

Executive Roundtable and Professional Placements

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Session 1, Part 2

Current Assessment:

Global / Regional Dimensions of Instability

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1. Causes of the financial turmoil

- low global interest rates
- the savings glut
- financial innovation resulting from search for yield
- underpricing of risk
- regulatory failures – e.g. inadequate capital in banks' off balance sheet entities.

2. International transmission

- Financial markets in developed economies are closely integrated through the global activities of their banks and financial institutions – e.g. a significant proportion of assets held by European banks were US assets, funded in US money markets.
- Emerging market banking sectors were affected less directly by the sub-prime crisis, but emerging markets were nonetheless affected through channels such as rising price of risk, reduction in international bond issuance, falls in equity prices and unwinding of carry trades.
- The global economy also has been affected by another common shock over the past year – the rise in the oil price – so it is hard to disentangle the effects of oil prices and the financial crisis.
- Many countries have displayed similar economic symptoms – falling business and consumer confidence and slowing GDP growth (with many countries experiencing a negative GDP outcome in second quarter).
- Globally, markets for housing finance have been more affected than those for business finance. Most countries have experienced a sharp slowing in finance for housing.

- A feedback loop may be developing, with the credit crunch leading to declining economic activity which in turn leads to rising defaults which leads to further tightening of credit.

3. Issues for policy

- The response on liquidity support has been fairly uniform. Most central banks have liberalised their provision of liquidity, the range of collateral they are prepared to accept, and the range of institutions to whom they are prepared to provide liquidity. They have also increased the amount and the term of liquidity they have supplied.
- The response on monetary has been varied; some central banks have tightened, others have eased, some have kept rates unchanged. Monetary policy decisions have been separated from liquidity support decisions.
- Many central banks are dealing with the question of how to respond to emerging stress in financial institutions that are “too big to fail”. An important issue is whether the list of institutions that are too big to fail can be reduced by improving the resilience of market infrastructure, such as clearing and settlement arrangements.
- The international regulatory response has been co-ordinated by Financial Stability Forum. It has put forward recommendations to improve regulation and prudential oversight, risk management practices and standards for valuation and disclosure. Another area of reform is the use of credit ratings and the regulation of ratings agencies.
- Priority issues for central banks are the international co-ordination of liquidity provision to globally active banks, and how to co-ordinate responses should a globally active financial institution come under stress.
- There is also a need for better co-ordination of the work of international organisations such as the IMF, the FSF and the G20.