

CHAPTER SIX

THE ASIAN FINANCIAL CRISIS

6.1 The 'Asian financial crisis' which started in currency markets in South East Asia, then spread to other markets, undermined first confidence, then faith in the certainty of continued high growth in the region - the so-called East Asian Miracle. The ensuing economic downturn has raised questions about the foundations of that growth, the soundness of the region's financial sectors, the role of government in directing investment and lending, even the appropriateness of 'Asian values' in the context of free market orthodoxy. It has also presented the region's economies with a number of inter-related challenges: implementing the financial sector reforms needed to attract foreign capital back into the region; establishing governance practices which will improve transparency and accountability; and developing growth strategies which are both sustainable and inclusive.

6.2 For ASEAN as a grouping and as an organisation, the crisis also presents a number of challenges: the need to maintain the momentum of intra-regional trade liberalisation and economic cooperation under AFTA in the face of severe domestic constraints; the need to devise regional strategies which can practically assist battered economies regain stability and health; and more specifically, the need for ASEAN to assume a greater role in the process of institution-building in the region.

6.3 Recognising the significance of the financial crisis to the ASEAN economies, the Committee felt it important to consider the crisis in some detail, its extent and causes, the impact on the region, its implications for ASEAN, and its likely impact on Australian trade and investment interests in the ASEAN region. Indeed, much of the evidence to the inquiry following the devaluation of the Thai baht in late July 1997, focused on questions posed by the unfolding crisis, and in particular, the longer term implications for Australia of the economic downturn.

6.4 Most witnesses agreed that the economic problems of the region will result in significant contractionary pain for the ASEAN economies in the immediate term, but that in the longer term, their strong macro-economic fundamentals - high savings and investment rates, low levels of public debt, competitive factor markets - should ensure a return to high growth. The regional economic downturn in turn will affect Australia's trade performance and domestic growth; however estimates of the likely extent of the economic dislocation varied considerably. Where commentators were predicting that the crisis would reduce Australia's GDP growth by around half a per cent in 1998 six months ago, many now see the growth rate as likely to be slowed by 1 to 1.5 per cent. In terms of Australia's export markets in ASEAN, the hardest hit are likely to be building and construction, tourism, transport, primary commodities such as livestock and cotton, elaborately transformed manufactures, precious metals and some capital intensive goods (such as marine vessels). Domestic markets are also likely to be affected by the increased competitiveness of ASEAN imports, particularly manufactures, resulting from the recent significant devaluations of regional currencies.

6.5 While the implications of the regional economic downturn for Australia's trade performance in the region, and indeed our economic outlook, are, in the main, likely to be negative, it is important to note that the crisis also holds a number of potential positives for Australia, in terms of diplomatic and trade relations with our ASEAN neighbours. A number of witnesses emphasised that the economic difficulties facing ASEAN members have provided a valuable opportunity for Australia to improve its 'credentials' as a regional partner, both through contribution to international financial assistance efforts, and through stepped-up bilateral trade and investment links, particularly in the financial and professional services sectors.

Overview of the Crisis

6.6 In order to gain some appreciation of the dimensions of the crisis, which started as a currency collapse in a number of South East Asian economies but rapidly expanded to other financial markets, it is useful to look at how exchange rates across the region have been affected, the effects on stock and financial markets, and the flow-on effects to other parts of the region. It should be noted that this section will attempt to focus more closely on the extent of the crisis within ASEAN, although the financial instability subsequently experienced in North Asia obviously has had ramifications for the ASEAN economies.

Exchange Rates

6.7 Prior to July 1997, the exchange rates for most of the convertible ASEAN currencies were loosely tied to the US dollar. The Thai baht, although tied to a basket of currency, was effectively pegged to the US dollar (the primary weight in the currency basket) at an exchange rate ranging around 25 baht. Like the baht, the Philippine peso was allowed to move in a fairly narrow range around the US dollar at a rate between 25 and 27 pesos to the US dollar. The Indonesian rupiah was subject to managed, gradual devaluation against the US dollar, in effect a moving peg, which drifted toward the 2,500 mark through the first part of 1997. The Malaysian ringgit was allowed to fluctuate more than the other three currencies, but still maintained a rough band of around 2.5 ringgit to the dollar. The Singapore dollar, in contrast to the other ASEAN currencies, has long been floated against the US dollar, while the currencies of the newer ASEAN members (with the exception of Myanmar) remain non-convertible.

6.8 In June 1997 the Thai baht came under increasing downward pressure as international and local financial interests speculated that existing exchange rate levels could not hold given prevailing conditions, which included already high interest rates, a widening current account deficit and large inflation rate differentials. In response to the sustained pressure, largely galvanised by the activities of a number of hedge funds, and following the failure of the Thai Central Bank to prop up the currency (expending nearly US\$26 billion in the process), the Thai Government abandoned the baht peg on 2 July 1997. In the following days the Thai baht lost 15 per cent in value against the dollar, with domestic asset markets quickly following. Remarkably similar conditions in neighbouring economies, particularly Indonesia and to a lesser extent Malaysia and the Philippines, prompted attacks on the rupiah, ringgit, and peso. Again these attacks were engineered by a combination of hedge fund speculation and 'herd' panic. The result was a wave of currency devaluations throughout the region, as governments abandoned their *de facto* pegs to the US dollar. According to one report, the value of the Thai baht against the US dollar dropped by 31.9 per cent over the six

months to November 1997, while the Indonesian rupiah (28.1 per cent), the Malaysian ringgit (24.2 per cent) and the Philippine peso (22.4 per cent) also experienced severe devaluations.¹

