

Australia's Foreign Currency Exposure and Hedging Practices

Introduction

The Asian financial crisis led to renewed debate about the vulnerabilities that countries face if they have large unhedged foreign currency liabilities, particularly in the banking system. In the case of Australia, the data available from the foreign investment statistics published by the Australian Bureau of Statistics (ABS) show that the economy as a whole is not exposed to such risks, as foreign currency assets of Australian entities exceed foreign currency liabilities.¹ The resilience of the economy to the substantial fluctuations in the exchange rate that have been experienced in recent years confirms this assessment.

Nonetheless, the Reserve Bank felt that it would be useful to have more detailed information on foreign currency exposures in the economy, including by various sectors. The only sector where good information had previously been available was the banking sector, where data on currency exposures are collected as a by-product of bank supervision. This has always shown that Australian banks have little foreign currency exposure, even

though they have large overseas borrowings, as these borrowings are hedged back to Australian dollars. An article in the August 2000 Reserve Bank *Bulletin* showed how banks hedged the exposures arising from their overseas borrowings.

In order to improve the data on foreign currency exposures in the economy, the Bank approached the ABS to conduct a survey of hedging practices and policies so that both financial and non-financial enterprises were covered. This article describes the results of that survey.

Main Results

Entities approached by the ABS to take part in the survey were those residents that contribute to the quarterly Survey on International Investment, as well as a selection of significant importers and exporters. Details of the Survey are given by the ABS in the December quarter 2001 *Balance of Payments and International Investment Position*, in an article entitled 'Measuring Australia's Foreign Currency Exposure'. Firms that responded to the Survey accounted for around 90 per cent

1. See Australian Bureau of Statistics, *Balance of Payments and International Investment Position*, Cat No 5302.0.

of the total foreign currency assets and liabilities identified in the Survey on International Investment.

The Survey collected information as at 30 June 2001 on:

- (i) foreign currency denominated debt assets and liabilities;
- (ii) foreign equity assets;
- (iii) the notional value of outstanding foreign exchange derivatives; and
- (iv) the policies enterprises adopted on hedging foreign currency exposure.

The aggregate figures from the Survey are given in Table 1. At 30 June 2001, Australian entities had net foreign currency debts of \$165 billion, foreign currency equity assets of \$228 billion, and a long position in foreign currency derivatives (i.e., a right to acquire foreign currency) of \$85 billion. The net of these is a long foreign currency position of around \$149 billion – i.e., for the economy as a whole, foreign currency assets exceed foreign currency liabilities by \$149 billion.

The information collected in the Survey does not allow the derivative positions to be allocated precisely to debt and equity.

Responses to questions on hedging intentions, however, suggest that the bulk of the long position in derivatives was intended as a hedge against foreign debt. Respondents on average intended to hedge 77 per cent of the value of their foreign currency denominated debt compared to only 12 per cent of the value of their foreign equity assets. Australian borrowers tend to hedge their foreign debt back to Australian dollars because, in raising funds overseas, they are not looking to switch to currencies in which interest rates might be lower than in Australia; rather, they are simply looking to access a wider pool of investors. By contrast, Australian investors tend not to hedge their holdings of foreign currency equity assets as these are typically regarded as long-term investments for strategic or diversification reasons, and the exchange rate exposure is part of the rationale for the investment decision.

Forward foreign exchange contracts and cross-currency interest rate swaps were the main instruments used to hedge. The use of options, futures and other derivative contracts was only marginal (Table 2).

Table 1: Total Foreign Currency Exposure

A\$ billion, as at 30 June 2001

| | | |
|---|------|-------------|
| Foreign currency debt assets | 156 | |
| Foreign currency debt liabilities | -321 | |
| Net position on debt | | -165 |
| Foreign equity assets | | 228 |
| Foreign currency derivatives in a bought position | 548 | |
| Foreign currency derivatives in a sold position | -463 | |
| Net position of foreign currency derivatives | | 85 |
| Foreign currency exposure | | 149 |

Notes: Negatives indicate a short foreign currency position. Amounts may not add due to rounding.

