Malcolm Edey: General economic and financial environment in Australia

Panel session speaking notes by Mr Malcolm Edey, Assistant Governor (Financial System) of the Reserve Bank of Australia, to the Property Council of Australia, Darwin, 25 July 2011.

* * *

I've been asked to speak today about the general economic and financial environment in Australia. I'll leave it to the other panellists to talk more specifically about the property sector.

As you know, the Australian economy came through the recent financial crisis in better shape than most – certainly in the developed world. In fact, what is often referred to as a global crisis was mainly a crisis of the United States and Europe. Those were the economies that experienced the most serious distress in their financial sectors, and they were also the ones that required significant public-sector capital support for their banks. They also experienced severe recessions, from which they are still recovering.

The Australian economy avoided recession, and the banking sector remained in relatively good condition throughout the recent period, though of course it was not immune from the international distress.

The overall dimensions can be summed up in a few facts and figures:

- At the height of the downturn, the US economy contracted by about 4 per cent over a year; the euro area by 5 per cent, and the UK by 6 per cent. For all these economies, it was their most severe recession in the post-war period.
- In contrast, growth of the Australian economy remained positive. It dipped to an annual figure of around 1 per cent during much of 2009, before picking up to a pace that was around trend in 2010. (I note in passing that the most recent growth outcomes are affected by the temporary effects of flooding and cyclone at the beginning of this year.)
- Unemployment in Australia rose only moderately during the global downturn, and has since fallen.
- And Australian banks, in aggregate, remained profitable, although they did experience a decline in loan quality. Loan losses have generally now peaked, and banks have strengthened their capital and liquidity positions since the crisis.

When I'm asked to explain Australia's good performance in this period, I usually attribute it to a mixture of good luck and good management.

Australia was fortunate to have been at a relatively strong point in the business cycle when the crisis hit; and, in the recovery phase, as is often remarked upon, we have benefited from being well connected to the fast-growing economies in the Asian region.

But I think there were also some important areas of good management in macroeconomic and regulatory policies:

- Australia's strong fiscal position allowed plenty of scope for countercyclical action to support growth during the world downturn.
- Monetary policy was well-positioned to cut rates aggressively at the height of the crisis.
- And our financial system has been well served by APRA's relatively conservative prudential approach. Australian banks were held to higher standards than many of their international counterparts, and we've been well served by a prudential regulator prepared to ask banks tough questions about the risks they were taking. The upshot is that, although there was some deterioration in banks' asset quality

around mid-decade, this was nowhere near as pronounced as it was in the US and Europe.

In saying all that, I also like to make the point that the resilience of the financial sector and the real economy are inter-related. The banks performed well partly because the economy itself kept growing; and the economy in turn was resilient partly because there was no major deterioration in the balance-sheet quality of our banks.

One of my responsibilities at the RBA is to oversee production of the half-yearly *Financial Stability Review*, which reports on developments and risks in the financial system (both globally and domestically). I'd like to pick up some of the themes from our recent reports.

The most intense phase of the financial crisis is now some way behind us. It corresponded roughly to the six-month period from September 2008 to March 2009, which was just following the collapse of Lehman Brothers (along with a number of other high-profile failures in the US and Europe).

That six-month period was the period of sharpest falls in world equity prices, and the most serious dislocation in credit markets. Global banks posted major losses, and there was a sharp contraction in trade and output across the US, Europe and Asia.

Since then, financial conditions have generally been improving, along with the recovery in the global economy itself. Global economic growth has picked up to a strong pace overall, led by China, India and a number of other economies of the developing world.

In the most heavily crisis-affected countries, indicators of financial sector performance have improved across a range of fronts:

- Banks have generally returned to profitability
- Asset quality in the banking system has begun to recover
- Equity markets have recovered from their early-2009 troughs
- And conditions in credit markets have improved.

These are encouraging signs, but they certainly don't amount to a return to pre-crisis conditions. Loan impairment rates are still high and property markets in the US and Europe are still weak, and these things have contributed to some ongoing nervousness in global credit markets.

In addition to all that there is a particular focus at present on sovereign debt. A number of countries are running with very high levels of government debt in relation to their GDP and large fiscal deficits; and there is obviously considerable focus on the sustainability of those positions and the risk of default.

I'm not going to make any predictions as to how that might evolve, partly because the situation is subject to ongoing change and policymakers in the various countries are still developing their responses.

But I would make two points regarding potential implications for Australia:

- First, the Australian banks have only limited direct exposures to sovereign debt in the countries regarded as being most at risk. So potential effects on Australian banks' overall asset quality are not an issue.
- A second channel of possible effect would be if there were some generalised disruption in global wholesale funding markets. Here it is important to note that, in the post-crisis environment, the Australian banks have significantly strengthened their positions. They have increased their reliance on domestic deposit funding, lengthened the average term of their wholesale funding, and correspondingly reduced their reliance on short-term wholesale debt. These changes will help to

make them more resilient to any disruptive event in international credit markets, should it occur.

Let me make a few more general remarks about the Australian financial system in the current environment.

I've already made the point that Australian banks came through the crisis in good shape. Bank profits did decline during the downturn but they have since recovered, largely as a result of declining loan loss charges. Arrears rates in some areas have continued to creep up, but asset quality generally remains good (especially by international standards).

Despite the uncertainties about Europe that I've already referred to, conditions in funding markets for the Australian banks have improved since the crisis, and so has system-wide growth in deposit funding. Domestic securitisation markets have been recovering. These developments have helped smaller lenders to regain some of the market share lost during the crisis period.

Aggregate lending by banks has been relatively subdued in the past few years. Lending to the housing sector has continued to expand, but at a slow pace, while business lending has tended to fall, with businesses relying more on internal funding and equity raisings.

These trends have reflected several factors, not least of which has been a shift towards greater financial conservatism by households and businesses. Household saving rates have increased, and there has been widespread de-leveraging by businesses.

I expect this audience will be interested in the likely environment for lending by banks in the future. The trends I've just described can be seen (at least in part) as responses to the lessons drawn from the crisis – by households and businesses – regarding the dangers of excessive debt. Another factor is that the funding environment for banks has been more difficult than it was before the crisis, and this has raised the net cost of financial intermediation. To some extent, these effects might be expected to fade as economic expansion proceeds and confidence in global credit markets improves.

Nonetheless, when we think about what the post-crisis environment might look like further ahead, it seems unlikely that we'll be going back to the days of consistent double-digit growth in lending that we saw in the pre-crisis years. That growth was driven in part by factors that can't be repeated – the deregulation of the financial system in the 1980s, and the transition to low inflation in the 1990s. There was also a world-wide trend towards greater appetite for risk and leverage.

In the post-crisis environment, borrowers and investors are more cautious than they were, both at home and abroad. That's likely to mean less demand for leverage and more reliance on equity funding, even when the economy itself is growing strongly. If those trends continue, I think it will be good for financial stability, but it will also mean that our lending institutions have to get used to lower rates of expansion than were typical in the pre-crisis years.