The 2008 Lowy Lecture on Australia in the World

Ian Macfarlane, AC

THE ANNUAL LOWY LECTURE provides a platform each year for an eminent speaker to reflect on some of the major issues affecting Australia and its place in the world. It is one of the ways in which the Lowy Institute fulfills its mission of informing and deepening the public debate in Australia about international policy.

The 2008 Lecture, the fourth in the series, deals with the causes and implications of the global financial crisis which so dramatically and unexpectedly transformed the international economy in 2008. No country, however remote from the world's major financial centres, will be immune from its consequences. It is hard to think of a single area of Australian international policy which will not be affected by the crisis. Beginning with its immediate impact on the international economy, its implications will certainly spread to the political stability of individual states, relations between states, to the global security outlook and even the environment.

We were enormously lucky to have on our own Board of Directors the ideal person to deliver this lecture. Ian Macfarlane AC is one of Australia's most distinguished economists and public servants. He was Governor of the Reserve Bank of Australia from 1996 to 2007. He is a Fellow of the Academy of Social Sciences in Australia and before beginning his career with the Reserve Bank worked at Monash University, Oxford University and the OECD in Paris. He has been a member of the Board of our Institute from its inception.

One of the first requirements for dealing with the financial crisis is to understand how it happened and what we can learn from history. In this reflective and broad-ranging lecture, Ian Macfarlane gives us an important perspective on the past and the present and a valuable insight into what we should now do.

Allan Gyngell
Executive Director

Australia and the International Financial Crisis

Ian Macfarlane AC

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INTRODUCTION

When Frank Lowy asked me to give this lecture the easy part was choosing the topic – what else could I talk about at this time? The difficult part was limiting myself to 30 minutes. So I have had to leave out a lot of important parts of the story. I hope I don't disappoint those listeners who are mainly interested in the bits I have left out.

Until about 30 years ago, most countries maintained an elaborate system of banking regulations that had been in operation since the 1930s or 1940s. These regulations were quite prescriptive, and had many of the characteristics of war-time price controls. For example, in Australia, the Reserve Bank, in conjunction with the government, set the interest rates that each bank could charge its borrowers and pay its depositors on each product. Other regulations laid down how much each bank had to keep on deposit at the Reserve Bank and what proportion of its assets had to be in government bonds. As a result of these restrictions, there was virtually no scope for banks to compete with each other by offering their customers more attractive terms.

As faith in the virtues of competition increased, most developed countries gradually dismantled these regulations, and we entered the era of deregulation. It is important to remember, however, that this did not mean that there would be no financial regulation, only that there would be a different and less direct form of regulation. Banks now have to adhere to the Basel Capital Accords, which stipulate minimum capital ratios, and regulators enforce many other restrictions such as limiting large exposures or related-party lending. Thus, when we talk about deregulation, we really mean lighter regulation that attempts to work within a

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market-based framework, rather than one which suppressed the market signals.

The new era was different to its predecessor in several respects. On the favourable side of the ledger, the competition that it unleashed enabled depositors to receive higher interest rates and borrowers to obtain more credit on better terms. On the unfavourable side of the ledger, it has led to a less stable system in that there has been an increased frequency of financial shocks, crises or bubbles — call them what you will.

FINANCIAL SHOCKS

In my reading of recent history, there have been seven significant financial shocks in the deregulation era up to the end of 2006. I am only including the widely known ones that reached the headlines — some scholars have longer lists than mine. The seven shocks in chronological order were:

1. The Third World Debt crisis of the early 1980s when the world’s largest banks made excessive loans to developing countries which were unable to service or repay them.
2. The Savings and Loan (S&L) crisis in the US in the mid-eighties caused by excessive lending to the construction and development industry which also could not service or repay them.
3. The sharemarket bubble which burst in October 1987 sending stock prices down 20 % in one day (Black Tuesday).
4. The fourth shock never acquired a name, which is unfortunate because it is probably the most important of the seven, particularly from Australia’s perspective. I refer here to the M&A and commercial property bubble that emerged in most countries at the end of the 1980s, and whose bursting

contributed so much to the early 1990s recession. The two extreme examples were the Japanese bubble economy of the 1980s, which was followed by the 'lost decade' of the 1990s, and the collapse of virtually the entire banking system in the three Nordic countries following their recent deregulation.

