Macroeconomic Policy Challenges in the Context of Regional Cooperation

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Even among economic disciplines now there are a lot of questions about some economic concepts, including macroeconomic concepts. That is why when three months ago Bank Indonesia approached me regarding this topic I immediately agreed to attend because this is really the time for economists, in general, to review and be humble as some of the concepts are in question.

Today I speak as an individual and it is my personal opinion, which has nothing to do with the Asian Development Bank. There are two buzzwords surrounding this seminar: global imbalances and balanced growth. Now here comes the different interpretations and Anoop was right that the concept of rebalancing means different things to different countries. For my session I was asked in particular to discuss a different topic, namely regional cooperation.

I think it is clear that everybody knows the world economic recovery after the global financial crisis was mainly driven by Asia and while this is good news there is also unfavorable news in the sense that Asia is also requested to do more than the previous process. For example, there is a lot of talk regarding the concept of the exchange rate and some have even coined the phrase "exchange-rate war" but I personally disagree with the word war, which was first used by the Finance Minister of Brazil during his talk a couple of months ago.

Fact number one, the global economic recovery was stimulated mainly by Asian countries but fact number two the responsibility is also greater for Asian countries. One such responsibility is the exchange rate. In the context of regional cooperation, this reveals a large question: to what extent Asian countries can coordinate the exchange rate. The concept of exchange-rate coordination has been around for a few years, it is nothing new. However, now it must really be put into action, it is up to Asian officials to extend their willingness to cooperate and coordinate regarding the exchange rate. In more general terms coordinate in a macroeconomic sense. This is one of the reasons why we started to see a proliferation of regional groupings, regional organisations and regional financial arrangements. One of the remaining components of the CMIM, which is *the* most important component, is surveillance and it was already decided a few months ago that there will be a autonomous office setup in Singapore dealing primarily with surveillance and so forth. This is just one example of regional financial cooperation that has sprung up partly in response to the new trend in the global economy.

Regarding global imbalances, one of the important components of the global imbalance as far as Asian countries are concerned is the following: Asian countries have excess savings, whereas deficit countries including the US have excess investment or a deficit of savings and that is why some economists are starting to use the term 'saving glut' and so forth. Why did this happen? This happens because the excess savings were basically put back into deficit countries like the US and EU and this excess money was brought back to Asia by private investors due to the attractiveness of Asia. What we have here is round tripping. What is wrong with round-tripping is that the transaction costs are so high. Therefore, one of the initiatives from Asian parties was to create more financial instruments in the region to avoid round tripping. One of the reasons why there was round-tripping was because of a lack of financial instruments in the region for long-term investors to put their excess savings. If such instruments were available in Asia then maybe round-tripping could be avoided. The most important example of such an instrument, which ADB has been very involved with, is regarding the initiative of the Asian bond market, known as ABMI (Asian Bond Market Initiative). Another example that ADB is trying is called CGIF (credit guarantee investment fund) because while there are excess savings and excess liquidity in Asia, ironically Asia also needs a lot of money for investment in infrastructure. This is the irony: we have a lot of liquidity but we also need a lot of infrastructure investment, not only physical infrastructure but also education and health. To avoid round-tripping and, therefore, keeping the excess savings and liquidity in the region, regional cooperation is required.

Another component of the rebalancing is the increase in intra-regional trade in Asia but if we look more carefully in terms of the composition of this trade, what is increasing is only trade in intermediate goods not in finished goods. Most exports of finished goods from Asia go to the traditional markets, such as the US and Europe.

When I was asked to join the office of regional cooperation I told them that I do not believe in cooperation. One of the reasons that I do not believe in cooperation is because Asia has been doing very well in the last 30 years without cooperation. The policies that have been taken by Asian countries are unilateral policies so why should we change the winning strategy for the next 20 to 30 years. The reason I changed my mind is because of the global financial crisis. In the past most of the exports of finished goods went to traditional markets such as the US and Europe but now, I am exaggerating, that market has gone. Of course it has not actually gone but being a teacher I like to exaggerate to make things clearer. What I'm trying to say here is that I do not think Asia can rely on the US and European markets in the next 10 to 15 years for exports of finished goods. What is the solution? There is no other choice but to cooperate and to increase exports, not only in intermediate goods but also in finished goods among Asian countries. This is one of the strong rationales for having cooperation.

Coming back to the concept of balanced growth, which means different things to different people, if we look at individual countries we can discuss the importance of cooperation and the need for cooperation but at the end of the day the actual policies are based on the national interest and this is where Asia did not really have a remarkable history of success in terms of willingness to forego some sovereign rights. Involvement in regional cooperation and multilateral cooperation includes forgoing several sovereign rights and Asia does not have a good track record in terms of this. If we look at the balanced growth concept but within the country, because that is what matters, the concept is really related to the global financial crisis.

