Don Abel: The economy, uncertainty and institutional response

Speech by Mr Don Abel, Assistant Governor and Head of Operations of the Reserve Bank of New Zealand, and Mr Steve Gordon, Head of Risk Assessment and Assurance of the Reserve Bank of New Zealand, at the Oceania CACS 2012, Wellington, 10 September 2012.

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The assistance of Bernard Hodgetts, Tim Ng and Mike Hannah in drafting this address is gratefully acknowledged.

The events of the past decade have been extraordinary.

Prior to the Global Financial Crisis (GFC) a western-based consensus, built around unfettered markets, in particular financial markets, allied with a commercial emphasis on the maximisation of shareholder value, dominated the evolution of developed economies. For many years this prescription seemed to work but some inherent flaws were revealed by the sudden collapse of financial markets in 2007–08 and the subsequent fall-out that we are continuing to experience today.

To remind ourselves of what happened is to provide a basis on which lessons can be drawn to improve our collective futures. As risk managers you need to be aware of these lessons that may directly affect your institutions and which you can reference to calibrate your responses in these uncertain times.

From the early 2000s there was a build-up in a number of troubling factors.

First, from the early part of the decade onwards credit began expanding in numerous countries at double-digit annual rates. Much of the credit growth was to households and coincided with a rapid increase in house prices along with a significant increase in debt burdens within the household sector. At the same time, there was a significant deterioration in lending standards in many countries as financial institutions attempted to sustain the growth in credit.

Second, financial risk management practices were adopted which, in hindsight, proved to be quite ill founded and based on a naive understanding of the underlying risks. The packaging of sub-prime loans into highly-rated residential mortgage backed securities in the United States, in an attempt to reduce risk through diversification, is the best example. When the United States housing market later weakened, investors holding these securities were exposed to risks they (and the agencies that had rated them) never thought existed.

Third, underlying fiscal imbalances in many countries continued to worsen. Many governments ignored the reality of longer term fiscal pressures associated with ageing populations and growing income inequalities leading to increased health and social security spending. Later decisions to support economies and financial systems in the wake of the GFC would further stretch fiscal positions.

Fourth, global imbalances were also continuing to worsen. While the causes of these imbalances are complex, the lack of fully flexible exchange rate regimes in some countries was undoubtedly an aggravating factor. Large and growing current account deficit countries in many western economies were mirrored by large and growing current account surpluses in other countries such as China. These surpluses then formed the basis for much of the financing of the debt-fuelled imbalances occurring in the western economies.

Surprisingly many of these phenomena were largely ignored by policy makers, until it was too late to intervene. The financial institutions and rating agencies that were meant to monitor and price for risk proved to be more interested in short term profits and management bonuses. Governments were reluctant or unable to take the longer view in terms of their fiscal positions. The regulators in western developed economies displayed a notable

reluctance to take action at an early point when it might have made a difference. In the end the inevitable financial crash occurred and governments around the World were left to pick up the pieces and the taxpayers the tab.

What the financial collapse revealed was a world economy that was "seriously imbalanced". On the one side stood the western developed economies whose societies had expanded debt, both private and public, to maintain and lift living standards. While, on the other, the newly emerging economies, benefiting from globalisation and the low cost production of manufactures, had recycled their earnings as savings to the western economies. For most of the 2000s this apparently mutual beneficial relationship persisted, but eventually it unravelled as a substantial part of the debt accumulated in the developed countries turned out to be unserviceable.

The pressures of rapid growth in the developing countries were also becoming apparent. Oil prices started to rise rapidly from a low of around $20 a barrel in 2001 to a peak of $140 just prior to the GFC. Currently the price of oil is around $100 a barrel. This represents an ongoing weight on economic activity that did not exist at the opening of the 2000s, despite the fact that the World is in a period of low growth.

There was also strong growth in non-oil commodity demand and prices. Hard commodities, like iron ore, coal and industrial metals were sucked into China and other East Asian economies to fuel industrial development and urbanisation. While soft commodities, like dairy products and meat, experienced substantial volume and price increases as the rapidly growing middle classes in the emerging countries, with rising incomes, shifted their eating preferences towards protein-based diets. The currencies of commodity producing nations became in-demand, appreciating in value as capital flowed into them, creating problems for import competing industries and, in some cases, exporters as well as the control of domestic monetary conditions.

