RESERVE BANK OF AUSTRALIA

On Europe's Effects on Australian Financial Markets

Guy Debelle
Assistant Governor (Financial Markets)

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ON EUROPE'S EFFECTS ON AUSTRALIAN FINANCIAL MARKETS[1]

Europe has been at front of mind a lot of late. The almost daily machinations of the European political behemoth have been a major driver of financial market volatility. On that, I was pleasantly surprised that the Australian summer holiday was relatively uninterrupted by European headlines. But the downside was that we didn't really get summer in Sydney.

European developments influence Australian financial markets through a number of channels. I will focus on a few of those today.

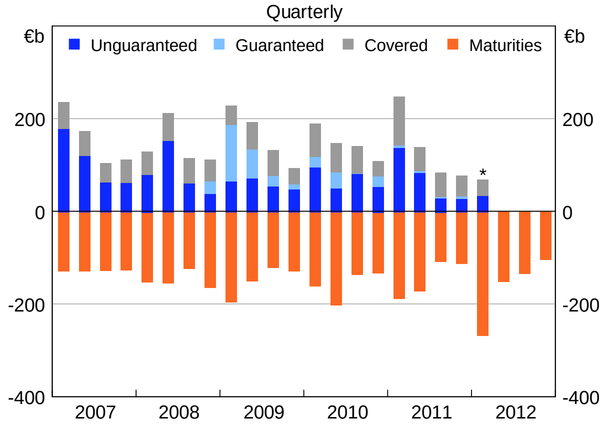
I think the European development that has had the most material impact on financial markets over the past few months has been the European Central Bank's (ECB) 3-year liquidity operation. In December, the ECB provided as much 3-year funding as the European banking sector desired at the ECB's policy rate (against acceptable collateral). Nearly €500 billion euros was borrowed.

This large liquidity injection has had a number of effects. One of the more important is that it effectively takes funding out of the equation for the European banking system in the period ahead. There are large maturities of bank debt falling due around now, a sizeable share of which is government-guaranteed (Graph 1). There were serious concerns about the ability of some banks to refinance themselves, but these concerns have been alleviated by the ECB's actions. The ECB has provided banks with the funds to repay these obligations and indeed ECB commentary suggests that a number of those who borrowed were those with large debt maturities coming up.

Graph 1

Euro Area Bank Bond Issuance

Quarterly



* Quarter to date

Sources: Bloomberg; Dealogic; RBA; Thomson Reuters

[1] Thanks to Justin Fabo, Craig Evans and Tom Rosewall for their help with this talk.

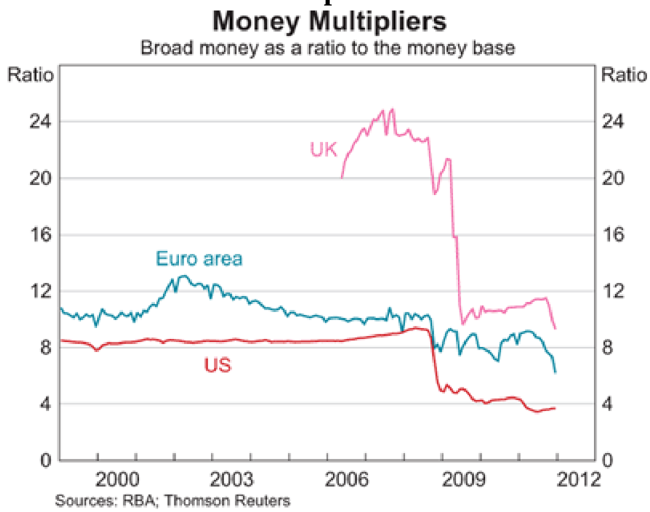
In assessing the impact of the ECB's actions, some commentators focus on the size of banks' deposits with the ECB as a measure of their effectiveness. If these deposits are rising, the assessment is that the ECB's actions aren't working, because the banks are just parking their money at the ECB and not lending it to the real economy.

