

Precautionary Principle Approach In Time Of Financial System Crisis

Kukuh Komandoko¹

¹University of Indonesia, Jakarta-Indonesia

E-mail: Kukuh.komandoko@gmail.com

Abstract--*The precautionary principle has the potential and essential role concerning specific fields to be applied more broadly and understood as an alternative approach in making decisions in the face of dangerous and uncertain threats. Thus, it is possible to use the precautionary principle approach in the financial system crisis prevention and or management framework. This article will discuss the precautionary principle and its possibility to use in the financial system crisis prevention and management framework. The discussion was carried out against the background of Indonesia's monetary and banking crisis in 1997-1998. The crisis has provided experience as well as empirical knowledge that is useful for Indonesia to build a system of prevention and handling of financial and banking crises. Included in this case is the research on the precautionary principle in crisis prevention and handling to be important. The main point is the possibility of applying the precautionary principle as an approach to overcoming the legal gap that occurs when there are legal issues.*

Keywords- *Banking Crisis; Financial Crisis; Legal Gaps; Precautionary Principle.*

I. INTRODUCTION

The banking crisis that hit Indonesia in 1997-1998 was the worst crisis ever experienced by Indonesia. The banking crisis of 1997-1998 was preceded by a fall in the value of the Thai baht currency and the Thai government's failure to maintain the bath's value. In a relatively short time, the fall in the bath value spread and was followed by the fall in several Asian countries' currencies, such as Malaysia, Indonesia, the Philippines, Korea, and Hong Kong, triggering economic chaos in Asia. After the Thai currency fall in July 1997, respectively, Malaysia, Indonesia, Singapore, the Philippines, and Korea experienced asset deflation of 40% to 70% [1] and currency depreciation of 18% to 85%. From several countries in Southeast Asia, Indonesia experienced asset deflation of 40% to 70%, and the Rupiah depreciated by 83.6%. The exchange rate to the US dollar experienced a free fall, from Rp. 2,432.00 in July 1997, to Rp. 14,800.00 in January 1998. [2]

Simultaneously, with the fall in the Rupiah's value, economic and financial conditions worsened and spread to the banking sector. The financial crisis was unstoppable and turned into a banking crisis!

On September 3, 1997, the government issued an economic policy package covering the monetary and fiscal sectors and the real sector. The policy package takes the form of trade liberalization and rescheduling government projects. The government is trying to solve bank liquidity problems in the banking sector, encourage bank mergers, and close down troubled banks and protective measures for customers. However, these actions did not produce results and were still unable to stabilize the Rupiah's value. In October 1997, it was recorded that the Rupiah had depreciated by up to 40%. [3] Likewise, in the banking sector, the number of banks experiencing liquidity difficulties increased, and some banks even started to have negative balances with Bank Indonesia.

Facing these conditions, the government approached the IMF, and on November 1, 1997, signed a Letter of Intent (LoI) with the IMF. In principle, the LoI November 1997 covers macroeconomic policies, financial sector restructuring, structural reforms, program supervision, and data transparency issues. [4] After signing the LoI with the IMF and immediately restructuring the troubled financial institutions, the government is more confident. As a follow-up, the government closed 16 troubled banks, which further undermined customers' and investors' trust. Public trust in banking fell drastically; customers rushed their funds and made banking conditions in Indonesia worse. As a result, the financial crisis was unstoppable and impacted the economic sector and developed into a banking crisis.

