

Reform of the International Financial System

The financial crises of the past two years, which began in Asia in mid 1997 and spread during 1998 to Russia and then to Latin America, have created a period of flux for the international financial system. They have raised questions about the stability of open international capital markets, the role of the International Monetary Fund (IMF), disclosure practices of governments and private agents, and the procedures for handling financial crises. In addition, the question of how to reconstruct the membership of the various financial fora (G7, G10, etc.) so as to make them more representative of current economic reality has become more pressing. The questioning was as intense as any seen since the current international financial architecture was set up in the immediate post-World War II years, and changes resulting from the current debate are likely to shape the system for many years to come.

Australia, itself, was not directly affected by the crises, but its close association with the Asian region gave a good perspective on some of the problems in current international financial arrangements, and reinforced to the Australian authorities the importance of achieving reforms. As many of the issues being discussed related to international financial markets and capital flows – areas in which central banks have a keen interest – the Reserve Bank saw it as important to contribute actively to the debate.

Along with other arms of government, particularly the Treasury, the Bank participated in a wide range of international meetings dealing with the Asian crisis and reforms to the international financial system. The Governor was a member of the Prime Minister's Task Force on International Financial Reform, and the Bank is a regular participant in the ongoing work of the Government's International Economic Policy Group, an interdepartmental committee which also includes the Treasury, the Department of Foreign Affairs and Trade and the Department of the Prime Minister and Cabinet.

In the international sphere, there was a lot of activity as several new international groupings were created in the search for reform. The first of these was the "Willard" Group of Finance Ministers and Central Bank Governors (the G22), which brought together a useful mix of developed and emerging market economies, including a good representation from Asia. In this respect, G22 was more representative than G7 or G10, which contain no emerging market economies and give heavy representation to Europe. G22 proved to be an effective forum for examining issues of transparency, financial system strength, and the handling of crises. Australia, represented by the Treasurer and the Governor, was one of the countries which participated. Officials of the Reserve Bank and Treasury also participated in two of the working parties which carried out detailed analysis and formulated specific proposals.

The G22 met twice, once in April 1998 and a second time in October 1998, the latter meeting chaired by President Clinton. Its recommendations, as embodied in its working party reports, have been influential in setting the reform agenda in other established bodies, such as the Bank for International Settlements (BIS) and the IMF. The G22 format, however, was not fully accepted by all members of the international community – particularly the European ones – and the G22 itself was disbanded after the recommendations were published. Nevertheless, the value of such an informal grouping of diverse countries has been widely recognised and the major industrial countries moved in mid 1999 to establish another such forum.

Meanwhile, some of the work initiated by the G22 working parties was progressed further by groups set up by the BIS. The BIS established working groups to examine disclosure in financial markets, including by highly leveraged institutions (both of individual information and of aggregate positions), and the interaction of banks with highly leveraged institutions. The Reserve Bank participated in two of the three working groups.

At the same time as the BIS work was proceeding, the G7 countries set up their own body, which had its inaugural meeting in April 1999, to ensure that the work of the G22 working parties was brought to fruition. This new body – the Financial Stability Forum – initially consisted of representatives from the G7 countries plus the main international organisations. In June 1999, the G7 decided to broaden representation in the Financial Stability Forum to Australia, Hong Kong, the Netherlands and Singapore. This was an important step for Australia, particularly in an environment where the membership of the “new” international grouping is in a process of evolution. The Governor will represent Australia on the Forum, along with his counterparts from the other new countries. Ric Battellino, Assistant Governor (Financial Markets) represents Australia on the Financial Stability Forum’s working group on highly leveraged institutions.

In all these groups, the Reserve Bank has focused on two main areas where it believed that reform was most critical: improvements to disclosure by, and supervision of banks’ dealings with, highly leveraged institutions (often referred to by the shorthand term “hedge funds”); and greater involvement of the private sector in crisis management. These were also endorsed as key issues by the Prime Minister’s Task Force on International Financial Reform in December 1998.

Highly leveraged institutions

As part of its involvement in the BIS, the Executive Meeting of East Asia and Pacific central banks (EMEAP) and Financial Stability Forum work, the Bank has prepared papers on *Hedge Funds, Financial Stability and Market Integrity* (in March 1999) and *The Impact of Hedge Funds on Financial Markets* (in June 1999). These papers drew on recent episodes of leveraged speculation in the Australian dollar market.

