# Indonesia: Ten Years After the Economic Crisis


## Sri Adiningsih*


## 1 Introduction

It is now a decade since the 1997 economic crisis hit Indonesia. Sparked off in neighbouring Thailand, the crisis was so deep and widespread that it was not until 2004 that the Indonesian economy was able to achieve a fully fledged recovery. Moreover, the economic reforms implemented under the IMF programme from October 1997 to 2003 made recovery efforts take longer than in other countries affected by the crisis. However, thanks to sound macroeconomic policies, financial sector restructuring and structural reforms, economic recovery eventually came to fruition. The deterioration of the social, economic and political environment – a consequence of the crisis – has also gradually been reversed. The economic crisis induced fundamental changes in the Indonesian economy, in the financial and non-financial sectors alike. In 2003, the country was able to graduate from the IMF programme. Supported by a strong foreign exchange reserves position, the Indonesian economy was able to bring forward the debt repayments owed to the IMF; and by October 2006, the country was able to repay the remaining debt of US$3.75 billion.

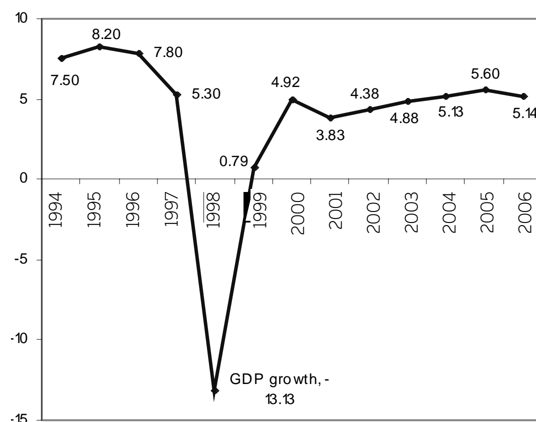
The economic reforms implemented to propel the economy out of crisis have in general been successful in creating macroeconomic stability. Fundamental changes have also been seen in the area of institutional and economic management, where a strong foundation for better economic development in the future has been laid. That said, it is not always the case that major reforms necessarily guarantee continued macroeconomic stability and sustainable economic growth. The Indonesian economy continues to be very vulnerable, and there is no better proof of this than the 'mini crisis' in the foreign exchange market, which hit the country in 2005, just a year after the recovery from the 1997 crisis had been fully achieved.

This article examines the Indonesian experience in dealing with the crisis. It describes the country's recovery from it and reforms undertaken, and identifies remaining sources of vulnerability facing the economy. It is organised into six sections. Following this introduction, Section 2 analyses the process of economic recovery and Section 3 the financial market developments. Section 4 analyses trends in capital flows and the level of international reserves. Section 5 discusses the remaining sources of vulnerability, and highlights the 2005 'mini crisis' as a warning call to the degree of vulnerability facing Indonesia at present. Section 6 concludes.

## 2 Economic recovery

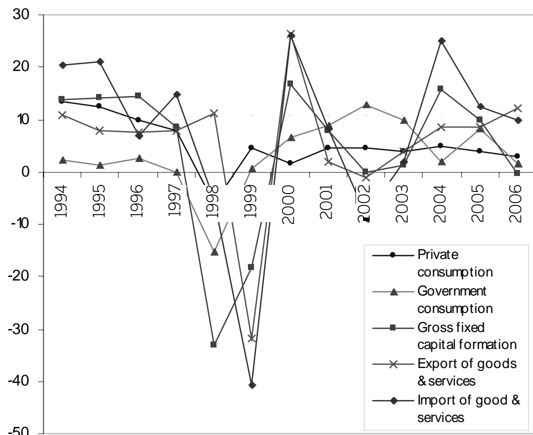
The economic crisis reached its peak in 1998 when the Indonesian economy experienced a severe 13.13 per cent GDP contraction. The year 1999 marked the start of the economic recovery phase.

**Figure 1 GDP growth (%)**




Note until September 2006.
Source Central Bank of Indonesia.

Figure 2 **GDP growth by expenditure (%)**




Note Until September 2006.
Source Central Bank of Indonesia.

The country's economic growth (Figure 1) has been around 5.5 per cent over the past few years.

In the recovery phase, a shift in the main drivers of the economy was observed, with domestic consumption replacing investment and exports as the main driver. At the sectoral level, industry, electricity and construction are no longer the main engines of growth; the engines are now limited to the transportation and electricity sectors. Some report signs of de-industrialisation in the country. The economy continues to be bedevilled by structural obstacles such as an unfavourable investment climate, low competitiveness and limited high-quality human resources. Moreover, the above factors are compounded by hurdles which the government faces in policy implemention in Indonesia. Thus, it is not surprising that the performance of the economy has been rather modest, when compared with that of the pre-crisis period.

## 2.1 **Economic growth**

Investment, consumption and exports were the main drivers of economic growth prior to the economic crisis. However, real economic growth plummeted from 7.8 per cent in 1996 to minus 13 per cent in 1998. Consumption, investment and imports contracted (Figure 2). The only exception to the downward trend was the export sector (including both goods and services), which showed positive growth in 1998.

Figure 3a **GDP growth by sector (%)**

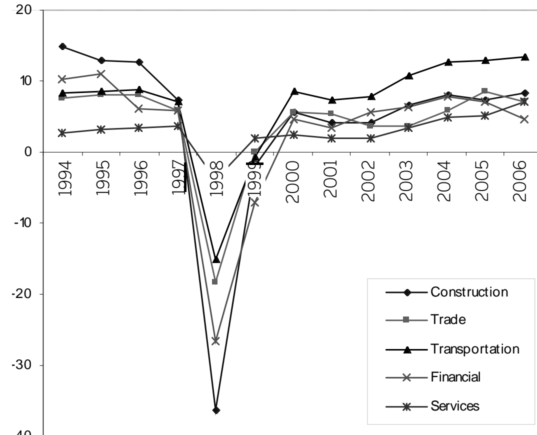
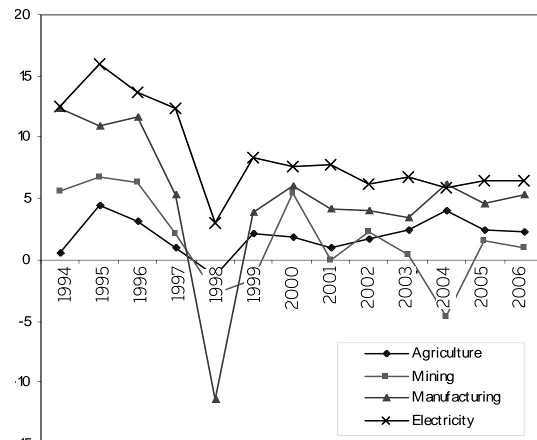



