Australia's Resilience During the GFC

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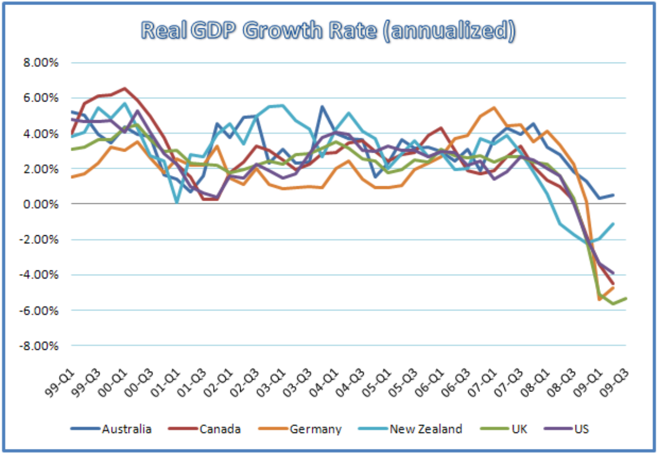
October 30, 2009

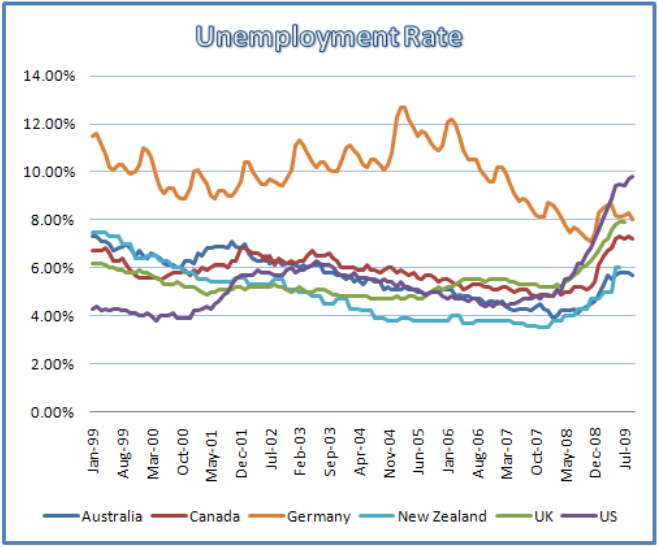
Outline

- Nature of the shock facing Australia
- Factors moderating the shock
  - Resilience of export markets
  - The banking system and regulatory structure
  - Bank deposit guarantee
  - Response of the Reserve Bank of Australia
  - Stimulus package
- Longer term issues
- Conclusion

Real GDP growth



Unemployment rate



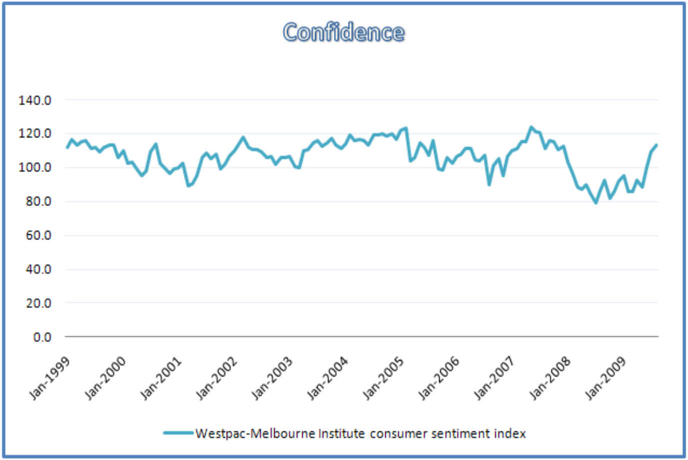
Unemployment rate

- 5.7 percent at the moment (down from 5.8% in the previous quarter)
- IMF forecast published in June of 2009 of 7.9%
- Treasury forecast published in June of 2009 of 8.25% by mid 2010

The shock

- The shock facing Australia was very different to that facing the rest of the world
- The shock was not sourced in our own financial sector
- The shock was an external shock from the US and elsewhere
  - affecting our confidence
  - affecting our financial sector

