

Introduction

Perhaps the country most seriously affected by the Asian financial crisis was Indonesia and unfortunately it also one of the slowest to recover. A number of critics lay the blame for the Asian financial crisis on attempts by developing countries to partake of the opportunities offered by globalization. It is therefore fair to ask “to what extent was globalization a factor in the economic crisis?” This brief contribution to the debate attempts to answer that question with respect to Indonesia.

About Globalization

Globalization is a set of economic, political and cultural processes of linkage and integration, both global and regional. Economic globalization, which is the focus of this study, underlies the phenomena of rapidly rising cross border economic activity leading to an increased sharing of economic activity between people of different countries. This cross border activity can take various forms, including international trade, foreign direct investment and capital flows.

It is important to recognize that economic globalization is not a wholly new trend. As Rodrik (1997) points out, this is not the first time we have experienced a truly global market. The world economy was probably even more integrated at the height of the gold standard in the 19th century than it is now. Figure 1 charts the ratio of exports to national income for the United States, Western Europe, and Japan since 1870. In the United States and Europe, trade volumes peaked before World War I and then collapsed during the interwar years. Trade surged again after 1950, but none of the three regions is significantly more open by this measure now than it was under the late gold standard.

Japan, in fact, has a lower share of exports in GDP now than it did during the interwar period.

Other measures of global economic integration tell a similar story. During the late 19th century, as railways and steamships lowered transportation costs and Europe moved towards free trade, a dramatic convergence in commodity prices took place (Williamson, 1996, in Rodrik, 1997). Labor movements were considerably higher then as well, as millions of migrants made their way from the old world to the new. In the United States, immigration was responsible for 24 percent of the expansion of the labor force during the 40 years before World War I. As for capital mobility, the share of net capital outflows in GNP was much higher in the United Kingdom during the classical gold standard period than it has been since (Rodrik, 1997).

The current round of globalization began after World War II and accelerated in the 1980s and 1990s, as governments everywhere reduced policy barriers that hampered international trade and investment. Opening to the outside world has been part of a more general shift towards greater reliance on markets and private enterprise, as many countries, especially developing and socialist countries, came to realize that high levels of government planning and intervention were failing to deliver the desired development outcomes. As in the 19th century, this round of globalization has also been fostered by technological progress, which has reduced the costs of transportation and communications between countries. Dramatic declines in the cost of telecommunications and of processing, storing and transmitting information, make it much easier to track down and close business deals around the world, to coordinate operations in far-flung locations, and to trade services that previously were not internationally tradable at all.

The data on international trade and capital flows support the proposition that we have seen a significant increase in globalization over this period. Among rich or developed countries the share of international trade in total output (the ratio of exports plus imports of goods to GDP) rose from 27 to 39 percent between 1987 and 1997 while for developing countries this same ratio rose from 10 to 15 percent. Firms based in one country increasingly make investments to establish and run business operations in other countries. American firms invested US\$133 billion abroad in 1998, while foreign firms invested US\$193 billion in the US. Global FDI flows more than tripled between 1988 and 1998, from US\$192 billion to US\$610 billion, and the ratio of FDI to GDP is generally rising in both developed and developing countries. On average developing countries received about a quarter of world FDI inflows in 1988-98, though the share fluctuated substantially from year to year. FDI is now the largest form of private capital inflow to developing countries (World Bank, 2000).

The World Bank (2000) points out a growing consensus in empirical studies that greater openness to international trade has a positive effect on per-capita income. In support of this position, the World Bank cites a number of studies including one by Frankel and Romer (1999) which estimates that increasing the ratio of trade to GDP by one percentage point raises per-capita income by between one-half and two percentage points. Numerous other studies reach similar conclusions, though the estimated size and statistical significance of the effects vary. While there is no consensus on the mechanism by which these gains are realized, globalization is generally believed to result in

increased competition, which obliges local firms to operate more efficiently than under protection, and greater exposure to new ideas and technologies.

While openness generally benefits all countries, there is some evidence (Ades and Glaeser in World Bank, 2000) that trade openness is particularly beneficial to poor countries and tends to reduce income inequality among countries. Figure 2 shows that while rich countries have on average grown faster than poor ones, poor countries that are open to trade have grown slightly faster than rich ones, and a lot faster than poor closed countries.

Indonesia's attempt at globalization

Up until the mid-1990s, Indonesia rode the tide of globalization extremely well. As early as 1980 Indonesia had embarked on various economic reforms that embraced the concepts that have ultimately been described as globalization. The decision to move in this direction was in part driven by an understanding of the benefits of openness, but it was also driven by the need to respond to the steep drop in oil prices after the sharp price increases in the 1970's. Many of Indonesia's earlier development efforts were supported by the oil bonanza and international assistance. As it became apparent that the economy could not rely much longer on oil income alone, a number of policies were introduced to stimulate the non-oil sector, especially manufacturing.

Beginning with tax reform in the early-1980s the reform effort broadened between the mid-1980's and mid-1990's to include a wide variety of measures to deregulate the economy and open up the market. As the Chairman of the Investment Board at that time, I took the initiative to consult investors who were already in Indonesia, so that they could tell us what they regarded as impediments to investing in

Indonesia. We organized seminars and consultations, with various business associations and Chambers of Commerce, domestic as well as international, to get inputs on how to make the investment climate in Indonesia more attractive and competitive, vis-à-vis our neighboring countries and other industrializing countries.

Through these actions, Indonesia's economy became more integrated to the global economy and world market. The results were clear: Indonesia emerged as one of the East Asia high performers, one of the "Asian miracle" countries. This was reflected in a number of academic studies. For instance, Radelet and Woo (in Woo, Sachs and Schwab, 2000), observed that many well-managed and competitive manufacturing firms producing a wide range of labor-intensive goods for world markets were established during this period. This rise in manufacturing output created expanded employment opportunities for Indonesia's huge workforce, steadily increased real wages, and lifted millions of people out of poverty. For these and other reasons, by the mid-1990s Indonesia had become a favorite destination for foreign investment.

How can we describe the policies that Indonesia adopted during that period? Stern (2000) discusses the economic policies that characterized this long period of rapid economic growth. He notes that Indonesia's policies were built on a series of sound macroeconomic principles that included the following elements:

- a) The adoption of an open capital account as far back as the 1970s, a policy stance Indonesia maintains to this day.
- b) The adherence to the so-called 'balanced budget' rule. While the concept of a 'balanced-budget' as used in Indonesia permitted a deficit equal to foreign

assistance receipts so that the budget was not strictly balanced, reliance on this concept, even in its modified form, helped enforce strong fiscal discipline.