The closure of 16 banks was not supported by an adequate legal framework, resulting in legal gaps in the process. Legal gaps that occur are not handled

carefully and failed to mitigate the risk. The idea to overcome legal gaps in crisis prevention or management is to use the precautionary principle approach. Many jurists agree that the precautionary principle's essence intends to act with caution before there is severe or irreversible damage, even if there is uncertainty about the threat of harm that will occur, or if it will be done at all. [5]

The precautionary principle, a translation of the *Vorsorgeprinzip* phrase, was echoed around 1970 in Germany and then used in German Environmental Protection in 1974. However, Frank B. Cross, a Professor of Business Regulation from the University of Texas, argues that the phrase precautionary principle is used for the first time in 1965 on the German Administrators Committee. [6]

Since it was first echoed in the 1970s, various versions of the *Vorsorgeprinzip* or precautionary principle were discussed in international conventions or conferences. The phrase precautionary principle was first recognized in the World Charter for Nature, which was later in 1982 adopted by the UN General Assembly. The Vienna Convention for the Protection of the Ozone Layer included this principle in international treaties in 1985 and following in 1987 by the Montreal Protocol on Substances that Deplete the Ozone Layer. In 1990, the Bergen European Ministerial Declaration linked the precautionary principle with sustainable development policy and set out actions to anticipate, prevent, and address the causes of environmental degradation. [7]

The practice of the precautionary principle in Europe is also increasingly widespread, not only in environmental protection. The precautionary principle as a basis for consideration in international agreements and declarations in sustainable development, environmental safety, health, trade, and food security. In a sustainable economic growth, the precautionary principle is seen as an integral principle of ethics about justice and between generations. The precautionary principle is a principle that can meet the needs of the present without having to sacrifice future generations to meet their needs, maintaining natural resources from severe or permanent damage, and can endanger future generations to meet their own needs. [8]

Judging from its history, the precautionary principle was born because of the need for an approach to decision-making to protect human health from epidemics of disease and environmental

damage, primarily dealing with risks and uncertain situations. Health problems and environmental damage, which are increasingly complex compared to science and legal policies' ability to identify and deal with hazards, have driven the precautionary principle's development. In other words, the complexity of the problem, the uncertainty, and the potential for disaster are the most substantial driving factors for developing and implementing the precautionary principle. The term precautionary principle is commonly used in its development and application. It provides a more comprehensive framework, connecting various disciplines such as environmental science, cognitive science, and public health. [9]

This article will examine the precautionary principle, which has the potential to fulfill an essential role concerning a particular field in which it is applied and more broadly. Thus, it is possible to use the precautionary principle approach to prevent and or resolve financial system crises. The study on applying the precautionary principle in preventing and managing crises that can endanger the national economy is essential. The study will be conducted on handling the 1997-1998 banking crisis, mainly on applying the precautionary principle during the crisis period.

II. PROBLEMS

Related to research on applying the precautionary principle in preventing and managing Indonesia's financial crisis, several problems can be formulated to be examined. First, has the precautionary principle been involved in a broader field other than environmental and health law? And Second, was the precautionary principle been used in the 1997-1998 banking crisis in Indonesia?

III. RESEARCH METHOD

The research is emphasized on the principle of law. Normative legal research examines the principle of law as a system related to a specific legal occurrence. The research approach is the legislative approach, relating to legal issues with the occurrence. The sources of the research consist of primary legal materials and secondary legal material. The data collection is through a literature study by referring to the origins of primary and secondary legal materials

and non-legal materials.

IV. DISCUSSION

The author emphasizes using the term precautionary as a precautionary principle, which will be discussed in this article to distinguish from the word prudent, which is the principle of prudence in bank development and supervision in banking law. The precautionary principle is a principle that has its place in the legal system. In general, the precautionary principle is understood as an approach in making decisions to face dangerous and uncertain situations, especially in the environmental field. [10] The precautionary principle was applied for the first time in a German Environmental Protection Program in 1971, using *vorsorgeprinzip*. *Vorsorgeprinzip* was again adopted in a series of laws regulating or relating to the environment. Germany's precautionary principle is then applied in other European countries' legal systems and was used to the environment and is widely associated with food safety and public health issues.[11]

