ECONOMIC CRISIS AND FINANCIAL REFORM IN INDONESIA

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1. Introduction

After almost two years since the onset of the economic crisis Indonesia has still not been able to come out completely from this crisis. The exchange rate, though relatively stable in a range of Rp8,000-9,000 per US dollar, is still quite high compared to the rate before the crisis and could still be considered as undervalued. The bank loan interest rate is still high at over 35%. The growth rate for fiscal year 1999/2000 ranges from -1 to 1% (which is the government target and the implicit assumption for the budget (R APBN)[1]. The inflation rate is estimated around 15-20%, higher than before the crisis, when the rate never reached two digits.

Compared to the progress in neighboring countries that have also undergone economic crisis, the economic recovery in Indonesia is more sluggish.[2] This is probably related to the fact that, besides experiencing a serious economic crisis, Indonesia simultaneously experienced social crisis and political tension generated by dramatic change from a 32-year period of closed and authoritative political control to a more liberal and democratic political system. The radical change accompanied by the weakening government authority—which had had a very strong hold—caused commotion and riots colored by economic, political, racial and religious conflicts, which actually were explosions of long pent-up feelings of dissatisfaction. This climate is clearly not conducive to investment, business development, or economic recovery.

The experiences of Indonesia's neighbors indicate that the necessary factor to come out of the economic crisis is a thorough economic reform combined with consistent economic policy and political stability. Those elements have not fully existed in Indonesia. The problem becomes more complex since Indonesia is still undergoing a transitional period. In this transitional period, political uncertainty is intensifying, as the old tradition and rule has collapsed while the form of the new rules is still unclear. For the first time in 44 years Indonesia will carry out a genuine multi-party general election. Except for the ruling party Golkar, the 48 political parties participating in the election do not have a track record in implementing economic policy. This makes it difficult to predict what kind of economic policy will be adopted after the election, particularly whether or not it will be conducive to economic recovery. Moreover, it is uncertain whether the new government will maintain the commitment to carry out economic and monetary reforms begun by the current government together with IMF. Furthermore, since it is unlikely for a single party to be clearly dominant after the election, will a coalition government be able to carry out the reform? Even if the winning party is committed to reform, will it have sufficient strength to act without regard to the interests of certain groups and uninhibited by the need to conduct political bargaining with its coalition partner(s)?

2. From Currency Crisis to Economic Reform

The journey of Indonesian economy during the last 32 years has been like a roller coaster ride. At the beginning of the New Order government 31 years ago, the development economic expert, Benjamin Higgins described Indonesia as "the number one failure among the major underdeveloped countries".[3] Twenty-five years later the World Bank crowned Indonesia as "one of the eight high-performing Asian economies" and Indonesia was often included as one of the countries that had undergone the "East Asia Miracle". Now, only 5 years later, *Time* magazine named Indonesia "The country with most dramatic reversal of fortune after World War II". What has caused "the number one failure among

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[1] RAPBN - The Plan for State's Revenue and Expenditure Budget

[2] See, *IMF-Supported programs in Indonesia, Korea and Thailand: A preliminary assessment,* IM, January 1999.

[3] Higgings, Benjamin, *Economic Development,* New York, W.W. Norton, 1968.

underdeveloped countries" to became a country with miraculous growth and then to experience a “most dramatic reversal of fortune”? Part of the answer lies in whether or not economic reforms were implemented when the situation required.

Economic reforms which renew the existing economic policy occurred for the first time in Indonesia during the transition from the Sukarno to the Suharto regime. At that time a severe economic crisis resulted from Sukarno's populist policies that generated a budget deficit, high interest rates, hyperinflation, and negative economic growth. The economic reforms adopted by the new government included implementing budget discipline, opening the door to foreign investment, restoring the exchange rate through control of the money supply, simplifying the exchange rate system towards the implementation of a single exchange rate, and restructuring debt through the Paris Club and the establishment of IGGI. This reform episode altered the direction of economic policy from a non-transparent, populist economic dogmatism to a pragmatic, open and friendly stance towards business, both domestic and foreign. However, the government's role remained substantial, foreign trade policy continued to be highly protective and strongly biased toward import substitution, and restrictive financial policies were adopted keep loan interest rates low. This reform period lasted from the beginning of 1970 until the beginning of the 1980s when the need for further economic reforms did not appear to be crucial in view of the rather high economic growth rate that reached 7% annually between 1967-1981, sustained by the high price of oil.

