Restoring East Asia's Dynamism

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Foreword

In the wake of the Asian financial and economic crisis of 1997–98 an enormous amount of energy has been expended to stabilise and restart the East Asian economies. Moreover, the post-crisis environment for long-term economic growth in East Asia looks to be significantly different from and far more complex than before the crisis. The profound transformation in financial systems that occurred in the process of solving the crisis, for example, will have a far-reaching impact on corporate governance. At the same time, the paradigm shift from manufacturing technology to information technology that is spreading around the world along with increasing economic globalisation appears poised to take effect in East Asia. These environmental changes will require East Asian economies to make significant structural adjustments.

With these issues in mind, in the spring of 1998, the Tokyo Club Foundation for Global Studies asked the ten leading think tanks in East Asia (the AT10) to research the problem of re-establishing the dynamism of the region's economies. The AT10 researchers grappled with a variety of issues pertinent to their respective economies. They came together in late January 1999 to present their papers and exchange ideas. The papers collected here are the revised versions of those efforts. I am delighted that the Tokyo Club, with the co-operation of ISEAS and NRI, can make them available.

In the past year, the East Asian economies as a whole have rebounded from the crisis almost beyond expectations, showing remarkable resiliency. Some economies, however, are still plagued with the after-effects, and even those that have done relatively well have found their future growth path less certain because of the newly evolving environment. Looking forward East Asian economies need both to tackle their immediate problems and to undertake the structural changes necessary to put them on a desirable path for long-term development. The papers in this volume address issues that are critical to defining a new paradigm for East Asian economic growth. I hope that they will contribute to the emerging debate.

Shozo Hashimoto February 2000
President
Tokyo Club Foundation for Global Studies

INTRODUCTION

Seiichi Masuyama

In spring 1998 in the midst of the Asian crisis, the Tokyo Club Foundation for Global Studies asked ten East Asian think tanks (AT10) to study the problem of restoring the region's economic dynamism. The papers in this volume are the result of those studies. They were presented for discussion at a conference in Tokyo on 28 and 29 January 1999 and modified thereafter.

Although the papers cover a wide range of subjects, they are by no means comprehensive. The issues they do consider may be divided into three categories: strategies to cope with the crisis; policy responses to rectify weaknesses that might have induced or aggravated the crisis; and structural problems to be resolved in order to bring East Asian economies back firmly to a path of long-term growth. Before specifically taking up these issues, most authors assessed, if only briefly, the causes and magnifiers of the East Asian economic crisis.

CAUSES AND MAGNIFIERS OF THE ASIAN FINANCIAL CRISIS

Although the primary cause of the financial crisis is generally thought to be the failures of global capital markets rather than the defects of East Asian socio-economic systems, there is a general recognition that too hasty financial liberalisation made the region's financial systems vulnerable to sudden reversals in international capital flows. Since the outbreak of the crisis the Asian value system has been deluged with allegations that it is prone to corruption and cronyism, but these criticisms are over-exaggerated and lack historic perspective (Chapter 10). Nevertheless it is true that the structural problems of East Asian economies increased their vulnerability to the financial crisis and magnified its scale and reach.

Rigidity in many East Asian economic systems had made these economies vulnerable to the external shocks. The rigid exchange rate regime under a dollar-peg system adopted by many East Asian economies is generally blamed for the accumulation of unsustainable imbalances. Hong Kong's currency board arrangement and linked exchange rate regime limited the ability of monetary policy to cushion the economy from major external shocks (Chapter 6). Inflexible factor markets also increased the vulnerability of the region's economies to external shocks. In Hong Kong the limited supply of public land and the government's tolerance of oligopoly in the property sector restricted the economy's ability to adjust to changed circumstances and reduced its international competitiveness by raising business costs (Chapter 6).

The weak crisis management capability of some East Asian governments aggravated the crisis. Inconsistent government policy announcements in Indonesia contributed to the spread of the crisis by undermining investor confidence. Empirical analysis of the contagion emanating from initial financial crisis in Thailand found that announcements by the Indonesian government, rather than movements of the baht exchange rate, led to the instability and depreciation of the rupiah exchange rate in late 1997 and early 1998 (Chapter 1).

Inefficient financial systems in East Asia misallocated the inflow of foreign capital and these systems either became extremely unstable or totally collapsed when international capital suddenly flowed out. Insider transactions and a lack of transparency plague banking systems, the mainstay of the financial systems in the region. Implicit government loan guarantees have created moral hazard (Chapters 2 and 10). Owing to its transitional economy, the banking system in China has accumulated a dangerous amount of non-performing loans even without liberalisation of capital flows, by lending to inefficient state-owned enterprises (SOEs, Chapter 5)

The inefficiency of financial systems is closely intertwined with the slow development of modern corporate governance in East Asia. A lack of transparency is thought to have weakened the confidence of international as well as domestic investors in the region's financial systems, thus aggravating the scale of the crisis. As the contributors from Thailand observed: "Although it is far-fetched to attribute this crisis to bad corporate governance per se, weaknesses in governance certainly rendered the Thai economy more vulnerable to imbalances" (Chapter 3). Concentration of corporate ownership among a few families resulted in the prevalence of connected-lending in countries such as Thailand and the Philippines (Chapters 2 and 3). The state-owned enterprise system in China has a three-faceted corporate governance problem: inadequate incentives for management, an inadequate mechanism of external discipline, and inadequate control over enterprise managers by boards of directors. This has resulted in rampant administrative interference in enterprise affairs and insider control (Chapter 5).

