

# LESSONS FROM SOUTH ASIAN CURRENCY, STOCK MARKET AND ECONOMIC CRISES: OPPORTUNITIES FOR BUSINESS

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## ABSTRACT

The exchange rate and stock market crises have steadily spread from Thailand to most of South East and North Asian region. It is now impacting on the banking and financial sectors of most of these economies. Poor economic policies, specially poor financial management policies, are at the heart of their problems. This paper examines the relevant lessons and policies. It argues that increased movements of finance capital provide more opportunities and pose greater risks. It also explores the opportunities available to Australian business and industry in the current crises.

## I. INTRODUCTION

At the 1996 APELF, I argued that the meltdown, which occurred at the end of 1994 and early 1995 in Mexico and its spread to some of the other Latin American economies (through what is termed as the Tequila effect) could not occur in East and South-East Asia.<sup>1</sup> Essentially what had happened in Mexico was that massive amounts of capital had flowed out of that country, forcing down the value of that currency and creating an economic crisis through an increase in international debt through the valuation effect and through the run down of foreign currency reserves. There were also pressures on the Argentinian peso and on the Brazilian real, which were only resisted through a substantial increase in interest rates and consequently a much slower economic growth rate. Mexico was bailed out through a USA sponsored \$40 billion package, but under the supervision of the IMF.

My argument then was that the Asian economies ( sometimes referred to here as Group A) had much stronger savings ratios, and, therefore, were less reliant on international capital flows to drive their investment ratios and therefore their economic growth than was the case with Mexico and the other Latin American economies in general (sometimes referred to here as Group B). Economic inequalities were much greater in Group B and they also created greater tendencies towards higher inflation and therefore reduced export competitiveness in this Group than in Group A. Central to the whole argument was the assumption that economic management and governance was much better in Group A than it was in Group B. This assumption was based on the data showing that government outlays as a proportion of Gross Domestic Product were much lower and that budgets were in better balance in Group A than in Group B. But as we all know there has been in 1997 a currency meltdown in Thailand, which has spread to the rest of the region through a negative loop or what has

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1 D B Gupta, "APEC and Global Economic Integration" (1996). Paper presented at Feb. 1996 APELF, Canberra.

been termed as the Laksha effect. Without going further, I will briefly repeat my 1996<sup>2</sup> contention, made then in the context of tighter fiscal policies pursued by European Union (EU) member countries to meet the Maastricht criteria for single currency, that increased regional integration has not only an upside, but also a downside to it. The current spread of deflation from within the South-East Asian region to beyond and possibly to the international economy is something more than I anticipated then. It demonstrates that as before the capitalist system is driven by 'animal spirits' or capitalist sentiment and remains subject to not only to occasional booms but also to occasional busts (recessions). These can only be contained through good policies in individual economies and particularly in major economies. At the global level, it requires co-ordination and constant vigilance and from time to time, depending upon the international conditions, it may require the tightening or easing of monetary policy and/or fiscal policy by the major global players. John Maynard Keynes' General Theory<sup>3</sup> then becomes relevant at the international level.

As we all know there have been sharp falls in the values of several East Asian currencies in 1997. There have also been sharp falls in their stock markets some falls and further expected falls in their property prices. This paper attempts to explain the current South East Asian crisis and its spread to North Asia and the potential risks to the global economy. It also looks at the issue of whether or not speculators have a role to play in the global economy. It also provides some lessons and policies, some of which are drawn on the policies adopted by Group B countries, in the aftermath of the Tequila effect. It also argues that there are opportunities for Australian businesses in the current crisis.

## II. WHERE DID I GO WRONG?

Where did I go wrong in predicting that East Asia could not suffer the fate of Mexico? I was not wrong in the assumption of high saving rates sustaining high investment and economic growth rates. In fact, the two economies, which have suffered the most serious of economic crises in 1997, Thailand and Indonesia, are also the economies to have enjoyed extraordinary high economic growth rates over the 1985-95 period. Per capita Gross National Product in Thailand and Indonesia averaged an annual rate of 8.4 percent and 6 percent respectively over that period<sup>4</sup> and such extraordinary growth rates were facilitated by similar increases in investment.

