

Coping with the emerging markets crisis: a view from the markets[†]

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1. Introduction

From a market perspective, the emerging market crisis began with the float of the Thai Baht on 4 July 1997 and spread quickly through a wave of speculative attacks on other Asian markets. But it was when the Korean economy deteriorated and the government was forced to approach the IMF for assistance that many market participants began to take the issues more seriously. Effectively this occurred a year before the symposium at which this article was originally presented. (I have tried to present the information as it was at the time of the symposium, but this article also updates for more recent data.)

Australia has to date come through the crisis in much better shape than had generally been predicted. Indeed, given that the decline in growth in emerging countries in the Asian region turned out to be greater than forecasts in the early stages, the growth impact on Australia was even less than the most optimistic of forecasters had predicted. The noted American economist, Paul Krugman, dubbed Australia 'The Miracle Economy' and claimed to be unable to understand how this outcome had been achieved. This article attempts some simple explanations of what went right in the Australian economy and how market players and others failed to appreciate some of the dynamics involved.

2. What we trade is also important

The first mistake that market players made was to observe that Australia sends around 65 per cent of its exports into the Asian region, a much higher

[†] An earlier version of this article was presented at the AARES Symposium, The Asian Crisis and the Australian Agricultural and Resource Sectors, held in Sydney on 20 November 1998.

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percentage than any other developed nation (see table 1). It was a simple matter to assert that because of these strong trade interlinks, the impacts of slower growth in the region would be strongly felt in Australia.

But much of what Australia exports to the region is commodity based, with tourism services also of increasing importance. From the start of the crisis my Australian colleagues and I urged both our international colleagues and our clients to remain mindful of this. As table 2 shows, the initial response of global forecasters seriously underestimated the impact on the emerging Asian markets of the policies that their governments were forced to pursue to stabilise their own economies. Such forecasts generally presumed that there would be a move to current account surpluses as countries sought to maximise exports whilst limiting imports wherever possible.

As it turned out, the impacts on domestic demand in particular in the emerging markets were more severe than had been anticipated. But the

Table 1 Trade matrix: per cent of total exports

Importing country	Exporting country			
	Australia	Japan	US	EU
ASEAN-4	10.2	12.1	4.1	1.7
Korea	8.4	7.1	4.4	0.9
Hong Kong	3.9	6.3	2.4	1.1
China	4.3	4.9	2.0	1.0
Taiwan	4.6	6.5	3.3	0.7
Japan	23.0		11.0	2.2
Asia	65.0	43.6	30.9	9.3
Rest of World	35.0	56.3	69.1	90.7

Source: IMF.

Table 2 Growth forecasts (percentage change, year on year)

	Pre-Crisis	November 1997		March 1999	
	1998	1998	1999	1998 ^a	1999
Industrial countries	3.0	2.9	2.6	2.4	2.2
Asia	6.5	4.7	5.7	0.4	1.9
Latin America	4.8	3.1	3.5	2.4	-1.6
CIS	3.2	3.2	4.0	-4.7	0.6
World	3.5	3.1	3.1	2.1	1.9
Australia	3.9	3.7	3.7	4.8	3.3

Source: Deutsche Bank.

Note: ^a Figures in this column are not forecasts. Some were estimates made prior to the release of national statistics.

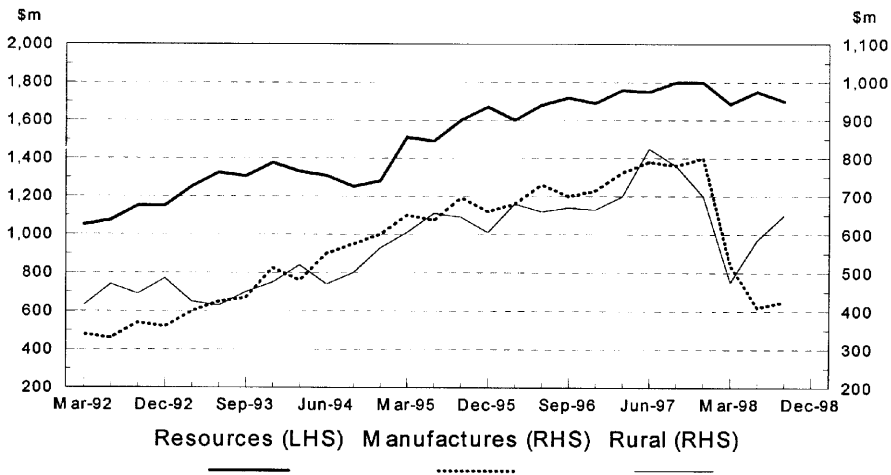


Figure 1 Australian merchandise exports to troubled Asia (seasonally adjusted)

