Glenn Stevens: "How do we withstand shocks?"

Remarks by Mr Glenn Stevens, Governor of the Reserve Bank of Australia, to ASIC (Australian Securities and Investments Commission) Annual Forum 2016, Sydney, 22 March 2016.

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I thank Emily Perry for assistance in compiling these remarks.

I'm pleased to be here to take part in ASIC's annual forum.

The listed topic for this session was 'can we withstand a major global shock?' I'm going to take a few liberties with that title and re-frame it as '*how* do we withstand shocks?'

For it is inevitable that 'shocks' will come along [1] One way or another the human condition is characterised by things happening that were not well predicted and for which we are sometimes less prepared than we might, in hindsight, have wished to be.

So the question is not if such events will occur, but when. There is a business cycle, and there always will be. There is a cycle of fear and greed in financial markets; it was ever thus. Things rarely move in straight lines and even when they do, as we start to assume that will continue, we set up the very dynamics that ensure it won't.

Unfortunately, we will not be very good at forecasting these events. In fact forecasts, almost by definition, assume 'shocks' will not occur. About the best that forecasts can do is to sketch out the likely effects of shocks that are known already to have occurred.

What that means is that we need resilient systems – systems that are robust to some things going wrong. We need flexible, adaptable economies. We need financial markets that price risk sensibly as opposed to habitually 'pricing for perfection'. We need providers of finance, be they banks, so-called 'shadow banks' or capital markets, that have ample capacity to bear losses when things go wrong – because sooner or later some things will.

With that framing, two questions to ask are:

- What shocks are we grappling with at present?
- How do we assess our capacity to cope with those, or worse?

Recent Developments

There have been a few developments that have attracted attention for their potential implications for the global and local economies.

First, commodity prices have fallen considerably. In Australia, of course, this is part of the everyday narrative. Our terms of trade peaked about four and a half years ago and have fallen by about 35 per cent since then. This has a number of important effects and has caused considerable adjustment in the economy.

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[1] To be clear about what we mean by the term, a shock is an event or development, typically un-forecasted (and sometimes only dimly perceived even as it occurs) that has significance for the economy or financial system and requires adjustments of various kinds over a period of time. They can be adverse – consider the sudden reduction in risk appetite and drying up of liquidity in international financial markets in 2008. Shocks can also be positive – consider the way the entry of China into the global economy and the development of the efficient east-Asian manufacturing production chain in the 1990s lowered costs of consumer goods for the world. Or of the way Australia's terms of trade have, for the past decade, been way above their historical average.

The effect of the terms of trade fall on which our public discussion typically focuses is the impact on the Federal government's fiscal position. Since the outlook for nominal GDP is critical to projections of tax revenues, the linkage of commodity prices to revenue forecasts has become a key part of the economic story. That is reasonable so far as it goes, though the sequence of downward revisions to terms of trade assumptions, while important, has really served to expose the deeper, and more profound, fact that the budget is structurally in deficit, for reasons largely unrelated to the commodity price decline. That is still something that, over time, we need to address.

But the effect of the terms of trade fall is more than just the effect on the budget. It is a large change in relative prices and real incomes. It results in different paces of economic performance by industry and region. Other things adjust, including the exchange rate and allocation of labour and capital resources. It's complex but overall, in my judgement, the Australian economy is adjusting quite well in the circumstances – certainly far better than in other episodes of commodity price fluctuations we have seen in history. That said, the adjustment is still a work in progress.

Out in the broader world, the price that has captured attention is that for crude oil, which has fallen by about two-thirds over the past two years. This was a genuine shock: it was not well predicted.

But what sort of a shock is it? It matters a great deal whether the price is falling because demand for oil has slumped – say due to a major slowdown in global economic growth – or whether it reflects a large increase in the supply of oil. The evidence thus far is that demand has slowed a little, but supply has increased rapidly in recent years and is expected to remain at a high level this year. This matters because, usually, more supply of something and a cheaper price is good news, not bad.

