Implications of the Globalisation of Financial Markets

This article reproduces the main text of a Treasury submission to the House of Representatives Standing Committee on Economics, Finance and Public Administration inquiry into the implications of the globalisation of international financial markets for macroeconomic policy and the operation of financial markets.

The submission was lodged in September 1999 and is available in full on the Committee's website at http://www.aph.gov.au/house/committee/efpa/ifm/.

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INTRODUCTION

1. The globalisation of financial markets has attracted particular public attention through the 1990s, as one striking aspect of a longer, general trend to increasing globalisation.

2. One aspect of globalisation, the globalisation of financial markets, is complex and only imperfectly understood. Many question whether it has given rise to, or amplified, shocks to global economic activity. They point to the 1987 stockmarket crash and four major international currency and economic crises in the 1990s: the crisis affecting the EU's Exchange Rate Mechanism in 1992-93, the Mexican crisis in 1994-95, the Asian crisis of 1997-98 and the Russian crisis of 1998.

3. It is also frequently suggested that globalisation has reduced the scope for independent macroeconomic policy action by national governments, damaged the quantity or quality of employment growth in advanced economies, widened the dispersion of income, and so on.

4. So globalisation in general, and especially financial globalisation, often get a 'bad press'. Even those who accept globalisation as inevitable or irreversible, and who focus on how best to adapt to its forces at the national or international level, often do so without paying much attention to the positive potential of globalisation in a sound policy framework to improve national and global welfare.

5. This submission focuses mainly on the three major clauses in the Inquiry's terms of reference in the context of financial globalisation, rather than on the broader social issues raised by globalisation in general. However, to analyse the three topics posed by the Inquiry, we first set the economic scene by considering the definition and the nature of economic globalisation. We offer some brief comments on the forces propelling it, the nature of its potential benefits and costs, and some of the unusual factors influencing the globalisation of financial markets.

Definitions and scope

6. Globalisation is a concept that is frequently left undefined or defined almost circularly as 'internationalisation'.[1]

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1 One OECD study, *Globalisation of Industrial Activities: Four Case studies: Auto Parts, Chemicals, Construction and Semiconductors* (1992) offers no definition, but speaks merely of a 'third phase of internationalisation', with characteristics roughly corresponding to the fuller definition in paragraph 7. In another example, John Clark's *Dictionary of Banking and Finance Terms* defines globalisation (somewhat circularly) as simply 'Increasing internationalization of all markets, industries and commerce' (Prospect, Sydney, 1999) p. 166.

7. One of the more careful definitions of 'globalisation' stresses '… the geographical dispersion of industrial and service activities (for example research and development, sourcing of inputs, production and distribution) and the cross-border networking of companies (for example through joint ventures and the sharing of assets)'.[2] Such concepts of 'globalisation' focus on the movement of economic activities around the world from their original 'homes' in domestic corporations, and the impact of those shifts on the nature of domestic corporations and employment.

8. Is such 'globalisation' any more than contemporary shorthand for the increasing cross-border flows of goods, services and finance? It is useful to examine whether 'globalisation' is a fundamentally new economic phenomenon, or whether it is simply a useful label for today's form of a very old phenomenon: the tendency towards increasing specialisation and trade, with the associated implications for increased financial flows.

A brief history of 'globalisation'

9. Increasing specialisation and trade have been key contributors to social progress since humanity's emergence from the rigours of subsistence, hunter-gatherer life in prehistoric times.[3]

10. Down through history, specialisation and trade increased progressively beyond the village to the province, the country, the region and the world. At each stage, the boundaries to profitable specialisation and trade were influenced mainly by 'technology', broadly defined. Especially relevant in expanding those boundaries were the 'physical technologies' which lowered production costs and transport costs, and the 'social technologies' embodied in social institutions which facilitated finance, contract enforcement and payment.[4] The evolution of 'social technologies' became particularly important as economic relations

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[2] This definition is cited in the *Penguin Dictionary of Economics*, by Bannock, G., Baxter R. E. and Davis, E., 1998, sixth edition, Penguin Books, London, pp. 176-177. It is said in turn to be drawn from the OECD usage.

[3] To attribute such a central role to specialisation, division of labour and trade is not to conceive of human progress solely in materialistic terms: a society with a high degree of specialisation and division of labour is a prerequisite to the existence of professional teachers, philosophers, composers, priests and politicians. For a discussion of the likely role of specialisation and trade in the pre-historic emergence of civilisation, see Diamond, J. *Guns, Germs and Steel: the Fates of Human Societies*, Jonathan Cape, London, 1997, pp. 61-66. Plato also clearly analysed the central role of specialisation and trade in an ideal city, some 2,400 years ago. See *The Republic of Plato*, translated by Bloom, A. Basic Books, New York, 1968, pp. 46-51.

[4] It is unusual to conceive of the social institutions of commerce as 'technological' innovations, but they arose endogenously and spread within communities in response to just the same sort of trial-and-error experimentation as selected superior strains of grain for farming, or devised better tools for making shoes. Thinking of social and commercial innovation with this 'technological' analogy can be particularly helpful to considering the nature and implications of today's globalisation, especially financial globalisation.

intensified across national boundaries, encountering new risks such as losses in transport, difficulties in enforcing deals with distant, anonymous counterparties, disputes about timely payment, and so on. (For example, marine insurance had emerged in simple form by 1800 BC, and developed during the Roman empire, but insurance only blossomed as a generalised concept of wide commercial application in the 18th century.)[5]

11. With each extension of the boundaries to profitable specialisation and trade, living standards rose. Particularly rapid rises in living standards attended major technological and social innovations in the 18th and 19th centuries. The technological drivers of economic progress were particularly apparent in the 19th century, when steam engines powered specialised machinery to increase productivity in factories; canals, railways and steamships radically lowered transport costs; and the telegraph lowered the costs and increased the speed of communications. The earlier emergence and evolution of 'commercial technologies' such as the joint stock, limited liability corporation, and the application or spread of more sophisticated means of risk management such as insurance, forward contracts, futures and options contracts were vital to financing the construction, operation and trade in the products of the new 'physical technologies'.[6]

12. At every stage of these increases in specialisation and trade, unanticipated consequences and occasional crises had to be corrected in the light of experience. To give just a few examples: the interaction of credit facilities and an early form of options with physical asset markets allowed a price bubble and crash in tulip bulbs in the 17th century; and the introduction of steam locomotives caused fires and destroyed crops and agricultural property adjoining railway lines; common law had to evolve (and subsequently statutory law was passed) to assign responsibilities and award damages, which encouraged railway operators to fit spark-arresters to locomotives.[7]

13. The progress of specialisation and growth in trade was of course not smooth, but ebbed and flowed through history with many influences, including policy changes. For example the repeal of the Corn Laws in 1846 which ushered in Britain's embrace of free trade, probably contributed, together with the technological advances of that era, to accelerated world trade growth.[8]

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5 Bernstein, P. L. *Against the Gods: the Remarkable Story of Risk,* John Wiley and Sons, New York, 1996, p. 92.

6 Ibid, pp. 1-8, 88-96 and 304-328

7 See Kindleberger, C. P. *Manias, Panics and Crashes: A History of Financial Crises*, 1978, Basic Books, New York, and Coase, R. H. *The Problem of Social Cost*, Journal of Law and Economics Vol III October 1960, pp. 1-44, esp pp. 29-34.

8 Bhagwati, J. (1988) *Protectionism*, MIT Press, Cambridge Massachusetts, pp. 17-23.

14. At the macroeconomic level, it seems likely that by the end of the 19th century, 'globalisation' in the sense of net annual international trade and capital flows as a proportion of contemporary GDP, was about as advanced as it is today. For example most industrial economies' trade-to-GDP ratios were almost as big as today's. Net capital flows were already actually larger relative to GDP than they are today (though there is no doubt gross capital flows are now much higher — and of course much more quickly responsive to new information — than 100 years ago). To put the same observation another way, the correlations between domestic savings and investment rates were actually lower at the turn of the last century than today, so that net saving countries lent or invested more funds to net borrowing countries that had profitable investment opportunities than today. Australia even then was a principle beneficiary of those capital flows, averaging a current account deficit (CAD) of 3.7 per cent of GDP from 1880 to 1913. Canada's performance was even more remarkable, averaging a 7.7 per cent CAD over the same period.[9] European countries' stocks of direct investment abroad were much larger relative to GDP at the end of last century than they are today. Even international labour flows were larger then than now.[10]

15. The potential risks of such high international links were managed quite differently then than now. For example, exchange rate risks were prevented by the gold standard, and other international commercial and political risks in trade and investment were limited by the fact that international flows took place largely within colonial links.

16. Today, however, the high degree of globalisation at the end of the 19th century is largely forgotten, because benchmarks in living memory have been set by the beggar-thy-neighbour rounds of tariff escalations, competitive exchange rate depreciations and the erection of capital controls that accompanied the Great Depression.

17. Trade barriers erected in the Great Depression only began to be dismantled in earnest after World War II, with the creation of the General Agreement on Tariffs and Trade (GATT). Governments of the industrial economies cut tariffs by some 90 per cent through successive GATT rounds of bargaining through to the early 1990s, and that extended process contributed to the leading role of trade growth in stimulating overall economic growth in the second half of this century.

18. In contrast to this slow but steady trade liberalisation, capital controls were maintained until after the breakdown of the Bretton Woods arrangements

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9 Bayoumi, T. 'Saving — Investment Correlations', *IMF Staff Papers* Vol 37 No 2, pp. 360-387, 1990, cited in NZ Treasury Working Paper 99/6, *Economic Integration and Monetary Union*, by Andrew Coleman.

10 Woodall, P. 'Survey of the World Economy: the hitchhiker's guide to cybernomics', *The Economist*, 28 September 1996. See also *The Economist* 18 October 1997.

from 1971 to 1973, and persisted in minor form in such major economies as France and Italy until as recently as 1990. One reason financial globalisation has recently proceeded so fast is that it was repressed by capital controls for so long.

19. So the degree of international trade and capital flows at the end of the 20th century is not unprecedented. Rather, in modern times it is the heights of trade and capital restrictions in the inter-War era that should be regarded as exceptional.

20. Seen against this historical background, the current, distinctive element of globalisation can be considered in large part to be a particular type of technological change in the 1980s and 1990s: the precipitous fall in the cost of information technology, including semiconductors, computers, software and telecommunications. Since 1964, the real cost of processing information has fallen more than 95 per cent.[11]

21. This fall in the cost of IT has greatly reduced the cost of producing and trading in many services. This technological change interacted with great social and institutional innovation in subcontracting, outsourcing or licensing many aspects of work. It seems likely that the development of international standards in important commercial areas such as accounting and auditing has also contributed. Together, these developments facilitated greater specialisation and international trade, particularly in many services that could previously only be supplied within national or regional boundaries (or even only within the boundaries of the firm itself).

22. Current interesting examples of such globalisation include an Australian computer booking centre for an international airline headquartered in Asia, and international shared service centres, such as Infinium, a joint venture in Singapore by Exxon and Shell to provide outsourced global accounting services to the global operations of both corporations, including their American and European head offices.[12] Such operations, and hundreds of others like them, would have been commercially inconceivable even 20 years ago (being prohibitively expensive with then-prevailing computing and communication technologies, and therefore bound to 'in house' provision in metropolitan corporate headquarters.)

23. The other reminder from inter-war history is that, contrary to popular contemporary claims, globalisation is not necessarily irreversible: it was in fact reversed very effectively in the second quarter of this century. The more pertinent observation is that that reversal cost us all very dearly, because it involved the sacrifice of the gains of specialisation and international trade. (We would hope that globalisation would in practice be more difficult to reverse

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11 Smith, C. W. *Globalization of Financial Markets*, Carnegie-Rochester Conference Series on Public Policy, Volume 34 Spring 1991, North Holland, pp. 77-96.

12 See Florence Chong, *Two to Tango*, *The Australian*, 15 June 1999, p. 32.

today than in the Great Depression. Reasons include: the institutional foundations for international commerce and finance are now sounder; the commitments to avoiding protectionism are now embedded in a multilateral treaty and other multilateral commitments (such as in APEC), rather than only in an incomplete network of bilateral treaties; and the social safety nets, private insurance and macroeconomic automatic stabilisers that mitigate welfare losses in economic downturns are now much larger.)

Financial globalisation

24. Increased international trade in goods and services is inextricably linked to increased international financial flows through complex relationships.

25. At the microeconomic level, any international trade in a good or a service gives rise to associated international payment transactions, and frequently generates the international provision of additional financial services such as bankers' acceptances or letters of credit, or hedging in futures or options markets to manage risks of changes in exchange rates or other prices.[13]

26. Paradoxically, even the impossibility or prohibitive cost of trading some goods can also give rise to an international flow of investment (for example to finance foreign direct investment to produce that good behind a national protective barrier), or of finance (for example in licence fees for a local producer to manufacture a product using a technology or a brand owned abroad).

27. At the macroeconomic level, if a country invests more than it saves, or consumes more than it produces, it must import capital — ie run a capital account surplus equal and opposite to its current account deficit. So the levels and patterns of the world's net international capital flows in any period are determined by the large constellation of influences that set countries' savings, investment, GDP and GNE. However, gross international financial flows can be many times larger than net flows, and it is these gross flows that are now at unprecedentedly high levels, and whose volatility has become of growing concern.

