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# A Message From the Co-Directors ...

*Esmeralda O. Lyn, Ph.D. and George J. Papaioannou, Ph.D.*

A few months ago the financial sector entered the new millennium with several forces and trends challenging its traditional structures. As usual, the underlying drivers are technology and deregulation. Financial institutions are rethinking the effectiveness of their business models due to the phenomenal growth of online securities trading and other financial services. This new channel of delivery of financial products, along with deregulation (especially the repeal of the Glass-Steagall Act in the United States) and further cross-border liberalization of financial services are changing the terms of national and global competition and are giving rise to a significant consolidation of the financial services sector through mergers and alliances.

This upheaval has not even spared the rather staid world of stock markets. That stock exchanges would be thrust into the pit of competition is remarkable testimony to the power economic laws have in forcing organizations toward efficiency as a condition for survival. Both in the United States and Europe, new and technologically adept market and trading systems are challenging the supremacy of traditional stock markets that had enjoyed heretofore the status of national institutions.

In the United States the challenge to the New York Stock Exchange and Nasdaq has come from the electronic communications networks (also called ECNs), which serve as trading platforms for retail and institutional investors. In Europe the highly-fragmented stock market has created conditions for multiple forms of competition. On one level, new electronic trading systems like Tradepoint, E-Crossnet and Nasdaq-Europe, are aiming at facilitating the pan-European trading of stocks. On another level, either independently or as offsprings of established national stock exchanges, several stock markets have emerged or are in the planning stage with the purpose to cater to new and growth-oriented companies. Such markets include Easdaq, Nouveau Marche (Paris), Neuer Markt (Germany), EuroNM (Belgium), Nieuwe Markt (Amsterdam) and Nouvo Marcato (Italy). Finally, the major European national stock exchanges themselves are competing in an effort to be the first to establish true pan-European trading systems. The most notable example in this case has been the joint effort of the London and Frankfurt Stock Exchanges to lead an eight-member alliance that would have included the Paris Bourse among other markets. Having made very little concrete progress toward that goal, the next move belonged to the Paris Bourse which, in alliance with the Amsterdam and Brussels Stock Exchanges, formed the Euronext earlier this year.

The newly emerging stock markets and trading systems seem to pursue strategies that will establish them as superior outlets in either the primary or the secondary markets. Thus, stock exchanges that are interested in listing stocks structure their criteria so as to attract firms with specific profiles and attributes. Stock markets and trading systems primarily interested in attracting trading volume adjust their order execution processes so as to minimize costs and offer investors access to multiple sources of liquidity and price quotes.

Several interesting observations can be made in the context of these developments:

- It is becoming more obvious that listing on an exchange and trading exclusively on the same exchange is a thing of the past. It appears that the screening, monitoring and certification of stocks through listing will remain in the domain of responsibilities of the organized exchanges, but trading will be conducted through the most efficient trading systems.
- The emergence of new stock markets is fueled by the tremendous need to raise capital for startups and enterprises that would otherwise be left out of market-based financing. Thus, these new mar kets with their flexible listing criteria are becoming engines for providing venture capital through the mechanism of public financing.
- The interests of retail and institutional investors seem to converge toward three priorities: rapid execution of orders, low cost trades, and access to information about price quotes.
- The power of the Internet, which has the potential to unify markets into bigger super- and supra-national markets, is contributing, for now at least, to the fragmentation of the national securities markets.

As the competition among stock markets intensifies and the proliferation of trading venues continues, academics and policy makers have to ponder what the implications are for the two basic properties of securities markets, namely, price discovery and liquidity. Although it seems at the moment that other imperatives, such as offering direct access to secondary market trading to investors and public market financing opportunities to new ventures, may be driving the competition and emergence of stock markets, eventually it will be their ability to facilitate trades at the best prices and with maximum liquidity that will determine their long-term survival.

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### The Merrill Lynch Center Mission Statement:

*Established to promote and facilitate faculty and student study in the field of international financial services and markets and to communicate knowledge to the academic and business communities.*

# A Message From the Editor ...

*Professor Gioia P. Bales, Merrill Lynch Center Coordinator*

The dynamic changes that have occurred in the financial markets in recent years - and their profound effect on institutions and markets - have been the catalysts behind the many informative programs offered by the Merrill Lynch Center. Our programming will continue to explore the important themes and questions that are relevant in today's global markets.

