

# AUSTRALIA'S FOREIGN CURRENCY EXPOSURE AND HEDGING PRACTICES<sup>1</sup>

## Introduction

The foreign currency exposure of Australian enterprises has an important influence on their resilience to exchange rate movements. To improve understanding of these exposures the Reserve Bank in 2001 asked the Australian Bureau of Statistics (ABS) to survey Australian entities in relation to their foreign currency exposures and hedging practices. The results of that survey were very reassuring, showing that, despite large net borrowings from non-residents, Australians had few foreign currency liabilities as the bulk of the borrowing was either denominated in Australian dollars or hedged back to Australian dollars. In fact, Australia as a whole had substantially more foreign currency assets than foreign currency liabilities.

Because of the importance of these statistics for any assessment of Australia's economic and financial vulnerability, earlier this year the Bank commissioned the ABS to carry out a repeat survey. The results are now to hand and show a very similar picture to the earlier survey. About 95 per cent of Australian external liabilities were either in Australian dollars or hedged to Australian dollars, and foreign currency assets continued to exceed foreign currency liabilities.

## Main Results

In conducting the survey on foreign currency exposure and hedging practices, the ABS approached Australian enterprises that are contributors to the quarterly Survey on International Investment, as well as a selection of significant importers and exporters.<sup>2</sup> Firms responding to the survey accounted for over 90 per cent of Australia's foreign currency assets and liabilities.

The survey collected information as at 31 March 2005 on:

- foreign currency debt assets and liabilities;
- foreign currency equity assets (there are negligible foreign currency equity liabilities);
- expected foreign currency receipts and payments related to trade;
- the notional value of outstanding foreign exchange derivative contracts;
- the policies enterprises adopted on hedging foreign currency exposure; and
- as an important extension to the 2001 survey, the currency composition of balance sheets and derivative contracts.

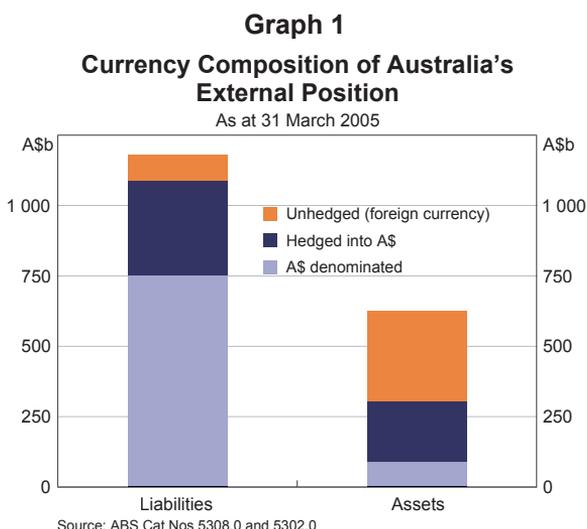
Before discussing the results of the survey in detail, it is worth putting the aggregate figures into the context of Australia's overall foreign investment position. This is shown in Graph 1.

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<sup>1</sup> This article was prepared by Chris Becker, Guy Debelle and Daniel Fabbro of International Department.

<sup>2</sup> Details of the survey are available in ABS publication 'Foreign Currency Exposure' (Cat No 5308.0), March 2005.

As at March 2005, total liabilities to foreigners were about \$1 200 billion. As can be seen, about two-thirds of these were denominated in Australian dollars, comprising Australian dollar debt and equities held by foreigners. Of the remaining third that was denominated in foreign currency, the great bulk was hedged back to Australian dollars through derivatives. In total, only about 5 per cent of Australia's external liabilities involve a foreign currency exposure, and it is likely that most of this is held deliberately because it acts as an offset either to a foreign currency asset (e.g. an Australian company issuing US dollar debt to fund a US equity investment) or an expected foreign currency receipt (e.g. US dollar proceeds of export sales).



Foreign assets held by Australians are only about half the size of liabilities (i.e. a little over \$600 billion) but a much higher proportion (about half) is denominated in foreign currency. As a result, there is an excess of foreign currency assets over foreign currency liabilities of \$218 billion, or 26 per cent of GDP. This is a little larger than in 2001, when the corresponding figures were \$149 billion and 22 per cent.

Table 1 gives more details of the foreign currency exposures as at March 2005, together with the 2001 results. Net foreign currency debt on the balance sheet of Australian entities was \$252 billion. However, information from the hedging intentions of respondents shows that about \$200 billion of this was hedged back to Australian dollars through derivatives, leaving a net foreign currency debt exposure of about \$50 billion. As noted, it is likely that even this figure may overstate foreign currency risk, as at least some of this foreign currency debt would be issued deliberately to offset other foreign currency exposures such as a foreign equity investment or an expected foreign currency receipt.

