ASIA, AUSTRALIA AND FINANCIAL MARKETS[1]

Address by Mr Glenn Stevens, Governor, to the Asia Society AustralAsia Centre CEO Asia Update Luncheon, Sydney, 18 September 2007.

As you would all be aware, 2007 is the 10th anniversary of the Asian financial crisis. The crisis is usually dated as having begun with the float of the Thai baht in July 1997, though the problems had been building for some time before that. The events of 1997 and 1998 profoundly affected the region's economic growth.

In a speech earlier this year, I reviewed the key events of the crisis.[2] Rather than go over that ground again today in detail, I will address the question of how Asia is coping with the recent distinct change in global financial market conditions, before talking about how the same events are affecting Australia. I want, then, to turn to issues for the future and, in particular, what interests the Asia-Pacific region has in the ongoing efforts to renovate the post-war official architecture of the international financial system.

Recent Financial Events

For a number of years now, many commentators have expressed concerns about the under-pricing of risk in financial markets, with investors increasingly willing to purchase risky assets at high prices and often with considerable leverage. Easy credit conditions accommodated and encouraged these trends.

Over the past couple of months, we have witnessed something of a reversal. The initial trigger was the deterioration in the US sub-prime mortgage sector, itself a result of declining credit standards and a slowing US housing market. Since the exposures to these risks had been spread via securitisation into global financial markets, losses are being borne in most parts of the world, including in Australia and some countries in Asia.

Those losses have been coming to light only slowly, however, in part because the complex and opaque nature of some of the financial instruments in use makes valuation difficult, or even impossible under adverse conditions. In some cases, there simply is no market for, and hence no way of providing an objective valuation of, the claims in question.

In the ensuing climate of uncertainty, investors rapidly have become quite risk averse, and some parts of the global capital market have suffered severe dislocation. In turn, institutions

1 *I thank Vanessa Rayner for assistance in preparing this address.*

2 *See 'The Asian Crisis: A Retrospective', address to The Anika Foundation, 18 July 2007. Available at <http://www.rba.gov.au/Speeches/2007/index.html>.*

that rely heavily on wholesale capital markets, either for balance sheet funding or to securitise assets they have originated, have experienced difficulties. So-called conduits, credit arbitrage funds and various other vehicles often issued short-term commercial paper to fund their assets. This strategy, which was in some cases designed to avoid capital requirements for loans held on banks' balance sheets, can carry significant maturity mismatch and hence funding risk. When investor attitudes changed abruptly in early August, asset-backed commercial paper markets around the world virtually came to a standstill, forcing many of these vehicles to tap lines of credit they had with banks.

This, of course, transferred the funding pressures to the banks. Since there is a great deal of uncertainty about the likely demand on their own liquidity, banks have been conserving liquidity and have been reluctant to commit to lending to others for anything beyond a very short horizon. Institutional investors, which are now in a much more powerful position than a few months ago, have behaved cautiously and are demanding higher yields to accept bank paper. Hence, short-term funding rates have moved higher in a number of countries. In some cases, even overnight rates spiked sharply higher.

Changes in attitude to risk also spilled over to other markets. The difficulties have spread beyond sub-prime mortgages *per se* to include the broader range of instruments euphemistically labelled 'structured products'. As investors have looked for more secure and liquid assets, yields on government securities have declined, share prices have fallen and there has been some significant readjustment of exchange rates. Volatility across a range of markets has increased significantly.

So risk is being re-priced, and strategies that looked like easy ways of making money in good times are being tested. The episode is also a reminder of the key role still played by the core banking system, despite the growth of capital markets. Banks were the first line of liquidity support when capital markets stumbled. For the time being at least, more of the flow of new credit needs to be done on, and to remain on, the balance sheets of the core intermediaries than has typically been the case over recent years. It is helpful, then, that in most countries, those core institutions are profitable and well capitalised, since there may be quite a considerable process of re-intermediation to be undertaken over the months ahead.

Effects of Recent Developments on Asia

There are several potential channels through which these events could have an impact on east Asia. Asian investors could be exposed to the underlying problem assets; Asian institutions and markets could be affected by the backwash of liquidity and funding issues in the major markets; and Asian economies could be affected by broader macroeconomic effects. Let's consider a few of these channels.

At this point, disclosed exposures of Asian financial institutions to the US sub-prime mortgage market *per se* have been limited and look small relative to the total assets of the institutions concerned.

