RESERVE BANK OF AUSTRALIA

Speech

Australia's External Position and the Evolution of the FX Markets

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Introduction

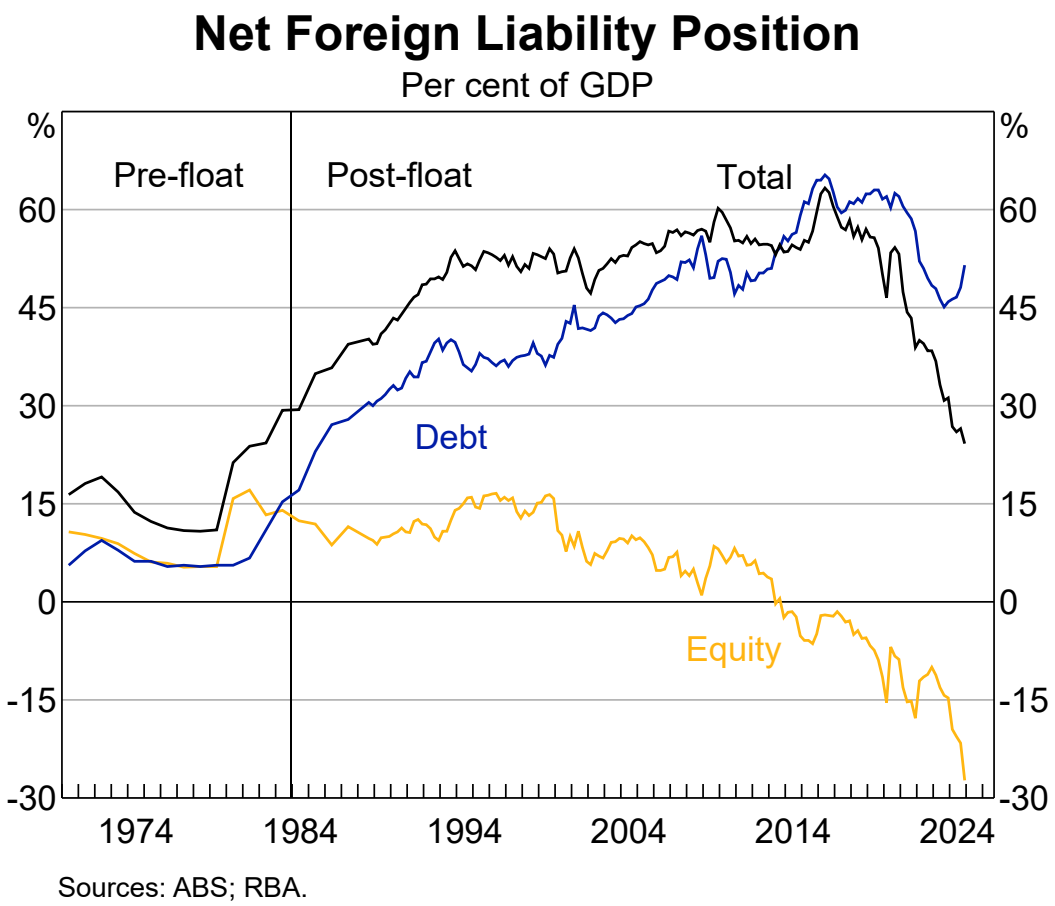
I would like to thank Bloomberg for hosting this event. Today I will discuss Australia's evolving external position and the development of foreign exchange (FX) markets.[1] I will emphasise the growing footprint of superannuation funds in Australia's capital flows and the importance of these and other 'buy-side' firms of adopting best practices in FX markets.[2]

Australia's capital account and FX markets since the float

The removal of capital account restrictions and the floating of the Australian dollar in 1983 reshaped our economy. Free capital movement facilitated large increases in foreign investment in Australia and allowed Australian households and firms to diversify their portfolios by investing overseas. Deep, well-functioning FX markets that developed following the float helped banks, businesses and fund managers to manage their foreign exposures.