Since the 1992 Rio Declaration, efforts to define the precautionary principle have continued. There are various understandings of the precautionary principle that appear in international conventions, declarations, and documents. The many different definitions make it difficult to determine the exact parameters regarding the precautionary principle. [12] Likewise, with references to damage or danger or threats from other precautionary principles, it adds to the difficulty of making a standard definition. Such as the precautionary principle formulation concerning damage or harmful effects. There is a precautionary principle in other texts that focuses on serious damage, and some refer to severe and irreversible damage. There are even references that focus on global destruction. Also, there are precautionary principle concerning cost-effective measures or even have other considerations for costs.[13]

Nevertheless, in terms of the normative challenge, the precautionary principle is defined as the obligation to have scientific judgment by considering logical reasons as a normative qualification to link the quality of available information with possible adverse effects. The possible side effects and scientific uncertainty are considered the trigger factors for the precautionary principle. This understanding uses a cost-benefit analysis, with the

highest priority being human health and the environment. Since the understanding is only a temporary measure, a more comprehensive risk assessment shall be carried out when further scientific information is obtained. Such provisional measures must also be taken immediately without waiting for the severe impact of the dangers.[14]

From a decision-making perspective, the precautionary principle is the basis for making decisions on environmental policies and other fields, such as trade. In this regard, the regulatory measures must be taken immediately, even when the threat of harm is uncertain, and even when it is highly speculative. Applying this principle, in whatever form and scope, can significantly influence the strategies and policies that are the result of decision making, primarily to assist decision making in difficult situations. However, although it helps in the decision-making process under challenging conditions, it is possible that the results of decisions can raise doubts about many regulations, and the most common thing is that the precautionary principle is often paralyzing. This can make the precautionary principle an obstacle to rule and non-regulation, and everything in between.[15] The precautionary principle should not become an obstacle to decision-making. The precautionary principle must be characterized in terms of what forces the decision-maker to do and what drives us to believe.[16]

Apart from the notion of the precautionary principle outlined above, expanding the precautionary principle concept to become universal, which recognizes the relationship between society and land, elevates community welfare, culture, and the economy as values that are as important as environmental issues. In this notion, system, governance, diversity, and resilience are guidelines for implementing the Universal precautionary principle on legal, policy, management, and community platforms.[17] The concept is interdisciplinary and can be used not only for health and environmental protection but includes development, economy, education, technology, social justice, and security.

The idea of the Universal Precautionary Principle arose because of needs. Apart from that, it is also considered to have gone out of purpose by excluding society, culture, and economy. Although the Universal Precautionary Principle idea has not been

proven to apply, this idea can be realized in theory. Of course, the application of the Universal Precautionary Principle in practice depends on the context and interests of policymakers or lawmakers. As it has been realized, the law does not necessarily provide an answer for every incident. If it turns out that the existing law is not supportive and the general legal principles available are also inadequate, this will impact the decisions that will be made. However, decisions and solutions must be found using complementary approaches.

When the law has no answer to an event, the gap can be filled using general principles or principles in direction. The use of general principles is essential, and it is hoped that its role can help fill legal gaps and improve legal rules. The fundamental reason is the same as what judges do when handling cases where the legal text does not provide precise rules. Judges with professional considerations can use other legal sources, namely, general principles in law.[18]

An Economic-banking crisis is a phenomenon that often occurs, and in hard cases, crises create unreasonable panic [19] and even can turn a country into ruin. [20] Financial instability, systemic risk, economic instability, or high risk of the financial crisis are understood as a fall down of the financial system, the inability to provide payment services or allocate credit for productive investment opportunities. [21] In general, financial instability will have a significant impact on economic activity. Threats of danger or risks systemic in nature tend to be related to financial institutions' solvency problems, liquidity issues, and market infrastructure.

Apart from the issues related to the economy as described above, during 1997-1998, Indonesia did not yet have a set of regulations and legal frameworks for dealing with crises. When facing a financial-banking crisis, the main problem faced by a country is that the existing legal rules cannot handle the crisis in question. This could be due to unfulfilled emergency factors that may occur for theoretical and methodological reasons. This condition creates legal gaps or gaps in the rule of law in handling the crisis that ensued.