Figure 3b **GDP growth by sector (%)**

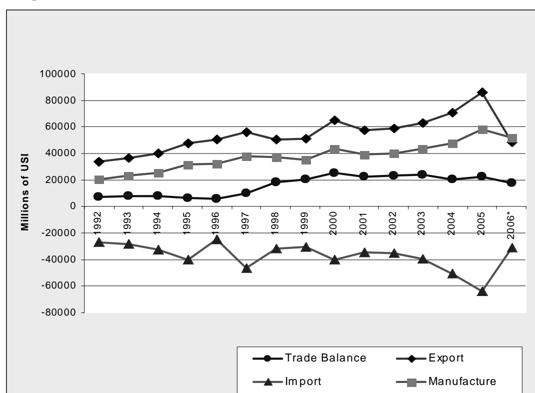



Note until September 2006.
Source Central Bank of Indonesia.

The economic crisis undermined growth in all sectors of the economy (Figures 3a,b), with the exception of agriculture, electricity, gas and clean water. Construction, trade, hotels and restaurants and the financial sector fared worst. The process of economic recovery started in 1999, when growth in consumption expenditure gradually moved into positive territory. The turnaround became more evident in 2000, when all sectors registered positive growth with the processing sector coming out as the best performer, followed by the trade and transportation sectors.

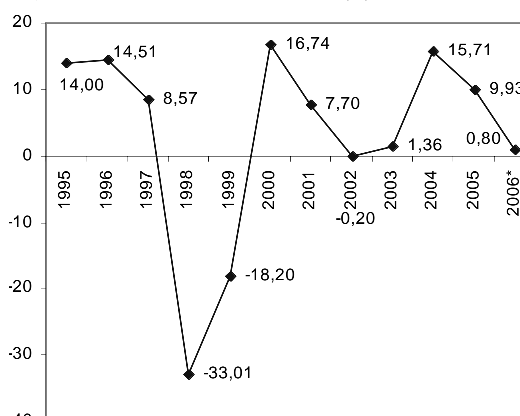
There are some signs that Indonesia experienced a de-industrialisation process. Such signs include the

**Figure 4 Indonesia's trade balance**




Note Data available until June 2006.
Source *Indonesian Financial Statistics*, Bank Indonesia, various issues.

**Figure 5 Growth of investment (%)**




Note until September 2006.
Source Central Bank of Indonesia.

tendency for the contribution of the processing industry to cause GDP growth to fall over the post-crisis period, despite strong recovery from 2000 as just highlighted; another factor was the reduction in employment generated by the industry. Two factors responsible for the decline in the contribution of the processing industry to GDP growth are the closure of some companies and the relocation of others to foreign countries. The aforementioned problems are, by and large, attributable to the government failure to resolve a number of outstanding issues in the country, that range from labour related issues, the multitude of regulations stifling business operations, tax bureaucracy, especially the lack of transparency in executing tax returns, and rampant smuggling.

### 2.2 International trade

After a decline in 1998–9, exports in 2000 showed signs of recovery. This was due mainly to an increase in non-oil exports as well as higher oil export revenues arising from high international oil prices. An upward trend in both exports and imports can be observed over 2000–5.

Textiles, textile products and electricity goods constitute important sources of non-oil exports for Indonesia. Plywood, palm oil, coal, rubber products, copper ores, chemical products, paper, iron/steel products and shrimps also have a significant role.

Despite the positive performance of exports in the aftermath of the crisis, a number of factors threaten its sustainability: growing competition with China and Vietnam, persistence of non-tariff policies in importing countries, and the high deposit margin demanded by foreign banks within the L/C (letter of credit) scheme. Meanwhile, strictly domestic related factors include: increase in production cost due to increases in fuel prices, electricity charges, illegal levies, unfavourable workers' regulations which reduce competitiveness, poor law enforcement and security, and higher interest rates on credit in Indonesia than other regional competitors.

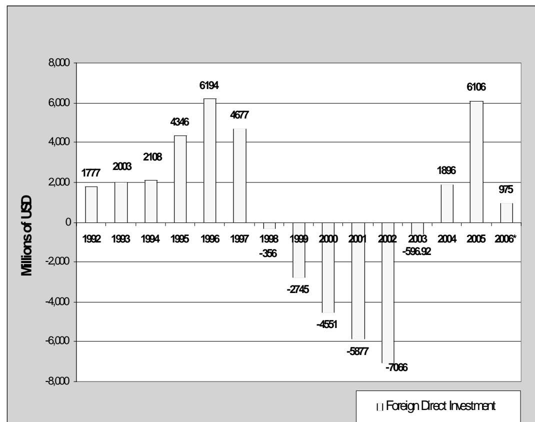
In turn, the trade balance (Figure 4) showed a large surplus after the crisis, which was more than enough to compensate for the deficit in service transactions, thereby contributing to a current account surplus. However, since 2001, the size of the current account surplus has been showing a downward trend due to the larger service deficit growth than the trade balance surplus, although a reversal in the trend started to be observed in 2006.

The rising deficit in the services account in the aftermath of the crisis was caused by the high cost of debt servicing by the government, an increase in transportation transactions, and the oil and gas sector deficit.