Source: ABS Cat No 5302.0

Table 2: Types of Foreign Exchange Derivatives used for all Sectors

Notional value A\$ billion, as at 30 June 2001

| | Long foreign currency/short A\$ positions | Short foreign currency/long A\$ positions | Net position |
|------------------------------------|---|---|-----------------|
| Forward foreign exchange | 385 | -346 | 39 |
| Cross-currency interest rate swaps | 122 | -82 | 41 |
| Futures | 7 | 0 | 7 |
| Currency options | 22 | -27 | -5 |
| Other derivative contracts | 11 | -9 | 3 |
| Total | 548 | -463 | 85 |

Notes: Negatives indicate a short foreign currency position. Amounts may not add due to rounding.

Source: ABS Cat No 5302.0

Sectoral Results

While these aggregate figures give a reassuring picture of Australia's foreign currency exposures, it is possible that they could disguise substantial imbalances within sectors of the economy. For this reason, the Survey compiled data for various sectors of the economy. The rest of this note describes the results for the main private sector groups: banks, other private financial corporations, and other residents.

Banks

The banking sector has a large stock of foreign currency debt, amounting to \$117 billion, or 70 per cent of Australia's net foreign currency debt (Table 3). In recent years, banks have met the increase in domestic demand for credit by raising a greater proportion of their funds offshore. Offshore funding has been comparatively attractive, offering a greater funding base and lower costs than domestic financing.

While the banking sector's net foreign currency debt position is large, so too is its use of foreign currency derivatives. It had a net long position in derivatives of \$109 billion, virtually all of which was intended as a hedge

Table 3: Banking Sector's Foreign Currency Exposure

A\$ billion, as at 30 June 2001

| | |
|--|-----------|
| Net position on debt | -117 |
| + | |
| Foreign equity assets | 31 |
| + | |
| Net position on foreign currency derivatives | 109 |
| = | |
| Foreign currency exposure | 23 |

Notes: Negatives indicate a short foreign currency position. Amounts may not add due to rounding.

Source: ABS Cat No 5302.0

against their foreign currency debt. This means that banks have very little net exposure to foreign currency debt. This is consistent with the findings in the August 2000 Reserve Bank *Bulletin* article.

The main foreign exchange exposure of banks on the asset side results from their equity investments in offshore operations. These assets amount to about \$31 billion in total, and little of this is hedged back to Australian dollars. In this regard, banks are behaving in much the same way as other Australian corporations in having their overseas direct equity investments largely unhedged.

The derivative contracts that banks have undertaken to hedge their foreign currency debt are largely with non-residents (Table 4). These would most likely be entities which have borrowed in Australian dollars and are seeking to swap their liability back to their home currency. Most of the remainder of banks' derivative positions represent swap transactions with the Reserve Bank, which have been undertaken for domestic liquidity management purposes. The first leg of these transactions involves banks selling foreign currency to the Reserve Bank in exchange for Australian dollars. They source the foreign currency (typically US dollars) by short-term borrowings in US money markets. At the same time as the first leg is transacted, details of the second leg (i.e., the reversing transaction) are agreed, including both the date and the relevant exchange rates. This means that banks have no exposure to exchange rate changes; their obligation to repay their US dollar borrowings is matched by the foreign currency they will receive from the Reserve Bank in the second leg of the swap. The Reserve Bank, for its part, simply holds the foreign exchange banks sell to it in the first leg of the swap, until it is time to repay in the second leg. It, too, therefore has no net foreign currency exposure.

Table 4: Counterparties to Banking Sector's Net Off-balance Sheet Position

A\$ billion, as at 30 June 2001

| | |
|------------------------------|------------|
| Non-residents | 71 |
| Residents: | |
| RBA | 29 |
| Other financial corporations | 1 |
| General government | 3 |
| Other resident sectors | 7 |
| Sub total | 39 |
| Total | 109 |

Note: Amounts may not add due to rounding.

Source: ABS Cat No 5302.0, companion data, Table A

Other private financial corporations

Broadly speaking, other private financial corporations consist of two groups: collective investment vehicles (insurance companies, superannuation funds, and public unit trusts) and non-bank intermediaries (finance companies, money market corporations and non-bank depository corporations). As a whole, at 30 June last year, this sector had foreign debt liabilities of \$28 billion, foreign equity assets of \$84 billion, and a net long derivative position of \$8 billion (Table 5).