Clearly, the most profound event in the history of the financial markets during the past 100 years is the European Monetary Union and the introduction of the Euro currency. It has implications on many facets of global business. In May 1999, the Merrill Lynch Center hosted a one-day seminar on the challenges faced by U.S. businesses and investors in this radically altered environment. The program commenced with an executive breakfast, hosted by the Scott Skodnek Business Development Center at Hofstra University, which featured Ernest T. Patrikis, special advisor to the chairman of American International Group. This was followed by two panel discussions, which explored issues in pricing, marketing and investment strategies, and opportunities and issues in treasury operations and financial reporting.

Appropriately, the Merrill Lynch Center closed, and then opened the millennium, with two programs on technological advancements and their implications for global finance. In December 1999, a panel discussion titled "Financial Information Technology" featured professionals from ECN, OPENLINK Financial, Hyperfeed Technology and Money Line. In March 2000, Evan Misshula, managing director of Sane Capital Partners, discussed broadband and wireless technologies and the companies that are poised to take advantage of this exciting, new technology.

In addition, on May 10 the Merrill Lynch Center in conjunction with the Hofstra University Scott Skodnek Business Development Center hosted "The Strategic Impact of Mergers in the Financial Sector." We were proud to welcome Mr. John Morris, managing director of Salomon Smith Barney as our keynote breakfast speaker. This was followed by panel discussions featuring leading representatives of the Federal Reserve, European American Bank, and Hofstra and New York Universities. The program closed with a talk by Mr. John J. Conefry, Jr., vice chairman of Astoria Financial Corporation on the effect of mergers on medium/small-sized banks.

## Merrill Lynch Center Hosts Conference on the Impact of Mergers in the Financial Sector

On May 10, 2000, The Merrill Lynch Center of the Frank G. Zarb School of Business, in conjunction with the Scott Skodnek Business Development Center, hosted a one-day conference titled "The Strategic Impact of Mergers in the Financial Sector." The program commenced with an executive breakfast, featuring keynote speaker John Morris, managing director of Salomon Smith Barney, who spoke of the macro aspects of financial sector mergers.

The breakfast was followed by three panel discussions. In session one, Simon Moules, executive vice president of HSBC-Investment Services Division, and Michael Nelson, vice president and counsel of the Federal Reserve Board, addressed cross-selling of financial services. In session two, Mark Anderson, executive vice president of EAB, and Nicholas Economides, professor at New York University's Stern School of Business, explored electronic commerce and other technology-driven strategies utilized by financial institutions. After lunch, John J. Conefry, Jr., vice chairman of Astoria Financial Corporation, discussed the effect of consolidation on small- and medium-sized banking institutions.

# Mismatches, Lags and Conflicts: Some Observations After the World Bank/IMF Meeting

The following remarks were given by Eugene Rotberg at a seminar hosted by the Merrill Lynch Center at Hofstra University on November 18, 1998.

***Mr. Rotberg is an adviser to governments, international institutions and the private sector on matters dealing with reserve management, interest and exchange rate volatility, the regulation of financial markets, and on privatization and direct investments in developing countries. He previously held the positions of vice president and treasurer of the World Bank for 19 years.***

My remarks today are divided into several parts: first, a reminiscence of financial developments worldwide during the last several decades and their implications and, second, a summary and assessment of major issues that troubled policy makers and government officials in the recently concluded World Bank/IMF annual meetings. Let's start with the past.

*THE PAST*

• **Floating exchange rates.** At first the world was fixed. Then the Yen rose from 360 to the dollar to 300; to 240 to 200; deteriorated to 300 then revalued to 80; then devalued to 150 yen to the dollar and recently improved to the 120s - with many changes of direction in between. That volatility, which occurred in many currencies, created the incentive to speculate or hedge on potential exchange rate movements - or if possible, to cause them.

• **Volatile interest rates.** In the United States, long-term interests moved 1 percent in the period 1955-1965. Since then, long-term rates have moved from 7% to 15%; down to 8%; rose to 12%; and now are below 5%. Short-term dollar rates have fluctuated between 3% and 20% and everywhere in between. That volatility also created a potential for profit by speculating on interest rate movements.

• **Huge shifts in savings.** Governments in the last 20 years, with little previous precedent, permitted the tapping of domestic savings by non-resident borrowers and issuers of equity alike. Similarly, those seeking capital - debt and equity - had the freedom and risk to go outside their borders - indeed, outside their currency for capital.

• **Deregulation of financial intermediaries.** Deregulation lets everyone in everyone else's traditional line of business. In industrialized countries, insurance companies, banks, pension funds and securities firms were permitted to compete for savings between end buyers and sellers, both domestically and worldwide. They offered remarkably similar products.