### 2.3 Investment

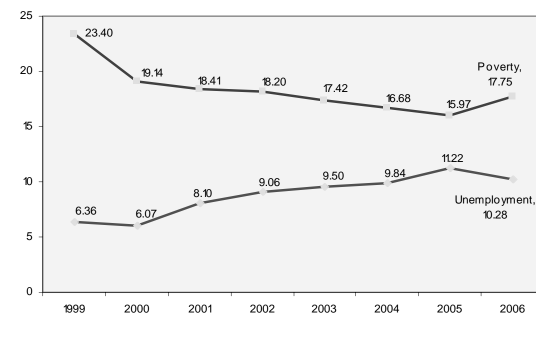
Prior to the crisis, Indonesia registered high gross fixed capital formation growth (Figure 5) hovering at about 14 per cent per annum. However, the onset of the crisis had a massive impact on gross capital formation, sending its evolution into negative

Figure 6 **FDI in Indonesia**




Note until September 2006.
Source Central Bank of Indonesia.

Figure 7 **Poverty and unemployment (%)**




territory during the 1998–9 period, followed by a turnaround which meant positive growth, more recently. Even then, the growth achieved so far is still below the levels achieved prior to the crisis; a common pattern across the crisis-affected countries (ADB 2007).

Net foreign direct investment (FDI; Figure 6) flows into Indonesia decreased drastically during the crisis, culminating in net negative flows as foreign investment outflows outweighed inflows. The FDI deficit reached a maximum of US$7.1 billion in 2002. However, in 2004, FDI flows registered a surplus of US$1.8 billion, which increased to US$6.1 billion in 2005. The higher FDI level in 2005 is due to foreign acquisition of the HM Sampoerna tobacco company by a US-based company. The FDI surplus for the first half of 2006 reached US$975 million.

The investment climate is not yet conducive enough to attract substantial foreign and domestic capital into the Indonesian economy.

Indonesia has earned a very low rank in a survey conducted by the International Finance Corporation (IFC 2005 and 2006) on Doing Business in Indonesia (Table 1) – ranked 135th in 2006, lower than the 131st rank earned in 2005. According to the IFC, Indonesia continues to experience serious problems that range from starting a business, processing operational permits/licences, labour issues, registering property ownership, paying taxes, implementing contracts and in closing businesses.

In a bid to promote economic growth, especially by increasing investment and production, the government issued three policy packages on infrastructure and investment in February 2006, and on the financial sector in July 2006.

The key component of the infrastructure policy package is the establishment of a Public Private Partnership (PPP) Centre, which is charged with the task of formulating the working model for government–private collaboration on infrastructure as well as the establishment of a financing agency responsible for financing infrastructure projects outside of the government. The investment package was issued with the goal of improving investment service delivery; customs and excise programmes; and tax incentives for investment. It has also included the revision of the value added tax for the promotion of exports; labour issues and the creation of a flexible and productive labour market; and policies on the empowerment of SMEs (Small-and Medium-sized Enterprises) and cooperatives. Sluggish performance of investment in Indonesia makes the package vital.

Meanwhile, the goal underlying the financial sector package has been the need to enhance the performance and efficiency of the financial sector which is seen as necessary for improving the investment climate. The financial sector policy package covers such areas as financial system stability, bank financial institutions, non-bank financial institutions and the capital market.

Nonetheless, the spate of policy packages so far issued by the government have not yet yielded

**Table 1 Doing business in Indonesia (comparing 175 economies)**

| Ease of … | 2005 rank | 2006 rank | Change in rank |
|---|---|---|---|
| Doing business | 131 | 135 | –4 |
| Starting a business | 161 | 161 | 0 |
| Dealing with licences | 129 | 131 | –2 |
| Employing workers | 141 | 140 | +1 |
| Registering property | 118 | 120 | –2 |
| Getting credit | 76 | 83 | –7 |
| Protecting investors | 58 | 60 | –2 |
| Paying taxes | 129 | 133 | –4 |
| Trading across borders | 55 | 60 | –5 |
| Enforcing contracts | 144 | 145 | –1 |
| Closing a business | 126 | 136 | –10 |

Source IFC.

significant results due to slow implementation of the policies and a host of other obstacles.

### 2.4 Unemployment and poverty

One of the adverse effects of the economic crisis was the rise in unemployment and poverty levels. Although Indonesia has made significant progress in economic recovery and growth, the unemployment rate remains high. According to the Central Bureau of Statistics (CBS) data, the rate of unemployment shows an upward trend (Figure 7). It was at 11.2 per cent in 2005, higher than the 8.1 per cent registered in 2001. The most recent CBS survey puts the rate of unemployment at 10.28 per cent in 2006.

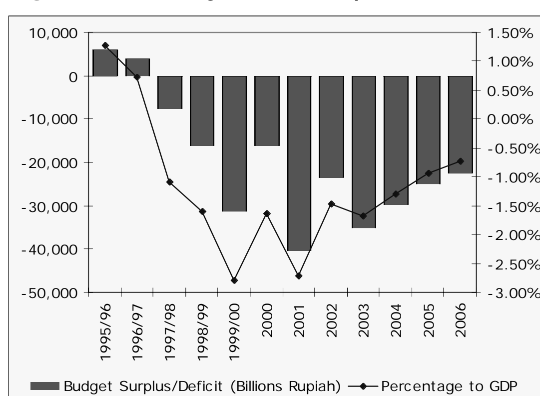
The economic crisis sparked off a sharp increase in the number of people registered as poor. To mitigate the impact the crisis had on people's living standards and on poverty, the government implemented emergency social security net programmes in 1998. Poverty incidence reached its peak in 1999, when 23.4 per cent of the population was categorised as poor. However, unlike the rate of unemployment, which continues to rise, poverty levels show a downward trend. Poverty incidence was 15.9 per cent in 2005. Nonetheless, the poverty level rose again to 17.7 per cent (CBS Survey of March 2006), partly as a result of the fuel price hikes observed in October 2005 (Figure 7).

***Recent developments of the fiscal and foreign trade indicators***

The economic recovery programme has drained the country's budget, pushing the budget deficit to unprecedented levels. In light of that, the Indonesian government embarked on fiscal consolidation measures which were aimed at reducing government debt and the budget deficit. Signs of success of fiscal consolidation measures began to emerge in 2001, with the fall in the debt as a proportion of GDP and the budget deficit decrease (Figure 8).

