PRIORITIES FOR AUSTRALIA'S PRESIDENCY OF THE G20 IN 2014 AND THE ROLE OF THE GLOBAL FINANCIAL SAFETY NET

SPEECH TO THE SEOUL G20 CONFERENCE

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MR BARRY STERLAND PSM[1]

AUSTRALIAN G20 FINANCE DEPUTY

Introduction

Thank you for the opportunity to address you today, and may I also extend my own warm welcome to this conference. This is our first international public event and this is appropriate, given Australia's longstanding relationship with Korea and our location in the Asia-Pacific.

The G20 will be dealing with an uncertain and challenging environment over the coming year. There are some welcome positive signs for growth, particularly in the US and Japan and the stabilisation of growth in China. However, it is clear that world economic growth is weak and continues to disappoint, particularly the presence of high output gaps and spare capacity.

Unemployment remains unacceptably high in many countries, financial systems remain vulnerable, and government balance sheets remain under stress.

In the face of slow growth, advanced economies need to boost investment and trade in order to lift demand, employment and productivity, continue financial sector repair while restoring fiscal sustainability over the medium to longer term.

Emerging economies face the challenges of slowing growth, tighter global financial conditions, and the need for significantly increased levels of high-quality investment.

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Australia’s G20 priorities

I am optimistic that ambitious outcomes can be delivered at the Brisbane Leaders’ Summit that respond in practical ways to these challenges.

As the Australian Treasurer, Mr Joe Hockey, has said, we will aim to shift the dial on growth.

Restoring strong growth across the global economy will clearly be the biggest of the challenges we face, and it will not be easy to tackle.

We want to maintain a tight focus on practical outcomes that will lift investment and trade, boost participation, create jobs and build the resilience of the global economy.

Building on the St Petersburg Summit, we are well placed to do this in 2014.

Australia’s G20 Presidency will structure discussions around the G20’s core agenda of promoting stronger economic growth and employment outcomes, and making the global economy more resilient to deal with future shocks.

Australia’s priorities are outlined in the 2014 priorities released on 1 December 2013. I will focus on my Finance Track responsibilities given the emphasis of this conference, but it is important to note that the core growth response will draw on policy responses from across the G20 agenda, including trade, employment and development aspects.

Boosting private sector-led growth through investment in infrastructure will be a key priority for Australia’s Presidency. Such investment presents an opportunity to contribute much needed demand, while also enhancing the productive capacity of the economy.

We are looking to open up high-quality investment opportunities and make it easier for funds to flow to these. Improved governance and project standards are critical in ensuring that the productivity benefits are maximised. We are aiming for a package of measures that will measurably lift quality investment in G20 countries and beyond.

The infrastructure work will be a key element of the comprehensive growth strategies called for by leaders at St Petersburg. They will be at the core of the Brisbane Action Plan. This will be combined with practical measures to improve trade and strengthen employment.

The issue of investment and infrastructure is relevant to debates about the need for better coordination of macroeconomic policy, particularly monetary policy and related spillovers.

I believe that decisive action to lift high quality investment could make a significant contribution to better coordinated and balanced policies by reducing the weight monetary policy needs to bear.

Our second overarching theme is building resilience in the world economy.

A particular focus will be reforming international tax arrangements. We want profits to be taxed where the economic activities are performed and value is created.

Tax base erosion and profit shifting reflects a failure of international tax systems to keep pace with the changing structure and dynamics of the global economy, including the rise of the digital economy.

This has provided tax planning opportunities for some corporate profits to be subject to artificially low or even no taxation. These practices pose a threat to the sustainability of public finances and mean that domestic businesses face an unfair burden. As a result, it is harder to maintain a tax system with wide bases and low rates to support growth.

Australia will also continue to work on building a more resilient global financial system. We want to complete financial reforms that respond to the root causes of the last crisis: building the resilience of banks; ending too big to fail; making derivatives markets safer; and improving oversight of the shadow banking sector.

It is important to emphasise that the themes of growth and resilience work hand in hand.

A steady and robust flow of investment relies on stable financial markets – we can’t achieve our investment agenda unless there is confidence in the safety of the global financial system.

Our work on removing obstacles to capital market financing seeks to ensure the overall financial system provides strong support for growth.

The global financial safety net

Economic resilience also requires an effective global financial safety net. The IMF is the cornerstone of this safety net, and IMF reform is critical to the legitimacy and effectiveness of that institution.

You can be sure Australia will continue the G20's focus on this important reform. Given the focus of this conference, I thought I would reflect on the broader issue of ensuring a strong global safety net.

