FROM HEALTH CRISIS TO FINANCIAL CRISIS: THE ROLE OF AUSTRALIA'S FINANCIAL SUPPORT IN PREVENTING DEEP CRISES IN ASIA

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What started as a health crisis has quickly become a financial crisis. COVID-19 has unleashed a surge of financial crises across the developing world. Ecuador and Zambia have been the first to default and Argentina has postponed negotiations with creditors (Wallace 2020). Turkey, Lebanon and Rwanda look increasingly vulnerable and the International Institute of Finance warns South Africa is next (IIF 2020). More than 100 countries have approached the International Monetary Fund (IMF) for help since January 2020 (IMF 2020). If collapses in exchange rates are an indication of who might follow, Brazil, Russia and Mexico are at the top of the list.

Indonesia is on the front line in Asia. The rupiah lost almost 20 per cent of its value from January to April, with Thailand and Malaysia not far behind. South Pacific economies, such as Fiji, are similarly facing difficulties (Sayed-Khaiyum 2020). Emerging economies in Asia face a perfect financial storm, facing the largest capital outflows in history (International Institute of Finance 2020a). Collapsing exchange rates mean foreign debts are increasing in size while the foreign incomes used to finance those debts have collapsed as their exports stall, tourists flee, commodity prices fall and investors scramble. An inadequate global financial safety net means Asian economies are left to fend for themselves (Triggs 2020; IMF 2016; Denbee *et al.* 2016; G20 Eminent Persons Group 2018). Years of reform

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have substantially strengthened Asian financial systems and built significant buffers, but nothing could have prepared them for the scale of the COVID-19 financial shock.

Australia can help, and it has an incentive to do so. This paper explores the incentives Australia faces in helping ensure the financial stability of Asia's emerging economies and outlines practical ways Australia could help deliver it. Australia should extend and expand its network of central bank currency supports in the region, substantially boosting financial stability which, under any realistic scenario, will be costless to the Australian Government. The paper explores other actions Australia can take using its membership in regional and global institutions to support Asia and strengthen Australia's standing in the region.

The perfect financial storm hitting Asia

Emerging economies in Asia face a perfect financial storm of events. First, they have significantly weaker healthcare systems, weaker social safety nets and large informal sectors. This makes the virus spread faster and more difficult to contain. The substantial investments required to bring healthcare systems up to speed impose a significant burden on Government budgets. Weak social safety nets and high rates of poverty make social isolation and social distancing difficult. Large informal sectors mean getting government support to those who need it is a challenge.

Second, many Asian economies have large amounts of foreign debt. Indonesia alone has $410 billion of foreign debt (Bank Indonesia 2020). As COVID-19 sends investors fleeing, these economies have seen their exchange rates depreciate while the safe haven currencies in which their debts are denominated have gone up in value (*e.g.* the US dollar). This has caused the size of these foreign debts to increase substantially, making previously sustainable debts problematic.

Third, the cost of servicing these debts has risen quickly. Interest rates on government debt (10-year government bonds) have increased 25 per cent in Indonesia since the beginning of March 2020 as investors sell these assets (Bloomberg 2020). Governments already facing fiscal pressures from the health crisis must now devote more of their budgets to financing foreign debts.

Fourth, much of this debt needs to be refinanced given it was borrowed short-term. India needs to rollover $150 billion of government debt in 2020 alone (*The Economist* 2020). For Indonesia, it is $44 billion (Bank Indonesia 2020). Emerging economies are seeing the largest capital outflows in history. The International Institute of Finance has warned that a sudden-stop, where an economy is no longer able to borrow internationally, is preventing some countries from refinancing their foreign debts (International Institute of Finance 2020a).

Finally, while these debts and the cost of servicing them are rising, the foreign incomes used to repay these debts and the interest on them is falling. The global drop in trade, commodity prices, oil prices and international tourism has created an unsustainable position for these economies: falling incomes and rising debt (International Institute of Finance 2020b). A circuit breaker is needed.

Why Asia needs help

The financial impacts of COVID-19 are producing a difficult trade-off for Asia's emerging economies. Inflationary constraints and shallower financial systems mean these economies cannot undertake policies like quantitative easing and substantial fiscal expansions to the same extent that advanced economies can (*The Economist* 2020). Instead, they must borrow internationally to finance health systems and strengthen social safety nets to reduce the social and economic cost of the virus. But borrowing internationally raises the risk of financial crises through currency and maturity mismatches. The consequence of this trade-off is too much financial risk and too little fiscal support to fight the virus.

