Macro Prudence vs. Macro Prudential Regulation:

Public Sector Coordination and Intervention for Long Term Financial Stability

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Macro Prudential Supervision vs. Macro Prudence

Macro Prudential Supervision:

Supervisory tools and governance

Macro Prudence:

Public sector working collectively to promote financial system stability

What is financial stability?

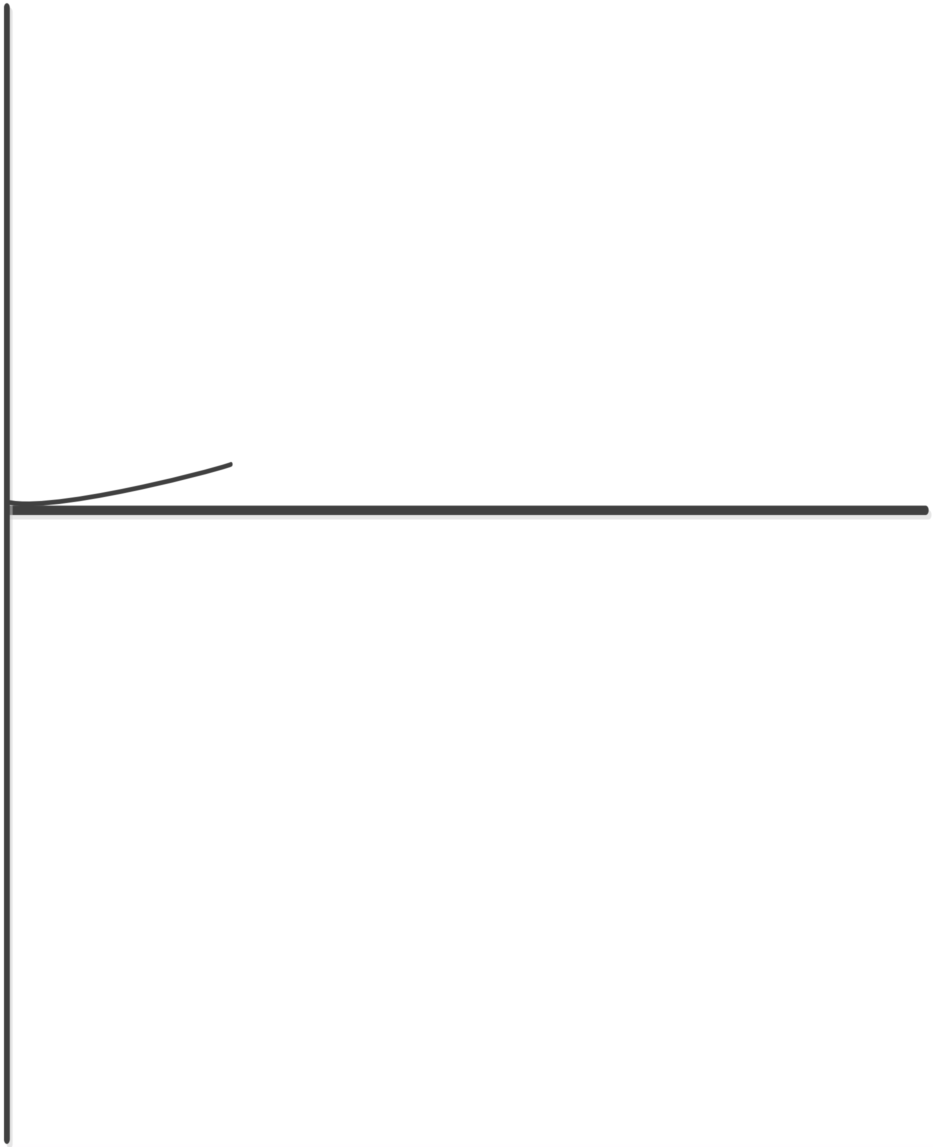
- *Payment systems work*
- *Justifiable confidence that "safe" money is safe*
- *Reasonable access to credit*

- *Major bank failures inconsistent with financial stability*
- *Many bank failures, non bank failures also problematic*

