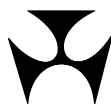

RESERVE BANK OF AUSTRALIA

TRANSCRIPT OF REMARKS AND QUESTION & ANSWER SESSION

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DR DEBELLE: Thanks very much, Eric. I'm very happy to be here to talk about John's paper, and I'd actually commend that you read the publication he's put out for the Whitlam Institute which is a very nice and thoughtful piece.

I think – John mentioned this – that there is an important distinction to be made between Australia and most of the rest of the world in the sense that, by and large, our markets and institutions have functioned well and effectively. So, in the face of the largest downturn in global output since the great depression, we've actually – the Australian economy has faired relatively well, and I think our markets and institutions have contributed to the relative stability of the Australian economy.

But, as John says, we really do need to question why this is so and that we can't, to some extent, rest on our laurels, and we certainly shouldn't take this for granted and assume that it may have just been plain good luck. And we need to look at the lessons of what's happened, both for ourselves and the lessons for others.

But, as I said, I think our regulatory system has worked reasonably well and our macro-policy institutions have – obviously I'm going to say this – but our macro-policy institutions, I think, have functioned reasonably well, and we need to be careful that we don't throw the baby out with the bath water. We also need to make sure that we're in a position to capitalise on our strong points in an environment where the Australian economy potentially is emerging stronger than most.

Let me just digress a little bit and just comment on a couple of things Steve said. The last time Steve and I were on a panel was in Adelaide, which is my home ground, so this time I'm on Steve's home ground, so I'm the away team. When I used to play footy in Adelaide, sometimes when you played in some away team you needed to have your car parked very close to the oval to get out quickly at the end of the game so – well, this time I have to get in a taxi.

But one thing which is sort of interesting – if you think about house prices, and Steve showed you the picture of house prices going up dramatically – is that housing, in the end, is just something we consume, just like food, like your TV or your car. And relative prices of goods and services move around, so if Steve could have actually stuck up food on that graph, and food would have actually gone up relative to some of those things; if he'd stuck up TVs, it would have gone the other way, so your TV price would have gone down a long way. So I'm not saying that house prices are necessarily fairly valued but just relative prices move around and some of them, in moving around and moving around in a relative sense, means some have to go up and some have to go down.

The other thing about debt is that, I don't know – I mean, I've got a mortgage. I'd assume that some of you – well, some of you are students who probably don't have mortgages, but those who aren't students probably have a mortgage. When you go into your bank to get a mortgage, they lend to you to some extent, and your willingness to borrow depends on your expectation of your future income. One of the primary criteria they do use as your ability to service the mortgage is, indeed, your current income, but your willingness to go and stick a large mortgage on a house to some extent reflects your assessment of where your income is going to be in the future.

So debt – if I look at my debt when I first went and took out my mortgage, it's high relative to my income. And, over time, hopefully, my income grows and also I start paying back my mortgage, and my debt relative to my income fails. So if we're sitting here in Australia and we think the prospects for our country are actually pretty good, then having a relatively high level of debt relative to the current income is not necessarily a bad thing if, indeed, those expectations are realised. Now, you can argue about whether those expectations are realistic but I suppose my point is that expected income matters just as much as current income.

Now, Steve has a reasonably well-publicised bet – I'll have to declare some conflict of interest here in that it's actually a bet with a mate of mine – about where house prices are going in Australia. Now, I was, if I'd had time, going to stop at the local Woolies and pick up a pair of Dunlop Volleys and give them to Steve because I think, on the terms of the bet – okay, well – and I didn't know your shoe size either. But I was actually going to give the shoes to Steve because there's a fair chance that next month he actually might have to start walking. At least starting in Parramatta, it's a slightly shorter walk to Kosciusko than it is from the centre of Sydney.

Let me turn to talk about some of the points that John made. And I think one point I want to pick up is about the reform of the international financial architecture. And a lot of the points that John raised with his colleagues – with his other five economists I think, to some extent, are under way in one shape or another around the globe. At the moment there is a serious examination going on of counter-cyclical financial tools: what can be deployed, whether those tools actually exist, or whether they need to be created. And that debate is happening at particularly an institution which the Reserve Bank is a member of. There used to be a body called the Financial Stability Forum which arose out of the Asian crisis and the RBA was on that. It's now been transformed into the Financial Stability Board which has a much large membership, its membership which is, by and large, the membership of the G20, which is representative of both developed and developing countries. So within that forum at least, and in other forums, there is a serious examination going on of counter-cyclical financial tools.

