AUSTRALIAN CAPITAL FLOWS AND THE FINANCIAL CRISIS[1]

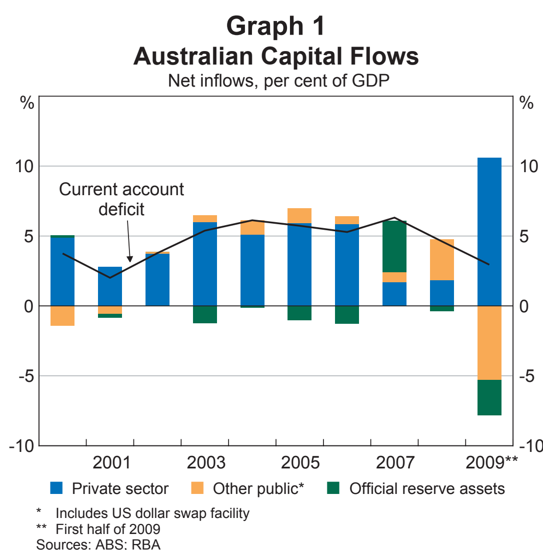
Introduction

For many years, Australia's high level of investment relative to savings has been supported by net foreign capital inflow. This net capital inflow, which has averaged around 5 per cent of GDP over the past decade and is the counterpart to Australia's current account deficit, masks much larger gross flows including substantial investment by Australians offshore. Despite the global financial crisis affecting the usual configuration of Australia's capital flows, net inflows of foreign capital continued throughout the episode. This article reviews how Australia's capital flows were affected by the financial crisis. It notes the relative stability of direct investment flows and the role of repatriation flows. Finally, it considers the recovery in private capital flows in the first half of 2009 and discusses some compositional differences compared with the pre-crisis situation.

Capital Flows Prior to the Crisis

Between 2000 and 2007, the pattern of Australia's capital flows was quite stable although, in line with the worldwide acceleration in financial globalisation, gross flows tended to grow significantly faster than the economy. Flows were dominated by the private sector; the balanced fiscal position of the public sector meant that net public sector flows were relatively small (Graph 1). Private sector inflows reflected large foreign purchases of Australian debt, much of it issued by the banking sector, and somewhat smaller portfolio and direct equity investment in Australian assets. These inflows were partly offset by Australian investment abroad, which consisted of both sizeable foreign debt and equity portfolio investment by fund mangers and direct foreign investment by non-financial corporates.

On average over the decade, there were small public sector net outflows resulting from the gradual accumulation of official reserve assets by the Reserve Bank. In 2007, however, the Australian Bureau of Statistics recorded an inflow of public capital owing to a decline in the Bank's holdings of foreign exchange



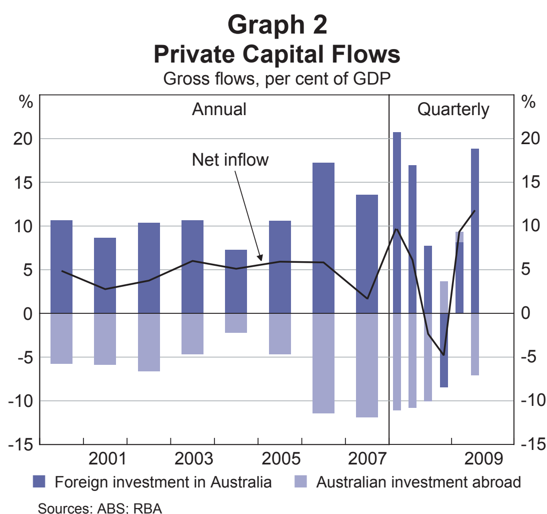
1 *This article was prepared by Patrick D'Arcy and Crystal Ossolinski of International Department.*

held under foreign exchange swap agreements, a component of official reserve assets. Two factors caused the Bank to reduce these swap holdings of foreign exchange while maintaining its outright holdings of foreign reserve assets.[2] The first, which predated the crisis, was the contraction of the Bank's balance sheet due to the withdrawal of deposits by the Australian Government's Future Fund, as the Fund began to invest in a diversified portfolio of assets. The second was the Bank's decision in the latter part of 2007 to accept more domestic collateral in its daily liquidity management, rather than foreign exchange under swap, in order to improve liquidity conditions in domestic securities markets. Although the decision to run down the swap book changed the recorded composition of capital flows between the private and public sectors, it had no effect on net capital flows. The exchange rate was also unaffected because foreign exchange swap agreements do not change the net demand for foreign exchange in the market.