Reasons for the growth of international financial transactions

28. International gross financial flows have mushroomed over the last 25 years for many reasons, including:

- trade has expanded at roughly twice the rate of GDP growth, international direct investment at roughly three times the rate, and international equity investment at some ten times that rate;

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13 We abstract from the special case of countertrade, an inefficient process associated with either the birth of international trade in goods in the absence of developed payments machinery, temporary measures in response to catastrophic economic disruptions, or ideological considerations which shaped the trade relations among the former communist bloc.

- risks of exchange rate movements expanded with the end, between 1971 to 1973, of the Bretton Woods system of fixed exchange rates. So traders and producers had to find new ways of managing those risks, and to use existing methods of 'risk insurance' more intensively;
- capital controls were abolished in the US and Germany almost immediately after the end of fixed exchange rates, in the UK in 1979, in Japan in 1980, in Australia in 1983, but in France and Italy not wholly until 1990;
- financial innovation has expanded the range of available derivative instruments for pricing and trading the risks associated with the preceding three factors, and businesses have found it useful to pay to use those instruments;
- demographic changes in some of the advanced economies have increased the size of pension funds, which in turn have increasingly sought international portfolio equity investments to form an internationally diversified portfolio of high yields to reduce home country risks;
- competition in financial service provision has cut costs. For example average commissions on UK equities trading fell by around two thirds over the period 1980 to 1992, and average commissions on Eurodollar bond issues fell by around 40 per cent between 1980 and 1987;[14] and
- perhaps most importantly in recent years, information technology advances have greatly reduced the costs of international communication, and of managing and transferring funds.

29. Since communication and financial transaction costs are a relatively large part of the costs of doing international financial business, the effect of advances in IT on global capital markets has been even larger than their effects on the broader economy.

Areas and rates of growth in international financial flows

30. Growth in international financial flows has not been restricted to new financial derivatives: portfolio and direct investment flows, and traditional bank loans have also grown strongly. Table 1 illustrates the rapidly increasing size of these flows since the mid-1970s. Since the 1970s, portfolio capital flows have often been larger than direct investment and bank credit flows combined.

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14 Cited in Edey and Hviding (1995).

Table 1: Global Portfolio and direct investment flows, net bank credit ($USbn)[15]

	1976-80	1981-85	1986-89	1990	1991	1992	1993	1994	1995	1996	1997
Outflows											
Direct	40	44	154	238	193	195	224	256	327	313	419
Portfolio	16	64	198	187	338	363	560	320	365	609	694
Total	56	108	352	425	531	558	784	576	692	922	1113
Inflows											
Direct	32	53	137	204	154	167	219	243	329	334	418
Portfolio	34	82	209	184	466	456	754	425	595	919	1002
Total	66	135	346	388	621	623	973	668	924	1253	1420
Net Bank Credit	109	134	299	465	80	165	200	190	330	420	500

Source: Andersen (1995), IMF, Balance of Payments Statistics Yearbook, BIS Annual Report, 1998.

31. A particular feature of short-term capital flows is the speed with which such flows can reverse themselves. An obvious example is the sharp reversal of private capital inflow into the Asian region beginning in mid-1997. According to Bank of International Settlements (BIS) estimates, net private capital inflow into the Asian region fell from $US81 billion in 1996 to outflows of $US45 billion in 1997 and $US66 billion in 1998.[16] Driving this reversal was a reduction in, largely short-term, commercial bank credits which reversed an inflow of over $US50 billion in 1996 to an outflow of $US21 billion in the following year (Eatwell and Taylor 1998).

Box 1 illustrates growth in capital flows in a range of other markets.

15 In principle, global inflows should equal global outflows, just as global aggregates for exports should equal global aggregates for imports. However, for various reasons, countries generally do not correctly record all transactions, or corresponding transactions are classified differently. This leads to errors and omissions in national data that cause discrepancies in global aggregates.

16 China, India, Indonesia, Korea, Malaysia, the Philippines, Singapore, Taiwan and Thailand.

Box 1: Growth in global financial flows — some examples

Foreign exchange trading

Since the abolition of controls in the early 1970s, international capital flows have grown exponentially, with growth in foreign exchange trading providing the early impetus.

Eatwell (1996), cites BIS estimates that by 1980, foreign exchange trading equaled a daily average of $80 billion with a ratio of forex trading to global trade of 10 to 1. By 1992, trading averaged $880 billion a day, a ratio of 50 to 1; and in 1995 $1,260 billion with a ratio of 70 to 1.

Bond trading

The bond market, Eatwell notes, began to grow considerably faster in the 1980s.

- 'From 1983 to 1993 total cross-border (cross-currency) sales and purchases of United States Treasury bonds rose from $30 billion to $500 billion. Sales and purchases of bonds and equities between foreigners and United States residents rose from 3 per cent of United States GDP in 1970 to 9 per cent in 1980 to 135 per cent in 1993. Over the same period, cross-border securities transactions in the United Kingdom rose from 'virtually nothing' to more than 1000 per cent of GDP.'

Bank lending

In a similar way, the stock of international bank lending has surged from $265 billion in 1975 to $4,200 billion in 1994.

All financial assets

The McKinsey Global Institute estimates that the stock of all financial assets traded in global markets rose from $5,000 billion in 1980 to $35,000 billion in 1992 — twice the GDP of the OECD economies. The Institute has estimated that the stock of these assets will have reached $83,000 billion in 2000 — three times OECD GDP. (Woodall, 1995).

32. The most extraordinary growth has been in the 'notional principal' value of interest rate, currency, equity and commodity derivatives. By far the fastest growth has been in interest rate and currency derivatives, which constitute

about 98 per cent of the total. By 1995, the notional value of outstanding contracts traded over the counter or on organised exchanges was around $US57 trillion. By 1998, this had risen to around $US86 trillion.[17]

33. While these values and growth rates could reasonably be described as astronomical, it is worth noting that the 'notional principal' values commonly cited are the face values of the contracts traded. However, with these products, typically only fractions of the face value of the contracts are the subject of margin calls, according to price movements in the underlying product covered by the contract. Thus the actual international financial flows, the credit exposure, and the money at risk in these derivative contracts, is typically only a few per cent of the 'notional principal' value.[18] Moreover, to the extent that the actual additional international capital flows as a result of derivatives use shift risk to those most able to bear it, such increases are likely to be stabilising rather than destabilising.

Table 2: Selected financial derivatives markets ($USbn, notional amounts outstanding at year-end)

Instruments	1986	1988	1990	1992	1998
Exchange Traded Instruments	583	1307	2292	4641	13549
Interest rate options and futures	516	1175	2054	4288	12305
Currency options and futures	49	60	72	105	57
Stock index options and futures	18	72	166	248	1186
Over-The-Counter Instruments	500	1330	3451	5346	50997
Interest rate swaps	400	1010	2312	3851	--
Currency and interest/currency	100	320	578	860	--
Other	--	--	561	635	--
Total	1083	2637	5743	9987	64546

Source: Bank of International Settlements Annual Reports, various.

Benefits from financial globalisation

34. Financial globalisation directs global savings to their highest returns and, through a more complete range of more liquid international financial markets, allows the better identification, pricing and trading of risk. There are great potential advantages for global and national income growth from that development, though also (paradoxically) some new types of risk may be created at the same time.

- More complete and more liquid markets for equity and debt, and for derivative instruments such as futures and options, allow savers, investors, producers and traders to better manage the risks of price, interest rate or exchange rate movements. This benefit arises because risks

17 Bank for International Settlements Annual Report, various.

18 IMF, *International Capital Markets: Developments, Prospects and Key Policy Issues*, World Economic and Financial Surveys, September 1998, p. 97 fn 14.

of adverse interest rate, exchange rate and commodity price changes that might impact in a complex pattern on a project (such as a decision to finance and build a mine, and export its output) can be better identified, 'unbundled', and priced in liquid, specialised financial markets, separated from their underlying 'real' activities (setting up and operating the mine), and traded to those best able to bear those risks. With the better pricing, trading and management of risks, underlying activity can be higher than if the miner had to bear all the risks.[19]

- Other examples might include an Asian agricultural importer hedging commodity price risks on a Chicago commodities exchange and interest rate and exchange rate risks on a London financial exchange, or a Canadian fuel importer hedging on New York energy and financial exchanges. The counterparties to such hedging might be other traders or processors in third countries facing opposite risks, or speculators simply prepared to act on their belief that prices are more likely to move in one direction than the other. Transactions of this type have contributed to the widely observed explosion in the volume of gross international financial flows, to many multiples of the annual value of global trade, or of net global capital flows, or of GDP.[20] A single trade flow of $100 of goods might give rise to gross trade financing, futures hedging, and other secondary financial market flows of many times that amount. But those 'excess' transactions are not economically meaningless, or 'casino' entertainment for the traders involved: they serve a real economic (and social) purpose of allowing real production to be higher than it otherwise could be.
- One lesson from the Asian crisis is that businesses in many regional economies would have been better served by participating more in the explicit pricing and trading of risks of exchange rate and interest rate changes, than in believing government assurances that those risks did not exist.

• More complete and more liquid international markets for equity and debt achieve better allocation of world savings to the highest-yielding investments. At the microeconomic level, more globalised financial markets could achieve internationally what a developed domestic financial sector can achieve nationally: participants could borrow and lend in the face of negative or positive shocks to their income, smooth their consumption over time, and thus improve their welfare.

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19 Ibid., Annex V pp 180-196.

20 Note that in the examples given, the trade flow may be between country A and country B, but the financial hedging flows might be between country A and country C, and country D and country C. Many of these complex gross flows net out in the trade and capital account data.

- In fact, individuals' or regions' consumption and income is only weakly correlated within nations because of relatively efficient national financial sectors. But national consumption is strongly correlated with national income, because of relatively incomplete global financial sectors.

- More complete and more liquid international financial markets would finance international arbitrage in goods and services to reduce international price differences (after transport and other transaction costs).

  - That would also enhance welfare, by shifting market supplies, at the margin, from national markets in which they are lowly valued, to markets in which they are more highly valued.

  - This example again reminds us that the liberalisation and globalisation of goods markets and financial markets go hand in hand. As one commentator notes: '…. both goods market and financial market integration are necessary for full economic integration, as any desired current account position entails the simultaneous exchange of financial assets. Consequently, if local people prefer to exchange financial instruments with other local people rather than with outsiders, goods market flows will be impeded'.[21]

- More complete and more liquid international financial markets would better perform their role in 'price discovery', by which market prices for a financial asset (eg a share) adjust promptly and smoothly to new information about the value of the underlying asset (the company).[22]

  - Large, liquid markets ensure that a seller of an asset receives its highest current price. Conversely, segmented smaller markets reduce the chance that a seller will receive the best price. The best 'price discovery' results arise when all offers to buy and sell at a given time are crossed in the one market. These considerations help explain why, with the fall in trading costs within the US in the 1800s and early 1900s permitted by the spread of the telegraph, the stock ticker and the telephone, the New York Stock Exchange steadily increased in prominence and liquidity at the expense of the many smaller regional stock exchanges, but to the advantage of efficient capital raising.[23] We would expect similar forces to be at

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21 Coleman, A. *Economic Integration and Monetary Union*, NZ Treasury Working Paper 99/6, p. 9.

22 The somewhat arcane issue of financial market efficiency in price discovery is outlined in Yakov Amihud and Mendelson, H., *Trading Mechanisms and Value-Discovery: Cross-National Evidence and Policy Implications*, Carnegie-Rochester Conference Series on Public Policy, Volume 34 Spring 1991, North Holland, pp. 105-130.

23 Smith, opcit, pp. 80-81.

work today with the fall in international financial trading costs as a result of cheaper IT.

- Finally, more competitive and specialised international financial markets reduce the spreads between borrowing and lending rates and the fees for providing financial intermediation. As with any competition-driven reduction in costs of a factor of production, such developments are to the ultimate advantage of a wide range of businesses and consumers.[24]

The risks of increased financial globalisation

35. Of course, to argue that more financial globalisation is potentially welfare enhancing is not to suggest it will automatically occur in the way that will maximise the net benefits.

36. One key area of risk, now receiving much attention, is the potential for excessive volatility in short-term gross capital flows. Even where net annual capital flows summarised in the capital account of the balance of payments are not large, shorter-term gross flows are much larger and can reverse very rapidly if there is a change of sentiment in capital markets. Such reversals may occur either 'rationally' with the emergence of pertinent new information on the creditworthiness or likely prospects of industries or economies, or in a sense 'irrationally', through herd-like changes in prevailing market opinion.[25] The nature of these risks has been clarified in recent studies of the likely linkages behind so-called financial 'contagion'.[26]

37. Contrary perhaps to current impressions, the evidence is that over the last 25 years, financial crises were more frequent in the period 1975 to 1986 than more recently, while banking crises were at their peak in the early 1980s. Not

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24 'Funds that might once have gone into banks or life insurance companies are now as likely to wind up in mutual funds or pension (ie superannuation) funds. Here technology plays an important role. Many of these new savings institutions are more cost efficient than traditional intermediaries. In the US a $10 billion bank has between 5000 and 7000 employees. In contrast, a $10 billion mutual fund can be managed by 20 professionals and a computer.' Smith, C. W. *Globalization of Financial Markets*, Carnegie-Rochester Conference Series on Public Policy, Volume 34 Spring 1991, North Holland, p. 81.

