Mr Grenville discusses financial crises and globalisation from an Australian perspective

A paper presented by Mr Stephen Grenville, Deputy Governor of the Reserve Bank of Australia, to the Reinventing Bretton Woods Committee Conference on "International Capital Mobility and Domestic Economic Stability" in Canberra on 15 July 1999.

As part of the debate on the Asian crisis, two separate views emerged to explain the crisis – those who blamed deficiencies in the crisis countries themselves (cronyism, corruption, misguided policies and so on), and those who found intrinsic flaws in the international capital markets.

Time has brought some perspective to these issues, and a consensus is emerging that a variety of problems contributed. Not surprisingly, with complex and multiple causation, there are lots of things to be fixed. The domestic/international dichotomy is still a useful one, here, because it allows us to focus exclusively on the international issues, without implying that the domestic deficiencies were unimportant. A conference on "Reinventing Bretton Woods" lends itself to exclusive focus on the international aspects, and, if "reinventing" is needed, something must have gone wrong with the old structure of discussion, rule - making and crisis response.

The focus, in this paper, is on Australia, but we need to put this in a wider context to draw out the lessons for ourselves, and for others:

Why were we in Australia not subject to the same degree of contagion as our near neighbours?

As participants in the debate on reforming the international economic architecture, what elements of reform should Australia be promoting?

Why Australia escaped

There were certainly serious concerns, 18 months ago, that the Asian crisis would do significant damage to Australia. But it was not a concern about contagion and a repeat of the Asian problems – in the form of a major reversal of capital flows. Rather, the issue was that our international environment would be unfavourable, with stunted growth in our export markets, particularly in the region which had provided us with such a useful stimulus over recent decades. As things have turned out, domestic demand has remained strong (with very little adverse confidence effects from Asia), and the lower exchange rate effectively buffered us from the worst aspects that had been expected. But it is worth emphasising that no one, as far as I know, ever expected Australia to be sucked down into the same financial maelstrom – our adverse impacts were expected to be from *secondary* effects. It was always clear that we would avoid the direct contagion, because we were not subject to the fatal combination that had infected Asia – the interaction of large and volatile capital flows, with a fragile domestic financial sector. The capital flows to Australia are nothing like as volatile (and are not even as large): but, more importantly, we did not have a fragile domestic financial sector.

It is true that Australia is very dependent on international capital inflows, with an average current account deficit of around 4½ per cent of GDP for the last couple of decades. These flows are large, but nothing like the flows experienced in Asia: in 1996, for example, Thailand received capital flows equal to 13 per cent of its GDP. Just as important, the capital inflows that funded the Australian deficit were, by - and - large, quite stable. Even in the mid - 1980s "Banana Republic crisis", which saw a large change in the value of the Australian dollar, the most that the current account adjusted in any one year was a little under 2 per cent of GDP (in 1986/87). Compared with changes in current account balances in some countries in East Asia in 1998 of up to 15 per cent of GDP in a single year, our fluctuations were manageable. One - third or more of Australia's capital inflow is in the form of foreign direct investment, which, even in the crisis countries, tended to be quite stable. A quite minor part was in the form of the elements which turned out to be extraordinarily volatile and flighty in

Asia – bank - to - bank flows. The three crisis countries had been receiving bank - to - bank flows at an annual rate of around US$50 billion in the years leading up to the crisis, and were subject to outflows – total reversal – of nearly US$75 billion in the first nine months of the crisis. Nor, incidentally, were we vulnerable as a creditor: Australian banks had not lent much to Asia.

Australia has had plenty of experience of changing sentiment – "flavour of the month" at one moment and poor cousin the next – but has not had the kind of total *volte face* experienced in Asia ("euphoria turned to panic without missing a beat" (Sachs 1997)). One reason why Australia is not subject to these sorts of dramatic reversals is the depth and maturity of our financial markets. The institutions and instruments that foreigners invested in tended to be longstanding and stable, with quite well-defined prices and behaviour, so there was no basis for the kind of blind-panic flight that occurred in Asia. Surprises occur in Australian financial markets, but not to the extent that occurred in Asia.

