SUSTAINING GROWTH IN THE ASEAN COUNTRIES

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It is an honor indeed for me to address the Indonesian Economic Scholars' Association today, on my first visit to Indonesia. I am especially pleased to have the opportunity to exchange ideas with this Association, which exemplifies my firm conviction that economists should study policy issues and try to take part in policy formulation in the country in which they live -- and that the quality of policy, economics, and the economists will all benefit in the process.

While it has taken me too many years to reach Indonesia, I can share the IMF's pride in our long and close relationship with your country. You have many friends at the IMF, and I am sure our relationship will strengthen over the coming years during which Indonesia will realize its economic potential and play an increasingly important role in the world economy.

Indonesia, together with its fast growing neighbors, Malaysia and Thailand, today stands at the center of the most dynamic region in the world. Together these three countries account for about 5 percent of world population and a rapidly growing share of

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world output. Most impressively and importantly, each has seen sustained growth in living standards and consistently declining poverty over a long period.

If I were lecturing anywhere else in the world, I would devote a large part of my talk to the lessons of Asian success, the Asian miracle.[2] Speaking here today my topic is instead the closely related one of how to sustain the momentum of these extraordinary successes. I will start by briefly reviewing the record of achievements in these countries, and the policies that have been responsible for them. I will then turn to the economic challenges that lie ahead, and policy responses to meet them. Finally, I will examine institutional changes that could strengthen the policy framework.

I. The Record

The economies of Indonesia, Malaysia and Thailand have been totally transformed over the past quarter century. Painting with a very broad brush, three key achievements stand out:

- First, the average per capita growth rate has been narrowly clustered around 5 percent. By historical, or for that matter contemporary, standards, this is a remarkable achievement. It is two to three times the current growth rate of per capita income in industrial countries, and more than double the rate in other developing countries in Latin America (See Table 1). With per capita growth at 5 percent, income per head doubles every 14 years -- which implies that per capita incomes in ASEAN have almost quadrupled in the past quarter century.

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[2] See for instance, World Bank (1993), Amsden (1989), Easterly (1995), Kim and Lau (1994), Krugman (1994), Rodrik (1994), Sarel (1995), Wade (1989), and Young (1994a and 1994b).

Table 1. Real GDP Growth
(Period averages)

	1971–80	1981–90	1991–95	1971–95	Per Capita Growth	
Indonesia	7.8	5.4	7.8	6.9	4.8	(1971–95)
Malaysia	8.0	6.0	8.7	7.4	4.6	(1971–95)
Thailand	6.9	7.9	8.4	7.6	5.5	(1971–95)
Developing Countries	5.7	4.4	6.0	5.3	2.8	(1973–95)
Asia	5.7	7.1	8.4	6.8	5.1	(1973–95)
Africa	3.8	2.4	1.7	2.9	0.1	(1971–95)
Middle East And Europe	6.1	2.7	3.5	4.2	0.8	(1971–95)
Western Hemisphere	6.2	1.7	3.0	3.8	1.5	(1971–95)
Countries In Transition	5.1	2.2	−9.0	1.1	−0.3	(1975–95)
Industrial Countries	3.2	2.9	1.7	2.8	2.0	(1971–95)
World	4.1	3.4	2.7	3.5	2.0	(1975–95)

Source: IMF, World Economic Outlook.

- Rapid growth has been accompanied by dramatic reductions in poverty (See Table 2). The region's strong emphasis on education and other growth-sharing policies has certainly contributed to this result. Despite this important progress in reducing poverty, it remains true that there is much to be done to improve the distribution of income.
- Third, each of the three countries has pursued policies that encourage exports and integration into the world economy. As the region has grown, the momentum of growth has increasingly been generated within East Asia, by rapidly growing domestic demand and by intra-regional trade, especially in manufactured goods (See Table 3). The record of consistent growth in the 1990s is testimony to the region's resilience to cyclical movements in industrial countries.