These economies are not to blame. Asian financial systems are managing risk much more effectively than in the 1990s, thanks to decades of reform. Banks are well-capitalised, supervisory frameworks are stronger, exchange rates are more market-determined and better able to absorb shocks (Sterland 2017). Large current account imbalances have narrowed considerably. The absence of high inflation and increased macroeconomic credibility has given Asian economies more monetary and fiscal policy freedom than in previous crises.

Many economies have built large domestic buffers of foreign exchange reserves. These give them the greater capability to finance foreign debts during times of stress. But such reserves are finite. They will only buy

these countries time. If the economic dynamics of rising debts and falling incomes do not change, those buffers will be depleted quickly.

No amount of domestic reform or preparedness could have prepared for a financial shock on the scale of COVID-19. Asia's emerging economies will be forced to rely on what is called the global financial safety net — the collection of bilateral, regional and global institutions and mechanisms designed to help countries facing financial crisis and prevent those crises from spreading. But the global financial safety net is inadequate in several ways (Triggs 2020; IMF 2016; Denbee *et al.* 2016; G20 Eminent Persons Group 2018).

At the global level, the safety net consists predominantly of the IMF and the World Bank. But painful memories of the IMF's mishandling of the Asian financial crisis and the negative political and economic stigma of seeking IMF assistance make the IMF a politically impossible proposition for most Asian economies, particularly those involved in the Asian financial crisis, such as Indonesia (Basri 2019). Precautionary lending — where the IMF provides assistance well before a crisis occurs with limited conditions requiring reform — remains relatively small.

At the regional level, regional financing arrangements have been created to provide emergency liquidity assistance to countries within particular regions, such as the European Union's European Stability Mechanism. The Asian equivalent is the Chiang Mai Initiative Multilateralization (CMIM) which has a lending capacity of $240 billion. But the CMIM is untested. It is not yet operational and many question whether it is workable, given the complex, bureaucratic and politically-charged process required to access it (Sterland 2017). The financing available to individual countries is typically small and if countries wish to borrow more than 30 per cent of their available financing they must be on an IMF program — Indonesia, for example, could only access US$7 billion outside of an IMF program. Development banks, like the Asian Development Bank and World Bank, can also offer liquidity programs but many of the programs previously used have been closed (Basri 2019).

At the bilateral level, the United States has created a network of currency swap lines. These allow central banks to swap their currencies for US dollars with the US Federal Reserve. This gives them vital foreign exchange, reassuring markets that they can finance their foreign debts. But the only Asian economies to receive one are those not facing financial difficulties: Australia, New Zealand, South Korea and Singapore.

Countries such as Indonesia have swap lines with other central banks — including Australia, China and Japan — but many central banks, including Australia, do not allow these swap lines to be accessed during a crisis (Triggs 2018). Loans between finance ministries are another option, but historically these are only provided once a crisis has materialised.

It follows that most emerging economies in Asia have few options available to them. They face deteriorating health situations domestically with limited fiscal space, rising debt stocks, increasing interest payments and falling foreign incomes. Their domestic foreign exchange buffers will buy them time, but only a change in these economic dynamics will remove the threat. In the meantime, they are forced to rely on a flawed global financial safety net which offers piecemeal, fragmented support.

Why Australia should help, and what it can do

There are practical things Australia could do to help, and Australia has a strong incentive to provide that help. Prime Minister Morrison remarked in 2018, for example, that 'Indonesia's success is our success' (Morrison 2018). The data supports this view. Two-way trade between Australia and Indonesia is almost $12 billion a year. Indonesians pour almost $7 billion each year into Australia's universities, mining companies and agricultural sector, and maintain another $1 billion worth of investment in Australia (DFAT 2020). It cuts both ways. Australian households and businesses have more than $10 billion invested in Indonesia (DFAT 2020). Australia's prosperity and Indonesia's have grown together.

