CHAPTER – III

INDONESIA

Background :

This chapter studies the conditions under which Indonesia adopted the structural adjustment programme of the IMF and the World Bank. Upto the early 1980s, its economy was dependent on an overwhelming manner on the revenue that, received from oil and gas. Indonesia benefited from the oil price increase of 1979 and it pursued an ambitious import substituting growth strategy with larger government investment in big industrial units. It implemented these policies vigourously under five year plans during the period 1974-75 to 1978-79 and 1979-80 to 1983-84, and could maintain a GDP growth rate of 5.5% on an average during this period.

However, Indonesia was adversely affected by the global economic recession of 1982. Moreover, the oil price fell steeply from $ 35 a barrel in early 1981 to about $ 14 a barrel in March 1986. It fell further to about $ 10 a barrel in August 1986. It external debt increased in volume and its debt service ratio reached an unsustainable level of 38% during 1986-87. All these external shocks weakened the Indonesian economy and had to adopt the structural adjustment programme consisting of policies that corrected the adverse impact of the external shocks.

It pursued monetary policy and fiscal policy that could contain inflation and could keep budgetary deficits within sustainable limits. Between 1986 to 1997, Indonesia could achieve high rate of GDP growth, and very high rate of saving and investment. Its fiscal deficits and balance of payments deficits were quite moderate except for the year 1995, when its deficit in the current account of the balance of payments as a percentage of GDP was very high – 8%. Thus, Indonesia's macroeconomic fundamentals were quite strong except for the year 1995, when its balance of payments deficit reached an unsustainable level.

The financial and currency crisis struck Indonesia in August 1997 and its currency was devalued by about 50% in course of the next six months. The IMF, the World Bank and some friendly countries extended large financial support to Indonesia which in turn agreed to a package of economic reforms with the multilateral financial institutions. In spite of all these efforts, Indonesia took five years to get back to the earlier growth path.

The financial and currency crisis of 1997 exposed the serious weaknesses of its financial institutions and a substantial number of the weak finance companies were asked either to close down or agree to a merger proposed with sound financial institutions. The crisis also raised a serious question before the multilateral financial institutions whether the developing economies should be advised to go for full currency convertibility before placing its financial system on sound footing.

Indonesia won its independence in 1945 and its first President – President Sukarno followed the policy of guided socialism. Under this policy, the state came to acquire control over the commanding heights of the economy as in India, while the private sector was regulated with the help of vast and complex direct and indirect measures relating to bank credit, trade and investment. Indonesia was also swept by nationalistic sentiments, the foreign companies were nationalized and the foreign investment was discouraged. The prices of essential commodities were controlled. However, after fifteen years of Sukarno's rule, by early 1960s, the adverse effects of the highly regulated and authoritarian rule came to the face in the form of massive corruption, rent seeking, black marketing etc. The GDP growth turned negative, inflation reached the astronomical rate of more than 1000 percent, foreign exchange reserves were exhausted and debt servicing amount was larger than export earnings. During the political and economic chaos and consequent rebellion that took place, President Sukarno was thrown out of power and the discredited policy of guided socialism had to be given up. The next President – President Suharto brought a clear turnaround in the economic policies. One important economic policy measure taken in 1967 was to return the foreign companies nationalized earlier during 1945-65 to their former owners. Moreover, the foreign capital inflow was encouraged. In the realm of fiscal policy, the government pursued the policy of balanced budget and the shortage of domestic resources was met through borrowing from other countries. The Indonesia currency – Rupiah – was made convertible in 1971. Indonesia benefited considerably from the oil price rise in the 1970s, itself a major oil and gas producing economy, and the additional revenues enabled it to pursue an ambitious import substituting growth strategy with larger government investment in mega projects. In the next two five year plans known as Repelita II and III covering the period 1974-75 to 1978-79 and 1979-80 to 1983-84, while Indonesia could keep its growth rate on an average to 5.5%, it also became more protectionist in its trade policy than before. Tariff and non tariff barriors to imports widened and restrictions on foreign investment became more stringent. With the oil price increase, which was accompanied by large inflow of foreign exchange into the economy, Indonesia experienced high rates of inflation. While the Rupiah was devalued in 1978, its beneficial effects on the economy were lost as it was accompanied by high rate of inflation during this period. Indonesia thus, as it entered the decade of 1980s was an import substituting inward looking economy with its heavy dependence on the oil and gas resources. This sector of the economy accounted for almost 80% of its total export earnings and its contribution to the government revenue was around 70% in 1981-82. While the non oil industrial sector also expanded quite rapidly, its share in the economy's total GDP was only about 8% in 1981-82.

External Shocks :

The oil price began to fall from 1982 under the impact of the global economic recession. During the period 1982 to 1986, the oil price fell from $ 35 a barrel in early 1981 to $ 25 a barrel in January 1986 and in next two months, it crashed to $ 14.45 a barrel in March 1986 and in another five months it reached an all time low to $ 9.86 in August 1986. As a result of this, Indonesia's current account deficit increased from about 3% of GNP in 1981-82 to an unsustainable level of almost 8% of GNP in 1982-83 and continued to remain at 6% in 1986-87. This was associated with the decline in the value of the US Dollar and the currency realignment at the Plaza Accord of 1985. With this, Indonesia's external debt increased as it was primarily denominated in currencies other than Dollar and their value against the Dollar had gone up. This had an adverse impact on the debt service ratio which increased from 16.8% in 1982-83 to 25% in 1985-86 and then to 38% after one year, in 1986-87. During this period, the government savings also declined sharply. The series of external shocks during the first half of 1980s required correction in the prevailing economic policy in whose absence, the huge loss of national income associated with these shocks could have destabilized the economy.