Companies hedge their debt back to Australian dollars to avoid currency risk. Even though this hedging closes the interest rate gap that might exist between Australia and some other countries where interest rates are lower, companies still see benefit in issuing debt in overseas markets because these are often larger, thereby offering greater liquidity and investor demand for a wider range of credit risk and/or maturities.

Foreign currency equity assets held by Australians were \$344 billion, of which about 20 per cent was hedged back to Australian dollars. This left net foreign currency equity holdings of about \$270 billion. The lower proportion of foreign equity assets that is hedged reflects the long-term nature of much of these investments, where firm-specific strategies or diversification benefits often underlie the investment decision.

**Table 1: Foreign Currency Hedging Policies by Instrument**A\$ billion<sup>(a)</sup>

	30 June 2001	31 March 2005
Net FX position on debt	-165	-252
Derivative positions to hedge debt	126	199
<b>Net FX position on debt (after derivatives)</b>	<b>-39</b>	<b>-53</b>
Foreign equity assets	229	344
Derivative positions to hedge equity	-28	-72
<b>Net FX position on equity (after derivatives)</b>	<b>201</b>	<b>272</b>
Net expected foreign currency trade <sup>(b)</sup>	-	4
Residual derivative positions	-13	-5
<b>Foreign currency position (after derivatives)</b>	<b>149</b>	<b>218</b>
<b>Per cent of GDP</b>	<b>22</b>	<b>26</b>

(a) Negative values indicate a short foreign currency position.

(b) Data not available in 2001.

Source: ABS Cat No. 5308.0

While the flows of foreign exchange associated with exports and imports are large, the survey shows that for the country as a whole net foreign currency exposures resulting from international trade were negligible. Even though Australian imports exceed exports, a smaller proportion of imports are denominated in foreign currency and export receipts are contracted over longer periods than import payments.

Australian entities used forward foreign exchange contracts and cross-currency interest rate swaps as their main hedging instruments (Table 2). The table shows that there were large derivative contracts on both the short and the long side, much of which were held by financial institutions. However, these positions mostly netted out, the exception being cross-currency interest rate swaps which had a large long position in foreign currency. These instruments are primarily used to hedge foreign currency borrowing.

**Table 2: Types of Foreign Currency Derivatives Used**Notional values in A\$ billion, as at 31 March 2005<sup>(a)</sup>

	Long foreign currency/short A\$ positions	Short foreign currency/long A\$ positions	Net position
Forward foreign exchange	750	-747	4
Cross-currency interest rate swaps	330	-204	126
Futures	87	-87	0
Currency options	67	-75	-8
Other derivatives	1	0	1
<b>Total</b>	<b>1 235</b>	<b>-1 113</b>	<b>122</b>

(a) Negative values represent a short foreign currency position. Amounts may not add due to rounding.

Source: ABS Cat No 5308.0

## Sectoral Results

The survey shows that all the main sectors of the economy were either balanced in their foreign currency exposure or had a long foreign currency position (Table 3). For those sectors with sizeable foreign currency borrowing, much of this is directly hedged, while those sectors with less direct hedging have sizeable foreign equity asset holdings. The rest of this section discusses each sector in more detail.

**Table 3: Foreign Currency Hedging Policies by Sector**  
A\$ billion, as at 31 March 2005<sup>(a)</sup>

	Banks	RBA	Other financials	Government	Other residents
Net foreign currency position on debt	-186	44	-47	-3	-60
Derivative positions to hedge debt	168	-21	39	3	27
<b>Net foreign currency position on debt (after derivatives)</b>	<b>-18</b>	<b>22</b>	<b>-8</b>	<b>0</b>	<b>-33</b>
Foreign equity assets	33	0	160	-	150
Derivative positions to hedge equity	-10	0	-60	-	-2
<b>Net foreign currency position on equity (after derivatives)</b>	<b>23</b>	<b>0</b>	<b>100</b>	<b>-</b>	<b>148</b>
<b>Net position</b>	<b>5</b>	<b>22</b>	<b>92</b>	<b>0</b>	<b>115</b>

(a) Negative values indicate a short foreign currency position. Amounts may not add due to rounding.  
Source: ABS Cat No. 5308.0

## Banks

The banking sector accounts for a large proportion (74 per cent) of Australia's foreign currency debt. Australian banks are active in raising funds offshore because they like to diversify their funding base and their sound reputation ensures a ready demand for their debt in overseas markets. Their high level of financial sophistication also puts them in a stronger position than other Australian corporates to exploit small differentials in funding costs across world markets.