• **Lowest-common-denominator regulatory and supervisory controls.** If a financial intermediary could not offer particular services because of national controls, it moved its operation to a more accommodating environment. Or, if the site became too intrusive, financial institutions shifted to a different product, say, foreign exchange trading or derivatives where leveraging was the rule and quite difficult to understand, let alone monitor or regulate.

• **Communication.** The growth of communication systems let everyone know what all markets and participants were doing and seeing at the same time. That, in turn, narrowed spreads between buyers and sellers. However, the high volumes became destabilizing when markets responded to the same information. The increased volumes, therefore, did not reduce price volatility given the immediacy of the information flow. It increased it. It is a myth that increased liquidity and volume reduces volatility. Increased liquidity merely narrowed the financial difference between buyers and sellers - a rather unimportant economic event - except for the profit pressures on the intermediaries who were pushed inexorably into alternative ways of achieving a decent return on capital in an increasingly volatile and competitive environment.

• **Disintermediation.** Money market funds vs. bank deposits; commercial paper vs. loans; short-dated governments vs. C.D.s; securitized mortgages vs. bonds; syndicated loans vs. bonds. That meant that each product and financial intermediary "cannibalized" the worldwide savings base.

• **An accommodating accounting system.** That permitted failure and risk to stay undisclosed because of the practice throughout the world of not marking assets to market - despite their depreciating value.

• **An asymmetrical compensation system.** That permitted risks to be taken by managers and traders with potential asymmetrical rewards for getting it right with minimal downside penalty for loss.

• **Government insurance of bank funding sources.** In the United States, indeed, all over the world, governments insured the depositors while deregulating how the deposits could be used. That removed the depositor/creditor as a constraining influence over the deployment of assets as governments permitted an even wider range of investments and activities for banks. In short, the liability side of the balance sheet was nationalized; the asset side alone was privatized. Bad news.

• **Direct government intervention in foreign exchange and credit markets.** That meant a force would directly intervene in the market, instead of as a profit-driven player, it was a politically driven player - therefore a potential patsy for the private sector. Moreover, combined with depositary insurance, it meant that banks, for example, could now speculate on the value of a currency - in an adversarial position against their own government or Central Bank with the government locked into making political, not financial, decisions. Yet the banks' funding for such activity was, if not financed (and they often were), guaranteed by those same governments. Governments, therefore, found that a) they were in an adversarial position to their banks; b) they didn't have the resources of the private sector in conducting FX activity; c) they were making political, not market-based decisions; d) they funded and guaranteed their market adversaries; and e) they, indeed, did not even use the same kind of leveraged products in conducting their rate stabilizing activity. Not a happy situation for Central Banks.

• **Financial engineering.** It gave great advantage to first-users. More important, the products were complex, leveraged, not readily understood by senior managers or regulators, and off-balance sheet, which meant that they were and are often "unrecorded" by anyone, electronically transmitted with unknown or uncertain risk, and not readily subject to traditional accounting or risk management systems.

Such was the environment. Such is the environment.

*THE RESULTS*

• All of this was in the context of little expertise by policy makers in the workings of a rapidly changing and complex market;

• Tremendous unrecorded access to capital by virtually any government or the private sector borrower in the world;

• Disparate legal and property rights worldwide;

• Little corporate governance and social safety nets in emerging markets;

• Huge disparities in the liquidity of certain instruments as compared to others;

• Highly uncertain risk management controls.

The results should not have been unexpected:

• An S&L crisis in the United States;

• Excessive or imprudent lending by banks;

• Currency crises in Mexico, Western Europe, Russia;

• Orange County, Barrings, Long-Term Capital;

• Korea, Malaysia, Indonesia.

**It is the context of these troublesome events that we recently concluded the World Bank/IMF meetings in September 1998.**

The recent World Bank/IMF annual meeting provided, yet again, an opportunity to hear what the assembled heads of state, finance ministers, planning ministers and Central Bank governors were worried about. It also provided insights into what problems were under their control, which were contentious and which were simply too painful to be discussed. The fact is that the world's financial system is now subject to events and conditions that cannot be coped with at this time by either national governments or multilateral organizations. There are simply too many mismatches, lags and conflicts between the problems and the "solution." The comments below reflect the speakers' consensus in the meetings and my own observations.

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# Mismatches, Lags and Conflicts: Some Observations After the World Bank/IMF Meeting

*(continued from page 3)*

***SHORT-TERM CAPITAL FLOWS***

Consensus: They were dangerous and should be monitored and controlled.

