

Asian financial crisis

- 2.1 The Committee examined closely the Asian Financial Crisis, which reduced the world's economic powerhouse to chaos in 1997-98. Australia's close linkages to the Asian economies and particularly their importance for Australian exports, made it essential that the causes of the upheaval should be fully understood.
- 2.2 The other aspect of the Crisis which drew the Committee's attention, was the ability of the Australian economy to absorb the shocks produced by the Crisis. It is important, the Committee said, to understand why other economies crumbled but Australia, with similar financial commitments and pressures to some of them, continued to grow strongly.

Background to the crisis

- 2.3 The Asian Financial Crisis produced deep-seated reactions of shock around the financial world. The reaction was linked, not so much to the fact that a crisis had occurred – the world community is used to that (two American economists identified 117 crises in 105 countries between 1971 and 1992¹) – but that this crisis arose in what had been the fastest growing area in the world. Asia had promised to be the main engine of world growth into the new century but, to many observers, the crisis seemed to indicate that the area would be unable to live up to expectations. As the effects of the crisis spread beyond Asia into Russia and Brazil, there were fears of a world-wide breakdown of financial arrangements:

The IMF found itself confronted with problems it never had to face before. The Asian crisis was a complex crisis, with a currency component and a credit component. The credit component, in

1 Referred to in: Barry Bosworth, *The Asian Financial Crisis*, Brookings Review, Vol. 16(3), Summer 1998, p.7.

turn, had an international aspect and a domestic aspect, and all the various components were interrelated. What made the Asian crisis different from any the IMF had faced before was that it originated in the private sector; the public sector was in relatively good shape.²

- 2.4 It is necessary to go back to the early 1990s to detect the origins of the Asian Financial Crisis. In that period low interest rates in the USA, combined with a period of economic growth in that country, channelled money into Asian stock-markets where higher returns were available. Similarly, investors from the depressed European and Japanese economies sought higher profit margins in Asia. All of these investors rated their risk level as very low; relying on the fact that the Asian currencies were pegged to the \$US.
- 2.5 In discussions on international financial matters, one of the most debated topics is: 'what factors actually caused the Asian crisis to erupt?' In many cases the debaters have concluded that there were insoluble problems in the Asian economies and that the crisis was somehow inevitable. On the other hand, the Chief Economist of the World Bank, Joseph Stiglitz, argued that this thesis ignores the strengths and successes of the Asian economies, particularly those in East Asia. He was critical too of the tendency to automatically label any pre-existing economic or structural problem as a root cause of the crisis.³
- 2.6 There *were*, of course, a number of systemic weaknesses, and most commentators agree they *did* contribute to the crisis. Consequently, Stiglitz examined these in an effort to determine whether they were the only factors. He noted that financial sectors were weak, there were high levels of corporate debt and transparency was inadequate but he doubted whether these factors could "... *explain* the scope, timing and severity of the crisis."⁴
- 2.7 The Report of the Task Force on International Financial Reform, commissioned by the Australian Government, outlined the range of opinions:

2 George Soros, *The Crisis of Global Capitalism*, Little, Brown & Company, London, 1998, p.146.

3 Joseph Stiglitz, Senior Vice-President and Chief Economist of the World Bank, *The Role of Financial Institutions in the Current Global Economy*, Address to the Chicago Council on Foreign Relations, Chicago, 27 February 1998, p.1
(<http://www.worldbank.org/html/extdr/extme/jssp022798.htm>)

4 Joseph Stiglitz, Senior Vice-President and Chief Economist of the World Bank, *The Role of Financial Institutions in the Current Global Economy*, Address to the Chicago Council on Foreign Relations, Chicago, 27 February 1998, p.2)
(<http://www.worldbank.org/html/extdr/extme/jssp022798.htm>)

Many saw the problem as stemming from policy shortcomings and structural problems in the emerging markets, although there were always concerns about contagion. Others focused on the potentially devastating effects of vast flows of short-term capital, as well as the inadequate risk assessment by the private sector. Some saw the response of the international financial institutions (IFIs) as inadequate and, indeed, contributing to the depth of the crisis. Attention has also focused on deficiencies in the financial supervisory arrangements in the developed economies.⁵

- 2.8 The Committee found that there is little common ground among the commentators looking at the Asian crisis. However, on one issue they all seem to agree – that the high proportion of capital inflows to Asia consisting of short-term investments, denominated in foreign currencies, was the catalyst which sparked the crisis. When the flow of funds was reversed, the financial systems of first Thailand, then Korea, Indonesia and Malaysia, revealed critical weaknesses both in their regulatory systems and the financial institutions themselves. Ross Garnaut has reported:

The current account deficit [in Thailand, Malaysia and Indonesia] resulted from private investment exceeding private savings, and private domestic savings were reasonably large. The deficits could be seen, therefore, as the response to high levels of international direct and portfolio investment, encouraged by perceptions of high prospective profits and yields. The contribution to those perceptions of implicit guarantees of various kinds (including the promise of a steady relationship between the domestic currency and the US dollar) was rarely acknowledged. Nor was the potential for rapid change in perceptions about prospective returns on investment.