The heavy dependence of many East Asian economies on foreign direct investment (FDI) was both positive and negative. FDI proved to be the most stable form of international capital flow. Most export-oriented investments were resilient to the shock of the crisis, as they are efficient and benefited from the devaluation of local currencies (Chapter 9). On the other hand, the crisis has slowed down inflows of green-field investments, although this has been offset to a large extent in Korea and Thailand by a sharp increase in M&As. As the net inflow of M&A capital is probably more cyclical than green-field investments, East Asian economies are likely to be forced to draft a new growth strategy that depends less on FDI.

STRATEGIES TO COPE WITH THE IMPACT OF THE CRISIS

East Asian governments have responded to the negative impacts of the crisis with a variety of polices. The main responses are first, adopting macro-economic stabilisation policies and, in the exceptional case of Malaysia, re-instituting capital control; second, restructuring the financial sector with improved transparency; third, reducing operating costs for businesses; and fourth, strengthening social safety nets.

Macroeconomic Stabilisation Policy and Exceptional Capital Control

The initial IMF prescription for a tight fiscal and monetary policy mix has been widely recognised as counter-productive in the strong deflationary environment at the height of the Asian financial crisis. As a result, many East Asian governments have modified their macroeconomic policy mix to adopt a more stimulative stance. China, which has maintained capital control, pursued stimulative fiscal and monetary policies to alleviate the deflationary impact (Chapter 5). Malaysia had a reasonable degree of success introducing capital controls as an emergency measure in conjunction with relaxing fiscal and monetary policy (Chapter 4). Indeed, capital control is becoming recognised as an acceptable means for less developed economies to avoid the destabilising impact of oscillating flows of short-term capital. Indonesia, on the other hand, was forced to tighten monetary policy to compensate for its deteriorating fiscal balance due to the additional expenditures needed to address the grave social consequences of the crisis. The policy that Indonesia formulated with the help of international organisations also seems to have stabilised the exchange rate (Chapter 1).

Restructuring Financial Institutions and Improving Financial System Transparency

Since the deteriorating quality of financial systems in the crisis-affected economies has had severe negative consequences on the real economy, the restructuring of financial institutions has become the top priority. Chapter 1 explains the efforts of the Indonesian government to restructure insolvent Indonesian banks and Chapter 2 describes the reform agenda for the Philippine banking system. The Philippine paper suggests that requiring a higher equity ratio for financial institutions may restrain excessive risk-taking. It may even be reasonable to require higher equity ratios for financial institutions in developing economies than in developed economies because of the riskier environment. The author also argues for maintaining a relatively low limit on deposits covered by insurance to prevent moral hazard problems on the side of depositors and stricter central bank policies toward bank failures to prevent moral hazard problems on the lender side. Such restructuring of the financial system will have a significant long-term impact on economic performance through better allocation of resources and improved corporate governance.

Reducing Business Operating Costs

Singapore and Hong Kong, which were not forced to make large currency devaluation, had to cope with the weakened cost competitiveness of locally based businesses. To improve its competitiveness against countries that experienced major devaluation, Singapore instituted cost-cutting measures including an income policy that reduced government wages by 5 to 8 percent (Chapter 7).

Strengthening Social Safety Nets

The traditional social safety net systems of East Asian economies proved grossly inadequate to cope with the significant economic dislocation that resulted from the Asian financial crisis. For example, Indonesia had to increase its expenditures on social safety net programs to address the scale of problem (Chapter 1).

Strengthening social safety nets is not only a short-term measure to cope with crisis. It will be necessary in the long-term as well. Structural reforms to improve efficiency and international competitiveness involve reducing protection of industries, and this means that governments will have to take over some social policy functions, such as maintaining employment and providing housing and medical care, that had been imposed on corporations. The task of reform is particularly significant in China's transitional economy in which SOEs are a major provider of social welfare functions. China has embarked on such reform (Chapter 5).

POLICIES TO REDUCE VULNERABILITY TO EXTERNAL SHOCKS

Apart from direct responses to the negative impacts of the Asian financial crisis, East Asian governments need to improve their economies' capacity to absorb large-scale external shocks to prevent the repetition of the crisis. The papers in this volume suggest two areas for improvement: first, enhancing the crisis management capability of governments and second, increasing the flexibility of factor markets.

Enhancing Government Crisis-management Capability

The experiences of the Asian financial crisis call for the improved ability of East Asian governments in crisis management. There is a need for consistency of government policy announcements and transparency in policy formulation. This is true not only with governments of crisis-hit economies such as Thailand, Indonesia, and Korea but also with some other governments such as Hong Kong. The authors of Chapter 6 think that "the Asian financial crisis highlighted the need for the Hong Kong government to enhance ability to take the initiative capacity of crisis management" in response to a currency attack. They argue that the Hong Kong government should be more transparent about how the pegged exchange rate regime and currency board system work.