5. The Asian crisis of 1997/98 which resulted from excessive financial inflows (mainly bank lending) into Asia followed by a sudden outflow. In turn, Latin America, Russia and a number of other emerging markets were affected.
6. The LTCM crisis of late 1998, when the collapse of a single hedge fund threatened the stability of the US financial system and necessitated a collective solution organised by the US Federal Reserve.
7. The 'tech boom' of the late 1990s followed by the bust in 2000 resulting in a recession in the US and much of Europe.

Of these seven crises, four (the first, second, fourth and fifth) were clearly credit events, that is episodes where there was excessive lending to borrowers who were unable to pay it back. Now we have crisis number eight — the current international financial crisis that was triggered by the excesses in the US sub-prime mortgage market. So five of the eight crises have been based on failures in the credit markets, or in more common parlance, banking crises.

Is the current crisis more serious than its seven predecessors? Clearly from an international prospective it is. We have never seen such a freezing up of lending between the banks before, and we have never seen a situation where in the US, the UK and Europe so many banks and other financial institutions have had to be fully or partially nationalised in order to prevent their collapse.

Has it invalidated the model of a deregulated financial system that has

operated in recent decades? Again, from an international perspective, it clearly has. Not only has the system proved to be unstable in itself, it has transmitted this instability to the wider economy and caused major collateral damage. (I use the term in the military, rather than the financial sense). More specifically, it has failed the market test — it has lost its owners, i.e. shareholders, vast amounts of money. It has also greatly reduced the moral authority of the US in international financial affairs, and that of the G7 countries as a whole vis-à-vis the developing countries.

You will notice that I answered both of the aforementioned questions by specifying that my judgement was from an international perspective. I did this because if you based your answer on Australian experience, you would say no to both questions. The current episode is not the worst we have experienced in recent memory, and domestic developments have not invalidated our regulatory approach, although we will no doubt learn much from them and modify the system where necessary.

Our worst financial crisis in living memory was the asset price boom of the late 1980s and its bursting in the early 1990s — the one I referred to as shock number four. In that episode two significant banks failed (both state government owned), as did the second biggest building society, the biggest credit union, three merchant banks, a mortgage trust and a friendly society. A number of iconic companies had to be sold in distressed circumstances, and two of the big four banks made annual losses and had to be recapitalised by their owners. You have to go back to the 1890s to find a worse period of financial failure in Australia.

On this occasion, our banks remain well-capitalised, profitable and not exposed to sub-prime mortgages locally or in the US. Of the top 100 banks in the world

(ranked by assets), only 11 are rated AA or above. All four Australian major banks are in this select company. Mortgage arrears in Australia are miniscule by world standards and most of the corporate sector is moderately geared at less than half the level it was in the 1980s, although household gearing is a lot higher than in earlier eras.

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Clearly, if we had to make a judgement on whether our system was fundamentally unstable, we would have to say we see no evidence to suggest it. That does not mean we will not suffer from world events as we have done in the past, nor that some businesses will not get into difficulty. We have already seen the demise of several highly-geared asset speculators who seem to have fallen over at the first hurdle.

Returning to the international scene, I want to try to answer the question of why this financial crisis has turned out to be more serious than its predecessors. I am not trying to answer the deeper question of what caused the crisis; that would require another speech. A number of explanations have been put forward for the severity of this crisis starting with that old favourite — greed. But greed has always been with us, like original sin. We will have to do better than that if we are to come up with a better system for the future.

My approach is to try to identify an observable excess and then work back to see what forces produced it. The two clear candidates are the degree of leverage in the financial system and the extent of bad loans. To my mind it is the former which was the main culprit, although the latter was obviously also important.

It is now apparent that the degree of leverage (also known as gearing) in the

system was grossly excessive. A modest amount of capital was augmented by extremely large amounts of debt to hold assets of dubious quality. It should not surprise us, as excessive leverage is common to all credit crises, but on this occasion it was more than usually difficult to judge its extent. We knew that, for the most part, the non-financial corporate sector did not take on excessive leverage, nor did the plain vanilla commercial banks, which were constrained by the Basel Capital Accord. But there were few if any constraints on:

- the investment banks;
- the hedge funds;
- the investment banking arms of large commercial banks (think Citi and UBS);
- the off-balance-sheet special investment vehicles of many other commercial banks;
- the private equity industry;
- the property trusts; and
- perhaps most importantly, the leverage embedded in many derivative instruments.

