# financial(s) MATTER

## the Who, How & Why of Australian financial flows

1 June 2022

*The BOP/IIP release provides a breakdown of the key types of cross-border investment undertaken each quarter (the financial account); Australia's consequent stock of net international financial assets and liabilities (Australia's IIP); and associated income flows (the net primary income deficit, part of the current account). All figures are in Australian dollars.*

The financial account is reported on an unadjusted basis, so a measure of volatility is certain every quarter. Q2 2020's reading however was unparalleled as the pandemic sent shock waves through the world's financial accounts. Thankfully, flows settled down quickly and have been relatively well behaved since.

Over the 12 months to March 2022, direct investment in Australia rebounded strongly, the gross inflow from foreign investors over the period being six times that seen in the same period a year earlier (an inflow of $116bn versus $19bn to March 2021). The inflow over the 12 months to March 2022 was also almost twice the average of the five years prior to the pandemic (to December 2019), indicating that the pandemic has not diminished foreign investors' appetite for Australian assets.

Uncharacteristically, Australian businesses foreign direct investment abroad was stronger still over the 12 months to March resulting in a net capital outflow of $18bn. This outflow from Australian firms is atypical and likely to normalise, seeing a resumption of net direct inflows to Australia's economy.

Portfolio flows are typically much more volatile than direct flows, being the result of individual, in-the-moment investment decisions in liquid assets such as equities and bonds. Looking at the portfolio investment gross flow detail for the 27 months to March 2022, having pulled $44bn and $9bn from Australia in Q1 and Q2 2020 respectively, foreigners invested $117bn during Q3 and Q4. After a small outflow in the first half of 2021, inflows returned at pace in the second half, circa $81bn, and were strong again in Q1 2022, $65bn.

Australian investors' reset during the second half of 2020 was even more aggressive, the $118bn outflow almost four times the repatriation flows of Q1/Q2 2020. In 2021, Australian investors continued to invest abroad at pace, at more than twice the annual average of the five years to end-2019. The outflow slowed in Q1 2022 amid uncertainty, but was still strong at $28bn.

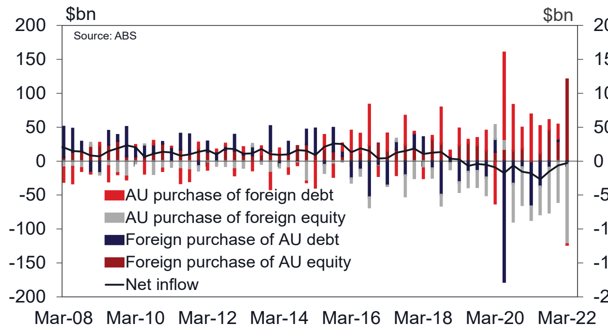
**The financial sector.** Market uncertainty usually temporarily restricts new debt issuance by financials. But, from July 2020, Australia's outstanding financial sector debt continued to decline despite strong risk appetite and ample liquidity.

The RBA's bond data suggests financials' outstanding stock of foreign-issued debt fell consistently over the year to Q1 2021 by $16bn per quarter, then a further $8bn in the six months to September 2021. Only in Q4 2021 was there a partial reversal, a $5bn increase, followed by another $9bn in Q1 2022.

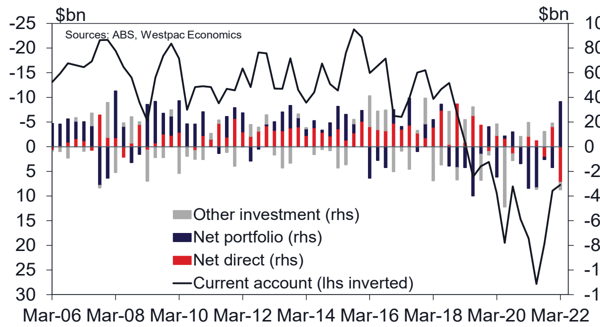
These outcomes are the result of the combined effect of: weak credit demand before and during the early stages of the pandemic; strong growth in deposits on precautionary savings and fiscal support; as well as the availability of funding through the RBA's Term Funding Facility. Now though, 2020/21's dramatic reversal in housing credit growth and the closing of the TFF has changed the funding equation for Australian banks. This change will become more pronounced as the household savings rate falls, particularly if savings accumulated during 2020 are also spent.