- c) The maintenance of a competitive real exchange rate through periodic adjustments to the nominal exchange rate to capture differences between domestic inflation and world inflation. While in the mid- 1990s the rupiah did become overvalued and exports began to suffer, the overvaluation was relatively minor, particularly in comparison to a number of other regional currencies. Moreover continued large capital inflows exerted a-persistent upward pressure on the rupiah.
- d) Increasing deregulation of foreign trade. By September 1997 the average unweighted import tariff had fallen to 11.8% and the import weighted tariff to 6.3%. There was also a sharp reduction in the use of NTBs, export licenses, and other restrictions on international trade.
- e) The reduction and eventual removal of a myriad of restrictions on foreign direct investment.
- f) The liberalization of the financial sector. Measures to deregulate the financial sector including the banking sector contributed significantly to improved financial intermediation, which fueled the phenomenal growth of Indonesia's private sector over the last decade.
- g) The adoption of a modern, simplified tax system, that removed low-income wage earners from the tax net, eliminated, at least in principle, nearly all exemptions, and introduced a value added tax.

And what were the outcomes?

The opening up of the economy and the shift in economic policy from one that focused on developing import substitutes for the domestic market to one that forced domestic agents to improve productivity so that they could compete in the world market, always had its critics. But even a cursory review of the economic and social developments since the process of deregulation began leaves little doubt that such policies had a beneficial impact.

Rising per capita income. Over the period 1965-95 real GDP per capita grew at an annual average rate of 6.6%. In the mid 1960s Indonesia was poorer than India. By mid 1995, Indonesia's GDP per capita exceeded \$1,000, over three times that of India (World Bank, 1997)

Decreasing rate of inflation. The very high levels of inflation seen in the mid- to late- 1960s were brought under control. In the years immediately preceding the crisis, Indonesia had managed to keep inflation in the single digit range.

Increasing food supplies and the attainment of rice self-sufficiency. Market friendly interventions helped reduce price instability and inflation, combined with strategic investments that increased agricultural productivity, resulted in rising rural incomes and welfare, and reasonably stable rice prices.

A rising share of manufacturing output in GDP. The share of the manufacturing sector in GDP rose from 7.6% in 1973 to nearly 25% in 1995. This was driven by the rapid growth of manufactured exports (as shown in Figures 3, 4, 5 and 6). Non-oil exports, which are now predominantly manufactured products, grew by roughly 22% per

annum over the decade from 1985, when trade liberalization was first implemented, to 1995; a rate four times faster than the growth of world trade (Stern, 2000).

Sharply declining levels of poverty. The proportion of the population living below the national poverty line fell from around 60% in 1970 to 40% in 1976 to 15% in 1990 and to 11.5% in 1996 (as illustrated in Figure 7). Before the crisis, it was predicted that by the year 2005, when Indonesia's GDP would have reached \$2,300, and Indonesia would have become a middle income industrialized country, the incidence of poverty would have been reduced to less than 5%, which would be about the same level as other newly industrialized countries.

According to a World Bank document (1997), Indonesia's broad based, labor-oriented growth strategy, backed by a strong record in human resource development, brought about one of the sharpest reductions in poverty in the developing world. At the same time, this strategy resulted in real wages rising about as fast as per-capita GDP and benefited women by providing them with rapidly growing paid employment in the formal sector that allowed them to move out of unpaid work in the rural sector. Social indicators, such as infant mortality, fertility and school enrollments, also showed significant improvement.

Then came the crisis

The East Asian financial crisis has set Indonesia's development back many years. While growth in 1995 was 8.2% and in 1996, the year before the crisis, was 7.8%, in 1997 growth fell to 4.9%. But at least through 1997 growth was still positive. In 1998, at the peak of the crisis, Indonesia's economy contracted by 13.6% and other macroeconomic indicators deteriorated as inflation raged at 77.6%.

The crisis was driven by a depreciation of the exchange rate that seemed almost exponential, following the fall of the Thai baht in July 1997. From an exchange rate of Rp.2, 400 to the dollar in mid-1997, the rupiah collapsed to Rp.16, 000 to the dollar by June 1998. By that time Indonesia had lost its standing in international commerce; the public had lost all faith in the banking sector; Indonesia's exports were hampered by a lack of trade financing for imports; and some foreign customers were canceling orders because of lack of confidence in the ability of Indonesian firms to deliver the goods. Non-oil exports receipts fell 2.4% in 1998 and 4.6% in 1999 compared to the preceding year.

Among the Asian countries that were affected by the crisis, Thailand, Indonesia, and Korea sought IMF assistance to cope with the crisis, while Malaysia decided to go on its own and instituted capital control. The Philippines continued its arrangements with the IMF. By working with and agreeing to the terms of the IMF, Indonesia was seen as seriously tackling the problems that came with the crisis. However, it soon became apparent that President Soeharto, who signed the second agreement with the IMF himself, was not serious in implementing the reforms program. He became entangled in confrontations with the IMF. The market had become nervous not only with the conflicting policies but also with public statements made by the officials of the IMF and the World Bank criticizing the government. The economic situation had progressively deteriorated, as reflected in the value of the Rupiah, which continued to weaken.

In March 1998, amid mounting opposition against his rule, President Soeharto was reelected President by the People's Consultative Assembly (MPR). He formed a new Cabinet, in which I was appointed Coordinating Minister of the Economy, Finance and Industry. My task was to get the economy out of the crisis. The first order of business

was to restore the confidence of the market and mend the relations with the international community, especially the international financial institutions such as the IMF, World Bank and Asian Development Bank. An agenda of economic recovery and reform was drawn up and the first steps towards recovery were initiated.

However, with growing oppositions to the continuing rule of President Soeharto, political tensions heightened. The financial crisis was the catalyst, which prompted various forces demanding political reform to come together. These forces were led by students who had a long history of political activism.

In mid May 1998, riots exploded in Jakarta. During these riots, the Chinese community became the object of social unrest and the target of violence. The unrest and violence against the Chinese community and businesses resulted in more capital flight, already a feature of the financial crisis, and a breakdown of the distribution system in which Chinese merchants played a predominant role, further plunging the economy into deeper crisis.

At the same time that the Indonesian economy was reeling under the onslaught of the Asian financial crisis, it was also afflicted with a crisis driven by natural causes. In 1997, Indonesia was struck by a particularly fierce El Niño that resulted in the most severe drought in 50 years. The resulting drop in food production contributed significantly to the rate of inflation of 1998, increased pressure on dwindling foreign exchange reserves, reduced domestic demand, lowering rural incomes, and increased rural poverty. In Sumatera and Kalimantan, rampant forest fires made worse by the drought destroyed hundreds of thousands of hectares of forests. This created an

environmental and health hazard that added another dimension to the problems already faced by Indonesia.

