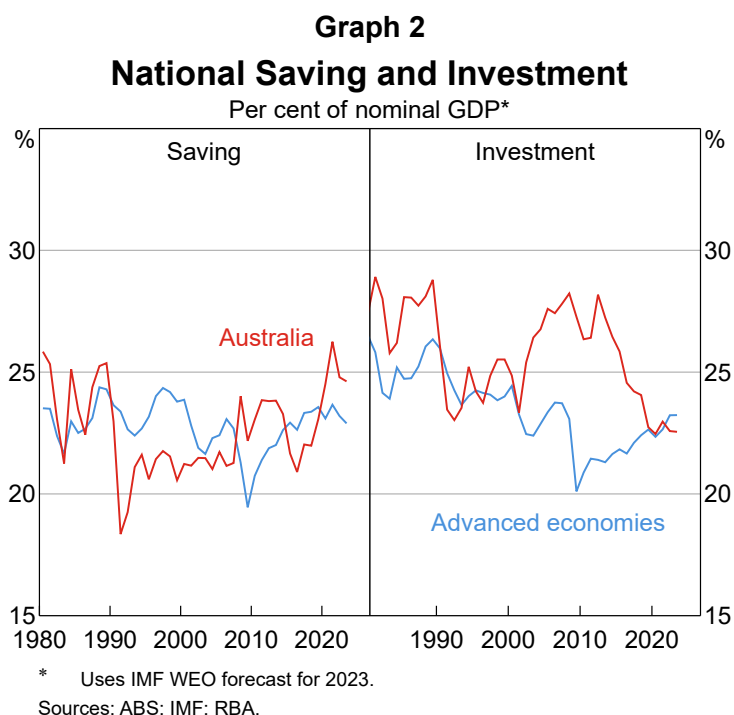
In terms of the economic significance, I will observe that a net foreign liability or asset position is not necessarily good or bad. External debt does not create a significant vulnerability for Australia because most of Australia’s external debt liabilities are issued in Australian dollars and those that are not are very well hedged.

## Explaining the current account surpluses and net capital outflows

### Trends in national saving and investment

Turning first to the reasons why Australia has become a net exporter of capital.

National saving and investment refer to the combined saving and investment of households, businesses and government. When national investment is higher than national saving, a country will be a net importer of capital. Australia has historically been a net importer of capital, not because national saving has been low in comparison to other advanced economies, but because investment has been high (Graph 2). Foreign capital has been attracted by an abundance of investment opportunities that offer relatively high rates of return.



This was especially apparent during the mining investment boom that started in the early 2000s when high commodity prices raised the expected relative rates of return to investment. As the mining boom transitioned from the investment phase to the production and export phase, national income and saving were boosted by higher export volumes and there was a commensurate decline in investment as a share of national income.

Meanwhile, Australia's Superannuation Guarantee has supported a trend increase in household saving over many years.<sup>[2]</sup> Mandatory superannuation contribution rates have increased gradually from an initial rate of 3 per cent in 1992, to reach the current rate of 11 per cent in June 2023. It is scheduled to increase further to 12 per cent in 2025.

