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JOINT STANDING COMMITTEE

ON

**FOREIGN AFFAIRS, DEFENCE AND TRADE
(Foreign Affairs Subcommittee)**

Reference: Relations with ASEAN

CANBERRA

Monday, 1 December 1997

OFFICIAL HANSARD REPORT

CANBERRA

JOINT STANDING COMMITTEE ON FOREIGN AFFAIRS, DEFENCE AND TRADE
(Foreign Affairs Subcommittee)

Members:

Mr Taylor (Chairman)	
Mr Barry Jones (Deputy Chairman)	
Senator Bourne	Mr Bob Baldwin
Senator Chapman	Mr Bevis
Senator Ferguson	Mr Dondas
Senator Harradine	Mrs Gallus
Senator MacGibbon	Mr Georgiou
Senator Reynolds	Mr Hollis
Senator Schacht	Mr Lieberman
Senator Troeth	Mr Leo McLeay
	Mr Nugent
	Mr Price
	Mr Slipper
	Dr Southcott

Matter referred for inquiry into and report on:

The development of ASEAN as a regional association in the post Cold War environment and Australia's relationship with it, including as a dialogue partner, with particular reference to:

- . social, legal, cultural, sporting, economic, political and security issues;
- . the implications of ASEAN's expanded membership;
- . ASEAN's input into and attitude towards the development of multilateral regional security arrangements and processes, including the ASEAN Regional Forum (ARF);
- . ASEAN's attitudes to ARF linkages with, or relationship to, other regional groupings;
- . economic relations and prospects for further cooperation, including the development of the ASEAN Free Trade Area (AFTA) and possible linkages with CER;
- . development cooperation; and
- . future prospects - in particular the extent to which the decisions and policies of ASEAN affect other international relationships.

WITNESSES

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JOINT STANDING COMMITTEE ON FOREIGN AFFAIRS, DEFENCE AND TRADE
(Foreign Affairs Subcommittee)

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CANBERRA

Monday, 1 December 1997

Present

Mr Taylor (Chairman)

Mr Bevis

Mr Dondas

Mr Hollis

Mr Barry Jones

Mr Price

Mr Sinclair

The subcommittee met at 10.00 a.m.

Mr Taylor took the chair.

DAVIS, Mr Robert Brent, Director, Trade and Policy Research, Australian Chamber of Commerce and Industry, 24 Brisbane Avenue, Barton, Australian Capital Territory 2600

CHAIRMAN—Welcome. On this committee we have changed our rules a little in that, although we take evidence in public, we do not ask you to swear or affirm. But, of course, these are still legal proceedings of the parliament. We have received *The ASEAN free trade area: what's in it for Australian business?* as an exhibit to this inquiry. Would you like to make a short opening statement?

Mr Davis—Thank you, Chairman. The Australian Chamber of Commerce and Industry has had a long interest in affairs around the world, with Asia-Pacific being one of our most important marketplaces for Australian business and, within that, South-East Asia, which has come together in a group called ASEAN—the Association of South-East Asia Nations.

Our involvement with that region goes back at least 30 years, through the Confederation of Asia-Pacific Chambers of Commerce and Industry, which draws in about 20 national chambers from around the Asia-Pacific region, and the Pacific Basin Economic Council, which draws in about 1,200 firms from around the region. We host a number of bilateral business councils that cover the South-East Asia region and we have extensive lists with our sister national chambers in that region.

We also more recently joined with a number of our sister national business organisations in Australia to have a look at what you can do to build relationships with South-East Asia. Much of that work started before the recent currency and equity market turmoil, but is going to continue on regardless. In the paper which we have given to this committee, which was written originally to guide us in that work, we looked at the nature of ASEAN and the nature of the AFTA initiative. Of course, AFTA is not the totality of the relationship with South-East Asia. There is an investment parallel to AFTA coming through and there is a services one coming through as well.

As we point out in our paper, we think there is much to be gained from closer relations with ASEAN but, again, it has to be kept in perspective. The main game for Australia will always be the World Trade Organisation—the biggest bang per buck will always come from that mechanism. APEC will be important, although it is starting to get the wobbles a bit at the moment. We are not quite sure whether those wobbles will continue or whether it is just a bit of short-term shake and shudder. But in the intervening period we have seen the equity market and currency market turmoil, and I think that adds a new complexion.

In summary, our view on ASEAN is that it is worth building a relationship but we have to move along several steps. The first one is to bear in mind that ASEAN's first priority for itself will always be consolidation. It has taken on new members—Vietnam,

Laos and Burma—and there is the effort needed to fully consolidate and induct them into the process. They have to meet AFTA requirements, they have to participate in the new investment agreement, and so on.

There is the vexed foreign policy question of Burma. It is already rocking the boat with ASEAN and Europe, for example, and we have seen a meeting aborted because of the presence of the Burmese. We think there will be some more stand-offs in that quarter as well.

The next phase is how they respond to the currency and equity market turmoil. That is a very big issue, which I believe is before this inquiry. It will consume a lot of intellectual capital in many capitals of the world. The third component is outreach for ASEAN. But we are one of a number of options there for them. As one would have observed with their recent leaders' meeting, they had outreach programs with North America, north Asia, southern African, Europe, South America and us. So we were one of six. We are probably slightly ahead of the game in the development of those dialogues but, again, it does reinforce the fact that we are just one of six.

In closing, we do belong, with a number of our sister national trading organisations in Australia, to an ASEAN-CER business dialogue group that has been running now for about a year and a half. Our friends at the Metal Trades Industry Association took the initiative of getting that off the ground, and that has had some productive first steps. We are now into a second phase of how to strengthen that. The message coming from our colleagues in ASEAN is that they really want to start with, virtually, a two-hub and spoke system: the ASEAN Chamber of Commerce and Industry being the hub in Asia, and the Australian and New Zealand Chambers of Commerce being the hubs down in the Southern Ocean area. We are currently looking at how we can progress with that. It will be a slow process.

We believe that we are still in what we call the confidence-building measures phase, and that will take several more years yet before we even move into the trade facilitation phase. Following that will be phase 3, economic and technical cooperation, and then phase 4, trade liberalisation. We are aware that some believe we can get a free trade agreement between ASEAN and CER by 2003. We regard that as exceptionally optimistic but we think that, if we play our cards right and take it at a pace which is acceptable to the ASEANs, we can get a better relationship. But we are not putting any time frames on it, because we think we have a long way to go and we would prefer to take a cautious step-by-step approach rather than rush in at this stage.

CHAIRMAN—On the point you made about the other relationships between AFTA and NAFTA and all the rest of it, it would be fair to say that in the evidence that this committee has received there has been a lot of importance attributed in general terms, from an Australian perspective, to the strengthening of that relationship.

Mr Davis—Australia and NAFTA?

CHAIRMAN—CER and AFTA, in particular. But there does not seem to be the same sort of warmth or commitment from the AFTA end. You raised that in discussing generally your third point. In the light of what has happened in the last few months, with currency wobbles and internal problems in some of those countries, do you think we are being a little unrealistic in Australia in pushing that to the extent that we are? Or do you see some sort of reciprocal attitude coming back from AFTA members in due course?

Mr Davis—Just to clarify a point, we are talking about ASEAN, because AFTA is just one part of ASEAN and it is not the totality of it. Hopefully, the committee would think along those lines, too. As I alluded to in my comments, there is an investment stream and a services stream coming through. AFTA, which is a manufactures stream, will be one of the three pillars of that, of course. There is still the defence part—the ARF element. To answer your question more specifically, yes, the ASEANs are cooler on the relationship, as I alluded to.

There are about six of these dialogues going on at the moment, and they will continue like that. There could be a seventh coming through: I omitted to mention the one with the South Asia Association for Regional Cooperation—SAARC—which is the India grouping. One has to bear in mind that ASEAN has about 300 meetings per year and, of that, we have two meetings. There is an informal ministerial that takes place each year in about October, and there is a business dialogue that has traditionally taken place in March. We are now encouraging our CER friends to bring it back to October so that it goes back-to-back with the ministerial. We think there is receptiveness on that side.

We think we can achieve improved dialogue by staying with a modest pace in what we call the confidence-building measures phase, which we think will last for two or three years. It is a simple case of not knowing the chap or the lady on the other side of the table, and so it takes a while to learn and get to know them. Again, the Asian approach to doing business, which is probably well known to this committee, is very different from the western approach: one has to take that time in the three- to five-year cycle.

We think it can work but, again, we have to bear in mind what is in it for the ASEANs and, as I alluded to, they have got a very busy agenda for themselves. As you pointed out, Chairman, they have got the question of the currency equity market turmoil to come to terms with—and that is a very big ask—and then they have got to look at where we fit into the scheme of things. We are adopting a 12-to 15-year horizon on this.

There are a number of ways we can accelerate it. The APEC process is very useful, as it enables a lot of bilaterals to take place between leaders. We are working at it on a separate track, as well, through our Confederation of the Asian Chambers of Commerce network—20 national chambers—and the PBEC stream as well. So work is

taking place. A challenge or threat to it would be excessive ambition from the CER partners. I think we have to consult carefully and informally with the ASEANs and move along at a modest pace. If we stretch it too fast, then I think we could break it prematurely. There is little to be gained in moving too quickly in this phase.

Mr BARRY JONES—I was thinking of asking Mr Davis a question, because I know he is a lateral thinker. I was going to go out of this mode and actually look at the Kyoto conference. The thing that strikes me—and I am interested in your reaction—is that Australia is engaging in a massive exercise of special pleading which says, ‘Listen, we’ve got absolutely special circumstances that demand us putting in a default.’ But is there not a kind of inherent contradiction in that? When we are talking about free trade and WTO, we say that we want the chips to fall where they lie. We want an absolutely open situation. We do not want a protected or enclosed regime and we do not take account of special pleading. But then we go to Kyoto and say, ‘We do want you to take account of special pleading.’ Does it occur to you that it may weaken our credibility in other areas?

Mr Davis—I am not a gambling man, Mr Jones. But I remember a colleague of mine who did quite well in gambling activities and he said, ‘If you ever see a horse with "national interest" on it, back him every time.’ We are quite comfortable to see our government, of whatever persuasion, going forward and arguing Australia’s interest in fora, whether ASEAN, APEC or the WTO. I am not an expert on the Kyoto environment. I have a colleague who is. But his advice in our policy fora is that we are pursuing our national interests most vigorously. We believe that that is an important role for our ministers and our government.

Mr BARRY JONES—Absolutely. But we are also saying that the line that we are pushing when we are talking about the broader fora is to say, ‘You ought to push along with the process of opening up markets. You ought not to be hanging on to short-term national interests. You ought to be pursuing the long-term ones.’ The question is whether you look at national interests in a long-term or a short-term context, and the curious thing is that we have been the boy scouts, in a way, in a number of these areas where we were saying, ‘Even if there are initial difficulties, as Australia has had some initial difficulties, we ought to be pushing for the long term.’

But what we seemed to be saying on Kyoto was, ‘We think that really, in the circumstances, we ought to be pushing for the short term. The long term is too far down the track to be able to see: we can understand what short-term losses are.’ But it seems to me that we are pursuing two completely different concepts of what we mean by national interest.

Mr Davis—Again, in the Kyoto context, Mr Jones, I would have to get a colleague to come and speak to that. I have only got a very thin analysis from general statements.

Mr HOLLIS—What do you think is the long-term implication, for our trading

relationship with Asia, of the current upheaval that they have been going through? There was a program over the weekend—which I must say I did not see, but I just saw the trailer of it—which was saying that we are going to cop the impact on what has happened there in two years time or so. What is your reading of it?

