The GFC and Australia

Source: ***Edey (2021)*** **The role of the RBA in Australia's crisis response**

Additional background: Papers by Henry and Tune from 2021 GFC review

Note on sources

Papers commissioned by David Gruen (now Australian Statistician) in early 2019

Purpose: review by former officials of

- Australia's crisis response
- lessons regarding future crisis readiness

Status of review: non-official, but authors given archival access

Authors: Henry (fiscal), Tune (whole of government), Edey (RBA)

Papers completed: Feb 2020 but launch delayed due to Covid

Launch, with Covid postscripts added: May 2021

General themes

- Crisis impact in Australia was less severe than elsewhere
  - no recession
  - no bank failures
- Combination of good luck and good management
- Luck: trade exposure to China, timing of crisis, nature of banking structure
- Management:
  - monetary
  - fiscal
  - prudential

Nature of the crisis in Australia

- Two sources of banking stress
  - asset quality (asset side of balance sheet)
    - remedy: capital injection
  - liquidity (liabilities side)
    - remedy: liquidity support

- Potential interaction between the two
- In Australia, the main vulnerability was on the liabilities side
  - reason: Australia a large net capital importer
  - contrast with European banks
- Hence, important role for RBA in liquidity support
- In addition, GFC was a major business cycle event, requiring countercyclical monetary and fiscal action

RBA risk assessments in lead up to the crisis

- Wallis reforms (1998)
  - Bank supervision moved from RBA to APRA
  - RBA retains focus on system stability (but not individual institutions)
- RBA financial stability assessments reported to Board twice-yearly
- These assessments published (in modified form) as FSR since 2004
- Assessment in lead up to crisis highlighted:
  - general build-up of global risks (associated with <u>search for yield</u>)
  - structured securities
  - domestic housing market and associated debt
- But, overall tone was fairly positive
- Australian and world forecasts were for strong growth, with inflation seen as the main risk

Contours of the crisis

Relevance of Reinhart-Rogoff analysis: zones of vulnerability

Implications for crisis predictability

Vulnerabilities: US subprime, risky securitisation, poor risk management

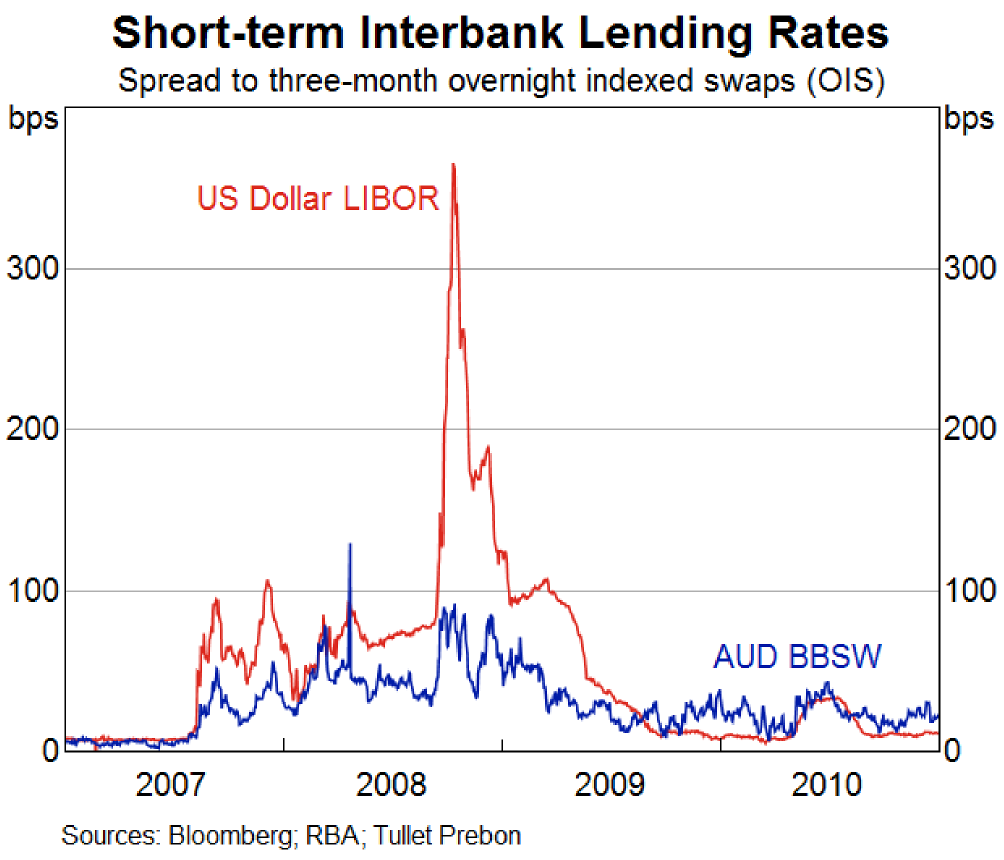
Trigger: collapse of US housing market

Contagion: Interbank exposures, interconnected markets

Feedback: The ‘self reinforcing’ cycle (Bernanke et al)