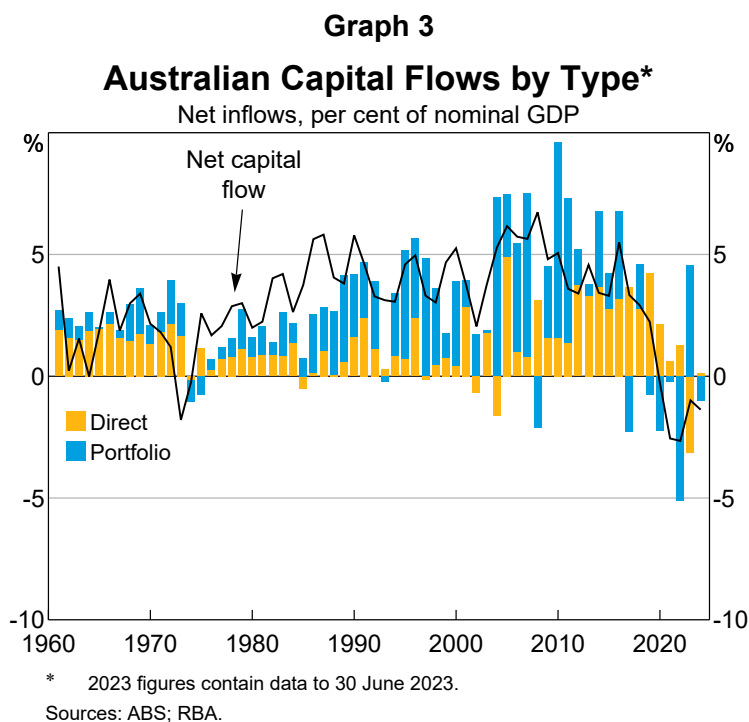
National saving was further boosted during the pandemic when a sharp increase in household and corporate saving was not completely offset by the Australian Government's substantial fiscal stimulus. More recently, household saving has declined to be below pre-pandemic levels, while government saving has increased as fiscal consolidation has taken place. However, national saving remains at a high level both in historical terms and in comparison to other advanced economies.

The outcome of these developments is that national saving has been above national investment since 2019. And in a departure from history, Australia has recorded current account surpluses and net capital outflows for the first time in over 40 years. Importantly, net capital outflows do not necessarily imply that Australia no longer offers an abundance of profitable investment opportunities. While the share of investment in GDP is lower than in the past, it is similar to other advanced economies.

## The capital and financial account

Given this, I will now turn to a brief examination of the composition of capital flows.

During the mining boom, a large share of investment was financed through foreign direct investment (FDI) (Graph 3). Part of this was in the form of reinvested earnings by mining companies during a period where their profitability was high. As the mining boom shifted from the investment phase to the production and export phase, FDI in Australia declined. A greater share of mining profits is now paid out as dividends.



Another notable trend over recent years has been an increase in portfolio outflows. This largely relates to increased investment overseas by Australian superannuation funds.

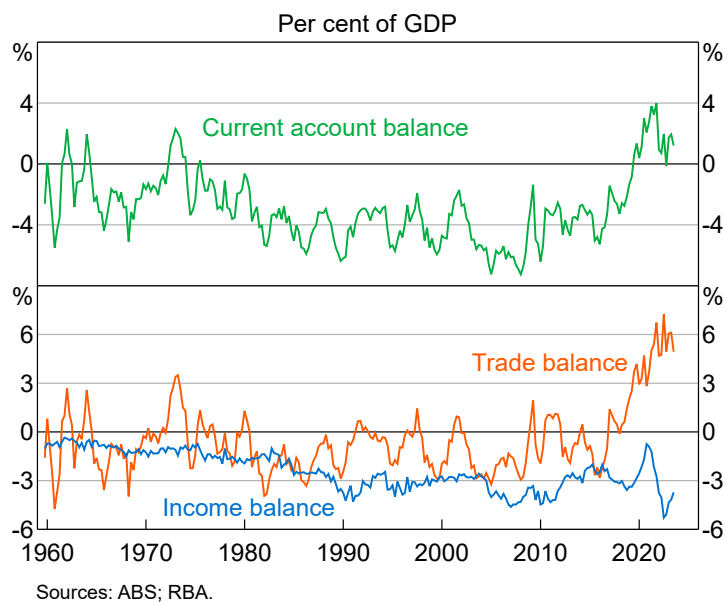
Examining trends in capital flows can be instructive, but care needs to be taken when interpreting *net* capital flows in any given year. In 2022 Australia recorded the largest net FDI outflow in any period since at least the 1960s. This did not imply a withdrawal of investment by foreigners. Capital flows were affected by a range of highly publicised mergers and acquisitions in 2022.<sup>[3]</sup> Gross FDI inflows into Australia actually *increased* in 2022 and Australia was one of the top global destinations for FDI.

