Contribution to
Terry McKinley, *et. al*. (2003) *Macroeconomic Policy for Pro-poor Growth: Case study of Indonesia* (New York: UNDP, Asia-Pacific Programme)

Chapter 2
Section A: Towards Pro-poor Development Strategy

1. Sources of Growth in the Indonesian Economy

For about thirty years, 1968-1996, the Indonesian economy grew at a phenomenal rate of 7.5 percent per annum. Over these three years growth was quite balanced. While for the period as a whole export growth was above the overall rate, it was not dramatically so. Then, in 1997 the Asian financial crisis struck the country, leading to a catastrophic decline in national income, of twenty percent from the last quarter of 1997 to the last quarter of 1998.

The dramatic fall in national income is shown in Figure 1, which gives annual growth of gross national product in constant prices, 1960-2001. From 1968 through 1996, the annual growth fell below seven percent in only seven of the twenty-nine years, and below six percent in only three years. By contrast, during the five years period 1997-2001, the growth rate failed to reach five percent. The impact of the crisis is revealed even more dramatically by quarterly data, shown in Figure 2. From the first quarter of 1989 through the second quarter of 1997, GDP grew at a quarterly rate of 1.7 percent (seven per annum). Recovery from the crisis began in the first quarter of 1999, after which the economy grew at a quarterly rate of only one percent (4.1 per annum).[1] Understanding why Indonesia's recovery proved so slow is essential to developing a pro-poor growth strategy. As a first step, this section investigates the determinants of growth on the demand side over the period 1972-1999. The initial year is chosen because of the availability of statistics that allow disaggregation between public and private investment. The terminal year is selected in order to contrast the period of rapid growth to the years of crisis. As of the writing of this report, it was too soon to evaluate the recovery with the method used here.[2]

Our calculations derive from the basic national income identity:

[1] In terms of frequency of growth rates, the annualised rate exceeded six percent in 24 of 30 quarters from the beginning of 1989 through mid-1997. From the recovery in the first quarter of 1999, the annualised growth rate failed to reach five percent in all but two quarters out of twelve.

[2] Our calculations are analogous to those used by the IMF in its recent report on Vietnam (IMF 2001).

$$Y = C + I + G + (X - M)$$

Consumption (C) and investment (I) are separated into private and government. Private consumption and imports (M) are assumed to be functions of national income (Y), as is standard procedure. The autonomous components are private investment (I_p), government consumption (Cg), government investment (I_g), and exports (X). Keeping with standard presentation, we present the expanded identity as follows:

$$Y = C_p + I_p + [C_g + I_g] + [X - M]$$

The equation becomes an identity by including inventory change in private investment. If α is the marginal propensity to consume out of GDP, β is the marginal propensity of import out of GDP, t is the marginal generation of government revenue, S_j is an aggregate share in GDP, and lower case letters indicate growth rates, then the growth rate of GDP is:

$$y = \{S_{cp}c_p + S_{ip}i_p + S_{cg}c_g + S_{ig}i_g + S_x x\} / \{1 - \alpha[1 - t] + \beta\}$$

The sources of demand calculations are based on Table 1 (growth rates). The numbers in bold are the standard text book categories: household expenditure, private expenditure, government expenditure, and exports and imports, divided into four time periods, 1972-1980, 1980-1990, 1990-1996, and 1996-1999.[3] Marginal values for shares are given by time period in Table 2. Some have argued that the down-turn was moderated by households maintaining their expenditures in face of income falls, and this allegation has been extended to conclude that the recovery was 'consumption-led' (World Bank 2002, 2-3). A glance at Table 2 indicates that the former is not correct, for the marginal propensity to consume out of GDP (less government revenue as an approximation of disposable income) was the same during the down-turn as for the previous time period. The only category of demand that did not fall, as one would predict, was exports, which rose as GDP declined. Overall, the behaviour of the private and external components of GDP are what a simple Keynesian model would predict: private consumption had an elasticity with respect to GDP not significantly different from unity; import demand shows an elasticity of greater than one; private investment was highly volatile; and producers turned to the export market when the home market collapsed. With regard to policy components, government investment

[3] There is no overlap in the calculations. Shares are calculated 1972-1979, 1980-1989, etc; and growth rates are compounded, 1972-1980, 1980-1990, etc.

was strongly pro-cyclical, and government consumption expenditure slightly procyclical. Thus, policy magnified the down-turn.

