



ANALYSIS

Managing economic risk in Asia: A strategy for Australia

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EXECUTIVE SUMMARY

Twenty years on from the Asian Financial Crisis it is timely to assess how the region is placed to manage and mitigate risks of economic crisis, and to consider Australia's role in this. This Analysis frames the policy options Australia faces through imagining a potential future scenario where a major ASEAN economy faces vulnerabilities as a result of volatile capital flows, exposing gaps in current risk management and crisis mitigation arrangements.

Australia can contribute to reducing external risks through a strategic and consistent approach to its bilateral engagement with countries in the region. It should look for opportunities to work with countries in the region to make maximum use of the G20 and International Monetary Fund given the significant common risks that could affect the region as a whole. At the same time, it should increase its preparedness for a range of crisis situations and create some flexibility in its legislative framework to provide support outside the framework of an IMF-supported crisis program. This would allow it to respond flexibly alongside regional partners in a fast-moving crisis situation. It would also provide a basis to work with regional partners in 'peacetime' to improve its ability to link with regional crisis arrangements. This would also give Australia greater confidence in achieving better outcomes in future crisis situations, contributing to the resilience of the region and, ultimately, the Australian economy.

A HYPOTHETICAL SCENARIO

It is a Friday night sometime in the future. Pressure has been building in currency and bond markets of several Southeast Asian economies. Officials of one large ASEAN country have contacted counterparts in the region nervous that it will face a serious market disruption early the following week when markets open. The economy has to date been performing well. However, markets have been reacting to a rising perception of risk in some emerging economies. Interest rates have risen, capital inflows have stopped abruptly and the tide is now going out. This has come at a time when financial instability and falling demand from China has put pressure on macroeconomic settings. There is talk of 'another Asian Financial Crisis' and there are early signs of a run on a couple of financial institutions.

The ASEAN country has been in discussion with IMF staff in Washington but is nervous about the domestic political consequences of approaching the IMF for support. The authorities are seeking bilateral support from several regional partners including China and Japan, chiefly in the form of foreign currency swaps. Yet China is facing capital account pressures of its own, while Japan is facing the same demand shock from China with very little macroeconomic room to manoeuvre. Parallel discussions are taking place with other members of the ASEAN+3 grouping (ASEAN member states plus China, Japan, and South Korea) about assistance through their foreign currency swap arrangement, but there is uncertainty over whether this mechanism will be triggered.

The Australian Government is approached for support. The Australian dollar is itself under pressure, fulfilling its normal role as a shock absorber, although the Reserve Bank is keeping a close eye on the market given regional volatility. The Budget is under pressure as lower commodity prices reduce revenues.

There is a hard weekend of decision-making ahead for ministers and officials in Canberra and Sydney. It will involve hurried calls across time zones, and economic, budgetary, and foreign policy choices will need to be made with incomplete information. Australia may well agree to provide support, although under uncomfortable circumstances which it will share with regional partners. Potentially, there will be no IMF 'cover' for bilateral financing. Assessments will be made on the run with other donors, each with different perspectives and interests, resulting in delays in putting together a financing package. And even then there will be a risk that the scale of support will not be enough, or will be delivered too late, to prevent a panic, resulting in failed financial institutions, a sharp drop in economic growth, increases in poverty and unemployment, and political instability.

INTRODUCTION

The 20-year anniversary of the onset of the Asian Financial Crisis is a timely moment to examine what Australia could do to reduce the risk of such an event, and minimise the impact of such a crisis were it to occur. These issues warrant some thinking and discussion with various international partners in 'peacetime', so Australia is confident in its ability to act swiftly in a crisis.

The hypothetical scenario above may well never occur. Policymakers in the ASEAN country concerned may pick up the danger signs in time and successfully manage the combined external and financial shock. The IMF may be brought in early. Regional arrangements may operate smoothly and link well with IMF support. Any Australian contribution may therefore be supplementing a more familiar framework of multilateral cooperation.

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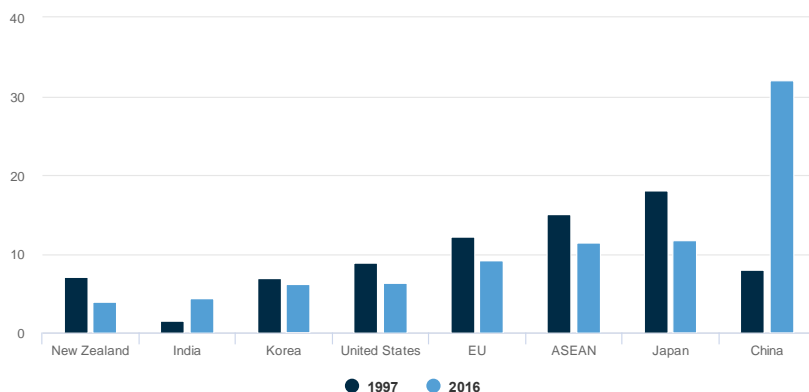
But the scenario is not fanciful either. While the region is likely to continue to drive global economic growth for some time yet, there are several risks that could severely stress regional economies in the medium term. Moreover, there are gaps and inadequacies in the early-warning systems and international financial safety nets that mean they may not function well under stress, leading to serious economic consequences.

The aim of this Analysis is to map out a better set of policy choices available to Australia, and indeed our regional partners, should this hypothetical scenario occur. It reviews the regional economic risk situation, both in the short and medium term, and looks at the various international policy mechanisms that can reduce risks and mitigate crises, should they occur.

ECONOMIC RISK IN THE REGION

Australia's heavy economic exposure in Asia means that it will always have a particular focus on economic growth and stability in the region (Figure 1). The size of trade with China, and China's linkages with other trading partners, makes it the primary focus for Australian policymakers. Japan and Korea are important trading partners, while trade with India is rapidly expanding. ASEAN economies are important given their aggregate economic significance, and geography provides additional reasons to focus on their economic prosperity and stability. Australia's financial linkages with the region are also growing.

Figure 1: Australia's trade exposure
(Value of goods and services exports in % of total exports)



Note: The figure for China includes Hong Kong SAR
Sources: ABS trade data on DFAT STARS database (August 2016 data), ABS Catalogue 5368.0.55.004 and unpublished ABS data

Emerging Asia continues to contribute the majority share of global growth, and regional growth is taking place against a backdrop of a strengthening world economy and some reduction in global risk.¹ The Chinese economy has recently stabilised and continues to post strong growth. The recovery in the US economy seems well underway, and markets appear to be taking the prospect of monetary normalisation in their stride. The eurozone and Japanese economies have started to show welcome signs of firming growth. Prudential regulations and monitoring of financial sectors have been strengthened.

Nevertheless, there remain significant risks to this outlook. These chiefly relate to the resolution of China's credit boom and a potential tightening in international credit conditions. Importantly for the policy time frames considered in this Analysis, there are several structural reasons for thinking that risks will remain high in the medium term.

The domestic risk profile of Asia's emerging economies and North Asia's systemic economies are reviewed below, as well as the potential external shocks that could put regional economies under pressure.

ASIA'S EMERGING ECONOMIES

In the years leading up to 1997, the fast-growing economies of East Asia experienced strong capital inflows as foreign investors chased financial returns. The widespread prevalence of exchange rates 'pegged' to the US dollar generating incentives for 'one way bets'. Strong capital inflows fuelled growth in under-supervised and rapidly developing financial systems, and led to rapid asset price growth in some countries.

In mid-1997 the Thai baht came under strong speculative pressure and a rapid rundown in reserves caused the Thai authorities to break the peg against the US dollar, leading to a sharp fall in the currency. Capital flows reversed, and domestic financial institutions came under pressure due to unhedged currency mismatches on their balance sheets (typically borrowing in US dollars and lending in local currency). The sharp drop in

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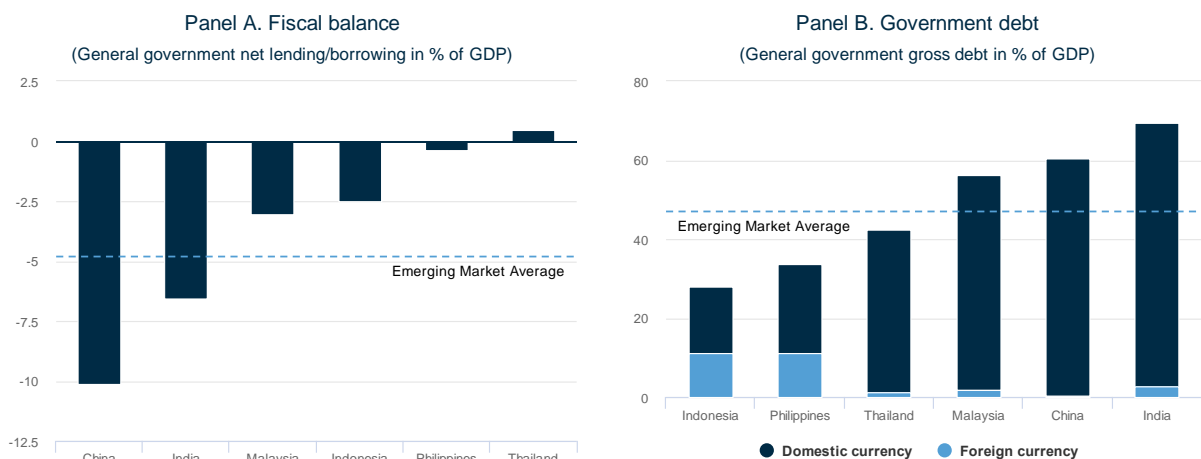
the Baht soon developed into a full-blown crisis in Thailand, with crisis conditions spreading to Indonesia and eventually the much larger Korean economy. Domestic financial institutions and companies failed, confidence plummeted and foreign exchange sources dried up. Growth plunged from positive 7 per cent in the years leading up to the crisis to negative 7 per cent, with Indonesian GDP declining 13 per cent.