In the aftermath of the crisis, Indonesia's debt burden has increased substantially. In 1999 Indonesia's total external debt amounted to \$148 billion, or 104% of GDP, about half of it owed by the private sector, including public enterprises. The cost of restructuring the domestic banking system after its collapse during the crisis is likely to cost about \$65 billion adding significantly to the government's debt burden.

Until now I have focused on the macroeconomic aspects of the crisis. But the crisis also had a significant social impact. Millions of individuals lost their job. Children left school because they could not afford to pay the necessary school fees or because they had to help support their families.

The efforts at recovery

In May 1998, facing mounting popular pressure, spearheaded by the students, President Soeharto stepped down and was succeeded by Vice President Habibie. President Habibie asked me to stay on as Coordinating Minister for the Economy to continue the reform program that had been initiated during the previous government. The new government immediately embarked on a series of measures with the support of the international community, to halt the deterioration of the economy and ignite the recovery of the economy.

On the economic front, the recovery agenda consisted of five programs: i) restoring macroeconomic stability; ii) continuing with structural reform; iii) restructuring of the banking system; iv) resolution of corporate debt and; v) reducing the impact of the crisis on the poor through the speedy implementation of a social safety net. Through

these measures, the new government managed to stop the deterioration of the economy and put Indonesia back onto the path to recovery. Moreover, it was able to restore stability and lay the foundation for economic reconstruction. By the time of the Presidential elections in October of 1999, the rupiah had recovered, reaching a level between Rp.6,500 to Rp.7,500 to the US dollar and it held that level for some time. Inflation had been brought under control, and in 1999 was reduced to 2% (Figure 8). This allowed the government to lower interest rates from 80% to 11-12%. Domestic consumption began to recover, especially in the automotive and construction industries. The downward tailspin of the economy had been arrested.

By mid-1999 the economy bottomed out and was beginning to grow again. For the year, very modest growth returned with GDP rising by 0.3% (Figure 9). If the recovery momentum could be maintained, it was predicted at that time, that growth in the year 2000 would be around 4-5%. Importantly, exports began to revive, as exporters reaped the benefits of the heavily depreciated local currency (Figure 10 shows the trend in some other regional countries as well).

To help cushion the impact of the crisis on the poor, a multitude of social safety net programs were designed and immediately launched. These included providing subsidized rice for poor households, granting scholarships for schoolchildren (reaching 1.7million pupils), providing free health care to poor families, and building rural infrastructure to create jobs. At the same time, rice production had returned to its previous level, supported by empowerment programs for the farmers, which included credits, and technical assistance channeled through local universities, NGO's and cooperatives, as well as a return to more normal weather patterns.

The reconstruction of the economy was carried out by the introduction of a number of new laws and regulations and the establishment of needed institutions. For instance, the Habibie government introduced a new bankruptcy law that provides certainty for creditors and debtors and also established a mechanism of corporate debt settlement through the Jakarta Initiative Task Force. Other reform actions included the closing or taking over of ailing banks and banks that had violated banking regulations, establishing an independent Central Bank (Bank Indonesia), setting out rules to ensure fair competition and outlaw monopoly and other harmful business practices, and working with the private sector to develop standards for good corporate governance.

While pursuing these economic reforms, the Habibie government also initiated political reforms to lay the foundation for democracy and settle politically sensitive issues in the international forum, such as the East Timor issue. A general election was held in June 1999, which was the first multi-party democratic election in 45 years. The general election was followed by the presidential election by the People's Consultative Assembly, the first democratic presidential election since the country declared its independence in 1945. Steps were taken to ensure the respect of human rights and the rule of law. The police was separated from the military and the military was to be put under civilian control. Control of the press was abolished. Freedom of association and expression were assured. Labor unions were no longer restricted.

What caused the crisis?

Many studies have been done on the Asian financial crisis. Although the general characteristics of the crisis were similar in the various crisis countries, the depth and duration of the economic crisis in Indonesia were arguably unique (the only potentially

comparable situation being Russia). In this section we examine briefly why the crisis has been so severe in Indonesia and why the recovery has been so slow.

In retrospect we now know that Indonesia's crisis was largely unforeseen. Indeed, Furman and Stiglitz (1998) find that it was the least predictable from among a sample of 34 troubled countries. When Thailand was showing the first signs of crisis, it was generally believed that Indonesia would not suffer the same fate. Indonesia's economic fundamentals were believed to be strong enough to withstand the external shock of Thailand's collapse.

Although there were already some indications of difficulties in the banking sector, especially related to loans in the property sector, the mood was that of confidence. There were some justifications for this confidence. The current account deficit was the lowest among the five Asian countries affected by the crisis. Exports in 1996, although down from the 1995 level, were the second highest in the region. The budget had been in surplus for several years. Credit growth had been modest compared with most other high growth countries in the region. Foreign liabilities of commercial banks were essentially lower than those in other affected countries, and the stock market continued to be strong through early 1997 as an indication of a buoyant mood at that time. Up until September 1997, the government was still contemplating and engaging in negotiation with the Russians to buy a squadron of Russian-made fighters in a counter-trade scheme. As the Minister of Planning at that time, I was involved in the negotiation with the Russians. The plan was of course abandoned, when it had become apparent that the situation was more serious than many people, even those among the economic ministers, had thought.

Indonesia did suffer from the crisis and suffered the most. *But why?* I believe that there are four factors that can help explain the Indonesian situation.

First, Indonesia's large stock of short-term private external debt created the setting for instability. A contributing factor to the complacency lay in the ignorance even among the economic ministries and probably within the banking community of the magnitude and terms of the debt of the private sector. The government had always been extra careful about the public debt, making all efforts to contain it within a manageable range, but it had no mechanism to monitor the debt incurred by the private sector. Only later as the crisis was progressing was it realized how serious the private sector debt problem was. Between 1992 and July 1997, 85% of the increase in Indonesia's external debt was due to private borrowing (World Bank 1998). This is similar to the phenomenon of other Asian countries that were struck by the crisis. In many ways, the country was a victim of its own success. Foreign creditors were eager to lend money to companies in a country which had low inflation, a budget surplus, an abundant and relatively well-educated labor force, good infrastructure, and an open trading system. Attracted by these 'dynamic economies', net capital inflows (long term debt, foreign direct investment, and equity purchases) to the Asia Pacific region increased from \$25 billion in 1990 to over \$110 billion 1996 (Greenspan, 1997).