25 Concepts of rationality and irrationality need to be treated cautiously in discussing market sentiment. Information for fund managers to make fully informed individual decisions is expensive, and national *de jure* (and international *de facto*) lender of last resort facilities can make it 'rational' (if not socially optimal) for a fund manager to 'hide in the herd'. If all goes well, fund performance is no worse than average, and if the worst comes to the worst, bad performance is still no worse than average and is underpinned by 'lender of last resort' intervention by national or international authorities. This type of constrained 'rationality' is a reminder of the importance of 'moral hazard' in altering the nature of financial behaviour.

26 A summary of this family of 'contagion' research, and new empirical evidence on the role of 'contagion' in currency crises is in the IMF's *World Economic Outlook May 1999*, Chapter III, pp. 69 - 87.

surprisingly, crises have been more frequent in emerging markets than in industrial economies.[27] There is some evidence that 'contagion' has become more prevalent, leading to a greater clustering of crises. The tentative findings from these studies confirm the value of sound domestic policy settings and robust commercial institutions, especially in the banking sector and the prudential supervision thereof.[28]

Is globalisation near its limits?

38. In an imaginary world where national markets were seamlessly integrated with one another, goods, services and capital would flow as easily, and prices would adjust as quickly, among nations as within them, after allowing for transport cost and transaction cost differences. In such a world, it would be impossible to make anyone better off by trading a good, a service or finance from a lower valued use in one market to a higher valued use in another.

39. Against that hypothetical benchmark, there is abundant recent evidence that profitable and socially beneficial globalisation potentially has much further to run.

40. Since the mid-1990s, a number of studies have been published comparing the trade flows, capital flows and price differences among the Canadian provinces and between them and the US, and similar studies have also been performed among some other members of the OECD. While the detailed estimates differ, all studies show that even among closely integrated economies and after allowing for distance, market size and transactions costs, there remains a very large 'home bias': markets distribute goods, services and capital much more efficiently within national boundaries than across them.[29] Recent globalisation trends have somewhat lowered 'home bias', but there are likely to be many profitable opportunities to reduce it much further. For example, we have barely begun to see the practical impact of the internet on international trade in goods and services, or in retailing, banking or stockbroking.

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27 IMF *World Economic Outlook, May 1998*, chapter IV pp. 74-97.

28 IMF *World Economic Outlook, May 1999*, chapter III pp. 66-87.

29 A comprehensive summary of such evidence is in Helliwell, J F. (1998), *Do National Borders Matter?*, Washington DC, Brookings Institution, Chapter 4.

TERMS OF REFERENCE 1

The implications of the globalisation of international financial markets for the conduct of fiscal and monetary policies in Australia, including medium-term and other strategies to cope with potential volatility in markets.

41. The focus of macroeconomic policy is to provide an economic environment in which output, employment, and thus living standards can grow as fast as possible in a sustainable way. From this policy perspective, the role of financial markets is to contribute to growth in living standards by promoting an efficient allocation of capital to profitable investments and through this to growth in output and employment.

42. As financial market globalisation has developed over the past 25 years and regulation of capital flows has declined, financial market players have become a much more important determinant of the allocation of capital both domestically and internationally. Because of the increasing potential for capital flows to affect growth, employment and living standards, macro (and micro) economic policy has had to increasingly recognise, and adjust to, the impact and behaviour of financial markets.

Managing globalisation in the 1990s

43. While many economists would agree that there have been important benefits from globalisation,[30] a key element of the critique of 'globalisation' is that there are important potential costs, principally in terms of additional instability of capital flows and volatility in domestic financial markets.[31] This section discusses both costs and benefits and the role of policy in relation to these issues.

Indicators of volatility

44. Given the increasing share of capital flows accounted for by short-term or portfolio capital and the increased use of derivatives and leveraging, there is a concern that financial market volatility has increased significantly.

45. Clearly, exchange rate volatility is now higher than in periods when exchange rates were fixed and interest rate controls formed part of Australia's regulatory framework. However, it is not clear that there has been a general trend increase in financial market instability across major economies and for Australia in particular in the period following deregulation. Market instability in

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30 For example, see Argy (1995) and Edey and Hviding (1995).

31 For example, see discussion in Argy (1996).

major economies, in general terms, appears to have peaked in the early 1980s, showing a decline thereafter.[32]

46. By way of example, Table 3 below shows several measures of volatility in Australia's financial markets since the 1970s.

Table 3: Volatility in Australian financial markets (standard deviations of monthly percentage change)

	Exchange Rate		Interest Rates	Equities
	$A/$US	Trade Weighted Index	10-year Bonds	All-Ords
1970-79	2.6	2.3	0.2	4.8
1980-85	2.9	2.3	0.5	5.5
1986-89	3.8	3.8	0.5	7.1
1990-94	2.2	2.6	0.4	3.5
1995-current	2.4	2.7	0.3	2.9
1997-current	2.9	2.8	0.3	3.3

Volatility measured as standard deviation of monthly changes — per cent with exception of percentage point for 10-year bonds. Source: Treasury estimates.

47. The data in Table 3 suggest that volatility appears to have diminished during the 1990s, relative to the period immediately following significant financial market deregulation in the early 1980s. Other evidence also supports the view that there has been a trend decline in Australian financial market volatility over the period 1987 to 1996.[33] This evidence suggests that the apparent volatility associated with deregulation appears to decline following what might be described as a learning period.

48. However, episodes of instability in the global economy can increase volatility in Australian financial markets.[34] The market most affected in the late 1980s was equities, not suprisingly since the source of the instability was the correction in the US equity market. In the period since the onset of the Asian crisis in 1997, volatility in the $A/$US exchange rate has risen. However, the extent of volatility has been much lower than in the late 1980s.

32 See Edey and Hviding (1995).

33 Kortian and O'Regan (1996). The authors also find that the $US/$A and the TWI rates had the lowest volatility over that period of the five currencies examined. The others were the JPY/USD, DEM/USD and GBP/USD.

34 Kortian and O'Regan (1996).

Potential effects of volatility

49. Some commentators have suggested that globalisation has actually increased the exposure of the economy to macroeconomic shocks.[35]

- It is argued that financial markets may extrapolate developments in one country to another with incomplete or inaccurate understanding of an economy's fundamentals. This effect can be exaggerated by the tendency for 'herd-behavior' leading to overshooting in financial markets.[36]
  - In 1997 and 1998 there were abrupt falls in the $A in response to developments in Korea, Indonesia, Russia and Brazil. The markets, by correlating Australia's economic fortunes with those of our export markets and other commodity producing countries, forecast dire consequences for the Australian economy. In the event, this over reaction was not sustained, although there were times when the exchange rate market was unstable.
- Financial markets' over-riding goal of short-term profitability may increase the potential for destabilisation of the real economy and push an economy to a lower equilibrium growth path.[37]
  - This may occur, for example, if the volatility associated with this phenomenon: adds to business and investment uncertainty, leads to a higher risk premium on equity and long-term debt, deters foreign trade and long-term direct investment or causes higher risks of financial system failure.
- Finally, it is speculated that an increase in financial market volatility could impose considerable potential costs because it would lead to increased volatility in output and inflation and thus potentially contribute to the ratcheting up of unemployment.[38]
  - However, as noted above, there is no evidence of an upward trend in financial market volatility in Australia, although there have been episodes of significant instability.
  - The episodes of volatility in the early stages of the floating exchange rate regime were associated with weaknesses in the policy framework and immaturity in financial markets. Recent volatility has tended to be short lived, and output and employment growth has continued to be strong throughout these periods, a testament to a much improved policy framework.

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35 See, for example, Mathews (1995) and Manning (1995).

36 For example, see Lux (1995) or Kortian (1995) for discussion of this phenomenon.

37 For example, Argy (1996), Dooley (1996) and Eichengreen and Wyplosz (1996).

38 See *The Economist*, 16 March 1996.

50. While there does not appear to be a structural increase in financial market volatility in Australia, there can be periods of instability that may increase volatility in Australian financial markets. Increases in volatility may in some circumstances serve to highlight weaknesses in an economy's policy framework, suggesting a need for reform.

51. However, financial market volatility may occur even when the economy's policy framework is sound. Speculative attacks on currencies can be destabilising. The Reserve Bank of Australia's submission to this inquiry discusses in some detail the role of hedge funds, and provides some evidence of their recent involvement in Australia.

Benefits from exchange rate movements

52. All volatility is by no means bad.

Assisting economic adjustment

53. Movements in the Australian exchange rate — both overall and via bilateral movements — are a key part of Australia's adjustment mechanism.[39] As illustrated over the past two years, a decline in the exchange rate in response to falling commodity prices due to the impact of the Asian economic crisis has provided support to the economy by boosting the competitiveness of Australian exporters. In other words, a worsening of the fundamentals underpinning Australia's external position was followed by a partially offsetting, stabilising, reaction in the exchange rate.

54. Movements in Australia's real exchange rate (the nominal exchange rate adjusted for movements in Australian inflation relative to movements in inflation in the economies of our trading partners), if it is flexible enough, will tend to mitigate the effect of external developments on growth, whether they are positive or negative. For example, negative external developments should lead to a depreciation of the real exchange rate, in turn stimulating domestic and foreign demand for Australian goods in an offsetting manner.

55. The speed with which the real exchange rate moves is of critical importance to both the initial effects of external disturbances on the economy and the subsequent product market adjustments. With the floating of the nominal exchange rate, real exchange rate movements have become more rapid, with movements in the nominal exchange rate driving movements in the real exchange rate.

56. Before the floating of the Australian dollar, nominal exchange rate movements were restricted by exchange controls, which tended to prevent or delay changes in the nominal exchange rate in the face of external disturbances. Changes in the real exchange rate therefore depended more on changes in

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39 See, for example, Gruen (1995) or, for a more theoretical approach, Harvie and Lee (1996).

Australian inflation. Relatively high inflation over this period meant that real appreciation (a loss of competitiveness) was easily achieved. Less easy was achieving a real depreciation (gain in competitiveness) as this would have required inflation to fall.

57. Changes in real wages are an essential part of the economy's adjustment to external shocks. A fall in real wages is required to maintain the gain in competitiveness from exchange rate depreciation and allow employment to be maintained in the face of an adverse shock, such as a large fall in the terms of trade. Under a floating exchange rate, the downward adjustment occurs through prices increasing, via import price effects, relative to nominal wages. Under a fixed exchange rate, this requires falls in nominal wages, which have tended to be more difficult to achieve.

58. A key problem with fixed exchange rates is the difficulty for the authorities in determining when the exchange rate is out of line with fundamentals, and what the appropriate level should be. As the experience of the crisis economies of East Asia clearly demonstrates, the process of adjusting a fixed exchange rate can be problematic. Where the authorities have staked their credibility on maintaining a fixed exchange rate, and the private sector has acted on the assumption that it will be maintained, achieving an orderly and timely adjustment can be extremely difficult.

Improving the policy framework

59. The prospect of financial market volatility can drive policy change to reduce the risk and uncertainty which investors in domestic assets face. Achieving a reduction in financial market perceptions of risk and uncertainty associated with investment in an economy, for example linked to poor corporate governance or a poor macroeconomic policy framework, is likely to reduce the risks of destabilising movements in exchange rates or bond rates.

Effectiveness of macroeconomic policy in a globalised world

60. Some commentators have argued that globalisation has limited the ability of governments to use fiscal and monetary policy to manage the macroeconomy and achieve full employment (Latham 1998). However, Australian experience casts some doubt on this argument. The history of the 1990s shows well that national governments can run independent economic policies, and that a sound policy framework can facilitate good economic outcomes. Such a policy framework can also reduce the potential for external shocks to destabilise the economy.

61. What is also clear is that globalised financial markets can impose severe costs on governments that pursue what the markets view as *inappropriate* policies, and it is probably true that 'bad' policies are more readily penalised by investors than previously.

62. It is worth noting that the importance of overseas investors' views of Australian policy does not arise from globalisation per se. Rather, it arises from the fact that investment opportunities exceed domestic saving. This has been the case over most of our economic history. What has changed is that technology has increased both investors' access to information and their ability to act quickly based on that information.

63. In Australia's case, financial markets are essentially concerned with Australia's ability to achieve strong sustainable growth, without rising inflation or unsustainable current account deficits. They can certainly react quickly and adversely to policies that they believe would adversely affect these indicators. However, there appears to be very little conflict between what is valued by financial markets and what is in Australia's longer-term economic interests.

64. Achieving sustainable reductions in unemployment depends fundamentally on conducting policy in a way that avoids contributing to inflation and unsustainable current account pressures.

65. Economists now generally recognise that it is not possible to trade-off higher inflation for lower unemployment beyond the short-term. Hence, there is not generally any long-term benefit in using macroeconomic demand stimulus to push unemployment below the level at which inflation starts to accelerate. Higher inflation imposes economic efficiency costs, because it distorts price signals, and has arbitrary distributional impacts. The appropriate remedy for structural unemployment is to reform workplace relations, labour market regulation, vocational education and training and tax and benefits systems so that the labour market works more efficiently.

66. Recent US experience does suggest that the structural unemployment rate may not be fixed, but may move downward as unemployment is reduced. However, achieving such a fortunate outcome is likely to require considerable flexibility in labour and other markets and skilful management of policy to achieve a gradual approach toward capacity limits.