- These things applied to the crisis as a whole
- But also to each successive wave

Risk metric for Australia



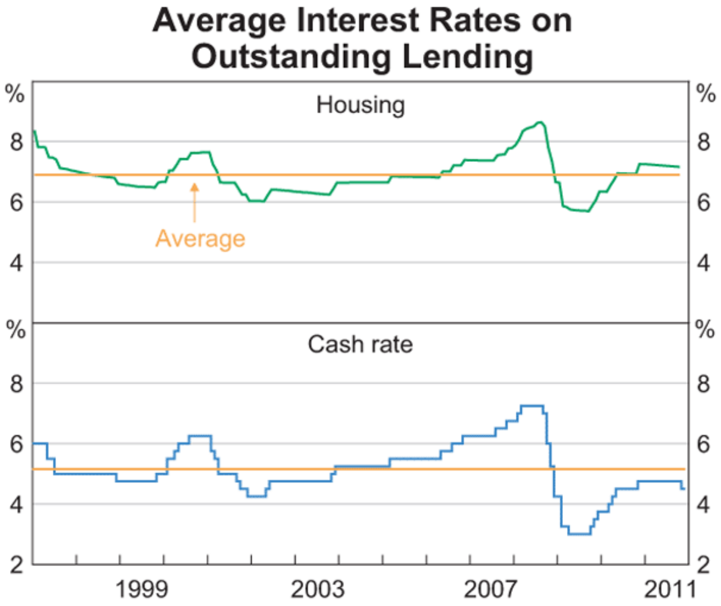
- On this metric, risk perception in Australia less severe than in US
- RBA reports that interbank markets in Australia remained open
- Market stress was correlated with, and caused by, international developments
- As elsewhere, peak stress points were triggered by BNP, Bear and Lehman

Impact on Australian financial system

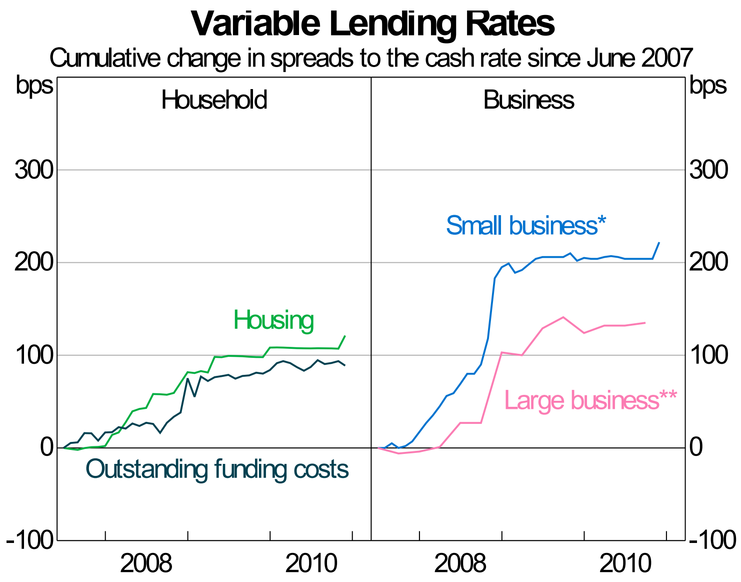
Cost and availability of funding to banks

- Banks faced higher risk spreads when borrowing in wholesale markets
- Risk of outright closure of some funding sources (international)
  - counteracted by RBA liquidity support, government guarantees
- Bank interest rate structure (both deposit and loan) rises <u>relative to</u> the policy rate
- This raised concerns about:
  - effectiveness of monetary policy (‘incomplete pass-through’)
  - profiteering and competition