II. Contributory Policies

There has been no shortage of academic research seeking to explain the rapid growth of GDP in this region.[3] Some lay stress on initial conditions, especially broad-based primary education, relatively low population growth rates, and the pattern of land ownership, some of that a result of land reform. Others stress natural endowments such as oil. Of course, both Indonesia and Malaysia are important energy producers -- but possession of natural resources has often been a curse rather than a blessing.

As the case of energy makes clear, while natural endowments can help, it is policies that lie at the heart of East Asian growth. Indonesia's experience has helped researchers focus on policies that have been able to deliver the high quality growth the region has experienced. Five sets of policies deserve emphasis:

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[3] See the references in footnote 2.

Table 2. Incidence of Absolute Poverty

	Percentage of Population Below the Poverty Line 1/		
	1970	1980	1990
Indonesia	60	29	15
Malaysia	18	9	2
Thailand	26	17	16

Source: Johansen, Frida (1993) "Poverty Reduction in East Asia: The Silent Revolution", World Bank Discussion Paper No. 203.

1/ The poverty line allows for 2,150 calories per day per person, with 90 percent of the calories derived from grains, the lowest-cost source of calories in East Asia.

Table 3. Export Shares of Asia and Other Developing Countries
(Percent of total exports)

	Exports to Developing Countries										Exports to	
	Asia		Africa		Middle East and Europe		Western Hemisphere		Total 1/ Developing Countries		Total 1/ Industrial Countries	
	1985	1995	1985	1995	1985	1995	1985	1995	1985	1995	1985	1995
Exports from												
Developing Asia	**27.6**	**39.7**	**1.7**	**1.3**	**4.8**	**2.5**	**1.7**	**2.3**	**38.7**	**47.5**	**59.9**	**51.3**
Other Developing Countries	7.7	12.4	2.7	3.1	3.9	2.9	7.1	10.2	26.1	30.7	67.4	62.9
Africa	3.3	8.4	4.9	9.5	1.1	1.9	3.4	2.3	16.1	23.7	71.4	64.5
Middle East and Europe	13.4	23.3	1.8	2.1	6.5	5.7	4.3	2.2	32.6	37.0	60.8	52.9
Western Hemisphere	4.3	6.3	2.4	1.1	2.9	1.3	12.6	19.5	25.6	29.4	72.1	69.4
Industrial Countries	9.2	14.8	3.1	2.1	5.4	2.9	4.5	5.1	26.1	28.9	72.7	70.5

Source: IMF, Direction of Trade Statistics.

1/ Exports shares of each region to all developing and industrial countries do not add to 100 percent because trade with the countries in transition is excluded and because of some underreporting of trade.

- First, countries in this region have maintained macroeconomic stability, which is crucial to the achievement of the virtuous circle of high saving, high investment, and rapid growth that the region has enjoyed. The attainment of macroeconomic stability can be summarized by the ability of a country to maintain a consistently low rate of inflation;[4] it also requires a willingness to take quick corrective action when the budget or the balance of payments shows signs of worsening.[5] Monetary policy, including exchange rate policy, and fiscal policy interact to determine macroeconomic performance. It is sometimes said that the letters "IMF" stand for "It's Mostly Fiscal" -- but despite the joke, fiscal policy does indeed play a special role.[6] A country with an excessive budget deficit cannot maintain low inflation, however good the monetary policy -- indeed as shown in a famous article by Sargent and Wallace (1981), low inflation now may mean higher inflation later. In Indonesia, for example, the balanced budget rule has contributed to fiscal sobriety, which in turn has encouraged monetary virtue. The central importance of fiscal policy is emphasized in the May 1996 issue of the IMF's World Economic Outlook.
- Second, the overall economic strategy pursued in these three countries has been market-friendly[7] and outward-oriented. The growth process needs to

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[4] See for instance Fischer (1993), Barro (1995) and Sarel (1996).

[5] See Dornbusch and Fischer (1993).

[6] For a view of this point written in the World Bank, see Easterly and Fischer (1991).