Increasing the Flexibility of Factor Markets

A lesson from the Asian financial crisis is that East Asian governments need to enhance the flexibility of factor markets in order to strengthen the economies' adaptive capabilities to large shocks and to increase and maintain international competitiveness. The rigidity in the property market together with a fixed exchange rate system in Hong Kong has resulted in a loss of competitiveness as explained before. The Hong Kong government had announced a long-term strategy to increase the supply of housing just before the crisis, but it reversed the policy and froze the sale of land and scaled back the building of subsidised housing. The authors of Chapter 6 argue that the government instead should have adhered to the policy of expanding the supply of land and housing and rectifying the oligopolistic structure of the property industry.

Labour markets in East Asia seem to have had a fairly high degree of flexibility, except in economies such as Japan, Korea and China. In China, labour market reform is a necessity to implement SOE reform, and such measures as publicity campaigns, vocational training, and opening of re-employment service centres have been taken (Chapter 5).

AGENDA FOR LONG-TERM DEVELOPMENT

As East Asian economies have shown a remarkable ability to rebound from the crisis, of which they were more a victim than perpetrator, it is easy to fall into complacency. Indeed, it is also crucial for the future long-term development of East Asian economies to preserve the factors that aided their past 'miraculous' growth. Asia's cultural tradition, which places a high value on education and saving, should be preserved with some modification such as more orientation to innovation in education to support the relatively high growth rates targeted by East Asian economies. The outward-looking economic policy needs to be maintained as well with some modification such as pragmatic control of capital flows. Continued attraction of foreign direct investment will be crucial. Government involvement to correct market failures also continues to be necessary, again with some modification such as more indirect intervention than in the past, so as to foster independent entrepreneurship in the private sector.

However, even before the crisis, East Asian economies were approaching a crossroads in their development path. Some possible constraints to sustainable economic development had become apparent. The front-running developing economies such as Malaysia and Thailand had begun experiencing a shortage of skilled human resources, which could have constrained their industrial upgrading. Imbalance between the protected and inefficient domestic market sectors such as the financial sector and the more open and competitive export-oriented manufacturing sector had become too large to sustain balanced economic growth in most East Asian economies, with the possible exceptions of Hong Kong and Singapore. Thus, East Asian economies, particularly as they continue on the path of development, need to resolve bottlenecks to sustainable development. They need to maintain outward-looking economic policies and to develop industrial diversity by steadily upgrading toward a knowledge-based industrial structure and developing an efficient and competitive financial sector. Such a broad and upgraded industrial structure depends on skilled human resources and efficient corporate organisations. Efficient and competitive financial and corporate sectors are predicated on the establishment of a well-functioning corporate governance system. To maintain a robust and competitive economy in an environment of globalisation, East Asian economies need to enhance regionalisation of the economic and industrial structure.

Maintaining Outward-looking Economic Policies

It is crucial that East Asian governments continue their outward-looking economic policies to maintain competition and to enjoy the merits of economic globalisation. East Asian governments have rightly even further liberalised FDI policies in response to deteriorating FDI inflows (Chapter 9). Although the Malaysian government tightened capital control, the selective capital control seems to be justified as a measure to cope with the consequence of the market failures of global capital markets. This should not be seen as the reversal of the outward-looking economic policies in the region.

Broadening the Industrial Base

The development of a more broadly based infrastructure to reduce concentration on either the manufacturing sector or the service sector is necessary to increase competitiveness and to diversify risk. An efficient service sector is becoming more and more important for East Asian economies since, aided by the development of information technology, corporations world-wide have pursued total efficiency throughout all stages of the value chain, from research and development to production, logistics, marketing, sales, and finance. Moreover, many East Asian economies need to develop an efficient service sector to avoid concentration on the manufacturing sector. In Hong Kong, on the other hand, there is a recognition that "the economy's extreme service- and outward-orientation greatly concentrated business risks" (Chapter 6). Moreover, to reduce the over-dependence on foreign firms, the development of domestic firms is increasingly recognised as crucial. Singapore aspires to build world-class companies (Chapter 7).

Upgrading to a Knowledge-based Industrial Structure

In order to broaden industrial structure, upgrading to a knowledge-based industrial structure is increasingly necessary as East Asian economies climb the development ladder. Singapore acknowledges a need to have "an advanced and globally competitive knowledge economy within the next decade," which requires "a strong technological capability and a vibrant entrepreneurial culture" (Chapter 7). It is also obvious that Hong Kong needs "to promote high value-added industry, based on knowledge centred on technology" (Chapter 6). For that purpose investment in physical as well as human capital and in knowledge-creating activities is desirable. Moreover, the acute need to expand and upgrade university education and research capability is clearly recognised. Developing a knowledge-based industrial cluster may call for proactive government involvement. The authors of Chapter 6 claim that "fiscal incentives and reduced land costs for targeted industries could be justified by positive externalities emanating from these knowledge-generating industries." At the same time, government involvement should be indirect so as not to kill entrepreneurship in the private sector.

The Hong Kong government established the Commission for Innovation and Technology in 1998 to examine the problems for the creation of knowledge-based industries and to formulate necessary polices, recognising Hong Kong's lagging behind other NIEs in R&D expenditures relative to the economy's size (Chapter 6). This is a significant modification of its traditional laissez faire economic policy. The IT industry has been targeted by most East Asian governments to spearhead the transformation to a more knowledge-based industrial structure. The Hong Kong government proposed a HK$13 billion "Cyberport" project, funded mostly by private investment, to develop an infrastructure for information service industries (Chapter 6).

