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# Current Financial and Economic Challenges

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## Outline

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- What are the key challenges?
- How are they interrelated?
- Where to from here?
  - Financial Markets
  - Financial Managers
  - National governments

## The Key Challenges

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- The sub-prime crisis
- Climate change
- Changing global economic landscape

## The Key Challenges

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- The sub-prime crisis
  - Climate change
  - Changing global economic landscape
- not to mention
- Terrorism
  - Food shortages
  - Commodity prices
  - Demographic trends
  - Floods, plague, pestilence.....

**Sub-prime crisis: Is it over?**

**5:00AM Saturday October 06, 2007**

By [Liam Dann](#) and [Adam Bennett](#)

When the sub-prime crisis rocked world markets on July 27, New Zealand's sharemarket followed the same dismal path as Wall Street. It sank almost 10 per cent in less than a month.

But the NZX-50 index stopped just short of a fresh closing high on Tuesday and overseas markets have also recovered. The sorry episode appears to be fast disappearing in the rear view mirror.

However sharemarkets do not represent any country's entire economy, and some commentators argue the fallout from sub-prime and the credit crunch that followed represents a huge change in financial fundamentals that is likely to run for some time yet.

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## How Exposed was NZ?

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- Little direct exposure
- Little securitization
- Small securities markets/funds management/derivs
- Well regulated banks !

But

- International linkages
    - small open economy with a large external debt
    - Importance of 'carry trade'
  - "home-grown" problems
    - Finance company failures
    - House-price exposure
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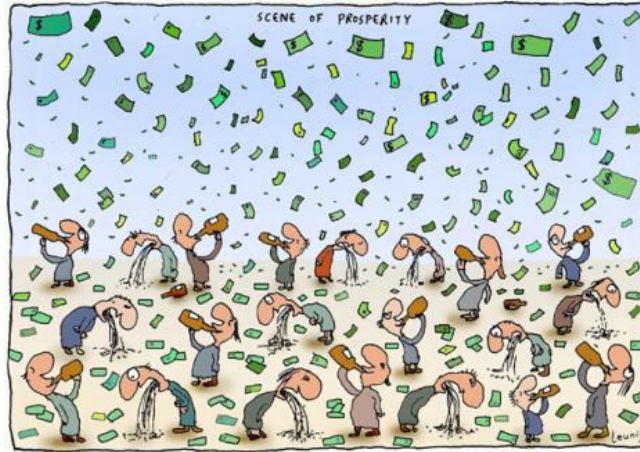
## The sub-prime crisis

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- Causes
  - Liquidity, Leverage, Laxity
- Consequences
  - Asset price inflation → losses → financial chaos → “policy on the run” → reshaping/reregulation of financial system → ????

## A simple perspective

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Ian Ramsay April 1, 2008

<http://business.theage.com.au/opes-prime-who-understood/20080331-22of.html>

Illustration: Michael Leunig

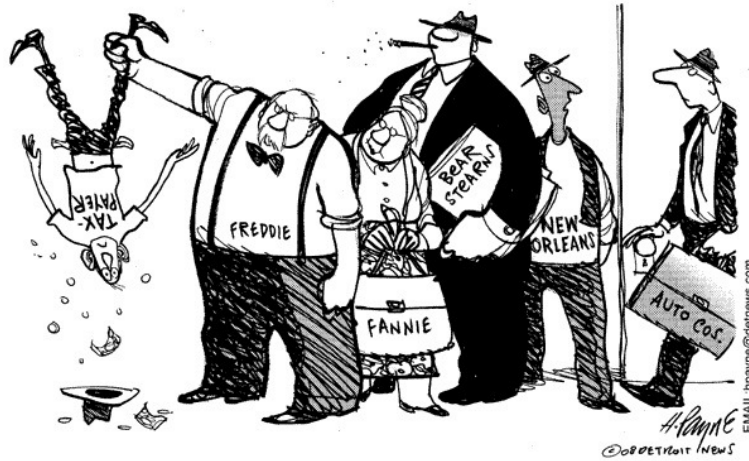
## The sub-prime crisis

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  - Short term crisis management decisions pose risks for formulation of future financial system structure

## Socializing the losses

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*"Take a number."*

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## The sub-prime crisis

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  - Consequences
    - Asset price inflation ⇌ losses ⇌ financial chaos ⇌ "policy on the run" ⇌ reshaping/reregulation of financial system ⇌ ????
    - Short term crisis management decisions pose risks for formulation of future financial system structure
    - Has "temporarily" distracted attention from other major challenges
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## Climate Change