[7] This term summarizes the development strategy laid out in detail in the 1991 World Development Report.

be supported by the steady unfolding of supportive structural policies, starting from policies that encourage exports and liberalize trade, and that then gradually but surely liberalize the entire economy, in goods, labor, and financial markets. Much empirical work[8] supports the contribution such a strategy can make -- and, in Indonesia's case, did make -- to the productivity improvements that lie at the root of the growth process.

- Third, policies have encouraged investment in physical capital. Investment levels in the fast growing Asian economies have generally been very high, with Hong Kong the much-noted exception. The great bulk of this investment has been financed by domestic saving, which therefore plays a crucial role in the growth process. Macroeconomic stability underpinned by fiscal balance, and financial policies that avoid negative real interest rates, together with the right structural policies, go a long way towards promoting private saving and investment. Pension schemes that promote or require private saving have also played an important role in several countries in this region.
- The ASEAN countries have invested in human capital, especially initially in universal primary education that ensures broad-based literacy, for both boys and girls. In this area too there is a powerful virtuous circle of education spending, productivity, and growth that promotes higher levels of educational attainment.
- Fifth, in addition, most countries in this region have pursued targeted anti-poverty programs that helped spread the benefits of growth; these programs

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[8] See for instance Barro and Sala-i-Martin (1995), Fischer (1993) and Lee (1993), as well as the World Development Report for 1991.

are desirable not only in their own right, but also because they help ensure the political sustainability of the reform process.

Before leaving this subject, let me draw one more lesson: policies have to be flexible, and responsive to internal and external economic shocks. Indonesia has a good record in this area. After the stabilization of the Indonesian economy in the 1970s, the country took action whenever there were signs of macroeconomic difficulties. More recently, a number of adverse shocks have, periodically, threatened macroeconomic stability or the pursuit of growth enhancing policies. Thus, in recent years, both Indonesia and Malaysia have had to contend with declining revenues from the energy sector, and are doing so. Bouts of domestic overheating, such as in the late 1980s, when private sector demand was expanding too rapidly, have led to policy tightening. In facing these and other challenges, policy responses in the region have been commendably quick, thereby minimizing the output costs of adjustment. Generally, expenditure-reducing policies -- restraint over public investment demand and private credit -- have been balanced with competitive exchange rates to maintain the basic, outward-oriented development strategy.

III. Challenges

The economic challenge facing the countries in this region is to maintain and build on the successes of the past quarter century. It remains essential to maintain macroeconomic stability, pursue a market-friendly economic strategy, maintain and promote investment in physical and human capital, and continue the successful fight against poverty. But as global integration proceeds apace, there are more specific challenges, including strains on the macroeconomic framework.

These strains are not surprising after the recent years of rapid growth. Specifically, in the last year:

- Inflation rates have risen, in Indonesia to almost twice the Repelita VI target of 5 percent per annum, and in Thailand also to a level (some 7 percent) that is high by domestic standards.
- External current account deficits have also widened. The current account deficits in both Indonesia, now at over 3 percent of GDP, and Malaysia, now over 8 percent of GDP, virtually doubled between 1993 and 1995. The external deficit in Thailand last year, 8 percent of GDP, was also well above the average of the previous three years.

These developments need to be assessed against some key lessons learnt both your own experience and from other parts of the world. Thus:

- Inflation is bad for growth. It has long been known that this is true at high inflation rates, say above 40 percent. More recently, economists have examined the relationship between inflation and growth at low inflation rates.[9] It is clear that inflation is negatively correlated with growth even when inflation is as low as 8 percent per annum. Barro (1995) and Sarel (1996) claim that there is no clear relationship at lower rates of inflation; in my own work I have found the negative relationship to continue at even lower -- but positive -- inflation rates. Whatever the precise relationship at low inflation rates, a country with inflation rising to 10 percent is courting danger: getting rid of double digit inflation is difficult, partly because inflation in that range is high enough to become entrenched in expectations and in economic institutions. Any country that can, should steer well clear

[9] See for instance Barro (1995), Fischer (1993) and Sarel (1996).

of double digit inflation, preferably by keeping it at a much lower level, and by promptly tightening policy if it shows signs of rising.

