

Glenn Stevens: Australia, New Zealand and the international economy

Address by Mr Glenn Stevens, Governor of the Reserve Bank of Australia, to the Trans-Tasman Business Circle Business Luncheon, Sydney, 21 October 2008.

I thank Clare Noone for very able assistance in preparing this address.

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In Les Carlyon's *Gallipoli*, a conversation is recounted in which a Turkish soldier is said to have asked some New Zealand prisoners why it was that they had come so far, voluntarily, to fight a war in Europe. They apparently replied that they had expected it to be rather like playing a game of rugby. It is not recorded how Australians answered the same question (perhaps they could not decide which code of football was most apt). But they certainly also went in a spirit of optimism.

That optimism was soon a casualty of war. Optimism seems also to have been a casualty of recent financial events abroad, as outcomes have been rather unlike what the sophisticated modern set of institutions and markets were supposed to have delivered.

Many have observed that the world faces the most serious international financial crisis since the 1930s. The world has, of course, experienced many crises, of various kinds over the decades, not least the one to which the ANZACs responded. These were often, in terms of potential and actual human misery, far more perilous than today's financial dislocation.

Nonetheless, the situation is very serious. It is up to policy-makers and private market participants to put the system back together, without the excesses that built up over the past years, so that it can serve its proper function: facilitating trade and genuine investment flows, in the process supporting economic growth.

For this audience, I had intended to talk about the Australian and New Zealand economies – noting some of their similarities and differences, and common interests. Given the circumstances, I will touch briefly on those issues, and then devote some time as well to talking about our shared interests in getting the global financial system back into shape.

Australia and New Zealand

It is stating the obvious that the two countries have a lot in common, dating back at least to James Cook. We share the British system of laws and custom, the historical relative geographical isolation from "old" Europe, an increasing orientation towards Asia, and generally an outward-looking mentality reflecting small economic size. Notwithstanding that Australia's GDP is seven times that of New Zealand, we still see ourselves as small.

There is a significant amount of grass-roots integration between the two countries which has occurred fairly naturally. Apart from the relative ease of population flows – which facilitates labour mobility – one is struck by the number of Australia-New Zealand Associations and Societies of one kind or another. Try an on-line search of the words "Australia, New Zealand, association and society" to see what I mean.

The industry structures of the two economies differ somewhat, reflecting natural resource endowments (Table 1). Australia has more mining, but less manufacturing and farming, as a share of GDP, than New Zealand. But on the whole, the differences are perhaps not as striking as the similarities.

Table 1: Economic Structure
Percentage share of GDP, 2007/08

	Australia New Zealand	
Manufacturing	10.1	14.1
Mining	6.8	1.2
Agriculture, forestry and fishing	2.3	5.8
Total of above	19.2	21.1
Finance, property and business services	19.4	20.9
Health, education and community services*	13.4	11.9
Wholesale and retail trade**	12.3	15.4
Construction	6.8	4.6
Utilities and transport	6.8	6.5
Government administration and defence	3.8	4.6
Communication services	2.7	6.1
Other	15.5	8.8

* includes cultural, recreational and personal services

** includes accommodation, restaurants, cafes and bars

Note: Data are not strictly comparable as industry value-added in Australia is measured at basic prices and in New Zealand at producers' prices

Sources: ABS; Statistics New Zealand

The two countries do a good deal of bilateral trade, helped by the Australia New Zealand Closer Economic Relations Trade Agreement (CER) of 1983,¹ and Australia is easily New Zealand's largest trading partner. Interestingly enough, though, while growth in trans-Tasman trade has been faster than growth in trade with Japan, the United Kingdom or the United States, traditionally big trading partners, it is not especially fast. The most striking thing is that growth in trade with China and other east Asian economies has been much faster for both

¹ Further information on the Australia New Zealand Closer Economic Relations Trade Agreement is available at: <http://www.austrade.gov.au/ANZCERTA/default.aspx>.

countries than growth in trade with each other, despite the CER. I am neither arguing that the CER restrains trade nor that it might not be amenable to improvement to facilitate further trade. I simply observe that the massive increase in the prominence of Asia in the global economy over the past 25 years provided both countries with opportunities. We are both able to take those opportunities because of the open approach we have taken to trade generally.²