Economic Reforms :

The government of Indonesia took many economic policy measures which were aimed at restoring macro economic stability. The other important objective of the government was to bring about significant diversification in the manufacturing sector to reduce its dependence on oil and gas sector. The policy changes were related to fiscal and monetary policies, external trade and foreign exchange rate.

Fiscal Policy :

One important measure relating to fiscal policy was to reduce public expenditure. Towards this objective, the government reduced subsidies, introduced restrictions on employment and salaries of the civil servants and increased the allocation of expenditure on social sectors especially including education and health.

As a result of these measures, the public expenditure decreased during 1982-83 and 1986-87 by 19% and while it increased slightly in the next few years, on the whole, it fell short of public expenditure planned for Repelita IV that covered the period from 1984-85 to 1988-89 by 21%[1]. The government had to reduce its expenditure on routine expenditure like the wages and salaries of the civil servants. It had also to undertake reduction on capital expenditure as well as subsidies on fertilizers and pesticides. However, the revenue transfers to the local governments were protected, in the sense that the reduction made here was much smaller. The government was compelled to resort to expenditure reduction in order to be able to meet the increasing external debt servicing charges.

The government had to reconcile to the reduction in the oil revenues which so far was the most dominant part of its total revenue. The government resorted to some important tax reforms with an objective of diversifying its tax structure as well as improving the efficiency of its tax

[1] Thorbecke, Erix, "The Indonesian Adjustment Experience in the International Perspective". 1991 Quoted by Mishra Veena, Indonesia : Adjustment in the 1980s in Agrawal, Pradeep et al (ed) Economic Restructuring in East Asia and India, 1995.

system. The tax reform consisted of two changes – the income tax rates were reduced and the sales tax was replaced by the value added tax.

Monetary Policy :

The important objective of monetary policy during this period was to maintain low rate of inflation and price stability. During the period 1983 to 1985, interest rate regulations on the commercial banks were removed. Similarly, ceiling on sectoral credit flow was also abolished. New market oriented instruments like the Bank of Indonesia certificates and certificates of deposits issued by the commercial banks were introduced with an objective of ensuring effective monetary management. Further relaxations were introduced between 1987 to 1989 when restrictions on new entry into the banking sector were removed, foreign banks were permitted to open branches in six more major cities, over and above Jakarta. What was even more important was that the Central Bank of Indonesia reduced the reserve requirements to be maintained by the commercial banks from 15% to 2% to enable them to have large credit expansion with the existing cash reserves. Similarly with a view to expand the flow of external capital to Indonesia, the foreign individuals and institutions were permitted to invest in the equity capital of the domestic companies and the foreign investment firms were permitted to form joint ventures with the local partners. However, the government also wanted to regulate the concentration of bank lending, bank risks and speculation in the foreign exchange market. A commercial bank's exposure to any single borrower was restricted to 20% of bank capital, and up to 50% in case of one group of corporations under the common ownership.

All these measures resulted into a rapid expansion of financial institutions and the stock markets and in course of time, exerted considerable strain on the legal and the supervisory institutions in the country. In March 1991, the government took many comprehensive measures to strengthen the regulatory framework of the commercial banks. These measures consisted of stricter conditions for obtaining bank licenses and opening new branches, a phased compliance with the capital adequacy requirements recommended by the Bank of International Settlements, mandatory provisioning for substandard and doubtful non performing assets and more detailed reporting to be made by the commercial banks to the Bank of Indonesia – its Central Bank.

Foreign Exchange Rate Policy :

The overriding objective of the foreign exchange rate policy was to control deficit on the balance of payments on the current account. As the overvaluation of the domestic currency – Rupiah – was the major cause for the persistent deficits in the balance of payments, it was devalued by 28% against the US Dollar in March 1983 and was again devalued by another 31% in September 1986. These two devaluations of domestic currency succeeded in reducing the deficits. This happened because on the one hand, imports became more expensive and thus demand for imports was reduced. The 1986 devaluation was also accompanied by significant reduction in tariff rates. The devaluation and the consequent increase in the price of imports could restrict the increase in imports which could have otherwise taken place because of the liberalization in the economic policy.

Foreign Trade Policy :

Indonesia began its fiscal and monetary reforms in 1983. However, its trade sector reforms could be initiated slightly later. In fact between 1983 and 1985, import restrictions with the help of import licensing were strengthened with an objective to protect foreign exchange reserves as much as possible as its balance of payments situation deteriorated quite sharply. However, with the Plaza accord of 1985 and oil price crash, the government could move in the direction of trade liberalization policy. One important objective of the government in adopting the structural adjustment programme was to bring about a shift from the import substituting and inward oriented trade policy to export promotion and outward oriented policy with less dependence on a single industry like oil and gas to a more diversified industrial structure. The government took number of measures for export promotion including stable real effective exchange rate. In March-April 1985, the government undertook tariff reduction for all categories of imports and rationalized the tariff structure. Moreover, it abolished its customs department and entrusted this work to a private Swiss firm.

The reduction in tariff rates was quite substantial from 0-225 percent to 0-60 percent and the number of tariff levels were reduced from 25 to 11. The tariff rates were reduced further in October 1986 and May 1990, bringing down the maximum rate to 35 percent. Again in October 1986, the government adopted an important reform in trade policy when it initiated a policy to move from non tariff barriers to tariffs and this was further strengthened in 1990. Moreover, between 1986 and 1990, the import licensing system was further relaxed and the licensing procedures were further simplified.