Australia's integration into global capital markets saw two distinct trends in our net investment position with the rest of the world (Graph 1). First, in the decades after the float, Australia's high investment rate was associated with rising foreign debt. This saw net foreign liabilities rise substantially to around 50 per cent of GDP. Second, over more recent years, outbound investment has grown as a share of GDP as Australia's saving rate rose and domestic investment declined. This accumulation of foreign assets has contributed to an extraordinary decline in Australia's net foreign liabilities to levels last seen prior to 1983.

Graph 1



Sources: ABS; RBA.

The rise in external debt and the internationalisation of FX markets in the 1980s

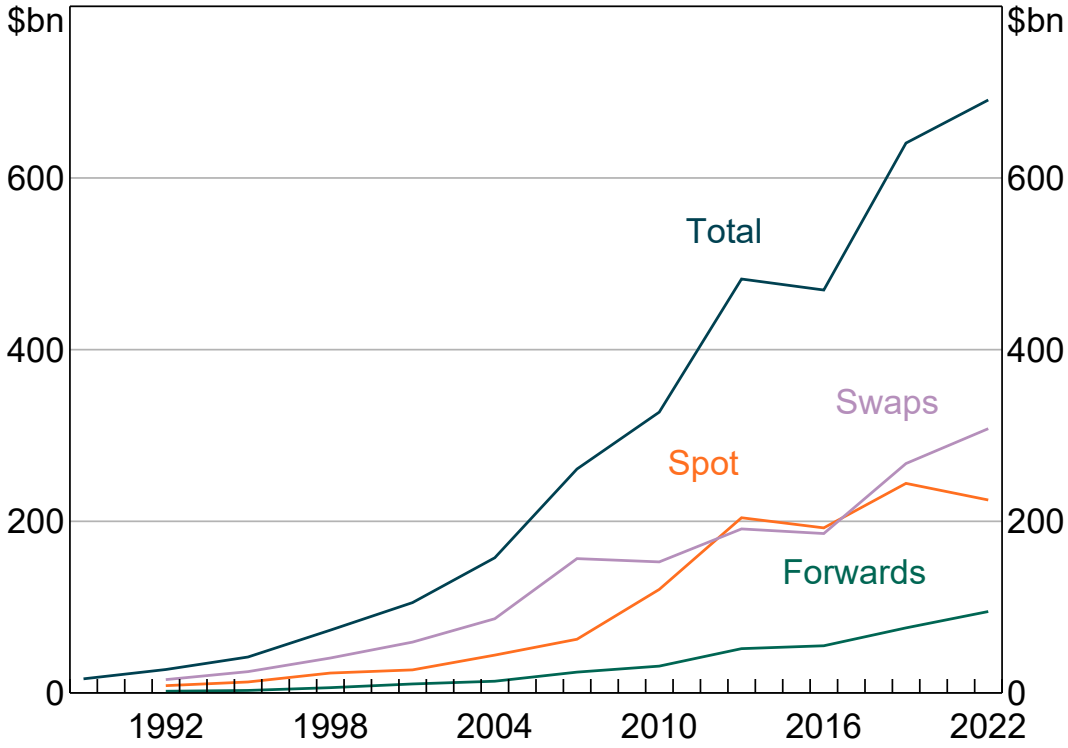
While foreign ownership of Australian assets was already common in some sectors, the full opening of the capital account allowed for much more foreign investment in Australia. The growth in debt held by overseas creditors was particularly noticeable in domestic banking and resource sectors.[3]

The increase in cross-border investment was accompanied by a rise in FX transactions. Prior to the float, spot transactions by local commercial banks dominated FX transactions.[4] While the Australian dollar spot market grew strongly, the 1980s also saw the establishment of FX swap markets. These instruments, which allowed market participants to better hedge their foreign currency exposures, quickly became the most traded in Australian dollar markets (Graph 2). The deepening of FX markets locally was also supported by the Australian Government's steps to broaden foreign banks' participation in Australia's markets.[5]

Graph 2

Foreign Exchange Turnover by Instrument

Global average daily turnover – AUD transactions*



* Net-net basis. Global turnover as in BIS Triennial Survey; measured in Australian dollars.

Sources: BIS; RBA.