Support was quickly organised to assist Thailand, Indonesia, and Korea respond to the severe balance of payments crises that erupted, including significant regional resources pledged early from Japan and Australia. IMF adjustment packages were developed, with IMF lending, bilateral pledges, and development bank finance totalling over US\$100 billion in 1997 dollars. The conditions on the IMF packages were controversial, with concerns that IMF policy responses, under US pressure, imposed the wrong prescription: excessive austerity, insufficient stabilisation of the financial sector, and too much focus on a range of structural reforms that appeared to go beyond the immediate requirements for stability.

The region has reacted to this searing experience by developing regional institutions to enable it to reduce reliance on the IMF — this is the main focus of the policy discussion later in this Analysis.

The Asian Financial Crisis also led to a significant strengthening of macroeconomic and financial frameworks in the large emerging economies of Asia.² Monetary policy frameworks and institutions have been strengthened. Budgets have been placed on a solid footing in Southeast Asia (see Figure 2, panels A and B), although fiscal risks are rising in China and India.

Figure 2: Public finances

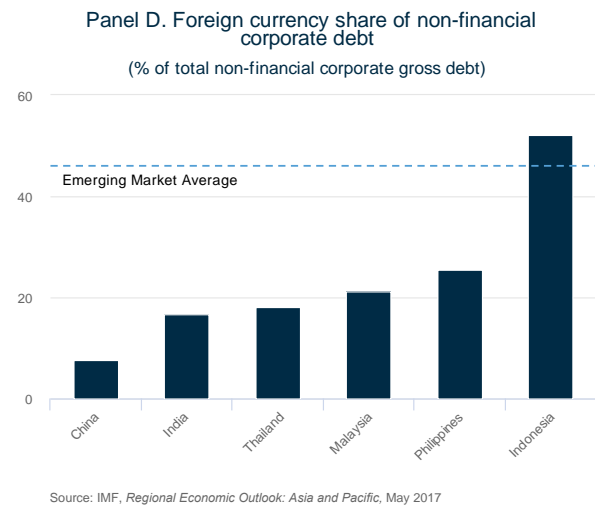
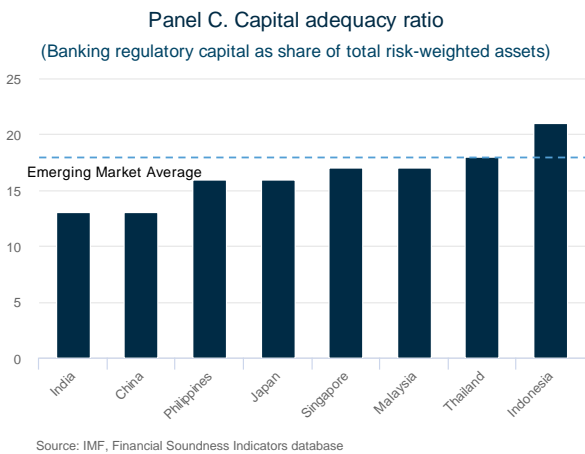
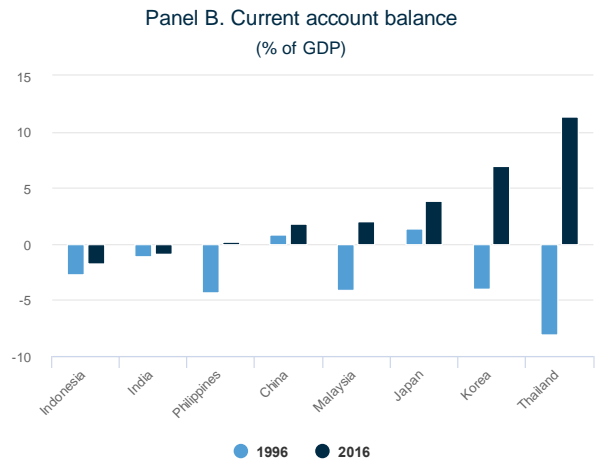
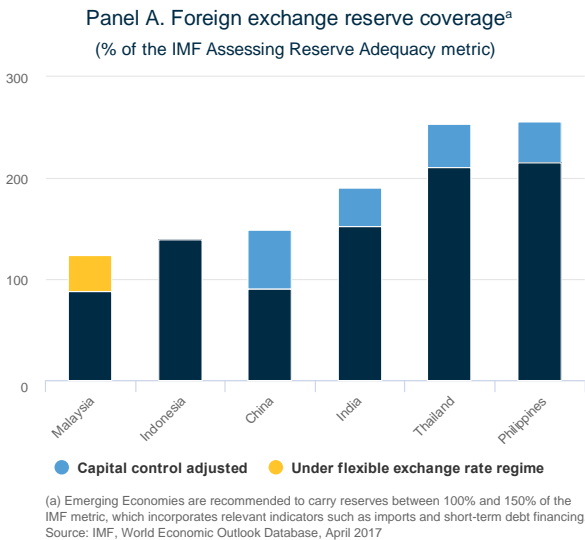


Note: The figure for China corresponds to the augmented fiscal balance found in the 2016 Article IV
Sources: IMF, World Economic Outlook Database, April 2017; IMF Country Report No 16/270, 2016 Article IV Consultation for China

Notes: The general government gross debt figure for China corresponds to the augmented debt found in the 2016 Article IV; the foreign currency shares of government debt were extracted from the IMF's May 2017 APAC REO
Sources: IMF, World Economic Outlook Database, April 2017; IMF Country Report No 16/270, 2016 Article IV Consultation for China; IMF Regional Economic Outlook: Asia and Pacific, May 2017

Over the past two decades, exchange rates have become more flexible, offering additional options for economic shock absorption. Foreign exchange reserve levels are generally robust across all key economies, and external positions look healthy (see Figure 3, panels A and B).³

Figure 3: Risk indicators



Financial stability frameworks have also been improved, and risks appear to be being managed. In key ASEAN countries the banking sectors are well capitalised (see Figure 3, panel C), supervisory frameworks are strong, and the economies appear robust to a range of shocks including those emanating from sharp exchange rate movements.⁴

There are, however, some issues to watch. In terms of ASEAN economies, Indonesia has a relatively high share of foreign currency non-financial corporate debt (see Figure 3, panel D), and some weakness in the quality of bank debt, while Malaysia has lower levels of

foreign exchange reserves and higher budget financing requirements than others in the region (see Figure 2). In each case, though, there is a policy focus on the issue and/or mitigating factors.⁵ India has several emerging vulnerabilities, particularly weakness in the state-owned banking sector and a stretched fiscal position, although these are occurring in the context of a strong current account position.⁶

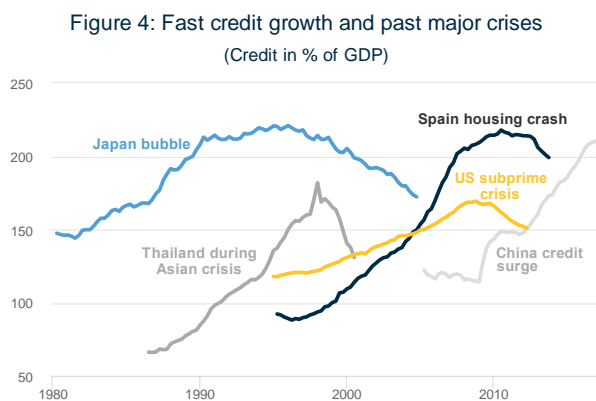
Nevertheless, the current strength displayed by Asia should not lead to complacency that emerging risks will always be successfully contained. As the global financial crisis (GFC) made clear, risks are inherent to the credit intermediation process in all countries, where institutions generally borrow 'at call' deposits and loans, and lend for long-term purposes, taking on both credit and maturity mismatch risks. In this situation, liquidity and solvency issues can arise, and panics can threaten even safe institutions. Emerging economies (and some small advanced economies) face comparable risks from volatile international financial flows, which can lead to sudden stops and capital flow reversals, and contagion between economies with apparent similarities. As the Asian Financial Crisis and other crises have demonstrated, these domestic and external sources of financial risk can combine to produce significant economic disruption.⁷

NORTH ASIA

While for most emerging economies in the region *domestic* risks seem well contained, the same cannot be said of China, which also presents significant *external* risks for other countries in the region. China's strong growth and generally adaptive policy management to date have been of enormous benefit to the world economy and to the region's economic performance. At the same time, the Chinese economy is a major source of risk to the world and regional economies because of its sheer size and the complex nature of the multiple structural challenges it faces. This will remain true for some time.

