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SM/96/292

November 25, 1996

To: Members of the Executive Board

From: The Secretary

Subject: **Bank Indonesia - IMF Conference on Macroeconomic Issues Facing ASEAN Countries**

Attached for the information of the Executive Directors is a report on the Bank Indonesia-IMF conference on macroeconomic issues facing ASEAN countries, held in Jakarta, Indonesia on November 7-8, 1996. Also attached are abstracts of papers that served as background to the conference.

Mr. Anoop Singh (ext. 36222) or Mr. D. J. Robinson (ext. 37489) is available to answer questions relating to this paper.

Att: (1)

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INTERNATIONAL MONETARY FUND

Bank Indonesia-IMF Conference on Macroeconomic Issues Facing ASEAN Countries

Prepared by the Southeast Asia and Pacific Department

Approved by Kunio Saito

November 25, 1996

On November 7-8, 1996, Bank Indonesia and the IMF sponsored a conference on "Macroeconomic Issues Facing ASEAN Countries", held in Jakarta. The purpose of the conference was to take stock of the achievements of the countries of the ASEAN region over the past decade; to identify their key determinants; and to look at how best ASEAN's success can be sustained in today's fast changing international economic environment, including the global integration of goods and capital markets. The conference, which was opened by Finance Minister Mar'ie Muhammed and Governor Soedradjad Djiwandono, brought together Finance Ministers, Central Bank Governors, and senior officials from across the Asian region, as well as private sector representatives, academics, and representatives of international institutions.

In his address to the first session,[1] which focused on the strategy to sustain ASEAN's remarkable economic performance, the Managing Director stressed that the region's record of policy prudence and adaptability should be maintained through measures to reduce reliance on foreign savings—particularly through further fiscal consolidation; to encourage private capital flows to take the form of long-term private investment; to strengthen domestic banking systems; and to ensure an appropriate role for the State. Many of these themes were taken up in the remaining three sessions of the conference.

The second session, covering issues related to savings, investment and current account sustainability, featured an opening address by Governor Gabriel Singson of the Philippines, who reviewed the lessons to be drawn from the recent experience of the Philippines, emphasizing the need for strong political commitment to adjustment, and for monetary, fiscal and structural policies to be mutually supportive. During the ensuing discussion, speakers noted that while present current account deficits were not unsustainable—and reflected high private investment and not low savings or a weak fiscal position—they gave rise to risks. Further fiscal consolidation was generally supported, although it was noted that with many countries already in substantial surplus, this could prove difficult to achieve. There was also

[1] See "Sustaining Macroeconomic Performance in the ASEAN Countries", Address by Michel Camdessus, IMF 96/20.

felt to be scope to increase private savings, including through the establishment of provident funds, although such measures would take time to have an effect.

In his opening address to the third session, covering issues of monetary policy, financial liberalization, and capital market liberalization, Governor Djiwandono emphasized the need for monetary authorities to stand ready to adapt policies to the changing financial environment; in this context, he noted the complications that increased capital inflows caused for monetary policy (which Indonesia has begun to address through widening the exchange rate band) and the importance of ensuring bank soundness. The latter theme was taken up by several other speakers, who emphasized the need for improvement and strict enforcement of prudential regulations, as well as ongoing assessment of banking system vulnerability to various shocks.

In discussing the impact of financial liberalization on the conduct of monetary policy, there was considerable interest in the Philippines' experience with inflation targeting as one method of addressing instability in the demand for the monetary aggregates. While financial market development was seen as crucial—and an important way of increasing the maturity of capital inflows—it was also felt that it should be undertaken gradually to allow the monetary authorities time to adjust. While a variety of views were expressed on exchange rate policy, there was general agreement that ASEAN's success owed much to the avoidance of significantly misaligned exchange rates in recent years. Several speakers felt that, in some circumstances, controls on inflows could play a useful role in dampening exchange rate volatility on a temporary basis.