The growth of currency markets enabled non-financial corporations to make use of hedges in support of their trade flows and foreign-currency borrowing.[6] This hedging was in part a response to post-float currency volatility and high-profile losses by unhedged borrowers.[7] Over the 1980s, both the share of firms hedging and the average share of currency exposures hedged increased significantly.

By the mid-1990s, the internationalisation of the Australian dollar and its capital markets was well advanced. Trading in Australian dollar FX derivatives had risen to $75 billion per day, with about 60 per cent undertaken offshore.[8] Also, foreign entities were issuing debt in Australian dollars in the 'Kangaroo bond market'.[9] This issuance grew steadily over the 2000s, supported by cross-currency basis swaps, another FX derivative but with longer tenors that enabled better hedging of long-lived foreign currency borrowings.[10]

Rising demand for Australian dollar assets from international investors enabled Australian businesses to issue debt in Australian dollars.[11] At the same time, Australian banks and businesses issuing in large offshore markets could hedge their foreign currency-denominated debt back into Australian dollars at a

modest cost. Both developments greatly reduced the vulnerability of Australian debtors to Australian dollar depreciation.

The growth in Australian dollar FX markets since the float has been remarkable: it is the sixth most traded currency, even though Australia ranks 13th in economic size.[12] This demonstrates the importance to Australia of FX markets in support of foreign trade and investment. But it also reflects the attractive correlations of the Australian economy (and hence the Australian dollar) with economic developments in Asia, coupled with strong institutional settings in Australia, including the free movement of capital.

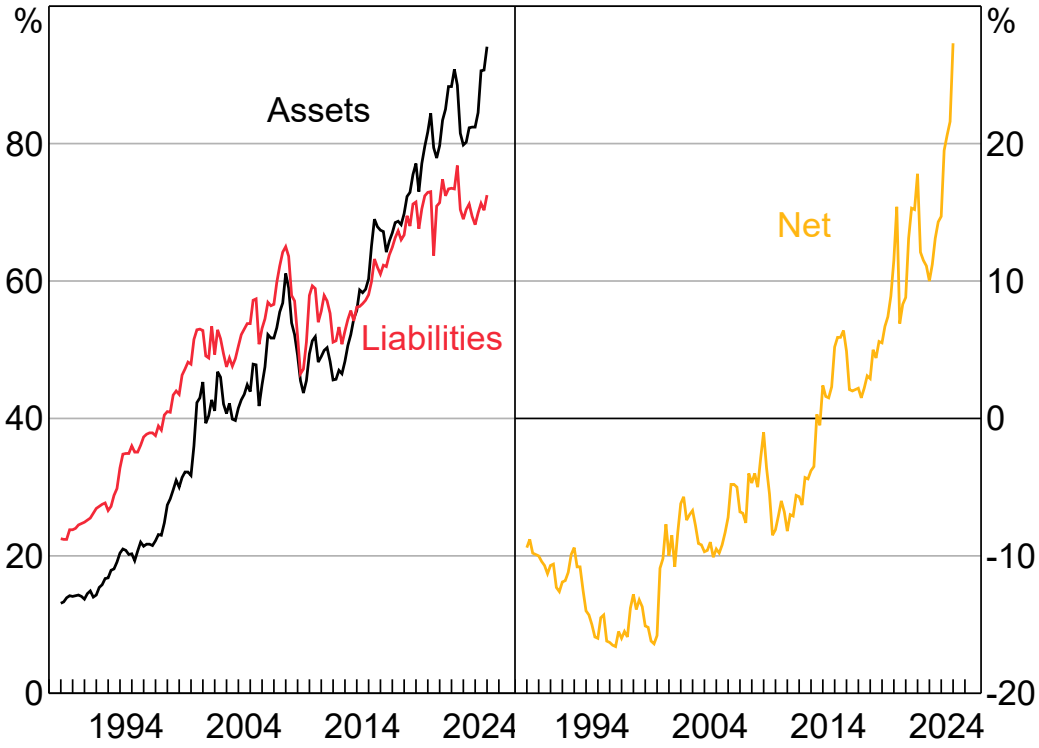
The increasing role of superannuation funds in Australia's FX markets

Another key facet of Australia's external position has been the substantial growth of the net foreign equity position. Australians have steadily accumulated more foreign equity holdings than foreigners have accumulated in Australian equity. Indeed, since 2013 we have had a positive net equity asset position (Graph 3).