There has been some shift in the centre of gravity of opinion on hedge funds. The initial reluctance by many countries to interfere in the workings of financial markets has been replaced by recognition that the prudential system had allowed core financial institutions (mainly banks) to provide excessive leverage to the hedge funds. The focus in these discussions was on the prudential ramifications. The recommendations of the two BIS working groups, together with the recommendations of the Basel Committee on Banking Supervision Working Group on Highly Leveraged Institutions, have since been endorsed by leaders of the major industrial countries. They provide a blueprint aimed at putting the relationship between highly leveraged institutions and lenders on a more prudent footing and increasing the degree of transparency in markets. If they prove to be insufficient in achieving this, further measures may need to be considered. There is less unanimity on a second aspect – the possibility that the activities of highly leveraged institutions damage market integrity, adding to price volatility and exacerbating a crisis. The Financial Stability Forum's working group on highly leveraged institutions is expected to assess the cases for and against further measures as part of its preliminary report in September 1999 and final report in early 2000.

Involvement of the private sector in orderly workouts

The G22 working group on international financial crises, in which the Bank took part, recommended the development of an enhanced framework for management of future crises, in which the private sector could be included in an orderly and co-operative way. The Bank, together with other Australian representatives, has continued to press for such development in regional discussions and in the key international organisations.

The need to involve the private sector has been apparent since the Mexican crisis of 1994/95, where foreign investors had been fully repaid by IMF/US assistance at the time of the crisis. While this undoubtedly helped to bring the crisis under control, it created "moral hazard" – where risk-takers are protected from the consequences of an unfavourable outcome and which seriously distorts investors' risk considerations in future investment decisions. The answer is to ensure that private sector creditors bear some of the costs when things go wrong. How to achieve this is still hotly debated but, again, opinion has swung substantially over the past two years in the direction of searching for a way of effectively "bailing-in" the private sector to provide significant burden-sharing, not only to address the problem of moral hazard, but also to assist in managing outflows during the crisis and to alleviate the burden on official assistance.

Already there have been significant steps in the right direction, such as the IMF's willingness to consider, on a case-by-case basis, continuing to lend under a program to a country in arrears on old debt. There remains, however, a need for further exploration, particularly of how to stabilise financial flows during the period between a crisis emerging and the development and implementation of a credible management program. Difficult issues are involved, such as the problems of identifying creditors. There is also a need to minimise the risks of unilateral action which creates panic or contagious reactions by creditors.



*Deputy Governor, Stephen Grenville, and
Head of International Department, Bob Rankin,
attend a meeting of EMEAP Deputies, hosted by
the Reserve Bank in Melbourne in March 1999.*

There is now general agreement that there needs to be a broad *ex-ante* framework which sets out the principles and procedures which would be applied to ensure that the workout of a crisis can be done in an orderly fashion, without a destructive race by lenders to be the first out the door once the crisis breaks. This consensus now needs to be translated into something practical.

None of the very real progress which has been made over the past year or two will abolish crises. International financial integration – an aspect of globalisation – brings benefits and risks. The aim, in attempting to improve the international architecture, is to produce a more favourable balance between risk and benefit.

Other international involvement

Within the region, the Bank has continued its close involvement with other central banks, mainly within the EMEAP framework. Governors of the eleven regional central banks meet each year, with more frequent meetings at Deputy Governor level. The three specialised working groups (covering financial market issues, prudential supervision and payments systems) each have ongoing work programs covering issues of a more operational and technical nature. The Asian crisis has diverted attention (and key personnel) away from these medium-term issues, but as these economies recover, the regional network will provide opportunities for co-operative exchanges as the reform elements – the beneficial aspects of the crisis – are put in place. The Bank has also participated, along with the Treasury, in the Manila Framework Group (which consists of representatives from finance ministries and central banks of 12 Asian economies plus the United States, Canada and the main international financial institutions).

In the past year, the Bank has provided technical assistance on information technology issues to the Bank of Thailand, in conjunction with the Australian Government's Overseas Aid Program (AusAID), on foreign exchange management to Bank Indonesia and the Reserve Bank of Fiji, on financial risk measurement and management to Bank Indonesia, and on infrastructure for the implementation of market-based monetary policy to the Reserve Bank of Vanuatu.

The Bank is also participating in an initiative on the development of domestic bond markets sponsored by the Asia-Pacific Economic Cooperation (APEC) Group, which will establish a compendium of sound practices in the areas of market infrastructure, liquidity, risk management, regulation, and government policies. These are intended to serve as benchmarks for APEC economies seeking to develop their local bond markets in order to improve the access of government or private borrowers to domestic savings.

Although the Bank no longer has responsibility for bank supervision in Australia, its experience in the past and its close relationships with Indonesia led to the appointment of the Bank's Deputy Governor to the Independent Review Committee of the Indonesian Bank Restructuring Agency (IBRA). The role of the Committee is to review and verify the activities of IBRA, which took over during the year responsibilities for the restructuring and recapitalisation of Indonesia's troubled banks.