

International and Regional Developments

by

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This past year marked the first “anniversary” of the onset of the Asian crisis. While hardly an occasion for celebration it is an event that will be studied for years to come and from which we have much to learn. The insights we gain from reflecting on the events of the past year should help us prevent similar crises in the future and can help shape our thinking about reforming the global financial infrastructure.

While an economic recovery may still be some months off, a number of steps have been taken to lay the foundation for an economic recovery. Analysts are beginning to focus on some of the critical weaknesses, in domestic economic management and in the international financial institutions, which made the Asian economies so vulnerable. The insights gained from such analysis should allow us to build a financial infrastructure, both domestic and international that are stronger and more suited to today’s global environment. We have already learned that maintaining a sound macroeconomic framework, as Indonesia generally did in the past, is a necessary condition for growth. But it is by no means a guarantee that a financial setback can be avoided. This will require not only more stringent domestic surveillance of our financial institutions but a serious look at the international financial structure.

It is also encouraging to note that there has been a global response to the Asian economic crisis. Not only have donors, multilateral as well as bilateral, provided financial support and technical assistance to Indonesia and to the other affected economies, but there also has been a major and ongoing discussion in various international fora of the need to revise the international financial architecture. Many of the ideas that have been put forward will require a consensus among the major economic groups. Achieving such a consensus will take time. But there are steps, some of which have been proposed in regional fora, which can be implemented more quickly.

Some lessons have already been learned. First, to our great regret, we now know that sound macroeconomic policies do not guarantee economic stability. Consider the simple fact that any analyst, looking at Indonesia’s macroeconomic policies and at macroeconomic indicators in the early 1990s, would have seen few warning signs of an impending disaster. Most certainly they would have seen no indication that a major economic collapse was imminent. To the contrary: in the period before the crisis, the Indonesian economy had compiled a strong record of economic growth, that resulted in a major improvement in living standards and a substantial reduction in poverty levels. It is necessary to emphasize this point since some now argue that poverty reduction in Indonesia was only a “*mirage*” while others suggest that the economic crisis has eroded all of the gains of the past three decades. Both observations are wrong. The economic and social welfare gains of the past thirty years were enormous and most of these gains have been maintained.

Prior to the onset of the Asian financial crisis, Indonesia’s economic growth exhibited all the signs of a sound macroeconomic framework of Economic activity was marked by a steady decline in inflation and a shrinking current account deficit. It is true that many of our banks and corporations increased their short-term borrowing but such capital inflows did not seem disproportionate to our total capital inflows. Moreover, Indonesia’s foreign banking liabilities, expressed as a percent of GDP, had declined throughout the 1990s and were lower, by a substantial

amount, that than of any of the other Asian countries affected by the crisis.¹ Nor did Indonesia peg its exchange rate. Admittedly our exchange rate was determined by a basket that gave a considerable weight to the US dollar, so that we were not immune to the impact of the dollar appreciation, and the exchange rate adjustment did not fully compensate for relative inflation. Nevertheless, the best estimates of the degree of overvaluation of the currency hardly suggested that a major realignment was called for.

How then do we explain the spread and impact of the economic crisis? In no small measure our vulnerability to external shocks was a result of a financial policy that used the banking system as an instrument of industrial policy. Politicians and bankers worked closely to ensure that funds flowed to projects which, it was argued, were critical for our industrial development but whose underlying economic value was often in doubt. The close link between industrial and financial policy had worked well. It ensured high rates of investment and powered much of our growth for a decade beginning in the mid-1980s. Although our efforts at financial and trade deregulation were meant to open the economy to global competition, in the expectation that this would avoid some of the major excesses, we were not fully successful. As industrial projects matured and came on stream, exemptions to the generally positive deregulation trends were used to ensure their profitability.

This, we now know, is a formula that cannot work forever. It depends in large part on a continued inflow of capital to sustain high investment levels and provide an apparent growing domestic market for products that are not competitive on the world market or are non-tradable. When an external shock changes expectations, the capital inflows can quickly turn to outflows, leading to a quick and sharp decline in domestic demand. To allow domestic firms to switch to exports required a sharp exchange rate depreciation but this very act made foreign denominated debt unserviceable. The fall in the exchange rate led to a growing debt burden that neither the corporate nor financial sector could meet.