Developing an Efficient and Competitive Financial Sector

Upgrading the relatively underdeveloped financial sector is critical for the long-term economic development of East Asian economies as they become more sophisticated. The sector plays a key role in a market-oriented resource-allocation base for modern corporate governance and venture capital finance. Liberalisation is the basic policy direction, but proactive government policy is also required to develop the basic infrastructure. Singapore is liberalising its financial sector to compete with more liberalised Hong Kong.

Singapore is de-mutualising and merging the Stock Exchange of Singapore and the Singapore Monetary Exchange. It continues to develop the asset management industry (Chapter 7). The underdeveloped local currency bond market is recognised to have led to the increased financial risk as evident in the Asian financial crisis with the heavy dependence on the banking system and concentration of financial risk in the short-term debt markets (Chapter 6). The conservative fiscal policies pursued by East Asian governments until the Asian financial crisis limited the supply of government bonds, which play a catalytic role in the development of bond markets as benchmarks. The Hong Kong Monetary Authority started to issue Exchange Fund Bills and Notes for that purpose (Chapter 6).

Venture capital markets are becoming recognised as necessary infrastructure to support the development of local firms, which could help broaden the industrial structure.

Developing Human Resources and Networking

Abundant supply of skilled human resources is the key to upgrading to the knowledge-intensive industrial structure that is needed for sustainable economic development. While attracting foreign professionals is a short-term solution, development of local talent is the long-term objective. East Asian economies must place high priority on investment in education, particularly higher education, and training. Recognising the limited supply of skilled financial personnel as a bottleneck to the development of its financial sector Singapore is accelerating the training of local personnel and attracting more foreign talent (Chapter 7). The Hong Kong government urgently needs to attract overseas professionals and "serious consideration should be given to dealing with related issues such as immigration rules, living environment, and social life" (Chapter 6).

An interesting idea to overcome the constraint on innovative human resources in a single economy is to network research activities among the large pool of human resources in the community of Chinese-speaking economies. For example, Hong Kong could specialise in applying and commercialising research results that are generated at institutions in Mainland China (Chapter 6). This implies a need for further regionalisation of economies and industries about which more is said below.

Developing Efficient Corporate Organisations

In order to achieve sustainable industrial development, it is essential to develop efficient corporate organisations. After all, applying increasing knowledge to increasing capital and labour creates economic wealth. The way it is applied is crucial for the growth of productivity. The traditional heavy dependence of many East Asian economies on FDI is due to the inadequacies of domestic corporate organisations in addition to the lack of technology. While East Asian economies must attract sufficient FDI to maintain industrial strength and spur domestic corporations, they must also generate efficient and competitive domestic corporations in order to develop a broader, more balanced industrial structure.

Despite the imperative to develop domestic firms, the papers in this volume have not raised the traditional cry for infant industry protection. I think this is because the detrimental effects of protectionist policies on competition and entrepreneurship have been increasingly accepted. Instead of infant industry protection they make the case for generating a favourable environment for the development of small and medium-sized enterprises and argue for government to take a role as a venture capitalist.

For East Asian developing economies encouraging small and medium-sized enterprises (SMEs) seems to be a more natural and viable approach to fostering domestic enterprises than pursuing large national champions. The Korean economy, which was oriented to large conglomerates known as *chaebol*, proved to be highly vulnerable to the large-scale shock of the Asian crisis, while the Taiwanese economy, which depended to the highest degree on SMEs, was highly resilient. To the extent that development of SMEs in Taiwan owes to its cultural and social background, or "the closely knit Chinese family and kinship structure" (Chapter 8) its experience is not necessarily directly transferable to other economies. However, to the extent that government's restraint against direct interference in business affairs contributed to the development of its SMEs (Chapter 8), Taiwan's experience challenges other East Asian governments to modify their more interventionist industrial policies. It is noteworthy that industrial development in interventionist Singapore focused largely on multinational corporations and that Singapore's domestic enterprises are still relatively underdeveloped.

Business efficiency often seems to depend on entrepreneurial independence together with networking capability rather than on the economies of scale typically pursued under interventionist industrial policies. Again, Taiwan is a case in point. The strong networking capability of Taiwan's SMEs seems to compensate to some extent for their lack of economies of scale. Moreover, ease of entry and exit and involvement of most SMEs in highly competitive export markets has preserved a competitive environment. For example, "Taiwan's simple bankruptcy procedures facilitated the exit of inefficient firms" (Chapter 8). In industries such as the IT manufacturing sector with vertical production characteristics, Taiwan's SME networks have been reorganised to form centre-satellite contracting relationships, which are often more efficient and flexible than the large firm-oriented systems of Japan and Korea (Chapter 8). Taiwan's centre-satellite contract networks offer a potential corporate model suitable to the information age. Still, SMEs are often handicapped by a lack of economies of scale in R&D, human resources, and management capability. Corporate efforts and indirect government policy support will be necessary.

In this context, East Asian governments are taking on a role as venture capitalists to develop a knowledge-based industrial structure. The Hong Kong government, for instance, set up a HK$5 billion Innovation and Technology Fund to support innovation and the commercial application of technologies (Chapter 6).