## The current account

The current account records the flow of payments across borders related to trade and net income on foreign assets and liabilities. In 2019 the current account turned from deficit to surplus because the trade surplus became larger than the net income deficit (Graph 4).

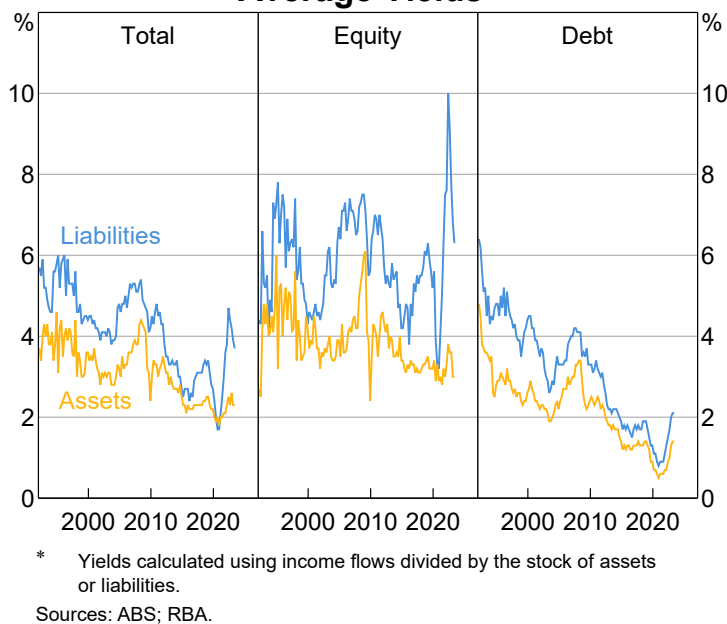
Since 2018, Australia has recorded trade surpluses, which have supported national income. High commodity prices and the mining sector's greater productive capacity following the mining investment boom have supported exports over this period. Services, including education and tourism, account for a smaller share of trade but have also supported net exports of late, with services exports recovering by more than services imports since borders opened after the pandemic.

**Graph 4**  
**Current Account Balance**



Australia's persistent net income deficit reflects our net foreign liability position. It also reflects that yields on Australia's external liabilities have been higher than yields on our external assets (Graph 5).

**Graph 5**  
**Average Yields\***



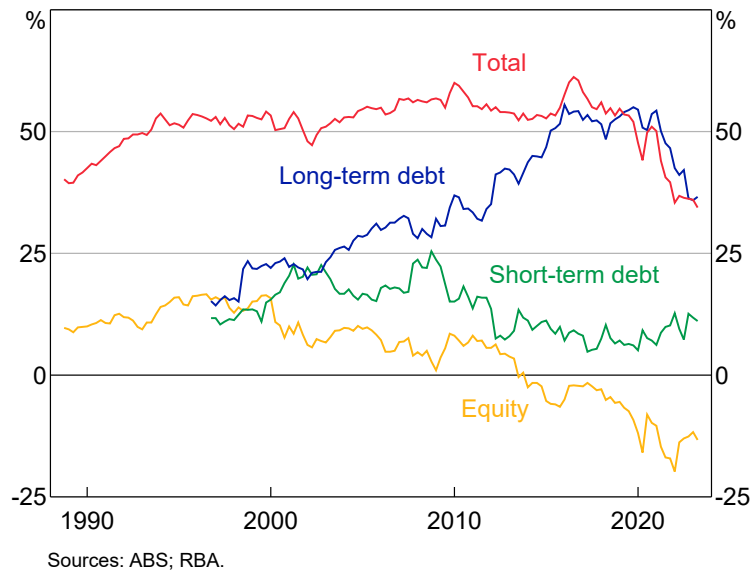
The net income deficit has widened since 2019 owing to higher dividend payments on foreign-owned equity. This mainly relates to the increased profitability of foreign-owned mining companies given high commodity prices.<sup>[4]</sup> The pandemic caused significant volatility in equity payments to non-residents. There was a sharp fall when Australian companies froze dividend payments in the early stages of the pandemic and a rebound when dividend payments subsequently caught up to corporate profits as economic conditions turned out to be far better than had been expected.