In other words, leverage in the areas we knew about did not appear to be excessive, but it was in the areas we didn't know how to measure with any confidence — what is sometimes called 'the shadow banking system'. As a result, total leverage rose excessively and when doubts emerged about the quality of the assets being supported, the system went into reverse through the very debilitating phase of de-leveraging we are currently going through.

Some may question my emphasis on leverage and say that surely the root cause was the increased quantity of bad loans. My first response is that bad lending is always a part of a credit crisis, and in fact the ratio of bad loans to bank capital was higher in the Third World Debt Crisis than today. Also, the ratio of debt write-offs to GDP was higher in the Asian countries during the Asian crisis than for the affected countries this time. More

importantly, the reason why so many bad loans could be originated and distributed was that there were so many institutions willing to invest in them with borrowed money. The leverage allowed the quantity of bad loans to be expanded — it wasn't the bad loans that caused the leverage.

When the two Bear Stearns hedge funds holding CDOs of sub-prime debt collapsed in June 2007, an event which many would see as the starting point of the current crisis, it was revealed that one was geared 20 times and the other 50 times. I am told that the AIG vehicle that wrote so many credit default swaps, and was responsible for the demise of that institution, was geared 100 times (if anyone could measure it).

Why did leverage increase so much? Because increasing leverage is the easiest way to increase returns in a rising market — what Paul Volcker recently called the 'transient pleasure of extreme leverage'. Why did market participants choose this path? Because there were incentives in the system to chase these returns and to ignore or downplay the risks. The mortgage originators, who were commission agents paid by sales volume and the ratings agencies paid by the promoters of the debt, were two clear examples. But the biggest misdirected incentive was the performance-based pay structures which awarded massive bonuses to the management of financial institutions on the basis of short-term profit results. Annual bonuses in the millions or ten millions of dollars were available to the most successful profit earners, and, of course, were not returnable when the short-term profits were lost in subsequent years. I have already written on this subject in my 2006 Boyer Lectures and in my Sir Roland Wilson lecture earlier this year, so I will say no more at this time.

I said that highly-geared entities ignored or downplayed the risks, especially liquidity risk. It was easy to do so because

there appeared to be an unlimited amount of credit available, and it would always be easy to roll over maturing debt. But this confidence was based on a hidden presumption — that highly-geared positions in illiquid assets could always be funded because those doing the funding (the lenders) would always assume the borrower was a going concern (Paul McCulley). Once doubts began to emerge about whether the borrowing entity was a going concern, the funding dried up remarkably quickly, and doubts then spread to other borrowers. That is the problem we are still trying to unravel. If I have doubts about your solvency, I will not lend to you no matter how high the apparent rate of return is. As Mark Twain put it 'I am not interested in the return on my money, but the return of my money'.

Complexity is also a contributing factor, but there is nothing very complex about most sub-prime mortgages. Also complexity has been around for some time as the LTCM crisis showed. I am reminded of an investment note that once crossed my desk titled 'Fixed income investment opportunities: creating high yielding synthetic commercial mortgage-backed floating rate notes through interest rate swaps'. That note was produced by Salomon Bros. in 1985. I suppose what we should say is that in this episode, complex instruments were sold to the public (rather than investment professionals) on a larger scale than formerly.

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Another factor behind the excessive risk-taking and excessive leverage was the mistaken belief that you should be able to achieve double-digit rates of return on

an investment portfolio. It is true that in the most buoyant periods of the 1980s and 1990s, those sort of nominal returns seemed to be effortlessly achieved, but they should be viewed as the exception rather than the rule. In more normal times such returns can only be achieved by taking very large risks, and then generally only for short periods.

Over long periods of time, the profit share of GDP fluctuates around a flat trend, as does the price-earnings multiple. This being so, for a given degree of leverage, the average return on a diversified investment portfolio should be closely tied to the growth rate of nominal GDP. In Australian terms, at present this means an average return of about 6%. I explained this to someone recently and they said they agreed with the arithmetic and had been waiting for it to happen, but it never seemed to come. Well it has come, and not just in the current bear market.

In the 19 years from 1981 to 2000, real US asset wealth (a combination of shares, bonds and houses) rose at an annual rate of 8%, with shares rising by 10½%. In nominal terms two or three percentage points would have to be added onto these figures. That is what people think is normal, but it isn't. We did not achieve these returns in earlier years, and we have not more recently.