Capital Flows During the Financial Crisis

The global financial crisis severely affected the normal functioning of global credit and capital markets. In particular, the increase in risk aversion among investors led to a fall in cross-border investment activity globally after several years of strong growth. Not only was it difficult for borrowers to obtain funding in international markets, but many international investors repatriated existing offshore investments. In essence the crisis induced a temporary bout of 'home bias' among global investors.[3]

In line with these developments, various components of Australia's capital flows were affected by the crisis. The volatility was concentrated in flows related to credit markets – those intermediated through the banking sector and asset-backed securities markets – and those related to portfolio investments managed by institutional investors. Direct investment flows, both into and out of Australia, were relatively unaffected by the crisis: the net inflow of direct investment in 2008 was close to its long-run average of 1 per cent of GDP.



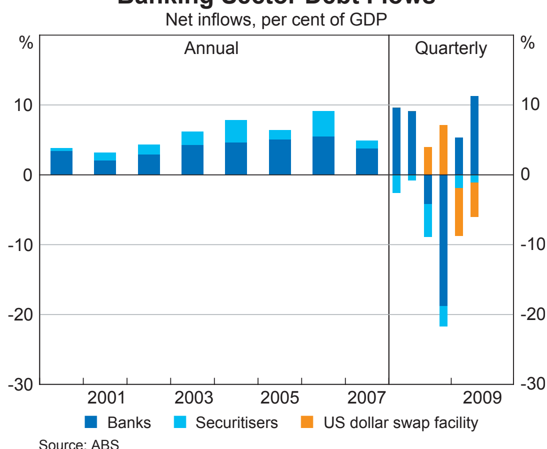
Private foreign investment in Australia contracted sharply over 2008 from an historically high level relative to GDP (Graph 2). Moreover, during the period of acute risk aversion immediately following the Lehman Brothers collapse in September 2008, foreigners actually repatriated funds from Australia. However, the effect of these outflows on net capital inflows was mitigated by repatriation flows by Australians, as portfolio investors pared their foreign investments over late 2008 and early 2009. These repatriation

2 *See 'Box A: The RBA's Foreign Exchange Swaps'*, Statement on Monetary Policy, *February 2008, pp 23–24.*

3 *Global capital flows are discussed in more detail in 'Box C: Gross International Capital Movements'*, Statement on Monetary Policy, *August 2009, pp 32–33.*

flows were driven by investors' general desire to shed risk and by investment mandates that required local fund mangers to rebalance portfolios away from foreign assets and into domestic assets to counteract the valuation effects caused by the depreciation of the Australian dollar. In net terms, private capital flows were negative in the third and fourth quarters of 2008, but the net withdrawal was considerably less than would have been the case had Australian investors continued to invest abroad at the pace seen in 2006 and 2007.

A key characteristic of Australia's private capital flows prior to the financial crisis was the significance of the offshore issuance of bank debt and asset-backed securities (mainly residential mortgage-backed securities). Together these two sources amounted to capital inflows of around 8 per cent of GDP between 2004 and 2006 (Graph 3). Not surprisingly, these flows were extremely volatile through the crisis period and largely accounted for the volatility in gross private capital inflows over 2008 and 2009; other portfolio inflows (equity and non-banking sector debt) were less volatile over the period. Offshore issuance of asset-backed securities ceased in mid 2007, and since then the amortisation of the outstanding stock and some sales of foreign holdings to domestic investors have resulted in consistent net capital outflows. Net foreign purchases of bank debt slowed in 2007 during the initial stage of credit market strains, but actually picked up in early 2008 as Australian banks used the relative strength of their balance sheets to raise debt in offshore markets during the temporary reopening of credit markets. A strategy of 'pre-funding' – increasing liabilities ahead of credit growth – was pursued and provided Australian banks with an additional funding buffer when international debt markets all but closed following the Lehman Brothers collapse.