Financial stability risks in the region are currently concentrated in China, and much of the region's stability will depend on how these risks are navigated. Credit growth and levels are comparable to previous episodes of financial crisis in other countries (see Figure 4). Corporate debt is high, and risky debt is rising.⁸ There are substantial buffers within the Chinese financial system against adverse scenarios, the major banks are state owned and reasonably capitalised, and much of the debt is held by other state-owned counterparties. The complexity of the Chinese financial system means, though, that there is a risk of unpredictable and disorderly outcomes.⁹

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Source: IMF, *Global Financial Stability Report: Getting the Policy Mix Right*, April 2017; Bank for International Settlements

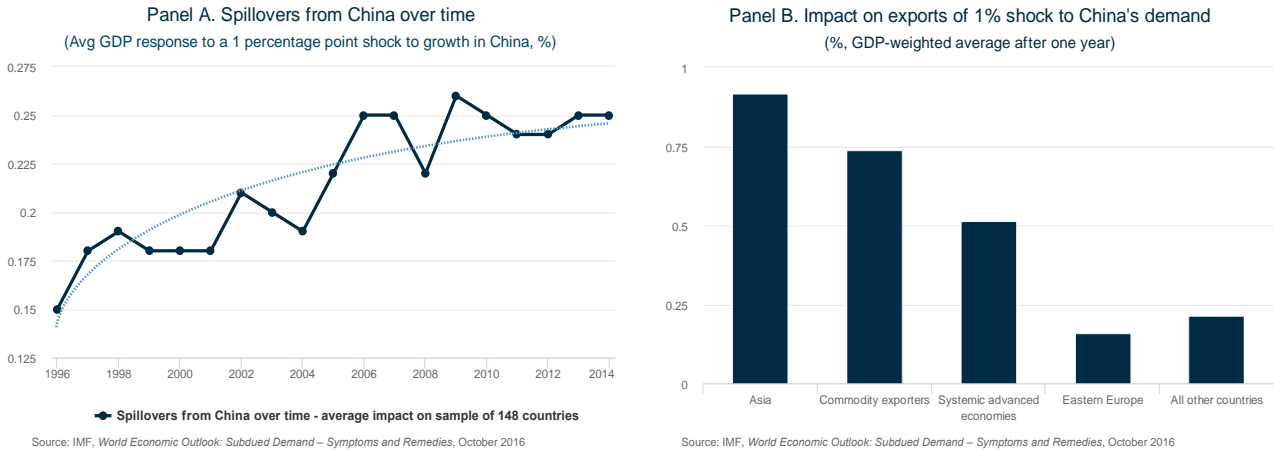
The key priority for China over the next few years will be to accept some temporary slowing of growth as it introduces greater market and regulatory discipline into its financial system. Chinese authorities have been intensifying moves to strengthen supervision, and this is having some impact on slowing the growth of risky lending, although the size of outstanding debt will mean risks around financial stability will remain for some time.

China has some policy space to react to financial or economic instability, although this is diminishing (Figure 2). It has seen significant increases in public debt in recent years although Beijing retains some fiscal flexibility at the central government level to respond to a shock (for example, to stabilise financial institutions). Pro-growth structural and fiscal reforms are available to the Chinese authorities that would unlock new private investment and consumption opportunities, and assist in managing the economic impact of slowing credit.¹⁰ It may also have some space to use monetary policy, although this depends to some extent on the ongoing credibility of its exchange rate framework and the effectiveness of its capital control regime.

Risks to China are also risks to the region, including Australia (see Figure 5). East Asian economies are more integrated than ever meaning economic shocks in one part will spill over within the region. Complex supply chains, commodity supplies, and trade in services have increased intra-regional trade. Capital flows are both growing and increasingly coming from within the region.

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Figure 5: Linkages to China



Financial instability would have a regional economic impact mainly through demand and confidence channels, with direct financial disruption being somewhat muted by China's external position and capital controls.¹¹ Still, financial distress among Chinese corporates could amplify vulnerabilities in companies and financial institutions in other countries in the region.¹² In addition, China has seen strong capital outflows in times of domestic instability in the past two years and pressure on the exchange rate, which has led authorities to draw on reserves to assist in maintaining broad stability in the exchange rate. Domestic financial disruption could therefore have significant effects on international financial markets. As China continues to open its capital account, direct financial linkages and flows within the region will increase over time, raising both opportunity and risks.¹³

The second-largest economy in the region, Japan, is also a source of risk. Its macroeconomic policies are fully extended, and it has little ammunition to respond to new shocks. But a demand shock in Japan is not nearly as significant as the spillovers that would arise from China.¹⁴ Nevertheless, Japan's government borrowings, while mainly domestic, are well above that for any advanced economy outside wartime. As Japan is the key capital market in the region, instability or loss of confidence there would have unpredictable ripple effects throughout Asian and global financial markets. Geopolitical risks in North Asia, including on the Korean peninsula, also add to economic risk.

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RISKS EXTERNAL TO THE REGION

Risks from outside the region are also important. In the United States, monetary policy is moving into a tightening cycle. This will bring net benefits to the region if rising US demand is accompanied by smooth and well-calibrated increases in interest rates. However, term and risk premiums can move unpredictably, raising the possibility of sharper rises in long-term interest rates and capital flow volatility. The Trump

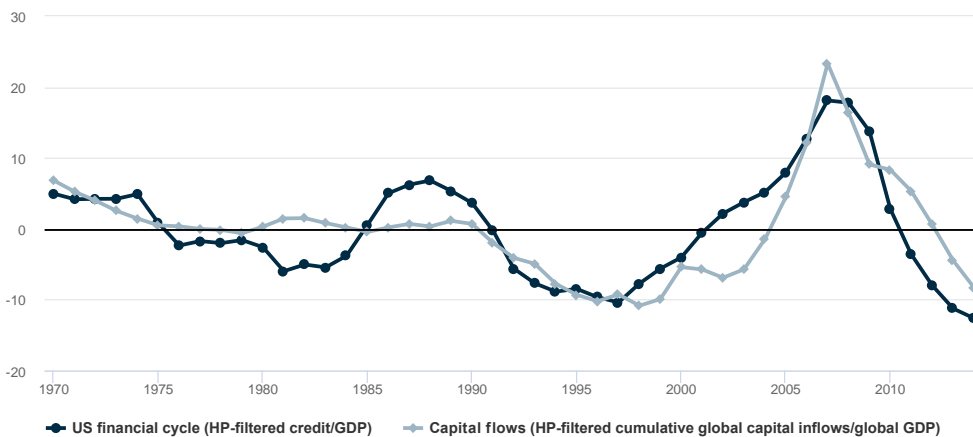
administration’s policies also carry risks, both upside and downside. In particular, different tax and fiscal policy approaches will have quite different effects on US growth, interest rates, and exchange rates, with some scenarios potentially placing stress on emerging economies.¹⁵ Possible action by the United States that contributes to global protectionist pressures carry clear risks for Asia, given its dependence on trade. The interaction of risks in the United States and China — for example, the impact of protectionist action in the United States on credit vulnerabilities in China — warrants close attention.¹⁶

Possible action by the United States that contributes to global protectionist pressures carry clear risks for Asia, given its dependence on trade.

There are important differences between the current and the pre-GFC period with respect to the risk preparedness of the US economy. Macroeconomic policy is more constrained due to higher public debt and structurally lower interest rates in the United States and other key advanced economies.¹⁷ This means that even ‘normal’ recessions may have a greater global impact on activity and financial stability. On the other hand, improvements in financial regulation have increased oversight of, and buffers within, the financial system, which will reduce the risk of crisis if they are maintained.¹⁸

Risks from the United States matter due to its size as an export market, but more importantly because of the dominance of US dollar funding in global and regional finance and the impact of the US financial cycle on international capital flows (see Figure 6). Capital flows played a critical role in the Asian Financial Crisis, and fluctuations during the GFC and in subsequent years have at times had a significant impact on regional economies. It was for these reasons the scenario at the start of this Analysis featured a crisis brought on by volatile capital flows. Other risks that could affect regional capital flows arise from the ongoing fragility of parts of the European banking system, Brexit, and heightened financial and policy risks in large emerging market economies outside the region such as Brazil or Turkey.

Figure 6: US financial cycle vs global capital flows



Notes: Global capital inflows/GDP is not directly comparable to credit/GDP (flow vs stock). Capital flows are therefore accumulated over time, de-trended, and HP-filtered with lambda=400000. Credit/GDP series is HP-filtered with same parameter. Source: IMF, Strengthening the International Monetary System: A Stocktaking, March 2017

MANAGING AND MITIGATING REGIONAL ECONOMIC RISKS

There is a good chance that the region, including Australia, will continue to benefit from favourable growth in coming years. However, several economic risks remain for the region. These are increasingly concentrated in the large economies of North Asia, particularly China and Japan. In addition, the region faces the ever-present risk associated with volatile capital flows.

While the short-term outlook is reasonably benign, there remains a reasonable risk of a disruptive crisis event somewhere in the region in the next decade. This could be in the form of crises in one or two regional economies due to policy mistakes or unrecognised vulnerabilities. However, given the way that the region has evolved since the Asian Financial Crisis, risks of a region-wide shock must be at the forefront of Australia's risk planning.

The first thing Australia should do is to focus on those things it can influence most to manage risks. This includes its own policy settings, particularly those that relate to Australia's resilience in the face of economic and financial shocks. While the focus of this Analysis is not on domestic policy settings, the analysis above reinforces the need to maintain and, where possible, carefully build strong macroeconomic and financial buffers. As the GFC showed, a strong financial sector and government balance sheet, supplemented by good international relationships, are critical to managing the severest of international crises.¹⁹

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In terms of managing external risks, there are several international mechanisms available to Australia. Australia has strong bilateral economic partnerships with key countries in the region. It is a member of leading international economic institutions that play an important role in regional policy dialogue and surveillance, and is part of some, though not all, regional institutions (see Table 1).