Stock markets

6.9 Dramatic devaluations to the region's currencies and the general loss of investor confidence in the Asian economies in turn triggered a sharp decline in share prices in a number of ASEAN stock markets. It should be noted that in the case of Thailand, Malaysia and the Philippines, these declines had actually begun months earlier. For example, in the first half of 1997 Thai and Malaysian stock prices on average fell by 12 per cent, while the Philippines market lost close to 15 per cent. Whether this earlier decline was a part of a larger pattern of increasing investor nervousness in the region or a cyclical response (for example an adjustment in macro-economic policy such as an increase in official interest rates) is not clear. Following the devaluation of the Thai baht in July, stock prices in the region fell dramatically. Thai and Philippine stock markets each suffered 30 per cent reduction in average equity prices, with greater falls in Indonesia (32 per cent) and Malaysia (38 per cent). Attempts by central banks to hold exchange rate pegs with the US dollar resulted in relatively sharp increases in interest rates, which encouraged investment funds to flow into other types assets (for example loan capital) or out of the region completely. In turn, the fall in exchange rates, coupled with the still high interest rates, increased the rate of business insolvencies in the region, further undermining confidence in share markets and asset prices.

6.10 In the case of some countries, share price declines were exacerbated by restrictions placed on foreign investment. Some commentators maintain that, as markets declined, the limited stock selection available to foreign portfolio investors, for example in Thailand, may have encouraged some to abandon the market completely rather than diversify shareholdings.² Further, the additional lack of hedging facilities in many countries meant that investors had little alternative other than to reduce their country portfolio weighting to zero. While the outflow of foreign funds has been significant, it should be noted that in most economies in the region, local investor activity has also had an important impact on stock market declines. In a number of countries the bulk of stock market ownership remains local (for example, over 75 per cent in Thailand and Malaysia).

Financial Markets

6.11 The impact of currency devaluation and falls in equity prices on financial sectors in almost all of the ASEAN economies through the latter part of 1997 has been severe. Banks and financial institutions throughout the region became exposed to increasingly high levels of bad debt. This is because many customers used stocks as collateral or borrowed abroad at artificially low exchange rates, only to default when both the foreign exchange and stock markets declined. By December 1997, some 58 financial institutions in Thailand had been closed, with remaining firms requiring an estimated US\$13.9 billion in bailout funds from authorities (equivalent to approximately 10 per cent of Thai GDP) to remain solvent.³ In Indonesia sixteen banks have been closed and deposits in remaining banks have shrunk dramatically. Financial markets in Malaysia and the Philippines have also been affected,

1 Exhibit No. 51(e), Malcolm Dowling & PJ Lloyd, *The Asian Currency and Economic Crisis: Dimensions, Explanation, Outlook and Lessons*, 4-5 December 1997, p. 3.

2 *ibid.*, p. 4.

3 Exhibit No. 55(c), DFAT, *Thailand Country Brief*, December 1997.

although to a lesser extent, with no reports of closure or suspension of lending institutions in either country. Strong prudential controls and relatively low levels of external debt, at least compared to Thailand and Indonesia, helped both the Malaysian and Philippine financial sectors withstand heavy falls in asset prices. As instability triggered market declines in other parts of the region, it exposed a number of weaknesses in financial sectors in other parts of Asia, particularly Korea, Hong Kong and Japan.

6.12 To some extent, it is still too early to assess the damage to regional financial markets. Governments have shown some reluctance to force consolidation or closure on crippled lending institutions. There are indications that some banks and financial institutions are being propped up by central bank support (including relaxation of statutory reserve ratios), a situation which could become untenable if the quality of bank assets continues to deteriorate. Poor disclosure and auditing provisions, and in some countries, arcane commercial holding provisions, mean that many banks and finance companies are still in the process of establishing the health of their balance sheets.

Contagion Effect

6.13 Currency and stock market devaluations in South East Asian economies prompted international (and local) investors to look more critically at other markets in the region. Many of the conditions present in South East Asia - over-investment in certain sectors, high and growing current account deficits, and increasing financial sector exposure to bad debt - were present in the region's other tiger, South Korea. Consequently, by early October 1997, speculative pressure on foreign exchange markets had led to a significant devaluation of the Korean Won, despite its relatively low real effective exchange rate against the US dollar, and large falls in stock market capitalisation. Falling exchange rates in turn exposed the huge short-term foreign debt held by many large conglomerates (Chaebol), estimated at around US\$100 billion. By the end of 1997, eight of Korea's fifty largest companies had declared bankruptcy or were technically insolvent.

6.14 Other countries, though shielded from currency turmoil to some extent, suffered stock market declines as investor's grew more nervous at the extent of North Asian corporate exposure to South East Asia's mounting debt problems. In November 1997, the Japanese Nikkei fell to its lowest level in three years, while the Hong Kong stock market fell around 40 per cent from a mid-year all-time high. Market volatility exposed a number of pre-existing weaknesses in Japan's financial sector, including excessive levels of bad debt, pushing one large Japanese bank, a smaller bank and a handful of stockbroking and securities firms to bankruptcy.⁴ In Hong Kong, stock market volatility placed some stress on the financial sector, affecting mainly local banks and investment funds with high exposure in South East Asia, such as Peregrine Ltd (which subsequently went into receivership in early January 1998).

