

## RBNZ/VUW PROFESSORIAL FELLOWSHIP WORKSHOP, 17 JUNE 2009

### Discussant comments on “*New Zealand and the Financial Crisis of 2008*” by David Tripe, Centre for Banking Studies, Massey University

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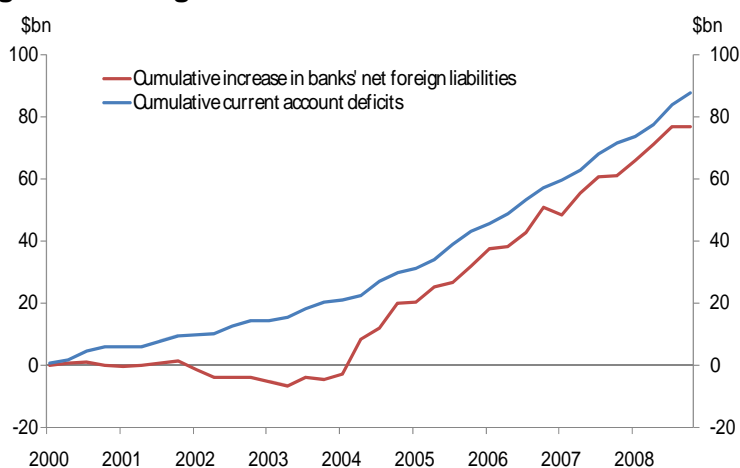
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It is traditional for discussants at events such as today’s workshop to begin by thanking the presenter, and I certainly do not intend to break with this particular tradition. David Tripe has prepared an interesting and topical paper – the latest in a string of valuable contributions looking at the banking sector in New Zealand. We would need a whole separate workshop to examine what the present crisis tells us about the relative efficiency of market and regulatory discipline, but the utility of David’s detailed examinations of registered banks’ disclosure statements over the past several years should not be underestimated.

Turning to today’s paper, the key message I take from the analysis is that banking sector risks cannot be truly divorced from macroeconomic risks, at least in so far as New Zealand’s external accounts are concerned. As David has observed, the New Zealand banks’ offshore borrowing plays a key role in funding the current account deficit – a theme that has featured prominently in recent editions of the Reserve Bank’s *Financial Stability Report*. Figure 1 shows how growth in net offshore borrowing by registered banks has closely tracked the current account over recent years, with the relationship particularly strong from 2004 onward. Partly as a result of these flows, bank debt now accounts for around two-thirds of New Zealand’s total net international liabilities (figure 2).<sup>1</sup>

**Figure 1: Funding New Zealand’s current account deficit**

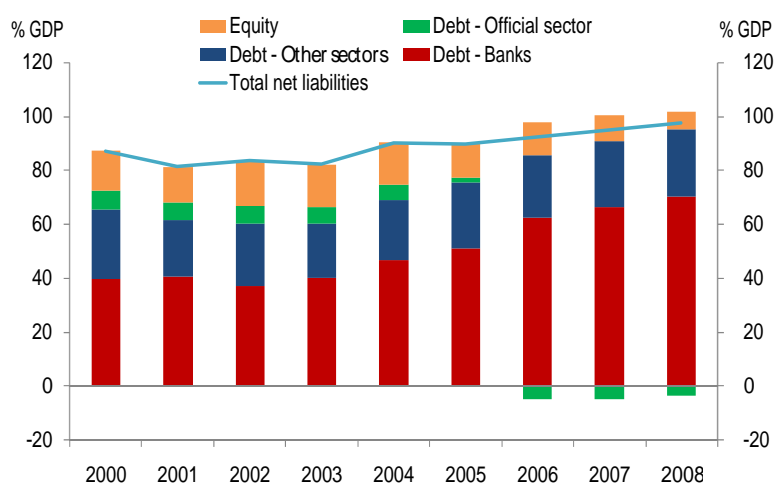


Sources: Statistics New Zealand, RBNZ.

Note: Net foreign liabilities defined as registered banks’ non-resident funding minus non-resident claims.