What lessons can be learned from this explanation of the Indonesian crisis? *First*, that the use of financial institutions as a vehicle for industrial policy promotion is dangerous. Forcing banks to finance industrial activities results in banks that misuse their funds and creates a financial system whose income depends on extending ever more loans to poorly conceived projects in order to salvage the value of past loans. On the basis of this insight we are moving rapidly to create a more robust financial system. At its center will be an independent central bank, whose overall objectives the government can specify but which will be free to determine the means of attaining its goals. In addition our banks will face more stringent supervision. This too will enhance their future capacity to compete in the global financial community and ensure that future exogenous shocks will be absorbed by the financial system, not transmitted by them.

Second, the crisis was not caused by a trade imbalance and we will not allow the crisis to become an excuse to weaken our determination to create a more competitive and open economy. The crisis was caused by a sudden reversal of financial flows that exposed fatal weaknesses related to the financial sector. Hence the crisis should not be used as a cover to retreat from our past deregulation measures. Over the past decade we have made considerable progress in lowering tariffs, removing non-tariff barriers on both imports and exports, and in creating a welcoming climate for foreign direct investment. The Government of Indonesia still believes that greater competition achieved through international trade and the integration of our domestic economy with the world economy will benefit all. We espoused this view at the recent APEC meeting and we will continue to honor our WTO commitments.

Our commitment to freer trade also reflects a recognition that increased exports will be a major engine of our recovery. But exporting requires both growing demand in importing countries and access to markets. It is important for Indonesia's recovery that demand in the economies of our major trading partners continues to grow. And access to such markets must not be re-

¹ Steven Radelet and Jeffrey Sachs. *The Onset of the East Asian Financial Crisis*. NBER Working Paper No. 6680 (August 1998) Cambridge, MA: NBER.

stricted through tariffs or through non-tariff barriers, such as the application of inappropriate safety and hygiene standards. While each nation has the responsibility to protect the health and safety of its population we should ensure that efforts to improve health and safety standards are not an alternative means of providing protection against imports. I am particularly pleased to note the major achievements that the *Working Group on Agricultural and Food Cooperation* has played in facilitating live cattle imports from Australia. And, until the drought affected our agricultural sector, we also recorded a rapid growth in agricultural exports to Australia. It is my hope that we can also move to establish equitable measures, such as those being carried out under the food certification system, that will protect the health of our citizens and allow both our nations to enjoy the fruits of increased trade.

The international community responded to the Asian economic crisis by mounting a speedy, and on the whole, effective program of financial and technical assistance. Multilateral as well as bilateral aid donors offered immediate and strong support for Indonesia's efforts to stabilize the economy and have continued to provide assistance as we move from stabilization to renewed growth. The World Bank, the Asian Development Bank, and the International Monetary Fund have not only increased their financial support but have established a framework that allows bilateral donors to provide both financial and technical assistance. The Government of Australia has of course played its role and its contributions have been important not only for their direct impact but also as a measure of the depth of our bilateral relations. Australia has provided wheat and rice, has increased by one-third its 1998/99 pledge of assistance provided under the Consultative Group for Indonesia, and has indicated a willingness to assist in a number of other ways, both through financial assistance as well as through technical assistance.

All donor assistance, including that provided by Australia, was premised on the assumption that Indonesia would vigorously tackle some of the major weaknesses in its economic and political sphere that contributed to the crisis. Let me assure you that we remain fully committed to the policy reforms as set forth in the various letters of intent that we have concluded with the IMF. We are moving to create an economic-legal structure that can support a modern industrial nation. And we are embarked on a major political reform that will lead to elections this June that will be more open and more contestable than any election in our history. We are doing this not because we have made a pledge to the multilateral and bilateral donors. We are doing this because we recognize that improved governance, for corporations and for government, is a prerequisite for regaining the confidence of the Indonesian public, the business community, and international investors. By improving our economic and political governance can we ensure that future growth is sustainable.

Many of the reforms we are implementing will take time to mature. Nor will all reforms be adopted without debate and without a recognition that different societies must be able to mould these general principles to their specific needs. But the outcome will be a nation whose economic system will be increasingly governed by transparent rules and whose citizens can freely participate in the determination of national goals.

