The governor of the Reserve Bank of Australia, IAN J. MACFARLANE, also analysed the background of the Asian financial turmoil in a speech to the Australian Business Economists' 13th Annual Forecasting Conference dinner in Sydney on 4 December. This is an edited extract.

At the risk of some oversimplification, I think there have been two basic types of economic crisis. The old-style economic crisis I will call Type 1, and the new-style, which has come to prominence over the past decade, I will call Type 2. Most of these crises occur in developing countries, but developed ones have not been immune from them.

The standard way that countries — particularly developing countries — got into trouble in the past was that their governments did the wrong thing by running bad fiscal and monetary policy. Governments ran large budget deficits and did not finance them properly — they wrote cheques on the central bank, which is colloquially known as printing money. Interest rates were held artificially low (or negative in real terms) and money supply ballooned, resulting in accelerating inflation, a loss of competitiveness, large current account deficits and a collapsing currency. This was a Type 1 economic crisis, and the IMF has a standard set of arrangements for dealing with this problem.

Just about every developing country ended up in this predicament at some time or other. Some of the Latin-American countries did it again and again.

We skirted perilously close to it in Australia, particularly in the mid-seventies, but did not end up in the hands of the IMF. The United Kingdom, however, did. It suffered a classic Type 1 economic crisis in 1976, and needed a support package from the IMF, with the usual conditionality requirements.

The Type 2 problem is very different. Although it has become common in the past decade in a wide range of countries, the best examples at present are to be found in Asia. Type 2 economic crises are not caused primarily by bad fiscal or bad monetary policy. One of the reasons I have a lot of sympathy for the Asian countries at the moment is that they did not get into their present trouble through undisciplined fiscal policy, and their monetary policy in the conventional sense was quite good.

This is shown by the fact that their budgetary positions are on average much better than OECD economies, and most have inflation rates that are quite low for developing countries.

A Type 2 crisis is really financial in nature, rather than stemming from poor macro-economic policies. Its central dynamic is the credit cycle and the main players are companies and banks, or financial institutions more generally. A Type 2 crisis usually traces its roots to a period when the economy was doing well, growing quickly and becoming popular with investors and lenders. Usually, but not always, an inflow of foreign capital is part of the process which bids up asset prices (and attracts more foreign capital).

Domestic banks do not sit idly by — they join in to lend money for all sorts of promising projects and asset purchases. If the economy is growing strongly at the time, which it usually is, it looks as though everyone can make money. Some of the finance is invested wisely and makes a good return, but much of it is inevitably invested unwisely.

At some point, something happens and the whole process goes into reverse. In the case of South-East Asian countries, the event that triggered the reversal was the realisation that their currencies (initially the Thai baht) had become overvalued because they were tied to a strongly appreciating US dollar. The real exchange rate was also the trigger in Mexico in 1994. The mechanism by which the reversal occurs is usually capital outflow.

Even without an external “shock”, a reversal would eventually occur, as it did in Japan’s case. Domestic and foreign investors sell assets and take their funds out of the country. The early ones realise good profits in the process; the slow movers are motivated by a desire to cut their losses.

In the process, the exchange rate falls
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Table 1: Systemic banking crises: cost of recapitalisation

<table>
<thead>
<tr>
<th>Country</th>
<th>Period</th>
<th>Cost as % of GDP</th>
</tr>
</thead>
<tbody>
<tr>
<td>Finland</td>
<td>1991-1993</td>
<td>8.0</td>
</tr>
<tr>
<td>Norway</td>
<td>1987-1989</td>
<td>4.0</td>
</tr>
<tr>
<td>Spain</td>
<td>1977-1985</td>
<td>16.0</td>
</tr>
<tr>
<td>Sweden</td>
<td>1991</td>
<td>6.4</td>
</tr>
<tr>
<td>United States (S&amp;L)</td>
<td>1984-1991</td>
<td>3.2</td>
</tr>
</tbody>
</table>

Source: Caprio and Klingebiel, World Bank, July 1996

of policies altogether — the policies directed at financial system stability.

INCREASED FOCUS ON FINANCIAL SYSTEM STABILITY

There has been increased recognition in recent years that more attention should be devoted to policies directed at financial system stability. The two best examples of this are the Basle capital adequacy guidelines and, more recently, the Core Principles jointly promoted by the BIS and the IMF. One reason for this is that we now have a better understanding of the huge economic costs that are incurred whenever there is a systemic failure of the financial system. Systemic failure invariably results in a recession and can turn a probable recession into a depression. Modern scholarship now identifies a systemic banking system failure as the principal reason that the US economy experienced a depression in the 1930s, rather than a short-lived recession.

