COMMONWEALTH OF AUSTRALIA

JOINT STANDING COMMITTEE

on

FOREIGN AFFAIRS, DEFENCE AND TRADE

SEMINAR

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CANBERRA

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OFFICIAL HANSARD REPORT

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ZELLER, His Excellency Dr Klaus, Ambassador, Embassy of the Republic of Germany

[9.04 a.m.]

CHAIRMAN—Good morning, ladies and gentlemen, I have much pleasure in welcoming you to this seminar on the Asian currency crisis to be held here today. This is one of a series of seminars that has been an innovation of the 38th parliament and owes its origins to the former chairman, Mr Ian Sinclair. We have run a series of these seminars: one on PNG and one on ANZUS, and on other topics. We will continue to run two or three more through the life of this parliament.

There are some limitations to running a seminar program such as we are today but there are also some very great advantages. I have a very strong personal feeling, which the committee shares, that the parliament needs to build bridges with the community. The committee system does provide a very good bridge between the parliament and the people through the inquiry process that we have at the present time. The inquiry process, where a committee picks up a formal inquiry for a matter of 12 months or sometimes for the life of a whole parliament, does allow the community to make submissions, to appear as witnesses and to feel they have some real and practical involvement with the conduct of the affairs of state. That is an essential process but it is a rather protracted one.

The seminar does give us the great advantage of immediacy. We can bring a large group of people together. The response that we had for the seminar today was such that we had to move the committee room to the biggest room we had available—short of the main hall—which is this one. There has been a very great public acceptance of the seminar program and we see it as an essential adjunct now, a complementary factor to the formal inquiry process that we have.

A full transcript of today's proceedings will be available in *Hansard* and all the participants who are here will receive a copy of it. The committee will also prepare a very short report, which we will table in parliament, covering the transcript and providing an opportunity for the parliament for debate on it.

I am very pleased that some of my parliamentary colleagues are here to join me this morning: Mr Hollis on my left and Mr Taylor on my right. There will be other members coming in as the aircraft come into Canberra this morning. I would particularly like to welcome Monsieur Lellouche, from the French parliament, who has joined us this morning as a guest and who is visiting Australia, as well as members of the diplomatic corps and representatives of industry. You are all very welcome here this morning.

We would like this debate to be as wide ranging as possible. Everyone is free, and no-one should have any mental restraint about joining in and making their contribution. The only thing I would ask is that, as there are a number of participants and attendees here, please try to keep your questions short and not turn them into long speeches, so that everyone gets a chance to ask a question.

In holding this seminar, we are aware that there have been a number of other fora around Australia where aspects of the Asian currency crisis have been discussed. What we tried to do here today was to involve a wide section of the community and seek a broad range of views from across government departments, academia, the business community and international commentators to meet the unique needs of this committee. The aim of the seminar is to facilitate the involvement of a wide section of the community in the consideration of the so-called Asian currency crisis and, in doing so, inform the Joint Standing Committee on Foreign Affairs, Defence and Trade through the parliament and, through it, the parliament on the likely effects on Australia.

There are many issues that we hope to cover today. I would like to commence by introducing Mr Tim Fischer, the Deputy Prime Minister of Australia. Mr Fischer needs no introduction to anyone in this room. We have never had a more itinerant or peripatetic trade minister in the years since Federation and it is with very great pleasure that I would like you to welcome Mr Tim Fischer.

Mr TIM FISCHER—Congratulations, David, on your ascension to the chair of this very important committee. My parliamentary colleagues, Bill Taylor and Colin Hollis, and my friends in the diplomatic corps, your excellencies, I bid you welcome to parliament this morning. Mr Lellouche, the member who resides somewhere between the 8th and 9th arrondissement—pretty good territory, I might add, in the middle of Paris—as a representative of the chamber of deputies you are indeed welcome to our country. It is good that France is maintaining a continuing interest in all that is happening in the economic matters of this region. Welcome also ladies and gentlemen.

Two days ago I had the pleasure of shaking hands with that billionaire known as Bill Gates. I have been looking at my hand ever since because I gather, in the couple of seconds I was holding his hand, he earned another $1.2 million. Alas, I was not successful in prising anything out of him in that regard, but I did get some interesting ideas.

As I turn to the important matter of this seminar—and I also recognise my colleague, Ralph Willis, who has just joined us—can I make the point that, as we end this 20th century, at long last the technology developments are swinging back in favour of the more decentralised, the more isolated, the smaller rather than the larger.

That is good news for Asia and it is good news for Australia. Think about it; in the last hundred years, there has been massive technology change. Almost every aspect of that change, especially with regard to the transport industry, has involved more centralisation—bigger aeroplanes flying longer distances, for example, Sydney to Los Angeles, rather than the old Sydney, Fiji, Hawaii, Los Angeles route. Or in the other direction it was four hops between here and Tokyo, and now, of course, the flights are direct every day and every night. The whole technology has been towards hubbing or centralising, be it road or rail transport and the like.

What do Bill Gates and IT represent? What does the Internet represent? Yes, we still have six operating railway gauges in this country and we have got a long way to go, but we exit this century with technology unfolding and expanding in relation to the Internet which gives great hope to the smaller countries of Asia, Australia and the isolated parts of Australia.

Jim Middleton rubbished me for presenting a whip to Bill Gates the other day. There was a very good reason why I gave him that whip. Some of you may not be aware of it. This guy lives between Darwin and Alice Springs. He makes hand-plaited whips. He opened a web page 18 months ago under one of the governmental programs. His business has gone up 700 per cent since he opened that web page and a quarter of his whips are exported to the USA. I am proud of the fact that I gave an electronic commerce example par excellence to Bill Gates. I am delighted that small is beautiful in terms of the technological developments of the Internet.

Why is this relevant to what we are considering here today? I will leave you with one message as other people speak to you in more detail. I welcome the Department of Foreign Affairs and Trade and Austrade component of this seminar. I will leave you with one particular thought that you might remember. In all the severe adjustment, the currency corrections and the turmoil of the last 12 months in Asia, there is enormous pain, but there is also some opportunity and some gain for the medium and longer term.

There is the example of Mincom, the software factory in Brisbane. They are full of ideas. They got their big leap up when Victoria went belly-up and suddenly companies started to make very hard decisions about how they were going to control their assets and how they were going to reorder the whole management process of their internal administration. That software became very popular across the byways and highways of Victoria and Mincom grew a great deal as a consequence.

Today Mincom are in Bangkok pushing that product, enjoying the fact that the Thailand economy is plateauing out and now starting to turn up and improve. They are selling that product as companies face up to making the hard decisions to bring on new technology and new software to improve their efficiency and effectiveness. Yes, there is a lot of doom and gloom as you go about making your assessment of the impact on Australia of the Asian instability, but there is also opportunity.

Mr Chairman, let me lay out quickly what the federal government has done during the course of the last 12 months in responding to the situation. Of course, last year it moved into the IMF reform packages for Thailand, Korea and Indonesia. In respect of the first two, a great deal of progress has been made. They worked their way through the very difficult circumstance and there has been some improvement and upturn and a return to normal letter of credit operation is starting to emerge with the trading patterns to Thailand and Korea. I commend that. In respect of Indonesia, it is still an unfolding situation.

It was not necessarily the most populist thing to do here in Australia, but it was the correct public policy position. It involves a currency swap and other special arrangements. We went into the IMF reform package for Thailand, Korea and Indonesia and we stand by that.

On 2 January this year reports hit my desk about the breakdown in the mechanical side of the trade. John Moore and I went back into cabinet and the national interest operation of the Export Finance Insurance Corporation was rafted up $300 million by cabinet decision. It was levered up further in respect of Australian and Korean trade, case by case in respect of Indonesia, and a couple of weeks ago a $380 million special package associated with the export of Australian wheat to Indonesia was committed to at cabinet level.

Why should it go to cabinet? I will tell you why it should go to cabinet—because, if it all goes wrong, it comes right back on to the bottom line of the federal budget. These are very big decisions. These are quite considerable amounts of money and they are all about improving the conduit of trade. So we have gone down that pathway.

In January we held a number of exporter summits with manufacturing, agriculture and services sectors and with resources, education and tourism sectors more recently. We will continue to interface with the export sector at the direct level to help build our knowledge base and update on the situation.

Austrade has set up an Asia crisis centre and Internet site with alerts and advice which is updated regularly with very good information. There is very good up-to-date information flowing through the Austrade networks which has been revamped through Asia and through Foreign Affairs and Trade and Austrade in respect of daily and weekly events unfolding.

We have boosted the ministerial contact with Minister John Anderson going to Korea and Minister Downer going to Japan and Korea in the next couple of weeks. The Prime Minister is going on a slightly extended visit to Thailand at the end of next month and further visits are taking place to maintain that level of activity and boost our trading circumstances in the process.

I would mention that in Melbourne on 15 June there will be the Australia Summit, which is very well timed and well located to review the whole circumstances. It is the old NTIOC redeveloped—the National Trade Investment Outlook Conference—and will involve the International Tribune Group in Paris. It is a very timely conference which will auger well.

Finally, I am Minister for Trade and, as things are allocated—as Ralph would remind us—it is Treasury's domain to do all the economic projections. It is not directly Foreign Affairs and Trade or other departments' turf. I quite happily yield to Treasury and the mid-term budget review which gave an assessment with regard to these matters in the formal sense. What has happened since that assessment is things which you will work on in making your judgment here today.

I admit that there will be an impact on the Australian export performance, although it has held up longer and stronger during the course of this financial year, notwithstanding all that is happening in parts of Asia near to Australia. Therefore, I would urge our exporters and reiterate our strategy, which is not only to diversify our trade to Asia and into South Asia, but also trade with the rest of the world. In the two years I have been Minister for Trade, we have sought to build the strategy beyond Asia as well as to Asia, and that has been quite useful.

The trade outcomes and objective statement report tabled two weeks ago emphasised the fact that our fastest growing export destination right now—it is in the top 20 where it counts and off a reasonably small base, but of some significance—is in fact Iran, plus 71 per cent. Egypt is plus 51 per cent; South Africa is plus 32 per cent. A year ago it was South Africa that was at the top of that particular pedestal, but it has been knocked off by Iran and Egypt. All three are powering ahead in the top 20 where it counts. Yes, our exports in Japan have come back a little. Some of the people here will give you more detail in relation to that, but that reflects the lack of economic growth in Japan over recent years.

Ladies and gentlemen, it is an unfolding situation. I do not believe any one of you in this room can write down the exactitude of the impact which will apply—not so much for this financial year, which is already eight months through, but for the next financial year, which is the critical question. We are working damned hard to militate against the unfolding circumstances out of a number of the countries of Asia.

We remain committed to Asia for the long haul. We are not just fair-weather friends. There is tremendous potential. Asia will recover and it will work through these difficulties. As I mentioned before, Indonesia, Malaysia, the Philippines, Thailand and Korea are making good progress. It will not be without pain, but in that painful circumstance there is also opportunity and gain. Opportunities are opening up for the first time in many years.

I will close by leaving you with an anecdote. It underlines another thing which Australians are not necessarily good at, and big companies are not necessarily good at, and that is maintaining contact during these periods of difficulty. This concerns an Adelaide pharmaceutical firm. A vigorous lady, a director of Austrade, Patricia Crook, suddenly found her orders from her contact company in Thailand had dropped off, were cancelled, and the payments had been held up. She got on a plane and went up there. She found that management had zero experience with a new circumstance which unfortunately Australians do have a bit of experience with, and that is an economic cycle where things go down as well as go up. Management there had zero experience with a contraction of the market, zero experience with managing a devaluation of assets and a collapse in purchases.

They sat down and worked through it for a week and then drew up a revised business management plan. Four months later that company is back in business in a solid way and is reordering pharmaceutical product from Adelaide. It is paying for that product on time and it is withstanding the situation better than some of its competitors because of a valuable week of liaison and contact between the exporter here in Australia and the purchaser in Thailand. That purchaser had been experiencing a new trading circumstance which it had not encountered in two generations of growth in the economic tiger economy of Thailand. It is a very interesting anecdote, a true anecdote. If you want more information, sign up for Austrade. They will supply it to you. Good luck with the seminar.

CHAIRMAN—Thank you very much, Tim. At the start of this seminar we would like to examine initially the challenges confronting those countries in the region which have arguably been hit the hardest—Indonesia, South Korea, Thailand, the Philippines and Malaysia. A number of speakers have been invited from around Australia to present their views. Each has been allocated 10 minutes to speak, with a brief five-minute period at the conclusion of their presentation for questions. There will be a further general question period at the end of this block of speakers.

What we try to do in these seminars is to get as diverse a range of views as possible. Therefore, we have a large number of speakers with necessarily a short time for each segment. The real difficulty from a chairing point of view is to stick to the timetable because we have no kidney fat at the end of the day to run into. Therefore, I would like both the speakers and the questioners to stick to the times that have been allocated to them.

I have very much pleasure in inviting Dr Peter Brain to speak to us. He is one of Australia's best known economists in the development and application of macro-economic models. Since co-founding the National Institute of Economic and Industry Research, he has participated in a wide range of economic projects across national, state and regional economies, as well as key Australian institutions. I welcome Dr Brain to the rostrum.

Dr BRAIN—Thank you, Mr Chairman. I will race through this fairly quickly. The catalyst for the crisis is the roughly $80 billion turnaround in 1997 of largely commercial bank lending to the region. This is the general proximate cause of the crisis. Thailand was the first country, the trigger for this crisis, and there are a number of reasons for that. Through late 1996 and into 1997 they were faced with a large surge of capital inflows, an overheating economy due partly to years of not investing in infrastructure to the same extent to drive the growth, inflationary pressures building up, and deteriorating underlying micro-economic fundamentals. This was due partly to the fact that excess manufacturing capacity by June 1997 had reached about 45 per cent. On projections, even assuming that Thai growth had maintained an eight per cent growth through 1998 and 1999, there was going to be a very large build-up in excess capacity in retail and commercial infrastructure, a la Melbourne proportions.

It was quite clear it could not go on. So, lo and behold, the Thai policy makers decided that they had to cool the economy—it was getting structurally unbalanced—and they took the radical step of deciding to use the exchange rate mechanism to dampen capital inflows and try to improve the current account deficit. Technically, that is the standard policy prescription for countries in these difficulties.

Secondly, they had been hurt relatively badly by the Chinese devaluations a bit earlier. But the third reason why they considered that was Thailand's relative uniqueness in this situation. That is, it is not the formal corporate estate of the north Asian economies where at least there is de jure separation between government and business, nor was it the complete corporate state of the crony capitalist type of the south Asian economies where there does not seem to be any de jure separation between business and government.

A fundamental instrument of these states was the stable exchange rate. This was one of the important levers which had driven their growth and their quest for complete business certainty. Because of that, their companies could go offshore, borrow at the lowest cost of capital markets and be sure that their competitiveness could be maintained. But no-one told this to the Thais.

Therefore, when they decided to float, which led to the subsequent devaluation of the currencies, it triggered a shock wave through Asia because it undermined the key formula or benchmark of these economies, that is, that there be no devaluation of the currency. That Thai action led to the situation you can see there on that slide where, with the current exchange rate regimes, there are huge debt servicing costs now faced by Indonesia and South Korea.

In relation to the Thai and the Philippines situation, you can see that although Thailand is a bit better off compared to Indonesia and South Korea in terms of the debt service aspect of the problem, they still have a large internal debt problem and share that with Malaysia. So Thailand, in terms of its underlying financial fundamentals, is very similar to Malaysia.

As you know, Thailand was forced to go to the IMF and agreed to do certain things. It agreed to run a very tight fiscal policy. The government deficit was to be no more than 1½ per cent of GDP—it has now been revised to 2½ per cent of GDP—and it was to start opening up markets and opening up the economy. In the 24 February realignment of the IMF package, they have also got to recapitalise the banking system before the end of the year; otherwise they will be shut down.

Thailand is getting quite good press at the moment, but I think it is a bit of a spin. Interest rates are currently 20 per cent nominal and inflation rate is currently 10 per cent, but if you look behind what is going on there does not seem to be the complete political will to restructure and reform as there appears to be in the case of South Korea. The government has done nothing about the selling of assets. It has sat on its hands since it closed down those 56 finance companies last year.

In terms of the banking system, it is trying to paper over the crack in the banking system by taking over six banks, and is lending to the rest. At current rates it is estimated it will cost them about $US22 billion to fix the problem; it is well beyond their resources.

There are still heavy restrictions on foreign capital involvement. The asset sale program is not going well. They are asking too high prices and they are putting, in some cases, time constraints on the duration of foreign investment, for example, in the banking system.

On the fiscal side, they have not really come to grips with it. They do not know what to do—raise petrol prices or cut out electricity subsidies. They are still debating internally how exactly they are going to face their fiscal tightening long-term profile. They really have not come to grips with it despite the spins.

For what it is worth, these are our projections for Thailand this year. But Thailand’s outlook is very much influenced by how its neighbouring economies are going. Like us, it is about 50 per cent exposed to the East Asian region. These are our recent projections of the outlook. You can see that, when you translate that into how trade is likely to perform, this year is going to see very large declines in trade between countries in the region, including us. With those sorts of declines and their internal domestic problems, Thailand is by no means out of the woods. That sort of scenario indicates to me that there will be another couple of crises which I think are necessary for Thailand to start getting real about structural reform.

CHAIRMAN—Thank you very much. Are there any questions?

Mr SHERWOOD—I am very interested in the fact that you seem to have some very large turnarounds in those predictions for next year, which of course is only nine months away. What is that based on? Are you saying that the crisis has ended and we are now on an upswing? What are the indicators that that upswing is about to occur?

Dr BRAIN—The turnaround in trade is that it brings trade to less than what it was in 1997. It partly reflects the big turnaround and declines in trade this year. The heavy stock fall-off is basically stocks and the fact that, in 1999, when the foundations for recovery start to occur through asset sales, restructuring and throughout Asia at current exchange rates, they are highly competitive if there is a change of ownership. Now, of course, they are bankrupt, but if there is a change of ownership, and a lot of that will be driven by Western capital, exports start revving up and going out into the OECD countries. That will suck back imports. But in all countries the turnaround in the growth brings trade back to a lower level than what it was in 1996.

Mrs GALLUS—Dr Brain, a recent analysis by Ian McPhee suggested that a lot of the cause of what happened in South-East Asia was psychological because of the unfamiliarity with the markets, the amount of capital that was in those markets and investors suddenly getting very nervous. The whole thing was a domino effect. How much would you subscribe to this theory or how much do you think it was much more hard factors that caused the crisis?

Dr BRAIN—I believe it was hard factors. The Asian economic miracle was largely driven by the recipe book taken out of the fascist economies of the 1930s. The basic idea there was to create a very low risk economic environment by exchange rate control; control over the financial system, the banking system; and ironclad economic protection so that the domestic producers knew that they were not going to be knocked off by foreign competitors in their own market. Basically, that was the route taken. It fell apart because they did create a low risk environment because of the success over a number of years. That led the actors to take leverage, debt, foreign borrowings and investment efforts well past the level which was sustainable on any sort of long-term basis.

There are many factors of the corporate state which have led to the current difficulties. One of these things was the exchange rate and the control over the financial system. That has to be kept simple as a handmaiden to economic development. That is required to be banking system oriented. For years we have been lectured on the value of the high savings ratio of these economies of about 35 per cent but keeping their financial system unsophisticated means that debt was the major instrument which was required to translate those savings into investment. That is the other reason why in that earlier graph we have such horrendous international and domestic interest debt service ratios.

It was a conscious effort to defeat the liberal democratic economic systems by the use of a system which did have some strong success in the 1930s in Germany where they reduced unemployment from 33 per cent to six per cent during the Depression. It was a conscious, hard-headed decision to defeat liberal democratic economic systems. In that sense, it was hard.

Mrs GALLUS—Taking your point while remembering Mr McFarlane’s point, why did it happen at that particular time? This had been going on for a long time. What was it in that particular time that caused it?

Dr BRAIN—What caused that was basically the Cold War. Asia’s economic advantages were created by the Cold War. The Americans accepted the rule of thumb that every five jobs created in Asia for one job loss in the United States was cheap defence. It gave them liberal access to technology and markets and also created this role model. Obviously they had the skills and the entrepreneurial zeal to take advantage of that where a lot of other countries would not, but, as soon as communism fell, the underwriting of the East Asian economic miracle was withdrawn.

Unfortunately, as always is the case when that sort of guarantee is withdrawn, the Western financiers suddenly thought that this was going to go on forever and threw about $700 billion into the system between 1991 and 1996 as happened in Latin America in 1975. We forget that Latin America was the darling of the world back in the late 1960s and the first half of the 1970s. It registered growth rates of up to eight per cent. When all the liquidity that was freed from the oil price shocks wanted to find a home, it was directed at Latin America and that accelerated its growth to 10 per cent between 1975 and 1980. The underlying fundamentals were just as rotten as they were in Asia, largely in part through the previous success and growth that was taken beyond the point of sustainability.

The point I am making is that the Western financiers got into the act when the use by date of the system was becoming apparent but they kept it going just that bit longer. Given the volume of funds that was thrown at it, that created the excesses which led to the severity of the crash through over-investment not only in commercial property but also in terms of the manufacturing sector. Because they had been steadily building up bad debt loans in their financial systems, which are now reaching a tremendous situation—Thailand is about $22 billion of GDP which is about $US120 billion—that allowed the cancer of that inflow of capital to be put up with for just that much longer.

CHAIRMAN—Thank you. There is one quick question from Mr Taylor and then we must move on.

Mr TAYLOR—Dr Brain, your views are more pessimistic than most I have heard. In particular, the United States on the hill in Washington does not seem to share the pessimism that you do. What have they missed that you have picked up?

Dr BRAIN—They probably have not looked at it. The situation is that we have an economy with very large excess capacity both in manufacturing and the retail sector. We have a bad debt loan portfolio of the banking systems that go anywhere between 20 per cent of GDP, which is the Thai case and the Malaysian case, to 40 per cent of GDP, which is the Chinese case. We have a situation in Japan of only about an eight per cent of bad debt to GDP ratio. They cannot get growth going simply because they have not fixed that problem.

So if anyone says that the problem is going to be a quick fix—when you look at those relativities and at the case study we have before us of what is happening in Japan and the overhang that their relatively minor financial difficulties have caused to their growth rate—I think they are not on this planet.

CHAIRMAN—Thank you very much, Dr Brain. I would now like to welcome Professor David Lim from the faculty of Asian and International Studies at Griffith University in Brisbane to present his views on the issues confronting Malaysia.

Prof. LIM—Thank you, Chair. I thought the next country to be looked at was the Philippines but, obviously, we will come back to it later. I will begin by simply presenting a few facts about the fall from grace of the Malaysian economy and basically look at the two major indicators that have been discussed so far.

One is clearly the ringgit, the Malaysian dollar. As you can see from these figures, there has been quite a major drop. The low point was in January 1998. There has been a slight movement up, but not much more. The KL composite index has also fallen quite drastically. There has been a bit of rebound since some time in January and it is now hovering around the 700 mark.

If you were to ask what have been the reasons for such a dramatic fall from grace—not as severe as those in South Korea or Thailand, but certainly pretty severe—a number of reasons have been put forward. The conspiracy theory, clearly, we can discard, because I do not think there is any substance to that. But of the others, poor economic fundamentals, political and social instability, a true contagion effect and a victim of what I call casino capitalism or hot money terrorism—all of these factors have a part to play. What I am going to say on each of those points is nothing new but, hopefully, what would be new would be an attempt to put the four factors together to try to explain what has gone on in the Malaysian scene.

On economic fundamentals, on the surface you would say that Malaysia had done pretty well up until July 1997 when the crisis broke. It appeared to have adopted market friendly policies, obeying quite religiously the type of policies that the World Bank had been keen to push through, and certainly the IMF. On privatisation, it had led the developing world in going down that track, and there had been some quite brilliant successes.

On budget surpluses, it has gone into a surplus since the early 1990s. There was a high external debt level, but since that was private sector driven as opposed to the position in the early 1980s, people did not hold much fear for that. All these things seemed to suggest that the fundamentals were pretty okay.

I have a table which summarises the main features of Malaysian growth since the early 1980s in terms of crucial periods. This table will obviously be available when the proceedings are published somewhere along the track (see appendix 1). I do not want to bore you with statistical data, so I will leave that for the time being. When you scratch below the surface of Malaysian economic growth, you will find there is a bit of underbelly to it. I will go through each one of them in a bit more detail.

The first one is that because of the very rapid rate of growth since the late 1980s, touching 8.5 per cent in real terms per year—investment ratio was pretty high, savings ratio was quite high—there was a general belief in the system that the way to sustain rapid growth was to keep looking for big projects. They found those in terms of big projects in the infrastructural sector and also in the property sector.

There is a term ‘megaproject’ in Malaysia which has been used to describe some of the huge projects that have been planned such as the Bakun Dam, the linear city in Kuala Lumpur and so on. If you were to talk to people who have actually done work on the economic viability of some of these projects, they will tell you that very often these things were pushed through with not a great deal of concern for the economic viability of such projects. That is one negative aspect of what has been going on in Malaysia.

The other one, and this is obviously related to the first one, is lax monetary policies. I think the credit growth has been about 20 per cent per annum, and that is a pretty high level, which has resulted in a number of adverse effects operating in the system.

The first one clearly is a huge investment and lending boom and, more importantly, associated with that, pretty poor investment decisions on a number of fronts, and slack lending procedures. One impact of the slack lending procedures is the type of bank failures that we are beginning to see at the moment. I think Sime Bank and Bank Bumiputra have announced huge losses in the last financial year and that will have a huge impact on things to come. There has also been a rise in inflationary pressures in the last few months as a result of the lending policy.

Related to that issue is the operation of a highly protected financial sector. There has been a fair amount of protection granted to the local financial banking sector. It was very difficult for foreign banks to come in, and one important effect of this has been that best practice in the usual type of things you look for in a banking sector—accounting practices, auditing practices and financial reporting—have not been adopted or have been adopted not very seriously. There has also been a pretty uneven development of the financial sector. As Peter said earlier, this has obviously quite drastic consequences in the way business is carried out.

Another negative aspect to macro-management in Malaysia has been the way in which the privatisation program has been conducted of late. I said earlier that Malaysia is often seen as the leader in the program to privatise public sector utilities, but recently it has taken quite an unpleasant direction and this is that very often projects have been awarded, not through the usual competitive bidding process, but through a negotiated basis with contracts being awarded to a chosen few, leading therefore to, if you like, a system of crony capitalism where projects, given only to people with connections, are now beginning to come to the surface in terms of their economic non-viability.

Those are the types of economic issues which I think investors in Malaysia and overseas have seen as being quite negative as far as Malaysia is concerned. If you were to then ask, ‘What impact has the inter-ethnic rivalry that overhangs the nation in Malaysia had on the economic crisis? Has it accentuated it?’, I would say, basically inter-ethnic rivalry is not the explosive issue it was in the late 1960s and early 1970s. It has an impact only in the sense that the adherence to the new economic policy and distributional goals have had an impact on the way in which privatisation and certain businesses have been carried out in the system.

In terms of the succession to Mahathir, I do not think that is a big issue really. It was a heated matter and an issue for great debate a couple of years ago, but I think things have settled down. Both camps have decided to work with each other. It is simply a question of when Anwar would take over rather than if he would take over. In any case, even if he were to take over, he is not a Habibie. He is somebody who is quite liberal minded and would be a much more acceptable character to the West than Mahathir has been or will be. In terms of the impact of political and social developments on the Malaysian economic front, I do not think it has much of a direct impact in the way political instability has in certain countries.

What I want to turn to now is the third factor which might have played a part in the fall from grace for the Malaysian ringgit and stock exchange. These are changes to the international monetary system, which together have acted to magnify, many times over, any economic mismanagement there might have been in any system, whether it be in Malaysia or Thailand, and any political instability that there might have been in any country.

Three developments are of interest and relevance to the Malaysian case. The first is clearly the establishment of huge offshore funds—Euro dollars. The second development is the global shift of many countries into variable exchange rate regimes. That increases uncertainty and, clearly, the degree of risk in international financial management. That increases manyfold the number of financial transactions between banks and financial institutions. The third development is the one that Mr Fischer talked about, which is the rapid development in electronics which has made possible continuous worldwide exchange trading, the rise of electronic money and cyber-cash.

These three developments have enabled decisions on exchange rates and the stock markets to be made in a matter of seconds. If you and I were to sit down and work out some industrial project to implement or even some new course to introduce in a university, it would take us a couple of months at least to push through the whole thing. The way things are done these days is they are conducted by young, energetic professionals who make decisions on the spot. Some would say that it is driven by pure profit motives and that decisions—to paraphrase George Soros himself—are guided more by intuition and instinct, more by herd behaviour, than by a careful assessment of economic fundamentals.

The third impact of the three developments would be huge sums being traded on the exchange market. I have some figures from the early part of the 1990s. These are actually much smaller than they would be now. I think in 1993 $US275 trillion were traded on the exchange market. This is an enormous sum in relation to real figures such as the US GNP of $7 trillion, world output of some $20 trillion and world tradeable financial assets of $30 trillion.

If you have these huge sums floating around the system, ability to trade in a matter of seconds and decisions made by people driven by pure profit motives and persuaded more by instinct and what the others are doing, some people would argue this has given rise to what has been called casino capitalism—with the huge amount of gambling involved—and hot money terrorism. As I said before, the impact of any economic mismanagement, especially of the serious type, in Malaysia, Thailand and South Korea would be magnified many times over.