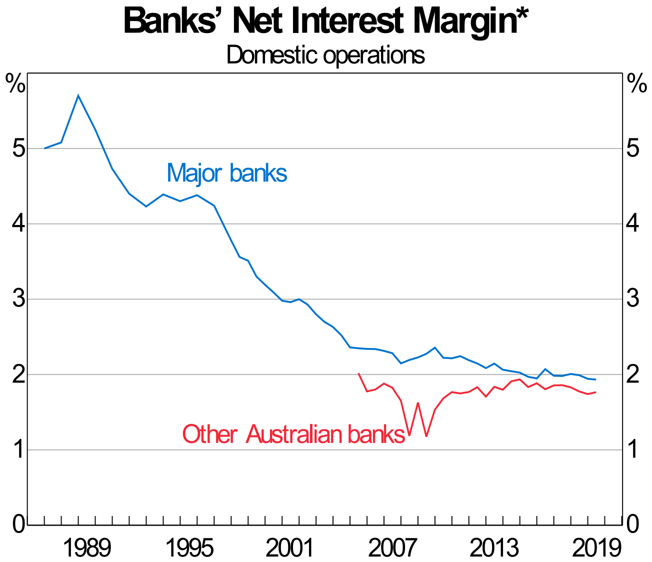
Bank interest rates and margins



Sources: ABS; APRA; Perpetual; RBA



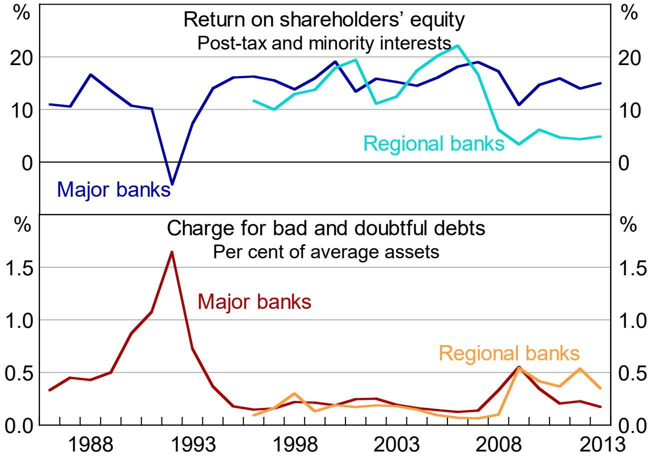
* Indicator rate on residentially-secured term loans
** Average rate on credit outstanding; includes bill lending
Sources: ABS; APRA; RBA



* Data from 2005 are from APRA; data before 2005 are collected from bank reports; data are annual prior to 1998 and semi-annual thereafter
Sources: APRA; Banks' financial reports; RBA

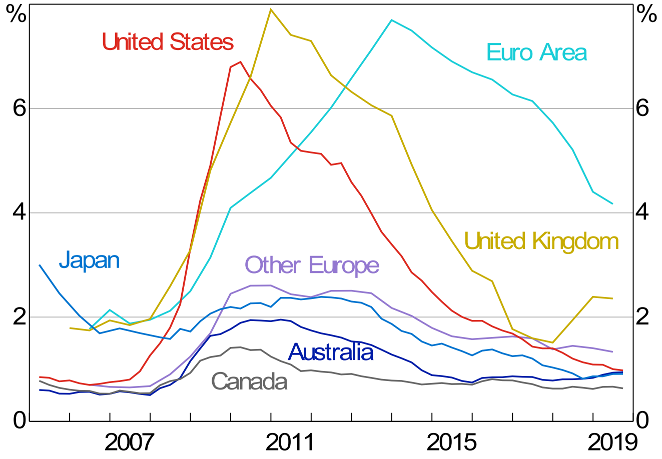
Asset quality and profitability deteriorated …
… but less so than in other economies or in early 1990s

Bank Profitability*
Institutions operating in Australia



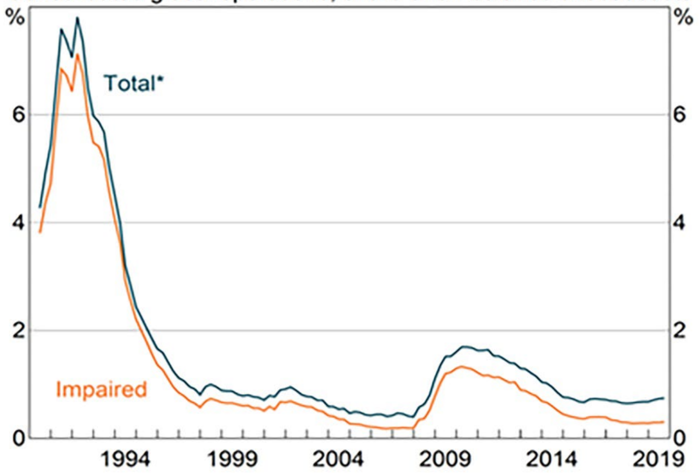
* From 2006 data are on an IFRS basis; prior years are on an AGAAP basis; includes St. George and, from 2009, Bankwest
Sources: RBA; banks' annual and interim reports

Large Banks' Non-performing Loans*
Share of all loans



* Definition of 'non-performing loans' differed across jurisdictions before 2016; number of banks: Australia (4), Canada (6), Euro area (41), Japan (3), Other Europe (10), United Kingdom (4) and United States (19)
Sources: APRA; Banks' Annual and Interim Reports; Bloomberg; FSA; RBA; S&P Global Market Intelligence