Trade liberalization polices were continued in the decade of 1990s. In May 1990, the import licensing restrictions were abolished on 335 commodities and ceiling tariff rates were reduced from 60% to 40%. This process of trade liberalization resulted in June 1991 to the abolition of import licensing restrictions on additional 322 commodities and the ceiling tariff rates on imports were further reduced from 40% to 30%.

Impact of Structural Adjustment Programme :

The structural adjustment programme that was initiated by the Indonesian government in response to the grim economic situation in mid 1980s succeeded in creating a favourable impact on the economy. Almost all macro economic parameters showed considerable improvement within a short span of five years. The following table provides necessary information on the subject.

Table : III.1 – Recent Economic Development, Indonesia[2] 1975-1990[1]

	1975-83	1984-85	1986	1987	1989[2]	1990
Real Growth Rates						
(% p.a.)						
GDP	6.5	4.5	5.9	5.0	7.4	7.1
Non – Oil GDP	7.0	5.2	6.2	5.8	8.1	7.7
Manufacturing	10.6	12.7	11.1	11.4	11.6	12.8
Fixed investment	10.7[3]	-5.8	-5.5	2.6	13.0	16.2
Public	12.6[3]	-2.9	19.1	-4.5	6.2	9.6
Private	9.1[3]	-8.6	8.7	8.1	17.7	19.9
Non-oil Exports	10.5[3]	10.4	4.1	25.3	15.9	6.7
Non-oil Imports	13.8[3]	-11.8	-13.6	5.0	18.2	29.4
Ratios (Percent)[4]						
Overall Public Sector	-4.8[5]	-3.0	-4.1	-2.7	-2.2	2.0
Balance / GDP						
Current Account / GNP	-7.8[5]	-2.6	-5.8	-2.3	-1.9	-3.8
Debt Service / Exports	16.8[5]	25.1	38.0	35.5	32.1	27.3
Fixed Investment / GDP	25.1	20.5	20.1	19.2	21.1	21.1
National Savings / GDP	21.1	21.6	17.5	19.2	21.3	NA
Prices						
Oil Prices (US $ bb+)[2]	28.4	25.0	12.8	17.6	17.9	NA
Terms of Trade[4]	100	93.2	62.4	71.6	73.0	75.8
Domestic Inflation (% p.a.)[6]	16.2	8.1	5.8	9.6	6.3	7.9

Notes :
1. BOP and fiscal data are for fiscal years, other indicators are for calendar years.
2. National Accounts data for 1983-89 are based on the preliminary revised series recently published by BPs (Central Bureau of Statistics in Indonesia)
3. For 1978-82 Only.
4. For last year of multi year periods, with 1983-84 = 100
5. For 1982-83.
6. As measured by the seventeen city CPI adjusted for rice prices during 1987-89.

Source : Central Bureau of Statistics (BPs), and World Bank Staff estimates.

The GDP growth rate, that was quite satisfactory, during 1975-83, came down to 4.6% during 1984-85. From this low level, it increased at a moderate rate during 1986 and 1987, from where it increased to little above

[2] Veena Mishra, Ibid. P.116.

7% during 1989 and 1990. The growth of the non oil economy was particularly quite impressive during 1989 and 1990 when GDP growth rate was 8.1% and 7.7% respectively. The significant improvement in the fiscal situation can be seen from the fact that the negative balance was considerably low during 1987 and 1989 and was turned into positive 2% during 1990. The external sector situation was quite grim during 1975-83 period when current account deficit as a percentage of GNP was -7.8% and again -5.8% in 1986 from where it showed considerable improvement during 1987 to 1990 period. While its debt service ratio was not alarming during 1975-83 period when it was on an average 16.8%. However, in 1984-85, the situation became difficult when it reached 25.1%. However, the external sector situation became extremely difficult in 1986 and 1987, when the debt service ratio increased to little above 35%. Under the impact of trade liberalization policy, it came down to 32.1% in 1989 and to 27.3% in 1990. There is one area where the structural adjustment programme did not show any favourale impact. Fixed investment as a percentage of GDP was almost 25% during 1975-83 period, which was quite commendable among the developing economics of the world. During the years 1984-85 to 1990, it remained constant at about 21%. The rate of saving as a percentage of GDP was 21% during pre reform period of 1975-83 and also during 1984-85. During the period of two years 1986 and 1987, when the reform programme was undertaken marking a sharp departure with the earlier set of policies, the savings rate came down, only to reach 21% during 1989. One important area of thrust under the economic reforms after 1986 was to reduce Indonesia's dependence on exports of oil and gas. While the non-oil exports grew by 10.5% per annum during 1975-83, such exports registered considerable improvement by 1987 when they were increased by 25.3%. However, the non oil exports could not be sustained at such a high level and came down to growth rates of 15.9% and 6.7% during 1989 and 1990 respectively. On the other hand, the non oil imports were increased by 13.8% during 1975-83. These imports came down to 5% growth during 1987 but then increased by 18.2% and 29.4% during 1989 and 1990 respectively. Another area that showed considerable change was private investment that was 9.1% of GDP during the pre reform period 1975-83 and increased to 17.7% and 19.9% during 1989 and 1990 respectively. Again, there was a sharp fall in the oil price since 1983. The oil prices were quite high at $ 28.4 per barrel during the pre reform period 1975-83. It had fallen by a little more than half by 1986 when it stood at $ 12.5 per barrel and then increased to $ 17.9 per barrel in 1989. At this level, it was almost 35% lower than what it was during 1975-83. This is a measure of the diversification in the structure of industrial production and in the structure of exports that the economy of Indonesia could achieve within a short span of four years during which it could bring about a significant improvement in its balance of payments situation inspite of an almost 35% fall in the oil price. Indonesia could also bring about impressive turn around in the realm of inflation. While its economy experienced a rather high and unsustainable rate of inflation – an average of 16.2% during the pre reform period 1975-83, it succeeded in bringing it down to a moderate level of around 8% in the post reform years. Thus, the rate of inflation was almost halved during the post reform period in comparison to what it was during 1975-83. Except for the saving rate and the investment rate, which did not change much in the post reform years in comparison to what they were in the pre reform period, the macro economic performance of Indonesia in response to the economic policy changes was quite encouraging. For the post reform years, the fact that the investment rate was almost equal to the rate of saving implies that there was no inflow of foreign capital on any significant scale in Indonesia during 1986-90.

