Guy Debelle: Funding Australia's future

Remarks by Mr Guy Debelle, Assistant Governor (Financial Markets) of the Reserve Bank of Australia, at the Launch of Funding Australia's Future, The Australia Centre for Financial Studies, Sydney, 10 July 2013.

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Thanks to Chris Stewart for his help with these remarks.

The Australian Centre for Financial Studies has put together a very interesting and timely body of work on an important topic.[1] It is a good example of a collaborative effort that encompasses academic research with a very applied focus.

The financial sector plays a unique role in the functioning of the economy. It acts as the intermediary between the myriad saving and spending decisions of households, businesses and government, both domestic and foreign. In doing so, it is unlike other parts of the economy. As I've said before, the financial sector is not at the end of a production chain producing something which directly generates utility for society.[2] Rather, it is a critical link along the way, the oil that keeps the economy ticking over. When the oil dries up, the economic engine starts to malfunction and can ultimately grind to a halt.

So in that sense, the set of papers that we have here tonight gets right to the heart of the issue of how well that oil is working and whether there's any risk of it drying up in the future.

There's clearly been a lot going on in the global financial sector over the past few years. At various times, some channels of financial intermediation *have* actually seized up, much more so offshore than onshore. So the question at the heart of these set of papers is well worth posing. It is also very timely as the financial sector is still undergoing considerable change as it adjusts to the lessons learned from the turmoil of recent years and the regulatory changes that have come along with that.

Today, I will try to give a quick overview of the work that has been done as part of this project, and talk a bit about where to from here. But the main point I would like to get across is that you should take the time to read each of these three papers. They each provide plenty of food for thought.

Before getting to the papers individually, I'll step back and talk about the project as a whole. The aims of the Funding Australia's Future project are to:

- assess the future demand for and supply of finance in Australia;
- consider the interaction between different participants in the financial system;
- identify the potential challenges facing the system; and
- outline institutional or regulatory changes that might improve the operation of the system.

That's a fairly hefty agenda, as you can see.

In looking at the papers, where I think they are the most useful is in providing a clear, well-articulated framework to think about these issues. Such a framework has often been lacking in the debate that has gone on at various times over the past few years.

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1 <http://www.fundingaustraliasfuture.com>

2 See Debelle G (2012), "Credo et Fido: Credit and Trust", Deakin University's 2012 Richard Searby Oration, Melbourne, 25 September.

Take one current example, which is on the G20 agenda, namely the "lack of infrastructure funding". To answer this question appropriately, we need to know whether it is a problem for financing different stages of a project, what type of risk is holding any financing back, what type of institutions and instruments might help any shortfall, etc. But there needs to be a coherent framework in mind to be able to do this, and to know what are the right questions to be posing.

The papers commissioned for Stage 1 of the project are designed to set the scene. I will give a brief summary of each of the main points I take away from the three papers.

Kevin Davis' paper, "Funding Australia's Future: From Where Do We Begin?" provides an insightful overview on a number of topics. Let me give a brief disclaimer here. Kevin was my first macroeconomics lecturer at university back in the day, so I am very much in his debt for all he taught me about macro and monetary economics.

- The first main point in Kevin's paper is the identification of the ways in which the Australian financial system differs to other developed economies.
- Second, it discusses the main consequences of the financial crisis for financial flows in Australia as well as some of the more fundamental forces influencing the longer-term evolution of the sector.
- Lastly, it identifies some of the implications of these influences. For example, it links changes in the competitive advantage of banks in raising deposits to changes in the nature of the loan origination process, the length of the financial intermediation "chain", and the overall cost of intermediation.

Daniel Mulino's paper, "Improving Australia's Financial Infrastructure", provides a comprehensive overview of what the Australian financial system does well and summarises current and prospective issues.

- While Daniel notes that the sector performs well in supporting the economy, he argues there are a number of issues that are worth further exploration. In doing so, he highlights, for instance, the potential improvements to the payments system; the financing of greenfield infrastructure and high-risk innovation projects; and the arrangements around post-retirement savings products and the regulation around SMSFs.
- Dr Mulino notes that in some areas, such as the payments system, there is already work underway by agencies including the RBA. In other areas, such as infrastructure funding, he notes that Australia is not alone in dealing with some of these challenges.

Rodney Maddock and Peter Munckton's paper, "The Future Demand and Supply of Finance", considers the longer-term availability of funding for Australia's economic growth, the composition of these funding flows, and the role of regulation in their determination.

- As such, it sits between the other two papers in that it provides a longer-run analysis of the flow of funds in the economy – such as the domestic savings rate back to the 1870s – as well as a broader overview of the role of regulation on these flows. It also places a much greater emphasis on the flows within the system rather than the balance sheet structures.
- Overall, it concludes that the demand for and supply of finance should align over coming years, although there are a number of factors that might alter this balance and hence the cost of intermediation.