... Once anxieties about asset prices and exchange rates began to precipitate a reversal of the large inflows of capital, the change of sentiment fed upon itself, eventually forcing the movement to floating rates and large depreciations.

A conspicuous feature of the East Asian financial crisis is the extent to which financial institutions and other enterprises were exposed to foreign exchange risk. A high proportion of foreign liabilities had relatively short maturities. In normal conditions of continuing growth and economic stability, such loans would easily have been rolled over, but in the crisis conditions of the second

5 Task Force on International Financial Reform, *Report to the Prime Minister*, AGPS, Canberra, 1998, p.1.

half of 1997, lenders insisted on immediate repayment at the crisis exchange rates.

... The accumulation of large, uncovered foreign liabilities reflected imprudences on the part of several parties: borrowers and their owners; domestic banks and other lenders; and foreign lenders and portfolio investors. How was imprudence possible on such a large scale? Lack of transparency about corporate financial affairs and the ineffective prudential supervision of banks both contributed. So did the presence of implicit guarantees on exchange rates, bank safety, and sometimes other business parameters. 'Moral hazard' might have played a role, influenced by an expectation that public international support would become available to offset losses that might be incurred in the worst of circumstances.⁶

- 2.9 The inflow of foreign capital contributed to a boom in bank and non-bank credit to the private sector. In Thailand, Indonesia, Malaysia and the Philippines particularly, this credit expansion outstripped the already rapid growth of the economy. When the foreign investors began to withdraw and credit conditions were tightened, the construction boom came to an end, real estate prices fell and the number of non-performing bank loans began to increase. In turn, these problems were compounded by speculative attacks on the currencies of several Asian countries.⁷
- 2.10 As observed above, a key problem stemmed from the proportion of investments in East and South-East Asia which involved short-term credit. For example, the IMF estimates that from 1994-96 short-term loans to Thailand reached 7-10% of GDP, while foreign direct investment was only 1%. In all, the International Monetary Fund (IMF) estimates that by the end of 1996 \$US 624 billion had been lent to East Asian countries, much of it as short-term debt.⁸
- 2.11 The IMF summarised the conditions leading to the crisis, as follows:
- A combination of inadequate financial sector supervision, poor assessment and management of financial risk, and the maintenance of relatively fixed exchange rates led banks and corporations to borrow large amounts of international capital, much of it short term, denominated in foreign currency and

6 Ross Garnaut, *Overview*, in Eds Ross H. McLeod and Ross Garnaut, *East Asia in Crisis: From being a miracle to needing one?*, Routledge, London, 1998, pp. 13, 16-18.

7 Gerhard Aschinger, *An Economic Analysis of the East Asia Crisis*, *Intereconomics*, March-April 1998, p.56.

8 Nayan Chanda, *Rebuilding Asia*, *Far Eastern Economic Review*, 12 February 1998, p.47.

unhedged. As time went on, this inflow of foreign capital tended to be used to finance poorer-quality investments.⁹

- 2.12 In his article *Rebuilding Asia*, Nayan Chanda commented that “foreign banks frequently lent blindly, with little or no due diligence.” He quoted a European bank official as saying:

... all banks are under certain competitive pressure. If the market is attractive you go with the herd. Even if you have doubts you don't stop lending.¹⁰

Such a comment has an all too familiar ring in relation to the end of economic booms.

- 2.13 The IMF, in its report *International Capital Markets* released in September 1998, said that the crisis:

... followed a period characterised by record private capital inflows into the emerging markets and a relatively sharp compression of spreads¹¹ across a wide range of emerging market credit instruments.¹²

The spread of the crisis

- 2.14 In early 1997 concerns were already emerging about the narrowing of spreads for borrowers in the emerging Asian markets and the likelihood of the flow of capital reversing itself.¹³
- 2.15 On 2 July 1997, Thailand severed the link which foreign investors had relied upon – the baht's peg to the \$US – and the Bank of Thailand withdrew its support for the currency. Within a few hours the baht had fallen 15% against the \$US and the crisis was under way. In the next few

9 International Monetary Fund, *The IMF's Response to the Asian Crisis*, 17 January 1999, p.1. <http://www.imf.org/External/np/exr/facts/asia.HTM>

10 Nayan Chanda, *Rebuilding Asia*, Far Eastern Economic Review, 12 February 1998, p.47.

11 Spread: The difference in a quotation between buying and selling prices. A large spread normally indicates inactive trading of a product. *Reuters Glossary of International Financial & Economic Terms*, Edited by the Senior Staff of Reuters Limited, Longman Group Limited, Essex, UK, 3rd Edition, 1994, p.118.

12 International Monetary Fund, *International Capital Markets: Developments, Prospects, and Key Policy Issues*, World Economic and Financial Surveys, by an IMF Staff Team, International Monetary Fund, Washington, September 1998, p.1.