• Perhaps fundamental is the mismatch between the expertise of the private financial market participants and the policy makers in the public sector. There is no regulatory or supervisory agency in any country, including the United States, which fully and comfortably understands, for example, how leverage is accomplished, in what volumes, with what participants and products, the nature of the collateral and the minute-to-minute shifts of positions by the players. It was not meaningful, therefore, to talk about monitoring, let alone controlling or regulating the activities, of say, hedge funds (which at least a dozen finance ministers suggested) without an underlying detailed knowledge as to how leveraging and complex derivatives actually work in the private sector. The public sector does not have that knowledge base.

• Governments also are mismatched in their use of derivatives in their attempts to stabilize currencies as compared to private sector players. As a result, their lack of sophistication not only inhibits their regulatory posture, but also inhibits effective market response by a central bank when it attempts open-market currency support using inefficient and awkward instruments against the leveraged instruments used in the private sector.

• There is also a mismatch between the sheer volume of transaction flow, much of it electronically transmitted, and the monitoring or recording of such transactions within a given country, let alone globally across borders. The reason is because the private sector players either have no recording obligation, or the data is not centralized and certainly not coordinated across national borders. While Central Bank governors and finance ministers fell all over each other supporting the need for constraints (they called it sequencing) over volatile (speculative) flows, it was clear they didn't have the vaguest idea of how to do so without shutting down their access to resources.

• Virtually every official commented on the volatility of the short-term financial credit flows in their country, and the severe impact on interest rates and currencies when capital was quickly withdrawn. Few, however, noted the mismatch between those flows and the lethargic, bureaucratic and often hostile attitude toward direct foreign equity investment. As a result, governments have created incentives to investing short, liquid and as a creditor rather than as a long-term, less liquid equity investor. That comes from dealing with financial institutions rather than the corporate sector. That tilt, in turn, reflected an underlying hostility in a number of countries to a concern over the potential for losing independence and patrimony to foreign ownership of commodities and natural resources. The result was bound to create substantial pressure in the alternative investment vehicles - the debt and currency markets where, as noted above, the official sector was at a decided disadvantage, their monitoring tools least advanced and where adverse impact was swift and without recourse. Moreover, the availability of liquid and leveraged instruments on the debt and currency side encouraged market players to engage in transactions whose very volumes would prove destabilizing when withdrawn.

***SOCIAL SAFETY NETS AND TRAUMA***

Consensus: Safety nets are required. They are not in place.

• Financial and political traumas in recent years, and particularly in the last six months, have occurred in response to rapid and severe currency attacks and flight of short-term capital from the credit markets. The immediate effects were currency devaluation, extremely high interest rates and collapse of financial intermediaries whose investments or loans depreciated in value. It occurred with such speed that there was little coping mechanism in the form of social safety nets to cushion the adverse economic outcomes from unpredictable financial events.

• The absence of social safety nets reflected the mismatch between the rapid privatization of productive enterprises as compared to the lagging attention paid to pensioners, those on fixed incomes, unskilled workers, the unemployed or unemployable.

• The fundamental debate between that part of a society, in emerging markets, which takes pride in "market efficiency" (downsizing, reduction of subsidies, low minimum wage) to obtain a comparative trade advantage vs. the concern over safety nets (minimum wages, standards of employment, food and housing subsidies, unemployment compensation) has not been joined. That, in turn, reflected the absence of a political consensus as to the role of government in providing health and educational programs or other support systems vs. supporting through tax policies or otherwise private investments that have positive cash flow. There is little wonder that the social safety nets were not in place, let alone those that are automatic and quick acting. The reason they are not in place is simply because in most emerging markets there has not yet developed the basic social contract as to the roles of labor, owner, manager and government. And without that consensus the perceived easier path is to control the perceived "causes" of the trauma - the speculative or short-term capital flows - though they have neither the understanding of those markets, nor the infrastructure to monitor, let alone regulate them.

• Related to the foregoing is the mismatch between the private sector (and the availability of capital to support that sector) vs. the quality of corporate governance, the rule of law, and the existence of a predictable tax system. Here, too, the highest officials in scores of countries referred to the need to address these matters. But the reason they have not been addressed, again, is because the countries have not developed into a mature, political economy in which the major competing constituencies have fought and resolved highly contentious battles. The compromises have not been reached. Those compromises are precursors to establishing a division of power and resources. Instead, privatization and stock markets came first - the icing on the cake before the cake was baked.

***INFORMATION FLOW***

Consensus: There should be more transparency of data and policies. These should be quickly disseminated.