When the financial collapse occurred it was sudden, and sharp, and unprecedented in the post-Second World War era. Global financial institutions, big names, were wounded, some fatally, others less so. Some required bail-outs from governments. Financial markets were in turmoil, unable to distinguish between potentially "good" names and potentially "bad" names and, for a short period, the flow of money in the world economy practically stopped. Even small financial markets like in New Zealand were caught in this maelstrom. In concert with other governments around the World, we were forced to take action to safeguard our domestic-based financial institutions.

The difference for New Zealand, though, was that the vast majority of the growth in financial assets was held on the balance sheets of the four large Australian owned banks. Rather than on-selling mortgages or transforming their risk through complex financial derivatives, New Zealand's domestic banks had supplied plain-vanilla financial products and avoided an excessive leveraging of their capital.

Furthermore, lending standards in New Zealand, at least within our banking system, had generally remained sound. But within parts of our non-bank deposit taking sector – most notably the finance companies – New Zealand experienced its own homegrown example of poor risk management, leading to considerable financial loss for many people. High risk loans made in areas like property development, financed from household deposits, proved to be an unsustainable combination when property markets turned down from around 2007 onwards.

A lesson from the GFC for risk managers is that "innovative financial products" should be treated with a great deal of scepticism. Understanding where the true risks lie and how they could play out when economic fortunes change is paramount.

Another lesson is that poorly managed risks may take years to be realised. The build up of risk on financial institutions' balance sheets, which was uncovered by the GFC, was created over a number of preceding years.

The current situation

The New Zealand economy was not immune to the collapse in World financial markets. As credit growth and commodity prices tumbled, our GDP shrunk through 2008 and in the first half of 2009. But, by the second half of 2009, with commodity prices lifting again, modest growth resumed in the order of 2% per annum. Banks, which had relied heavily on short-term wholesale funding from offshore during the boom, found funding harder and more expensive to obtain. The situation was gradually alleviated following the introduction of a government guarantee for wholesale debt and as funding markets reopened in early 2010.

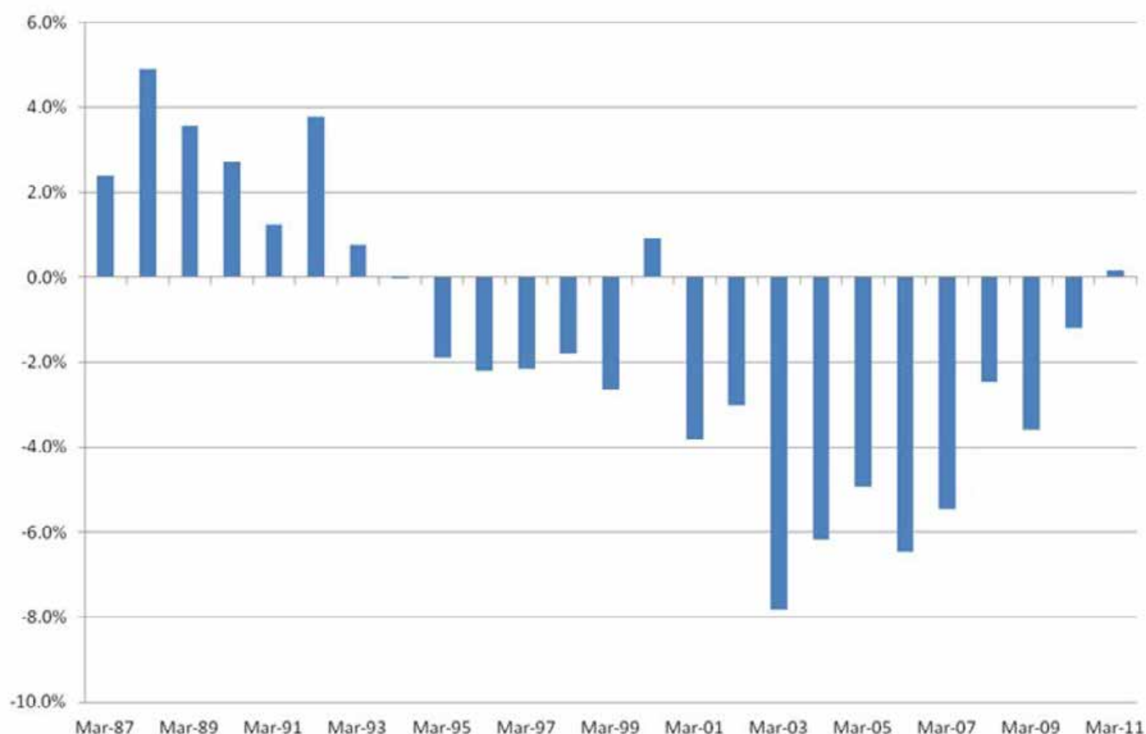
The downturn associated with the GFC, nevertheless, had more long-lasting effects for our businesses and households as inflated property prices were punctured. As noted earlier, many non-bank financial institutions failed with depositors suffering great loss. And, with a high degree of uncertainty about the future, businesses and households preferred to be conservative, reducing debt and spending and avoiding future commitments.

