

Glenn Stevens: Recent financial developments

Address by Mr Glenn Stevens, Governor of the Reserve Bank of Australia, to ACI2010 49th World Congress, Sydney, 26 March 2010.

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Welcome back to Sydney.

The last time that this body met here was in 1992. At that time the Australian economy was in the early phase of a recovery from a deep recession. Pessimism about the future was deeply rooted. The financial system was under considerable strain. Unemployment was in double digits and still rising. Inflation had fallen significantly, but many people thought this was a temporary impact of the downturn. They thought that if we did get a recovery – and some despaired of that – we would return to our old bad habits of high inflation. People worried a lot about Australia's substantial current account deficit. There were relatively few optimists. You might notice some of that sort of thinking today, in some other countries.

I imagine that among the participants of that 1992 meeting one could have gotten some pretty long odds against Australia having a long upswing, with inflation averaging “two point something”, surviving the financial crisis and ensuing global downturn with one of the mildest domestic downturns we have seen, and facing the future with a fair degree of confidence. This shows how hard it is to forecast, of course. But perhaps it also demonstrates that with time, effort, discipline, good policies and a bit of luck, economies can be returned to health and their citizens to prosperity.

Financial market recovery

To that end, it is helpful that the global financial system is gradually recovering its poise, after a near-death experience eighteen months ago. Perhaps like a patient that has suffered an acute cardiac event, there has been some lasting tissue damage, but quick intervention avoided something much worse. A period of emergency life-support has been followed by a period of recuperation, with some ongoing medication, during which the patient has been able gradually to resume normal activities.

Certainly the functioning of money markets has improved substantially. Extreme counterparty risk aversion has abated and spreads of LIBOR rates to equivalent maturity OIS rates have come down to about the lowest levels since mid 2007. The dramatic expansion in the balance sheets of central banks in major economies has largely ended, though policy interest rates remain at 50-year lows.

Australia's situation is more advanced in this regard. The expansion in the RBA's balance sheet was unwound nearly a year ago and the policy rate has been increased somewhat, reflecting the very different circumstances facing the Australian economy. But we are not the only country seeking to manage the “return to normality”. An increasing number of countries outside those most directly affected by the crisis have begun this process – though the speed of adjustment naturally depends on national conditions.

Capital markets have also improved, with spreads to sovereign bond yields for private borrowers across most of the risk spectrum back to “pre-Lehman” levels, and for the best rated borrowers back almost to mid-2007 levels. They are not quite back to pre-crisis levels, but then, they probably should not have been at such low levels anyway. Similarly, spreads for emerging market sovereigns are well down from their peaks. In fact overall borrowing costs for quality corporates and emerging market sovereigns are similar to or slightly below what they were in 2006. This finer pricing is being accompanied by a gradual pick-up in debt issuance.

Appetite for risk has increased significantly since the end of 2008, albeit with some occasional setbacks. Of course we should expect that it would have increased, since September and October 2008 were characterised by sheer panic – there is no other word – and a flight from virtually any risk at all. Once the global financial system did not actually go over the precipice, there was going to be some re-appraisal. Hence, even as evidence continued to emerge in the first half of 2009 of the dramatic fall in demand for goods and services, share prices and spot commodity prices began to recover. Share prices are now about 60 per cent higher than the “priced for disaster” low point, while commodity price indexes have increased by a third. Some individual commodity prices have risen by much more.

Similarly, we have seen a preparedness to take foreign currency risk, and flows into emerging markets involving both foreign currency and credit risk have increased. Again, risk appetite has not returned to the heady days of the mid 2000s, but nor should it. Even the flows we have seen have begun to raise concerns among policy makers in some of the emerging countries about potential risks of asset market excesses and eventual capital flow reversal.

The banking sector

For major financial institutions, the picture has also improved. The general decline in risk aversion has eased funding problems, and some countries have been able to terminate or scale back their government guarantee programs as banks are increasingly able to access term funding markets under their own names. Share prices for those financial institutions that are still privately owned have generally increased by more than the broader market. A number of large American and European banks that accepted public-sector capital injections during the crisis have moved to repay them.

The challenges that remain ahead for the banking system in major countries nonetheless remain considerable. The outlook for some of the remaining government ownership stakes remains unclear. While losses coming from write-downs of securities slowed some time back, losses are still occurring in lending books as a result of the normal effects of big recessions, not least in the area of commercial property. This will continue for a while. In addition, banks, particularly large internationally active banks with big trading operations, will require additional capital over time under proposed changes to global prudential standards.