• There was a lot of schizophrenia about "information" flow. The mantra was clear. Policies and data must be transparent and current. But the consensus was hedged. The IMF and World Bank should facilitate timely publication of public sector data but without breaching the confidentiality of the information provided to those institutions! Moreover, few officials recognized that the better the quality and immediacy of information given the speed of its dissemination, the greater the probability for sharp and volatile price movements as each market participant, in response to adverse information, would seek to leave through the same door. Fundamentally, free, open, transparent and immediate information was mismatched with the absence of safety nets in the event of adverse economic or financial outcomes from the quick dissemination of such information.

***PRUDENTIAL LENDING***

Conclusion: Banks should be required to be more careful in their lending.

• It was clear that the need and availability of capital far outstripped the rules for prudential lending. Again, here too, the social/political structure did not have the time to create a system of checks and balances, a sharing of power and responsibilities so necessary as a condition precedent to the establishment of formalized rules and guidelines. The simple truth was that emerging markets in many cases were opened quickly to receive capital, before the political economy had a consensus for the establishment of the rules of wise, ethical and correct financial and corporate behavior. That takes time and rarely can be accelerated by either flat, market forces or outside consultants. The mismatch between the ease of allocating capital and the absence of a social consensus, in certain countries, has dangerously pushed certain countries to the brink of a centralized, closed environment.

***Conclusion: The talk about safety nets, poverty alleviation, the rule of law, cross-border controls and corporate governance had a vaguely unreal quality about it. One sensed the reluctance of each speaker to admit that the fundamental coping mechanisms were not yet there because of an absence of political will/maturity that simply could not keep up with or respond to the huge cross-border financial flows that so drastically affected them. Also, even if the political will were there, one sensed that nation states simply did not have the capacity to understand, predict or respond to this new variable - cross-border financial flows in the debt and currency markets - which dwarfed their domestic economy.***

# The Asian Crisis -

## *The Australian Experience*

*The following remarks were made by Neil Mackrell, Chief Representative, New York Representative Office, Reserve Bank of Australia, at a seminar held at Hofstra University on April 23, 1999. Mr. Mackrell was joined by Mr. Bo Yung Chung, Chief Representative, Bank of Korea, speaking on "Korean Crisis: Causes, Consequences and Prospects"; Mr. Esmond Lee, Chief Representative, Hong Kong Monetary Authority, speaking on "Hong Kong: Currency Stability and Recovery Prospects"; Mr. Raymond W.M. Fan, Director, Hong Kong Economic & Trade Office, speaking on "Hong Kong's Economic Ties with Mainland China." The seminar was organized by Dr. Zhongjun Hao, C.V. Starr Chair of International Business of the Frank G. Zarb School of Business.*

My aim today will be to outline Australia's experience, and the ongoing structural and policy adjustments that we believe have been so important to us during this turbulent period.

I would like to start by taking a slightly longer-term view. During the first nine years of the decade of the 1990s, a period that includes some recessionary periods for each of the countries in the comparison, Australia has grown faster than other comparable OECD countries.(see Table 1) Only Ireland and Norway have done better, but taken together they are about half the size of Australia, and there are some special circumstances about each of them.

Table 1

**Real GDP Growth Average annual rate (past nine years)**

| | |
|---|---|
| Ireland | 6.8 |
| Norway | 3.5 |
| Australia | 3.2 |
| Netherlands | 2.8 |
| United States | 2.5 |
| Denmark | 2.5 |
| Germany | 2.2 |
| Spain | 2.2 |
| New Zealand | 2.1 |
| Canada | 1.9 |
| United Kingdom | 1.9 |
| Belgium | 1.9 |
| Japan | 1.8 |
| France | 1.7 |
| Finland | 1.3 |
| Italy | 1.3 |
| Sweden | 1.1 |
| Switzerland | 0.8 |

Of course, these figures are averages over nine years. Table 2 looks at growth in the latest year (1998) particularly in those countries in Asia and the Pacific Rim. The story is well known to you by now, but nevertheless the figures do not paint a pretty picture. Many of the countries have experienced an actual contraction in their levels of income. Apart from China, which remains a relatively closed economy, Australia recorded the strongest growth in the region. The real growth rate of 4.7% over the year to last December was a lot stronger than any of us had forecast, particularly given the pressures that were being felt by our trading partners. We had been expecting a noticeable slowdown and we still are, but at this stage we are still raising our growth forecasts for 1999.