This last point is a particularly important one. The experience over the past few years in Australia shows that even in the most stressed of circumstances, the financial sector can often adapt and re-equilibrate to quite dramatic changes in circumstances. This might involve sizeable changes in prices, but it is important to look at things from a general equilibrium perspective, rather than analysing things in a partial manner. The financial system is very much a system, with a high degree of interconnectedness.

A number of other general lessons can also be gathered from the papers.

1. As noted by Kevin Davis, the financial sector influences the amount of aggregate risk-taking in the economy, it affects how that risk is distributed, and in doing so can either amplify or moderate the effects of shocks to the system.

2. The structure and activities of the financial sector are the outcome of numerous forces over long periods of time.

3. Looking at aggregate information, or one aspect in isolation, can often be misleading. This is true when we are looking at the capital flows into and out of Australia. The net flows, which are often the focus of analysis, conceal a lot of important information that is only evident if you look at the gross flows.[3] Another example is thinking about the financing of the corporate sector, where the preference for debt versus equity funding varies considerably depending on the nature and size of the business. Just looking at bond and equity financing in aggregate again conceals much of the interesting information.

4. Stocks matter at least as much as flows. Just as a disproportionate amount of analysis is partial rather than general, stocks are very often neglected in favour of flows, as on the price side, are levels rather than rates of change.

5. The financial system is always evolving – in both cyclical and structural senses.

    – In terms of cyclical aspects, financial institutions currently have a better appreciation of liquidity risk than they did six years ago. But if history is any guide, at some point in the future, that appreciation is likely to wane; for example, the lessons from the runs on some deposit-taking institutions and trusts in the early 1990s or the concerns about liquidity in Sydney's early days as a colony (there aren't too many around in the financial sector today who remember that).

    – The financial system is also continuously evolving in a structural sense. There are a large array of financial products that simply didn't exist two decades ago. In some cases, their arrival has not always been a good thing. In other cases, such as that of asset-backed securities, or going back a bit further, junk bonds, a new product arrived, the market grew too fast too quickly resulting in considerable dislocation, before settling down to be an important, but much smaller part of the financial landscape.

6. The factors driving evolution are sometimes very similar over the decades, while some factors fade in importance and new drivers emerge.

    – The increasing size of superannuation funds has played an important role in influencing the shape of the financial sector in Australia for the past couple of decades, and given its current size, is likely to continue to do so for the foreseeable future.

    – Likewise, government financing arrangements, banking regulations and banks' liquid asset holdings continue to be strongly related.

    – In contrast, unlike the 1990s, we no longer talk about how life insurance offices' mortgage lending activities might return to their 1950s and 1960s levels of importance.

[3] See, for example, Debelle G (2013), "Funding the Resources Investment Boom", Address to the Melbourne Institute Public Economic Forum, Canberra, 16 April.

7. More generally, how the system evolves to these forces is impossible to fully comprehend ahead of time.

   – Twenty years ago, for example, it would have been very hard to see exactly how the competitive dynamics would play out in the banking sector. In the housing loan market, discounts became increasingly common (and larger) while in the credit card market banks initially competed through loyalty programs rather than through lower interest rates.

   – Furthermore, there was a view in the mid 1990s that a rapid expansion in the debt market could be driven by the growth of superannuation funds, but it was unclear whether any disintermediation would be most pronounced in the corporate bond or mortgage markets.

   – Likewise, while people understood that new distribution methods in the banking sector were likely to evolve, few people would have appreciated the move from ATMs and telephone banking to internet banking and banking on our mobile phones.

   – This reflects the fact that technology progresses in ways that we can't imagine.

   – Differences in incentives and the starting position of market participants matter a lot in terms of behaviours and subsequent developments.

   – Society's attitudes towards efficiency and risk evolve and are very much shaped by the course of history. Someone born in the Depression had a different attitude to risk than a baby boomer who in turn probably has a different attitude to risk than someone gaining financial literacy in the current environment.

8. A key consequence of this last point is that the industry and regulators have to ensure that institutions are resilient to short-run shocks but are able to adjust to longer-run secular trends with adequate consideration for both competition and financial system stability.

With these three papers providing a sound foundation, where to now?

Just as there are differences in opinions on some of the issues raised in these papers, there will also be different views about how to prioritise these areas for the next stage of the review. But as I said earlier, I think one of the most useful outcomes of the work to date is the articulation of a coherent framework with which to consider the question.

That said, I think one of the key areas that requires more work is one which is very much in a state of flux at the moment, namely the implementation of the vast regulatory reform agenda. A holistic view of how the Australian and global financial system is being transformed by this would be very welcome and is much needed.

Finally, a particularly useful outcome of this project is the bringing together of many of the key participants in the sector to discuss the issues and providing a fruitful forum with which to do so. I thank the ACFS for the efforts in coordinating the work and wish the participants luck in this regard as well as again commending the amount of work already accomplished. As I said earlier, my main recommendation is that you spare the time to read these three papers.