Both economies have a high export rate of commodities – relatively more minerals for Australia and more agricultural products for New Zealand. Not surprisingly therefore, both countries have had very significant changes in our terms of trade over the past several years. New Zealand is a more open economy than Australia, so a rise in the terms of trade of any given percentage has a larger effect on incomes there. But the sheer magnitude of the terms of trade gain for Australia means that the gain in real domestic income over the past five years was roughly double the size of the impact in New Zealand. In both cases, the terms of trade look like they are now starting to moderate.

The two countries share structural policy features:

- floating currencies and central banks with a medium-term, flexible inflation-targeting approach to monetary policy. New Zealand was, along with Canada, a pioneer of inflation targeting; and
- a history of governments, of varying political persuasions, which have maintained a general commitment to market-opening, liberalising policies over the past generation, including financial liberalisation.

The two countries also share the same major banking groups, with the large four Australian banks having New Zealand subsidiaries and branches. The operations of these entities account for 90 per cent of the market for bank deposits and loans in New Zealand.

For that reason, Australia and New Zealand have a common interest in sound functioning of the international financial system being restored. Our financial systems, like those of most countries these days, are connected to global markets and our large financial institutions are active in international markets. So there are impacts on our systems of the extreme dislocation in international markets, even though the Australian banks have strong balance sheets with good asset quality. Moreover, these same disturbances are in the process of slowing down major economies and hence global growth, which obviously will have some impact on our own economies.

It is time therefore that I turned to say something about those issues.

Recent events

The genesis of the problems – the search for yield in a lengthy period of low global interest rates, the associated disregard for growing risk, structural flaws in the “originate and distribute” model of financing, the deterioration in lending standards – have been discussed at length over the past year. For today, it suffices to say that a lot of new risk was created and, far from being widely dispersed, a good deal of it ended up on the balance sheets of the most leveraged parts of the international financial system – banks and investment banks.

The problems of counterparty risk aversion and reluctance to lend at term – that is, a breakdown in trust – first erupted in August last year. Term borrowing rates rose sharply

² Some research results imply that Australia and New Zealand both do significantly more international trade than would be implied by empirical models of international trade. See Guttman, S and A. Richards (2006), “Trade Openness: An Australian Perspective”, *Australian Economic Papers*, 45(3), pp. 188-203. Those authors also note that our two economies are the most “economically remote” countries in the world, in terms of average distance to potential trading partners. However, that relative disadvantage is falling somewhat with the growth of Asia relative to the economies of the North Atlantic.

relative to overnight rates. This intensified through to the end of each calendar quarter as bank accounting dates approached, and lessened thereafter. This cycle was repeated several times through to the middle of 2008. While that was going on, a number of major international institutions accepted write-downs of their exposures to US mortgages, which were often via complex structured products whose prices proved to be very volatile – when they could be measured at all. They simultaneously sought new capital, though as fast as they received it, capital was being burned up in losses.

Things proceeded in this way for over a year, without getting noticeably worse, but not getting noticeably better. Then during the months of September and October 2008, in a sequence of events historians will study at length for decades ahead, the international financial landscape changed dramatically. In the space of six weeks:

- the remaining four large American investment banks disappeared – into bankruptcy, merger or by taking a banking licence, which gets them closer to the support of the Federal Reserve;
- one of the world's largest insurance companies, hit by a wave of margin calls on credit default insurance contracts it had written, had to take a loan from the Federal Reserve and is effectively in public ownership;
- the largest participants in the US mortgage market, which had always been seen as implicitly government guaranteed, were explicitly nationalised;
- the US Treasury brought forward a plan to purchase assets from lenders' balance sheets for a sum of up to 5 per cent of US GDP. A version of this plan was approved on the second attempt, after several anxious days in which confidence was further eroded;
- a number of European banks faced failure, including some quite large ones, and needed government support or were nationalised; and
- governments in a number of countries felt the need to guarantee some or all of the deposit obligations of their banks.