13 International Monetary Fund, *International Capital Markets: Developments, Prospects, and Key Policy Issues*, World Economic and Financial Surveys, by an IMF Staff Team, International Monetary Fund, Washington, September 1998, p.1.

months it spread across East and South-East Asia, triggering currency collapses and widespread business failures.¹⁴

- 2.16 During the second half of 1997, several other Asian countries severed the link between their currency and the \$US. One after the other, those currencies began to depreciate. Intense pressure was suffered in turn by Malaysia, the Philippines and Indonesia. Next Singapore's currency was weakened and then Hong Kong SAR and Korea were affected.¹⁵
- 2.17 The extent of the crisis can be gauged by the fact that at their low point in January 1998, currency depreciations had reached extraordinary levels by comparison with the situation in July 1997. The Indonesian rupiah had fallen by 81%, the Malaysian ringgit by 46% and the Thai baht by 55%. The Korean won suffered a similar fall of 55% between October and late December 1997. Average levels of exchange rate volatility increased by a factor of 10 compared to the previous year, during the second half of 1997. Transactions costs rose dramatically in the spot, forward and other derivatives markets and liquidity dropped.¹⁶
- 2.18 Professor L. Krause of the University of California, observed that although the crisis was triggered by the Thai depreciation, there were underlying weaknesses in several countries which were the direct causes of the crisis. He commented that "an international financial and economic crisis occurs only when both domestic and foreign investors lose confidence in the foreign exchange value of a currency." In the case of Asia, several regional currencies had become overvalued during the 1990s, the countries involved were recording large and growing current account imbalances and official foreign currency reserves were insufficient to withstand an attack by currency speculators.¹⁷
- 2.19 Reviewing the events leading up to the crisis, Professor Krause highlighted the fundamental causes of any financial crisis and their relationship to the Asian crisis in 1997-98:

... One must look to a combination of factors to explain the Asian financial crisis. It may well be that four factors were involved and *all* must be present for a crisis to be triggered.

14 Nayan Chanda, *Rebuilding Asia*, Far Eastern Economic Review, 12 February 1998, p.46

15 International Monetary Fund, *International Capital Markets: Developments, Prospects, and Key Policy Issues*, Washington, September 1998, p.2.

16 International Monetary Fund, *International Capital Markets: Developments, Prospects, and Key Policy Issues*, Washington, September 1998, p.1.

17 Professor Emeritus Lawrence B. Krause, *The Economics and Politics of the Asian Financial Crisis of 1997-98*, report prepared for the Council on Foreign Relations, p.3.
<http://www.cfr.org/public/pubs/crisis.html>

The first factor ... is that a currency is significantly overvalued. This can only happen if the monetary authorities are unwilling to let the currency depreciate in a timely and orderly manner.

The second factor ... is a rapid and substantial build-up of short-term foreign debt. If a current account deficit is entirely financed with ... an inflow of real long-term capital ..., then the soundness of a currency is rarely questioned. ... In contrast, if short-term borrowing is relied upon ... then serious concerns are raised as to whether the debt can be repaid. ... Short-term debts are constantly being reviewed and can reverse direction quickly. Thus if short-term capital is being relied upon and access to additional amounts begins to be problematic, then the conditions for a reverse flow are created that can initiate a currency crisis.

The third factor is disarray of public finances, or the existence of fragile private domestic financial institutions. In [Asia] ... the private finance companies and banks were fragile, and their condition combined with weak prudential oversight by their governments.

Political uncertainty is ... rarely appreciated as a necessary condition for the triggering of a financial and economic crisis. Markets clearly do reflect political variables. When politics change, markets react. Investors and speculators will become uncertain when they cannot anticipate the economic policy that will be implemented.¹⁸

2.20 A major problem which emerged and served to deepen the crisis, was the discovery that the foreign currency debts of Asian companies were much greater than had been suspected. The reporting system put in place after the Latin-American crisis in the 1980's, and intended to eliminate this problem, failed to work.

2.21 Lester Thurow writing about the Asian crisis in 1998, commented:

While everyone knew that accounting systems were a little squishy on the Pacific Rim, everyone had been surprised by just how fraudulent they really were.¹⁹

2.22 Thurow went on to note as examples, that:

18 Professor Emeritus Lawrence B. Krause, *The Economics and Politics of the Asian Financial Crisis of 1997-98*, report prepared for the Council on Foreign Relations, pp. 3-5.

<http://www.cfr.org/public/pubs/crisis.html>

19 Lester Thurow, *Asia: The Collapse and the Cure*, The New York Review, 5 February 1998, Section 4.

- a major Japanese financial house had been allowed to keep \$US 2.6 billion in losses off its books – with the knowledge of the Japanese Ministry of Finance; and
 - the Korean Central Bank reported as national currency reserves, funds which had already been lent to Korean companies to repay \$US denominated loans.²⁰
- 2.23 These weaknesses added to the existing negative impressions of foreign investors and in 1997 Asia's capital inflow began to reverse itself. The 1990s had seen continuous strong inflows of capital to the Asian economies. In 1997, however, private capital flows into the countries first affected by the crisis fell by \$US 100 billion. Predictably, the reductions mainly affected short-term international bank credit and portfolio flows. In the last part of 1997 bank lending collapsed. Foreign direct investment was less affected because for those funds, longer term factors are more important.²¹
- 2.24 The IMF, analysing the origins of the crisis, noted that the problems in Asia were not primarily caused by macroeconomic imbalances but were mainly the result of weaknesses in financial systems and failures in governance.²²
- 2.25 In addition, the high level of foreign currency denominated debt led the IMF to say that the depreciations:
- ... seriously impaired the balance sheets of already weak and unhedged domestic financial institutions and corporates and led to sharp increases in credit risk.²³
- 2.26 The Department of Foreign Affairs and Trade's East Asia Analytical Unit (DFAT EAAU) in a report on Asia's Financial Markets, also recognised these weaknesses and set out the problem areas in the financial sector in some detail:
- ... in many regional economies, financial sectors formed the weak link in development strategies. Because many financial sectors were protected from foreign and domestic competition, regulated poorly or subject to government credit allocation and interest rate intervention, they often were inefficient, poorly capitalised and
-