Mr Davis—We have got people going up through Asia all the time and coming back to us, and that is one of the issues we ask them to look at. You have got to break it into two components: the short-term response and the long-term response. The short-term response is quite natural. Most people are, to use the metaphor, pulling their heads in and hunkering down. Australia has been through a sudden shock like that, 10-odd years ago. Mexico went through it five-odd years ago, and now it is hitting Asia, both South Asia and North Asia.

From our discussions around the region, a lot of them are naturally shell-shocked. You do not see a 30 per cent fall in your currency and a comparable fall in your equities market without really making any sharp response to that. It is like being hit by a bus and just regarding it as a minor flesh wound. Well, it was not. You were hit by a bus. That is what has happened up there. So what we expect is that a lot of the economies up there will, if you like, just stop and take reconnaissance of what has happened and I think, in the short term, there will be a lot of countries that will be proceeding very cautiously.

Now it is still not abundantly clear from a lot of them how they are proceeding under the IMF intervention. For instance, Indonesia called in the IMF and only asked for policy advice. They did not take the money and that was a very good strategic move by President Suharto. Thailand, for instance, needed the advice and the money. But in the case of Malaysia, it was unclear. They rejected all the advice and so they do not need the money. Although there are stories circulating, on which we have not had any official confirmation, that Malaysia will be calling on the IMF to take the money but not the advice. We now see that Korea has come forth and said, 'Yes, we need the advice and the money'. Now part of the problem is getting the money for Korea. One does not sort of pull roughly \$A80 billion out of a hat. That is a very big ask for the global capital markets. Of course, we are now wondering what is going to happen in Japan and Japan may respond itself.

In the short term, we think there will be something of a pause. We do not know whether it will impact on our trade performance but tourism and the student intake will probably dip quite markedly because they are the most obvious short term. Much of our commodities trade with Asia is based on long-term contracts. So it will not hit in the near term but it will be in the year two, year three stuff, when some of those contracts are up for negotiation. But again they tend to take a long-term mind-set.

Moving to the longer term, say, 2002 or 2003, many of these economies—if they take the bitter medicine, if they go through the necessary structural changes—are going to come out of this like an absolute rocket, which is a lesson for Australia, for Britain when

they had the interventions and for Mexico. Former Prime Minister Keating, when he was treasurer, talked of a J curve and was maligned for it. If you imagine a J curve, you are going to see these economies roar ahead now. Thailand might have a few problems, but if they take the medicine and they use the emergency funding wisely not just as a cover for some indebtedness—that is, if they use the funds almost as investment money—they are going to do exceptionally well. If we are better integrated with them, if we can get some trade liberalisation out of them now, while their currencies have depreciated, which is a logical time to move on liberalisation, if you will, we can hold on to the tiger's tail with two hands and watch the tiger run in about four to five years.

Mr HOLLIS—Yes, but won't there be a lot of scepticism about where the tigers are going? I mean, they have always been pointed out as an example of what to do. And suddenly, you talk about Mexico. That was one country. We have now got a region and the old domino effect is actually coming into play, as you see one country after the other falling like that. Countries, it seems to me, always have a history of not using that investment money wisely. I am not an expert on it, but it seems to me that a lot of people will be looking with a certain amount of scepticism towards Asia in future, especially when they are considering investment.

Mr Davis—I think you will see a lot of corporates still viewing Asia in a very positive light. You are absolutely right that they have not used a lot of the money very wisely in the past. It was funded as speculative bubble. Thailand is an apposite case where they just funded into the stock market and into property speculation. A lot of it was wasted money. I would not deny that there is a bit of seepage around Asia into corruption as well.

But I think the IMF is the critical difference in the two circumstances. To get the money, you have to take the IMF intervention. Now this is not advice which you listen to and then proceed. The IMF stays there and, to use a metaphor, sits in your treasury and watches what you do very intently. It is bitter medicine but, from our observation, those who have gone through the IMF intervention have come out better for it, because it is not just a matter of making sure that the money you are given is spent wisely. There are a lot of other policy changes that you have to go through—greater transparency in your public accounts, holding down inflation and taking some bitter medicine in some of your industrial areas where structural change is needed. You have to make some hard decisions about old industries. If you have got labour laws that are clogging up the system, you have to bite the bullet. If the tax system is full of holes, you have to plug them up. In some cases, you have to undertake substantial tax reform. So we would see that a part of that will put them on a more solid platform for the future.

Mr DONDAS—Mr Davis, is the ACCI or its members monitoring what is happening, for example, in Indonesia in the construction industry? I ask the question in the context that at the moment, I understand, there are something like 2½ million construction workers in Indonesia unemployed. It is very likely that, by this time next year, something

like four million construction workers are going to be unemployed. They are just walking off the job because of the financial crisis that exists in Indonesia. If it is happening in Indonesia, it has got to be happening in Malaysia and other places. What are we able to do to monitor that situation? If you have got four million unemployed construction workers in Indonesia, especially in Jakarta, in 12 months time it is going to have some impact on our trade and doing business with those people.

Mr Davis—One of the observations we have made in the past, and one of the lessons of the 1987 stock market shake-out, is that when you go through an exercise like this often you see what you call capital flight from the financial economy to the real economy. That was one of the great lessons of the late 1980s after the stock market fall. In one respect, that could happen again. What Mr Dondas refers to is probably quite accurate. A lot of people are stopping and taking stock. A lot of that labour is effectively day labour where there are people wandering in from the provinces into Jakarta and making themselves available on a day rate. The question of whether those people drift back to the provinces in response is unknowable. It is probably doubtful. Whether they drift off and become illegal labour in other parts of the world is a question that could be asked. But taking Mr Dondas's proposition one step forward, Asia is uniformly suffering the same contagion, so it is doubtful that they will drift off to other countries like Singapore, Malaysia and so on.

In Indonesia, we think it is probably part of a speculative bubble. Maybe some consolidation of policy will take place and you may well find that enough money flows back into the real economy that those projects kick-start again. We would think that those behind them, if they have poured substantial amounts of money into some of these big infrastructure programs, cannot allow them to sit and waste because in the tropics you get what is called concrete cancer which destroys the concrete and the infrastructure that you have already built. You either finish it or you demolish it. Perversely, there may be some work for the four million people in demolishing what they have already built. As in Thailand with the overhead highway, you either have to finish it or demolish it.

In many respects the future of these projects will depend on their underlying economic value. If they were just built for speculative purposes, then the outcome will be different from if they have a real fundamental value. For example, in Thailand, they still need to do a lot about their transport system. All around Asia, they still need to do a lot on power generation. Just because they have had what some people have called a hiccup—we do not put it that lightly; we call it one hell of a jolt—does not obviate the need to do a lot of things in a lot of areas. After some sort of interregnum where people take stock and reconsider where they are going, as I say, it could take off again quite quickly.

CHAIRMAN—Can I just take you back to the Bogor declaration and the move towards greater liberalisation of trade? Again, in the light of what has happened in the last few months—currency and other issues—and most recently, listening to what Mahathir had to say at APEC about that, do you think that a degree of backsliding might take place

in some of these ASEAN countries?

Mr Davis—In fact, in the case of most countries, I think we would be happy for the breather. As we read the individual action plans—and our Prime Minister has as much as admitted it—most of them are a nice consolidation of existing policy. There is very little in the IAPs that is new or specifically written for APEC. In one respect that is useful. There is a lot of transparency. It forces a lot of governments to put in one place a lot of very valuable information and, if one likes, pin their colours to the mast. But, of course, with APEC, we had hoped for more. We hoped it would be a vehicle for liberalisation, just not a library of existing facilities.

Our concern now with APEC is probably twofold. The idea of priority sectors we thought was worth while as long as it did not detract from the individual action plan approach. It appears that it is going to detract and that is of concern. When we thought priority sectors, we thought that was a good idea—four or five of them, where we would see real outcomes in a defined number of areas. We thought that was substantial. When we heard it was 15, we were—how can I say it—less than impressed. Fifteen and priority does not seem to sit naturally to us. It is almost an oxymoron. Then, of course, the admission of Russia dramatically changes the nature of APEC far more than people realise—both the admission of Russia and the nature of its admission.

We think APEC will go forward. We think it is useful. If nothing else, it is a backstop for governments to stop them going backwards. It does not necessarily mean that they will not stop; they may go forward slower. But at least it stops them from hitting reverse. One saw that in the tariff debate here with TCF and PMV. One of the most current themes with the current government was, ‘We can’t raise tariffs because of our APEC obligations.’ Leaving aside whether that is true or not, it was useful for putting a ‘de-minimist’ position in there. In terms of APEC going forward, we think it has a little turmoil ahead, as I mentioned, probably in those three areas.

CHAIRMAN—Is the turmoil as a result of the Russian admission?

Mr Davis—The admission of Russia, the nature of the individual action plans and the nature of 15 priority sectors. Our concern would be that governments, with their finite resources to devote to this sort of activity, will use those same resources to focus on the 15 priority sectors that would otherwise have been devoted to the individual action plans. So the IAPs will be a stocktake of existing policy around the region, but they probably will not be a spearhead to take us forward. It will be those priority sectors.

In time, when we get a new millennium round of the WTO, that might again feed into that process. But we suspect that, with the admission of Russia, you will start to see the political strategic issues rise up in APEC. We are not sure whether that is the most appropriate vehicle. As one looks at many of these things around the region, it is always very clear to keep the political/military in one stream and the economic in another. We

think that is a very wise strategy.

Mr BARRY JONES—I just want to ask one general question about your document, *The ASEAN free trade area: what's in it for Australian business?* First of all, it does tend to be rather general, and there is very little of a specific nature, for example, about what the internal impediments could be about Australian and Indonesian trade, irrespective of whether it is without ASEAN. There are some fast-track opportunities for certain persons in Indonesia. But there is nothing here in that report. Has your organisation done any specific reports at the bilateral level of some of the ASEAN participants like Malaysia, Indonesia and so on? If that is the case, is it commercial-in-confidence or is it generally available? If it is available, could we see it?

Secondly, I notice this is dated October 1997. If it was rewritten for December 1997, would the document be radically different? If so, what sorts of things would be different?

Mr Davis—We have not done any specific chronologies of trade barriers in the ASEAN countries. That sort of information does come up to us through the ACCI as well as through our various bilateral chambers and business councils. We have generally passed that information on to the Department of Foreign Affairs and Trade through its market development task force, which is a very useful initiative for dealing with some of these bilateral problems. We do take them up from time to time when our groups meet together.

Again, in terms of the ASEAN process, our emphasis at the moment is a confidence building measures phase. To leap straight into what would amount to trade negotiations on trade barriers would be too much too soon. So, in fact, as a conscious policy decision, we have avoided doing that. We think that sort of trade negotiations issue is five, seven or eight years down the track.

As to whether we would rewrite the paper any differently, no, we think the conclusions are still much the same—that is, ASEAN-CER is probably worthwhile in the longer term. Our priorities must be confidence building measures at this stage. There are still a lot of discussions needed about restructuring the nature of the business-to-business relationship. On balance, we think that the dividends over APEC are probably modest and the main game will remain with the WTO.

If anything, the main change we would make is to reflect on the nature of the currency equity market turmoil, which probably means we adopt a more cautious, tempered approach over a longer time frame. So if anything else—to respond to Mr Jones—we would just say, 'Take it slower, take it more cautiously and take it longer with respect to the currency equity market changes.' They would have slowed the process rather than accelerated it.

Mr BARRY JONES—Perhaps I misunderstood. I thought you said that the

benefits from the APEC linkages were likely to be modest.

Mr Davis—No, the ASEAN linkages.

Mr BARRY JONES—Sorry, I just wanted to clarify that.

