LESSONS FROM THE RECENT FINANCIAL CRISIS IN INDONESIA

Abstract

Anwar Nasution
Center for Policy and Implementation Studies, Jakarta

The currency and financial crises in Thailand in March-June 1997 spread rapidly to other Asian countries, including Indonesia. On August 14, 1997 Bank Indonesia, abandoned its exchange rate intervention band and moved to a floating exchange rate system. From June to December 1997, the rupiah depreciated by over 50 percent against the US dollar, interest rates soared to over 30 percent per annum, and the Jakarta Stock Exchange plunged by about 50 percent. Capital outflows continued to accelerate in spite of the IMF Standby Arrangements, high interest rates on Indonesian securities, rupiah depreciation, and financial indicators that pointed to long-term solvency. This was because of the absence of a clear cut, detailed government program to resist private sector external debt.

Over-investment in the non-traded goods industry and highly protected manufacturing industry and a weak financial system are the roots of Indonesia's present financial crisis. The investment was funded by massive capital inflows that resulted in a growing current account deficit and mounting external debt. With over-investment in less efficient investment projects less resources were being devoted to enlarging Indonesia's productive capacity and hence its ability to service and reduce its external liabilities. Moreover, the over-investment caused other distortions such as asset price appreciation in the real estate sector.

The changing composition of the capital inflows significantly added to the vulnerability of the system as a whole. Short-term bank borrowings and portfolio flows invested in the stock market and in private sector instruments expanded rapidly. Surging local interest rates and depreciation of the rupiah raised the cost of renewing or rolling over short-term floating-rate dollar and yen loans in real terms. To some extent, the authorities influenced both the size and the composition of the short-term capital inflows by imposing ceilings on them and by raising their costs.

Part of Indonesia's current troubles stems from weaknesses in the banking system. Reforms ended financial market segmentation and improved competition, but the combination of relaxing restrictions on bank lending and asset portfolios, lowering reserve requirements, market opening, privatization, and greater access to offshore markets encouraged rapid credit expansion. Together with the perception of Indonesia as a stable country and one of Asia's success stories, the reform generated a massive capital inflow from the early 1990s. Despite reform, the banking system had several critical problems including: the increasing maturity and currency mismatches of bank liabilities; the weak financial position of banks and highly concentrated problem loans; heavy government involvement in directing credit; deficiencies in financial sector governance; and Bank Indonesia's role as lender of last resort to distressed banks and politically connected institutions.

The Policy Responses

Indonesia's current crisis demonstrates the inconsistency between fiscal and monetary policies in an exchange rate system with an intervention band. The massive capital inflows drove up the real exchange value of the rupiah reducing Indonesia's international competitiveness and providing further incentives to invest in the non-traded sector. Indonesia's exchange rate policy and the real appreciation of the rupiah from 1990 to 1996 were incompatible with the realities of the government's fiscal situation which contributed to the widening current account deficit and the unprecedented increase in external debt, particularly short-term borrowing from foreign banks.

When indirect policies, especially prudential rules and regulations, failed to restrain the expansion of liquidity and the current account deficit, the authorities restored direct administrative controls including eliminating the subsidy on the exchange rate swap facility and reinstitution of ceilings on external borrowing by the public sector. The link between the base money and broad money was weakened by raising the non-remunerated reserve requirement ratio and setting specific credit growth targets for individual banks. To support sterilization operations, the Ministry of Finance forced state-owned enterprises to shift their deposits, mainly from state-owned banks, to the central bank. This move dried up liquidity from the economy.

Fiscal adjustment had been a key component of Indonesia's stabilization and adjustment programs. Tax reforms raised economic efficiency and improved external competitiveness and the authorities used oil revenue windfalls and proceeds from the privatization of state-owned enterprises to retire expensive external debt. However, non-budget expenditures did not exhibit the same discipline and restraint as the formal budget. Investments in 'strategic industries' such as the national car program and excessive infrastructure that required import protection and scarce foreign exchange and skilled manpower were protected from the cut in the public budget.

Because it was not supported by proper fiscal and monetary policy and healthy banking system, Indonesia abandoned its moving exchange rate band system on August 14, 1997 and shifted to a floating exchange rate system. The economic costs of this change are likely to be severe because of the resulting sharp depreciation of the rupiah, surge in interest rates, plunge in share prices, and acute liquidity crunch. All of these will cause bankruptcies both of banks and of their customers, a lower growth rate, and higher unemployment and inflation rates. Such an economic recession depresses investment and push down asset-prices. The closing of 16 financially distressed private banks in November 1997 aggravated the problems as it ignited a bank run, capital flight, panic buying, and reluctance of foreign banks to accept Indonesian letters of credit. Even domestic banks became reluctant to lend to each other.

The revised IMF program announced on January 15, 1998 focuses on further reform in trade and investment policies, the financial system, and market infrastructure. The program is a good start to strengthen the economic institutions, to improve domestic competition, to increase efficiency, and to remove distortions that restrain exploitation of Indonesia's comparative advantage in labor-intensive and natural resource-based sectors.

The IMF program does not specifically address private sector short-term external debt, but it does help restore confidence of the private sector to roll over maturing loans as the reforms under the program act like an 'entrance ticket' to international financial markets. Confidence will be further restored with the progress of bank restructuring, raising productivity, and in promoting non-oil exports as they will loose the tight liquidity and restore economic growth. These will allow expansion of domestic aggregate demand and resume inflow of foreign capital.

To restore public confidence in the banking system the authorities have provided a government guarantee on claims of depositors and creditors of banks operating in Indonesia. Rebuilding the dysfunctional financial system will require strengthening both the central bank and commercial banks. State-owned banks (including state-owned non-bank enterprises) need to be de-linked from the government bureaucracy and privatized. In addition, market infrastructure needs to be improved to enforce the implementation of prudential rules and regulations, to promote competition, and to adhere to strict credit policies.

In a policy statement issued on January 27, 1998 the government proposed temporarily freezing private sector external debt service. The authorities have also made clear that borrowers and lenders must solve the corporate debt problem on a voluntary basis; it will not provide financial resources, subsidies, or guarantees to bailout those companies which cannot survive the high real interest rates and rupiah devaluation. Private sector default will be permitted, even in the financial sector.

The social and political costs of the adjustment program are likely to be very high. Along with stimulating the traded goods and export sectors, devaluation will increase inflation. The contraction in domestic expenditures and economic growth and the increase in bankruptcies will raise unemployment. The distributive effect of the adjustment program is partly influenced by the structure of the expenditure cut.

Vigorous economic reform, including restructuring of the financial and corporate sectors, should raise productivity and production and promote non-oil exports to lead Indonesia to economic recovery in the medium-and long-run. Sound fundamentals for economic growth, including dynamic entrepreneurs, skilled labor, adequate economic infrastructure and a relatively high savings rate, are still in place.

Overcoming the crisis, however, also depends on financial conditions. Tight liquidity means that working capital, an important ingredient of recovery, is now scarce.