The development of efficient corporate organisations is a particularly challenging task in China's transitional economy because of the inefficiency of many SOEs. The priority of the SOE reform program is on reform of large state enterprises. The government has introduced such measures as allowing SOEs to re-capitalise by swapping debt for equity and allowing the healthiest enterprises to raise funds in domestic and international capital markets, encouraging large and medium-sized SOEs to merge unprofitable SOEs, and converting SOEs to shareholding organisations. Moreover, the government is forcing restructuring of the textile industry, which is plagued with oversupply and weak profitability (Chapter 5). It remains to be seen whether such mandatory restructuring operations to rescue inefficient enterprises may not cause adverse selection or undermine the competitive environment necessary for organisational efficiency. The government's policy of forming SOEs into large enterprise groups in order to increase economies of scale may not pay enough attention to the necessary environment of competition.

Establishing Effective Corporate Governance Systems

There is growing recognition that corporate governance systems are in need of comprehensive reform in order to develop a well-functioning financial sector and to develop efficient and competitive corporate organisations. The problem of concentrated corporate ownership among a small number of family empires is now being resolved with the restructuring process in the aftermath of the Asian financial crisis in countries such as Thailand and Korea. The massive sale of subsidiaries to keep parent corporations afloat should dramatically alter the ownership structure of Thai corporations (Chapter 3). Apparently the same applies to Korean corporations as well. The Philippines needs to address the problems of interlocking directorates and connected-lending in the private sector. The latter may be helped by improvement of transparency and increased presence of foreign financial institutions (Chapter 2). In China diversifying corporate ownership amounts to the wholesale reform of SOEs. While this reform is ongoing, China has begun to strengthen internal accounting and auditing procedures and implement a special governmental inspection system as steps toward improving enterprise governance (Chapter 5).

Enhancing Regionalisation

The regionalisation of East Asian economies will increase their growth opportunities as well as their resiliency. Regionalisation continues to be a pillar of Singapore's development strategy despite some criticism that the strategy has made the city-state vulnerable to external shocks such as the Asian financial crisis. The Stock Exchange of Hong Kong already lists 41 China incorporated enterprises and the authors of Chapter 6 argue that Hong Kong should continue to develop its fund-raising role for Mainland China. Crucial trends to deepen regional ties in East Asia are for ASEAN to maintain the liberalisation drive exemplified in AFTA and for the integration of Chinese-speaking economies to proceed further. Moreover, recent moves towards formation of free trade areas between Singapore and Japan and between Korea and Japan are steps in this same direction.

Redefining the Role of Government

As East Asian economies move from the early stages of development to become more complex, government' s role also needs to be transformed. East Asian governments have scaled back or ceased their direct intervention in business operations. With economic progress based on innovation, individual initiative becomes more important than co-operation with authoritarian directions. The Asian, or Confucian, value placed on accepting authoritarian rule needs to be modified to accommodate more democratic behaviours. In the words of Korea's President Kim Dae Jung: "in order for Asian nations to foster innovation and to make a successful transition from input-driven growth to productivity-driven growth, Asia would have no other practical alternative to democracy" (Chapter 10). This does not necessarily mean that East Asian people share the instant democratisation often advocated by the Western people. Chapter 10 considers Asian values in relation to regional economic development, and contemplates the role of government in this context.

As it makes the transition to a market economy China needs to lessen the direct intervention of government in economic affairs. In a first step in a program to improve the business environment, China reduced the number of central government departments and commissions from 40 to 29. Most of the reduction came by eliminating industrial departments that interfered in enterprise operations (Chapter 5).

While taking a less authoritarian and less interventionist stance toward the economy, governments in East Asia must also work to create an environment that is conducive to industrial upgrading. This is evident in Hong Kong where the laissez-faire policy that contributed so significantly to economic growth in the past is recognised as inadequate for the industrial upgrading that is necessary for future growth. The authors of Chapter 6 argue that "governments should become proactive in projecting future market developments and in shaping industrial policies accordingly in order to shift their competitive advantage." They say that this can be implemented by "designing a tax regime and allocating public and financial resources to favoured sectors as well as investing in the supply-side economy to promote long run economic growth." These are the areas through which East Asian governments can support the long-term sustained development of their economies.

1

From Currency to Economic Crisis[1]

Yoopi Abimanyu

INTRODUCTION

From August 1997 the Indonesian rupiah was profoundly shocked by currency fluctuation. As of the first quarter of 1998, the rupiah had depreciated much further than other currencies in the region. This currency shock was unanticipated (Radelet and Sachs 1998 *b*). At its onset, the depreciation of the rupiah was widely viewed as contagion from other Asia-Pacific countries, as Indonesia's macroeconomic fundamentals were considered sound (Chan 1997). According to this view, the behaviour of the rupiah was mostly due to the movement of other Asia-Pacific currencies. Announcements by public officials that added to domestic political uncertainty exacerbated the depreciation of the rupiah. The currency crisis led to economy-wide deterioration. By late 1998 Indonesia's economic condition had stabilised somewhat due in part to steps taken in the fiscal, monetary, and banking sectors and to the government's efforts to maintain a stable exchange rate.

This chapter aims to document the currency and economic crises that stand in the way of Indonesia's return to dynamic economic growth. First, it describes the unfolding of the currency crisis in Indonesia and investigates the empirical connection of contagion and political announcement effects to the drastic fall in the rupiah. Then, it describes Indonesia's macroeconomic crisis in terms of negative growth, high inflation, and balance of payments problems, and the economic conditions in the fiscal and monetary sector, the banking sector, and the exchange rate.