I was also not wrong in my assumption about poverty and distribution of income and the related impact on inflation. Absolute poverty as defined by the percentage of population living on \$1 a day (on a purchasing power parity basis) had been literally eliminated in Thailand and had fallen to 14.5 percent in the case of Indonesia by 1995.<sup>5</sup> Income inequality in general is lower in Group A relative to Group B.<sup>6</sup> Inflation averaged only 5 percent per annum in the case of Thailand over the 1985-95 period and was in

2 Supra, n 1.

3 J M Keynes, *The General Theory of Employment, Interest and Money*, Macmillan, London, 1936.

4 The World Bank, *World Development Report 1997*, Oxford University Press, Washington D.C. 1997, p 214, Table 1

5 Supra, n 4.

6 Supra, n 4, p.222, Table 5.

single digits for the rest of the Group A countries.<sup>7</sup> It was over the same period in high double digits for most of the Group B countries and in triple digits in the specific case of Brazil.<sup>8</sup>

Where I went wrong in early 1996 was in assuming that good economic policies were in place in Group A countries and that they will continue to be so in the future. Data available on the budgets of the South-East Asian economies appeared to suggest then that they were well managed. For instance Indonesia and Thailand respectively had a surplus on central government budgetary outlays in 1995 of close to 10 percent and 8 percent of GDP. Compared to Brazil, which was running a deficit of more than 13 percent of GDP and Mexico, which had a surplus of around 2.5 percent of GDP in the same year,<sup>9</sup> Indonesia and Thailand appeared to be paragons of virtue. It now appears that there is a lack of transparency in budgetary data of some of the Group A countries, which means that the information available then was not reliable. There were considerable above budget outlays, and such information was not made available to the World Bank, by both Indonesia and Thailand. Therefore the data I was using was flawed. In addition around 1 percent of Indonesia's growth rate and around 2 percent of Thailand's growth rate had been sustained by international flows of finance capital. In general such capital flows, especially if they are in the form of foreign direct investment (FDI), are beneficial to the recipient country or countries. FDI brings in international technology and management skills. This enables the recipient to lift its growth rate. But unless right relative price signals are available, there can be over investment in some sectors and under investment in others. Relative prices became distorted in Thailand and Indonesia in 1996 and 1997. This was partly because of the fixed exchange rate regime, with a peg to the US\$ and partly because of policy decisions by the government to develop and nurture through a highly protective regime some highly capital intensive projects.

### III. THE PROBLEMS OF THE FIXED EXCHANGE RATE

A number of East Asian economies pegged their exchange rate to the US\$ — the more extreme case of it was Thailand with its fixed peg to the US\$; Indonesia adopted a crawling peg. For a period, such a fixed peg, in the context of what appeared to be sound budgetary policies, facilitated investment, because the risk of depreciation was reduced. But the external value of the US\$ is determined by international demand and supply conditions operating for that currency and it was not necessary that the same conditions would continue to operate day in and day out and year in and year out for the Asian economies. The period up to 1995 was in general benign in terms of the movement of the US\$, which depreciated against the Japanese yen and the German mark. This movement of the US\$ and thus of the Thai baht for instance ensured that Thailand's exports remained competitive. But the US\$ began to appreciate against the other two major currencies in 1996 and in 1997. This also made the currencies, which were tied to the former to appreciate, in turn making the exports of such countries uncompetitive. Export growth slowed, especially to Japan, which had

7 *Supra*, n 4, p.216, Table 2.

8 *Supra*, n 7.

9 *Supra*, n 7.

steadily become a major trading partner for East Asian economies. Prices of their exports also fell because of increased capacity building and exports from China. FDI slowed down. But external debt financing, especially of the short-term nature, increased sharply. There was a clear need to change the exchange rate policy in 1996, but this did not occur.

#### IV. THE POLICY OF HIGH INTEREST RATE

Instead a policy of high interest rate, with a fixed exchange rate in place, was pursued. One consequence of this was that banks in Thailand, Indonesia, Malaysia and Philippines borrowed foreign currency at low USA interest rates to on-lend at higher interest rates in their respective countries. A lot of such investment went into the property and real estate sector and did not facilitate the expansion of exports or of import replacement industries or of what is termed as the tradeables sector. The latter were squeezed, because of the high cost of finance capital. This rising cost and related fall in profitability was also reflected in the falling shares of such companies on the stock market. It became obvious to speculators, in the context of such fixed exchange rates, falling exports, large current account deficits and rising external debt that money could be made betting against such currencies. If central banks defend the existing parity, such speculation becomes destabilising speculation. This is because the central banks of the affected countries lose their foreign currency reserves in defending an exchange rate, which is seen to be unsustainable by the markets.<sup>10</sup> The gains of successful destabilisation go not only to the speculators but also to those who move out of the local currency for precautionary reasons (see below). This is because the central banks sell the foreign currency at a fixed rate, but when the currency depreciates, they get less foreign exchange for the local currency.

