Indonesia-China Economic Relations: An Indonesian Perspective

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ABSTRACT

In the past, the economic relationship between Indonesia and China had not been smooth, mainly due to political reasons. However, increased integration of China into the world market after its joining of the World Trade Organization (WTO) provides the opportunity for an economic relationship that is more detached from politics. As China becomes more integrated into the world market, Asian as well as global economies will reap the benefits of a more open trade partner. Furthermore, China's involvement in the ASEAN+3 group to promote cooperation in financial, monetary, and general economic fields is an important step toward further integration of Asian economies as a whole.

Keywords: *Indonesia, China, trade, World Trade Organization (WTO), Association of Southeast Asian Nations (ASEAN), ASEAN Plus Three (ASEAN+3)*

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1. Introduction

In 1990, Indonesia restored its diplomatic relation with China after it was frozen for a quarter of a century. Five years earlier, a direct trade link was established between the two countries. Since then, the volume of trades between them has increased significantly. There have also been some flows of investment between China and Indonesia but the volumes are still relatively insignificant.

Indonesia's and China's economies are more or less on the same level of development, albeit China's economy is arguably a more diversified one. At the current stage of development the two economies lack the complementarity necessary for the trades between them to grow rapidly. Instead, companies from both countries are vying for the same export markets most notably in the US, EU and Japan. In addition, the two countries are trying hard to attract investors from other countries to invest in their respective economies.

China's is by far a bigger economy, and it seems to be a foregone conclusion that China will eventually become a superpower. Because of its domestic market potentials, ever since China began to open its economy, foreign companies have been trying to get footholds there. It is therefore important, in discussing China's economy, to keep in mind that being large, China's trade and investment policies are likely to have impacts on other developing economies, Indonesia included. This paper assesses the importance of economic relations with China from an Indonesian point of view. A special emphasis will be put on understanding the significance of China for the Indonesian economy.

In contrast to its economic relations with China, which had gone through turbulent years, Indonesia's economic relations with Taiwan and Hong Kong have always been relatively smooth. These relations were primarily driven by private sectors in those countries with minimum, if any, government involvements. These two economies have become important sources of foreign direct investment, and with it, technology, in Indonesia since late 1980s.

By comparing those economic relations the paper shows that in fact they represent two very different modes of relations. The ones with China are still influenced by political relations between the two countries, whereas those with Taiwan and Hong Kong are very much free of political influence. It is expected that,

as Indonesia's and China's economies are increasingly integrated into the world economy, political influence will be gradually detached from their economic relations.

Finally, this paper also assesses the current economic crisis, and discussed lessons learned that will be mutually beneficial to the economies of Indonesia and China – and, to some extent, to the global economy as a whole.

2. Indonesia's Economic Relations with China Since Mid 1980s

In July 1985, the Indonesian Chamber of Commerce and the China Council for the Promotion of International Trade (CCPIT) signed a memorandum of understanding (MoU) for the reestablishment of a direct trade link between the two countries. Five years later, China and Indonesia resumed the diplomatic relation that had been frozen since 1966. The fact that it was the trade relation that had first been reestablished may be interpreted as a sign that both countries regarded economic relation as one of the most important – if not the least contentious – factors in their relationship. By the same token, one may argue that, being one of the least contentious issues, the establishment of a direct trade was only a necessary step toward a full diplomatic relation.

Be that as it might, some significant political and economic changes had taken place in both countries, most notably in China during 1970s and early 1980s. These changes had arguably also influenced the way the two countries considered each other's positions in the regional as well as in global settings. In addition, as early as 1980s, there had been discussions among many scholars in the region regarding the need to establish some kind of economic cooperation between countries in the Pacific Region. In this context, the China-Indonesia rapprochement might be considered as a logical step in anticipation of such a cooperation.

This paper argues that, among other things, the normalization of China-Indonesia relations, especially economic ones, had been primarily driven by the two countries' efforts to integrate their respective economies into the global market. The subsequent developments in these relations were the logical consequence of these efforts.

Background Development

Economic Reform in China since 1970s

There were several developments in China that arguably had made the condition in the mid 1980s conducive for the reestablishment of a direct trade between Indonesia and China.[1] First, toward the end of the Vietnam War, China and the United States began to establish direct contacts that eventually led to the establishment of a diplomatic relationship between them. As a result of this rapprochement, China joined the United Nations and became the member of the Security Council in Taiwan's stead.

The second factor was associated with the opening of China's economy that had resulted in increasing trade and investment flows between China and other countries. In the early 1980s China began to liberalize its economy with the prime objective of attracting foreign technology either though foreign investment or through trade. This development had been made possible by a change in the leadership in Beijing after the death of Chairman Mao in 1976. The new leadership had put more emphasis on economic development and was more willing to embrace market economy than ever before. It was also considered less likely to meddle in the internal affairs of other countries.[2]

Finally, the prevailing perception among many observers was, and still is, that China had a huge economic potential and that it was only a matter of time before it becomes an economic superpower. China had, undoubtedly, cultivated this perception for its own benefit. During the period under consideration, China tried hard to acquire foreign technology through, among other methods, attracting foreign investment. And, indeed, this perception along with the economic reform programs that had resulted in subsequent rapid economic growth, had made China increasingly attractive to foreign investors and foreign traders alike.[3]

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[1] Indonesia froze its diplomatic relation with China in 1966 following the abortive coup at the end of September 1965, for which the Indonesian government blamed the Indonesian Communist Party (PKI). The Indonesian government had accused China as providing supports for the PKI, especially in the aftermath of the coup.