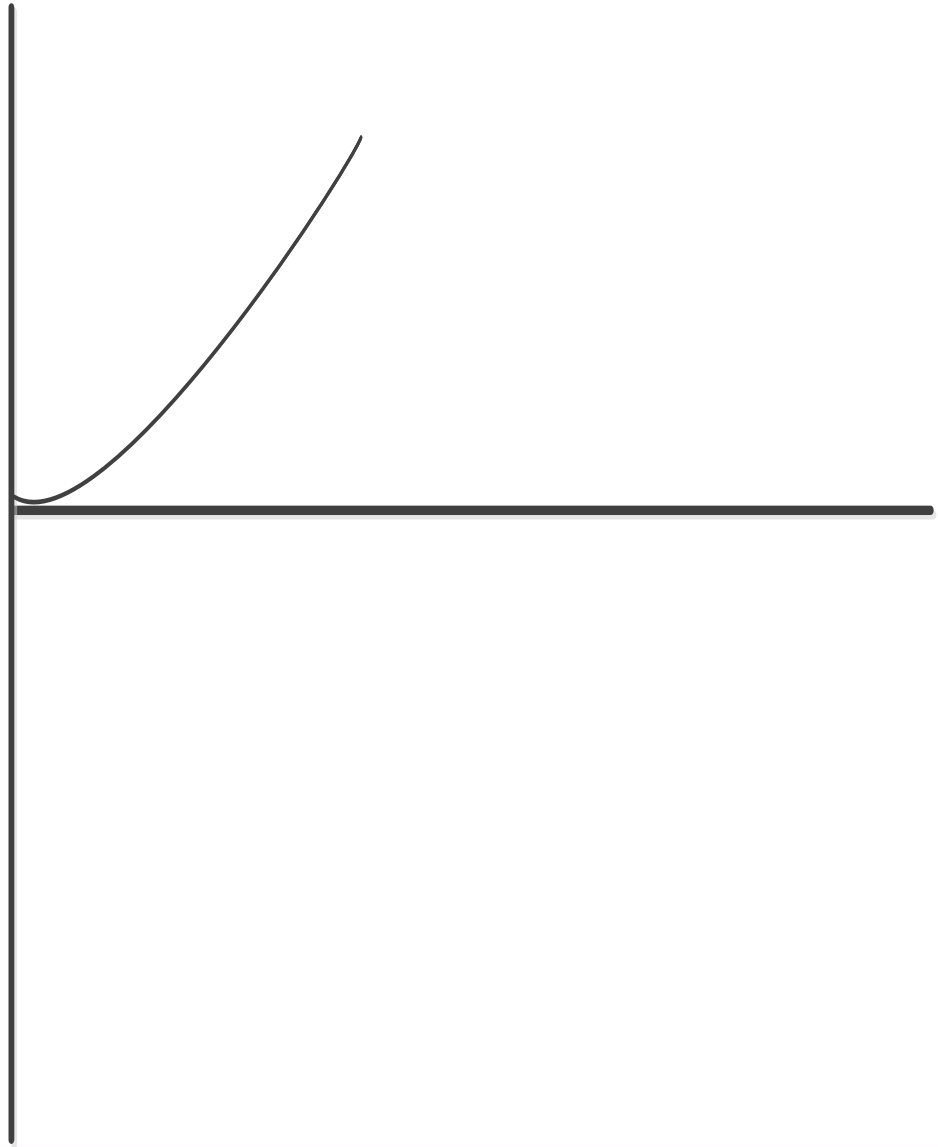
Cyclical instability is the natural state of the world

- *Left to their own devices, banks fail too often*
- *Ditto markets, economies*
