The fear of bank deleveraging

Bank Indonesia Governor Darmin Nasution has repeatedly assured the market that it is fully geared up to protect the financial services industry from any contagion from the lingering fiscal and financial crisis in the eurozone.

The incoming chief of the Financial Services Authority (OJK) Muliaman D. Hadad, who is now deputy governor of of the central bank, also asserted immediately after his selection by the House of Representatives on Tuesday that he would strengthen bank supervision to insulate the industry from any fallout from Europe's crisis.

Of more importance is the fact that the central bank puts its money where its mouth is, as can be seen from its active intervention in the foreign exchange market, its decision to maintain its benchmark interest rate at 5.75 percent and its measures to replenish its foreign reserves by selling dollar-denominated term deposits.

It is indeed the financial market contagion from the euro crisis — not trade channels — that could adversely affect Indonesia's economy in view of the likelihood of bank runs in the eurozone, especially after Moody's Investment Services on Thursday downgraded by two to three notches 15 of the biggest global banks in Europe and the United States.

Even though the exposure of our banks to Europe through trade channels and money market was estimated by the central bank at only about US$16.5 billion, around a mere 5 percent of the banking industry's assets, the monetary authorities should remain alert.

If the current financial distress worsens into a panic, it could trigger a massive withdrawal of Western lenders from emerging Asia, including Indonesia.

When capital is tight, banks usually focus on core markets, not the more challenging emerging markets such as Indonesia, and on core large clients, not small- and medium-scale borrowers, causing what economists call bank deleveraging.

Deleveraging takes place when lenders from developed countries systematically withdraw funding from emerging markets, either by naturally shrinking their asset bases by reducing loan rollover rates, or by selling equity stakes in local subsidiaries.

Western banks have been retrenching quietly, calling in loans or quietly withdrawing debt facilities or cross-border credit lines. Even the International Monetary Fund forecast in April that eurozone banks would shrink their balance sheets by $2 trillion over the next 18 months.

This is what has been happening in the eurozone where deepening economic contraction and rising bad loans have caused a credit crunch.

Its impact, though not as severe as the fallout from the global financial crisis which started in the United States in late 2008, has been hitting Indonesia, pressuring down the rupiah and share prices over the last few weeks.

Analysts predict deleveraging is likely to increase if the eurozone crisis isn't sorted out as the strength of the balance sheets of parent banks is now being questioned.

Falling liquidity caused by deleveraging could hurt emerging stock markets, especially Indonesia's, that depends mainly on external financing, and this would adversely affect capital-expenditure plans and slow economic growth.

But as we have often stressed in this column, our first line of defense against financial market instability is policy consistency and predictability, one of the keys to attracting direct investment.

Because unlike holdings in the stock market, bond or other money market instruments, which can be sold quickly when traders in Europe or US get jittery, direct investments in factories, companies and other fixed assets are harder to sell and are in the first place made and held for longer periods.

Other opinions

Sanctions against Iran

It is disappointing but not surprising that two days of negotiations last week failed to produce any real progress toward curbing Iran's nuclear program. Iran is still trying to figure out how much economic pain it is willing to accept to maintain its nuclear ambitions and what, if anything, it is willing to give up.

It is in the interest of the United States and its allies to keep talking, especially since a new round of sanctions are scheduled to go into effect. On June 28, the US can start barring foreign banks doing oil-related business with the Central Bank of Iran from access to the American financial market. Starting on July 1, all members of the European Union will be prohibited from buying oil from Iran and insurance for ships that carry Iranian oil.

No president has been as successful as Obama in rallying the major powers to impose sanctions with bite. These are the first serious nuclear talks in years, and there is still time to let them run.

— The New York Times, New York

The bloody cycle

Although it happens with cyclical regularity, this phenomenon is no wonder of nature. Once every few months, the Palestinians or their supporters try to carry out a terror attack or launch rockets from Gaza. Israel immediately and automatically responds forcefully; the Palestinians respond to the attacks on them; and southern communities turn into a war zone for a few days, until yet another temporary cease-fire is arranged and life returns to normal. This cycle can and must be broken.

The time has come for a rethink and a different modus operandi. Israel can restrain itself from time to time without harming its citizens' security. There are situations in which restraint is actually the truer demonstration of strength.

Israel doesn't need to fall into every trap set for it by the terrorist organizations in Gaza and Sinai, which have an interest in bringing about an escalation.

Sometimes, restraint is the wiser option.

— Haaretz, Tel Aviv

Yudhoyono and Petraeus: Between military and leadership

Wibawanto Nugroho
WASHINGTON DC

What does it take to be a great leader? Although the term "leadership" may have existed for thousands of years, it remains difficult to define. But everyone seems to agree that a great leader has the ability to push people forward and achieve greatness.

To understand leadership, we must dig deep into the core. Leadership is a biological, psychological and socially-constructed characteristic and capability.

Many findings of social constructivists, however, argue that social factors shape leadership characteristics much more than biological and psychological factors do. Correspondingly, it is interesting to examine the leadership characteristics of Indonesian presidents from Soeharto to the incumbent, President Susilo Bambang Yudhoyono (SBY).