The global financial safety net is a policy challenge that the G20 has been at the frontier of for close to 15 years. It is an issue uniquely suited to the G20 as all countries benefit from the positive externalities that flow from an effective global financial safety net that takes in global, regional, bilateral and national arrangements.

This part of the agenda comes with its own challenges. Most recently, there has been uncertainty around whether we will complete the significant reforms to the IMF that the G20 agreed to in Korea in 2010. I remain hopeful that we can soon have progress in finalising these reforms, which will provide an important platform for further discussions this year.

Discussion of the global safety net has taken an extra significance this year as a result of the broader macro-economic environment.

Investors have been reacting to a rapidly changing environment. Faced with historically low returns on traditionally safe securities in the major advanced economies, periods of relative calm have seen capital pour into higher risk investments across a range of markets. Some of this capital has proved to be flighty in the face of tremors in global markets.

As we move towards the normalisation of monetary policy in major advanced economies, this will be a component of G20 discussions throughout 2014.

Australia will be looking to anchor these debates in the importance of sound macroeconomic frameworks to cushion against economic shocks and ensure flexible responses. The right domestic policy settings will depend on a country's circumstances; however, there are some common principles.

Flexible market-determined exchange rates can act as a shock absorber by ensuring that prices and economic activity adjust dynamically to changes in the rest of the world.

Of course, a market-determined exchange rate can sometimes overshoot and there have been periods where the Australian dollar has appeared out of alignment with fundamentals. Our Reserve Bank Governor has indicated recently that this appears to be the case at the moment. He has also indicated that intervention is sometimes warranted.

But, by and large, the Australian economy has been well served by its approach to foreign exchange rate management.

A trend towards capital account opening will gradually help develop and deepen domestic financial markets. This will provide the tools to the private sector to manage their own exposures.

Efforts to improve prudential oversight of the financial system will better manage the risk of local financial institutions channelling shocks that originate offshore to the domestic economy.

And credible macroeconomic arrangements will underpin stability as markets see that governments have the headroom to respond to crisis situations.

Finally, there can be a role for targeted interventions in financial markets to deal with particular vulnerabilities. In this regard there has been international interest in macro-prudential policies and targeted capital account management, with the latter being particularly relevant for emerging economies.

Even with the right domestic toolkits, however, financial safety nets will still be required as insurance against the most severe events.

So this brings us to an important question for this conference. In today's world, what is the appropriate role, composition and size of the global financial safety net?

Let me outline a few thoughts in response to this question. I think that these represent the conventional wisdom in this room, but it is sometimes worth repeating basic propositions to ensure that we are all on the same page.

My first point is that there is a strong case for maintaining a well-resourced financial safety net.

Resources in financial safety nets had largely stagnated during the decade leading up to the global financial crisis. Since the early 1990s, the size of the IMF balance sheet simply had not kept pace with strong global economic growth and the growth of gross capital flows and trade.

It's always easier to say in hindsight, but perhaps this was due to the mistaken belief that the likelihood of large crises had permanently fallen. This belief was surely shattered with the collapse of Lehman Brothers.

The global financial crisis demonstrated that advanced economies may need to call on safety nets, and has highlighted the risk of contagion effects amplifying the cost of crises. At the same time, emerging market economies represent a growing share of the world economy and capital markets. Historically, countries with developing financial systems have been a source of instability.

Therefore, we should look to ensure that the global financial safety net is sufficiently resourced. As always, this must be balanced against the risks of moral hazard and inconsistent approaches to crisis prevention and resolution.

The role of the safety net is to support economic and financial stability by acting as a financial backstop, providing emergency financing where a country is unable to meet external payments and cannot access markets. Safety nets are not a panacea for all ills. They are, and should remain, a last resort. And they should be activated in the context of soundly based policy settings aimed at addressing underlying policy weaknesses where these are present.

This suggests a key role for a strong, objective, independent international institution. It leads to my second point - that the global financial safety net should be structured around the linchpin of the IMF.

A diverse membership and long history provides the IMF with several unique features that are irreplaceable at a regional or bilateral level.

The IMF has the greatest capacity to raise resources in times of need and to ensure that credit risk is diversified globally to the greatest extent possible. As such, it provides the most effective and low cost insurance against crises.

The range of perspectives also makes its advice more robust and provides a greater degree of autonomy and independence compared to other institutions. These characteristics, if well used, provide the IMF with the potential and credibility to impose conditionality fairly and impartially. Reforms to its surveillance functions, and its own independent evaluation function, have sought to enhance this role.

We should make no mistake. A safety net without the IMF at its centre would be incomplete and would put at risk global economic and financial stability.