In the 1997-1998 banking crisis, Indonesia faced legal gaps related to the following: (1) Bank Indonesia is not in an independent position in banks' development and oversight. Banking arrangements are made for and on behalf of and based on the Minister of Finance's decision. [22] Rigid processes

and relationships, in an event, create problems of legal certainty and usefulness. This situation gets worse when faced with the threat of a crisis. (2) Law No. 13 of 1968 did not provide many options for Bank Indonesia in managing banks, which is experiencing liquidity difficulties. Managing is limited by providing credit to banks to overcome liquidity problems in an emergency (the lender of last resort). (3) Likewise, Law 14 of 1967 concerning Banking Principles does not provide an adequate legal framework regarding what actions to take if a bank experiences a dangerous situation or can endanger solvency or liquidity and affect the banking system. (4) Government Regulation Number 34 of 1973, which regulates the guarantee of money deposits at banks, has not been implemented firmly and consistently. (5) Indonesia did not yet have an institutional framework for coordination between competent authorities in the financial and banking sector, which aims to formulate appropriate and comprehensive policies to deal with emergencies and crises in the financial-banking sector. (6) Law Number 7 of 1992 concerning Banking does not yet have qualified legal principles to save and restructure the banking system.

As described above, legal gaps influenced the legal frameworks, speed, and accuracy of the government's response to the financial crisis's prevention and resolution developed into a banking crisis in 1997-1998. One of them is a response to maintain public trust by closing 16 banks. In many literatures, it is stated that the absence of deposit insurance caused the fall in public confidence. IMF suggested the 16 banks' closure due to fears of a systemic impact on the banking industry. If not handled immediately, the crisis costs could soar up to Rp. 600 trillion.[23] Despite the fact, based on the 2003 IBRA report, the crisis cost reached Rp. 698 trillion. Both government and the IMF did not suspect the closure to impact the bank rush.[24] Apart from the small number of assets, the closure was only guarded by a guarantee scheme for small depositors' refund, limited to Rp 20,000,000, - (twenty million Rupiah) per depositor per bank. It was not good enough to maintain an immense depositor trust. These conditions were exacerbated by political turmoil and legal gaps, which cumulatively led to the loss of public confidence in banking.

The trust of depositors and investors had faded due to policies that could not accommodate their

wishes. Even the government's response to the crisis is considered to have damaged international confidence in the Rupiah. [25] The political turmoil and riots further exacerbated the situation. Big depositors rushed out and made banking conditions in Indonesia worse. [26] As a result, the financial crisis was unbearable; this impacted the economic sector and developed into a banking crisis.

However, the leading cause of falling public trust was not only the absence of a deposit insurance scheme. [27] It would be inappropriate for the absence of a deposit insurance scheme and inconsistencies in government policies to be the main reasons for the government's public trust (especially in the banking sector). [28] There are at least 6 (six) factors that cause the damage of public confidence in banking after the closure of 16 banks, namely: (1) the fluctuation of the Rupiah as a sign of the threat of the financial crisis; (2) Indonesia already had Government Regulation No. 34 of 1973 concerning The Guarantee of Money Deposits with the Banks. However, it does not appear consistently carried out by Bank Indonesia. Besides the fact, as mentioned earlier, guarantee for limited depositors' funds up to a limited value of Rp. 20 million shows that it was not effective in maintaining public trust; (3) asymmetric information, coupled with rumors regarding the names of banks experiencing liquidity problems, has further encouraged people to take irrational actions; (4) Bank Indonesia, as a central bank, was not independent and considered weak in supervision and not responsive in taking bank restructuring measures; (5) unhealthy political turmoil has made the public begin to doubt and distrust the government under the leadership of President Soeharto; and (6) the rule of law in the financial and banking sector is not yet capable of facing the threat of crisis and banking restructuring/rescue.