The effectiveness of these mechanisms in influencing domestic policy and therefore reducing risks has been much debated. International dialogue and surveillance appears to be most effective when domestic authorities work closely with international bodies to collaborate on reforms. This occurred in the 1980s and 1990s in Australia in relation to the Organization for Economic Co-operation and Development, where the government actively sought international input to develop its reform agenda.²⁰ Something similar seems to be occurring in China in relation to IMF advice, which appears to be getting increased traction within China. Common standards for financial regulation, even if voluntary, are an important tool for risk reduction as these can influence policy positions directly through peer pressure and market forces.

Table 1: Institutions for macro-financial surveillance and policy dialogue in Asia

Institution	Membership	Functions
International Monetary Fund (IMF)	Universal.	Bilateral and multilateral policy monitoring and recommendations; Early warning on macro-financial and economic vulnerabilities; Data standards and provision; Crisis support lending.
Group of Twenty (G20)	Australia, China, India, Indonesia, Japan, and Korea as full members; ASEAN as invited observer.	Peer review; Policy cooperation; Support for standard-setting.
Financial Stability Board (FSB)	Australia, China, Hong Kong SAR, India, Indonesia, Japan, Korea, and Singapore. The FSB regional forum involves all significant regional central banks and regulators.	Financial regulatory standards development; Peer review on implementation; Early warning on financial vulnerabilities.
ASEAN+3 peer review processes, including the AMRO	ASEAN, China, Korea, and Japan.	Peer review at regular ASEAN+3 finance meetings; ASEAN+3 Macroeconomic Research Office (AMRO) conducts bilateral and regional policy monitoring and surveillance; Advisory role on activation of the regional crisis foreign currency swap arrangements known as the Chiang Mai Initiative.
Executives' Meeting of East Asia and Pacific Central Banks (EMEAP)	Australia, China, Hong Kong SAR, Indonesia, Japan, Korea, Malaysia, New Zealand, Philippines, Singapore, and Thailand.	Policy dialogue between central banks on economic and financial challenges.
Organisation for Economic Co-operation and Development (OECD)	Australia, Japan, Korea, and New Zealand as full members; China, India, and Indonesia as key partners invited to cooperate through "Enhanced Engagement" programs.	Policy surveillance, particularly focused on structural and fiscal reform.

Australia is a well-established member of the most important global mechanisms, including the IMF, G20, and Financial Stability Board. Australia has good influence in these bodies as a successful medium-sized economy. Its views are respected given its generally sound policy track record, relatively strong analytic capacity, and history of constructive engagement. And it has some unique perspectives as an advanced economy with strong links to regional emerging economies, operating with independence and flexibility outside blocs such as the G7.²¹

To get the most out of these mechanisms Australian policymakers need to maintain clear and consistent views on the issues, including risks, that matter most to us. This starts from a good understanding of the policy choices facing countries in Asia, including by using bilateral and multilateral processes to listen and better understand the trade-offs our regional partners face. Good use of these mechanisms also requires a clear sense of which policy choices that might be pursued by Asian economies are in Australia's interests. Generally, these will align with those of the country concerned, but this will not always be the case.²²

Given the difficult transitions occurring in our region and the potential scale and rapid evolution of risks in the region, there could be value in institutionalising a more deliberate approach to Australia's external risk management. This could involve developing and maintaining a standing and shared whole-of-government view of desirable directions for key regional and global economies, and doing so across key government institutions — particularly the Treasury and Reserve Bank, but also the Departments of the Prime Minister and Cabinet and Foreign Affairs and Trade. This could ensure Australia's messaging across all channels was consistent and targeted.

Good identification of external risks and policy priorities provides the basis for an influencing strategy. Communication style matters a great deal, and Australia cannot be seen to be lecturing others in the region. Less confronting approaches are more likely to achieve good traction. For example, many countries in the region are keenly interested in hearing about the successes — and, just as importantly, the mistakes — of Australia's own economic reform experience. But stronger messages sometimes also need to be delivered to highlight sharply escalating risk, and a mix of private bilateral engagement and well-crafted multilateral intervention can achieve this.

Australia should use its strong regional network within the key international institutions to increase its ability to manage identified risks.

Australia should use its strong regional network within the key international institutions to increase its ability to manage identified risks. The impact of international policy dialogue and surveillance is stronger where a range of external partners — and particularly friends — deliver a consistent message. A well worked through whole-of-government view forms a good basis to compare notes with regional partners on desirable policy actions in common trading partners, and to coordinate messaging. This sort of cooperation is instinctive in other regions, particularly in Europe where the institutional architecture supports it. The economies of Asia should make greater and more deliberate use of their own network of relationships to influence global dialogue. Australia is well placed to work with the various regional players to achieve these goals.

Regional forums can draw on familiar relationships and local knowledge, and therefore provide additional perspectives to those coming out of global institutions and processes. Australia is an active member in some important regional forums, particularly the East Asia and Pacific network

of central banks known as EMEAP, the membership of which has good coverage of the most closely integrated regional economies.

Australia is not part of the ASEAN+3 finance processes, but should deepen links with these regional institutions. These are important in regional policy dialogue, and likely to be central in future crisis responses through the Chiang Mai Initiative (CMI) arrangements (see below). Australia should particularly look for opportunities to engage with the ASEAN+3 Macroeconomic Research Office (AMRO), which is developing its own regional surveillance capacity and also plays a role in the CMI.

Over time, greater cooperation on crisis response mechanisms may give rise to wider regional economic surveillance processes involving Australia. The emphasis for now, though, should be on building cooperation with the ASEAN+3 institutions rather than expanding that architecture or developing a new overlapping architecture.²³

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CRISIS MITIGATION MECHANISMS IN THE REGION

Even with the most effective surveillance and policy dialogue in place, the potential for crises remains. Policy mistakes can be made, particularly in extended periods of growth. And there is a possibility that external shocks coalesce to produce tail risk events that are difficult for individual countries to prepare for, even with strong economic policy foundations.

Depending on the nature of the crisis, a country may seek to ride it out with unilateral responses, such as making macroeconomic and exchange rate adjustments, drawing on foreign reserves, and imposing capital controls. A country may also seek to renegotiate the terms of its foreign sovereign debt obligations. In this way creditors can contribute to emerging funding gaps and therefore the crisis resolution. Nevertheless, despite some improvements in international debt resolution frameworks, unilateral renegotiation of debt is unlikely to be a complete solution to most significant crises.²⁴

Hence there will often be a role for international institutions to mitigate crises. First, and particularly important in systemic crises affecting several countries, international institutions can assist in coordinating macroeconomic and financial policies to ameliorate the crisis. Second, international and regional financial safety nets can mobilise resources to assist countries facing crisis.

INSTITUTIONS TO COORDINATE CRISIS RESPONSES

Crisis cooperation is the G20's core responsibility. It was originally created as a finance forum in the wake of the Asian and other emerging economy crises of the late 1990s, and elevated to a Leaders' forum in the midst of the GFC to coordinate policy responses. The G20 has a

wider work program, largely connected to issues of economic prosperity and governance. It can make useful progress on these in ‘peacetime’, although this is not always easy given the varying interests of member states.²⁵ In a crisis with global effects, interests tend to align more readily and the G20 can draw on ‘habits of cooperation’ to coordinate responses. This function is one of several important reasons why Australia should continue to accord priority to the G20 in its international diplomacy.

Six countries from the Asian region are members of the G20, ASEAN is a permanent invitee, and other Asian countries often participate as invited guests. It would therefore be the key forum to coordinate the broader policy response to a crisis in Asia. While a crisis in Asia would have global implications, it would have differential impacts on key economies that could weaken incentives for cooperation. Regional members would therefore need to cooperate closely to ensure this forum effectively fulfilled its global crisis response role, and Australia would have an important part to play in working with others to achieve aligned positions.

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Crisis coordination involves several layers of responses: sharing of information and analysis between all key economic decision-makers and aligning public messaging; coordinating macroeconomic policies and potentially regulatory responses to ensure spillovers between systemic economies are taken into account; and marshalling crisis resources to respond to the crisis, including from international institutions and other large economies. All these responses are likely to be important in any future crisis, including one whose epicentre is located in the Asian region (given its size and importance to global growth). However, with macroeconomic policy space constrained over the medium term in all key global and regional economies, due in part to the legacy of the GFC, international safety net arrangements will bear relatively more weight in the event of a significant crisis event.²⁶

CURRENT FINANCIAL SAFETY NET RESOURCES FOR THE ASIAN REGION

There are three elements of the financial safety net as it relates to the Asian region: global resources in the form of IMF lending; regional resources largely in the form of the mutual foreign currency swap arrangements available between the ASEAN+3 grouping known as the Chiang Mai Initiative (CMI);²⁷ and bilateral resources committed between countries in the form of foreign exchange swaps and loans.

Substantial resources are available from global and regional sources, at least on paper, with scope for expansion in a situation of significant need. Table 2 shows one measure of crisis resources available to key East Asian economies from global and regional sources.²⁸ The IMF remains the largest source of lending and is backed by an independently

funded balance sheet. The 'normal' access outlined in Table 2 can be exceeded in serious crisis situations.²⁹ The IMF can provide conventional loans organised in response to a crisis. These involve policy conditions to ensure macroeconomic policies contribute to stabilisation after a shock. It also has precautionary facilities that allow countries meeting strong qualifying conditions of strong economic management to have unconditional access to credit lines in a crisis. The IMF enjoys 'preferred creditor status' meaning its lending is regarded as senior to other crisis contributions.³⁰

The CMI arrangements comprise US\$240 billion in mutual swaps from members' foreign exchange reserves. A portion of CMI resources, currently 30 per cent, can be provided outside the context of an IMF program, with the remainder contingent on IMF support. It has both 'precautionary' and 'stabilisation' facilities, similar to the IMF.