Source: ABS, Deutsche Bank.

fundamental flaw in the logic was the failure to appreciate the nature of these countries' trading patterns. Taking Korea as an example, roughly 50 per cent of all imports would be classified as capital goods, 40 per cent as intermediate goods and 10 per cent as consumer goods. Given the priorities in such an economy, the best-placed trading partners (or least-worst) should be those supplying inputs to the production processes within the export industries. (This pattern is evident across the region in the pattern of Australia's trade and is illustrated in figure 1.) Put another way, as I told my colleagues in a global forecasting hook-up in November 1997, it is much better to export coal and iron ore into the Korean economy than computerised lathes or luxury motor vehicles. As we will also see below, the fungible nature of Australia's commodity and service exports allowed for other opportunities that did not exist for many other developed economies.

3. Keeping the emerging markets in perspective

As the crisis deepened, many commentators exaggerated the impact on the global economy. In the early days of the crisis, we could be comforted that the problems of the smaller economies would have little effect internationally. After all, in a normal year, the incremental output in China would account for Malaysia's GDP in just six months and Thailand's within another twelve. The impact of slower growth was always likely to be more

marked within the region. In the global recession of the early 1990s the Asian tigers had sustained their growth, at least in part, through an increase in intra-regional trade and the servicing of each other's rising consumer classes. Much of the region's growth came from within and was satisfied from within. In reality, by 1995 non-Japan Asia accounted for only about 22.5 per cent of global industrial production compared with the United States at 22.4 per cent, Japan at 11.7 per cent and the rest of G7 at 21.1 per cent.

From Australia's perspective, the importance of the US cycle should not be underestimated. Though the direct linkages are low (we run our largest trade deficit with the United States), the United States is an important market for many of our trading partners and this is what links our growth cycles as closely as figure 2 illustrates.

US growth has similarly surprised commentators with its strength. Though not as likely to have been influenced by a downturn in Asia, the US economy was already over seven years into a growth phase when the crisis hit. But policy authorities in the United States did not tamper with the cycle. Inflation remained benign, and the disinflationary influences from global excess supply that the emerging crisis had highlighted, combined with a strong currency and flexible economy to allow the policy authorities to remain on the sidelines. In the United States, the Federal Reserve's Open Market Committee was eventually called into the fight to ease monetary policy on three occasions, but as a precaution against systemic risks in financial markets as crisis conditions also emerged in Latin America and Russia. Strong US growth, however, was exactly what the times required.

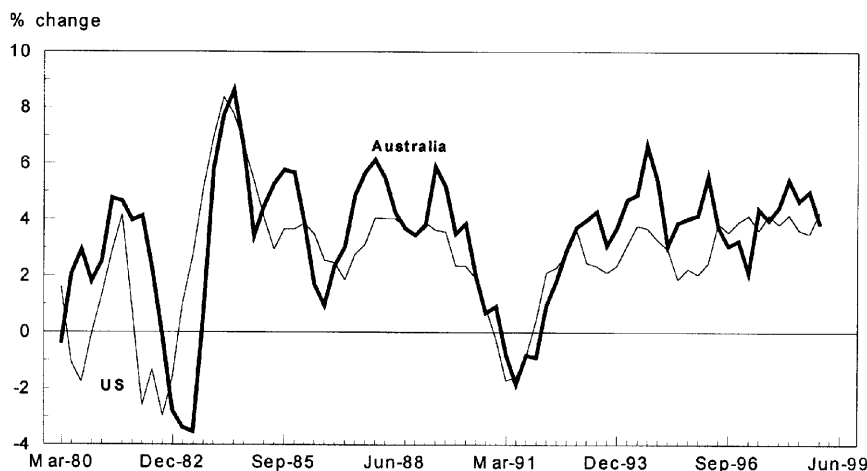


Figure 2 Real growth in Australia and US (4 quarters ended, per cent change)

Source: Datastream International, Deutsche Bank.