Another issue which is being seriously looked at is the assessment of "too big to fail" or "too big to rescue" or also "too interconnected to fail" which is a slightly different variant. Now, there's a reasonably well-known line going around that if, the problem with "too big to fail" basically just means too big. But the question is once you have institutions which are in that situation, what do you actually do about it? How do you stop them either getting too big or, if they are too big, what can be done to make them smaller? And in that sense, I think the point John made about the share of financial services is actually quite interesting. If you look at the economies which have got the hardest questions to ask in this environment, it is the countries where the share of financial services was very large relative to the size of the economy. So Iceland is the most extreme example of that, where the size of the banking system was about seven or eight times the size of the country. Ireland is another example where the size of the banking system is quite a decent multiple of the size of the country, and Switzerland as well.

The UK and the US – the US, actually the size of the banking system is not that large relative to the size of the economy. It's large but not that large. But when you have banking systems which are a multiple of the size of the country and which obviously then have activities in other countries, there's the issue of how do you resolve a bank which is in trouble when it has operations in a whole bunch of countries. And that a question where there's a lot of examination going on as to what might be the possible solutions to that.

One thing again, when assessing the size of the financial sector and its appropriateness, is sort of the allocation of society's resources. Have too much resources gone into financial innovation which could have been otherwise deployed to other activities? In saying that, it should be borne in mind that some of the financial innovations that we've seen over the past 2000 years or so have probably been beneficial. So some financial innovations are good, some of them not necessarily so. But that's true of any sector of the economy. To some extent it might matter a bit more with the financial sector, given the role that – the place that it sits in the economy but it's, again, something which happens right across the economy.

In terms of looking at ways which one might go about resolving these issues, one issue which I think is not dissimilar to something that John raised, and has raised I think in more detail in his paper, is the prospect of having higher capital provision or capital charges for risky activities. And to some extent, if the capital charges are high enough, then an institution which indulges or partakes in too much of those risky activities may have an incentive to be smaller than it otherwise would be, which is another way of – it's a tax on the provision of those services.

One point which John did talk about today was making sure there are sharp boundaries between publicly-supported and unsupported institutions which I think, in principle, is very fine. I think the difficult problem that we have to address as policymakers is how to put that in place in practice. If you think about the '70s and the '80s in the Australian context, and John mentioned the case of the Bank of Adelaide, to a large extent, those innovations were occurring outside the regulatory net and, to some extent, the linkages between those inside the regulatory net and those outside the regulatory net are not all that clear until they become clear because you've got a problem. And making sure that those linkages aren't there is a difficult problem because there's always an incentive to arbitrage around that.

That said, just because it's a difficult problem means you don't have to try and address it. One of the objections raised to the Tobin Tax, for instance, is that – and John mentions this – if it wasn't implemented in every single country in the world you'd see the whole of financial services shift to the Cayman Islands or the like where this wasn't there. And that argument I think can always be put in the way of any regulatory change, but to some extent, if you're throwing sand in the wheels, then some of the sand is probably going to slow things down. Yes, it's not going to be completely effective, the car's probably still going to keep on driving, and there's always going to be regulatory arbitrage, but that doesn't mean you don't contemplate these sort of things.

I think a more difficult question to answer is sort of what is systemically important because, to some extent, that's very time-varying. At the moment, it's almost the case of any financial institution is systemically important because, if we have another reasonable financial collapse, there's probably – panic is going to set in again and we'd be back where we were in October which is a month I don't want to particularly revisit again.

And if you think about – if you were sitting there at the beginning of 2007 and you asked people in the UK was Northern Rock a systemically-important institution, most people probably would have said, "No, it's not." But come sort of mid to late 2007 it turned out it was a systemically important institution. So it partly depends on the circumstances, and the circumstances tend to change reasonably quickly. So, you know, being able to answer that question, I think, is a difficult question. It doesn't mean you don't ask the question, but I think, as in all of these things, the answer is a lot harder than the question.

That said, I would like to highlight one point John made which is the important role of government as a provider of public insurance. And you see that across a whole set of dimensions in terms of the social safety net – and Australia, by and large, has a pretty good social safety net if you compare that to China where the social safety net is nowhere near as developed as it is here – that has serious consequences for household behaviour. For instance, the high rate of saving in China has a lot to do with the fact that there isn't much of a social safety net in place and there isn't much of a health safety net in place.

To some extent it will be interesting to see what happens in the US at the moment in the sense that their social safety net is, to some extent, not as well – not as well developed is not the right word – but it's not as comprehensive as it is here, both in terms of unemployment and also in terms of health. And the government does serve an important role as a collective risk manager to handle things like intergenerational transfers probably better than nearly everyone – nearly any other institution we have around.