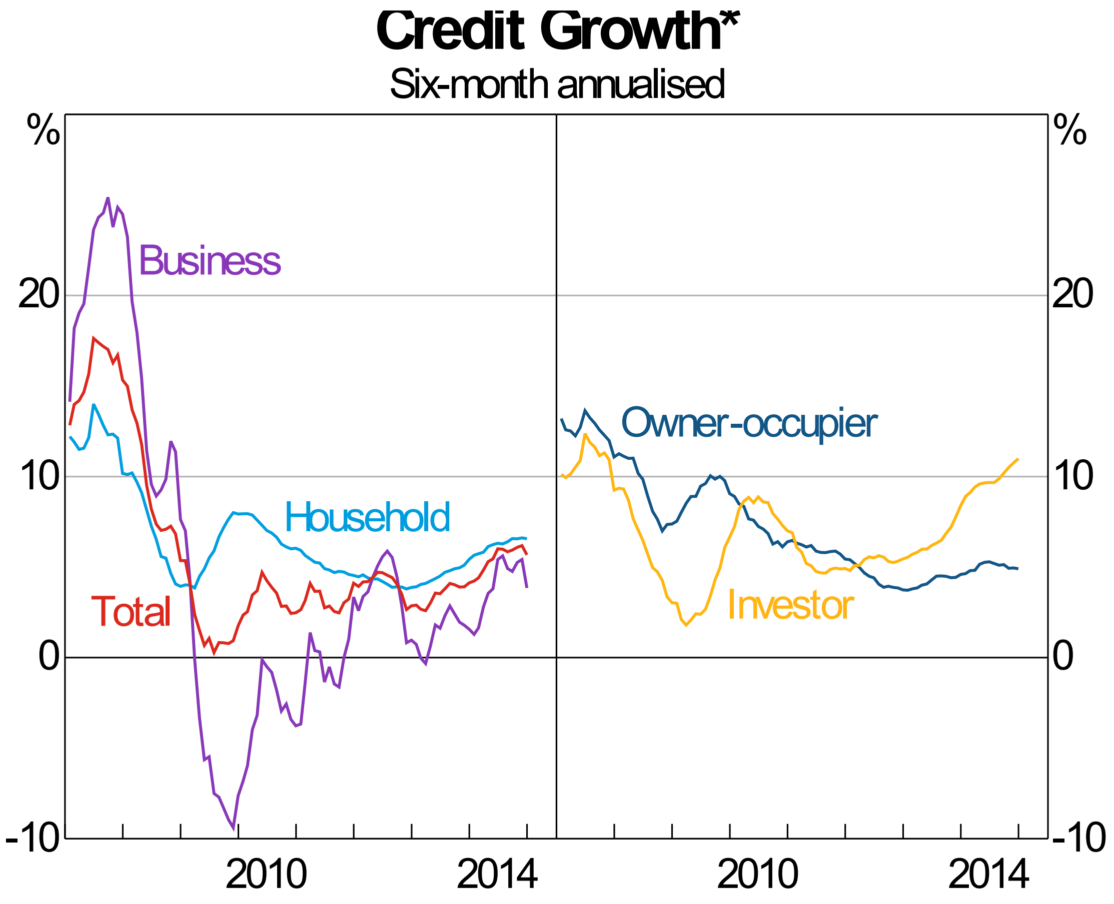
Banks' Non-performing Assets
Consolidated global operations, share of on-balance sheet assets