It is striking to note that the economy became much more volatile during the downturn, with the autonomous expenditure multiplier more than doubling, from 1.56 to over three. In other words, automatic stabilisers, which had moderated the volatility of the economy during 1970-1996 virtually disappeared. On the one hand, tax collections declined at the margin (from .14 to .03), dampening the decline, a severe reduction in the propensity to import magnified the contraction. Thus, to the extent that the contraction was moderated, this resulted from the fiscal structure, not consumer behaviour. Hopes that future growth might be based on 'consumer confidence' have no support from past behaviour, before or during the crisis.

Table 3 uses the previous calculations to decompose the growth in aggregate demand by percentage points, and Table 4 distributes these in percentages of the aggregate growth rate. Growth in the 1970s can be described as 'export-led', for external demand represented almost sixty percent of total demand. By contrast, the 1980s were 'investment-led', largely by the private sector,[4] with a strong government investment contribution. In the 1990s, before the crisis, private investment (domestic plus foreign) was virtually equal to export demand. For the twenty-five years, 1972-1996, private investment was quantitatively more important that exports in generating demand; total investment, private plus public, accounted for half of the growth of demand. Exports as such were a substantial contribution, but less than forty percent.

From this accounting of the sources of demand growth, we conclude that regaining a strong growth rate will be based on investment, rather than exports. This conclusion is strengthened by the likelihood that in the medium term the world economy is unlikely to generate a rate of growth of trade that would allow Indonesia to achieve the export expansion it enjoyed in the 1970s. Indeed, the rate achieved in the first half of the 1990s may not be obtainable. Thus, while a robust export performance is necessary to relieve the foreign exchange constraint, pro-poor growth in Indonesia will be based in practice on investment growth. The extent to which this can be based on private sector investment is discussed below.

[4] Very little of the private invest was from abroad. In no period could it have accounted for more that a tenth of a percentage point of aggregate demand. Precise calculations are not possible, because the FDI data are a balance of payments category, indicating capital inflows, not actual investment.

Table 1: Indonesia: Growth Rates of National Income Categories, 1972-1999

Category	1972-1980	1980-1990	1990-1996	1996-1999
private consumption	**4.2**	**7.8**	**8.9**	**-3.2**
investment	9.3	9.0	7.8	-11.0
private	**7.1**	**11.7**	**9.0**	**-10.0**
gov't	13.9	3.0	3.2	-16.0
Total gov't expend	**12.5**	**3.9**	**4.3**	**-11.0**
gov expend (cons)	11.3	4.5	5.1	-7.8
exports	**17.4**	**3.2**	**8.2**	**7.3**
imports	**11.1**	**8.1**	**9.8**	**-2.4**
GDP	8.0	6.4	7.8	-3.0

Source: World Bank, *World Development Indicators 2001*(CD-rom)

Table 2: Indonesia: Marginal Shares in GDP of National Income Categories, 1972-1999

Category	1972-1980	1980-1990	1990-1996	1996-1999
private consumption	.31	.68	.68	.75
investment	.27	.38	.31	1.05
private	.13	.35	.28	.80
gov't	.13	.04	.02	.25
Total gov't expend	.26	.11	.08	.44
gov cons expend	.13	.07	.05	.19
exports	.54	.15	.27	-.70
imports	.25	.28	.31	.21
Marg propensities				
to consume (Yd)	.48	.80	.78	.78
to generate rev	.31	.16	.14	.03
Multiplier	1.03	1.66	1.56	3.20

Note: For 1996-1999, all categories were negative except exports.
Source: World Ban, *World Development Indicators 2001*(CD-rom)

Table 3: Indonesia: Percentage Point Contributions to Aggregate Demand, 1972-1999

Category	1972-1980	1980-1990	1990-1996	1996-1999
investment	2.2	4.3	3.8	-9.9
private	**1.1**	**3.9**	**3.3**	**-8.1**
gov't	1.1	.4	.4	-1.7
total gov't expend	**2.2**	**1.2**	**1.2**	**-2.9**
gov't cons	1.1	.7	.8	-1.1
exports	**4.7**	**1.4**	**3.4**	**8.0**
GDP growth	8.0	6.4	7.8	-3.0

Source: World Ban, *World Development Indicators 2001*(CD-rom)

Table 4: Indonesia: Relative Contributions to Aggregate Demand (percentages), 1972-1999

Category	1972-1980	1980-1990	1990-1996	1996-1999	1972-96
investment	27.5	67.2	47.2	-327.6	49.9
private	**14.3**	**60.3**	**41.6**	**-270.7**	**41.4**
gov't	13.2	6.9	5.6	-56.9	8.5
total gov't expend	**27.0**	**18.7**	**15.4**	**-95.6**	**20.4**
gov't cons	13.8	11.7	9.8	-38.8	11.9
exports	**58.7**	**21.0**	**42.9**	**266.3**	**38.2**
GDP growth	100.0	100.0	100.0	100.0	100.0

