Mr Grenville deliberates on Asia's financial markets and on capitalising on reform

Notes for a talk given by Mr Stephen Grenville, Deputy Governor of the Reserve Bank of Australia, to the Department of Foreign Affairs and Trade Seminar, held in Sydney on 30 November 1999.

*　　*　　*

Causes of the crisis

In early diagnosis of the cause of the Asian crisis, there was much emphasis on the mistakes of *domestic* policy. There was talk of over-valued exchange rates, and much emphasis on "crony capitalism". There were, it needs to be emphasised, serious problems in domestic policy in these countries, and some of these were an important ingredient in the problems. But it should be noted that, no matter how unattractive crony capitalism, it existed during the 30 years of outstanding economic performance.

Over time, serious commentators came to realise that, whatever the problems of domestic policy-making, there also seemed to be serious problems in the *international financial order*, particularly relating to the volatility of foreign capital flows. So it was not too long before a more balanced and operationally useful assessment appeared, in which the central issue was identified as the juxtaposition of two fatal flaws – huge and volatile foreign capital flows, and a fragile and poorly functioning domestic financial system.

How to address these problems?

The answer is not to draw back from the broad path of development these countries were on, relying predominantly on markets for the allocation of resources. No one, to my knowledge, has suggested a fundamental departure from the market-based path. The issue, rather, is the recognition that the transition from regulated to unregulated financial markets is a difficult one, with very significant vulnerability along the way. It seems that when the transition is over, and markets and institutions have adapted, many of the dangers disappear, and the benefits are more prominent. It is like the relatively calm waters above and below the Niagara Falls, but with very significant turbulence in the transition between the two tranquil states. This problem has produced a number of different images with a common theme: the central bank governor in one of the crisis countries said that they were asked to host a house-warming party while the house foundations were still being constructed. Another observer talked about the problem of plugging into a high-voltage power grid.

Some have drawn the connection with the old sequencing debate, common in the economic literature for some decades. The broad thrust of this message was that the most general, ubiquitous and far-reaching elements of deregulation should be done last. In particular, financial deregulation should come last, because, if it did not, the price distortions inherent in a regulated economy would be exacerbated, exaggerated and exploited by a deregulated financial system. But the reality is that deregulation can and should take place when the opportunities are available. *Carpe diem* is the watchword of reformers. This was certainly the case in Australia, where financial deregulation preceded other important deregulation – most notably, in the labour market. So there is no simple answer in sequencing. The uncomfortable reality is that much of the "plumbing" that needs to be put in place during the process of financial deregulation – in terms of the experience, reputation and institutional structures – takes time to create. Waiting for some propitious moment does not solve the problem, because it is largely a process of "learning by doing". But at least if the transition is recognised as tricky, then it may be possible to spread it out over a period to reduce the vulnerability.

It might be worth noting that in Australia we went through this awkward and vulnerable transition period, with the most obvious manifestation being the "Banana Republic" difficulties in the mid-1980s. We clearly did not come through this unscathed, but we were lucky that our foreign

exchange problems (which occurred in the mid-1980s) did not coincide with our prudential problems (which occurred in the late-1980s and early-1990s). The two elements – often seen coinciding in the transition – were nicely out of phase for us, and we should be thankful for that.

What could be done? In the course of looking at possible changes to the international financial architecture, various ideas have been put forward which, provided they are not seen as panaceas, might help. There are efforts currently underway to obtain more disclosure from hedge funds, and to develop some procedures for "bailing in" private-sector creditors. Some have suggested that collective action clauses should be built into bonds, and this seems broadly a good idea. Other suggestions about private contingent credit lines seem, to me, less likely to contribute much to "shock-proofing" the transition, principally because those providing the private-sector contingent credit lines will have an incentive to do offsetting transactions if it seems likely that the contingency will arrive.

One helpful change is one of attitude. One problem with the process of financial deregulation that has taken place in the Asian countries over the last 10 years or so is that it was driven partly by *doctrine*. This doctrinal imperative reflected two separate forces, which came together more or less by accident. The first of these forces was the dominance in academic circles of the "efficient markets paradigm". This is a powerful analytical device, which has taken thinking in economics down very useful directions. But it, like all paradigms, is an imperfect representation of the real world. Perhaps more seriously, in the course of academic debate, it became quasi-religious, with beliefs and facts becoming confounded. This made it hard to leaven the efficient markets paradigm with some real-world facts – principally, that markets are imperfect. The second force was a simple commercial imperative on the part of foreign financial institutions to gain access to new markets and compete in the most vigorous way. This commercial imperative was successfully transplanted into the political processes, so we saw, for example, the OECD insisting on capital market deregulation as a condition of Korea's membership of the organisation. These forces combined to form powerful rhetorical pressures, to deregulate as fully as possible, with special virtue being attached to those who opened their markets at the most breakneck speed. One of the notable manifestations of this was the Bangkok International Banking Facility, whereby small Thai businesses were presented with a frictionless conduit to international financial markets, where they could borrow at attractively low interest rates, in foreign currency. In Australia, we know, from our small taste of the Swiss loans in the 1980s, how dangerous it is to have relatively unsophisticated borrowers given the opportunity and incentives to take on sophisticated products involving foreign exchange risk. But in Australia this was relatively modest in macro-economic terms. In Thailand, the inflow through the Bangkok International Banking Facility was not far short of 10% of GDP.