- While current account deficits may be -- and clearly have been in this region -- an entirely appropriate way to tap foreign saving, to finance investment, and maintain high growth, their recent widening in the region requires closer scrutiny. There is no simple numerical guide to the size of current account deficit that is advisable: that judgment has to be made on the basis of each country's economic structure and vulnerability to internal and external shocks, balancing the many benefits of capital inflows against the greater vulnerability to shocks that they may imply. One indicator of sustainability is whether the deficit is financing consumption or investment. There is some evidence that consumption and property-related spending -- in addition to investment -- may be important elements in the higher current account deficits in the region. The economy of a country with a large deficit is always more vulnerable to external shocks, or a moderation of growth, all the more so if the deficit is financing a consumption boom rather than investments that strengthen the supply side of the economy. The risks of any given current account deficit are clearly reduced the stronger the underlying economic fundamentals -- such as the fiscal position, domestic saving, and export growth -- and the more they are financed by long-term flows, especially foreign domestic investment.
- Open economies, such as those in your region, have to pay increasing attention to capital inflows and to market sentiment. Given the mobility of capital flows, and their speedy response to concerns about sustainability, there is a clear premium on not delaying policy adjustments.

- The massive volume of resources intermediated by domestic financial systems, especially in the context of the surge in capital flows, has naturally added strain to these systems. By potentially increasing vulnerability to shocks, these strains also bear on current account sustainability. They might also raise the costs of adjustment were they to constrain macroeconomic policy, especially monetary policy.

The immediate challenge is three-pronged. I have already discussed the first challenge: to continue the policies that have produced the high quality growth of the past quarter century. In the remainder of my lecture, I will concentrate on: the second challenge, to address the pressures that have contributed to the present overheating; and the third, to establish institutional structures to sustain a stable macroeconomic framework.

IV. Policy Responses

As in the past, there have been some commendably quick policy responses. Initially these were designed to deal with the continuing surge in capital flows and reduce their impact on money and credit growth. The following are some of the main elements of the policy response in recent years:

- The first line of defense was intervention in the foreign exchange markets. Reserves were accumulated and -- at least initially -- there was some success in sterilizing their impact on liquidity. This meant that domestic money growth was insulated from the capital inflows.
- While fiscal policy was tightened in a number of countries, it was generally not used as an instrument of countercyclical demand management. This reflected the longer run setting of fiscal policy, commendably aimed at broad balance with the support, in some cases, of balanced budget rules.

- In most cases, countries took the opportunity of the pressure of inflows to advance the liberalization of current and capital account transactions. This helped offset the inflows, thereby deflecting pressure from domestic monetary aggregates, while achieving higher overall efficiency. Where short- term inflows have been large, some countries have introduced direct measures to deter capital inflows. These measures have been motivated by prudential concerns as well as the broader macroeconomic perspective.
- Steps are also being taken to maintain sound domestic financial systems. This is clearly essential to minimize potential fiscal costs from weak portfolios. Thus, capital adequacy ratios have been reviewed, provisioning increased, and limits tightened on banks' net open foreign exchange positions.

While these measures have been phased in over time, taken as a whole they constitute a comprehensive response to the overheating problem. They have helped contain the problem but, judging by its persistence, they have not fully resolved it. There are a number of reasons that the inflows persist:

- Economic growth has remained very strong and margins of excess capacity that existed earlier may now have been fully absorbed. We see this in the capacity constraints being encountered in a number of areas, such as infrastructure and skilled labor. While potential output is difficult to measure, actual output must now be pushing against that constraint.
- The increasing flows of capital from the developed to emerging capital markets, one of the most visible signs of the globalization of the world economy that proceeds apace, as well as the increasing openness of regional economies, have meant both opportunity and challenge. The inflows

represent an opportunity because their availability has permitted high investment and growth to be sustained. The inflows represent a challenge, because they have complicated macroeconomic management and strained domestic financial systems. To be sure, this region has experienced less volatility, and a better mix of capital flows -- and here I refer to the predominance of direct and equity investments -- than other emerging markets. This is in large part because of its strong record of macroeconomic management. Nevertheless, the region has not escaped the macroeconomic dilemmas created by powerful capital flows.