Unfortunately much of the capital inflow did not find its way into productive agricultural or industrial sectors. Instead it gravitated towards the stock market, consumer finance and, particularly in Indonesia and Thailand, to real estate. These sectors boomed, while the real appreciation of the exchange rates, caused in part by the capital inflows, led to a slowdown in exports, the mainstays of the national economies. Many of the loans

were also made on the basis of political connections rather than economic viability and on the perception that the government would bear the cost of failure. Financial institutions were making loans on the basis of already inflated assets in a circular process that led to further appreciation (Kelly and Olds, 1999). This was an outcome of a system often referred to as 'crony capitalism'. The moral hazard and asset inflation was, as described by Krugman (1998), a strategy of 'heads I win, tails somebody else loses'. While this 'virtuous' circle continued to inflate, financial institutions were borrowing in US dollars and lending in local currency (Radelet and Sachs, 1998). To make matters worse, the average maturity of the credit to the private sector was declining. At the time of the crisis the average maturity of private sector debt was 18 months, yet by December 1997, \$20.7 billion had to be paid in a year or less (World Bank, 1998).

Second, and related to the above, the flaws in Indonesia's banking system ensured that problems with external corporate debt would become a domestic banking problem. When the banking system was liberalized in the mid-1980s, the supervisory and monitoring mechanism was relatively ineffective and could not keep pace with the rapid growth of the banking sector. Worse yet, banking regulations were inadequately enforced, and this was particularly true for rules covering intra-group lending, loan concentration and the application of creditworthiness criteria. At the same time, numerous banks were seriously undercapitalized. All of this meant that when the rupiah began to depreciate, banks were poorly positioned to absorb the resulting further deterioration of their balance sheets.

Indeed, Greenspan (1998, as quoted by Kelly and Olds, 1999) identified the roots of the Asian financial crisis as lying in economic mismanagement where market signals

had not been allowed to cause adjustments until the bubble burst. Thus, when global financial managers detected disparity between exchange rates and global competitiveness, institutional investors and speculators began to move the capital out. Then the 'virtuous circle' was broken and a financial contagion spread across the region. The situation was exacerbated by the domestic buying of dollars, some of which was used in a belated effort to hedge foreign currency exposure and also because of fear of domestic political instability and social unrest.

Third, as political change became more likely, issues of governance created problems for the economy. Hill (1999) wrote that the prevailing intricate web of vested interests prevented or frustrated the capacity of governments to act decisively in a crisis. Long before the crisis, foreign investors and businessmen doing business in Indonesia complained about a lack of transparency, certainty and legal protection. This was often referred to as the hidden cost of doing business in Indonesia. None of these perceptions worked seriously against Indonesia during the economic boom. However, once the crisis hit, governance weaknesses limited the government's ability to manage the crisis. These issues also limited the institutional capacity to respond quickly, fairly and effectively. This eventually led to a crisis of confidence, which has been the most damaging of all of Indonesia's woes because it continues to delay the return of capital flows that are badly needed.

Fourth, the evolving political situation was worsened by the crisis and in turn heightened the magnitude of the crisis. This factor has been the most difficult to resolve. The failure to re-establish social and political stability has made it difficult for the economy to gain the momentum needed for a sustainable recovery.

While the large bank and corporate debts pose real problems for the economy, the last two factors are seen as the main reasons why Indonesia's economic recovery has been so slow. It is difficult for the economy to recover without the return of market confidence and market confidence will not return without political stability and a credible government.

The role of the IMF

Any discourse on the Asian economic crisis would be incomplete without looking at the role of the international community, primarily represented by the IMF. The importance of the IMF was made clear to me when at the end of March 1998, on the eve of my appointment as the Coordinating Minister for the Economy in the last Soeharto cabinet, I received a telephone call from the then-US Secretary of Treasury Robert Rubin. He told me that the American government was concerned about the deteriorating situation in Indonesia and wished to help. But he said that Indonesia would first have to restore its relations with the IMF, as the American government could only help Indonesia through the IMF. I received the same message from the Japanese and German governments. These three countries are Indonesia's major donors. At that time, the relationship between Indonesia and the IMF had come to a virtual standstill. The Indonesian government perceived the IMF, with its conditionality for assistance, as overly interfering in the domestic affairs of the country. In turn, the Fund regarded Indonesia as reneging on its commitments.

With the benefit of hindsight, several lessons can be drawn from the involvement of the Fund in helping countries overcome their financial crises. There are ample reasons to believe that the IMF initially actually mishandled the crisis, prescribing the right

medicine for the wrong illness. The Indonesian government's decision to close 16 small banks in November 1997 was greeted with much jubilation, and was seen as a victory for reform. As a number of these banks had belonged to the President's family, this decision showed that the Indonesia government was serious about tackling the problems.

However, the closing of these banks was done without sufficient preparation, and instead of creating confidence, created precisely the opposite atmosphere. With the deposit guarantee not yet in place (it would not be in place for another three months), and rumors that more banks would be closed, the financial market was thick with uncertainty, creating additional pressure on the currency. Some observers have speculated that a number of important businessmen, seeing that the President could not even protect his own family's business interests, felt that perhaps he could not protect their own position either. In this view, what was to have been a move to show that the government was serious about rooting out nepotism, came to be seen as a sign of weakness, not strength. This aggravated the loss of confidence and triggered more capital flight. The fact that one of the banks was later resurrected, albeit under a different name, only added more confusion and caused the government and the economic team to lose their already-thin credibility.

The IMF's preoccupation with structural reform in the midst of a crisis was also questioned. In the first and second MOU (Memorandum of Understanding) considerable attention was paid to structural adjustment programs, but little or insufficient attention to substantial and concrete measures on how to deal with the two main causes of the crisis, i.e. the failure of the banking system and corporate debt. Initially the Fund even insisted on tight fiscal and monetary policies, requiring a budgetary surplus at the same time that

high and rising interest rates served to choke off investment and consumer demand.

Eventually the fiscal requirement was eased, and the IMF subsequently shifted its stance to one of strongly encouraging a fiscal deficit to stimulate the economy.

One major flaw in the IMF formula was its insistence on raising fuel prices, reducing and eventually eliminating fuel subsidies. It was generally recognized that fuel subsidy was an issue that needed to be addressed. Indeed the economic ministers had argued many times for changing the oil price mechanism, noting in particular that the kerosene subsidy that was intended to help the poor was an ineffective redistributive tool. However, the timing of such a change has to be right. Raising fuel prices during an economic crisis when there is increased unemployment and incomes are reduced in real value would be unfair to the people and would have very serious social and political implications. Yet the Fund remained adamant in its insistence that immediate actions be taken to reduce the fuel subsidy. In negotiations with the Fund in April 1998, I argued that the fuel price hike should be postponed until the right moment. The Fund agreed to a postponement only until June that year. However, President Soeharto, just before leaving for Cairo in early May 1998, decided to raise fuel prices immediately. His advisors, including myself and the Minister of Mines and Energy, warned him that doing so would be a serious mistake. President Soeharto felt that if fuel prices had to be raised, it might as well be done right away. The timing backfired. In the face of student protests, the government had to retract its decision to raise the fuel prices, further indicating a weakening government unable to defend its own policy.