4 Exhibit No. 47, *The Far Eastern Economic Review*, 12 February 1998, p. 59.

IMF Assistance

6.15 The magnitude of market shocks in a number of regional economies effectively forced governments to seek international assistance. In Thailand, the serious depletion of Thai foreign reserves, resulting from an ultimately unsuccessful bid by the Thai Central Bank to 'hold' the baht against speculative pressures on foreign exchange markets, coupled with the mounting debt burden faced by the financial sector, prompted the Thai Government to seek the assistance of the International Monetary Fund (IMF) in early August 1997. A bailout package was subsequently negotiated, providing the Thai Government with access to a US\$17.2 billion credit facility, conditional on the implementation of a stabilisation program. This program consisted of a range of measures to improve the current account, including increases in consumption taxes and reductions in areas of public expenditure, and re-structure of the financial sector (including the closure of chronically over-extended financial companies).⁵

6.16 In response to continued sharp falls in the value of the Indonesian rupiah in late September 1997, the Indonesian Government was also forced to request financial assistance from international institutions, including the IMF. A 'bailout' package was subsequently negotiated, involving provision of a fund facility in return for implementation of a program of economic reform measures. These measures included targeted reduction of the current account deficit, tariff reductions on a range of industrial inputs (for example, chemicals, coated steel products), deregulation of imports of basic foodstuffs, and simplification of import procedures. The financial assistance element of the package, to be administered by the IMF, was placed at US\$23 billion (of which Australia agreed to contribute US\$1 billion), and was subsequently increased to US\$43 billion (A\$63.87 billion).

6.17 Unfortunately, the IMF reform measures adopted by the Indonesian Government to date do not appear to have restored either investor confidence in the Indonesia economy or stability in financial and asset markets. At the time of writing, the Indonesian rupiah continued its fluctuation against the US dollar, veering from 8,500 to 11,200 in the course of two trading days. Much of the continuing market instability has been fueled by political uncertainty, particularly in relation to the Indonesian Government's commitment to implement the IMF reforms, but also in relation to the competence and the future of current leadership in the country.

Causes of the Crisis

6.18 Attempts to explain the causes of the regional crisis, and in particular the severity and extent of financial collapse, have tended to concentrate on a number of trigger factors, for example: pegged exchange rates which had become over-valued; high interest rate differentials between domestic and offshore capital markets; and growing inflation and current account deficits which inevitably began to sap investor confidence.⁶ However, they have also identified a number of underlying causes, related to critical weaknesses in financial systems throughout the region which have been exposed by rapid, uneven liberalisation, and the increasing mobility (and hence volatility) of international capital.

5 Exhibit No. 55(d), DFAT, *Asialine*, December 1997, p. 16.

6 For example, Exhibit No.14(u), Phil Hanratty, *Economic and Financial Turmoil in South-East Asia: Origins and Consequences*, Department of the Parliamentary Library, December 1997, pp.3-4.

6.19 This section will firstly consider the factors that triggered, then compounded the extent of the crisis: the appreciation of pegged exchange rates on a trade weighted basis which reduced the international competitiveness of South East Asian economies and contributed to an export slowdown; high interest rates which first exacerbated real effective exchange rate appreciations, then, as nominal exchange rates fell, contributed to a liquidity 'crunch'; and the emergence of price inflation 'bubbles' in key asset markets which were both fueled and undermined by speculative attacks on local currencies. It will then consider some of the underlying factors, principally inadequate prudential and regulatory controls in certain financial sectors which facilitated the over-extension of credit, and the increasing volatility of large scale capital (reflecting globalisation and increasing inter-connectedness of international financial markets).

6.20 Through the first part of the decade the real effective exchange rates of most ASEAN currencies were relatively stable. With the depreciation of the yen in late 1995 and 1996 against the US dollar, the ASEAN real trade weighted exchange rates began to appreciate, although not significantly until the latter part of 1996. Real effective exchange rate rises reduced the international competitiveness of the ASEAN economies, particularly in relation to China, and contributed to the slowdown in exports experienced throughout the region. The slowdown was also caused by a dramatic contraction in international demand for computer chips and computer peripherals in 1995-96, which principally affected Malaysia but also Thailand and the Philippines, and wage inflation in labor-intensive manufacturing sectors in Thailand and Malaysia which further eroded export competitiveness. Reduced export levels slowed economic growth, in turn fuelling market speculation that high real effective and nominal exchange rates could not be sustained.

6.21 A second factor which both precipitated and then compounded the regional crisis was the high interest rates regimes maintained by many ASEAN governments. Initially, this created a greater incentive for financial institutions and companies to borrow offshore or raise capital through expanded listings on local stock exchanges, generating significant foreign capital inflows.⁷ In the absence of adequate sterilisation mechanisms, these capital inflows placed sustained, upward pressure on nominal exchange rates, which lead to real effective exchange rate appreciations. Subsequently, as pressure mounted on exchange rates across ASEAN, and devaluations inevitably took place, real interest rate rises were used to attempt to 'hold' the value of local currencies, and contain the inflationary effects of such exchange rate depreciations. Unfortunately, higher interest rates (coupled with lower nominal exchange rates) substantially compounded the level of corporate indebtedness, particularly in highly leveraged sectors, leading to increased rates of insolvency which in turn further undermined confidence in financial and share markets.

6.22 A third factor which both precipitated and intensified the effect of the crisis was the existence of asset price inflation bubbles in a number of ASEAN economies, particularly Thailand and Indonesia, which resulted, in part, from tremendously high rates of investment in particular sectors of those economies. As noted above, these investment rates were largely being sustained by massive inflows of foreign capital, much of it short-term. High returns in share markets, as well as commercial property and other sectors, attracted greater rates of investment in those markets, which in turn fed asset price inflation. Inevitably, as the productivity of investment decreased and returns shrank (reflected in a rise in the rate of loan defaults and reduced credit lines), asset prices became subject to correction (reflected in the

7 Exhibit No. 55(d),*ibid.*, p. 6.

fall of equity prices in Thailand, Malaysia and the Phillipines through the first part of 1997). The subsequent significant devaluation of currencies throughout the region, however, triggered a much greater correction, indeed a collapse, in asset prices.

Financial Sector Weaknesses

6.23 As the difficulties in the region intensified and spread from currency to asset markets, it became clear that the crisis could not be explained simply in terms of exchange rate appreciations, currency devaluations or changes in monetary policy. Similarly, it was apparent that the crisis had little to do with poor macro-economic management on the part of governments in the region. For the most part, governments in the region have exercised disciplined fiscal policies, posted budget surpluses and maintained relatively low inflation rates (at least by developing country standards).