67. Nor is it sustainable for governments to run continuing budget deficits that contribute to unsustainable current account deficits. Ongoing government borrowing that is not used to fund investment that yields adequate returns is not generally likely to be in Australia's longer-term interests. Such deficits pass higher debt servicing costs on to future taxpayers without increasing future incomes. They may also put upward pressure on interest rates and reduce business confidence, thereby 'crowding out' private investment. This detracts from future output growth. The experience in Australia and many other countries since the mid-1970s suggests that running budget deficits on an ongoing basis has not been effective in delivering a sustainable lowering of unemployment, due to adverse effects on confidence and interest rates and insufficient attention to structural factors affecting unemployment.

68. While the concerns of financial markets broadly accord with the requirements for maximising sustainable growth, market views may on occasion

be misguided or over-simplistic. Policy needs to be based on sound and appropriately nuanced economic analysis, rather than simply validating market views. Governments may not be able to directly control the reactions of financial markets, but there are strategies they can adopt to minimise the risk of policy being hostage to capricious or arbitrary reactions. Macroeconomic policy can still be effective, but its effectiveness is likely to be compromised unless it is soundly based (recognising the limits of what macroeconomic policy alone can achieve), credible and conducted in a transparent manner.

69. Transparency is particularly important in this regard. Governments need to communicate clearly their policy objectives and the rationale for policy approaches, particularly in terms of how they contribute to sustainable long-term growth. Markets also need to be able to have sufficient information to assess performance. Another important element is that government's relations with the private sector be conducted on a sound and transparent basis. Transparency can bring significant benefits in terms of educating markets and promoting confidence in the policy framework.

70. Australia has been able to sustain strong economic performance notwithstanding the financial crisis that spread through much of East Asia. Paul Krugman went as far as to suggest that Australia's performance makes it the 'miracle economy' of the region.[40] Australia's ability to sustain strong growth has been due, in no small part, to the institution of sound macroeconomic policy frameworks and, in particular, the restoration of the budget to surplus.

71. Transparency has also been important in helping Australia maintain credibility in the eyes of the market. One example is the Charter of Budget Honesty, backed by legislation, which came into operation in 1998 and aims to improve fiscal outcomes by enhancing the transparency of and accountability for fiscal policy. In particular, the Government is required to set out its fiscal objectives and strategy, and provide full economic and fiscal outlook reports at the time of the budget, at mid-year and prior to elections.

72. More detail on the transparency of Australian government policies and the policy framework was provided in the report 'Making Transparency Transparent: An Australian Assessment'.

73. The benefits to Australia of greater transparency are illustrated when considering the recent widening in Australia's current account deficit (CAD). With the public sector in surplus, the CAD reflects an excess of private sector investment over private sector saving — financed by private sector lending from abroad. A similar moderate growth/high CAD scenario also existed in the East Asian economies before the onset of the financial crisis. However, the greater transparency of Australia's institutions and policy framework has provided investors with greater certainty as to the economic and legal

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40 Paul Krugman writing in *Forbes Magazine*, December 1998.

environment in which they operate. The ability to make such an informed assessment of commercial risk has helped investors to differentiate between conditions in Australia and other economies.

74. In marked contrast to the East Asian economies, Australia has had a well-regulated financial sector, and sound and transparent corporate governance. Financial markets have not been distorted by explicit or implicit government guarantees on corporate borrowing. This has allowed foreign lenders the confidence to assess commercial risks and continue lending to the private sector.

75. It is sometimes argued that financial markets do not adequately distinguish between 'bad' budget deficits and 'good' budget deficits, used to fund sound public investment or to support inadequate demand growth. There may be an element of truth in this, but the main problem is more likely to be that governments may be viewed as lacking credibility, because in the past they have tended to resile from running surpluses when demand was strong, or to fund poor quality public investments. The solution for governments is to build credibility by establishing a track record of consistent fiscal soundness, and to conduct policy on a transparent basis with clearly articulated policy objectives.

76. Governments can also take steps to ensure a sound framework for public investment provision: including through privatisation of functions that are better performed by the private sector; contracting out of service delivery; corporatisation of government business and the introduction of competition.

77. Credibility and transparency together are likely to provide governments with more scope for flexibility in conducting policy. In the absence of credibility and transparency, markets are much more likely to react disproportionately to short-term developments or to apply rigid strictures as to what constitutes appropriate policy.

Contribution of structural reforms to enhancing Australia's growth performance

78. While beyond the terms of reference of this inquiry, Australia's economic performance, and its ability to prosper in an increasingly globalised world is also dependent on the flexibility and responsiveness of product and labour markets, and the regulatory infrastructure that governs the behaviour of firms

and financial institutions.[41] We have seen in Australia ongoing structural reform over the past decade and a half: including sustained tariff reform; financial market reform; reform of the operation of government business enterprises; enhancing national competition policy; changes in foreign investment rules; tax reform; labour market reform; reform of corporate governance arrangements and the like.

79. A prime focus of reform has been to subject the private sector in Australia to more competition from both domestic and international sources and to improve the performance of public utilities. The direct benefits of these reforms are lower prices and increased productivity, which in turn reduce input costs for other industries and increase aggregate employment opportunities. Aside from lowering the cost structure of downstream businesses, such price falls also exert downward pressure on inflation and inflation expectations and assist the macroeconomic management task.

80. In recent years, in particular, a number of reforms stand out.

- Significant reforms to workplace relations arrangements and labour market regulation and assistance have increased the responsiveness of the labour market to changes in the economy, and reduced impediments to job creation, participation in employment and improving productivity. The *Workplace Relations Act 1996* accelerated the move from centralised wage fixing to enterprise bargaining and imposed tighter limits on industrial action. Other policies, such as the mutual obligation principle, have been directed at assisting and encouraging job search by the unemployed.
- The quality of regulation required to ensure well functioning markets and financial system stability has been enhanced, through the financial sector reforms that arose from the Wallis Inquiry.[42]
  - The recent reforms establish a more flexible regulatory system, with a functional rather than institutional focus, that is better able to respond to a rapidly changing environment without stifling innovation and competition. This will meet the need for regulation to ensure stability and integrity, without endangering efficiency.
- The Corporate Law Economic Reform Program is modernizing and giving an economic focus to regulatory requirements regarding fundraising, takeovers, corporate governance, financial reporting and conduct and disclosure practices in financial markets. The focus is on providing the

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41 It has been noted that, historically, when Australia was inward looking (economic nationalism was the overriding orthodoxy) Australia's growth rate of GDP slipped behind the OECD average, and, while other OECD economies closed their per capita GDP gaps relative to the then leader (the US), Australia slipped down the per capita GDP rankings. See Caves and Krause (eds) (1984).

42 Financial System Inquiry (1997).

regulation necessary for well-functioning markets, without compromising efficiency.

  - These reforms will help to maintain a high level of business and investor confidence thereby reducing the risk of damaging swings in capital flows and spending. This also makes the macroeconomic management task easier by reducing the likelihood of booms and busts and thus allowing strong sustainable growth. The events of the 1980s with the 'corporate cowboys' and the early 1990s with impaired bank balance sheets due to increases in bad loans are much less likely to recur.

- A fundamental reform of the taxation system which is badly in need of repair is also being undertaken. The aim is a tax system designed to increase incentives to work, save, invest and export. The central elements of the tax reform include: abolishing the Wholesale Sales Tax (WST) and the most inefficient State indirect taxes; introducing a Goods and Services Tax (GST); reforming Commonwealth-State financial relations; cutting income taxes; and increasing benefits for families, pensioners and self-funded retirees.

- The Review of Business Taxation will also bring forward a comprehensive agenda for reform of the business taxation system on two fronts. This involves applying a framework of redesigned company taxation arrangements to all limited liability entities consistently and considering the scope for more consistent taxation treatment of business investments with the prospect of achieving a 30 per cent company tax rate and further capital gains tax relief.

Globalisation and Australian economic development

Benefits from policy reform

81. The benefits of the economic policy reforms discussed above are now clearly visible.

- Low inflation has been consolidated, with underlying inflation remaining below 2 per cent over the last two years. Low and stable inflationary expectations reduce the likelihood that domestic inflation will respond in a sustained way to transitory pressures. Consequently, there is less need for monetary policy to respond to such developments.

  - The onset of the East Asian financial crisis in 1997 contributed to a significant but orderly depreciation of the Australian dollar, particularly against the currencies of the major economies. In the past, falls in the currency have flowed through into higher consumer price inflation. This time, assisted by declining international producer prices, a better policy framework and a

more competitive economy have helped minimise the flow-on of import price rises into domestic prices and wages.

  – More stable and low inflationary expectations should mean less need for policy to be tightened aggressively in the face of an increase in inflation. In the past, policy often had to be tightened aggressively in order to avoid strong growth being translated into a rise in inflationary expectations. These expectations tended to rise with rising growth and inflation with the consequence that wages and prices rose further leading to an inflationary spiral. The policy tightening required to rein in these spirals often led to sharp falls in economic activity and steep rises in unemployment. If inflation expectations remain low and stable in the face of strong economic growth, this reduces the need for sharp tightening of policy and wide swings in economic activity. This reduction in output volatility and policy uncertainty should provide a supportive environment for employment growth over the longer-term.

- The Commonwealth budget has been returned to surplus (and is projected to remain in surplus over the next four years) reducing concern in relation to the current account. It is now much clearer that borrowing from abroad is for private purposes, assessed against commercial criteria.
- Long-term bond differentials with the US have narrowed considerably, remaining below 0.5 percentage points over most of the past two years.
- Average multi-factor productivity growth since 1993-94 has been a full percentage point higher than the long-run average. The economy is expected to record its second successive year of economic growth in excess of 4 per cent, with the expansion now in its eighth year.
  – Importantly, the recent period of strong economic growth has not been associated with the emergence of unsustainable wage pressures that have contributed to increasing inflation in past periods when the economy has grown strongly at an advanced stage of the expansion. More flexible workplace arrangements have sharply reduced the tendency for wage-setting processes to contribute to inflationary pressures that might otherwise have necessitated a contractionary policy response.
- Sound corporate governance and prudential supervision of the financial system have enhanced foreign investor confidence in Australia at a time when many economies around us were being buffeted by uncertainty.

82. It is clear that 'national economic policies will, in part, determine how well we manage the consequences of global markets'.[43]

43 Fraser (1999).

83. The robustness of the current policy framework has been 'stress tested' in the aftermath of the financial crisis that emerged in East Asia in late 1997. This resulted in a severe economic downturn in many of our major trading partners in the region, and a large fall in world commodity prices.

84. In the past, such developments might have created severe difficulties for Australia. Indeed, many observers expected that Australia would experience a serious economic downturn on this occasion. The decline in the $A might have contributed to domestic inflationary pressures. Investor confidence might have declined in the face of a widening current account deficit (CAD), putting further pressure on the currency. The result would likely have been higher short and long-term interest rates.

85. The key difference on this occasion has been that sound fiscal, structural and monetary policy frameworks have maintained foreign investor confidence in Australia. A fiscal surplus, together with a sound microeconomic environment underpinning private sector investment decisions, has been essential to market acceptance of a widening CAD. Currency depreciation has not fed through into higher inflation. Consequently, the Australian economy has been able to benefit from an increase in competitiveness arising from an orderly currency depreciation, while maintaining low interest rates.

86. Other developments have reduced the level of risk attached to Australia's external liability position and helped to reduce our vulnerability to external shocks.

- Australia's net foreign debt to GDP ratio has stabilised in recent years, with the moderate expansion in our net liabilities being largely met by increased net equity investment.
- The net debt-servicing ratio has gradually fallen to 10 per cent of exports, the lowest ratio since 1984.
- Australia's foreign currency denominated liabilities are now outweighed by foreign currency assets, so that the net income deficit no longer tends to escalate when the $A depreciates.
- The public share of net external debt has also fallen to its lowest level since 1984.
- Over 70 per cent of short-term debt is held by the Reserve Bank and prudentially-regulated depositary corporations.

87. There is, however, no room for complacency. Continuing structural reform is necessary to reduce constraints to growth by raising productivity growth, increasing flexibility and extending competitive pressures throughout the economy.

Losers from structural change

88. There have been concerns that globalisation has hurt some in the community.

89. Globalisation, like most significant economic change, while contributing to an overall lift in economic performance as constraints on financing are raised, may also result in there being some (individuals, enterprises, industries) who are made worse off, in particular during a transition period. In aggregate, change can bring significant benefits to the economy as a whole. Scarce resources can be redirected into those sectors that yield the highest return and at the same time are likely to provide the most stable employment prospects and strongest employment growth. The adjustment process may involve people retraining and/or changing jobs within a region, or moving to locations with expanding opportunities.[44]

- There has been no upward trend in job losses due to retrenchment or business closures over the past 20 years. Typically, these account for 15 to 20 per cent of total job separations.[45]
- While regional fortunes have changed over the past 10 years, more have grown (those in coastal areas, or near capital cities or associated with growth industries) than those that have contracted (those inland in wheat/sheep belts and dryland grazing or mining regions).

90. Government has a role in minimising the transition costs of structural change. It can do this by reducing the distortions in the economy, which retard change and people's ability to manage it. For example, the government also has at its disposal generally available welfare, job search and training programs, as well as, depending on the circumstances, the option of targeted support measures.