The net cost of servicing Australia's external debt liabilities has also increased over the past two years, as interest rates have risen in Australia and overseas.

## The composition of net foreign liabilities

Turning now to the composition of net foreign liabilities. On the liability side, there has been a substantial decline in long-term debt as a per cent of GDP since 2020 (Graph 6). That said, long term debt still accounts for the bulk of external debt. Meanwhile Australia’s net holdings of foreign equities have been increasing for many years.

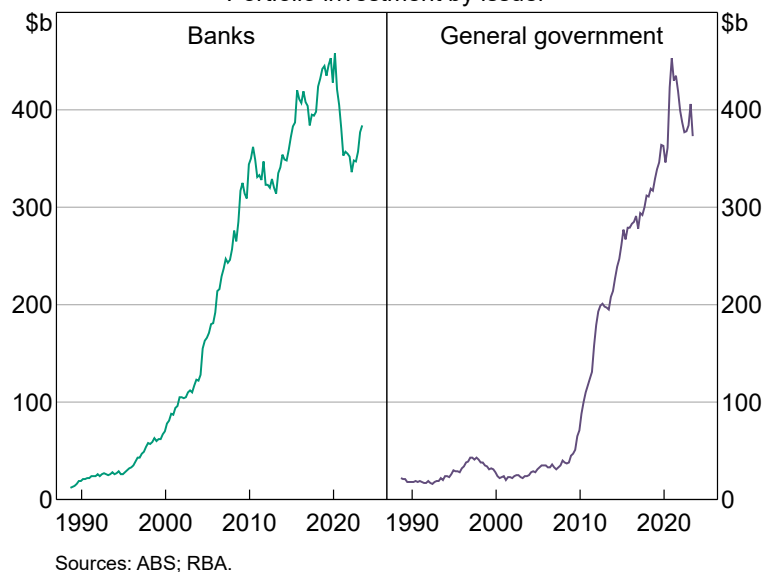
**Graph 6**  
**Net Foreign Liability Position**  
Per cent of GDP



## Debt

Banks account for a large portion of the decline in long-term external debt since early 2020 (Graph 7). In the early stages of the pandemic, there was a decline in the stock of banks’ offshore debt. In part, this reflected access to low-cost domestic funding, including through the Reserve Bank’s Term Funding Facility, as well as lower credit growth. The Term Funding Facility closed to new drawings in June 2021 and debt issuance by Australian banks has since increased.

**Graph 7**  
**Long-Term Foreign Debt Liabilities**  
Portfolio investment by issuer



The Reserve Bank's bond purchases to address market dysfunction, support the yield target and through the bond purchase program may have contributed to a decline in the share of government debt held by foreigners, though the effect on the level of external government debt was offset by substantial fiscal stimulus. More recently, fiscal consolidation has been taking place.