Such an assessment is inaccurate. The size of the banking system's deposits with the ECB is completely determined by the ECB's liquidity operations. On the ECB's balance sheet, the assets it generates by lending to the banking system *must* also appear on the liabilities side as bank deposits with the ECB. That is, once the ECB has done its liquidity operations, the size of the ECB balance sheet is what it is. The amount of deposits provides no real information above and beyond the net amount the ECB has injected into the system, which is already known. It does not tell you anything about what the banks are doing with the funds they have borrowed from the ECB. Or about how many times those funds circulate before ending up back at the ECB.

This is true of all central banks, not just the ECB. A similarly misleading statement is often made about the Fed, with bank deposits 'piling up' at the Fed supposedly indicating that the Fed's policy actions are ineffective. Again, the size of banks' deposits at the Fed is the mirror image of the Fed's liquidity operations.

One possible way to gain a handle on the impact of these operations, and the extent to which the liquidity has circulated, is to look at money multipliers. Graph 2 shows money multipliers for the euro area, the US and the UK. The money multiplier is the ratio of a broad measure of the money supply to the money base, which is the part that is more or less under the control of the central bank. The graph shows that there have been large declines in the money multiplier in all three regions.

Graph 2



These declines provide some indication that the banks aren't circulating the liquidity as much as was the case in the recent past. The declines are consistent with the deleveraging that is occurring in the banking sector and on private sector balance sheets. It also suggests that the economies in each of these regions are likely to have been significantly weaker if not for the large expansion of central bank balance sheets.

While the ECB's liquidity provision significantly reduces the funding risk for European banks, there are still pressures in terms of bank capital. A number of European banks are responding to these pressures by deleveraging rather than by raising equity in the market. Some of that is evident in Australia and the Asian region more generally, particularly around the provision of commodity finance. However, at least in Australia's case, European banks do not have a large presence, and thus far we have seen other banks step in to offset some of the withdrawal.

There are also clearly still significant issues in terms of sovereign debt to be resolved. The ECB will conduct another 3-year operation at the end of the month. There is some possibility that banks will use that operation to fund increased purchases of sovereign debt and earn the large carry on offer, which might help alleviate the sovereign pressures for a time.

Graph 2 showed the collapse in money multipliers that has occurred. But it is also interesting to think about the equivalent concept on the other side of the balance sheet, what might be called collateral multipliers. That is, how many times do assets get recycled in the system, particularly in terms of generating funding. Collateral multipliers don't appear in standard textbooks, but they are an important construct in the world of shadow banking, where repo, collateral hypothecation etc are crucial. Some very interesting work has been done on this in recent times, including by Manmohan Singh and Zoltan Pozsar at the IMF, along with James Aitken.[2] Hyun Shin and others have developed a useful framework in which to think about the issue.[3]

The evidence seems to be that there is a sizeable reduction in the velocity of collateral taking place. Some of this is because of a change in the willingness to lend securities on the part of some asset managers, some is a function of regulatory changes. This has implications for the provision of credit, particularly from the shadow banking sector. It is an area which is certainly worth examining in more detail.

Returning to the topic of debt issuance, the new year has seen a thawing in bank debt markets. Some of this I think can be attributed to the calendar itself. Investors were reluctant to take any position towards the end of 2011, either to lock in gains already

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[2] Singh M (2011), 'Velocity of Pledged Collateral: Analysis and Implications', IMF Working Paper WP/11/256; Singh M and J Aitken (2010), 'The (Sizable) Role of Rehypothecation in the Shadow Banking System', IMF Working Paper WP/10/172; Pozsar Z and M Singh (2011), 'The Nonbank-Bank Nexus and the Shadow Banking System', IMF Working Paper WP/11/289.

[3] See, for example, Adrian T and HS Shin (2010), 'Liquidity and Leverage', *Journal of Financial Intermediation*, 19(3), 418–437.

accrued or to avoid exacerbating losses in an environment of considerable uncertainty. With the beginning of the new year, the investment slate is clean and risk tolerance thus far is on the increase. This development has been bolstered by the avoidance of worst case outcomes and, as I've already mentioned, by the ECB's action.

However, there is a reasonably large amount of bank debt maturing in the first quarter and concerns continue to be expressed about that. In that regard, it is always important to remember that when the debt matures, the investor in the maturing paper has to decide what to do with the cash. Do they reinvest in bank debt or do they invest it somewhere else? In the current quarter, an additional wrinkle in thinking about this is that a fair chunk of debt maturing is government-guaranteed bank paper. So the decisions of some of these investors may not be the same as those of more traditional bank credit investors.