[2] China's support for communist insurgencies in Southeast Asia had in the past become one of the sore points in the relationships between Southeast Asian countries and China.

[3] Some scholars (e.g., Segal, 1999) consider the importance of China's market as being overrated. They argue that it will take many years or even decades before China's economy may be classified as a developed one. Between now and then, China has to face formidable challenges to modernize its economy.

Economic reform in China began in 1978/79 and might be divided into two areas, i.e., rural and urban areas (cities). Owing to different economic activities in those areas, the reform measures for each of them had distinctive features. Reform in the rural areas had one main objective, namely, to provide farmers with incentives that would induce them to improve their productivity. The incentives came in two forms: improvement of farmers' purchasing power and transformation of land ownership. Years before the reform China had instituted a two-tier price system for certain agriculture products: quote prices for crops sold in fulfilment of procurement obligations, and above-quota prices applied to crops sold in excess of the obligations. To increase farmers' purchasing power, the government raised both the quota and the above-quota prices (Zhou, 1992 and Lin, 1996).

The most important reform in rural areas, however, was the dispersion of agricultural decision making responsibility. The ownership title over land as an important means of production had been gradually transferred from the State to collective farms which were operated and managed mainly by individual farming households. The system, also known as the household responsibility system, was not initially sanctioned by the government. In fact, the subdivision of collectively-owned land and delegation of production management to individual households were prohibited. Nevertheless, the prohibition did not stop a small number of production teams to transfer some of the activities through contracts to individual households. Faced with the increasing number of production teams that had adopted the household responsibility system, which might be regarded as a bottom up process, the government eventually gave its official recognition to the system as an acceptable mode of farming in 1981. The percentage of production teams that adopted the household responsibility system increased rapidly from a mere one percent in 1979 to 99 percent in 1984 (Lin, 1996).

In the cities, the reform comprised of several aspects (see, e.g., Zhou, 1992 and Wong et al., 1995). First, to diversify Chinese enterprises' ownership and forms of operation. The township collective economy and private sector developed rapidly. For a state-owned enterprise, a rigid state control over the enterprise was relaxed, hence allowing the enterprise to become relatively more independent. This included, among other things, allowing the enterprise to retain a certain portion of the profits, and holding the enterprise responsible for its own profits and losses. The share of the

state sector in the gross industrial output fell from around 85 percent in 1978 to less than 30 percent in 1997 (van Kemenade, 1999).

Second, to make the market system function. Rural free markets were opened, allowing the trading of excess farm products, i.e., leftover products after the fulfillment of the state purchase quotas and fixed purchase quotas. In the urban areas, various kinds of trade centers were established. The means of production were traded freely just like any other commodities, a practice that was hitherto considered as taboo.

Third, to open the economy to the outside world. Foreign enterprises were encouraged to invest in China either by establishing enterprises or joint ventures there. To facilitate this effort, special economic zones (SEZs) were established in Shenzhen, Zhuhai, Shantou, and Xiamen, followed by the opening of a number of coastal cities to foreign investment. To increase foreign trade, control over many of the commodities that were formerly under the control of the Ministry of Foreign Trade was handed over to local organizations or other departments.

China's economic reform was markedly different from those taken by countries in the Eastern Europe and the former Soviet Union a decade later. As is evident from the above discussion, the Chinese government only gradually loosened up its control over the country's economy. Nevertheless, the Chinese leadership had acted quite swiftly in initiating the reform, given the fact that it was introduced only two years after the death of Mao, which was also marked as the end of the cultural revolution that had shaken the country. It is quite likely that China had been taking some lessons from its neighbors, most notably from South Korea, Taiwan, Hong Kong, and Singapore, regarding economic reform. All of these economies had experienced rapid growth during the 1960s and 1970s and they all had adopted an export-oriented policy. Moreover, the Chinese leadership could not have failed to notice the experiences of South Korea, Taiwan, and to a lesser degree, Singapore, which, despite of their relatively high degrees of economic freedom, had hitherto maintained authoritarian regimes that mostly restricted political and civil rights of

their respective populations. The subsequent development in China closely resembled this pattern.[4]

Economic Policy Changes in Indonesia since 1970

During the 1980s, Indonesia also undertook significant economic policy changes. Between 1970 and the early 1980s, the government pursued an inward looking, import substitution, policy. The main feature of the policy was industrial and firm targeting. Industries and firms that were perceived as important to industrial development received special treatment, such as subsidized credits, special access to industrial licenses and public procurements, inputs and source of energy at below market prices, as well as monopoly and oligopoly rights. Subsidized credits were instituted through the state banking system.