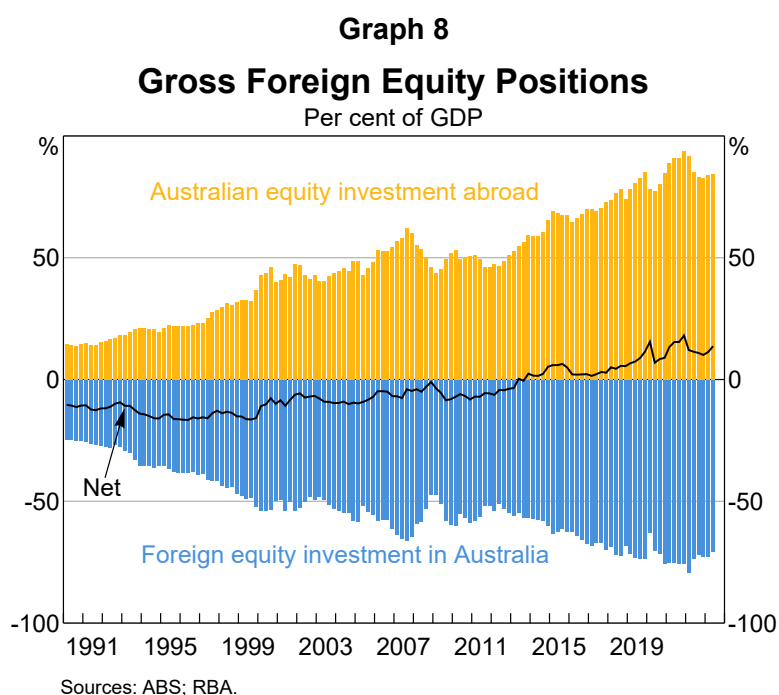
It is worth observing here that while the Reserve Bank's pandemic response affected the composition of net foreign liabilities, it did not necessarily *cause* net foreign liabilities to decline. As I have already discussed, net capital outflows occurred because national saving was higher than investment.

Since early last year, rising interest rates have caused bond prices to decline, and this has contributed to the decline in the valuations of long-term debt liabilities, and net foreign liabilities overall. Longer term bond prices are more sensitive to interest rate changes than shorter term bond prices because of their higher average duration. Meanwhile, the exchange rate has had very little impact on the value of Australia's net long-term debt. As I will shortly discuss, most of Australia's external debt is denominated in Australian dollars.

It is also worth observing that higher commodity prices and inflation have increased nominal GDP relative to the stock of existing liabilities. In other words, some of the debt has been inflated away.

## Equity

Another key driver of the decline in Australia's net foreign liability position has been the increase in Australia's net holdings of foreign equities. Some of this increase reflects the accumulation of foreign equities by superannuation funds, which have invested a greater share of funds offshore.



Valuation effects have also lifted the value of foreign equity assets in Australian dollar terms in recent years. Indeed, the price of US equities – which make up around half of Australia's portfolio equity assets – have increased by over 150 per cent over the past decade. This compares to a 30 per cent increase in Australian equity prices over the same period. The depreciation of the exchange rate in recent years has further boosted the value of foreign equity assets in Australian dollar terms.

## Australia's external liabilities and financial stability

This leads me to another important point about Australia's experience with a floating exchange rate. The health of financial institutions and other corporations has been largely unaffected by exchange rate fluctuations. This is because most of Australia's external debt is denominated in Australian dollars and the debt that is not is very well hedged through financial and natural hedges.

The dangers of unhedged foreign currency borrowing are well known. Australians learnt an important lesson about this in the years after the float. In the mid-1980s, some borrowers tried to avoid paying much higher domestic interest rates by borrowing in Swiss francs. But when the Australian dollar subsequently depreciated sharply against the Swiss franc, borrowers found themselves unprepared for the sharp rise in debt servicing costs. While the overall quantum of borrowing was small enough that this did not cause systemic problems, it did receive a lot of publicity.<sup>[5]</sup>