Mr Davis—We drew upon the modelling work of the Centre for International Economics, which we believe has been before this committee. All sorts of arguments could be made about economic metric modelling, but we think it is indicative and probably right. There are modest benefits from ASEAN over APEC. Of course, the whole modelling may change if we get a new millennium round under the WTO.

CHAIRMAN—Thank you very much. Did you want to make any final comment before you go?

Mr Davis—It struck me that, initially this was an inquiry into Australia's relationship with ASEAN, which we thought very worthwhile. What has struck us from the questioning is the implications of the currency equity turmoil. It occurred to us that a special inquiry could be worthwhile because the nature of the people who would volunteer for an ASEAN inquiry might be terribly different from those who would come forward for a more specialised inquiry into the currency equity market. In fact, we would put in a submission ourselves that was structured very differently. We might leave that as a pregnant thought for the committee.

Mr SINCLAIR—There is something I did want to ask. The one thing that worries me about the present crisis is that people have not realised the degree to which the Japanese banks are so significant in the lending pattern in most of the countries of Asia. The Koreans and the Taiwanese are also there. I just wondered to what degree in business this affects the actual trade between us. Essentially, as I understand it, Japan has gone into a raft of investments in each of the ASEAN countries. Of the ASEAN group, Thailand and Indonesia—and to a lesser degree Malaysia—have these very major investments which must be not as secure as they were. Just as in Australia, the Japanese have been withdrawing their investment. Have you had any signs of that? Do you see that that will have any impact at the moment on our ASEAN trade flow and, if so, what?

Mr Davis—Mr Sinclair has probably hit on the big unknown, the great uncertainty and the big worry of where we go for the future. How does the Japan issue play out? In the short term, we think there will probably not be a huge increase in Japanese lending into South-East Asia. I doubt if they will force the liquidation or anything else of those investments where the investments were made to business houses. The business houses would have taken commercial risk into account.

The capital investment that was funded by the Japanese banks for Japanese firms in South-East Asia is probably reasonably settled. That does not mean servicing that debt will

not be harder in more difficult environments. If the consumers in Thailand or Indonesia are pulling their heads in because of the battering from the currencies and equities market and the loss of confidence, then some of those markets will go softer. We think that that will create some difficulties, but we would expect the business people to go through that. Whether they can go back for supplementary funding is another issue.

The more interesting question is: how do we go for the future with funding of Japanese business going into Asia via the financial institutions? There is a very big bad debt problem in Japan. Their state of denial is probably over. The next step is getting government authorities in Japan to do something about it. They have been in denial for about eight years. It will be interesting to see whether they continue to deny it or are prepared to make some hard decisions.

Letting Yamaichi go under was positive. Several other banks have been allowed to go under in the last few months. That is not an open-ended case of just letting the market take care of it. There can be some quite bold actions. Markets are very unforgiving things. They can do in three months what governments may like 10 years to do. What policy makers would like to handle in a managed way, markets will do quite savagely. They will get there more efficiently and effectively but, whether that is the best path, is a moot point.

In terms of how Japan proceeds, Japan could probably do with some good advice from the IMF about how to handle the unwinding of its financial bad debt situation. I do not have figures in front of me. I am sure Treasury and Foreign Affairs could give you some figures. I do not think I would be thrown out of court for saying some of those bad debt figures are astronomic.

We are already hearing stories of Japanese businesses and financial institutions liquidating assets abroad. We do not think that will be dramatic at this stage. I think that the Japanese will adopt a middle course between denial and biting the hard bullet. They will take a middle course which really says, 'Let us just bring it back gradually. Let us do what we have to do.' But they still will not make some hard decisions about really puncturing that bubble.

Probably the most significant issue for them is how they value property on the balance sheets of their financial institutions. Property and equity values are largely done at historical or book price, and they are up about here. In reality, their market value is about down here. The quickest way to get a good picture of the books of a lot of these institutions is to change the law and say that assets have to be valued at market rates and not at book rates. Then secondly, make some allowance for the dramatic jolt that it will make. But for the time being in Japan we hope that in the choice between denial and hard decision, they will lean towards the hard decision because we do not think time allows them any more to stay on in that area of denial.

Mr SINCLAIR—But at this stage not many of them have valued their assets other than at the price of acquisition, or at some inflated rate, and unless they are prepared to exercise some realism in looking at the value of their assets, there are going to be troubles.

Mr Davis—To do that they would have to have some comfort from the Ministry of Finance that with their cash flow position problems the Ministry of Finance would stand behind them. The message that we are picking up is that they are not exactly clear on that. To do that, I think it would have to be a case of making a charge. Several of them would have to do it together as the one bit of medicine and a sharp jolt over two years. We are not quite sure at this stage whether the Japanese financial system is amenable to, or capable of, doing that.

Mr SINCLAIR—Brent, the one reason I wanted to ask you another question was that it seemed to me that perhaps through your ACCI there might be an opportunity—perhaps, by surveying your members—to get some idea of the position to see whether there is something that needs to be done from the point of view of Australian investors, practitioners, traders, whatever. Have you done that and, if so, what is the result?

Mr Davis—At the outset we are sending people up through Asia all the time and we are taking anecdotal evidence from them. The overwhelming messages coming back in the short term are that most business people in Asia are hunkering down—to use a metaphor. They are taking stock of the situation. As I indicated, if one loses 30 per cent of a currency in the equity market in three months, it is a sharp shock to the system. For the foreseeable future, the message coming back to us continually is one that says, ‘We are just stopping and taking stock of what has happened to us.’ Our expectation based on experience elsewhere in the world—and taking a longer-term view—is that they are going to come out of this like an absolute rocket. Australia and Mexico are worth studying in that regard.

So, it is a question of how they respond to the situation with the IMF; whether they just take the money, listen to the message and ignore it; or whether they take the message on board and do something reasonable, and we are seeing a mixed experience around Asia on that. Mr Suharto appears to be listening and taking some of the message, as well as the money. Thailand is taking the money and the message, it appears. Mr Mahathir has got his ears closed it would appear.

Mr SINCLAIR—The reason I ask is that we have had some views put to us that this seems to be a wonderful time for Australia to re-establish her position in the region. Those who are there now when the market does take off again are going to be remembered. At the same time you have got to be open-eyed and register the proper concerns there are and react responsibly to them.

Mr Davis—About a fortnight ago a businessman said to me, ‘There are a lot of

lovely, cheap market opportunities up there at the moment.' All he has to do is get up there and have a look around. But his view for the time being is to sit and wait and just see how it plays out. So, I envisage that he will probably spend much of January up in Indonesia and Thailand looking at opportunities .

CHAIRMAN—Could I just ask you a final comment on the Asian fund facility to supplement IMF? Does the ACCI have a view on that? Is that a step in the right direction?

Mr Davis—Our view has been that as long as it is subject to the IMF rules, it is fine. If it is an alternative to the IMF, then we are not so convinced. The great problem with all of these things, of course, is the moral hazard which says, 'Somebody else will bail me out now.' A concern within the Asia fund is that it does encourage that moral hazard. It is seen as an alternative to the IMF and it diverts financial resources away from the IMF. One of the big problems that I alluded to was that if there is a big bailout required for South Korea, where is the money going to come from? There are an awful lot of takers out there, but not many givers.

CHAIRMAN—Yes. Thank you very much.

[10.41]

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**RICHARDSON, Mr John, Assistant Secretary, North-East Asia Branch, Department
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CHAIRMAN—We have changed our rules a little in this committee. We do not expect you to be sworn or affirmed but I remind you that these are formal proceedings of the parliament.

Thank you very much for coming along this morning. I think it is about six months since DFAT first appeared on this inquiry. A lot of water has flowed under the bridge since then. You heard Mr Davis in the questioning refer to one or two events. We thought it would be an appropriate opportunity to get you back to outline some of these developments, not necessarily strictly related; Mr Sinclair raised the North Asian situation because it does appear to impact on the ASEAN relationship. We will ask you to make some general comments about developments since we last met. I think that is probably the best way to play it. Thank you, Michael.

Mr Potts—Thank you, Mr Chairman. The department is pleased to be here. As you say it is a very topical occasion just to take stock of what has been happening in the region. In my brief remarks I want to focus essentially on Australia and ASEAN but certainly we have a wide range of departmental expertise represented here and we are obviously open to questioning from a more general perspective.

Looking to ASEAN first I think I should highlight the expansion in ASEAN membership. Laos and Burma are now members bringing ASEAN pretty close to the vision of an ASEAN of 10. But, of course, the exception at the moment is Cambodia. It had been expected to join ASEAN in July with Burma and Laos but, following the outbreak of fighting in Phnom Penh on 5 and 6 July, there was a pretty general feeling within ASEAN that it was better to wait and to hold Cambodian membership in abeyance until the situation settled down. The thinking at the moment is that at this stage Cambodia

is likely to be admitted to ASEAN after the national elections in Cambodia next year. They are scheduled to be held in May.

For our part we have been very pleased with the role that ASEAN has taken over the events in Cambodia. It has played a leading diplomatic role through its ministerial troika, the foreign ministers of the Philippines, Thailand and Indonesia, and they have kept the international focus on the holding of free, fair and credible elections on schedule in Cambodia.

We, in Australia, have played an important part in cementing more general support for ASEAN's leading role, particularly through Mr Downer's efforts at the ASEAN ministerial meeting in Kuala Lumpur in July. That has been followed by Australian participation in the so-called Friends of Cambodia meetings. The most recent one was held in Vancouver in the margins of APEC about a week ago.

On Burma: we have also been looking to see what progress the international community can bring about in terms of moving towards better observance of human rights standards and some progress on democracy. Mr Downer has raised our concerns at the General Assembly, at ASEAN meetings, at the ARF, and also at bilateral meetings in the margins of these wider groups. In our dealings with ASEAN, we continue to make known to them, and also to the Burmese government, our strong concerns about the situation there. As you know, I think Mr Downer sent a senior officer of the department, Mr John Dauth, to Rangoon as his special envoy in September to raise our concerns directly with key government leaders in Burma. It is fair to say that since Burma joined ASEAN in July there has been some modest—and I emphasise the word modest—progress in the country. Having said that, there have also been a number of backward steps, particularly the fact that Daw Aung San Suu Kyi has not been able to attend a number of township meetings with her party activists. It is fair to say that relations between the two sides remain very testy.

Just looking for a minute at the ASEAN Post-Ministerial Conference, it is fair to say of course that Cambodia was its major focus. There was also, as I mentioned, a specific focus on Burma and Mr Downer took the opportunity to speak in some depth with the Burmese foreign minister, U Ohn Gyaw.

More widely, Mr Downer also announced a number of initiatives with regional countries. These included the establishment of bilateral security dialogues with the Philippines, with Thailand, with China and with Vietnam. With Malaysia, he established a more regular ministerial dialogue, plus increased cooperation in sports administration and in IT as well as announcing a double taxation agreement. With the Philippines, he also announced a regular ministerial dialogue involving business people and academics, and the first such dialogue has recently concluded. A survey of Australian investment in the Philippines, and an exchange of visits between foreign ministers. This sort of grab bag of announcements and initiatives testifies to the continuing utility for Australia of the

whole ASEAN process and our dialogue status with it.

You will know also that ASEAN economic ministers met in October. Among the highlights that came out of that were the AFTA council's endorsement of the CEPT package. Member countries will begin implementing that in 1998. AEM ministers approved an initial package of liberalisation of services. These are to commence no later than the end of March next year. They are focussing on five sectors: air transport, business services, maritime transport, telecommunications and tourism. Finally, looking at the AEM, it was agreed that liberalisation of services should be done on a sectoral and a subsectoral basis rather than product by product.