In the preceding 14 years, 1966 to 1980, real US asset wealth rose at an annual rate of 0.6%, with shares falling by 5% per annum.

Similarly, in the five years from 2001 to 2006, real US asset wealth grew by 3% per annum, with shares again declining by 0.4%. If we were to update this figure to 2008, the result would be bigger negatives all round.

We will just have to get used to the fact that long-run returns are going to be a lot lower than we thought they were, based on the buoyant years of the 1980s and 1990s.

So, where does that leave us, and what

should we do about creating a more stable financial system? In the little time I have left I will provide a few preliminary thoughts.

While in the medium-term we will have to move to a wider and stricter system of regulation, the immediate need is to get credit flowing again. We must return to a situation where lenders will be prepared to take the normal commercial risks, without which no economy can function. Thus, there is no point in moving to a tougher regulatory regime until we get the present mess sorted out. For example, imposing higher minimum capital ratios now would be counter-productive.

Minimum capital ratios, as in the Basel framework, have made a useful contribution to financial stability over the years. But their main purpose is to avoid bank defaults, rather than to protect the wider economy from financial shocks. When economic conditions deteriorate, banks can maintain their capital ratios by either raising capital or by restricting (or reducing) their lending. In the interests of the wider economy, it is important that they choose the former path, but their individual self-interest may push them towards the latter. This is an area where some element of collective decision-making is likely to lead to a socially superior outcome than if it is left to individual decision-makers.

The task of regulatory reform will be made easier by the fact that some of the worst excesses of the recent past are being taken care of by the marketplace and the passage of time. The class of institution known as an investment bank is now extinct, the hedge fund industry will probably shrink to a quarter of its former size and the off balance sheet vehicles of commercial banks have disappeared.

When it is time to rebuild the regulatory system, I have no doubt that it will have to be more all-encompassing than formerly, but I don’t see any likelihood of us returning to the old price-control type

of system that we had 30 years ago. To me the major challenges will be to:

- rein in the what is left of the 'shadow banking system';
- be able to measure the aggregate gearing ratio of the financial system and use this as a guide to policy;
- incorporate the risks arising from the reward structure of management into the regulatory framework;
- do something to address the inherent pro-cyclicality of conventional risk management frameworks and systems of bank supervision;
- resist the calls for self-regulation. As one astute commentator observed — 'self-regulation is to regulation as self-importance is to importance';
- bring some of the derivative instruments, particularly credit default swaps, back onto an exchange so we can at least measure their extent and the risks embedded in them, as well as reduce counterparty risk.

We have to concede there was also regulatory failure, particularly in the US. Partly this is a result of their very fragmented regulatory framework, where, for example, there are four different bank regulators, and where as systemically important a set of institutions as the monoline insurers are regulated by a state regulator. But partly it is also a result of insufficient curiosity and scepticism on the part of regulators about what was going on around them. They placed too much faith in 'science' and not enough in history. The best and brightest MBAs and PhDs are still capable of making the same mistakes as their less-educated forebears, but it is now so much harder to keep track of the inherent risks in the products they design, particularly liquidity risk.

Of course there are major macroeconomic challenges to face as well. In this respect, Australia is better placed

than any other OECD country I can think of. Given our starting point, we have scope to move both monetary and fiscal policy in an expansionary direction and to let the exchange rate play its traditional shock absorber role.

There has also been a welcome move towards increased international cooperation as a means of addressing the current crisis, and we all hope, moving to an improved system of regulation. As someone who represented Australia, along with the then Treasurer at the first eight meetings of the G20, I am pleased to see that this forum has been selected for the purpose. To the extent that Australian diplomacy was an important factor in this result, we should be proud. Although it has only been in existence for ten years, (it was a response to the Asian crisis), the G20 is a much better forum than the G7 or G8 who, as I said before have lost a lot of credibility as a result of this crisis.

It will obviously take a good deal of time before the present round of international cooperation brings any results in terms of better regulation, but I am pleased that one of the first things this meeting did was to get agreement that the worst thing countries could do would be reach for protectionist policies. Such a beggar-thy-neighbour approach would be harmful to all countries and spread the problems even to the innocent bystanders. This allows me to finish on one of the few optimistic notes of the current situation, namely that we appear to have learnt something from the lessons of history.

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