20 Lester Thurow, *Asia: The Collapse and the Cure*, The New York Review, 5 February 1998, Section 4.

21 International Monetary Fund, *International Capital Markets: Developments, Prospects, and Key Policy Issues*, Washington, September 1998, p.3.

22 International Monetary Fund, *The IMF's Response to the Asian Crisis*, 17 January 1999, p.1. <http://www.imf.org/External/np/exr/facts/asia.HTM>

23 International Monetary Fund, *International Capital Markets: Developments, Prospects, and Key Policy Issues*, Washington, September 1998, p.3.

weak in managing risk. Private and state owned banks dominated financial activity at the expense of capital markets and non-bank financial institutions. Banks often made capital available to favoured sectors and borrowers; lending was based on connections rather than sound credit risk analyses. Consequently, many financial institutions were highly leveraged after lending to risky private and public projects. Heavy, often indiscriminating, international capital flows into these financial sectors exacerbated risks.²⁴

- 2.27 The problems were further complicated by the continuing weakness of the Japanese economy. Japan had long been relied upon as a strong source of investment funding by the Asian economies. In 1997, under the pressure of domestic weaknesses, Japanese investors withdrew from the regional economies.²⁵
- 2.28 The group of countries which were first, and hardest, hit by the Asian Crisis, displayed a wide variety of economic conditions. In an interview an IMF official, Karen Lissakers, described the situation in Thailand as acute overheating and asset inflation, added to a rapidly expanding foreign debt. Whereas in Korea, she said, while there was some overheating, the economy had actually slowed in 1997. Also, Korea did not have a huge foreign debt, although the proportion of short-term debt was high. A particular problem in Korea was that the true position of the banking system was not revealed by the supervisory and accounting systems. Indonesia exhibited elements of all of the Korean and Thai problems. The main debt problem here was corporate indebtedness, however, rather than short-term debt threatening the banking system.²⁶
- 2.29 Fears for the entire international financial system surfaced when the contagion spread beyond the Asian region. In October 1997 after Korea had been drawn into the crisis, pressure began to mount on Brazil and Russia because Korean banks were selling off Brazilian and Russian bonds. There were also some market reports of bank exposures through off-balance sheet derivative transactions but the information available is scanty.
- 2.30 The Committee noted that the glaring weakness in the Asian economies at the outbreak of the Asian Crisis was their exposure to short term debt. The problem was compounded because much of that debt was written in

24 East Asia Analytical Unit, *Asia's Financial Markets: Capitalising on Reform*, Department of Foreign Affairs and Trade, Canberra, 1999, p.13.

25 International Monetary Fund, *International Capital Markets: Developments, Prospects, and Key Policy Issues*, Washington, September 1998, p.3.

26 Karin Lissakers, US Executive Director, IMF, *The IMF and Reforming the Global Financial Architecture*, interview p 3. <http://www.usia.gov/journals/ites/0898/ijee/ejfliss.htm>

foreign currencies and unprotected by hedging arrangements in the market. When Asian currencies began to depreciate, the burden of that foreign currency debt began to rise and the situation quickly became untenable. With the benefit of hindsight, we can see that, yet again, the dangers of the herd mentality have been demonstrated, as in similar periods of financial excesses in the past.

- 2.31 The other weaknesses which became apparent, were the over-extension of individual financial institutions and the level of bad debts within the system. The Committee considered that one of the keys to Australia's resistance to the shock of the Crisis, was the standard of regulation and prudential supervision in the Australian financial system. The high standards in these areas prevented the problems of over-extension and an excessive level of bad debts from emerging.
- 2.32 Although the Australian economy performed well during the Asian Crisis, the period was not without its challenges. When the Committee examined the effects of the Crisis on Australia, it found that the economy had exhibited a remarkable degree of resilience in dealing with the problems caused by the chaos in some of its major trading partners.