THE CURRENCY CRISIS

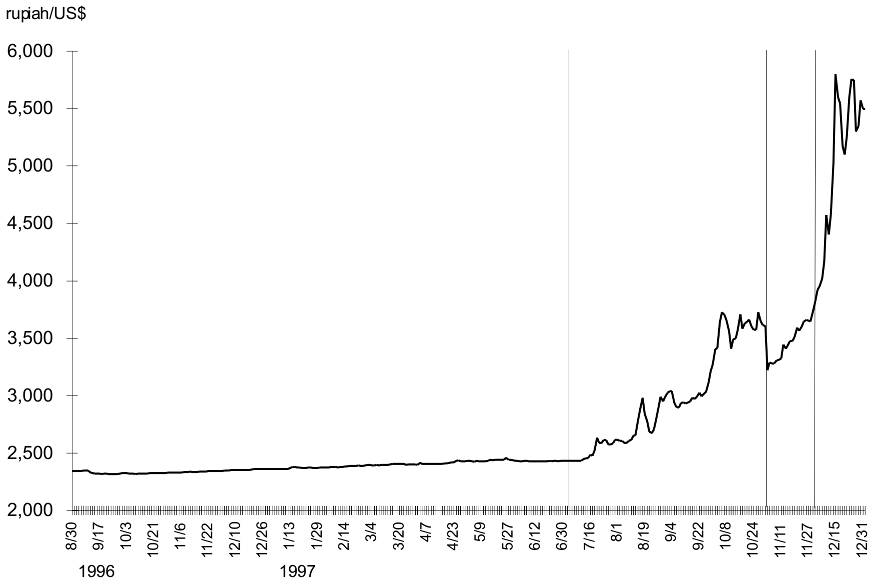
The Currency Shock

For the past several decades, prudent macroeconomic policies and continuing deregulation kept Indonesia on a path of rapid economic development. Since the 1970s, economic growth averaged 7 percent per annum, raising Indonesia's GDP per capita to the level of middle income countries by the mid-1990s. Broad-based, labour-intensive growth, together with sustained improvements in basic education and health services, dramatically lowered the incidence of poverty—from over 60 percent in the late 1960s to 11 percent by the mid-1990s.[2] Indonesia's economic structure diversified. Dependence on the oil sector declined as an export-oriented manufacturing base emerged, led by a dynamic private sector and fuelled by high domestic savings and large inflows of foreign direct investment. Indonesia maintained macroeconomic balance: the budget was balanced; inflation was contained; current account deficits were relatively low; and international reserves were built up to a comfortable level, pushed by 10.4 percent export growth in 1996.

Despite these sound macroeconomic conditions, the rupiah was profoundly shocked by currency fluctuation from August 1997. Until July 1997, the rupiah had been considered one of the stable currencies in the Asia-Pacific region. From September 1996 to July 1997 the currency depreciated only 3.83 percent, from 2,342 rupiah per U.S. dollar to 2,432 rupiah per U.S. dollar (Figure 1.1). However, from July to November 1997 it depreciated about 47 percent and it fell another 35 percent in December 1997 alone, for an overall decline of 67.1 percent from July to December 1997.[3] The rupiah fell much further in value than did the other currencies in the region.

The Indonesian government responded to the initial shock by abandoning the crawling peg exchange rate regime and letting the currency float to seek its market-determined level from 14 August 1997. At the same time, it tightened the money supply, thereby raising domestic interest rates as a means of defending the currency. The aim was to maintain interest parity in order to avoid a massive depreciation of the rupiah.[4] In November 1997 the government signed agreements with the International Monetary Fund (IMF) for Stand-by Loan Arrangements in the amount of US$43 billion to strengthen the country's foreign exchange reserves.

FIGURE 1.1
Exchange Rate of the Rupiah against the U.S. Dollar, 9/96–12/97



Source: Dow Jones. http://djinteractive.com

Unanticipated Shock

Radelet and Sachs (1998b) argue that the currency shock was unanticipated. They found no prior sign of looming crisis among market participants or market analysts. The ongoing assessment of credit risk in the domestic market by rating agencies such as Standard and Poor's, Moody's, and other independent agencies was a positive and stable outlook. Even forecasters at the IMF and World Bank gave only a slight indication of macroeconomic risk in the region. The real exchange rate appreciation was thought to be a short-term phenomenon and not a sign of impending crisis.

The initial shock to the rupiah was widely viewed as contagion from other Asia-Pacific countries, particularly Thailand, as Indonesia's macro-economic fundamentals were considered sound (Chan 1997; Nasution 1997; and Fratzscher 1997). The general view was that the actual behaviour of the rupiah was mostly due to the movement of other currencies in the region. After the initial shock, the Indonesian financial market plummeted in late 1997, despite the small current account deficit, relatively little bank debt, no significant corporate bankruptcies, and the steady growth of the stock market.