Source: World Ban, *World Development Indicators 2001*(CD-rom)

Figure 1: Indonesia Annual GDP Growth, 1960-2002

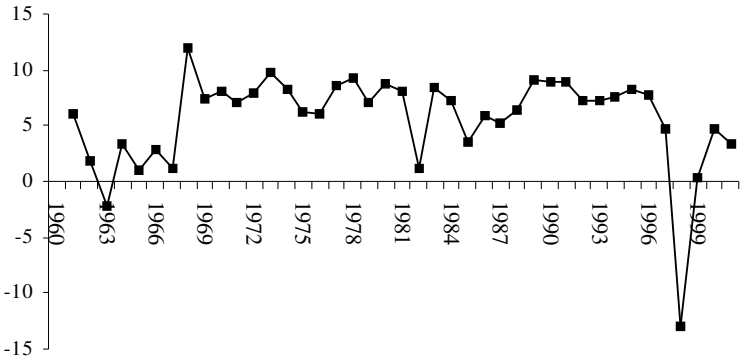
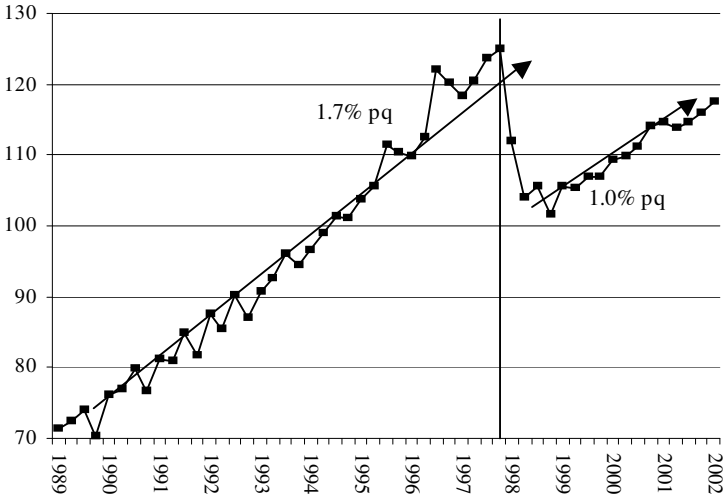


Figure 2: Indonesia, Quarterly Index of GDP, 1989-2002



Section II. B.1 Fiscal Policy and Effective Demand for Pro-poor Growth

In light of the present state of the world economy, it is unlikely that Indonesia in the near future will achieve the seven to eighth percent rate of growth that characterised the thirty years, 1966-1996. A realistic target would be four to five percent, which would imply per capita growth of 2.5 to 3.5 percent per annum. A central question is from where will come the aggregate demand to achieve this growth target.

As shown in the previous section, the growth of the economy in the past has been relatively balanced in terms of the distribution of aggregate demand. Over the years 1972-1996 (see previous section), total investment contributed slightly less than half of the increment in demand, with private investment representing thirty-eight percent, government investment nine percent, and foreign investment about 1.5 percent. The contribution of exports was forty percent, and current public expenditure twelve percent.

It would be optimistic to assume that export growth in the medium term could achieve the average contribution that it made for the entire period of rapid growth. Only in the 1970s did exports grow at a pace that led the economy to a boom, and world market conditions are now considerably less favorable. Doubts must also be cast upon the likelihood that growth could be led by private sector investment. For example, the Asian Development Bank's country review for 2002 comments, 'low investment has raised concerns that future growth prospects will be limited' (ADB 2002, i). The report goes on to note that 'the current share of GDP allocated to private investment is low by recent historical standards' (ADB 2002, 5), and cites the Indonesian Coordinating Board for Investment (BKPM) that reported a fall in investment projects by both foreign and domestic firms.

It would appear that private investment is not constrained by saving: on the contrary, in recent years the private sector balance (investment minus saving) has been negative (ADB 2002, 6), implying a contractionary effect on aggregate demand. If neither exports nor private investment are likely to be engines of expansion in the near future, a strong growth performance will require expansionary fiscal policy. There is scope for increasing government expenditure, since the overall deficit was two percent for 2000-2001, and project to be 2.4 percent for 2002 (ADB 2002, 7; World Bank, Indonesia office website). None of the deficits were financed through

domestic borrowing, being covered by asset sales of slightly over two percent of GDP, and foreign assistance inflows, which were less than one percent. In terms of fiscal policy, only the foreign assistance component was expansionary. A legal change to allow for domestic borrowing for a further fiscal stimulus would seem justified in light of the economy's slow growth rate.