Banks continue to hedge their debt back into Australian dollars. Once account is taken of derivative positions, the unhedged proportion of the banks' net foreign currency debt positions is only \$18 billion. Some part of this unhedged debt is likely to be associated with the banks' direct equity investments offshore, and as such this debt is offset by the equity holdings.<sup>3</sup> This particular hedging policy towards direct equity investments is similar to that of many non-financial firms with foreign operations (described below).

Overall, these results imply that while the Australian banking sector features prominently in Australia's gross foreign currency positions, having large stocks of both assets and liabilities, it continues to remain well insulated from exchange rate movements due to its hedging.

<sup>3</sup> Notably, banks also match the maturity structure of their derivative contracts to their offshore debt issuance. For previous discussion, see the [August 2000](#) and [August 2002](#) Reserve Bank Bulletin articles.

## Other private financial corporations

Other private financial corporations can be broadly categorised into two groups: managed funds (predominantly life insurance companies, superannuation funds, and public unit trusts) and non-bank intermediaries (registered financial corporations, securitisation vehicles, and non-bank depository corporations). As at March 2005, this sector as a whole had foreign equity assets of \$160 billion with net foreign currency debt liabilities of \$47 billion.

In recent years there has been a substantial increase in the foreign equity assets of this sector, primarily reflecting the continued growth in funds under management, as the share of funds invested in overseas assets has remained relatively stable at around 20 per cent of total funds under management. The equity hedging policies of the sector, largely reflecting those of fund managers, suggest that a little over one-third of equity assets were hedged as at March 2005, compared to around 20 per cent in June 2001. The upward trend in the Australian dollar between the two surveys probably explains why funds managers are more heavily hedged now than four years ago as, in the absence of hedging, a rising Australian dollar would lower returns on foreign assets.

The net foreign currency debt liabilities of this sector have also risen over the past few years, largely reflecting the increase in offshore issuance of asset-backed securities by securitisation vehicles to finance the sizeable increase in their domestic mortgage assets. Securitisation vehicles now account for the largest proportion of this sector's foreign currency liabilities. Registered financial corporations, particularly money market corporations, also account for a notable share of foreign currency borrowings. These are often the subsidiaries of major foreign banks and hence have ready access to offshore funds. The survey results show that around four-fifths of this sector's foreign currency debt liabilities are hedged.

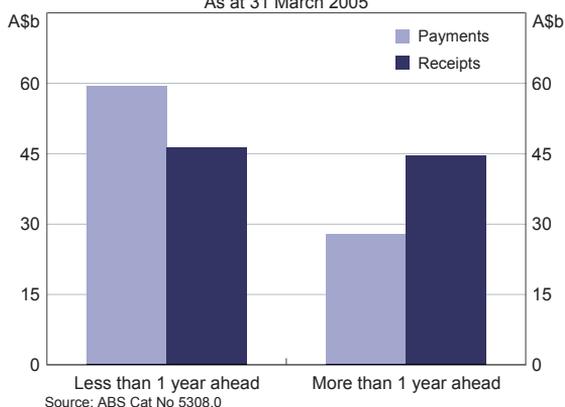
## Non-financial corporations (other residents)

The 'other residents' sector largely comprises non-financial private corporations. The sector has substantial operational exposures to foreign currency movements arising from equity and debt associated with foreign operations, as well as expected foreign currency receipts and payments of exporters and importers.

The foreign equity assets of this sector are largely overseas direct investments of a long-term nature. Given that derivative hedging may provide little benefit over a long horizon, it is not surprising that there is almost no derivative hedging of these investments. The foreign currency borrowing associated with these operations is also unlikely to be hedged as it will generally be naturally hedged by the equity holdings underpinning the investment. For example, an Australian company may acquire a foreign company and fund the purchase with borrowing in foreign currency. It would then hold an equity asset denominated in foreign currency offset against its foreign currency borrowing, leaving no net currency exposure.

Around three-quarters of export receipts are denominated in foreign currency while around two-thirds of imports are denominated in foreign currency (ABS Cat No 5422.0). To protect themselves against movements in the exchange rate between entering the contract for the goods and receiving or making the payment, these companies in the traded sector may take derivative positions in the form of forward foreign exchange contracts or currency options (shown in Table 2).

**Graph 2**  
**Expected Trade Denominated in Foreign Currencies**  
 As at 31 March 2005



Graph 2 shows that exporters had contracted foreign currency receipts of around \$45 billion within twelve months and the same amount beyond twelve months, whereas importers had larger payments within twelve months but smaller payments beyond that horizon. This probably reflects the greater use of longer-term contracts by exporters.