<sup>1</sup> A large fraction of New Zealand’s international equity liabilities are also due to the banking sector. David’s paper notes that the four largest Australian banks’ equity investments in their New Zealand subsidiaries amounted to \$17 billion at the end of 2008; this compares with total inward equity investment of around \$60 billion.

**Figure 2: Composition of New Zealand's net international liabilities**



Sources: Statistics New Zealand.

Note: Official sector includes general government and the Reserve Bank. Data are for December years.

Viewed from this perspective, it seems clear that a bank funding crisis and a “sudden stop” in capital inflows amount to two sides of the same coin in New Zealand.<sup>2</sup> Two interesting analytical questions flow from this observation: first, how great is the risk of a funding crisis/sudden stop; and second, what (if anything) can policymakers do to reduce that risk?

The remainder of this comment explores these questions briefly, in an attempt to catalyse wider discussion. In so doing, it draws on material from the latest edition of the *Financial Stability Report*, which is available on the Reserve Bank website.

### **Shocks and vulnerabilities**

One convenient way of analysing the risk of a funding crisis/sudden stop is to distinguish between the underlying *vulnerability* and the *shocks* that might expose it. As David discusses in his paper, the vulnerability stems from the New Zealand banks’ heavy dependence on offshore funding and the relatively short maturity of a their international debt. Consistent with these patterns, the US commercial paper (CP) market has for several years been a key source of funding for New Zealand’s major banks.

Given these characteristics, rollover risks are clearly significant for banks in New Zealand. There are, however, some important mitigating factors: exchange rate risks are fully hedged using financial derivatives (such as cross-currency swaps); the major banks are able to borrow from their Australian parents; and all banks have access to the Reserve Bank’s expanded liquidity facilities. Nevertheless, it is evident that an assessment of the willingness of international investors to purchase debt issued by New Zealand banks is central to any analysis of the funding crisis/sudden stop nexus.

<sup>2</sup> Note that a sudden stop is not quite the same as a run on the currency. The latter could also occur as a sharp drop in investor appetite for New Zealand dollar denominated debt issued in international markets by non-residents. Uridashi bonds are a good example. The sale and purchase of these instruments does not involve a capital inflow to New Zealand, although they do play an important role in allowing banks to hedge the exchange rate risk associated with their offshore borrowing.

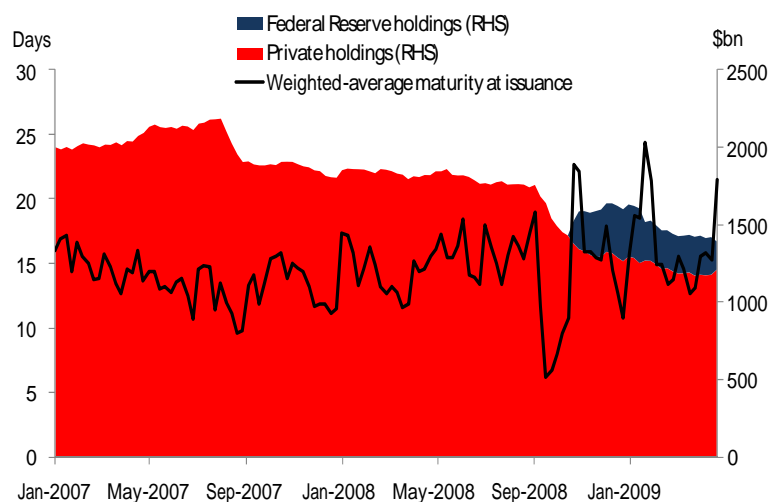
What sorts of shock might undermine this willingness, thus creating a sudden stop and a bank funding crisis? Constructing an exhaustive list is beyond the scope of this comment, but it is reasonably straightforward to identify three leading candidates:

- 1) A marked deterioration in the New Zealand banks' (perceived) creditworthiness;
- 2) Financial distress affecting one or more of the Australian parent banks; and
- 3) A sharp rise in global risk aversion that results in a generalised 'creditor strike' against all forms of bank debt, irrespective of underlying credit quality

Evaluating the risk of a funding crisis/sudden stop in New Zealand requires an assessment of the likelihood of one or more of these shocks occurring within a given time frame. Of course, this is far easier said than done, with models of financial stability clearly still in their infancy. In my own personal judgement, however, shocks (1) and (2) remain highly unlikely. Neither the Australian nor the New Zealand banking systems have experienced credit losses on anything like the scale seen in other developed economies over the past two years, and their exposure to distressed assets in the US and Europe is minimal. Nevertheless, there is clearly no room for complacency, with measures of asset quality currently deteriorating on both sides of the Tasman, albeit from very strong starting points.