At the beginning of 1982, a recession overwhelmed the world economy and oil prices plummeted. In 1982 Indonesia's economic growth dropped drastically to 2.2%, triggering the beginning of a second phase of economic reforms, popularly named the "deregulation and de-bureaucratization era". The deregulation measures had two underlying principles: to enhance the role of both domestic and foreign private firms in financial and real sector and to reduce government intervention in the economy. Deregulation measures were adopted in the financial sector, starting in 1983 with abolition of financial repression in the form of interest rate restrictions, followed by liberalization of the banking sector from 1988, and reform of the capital exchange market in the same year. In international trade, an export-beneficial exchange rate was introduced and the protection level was decreased to open access to cheaper raw materials. Aseries of reforms was adopted to create an investment regime that was more accessible to foreign investment. These deregulation measures gave the impression of being reactive and ad hoc. For example, after 1983 the over-valued, export-deterring exchange rate was devalued in reaction to the decline in oil prices, which necessitated diversification of exports and sources of funds for development. But adoption of a more flexible managed float exchange rate system and elimination of the anti-export bias was not accomplished until 1986, having been delayed by the recovery of oil prices in 1984-85.[4] Moreover, the second-phase deregulation did not attempt economic improvement of the domestic market structure and the level of effective protection was still high (**Table 1**).

[4] For a detailed explanation of the dynamics of deregulation in Indonesia, see Radius Prawiro, *Pergulatan Indonesia Membangun Ekonomi, Pragmatisme Dalam Aksi*, Gramedia, Jakarta 1998 (English edition forthcoming).

Table 1: Effective Rate of Protection Indonesia, 1987 and 1990

Sub-sector	ERP 1987	ERP 1990
Food and beverages	122	120
Textile	102	34
Wood	25	33
Paper	31	20
Chemical products	14	12
Metal products	57	44
Non metal products	13	10
Machinery	152	82
Other	124	80
Average	*68*	*52*

Source: *Indonesia: Industrial Policy Shifting into High Gear,* World Bank, 1993

The period from 1993 up to the IMF agreement is often referred to as the period of "deregulation fatigue". No substantial deregulation to make the domestic market structure more competitive was launched during this time because of the strength of vested interest groups and the weakness of institutions. Sometimes government economic policy seemed to be going backward, to be inconsistent, or to be confusing as reflected by the sensational National Car policy.

This period was also marked by the emergence of a problem that resulted from the liberalization of the banking sector without the support of appropriate prudent rules and in the midst of institutional weakness. The seeds of the banking crises were to be seen in the increasing rate of unpaid debt and the inability of thegovernment to control the growth of the banking sector. This was apparent from the increasing violation of legal lending limits—without any legal actionbeing taken against obvious infringements of the banking law (**Table 2**).

Table 2: Non-performing Loans and Growth of Credit to the Private Sector

	NPLs/Total Loans	Growth Rate of Credit to the Private Sector
1994	12.0	22.97
1995	10.4	22.57
1996	8.8	21.45

Source: Bank Indonesia *Annual Report*.

A World Bank study (1988) identified at least four developments within this period that instigated the economic crisis:

1. The accumulation of substantial quantities of un-hedged private short-term borrowings within the previous few years.
2. The high growth rate of loans, under the weak control system , that ultimately resulted in banking crisis.
3. The perception of bad governance which gave rise to uncertainties about the

government's ability to manage a crisis appropriately.

4. Political uncertainty mainly related to instability after the presidential succession.

There are at least two reasons why the private borrowings had not been hedged: first, low interest rates on foreign loans compared to domestic interest rates, which were high because of the inefficiency in the domestic banking system and second, the expectation of exchange rate stability since the government had maintained a managed float which had been very predictable for a long time.