6.24 Increasingly, commentators and experts alike have focussed their attention on other causal factors, in particular weaknesses in the financial sectors of some (but not all) affected economies, and the increasing mobility of international capital resulting from the globalisation of financial markets. As such, the crisis can be understood as one principally resulting from the failure of the financial intermediation process. Financial sectors, lacking adequate prudential supervision and regulation, could not efficiently allocate the enormous volume of funds being pumped into their economies.⁸ The second factor, of course, is the large scale movements or surges in international capital, particularly short term investment capital, which accompanied (and to some extent predated) large currency depreciations across the region.

6.25 A recent report by the World Bank on East Asia's financial sectors identifies a number of structural problems which compounded the effects of rapid deregulation and even more rapid credit expansion on economies in the region. At the heart of the problem lies weaknesses in banking systems. The report notes that most financial intermediation in East Asia (including ASEAN economies) is handled by banks and non-bank lending institutions. On a stock basis the region is relatively well capitalized, but banking systems have tended to control most new capital flows.

6.26 The major problem affecting banking sectors has been the rate of non-performing loans, caused by a combination of factors. Many banks have liquidity problems, and state-directed lending, political pressures and poor lending practices, particularly by State-owned banks, remains a problem. Weak regulatory supervision is also a recurring problem in financial sectors across the region. In a number of countries, the combination of insider or related party lending and weak regulatory supervision created an environment conducive to increased financial risk. In Indonesia and Thailand for example, where most private banks are part of large corporate groups, related-party lending bypassed credit controls entirely. Often, authorities appeared more eager to protect client interests than those of banks, condoning non-compliance with regulations, or worse, ignoring flagrant violations.

6.27 Financial sector weaknesses in some countries were compounded by the restrictions placed on entry of foreign banks and financial institutions. As a result, financial sectors were less exposed to competition from foreign-based financial service providers. To some extent this has been offset by the process of disintermediation, where borrowers

8 Hartcher Transcript, p. 669.

increasingly source funds from abroad at more attractive interest rates. This in turn lead to market segmentation, with competitive firms borrowing more offshore or from foreign banks, and less credit-worthy customers obtaining funds from domestic firms.

6.28 Certainly there is little doubt that the lending practices of banks and non-bank financial institutions contributed to the development of asset price inflation bubbles in a number of ASEAN economies. Financial sectors in these countries lacked the regulatory controls needed to ensure the security and efficient allocation of the large amounts of foreign capital being pumped into their economies. In many cases, the rapid credit expansion simply outstripped the development of prudential regulation.

6.29 Another factor, which tended to compound the problems of inadequate prudential controls, was the extent to which banks and finance companies appeared to be operating on the basis of implicit government guarantees. According to Paul Krugman, these guarantees (whether real or assumed) together with poor regulation, helped to distort investment decisions, and encouraged finance of high risk/profit ventures in the expectation that governments would cover serious losses. Competition for increasing investment funds lead to more offshore borrowing, closer margins and less hedging by financial institutions. It also rapidly lead to more fragile balance sheets. As Krugman explains:

The problem began with financial intermediaries - institutions whose liabilities were perceived as having an implicit government guarantee, but were essentially unregulated and therefore subject to severe moral hazard problems. The excessive, risky lending of these institutions created inflation - not of goods but of asset prices. The overpricing of assets was sustained in part by a sort of circular process, in which the proliferation of risky lending drove up the prices of risky assets, making the financial condition of the intermediaries seem sounder than it was.⁹

6.30 Krugman suggests that, once asset price bubbles burst, punctured in part by falling investment returns; inevitable bailouts and realisation among investors that governments could not honour implicit loan guarantees, a reverse cycle was triggered: falling asset prices lead to more visible insolvency on the part of intermediaries, which further fed asset price deflation. Although the analysis is rather crude, it does illustrate the central problem; lack of prudential and regulatory controls allowed banks and financial institutions to carry increasingly high risk debt, which then could not be adequately covered when asset price inflation bubbles burst.

Rapid Liberalisation of Financial Sectors

6.31 While structural weaknesses in financial sectors, particularly in banking systems were principally at fault for the crisis, it is possible that these weaknesses may have been exposed, and even compounded, by the liberalisation process underway in many countries. In a recent speech on Asia's financial sector problems, the Deputy Governor of the Reserve Bank of Australia pointed out that:

9 Exhibit No. 56, Paul Krugman, *What Happened to Asia*, January 1998, p. 3.

While it is easy enough now to see the fracture lines and lack of resilience of these financial sectors, it was less easy to predict the outcome beforehand. The transition from a regulated financial system to a deregulated financial system is intrinsically difficult ... It leaves the system quite fragile during the process. There is a fair bit of evidence that problems have arisen for almost every country during the transition, with the problem usually taking the form of excessive lending as each institution in the deregulated sector competes for its share in the new world. In the process, poor loans are made and asset prices are bid up.¹⁰

6.32 In the context of the current financial crisis, it is possible that increasing liberalisation and de-regulation of financial sectors did contribute to the impact on asset price markets; however the primary causes of the crisis were weaknesses that had existed for some time, and had yet to be addressed by the reform process. These included major gaps in the regulatory and prudential supervision framework, opaque relationships between government and the banking sector, and poor accounting and disclosure procedures, which allowed ailing banks and financial firms to carry under-performing assets and bad debt for too long.

International Capital Flows

6.33 Another underlying factor of the crisis, touched on by some analyses,¹¹ relates to the greater mobility of international capital made possible by liberalisation and increased global integration of financial markets. To some extent this has made countries, and even entire regions, more vulnerable to the effects of rapid, large-scale capital flows.