More importantly, Australia's financial sector (centred on the banks) was particularly strong. It might be worth pausing a moment, simply to record that the strength of the Australian financial sector was in large part because it had already had its "learning-by-doing" crisis nearly a decade earlier. Just about every episode of financial deregulation has been accompanied by a period of crisis and turmoil. In Latin America, in the 1980s, the nub of the issue is captured in the title of the definitive analysis of the period: "Goodbye Financial Repression, Hello Financial Crash" (Diaz - Alejandro 1985). Even the United States, less than a decade ago, experienced the Saving-and-Loans crisis, the direct result of lop-sided deregulation and market-distorting official guarantees. The United Kingdom and Japan had credit-induced asset booms and busts only a decade ago. Sweden experienced a meltdown of its financial sector in the early 1990s. Australia was not an exception to this generalisation, but had its crisis in the 1980s. It is hardly surprising that a cosy, protected financial sector, when newly exposed to the chill winds of international competition and much more hard-edged, sharp-pencil tactics, is at its most vulnerable. Perhaps the most dangerous aspect is that the additional competition lowers credit standards – the new competitors look for customers to lend to, and the old institutions preserve their markets by being readier to lend to customers who previously would not have been regarded as creditworthy. Deregulation gave borrowers a new-found freedom, and for some of them it was a case of giving them more rope with which to hang themselves.

"Failure builds character", they say: so, too, does failure give rise to a corrective process that makes a repeat less likely. We certainly had this experience in Australia during the 1980s, which was the main reason why our financial sector was in such good shape when the Asian crisis hit in the 1990s. The corporate sector also learned the dangers of currency speculation and became much more cautious. While recording the immunising effect of "been there, done that", it might be worth remembering some aspects of this common experience. We had our own foreign-currency-denominated borrowing experiences (remember the Swiss franc loans?), but fortunately they were, at least in macro terms, insignificant. While we are remembering our luck, we might remind ourselves that Australia's foreign exchange crisis (which occurred in the mid 1980s, associated with the "Banana Republic" debate) occurred *separately* from the prudential problems in the banking system, which are associated with the boom and bust of the asset price bubble of the late 1980s. Asia had its foreign exchange crisis superimposed on its prudential crisis.

Most of the players in the Australian market have a good understanding of how the foreign exchange rate would normally behave – i.e. the exchange rate is reasonably well anchored in "the fundamentals". But even in this world, some puzzling things still happen. One such puzzle is the Australian dollar's tendency to move more than might be expected over the course of the commodity cycle. Even when terms-of-trade changes are temporary, we might expect *some* change in the exchange rate. But what we have seen, quite persistently since the float, is movement in the exchange rate by around 25 or 30 per cent between peak and trough, and this is much more than can be explained simply in terms of the proper textbook reaction to cyclical terms-of-trade changes (see Gruen and Kortian (1996)).

We have, over time, learnt to adapt to this world. With low inflation well established now, there is less danger that these cyclical fluctuations in the exchange rate will damage inflationary expectations – they seem to be absorbed, to a large degree, in margins. The Reserve Bank's response is to be ready to intervene in the more extreme swings of the exchange rate. We do this principally because there is always some danger, at the extremes, that these swings may damage confidence in the domestic economy (particularly in the downward swings). Incidentally, in the process, we make a tidy profit through the rather old-fashioned form of trading, under which we buy cheap and sell dear (Andrew and Broadbent (1994)). This experience, over more than a decade, has made us sceptical about the Friedmanite idea that speculators always buy cheap and sell dear, and if they do not, they quickly go out of business. Why have the processes of natural selection not weeded out our counterparties from this zero-sum game?[1]

With this experience in mind, we were less surprised than some when the Asian currencies, once unhooked from their semi-fixed pegs, moved excessively – each of them over-shooting dramatically, by far more than any conceivable initial over-valuation. For all the virtues and advantages of exchange rate flexibility, it is dangerously naïve to "sell" the idea that floating the exchange rate will be a painless solution to international financial integration.

Having made the case that Australia was never vulnerable to the sort of catastrophic capital reversal that was experienced by some Asian countries, the question is: "why are we so interested in the issues of new financial architecture?".The short answer is that we believe that international capital markets are *not* working as well as they should. Even if Australia can survive in the current world, we all (developed and emerging markets alike) would benefit from some changes in the international architecture.