The IMF has also been suspected of acting in the political interests of the major donor countries rather than acting solely in the interest of its client state - Indonesia. For

example, when the situation in East Timor began worsening, the IMF suspended its negotiations with the Indonesian government.

Having said all that, it is unfair to only blame the IMF without giving the Fund its due credit. Indeed, in the later stages of the economic recovery efforts, the Indonesian government and the Fund developed effective working relations, enhanced by open dialogues. As a result, the reform agenda and its implementation were not regarded merely as the product of an IMF program, but were also the product of the Indonesian government's program, thereby establishing the question of ownership of the reform packages. Whether or not one likes the IMF, and whether or not one agrees with the IMF prescription for recovery, support from the Fund was taken as an indication of the support of the international community. The market watches very carefully a country's relations with the Fund, how the country's economic policies are perceived by the Fund, and whether the country is adhering to or sliding back from the agenda that was committed to when it came into an agreement with the Fund.

Globalization and the crisis

We now turn to the question of whether globalization was to blame for what happened in Indonesia. Some might argue that had Indonesia not gone so far in liberalizing its economy, had it retained some basic elements of control such as limits on capital account transactions, the outcome of the crisis would have been different. Some observers point out that those large countries that had maintained firm control over their economies, like China and India, were spared the fury of financial crisis. Only countries with open economies fell prey to the financial predators, and became victims of crisis, countries like Indonesia, Korea, Thailand, Brazil, Russia and even Hong Kong. Malaysia re-imposed controls before it was too late.

Analysts, such as Kelly and Olds (1999), for instance, suggest that the Asian financial crisis has fostered a heightened sense that globalization implies a loss of ability to effectively regulate national economies and a diminished influence of societies over their own destinies. They maintain that the roots of the crisis can be viewed not as a reflection of domestic regulatory imperfections, but as a consequence of the level of globalization to which Asian economies have exposed themselves. They cite Bello (1997), who suggests that the exposure of Asian economies to global capital flows inevitably left them vulnerable to the vagaries of the international financial system.

Others argue that had Indonesia and the other 'successful' East Asian economies not deregulated and liberalized their economies, they would not have achieved such a phenomenal progress both in economic as well social terms in the decade before the crisis. The argument is then that the benefits from globalization over the past decade far exceed the harm caused by the financial crisis. The export-led growth in Indonesia, Thailand, and other newly industrializing countries, led to large increases in wage employment not possible without the capital and technology inflows that accompanied globalization. It should also be noted that new benefits of globalization come from technological change spurred by information technology. A very good example of this can be found in India where much 'back office' work (e.g., data processing) is conducted on the Internet for large Western firms. This has brought higher value jobs to the economy, which would not have been possible without globalization.

The two arguments, representing differing schools of thought, continue to be fiercely debated. As Kelly and Olds (1999) describe it, contradictory tendencies are apparent in popular representations of globalization. It has been 'the root' of economic

triumph as well as economic crisis; it has been resisted as an insidious process of undermining 'Asian values', but courted as a source of social change that produces cosmopolitan citizens who are adaptable to new ideas; and finally, it has been heralded as the end of the nation-state, and yet assiduously promoted by many states within the Asia Pacific region.

My own view is that globalization should be welcomed, particularly by emerging market countries. It offers an opportunity to break down the historic advantages enjoyed by the 'rich' countries. For example, the abolition of capital controls in the rich countries means that citizens and corporations of the rich countries can now invest in emerging market economies. Even more important, trade liberalization means that emerging market countries' advantages in the factors of production (abundant land and labor principally) can be exploited. While there is much to be lost by emerging markets when globalization goes bad, there is also much to be gained when globalization is managed properly.

There is little doubt that Indonesia benefited from its increasing integration into the global economy. It is important to recall that when Indonesia began the process of transforming itself into a modern economic state, the accepted policy paradigm was based on the development of import substituting industrialization. Indonesia came to an early recognition that developing industries that insulated themselves from international trade suffered from slow growth, slow employment creation, and high-cost of production. It is my belief that Indonesia is better off for having liberalized even with the crisis than it would have been had it not followed the path that it chose in the 1980s.

Not surprisingly the financial crisis raised questions in the region, and indeed globally, about the value of further liberalization of trade in goods and services. The

challenge, in the backdrop of a potential backlash against globalization, is how to seek a means of ensuring that the emerging economies can continue to reap the benefits of globalization without exposing themselves to sudden sharp 'reversals of fortune'. I would point out that Indonesia's present problems were not caused by policy decisions taken during the last decade on the liberalization of the economy, but because policies were not changed in response to increasing globalization. Hence the question arises of how a country can best manage globalization and the risk of sudden crises (and not to retreat from it). I will address this question from the Indonesian perspective with the hope that the lessons from Indonesia may be useful elsewhere.

What needs to be done

In terms of domestic policy, the lessons of the crisis for Indonesia are reasonably clear, even if the steps that the lessons suggest must be taken to promote recovery are difficult and will take time to implement. Chief among the actions that we must take is an effort to reform governance, including and especially the legal system. Laws and regulations must be strictly, fairly, transparently and even-handedly enforced. Achieving this will require political will, improved legal infrastructure, and social control through democratic institutions. This is an agenda that should be given the highest priority.

It is possible, as Indonesia has shown, to reap the benefits from globalization and create a modern economic state. By increasing access to foreign private capital, and the technology and entrepreneurial talents that often accompany such flows, Indonesia created a modern industrial sector and improved its transportation and communications systems. In many ways Indonesia took on the trapping of a modern economic state,

producing a wide range of consumer products and even machinery, creating employment for an increasingly urbanized labor force.

But the political developments failed to keep pace with the modernization of the economy. As a result, the very institutions needed to support a market-based modern economy failed to evolve. Every society confronts these tensions. But societies with more vibrant political institutions, with more transparent economic and legal rules, and with greater opportunities for dissenting voices to be heard, are more likely to achieve a better balance between private wealth accumulation and the protection of the public welfare.