Making assessment of the economic reforms since mid 1980s, Asian Development Outlook maintained that, "the substantial structural reforms undertaken over several years have succeeded in building strong foundations for the Indonesian economy. Diversification of the productive base has been coupled with an expanded role of the private sector and reduced reliance on oil and gas revenues. There has also been marked success in poverty reduction and commandable efforts are being undertaken to improve environmental management".[3]

Indonesia in the 1990s :

The relevant information on the major economic indicators for Indonesia is given in the following table –

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[3] Asian Development Bank, Asian Development Outlook, 1994 Page 95.

Table : III.2 – Major Economic Indicators : Indonesia (1991-1995)[4]

	1991	1992	1993	1994	1995
Gross Domestic Product % Change	6.9	6.4	6.5	7.5	7.6
Agriculture % Change	1.4	6.5	1.5	0.6	2.5
Industry % Change	10.3	5.4	6.9	11.2	10.6
Services % Change	6.1	7.5	8.3	7.0	6.7
Gross Domestic Investment % of GDP	35.0	34.6	35.2	34.0	38.3
Gross Domestic Saving % of GDP	35.4	37.3	38.2	35.3	36.0
Inflation Rate % of Change in CPI	9.2	7.5	9.0	8.5	9.4
Money Supply Growth % Change	17.1	20.2	15.3	20.2	24.1
Merchandize Exports $ Billion	29.4	32.5	35.8	40.2	44.7
% Change	9.8	10.4	10.0	9.9	11.1
Merchandize Imports $ Billion	24.6	26.5	29.1	32.3	39.8
% Change	14.8	7.5	10.0	13.9	23.1
Current Account Balance $ Billion	-4.1	-3.7	-3.0	-2.8	-8.0
% of GDP	-3.5	-2.9	-2.1	-1.6	-4.0
External Debt Outstanding $ Billion	76.1	84.4	90.0	95.5	104.0
Debt Service Ratio % of Exports	32.6	32.1	29.9	30.0	33.7

As in the past, Indonesia's GDP growth rate remained at a high level – above 6% during 1991 to 1993 and at about 7.5% during 1994 and 1995. While the growth rate of its agriculture was 6.5% during 1992, that was an exceptionally good year. For the rest of the period, the performance of this sector was poor and hovered around 1.5% per year. The industrial sector's performance was quite satisfactory and for three years out of five, it was a little above 10%, comparable with the best in the South-East Asian region. The growth of the services sector remained above 6% for all the five years

[4] Asian Development Bank, Asian Development Outlook, 1994, Page 16 and 1996 and 1997 Page 82.

and did not show wide fluctuations as seen in the growth pattern of the agricultural sector and the industrial sector. Like the growth rate, Indonesia could also continue with its high rate of gross domestic investment during the first half of 1990s. While it remained at a high level of about 35% for most of these years, it reached an all time high level of 38.3% in 1995. Writing on the overall macroeconomic situation in Indonesia, Asian Development Outlook summed up as under, "The Indonesian economy continued to grow strongly in 1995 and, driven by strong private consumption and investment demand, can be expected to maintain that momentum over the next two years. As the economy is operating at a very high level of capacity, macroeconomic policy is critical to the maintenance of stable growth and to the avoidance of overheating. Although inflation shows signs of moderation, it remains high, and the current account deficit which deteriorated in 1995, must be addressed in a timely manner".[5]

In line with the high rate of gross domestic investment, Indonesia's gross domestic savings rate also continued to be quite high. While it was around 35% for most of these years, it became all time high at 38.2% for the year 1993. Again for most of the years, the rate of saving was higher than the rate of investment which would ordinarily imply that Indonesia had became a capital exporting county. However, that was not the case as can be seen from the growing volume of outstanding external debt and the high debt service ratio. In this context, it is pointed out that "Indonesia is one of

[5] Ibid, 1996 and 1997 Page 79.

the few Asian economies where gross national saving is substantially lower than gross domestic saving. The difference has ranged between 4 and 5 percent of GDP and is due to outflows of net factor income and servicing of debt. Gross national savings in 1993 was 33.3 percent of GDP, 4.7% less than GDS and almost 1.9 percent less than GDI. Therefore, despite a very high domestic saving rate, Indonesia still has a resource gap. This gap has declined over the years as savings have increased and outflows of net factor income have remained relatively stable".[6]

The inflation rate in Indonesia remained quite high during the period at almost 9% during most of this period. At the same time, growth of money supply was also taking place at the rate of about 20% and in 1995, at the rate of 24%. The faster growth in money supply and high inflation rates are explained as under, "The monetary authorities have focused on managing monetary aggregates with a view to dealing with inflationary pressure and the effects of large inflows of international capital. Using open market operations in Bank Indonesia Certificates (SBIs) and money market securities (SBPUs), the authorities adopted an expansionary stance in response to capital outflows in the first two months of 1995 in the wake of the Mexican financial crisis. In contrast, a contractionary stance was adopted in June and July to offset large capital inflows resulting from widened spreads between domestic and international rates of interest. In September, monetary policy was again eased in response to devaluation rumors caused