Though the Malaysian Prime Minister, Dr. Mahathir blamed the speculators and more specifically Mr. Soros, for the currency crisis, the pressures on the currencies intensified, because precautionary holders of the local currency joined the speculators in selling down the local currencies. By persistently attacking Mr. Soros and the speculators, a greater degree of attention was drawn to the problems of South East Asian economies and there was a greater degree of speculative and precautionary movement out of their currencies than was necessary simply on the basis of fundamentals. This is certainly the case with regard to Malaysia. Malaysia, with its relatively low inflation level, a more developed banking system and a more transparent budgetary process and fiscal policy than Thailand and Indonesia, should have escaped relatively unscathed, but in the end did not. This was partly because a lot of external debt build-up was going into non-tradeables and therefore was not enhancing export competitiveness. It was partly because Malaysia (as was Singapore to a more moderate extent) was caught in the negative loop of the Laksha effect and partly because of perceived risks that Malaysian government may act to stop capital outflows. The latter was connected to Dr. Mahathir's attacks on speculators.

10 B V Yarbrough and R M Yarbrough, *The World Economy*, The Dryden Press, Fort Worth, 1997, p 519.

## V. THE ROLE OF THE SPECULATORS

Dr. Mahathir has raised the important issue of whether or not speculators have a role in the international financial system.<sup>11</sup> His view is that they do not and that finance capital should simply be there to finance trade and investment. But in investing in an economy either directly or through the bond and stock market, fund managers and individuals are making a judgment about the rate of return they are likely to get. Such returns constantly change in response to changes in governments' interest rate policy, investment activity and companies' profitability and other information relating to countries and companies. What is termed as speculative activity are investment decisions by fund managers and a response to perceived opportunities as well as to perceived problems. Since they go in favour of the highest possible return at the international level, they are generally seen to improve the allocative efficiency of international finance capital. But this assumes that there is adequate and transparent information available to such fund managers and investors. As is quite apparent from my previous discussion of the Indonesian and Thai budgets, such transparency was lacking. There is similar lack of transparency and reliable information about firms in a number of countries. As new information becomes available, the sentiment can change in favour of or against a particular currency and country. The weight of money, the spread of players through increased privatisation, and technological developments can increase the speed with which a change in sentiment can push up or down the securities markets and eventually the currencies. Speculative activity can then be in favour of the currencies and securities markets of a country as well as against it. It had turned against the securities markets of Thailand in 1995-96 and this was reflected in an increase in interest rates and a fall in its stock market. As the competitive position of Thailand was seen to deteriorate, there was pressure on Thai baht, eventually spreading to the other South-East Asian economies through a negative loop or contagion effect.

By attacking the speculators, Dr. Mahathir focused the attention of the fund managers much more on the region than would have been the case otherwise. The risk premium of holding the Malaysian ringgit in particular, but also the other South-East Asian currencies shot up. This is because the possibility of exchange controls being imposed was seen to be real. This was in spite of the fact that Malaysia continues to move towards liberalising its financial sector. A concerted policy response based on explaining the actual situation with regard to the fundamentals and on taking action to improve them, where such fundamentals were seen to be weak, would have reduced the magnitude of contagion out of Thailand, Indonesia and Philippines. One consequence of Dr. Mahathir's attacks on the speculators and by implication on the fund managers has been that the currencies and the stock markets in the region have overshot in the downward direction. The Indonesian rupiah is certainly undervalued, as is the Singapore stock market.

Even apart from the current developments, capitalist and financial market sentiment driven as it is by animal spirits, has a tendency to

<sup>11</sup> C Ryan, "US spreads the word on bailout funds" (1997) *Australian Financial Review* November 17 1997, p 13.

overshoot in both directions. When it is buoyant and riding high, it tends to ignore fundamentals for a period and drives the securities markets to unrealistic heights, spilling eventually into the property markets. When the sentiment turns negative, then it has a tendency to overshoot in the downward direction and to depths, which are not warranted by fundamentals. By and large it is self-correcting. But where fears of global slump feed on one another, it may not be self-correcting and may need a liquidity shot in the arm to recover. In addition, given the tendency towards overshooting and its related consequence of excessive asset price inflation and excessive price deflation, there is a need to dampen these cycles of booms and busts.