The government sector, on the other hand, faced a prospect of accumulating debt as tax revenues fell and spending demands increased. In the space of five years from 2008 the fiscal deficit as a percent of GDP moved from a positive 3% to a negative 4%.

In comparison, the shift to increasing household saving can be traced in Figure 1 with the ratio of saving to disposable income changing from a substantially negative position in 2003 to a slightly positive one today.

Figure 1

Household saving to disposable income ratio



Source: Statistics NZ

Into this mix another completely unanticipated event fell. The Canterbury earthquakes, centred on the second largest city in New Zealand – Christchurch – caused a catastrophic loss of life, property and infrastructure.

To rebuild Christchurch will cost at the very least $20 billion. While the impetus to the regional economy of Canterbury will be very large, this spending represents a replacement of damaged buildings and infrastructure, not a net gain to national wealth. And, the extent to which the cost is not covered by insurance, it results in a further need for fiscal consolidation at the central government level and increased property rates at the local, Canterbury, body level. In addition, overseas reinsurers are now acutely aware of natural disasters and the cost of property insurance for all New Zealanders has risen across the country with Christchurch and Wellington being especially impacted.

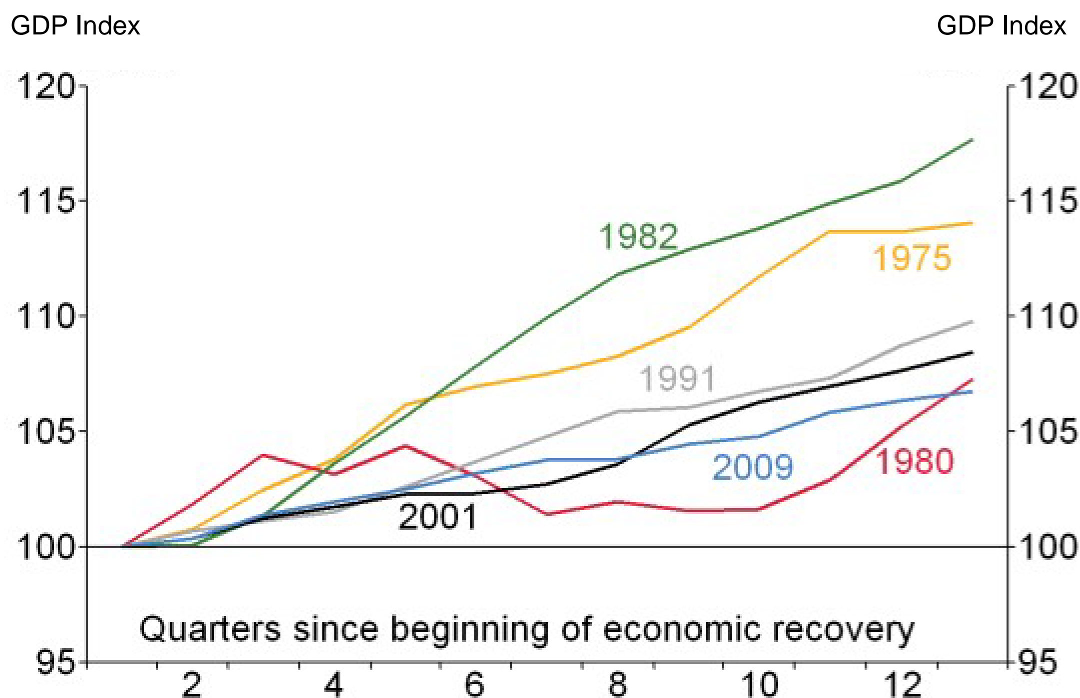
Medium term influences

As the governments of developed countries in the western hemisphere struggled to deal with the consequences of the GFC, their spending and borrowing ballooned causing fiscal deficits to rise at pace. The central banks in these countries also had a role to play by reducing policy interest rates close to zero – "the lower bound" – and embarking on programmes that substantially expanded their monetary bases (quantitative easing) in an attempt to push up domestic demand while depreciating their currencies.

