

Two Occasional Addresses by the Governor

Address to the East Asia Economic Summit in Singapore on 14 October 1998.

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 co-operation 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 past 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 was 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.

First, hedge funds.

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.

Address to the International Conference of Banking Supervisors in Sydney on 21 October 1998.

I would like to start by adding my voice to those who have already welcomed you to this Conference and to the city of Sydney. It goes without saying that there could hardly be a more propitious time for the international leaders in the field of bank supervision to be meeting. When we first started planning this Conference a couple of years ago, we did not know whether it would attract a lot of interest or would be greeted with a yawn. We now know it is the former, and we in the Reserve Bank, and our colleagues at the Australian Prudential Regulation Authority, with whom we are jointly hosting the Conference, are sure that you will be in for a couple of very interesting days.

It is hard to pick up a newspaper these days without seeing the word 'crisis' prominently displayed in a headline somewhere. First, we had the Asian crisis, then it spread into being an emerging markets crisis, and now we hear so much talk of a world financial crisis. It is interesting that, so far, the focus is on the word *financial* and not on the more general word *economic*. It is also interesting that these troubling financial events are no longer confined to emerging market economies. One consequence of these two trends is that the contrast between *economic* health and concerns about the *financial* sector is as marked in the world's most powerful economy – the United States – as elsewhere. There is a big challenge, therefore, to the bank supervisors of the world, and it seems to be equally large whether they are dealing with the least, or the most, sophisticated of the world's banking systems.

I see two main challenges for the world's economic policy-makers – one for the short term and one for the medium term.

In the short run, the challenge is to get through the current crisis – to make sure no more dominoes fall through contagion. The region at risk is clearly Latin America, even though many of these countries are now running infinitely better macroeconomic

policies than could have been imagined a decade ago. It would be tragic for them to be blown off course by the spread of financial turbulence that they had no significant part in the making of. It would lead more countries to question the wisdom of adopting sound macroeconomic policies and of opening their economies.

One helpful recent development is the acceptance that there should be behind-the-scenes discussions between a potential borrower and the IMF. If an IMF package does prove to be necessary in the case of Brazil, for example, it will already have had its voice heard, and it will know exactly what the conditions are in advance. It thus should be able to sign up on Day One and so avoid the situation that occurred in Asia where countries put themselves in the hands of the IMF without knowing what the conditions would be. Thus, the handling of the Brazilian situation seems to be benefiting from one of the lessons of the Asian rescue packages.

What can bank supervisors do to assist in the resolution of the present situation? Given that a major part of the problem is an increase in risk aversion by lenders and a possible 'credit crunch', it seems to me that bank supervisors will inevitably have a very big influence on the outcome. I would like to endorse the remarks I recently heard Bill McDonough make that bank supervisors will have to be extremely careful not to inadvertently encourage banks to become even more risk averse than they currently are. This will require great sensitivity on the part of supervisors, and I am sure you will all rise to the challenge.

The second big challenge to all of us involved in international finance is to devise a better system for the long run. None of us should be happy about how events have unfolded over the past five years, and none of us could deny the claim that the international financial system is prone to periods of extreme financial turbulence that leave lasting economic costs.

- At first, this instability was attributed to deficiencies in the financial infrastructure in some emerging market economies.

- Soon, however, more thoughtful people saw the source of the instability as being the combination of two things – large movements of short-term capital taking place in countries that had small and not very well developed financial infrastructures.
- We now know that there is a third important factor at work as well – banks in developed countries (often in conjunction with hedge funds) have been taking much bigger risks than their supervisors or their shareholders thought.

How do we go about devising a better system or, in current parlance, designing the new international financial architecture? Obviously, this will be a very large task, and I can only offer a few observations here this morning.

First, we all recognise that access to the international capital market has, on balance, bestowed enormous benefits on participating countries, particularly developing countries. The world is a much better place when it is outward looking – historical epochs where large international transfers of capital were taking place were those where living standards around the world were rising fastest and where poverty declined most. I, for one, would be saddened if a number of countries responded to the current turmoil in international markets by cutting themselves off from the international market place thereby forgoing the benefits that the use of foreign savings can bring. It goes without saying that Australia is completely happy with its policy of permitting the free movement of international capital and sees no case for any change.