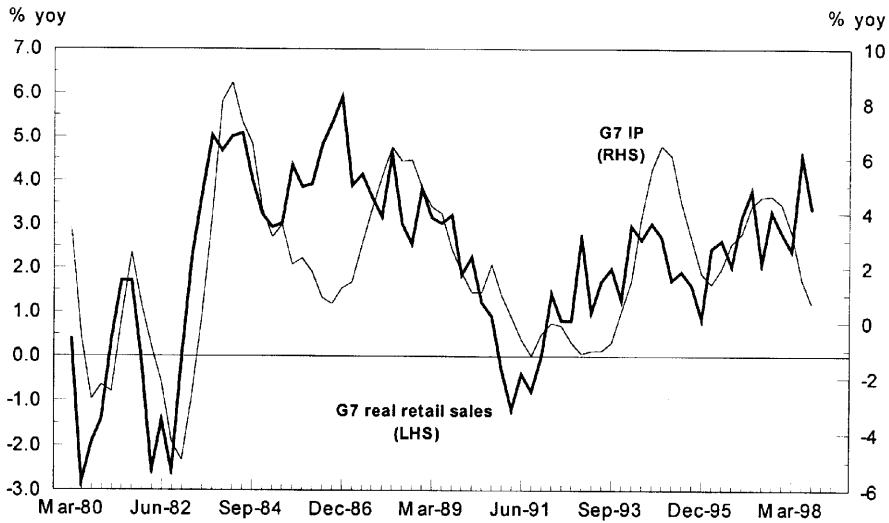


Figure 3 Working off excess supply

Source: Datastream International, Deutsche Bank.

Growing markets in North America, and to a lesser extent Europe, provide the outlet for emerging market production that potentially allows for all countries to export their way out of the crisis. As figure 3 shows, 1998 saw a substantial wedge emerge between G7 demand and G7 production. One way that this circle is squared is through international trade, as demand is satisfied by emerging country production.

4. Australia was in good shape when the crisis hit

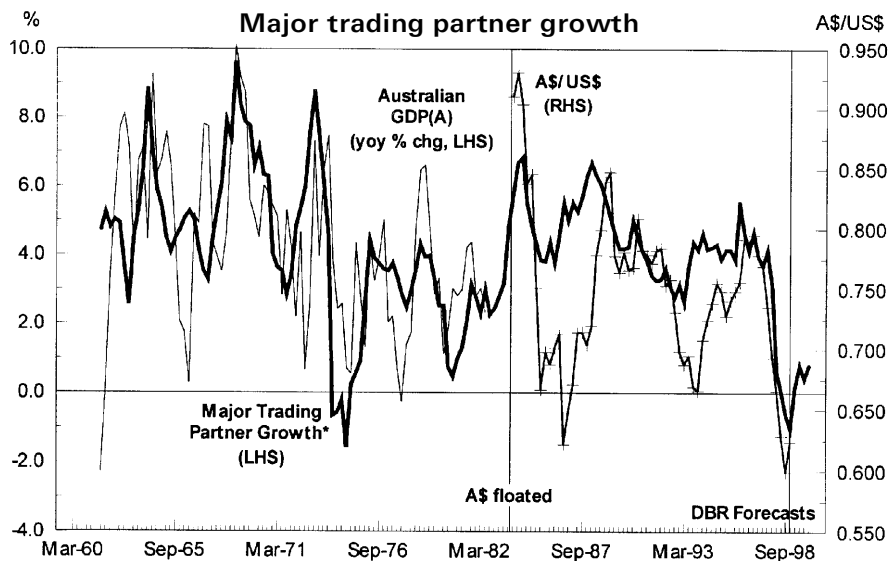
Compared to the underlying structure of the economy just over a decade earlier, when the then Treasurer Paul Keating warned that Australia faced a future as a 'Banana Republic', the Australian economy was travelling well when people began to worry about Asia. This allowed the policy authorities the room to move, or more precisely, the ability to tolerate some wild fluctuations in financial markets without needing to respond. As table 3 shows, Australia had above trend growth, inflation below the Reserve Bank's 2 to 3 per cent target over a run of years and a current account deficit near the bottom of the levels of recent cycles. Interest rates were also at the lowest levels for 30 years and bond spreads were favourable — indicating some degree of investor confidence in the sustainability of these policy settings. In addition, the Commonwealth Government's Budget had just returned to underlying surplus.