Despite these unprecedented interventions economic recovery in Europe, the United Kingdom and the United States has remained stubbornly subdued. This can best be illustrated by comparing the current path of the recovery in the United States with previous recoveries in the post-war period (Figure 2).

Figure 2

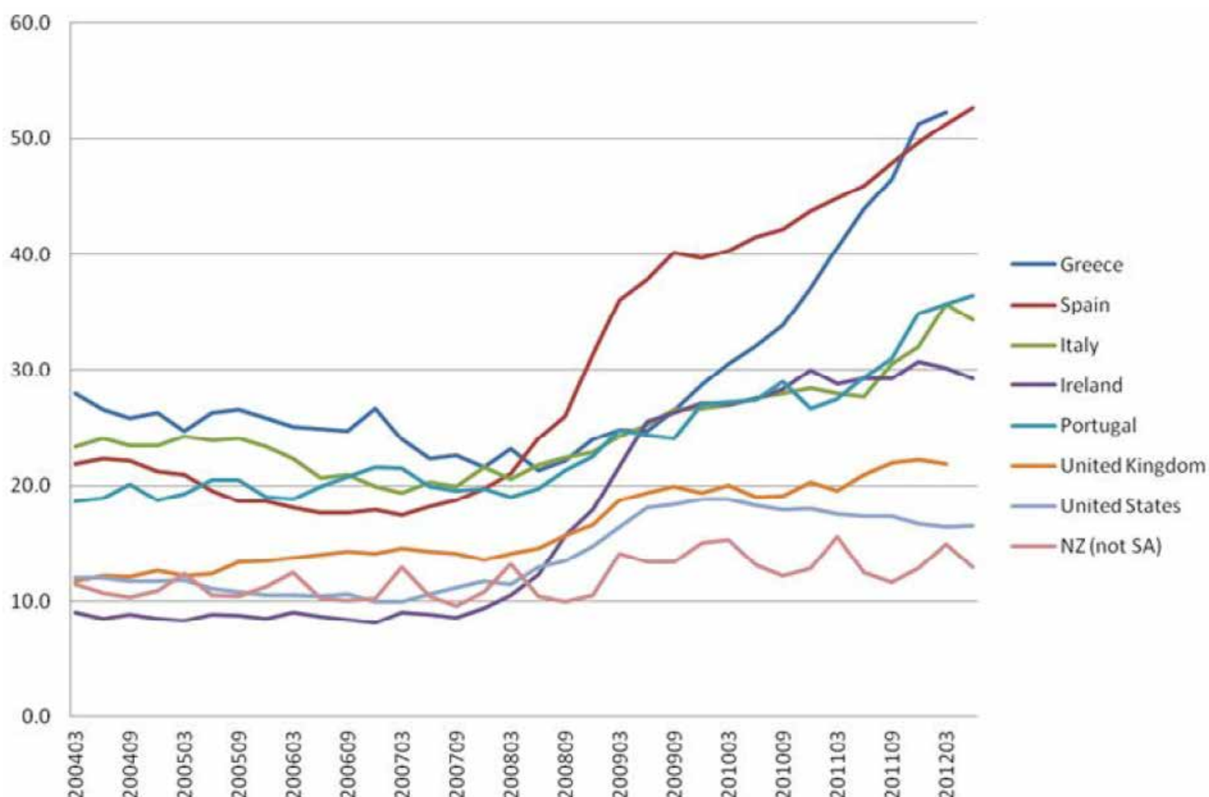
Path of real GDP since end of recession



Unemployment in many of these countries has lifted sharply and, of particular concern is the high level being recorded amongst young people. In Greece and Spain, for example, the rate of unemployment for those under 25 years of age has risen to around 50%. To put this in perspective, the comparable number in New Zealand is 12% (Figure 3).