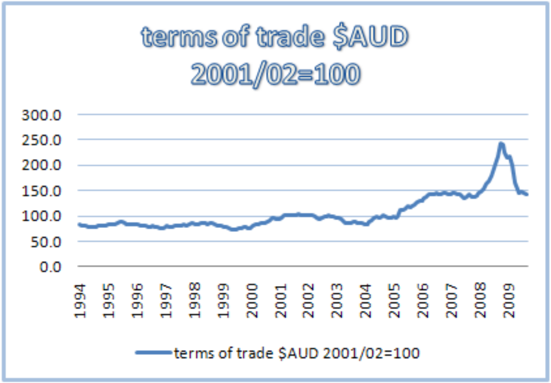
Confidence


Confidence
140.0
120.0
100.0
80.0
60.0
40.0
20.0
0.0
Jan-1999
Jan-2000
Jan-2001
Jan-2002
Jan-2003
Jan-2004
Jan-2005
Jan-2006
Jan-2007
Jan-2008
Jan-2009
Westpac-Melbourne Institute consumer sentiment index

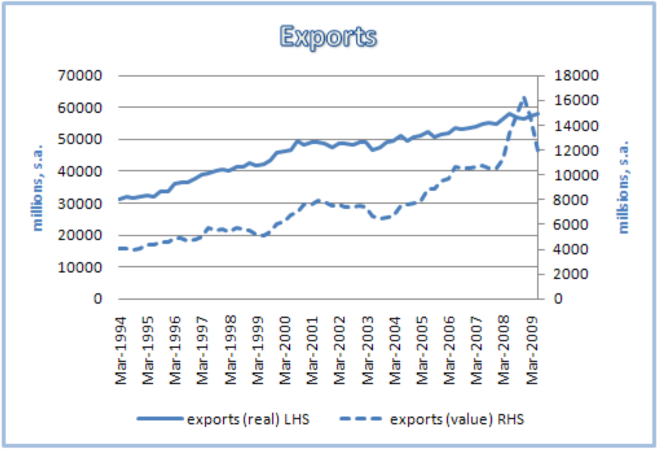
Equity markets

Resilience of export markets

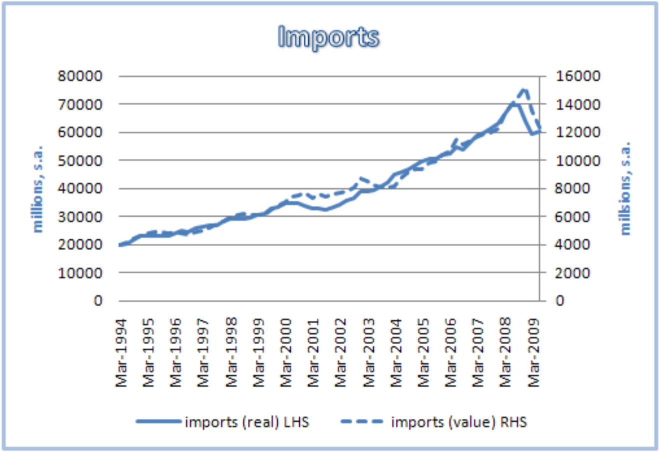
- As the crisis hit, Australia was in the midst of an extended commodities boom



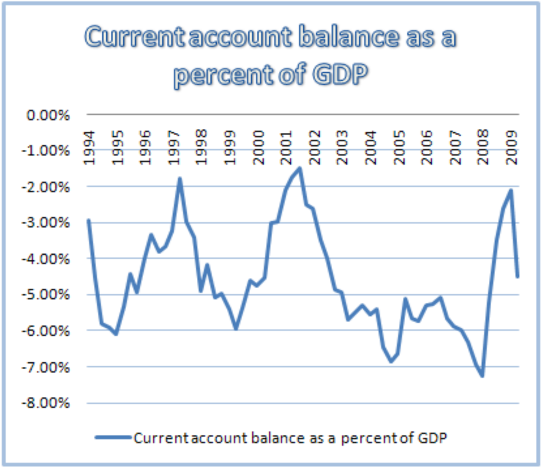
Resilience of export markets



Resilience of export markets



Resilience of export markets



The regulatory structure

Council of Regulators

- The Reserve Bank of Australia
- The Australian Prudential Regulatory Authority
- The Treasury
- The Australian Securities and Investment Commission