In addition, to encourage the development of the targeted industries, the government also resorted to adopting some protective measures. Import tariffs were set at high and sometimes prohibitive rates, especially on products similar to those of the protected industries. The importation of such products as radio and TV sets were completely banned, while some others could only be imported in completely knocked down forms. Yet, those measures had failed to bring about the intended outcomes. Part of the reason is that since the infant industry protection was given to industries with an open-ended commitment, those industries never reached maturity during the period under consideration.

The dynamics of the Indonesian economic policy since 1970 was partly determined by the availability of resources to finance the government development program. The government was able to pursue the above policy partly because it was able to secure large enough oil revenues – thanks to the upsurge of oil prices in 1973/74 and again in 1979/80. In 1980/81, oil and gas accounted for 75 percent of export earnings and 70 percent of the government budget revenues. In addition, the government was able to secure loans with favorable terms from the Inter-Government Group for Indonesia (IGGI) member countries as well as multilateral institutions, such as the World Bank.

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[4] The Chinese authority has loosened up its control over the economy and China's exports have grown rapidly since early 1980s. However, the Chinese authority keeps a tight control over the country's political life, and does not hesitate to take severe measures against any political activity that is considered as constituting a challenge to its authority, such as the harsh repression against student movement in 1989, and the banning of the Falun Gong movement and the prosecution of its followers.

During the first half of the 1980s oil prices fell sharply in the world market. The event marked a turning point for the government's economic policy as it then could secure much smaller earnings from oil exports. Consequently it was forced to reconsider its costly inward looking policy. Following the event, a series of economic reforms were undertaken – this time, to open up the economy. The reforms encompassed many important sectors, such as financial, trade, as well as fiscal. This was an arduous process since, by the early 1980s, the structure of the protection had become so complicated that it would need many reforms to disentangle and reduce or eliminate them.

The first deregulation attempt was in June 1983, when the government introduced the financial sector reforms with an aim, among others, to increase domestic savings. The deregulation covered the removal of all credit ceilings, the removal of controls on both lending and deposit rates of state banks, the removal of remaining subsidies on deposit rates paid by state banks, and a reduction in the number of credit categories financed by liquidity credit. Following the collapse of world oil prices in 1986, the second financial reforms was announced in 1988 which, among other things, removed most of entry barriers into the financial and banking services, relaxed the restrictions related to the opening of new branches, and a reduction of reserve requirements.

Along with the financial sector deregulation, a sweeping fiscal reform was announced in 1984/85. The reform included the introduction of the value-added tax (VAT) and a simplification of income tax rates from 16 categories to three categories. Sales tax was also rationalized. Wealth tax, except for properties, was abolished a year earlier in 1983. As a result, the government received an increase in its tax revenues.

The financial and fiscal reforms were then followed by reforms in trade. The first of a series of trade deregulation packages was announced in 1985. In March of that year, the government announced an across-the-board reduction in the range and the level of import tariffs. The tariff ceiling was reduced from 225 percent to 60 percent, with tariff rates for most products ranging from 5 percent to 35 percent, and the tariff system was simplified by cutting the number of tariff levels from 25 to 11. However, the rationalization of the tariff system was immediately followed by the proliferation of license restrictions. This inconsistency on the part of the government

would inevitably reduce the full benefit of the rationalization. Similar phenomena have often been observed in many of the subsequent deregulation packages. One explanation that could be offered for such inconsistencies is that, as mentioned earlier, the protection was so rampant and that various interest groups had been benefiting from it that its reduction, let alone its elimination, became a tough call to undertake.

Other reforms covering customs, foreign investment, shipping, capital market, state enterprises etc., were introduced between 1985-1997. As the result of these reforms, the economy – prior to the crisis – was in a much better shape then in the early 1980s, when the first reform was introduced. The economy had gradually shifted from oil-led growth to private-led growth, which, in a way, improved the likelihood of a sustained rapid growth for the years to come. Liberalization and deregulation had also gradually established the primacy of the market system, and the private sector had increasingly become the engine driving industrial development. This had put a pressure on the government to adopt new policies, especially those ramping up competitiveness, increasing investment from both domestic and foreign sources, ensuring the inflow of new technologies, facilitating the privatization of public companies, and boosting human resources development. In addition there was also an increasing demand in recent years for more transparent policies.

Sino-Indonesia Economic Relations in the 1990s

It was in such political and economic environments in China as well as in Indonesia that the rapprochement between the two countries took place. The process began at the time when both countries were entering new phases of their respective economic reforms. In the domestic fronts both governments introduced policies that would allow greater role of the private sector, while on the external fronts policies were directed toward increasing trades and foreign investment. Viewing from this perspective, the establishment of a direct trade between the two countries in 1985 and the improvement in economic relations between the two countries afterwards might be regarded as parts of their efforts to integrate their economies with the emerging global economy.

From an Indonesian perspective China was considered as having a large economic potential and hence, in an increasingly integrated world economy, simply could no longer be ignored. Indeed, China had experienced an astonishing economic

growth since early 1980s, and by 1997 China's gross domestic product (GDP) had reached $ 901 billion (official estimate) with a total value of export of $ 182.7 billion. In comparison, in the same year Indonesia's GDP was around $ 204 billion and the value of its exports was $ 56 billion (Asia Pacific Economics Group, 1998).