But, to some extent, and I think part of the sort of progression that John mentioned between the sort of '70s and where we are today in terms of the role of the government in the economy, to some extent reflects the influence of economic ideas. It also, I think, to some extent, reflects the preferences of the median voter. Now, I can sit here – throughout my whole life I will never be the median voter. I'm in that generation which is, unfortunately, screwed by the people sitting at this table who are, throughout their whole life, the median voter. So the baby boomers are the median voter pretty much their whole life, but I'm, unfortunately, a member of Generation X – throughout the first part of my working life we paid down the public debt in this country. By the time I get towards the end of my working life, I'll be paying off the pensions of the baby boomers. By the time I actually get to be on the pension, assuming I'm ever allowed to retire, Generation Y who's actually – there are more of them than there are of me – will be coming along and reducing my pension. So the students of today won't have this problem because you'll be – Generation Y, there'll be more of you than there are of me.

And let me just finally talk a little bit about the current account which John talked about. I don't see it quite as a vulnerability to the country that John does. It's not something that we ignore, but I don't see it as quite the vulnerability that he does. By and large, I think it reflects a desire to invest in Australia because of the future prospects that the global community sees in the country and the future income growth that the global community sees in this country.

As John said though, that means that assessment needs to be maintained to keep the funds flowing this way. But that said, we have had, over the past 15 years, fairly sizeable swings in the current account deficit in this country. For instance, just over 12 months ago it was about – over 7 per cent of GDP. Today it's about 1 ½ per cent of GDP. So we've had a major swing in the size of the current account without a particularly large disruption to the local economy. And, in fact, if you go back to the early 2000s where the current account again swung from about 6 1/2 , 7 per cent of GDP down to 2 per cent of GDP and basically no one really noticed, so I think, to some extent, the flexibility we have in the country nowadays allows us to adjust to those swings without too much drama.

The other point about current account deficit is that, by and large, someone has to run a current account deficit so – when I was at the IMF, it used to be quite interesting because you'd see the – you used to work on particular countries at the IMF and every economist who worked on a particular country would say that this country's current account deficit would have to be smaller or this country's current account surplus had to be larger. But there's a bit of a fallacy of composition here – that you can't have every country run a smaller current account deficit because someone has to actually be on the other side of that.

So one thing that – hopefully you still get taught this in university economics is about the value of portfolio diversification. Well, if you want to diversify your portfolio across the globe, that actually means money needs to flow from one place to another, and it probably means, given that, say, if you compare Australia versus Japan where the future income and growth prospects here are probably better than they are in Japan, that it's probably going to be the case that we are going to be running a current account deficit and they're probably going to be running a current account surplus. So to allow that sort of global portfolio diversification to occur, you do need to have cross-border capital flows and you probably do need to have some countries running current account deficits and some countries running current account surpluses, just as, within a country, you have some households, like me, who have a mortgage and you have people who have retired who probably don't have a mortgage. And the same thing sort of happens on a global scale.

So let me just finish by saying I very much – I would commend you to read John's paper which he's put out through the Whitlam Institute. I think it is a very thoughtful piece which raises a lot of interesting questions and I would – John does actually try to give some answers to those questions – and he is thinking very hard about these issues, as he's thought hard about them over a number of decades. So, it does throw up a lot of interesting questions. Us on the policymaking side have to think very hard about those questions. I think that thinking is going on. It will take some time to – you have to diagnose the problem. As I said, the problem is less here than it is in other parts of the world. You have to diagnose the problem and have some understanding as to what's caused that situation before you move too quickly into determining the appropriate remedy to that problem. But that process is under way. To some extent it's necessarily somewhat slow moving, and probably that's more of a good thing than a bad thing.

But I think – the bottom line is Australia has come through this episode really well – reasonably well, sorry. I don't share Steve's pessimism about the future obviously. And I think we, nevertheless, can still look at the issues that have arisen elsewhere. We can assess whether our system – whether we are in the situation by good luck or by some combination of good management and good structures – and question hard why we are where we are, why the rest of the world is where they are, and try and learn those lessons.

So thanks very much, and I'll leave it there.

MC: Thanks very much, Guy. So we've got a few minutes and we want to maximise the opportunity for you to ask your questions, so what I'd like to suggest is that, when you ask your questions, just say, if you don't mind – if you don't want to, you don't have to, of course – who you are and what your interest is. So the floor is open to you. There are two microphones. We have a hand – desperate to ask a question over here. Go ahead, please.

QUESTION: Hi. I'm just - - -

MC: I'm sorry; I had trouble seeing up there.

QUESTION: I'm a school kid from Westfields. What about the consenting adults' theory?

MC: Which theory?

QUESTION: The consenting adults' theory.

