

Mr. Macfarlane puts recent suggestions for improving the operation of the international financial system into perspective

Talk by the Governor of the Reserve Bank of Australia, Mr. I.J. Macfarlane, to CEDA Annual General Meeting Dinner in Melbourne on 25/11/98.

It is a pleasure to be in Melbourne again for CEDA's Annual General Meeting. The last time I addressed this group two years ago I spoke about the Australian economy, monetary policy and wages. Events have moved on a good deal since then, and I hope what I have to say tonight reflects this.

The biggest change is that attention is now more focussed on the international economy than on domestic events. This change can be dated from the start of the Asian crisis in the middle of 1997, and has continued through more recent episodes which have affected other emerging markets as well as financial institutions in developed countries. These events have led a number of participants in international markets, myself included, to question some aspects of the present international financial system, and to make suggestions for improvements.

I have said a number of things recently that have sounded a bit out of character from a central banker. Both I and my deputy have shown a lot of sympathy for our Asian neighbours and felt that it is unfair to place the blame for their current plight solely on their own policy inadequacies. We have also said that the present international financial system is unstable, that hedge funds should be brought into the disclosure and supervision net and that the western policy establishment was wrong to encourage emerging markets to embrace the free movement of international capital so early in their development.

This has led some people to wonder what has come over us, and to question whether we have deserted orthodox economics to follow more populist creeds. I have been asked whether we no longer believe in markets, and whether we have become proponents of capital controls. These questions worry me because they suggest that, for some people, there are only the two polar positions, and that if you express some reservations about one, you are automatically placed in the other. For these reasons, I want to spend some time tonight trying to place the recent suggestions for improving the operation of the international financial system in some sort of perspective.

1. From the Perspective of Australia

From the perspective of the Australian economy, the move to financial deregulation, and to the lifting of restrictions on international capital movements, has been a success. We can date it approximately from the floating of the exchange rate, and the abolition of exchange controls, in 1983. Although we characterise this 15-year period as being an era of deregulation, that is only a very approximate description. While the authorities have stopped setting prices such as the exchange rate or the interest rates banks can charge on mortgages, there is still a large ever-evolving body of regulation in place aimed at ensuring financial stability and efficient and fair markets. The stock exchange and the futures exchange have a comprehensive set of rules that participants must adhere to, and, of course, they are also regulated by ASIC. The banks and insurance companies are regulated by APRA, the payments system by the Reserve Bank, and competition policy is enforced by the ACCC. Underlying all this, are the body of commercial law and the accounting standards.

This approach to organising financial markets - which, in deference to common usage, I will call the deregulated approach - has not been without its critics. A common criticism is that international capital has forced the Australian Government to run macro-economic policies that were not in the interests of the domestic economy. By this, the critics mean policies that are tighter than the ones they favour. I have never agreed with this proposition. There has been an on-going struggle in Australia by governments of both sides to return fiscal and monetary policy to sustainable long-run settings after the turmoil of the 1970s. The influence of financial markets has been a helpful one in bringing this about. Now that policies are in a sustainable and responsible position, I am not aware of financial markets pushing for tighter policies.

The other common criticism is that financial markets in Australia have been unstable. The simplest answer to this charge is to point out that they would have been more unstable over the past 15 years if we had tried to find a path through the ups and downs of the world economy with a managed exchange rate and a set of interest rate ceilings. We would not have had the daily movements as under the present system, but the pressure would have built up and when the dam broke, as it assuredly would have, the crisis would have been worse.

While I am confident that the deregulated system performed better than a continuation of the old regulated one would have, I do not want to give the impression that it is without fault. We are already on record as accepting that the exchange rate went down too far in the mid-1980s, that asset prices such as shares and, later, commercial property underwent a boom and bust at the end of the 1980s and beginning of the 1990s, partly as a result of excessive lending by newly-deregulated banks. Our whole approach to foreign exchange intervention is based on our view that the foreign exchange market is not "efficient" in the academic sense, but that it is prone to overshooting in both directions from time to time.

In other words, we do not have an idealised view of how deregulated asset markets behave - we have a realistic "warts and all" view. But even holding that view, we are confident that a deregulated model with no obstacles to capital movements is the best one for Australia. It took us a long time to adopt it, but there is now wide support for it at the political, policy adviser and community level, and I hear no suggestions that we should change it. But that does not mean that we should be urging every other country to adopt this model regardless of their state of development. Eventually, I think it will be in the interest of emerging market economies to do so, but the sequencing of this and other policies is crucial.

2. *An Emerging Market Perspective*

When we look at international capital movements from the perspective of an emerging market economy, the view can be very different.