For this sector as a whole, the exposure on foreign equity assets and expected foreign currency trade receipts can provide firms with an offsetting exposure to foreign currency debt liabilities. The survey

information does not enable us to determine the exact extent to which firms use these natural hedging techniques. However, information collected in the survey suggests that around 45 per cent of net foreign currency debt liabilities of this sector are hedged back into Australian dollars through derivatives (Table 3), with the remaining unhedged debt of around \$33 billion probably used as an offsetting exposure to equity assets or expected foreign currency receipts.

## Reserve Bank of Australia

The RBA's foreign currency assets represent official reserve assets it holds in US dollars, euros and Japanese yen. Since net reserves have been acquired outright through intervention in the foreign exchange market, they cannot be hedged back to Australian dollars, as this would effectively counteract the intervention. In addition to holdings of net reserves, the RBA acquires foreign currency through foreign exchange swap operations, undertaken mainly for domestic liquidity purposes. These holdings are effectively hedged because, at the time the foreign exchange is acquired under the swap, agreement is also reached on the exchange rate for the reversal.<sup>4</sup>

## General Government and Central Borrowing Authorities

The net foreign currency debt liabilities of the government sector are very small, amounting to \$3 billion, and are entirely those of the States' borrowing authorities. They are fully offset by derivatives that convert them into Australian dollars. The remaining net foreign currency exposure of this sector is a result of expected net foreign currency payments related to trade, amounting to \$3 billion. The Commonwealth Government has adopted a policy of not hedging these small exposures.<sup>5</sup>

<sup>4</sup> For more information see the *2005 RBA Annual Report*.

<sup>5</sup> The longstanding policy of not hedging was restated in July 2002, following a directive given by the Department of Finance and Administration (DOFA). Only government entities with a demonstrable hedging requirement can seek exemption from this directive. See DOFA Finance Circulars 2002/01 and 2004/11 for more details.

## Counterparties to Derivatives

As shown above, Australia as a whole has a net long position in derivatives with non-residents of \$122 billion, largely representing hedges against foreign currency debt liabilities. Under these contracts, non-residents have effectively guaranteed to supply Australians, at some point in the future, foreign currency in return for Australian dollars at pre-determined exchange rates. These contracts are possible because non-residents are willing to hold a proportion of Australian dollars in their portfolios. Given the large size of banks' debt liabilities, it is not surprising that banks account for the bulk of the net derivatives position with non-residents (Table 4).

**Table 4: Counterparties to Sectors' Net Off-balance Sheet Position**

A\$ billion, as at 31 March 2005<sup>(a)</sup>

	Banks	RBA	Other financials	Government	Other	All sectors
<b>Net bought/sold FX derivatives position</b>	153	-21	-15	3	2	122
With:						
Non-residents	119	0	-15	3	16	122
Residents	35	-21	0	0	-14	0

(a) Negative values indicate a short foreign currency position. Amounts may not add due to rounding.

Source: ABS Cat No. 5308.0 (Data cubes, Table 8)

## Currency Composition

To see whether entities had exposures as a result of mismatched positions between foreign currencies, the latest survey also collected information on the currency composition of the various exposures. The data show that this has not been a source of exposure.

For the private sector the most important overall balance sheet exposures are, as expected, to the US dollar, making up 50 per cent or more of total foreign currency exposures. The euro is also an important source of balance sheet exposures (around 15 per cent of total exposures), but thereafter the other currencies explicitly enumerated in the survey (the British pound, Japanese yen and Swiss franc) play a relatively minor role. The survey results indicate that the currency composition of the derivative positions provide the appropriate hedge by closely aligning with the balance sheet exposures for each sector.

For the government sector the most notable balance sheet exposure arises as a result of the state borrowing authorities raising funds in Japanese yen, but an offsetting derivative position in yen directly insulates that part of the state governments' exposures from exchange rate fluctuations.

## Conclusion

Mature industrialised countries such as Australia are able to gain access to international capital in their local currency, either directly or through derivatives. It is therefore possible for them to have a sizeable stock of net foreign liabilities while avoiding exposure to exchange rate risk. The

results of the latest hedging survey show that the bulk of Australia's foreign currency liabilities are hedged back to Australian dollars. Much of the small remaining stock of unhedged debt is likely to be hedged naturally by foreign equity holdings or expected foreign currency export receipts. This is the case for the Australian economy as a whole and for each of its main sectors. ✎