[6] Ibid, 1994 Page 96.

by nervousness associated with worsening of the current account deficit and falling interest rates. In response to increased capital flows, the Central Bank also adopted more flexible interest rate and exchange rate policies to enhance the effectiveness of money supply control. Interest rate targeting was abandoned in favour of auctioning a specific quantity of SBIs. This change in policy aimed to make the SBI rate, which is closely related to other domestic rates, adjust more quickly to changes in rates abroad. The exchange rate has also been used to stem speculative capital flows by gradually broadening the daily Rupiah – Dollar trading band to increase the cost of currency speculation. Further, to encourage the development of a domestic market to swaps and to insulate the foreign reserves held by Bank Indonesia from speculative pressures, the swap facility provided by Bank Indonesia was suspended".[7]

The merchandize exports increased during this five years period by almost 50%, from $ 29 billion to $ 45 billion, increasing on an average at the rate of 10% per year. Similarly, the merchandize imports increased by almost 60% from $ 25 billion in 1991 to $ 40 billion in 1995, increasing on an average at the rate of 12% per year. The rate of growth of merchandise imports has been uneven, increasing at a slow rate of 7.5% in 1992 and increasing at an extremely rapid rate of 23% in 1995. Indonesia thus had a current account deficit which was 3.5% of GDP in 1991, came down to 1.6% of GDP in 1994 and again rose to 4% of GDP in 1995. In absolute

[7] Ibid, 1996 and 1997 Page 81.

terms, the current account of the balance of payments can capture the sharp deterioration much better as the deficit in the current account increased from \$ 2.8 billion in 1994 to \$ 8 billion in 1995. This outcome was the result of the simple fact that the robust growth of exports was more than counter balanced by much faster import growth. The widening of the services account deficit from \$ 11.3 billion in 1994 to \$ 13 billion was due mainly to an increase in the debt servicing costs and appreciation of the yen. The year 1995 also witnessed rapid increase in foreign investment approvals increasing from \$ 23.7 billion in 1994 to \$ 39.9 billion in 1995 – an increase of almost 70% in a single year. Almost 50% of this came for the petrochemical sector and the UK emerged as by far the most important source of FDI flow, surpassing Japan. The net foreign investment flows in 1995 were quite large – something like \$ 6 billion. Other short term borrowing and capital flows were close to \$5 billion in 1995 in contrast to about \$2 billion in the early years of the 1990s. Total official and non-official capital flows resulted in an estimated net capital inflow of \$10 billion in 1995 which was sufficient to meet the current account deficit and add to the foreign exchange reserves which reached the level of \$ 15 billion in 1995, which was enough to pay for four and half months of import bill.

The external debt of Indonesia which was \$ 76 billion in 1991 gradually went on increasing and stood at \$ 104 billion, signifying an increase of almost 35% in five years. That the external debt problem was becoming serious can be better grasped from the debt service ratio which remained at 30% upto 1994 and increased to 34% by the end of 1995.

While Indonesia undertook wide ranging economic reforms since mid 1980s, that resulted into strengthening of most of the macro economic indicators during a period of a decade from 1986 to 1995. However, the Indonesian government appreciated the need for further deregulation measures. "It will be important to continue deregulation measures in 1996 and 1997 to increase competition and improve economic efficiency. A trade deregulation package, including tariff reductions and a schedule for further liberalization was introduced in May 1995 and another in January 1996. However less progress has been made in removing non-tariff barriers in agriculture and in deregulation of domestic distribution. The drive for increased productivity and competitiveness requires improvements in the technological capabilities of the country's human resources as well as further reform of the present regulatory framework that imposes large unnecessary costs on business".[8]

The following table provides information on macro economic situation in Indonesia during 1996 and 1997 when it was severely hit by the financial and currency crisis of mid 1997.

[8] Ibid, 1996 and 1997, Page 79.

Table : III.3 – Major Economic Indicataors : Indonesia 1996 and 1997[9]

(Percent)

Item	1996	1997
Gross domestic product growth	8.0	4.6
Gross domestic investment / GDP	30.8	31.6
Gross domestic savings / GDP	30.2	31.0
Inflation rate (consumer price index)	7.9	6.6
Money supply (M2) Growth	29.6	27.7
Fiscal balance / GDP	0.8	-0.2
Merchandize export growth	5.8	11.2
Merchandize import growth	8.1	4.8
Current account balance / GDP	-3.4	-2.7
Debt service / Exports	29.5	30.0

During 1996 and 1997, the rate of gross domestic investment and the rate of gross domestic savings came down sharply in relation to the high level they had reached during the first half of 1990s. The money supply increased during 1996 and 1997 at a faster rate than during the earlier years, the rate of inflation more or less remained at the same level. Actually the rate of inflation at 6.6% during 1997 was the lowest during the period 1991 to 1997. There was a small fiscal surplus in 1996 which gave way to a small fiscal deficit. The exports growth considerably slowed down in 1996 but again picked up the level that prevailed in the earlier years. It was, however, the rate of growth of imports that came down steeply to 8.1% in 1996 and then fell further to 4.8% in the year of unprecedented financial and currency crisis. The current account deficit came down in comparison to 4% of GDP to which it had sharply risen in 1995. The debt service ratio continued to

[9] Ibid, 1998 Page 37.

remain at a high level much like the earlier years. While GDP growth rate was predicted to remain at a high level during 1996 and 1997, the prediction could come true for the year 1996 but went very much off the mark for the year 1997, when it increased at a rate of only 4.6%, the lowest since 1991.