- *Public sector intervention sometimes helps...*
- *...and sometimes not*

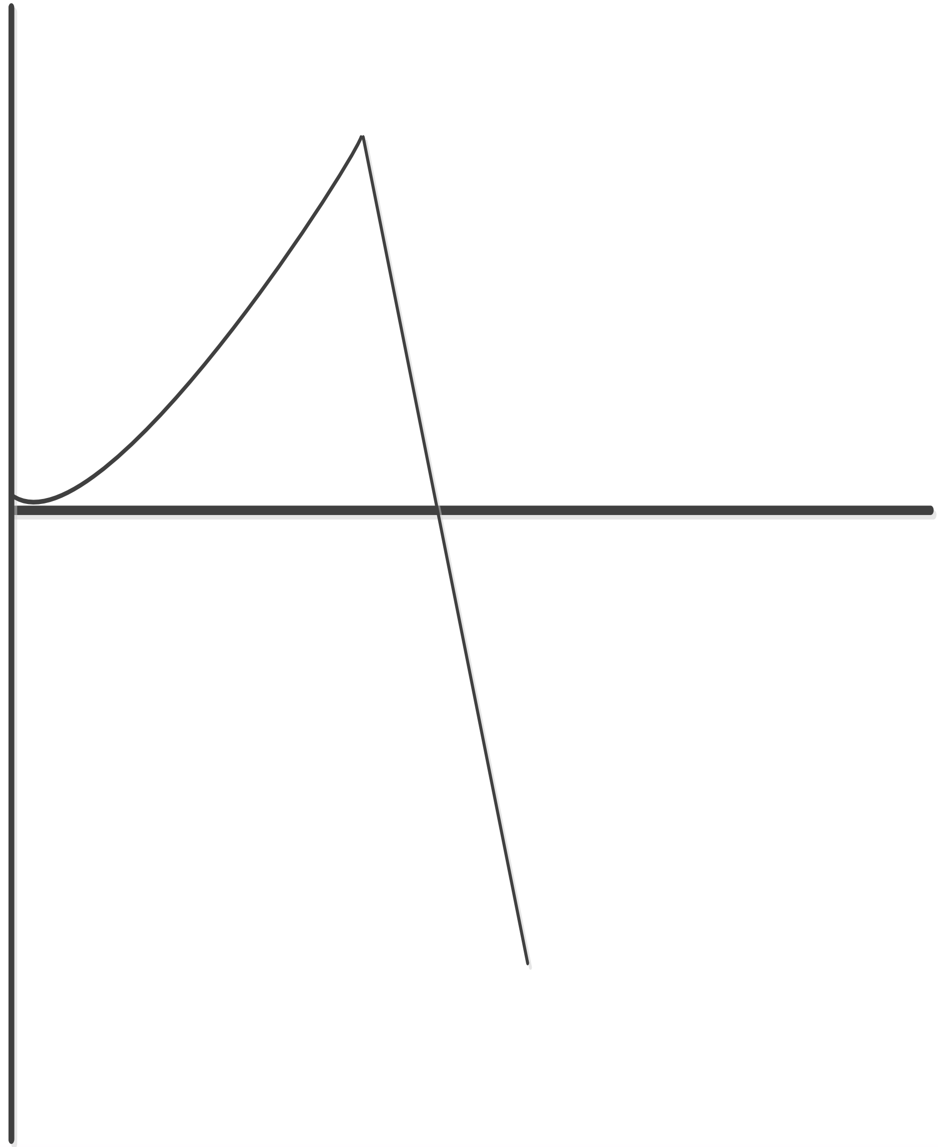
The standard cycle
Phase 1: Confidence grows



