Philip Lowe: Remarks to the Asian Development Bank – Institute of Global Finance International Conference

Remarks by Mr Philip Lowe, Deputy Governor of the Reserve Bank of Australia, to the Asian Development Bank – Institute of Global Finance International Conference, Sydney, 8 September 2016.

*   *   *

I would like to welcome you all to Sydney to this important conference. It is fantastic to see the Asian Development Bank working so closely with an Australian university, the Institute of Global Finance at the University of New South Wales. It is also very pleasing to see that this collaboration is occurring in this beautiful city. I am sure that you will find this conference stimulating and that you will receive warm hospitality in our city.

The title of this conference is long. Ten words: "Financial Cycles, Systemic Risk, Interconnectedness, and Policy Options for Resilience". It is also challenging. I say this because just below the surface of these 10 words lies a host of complex and difficult issues. The proper functioning of our modern economies depends on us understanding and addressing these issues as best we can. If we get things wrong here, the outcomes can be really bad: our economies will be more volatile, job security will be less and people's hard-earned savings will be at greater risk. The global financial crisis was a powerful reminder of this. So the issues that we will discuss at this conference really matter.

It is appropriate that the discussion is taking place at an international conference, which features distinguished speakers from the region and elsewhere. After all, financial stability is a global issue: instability in one country can ripple right around the world. And many of the reforms to address instability are best accomplished internationally. We can also learn a lot from one another's experiences.

In my remarks this morning I would like to highlight three specific questions that are suggested to me by the conference title and papers. These questions are:

i. How can we make our financial systems more resilient, particularly in a world in which capital flows easily across borders?

ii. How should we characterise and respond to episodes of financial boom and bust – the financial cycle?

iii. What determines the amount of systemic risk we are exposed to, and how can we identify and analyse it?

The positive news is that in each of these three areas much has been learnt since the crisis. The not-so-positive news is that our answers to these questions are still incomplete and, just as one issue is resolved, too often another seems to emerge. I would like to reflect on each of these three questions, highlighting the progress that has been made and offering a few thoughts on some of the work that remains.

Resilience

First, to the issue of resilience.

Looking back at the experience of the past 20 years, I am struck by the fact that large financial disturbances are repeatedly caused by the same factors. Three stand out:

i. poor asset quality, particularly in the area of commercial property development

ii. inadequate attention to liquidity management

iii. the build-up of unhedged foreign currency exposures.

Not surprisingly then, it is these areas that have received the most attention from the international regulatory community. Over recent years, the most extensive of the global reforms has been the Basel III package. This package means that, globally, banks now have more and better-quality capital, so they are better placed to absorb losses. In addition, minimum standards for banks' liquidity management are now more rigorous and transparent. The stronger liquidity standards also help reduce vulnerabilities from foreign currency exposures, by giving supervisors new ways of monitoring liquidity requirements on a per-currency basis. Other reforms have helped increase resilience in other parts of the financial system, including derivative markets and shadow banking.

But the reforms remain incomplete and challenges remain. The last chapter of the Basel III package is being finalised this year. While some of the reforms have helped address the too-big-to-fail problem, there are still considerable challenges in developing recovery and resolution plans for the largest global financial institutions. And, in the area of over-the-counter (OTC) derivatives market reform, legal restrictions sometimes still make it difficult to share information across borders.

The Basel Committee and the Financial Stability Board are both reviewing the overall calibration of the reforms. This is essential because with so many new metrics and requirements, we need to ensure they do not interact in unintended ways. Of course, some of the effects that market participants comment on are intended. Maturity transformation has become more expensive. So too, has providing market making services in some financial instruments, generating concerns about a lack of liquidity in bond markets. More broadly, the cost of many forms of financial intermediation across banks' balance sheets has become more expensive. The promised benefit of this additional expense is that the system is now more stable. But we need to keep an eye on this trade-off, because a well-functioning system needs to be able to take risk at a reasonable price.

A well-functioning system also needs to be resilient to the shifting flows of capital across borders. Collectively, global investors can deploy funds on a much larger scale than many markets can absorb without large price movements. In some countries this has led to discomfort with the free flow of capital. But at the same time, access to foreign capital can help drive prosperity and economic development, and allows people to hold more diversified portfolios.

The challenge we face then is to design arrangements that allow us to all capture the considerable benefits that open capital markets can deliver, while minimising the attendant risks. The work on the global financial safety net being undertaken in international policy circles is an important contribution here. One of the questions still to be resolved is how extensive that safety net should be and what form it should take.

The financial cycle

An important theme of this conference is that of "financial cycles". Identifying and understanding these cycles has become an active area both for academic research and policy development.