- The capital inflows problem severely complicates monetary policy. With an open capital account, a country cannot both fix its exchange rate and set domestic interest rates independent of world levels. The problem is most marked when a country with a fixed exchange rate is running a tight monetary policy to fight inflation. Tight money raises interest rates and attract capital inflows. These have either to be accommodated, tending to offset tight money, or to be sterilized. The larger the difference between domestic and foreign interest rates -- and a difference is inherent in this situation -- the more expensive is sterilization. Tight money becomes more expensive and less effective over time. If the authorities have to accommodate the capital inflows, by monetizing them, then they threaten future inflation, offsetting the effects of tight money.
- The capital inflows problem has affected countries all over the world, most powerfully when low interest rates in the major financial centers made investment in emerging markets more attractive. The obvious response is to

allow the exchange rate to appreciate. But this may be problematic if the current account is a concern.

- Under certain circumstances, the exchange rate is the best nominal anchor for monetary policy. This is particularly the case for countries stabilizing from high inflation, when a money growth anchor is less useful because there is substantial uncertainty about the demand for money as the economy settles down to lower inflation. Many countries also use the exchange rate as an anchor, a guide to monetary policy, and a constraint on fiscal policy, and to guide expectations, at lower inflation rates. But the implied loss of exchange rate flexibility may under certain circumstances complicate the task of monetary policy.
- Policymakers may be able to influence the rate or type of capital inflows directly. Since the greatest threat of instability is posed by short-term inflows, policymakers in many countries have attempted to attract longer-term inflows, such as foreign direct investment, and to discourage short-term inflows. The most important incentives to attract foreign direct investment are the same as those that encourage domestic investment, a stable, business-friendly investment climate and expanding domestic and foreign markets. Many countries also provide special tax incentives for foreign direct investment. Direct quantitative controls on inflows rarely work for any sustained period. Market-based policy measures to deal with inflows, such as imposing taxes on short-term foreign borrowing, may be effective in reducing the pressure of inflows for a while. But their effectiveness is typically eroded over time as ways are found around the taxes and regulations.

- In countries with controls on outward capital movements, policymakers may also be able to reduce the pressure of capital inflows by taking the opportunity to gradually liberalize foreign exchange regulations.[10]

V. Strengthening Domestic Policy Responses

While there is no easy solution to the capital inflows problem in the face of potential overheating, there are ways of mitigating the problem. The response in any particular situation depends on the country-specific context. But there are two general directions in which policy can be strengthened, first by adapting the macroeconomic policy mix to better deliver the necessary demand restraint, and second --and this issue may be particularly relevant to Indonesia -- by improving the institutional setting for policy.

Macroeconomic Policy Mix

The first question to consider in assessing the macroeconomic situation is whether the current account deficit is sustainable. This evaluation depends first on the size of the inflow relative to the economy, but also on the current and expected growth rates of the economy, on the current and prospective real interest rates, on the nature of the inflows (short- versus long-term), and on whether the inflow appears to be financing investment or consumption.

To the extent that a lower current account deficit is desired, it is necessary to increase saving relative to investment. The surest way for policy to affect national saving in the short and medium term is through fiscal policy, reducing the government budget

[10] However, the lifting of controls on outflows has sometimes led to an increase in inflows.

deficit to increase public sector saving.[11] While theory points to the possibility that private saving will decline to offset the increase in public saving, the so-called Ricardian equivalence issue, evidence suggests that offsetting behavior by the private sector has been relatively limited in the ASEAN region.[12] The improvement in the fiscal position could be achieved either through a larger surplus in the Central Government position or through tighter control over the operations of public enterprises.