Figure 3

Unemployment rate: Under 25 (SA, %)



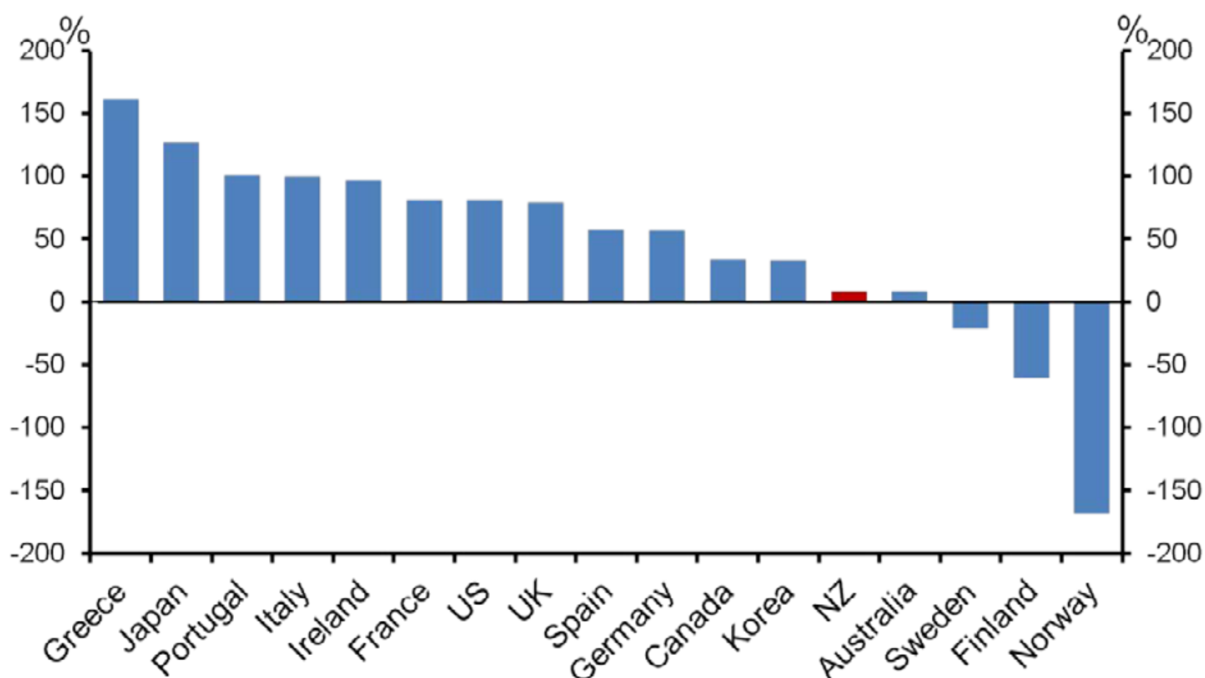
The social and political ramifications of these levels of unemployment in the Eurozone are considerable and weigh heavily on the economic policies that governments are able to pursue.

CPI inflation in the western economies, on the other hand, is largely stable at around 2% and the far more pressing financial issue facing these countries has been the build-up in sovereign debt. As can be seen from Figure 4 a number of European nations, the United Kingdom and the United States all have levels of debt in excess of 50% of GDP.

The sovereign debt crisis has become critical in the Eurozone as the southern, peripheral states of Greece, Portugal, Italy and Spain have struggled to implement domestic economic austerity and structural reform policies aimed to placate financial markets and reduce their debt and borrowing costs. Their individual ability to trade their way to stability and growth has been circumscribed by membership of the Eurozone and consequent adoption of the Euro currency. For at least the past year, the World has watched, in a combination of concern and fascination, as Eurozone governments and the IMF have moved from one crisis meeting to another in the hope of finding a solution that will maintain the integrity of the European bloc but also the economies of the constituent sovereign states. At this point it is not at all clear how the crisis will resolve. What is evident is that the Eurozone as a whole is falling into recession with the weaker southern states pulling the stronger northern states down. While countries within the European bloc undertake much of their trade with each other, lower growth overall is having a dampening effect on World output more generally.

Figure 4

Sovereign debt



Austerity measures are also being pursued in the United Kingdom and the United States. Tightened government spending in combination with restrained business sector investment and household consumption and investment – housing – has meant these economies respectively are not growing or growing only slowly. In the case of the United States the situation is complicated by the November presidential election which has the effect of postponing difficult decisions, in particular how to deal with the impending "fiscal cliff" of expiring tax cuts and increased spending cuts. Together these two policy measures if fully engaged would be likely to push the United States back into recession.