6.34 Some commentators have argued that the severity of the crisis may have been caused more by a 'panicky outflow of international capital', than fundamental weaknesses in regional economies. In evidence to the inquiry, Greg Sheridan argued that the markets 'have wildly overcorrected beyond anything justified by macro-economic mismanagement in South East Asia'.¹² The effects of such panic, or over-reaction, emphasise the important role played by large institutional investors in channelling capital flows.

10 Exhibit No. 38(c), Reserve Bank of Australia Bulletin, *Asia and the Financial Sector*, December 1997, p. 24.

11 For example, see Exhibit No.14(u).

12 Sheridan Transcript, p. 614.

Regional Assessment

6.35 At the time of writing, South East Asian share and currency markets continued to show signs of volatility, but appeared to have reversed the 'long slide' of the second half of 1997. Stock market gains in recent weeks in a number of countries may signal a return of optimism to the region, or at least, an indication that the capital flight might be slowing. Through the first week of February 1998 the Malaysian stock exchange rose by around 25 per cent, while Thailand's stock market, which had already climbed 34 per cent in January 1998, added another 6.7 per cent.¹³ Stock markets in Jakarta, Manila and Singapore also showed solid gains in January 1998.

6.36 The impact of the crisis on the Indonesian and Thai economies has been particularly heavy, with both countries experiencing continuing (albeit smaller) shocks. In Indonesia, the severity of the economic downturn has been much greater than earlier predicted. GDP growth for 1998 is now expected to be negative, with some forecasts as low as negative five per cent. Inflation has risen dramatically, from an average of 8 per cent in 1996 to around 25 per cent by the end of 1997, and is expected to reach the 50-60 per cent range by the end of the year. The combination of rising inflation and large-scale workforce reductions has sparked some social unrest, which in turn, has further undermined confidence in the rupiah and prospects for economic recovery. The IMF program has not brought stability to currency and share markets, largely because of lack of confidence on the part of international and domestic investors in the reform process. In response to the worsening exchange rate of the rupiah (which sank below 15,000 to the US dollar in early January 1998) and the extent of private debt (now estimated at close to US\$74 billion, much of it held offshore), the Indonesian Government announced a moratorium on interest repayments for foreign denominated loans in January 1998 - a move which only further eroded confidence in the rupiah.

6.37 In Thailand, economic growth forecasts and tax revenue have fallen far below levels predicted only several months ago. Conditions imposed as part of the IMF bailout, particularly those requiring reduced fiscal spending and interest rates hikes, have actually further retarded growth. The IMF has conceded that the rehabilitation program may have been too vigorous, given the extent of the slowdown, and has agreed to allow the Thai Government to run a smaller budget surplus than originally mandated. The Thai economy is now experiencing negative growth, and some economists have predicted that it could shrink by as much as 5 per cent in 1998.¹⁴ Inflation has remained relatively stable through the crisis, although it is expected to exceed the 10 per cent target set by the IMF in August 1997. Fear of a declared moratorium on foreign debt has eased with a dramatic improvement in the current account, which posted a surplus for the last three months of 1997 and is expected to reach US\$18 billion by the end of 1998.¹⁵

6.38 Malaysia has also been hit hard by the regional economic downturn. The ringgit experienced significant devaluation against the US dollar through the latter part of 1997, and stock market capitalisation has also been radically reduced. As at 15 December 1997, the Kuala Lumpur stock exchange's capitalisation had shrunk by 54 per cent to rm 375 billion

13 Exhibit No. 47, *The Economist*, p. 73.

14 Exhibit No. 47, *The Sydney Morning Herald*, 12 February 1998, p. 30.

15 Exhibit No. 47, *The Far Eastern Economic Review*, 19 February 1998, p. 57.

- down from a level of rm 807 billion at the end of 1996.¹⁶ Despite relatively low levels of external debt (estimated at slightly over 30 per cent of GDP), Malaysia has experienced a significant rise in the rate of non-performing loans and business insolvency. Financial sector turbulence, including interest rate hikes, has contributed to a sharp contraction in business activity, further undermining growth and employment. Government forecasts for GDP growth in 1998 now stand at 4 per cent (down from 8.2 per cent in 1996), with private sector forecasts ranging between 0 and 5 per cent.

6.39 Although less severe, the impact of the crisis on the other ASEAN economies has still been substantial. Singapore, which appeared to have been insulated from the worst of the currency and asset market declines, has subsequently begun to suffer from the flow-on effects of the economic downturn throughout the region. Most private sector growth forecasts for 1998 are between 1-4 per cent, compared with 7.6 per cent in 1997. Heavy private sector investment in the ASEAN region, particularly in Indonesia and Malaysia (estimated at more than 17 per cent of total bank lending), has resulted in significant exposure to non-performing loans, placing strains on bank balance sheets and profitability. Lower domestic consumption has to some extent been offset by continued growth in exports, including exports to ASEAN, in areas such as electronic components and chemicals.

6.40 In the Philippines, there have been some signs of resiliency to the financial contagion which has struck the region. Despite a decline in the value of the peso of around 34 per cent over the past six months, a balance of payments blow-out, high interest rates (approaching 30 per cent) and rising inflation, the Philippines economy managed to maintain some forward momentum into the new year. Full year GDP growth for 1997 reached 5.1 per cent, down from 1996, but higher than the 4 per cent predicted by the IMF.¹⁷ Government forecasts optimistically place growth for 1998 at 4 per cent, with private sector estimates ranging between 0 and 3 per cent. Of greatest concern is the balance of payments deficit, which ballooned to US\$2.3 billion in 1997, and the significant drain of capital flows essential to Phillipines high-growth export industries.

