LOWY INSTITUTE
FOR INTERNATIONAL POLICY

NOVEMBER 2008

ANALYSIS

DR STEPHEN GRENVILLE AO
Visiting Fellow
sgrenville@lowyinstitute.org

AUSTRALIA, EAST ASIA AND THE CURRENT FINANCIAL CRISIS

The international financial crisis has created vulnerabilities in East Asian economies that would otherwise be in good shape. Indonesia, for example, is susceptible to sudden loss of external confidence and needs to supplement its own foreign reserves with external back-up. The conventional source – the International Monetary Fund (IMF) – will not be politically acceptable unless the crisis becomes very severe, and by that stage it will be difficult to restore confidence. The Chiang Mai Initiative (CMI) is potentially an effective regional response, but is constrained by the requirement that lending be supervised by the IMF, putting its use off limits.

Australia, not a member of the CMI, can't do much to change its rules, but might find a low-key way to urge a modification which would remove this counter-productive constraint on the CMI.

LOWY INSTITUTE FOR
INTERNATIONAL POLICY
31 Bligh Street
Sydney NSW 2000
Tel: +61 2 8238 9000
Fax: +61 2 8238 9005
www.lowyinstitute.org

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Australia, East Asia and the current financial crisis

The knock-on impact of the world financial crisis is beginning to be keenly felt in East Asia. China is heading for a significant slowdown and even strong economies like Singapore are forecasting negative growth. Several other Asian countries – South Korea and Indonesia – are looking fragile.

In both South Korea and Indonesia the domestic economies are in reasonable shape. Indonesia, for example, has near-balance on its external account and a small budget deficit. But the two countries are sufficiently integrated into the international financial world to have suffered sharp falls in their stock markets and exchange rates, simply through the fall in commodity prices and the general contagion from America. This contagion is familiar to us in Australia, but the impact on Indonesia is potentially much greater. Its external sector is always on a knife-edge of fragile confidence. The financial sector in Indonesia lacks the depth and maturity of Australian financial markets, and foreign investors are flighty and less committed because they lack long association with the country. This fragility leads to the sorts of 'multiple equilibria' we saw in the Asian crisis ten years ago: an exchange rate which is seen by financial markets to be broadly appropriate at one moment is judged to be grossly out of line a short time later. Confidence can change dramatically from optimism to deep pessimism, without any significant cause. So maintaining confidence (especially financial market confidence) is critical.

So far the Indonesian exchange rate has been well behaved and well managed. It has fallen over 30% during the past month or so, which mimics the behaviour of Australia's commodity-based dollar. As with Australia, this outcome reflects some management through intervention on the part of the central bank. Market commentators are currently watching the foreign exchange reserve levels closely. While reserves were still at a healthy US$50 billion at the end of last month, market commentators are looking at the rate of change as much as at the absolute level. So augmenting or backing up these reserves is a high priority.

The options to do this are limited. The Indonesian President raised the possibility of a Global Fund at the recent G20 Leaders' meeting. This idea, however, is likely to take years to get any traction. The US Fed has offered US$30 billion short-term swap facilities to South Korea and Singapore, but the Fed may be reluctant to make this available more widely. Indonesia may get loans from the World Bank, the ADB and countries like Australia, but the aggregate total is likely to be rather modest, not large enough to make a sustained difference to market confidence. Indonesia might raise around US$5 billion in this ad hoc way (i.e., around 10% of their existing reserves level), and it would be a once-off supplement. What is needed is money which has some prominence and leverage, either by virtue of its volume or by the implicit endorsement that comes with it.

The conventional source of such catalytic money is the International Monetary Fund (IMF). Sadly, the reputation of the Fund was so damaged during the Asian crisis that no East Asian country seems likely to tap into any

source of funds with the 'IMF' label on unless the situation becomes so parlous that they have absolutely no choice. Even the IMF's recently-introduced swap facility (Short-term Liquidity Facility or SLF), which has no conditionality attached (other than that the recipient still be in reasonable shape) is not attracting any interest from East Asia. While the Fund's resources are not unlimited, it has enough available to make a significant difference – the SLF has the potential to lend 500% of quota, which in Indonesia's case would be around US$15 billion. The irony of this is obvious: the Fund has radically reformed its attitudes and facilities over the past decade, but has not shaken off the reputation which makes it politically unacceptable for countries like Indonesia to use its facilities.

The opprobrium attaching to the IMF label carries over to the Chiang Mai Initiative (CMI) – the East Asian arrangements set up after the Asian crisis to provide foreign exchange swap facilities when needed, precisely in times like this. But to draw substantial amounts under the CMI, countries must agree to have a program of IMF conditionality, with the Fund setting down policy-reform measures and supervising their implementation.

What might be done?

The first-best policy would be to make the Chiang Mai Initiative acceptable to potential borrowers by removing the requirement for IMF conditionality.

The origins of this conditionality are logical enough. When the CMI was set up in the aftermath of the 1997 crisis, there was no regional institutional arrangement capable of providing adequate surveillance over the lending. The largest potential lenders – China and Japan – understandably wanted some assurance that their funds would not be used in the futile defence of failed economic policies. It could readily be argued that this deficiency in the regional architecture still exists: regional surveillance has not progressed to the stage where it could ensure the 'tough love' that might be needed in some cases. But the current circumstances do not seem to need much in the way of surveillance, and what is needed could be provided by the existing modest low-key regional surveillance capacity. Most observers would regard Indonesia's macro stance as appropriate and competently implemented.

More tellingly, the outcome of the unacceptable conditionality is entirely counter-productive: the swap facility will not be activated early on in the crisis, in the phase when it would be most effective in boosting confidence. Rather, it would be used only if things are so desperate that the borrowers are prepared to swallow their pride and submit cap-in-hand to the Fund's tutelage. By that stage, credibility will have been seriously damaged and even large funding may not do the job.

Once the CMI is activated, it has the potential to tap the two big sources of funds in the region: Japan and China. The amounts which could be put on the table would be truly confidence-boosting.

Can Australia help here? Unfortunately we are not even a member of the Chiang Mai Initiative so it would be presumptuous on our part to suggest this modification to the CMI arrangements. We lack leverage because we

have not participated in the appropriate discussions in the past. But we have a big interest in supporting the outcome (Indonesia's on-going stable economy). We risk a rebuff if we start telling the CMI countries what they should do. But if we don't, it's quite possible that everyone else is so busy with their pressing domestic concerns that no-one will think through the logic of this modification to the CMI.

Why not a bit of regional diplomacy to take this case to the Chinese and the Japanese?

About the Author

Dr Grenville is a Visiting Fellow at the Lowy Institute for International Policy and works as a consultant on financial sector issues in East Asia. He is a Director of AMP Capital Investors Limited and an Adjunct Professor at the Australian National University. Between 1982 and 2001 he worked at the Reserve Bank of Australia, for the last five years as Deputy Governor and Board member.

Before that, Dr Grenville was with the Organisation for Economic Co-operation and Development in Paris, the International Monetary Fund in Jakarta, the Australian National University and the Department of Foreign Affairs.

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