In terms of concluding comments on the Malaysian case, I think that a fall in the value of the ringgit and the KL composite index is really a mixture of bad economic management and the operation of casino capitalism. The response of the Malaysian government in its 1997 budget introduced in mid-October was to increase the budget surplus, reduce credit growth rate and defer certain mega-projects. These measures were not taken seriously at all by the market—resulting in further falls in both variables, the ringgit and the Kuala Lumpur composite index.

Emergency measures were introduced in December of that year that reduced the growth forecast for 1998—not to the extent of 0.7 per cent, but something like four per cent or so, which I think is still far too high. There was reduced government spending; tightened property lending; freezing of new stock market listing; and an increased rate of reduction of the external account deficit. But the falls have continued since that time, and the situation is still pretty volatile. Probably the market is waiting to see whether some of the mega-projects will be deferred for some time.

In relation to this, it will be useful to finish off my presentation by simply saying that there are some who believe that the US dollar and the stock market are the most overvalued in the world. If the onslaught comes, how much of a defence fund will be needed by the US to deal with an onslaught of $275 trillion dollars?

CHAIRMAN—Thank you, very much, Professor. Are there any questions?

Mr SINCLAIR—I was interested in the comment that there has been an assessment in Malaysia that poverty was worse now and is continuing to deteriorate. Is your assessment that, whereas Indonesia is still in a state of total uncertainty, the real problem could be Malaysia’s, and that in fact a disaster is still waiting to happen?

Prof. LIM—I would agree with that to a certain extent. Recently, it was clearly noticed that the Sime Bank, which is the banking sector of Sime Darby, a huge Malaysian owned company, has reported huge losses. Bank Bumiputra, again one of the big banks in the country, has also reported huge losses for the first half of the financial year or the second part of the calendar year. What these losses have shown is that the banking sector is basically not a very efficient sector in the system. Loans have been given out quite freely, very often, because of requests from characters using share values as collateral.

With the huge drop in the KL composite index of 50 per cent on average, these characters will be in real strife. There has been a call in parliament in Kuala Lumpur for those people responsible for borrowing huge sums of money which they cannot service, to have their names published to let the public know about it. You will see that there is a fair amount of correspondence between those names and the role they have played in the political system in the country.

Recently, just two weeks ago, my own university ran a similar conference where we actually had people from Malaysia, South Korea and the Philippines come to talk to us Australians about the situation in their own country, in the belief that they would know more than we would about the situation. In the Malaysian case, there was somebody from the banking sector. His view is that we actually have not seen the worst of things in Malaysia yet.

CHAIRMAN—Thank you, Professor Lim. I was waiting for a suitable break in proceedings, because of the importance of the next announcement, and that was to welcome the new Speaker of the House of Representatives to this meeting. Welcome, Mr Sinclair. Are there any further questions for Professor Lim? If not, we thank you very much, Professor. I would now like to call Dr Brain, for the conclusion of his remarks on the Philippines.

Dr BRAIN—I will not put a slide show up; I will ignore the slides I had on the Philippines. The Philippines is interesting, though, as a counter-case. Largely, the Philippines has missed out on the full, longer-term negative effects of the current Asian crisis—although in the short term they will be affected but in more of a traditional way. That is because they have not been the flavour of the month or the year for about a decade. It took about a decade to recover from the 1983-84 recession. This is important and in a minute I will go through what happened then.

It was not until 1993-94 that they started to win back international confidence. As a result, it was only in 1994-95 and 1995-96 that they were recipients of large amounts of capital inflow. Commercial bank lending from OECD went up from something like $0.5 billion or $1 billion, the average through the previous 10 years, to something like $12 billion or $14 billion in those years. Their growth accelerated between one per cent and three per cent over the previous 10 years, to six per cent. Therefore, as you saw from the earlier figures I put up, their external debt and their domestic debt GDP ratios are quite low in comparison with those of other Asian economies: instead of having a bad debt and non-performing loan ratio of 20 per cent plus of GDP, which is the minimum for the other economies, it is somewhere around the seven per cent mark—largely through overinvestment in property. Therefore, their economic situation now is much akin to a normal severe recession here.

If we look back at the 1983-84 recession, which I find interesting, that recession virtually wiped out the non-banking financial sector; they were shut down and the country has been more or less under IMF supervision now for about 35 years, on and off. The banking system was also in a similar crisis situation—but not quite as bad—as that now prevailing throughout Asia. It almost brought the financial system to a collapse—just as we are facing now in other Asian economies—and it has taken them really the hard slog of 10 years to work themselves out of that mess. That is another factual case to give you some idea of how difficult it is and how long it takes, once you create these structural imbalances in these economies, to work yourself through.

In regard to the short- to medium-term outlook, given those trade growths that I put up before, they are obviously going to be severely affected by a drop-off in trade, but they also have underlying macro-economic or micro-economic fundamentals that are not too distinct from ours in a severe recession. At the moment, they have got a quite bad trade balance.

The government is, in an election year, pump priming. A five percentage point growth in government revenues has basically gone to fund projects for an election year, and so fiscal policy is loose. Interest rates are high as a consequence, at 25 per cent. It is holding the peso, though, at the critical 45 to 50 range. If the crisis hits further, as I anticipate, and if the peso goes up to 55 or 60, as I think likely, you are starting to put Filipino firms into the sort of technical bankruptcy status that we now see for companies in Indonesia, Korea and Thailand. There are big downside risks that a normal recession response in terms of the underlying fundamentals and macro-economic weakness will be translated into a full-blown severe crisis for the Philippines—although they have not had the same excesses, the fact is that they have not fully recovered from the 1983-84 crisis.

CHAIRMAN—Thank you, Dr Brain. We will now move to South Korea. You would all be aware that there is a new president in South Korea and a new government who are tackling the realities of implementing the requirements of the country's $US57 billion IMF package. Dr Heather Smith has a keen research interest in South Korea's economic reform and is currently the coordinator of the Korean economy program in the Department of Economics at the Research School of Pacific and Asian Studies at the ANU. Dr Smith, I invite you to take the rostrum and address the problems of South Korea.

Dr HEATHER SMITH—Good morning, ladies and gentlemen. I am going to focus on four major issues in the brief time that I have. The first is to look at why Korea went through this crisis, and I do not want to spend too much time on this because we are all quite familiar with most of the dynamics. Also, I want to look at the IMF package, whether Korea is going to be saved by the IMF package, and then focus on some risks to the reform process undergoing in Korea at the moment.

Slides were then shown—

Dr HEATHER SMITH—This slide looks at the factors behind the crisis and I have divided those factors in two issues. The first are the systemic factors underlying the crisis. The first dot point on the slide is the role of state directed lending, giving rise to the moral hazard issue in Korea. This has been going on for about three decades in Korea allowing banks and firms to pile up considerable debt. It has also given rise to a banking system which is characterised by considerable lack of commercial orientation with limited experience in pricing and managing risks to very limited prudential supervision standards.

A second factor underlying the crisis is the repressed financial sector which has given rise to a short-term lending splurge which took place between 1992 and 1997. This has largely arisen because of government restrictions on lending, which has raised the cost of finance for banks and firms. They have headed offshore for low interest rates, given the high interest rate structure in Korea.

A third underlying factor is this massive build-up of corporate debt which Peter Brain alluded to. The chaebol—the industrial conglomerates in Korea—have always been very heavily geared. In the 1970s when the government was undertaking its heavy industrial push, there were gearing ratios or debt equity ratios of around 500 per cent. These have come down over the years, but they are still around 300 per cent. If you compare that to the gearing ratios on the New York Stock Exchange being around 170 per cent, then they are very highly geared companies.

The fourth factor is backsliding on reform. If you remember when Kim Young Sam came into office in 1992 his platform was pretty much financial reform, breaking up the chaebol and trying to do something about the labour market. There was some progress in these issues up to about 1994-95, but you are probably aware of some political factors going on in terms of corruption charges against former presidents and that has tended to deflect away from the reform process in South Korea.

In looking for a catalyst or a trigger underlying the Korean crisis, there have been some cyclical factors going on over the past two years or so. The first of these was the so-called yen effect. What this graph shows is the real effective exchange rate. An increase in the index indicates that Korea's prices are falling relative to its trading partners, indicating Korea was undergoing an increase in competitiveness. Up until the mid-1990s, the strong yen had made Korean exports very competitive and, as you are probably aware, Japan and Korea compete together in third markets. They have very similar industrial and export structures.

As exports surged the conglomerates poured most of the proceeds into new investment, but when the yen started to fall around September 1995, Korea lost a lot of its advantage and export growth slowed. This slowing was quite dramatic. Exports in 1995 grew by around 32 per cent and in 1996 growth fell to around four per cent. A lot of this was the fall in prices of semiconductor chips, of which Korea is a major exporter.

The slowing exports started to squeeze the profits of the chaebol and the structure of the chaebol is such that they tend to fund most of their activity by finance rather than retained earnings. They need to generate cash flow in order to service the debt that they built up over a long period of time. The foreign currency crunch came obviously when the currency was falling, but most of this debt being short term—defined as debt coming due over the next 12 months—meant that Korea had a problem or a credit crunch on its hands when exports slowed. Another factor taking place during 1997 was the erosion of investor confidence. The stock market had been falling gradually throughout the year in the wake of corporate bankruptcies and corruption scandals.

There was also industrial unrest. If you recall, Kim Young Sam was trying to reform the labour market in late 1996, but this backfired because of the authoritarian way with which he tried to deal with it. Then came the presidential election in December. Prior to the election there was a lot of policy paralysis. One of the major factors which was a trigger for the markets, which were looking for a circuit breaker, was the government's failure to pass a financial reform bill on the last sitting day of parliament. That was a big factor leading to the continuing fall of the currency and the stock market.

The final factor is the contagion effect from South-East Asia, but I would put that on the bottom of the list for the reasons that I have just outlined.

The IMF package is perhaps as comprehensive as it is for Indonesia. What it specifically involves is a major overhaul of the financial system, pretty austere monetary and fiscal policy, the opening up of business to external scrutiny and a considerable removal of barriers to the domestic market. I will focus mainly on the monetary and fiscal policy. I could get into the debate about whether the IMF has extended its domain here, but some of those issues have already been on the Korean political agenda for many years, particularly trade liberalisation. Most of the trade liberalisation issues which the IMF raised, Korea had already started to commit to anyway.

The IMF requires very tight monetary policy—raising the ceiling on interest rates from around 25 to 40 per cent. Rates on three corporate bonds peaked at about 30 per cent and they have come down to about 24 per cent. The IMF also required Korea to float the exchange rate, which will be an issue down the track as to how they actually behave in this new monetary policy environment, or how the central bank learns and behaves in this new environment.

Fiscal policy is contractionary in the sense that the IMF requires a balanced budget, or the budget to yield a small surplus of around 0.3 per cent of GDP. The IMF is quite correct when it says that all it is seeking to do is cover the cost of restructuring of the financial sector. So the government has to embark upon revenue raising measures which mean an increase in prices of energy inputs and utility prices and spending cuts.

When I introduced the topic perhaps I asked the wrong question. The answer as to whether Korea will be a success story will probably be a result of Kim Dae Jung's commitment to reform, rather than the IMF policy prescriptions. There are two reasons why it is important that Korea pursue this track. I think the IMF has this in mind in that it is seeking to entrench reform, rather than allow the chaebol to benefit from a devaluation of the currency without cleaning up the financial system which is behind many of Korea's problems.

The other issue is North Korea. Regardless of the form of unification that takes place on the peninsula, South Korea needs to start preparing its economy for the impact. There has been no indication over the past five years that the government has put any serious planning into the fiscal and financial structure to deal with this. This is an underlying issue which is very important for the future of the peninsula.

Along with the IMF package, there needs to be considerable flexibility. One of the issues I would highlight is that interest rates will probably have to be lowered before the current IMF timetable in the last quarter of 1998. Rates have dropped somewhat but the IMF is making it conditional on the exchange rate levelling out at around 1,300. Interest rates that are too high for too long are really going to squeeze the small and medium size business sector in Korea and it could push the economy into recession.

The second thing is that fiscal policy is probably too tight, mainly because Korea has exhibited considerable fiscal prudence in the past and is quite capable of being a bit more expansionary in this. The IMF is also requiring some very important infrastructure projects to be wound back. That is also something which Korea needs to spend more on for the future.

The third point is perhaps a bit of a case study of 1980. We tend to forget that these economies do go through business cycles, although the period around 1980 was characterised by political turmoil as well, with the assassination of Park Chung Hee. You had a very similar macro-environment—an overheated economy with a few chaebol going under and a lot of heavily geared companies. Korea and the IMF were at loggerheads over the response to this crisis. In fact the policy response was quite different to the current policy prescrption. Korean monetary and policy was actually very expansionary in the early period. Initially the government tightened interest rates in the beginning of 1980, but then started to relax them in June. The budget deficit blew out to around four per cent of GDP between 1980 and 1982. After that period, the government embarked on some serious structural reform. So the current case study is quite different from the last policy response when Korea achieved negative growth at around 3.8 per cent.

The depth of the turndown within Korea really depends on the speed and vigour of reform and the flexibility to adjust policy settings. There is going to be considerable fallout on consumption and investment, as we have already seen. It is also not yet clear whether Korea is going to have an export-led recovery. Certainly there is no indication in the first two months of this year, although they do have a huge competitiveness effect now vis-a-vis other countries in the region.

The key to this is really the political commitment which Kim Dae Jung has made to reform, which differentiates it from a number of the other case studies. Really, on that basis, you would have to say that Korea will probably emerge earlier from this crisis.

There are four substantial risks to this process. The two I will concentrate on are labour unrest and backsliding by the chaebol. If you are aware of the election results, you will know that the governing party does not have a majority in the National Assembly. So down the track there could be a few problems. In the immediate period, there seems to be consensus to push through major legislation.

In February, the government passed a major reform bill which is quite unique for Korea, and that is obviously because of Kim Dae Jung's relationship with the union movement in the past. That bill is designed to improve labour market flexibility. It has been very difficult to lay off workers in Korea. Some estimates say that firms are overstaffed by around 10 per cent. So the deal struck with the union allows large scale lay-offs. The government is also starting to budget for an unemployment insurance system. There is really not a good social welfare net in Korea to deal with the massive unemployment which is going to take place. Unemployment was around 2.6 per cent last year and forecasts are six to seven per cent unemployment this year.

The deal struck with the union movement legalises unions within Korea. As I said, unions have agreed to accept lay-offs as a result of mergers and acquisitions of foreign companies coming in. Employers are required to give employees 60 days notice of lay-offs, instead of the 30 days notice which the government was originally trying for. The hardest hit, when the reforms really start to bite, will be the SME sector—the small and medium size enterprise sector—because they are very dependent on the business and the subsidiaries of the chaebol. As I mentioned, the government is probably going to need to expand fiscal policy beyond what it has already allocated—which is around 3.2 billion—towards an employment insurance system.

The worry is, if the chaebol are not perceived to be doing their fair share of restructuring, the labour unions are going to start to buck. There are two major unions in Korea. The more militant one is willing to accept wage freezes and job losses but it is also demanding the dissolution of some of the family owned conglomerates and that the chaebol heads use their personal wealth to deal with some of their debt problems. So if the chaebol are not seen to pull their weight, it is going to be a problem with the labour movement.

The second last slide looks at the chaebol. On any financial indicator, their balance sheets are in an appalling state. When you look at their structure—take, for example, the top three chaebol in Korea—they have an average of around 100 businesses, but only one or two of those are likely to be profitable. So the reforms which are in the IMF package—they were also part of Kim Dae Jung's political platform for many years—involve considerable increases in management transparency with the chaebol. One of the most important reforms is the elimination of the cross-loan guarantees, which are, to a large degree, why the chaebol are in such a mess. Under the system, a subsidiary of a chaebol was able to borrow from the international market or from the banking sector using the assets of the parent company as a guarantee. If you have thousands or hundreds of subsidiaries, it becomes a real problem and very messy to sort out the debt structure.

What has been the response of the chaebol to date? They have really just started to scale back their activities. If you recall, they have been on this huge expansion over the past three or four years setting up offshore subsidiaries. Most of them are starting to scale those back, particularly in Europe and in South-East Asia. They are also starting to reduce management structures, rather than initially wanting to lay off workers, and are undertaking debt reduction. There are laws which now require that they must lower their debt-equity ratios over a certain time period. There is a possibility of some backsliding here. Initially Kim Dae Jung was not pleased with their efforts to come up with a reform package and he has indicated he will legislate if they try to buck the system. It is quite difficult to figure out what is going on in terms of the chaebol saying that they will divest of certain units, when a unit could mean anything from a subsidiary to a particular product line. So they are really going to have to monitor the behaviour of the chaebol.

The insurance policy against the chaebol backsliding is the overwhelming public support or the public anger against the build-up of wealth within the chaebol. So Kim Dae Jung certainly has a mandate for this reform.

Moreover, it is in their best interests anyway. Korea's scale intensive industry structure is really starting to limit their competitiveness and their ability to become more innovative and flexible. The obvious contrast, of course, is Taiwan, which is made up of thousands of firms. When you look at the performance of the electronic sector of both of these countries, when the export prices for electronics started to fall, Taiwan managed to maintain its competitiveness because of its very flexible and nimble small companies which can move into niche markets very quickly. So this model is really starting to inhibit Korea's competitiveness, which is why Kim Dae Jung remains committed to the reform process, certainly in the short to medium term. Thank you.

CHAIRMAN—Thank you very much, Dr Smith.

Mr SINCLAIR—Dr Smith, there are three factors that you have not mentioned that all seem to be pretty material in the instance of Korea. The first is the famine in North Korea, the second is the very significant and ongoing expenditure on defence and the third is turbulence in the universities. I wonder whether you would like to comment on each of those?

Dr HEATHER SMITH—I will start with the last one. Turbulence in universities in Korea is pretty much a way of life. I am not sure that I have seen that much activity in relation to Kim Dae Jung. He has traditionally had the support of the university sector, so I do not see the university students as being much of a problem. When you ask our Korean students about the protesting of students, it is pretty much like a job application. If you go to work in a chaebol, one of the questions is: have you protested? It is really just a rite of passage. So I do not think there is really that much to it.

With the famine in North Korea as bad as it is, it is probably a good thing that Kim Dae Jung is now in power because he has thought far more deeply about the North-South relationship and wants to engage in economic cooperation, and certainly technical cooperation, with the North. That is a big change from the oscillating policy of the past. Given that environment, and with the four-party talks which are going on at the moment, that famine has been driving the North to the negotiating table and, with a far more sympathetic president in the South, there could be prospects there for certainly an improvement in the relationship and increased dialogue.

The defence budget has been slightly cut, I think, under the current package to parliament. There is incentive here for both the North and South to wind back the package in this time of economic austerity, but I suspect that it will remain relatively insulated in the short to medium term.

CHAIRMAN—Thank you.

Dr BRAIN—It seems that the speed of South Korean recovery will depend on how quickly they reorganise their assets and the chaebol restructure and cut back to core business and sell assets, mainly, I guess, because of the general excessive debt to foreigners. Therefore, the key question becomes: how quickly do you think that the Koreans will in fact embark on a wholesale assets sale to foreigners and start offering prices that are realistic for foreigners to pick up?

Dr HEATHER SMITH—On debt restructuring, Korea has been successful in that the composition of its debt is held mostly by the banking sector, so they are able to go on this travelling road show, like Mexico did in the 1980s, and sell the commitment to reform and roll over the short-term debt, which they have managed to do. Sorry, what was the other section of your question?

Dr BRAIN—The time frame—

Dr HEATHER SMITH—I guess it is pretty much sink or swim for a lot of these businesses. One indicator that people use is that all the hotels are booked out in Seoul with business people there, but it is not clear yet that there are that many transactions taking place. But if they want to survive, they really do have to off-load some of this debt, and that becomes an issue for foreigners. They need probably a longer period of increased transparency so that they can see what debt a lot of these corporations are holding before they get in and start buying up. But there is likely to be some sort of backlash because you have got some really good companies going at fire sale prices in Korea. Once the public starts to see some of that taking place in very visible sectors, such as the retail distribution sector, then it is going to take on a new dimension.

It is two months since the IMF was in Seoul, so we really need a period of time yet to see how it is going to play out. But if the government is committed, then it is sending the right signals in terms of confidence to the international community. Korea looks attractive relative to other countries in the region at the moment.

Mr TAYLOR—Dr Smith, I agree with you that the secret lies in political commitment and national will. Also, the rhetoric of Kim Dae Jung has been very strong in terms of reform of the chaebol, prudential controls, and labour reforms, which he has already had limited success with in the parliament. But what does that all mean? Could we have an assessment from you, bearing in mind that the Republic of Korea is our second largest market, of what the short- to medium-term impact is on Australia?

Dr HEATHER SMITH—Australia is going to be impacted because the impact is going to fall on Korea's domestic economy rather than on the export sector. In terms of falls in domestic consumption, particularly of luxury goods and of capital imports and raw materials, which is going to impact on Australia, there are massive falls in imports of these goods over the first two months of this year. Whether it is implicit or explicit, the government does encourage frugal living, as we know, in Korea. In the services sector, there has been, obviously as part of this frugality, a drive for students to pretty much stay home. When you think that our education sector takes a lot of Korean students, particularly for English language studies, then that market is certainly going to dry up.

In terms of the raw material sector—beef, wool, iron ore, coal—it is certainly going to have an impact on Australia, also because the chaebol are having problems getting access to letters of credit in the short term, which is why it is important that they roll over this debt. For example, Posco, which is our biggest single buyer in Australia and is a healthy, well-structured company, is having problems getting access to finance. I believe that the beef tendering process is also very slow or non-existent at the moment.

To some extent, when Korea comes out of this you will still have a middle class which, even though disposable income is going to fall over the next two years or so, is going to rebound. And you will have a huge market opening in terms of foreign investment opportunities and increased transparency of doing business in Korea, which is very different from what it was last year.

Mrs GALLUS—Following up on the last question, will Korea be able to maintain its strong push for exports without the strength of the domestic demand, with that demand falling? For instance, the car industry have been very aggressive internationally; they have based it on their domestic demand. With all the factors that play into that, what is going to be the end result?

Dr HEATHER SMITH—There is considerable excess capacity in a number of industries in Korea. There will be a restructuring in the car industry in Korea which is going to cut back the number of producers in the longer term. But their markets for exports, particularly for their most competitive sectors, are still the US and the UK. So there is still going to be pretty healthy demand for their electronics, their telecommunications equipment, which has been showing strong growth.

It really depends on the extent that interest rates remain high, for how long they remain high, on how far they screw down the economy and particularly the chaebol. There are very high stock inventories in the country because of the massive industrial expansion has been going on over the past three or four years. Even though around 50 per cent of their exports do go within the region, the market for most of their major goods is still pretty strong in the US and Europe.

CHAIRMAN—Thank you very much, Dr Smith. We have two more speakers to conclude this session. The first one is Dr Ross McLeod, who will speak on Indonesia.

For Indonesia, a key point was probably the first week in November 1997, when 16 banks were closed in line with the requirement of the first IMF package. Through the last 12 months, the Indonesian stock market value has declined by 80 per cent and the value of the rupiah by 70 per cent. Capital has dried up, and now there are associated political and social impacts which look to be quite significant and are having a major effect on everyday life. As it is our near neighbour, Australia is vitally concerned with the stability and prosperity of Indonesia. I therefore welcome Dr Ross McLeod to discuss the situation in Indonesia today.

Dr McLEOD—Thank you, Mr Chairman, and good morning, ladies and gentlemen. I do not have the high-tech skills of my friend and colleague, Dr Smith, so I will stick with the boring old overhead transparency projector.

I guess I am not going to give a long story about what I think caused the crisis as far as Indonesia is concerned. In a sense, it is almost ancient history now even though it is only a few months ago. What is perhaps more interesting to me and, I hope, to you will be to have a bit of a discussion on the current state of play and what looks like happening in the near future.

I think I can summarise what has been going on by saying that the economy has gone from high flier status to shambles status in a very short space of time. The Indonesian economy, prior to the middle of last year, had been growing on average by eight per cent per annum in real terms. That is a phenomenal rate of growth to be able to sustain over many years, and very few countries were able to match that. Its inflation rate was quite low and falling at about five per cent at that time. But now when we look at the circumstances in Indonesia, we see rapidly growing unemployment and accelerating inflation—you might even call it hyperinflation, although it has not been established for very long. Also, if we look at the currency itself, the picture tells the story. While it does not tell the whole story, it is certainly indicative of what has been going on.

A slide was shown -

Basically the rupiah was very carefully managed for a very long period. For 10 years prior to the crisis it depreciated at a very slow predictable rate of about four per cent per annum and then suddenly, after the Thai baht was floated in July of last year, the rupiah came under speculative pressure. The small jiggles that you see in about August and September at the time we felt were quite outrageously large but of course they have been dwarfed into insignificance subsequently. The rupiah has gone in very rough terms from 2,500 to the US dollar to about 10,000 to the US dollar presently.

That means that every firm that has a debt denominated in foreign currency now has a debt which is four times as large in rupiah terms. If you are an average Indonesian wanting to feed your family, the threat is that the price of the food you want to buy, and the other services you want to buy, is likely to rise ultimately also by a factor of four if this exchange rate is maintained for any length of time. For the time being, the government has been able to keep a lid on the price of goods and services but that will not be possible in the longer run if the exchange rate stays where it is now.

I also want to talk a little about the IMF's role in the crisis in Indonesia. As you know there have been two IMF packages. One was announced at the end of October last year and a second one was announced on 15 January of this year. I think we can now say that that package has failed in the sense that the rupiah has not recovered, and there is no end in sight. There is no light at the end of the tunnel. In fact, it seems we are more likely in a cave than in a tunnel.

The problem that the IMF package does not address properly is the problem of foreign debt or, more precisely, foreign currency debt. Companies in Indonesia simply cannot repay that debt with the rupiah where it is at the moment. The change in the rupiah has simply wiped out their capital. Secondly, the banking system, as the chairman mentioned a moment ago, is in a mess. That means that there is no liquidity for working capital in the Indonesian economy. The analogy I make with that is that it is like trying to run a motor car without any oil in the engine. Without liquidity, the economy simply seizes up.

I do not see that either IMF package addresses those key issues. I am very critical of the approach that the IMF has taken in Indonesia, and I use the following analogy to try to get my point across. Imagine that we are in a village and that one of the houses in that village is on fire. The family that lives there is stuck inside and is calling on the neighbours for help. The neighbours are outside and the chief neighbour, let us say the village headman, says, ‘Yes, we are willing to help you, we are willing to put out the fire and get you out of your predicament, but remember that we have been trying to convert you to Christianity for the last 20 years without success. Provided you convert to Christianity now, we will get you out of this house fire.’

That, it seems to me, encapsulates the IMF’s approach to Indonesia at the moment. It is virtually asking Indonesia to adopt a particular religion which some people describe as economic rationalism. The IMF has virtually imposed a whole stream of micro-economic reforms on Indonesia which economists such as myself, people from the World Bank and the IMF itself have been asking for for many years. It seems to me that the IMF has seen in this crisis an opportunity to hit Indonesia—or specifically the President—while it is in a weak position, and so it has virtually gone for broke.

The important thing that I want to stress here is that the reform package is not really the solution to Indonesia’s crisis. I see it as the price of IMF goodwill—the IMF’s imprimatur and so on. It is a very important consideration because, if the IMF badmouths Indonesia or indicates it is not happy with progress in Indonesia, the financial markets move very rapidly to push the rupiah down even further and to make the problems even tougher to solve.

The important point I want to stress is that I do not see in that huge range of 50 points in the second IMF agreement the solution to the crisis because not enough of those points—in fact, hardly any of them—deal with the fact that the companies cannot repay their foreign currency debts and the banking system has simply stopped working.

The technocrats are the people who had such a wonderful record of managing the Indonesian economy over more than three decades. They, in Indonesia, were the darlings of the IMF and the World Bank up until the middle of last year. Now, unfortunately, the crisis has not been solved. As long as the IMF has been there, the crisis has gone from bad to worse to really terrible and, as a result of that, it is not really surprising that those institutions and those people have really lost their credibility with the President. I think that is the first time that that has happened over his more than three decades in power.

As a result of that, economic policy making in Indonesia is now in disarray and you see the President turning instead to an American economist who has advised him that a currency board would be a good idea. Everybody else seems to hate the idea, but the President still seems somewhat interested in it. So there is no coherence now in economic policy making in Indonesia, and that just does not bode well for the future.

As you are no doubt all aware, Indonesia just went through a process which is referred to as an election. The President was re-elected. He managed to get his good friend and protege Minister Habibie as his Vice-President, and he has appointed a new cabinet which really looks quite different from cabinets that we have had in the past in Indonesia.

From the composition of that cabinet, you could bet quite a large amount of money on the proposition that it is most unlikely that the IMF packages will be implemented in Indonesia. The reforms that the IMF was asking for really took a big swipe at Habibie himself by trying to close down or seriously constrain his aeroplane building fetish, shall we say. It tried to close down a lot of the crony capitalism, the monopolies that were given by the government to various business associates of the President, and it tried to take a strong hit at first family interests.

What do we find now? Professor Habibie is now the Vice-President and seems set to be given quite a big say in determining economic and industrial policy. We find that one of the two main business associates of the President, Mr Bob Hasan, has been appointed as Minister for Industry and Trade no less. The likelihood of those sorts of reforms being implemented seems negligible. The President's daughter is also amongst the cabinet ministers. That seems to send a fairly clear signal, if one were still needed, that the President is not going to have the government moving against his own family interests.

