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EDITORIALS/OPINION

To Liberalize, Indonesia Has to Reform the State

By Hilton L. Root

MANILA — Indonesia's currency has plummeted, losing about 80 percent of its value against the U.S. dollar. Per capita income has fallen from $1,130 to $340, wiping out several decades of economic progress in just over six months. Exploding unemployment may result in serious social unrest, which threatens the prosperity of Indonesia's neighbors.

Peregrine Investment Holdings, an icon of the "Asian miracle," is already one of the casualties. It has sunk, weighed down by a large loan it extended to an Indonesian transport company with ambitious expansions plans. Like hundreds of international firms operating in Indonesia, Peregrine used connections to the top leadership to secure the deal. That security now appears to have been an illusion.

The family of President Suharto built an extensive business empire worth an estimated $40 billion by using political connections to gain special economic privileges. That empire is the prime target of a reform package sponsored by the IMF that includes fiscal austerity and a cleanup of the banking sector.

The package aims to open markets in Indonesia and end sweetheart deals for relatives and friends of those in power.

Yet the reform package ignores the fundamentally political nature of the meltdown. Economic liberalism may be what is needed to resurrect the economy, but for liberalism to work the Indonesian state must be reformed.

Indonesia is a weak state with a strong ruler. Mr. Suharto, a retired army general, has been in power for 32 years. He has created a highly personalized and centralized regime. As a result, the country has been unable to enforce property rights and even many of its own laws.

With its legal system and commercial codes unable to sustain modern transactions, investors depend on administrative or executive discretion. The result has been corruption and opportunism. The inability to enforce rules reduces private business activity unless some important agent of the state, such as the president's family or inner circle, intervenes.

Because of the state's inability to ensure functioning markets, the ruling family has gained vast leeway to extract value from proposed economic activity. The political muscle of the family and cronies is needed by would-be investors to enforce property rights, overcome regulatory uncertainty and ward off rampant bureaucratic malfeasance and graft in the civil administration.

The IMF reform package is designed to remove much of the government's power to bestow monopolies, but does not address the reasons why monopolies and other insider deals thrive in Indonesia. They flourish due to the absence of appropriate constitutional restrictions on state power. Ownership rights must be secured through connections to executive authority.

Indonesia's failed state is an extreme illustration of why competitive markets are not sustainable in much of Southeast Asia. In Malaysia, Thailand and the Philippines the accumulation of wealth and status has been through networks of kin and personal ties, rather than open competition and disclosure of information. None of these countries has been able to develop durable constitutional limits on government that ensure clear boundaries between the private and public sectors, and that protect the ownership rights of private investors.

Indonesia's fall shows the dangers of substituting continuity of leadership for institutional predictability. A liberal trading system needs consistent expectations about enforcement of contracts.

Consistency requires a range of institutions, rules, practices and norms which distinguish the system of public administration from the system of private economic ownership. Without institutions that separate political sovereignty from private ownership, liberalism will not surmount cronyism, and business confidence will fail.

The IMF's reform package for Indonesia is designed to overcome the shortage of foreign exchange and revive the currency. But it is the shortage of governance, not of capital, that has led Indonesia to ruin.

The writer, a senior research fellow at Stanford University's Hoover Institution and author of "Small Countries, Big Lessons: Governance and the Rise of East Asia," contributed this comment to the International Herald Tribune.