A reform agenda

Since the crisis broke, there have been five issues on which Australia has spoken out in international forums:

- Representational issues;
- Hedge funds;
- "Bailing-in" the private sector;
- Capital controls;
- Transparency.

International representation

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[1] At a recent conference on exchange rates run by one of the big players, they predicted dramatic further strengthening from the then-prevailing level of US66 cents. This was on the basis that the 55-day moving average had moved above the 200-day moving average, and that they were experiencing strong customer demand. I asked them why they had not recommended buying the Australian dollar six months earlier at US55 cents. If moving-average and market-momentum rules are the guide, then it is hardly surprising that over-shooting occurs - there simply are not enough market players looking at the "fundamentals", and prepared to back their assessment.

Well before the Asian crisis, it had been obvious that the international institutions formed shortly after World War II no longer represented the current world economy. As a small country, Australia accepts that many important international decisions will be made in a small sub-set of the largest countries, such as the G3. It is harder to accept that important decisions (such as the development of global prudential rules) should be made in a group as unrepresentative as the G10 – which contains four smallish European countries, of which only one is as large as Australia. If these institutions are Eurocentric (only one Asian: no Latin American representation), the exclusion of emerging markets is just as obvious. The IMF tackles these problems differently, with formal representation of all members – but few would doubt who is calling the shots, with America alone having enough votes to veto issues. Constituencies represent hugely different population sizes and degree of interest in international issues. This is why we were so attracted to the idea of G22, when it formed in the aftermath of the Asian crisis. In this form, it has been vetoed by the European countries not yet ready to give up their over-representation on international economic issues. These issues are on-going and unresolved, but one beneficial result of the Asian crisis is to bring this issue to the fore, and while G22 no longer exists, a wider representation on the working groups discussing some of the important issues (such as highly-leveraged institutions, offshore markets and short-term capital flows) has been achieved.[2]

Hedge funds

As noted above, Australia had its searing experiences with volatile exchange rates in the mid 1980s, but has now come to terms – and is comfortable – with its floating exchange rate. We think that, in general, it works well, and that the float has been enormously beneficial for Australia. We have come to accept some over-shooting as a puzzling but tolerable quirk of the market.

In the most recent episode (coinciding with the Asian crisis), however, we saw a variant on this theme – speculators who believe that they can make money by attacking an exchange rate which has already over-shot, so that it over-shoots even further. The tactic is straight-forward enough – quietly take a short position in the currency which is already a bit under-valued, and then, by a mixture of highly-public additional short selling and vigorous orchestration of market and press opinion, get the exchange rate to move down quite a bit further. As it does, a bandwagon forms, with market players anxious to sell the currency as it becomes cheaper, in the belief that it will become cheaper still. As the herd moves in, the original speculators can square-up their position, at a profit.

This is the world that we saw in operation in the middle of last year. As a matter of shorthand, we have referred to these attacks as being driven by hedge funds, but this terminology is probably more specific than we need to be to make the point. It is worth emphasising, here, that we think it was useful that the Australian dollar moved down somewhat in 1998, reflecting the fundamentals of a much less benign external environment. This softening of the exchange rate was an important factor in buffering Australia from the external crisis. But too much of a good thing is a bad thing. The gathering downward momentum, one-sided sentiment and thin market were certainly matters of considerable concern to us, in the middle of last year, and this was reflected in our actions to support the exchange rate.

The most disturbing element of this is that it was part of a concerted effort at market destabilisation. Some of the players themselves told us, at the time, that their objective was to push down the yen to the stage where the renminbi was under irresistible pressure to devalue, which would have broken the Hong Kong dollar peg. The Australian dollar was a minor secondary target – collateral damage – for these Masters of the Universe. As things turned out, we came through this episode quite well. But it is a matter of historical record that this episode came to an end because of the combined effects of the LTCM near-meltdown and the financial crisis in Russia – we were saved by crises elsewhere. So

[2] We note with some satisfaction that the Financial Stability Forum has recently been enlarged to include some non-G7 economies, including Australia.

while we came through that episode quite well, and we are confident that we have the resilience to weather similar episodes, we carry from this experience a strong viewpoint into the debate on international financial architecture concerning the hedge funds (or, as they are known in that context, the "highly-leveraged institutions"). There are those who deny, even now, that the hedge funds played any significant role. For these pundits, it may be enough to simply observe that the hedge funds themselves do not deny their actions (George Soros has written a best-selling book about it!) – it walks like a duck, quacks like a duck and says it is a duck – what more evidence do you want? But the movement of exchange rates over the period – even large currencies such as the yen – provides more evidence. As the hedge funds cut their short positions in yen to cover their disasters in the rouble, the yen rose 15 per cent in a little over a day, driven by events unrelated to any Japanese "fundamentals". Is this a well-functioning market?