Australia's experience

- 2.33 The Committee recalled that when the Asian crisis struck, there was widespread alarm in Australia. It was thought that the volatility of currency markets would infect the \$A and that the economic difficulties in some of our major export markets would lead Australia into the same sort of difficulties as our Asian neighbours.
- 2.34 However, in reality, the Committee found that the Australian economy coped very well with the Asian crisis. Despite an attack on the currency and drastic reductions in trade with Asian markets, Australia emerged as an economy which promised stability in the midst of the Asian turmoil. Other countries began to look at the Australian economy for ways in which they might insulate themselves against future crises. American economist Paul Krugman described the Australian economy as the 'miracle economy of the region'.²⁷
- 2.35 The Reserve Bank unequivocally indicated the flexible exchange rate as the main reason for the Australian economy's resilience in the crisis:

... does the country have a risk management strategy to avoid having the sort of things happen to us that happened to a number

of these Asian countries? In fact, we have a risk management strategy ... which is responsible for the reason that we did not get into trouble. The major component of that ... is a floating exchange rate. When we look at what happened in Asia, the countries that had the most severe difficulties had a fixed exchange rate or semi-fixed exchange rate. The countries that did best had floating exchange rates, Australia being the best example. I think the reason Singapore did better than Hong Kong was that Singapore let their currency move and Hong Kong could not; Taiwan did quite well.²⁸

- 2.36 Dr John Edwards of The Hong Kong and Shanghai Banking Corporation (HSBC), in his evidence to the Committee, supported the Reserve Bank view and said:

I am in complete unanimity with the view the Reserve bank Governor has put to this Committee ... that the strength of the Australian banking system was tremendously important – its strength and reliability, its success in internal prudential controls, and the success of its supervisory institutions – as well as the floating Australian dollar.²⁹

- 2.37 In evidence, ASIC offered three additional reasons why Australia was able to withstand the main stresses of the Asian crisis:

One is that we have well-established securities and futures markets that have a long history of both self-regulation and regulation under the Corporations Law, we have well-established markets and well-established practices within those markets for the supervision of market activity.

Secondly, the communication between regulators and exchanges domestically and internationally works quite well. ...

... We have subsequently done further work, both within ASIC and between ASIC and the exchanges, on developing protocols for dealing with market break-outs of any kind, ...

Thirdly, on the regulatory framework, the legislative regime in Australia came out fairly well ... It is robust. It deals with many things that were not in place in other jurisdictions and it showed itself to be a calm, comprehensive and effective regulatory framework, able to get to grips with the problems that are often associated with sudden market break-outs.³⁰

28 Evidence, Reserve Bank of Australia, 9 February 2000, p.5.

29 Evidence, Dr J. Edwards, 22 March 2000, p.96.

30 Evidence, Australian Securities and Investments Commission, 22 March 2000, p.61.

2.38 ASIC continued that, rather than any single factor, it was a combination of things which allowed Australia to cope with the crisis:

... the sophistication of the participants, the robustness of the regulatory framework in which things take place and, in effect, the long and relatively deep experience of those with regulatory or supervisory responsibilities.³¹

2.39 The Treasury submission also addressed the reasons for Australia's success in dealing with the crisis:

The robustness of the current policy framework has been 'stress-tested' in the aftermath of the financial crisis that emerged in East Asia in late 1997. This resulted in a severe economic downturn in many of our major trading partners in the region, and a large fall in world commodity prices.

In the past, such developments might have created severe difficulties for Australia. Indeed, many observers expected that Australia would experience a serious economic downturn on this occasion.³²

2.40 The Treasury point of view was that because of the structural reforms in Australia over the past fifteen years, the anticipated problems were contained much better than they had been during past crises. Currency depreciation did not cause inflation. The current account deficit was offset by a fiscal surplus and a sound microeconomic environment, so that private sector investment did not suffer. As a result, foreign investor confidence in Australia was retained and Australia was able to benefit from increased international competitiveness.³³

2.41 Treasury also listed a number of other factors which reduced Australia's vulnerability:

- the stabilisation of Australia's net foreign debt to GDP ratio;
- reduction of the net debt-servicing ratio to 10% of exports, the lowest since 1984;
- Australia's foreign currency denominated liabilities are now outweighed by foreign currency assets;
- the public share of net external debt also at its lowest since 1984;
- over 70% of short-term debt is held by the Reserve Bank and prudentially-regulated depository corporations.³⁴

31 Evidence, Australian Securities and Investments Commission, 22 March 2000, p.62.

32 Submission No.13, The Treasury, p.30.

33 Submission No.13, The Treasury, pp.27 & 30.

34 Submission No.13, The Treasury, pp.30-1.

- 2.42 The Committee concurs and emphasises the importance of all of these factors, including well established political stability and the expectation of responsible government in maintaining confidence in our economy. The strength of our democratic systems – the separation of powers between an elected parliament and the judiciary, plus the freedom of the media – are all very significant factors and not to be taken for granted. The ability to change government without disruption of government processes, is a very valuable asset.
- 2.43 One tangible result of Australia's success, is that countries in the region are showing an increasing interest in studying the Australian system. The Australian Securities and Investment Commission (ASIC) and the Reserve Bank both reported an increasing involvement in technical assistance to the region³⁵. In evidence also, the Bank made reference to its activities in regional forums and its assistance to smaller countries in the region.³⁶

Recovery from the crisis

- 2.44 The DFAT EAAU considered that by late 1999, the main economic variables in the region had made a substantial recovery. The Unit indicated that positive growth had returned, exchange rates had stabilised, interest rates were down and current account deficits were disappearing.³⁷
- 2.45 Investment advisers Morgan Stanley Dean Witter, in a paper in May 2000, were extremely positive about recent progress in Asia. The paper forecast GDP growth of 6.7% for non-Japan Asia in 2000-01. It noted also that there were encouraging signs that the region's governments were tackling the heavy task of structural reform.³⁸
- 2.46 In general terms, most of the economies in the region have made a fairly rapid recovery. The Reserve bank commented:

I think the good news for Australia is that Asia is back and growing again, with a question mark still about Japan and, of course, a question mark about Indonesia, but by and large most of

35 Evidence, Australian Securities and Investments Commission, 22 March 2000, p.62 and *Reserve Bank of Australia, Annual Report 2000*, Reserve Bank of Australia, Sydney, 3 August 2000, pp.24-5.