Table 3 Australia: then and now

	June 1997	December 1998
GDP	3.7	4.7
Underlying CPI	1.7	1.6
Current account deficit (% GDP)	3.3	5.4
Cash interest rate	5.5	4.75

5. The importance of the exchange rate

When Paul Krugman professed that he didn't understand the Australian miracle, it seems that he forgot the Macro 201 lecture about the power of floating exchange rates. Indeed almost all forecasters forgot the message that a freely floating exchange rate in a small open economy will bear much of the brunt of any external shocks. Market economists have much to be modest about in this episode. Figure 4 looks at Australia's major trading partner growth performance (adjusted for the changing composition over time). In the pre-float period external shocks were reflected in the real economy, but in the post-float period, and in particular in the latest episode, the real economy has been insulated by adjustments in the exchange rate.

**Figure 4** Major trading partner growth

Note: * Calculated using annually adjusted weights from 1981–82 and Australia's top 10 export destinations. Prior to 1981–82 calculated using top 7 export destinations with weights fixed for seven year periods
Source: ABS, Deutsche Bank.

Unlike Australia, both Canada and New Zealand used a monetary conditions index (MCI) approach to monetary policy, tightening short-term interest rates to stave off the inflationary consequences of lower exchange rates, and even to try to reverse the exchange rate declines. In the case of our neighbours across the Tasman, this all but produced a domestic recession even though their principal export market (Australia) was continuing to grow at a surprising pace.

The Australian dollar was also the 'victim' of what might be termed proxy selling. With market perceptions about Australia's economic fortunes being tied to emerging Asia, this exaggeration offset the overly optimistic early forecasts for Asian growth. Australia remained a liquid foreign exchange market and there was little political risk of its markets being closed. Traders who had become more risk averse traded the Australian dollar as a proxy for any bad news out of Asia rather than risking direct involvement with emerging markets.

At the same time, for almost exclusively domestic reasons, the Japanese economy was deteriorating. This deterioration led to a fall in the yen against major currencies, and bad news in Japan was seen as a source of further stress for non-Japanese Asia. As a result, both the Japanese yen and the Australian dollar fell almost in lock step in the year from July 1997 (see figure 5), prompting many to believe that a new link was emerging. (It is well understood that most external shocks will impact in opposite ways on the two economies so there is little justification for any link of the Australian dollar to a Yen-bloc.)

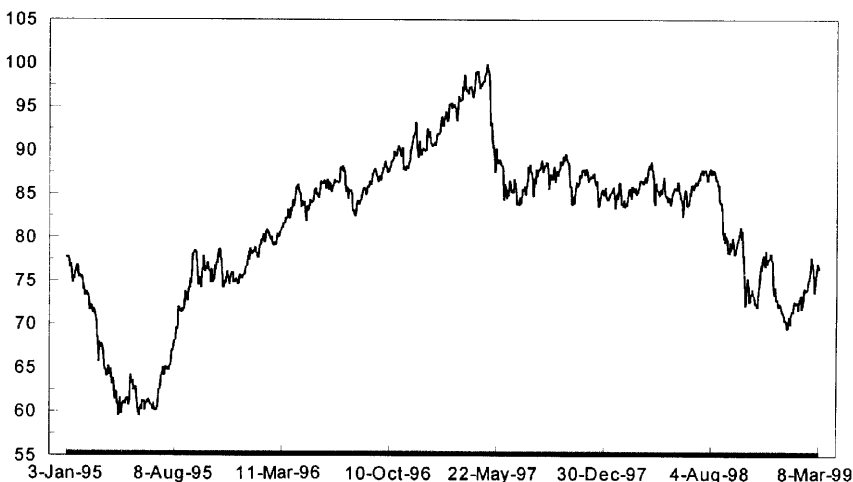


Figure 5 Australian dollar/Japanese yen

Source: RBA, IRESS, Deutsche Bank.

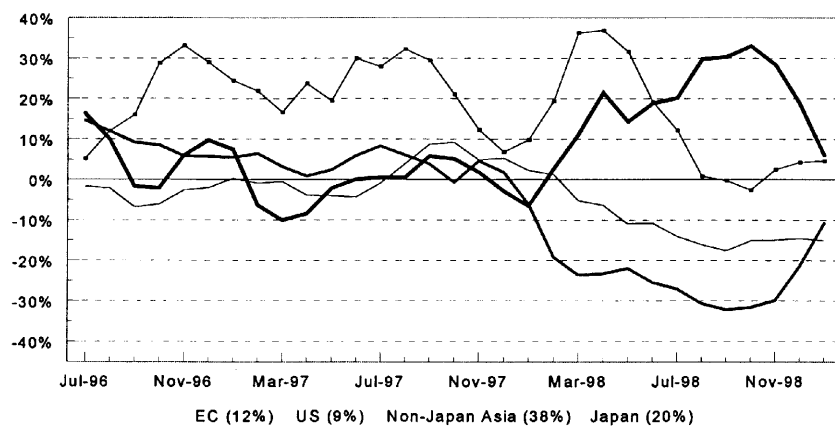


Figure 6 Australia's exports by major destination (US\$, % year on year, 3-month moving average)

Source: ABS, Deutsche Bank.

