The Experience of Indonesia

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My opinions on the various issues that we have discussed since yesterday are, of course, heavily colored by the experience of Indonesia after the crisis. It is fair to say that we should be very cautious, because some downside risk remains in the global economy and we cannot discount the possibility of a new crisis emerging. And looking ahead, prevention should remain at the center of our goals. I believe prevention will have to be achieved through the strengthening of institutions and a better idea of what future priorities should be, in particular for emerging countries like Indonesia. And this strengthening must be done in the most expeditious and comprehensive manner.

Let me start with a summary. I believe that in today's environment of globalized capital flows, the maintenance of financial stability should be the shared responsibility of all parties. In light of this, I remain of the opinion that all players in the international financial market, both public and private, should abide by certain rules and standards. For the public sector, the benefits of adhering to international rules and standards are self-evident. But for the private sector, as I see it, the task of ensuring non-destabilizing behavior still remains primarily with the public supervisory bodies. I would also pose the question of how far market discipline can really be relied upon without creating negative sentiment among market participants.

Turning to the issue of the capital account, I do not think any of us here would deny that emerging markets and developing economies have benefited from the trend toward the globalization of capital flows. In many countries, capital inflows have facilitated the efficient utilization of

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resources, provided liquidity in the financial markets, and promoted long-term development of the economy. But I would stress that the first outcome that I have mentioned, the efficient utilization of resources, has not occurred in every country, only in some countries.

The recent crisis has exposed the danger of letting the benefits of free capital movements overshadow the dangers. In the case of Indonesia, for example, we followed a disorderly sequencing in our liberalization efforts. We started capital account liberalization in the 1970s, before the liberalization of the current account, and it turned out that as time went on, liberalization of the capital account was agreeable to the Indonesian authorities, since it succeeded in filling the saving-investment gap and widening the range of opportunities available to foreign investors.

However, the surge in capital inflows, in particular in the early 1990s, occurred when Indonesia's economic integration into the world market was not supported by a well-developed institutional and regulatory framework. We now think that if we could turn the clock back, we would not have moved so swiftly; for example, we would not have removed the ceiling on foreign commercial borrowing by banks in 1989, nor provided a swap facility through Bank Indonesia until 1994-95, given the overall weaknesses in the financial system.

These weaknesses stemmed from inadequate regulation and supervision, a tradition of implicit and unwarranted government guarantees to industry, and significant governmental withdrawal from credit allocations for some investments that were genuinely important, for example, investments in infrastructure and electricity. Most important were the weaknesses in governance at a more general and fundamental level. These problems were all reflected in the misallocation of credit and inflated asset prices. So the first benefit of capital account liberalization that I mentioned, the improvement in the utilization and allocation of funds, has not occurred in Indonesia. Some international funds are not being used efficiently, and we are going to have to end some projects.

Another typical fragility in Indonesia stemmed from large, unhedged liabilities in foreign currencies, accumulated by highly geared private corporations. This buildup intersected with exchange rate developments. When our fixed exchange rate regime in the 1970s turned into managed floating in the late 1980s, we had another fixed regime in reality. Because the managed floats became guarantees by the government, nobody thought that they should hedge any foreign debt exposures. This led to corporations' making very unsound decisions in their borrowing, while lack of information also made it difficult for lenders to assess the riskiness of borrowers in Indonesia. So lack of economic and financial data for making good and informed decisions contributed to the inadequate capacity for risk management and the accumulation of dangerous imbalances.

From this experience, I would say that poorly sequenced or poorly

supported capital account liberalization lay behind the problems in Indonesia. Excessive short-term debt and highly leveraged positions in both the banking and the corporate sectors were the basic problem, not the capital account liberalization itself. Before I describe our thinking about this capital account issue, I would point out that on May 17, 1999, Indonesia enacted a law governing the capital account and exchange rate system. This new law states that we will adopt an open capital account and embrace a free flow of capital. From our own experience, we know that for the open capital account to provide real long-term and sustainable benefits to our country, we have to overcome all the issues that I have just mentioned. Therefore, let me cite several things that we are doing in order to reap the benefits of what we believe to be the best choice for Indonesia, an open and free flow of capital.

First and foremost is the strengthening of the domestic financial system, and that includes the establishment of adequate laws and regulations for foreign exchange transactions, to force this market to develop properly. We also need appropriate reporting and disclosure requirements and accounting and payment systems, to improve market transparency and functioning. We must strengthen our prudential and regulatory frameworks, as well as our capacities to identify, price, measure, and manage international liquidity, credit, and foreign exchange risk. This means strengthening systems of risk management, not only externally but also internally within the banks, and direct regulation of risk exposure, by such means as limits on open positions and limits to maturity mismatch, and so forth. We also believe that a system of penalties for nonviable institutions, like closures, and the actual enforcement of regulations could improve the efficiency with which we intermediate the capital flows that we view as the best option for Indonesia. Moreover, while I would say that capital controls are not a long-term solution, in a world where markets do not always function in an orderly manner, second-best capital controls should be treated as one of the necessary alternatives. But in the case of Indonesia, I do not think we have the option to go back to closed capital markets.

Second, capital account liberalization needs also to be fully supported by a consistent macroeconomic framework, including a consistent money and exchange rate policy. The new central bank law leaves Bank Indonesia independent and focused solely on price stability, and that law will make it easier to run our monetary policy, as we do not have to be bogged down in choosing exchange rates and interest rates. Learning from our experience, I believe that while huge short-term capital inflows involve risks, nothing is wrong with short-term capital inflows per se. But the other side of the coin is equally important; these flows must occur within a system of good public and private sector governance and all the other institutional requirements I have mentioned.

I would like to add two other very important conclusions we have

drawn. One concerns exchange rate systems. We believe that our new flexible exchange rate system, with floating rates since August 14, 1997, provides a built-in discipline in a market where all the other infrastructures are not sufficiently strong. This float will in itself create a brake on huge and unwise borrowing from overseas, because market participants will have to weigh the cost of possible rupiah depreciation against that of borrowing overseas, since our interest rates are still so much higher than those abroad. Therefore we believe that, for the time being, despite the importance of a stable exchange rate for the real sector, it is more beneficial for us to teach market participants the lesson that they have to hedge, if they are going to choose to borrow abroad.

The last point concerns the international lender of last resort. Our experience with the international lender of last resort was unique. When our government finally decided to seek international help, led by the IMF, it was with the understanding that the bailout would enable Indonesia to regain a positive reception from market participants, and that we would have adequate foreign exchange reserves despite the sudden reversal of private capital inflows. However, the conditions imposed included removal of subsidies to various enterprises and monopoly practices (which resulted in huge public protests and, thus, no strong support from the authorities), and the closure of 16 banks without any deposit insurance in place. In addition, the so-called $43 billion package was dispersed in small shares, with only a $4 billion initial disbursement. These conditions and the modest financial support have exacerbated market skepticism that Indonesia can really overcome its problems. Of course, I should not discount the fact that Indonesia has still another problem, political uncertainty, but the fact that the bailout has not been that efficient in improving confidence is quite significant to Indonesia. In fact, I tend to agree with Jeffrey Sachs, that the Frankfurt deal on interbank debt restructuring was more important to restoring confidence in Indonesia than was the IMF rescue. And, therefore, apart from the fact that the IMF cannot print money and does not have adequate resources, I leave with the question of whether an international lender of last resort can be very helpful.