36 Evidence, Reserve Bank of Australia, 9 February 2000, p.13.

37 East Asia Analytical Unit, *Asia's Financial Markets: Capitalising on Reform*, Department of Foreign Affairs and Trade, Canberra, 1999, p.13.

38 Morgan Stanley Dean Witter & Co., *A New Asia Emerges*, in *Global: Daily Economic Comment*, May 10, 2000, New York, p.2.

our big trading partners are back and growing again. That is good for Australia. We can get on with developing the sorts of businesses and the connections with Asia that we were doing in the past.³⁹

- 2.47 Similar thoughts were expressed in an article in the *Business Review Weekly*, just prior to September's World Economic Summit 2000. The author said that recovery in Korea, Singapore, Malaysia and Hong Kong had set off a 'chain reaction'. The article said that the region (excluding Japan) is expected to grow by 6.8% this year and over 6% next year. It noted that even Japan, after ten years of stagnation, is expected to increase its growth rate from 0.6% last year to 1.5% in 2000 and nearly 2% next year. The leaders in this recovery are: Korea (7.5%), and Taiwan (6%), plus continuing high rates of growth in India and China, which were less affected by the Asian Crisis. Indonesia, struggling with its political problems, and the Philippines (large budget deficits and security concerns) are the exceptions.⁴⁰
- 2.48 The EAAU suggested that a number of factors combined to boost growth in 1999. The Unit listed eight major points contributing to this outcome:
- capital flight was exhausted by the end of 1998;
 - large trade surpluses were being achieved and rebuilding of reserves was under way;
 - trade financing had resumed in most economies;
 - monetary conditions had loosened and real interest rates had fallen;
 - as interest rates fell, the excessive inventory contraction of 1998 halted;
 - rising budget deficits provided a fiscal stimulus;
 - consumer confidence and spending was returning in some economies; and
 - substantial excess industrial capacity was allowing production and exports to expand without new investment.⁴¹
- 2.49 The Committee said that the proposed Asian Regional Financial Arrangement is an encouraging initiative, which could assist the recovery of confidence in the region. This arrangement would involve Japan, China, Korea and the Association of South East Asian Nations (ASEAN)⁴² in a network of currency swaps designed to provide a backstop to defend against future speculative attacks on the region's

39 Evidence, Reserve Bank of Australia, 9 February 2000, p.14.

40 Tom Skotnicki, *Asia Looms Even Larger*, *Business Review Weekly*, Friday, 8 September 2000, p.52.

41 East Asia Analytical Unit, *Asia's Financial Markets: Capitalising on Reform*, Department of Foreign Affairs and Trade, Canberra, 1999, p.36.

42 The ASEAN 10 includes: Singapore, Malaysia, Thailand, Indonesia, the Philippines, Brunei, Cambodia, Laos, Myanmar and Vietnam.

currencies. The proposed members have available more than \$US 700 billion in foreign exchange reserves. In addition, Hong Kong and Taiwan hold over \$US 200 billion which might also be utilised to augment the network.⁴³

2.50 Full recovery of the Asian financial systems, however, will take some years. The EAAU report on Asia's Financial Markets pointed out that the reforms needed – restructuring of financial sectors, writing off non-performing loans, recapitalisation of the banks and restructuring of corporate debt – will require enormous work, especially in Indonesia and Thailand and, to a lesser extent, Malaysia and Korea.⁴⁴

2.51 The Governments in the region also face the task of reinforcing their economies to withstand future shocks. According to the EAAU, this task will involve structural reform, strengthening regulation and supervision of the financial markets, opening financial sectors to competition, upgrading bankruptcy procedures and improving financial sector infrastructure. These tasks will not be completed quickly, although the Asian Regional Financial Arrangement mentioned above would be a valuable step forward.⁴⁵

2.52 The Australian Treasurer, Mr Costello, said:

Although all of the major regional economies are now improving, the strength of the recovery across the region varies. ... We expect that Asia's growth will continue this year and next, supported by the strength of activity in the world economy. But the challenge Asia faces is to put in place the framework to ensure sustained economic growth.⁴⁶

2.53 Despite the array of tasks still to be done, the Committee said, there is an air of optimism that the Asian crisis is, in fact, behind us. One commentator noted, however, that even if that is true, the stresses of the crisis have left their mark:

43 Morgan Stanley Dean Witter & Co., *A New Asia Emerges*, in *Global: Daily Economic Comment*, May 10, 2000, New York, p.2.