Thus most of the macro economic indicators for the Indonesian economy were sound and in line with the sound performance indicators of the earlier years since 1991, "the strong economic performance before the crisis was not, however, without its problems, and the apparent credit worthiness of Indonesian borrowers, coupled with low interest foreign commercial loans, increased their exposure to unhedged short term external debt. The growth of non-oil exports had slowed and oil exports grew sluggishly. The Rupiah began to weaken in the second week of July 1997, immediately following the floating of the Thai Baht. GDP growth for 1997 declined to slightly less than 5 percent. Growth in the manufacturing sector slowed to 6% because of liquidity constraints, the drought brought about by EI Nino hampered agricultural performance, causing agricultural prices to rise, and at the same time, the forest fires in Sumatra and Kalimantan imposed severe costs on the economy and reduced tourism, the country's third largest export industry".[10]

In terms of its currency depreciation, Indonesia was the most serious casualty of South East Asia's financial and currency crisis. This appears quite paradoxical, keeping in mind its economic situation up to 1996 and its

[10] Ibid, 1998, Page 86.

good performance during the first half of 1997, which was assisted by its tight fiscal policy and prudent monetary policy as well as foreign exchange rate policy. Indonesia's Rupiah depreciated by 80% between July 1997 and January 1998. The private borrowers' creditworthiness suffered in the rating of external creditors, the inflow of capital to the Indonesian corporations sharply declined, putting further cumulative pressure on its foreign exchange rate. By mid 1997, financial investors appeared to have become concerned about the common domestic economic developments among the four economies of the South East Asian region. In fact, Indonesia, was much similar to Thailand in the sense that the international financial markets had before 1997 been quite satisfied with their internal economic situation. However, immediately after the Thai crisis, the policy difficulties in all these countries were reassessed as being far more precarious and unsustainable than what was thought before which prompted international investors to suddenly withdraw short term funds from these countries. Again, the international investors believed that currencies in this region including Indonesia's Rupiah would be forced to move downward together with that of Thailand owing to the competing nature of their exports, superimposed by an additional relevant factor that the South East Asian region had became increasingly interdependent with all these economies adopting the outward oriented trade policy from the beginning of 1980s.

During 1997, Indonesia's exports increased by 11.2%. Imports, that increased by 8% during 1996, could increase by only 4.8% in 1997. Most of this decrease in imports was related to the consumer goods. The decline in the imports of capital goods was relatively small as the rate of gross domestic investment in the economy was very high until the middle of 1997. The deficit in the current account of the balance of payments as a percentage of GDP had come down to 2.7% and the total external debt was 61% of GDP and 50% of this external debt was accounted for by the private sector. The debt service ratio continued to remain at 30% as in the past few years and by 1997, Indonesia's international liquid reserves were estimated at $ 20 billion including the financial assistance from International Monetary Fund under its stand by facility availed by it in November 1997. in 1996, the international liquid reserves were enough to meet five months imports and as late as May 1997, the foreign exchange reserves were equivalent of 5.5 months imports. Thus, as far as the balance of payments situation of Indonesia is concerned, it showed hardly any sign of the impending severe financial crisis.

Indonesia had framed its foreign exchange rate policy to accommodate increased flow of foreign capital including the volatile short term portfolio investment and debts undertaken by the private corporations. Since 1993, the Central Banking authorities had adopted a policy of periodic widening of the nominal exchange rate band. While announcing the increase in the foreign exchange rate band from 2% to 3% in December 1995, the monetary authorities had announced that the measure was aimed at improving the effectiveness of monetary control and the stability of the foreign exchange rate keeping in view the anticipated flow of foreign capital. During 1996, the band was again widened twice and it was again widened in July 1997, when it was increased from 8% to 12%. However, this measure was short lived as the South East Asian financial and currency crisis broke out, beginning from 2nd July 1997 when Thailand's Baht was allowed to float, giving up its earlier policy of pegging it to Dollar, and Indonesia was also forced to float its Rupiah from August 14, 1997.

The Indonesian economy was in the robust condition even as the financial crisis engulfed Thailand first. After the Thai Baht was put on a free float and was allowed to depreciate against the Dollar and other major currencies of the world, the Rupiah also entered a difficult phase during which the international financial markets widely anticipated its large depreciation and the rest of the story, as had been repeated in many countries including the UK in early1930s and the USA in the late 1970s and in early 1971, was a self fulfilling prophesy. The crisis, however, magnified the unfavourable consequences of the past policy mistakes.

On 14 August 1997, Bank of Indonesia, the Central Bank of the country, gave up its attempt to keep the value of Rupiah within a certain trading band against the US Dollar under the extremely heavy selling pressures. The Central Bank was obliged to float the currency after it had used half a billion Dollar from its foreign exchange reserves to intervene in the volatile foreign exchange market during a day – 13 August. Moreover, abandonment of the trading band was necessary to realign the Rupiah with other heavily depreciated currencies of the region – a measure that was simply necessary to protect the competitive strength of Indonesian exports. The government of Indonesia also introduced other measures as well to arrest the depreciation of its currency as well as volatility in the stock prices. On 31 August, Indonesia limited forward foreign selling against the Rupiah by domestic banks to non resident customers and it limited outstanding positions in the forward exchange market to about $5 million per bank. While these measures aimed at limiting speculative activities in the foreign exchange market, they also led to a backlash in the stock market as well as foreign exchange market which regarded such new measures as a possible sign of reversal of the market friendly economic policies which were adopted and implemented vigorously since 1986.

