

The Asian Financial Crisis - Its Impact on the Australian Cotton Industry

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Introduction

It is very important to understand the nature of the phenomena which have been collectively characterised as the 'Asian financial crisis' or the 'Asian meltdown'. I would like to take you through an analysis of what really happened to provide a context for the outlook for cotton in particular and Australian trade in general. A good understanding of the events is also necessary before we can attempt to draw out any lessons from the experience.

Location of the crisis

When we speak of the 'Asian meltdown', the immediate picture is one of an entire region in crisis. This is not the case, or at least not entirely. Only 5 of the economies (Thailand, Indonesia, Korea, the Philippines and Malaysia) suffered serious difficulty relating to currency problems. Other countries on the Pacific rim (China, Japan, and Australia, for instance) are feeling the repercussions of these events, but like most echo effects, the impact is not really comparable to the initial blows felt by the 5 nations in question. Nevertheless these countries are facing significant difficulties of their own.

The situation is bad enough as it is, but a true Asian meltdown would have us in a much worse position. This is cold comfort for the cotton industry, of course. Even by isolating the crisis to those five markets, we are still talking about the destination of almost exactly 50% of 1997 cotton exports.

Nature of the crisis

Just as the crisis only affects some countries, the nature of the crisis varies between them. There are some common factors, not the least of which is that all the currency collapses happened within a very short period, but each country also had very individual difficulties and responses to the crisis.

Common factors

The common factors in each case included the following items. Each country had experienced high rates of economic growth for an extended period, with much of this being funded by external investment. There were therefore high levels of external debt, although it varied as to whether this debt was more in the hands of the

Government or of private interests. Debt was usually denominated in a foreign currency (typically US dollars) and therefore vulnerable to a slide in exchange rates.

However, while foreign investment and market sentiment remained strong, there was little threat to the exchange rates of these countries.

This was a strategy well suited to the 1960's and 1970's. With the development of computer trading of stocks, large pools of very mobile investment funds ('hot money') and more sophisticated means of manipulating money markets, the position of these, and other countries, became more vulnerable. Whether the accusations regarding particular financiers were well founded is irrelevant - the important point was that if market sentiment turned very bearish, investors could take significant funding out of an economy very quickly.

A vicious circle of falling exchange rates leading to further withdrawals of funds (as investments became less profitable) and causing more falls in the exchange rates now existed. Loans denominated in foreign currencies quickly became unserviceable.

The world responded with rescues co-ordinated by the International Monetary Fund (IMF) with voluntary contributions from a number of countries. These were not gifts, but loans intended to take the pressure off ailing economies. The IMF also imposed fairly strict conditions on receipt of the funding, designed to return countries to a stable economic position as quickly as possible. The pain imposed by the cuts to public spending and the curbs on borrowing and lending led one Korean hairdresser to advertise an IMF special - **first** the cut, **then** the perm.

The austerity measures imposed meant that most banks were suddenly unable to issue letters of credit, as their lendings were already well in excess of the IMF guidelines. In turn, Australian exporters had to find banks in Australia willing to bear the risk, when most banks were reluctant to increase exposure to the countries in question, find commercial insurance or carry the risk themselves. They were facing a credit crunch applying as if by design to international trade.

This situation could not last.

Before looking at Australian responses to the problems, however, we also need to consider what aspects distinguished the markets from one another. To repeat, this crisis was specific to a very few countries, and happened under different conditions.

Distinguishing factors

Both Korea and Malaysia had the key characteristic of a strong underlying economy. Despite levels of foreign debt in Korea and a perceived thinness or vulnerability to

speculation of the Malaysian market, both were seen essentially as having the fundamentals right.

Ironically, the attempts of the Malaysian leadership to blame the country's economic woes on outsiders alone proved damaging to the economy as it increased the level of investor nervousness, rather than calming the market.

Indonesia, on the other hand, genuinely had significant economic weaknesses. The perception of less soundness in the integrity of economic structures encouraged investors to withdraw at the first opportunity. The large amount of private (not government) foreign debt made the system much less malleable to economic correction through policy adjustments.