To be sure, lower oil prices require adjustment on the part of producers – corporate and sovereign. But this has always been so and an increase in the availability of energy and cheaper prices has generally, in the past, been seen as a plus for overall global growth – a positive 'shock'. This was because the response of consumers of oil to a decline in its price was to consume more – not just more oil but other goods and services as well, using the higher real income afforded by lower oil prices. It was thought that this outweighed the negative effects of spending cutbacks in oil-producing countries.

It seems people are less confident this time of a fall in oil prices being expansionary. Why so?

The fact that the United States has become a larger oil producer (and a significant producer of the short-run 'marginal barrel') is clearly relevant. So is the possibility that consumers both there and in Europe may, for particular reasons, be more inclined to save any windfall from lower oil prices than they used to be. These factors may, for a time, work against the traditional positive effect.

In addition, the price for oil was high enough, for long enough, that many investment and spending decisions were taken around the world that look, perhaps, not quite so sound in hindsight. Hence, producer countries have budget strains; some sovereign wealth funds are liquidating financial assets; spreads on debt instruments issued by energy companies have widened sharply; exploration and new investment is being curtailed rapidly. It seems as though the sheer strength and longevity of the preceding period of very high oil prices prompted behaviour that made some players more vulnerable to a price decline. That, of course, is not unknown in the history of commodity markets.

Having said all that, people might be being a little too pessimistic about the effects of the fall in oil prices. It is still equivalent to a reduction in taxes for a very large number of consumers around the world who now have more disposable income to spend or to repay debt. The shareholders and state owners of the producing assets, who gained from the higher prices, are wearing most of the costs of the lower price, along with those who provided capital market debt funding. At this stage, though, it does not appear that the effects of lower oil prices are being greatly magnified through significant adverse effects on the banking system – though of course this has to remain under careful watch.

The second development is that the outlook for global growth is assessed as having weakened, with forecasters expecting less growth in the global economy this year and next year than they did six months ago. The point here is not so much that growth is *that* weak: it is forecast to be higher than it was in the relatively mild global slowdown in the early 2000s, for example, and nothing like as weak as 2009. It is more that there have been a number of years now of below-average performance and the effects of that are cumulating. Many countries are finding the 'strong, sustainable and balanced growth' talked about in the G20 process to be rather elusive. The emerging world, which led growth after the crisis of 2008-09, accounts for much of the slower performance of late, and there has been a focus on China in particular.[2]

There is no doubt that China's growth trajectory today, and in the foreseeable future, is a slower one than that which we saw up to about 2011. The Chinese authorities have been telling us for some years that this had to occur. The real question is how successful they will be in landing a transition to a sustainable but still strong growth model, one that is less reliant on investment, more driven by domestic consumption and associated with less build up in leverage. They also have to manage the debt legacy of the previous period of expansion. The truth is that we can't know how all this will turn out. No one has done such a transition on this scale before.

A third feature is that observers and investors have to grapple with a more complex policy environment. The Federal Reserve's interest rate decision in December was very well telegraphed and understood. So it, *per se*, doesn't really count as a 'shock'. It resulted in the expected sorts of effects – like a turnaround in earlier international capital flows to emerging markets. Some of these actually began ahead of the event itself.

At the same time, though, the very low rates of inflation and still very gradual pace of economic growth have led other central banks to seek further easing of monetary policy. Balance sheet measures have been stepped up and several European jurisdictions have applied negative interest rates to parts of banks' reserve holdings at the central bank. The same is happening in Japan. At this point, people are still trying to assess the implications of these changes. Meanwhile, for various reasons there has been renewed focus on asset quality in parts of the European banking system and Europe's resolution arrangements. Changes to China's exchange rate mechanism have attracted much attention.

So, in summary, there has in recent months been somewhat more policy uncertainty. This, in turn, reflects the difficulties that policymakers are having in securing growth.