## VI. THE PROBLEMS OF THE FINANCIAL SECTOR

The excessive lending and debt creation of the nineties, through borrowing by local banks in foreign currency and on lending in local currency, has created in 1997 and beyond a serious problem for the financial sectors of Thailand, Indonesia, South Korea, Malaysia and Philippines. The currency meltdown has increased, through the valuation effect, the cost of foreign borrowing and the amount due for repayments. Banks get repaid in local currency but have to make their repayments in foreign currency. Banks have to dig deeper in their pockets to find such money. In addition the tighter monetary and fiscal policies necessitated by higher inflation and large current account deficits have reduced local demand and created over-capacity in the property sector, against which a number of loans were made and are now outstanding. As property prices have tumbled, the collateral now seems inadequate. In Indonesia and Thailand, there was also inadequate hedging for imports, thus raising the cost of imports and an incapacity by importing firms to pay their bank loans. Lenient disclosure rules and a blind eye to poor lending banking policies to fuel the property bubble in the case of Thailand, and lax supervision in the context of financial deregulation in Indonesia, has worsened the situation.<sup>12</sup> The proportion of non-performing loans in the portfolio of banks in the East Asian countries has risen dramatically as a consequence and now in the case of Thailand is approaching the proportion of Mexico in 1995, where around a quarter of all outstanding loans then fell into that category.<sup>13</sup>

Mexico's bad loans problem spread in 1995 to Argentina, where there was a substantial withdrawal of funds from the banks. In the end the cost of repairing the financial system in Mexico was immense (more than \$30 billion) and without the support of the rescue package from the USA and the IMF, such a repair would never have been accomplished.<sup>14</sup>

The experience of bad loans is not limited to the developing economies. More advanced economies such as those of USA, Britain and Australia have gone through the same problem and, more seriously currently for the global economy, in the case of South Korea and even Japan are going through the same problem. Given the moral hazard, which is explicit for some countries and implicit for others and is embedded in the acceptance

<sup>12</sup> *The Economist*, "Asia's Economic Crisis: How far is it down?" (1997) November 15 1997 pp 19-23.

<sup>13</sup> *Supra*, n 12.

<sup>14</sup> *Supra*, n 12.

that depositors will be protected and no major financial institution will be allowed to go broke, there is always a tendency for the banks and other financial institutions, placed in similar circumstances to provide loans to some highly risky ventures. Moreover changing economic conditions can make loans, which looked viable at the margin in a low interest, high growth economy, non-viable and non-performing, if and when such an economy enters a high interest, low growth period.

The intensity of the financial sector problem in the case of USA and Australia was much less severe than is the case with Japan and South Korea. Nevertheless the swiftness with which both USA and Australia handled their bad loan financial sector problems should be contrasted with the long drawn process that Japan has adopted and now South Korea is adopting. Moreover, Japan and South Korea's more serious problems are connected to the bursting of the asset price bubble in 1990, laxity in supervision and enforcement of accounting and auditing standards and the slow pace of restructuring of their financial sectors and are now worsened by the crises in South East Asia.<sup>15</sup> Poor risk management practices are widespread among Asian banks. South Korea's external debt structure, with 30 percent of its debts maturing within 12 months, is putting increasing pressures on its economy in the current climate of poor capitalist sentiment and falling won and stock market. The slowness of restructuring has mirrored Japan in a prolonged period of recession and could do the same in the case of South Korea.

## VI. GLOBAL RISKS

The crisis in South East Asia and even in South Korea has only a minor negative implication for the global economy. This is partly because their combined output is only 2.5 percent of the global output and partly because the international funds, which have quit their economies, have gone to the USA and Europe and have fuelled growth in those economies. But the failure of the Japanese financial sector to restructure has created the potential for systemic risk, which will have serious consequences not only for the Japanese economy through a recession, but also through its flow through on to the rest of the world. This is partly, though only to a small extent through trade, but more seriously through the risk of funds being pulled out of the rest of the world. Japan, because of its large surplus of domestic savings over domestic investment has been the world's major supplier of international capital for a number of years. Such a pull back is not necessary, but remains a possibility. It will pose a threat to the US economy, where most of the Japanese funds have been parked, mostly in US bonds. As some of the regional banks and security houses are liquidated, a shortage of cash within Japan will require such pull back of funds from the USA. This in turn could trigger a collapse in US bonds, leading to an increase in US interest rates with all its adverse consequences on US asset values. When combined with a flow through of such development to Europe and an increased cost of external debt, which such an increase in interest rates imply, a global slump becomes a real possibility. Some of the

15 B Bremenes and E Thornton, "Is Japan at the brink too?" (1997) *Business Week* November 10 1997, p 30

European, particularly German, banks are exposed to East Asia, mainly to South Korea. Therefore Europe is not immune from contagion spreading to it.<sup>16</sup>