We have learned a clear lesson that liberalization carries with it a responsibility: to create or nurture the institutions that can effectively allocate resources to their most productive use. It is important to assure that funds will be channeled to productive uses, rather than lent to ventures whose return depends on political connections. This requires not only a well-regulated set of financial institutions but also the establishment of markets that allow entry to potential entrepreneurs and encourage exit for those who fail. Unfortunately, in Indonesia, as in some other Asian economies, markets tend to operate to protect those who have already established themselves. Too often, our market structure restricts access to those fortunate enough to obtain access to credit, to licenses, or to land. By doing so we deny access to those most willing to bear risks and we inevitably screen out the most entrepreneurial. By allowing companies that fail to continue to exist we tie up capital in inefficient enterprises and reduce our competitiveness. We need to create markets that encourage entrepreneurial behavior and risk-taking and that force those who fail to surrender their hold over scarce resources. Until we do, our industrial structure will be weak and easily buffeted by the next financial crisis.

In the longer run, and in a wider context, there is a real need for better and more current information on private capital flows. After all, it is the prevalence of private capital flows in the 1990s that exposed emerging economies to the excessive risks that resulted in the current financial crisis. I hope that from this crisis we at least reap the benefit of a new information source that allows private capital flows to continue unhampered, but that will allow us to correctly assess and deal with the associated risks.

Furthermore, not only do we need better data on such capital flows, we need to have a better understanding of the risks associated with them. The development of ever more esoteric financial instruments, including derivatives, makes it difficult to trace flows and often makes it impossible for governments and others to understand the economy's exposure to risk. What is required here is not only more information on the volume of private capital flows, but also on their structure and risk. Central Banks can only monitor their exposure to foreign exchange risks if they have a true assessment of the types of instruments used to access capital, and of their associated risks.

Individual countries can do much more to collect such information. However, only when all countries collect such information on a consistent basis, and make the information accessible, will we have a clearer picture of the potential damage that such flows can do. International financial institutions such as the International Monetary Funds (IMF) should play a leading role in this initiative. It is worth noting that when the Latin American debt crisis of the 1980s arose, the world lacked a true global picture of sovereign debt exposure. In response to this crisis the World Bank developed its debt database, which is now recognized as the most comprehensive and reliable statistics on

sovereign debt. The possibility of extending this database to other types of financial assets should be considered.

Finally, it is clear that the operations of the international financial institutions must be improved. Much has been said about the failure of the IMF to correctly assess the depth of the crisis. Some have even argued that the Fund's policy prescriptions were counterproductive. My concern here is not with the adequacy of the multilateral organizations in rescuing economies once the crisis has hit, but in strengthening their ability to ensure that the crises do not occur, or to withstand external shocks that may visit them, in the future.

Conclusion

It is always true that in the aftermath of every crisis there is a certain amount of soul searching in an effort to build a better system so that the crisis will not happen again. Obviously one should look hard at the core causes of the Asian financial crisis, and in particular the severity of its impact on the Indonesian economy. However, we should be under no illusion: no amount of restructuring of domestic institutions, no new 'financial architecture', and no new restrictions on trade or capital flows will prevent the next crisis. Economic expansions have led to a period of contraction ever since modern market economies emerged. There is little reason to believe that we can now design an international or domestic financial system that will eliminate future risks of economic collapse. We can, however, draw lessons from the recent experience, and especially the experience of Indonesia, to ensure that the next crisis, when it comes, will not be as severe and as destructive as was the 1997 crisis.

I believe there are at least three lessons that we can learn from the recent experience. Briefly they are:

First, the Asian financial crisis was a capital market crisis. It was not a crisis of market economy overall, nor was it a crisis caused by the global integration of our economies. Rather, the financial systems of the affected countries were weak and poorly supervised. A well-supervised financial system would have sharply reduced the risks to which our financial institutions were exposed, and would have prevented banks from feeding an excessive investment boom. Negligence or lack of financial regulations, supervision, and transparency explains why the financial structures were so fragile and why the financial crisis was so severe.

Second, the crisis was not caused by efforts to liberalize the economy or to link domestic activities to global product and capital markets. Let me be emphatic on this point: a more open domestic market does not necessarily pose a handicap for developing countries. On the contrary, open markets are a source of competitive strength, efficiency, and productivity gains. They are the engines for economic growth.

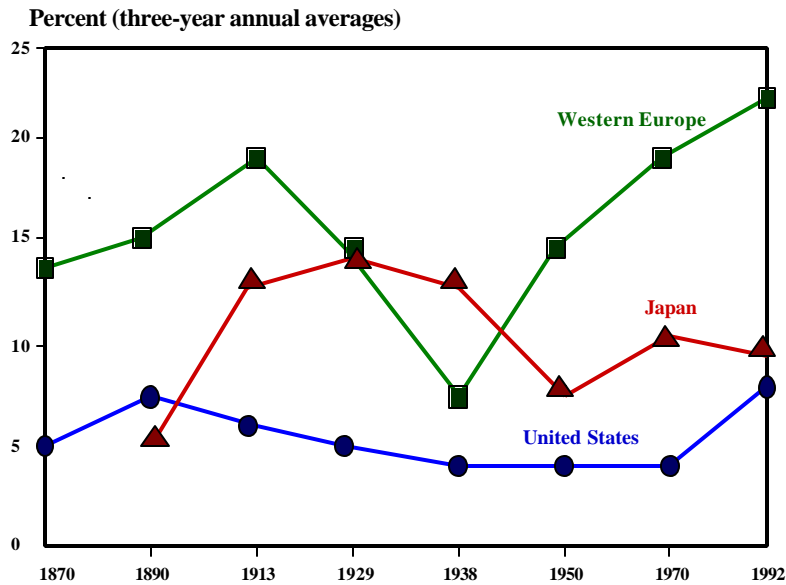
Third, development of a modern economic state must occur together with the development of a modern political state. We can define a modern political state as one where different voices are heard, where the rule of law prevails, and where constraints are in place to ensure that private actions are undertaken not only for private gains but also for the common good. Obviously investors take actions to benefit themselves –

they would be negligent if they did otherwise – but market regulations should ensure that there is a reasonably balanced correspondence between private gains and public welfare.

These then are the conclusions one can draw from the review of the economic crisis that befell Indonesia in particular. It has the resources – financial, natural and most importantly human to overcome the crisis. Unless it deals with the issues identified here, however, there is no guarantee that a future crisis will not again devastate the economy. Creating sound and well supervised financial institutions, while maintaining links to the international trading and financial community, will allow the country to grow rapidly again while providing some guarantee that its institutions will mitigate rather than amplify the impact of any future crisis.