The rise in international oil prices in 2005 has put fiscal pressure on the national budget due to an increase in fuel subsidies. The policy adopted by the government in October 2005 to increase fuel prices has helped to reduce the effect of oil subsidies on the budget. As compensation for cuts in fuel subsidies, the government introduced the direct cash transfer programme for the poor. To finance this and other social sector programmes, it helps that tax revenues are rising over time as a result of intensification and widening of the tax base, supervision, and improvements in tax regulations. That said, Indonesian tax to GDP ratio remains at a mere 13 per cent, which is low even when compared with countries at a similar stage of development.

**Figure 8** State budget deficit/surplus




In the wake of the economic crisis, Indonesia established a stable deficit policy up to the present day. The deficit shows a downward trend since 2003, which is attributed to government endeavours to maintain fiscal sustainability and improvement in budget management. By 2006, the percentage of government debt to GDP had reached below 50 per cent. However, Indonesia being a relatively small open economy and characterised by vulnerable fundamentals, the ratio is still too high. The level of debt that is safe for Indonesia is believed to be around 30 per cent of GDP.

Financing the budget deficit comes from the domestic economy, especially banking and revenues generated by bond issues. Borrowing from abroad, especially project loans, is another source of financing the budget deficit. The Government Debt in 2005 had reached US$134,774 million, 51 per cent of which constitutes domestic debt and 49 per cent foreign debt (Table 2). In general, both the domestic and foreign debt are showing a downward trend, which will reduce the impact on the budget.

## 3 Financial market development

Banking reforms have involved improvement in the banking industry as well as supporting the development of Indonesian financial markets. The development of the non-bank financial institutions in Indonesia has been very rapid (Table 3), with their share of GDP increasing over time. Although the banking industry remains the dominant part of the system, and its asset values have increased over time, its share of GDP has declined, from 75 per cent in 2000 to 53.8 per cent in 2005.

### 3.1 Banking sector

The banking sector has experienced very rapid growth in Indonesia, especially since the financial deregulation package issued in 1983. As the primary financial institution in the financial market, the state of banks bear strongly on the Indonesian economy, which is why the 1997 banking crisis had so many dire consequences for the economy.

The problems facing the banking sector were aggravated by poor management during the initial

**Table 2** The position of government debt by duration

| Dalam Juta* (US$) | 2000 | 2001 | 2002 | 2003 | 2004 | 2005 |
|---|---|---|---|---|---|---|
| **External debt** | 60,796 | 58,814 | 69,789 | 68,939 | 69,471 | 66,066 |
| Total of GDP (%) | 46.7 | 48.2 | 48.7 | 47.3 | 49.7 | 49.0 |
| Short-term | – | – | – | – | – | – |
| Long-term | 60,796 | 58,814 | 69,789 | 68,939 | 69,471 | 66,066 |
| **Domestic debt** | 69,288 | 63,157 | 73,642 | 76,799 | 70,281 | 68,678 |
| Total of GDP (%) | 53.3 | 51.8 | 51.3 | 52.7 | 50.3 | 51.0 |
| Short-term | 1,358 | 2,018 | 3,029 | 4,100 | 2,412 | – |
| Long-term | 67,930 | 61,139 | 70,613 | 72,699 | 67,869 | 68,678 |
| **Total** | **130,084** | **121,971** | **143,431** | **145,738** | **139,752** | **134,744** |

* in million

Source Ministry of Finance, calculated.

**Table 3 Assets of Indonesian financial institutions, 2000–5 (trillion Rp)**

| | 2000 Value | 2000 % GDP | 2001 Value | 2001 % GDP | 2002 Value | 2002 % GDP | 2003 Value | 2003 % GDP | 2004 Value | 2004 % GDP | 2005 Value | 2005 % GDP |
|---|---|---|---|---|---|---|---|---|---|---|---|---|
| **Banks** | | | | | | | | | | | | |
| Commercial banks | 1,039.9 | 74.8 | 1,099.7 | 65.3 | 1,112.2 | 59.7 | 1,213.5 | 59.1 | 1,272.1 | 56.0 | 1,469.8 | 53.8 |
| Rural credit banks | 4.7 | 0.3 | 6.5 | 0.4 | 9.1 | 0.5 | 12.6 | 0.6 | 14.4 | 0.6 | 16.8 | 0.6 |
| Insurance | 52.4 | 3.8 | 64.9 | 3.9 | 70.4 | 3.8 | 88.3 | 4.3 | 105.8 | 4.7 | 75.1 | 2.8 |
| Pension fund | 30.0 | 2.2 | 34.9 | 2.1 | 41.2 | 2.2 | 49.5 | 2.4 | 107.1 | 4.7 | – | – |
| Pawn services | 1.4 | 0.1 | 1.8 | 0.1 | 2.4 | 0.1 | 2.7 | 0.1 | 3.5 | 0.2 | 4.8 | 0.2 |
| Finance company | 35.8 | 2.6 | 37.3 | 2.2 | 39.9 | 2.1 | 47.2 | 2.3 | 74.9 | 3.3 | 95.2 | 3.5 |
| **Capital market** | | | | | | | | | | | | |
| Shares issued | 225.8 | 16.2 | 231.3 | 13.7 | 241.3 | 13.0 | 251.3 | 12.2 | 257.8 | 11.3 | 267.2 | 9.8 |
| Bonds issued | 28.8 | 2.1 | 31.7 | 1.9 | 37.8 | 2.0 | 63.8 | 3.1 | 83.0 | 3.7 | 91.1 | 3.3 |

Source Bank Indonesia Annual Report, Ministry of Finance, CBS, World Bank.

stages of the crisis, which undermined public confidence. Falling public confidence compounded bank woes by inducing bank panics. Moreover, the steep depreciation of the Rupiah compelled the monetary authority to raise interest rates as high as 70 per cent (Bank Indonesia Certificate). Non-performing loans (NPLs) rose to about 60–70 per cent. The rise in NPLs, the banking structural and economic problems, and the unfavourable social and political situation which affected bank operations, drove the Indonesian banking industry into crisis. The banking crisis caused a steep decrease in financial intermediation as well as in other banking services. Thus, bank restructuring had to be undertaken in order to restore the soundness in the banking industry.