The lower Australian dollar was also an important element in the export diversion story. Though we had lost competitiveness and even some markets in Asia (see figure 1), our competitiveness across a range of commodities, goods and services against European and North American producers had risen (see figure 6). In aggregate, export volumes regained pre-crisis levels quite quickly (see figure 7), while the heavy decline in Asian tourist arrivals (see figure 8) was largely covered by a surge in arrivals from Europe and North America (see figure 9), much of which was driven by a favourable shift in the Australian dollar.

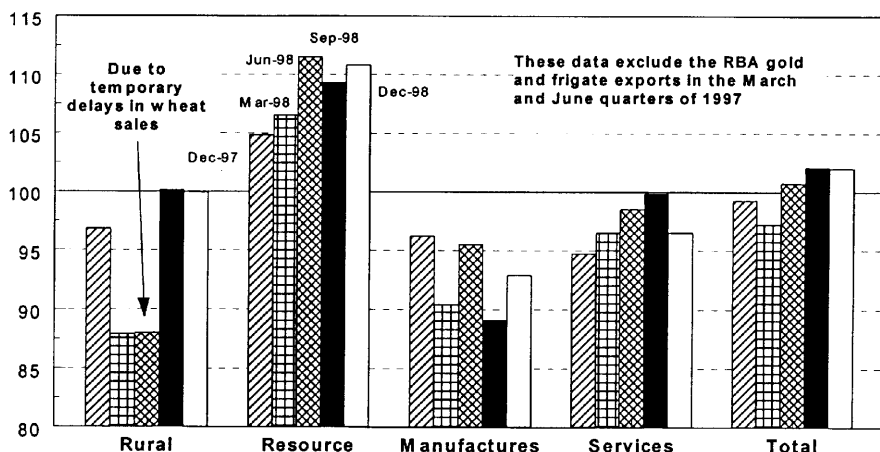


Figure 7 Australian export volumes (Index Sept 97 = 100)

Source: ABS, Deutsche Bank.

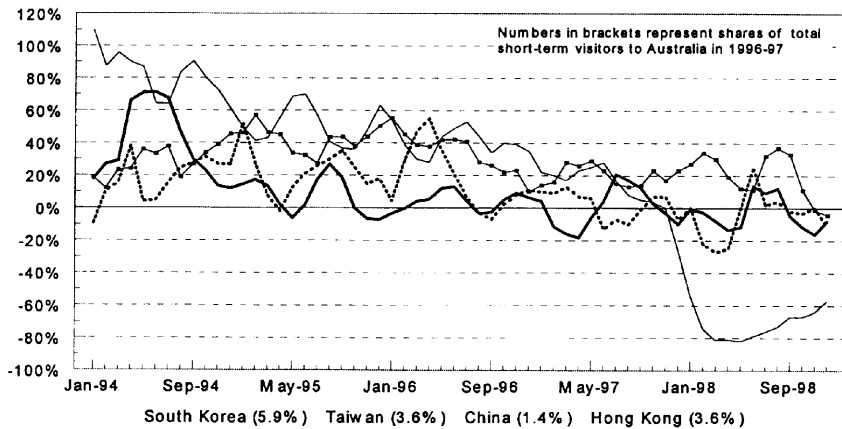


Figure 8 Tourist arrivals by country of residence (% change, year on year, 3-month moving average)

Source: ABS, Deutsche Bank.

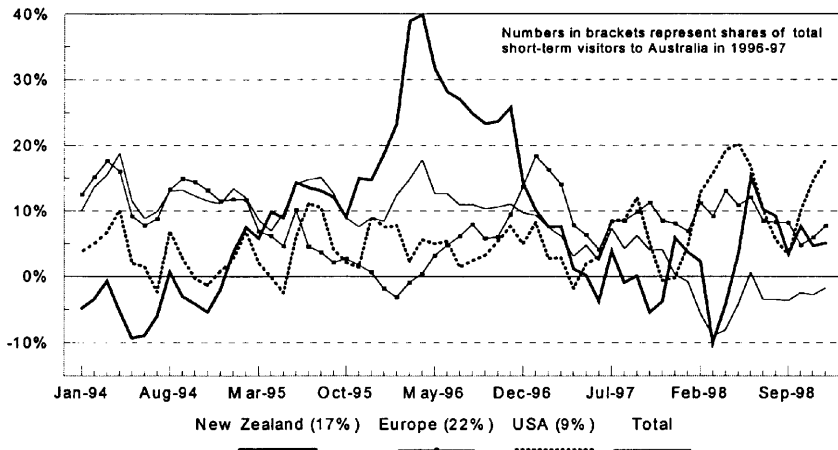


Figure 9 Tourist arrivals by country of residence (% change, year on year, 3-month moving average)