Globalisation and income distribution

91. Over the last twenty or so years there has been a widening of income distribution in many countries. Some have argued that this is due to increased trade and globalisation.

92. The argument is that countries with large supplies of skilled labour have switched to production of goods and services that make intensive use of skilled labour and to the import of goods and services that make intensive use of unskilled labour. The result in those countries is a decline in demand for unskilled workers and a resulting increase in earnings dispersion. However, there are two problems with this hypothesis. First, the compositional shift between skilled and unskilled workers has been found to be too weak to explain

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44 Productivity Commission (1998).

45 Ibid.

the increase in inequality and, second, there has been a relative increase in demand for skilled labour in virtually all countries. [46]

93. A more consistent explanation is that organisational change — facilitated by computer and telecommunications technology — has changed the type of employee skills that are now in demand. Skills that appear to be increasingly valued include versatility across tasks, ability to learn new tasks, aptitude to take advantage of complementarities between tasks, ability to communicate with other employees in a team, and increased responsibility and decision-making power.[47] While this explanation is more consistent with observed compositional changes, further analysis is required.

94. While it is not possible to be conclusive about the causes of increases in dispersion of earnings, it is important to understand that there is a trade-off between policies designed to achieve a more equal income distribution and those that might contribute to a higher aggregate level of income.

95. Australia should seek to implement policies that place it in a strong position to exploit the opportunities of trade and globalisation. Such policies will include:

- labour market policies which ensure jobs are properly rewarded and that employers and employees can negotiate to facilitate structural changes; and
- education and training policies, which equip the workforce with the skills to adapt to and take advantage of organisational changes.

96. While these policies may not prevent some increase in *earnings* dispersion, they do not imply a less equal distribution of national income. Importantly the operation of taxation and welfare policies in Australia has meant that family *income* distribution has improved progressively over the last two decades. In particular, those families on the bottom quintile have improved their relative position.[48] Further, recent evidence suggests that there has been a reduction in job insecurity.[49] In other words, while macroeconomic and structural policies have adopted a less interventionist perspective, it has been possible for policy to also address income distribution issues. The challenge will be to maintain this balance.

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46 Analysis in Australia suggests that changes in the distribution of, and returns to, unobservable characteristics are important factors in explaining the increase in earnings inequality. See, for example, Borland (1996).

47 These issues are discussed by Dennis Snower, Causes of Changing Income Inequality, in *Income Inequality: Issues and Policy Options*, A Symposium sponsored by the Federal Reserve Bank of Kansas City, August 1998.

48 See for example Johnson, Manning, and Hellwig (1995).

49 See Wooden (1998).

Looking forward — opportunities from globalisation

97. The important role of IT in globalisation, together with pre-existing Australian strengths, provides an opportunity to conquer the 'tyranny of distance'. Our potential comparative advantages in a globalised world are not just the obvious ones of reasonable telecommunications, good IT literacy, and a sophisticated domestic financial sector with good regional and global experience. Our advantages extend to the less obvious, but highly relevant institutional strengths of a rule of law, respect for intellectual property rights, good macroeconomic policy arrangements, good prudential supervision arrangements, and a strong civil society with capable professional groups underpinning good standards of accounting, auditing, and other professional skills that are likely to be easily exported into globalised markets.

98. As one analyst noted of the globalisation of securities trading: 'In a global market environment, being located in a country with a long tradition of property rights security provides a competitive advantage. Thus, economies with a higher probability of the imposition of exchange controls, multiple exchange rates, restraints on foreign investments or interest equalisation taxes undermine the competitive position of their securities markets in global competition.'[50]

99. Australia's particular comparative advantages for the world of globalised finance should give us an even stronger national interest in ensuring that globalisation is advanced on a secure, sustainable basis, rather than crimped or slowed.

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50 Smith (1991), op cit, p. 88.

TERMS OF REFERENCE 2

Information requirements for the stable and efficient operation of international financial markets including the provision of information by governments and disclosure by market participants, especially by large market participants including highly leveraged institutions.

100. Events over the past two years have highlighted the need for governments to do more to realise the benefits and minimise the risks inherent in the dynamism of the international financial market place. Central to this objective is creating an environment in which markets operate efficiently through informed decision-making and appropriate risk management.

101. The recent crises have revealed shortcomings in the way investors and creditors have evaluated and priced the risk of their investment and lending decisions. In particular, an absence of adequate, reliable, and timely information is now widely accepted as one of the factors which exacerbated the severity of the East Asian financial crisis. A lack of information makes it difficult for investors to assess risk and distinguish between firms and financial institutions that are sound and those that are not, leading to many borrowers being grouped equally relative to risk. This in-turn, at a time of crisis, can exacerbate any indiscriminate withdrawal of capital.

102. Such an event reflects an underlying failure on the part of market-based mechanisms to adequately provide and assess information. The increasing sophistication and integration of financial markets over the last two decades, such as the growth of derivative markets,[51] have compounded the difficulty faced by the market in addressing information requirements. In particular, the information requirements, which underpin the efficient allocation of resources and identification of risks, are continually evolving as the global environment itself changes. This development and its implications for macroeconomic stability imply a greater role for public policy at the national and international levels, policy that balances the costs and benefits of increased information, and takes into account the changing underlying environment.

103. To address this, governments and the international community have placed a priority on greater transparency, improving the quality of information through codes and standards, and more effective surveillance — as an integral part of the wider effort to strengthen the international financial system.

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51 For instance, the turnover of futures contracts traded on international exchanges increased almost three-fold between 1990 and 1995 from 288 million to 774 million. *International Finance 2nd Edition*, Pilbeam, MacMillan Press, 1998, p. 337.

Greater transparency

104. There is widespread recognition of the importance of greater transparency. The Treasurer in his opening address to the Manila Framework Group meeting on 26 March 1999 identified improved transparency as one of the key elements in working towards an improved international financial system.[52] The IMF Managing Director Michel Camdessus commented in a recent address to the International Organisation of Securities Commissions (IOSCO) that greater transparency in international finance held the key to world economic stability.[53]

105. By improving transparency, policy makers and markets will have at their disposal more readily available information on which to base policy and commercial decisions. For the public policy-maker this allows the timely identification of emerging policy and institutional fragilities, and facilitates their correction before they become embedded and more difficult to remedy. For private sector participants, greater transparency promotes (but does not guarantee) market efficiency by allowing participants to better identify and price risk.

106. Transparency is more than simply the availability of information. In particular, an environment of greater transparency has the added benefit of enhancing accountability. Ultimately, policy makers and private sector participants are accountable either to the market and shareholders, or to the ballot box, to deliver sound policies and good governance. This imposes a discipline on players to deliver sound policies and good governance from the outset, and a strong incentive to respond promptly to any weaknesses that may arise.

107. A number of fora, including the G-22 Transparency and Accountability Working Group, have considered what measures the international financial institutions and governments can take to improve transparency. In the G-22 Working Group there was consensus on the need to improve policy transparency and data provision, including on foreign exchange reserves, external debt and financial sector soundness. The Working Group recommended that consideration should be given to compiling data on international exposures of investment banks, hedge funds and other institutional investors.[54]

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52 *Opening Address at the Manila Framework Group Meeting*, The Hon Peter Costello MP, 26 March 1999, available on-line at http://www.treasury.gov.au.

53 *Stable and Efficient Financial Systems for the 21st Century: A Quest for Transparency and Standards*, Address of Michel Camdessus, Managing Director of the International Monetary Fund, at the XXIVth Annual Conference of the International Organisation of Securities Commissions (IOSCO), Lisbon, Portugal, 25 May 1999.

54 The report of *The G-22 Working Group on Transparency and Accountability*, 5 October 1998, is available on-line at the Bank for International Settlements website at http://www.bis.org.

108. The G-22's recommendations have served as a basis for further work by the IMF and other international institutions, and considerable progress is being made. The Bank for International Settlements (BIS) has established a Working Group (the Patat Group) on transparency regarding aggregate positions to look at what aggregate data could be collected to enhance the efficient operation of markets. The IMF Executive Board, in March 1999, approved an expansion of the Special Data Dissemination Standard (SDDS)[55] to include data in the areas of debt and international reserve positions. At present, about one-quarter of the IMF's membership comply with the provisions of the SDDS. Australia subscribed to the SDDS in April 1996. The IMF, in conjunction with the OECD, World Bank and BIS, has also put in place arrangements to facilitate access to creditor side external debt data.[56]

109. The G-22 Working Group also recommended that the IMF, in the context of its Article IV consultations, prepare transparency reports for economies summarising the degree to which the economy meets internationally recognised disclosure standards. The recommendation was endorsed by a Task Force on International Financial Reform commissioned by the Prime Minister in October 1998 to advise on how Australia could contribute to international financial reform. The Task Force, chaired by the Treasurer, recommended that Australia take the lead in preparing a self-assessment transparency report, providing a format and methodology that other countries may choose to follow.

110. The report, released by the Treasurer on 26 March 1999,[57] benchmarks Australia's practices against a wide array of 'best practice' international standards and gives an example of how economies can explain their economic policies and institutional arrangements. Ensuring that such policies are comprehensively understood in the global market place establishes credibility and, as indicated earlier, allows investors to make a more informed risk assessment. This not only promotes market efficiency, but may also reduce the risk of 'contagion', at a time of crisis, as lenders are able to distinguish between the financial circumstances facing different countries.

111. Following on from the Australian example, the IMF launched a pilot project of experimental case studies on transparency practices. The transparency reports are to be used on a trial basis as part of the IMF's surveillance activities. To-date, case studies have been prepared by IMF staff for the UK and Argentina and a second round of case studies is shortly to be undertaken.

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55 Background on the SDDS is available on the IMF web site at http://dsbb.imf.org.

56 The statistics are located at http://www.oecd.org/dac/debt. Information about this initiative is also available from the IMF web site at http://www.imf.org.

57 *Making Transparency Transparent: An Australian Assessment*, Department of Treasury, March 1999, available on-line at http://www.treasury.gov.au.

112. Those countries that have adhered to standards and been more transparent in their policy-making have fared relatively better in the face of the turbulence of the past two years.

113. Nevertheless, transparency alone will not solve or forestall financial crises. Improving the availability of data is an important step, but if the risk of financial instability is to be reduced, transparency must be taken a step further and integrated into an assessment of the market. The failure of external ratings agencies to downgrade the debt of many of the East Asian crisis countries until after the onset of the crisis demonstrates a weakness on the part of some private participants to adequately assess available information.[58] Ministers at the Sixth APEC Finance Ministers meeting in Langkawi, Malaysia, May 1999, tasked their Deputies to survey the codes of conduct and practices currently in use by various credit rating agencies with a view to encouraging greater accountability.[59]

114. This is, largely, an issue for the private sector to address. Competitive pressure in the supply of advice, on issues such as credit risk, is growing. However, there is an onus on governments to strengthen their own information and disclosure standards and to communicate more effectively with the market place. In this regard, greater transparency can play an important role in building trust and strengthening the partnership between government and the private sector.

115. Good public policy aims at ensuring an appropriate balance between costs and benefits for any particular measure or set of measures. This applies also to transparency. Apart from the direct resource costs involved in collecting and disseminating information, there may also be instances where greater transparency becomes counterproductive to its objectives. Governments and international financial institutions need to consider carefully the economic variables they choose to highlight. Release of too much data could serve to obfuscate rather than inform. Release of certain data, not set within an appropriate context, runs the risk of an adverse market reaction, regardless of whether it represents fundamentals.

116. For example, the Thai authorities, in the midst of the crisis, were required to release data on the central bank's forward foreign exchange positions. This was intended as a step towards greater transparency, in line with the Fund programme, but its timing weakened the impact on confidence that the

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58 *Underpinnings for a Stable and Equitable Global Financial System: From Old Debates to a New Paradigm*, Stiglitz and Bhattacharya, Paper prepared for the Eleventh Annual Bank Conference on Development Economics, 28-30 April, 1999, p. 8.

59 *Sixth APEC Finance Ministers Meeting — Joint Ministerial Statement*, Langkawi, Malaysia, 15-16 May 1999, paragraph 33.

announcement of the programme could have otherwise had.[60] By contrast, it can be argued that if transparency on net official reserves had been in-place prior to the crisis, much of the run down in reserves may have been avoided. While the above illustrates that greater transparency needs to be carefully considered, as a general rule, exceptions to full transparency should be well justified and only occur at a time of particular market sensitivity. Once the period of market sensitivity has passed, the rationale for the exception should be re-examined.

117. Efforts to improve transparency are normally associated with the public sector. In particular, this involves increasing public accountability in an environment where public agencies are generally not subject to the same degree of discipline as exists in the private market place. However, recent problems in Asia, especially weaknesses in the corporate and financial sectors, have drawn attention to the issue of greater transparency (and disclosure) in the private sector. Participants at both the Manila Framework Group meeting (Melbourne, March 1999) and Sixth APEC Finance Ministers meeting (Langkawi, May 1999) emphasised that attention must be focused on both if we want to lift efficiency in the financial market place. There is a strong case for greater disclosure by the private sector. Developments in this area are discussed in the following section.

Private sector disclosure

118. The role of the private sector in forestalling and resolving crises is one of the most complex issues being considered in moves to strengthen the international financial system.