However, the failure to stem the crisis is inseparable from the view that the IMF's biggest policy mistake, especially the failed bank closure mistake in November 1997, and the overly tight monetary policy at the end of 1997. [29] The conditions put forward by the IMF were not only for the Banking sector, but extends to clove and plywood monopolies, trade-in wheat flour, soybeans, and garlic, suspension of significant infrastructure projects freeing up industries closed to foreign investment. In other words, the IMF was trying to seize the opportunity in the country. [30]

V. CONCLUSION

This article seeks to state that the precautionary principle can be applied in many fields with all its elements and criteria, including a basic guideline in decision-making to prevent and overcome financial and banking crises.

Since the law is not always adequate to prevent and manage crises, considering the concept of the four pillars and all the criteria contained in the precautionary principle, it can be ascertained that the precautionary principle is a general principle. That fills legal gaps in its relevance as a guideline in the framework for preventing and managing crises in the financial and banking system.

Under high pressure, coupled with the inadequate rule of law facing the threat of crisis, the government may not be aware of the risks that cause loss of confidence as outlined in closing 16 banks. The government may fail to identify possible negative impacts comprehensively. The failure to identify can be caused due to the less in-depth evaluation of the data and information available at that time. With a very complex variety, high pressure, limited time, and legal gaps should make the government put the precautionary principle about the dominant scientific uncertainty.

From the discussion, it can be seen how the precautionary principle has been applied, namely in environmental and health law. Over time, experts have made many efforts so that the precautionary principle can be applied more broadly than in environmental and health law.

The precautionary principle approach's application should be an essential consideration, given the law's poor state in the banking sector when facing the threat of crisis and banking restructuring/rescue.

It was apparent that the government and the IMF were less precautionary or worse; the precautionary principle was not applied comprehensively as a basic framework for policymaking and therefore failed to manage risks appropriately. Risk is a fundamental factor in building public trust since understanding and perceptions of risk also depend on public confidence in those who convey information about the threat itself.[31]