Actually, to digress for a moment, for *most* holders of such exposures, losses should be sufficiently small as not to fatally undermine the solvency of the holder, unless the holder is leveraged. The biggest problem thus far has *not* been that exposures are large, but that they are not transparent. The sooner they are all on the table, the sooner the uncertainty will be lessened and the sooner market participants can discriminate sensibly among their counterparts. This is not easy to achieve given the pricing issues, but at the moment, there is widespread suspicion in the absence of clear information. It would be very damaging for that lack of information to lead to a lengthy period of severely reduced credit flow to perfectly good borrowers simply because investors cannot tell who is sound and who is not. More information is needed.

Against a backdrop of rising global risk aversion and increased demand for liquidity, investors sold off emerging Asian equity holdings in late July, resulting in noticeable falls in share prices (Graph 1). Asian currencies fell (Graph 2). These movements were not especially large, however, compared with numerous others seen over the past couple of decades.

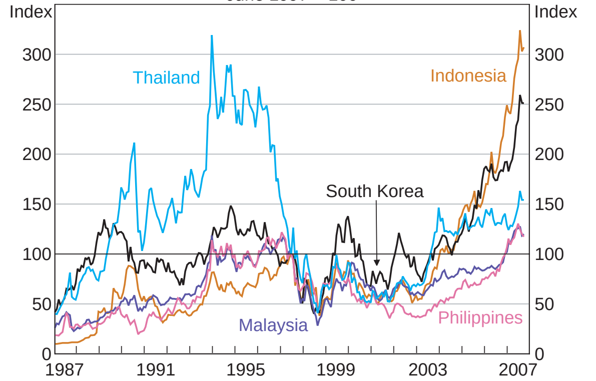
Asian sovereign debt spreads to US Treasuries have risen over recent weeks, though by less than the spreads on low-rated American corporate debt. Indeed, the absolute level of sovereign bond yields in Asia has changed little (Graph 3).

The sharp increases in short-term money market rates in developed countries do not seem, as yet, to have been a widespread feature of emerging Asian markets. There are a couple of reasons for this. Mortgage lending via securitisation plays a relatively small role in most Asian housing finance markets, which means that the region's banks have not had to fund warehousing of