The likelihood of shock (3) is somewhat more difficult to judge. The collapse of Lehman Brothers in September last year resulted in an unprecedented surge in risk aversion, with investors generally unwilling to lend to any type of financial institution for maturities longer than a few days.<sup>3</sup> The US commercial market was severely affected and contracted sharply through September and October 2008, before a Federal Reserve purchase programme helped restore a degree of market stability in November (figure 3). This level of market dysfunction inevitably placed material pressures on the New Zealand banks' funding during the latter part of last year.

**Figure 3: US commercial paper outstanding and average maturity at issuance**



Source: US Federal Reserve.

Note: Weekly data, not seasonally adjusted. Weighted average maturity is estimated from daily issuance data, assuming the typical maturity of longer-dated CP is 90 days. Data are to end-April.

<sup>3</sup> Another relevant factor may have been the treatment of senior bondholders in the US government-arranged takeover of Washington Mutual by JP Morgan shortly after Lehman Brothers filed for bankruptcy.

Since the start of 2009, however, conditions in offshore credit markets have improved markedly, in large part due to extensive government intervention aimed at avoiding any further systemic failures in the international financial system. Funding risks facing the New Zealand banks have diminished accordingly, with access to offshore credit markets much easier currently than six months ago. On one level, some comfort can be taken from the banks' ability to ride-out an unprecedented period of credit market dysfunction. But it is also clear that investor sentiment remains extremely fragile by historical standards, and the risk of a further wave of financial market turmoil cannot be ruled out in the current environment. Although clearly lower than in the recent past, the likelihood of shock (3) triggering serious pressures on bank funding and a sudden stop is still uncomfortably high.

### ***Policy actions***

There is generally little policymakers can do to affect the likelihood of a particular shock, and this is certainly the case in the context of developments in offshore credit markets. Vulnerabilities, on the other hand, can usually be mitigated by suitably designed policies, although the lead time required to make a material impact is often very significant. Policymakers also need to be conscious of the law of unintended consequences, and the risk that positive action to address a specific vulnerability will inadvertently create another elsewhere in the financial system.

As David notes in the concluding section of his paper, reducing New Zealand's vulnerability to a bank funding crisis/sudden stop rests primarily on increasing the national savings rate and narrowing the current account deficit. Some movement in this direction appears likely over the next few years, which may ultimately stabilise net international liabilities as a proportion of GDP. However, it would take an unfeasibly large and costly macroeconomic adjustment for New Zealand to actually begin reducing its level of external indebtedness any time soon. The implication is clear – continued dependence on international capital will be an unavoidable reality for the Reserve Bank and other economic policymakers in New Zealand for the foreseeable future.

This does not mean, however, that the extent of the vulnerability cannot be reduced in other ways, for example using financial sector policy. Recent adjustments to the Reserve Bank's liquidity facilities (see above) provide one good example. The Reserve Bank is also in the final stages of promulgating a new prudential liquidity policy that will apply to all registered banks in New Zealand, with the ultimate objective of sharpening incentives for prudent management of funding risks. Among other things, the policy will require banks to lengthen the maturity profile of their debt liabilities. While adjustment will not occur overnight, the introduction of this policy should ultimately help to limit the rollover risks David describes in his paper.

To summarise, David has produced a paper that contains a wealth of valuable information and highlights a number of interesting analytical questions. There is ample opportunity for further work in this space, which is clearly of considerable interest to policy institutions as well as the academic community. In this sense, the paper has clearly achieved its objectives and constitutes a valuable contribution to today's workshop.