On 3 September, 1997, the Indonesian government announced new economic measures to reform the domestic financial sector and attract inflow of external capital to the economy. The new policy measures removed the 49 percent upper limit on foreign purchases of new initial public offering and encouraged the liquidation or merger of insolvent banks. The government also reduced its spending on large infrastructure projects in order to improve budgetary position and to contain the deficit on the current account of the balance of payments.

On 31 October, 1997, the International Monetary Fund announced a special financial rescue package for Indonesia consisting of the first line of financing of the size of $ 23 billion and an additional $ 14 billion in the nature of the second line of defense which was to be contributed by several friendly countries. The first line of financing consisted of \$ 10 billion stand-by loan from the IMF, \$ 4.5 billion from World Bank, \$ 3.5 billion from the Asian Development Bank and the remaining amount from the friendly national governments. The second line of defense of \$ 14 billion was made available by several countries like Australia, China, Hongkong, special Administrative region of China, Japan, Singapore and the United States in the situation of unanticipated external circumstances. In a similarly gesture, Malaysia offered on 27 October, 1997, financial assistance to Indonesia upto \$ 1 billion to help ease the impact of the South East Asian currency turmoil. Continuing with its drive for economic reforms the government of Indonesia on 1st November, 1997 announced the cancellation of the licenses issued to 16 commercial banks as part of the financial restructuring plan to which it had earlier in October 1997 agreed with the International Monetary Fund. In next two days on 3 November, 1997 the government announced that it would cut import duties, relax regulations on the distribution and wholesale trade and further open up more industries to foreign investors. In addition to these measures, the Central Bank of Indonesia, Japan and Singapore announced that they had intervened jointly in the Singapore foreign exchange market to support the Indonesian currency, the Rupiah. It was intended to influence the exchange rates more effectively by showing their firm and cooperative stance to support the currency. The Rupiah could rebound somewhat as a result of these interventions but could not gain much ground.

In spite of number of measures that the Indonesian government and other governments of the friendly countries took, the Rupiah steeply plunged to a record low level of 6300 Rupiah to the Dollar on 24 December 1997 after a European investment house announced that Indonesia's external debt might be substantially larger than $ 117 billion, the official figure that was earlier reported by the government. This kind of information pointed to the fact that the international financial markets did not regard the financial reporting system as transparent and had not regained their confidence in the Indonesian economy and what is even more important in the implementation of the economic reform programme. On account of number of factors such as these, Moody's investor services, one of the widely trusted international rating agencies, severely downgraded the long term sovereign debt ratings of Indonesia, together with Thailand and the Republic of Korea to the level of "Junk Bonds". With this, the debt situation of these three countries was expected to deteriorate further. The severe downgrading of their rating dampened any hope of these governments to refinance their emergency borrowing from the IMF with issues on the international capital markets. By December 1997, the Indonesian Rupiah had declined by 58% against the Dollar as compared to its value at the beginning of the year.

One major change in the foreign exchange rate system that was under the serious consideration of the Indonesian government was to establish a currency board. Under this system, Indonesia wanted to peg the Rupiah at a fixed exchange rate with the Dollar at 5000 Rupiah equal to one Dollar. Under this arrangement, Indonesia's money supply would be backed by the Dollar reserves at the fixed foreign exchange rate. The most important economic policy implication of such an arrangement would be that the country would lose its ability to use monetary policy. The main advantage at the same time would be that it would bring monetary and fiscal discipline to the economy as, for example, the government could not expand money supply to finance a budget deficit unless such an expansion was backed by an equivalent amount of Dollar at the fixed foreign exchange rate. However, Indonesia did not, under those turbulent financial conditions, meet the requirements for the establishment of a currency board. The currency board would require the commitment to exchange domestic currency for Dollars at a fixed rate and also a commitment to issue currency only if it were backed by the Dollars. Moreover, such a system would presuppose that the country had a sound banking system. Indonesia at that time could not have met these requirements. On account of such reasons, at the end of February, 1998, the International Monetary Fund and the Indonesian government agreed to postpone the establishment of a currency board.

Another serious problem at that time was the crisis of the banking sector. The IMF reform package provided an outline of how the banking sector could be restructured and in response to this IMF requirement, the government announced the establishment of the Indonesian Bank

Restructuring Agency which was to help or takeover the banks facing serious financial difficulties. The objective was to have fewer but more efficient banks. The number of state controlled banks was to be reduced from 7 to 4 and the remaining 144 private banks were required to opt for either consolidation or mergers. The government with a view to restore confidence in the banking system, also announced the provision of a guarantee to all depositors and creditors of locally incorporated banks for at least two years. The deregulation of the financial sector would encourage foreign participation including granting permission to start full branching and removing the 49% upper limit on foreign ownership of publicity listed banks. The IMF reform package also required the Central Bank to undergo institutional changes in the light of its weaknesses in bank supervision.

The next financial problem which was related to the stabilization of the Rupiah was the private sector debt crisis. Without a stable currency, the burden of the external debt would keep on increasing and without serious prospects of debt reduction, the Rupiah would continue to be under pressure and would go on falling in value against the Dollar and other major currencies. The government made announcement of a voluntary temporary freeze on corporate foreign debt repayments and that was expected to reduce pressure on the domestic currency in the short run. As the debt crisis could not be resolved, the investor sentiment remained volatile.

Post 1997 Crisis Development :

As could be expected, the financial and currency crisis of mid 1997 brought about significant meltdown in the Indonesian economy. The growth momentum had already slowed down in 1997. The GDP growth rate turned negative in 1998 by -3% and the economy had hardly recovered from the shock administered by the crisis. The Indonesian economy had witnessed robust growth from mid 1980s, having growth rate of above 6% for most of this period. The following table presents the relevant information for three years -1998 to 2000.