In addition there is a rise in protectionist sentiment with MERCOSUR (led by the large Latin American economy, Brazil) raising its common external tariff. Protectionist sentiment, though not action as yet, is spreading within the USA, as its trade deficit with East Asia widens and fears of a flood of exports from East Asia intensify.<sup>17</sup> This is reflected in the inability of President Clinton to win support from US Congress for the fast-track trade negotiating authority he needs to make trade deals.<sup>18</sup> It implies that US leadership in pursuit of free trade is likely to be absent in the immediate future. It also means that any recovery in East Asia based on export led growth, particularly from Japan, will be resisted by the USA. Risk of global slump is greater, now, consequently than it has been for some time. This is because Japanese domestic requirements are likely to force Japanese companies to pull out funds from USA. If that happens, then it will in turn increase US interest rates ushering in US recession, with all its consequent implications for the global economy at a time when Japan is mired in recession and European recovery is still weak.

Russia, which has had its income cut back by more than a third over the nineties is threatened with its incipient recovery being cutback in 1998 by reduced investment flows from East Asia.

There are also developments in Hong Kong and by association in China (see below), which are adding to the universality of such a slump.

## VII. HONG KONG DOLLAR UNDER THREAT

The attack on the HK\$ came as a surprise to most economists and requires an explanation.

Hong Kong, which was assumed to have sound fundamentals, no government debt, high international reserves and a well-developed and liberalised financial sector is facing somewhat of a financial crisis. The crisis started with an attack on the fixed parity of the HK\$ to the US\$. The appreciation of the latter and therefore of the former against the other major currencies, should not have had a substantial impact on the Hong Kong economy, because unlike Thailand, Indonesia, Malaysia, Philippines and even South Korea, Hong Kong is not dependent on manufacturing exports. It has a highly developed service economy. Services are not in general price sensitive, though one part of it, tourism, is.

Even with sound fundamentals, as for instance in the case of Singapore, currencies can from time to time come under pressure. This is simply because countries with which Singapore is trading and providing services to, face economic difficulties and a slow down of economic growth and there is the reasonable conclusion that this will have an adverse impact on Singapore. Therefore in the same way that the Singapore dollar came under pressure and lost in value against the US\$, the speculators would expect the HK\$ to shed some value against the US\$. Moreover, tourism has

16 AP-Dow Jones, "Asian crisis sparks fears for Europeans" (1997) *Australian Financial Review* November 28 1997, p 54.

17 I Porter, "Ford warns of yen fallout" (1997) *Australian Financial Review* November 28 1997, p.10.

18 *The Economist*, "The free-trade winds die away" (1997) November 22 1997, p 49.



dropped in value in Hong Kong after its return to China. The reasons for this are connected to higher relative costs of visiting Hong Kong compared to countries whose currencies have depreciated, a decline in purchasing power of a number of regional economies and at the margin the perception of increased risk of visiting Hong Kong. There may also be a view that the large debt overhang of the Chinese state or government business enterprises could adversely impact on Hong Kong. In addition, with the floating of the other East Asian currencies, the fixed parity of the HK\$ is like a rag to the successful bulls in the currency markets.

The Hong Kong administration appears determined to maintain HK\$ peg with the US\$. One consequence of this determination has been large increases in interest rates. These in turn are impacting adversely on the stock market, on the property market and on other economic activity, including the financial sector.<sup>19</sup> There is some erosion of confidence in the financial sector, with a run on one of the banks.<sup>20</sup> Hong Kong is much better placed than other East Asian economies to protect its banks. But there is no evidence that the performance of an economy is necessarily improved by having a fixed exchange rate. In fact, once the sentiment has turned against a currency, the performance of that economy is improved by letting the currency depreciate. This is certainly the experience of the British economy, which has performed considerably better after it withdrew from the European Monetary Union in 1992. Defending the value of a currency is not a sign of virility; it is a sign of weakness. Though floating a currency adds to some costs (such as transaction costs and costs of hedging), nevertheless these costs are considerably less than the loss of output, which is the consequence of the perception of an overvalued currency and the associated down turn in capitalist sentiment or 'animal spirits'.