**Non-financial corporates and public sector.** As above, direct investment into Australia slowed through 2020 as a result of the pandemic. Despite multi-month lockdowns through mid-2021 however, direct investment in Australia picked up, from an average of $4bn per quarter over the year to June 2021 to an average of $16bn in Q3 and Q4 then $82bn in Q1 2022.

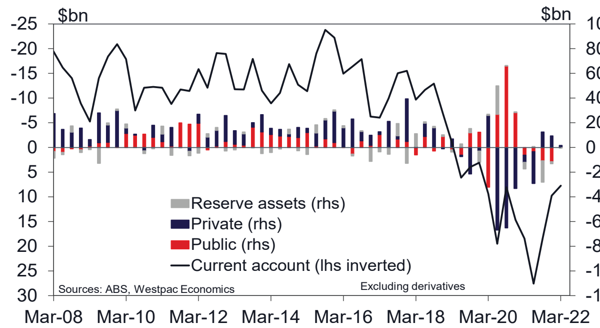
### Australian external financing gross flows



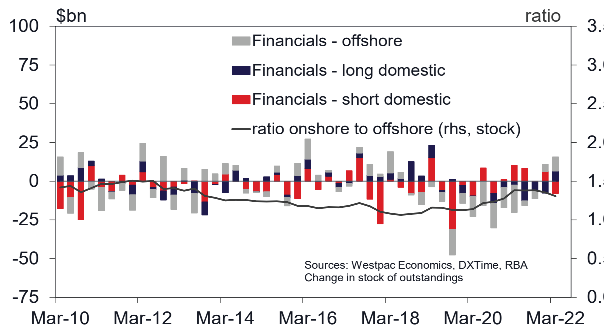

### External financing: direct, portfolio and other




### Private and public external borrowing




### Australian financial sector fund raising



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Now out of lockdown, and with our vaccination drive having proved successful, as the global recovery gains greater breadth, strength in direct investment is likely to persist. The current pipeline and return profile of mining investment as well as Asia's structural development also warrant such an expectation.

During 2021, gross direct equity investment in Australia was robust at 73% of the average of the five years to December 2019, but this inflow was entirely due to re-invested earnings. Come Q1 2022 however, 73% of direct inflows were into new investment.

Australian firms also look committed to expanding offshore at the start of 2022, with the direct investment outflow of Q1 2022 unparalleled in size and with 87% targeting new investment.

Note the size of both Q1 gross flows is highly unusual and could simply be a consequence of one-off corporate actions. Time will make clear the trend.

Gross portfolio investment outflows from Australian investors meanwhile remain focused on recovery and growth, with 90% of the past year's outflows invested in equities. However, it should be noted that in Q1 2022, equity's share was only 61%, with higher term interest rates and uncertainty related to Russia's invasion of Ukraine rebalancing new flows towards debt.

Q2 is likely to show further risk aversion. But, if time sees tensions subside and global momentum sustained, long-term growth opportunities are likely to be pursued once again. Australia's savings pools, particularly super, are well suited to taking up such opportunities.

Foreigners' portfolio investment in Australia remains more skewed to debt, with a near 50%/50% split reported for 2021. Note though, this is up from a 80%/20% debt/ equity split over the year to Q2 2021.

In the long-run, Australians committing a higher proportion of funds to equity investment offshore than foreigners do here is a positive for our nation, improving net returns and building national wealth.