REFERENCES

- [1] S. Economics, "RAND Corporation Chapter Title: TAXES, TRADE, AND GROWTH Book Title: Straddling Economics and Politics Book Subtitle: Cross-Cutting Issues in Asia, the United States, and the Global Economy Book Author(s): Charles Wolf" pp. 118–124, 2002.
- [2] M. F. Montes, *The Currency Crisis in Southeast Asia*. Singapore: Institute of Southeast Asian Studies, 1999.
- [3] A. D. Daruri and D. Edward, *BPPN Garbage In Garbage Out*. Jakarta: Center for Banking Crisis, 2004.
- [4] International Monetary Fund, "Evaluation Report, The IMF and Recent Capital Account Crises, Indonesia, Korea Brazil," 2003.
- [5] I. Lauridsen, "Precautionary Action, A Study on the Status and Implications of the Precautionary Principle in International Environmental Law," Lund University, 2013.
- [6] F. B. Cross, and F. B. Cross, "Paradoxical Perils of the Precautionary Principle Precautionary Principle," *Washington and Lee Law Review*, vol. 53, no. 3, Summer., pp. 851-927, 1996.
- [7] X. Wang, "Ecological wisdom as a guide for implementing the precautionary principle," *Socio-Ecological Pract. Res.*, vol. 1, no. 1, pp. 25–32, 2019,
- [8] S. and C. O. United Nations Educational, "The Precautionary Principle," 2005.
- [9] D. Kriebel *et al.*, "The precautionary principle in environmental science," *Environ. Health Perspect.*, vol. 109, no. 9, pp. 871–876, 2001.
- [10] J. Ellis and A. FitzGerald, "The Precautionary Principle in International Law: Lessons from Fuller's Internal Morality," *McGill Law J.*, vol. 49, 2004.
- [11] R. Andorno, "The Precautionary Principle: A New Legal Standard for a Technological Age," *JIBL*, vol. 01, 2004.
- [12] D. Vanderzwaag, "The precautionary principle and marine environmental protection: Slippery shores, rough seas, and rising normative tides," *Ocean Dev. Int. Law*, vol. 33, no. 2, pp. 165–188, 2002.
- [13] C. Weiss, "Scientific Uncertainty and Science-Based Precaution," *Int. Environ. Agreements*, vol. 3, no. 2, pp. 137–166, 2003.
- [14] R. von Schomberg, "The precautionary principle and its normative challenges," in *Implementing the Precautionary Principle Perspectives and Prospects*, Massachusetts: Edward Elgar Publishing, Inc., 2006, pp. 19–41.
- [15] R. W. Hahn and C. R. Sunstein, "The Precautionary Principle as a Basis for Decision Making The Economists' Voice The Precautionary Principle as a Basis for Decision Making," *Econ. Voice*, vol. 2, no. 2, p. Article 8, 2005.
- [16] A. M. Peterson, "Journal of Medical Ethics," *Med. J. Aust.*, vol. 2, no. 8, pp. 294–294, 1975.
- [17] A. Akins, P. O. B. Lyver, H. F. Alrøe, and H. Moller, "The universal precautionary principle: New pillars and pathways for environmental, sociocultural, and economic resilience," *Sustain.*, vol. 11, no. 8, 2019.
- [18] J. Raz, "Legal Principles and the Limits of Law," *Yale Law J.*, vol. 81, no. 5, p. 823, 1972.
- [19] J. S. Mill, *Principles of Political Economy with Chapters on Socialism*. New York: D. Appleton and Company, Inc, 1885.
- [20] J.-J. Rousseau, *The Social Contract*. London: Penguin Books Ltd, 1968.
- [21] E. Davis, "Towards a typology for systemic financial instability," *Econ. Financ. Work. Pap. Brunel Univ.*, no. 2, pp. 1–23, 2003, [Online]. Available: <http://bura.brunel.ac.uk/handle/2438/916>.
- [22] S. Batunanggar, "Indonesia's banking crises resolution: Lessons and the way forward," *Bank. Cris. Resolut. Conf. CCBS, Bank Engl.*, vol. 2002, no. December, p. 47, 2002.
- [23] D. Edward, *BLBI Extraordinary Crime, Satu*

Analisis Historis dan Kebijakan. Yogyakarta: LKiS, 2010.

- [24] Bank Indonesia, *Krisis Global Dan Penyelamatan Sistem Perbankan Indonesia*. Jakarta: Bank Indonesia, 2010.
- [25] S. Sherlock, "Crisis in Indonesia: Economy, Society and Politics." *Parliament of Australia*. , 1998
- [26] Lembaga Penjamin Simpanan, *5 Tahun LPS Menjamin Simpanan Nasabah Dan Menjaga Stabilitas Sistem Perbankan*. Jakarta: LPS, 2011.
- [27] J. S. Djiwandono, "Bank Indonesia and the recent crisis," *Bull. Indones. Econ. Stud.*, vol. 36, no. 1, pp. 47–72, 2000.
- [28] J. E. Stiglitz, "Knowledge for Development Economic Science, Economy Policy, and Economic Advice." Washington DC, 1998.
- [29] L. Martinez-Diaz, "Pathways through financial crisis: Indonesia," *Glob. Gov.*, vol. 12, no. 4, pp. 395–412, 2006.
- [30] N. Woods, "Understanding pathways through financial crises and the impact of the IMF: An introduction," *Glob. Gov.*, vol. 12, no. 4, pp. 373–393, 2006.
- [31] B. Rohrman and O. Renn, "Risk Perception Research," in *Cross-Cultural Risk Perception: A Survey of Empirical Studies*, O. Renn and B. Rohrman, Eds. Boston, MA: Springer US, 2000, pp. 11–53.