119. The report of the G-22 Working Group on Transparency and Accountability, in October 1998, highlighted the importance of improving data on the international exposures of banks and institutional investors. The Group identified an absence of principles and standards to guide disclosure practices and recommended further work in this area. In response to these recommendations and more widespread concerns among the international financial community, work on enhanced transparency and disclosure of financial market participants, including highly leveraged institutions (HLIs), is being progressed in a number of specialised fora.[61]

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60 *IMF-Supported Programs in Indonesia, Korea and Thailand: A Preliminary Assessment*; Lane, Ghosh, Hamann, Phillips, Shulze-Ghattas and Tsikata, International Monetary Fund, January 1999, pp. 43-44.

61 The Bank for International Settlements (BIS), Basle Committee on Banking Supervision (BCBS), Committee on the Global Financial System (CGFS), International Association of Insurance Supervisors (IAIS), International Accounting Standards Committee (IASC), and International Organisation of Securities Commissions (IOSCO) are undertaking ongoing work on disclosure requirements. The BCBS and IOSCO published recommendations in February 1999 on disclosure of trading activities of banks and securities firms — see http://www.bis.org/wnew.htm.

120. The role of HLIs and other large institutional investors in financial markets is a topic that has attracted considerable attention. In particular, there is a concern that the profit seeking behaviour of 'global macro' hedge funds may lead to market manipulation and destabilisation of small-medium sized economies. The near collapse of Long-Term Capital Management in September 1998, also heightened concern about the potential for these institutions to introduce new sources of instability. A Working Group on Financial Markets,[62] established at the initiative of President Clinton, recommended, in April 1999, improvements in disclosure and risk-management practices for HLIs, which would, if implemented, help to constrain excessive leverage in the system and contribute to a reduction in systemic risk.

121. The report of the Group builds on a growing consensus that HLIs, like other financial institutions, should comply with appropriate transparency, disclosure and regulatory requirements. To this end, the Financial Stability Forum (see also paragraph 187), created by the G-7 to strengthen cooperation among the international groups involved in financial regulation and oversight, recently established a working group to prepare a report on HLIs by September 1999.[63] The Reserve Bank of Australia (RBA) is represented on the HLI Working Group.

122. Treasury and the RBA have shared views on matters related to HLIs and we refer the Committee to the submission prepared by the RBA for further detail on this issue.

International codes and standards

123. There is a widespread consensus among policy makers and regulators that more widely accepted rules and standards need to be put in place to promote greater market efficiency and facilitate the integration of global financial markets.

124. The development and implementation of codes and standards has three principal objectives:

- First, to serve as a benchmark for economic performance. This will assist policy makers and regulators to identify instances of poor performance and take corrective action.
- Second, to provide for the dissemination of relevant, accurate and timely information by governments, financial institutions, and the private sector. High-quality standards, especially in areas such as accounting, assist in

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62 *Hedge Funds, Leverage, and the Lessons of Long-Term Capital Management*, Report of the President's Working Group on Financial Markets, US Treasury, April 1999.

63 The Financial Stability Forum was established on the recommendation of the President of the Bundesbank, Hans Tietmeyer. More information on the Forum can be obtained from the BIS web site, http://www.bis.org.

the accurate interpretation of information. In the absence of standards, information being disclosed may mislead the market resulting in less than optimal resource allocation and uncertainty.

- Third, to facilitate the comparability of data — allowing informed comparisons of the financial and economic performance of firms and economies.

125. Developing and implementing standards and codes of good practice that meet these three objectives will, together with greater transparency, play an important role in building stronger, more resilient and more efficient financial systems at the national level — systems in which investors and creditors are better able to make knowledgeable decisions, and supervisors are able to judge the soundness of commitments by their financial institutions. The global acceptance, and credible and rigorous implementation, of appropriate standards and codes will in-turn strengthen the international financial system — helping to prevent future crises.

126. Codes of good practice or their equivalent now exist, or are at advanced stages of preparation for: releases of economic data; fiscal transparency; monetary and financial policies; banking supervision; securities market regulation; insurance regulation; accounting standards; auditing standards; corporate governance; payments and settlement systems; and bankruptcy.[64] Countries are being strongly encouraged to adhere to these standards and codes. The codes will apply both to the public sector (eg the conduct of monetary and financial policy) and to the private sector (eg codes of corporate governance, accounting and auditing).

127. Of particular interest are codes and standards being developed to strengthen risk management and prudential regulation. Events in Asia reminded us that investors and lenders have a tendency to underestimate risks in good times and overestimate them in bad times. Financial market participants need to strengthen their practices of managing credit and market risk — and supervisors need to increase their oversight in this area. One important step is the updating of the 1988 Basle Capital Accord risk weighted capital system so that it better reflects the credit risks associated with different activities. The Basle Committee on Banking Supervision (BCBS) has undertaken a review of the Capital Accord and on 3 June 1999 released a consultative paper on a new capital adequacy framework.

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64 Agencies involved in developing and or refining new standards include: the IMF; the World Bank; the OECD; the International Organisation of Securities Commissions (IOSCO); Basle Committee on Banking Supervision (BCBS); the International Association of Insurance Supervisors (IAIS); the International Accounting Standards Committee (IASC); the International Federation of Accountants (IFAC); the United Nations Commission on International Trade Law (UNCITRAL); and the Committee on Payment and Settlement Systems (CPSS).

128. The BCBS paper identifies 'three pillars' in the new Accord: minimum capital requirements, which seek to develop and expand on the standardised rules set forth in the 1988 Accord; supervisory review of an institution's capital adequacy and internal assessment processes; and effective use of market discipline as a lever to strengthen disclosure and encourage safe and sound banking practices.[65] While the focus of the Accord is on internationally active banks, its guiding principles are applicable to banks more widely and it will play an important role in strengthening prudential regulation.

129. The recent crises have also demonstrated the risks associated with excessive short-term borrowing, particularly in foreign market currencies. The bias in favour of short-term financing has arisen as a result of distortions at both the national and international level. At the national level these include tax or regulatory arrangements, while at the international level it has become apparent that the current Basle risk-based capital requirements favour the use of short-term interbank credit lines.[66] The Interim Committee (IC) of the IMF in April 1999 endorsed further work to eliminate this regulatory bias[67] and the BCBS, as part of its review of the Capital Accord, is considering ways to factor maturity more explicitly into the assessment of credit risk.

130. With the development of many codes and standards at an advanced stage, the focus is now shifting to implementation. Since countries are often at different stages of development, individual countries must, according to their domestic circumstances, turn the principles being formulated at the international level into more precise standards. This will be a complex, and at times politically sensitive, task and a number of countries are likely to require technical assistance in adopting the new standards.

131. Codes are not compulsory — rather they are examples of best practice-and if the international financial system is to be strengthened, governments will need to be encouraged in their use. Peer review through organisations such as the OECD and APEC will play a valuable role, and the IMF in carrying out its Article IV surveillance activities will also be examining adherence to international standards. The report of G-7 Finance Ministers to Leaders on 18 June 1999 recognised the challenge of implementation and called for country adherence to be used in determining IMF conditionality.[68] Perhaps the greatest inducement for governments to adopt codes and standards will be the use of conformity with international 'best practice' by markets in their

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65 The *Consultative Paper on a New Capital Adequacy Framework* is available on-line at http://www.bis.org. The BCBS seek comments on the proposals by 31 March 2000.

66 The risk weight for short-term interbank lending is 20 per cent, compared with 100 per cent applying to longer-term interbank lending.

67 See the Communiqué of the IMF Interim Committee meeting, 27 April 1999.

68 Report of the G-7 Finance Ministers on *Strengthening the International Financial Architecture*, 18 June 1999.

assessments of the sustainability of a country's policies and economic performance. This in-turn is likely to impact upon borrowing costs and flows of investment and should prove a strong incentive for countries to voluntarily implement 'best practices'.

The role of surveillance

132. A key element of crisis prevention is better surveillance. That the Asian financial crisis came as a surprise indicates that surveillance has been inadequate. Surveillance requires having in place the necessary processes for identifying risks to economic management at the national and global level. To be effective, surveillance must be much more than identifying emerging problems. It also requires the development of options, assessment of downside risks, and ensuring the implementation of remedial action.

133. Surveillance will continue primarily to be the role of the IMF and World Bank. The IMF through its Article IV consultations conducts an annual assessment of the monetary, fiscal and structural policies in individual member economies.[69] The recent financial crises, however, have led to calls for the IMF to enhance its surveillance activities to include the broad range of policies now understood to be crucial to financial stability, in particular the health of financial and corporate sectors. In this regard, the IC in April 1999 requested the IMF and other relevant fora to move forward expeditiously with efforts under way to improve data on capital flows, and supported the establishment of systems for high frequency monitoring of private external liabilities.

134. In addition to a focus on the capital account, the IMF, as indicated earlier, will be extending its surveillance role to monitor the updating of standards, principles, and codes of good conduct in member states. This will particularly be the case where a member requests access to the newly established Contingent Credit Line (CCL) — where included among the five criteria for access to the CCL is the country's 'progress in adhering to relevant internationally-accepted standards.'

135. Australia is supportive of the IMF, in consultation with other international financial institutions, continuing to take the lead in surveillance. In executing these new tasks, it is evident that the IMF will have to supplement its in-house expertise and draw on the skills, resources and advice of the many agencies engaged in developing and defining standards. In this regard, the establishment of the Financial Sector Liaison Committee should help improve coordination between the Bank and Fund and contribute to high quality surveillance and the provision of sound advice.[70]

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69 See also IMF Annual Report 1998, Chapter VI 'Surveillance'.

70 The Financial Sector Liaison Committee was established in September 1998.

136. In the context of transparency, IMF members are now being encouraged to voluntarily release the results of the surveillance undertaken by IMF staff. The aim of this development is to promote better decision-making and economic performance by further improving transparency in the policies and practices of member countries.[71] However, an issue that needs to be considered is whether the effectiveness of surveillance may be undermined if the publication of Article IV reports inhibit the openness and candour with which national authorities deal with IMF staff.

137. As noted earlier, to be effective, surveillance must lead to the implementation of remedial action. In this context, peer review processes such as in the OECD, ASEAN and APEC can be influential in shaping the direction of a government's policies. One further step, to which Australia attaches particular importance, is the establishment of the Manila Framework Group in November 1997.[72]

138. The Group comes together every six months and has proven to be a useful forum for frank discussion of the economic issues impacting upon our region. In hosting the most recent meeting of the Group in March 1999, Australia/Treasury actively engaged participants in discussions about the macroeconomic outlook, policy issues (particularly in regard to the design and implementation of the IMF-supported programs in Asia), and reform of the international financial system.

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71 See '*A Guide to Progress in Strengthening the Architecture of the International Financial System*', 28 April 1999, available on-line at http://www.imf.org.

72 The Manila Framework Group brings together Finance and Central Bank officials from: Australia, Brunei, Darussalam, Canada, China, Hong Kong SAR, Indonesia, Japan, Korea, Malaysia, New Zealand, the Philippines, Singapore, Thailand and the United States. APEC Economic Leaders endorsed the Group on 25 November 1997.

TERMS OF REFERENCE 3

The relevance to these issues of recent developments in the international frameworks for financial regulation.

139. The crisis in East Asia has focused attention on the need to deal with the serious challenges being posed by globalisation and other changes in financial markets. There is a broad consensus that addressing these challenges requires:

- promoting soundly based liberalisation and more stable capital flows;
- strengthening domestic financial systems, macroeconomic and regulatory policies; and
- strengthening the international financial system to better prevent crises and to manage them if they do occur.

140. The following discusses recent developments and draws on the Australian experience in dealing with the issues raised.

Soundly based liberalisation and more stable capital flows

141. Open and integrated financial systems pose challenges for policy makers and others. However, the potential benefits to be derived from liberalisation and globalisation are large. The challenge is to seek to improve the stability of capital flows and the international monetary system more broadly, and in so doing, maximise the potential benefits of greater openness.

142. More open capital markets can bring, and have brought, substantial benefits. However, volatile capital flows can also punish economies. This is particularly the case for those countries not pursuing sound macroeconomic policies, appropriate debt management and do not have in place financial institutions supported by strong supervisory and regulatory frameworks. Ongoing financial innovation and technological change underscore the potential risks of premature liberalisation, which have served to increase the volume and complexity of capital flows.

143. The crisis has shown that the pace of liberalisation of capital accounts should be undertaken in a manner consistent with a country's financial infrastructure. Equally important, the sequence of liberalisation should be appropriately balanced. One of the factors contributing to the evolution of the recent crisis was that countries pursued early and unbalanced liberalisation, in that they opened themselves up to short-term capital flows but not longer-term flows, and liberalisation took place without having sufficiently strong financial institutions to cope with those flows.

144. There now appears to be a consensus that liberalisation should not be pursued without due regard to the strength of domestic financial institutions.[73] The Interim Committee (IC) of the Board of Governors of the IMF has tasked the IMF with undertaking further work on the appropriate pace and sequencing of capital account opening.[74]

145. Language such as 'appropriate pace and sequencing' of liberalisation is often taken to be a euphemism for resisting greater openness or 'going slow'. This is not the case being put here. The purpose of liberalisation is to improve economic prospects and standards of living. To achieve this, important pre-requisites need to be put in place — notably sound financial supervision. Sound corporate governance arrangements are also important. Liberalisation should be undertaken in a manner that allows for these 'pre-requisites' to be put in place. Premature or ill-considered liberalisation is likely to bring with it substantive costs.