While this was occurring, global markets for equities, currencies and commodities saw extraordinary price movements, while yields on many short-term government securities fell sharply. Volatility in daily prices increased significantly. Interbank and commercial paper markets, which had already been under pressure, effectively closed in a number of countries. (It is worth noting that most key markets in Australia have continued to function through this period, even if under some pressure.) The extreme counterparty risk aversion in markets saw the shortage of US dollar liquidity in the European and Asian time zone worsen seriously, to the point that the effective cost of borrowing US dollars via swap in the Asian time zone reached well into double digits in mid September, and on some days the market was, for all intents and purposes, not available.

The fall in commodity prices brought pressure to some emerging market countries, which saw falls in currencies and share prices, and which in some cases closed share markets. Since late September, many currencies have come under downward pressure against currencies like the yen, which was a favoured funding currency for various positions in higher-yielding currencies. The Australian dollar fell particularly sharply, in part because of the changes in interest rate expectations and commodity prices, and partly because its relatively liquid market sees it used by many managers as a device to change quickly their exposures to some other currencies and commodity-based strategies.

In summary, what appeared for the preceding year to be a serious, but containable, problem of liquidity and concerns over creditworthiness turned suddenly into a very fast-moving crisis of confidence in key players in the international financial system, where questions of solvency came much more to the fore. It has presented financiers, and policy-makers, with the most difficult set of challenges of its kind for generations.

What should be done?

The question, then, is how to restore confidence and stability to these important markets and institutions.

The first thing is to continue to provide liquidity. This requires central banks to expand their balance sheets if necessary, so that the private financial sector can continue to fund its existing asset book for the time being, and so that the broader process of de-leveraging can be accommodated with as little disruption as possible.

Central banks have stepped up their liquidity efforts in a major way, with a number of them providing much more in the way of own-currency funding against a wider range of collateral. But the most visible impact is on the Federal Reserve's balance sheet, where assets have nearly doubled in the past six weeks as a result of increases in the Fed's various facilities. An increase in swap lines with other central banks, which allows the supply of dollar liquidity in Asian and European time zones, has been one large contributor to the expansion (and the RBA has participated in these lines). The most recent development has seen this liquidity operate on tap in several major countries – at a fixed price, in any amount market participants require, for terms extending out to three months. As a result, there is now a huge amount of US dollar liquidity in the system.

But while liquidity provision helps, it can, at best, ameliorate the impact of counterparty risk. It cannot eliminate it. The second thing that is needed is a restoration of confidence in the key financial institutions.

Because the lack of confidence is, ultimately, about solvency, re-capitalisation of the relevant institutions is required. The lesson of past banking crises, moreover, is that when there are really serious problems in private balance sheets, capital may be available in sufficient quantity only from the public purse. This should of course come with appropriate conditions – private shareholders should absorb the losses from past problems, governments that put in new capital should share in the upside and guarantees that are offered should be priced. Governments should plan to divest their holdings in banks in due course.

The UK Government's plan announced a couple of weeks ago, which seems to have become something of a template for these sorts of intervention, appears to have the key elements needed to restore health to the key international institutions.

It increases further the supply of liquidity for the short term. It also provides for an increase in the capital of key UK institutions, from the public sector if needed, via the government underwriting capital raising. And it provides some confidence for term funding markets by offering a guarantee of the debt obligations of the relevant banks for a period of time. This guarantee is not free to the banks – they will pay for it on commercial terms, which in the current environment are unlikely to be cheap. The intention is not to subsidise the price of borrowing but, by promoting confidence of repayment, to allow the market to find an appropriate price, which of late it has had trouble doing.

The Australian response has taken careful note of the elements of this plan which are pertinent to our situation. The RBA's liquidity facilities had already been further expanded, to allow our counterparties to bring to us internally securitised mortgages as collateral, to get funding for out to a year. This is available at market prices every day. The additional eligible collateral available to the Australian system as a result of the most recent changes can support over \$50 billion of additional liquidity (after allowing for haircuts), if needed.