Additional public expenditure could contribute to pro-poor growth in two ways, by increasing transfer payments to the poor, and by investing in projects that are directly poverty reducing, which are discussed elsewhere in this report. The consensus of the IFIs is that 'the biggest constraint on fiscal policy in the need to meet debt service obligations, (ADB 2002, 7), which primarily arise from bank recapitalisation. What is frequently omitted from the discussion of domestic debt service, which will average 3.5 percent of GDP for 2000-2002, is that it represents a political decision, rather than a technical imperative. More specifically, it represents a political decision about who will pay for the financial crisis. Interest payments on the domestic debt represent a substantial redistribution from the population as a whole, via public revenue and asset sales, to the commercial banking system. In the case of private sector banks, the redistribution is regressive, since the owners of banks are the wealthiest Indonesians. For state banks the redistribution is also regressive, from public expenditure that partly goes to social services, to institutions that lend primarily to the wealthy.

Thus, the interest payments involve the population as a whole bearing the cost of recapitalizing a banking system that in part was responsible for provoking the crisis through its imprudent lending practices. This is unwise public policy for several reasons. First, for practical purposes it institutionalises 'moral hazzard'. Recapitalizing the banks, with full coverage of their lost assets, carries the lesson that banks will be rescued from the consequences of reckless financial practices. Second, it is profoundly regressive in its effect on the national income distribution.[5] As a direct consequence, any given rate of economic growth will be less poverty reducing. Third, it shifts the cost of the crisis to households that suffered more during the crisis, and towards those who suffered least.

It goes without saying that Indonesia requires a sound banking system to finance the needs of economic growth. However, this fact should not be treated as a

[5] IN 2000, the World Bank asserted, 'The recovery has been decidedly pro-poor' (World Bank, 2000, 1). If true before, it will not be the case in the future if interest payments rise.

blank check for the banking system. It is encouraging that the government recently decided to end its policy of recapitalizing banks to the full amount of their lost assets. Had this approach been taken from the outset, the interest burden would be considerably lower that it is now. Further steps can be taken. A quite moderate one which would have a substantial impact, would be to recapitalize to the minimum capital adequately ratio that is nationally acceptable, rather than raising it to international 'best practice'. Second, since the recapitalisation bonds are in effect a free gift to the banks from the public, it would be justified to issue them as below market interest rates. Third, and complementary to the second, the bold step could be taken to set an upper annual limit to the interest payments on recapitalisation bonds. Such a step would not meet with the approval of the financial sector, but would be consistent with an international consensus on the relationship between debt and poverty. Just as the HIPC initiative has reduced international debt to official lenders on the condition that the saving be used for poverty reduction, so could the service on Indonesia's domestic debt be constrained by the government's commitment to poverty reduction. This would establish the principle that during the economic recovery, the lingering costs of the financial crisis will shared, and made contingent on achieving a recovery that benefits the population as a whole. While the policy is bold, the principle upon which it based represents fairness in its simplest form.

Section II. B.2 Monetary Policy

During the crisis of mid-1997 through 1999, the Indonesian government used the central bank rate to maintain the exchange rate, with total failure. Indeed, we and others argue that the interest rate policy applied during the crisis was a major factor that turned would could have been a severe downturn (as in other countries of the region) into an unprecedented catastrophe.

The conversion of the Indonesian currency crisis of mid-1997 into a collapse of the real economy was the direct result of attempting to support the Rupiah by use of the central bank rate. From July to August 1997, the central bank rate doubled, from 11 to 22 percent. Over the same period, the nominal exchange rate rose (depreciating) from about 2500 to 3000 to the US dollar. During the next eight months, the bank rate more than trebled, to 71 percent, and the exchange rate collapsed to 14,000. The interest rate increases had no strengthening effect on the

exchange rate. Indeed, over the four years, 1996-2000, the relationship between the central bank rate and the exchange rate was *positive* (i.e. higher interest rates were associated with depreciation of the exchange rate). While this would appear to defy all theory, there was a simple explanation. Due to conjunctural factors, the collapse of the exchange rate could not be stopped. Operating as if the interest rate could do so, Bank Indonesia was in effect letting it be led upwards by the exchange rate. If one lags the exchange rate one month, it explains almost forty percent of the variation in the interest rate.

As chasing the exchange rate sent the interest rate upwards, domestic debt service costs drove the private economy to collapse, with the correlation between the nominal interest rate and real GDP about two-thirds. Correlation need not imply causality, but in this case the mechanism by which the nominal interest rate devastated the growth rate can be specified concretely. In 1996, with an exchange rate of 2342 Rupiah to the dollar and a central bank rate of eleven percent, the operating surplus of the manufacturing sector was nineteen percent of total revenue. For 1997, the Rupiah averaged 3550 to the dollar and the interest rate 14.5 percent, which resulted in a surplus of about fifteen percent of revenue. When in 1998 the exchange collapsed to an annual value of almost 10,000 and the interest rate averaged almost fifty percent, the operating surplus turned negative, to minus ten percent of revenue.[6] The response of the private sector to the collapse of profitably was widespread bankruptcy and a massive drop in real output.