Graph 3

Foreign Equity Position

Per cent of GDP



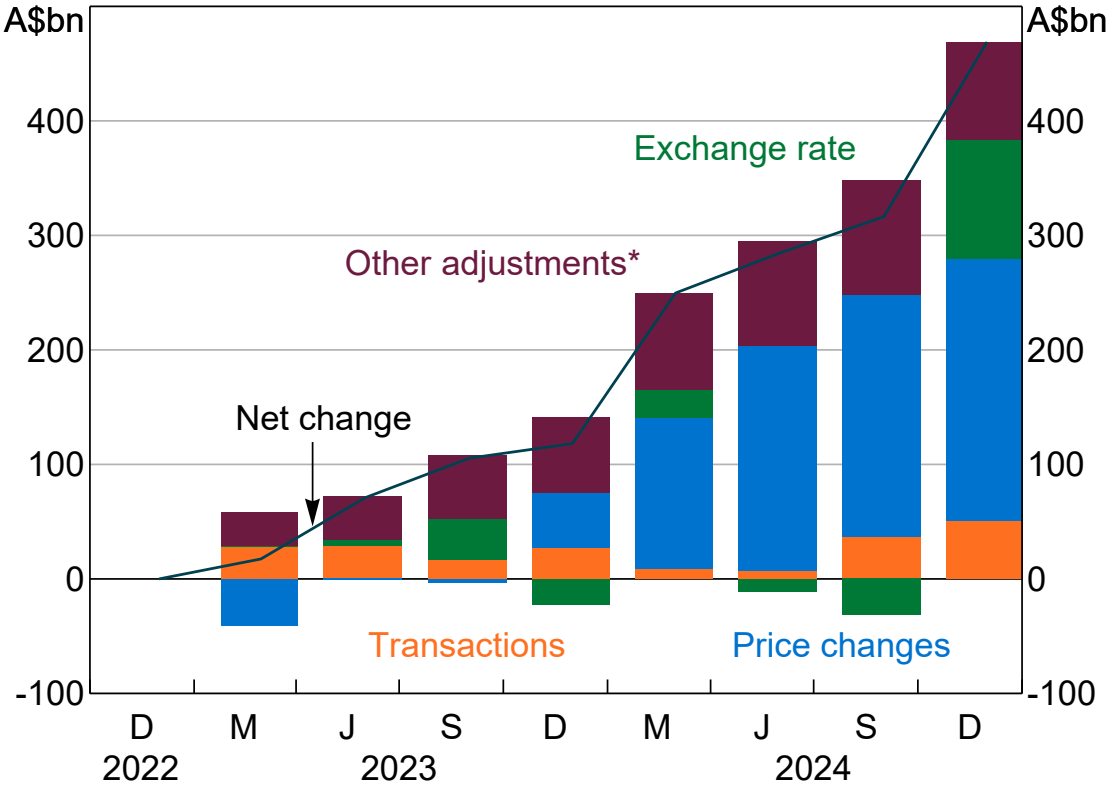
Sources: ABS; RBA.

The rise in net equity assets of late has occurred while Australia has been running a current account deficit, creating an unusual situation. Inflows of new liabilities rose with the banks returning to offshore debt markets as the RBA's Term Funding Facility came to an end. However, a further rise in foreign equity holdings offset this, so net liabilities still declined. Much of the rise in net foreign equities reflects valuation effects from the Australian dollar's depreciation and rising overseas equity values (Graph 4).[13] Even so, new equity accumulation continues, driven by investment from Australia's superannuation funds.