The Australian Government has announced a general guarantee of deposits, as a precaution to allay any public anxiety over security of their savings. It has also decided to offer to guarantee wholesale debt obligations of Australian authorised deposit-takers and authorised Australian subsidiaries of foreign banks, on commercial terms. This will ensure that Australian institutions, some of which are among the highest rated of the world's banks, are able to retain adequate access to term funding in an environment where banks of other countries are able, in effect, to use the rating of their governments when borrowing. Steps in

these directions, in the context of what other countries were doing, were sensible and the Reserve Bank supported them. As is also the case in other countries, the design features of the various guarantees will be important. Little detail is available from other countries yet. Meanwhile, the Reserve Bank is working with our colleagues in the Treasury on the details of the Australian arrangements, including on how to maintain continued healthy functioning of Australia's short-term money markets.

The element of the UK plan Australia has not sought to emulate is public underwriting of capital injections. The Australian banks have strong capital positions and profits, so they should be able to approach the market on normal commercial terms if they desire additional capital.

Where to from here?

At moments like this, it is hazardous to make predictions. However, it seems to me that the key elements of dealing with the root issues in the crisis are starting to come into place. Policy-makers in the major countries do "get it". The plans are not precisely uniform across countries – that is never achievable anyway – but we can, I think, see the shape of a broad common outline. It addresses the issues of liquidity, capital and confidence. There is much more work to be done yet on the design details, and one area in which further international co-operation would be helpful is in the area of making these various guarantee arrangements broadly consistent. But the world is, it seems to me, getting on to a better path. As a result, the likelihood of a global catastrophe has in fact declined over the past couple of weeks.

The question of the appropriate macroeconomic policy settings to help economies through this period will also be receiving attention around the world. In those countries where previous settings have been prudent, and where inflation prospects permit, policies can be eased to counteract some of the contractionary forces set in train by the deterioration in global growth prospects resulting from the credit turmoil. Central banks in major countries, recognising weaker demand and the likelihood of easing pressures on prices, reduced interest rates in October.

In Australia, the Reserve Bank made a substantial cut to the cash rate at its October meeting, bringing forward reductions that might ordinarily have taken place over several months. CPI inflation is likely to remain high in the period immediately ahead, and yesterday's PPI data illustrate the concerns that the Bank has long expressed about inflation. But looking forward to next year, forces seem now to be building that will start to dampen pressures on prices – even though we won't have evidence for that for a good six months. The Board sought, as always, to respond to the medium-term outlook for prices, not just the current data.

The Australian Government has made a significant change to the fiscal stance which will flow through the demand side of the economy during the summer. The decline in the Australian dollar by about 20 per cent against a trade-weighted basket also amounts to a significant change for the trade-exposed sectors of the economy, though at the cost of some temporarily higher price rises. These changes will act to lessen the extent of the likely slowdown in Australia's economy, even as global forces work the other way.

The Reserve Bank will publish its next update on the economic outlook on 10 November, so I will not say any more about that today. I shall finish with the question of what trends will be of importance beyond that horizon.

As I have said before, the emergence of China is not complete and has many years to run. Right now, China's economy is slowing. This is a reminder that China's economy has cycles, like economies everywhere. But even if it slows a lot, it will pick up again in due course and will probably grow pretty strongly, on average, over many years.

In countries like Australia, perhaps the long period of household debt build-up is now giving way to a period in which balance sheets will see some consolidation. If so, household credit growth will not be as fast as it was for the past decade and a half. Perhaps we will need also to get better at turning borrowing for housing into more dwellings rather than just higher house prices.

Perhaps the finance sector globally will return to fulfilling something more like its historical role of being “the handmaiden of industry”, with a bit less in the way of exotic innovation of its own. In such a world, a renewed focus on the processes in the real economy which generate growth in productivity could also be apt. In the case of Australia at least, it is now hard to avoid the conclusion that underlying growth in productivity has slowed over the past five years, compared with what was seen through most of the 1990s and the early part of this decade. Of course, these things are notoriously hard to measure and there will be various opinions about the extent of the slowing, why it occurred and what might be done about it. Nonetheless, once the immediate crisis has passed, that might be a conversation worth having.