High-level policy panel on monetary policy and exchange rate issues: the RBA'S monetary policy challenges during the international financial crisis

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1. Introduction

The past year has been a very challenging period in Australia as it has been elsewhere. So far, however, the Australian economy has weathered the global financial crisis relatively well.

There are a number of factors that may have contributed to this, which I will touch on in my comments. But let me start by briefly describing the economic and financial background in Australia prior to the onset of the crisis. I will then outline the challenges we faced over the past couple of years, as well as the measures we took in response, and provide an assessment of how effective they have been.

2. Some background

The economy

In the years leading up to the onset of the crisis, the main challenge the RBA was facing was the risk of overheating in the Australian economy.

This was mainly due to the sharp rise in the terms of trade, which in 2008 reached their highest level since the wool boom of the 1950s. They were about 70 per cent above their long-term average.

The boom in income from the terms of trade led to very strong spending; the labour market became very tight, with unemployment at generational lows; and inflation rose above the target range of 2–3 per cent to a peak of around 5 per cent.

The financial system

Like many other developed economies, Australia had experienced a very large increase in house prices since the mid-1990s.

But the ratio of house prices to income peaked much earlier in Australia than in most other countries – in 2003 – and this ratio had adjusted down substantially by the time the global financial crisis hit. High interest rates, jawboning by the RBA about the dangers of a housing bubble, and supervisory pressure by APRA on banks to maintain lending standards were all used to help restrain house prices.

The other feature of the Australian housing market that differed from some other countries was that lending standards did not deteriorate to any significant extent during the boom. Sub-prime loans were less than 1% of the market. Arrears rates on housing loans have remained low, at around 0.5%.

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Finally, and related partly to the previous two points, the Australian banking sector has remained in a very healthy position over the past couple of years. Profits have remained high and banks continue to be well capitalised; domestic loan defaults have been low; and Australian banks' international exposure to US sub-prime loans has been negligible.

3. RBA responses to the crisis

Mid-2007 to mid-2008

When the crisis first emerged in mid-2007, the RBA saw the challenge as being mainly to ensure that Australian banks and other market participants had adequate access to liquidity.

That was not too difficult because the RBA has always had flexible liquidity management arrangements:

- we deal in a wide range of securities;
- we deal with any counterparty who has eligible collateral; and
- we are flexible in the terms to maturity of our repos.

The challenges faced during that first year of the crisis – from mid-2007 to mid-2008 – were readily dealt with by existing liquidity management arrangements. There were no significant changes to operating procedures, although the RBA provided a greater than usual volume of reserves to the banks, and it somewhat lengthened the term of its repos.

There was no adjustment to monetary policy at that stage on account of the crisis because, as noted, the crisis up until then was centred largely on a shortage of liquidity and was readily dealt with through market operations. Monetary policy continued to be tightened through to early 2008 due to rising inflationary pressures.

September 2008 onwards

After the collapse of Lehman Bros in late 2008, the economic and financial situation in Australia changed abruptly, as it did in all other countries.

In response, monetary policy was eased quickly; six years of tightening were unwound in the space of six months, though official interest rates in Australia did not fall to the low levels seen in a number of other countries.

The reduction in official interest rates in Australia was passed through to interest rates on loans to borrowers to a greater extent than in other countries. That is, borrowers in Australia benefited from larger reductions in interest rates than those in other countries, which made the monetary easing more effective. This reflected the fact that:

- the banking sector in Australia was healthy and therefore operating effectively; and
- Australia has a predominance of floating rate loans so the interest rate cuts passed through to borrowers very quickly.

The RBA through this period did not give any promises or guarantees about the future path of official interest rates. We are pleased we did not do so, as this has preserved flexibility in exiting from the "emergency" setting of interest rates that was put in place during the crisis.

As well as easing monetary policy sharply, the RBA undertook a number of "balance sheet" measures to reduce stress in the financial system:

- the supply of bank reserves was increased substantially further after September last year;

- the range of collateral accepted in repos was also widened further, though the requirement for collateral to be AAA rating was retained;
- the term of repos was lengthened considerably;
- a term deposit facility at the central bank was introduced to allow banks to park excess liquidity; and
- the RBA joined the list of central banks with which the US Fed undertook foreign exchange swaps. (Australian banks did not need US dollars, but Australian pension funds did, in order to roll over hedges on US investments. The bulk of the US dollars supplied by the Fed, however, were in fact recycled, through Australian banks, back to banks in the northern hemisphere.)

These measures continued to give the RBA a high degree of control over money market interest rates, and the overnight interest rate in the market rarely departed from the target rate.

These measures proved very effective and have now been fully reversed. The RBA's balance sheet is back to the level it was before the crisis; and the provision of bank reserves has been scaled back to relatively normal levels. Our experience through this period reinforced the importance of central banks having flexible procedures for market operations, so that they can respond quickly, and without adding to the sense of crisis, to evolving market circumstances.

Another important development was that the exchange rate fell sharply – by more than 30% in the space of three months. This helped insulate the Australian economy from the collapse of global demand. The RBA did not stand in the way of this initially, but undertook some intervention towards the lower end of the exchange rate range, to help stabilise conditions. A flexible exchange rate remains one of the key factors behind the resilience of the Australian economy, due to the consistent tendency of the exchange rate to move countercyclically.

4. Government measures

As well as the monetary and balance sheet measures taken by the RBA, the Australian government also undertook a range of measures to support the financial system and economic activity. These included bank guarantees, credit easing policies and fiscal easing.

Bank guarantees

When the crisis hit, most countries with deposit insurance arrangements responded to the loss of depositor confidence by increasing the size of deposits that were insured. Australia did not have a deposit insurance scheme at that time and the Australian Government responded to the crisis initially by guaranteeing all deposits of all authorised deposit taking institutions, for free.

This was subsequently amended to put a cap of $1 million on deposits that were automatically guaranteed for free. Larger deposits are only guaranteed on application, for a fee.

The guarantees on bank deposits were certainly effective in calming community fears. An important policy challenge will be how and when to reverse them.

A guarantee on wholesale funding was also introduced, as it was in many other countries. This was very effective in allowing banks to sustain access to wholesale markets and, in the event, Australian banks for a time were among the heaviest users of wholesale funding guarantees. Their use of the guarantees has diminished sharply as market conditions have improved.

Credit easing policies

The RBA did not engage in any credit easing policies. The credit exposure on its balance sheet today is no higher than it was a year ago.

The Australian Government did, however, undertake two initiatives that can be thought of as "credit easing" policies:

- it set up a small fund to provide financing to car dealerships after some vehicle financing companies withdrew from the market; and
- it bought, through its debt management agency, a small amount of mortgage-backed securities to help maintain the flow of new securitisations.

Fiscal policy

The Australian Government also engaged in a very large fiscal expansion. It had ample scope to do so because Australia had run budget surpluses for much of the previous decade, and had paid off all government debt.

The strong starting position on fiscal policy, plus the fact that the Government was able to publish a credible path for return to fiscal surplus, are likely to have contributed to the effectiveness of the fiscal easing.