The regulatory structure

Council of Regulators

- An informal council with no power as a group
- Very clearly defined role of each of the parties
- No room for regulatory arbitrage
- APRA particularly conservative

The four pillars policy

- 4 largest banks in Australia are prohibited from taking each other over
  - 1990 policy initial version 6 pillars under Paul Keating
  - 1997 Wallis inquiry recommended dismantling the policy
  - The treasurer changed the policy to a 4 pillar policy
- Aim to avoid reduction in competition by merger or take over of each other
  - banks argue international competitiveness is limited
  - doesn't mean the big four can't take over small banks

The four pillars policy

- Structure of four pillars made space for banks to be profitable from lending to the domestic household sector
- Small number of entities to benefit from a lack of competition
- Large enough entities to still compete with each other

The Banks

- All 4 major banks AA rated by Standard & Poors
- Banks 13.5% after tax return on equity from January - June 2009
  - although this is down by 14% from the previous years
  - reduction in profits due to increased provisioning
- Higher interest rates than most economies meant less need to search for yield
- Only 5% of the income from banks from trading

The Banks

- Little exposure to CDOs and MBS
- Lending standards are generally high and prudential supervision conservative
- Credit assessments of third pary originators stringent
- APRA introduced higher risk weights on loans with low documentation
- Borrowers cannot walk away from their debt providing incentives to repay early
- No tax deductibility of mortgage interest payments provides incentive to repay early
- (see Bloxham and Kent 2009)

The Banks

- Lending is generally funded by offshore borrowing by the banks
- Access to this funding at the height of the global crisis created problems for Australia
- September-October, 2008
    - deterioration in global money markets
    - difficult for authorized deposit taking institutions (ADIs) to manage their liquidity
    - RBA expanded domestic market facilities to alleviate
    - included increasing swap facilities in US dollar short term funding markets

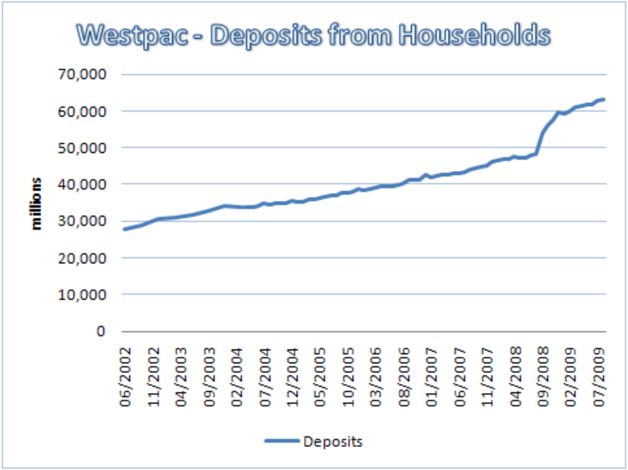
The bank deposit guarantee

- October 12, 2008 the government announced
  - a guarantee all deposits and wholesale funding ADIs
  - aim to facilitate access to funding
  - guarantee was unlimited

The bank deposit guarantee

- Created substantial distortions in financial markets
  - institutions not subject to the guarantee were hit hard hit
  - created instability in other sectors of the financial markets
  - some non-guaranteed institutions even stopped allowing withdrawals
  - those affected still do not have access to their money
  - Australia almost had it's own financial market crisis

