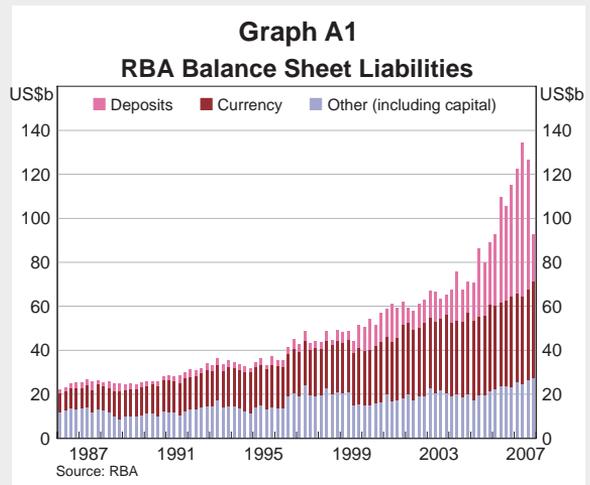


Box A: The RBA's Foreign Exchange Swaps

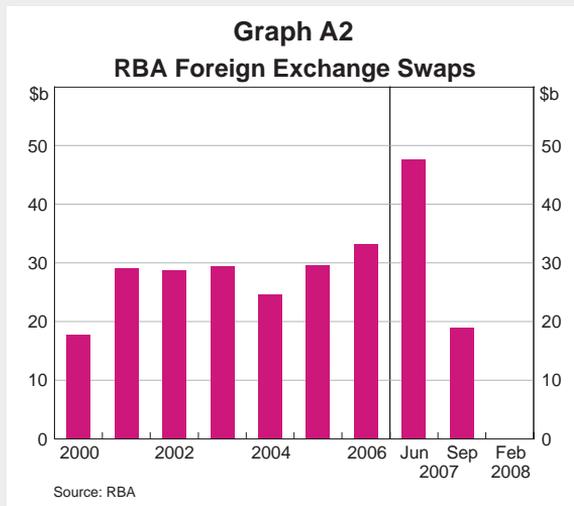
Foreign exchange swaps are transactions which involve the purchase of one currency against another at an initial date and an agreement to reverse that transaction at a future date and at a specified rate. For many years now, the Bank has routinely used foreign exchange swaps to supplement its open market operations in domestic securities to manage domestic liquidity. To inject liquidity, for example, the Bank may enter into a swap arrangement involving the delivery of Australian dollars in exchange for US dollars at the prevailing exchange rate and a commitment to reverse the transaction at a specified rate and agreed date in the future. As such, the swap is similar to a repurchase agreement in domestic securities, the only difference being that the Bank is temporarily providing Australian dollars in exchange for foreign currency rather than in exchange for domestic securities. As the price is agreed for the term of the swap, the Bank is not exposed to any foreign currency risk. Importantly, as the swap involves both a sale and a purchase of foreign currency the transaction has no effect on the exchange rate.

This recourse to foreign exchange swaps for managing domestic liquidity came about due to a combination of growth in the Bank's balance sheet and a decline in the stock of Commonwealth Government securities (CGS) on issue. These developments meant that from the late 1990s onwards, the Bank held an increasingly large proportion of government securities on issue, particularly around the times of seasonal peaks in its balance sheet. By undertaking foreign exchange swaps, rather than always purchasing domestic securities, the Bank aimed to limit the distortions that its open market operations might otherwise have had on the CGS market. This became increasingly important as the Bank's balance sheet was temporarily expanded in recent years by deposits from the Australian Government and its agencies, in particular the Future Fund, pending their investment in a wider range of assets (Graph A1). This preference for using swaps largely reflects the liquidity of the foreign exchange swap market: average daily turnover in Australia of foreign exchange swaps involving the local currency is around \$60 billion, compared with average daily turnover in the CGS market of less than \$1.5 billion.

Over the past six months the Bank has wound back its holdings of foreign exchange under swap for two reasons. The first is the significant contraction in the Bank's balance sheet which occurred over the second half of 2007, as the Future Fund



withdrew its deposits. The second reflects a shift in the Bank's open market operating procedures, as the Bank responded to the global financial turbulence by providing banks in Australia with liquidity through repurchase agreements secured against a wider range of domestic collateral. This shift was designed to ease liquidity pressures in the domestic money market as conditions in global financial markets deteriorated.



As a result, the Bank's holdings of foreign exchange swaps, which were \$45 billion in early August, had been completely run off by November. In fact, as the Bank subsequently drained some of the liquidity from the domestic money market, it temporarily entered into a number of short-term exchange swaps involving the *delivery* of foreign currency in return for Australian dollars (Graph A2).

None of these shifts in the Bank's foreign currency portfolio have had any implications for the level of the Australian dollar exchange rate. This

is because swap transactions, in and of themselves, have no bearing on the net foreign currency position of market participants and, by extension, no impact on the underlying demand for Australian dollar assets. In a swap transaction, the Bank and its counterparties – generally banks in Australia – are simply exchanging currencies between themselves at previously agreed prices. ✎