This underlines the urgency of reforming the IMF to provide a greater voice for emerging and developing countries to ensure its ongoing credibility, legitimacy and effectiveness. Australia is completely committed to this. Without reform, there is potential to wear away the advantages the IMF brings to the safety net.

There is also a need to continue to ensure the IMF is a trusted institution. This will only come from the right governance, a track record of consistent and effective IMF surveillance, and well-calibrated responses to crises. The dialogue at this conference is one way of contributing to this.

The third point of the emerging conventional wisdom is that regional financial arrangements (RFAs) and bilateral support can have an important role within the safety net and that they must be rigorous and structured so as to complement the IMF.

RFAs can deepen and diversify safety net resources, contribute regional perspectives to surveillance and program design and exercise suasion over member countries in a way that—if effective—can complement the role of the IMF.

Yet, the very strengths of RFAs can also be their weaknesses. The closeness of countries that participate in regional arrangements means that imposing potentially painful but necessary conditions for assistance can be difficult and uncomfortable. The narrower base of resources means they are less reliable, less diversified and therefore more risky for contributing countries. Finally, RFA surveillance may be partial as the global picture is not as obvious.

More can be done to improve collaboration between the IMF and RFAs to leverage their individual strengths, which will be the subject for tomorrow's seminar.

Bilateral support can also be an important buffer that has the advantage of being able to be mobilised quickly. This feature means it is a form of assistance that many countries prefer.

Over-reliance on a web of bilateral arrangements, though, will leave the safety net incomplete and peppered with holes, and undermine the positive externalities that the global financial safety net provides. And the issues around diversification, monitoring and policy conditionality apply ever more to these arrangements.

Nevertheless, the issue of how bilateral arrangements link with global, regional and national arrangements may warrant more attention.

Australia's experience

At this point, you may be asking yourself why an Australian is speaking to you at this conference on regional financial arrangements.

After all, Australia's levels of foreign exchange reserves compared to other G20 countries in our region may seem incompatible with taking an interest in these matters.

We have around $50 billion in reserves, compared to reserves of China with $3.7 trillion, Japan with $1.2 trillion, Korea with $332 billion and Indonesia with $92 billion. They are lower in proportion to our economy's size though more in line with some other advanced economies outside the region.

I can assure you that this does not mean that Australians are ambivalent towards the risks of shocks and crises. Rather, our level of reserves balances the need for sufficient capacity to mitigate shocks whilst minimising the opportunity costs and risk exposures of reserve assets.

It is also consistent with our decentralised approach in which the private sector manages its own risks. Deep financial markets provide the instruments needed for private actors to hedge external liabilities.

It could be argued that this combination provides a more resilient overall economic structure.

Australian corporates make very active use of financial markets to hedge their exposure, either through taking on Australian dollar denominated external liabilities, or through hedging instruments.

Breaking this down further, Australia's banking sector, which has a lower tolerance to shifts in the external position, uses hedging more heavily to ensure that their net exposure is very low.

In this context, these regional or bilateral arrangements which require the pre-commitment of foreign currency resources will be costly for Australia to directly participate in.

Unlike others in the region, we do not maintain large reserves to pre-commit in bilateral or multilateral swap arrangements. And in the end we think our approach to reserves has fundamental merit, and so would aspire to long run regional arrangements consistent with this.

Nonetheless, we are actively seeking to engage with the financial architecture in our region and have a strong interest in ensuring that it develops in a way that is consistent with the framework I outlined earlier.

Using the central government's balance sheet provides one avenue for providing bilateral support instead of using foreign exchange reserves. That is why we have been willing to contribute to stand-by loan arrangements with regional partners.

Contingent budgetary support is more consistent with our own approach of low reserves, flexible exchange rates and ensuring domestic policy settings guard against shocks so that safety nets are a last resort.

Australia has also entered into a local currency swap arrangement with China to provide a useful backstop to trade settlement. This sits well with our philosophy of ensuring markets are the primary channel for adjustment.

We are also open to considering other avenues to engage with the region at a bilateral and multilateral level. For example, Australia stands ready to assist in the development of AMRO which has the potential to fill any existing gaps in regional surveillance of the Asian region.

We will look to lend our support to a range of initiatives such as this conference because of our view that the links between the different parts of the global financial safety net are crucial to ensuring that, as a whole, it is cohesive and effective.

Conclusion

To conclude, these issues are all squarely within G20's remit and will be present in discussions in 2014. Australia will be aiming to ensure a strong ongoing global financial safety net that will hold us in good stead for the years to come.

Thank you for listening.