146. Recognition of the importance of pursuing orderly liberalisation has raised questions about a possible role for capital controls in enabling countries to better manage short-term flows. Some suggest that controls on inflows (especially market-based controls) can provide a useful means of reducing vulnerabilities. Australia had previously adopted such an approach and Chile currently has controls on capital inflows. An alternative is to place controls on outflows. Such an approach has been adopted by Malaysia, which implemented controls on outflows in an effort to avoid a crisis triggered by a sudden reversal of short-term flows.

147. In 1972, Australia introduced the variable deposit requirement (VDR), which acted as a market-based restriction on capital inflows. Under the VDR scheme, a proportion of overseas-borrowed funds had to be placed in Australian dollars with the RBA in an interest-free non-assignable deposit until loan repayments were made. By raising the cost of overseas borrowings, the VDR in effect acted as a tax on funds borrowed from abroad. The VDR was suspended in July 1977.

148. The VDR was introduced in Australia under a pegged exchange rate regime at a time when capital inflow, and in particular portfolio investment and increased borrowing abroad, was considered to be high. This capital inflow was causing a sharp accumulation of reserves, leading to disequilibrium in the balance of payments, and putting upward pressure on the exchange rate. The introduction of the VDR was accompanied by a revaluation of the Australian dollar and also an embargo on short-term borrowing abroad. These three policies were implemented with the objective that in combination they would reduce domestic liquidity, which had been at exceptionally high levels, and

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73 APEC Leaders' Declaration of 18 November 1998 also underscores the importance of domestic financial systems being able to withstand the pressures of short-term flows.

74 See the Communiqué of the IC meeting, 27 April 1999.

improve Australia's external balance by inhibiting inflows of capital which were destabilising with respect to the spot exchange rate, the balance of payments and domestic monetary conditions. Each of these measures was considered a temporary instrument to address temporary capital account pressures.

149. While the empirical evidence on the effects of the VDR is inconclusive, it does appear that the implementation of this instrument, together with the short-term borrowing embargo and exchange rate revaluation, had some temporary effect in reducing the volume of inflows to Australia. To this extent the VDR appears to have met the desired objectives of the time. This control on capital inflow did impose costs, to borrowers and to total economic activity through the likely distortions in resource allocation. However, at the time it is likely that these costs were considered more manageable than the inflationary consequences of high domestic liquidity or a larger appreciation of the pegged currency. In the period since the suspension of the VDR, Australia has adopted a freely floating, market-determined exchange rate. Although this means we no longer have control over the level of the exchange rate, Australia has gained control over domestic liquidity levels, and received the benefits of a more competitive and efficient capital market.

150. A present-day example of an attempt to control the composition of foreign borrowing to an economy is provided by the capital controls currently in place in Chile. In the early 1990s, Chile's monetary policy objectives came under increasing pressure from a growing surge in capital inflows. In response, authorities introduced a one-year unremunerated reserve requirement (URR) on all non-direct foreign investment entering the country. This URR is currently set at 10 per cent. Designed to discourage short-term borrowing without affecting long-term foreign investments, this system is equivalent to the imposition of a tax on capital inflows inversely proportional to the length of the stay of the inflow.

151. The Chilean experience has been viewed by many as a means of controlling the composition of foreign borrowing to an economy. Increasingly popular is the view that short-term capital flows may increase the vulnerability of emerging countries to financial crises, and the Chilean controls have been increasingly identified as an example of an effective method of insulation against rapid capital outflow. Certainly the composition of capital inflows does appear to have been altered in favour of long-term flows and Chile has been relatively unaffected by recent financial crises. Nevertheless, without the counterfactual, it is difficult to directly attribute this recent stability to the effectiveness of the Chilean controls. In particular, Chile's financial sector may also be protected from severe capital flow swings by its relatively strong and well-designed prudential regulations which, together with the capital account restrictions, act to limit the foreign exchange exposure of both bank and nonbank entities. Further, by increasing the cost of capital inflows, the URR may act as a constraint on the volume of capital inflows to the Chilean economy.

152. Another economy that has recent experience of capital controls is Malaysia. In late 1998, the Malaysian Government fixed the exchange rate (the ringgit) and implemented controls to limit the convertibility of the ringgit for capital account transactions. Under these controls, approval was required for the transfer of funds between External Accounts and foreign investors were barred from repatriating the principal of their investments for at least a year. Introduced during a period of relative capital market instability, the objective of these controls was to contain speculation on the ringgit and de-link domestic interest rates from the exchange rate to allow a loosening of monetary policy. In early 1999 the condition barring repatriation of profits was replaced by a graduated exit tax, which ranges from 30 per cent for funds repatriated less than seven months from the date of investment through to zero for funds repatriated after one year.

153. In contrast to the controls in place in Chile, the Malaysian system is directed at outflows, rather than inflows of capital. As a policy instrument, controls on outflows have attracted considerable criticism. To be effective in reducing capital outflows, these controls generally have to be wide-ranging and as such do still impose costs on long-term as well as short-term investment. By creating a more uncertain investment environment and increasing investors' perceived risk, these controls may also have damaging effects by discouraging rollovers and new capital inflows. Nevertheless, these controls may be effective in the short-run if they are designed to provide temporary breathing space while necessary financial sector reforms are introduced and capital account liberalisation is pursued. Since the implementation of capital controls, Malaysia has shown commitment to financial restructuring, working to clean up bad loans and recapitalise the banking system. This appears to have reduced the uncertainties that clouded the investment environment when these controls were introduced. The controls have since been progressively eased and net capital inflow has continued to grow.

154. The imposition of controls on capital outflows can be justified only in exceptional circumstances. They should operate only as a temporary safeguard until such time as the financial system has been restructured and strengthened. The Executive Board of the IMF has had discussions on the effectiveness of short-term capital controls and the IC has tasked the IMF with refining its work on this topic.[75]

155. Improved monitoring of short-term flows also offers scope to reduce the vulnerabilities associated with excessive reliance on short-term capital flows. As mentioned in paragraph 108, the IMF has strengthened its

75 A short summary of the Executive Board discussions on the effectiveness of short-term controls on capital is contained in 'The Report of the Managing Director to the Interim Committee on Progress in Strengthening the Architecture of the International Financial System', IMF, 26 April, 1999. A copy of this paper is available on the IMF's web site at http://www.imf.org.

Special Data Dissemination Standard (SDDS) to improve data on short-term liabilities of the official sector and arrangements are in place to facilitate access to creditor side external debt data.

156. The risks and vulnerabilities associated with excessive short-term borrowing strongly suggest that sovereign debt management strategies may need to be improved. As a 'typical' yield curve is upward sloping, there may be a tendency for sovereign debt managers to rely excessively on 'cheaper' shorter-term sources of financing. However, such a strategy ignores the risks associated with the need to re-finance on a regular basis. US Federal Reserve Chairman, Alan Greenspan, has noted that 'for too long, too many emerging market economies have managed their external liabilities so as to minimise their current borrowing cost. This short-sighted approach ignores the insurance imbedded in long-term debt, insurance that is almost always well worth the price'.[76]

157. Sound principles for sovereign debt management suggest borrowers should be mindful of both the costs and risks associated with debt instruments. While foreign short-term or floating rate debt instruments tend to be less costly than domestic long-term or fixed rate instruments, in the short-term at least, they also present greater risks with respect to the volatility of future debt service costs. In particular, short-term debt instruments increase countries' exposure to refinancing or funding risk (the risk that they will be unable to obtain new financing as debt matures or only be able to refinance at a high cost).

158. Australia has progressively adopted a risk management approach to debt management over recent years. With respect to the management of funding risk, Australia's broad objective is to maintain on-going market access on favourable terms. Debt issuance is concentrated into a relatively small number of liquid benchmark lines along a yield curve extending out 12-13 years. High priority is given to maintaining the length of the yield curve to ensure, in the longer term, a smooth progression of stocks available to move into the ten year bond futures contract.

159. Australia's approach to managing market risk (the risk to the future value of the debt portfolio from changes in financial prices) has focussed for a number of years on the establishment of a carefully defined benchmark to serve as a target for currency and duration objectives. The benchmark reflects a hypothetical portfolio structure that can be expected to minimise the expected cost of debt over the longer term, subject to an acceptable expected degree of volatility in annual debt service costs (that is, risk). Cross currency and domestic

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76 Testimony of Chairman Alan Greenspan 'Efforts to improve the 'architecture' of the international financial system', before the Committee on Banking and Financial Services, US House of Representatives, May 20, 1999. Greenspan also makes the point that excessive reliance on short-term debt means that the entire burden of a crisis falls on the emerging market economy in the form of a run on reserves. In contrast, if longer-term maturities are relied on, creditors share some of the burden in the form of a fall in the value of their assets.

interest rate swaps are utilised to maintain the debt portfolio in line with the benchmark target.

Strengthening domestic financial systems, macroeconomic and regulatory policies

160. A number of core conditions need to be in place to support financial stability. These include sound and sustainable macroeconomic policies, sound prudential arrangements, strong and independent supervisory agencies, procedures to deal with insolvency and effective market discipline.

161. The East Asian crisis economies were perceived as leading the developing world in responsible macroeconomic management.[77] However, the recent crisis exposed weaknesses in their financial systems and approach to public and corporate sector governance, which made them vulnerable to financial instability. The crisis economies have since made significant progress in advancing appropriate reforms, with the support of the IMF, to address these problems. In particular, reform programs have focused on:

- implementing high standards of governance and transparency. Promoting 'arms length' relationships among governments, corporations and banks.
- implementing sound regulatory and supervisory structures. Improving prudential regulation and establishing supervisory agencies that have a high degree of independence from banks, the private sector, and other official agencies. The precise institutional arrangements will vary from one country to another.
- promoting independent and competitive financial and corporate sectors. Restructuring and/or recapitalising troubled banks and pressing ahead with corporate debt workouts to establish viable corporations on a sound financial footing.

162. Although significant progress has been achieved, a number of challenges remain. In particular, with the crisis now abated there is a sense that some of the momentum for reform has waned. Australia has consistently highlighted in regional fora that reform must continue if the crisis economies are to return to sustainable growth.

163. In this respect, Australia successfully pressed for a Ministerial-level commitment to maintaining the momentum for reform at the Sixth APEC Finance Ministers Meeting in Langkawi, Malaysia in May 1999. APEC, and in particular APEC meetings of Finance Ministers, has provided a useful forum for dealing with the causes and effects of the East Asian crisis.[78] Australia

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77 *The East Asian Miracle: Economic Growth and Public Policy*, published for the World Bank by Oxford University Press, 1993.

78 A detailed account of APEC's response to the financial crisis can be found at http://www.apecsec.org.

has attached particular importance in APEC to promoting good governance as a means of addressing financial and corporate sector vulnerability. Treasury was one of the authors of the report 'Strengthening Corporate Governance in the APEC region' endorsed by Ministers at the Langkawi meeting. The report, inter alia, recommended that governments give priority to legal reforms such as in contract and insolvency law; strengthen education and training for the judiciary and professionals such as accountants and auditors; and work cooperatively and flexibly with the private sector to improve corporate governance practices.

164. To maintain the momentum in the corporate governance area, Australia offered access, at the Langkawi meeting, to various corporate governance training facilities and proposed a joint APEC-OECD workshop on insolvency law. The proposal was accepted and the workshop will be held later this year.

Implementing a sound prudential and regulatory financial framework — the Australian experience

165. Australia first embarked on reform of the financial sector in the early 1980s when the Campbell Committee recommended promoting efficiency in the financial system by deregulation of the banking sector, floating the Australian dollar and allowing the entry of foreign banks. The underlying philosophy of the approach was one of liberalising markets.

166. In 1996, Australia recognised the need to update the financial sector regulatory framework to keep up with the rapid pace of change in financial markets. In particular, developments in technology and innovation in products and delivery of financial services. The aim was to ensure a regulatory system that was flexible and responsive enough to accommodate further rapid change in the financial sector. This led to the report of the Wallis Inquiry in March 1997 which found that regulatory arrangements did not treat all new market structures and activities equally, giving rise to biases in the system. This had the effect of limiting competition and increasing costs in the financial sector.

167. In response to the Inquiry, the Government undertook a substantial refocusing of regulatory agencies with the aim of ensuring that Australia's national system of financial regulation is world class for the benefit of consumers and business. In particular:

- a new organisational framework for the regulation of the financial system; and
- a variety of measures to improve efficiency and contestability in financial markets and the payments system.

168. The new organisational framework consists of three single, separate regulators each responsible for clear regulatory objectives. First, the role of the

RBA[79] is focussed on the objectives of monetary policy, overall financial system stability, and the regulation of the payments system. The new Payments System Board within the Bank has been established with greater powers to ensure safety, greater competition and ease of entry into the payments system. Second, the Australian Prudential Regulation Authority (APRA),[80] a statutory body responsible for financial safety across all sectors requiring prudential regulation — deposit-taking, life and general insurance, and superannuation. And third, the Australian Securities and Investments Commission (ASIC),[81] with a focus on market integrity, disclosure and other consumer protection issues.

169. Each regulatory agency has substantial autonomy and a clear charter of objectives. They have boards of directors or commissioners responsible for operational and administrative policies, and are accountable through the Treasurer to the Parliament of Australia.

