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WHAT DOES LOWE THINK?

PHILIP LOWE'S PERSPECTIVE ON BANKING CRISES

Philip Lowe's Perspective on Banking Crises

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Banking crises, although relatively rare, can have devastating impacts on both industrial and emerging market economies.

Particularly since the wake-up call of the Global Financial Crisis in 2007-08, it has become increasingly important to develop tools to predict and prevent banking crises.

In Australia, then, it is worth examining the perspective of Philip Lowe, current Governor of the Reserve Bank of Australia (RBA), on banking crises. By doing so, we can better understand the viewpoint of one of the most influential people in Australia's financial sector.

In this report, Secret Agent analyses a 2002 paper by Lowe and economist Claudio Borio, which suggests a method to predict banking crises.

Borio and Lowe argue that economists should aim to find a set of indicators which can fairly accurately predict the onset of a banking crisis. What these indicators are will depend largely on the economist's perspective on the origin of banking crises. In other words, how we respond to banking crises will be influenced by our perspective on the causes of them.

The authors' view of banking crises can be broken down into four main points:

1. Banking crises tend to arise from deteriorating economic fundamentals, particularly declines in asset quality.
2. Crises with the most significant impacts stem from the exposure of multiple institutions to external risk factors, rather than failure for internal reasons.
3. Vulnerabilities can build up over time, and are linked to financial cycles. For example, stable economic conditions leading to cheap lending and unbalanced investment, which then triggers a reversal.
4. Banking crises have unpredictable timing, although we should be able to detect the symptoms.

Borio and Lowe propose a set of indicators which may be able to detect the above characteristics, leaving enough time to take preventive measures.

They suggest that a small set of three variables are useful for this task: ratio of private sector credit to GDP, equity prices, and real effective exchange rate. Significantly, they leave out property prices due to lack of data, despite the fact that these seem to play a significant role in banking crises.

They test these indicators by looking at banking crises in 34 countries over the period 1960-1999. Their reliability is measured by seeing whether they reliably predict crises, and whether they give false positives.

Table 1
Composite Indicators, all countries
Source: Borio & Lowe 2002, p.49

Horizon (years)	Credit (4) and asset price (40)		Credit (4) and exchange rate (7)		Credit (4) and (asset price (40) or exchange rate (9))		Credit (4) and (asset price (40) or exchange rate (4))	
	Noise/ signal	% crises predicted	Noise/ signal	% crises predicted	Noise/ signal	% crises predicted	Noise/ signal	% crises predicted
1	0.14	43	0.10	43	0.13	63	0.08	25
2	0.08	55	0.09	43	0.10	68	0.05	30
3	0.06	60	0.08	43	0.08	70	0.03	33

[1] A signal is correct if a crisis takes place in any one of the years included in the horizon ahead. Noise is identified as mistaken predictions within the same horizon. Given the data frequency and difficulties in assigning crises to a specific date, year one includes, in addition, the current year; the size of the threshold is shown in brackets.
[2] All variables are measured as gaps, i.e. as a percentage point or percentage deviation from an ex ante, recursively calculated Hodrick-Prescott trend. The size of the threshold is shown in brackets. Credit is measured as the ratio of private sector credit to GDP; the asset price is a real equity price index; the exchange rate is a real effective exchange rate.

The results are somewhat mixed. Firstly, looking at crises over a period of three years improves results compared with just one year. Secondly, combining indicators increases the accuracy of results.

Of the two-variable indicators, looking at credit and asset prices together over a three-year period predicted up to 60% of financial crises, with about one in 20 being false positives.

The three-variable indicator which required two out of three positives was the best predictor at 70% over a three-year period, although with a slightly higher false positive rate – roughly one in 15.

Unsurprisingly, the three-variable indicator which required all three variables to indicate a crisis had the lowest prediction rate (33% over three years), but also the lowest false positive rate (roughly one in 26).

DISCUSSION

Borio and Lowe argue that it is possible to construct some simple indicators for banking crises, and attempt to demonstrate one possibility for this.

There are a few caveats, however. For one, these indicators do not seem accurate enough to work alone, and therefore would need to be one diagnostic tool in a larger toolkit.

As the authors note, they have assumed that the experiences of different countries with banking crises are transferable, because financial crises are fairly rare. However, they argue that history shows that banking crises have generally been based on the shared characteristics discussed above.

Most significantly, this study did not test cases outside of the period 1960-1999. This assumes that these shared characteristics will continue over time, if the model is to remain accurate. Given that the authors are writing in 2002, it would be interesting to see if their model predicted the GFC.

Further to this last point, it is worth noting that Borio and Lowe primarily focus on the material causes of crises. In doing so, they omit discussion of more socio-political causes of financial crises which have emerged in the wake of the GFC.

Some examples of this are the extent to which "crony capitalism" prevents regulation (Johnson 2009), the structural power of banks (Bell & Hindmoor 2017), and the expectations of publics of governments in the wake of financial crises (Chwieroth & Walter 2017). Academics and economists have called for more focus on these factors, in addition to the financial indicators.

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