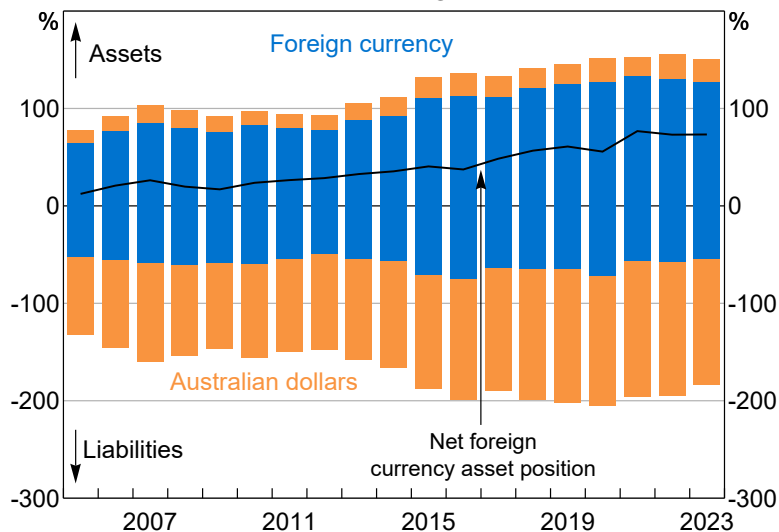
If a country has significant unhedged foreign currency borrowings, there is a risk that the so-called 'financial channel' of the exchange rate can offset the traditional 'trade channel'. Under the trade channel, an exchange rate depreciation increases foreign demand for exports and reduces domestic demand for imports, which stimulates the economy, all else equal. But if borrowers have more unhedged foreign currency debt than assets, an exchange rate depreciation weakens their balance sheets. This tightens domestic financial conditions and dampens investment and economic activity.<sup>[6]</sup> If a currency depreciation increases the value of unhedged foreign currency debt to the point where there are concerns about borrowers' capacity to service and repay it, there can be 'sudden stops' in capital flows as investors try to withdraw, which worsens the situation.<sup>[7]</sup> Overall, unhedged foreign currency borrowing can significantly diminish a floating exchange rate's shock absorbing properties.

## Australia's net foreign currency asset position

The financial channel of the exchange rate is not likely to be important for Australia because Australia as a whole has a net foreign currency *asset* position of around 75 per cent of GDP (Graph 9). Our external liabilities are mostly denominated in Australian dollars, while our foreign assets are largely denominated in foreign currencies.<sup>[8]</sup> In fact, all Australian Government debt is issued in Australian dollars.<sup>[9]</sup>



**Graph 9**  
**Currency Composition**  
**of Australia's External Position\***  
 Per cent of GDP

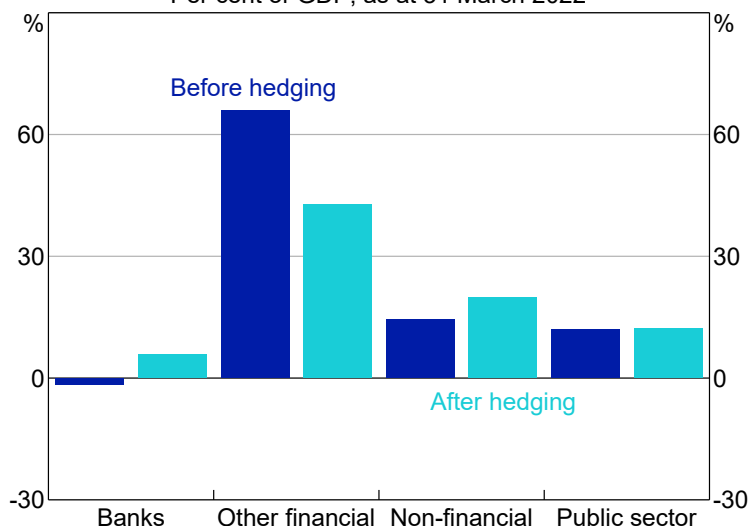


\* Assets are shown with a positive sign, while liabilities are shown with a negative sign.

Sources: ABS; RBA.

Now, there could still be vulnerabilities to exchange rate depreciations if some sectors of the economy have unhedged foreign currency exposures, but this does not appear to be the case. While individual firms may occasionally run into trouble by not hedging their currency risk, all sectors of the economy have net foreign currency asset positions once hedging using derivatives is taken into account (Graph 10). Importantly, this includes banks which account for the majority of gross foreign currency liabilities.

**Graph 10**  
**Net Foreign Currency Exposure by Sector**  
 Per cent of GDP, as at 31 March 2022



Sources: ABS; RBA.