In conclusion, there are probably three small things to mention. First, the second ASEAN informal summit will be held on 14 and 15 December in Kuala Lumpur and that will have a focus on commemorating ASEAN's 30th anniversary. The ASEAN leaders will also meet with heads of government from Japan, China and Korea at that time. The second point to mention is that there will be a meeting of the finance ministers of ASEAN and the five countries which contributed to the IMF assistance packages for Thailand and Indonesia today and tomorrow, 1 and 2 December. Mr Costello is attending from Australia.

The third point to mention is that I am pleased to highlight the fact that we were invited for the first time to participate in the meeting of the ASEAN committee on culture and information, COCI, that took place in Malaysia in July. We advanced a number of proposals at the meeting including an initiative to develop a regional ASEAN policy and strategy on cultural heritage. We have invited the chairman of ASEAN COCI, Mr Choo, to visit Australia as a guest of the department. I am happy to leave it at that and, obviously, to invite questions.

CHAIRMAN—I think you came in as I was asking Mr Davis—and I will ask you the same question—to go back to Bogor and the declaration and trade liberalisation, and in the light of everything that has happened in recent months, whether there is an indication of any backsliding. We heard Mahathir in Vancouver making some usual Mahathir comments in relation to a question mark about the liberalisation process. Is there evidence that there has been or is likely to be some backsliding by some of our ASEAN neighbours, in particular?

Ms Fayle—No, there is no indication at this stage, apart from, as you say, some public comments by certain individuals. Certainly, at the APEC ministerial meeting and the APEC leaders' meeting in Vancouver, it had in fact quite the opposite impact. There was a great desire on the part of ministers and leaders to demonstrate a reinvigorated commitment to the liberalisation process as part of the confident messages they wish to deliver to the international markets about where the region is heading.

In a sense, it has had the opposite effect. It has reinvigorated a desire to move

ahead and to maintain the momentum of liberalisation. There are certainly no specific instances, other than in the content of IMF packages where a number of tariffs have been raised—within binding commitments, though—to extract further revenue for governments as part of IMF packages. As a general result of their reactions and the policies that are being put in place, there is no indication of a desire to increase protection in the markets affected.

CHAIRMAN—Yet you see in the most recent Malaysian budget an indication of increases in tariffs.

Ms Fayle—I think those increases are within binding commitments. However, as I said, they are for revenue purposes. They tend to be on luxury items; there is no overall indication. For example, in Korea's case, they have just reduced protection on some 180 items.

Mr BARRY JONES—You will have noticed that Ms Hanson, among others, has indicated some alarm about Australian participation in financial bailouts in South-East Asia. There is obviously a broad concern to understand precisely what it involves, how far Australia is committed, whether we expect to see any of the money back and whether there are collateral benefits down the trail. In particular, in the case of Indonesia, given the rather Byzantine nature of business relationships with the government and so on—family connections and the rest—are you optimistic about the prospect of Indonesia being able to meet its international obligations and to continue on the reform process?

Mr Heseltine—I could just make a couple of comments on that. We have absolutely no reason to have any concerns about that. Indonesia in the past has always had an excellent record in paying back its loans. In the case of Singapore, which as you know participated in a very large way in the package with two tranches of \$US5 billion, it was an issue that got an airing in the Singapore media in respect of whether the funds from which the Singapore package was coming were in danger. Statements from the Singapore government indicated that they had full confidence in Indonesia's willingness and capacity to repay and they made that same point—that Indonesia has had an excellent record in the past.

Mr SINCLAIR—One part of the Asian growth that really still puzzles me is that you have a very high domestic savings rate in Asia and there has always been a lot more money held within the families and not put out in the system. Much of the growth has been funded overseas rather than being funded domestically. To what extent is there, within most of the countries of ASEAN, a significant domestic pool of money that is sort of stored as cash or not in the system? They are all related, so just let me put them out, because I am interested to know what sort of answer you will give.

Secondly, much of the significant ownership of property and of business has been in expatriate Chinese hands. I am not too sure whether that is family money or where their

money comes from. Sure, they have borrowed wherever, but how significant is that expatriate Chinese link? What role is that going to play in this present financial crisis?

Thirdly—this is a bit related—most of them have fairly significant overseas surpluses. I gather that much of that is invested in areas that is not easily returned, and you have a debt on the one hand and a credit on the other. In a country like Japan, when they started having troubles with their over-valuations in the CBD properties over the last five or six years, you have seen companies starting to return their capital by selling properties wherever they are.

Is that a factor which is going to have any bearing in Australia? I do not know what ASEAN investment there is in Australia. Brunei, of course, has significant investments, but I do not think Brunei is in trouble. What about others? Is that going to be a factor? In order to get their money back, are they likely to sell assets and businesses that they have in Australia? They are three different, but related, questions. That is in the first order.

Ms Fayle—I might start on that and then ask some of my colleagues to chip in. In terms of the high domestic savings rate, you partly answered your own question with the second point. A lot of the domestic savings, certainly in the expatriate Chinese families, have been used to invest in their own businesses and have driven a lot of the growth, particularly at the small and medium-sized firm level, in a large part of the region.

However, it has been a factor of growth in South-East Asia over past decades that they have been fairly largely dependent on international capital, originally in the form of development assistance programs and then, increasingly, as they opened to foreign investment and put in place certain structures, they were inviting a lot of foreign direct investment. Certainly, you are right in saying that foreign direct investment has played a large role in the development of those economies and a substantially larger role in the savings levels that are there.

In terms of the role of the expat Chinese families, it would differ in different economies. It is a substantially different role in, say, Indonesia, to what it is in Thailand, to what it is in Malaysia. It is very different in different economies. There is no doubt that they play a very strong role in key parts of industry and in key export industries which are going to bear the brunt of some of the recovery over the next few years. I would imagine that they will play a substantial role in pulling these countries back to stronger growth paths.

In terms of the Japanese issue that you spoke of and pulling money back—I will ask John Richardson to follow this up—certainly there has been a history in the past—we have experienced it in Australia as well—of the Japanese pulling out of investment in real estate or other forms of investment that is relatively easy to cash out in order to bring the money back home to help when there is trouble at home. There are certainly expectations

that that may be a factor that we look at over the next 12 months to two years as Japan tries to deal with what is essentially for them a domestically driven financial crisis rather than one imposed by regional developments.

Mr Richardson—I certainly agree with the comments on Japan. There is no doubt that, given the very high debt equity ratios of a number of Japanese institutions, they will try to improve their balance books, and that will also be the case in Korea. To that extent, you would expect that they would seek to rebalance their financial assets. I think your question was directed to whether that would occur amongst South-East Asian institutions. Logically, you would expect it to as part of an overall financial restructuring.

I suppose one key question is whether it will lead to the sell-off of existing assets or simply a reduction in outward investment. I suspect, in the case of Japan, it is more likely to be a reduction in the flow of outward investment rather than necessarily a sell-off of existing assets, except of the assets which are non-core assets.

Mr Potts—I should comment also on Mr Sinclair's question on South-East Asian investment in Australia and what knock-on effect that might have here. The level of investment from South-East Asia is reasonable, but not huge. The three big investors among the ASEANs would be Malaysia, Singapore and Brunei. I think it would be Singapore first, Malaysia second and then Brunei. Only one of those countries really has been knocked around all that much in the currency problems up until now. Indonesia has some investment in Australia, but I think it is only in the region of 20 million or thereabouts.

Mr BARRY JONES—How much?

Mr Potts—About 20 million. Thai and Philippine investments are close to negligible. There will be some effect certainly from Malaysia. Historically, Malaysian investment in Australia has concentrated on property, although not exclusively. There has been some investment in the mining sector in particular and some in industry. I would imagine, nonetheless, that Malaysians would be pretty cautious for the moment.

Ms Fayle—While those investment figures are generally termed official investment figures, we have known for some time that official investment statistics tend to understate the flow of investment from particular countries. That is simply because of the way the transactions occur. For example, a lot of the so-called Singaporean investment in Australia may in fact originate in Indonesia or some of the other ASEANs because it goes through financial institutions there.

Mr SINCLAIR—The second question relates to directions of spending in these countries. Obviously, if you go to Bangkok, every crane is standing idle and there is a demonstrable termination of work effort on major buildings. But the secret of the growth of many of the countries has been their infrastructure development. If infrastructure is

stalled, it is going to have a far greater ongoing consequence than if you just stop building. Buildings are buildings. You can either restart the building when demand takes up or set it aside or whatever. Infrastructure is different. Much of the infrastructure has been funded by World Bank and the Asian Development Bank, and by multilateral rather than bilateral funds. What is the state of play across ASEAN in terms of infrastructure spending? Is it also stalled or has it been maintained? What is happening to it?

Ms Fayle—It is a little difficult to ascertain at this stage. Certainly, some major infrastructure projects are being put on hold in the region. There is also an overriding trend in the region, however, towards greater private sector investment and funding of infrastructure projects. That tends to reduce the weight on the government sector in those countries to fund these projects. The government sectors have been putting on hold a number of projects in an effort to constrain government spending as part of the steps that they are taking to deal with the crisis.

Infrastructure, the financial sector and the level of skills have been three watch points that the department has had identified for a number of years now as possible areas that might impede the progress of growth in the region. We have seen the financial sector one come to fruition, I guess. In terms of infrastructure, I do expect that there would be some impact and some slowing down in infrastructure development and that that would also play through into some slowing of growth paths in the region.

Mr Potts—A comment on detail would be to contrast Thailand with Malaysia and Indonesia. In Malaysia and Indonesia, the governments there have announced the deferral of a number of significant infrastructure projects. In the case of Thailand, the impact seems more to have been on the property market rather than infrastructure development, for the moment at least. I am aware in Thailand of only one major infrastructure project that has been deferred, and that has been because of internal financing problems rather than external problems.

Mr SINCLAIR—In their five-year plans there has been an ongoing series of new infrastructure programs. Are they still ongoing, apart from the one that you mentioned? Have there been any new ones started? Has only one stopped or are they all now stalled?

Mr Potts—Certainly, historically, they have been ongoing. In Malaysia the government has a series of 15 to 20 very large national projects and a proportion, maybe a third, has been deferred. There are obviously no new projects being brought on to compensate for that for the moment; there has just been a run down in government spending. I imagine the intention is to try to pick it up in the second half of the five-year cycle but, even so, there are definite constraints on how much growth you can engineer down the track.

Mr Heseltine—It is early days yet and the picture is a little patchy. Certainly in the case of Indonesia it is relatively early on. During the currency crisis they did announce

the postponement of 15 infrastructure projects, but they were subsequently reinstated. The problem for the Indonesian government is that of all the difficulties they face, unemployment is the biggest single one that they are focussing on at this moment. They are obviously very mindful of the employment effects.

As far as Malaysia is concerned, I am not aware of any curtailment of infrastructure projects. They announced the week before last the establishment of a National Economic Action Council, which is a fairly unusual move on the Malaysian government's part—setting up a body like that. Over the coming weeks we will see the results of their deliberations.

Mr SINCLAIR—Dr Mahathir made some announcement over the weekend allowing a greater measure of overseas investment in projects too, which seems to be indicative of change. On another matter, is China now attracting more overseas investment than the ASEAN countries, or is it still too early to say?

Mr Richardson—It is too early to predict any trend in that respect. China has always been a very large recipient of FDI over the last few years. It will become more apparent over the coming months as to whether there is a redirection, but it is too early to make any real judgment on that at this point.

Mr SINCLAIR—We have seen some quite reasonable growth in trade between the countries of ASEAN. Part of it is AFTA related and part of it is naturally the growth of their economies and the fact that they have ways by which they can do business with each other. Has that been affected by the drop in currency values? Is there any stalling of that growth in trade between the countries of ASEAN? Is it still too early to gauge what the effect of the falling currency is going to be on trade with Australia, with trade out of the ASEAN region, as well as trade within the ASEAN region?