It may similarly be argued that China held a similar view about Indonesia. With a population that then rapidly approaching 200 million, and endowed with abundant natural resources, Indonesia, like China, had a large economic potential. Moreover, Indonesia was also an important member of the Association of Southeast Asian Nations (ASEAN). Then, it was arguably the first among the equals of ASEAN members. Singapore, for instance, normalized its relations with China only after Indonesia did the same. Thus, by normalizing its relations with Indonesia, China also posed to gain from improved economic relations with the rest of the ASEAN members.[5]

Trade between China and Indonesia increased rapidly since early 1990s, albeit from a relatively small volumes. Between 1991-98, Indonesia's non-oil and gas export to China has increased from around $ 580 million to over $ 1320 million. Similarly, Indonesia's import from China rose from around $ 800 million in 1991 to around $ 1270 million in 1997, and then subsequently fell to $ 980 million in 1998; the latter was primarily due to severe economic crisis in Indonesia. Since 1985, Indonesia's exports to and imports from Chinese economies (China, Hong Kong and Taiwan) have been steadily increasing. In fact these economies have surpassed ASEAN in both account. In 1985, Indonesia's exports to and imports from other ASEAN countries accounted for 10.6 percent and 9.4 percent of its total exports and imports, respectively. In 1997 the numbers were, respectively, 6.2 percent and 6.7 percent. On the other hand, Indonesia's exports to and imports from the Chinese economies in 1985 accounted for 4.2 percent and 5.7 percent of its total exports and imports, respectively. By 1997, these numbers were respectively 11.3 percent and 9.7 percent.

Notwithstanding the above impressive figures, for an obvious reason, trade between the two countries remains small relative the size of these economies. Both

[5] As an example, FDI flows from Singapore to China increased rapidly from 1.1 percent of the total FDI in China in 1992 to 5 percent in 1996. During the same period, the total FDI in China increased from $11,292 million to $42,135 million (Wong, 1999, Nyaw et al. 1999).

Indonesia and China are developing economies, with more or less the same levels of development. They lack economic complementarity which is necessary for extensive trade between them to take place. In reality, both countries are vying for the same export markets, namely, North America, Japan, and the European Union.

As a large economy, China's economic policy – its trade and investment policy in particular – will have repercussions, directly or indirectly on other developing economies, especially on their international trade and investment activities. The most recent example was in 1998, when many countries in Asia urged China to restrain from devaluing its currency. Had China devalued its yuan – which it did not – the crises that some of the Asian countries were suffering from would certainly be exacerbated.

For years, both China and Indonesia have been trying hard to attract investment funds from other countries. Foreign direct investment (FDI) into China has increased rapidly since 1990. In 1990, China received $ 3.5 billion or 17.5 percent of all FDI to East Asia. In the same year Indonesia received around $ 1.1 billion. By 1997, FDI into China stood at $ 43 billion out of $ 83.5 billion that went into East Asia. During the same year Indonesia received only $ 5.7 billion of the amount. One of the reasons for the introduction of a new foreign investment policy by the Indonesian government in 1994 was to increase the attractiveness of the country's investment environment in the face of increasing competition from China, Vietnam and other countries in the region. Under this new policy, foreign investors are allowed to own 100 percent of the companies they have invested in.

In recent years, there have also been some investment flows between China and Indonesia but the volumes were still relatively low. Unlike companies from developed countries whose investments often involve footloose industries and which merely use the host countries as their bases for export orientation, Indonesian investors in China and vice versa seemed to have been involved primarily on projects with longer term horizon, such as in pulp industry and the like.[6]

Trade and investment flows between China and Indonesia are expected to remain relatively low in the near future. Their main export partners will continue to be developed countries in North America, Western Europe and Japan. Similarly, they

[6] *Suara Pembaruan*, November 20, 1997.

will continue to rely on developed countries as well as the Asian NIEs as sources of FDI flows into these countries. The trade and investment flows between them will grow only gradually matching their respective economic and technological developments. As the diversification and specialization of these economies continue, commensurate with the levels of their development, economic complementarity, and hence trade opportunity, between them will increase as a result. However, trade and investment are not the only forms of economic relations. Other forms economic cooperation such as joint technical development, tourism, etc., need to be promoted and developed as well.