Perhaps it's not altogether surprising, then, that we have seen some periods of elevated volatility in financial markets over recent months. Financing conditions for some emerging markets were becoming more difficult a year or more ago; that has generally continued. Major advanced economy sovereign bond yields, on the other hand, have remained very low or even fallen. The Bank for International Settlements has calculated that about US$6½ trillion in sovereign bonds, or about one-quarter of the JPMorgan government bond index according to one report, are now trading at negative yields in global capital markets. The Japanese government – by far the most indebted government in the developed world – can borrow for 10 years at a negative interest rate. But spreads for lesser rated sovereign and private debt have widened, in some cases quite significantly.

Equity prices have been choppy and generally weaker. Exchange rates have become more volatile and have been particularly sensitive to shifts in perceptions about central bank actions.

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2 Incidentally, I have not seen evidence that weaker Chinese demand for oil has been a big factor for oil prices. If anything, what slowing in demand there is for oil seems to be occurring elsewhere in the world.

Uncertainty about the future direction of the renminbi has been a factor in exchange markets, but the same must be said about the yen and the euro.

How should we evaluate this period of volatility and reduction in risk appetite? Is it just reflecting the same information that is embodied in the softer global growth forecasts? Or is it telling us there has been a significant shock we don't see in other data? If it persists, could it *be* a shock that leads to a worse global outcome – by leading to a tightening of credit conditions, loss of wealth and confidence and therefore crimping demand? Alternatively, might the trend of the past couple of weeks, when markets seem to have been regaining a degree of composure, continue? If it does, might we look back on this recent period of turbulence as just a bout of market nervousness that that carries little lasting importance?

These are the questions policymakers have to grapple with and as yet we do not know the answers.

Resilience

But *if* there *were* a material change to the global outlook happening – and, let me be clear, I am not saying there is, but *if* there were – how resilient are we? And how can we be more resilient?

There are a couple of things to say at a global level. The first is that the global banking system is better capitalised and more liquid, and hence more resilient, today than it was eight years ago. This part of the financial sector is a good deal less likely to be an amplifier of other shocks than it was then. Of course this strengthening needs to continue; there is a way to go yet for full implementation of the various reforms. But progress is being made.

It is noteworthy that much of the increase in financing in recent years has flowed through capital markets. It has to be acknowledged that bond markets are less liquid than they used to be. This is partly because the major international banks now do not commit the same size of balance sheet to market-making activities – and that stems, in part, from regulation. This, no doubt, is part of the story as to why markets have been more volatile recently, though it is probably not the whole story.

Large investors are coping with this by accepting that it takes longer to move a parcel of securities. But some worry that liquidity may be much more significantly reduced in moments of stress, meaning that it may require much bigger price changes for markets to clear. As it is, some of the world's deepest and most important markets have, on a few occasions over the past year, seen very large price movements – thankfully for only fairly short periods. More generally, the search for yield has seen investors, including sovereign funds, insurers, and mutual funds held by retail investors, move into assets that are inherently less liquid.

This leaves us, unavoidably, with a degree of uncertainty about how markets might cope with larger shocks, and how larger price changes for assets priced in those markets may feed back to the economy. Not surprisingly, liquidity management for asset managers and the question of liquidity conditions in markets in general are key themes for the Financial Stability Board at present.

But for all that, it seems to me generally a good thing that (1) more of the credit risk is borne by entities or forms of financing generally less characterised by leverage; and (2) those entities that do have leverage (i.e. banks in the main) have less leverage than they used to. Such developments lessen the system's tendency towards crisis; resilience is greater. That said, all of this is still a work in progress and more progress is required.

On the domestic front, the information we have received recently suggests that the Australian economy was growing at a respectable pace in the second half of last year. The national accounts data released this month showed that the economy expanded by 3 per cent over 2015, a bit better than we estimated at the time of our most recent *Statement on Monetary Policy* in February. This outcome seems to fit together with other pieces of information such as business surveys and labour market data, which improved noticeably over the course of 2015.