Mr Garner—Whilst it is still a bit too early to determine whether trade within the different regions will be hit in a significant way, over the past few years it is apparent that ASEAN trade to North-East Asia has been increasing along with North-East Asian trade to ASEAN.

Mr BARRY JONES—Which has been?

Mr Garner—ASEAN trade to North-East Asia—

Mr BARRY JONES—Has been increasing?

Mr Garner—Trade has been growing strongly between ASEAN and North-East Asia, with North-East Asia exports to ASEAN growing at a slightly faster rate than ASEAN exports to North-East Asia. But, in terms of the overall levels of trade, one of the reasons at the moment that you have got significant falls in equity markets is that there is

a view that companies' profits will be lower in the region because of lower levels of trade. So the markets are viewing it as saying that there will be lower levels of trade within the region for the short term.

Mr SINCLAIR—Why is the level of trade from ASEAN to North Asia falling? I would have thought, with currency devaluation, their commodities would be cheaper and therefore there would be an increase.

Mr Garner—At this stage we have not seen the impact of the currency depreciations on the levels of trade. It has been a longer-term pattern.

Mr SINCLAIR—Is that because of the components of the trade?

Mr Garner—Yes, that is right.

Mr SINCLAIR—What do they sell to North Asia?

Mr Garner—Electronic equipment and capital intensive products. Also there is commodities trade.

Mr SINCLAIR—Maybe towards manufacture: so it would be silicon chips towards producing TV sets, et cetera.

Mr Garner—That is right.

Mr DONDAS—Live cattle exports out of the Territory have been very positive in the past few years. Is there likely to be any great impact on that now with the currency crisis that we are facing in Asia?

Ms Fayle—There already has been an impact with some reduction in the shipments of live cattle to Indonesia. The cattle people expect that that will continue probably for some time. That is simply because beef is a luxury item to an extent in Indonesia, and so it is one of the products that is likely to be affected soonest by any reduction in levels of growth in the market. Similar products—tourism, and education services—are also likely to be affected more than our exports of inputs to production of exports in those markets. There has already been a bit of a downturn, but there is a seasonal downturn anyway at this time of year in our exports. However, the figures do show that it is a greater downturn than would have been expected due to seasonal factors alone.

Mr DONDAS—I asked the ACCI representative this morning about the construction industry in Asia and more so in Indonesia. At the current time, there are about 2½ million unemployed construction workers in Indonesia. That figure is likely to blow out by this time next year to about four million. What likely impact is that going to

have on our region—hypothetically?

Mr Heseltine—Obviously, the construction sector in Indonesia has been the first and most heavily hit, and that is, as you say, already showing up and will continue to. It is obviously of great concern to the Indonesian government. As I mentioned before, the unemployment problem will be most seriously and immediately affected in that sector.

In terms of what it is going to mean for the region as a whole, it is a bit hard to tell at this stage. I would imagine, and I think it is already showing, that companies, including Australian companies, in the building materials business are probably in for a fairly tight time. Similarly, companies involved in property—and there are a number of Australian companies and other regional companies in that sector—will also be affected.

Mr DONDAS—So we are monitoring it?

Mr Heseltine—We are.

Mr BARRY JONES—Given the depreciation of the currencies of many of the countries of ASEAN, what are your projections about what effect it would have on their trade with us? Presumably it is going to make it harder for us to sell to them and much easier for them to sell to us. Have you done any quantitative estimates about what impact there is likely to be?

Ms Fayle—We have not done quantitative estimates at this stage, because the volatility is still there. We have done some qualitative examination of the situation. It is a fairly complex mix. Certainly, South-East Asian exports will be cheaper for us to buy, but it is a little difficult to assess to what extent that will involve replacing our imports from other countries. We may perhaps switch from a Korean product to an Indonesian product or from a Chinese product to an Indonesian product, if the devaluation suggests that it is a cheaper product. That may then have nothing other than a positive effect on Australia in the sense that our imports are cheaper overall. However, there is also likely to be some increased importing from the region, I suspect, particularly given that domestic demand in Australia is particularly strong at the current period of time. Most expectations from Treasury and ourselves are that we are likely to suck in a few more imports as a result of the devaluations.

Mr BARRY JONES—So the Indonesian car industry might come good after all?

Ms Fayle—I do not know about that. I would not go quite as far as saying that. In terms of our exports, yes, they will be more expensive in these markets. That may not necessarily affect all exports. As I said earlier, it is most likely to affect the sorts of things that are considered to be luxury items, where there is a choice of whether to spend the money or not on things such as beef, education services and tourism services.

It is less likely to affect products that are seen as essential inputs into their own production capacity such as intermediate manufactured items, parts, raw commodities and primary products. Staple food products are less likely to be affected where there is no obvious substitute within those markets. It is a very complex picture, with some products affected and others not. Some could even be affected in a positive way if, given Australia's own devaluation, we are seen as a more competitive supplier than, say, the United States or a European supplier. Given the complexity of that sort of picture, we do not have any accurate quantitative assessment at this stage.

CHAIRMAN—Could I just change tack a little and perhaps hear some comments about the ARF? Would it be reasonable to say that there has already been a changing face to the ARF? How much do you see of the ARF changing in the short to medium term?

Mr Potts—I think it is fair to say that it has already changed in many ways. It has gone past that initial skittishness and reluctance to talk about issues that were seen as sensitive by the neighbours. I think that comfort level has already been created. The big question, I guess, is now how long will it take before they go a little further down the agenda and move into the very hardest of issues. I suppose we are probably talking half a decade to a decade, perhaps, before you get to that next threshold. That is a very impressionistic sort of read-out because these things are influenced by mood, I think, and by a lot of intangibles. That is probably our sense.

Mr SINCLAIR—There have been general talks that perhaps some link between AFTA and CER would be a good thing. That has not got off the ground at all, has it?

Ms Fayle—No, it is not accurate to say that. There has been an ongoing dialogue between AFTA and CER. If you are talking about turning it into a preferential trade arrangement, then that has not got off the ground. But we have actually had some successful outcomes from the dialogue, particularly in the area of standards and customs. In the customs area, a big outcome recently was the publishing of a handbook on customs procedures of all the ASEAN and CER countries. The focus has been on trade facilitation issues and there has been considerable progress there. Quite frankly, it has also provided an extra area of dialogue on issues that affect the ASEAN countries, Australia and New Zealand that we did not have before. It has been extremely beneficial in that sense.

Mr SINCLAIR—I do not know where the devil it comes from, but we have got a review of ASEAN's political, security, economic and functional cooperation and external relations since the 29th AMM/PMC in July 1996. Was that prepared by your department, do you know? Where did that come from?

Mr Potts—Off the Internet.

Mr SINCLAIR—Off the AFTA web site? I see. I just noted that one of the things that hits you—it is off the AFTA web site, so obviously it has to be right—that what was

being progressively developed was the frequency of meetings at all levels through ASEAN. How are they getting on? Are they still meeting frequently? Are the new members, particularly Myanmar and Laos, playing a part? What are they doing with Cambodia? Is Cambodia coming in as an observer? What is happening?

Mr Potts—Essentially, Cambodia is being treated as an observer for the moment. I think with new members, you have already got a first tier and a second tier in the sense that you have the original five plus Brunei. Vietnam has become a fairly active member. It services most of the meetings—we are talking about basically 300 meetings a year—out of Hanoi, although it uses its embassies in the region to some extent.

Mr SINCLAIR—Do they meet all round the region?

Mr Potts—Yes, all round. With Laos and Myanmar, what you see is essentially the local embassies generally servicing meetings. It is being done on an incremental basis for them as they build up the number of ASEAN literate bureaucrats in their own governments.

Mr SINCLAIR—What about the obvious problems with the IMF? Are they all being dealt with in a bilateral basis or is ASEAN looking at the deals with Thailand, Indonesia and so on?

Mr Potts—Not in a structural sense, I don't think. But it is obviously the case that when their finance ministers, especially, meet they would be swapping notes. I imagine also that as a particular country considers whether it needs to come to an arrangement with the IMF, it calls on one or two of their neighbours that have already had dealings with it for a second opinion.

Mr SINCLAIR—How do we find out what goes on? Do we rely on the place where the meeting takes place or just the rapport that develops between our second secretaries and others across the divide? How do we find out what happens in those meetings?

Mr Potts—There are a whole range of monitoring devices. Some are simply by our embassies keeping a very close eye on the ASEAN calendar. The second element is liaison with the ASEAN secretariat in Jakarta. We have a very good dialogue with them. Thirdly, in a number of specialised areas, the habit of consultation between Australia and its ASEAN neighbours has developed very strongly. People now tend to get on the phone quite a lot to their colleagues when an issue is live.

I will give you one or two examples. We have had a longstanding officials exchange program with the Indonesian government. The result is that we have secondments of three to six months in particular ministries. That has led to our having easy points of access to their particular ministries. For instance, when we have a regional

problem like the haze problem or something like that, we will have contacts within their department of environment who can be contacted directly from Australia.

Ms Fayle—In terms of the IMF issue that you mention, there are also a number of other dialogue fora in which Australia is involved. At the financial minister's level of course there is an APEC financial minister's meeting. But at the finance deputy's level, the secretary to treasuries and finance departments levels and also the deputy governor of the central bank levels, there are a number of existing meetings that occur. Those individuals are in fairly close contact anyway on an ad hoc basis between meetings. Also, in the case of Indonesia, one of our Reserve Bank officials is part of the IMF team that is in Indonesia. So we have the capacity to have fairly extensive information on what is going on there.

Mr Heseltine—I was about to make much the same point. But I might just add—it has already been mentioned, but it is very significant—that the ASEAN plus six finance ministers are meeting today and tomorrow, which involves the IMF on the first day and then it goes into other meetings the second day. So there is an example where Australia has actually got a seat at the table, as it were.

Mr SINCLAIR—Has Australia decided to change its attitude towards, for example, the Mekong project and so on or are we still letting things run as they are?

Mr Potts—I would not say that we are letting things run as they are, because that is just too much permissiveness—laissez faire. What we are trying to do, first of all, is to get a sense of where it is headed now that several of their key economies are inwardly focused. We have been talking especially to the ASEAN secretariat and to the Mekong committee in Bangkok to see what their sense of the evolution of their projects—in particular their infrastructure of projects—is likely to be. It is too early to get much of a sensible read out from them, but you would have to think that there would be some fall off in momentum at least.

ACTING CHAIR (Mr Barry Jones)—I was interested in your comment that we are now against laissez-faire.

Mr DONDAS—In terms of the discussions that are going on with the IMF and the bail-out, it is all very pleasing to know that we are getting involved in high levels of discussion and can pick up phones and talk to people. But in terms of the currency swap with Thailand and the bail-out with Indonesia and possibly now further financial considerations going to Korea, are we placing ourselves in a position where we can pick up all these good things we are doing as good neighbours at some future date and at least expand our areas for further trade?

Because as I move around Asia I always get a distinct feeling that, while Australia is doing all the good neighbourly stuff, New Zealand is knocking us off for the trade. I

know what I am saying. We seem to be behind the eight ball all the time and New Zealand seems to be in the forefront in terms of its distribution of produce throughout the region. Are we going to use this catalyst of being a good neighbour to get in there and drive a harder bargain for us? That is DFAT's job—not hypothetically.

Ms Fayle—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. It has been recognised at the highest levels. 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.