3. Indonesia's economic relations with Hong Kong and Taiwan: A comparison

Unlike China, Taiwan and Hong Kong has always maintained good economic relations with Indonesia, but with less political clouts. It should be noted that Indonesia never established a diplomatic relation with Taiwan; it always adheres to a one-China policy whereby it recognizes the government in Beijing as the only legitimate government of China; it did so even during those years when the two countries froze their diplomatic relation. As for Hong Kong, because of its status, political considerations have rarely had any significant influence in its economic relations with other countries. This is also in line with the laissez-faire policy, which the government Hong Kong has been perceived as always following.[7]

In spite, or perhaps more precisely because, of the above, economic relations between Indonesia, on the one hand, and Taiwan and Hong Kong, on the other, have flourished over the years.[8] Also, unlike China, Hong Kong and Taiwan have more advanced economies, and therefore have more to offer in terms of technology, expertise and investment funds to Indonesia. Hong Kong and Taiwan have two quite different economies, each specializes in the areas where its comparative advantages vis-à-vis other countries lie. Owing to its rapid economic development since 1960s,

[7] Not everybody will agree with the liberal use of the laissez-faire term in this respect. Youngson (1982), for example, had argued that the government of Hong Kong followed the laissez-faire policy only in selective sectors, one of them was trade. In other sectors, such as in the housing sector the government had then become the biggest landlord. Also, land as a scare resource in Hong Kong, was available only through the government. These were the examples of government activities that violated the very idea of laissez-faire.

[8] During the period when Indonesia and China stopped trading with each other, Hong Kong had acted as an intermediary that facilitated trades between the two countries.

Taiwan has emerged to become a major industrial powerhouse in East Asia. In 1997, its manufacturing sector accounted for around 28 percent of Taiwan's GDP. Since 1980s, Taiwan, like the other Asian newly industrialized economies (NIEs), i.e., Korea, Hong Kong and Singapore, has become one of the main sources of FDI in Indonesia. Along with its investment, Taiwan also transfers, and has become one of the main sources of flows of, manufacturing technology into Indonesia.

It is interesting to note that Taiwanese FDI ventures in Southeast Asia have been dominated by small and medium enterprises (SME). A study by Chen (1995) shows that Taiwanese SMEs' affiliates outnumber the country's large companies' affiliates by a ratio of 2 to 1.[9] Chen also shows that although small affiliates do not always correspond to small parent companies, the degree of correlation is high. This finding would certainly have some implications on the transfer of technology and knowledge from the parents companies to their affiliates.

It is often assumed that due to limited technological and managerial manpower, SME parent companies are less able to transfer technology than large companies. This, however, is not necessarily so. In fact, the opposite may instead be the case. In the case of Taiwan, for instance, in order to compensate for the aforementioned deficiency, SME affiliates may have to acquire technology locally through R&D or from other sources. Similarly, they may have to train their manager locally or send a small number their staff to parent companies for training. Indeed, Chen's findings confirm some of these conjectures. In particular he found that SME affiliates tended to localize, i.e., to enhance linkage to local economy by increasing local sourcing of materials, machinery, and equipment. They therefore enhanced the local economy in a different way.

Unlike Taiwan, rapid economic development since 1960s has turned Hong Kong into a major financial center in East Asia and has a particularly large service sector. The service sector accounted for 84.7 percent of the GDP in 1997, of which the contribution of the financial sector alone accounted for around 24.7 percent of the GDP. The share of the manufacturing sector on the other hand is relatively low; in 1997 it contributed only 7.3 percent to the GDP. As a major financial center Hong Kong such has acted as a conduit that channels financial resources to users throughout

[9] Chen (1995) defines small and medium enterprises as those with less than 300 employees.

the region. By providing financial services, Hong Kong has benefitted the region as a whole with its expertise and human resources. Hong Kong, for example, has been instrumental in bringing about the rapid economic development in South China through massive injections of enterprise, capital, and expertise. It has acted as an intermediary for investment from other countries, most notably from Taiwan and South Korea, and by doing so, it also serves its own interests.

While undoubtedly Hong Kong main interest lies with China, Hong Kong also trades but above all invests in the rest of East and Southeast Asian countries. For instance, Hong Kong has become one of the main sources of foreign direct investment (FDI) in Indonesia. In 1997, when many countries virtually stopped, delayed or withdrew their investments in Indonesia, Hong Kong was one of the few countries that have managed to stay put. Its realized investment that year was $2,383 million but subsequently fell to a mere $37.4 million the year after.

Hong Kong banks have generally withstood the crisis with estimated non-performing loans below five percent. However, recent moves to tighten regulation may undermine Hong Kong's status as one of Asia's main financial centers. The new regulation, viewed by investors as a nuisance, is designed to prevent currency speculators and hedge funds from attacking the Hong Kong dollar and its futures market by requiring securities firms to disclose the identities of large futures clients and increased margins on futures trades. This new regulation, together with the Hong Kong government's intervention in the stock market in 1998, is viewed as a departure from the laissez-faire tradition (see e.g., World Economic Forum, 1999a).

From a regional perspective, it is important that Hong Kong retains its role as one of the region's financial centers. It has thus far benefited the region by acting as an "intermediary" that channels financial resources from one country to another as well as providing the region with the badly needed financial expertise. Competition among the region financial centers: Tokyo, Hong Kong and Singapore will benefit the region as a whole through better and more diversified financial services. This will require Hong Kong to retain some degrees of independence to pursue policy or policies that better suit its role as a major financial center.

On a related issue, it is interesting to notice that Taiwanese companies have done something that the government in Taipei has attempted but, for a political

reason, failed to achieve, namely, promoting Taiwan's interest in Southeast Asia. In a sense, Taiwanese companies, while promoting their own interests, have at the same time been engaging in a "private sector diplomacy". It may similarly be argued that Taiwan was able to join APEC partly because it had a strong private-based market economy to begin with.[10] Incidentally, this phenomenon of economic interdependence with less or without political influence is considered by many as one of the main features of the global economy. This is but one example of how the globalization process has helped to readjust and rearrange the roles of the government and the private sector in one country.