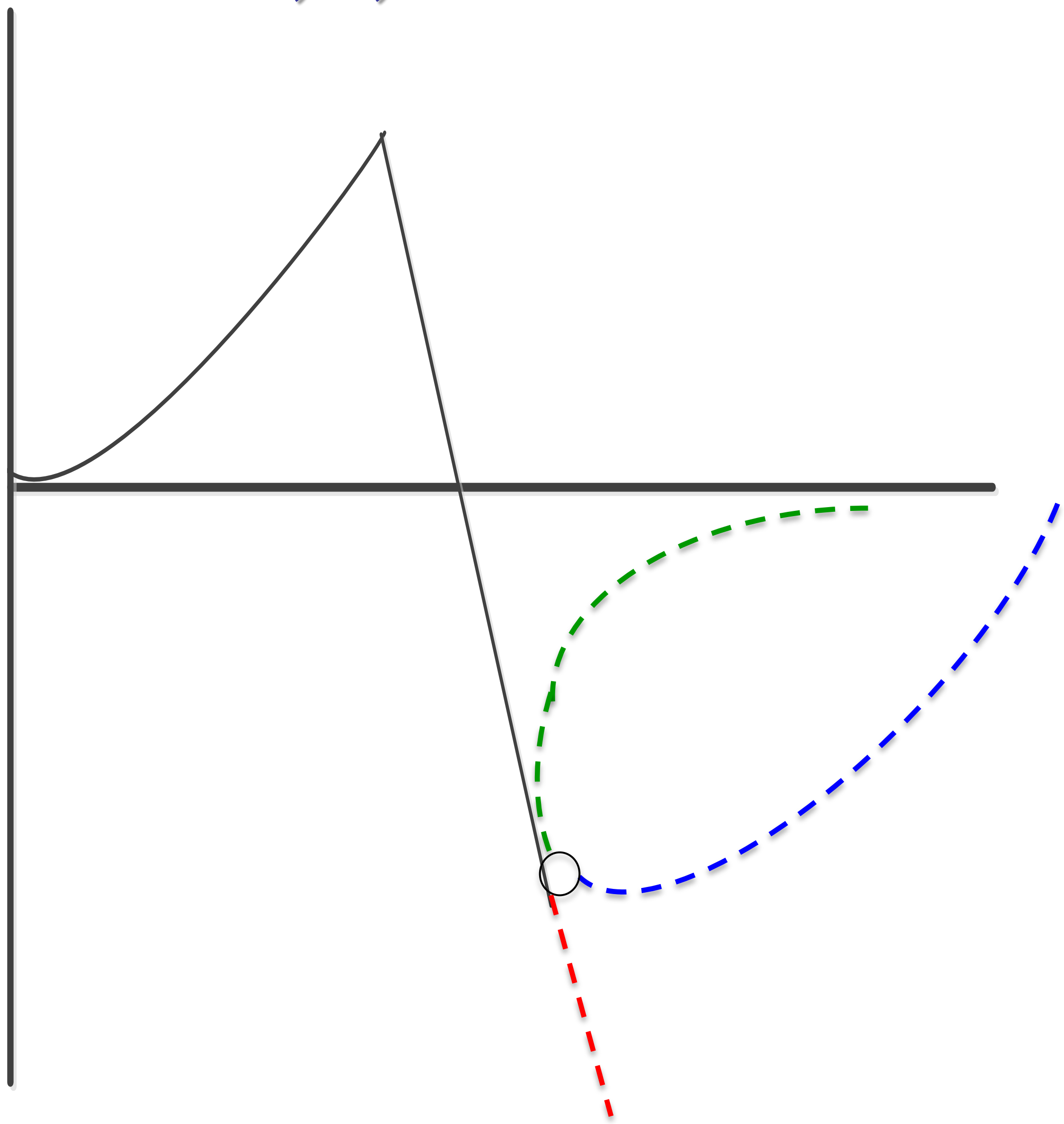
The standard cycle
Phase 2: …leading to a boom