* Includes assets 90+ days past due that are well secured
Source: APRA

Bank lending to households and businesses …

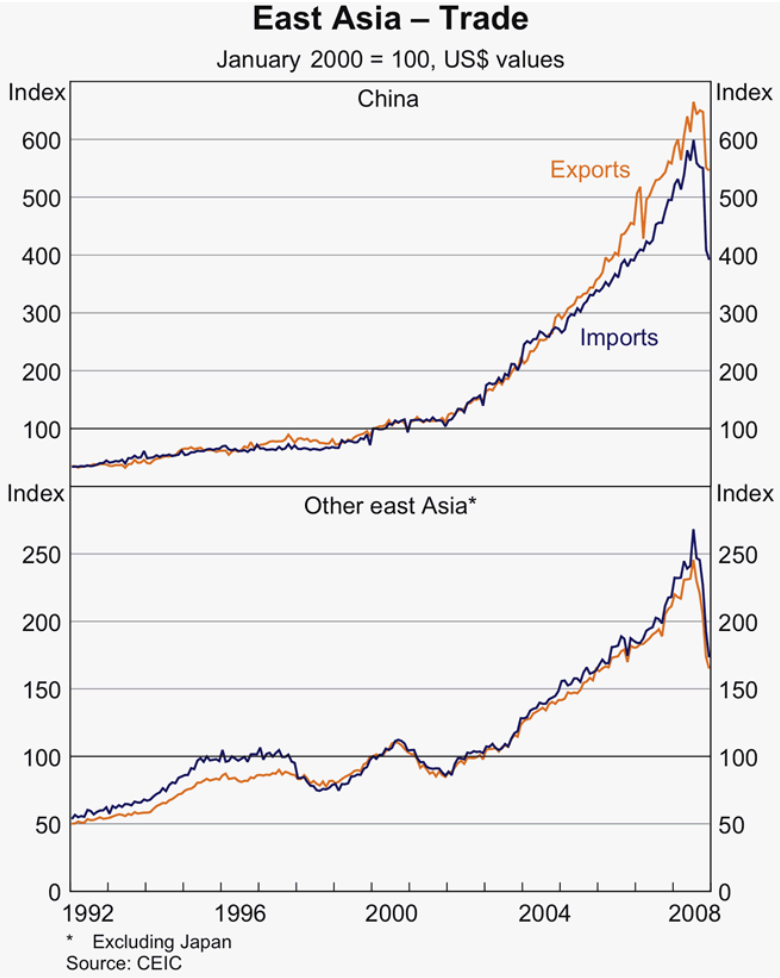
… a retreat from risk



* Seasonally adjusted and break-adjusted
Sources: APRA; RBA

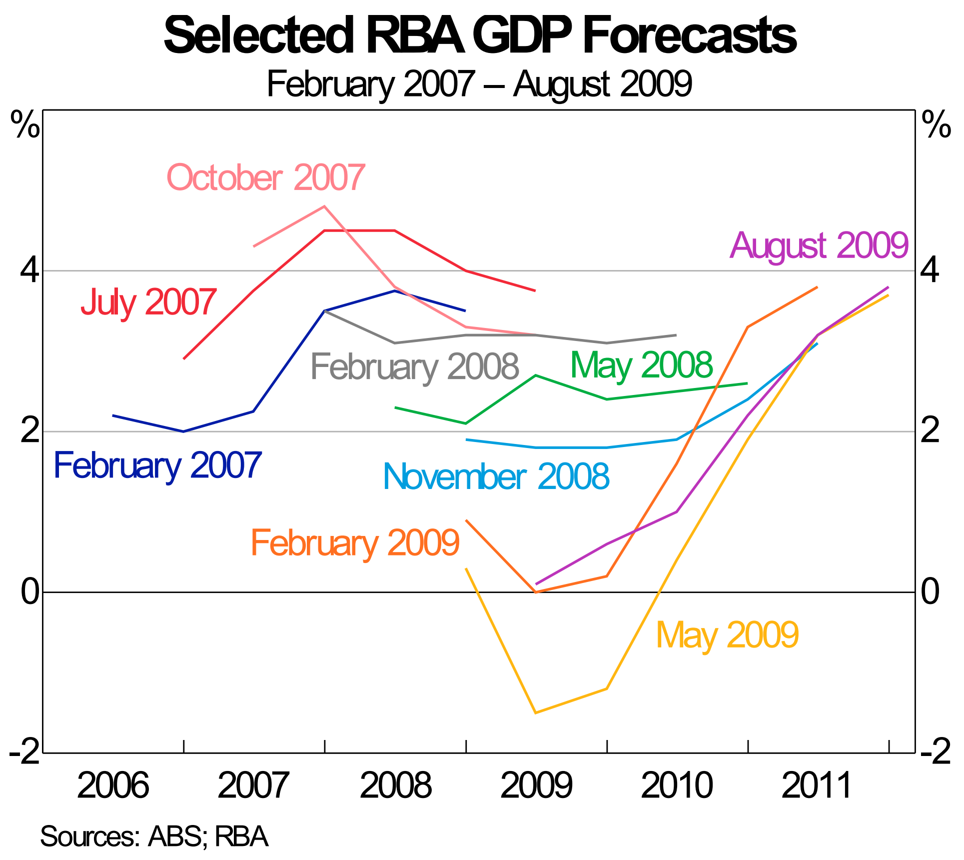
The evolving economic outlook: GDP

- For most of 2007, forecasts were being revised upwards
- BNP to Lehman: moderate downward revisions
- Immediate post Lehman: significant downgrade (but no recession) reflecting expected financial impacts
- late 2008/early 2009: RBA forecasts deep recession, in response to first signs of international impact (see right, from Feb 2009 SMP)