Australia's interests are not limited to Indonesia. Asia represents two-thirds of Australia's two-way trade, with 12 of Australia's 15 largest trading partners in Asia. The stock of foreign investment in Australia from Japan, China, Singapore and Hong Kong is growing more than a third faster than that from Australia's major traditional investor, the United States (Austrade 2020). This is forecast to continue to increase. ASEAN countries quadrupled their nominal output value over the last two decades. The Asian region will soon account for half of global GDP (Austrade 2020). Indonesia is on-track to be the fourth largest economy in the world by 2050 (PwC 2017). Since trade and investment are more about geography than anything else, the benefits to Australia from Asia's continued rise will be significant. If Asia does badly, the financial and economic costs will reverberate back onto Australia and around the world.

The economic importance of Asia to Australia is matched by its strategic importance. Australia cooperates with Asia on combatting terrorism, regional security, refugee resettlement, cyber security, the digital economy and regional connectivity. Australia's cooperation with East Asia has become increasingly important to managing US-China tensions and reforming global governance and global institutions.

Australia has much at stake in the region and there are practical and relatively costless things Australia can do to help emerging economies in Asia manage the financial impacts of COVID-19. First, Australia should extend and expand its bilateral currency swap lines. With the backing of Treasury and parliament as necessary, the Reserve Bank should change its policy and make it clear that its swap lines with Asian economies are available during a crisis. These swap lines should then be increased in size to reflect the challenges facing the region from this unprecedented crisis.

In any realistic scenario, the risk to Australia from these swap lines is non-existent. The absolute worst-case scenario is the materialisation of credit risk, where one of these Asian economies completely collapses and its currency loses all value. If this happened, the Reserve Bank would be temporarily stuck with a worthless currency and would have temporarily lost the money it provided through the swap. This scenario is both highly improbable and manageable. If the Indonesian economy were to collapse, Australia would have much bigger problems than a write-down on the Reserve Bank's balance sheet. Even if it did occur, it would mean that Australia would be repaid later than expected once the Indonesian economy eventually recovered.

The much more likely scenario is that these swap lines reassure markets that debts will continue to be financed and, consequently, are never used. This has been the historical experience. Investors can create a self-fulfilling prophecy where they fear a default on foreign debt in an emerging economy and withdraw their capital, but by withdrawing their capital they raise borrowing costs and increase the size of the stock of foreign debt through the depreciated exchange rate, potentially triggering the very crisis they were seeking to avoid. Currency swap lines avoid this. They act as a circuit breaker by reassuring investors that the government can continue to service foreign debts.

There is more Australia can do, regionally and globally. Forgiving emerging economies' debt or suspending interest repayments bolsters their financial stability. Australia can use its position in the G20 and APEC to

push for more ambitious debt or interest repayment forgiveness than has been delivered thus far. It can use its voting power in institutions like the IMF and regional development banks to push for greater access to precautionary financing facilities and, in the IMF specifically, push for a new issuance of Special Drawing Rights — an international reserve asset composed of the currencies of IMF members which the IMF can issue to countries in need of foreign exchange, provided it has the agreement of its members.

Conclusion

The Asian Century White Paper and the Foreign Policy White Paper are two of many policy processes instigated by the Australian Government which sought to find practical ways to strengthen Australia's engagement in Asia at the lowest possible cost. COVID-19 has provided an opportunity to do exactly that.

Asia faces its most challenging financial circumstances in modern history. Weak healthcare systems are placing unprecedented demands on government budgets, while global macroeconomic forces cause their foreign debts to rise, their foreign sources of income to fall and their interest repayments to increase. An inadequate global financial safety net means most are left to fend for themselves. Years of reforms to strengthen their financial systems and build domestic buffers will buy them time but little else.

Australia can help and it has the incentive to do so. Australia's prosperity will rise and fall with Asia's. Its geographic proximity means Australia will substantially benefit from the growing trade and investment opportunities in the most dynamic region in the world, while its strategic interests continue to deepen. Conversely, the materialisation of financial risks in Asia will reverberate throughout Australian markets, weakening demand for its exports and assets, disrupting the supply of vital imports and financial flows and causing serious threats to its national security.

Extending and expanding Australia's network of bilateral currency swap lines will help stabilise financial systems which, in all plausible scenarios, will impose no cost on Australia. They will provide vital access to foreign exchange, reassuring global markets that these countries can continue to finance their foreign debts. Using its position in the G20, APEC and on the boards of the IMF and development banks, Australia can push for further

supports for emerging economies in the region, affirming Australia as a constructive and reliable partner.

It is rare for a country to be able to bolster its foreign policy credentials with little to no cost to its taxpayers. The Australian Government should not let this opportunity pass it by.

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