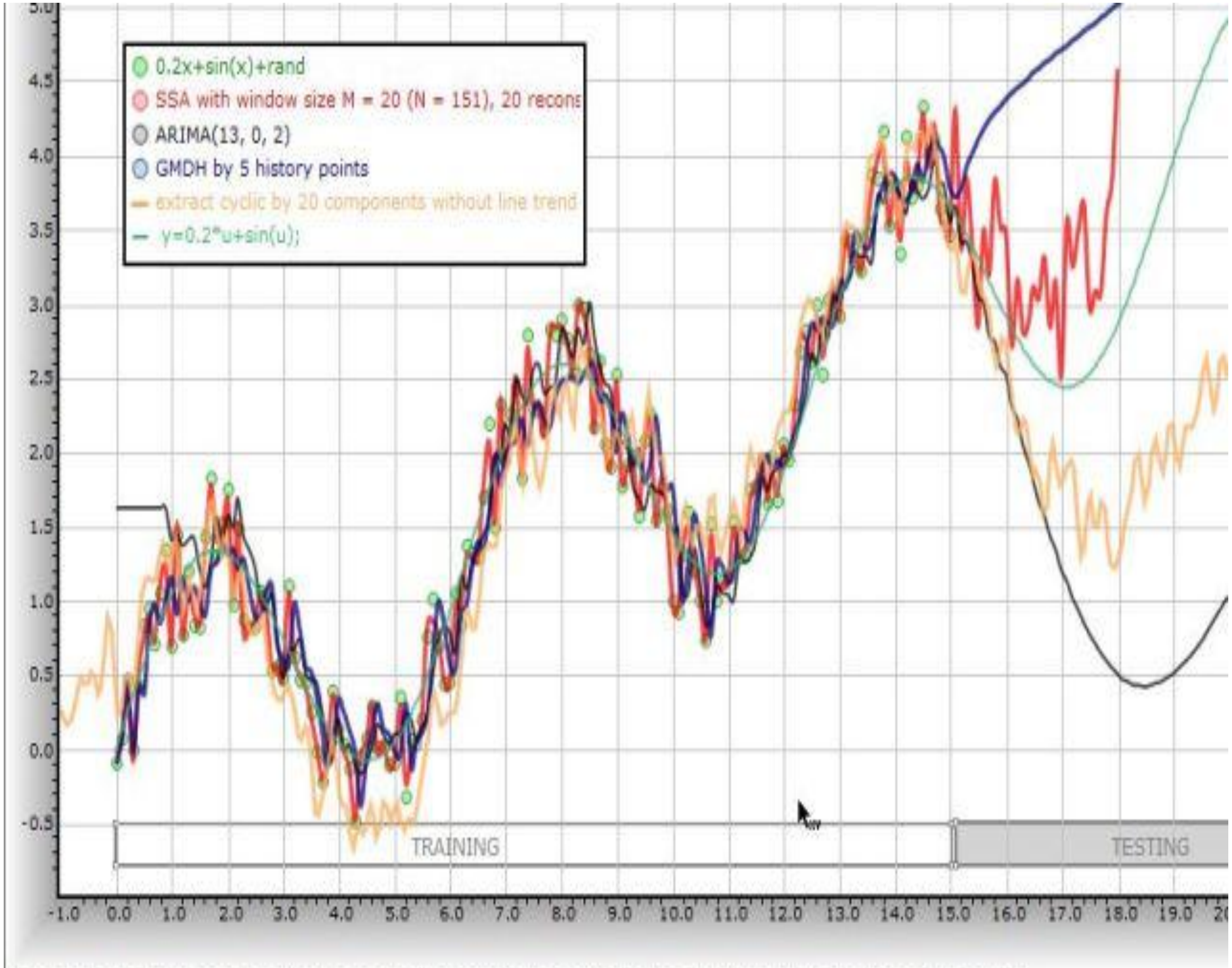


The standard cycle
Phase 3: …the bust



The standard cycle
Phase 3: V, U, or crash

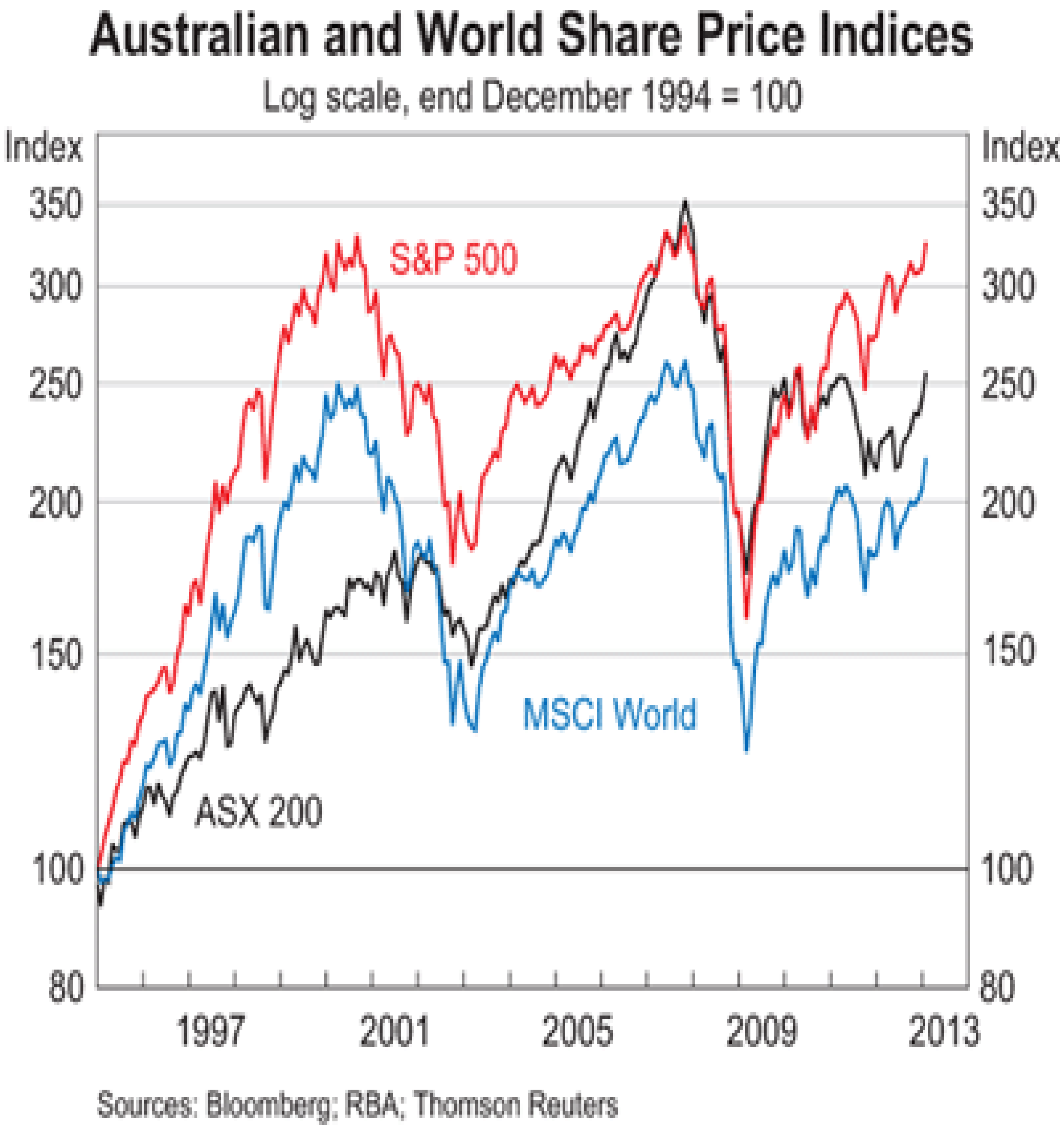