Table 2

**Real GDP Growth: Asia and Pacific Year to latest**

| | |
|---|---|
| China | 9.6 |
| Australia | 4.7 |
| United States | 4.3 |
| Taiwan | 3.7 |
| Canada | 2.8 |
| Philippines | -0.2 |
| New Zealand | -0.7 |
| Singapore | -0.8 |
| Japan | -3.5 |
| Korea | -6.8 |
| Hong Kong | -7.0 |
| Malaysia | -8.6 |
| Indonesia | -19.6 |

The other main comparison to draw against economic growth during the 1990s is to look at the rate of inflation (see Table 3). During the first nine years of this decade, Australia's inflation rate has averaged 2.8% per year, which is slightly higher than the OECD average. But still in the range of 2 to 3% that the Reserve Bank specifies as Australia's inflation target. If the first two years (1990 and 1991) were deleted from that comparison, the inflation rate would be about the average for OECD countries.

Table 3

**Consumer Price Inflation Average annual rate (past nine years)**

| | |
|---|---|
| Japan | 1.3 |
| Belgium | 1.9 |
| France | 2.0 |
| Canada | 2.2 |
| Sweden | 2.2 |
| Denmark | 2.2 |
| Ireland | 2.4 |
| New Zealand | 2.5 |
| Norway | 2.6 |
| Netherlands | 2.6 |
| Finland | 2.7 |
| Switzerland | 2.7 |
| Germany | 2.7 |
| Australia | 2.8 |
| United States | 3.3 |
| United Kingdom | 4.0 |
| Italy | 4.5 |
| Spain | 4.9 |

Naturally enough, this rather sanguine view of Australia's experience since the Asian crisis began is the net effect of the wide range of actions, reactions and adjustments within our country to the pressures that were brought to bear on us. We do not know with any preci-

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# The Asian Crisis -

## *The Australian Experience* *(continued from page 5)*

sion all the reasons as to why the Australian economy has performed so well during such a difficult period (and I note in passing that Mr. Greenspan in recent testimony has expressed similar sentiments about the performance of the United States economy). However, we do think that a lot of the credit can be traced to a range of broad-based and quite fundamental economic and structural reforms that were implemented during the preceding decade. Many of these are ongoing reforms that are aimed at further strengthening our institutions and our competitive capabilities.

**Macroeconomic policy, particularly monetary policy, and including our exchange rate policy, has played a major role in recent times. Fiscal policy reforms have also been important. But the microeconomic influences, many of which show up in heightened competition and greater flexibility, have been very important** (see Table 4). They help to explain not only Australia's move to a lower inflation environment but also the economy's growth and resilience in the face of external contraction.

Table 4

**Areas of Microeconomic Reform**

- Substantially lower tariffs;
- Deregulated financial markets and floating exchange rate;
- Stronger prudential supervision of financial institutions;
- A more stringent regime of competition policy;
- Privatization of many public utilities; and
- A good deal more flexibility in wage bargaining.

These have all contributed to making the economy more efficient and more flexible and thereby more competitive and more resiliant. But of course in the short run, they also had their costs. For example, there is always an increase in uncertainty in an economy when change, and at times rapid change, is occurring and there are often job losses involved such as when a large, overstaffed utility is privatized. But there are also large benefits that are often undervalued such as cheaper electricity, cars, telephone calls, airline flights, new export industries and new jobs in the competitive industries. Australia has seen both sides of this coin.

**Perhaps the best quantitative indicator that these structural reforms have yielded good results is that the economy is now more productive than ever.** The increase in productivity in the current expansion, at 1.9%, is a good deal better than the figures we had in the expansions of the 1970s or 1980s. This figure is for multi-factor productivity, a measure of productivity that cannot be increased simply by shedding labor and replacing it with capital. It can only be increased by using labor and capital more productively. Again, there is an analogy to current productivity performance of the U.S. economy.

**Public finance has been another important aspect in Australia's body of economic reforms; and an area where the reforms were put in place in time to help shield our economy from external pressures.** On comparable OECD figures, our budget was in surplus to the tune of 1/2% of GDP in 1998 and a bigger surplus is expected in 1999.

Perhaps a better measure of the long-run effect of fiscal policy can be taken from the ratio of general government debt to GDP.(see Table 5) This effectively measures the accumulated debt that is needed to finance them. On this measure, Australia's public finance has resulted in the smallest call on capital markets of OECD countries.