The reasons why the economic crisis occurred are still a matter of dispute. The beginning was the financial crisis in Thailand, which subsequently had a contagious effect on Indonesia. The financial crisis eventually developed into an economic crisis marked by economic contraction and hyperinflation.

In its efforts to overcome this crisis the government of Indonesia requested IMF assistance to support Indonesia's economic recovery. Along with an economic assistance package of US$43 billions the IMF insisted on economic reforms to be carried out by Indonesia. This agreement between the government of Indonesia and the IMF became the third episode of economic reform in Indonesia. This reform package was quite comprehensive, and periodically the Indonesian government and IMF are to conduct a study on the implementation of stabilization and reform programs. Based on the adherence to the performance criteria stipulated in the previous agreement and the findings of the observation on the economic development, Indonesia and the IMF will make adjustments and additions to the original programs. Up to April 1999, five such reviews have been completed.

3. Evaluation of the Implementation of the Reform and Economic Stabilization Policy

The economic recovery package agreed to by the Indonesian government with IMF has undergone several fundamental changes. The proposed program for the reform and stabilization consists of four aspects:

1. a package of loans to the central bank and government that could be drawn upon directly or indirectly to help support the repayment of debts falling due to international creditors and directly or indirectly to help stabilize exchange rates.
2. a macroeconomic framework based on budget balance or surplus, high nominal interest rates, and restrictive domestic credit targeted at exchange rate stability
3. a program of drastic financial restructuring built on the immediate closure or suspension of several financial institutions and significant intensification of financial sector supervision
4. "good governance" and structural measures aimed at increased transparency and competitiveness of the economic system, including accelerated trade reform, de-monopolization, and privatization.

This program is designed to restore the confidence of international financial markets in the short term by stabilizing the exchange rate through a combination of macroeconomic discipline (a surplus, or at least, balanced budget, high interest rates, and tight monetary policy), availability of a sufficient foreign reserves, and the indication that fundamental reforms of the economic system are underway. To strengthen this impression, at the initial stage of the program the authorities took the firm step of revoking the operating licenses of insolvent financial institutions and announced a detailed and tight schedule of financial reforms, corporate governance, and market opening (improving market transparency).[5]

In its implementation, the Reform and Stabilization Program has undergone several modifications. Sachs and Radelet (1998) strongly criticized the original IMF program, which emphasized the announcement of firm measures against financial institutions, a fiscal surplus target, and high interest rates. This original package raised panic in international markets

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[5] Jeffrey Sachs and Steven Radelet, "East Asia Financial Crises: Diagnosis, Prospect and Remedies," *Brookings Papers on Economic Activity*, April 1998.

and thereby worsened instead of improving the rupiah exchange rate and it increased the social tensions due to the sudden release of subsidies in the midst of a sensitive political situation.

The most significant modification to the IMF program was the revision of the budget target from a generating a surplus to minimizing the deficit, and also the gradual inclusion of private foreign borrowings and a banking restructuring program. The element that is still maintained up to date is the high interest rate.

The implementation of the Reformation and Stabilization Program has also been rather sluggish. The diversity of political interests has obstructed the smooth implementation of this program as well as frequently giving confusing impression to international markets. At the beginning of the program, just a few days after 16 insolvent banks were closed, an ex-owner of a defunct bank (the son of the former president) was able to obtain a license for a new bank. The program's implementation was held in check for a few months in early 1998 when the government considered a plan, opposed by the IMF, to apply a currency board system (which might have benefited a number of entrepreneurs who had substantial foreign debt and close relationships with the former president). Most recently, the government's announcement of further bank restructuring measures was delayed for a few days because of the alleged efforts to rescue a bank whose owner has a very close relationship with several cabinet ministers.

Another matter that needs to be looked into is the implementation of the social sector policy by the adoption of a social safety net program (JPS). This program which is in fact a rescue program for susceptible community apparently still has a number of weaknesses. The major difficulty lies in the identification of target groups, because of lack of current, reliable data and the weakness of the implementers who acted as the net to ascertain that the benefits of the program could reach the target group.