The final session, looking to the medium term, featured a round table of speakers from the ASEAN region and the Fund. It was generally agreed that ASEAN's traditional mix of prudent and market-oriented economic policies had stood the test of time, and countries in the region were urged to disseminate their experience to other parts of the world. Speakers were generally optimistic about the economic outlook—indeed it was noted that by the year 2000, ASEAN's weight in world output would be between that of Germany and Japan—but stressed the importance of continuing to invest in infrastructure and education to support total factor productivity growth over the medium term. Several speakers emphasized that the government retained an important role in these and other areas, stressing in particular the importance of transparency and openness to assure excellence in governance.

The staff had prepared—or coordinated the preparation of—a number of papers that served as background to the conference. Abstracts of these papers are attached, for the information of Executive Directors. The papers represent work in progress and will be finalized for publication next year.

Attachments (10)

Current Account Imbalances in ASEAN Countries:

Are They a Problem?

Jonathan D. Ostry

Current account deficits in a number of ASEAN countries have widened in the 1990s. While these deficits have generally been regarded as being sustainable over the medium term—mainly on account of the high investment levels that have accompanied them—conventional wisdom suggests that they are not without risks. Against this background, this paper assesses the sustainability of these deficits from a number of perspectives.

First, a model is estimated in which the current account acts as a buffer to smooth consumption in the face of transitory shocks to output, investment, and government spending. A key conclusion of the model is that excessive external borrowing for consumption (defined as an actual deficit above the level generated by the model) has *not* tended to characterize the experience of any ASEAN country in recent years. The paper thus confirms that the deficits are primarily a reflection of high levels of investment rather than excessive private consumption.

Beyond the model, the paper discusses other factors that affect sustainability and, especially, the risks of running large external deficits. The analysis highlights the roles of the level and composition of external liabilities; the flexibility of macroeconomic policies; the efficiency with which investment is used; and the health of financial systems. The paper concludes that, even when the external position appears sustainable, there is a need to pay special attention to these factors and to reduce current account deficits over time in order to minimize risks that may arise from such factors.

Jonathan D. Ostry is a Senior Economist in the Fund's Southeast Asia and Pacific Department. Prior to that, he was an economist in the Fund's Research Department and at the Bank of Canada. He was educated at Oxford University and the London School of Economics, and holds a Ph.D. from the University of Chicago.

Saving in Southeast Asia and Latin America Compared: Searching for Policy Lessons

Anuradha Dayal-Gulati and Christian Thimann

High saving rates in Southeast Asia have received much attention, in part because of their distinctive role in fostering rapid growth in this region. In Latin America, saving and growth rates have been significantly lower. This paper examines the main determinants of saving across the two regions, both from the perspective of the relationship between saving and growth, and to give some guidance to policymakers seeking effective means to restrain external current account deficits.

Thus, the paper undertakes an empirical analysis of the determinants of saving behavior in the two regions over the period 1975–95. The analysis points to private savings being positively influenced by a number of factors, such as lower social security expenditures, fully-funded pension schemes (although this effect is diminished if withdrawal restrictions are eased), and financial deepening; on the other hand, high volatility in the economic environment discourages saving. In addition, fiscal policy is found to play a key role in determining national saving rates since public saving only partially crowds out private saving. The level of per-capita income is also a significant determinant of private saving rates, suggesting that economies increase their saving rates as they develop.

From a policy perspective, two conclusions bear underscoring: prudent fiscal policy (including funded social security arrangements) increases national saving; and policies that improve the economic framework by encouraging macroeconomic stability and financial development also play a central role.

Anuradha Dayal-Gulati is an economist in the IMF's Southeast Asia and Pacific Department. She holds a Ph.D. from Brown University.

Christian Thimann is an economist in the IMF's Southeast Asia and Pacific Department. He holds an M.Sc. from the London School of Economics and a Ph.D. from the University of Munich.