The advice to tighten fiscal policy in the face of capital inflows of course creates a problem for governments under pressure, perhaps for good reasons, to spend more on physical infrastructure and human resource development. The good reasons are that maintenance of rapid growth requires large-scale investments in infrastructure, and that both rapid growth and equity demand an emphasis on health and education spending. In seeking to strike a balance between valid spending needs and the demands of macroeconomic stability, many countries are looking for ways to tap private finance for infrastructure development. Greater reliance can also be placed on more economic (or market-based) pricing of infrastructure services, which could support broader social and environmental goals at the same time as it helps the fiscal position.

The fiscal situation can be further strengthened through both expenditure reform and a greater tax effort. In Indonesia, for example, there may be scope to raise the non-oil tax ratio. More generally, there is potential in several countries for increasing reliance on a broad-based consumption tax.

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[11] Of course, public policies to increase private sector saving, for example through reforms of the pension and social security systems, are also critical in many countries, but are less likely to have an impact on saving in the short run.

[12] See for instance Faruqee and Husain (1995).

The tightening of fiscal policy tends to reduce interest rates and the current account deficit, and is thus the right solution to the capital inflows problem. The tightening of monetary policy by contrast has conflicting effects. By reducing aggregate demand tighter monetary policy tends to reduce inflation and improve the current account. But by raising domestic interest rates, monetary policy tends to strengthen capital flows and worsen the current account. The more sensitive are capital flows to interest rate differentials, the more likely is a tighter monetary policy to lead to a real exchange rate appreciation and a worsening of the current account.

Monetary policy can be used to deal with the domestic inflationary aspects of overheating provided the current account is not an immediate concern. Indeed, if inflation is the problem, and the current account is strong, and if the exchange rate is flexible, monetary tightening will be especially effective, since the resultant appreciation of the currency will produce an immediate impact on domestic prices.

However, when the current account deficit is a concern, monetary policy is best used in conjunction with fiscal policy, with both policies working in the same direction to reduce aggregate demand and thus inflationary pressures, and their offsetting effects leaving the exchange rate approximately unchanged.

Institutional Setting

In recent years, governments of countries at all stages of development have begun to think more consciously about the institutional setting in which policy decisions are made. Governments in several countries have strengthened central bank independence and formalized the setting of monetary policy goals and procedures; similar changes are being considered for fiscal policy, for instance through balanced budget laws and in the proposed Stability Pact for countries that will enter the European Monetary Union. This trend is backed up by academic research that emphasizes the beneficial impact on private sector

expectations of the government's being able to commit itself to follow consistent policies.[13] I will take up in turn, and briefly, monetary, exchange rate, and fiscal policy arrangements.

In the monetary policy area, there is growing recognition of the benefits of an independent central bank, charged with a clear mandate. In most recently introduced legislation, the central bank is given the primary mandate of protecting the value of the currency, that is, of maintaining low inflation. It may also be given the goals of maintaining full employment and promoting economic growth, to the extent that these goals do not conflict with those of maintaining the value of the currency.[14]

As to monetary policy procedures, some such as the Bundesbank and the Swiss National Bank, which have strong reputations do not declare a formal inflation target, and announce money targets, but it is generally understood and believed that these banks will try to maintain inflation at around 2 percent or less. Central banks which have converted to the anti-inflation cause more recently, such as the Reserve Bank of New Zealand, the Bank of Canada, the Bank of England, and the Bank of Sweden, have adopted formal inflation targets and procedures to reach them. The targets are typically in the range of zero to three percent per annum. The formal commitment to a numerical inflation target enhances accountability and helps ensure that the target is taken seriously. So far, inflation targeting has worked well.

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[13] This work is associated with the notion of dynamic inconsistency of policies, which results in policies that are very short-sighted as a result of the government's inability to commit itself to follow consistent policies over long periods. See Fischer (1990) for an exposition in the context of monetary policy.

[14] This is the language of the mandate of the new European Central Bank. For a fuller discussion, see Fischer (1996).