I have a few last points. There is a racial or an ethnic problem in Indonesia. As you know, the ethnic Chinese comprise about three per cent or four per cent of the total population but they are in a dominant position in the modern sector of the economy. We have seen quite significant outbreaks of violence and anti-Chinese sentiment in recent months, but it does not seem to have been such a problem in the last few weeks. The violence that we saw with the looting and burning of Chinese shops in small towns in various places, especially in Java, indicates one of the sad features of Indonesian political reality—that is, that various people from time to time find it expedient to beat the anti-Chinese drum, to treat the Chinese as scapegoats and to imply that the Chinese have been the cause of Indonesia's problems.

I am less pessimistic about that fact now than I was a month ago at the height of those anti-Chinese riots. But I think this anti-Chinese sentiment is still a possible obstacle to the recovery of the economy. After all, the very fact that the Chinese are so dominant in the modern business sector means that, if you beat them up too much, and if they start emigrating or if they just start putting most of their capital off shore, Indonesia would be shooting itself in the foot by that means.

Finally, let me say that what began as a financial crisis in my opinion has been very badly mismanaged during the period it has been running. It has now become very much a fully- fledged political crisis. Again, from time to time, in really pessimistic moments, I think revolution is just around the corner. The problem is that huge numbers of people have become unemployed and everybody is facing quite drastic increases in the cost of living—in food and services prices. If people get upset enough about those sorts of things, then it is not out of the question as far as I am concerned that you could have the spontaneous development of some kind of a people's power movement as we saw in the Philippines long ago, but it is not going to be tomorrow.

Suharto still enjoys the loyalty and the support of the armed forces. In politics, the armed forces are just about all that counts as far as a credible source of power. Until and unless masses of people get out on the streets and start protesting in a very big way, I think it is unlikely that the army is going to move against the President. If that is the case, then all I can see is a very long, slow and hard grind out of this crisis.

CHAIR—Thank you very much, Dr McLeod. Are there any questions?

Mr DUNN—You suggested that the problem with the IMF package is that it did not offer a solution to the Indonesians and it still left them with very high levels of indebtedness. The problem, however, as I see it, is that there is no alternative to the IMF package. Is there one for Indonesia?

Dr McLEOD—If you ask if there is an alternative, I think that that implies that you think that this package will work eventually. I simply do not believe that that is true. I do not believe it addresses the fundamental problems and I do not see anything much in the package that tells me it is going to be the solution to the problem. There is an alternative floating around even though it does not enjoy very much support, and that is the currency board idea. Think about that a little bit.

It seems to me that the basic resolution to the crisis must involve the rupiah strengthening a great deal. Every economist who works on Indonesia thinks that the value of the rupiah now is totally artificial. Somewhere in the future, if we can imagine Indonesia getting back to normality, we think that there must be a huge appreciation or a strengthening of the rupiah. Somehow that needs to be made to happen, because, as I have said before, the corporate sector cannot repay its foreign currency debt with the rupiah where it is and the poor cannot afford to feed themselves and the government cannot afford to feed them.

The second problem with the crisis is the banking sector. The banking sector is more or less dead at the moment. It is having a very difficult time staying afloat. The government seems to think that by forcing the banks to merge it will solve these problems. I personally think that forcing them to merge at this time will make it worse.

If you adopt as your starting point the idea that the rupiah must be strengthened as part of solving this crisis, then the currency board idea begins to have a little bit of interest, to me at least. I am not one of those who is willing to write the currency board idea off. On the one hand people say, ‘Indonesia cannot get out of its crisis unless the rupiah becomes much stronger, say, closer to 5,000 to the dollar.’ Yet when there is a proposal to set up a currency board which would do precisely that—set the rupiah at rates of that order—people say, ‘This cannot possibly work.’ Our own Reserve Bank seems to have been putting out the idea recently that Indonesia might do well to adopt a two-tier exchange rate system. When people look at that proposal, they will find just as many and perhaps a good many more flaws than with the currency board idea itself.

I do not really have a good answer to Indonesia's crisis. As I say, it is either going to involve a long, slow grind to get out of it or there may well be the revolution that topples the present regime and then we kind of start from scratch. The currency board idea is one alternative, which has not been given proper consideration. I think we really ought to study it more carefully because it is not at all clear to me that the President himself will not tomorrow or the next day just say, 'Well, here it is,' and the world will have to get used to the idea.

Mr SHIELDS—Dr McLeod, what I do not understand is the starting point of your argument. It seems to me there are very similar causes or outflows of the crisis in each of these Asian economies we have discussed this morning—banking system, currency depreciation, and, in some areas, excessive spending. Yet in all other cases the same structure, not the same specific measures, of IMF programs has been accepted by governments and I would argue perhaps are beginning to already see some return of confidence, for example, in the Korean situation and in the Thai situation. Why is Indonesia fundamentally different?

Dr McLEOD—I am more and more coming to the view that the crisis in each country does not have similar causes. I have heard various presentations from various people who prefer to tell the kind of story where one size fits all and one particular story suits all of the countries. I do not believe that is true. I will give you just some points of difference between Indonesia and Thailand. I mentioned that prior to the crisis Indonesia was growing very strongly and that its exchange rate was moderate and falling. Thailand had a fixed exchange rate policy which made it uncompetitive given the weakening of the Japanese yen. Unbeknownst to most of us, the central bank in Thailand was frittering away its international reserves right from the beginning of last year, if not earlier.

That is simply not the case in Indonesia. If you look at the foreign exchange reserves figures for Indonesia—the correct ones: I have to point out that there are two sets of figures and one is right and one is wrong—you will find that Indonesia's foreign exchange reserves increased by 38 per cent in just 10 months prior to the crisis. That is a huge amount. So Indonesia's balance of payments position was totally the opposite of Thailand, for example.

You mentioned that another common characteristic was excessive spending. I am not sure if you were referring to the government or to total aggregate demand.

Mr SHIELDS—Both.

Dr McLEOD—If it is both I guess I disagree with you on both. In Indonesia, fiscal policy was very conservative. Indonesia has prided itself for years and years, for decades in fact, on running what it calls a balanced budget policy. In fact, it had something even tighter than a balanced budget policy and, as a result of that, the government itself was able to build up its own deposits in the banking system to about the order of magnitude of $11 billion before the crisis happened. So there is certainly no excessive spending by the government in Indonesia; the government is a relatively small part of total GDP.

If we are talking about the economy as a whole, I think I heard Peter Brain mentioning that overheating was a problem in all of these countries. There was a lot of commentary that Indonesia was also suffering from overheating prior to the crisis. For what it is worth, I and some of my colleagues were arguing quite the opposite. You simply had a very vigorously growing economy. There was no overheating, and the evidence for that is, first, the inflation rate was tending to fall not to rise and, second, the current account was being more than fully financed by capital inflow. In other words, the current account deficit was not excessive in the sense that it was causing the foreign exchange reserves to run down; on the contrary, they were rising. So I would simply take issue that the same story fits all of these economies; I do not believe that is true.

One of the interesting things that we can learn from the crisis comes from studying not only the countries that have had the hardest time or the worst experience, like Indonesia, but also by studying another country that Heather mentioned before, which I do not think is on our list today, and that is Taiwan. How come Taiwan seems to have been able to handle this crisis and come out of it relatively unscathed? If we are telling the story that all of the East Asian and South-East Asian countries were having the same sorts of fundamental weaknesses then I would disagree. One of the reasons why I would disagree is that some countries have come out of it relatively well and some have fallen into a deep black hole.

CHAIRMAN—If we do not get too far behind schedule, I think Mr Walsh will deal with Taiwan quite admirably after we have a morning tea break. I have two very quick questions, one from Dr Southcott and one from Mr McLeay.

Dr SOUTHCOTT—Dr McLeod, just going through the currency board system, how would you see that it would work? One of the problems would be that, if you had a fixed rate at say 5,000 rupiah to the US dollar, no-one would want rupiah; everyone would want to change their rupiah for US dollars. You mentioned that Indonesia had done quite well by increasing their foreign exchange reserves, but just a market rate like that would have the potential to wipe out their foreign exchange reserves in a matter of hours.

Mr LEO McLEAY—You also said, Dr McLeod, that you see Indonesia moving more to a political crisis than to an economic crisis at present. What is your answer to the suggestion that a currency board is seen as more a mechanism to preserve the assets of the elite, particularly those around the President, rather than necessarily affecting the Indonesian economy?

Dr McLEOD—Thank you for those two sets of questions. I want to stress that I am not a supporter of the currency board system. I am rather an agnostic. I guess the reason I do not instantly dismiss it is precisely because everybody else does, and they do so, I think, without proper analysis.

One of the points that you made, Dr Southcott, is that Indonesia would very quickly run out of reserves. The fact of the matter is different, I believe. One of the principal requirements of the currency board system is that the amount of reserves that it holds must exceed the amount of base money in the system. Base money is a technical term for the monetary liabilities of the central bank, or what would now be the currency board. If you look at the numbers at the moment in Indonesia, Indonesia's reserves are greater than the amount of base money in the system.

If you can just imagine a very simple balance sheet of the currency board, with foreign exchange assets on this side and only base money as its liabilities on that side, plus its own equity; if this number is bigger than that number, then the currency board can never run out of foreign exchange reserves because, to buy those foreign exchange reserves, you have to use base money. The practical problem with the currency board is not that Indonesia does not have enough reserves; it is the fear that when everybody tries to take money out of the banking system to buy foreign currency, then the banking system will die.

It is a little bit of an act of faith, I suppose, on the part of those who support the currency board system. They say that if this thing can be credible enough, then people will not rush to take their money out of the banking system. To the extent that they do, interest rates will simply shoot up so high for rupiah deposits that people will be dissuaded from speculating against the rupiah because, on the one hand, you are worried about the possibility of the peg not holding but, on the other hand, you can get this huge juicy interest rate if you just stick with rupiah.

That is really the issue that needs to be addressed, not the red herring of whether Indonesia has enough reserves. It does not matter how much reserves the currency board will have, you will always face the problem of what happens to the banking system—could it stand up to the buffeting that would inevitably happen?

To turn to Mr McLeay's question: is the currency board a proposal simply to preserve the assets of the elite? We have heard this suggestion quite often. It is the idea that the first family and the cronies and so on want to use the possible setting up of the currency board as a means to get their assets out of the country. I do not think they have any intention of getting out of the country. On the contrary, I think the fact that the President has set up his own family member and his best business buddy in his cabinet indicates very clearly that he intends to stick around for a very long time, and he expects his family and his friends to stick around.

The point about it is that, if the currency board strengthens the financial position of first family businesses and crony businesses, it also strengthens the financial position of the whole corporate sector in Indonesia, and that is not something that I would want to argue against. On the contrary, the greatest thing that could happen to Indonesia now would be if the corporate sector could be given a new lease of life.

CHAIRMAN—Thank you. A very quick question from Mrs Gallus, and then I am closing this section.

Mrs GALLUS—You mentioned the possibility that, with the attacks on the Chinese, there would be a capital outflow. The Chinese, from my memory, control about 70 per cent of the wealth of the country, and if that were to happen, it would obviously be disastrous for Indonesia. I am aware that there is a great movement in gold and jewellery out of the country, but surely the low rupiah will, in fact, keep all the money in the country and make it difficult for the Chinese at this time to actually export most of their capital?

Dr McLEOD—I had not heard about gold and jewellery moving out of the country. If you tell me it is true, I will believe you.

Mrs GALLUS—I believe if you have a look at the figures for January, there is quite a difference between January last year and January this year in the amount of gold and jewellery that came out of Indonesia into Australia.

Dr McLEOD—You have got me there. I am embarrassed, because I am a person who researches Indonesia all the time and I would not even know where to find those particular figures that you mentioned—pardon my ignorance. There would certainly be a problem if the ethnic Chinese Indonesians moved all of their wealth out of the country. As you suggested, and as I suggested previously, the very fact that they have been so central to the economy would leave it in a very parlous state, much more parlous than now, if they were to go offshore.

I do not think this is a realistic possibility unless political conditions deteriorated very greatly. The Chinese population is only three or four per cent, but that is three or four per cent of 200 million people, so you are talking about eight million people, and they cannot just all suddenly emigrate. The facts of life are that most Chinese are going to have to continue to call Indonesia home. I think it is also not a realistic proposition to suggest that they would put their capital offshore and yet stay there themselves, because having capital is the means of having a livelihood, having a job.

If people invest their financial capital in their own businesses, thereby they get to use their own labour in their own businesses, their family members move into the same firms and so on. If you put your financial capital somewhere else, what are you going to do with your labour skills? They are just going to sit at home in Indonesia with no work to do. I am not sure that I am making that point very clearly, but I do not think it is realistic to imagine that the Chinese community is going to put all or even a large part of its capital offshore unless things become very serious indeed.

CHAIRMAN—Thank you very much, Dr McLeod. Regrettably, we must draw this section to an end. In conclusion, to provide a departmental overview of the countries we have been considering, we have Ms Pamela Fayle, the First Assistant Secretary, Marketing and Development Division, Department of Foreign Affairs and Trade.

Ms FAYLE—I was asked to come along with a blank sheet of paper and listen to everybody speak and then respond on behalf of the department, so that is what I have done. I think we are probably running short of time, so I will try to be as brief as possible.

The first comment I would make that is probably fairly obvious from the presentations this morning is that, just as there is no such thing as Asian culture, there is no such thing as an Asian crisis. There are, indeed, commonalities in what has happened in the various economies, as you would have detected from the presentations, but not every case is exactly the same in the detail, and certainly it is not a case of some sort of virus that has been caught from one country to another. As Heather Smith pointed out, that sort of linkage is a fairly minor sort of reason for what happened in Korea, other than perhaps the fact that because of what happened first in Thailand, the markets were looking very much more closely at these economies and the economic figures than they perhaps might have before. They were very much more nervous and therefore responded much more quickly than they might have before. So that is the first thing that occurred to me.

There was a lot of talk about fundamentals in some of the presentations too. We have had a look at this in the department. There is no exact definition of what is meant by ‘fundamentals’. I was in the region recently and an economist there said to me that he thought there were three types of fundamentals: economic fundamentals, which we all sort of think of as the macro-economic data; market fundamentals, which were things like equity markets, currency markets, real estate markets; and psychological fundamentals. He said that all three really needed to be considered as fundamentals if you were looking at what was going to happen in particular economies. I think there is a lot in that.

Peter Brain gave a fairly pessimistic assessment of what is going on and what the outlook might be and others were perhaps less pessimistic. In the department, we balance the full range of those views. We always, in making assessments about our important trade partners, try to identify downside risks and watch points. The difference in assessments comes with how much weight you place on those downside risks; how likely you think they are to happen. Before I came along here I went through a number of departmental publications anywhere from 1991 through to 1993—they were publications covering the region. In the cases of Thailand, Korea and Indonesia, in all of those reports what has now transpired was identified as a downside risk, but identified as just that. It was not identified as what we thought the main game would be. But I think, as somebody else said, if anybody thinks they know the answers, or indeed knew the answers, then I think they are lying. Nobody predicted the timing of what happened, even though a lot of people in this room had an eye on some of the weaknesses that were evident in these economies.

Moving on to outlook, the minister this morning talked a lot about the opportunities and what the government is doing. I will not go into that, except to say that we do anticipate slower growth in these markets, as I think all of the speakers this morning do.

We do expect that to have a negative effect on our export growth patterns. Our exports are already being affected. The data that Mrs Gallus was talking about, by the way, is probably the ABS monthly trade statistics, I suspect, between Australia and Indonesia. If you look at that data for all of these countries, and look at the data for, say, the last six or seven months and compare it to that six or seven-month period in the previous year, you can already detect that we have negative export growth for Korea and Thailand and we are just about even, bordering on the negative, with Malaysia and Indonesia.

The biggest fall has been in Korea. However, I should caution that that has been fairly largely caused by a fall in our gold exports and, in terms of impact on the Australian economy, those gold exports have continued to grow and are just being picked up elsewhere in the world market. So the overall impact is overestimated by just looking at that figure for Korea.

In the longer term, I guess it is fair to say that the department is very positive. You have to look at the fact that this region, without any growth at all, imports $1.4 trillion worth of goods and services every year, and those are big figures regardless of any growth that might be superimposed on them. The dept is also looking at the moment at some of the structural change that is likely to flow from what is happening to try to make assessments.

Quite apart from the hiccups of what has happened in the short term, there will be some longer-term changes that flow out of what has happened in the region and we are looking at what that might mean for Australia. There are certainly areas where we have been supplying goods to meet regional demand where demand is likely to drop off because those particular sectors are going to be moved out of by these economies, and there are others that they will move into and we will need to think in the medium to longer term about responding to those changes. In terms of the IMF programs, and other government responses to what is happening, there is a lot of liberalisation in amongst all of that that can be very good for Australia so we are keeping an eye on that as well.

Peter Brain talked about us being 'exposed'—if I can comment on that—and I think, or hope, he was talking about us being exposed in the trade sense when he talked about the 50 per cent. Indeed, about 60 per cent of our exports go to east Asia and probably around about 25 per cent of them go to the most affected economies, including Korea. Exposed, though, in an overall sense, needs to take account of the fact that only 20 per cent of our GDP actually comes from exports. At the moment, we have a very strong domestic economy. For Australia's outlook, that is ameliorating some of the effects of what is happening in the region. Also, strong demand growth in the United States, which is a major market, helps to offset some of the slow down in growth.

Nevertheless, if you just look at exports, we are going to take a hit and even though it is already showing up in the statistics we have not seen the full effect yet. A lot of trade is done on the basis of longer-term contracts and a lot of the cash flow problems have not flowed through into business being cancelled or non-payment on business already done. I think, as we look out over the next six months, we can expect to see an even greater impact from what is happening in terms of Australian exports.

The impact is different across industries and firms and that is why it is very hard as a government official to get up and say, 'The growth projection is around about 3.25 per cent in real GDP terms for next financial year and that is a pretty good performance.' That does not help if you are an industry that is badly affected, such as the live cattle industry exporting into Indonesia, or if you are a consultant in the construction area and you have been totally wiped out by what has happened in the region.

There will be some sectors and some firms that go under as a result of what has happened. But, as the minister said this morning, there are some who are turning things around and taking advantage of opportunities arising. There is a lot of easy, cheaper access—riskier access—to a lot of markets. If you believe they are going to grow in the future, it is a very good time to get in and take advantage of that. So there is a mixture of things happening there. By and large, my assessment is that the Australian business community is very well informed on these things and is keeping an eye on each of these markets.

In terms of assessments for the future, it is very difficult to make predictions about the future. I know the people here will say, 'That is what you would expect a government official to say; they do not want to put themselves on the line.' But let me tell you why it is difficult. As we have moved from financial turmoil into impacts on the real economy, we have now got to a stage, particularly in Indonesia, but also to some extent elsewhere, where the assessments need to be made factoring in how the government responds to what is going on. They are political and government policy type assessments.

So the future—the pace of recovery, the degree of recovery—depends much less on looking at nice quantifiable macro-economic data, and more on making value judgments and assessments about the ability and the willingness of political players and governments to take certain decisions, and follow certain paths to put their economies back on sounder footing and to convince the markets of that. We are dealing with some aspects that feed into outlook that are much more difficult to make firm predictions about.

Let me just talk about export led recovery briefly because it was mentioned by a few of the speakers. There is a high expectation out there amongst analysts, and the department is no exception, that we expect export growth to be a saviour for a lot of these economies to help lead them back to growth. Let us look at the Mexican case very quickly. They turned their situation around—almost entirely because the devaluation made them more competitive—and they were able to grab export market share from other economies.

It is going to be much more difficult in the region for that to happen or to happen as quickly. That is because there are a lot more economies in the same situation. You have to ask questions about where in the world economy is the absorption of this big growth in exports going to happen. If you look at the big markets that might help to absorb those exports. In Mexico's case, the US, of course, absorbed a lot of exports. But if you look at this situation we have now, when you think of the three biggies—Japan, the EU and the US—Japan is in a fairly flat state in its economy and any sort of growth factor there probably has to be conditioned by that. In Europe, yes, there is potential. They have strong demand growth but they are on a bit of an export promotion rather than an import absorption path at the moment so there have to be a few question marks there.

The United States is expected in all of these analyses to be the big absorber of all of these now cheaper products from the region, and that leads on to a few downside risks that we look at in the department for the future. The political cycle of the United States is such that a large influx of cheap Asian products into the American economy at particular points in time could have certain political implications. I guess we have a question mark over how any resurgence of protectionist sentiment in the United States might play through into this. Again, this is not something that we plot as the main game but it is something that we are keeping a very close eye on because the US economy's role in the recovery of these economies is quite critical, and we would like the Japanese economy's role to also be critical. But there are, as I say, a few question marks there.

Indonesia is a very difficult case and we consider it in a slightly different way in the department these days. We think the issues are now very political, strategic issues and that there are a lot of question marks. I do not think we would agree entirely with Ross McLeod's assessment of the IMF packages. If you are talking about a return in confidence from the markets, it is very important that a lot of the reforms in the IMF packages are put in place. Somebody asked a question about alternatives, but I do not see any alternatives for that.

I do say that the department has a view that the IMF has to have a degree of flexibility in how it deals with Indonesia. Certainly, Mr Downer is in the United States at the moment very much with that in mind. We think it is in Australia's best interest to encourage better accommodation and partnership between the Indonesian government and the IMF at this point in time. I think I will probably leave it there. I do not know if you have any questions. I am used to being asked questions by this group.

CHAIRMAN—I think we might take the questions, Ms Fayle, over morning tea because we are 20 minutes behind the schedule and, for someone who is a little interested in time, it is a matter of some concern. Thank you very much for your address. We will now have a short tea break.

Proceedings suspended from 11.20 a.m. to 11.38 a.m.

CHAIRMAN—We will start the next session of this seminar. We have been looking at a number of countries that have been in difficulties and in the next period we want to look at China, Japan, Singapore, Taiwan and other regional neighbours that are in a different category. Japan and China have undoubted leadership roles in this, as does Singapore with its strong financial base. For this section we have Mr Max Walsh from the *Sydney Morning Herald* to talk about these countries for us. I do not need to introduce Mr Walsh; he is probably one of the longest serving and best respected economic writers in Australia today.

Mr WALSH—Thank you, Senator, ladies and gentlemen. First off I can reassure you that if you cannot read this screen do not worry, I am low tech. This morning I have been asked to address the outlook for those economies of the East and South-East Asian region that have not been directly caught up in the contagion or Asian flu, as some call it. As well as the domestic outlook for these economies I will also look at their relationship with the regional and global economy.

We are talking here about Japan; China, including Hong Kong; Taiwan; and Singapore. Both Japan and China are individually larger economic entities than the aggregated economies of Thailand, the Philippines, Malaysia, South Korea and Indonesia. Using today's exchange rates, the Japanese economy is in fact bigger than those of Britain, France, Italy and Canada combined. So in both regional and global terms, the Japanese economy is a very major player.

This fiscal year, Japan will post its first annual contraction in economic growth since 1974, when the first oil shock pushed the global economy into its worst post-war recession. Were it not for the Asian currency crisis and the spectacular destruction of wealth that has occurred as a result of that, the state of the Japanese economy would be the dominating economic debate in global terms. In fact, within the international economic institutions and forums it is Japan which is the single greatest cause of concern because this economy, which should be hauling the troubled Asian economies out of the economic bog in which they find themselves, may actually drag them into even deeper trouble.

Japan is both the major market for East Asian exports and the major provider of its capital inflow. On the latest figures available, which cover the first half of last year and which understate the full extent of bank lending to Asia, the Japanese banks had advanced, in Australian terms, $190 billion to the East Asian region. The withdrawal of short-term bank lending has been identified by central bankers Alan Greenspan of the Federal Reserve and Stephen Grenville of our own Reserve Bank as a major factor leading to the dramatic devaluations of the currencies of Korea, Thailand and Indonesia. At this stage, the nationality of the banks which reversed their capital flow to the region are not known but it would be surprising if, when those details were revealed, Japanese banks were not prominent. While all banks with unhedged Asian exposure have reason to be worried about their loans, Japanese banks have the additional problems of a large bad debt exposure on their domestic dealings and a domestic economy that has now slipped, as I said, into recession.

For some time now, but with increasing stridency of late, leading members of the Clinton administration have been urging Japan to reflate its economy. Others have now joined the US administration. At the recent G7 meeting of finance ministers, the final communique came as close as such a statement ever does to criticising a participant—Japan. Last Friday the *Wall Street Journal* carried a report which led with the following sentence:

> In a series of private conversations between senior US Treasury officials and their Japanese counterparts the US is telling Tokyo, with unusual specificity, that Japan urgently needs to cut taxes and raise spending by $65 billion to $80 billion.

I guess the analogous situation would be Washington telling Peter Costello to bring down a budget that increased spending and cut taxes in Australia by $6 billion. You can imagine the political and media uproar if it was discovered that our domestic economic policy was being dictated in such terms by Washington. There is no doubt that this would be seen as an exercise of crassly insensitive arrogance by the Americans—and so it would be.

In the case of Japan, however, the situation is rather different. The Americans are breaking a convention of international relations because the stakes are so high and because they believe, correctly in my view, that they have widespread support from Europe and Asia. However, the solution that the US is suggesting to remedy the Japanese economic crisis—and crisis is not too strong a word—is by no means assured of success; in fact, it could be argued that the US solution will further exacerbate Japan's predicament.

In many ways what has happened in Japan over the last seven years is an extended, slow-motion version of the Asian currency crisis. This should not be surprising because the Asian economies have emulated the economic growth model that saw Japan become the second most powerful global economy. Where the crisis in the Asian economies has been compressed down to a six-month time frame, Japan has been in slow motion decline since 1991. Throughout that period its average annual growth was less than one per cent. Now, I repeat, it has slipped into recession.

Japan's fall from economic grace is a direct result of an approach to economic policy which stressed the supremacy of national aspirations as the measure of success. The defining characteristic of Japanese economic policy and the Japanese model, as it is called, was administrative guidance. In effect, the central element of the Japanese economic model was that it was a command economy that evolved, over time, into an institutionalised system of what we now call crony capitalism—one based on bureaucratic and industrial networks rather than what one would say was the nepotistic model favoured by Indonesia.

Initially, this approach to economic management was informed by a sense of common purpose—that is, to rebuild the nation from the ashes of a devastating military defeat. Its successful execution was helped immeasurably by the legendary frugality of the Japanese people. Japan built its economy by mobilising low-cost high levels of domestic savings to fund investment in an export manufacturing sector that pursued a strategy of dominating key sectors of global markets. The way in which Japan leveraged the comparative advantage of low-cost investment into a global manufacturing juggernaut has been well documented.

Less well documented, but becoming much more widely understood, is how the system of administrative guidance evolved into a cosy relationship between the bureaucracy and the industrial groups known as the keiretsu. At the centre of each of these keiretsu sits a bank. The function of the bank is to build and expand the keiretsu. A by-product of this has been that the Japanese banking system, even when operating in the most benign of economic circumstances, runs on very skinny margins.

The banks are often run by former senior bureaucrats of the ministry of finance. I will briefly sketch in the structural background in order to explain why Japan moved into the economic doldrums during the 1990s and why its economy, having lost momentum, is now taking on water. The late 1980s in Japan was a period known as the bubble economy, when the economy went through an enormous bout of asset inflation. This was a direct result of Japan’s efforts to reduce its current account surplus by pushing up the value of the yen against the dollar. The mechanism employed to do this was monetary policy. The Bank of Japan’s discount rate at the end of the 1980s was held at a postwar low of 2.5 per cent, and it was held there until May 1989.

In the two years following the 1987 stock crash, the Nikkei index doubled and property prices went the same way. Then the Bank of Japan pricked the speculative bubble. What should have happened, and would have happened in an economy where market forces were allowed free play, is that the crash in the stock market and property values should have led to the bankruptcy of overexposed borrowers in the corporate sector and the rationalisation of the financial sector, where it was obvious that a number of banks and other institutions were no longer viable.

Instead, what happened was that the banking system, which operated under accounting standards designed to conceal rather than reveal the true state of affairs, simply ignored its bad debt problem. It was assisted in this by its close relationship with the prudential supervisor of the system, the ministry of finance. We now know that, even when these permissive accounting regulations were not sufficient to hide the true bad debt situation, there were friendly bureaucrats at the ministry who would tip off the banks about random audits; this was done for a round of golf or a night in a bottomless bar.

This state of affairs was tolerated because there was a belief, as there always is in these situations, that the banks would grow their way out of their problem loans. Unfortunately, the bad debt problem with the banking system has grown worse with the passage of time and the capitalisation of interest. Even cutting the official discount rate from six per cent in 1991 to two per cent in 1993 and down to 0.5 per cent in 1995, where it remains today, has not stimulated the Japanese economy. Paradoxically, the economy is, despite recording the lowest interest rates in history, apparently suffering something of a credit squeeze.

In February, the total value of outstanding loans supplied by Japanese banks actually fell by 0.6 per cent, and that was the largest monthly fall ever recorded in that economy. This reflects the way in which the recession is now affecting the capital adequacy ratios of the banking system. Falling share prices are reducing the capital base of the banks and also the value of collateral of clients.

In a typical Japanese solution to this problem, the government is pumping $20 billion of public funds into the capital base of the banking system. But, of course, the banks are still being run by the same people who loaded them up with bad debts in the first place. You may appreciate the irony that two of the recipients of this government largesse are banks which, we were told last week, have been bribing a Bank of Japan official in order to obtain inside information on the central bank's open market operations. The banks have not been charged; they have been rewarded.