The IMF enjoys 'preferred creditor status' meaning its lending is regarded as senior to other crisis contributions.

Table 2: Crisis resources available (US\$ billions)

	Chiang Mai Initiative Multilateralization	IMF (normal access)	Total
Korea	38.4	52.2	90.6
Indonesia	22.8	28.3	51.1
Singapore	22.8	23.7	46.5
Malaysia	22.8	22.1	44.9
Thailand	22.8	19.5	42.3
Philippines	22.8	12.4	35.2
Vietnam	10.0	7.0	17.0

Sources: IMF and AMRO

Significant bilateral safety net resources are also available but it is hard to quantify these on a basis comparable to the figures in Table 2. Bilateral foreign or local currency exchange swaps between countries are provided for a variety of reasons, but the latter are often directed at market liquidity rather than for balance of payments reasons. This, for example, is the case for the Reserve Bank's swaps with China, Indonesia, Japan, and Korea. The People's Bank of China has developed swaps with most central banks in the region, mainly directed at facilitating the internationalisation of the renminbi by assuring market liquidity. They have, however, been used in balance of payment crisis situations including as part of international efforts.³¹ Japan has both local currency swaps aimed at bolstering financial market liquidity,³² and an

array of foreign currency swaps with ASEAN countries with broader crisis mitigation goals comparable to those of the IMF and CMI. Other examples of standing bilateral assistance include a US\$5 billion contingent loan arrangement with Indonesia following the GFC and then continued until 2015, with Japan and Australia contributing along with the Asian Development Bank (ADB) and World Bank.

In a severe crisis, substantial additional resources are likely to be placed on the table, often alongside an IMF lending package. World Bank and ADB loans have typically been provided and new institutions such as the Asian Infrastructure Investment Bank may also play a role in future. Regional and global partners also make bilateral commitments. Up-front bilateral commitments in the Asian Financial Crisis (including from Australia) were larger than even the exceptional amounts available from the IMF, even though many were not eventually drawn on.³³

In total, and bearing in mind these caveats, bilateral crisis response resources in the region are likely to be similar in magnitude to those available from each of the IMF and CMI, and are also likely to be a significant part of the crisis response.

Australia's main involvement in these safety net arrangements is through its membership and contribution to the IMF (currently over A\$20 billion in actual and contingent commitments),³⁴ although it has also committed significant bilateral resources in past crises.

WILL THESE RESOURCES BE DRAWN ON IN A CRISIS?

There are, however, issues with each of the elements of the safety net, which raise questions over their practical availability and effectiveness in a crisis.

The region has bad memories of IMF involvement in the Asian Financial Crisis. The IMF package involved policy mistakes that worsened the economic disruption, and was overly intrusive. This was a significant motivation behind developing the CMI arrangements and progressively 'de-linking' assistance from IMF funding packages. The region's relationship with the IMF has improved in recent years, including as a result of the IMF's own reflection on the Asian Financial Crisis experience.³⁵ There would still be significant domestic political costs in the region arising from approaches to the IMF for support, and this could produce critical delays in the ways that capitals respond to a crisis, worsening the loss of confidence and economic dislocation.

There is greater ownership of the CMI within the region, although there still could be barriers to using this mechanism due to the inherent 'stigma' associated with drawing on external support. There are also doubts about the operational readiness of the CMI, in particular whether assessment and decision processes would function smoothly in a crisis. Geopolitical tension could affect cooperation among the key North Asian

The region has bad memories of IMF involvement in the Asian Financial Crisis.

members. There are also doubts about the CMI's readiness to link with the IMF, which matters given that link is necessary to draw on more than 30 per cent of funds. The CMI has not been drawn on to date.

Turning to bilateral arrangements in the region, the criteria for triggering many of these are unclear, as are the protocols for how they would work together. That said, the proliferation of bilateral arrangements is in part due to the doubts surrounding other elements of the safety net, and the perception that they involve more straightforward decision-making processes.

AUSTRALIA'S INTERESTS IN A STRONG REGIONAL SAFETY NET

Australia should have four strategic goals in its approach to the regional safety net. First, it should seek a safety net that provides good incentives to continue to implement strong economic policies, and more generally avoid 'moral hazard' in borrowing and lending decisions.³⁶ Second, resources need to be able to be drawn on and delivered rapidly in crisis situations, especially in cases where well-managed economies suffer from capital flow volatility. Third, the size of available standing resources should be enough to effectively respond to imaginable regional scenarios. Fourth, flowing from the other objectives, Australia should work to ensure the different layers of the safety net integrate effectively. This suggests specific priorities for how Australia should approach each element of the safety net in the region.

ENSURING IMF IS AN 'EARLY RESORT' IN A CRISIS AND IMF LENDING POWER IS MAINTAINED

The preponderance of systemic and common risks facing the region means that a well-resourced IMF, readily accessible by the region, should be a central goal of Australia's strategy to mitigate crisis risk.

The first priority is to work with both the IMF and the region to ensure the IMF is an early rather than a last resort in a crisis situation. Modelling analysis suggests rapid access to both IMF and regional resources can greatly reduce the severity of systemic and regional shocks.³⁷ Achieving more rapid resort to the IMF will involve using the IMF and other forums to ensure that: the IMF is operating in an even-handed manner and that its policy agenda and prescriptions are relevant to the region; that its understanding of regional economies is nuanced; and that governance continues to become more reflective of the growing weight of dynamic emerging economies in the region. At the same time, significant progress has been made on these fronts since the Asian Financial Crisis. The location of the 2018 IMF/World Bank Annual Meetings in Indonesia, the first in emerging Asia since the Asian Financial Crisis, will offer an important opportunity to further strengthen the IMF's relationship with the region.

The first priority is to work with both the IMF and the region to ensure the IMF is an early rather than a last resort in a crisis situation.

Changes in lending policy could also assist early resort to the IMF in a crisis. Australia should take a positive approach to new lending tools that may be suitable for use by the high-performing economies in the region, and which could be used in a pre-emptive and precautionary way. Following the GFC the IMF introduced precautionary lending facilities providing significant liquidity for good performers that meet demanding policy criteria up front. There has been relatively limited take up to date, and none in Asia, including due to the negative stigma associated with IMF programs. Indeed, a widespread take-up of this facility could stretch the IMF's balance sheet. The G20 has endorsed IMF work on new instruments that provide for smaller, revolving, short-term liquidity lines to similarly pre-qualified countries. There has not been agreement on a new instrument to date, although there has been some progress in expanding the range of options for IMF engagement.³⁸

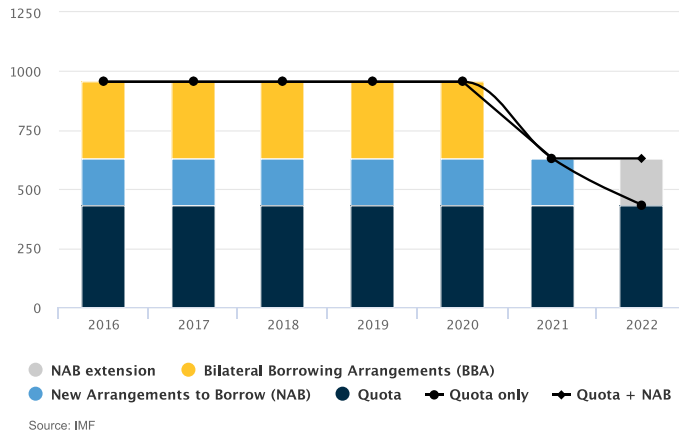
A more medium-term concern is ensuring IMF lending firepower remains strong.

A more medium-term concern is ensuring IMF lending firepower remains strong. The IMF balance sheet is sound for the next few years due to the finalisation of the 14th IMF quota review and various borrowing arrangements in 2016, which together bring IMF lending capacity to around US\$1 trillion. The borrowing arrangements are agreed until around 2020.

After 2020 there are significant risks to the IMF balance sheet (see Figure 7). The upcoming 15th review of the adequacy and distribution quota (equity) resources, due to be finalised in 2019, will be very contentious and increases in quota are typically hard to achieve. The willingness of the United States and other large shareholders to continue to support higher levels of commitment to the IMF will be key, and this is uncertain given how difficult it has been in the past to secure the support of the Congress, and in light of the current political climate in the United States. The membership is likely to resist ongoing reliance on borrowed resources. And divergent interests over the distribution of quota and voting power, including within the region between Japan and emerging economies such as China, may also stymie agreement to increase quotas to replace expiring borrowings. As a result, there is uncertainty about the size of the IMF lending pool available in the medium term.

Australia should work to ensure that the current available resources to the IMF do not contract, and should support carefully considered increases. Even simple analysis suggests the numbers required in the region could be large. Just scaling the 1997–98 support packages for Korea, Indonesia, and Thailand by nominal GDP would give a figure of well over US\$300 billion in today's dollars. More comprehensive analysis suggests that current global safety net resources would just cover global financing needs in some widespread shock scenarios, under the strong assumption that all elements are effectively drawn on.³⁹

Figure 7: IMF lending profile to 2022
(US\$ billions)



This possible looming gap between potential need and the willingness of large shareholders to contribute resources is a key risk for global economic arrangements and for Australia. At the same time, Australia brings unique perspectives to this debate given its economic linkages to emerging economies, its strong relationships with most of the key players, and its history of positive engagement on IMF governance reform. Maintaining the IMF balance sheet at least at current levels will involve cooperating closely with the United States and regional partners to draw out the benefits for all, including the Asian region, of a well-resourced IMF at the centre of the global safety net. It will also mean working with regional partners to ensure divergent interests (for example, over voting shares) are carefully managed to achieve an overall outcome in the region's interests.

