Banks Servicing Communities in the Context of a Burgeoning China

P J Keating

The Asian Banker Summit

Shangri-La Hotel, Jakarta

26 March 2007

Let me begin by saying I am pleased to be in Indonesia once again.

When one thinks about the financial and banking system in Indonesia, especially when one is asked to talk about it, one cannot help but reflect upon those untimely events of 1997 which brought on the so-called Asian financial crisis and with it, brought Indonesia's economy and financial system to its knees.

Those events happened a decade ago this year and it has taken Indonesia most of that decade to recover the financial equilibrium it had before the onset of that crisis.

The fall in GDP in Indonesia and its consequent effects upon employment and poverty were greater than in any comparable country since the Second World War.

Indonesia was at the butt end of the early movement towards globalised financial markets and coordinated exchange rate management.

But that butt end caused banks to fail, to see their capital eaten up and the lot of those who depended on those banks for their security and commerce, to spiral into insolvency.

In 1997, Indonesia was the victim of a capital account crisis. It was not the victim of a current account crisis.

At the time, Indonesia's currency was pegged to the US dollar and the US dollar rose 60% against the yen following decisions and coordinated central bank action by the United States and Japan.

The consequent sharp rise in the rupiah made Indonesia's exports sharply uncompetitive, while imports picked up significantly.

The resultant merchandise trade account gap put downward pressure on the rupiah forcing a break in its linkage to the US dollar. Compounding the problem was President Soeharto's acquiescence to US Treasury Department pressure for Indonesia to open its banking system to financial flows from international banks, including, of course, US banks.

This encouraged domestic Indonesian banks to borrow US dollars at around 6.5% at the time and on lend them to domestic customers without in any way hedging the currency risk, for it was believed the national exchange rate link to the dollar was insurance enough against currency risk.

Many domestic businesses were encouraged to take up that liquidity, especially when the cost of doing so in their own currency was around 17%.

When the blow up came as a result of actions which had little to do with Indonesia itself, President Soeharto did the thing any prudent national manager would, and that was call in the International Monetary Fund for advice and support.

To its eternal shame, the IMF came armed with a pocketful of US Treasury prejudices and the one set of prescriptions it always had faith in; its current account crisis software.

Despite the fact that it knew that US action with Japan over their currencies had brought on the crisis and that US pressure to open Indonesia's banking system to the West had exacerbated it, the IMF laid out its classic current account prescriptions, prescriptions which brought the Indonesian economy to its knees.

These prescriptions were the grab bag of structural changes that they insisted that President Soeharto should implement immediately, though similar structural changes in countries like the US and Australia had taken 15 years to implement. In the jargon of the IMF, it was called 'structural conditionality', that is, the structural changes a country must meet as a condition of receiving IMF balance of payments support.

The US would not support 'stand still' clauses for international bank exposures in Indonesia, though it insisted on it in Korea.

These days of course, there are a lot of repentant sinners in the IMF and in the US Treasury over this episode. But the IMF's policies coupled with the Clinton White House's 'spread of democracy', meant that President Soeharto did not stand a chance of maintaining his otherwise 20 year long record of compound growth and Indonesia did not stand a chance from falling into massive structural and cyclical decline.

President Clinton's White House got its spread of democracy, but it got it at a very high price for Indonesia. The immediate uplift in poverty was stark, as was the abandonment of such things as education and training. A generation of Indonesians will remain adversely affected from the fallout of this epoch, with the Indonesian still struggling, a decade later, to absorb workforce growth.

The banks and the financial system were the first to feel impact. Many banks were closed or incorporated into other structures and were later recapitalised by the government after taking non performing loans into a so-called 'BAD' bank, which subsequently, IBRA became.

What has happened subsequently in the financial system, especially the banking system is, I think, the best thing that could have happened. After having been cleaned up, banks were sold off to be capitalised by private banking capital with expertise in risk management.

Many of the world's major financial players are now represented in the Indonesian banking system, as are many regional players. With the crisis still fresh in their minds, in both Indonesia and at home, these new owners will no doubt approach the Indonesian economy much more prudently than banks had formerly approached it.

With the float of the rupiah and the enhanced ability to run a centrally directed monetary policy, it is no longer necessary for government to control individual banks. When changing the Australian financial system, just on 25 years ago, I used to say the government's job was to 'steer the boat not row the boat'. Indeed, I myself privatised the Australian government's largest bank, the Commonwealth Bank of Australia.

What Indonesia and countries like Australia both need and want is the freedom for financial institutions to fund themselves and take responsibility for their own lending decisions, broadly free of regulatory oversight, but in a framework of more formal prudential structures and requirements; such as reserve ratios and measures that guarantee the more efficient spread of risk.

