Arguments against APRA Proposals are Straw Dogs

The Australian banks have been vigorously resisting APRA proposals for new, higher, liquidity requirements, with most of the attack being focused upon requirements to hold larger amounts of government securities. There are three main issues which are being targeted.

The first is the claim that a requirement to hold more low yielding liquid assets will mean a switch out of higher yielding loans and thus reduce bank profitability and international competitiveness or, God forbid, require the costs to be passed on to borrowers. As I have previously argued ("RBA's third law of finance", AFR Nov. 2 2009) this is a myopic view which ignores the system wide effects.

To illustrate, consider the case where a bank buys government securities from a superannuation fund to bolster its liquidity holdings. Because bank deposits are the means of payment for society, the net outcome is that banks, in aggregate, have an increase in deposit liabilities (to the superannuation fund seller of securities) and an increase in government security asset holdings.

Yes, there may be some interbank settlements required if the super fund has its accounts with another bank, but in aggregate banks have an expanded balance sheet – and probably make a miniscule (or maybe larger) margin on the difference between government security yields and deposit interest rates.

A second argument is that there is not enough Australian government debt to go round, and that liquid asset requirements should allow for a broader range of assets. However, broadening the range of eligible assets to include securities which have default risk would defeat the purpose of the requirements.

As the GFC has shown, if banks attempt to dump private sector securities into the market to generate liquidity, the prices of those securities are driven down and yield spreads increase. This can lead to a vicious cycle where lower financial asset prices spark margin and collateral calls, causing further selling pressure and a downward spiral.

In contrast, if banks unload government debt, there is no such credit spread, and asset price deflation spiral, effect. Yes, government yields might tend to rise, but the Reserve Bank is able to offset that by amending its target cash rate, or by stepping in as the purchaser of such securities.

And looking ahead, it is far from obvious that the shortage of government debt of recent years is indicative of the future. Governments around the world have gone into deficit financing mode, and the world is awash with government guaranteed debt (mostly issued by banks!)

The third issue is whether such liquidity holdings will work in the event of a crisis? Unless Australians take to withdrawing cash and hiding it under their mattress the answer is yes. The reason can be found hidden in the complexities of our financial system architecture.

Ultimate liquidity (currency and deposit liabilities of the Reserve Bank, traditionally referred to as base money) changes day by day (to a first approximation) only as a result of: government expenditures or receipts; RBA intervention in the forex market; or RBA transactions in securities with the private sector. It is essentially a closed system under the control of the RBA. Withdrawals of deposits by bank customers (except of the mattress stuffing kind) to place elsewhere (including overseas) only redistribute the ultimate liquidity within the banking system (although they might have significant effects on asset prices and exchange rates).

So a liquidity crisis consists essentially of banks being unwilling to lend ultimate liquidity to each other, and preferring instead to build up their holdings of it in deposits at the RBA. The result - the interbank lending rate would climb above the RBA target cash rate, and the RBA would need to inject further ultimate liquidity into the system to meet the increased demand. How do they do that – by purchasing government securities from banks!

It may be argued that the RBA liquidity injection could take the form of purchases of different sorts of securities from all sorts of entities (rather than banks) – so why force banks to hold government securities to enable this method of system liquidity management. Well, it's simpler, the banks already have a special position in terms of accounts at, and dealing arrangements in government securities with, the RBA, and use of private sector securities raises complications about terms and collateral requirements involved in repurchase agreements. And the other arguments advanced against it (about costs, competitive effects, and availability of government securities) don't stand up to scrutiny.

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