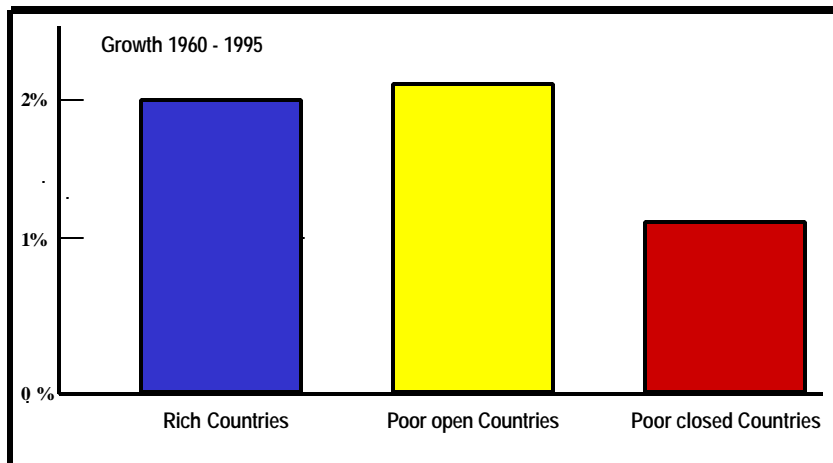
Illustrations

**Figure 1. Japan, United States, and Western Europe:
Merchandise exports as a share of GDP, 1870-1992**



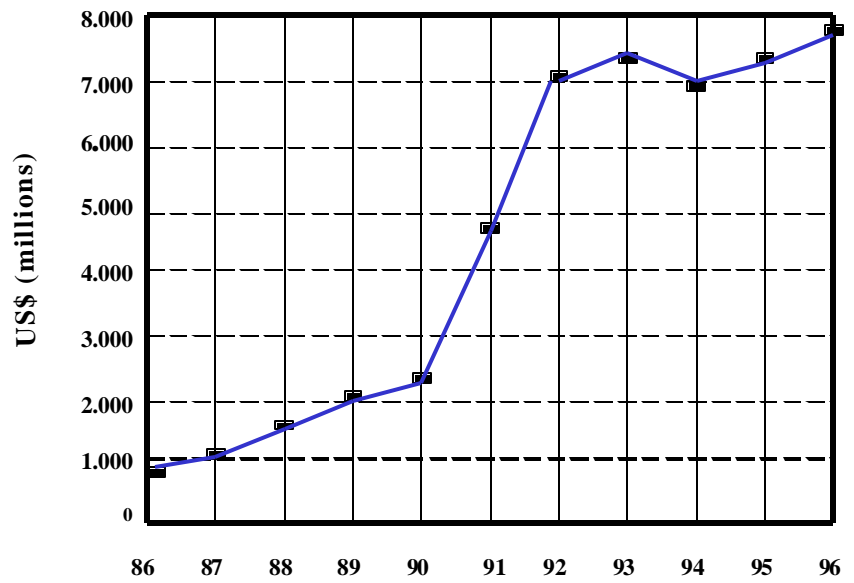
Source: 'Has Globalization Gone Too Far?', Dani Rodrik, 1997

Figure 2. Lack of openness increases inequality between countries



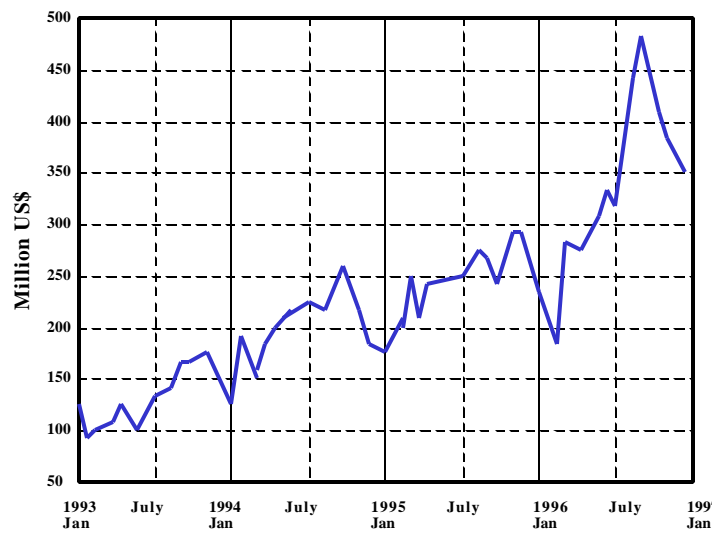
Source: 'Assessing Globalization', Briefing Papers, World Bank, 2000
(<http://www.worldbank.org/html/extdr/pb/globalization/paper3.htm>)

Figure 3. Exports of garment, fabric and footwear, 1986-1996



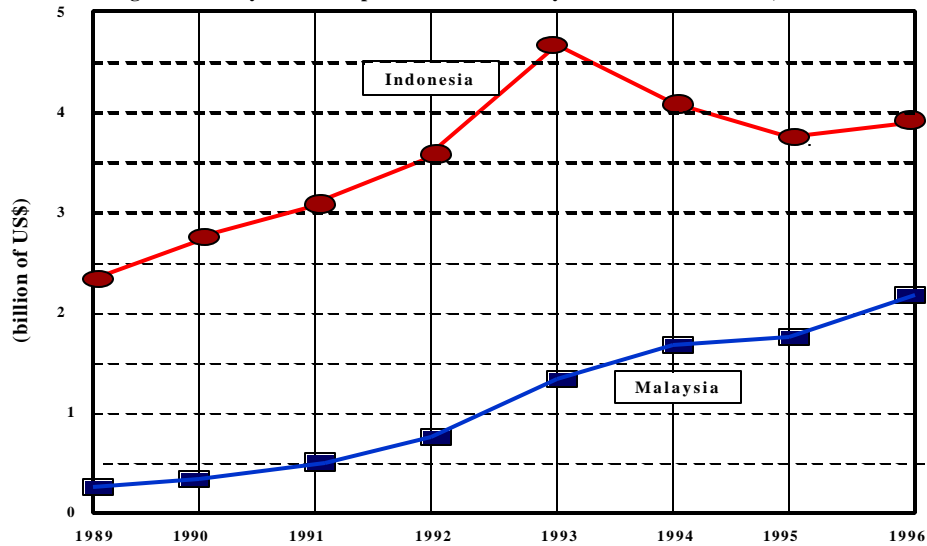
Source: 'Quarterly Economic Report, May 1997 – First Quarter 1997', HIID, 1997