Indonesia's Fiscal Position: Sustainability Issues

Geoffrey Bascand and Assaf Razin

Fiscal deficits, largely financed abroad, caused Indonesia's public debt to rise in the early 1980s. It remains high, despite the commendable strengthening of the fiscal position in the 1990s. Meanwhile, the value to government of oil reserves has declined sharply because of lower international oil prices and the ongoing depletion of reserves. Against this background, as well as in light of the region's experience with capital outflows and their impact on the current account deficit, this paper examines whether further fiscal consolidation is needed to reduce possible risks from external shocks, strengthen the resilience of the economy, and sustain growth.

The paper considers three broad dimensions of fiscal sustainability: (i) solvency; (ii) the interaction of the fiscal position with external sustainability; and (iii) the reliance of the fiscal position on inflation. The analysis shows that, even after adjusting for the exhaustibility of oil reserves, Indonesia's fiscal solvency is assured—in the sense that policies can be maintained while meeting debt obligations and without recourse to monetization. However, in part because of declining government net worth (as oil revenues diminish), fiscal consolidation would be prudent both to strengthen external sustainability and reduce Indonesia's vulnerability to external shocks. This could be achieved through broadening the tax base and improving tax administration.

Geoff Bascand is an economist in the Southeast Asia and Pacific Department of the IMF. A graduate of Otago and Australian National Universities, he was previously Director of Macroeconomic and Tax Forecasting with the New Zealand Treasury.

Assaf Razin is a Resident Scholar at the International Monetary Fund. His book **Fiscal Policies and Growth in the World Economy** (co-authored with Jacob Frenkel and Chi-Wa Yuen) has been recently published by MIT Press.

Philippine Fiscal Policy: Sustainability, Growth and Savings

Philip Gerson and David Nellor

Since 1990, the Philippines' fiscal accounts have improved dramatically, with the consolidated public sector deficit declining by about five percent of GNP, and expected to reach approximate balance in 1996. Against this background, the paper assesses the remaining agenda for fiscal reform in the Philippines— especially tax reform—to fully satisfy sustainability conditions and meet the Government's macroeconomic objectives.

A key condition of fiscal sustainability is the ability of the fiscal stance to meet public debt obligations without discretionary changes (and without sharp cuts to investment expenditure). A review of recent indicators suggests that this key condition for sustainability is likely to be satisfied. A more rigorous econometric analysis suggests that this condition would be more comfortably met with additional measures, such as the government's planned comprehensive tax and civil service reforms; such reforms would give substantial assurance that needed infrastructure investment would not need to be sacrificed for sustainability.

The second part of the paper examines how fiscal policy can contribute to meeting the government's broader macroeconomic objectives. It is argued that a significant increase in government investment expenditure will be required to meet targets for economic growth and that, to avoid pressure on the external current account, a marked increase in domestic savings is needed. To achieve this, it will be prudent to target for a substantial improvement in government savings over the medium–term. As noninterest government current expenditure is relatively low and largely nondiscretionary, the paper concludes that this would need to be achieved mainly through higher revenue.

Philip Gerson is an economist in the Fiscal Affairs Department of the IMF. He previously worked for a major U.S. commercial bank. He holds degrees from Dartmouth, Cambridge, and The Johns Hopkins University.

David Nellor is the Fund's resident representative in Manila.

Financial Liberalization and Money Demand in ASEAN Countries: Implications for Monetary Policy

Robert Dekle and Mahmood Pradhan

Monetary developments in Indonesia, Malaysia, Singapore, and Thailand since the early 1980s have to be assessed in the context of substantial changes in their financial markets. This paper examines the extent to which financial market development and liberalization in these countries since the 1980s have affected money demand and seeks to draw implications for the operation of monetary policy.