Table 5: Other Private Financial Corporations' Foreign Currency Exposure

A\$ billion, as at 30 June 2001

| | |
|--|-----------|
| Net position on debt | -28 |
| + | |
| Foreign equity assets | 84 |
| + | |
| Net position on foreign currency derivatives | 8 |
| = | |
| Foreign currency exposure | 64 |

Notes: Negatives indicate a short foreign currency position. Amounts may not add due to rounding.

Source: ABS Cat No 5302.0

The debt position of this sector mainly reflects foreign borrowings by non-bank intermediaries, particularly merchant banks which largely fund themselves through their offshore parents. The foreign equity assets consist largely of offshore investments by collective investment vehicles. Australian funds managers, for example, typically hold about 20–25 per cent of their assets in the form of offshore equities.

The hedge position of this sector as a whole is relatively small, though this is the net of large long and short positions. Non-bank intermediaries have derivatives positions which are long foreign currency as a hedge against their foreign currency debt; virtually all their debt is hedged in this way. The collective investment vehicles, on the other hand, have derivative positions which are short

foreign currency, representing a hedge against about 20 per cent of their foreign currency equity assets. Compared with other sectors, which hedge virtually none of their offshore equity holdings, this is a relatively high use of hedging. The greater use of hedging by this group may be because their equity investments are mainly in the form of portfolio investments, rather than direct investments, and subject to short-term reporting requirements. This may make them more sensitive to exchange rate changes.

Other resident sectors

The 'other resident' sectors in the Survey consist largely of non-financial private sector enterprises – mainly corporations and other exporters and importers. Accordingly, this group will inevitably have substantial operational exchange rate exposures – for example, on expected receipts and payments – in addition to those from positions in financial assets and liabilities and/or derivatives.

This sector in total had \$50 billion in foreign currency debt liabilities and \$114 billion in foreign currency equity assets (Table 6). The net position in derivatives is insignificant, though the long and short positions were both quite large, possibly reflecting the hedging activities of exporters and importers.

The foreign debt liabilities of this group arise for two main reasons. First, these entities often

raise foreign currency debt to fund purchases of foreign currency equity assets. As such, the foreign currency debt exposures can represent an offset to the foreign currency equity exposures. The information available to the Bank does not allow it to measure the extent to which this is the case. Second, exporters who will receive a flow of foreign currency payments in the future often hedge this exposure by undertaking their borrowings in foreign currency. Therefore, some of the foreign currency debt should also be viewed as an offset against these expected export receipts. Again, details are not available to the Bank to allow it to do this precisely, though foreign currency merchandise export receipts for Australia are about \$100 billion a year, well in excess of the foreign currency debt exposures of this sector. In short, therefore, it is likely that the foreign currency debt liabilities are largely offset against either foreign currency equity assets or expected export receipts.

The foreign currency equity assets of this sector would mainly consist of direct investments overseas by Australian corporations, in a wide range of industries, including resources, manufacturing, services and property. These investments would mostly be long-term investments and therefore it is not surprising that virtually none of these are hedged with derivative contracts.

Table 6: Other Resident Sectors' Foreign Currency Exposure

A\$ billion, as at 30 June 2001

| | |
|--|-----------|
| Net position on debt | -50 |
| + | |
| Foreign equity assets | 114 |
| + | |
| Net position on foreign currency derivatives | -3 |
| = | |
| Foreign currency exposure | 61 |

Notes: Negatives indicate a short foreign currency position. Amounts may not add due to rounding.

Source: ABS Cat No 5302.0

Conclusion

Even though Australians have substantial net debt liabilities to foreigners, a large amount of these are either denominated in Australian dollars or hedged back to Australian dollars. The remaining amounts of foreign currency debt outstanding are more than offset by holdings of foreign currency assets. As a result, the Australian economy as a whole, as well as individual sectors, do not appear to have significant foreign exchange exposure. ✎