Table 5

**General Government Debt Percent of GDP, 1998**

| | |
|---|---|
| Italy | 119.4 |
| Belgium | 117.3 |
| Japan | 99.9 |
| Canada | 90.0 |
| Sweden | 73.1 |
| Spain | 72.0 |
| Netherlands | 67.9 |
| France | 66.4 |
| Germany | 62.6 |
| Denmark | 59.3 |
| United States | 57.4 |
| United Kingdom | 57.2 |
| Ireland | 56.6 |
| Finland | 52.5 |
| New Zealand | 37.6 |
| Norway | 37.1 |
| Australia | 37.0 |

**Reform of the banking system and its regulatory environment greatly strengthened our financial institutions ahead of the general turmoil in financial markets.** This was also important in shielding our real economy from much of the financial woes of the last two years. As the consequences of the asset boom earlier this decade were unraveled, bad loans reached a peak of 6% of assets in 1992 but it has come down pretty much continuously since that time. At present, the ratio is less than 1%, and this is probably about as low as it could reasonably be expected ever to get. In other words, Australia had significant problems in its banking system at the beginning of this decade along with a lot of other countries. But the bad loans were run off relatively quickly, and bank balance sheets in Australia have been particularly strong throughout the period of the Asian crisis. New institutional arrangements have also been introduced recently to strengthen further the regulatory environment in which our financial institutions operate.

**The subject of the current account deficit and the level of external debt tended to dominate economic discussion in Australia in the 1980s.**

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*The Associates are the backbone of the Merrill Lynch Center, representing Hofstra faculty from a wide range of disciplines. Each of our 19 Associates is committed to contributing to the study of one specialization within the field of international financial services and markets. Their responsibilities include: maintaining current familiarity within their area, preparing one review paper every two years and initiating programs - such as seminars and symposiums - to further enhance and expand the knowledge and understanding in their areas.*

Specializations include:

- Emerging Markets
- International Investments
- Derivatives
- Law and Regulation
- Information Technology
- International Economics
- Marketing of Financial Services
- International Banking
- Accounting for International Markets and Services
- Management and Organization of Financial Services
- International Investment Banking

# The Asian Crisis -

## *The Australian Experience* *(continued from page 6)*

There were fears that Australia's current account position might be unsustainable. At that time there was a large fall in the real exchange rate and a number of other adjustments had to be made including a substantial tightening in fiscal policy.

With the benefit of hindsight, it is now clear that the situation was not unsustainable. Australia's current account deficit as a percentage of GDP has tended to oscillate between about 3% to a little more than 6% over the last two decades. It is obviously very strongly cyclical and on four occasions it widened to around the 6% mark. We have been expecting that it would do the same on this occasion because of the contraction in our traditional export markets and our own relatively buoyant domestic demand. It is somewhat surprising that it has not happened although we would not be surprised if it did happen at some stage. Unfortunately, the only sure way of preventing such an outcome would be to slow the Australian growth rate and nobody wants to do that. It would be poor economic policy, and unhelpful for regional recovery.

**It is interesting to consider what has happened to our exports since mid-1997:**

• exports to those countries in Asia that were hit initially by the crisis (ASEAN and Korea) have fallen by 16%;
• exports to the rest of Asia have been relatively flat;
• but on the other hand, exports to Europe are up by 18%, to the United States by 24%, and to other markets by 13%.

Over the years we have often felt ourselves to be vulnerable because such a high proportion of our exports are commodities. But as we have seen, in the situation of a regional crisis, this can be an advantage.

Let me return to the issue of sustainability of our external position. The level of Australia's foreign debt rose from almost nothing to about 35% of GDP in five years in the mid-1980s. This caused a lot of concern at the time as people tended to assume this sharp upward trend would continue. In the event, the sharp rise in this ratio flattened out and it is currently about the same as it was in 1992 and not a lot higher than in the mid-1980s. The mathematics is such that by holding the current account deficit fairly constant as a proportion of GDP, the foreign debt ratio does not rise forever but tends to flatten out at a new level, and this is what has been happening.

**Exchange rate management is always a topical issue in a country with an open economy such as Australia's.** To see how the developments have affected our exchange rate, I think it is appropriate to firstly give a medium-term perspective before turning to developments since the Asian crisis occurred.

If we look back over the last 20 years or so, there has been only one major change. That was a downward shift in the real exchange rate that occurred in 1985/86, which I referred to earlier. But since then, while it has moved quite a lot from quarter to quarter and even from year to year, it has been basically a flat trend. Looking at the Australian dollar against other major currencies, we get a similar picture. The Aussie dollar against the Yen shows the same pattern but perhaps with a very slight downward slope. Looking at the Aussie dollar against the U.S. dollar, again the same pattern but on this occasion the long-term, flat line trend is probably appropriate.