An important prerequisite for operating a policy framework centered around monetary targets is a stable and predictable demand for money. However, consistent with a number of previous studies and with the recent experience of many industrialized countries, the paper's empirical results suggest that there is continuing instability in the relationship between money growth, economic activity, and inflation. This suggests that policymakers cannot rely exclusively on the behavior of monetary aggregates to assess monetary conditions. Policy decisions will need instead to be based on a wider set of monetary and real sector indicators of inflationary pressures.

The feasibility of alternative policy frameworks, including nominal exchange rate targets and inflation targets, is discussed in the context of the increasing integration of financial markets and the substantial increase in foreign capital inflows. Experience with the operation of inflation targets in other countries suggests that policy credibility is aided by the transparency of decision making.

Robert Dekle is an economist in the Central Asia Department of the IMF. Prior to joining the Fund, he was an economist at the Board of Governors of the Federal Reserve System. He received his Ph.D. from Yale.

Mahmood Pradhan is an economist in the Southeast Asia and Pacific Department of the IMF. Prior to joining the Fund, he was an economist at the Bank of England. He holds an M.Phil from the London School of Economics.

Exchange Rate Policy and Macroeconomic Management in ASEAN Countries

Peter J. Montiel

This paper is motivated by the issue of how to interpret the recent behavior of the real effective exchange rate (REER) in five ASEAN countries, which has been relatively stable since the late 1980s despite the arrival of sizable capital inflows. There are two possible explanations for this outcome: It could reflect active management of the nominal exchange rate in pursuit of a competitiveness objective; or, it could be an "equilibrium phenomenon," if other fundamentals moved in such a way as to offset the tendency of capital inflows to appreciate the real exchange rate.

The estimated long–run equilibrium REER is found to have responded to different factors in each of these countries, and to have exhibited substantial variability over time, suggesting that more is at work in the determination of the equilibrium REER than simple purchasing power parity or long-run sectoral productivity differentials (the Balassa-Samuelson effect).

The recent capital inflow episode did not result in an appreciation of the long-run REER in all of these countries. The equilibrium rate appreciated in Singapore after about 1987, and in the Philippines after 1990, but stabilized or continued to depreciate in Indonesia, Malaysia, and Thailand.

There is no evidence of misalignment in the real exchange rates of any of the countries in the sample at the end of 1994: the sizes of the gaps between the actual and estimated equilibrium REERs are not meaningful in a statistical sense. The central conclusion of this study, therefore, is that current REER performance in these countries is best interpreted as being consistent with long–run equilibrium.

Peter J. Montiel is Professor of Economics at Williams College, USA. He was previously Chief of the Macroeconomics Division at the World Bank.

Capital Market Development and Financial Deregulation in Thailand and Malaysia: Implications for Financial Structure and the Monetary Transmission Mechanism

Tim Callen and Patricia Reynolds

Capital market development and financial deregulation in Thailand and Malaysia are opening up new financing opportunities for domestic firms and households. This paper looks at the impact of these developments on the financing of economic activity in Thailand and Malaysia over the period 1980–95, and the implications for the conduct of monetary policy.

The paper finds that rapid investment and growth has been associated with a shift in corporate financing from internally generated to externally generated funds. In Thailand, these have been raised mainly through financial institutions; in Malaysia, use of capital markets has expanded. In both countries, corporate leverage ratios have risen; the paper finds evidence that this—together with financial liberalization—has increased the efficiency of interest rate policy.

Looking to the future, developments in corporate leverage ratios, the growth of domestic bond markets, and changes in the composition of bank loan portfolios, as well as continued financial liberalization, will all have important effects on monetary policy implementation. The paper underlines the need for close monitoring of these trends and their implications to facilitate monetary management in the future.

Tim Callen is an economist in the Southeast Asia and Pacific Department of the IMF. Prior to joining the Fund, Mr. Callen held positions with the Bank of England, the Reserve Bank of Australia, and Hambros Bank.

Patricia Reynolds is an economist in the Southeast Asia and Pacific Department of the IMF. Before joining the Fund, she was an Assistant Professor at the University of Southern California.