The sharp decline in aggregate output caused by the high interest rates also explains the run-away inflation in 1998. So rapid was the fall in output that it left an excess demand for goods, pushing prices up. Of course, devaluation itself was fuelling inflation, but interest rates also played an important role. The inflation story was as follows: the fall in output and the runaway inflation were both the result of the futile attempt to arrest the collapse of the exchange rate with the central bank rate. The devaluation generated inflation at the expected 'pass-through rate'; that is, it was transmitted proportional to the share of imports in GDP. At the same time, given the money supply, falling output produced an inflationary effect (reducing the real money supply to eliminate excess demand), with an elasticity of unity, as the Quantity Theory would predict.

[6] This discussion is based on calculations found in a technical paper prepared for this report by John Weeks and available from the author.

Misuse the interest rate to during the crisis, to support the currency, should not be revisited by misusing it to 'target' inflation. Given the severity of the Indonesian crisis, which resulted in the collapse of the country's financial infrastructure and investment, it is not surprising that economy shows evidence of being inflation-prone. Indeed, the striking thing is that recent inflation has been roughly in line with historical experience. During the 1970s, when the economy grew at eight percent per year, the consumer price index showed an annual rate of increase of seventeen percent. In the following decade a lower rate of growth as accompanied by a lower, but substantial rate of inflation of ten percent. During 1990-1996, the growth rate returned to eight percent, and inflation continued close to double figures, at nine percent. Thus, for almost three decades of rapid growth, the economy averaged double-digit inflation, with a relatively low standard deviation. This historical experience casts doubt on allegations that recovery in Indonesia requires a stable price level.

Moderate real interest rates would contribute to pro-poor growth, since they would be associated with monetary expansion to stimulate money demand, and lower the costs of investment. An appropriate guideline would be the so-called Golden Rule, that the real interest for investors and savers should approximate the sustainable rate of growth of per capita income. Assuming that a growth rate of five percent could be sustained, and population growth in the medium term is between 1.5 and two percent, the growth-accommodating real interest rate should be slightly over three percent. From the second half of 1999 through mid-2000, the real central bank rate averaged almost ten percent, then five percent from mid-2000 to the end of 2001. Briefly in early 2002, the real interest rate approach the Golden Rule level, but has risen subsequently. Lending and borrowing rates in the market were considerably higher than the central bank rate in all periods.

Thus, the immediate task of the central bank is to use its administer price, the nominal interest rate, to bring down real interest rates. This would stimulate growth without serious impact on inflation.

Section II. B.3 Exchange Rate Policies and the Capital Account

If ever there were a country in which market-based controls on the external capital account represented rational policy, it was Indonesia at the beginning of the twenty-first century. This is all the more the case because expert opinion has shifted towards greater tolerance for such controls. The rationale for controls derives from basic factors constraining the recovery of the economy: the severity of the crisis from which it has emerged, investor confidence, and international capital market volatility.

A legacy of the collapse of the Indonesian economy is an exceptional degree of pessimism about economic institutions and the capacity of the country to recover to its historic strong growth performance. This pessimism is not unfounded, because the collapse of the economy destroyed or severely damaged many key economic institutions, with the banking system being the most obvious. As a result, companies and wealthy Indonesians are highly prone to capital flight, which could be promoted by events that in other circumstances would be hardly noticed. Investor confidence itself remains highly volatile and ruled by pessimism. Rebuilding the confidence of the private sector in the economy will be a lengthy task. The heterogeneity of the private sector implies that measure that will build confidence with some factions of the private sector will not with others. Circumstances call for interim capital controls, which would be maintained until the economy recovers to a strong growth performance, re-establishing expectations of long-term profitability.

Given this domestic situation, the government of Indonesia is not well equipped to deal with the normal volatility of international capital markets. Prudential controls, weak before the crisis, have yet to be adequately established. Indeed, it may be the case that adequate controls are beyond the capacity of a country as underdeveloped with regard to skills as Indonesia. International volatility combined with domestic vulnerability to external shocks makes a strong case for capital controls.

The precise form these take will depend on the goals of the government with respect to exchange rate stability, the type of foreign investment it seeks to attract, and the capacity of the government to implement them. These constraints can be incorporated into a effective package of regulations, as has been done in other countries, most notably Indonesia's neighbor, Malaysia.