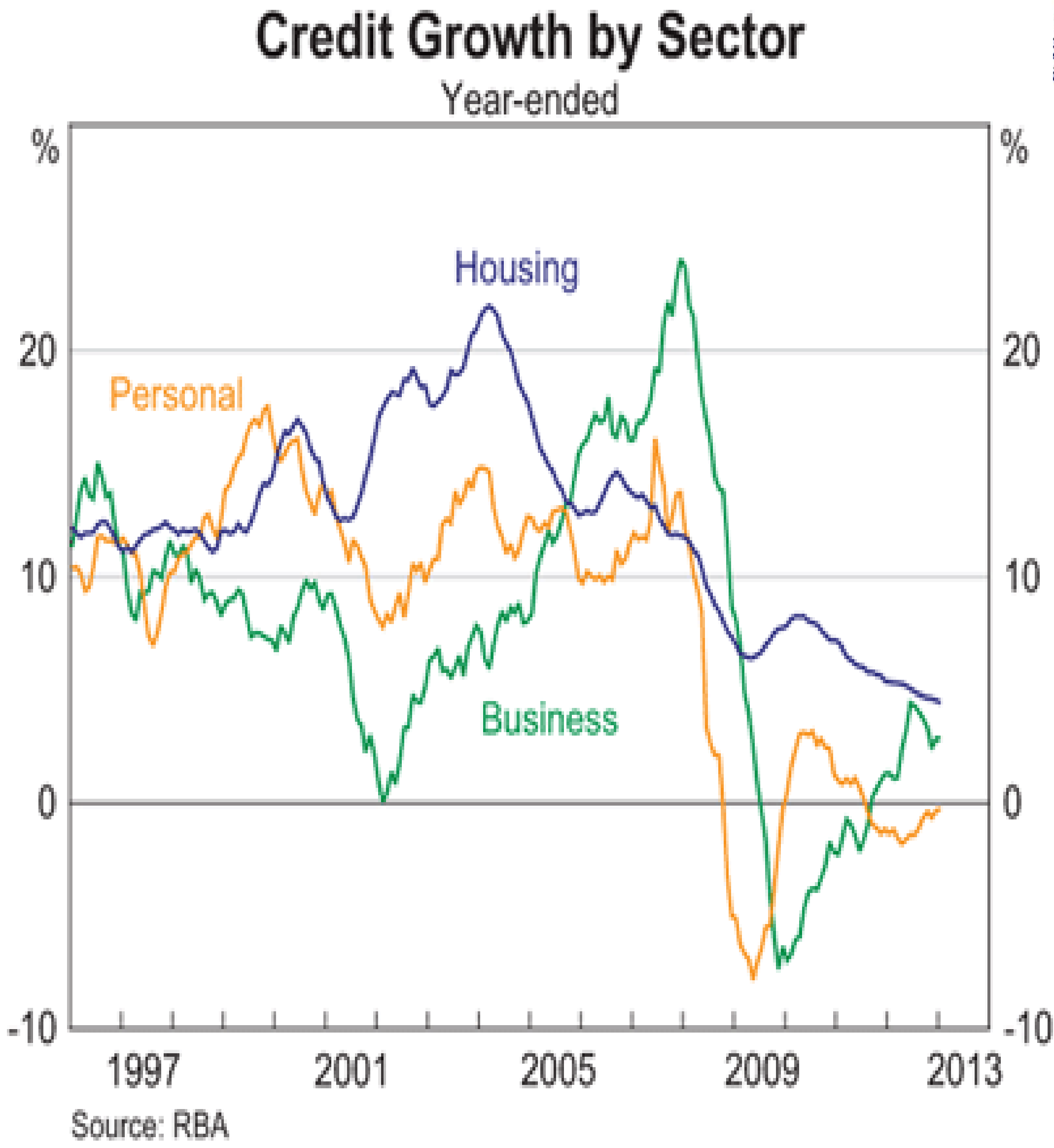


To compare short term and long terms forecasts, we prepare time series testing data (trend with noise) based on formula:

y = 0.2x+sin(x)+random

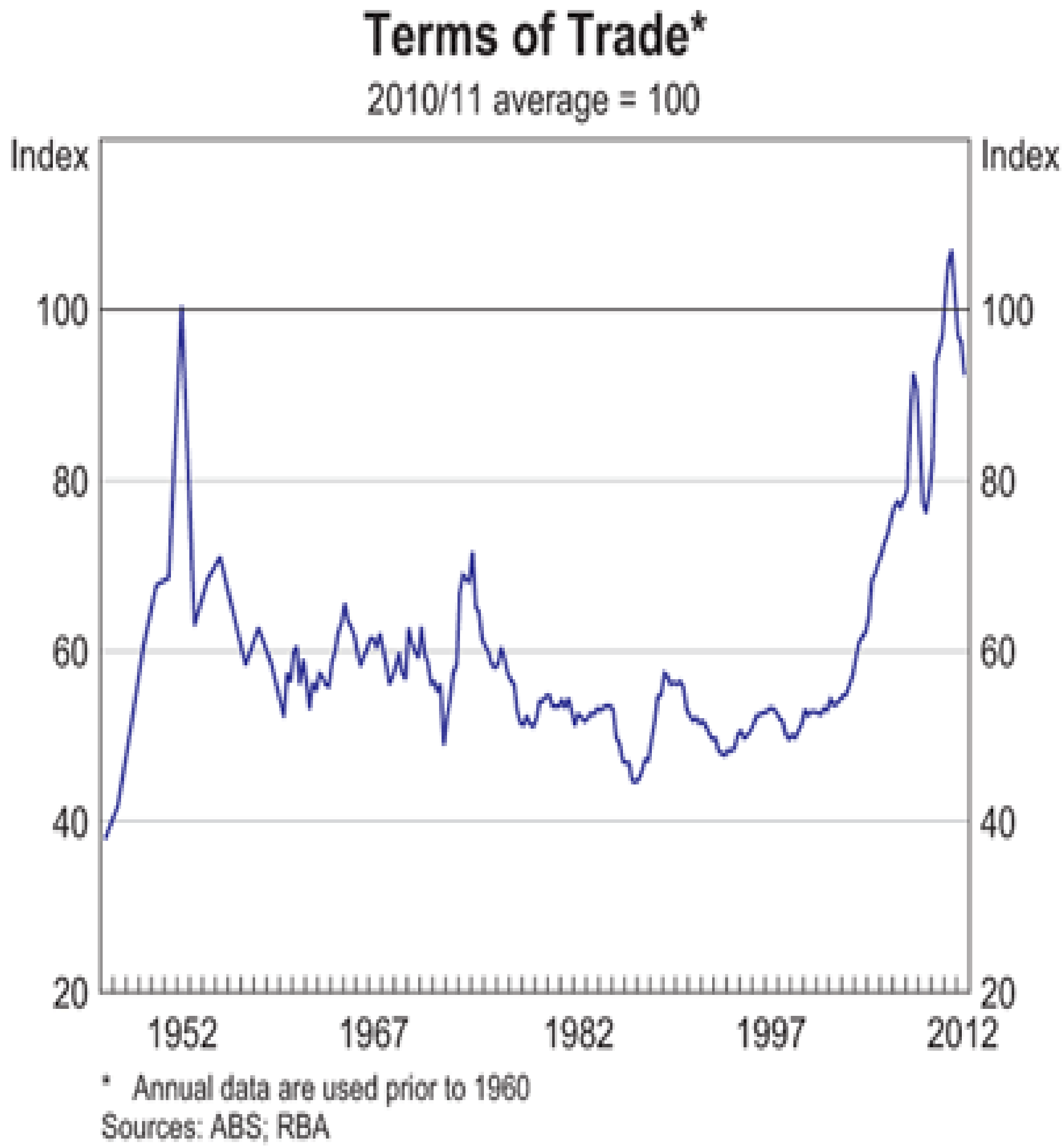
Next we apply SSA, ARIMA, GMDH, and cyclic extraction method to training data in interval 0-15. Results are compared with y = 0.2x+sin(x)


Australian and World Share Price Indices
Log scale, end December 1994 = 100
Index
350
300
250
200
150
100
80
S&P 500
MSCI World
ASX 200
1997
2001
2005
2009
2013
Sources: Bloomberg; RBA; Thomson Reuters


Credit Growth by Sector
Year-ended
%
%
Housing
Personal
Business
20
10
0
-10
20
10
0
-10
1997
2001
2005
2009
2013
Source: RBA

How should the public sector support financial stability?

- *Moderate booms*
- *Prevent crashes from becoming depressions*
- *Encourage V shaped rather than U shaped recovery*
- *Financial sector is an economic shock absorber, not an accelerant*



Terms of Trade*
2010/11 average = 100
Index
Index
100
80
60
40
20
1952
1967
1982
1997
2012
* Annual data are used prior to 1960
Sources: ABS; RBA

Macro Prudential Supervision

- *Only a sub-set of stability policy*
- *We already have the tools…*
- *…and we already use the tools*

The core Agencies

- *Treasury/finance ministry*
- *Central bank*
- *Market/behaviour regulator(s)*
- *Prudential regulator(s)*

Macro Prudence

1. ***Where are we in the financial cycle?***

2. ***Do we need to act?***

3. ***How to coordinate for mutual support?***

Agency roles in Macro Prudence through the economic cycle

	Normal	Boom	Crisis	Recovery
APRA	Discipline outliers, ensure sound prudential framework	Active restraint of most aggressive; possibly tighten standards	Advise on which entities are sound and which troubled, estimate losses	Avoid undue conservatism, manage exits
RBA	Analysis, deepen understanding of potential threats	Jawbone to support APRA, maybe monetary policy	Liquidity support, systemic risk estimates	Monetary policy
Treasury	Guard against complacency, advise government, lead on legislation	Support APRA, emphasise the cost of complacency	Advise government on ad hoc responses	Recovery initiatives
ASIC	Discipline outliers	Proactive enforcement	Protect market operations	Cleanup enforcement
All Agencies	Building intra-agency cooperation, capacity building, contingency planning	Coordinate anti-boom strategy	Close coordination and crisis response	Learn from experience, adjust statutory framework, encourage recovery

Hallmarks of public sector success - pushing back the boom

- *APRA "most valuable when least valued"*
- *Treasury and RBA: Support necessary, unpopular APRA decisions*

An example: 2002 – 2005 home loans

- *Discussion/warnings to Executives and Boards*
- *Discourage sub-prime lending*
- *Changed capital, risk weighting standards*
- *Stress testing*
- *Supervisory intervention*