Graph 1

Selected Asian Share Indices

June 1997 = 100

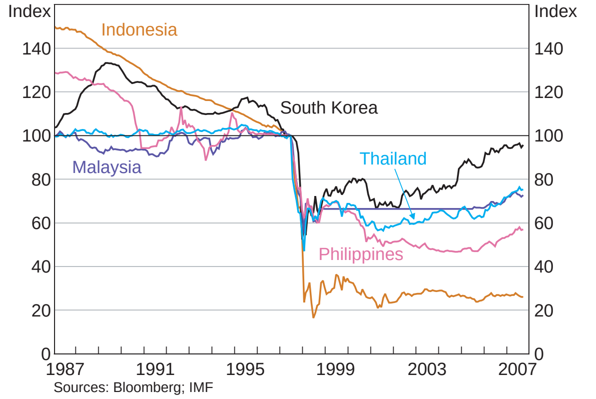


Source: Bloomberg

Graph 2

Selected Asian Exchange Rates Against US$

June 1997 = 100

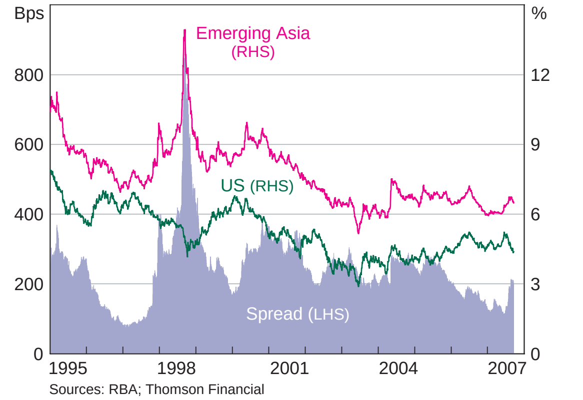


Sources: Bloomberg; IMF

Graph 3

Sovereign Bond Yields

Maturity of 7 to 10 years

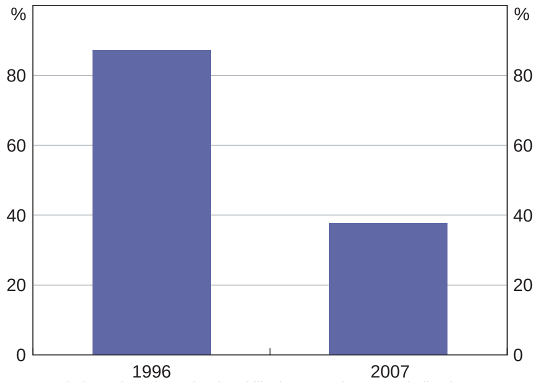


Sources: RBA; Thomson Financial

Graph 4

Selected Asian Countries* – International Credit

Ratio to nominal GDP



* Includes Indonesia, Malaysia, Philippines, South Korea, Thailand

Source: BIS

loans.[3] This, along with the fact that most banks in east Asia tend to rely less on offshore or wholesale sources of funding than many of their developed country counterparts, means that it is unlikely these banks have been under much additional funding pressure as a result of tighter global credit conditions. In fact, foreign bank claims on the 1997 crisis countries in total, as a ratio to GDP, have declined substantially over the past decade (Graph 4).

The rapid growth that we have witnessed in east Asian equity markets may pose a risk. Despite the Asian region being a net creditor, net *private* capital inflows have been positive over the past few years, partly reflecting strong equity inflows. If conditions in global financial markets deteriorate further and risk aversion becomes more entrenched, there is always a possibility that equity capital could flow out of the region reasonably quickly. But Asian equity market valuations are generally not that high, with solid corporate earnings keeping P/E ratios down despite the sharp rise in equity prices recorded in recent years.

More generally, in my judgment, structural changes and reforms to Asia's banking and corporate sectors over the past decade leave the region in better shape than it was a decade ago to cope with any potential problems which may occur.[4] Bank balance sheets are typically stronger, a result of improvements to the quality of supervisory oversight and risk management practices, and reduced fragmentation and government ownership in the banking sector. A range of indicators also point to a healthier corporate sector in Asia.[5] There is also generally more flexibility in exchange rates today. That, combined with the large build-up in foreign exchange reserves, means that capital outflows, were they to occur, could now be handled more effectively than in the past.

Of course, the region could still be affected by international events through the trade channel. The ratio of exports to GDP has increased for all Asian countries over the past decade. While it is true that intra-regional trade has expanded a great deal, it remains the case that a considerable part of this activity is ultimately aimed at delivering goods to outside the region. So a major slowdown in the US economy would still be important for east Asia, the more so if the slowdown also extended to Europe. China is growing strongly, which will help the region

3 *See Chan E, M Davies and J Gyntelberg (2006), 'The Role of Government-Supported Housing Finance Agencies in Asia',* BIS Quarterly Review*, December. Available at <http://www.bis.org/publ/qtrpdf/r_qt0612h.htm>.*

4 *For a discussion of banking systems in east Asia since the crisis, see Turner P (2007), 'Are Banking Systems in East Asia Stronger?',* Asian Economic Policy Review*, 2(1), pp 75–95.*

5 *See Pomerleano M (2007), 'Corporate Financial Restructuring in Asia: Implications for Financial Stability',* BIS Quarterly Review*, September. Available at <http://www.bis.org/publ/qtrpdf/r_qt0709i.pdf>.*

to expand even in the face of weaker conditions elsewhere. But, the Chinese authorities are trying to slow their own economy to avoid overheating. So, Asian nations will need to assess the overall economic fall-out from the current episode in formulating their own policies.

In summary, the impact of the recent tightening in global credit conditions on Asian financial markets has, so far, been reasonably well contained. In comparison with the extreme volatility experienced in financial markets during the Asian crisis, recent market movements are minor.

This is not surprising, really, given that the nature of the shock we are experiencing today is very different from that of a decade ago. In 1997, the epicentre was in Asia, with inability to distinguish between countries resulting in regional contagion. In contrast, the shock we are experiencing today originated in the developed world, with events in the US housing market the catalyst. The relatively lesser degree of international integration of Asian capital markets with the global system has, in this instance, probably been a blessing.

It would appear from this analysis that the main risk to most of the east Asian economies lies not so much in the area of direct financial contagion, as in the ordinary macroeconomic impacts of, potentially, a slower US and world economy.

Effects of Recent Events on Australia

Australian financial markets are part of the global financial system, and have become progressively more integrated over time. This has had many benefits, not least of which has been improved access to global capital markets for Australian investors and borrowers. By the same token, when there are major events in global markets, Australian markets can expect to be affected. Recent weeks have offered a clear demonstration of that fact.

As I noted earlier, international commercial paper markets have had a very difficult time over the past month. For some weeks, outstanding paper was not able to be rolled over, and it was almost impossible for many entities to issue new paper. The same was true for residential mortgage-backed securities. Some Australian entities have been significantly affected by these disruptions.