Figure 4. Exports of Electronics, 1993 to 1996



Source: 'Quarterly Economic Report, May 1997 – First Quarter 1997', HIID, 1997

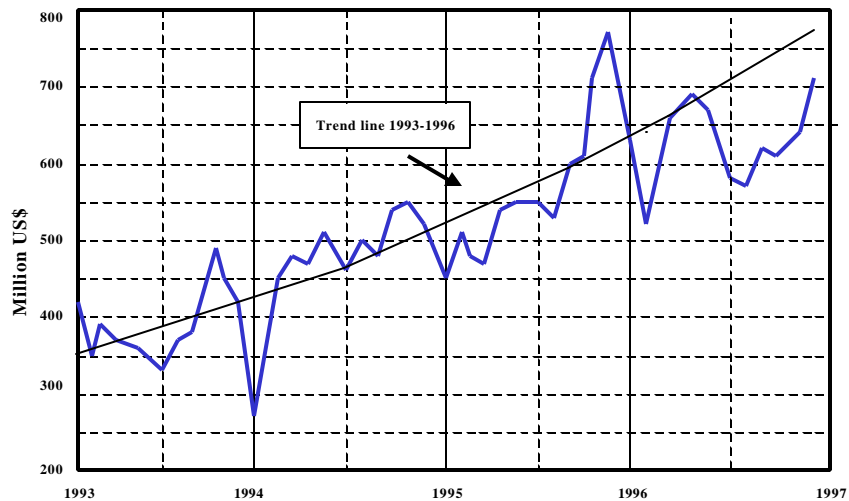
Figure 5. Plywood Exports from Malaysia and Indonesia, 1989-1996



Note: 1996 plywood export values are projected based on the growth rates during the first ten months of 1996

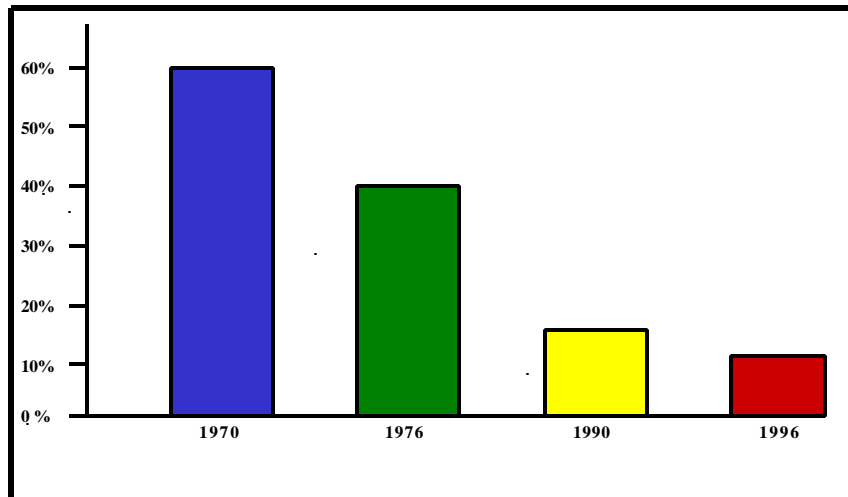
Source: 'Quarterly Economic Report, May 1997 – First Quarter 1997', HIID, 1997

Figure 6. Exports of Other manufactured products, 1993-1996



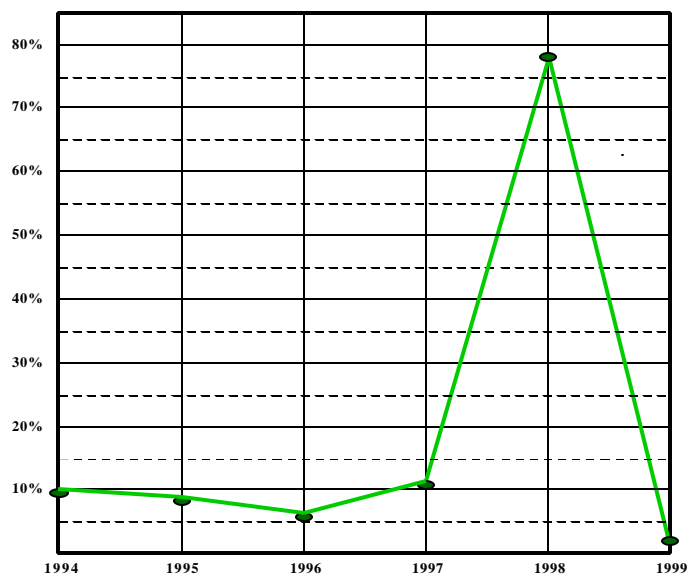
Source: 'Quarterly Economic Report, May 1997 – First Quarter 1997', HIID, 1997

Figure 7. The Proportion of the population living below the national poverty line



Source: Badan Pusat Statistik, Indonesia

Figure 8. Customer Price Index (End of Period), 1994-1999



Source: Badan Pusat Statistik, Indonesia

Figure 10. Export of Manufactured Goods of some Asian Countries

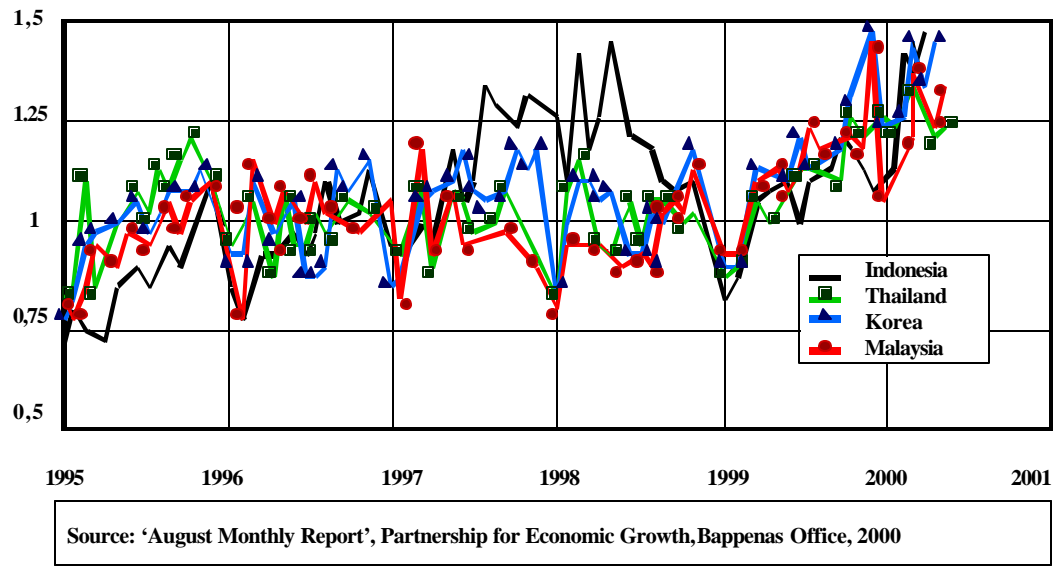


Figure 9. Growth of Gross Domestic Product, 1991-1999



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