Such decline in capitalist sentiment in Hong Kong will in turn have an adverse impact on China. This is because China is dependent on international investment flows through Hong Kong, which have brought technology and managerial skills to it in the eighties and nineties. Such investment flows have already slowed down in 1997. Productivity improvements, which such foreign direct investment has brought to China, will slow consequently. The cost of raising capital in Hong Kong has gone up and this will have implications for investment in China. Privatisation and restructuring of state owned businesses, with reduced demand for such assets may consequently become more difficult in China in turn creating enormous difficulties for China's bad loans, which perhaps amount to 30 percent of its GDP.<sup>21</sup> The growth of the Chinese economy will be adversely affected. The Chinese economy is approaching 4 percent of world GDP and when added to the other negative developments discussed above increase the probability of a global slump.

19 B Einhorn and K Capell, "A red flag for red-chip stocks" (1997) *Business Week* November 3 1997, p 49

20 R Callick, "Hong Kongers ignore 'don't panic' advise" (1997) *Australian Financial Review* November 27 1997, p 16.

21 *The Economist*, "When China and India go down together" (1997) November 22 1997, p 30.

## IX. LESSONS AND POLICIES FROM THE ABOVE

The large scale bail-out of Indonesia and Thailand under the supervision of the IMF, but funded largely by Japan and other regional economies, has revived the issue of a regional bank/fund<sup>22</sup> with functions probably similar to those of the IMF. In having a global focus the IMF is unable to effectively supervise and advise increasing risk countries before the on-set of a crisis. The growth of finance capital and associated technology has made the task too great for IMF on its own. The evidence of this is in the mega-crises associated with the Tequila effect and now with the Laksha effect, which the IMF failed to prevent or reduce the magnitude of. A regional fund will be able to further underpin the hands-on policing role of the central bank of a regional country (see below) through technical advice and through the provision of technical personnel. It will be much more focused and will be able to act more swiftly before bush fires turn into destructive, large-scale ones. Moreover increasing regional integration means that a regional fund, sponsored by regional countries, will have a much greater interest in ensuring stability in regional economies. The problem will be in persuading USA, given its current opposition, that such a development is in the US and global interest. Against this should be weighed the possibility that such a fund may be too soft in its enforcement role, which is better left to the IMF, with its tough conditionality and experience in enforcement of financial sector restructuring. This may mean the creation of a new regional body(ies) responsible for day to day overview, supervision and co-ordination of financial market developments in the regional economies, while the IMF retains its current role. Without any funds, it/they will have to be under the umbrella of the IMF, with the threat of having to call in the IMF, giving it/them the effectiveness in enforcing such supervisory role(s).

The East Asian economies are facing a major financial and banking sector crisis. Mexico with around a quarter of its banking sector loans non-performing was able to turn around its banking sector and its economy within a short period. There are some lessons from Mexico and the experience of other Latin American economies since early 1995.<sup>23</sup>

Like Mexico and other Latin American economies facing the Tequila effect, the East Asian economies will have to open their banking system to foreign ownership. The entry of foreign banks and foreign ownership will lift the state of technology and the credit-assessment and service standards.

Latin American economies under international pressure closed some of the worst performing banks and forced the others to consolidate. Consolidation was forced through by lifting the banks' capital requirements. Cash-strapped institutions with no alternative were consequently forced to merge with rivals. A similar strategy will have to be adopted by East Asian governments.

A much more hands-on approach to policing of banks' credit assessment and lending practices was adopted by central banks in Latin America. Banks were forced to build reserves against loans not yet in default, but which looked shaky on the basis of future outlook. A tougher hands-on policing

22 G Earl, "Asian crisis: new rescue fund formed" (1997) *Australian Financial Review* December 1 1997, p 1.

23 Supra, n 12..

approach will have to be taken by East Asian governments. A related issue is the move to a mega-regulator adopted by Britain, Australia and now South Korea. Excising the prudential supervisory role of the central bank at a time when systemic risks are increasing, and transferring them to a mega-regulator seems to be a higher risk strategy and therefore a retrograde step. In the same way as the world financial system is becoming too complex for the IMF to manage on its own, there is a greater need for more specialist supervisors of the financial sector not less. Obviously, there is the need for a co-ordinating body (and these exist in most countries), so that developments in one segment of the financial sector do not impact adversely on the rest of the financial sector. The argument of convergence between banks and non-bank financial institutions, in the context of technological changes, is provided as the basis for a shift to a mega-regulator.<sup>24</sup> It is also argued that a single prudential regulator will facilitate technological change. In practice the credit unions and building societies are either minnows or have been able to convert themselves into banks in the past. At the same time, separate regulators have not hindered the entry of banks into superannuation and insurance in the past and superannuation and insurance companies have been acquiring banks as a means of diversifying their business. Technological changes and efficiency improvements of the financial sector in Australia have been evident. Australian banks, particularly the National Australia Bank, have been among the best performing, in terms of profitability and prudential management. This is quite clearly evident, in terms of the financial sector problems of Japan, South Korea and other banks in developed European economies. Prudential supervision of the banking sector by the central bank has not prevented competition from intensifying in the financial sector, which is the other objective of the regulatory changes in Australia. In any case at the core of the financial system remain the banks and central banks have acquired a certain degree of expertise in the supervision of the banks. A mega-regulator will lack a clear focus and the risk to the financial system and the real economy will rise consequently.