Superannuation funds have significant holdings of unhedged foreign currency assets, so the Australian dollar value of superannuation assets will be affected by exchange rate fluctuations. However, this is not likely to create financial stability risks.<sup>[10]</sup> One reason is that superannuation funds in Australia are defined contribution. And as I

have already described, foreign equities account for a significant share of superannuation funds' assets. In periods of crisis and increased risk aversion in global markets, the Australian dollar typically depreciates. This at least partly offsets declines in the prices of risk assets like foreign equities in Australian dollar terms.<sup>[11]</sup>

Given Australian superannuation funds have substantial holdings of unhedged foreign currency assets, it is interesting to ask if a financial channel that works in the same direction as the trade channel might be in operation. This could occur if households responded to increased superannuation wealth by increasing their consumption. The answer is probably no. Reserve Bank research has found little evidence that stock market wealth has a significant impact on households' spending in Australia, especially when it is indirectly held through superannuation.<sup>[12]</sup>

Overall, Australia's freely floating exchange rate does not create significant financial stability risks because of the net foreign currency asset position that is enhanced by hedging. As a result, the exchange rate's ability to act as an effective shock absorber is not impeded by Australia's net foreign liability position.<sup>[13]</sup>

It is worth observing that it took time for deep and liquid hedging markets to develop. Development was spurred in part by the increase in Australian dollar volatility after the float, and the need to hedge the interest rate and foreign exchange risks associated with increased borrowing from offshore.<sup>[14]</sup> For Australia, floating the exchange rate and removing restrictions on capital flows catalysed the development of financial markets. In doing so, the risk of sudden stops has been all but eliminated.

## Conclusion

To sum up my points today, the substantial decline in the value of Australia's net foreign liabilities as a share of GDP reflects two main factors:

1. a high rate of national saving and the shift to current account surpluses since 2019.
2. valuation effects where rising interest rates have reduced the value of existing external debt while rising global equity prices and a depreciation of the exchange rate have supported the value of external equity assets in Australian dollar terms.

National income and saving have been supported by the large trade surplus generated by high commodity prices and export volumes. Meanwhile, the Superannuation Guarantee has contributed to a trend increase in saving over many years. Higher national saving during the pandemic also contributed.

Overall, Australia's net foreign liability position is not a cause for concern. Australia benefits from strong institutional arrangements, the ability to issue debt in Australian dollars, and deep and liquid foreign exchange hedging markets that Australia developed after the float. Most external debt is longer-term debt and issued in Australian dollars. And debt that is issued in foreign currencies is very well hedged. Together these features have enabled Australia to significantly benefit from the decision 40 years ago to float the exchange rate and liberalise the capital account.

## Endnotes

[\*] I would like to thank Jack Beardsley, Katie Sun and Jess Young for their excellent assistance in preparing this speech. I would also like to acknowledge that this speech draws heavily from Atkin T and J Harris (2023), '[Foreign Currency Exposure and Hedging in Australia](#)', *RBA Bulletin*, March; Adams N and T Atkin (2022), '[The Significant Shift in Australia's Balance of Payments](#)', *RBA Bulletin*, March; and Debelle G (2019), '[A Balance of Payments](#)', Speech to the Economic Society of Australia, Canberra, 27 August.

[1] This was not a historical high. While comparable data is not available, estimates are that net foreign liabilities reached around 120 per cent of GDP ahead of the Great Depression and more than 150 per cent of GDP ahead of the depression of the 1890s (Belkar R, L Cockerell and C Kent (2007), '[Current Account Deficits: The Australian Debate](#)', RBA Research Discussion Paper 02).

[2] Compulsory superannuation has led to higher national saving because it has not been completely offset by reductions in other forms of private and public saving. Gruen and Soding attributed this to the tax-preferred status of superannuation and the

nature of the government's fiscal strategy (Gruen D and L Soding (2012), 'Compulsory Superannuation and National Saving', Economic Roundup Issue 3). Meanwhile, Conolly estimated that for every dollar contributed to compulsory pension accounts, other types of household saving fall by 30 cents or less (Conolly E (2007), The Effect of the Australian Superannuation Guarantee on Household Saving Behaviour, RBA Research Discussion Paper 08).