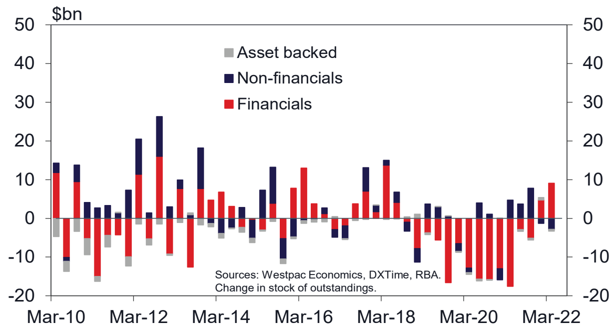
**The international investment position (IIP).** Australia's international investment position has improved materially over the past year, from a net liability position of 47% of GDP to 37%, continuing the downtrend from mid-2016's 61% peak.

Our stock of debt liabilities has decreased by around 12ppts of GDP since the 2016 peak, explaining about half the total improvement. The remainder stems from the dramatic increase in our net equity assets, from 2% of GDP to 14%, chiefly as a result of continued strong growth in super balances and more of these funds being invested offshore.

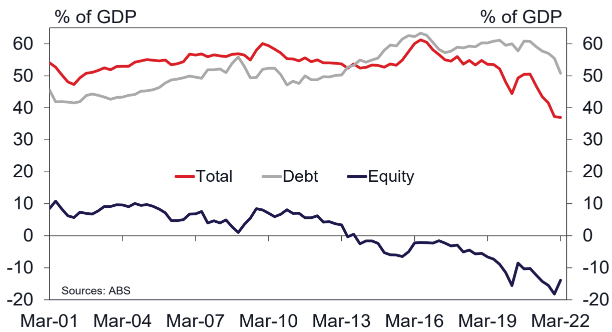
This significant shift in our financial assets and liabilities has, combined with low interest rates globally, materially reduced our net primary income deficit (NID). While the NID jumped over the 12 months to March 2022 by 2.5ppts to 3.5% owing to an outsized increase in dividend payments to foreign investors in Australian equities, the NID still remains materially below Q2 2007's 4.5% peak. Now versus then, the cost of our debt liabilities is just 0.7% compared to 2.4%.

Regarding equity flows, it must be recognised that, relative to the rest of the world, a greater proportion of the total investor return from Australian equities is income versus capital gain. This structural trait widens Australia's NID. For Australia's offshore investments, capital gains will instead compound through time and become available when the assets are sold.

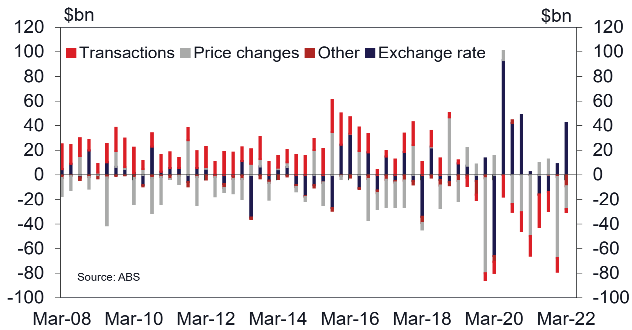
## Private offshore issuance: Australia



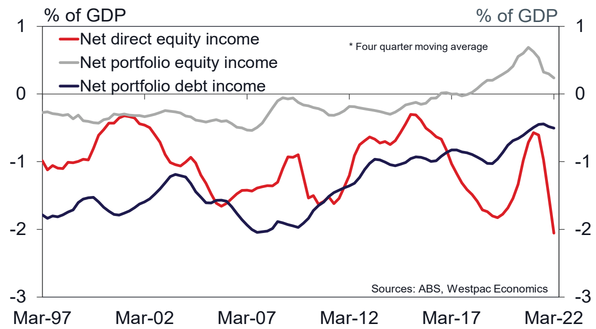

## Australia's net stock of liabilities




## Quarterly change in net stock of liabilities




## NID remains materially below peak level

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