When we first talked about our experience with hedge funds in mid 1998, this was derided as "the Australian anecdote". But you may recall the old quip about the plural of "anecdote" being "data".Hong Kong, South Africa, Malaysia and Thailand all pointed to their "anecdotes". Then came the near-collapse of LTCM: the tenor of the debate changed. But as the LTCM crisis recedes, international concerns have become more muted, even stifled. The G7 authorities are prepared to concede that there were *prudential* issues involved in the high leverage of these funds – it threatened those who had lent to them. But there is less recognition of the *market integrity* issues involved – i.e. the general damage they do by inducing more volatility (and otherwise-unnecessary interest rate increases) into exchange markets (see two papers by the RBA (1999)).

Bailing-in the private sector

We have argued that there should be a greater readiness, in the event of crisis, to "bail-in" private-sector creditors – i.e. to require a stand-fast on repayments and the working out of orderly arrangements for repayment, which may well involve delay in repayment and, possibly, creditors taking a "hair-cut" on their repayment.

Some private-sector participants in this debate have articulated a sort of bewildered resentment at the idea of compulsory bailing-in in the course of an orderly debt arrangement: they talk in terms of "consenting adults", who have freely made a contract which no-one else should rend asunder. It does, however, seem a bit more complicated than this. First, private creditors accept, within all domestic jurisdictions, the possibility of bankruptcy procedures *in extremis*, which involve two elements – the declaration of inability to pay in full; and some kind of stand-fast in which the available assets are assembled and decisions made on an equitable distribution. This procedure, everywhere, over-rides individual deals done either before or after the event. The justification for this is that an orderly arrangement is better for just about everyone than an unseemly rush to seize any available assets. This rationale carries over into the international forum in principle, although of course finding legal jurisdiction is another matter altogether. This was well illustrated in late 1997, when Korea was within a couple of days of defaulting on government-guaranteed bank debt owed to foreign banks. Under the detailed orchestration of the US and IMF authorities, a deal was struck whereby US$24 billion of bank-to-bank debt was rolled over, at an attractive interest rate for creditors. This deal changed sentiment towards Korea dramatically, and it would be hard for any creditor to claim that the outcome was anything except greatly beneficial to them.

But the case for bailing-in the private sector goes beyond this, at least in cases where the official sector (often through the IMF) has taken part in something analogous to a "lender-of-last-resort", in which additional funds are made available to shore-up creditor confidence. The rationale for such a facility goes beyond the normal bankruptcy arrangements, to the further argument that where the problem is one of liquidity rather than insolvency, a lender-of-last-resort will avoid "runs" on debtors. Given that it is taxpayers' money (usually via the IMF) which is being put at risk to bail-out private-sector creditors, taxpayers are entitled to expect some contribution from the creditors. The relevant lessons come from Mexico in 1994/95. Prior to the crisis, investors had received higher returns for the risk they were running. When confidence evaporated and creditors refused to roll-over their loans at the end of 1994, default loomed. The IMF and the US Government acted as lender-of-last-resort, repaying all creditors in full and without delay. This was, in almost all aspects, extremely successful. The "run" was contained, and Mexico experienced a "V-shaped" recovery. But it did highlight the moral hazard that goes with bail-outs – it left the impression that lenders would be protected when things went wrong (see Dooley (1997)).

The contrast to this is bailing-in the private sector – enforcing a stand-fast and "hair-cut". This not only addresses the source of the immediate problem, but it is also equitable, and directly addresses the moral hazard problem.

In making this case, Australia has argued that such arrangements should focus exclusively on sovereign or quasi-sovereign debt, in particular the *bank-to-bank* flows: the bulk of the capital reversal in Asia was taking place between banks, who were using their access to government guarantees in order to finance the capital outflow. This makes an important distinction between those who can easily "take the money and run" (on the basis of government guarantee) and those who lent to non-banks, who will have to work through the domestic bankruptcy system to gain repayment.