Investor Confidence

The cause of the Indonesian crisis is explained by the following superficially robust argument, that turns on the concept of 'investor confidence': 'investors' established limits for major economic indicators which is not exceeded, would keep their 'confidence'. The crisis was so severe and the recovery so slow because the Indonesian government failed to maintain indicators within that range.

This simple story has several problems, each of which is potentially fatal. First, there may be no consensus among 'investors'. The lack of a consensus can result from 1) different investors having different access to information; 2) investors having the same information, but different economic interests;[7] and 3) investors having different analytical frameworks to process economic information. If there is no consensus, then the 'sustainable' range into which outcomes must fall to maintain confidence may be so wide as to be irrelevant for practical policy.[8] Second, the control governments have over outcomes is limited, by the effectiveness of policy instruments; the capacity and experience of the policymakers; and the non-deterministic nature of economic and social behavior.

Even if one assumes that economic processes are deterministic, so that outcomes are strictly stochastic in the sense that precise probabilities can be assigned to all possibilities, the 'investor confidence' argument can breakdown logically and practically. Consider, for example, a 'confidence range' so narrow that purely random effects on policy would result in outcomes falling beyond the boundaries of the range a high proportion of the time (see box). That is, by a Rational Expectations argument,[9] one could predict that instruments would produce outcomes in the centre of the range *on average*, but the actual outcome, even with 'best practice' policies of the IFIs, would fall outside the range, say twenty percent of the time. In such a

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[7] For an insightful discussion of this point, see Mishra (2000). He points out, 'In fact the investor community in Indonesia today is divided into a wide range of categories: large and small, debtors and creditors, foreign and domestic, Chinese and Pribumi, portfolio and direct (p. 22)'. With this in mind, he goes on to warn,

> Singing the mantra of some generic 'investor confidence' or using such a term as short hand for 'foreign' investor confidence will actually serve to diminish rather than enhance the confidence of long-term investors. (p. 2)

[8] In the absence of a consensus, there may be no range which all major market agents judge as sustainable.

[9] The Rational Expectations Hypothesis holds that the expectations of market agents are fulfilled on average (i.e. on the fiction that the same act can be repeated again and again), but not for every outcome.

situation, the resulting loss of 'investor confidence' is the result neither of bad policy nor unstable international markets, but the consequence of a mismatch between investor rules of thumb and the inherently stochastic nature of economic phenomenon.

If, as is likely, there is no consensus among investors, and instruments had limited and occasionally unpredictable effects in Indonesia, then the 'investor confidence' argument completely breaks down. To quote the head of the United Nations Special Fund for Indonesian Recovery,

> There is a consensus that countries in the midst of a crisis need to restore confidence. How can this be done?...Confidence is an elusive concept. One is tempted to define it as a successful outcome, but then we are left with the unhelpful tautology that successful policies lead to successful outcomes. (Mishra 2000, 30)

An example of the 'investor confidence' explanation for the Indonesian crisis is found in Burnside, Eichbaum and Rebello (1999). After accepting the consensus that 'the [Asian] crises] could not have been predicted on the basis of large and/or growing pre-crisis fiscal deficits' (pp. 30-31), these authors introduce the concept of 'prospective deficits' to develop their argument (derivative from a model by Obstfeldt 1986). In their analysis 'prospective deficits' refers to the fiscal balance which would occur were all government financial obligations to come due. These obligations are of two types, explicit and implicit. Explicit obligations would include government debt paper, whose burden falls due on the date of the paper, and deposits in commercial banks guaranteed by the government. More important in their analysis of the Asian crisis are implicit obligations, which for them include virtually all foreign loans held by the public or private sector, which are included under the broad phase 'guarantees to failing banking systems' (p. 3). Central to the argument is the assumption that such guarantees, were they to be realised, would be covered by money creation:

> The expectation that these future deficits would (at least in part) be financed by seignorage revenues led to a collapse of the fixed exchange rate regimes in Asia. Of course market participants could have believed that governments would fund their obligations by raising taxes or lower expenditures. But is this credible? In our view it is not. (Burnside, Eichbaum & Rebello 1999, 3)

In other words, 'market participants' sum all explicit and implicit guarantees, and anticipate that governments will if necessary enter into a virtually unlimited

bailout of the private sector *via* money creation. The problem with this analysis is summarized famously in J. K. Galbraith's comment in the 1960s about the US stock market and recessions, that the former had successfully predicted ten of the three downturns in the 1950s and 1960s. It is common, almost universal, that governments provide some guarantee to private depositors. Indeed, a modern banking system would be impossible without such guarantees, and this obligation alone would be sufficient in most countries to imply an unsustainable fiscal burden. If to this one adds all foreign loans, one would anticipate currency crises in most countries, developed and underdeveloped.[10] Doubt is cast on the 'prospective budget' explanation for Indonesia when one inspects the authors estimates of 'non-performing loans' for the five crisis-struck countries, and finds that Indonesia is number four on the list by one measure, barely higher than the Philippines.[11] Yet, it was Indonesia that suffered most severely from a run on its currency.