At the same time it is reported that the government is about to prop up the stock market with a $13 billion interjection of deposits through the post office savings system. This and other changes to accounting standards approved by the government will enable the banks to rule off their books at the end of the financial year with inflated stock prices.

It is not only the capital adequacy issue which is resulting in the contraction of credit. Since last April, when the sales tax rate was increased from three to five per cent, consumer demand has been flat to falling in Japan. In the September quarter national accounts released last Friday, personal consumption fell over that quarter by 0.9 per cent. Through the whole of calendar year 1997, domestic demand actually subtracted 0.5 per cent from GDP growth. That is the first time, again, that that has happened since 1974.

As domestic demand is still falling, so too is demand for Japanese exports. Asia, before the crisis, accounted for 40 per cent of all Japanese exports. Consequently, because of the crisis in Asia and the fall in exports, fall in domestic demand, inventories in the Japanese economy are presently at a record level as a proportion of GDP.

At the same time that domestic and export demand are falling, the corporate sector is reducing its investment activity, because low interest rates through the 1990s have actually encouraged relatively high levels of investment, even though the economy has been growing only slowly. As a result, Japan has a significant oversupply of capacity in many areas. Consequently, the contraction in bank credit reflects both supply side and demand side forces. In such circumstances, no wonder that the US and others are calling for large-scale fiscal stimulation by the Japanese government and, doubtless, there will be some practical acknowledgment of this very soon. However, fiscal stimulation, be it in the form of tax cuts or increased government spending, is no guarantee that the Japanese economy will turn around.

Since 1992, the Japanese government has had a succession of fiscal packages. All up, a total of ¥75 trillion—in round figures, $A750 billion—has been pumped into the system. The main result has been to blow out the nation’s fiscal deficit, increase public debt and leave the electorate even more cynical about the government’s strategy.

Because Japan has the most rapidly ageing population of all the advanced economies, there is considerable concern in that country about the level of public debt and the ability of future Japanese governments to provide pensions and health services for its greying population. As a result, the more Japan seeks to stimulate the economy by way of fiscal deficits, the more the electorate at large is encouraged to save to finance its old age. So you have a liquidity trap. Low interest rates are not encouraging consumer spending or investment. As a result, income growth is now decelerating and investment will almost certainly begin contracting before long. At the same time, we have the deflationary impact of lower Asian prices for imports coming through. A conventional Keynesian stimulus in the form of increased public spending is just as likely to be counterproductive.

There is a final point I would make about the Japanese economy before moving on, and that is the role of the exchange rate. With the advantage of hindsight, it is now obvious that the present currency crisis in Asia had its roots in the sudden depreciation of the yen which occurred from mid-1995, when it moved from ¥80 to the US dollar to more than ¥130. This was an effective depreciation of 40 per cent. As Thailand, Indonesia and Korea pegged their exchange rates to baskets of currencies largely dominated by the US dollar, their currencies, like the US dollar, appreciated against the yen. The blow-out which that caused in the Thai current account and the way in which the loss of import income exposed its overextended financial sector was where the crisis began.

However, the Japanese-US dollar exchange problem goes beyond that episode, dramatic and all as it has been. Since 1971, the yen has appreciated against the dollar: with 360 then, it is now 128. The depreciation, of course, has not been in a straight line. It has been, as we saw in 1985, quite volatile, but the trend is unmistakable and the markets know that. Because the yen has this record of appreciating over time against the dollar, the yen bond rate is persistently and significantly lower than the US dollar bond rate. At the moment it is about 400 basis points at the long end.

Consequently, when US interest rates are low, as they are now, the end long-term interest rate is under two per cent. In fact, it was 1.89 per cent yesterday, which is referred to as being the lowest level ever in history, and not just in Japan but anywhere. This inhibits the use of orthodox countercyclical policy by the Japanese authorities. I can illustrate with a local example. When Peter Costello reduced the fiscal deficit in his two budgets, the Reserve Bank was given freedom to move on the interest rate front, and this has had quite a favourable impact on the level of domestic activity in Australia.

The same monetary easing as a result of fiscal tightening is now showing up in the European economies that have cut their deficits in order to qualify for the monetary union. But Japan cannot capitalise on this approach. It cannot cut interest rates and tighten fiscal policy: rates are already close to zero. What is needed is a credible stabilisation of the yen-dollar exchange rate, which would see a convergence in US and Japanese interest rates. I have to tell you that is not even on the global radar at this stage.

To summarise, the Japanese outlook in a single word is gloomy, a view now being openly endorsed by international political leaders not normally given to offering negative views about the future. Also, it is evident that conventional pump-priming will not work until two other basic problems are addressed: firstly, the restoration of health to the banking system, and that involves rationalisation; and, secondly, the stabilisation of the exchange rate regime between Japan and the US.

Political relations between the two countries are, however, becoming strained rather than cooperative, and that situation will, I suspect, worsen in the months ahead. One of the reasons I say this is the second subheading of this paper, China. From what is actually a far more difficult economic base than that of Japan, China has actually played a most astute political hand through the Asian crisis. Last week, President Clinton announced he would be visiting China in June. At the same time, speculation mounted that the US would be backing China's entry into the World Trade Organisation, the implications being that this is a reward for the responsible way in which China has handled itself through the Asian currency crisis.

Certainly, China has indicated that it is looking for some quid pro quo for its responsible response to the Asian currency crisis—that is, in not devaluing the currency despite the fact that its regional competitors have undergone major devaluations. Given the domestic situation for the Chinese economy, this rejection of the devaluation option can be characterised as being a case of self-denial for the greater regional good. However, China stands to be hurt as much as anybody else should there be a round of competitive devaluations in the region.

Nonetheless, it does appear that the basic reason for retaining the exchange rate at its pre-crisis level has been political rather than economic. Entry into the World Trade Organisation would upgrade China's status amongst global players. Also, I must say that I would be watching closely for any suggestion that China should be extended the same treatment in respect of G7 meetings as Russia has been. In effect, Russia has been given a seat at that particular table.

While it is early days yet, it seems to me that a significant change is under way between US relations with China on the one hand and Japan on the other. Where Japan has, until now, been seen as the economic anchor for the region, its failure to fill that role through the Asian currency crisis, and the cultural institutional hurdles it faces in dragging itself out of recession back on to a growth path, may turn out to be seen with hindsight as a watershed in regional political and economic relationships.

I simply flag that in a qualified and tentative fashion because, while China has played its politics quite astutely through the crisis, the fact remains that its economic challenges are truly monumental. Because of its sheer size, China is in aggregate one of the largest economies on the globe. Using purchasing price parity as a basis for comparing the size of various economies, the IMF reckoned that China was a $3.5 trillion GDP economy, compared with Japan's $2.7 trillion. Of course, it hedges that with particular qualifications; but, even allowing for a 25 per cent error factor, that puts China right up there with Japan.

In per capita terms, however, China is still a very poor economy. In terms of purchasing price parity, its per capita income is $2,900 as compared with $21,000 for Japan. Furthermore, in structural terms, China remains a dangerously dysfunctional economy. I hasten to say that it recognises this and has embarked on a program of structural reform, the scale and pace of which, it is being suggested, are quite mind-boggling.

In detailing the present situation in China and the program of structural reform about to be overseen by the country's new Premier, Zhu Rongji, I should first warn you that the official Chinese economic data must be treated with caution. Apart from the obvious difficulty of collecting accurate statistics in this large, complex and diverse economy, it is also a country run by a centralised authoritarian government which is often more concerned with its reputation than the integrity of its statistics. For example, the official unemployment figure in Japan is three per cent; the actual figure is undoubtedly closer to 10 times that figure.

However, China is becoming more transparent in economic terms. One of the more surprising aspects of the recent meeting of the national party congress, the National People's Congress, was the candour with which the country's economic problems were addressed. We saw a number of significant policy announcements that show that China acknowledges the more obvious structural defects in its economy.

Without doubt, the most important decision taken was the election—'appointment' is probably a better word—of Zhu Rongji as premier. Zhu's success in winding back inflation in China from over 20 per cent to virtually zero over a period of three years, without pushing that economy into recession, has been a singularly impressive exercise in economic management and political courage.

Remarkable as that exercise was, it pales into insignificance compared with the challenge he now has to reform the state-owned enterprise sector, SOEs as we call them, and turn them into a collection of viable profitable enterprises. The state enterprise sector accounts for 40 per cent of the Chinese economy. It employs 14 per cent of the non-rural work force, and its borrowings from the banking system represents 75 per cent of total outstanding bank credit. A dangerously high proportion of that credit to the SOEs is non-performing.

Putting a figure on bad debt or non-performing loans of the Chinese banking system is rather difficult. Officially, the Bank of China said the bad loans represent six per cent of total loans, and that figure is, of course, a fanciful understatement.

Nicholas Lardy, a senior fellow at the Brookings Institute in Washington, who spends all his time looking at the Chinese economy, puts the figure at 22 per cent. His is by no means the extreme end of bad debt estimates. Standard and Poors, the respected ratings agency, quotes a figure double that of Lardy's. So Lardy's figure, 22 per cent, translates to $A230 billion and that compares with the declared capital base of the system of only $80 billion. In other words, China's banking system is technically insolvent, bankrupt.

However, the banking system retains the confidence of its depositors because it is a state-owned system and ultimately backed up by the taxation power. This is not as reassuring as it sounds when it is appreciated that the banking system has been expanding credit at three times the rate of growth in total revenues collected by all tiers of government.

The reasons that China, with these unsustainable financial relationships, has not been subjected to the currency price contagion which has swept through other Asian economies are: firstly, its currency is non-convertible for capital transactions; secondly, the country has foreign reserves of $US140 billion; thirdly, it has been running a substantial trade account surplus; and, fourthly, it has no exposure—or no real exposure, it says—to unhedged short-term foreign debt.

I should quickly qualify that final observation to note that this is the official position—in fact, it appears that Chinese corporations have been significant short-term borrowers through Hong Kong, and they probably have unhedged debt to the order of about $US50 billion. In the last few weeks at the National People's Congress, the Chinese authorities announced that they will recapitalise the banking system with an injection of nearly $A50 billion.

Recapitalising the banking system is a pointless exercise, however, unless the SOE system is forced to stop using it as a welfare system and that is Zhu Rongji's job. Even the Chinese admit that the SOE will need to be downsized by 30 to 50 per cent for it to become profitable. This sector employs 90 million people.

The political risks, of course, of rationalising the SOE sector are compounded by the fact that Mao Tse Tung located most of the SOEs in the north-east and in the Sichuan province for defence reasons. But the concentration of those makes it obvious that the rationalisation process will have a big question mark over possible social and political developments.

Looking at the economic aspects of what is happening, it is evident that there will be a significant increase in unemployment through China in the year or so ahead. This comes at a difficult time, because it is evidence that China's engines of growth, which have been very powerful for the last 20 years, indeed, are now spluttering. Some 25 per cent of the country's exports go to Japan, which has already slipped into recession.

In other markets, it faces increased competition from the East and South-East Asian economies, which have undergone large currency depreciations. Most of the direct investment in China has come from the Asian region and this has already slowed down quite substantially.

The deceleration in domestic demand, export demand and foreign investment has exacerbated the bust of the property development boom, which has seen absolutely huge excess capacity built in Beijing and Shanghai. At one stage, the mayor of Shanghai was boasting that one-fifth of all the construction cranes in the world were operating in his city.

The Chinese economy needs to grow at six per cent annually to soak up the natural growth in the work force. The latest official forecast is eight per cent—a forecast which needs to be treated with even greater scepticism than normal.

With the headwinds that I have enumerated above, such a growth rate will be difficult. The obvious solution, in economic management terms, is the one that has been ruled out—a devaluation of the currency. I think we can reasonably be confident that this will not happen in calendar 1998 for the political reasons that I have advanced. But given the domestic structural problems and the realisation that, unless they are addressed, a full scale economic crisis is on the cards. For that reason, the devaluation decision will not be postponed indefinitely.

That is why it is crucial for stability to be restored to the region as quickly as possible. Were China to devalue before that happened, a further round of competitive devaluations would be a real risk.

I will now turn briefly to Taiwan and Singapore, two economies which have come through the crisis relatively, but not entirely, unscathed. Taiwan is much the larger of these two economies and it possesses, after Japan and China, the largest level of foreign reserves. Significantly, this did not stop Taiwan from devaluing its currency last October. This was entirely unexpected at the time and occurred at a particularly sensitive time in its crisis, when Hong Kong and Korean exchange rates were under considerable pressure. The effect of this devaluation was to protect its export base. But Taiwan’s decision to protect its export base by devaluing, despite its huge war chest of foreign reserves, set off another round of market-driven devaluations through the region.

The Chinese authorities in Beijing have not been backward about stressing their responsible behaviour compared to the damaging self-interest displayed by Taiwan. Taiwan’s decision was almost certainly driven by local politics. Had it decided to defend the exchange rate, then interest rates would have jumped and the stock market would have fallen and probably crashed.

Local government elections were scheduled to be held in November and the ruling Kuomintang were on the back foot. The stock market crash would have led to a landslide against them. As it was, the KMT lost in these elections. Its long-term stranglehold on the national government will be under serious challenge when the parliamentary elections are held in Taiwan later this year. This suggests to me that domestic political considerations will continue to dominate economic policy formulation in Taiwan.

As long as the currency crisis is defused and moves towards stabilisation, that suggests Taiwan will not do anything that could upset the situation. Should, however, the region suffer another dose of the wobbles, for whatever reason, then Taiwan could not be guaranteed to place regional considerations ahead of its domestic political agenda. In other words, it cannot be ruled out that Taiwan could set off another round of competitive devaluations.

Singapore has been suggested as the Switzerland of Asia: a small, well-run economy that is a small island of tranquillity in an ocean of turmoil. Well, not quite! Singapore has been a safe haven in much the same fashion as Australia has. It has seen its currency depreciated by 18.6 per cent since July last year. By comparison, the Australian exchange rate is down 10.7 per cent.

Singapore’s economy grew by 7.8 per cent last year and the official forecast for this year is between 2.4 per cent and 4.5 per cent. Looking at the figures now coming to hand, even that modest growth forecast looks to be on the ambitious side and 75 per cent of Singapore’s exports are electronics, mainly disc drives. They are now starting to see some figures come through for what has happened to the prices of Asian exports. The Singapore export price index for November was 10.5 per cent below its average for the past 12 years. The figures for export indexes from Korea and Taiwan are actually even worse.

This is evidence that the importers of electronic equipment from Asia—and that basically at this stage means the United States—are forcing the Asian exporters to pass on some of the currency gains they have had from their devaluation. The Asians have no pricing power. It was the reflection of the overcapacity in their exporting sectors.

I will conclude there. Of necessity, this has been a hurried trip through some very complicated and, in some ways, unexplored country. Naturally, I would be happy to answer any questions. I should say I will try to answer any questions.

Mr WILLIS—In relation to Japan, as you have said, there has been an enormous amount of pump priming going on. I think it has been in the order of some 75 trillion yen, which is around $860 billion Australian dollars, about 1¾ times our GDP, which is an extraordinary amount of money to pump in for no result. You said that is basically because the Japanese people have increased their savings in response at the same time. Would you like to explain a bit more why there has been this reaction of the Japanese people to save and, therefore, negate the pump priming effect? Does that mean that in any future pump priming exercise some new approach needs to be taken, perhaps by pumping the money into the banking system to overcome their capital problems, boost the credit system and get a double bang for the money?

Mr WALSH—As you know, this is largely unexplored territory. Japan is breaking all of what we would call the orthodox rules of economics by its behaviour through these pump priming exercises. It should be first of all said about the pump priming exercises that they have not been conducted in the most efficient manner in the first place. A significant amount of money has gone into land purchases, which puts money into the economy but does not help investment activity.

The second and large amount has gone into infrastructure development. It has largely gone to the construction industry who are very friendly with the government. That is part of their system of crony capitalism, which is among the reasons which lead to cynicism amongst the electorate at large.

Japan also has the most rapidly ageing population of all the advanced industrial countries. It has a pension system which is not particularly generous in the first instance, so people have to look after their own retirement. The Japanese people are traditionally quite frugal anyway. But they have watched their budget deficits blow out, they have watched these packages come forward which have expanded their public sector deficits and lifted their level of public debt. Their last election, I should remind you, was actually fought on a platform where the present Prime Minister Hashimoto promised that he would bring the budget back into balance within a period of three years. Instead, that budget deficit has expanded.

This is a very awkward situation. Having frightened the wits out of the electorate and told them that the government would be unable to fund their pensions in their old age if they continued to run large surpluses, we now have a government which is doing a U-turn on policy and starting to run surpluses. It is not surprising the electorate should behave in this fashion.

I did not touch on a number of other aspects of the Japanese economy because it was only a brief overview. Japan continues to run the most closed economy of all the advanced economies, in terms of its level of imports to GDP and in respect to its level of foreign investment. It has these institutional and cultural traditions which make it very difficult for it to change its approach to its economic settings.

We have been talking for twenty years about the need for the Japanese economy to deregulate. The OECD has brought down repeated reports on this. Every time the Japanese say they will do it, they move forward with a glacial speed. We are going to see on April 1 what they call their big bang. That will start to deregulate their financial system, which is actually where you do have to start with deregulation. That will be a step forward.

Nobody pretends that deregulation at this particular stage is going to be the magic pill for the Japanese economy. They are still placing their faith in the orthodox economists, the American administration, the G7 people and in Keynesian demand expansion proposals. I am suggesting one. They have not worked in the past; they are unlikely to work in the future.

Secondly, I did not quote the source about the exchange rate as I was only touching on it briefly though it is tremendously important. Professor McKinnon from Stanford University, who has done a lot of work in this area on foreign exchange rates, points out that the belief of all financial markets that the Japanese yen will continue over the long haul to appreciate against the US dollar imposes an impossible road block on the path to stimulating the Japanese economy.

As I said, addressing that problem requires a degree of cooperation between the US government and the Japanese government in terms of economic policy, which simply is not even at first base at this stage. The Japanese economy has been more or less stagnant since 1991. We thought it was going to take off a year or so back. I think it was in 1996 that they got the growth rate up, but it just fell back again. They tried.

They increased taxes last April. Their retail sales tax moved to five per cent from three per cent. Everybody knew it was coming, so they jumped in and bought in January. In January, the motor vehicles sales were 22 per cent lower than they were last year. The Japanese economy is not going to take off.

Dr McLeod—Max, I am sorry, I did not realise you were going to be talking about Taiwan.

Mr WALSH—I only talked briefly.

Dr McLeod—That is precisely what I want to ask you about now. You talked very briefly about Taiwan. I would certainly be very interested to know a bit more about it. Specifically, I have the impression that Taiwan has been largely unscathed by this crisis, yet it is part of the very same region where all the other countries have been having such a tough time. You mentioned that they did a devaluation. I assume that was relatively small, but I do not know whether that it is true or not.

Mr WALSH—They have devalued about 16 per cent all up since last July. It is a fair devaluation.

Dr McLeod—Coming from Indonesia, when I talk about 80 per cent, that is a devaluation—16 per cent sounds pretty small. Is the Taiwan economy still chugging along pretty well? Is there mounting unemployment or is it still going well? If so, how come Taiwan is different?

Mr WALSH—Taiwan is different because, while it followed the Japanese model initially of administrative guidance or crony capitalism, it did move away from that model—painfully I understand. There are obviously still overtones of it and I do not pretend to be a great expert on this subject. I have followed with particular interest Taiwan's behaviour, especially through the crisis. It moved away from that style of capitalism which was first of all perfected by Japan and copied in one form or another by most of the Asian economies. Its industrial and export structure is characterised by small-scale operations and not large-scale operations.

Another interesting thing about Taiwan which people do not appreciate is that, although it is quite a successful exporter of high-tech goods, it also has a rural sector. It has larger agricultural exports than Australia does. It has never, ever turned all its energies to being just a high-tech producer and relying on a narrow range of products. The Taiwanese processed food conglomerates are amongst the biggest in the world.

Its entire structure is characterised by small-scale operations relative to what we see in Japan and Korea, for example. As one of the earlier speakers said, they are quite nimble. They will hunt around and find their niches and that has been part of their success. And because they are small-scale operations, they tend not to be highly geared the way large-scale operations are. Also, as has happened with Japan and Singapore—it is not the case for the other countries—they have run consistent current account surpluses. All of these things have helped them weather their particular situation.

In essence, Taiwan is closer to being a westernised market force economy than any other in the region. Singapore is there, but I regard Singapore as a suburb of Asia. It simply does not have the particular problems that you have in a large economy. It does not have an agricultural sector to begin with and you can run Singapore like a large company. But Taiwan is a country and it has gone close to replicating what is now being called the Anglo-Saxon model by everybody else in Asia. In that, I think there is a large explanation for how it has currently weathered the storm.

This is evident, I hasten to say—it is not just in its economics—in that it is moving further down the road to genuine democracy than just about any other country in the region. That reflects its economic interest groups as well. Thank you.

Dr HEATHER SMITH—As someone who did their PhD thesis on Taiwan's industry policy, that was a very good answer. I want to follow up on Dr McLeod, just to say quickly that the Taiwan government was pegging the exchange rate pretty much constantly since the missile crisis surrounding the presidential election. When you had the run on the currency in Taiwan, the central bank made the mistake of thinking that it was foreign speculators trying to attack the currency, so they kept it pretty stable. But the markets were judging that the currency was over-valued. As soon as the government floated the currency, the run stopped. The markets adjudged the currency to be over-valued, but they judged the macro-economy to be very sound for the reasons that you mentioned.

I have a quick comment on China. You mentioned Nick Lardy's paper. I want to stress that there are probably some dangers with that recapitalisation which Zhu Rongji has announced because, as you probably know, the government's plan is to issue bonds and then to ask the banks to buy those bonds. The way the banks are going to buy those bonds is to lower their reserve ratio. So it would be quite a problematic scenario if it were not done properly. That is my comment.

Mr WALSH—That is perfectly true. In fact, what Zhu Rongji did in his anti-inflation policy was that he insisted the banks increase their reserves as a ratio of deposits. Also, I think a figure of six per cent of deposits had to be placed with the central bank. My understanding at the moment is that the money they have in the central bank is going to be conscripted to pay for these bonds, which is rather typical of what you encounter with Chinese economic decisions. They seem to go around in circles without actually changing the system.

CHAIRMAN—Dr Southcott.

Dr SOUTHCOTT—Thank you very much. Max, you mentioned that Singapore and Australia had been safe havens. I would be very interested in your view as to whether that would still be the case with Australia without the last two years of fiscal consolidation—if Australia had entered this period of a currency crisis with a deficit of $10½ billion, whether the currency would have come under more pressure?

Mr LEO McLEAY—Can we then get a comment from Ralph?

Dr SOUTHCOTT—I am mindful of the fact that the former Treasurer is in the audience.

Mr WALSH—I have no doubt that even Ralph would agree that we would have come under greater pressure had we been running a larger fiscal deficit than we have been running. I think that is without any doubt. Also, it is very important—and it is not often referred to—that we took our pain in the late 1980s to early 1990s when we cleaned up our act in our banking system. We still have the memory of that. We have a much more transparent and more highly regarded banking system than the countries of the region.

I would however enter this particular caveat: it is often overlooked here that a very high proportion of our foreign debt—and our foreign debt is very high by international standards—is held on a short-term nature. How much of it is hedged I do not know, but there is no doubt it represents a very significant proportion. As Greenspan has pointed out, and others have pointed out, the transmission process of the contagion was the movement of short-term capital in the system. Greenspan and other central bankers—Stephen Grenville and Ian Macfarlane—also refer to this. This is a problem that has to be addressed because what they want is regulation. I cannot see what possible regulation can come forward.

There have been various suggestions, like the Tobin tax, et cetera, but I merely flag the fact that while we have escaped the contagion it could have been worse. The other very important point which occurred in Asia—and, Dr Brain, another aside—is that you can point to all the fundamental weaknesses that existed in those economies but we have never seen anything of this magnitude and speed when it comes to the destruction of wealth. This is something beyond economic history. Everybody is looking at it to figure out how it happened and why it happened. Those short-term overnight loans through the banking system were one of the important ingredients.

We have got through. We continue to get through. I think we would have been worse off if we had been running a different fiscal policy.

Mrs GALLUS—Following up on Singapore, I have just two very quick questions. You mentioned that Singapore's devaluation of currency is 18.6 per cent, which is just marginally higher than Australia's has been at its peak. Do you see that stabilising at that level?

Mr WALSH—No.

Mrs GALLUS—Do you think it is going to depreciate further than that?

Mr WALSH—Yes. Not even in Singapore do they know how all their connections with the region work. They can look at their trade figures. Everybody can look at the exports and imports. Singapore is a modern economy. It is very much the service centre for Asia. Nobody knows how those services are going to be affected. As I said, I think their growth expectations of 2.5 to 4.5 per cent are on the ambitious side at the moment, especially seeing what is happening in the electronics area. Singapore's exports are unbelievably dependent upon financial returns from the electronics sector—75 per cent—and the electronics sector competes against Taiwan, Malaysia and China, in particular, in these areas. We have not seen the last of the problems in the electronic area. There is an immense overcapacity. If I had to bet I would say I would expect the Singapore dollar to depreciate further. That is just the way things are shaping up at the moment.

Mrs GALLUS—My second question concerns electronics. Have the exports in electronics actually decreased or just the value of those exports?

Mr WALSH—In the electronics area, there has been an absolute glut, particularly of semiconductors in the world market. I was looking yesterday at how Hitachi is closing down factories all around the world. It was just announced yesterday. There is a rationalisation occurring in the electronics industry. There has been a fall-off in the volume, as Intel pointed out to the New York Stock Exchange about two weeks ago. They expect sales of personal computers to fall this coming year, which is the biggest single use of electronics. I have not seen the figures coming through. You see the export figures expressed in terms of the currency. You do not see them expressed in terms of volume at this particular stage—at least I have not. These economies do not have the best statistics anyway and they are slow coming to hand. This crisis, in all honesty, you can time from October. What happened before October did not matter. It is the post-October situation. I would be very surprised if the figures when we do get them do not already show the volume as falling away, but most certainly I can say the volume will fall away.

CHAIRMAN—We thank Max very much for a very interesting talk. I was going to reluctantly close at that point because we are 30 minutes behind schedule but I see the Singaporean High Commissioner is signalling me frantically so I think out of courtesy we must listen to the other side of the picture.

Mr LOW CHOON MING—I am not intending to make a long statement. I would just like to clarify some of the points. Firstly, with regard to the exchange rate of the Singapore dollar we are floated against a basket of currencies and the US dollar constitutes 21 per cent of that basket. When you talk about devaluation of the Singapore dollar I think you have to look at the basket of currencies.

Secondly, the Singapore economy remains very strong at 2.5 to 4.5 per cent growth. The Singaporean way of looking at figures is generally conservative, so I am quite confident we will achieve that, if not better.

The fundamentals of Singapore have been elaborated often. First, we have no foreign debt; second, we have huge reserves; and, third, we have a high productivity budget surplus and high savings of 49 per cent of GNP. We are optimistic that the crisis in the region will, sooner or later, have to come to an end and growth will resume. So I am optimistic that I shall continue to receive my salary. Thank you.

CHAIRMAN—Thank you, High Commissioner. As some of the previous speakers have highlighted, there is more to the current crisis in East Asia than simple economic issues. Political manoeuvring and internal stability will play a crucial part in the ability of nations to recover from their current situation. We welcome our next speaker, Mr Alan Dupont, the Director of the Asia Pacific Security Program at the Strategic and Defence Studies Centre at the ANU.

Mr DUPONT—Mr Chairman, I am conscious that we are running out of time, so I will try to keep my presentation to about 15 minutes or so. I intend to canvass the issues I have been asked to address today by venturing answers to five questions, the first being: to what extent is the stability of the region threatened by the economic crisis? If I may begin with a medical analogy, the economic crisis can be likened to an irritating rash on the epidermis of East Asia, which has mutated with quite alarming speed into a virulent, invasive and systemic assault against the body politic. With the benefit of hindsight, a competent medical analysis would reveal that the rash was in fact the symptom of a far more deep-seated and serious condition than first thought. To extend the medical analogy a little further, it is now clear that in some parts of the body the doctor's prescribed medication has produced a violent reaction almost as severe as the ailment itself. Here, of course, I refer to the IMF.

As successive East Asian states succumbed, one by one, to the spreading financial and economic contagion in the latter half of 1997, it has become all too apparent that the economic crisis also poses major political, social and security challenges for the region. Domestically, governments have struggled to reconcile themselves to the stark reality that the most sustained period of economic growth in the region's history is now over, and the prospect of the region returning soon to a high growth path is receding with each passing month as the full extent and enormity of the crisis becomes soberingly clear. Rising unemployment, bank closures, the widespread cancellation or suspension of development and infrastructure projects, soaring inflation and rising food prices are clearly stretching the social fabric of the region's developing states and severely testing their much vaunted political and economic resilience.