The significant rigidities in the Indonesian system included food subsidies and price controls, which were seen as political touchpoints. The early attempts to blame problems on the ethnic Chinese community led to civil unrest becoming more likely, rather than less. The Indonesian Government's unwillingness to change obviously flawed practices (as opposed to implementing overly strong IMF prescriptions) further undermined confidence in the rupiah.

As if all of this wasn't enough, both Thailand and Indonesia were suffering from the effects of an El Niño-induced drought. The cumulative effect of drought and smoke from forest fires which blocked off the sun on Indonesia led to the worst agricultural conditions in 50 years at the time when Indonesia could least afford imports.

Impact on rural exports

Although rural exports received much of the focus, we should not lose sight of the fact that Australia's minerals exports met with quite a bit of difficulty, while manufactured exports to the countries become largely unaffordable except in the case of key production machinery.

Horticultural exports, considered a luxury item in these markets, almost completely ceased. The live meat trade to a number of the markets was being described as "dead in the water".

Cotton, wheat and sugar were the 'big ticket' Australian crops which were affected.

Short term

The current weakness in the Japanese economy is helping no-one's recovery, as it is keeping exchange rates low. Despite the increased competitiveness that this offers, the consequent increase in the burden of foreign currency denominated debt that low exchange rates cause means that the countries are maintaining high interest rates to defend the exchange rates. High interest rates lower investment, so a short, or even

medium term spurt in production capacity is not likely. This may delay longer term recovery.

Korea

The short term outlook for Korea is gradually improving. Tight fiscal and monetary controls have been effective in lowering debt. Public appeals to contribute personal stocks of gold and jewellery, as a means of paying off debt, have been remarkably successful. These contrasted with the early Indonesian experience, in which decisive action could possibly have averted investor panic.

The key for Korea may be in Japan, its major market. A Japanese recovery would stimulate the entire region, but none more than Korea.

Indonesia

Indonesia, of course, has undergone the greatest changes. The Habibie Government has the difficult job of ensuring that some economic fundamentals involving competitiveness are restored to the economy while being cognisant of entrenched interests. The Australian Government has pointed out the difficulties Indonesia faces, with the IMF seeking a complete change in corporate culture.

Indonesia has the most volatile position, with swings in the value of the rupiah still making investment in the country a difficult proposition. For Indonesia, the single greatest challenge will be to restore faith in Governmental processes, both from within and outside the country.

Others

The other countries in the region have been somewhat indeterminate in outlook. Thailand has been suffering some setbacks, especially due to El Niño effects. The Philippines has seen the election of a new Government, with all the uncertainty that is implied. Malaysia has had both gains and reversals, mostly attributable to domestic factors and to the Japanese troubles. Other economies in the area, particularly Singapore and Hong Kong, have also come under pressure. Property speculation has appeared to play a key role in some of the losses currently being experienced. In the short term, each of these can expect difficulties, but not disasters, as they seek new markets for their goods and battle the effects of lower currency values or pressures to devalue.

Medium and long term

It would be brave to make determined pronouncements as to the likely future of these countries further down the track. However, I have been asked to do so and I'll put forward a couple of points for consideration

Expect to be surprised

Some countries will move against the trend for any number of reasons. In addition, some industries, including cotton, may not follow the general trend in particular countries or across the board. The cotton industry is well known in Australia for its risk hedging arrangements and sophisticated marketing tools. Futures and currency hedging have already much reduced the impact the current situation might have inflicted on the industry. You will need these and other methods over the coming few years to avoid being ambushed by unforeseeable market developments.

The scramble to diversify

Market access and market development will be important to take off what might otherwise be world production surpluses. There will be stiff competition, both commercial and Government-backed, to develop and hold new markets or supplant existing suppliers in established markets. More than ever before, information and contacts will be at a premium.

Expected effects on cotton exports

Cotton exports, looked at from a purely Australian viewpoint, will be affected by their competitiveness and effects on cotton consumption

Competitiveness

The short analysis of the situation is that our forward contracts are set in US dollars, hedged against excessive variability. To the extent that our customer also hedged, much of the direct effect of currency movement is mitigated. Where the customer instead chose to bear the risk, the price from their point of view may have doubled (in Korea) or quadrupled (in Indonesia) long before delivery was to take place. The Australian cotton trader will have already contracted a price to the grower and to the extent that currency movements allow flexibility, might be able to negotiate downwards the US dollar price of the contract without damaging profitability. Of course, if the customer does not survive commercially, the trader will need to be covered against risk.