It has always been our aim to demonstrate that we are engaged with the region and this has been one way that we have done that. So, yes, we will use it positively, albeit subtly from here on in. I think you have to be realistic in looking at New Zealand. I would certainly stress that the absolute level of our trade with the region is much greater than New Zealand's. So you need to be carefully listening to the positive rhetoric coming from the New Zealanders on this issue.

Mr DONDAS—I get a bit tired when I go to the Sheraton group or the Hyatt group throughout Malaysia and every time I get a butter patty it is always a bloody New Zealand butter patty.

Mr SINCLAIR—I notice you are all linked together here today, yet really within the department we essentially focus on a bilateral basis, do we? Do you talk ASEAN? When you are preparing for ARF—which is probably one of the more significant of the groups and we have not spoken about ARF—do you meet and look at where you are bilaterally and what you want to get out of ARF? How do you determine what your policies are going to be towards ARF or do you look at the issues that you know are coming up and try to do it the other way? Within the department how do you structure your policy towards particularly an ASEAN regional forum meeting?

Mr Potts—The best way of answering that in a sense is to say that the year has an annual rhythm and it really comes to the fore in July for PM&C and the ARF meetings. Typically, what you have over the three months before is a huge amount of consultation. I was going to say intra-departmental consultation, but it is wider than that, especially on questions like the ARF. That would involve Defence obviously, but also PM&C and Treasury to the extent that some issues have economic dimensions and so on. There is a reasonable discipline to the approach that we bring and it is done on a fairly hard-nosed and forensic basis, especially given the way that the year develops.

Mr SINCLAIR—Who sponsors that? Is it done by DFAT or does PM&C say, 'We've got an ARF meeting.' Will these departments meet together? Do they have an inter-departmental committee that gives their input? Is that the way it is done?

Mr Potts—It is certainly a DFAT responsibility and within DFAT it is the South and South-East Asia division that has the prime carriage and my branch in particular.

Mr SINCLAIR—There are issues at the moment in, for example, the migration field. We always have worries about what is happening with a few of the minority groups in Myanmar, where they are and what is happening to them. Do you get migration in? Who makes those decisions, or do you worry about your own people with UNHCR who tell you what is going on? How do you handle those issues that are not perhaps directly involved, but are very much behind the security concerns we have?

Mr Potts—We try to do it on a whole of government approach, especially when we are doing the annual briefs for PM&C and the ARF. We seek briefing contributions from a wide range of departments. It goes beyond that in a sense. If we do detect that there is a thematic issue which goes across most of the region, we will call ad hoc meetings and so on with, for example in this case, the department of immigration to talk through how we approach a particular issue. In fact, probably in most areas of DFAT we spend a lot of time on consultation with our colleagues in other departments.

Mr SINCLAIR—I have two other questions. Firstly, ASEM, the Asia-Europe Meeting, has slipped to the back burner because of Europe's attitude towards Myanmar. What is your current position on ASEM?

Mr Potts—It is probably a little unfair, at least from the way the Australian government approaches it, to characterise it as slipping a bit onto the back burner. The position remains the same from our perspective: that we are very interested. We have applied to join on the Asian side of ASEM and that remains our wish. It is subject to a consensus and there is not yet a consensus. We take suitable opportunities of reminding the existing membership on both sides of our view, including those that we sense are not 100 per cent convinced of our claims.

We see it as a process that may not yield fruit next year at London, although that has been our short-term objective. But certainly we see it as an important national interest, one that we are going to continue to promote, but at the same time it is not one that we are going to put at the top of every foreign policy agenda.

Mr SINCLAIR—It was suggested that we got some support from a few countries, and Japan in particular, but that Mahathir might even accept our joining ASEM, providing the East Asia Economic Caucus concept was allowed to proceed. Is that still on the drawing board, or is that just waiting in the wings?

Mr Potts—It is certainly the case that we have had some very valued support from good friends—mainly in the existing ASEM membership—and they have been helpful, and in many cases assiduous, in reiterating our case to their colleagues in their meetings within ASEM.

As regards Malaysia, I do not know that it has ever been put in the sense of, 'We will be more accommodating towards you, if you are more accommodating on EAEC.' We certainly do not have that sense at all. Rather, what the Malaysians have been saying to us is, 'We understand where you are coming from and in our minds, it is not a question of if, but when.' We are waiting, in a sense, for them to try and cross that mental barrier from the 'if' to the 'when' stage.

Mr SINCLAIR—I know Barry was always very keen on forward planning, but has the department sat back and thought, 'Twenty-five years hence do we want to belong to ASEAN? What relationship will be there between the South Pacific forum and ASEAN? Where is Papua New Guinea going to be?' Have you sat there and had a bit of a navel gaze? If so, could you enlighten us on what you reached?

Mr Potts—I do not know that we have done it in more than an overall conceptual basis. The starting point for looking ahead in our foreign policy and the way we see the white paper, that looks 10 to 15 years out. We certainly do have informal brainstormings with the department from time to time. But, because of their imprecision and because you are dealing with a very volatile environment in the zero to 25 range, I am not sure that the results of those brainstorming sessions give much to inform current policy options.

Mr SINCLAIR—Surely, that is what you do with your strategic bases paper, and you have just completed it.

Mr Potts—Yes, that is certainly the case.

Mr SINCLAIR—Why can't you tell us where you are at in your non-strategic area? Somebody needs to look and say, 'If this happens, this will happen.' You have got all sorts of predictions; we all know those. I just wanted to get an idea of where all of you saw it happening.

Mr Potts—Your problem in this is where you say, 'That one thing might happen and then this will happen,' but, when you are looking at the probability for the first thing happening, you only give it a relative possibility and the more imprecisely you go out from there the less you have something on which you can base much in the way of hard-edged forward planning.

We do have a policy planning unit, which operates within the executive secretariat of the department. They spent a lot of time in the formulation of the white paper in particular. The other area of the department which does a fair amount of forward planning is the strategic assessments branch in the defence area. They obviously work very closely with the Department of Defence.

ACTING CHAIR—You would remember the celebrated remarks of Dr Mahathir about George Soros and the extent to which the decline of the Malaysian economy had

been as a result of his direct speculation. Nevertheless, one could imagine that, given the circumstances, there could be people who stand to benefit by the deterioration of and also by a rapid appreciation of the various currencies. Is there much evidence since the decline and since the depreciation that speculators are interested in driving the rates down, looking towards a recovery later on? Has much work been done on it?

Ms Fayle—I think you probably have to ask Treasury officials. That is moving a little bit more into their area than ours. Certainly there has been a feeling that the markets have overly punished some economies when you look at the whole range of macro-economic fundamentals, as well as the finance sectors in those economies. There are a number of published articles and papers around to suggest that the markets have overshot and there will be some coming back. I would imagine that speculators have played a role in that to the extent that it is true, but we do not have any detailed information on that sort of activity.

Mr Heseltine—Indeed, what to do about that kind of situation is on the agenda at the meeting in Kuala Lumpur today and tomorrow. There is a sense that what you are talking about is happening and that there is a lack of transparency about how all these things occur.

Mr Richardson—A critical role of anyone investing in any market is when to sell out and buy back in. That is a perfectly normal function and that is quite separate from what I think you might have been implying in your question.

ACTING CHAIR—Okay. We have been told that Mr Hartcher has been delayed. He was going to follow at 11.30. We can either keep on talking or we could adjourn for half an hour or thereabouts unless people are bursting to ask anything more. We might adjourn and I think we will probably have to have a ring-around when Mr Hartcher arrives. Thank you very much and I look forward to our continuing.

Short adjournment

[12.32 p.m.]

HARTCHER, Mr Peter, Asia-Pacific Editor, Australian Financial Review, 201 Sussex Street, Sydney, New South Wales 2001

ACTING CHAIR (Mr Barry Jones)—In the absence of the chairman, I declare this meeting resumed. This is the final public hearing of the inquiry being conducted by the Foreign Affairs Subcommittee of the Joint Standing Committee on Foreign Affairs, Defence and Trade into the development of ASEAN as a regional association and Australia's relationship with it.

We prefer that all evidence is given in public, but should you at any stage wish to give evidence in private you may ask to do so and the subcommittee will consider your request; that would mean it would not then be recorded by *Hansard*. It used to be the convention that the committee required people to give evidence on oath. That is no longer the case, but I still have to warn the witness that these hearings are legal proceedings of the parliament and, as you know, the parliament takes its own hearings very seriously—

Mr Hartcher—What is the value of a journalist's oath, though!

ACTING CHAIR—Anyway, they have the same status as proceedings of the House itself. Peter, thank you very much for agreeing to speak to us. If you would like to give an introductory statement, then we will have questions.

Mr Hartcher—Sure. Journalists, as you know, generally focus on the short term and the immediate, so I thought I would take the luxury of this appearance to step back from the entire regional economic circumstance—

ACTING CHAIR—Incidentally, I should have interpolated that you are currently Senior Editor (Asia-Pacific Affairs) of the *Australian Financial Review* and have written extensively on this area. I am sorry I did not put that in.

Mr Hartcher—That is all right. There is a big remarkable profound phenomenon that has been going on world wide that is remarkably undiscussed and unnoted—that is, the return of the former communist world into the global market economy. The return over the past decade or so of China, India, Vietnam, the Eastern bloc and Russia itself has brought a tremendous new supply of labour and productive capacity into the world market. These are blocs and areas, as you know, that were locked out of the global market economy for most of this century, and they are back.

To make their way in the global market economy, what mechanism are they using to get through? It is a heavy dependence on exports. The first chart that I have supplied gives you a look at how, particularly in the most recent couple of years, industrial production almost worldwide has been increasing faster than has real consumer spending.

In other words, we are looking at a global glut. Everyone is madly pumping out exports, yet domestic demand is not growing fast enough to keep up with that pressure. This big new surplus of global productive capacity that has come onto the market in the past 10 years has been also compounded by some of the big rich countries with their own problems of stagnation and economic reform: most notably, Japan—which despite a decade of rhetoric has been absolutely unable to do anything to stimulate domestic demand—and Europe, another tragic failure of reform that we know all too well.

As to the combination of these events, the second chart shows some IMF numbers which summarise what has happened to global trade, both in volumes of trade and in the prices of trade. If you have a look at the 10-year averages columns, you will see that in the past decade, basically in the 1990s, the average growth rate of world trade in terms of volume has increased. But the value of that trade and the rate of price increase has fallen away very sharply because, although there is a lot more trade and it is growing faster, there is also much more competition, and this is taking the inflationary urge out of the system.

This goes a long way towards explaining the deflationary or disinflationary trend that has now taken hold in economies around the world, including in our own, and it is much remarked in the US. People are still grasping to understand the cause of it, but this is a very profound trend and movement. There is a tremendous pumping out of new exports from the former communist countries, of course, in addition to the tremendous export growth that the rest of Asia and the other market economies were already producing. You have got that going on at the top level as the overarching trend.

Then we come down to South-East Asia. Let us have a look at what has been happening there. The boom in South-East Asia, already a decade old, was starting to come under strain in the past few years. The third chart challenges the fallacy that Asian companies are inherently efficient. You can see that, for five of the eight countries in Asia, excluding Japan, for which there was a five-year history, earnings per share for corporations in those markets were actually falling or failing to keep up with the economic growth rate. In other words, the companies in these markets were not extracting value from the growth surges that they were riding; they were quite clumsy surfers on the wave of Asian economic growth, and that performance had been getting steadily worse as years went by.