Many people may not realize that the incumbent Indonesian President has much in common with one of the best living generals in the US, current CIA Director David Petraeus. First, the two were raised in a disciplined family: SBY is the son of an Army officer, while Petraeus is the son of a Dutch sailor. Both went to their country's military academies, holding top positions during their cadet years. While SBY graduated from the Military Academy in Magelang in 1973, Petraeus graduated from the Military Academy, West Point in 1974.

Upon their commission as army officers, both married the daughter of their respective military academies' commandants. SBY married the daughter of Lt. Gen. Sarwo Edhie Wibowo, then the governor of the Magelang Military Academy; Petraeus married the daughter of Lt. Gen. William Knowlton, the Superintendant of West Point.

Subsequently, they also went on to the US Army Ranger — Airborne course in Fort Benning, Georgia where they qualified in Special Forces. Both were also assigned to the elite US Army Airborne Division, 82nd Airborne Division.

At that time, SBY did his on-the-job training as a military student on attachment from the Indonesian Army. After some time in their career paths, like any other US army officers, SBY and Petraeus went on to the US Army Command and General Staff College (Seskoad) in Fort Leavenworth, Kansas.

> History will show whether Yudhoyono is just a clever military general who tried his luck as a politician or he is truly a great leader.

Upon their graduation from this great military school, they returned to serve their own countries until they reached the positions of commanders of airborne divisions, territorial commands and being involved in multinational forces.

While SBY led the Army Strategic Reserve Command (Kostrad) 17th Airborne Division, the Yogyakarta Military Resort Command, and was an observer for Indonesian peacekeeping forces in Bosnia and the Sriwijaya Military Command; Petraeus rose to become commander of the 82nd Airborne Division, US Central Command overseeing the Middle East, and International Security Assistance Forces (ISAF) in Afghanistan. Due to his relative success in bringing stability to Iraq and Afghanistan, Petraeus is called in Iraq "King David".

Apart from field experience, the two are famous in their respective countries as thinking generals and were often entrusted with drafting important military policies. While SBY holds a doctoral degree from the Bogor Institute of Agriculture, Petraeus has his PhD from the prestigious Woodrow Wilson School of Public and International Affairs at Princeton University.

Not only that, the two also share leadership experience that has catapulted them to state jobs outside their military assignments. SBY was twice appointed a minister under two different presidents; Petraeus was appointed Director of the CIA by President Obama in 2011.

In the US, not all great battle-tested generals can succeed in jobs outside the military. A phenomenal general in World War II, Douglas McArthur, resigned from his position as the Commander of United Nations Command (Korea) after his disagreement with President Truman over the Korean War; Gen. Stanley McChrystal resigned in 2010 from his post as the Commander of ISAF after his disagreement with President Obama and former US Pacific Command chief Adm. Dennis Blair quit in 2010 from his job as Director of National Intelligence. Gen. James Jones, a former commander of the US Marine Corps and NATO, stepped down in the same year from his position as a National Security Adviser to the president.

There is only one significant difference between SBY and Petraeus. While SBY decided to turn to politics and was elected President twice, Petraeus refused to become a politician and decisively turned down an offer to contest the 2012 US presidential election.

Obviously SBY has everything that Petraeus possesses, but not the other way around merely because unlike SBY, Petraeus is not a commander-in-chief of his country. This could be a sign; however, as to whether excellent military leadership experience is suitable for political leadership.

Some argue that SBY was a shrewd military general, but not fit for political jobs where the sense of hierarchy is blurred.

Practical politics contradicts the military chain of command where hierarchy is clear and subordinates have to obey commands, respect their leaders and address their voices in a well-mannered way.

It was the capacity to move in two different realms: Military and political that made Gen. Eisenhower a great US president. Unlike his West Point classmate, Gen. McArthur, Eisenhower knew how to become a true politician and successful president. History shows president Eisenhower was successful in building post-war Europe, restoring the US economy after World War II and building the nationwide freeway transportation system connecting the entire US mainland, among many other achievements.

Eisenhower successfully exercised effective leadership, with most of his policies well-supported and implemented by his administration, local governments and the US Congress, including when dealing with the resistance of the Arkansas governor regarding his courageous policy to protect minority Afro-American students in 1957.

It is not too much for the people of Indonesia and the international world to expect Gen. Yudhoyono to do more for his country, surely more than what Gen. Petraeus can do for the US.

Only two years are left before Yudhoyono ends his term in 2014. He is racing against time to achieve a lot — issues in Papua, corruption, religious freedom, minority rights and the acceleration of economic development, among other things.

History will show whether Yudhoyono is just a clever military general who tried his luck as a politician or he is truly a great military leader who succeeded as a civilian, democratically elected president like Gen. Eisenhower.

The writer currently, a PhD Fulbright Presidential Scholar at the GMU School of Public Policy, was an International Fellow at the US National Defense University, Washington DC in 2007.