The issue of core versus non-core parts of the financial sector is also connected to the issue of lender of last resort and which areas of the financial sector will be protected in the ultimate. All depositors are either explicitly or implicitly protected. A deposit insurance scheme operates in most countries to ensure this, but it does not operate in Australia. This means that the guarantee is implicit in Australia. Whether it should be made explicit is a matter of debate. An explicit guarantee is likely to increase moral hazard and risk taking. But at the same time it will ensure that when the crunch time comes there are likely to be funds to pay off the depositors; though Japan's deposit insurance scheme has already run out of funds, making the taxpayers responsible for further pay-offs.<sup>25</sup> At the same time despite the risks of a moral hazard, no country is likely to allow its major banks to go under. Once an implicit guarantee is available that the large banks will be protected, because of the risk to the system that their collapse poses, then they need to be more closely scrutinised. Since the central bank, even in the case of Australia remains responsible for systems stability,

24 Wallis Inquiry, *Financial System Inquiry Final Report* (1997) AGPS, Canberra.

25 T Boyd, "Weak will perish as cash crisis worsens" (1997) *Australian Financial Review* December 1 1997, p 11.

it strengthens the case for it to have continued prudential supervision of the core banking system.

A fixed exchange rate regime in a situation of changing relative fundamentals is unsustainable in the face of changing sentiment, except at the cost of economic growth. The British fixed exchange rate experience during its 1992 currency crisis and the more recent developments with respect to Hong Kong clearly suggest that protecting a fixed exchange rate, which the markets think is unrealistic, is not in the economy's interest. If Hong Kong does not go for a market determined value of HK\$, then it will have adverse implications not only for the Hong Kong economy but also for that of mainland China. Hong Kong must therefore unpeg its currency.

Speculative attacks on a currency suggest that there are perceptions that some of the fundamentals of that economy are poor. Therefore, the appropriate response is not to attack the speculators, but rather to examine the fundamentals and to explain to the investors, where and why the fundamentals are seen to be strong and what action is being taken to improve the fundamentals where they are seen to be weak. Attacks on speculators are counterproductive. They raise the risk of holding the currency of the country concerned, because of fears of exchange control being imposed.

Nevertheless, there is obviously a case at the global level of an action, which will curb the tendency towards asset price booms and bursts, if they are driven by speculators. This is because this is destabilising speculation. Any action, which does not require exchange controls, but which will moderate exuberance and pessimism should be considered. Exchange controls will reduce the current gains of free flows in improved global efficiency. A very small tax on capital outflows, probably \$1 in \$10,000, may dampen some of these amplitudes. It may also satisfy some of those who see speculators as villains, rather than traders and participants, who fulfil a need in the financial markets. The revenue generated could be used to beef up the funding for the IMF, the demands on which have increased dramatically in the nineties.

In the context of the crises in East Asia, there is the question of whether or not financial sector liberalisation should proceed or should be reversed. This question is related to moving from an interim WTO financial services agreement, signed without USA in mid-1995 to a final WTO agreement in which USA is also a signatory. Given the benefits of the entry of foreign banks cited above, there is a strong case for moving towards financial sector liberalisation, but in a phased manner. A phased entry and steady moves towards liberalisation will improve the quality of the financial services, without destroying the local financial institutions. Despite the turmoil in the ASEAN economies, Malaysia, Indonesia and Philippines offered in mid-November 1997 improved access and entry to foreign banks and insurance companies and Thailand was expected to follow suit.<sup>26</sup>

There is the assumption that because of the small size of the economies impacted on through the Laksha effect, the adverse consequences on the major economies and therefore on global output are likely to be small – around 0.2 percent. But the contagion has already spread to the somewhat larger economy of South Korea, where problems of external debt have

26 F Brenchley, "Malaysia offers to drop its investment barriers" (1997) *Australian Financial Review* November 14 1997, p 30.