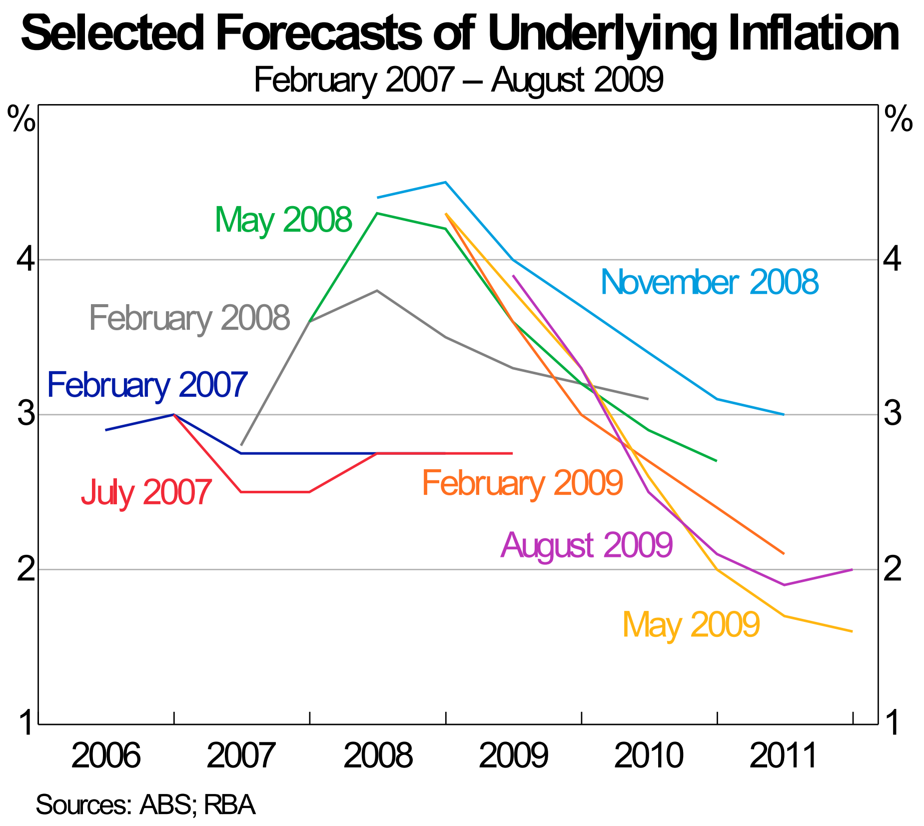
The evolving forecasts

- Feb 2009: IMF forecasts 4 per cent contraction in world GDP
- This turns out to be broadly correct
- RBA forecasts recession in Australia similar to early 1990s
- In the event, this outcome was avoided



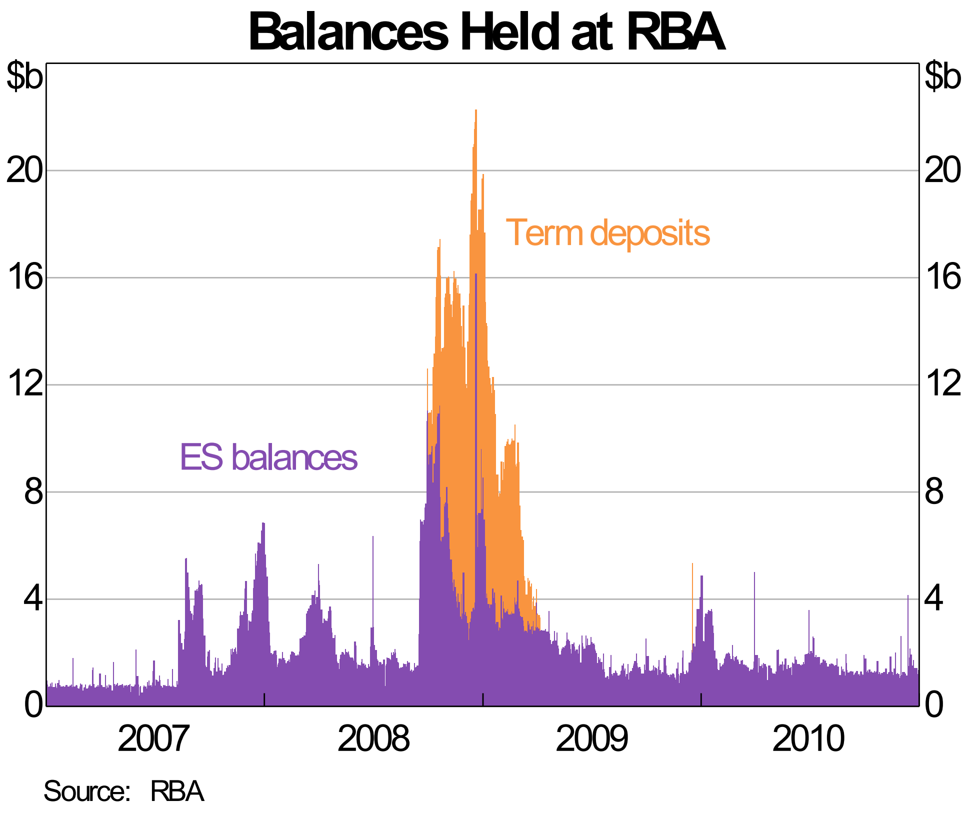
Evolution of the inflation forecasts

- Early 2007 to late 2008: Upward revisions, inflation above target
- This was mainly a response to higher actual inflation outcomes
- Post Lehman: downward revisions
- Mainly a response to <u>expected</u> economic developments
- This assessment broadly validated by subsequent data