With less rigour, the World Bank and the IMF also explain the crisis in Indonesia in terms of all-purpose 'investor confidence'. For example, one reads in the 'Memorandum of Economic and Financial Policies' (MEFP) of January 1998, 'the large depreciation [of the Rupiah] reflected a severe loss of confidence in the currency, the financial sector, and the overall economy' (RI&IMF 1998a, p. 1). The MEFP of June 1998 based its hopes for recovery on the same elusive concept: 'we believe that the decline in [economic] activity should bottom out as…confidence is restored' (RI&IMF 1998c, p. 1). If anything, the World Bank seemed even more reliant on 'investor confidence' as an explanation for the ebb and flow of the Indonesian economy.[12]

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[10] Given that the authors include deposit guarantees as part of 'prospective' deficits, it is not clear why they do not also include the entire Indonesian money supply, since there was free convertibility.

[11] In their table on page 32, non-performing loans as a proportion of GDP for Indonesia is given as 9.4 percent, compared to 7.8 for the Philippines, and over twenty percent for Korea, Malaysia and Thailand. Measured as a portion of government revenue, the Indonesia estimate is 63 percent, again above the Philippines (41 percent), but well below the other three countries, all of which are at or above one hundred percent.

[12] Often in its documents, the World Bank appeared to treat the concept as so self-evident that no specifying adjective was attached to it. For example, in its report just prior to the crisis, one reads that 'with improved confidence…[interest] rates attracted large [capital] inflows…', but worried that 'widening current account deficits could weaken external confidence' (World Bank 1997, p. xxi, 29). Two years later, explaining sluggish growth, the World Bank equated 'confidence' with real economic variables in determining investment: '[i]nvestment has plummeted, hit by problems of confidence and listless domestic demand' (World Bank 2000, p. 1). Similarly, recovery was attributed to the same phenomenon: '…[T]he experience of

It was not always clear what 'confidence' might mean to the IFIs, though it appeared to be related to economic institutions in Indonesia. In the first Letter of Intent between the IMF and the Indonesian government, dated 31 October 1997, the onset of a crisis of 'confidence' was explained by 'a number of underlying weaknesses…which have made the country vulnerable to adverse external shocks' (RI&IMF 1997, p. 2). The 'underlying weaknesses' listed were of two types, the first listed being government-generated 'inefficiencies' due to 'regulations in domestic trade' and import monopolies. Second, along the lines of Burnside, Eichbaum and Rebello, it was pointed out that non-performing loans had reached dangerous levels due to 'the rapid expansion of the financial system', and 'high levels of overseas [private] borrowing', due to 'high rates of return on domestic investment' and the 'relative stability of the Rupiah' (*ibid.*).

In practice, an extremely high degree of pessimism and Cassandra-esque foresight would have been required to prompt serious anxiety about the state of the Indonesian at the end of 1996.

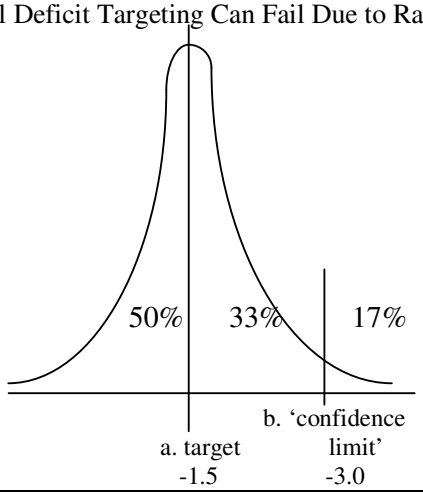
[other Asian countries] also shows that sustaining the early fragile forces of recovery will require steady progress in bank and corporate restructuring *and the gradual return of confidence* that it will hopefully [*sic*!] bring' (*ibid.*, p. 3, emphasis added).