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- The weight of evidence supports.....?
- The weight of opinion supports...
  - some action – but what, and at what cost?
  - And by whom?
- Classic “free rider” problem
  - Compounded by international dimensions
- Sub-prime crisis impeding action
  - Distracting policy makers
  - Economic disruption and costs
  - Viability of most favoured solution

## Climate Change

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- Dominant paradigm
  - create carbon (financial) markets based on limited tradeable entitlements
    - such that environmental effects are “priced into” decision making
- Price signals provide information on expected costs and influence investment decisions
  - But driven by expectations regarding future government decisions on market size, penalties etc
  - Potentially subject to speculation, dominance of traders, volatility, complexity



## Climate Change and Financial Crises

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- Will support persist for creation of new complex financial markets for sophisticated traders, given:
  - sub prime experience
  - need for political allocation of property rights
    - given budgetary cost and arbitrariness of sub prime bail outs
- simplicity of a budget neutral tax alternative
  - eg Tax emissions, return funds pro rata on output basis
    - High emissions/output firms net payers
    - Low emissions/output firms net beneficiaries
- What happens to markets if crisis situation reached?
  - Use of “command” rather than market economy techniques
    - E.g. banning of short sales (globally)

## Changing Global Economic Landscape

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- Financial system is key to adjusting to:
  - Economic Growth of BRICs
  - Weakened US Economy
  - Global payments imbalances and Sovereign Wealth Funds
  - Commodity price movements
  - Increasing role of Euro
- World Economic Outlook
  - High financial markets volatility
  - Stagflation risk

## Prospects for the Financial Sector

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- Reshaping/regulatory change
  - being made on the run
    - Will influence long term outcome, but
  - More considered analysis needed
- Some possible outcomes
  - Monetary policy will respond to asset price inflation
  - Macro-prudential policy adopted
  - Taxes on asset trading (“sand in the wheels”)
  - Financial product “suitability” standards
  - Increased role for exchanges ?

## Other Future Regulatory Debates

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- Basel 2 , 3, .....,n ?
- Universal banking and investment banking regulation
- Future financial market liquidity support arrangements
- “Too big to fail” paradigm
- Accounting Standards and marking to market
- Corporate Disclosure Requirements
- Stock lending, short selling, margin lending arrangements
- Security/ Financial Product issuance arrangements
- Depositor/Investor Protection
- Financial Advice
- Director’s duties

## What Implications for Financial Managers?

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- Prolonged period of increased cost of capital and reduced liquidity
- Increased attention to risk management
  - Increased volatility
  - Counterparty risk
  - Internal controls
- Increased attention to capital management
  - Funding mix
  - Liquidity
- Improved understanding of financial products/services being offered
  - Investments, funding, and working capital
- Market distrust of opaque complex financial structures

## Implications: National Financial Services Strategies

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Heightened importance of

- “safe haven”
  - Deposit insurance, prudential regulation
- Drawing a “line in the sand” re govt bailouts
- Protecting unsophisticated investors/borrowers
  - Advice, education, disclosure strategies don’t work!
  - Try prohibitions, tax/incentives, penalties?
- Avoiding excessive concentrations of financial power
  - Should competition regulators consider systemic risk implications (eg concentration in CDS market)?
- Developing listed exchanges and public markets

## Implications: National Financial Services Strategies

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- Financial sector growth likely to slow - temporarily
  - An important industry; contributions to “real sector” development critical; have been overshadowed by excessive “intra-industry” activities (and pricing which exaggerates value added)
  - How to restore supporting role focus?
- Becoming a regional financial services hub?
  - Australian Government strategy
    - A tarnished industry, but competition weakened
- Developing the local financial services industry
  - Spill-over benefits of local head offices
  - Value of local information in finance
  - What financial structure maximizes national social value added?

## Conclusion

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- World financial sector in chaos
  - Liberalization and innovation have brought benefits
    - Have also brought excesses
- Financial crises increasingly common
  - Financial systems inherently fragile (and complex)
- Design of adequate regulatory system
  - Being done on the run in major centres
  - Reduced influence of free-market ideology
- Risks of
  - Stagflation
  - Regulatory overreaction stifling “good” financial activity
  - Inadequate attention/ ability to deal with other key challenges