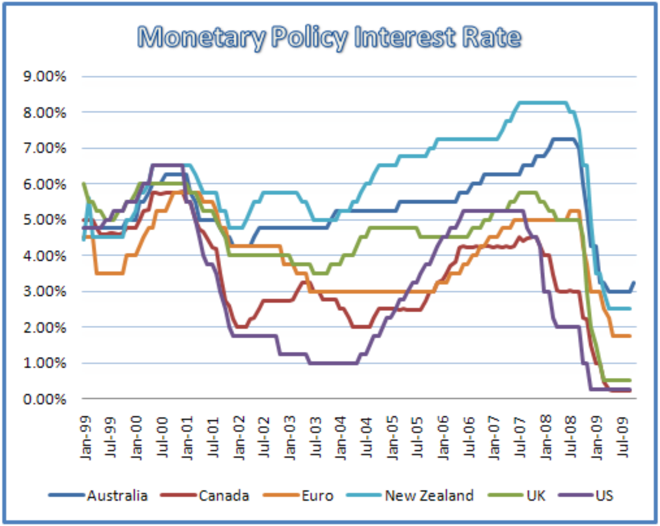
The bank deposit guarantee



The bank deposit guarantee

- Amendments to the guarantee to avert a financial crisis in Australia
- On 24 October 2008,
  - a threshold of $1 million
  - over this amount, a fee is charged to receive the benefits of the deposit guarantee
  - foreign bank branches in Australia also covered

Interest rates (nominal)



Interest rates

- Prior to the crisis cash rate 7.25%
- Reached the emergency rate of a low of 3% in 4 dramatic and 2 conventional moves
- High enough interest rates prior to crisis to not approach the zero bound when cutting rates
- The first developed economy to raise interest rates following the crisis by 0.25 basis points in October 2009

The stimulus package

- Australia has a long history of surpluses so was in a good position prior to the crisis
- Stimulus package 3.9% of GDP (42.4 billion dollars)
- Compared to an OECD average of 2% of GDP
  - of OECD countries only the US (5.6%) and Korea (4.9%) are greater
- Treasury estimated that the economy would contract 1.3% without the package
  - there is discussion that this figure will be revised
  - actual growth 0.6%

The stimulus package

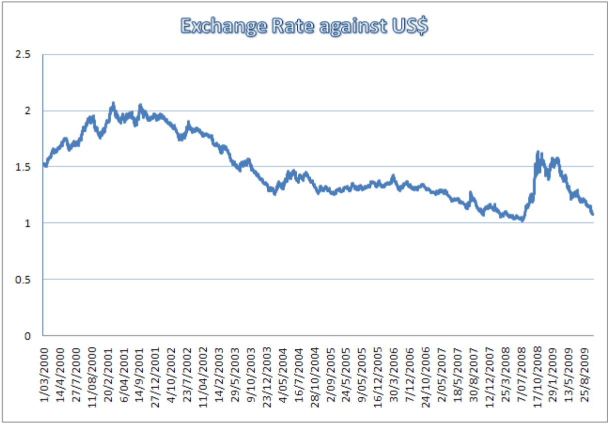
Measures

- Short term
  - immediate transfer payments of $900 to tax payers earning less than $100,000
- Long term
  - Infrastructure and investment
  - Investment incentives
  - Education
- Weight more on increasing government expenditure than reducing taxes

Longer term issues

- Much criticism that the stimulus package is too big and should be below the average of the global stimulus given initial conditions
- Problem is that the size of the package is much larger than the average of the rest of the world (3.9% of GDP v's average of 2% of GDP))
  - crowding out of export markets
  - appreciation of the Australian dollar
  - export markets and jobs in export makets likely to be affected in the longer term

Longer term issues



Longer term issues

- Much criticism that the Government directed stimulus expenditure not necessarily focussed in the right areas for long term growth
  - Business Council of Australia calling for 'better expenditure' on infrastructure and fear that capacity constraints are to be met again
- Housing market extremely strong still

Conclusion

- The shock facing Australian was very different to the one facing the rest of the world
- Main factors in Australia averting a crisis were
  - export resilience
  - strong regulatory structure
  - strong initial conditions
- Possibly too early to comment on the true success of Australia through this period
  - some longer term issues emerging

References

- Bloxhsm, P. and Kent, C. (2009), "Household Indebtedness", *The Australian Economic Review*, 42(3), 327-39
- OECD (2009), "Strategies for aligning stimulus measures with long term growth", manuscript, OECD
- The Treasury (2009), Fiscal Stimulus Packages announced 2008 and 2009 - 5/02/2009, submission Tabled at the Parliamentary Inquiry into the Nation Building and Jobs Plan.