Even while that was going on, while corporate returns on shareholder funds were declining, the capital kept pouring in. The fourth chart is a summary of total funding inflows to ASEAN countries for this decade until 1996. There is far too much detail for anybody to comprehend quickly, but it shows that funding from all sources into ASEAN economies over those six years was running at an average compound annual growth rate of 19 per cent. At the same time, nominal economic growth in these countries was only 13 per cent. So there was a funding flow, year after year, which was six per cent faster than economic growth. It was no wonder you had a liquidity glut and no wonder you had all

this money swishing around in the system looking for somewhere to go. Declining investment returns on top of that produced an economic boom that was starting to look pretty tatty through its own performance and the maturity of the expansion phase in South-East Asia.

Then two things happened to put the entire show under particular duress. There was a double whammy. The first was in 1994 when China—which had been, as you know, gradually re-entering the market economy and relying very heavily on export growth to drive its economy—devalued the renminbi, and there was a de facto devaluation of 25 per cent. Chart No. 5 shows the real effect of exchange rates of China versus ASEAN over the decade since 1986. For 1994, when China devalued but the ASEANS did not, you can see quite a sharp effect: the ASEANS' exchange rates were roughly stable.

So the Chinese bought themselves a huge competitive advantage. They cranked up their export growth tremendously as a consequence of that. China was having 30 per cent export growth annually averaged over the years following that devaluation. So, at the bottom end, the cheap end of the market making cheap toys, cheap textiles, cheap electronics and all that sort of stuff, you have a big new competitive pressure from China.

The second part of the double whammy came from another devaluation, a much undernoted one, in Japan. The background to the Japan devaluation, which has turned out to be far more profound than anyone could have imagined—

ACTING CHAIR—Which year was that?

Mr Hartcher—In 1995. Japan got itself, as you know, into a combination of economic stagnation and financial system distress. In 1995, in the throes of a severe banking crisis, the Japanese went to the Americans. Specifically, the guy nicknamed 'Mr Yen', Mr Sakakibara from the Ministry of Finance, went to Larry Summers at the US Treasury. They had studied together. They had a long personal relationship. And now they were interlocutors across the bargaining table.

Larry Summers said, 'We are tremendously worried about your banking system, and your banks hold \$US400 billion of US treasury bonds. We are worried that they are going to sell them to try to fix their tattered, battered balance sheets at home.' Sakakibara said, 'Look, there is a solution. You help us to devalue the yen. The yen has been far too high, making it difficult for our exporters. If you help us to devalue the yen, we will be able to export our way back into growth. With that growth, we will use the opportunity to restructure our economy and grow our banking system back into health.'

The Americans sent a team of treasury officials to Tokyo to examine the situation, discovered that it was in fact as severe as Sakakibara had described, and launched a joint and very successful program of monetary policy and money market intervention, effectively to push the yen down quite sharply. The yen, since its peak in that period, has

now fallen almost 60 per cent. This is obviously a very big devaluation. Why is that important? Why is that significant for Asia?

Pick up the sixth chart and look at those three charts at the top of the page. They correlate movements in the yen and US dollar exchange rate with Japan's investment in the region and, below that, overall economic growth in Asia, excluding Japan. What you can see there—and this data is from Nomura Securities, by the way—is a remarkably close degree of correlation. When the yen gets stronger, Japanese companies—in order to avoid the high cost of production at home—invest more in South-East Asia and China; hence the second chart. When the yen goes up, they rush overseas and set up more factories overseas. The scale of this is almost unimaginably large. In the past decade, on average, Japan has been shifting one per cent of its manufacturing base offshore. It is the equivalent of relocating the entire economy of Singapore every year. It is the exchange rate that drives that.

The other factor that kicks in is that, when Japan's exchange rate goes up and its competitiveness therefore declines because its goods become more expensive to the rest of the world, this is a competitive fillip for its competitors in the region, most notably Korea and Taiwan, but it assists everybody directly and indirectly. It assists all of Asia to grow faster. If you look towards the end of those charts, in the final year, 1995, with the yen-dollar exchange rate, because of the deal between the ministry of finance in Japan and the treasury in the US, when the yen rate fell, it also slowed the rate of Japanese investment in the rest of Asia and punished the overall economic growth rate in Asia.

What you have got is this double whammy, with the Chinese devaluation operating to undermine the competitiveness of ASEAN exports at the lower end of the spectrum, with the Japanese devaluation operating at the same time setting up the stresses with declining foreign investment and a declining overall growth rate in the region. That is why you suddenly get this tremendous pressure on the South-East Asian economies, capital flows out, and you get de facto devaluations. We are now in the acute phase of the crisis that we have all read about in recent months. I will not bore you with the detail there because you know it far too well and, in any case, it is a short-term dislocation.

There will be continued pressure on South-East Asia because the knock-on effects that it has transmitted north will rebound back to the south. There are many interconnections. For example, South Korea, which is now, as you know, in the hands of the International Monetary Fund, accounts for around a third of all the overseas foreign debt held by Indonesian companies.

As a consequence of the problems with South Korea now, South Korean banks are going to be much less willing to refinance or even sustain that lending to Indonesia, therefore there is going to be more financial pressure on Indonesia as South Korean banks retreat, and ditto with Japanese banks. There are many of these interconnections and knock-on effects that will continue to keep South-East Asia under not just the existing

pressures, but new pressures as the crisis worsens in North Asia. The pressure is going to stay on.

The other sitter that has not really been perceived yet, but I think it is going to be in the coming months, is the pressure that South-East Asia is now putting on China. We talked before about how the 1994 devaluation from China had put pressure on South-East Asia, and now it is coming full circle. About \$US40 billion worth of China's exports every year compete directly with South-East Asia's exports. Therefore, that \$US40 billion in Chinese exports is now directly under pressure from the devaluation of the currencies in South-East Asia.

An autonomous slowdown has been going on in China for the last couple of years. One measure of that deflationary urge has been that corporate profits of listed Chinese companies have fallen 75 to 80 per cent over the last two years. Real interest rates have gone from zero to about nine per cent, and we have just started to see in the data from China, zero inflation—in fact, falling inflation—in the latest monthly figures, plus we have seen GDP growth falling from 9½ per cent to eight per cent in the last quarterly numbers. That trend will continue into next year. Chinese growth domestically will continue to slow.

At the same time, the Chinese are going to be taking pressure on their exports because of the pressure from South-East Asia. If you have a look at the seventh chart I have supplied there, you will see what the devaluations have done to affect the comparative costs of labour. This is just one other measure of the pressure that China is now applying to South-East Asia.

Until now, China's wage costs have been far cheaper than everybody else's on the chart. You will see that now it is comparable with Indonesia's. They are very much in the same league. That is a partial indicator, but it is an important one. It is another indicator of the pressure that China is going to come under. We can certainly expect a serious slowdown in China's growth next year, and possibly another devaluation of the Chinese currency next year.

The big picture consequence of what is already happening in Asia and the global consequences show up in the eighth chart I have supplied you, which accounts for where growth in the world economy has been coming from in the 1980s and the 1990s. As you can see, Asia has supplied roughly half of all growth in the global economy in the last decade. That has now been punctured. That is the global significance of what has just happened in the Asian markets. It is the puncturing of the biggest single impetus for growth in the global economy. We have mentioned some of the direct consequences of the Asian crisis. There is a big global consequence that is going to have indirect effects on everybody, including keeping further pressure on South-East Asia.

When we get through the adjustment though, I would suggest to you that ASEAN

is not in a dreadful position to re-establish itself and to reassert its competitive strengths. First of all, it has had the benefit of a large currency devaluation. Secondly, some of the economies will have the benefit of getting their backside smacked by the International Monetary Fund.

The fastest growing region in the world at the moment is Latin America. The last chart I have given you compares ASEAN's economic fundamentals with Latin America's. You will see from that that on every measure, ASEAN's fundamentals are actually much better than Latin America's. In the acute phase of a financial crisis, fundamentals do not matter very much because investors only want their confidence to be massaged, and they really do not care about fundamentals. But after the acute phase passes, fundamentals do matter. You will see from that that South-East Asia ultimately is probably in a pretty strong position to make a competitive return, or a return to the competitive international marketplace.

That is all I wanted to say by way of introduction. If there is anything else you would like to know, I am happy to answer.

ACTING CHAIR—Thank you very much, Peter. If I can venture, as Tim Fischer would say, a bit of obiter dicta, it would be to say that I am sorry we did not have you at the beginning of the round rather than at the end because you have tossed up more provocative issues that we really need to pursue with many of the people who sat in that chair before you.

I will hop in first with a couple of questions. How do you feel about the IMF bailout in Indonesia and Thailand and, in particular, Australia's involvement in it? Does it follow from what you were saying earlier that you think that the infrastructure is strong enough and the broad thrust of where they are going is strong enough to make it seem a worthwhile investment, both in the medium and long term? How do you react to the bailout?

Mr Hartcher—Overall, I think the policy is absolutely right. Australia spent the first 150 years of white civilisation on the opposite end of the earth to the main centres of commerce and industry. The rise of Asia reverses that liability and makes it an asset. We are sitting on the cusp of the world's major growth area. In the medium term, I think that both in South-East Asia and North Asia the growth will return. Therefore, if you think that that is the case, you really have no alternative but to support these countries in times of crisis, quite apart from the fact that we happen to live in the region. I think the policy of supporting them through loans, which are after all interest bearing, is pretty hard to challenge.

Mr DONDAS—It has been said in terms of foreign aid, especially into the Asian region, that the Australian government has not been strong enough in trying to tie its aid programs with some product that we might be able to provide, as other countries do. It is

not a good neighbourly thing to do. But then at the same time, the currency exchange with Thailand and the financial bail-out of Indonesia and the possible bail-out of Korea, another very good trading partner, obviously sees us in a very good position to be a good neighbour.

Do you think that Australia and the Department of Foreign Affairs and Trade, especially the trade area, have the tenacity to go in there and really drive a hard bargain and say, 'Well, we are doing all these good things and we want you to reconsider your position in terms of our trade'? As I said earlier today, for some strange reason, as few as the exports are that come out of New Zealand, New Zealand has, I suppose, more prominence in terms of what they are doing than does Australia.

Mr Hartcher—The first point is that the \$US1 billion that the federal government has pledged to Thailand and to Indonesia is already supplied on IMF conditionality. The Australian funding is supplied on IMF conditionality, so there is already a fairly stringent set of guidelines and conditions attached to that. What you are suggesting, if I read you correctly, is that we go beyond that and try and attach other conditions, or at least—

Mr DONDAS—Is there a danger?

Mr Hartcher—In the acute phase of the crisis it is probably a tricky thing to try to do, to extract further concessions to go with your participation in a larger bailout. I think possibly there are other things that could be done at the same time. One small example was in the automotive sector. There was an Australian trade mission to Thailand a few months ago. As a consequence of that, of the 14 companies on the mission, six have come out with significant new business from that mission. Three are now building new manufacturing facilities in Thailand and the other three now have major distribution agreements with Thailand. Many millions of dollars worth of business are going to be generated by this. Why? Because they thought to go to a country in the middle of a crisis rather than run away from it. Secondly, taking a longer term view on the prospects for Thailand, they discovered that there was a lot to be done. Thirdly, they found that other investors and other countries and other people were running away from the place because there was a whiff of crisis.

I lived in Japan for a long time. I was a very bad student of the language, but one thing I did learn is that the kanji character for crisis is made up of two symbols. One of them says danger and the other says opportunity. As you are saying, this is a good time to look at the opportunity end of the equation. I do not know if there is much more that you could prudently try to extract directly and immediately through emergency credit support, but I think probably creatively and proactively there is a lot more that Australian industry could do in conjunction with Australian officialdom, which this automotive mission was actually a model for, to exploit what is going on.

Mr DONDAS—There is a perception in the electorate that says we are giving all

this and we are not getting enough back for it. I suppose in another respect it is up to us, and our ministers and our department of trade, to be sending more groups, more missions to this area almost on a weekly basis just to get the message across that we are close by and do not forget about us. That is the subtle way of doing it.