44 East Asia Analytical Unit, *Asia's Financial Markets: Capitalising on Reform*, Department of Foreign Affairs and Trade, Canberra, 1999, p.13.

45 East Asia Analytical Unit, *Asia's Financial Markets: Capitalising on Reform*, Department of Foreign Affairs and Trade, Canberra, 1999, p.13.

46 Mr Peter Costello, The Treasurer, *Learn the Lessons, Seize the Opportunities*, *BusinessReview Weekly*, Friday, 8 September 2000, p.53.

... Although most economists say the Asian recovery is well entrenched, in some ways it is a new Asia, tempered by the reality of its most serious and sustained downturn for at least 30 years.⁴⁷

- 2.54 The Committee is a little more cautious than the commentators. There are encouraging signs of growth but the continued sluggishness of the Japanese economy is a worrying factor. Until they agree to restructure, their growth prospects remain hampered. The Committee is also concerned at the likely effect on Asia as the US economy slows down. Many of the Asian economies are relying on the strength of the US economy to help them back to sustained growth.
- 2.55 In addition, there are unresolved problems of financial reconstruction and elimination of bad debts in the banking systems of countries, such as Thailand and Korea, which were badly affected by the Crisis.
- 2.56 Overall, the Committee is hopeful that enough has been done in these areas to prevent a slump back into the crisis conditions. For the recovery to be firmly based, however, it will require a much stronger performance from Japan and for the Crisis countries to move quickly on the restructuring of their banking systems. It will also require improved prudential arrangements in the Crisis countries to support the restructuring process and avoid any repetition of the pre-Crisis conditions.

Capital controls

- 2.57 In the years after World War 2 when the Bretton Woods Agreements were drawn up, capital controls were a widely used and accepted method for a country to control the flow of overseas investment funds.
- 2.58 When the Bretton Woods arrangements collapsed, countries began to abandon the use of capital controls. By the onset of the Asian Crisis they were a rarity. Consequently, when Malaysia decided to introduce capital controls on capital outflows⁴⁸, in an attempt to quarantine the Malaysian economy from the effects of the crisis, it was widely criticised for the move.
- 2.59 In its evidence to the Committee, the Reserve Bank declined to join in the criticism of Malaysia. The Bank said:

I do not think in any way that Malaysia should be seen as some sort of pariah just because they chose that particular way of

47 Tom Skotnicki, *Asia Looms Even Larger*, Business Review Weekly, Friday, 8 September 2000, p.53.

48 Submission 13, The Treasury, p.44.

solving the crisis. I think it is very interesting that they did. It is going to give people a nice experiment to study in years to come, to see whether that was ... better than the path that, say, Thailand adopted. But I do not think there was anything hostile in them choosing that path.⁴⁹

2.60 Treasury also presented the view that the decision on whether capital controls should be applied “should be attuned to the development or the sophistication of the financial infrastructure in the economy that is at issue.” Treasury regarded the move by Malaysia as an extreme position but also indicated that the idea could not be ruled out entirely. It was, however, “the last thing you can imagine us endorsing”, according to Treasury:

... but we would say that there could be circumstances which are of sufficient concern that even something as extreme as that could be an appropriate vehicle.⁵⁰

2.61 Dr John Edwards said that Australia has in the past used capital controls quite successfully and Chile has used similar policies. In the Asian crisis, Malaysia was the only successful example and Russia’s attempt to impose controls ended in disaster. He explained that Malaysia was dealing with a vastly different situation to Russia. Investment in Malaysia was largely long-term capital investment, while Russia was dealing with short-term speculative funds. As Dr Edwards put it: “Japanese firms went in there [Malaysia] and built factories which they could not take away – whereas Russia’s was entirely short-term obligations.”⁵¹

2.62 The Treasury summarised the arguments by saying that in certain circumstances there could be an argument for measures such as capital controls - but warned that they tend to result in some other problem, which the Government must then address:

I am not saying that there is absolutely no place for these things. In certain circumstances, for short periods of time, there could be, but I do not think we should believe that these things are welfare enhancing. I think the evidence is that these things are generally welfare detracting and that normally they create at least one other problem that governments then have to address, such as higher rates of unemployment which then have to be addressed through unemployment benefits and so on.⁵²

49 Evidence, Reserve Bank of Australia, 9 February 2000, p.12.

50 Evidence, The Treasury, 13 March 2000, p.48.

51 Evidence, Dr J. Edwards, 22 March 2000, pp.101-2.

52 Evidence, The Treasury, 13 March 2000, p.49.

- 2.63 In its submission, Treasury explained that while capital controls may be effective in providing a breathing space in difficult circumstances, they do have some drawbacks. They can impose additional costs on long-term investments as well as the short-term funds which are the target. They can also create a more uncertain investment environment, increase the perceived level of risk and thereby discourage the roll-over of funds and new investment flows.⁵³
- 2.64 Over all, Treasury believes that capital controls can only be justified in exceptional circumstances and should only operate as a temporary measure until reconstruction and strengthening of the financial system has been achieved.⁵⁴