In this way, Indonesia should be able to get what it really needs; a capital adequate, responsive and open financial system well managed as to risk and able to meet the reasonable needs of a burgeoning Indonesian economy.

Without this, there is no way that a government relying on its own dexterity or resources can make the difference, in national terms, between inadequate economic performance and optimal economic performance. A competent, well managed banking system is a central building block in any growth economy.

But, financial systems are not just about banking systems. They are also about capital markets and stock markets. A bank intermediated economy can not of itself, provide enough pep of the kind that a country like Indonesia needs. The ability to raise money outside of the banking system is central for companies that need access to the larger licks of capital for growth and sustenance. Bank intermediated financial systems invariably become too 'corporate' in their behaviour and too responsive to official guidance. They more often than not, dampen or extinguish the very flames of entrepreneurship that capital markets and stock markets are best set up to feed.

Banks should be doing what banks are best set up to do and that is service the retail sectors of the economy and smaller business. An economy like Indonesia's will profit when government policy and the financial system encourages the growth of domestic demand and within that, private demand. In this way, ordinary people are able to garner their share of the consolidated wealth. And banks are uniquely positioned to facilitate their participation.

Ordinary people secure real growth in disposable income in two ways. The first, by an increase in real wages, the second, by a fall in the price level.

This is why the quest for low inflation is so completely central to the well being of the population at large.

Lower inflation rates, in the end mean, lower interest rates and with the lower cost of capital people are able to do things. Also, a truly competitive banking system will bring down lending margins as volumes and efficiencies reduce unit costs.

Let me give you an example.

In Australia, housing lending by banks was conducted at a margin of about 350 basis points over funding costs. As a result of competition and larger volumes, that margin has been reduced to about 90 basis points. In the space of a decade, banks' lending margins on housing have been reduced by two thirds. And the beneficiaries have been working Australians trying to put a roof over their heads.

Deregulation and competition are pro-consumer developments and any financial minister worth his or her salt, should be trying to establish a structure which has those characteristics.

The crisis in 1997 also did something else which turned out to be quite profound.

In a stroke, it directed the great flows of foreign direct investment away from South East Asia to North Asia; to China in particular.

In many respects, China became the principal beneficiary of the crisis. Not that China did anything to promote the crisis, nor did it seek to be the principal beneficiary, but that is how it turned out.

When China, showing judgment and concern, maintained the exchange of the RMB while the currencies of all the countries around it were depreciating markedly, it won grand plaudits from the United States and the international trading community generally. This was one of the actions by China which practically promoted its membership of the World Trade Organisation.

Also, in responding to the crisis, the government of China embarked upon a massive government sponsored infrastructure program to lift domestic demand to compensate for the negative employment effects on its export markets.

This combination of factors, the enhanced flow of FDI into China, the infrastructure program and China's own acceleration in the dismantling of its state-owned enterprise structure gave China a momentum which has propelled it, in a decade, to be the state we know today.

And China, by adding so much to world GDP, has also had the effect of helping to pull Japan from its structural recession. Now we have the second and the third largest economies in the world, both in Asia, growing significantly.

China's GDP, which, by all reasonable measure, must stand at around US$4-5 trillion, will this year grow by 10.4%, contributing US$400-500 billion of new wealth. By contrast, the United States itself, off a base of US$12 trillion and growing at 3.2% GDP growth, will be adding around US$384 billion. Let's call it US$400 billion. In other words, China is adding to the world economy, wealth comparable to the increment flowing from the United States.

This is a profound development. Indeed, never before in world economic history have we seen anything like it.

If we ponder for a moment the origins of the long economic waves over the past 200 years, we find that in the first half of the nineteenth century, economic growth and innovation was led by the United Kingdom; in the second half of the nineteenth century by continental Europe and the east coast of the United States; in the first half of the twentieth century by the United States and in the second half of the twentieth century by Japan. The current long economic wave, begun in 1990 with the innovation of the digital age, will extend long into this century, but it will be driven by China. China will be the base upon which the first long wave of the twenty first century is centred.

China is already a motor of the world economy and it is a motor which spins in our backyard.

Already, we are witnessing China's quest for resources and semi-finished products. Australia, for instance, is a major supplier of iron ore and other non-ferrous metals. Countries like Indonesia, Malaysia and Vietnam will become caught up in China's supply chain. We are already seeing the signs of Chinese direct investment in the supplying countries to its south. These investments will begin to add to national product in the ASEAN group of countries, as it will do in Australia.