One policy initiative that affected capital flows during the crisis was the establishment of US dollar swap lines between the US Federal Reserve and other major central banks. The swap facilities were designed to ease the cost to banks, particularly those in Europe, of borrowing US dollars outside of the United States. The first were established by the Fed with the European Central Bank and the Swiss National Bank in December 2007.[4] Facilities with 12 other central banks were introduced as the crisis intensified in the second half of 2008, including the Bank of Japan, the Bank of England and the Reserve Bank of Australia. The operation of the facilities involves the central banks holding auctions at which local banks bid for US dollars in exchange for local-currency-denominated collateral under short-term repurchase agreements. The central

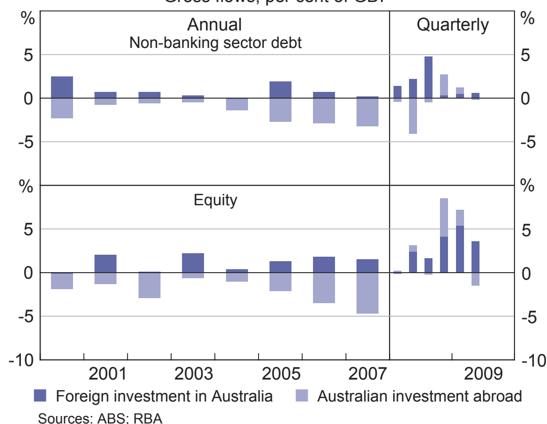
4 *For more information on the global scheme see 'Box B: US Dollar Swap Arrangements between Central Banks',* Statement on Monetary Policy, *November 2008, pp 23–25.*

banks obtain the US dollars from the Fed in a foreign exchange swap for local currency, which the Fed holds on deposit at the counterpart central bank for the term of the swap. In effect, the central banks intermediate the Fed's provision of US dollar liquidity to banks outside the United States.

The swap was priced at a spread above the rate available for accessing the Fed directly but, in order to ensure lower borrowing costs, considerably below that available in the interbank market during the crisis. The spread was calibrated such that as market conditions improved institutions would have an incentive to revert to the market for funding relatively quickly.

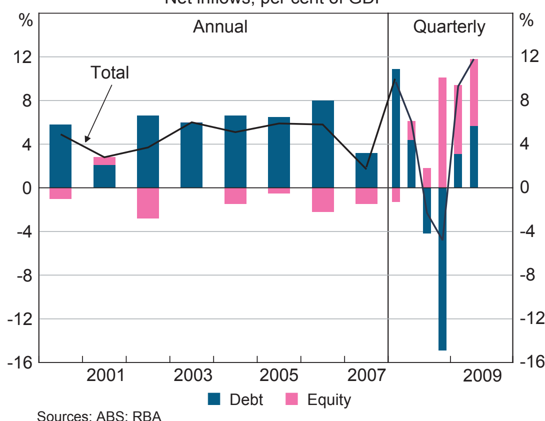
The net effect of the transactions that comprise the swap – the Fed holding a deposit at the central bank and the central bank holding the local-currency-denominated collateral of its domestic banks – is recorded as public capital inflow in the balance of payments statistics. This is evident in the Australian statistics (Graph 3). Reflecting the fact that the US dollar funds available under this facility were cheaper than available in the market, particularly in the December quarter, Australian banks replaced some of their short-term foreign funding with funding through this means. It also appears that some of the US dollar funds obtained by Australian banks at the Reserve Bank auctions were lent to other banks offshore, particularly by foreign-owned banks under pressure to provide US dollar liquidity to foreign parents. Thus, the availability of this facility is likely to have contributed to the net outflow of debt from the banking sector in the September and December quarters of 2008.