Generally speaking, the multi-ethnic states of South-East Asia are more at risk than the ethnically homogeneous North-East Asian states, simply because the scope for economic conflict is greater, accentuated in the case of states like Malaysia and Indonesia by religious differences between the dominant Islamic political elites and their largely Christian or Buddhist Chinese minorities. On the other hand, while the prospect of ethnic conflict has been heightened, it is important not to exaggerate the threat. In my view, Indonesia aside, a major outbreak of region-wide ethnic conflict is not in prospect. Even in Indonesia, while there is evidence to suggest that the Suharto government has been prepared to tolerate a degree of public anger directed against the ethnic Chinese community as a means of releasing some of the social and political pressure built up over the past few months, Jakarta is unlikely to tolerate a repeat of the anti-Chinese pogroms of past eras, for compelling economic and security reasons.

The domestic stability of regional states is more at risk from rising middle class frustration sparking the smouldering resentment of the economically and politically disenfranchised urban poor who may feel they have nothing to lose by venting their feelings in anti-government protests. This is why regional governments are so concerned by their escalating levels of unemployment and increases in the basis costs of foodstuffs.

One other security consequence is that the unprecedented modernisation of regional armed forces, which has taken place over the past decade, is likely to slow significantly as a result of the new economic and financial stringencies imposed by the IMF and enacted by east Asian governments. Already a number of states have announced significant defence budget cuts, with a raft of big ticket equipment purchases cancelled, suspended or delayed. The good news is that the possibility of a destabilising arms race developing in the region can be discounted for the foreseeable future. On the other hand, regional armed forces are likely to have their hands full maintaining domestic stability if social disturbances worsen.

Is it conceivable that political instability could cause a large-scale exodus of people from Indonesia and other troubled parts of the region? While it is possible that some people might attempt to flee their home states for safer destinations elsewhere, as a result of ethnic conflict, on balance I do not believe that we are likely to see a massive regionally destabilising refugee exodus. A far more likely problem, and a security dilemma already faced by European countries, is that in dealing with the repatriation of unwanted foreign guest workers to their home states, there will be significant social and political tensions between states and within states.

Already, Thailand has indicated that it is considering returning to Burma some of the 350,000 illegal migrants who have crossed into Thailand in search of employment or because of political persecution at home. Closer to home, Malaysia is host to some two million foreign workers, half of whom are working illegally, including 600,000 labour migrants from Indonesia. The forcible repatriation of guest workers and illegal migrants will almost certainly generate political tensions between states, and add to the economic problems of the sending states as they seek to accommodate thousands of returning citizens and contemplate the loss of overseas remittances from their earnings, which account for a sizeable slice of the foreign exchange earnings of some states. By way of illustration, remittances from Filipinos working overseas were estimated to be worth about $US4 billion in 1994.

Another important question which as yet remains unanswered is whether or not there will be a rolling back of the long-term regional trend towards democratisation and a reversion to political authoritarianism of the hard-edged variety. My gut feeling is that there will not be a widespread reversion to authoritarianism and that democratisation will continue, albeit it at a slower and more uneven pace. My cautious optimism is based on the encouraging comments and policy pronouncements in favour of continued economic and political liberalisation made by leaders of some of the states most affected by the regional economic downturn.

One other ground for optimism is that the growth of democratic institutions, and the strengthening commitment to internationally excepted norms of human rights, has been a remarkable and much understated hallmark of the region's economic and political development over the past two decades. Consider the fact that for the first half of the Cold War Japan was the only East Asian state with a fully functioning democracy. It has since been joined to varying degrees by Taiwan, South Korea, the Philippines and Thailand, while a form of soft authoritarianism prevails in Malaysia, Singapore and Indonesia.

Even in the pseudo-Marxist states of China and Vietnam, there is far more openness and tolerance of dissent today than was the case 10 or 20 years ago. Of course, it could be argued that democratisation and respect for human rights might be the first casualty in any upsurge of anti-government protest, especially in Indonesia. I certainly do not rule out the possibility of martial law and the curtailment or suspension of civil rights if the situation in Indonesia worsens appreciably. Even if this were to be the case however, I believe that whatever happens over the next 12 to 18 months, we will not reverse the long-term trend to more representative and open government in the region.

How will the crisis affect the process of generational change among the region's leaders, and shape their political and economic outlooks? It is important to note that since the economic crisis began there have been leadership changes in Thailand, Vietnam and South Korea. Cambodia and the Philippines are due for elections later this year and a new generation is destined to take over the reins of power in Indonesia and Malaysia eventually. It is also less than 12 months since Jiang Zemin was formally anointed by the Chinese Communist Party as Deng Xiaoping's successor.

The reconfigured economic and political landscape which these leaders are now contemplating is dramatically different from that faced by previous generations—although not necessarily more challenging, I hasten to add. It is perhaps worth recalling that the political, social and economic milieu of Asian leaders such as Lee Kuan Yew and Suharto, in their first years of office, and other seminal Asian figures, such as Ho Chi Minh, Mao Zedong, Sihanouk and Ne Win was both complex and demanding, and the consequences of failure were correspondingly high. Yet all remained in office for long periods of time, despite the fact that for much of the Cold War era East Asia was rent by conflict and divided along political, ideological and ethnic lines.

It is really only in the past two decades or so that prosperity, political stability and sustained economic growth have become entrenched in the region. Nevertheless, times change. With the fading of nationalist and ideological elan, the claims of most governments in the region to represent the will of their people has been based increasingly on what has been called performance legitimacy, rather than political legitimacy. By this, I mean that in the absence of what we in Australia would consider to be genuinely democratic elections, many East Asian governments have derived their legitimacy and authority from their ability to deliver sustained economic growth.

With the temporary loss of their economic management credentials, East Asia's political leaders will be under far greater pressure domestically, as well as internationally, to demonstrate that they preside over governments which are financially prudent, economically sagacious and far more sensitive politically to the needs and aspirations of their people. Their willingness and ability to adapt to the region's new political and economic realities will ultimately determine their fates.

East Asia's current crop of leaders, and those waiting in the wings, will also have to reconcile the need for strong leadership and effective management of centrifugal forces with the growing pressure for more transparent and more representative systems of government, and continued improvements in standards of living and quality of life. Improved quality of life, I might add, is not synonymous with high levels of economic growth, as the region's worsening pollution and eroding natural resource base attest.

Declining government budgets are going to mean less money available for pursuing environmentally sound economic development. It is now becoming quite clear that environmental degradation contributes to regional conflict formation because it exacerbates social and political tensions within and between states, damages the physical environment and circumscribes economic development.

To give one example, the Asian Development Bank estimates that developing Asia will need to invest up to $US40 billion annually in its mega-cities to ensure a satisfactory quality of life for its inhabitants and to allow the region's premier cities to remain economically competitive. Given the flight of capital from the region, it is pertinent to ask where east Asian governments will find the required level of investment to meet their future development needs.

Finally, how will the economic crisis affect the region's self-confidence and external orientation? For a start, the crisis calls into question the underlying assumption of the so-called Asian way, the notion that because East Asia's political and economic rise is directly attributable to distinctive Asian cultural traits, the region would be largely immune from the cyclical periods of recession and low growth which have characterised economic development in the rest of the world. This proposition is no longer tenable.

It is clear, if there was ever room for doubt, that East Asia's impressive growth over the past four decades was essentially due to the fact that regional states were able to adapt some of the best practices of market capitalism to create an environment for profitable private investment in conjunction with foreign capital. There is nothing uniquely Asian about this in a cultural sense, nor has there ever been such a thing as an Asian economic model. Nevertheless, East Asia's economic success had created a greater sense of regional self-confidence and awareness, reflected in the far more proactive and assertive international stance that has been adopted by East Asian states collectively and individually since the end of the Cold War.

Although basically a healthy and natural development, in some states the proclamation of an Asian way came dangerously close to a form of cultural triumphalism, a belief that Asians were inherently more hardworking, socially disciplined, and morally superior to Westerners, shades, I suspect, of a comparable and equally egregious Western disposition.

Whatever the merits of these beliefs and assertions, the economic crisis has been a humbling psychological experience for East Asians, the long-term effects of which may be greater than the immediate economic and political fallout. As a result, the states of the region, with the possible exception of China, face a lengthy period of introspection and preoccupation with their own domestic problems which will make them collectively less inclined to strut upon the world stage and correspondingly less able to exercise influence in the international corridors of power.

Hard questions will continue to be raised about the utility and effectiveness of the region's still nascent political, economic and security structures and the inability of key states in the region—most notably Japan—to provide leadership at a time of crisis.

On the other hand, there has been a palpable rise in anti-Western sentiment in the region and conversely a kind of Asian bonding which stems from the sense of shared adversity and misfortune made more bitter and less palatable by a widespread belief that the crisis was not of Asia's making, that the region has been a victim of financial manipulation by unscrupulous, international speculators who care not a whit for economic fundamentals in their pursuit of the baht, rupiah, won and peso. On balance, however, I believe that any overt manifestation of anti-Western sentiment is likely to dissipate fairly rapidly for the simple reason that East Asia now needs the west's political and financial support more than at any time since the end of the colonial period.

In conclusion, and by way of qualification, let me stress the tentative nature of these judgments. We need to carefully watch how events unfold over a much longer period of time before firming up our views about the long-term political, economic and security implications of the current economic crisis. That being the case, my one recommendation is that we all reconvene in this room six months hence in order to revisit this important and unfolding story. Thank you.

CHAIRMAN—We will see if we can do just that. Thank you very much, Mr Dupont.

Mr NUGENT—I have two questions. Firstly, if the nations of the region are going to indulge in, I think you used the words, 'less strutting on the world stage', what impact does that have for things like APEC? What is the prognosis? Secondly, do you see any significance of, if you like, natural phenomena such as El Nino and the consequent drought and fires? Relatively, is that really a major factor or relatively inconsequential in terms of the rest of the damage?

Mr DUPONT—I might just pass on the first question, only because we have a speaker addressing the implications for APEC this afternoon and I do not particularly want to get into his territory. I will be happy to comment later on, if you like, on that.

Mr NUGENT—Perhaps he can take that question on notice.

Mr DUPONT—I think that is probably a good idea. Concerning El Nino and the broader question of global climate change, I think that so far the impact of these climatic factors has been at the margins. They have exacerbated the political and economic problems that were already there. In the case of Indonesia, El Nino has had an effect on the rice crop for this year, so it is exacerbating the food situation there. But I do not see drought and climatic disturbances as a primary cause of the political instability the region is likely to face in the next 12 months.

In the longer term, of course, I would suggest that there is a different scenario altogether. Climate change, of which El Nino may be an important element, may actually have some major implications for the politics and security of the region.

Dr DAVID KELLY—You mentioned in your presentation the unlikelihood of a regional arms race, but do we not have a different question to ask, namely, given the previous scenarios of a developing hierarchy of defence or security or military capacities being suddenly altered, it may not require an arms race to trigger a new hierarchy of security capacities. Could you comment on that? Also, could you possibly comment on the role of ASEAN and its previous policies of non-intervention?

Mr DUPONT—To take the last part of your question first, ASEAN is being addressed this afternoon but I will say a few things about that now. There is a view that ASEAN has been largely impotent in this crisis, as have all the regional structures that have been set up over the last 10 years. There has also been a lot of criticism of the fact that neither ASEAN nor APEC or the ARF have been able to take any proactive measures to deal with the economic crisis. That is one point of view.

I do not think this is actually a fair assessment. You have to ask yourself how these regional bodies would deal with these sorts of issues when individual states are having difficulty coping with their own unilateral problems. The crisis has unfolded so quickly that most member states have been essentially overwhelmed with their own national problems. It is only now that the regional states are starting to realise that this is essentially a regional transnational issue and that there may be some policy measures that they can take which would benefit all. But again I point out the fact that the crisis has unravelled so quickly, and national governments have been so preoccupied with dealing with their own domestic problems, that it has been very difficult to get it up on the agenda sufficiently to actually deal with it.

Then you have the question of what bodies like ASEAN could actually do about it. Clearly, there is not a lot that can be done because ASEAN does not have the economic clout to deal with the problem, hence the need for the IMF.

Concerning the question about hierarchies of power, again one view is that China is going to be the strategic beneficiary of the economic crisis. The reason for the argument is that because the South-East Asian states and virtually most other states in East Asia are taking significant budgetary cuts in their defence programs, so their relative defence capabilities vis-a-vis China will decline. That is the first point.

Secondly, China has been so far largely unaffected by the fallout from the economic crisis. Therefore, relatively it is in a stronger position politically and economically, which will enhance its leverage in the region. That is the second issue.

That is true, up to a point, but the thing is this crisis has got a long way yet to unfold and we may well find that China, later this year, also has to deal with the same sorts of issues and problems that the rest of the region have dealt with already. So I think it is too early to make judgments about what sorts of fundamental changes there are going to be to regional order until we see this played out for another six months at least.

Dr COBB—Alan, you made quite a good case for a fairly up-beat security assessment of the region. Could you give us a worse case scenario for Indonesia and the likely consequences for Australia, particularly with reference to our security treaty with Indonesia?

Mr DUPONT—The worse case scenario is what is known as the Balkan scenario. I do not think I really need to elaborate on that. Essentially, if you return to the 1950s where Indonesia had problems with dissident ethnic groups and breakaway states, the argument is that the economic crisis will basically dissipate the economic and political underpinnings in the Indonesian state. It will disintegrate or implode in some way and then you will have a massive haemorrhaging, forcing an exodus of people from Indonesia.

That is the worst case situation. I do not believe that that is likely, but, if that were to happen, obviously it will have major implications for Australia. One is our trade with Indonesia, which is now about $3½ billion. We therefore have a major economic stake in what happens in Indonesia. We did not have one 10 years ago. So there is a very important difference there. Secondly, we now have a multiplicity of political and defence arrangements with Indonesia, all of which would be affected if there was a major breakdown of social and political order in Indonesia.

Australia has been successful in enmeshing itself with Indonesia to such an extent that when Indonesia sneezes we get a cold. That was not the case 10 years ago. There are some good things and bad things about that. The bad news is that, if something goes fundamentally wrong in Indonesia, we are going to be directly affected in all those sorts of dimensions of the relationship.

Mr TAYLOR—My question is an extension of that question, but it is about the internal security in Indonesia. Would you comment about the degree to which, if any, the role of ABRI may change as a result of this crisis or perhaps a worsening crisis?

Mr DUPONT—The change that is going to occur is that there is going to be no change. What I mean by that is that, as you are well aware, one of ABRI's chief functions is support for the regime. It has a social political role that western armed forces do not have. There has been a lot of discussion over the last three or four years that perhaps it was time for the Indonesian armed forces to move away from direct involvement in politics to transform itself, if you like, into a more professional armed force in the sense that we would understand—that is, primarily configured for defence of the nation against external attack rather than support for the regime.

There were some indications that that was beginning to happen, but this economic crisis is going to ensure that this does not happen for some time to come. In other words, the number one concern of the Indonesian armed forces for the foreseeable future will be the traditional one—domestic stability and support for the incumbent regime.

Mr LEO McLEAY—If there is a continuation of societal breakdown in Indonesia, what is the likelihood, for instance, of that getting worse and having refugee outflows towards Australia? What might be the magnitude of that?

Mr DUPONT—I have no doubt that the situation in Indonesia will deteriorate further. But the $64 question is: how seriously will it deteriorate? Over what time and what will be the consequences? I have obviously made it clear that I do not buy the worst case scenario. What is likely to happen is that we are going to have a continuation in the rise of social and political tensions in the country. We will see further outbreaks and perhaps worsening outbreaks of social disorder, including in Jakarta. But, at the moment, the armed forces probably would be able to contain that. Therefore, I do not see a major outflow of people from Indonesia to Australia.

However, you have to qualify that because no-one can crystal ball that far in the future and say categorically that that will not happen. Again, it is conceivable that, if there is a major political crisis in Indonesia in the next, say, three to six months, we may well find some people seeking safety in other countries including Australia. I actually do not think they are going to go to Australia; they are more likely to seek refuge in Malaysia. It will be Malaysia which is going to have the biggest problems. There are all sorts of obvious reasons, one being that they have similar cultures and language. Therefore, Indonesia would be more inclined to look that way.

There are two aspects to this. One is that there is an outflow of Javanese and people from Sumatra to countries like Malaysia. That is different from the question about whether there will be ethnic Chinese seeking to flee Indonesia in the event of political crisis. The ethnic Chinese may well seek to go elsewhere and some of them may seek to come to Australia. But I do not believe we are going to see thousands of Indonesian boat people coming into Darwin. We may see hundreds, but I do not think we are going to see massive numbers.

CHAIRMAN—If there are no further questions, I formally and sincerely thank the lecturers we have had this morning. Some have left and some will leave through lunch, but I think we have had a very good morning and very good value from our lecturers. A light lunch will be served outside in committee room 1R1. We will meet back here at 1.45 p.m. Thank you very much.

Proceedings suspended from 1.01 p.m. to 1.49 p.m.

CHAIRMAN—Welcome back, ladies and gentlemen. Before we broke for lunch we were considering some of the elements that contributed to the current situation. This afternoon we would like to look at some of the challenges and also the opportunities that face Australia that are now becoming evident. We would like to start by addressing regional issues, firstly, the responses and responsibilities of regional forums such as APEC, ASEAN and the ASEAN Regional Forum.

To lead us in this discussion I welcome Mr Alan Oxley, the Chairman of the APEC Studies Centre. Alan Oxley is very well known to everyone as a former ambassador to and chairman of GATT, the predecessor of the World Trade Organisation.

Mr ALAN OXLEY—Thank you, Mr Chairman. What I propose to do is not give you a blow-by-blow analysis of the capacities of the regional organisations which may have a role to play in addressing the problems caused by the Asian currency crisis, but, first, to put them into a setting. The capacity of an organisation to act is directly a function of the total sum, I suppose, of the interests, pressures and powers of its key members; some organisations are simply not capable of doing more than their brief permits or the strength and power that their membership creates. I explain this by way of perhaps a reservation from the outset, but, as I proceed through, you will see that I am using that as a frame to explain what ASEAN may or may not do and what APEC may or may not do.

The first thing to appreciate about the Asian currency crisis is to recognise that some dimensions of the crisis, as it affects some countries, mean that in part it is an international problem and in part a regional problem. This, in my opinion, is a function of the size of the economies. It is important for us to continue to retain as a reference point the relative size of the economies of the countries involved and their trade and investment share.

ASEAN looms large to Australia politically; but, in world economic terms, ASEAN is not particularly significant in absolute terms. Korea, in fact, is a far more significant world trading and investment economy; therefore the problem with Korea going down was an international problem and the countries which stepped in to deal with Korea represented more that international mix. The United States was a key player in that. To that degree, we can regard the problem facing the ASEAN countries, therefore, as a regional problem. But, again, when we see who the powers are and what we are seeing with the issue of the IMF and the requirement to get clearance of additional funding from the IMF through the US Congress, we are reminded that the United States has a presence here.

The interesting thing about the United States and Indonesia, which is where the current focus of a great deal of attention is, is that the US level of investment in Indonesia is relatively small. Indonesia has never been part of the United States extension into the Asian region for investment in manufacturing and trade. I can remember some American businessmen and officials saying to me at one point that the American view of South-East Asia was a line that skirted round Malaysia and Singapore but actually excluded Java. This was really a reflection of where the investment and trade is. If you look at the trading patterns, that largely is right. In fact, the United States is the major trading partner of every APEC country but two, and one of those two happens to be Indonesia, which has significant exports to Japan and some to Europe, but the United State is, for example, Malaysia's largest trading partner when you wash out the re-exports through Singapore. That is something that is overlooked.

So is this a global crisis? Is it a regional crisis? I think one can therefore ask the question: to what extent does Asia have global standing? Again, in Australia, if we are making an assessment of whether this is an international issue or a regional issue, we have to in a sense, as Australians, step outside ourselves a little and see it from the global perspective. For us, Asia is dominant: it takes the lion's share of our international effort, the lion's share of our trade. But I would contend—we will put Japan aside for the moment—that Asia, in the international economy, is globally insignificant unless you use the Asian-Pacific appellation. By that I do not mean to include the non-Asian geographic countries, like Australia and New Zealand; I mean, again, the United States, because in fact the pattern of trade and investment in the Asian-Pacific region represents something of an Asian-Pacific economy. Even most Japanese investment in the Asian economies is for industries which in fact export into the United States. This in a sense completes the pattern and the dynamic of trade and investment in the region. Therefore Asia's economic power, to a large degree, remains contingent on association with the United States.

In this Asian economic crisis we are seeing the emergence of some quite fascinating trends which represent some of the—'power plays' is a somewhat overstated word—broader tensions that are operating behind the scenes. Anybody who has been to a regional meeting in the last five or six years will have been struck by the visibility of the tension between the Japanese and the United States over very small issues to very large issues. Basically, these two powers are to a degree jockeying for a degree of influence. All large powers seek to exert influence in one way or another; I am not making a moral judgment about this but merely an observation of a fact of international life.

To a degree it is quite interesting that we are seeing something of a competition for leadership here. One of the great features of the Asian-Pacific century, the 21st century that we have talked about for a long time, is going to be some degree of competition and rivalry between models. It is never expressed as overtly as this, but certainly the logic of the East Asian economic caucus was an expression of an interest on the part of the Malaysian leadership to try and garner a greater degree of authority around Asian economies. There is an evident strand of nationalist unhappiness with the influence of Western institutions and power, as expressed frequently by the Prime Minister of Malaysia, and in that sense he is not really alone.

He may be sharper in his expression of his ideas, but in fact it resonates because in the Asian region there has been an enormous degree of pride with the emergence of nationalism. Indeed, lurking behind the debate that is going on is a bit of a sense that maybe the Asian way had more going for it than was thought, and also a degree of perhaps premature self-confidence because what we have been seeing with the economies is that analysts have been pointing out for a long time some of the fundamental weaknesses of some of these economies. The circumstances of the Asian economic crisis have certainly revealed those weaknesses quite starkly in terms of what we have seen.

I am not saying that the effect of the crisis was warranted according to the extent of those weaknesses. We have not really worked that out, but to a degree there is also a sense of almost an Asian corporatism versus the Western open markets. Business people—these are people with whom I spend most of my time—will regularly find that, when they are told to do business in the Asian region, they are told—the word ‘corporately’ is not used—that you need a partner who is close to the government. Some people are even advised to have government partners—that is dreadful advice for any business person. But it is a philosophy and a concept about doing business which certainly does not exist in what we call the West—in the United States or in our system. To a degree, part of the debate about the Asian economic miracle has had underneath it something of a sense that there is a different Asian model, and indeed some of the experiments that have been conducted in monetary and financial policy in the region might be explained against this.

So that is if we have this broad model, and I am not overstating it; it is a current issue behind the background. In fact, it is what is really going to be the defining issue in the 21st century in the Asian-Pacific region, and it is replete with complicated questions. I am always fond of saying to people that capital is capital; it does not matter where it comes from. The rate of return is the rate of return. Efficient use of capital is efficient use of capital. There are no different rules on this. At the end of the day I think that is what is going to be the case, and maybe what we are seeing in the region is an adoption of an economic model, basically the free market model, and yet the way in which that is to be made to work in non-Western economies has not been finally sorted out. I am confident that they will end up market economies, but there is a fair way to go yet for many of the economies before the frameworks are put in place where capital can move and generate the sorts of returns that it will seek.

In terms of this competition for influence, we have witnessed something very significant in the last six months. Japan is one of the world's leading economies. For many years there has been talk on and off about a yen block and, frankly, I think if Japan were going to play the role of a global economic power, we would have seen it do so in the last three months. The reality is that because of its own domestic circumstances the opportunity for it to play that role has passed, and it may have passed quite some time ago. One of the odder manifestations of the crisis was the proposal by Japan to set up a fund to financially back how many of the economies in the region might get out of their trouble. When one perceives the problems that exist in Japan—with the financial sector, which is not modernised; with a large amount of debt which has still not been written off; with the regulatory system, which the Japanese government has now admitted is not working—if anything could indicate an inability to provide a degree of moral authority, it is that.

The interesting thing, which we have not paid much attention to in this country, I think because Asia has been so important to us, is that it is very plain now that the United States has re-emerged as the leading economic power in the world. The economy is in extraordinarily good shape, the fundamentals in it are very strong and it is going to continue to provide a very significant influence. I mentioned before that it does exert an influence where its business interests are strong, and they have certainly been stronger in Korea than, say, in Indonesia, simply because of the fact that it is the largest economy which will provide the funding.

Regrettably, like many other features of international life, we are required to dance to the tune of the political interests of the US Congress one way or another. We know this very well ourselves from the Howe leather case, which was put up by a very effective lobby group in an election period. That was really something that I think, if the administration had had a choice, it would not have run. There are processes in the US system which just have to roll and the rest of us have to cop it, I am afraid. The reality is that this is the setting in which these institutions are operating.

The capacity of regional institutions to assist in this crisis is quite limited. You asked me in my brief to consider ASEAN and, in that, the ASEAN Free Trade Agreement; and APEC. You also included the ASEAN Regional Forum. Frankly, I may duck the last one since that is a military forum or a political forum and, as yet, I do not think the crisis has reached the point where it is being treated in any way as something which is causing problems for international security, although there may be spin-offs from some developments. I will concentrate on ASEAN and, in particular, the ASEAN Free Trade Agreement, which is the principal economic instrument among the ASEAN countries.

Again, the function of the ASEAN Free Trade Agreement is limited by the patterns of trade and investment in the region. The reality is that ASEAN countries are not each other's major trading partners; they are externally oriented economies. Most of their trade is with countries outside the ASEAN group and it may be that only about 12 per cent of trade among the ASEANs is covered by the ASEAN Free Trade Agreement. So, as an instrument which has a degree of authority or bounce, it is not all that particularly significant.

On the trade side, the area that you would look for to see whether there was some scope for combined ASEAN solutions would be whether or not the agreement has rules on opening services markets, because one of the problems that this currency crisis has demonstrated is that the level of sophistication in the services sector, particularly banking and finance, is simply not strong. It needs to be more rigorous. It is not an accident, I do not think, if you are reviewing the national trade agreements, that the ASEAN countries, along with most of the Asian economies with the exception probably of Hong Kong, have been reluctant to accept international obligations to open services markets. In Singapore's case, for example, while it certainly had a very strong free trade position on trading goods, it has been distinctly mercantilist when it comes to the services sector. Basically, while it allows foreign banks to operate in your offshore banking sector, there are no open opportunities for foreign bankers to get domestic banking licences in Singapore. It is a conscious policy.

The ASEAN Free Trade Agreement imposes no obligations on its members to liberalise and open their financial services sector or their services sectors at large. They have recently initiated a proposal which is a bit like the APEC do-it-yourself liberalisation system, where people are invited to offer up areas where they may show that they will open up their markets. The offers have been quite limited and my experience of international trade agreements tells me that usually, if you ask people to voluntarily liberalise, you do not get much. If it was that easy they would not have to be asked. ASEAN, therefore, I do not think is an institution which is likely to be able to do much to address the problems of the Asian currency crisis. It will create a political forum in which the ASEAN countries will come together and talk, as they do regularly, and ASEAN is replete with ministerial fora.

The truth is that only Singapore is cashed up to an extent where it can be a donor to contribute and provide some degree of stability to the region. It is a fact that it has already been extremely generous. The level of per capita contribution, as I understand it, that Singapore has made to both Thailand and Indonesia probably vastly exceeds that of any other country but there has to be a limit to how much Singapore can finance developments in the rest of the region. Frankly, the enormity of the financial requirements to fix these economies is such that the collective economic power of the ASEAN countries is simply not large enough. It may, in fact, explain why, if you look between the lines when you read the various statements, the Singaporeans have been the ones who have been most open about trying to bring in the IMF and bring in the United States. That is where the money lies which is needed to address the problems.

APEC is constrained by other factors. I have already mentioned the constraints on the ASEAN free trade agreement. One of the weaknesses of APEC—we do not talk about them much; because it is such an icon we are only supposed to say nice things about APEC—is that it was actually put together by foreign ministries and trade ministries. I never draw a smile from my former colleagues in the Department of Foreign Affairs and Trade when I say this but I can tell you that, if you go around the world and meet officials, the finance officials and finance ministers always tell you that they have the power and the clout—and I am going to explain to you that they manifest this in a number of small ways as well as major ways. In fact, if APEC was to have been an organisation which was going to play a central role initially in financial matters it would have been something put together by the treasuries and the finance ministries.

It was an initiative of foreign ministries and trade ministries and, frankly, the finance ministries were a bit snooty about this and for some time almost refused to participate in APEC. In fact they are an emerging part of the system but the reason I mention all this is that if you read through APEC documents you will see the dynamic, until now, has actually been on trade policy issues. We all know about the Bogor declaration. For those of you who are students of this you know about the individual action policies and, like any organisation which has been around for a while, APEC is now starting to be replete with initials of things which do not mean anything except to those who cannot sleep and who read the communiques of the meetings.

I will come back to the point. Having been basically an organisation built on trade policy it, to date, has not been one which has naturally been in a position where it can address the financial issues. APEC as well has had to be a body which has had to straddle these twin pressures of a Western approach and of an Asian approach. Pamela Fayle is here and if you talk to officials who go to APEC meetings this is something which is a constant theme. It is talked about a bit too much in my opinion but it is a reality and the organisation has been successful in creating a common sense of purpose across really quite a significant cultural divide.

Having said all that, I think APEC, in fact, does offer the best prospects of any organisations in the region to address the politics of the region. I underline politics because pretty plainly it has to be the IMF or the ADB or some combination of those interests through which any international programs which are regarded as acceptable by world markets will be effective to address the currency crisis. I do not plan to get into a discussion about whether the IMF has been right or wrong or too insistent, extending too far into the sovereign rights of another country, in particular Indonesia, but the currency crisis has to be solved fundamentally by action on financial matters and that is going to have to come through those institutions. APEC has not been established to create any sort of regional banking facility. This is just not what it is about; it is essentially an organisation which focuses on policy questions.