Source: ABS, Deutsche Bank.

6. The importance of domestic conditions

The final element in understanding how Australia has coped with the Asian crisis is to appreciate the importance of domestic economic conditions in determining growth outcomes. In the year prior to the crisis, domestic final demand accounted for 99.9 per cent of Australia's output. Traditionally net

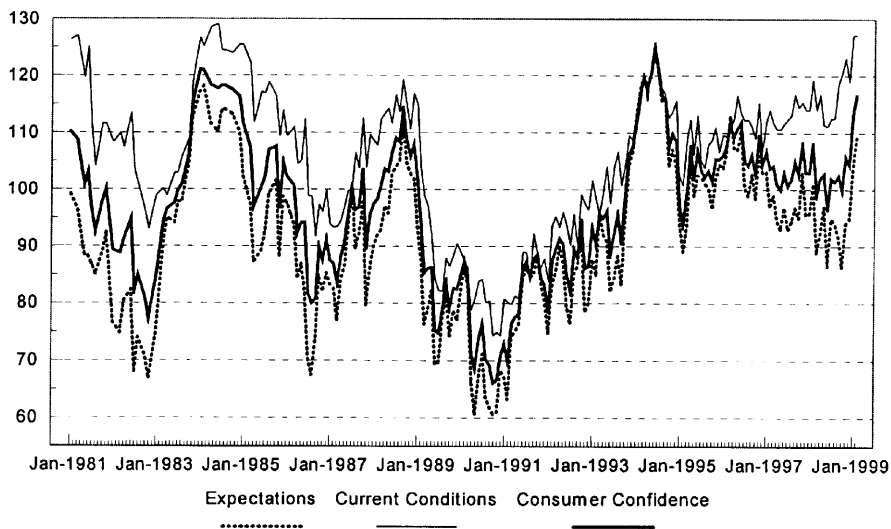


Figure 10 Consumer confidence index

Source: ABS, WBC/MI, Deutsche Bank.

exports and changes in stocks adjust to offset each other and are buffers to domestic production.

In the early stages of the crisis, domestic consumers and businesses, faced with dire predictions and gloomy news stories, began to fear the economic outlook for the coming year or so. But as figure 10 shows, there was a dichotomy between assessments of current and future circumstances. In the Australian vernacular, consumers were saying 'I'm all right Jack'. Confidence in current conditions rose to the highest level in the present cycle at the same time as assessments of future conditions fell to cycle lows. As employment growth picked up in the second half of 1998, confidence in future conditions also recovered, driving overall confidence higher. This sets up the virtuous circle of increased confidence resulting in higher consumer spending, leading to increased employment and further rises in confidence and so on. Effectively consumers (and their business counterparts) began to notice that Jack was all right too.

7. Conclusion

Much of the analysis that takes place in financial markets is based on the KISS principle (keep it simple, stupid). Market economists apply their training to looking for and explaining correlations between economic data and market behaviour. This article has tried to show where the reality of the emerging markets crisis and its impact on Australia diverged from early

expectations. Some of these possibilities were being flagged relatively early in the debate while others have become clearer with the advantage of hindsight.

It may well be that not all of the explanations proffered in this article would stand up to more rigorous assessment using econometric techniques. But market participants, and those who advise them, must form judgements quickly and act upon them. Often, this means that markets act out of instinct, and the instincts of the mob are often a powerful force. Those who are the first to make accurate assessments of the eventual outcome will be the first to see opportunity in what others perceive as a threat.

The better-than-expected performance of the Australian economy has been not so much a miracle, and certainly not some overnight flash in the pan, but the result of changes made over the past decade and a half. The most significant of these in the circumstances was the December 1983 decision to float the Australian dollar. But also important was the determination by the Reserve Bank that the float should remain clean and to place considerable faith in the market mechanism as a means of transmitting appropriate adjustments to the economy.