Graph 4

Net Foreign Equity Asset Position

Cumulative change



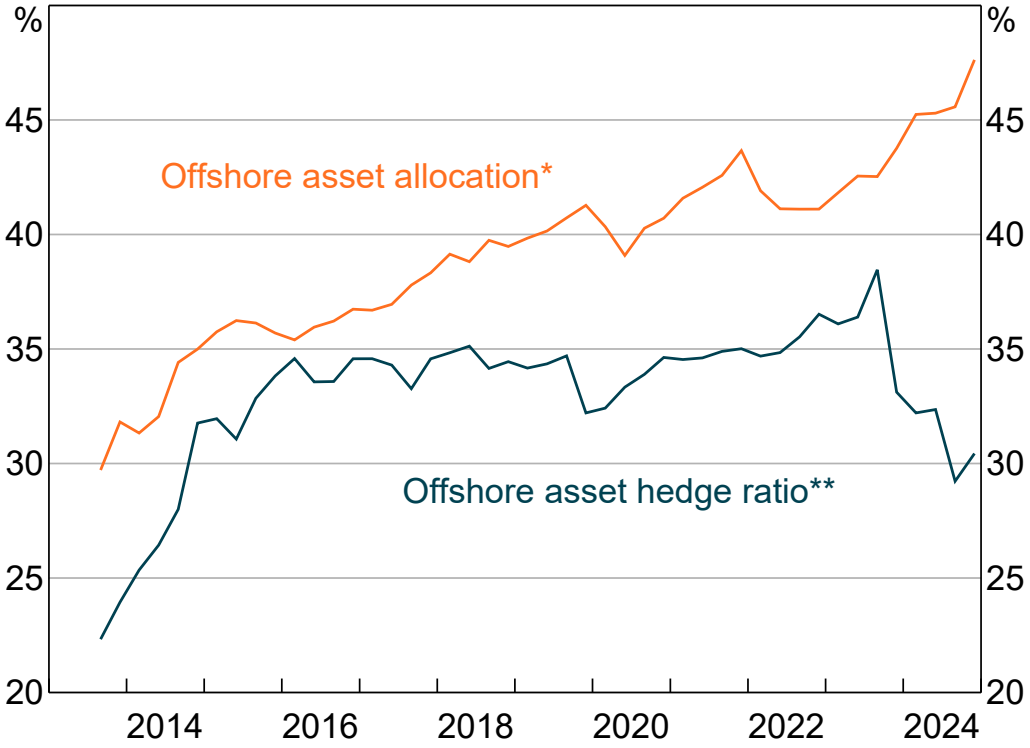
* Other adjustments include those due to the write-off of debt, reclassifications, and changes in financial assets and liabilities due to migration.

Sources: ABS; RBA.

The growth of superannuation funds since 1993 and their rising offshore investments have significantly shaped Australia's balance of payments. Super funds' offshore asset allocation has increased from nearly one-third in 2013 to about half in 2024 (Graph 5). As a result, super funds now account for a substantial share of Australia's capital outflows.

Graph 5

Superannuation Funds' Offshore Assets



* Per cent of all assets.

** Per cent of all offshore assets.

Sources: APRA; RBA.

Purchases of foreign currency assets by superannuation funds expose them to exchange rate fluctuations. Many funds shield their members by partially hedging the foreign exchange rate risk associated with offshore assets via, for example, FX swaps. Given the large increase in super funds' offshore assets, the extent of foreign currency assets hedged has more than quadrupled since 2013.[14] This has made the super funds natural counterparties to domestic banks, which are hedging their FX exposures arising from issuing debt offshore in foreign currency terms.

The Foreign Exchange Global Code

This discussion highlights the increasing role of superannuation funds and their asset managers in FX markets. For FX markets to meet participants' needs, it is important that they all observe common standards promoting fair and transparent markets. The Foreign Exchange Global Code (Code) fulfills that function.

With the advent of the Code in 2017, buy-side participants like super funds can have greater confidence in market functioning and the behaviour of their sell-side counterparties. But this is a two-way street: both sell-side and buy-side firms should adhere to the Code's standards. Moreover, one way for fund managers to demonstrate that they are meeting their fiduciary duties is to adhere to the Code. Encouraging more buy-side participants to sign up is a focus of the Global Foreign Exchange Committee (GFXC).

To this end, the GFXC has worked hard to explain the process of signing up to the Code. We have emphasised that adoptees can concentrate on those aspects of the Code that are material to their activities, thereby greatly reducing the burden for buy-side firms.