Turning now to the more recent developments, over the last two years, the value of the Australian dollar has obviously depreciated. The depreciation against the U.S. dollar looks to be quite pronounced partly because the U.S. dollar has been quite strong; the depreciation in trade- weighted terms looks more modest because the Australian dollar has risen against some Asian currencies that have been relatively highly weighted in the index. If we look over the whole period of nearly two years, we think that the Australian currency has behaved in a reasonably exemplary fashion although there were a couple of periods where it threatened to overshoot.

**To sum up, the Australian economy has responded surprisingly well to pressures that produced such havoc in parts of Asia and beyond.** Our economy has rarely performed better than it is right now. Macro-economic policy and fiscal reform have been important. But in the decade leading up to the Asian crisis, Australia implemented broad-ranging, and at times painful microeconomic reforms that virtually transformed the economy, giving it the flexibility, resilience, integrity and competitive ability that have enabled us to withstand the recent turmoil and come out all the stronger.

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# THE MERRILL LYNCH CENTER FOR THE STUDY OF INTERNATIONAL FINANCIAL SERVICES AND MARKETS

## PAST AND FUTURE ACTIVITIES REPORT: 1998-2000

**October 1-3, 1998**
"Financial Services in the Evolving Global Marketplace: Approaching the Next Millennium"
Three-day international conference.

**October 30, 1998**
The Long Term Capital Management Debacle: Lessons and Implications"
Faculty panel discussion.

**November 18, 1998**
"The World of International Finance: A New Role for the World Bank/IMF?"
Lecture by Eugene H. Rotberg, former vice president and treasurer of the World Bank and former executive vice president of Merrill Lynch & Co.

**March 26, 1999**
"The Global and Legal Impact of the Y2K Problem"
Seminar by Dr. Laura Lally and Mr. Charles Kerr, partner, Morrison & Foerster, LLP.

**April 23, 1999**
"Asia: The Road to Recovery"
Panel presentation by the chief representatives of the Bank of Korea, the Reserve Bank of Australia, the Hong Kong Monetary Authority, and the director of the Hong Kong Economic and Trade Office.

**May 5, 1999**
"The Euro and Its Impact on U.S. Business"
Lecture by Ernest T. Patrikis, special advisor to the chairman, American International Group, at the business executive breakfast jointly sponsored by the MLC and the Hofstra University Scott Skodnek Business Development Center.

"The Impact of the Euro: U.S. Firm Operations and Investors"
Symposium with panel presentations by faculty, investment, banking and business speakers.

**December 10, 1999**
"Financial Information Technology"
A panel discussion featuring professionals from ECN, OPENLINK Financial, Hyperfeed Technology and Money Line.

**March 17, 2000**
"Broadband and Wireless Technologies -- What are they? Who are the public and private companies poised to take advantage of this tectronic shift?"
Presentation by Evan Misshula, managing director, Sane Capital Partners.

**May 10, 2000**
"The Strategic Impact of Mergers in the Financial Sector"
Presentation by John Morris, managing director, Salomon Smith Barney.

**November 16-18, 2000**
International Conference
(see below)

## MARK YOUR CALENDAR

**EURO Working Group on Financial Modeling of Erasmus University Rotterdam, the Netherlands**

in conjunction with

**The Merrill Lynch Center**
**Hofstra University**

will host an international conference

**November 16, 17 and 18, 2000**
**Yale Club of New York City**

The EURO Working Group on Financial Modeling was founded in September 1986 in Lisbon. Its primary field of interest is financial models that solve problems faced by financial decision makers in the firm, intermediaries and the investment community. From this, the following objectives of the EURO Working Group are derived:

• Providing an international forum for exchange of information and experience on financial modeling;
• Encouraging research in financial modeling (new techniques, methodologies, studies, software, etc.);
• Stimulating and strengthening the interaction between financial economic theory and the practice of financial decision making;
• Cooperating and exchanging information with other universities and financial institutions throughout Europe.

The EURO Working Group now has members in 34 countries spread across four continents. The meetings of this organization are attended by 80-100 members on average, most of them scientists, but also representatives from financial institutions, and are usually organized on Thursday, Friday and Saturday morning. The organizers are expected to schedule three types of sessions: a round-table session with invited speaker(s), regular sessions with the presentation of refereed papers and balloon sessions in which unrefereed papers, new topics and "loose" ideas can be discussed.

For information regarding the EURO Working Group contact:
Helene Molenaar, Erasmus University, at molenarr@few.eur.nl.

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