With regard to bank restructuring, the government undertook the re-capitalisation of banks then facing financial hardships, a process which led to large scale nationalisation of the banking industry. The immense financial resources spent in the re-capitalisation process reached Rp658.7 trillion (around 55 per cent of GDP), and had serious repercussions to the national budget. In addition, with the objective of restoring public confidence in banking institutions, the government implemented the full blanket guarantee policy on all bank obligations. Such a policy induced a shift in the public's preference from investing in alternative assets, to saving their money in banks, where it earned certain returns at lower risk. However, the full blanket guarantee policy has now been rescinded, in line with the establishment of the deposit insurance agency, which offers limited guarantee.

Key indicators underlying the health of the banking industry have shown remarkable improvement. Figure 9 shows the decrease in NPLs and an increase in capital adequacy ratio (CAR). Bank intermediation is back on track and is improving; a fact shown by the rise in the loan-to-deposit ratio (LDR). Credit expansion has pushed the LDR ratio to 66.2 per cent in 2005, far higher than the 33.0 per cent registered in 2001. Nonetheless, the recent macroeconomic instability has somewhat reversed the upward trend in LDR, as it fell to 65.3 per cent in September 2006 and also sparked an increase in net NPLs from 1 to 3 per cent during the 2002–4 period, to 5 per cent in 2005.

As regards credit disbursement by purpose/use, consumer credit registered the highest growth: 38 per cent in 2004 and 37 per cent in 2005. Meanwhile, investment credit grew at a lower rate, by 25.7 per cent in 2004 and 13.2 per cent in 2005. A similar trend is observed regarding working capital credit. This latter type of credit constituted the largest percentage of credit disbursed by the

**Figure 9 Indonesian banking sector performance (%)**

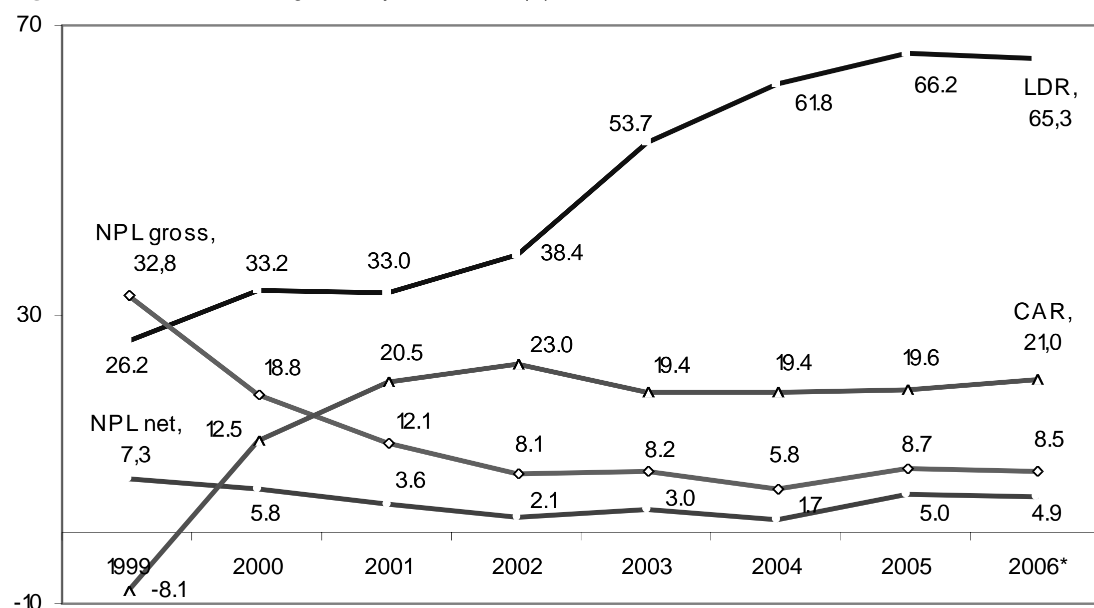



**Table 4 Developments in Indonesian bank credit, 2001–6**

| | 2001 | 2002 | 2003 | 2004 | 2005 | 2006* |
|---|---|---|---|---|---|---|
| Position (trillion Rp) | | | | | | |
| Working capital | 181.6 | 206.6 | 231.2 | 289.6 | 354.5 | 382.7 |
| Investment | 75.8 | 84.4 | 94.5 | 118.7 | 134.4 | 140.5 |
| Consumption | 58.6 | 80.0 | 109.4 | 151.1 | 206.7 | 217.9 |
| Total credit | 316.0 | 371.0 | 435.1 | 559.4 | 695.6 | 741.1 |
| Growth (%) | | | | | | |
| Working capital | 5.6 | 13.8 | 11.9 | 25.2 | 22.4 | 12.2 |
| Investment | 10.5 | 11.3 | 11.9 | 25.7 | 13.2 | 5.4 |
| Consumption | 39.0 | 36.5 | 36.8 | 38.1 | 36.8 | 9.6 |
| Total credit | 11.7 | 17.4 | 17.3 | 28.6 | 24.4 | 10.1 |
| Share (%) | | | | | | |
| Working capital | 57.5 | 55.7 | 53.1 | 51.8 | 51.0 | 51.6 |
| Investment | 24.0 | 22.7 | 21.7 | 21.2 | 19.3 | 19.0 |
| Consumption | 18.5 | 21.6 | 25.1 | 27.0 | 29.7 | 29.4 |
| **Total credit** | **100** | **100** | **100** | **100** | **100** | **100** |