However, it is an organisation in which the politics can be discussed because the issues which arise from decisions about whether or not various monetary and fiscal policies arise, which are inevitable if you are going to be sitting in an IMF context, do not have to dominate discussions in APEC. APEC is a forum in which there can be a decision to use the politics of the body to try to address the issues. And in fact what is actually happening is that APEC's capacity to do this has risen steadily.

If you looked at the leaders communique from the Vancouver summit, for example, for the first time you would find reference to financial issues and the finance ministers starting to be uppermost in the outputs of APEC. This is quite new. Previously, all the time and effort in APEC was focused on discussions of trade issues. To a degree it was fortuitous.

I mentioned that the finance ministers still like to be a bit separate. The core ministerial steering group in APEC, which is comprised of foreign affairs and trade ministers, always meets just before the leaders summit. But the finance ministers like to meet earlier than that in a different city and usually a year behind everybody else. The Vancouver summit was held in Vancouver, but the finance ministers had their meeting in September in the Philippines because the previous summit had been in the Philippines.

Indeed, at the leaders summit the central ministerial group implored the leaders to encourage the finance ministers to become more centrally engaged in these processes. That is happening. Quietly, there have been a series of technical level meetings run by officials and subofficials of the central agencies. Our Reserve Bank is participating, as are the central reserve agencies in the other APEC countries. They are today putting together a series of programs to try to strengthen the capacity of countries in the region to manage their fiscal and monetary policies. This is a separate matter from what money is going to be provided by the IMF or whoever is going to provide the money. Everybody has recognised there is a need to strengthen the capacities—the jargon used in the aid agencies is 'institution building'.

We will see results of that quite soon. There is a finance ministers meeting next month. They are currently working through a series of programs. Whether they come public with it or not is another matter. Those of you who are in government and have been in government will recognise that Treasury types are retiring types and they usually like to assuage publicity. The important thing about this is that APEC is being used in this forum and is going to assist.

What should be done? How should APEC assist in all this? The cri de coeur of the trade and foreign ministers to get the finance ministers more actively engaged in the middle of this should be strongly supported. You had a state of affairs for a period of time in APEC where there was an economic committee and the finance ministers meeting, but the two were not connected. That was not such a problem in Australia because our Treasury were strong participants and activists in APEC, but there was this tradition amongst some of the other finance ministers around the region that APEC was not really their body and they really did not want to have much to do with it. That is changing. You are now getting a much greater integration of macro-economic work in APEC and analysis of these financial economic issues. The need to respond to the currency crisis is going to have a welcome impact on that.

APEC could be used because it is a political forum to provide a way in which there could be some coordination by the various regional agencies to assist countries in the region to set circumstances to avoid the same thing happening in future. Equally, there should be a much greater level of activity in the finance ministers forum. Broadly, I do think that we are going to have to come to terms with the fact and some things are better said than not said.

Quite clearly the way in which the dispute, particularly with Indonesia and the IMF, has manifested itself is as a very distinct east-west conflict emerging here. To a degree, while it is useful to understand that debate in terms of what informs people and why they are taking positions that they do, it is very critical not to allow that dichotomy to be the one through which the issues are defined.

At the end of the day, capital is capital and efficiency is efficiency. The time and effort should be focused on concentrating on those things which will be critical to the development of market economies. We are not at the point yet where anybody in the region is saying that we wish to move away from the model of using market economies as a primary basis for development in the region.

CHAIRMAN—Thank you very much, Mr Oxley. We are going straight on to Mr Paul Kelly to speak on Australia’s role as a regional player. Mr Paul Kelly is currently the international editor of the *Australian* and one of the longest serving editors-in-chief that this paper has had. In relation to another matter, I was going through some files of mine over the weekend and saw cuttings by Mr Kelly from 20 years ago relating to international affairs when he was writing for the *Australian*. He has had a very long public position in foreign matters, so it is with very much pleasure that I welcome Mr Paul Kelly to the seminar.

Mr PAUL KELLY—Thank you, Mr Chairman. I want to do two things today. First of all, I want to provide an overall analytical framework for the crisis and, as a result of that, talk in more detail about Australia’s role in the region.This is a deep crisis of multiple origins. Beware of the simplifiers and ideologues telling us the problem is all because President Suharto is a terrible dictator, as they call for his liquidation.

There are three types of crises on display at the moment in East Asia—exchange rate, economic and political crises. In Australia in 1986 we had an exchange rate crisis with the banana republic episode. It did not become an economic crisis or political crisis. In Thailand, Malaysia, Korea and Indonesia today, we have seen an exchange rate crisis rapidly transmit into an economic crisis as well. In Indonesia, the transition has gone fully fledged to the third stage of political crisis. The lesson is that the situation varies very much country to country. The core of the exchange rate crisis, the heart of the problem, originates in the banking sector. It lies in the lethal mixture of massively volatile capital movements and poorly supervised financial systems.

The capital flow into the affected nations was $US40 billion in 1995 and $US100 billion in 1996, turning into a huge correction in 1997 with an outflow of $US12 billion. The capital inflow was biased towards short-term debt in foreign currencies. If any economy, for example, the United States, Australia or Europe was subject to such capital flow reversals, the consequences both economic and social would be severe.

When one looks at the composition of the capital flows, it is clear the culprits are the commercial banks. What is happening is financial imprudence on a grand scale involving miscalculations by borrowers and lenders. The massive capital inflow meant easy funding for projects and escalating asset prices. A fixed exchange rate meant there was little need for institutions borrowing in foreign currencies to hedge their debt. There were great potential dangers in this, but Asia had to come to believe in its own economic invincibility. Poor prudential supervision and weak central banks accentuated these dangers.

Once Thailand was forced to devalue and break its US dollar currency link, it was clear that corporations and banks would have to rethink the basis of all their assumptions. What turned an exchange rate collapse into an economic crisis? The answer is the weakness in banking sector supervision, the massive extent of poor quality loans, unhedged foreign borrowings, poor governance, crony capitalism and an inability on the part of governments to take the firm economic action required. These governance factors were always there. They did not cause the currency crisis, but once the exchange rates fell, these factors came into play and precipitated an economic crisis.

In Indonesia, the international currency markets have formed a view that President Suharto and his government lack the ability and will to resolve the problem. In Indonesia, the judgment of markets is qualitatively different. It is purely a political judgment. The exchange rate for the rupiah today has nothing to do with the economic or financial fundamentals in Indonesia. It is driven completely by politics and by a vote of no confidence in the regime in Jakarta.

It is also possible and, I believe, valid to see the crisis as a contest between East Asian and Anglo-Saxon capitalism. In a sense, the banking systems in Japan and Korea have been run as an extension of industry policy, a system of government direction or crony capitalism. One reason Japan's difficulties are so protracted in the 1990s is that the financial changes required in that country go to the very heart of its financial system.

In Asia today there are two responses to the crisis and those two responses lead directly to two broadly based scenarios for the future. Scenario 1 is that balance sheets will be improved, there will be a restructuring of debt, greater accountability and transparency in the financial sector and an improvement overall in systems of governance; that these countries will follow more the Western orientated prescriptions of the capital markets, the IMF and the G7. Scenario 2 is that the resentment towards the West, towards Anglo-Saxon capitalism, and hostility towards the IMF will eventually prevail, fuelled by a belief that Asia is a victim, that while the region made mistakes it is being punished beyond any justifiable level; that, as Singapore's Prime Minister Goh Chok Tong has warned, there may be a fundamental and adverse reappraisal within the region against the West.

Which scenario is likely to prevail? I would argue that depends on the rate of economic recovery. If we get a reasonably quick economic recovery, then scenario 1 will probably prevail. That is a good result for everybody—the region and the international economy. But if we do not get a reasonably rapid recovery, or at least a recovery in which there is steady and manifest progress, then we will see stagnation. There will be economic and social decline. We are likely to witness a rise in economic nationalism, a rejection of economic liberalism, a growing sense of cultural isolation and xenophobia, an inward looking provincialism and growing political disturbances. We see signs of all these today in Indonesia.

I think there have been two turning points at which the cycle of crisis could have been broken. First, right at the start, if there had been prompt and strong action by Japan in relation to Thailand. It is the Japanese banks which have the outstanding exposure to Thailand. It is Japan which was closest to Thailand's emerging problems. It is Japan which was closest to what was happening in Thailand's financial sector. If Japan had moved sooner in terms of coordinating a debt restructuring, in terms of making a greater financial contribution to Thailand's bailout, then there is a chance that the psychology of the crisis may have been different.

The second turning point was in early January, when the IMF gave the thumbs down to the Indonesian budget. This budget had lots of problems. But, given the magnitude of the economic crisis facing Indonesia and the decision making process in Jakarta, this budget was not too bad an effort at all. It got a no-confidence vote from Washington, it got a no-confidence from the IMF, all of which was reported very prominently in the quality American papers. This fed straight into the sentiment of international currency markets. Indonesia has not recovered since.

My final point of analysis concerns the IMF and I would like to make two arguments in relation to this. First of all, the IMF failed, particularly in Indonesia, to prescribe debt restructuring and involve the private banks in this endeavour as part of the solution. The IMF's financial prescriptions did not address the core problem: debt, debt and more debt. The IMF required Indonesia to implement a series of macro- and microeconomic reforms, all of which are desirable, but none of which deals with the foreign debt liabilities, which cannot be repaid at the current exchange rate. A similar point applies to the US government. The US administration was far more willing to get involved in debt restructuring in Korea than it has been in Indonesia. To this extent neither the US or the IMF has been committed to solving the immediate problem in Indonesia—the debt overhang.

Secondly, if you read the 15 January IMF conditionality document signed by President Suharto, it is clear that this is designed not just to stabilise the exchange rate. It is a socioeconomic redesign of Indonesian society according to Western values of accountability, transparency, privatisation, deregulation, central bank independence; it is a market orientated, liberal political philosophy of Anglo-Saxon capitalism. I have read this document carefully, so the judgments I have made are based very much on my reading of the document. It is extraordinary for its sweeping nature and the details of its prescriptions. To me, this is excellent public policy; I support it. But I believe that any country, whether it be Australia, the United States itself or the Europeans, would have great trouble implementing a comparatively similar document without major internal dissent over its philosophy and details. In conclusion on this point, it is my judgment that the IMF is giving a weight to these issues of governance greater than their contribution to the initial crisis.

Finally, on this matter, I would draw the attention of this meeting to the recent speeches given by the head of the US Federal Reserve, Alan Greenspan, who has addressed himself in great detail to the origins of the East Asian crisis. While being critical of economic policy and of governance in East Asia, Greenspan has also been at pains to point out that the markets in many ways have acted irrationally. In his speech in Miami he referred to a 'visceral engulfing fear' driving the markets. It is interesting to note that Dr Greenspan has invited a debate about reform of the international financial system and that this issue will be taken up in April at a meeting of central bank governors and treasury officials in Washington.

I now want to turn to Australia's situation. The nature of the crisis—both intensely local and also, as I have described, international—meant that it was always difficult for Australia to influence these events. We were quite right to be involved in the three IMF bailout packages, to Thailand, Korea and Indonesia. It would have been a severe mistake for Australia not to have been involved. It is appropriate that Japan and Australia are the two countries from the region involved in the three bailout packages. That is a significant bull point for Australia, financially and diplomatically. It is a message that we are in the region for the long haul, that we are not merely a fair-weather friend. It also sends another, more subtle, message about the underlying economic and institutional strengths of Australia as a society and suggests that they will be better appreciated in Asia in the future than in the past.

It is a lesson for Australia and the Howard government that Asian engagement should not be sold just as a bread ticket. Our commitment to Asia is part of the process of reconciling our history with our geography. This is a grand endeavour. It is not just about economics. It is not about financial gain or national income. It is about many things: preserving our security; advancing our interests; striking up collaborative and worthwhile partnerships; learning and changing as a society; and pursuing a broad range of institutional, economic, social and cultural engagements. Overselling Asia as the latest financial bonanza has been a mistake. No country and no region is exempt from the business cycle or, these days, from economic crisis.

Australia, I believe, faces a new challenge in its bilateral and regional relationships. It needs to provide practical and constructive advice and assistance to help the nations affected to recover. This will require a high degree of judgment and sensitivity. As a society, Australia—considering its resources in government, central banking, treasury, commercial banking, the law, international aid and its financial sector overall—has a significant role to play. This will be spread across the public and private sectors and will need some degree of coordination. It is also, of course, an opportunity for Australian banks and other institutions to acquire holdings in the region, a practical consequence of benefit for Australia.

Australia has been involved in heavy dialogue with certain countries in the region: Singapore, Japan and, of course, Washington, particularly in relation to the Indonesian crisis. Our immediate objective—and it has been a very ambitious one—has been to try to bring together the Suharto regime and the IMF. We have correctly recognised that they have been talking past each other and have not been involved in real dialogue with each other.

I think that Australia’s analysis has been correct and that its prescription has been correct but, frankly, the execution of this policy is exceedingly difficult. The IMF has an international perspective. Indonesia has never been its greatest priority in the past, nor will it be in the future. The IMF, of course, is heavily influenced by United States priorities. There is a great disparity here. Indonesia is a small player in the global economy. The IMF and the United States have great global concerns. Indonesia is not the most important of them.

It is interesting to note that in recent years Australia has been involved very actively in diplomatic efforts involving Jakarta and Washington. This was very much in the APEC context, where former Prime Minister Keating was involved in a considerable diplomatic effort, involving both President Suharto and President Clinton, in helping to secure free trade commitments from the Bogor APEC summit in the early 1990s. A similar diplomatic effort is required now, but I must say that it seems to me that the degree of difficulty is much greater than it was for the APEC diplomacy involving Washington and Jakarta on that earlier occasion.

I do not want to prejudice Alexander Downer’s recent mission to Washington. I hope he does well. However, we must be realistic about the situation in the region at the moment. Asia, in terms of its dealing with the IMF, has been weak, divided and confused. The region is demoralised. Its natural financial leader, Japan, cannot lead. Japan is part of the problem and not the solution. Its proposal for an Asian financial fund in late 1997 was swept aside by the United States Treasury and the IMF.

ASEAN nations are confused about the crisis and are divided about what to do. What is required is a collaborative and collective effort to reshape the terms of the IMF's relationship with East Asia. Australia cannot do that on its own. Singapore cannot do that on its own. Neither can Japan. But, frankly, the chances of getting such a coordinated and collaborative effort appear very remote. Existing regional organisations, such as ASEAN and APEC, seem essentially irrelevant in terms of addressing this crisis. I therefore conclude that the crisis has exposed the weakness of the region, its inability to act together and the inability of regional institutions to address the problems.

For Australia, the great difficulty has been to find allies and make joint representations to Washington in this situation. What is at stake is the strategic outlook and values system of East Asia. I cannot hazard an answer; I can only pose the questions. Will ties between the United States and East Asia prosper or deteriorate in the medium term? Will East Asia stay committed to market liberalisation? Will East Asia make the logical point that, if the cause of the crisis was excessive volatility in capital flows—and I believe that it was—some reform and regulation of such flows will be necessary? Will APEC as a regional organisation maintain its commitment to free trade according to the 2010 and 2020 timetable? If not, what will be the consequences for Australia?

Finally, let me make a couple of points about Indonesia. As far as Australia is concerned, the real consequences in relation to Indonesia are non-economic, yet the entire debate in the Australian media has focused on the economic and financial consequences. President Suharto, for all his faults, has been a better than average leader, as far as developing countries have been concerned over the course of the past 30 years. His achievements have been immense: national unity; economic progress; a constructive leadership role in ASEAN that has promoted the unity and advancement of that regional grouping; a very important role in APEC leadership; and a leadership that has been favourably disposed towards the United States and Australia and that, more recently, has committed to a formal security agreement between Australia and Indonesia.

But, beyond all this, what we fail to understand in Australia is that very many of our political, social and economic values are a function of having had a benign regime in Jakarta over the past 30 years. Our contemporary debate about Australia's engagement with Asia has been driven by the fact that Asia has been an opportunity and not a threat. This has underpinned Australia's development as a tolerant, multicultural, multiracial society with low defence spending, one which has been able to negotiate very successful bilateral and regional relationships in the region.

The United States and Europe can afford to be almost cavalier about the consequences of a change of regime in Jakarta. It means, at the end of the day, very little to them. It is not an overriding priority of either their foreign policy or their national life. But it is very important to Australia. It is a priority in terms of our foreign policy and, more importantly, in terms of the domestic internal policy parameters in this country.

Change in Jakarta is coming. The big question is whether the change is a managed transition or whether it is an imposed transition. At the end of the day, the two institutions in Indonesia which will be very important in the transition will be the army and Islam. What happens will be enormously important to Australia, and not just at a government-to-government level but at the level of public opinion. At the end of the day, one of the fundamental questions is whether public opinion in Australia remains committed to the engagement with Asia.

CHAIRMAN—Thank you very much, Mr Kelly. We have had two very good papers after lunch, and the seminar is now open to question time. Unlike this morning, when our time was very constrained, we have 35 minutes for questions. I hope that we have some very penetrating questions for these two excellent speakers. Mr Taylor is first.

Mr TAYLOR—This morning, in the earlier sessions, we heard a lot about the IMF package. What Alan Oxley and Paul Kelly have done this afternoon is to inject a little realism into that IMF package by introducing the United States. The United States, as both speakers have said, is very important for—and, indeed, critical to—this whole rescue package. Would both speakers comment on what is going on on Capitol Hill at the moment in terms of the additional $18 billion, the IMF funding, where there are strange bedfellows: the left wing of the Democrats, for ideological reasons, and the ultra right wing of the Republicans, who do not want to deal with anything outside continental US? Both of you might like to comment about the prospects of a viable package emerging that will overcome this crisis.

Mr ALAN OXLEY—I cannot give you much detail about what is going on with the line-up of the particular positions on the issues, I am afraid; but I would make one general comment. You made reference to the fact that we seem to see both the left and the right coming together on this issue. It is part of something broader going on that is a little peculiar. We have had the debate in this country about the multilateral agreement on investment. I have not seen anybody observe the strangeness of the fact that Pauline Hanson and the Greens have the same position on an issue.

Mr TAYLOR—We have.

Mr ALAN OXLEY—This is going on in the States. None of this is mainstream; it is all fringe stuff. But, in the right of the United States, there has always been an aversion to international organisations. Where the two have come together is that they consider these things a threat to sovereignty. These are old traditional US political issues. They come and go like microbes in the water. They are not really part of our debate. I think it quite important that we separate them out and not see ourselves as seeing some vast new trend taking place here. But, as for the details of how they get the money through, your question implies a strong sense of just how much that depends on the politician and the issue. I do not know much about that. Paul Kelly must.

Mr PAUL KELLY—Mr Chairman, I cannot answer the question in venturing a prediction as to what might happen. The point I would make is that there is an extraordinary paradox in the United States today. We have had this debate over the past 10 years about imperial overstretch, the decline of America, the Kennedy thesis and so on. Yet what has really happened is that the United States has emerged, partly as a result of the operations of the international financial system, in a very powerful position—at the moment, anyway. This may prove to be temporary. We have to see to what extent Wall Street is quarantined from the East Asian crisis. We should not overlook the fact that, with the way that markets operate, we may well see a very big turnaround in capital flows over the next several years, and the vulnerability of the United States should not be overlooked.

At the moment, we see America looking very dominant. American leadership is absolutely fundamental to any of these outcomes. If the United States were to change its attitude towards Indonesia, quite clearly we would see a change of attitude towards Indonesia on the part of the IMF. One of the problems here is the United States Congress: while the United States is in a very powerful international position at the moment, the United States Congress, in terms of its outlook, seems to be getting, if anything, more and more provincial. This is a great paradox.

It is a paradox which we have always seen in America. It is embedded in America's political institutions; it is embedded in American culture. But it is a tremendous difficulty. We cannot overlook the danger of, in fact, East Asian exports recovering and America getting itself involved in another major trade policy debate with a lot of protests against the extent of imports into the United States from East Asia, which could lead to a significant rise in protectionism in America in the context of the next presidential election campaign. It seems to me that the conflict between America's international powers and responsibilities on one hand and the provincial predilections of the Congress on the other is a real difficulty.

Ms HUNT— I wonder if Mr Kelly or Mr Oxley would like to comment on the role of Europe. I appreciate that the US is absolutely critical, but I am aware that there is an ASEM meeting coming up in April. We have heard nothing at all about the role of ASEM or what might possibly emerge at that meeting—whether there are any possibilities that could emerge from that meeting that might be helpful in the situation.

The other comment I have concerns the second scenario that Paul Kelly mentioned, about the resentment at Western hostility to the IMF prevailing. I am wondering, given that Indonesia and Malaysia have, in a sense, vied for leadership of the developing world—and there are these other developments with the MIA and so on going on—whether you see the situation emerging where there will be a much, much wider gulf between the developing world and the OECD countries over trade policy, liberalisation of services and so on following the events in East Asia.

Mr PAUL KELLY—This time I will go first and Alan will reply after me. I think one of the really interesting things about the crisis is the way it has changed the agenda so much. If you look back at some of the issues which we were very concerned about in this country nine months ago, two were Pauline Hanson's impact in Asia and the battle for Australia to be involved in the Asia Europe summit meeting. I think it is quite clear that those two areas have diminished as problems. Clearly, there are far more important issues in Asia today than Pauline Hanson. To that extent, that has been a not insignificant plus for Australia. The paradigm at the moment is Australia attempting to come to grips with the East Asian crisis, not so much the impact of Pauline Hanson.

Secondly, I think the same effect is at work in relation to the Europe Asia summit. I know when Steve FitzGerald wrote his recent book he began the book by talking about Australia's exclusion from the Europe Asia summit as being a defining event for this country and for Australian foreign policy. I think the jury is very much out on that. It seems to me at the moment, having made a few inquiries about what might emerge from the London ASEM meeting, that the answer is 'not very much at all' and that ASEM itself is having a lot of trouble coming to grips with the East Asian crisis and attempting to sort out what sort of role it can play in this context.

In relation to the Europeans and the IMF, the firm impression I have is that the Europeans are far more hard line even than the Americans and that the Europeans are arguing the strongest possible case not to make any concessions on the part of the IMF to Indonesia. So again we see a very, very significant gulf between the Australian government and the Europeans.

In relation to what we see emerging from this in terms of the gap between the developing world and the OECD, I think the answer to that, as I said in my presentation, is a function of the recovery. If we get a good recovery, what we are likely to see is liberalisation being reinforced. We are likely to see better governance, better prudential supervision and a greater commitment to market orientated economies. But if, in fact, we do not get the recovery and we get all sorts of protracted difficulties, then I think we are likely to see, in the case of some countries, a greater division between the developing world and the OECD.

Mr ALAN OXLEY—I concur with everything Paul said except for the last point. I have never really understood why we made such an issue about not being in the Asian-European summit. The reason the Europeans created that forum is that they looked around and saw the emergence of regional trends and saw themselves excluded. APEC was quite intimidating for Europe because you had Japan, United States and the emerging Asian economies and no Asian linkage. So we were part of APEC. Why would we be agitated if the Europeans then turned around and sought their own linkage with the Asians, with

Europe, when, in fact, we had the institution of APEC? I never really understood why we thought that was something that we should be exercised about.

I agree with Paul. I think the Europeans will give succour to the hard line of the United States. When it comes to these monetary matters, they are quite tough—if their finance ministry people are in there. It is the Europeans and the United States who create what are the prevailing values of the IMF. So I do not think there is going to be much change for the Asian economies there.

As a final point on the issue of whether this are likely to open up wider gulfs between the developing countries and industrialised countries, the MAI is not an issue which is dividing developing and industrialised countries in the way in which the debate is being run. Something about the debate which has not become particularly clear is, firstly, that the MAI itself is about as exciting and substantive an issue as the debate a few years ago about whether we should have salt in food. It was of some passing interest but not terribly significant. I say that because the MAI is an agreement which is to require OECD countries to open up capital markets among themselves.

The effect on those countries will be extremely small because almost all OECD countries have very open markets on capital right now. Australia will grandfather a few things, such as it has already in the agreement with New Zealand. So will the others. It will really be no change. Why is all the fuss being created? It is environmental and development groups in Europe who are campaigning to have added to the MAI conditionality on investment, on environmental grounds and labour rights grounds. In other words, they are trying to insert into the OECD investment agreement what they failed to insert into the WTO in the lead-up to the Singapore ministerial meeting, which was to add conditions justifying trade restrictions on environmental grounds and labour rights grounds.

We do not like those much in this country, but we do not dislike them nearly as much as developing countries. So the campaign against the MAI is actually a Western lobby against Western governments. If you asked the developing governments where they sat, they would be extremely opposed. So I do not think that is an issue which is going to open up any sort of gulf between the developing countries and the OECD.

Mr WILLIS—I want to take issue with one point raised by Paul Kelly in his otherwise excellent address, and that was the agreement reached between Indonesia and the IMF, which Paul said was good public policy, all of it, but that he disagreed with it because of the value system that it was trying to impose rapidly on Indonesia.

One of those aspects of public policy which it imposed was that there would be a budget deficit of one per cent of GDP. Indonesia has historically run good budgetary policy—a lot of budget surpluses and balance, et cetera. In the context of an economy which is falling through the floor, with Peter Brain forecasting a fall in GDP of 6½ per cent for Indonesia this year, a budget deficit of one per cent of GDP is exceedingly tight budgetary policy.

Of course, to get there, one has to do nasty things—including abolishing subsidies on things like food, the price of which is going through the roof because of the enormous increase in import prices. Taking away the subsidies is going to push those prices even higher and make social conflict in Indonesia that much greater. This does not strike me as good public policy. I wonder if Paul would like to comment.

Mr PAUL KELLY—I would endorse the point Ralph is making. When I talked about good public policy, I was referring to the overall framework of the document and the values in the document. If that framework and those values were to be implemented and accepted by Jakarta, I have no doubt that economic, social and political conditions for the majority of the Indonesian people would significantly improve.

I do agree, though, with the particular point that he made about the budget and I think this is, however, related to another point that I made in my address. When I talked about turning points, I said that I thought there were two quite significant pivotal points in the East Asian crisis: firstly, the inability of Japan to act more resolutely earlier in relation to Thailand, which would have had a possibility of changing the overall psychology in the region; and, secondly, the reaction to the Indonesian budget—that 5 January budget.

I said that, while this budget was a long way short of being a perfect document, all things considered, it was a pretty good effort. And what happened was that budget got the thumbs down comprehensively by the United States administration and by the IMF. It was done in a very public way—the way these things are—conveyed in the quality American media very quickly. My own view is that the reaction of the IMF was important in shaping sentiments in financial and currency markets—and, of course, we have never recovered since then. And implicit in what I am saying there is, firstly, that there should have been a much greater awareness of the merits of that budget; and, secondly, that there should have been less reluctance on the part of the IMF and a greater appreciation of the great dangers in being seen publicly to dump all over it.

Mrs GALLUS—Just a few questions for you, Paul. Firstly, you are very critical of the IMF for not looking at the restructuring of debt and addressing that as one of the central questions. What do you see that the IMF should have done that it did not do? Or what could it possibly do?

Mr PAUL KELLY—In relation to me being critical of the IMF, yes, I am. I am also very critical of the Suharto regime. I will just make a few comments about the overall situation there. I think this is one of the great political tragedies that we have seen for a long time, because I think there is no real communication here. People are talking past each other. I think we really do have to reappraise President Suharto, because nobody can get through to him. It does not matter who it is, whether we are talking now about Paul

Keating, Bill Clinton, John Howard, Prime Minister Hashimoto or Goh Chok Tong. It just does not work.It seems to me that the communication is just not being made.

So I am very critical of what President Suharto is doing. He says that the IMF package has not worked in Indonesia. Sometimes, if you look at some of the public comments that he has made, he says, ‘Well, give me another solution’, which seems to me to be extending an olive branch and asking for advice. And then, at one stage, he said, ‘I am interested in an IMF plus solution.’ And a senior US administration official said, ‘We don’t know what IMF plus means.’ So I think the connections and the communications are simply not being made and this is a great tragedy—not just at the political level; it is going to turn into a massive human tragedy.

You ask: what else could the IMF have done? Well, I guess, what I would say about it is this. Firstly, the IMF should have been aware that this was a different sort of crisis. This is not one of your classic balance of payments crises at all. When you look at the actual macro-economic fundamentals of a lot of these countries, they are very good. Martin Wolf wrote a very effective column in the *Financial Times* pointing out how good a lot of the economic fundamentals of Indonesia were. He was attempting to rebut the comment made by the senior IMF official, Stanley Fisher, when he said, ‘All these problems are home grown in Asia.’ Some of them are home grown, but there was a lot of good in terms of the economic fundamentals in Asia as well.

The origins of the crisis, as I have argued, lie in the banking sector. The core immediate problem is debt. The debts cannot be repaid at the current exchange rate level in Indonesia. What this means is that companies are technically bankrupt. People are being thrown out of work. The banking sector is not operating. The corporate sector is not operating. The situation is much worse than what Suharto understands it to be. Even if we had an immediate solution tomorrow, the consequences would be dire.

Accordingly, what the IMF should have done was, firstly, to have recognised that the nature of the problem was different. Secondly, if the nature of the problem was different then it needed a different solution. The problem was different because it originated within the transactions of the private banks. Therefore, the solution had to involve a debt restructuring, not just macro-economic and micro-economic reforms, which are the bulk of the IMF’s conditions.