Australia is better placed commercially than our major competitor in these markets, the US, due to the exchange rate movements. Of course, commercial considerations are not the only factors at play. I'll address Government intervention shortly.

Other contributors to competitiveness are cotton quality, and shipment time. In the past these brought premiums to the industry. Now, the Australian reputation for quality product and timely delivery present something even more valuable - preferred supplier status in a limited market.

Expected effects on cotton consumption

Perhaps the largest question mark hanging over our exports is not who will buy from Australia, but who will continue to buy at all.

I've discussed price competitiveness against other cotton exporters, but we have to look more broadly. With foreign exchange becoming scarce it becomes a critical matter for Governments to decide on what that currency will be spent. The general policy imperatives will dictate that food and strategic industrial supplies will head the list. In this, cotton is fortunate.

It is an input to the textiles and clothing sectors of the major exporters of finished product. The currency movements have made the output of these already-competitive manufacturers even cheaper in the export markets. Those manufacturers who are not struggling under highly leveraged foreign-currency debts are therefore in a good position and are prized by their Governments as currency earners.

Their competitiveness is offset by the necessity to charge considerably higher prices on their domestic market, however. Since this applies to many goods, including food, domestic populations have effectively had their disposable incomes lowered, leading to a fall in demand.

Finally, cotton also continues to face the challenge from synthetic fibres and yarns. In some countries, the high local cost component (which has not risen with exchange rate falls) of converting petrochemicals into yarn has increased the price advantage of the synthetics.

In summary, it's a mixed picture best summarised as presenting cotton as a high priority product in an unstable and possibly declining total market. The total market for finished products may increase due to increased cost competitiveness, but another factor has arisen that works against the market trend.

Protectionism

The greater international competitiveness of yarn, textile and clothing manufacturers has also led to calls for increased protectionism to prevent entry of lower priced textiles into countries which have not suffered exchange rate falls.

To a degree, the exporters will be protected by World Trade Organisation (WTO) disciplines, especially where importing countries have tariff levels which are already at their maximum agreed potential levels (known in the jargon as the 'bound rate'). Where the existing tariff is lower than this, countries are free to increase tariffs up to the bound rate if they wish. However, the possibilities of retaliatory increases always need to be borne in mind.

Export oriented industries such as the cotton industry can only view such developments with worry.

The Government's responses to the crises

So what has the Government done to help our primary industries in a time when they are suffering damage to their exports? You will all be aware of the importance the Government places on our primary industries. Exports from this sector are valued at over \$16 billion every year, while imports are less than \$4 billion. Maintaining our export capacity is crucial to the country's health and particularly the health of rural Australia.

Limitations to our capacity to respond

Government is often viewed as having free reign to do anything it likes, but it seems to hold back from taking the necessary actions through an inability or unwillingness to understand the plight of which ever sector requires assistance.

Of course, it's not that simple.

I mentioned a short time ago how WTO disciplines prevent the downstream products of your industry being taken out of the market by protectionist measures. Australia fully supports the WTO because fair trading is to our advantage.

It is especially to the advantage of the rural sector. We have everything to lose from trade retaliation and little to gain. In an industry that exports up to 95% of its production, you would be the first to appreciate this point.

Secondly, we have to look beyond the present. If we take actions now that compromise our ability to gain market access later, or establish precedents that allow the major trading powers to subsidise exports and distort markets, we will lose in the end.

So we limit our actions to those which are consistent with the trade rules which we want everyone to follow.

Other countries appear to be exploring the option of easy credit at very low rates repayable over years or even decades. We are not. Why?

Apart from Australia's belief that such measures are at best dubious under WTO rules, the Australian cotton industry would directly bear the cost of subsidising overseas buyers. Australian suppliers, who currently utilise forward sales and offer little credit, would be expected to continue to sell on credit terms, long after the crisis had vanished over the horizon.

These and other considerations led the Government to take the action that it did.

Korea

In Korea, the Government authorised the Export Finance and Insurance Corporation (EFIC) to insure up to \$300 million worth of trade, to meet the gap generated by the inability of Korean banks to issue letters of credit and the unwillingness of Australian banks to exceed their 'country limits' i.e. expose themselves to more than a preset amount to any given country.