One indication of the mounting economic consequences arising from the exchange rate depreciation came from the financial sector. In early November 1997, domestic financial markets suffered a severe liquidity shortage.[5] The liquidity shortage was apparently caused by three factors: a run on certain private banks, a disruption of the interbank money market, and government interventions in the foreign exchange market that were not completely sterilised. Currency in circulation stood at roughly 25 trillion rupiah on 31 October 1997 and it had increased by 4.5 trillion rupiah to 29.5 trillion rupiah on 4 November, the second business day after the government announced the closure of sixteen banks. The amount of currency in circulation remained high through 17 November and then declined by around 5 trillion rupiah during the last two weeks of November. The interbank money market was disrupted beginning in November. Banks with excess reserves were hesitant to make loans to banks short of reserves, even overnight interbank loans, because of the possibility that other private banks might be closed. (Lists of additional banks to be shut were circulating.) Some banks were forced to turn to the central bank for support in the face of a severe liquidity crunch.[6] The government's intervention in the foreign exchange market during early November absorbed a large amount of liquidity. The decline in net foreign assets of the banking system was partly offset by an expansion of other central bank instruments, but this did not fully offset the contraction.

Mounting Crisis

The withdrawal of foreign funds created a chain reaction that quickly developed into a financial panic. The depreciation of the rupiah resulting from the flight of foreign capital sparked a renewed withdrawal of foreign exchange, as domestic borrowers with un-hedged currency positions rushed to buy dollars. Only a few Indonesian firms had hedged their foreign exposures, since most believed that the government would maintain the crawling-peg exchange rate regime with predictable, gradual depreciation. As the currency depreciated, foreign lenders became more concerned over the debt levels of their clients. Given Indonesia's lack of clear bankruptcy laws and workout mechanisms, they started to call in loans, which reinforced the depreciation. The withdrawal of foreign funds also set off a liquidity squeeze and a sharp rise in interest rates that made it difficult for firms to operate and created problems in the business environment.

The banking system started to bend under the intense pressure. Non-performing loans rose quickly and there were more runs as depositors rushed to make withdrawals either out of concern over the safety of the banking system or in order to meet pressing foreign exchange obligations. The capital base of the banks eroded, adding to the pressure.

As anxiety about the financial position of banks mounted, the public began to withdraw deposits at an increasing rate. While the amount of currency in circulation increased hardly at all during the third quarter of 1997, it rose by 17 percent during the fourth quarter. And in the first three weeks of January 1998 alone, it increased an alarming 24 percent. Despite the central bank's growing provision of funds to enable the system to continue operating, commercial banks were having increasing difficulty performing their usual functions:

- With a shrinking deposit base, banks had fewer and fewer funds available to lend to the corporate sector at time when corporations' need for credit was intensifying.
- Foreign banks were no longer accepting letters of credit from Indonesian banks, forcing companies to pay 100-percent of the cost of imports in foreign exchange, even before goods were delivered.
- Domestic banks were refusing to lend to each other. Since banks no longer trusted the financial condition of other banks, they would lend only for very short terms at very high interest rates.

In order to keep the system afloat, the central bank had stepped in to the interbank market to recycle funds from banks with ample funds to those short of liquidity. It offered swap facilities for exporters to entrust their dollars to commercial banks and schemes to help exporters obtain letters of credit. However, the problems steadily mounted while confidence continued to dissipate. Finally, to solve the underlying problems of the commercial banks and to rescue the banking system, in January 1998 the government introduced a comprehensive guarantee for all depositors and creditors of commercial banks. It also charged a new agency, the Indonesian Banking Restructuring Agency (IBRA), with restoring the banking system to financial health. By putting its full faith and credit behind commercial banks, the government expected that the public's fear would subside and foreign creditors would be convinced to rollover external loans. Also, the IBRA would insulate the central bank from the political consequences of restructuring and from the difficult decisions about which banks should be taken over, re-capitalised, or merged.

To reduce pressure on the foreign exchange market, the government required domestic borrowers to report their loans. Outstanding private domestic debt was disclosed at US$78.2 billion as of February 1998. The government also set up a small team called the Indonesian Debt Restructuring Agency (INDRA) to consolidate negotiations between domestic borrowers and foreign creditors. On 4 June 1998, this team succeeded in rescheduling a private sector foreign loan in Frankfurt, Germany for eight years with a three-year grace period.

Political Uncertainty

As the economic crisis took hold at the end of 1997 its causes became as much political as they were economic. Economic and political issues fed on one another, exacerbating the crisis. There were signs that former President Suharto's health was weakening and he had no apparent successor. There was growing discomfort with the economic role played by Suharto's family and its business-as-usual attitude in the midst of the economic crisis gripping the nation. There were riots preceding the campaign for the March 1998 presidential election. All these were indicators of growing domestic political uncertainty (Radelet and Sachs 1998 *b*).

Contagion and Political Effects

Thus, Indonesia's predicament has been viewed as a case of contagion, augmented by political issues, leading to unnecessary economic contraction. The rupiah's depreciation immediately after July 1997 has been attributed to uncertainties spilling over from the collapse of other currencies in the region and its continued slide into early 1998 is attributed to uncertainty over the domestic political situation. This interpretation can be tested empirically as a contagion effect and a political announcement effect on the exchange rate.