6.41 The other ASEAN economies have remained relatively insulated from the financial instability affecting the region thus far, due largely to their non-convertible currencies and lack of stock markets. The effects of the subsequent regional economic downturn are, however, likely to be felt in these developing economies in the medium term.

Implications for ASEAN

6.42 The implications of the regional financial crisis for ASEAN are far reaching. For individual members, the pains of significantly reduced growth, and hence output, have been compounded by substantial losses in real wealth. Many ASEAN governments are now faced with a range of social and political problems arising from climbing unemployment, reduced real incomes and purchasing power. They must also address the difficult task of restructuring financial sectors and improving the administrative and regulatory capacity of government in an economic environment characterised by uncertainty and instability.

6.43 The crisis also has a number of implications for ASEAN as a grouping. Perhaps most importantly, it provides an important test of ASEAN's ability to develop an effective

16 Exhibit No. 55(c), DFAT, Malaysia Country Brief, December 1997.

17 Exhibit No. 47, *The Far Eastern Economic Review*, 19 February 1998, p. 58.

regional response to difficulties facing individual members. The significance of this is not lost on some commentators. It has been argued that the economic turbulence could force the regional grouping, whose founding principles include non-interference in one another's affairs, to undergo a facelift. Where formerly, internal problems were sidestepped or ignored, ASEAN now realises that regional stability depends on being involved in each other's affairs.¹⁸ Recognising the need for a concerted, regional response has been an important first step for the association, but it has not yet demonstrated that it can play a role in helping economies of the region overcome their problems.

6.44 ASEAN's efforts thus far have tended to focus on addressing the effects of the crisis, rather than the root causes. In November 1997, ASEAN organised a meeting of regional finance and central bank deputies, ostensibly to develop a concerted approach to restoring financial stability in the region. In reality, ASEAN leaders were looking to muster international support for the establishment of a cooperative financing arrangement for the region, an Asia fund, that would operate independently of the IMF. Proponents of the Asia fund argued that such a facility would demonstrate the region's ability to handle its own problems, and enable countries to obtain rapid, flexible assistance. Regional partners, particularly Japan and the United States, appeared less enthusiastic about an 'independent' financing mechanism, which they argued would increase the risk of 'moral hazard' in regional financial systems. As a compromise, participants agreed to develop a number of initiatives which would support the work of the IMF, including: a mechanism for regional surveillance; enhanced economic and technical cooperation particularly in strengthening domestic financial systems and regulatory capacities; and a cooperative financing arrangement that would supplement IMF resources.¹⁹

6.45 More recently, ASEAN Governments have given consideration to a proposal by Malaysian Prime Minister Mahathir Mohammad to establish an ASEAN currency payment system for trade in local goods. It is argued that such a system would reduce the demand for US dollars and help regional currencies retain their value, either through denominating intra-ASEAN trade in the export source currency or establishing one currency - most likely the Singapore Dollar - as a peg. A number of commentators have argued that while the notion of using local currencies to transact regional trade is practical, it is likely to be of marginal benefit while the level of the intra-ASEAN trade remains low (estimated at around 22.8 per cent of total ASEAN trade in 1996).²⁰ Moreover, the idea of using the Singapore dollar as a peg would be made less practical if either Indonesia or Thailand proceed with plans to establish a currency board against the US dollar. Given these intentions, as well as Singapore's reluctance to link its dollar further to the region, it is unlikely that Mahathir's proposal will gain sufficient regional support to become a reality.

6.46 The regional crisis also has potential implications for ASEAN cohesiveness in the medium to longer term. While the grouping has been quick to project solidarity in the face of the crisis, if mainly by words rather than deeds, it remains to be seen how the grouping copes with the longer term pressures created by the regional economic downturn. For example, a sustained regional recession could further exacerbate ethnic tensions, already visible in Indonesia, social problems associated with large flows of migrant labour and possibly

18 Exhibit No. 47, *The Far Eastern Economic Review*, 19 February 1998, p. 26.

19 Summary of Discussions, Meeting of Asian Finance and Central Bank Deputies, 18-19 November 1997, p. 1.

20 *ibid.*, p. 25.

political refugees, and the effects of a range of environmental problems related to drought and unsustainable development. This in turn could sharpen regional tensions over domestic policies, and even slow plans to develop closer cooperation on economic security issues. There have already been hints that individual ASEAN members may be quick to dismiss regional interests if domestic problems worsen. The Indonesian Government, for example, has shown little regard for the strong concerns of Singapore, and to a lesser extent Malaysia, over its controversial plans to introduce a currency board, and little interest in the Malaysian proposal to establish a common currency peg to finance regional trade.

6.47 The regional crisis may also have an impact on the speed with which newer members become economically integrated into ASEAN. The expansion of the grouping to include Laos and Myanmar in July 1997 (and presumably Cambodia in the near future) was predicated, in part, on the assumption that the original ASEAN members, particularly Indonesia and Malaysia, would assume an active role in assisting these transitional economies become 'AFTA ready' faster. However, as the region's economic problems have worsened, there is some legitimate concern that efforts to help the new ASEANs become integrated into AFTA might be slowed, if not sidetracked. Fiscal tightening across the region, particularly in the hardest hit economies, will likely result in a reduction of resources available to help the new ASEAN members modernise their economies.

6.48 The crisis also has potential implications for both continued regional trade liberalisation and the implementation of ASEAN's regional economic cooperation agenda. Despite assurances from ASEAN leaders that the crisis had merely reinforced ASEAN commitment to push ahead with regional liberalisation under AFTA, as well as commitments undertaken in association with APEC,²¹ there are fears that 'protectionist' interests in the region could re-surface. Since July 1997, both Thailand and Indonesia have raised tariffs on a number of imports; however, these actions have been taken as revenue-raising measures under respective IMF programs, and have been within WTO binding commitments. To date, there has been no indication of 'backsliding' by ASEAN members on AFTA tariff reduction commitments, though it is more likely that any increase in trade barriers would be in the form of non-tariff measures, for example the use of customs surcharges.