As a concept, the financial cycle has considerable intuitive appeal. It has long been observed that financial systems seem to be subject to boom–bust dynamics. We have repeatedly seen credit and leverage build up over time in response to some initial impetus, only to generate excesses that ultimately unwind, sometimes painfully.

One question we face is how to define and measure these cycles. It has become common practice to start by looking at cycles in credit growth. But there are limitations here. Not all credit cycles end in a financial crisis; indeed in industrialised economies, only a minority have done so. And in some cases a period of fast credit growth, followed by a period of slower growth, might be exactly what is required, and so should not be viewed as problematic.

This means that we need to move beyond a focus on credit only. In my view, it is probably more useful to start with the question: are balance sheets in the economy being strengthened or weakened? If credit is growing quickly, we need to think about whether the credit is being used to create new productive assets or simply to finance current consumption. The implications are quite different. A protracted period of balance sheet weakening might reasonably be viewed as problematic, particularly if it increases the probability of future balance sheet strains and weak economic growth.

So a research challenge here is to find ways of systematically measuring the quality of balance sheets across the economy, taking into account the myriad influences that are at work. Close analysis and good judgement are both needed to do this.

A related research question is how policy should respond to a systematic weakening of balance sheets. This question is the subject of a lot of research at present, much of it prompted by work at the Bank for International Settlements (BIS). The work at the BIS, though it has focused heavily on aggregate credit as the indicator, has advanced the hypothesis that, in some circumstances, the build-up of financial imbalances may be a better guide to the sustainability of growth in the economy than is the current rate of inflation. Clearly, this hypothesis needs to be tested. If it were found to be valid, it would have implications for policymakers in a number of spheres, including monetary policy, prudential policy and even fiscal policy.

Systemic risk: interconnections and spillovers

Systemic risk is another theme of the conference, and again, a topic inspiring a great deal of academic research, some of which is being presented at this conference. Systemic risk cannot be seen, nor can it be easily measured. So we need to explore a range of indicators. Academic research is helping ensure that we are looking at the right ones.

The aspect of systemic risk that I would like to highlight is the interconnections between banks, firms and countries that lie at the heart of the contagion that can turn a small disruption into something much bigger. In the global financial crisis, when one entity became distressed their counterparties incurred mark-to-market losses on the value of securities issued by that entity. Investors also often started refusing to deal with those counterparties that had – or merely were thought to have – significant exposures to that entity. So, contagion could and did occur because of both direct and supposed interconnections. It can occur even as a reputational effect when two entities or economies are perceived to be similar: once investors have reassessed the risks in one institution or country, they often start to probe similar vulnerabilities elsewhere. We cannot escape the conclusion that greater interconnection is a prominent marker of increased systemic risk.

The global policy response to the financial crisis has recognised the importance of interconnections and built that into the design of regulatory reforms. Some of the design details are quite technical, but their essence is to create incentives against excessive interconnected exposures between banks, or between banks and other parts of the financial system such as so-called "shadow banking".

Contagion is most likely to occur when information is not equally available to all parties. Opacity and a lack of information about exposures were endemic to OTC derivative markets during the crisis, making these markets an important locus of contagion. Following the post-crisis reforms, derivative markets have functioned more effectively. Regulatory mandates and supervisory incentives are resulting in a larger share of derivatives transactions being cleared through central counterparties and more are being collateralised and are therefore safer. Policymakers also have more visibility about financial market infrastructures now that they play a more central role in financial markets. There are, though, some information-sharing issues in this area that still need to be worked out.

One other outstanding issue is how the multiplicity of indicators of systemic risk can inform policymaking, and how one might use the signal provided by an indicator to develop a particular policy response. This is no easy task. The insights of research such as the work presented at this conference will certainly be welcome.

Conclusion: the role of supervision

In all three areas I have spoken about – namely, resilience, the financial cycle and systemic risk – it is easy to focus mainly on the regulatory initiatives. Regulation can be printed, measured and enforced. But history teaches that regulation cannot solve all problems. The financial system evolves, so no set of rules can deal with all risks and problems. This is an important reason why there needs to be a parallel focus on strong and effective supervision. My view is that a strengthening of supervision is at least as important as are the post-crisis regulatory reforms. Rigorous, inquiring supervision that takes a holistic view of the environment is essential to maintaining financial stability and good outcomes for consumers. I encourage you to consider how the research agenda can be expanded to consider how to best balance regulation and supervision.

Thank you for your attention. I wish you the best as you grapple with this difficult set of issues over the next couple of days.