The budgetary cost of resolving a systemic failure is also extremely high. Some people may say that one way to avoid this is to let the private sector sort it out. The drawback to this suggestion is that once the problem has reached systemic proportions, the intermediation process has broken down so badly that good borrowers will be hurt as well as bad ones. The government has to step in and close down the insolvent lenders, and take the bad loans off the remaining banks so they can start with a relatively clean slate.

This solution is invariably costly and may not appeal to some on long-run moral hazard grounds, but the...
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alternatives are so much worse. In practice, this is the only practical solution to a systemic failure of the financial system. Table 1 shows some recent examples of the budgetary cost of systemic failures. It covers only recent episodes in OECD countries; much higher figures could have been cited if the coverage had been extended to developing countries.

The other reason for the recent emphasis on financial system stability is that economies appear to be more susceptible to instability as a result of the deregulated financial markets. Australia's experience in the late eighties points in this direction, but it is not an absolute rule. Just as Japan has shown that Type 2 episodes can occur without a lot of foreign capital flows (in fact, there were net outflows), there are many African and Latin-American examples of it happening in a heavily regulated environment.

The Asian countries, including Japan, which are now going through these difficulties could not be characterised as possessing highly deregulated financial sectors. The two Asian countries which most closely approximate the deregulated model are Hong Kong and, to a lesser extent, Singapore. To date, these countries have fared reasonably well.

The link between deregulation of financial markets and instability is obviously more complicated than meets the eye. It would probably be better to say that the transition phase from regulation to deregulation is a dangerous period. This will be especially so if the transition is rapid, and if it is not accompanied by increased transparency and the enhancement of other policies directed at system stability.

**PROBLEMS AND REMEDIES**

In essence, therefore, a Type 2 economic crisis is one which is centred on a failure of the financial intermediation process. The centrepiece of it is an environment which leads to excessive competition by banks to lend, resulting in a severe reduction in credit standards. The following features are normally present:

- Lending to related parties;
- Excessive concentration of lending to particular borrowers or areas, such as property;
- Excessively high loan-to-valuation ratios;
- Inadequate covenants to restrict the activities of borrowers;
- Lending based on asset values, rather than capacity to service from income;
- Failure to recognise and provide for deterioration in loan quality;
- Lending to firms or individuals as a result of government directive, rather than on a commercial basis.

These developments often take place against a background of limited transparency, where investors and depositors have difficulty monitoring the capital adequacy of individual banks. There appear to be no problems during the initial phase of rapid economic growth and rising asset prices, but doubts begin to arise when asset prices fall. The recognition that some banks (and companies) have become insolvent is difficult enough in sophisticated capital markets, but is harder again where there is little necessity to revalue assets and disclose

the results. Bank supervisors, as well as market participants, are thwarted by the lack of transparency. Inevitably, insolvent entities continue to operate, and there is widespread distrust of all banks because lenders and depositors cannot distinguish between creditworthy and insolvent institutions.

As a result of the presence of Type 2 economic crises, it is now recognised that governments require improved policies directed at financial system stability. Within this general field of policy, the one that has the most direct relevance is the prudential regulation of banks. This includes both preventative measures and crisis resolution.

But prudential supervision of banks is only one policy, although an extremely important one, among the range of policies that are required to achieve reasonable financial stability. Other important policies are those that pertain to the payments system and, of course, the whole field of securities regulation, including disclosure provisions and the enforcement of commercial and criminal law. In fact, it is possible to consider the whole body of law relating to claims over property and accountancy standards as being part of the necessary infrastructure for system stability.

**NOTES**

1. Conventionally loose monetary policy in a Type 1 sense would involve monetisation of the budget deficit, low (or negative in real terms) interest rates, continual downward pressure on the exchange rate and rising inflation. In most Asian countries over the past decade, these conditions did not apply; in fact, the opposite was more typically the case. On the other hand, monetary policy was not tight enough to prevent the strong expansion of the balance sheets of the banks. Such a degree of tightness would not have been compatible with the maintenance of a fixed exchange rate.

2. Japan in the 1990s is a classic drawn-out Type 2 episode, but one in which foreign capital played only a minor role.