Therefore, the IMF should have done something that it does not normally do; that is, it should have got the private banks and other governments involved and tried to put in place a debt restructuring. Someone had to accept responsibility to do this. Who accepts responsibility for it? It seems to me the problem is that nobody accepts responsibility. So I think the IMF should have done that.

I think also, at the second level, it should be more responsive to Indonesia in terms of the application of the package. And, as I have argued, the issues of governance in the

IMF package have a greater weight than they deserve as a cause of the problem.

Mrs GALLUS—You said that you hoped, because of the role that Australia is playing now, it would be better appreciated in South-East Asia in the future. Are you seeing now any signs of that appreciation?

Mr PAUL KELLY—It is hard to see signs of that appreciation at the moment because the region is in a genuine and very intense crisis. It is to Australia's medium term benefit that we were involved in those packages. It is also a strength that Australia possesses, which is more apparent now than before, although it is not something that we want to parade or trumpet, but it is implicit in the situation that we have a lot of institutional strengths as a society—economic, social and political. That means, of course, that we have not succumbed to a lot of these difficulties because we have had more appropriate institutional arrangements. This is an important strength which Australia has when one makes any assessment or comparison between Australia and the region.

What we do about this, in terms of our bilateral and regional relationships, is attempt to be a constructive friend and partner with the nations involved in the region and bring to bear our assets and our expertise to the extent that we can. Both in our public and private sector we do have a lot of expertise which could help. It is a question of how that is used and how that is coordinated.

Prof. PATEL—I have come here today to be educated, and I am being educated, but there are certain mysteries which I would like clarified. This morning we heard a variety of presentations which emphasised the domestic economic and political malaise in South-East Asia. There were some references to the external financial environment, and yet there was a statement made this morning by one of the speakers which said that in fact Indonesia was a target and that the government was a target, meaning Indonesia was targeted for some reason.

This afternoon we have heard some statements which allude to East-West conflict and which also allude to the idea that Indonesia is not a major player—as indeed the whole of Asia. If Indonesia is not a major player, why then is it a target? If it is a target, whose target is it?

We have heard also the question about the volatility of financial flows. Volatility of financial flows, presumably, is a nice way of saying financial speculation. If it is so, who is doing the speculating and for what purpose? Is it to target Indonesia, is it to target South-East Asia? Whose agenda is it? I would like some clarification.

CHAIRMAN—I do not think it is reasonable for the two speakers this afternoon to deal with comments that were made this morning, but in so far as some of the question relates to what has been discussed, would either of the two speakers like to say something?

Mr ALAN OXLEY—They are difficult questions to answer because if you answer the questions as you have put them, the answer is presumed to accept the presumptions which seem to sit under them. Your questions seem to imply that there are entities who are moving. I do not know who would think Indonesia was a target.

What we do know is that in the US Congress, attitudes towards Indonesia are influenced by the history of disagreement over the Timor policies. If Indonesia has a problem in the US Congress, it is that American interests in Indonesia are not deep enough. If there were deeper US economic interests in Indonesia, you would probably have a different picture.

Compare the state of affairs with China over MFN. The reason why the US administration has taken what is a quite enlightened position on MFN with China is that there are very significant economic interests in China which lobbied the other way inside the US Congress. Indonesia's biggest problem with the US Congress is that it is not taken seriously enough, not that there is some organised target running against it.

As for the speculators and the money. I do not accept the presumption that there is something wrong with the system because of speculators. I do not agree at all with Dr Mahathir's positioning on all this stuff. Dr Mahathir is an extremely successful politician, and in making those remarks I think he was shooting for a home constituency, not actually giving us an accurate theory of how world capital markets worked.

Mr PAUL KELLY—Indonesia is a target. Indonesia has been a target for quite some time. There have been successful resolutions moved in some of the state houses in the United States. I think Rhode Island and Massachusetts are examples of where action is being taken against Indonesia by individual American states. We have seen over the course of the last 12 months a very troubled relationship between the United States and Indonesia. We have seen the Indonesian foreign minister, Ali Alatas, extremely agitated about some actions of the United States Congress and some of these individual state legislatures in the United States.

Whenever I go to the Northern Hemisphere I am struck at the terrible image that Indonesia has. When I went to APEC last November and checked into my hotel and turned on the television, there was a 45-minute interview going on between two United States academics and a very friendly journalist. It was essentially about the Suharto regime, its comparison with Hitler's Germany, the nature of genocide being practised in Indonesia, and the need to liberate East Timor.

There is no doubt at all that the nature of the public debate about Indonesia in the Northern Hemisphere democracies is quite different from the nature of the debate in a country like Australia. There is no doubt that to a certain extent Indonesia is a target, and there is plenty of evidence of that.

The other point I made was that Indonesia is not a major player. Indonesia is not a major economy. As far as the international financial system is concerned, the advent of the euro is going to be an event of the first order—an event far more significant than some crises happening in a few small economies in South-East Asia. This is coming up; this is on the agenda. If you have this sort of global outlook, frankly, you do not give a lot of priority to a country like Indonesia. So the fact that Indonesia is not a major player means that it does not have a lot of leverage.

We have seen a complete breakdown in the relationship between, on the one hand, the forces of international political power in Washington—and international capital—and, on the other, the Jakarta regime. The attitude of President Suharto is that he thinks he has a better idea as to what is in Indonesia's interests, having run Indonesia for 30 years, than do the international currency markets, the United States President or the Prime Minister of Japan. President Suharto, at the end of the day, looks as though he is going to back his judgment rather than be told what he ought to do by people outside Indonesia. This is part of what I call the tragedy of the breakdown in communications.

CHAIRMAN—Thank you.

Dr McLEOD—I found myself agreeing with nearly everything that Paul Kelly said, except when he got down to talking about his explanation for how the crisis got under way or what caused the crisis in Indonesia. I think his story was that he was blaming it on a breakdown of the banking system or weaknesses in the banking system. I would like to put a different view.

Let us just imagine that there was no weakness in the banking system but that what Indonesia did have in July of last year was a huge amount of borrowing in foreign currencies, mainly the dollar, which was unhedged. Then the baht was floated and everybody suddenly realised that, if the rupiah happened to be floated for any reason whatsoever, they faced unlimited losses by virtue of their foreign currency denominated borrowings. As a result of that, I would argue that everybody rushed to buy dollars and that caused the rupiah to devalue.

It has been the devaluation of the rupiah which now makes the corporate sector largely bankrupt and, in turn, makes the banking system basically bankrupt. In other words, I am arguing that it has only been the sudden crash of the currency that has visited these enormous problems on the banking system and not so much problems with the banking system itself. I do not deny that the state banks had enormous bad debts but I would like to see the evidence that the private sector banks had enormous bad debt prior to this crisis, as was implied in Mr Kelly's comments.

CHAIRMAN—A question, a statement or a debate?

Mr PAUL KELLY—I stand by the comments I made about the banks. They were not made particularly in the context of Indonesia; they were made more in the context of Thailand and looking at what happened at the start of the contagion. But, certainly, if one looks at the start of the contagion and the situation in Thailand, I would stand completely by what I said—that the core of the problem lay in the commercial banks.

The problem in Indonesia is that the exchange rate should not be where it is. It serves no economic purpose. It is not helping anybody. It does not reflect any economic or financial reality. This is simply a political decision. This is a vote by the markets of no confidence in a government, in a leader and in a regime. It helps nobody and it plays no constructive role whatsoever to have the value of the Indonesian currency diminished by 75 or 80 per cent.

Essentially, the exchange rate has to be stabilised at a higher level. Because the problem is a political problem, the IMF and the United States are going to have some sustenance when they say, 'We need a political solution.' They do not put it like that, of course. They put it in different language but we all know it is a political problem now. How do you solve the political problem? Do you solve it with an economic solution or do you in fact need a political solution? The fundamental issue in relation to Indonesia is: is it possible to have a restoration of market confidence in Indonesia while Suharto is still in power? I do not know the answer to that question but I know that we should not have got to this stage.

Mr SHIELDS—I would like to comment along the lines of what Ross McLeod said. Firstly, in answer to what Paul just suggested, my answer from a market perspective, and from a business that operates in Indonesia, is, yes, there is no doubt you can restore market confidence with President Suharto in power. I think what might help us to understand a little why I say that is to take what Ross McLeod suggested and ask ourselves why the currency is at this current very unhelpful level.

When I last visited our business in Indonesia in late November, the currency was trading, after depreciating—for whatever reason, in response to this initial crisis—from about 2,400 to 3,800 rupiah to the US dollar. I would have argued that a lot of the reasons that have been discussed today were behind that. You could argue about the relative magnitude but most of our clients, while in a state of severe loss and having to work out their problems in Indonesia, nevertheless could do it at that sort of exchange rate.

It seems to me the real question to ask is why it slid from around 4,000 rupiah to the US dollar in late November to 16,000 in mid-January and has now come back to somewhere around 10,000. I think there is a substantial argument that the reason for that and the loss of market confidence both externally and, from what we see, on the part of domestic business, was due to the actions of the Indonesian government.

CHAIRMAN—Are there any more questions?

Mr NUGENT—I have a question for Paul Kelly. He spelt out two scenarios that might develop. One you could perhaps term as the good scenario where things get repaired fairly quickly and will start to get back on the right track and the other that the recovery is not very good and that there is some adverse reaction not only economically but politically in terms of the attitude of Asia to the rest of the world and, if you like, the Western system.

If the first scenario takes place, presumably Australia will come out of that smelling nicely not only economically but also politically. Paul also talked about what we could be doing or should be doing in the short term to make something happen. The nub of my question is: where do we stand, not only economically but also politically, if scenario 2 eventuates, given that we have taken the somewhat independent position from Europe and the States but obviously what we have been trying to do with Asia has not worked? Where would that leave us, in your view?

Mr PAUL KELLY—I should say for the record that I agree with the point that Bill Shields made in that previous question. I think it was Bill who was asking that question. I certainly think that the actions taken by President Suharto over the course of this year have been terribly counterproductive. Decision after decision has gone the wrong way. There is no doubt at all that when one has to sheet home accountability one has to, firstly, sheet home accountability to Jakarta. A lot of the pieces I have written over the course of the last four to six weeks have been making the point that time and again President Suharto has gone the wrong way—whether it was the initial selection of vice-president or whether it was the composition of the new cabinet just last weekend.

We have had these two forces feeding off one another and we have got locked into a downward spiral. It is very hard then, of course, for the moderates who want the IMF to introduce a softer package. They just have the rug pulled under their feet all the time as a result of the decisions which are made in Jakarta.

In relation to the question about what happens if we get scenario 2, I suppose one of my character defects is that I am still an optimist and I do not think we will get scenario 2. I think, hopefully even in Indonesia, we will be able to muddle our way through without getting a fully fledged scenario 2. But if we do get a scenario 2, it is going to have a lot of repercussions, both for the region and for Australia's relationship with the region. Essentially, if you have one country in the region breaking away in terms of its external orientation or in terms of domestic economy; that is, if you have one country which breaks away and is no longer on a successful growth path and is no longer committed to the sorts of macro-economic policy changes and market orientated changes which the region has been committed to for a very long period of time, and that country takes a different path—which of course leads to a lot of internal political disturbances and instability—then that is going to be a problem not just for Australia's relations with that particular country but for Asia and for the region as a whole and we are going to be caught up in all of that.

Dr MARFURT—One of the most fascinating aspects for a European observer coming over here to this region is to see the different patterns of regional cooperation and regional integration practised in Europe and in the Asia-Pacific region. In the European case, with the European Union, we are talking about a concept where legally binding arrangements—such as banking supervision or rules, or a new set of public order regulations—is the pattern which is followed; whereas, as we heard from Mr Oxley this afternoon, the APEC approach is more of a self-regulatory approach.

The question I would like to address to Mr Oxley is whether he thinks that the experience gained in this recent crisis in the Asia-Pacific region will lead to making the next step from the more self-regulatory approach to what he talked about this afternoon: the importance of policy focus, and even an institution building approach, of which the European Union is certainly a very important regional model. May I ask you to comment on that?

Mr ALAN OXLEY—It is a good question. Had APEC elected to use formal rules—binding rules—to commit its members to achieve the Bogor declaration, and had that followed the pattern that we have seen in the WTO and in other regional arrangements, then we would have seen the locking into place of some broader rules which would have had a beneficial effect on external governments and financial sectors. In fact, APEC faced a tension between building an institution which represented a consensus among the parties and in seeking to use that forum to achieve something. I think I did make the observation that I have never seen any examples where voluntary efforts by countries to impose external rules to open up markets actually succeed unless they do it for their own internal domestic purposes.

The crisis displays the relative weakness of the commitments to liberalisation. Financial services are talked about in APEC, but you will not find anything much in APEC which advances the requirement for countries to open up their financial sectors and liberalise them. I am not sure that would be too big an ask anyway for APEC. Remember, APEC also includes China, the United States, Korea, Australia, Canada and the ASEAN countries.

One of the great challenges going on right now, in terms of whether countries accept the external disciplines for markets, is China's accession to the WTO. This is not being held up on political grounds; it is being held up because China is unprepared at this point to accept the basic rules. These are basic market disciplines. So, if it is not possible for agreement to be reached speedily to get China into the WTO, it is very difficult to imagine how APEC could agree to a set of rules which would have a similar effect in a new area on the other countries.

However, what will save the day will be the WTO. With the talk of a new round, we will see the next WTO round become the dominant forum for further global liberalisation. We have seen a bit of a phobia about globalisation in Europe and the United

States. We are starting to see it appear here. Part of the debate about an MIA is this post-reform effect. I think it is going to be washed away once that new WTO agenda starts, because there are five or six major issues there which will take us into a new phase of global liberalisation.

That will be the vehicle through which the Asian-Pacific economies will then put themselves in a position where they will accept these external disciplines. The reality is that, for the process of economic development to take place, we still have a few notches to go. I do not think it is an accident that we have seen what happened, and at the same time they were unwilling to accept liberalisation to the services sectors over the last decade. There is a distinct connection between the two in my view.

CHAIRMAN—One more quick question and then we will take the rest of the questions at the open forum at the end.

Mr FERNANDEZ-CASTANO—Thank you very much for the session. This is a good opportunity not so much to get information on the Asian crisis, but especially about the Australian perception of the Asian crisis. I have been quite impressed by Mr Paul Kelly's view about the role of Europe. His alleged indifference of Europe towards Indonesia tends at times even to be perceived as a hostility. Even the euro has been portrayed here as El Nino currently affecting the Asian crisis, whereas I believe the euro event is going to stabilise the international currency system and therefore could help the Asian crisis to some extent.

To go back to what could be a European perception of the problem, I would like to say—since there is going to be a *Hansard* record of this meeting and my presence is going to be included—that, contrary to what has been said here, most Europeans are very concerned about the Asian crisis, not only because it could trigger a world crisis if Japan and Korea would not recover, but also concerned about a regional crisis in ASEAN countries, and specifically in Indonesia. It can be proved that European exposure in Asia has been higher than the American, and of course much higher than Australia's, taking into account the size of our economies. Therefore, there is a vital interest for Europe in Asia overcoming the current crisis.

Of course we cannot be responsible for whatever is said in free public opinion and I would not claim that everybody in Europe is a pro-Suharto campaigner. But for no-one other than the very reputable journalist, Mr Paul Kelly, it should be easier to make the difference between individual expressions of free public opinion and governments stances and governments concerns. I understand that we are in Parliament House, and the purpose of Mr Paul Kelly was not to launch a debate with European countries but to move parliamentary sensitivity towards the very important Indonesian problem, and in that I can go along with him. Thank you.

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CHAIRMAN—Thank you very much. The meeting stands adjourned until quarter to four.

Proceedings suspended from 3.30 p.m. to 3.47 p.m.

CHAIRMAN—In this final session we are looking at the challenges for Australia mainly from a domestic point of view. While the governments and analysts have forecast various downturns in growth levels for Australia, its industries and its exports, it is generally considered that the real effects on Australia are yet to happen. What might those effects be, what options exist and what opportunities are there for us to minimise and to take advantage of the situation? I would like to welcome now Mr Chris Richardson who is a director of Access Economics, the organisation that many regard as Australia's leading economic analytical unit. No doubt Mr Richardson's previous employment in the federal treasury and the IMF will assist in this presentation he is now going to give us on the prospects for Australia. Mr Richardson.

Mr CHRIS RICHARDSON—I am almost scared to admit that, yes, I have worked for the IMF.

CHAIRMAN—Treasury is worse.

Mr CHRIS RICHARDSON—Yes, Treasury is probably even worse. Starting to shift the focus of today a little towards Australia and the impact of what has happened in Asia on Australia, I would like to draw out some broad themes. There are points of consensus among Australian economists. We all tend to disagree on the degree to which Asia will have an impact, but it is the points of consensus that I would like to concentrate on today. There are varying degrees of agreement on these but let me go through a couple of points. First is that the Australian domestic economy is actually growing quite strongly at the moment so if Asia had to happen it is probably as good a time as any that it is happening now. Private final demand in Australia is running strongly and will continue to run strongly at least for a little time ahead of us. Second, yes indeed, as the senator said, the Asian impact on Australia will build. So far the main impact has been on tourism but a number of other sectors will be hit so I guess the third point in the consensus is the combination of those two: that 1998 will be an arm wrestle between the strength in the domestic components of the Australian economy against the weakness coming in through what has happened in Asia. As 1998 unfolds, increasingly you will see domestic strength worn down by that external weakness.

Fourthly, there is the question of which regions in Australia will be most affected. It is most likely to be Australia's sunbelt. Western Australia, Queensland and the Northern Territory will feel most of the effect from Asia. Fifthly, industries affected will range from tourism to mining, to the farm sector, and parts of manufacturing such as petrochemicals and cars.

Sixthly, there is the question of what is going to happen to employment and unemployment. I would simply draw again on the broad consensus that there is a lag between economic activity in Australia and job growth in Australia. There also tends to be a lag—though admittedly more variable—between employment growth and what happens to unemployment. That means that unemployment will probably continue to improve through much of 1998 and perhaps even into 1999.

A seventh point of broad consensus is that at some stage Asia will recover. Just as I will go through in great detail the pain that faces the Australian economy ahead, let us not forget that there will be a phase when the Australian economy will be benefiting from a rebound in Asia. It is some way down the track, but it will come.

The final point of broad consensus I would like to bring out is that there will be a hierarchy of recovery through Asia. Obviously, you have had speakers dealing with this at length. Just as a quick overview, there are a number of economies in Asia whose exchange rates have been relatively unscathed in this process: Singapore, Taiwan, China and Hong Kong, and Japan as well. I would expect that, as they are more on the periphery of this crisis, they will be the first to recover. They will be followed by Korea and Thailand. After that will come the Philippines and Malaysia. Last of all will come Indonesia.

I take you first to the Australian domestic economy and the strength that we currently have here in Australia. This is a point that lots of people are missing. The US and the UK are countries we often look to that are pretty close to peaking in their economic cycles. They have been through a recent phase of surprising forecasts on just how strong they are; they are now going to start to slow. That is not true in Australia. We have just been through a period of slow growth. The interest rate cuts and the real wage gains that we have been getting in Australia mean that we are starting to get improvement in things like the retail sector. There is a fairly impressive recovery there. There will be more gains to come as housing comes good, or more good, in Australia. That too will benefit retail. As the jobs recovery continues in Australia, that will be another benefit for retail.

Domestic bits of the Australian economy like retail are doing well, as is also housing. There is a modest recovery by past standards, but still a relatively sharp move. That dark line running through the middle there is trend activity growth in Australia over time. The red line is how we have gone. You can see the recession in 1983. You can see a slowing in the Australian economy in the mid-1980s. You can see the recession in 1991 and you can see that most recently Australia has just come out of weakness in 1996 and 1997.

The domestic cycle is turning our way. It is showing up in the retail sector. Here is real private consumption which is the same thing. The black line in the middle there is the trend. The red line is what has actually happened. You can see the weakness in consumption, for example, in the last recession and the considerable strength that we see at the moment, and see the housing recovery doing the same sort of thing.

To put that in an overall perspective: economies have cycles. They tend to be four or five year cycles. In Australia they run one about every 17 quarters. We had booms or upswings—whatever you want to call them—in 1984, 1989 and 1994. We are already seeing in Australia an upswing in the domestic cycle. It is simply coming at a time when Asian negatives will be slicing the top off that cycle.

There are further risks for Australia over and above what has already happened in Asia. People will have covered this. Briefly, the affected countries—notably Indonesia, Korea, Thailand, Malaysia and the Philippines—have thus far mainly had to deal with exchange rates. That is probably no longer quite true in Indonesia where things are moving very fast. Increasingly what we will get from here is an impact that will have more of an effect on Australia's real economy as companies and banks collapse in Asia and as recession hits most of those countries I mentioned, but not all, as unemployment rises and governments fall there. I guess I should take out Thailand and Korea, where governments have already changed, from those countries with potential falling governments.

The next possibility is that you could have Asia getting worse, from the viewpoint of its impact on Australia, if either Japan or China fall over any further than they have already. We know that the Japanese economy was going backwards in the closing months of 1997. It probably is continuing to go backwards at the moment, qualifying it to be termed as back in recession. We know that Japanese banks are incredibly vulnerable with their exposure to Asia. They were vulnerable before Asia happened and they are worse now. A common theme through the region, as Paul Kelly noted, has been weaknesses in the banking sector. The fact that Japan and China have not fallen over does not mean that they do not share those same weaknesses and that they may not also continue to be at risk from Asia. It could get worse in Asia and, therefore, it could get worse as an Asian impact on Australia.

However, I should say that I am an optimist, a rare being amongst economists. I do think that 1998 will be a surprisingly strong year for activity in Australia. I should say that, although I am more optimistic than the consensus, the publications that do survey numbers of forecasters suggest that the consensus is also optimistic. Australia is the only country in the East Asian region which is expected by the average consensus opinion of forecasters around the world to be growing faster in 1998 than in 1997. That is because of the momentum that has already built up in the Australian economy, notably in housing and retail but also in some other areas of the economy as they respond to the interest rate cuts that we have had since the middle of 1996.

A risk for Australia, and the basic arm wrestle that we will see in 1998, is that usually government policies should be aimed at avoiding booms and busts. This time round it would be great to have a boom in the domestic focused bits of the Australian economy because we know that the external accounts will introduce major weakness into Australia.

When the national accounts came out two weeks ago they gave us a snapshot of Australia at the end of 1997. For various technical reasons they understated the strength of growth but, to be fair, you would probably have to say that the nation has started 1998 not quite at a gallop. It needed to be at a gallop to say that 1998 would be a very good year. I would still call it a good year, but it will be true that Australia will be growing rather faster in the first half of 1998, where we are now, than it will in the second half and in early 1999.

I would say early 1999 is a particular danger for Australia. By that stage, our exports will be particularly hit by what is happening in Asia. We should be importing more from Asia as well and that means major external weakness coming into the Australian economy. The housing and retail booms that we are getting at the moment will be flagging somewhat by that stage. There is the risk that, because of what has happened to the Australian dollar relative to the countries that we import from like the US, you will start to see an increase in the inflation rate in Australia at that time.

The combination of a current account deficit pretty much in banana republic territory, or fairly close to it, rising inflation and an unemployment rate still falling because of those lags, may yet see the Reserve Bank virtually forced to raise interest rates, not markedly, in the first half of 1999 at a time when the economy is slowing fairly substantially. So that does shape as a danger period for Australia.

Of course, it is not impossible that rates will still fall between now and then. There is what I would see as a fairly brief window of opportunity for the Reserve Bank to kick activity along a little further here, but I would still expect that the next main move in interest rates in Australia will be up and that that will be giving us some pain in 1999.

There is the question of which states, which regions of Australia, are going to be most affected. We have people here from various states. There is good news and bad news. Obviously, the states at most risk are those states that tend to export the most. I have done this chart in terms simply of exports as a proportion of state product, but it looks pretty much the same if you do those exports specifically headed to Asia.

It shows Western Australia, the Northern Territory, Tasmania and Queensland as having, among exports of goods, a considerable exposure to what is happening in Asia. If you look at it in terms of exports of services, which given the Asian crisis will mainly come via tourism on the services front, then again you see Queensland, New South Wales as the national gateway into Australia, the Northern Territory and Western Australia. It is good news if you are in the ACT, a region which is not terribly exposed to anywhere much.

Another way to think of it is that although Western Australia, Queensland, and the Northern Territory are most exposed to Asia, they are also the parts of Australia growing fastest at the moment. If we are lucky and the Asian crisis turns out to be relatively short, then the enormous queue of mining projects in Western Australia, for example, will be only slightly affected.

Many of those projects will not occur or will be delayed because of the Asian crisis, but many of them are either currently being built or are on the verge of being built and will not be stopped as a result of events in Asia. That momentum will carry some of the sunbelt states like Western Australia through. If we get a long drawn out recovery in Asia then that is particularly bad news for places like Western Australia, Queensland and the Northern Territory.

If you look at South Australia and Victoria and to a lesser extent New South Wales, they are the regions in Australia more focused on the Australian domestic market. Because that market is going well at the moment, that will provide some offset for them.

When Asia actually does hit Australia there will be lots of losers. We have already had the tourism losers, the quite stunning drops in the numbers of people coming from Korea and Thailand. Malaysian and Indonesian travellers to Australia are still holding up but you cannot expect that to continue. So, tourism will be hurt more.

There is a variety of other industries that will suffer as a result of events in Asia. Just to list them, they include mining; the farm sector; textile, clothing and footwear as part of manufacturing; petrochemicals; food as part of manufacturing; electrical appliances; cars; publishing; forestry; education; prefabricated housing; and steel. The losers will be those industries that trade with the rest of the world. They either export to Asia or export to places where prices of things like gold have fallen as a result of the Asian crisis, or they will lose because they will compete with imports out of Asia.

This chart shows real growth in the Australian economy in calendar 1998 compared to calendar 1997. The line there roughly in the middle is just the average growth and the rest there are sectors. The fastest growing sector in Australia will continue to be communications, which is growing very fast. The construction sector is rising rapidly at the moment and will grow very strongly in 1998, again, another internally focused sector. The third fastest sector there has a different name according to the ABS but I call it 'accountants and lawyers'. They will grow fairly fast.

The weakest area is the farm sector up the top and that is going to be much harder hit by what has happened due to El Nino rather than Asia. You will have a fairly weak manufacturing sector and mining much slower than it has been. Just to look at it sector by sector, mining, oil, copper, gold, lead, coal, iron ore and nickel are all at risk in Australia from what has happened in Asia. There is less of a problem with aluminium and zinc where the fundamentals are better.

When I said tourism was the only sector that had felt it so far, I should have included live cattle exports. You have things like beef exports, niche exports of exotic fruits, and lobsters being sent to Hong Kong. Elsewhere in the farm sector things should hold together a bit better. With forestry you will have less demand for Australia woodchip exports and more competition from Indonesian hardwoods.

Everybody includes education in the list because there will be fewer Asian students studying in Australia. I have included it too but I feel a bit guilty because I really do not think this one is a major impact. There has been a considerable increase in the numbers of student visas coming from countries such as China, India and Vietnam, even though there have been major losses from some of the other Asian markets. There has been an offset.

Concerning textiles, clothing and footwear, those of you who live in Canberra might have noticed the ad in the *Canberra Times* last weekend saying that Grace Bros had Korean suits for sale, a German fabric but Korean suits. They were $179, a good price for a suit. I went along, I am an economist, I believe in this sort of thing. As it happens I did not like the suits on display but I suspect you will increasingly see those sorts of ads. The sectors that I have been through thus far have been the ones that will lose exports. It will be relevant to notice the ones that will lose sales to the domestic market because of imports, things like suits made in Korea rather than in Australia.

Food manufacturing too loses on both sides of the accounts. They will lose exports. They have been concentrating on being a supermarket to Asia. Obviously, that is a strategy in major difficulties. They will also face increased import competition at the same time from all sorts of canned fruits and vegetables and the like coming in from Asia.

Car makers will suffer. You probably saw those stories claiming that Korean car prices would actually go up. You should never have believed them. There may be a very short period in which Korean car prices will not go down but I think you will find very sharp pricing from those cars as 1998 unfolds. For anybody looking to update, hold on for a couple of months because I suspect you could get a very good deal. There are also obvious issues for Holden as it looks to produce the Vectra domestically and export it. That is obviously somewhat at issue now. They will do it but the speed with which they achieve success is at issue.

Publishers too will be affected. I got an unsolicited e-mail offering to print some of the publications we put out in Indonesia, and the prices were excellent. I certainly considered it carefully before I said no. Asia has enormous excess steel capacity and so BHP is particularly at risk. We could get imports of structural steel out of Korea. You could get reinforcing steel. I should not make Mr Hollis too worried here but the steel industry is obviously another one clearly at risk from what is happening.

Asia has excess capacity in petrochemicals—plastics, pipes, cables, tyres, detergents, inks and adhesives—the sorts of things that you do not notice but which are fundamental to the economy and its operation. We will get lots more imports of those. Airlines will be a little less affected than tourism as a whole because you will get an increase in the number of Australians going to Asia as a holiday destination. But airlines are suffering. We have already seen the cancellation of flights from Qantas and Ansett into Asian markets.