Table : III.4 – Major Economic Indicators, 1998 – 2000[11] (Percent)

Item	1998	1999	2000
Gross domestic product growth	-3.0	1.0	4.8
Gross domestic investment / GDP	25.0	27.0	15.8
Gross domestic savings / GDP	24.0	25.0	25.1
Inflation rate (Consumer price index)	20.0	15.0	3.7
Money Supply (M2) Growth	25.0	26.1	15.6
Fiscal balance / GDP	0.0	3.0	-1.6
Merchandise exports growth	5.0	7.0	27.6
Merchandise imports growth	-5.0	2.0	31.9
Current account balance / GDP	-1.6	2.5	5.0
Debt Service / Exports	28.0	30.0	--

The gross domestic investment rate and the gross domestic savings rate came down steeply from the high level reached during 1991-1995. During these years, both these crucial variables driving economic growth were at almost 35% which were among the highest among the developing countries. These rates had come down to almost 30% in 1996 and 1997.

[11] Ibid, 1998 Page 87, and 2003 Page 70.

Under the severe impact of the unprecedented financial and currency crisis, both the rate of savings and the rate investment came down to almost 25%, the rate of investment falling to an exceptionally low level of 15.8% in the year 2000. with this the GDP growth rate turned negative 3% in1998, increased by a meager 1% in 1999 and then expanded by almost 5% in the year 2000, way behind the average rate of growth of 7% that the economy had sustained over the past 15 years. While the inflation rate steeply increased to 20% in 1998 under the impact of financial turmoil, it again came down to 3.7% during the year 2000. The fiscal balance could be maintained under the impact of the wide ranging agreement with the IMF. Again with the turmoil in the currency market, the growth rate of exports and imports was unimpressive. However, with the currency market stabilizing after three years, the exports and imports picked up their old momentum. With the inflow of foreign capital having dried up considerably, the economy was not in a position to sustain deficit in the current account of the balance of payments.

By September 2002, the outstanding external debt was $ 131.3 billion, about 13% less than at the end of 1998 after the exchange rate shock resulting from the financial crisis. Public sector debt, that accounted for 56% of the total external debt had not changed much from its level in 1999. The ratio of external debt to GDP that had gone to an alarming level of 159% in 1998 came down to 77% by end of 2002. This decline took place not because the debt stock had become smaller but because of increase in nominal GDP and stronger currency. Thus, the external position remained precarious and any adverse exchange rate movement could create an unfaourable impact on the debt burden indicators. Again the short term debt continued to be a significant fraction of gross reserves – and the external debt was 226% of exports in 2002.

The slow growth momentum was expected to continue for the next four years – 2001 to 2004. The GDP growth rate was expected to move around 3.5% to 4%. The crucial savings and investment rates were also not expected to reflect any significant turnaround. The rate of investment was estimated to remain around 15% less than half the level that prevailed during 1991 to 1995. The rate of savings was also estimated to come down to around 20%. All these important economic indicators implied that Indonesia was hit very severely by the financial and currency crisis of 1997 and far more severely than Thailand which would reach its per capital income level by 2003. "The country remains vulnerable to external shocks. Continued improvement in debt indicators and the capacity to service existing debt are dependent upon Rupiah stability. Higher oil prices during the first quarter of 2003 provided some short term windfall profits for the budget, but also exacerbated the political difficulties of moving administered energy prices to market levels. Stronger security measures have provided some confidence to the international community that the government is taking what steps it can to improve security. Continued efforts may find a pay off in a return of tourists to the country, although the SARs epidemic will affect the tourism industry in the first half of 2003".[12]

Conclusion :

Indonesian adopted the structural adjustment programme of the IMF and the World Bank in the early 1980's. Before that, it was a country that followed import substitution policy. From mid 1980s, its economy, benefiting from the export promotion policy in the realm of foreign trade, and other measures leading to liberalization of the economy, started growing quite rapidly. It could achieve very high rates of saving and investment that ensured a rate of growth of 4% and above. Its fiscal deficits and deficits in the current account of the balance of payments were never very large. However, it was also struck by the financial and currency crisis in August 1997 and could secure financial assistance from the IMF. Its currency – Rupiah – was not pegged to Dollar as Thailand had done. However, its financial institutions were very weak and the proportion of short term capital in the overall flow of capital was quite large. Once the confidence in the currency was shaken, the foreign capital left suddenly and by December 1997, its currency was devalued by a little above 50%. It thought of adopting the Currency Board System to impart discipline to monetary policy but the conditions were not favourable for such an experiment. Indonesia experienced severe fall in its saving and investment rate and its growth momentum slowed down considerably. It was by 2003 that it could recover

[12] Ibid Page 74.

the lost ground with adoption of economic policy measures, correcting some it of the weaknesses of its financial structure.

Indonesia suffered from severe deficits in the balance of payments because of the steep fall in the price of oil from 1982. It began to adopt reform measures with some hesitation from 1982 but went ahead with economic reforms more aggressively from 1986. Between 1986 and 1990, Indonesia could achieve growth rate of about 6.5% on an average. Indonesia continued with this high growth rates between 1991 to 1995 with very high investment rate and saving rate both above 35%. However, when Thailand was affected by the currency crisis in July 1997, Indonesia also came to be affected by the crisis and in the next six months its currency Rupiah had to be devalued by 50%. Indonesia agreed to undertake further reforms particularly regarding its financial institutions. The IMF and the World Bank provided sizable financial assistance to help it to overcome the crisis. However, it was only by the year 2003 that it could recover the lost ground.