- [3] A particularly large corporate restructure was recorded as a sharp increase in Australian direct investment abroad that was partly offset by a matching portfolio equity inflow into Australia.
- [4] Two observations should be made about dividend payments by Australian mining companies. The first is that higher payments to foreign shareholders reduce the size of the current account surplus associated with the boost to the trade surplus. The second is that reinvested earnings are notionally distributed to foreign owners in the net income component of the current account before being reinvested back into the firm, at which point it becomes recorded as a direct equity inflow in the financial account (Debelle G (2017), Recent Trends in Australian Capital Flows, Speech at the Australian Financial Review Banking and Wealth Summit, Sydney, 6 April). Because mining companies' profits are mostly earned in US dollars and the distribution of those earnings to foreign owners are also predominantly in US dollars, these amounts never come onshore into Australia, or are converted into Australian dollars, even though the balance of payments records them as capital flows.
- [5] Debelle G and M Plumb (2006), 'The Evolution of Exchange Rate Policy and Capital Controls in Australia', *Asian Economic Papers*, 5(2), pp 7–29.
- [6] See, for example, Bruno V and HS Shin (2015), 'Capital Flows and the Risk-taking Channel of Monetary Policy', *Journal of Monetary Economics*, 71, pp 119–132 and Kearns J and N Patel (2016), 'Does the Financial Channel of the Exchange Rates Offset the Trade Channel?', *BIS Quarterly Review*, Bank for International Settlements, December.
- [7] A floating exchange rate greatly diminishes this risk. Indeed, David and Gonçalves show that countries with floating exchange rates experience shorter growth-reducing sudden stops than countries with more rigid exchange rate regimes (David C and E Gonçalves (2021), 'In Search of Lost Time: Examining the Duration of Growth-reducing Sudden Stops', *Journal of International Money and Finance*, 117, <<https://doi.org/10.1016/j.jimonfin.2021.102450>>).
- [8] It is worth observing that the currencies that are important for the trade and financial channels are different. For Australia, most foreign currency liabilities and assets are denominated in US dollars. However, the US dollar accounts for less than 10 per cent of Australia's trade weighted index.
- [9] James E and C Vallence (2020), The Road to Australian Dollar Funding, *RBA Bulletin*, March.
- [10] This hedging does expose superannuation funds to liquidity risks associated with margin calls. However, these risks are at least partly mitigated by a currency depreciation also lifting the Australian dollar value of these underlying assets, all else equal. This supports the ability of funds to sell foreign assets to meet margin calls associated with hedging contracts (RBA (2021), Box C: What Did 2020 Reveal About Liquidity Challenges Facing Superannuation Funds?, *Financial Stability Review*, April).
- [11] Jacobs D (2019), How Do Global Financial Conditions Affect Australia?, *RBA Bulletin*, December.
- [12] May D, G Nodari and D Rees (2020), Wealth and Consumption, *RBA Bulletin*, March.
- [13] Relatedly, the predominance of domestic currency funding means that the Reserve Bank is able to more effectively influence financial conditions in Australia (Kent C (2018), US Monetary Policy and Australian Financial Conditions, The Bloomberg Address, Sydney, 10 December). This is not to say that financial conditions in Australia are not affected by financial conditions elsewhere through mechanisms other than the exchange rate. For example, global risk premiums can also affect Australian risk premiums (Rey H (2015), 'Dilemma not Trilemma: The Global Financial Cycle and Monetary Policy Independence', National Bureau of Economic Research Working Paper No 21162). For further discussion, see Jacobs, n 11.
- [14] James E and C Vallence (2020), The Road to Australian Dollar Funding, *RBA Bulletin*, March.