So at the turn of the year the Australian economy seemed to have been picking up. That's a good starting point. In the case of business surveys, better conditions seem generally to have continued in the early part of 2016, though labour market data have been more ambiguous.

The fact that Australia has a sound and credible macroeconomic policy framework, which could, if needed, respond as appropriate to significant negative events is also a good starting point. Even with interest rates at already low levels, and public debt higher than it was, there would, in the event of a serious economic downturn, be more room to ease both monetary and fiscal policy than in many, indeed most, other countries.

Leaving aside the potential for macroeconomic policy responses, the economy's inherent ability to adjust has been on display through both phases of the mining boom. Of course we should always be looking for ways to improve that flexibility, but I think it should be said that businesses and their workforces have been much more flexible than once used to be the case.

Turning to financial resilience, Australian banks' asset quality has generally been improving over the past couple of years. Like their counterparts abroad, in the post-crisis period the banks have lifted capital resources, strengthened liquidity and reduced use of short-term wholesale funding. So their ability to handle either a funding market shock or an economic downturn has improved compared with the situation in 2008. At this stage we do not see a material problem in Australian financial or non-financial entities accessing capital markets. If anything, net bond issuance by Australian banks has been strong over recent months, and to the extent that banks are able to take advantage of this availability to extend the term of their wholesale liabilities, that will further improve their resilience to any funding disturbances that may eventuate. Wholesale funding is a little more expensive than it was, though marginal funding costs are still no higher than the average cost of the funding being replaced.

On the topic of loan quality, the strengthening of lending standards for housing that has resulted from the actions of both APRA and ASIC was timely. So often over the years, tighter standards tended to come too late and reinforced a downturn after it had begun. These measures have occurred ahead, so far as one can tell, of the point in the cycle when measures of asset quality start to deteriorate. Some moderation in house prices in some of the locations where they had been rising most rapidly, while not the direct objective of the supervisory measures, is also, in my judgement, helpful.

In the business space, the banking system has fairly modest direct exposure to the falls in oil and other commodity prices, with lending to businesses involved in mining and energy accounting for only around 2 per cent of banks' total lending.

More generally, competition to lend to business has increased over the past couple of years and business credit growth has picked up appreciably. Overall, this is to be expected and is a welcome development at a time when a missing element of the economic growth story is capital spending outside the mining sector, which appears to remain very weak. One notable trend is the aggressive expansion of some of the foreign banks active in the Australian market. Here there is a note of caution. If these are taking opportunities left on the table where local players (or earlier foreign players) were simply too conservative, all well and good. But one is duty-bound to observe that there is a history of foreign players expanding aggressively in the upswing only to have to retreat quickly when more difficult times come. It is worth remembering that cycle.

Conclusion

It seems to be part of the economic *zeitgeist* that people are continually looking for the 'downside' risks. It hasn't always been so - I recall lengthy periods when the mindset was always to see inflation pressures around every corner. That people seem to find it easier to imagine the downside today is a mark of the length of the shadow cast by the financial crisis, seven years on.

For financial regulators and policymakers, it is, of course, our duty to look out for possible problems. At present, we can think of several, not all of which, by the way, are on the downside. Some of those may come to pass; some probably won't. But it is virtually impossible to say which ones are which.

So, to repeat, the key thing is to try to build resilience in economies and financial structures so that, when shocks do occur, the damage can be contained rather than amplified.

In that respect it is good that banks in most places in the world are stronger, though that process needs to be completed. The bigger role in financing being played by capital markets is also, on balance, probably a good thing, even though we are yet to be able to assess how such markets will perform under more stressed conditions.

The local economy has been improving and the financial system overall gaining in resilience, albeit with a few pockets to watch. Given that and a reasonable track record of adapting to shocks, we have some grounds for confidence in our capacity to negotiate whatever lies ahead.