New Zealand's future, however, now resides firmly in the economies of Australia, China and East Asia. This grouping (excluding Japan) today accounts for 49% of our trade compared with 39% a decade ago. And it is this grouping that is experiencing growth rates of 5–6% per annum. Our problem is that Australia is dependent on China while China and East Asia have ties to the fortunes of the rest of the World. The question is to what extent will growth in the Asian economies be affected by developments in the West?

China's high rate of growth, averaging close to 10% per annum over the past decade, has been driven by exports and high levels of investment in infrastructure and housing. Neighbouring East Asian economies have benefited by supplying intermediate goods to Chinese manufacturers. There is no doubt that the low activity now being experienced by the western developed economies will slow expansion in China and East Asia but this seems more likely, perhaps optimistically, to be a relative deceleration rather than a plunge towards outright recession. There is still a lot of scope for China to increase efficiency and productivity as well as investment and its levels of urbanisation and consumption have the potential to expand considerably. What can be assumed reasonably is that the prospects for China over the next 4–5 years will be considerably better than for the Eurozone, United Kingdom and United States.

Within New Zealand the path of recovery from the Canterbury earthquakes has been a matter fraught with great difficulties and much heartache. Nobody anticipated the frequency and severity of the aftershocks that accompanied the February 2011 event. The scale of the

disaster has been enormous and only now as the aftershocks seemed to have dissipated does it appear that rebuilding can begin in earnest. The earlier forecasts of a relatively quick recovery can be seen to have been quite unrealistic as the detail of land use planning, sorting through insurance disputes, coordinating competing interests, providing logistical support and resources has taken over. The path for rebuilding, based on the most recent information available, suggests that activity will start to ramp up from the end of this year, accelerating through 2013 and 2014 before reaching a peak in 2015.

Degrees of uncertainty

Right now the uncertainties faced by decision-makers are unusually diverse and numerous. The World is in the process of transiting to a new order of economic reality, the dimensions of which are difficult to map with any certainty. What is clear, nevertheless, is that choices for policy makers, business leaders and householders can no longer be based on a simple assumption of brisk growth resuming as before and that the economies of the western hemisphere will be in a position to direct economic policy and growth ad infinitum.

With the rapid development of the Asian bloc and India, combined with a lack of access to easily recoverable energy supplies as well as political instability in the Arab states, the World is having to adjust to an environment of high and on-going energy costs. A new easily exploitable resource might be discovered, with a consequent reduction in prices, but this remains an uncertain prospect and definitely not one on which to base business decisions.

The western developed economies, in particular, face multiple challenges and the degree to which these will be overcome in the next five years is far from clear. The volatility seen in financial and equity markets is a symptom of this uncertainty currently most obvious in the responses to the Eurozone crisis. Structures, previously thought inviolable, such as the Euro currency, are now recognised to be vulnerable.

In the banking and finance sectors regulators are tightening standards, imposing new capital requirements and introducing new macro-prudential tools to assist in maintaining the stability of financial systems and the control of credit creation.

Fiscal policy is dominated by a desire to reduce sovereign debt by increasing government savings. On the one side financial markets need to be reassured that governments are able to act responsibly and implement sound, long term, economic policies to promote economic growth, while, on the other, the voting public have to be convinced that the lengthy period of restrained growth that typically accompanies structural reform and fiscal austerity is in their best long term interest. In these highly uncertain times households themselves act to restrain growth by increasing savings and reducing spending. Obtaining the right balance between these factors will largely determine the direction of the western economies with a positive outcome being sustained ultimately by the return of business and consumer confidence leading to investment and productivity growth.

Similar forces can be seen at play in the New Zealand economy. The difference being that the imbalances and structural issues here are not nearly as deep-seated as in many of the western economies. Furthermore, New Zealand has been fortunate to be placed geographically in the eastern part of the Pacific primarily selling soft commodities that are now experiencing increasing demand from Asian trading partners who continue to experience relatively good growth.