The above process, to reiterate one of the observations from the previous discussion, is primarily due to the activities of SMEs rather than to large companies, and hence appears to counter a popular belief that globalization is driven mainly by the latter. Moreover, while globalization may operate largely through pressure on, and actions by, corporations, this does not imply that the government will soon become irrelevant and the state wither away. For firms to flourish, the private contracts on which they rely must be underpinned and enforced by governments. The provision of law enforcement and justice will remain the purview of governments. There is no doubt that, as stated above, the process of globalization will further rearrange the roles of government and the private sector in the economy. For instance, in the provision of infrastructure services the role of the government will shift from investment and ownership to regulation. In short, the net effect of globalization on governments will be to focus their efforts on smaller but critical sets of actions. In addition, the process will also put pressure on the government to adopt common practices and standards that will lead to convergence in accounting standards, commercial law, and intellectual property rights.

In summary, one important feature of Indonesia's economic relations with Hong Kong and Taiwan is the interdependence without or with very little political influence. It is perhaps mainly due to the latter two economies' political status that political factors only rarely, if ever, influenced economic relations of the parties involved. As stated early, the lack of political influence is also one of the main characteristics of the global economy. The current trend is that while the economy is increasingly globalized, the politics tends to be localized. Some scholars (e.g., Kanter,

[10] APEC is the only organization where both China and Taiwan become members.

1999) regard the absence of political influence in the global economy as posing a dilemma, presumably because it limits the ability of one country to exert its influence over another. By the same token, it may be argued that quite often good economic relations between two countries are used or even sacrificed by one of the parties involved to advance its own political agenda that has less or nothing to do with the economic well being of their peoples.

By comparison, for various reasons such as historical background, Indonesia's economic relations with China will be only gradually less influenced by from political influence as both economies are increasingly integrated into the global economy. Seen from this perspective, it will be in the Indonesia's interest to support China's accession into the WTO. This subject will be discussed further below.

4. The Asian economic crisis and beyond

It is fair to say that nobody had expected the economic crisis that hit Asia in 1997 and is still going on in Indonesia. Indonesia has been particularly hard hit by the crisis; the rupiah suffered far greater depreciation compared to other currencies in the other trouble d economies. There were actually two parts of the crisis. First, the collapse of confidence on the local currency rupiah marked by initial sharp depreciation of the rupiah vis-à-vis other currencies, US dollar in particular. The central bank was then forced to float the exchange rate of rupiah. Second, the credit crisis that was prompted by foreign lenders who withdrew their short-term loans. The crisis has been further exacerbated by the subsequent banking and political crises. The questions that can be raised here are: whether there is any lesson that can be learned from the crisis; and whether there is anything that China and Indonesia – and for that matter, ASEAN – can do to prevent, or at least to reduce the risk of being exposed to a similar crisis in the future. China is suffering from problems, many of them are similar to those that Indonesia was suffering from prior to the crisis: a fragile banking sector, government favoritism toward well-connected firms, the lack of judiciary independence, etc (see World Economic Forum, 1999b). To address these issues, it will be instructive to first discuss some of the problems or weaknesses of the Indonesian economy that has been exposed by the crisis.

Banking sector problem

On the onset of the crisis, Indonesia has about 240 banks, a large number in a $ 200 billion economy. Many of these banks were small with only few branches, undercapitalized, and badly managed with high non-performing loans of about 8.8% (Johnson, 1998). As stated earlier, the country's banking regulation was relatively loose. Concerns had been expressed about the possibility of financial distressed and financial instability due to the rapid expansion of bank credits (Pangestu, 1993). But the prevailing attitude prior to the crisis was to allow for some learning period on the part of both the private banks and the central bank (Soesastro, 1998).

The banking crisis was triggered by the liquidation of 16 banks in November 1997 which, in turn, triggered bank runs as people were pulling their money out of the banking sector for fear of other banking closures. In an attempt to restore public confidence in the banking system, the government announced a new program in January 1998. The program comprised of two main elements, namely, the provision of the government's full guarantee to all depositors and creditors of locally incorporated commercial banks and the establishment of the Indonesian Bank Restructuring Agency (IBRA). Despite of the deposit insurance, public confidence on the banking sector has never really been restored. Sporadic bank runs still happened until June 1998.

It was immediately clear that the new program contained seeds for new problems such as a moral hazard problem. Because the government provided full guarantee to creditors and depositors, banks were under less pressure to improve their performances. Indebted banks were in no hurry to pay up their debts. Similarly, banks were less troubled when depositors withdrew their savings. Not surprisingly, therefore, that in a relatively short period IBRA had already had at least 40 troubled banks under its control. IBRA has become a conduit to channel money to banks that were short of liquidities. As people kept withdrawing their money from the banking sector, IBRA had been forced to keep pumping cash to a large number banks that were in needs for liquidities. The main problem was that the performances of those banks did not improve. On the contrary they seemed to have been getting worse.