Mr Hartcher—I think so.

Mr DONDAS—In another area which I have asked some questions on this morning, the construction industry throughout Asia has been one of the mainstays in terms of its economic development. In Indonesia today, as I understand it, there are something like 2.5 million unemployed construction workers and that figure is to rise to about four and a bit million by this time next year. What is the likely impact that is going to have, not only for Indonesia but also for its neighbours?

Mr Hartcher—Are you talking about the construction sector or the general phenomenon of unemployment?

Mr DONDAS—The flow-on from the collapse of the construction industry because of the currency crisis.

Mr Hartcher—Right. As you know, if you look across international experience over some years, it is quite a regular phenomenon. Australia had its big property bust in the late 1980s. In fact, we had many of the elements of this crisis. We had a forced float of the dollar, a devaluation, a banking crisis and a property crisis, so much of this is familiar ground. For Australia, it is just a question of magnitudes. You are right. Massive surplus capacity is still coming on stream in a lot of ASEAN economies. There is a property bubble developed in Hong Kong; another one is about to burst in Shanghai. New buildings are coming on the market with only 50 per cent occupancy rates. But I think the evidence is that it is a classic cyclical thing that these things have busts and then they recover.

There is one long-term historical symbol that I like to refer to sometimes. When the Empire State Building first opened in 1932, it was nicknamed the 'Empty State Building', and regarded as a national joke because it had no tenants in it. There was even a spire on the roof of the building, which was designed for balloons to tie up to, as the next big thing was balloon travel. The building was a joke but, as we all know, when the Americans recovered from the Depression, it went on to become a symbol of American strength and pre-eminence.

On the real estate industry as a particular sector, I do not think there is any long-term lesson to be drawn from it, except that in any business cycle you get a classic cluster of all the bad decisions being made at the end of the cycle when confidence is higher. I think it is just a symbol of that.

The unemployment question is a whole different kettle of fish and could be quite serious. As you know, Indonesia needs seven per cent economic growth every year just to keep unemployment stable. They are going to get much less than seven per cent economic growth over the next couple of years. That has serious consequences for unemployment, particularly among young people. Economic rates at below that level, both for Indonesia but also for other countries in ASEAN, probably rate as a political shock and may have social and political consequences.

Mr DONDAS—It is something to watch in the next 12 months.

Mr Hartcher—Sure. If I were a leader of an ASEAN country, I would be very concerned about the unemployment consequences.

Mr PRICE—IMF packages involve, as I understand it, balancing the budget, cutting public expenditure, et cetera, which is a good budgetary approach. What are the structural changes? Are there any structural changes being imposed by the IMF package?

Mr Hartcher—They are insisting on better surveillance mechanisms and disclosure mechanisms for the financial system, which could end up being one of the better things that come out of this entire correction. Beyond that, there is not a great deal of structural repair. In terms of structural issues these economies are quite peculiar. If you look at the classic check list of warning signs applied when a country is heading into a major crisis, many of the major ones were not flashing for these countries. For example, the classic and No. 1 on the IMF list is fiscal deficit. Mexico had a fiscal deficit. Countries often have major government deficits when they fall over. These countries all had robust fiscal positions. That is simply to make the point that in some of these key structural areas there was not much repair needed.

A lot of the other structural change that is going to be needed has to come from governments and industries themselves. One of the encouraging things about the outlook for ASEAN is that the countries in the region realised, even before this happened, that their competitiveness was under strain. The ASEAN secretariat commissioned a major study, which has not been published, on the competitiveness of member economies. Mari Pangestu at the Centre for Strategic International Studies coordinated it. It was quite interesting. It found that each country in ASEAN had to do more to trade its way up the value-added food chain. This work was all being done before the crisis broke out. That is where the burden of structural change is going to have to come from. The IMF will make some structural improvements and repairs but, at the end of the day, it is going to fall on these governments to do it themselves.

Mr PRICE—What is your relatively short- to medium-term view of the impact of this crisis on the Australian economy?

Mr Hartcher—Over the next couple of years, it just has to be a considerable

negative. Of all new Australian exports over the decade to 1995, 77 per cent went to Asia. That made Australia uniquely dependent on Asian exports. Australia was more dependent on our exports to Asia than any country in the world, including the countries of Asia. When you are uniquely dependent on something, then you become uniquely—

Mr PRICE—Hooked.

Mr Hartcher—Hooked, exactly. Even though growth in our economy at the moment is being driven from the domestic side rather than the export side, there have to be consequences for our balance of payments next year and probably early in the year after, and that has to be a negative. There are just no two ways about that. As you know, Australian officialdom has been desperately trying to avoid acknowledging that there are any serious negative consequences through a remarkable series of bureaucratic constructs in the way that they have defined the problem.

ACTING CHAIR—Yes, we heard some this morning.

Mr Hartcher—Did you?

ACTING CHAIR—Yes.

Mr Hartcher—It is just a nonsense to put the problem in a little box and say, ‘But only 10.7 per cent of our exports go to the four ASEANs, therefore that is the maximum consequence.’ As one of those last charts I showed you demonstrates, having punctured the main source of global growth, you cannot walk away from that and pretend nothing is wrong. Directly and indirectly, there are going to be consequences for our balance of payments next year.

The overarching problem is going to be that all of these economies are depending on exports to pull them out of their difficulties. If there is a future devaluation in China, they are going to be looking to exports to pull them out of their difficulties. The big question then is where the exports will go. There is really only one strong demand spot in the world economy to keep buying all this stuff, and that is the US.

The question then becomes: what is the tolerance in the US for massive increases in trade deficits over the next one or two years? You then hit a political question about the tolerance of the Congress, essentially. I hope that the congressional outlook is more enlightened than what we saw on the fast-track vote the other day, because the mood is obviously pretty ugly based on Clinton’s failure to get fast track.

I was there a couple of months ago and NAFTA was such an unpopular concept and the concept of free trade had been so badly damaged by NAFTA that it has done a lot to discredit the concept of free trade. The global economy is going to be looking to the Americans to mop up all these exports and help absorb the output that is supposed to lift

these economies back into growth. A key question globally is: how big will the American trade deficit get and how much will the Congress tolerate?

Mr PRICE—We are called the lucky country. As you say, we are sitting on the cusp of the greatest growth area in the world, yet we get economic hardening of the arteries every time we bounce a bit higher than 3½ per cent or 4½ per cent growth. I know the *Financial Review* has its own economic agenda in terms of micro-economic reform and cheaper wages, but do you see that it is impossible for Australia to get beyond that level of growth? What is your view on that and how would you go about it? If not, why not?

Mr Hartcher—The problem I have with this subject is that it is not my subject, and I have no particular expertise in it, so I would rather leave that to the people who do. I know something about the Asia Pacific, but—

Mr PRICE—Okay. Part of the inquiry is looking at Australia's relationship with ASEAN and the way ASEAN is developing as an institution. You have given us the economic interlinking points, but probably not more of the social links. Could you offer a view there? Your audience has walked out by the way. I am just showing you how loyal I am.

Mr Hartcher—I think the unemployment consequences and the possible social unrest that may result in South-East Asia are a liability for regimes in the region. I had a Malaysian politician trying to explain to me recently that anything below five per cent economic growth for Malaysia was a serious political problem if it lasted for anything longer than about 12 months.

The next sort of threshold of disruption in these economies is just how much those economic effects turn into politico-social effects. I think it depends on how long their problems go on. If it is a one to two-year phenomenon, as most economists think it is, then they can probably escape with minimal damage to the regimes everywhere, perhaps except Thailand. If we are talking about a five- or six-year adjustment, then I imagine there would be political upheaval everywhere.

ACTING CHAIR—Unfortunately, we will have to wrap it up. It has been extraordinarily interesting. Could I just put one question to you? I was in Japan a couple of months ago and I noticed that there was some extreme scepticism in Japan—and this was before the Japanese economy was looking a bit more shaky—about whether the Chinese economy would continue to effortlessly grow and grow. They thought there were too many inherent structural problems in it. The idea that by the year 2010 it would be the world's leading economy, really was not likely to be met. If the Japanese view is correct—and I would be interested in your view on that—and if the Chinese economy starts to overreach itself and those structural problems occur, does that give a fresh chance for ASEAN to expand?

Mr Hartcher—Because of that overlap in productive output between the two regions, yes, any deterioration in Chinese competitiveness does assist ASEAN competitiveness. What is the medium-term outlook for the Chinese economy? As I mentioned earlier, in the short term they are going to have a serious growth slowdown. I would not be surprised if this time next year that people were not talking about three, four or five per cent growth for China, which is a halving or more of China's recent growth.

That will probably crystallise other problems they have. The biggest potential problem they have is their banking system where, even by the admission of the People's Bank of China, there is a 20 per cent non-performing loan ratio in the banking system. Even Thailand only has 15 per cent non-performing loans. So there is a massive problem in the banking system waiting to happen. When growth gets sufficiently low, that threatens to crystallise those problems in the banking system and then you have a credit crisis.

What happens if you have a credit crisis? As you know, it is the equivalent of an economic heart attack and credit cannot circulate. That would exacerbate the whole thing and you would probably get a one- or two-year dislocation in the Chinese economy. If it did move beyond that to become a political or social issue, then all bets would be off and you would have to have a thorough re-examination. Prima facie, you have to say that China will have a slowdown, an adjustment and perhaps a banking crisis but then move beyond it.

It maybe gives ASEAN a couple of years breathing space, but it still does not absolve ASEAN from the need in the medium term—as their own studies have shown them—to restructure and move up the value added chain. Singapore did exactly that 10 years ago when the last recession hit ASEAN. It was the first time they had negative growth in 20 years. It was an opportunity for them to sit down and say, 'Hell, we have completely overlooked issues like productivity and value added technology, so let's do more about it.' If the rest of ASEAN draws the same conclusions from this slowdown, then it will serve them well.

Mr PRICE—Do you see institutionally—not as individual member countries, but the institution—ASEAN changing in any way in the next 10 or 15 years?

Mr Hartcher—In ASEAN or China?

Mr PRICE—In ASEAN.

Mr Hartcher—That is an extremely good question. At the moment, institution building is a catchcry in several of the ASEAN countries, particularly Indonesia, where institutions are perhaps weaker than they are anywhere else. The only two national institutions, as you know, are the army and the Muslim groups, and you need more than that to run a country.

ACTING CHAIR—And the family.

Mr Hartcher—And the family, that is right. I do not know what sort of outlook there is for the family as an institution beyond the longevity of the head of the clan. There the cry for institution building and institution strengthening—which is obviously necessary for the country—has become identified with opposition to the regime. It is an unfortunate blockage to the development of institutions. Elsewhere in the region, in the countries that need it most, such as Malaysia, Thailand and the Philippines, it is difficult to see any immediate progress in institution building occurring in any of those countries for a different set of reasons.

ACTING CHAIR—It has been extraordinarily interesting. As I say, my only regret is that we did not have you right at the start rather than at the end, because it might have had a serious effect on some of the lines that we pursued.

Mr Hartcher—I got here as soon as I could.

ACTING CHAIR—You will be sent a transcript of your evidence on which you can make corrections of grammar, fact and spelling.

Mr Hartcher—I will leave that to the *Hansard* reporters.

ACTING CHAIR—Thank you very much to *Hansard* and to the thousands of witnesses who have appeared before us.

Resolved (on motion by Mr Price):

That, pursuant to the power conferred by section 2(2) of the Parliamentary Papers Act 1908, this subcommittee authorises publication of the evidence given before it at public hearing this day.

Subcommittee adjourned at 1.16 p.m