Box x: Sound Policy Results in 'Loss of Confidence'

Governments do not determine economic outcomes by their policies; rather, those policies affect outcomes subject to random (stochastic) changes that affect economic agents. Consider the case in which 'investors' have a consensus that a budget deficit of over three percent of GDP would result in the loss of their confidence in the economy. To be safe, the government sets fiscal and monetary policy to achieve a deficit of 1.5 percent of GDP. If these policies could be repeatedly applied in exactly the same circumstances, the mean of the outcomes would be the government's planned deficit level. However, the actual outcome will be somewhere on a normal distribution around the intended policy-generated outcome. In the diagram below, there is one chance in six that the 'sound' policies will be associated with a confident-breaking outcome. If the standard deviation of the normal distribution is high than is assumed in the diagram, then the probability of loss of confidence from 'sound' policies is greater. Thus, the larger the expected variation around the policy outcome, the more cautious the policy-designated outcome must be (point a must be further to the left of point b). Since the policy package cannot be applied under the same conditions more than once, investors cannot tell if the unacceptably high deficit is the result of random shocks or 'bad' policy.

Also assume that the deficit chosen by the government was that which would be associated with the desired rate of economic growth, and smaller deficits (or surpluses), by suppressing aggregate demand, would reduce the rate of growth. In such a case, an attempt by the government to reduce the probability of destroying investor confidence would result in lower growth. To avoid trading growth for investor confidence, the government might introduce exchange controls in various forms to reduce the consequence of the most devastating manifestation of loss of confidence, capital flight.

Fiscal Deficit Targeting Can Fail Due to Random Factors:



In Indonesia during the Asian financial crisis it appears that investors were so risk-shy that the distribution of values around the mean was extremely wide, and not even extremely high interest rates and fiscal tightening could regain private sector confidence. Thus, there was a strong technical case for capital controls.

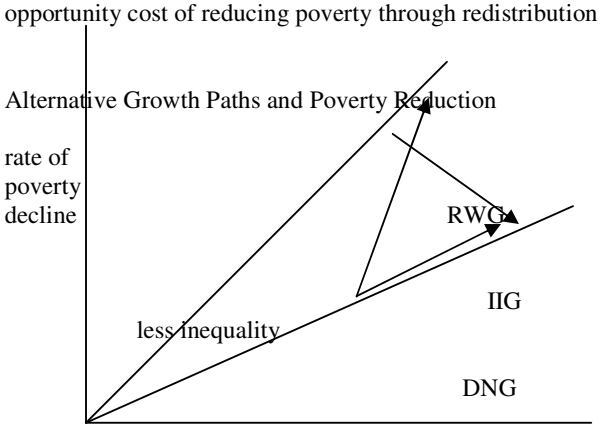
Box x: Redistribution Matters in Indonesia

Contrary to what the prevailing orthodoxy might suggest, income redistribution can have a major impact on poverty. The validity of this general principle is demonstrated in the diagram below. The relationship between economic growth and poverty reduction is determined by the overall distribution of income and the distribution near the poverty line. The economy-wide distribution sets the potential for redistribution, while the distribution near the poverty line determines the impact of a redistribution on the poor. If the poor are clustered just below the poverty line, then a given distribution will reduce poverty more than if most of the poor are well below that line.

The diagram treats the distribution near the poverty line as an extension of the distribution function for the entire population. The steeper line reflects a more equal distribution of income. Three possible growth paths are shown. On the basis of recent empirical work (Cornia 2001), it would appear that a common outcome in the 1990s was growth with increased inequality (line GII). In this case, the poverty- reducing effect of growth declines. Alternatively, growth can be distribution neutral (argued by Dollar & Kraay 2000), and the rate of poverty reduction is constant as the economy expands (line DNG). Most favorable for the poor is redistribution with growth (line RWG), in which any growth rate is associated with more poverty reduction.

The practical importance of these logical possibilities is substantial for Indonesia. Using the distribution of income for 1996 (Gini coefficient of 36.5), a rate of growth of one percent per capita that was distribution neutral would reduce poverty by .5 percentage points. That same rate of growth, distributed in equal absolute amounts across all households, would reduce poverty by 1.27 percentage points. In other words, with regard to poverty reduction, a one percent per capita redistributive growth is equivalent to a distribution neutral growth rate of 2.5 percent. Such a one-year redistribution rule would have reduced the Gini coefficient only to 35.7 This change is quite small compared to actual changes in distribution in the country, because in 1970, Indonesia's Gini coefficient was a modest .307. For Indonesia and a large number of other developing countries, Lübker has shown that regaining historic levels of income equality would have a dramatic impact on poverty reduction.

The difference between poverty reduction with distribution neutral growth and redistributive growth has important resource implications. To achieve the same poverty reduction as a one percent increase in redistributive growth, DNG must rise by an additional one percentage point. Assuming the aggregate capital-output ratio in Viet Nam is 3.0, this increase would require a rise in net investment of three percentage points. By any reasonable estimate of the administrative costs of redistribution, the opportunity cost of reducing poverty through redistribution should be less than for growth alone.



For further discussion, see Dagdeviren, van der Hoeven & Weeks (2002) and Lübker (2002).

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