For a start, the size of the financial sector in an emerging market is often extremely small relative to the flows of capital that emanate from developed countries. As Paul Volcker has put it:

"One common characteristic of (emerging market) countries, some large in population and area, is the small size of their financial sector. The aggregate size of the banks in the typical emerging country is now the size of a single regional bank in the United States - precisely the kind of bank that is told that it is too small to survive in today's turbulent markets."¹

¹ Speech to Institute for International Finance, Washington, October 1998.

What is a small adjustment of investment strategy for a few major banks or mutual funds may be a large injection or withdrawal of funds for an emerging market.

Second, it is clear that for most of the Asian emerging markets, some of the capital inflow that occurred in the mid to late 1990s was not, in any sense, needed. It was more than the amount required to finance their current account deficit, and it certainly was not needed to support their exchange rate because these were under unwelcome upward pressure throughout the period. The purist would say that if they did not want the inflow they should have let their exchange rates float upwards. This would have eventually curtailed the short-term inflows that result when a fixed exchange rate tries to co-exist with a positive interest differential. But what we do not know is how high the exchange rate would have needed to rise in the process and the extent to which this would have added to the economic difficulties. Remember the Thai currency crisis was triggered by the perception that the baht had become over-valued because it was tied to a rising US dollar. In short, if capital flows are very large relative to the size of the economies, they are, one way or another, going to cause distortions.

Of course, the above considerations would not matter if the international capital markets were a smoothly adjusting mechanism that constantly kept the exchange rate in line with the evolving fundamentals. But this is not what people observe - they see booms and busts and do not believe the proposition that the market is always right. Attempts by academic economists to persuade them that the free market always, or nearly always, gives the correct equilibrium price are unconvincing. The public's scepticism is well placed because the intellectual underpinning of the free market position in relation to asset price determination - the Efficient Markets Hypothesis - is very weak. In all the exchange rate tests of which I am aware, the hypothesis has been contradicted by the facts.

The third difference from an emerging market viewpoint is their relatively under-developed financial infrastructures and regulatory frameworks. They do not have as strongly a based system of regulating stock markets or banks or the underlying body of commercial (including bankruptcy) law or accounting practices. They also have serious deficiencies in the allocation of investment which unduly favours those who are well-connected to the government, the banks or both (the so-called "crony capitalism"). I have no intention of denying that these are serious shortcomings and that they should be rectified as quickly as possible if the countries concerned are going to achieve first world living standards. But we have to be realistic about how quickly these things can be achieved; in our own countries, these changes took decades or generations rather than years.

Such problems are heightened by the phenomenon of contagion, a fourth element particularly strong among emerging markets. In cases of panic, financial markets are not very discriminating. When one country suffers a withdrawal of capital, others come under pressure. Partly, this can be geography, as physical proximity can often mean economic and financial linkages. But even economies on the other side of the globe, with few direct linkages, can be affected for no other reason than that they are classified as "emerging markets".

Such countries might well have some weaknesses such as those noted above which, given time and a measure of economic and financial stability, might be adequately addressed. But under conditions of widespread desire to shed risk, they become immediate stumbling blocks for markets. This can put intense pressure on the policy authorities and economies of these countries - pressure which few countries can withstand easily.

For these reasons, the picture looks different from the perspective of the emerging market economies. What is good for us after a long period of evolution need not be good for another country at a much earlier stage of that evolution. In modern parlance, it is essential to get the sequencing right. Countries have to attain a high standard of financial infrastructure and regulation before they can submit themselves to the potential instability inherent in the totally free movement of capital. In the meantime, they should integrate themselves as closely as they can into the international capital market and, as their markets evolve towards maturity, they can take additional steps progressively to liberalise their regulatory regimes. To expect them to do it in the other order is to ask them to run before they can walk.

3. *What Should We Do About It?*

Fortunately, there is now a widespread agreement that something has to be done to improve the international financial system. The degree of instability, if it continues unchecked, could lead many participating countries to question the whole legitimacy of the system. The severity of the contractions in Asia is the most striking example, but so is the sudden recognition that a hedge fund can become so important that its failure could pose a systemic threat to the United States and international economy. The fact that the second most important exchange rate in the world - the US dollar-Yen rate - could move by 20 per cent in a month without there being a material change in fundamentals has also caused concern. I think there is now agreement that something has to be done, and it is heartening to see that the United States has taken a leadership role, including by convening the Group of 22 and its three working parties. I also think that the Australian Government has played a very useful role - first by its representations to the IMF urging more flexibility in its handling of the Indonesian crisis, and secondly by its attempt to keep the momentum of APEC heading in the direction of more liberal trade policies.

