

Executive Roundtable and Professional Placements

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Current Assessment:

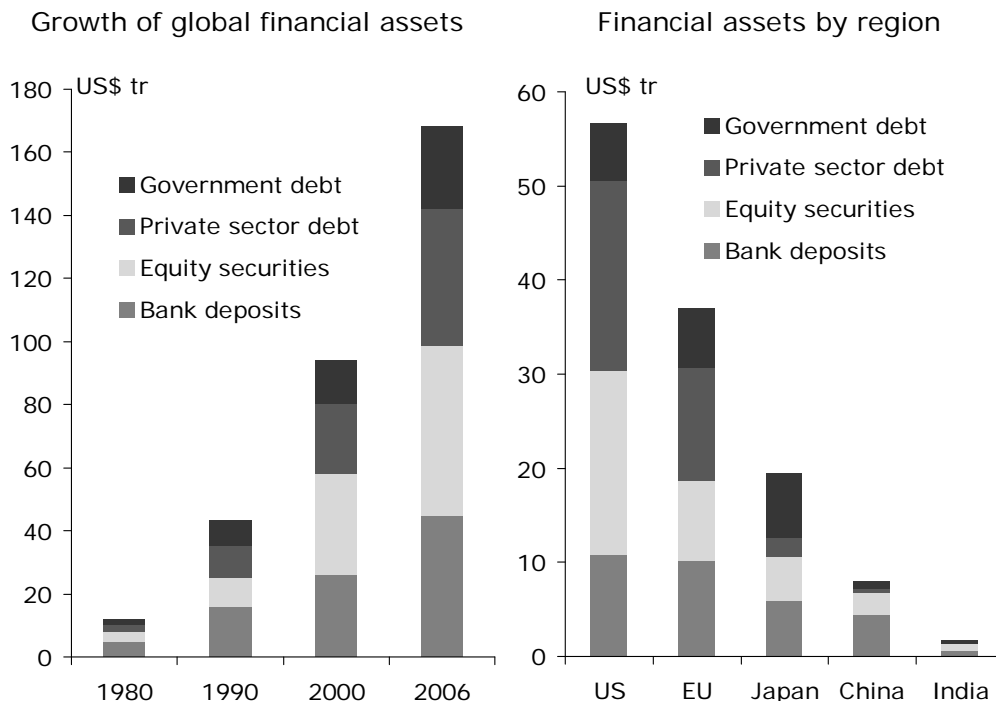
Global / Regional Dimensions of Instability

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Summary of observations

A study of financial instability in the Asia-Pacific region should take into account the lack of development of the capital markets in our region, and its implications. Relative to the rapid economic growth and opening of trade in the region, capital markets growth and cross border capital flows are stunted. Japan, China and India together account for 22% of the global economy, but account for only 17% of the global financial capital stock, of which Japan accounts for 12% alone.



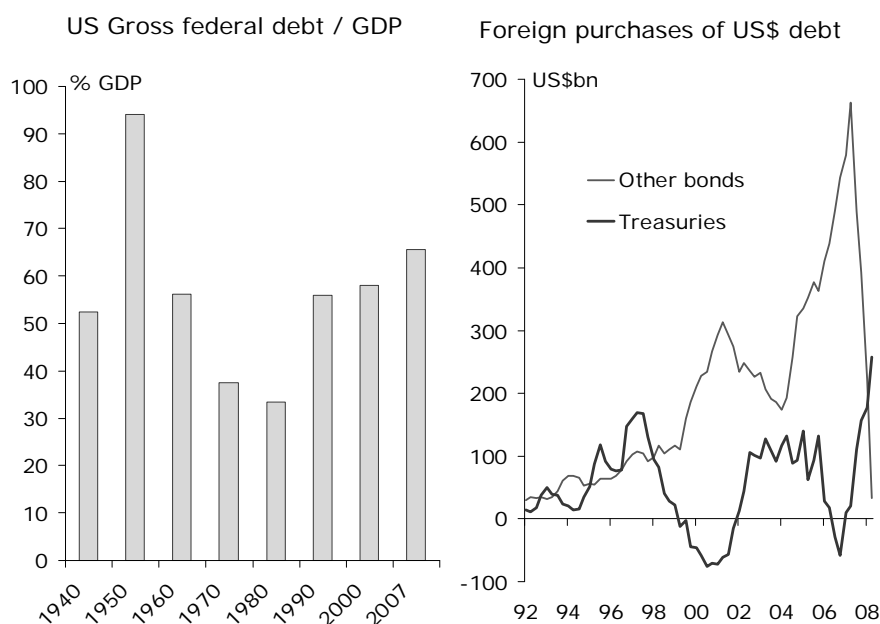
China's position in the global capital markets is an interesting one. China's domestic financial capital stock as a share of GDP is the highest among emerging economies, but is low relative to OECD economies. China's savings rate is also high, leading a much-noted global "savings imbalance". It can also be said that this savings imbalance is exacerbated by the inability of private capital to flow out of China to counterbalance its trade surplus.