This possible looming gap between potential need and the willingness of large shareholders to contribute resources is a key risk for global economic arrangements and for Australia.

At the same time, these efforts may not be successful given the many political hurdles. Australia therefore needs to work towards having the best range of options for maintaining an effective regional safety net in the absence of an adequately resourced IMF. This puts even more weight on ensuring other parts of the regional safety net are well resourced and operational, and that Australia is well set up to work alongside these arrangements.

SUPPORTING FURTHER DEVELOPMENT OF THE CMI

While decisions regarding the CMI are obviously a matter for the contributors to that arrangement, Australia has an interest in it being effective and operational given its potential to deliver resources quickly. This goal can be pursued through our bilateral relationships with members of the CMI and our involvement in the IMF and G20 which have both, with CMI member support, pushed for greater cooperation between the IMF and regional financing arrangements. A recent 'test run' between the IMF and CMI identified gaps that could hamper cooperation between the two institutions, including inconsistencies between the time frames of the lending instruments of the different

institutions, and the lack of a clear coordinating mechanism or structure.⁴⁰ Australia should support efforts to address these gaps in both organisations. And it should support more general efforts by the CMI membership to increase the operational readiness of the mechanism and its market credibility, including through increased transparency of policies and procedures.⁴¹

All this raises the obvious question of whether Australia should seek to join the CMI, as has been advocated by some in the region.⁴² The current structure of the CMI suits countries that accumulate significant foreign exchange reserves for their own purpose, and can devote a portion of these for a regional swap arrangement. Australia maintains low foreign exchange reserves by international standards due to our floating exchange rate and deep capital markets. In addition, the current arrangement represents a fine balance of the regional and national interests of current members,⁴³ which, like all international institutions, would be difficult to renegotiate.

Australia's immediate priority, therefore, should be on building effective working relationships with members of the CMI so that, in a crisis, it would be well placed to work alongside these arrangements. This may involve some engagement with the AMRO, which has an advisory role in the activation of CMI lending, although the primary engagement will need to be with individual countries given the member-driven nature of the arrangement. This would involve building confidence and understanding of how lending decisions will be made before IMF linkages are invoked, which could inform potential decisions Australia may need to make in an emerging crisis prior to IMF involvement. This would also position Australia for a situation in which the CMI arrangements further evolve into a stronger regional institution with wider membership and an independent balance sheet and lending capacity.⁴⁴ Such engagement will also inevitably involve close engagement with the main providers of resources within the CMI: China, Japan, and Korea, which also provide the bulk of bilateral crisis resources in the region.

BILATERAL SUPPORT: ENGAGING WITH POTENTIAL REGIONAL PROVIDERS OF CRISIS RESOURCES

Bilateral support may well provide the first response in a crisis given some of the political and other constraints outlined above for aspects of the safety net. Australia is likely to be part of any crisis response, and therefore will take a keen interest in how other bilateral arrangements will work together. The form that Australian support might take is discussed below, but the likelihood of Australian involvement suggests value in engaging in 'peacetime' discussions with other potential providers of crisis resources. Issues include how this support will link with IMF and CMI assessment and involvement, or operate in the absence of these. Agreement on broad principles to guide the use of bilateral crisis arrangements could be useful.⁴⁵

...the likelihood of Australian involvement suggests value in engaging in 'peacetime' discussions with other potential providers of crisis resources.

BROADENING AUSTRALIA'S INVOLVEMENT IN REGIONAL SAFETY NET ARRANGEMENTS

There is significant uncertainty about the way safety net arrangements will work in a crisis, how effective they will be, and how they will develop over time. However, Australia's national interests and its past actions suggest it is likely to be closely involved in future regional crisis responses. These factors together argue for Australia to both increase its preparedness for a range of crisis situations, and leverage its potential involvement to contribute to the effectiveness of regional safety net arrangements.

The framework for Australian involvement in the IMF and crisis responses, and appropriation authority, is laid out in the *International Monetary Agreements Act 1947*. This gives the Treasurer the authority to provide loans and currency swaps in support of another country in a crisis situation, if requested by the IMF, World Bank or ADB,⁴⁶ and provided at least one other country also involved is providing assistance. The Reserve Bank also provided crisis response resources in the Asian Financial Crisis within an IMF framework.⁴⁷

Regional developments and Australian interests suggest there are arguments for developing greater flexibility, particularly the requirement for crisis funding to be tied to an IMF (or similar multilateral) program. As indicated above, and in the scenario posed at the start of this Analysis, there are situations where Australia may want to act in a fast-moving situation along with regional partners.

One approach would involve introducing flexibility in legislation to allow the Australian Government to commit resources up to a specified dollar ceiling, which could be triggered if certain policy conditions are met such as a strong policy track record, and the co-involvement of other third-party countries. The legislative framework would still retain close links to IMF programs if more substantial responses are contemplated, or in situations requiring substantial policy adjustments, which is important both for risk management purposes and overall policy consistency. An approach involving 'delinking' a certain amount from IMF involvement would be broadly consistent with some regional arrangements, including CMI and bilateral swap arrangements provided by Japan.

There may also be a case for widening the range of response options beyond currency swaps and loans, to explicitly authorise the provision of guarantees on sovereign lending. There are some circumstances where the latter may better suit an evolving situation, especially when assistance needs to be delivered very quickly and Australia's own financial markets are facing volatility. Other highly liquid options, such as a standing foreign exchange fund, are likely to be too costly for Australia.⁴⁸ It is not desirable to draw on the Reserve Bank's foreign reserves or liquidity for these purposes.⁴⁹ Guarantees have the advantage of drawing on the broader government balance sheet, while

...Australia [should] both increase its preparedness for a range of crisis situations, and leverage its potential involvement to contribute to the effectiveness of regional safety net arrangements.

not requiring immediate provision of resources, and can assist in maintaining the crisis country's access to international financial markets. Any guarantees would need to be capped to limit exposure, and considered on a case-by-case basis along with other more conventional forms of assistance such as loans.

The introduction of such flexibility would require further policy development addressing: assessment of the appropriate level of any ceiling (which involves questions of appropriate burden-sharing with others in the region); the range of situations where such assistance would be contemplated; appropriate funding modalities for different circumstances;⁵⁰ and assessment, decision, and accountability processes. This would best flow from more detailed 'wargaming' within government of realistic crisis scenarios, to fine-tune the parameters and processes surrounding such a policy framework.

The suggested approach — involving an indication of Australia's willingness to contribute quickly as part of regional crisis responses — would also provide a basis for enhanced engagement with regional partners. Discussions with regional partners at a working level would complement domestic 'wargaming', including how different forms of assistance would work together in different scenarios. This could involve discussions over the extent to which countries would use similar assessment criteria, processes for sharing information, and technical cooperation with the IMF and AMRO.

The proposed approach could also bring a useful additional element to Australia's broader regional engagement. Economic crisis cooperation involves significant shared interests with a range of countries in the region. Given strong memories of the Asian Financial Crisis and continued interest in building economic resilience, such an approach would be viewed positively by many in the region. Greater policy flexibility and engagement would position Australia for a range of potential developments in regional safety net arrangements — from scenarios involving a deepening of the CMI and widening of its membership, to a more fragmented architecture relying on bilateral arrangements — while retaining its overall commitment to the important international public good provided by the IMF.

...an indication of Australia's willingness to contribute quickly as part of regional crisis responses would also provide a basis for enhanced engagement with regional partners.

CONCLUSION

Asia's emerging economies have strengthened their economies since the Asian Financial Crisis twenty years ago. At the same time the region faces a range of risks, including those arising from volatility in international capital flows and financial stability risks in the large economies of North Asia, risks that could affect the region as a whole rather than a few countries. Faced with this environment, Australia should take a deliberate approach to managing regional risks, including strategic use of regional networks and international forums. It should

continue to prioritise the G20 in its international diplomacy given its importance as a crisis management institution. Australia should also seek to close gaps in financial safety net arrangements that apply to the region, including: taking action to maintain the centrality of the IMF given the importance of access to global resources in current circumstances; improving the speed with which resources can be delivered in a liquidity crisis situation; enhancing linkages between different elements of the safety net; and, over the medium term, assuring the quantum of crisis resources available. Australia should also enhance its own readiness to contribute to regional crisis responses, including preparing for a range of possible scenarios.

Let me conclude by returning to the scenario outlined at the start of this Analysis to demonstrate the value of the approaches outlined.

International institutions, with the support of regional partners including Australia, identified growing risks in the large ASEAN country concerned, and encouraged national efforts to increase the strength of its domestic financial institutions. At the same time, the country has been in early discussions with the IMF, including about potential access to IMF precautionary liquidity facilities. Credible and sizeable global, regional, and bilateral crisis arrangements also increased market confidence in the crisis country's capacity to weather international shocks.

All of this may have helped prevent a crisis in the first place. But what if the call still came on this hypothetical Friday evening? The weekend is still going to be difficult but there are some new advantages.