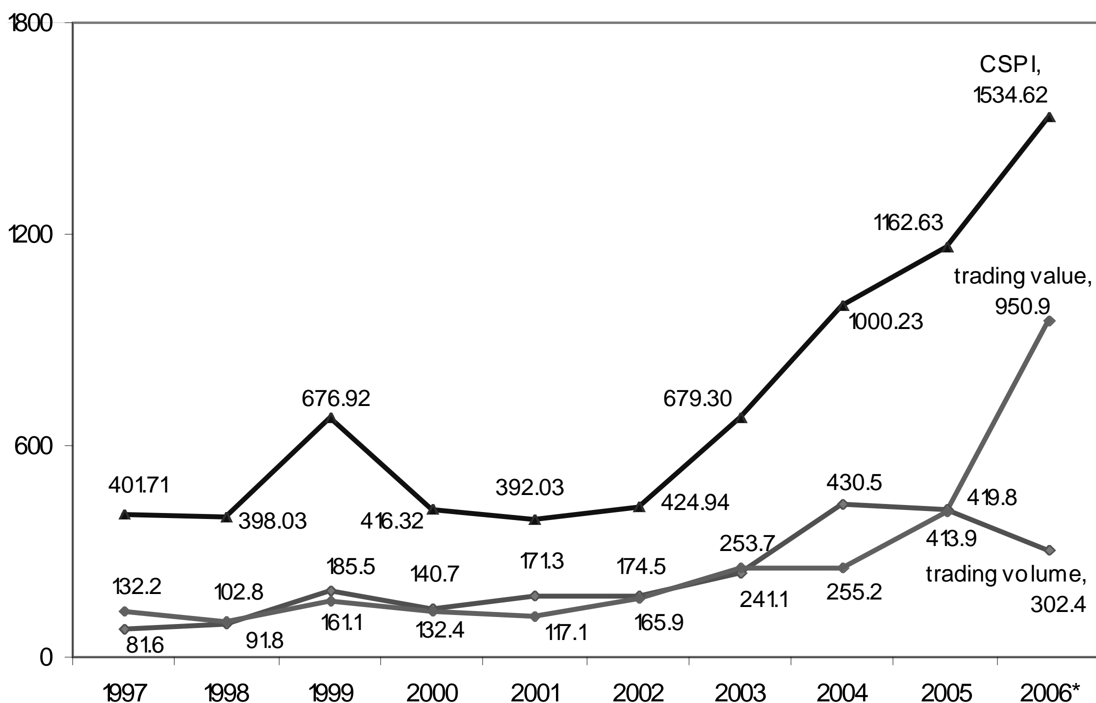
*September 2006

Source Central Bank of Indonesia, calculated.

Indonesian banking industry in 2005, registering more than 50 per cent of total credit, which is mainly channelled to existing debtors (Table 4).

The next phase of the banking reforms will be in four major areas, which will encompass sustaining the consolidation process, strengthening banking

**Figure 10 Transaction and Jakarta stock exchanges Composite Index**




*September 2006.

Note Trading volume in billion shares; trading value in trillion Rp. CSPI: Composite Share Price Index.

Source *Indonesian Financial Statistics*, Central Bank of Indonesia.

**Table 5 Foreign participation in the Indonesian financial market**

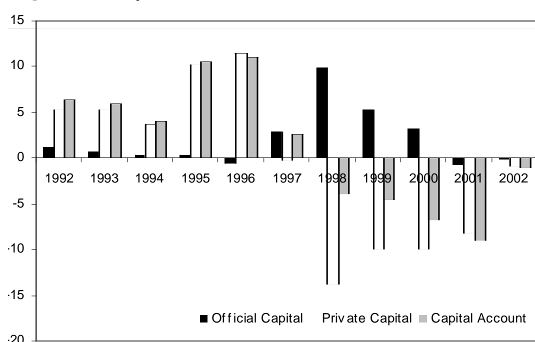
| | Ownership on Domestic Government Bonds (trillion Rp) | Total foreign trading (%) |
|---|---|---|
| 2000 | – | – |
| 2001 | – | 10.80 |
| 2002 | 1.04 | 8.00 |
| 2003 | 6.06 | 28.10 |
| 2004 | 10.74 | 41.00 |
| 2005 | 31.09 | 40.06 |
| 2006* | 53.97 | – |

*October.

Source JSX & Ministry of Finance.

infrastructure, bolstering prudential adherence in banking and the promotion of financial intermediation. Consolidation efforts will be carried out by strengthening bank capital through a shift in strategy from a market-driven to a light-handed approach.

**Figure 11 Capital account in Indonesia**




Source *Indonesian Financial Statistics*, Bank Indonesia.

Meanwhile, strengthening the banking infrastructure will entail the formation of the deposit insurance agency (Indonesian Deposit Insurance Corporation), human resource development in the banking sector and regulations on complaints mechanisms. Bolstering prudential banking will be done in accordance with the policy of adherence to the Basel Core Principles.

In transforming the banking industry, Bank Indonesia launched the Indonesian Banking Architecture (API) framework on 10 January 2004. The API framework, which is based on the vision of creating a sound, strong and efficient banking system that will ensure stability in the financial system, will provide the guiding principles for the development of the banking industry in the next 5–10 years. The vision is projected to come to fruition through the implementation of six interdependent steps: (1) healthy banking structure, (2) effective regulatory system, (3) independent and effective supervision, (4) strong banking system, (5) sufficient infrastructure support and (6) consumer protection.

Banking reforms have succeeded in improving the banking performance, but progress in certain areas is still slow, especially concerning credit expansion to the productive sectors.

### 3.2 Capital market

Economic recovery has stimulated capital market recovery. The number of new share issuers in the capital market, both initial public offering (IPO) and right issue in the capital bonds markets (especially government bonds), is rising. Figure 10 shows the capital market composite index which has risen rapidly from 2002 to 2006, and which made it one of the best performers in Asia and in the world. The development of the Jakarta Composite Index was the third best performer in the world in 2005, and the fifth best performer in 2006. Such a development points to good prospects for the emergence of a capital market that could become one of the main sources of financing in the economy. However, prudence needs to be exercised so that a possible bubble in the stock market does not become problematic.

Some of the factors that explain the buoyant performance of the stock exchange have been the improvement in investor confidence in line with marked progress in macroeconomic conditions in Indonesia, upgrading Indonesian government sovereign long-term debt denominated in Rupiah and foreign currency, and Indonesia's graduation from countries black listed for not cooperating in dealing with money-laundering related crimes. Besides, the inclusion of some blue chip shares in the ASEAN index, based on the composition of large market capitalisation value, high liquid transactions and significant public ownership criteria, provided positive sentiments that boosted capital market activities, and served as incentives that attracted foreign investors.