Much self-righteous indignation has been expressed by private-sector creditors at the very idea that the authorities might impose stand-fasts and hair-cuts on them. This would sound less disingenuous if it was not coming from the same voices who were so astounded by the Russian default of August 1998 – astounded not by the patently parlous creditworthiness of the country they had lent to, but by the absence of any official rescue package to save them from default.

Controls on capital flows

Two important lessons from the crisis are:

- That *short-term* flows were particularly vulnerable to reversals;
- That the *transition* from financial regulation to deregulation is a particularly vulnerable time.

There is now a wide acceptance that, instead of a blanket presumption in favour of quick and complete financial deregulation, deregulation should be "orderly", keeping pace with the build-up of the necessary institutional infrastructure – particularly capacity for prudential supervision. While this is now generally accepted, the operational corollary of this is not. If the problem was the huge capital inflow, what will prevent a recurrence when the next wave of euphoria arrives, and later evaporates?

One aspect is clear enough – far-reaching prudential rules should be put in place – e.g. restrictions on banks' short-term borrowing and on foreign-currency-denominated borrowing. In putting these prudential rules in place, it is important not to simply shift the risks out of the formal financial sector but leave the risk with those who are even more vulnerable – this just makes room for more problems later.

The other issue is whether Chilean-style controls on short-term capital inflow may also be useful. Such restrictions on short-term borrowers may not be perfect, but they make more sense than some of the alternative "solutions" which have been put forward. One suggestion (quoted by Greenspan (1999)) is that countries should hold foreign exchange reserves equal to all the short-term debt which is going to fall due over the next year. If this is a serious suggestion, then it raises the issue of why this short-term debt was useful in the first place, if the proceeds of the short-term borrowing have to be stacked away in reserves (at a lower rate of return than the cost of borrowing).

One lesson is that countries should resist the blandishments to set up arrangements like the Bangkok International Banking Facility, and should keep a very wary eye out for the operations of fly-by-night, foot-in-the-door financial entrepreneurs whose aim is to sell sophisticated (i.e. hard to understand) financial products to unsophisticated (i.e. gullible) customers, under the guise of “market broadening”

Transparency

Great emphasis has been placed on transparency – and it is as hard to disagree with this as it would be to disagree with the notions of peace, freedom and motherhood. But the transparency which is being advocated in the debate is a very partial concept. Whereas a case could be made that markets work better if all participants have full information, the emphasis so far has been confined to getting the official sector to give detailed and frequent information on foreign exchange reserves, for example. Meanwhile, the hedge funds and other major players can hold their cards close to their chest (even the investors in LTCM were not given details of the portfolio). If markets truly work better when better informed, this principle should apply to all players who are big enough to move markets. This view is gradually being accepted in some of the work taking place currently in the international arena, so I am hopeful we will see increased disclosure by all market participants over the coming couple of years.

The context of the debate: Globalisation

Given the complexity of the issues, it has been disappointing that much of the debate has been driven by ideology. Specifically, ideology seems to add a special piquancy to the debate on capital flows. The argument here is reminiscent of similar debates on “free floating” for the exchange rate: “free”, in this context, has the same connotation as “the free world” or “free speech”, i.e. indisputably a Good Thing. Absence of any rules seems to be a particular virtue. A theologian picked up the flavour of the debate, likening the arguments in *The Wall Street Journal* to his own specialisation: “Behind descriptions of market reforms, monetary policy and the convolutions of the Dow, I gradually made out the pieces of a grand narrative about the inner meaning of human history, why things had gone wrong, and how to put them right. Theologians call these myths of origin, legends of the fall, and doctrines of sin and redemption.” (Cox 1999).[3]

Some commentators took this vantage-point because they wanted to view the issues as part of a wider debate on the inevitable global triumph of the free-market paradigm (see, for example, Zuckerman (1998)). It was, in many ways, a curious prism through which to view the issues, because it was pretty clear that – whatever the deficiencies of alternative systems – this was hardly a triumph of market forces. Whatever the advantages of more open capital markets, the collateral damage from the excessive inflows and the subsequent massive capital reversals has been great, and could hardly be justified in terms of some market-clearing or “tâtonnement” process. Whereas it seems hard to deny that for every foolish borrower there had been a foolish lender, the response was to argue that there had been a “shortage of liquidity” (i.e. people could not get out of their positions quickly enough!) or deficient transparency (investors, by some extraordinary oversight, were unaware of cronyism, corruption or lack of effective bankruptcy procedures).