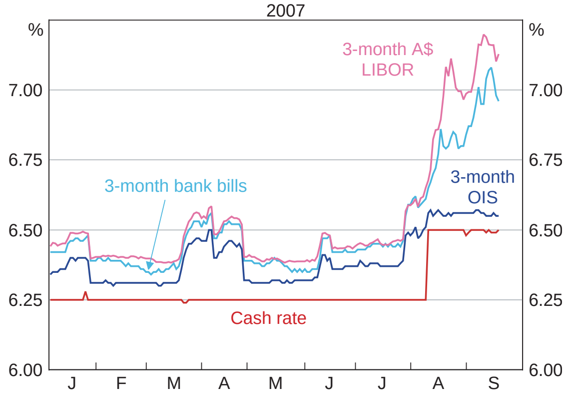
The underlying asset quality in Australia is clearly sound. Loans that could be called 'sub-prime' in Australia are about 1 per cent of the stock of total mortgages, compared with around 15 per cent in the US, and arrears rates on these loans are considerably less than those on US sub-prime loans. The securities backing these Australian loans continue to perform. For the housing loan portfolio as a whole, arrears rates remain exceptionally low by global standards; and for securitised loans in particular, arrears rates have been steady, at about 0.4 per cent, for about the past year and a half.

But at times like this, investors are often unable, or unwilling, to discriminate between different underlying credit risks. In such a climate, issuers have understandably been cautious about offering new paper because of the likely higher cost involved. In other words, uncertainty on both sides led to a drying up of the flow of funds in capital markets for several weeks.

In recent days, there have been some encouraging signs of new credit beginning to flow again. But conditions are still difficult and this may remain the case for a while yet.

Graph 5

Australian Short-term Interest Rates



Sources: Bloomberg; RBA; Tullett Prebon (Australia) Pty Ltd

In the meantime, the same sorts of pressures on term-funding costs for financial intermediaries observed elsewhere have been seen in Australia (Graph 5). International interbank rates for three month A$ loans have recently been about 50–60 basis points above the overnight index swap (OIS) rate (a measure of the expected cash rate). The normal margin is around 10 basis points. Bank bill rates in Australia have been as much as 40–50 basis points above OIS, compared with 5–10 basis points normally. These gaps are smaller than seen in other comparable countries but are nonetheless significant.

It is important to note that this is not due to a shortage of overnight liquidity. The system is amply supplied and settlement balances are, in fact, much higher than normal. The RBA has supplied as much cash as the market requires for the cash rate to remain at the level set by the Board, and that rate has indeed remained within a couple of basis points of the target throughout.

Other rates are determined, as they always have been, by market conditions based on participants' expectations about how the cash rate might move as well as term, liquidity and credit premia. Sometimes, as now, those premia have been known to move. It should go without saying that loan rates are decided by the intermediaries making the loans on the basis of their costs, risk assessments and competitive considerations. The RBA does not set these rates, though we can and do take account of how the margin between these rates and the cash rate alters.

As markets work to re-price risk and individual participants grapple with uncertainty about their own possible future liquidity needs, lending and borrowing have been kept very short-term. The RBA has acted to assist market functioning by extending the pool of acceptable securities for repurchase agreements. The intention of this is to give market players some additional confidence that quality assets can be turned into cash if needed, so they can get on with the job of re-pricing risk. From our point of view, this means accepting a little more private credit risk in our operations, but we have been moving in that direction anyway for years, if for no other reason than that there is no longer a sufficiently large stock of government securities on issue in which we and market participants could transact in volume. Provided the transactions are conducted on proper commercial terms with appropriate margins, we judge these credit risks to be manageable.

Helping financial markets to function as they undergo a re-pricing is, of course, one role of a central bank. But it is also important that we do not lose sight of our other role, of making monetary policy in pursuit of sustainable growth with price stability. From that perspective, we observe that funding costs for intermediaries have risen beyond the adjustments associated with the rise in the cash rate on 8 August. Some borrowers are being asked to recognise this higher cost in the rates they pay for their loans, a trend that will continue if the higher funding costs persist. Hence it appears, at this stage at least, that we may well observe a further tightening of financial conditions in the Australian economy in the months ahead.

In assessing that prospect, the Bank will need to take note of two forces. The first is that, going into this episode, the economy was travelling very strongly, with the outlook for growth and inflation being revised higher over recent months. The data since the August decision to lift the cash rate indicate an economy at least as strong as the Board's assessment at that time, with few signs of that momentum slowing.