Foreign participation is increasing in the capital market (Table 5), which can be construed from the increase in portfolio investment since 2002. However, the high short-term capital inflow into the capital market has the potential danger to increase vulnerability. The country should observe it with caution because short-term capital can easily exit the economy, sparking off financial market instability.

Derivative transactions in Indonesia, which are carried out by Surabaya Stock Exchange Bursa Efek Surabaya (BES) have very little value; Rp1.3 trillion in 2004 or 2005. The market has not developed to any real extent in Indonesia, making its existence insignificant in the financial market.

## 4 Capital flows and reserves

### 4.1 Capital flows

In 1998, large private capital outflows resulted in a large deficit in the capital account of the balance of payments (see Figure 11).

From 2002 onwards, the capital and financial account deficit started to decrease as a result of

**Table 6 Developments in indicators of Indonesia's external vulnerability (%)**

| Details | 1996 | 1997 | 2002 | 2003 | 2004 | 2005 |
|---|---|---|---|---|---|---|
| Current account to GDP ratio | –3.4 | –2.3 | 3.9 | 3.4 | 1.2 | 1.1 |
| Export goods and services to GDP ratio | 25.7 | 29.1 | 33.9 | 29.7 | 31.1 | 32.9 |
| Non-oil export to GDP ratio | 16.7 | 19.7 | 23.2 | 20.5 | 21.6 | 23.3 |
| Payment of external debt interest to GDP ratio | 2.7 | 3.0 | 2.7 | 2.3 | 2.2 | 1.7 |
| Payment of external debt (principle and interest) to export ratio | 35.9 | 44.5 | 33.1 | 34.1 | 30.1 | 25.3 |
| Capital account to GDP ratio | 4.8 | 1.1 | –0.6 | –0.4 | 1.0 | 2.2 |
| External debt to export goods and services ratio | 188.7 | 207.3 | 193.9 | 190.8 | 174.3 | 142.9 |
| External debt to GDP ratio | 48.5 | 60.3 | 65.7 | 56.8 | 54.2 | 47.0 |
| Reserves to external debt payment ratio | 91.2 | 73.4 | 142.9 | 158.9 | 153.6 | 147.2 |
| Reserves to external debt ratio | 17.4 | 15.7 | 24.4 | 26.8 | 26.5 | 26.0 |
| Reserves to import and government external debt payment (months) | 5.0 | 5.5 | 6.6 | 7.1 | 5.5 | 4.4 |
| External debt (US$ billion) | 110.2 | 136.1 | 131.3 | 135.4 | 137.0 | 133.5 |
| Foreign reserve (US$ billion) | 19.1 | 21.4 | 32.0 | 36.3 | 34.7 | 34.7 |

Source Annual Report Central Bank of Indonesia.

increasing private capital inflows, mainly in the form of portfolio flows and later FDI, and a decrease in private sector debt servicing commitments, especially in the banking sector.

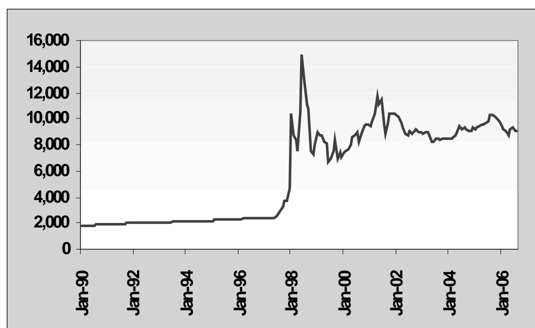
From 2002 to date, private capital flows to Indonesia are thus mainly in the form of short-term portfolio investment. FDI was negative until 2004, due to the persistent unfavourable investment climate, and strong competition in the Asian region, especially from China.

Private capital flows registered an increase in surplus from US$4.4 billion in 2004 to US$5.1 billion in 2005. The increase arose from a surge in net portfolio investment and net FDI inflow in 2005. However, in the second-quarter of 2005, a net outflow of foreign investor funds took place sending the account into deficit in that quarter. The large capital outflow was caused by factors such as the fall in public confidence in the Rupiah and the impact of the fuel price hikes on the sustainability of the fiscal policy. The increase in portfolio investment from 2002 to date must be observed with caution, as it shows high sensitivity to changes in macroeconomic and international conditions.

### 4.2 Reserve level

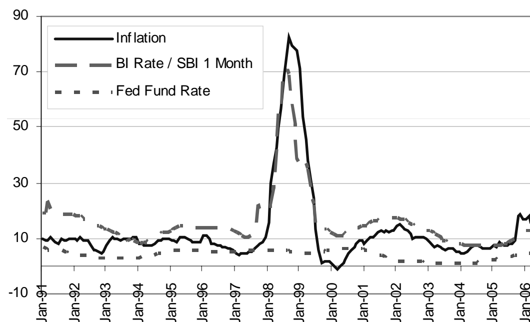
The level of reserves of Indonesia, burdened by both large long-term and short-term debt, should not be limited to the capacity to meet import payments. Equally important is to have the capacity to meet short-term outflows from international liabilities and broad money in anticipation of potential capital flight, to avoid the effect of strong foreign currency market fluctuations on the economy. Thus, the level of foreign reserves should be enough to enable the country to pay for its imports for at least three months, pay for short-term obligations and also account for broad money requirement and potential capital flight. Today, however, the current international reserve position in Indonesia is just sufficient to pay for imports and debt servicing commitments for four months. Some key international reserve indicators such as the international reserve to external debt servicing ratio, the international reserves to total foreign debt ratio and international reserves to imports and government debt payments plus interest, are shown in Table 6.

**Figure 12 Exchange rate (Rp/US$)**




Source IFS.

**Figure 13 Indonesia's inflation and interest rate (%)**




Source IFS, Bank Indonesia & US Federal Reserve.

More broadly, the level of international reserves Indonesia has had from 2001 to 2006 (September), has been just enough to pay for the country's import requirements for six months. The international reserves position in 2005 stood at US$34.7 billion, while payment for three months' imports required US$17.4 billion, and debt servicing needed US$24.4 billion. Nonetheless, the level of international reserves the country had fell far short of the total external debt obligations in 2005.