China is also attending to the foreign policy structures which best suit its position as the motor economy of East Asia. It is principally responsible for establishing ASEAN plus 3, which in reality is, China, Japan and Korea plus ASEAN.

It will deal through these structures with, I believe, a great degree of maturity and regard for the nations which are party to its growth and development and central to the peace and order of the region. I believe China will adopt a quite considerate approach to the countries around it.

Yet behind these approaches lies one of the most active transformations in economic experience. With urbanisation as the principal driver of change in China, China has to switch the growth in its economy from net exports to domestic demand. At the moment, investment as a proportion of GDP is a multiple of that experienced in any OECD country. The fact is, the availability of liquidity has caused China to be over-invested. We are now seeing myriad sub-optimal investments across China, when those resources would be far better employed in housing and consumption.

A long term, balanced economy must find equilibrium between housing and consumption and export led development.

China has to secure that balance and in my opinion, it will. But before it can, its weak financial services industry and capital markets will have to strengthened and brought up to speed. There are a lot of structural issues in this. In effect, what foreign direct investment has done is to have brought innovation and capital to China, by-passing China's immature financial system. In effect, sidelining it. This kind of foreign investment may work for exports and import replacement, but it will not work for consumption.

Perhaps the first of the first order structural issues needing to be dealt with is the exchange rate mechanism itself.

The managed exchanged rate system of the renminbi obliges the Central Bank of China to buy all foreign exchange. This is then added to the domestic money supply in local currency. The consequent growth in the monetary aggregates then floods liquidity into the banking system which it, in turn, funnels into investment. This system also places an enormous strain on the national budget in mopping up the excess liquidity with a vast Bond program.

More than that, managed systems never get the exchange rate right. China's exchange rate encourages exports to the cost of domestic consumption and domestic demand. The exchange rate, the most important price in the economy, ends up sending the wrong price signals through the economy. The Chinese government and its Central Bank Governor understand this well.

We should remember that the Chinese economy has gone from being an agrarian economy 25 years ago, to a rapidly developing economy today. The country has, as a result, become very much wealthier. Therefore, the real exchange rate of the renminbi has to rise. And attempts to hold down the nominal exchange rate will only end in tears as such action fuels domestic inflation.

The government of China will have to let the exchange rate go. And I believe it will go much earlier than most people think. Indeed, the quicker it goes, the earlier China will move to a more sustainable basis of economic growth.

The United States dollar also needs an effective real depreciation against the rest of the world. With the renminbi and the yen effectively shadowing the dollar down, the dollar gets no clear room to turn around the US trade account. This also means that the adjustment burden is disproportionately carried by currencies like the euro and the Australian dollar.

When China lets its exchange rate go, it will take an even larger seat in that small community of top performing economies. Such a development will help it better foster its urbanisation and with that, a plethora of opportunities will open up for the countries around it, especially South East Asia and Australia.

Such things as the removal of exchange controls and Chinese personal investments in this part of the world will make a great difference to regional prosperity. Outbound Chinese tourism is only just beginning to grow, but when their currency can buy more, it will grow a treat. Countries like the Philippines, Indonesia and Vietnam will be the first beneficiaries of this development.

Indonesia has always had an active Chinese community. A large part of its business community has been ethnically Chinese. This will be a real strength in the coming years. As the Chinese diaspora move in and out of China and are joined by Chinese nationals all around the region, we will witness the kind of cooperative prosperity this region has never before seen.

Something similar is also going to happen with India.

India is the only large country in the world without an ageing population. Its future is boundless, and as we know, many Indians make up and participate in the economies of South East Asia.

The conjunction of these two very great states in commerce and in people, must intersect through the countries of South East Asia, especially and including the archipelago of Indonesia.

The great challenge for statesmen today is to establish a new world order which reflects the realities of economic life as it is today. The G8, which includes countries like Italy and Canada, does not include China and India. More is the pity. The world is still set up on the template of 1947 with the United States as the main dog on the street, aided and abetted by the Bretton Woods institutions, the IMF and the World Bank. The United Nations Security Council remains as unrepresentative as it is ineffective.

A great period of prosperity lies before us but we have to have the structures in place to make it work. The good old days, which you so often hear about in the West, were the bad old days for great states like China and India and Indonesia, colonised, subjugated and left in poverty. Thank God those days are over.

A United States with some vision and sense of history should be trying to construct a world where the US is the first amongst equals, readying for the day when its unipolar moment expires, in the context of a safe and cooperative multipolar world. This will not happen under the current president, but let us hope it will happen under the next.