A final issue to be addressed is the need for a reform of the international financial architecture. The very fact that numerous policy makers and academics are debating this issue suggests that it is of some importance. But the fact that many proposals have been put forward, and none has found strong support, also suggests that any reconstruction of the international financial architecture will not be achieved quickly. Nevertheless, having recognized the need for reform also opens up the possibility that some measures to strengthen the international financial architecture can be taken at a more regional level in advance of a global restructuring.

On the one hand the severity and unexpected nature of the global financial crisis currently afflicting emerging market countries has led to a major reassessment of the relative risks and benefits of opening up financial markets in developing countries to volatile international capital flows. *We now recognize that the potential damage to emerging markets from a sudden reversal of capital flows can undo years, and even decades, of progress in economic development.* This heightened awareness has initiated calls for the establishment of a *'new international finan-*

cial architecture” to prevent similar crises from recurring in the future. While there is a growing consensus that the risks to emerging markets from an integrated, but highly volatile, world capital market, must be significantly reduced, there no strong consensus on how to accomplish this.

There are two main concerns that have been expressed about the current financial architecture which it should be noted has served the global economy well for over fifty years. *First*, many feel that as currently structured, the International Monetary Fund cannot respond quickly enough to an emerging liquidity crisis. By the time the IMF does mount an assistance package severe economic damage may have been done requiring severe measures to contain it. Such was the case in Indonesia. The question then becomes whether multilateral assistance can be mounted more quickly, perhaps even in advance of a crisis, so that it can prevent the worst impact of a financial collapse. *Second*, it has also been suggested that the IMF structure needs to be supported by the equivalent of an international bankruptcy court so that creditors and debtors can be quickly brought together to arrange for an appropriate debt workout. This proposal rightly recognizes that often the financial mismanagement is a result of bad economic policies on the part of the borrowing countries as it is of excessive and reckless lending on the part of creditors.

While both proposals may eventually find some favor and be adopted in some form, there are measures that can be taken more immediately and on a regional basis. Our experience has taught us that poorly managed banks and open capital markets are a dangerous mix when technology allows vast sums of capital to be moved from one country to another literally at the speed of light. We all agree that banks need to be better managed, that limits on intra-firm lending need to be rigorously enforced, and that bank capitalization levels need to be raised to levels that will provide an adequate reserve given the risks that banks may undertake.

But understand these risks and dealing with them are different issues. The fact is that implementing these measures requires not only better data but improved accounting practices. Agreement on what data is needed to improve the soundness of our financial sector and on what improvements we must make in accounting practices are steps that do not have to wait for an international effort to restructure the global financial architecture. Indeed, I doubt that we can afford to wait that long. If we are to regain the confidence of the international financial community then we must address these problems quickly.

Strengthening our financial system is an area where regional cooperation can be effective. The Asian economies can agree on accounting standards and can broaden the data collected on various financial flows and ensure their timely dissemination. And technical assistance can be provided by various regional economies to help implement these measures. I believe we should explore the possibility of developing accounting and data dissemination standards for the Asian region that will enhance confidence in our financial institutions.

Australia already contributes technical assistance in the area of economic governance under the *Technical Advisory Management Facility*. Whether under this facility or under a new facility, I believe that Australia can play an important role in upgrading our national financial statistics to international standards. It can also help by providing manpower and training for the technical personnel, accountants, financial analysts, and statisticians, needed to improve our financial reporting standards. Not only are such steps important but such actions can be taken well in advance of any restructuring of the global financial architecture.

There is one further step to we should be studied for future discussion. We may want to consider the creation of a regional body to provide surveillance of our national financial system. The European Union, for example, has a committee of independent statisticians that scrutinize the fiscal accounts of members and standardizes their reporting practices. Can such a measure be adopted by the Asian economies that have been affected by the financial crisis? Such a step would require some surrender of sovereignty and recognize that the regional economies have a mutual interest in the soundness of national financial institutions. But this may be a small price to pay for a return of investor confidence and the creation of banking systems in the region whose standards of accountability and safety truly meet international requirements.

As we gain a better understanding of what caused our economic crisis we are better able to create a social and economic infrastructure that will better insulate from future exogenous shocks. No amount of economic or political reform can guarantee that we will never face another economic setback. But a stronger financial system, a more competitive economic environment, and a more open political structure, will all serve to mediate any future economic shock.

Thank you.