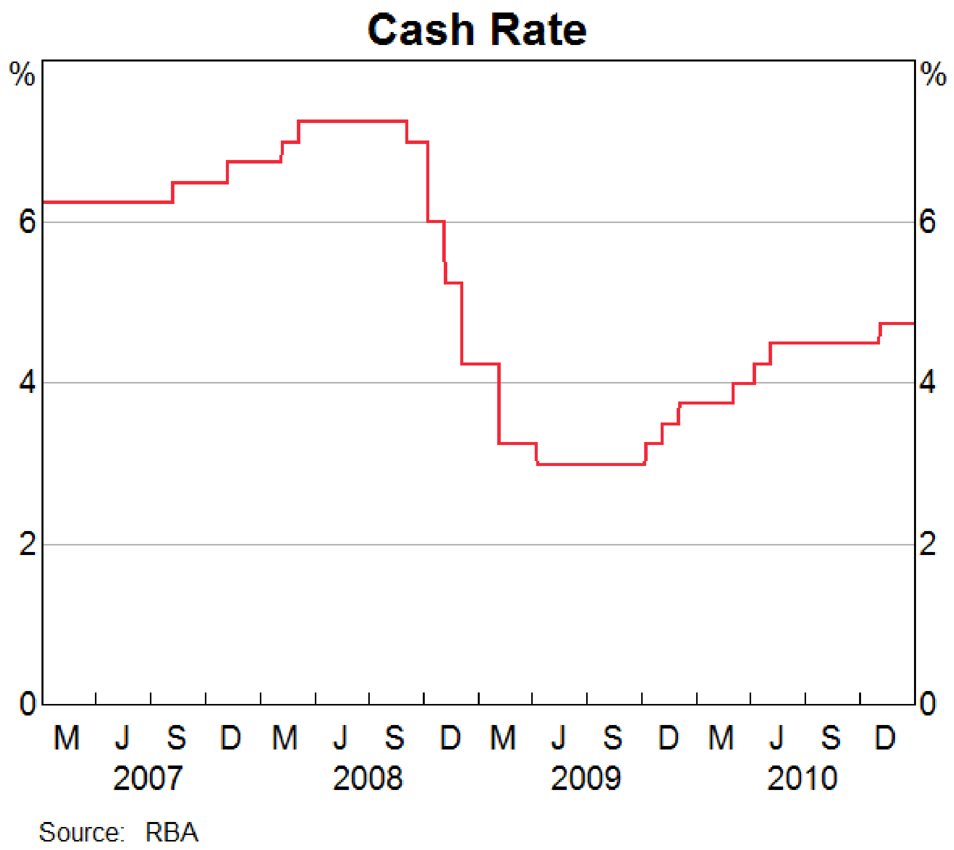
RBA liquidity support during the crisis

- RBA determines the available quantity of bank reserves (ES balances and deposits) through its market operations
- These are conducted via repurchase agreements with banks ('repos')
- In a crisis, demand for reserves rises
- RBA accommodates the demand with additional supply
- Collateral pool expanded to ensure it could not be exhausted