In the case of Indonesia, prior to the financial crisis the flow of funds indicated very clearly that savings are far less than investment in the real sector. This explains why Indonesia borrowed a lot of foreign currency in the short term and unhedged, which brought us to the crisis in 1997. However, the post-crisis flow of funds shows completely the opposite story where savings exceed investment in the real sector. The natural question is where does this excess saving go? From the flow of funds it very clearly goes to the financial sector, especially with the growing financial sector and mutual funds, bonds market, and equity market in Indonesia. This partly led to strong growth and V-shaped recovery after the Asian crisis but something else also changed and that relates to balanced growth.

It is clear that only a small segment of society participated in the financial sector. The larger segments of society did not and could not participate. I am often asked why employment elasticity in Indonesia is declining rapidly and I'm not saying this is *the* answer but it is one of the answers. Accordingly, there is V-shaped recovery of GDP growth but employment is not being created. Most of the profits coming from investing in the financial sector are reinvested in the financial sector. I will not talk about the further repercussions of this, for example poverty, income distribution and so forth but that is the concept of balanced growth if I talk to policymakers in this country. What do they mean by balanced growth? All countries have an international responsibility but they also have to think about balanced growth in the context of how to reduce the global imbalance.

The second point, which is to some extent unique to Indonesia as an archipelago of more than 16,000 islands, is balanced growth within the country inter-regionally and it is no secret that most of the activities in this country are taking part in the western part of the country. The eastern part of the country has somewhat been left behind. In that context, the concept of connectivity and infrastructure in order to increase domestic demand becomes very important. Accordingly, it is fitting that Bank Indonesia considers inflation from a different perspective; not only as a monetary phenomenon but also a supply-side phenomenon. In some areas of Indonesia inflation was double-digit but national inflation was just 4% so no matter how high the interest rates are raised it would have no effect because the reasons for the high inflation in that particular region are not monetary phenomena but a lack of the availability of basic goods. At that time the weather was so bad that no ships could dock on the island. Therefore, it is more challenging for central banks in countries like Indonesia to work on monetary policy but at the same time this also reflects the importance of the concept of balanced growth, not only in the global sense but also within the country.

Returning to the concept of global imbalances and capital flows, as I indicated earlier one of the important regional financial cooperation examples is CMIM and I also mentioned the Asian bond market and CGIF. In terms of the role of regional financial arrangements in Asia, we know the history of CMIM in the post-Asian financial crisis period and apparently some of the policies proposed by the IMF did not work effectively, therefore, several countries began thinking about having regional financial arrangements as a self-defense mechanism. A clear indication of a crisis is exchange rate depreciation. Now, however, the region is facing completely opposite pressures: exchange rate appreciation not depreciation. This again relates to global imbalances because one of the reflections of global imbalances is capital flows. As I said most capital flows are moving to emerging markets, of which one of the most important is Asia. The question I have is to what extent the regional financial arrangements in Asia can also coordinate in this context. CMIM is one that is how to deal with possible pressures on the exchange rate to depreciate but perhaps for the next five years the region will face completely the opposite pressure, namely how the exchange rate will appreciate. Do we have the instruments and institutions to deal with this pressure? So far the answer is no, therefore, do we need an institution in the region to deal with these massive capital inflows because so far what we have seen our individual country reactions through capital controls and so forth. The result has not been a resounding success because the exchange rate has continued to appreciate and on the other hand vast accumulation of foreign reserves has occurred. Do we need an institution in the region to deal with these pressures in the coming years?

Question and Answer Session

Question - Cecilia A. Harun - Financial System Stability Bureau, Bank Indonesia

We are starting to think about unconventional policies to overcome the global imbalances and you mention about the risk of capital inflows to emerging markets so my question is for the sake of reducing imbalances, because we know that capital inflows to emerging markets are usually in the form of portfolio investment, what you think about the policy of putting taxation on capital inflows? Accumulating taxes is actually securing funds for the emerging markets in order to overcome a sudden reversal that may eventually happen.

Question - Made Sukada – Former Bank Indonesia Official

I fully agree with Anoop regarding the uncertainties of the global recovery and the downside risks of the growth in developing countries. My question is what kinds of new policy instruments are available in order to enforce policy coordination, in particular among developed countries? Does the Fund have any global surveillance tools in order to ensure coordinated policies because I think it would be very difficult to expect policy coordination among developed countries in the future?

Question - Adrianus Mooy – Former Governor of Bank Indonesia

We have been talking a lot about internal as well as external imbalances and I think Prof. Azis tried to explain the difference between the imbalances in the financial sector and the real sector. This in my opinion is the key issue in Indonesia. I think in the case of imbalances between the financial sector and the real sector in Asia it is also a by product of global imbalances because of the savings and investment imbalances, including round-tripping. But I begin to wonder what was the root cause for the financial sector and real sector imbalances in the US because there is no round-tripping there. One wild idea is that we have not dealt deeply into the human aspect of the crisis. I mention this because financial innovation also creates changes in peoples' behavior. I think innovation, like technology, is very neutral but it depends very much on the people; it is only a tool. If the human side is very important here how could we rebalance human behavior in the short term as well as the long term so that in the future we can avoid similar crises?