Australia would have worked through crisis response options in advance including with partners, and have legislative flexibility to move quickly if circumstances demand. There would have been broad agreement among regional partners to operate using similar criteria for triggering support (which are themselves aligned to those of the IMF). Working relationships built up in prior discussions would facilitate rapid agreement to a regional package while IMF discussions were ongoing. A better relationship with the IMF, and perhaps precautionary lending arrangements, would have allowed faster access to global resources, and for a response package involving CMI and bilateral partners to be coordinated and scaled up quickly.

The G20 members in the region would ensure that the upcoming G20 Finance Ministers and Central Bank Governors Meeting had the crisis squarely on the agenda, and would present a strong common front. Through the G20 the region would have also secured more external bilateral commitments to a package, including by coordinating with the IMF. Policymakers would have a clear, shared sense of the risks for the global economy and implications for their own policy settings.

Australia should also enhance its own readiness to contribute to regional crisis responses, including preparing for a range of possible scenarios.

The combination of these actions brings confidence to markets and households and reduces capital outflow, stabilising the situation. Only a portion of the pledged support is required, and is quickly wound up as the situation is stabilised and the country has confidence it would have access for future events.

None of these outcomes are guaranteed even with the most effective set of surveillance and crisis arrangements. ‘Black swan’ events still occur that confound even the most well attuned early-warning systems, and overwhelm even well-resourced safety nets. But careful work with our partners inside and outside the region would give Australia greater confidence in achieving better outcomes, contributing to the resilience of the region and, ultimately, the Australian economy.

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NOTES

¹ IMF, “Global Prospects and Policy Challenges”, note prepared by IMF Staff for the Hamburg G20 Leaders’ Summit, 7–8 July 2017.

² ASEAN+3 Macroeconomic Research Office (AMRO), “ASEAN+3 Region 20 Years after the Crisis”, in *ASEAN+3 Regional Economic Outlook 2017* (Singapore: AMRO, 2017).

³ Indeed, the strength in some countries’ current account surpluses is itself a source of risk given the attention of the new US administration to bilateral and overall external balances.

⁴ See the various IMF 2016 and 2017 Article IV reports and supporting materials on Indonesia, Malaysia, Thailand, and the Philippines, which present the results of demanding stress tests on respective financial systems.

⁵ For example, much of the foreign exchange debt in Indonesia is between related entities, and regulation has been adjusted to allow financial oversight and prudential action in response. Malaysia operates a flexible exchange rate regime, which makes its reserves broadly adequate, and has fiscal reforms underway.

⁶ Strong reserves and a reasonably strong current account position limit the international implications of these risks, as does the relatively closed nature of the Indian economy. However, over time banking and fiscal vulnerabilities could reduce India’s resilience to external shocks by constraining response options.

⁷ See Timothy Geithner, “Are We Safe Yet? How to Manage Financial Crises”, *Foreign Policy*, January/February 2017, for a discussion of the risks around intermediation; and Stephen Grenville, “How the Asian Financial Crisis Exposed Neoliberalism’s Limits”, *Nikkei Asian Review*, 6 July 2017, for a discussion of specific issues around international capital flows.

⁸ IMF, “People’s Republic of China: Staff Report for the 2016 Article IV Consultation”, 7 July 2016, <https://www.imf.org/en/Publications/CR/Issues/2016/12/31/The-People-s-Republic-of-China-2016-Article-IV-Consultation-Press-Release-Staff-Report-and-44181>.

⁹ See IMF, “People’s Republic of China, Selected Issues Paper: Credit Booms — Is China Different?”, 14 July 2017, published as part of the 2017 Article IV consultations, <https://www.imf.org/en/Publications/CR/Issues/2017/08/15/People-s-Republic-of-China-Selected-Issues-45171>.

¹⁰ See IMF, “People’s Republic of China: Staff Report for the 2017 Article IV Consultation”.

¹¹ China’s domestic risks are not associated with external funding, high amounts of external debt, or strong counterparty links to international capital markets. This makes it a less likely source of a ‘Lehman’s’ type event.

¹² See AMRO, “Box A: Comparative Impact of Spillovers from the US, China and Japan — Preliminary Results from GVAR Analysis”, in *ASEAN+3 Regional Economic Outlook 2017*.

¹³ Peter Drysdale, Adam Triggs and Jiao Wang, “China’s New Role in the International Financial Architecture”, *Asian Economic Policy Review* 12, Issue 2 (2017), 258–277.

¹⁴ See, for example, the very limited affects arising from economic disturbances in Japan relative to China in AMRO, *ASEAN+3 Regional Economic Outlook 2017*.

¹⁵ See IMF, “Scenario Box 1: Permanent US Fiscal Expansions”, in *World Economic Outlook: Gaining Momentum?* (Washington DC: IMF, April 2017).

¹⁶ See IMF, *Global Financial Stability Report: Getting the Policy Mix Right* (Washington DC: IMF, April 2017) for discussion and modelling of interactions between US economic risks and financial stability in emerging economies including China.

¹⁷ See Geithner, “Are We Safe Yet? How to Manage Financial Crises”, the interview with Sir Charles Bean in William Turvill, “Markets Failing to Consider the Next Financial Crisis”, *City A.M.*, 10 August 2017, and Barry Sterland, “Global Financial Resilience in a Time of Uncertainty”, Parts 1, 2 and 3, Brookings blog, February 2017, <https://www.brookings.edu/blog/up-front/2017/02/14/global-financial-resilience-in-a-time-of-uncertainty/>.

¹⁸ See Geithner, “Are We Safe Yet? How to Manage Financial Crises”, and Financial Stability Board, *Implementation and Effects of the G20 Financial Regulatory Reforms: 3 July 2017 3rd Annual Report* for an assessment of the impact of financial regulation.

¹⁹ These elements provided the basis for the strong macroeconomic response to the GFC, and the key unconventional elements that were important in stabilising the situation in Australia — in particular, the guarantees provided by the Australian Government on domestic deposits which underpinned confidence in the banking system, government guarantees on bank wholesale lending which preserved access to international finance, and the temporary US\$30 billion swap lines provided by the Fed that delivered US dollar liquidity to the Australian financial market.

²⁰ See Stephen Grenville, “Policy Dialogue in East Asia: Principles for Success”, in *Financial Governance in East Asia*, Gordon de Brouwer and Yunjong Wang eds (London and New York: RoutledgeCurzon, 2004).

²¹ Barry Sterland, “G20: An Essential Element in Australia’s Economic Diplomacy”, Parts 1 and 2, *The Interpreter*, August 2016, <https://www.lowyinstitute.org/the-interpreter/g20-essential-element-australia-s-international-economic-diplomacy-part-1>.

²² For example, different mixes of macroeconomic policy can have similar growth affects within a country, but quite different risks for, and spillovers into, Australia and other countries.

²³ The developing cooperation and practical institution building in the ASEAN+3 grouping is likely to limit space for a new overlapping institution involving these countries. The East Asian Summit grouping — which includes significant East Asian countries, Australia, New Zealand, the United States, and India — has included Finance Ministers’ meetings from time to time although it is unlikely to gain traction in the area of crisis response and management. Australia played a role in the creation of the Manila Framework Group, which involved the most significant economies in the East Asian region, including Australia, as well as the United States and Canada. While a successful forum for dialogue in the post-Asian Financial Crisis period, it was wound up in 2004. The potential for

ASEAN+3 arrangements to expand to more inclusive membership is discussed in Barry Sterland, “Economic Risk and Resilience in Asia”, Brookings Institution Working Paper (forthcoming 2017).

²⁴ Improvements over recent years have included: the increasing adoption of standard clauses that facilitate more rapid agreement between creditors as part of a renegotiation; changes to IMF policies that provide greater bargaining power on the part of sovereign debtors (e.g. more willingness to lend into arrears or provide exceptional access in situations where good faith debt rescheduling negotiations are taking place); and the broadening of the membership of international groups involving sovereign creditors to assist in the coordinated renegotiation of public debt obligations. Efforts to introduce more streamlined sovereign debt resolution mechanisms have foundered for lack of consensus. Furthermore, there have been times when concerns about potential ‘contagion’ to other markets have led the international community to avoid the immediate renegotiation of creditor obligations (e.g. the early European packages involving Greece and Ireland).

²⁵ For example, progress has been very significant on financial regulation reform. See Sterland, “G20: An Essential Element in Australia’s Economic Diplomacy”, Parts 1 and 2.

²⁶ See Barry Sterland, “Part II: Global Financial Resilience in a Time of Uncertainty: Where is the ‘Dry Tinder’ Internationally?”, Brookings blog, 24 February 2017, <https://www.brookings.edu/blog/up-front/2017/02/24/part-ii-global-financial-resilience-in-a-time-of-uncertainty/>.

²⁷ There is a small regional arrangement for South Asia largely drawing on resources from India to support the economies of Sri Lanka, Bangladesh, Nepal and Bhutan, and China and India also participate in the US\$100 billion BRICS swap arrangements. I am focused on CMI as it is the largest and most developed, and most relevant to Australia’s strongest interests in Southeast Asia. The full name of the current iteration of the initiative is Chiang Mai Initiative Multilateralization (CMIM), the addition of the last word signifying it now involves a single agreement between governments. Previously it was a linked set of bilateral swaps agreements. I have used the shorter form for simplicity.

²⁸ The IMF is available to all member countries in the region, including China and advanced economies such as Japan and Australia (Korea is also now classified as an advanced economy). In practice, access by very large economies such as China and Japan, and even medium-sized economies such as Australia, would quickly put strains on the IMF’s lending capacity, particularly given this would only be relevant in very significant shocks to global financial markets affecting several regions and similar economies.