For some, this response was part of the commercial imperative for maximising the return on investments – if investors were seen to have been foolish, then this would reduce the chance of them getting official assistance in repayment. At a risk of sounding cynical, it could be argued that the loudest voices came from the representatives of financial markets, who not only saw commercial advantage in continuing to open-up new markets, but for whom the experience of Mexico in 1994/95 was quite satisfactory, and required no modification – they achieved good returns (including a risk premium) in good times, and they were bailed out – to a greater or lesser degree – in the bad times.

[3] The same tone had been picked up much earlier: “Economic liberalism was the organizing principle of a society engaged in creating a market system. Born as a mere penchant for non-bureaucratic methods, it evolved into a veritable faith in man’s secular salvation through a self-regulating market.” (Polanyi 1944, p. 135).

The free-market triumphalists found allies elsewhere. In academic circles, over the years, considerable intellectual endeavour had gone into showing that markets are efficient – whatever the convoluted and volatile path of financial prices over time, this is not only rational but indeed optimal (see, for example, Garber (1990)). The rationale for any one participant in pushing the price further away from its fundamental equilibrium was often along the lines of the "greater fool" presumption – however artificially high the price, someone would pay more for it later.

So the first stage of the debate, following the crisis, had an almost surrealistic air about it, with the IMF pressing at its Annual Meeting in Hong Kong at the end of 1997 to add capital account deregulation to its mandate, at the very moment when the excessive inflows and reversals had been shown to be so damaging.

The wider debate on globalisation is, of course, very relevant. One recent contribution (Friedman 1999) provides useful terminology. He talks of the "Electronic Herd" – the anonymous fund managers behind their screens – and sees the proper response for emerging markets being to don the "Golden Straitjacket" – whose specifications are a predominantly private-sector economy, balanced budgets, low tariffs, and open capital markets, including unrestricted foreign investment. This sounds very much like the "Washington Consensus", and as a framework of reference it makes good sense, particularly if it accepts the feasibility (and indeed the desirability) of some adaptation to the local environment, and acknowledges that there is more to a successful society than an identikit market economy. Friedman acknowledges complexities and subtleties – indeed, his title (The Lexus and the Olive Tree) emphasises the need to balance technology with tradition. And he does not confuse inevitability with desirability, as the triumphalists do.

But two aspects – the inevitability of the process and whether the end-point is the pure free-market model – require further comment. Some powerful forces clearly do encompass the globe in an irresistible way – some reflecting superior technology; some reflecting the need for a common standard; and some, the greater world integration through the communications revolution. There are plenty of examples of "winner takes all" – a dominant player or technology. But there are just as many examples of persistent national characteristics and behaviours. To imply that the whole package of essentially-US systems and values has to be accepted holus-bolus over-simplifies the forces at work.

Perhaps just as important, it would be a mistake to see these forces of globalisation attaching themselves uniquely to a textbook competitive free-market model.[4] Many aspects of globalisation are, in fact, the opposite: a dominant technology, a winner-takes-all player or a set of market behaviour rules such as the Basel Capital Adequacy Rules are hardly the world of atomistic competition of the textbooks. Far from demonstrating Adam Smith's invisible hand, globalisation is occurring within a complex set of rules, technical standards and regulations – some imposed by governments, but others by technological imperatives or by the private players in markets.

This is not to suggest that the end-point *should* be the 19th century brand of capitalism foreseen by some of the global triumphalists. "On the brink of the 21st century, the United States is at a point reminiscent of its entry into the twentieth. … Today, of course, the new frontier is the global economy." (Zuckerman 1998, p. 20). Not everyone feels so warmly sentimental towards the age of Robber Baron capitalism, and some may feel uncomfortable with the idea that "unimpeded access to

[4] Friedman (1999, p. 85-86) comes close to putting this pure free-market view: "those people who are unhappy with the Darwinian brutality of free-market capitalism don't have any ready ideological alternative now. When it comes to the question of which system today is the most effective at generating rising standards of living, the historical debate is over. The answer is free-market capitalism … Today there is only free-market vanilla and North Korea.".