Problems associated with open financial systems

The second problem was associated with the fact that Indonesia's corporate sector had not been properly prepared for international competition. Since the early 1990, interest rates were particularly high in Indonesia relative to other countries. This had compelled the corporate sector to borrow from abroad. At the end of February 1998, the private sector debt was estimated to be around $66.3 billion, of which private banks' debt was $6.3 billion, and non-bank corporations debt was $57.7 billion. A large fraction of the corporate debt was short term, as well as unhedged (Johnson, 1998). The corporate sector foreign debt problem may also be associated with moral hazard and complacency, for which both lenders and borrowers mostly to blame. For many years, until the rupiah exchange rate was floated in August 1997, Bank Indonesia, the central bank, adopted a managed floating exchange rate policy. Every year the rupiah was allowed to depreciate up to 4 percent against the US dollar. This policy had provided an implicit insurance for those who borrowed in dollar from abroad. And as interest rates were higher within the country than those abroad, many private companies had turned to foreign lenders for investment funds. Knowing that they were implicitly insured, they had simply ignored the need to hedge their debts.

The governance problem

The current crisis also reveals some of the governance-associated problems facing Indonesia. In fact the two previous problems may also be classified as governance problems. To a certain degree, the severity of the crisis can be attributed to those problems. At the root of this problem is the inadequacy of various institutions necessary to ensure a proper functioning of a market economy. Here, an institution is simply defined as a man-made constraint, either formal, such as the constitution, law, rule or informal, such as norm of behavior, convention, etc., and its enforcement characteristics (North, 1994). Together, various institutions in a society structure human interaction and define the incentive structure of the society and specifically the economy.

The importance of institutional infrastructure for sustainable economic development is now increasingly recognized. As the Indonesian experience clearly shows, an underdeveloped institutions/legal infrastructure may be harmful to economic growth in particular and economic development in general. One example is related to the weaknesses of the banking system. Prior to the crises, it was quite easy

to establish a bank, with a relatively low capital requirement. One would expect that, because it was easy to establish new bank, a prudential banking regulation with a strict banking supervision and enforcement should be in place to ensure proper banking activities. Even a purely laissez-fair financial system must count on some indirect government inputs such as efficient and fair judiciary system to handle the enforcement of contracts and the settlement of disputes and bankruptcy cases. Unfortunately, that was not the case with the Indonesian banking sector. The cases associated with bank failures and fraughts in early 1990s testify the weakness of banking regulation and banking supervision in Indonesia.

Another example is the virtually nonexistent bankruptcy law. The existing bankruptcy law is a legacy of the colonial period and was issued in 1905. It is simply regarded as inappropriate for the present corporate world. A new bankruptcy law was drafted on April 1998, and was put in force from August 1998. In addition, the government also failed to provide an effective, efficient and fair judiciary system, as well as a good police system. This has resulted in a lack of public confidence in both systems, including in the effectiveness of the judiciary system to handle corporate bankruptcy cases. As the consequence, all power to resolve corporate debts rest with debtor companies. In fact, many Indonesian companies that have both offshore and domestic debts are hiding behind the lack of legal remedies and refused to service their debts (Johnson, 1998).

Finally, the severity of the crisis may also be attributed to the fact that the government has actually mishandled it. The most extraordinary things about the rupiah crisis is the time it takes for the currency exchange rate to reach a new equilibrium point, and the extreme depreciation of rupiah which, at its lowest point, reached 85 percent. It seems that the rupiah crisis, which is widely believed to have begun through a contagion effect from the crisis in Thailand, has turned into a self-fulfilling crisis. In the latter, economic agents, for whatever reasons, lose confidence in the official commitment to defend or improve the currency exchange rate.

There are a few lessons that one can learn from the current crisis. First, while the crisis was triggered and in some cases made worse by exogenous factors, domestic factors had contributed to it as well. They did so in two different ways. First, it increased the country's vulnerability against any negative economic shock whether of external (e.g., through contagion) or domestic (e.g., lack of effective demand) origin.

The fact that some countries suffered the crises while others did not indicates that there must have been some differences – fundamental or otherwise – between the two groups. In the case of Indonesia, for instance, the size of its current account deficits prior to the crisis is often mentioned as one of the reasons for the attack on its currency. However, some argue (e.g. Krugman, 1999) that, as a percentage of its GDP, Indonesia's current account deficit in 1996 (less than four percent of its GDP), was actually lower than that of Australia. Hence, according to Krugman, it was the perceived problems that made Indonesia so vulnerable to self-fulfilling crisis. It should be noted that many of the problems, e.g., weak banking sector, are not something that are intrinsically associated with developing economies. Second, it made the crisis worse. Again, Indonesia's experience discussed earlier provides some examples of the domestic factors that have made the crisis worse, e.g., weak banking sector, obsolete bankruptcy law, etc.