Instead, the savings of Chinese citizens are accumulated as foreign currency – mainly US dollars – in the financial system. China's central bank acts as the financial intermediary for the net savings in the system via currency intervention, substituting for the private creditor outflows that would otherwise occur. This leads to a massive buildup in foreign exchange reserves. China has become a global creditor, but an "immature creditor." An immature creditor is one that cannot lend to foreigners in its own currency to finance accumulating current account surpluses (McKinnon, Shnabl BIS 2008). Instead, China "lends" in foreign currency, mainly US dollars.

Though Japan's domestic financial stock is larger than that of China's and its economy is more developed, in many ways Japan can also be considered an immature creditor as it does not lend much abroad in yen. Japan's central bank also has experienced massive foreign exchange reserve accumulation in the past, though the pace of reserve accumulation has slowed in recent years.

The position of the US dollar as the global reserve currency as well as the global funding currency makes it attractive for portfolio investment among immature creditor nations, particularly where the exchange rate has a significant impact on overall monetary conditions. By managing their home currency against the US dollar and using the proceeds to buy US dollar assets, the intermediating official institutions can maintain a favourable currency position on their investments, keep monetary conditions relatively loose and maintain an interest rate "wedge" that holds down domestic interest rates and allows for high levels of domestic investment. Strong investment and low inflation leads the authorities to judge this approach to monetary policy as a success in terms of the domestic economic impact.

Over time, however, this approach to monetary policy has led to an explosion of US dollar denominated debt. McKinsey's estimates that in 1990, there was US\$18 trillion of debt securities outstanding globally, or 70% of global GDP. In 2000, there was US\$36 trillion of debt globally, or 86% of global GDP. As of 2006, this had grown to US\$69 trillion, or 114% of global GDP. Of this US\$69 trillion stock of debt, US\$26 trillion was debt originating in the United States and US\$11 trillion was in US government debt securities. The flow of funds from official institutions in Asia has been mainly aimed at this US\$11 trillion, AAA-rated US government debt market.