But while the market has reopened in the new year, there has been a sizeable step up in the cost of the issuance. Investors are demanding much higher compensation for bank credit risk now than they were in mid 2011. The repricing probably happened in the last quarter of 2011, but the general lack of issuance made it more difficult to observe.

This global repricing of bank debt has clearly affected the Australian banks' wholesale funding costs. The Reserve Bank will provide a detailed analysis of this in the March *Bulletin*. Table 1 provides some illustration of recent developments.

Table 1: Bond Market Issuance Costs
5-year

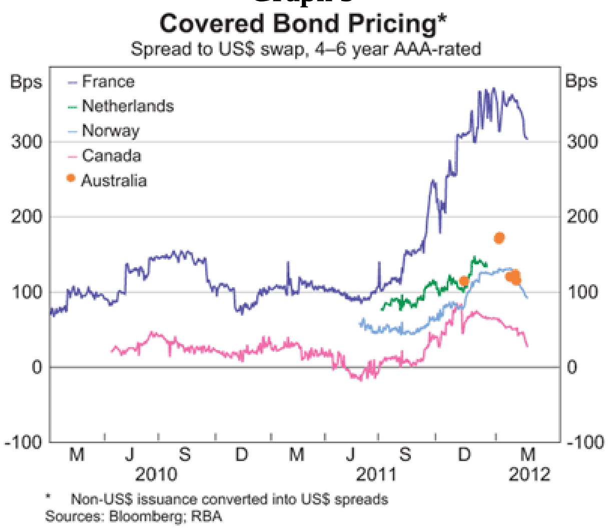
	Issue date	Spread to BBSW (bps)
Major banks		
Senior unsecured	Jun 2011	127
	Jan 2012	223
	Feb 2012	185
Covered bonds		
Domestic	Jan 2012	170
Offshore	Jan 2012	210
RMBS	Apr 2011	110
	Nov 2011	140
Corporates		
Coca-Cola Amatil (A-)	Jan 2012	45
Australia Post (AA+)	Jan 2012	130
SPI Electricity and Gas (A-)	Jan 2012	224

Source: RBA

It shows that the covered bonds issued by the Australian banks were at markedly wider spreads than their unsecured issuance mid year. This is notwithstanding the fact that covered bonds are senior in the creditor queue. While the cost of the first wave of covered bond issuance by the Australian banks has been high, it is broadly comparable to that of recent covered issuance by banks in other jurisdictions where there has been a similar step up in cost (Graph 3).

In the past few days, there has been a sizeable narrowing of spreads in the secondary market on the domestically issued covered bonds, to around 140 points over swap. This narrowing in bank credit spreads was confirmed by the unsecured issuance last week.

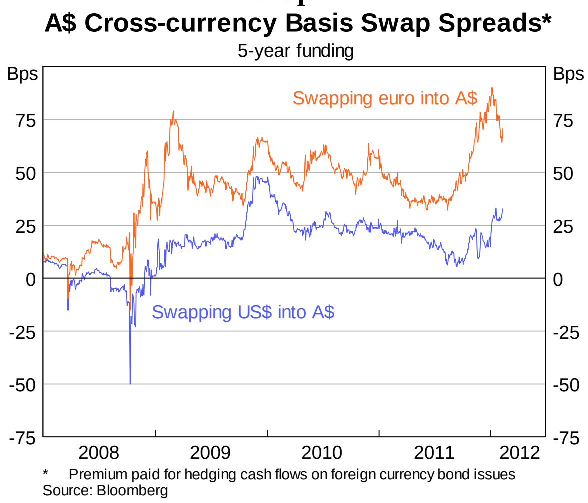
Graph 3



The other point of interest in Table 1 is that some corporates are able to issue at lower rates than the banks, even for the AAA-rated covered bonds. For example, Coke, which is rated A-, was able to issue more than 100 basis points below the AAA-rated domestic covered bond issues.