The insurance was on a 'national interest' basis, which covers all eventualities, and for which exporters pay EFIC's normal commercial rates plus 25%. The cost of the insurance, of course, makes this cover the insurance of last resort as is intended. EFIC also evaluates the credit-worthiness of each proposal and may refuse proposals that it finds too risky. This protects the Australian taxpayer's investment.

Indonesia

In Indonesia, the Government has authorised considerable amounts of cover for wheat and cotton exports in particular, as these are the highest priority imports for the country. The Government has taken a number of actions to protect against significant levels of default on EFIC insurance.

In both Indonesia and Korea, trade which would have otherwise been interrupted has instead taken place.

Others

In addition, Australia has, for its size, been a strong contributor to IMF bailouts of embattled Asian economies. At the time, the Government received a great deal of poorly informed criticism. The bailout funds were loans, lent at market rates and had the effect of enabling Asian economies to continue to purchase Australian exports.

The IMF bailouts imposed quite stringent conditions on recipient economies, designed to assist them to restructure towards a market oriented basis as quickly as possible. In the event, sometimes the IMF prescriptions were too difficult for the economies to absorb, and the Government played a lead role in convincing parties to soften the blow while urging its Asian partners co-operatively address the problems of restructuring.

Throughout this episode, the Government has attempted to play a constructive role, preserving existing trade relations through diplomacy and through legitimate trade measures. The long term benefits are expected to be a deepening of relations with

our major trading partners while preserving the integrity, and therefore the value to Australia, of international fair trading agreements.

It is worth noting that by taking on risks higher than the market could support, the Government was able to orchestrate the continuance of trade without a large upfront cost. Only time will tell, but it may be that the industry will benefit from EFIC cover being available, while the taxpayer makes a profit from the provision of that cover.

Lessons for the cotton industry

The Australian cotton industry has always held one great comparative advantage over its international competitors - its capacity and eagerness to learn. A number of lessons have been offered by the Asian currency crisis.

Market diversification

Cotton was hit harder than it might have been by concentrating over a third of all exports on one market. When the Indonesian market took the most damage from the crisis, commodities which relied on that market were most at risk. It may well be worth the industry considering how to further diversify its markets so that nothing short of a world recession would affect it.

It should, however, be recalled that cotton feeds in to industries which by their nature are more concentrated in the developing world. As such, cotton can always expect to be more vulnerable than items which are sold equally to richer and poorer economies.

Longer term issues for risk management

For the longer term, the industry might take on board some considerations which had seemed less important in earlier days. The effect of country limits combined with forward sales means that in future traders might do well to look at the potential for cover from banks if the unexpected occurs. How near the country limit is your proposed insurer already? Have you an alternate in mind?

Another avenue which may be worth following up is to establish and maintain relations with EFIC as a matter of course. The industry, or individual traders, by becoming known to EFIC may be able to very quickly access cover when their standard options fall through.

Government's commitment to export and partnership with the industry

One valuable lesson is this: the Government moved quickly to ensure that valuable exports were not displaced either by unforeseeable and widespread economic events nor by the attempts of other Governments to take advantage of the situation.

While lessons of the past make the Government less willing to intervene in normal business cycles, it was clearly evident that the Asian currency crisis did not fall into that category. When Governments attempt to "smooth out" the peaks and troughs that characterise an economy, the cure can sometimes be worse than the disease. However, in this instance, the problem was rapidly analysed and a solution consistent with Government policy produced and quickly implemented.

Conclusion

The Asian currency crisis is by no means over. A number of commentators have indicated an opinion that at least a year, and possibly much more time will be required before the 'Asian economic miracle' can reassert itself. When that does happen, it will in all likelihood be a changed entity.

The Australian Government will keep working in the interim to ensure a number of goals are achieved:

export industries, such as the cotton industry, will be monitored and difficulties imposed by the Asian crisis will be addressed as necessary

action will be taken to prevent poaching of existing Australian markets under the guise of trade assistance

Australia will maintain a high profile, healthy trading relationship with its valued Asian partners

positive support will continue to be provided through Government Departments and agencies, particularly Austrade, and through the use of Australian aid programs and mechanisms such as EFIC.

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