6.49 Of more concern in the longer run is the potential impact of the crisis on ASEAN's capacity and willingness to focus on regional liberalisation and cooperative efforts. Most commentators agree that, if anything, the economic downturn should encourage regional economies to embrace more ambitious export-oriented growth strategies. However, the increased competitiveness of ASEAN exports resulting from significant devaluations to regional currencies is likely to boost extra-ASEAN trade flows rather than intra-regional exports.²² Given reduced domestic demand, ASEAN Governments may face some pressure from industry, to take a 'breather' from AFTA liberalisation commitments, particularly in sensitive areas such as processed agricultural products, and concentrate more effort on securing greater access to major global markets. Attention to domestic reform programs and other initiatives to improve regional resilience to large scale capital movements, may slow efforts to extend intra-ASEAN liberalisation to trade in services, and investment measures.

21 DFAT Transcript, p. 654.

22 Exhibit No.56, Manuel Montes, Growing Pains: ASEAN's Economic and Political Challenges, December 1997, p. 11.

6.50 In the context of broader efforts to liberalise trade through the APEC process, it is simply too early to gauge whether the regional economic downturn will affect ASEAN members efforts to proceed with sectoral liberalisation commitments made under the Manila Action Plan for APEC (MAPA). At the APEC Summit in Vancouver, British Columbia in November 1997, all participating ASEAN members committed to meet Individual Action Plan targets, and to proceed with voluntary 'fast track' liberalisation in a number of identified sectors, including: chemicals; energy; gems and jewellery; and environmental goods and services.²³ However, it is important to note that IAP commitments are voluntary (not binding) and that timetables for 'fast track' sectoral liberalisation have yet to be finalised.

Implications for Australia

6.51 Given the importance of the ASEAN region to Australia's trade interests, few expected the impact of the regional financial crisis to be negligible. Moreover, as the crisis has gradually implicated the economies of Korean and Japan, our first and second largest trading partners respectively, the likely impact of the crisis on Australia's trade performance and domestic growth prospects has become more substantial. Australia's export markets in South-East Asia will experience some softening, due to reduced growth in ASEAN import demand and increased reliance on domestic production. There will also be some contraction in export levels to Japan and Korea resulting from the slower growth in those economies. Most analysts now expect that the regional downturn (including North Asia) could reduce Australia's GDP growth by as much as 1 per cent, though the Australian Government has maintained its late 1997 forecast of 0.5 per cent.

6.52 It is perhaps still too early to ascertain the impact of the regional crisis on Australia's exports to the region. In evidence to the inquiry, DFAT acknowledged that the outlook was complex, with some exports, such as those considered to be luxury or non-essential items, likely to be more affected than others. It noted that some exports could even be affected in a positive way, if, given the real depreciation of the Australian dollar, those exports could be more competitively supplied to ASEAN markets than the like from the United States or Germany.²⁴

6.53 To date, there has been some anecdotal evidence of reduced demand for Australian commodities in ASEAN markets, particularly in Thailand and Indonesia. Livestock exports to Asian markets have already been significantly affected by the regional downturn, with the Cattle Council of Australia predicting export levels for 1998 between 40 and 60 per cent of the volume of cattle shipped in 1997. Reduced demand in Indonesia, one of Australia's largest markets, is expected to cause the most damage to Australia's live cattle trade, despite the recent provision of a federal credit guarantee package for exports to Indonesia.²⁵ Horticultural exports to Indonesia, Malaysia and Singapore are also likely to be affected; however it remains too early to forecast the extent. Similarly, the Australian cotton industry, which relies heavily on exports to Indonesia (around 38 per cent of total exports in 1996), now faces the prospect of severely reduced sales in that market, due both to the

23 Exhibit No.56, APEC Secretariat, 21 November 1997.

24 DFAT Transcript, pp. 660-661.

25 Exhibit No. 47, *The Daily Telegraph*, 12 February 1998, p. 22.

collapse in the Indonesian rupiah and the increasing difficulties faced by importers in obtaining credit.²⁶

6.54 A related concern for Australian export interests in ASEAN's shrinking markets is increased competition from the region's major trading partners, particularly the United States. While more aggressive competition is largely expected as a result of market crowding, the Australian Government has expressed concern that this may lead to unfair, predatory trade practices. The Australian Government has reported 'anecdotal evidence of the US offering extremely generous lines of direct, long term credit to Asian buyers with which Australia cannot compete'.²⁷ The Australian Government itself has provided \$300 million in emergency credit insurance for exporters to slumping South Korean markets, as well as an uncapped case-by-case scheme for export credit insurance to Indonesia. In early March 1998, the government announced that it would also provide up to \$380 million in insurance cover for the balance of Australia's wheat sales to Indonesia through the Export Finance and Insurance Corporation (EFIC). However, while the Australian Government has demonstrated a commitment to assist Australian exporters in certain ASEAN markets with additional trade insurance, it clearly lacks the resources to extend large scale cheap credit to buyers in prime commodity markets to protect Australia's market share.