I will end by acknowledging the sharp rise in volatility in FX markets in early April as markets incorporated announcements about the US administration's tariffs and the subsequent ebb and flow of related news. The Australian dollar fluctuated within a range of US4 cents, experiencing its largest daily decline of 4.5 per cent against the US dollar outside of the global financial crisis. Also, measures of volatility from FX options increased to levels observed during the pandemic and liquidity deteriorated noticeably. While markets have been more settled of late, such episodes serve as a reminder of the importance of the Code. It enhances trust between market participants and offers standardised and predictable ways of doing business. Hence, the role the Code plays in proper market functioning is even more crucial during periods of great uncertainty when markets are adjusting to significant economic news.

Endnotes

[*] I thank George Tyler, Jason Griffin and Marcus Miller for their great assistance in helping me to prepare this speech.

[1] This work builds on previous RBA work including Smith P (2023), 'The Extraordinary Decline in Australia's Net Foreign Liabilities', Speech at the CFA Societies 2023 Australian Investment Conference, Sydney, 18 October; Debelle G (2019), 'A Balance of Payments', Address to the Economic Society of Australia, Canberra, 27 August.

[2] 'Buy-side' institutions purchase currency to invest in international assets; they include hedge funds, insurance firms, pension funds, and other asset managers. 'Sell-side' institutions – typically banks and currency brokers – trade currency with buy-side firms and provide liquidity in FX markets.

[3] Tease W (1990), 'The Balance of Payments', in *The Australian Macro-economy in the 1980s*, RBA Annual Conference, 20–21 June; Black S, J Kirkwood, A Rai and T Williams (2012), 'A History of Australian Corporate Bonds', RBA Research

Discussion Paper No 2012-09.

[4] Though a small market for non-deliverable forwards did exist prior to the float: Caballero RJ, K Cowan and J Kearns (2004), 'Fear of Sudden Stops: Lessons from Australia and Chile', RBA Research Discussion Paper No 2004-03.

[5] Fraser B (1994), 'Foreign Banks in Australia', Talk to the Overseas Banks' Association of Australia, Melbourne, 17 August; Debelle G (2006), 'The Australian Foreign Exchange Market', Speech at Insto's Foreign Exchange Conference, Sydney, 17 November.

[6] Debelle, n 5.

[7] Becker C and D Fabbro (2006), 'Limiting Foreign Exchange Exposure through Hedging: The Australian Experience', RBA Research Discussion Paper No 2006-09; James E and C Vallence (2020), 'The Road to Australian Dollar Funding', RBA *Bulletin*, March. In this episode, numerous borrowers incurred significant losses on unhedged liabilities denominated in Swiss francs, which encouraged a more sophisticated approach to foreign financing thereafter.

[8] This rose further over time and was around 85 per cent in 2013. See Bank for International Settlements (1998), 'Triennial Central Bank Survey of Foreign Exchange and Derivatives Market Activity', May.

[9] Debelle G (2008), 'Recent Developments in the Australian Bond Market', Address to the Westpac/KangaNews Speed-meeting Summit: Kangaroos & Kauris, Sydney, 5 March.

[10] Ryan C (2007), 'Some General Observations on the Kangaroo Bond Market', Address to the Kangaroos: Positioned for Growth Conference, Sydney, 29 March.

[11] Black *et al*, n 3.

[12] Bank for International Settlements (2022), 'Triennial Central Bank Survey: OTC Foreign Exchange Turnover in April 2022', 27 October. For GDP (current prices) data in 2022, see the International Monetary Fund World Economic Outlook Database.

[13] This is in fact not a new phenomenon for equities: since 2013, valuation changes have been the driver of declines in the net foreign equity position, rather than new transactions. This reflects the comparatively greater returns generated by US equities, the long-run depreciation of the Australian dollar, and the offsetting effect of foreign direct investment in Australian equities.

[14] Over recent years, the hedge ratio of offshore assets has declined sharply. While motivations and strategy vary by firm, there are likely to be several contributing factors to this decline, including economising on carry costs associated with hedging transactions and the use of a lower currency hedge ratio as a tail-risk hedge against declines in US equities.

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