The Canterbury earthquakes have proved to be an additional test of resilience for the country and although insurance will cover the majority of the cost of recovery, the process of rebuilding will take much longer than originally thought and may well cost more than currently forecast. The impact of these events on the provision and cost of insurance is now becoming apparent and is reflective of a general review of the insurance cover for natural disasters world-wide. The frequency and intensity of these types of events seems to be on a rising trend creating further management challenges for private and public enterprises.

Institutional response

Institutional language is now coloured by words such as austerity, crisis, collapse, disaster response, instability, volatility, vulnerability and, above all, uncertainty. The GFC exposed the weaknesses of risk management to the World and especially the inadequacy of institutions that allowed their risk management practices to be subverted by the drive for short term profitability. Many of these institutions no longer exist and if they do, not in a form they would have recognised prior to the GFC.

The irony is that despite its lack of strength in the decades building up to the GFC and its ultimate failure, risk management remains absolutely critical to the success of institutions. Furthermore, the incidence of risk means that the enterprise needs to take a long run view of its business not a myopic, short run, approach. Which is a good thing if it helps to make the business operating environment more stable.

The issues outlined earlier in this paper reveal the complexities that private and public enterprises will need to navigate in the future. Possession of a metaphorical radar, capable of identifying obstacles both near and far, should be second-nature to those leading and managing the enterprise. In the current climate effective risk management aligns very closely to the theme of your conference: "Embracing uncertainty and delivering value in turbulent times".

As risk professionals you must systematically identify the key areas of risk for your institution and develop a built-in resilience and ability to respond to whatever happens. Anticipation and not the "ambulance at the bottom of the cliff" is required. In Table 1 some key risks are set out. Your challenge is to interpret these macro developments and translate them into tangible business meaning.

Table 1

Areas of Focus

Risk Themes	Key Points and Area of Focus
Global economic and political	• High and volatile energy costs • Sovereign debt and austerity issues • Fragility and interconnectedness of the financial system • Eurozone developments • Credit, funding and liquidity conditions • Rising influence of Asia
Domestic landscape	• Growth • Household and business spending • Exchange rate developments • Property prices • Agriculture sector
Environmental	• Natural disaster preparedness • Business continuity planning
Information technology	• Significant dependency on technology • High impact risk area
Operational risk	• Change and uncertainty increase operational risk • Operational risk is pervasive and relates to many other risks that materialise

The first group relate to global economic growth and relevant questions for decision-makers, who have the ultimate responsibility to mitigate risks, are what does this mean for product demand and prices, cost of production, transport and supply of goods and services? Actually these questions are fundamental to how institutions are run. What is being suggested here is that a bit more thought is given to how events might deviate from what is perceived to be "normal"; what steps should be taken in settled times to ensure the future of the enterprise and through doing so the wider role it plays in society.

In our globalised and wired environment the speed at which information is transmitted would suggest that no one should be surprised at the consequences of a collapse of steel prices in China or a deep liquidity crisis in european funding markets. The point in question is to what extent have these types of events been imagined and planned for, sorting the "sheep from the goats". Tools such as stress testing and scenario analysis, if rigorously deployed, can provide valuable insight into the uncertain future and assist in preparing the institution to deal with an existential crisis that may arise.

In terms of the Bank, as you would expect, considerable effort is placed on monitoring and assessing all financial risks as these are of high relevance to monetary policy, our prudential and supervisory responsibilities as well as the management of our $27 billion balance sheet.

The second area noted in Table 1, which is inextricably linked to the first, is the domestic landscape. Growth has been modest and confidence somewhat repressed and there are no imminent signs of a sudden or material positive change to this pattern. In this setting, where there are limitations as well as opportunities, businesses will need to be astute in reading the emerging trends and, in doing so, identifying the risks associated with fulfilling their particular business objectives.

The next area of focus shown in Table 1 is described as environmental. The Canterbury earthquakes served as an unwanted illustration of the power to literally shift the ground on which institutions stood and planned their activities. The consequences are now playing out across many levels, including the fact that the insurance industry was poorly prepared to deal with such a cataclysmic event. Business continuity planning should be well within the frame for risk professionals. Possessing a clear understanding of critical business processes and having made the capital and human investment required to be able to continue operations in the event of a disaster is simply good management.

In February 2011 the Bank established a small satellite office in Auckland so that the time critical aspects of our business, such as the support of financial market liquidity and payment systems, could continue if Wellington was shutdown in a regional disaster. Recently a small internal flood on the Wellington site meant the building had to be evacuated and operations were carried out successfully in Auckland for the best part of a day.