6.55 Another expected casualty of the regional economic downturn has been the Australian tourism industry. According to the Australian Bureau of Statistics, total overseas visitors to Australia from South East Asia in December 1997 dropped by 24 per cent compared to December 1996, with major falls in numbers from Indonesia (53 per cent), Thailand (39 per cent) and Malaysia (31 per cent).²⁸ Together with significant reductions in tourist numbers from Korea and Japan, overall visitor arrivals to Australia dropped by 11 per cent for the month compared to the previous year, undermining forecasts of strong growth through 2000 that was expected to be lead by Asian markets. According to an Australian lobby group, the Tourism Taskforce, the cost in lost earnings to the Australian tourist industry would reach \$3.5 billion if the slump continued through the year. Combined with the expected growth in the number of Australians tourists taking advantage of reduced costs in Asian destinations, the Tourist Taskforce suggest that total losses to the Australian economy could easily reach \$5 billion.²⁹

6.56 Of course, reduced tourism earnings over the longer terms is likely to result in much weaker domestic employment, particularly in the hospitality and retail sectors. A Tourism Forecasting Council report issued in late 1997 concluded that a worst-case scenario of 3.6 per cent annual growth in inbound tourism would equate to job losses of 120,000 by 2006.³⁰ At this stage, however, it still appears too early to assess the likely extent of job losses resulting from the regional crisis, and indeed whether the recent fall-off in tourist numbers is the start of a long term Asian-induced downturn. Tourism industry analysts forecast no growth or negative growth in 1998, but expect a return to growth by 2000.³¹

6.57 The Committee recommends that:

26 Exhibit No. 47, *The Australian*, 18 February 1998, p. 4.

27 Exhibit No. 47, *The Australian Financial Review*, 6 February 1998, p. 8.

28 Exhibit No. 47, *The Australian*, 6 February 1998, p. 1.

29 Exhibit No. 47, *The Sydney Morning Herald*, 6 February 1998, p. 2.

30 Exhibit No. 47, *The Australian Financial Review*, 10 February 1998, p. 1.

31 *ibid.*

7. the Australian Government assist the Australian tourist industry, particularly through the Australian Tourism Commission, to increase promotional efforts in other key tourist markets, for example North America and Western Europe.

6.58 The regional economic downturn may also affect Australia's substantial commercial interests in participating in the development of infrastructure within ASEAN. In evidence to the inquiry in December 1997, DFAT acknowledged that there was some expectation of slowing down of infrastructure development, and that this would likely be more pronounced in areas dependent on government funding. However, it was also noted that the regional trend toward greater private sector investment in and funding of infrastructure would partially offset reduced government capacity to finance projects. DFAT also noted that the impact of the crisis on infrastructure development has been less acute than originally forecast, with a number of countries, such as Indonesia and Malaysia, either reinstating initially postponed projects or pushing ahead with existing plans.³² At the time of writing, there was little indication of immediate effects on Australian business interests in infrastructure related industries.

6.59 Amid general pessimism about the effects of the regional financial crisis on Australia's economic outlook in the shorter term, a number of commentators have emphasised that the crisis could provide Australia with opportunities to better position itself as a trade and investment partner to the region in the longer term. Some analysts have pointed out that the crisis should create opportunities for Australia, as a leader and innovator in financial sector reform, to provide technical expertise and services needed to reform Asian financial sectors.³³

6.60 In addition to niche opportunities associated with financial sector restructuring, Australian exports to ASEAN might also benefit from the devaluation of the Australian dollar against the US dollar in other areas, for example education and vocational training, medical services and in some sectors of goods trade (for example, intermediate manufactures). From an investment perspective, the significant reductions in asset prices across the region, driven in large part by outflows of European and US investment funds, have created a 'bargain' environment in which many Australian firms could find commercial advantage. There is already evidence that Australian industry may be benefitting from this window of opportunity. For example, an Australian trade mission to Thailand in the latter half of 1997 generated six new contracts for automotive component manufacturers; three involving the establishment of manufacturing facilities in Thailand and the other three involving distribution agreements.³⁴

6.61 In a broader sense, the crisis has also provided Australia with the opportunity to improve its credentials in the region. Australia's participation in the IMF co-ordinated facilities for Thailand, Indonesia and South Korea, as well as initiatives such as the Asian Finance deputies meeting, underscore our commitment to helping restore economic confidence and stability in the region. It also creates a climate of goodwill which may in the longer term open avenues for further trade expansion between Australia and ASEAN, as DFAT notes in the following:

32 DFAT Transcript, p.657.

33 Exhibit No. 47, AAP Wire Service, 25 November 1997.

34 Hartcher Transcript, p. 674.

Certainly Australia has received a lot of kudos from its willingness to participate in the packages and that has been recognised by counterpart ministers in their conversations with our ministers ... Obviously you have to be very subtle about how you use something like that as a mechanism for pushing ahead in a commercial trade sense, but it will certainly be part of the positive baggage that we take with us into our dealings with the region from here on in.³⁵

Conclusion

6.62 While the regional crisis has been far more severe than earlier predicted, the prospects for a return to robust growth in the region would appear to be strong. As a number of commentators have pointed out, the fundamental features of Asia's solid growth in the recent past have not changed:

[T]he hard work, entrepreneurship, high savings, low levels of taxation, family values and flexible labour markets that helped the region grow at 7-8 per cent a year for over a decade are still in place. So too the highways, factories and office towers these countries built at breakneck pace.³⁶

6.63 These fundamentals provide part of the foundation needed to sustain economic development and expansion. The other, more problematic, part has to be provided by the institutions ASEAN members have (or have yet to) put in place, particularly with regard to economic administration and regulation. The Committee recognises that while some countries in the region, particularly Singapore (and to a lesser extent) Malaysia have significantly improved their institutional infrastructure over the past twenty years, other countries have allowed institutional development to lag behind economic expansion. As the recent crisis has demonstrated, there remains a strong nexus between fully functioning, healthy market systems and clean and efficient administration.

What the region needs is to put in place a political system that places values on accountability and transparency, that controls corruption and sets up an administrative and regulatory system that is suited to the age of globalization.³⁷

35 DFAT Transcript, p. 664.

36 Exhibit No.47, *Far Eastern Economic Review*, 12 February 1997, p. 47.

37 Exhibit No. 47, *The Far Eastern Economic Review*, 12 February 1998, p. 49.