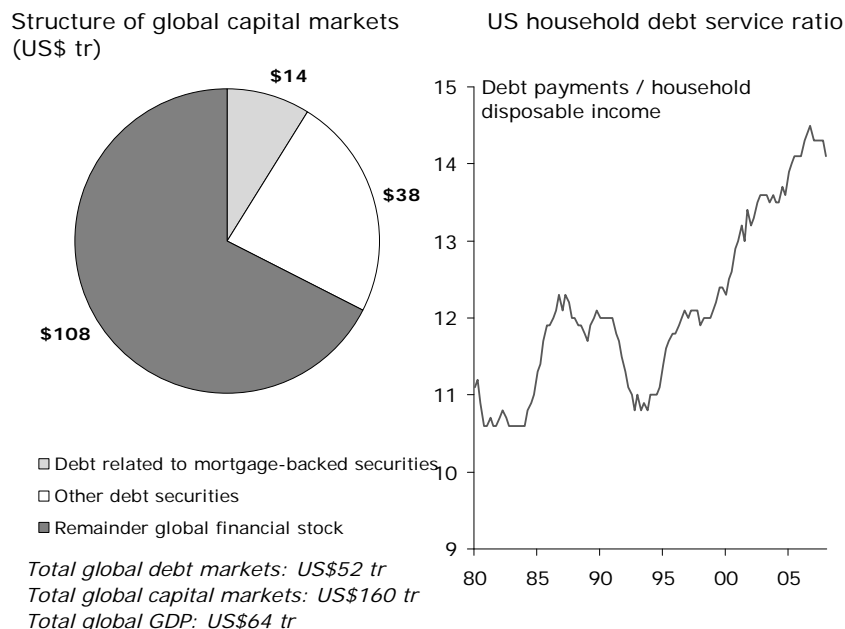
The Greenspan “conundrum” can be directly linked to this flow of investment from official institutions in Asia into US government bonds. Econometric models of US 10-year bond yields find that to 94% of the variation of 10-year bond yields that took place from 2003 until 2006 can be explained by increased foreign holdings of Treasury bonds (Joiner, Bandholz, Clostermann and Seitz).

The decision by immature creditor nations to “lend” to the rest of the global economy in US dollars contributed to the massive building up leverage amongst US households over the past eight years. Rising leverage led to rising asset prices, which encouraged further leverage in a low interest rate environment. The assets held on the books of the top 20 global banks as at end-2006 represented 58% of global GDP, up from 31% in 1996.

Total assets of top 20 global banks (US\$bn as at end 2006)				GDP of top 20 countries (US\$bn at PPP exchange rates, 2007)				Total central bank assets (US\$bn, end June 2007)	
UBS	1,964	JPMorgan	1,352	US	13,844	Spain	1,352	ECB	2,277
Barclays Bank	1,957	ABN AMRO	1,300	China	6,991	Mexico	1,346		
BNP Paribas	1,897	Société Générale	1,260	Japan	4,290	Canada	1,266	Fed	894
Citigroup	1,883	Mizuho Financial	1,235	India	2,989	Korea	1,201		
HSBC	1,861	ING	1,179	Germany	2,810	Turkey	888	BoE	183
Crédit Agricole	1,818	HBOS	1,160	UK	2,137	Indonesia	838		
Royal Bank of Scotland	1,711	Santander	1,098	Russia	2,088	Australia	761	RBA	101
Mitsubishi UFJ	1,579	UniCredit	1,084	France	2,047	Taiwan	695		
Deutsche Bank	1,483	Credit Suisse	1,029	Brazil	1,836	N'lands	640	RBNZ	19
Bank of America	1,460	ICBC	962	Italy	1,786	Poland	621		
		TOTAL	29,272			TOTAL	50,426	TOTAL	3,474
As a % of GDP of top 20 countries									
58%									

Source: 'Top 1000 World Banks 2007' The Banker July 2007, Datastream, Bloomberg, BoE, RBA and RBNZ.

Other factors such as a lax regulatory environment are also to blame for the present crisis, but the impact of suppressed yields cannot be ignored. As of 2006, the outstanding stock of residential mortgage-backed securities alone was US\$14 trillion, as large as the US economy. The US economy is now in the throes of a severe debt overhang.



Although the “savings glut” has long been blamed for generating global savings-investment imbalances, it should be recognised that this imbalance does not occur autonomously. Rather, it is the result of policies that encourage a one-directional flow of investment capital, concentrated in a low-risk, US dollar assets.

The buildup of US dollar debt, and its subsequent unwinding, has led to a sharp depreciation of the US dollar, which reached an historic low of 71.3 for the US dollar TWI earlier this year. The falling value of US dollar debt amidst a depreciating US dollar has become an issue for immature creditors who have a disproportionate level of savings held in US dollars. The currency mismatch between US dollar assets and local currency liabilities on financial institutions’ balance sheet has led to a degree of hand-wringing about the continued appetite for US dollar assets.