Change is already occurring in that the western policy establishment is no longer pushing emerging market economies to move quickly to full capital account convertibility. As recently as October last year the IMF, at its Annual Meeting in Hong Kong, was hoping to get its members' endorsement of a change to its Articles to make it easier for it to encourage countries to adopt full convertibility. This proposal was not put forward at the 1998 Annual Meeting in Washington because it was clear that it would not get support. There also seems to be greater tolerance for countries which have a generally outward-looking policy framework, but which have put in place some impediment to very short-term capital movements. I refer here to Chile's deposit requirement on foreign borrowing and to Singapore's and Taiwan's restrictions on their banks lending domestic currency offshore.

The more important task is to get on with the job of improving the international monetary system, with the specific aim of reducing the degree of instability. Some of this is the job of the emerging market countries, and in the first instance involves increasing disclosure by these countries' governments, companies and banks. As well as making markets better informed, and better able to judge the risks they are taking, the aim here is to make some progress on reducing the previously opaque links between governments, banks and companies, or, in other words, to improve governance. In addition, there is a lot of work to be done to bring the supervision of financial institutions up to standard - a task which will take a lot of personnel, training and time.

These changes are extremely important and require a lot of effort on the part of the emerging market countries. They also mean that a lot of time-honoured ways of doing things will have to be replaced. This is bound to meet opposition, and it will require political courage as well as economic expertise to achieve results. It will be made a lot easier if the developed economies are also seen to be examining whether there are aspects of their regulations that are contributing to

the instability of the international system. The most obvious reform here is to do something about the extent to which current regulations allow excessive leverage in financial markets. The immediate focus should be the close inter-connections between hedge funds, investment banks and commercial banks. The hedge funds have become the privileged children of the international financial scene, being entitled to the benefits of free markets without any of the responsibilities. Our reconstruction of the transactions that hedge funds undertook in Australia in June suggests that they could engage in almost infinite leverage in their off-balance sheet transactions if they so chose. One has to ask whether the Basle capital requirements are excessively generous in their treatment of financial market activities. A related problem is the weakness in banks' credit assessment processes that allowed them to build up some very large exposures to hedge funds and other financial institutions.

No matter how effective the above changes turn out to be, no-one expects that they will eliminate economic crises altogether. There still will be a need for improved crisis management.

Here, the most useful suggestion goes under the title of private sector burden sharing. This is designed to be used in a future crisis when a country's international reserves are exhausted and its exchange rate is plunging as a result of capital flight. In order to reassure markets, countries are often tempted to guarantee a variety of foreign borrowings, with the result that their taxpayers incur large losses while foreign lenders escape unscathed. Private sector burden sharing would stop the capital flight by bringing foreign creditors, the debtor country and the IMF together to work out a rescheduling, probably with a standfast arrangement to hold things together while negotiations take place. Thus, the burden would be shared more evenly, and the pressures on exchange rates could be reduced.

Another way in which crises can be handled better is illustrated by the recent IMF package for Brazil. It was an improvement on the Asian packages in two respects. First, the conditions were agreed on in advance in behind-the-scenes negotiations between the IMF and Brazilian authorities. This was much better than the public tug-of-war between national authorities and the IMF that occurred in Thailand and Indonesia. Second, I also note that the conditions are not as wide-ranging as in Indonesia, for instance. I agree with Martin Feldstein² that the IMF conditions should confine themselves to matters that bear directly on the currency crisis, namely fiscal, monetary and banking policy, rather than trying to reform the automobile, shipbuilding or clove industry, as in Indonesia.

4. Conclusion

It is important that we find a way of reducing the present extreme variability in international capital flows. It is also important that we find a way of managing future crises in a way that reduces the cost to the crisis country and shares the burden more evenly, and so reduces the moral hazard to lenders. If we do not succeed in doing these things, we face the prospect of a significant number of countries losing faith in open, market-based economic systems. It would be tragic if our failure to reform an unstable international capital market resulted in a return to inward-looking policies in the international trade in goods and services. And that may yet happen.

One reaction to the instability of the international financial system would be for countries to unilaterally impose quite restrictive controls on inward and outward capital movements, and thus miss out on the benefits that access to foreign capital can provide. We have already seen this

² "Reforming the IMF", *Foreign Affairs*, March/April 1998.

starting, and it would be regrettable if it were to spread. Even if this does not happen, there is still a possibility of other reactions which may be equally, or more, unhelpful to the world economy. In particular, I fear that a number of emerging market countries will take another form of safety-first policy by building up large international reserves - a new type of mercantilism. The problem with this solution is that to build up the reserves they would have to run current account surpluses for the foreseeable future. How will they do this? Will they be tempted to restrict imports, subsidise exports or maintain undervalued exchange rates? All of these are what used to be called "beggar thy neighbour" policies. The whole world cannot do this, so who will run the corresponding current account deficits? The final irony, if this situation eventuates, would be that we would have an international system in which the poor countries lend to the rich so they can spend more than their income.