# Mr. Macfarlane comments on the future international financial architecture

Talk by the Governor of the Reserve Bank of Australia, Mr. I.J. Macfarlane, to the East Asia Economic Summit in Singapore on 14/10/98.

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In my ten minutes here I will try and cover what I see as the main changes in perspective about what we formerly termed the Asian crisis, and then say a few words about future international financial architecture.

- The main change is that since August this year we no longer think of an Asian crisis but we now think of either an emerging markets crisis or a general world financial crisis.

- A second important change is that the western policy establishment can no longer believe that the root cause of the problem is the inadequacy of the financial infrastructure and governance of some formerly rapidly growing Asian countries. Of course, not everyone used to believe this, but there were some very influential institutions that thought this way.

- Everyone is now aware that contagion is a much stronger force than formerly thought. Contagion is an essentially irrational force which tars large groups of countries with the same brush, and causes fear to overrule reason.

- Given the bigger role for contagion, more and more people are asking whether the international financial system as it has operated for most of the 1990s is basically unstable. By now, I think the majority of observers have come to the conclusion that it is, and that some changes have to be made.

With pretty well everyone now conceding that changes have to be made, you would think it would be a relatively simple matter to move on to the next step. But it will not be, because there are still big differences of opinion about how serious the problem is.

- One school of thought held that the main thing required to restore stability was to improve transparency, particularly the Government’s transparency to the private sector - e.g. by more frequent and accurate publication of figures for international reserves. This school of thought also gave a fair bit of weight to improving the quality of bank supervision in emerging market countries. This explains the motivation behind two of the three working groups set up by the G22 in April.

- But an increasing majority think something more is required, and the most promising approach here goes under the general title of burden sharing with the private sector (the G22’s third working group). I would like to say a little more about this because I think it will be necessary if we are to make real progress.

If we go back and think of the Thai, Korean or Indonesian crises, we can see the problem if there is no formal system of burden sharing. Once the currency doubts started, short-term lenders knew that if they could get their money out fast enough they would minimise currency losses and loan losses. So when each loan had to be rolled over it was not renewed, and capital flowed out. Each day this happened the exchange rate came under further downward pressure, which encouraged further capital flight. Everyone wanted to be out before the point was reached where the exchange rate was so low, interest rates were so high, and insolvencies were so rife, that those who could not get out of the door would be big losers. This process ensured the maximum fall in the exchange rate.

Something clearly has to be done in terms of managing the crisis to reduce the incentives for everyone to try to be the first one out of the door. Some system of standfast followed by an orderly workout involving rollovers, reschedulings and, in extreme cases, debt equity swaps is clearly required. No country wants to be the first one to do this, and unilateral action could cause panic in other countries à la Russia. What is needed is a system that involves cooperation between the host country, private lenders and the IMF. We saw an example of how effective this can be for Korean bank-to-bank debt late last year.

Ideally, this should not be on an ad hoc basis, as it was in Korea, but should be thought out well in advance, with the possibility of such workouts included in loan documentation. This, of course, would increase the cost of borrowing by emerging market economies, but that would be no bad thing. One of the problems over the last five years was that it became too cheap and too much of it was done. It would be better than excessive lending followed by capital flight as we have seen over the past few years.

This is all becoming reasonably conventional thinking now and, as I said, it is contained in the third Working Party Report of the G22. But it was not that long ago that any suggestions along these lines were greeted with the response that it was out of the question because it involved interfering with the free movement of capital.

I would like to conclude by mentioning two other things that have changed over the past year.

<u>First, hedge funds.</u>

As recently as three months ago if you complained about the activities of hedge funds you were regarded as paranoid and you received a sermon on the dangers of shooting the messenger, etc.

Now, no one has got a good word to say for them, and they are likely to soon be brought into either:

- the disclosure net, or
- some form of supervision via their connections with banks.

Second, I see a clear improvement in future crisis management in the way the IMF is talking with Brazil.

Unlike the Asian crises, I don’t see any country in future putting itself in the hands of the IMF without knowing pretty clearly beforehand what the IMF conditions will be. If it doesn’t like the conditions, for example, because they are too wide-ranging, it will not go to the Fund. If it is comfortable with the conditions, it will be able to sign up from day one.

This way, we should be able to avoid the long periods of semi-public haggling over conditions that characterised the Asian crises and did so much to frighten the markets into pushing exchange rates down excessively.