Couple's counseling for the US and China

Yao Yang
PROJECT SYNDICATE/BEIJING

China has undoubtedly benefited from the world system created and supported by the United States. Indeed, Richard Nixon's journey to China in 1972 opened the door for China's return to the international community.

Most of the next two decades were a honeymoon for Sino-American relations. On the economic front, the US not only granted China most-favored-nation trade status, but also tolerated China's mercantilist approach to international trade and finance, notably its dual-track exchange-rate regime.

In the 1990's, bilateral economic ties continued to expand. American support for China's integration into the world system culminated with the country's accession to the World Trade Organization in 2001. Since then, China's exports have grown five-fold.

Of course, China's inadequate intellectual-property protection has damaged relations (a shortcoming that may be harming Chinese firms more than US firms by deterring American — and other advanced country — companies from deploying new technologies in China).

And the role of China's state-owned enterprises and official Chinese support for technological "national champions" (privileged companies that almost certainly use government money carelessly) has also hurt relations.

In fact, China's approach is akin to gambling against the odds. Successful hi-tech innovations are random events that follow the law of large numbers. When left to the market, many firms and individuals try to innovate, so the overall probability of success can increase dramatically.

The market allows the law of large numbers to work, whereas concentrated government support for a few favored firms undermines it.

But neither of these flaws, nor the exchange rate, is at the root of today's global imbalances. Consider the exchange rate. The United Kingdom maintained a current-account surplus for the century before World War I, and the US did the same for about 80 years before 1980. But neither country, apparently, did so by manipulating its exchange rate.

Moreover, the economies that managed to narrow their external gaps with the US substantially after World War II, notably Germany, Japan, South Korea, Singapore, and Taiwan, ran current-account surpluses throughout their rapid-growth periods.

> America's global hegemony has proven to be a curse as well as a blessing.

This contradicts American economists' conventional wisdom that fast-growing countries should borrow today against their larger future shares in the world economy.

One possible explanation is that the relationship between GDP growth rates and a country's current-account position is not linear.

Compared to countries with very slow growth rates, countries with reasonably high growth rates should borrow.

But when a country's growth rate continues to increase, its saving rate will increase faster than its investment rate, so it is more likely to run a current-account surplus.

For "catch-up" countries, like China, rapid growth is often accompanied by brisk structural change that moves factors of production, especially labor, from low-productivity activities to economic sectors with much higher productivity. This adds to the surplus by increasing firms' profitability.

China's exchange-rate policy is problematic not because it promotes exports, but because it has forced the country to accumulate a huge pile of wasteful foreign reserves.

The Chinese government's reluctance to allow faster exchange-rate appreciation may reflect its aversion to large, unforeseeable fluctuations, particularly given its determination to make the renminbi an international reserve currency.

While China's economy is hampered by structural difficulties, the US is not free of similar challenges.

Frankly, I am always struck by US economists' reluctance to discuss the structural problems that caused the current crisis, and that hinder America's recovery.

Most seem to believe that the crisis result from bad monetary policy and lax financial-sector regulation; some even blame the savings accumulated by Asian countries, especially China.

That may be true of the immediate causes of the crisis. But its eruption was far more deeply rooted in the American version of capitalism, which aims at high levels of competition, innovation, returns, and compensation. While this model has, of course, helped the US to become the world's leading economy, it has also delivered severe structural problems.

For example, to sustain high innovation, the US has maintained the most flexible labor market among mature economies. But this does not come without costs. Companies often lay off a whole department of scientists to shift to a new product, destroying not only human capital, but also human lives.

Moreover, flexible labor markets imply adversarial labor relations, particularly when compared to northern European countries. These countries are less innovative than is the US, but their economies and societies may be more resilient.

Meanwhile, the jewel of American capitalism, the financial sector, caused the crisis and is underpinning the US current-account deficit. Oil exporters aside, countries running current-account surpluses, such as China, Germany and Japan, have stronger manufacturing sectors relative to their financial sectors, while the relationship is reversed for countries running external deficits, such as the US and the United Kingdom.

Finally, America's global hegemony has proven to be a curse as well as a blessing. The US dollar accounts for 60 percent of world trade, and the US has the strongest military in the world, making it a safe haven for global investors.

But, while large capital inflows reduce borrowing costs, they also tend to cause current-account deficits: lower costs of capital boost asset prices, with the wealth effect then prompting people to consume more than they earn.

The policies adopted or discussed by American policymakers and scholars nowadays — quantitative easing, fiscal-stimulus packages, government-deficit reduction — seek to cure only the symptoms of a deeper malaise.

As a first step to recovery, the US must undertake serious financial-sector reforms. As Lenin pointed out, financial capitalism is the highest form of capitalism — that is, it is the end of capitalism.

Lenin may have gotten the underlying analysis wrong, but today we know that his conclusion may have been right for another reason: Financial capitalism forces a country into unsustainable indebtedness.

Unfortunately, America's financial reforms have been half-baked at best. For three decades, "reform" was a word reserved for the Chinese side of the Sino-American relationship. The US, one hopes, will grow to like the sound of it.

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