170. Underlying Australia's approach to financial sector regulation is the recognition that it is not the role of regulators to eliminate risk. Rather, their role is to allow financial markets to manage, allocate and price risk within a framework of disclosure and transparency so that consumers of financial services can assess the level of risk they are willing to manage.

Strengthening the international financial system

171. There have been a number of dimensions to the financial instability that has gripped parts of the world since mid-1997. Much of this has been the result of weaknesses in domestic policies. However, it has become clear that weaknesses in the international financial system also played a part. Recognition of the complexity of the crisis and the weaknesses revealed by it, underpins efforts in many international fora to reform and strengthen the international financial system.

172. In October 1998, the G-7 Finance Ministers identified the need for reform in six priority areas to strengthen the international financial system. These were:

- strengthening and reforming the international financial institutions and arrangements;
- enhancing transparency and promoting best practices;
- strengthening financial regulation in industrialised countries;
- strengthening macroeconomic policies and financial systems in emerging markets;

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79 Background on the RBA is available at http://www.rba.gov.au/.

80 Background on the APRA is available at http://www.apra.gov.au/.

81 Background on the ASIC is available at http://www.asic.gov.au/.

- improving crisis prevention and management, and involving the private sector; and
- promoting social policies to protect the poor and most vulnerable.

173. Many of the above issues have been addressed in earlier sections of the submission. However, it would be useful to outline Australia's approach to international financial reform and review developments in international cooperation and involving the private sector.

Australia's role in international financial reform

174. There are limits to what Australia, or any other individual country, can achieve on its own to strengthen the international financial system. To be successful, reform needs to be progressed in economies at all stages of development, across different regions, and in both the public and private sectors. This requires a global response. It is for this reason that Australia has been an active participant in advancing reforms through international groupings and fora with wide representation and involvement.

175. To enable Australia to play an active role to the best extent possible, the Prime Minister commissioned a taskforce (referred to earlier), which included prominent public and private sector representatives, to advise on how Australia can contribute to international financial reform. The report of the Taskforce,[82] was released in December of last year, and identifies a number of key findings, which have provided the foundation for Australia's efforts in promoting international financial reform. The key findings were that:

- reform will require a global response;
- Australia should support the continuation of the movement towards open international capital markets and soundly based and more stable capital flows;
- reform should be progressed through an international grouping with wide representation;
- improved transparency by corporations, governments and international financial institutions is needed;
- countries should improve, extend and implement internationally accepted standards and codes of conduct with respect to transparency;
- the IMF should prepare transparency reports for each member country. Australia should take the lead in the preparation of a self-assessment transparency report;

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82 The *Report of the Prime Minister's Taskforce on International Financial Reform*, 21 December 1998, available on-line at http://www.treasury.gov.au. Treasury provided a briefing to the Committee on the Task Force Report on 11 March 1999.

- all countries should be encouraged to meet the Basle Committee on Banking Supervision (BCBS) standards for banking supervision, particularly in the area of capital adequacy, loan valuation and provisions;
- encourage external surveillance of a country's supervisory arrangements as part of the IMF's Article IV consultations;
- consider increasing the level of cooperation between the Government, Australian financial institutions and private sector organisations in the provision of technical assistance to enhance financial supervision in regional economies;
- take steps to ensure adequate disclosure by hedge funds and other Highly Leveraged Institutions (HLIs) and to ensure appropriate risk management on the part of creditors and counter-parties in their dealings with such investors;
- facilitate private sector involvement in improved crisis management;
- maintain trade finance;
- strengthen national insolvency regimes;
- improve the composition of capital flows, in particular, to encourage long-term capital inflow rather than short-term flows;
- enhance international cooperation on financial sector policy issues; and
- advance regional cooperation on financial issues. Through organisations such as APEC, the Executive Meeting of East Asia-Pacific Central Banks and the Manila Framework Group.

176. Considerable progress has been achieved in addressing many of these issues.

Developments in international cooperation

177. The recent financial crises have proved a major challenge for the IMF and the international community more generally. This has highlighted the need for the international community to improve its approach to crisis prevention and management. In addition to crisis preventative measures, discussed earlier, there has been considerable discussion on: new facilities to strengthen the ability of the IMF to provide financial assistance; and new arrangements to enhance cooperation within the international community on financial matters, including more effective means of involving the private sector.

New financing facilities

178. To strengthen its capacity to respond to financial instability, the IMF has developed two new facilities — the Supplemental Reserve Facility (SRF) and more recently the Contingent Credit Line (CCL). These facilities were developed

with the full support of the IMF's membership and are tailored to respond to the types of financial crises that we have witnessed over the past two years. Both facilities provide large-scale and quick disbursing financial assistance. The facilities also carry higher rates of charge and countries are expected to repay the IMF in a much shorter time period than is normally the case.

179. The CCL makes available assistance for members with strong economic policies, as a precautionary line of defence against the risk of financial 'contagion'. The CCL is intended to provide further incentive for countries to adopt the sound policies and institutional arrangements important for crisis prevention, and should also help reduce the spread of 'contagion'.

180. The IMF has also taken steps to ensure that is has sufficient resources to meet the potential needs of members. It has done this through an increase in quotas and in adopting the New Arrangements to Borrow (NAB) of which Australia is a participant. Under the NAB, potentially 25 participant countries and institutions stand ready to lend the IMF up to SDR34 billion to supplement its regular quota resources when needed to forestall or cope with an impairment of the international monetary system or to deal with an exceptional situation that threatens the stability of the system. Australia played a key role in the development of the NAB and is the current chair.

181. New facilities to enable more rapid provision of assistance in crisis situations have also been put into place by the World Bank and the Asian Development Bank. Bilateral creditors, including Australia, have also played an important role in offering financial assistance in the context of IMF-supported programs.

Enhancing international cooperation

182. As recognised in the Report of the Prime Minister's Taskforce, if financial instability is to be addressed, a global response is required — a global response in the sense that all governments are encouraged to improve their national policy frameworks where needed and that steps to improve the operation of the international financial system itself are undertaken. Australia has been very active in this debate and believes that there needs to be 'ownership' by a wide group of countries if reform proposals are to be implemented.

183. Australia was a strong supporter of the G-22. The report of the Prime Minister's Task Force recommended that reform be progressed through an international grouping with wider representation, such as the G-22. In Australia's view, the G-22 played a vital role in responding quickly to the crisis.[83] However, it became clear that the G-22 did not have the broad support

83 The G-22 established three working groups to address: transparency and accountability; strengthening financial systems; and international financial crises. The reports of the working groups are available from the BIS web site at http://www.bis.org.

necessary for it to continue in its existing format, and the group has not met since October of last year.

184. Notwithstanding the demise of the G-22, the need for a broad representative forum remains. As such, Australia welcomed the call at the recent APEC Finance Ministers' meeting at Langkawi for the establishment of an ongoing mechanism for inclusive dialogue between industrial, developing and emerging market economies to build consensus on major economic and financial policies in the future.

185. The 18 June 1999 report of the G-7 Finance Ministers on 'Strengthening the International Financial Architecture' also recognised the importance of widening the on-going dialogue on the international financial system to a broader range of countries. To this end, the G-7 Finance Ministers agreed that, by the time of the next Forum meeting in September 1999, the Forum be broadened to include significant financial centres, in a format that provides for effective dialogue. On 21 June 1999, the Chairman of the Forum invited Australia along with Hong Kong SAR, Singapore and the Netherlands to participate.[84]

186. There have also been calls for institutional reform of the IMF. At its meeting in October 1998, the IC requested a review of the institutional components of the international financial system, 'including the possibility of strengthening and/or transforming' the Committee itself. There are a number of proposals on the table aimed at strengthening the IC and IMF, but little agreement has been reached. The 18 June 1999 report of the G-7 Finance Ministers recommended that the IC be given permanent standing as the 'International Financial and Monetary Committee.' It is unclear at this point whether this will lead to any change in the Committee's functions and operations.

187. In terms of other developments to enhance international cooperation, the Financial Stability Forum (FSF), as discussed earlier, has been established to improve cooperation between international organisations, regulators and experts with responsibilities in the area of financial regulation. In addition to this ongoing role, the Forum has established three ad hoc working groups to tackle a number of issues identified as needing further consideration, including:

- actions that may be needed to reduce the destabilising potential of HLIs in financial markets;
- evaluation of measures that could reduce the volatility of capital flows and the risks posed by excessive short-term external indebtedness; and

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84 *Australia to join Financial Stability Forum*, Press release of the Treasurer, the Hon Peter Costello MP, 22 June 1999.

- the role of offshore financial centres and progress towards enforcing prudential standards and information sharing agreements in relation to these centres.

188. These groups will report on their work at the next meeting of the Forum, scheduled for September.

Involving the private sector

189. As noted earlier, improved official financial rescue packages are an important element in restoring financial stability. However, official financial assistance carries with it the risk of moral hazard — where creditors fail to undertake adequate risk assessment and management as there is an expectation that the official sector will step in and bail out economies in times of trouble. This might not pose such a problem if this implicit insurance meant that creditors maintained capital flows. But, this is not the case. Events have shown that creditors 'rush for the exits' in an effort to be out before a crisis hits. These very actions can precipitate crisis.

190. It has also become clear that the official sector can no longer provide the volume of financial assistance needed to address crises in a world of integrated capital markets. By formally involving creditors in forestalling and resolving financial crises, the international community aims to:

- limit moral hazard; and
- equitably share the burden of crisis resolution with the official sector.

191. Reflecting this, the private sector was asked, through debt roll-over and restructuring, to play its part in the rescue packages put together for Korea, Indonesia and Thailand. This, however, took place in an ad hoc way and governments were cautious about being involved in negotiations between private parties.[85]

192. Since then, proposals for strengthening the international financial architecture to better involve the private sector[86] have been discussed in a number of fora — including the IMF Executive Board, G-22, G-7 and APEC. Much of this discussion has focused on either developing general guidelines for crisis situations or the use of specific market-based measures to cope with the risk of changes in investor sentiment leading to financial crisis.

193. A general framework to guide private sector involvement in crisis resolution will need to be flexible to take account of differing crisis situations but

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85 *Australia and the IMF 1997-98*, Annual Report to Parliament 1999, p. 8-9, available on the Commonwealth Department of the Treasury web site at http://www.treasury.gov.au.

86 For further detail on various proposals under consideration see '*Involving the Private Sector in Forestalling and Resolving Financial Crises*', IMF, April 1999. Available at the IMF web site at http://www.imf.org.

will also need to spell out the basic ground rules that will apply in crisis situations. In particular, any framework will need to provide creditors and debtors with clear expectations about the processes that will apply should a crisis develop. The 18 June G-7 Finance Ministers' report set out a broad framework of principles[87], including:

- crisis resolution must not undermine the obligation of countries to meet their debts in full and on time;
- market discipline will only work if creditors bear the consequences of the risks they take;
- in a crisis, reducing net debt payments to the private sector can potentially contribute to meeting a country's immediate financing needs and reducing the amount of finance to be provided by the official sector;
- no one category of private creditors should be regarded as inherently privileged relative to others in a similar position; and
- the aim of crisis management wherever possible should be to achieve co-operative solutions negotiated between the debtor country and its creditors, building on effective dialogues established in advance.

194. Measures to involve the private sector will play a key role in crisis prevention. In particular, ex ante measures can reduce vulnerabilities, reduce moral hazard and help avoid a crisis when pressures begin to emerge. Attention has focused on two particular market-based measures: private contingent credit lines and collective action clauses.

195. A number of countries have established contingent lines of credit with private creditors. These credit lines can be activated on the basis of predetermined conditions to provide financing in the event of adverse market developments. By providing additional financing in a time of difficulty, these market-based arrangements can help cushion the initial impact of payment problems and reduce the need to resort to more disruptive measures.

196. Collective action clauses in bond contracts is one approach aimed at fostering resolution of payments difficulties. These clauses provide for the modification of the terms of a bond contract, including those dealing with repayment schedules, by agreement between the borrower and a majority (usually a qualified majority) of bondholders. Such clauses can provide greater clarity about the circumstances in which contracts may need to be altered. They can also facilitate the process of restructuring and refinancing by not allowing individual bondholders to seek to gain advantage by obstructing agreements on restructuring. At the meeting of the IC in Washington on 27 April 1999, participants invited the IMF Executive Board and other relevant fora to explore

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87 Report of the G-7 Finance Ministers on *Strengthening the International Financial Architecture*, 18 June 1999, paragraph 45.

appropriate ways to introduce collective action clauses in sovereign bond issues.[88]

197. These and other *ex ante* measures can play an important 'circuit breaking' role in the event of payments problems. It is possible that these measures will increase the cost of borrowing, but this is not necessarily a bad thing, if the higher cost leads to more prudent borrowing and better reflects the risks involved.

198. Further work is needed to address the technical and legal implications of involving the private sector. In this respect, both the IC and G-7 Finance Ministers have asked the IMF to push ahead with its work on this topic[89] and report by the time of the IMF/World Bank Annual meetings in late September.

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88 See the Communiqué of the IC meeting, 27 April 1999.

89 See the Communiqué of the IC meeting, 27 April 1999, and the report of the G-7 Finance Ministers on *Strengthening the International Financial Architecture*, 18 June 1999, paragraph 51.

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