Information technology risk is an area that, no doubt, many of you will be very familiar with. Reliance on technology is immense and consequently the risks inherent in the loss of integrity or availability of systems is severe for most enterprises. Consumers and businesses depend on these systems to operate effectively on a minute by minute, day by day, basis. The potential business loss and reputational risks in not being able to deliver services are considerable and it is surprising that some businesses continue to be parsimonious when it comes to providing sound back-up systems. Of course when it all falls apart they come to central government for help – which in my eyes is as good a measure of managerial recklessness as any other.

The Bank acts as banker to the commercial banks, providing inter-bank settlement facilities and related payment services, so we are acutely aware of our responsibilities in the operation of the New Zealand financial system. Over the past decade we have invested $13m in upgrading and improving our payments infrastructure. As you would expect, across both the audit and corporate risk functions at the Bank, payment system assurance is given considerable focus and is subject to close monitoring.

Operational risk is the final area over which a close watch should be maintained. This risk relates to failures by staff and break-downs in processes, facilities and equipment in daily activities. Operational risk is pervasive across all business processes and, in fact, can be the root cause of a wide range of incidents that disrupt or impede the meeting of objectives. With increasing change and complexity as well as uncertainty, operational risk inherently grows. Mistakes and errors are more likely and institutions need sound policies to reduce both the underlying likelihood and impact.

Operational risk management is quite process oriented and is therefore one area within which businesses can focus on continuous improvement. Incident capture, causal analysis and applying lessons learned from an operational risk event can serve to strengthen the wider business environment. At the Bank we have a system called Proactive Problem Management to serve this purpose. It has been in place for over a decade and it is not about attributing blame but about improving how we do things. It entails line management reporting of incidents and, with the assistance of the central risk management function, finding ways to remediate the situation and, in some circumstances, identifying any wider systemic patterns that may be of relevance.

Although the Bank's Head of Risk reports directly to me, he has an indirect reporting line to the Governor and, with his team and me in attendance, meets with the Governor formally once a month. He also has an independent meeting with the Chairman of the Board Audit Committee at least once a year. He has ample opportunity to talk directly with the Governor or the Chairman of the Board Audit Committee if he feels that is required. Currently we are refreshing our risk model and have developed an embedded enterprise risk management lead community through all of our business units. These people work with the Heads of Departments to identify, assess and manage the business risks. The model is enterprise driven in that it aligns risks to departmental objectives in a context of the over-riding governing mandate for the Bank: the Reserve Bank Act. The model also includes major projects and smaller initiatives and actions that relate to specific risks. By doing so it provides an insight into active risk management mitigations that are underway giving a level of validation as to how resource is being directed towards certain risk areas.

Conclusions

The first half of this paper outlined the extraordinary events that have buffeted the World since the onset of the Global Financial Crisis. As noted earlier there was an inevitability about the financial crash. From a debt perspective western economies had become seriously bloated, and in the absence of any countering force, there was always going to be a day of reckoning as banks in many developed countries fed an insatiable appetite for credit in the pursuit of short term gain.

Better regulation and policy interventions in the future may help to stabilise markets by aiming to reduce excessive and risk-laden decisions. But ultimately it is the people involved in the key roles of institutions that largely determine the future of their enterprises. Accountability, honesty, responsibility; these sorts of well founded values must be present in the culture of institutions if they are to survive in a rapidly evolving and highly uncertain environment.

Risk experts are integral to this process and need to hold true to professional and personal values that instinctively drive judgement and consequent actions in the workplace. As skilled practitioners you should know the points at which proposed courses of action are misaligned to business goals in the broadest sense which include the enterprises' responsibilities to the wider community.

In good institutions there will be sound frameworks and governance protocols to address misalignments and the risk function has the important job of influencing and leading others to make the right decisions.

Uncertainty is a part of life and, indeed, can make life exciting, if not overdone. But Reserve Bank governors generally prefer "boring" and our Governor has been no exception, saying so on a number of occasions. Unfortunately the past five years and the immediate future will certainly not meet that preference.

By accepting uncertainty and looking for explanations of what is happening, you should be able to assist your institutions towards strategies that respond to the unusual pressures that we currently face.

Delivering value in these turbulent times should be second-nature to risk managers.