How Serious is the Damage?

Christopher Kent
Reserve Bank of Australia
• Not all bubbles are created equal
• Factors underpinning bubble and its resolution influence extent of
  – financial crisis
  – amplification of business cycle
Australian Experience

Four episodes – cycles in credit/property

1890s  1930s  1970s  1990s

D’Arcy and Kent (2000), ‘Cyclical Prudence – Credit Cycles in Australia’
Fisher and Kent (2000), ‘Two Depressions, One Banking Collapse’
Kent and Lowe (1998), ‘Property-Price Cycles and Monetary Policy’
Cycles in Australian Output, Construction, Property Prices and Credit

- Real GDP
- Construction to GDP
- Property Prices
- Credit to GDP

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%
Cycles in Australian Output, Construction, Property Prices and Credit

- Real GDP
- Construction to GDP
- Property Prices
- Credit to GDP
Capital Ratios

- Capital to loans and advances
- Capital to total assets
- Risk-weighted capital ratio

Note: Shading indicates peaks in real GDP.
Factors underpinning costly Australian crises

i. *credit* growth above trend PLUS

ii. rapid inflation *collateral* prices

iii. excessive *concentration* of investment/lending

iv. lack of *capital* accumulation

v. *competitive* pressures – liberalisation/innovation

• i. and ii. – Borio and Lowe (2002) – speed kills

• during contractions – policy matters
Patrick Honohan – Bank Failures

What he says…

• Overconfidence in risk management models
• Detailed account of a number of ‘failing’ financial institutions
• Estimates direct costs of write-downs and fiscal support
• Policy?
  – Short-term response to failing institutions – slow, equity losers, managers?
  – Long-term – need less rules based, more discretionary approaches to risk management
Patrick Honohan – Bank Failures

What I thought…

• The problem with models
  – ‘Normal’ times vs tail events?
  – Perceived risk – recent realisations – difference from actual risk?
  – Perceptions better than actual in upturns, worse in downturns
  – Models too similar? One-sided markets

• Case studies, common theme?
  – Rapid growth, capacity to manage/control? Driven by concerns re revenues & market-shares – e.g. UBS

• ‘Successful’ institutions’ strategies?
  – Senior Supervisors Group (2008)

• Why is capital so expensive?
  – Overoptimism of creditors – exit, rescue, perceived risks
David Greenlaw – Real Economy Costs

What he does…

• Estimates of losses by leveraged financial institutions
• Assesses implications for domestic lending
  – balance between capital losses and asset reduction
• Examines effect on economic activity
  – single equation estimate GDP growth link to DNFD
  – loan officer survey and TED spreads – used as instruments to identify true supply-side effect
David Greenlaw – Real Economy Costs

What I thought…

- Simplicity of approach is valuable
- But, single equation as it is may miss some important effects
- Financial accelerator – may make things worse
  - recursive feedback from real activity to financial sector: role for collateral prices, longer horizons, asymmetric effects?
- Strong policy response – may make things better
- Need a system of equations
What he says…

- Review of network market inefficiencies
- Contrast with ‘consolidated’ markets which have:
  - liquidity under stress, timely & ‘accurate’ price discovery, standardised products, central clearing house, disclosure rules, resolution of defaults
- Provides description of network market failures
  - amplification of shocks – role of collateral, margins, mark-to-market accounting
- Policy? Regulatory changes needed for
  - More: standardisation, market makers, transparency, role for clearing houses, among other things…
S “Vish” Viswanathan – Financial Market Damage

What I thought…

- Discussion for existence and benefits of network markets
  - why don’t they move to consolidated markets?
  - tailored products likely to remain? But which?

- How to encourage transformation?
  - need to focus on removing impediments to standardisation/simplification, use of clearing houses

- Scope for markets to do much on their own?
Conclusion