MC: Guy, did you want to, you know, buy in on consenting adults? I'd just be very worried, you know, the Gen Y question and the baby-boomer answer.

DR DEBELLE: Oh, why not? I'm Gen X. Sorry, I'm the squeezed generation.

MC: I know; that's what I mean.

DR DEBELLE: Oh, sorry – question from Gen Y answered by a baby-boomer, yeah, true. No, well, I think John put it pretty well and he certainly characterised John Pitchford's view nicely. I think it is – I wasn't in the Reserve Bank at the time so I can't – I was actually in the Treasury at the time. I can't really say what the Reserve Bank's view was back then as to whether the policy was directed at the current account. But if you think about the current account now, as I said, I think, looking at it from the capital account side rather than the current account side and you think about whether people are investing in this country because they like the future prospects here, a lot of times I think people look at the current account and say, "Oh, it's completed financed by the banks," which I think is – if you look at the capital flows for this country, they're actually very, very big in a whole – there's a lot of money which goes out of this country into the rest of the world. You know, a lot of your super is invested offshore. So there are big flows going in both directions. It so happens that the net of those is about the same size as the net funding of the Australian banking system, but there are a lot of big flows going on in both directions. And so one has to question – you have to look at whether those flows make sense in a gross sense as well as focusing on the net sense. So I think one has to be a little careful in just focusing on the net number, which is the net of some very, very big gross numbers in determining whether this is sensible or not.

QUESTION: Thank you.

DR ARVANITAKIS: I've got a question for Guy as well. My name is James Arvanitakis. I'm from UWS and I'm a Gen Xer as well, so I feel for you. What's – one of the questions, I suppose – one of the points of John's paper you didn't respond to was the issue of a people's or another public bank. Do you think the financial system within Australia is, I suppose, open to that possibility? Thanks.

DR DEBELLE: I've actually got some practice because someone asked me this question yesterday at another public event I was at, so I've actually had some practice answering this. I actually – one thing John mentioned, which I think is actually important, is there is – you know, credit unions and building societies – and despite what John said there are actually a few building societies left around the place. So credit unions and building societies are sort of local based institutions, very community oriented, and which by and large partake in the sort of narrow banking that John's talking about. So there is that entity out there. They're not a trivial part of the financial system by any means actually. So that's one point I'd make. The second point I'd make is that, we had a bunch of state-owned banks back in the '80s including – I saw this first hand in my own state in South Australia where – now, they didn't follow John's edict in the sense that they started heading into those investment banking territories that John doesn't want them to go into, so that's certainly the case. But, they were a state-owned bank and I think it just shows the sort of issues that can arise, even with what was set up originally as something designed to fulfil the sort of role that John was looking at. And now I'm not – that doesn't mean that, you couldn't prevent that happening again but, it is a place we were at and which didn't necessarily work.

MR SIEDLER: Yeah, I'm Sam Siedler(ph) from Sydney. I got a mortgage, Guy, so I'm on your side, and I'm a passionate follower of the Australian economic recovery and I'm cautiously optimistic for the fact that Glenn Steven's monetary policy since he released since October, they're heading in the same direction as Wayne Swan's or Ken Henry's fiscal direction. So what I am trying to do is to add value to the (inaudible) at the highest level of policy setting, in trying to make the financing of massive projects, PPP projects. Even though John was saying it's partly dead, I'm cautiously optimistic for the fact that those proposal can be made – why bother appealing to the private parties by providing (inaudible) for example Ken Henry's ones or by continually, sharing risk with the private parties, you see? What other options can you think of, Guy, in terms of making these PPP proposals viable and sort of practical in a pragmatic sense? I'm not an academic. You know, why I am asking this question is that, Guy, I strongly believe this is the time to be a debtor as opposed to other views expressed by some of the speakers and come out of the hole, with productive – again each one with capacity, you see? In layman terms – I'm not an economist. I'm an infrastructure guy, you see. So what can you tell us, Guy, please?

DR DEBELLE: John's actually a much better expert on all this stuff than I am. In fact, he's written a lot on that. The one thing – the one point which I think John makes nicely, and has made nicely a few times in the past – it's sort of sometimes interesting to think that you get - in terms of the financing of the project, the person who can actually borrow the cheapest is actually the government. So if you think about everything, there's a spread actually relative to government debt. And so the person who's actually borrowing the cheapest is the government and private sector is always going to borrow more than that. So, you know, I'm not going to draw any ramifications from that, but it's sometimes worth just throwing that out there. But if you think about management and whatever of projects, that may be a completely different issue, but I think it's always sometimes interesting to think on the financing side as to, where the cheapest financing options are.