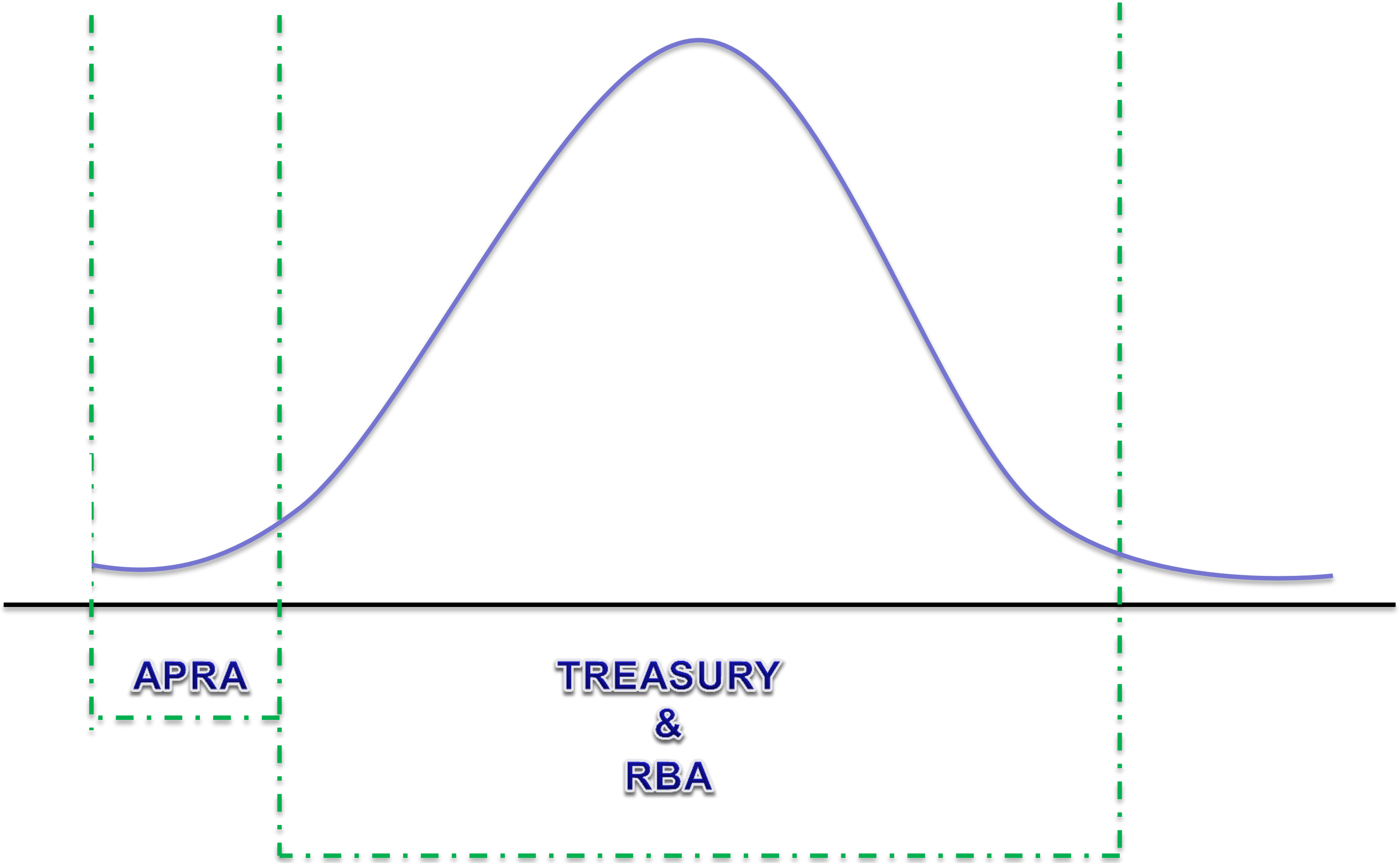
What about the Crisis? (2008 - 2009)

- ***APRA*: Fire fighting, information, problem solving**
- ***RBA*: Liquidity, Government advice**
- ***TREASURY*: Government advice**

The recovery 2010 -

- *Recovery to normal*
- *Strengthen prudential framework*
- *Continue strong supervision*

Who worries about what?



International conformity vs. optimality

- ***Many Groups writing rules***
  - *G20*
  - *BCBS*
  - *FSB*
  - *etc*

- ***"Do it our way"***

- ***Australian strategy***
  - *meet international standards*
  - *then adjust for Australian conditions*
  - *"Adjust" = "conservative"*

Inter-agency cooperation

- *Shared mission*
- *Minimal overlap/competition*
- *Maximum cooperation*
- *Personal relationships help*

Where to from here?

- *Incremental strengthening of Prudential Framework*
- *Improve supervision*
- *Allow for a strong economy…*
- *…but protect against a weak economy*
- *Repeat as necessary over decades*

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