The Indonesian Financial System: Its Contribution to Economic Performance and Key Policy Issues

John D. Montgomery

This paper examines the structure and performance of the financial system in Indonesia and considers its past and prospective contribution to Indonesian economic performance. It reviews the considerable progress already achieved in establishing the regulatory system for the sector, and points to possible areas where improvements in implementation can be made.

The author finds that the dominance of bank debt over other forms of finance facilitates monetary policy, although it may limit enterprises' financing choices (and could magnify the effect of a credit crunch on the economy). The paper points to the general experience in other countries with poorly capitalized banks, in particular, the increased risk that banks will make poor lending decisions were they to believe that they will be bailed out if the investments fail.

The author identifies five key policy issues that should provide the focus for further improvement of the performance of financial markets and institutions; in many of these, substantial reform is already under way.

- Rapid resolution of the problem of undercapitalized banks through the adoption of a credible liquidation policy;
- Continuing efforts to improve supervision and regulation of banks, in particular in the areas of compliance with capital adequacy ratios and legal lending limits, and vigilance in the areas of foreign exchange exposure, derivatives, and real estate lending;
- Enhancement of the competitive structure of banking markets, including eventual privatization of state banks;
- Deepening of securities markets and expansion of the domestic investor base; and
- Continued improvements in the supervision and regulation of securities markets, notably regarding disclosure and insider trading.

John Montgomery is an economist in the Capital Markets and Financial Studies Division of the Research Department of the IMF. He was educated at Yale University and the London School of Economics, and holds a Ph.D. from Princeton University.

ASEAN in a Regional Perspective

Jeffrey A. Frankel and Shang-Jin Wei

The conventional wisdom—based on simple trade share statistics—holds that trade within ASEAN is quite low, compared with other regions of the world. However, when allowance is made for income levels and other determinants of trade, the paper finds that, in fact, trade among the ASEAN economies is higher than one would expect. To the extent that this regional concentration of trade is attributed to regional trading arrangements, they appear to be trade-creating, not trade-diverting.

The *rate of increase* of trade within ASEAN, however, can be entirely explained by the rapid growth of the countries. The "gravity" model implies that trade among ASEAN countries should, in the future, rise about 12 percent a year faster than the world average, reflecting their more rapid economic growth. In addition, as the formerly autarkic Indochinese economies restore normal trade relations with the rest of the world over the coming decade, this factor alone would cause their trade to expand another seven-fold.

Foreign direct investment has played a central role in the development of ASEAN countries in recent years. While data are limited, the paper finds that FDI helps promote exports from the source country to the destination country. There is no evidence that Japan has accelerated its economic interactions with Southeast Asia, beyond what can be attributed to simple economic growth rates.

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Growth and Productivity in ASEAN Economies

Michael Sarel

An understanding of the sources of growth in the ASEAN economies—a much discussed subject in recent years—is central to an assessment of their past performance and future growth prospects. Some previous studies have concluded that growth rates of total factor productivity (TFP) in Asian economies are not nearly as spectacular as their growth rates of output, and, at least in Singapore's case, are virtually zero. If true, this would imply that the success of the ASEAN economies may not be sustainable.

This paper argues that the results of previous studies were greatly influenced by their reliance on national accounts data for measures of various variables. In particular, the results were driven by the values that were used for the factor income shares of capital and labor. This study uses internationally comparable data from the Summers-Heston database and explores an alternative method for estimating the capital and labor factor shares, based on the assumption that technological factor shares are determined by the industrial structure of the economy and, possibly, by its level of development.

The results of this study for the period 1978–96 show impressive growth rates of TFP in Singapore (2.5 percent), Thailand (2.0 percent), Malaysia (2.0 percent), a slower rate for Indonesia (1.2 percent), and a negative rate for the Philippines (-0.8 percent). The proportion of output growth per person attributable to TFP growth is not systematically different in the ASEAN economies and the United States.

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