Contagion Effect

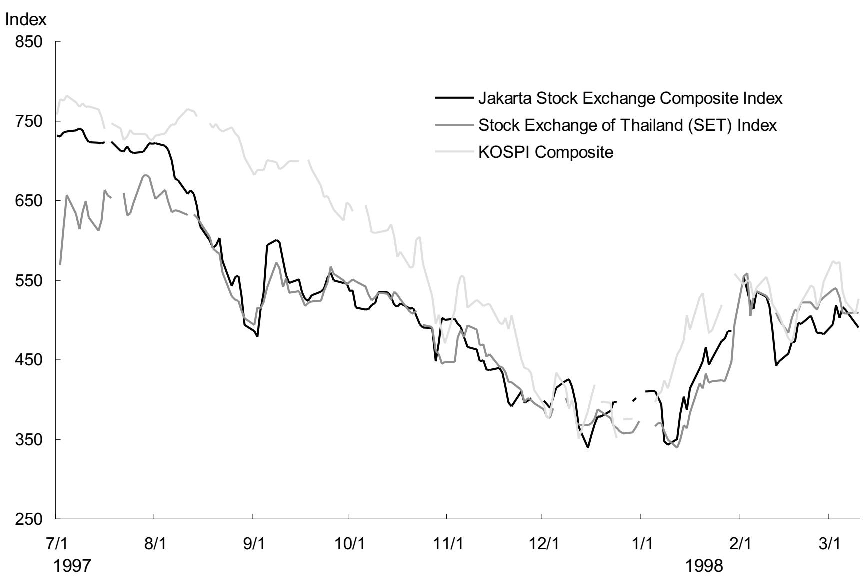
According to Fratzscher (1997) contagion occurs because open economies that are connected through trade, geography, common external shocks, or similar economic structures also have integrated financial markets. When one country is hit by a financial crisis, investors may flee the other countries as well, either because they want to adjust their investment holdings and raise cash ('constitutional' contagion) or because they fear the spread of the crisis to the connected countries ('herding' contagion, p. 13). The more financially integrated one country is with a country where a currency crisis begins, the more likely it is that the crisis will spread and the more severe the crisis will be in the infected country.

Most Asian countries, including Indonesia, were financially integrated with Thailand. The weekly returns on their stock markets were closely correlated. Most of these stock markets declined significantly after the crisis struck Thailand in early July 1997 (Fratzscher 1997, pp. 13, 14, 40). The similarity in the movement of stock market indexes and exchange rates in Korea, Thailand, and Indonesia between July 1997 and March 1998 suggests that there was a contagion effect running from Thailand to the others (Figures 1.2 and 1.3).

Political Announcement Effect

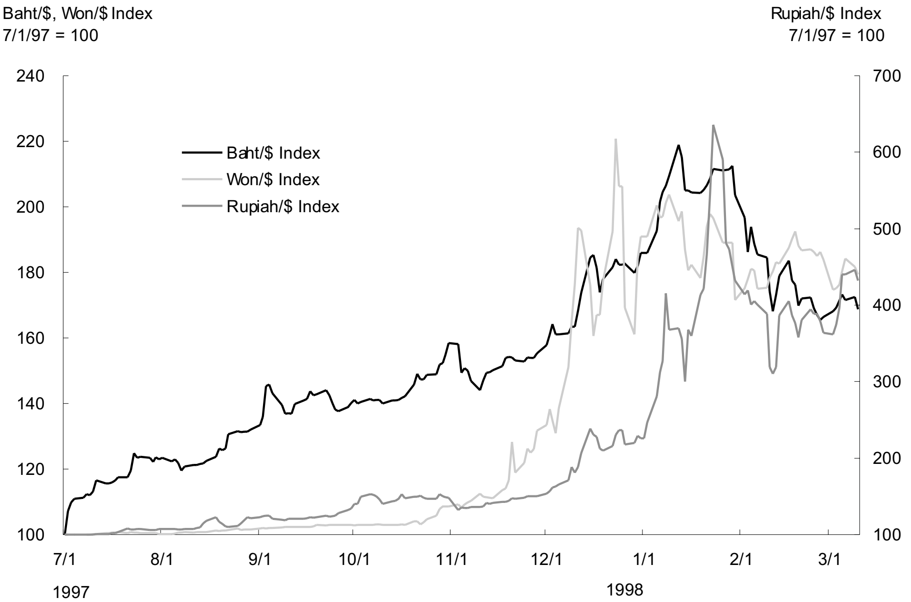
Weaknesses such as lack of transparency in policy decisions, crony capitalism, corruption, monopoly power, and growing short-term indebtedness existed in Indonesia before the shock, but after the shock the

FIGURE 1.2
Indonesian, Korean, and Thai Daily Stock Market Indices, 7/1/97–3/10/1998



Source: Dow Jones. http://djinteractive.com.

FIGURE 1.3
Daily Exchange Rates of Baht, Won, and Rupiah versus U.S. Dollar



Source: Dow-Jones Interactive, http://djinteractive.com.

sense of political uncertainty was heightened. Inconsistent responses of the Indonesian government to the evolving crisis added to the sense of uncertainty. For example, first the government postponed the large infrastructure investment projects, then it reinstated them, and then it postponed them again. The distrust created by such inconsistency was compounded by the fact that certain banks had close connections with government officials. Two of then-President Suharto's relatives publicly balked and threatened to sue the government when their banks were ordered closed, even though senior government officials strongly asserted that the decision was final and would go forward.

In this climate of uncertainty, the movement in the rupiah exchange rate appears to reflect the market's evaluation of the government's efforts with respect to the crisis. For example, the rupiah strengthened immediately when Indonesia signed its first agreement with the IMF on 3 October 1997. It was up 10.65 percent by 3 November after large concerted