There is a considerable contrast between that picture and the one for banks in most other countries. It is important to note that the majority of countries have not had a banking crisis as such. Everyone was affected by the seizing up of markets in late 2008, but most were *not* afflicted with the sorts of asset quality and capital issues that so bedevilled large US, UK and continental European banks. This in turn meant that once the panic had subsided, the banks in most countries were able to continue to carry out their functions – albeit under more difficult circumstances and facing much more subdued demand for credit, particularly from corporations.

Australia is a good example of this, though not the only one. The lowest rate of return on equity earned among the major banks here over the past two years was about 10 per cent in underlying terms; among smaller banks the lowest was 3 per cent. When markets for securitisation closed the major banks stepped into the gap by increasing their rate of housing lending, albeit at higher prices. These banks were able to support some business customers – again at a price – that in previous cycles they might have chosen to cut. The rate of provisioning for bad loans has stopped rising for several banks, and non-performing loans are likely to peak at a considerably lower share of loans than earlier expected. This general picture, even if not the exact numbers, would, I suspect, be replicated across much of Asia.

These differences in experience are an important backdrop for the international work on regulatory reforms. There is no question that there must be some significant reform. To use

the medical analogy again, the recovering patient is usually advised to consider some dietary and lifestyle changes, and perhaps to submit to some ongoing monitoring, in order to avoid further emergency procedures. These changes involve:

- removing the scope for taking on excessive leverage via regulatory arbitrage;
- making sure that adequate capital is held against risk that is being incurred;
- ensuring better management of funding liquidity;
- countering, to the extent possible, the inherent tendencies in both human nature and regulation to form assessments of risk in a pro-cyclical way;
- and improving resolution processes to ensure orderly and rapid crisis management and to help manage the issue of “too-big-to-fail” institutions.

These are all very important goals. The Australian authorities support them. But as we have said before, the really serious problems were generated in a relatively small number of very large, internationally active banks. They did not stem from the thousands of other banks around the world which have not needed to be “bailed out” and whose capital resources have, in most cases, proved adequate to cover normal losses in a cyclical downswing. Hence it is important not to shackle unnecessarily the latter group in our efforts to constrain the relatively small number which caused much of the problem.

Challenges from sovereign debt

Turning from banks to markets more generally, a recent development has been the increasing focus on sovereign debt and creditworthiness. The initial manifestation of this was late last year when Dubai World requested a six-month standstill agreement on its debt repayments.

More recently, the focus has been on Greece, after it was revealed that the Greek Government’s current borrowing requirement was much larger than had been previously disclosed. Greece is a small country – accounting for only half of one per cent of the world’s GDP. The significance of Greece is that it is a euro area country, which means two things. First, its adjustment to its predicament cannot involve currency depreciation (unless it were to leave the single currency). The only way it can grow out of the problem is by gaining competitiveness against other European economies via domestic deflation, which will be a difficult and lengthy process. A very large fiscal consolidation is an unavoidable part of this path. Second, the euro area has an interest in this effort succeeding, which is why there has been intense discussion about whether, and in what form, European assistance might be forthcoming. Any assistance would of course have to pass the test of credibility more generally in Europe, and would need to be applicable under similar terms to other euro area countries if needed. This is obviously a difficult problem, on which the policymakers concerned are continuing to work.

Perhaps the broader significance is that the difficulties facing Greece, while unusually stark, are a reminder of the challenges facing many governments in Europe, and for that matter the United States and Britain, over the long haul. Ratios of debt to GDP are rising quite significantly in all these cases. There are several reasons.

The first is the size of the recessions being experienced, which obviously reduces revenues and adds to some categories of spending – the so-called “automatic stabilisers”. This effect is relatively larger in some European countries but it occurs everywhere to some extent.

The second factor is the discretionary budgetary decisions aimed at stimulating demand and injecting capital into banks. In the circumstances, the former was understandable; the latter was unavoidable.

The “automatic stabilisers” will presumably “automatically” move budget positions in the right direction as economies recover. The costs of stimulus and bank rescue measures, while one-off in nature, do leave debt permanently higher. But without such measures, economies might have suffered much deeper downturns and so the extent of budget deterioration could have been much greater, itself leaving an even bigger debt legacy.

If that was the end of the story, we would not want to get too worked-up over debt ratios. Unfortunately, though, there is more to the story.