With this change of attitude, it should be easier to insert some common sense into the process of deregulation, and have the courage to say "no" (or "not yet") to some aspects of deregulation which seem to make countries more vulnerable. So it may be quite sensible, from this viewpoint, to put various restrictions on short-term capital inflows, and on foreign-currency borrowing. This is compatible with free-market principles, because these are properly seen as transition measures, to be modified and ultimately abandoned.

The other place where common sense might usefully prevail over doctrine is in recognising that, despite the very strong pressures for uniformity of rules and regulations internationally (in Thomas Friedman's terminology, adoption of the "Golden Straitjacket"), there is still some opportunity for tailoring the set of rules to the particular needs (and political consensus) of a country. Just to give one example, it would be a mistake to think that the full minutiae of bankruptcy laws have to be translated precisely and uniformly across all countries. The particular balance between debtor and creditor which is seen in Anglo-Saxon law is a product of the particular social values of these societies. Other countries have come up with different relationships – I have heard it said that one important reason why creditors have traditionally been in a weak position in Indonesia is the conscious recognition that creditors would often be Chinese businessmen and money-lenders, and the societal judgment was that it was not going to give powerful legal remedies to these creditors. The forces tending to push people towards a rather uniform Golden Straitjacket are powerful indeed, but individual countries can assess to what extent they can and should modify these rules, to make them more palatable to their societies, without at the same time making them more costly. This debate has

yet to be joined, or even defined, but it is nonetheless important. The central point here is that Thomas Friedman's Golden Straitjacket is not an axiom of market economics, but rather is a set of rules which have emerged to meet the needs of current-day developed-country markets.

The role of banks

One of the lessons commonly drawn from the crisis experience is that countries should quickly diversify their financial institutions, to become less dependent on banks and foreign bank inflows. Chairman Greenspan has referred to the need for a "spare wheel", which he envisages to be alternative forms of funding when bank financing dries up. There may well be a good case for developing new financial markets, particularly in bonds. But one of the intrinsic problems is shortage of knowledge, particularly commercial intelligence. In a world where information is scarce and at a premium (where the "model" is not well defined), markets which are continuously repricing assets will tend to be very volatile, as small accretions or revisions to information are absorbed by the market. It would seem to me to be a mistake to shift quickly away from the world in which banks are the fundamental financial intermediary, because banks are, *par excellence*, the institutions which focus on information collection and the assessment of idiosyncratic risk. Information about borrowers is their stock-in-trade. They do not have to reassess and reprice their assets continuously. Given past performance, there seems little likelihood that the credit-rating agencies can quickly improve their performance to the stage where they can provide sufficient information to allow investors to make smooth, non-disruptive investment decisions in markets which are constantly being repriced. If this assessment is correct, then the task is to make sure that the banks do a better job in acting as the guardians of the gateway to investment. This is a formidable task, but there seems a better prospect that banks will be able to act as a filter and provide a second opinion on investment projects, rather than rely on the much more sophisticated, information-intensive and indirect process that we see operating in developed financial markets.

Growth

In the wash-up to the Asian crisis, one could easily come to the view that the answer was to shift down a gear and grow more slowly. Within reason, this may be sensible and inevitable. But it would be neither sensible nor inevitable for these countries to adopt the lower rates of growth which are regarded as normal in developed countries. The problem is that higher growth is far more vital to these countries than it is to us. For us there are unfilled needs in education and health, but the reality is that much of any extra growth in Australia would go to far less pressing priorities. Given the extraordinary problems and pressing nature of the needs in the crisis countries of Asia, it is not sensible to see the answer being to slow growth. So whatever system and changes are put forward to address the problems of the last couple of years, they should pass the test of being compatible with a good pace of growth. One shouldn't be too pessimistic about this, because if the sort of efficiency-enhancing reforms which are being pursued on so many fronts are successful, then the potential rate of growth of these countries should be enhanced rather than diminished.

In conclusion

It is a pleasure to take part in this symposium, which addresses so directly what seems to me to be the central issue – how to make Asia's financial markets work better. I have touched, today, on some of the measures which go under the rubric of the International Architecture, but I have no doubt that the main task is in the hands of the policymakers of these countries. Central to this is to work much harder on prudential supervision, to create a set of rules which is both feasible of application and thoroughgoing in keeping the banking system as a whole safe. It is a formidable task, which will take dedication and the persistent application of common sense. I wish them well.