In a number of important respects capital flows returned to their pre-crisis configuration in the first half of 2009. Reflecting the improvement in global market conditions and the introduction of the government guarantee on bank debt, offshore debt issuance by Australian banks recovered solidly over the first half of 2009. Demand for the US dollar swap facility declined to zero as it became cheaper to access funding in the market directly. The amount outstanding was almost completely unwound in the first half of the year, resulting in an outflow of public capital via the swap facility that was more than offset by new issuance of bank debt offshore. The lower value of the Australian dollar in early 2009, following the sharp depreciation at the height of the crisis, also assisted the recovery in debt capital inflows by reducing the size of foreign currency issuance needed to support Australian assets. The low exchange rate may also have encouraged the modest pick-up in portfolio equity inflows in the first half of this year (Graph 4). Overall, the recovery in bank and portfolio inflows has seen gross private capital inflows rebound to almost 20 per cent of GDP in the June quarter (refer Graph 2).

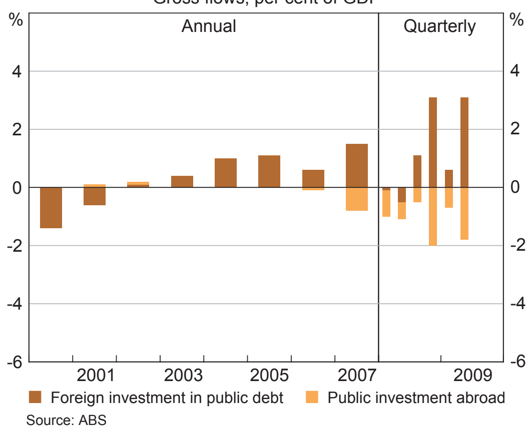


Australian investment abroad also resumed in the June quarter but remains somewhat below the pace recorded prior to the crisis. This is primarily the result of the lower level of Australian portfolio investment abroad compared with the pre-crisis situation (refer Graph 4). As discussed above, the large repatriation flows during the crisis period were dominated by portfolio flows that were in part driven by rebalancing as fund managers responded to the valuation effects of the exchange rate depreciation. Given the appreciation of the Australian dollar since March, it is likely that portfolio rebalancing owing to exchange rate valuation effects again contributed to the modest pick-up in Australians' portfolio investment abroad in the June quarter. Overall, however, Australian portfolio managers appear to have retained a relatively cautious approach to foreign investments to date, perhaps seeing the recent spate of local capital raisings, as listed firms reduce leverage, as a good opportunity to increase domestic allocations.

One consequence of the decline in foreign portfolio equity investment by Australians, and the pick-up in foreign portfolio equity investment in Australia, is that the composition of net capital inflows has shifted towards sizeable equity inflows. In the decade prior to the crisis there was net equity outflow (Graph 5).



Another consequence of the crisis for the composition of Australia's capital flows has been the increase in foreign investment in public debt, as State and Federal government budgets have moved into deficit (Graph 6). Federal government debt increased by $33 billion in net terms over the first half of 2009, and around $5 billion of this was recorded as being purchased by foreign investors. However, partly offsetting this is the ongoing investment in foreign equity assets by the public sector, mainly through the Future Fund, which amounted to $2 billion over the first half of 2009.



Summary

After a period of disruption to capital flows stemming from the financial crisis, the pattern of Australia's capital flows is returning to its pre-crisis configuration. Following a reduction in cross-border portfolio and banking sector capital flows during the crisis, private sector flows into and out of Australia have largely rebounded, with net foreign capital inflows into the banking sector picking up. Conditions have improved sufficiently for the demand for the US dollar swap facility offered by the Reserve Bank to decline to zero. Nevertheless, there remain some compositional differences relative to the pre-crisis situation; notably, Australian investors are yet to return to investing in foreign equities and portfolio debt at the rate observed prior to the crisis. ✠