Action required

- 2.65 Although the Australian economy emerged almost unscathed from the Asian Crisis, there is a continuing need for structural reform to continue in this country. The Treasury submission made it clear that the primary need is for continued productivity growth, increasing flexibility and greater competition in the Australian economy.⁵⁵
- 2.66 As a first step towards further progress in the financial system, the Prime Minister's Task Force on International Financial Reform compared Australia's arrangements with the recommendations of three Working Groups set up by the G22⁵⁶ countries. These Groups examined what the world financial system needs to do in three areas: transparency and accountability; strengthening financial systems; and international financial crises.⁵⁷
- 2.67 The Task Force found that Australia's arrangements compared favourably with the recommendations put forward by the three Working Groups. The Task Force Report recommended that Australia use its expertise to ensure that the momentum of reform is maintained, that the emerging

53 Submission 13, The Treasury, p.46.

54 Submission 13, The Treasury, p.46.

55 Submission No.13, The Treasury, p.31.

56 G22 consisted at first of: Australia, the G7, Argentina, Brazil, China, Hong Kong-SAR, India, Indonesia, Korea, Malaysia, Mexico, Poland, Russia, Singapore, South Africa and Thailand. At the second (and last) meeting of the Group, the Netherlands, Belgium, Switzerland and Sweden were also included. See Reserve Bank comment in Evidence, 9 February 2000, p.9.

57 Task Force on International Financial Reform, *Report to the Prime Minister*, AGPS, Canberra, 1998, pp. 37-42.

markets be given special attention (especially in Asia) and that the private sector should be encouraged to take part in progressing reform.⁵⁸

2.68 While the Task Force found that in most instances Australia's arrangements met the requirements of the Working Group recommendations, there are a few areas where some action is still needed. For example:

- the collection of information on the foreign exchange liquidity position of the public, financial and corporate sectors;
- the collection of data on the foreign currency exposure of the corporate sector;
- the Reserve bank to join other Reserve banks and the IMF in drafting a code of best practices in monetary policy transparency;
- Australia's risk management processes need further improvement and development;
- providing banking statistics to the Bank for International Settlements;
- implementation of an early-warning system⁵⁹ to deal with crises in the banking sector; and
- some areas of Australia's insolvency laws.

2.69 The DFAT EAAU Report on Asian Financial Markets also called attention to the need to maintain progress. It commented that the damage suffered by the Asian economies emphasises "the importance of ongoing vigilance to ensure that Australia maintains a world best practice financial sector regulatory framework, and continues microeconomic reform".⁶⁰

2.70 The EAAU reported that an important priority should be support for Australia's negotiations in the World Trade Organization talks on financial services. The EAAU highlighted several areas where the outcomes will be important for Australia:

- more operating licenses for Australian financial service providers;
- more transparent licensing criteria;
- fewer restrictions on the form of commercial establishment;
- higher levels of foreign equity participation;
- greater freedom for companies to employ their own personnel; and
- more flexibility in the type of products foreign firms can offer.⁶¹

58 Task Force on International Financial Reform, *Report to the Prime Minister*, AGPS, Canberra, 1998, pp.3-4.

59 The Task force on International Financial Reform described this as: "Adoption and implementation of a method of structured early intervention in the banking sector – which includes mechanisms to ensure a consistent and timely response by supervisors." Task Force on International Financial Reform, *Report to the Prime Minister*, AGPS, Canberra, 1998, p.40.

60 East Asia Analytical Unit, *Asia's Financial Markets: Capitalising on Reform*, Department of Foreign Affairs and Trade, Canberra, 1999, p.339.

61 East Asia Analytical Unit, *Asia's Financial Markets: Capitalising on Reform*, Department of Foreign Affairs and Trade, Canberra, 1999, p.339.

- 2.71 The Committee commends the assessment of Australia's financial system. It is clear, however, that the rapidly changing world financial conditions do not allow for complacency. As the pace of globalisation increases, the Committee said, the time frame for important prudential decisions shortens rapidly. For Australia to keep pace, it must continually improve its systems and the supervision of those systems.
- 2.72 The Committee's opinion was that the Australian system should be brought up to world's best practice in all areas of regulation and supervision as soon as possible. Implementation of the following recommendations would be an important step along that path, the Committee said.

Recommendation 1

2.73 The Committee recommends:

- **that the Government examine the feasibility of implementing those recommendations of the Group of 22 Countries Working Groups where Australia is yet to reach world's best practice, including:**
 - ⇒ **the collection of information on the foreign exchange liquidity position of the public, financial and corporate sectors;**
 - ⇒ **the collection of data on the foreign currency exposure of the corporate sector;**
 - ⇒ **the Reserve bank to join other Reserve banks and the International Monetary Fund in drafting a code of best practices in monetary policy transparency;**
 - ⇒ **further improving Australia's risk management processes;**
 - ⇒ **providing banking statistics to the Bank for International Settlements;**
 - ⇒ **implementation of an early-warning system⁶² to deal with crises in the banking sector;**
 - ⇒ **further improvements to Australia's insolvency laws; and**
- **that high priority be given to achieving successful outcomes in the World Trade Organization negotiations on financial services**

62 See definition at footnote 59.