The second factor is that the outlook for the US economy has been weakening and will presumably be affected to some extent by the credit market events themselves. It is conceivable that some European economies could be affected as well, given the credit difficulties in those markets. To this extent, global growth, which has continually surprised by its strength in recent years, could, other things equal, turn out to be a bit weaker than expected a few months ago.

Given the macroeconomic situation of the Australian economy thus far, some additional restraint would perhaps not be unwelcome. But just how much such restraint will occur as a result of a market tightening in credit conditions is not yet clear. Assessments of how much is warranted could be affected by changes in the international environment as well as by developments in the domestic economy. These are matters the Board will need to grapple with over the period ahead.

Asia-Pacific in the International Financial System

I turn now away from recent events, as absorbing as they are, to offer a few observations about the Asia-Pacific region in the international financial system over the longer run.

It is commonly observed that the 'centre of gravity' of the global economy is shifting east, away from the Atlantic and towards Asia – which, for this purpose, should be defined to include India. There is naturally a discussion about how best to recognise this greater importance of Asia in the 'architecture' of the international system, including in the official institutions.

Some initial progress was made in the small increases in quota allocations in the IMF to four emerging countries, two of which were in Asia, late last year. The much harder task of finding agreement for more far-reaching changes over a longer timeframe is now under way. That is very important work.

But the point I would like to offer here is the following. In parallel with the efforts to reform *governance* of the international institutions, there will need to be efforts to find agreement on *mandate* questions – that is, about what it is we want the IMF and other bodies actually to do, and not do. It will not suffice for Asia (or other regions in the emerging world) to expect more say in how the institutions are governed without being part of a clear consensus as to how they will use that increased influence. What is their vision of the IMF's role? What are the limits to that role? Those who will ultimately have to cede some of their current influence to accommodate the developing countries will surely be reluctant to do so unless there is clearer mutual understanding on those sorts of questions.

Asia must be prepared to contribute to this discussion. This requires meaningful engagement on the key issues such as:

- how can different national policies, including exchange rate regimes, be made to co-exist within the international system?
- what are the respective responsibilities of the various nations to foster that compatibility?
- what is the proper role for the IMF and other supra-national bodies, not just as occasional lenders to individual nations, but as custodians of the international system all the time?

The recent 'review' of the '1977 Exchange Rate Decision' by the IMF is a start on this discussion. It revises an agreed set of words from 30 years ago to form a more up-to-date basis for guidance to IMF members about exchange rate policies, and provides a framework for surveillance by the IMF membership of those policies.

This is a good start, but only a start. The key will be the way the surveillance is actually implemented. That is in the hands not just of the IMF's staff and management but also its membership. The membership from this region will need to be ready to play its part. By this I mean that the countries of Asia will need to be ready to defend their policies robustly, but also to work with others in understanding and mitigating unintended consequences of their policy choices. Asian countries should, of course, expect the same from other regions.

It is worth adding that, in other fora, Asian countries have a potentially strong voice if they can coalesce. In the G-20, for example, China, India, Indonesia, Japan and Korea are all at the table, as is Australia. If that group of countries could speak in a united way on issues of key mutual interest, it would be a powerful force in a globally significant group. It is not easy to find a common position, of course, and it will not be possible on some issues. We need only to look to Europe – a continent that has been working at this for a long time – to see how national differences frequently limit collective regional influence. But to the extent that Asian countries can agree on some things, they have the potential to be quite influential.

Conclusion

Recent events are putting financial systems to the test around the world. For years people have worried about the so-called 'global imbalances' leading to trouble because Asian investors might refuse to buy dollars. Others have feared some sort of repeat of the 1997-style 'sudden stop' crisis in the emerging world. But, in fact, it has been a domestically generated credit event in the world's most sophisticated economy, the United States, that has triggered the recent reappraisal of risk. The resulting financial strains have been most acute in the developed, rather than the developing world.

This episode may have some time to run. But the sooner the exposures to problem assets are accounted for and disclosed, the sooner markets can get back to pricing risk prudently and providing credit on sensible commercial terms. At present, without enough information, they are operating on an impossibly short timeframe, out of fear of what tomorrow might bring.

Asian countries appear, to date, to be weathering the storm fairly well, as is Australia in my view. But the episode reminds us all of the importance of working to improve the resilience of our own domestic financial systems and policy frameworks, and of the task, as yet uncompleted, of building better international arrangements for the future. ✠