On the other hand, it is simplistic to insist on the totally free movement of capital in all countries and in all circumstances. To do so would be to ignore the lesson from recent crises, to further risk the stability of the system and to invite a reaction which would make us all worse off. We need to devise a system for maximising the benefits to be gained from international capital while limiting the risks. For example, I think Chile was probably quite wise, and certainly within its rights, for a time to impose a tax on capital inflow which

impinged most severely on very short-term flows. (Note, however, that Chile did not impose controls on outflow.) Like Chile, the world economy has to reach a proper balance, and I think there is increasing recognition that it will involve a few trade-offs.

Within developed countries, a number of institutions have been designed to encourage investment and risk taking – the joint stock company, the concept of limited liability, bankruptcy laws and, of course, central banks as lenders of last resort. These are all accepted as necessary parts of a developed financial system, and help provide the right balance between encouraging enterprise while at the same time preventing individual financial distress from turning into widespread financial panic. All these things, by the way, have the by-product of creating an element of moral hazard. Internationally, on the other hand, despite all the talk of globalisation, a borderless world and the integration of financial markets, there has been a reluctance to go very far down the path of finding an international equivalent to the bankruptcy laws or the lender of last resort. The main objections have traditionally been that it would interfere with the free movement of capital and that it would create a moral hazard.

That attitude now appears to be changing, and the recent discussions of private sector burden sharing can be viewed as, in some sense, an international equivalent to domestic bankruptcy arrangements. In a company bankruptcy, failure to follow the right approach results in a ‘fire sale’ of assets: in a national financial crisis, it results in a flight of capital and an excessive fall in the exchange rate. The third Working Party Report to the G22 on International Financial Crises addresses the problem where, in a crisis, all individual creditors look after their own private interests and, in so doing, create a situation which is worse for them as a whole (and for the debtor country). This is the problem known colloquially as ‘everyone rushing for the exit at once’. The Report makes a number of helpful suggestions, all of which revolve around the recognition that a tripartite agreement between creditors, debtors and

probably the IMF would be the best way of resolving a crisis once it has begun. The agreement would involve some sort of standfast followed by a workout which would include rollovers of debt and rescheduling. This is a very promising approach, but as recently as last year in the Asian crisis was dismissed on the grounds that it represented an interference with the free flow of capital (which it does).

I should take this opportunity of saying how useful Australia has found the G22 Meetings. For a group that has only been in existence for a little over six months and has only met twice at Ministerial level, it has achieved a lot. The three Working Party Reports are the most constructive effort to date in laying out some practical steps towards improving the international financial architecture. I have already said how useful I thought the third Report was, but there is also a lot of good sense in the first one which deals with transparency and disclosure, and in the second one which deals with an improved financial system supervision.

Both these subjects – disclosure and supervision – have relevance for the very topical subject of hedge funds. In fact, the first Report recommends that *'a working party ... be formed as soon as possible to examine the modalities of compiling and publishing data on the international exposures of investment banks, hedge funds and other institutional investors'*.

We regard this cautiously worded recommendation as a big step forward, in that for the first time to my knowledge, an official international body has proposed bringing hedge funds into the disclosure net. But

I wonder if it is still too cautious. The big macro hedge funds have become, to some extent, an extension of the proprietary trading arms of major banks. There is, in fact, a continuum running from commercial banks to investment banks to hedge funds, and it is hard to see why some of this should be within the supervisory net and some without. This alone would argue for some degree of supervision – for example, limits on gearing – rather than just disclosure. The case becomes stronger when we take into account the fact that the New York Fed has had to organise a support package for a large hedge fund on the grounds that its failure would have systemic consequences (both nationally and internationally). If, like banks, they are important enough to have systemic consequences, it is hard to see why they should escape supervision of some form or another.

I want to conclude by sympathising with you as bank supervisors because of the inherent difficulty of the task you face. To some extent, the biggest challenge is to bring the countries furthest behind world best practice up to standard, and the Core Principles are a very useful step in this direction. But as recent events have reminded us, even in the countries with the most developed systems of bank supervision, we still continue to be surprised by the capacity of the best and the brightest to take risks the magnitude of which even they do not understand. This makes the task extremely hard for bank supervisors – you all have to run very hard just to keep up with developments in markets, and perhaps, the nature of risk itself. ✎