Countries in this region may wish to consider how recent approaches in other parts of the world could best be adapted for their own use. While the region already has a solid record in inflation control, I believe that central bank independence and explicit inflation targeting have many advantages -- in terms not only of short-run macroeconomic performance, but also of ensuring macroeconomic stability over the medium and long-term.

Monetary policy cannot be successful in the face of fiscal indiscipline. Thus a strengthening of the government's commitment to achieving fiscal balance, and sometimes when necessary surpluses, would help both monetary policy and the credibility of the overall policy framework. The broader the consensus behind the framework, the stronger its impact will be. The credibility of the framework would be enhanced by the dissemination of data that will allow markets to monitor progress.

The choice of exchange rate regime is another critical feature of the macroeconomic policy framework. A country that declares a peg to a basket of low inflation currencies is in effect committing to attain approximately their inflation rate.[15] As already noted, a peg may be especially effective for a formerly high- or moderate-inflation country seeking to reduce inflation rapidly. Once a country has achieved low inflation, and provided it can keep fiscal discipline without the constraint of the fixed exchange rate system, it can move to a system that permits more exchange rate flexibility. Whether it should do so depends on the country's inflationary history, on the effectiveness of alternative mechanisms -- such as inflation targeting -- to help maintain responsible policies, and on the extent to which exchange rate flexibility would be needed to adjust to shocks that the country may face in the future. In this area, more even than in others, arrangements have

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[15] This statement is true for traded goods prices, but there may be significant divergences between domestic and foreign inflation even under a currency peg, for a country in which productivity is growing fast.

to be tailored to fit the country's specific circumstances. Even if it is decided to choose a flexible rate regime, governments should not give the markets the impression that the level of the exchange rate is of no concern.

Finally, in discussing the institutional setting for macroeconomic policy, wherever elements of inflation inertia may have crept in (through, for example, the effective targeting of past inflation levels in wage determination, or the use of a real exchange rate rule) these would need to be dealt with. In the case of wage determination, this argues for strengthening the commitment to decentralized wage setting. Delays in establishing low inflation will help build in inertial elements, and thereby increase the ultimate cost of disinflation.

VI. Concluding Remarks

I have sought to convey three main messages about macroeconomic policy. First, macroeconomic stability matters. By macroeconomic stability I mean preventing overheating and maintaining low inflation. Macroeconomic stability matters because inflation and stop-go policies are bad for growth, It matters also for sustaining the region's record of equitable growth, because inflation not only tends to retard growth, but also has a direct and heavy incidence on the poor.

Second, watch the current account and its sustainability. Large current account deficits are a cause for concern and analysis. Rapidly growing countries with a sound macroeconomic situation can and have sustained current account deficits around 8 percent for sustained periods. Countries in this region have done so successfully. But the greater the dependence on foreign capital inflows, the more vulnerable the macroeconomy is to shocks, including changes in foreign interest rates and changes in sentiment. Capital inflows have many advantages, especially long-term capital inflows, especially foreign

direct investment, and they should be encouraged. But short-term inflows may complicate the tasks of monetary policy, especially in the presence of a sizable current account deficit. There is no easy way out of the capital inflows problem, but it is certainly easier to deal with if fiscal policy can be tightened.

Third, the institutional setting of macroeconomic policy matters. Central bank independence, a clear goal of maintaining low inflation, and an explicit and credible commitment to sound fiscal policy can go a long way in ensuring sound macroeconomic policy, and thereby go a long way to assuring the private sector of the stability of the framework in which they will be working and investing.

There is a fourth message. Macroeconomic stability is not all that matters for growth. Investment in physical and human capital, technical progress, structural policies to liberalize trade, policies to improve the financial system, to promote saving, to enhance competition, to ensure that the benefits of growth are widely shared, are the most important determinants of growth. Macroeconomic stability matters because, once it is assured, policymakers can focus their efforts on the most important growth- and equity-promoting policies.

The economic achievements of the countries in this region over the past quarter century are unparalleled in history. There can be little doubt that the region's role in the world economy will continue to grow at an extraordinary rate. Maintenance of macroeconomic stability is essential if that is to happen -- and it will.

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