Asian crisis breaches Australian “firewall”

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9 June 1998

The spreading impact of the Asian financial crisis and the emergence of global deflation are clearly visible in the rapid slide of the Australian dollar in world currency markets.

After a steady decline in trading last week, the dollar collapsed to a near all-time low of under US60 cents when markets opened on Monday. It went down along with currencies across the Asian region as the Japanese yen hit a seven-year low of 140 to the US dollar in anticipation of reports that official figures will show the Japanese economy has moved into recession.

The latest fall in the Australian currency came despite heavy intervention in financial markets by the Reserve Bank of Australia. While the bank has maintained an official silence on its activities, market analysts estimated it spent up to $3 billion, out of reserves of $15 billion, trying to halt the dollar’s slide.

Whatever its fluctuations in the immediate period, the dollar slide has shattered claims by the Prime Minister John Howard and his Treasurer Peter Costello that savage spending cuts in the budget had effectively “firewalled” Australia from the effects of the Asian economic meltdown.

If the currency slide continues, and all reports from financial markets indicate that the dollar could trade as low as 55 cents, then there will be major economic and political ramifications.

According to Dr Peter Brain, a director of the National Institute of Economic Research, who warned of the Asian economic slump when the currency turbulence began last July, a currency crisis could hit Australia in the near future, forcing the Reserve Bank to increase interest rates sharply, putting the economy into recession.

The last time such a crisis occurred was in July 1986 when the fall of the dollar prompted the remark by the then Labor Treasurer Paul Keating that the Australian economy was in danger of becoming a “banana republic”. In response to the crisis, the Labor government initiated major cuts — totalling more than $7 billion over two years in government spending — hitting social welfare, education and health.

The potential financial crisis in the 1980s was averted by the rise of the East Asian economies as Japanese investment poured into the area to set up offshore production facilities in Indonesia, Thailand and Malaysia following the revaluation of the yen under the 1985 Plaza Accord.

But now it is the Asian crisis, and the decline in markets for Australian exports it has produced, which is pushing the dollar down. Since December 1996, when it stood at 82 cents, the dollar has fallen 25 percent, the greater part of this decline taking place since last July when the Asian crisis began with the devaluation of the Thai baht.

With all the East Asian economies — from Japan to Indonesia — experiencing zero or sharply negative growth, export markets have been sharply reduced. The decline in exports saw the Australian balance of payments deficit rise to $A7.52 billion for the first three months of this year, an increase of 33 percent over the December quarter level.

Besides the decline in export markets, the turbulence on financial markets is also having a direct impact on the dollar’s slide. US-based hedge funds, especially those which are unable to shift money out of Indonesia because of the virtual collapse of financial markets in that country, are reported to be selling Australian dollars at every opportunity in order to try to lessen their exposure to Asian currencies.

While the actions of the hedge funds and currency speculators are playing their part, the decline of dollar is related to more fundamental tendencies operating in the world economy.

The most important factor in the Australian currency decline is the situation in Japan — the country’s largest export market. Despite cuts in interest rates and a series of government expenditure packages, the Japanese economy remains stagnant, with all predictions pointing to a continuation of the slump well past the turn of the century.

Japan’s unemployment level hit a record post-war level of 4.1 percent in April, and according to at least one prediction it could rise to as much as 10 percent in the next three to five years. Other forecasters say the Japanese economy will be “doing well” if it manages to average 1 percent growth per annum for the foreseeable future.

The Japanese economy is now caught in what has been described as an “incipient depression.” The official discount rate has been lowered to a record 0.5 percent while the yield on long-term bonds is less than 1.2 percent. According to some economists, Japan has entered a “liquidity trap” — the term first used by British economist John Maynard Keynes to describe the Great Depression of the 1930s — in which cuts in interest rate cuts are likened to “pushing on a piece of string,” so far as their effect in stimulating the economy is concerned.

Another factor impacting on the Australian economy, which is still dependent on exports of minerals and agricultural products, is the decline in world commodity prices set off by the Asian collapse. Commodity prices for oil, raw materials and base metals declined 3 percent in May, following an 11 percent decline in the second half of last year.

The price of metals and agricultural commodities have fallen by a quarter since 1995, while energy prices are down by more than one third since the end of 1996.

The Asian collapse has had a major impact on prices because these countries were important consumers during the boom. Asian developing countries accounted for two-thirds of the increase in world petroleum consumption between 1992 and 1996 as their share of world demand rose from 12 percent to 15 percent. Similar increases were recorded in the consumption of base metals, rubber, grains, fats and oils.

Falling commodity prices, especially for oil, are also one of the factors behind the Russian currency crisis which erupted last week when the government was forced to lift overnight interest rates to 150 percent. Pointing to Russia’s sensitivity to commodity prices, Zurich economist David Hale last week dubbed the Russian rouble the “Australian dollar of Europe.”

There is no suggestion at this stage that the Australian government may be forced to follow the Yeltsin regime and turn to the IMF. But the signs of financial crisis are growing.

Moody’s Investor Services announced last week that it was placing the currency debt ratings of neighbouring New Zealand on review for a possible downgrade. Moody’s has also announced that the debt ratings of three major Australian companies — BHP, Amcor and Pacific Dunlop — considered to be blue chip industrial stocks, are likely to be downgraded following a review.

In the face of the mounting crisis, the government is insisting that Australia should not be bracketed with the Asian countries and that the “fundamentals” of the Australian economy are sound.

It is worth recalling, however, that in the aftermath of the Mexican crisis of 1994-95 the British magazine the *Economist* singled out Australia, precisely because of its “fundamentals”, as the country which was the next most likely to experience a financial crisis. In the event, the financial crisis of the 1990s took place in East Asia. But, as every report on the state of world markets indicates, its effects are far from being played out.