that burgeoning marketplace was the one indispensable condition for the flowering of American enterprise" (ibid, p. 20).[5]

We need to ask, at the same time, whether the allocation decisions of the Electronic Herd make sense from an economic viewpoint – are they shifting the capital (and the real resources it represents) to the highest global usage? On recent performance, the answer would have to be "no". Leaving aside the extraordinary *volte face* from optimism to pessimism in Asia (and the mis-allocated investment that preceded the crisis), does the reassessment of US equity prices in 1987 (in the deepest market with the fullest information) make sense? Or the gyration of the yen/US dollar rate, from 80 in April 1995 to 147 a couple of years later? Are markets, with their constant quest to respond to the latest data, factoid, or rumour, the best allocators of capital and reliable guardians on the gateway to investment? Have the umpires – the credit-rating agencies – been forward-looking and insightful in their judgments? What should economies which *did* wear the Golden Straitjacket but were still subject to speculative attack (e.g. Hong Kong) do? In short, should we be spending more analytical time examining the behaviour of the herd, rather than simply noting its inevitability?

If we accept that the outcomes of globalisation are not, in all their manifestations, good, and that countries are not simply pawns on the global chessboard, then what needs to be worked out, on a case-by-case basis, is what modifications to the cut of the Golden Straitjacket can feasibly be achieved. Is it feasible to discourage the more volatile elements of the herd?[6] Some have resisted extra rules (collective action clauses and explicit efforts to limit moral hazard), on the grounds that these will reduce the flow of capital to emerging countries. If absence of moral hazard and full pricing of risk meant that capital flows would be smaller, then this has to be a plus rather than a minus. If this meant that very little *short-term* capital flowed to emerging markets, then it would be hard to argue that there would be any great loss.[7] The harder question is how to achieve effective restraint. But this should be possible. Just as anomalies in the Basel Capital Adequacy Requirements artificially encouraged bank-to-bank short-term inflows, feasible rules can influence outcomes in the opposite direction. Countries can, at least, avoid the frictionless conduit represented, for example, by the Bangkok International Banking Facility.

Markets can and do accept differences between regulatory regimes, and the view that all capital will flow to the country which prostrates itself lowest before the demands of the market seems nonsensical. After all, each of the crisis countries attracted *excessive* inflows into regimes which departed substantially from the Golden Straitjacket. More recently, Malaysia tapped international capital markets at a time when its anti-market rhetoric was still fresh in the minds of investors.

The starting point should accept the benefits of capital flows and the power of markets in allocating resources, but should also recognise that in just about every *domestic* market there are (often extensive) "rules of the game" and market infrastructure: what is needed now is a similar set of rules of the game for international flows. And there should be no presumption that the Electronic Herd should, alone, set the specifications of the Golden Straitjacket. There are tricky issues here – for example, the handling of intellectual property rights will determine how the benefits are shared between creator and user. These are not issues which the free market determines well, and a framework of rules is needed to get efficiency and equity.[8,9]

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5 "The markets" were seen, even in the age of unbridled capitalism, as being especially volatile: "While the productive labors of a society, the functioning of its ships and railroads, its mills and factories, give the effect of a beautiful order and discipline, of the rhythmic regularity of the days and seasons, its markets, by a strange contrast, seem to be in a continual state of anarchy." (Josephson 1934, p. 192).

6 In Friedman's terminology, the short-horn cattle.

7 This argument has particular force in relation to Asia, where national saving rates have been so high.

8 Similar variation may be possible in other rules. Bankruptcy rules, for example, have to fit societies' views on balancing creditor and debtor rights. Competition rules, patent rules, legal decisions, all find their basis in individual societies, with views on property rights and equity which are not ruled solely by the market.

Capital will follow risk-adjusted profit opportunities, and within this constraint, countries have opportunities to protect their societal interests. It would be nonsensical for a country to insist on reinventing, *ab initio*, technology or rules (e.g. Basel Capital rules for prudential supervision or accounting rules), but it seems entirely feasible for countries to put their own supplements on rules, without becoming pariahs in the eyes of international financial markets. Globalisation is an opportunity for countries to improve their living standards. It is up to individual countries to decide how deeply they will avail themselves of this opportunity. It is not an all-or-nothing choice.[10] They may well pay a price for this, in terms of GDP, but this is a choice countries can (and will) make. Total failure does not await those who modify the rules, sensibly, to fit their views of society and who recognise that you cannot neatly split production and distribution issues.[11] Sovereignty may have been modified by the Internet, but it has not been abolished.