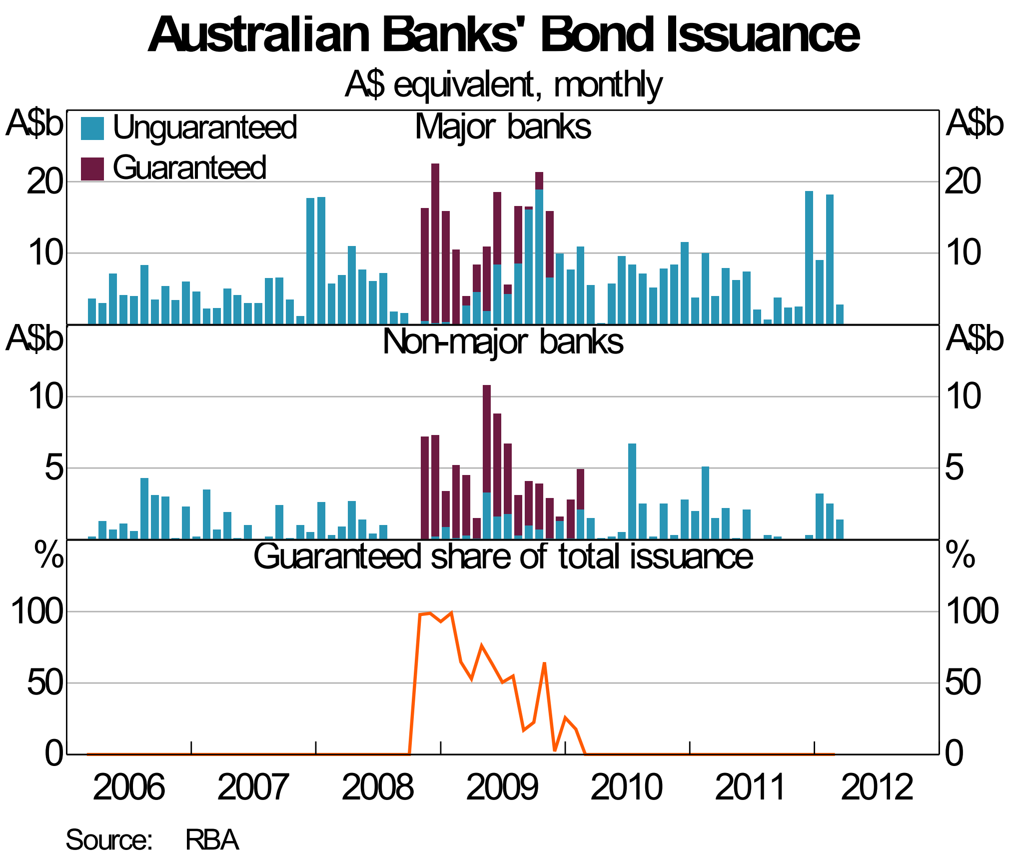
Interest rate decisions

- Phase 1 (pre Bear): domestic inflation concerns predominate
- Phase 2 (Bear to Lehman): a period of uncertainty
- Phase 3 (post Lehman): emergency rate cuts
- Feb 2009 meeting: 100bp cut, same day as fiscal package announced
- Last rate cut: 25 bp May 2009



Immediate aftermath: the RBA and ‘funding pessimism’

- Australian banks are normally large borrowers in international wholesale markets
- These markets dried up during the peak crisis period
- Government guarantees were put in place in many economies as an emergency measure to counteract this
- Cascading effect across countries



Design of the guarantee arrangements in Australia

- Large deposits covered under Financial Claims Scheme (initially, up to $1m per customer per bank)
- Wholesale funding covered, subject to a risk-based fee
- Administered by RBA
- Pricing designed to make the scheme redundant when market conditions normalised (consistent with Bagehot)
- In late 2008/early 2009, virtually all wholesale borrowing by Australian banks used the guarantee
- Scheme closed to new issuance in early 2010

The funding pessimism debate

- Widely held view that that Australian banks were vulnerable to closure of offshore funding access (eg, rating agency assessments, IMF reports)
- Two aspects:
  - currency of denomination
  - availability
- RBA argued that these concerns were greatly overstated, for two reasons
- <u>Effective</u> currency of denomination is AUD
- In the event of reduced access, market forces would bring other funding sources into play
- RBA presented detailed modelling to this effect to CFR
- This debate has now largely faded

Global legacy of the GFC (up to c.2019 - 2020)

- High debt
- Ultra low interest rates
- Explanations for low interest rates:
  - demographic/structural influences on R-star
  - debt overhang
- Policy mix – monetary – fiscal – prudential
- Chronic undershooting of inflation target
- CB framework reviews on how to respond to all this
- Question: has monetary policy run out of firepower?
  - continued debate on the Bernanke menu of policy options at ZLB

Covid postscript (2021)

- Policy makers <u>did</u> find the firepower to fight the Covid-induced downturn, through a combination of **fiscal expansion + QE**
- Some headline-grabbing distractions:
  - 'Modern Monetary Theory (MMT)'
  - Helicopter money
  - 'Financing the government' (note the RBA position on this: QE and fiscal are independent and separable actions)
- Matters of continued debate:
  - role (if any) for monetary/fiscal coordination
  - governance and calibration
  - inflationary risk from Covid-related actions
  - implications of increased fiscal debt overhang

Post-postscript (2023)

- Inflation takes off surprisingly quickly
- Reasons:
  - supply constraints (Covid as a supply shock)
  - Ukraine effect on energy markets
  - Demand stimulus by governments and CB may (with hindsight) have been overdone
- Debate has shifted to inflation control
- The re-calibration problem
- 2023 RBA Review recommends changes in <u>governance</u> and <u>culture</u>, but no major changes in the <u>inflation target</u>