Prefabricated housing and construction services will lose their Asian markets. If we look at the manufacturing sector—and this is not the whole economy, just manufacturing—the one in the middle is relatively slow growth in manufacturing as a whole. I expect major falls in textiles, clothing and footwear—the Korean suits; I expect weakness in food, beverage and tobacco, as food manufacturing gets hit; and I expect weakness in metal products, as the steel industry gets hit. The flip side of it, I guess, is that you are getting strength in some other areas in manufacturing, including, for example, the areas that feed into the construction sector—glass, bricks, cement, those sorts of things.

Jobs will do better than you think, because the Australian economy is still growing strongly. It will grow strongly through the first half of 1998. You will start to see Asian induced weakness in the second half of 1998 and I suspect that that will be at its worst in early 1999. But, remember, there is something like a six-month lag between that basic economic activity and what shows up in job growth in Australia and, although it is a variable lag, I would expect something like another six-month lag between jobs and unemployment. The unemployment rate is currently at 8.1 per cent in trend terms. I do expect that to be eight per cent or below the government forecast for the June quarter of 1998. I expect it to be below eight per cent by the end of 1998 and perhaps even as good as 7.5 per cent in the first half of 1999.

I should not give the impression of all doom and gloom, but perhaps the job sector shows up better than the others because of the lags there are in the system. It is a dangerous thing to say in Parliament House, but this shows job growth in 1998. Again, there is an average and we have the sectors. The fastest growing jobs should be among accountants and lawyers—that usually gets a few boos and hisses around the place.

What should governmental authorities do? Interest rates obviously are an issue. Inflation in Australia at the moment is very, very low. That gives us considerable room for manoeuvre, compared to where we otherwise might have been. A difficulty for Australia is that the Asian crisis has weakened the Australia dollar against the countries from which we import a lot. That means we will import a degree of inflation as 1998 unfolds. On the other hand, the Asian crisis has slowed demand from where it would otherwise be. That will help inflation. On balance, I think inflation will move up from its cyclical low at the moment. I suspect that the Reserve Bank may be forced to raise interest rates in the first half of 1999. I do not think that will be dramatic, but I suspect that it will happen. The impact of Asia on interest rates in Australia will be a mild negative. Asia makes it slightly more likely that rates will go up in 1999. The flip side of the coin is that if things get much worse in Japan and China, there is in fact a possibility of a short-term rate cut in Australia earlier rather than later.

There is the question of what the Commonwealth government should be doing; what budget policy should be doing. As the government has said, the 1996-97 budget and the considerable tightening that it saw at the time did help fireproof Australia against the financial market contagion. There was a period there when financial markets were pretty much going crazy and they were belting anybody who had their head above the parapet. Luckily, and in part due to the 1996-97 budget, Australia had its head below the parapet. It would be unwise in the coming budget to unwind much of that fireproofing. I realise that there are risks in both directions, but the coming budget surplus in Australia is a cyclical one. I am not sure that it is structural and it definitely should not be taken for granted.

The official forecasts suggest that we will have a budget surplus of $10.4 billion in the year 2000-2001. That simply will not happen. If it did happen, if the official forecasts were correct, at least that far out, that would be a first. The forecasts that far out virtually always underestimate outlays. I would expect government spending will be higher than the official figures; therefore the coming budget surplus definitely does not look as good as the official figures would have it.

In terms of a specific budget policy related to Asia, the government has been spending more money on various things in the last six months, obviously as we have moved closer to an election. That always happens. Only one thing could be said to be related to the Asian crisis: the move to provide extra funds for export insurance through EFIC. There are arguments both ways on that. It is undoubtedly business welfare and therefore it is risk; but equally, specifically because of the very long-term trading relationships that there tend to be between Australian firms and Asian firms, there is a national interest in maintaining those through a very difficult period and a case for that spending.

Asia will bounce back considerably, some earlier than others. The ones at the periphery—Japan, China, Singapore, Taiwan, Hong Kong—I can see coming back earlier rather than later. The recovery list in 1999, on my forecasts, will include Korea, Thailand, somewhat later Malaysia, which is taking a riskier set of policies to the problems it faces, and the Philippines. Somebody said to me that the Philippines is used to crisis. That is a little cruel but there is some truth to that; the Philippines will be bouncing back in 1999. By 2000 even Indonesia may have joined the recovery list—we do not know. Obviously Indonesia is the country most at risk. But at some stage it is clear that the Australian economy will again benefit from good growth in the Asian region, there will be an Asian bounce and it will be good for Australia to have an underdeveloped nation of 200 million people sitting immediately to the north of us. It will, however, be some time before

Indonesia in particular comes good for us.

CHAIRMAN—Thank you very much, Chris. Our next speaker will be Mr Bill Shields, who will talk about the possible strategies for Australian business. At the end of that we will move into a question time.

Mr SHIELDS—Thank you, Mr Chairman, and good afternoon everybody. I was very sympathetic this morning to the other speakers because I think many of them probably felt very constrained in having 10 minutes to describe not only what has happened in Asia but what is currently occurring, given that we have little actual data, and what is likely to occur in the next year or two. By contrast, my task—and in the original program I was given 30 minutes—was to tell you about business opportunities or strategies. My difficulty is that my honest bottom-line answer to that is that there are presently few, if any, in Asia for Australian business. I think I have been saved by the overrun on time, so I will try, in staccato fashion, to tell you what I mean by that bottom line.

It essentially reflects two judgments. One is more of a business judgment and the other is a judgment of what is happening in Asia. The business judgment has to do with the fact that I do not pretend to be able to provide a window for you to what is happening in all of Asia in a business strategy sense. We are a relatively small, although fairly successful, organisation. We have increasing business in Asia—in Hong Kong, China, Malaysia, Indonesia and Singapore, which is a regional business—but we do not pretend to know all sectors in these economies, nor do we pretend to know all other economies. So if a client asks me what a business strategy might be now in the Philippines, my honest answer is that we probably have very little knowledge. That is, of course, by way of being the classic economist's caveat to what I am about to say.

The more significant thing by far, apart from that limited window, is that in a lot of the debate to this point we have missed a distinction between what I call the financial crisis and the economic impact of the crisis. I believe that in most of Asia, with the possible exception of Indonesia, the financial crisis is by and large over. I do expect, however, to see through the course of 1998 a continuing unfolding of the economic impact of that crisis. That is neither a unique nor a particularly Asian phenomenon. We have seen it in many other countries in the past, including our own—sometimes self-inflicted, sometimes from outside and often a combination of both.

It will involve a lot of the things that previous speakers, and most recently Chris, have referred to—bankruptcies, business failure, failure to invest, lack of willingness to invest for the future on the part of both outside and domestic business, a loss of export markets, et cetera—until we start to see some recovery return. I cannot honestly tell you how long that process will take to unfold but I do believe, both on the basis of what we have seen in the past and through experience, that it is going to be severe and that it is not going to be as clear cut or as short term as a lot of people make out.

If you want to take as a benchmark the IMF program for Thailand, which has probably been the most transparent IMF program in history in terms of what the Thais have published on the letter of intent, they expect the fourth quarter of positive growth in 1998. Based on my trip last week to Bangkok, I would be extremely doubtful. We have yet to see the full impact of this crisis unfold—that is of the economic crisis as distinct from the financial crisis.

There are also other problems that face businesses that may wish to take advantage of opportunities they think are there. Some of these may seem a bit technical to you but if you are at a business level looking for opportunity they are very critical. The first is that, on the back of this economic crisis and the financial crisis that preceded it, we have as yet a very uncertain domestic regulatory regime in all of these countries. We are not clear, to take the Thai example, where they will end up in terms of foreign participation or ownership in their banking system; in terms of foreign participation or ownership of public entities through the privatisation program, although they are committed in principle to it; or in terms of private or foreign ownership, particularly of non-financial enterprises. That will unfold during the course of this year in response to the parliamentary process in Thailand.

It is very difficult in this environment to seriously carry on due diligence if you wish to purchase an asset in one of these markets or take advantage of an opportunity. We have already seen, in the case of Thailand, the situation where a number of foreign entrants have withdrawn because of the difficulties of doing due diligence, not just because of the very different accounting and legal frameworks and the lack of transparency—to use a much hackneyed term—but also because of this shifting regulatory policy environment. That, I think, will continue for a good six to nine months, even on their own calculations of what time it will take to get changes through parliament. Until then, people are not really going to want to commit money.

The final issue which is most significant, not just in Thailand but also in Malaysia, where I was recently as well, is financing costs. It is all very well to talk, as economists, about the recovery in the export sector on the back of a depreciated exchange rate, but if you are facing overnight rates of 20 to 35 per cent—depending on the country you are in, the market you are in and your relative size—for the purposes of working capital, it is a large task to borrow with confidence, plan for expansion or consolidation in the future, get production running, find markets and get the exports shipped—not to mention have all of that show up eventually in government statistics as export recovery. So the financing cost issue, the due diligence issue, the shifting policy and regulatory environment and the unfolding economic impact, which we believe could mean loss of GDP in Thailand and Indonesia of up to five to six per cent this year, all suggest that we are likely to see a very difficult environment to realise business opportunities in the near future.

That is the negative view and the situation we face at the moment. The positive view is that we are already beginning to see, I would suggest, a divergence in experience emerge in these countries. It is quite clear to me that, whether you look at currencies or whether you look at stock market performance in the last three or four months, you are starting to see some sort of hierarchy of perceptions about what is happening in Asia. For example, we have seen recovery, to a certain extent, in the Malaysian ringgit and in the Thai baht, and we have seen consolidation in the South Korean won. Yet we have seen continued volatility and the lack of any clear direction in the Indonesian rupiah, although we are above those very extreme lows of mid-January.

All the stock markets have recovered. If you look at the details, the Thai stock market, as of yesterday, was down all of nine per cent from its level prior to the currency crisis last July. That is a remarkable recovery. I think you are very wise to be cautious of that. You have to ask yourself, 'What does it signify?' I think it signifies in part the willingness of international asset allocators or funds managers, and perhaps proprietary traders, to want to be positioned just in case things recover more quickly than they think—because they were the ones, we have heard earlier on today, who basically fled these markets during the crisis last July-August and September-October, depending which country you look at.

But there is something more significant than that and, based on our own on-the-ground research in these countries in the last few months, I believe that you can see a quite surprising level of confidence emerging in a number of countries. It is not confidence that the worst is over, but confidence that we are on the right track and taking the right measures that will eventually see recovery. People may argue whether that recovery will be late 1998, early 1999 or mid-1999, but that confidence is very apparent, I would argue. If you go to Bangkok today, perhaps it is even more apparent than I was prepared for, and surprisingly so. I would argue that it is even apparent as of last week's visit in Kuala Lumpur, and from what I hear, although I have not been there the last two months, it is apparent in South Korea.

You ask yourself why this confidence is beginning to emerge in these two countries. I think that although there may be many reasons, if you look behind this, I would argue that first of all it is confidence in the policy measures that have been adopted, or in the broad terms the policy approach is being taken.

Bangkok is an interesting example of confidence that the government is willing to implement an IMF program. On the back of that two critical things happen. Based on our information, the banks—not necessarily publicly—have basically all rescheduled short-term debt liabilities and rescheduled them out one, two, or three years from what were essentially 60/90 day liabilities of the banking system and some private and non-financial corporations in that country.

That immediately addresses one of the major issues, of course, that is constraining recovery, and that is the availability of financing. You may not particularly like the cost, because bankers are businessmen and they will look for some protection in that rescheduling. You see this in the financial press in terms of arguments about the appropriate interest rate and maturity on the reschedulings. But the financing is basically there and that is a major benefit for eventual recovery.

The second area where you see that confidence is in the domestic economy. This is far more difficult, but I think it is very important. One of the biggest problems that we have seen in this crisis in Asia, I believe, is an evaporation of domestic business confidence. At the end of the day that means that nobody is willing to invest in recovery, even if they have availability or access to financing. This has been seen in many other places in the past. Again, it is not unique to Asia, south-east or north-east.

When I worked in the IMF in the old days we called it capital flight. The classic example was Latin America where most of the capital—and this is an overstatement, but basically an analytical point—was not in Argentina, and not in Chile, being devoted to domestic investment, but in Miami. And it was in Miami, even though many of the families still lived in those home countries, because they were terrified of the outlook. But the economic consequence of that was very simple: those economies deteriorated since no investment was undertaken.

Based on the sort of information we can gather, there has undoubtedly been excessive capital flight out of a number of Asian countries as a part of this crisis, and if I had to nominate any—although I cannot prove it with figures for you—the classic example would have to be Indonesia. That has already occurred, which makes some of the argumentation, incidentally, about the currency board issue and whether we are facilitating people to take assets out of the country like bolting the barnyard gate after the horse has already got out. We have already seen it happen. I do not think that the currency board issue makes that much extra difference.

What you are going to have to do, therefore, to see confidence restored is to restore, not just international confidence, but also confidence in the domestic business community. I cannot see any other way to do that but to have a credible package of policy measures even though you and I could spend many weeks arguing about the relative value of some of the individual issues in that policy package. Again, if you look back at my example and ask why the Korean won stabilised virtually from the week after the IMF package was announced; why volatility has declined; why the underlying volume of market transactions is still there; why spreads have narrowed; and why the exchange rate has appreciated, the reason is that confidence has returned.

In the Jakarta foreign exchange market there are no underlying transactions. Transactions in January may have been as little as one per cent of what they were last June. That exaggerates volatility and exacerbates the lack of confidence. And, of course, on the back of all of that are the press and media reports we get and all the speculation about what is being done, which simply erode confidence further.

However, there is other good news in what has been happening recently. As we start to see a divergence in market behaviour in response to this financial crisis, it suggests to me that contagion may actually be declining. Last week in Malaysia and Bangkok this suggests to me argument was put to me quite strongly, surprisingly strongly, by local officials and even business people for that matter. The argument was that if there were another financial crisis, perhaps, in Indonesia, the ringgit and the baht would not be dragged down, at least as significantly, or in as volatile a fashion, as occurred through the period from September to January. I think that there is a fair amount of argument in that. Time will tell whether that is right or wrong. I am not suggesting that there will be another financial crisis, but you are starting to see the contagion effect effectively breaking down. These are positive developments.

On the confidence issue—just to complete the story—I think that it is also very important to understand that in the context of this package, as I would put it, of credible policy measures, it is not really an issue of the IMF versus us, or the IMF versus nothing, because what you most clearly see now in the South-East Asian environment is countries which do not have IMF packages adopting policy reforms.

The classic example of that has to be Malaysia. If we want to be political about this, it may be for fear of having to call in the IMF. It may be for the more positive view—and I think that this is partly true—that they recognise some of the excesses of the past and realise that the banking system, for example, has to be restructured. Nobody, it seems to me, has illusions in Kuala Lumpur. The estimates I saw were that non-performing loans would rise from six to seven per cent of bank assets to a peak of between 15 and 18 per cent in the next six to nine months. By contrast in Thailand, you see figures mentioned of 16 per cent at the moment rising to anywhere between 30 and 40 per cent in six to nine months time. This is a significant work-out situation for financial institutions.

The point I am making is that it has to happen and is happening at the moment, regardless of whether there is an IMF program or not. I think that is what you increasingly see, not only in these countries, but perhaps also in other countries across the region—and China was mentioned this morning.

Where does that leave us? If I were advising a client and I had to tell him about business opportunities in Asia, a legitimate question I might ask before I even recommended things to him is: if I were now taking some of his equity investment in my bank and looking for opportunities in Asia, would he or she be comfortable with that? If you were a shareholder of Macquarie Bank, and I said to you that now is a wonderful time to buy an Indonesian bank, would you be happy for me to use your money, given the situation I have unfolded? I suspect the answer is that the majority of you would not.

That said, clearly we are seeing some positives. As management of a business in Australia, I would say to you in return, 'Be careful. We should be more confident looking further out.’ The real issue for business development and business opportunities depends on our time horizon and the current situation. We have political confidence, it appears from what we can see, in a number of these countries already—South Korea, Thailand, even Malaysia. We do not have it in some others. We have stock market recovery, as I have already mentioned, and underneath that, it appears from the evidence we can see, we have foreign capital inflow, not outflow. Figures that we have seen suggest that purchases on the Korean Stock Exchange and portfolio inflow may have been around $US50 million a day over the last two to three months, reversing some of the earlier outflow. So confidence is slowly building.

Finally, of course, what we have that is most critical from a business decision is the opening up of these economies. Economists will argue about this, and I am sure that there are people who will disagree with me, but it seems to me that at the end of the day one clear lesson out of this is that you cannot, or will not, turn back the clock. I do not seriously believe that any of these countries in two or three years time will have retreated behind barriers to shield themselves either from capital flows, which are causing so much concern at the moment, or from business competition in a variety of sectors.

We have opened the gate and that opening up will continue. It is pretty much the same as we have seen in Latin America and in Mexico as a result of the crises of the 1980s and the mid-1990s.

Already you see reports of not only official rescheduling by banks of South Korean short-term debt. Very remarkably, soon after the program was announced, the first tranche was rescheduled effectively in about mid-January and we are now seeing the second tranche talked about as being rescheduled by US banks. Our understanding is that the same has happened, by and large, with Japanese banks in Thailand. It has of course not happened in Indonesia because the bankers have no confidence to reschedule, given that there is no framework for looking at the workout of the situation.

So what would you suggest, given this framework, to a business client? I would suggest three or four things. If you are an Australian exporter into traditional markets, then basically it may not look too bad. First of all, you have the Australian dollar depreciation helping you out. The gold sector has been talked about already. If you look, as a businessman, at the gold sector—let us say I am a gold producer in Western Australia—the simple fact of life is that my Australian dollar gold price has not changed from a year ago. The currency has offset the lower US dollar gold price. The second thing, which I saw in the last few days in Western Australia, is that apparently demand for my product is not only holding up but has actually increased in South Asia. In South Asia in particular—perhaps as a result of this crisis—and even in some of South-East Asia, demand for that product has actually risen in the last few months.

This brings you back to an important issue from a business perspective. You must always understand what your own market is before you judge opportunities. I am trained like Chris, and Chris showed you a lot of sectors in the Australian economy. That is what economists look at. But, when you get to business operations, that classification really does not help. You have got to understand what your market is within those broader categories. For example, in Western Australia there is great concern about the decline in crayfish exports, particularly to markets outside Singapore and Hong Kong in the Asian region. But at the moment there is no problem with iron ore exports; in fact, for iron ore exports, not only has the US dollar contract price increased from 1 April this year but the depreciation of our dollar has increased local currency receipts even more than that.

So it is not looking too bad. Volumes in the year ahead may change, and that will depend on demand. But demand for that product feeds into one of the key export supporting industries which, many previous speakers have told you, is expected to lead the recovery in these economies; that is, steel fabrication and steel production. So perhaps it is not quite as bad as I thought. If, on the other hand, I am producing or selling into markets for consumer durables, particularly what we might call discretionary spending or luxury items—that is a bad term and economists should never use it, but I think you know what I mean—at the end of the day I am probably in real trouble, and I have to look for other markets. The classic case would be travel from Korea into Australia. Travel is something which all of us in this room, if we are under household budgetary pressure, probably think of as something we can sacrifice in the short term to repair our own finances. That is what these countries are doing: sacrificing in the short term, in a sense, to repair their finances.

Finally, I give another example where we want to be very careful, but I think it is important in understanding business opportunities. I agree with what Chris said: the education outlook is very grey. This is not because it is a relatively small sector, but because it is not at all clear that Australia will not benefit from Asia. Australia has gained a competitive advantage relative to North American or European providers of education, because of the fall in the currency. I would say that particularly applies to graduate education of various kinds, where our standards are high, our costs are relatively low—and we do not have terrible winters. So we are very attractive to students from Asian countries. I would argue that education is not seen as a luxury in many of these countries but as an essential, by families, by governments and by corporates.

The next area I would recommend to a client is market expansion. If I have an existing market operation it is obvious, for a variety of reasons, that market expansion may now be a way to think—looking forward not six months but two to three years. There are difficult issues here. The first issue is whether I do it through a joint venture or whether I try and buy something to fully own it. The problem with this is that the framework I am faced with is constantly shifting. As I said earlier on, it is not at all clear that the Thais want not only my money but also my management input or control. In fact, they do not want my management control, at least from the people I spoke to. So ownership may be a difficult issue. Joint venture may be even more difficult, however.

Let us take an explicit example. Say I am an Australian building materials producer located in Asia in a variety of places. I think that recovery will eventually come. I think I may have management skills and technology that are very competitive. I think that eventually some of the infrastructure projects will be restored. Now is an excellent opportunity to take on additional assets or other market operations, in those countries, and to build up my base for future competitive strength. At the same time, of course, I may regard the Australian situation as better—if you believe in the housing recovery. So I have a difficult choice, but opportunities are clearly there. There are a lot of issues in how I go about it.

The final issue that is most commonly referred to, particularly in my industry, is asset purchase. Asset purchase is one of those wonderful things where we can all see that the price of something falls by X per cent and therefore it must be a good buy. I would argue that this is probably the most difficult issue, though, for an Australian business looking for opportunities: not only are there the technical issues of due diligence and the problems with management control but there is also the very critical issue of what I am paying for the asset.

There is no doubt in my mind that you have not yet seen a significant part of the likely fallout in Bangkok property prices. For example, to gather together Australian investors and buy a hotel in Bangkok may look a very attractive option, given the depreciation of their currency, the likely attraction of tourists in the future and the fact that the price of the hotel has fallen. It may be going to fall another 100 per cent, 120 per cent, 50 per cent or 80 per cent: I do not know. I may get caught with something that eventually costs me money and undermines the apparent opportunity. This is a very difficult business judgment. We as an institution believe that we have yet to see, in the case of asset purchase, markets operating again in these countries. That requires liquidity, which provides at least a measure of underlying asset values.

Finally, of course, the financial institutions have another way to help which is very possible, I think, and that is through the provision of finance and letters of credit. For trade, financing opportunities abound in the region—not to mention other areas such as infrastructure financing. There are still mandates out there that are going ahead. It is not true that everything has stopped, although a lot of things have stopped. The provision of finance at competitive rates can build a solid client relationship for the future. It is a wonderful opportunity for an institution without requiring much equity investment, but utilising skills which we have in Australia, to sell those skills and that technology into the region as it recovers. So the bottom line, again, is a mixed bag of opportunities. There are not too many in the short term, I suspect; but, if you have got a long-term perspective, there are clearly ways to start develolping opportunities.

CHAIRMAN—Thank you very much, Bill. We have 12 minutes for an open session with respect to questions from the whole of the day. Ms Fayle is first.

Ms FAYLE—This is unusual: I get to ask a question instead of answering one! I would like to say that I do not disagree with a lot of what Chris Richardson said in his analysis, but I have a couple of comments. The first is a slightly flippant one about a growth industry that you left off your list, and that is that in Australia there is a growth industry at the moment in having conferences on the financial crises in East Asia. I suspect that in another 12 months time another growth industry will be in having conferences on unemployment problems in the region.

My second comment, a more substantial one, is really to reinforce something that Bill Shields alluded to in his comments. You put up some graphs showing the export exposure of the various states, and then you put some up showing the exposure of these states to exports to Asia, and you also talked about the impact on various sectors. I think that it is only when you put those two latter things together that you actually get a sensible picture of what the impact is likely to be. I do not think you get it by looking at exposure of a state to exports to Asia.

Some examples have been mentioned during the day. If you look at, say, Western Australia, to the extent that they are supplying such staple products as wheat, and to the extent that they are exporting to some of the less affected markets, all of that will play into the impact on those states, I think. It is at that level of generality that you lose some of the impact. For the same reason, with Queensland it may not look as serious as perhaps it is, because of their rather large dependence on tourism and high-value seafood and horticultural items, for example.

The gold situation is another issue in Western Australia. You can look at Western Australia exporting all that gold to the region. But if you just look at exports to the region, you do not get the real picture, which is that gold exports from Western Australia are not being adversely affected and do not appear likely to be adversely affected. Gold is a very strange product in that sense. I wanted to ask you if you have had a chance to have a look at that cross-matching of the sectors and the markets at a more detailed level.

Mr CHRIS RICHARDSON—You are right that doing everything at an aggregate level, even state by state, hides many things. Having said that, I would still stick by the basic point that Queensland, Western Australia and the Northern Territory are most exposed to Asia. The initial adjustment in Asia is coming from a compression in their imports—they are not importing. That means they are not buying Australia's exports. It is those very export oriented states that are hurting more. You are right that in Queensland it is notably tourism, in Western Australia it may be something else and the Northern Territory has, in particular, the live cattle trade and so on. But I would stick by that level of generalisation, that those sunbelt states are the most at risk. The advantage that they have is that those are the fastest growing states in Australia at the moment and, if we are lucky and Asia turns out to be shorter term rather than longer term as a problem, they may escape relatively lightly.

Mr DUNN—I was interested in the views of various speakers today on the question of economic liberalisation and what we have learned from this process. Some speakers have already commented on this and the range of views covers the spectrum. Bill Shields says that Asian economies are not going to turn back the clock. Paul Kelly still has scenario A and scenario B open. Other speakers such as Ross McLeod say that asking for these sorts of reforms in Indonesia is like asking a person whose house is burning down to convert to Christianity. I was wondering if other speakers have any other views as to what lessons we have learned from this process about liberalisation of the economies.

Mr CHRIS RICHARDSON—Not only did I work at the IMF, I actually worked in the same area that I think Bill Shields was in for a while, so it is clear, given my institutional background, that I am in favour of economic liberalisation. But it is also clear that mistakes get made. We made mistakes in Australia—they helped contribute to the severity of the recession we had here in 1991. It is always easy to have that hindsight.

In Asia, mistakes were made. But if you look at Asia today or, even more so, where I expect Asia to be in a couple of years, you would have to say that it is considerably advanced from where it was three decades ago. I would allocate a lot of that gain to the economic liberalisation and openness of policies that have occurred over that time. To the extent economics is a science and we try to do regressions and the rest of it, that is something that is impossible to prove, one way or the other. It all comes down to your value systems or how you work through the logic of liberalisation as it affects economies, but I would certainly vote in favour of liberalisation.

Mr SHIELDS—I think you can go a bit further than that. I would argue that one of the problems with the Asian crisis and the contagion aspect of the first few months was the failure or the unwillingness of the authorities to allow their financial markets to liberalise more rapidly, in particular the desire in some cases to control both interest rates and exchange rates actually exaggerated the volatility when the crisis hit.

We have been trying to build a business in a couple of countries in Asia for the last few years based on risk management, which is a very viable business in Australia. Many exporters know about foreign currency hedging, many financial directors and treasurers know about interest rate risk management, but these were relatively unused in Asia and people left themselves completely exposed to the changes in those rates. When you asked them why, the answer was very simple: 'Because the central bank told us the rates would not change.' If the policy settings are right over time, it is not a problem. But history tells us that policy settings are rarely right consistently over time.

CHAIRMAN—There are no further questions. I think we have all had a very stimulating day. We have covered a very wide field. I agree with Paul Kelly that we are facing here an unprecedented event, with respect to the scale, the size of the problem and its novelty. There is nothing we can to read to help us through this and no experience to draw on. The other point is that we are stuck with it. We have to live through it, manage it as best we can to minimise the pain and to maximise the opportunities that are inherent within it.

My great concern, as a parliamentarian, has been that the Australian public should understand very clearly that it is a major event; that, unlike New Zealand with respect to nuclear war, it is something that we cannot isolate ourselves from. It will have an impact and we must all be prepared for that. The other essential thing from the Australian public's point of view is that they must understand that we cannot control those courses of events that are around us. We do have minimal opportunities in some way or other to influence at the margins what is going on and we do have to do what we can to avail ourselves of those opportunities.

As one of the speakers said, confidence plays a very large part in that. To me, one of the reasons why the Australian economy was slow to take off was that lack of confidence in recent years, and I do not think this has fully returned within Australia. I am not an economist, but I think the place of psychology in economic practice is very important. My reading is that, firstly, there is a lot of money out there in Australia, but people just do not have the confidence, if they own businesses, to embark on the expansion that they could undertake at the present time.

Secondly, those who are employed have a great deal of job insecurity, so they do not buy that extra refrigerator or new car. That has slowed our growth up. We have not been able to start the year at a gallop, as was suggested as desirable for us to do in 1988. I do think, if we can generate some confidence, or a return of confidence, in the Asian areas, we will see a return to more normal times more quickly.

I would like to thank the members of the Joint Committee on Foreign Affairs, Defence and Trade who have shared the rostrum here with me today, and the other parliamentarians, like Mr Willis and the Speaker, who have attended. In particular, I would like to thank the speakers, who were quite outstanding today. I regret and apologise that we put constraints on them with respect to time, because all of them profitably could have taken double the time they spent with us, and I think we would all have enjoyed that. I would like to thank the members of the diplomatic corps who came along, particularly the European members. As someone who lived in Europe for a long time, I know there is definitely a lack of interest, if I could put it diplomatically, from many European nations, and their representatives, as to what goes on in the Pacific area and within Australia. So it is excellent to see that they are here today. Finally, my thanks go to all of you who attended. These seminars do not work without the cross-fertilisation and the interchange between the audience and the speakers, with the audience testing and drawing out the speakers at the end of their speeches.

There will be a report of this seminar laid down in the parliament in the near future. That will be a very brief report; there will be nothing much in that. But there will be a transcript published by *Hansard*. As soon as that is printed, all of you who have attended today will get a copy.

We will have another seminar which will be related in some way. We have not quite worked out the detail of it yet, but it will deal with Australia's future trade opportunities. That will be held some time after the budget, probably in the early part of June.Once more, thank you very much for your attendance, and your support. I hope to see you at the next one.

Seminar adjourned at 4.55 p.m.