The early analogy put forward (by Larry Summers (1998)) was with airline travel – bigger planes had brought great benefits of cheap travel to a wider group, and if this involved the occasional dramatic large accident, this should not be seen as a reason for banning international plane travel. But where does this analogy lead? Surely to the dual acceptance of the benefits to be derived from the new technology, with the need – at the same time – to do whatever can be done to make travel safer – even if this involves some rules and regulations.

Seen in this light, we are back where we should always have been in this debate – contemplating the transition from regulation to liberalisation, acknowledging the desirability of moving along this path as quickly as possible, but also acknowledging that it is a bumpy path. There has been, since 1997, some progress. The core rhetoric no longer simply extols the importance of immediate and total deregulation, but now puts in words like “orderly” to describe the process. To acknowledge this is one thing: to put it in place is another. In trying to put some practical content into the idea of “orderly” deregulation, there may be reminders of the old Irish joke about asking the way to Limerick: “I wouldn’t go there from here”. There is fairly unanimous agreement that we *do* want to go there from here. But deregulation has some of the characteristics of a rolling snowball, whose momentum is self-generated and uncontrollable. While there is a longstanding and extensive literature on “sequencing”, it is rather unsatisfactory. Countries often take the reform/deregulation opportunities in whatever order they come along. More seriously, the necessary infrastructure is not something which can be created instantly,[12] or even in advance of the requirement. Rather, it is put in place by trial-and-error and learning-by-doing, and some old-fashioned good luck is required to get this safety net firmly in place before it is needed. What is pretty clear is that the process of “reform-through-crisis” is a very painful one.

Conclusion

When the Asian crisis first broke, some of us thought of it as an opportunity for reform: there would be some pain, but the forces of beneficial change would be given impetus. We had in mind, I suppose, some version of the Golden Straitjacket. As the crisis developed, it became clear that for some

[9] As more international trade takes place in “weightless” technological services and products whose marginal cost is small compared with the average cost, the copyright and patent rules become more important. Countries which are large producers of high-technology product and intellectual property will be interested in incorporating into the Golden Straitjacket rules which protect their citizens’ commercial position.

[10] Singapore and Taiwan provide successful examples - they restrict their banks from lending domestic currency offshore, making it difficult for foreign speculators to “short” the currency.

[11] As implied by Friedman’s matrix (1999).

[12] Dennis de Tray (1999) describes it this way: “globalization operates at light speed along fiber optic cables, while institutional development takes decades.”.

countries (e.g. Indonesia) the downside of the crisis was far outweighing the opportunities for seizing the moment to reform.

For all of these countries, the ideas embodied in the Golden Straitjacket, or the Washington Consensus, have much to be said for them. Many of the elements were things which these countries had been striving (however imperfectly) to put in place. The danger, now, is that the idea will be over-simplified and over-sold. I have argued, here, that the basic elements of the Golden Straitjacket are desirable and, over time, feasible. But it should be possible to adapt it, to some extent, to the local environment and – more importantly – modify it so that the Electronic Herd is not so damaging.

So this takes us back to the issues raised in Section II – the various proposals made within the context of the New Architecture debate. Each of the elements Australia has advocated are aimed at building on the Rules of the Game – bailing-in the private sector; restraining short-term capital; and increased disclosure by major participants, including hedge funds. Greater transparency is something which *all* market participants (not just the official sector) should observe. And, finally, wider representation in the economic councils of the world would give more legitimacy to the Rules of the Game. If the Golden Straitjacket is to be the current international fashion, then its design should be a more democratic process, not confined to groups representing the (very different) international world of half a century ago, egged on by those who want to use globalisation as a battering-ram for their narrow commercial advantage. Some of the discussion of globalisation is in terms of a kind of breathless proselytising for a meta-trend whose time has come – "coming ready-or-not" globalism. Rather, it should be an opportunity to reap the rewards which come from sensible international integration.

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