4. The Agenda and Prospects for Economic Reform in Indonesia

Talking about the prospects of the economic reforms in Indonesia, there is no way that we can avoid discussion of the political prospects for Indonesia after the general election. The 7 June 1999 general election is expected to change Indonesian economic policy, both the substance of the policy itself and the methods to formulate the policy. Now five political parties are predicted to have the opportunity to form a government for Indonesia after the election. These are *PDI Perjuangan, Golkar, PPP, PAN,* and *PKB*. All five parties have indicated that they would continue to apply market-friendly policies **(Table 3)**. However, they have not announced their detailed future programs for economic recovery if they were to govern the country.

From incomplete newspaper reports, only Golkar, PDI Perjuangan, and PAN have disclosed specific programs to overcome the economic crisis. Golkar, more or less, would continue the policy of the current government and its cooperation with the IMF. *PDI Perjuangan* is highly critical of the IMF. One of its chairmen stated the party’s proposal to establish a fixed exchange rate but with foreign exchange support by the international world (Jakarta *Post,* 9 April 1999). Because the IMF apparently would find it difficult to accept such a policy, it is unclear whether the party would continue the IMF's involvement should it win in the election. On the same occasion, the Secretary General of PAN disclosed that the party views as one alternative "capital control" such as is now being applied by Malaysia. Based on Malaysia’s experience, such a system would ignite a dispute with the IMF, making it difficult to predict whether IMF reform programs would be maintained under a PAN government—despite the statement of the *PAN* national chairman that it would honor Indonesia’s agreement with the IMF.

Both the substance and the formulation of government policies will become more complex. Indeed at present it is quite difficult to predict the future political map. However, current indications point toward a growing political role in the policy formulation process, which is different from the last 32 years when professional technocrats dominated policy formulation. It remains to be seen whether this situation implies that political judgements dominate in determining economic policy, especially the aspect of who gets what. But, one thing is certain, the pressure of international market dynamics, which will responds immediately against bad policy in the current globalized economy, will become a substantial balancing factor to prevent policies that distort the market.

The implementation of the Reform and Stabilization Program in co-operation with the IMF, even though initially weak, is one step towards eliminating various structural imbalances in the Indonesian economy, such as restructuring the financial sector, de-monopolization, and elimination of market distortions. However, there is concern that the current economic program will aggravate poverty and income inequality unless it is supported by a further reform program that deals with the problem of income distribution. The safety net program, which is intended to minimize the social consequences of the Reform and Stabilization Program, should be intensified by identifying the appropriate target groups. The experience of the last 32 years has taught that high economic growth without attention to equality of distribution will generate a time bomb of social unrest that could explode any time.

Table 3: Where the Parties Stand on the Issues

Issue	PPP	PDI Perjuangan	PAN	Golkar	PKR
Economic System	People's economy	Market economy plus equity for the poor	More or less like South Africa under Mandela	Market economy plus structural changes	Market economy combined with socialist values
Taxation Policy	Progressive	Introduce wealth and inheritance taxes	Not available	Progressive	Progressive
Foreign Investment	Equitable partnership with local businesses	Greater share for Indonesian government and domestic private sector	Guarantee prior contracts	100% foreign ownership limited to export-oriented industries	Government should control majority stake in public utilities
Multilateral Assistance	Adjust to local conditions	See the IMF as bankers	See positive role of IMF in Indonesian development	Adjust IMF policies to Indonesia	See IMF as temporary solution
Big Business	Focus on export market	Introduce fair competition law	Must be regulated	Will not give special facilities	Will not give special facilities
Small and Medium Enterprises	First priority to develop	Will give protection to small business	Will give assistance to small business	Will help small business become strong medium business	Protect small business
Welfare System	Give education priority	Introduce social insurance and increase minimum wage	Policy to narrow gap between rich and poor	Empower traditional market	Not available

Source: *Indonesian Business*, 9 April 1999.