In a sense, however, official institutions are unable to move from their present investment positions, as their holdings are so large that sales would only cause further deterioration in existing portfolios. It would also cause their domestic currencies to appreciate against the US dollar, representing a tightening of monetary policy just as global growth is set to slow sharply. It should come as little surprise, therefore, that in the second quarter of 2008, the flow of official foreign capital into the United States covered 79% of the funding of the US current account deficit.

Australia and New Zealand were affected, though to a lesser extent, by Japan’s status as an immature creditor over the current business cycle. The desire of Japanese financial institutions to find yield abroad and diversify from holding US dollar assets has created a

demand for Australian and New Zealand dollar assets that is very large, and can fluctuate quickly. The size of the long position held by retail Japanese investors in Australian and New Zealand dollar assets has a major impact on the Antipodean currencies, and may have exerted downward pressure on interest rates during the peak of the economic cycle. New Zealand's central bank has made the observation that these capital flows made it quite difficult for the RBNZ to feel it had gained control over monetary policy in 2005 and 2006. At the same time, it is important to note that prudential regulation in Australia and New Zealand has thus far proven its ability to ward off systemic risk that might otherwise have resulted from a period of excessive leverage.

Looking ahead

The collapse of the US dollar funding market and prolonged weakness of the US dollar has brought forward some interesting themes.

First, a number of large official institutions in Asia have started to diversify their investment portfolios away from US dollars and toward euros. The Euro area is already "mature creditor," and indeed Germany's robust balance of payments position is helping to support the real economy through this crisis.

For official institutions in Asia to diversify away from US dollars is a prudent investment strategy, but shifting immature creditors from US dollars to euros runs the same risk of artificially depressing Euro interest rates over time and encouraging excessive leverage in the Euroland financial system.

Second, Japan has re-emerged as a potential creditor, with a number of financial institutions tapping into the Samurai market for funding. Perhaps this will contribute to a new equilibrium in Japan's savings-investment balance with other countries, as Japanese institutions are offered an increasing array of yen-denominated, higher yielding securities issues in their own market.

Going forward, the global savings-investment imbalance must be addressed to ensure that we do not have a repeat of the present crisis. The unfolding financial crisis seems to have led some observers in China to wonder about the wisdom of opening the capital markets. Indeed, one of the main differences between China and its neighbours of Japan and India in relation to its status as a creditor nation is that its domestic financial system remains tightly regulated internally, and closed to foreign participation. However, maintaining tight restrictions on global capital flows will perpetuate the impact of the global savings-investment imbalance between China and the rest of the world on mature creditor nations, putting downward pressures on yields of those economies. It will also inevitably diminish the returns realised by the Chinese people on these investments, as yields will flatten and currencies will eventually adjust.

Other major creditor economies may step forward to replace parts of the US dollar funding market in the months and years ahead – continuing a process that in fact began about two years ago. However, there does seem to be a need for additional policy steps

involving the further expansion of domestic debt markets; the prudential regulation of major banking systems; and the development of independent monetary policies in large immature creditor nations.

Supporting the growth in local debt markets may allow for reduced domestic savings through the more efficient use of investment, and a higher rate of return. A recent study by McKinsey Global Institute suggests that if India's capital markets were larger and more oriented to the private rather than the public sector, the rate of sustainable real GDP growth could rise to 9.4%. Similarly, McKinsey's estimates that the inefficient use of savings in China – where savings are now funnelled into bank deposits that are used to invest in inefficient state enterprises – costs 17% of GDP each year.

Policy development should also eventually allow for the increased flow of foreign capital into and out of the economy, so as to enable currently immature creditors to become mature ones. In this way, global savings-investment flows can be intermediated efficiently, so as to help avoid creating dislocations in the capital markets of mature creditor nations.