traditionally been more serious than the other developed Asian economies. It is also likely to spread to China, through the negative sentiment in Hong Kong and through the increase in interest rates. More seriously, it appears to be hitting Japan, at a time when it still has not recovered from the bursting of asset price bubble. The prospects of the pull back of Japanese funds from overseas, including from the USA is real. There is the danger of a global slump. Even if we ignore the latter, the developments in East Asia with the cut back in demand in their economies are deflationary. This has to be connected to the current evidence that at the aggregate global level production is outrunning aggregate global demand,<sup>27</sup> though this is not the case in the USA, where excess demand has been spilling over into imports. There is consequently a need for a boost in global demand so as not to convert the problems of East Asia into a global slump. This requires the USA and Europe to continue the easy money policy stance that they have been pursuing in 1997 and for Japan to inject a large fiscal stimulus, recognising that its easy monetary policy has failed to stimulate its economy during the nineties. It has to be recognised that the capitalist system is driven by 'animal spirits'. Given that negative sentiment is spreading throughout Asia and could spread to the rest of the world, it is important to give a boost to 'animal spirits' by adding a moderate stimulus to the global economy. Obviously, it is important for countries in financial crises, to move quickly to restructure their financial sector. The combination of an injection of liquidity at the global level and such restructuring by problem countries will restore confidence.

#### X. OPPORTUNITIES FOR BUSINESS

Though economic crises are periods, when the sentiment is against investing in economies which are going through such crises, in practice they are also periods of opportunities.

As mentioned above the currency and stock markets have overshot in the downward direction in East Asia. Singapore, where the fundamentals are in general really strong, has for its listed companies an average price:earnings ratio of under 10. This represents considerably better returns and prospects of appreciation of share values than other stock markets around the world.

There are also opportunities in Indonesia. This is based on the assumptions that the Indonesian rupiah is undervalued by around 20 percent and that the bargaining power of overseas investors is currently larger than what it has been in the past and probably what it will be in the future. Obviously opportunities should be tailored to areas of core competency.

For Australia, the major opportunities in the immediate period are likely to be in the areas of financial services. This is because Australian banking and insurance services are highly developed and Australian banks in general and National Australia Bank in particular have proved themselves quite adept at successfully restructuring their overseas acquisitions. The combination of the pressures from the IMF and of the impending WTO financial services agreement will require Indonesia to open up its financial sector to foreign investment and takeovers.

27 *Business Week*, "The Threat of Deflation" (1997) November 10 1997, p 30.

In the longer run, there will be opportunities in construction services, in which Australia also has comparative advantage. Consequently, given the value of the rupiah and the weakened bargaining power of the local firms, this is a good time to enter into strategic alliances, to await the recovery, which will come in time. Mexico recovered from its crisis within 10 months. Given Indonesia's much higher saving ratio, and the accepted need by the Indonesian government to restructure Indonesia's financial sector,<sup>28</sup> there is no reason to assume that Indonesia's recovery will not occur. With the recovery firms, which are already positioned and connected in Indonesia, will obviously gain from it.

The paralysis of the political decision making in Thailand and Indonesia makes for a more protracted and difficult recovery. Nevertheless IMF supervision and pressures emerging from the WTO financial services agreement, will force a restructuring of their financial sectors. There should be opportunities for Australian banks and other financial institutions, though risks in this case are much greater. There are similar opportunities in Philippines, though political uncertainties and a more unequal distribution of income and lower saving ratio, make it less attractive than Indonesia.

Malaysia's economy is in much better shape than that of Indonesia, Thailand and Philippines. With the further opening of its financial services, there should be opportunities for Australian financial institutions, though the calls by Dr Mahathir to curb the markets continue to create uncertainties and perceptions of increased risk in Malaysia. But the reality in Malaysia is to move towards the market. In fact, if anything, the current developments have increased the competitive position of Malaysia and the ringgit is probably undervalued by around 40 percent. The current account deficit, one of the concerns which has driven the sell-off of the ringgit and of shares in Malaysia, is falling because of the depreciation of the ringgit.

In addition, though the price of overseas education has gone up in East Asia in general, the impact of this is likely to be less in Malaysia. This is because of the continued growth prospects for its economy. Moreover given the depreciation of A\$ and NZ\$ vis-a-vis the US\$ and UK pound, the relative price of education in the antipodean economies compared to its US and British competitors has fallen. With proper marketing, then the adverse impact of the depreciation of the East Asian currencies on the sale of education services in the region as a whole can be minimised by both Australia and New Zealand.

28 G Earl, "Commitment to Reform will be Reviewed: IMF" (1997) *Australian Financial Review* November 13 1997, p 14.