For several important countries there was a trend increase in debt-to-GDP ratios going on before the crisis occurred. ***For the domestic audience, let me be clear that Australia has been a conspicuous exception.*** Particularly in mainland Europe, the pattern has tended to be for debt ratios to rise quickly in periods of recession, then to stabilise for some years, before rising again in the next recession. No doubt multiple factors are at work but the interaction of changing demographics and generous welfare, health and retirement systems is prominent. The same factors also work, other things equal, to lessen future potential economic growth.

It is certainly not unprecedented for countries to have debt stocks much larger than their annual GDPs. This has usually been seen when they faced the requirements of fighting wars. Those ratios subsequently came down over time. But the situation now is different. The decline in debt ratios seen after the Second World War, for example, driven by rapid growth in output as population expanded and productivity surged, will not easily be repeated in many of the major countries.

It is these more deep-seated trends, which were in place before the crisis, that are really the greater cause for concern; the crisis has brought them more sharply into focus. The demographic drivers will continue for the foreseeable future, while the unwillingness or inability to tackle the structural trends in earlier “good times” has significantly reduced future flexibility.

So a number of advanced industrial countries face some difficult fiscal decisions over the years ahead. At some point, significant discretionary tightening will be required. Of course policymakers need to get recoveries well entrenched, which is why many observers warn against attempting an early fiscal consolidation. But unless a credible path to fiscal sustainability can also be set out, growth could easily be stunted by rising risk premia built into interest rates as markets worry about long-run solvency. This is not happening as yet; long-term rates in many of the major advanced countries remain quite low. That provides a window within which to plan the eventual consolidation. Since markets can be fickle and things can change, governments will surely want to use the window.

Economic recovery

In the mean time differences persist in the pace of economic recovery across regions. In the United States growth spurred by a swing in the inventory cycle is thought to have marked the turning point in the second half of 2009, but most observers still expect only moderate growth this year. In Europe, the momentum of the recovery has been less certain. In both cases the old forecasting cliché about uncertainty applies in spades.

In contrast, it is apparent that the letter “v” is a reasonable description of the trajectory, to date, of important emerging countries like China, India, Brazil and a number of smaller east Asian countries. We should expect to see some moderation in the pace of growth of production in some of these cases this year. This is usually the case in “v-shaped” recoveries, since the initial pace of expansion is considerably higher than the long run sustainable growth rate.

The question of what happens to demand in these countries is of course distinct from that of what happens to production. Full employment in parts of the emerging world will probably be

reached before full employment in North America or Europe. Productive capacity therefore would remain to meet further demand from the emerging world, via imports of goods and services from the “old world”. That is, emerging Asia and some other parts of the world could see their living standards rise a bit faster than the increase in their own productivity, for a time, if they were prepared to meet some demand through imports. Facilitating this most efficiently would of course involve, among other things, allowing exchange rates to change.

The alternative approach would be to seek to slow growth in demand in the emerging world as production there approaches full capacity, so as to maintain internal balance at a given set of exchange rates. But that would leave unused capacity in the industrial countries and emerging world living standards lower than they could be. These are polar cases – it would of course be open to policymakers to steer some path in between.

Among Asian policy makers many factors go into thinking about exchange rates and trade and capital flows. They have a degree of suspicion of rapid capital flows and large movements in exchange rates, which is understandable after the experiences of the late 1990s. It is also understandable that the smaller economies, some of which are extremely open, with trade shares of more than 100 per cent of GDP, do not wish to see volatile exchange rates because it is disruptive for their economies. Moreover, the issue goes well beyond just exchange rates *per se*; it involves saving and investment patterns, and national policy approaches to growth, the speed with which these can be adjusted and so on. The point, nonetheless, is that the current and prospective differences in economic circumstances between significant parts of the world are likely to put strains on the relative settings of macroeconomic policies and exchange rate arrangements. This will need careful management, by all concerned, over the next few years.

Conclusion

The stabilisation of financial markets and banking systems over the past year or more is a welcome development for all of us. There are still difficulties to overcome for financial institutions in some key countries as a result of the depth of recessions, and these will be the subject of attention over the coming year. Looking ahead, the differences in the speed of economic recovery are starting to present challenges of their own, showing up as they do in capital flows, asset valuations and exchange rates. When we add to all that the looming long-term requirement for fiscal consolidation in a number of major countries, there is plenty for markets and policy makers alike to think about.

I'm sure your conference will take up these issues with great energy. I wish you every success in doing so.