The rise in wholesale funding costs has been accentuated for funds raised offshore by a widening in the cost of swapping foreign exchange into Australian dollars (Graph 4). This is another example of European issues affecting the local market, as the widening is partly a function of the lower volume of Kangaroo issuance in recent months. The Kangaroo issuers seek to swap the $A funding they raise back into foreign currency, while the Australian banks do the reverse with their foreign currency raisings.

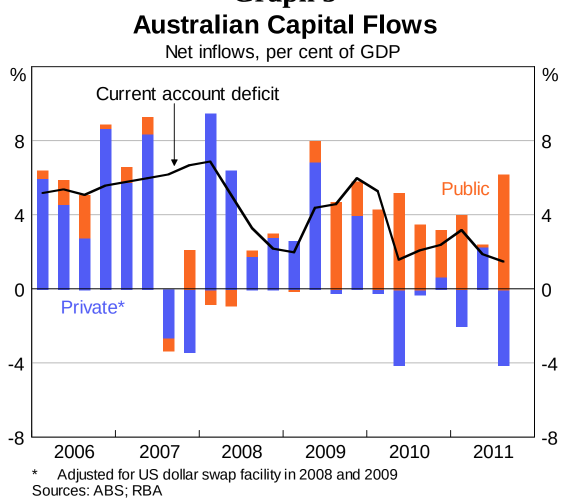
Graph 4



Over the past few years, issuance in the first quarter, particularly by Kangaroo issuers, has been strong. That has not been the case so far this year. Ratings uncertainty around European sovereigns has contributed to this. With the downgrade of a number of European sovereigns by some rating agencies in December, including France, some pan European entities, including the European Financial Stability Facility (EFSF), were downgraded. The European Investment Bank (EIB), historically a large issuer in the Australian market, was not downgraded, although it remains on negative watch. At times, there has been poor liquidity in the market, which has seen spreads on supranational debt marked a lot wider, particularly EIB, with little turnover behind the wider marks. Again, reflecting improved sentiment, those spreads have started to narrow.

The final channel I want to talk about today is the sizeable flows occurring into Australian government debt. This has been evident for quite a few quarters now in the balance of payments statistics (Graph 5). Over the first three quarters of 2011, the net purchases of government securities by foreigners amounted to over 3 per cent of GDP, markedly larger than the current account deficit. This pattern of capital flows likely continued in the December quarter.

Graph 5



As a result of these purchases, based on the ABS financial accounts data, our estimate is that around 75 per cent of the stock of Commonwealth Government securities (CGS) is held offshore, as at end September. Our discussions with market participants suggest that a sizeable share of recent purchases has been by sovereign asset managers. These investors tend to buy CGS predominantly (though not exclusively), rather than debt issued by the state government borrowing authorities (semis). This has contributed to the widening in spreads between CGS and semis. However, as the yields on CGS have fallen to 50-year lows, state borrowing costs are not all that high by historical standards notwithstanding the wider spreads.

This portfolio shift by foreign asset managers appears to be having an effect on the currency. The Australian dollar is close to its recent highs despite the terms of trade declining from their peak in the September quarter.

Conclusion

So these are some of the channels of influence of the situation in Europe on Australian financial markets. So far this year, that has been a more positive story than it was at the end of the last year. The major instigator of this change, in my opinion, was the ECB's 3-year liquidity operation. Whether this happier state of affairs persists is difficult to tell. There have been outbreaks of optimism over the past couple of years which were dashed.

I think the only thing which is certain, is that uncertainty is likely to persist for some time to come. In that regard I'd like to finish with a variation on the famous Rumfeldian take on uncertainty, recently articulated by David Murphy on his Deus Ex Macchiato blog: There are known unknowns and unknown unknowns, which complicate the pricing of risk, but over the past decade, there has also been a fair few examples of 'too-lazy-to-be-knowns'. European sovereign debt before 2007 might conceivably fall into that category. While mispricing due to Knightian uncertainty is excusable, mispricing due to laziness is not. As I said last November, you've got to *Know Your Product*, otherwise, it can quickly turn into a case of *No, Your Product*.[4]

[4] Aficionados of the Saints will be aware that these two songs bookend side one of *Eternally Yours*. This can be translated into financial terms as: If you owe the bank $100, that's your problem. If you owe the bank $100 million, that's the bank's problem.