Second, as a corollary of the former, the domestic problems may be resolved by the country alone or with the help of other countries or multilateral institutions. For instance, Malaysia has been trying to overcome and to some extent is quite successful in resolving the problems alone, while Thailand, Korea and Indonesia have turned to the IMF for help. Of all these countries, Indonesia has been the laggard in resolving its economic problems. One of the reasons is because those problems have been compounded by an equally serious political crisis.

Third, to reduce the risk of being exposed to a similar crisis in the future, it may be necessary for China and Indonesia – and for that matter, other ASEAN countries – to routinely exchange information in fields such as monetary and financial sectors. A joint statement by the governments of all ASEAN countries plus China, Japan and Korea, also known as ASEAN+3, that was issued in Manila on November 28, 1999, calls for the strengthening of policy dialogue, coordination, and collaboration on the financial, monetary and fiscal issues of common interest. The initial focus will be on issue related to macroeconomic risk management, enhancing corporate governance, monitoring of regional capital flows, strengthening banking and financial systems, reforming the international financial architecture, and enhancing self-help and support mechanism in East Asia.

Finally, we will be hearing more often about the issue of governance in the coming years as countries, developing ones in particular, will find themselves under

pressure from various corners to improve their governances, corporate governances included. However, this issue is by its nature a very sensitive one, because it involves, among other things, issues of political reform and other related issues. Even when one wants to focus his attention on corporate governance, as the ASEAN+3 joint statement cited above indicates, he will still be compelled to address issues such as corporate law, accounting standard and accounting practices, disclosure system, transparency and competition law, etc. The fact that corporate governance is associated with so many subjects that are mostly local in nature makes it not as readily transferable as, say, technology or corporate management. This issue will be best addressed at regional forums such as ASEAN or APEC, or through various second track meetings.

In the end, each country will have to choose for itself the best way to address the issue of governance. Discussions and seminars however will help facilitate this effort. There is a chance, however small it may be, that in an increasingly globalized economy the process may move forward much faster than otherwise, especially with respect to improving corporate governance. The corporate in a particular country will be under pressure from their peers in other countries to improve their business practices.

5. Concluding remarks

In an increasingly integrated world economy, it is utterly insufficient to analyze Indonesia-China economic relations in isolation from the two countries respective relations with the rest of the world. Nor will it be sufficient to concentrate only on trade, investment and the like. As the Asian financial crisis readily demonstrates, a shock to a particular economy may, in due course of time, affect some seemingly unrelated, far afield economies. The Asian financial crisis, for instance, after a while also adversely affected the Brazilian economy. The crisis also shows that an economic shock may propagate from one country to another through many different channels.

It is in the above respect, China's involvement in the ASEAN+3 group to promote cooperation in such fields as financial, monetary, and economic in general is an important step toward further integration of Asian economies as a whole. The next logical step will be to support China's, and for that matter Taiwan's, accession into

the World Trade Organization (WTO). China is already a major trading country, and since the WTO has the mandate to liberalize within a regulatory framework that clearly defines the rights and obligations of its members, China's membership is likely to accelerate further liberalization of its trade and related sectors. Moreover, the membership is also expected to put pressure on Chinese government to adhere to common practices and standards in such field as accounting, commercial law, intellectual property rights, etc.

Using a global computable general equilibrium model, Anderson (1996) estimated the impact of China's (and Taiwan's) accession into the WTO to some Asian countries, including Indonesia. According to this estimate, Indonesia's welfare gain from trade will be lower if China and Taiwan join the WTO than if they do not. Without China and Taiwan in the WTO in 2005, the welfare gain from trade to Indonesia was estimated at around US $11.1 billion, while with both economies in the WTO, the welfare gain would be US $9.1 billion, both measured in 1992 dollar. These estimates indicate that, for Indonesia, the impact of trade diversion will exceed that of trade creation with the accession of the two economies into the WTO. One then may ask, if so, why should Indonesia support China's membership in the WTO? There are several reasons why.

First, these estimates were based on a static model and hence did not take into account the dynamic effect of China's entering the WTO. That is, it did not take into account the long-term impact of the accession on Indonesia's economy such as economic growth. Moreover, the model did not take into account investments, and as the author of the paper asserted, by taking investments into account it would be less likely that ASEAN countries would be projected to lose from China's accession to WTO.

Second, the WTO has four main objectives: to set and enforce international trade rules, to provide a forum to negotiate and monitor trade liberalization, to settle trade disputes, and to improve policy transparency (Anderson, 1996, p. 208). As a member of the WTO, China will have to abide to the organization's trade rules and will follow more transparent policies on trade and investment. This will create a more conducive environment for trade and investment activities between the two countries.

Finally, from developing countries' perspective, China's membership may improve their bargaining power, as a group, vis-a-vis developed countries. One of the agenda in the next round of negotiations will be on liberalization on trade for agricultural products and on services. These two subjects are particularly sensitive for the developing countries and they should try to gain as many concessions from the developed countries as possible. This is, of course, assuming that China will enter the WTO as a developing country.

This paper has argued early on that Indonesia-China rapprochement may be seen as a part the two countries' quest to integrate their respective economies into the world market. Hence, for China, a WTO membership will become a milestone of that particular endeavor, and will benefit not only itself but other countries as well.

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