I J Macfarlane: What is the biggest risk to financial and economic stability?

Introduction by Mr I J Macfarlane, Governor of the Reserve Bank of Australia, to the Panel Discussion on Financial Stability - Consilium, Coolum, 9 August 2003.

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From the perspective of a developed OECD (Organisation for Economic Co-operation and Development) economy, what is the biggest risk to financial and economic stability? I suspect that at various stages over the past few decades, we would have come up with different answers. For much of the period, we would point to our apparent inability to control inflation, or to oil price shocks, or to governments' inability to control their finances. At other times, people would point to more purely financial vulnerabilities, such as fragile under-capitalised banking systems, excessive short-term international capital movements, poor prudential regulation or inadequate systems of governance. Others would point to the tendency of governments, central banks or the IMF (International Monetary Fund) to bail out failed systems and so create a moral hazard, as the main risk to future stability. You can make a good case for most of the candidates I have put forward.

However, I think there is one other risk that we have become aware of that now seems to be larger than those I have listed above. I refer to asset price booms and busts. While the existence of these was recognised, they were usually regarded as historical curiosities, or at least very low frequency events (e.g. once or twice a century). The US experience in 1929 and its aftermath was the classic case until recently. But now that we have seen the world's second largest economy - Japan - experience one in the 1980s, and the world's largest one - the United States - experience one in the 1990s, they seem to be not quite so 'low frequency'. We should also not forget that many other economies, including our own, experienced an asset price boom and bust in the late 1980s and early 1990s. Although they were not of the size of the Japanese one, or of the international significance of the US one, they were very costly to their respective economies.

What can be done about this tendency of otherwise well-managed economies to exhibit periodical asset price booms and busts? One response would be to give the task to monetary policy, so you will probably expect me to expound on this subject. Unfortunately, I must disappoint you because the subject is too complex to cover in the short time I have available, and besides, we at the Reserve Bank are hosting a conference on the subject in about a week's time.

Instead, I want to follow a different path and ask are there factors that contribute to asset price booms, that can be identified and eliminated or, at least, reduced? I have in mind various incentives, informational deficiencies and dubious practices which occur during the boom, but which we always seem to discover well after the bust has occurred. We realise then that these practices allowed distorted views of the profitability of businesses and investment strategies to remain in place long after they should have been corrected.

Each boom is different and the lessons we learn after the bust has occurred are also different. For example, after the asset price booms of the late 1980s collapsed, we learned that a lot of the problem was due to very poor banking practices - connected lending, concentrated risks, weak credit committees, forbearance whereby new loans were made to service existing debt, etc. In response to this, there have been enormous improvements in banks' risk management, accounting practices and bank supervision. Partly as a result, or partly due to good luck, banks do not figure prominently in the wash-up of the latest boom - the US equity boom. Instead, we discovered a new set of dubious or unsavoury practices.

- First, were features of the system that gave a very strong *incentive* for the major players to push up asset prices. The use of equity-based remuneration, particularly options, gave management a huge incentive to concentrate on short-term increases in share prices, particularly as they knew that the investment community demanded it.
- Second, there were many *means* available to make profits look larger than they really were. The non-expensing of options being the most obvious, but others would include the use of special purpose vehicles and other off-balance sheet entities, the non-recognition of deficiencies in company-sponsored defined-benefit pension funds and the bringing forward of revenue recognition. In this country, we saw some very creative things being done with financial re-insurance, which basically had the aim of inflating recorded profits.

- Thirdly, there was a failure of the *counterweights* in the system to limit the excesses. In particular, the conflicts of interest in the auditing profession and the lack of independence or forcefulness of boards of directors meant that excesses were not detected. Another counterweight is supposed to be the independence and scepticism of security analysts, but this was clearly compromised by the fact that the most prominent of them were working for investment banks which were sellers of securities and so had a strong incentive to look favourably on rising share prices.

One could construct a long list of abuses, and a correspondingly long list of needed reforms. In various countries this is being done by governments and their agencies - particularly the conduct-of-business regulators such as ASIC (Australian Securities and Investments Commission) in Australia or the SEC (Securities and Exchange Commission) in the United States. Internationally, a lot of this is being co-ordinated by the Financial Stability Forum. Usually it is being pursued in the interests of investor protection and of ensuring the integrity of markets. But from my perspective, I see these reforms as serving the equally important macro-economic purpose of reducing the tendency for asset price booms to occur, or shortening somewhat their duration. I would not be so confident as to suggest that the reforms, no matter how well designed, would be able to prevent such booms, but any reduction in their extent will reduce the severity of the subsequent bust.

I will conclude by making a comment about what we mean by a systemic financial crisis. Usually, it means a series of bank failures, bank runs, and the government or central bank having to recapitalise the banking system. Because of the improvement in banks' risk management and bank supervision, we have not even been close to systemic financial failure in any major country on this occasion. For this we should be thankful. But what we are getting instead are failures in the non-finance sector, Enron, WorldCom, etc., and more particularly a severe tightening of belts in the corporate sector with consequent contractionary effects on investment and employment. So the thing that is different this time is that the boom has not been followed by a financial crisis, but by an economic contraction as the most severely stretched parts of the economy seek to restore their balance sheets.