The opportunity cost always influences the decision to hold reserves, especially if the level of reserves is large. If the domestic interest rate is higher than that in the USA, the cost of holding international reserves increases. Thus, the level of reserves should be the level at which the marginal cost of holding reserves equals the marginal benefits derived from doing so. Research suggests that higher foreign reserves can help reduce sovereign spreads as well as improve credit ratings, and hence narrow the cost of holding it. Their main advantage is, of course, reducing the risk of crises. So, the greater the value of reserves, the lower the cost of borrowing, which should be weighed against the cost associated with interest rates differential.

In some cases, the central bank may choose to mop up liquidity that arises from reserve accumulation through sterilisation. This is sometimes necessary if the government has large sums of foreign exchange. Nonetheless, the case of Indonesia, with its relatively small reserve level, makes the issue of cost arising from sterilisation not a crucial one.

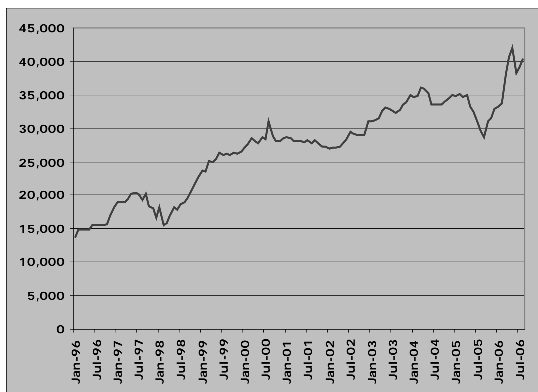
## 5 Vulnerability

Macroeconomic stability is gradually showing signs of returning to normality. Inflation, foreign exchange availability, interest rates, international reserves, budget deficit, the current account and the balance of payments are all indicators that point to overall improvement in Indonesian macroeconomic conditions. Nonetheless, the large government debt, the external debt, and the huge volume of short-term inflows into the Indonesian economy are factors that pose a potentially serious threat for economic stability in the future.

Even today, the economy remains quite vulnerable. Evidence of that were the nerves observed in the economy in mid-2005, partially due to high fuel prices, which hovered around US$70 per barrel on the international market. Specifically, the oil price hikes in mid-2005 had a destabilising effect on Indonesia's economy, as the government was left with no alternative but to increase domestic fuel prices by an average of 127 per cent. The hikes in gasoline prices sparked off increases in other prices, sending the inflation level to 17 per cent in 2005 (Figure 13). In August 2005, the rupiah experienced a mini crisis (as the World Bank puts it), caused by loss of market confidence in the monetary policy and concerns over the impact of increasing oil price on the state budget (Figure 12).

The rupiah was pushed up to nearly Rp11,000/US dollar in August 2005, the lowest since 2002. The crisis affected the international reserves position, which decreased from US$35 billion in early 2005 to US$28 billion in September 2005 (Figure 14). In response to such developments, Bank Indonesia adopted a tight monetary policy to avert a recurrence of the 1998 crisis, taking measures such as raising the interest rate on the Bank of Indonesia

**Figure 14 Indonesia's foreign reserve minus gold (million US$)**




Source IFS.

(BI) rate from 8.5 per cent in July 2005 to 12.75 per cent in December 2005.

By 2006, the macroeconomic turmoil was under control, allowing Bank Indonesia to resume its gradual interest rate cuts on the BI rate, which declined to 9.75 per cent by December 2006 (Figure 13). The inflow of short-term funds into Indonesia was resumed, thereby helping increase the level of international reserves once again. This has led to the restoration of macroeconomic stability. However, the rupiah faces vulnerability because its strength depends heavily on short-term capital inflows. Moreover, the impact of the mini crisis on economic growth, poverty and unemployment will take time to overcome.

## 6 Conclusion

The economic crisis, which rocked Indonesia in mid-1997, has taught Indonesia some vitally important lessons. The crisis that started as an exchange rate crisis of the rupiah, became a fully-fledged economic crisis. Indonesia, being a fairly small open economy, is increasingly becoming integrated into the global financial system, which increases its vulnerability to fluctuations in foreign markets.

The crisis made economic reforms imperative. The economic reforms which began with the policy package embodied in the IMF *Letter of Intent* (LoI) and *Memorandum of Economic and Financial Policies* (MEFP), hopefully laid a strong foundation for a sound economy, even though initially they had some very negative effects. The economic reforms encompassed the macroeconomy, financial sector restructuring and structural reforms. Consequently, many changes have taken place in Indonesia's economic institutions, taking the form of laws, or formation of new institutions and amendment of the Indonesia constitution. Financial market reforms, especially in the banking sector, have laid a strong foundation for a sound/healthy and efficient banking industry. A similar trend is apparent in the development of other financial institutions, which have registered remarkable progress since the crisis. However, the development of the non-financial sectors, especially the productive ones, continues to be slow, despite a number of policies implemented in their support. The result has been the development of the financial sector, which is not in consonance with that achieved by the non-financial sector. The poor performance of investment activities and, linked to that, the productive activities, has aggravated the situation. Doubtless, there is a wide gap between the performance of the financial sector and non-financial sector in Indonesia. The above drawback is compounded by the increase in short-term capital flows which, mainly lured by remarkable developments in the domestic financial markets, pose a potential threat to macroeconomic stability. The mini crisis that affected Indonesia, just a year after the country had graduated from the IMF programme, is a strong reminder of the high vulnerability of the Indonesian economy.

Indonesia will face formidable obstacles in maintaining macroeconomic stability in the future. The dilemma Indonesia faces is that in order to attract short-term capital flows, it must provide high returns, achievable with a high interest rate regime; while the low investment in the economy demands the adoption of low interest rates. Thus, in the short term, the government and the monetary authorities must find a solution to reduce the over dependence of the economy on short-term capital inflows, thereby diminishing the vulnerability of the economy from such an unstable and volatile type of capital. This is particularly the case because the country has fairly low foreign exchange reserves.

## Note

* This article was written with the help of Ahmad Adi Nugroho, Ratih Pratiwi Anwar and R. Awang Susatya Wijaya.

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