²⁹ The extent of ‘exceptional’ access lending will be limited by the IMF’s own balance sheet in a multi-country crisis involving several large emerging economies. This type of lending involves additional processes and substantive safeguards.

³⁰ The IMF’s preferred creditor status is widely supported in the international community, including by other official providers and regional arrangements, and reduces the risks surrounding the IMF balance sheet. While this adds to the risk surrounding any regional and bilateral contributions on a crisis (as in a situation of default it reduces the security of other official obligations), the IMF’s preferred

creditor status reduces risk overall as it makes it more likely the IMF is willing to take on the inherent risks associated with crisis lending, providing a better framework for managing risks. This is now agreed IMF policy governing the relationship between the IMF and Regional Financing Arrangements such as the CMI. See IMF, “Collaboration between Regional Financing Arrangements and the IMF”, IMF Policy Paper, 29 July 2017, 19.

³¹ The People’s Bank of China contributed currency swap resources in the case of the recent Mongolian IMF package, and also contributed to the Ukraine and Egyptian IMF adjustment packages in recent years.

³² The Bank of Japan has local currency swaps with several regional central banks — including the Reserve Bank — as well as being the only central bank in the region with standing unlimited swaps with systemic central banks such as the US Fed. The goal of the latter is to preserve liquidity in situations where reserve currency financial markets are not functioning. The Fed extended these swaps temporarily to other regional economies during the crisis, including to Australia. See Sterland, “Economic Risk and Resilience in Asia” for further discussion.

³³ This is common and indeed an intended outcome during crisis responses — the up-front commitment may not be disbursed as the announcement can provide market confidence allowing market access to return more quickly (e.g. the case of Korea in 1997–98), or worst-case scenarios do not come to pass and actual financing shortfalls turn out to be less than expected/feared. See Martin Parkinson, Phil Garton and Ian Dickson, “The Role of Regional Financial Arrangements in International Financial Architecture”, in *Financial Governance in East Asia*, De Brouwer and Wang eds, for a brief summary of Australian and regional involvement in the Asian Financial Crisis.

³⁴ Australia is also a member of the World Bank and Asian Development Bank, which are also likely to be part of any adjustment packages.

³⁵ See, for example, Mitsuhiro Furusawa, “What We Have Seen and Learned 20 Years after the Asian Financial Crisis”, IMF Blog, 13 July 2017, <https://blogs.imf.org/2017/07/13/what-we-have-seen-and-learned-20-years-after-the-asian-financial-crisis/>.

³⁶ Moral hazard can theoretically occur on both the borrowing and lending side if assistance arrangements shield parties from the consequences of their decisions and encourages them to undertake riskier behaviour. On the borrowing side, moral hazard is generally dealt with by imposing strong conditions on loans where policy has contributed to the crisis, to ensure needed adjustment occurs — this feature means that lending reduces but does not eliminate costs of adjustment. Precautionary facilities can guard against moral hazard by offering immediate liquidity in cases where the recipient meets ‘ex ante’ conditions indicating it has a generally sound policy regime and a good track record. On the lending side, moral hazard is generally dealt with by arrangements that ensure creditors bear some costs of a crisis through taking hair cuts on loans or losing value via renegotiated terms. At the same time, imposing costs on creditors needs to be balanced by assessment of the state of capital markets, as in systemic crisis situations a write-down of debt can propagate the panic to otherwise sound economies. Hence there can be a theoretical tension between minimising moral hazard and ensuring an effective standing safety net. There is, however, little evidence that moral hazard elements are strong in the region — if

anything, countries are taking excessive 'self insurance' and have a tendency to resist considering outside assistance even in circumstances where this is clearly warranted. There is also little evidence of excessive cross-border lending. This suggests that it is possible to develop an effective safety net that meets all the strategic objectives outlined in the text.

³⁷ See IMF, "Collaboration between Regional Financing Arrangements and the IMF".

³⁸ The IMF has developed a new Policy Coordination Instrument that could provide a lower-stigma framework for cooperation with the IMF in either peacetime or during an emerging crisis. This involves developing a program of policy benchmarks in consultation between the IMF and country authorities, which meet all the standards of a normal IMF program but with no funding attached. This is useful in situations where a country is seeking assistance and endorsement in its own reform program but does not require IMF financing. Adoption of such an instrument is likely to meet the requirements for regional and bilateral elements of the safety net, which are predicated on IMF involvement (past a certain level of 'de-linked' assistance). See IMF, "Adequacy of the Global Financial Safety Net — Proposal for a New Policy Coordination Instrument", IMF Policy Paper, 26 July 2017.

³⁹ See IMF, "Adequacy of the Global Financial Safety Net", 10 March 2016, for estimates surrounding the adequacy of current resources, including assumptions, and Edd Denbee, Carsten Jung and Francesco Paterno, "Stitching Together the Global Financial Safety Net", Bank of England Financial Stability Paper No 36, February 2016, http://www.bankofengland.co.uk/financialstability/Pages/fpc/fspapers/fs_paper36.aspx.

⁴⁰ Ibid.

⁴¹ See Changyong Rhee, Lea Sumulong and Shahin Vallée, "Global and Regional Financial Safety Nets: Lessons from Europe and Asia", in *Responding to Financial Crisis*, Adam Posen and Changyong Rhee eds (Washington DC: ADB and Peterson Institute for International Economics, 2013) and C Randall Henning, "Avoiding Fragmentation of Global Financial Governance", *Global Policy* 8, Issue 1 (2017), 101–107.

⁴² See, for example, Masahiro Kawai, "From the Chiang Mai Initiative to an Asian Monetary Fund", ADBI Working Paper No 527, May 2015, and Jayant Menon and Hal Hill, "Does East Asia Have a Working Financial Safety Net?", *Asian Economic Journal* 28, Issue 1 (2014), 1–17.

⁴³ For an account of the CMI negotiation process, see Kaewkamol Karen Pitakdumrongkit, *Negotiating Financial Agreement in East Asia: Surviving the Turbulence* (London and New York: Routledge, 2016).

⁴⁴ See Kawai, "From the Chiang Mai Initiative to an Asian Monetary Fund", Menon and Hill, "Does East Asia Have a Working Financial Safety Net?" and Rhee et al, "Global and Regional Financial Safety Nets: Lessons from Europe and Asia" for proposals that would move the CMI arrangements towards being structured more like the IMF or the European Stability Mechanism. The prospects for the CMI arrangements are further discussed in Sterland, "Economic Risk and Resilience in Asia".

⁴⁵ See C Randall Henning, “The Global Liquidity Safety Net: Institutional Cooperation on Precautionary Facilities and Central Bank Swaps”, CIGI New Thinking and the New G20 Series Paper No 5, March 2015, for some proposals along these lines, and Sterland, “Economic Risk and Resilience in Asia”, for an assessment of different options.

⁴⁶ The *International Monetary Agreements Act 1947* was amended to include reference to the World Bank and ADB to provide appropriation authority for the bilateral loan arrangement to Indonesia between 2010 and 2015, which Australia supported along with Japan and these two institutions.

⁴⁷ The Reserve Bank provided an early commitment of its own reserves in the Thai crisis of 1997, although the swap agreement was formalised when the IMF package for Thailand was finalised. As noted earlier, the Reserve Bank also has local currency swap arrangements with China, Indonesia, Japan, and Korea that, while directed at ensuring day-to-day market liquidity, include provisions that allow them to be used for other purposes by mutual agreement.

⁴⁸ This is suited to countries that hold high foreign reserves for domestic policy reasons (as with most of the countries of Asia), or reserve currency holders such as the United States with a range of financial stability objectives and international interests (the US Treasury Secretary can, under certain circumstances, draw on an Exchange Stabilization Fund of around US\$40 billion to promote international stability). However, this is a costly arrangement for Australia, given the foregone income in carrying low-return liquid foreign currency assets, particularly to fund episodic crisis events.

⁴⁹ The Reserve Bank would retain some options to act under its own mandate. However, given the issues of policy and foreign relations involved, the size of regional economies and nature of possible regional shocks, crisis planning should centre around the use of the central government balance sheet, including to avoid complicating the Reserve Bank’s own domestic policy response.

⁵⁰ For example, would assistance be reserved for pure liquidity events or also be able to be provided in crises involving the need for policy adjustment? Real-life situations often involve a mix of the two, and it is worth retaining some flexibility within broad policy parameters. Support in the latter instance may be provided in a situation where an IMF program is being negotiated, but there is value in regional partners acting quickly to provide limited liquidity while that occurs.

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Barry Sterland is a Visiting Fellow in the Global Economy and Development program at Brookings Institution, on secondment from the Australian Treasury. He finished a two-year term in October 2016 on the IMF Board representing Australia, Korea, and 13 other mainly Pacific countries. Prior to this, he was Deputy Secretary in charge of international economic engagement at the Australian Treasury. In this role, he led the G20 Finance Deputies group during Australia's Presidency of the G20 in 2014, represented Australia on the Financial Stability Board, and was closely involved in regional forums such as APEC and in Australia's bilateral economic engagement in the Asian region.

Previously he held Senior Executive roles in the Australian Government leading work in the areas of climate and budget policy, and Cabinet governance. In 2010 he received the Public Service Medal for his work on climate change policy. He was awarded a Fulbright Scholarship and completed a Master's in Public Policy at Princeton University, and holds a Bachelor of Agriculture Economics with first class honors from Sydney University.

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