NORTH-HOLLAND

Journal of Asian Economics 13 (2002) 577–596

JOURNAL OF ASIAN ECONOMICS

Indonesian economic recovery process and the role of government

Sri Mulyani Indrawati[a,b]

[a]*Department of Economics, University of Indonesia, Jakarta, Indonesia*
[b]*Andrew Young School of Policy Studies, Georgia State University, Atlanta, GA, USA*

Received 1 June 2002; received in revised form 1 July 2002; accepted 1 August 2002

Abstract

Indonesia is currently known as a country adopting the wrong sequencing in their liberalization process. Despite impressive economic performance in the 30 years before the recent crisis, Indonesia suffers from several weaknesses and vulnerabilities in both banking and corporate arenas. The Indonesian economic crisis was caused by a sudden loss of market confidence leading to abrupt capital outflow. The IMF plan was designed to regain and restore the market by imposing wide-ranging programs, but the designated steps are not without criticism.

Sustainability of economic recovery in Indonesia depends on two important programs, stability in the macroeconomic environment, and the implementation of a sound and credible restructuring of corporate debts along with strengthening of the banking institution. Public policy process outcomes are becoming complicated and difficult to predict under the democratic system. Indonesia's legal and judicial systems are still very weak, and often unable to safeguard public interest. Such weak quality institutions combined with the new political competition will, at least in the short run, result in more policy distortions, with the burden of cost shouldered by public interest.
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JEL classification: E0; E6

Keywords: Asian economic crisis; Liberalization sequence; Banking crisis; IMF stabilization program; Market confidence; Banking restructuring; Corporate debts restructuring; Public debts; Public policy process; Democratization

E-mail address: prcsmi@langate.gsy.edu (S.M. Indrawati).

1049-0078/02/$ – see front matter © 2002 Published by Elsevier Science Inc.
PII: S1049-0078(02)00176-8

1. Introduction

The Asian economic crisis began in 1997 and the struggle for recovery still continues after more than 5 years. Voluminous books and articles have been published about the Asian economic crisis, most of them attempting to explain the cause. Indonesia is among the countries hardest hit by the crisis. Despite achievements of high economic growth, poverty reduction, and maintenance of macroeconomic stability over the past 30 years, Indonesia suffers from several economic weaknesses. Problems existed prior to the crisis and were aggravated during the crisis. This raises the most important concern about how Indonesia will sustain its economic recovery from the most devastating crisis in the past 40 years.

Indonesia was suffering from a vulnerable balance of payment structure before the crisis. Persistent current account deficits from the services sector were funded mainly by government foreign debts, and right before the crisis were also supported by an influx of private, especially short-term, capital. A policy of free capital flow was adopted by Indonesia in the late 1960s, together with a policy to liberalize foreign investment. Yet, this decision was not based on appropriate policy sequencing, as was advocated by Washington consensus. Although free capital flow policy served the Indonesian economy well until the mid 1990s, the absence of a mechanism to manage and control short-term capital—especially under conditions of increasing international capital flow—makes Indonesia vulnerable to any potential capital shocks.

Indonesia is currently known as a country adopting the wrong sequencing in their liberalization process. McKinnon (1973, 1993) suggests that capital control should only be lifted at the end of liberalization, i.e., after financial liberalization, bank reform, and trade liberalization. The Indonesian case lends support to this analysis. After adopting free capital flow, Indonesia's banking sector continued to suffer from repression and heavy interventions. The central bank was far from independent, both in conducting its monetary policy and in regulating and supervising banks. A partial liberalization of the banking sector, introduced in the mid 1980s, caused an increasing *number* of banks, but with weak structure and owners of questionable character. At the same time the real economy was still suffering from major distortion policies, including high tariff protection, unfair competition, and pervasive practices of monopoly and oligopoly (cartel).

During this period, the economy accumulated high levels of vulnerability in both banking and corporate structure. Conglomerate businesses grew aggressively and dominated economic activities in all regions of Indonesia. Most private domestic banks were owned by groups of companies (conglomerates) who primarily used the banks for financing their other businesses, without regard for legal lending limits. State-owned banks were also abused, with funds being channeled into poorly run state government projects and high-risk projects owned by President cronies. Conditions in the banking sector were weak, both in terms of capital adequacy and in terms of risk management. Yet, even with bad governance and a lack of transparency and public accountability, companies in Indonesia still enjoyed wide trust and were able to expand business progressively, using debts from both domestic banking and foreign sources. Overleveraging companies matched with imprudent banking and lending policies, created superfluous financial risks for both the companies and banks.

Meanwhile, huge and rapid capital inflow caused a real appreciation of the exchange rate that eventually dampened exports and boosted imports. Such conditions discourage removal of protection and further aggravate economic distortions.

2. The crisis and the IMF program

The economic crisis was marked by a contagion effect of the Thai Bath collapse, leading to investor panic spreading to neighboring countries across the Southeast Asian regions. The process was followed by a sudden and huge capital outflow from the region. After enjoying private net-capital inflow of up to $11.5 billion before the crisis in 1996, Indonesia suffered reverse net-capital outflow of more than $13.8 billion in 1998 (Fig. 1). Central Bank's decision to widen the exchange rate band, and follow with a free floating exchange rate, was intended to maintain Indonesia's limited foreign exchange reserve. Following the free floating of exchange rate stem, the Rupiah began to fluctuate wildly with volatility beyond any theoretical explanations. With the collapse of the Rupiah, business viability was shattered, and investor panic ensued. Creditors withdrew capital, demanded immediate repayment of debts, and stopped extending new credit. This worsening trend occurred in massive and alarming ways, and lead to severe capital account deficit.

Unlike the balance of payment crisis experienced by many countries in the 1970s and 1980s, which was triggered by current account problems primarily due to external trade deficit, the Asian crisis in late 1990s was caused by a sudden crash and loss of market confidence leading to abrupt capital outflow from countries like Indonesia. IMF program design in these crisis countries was intended to restore market confidence, and result in the return flow of capital. But market confidence is an abstract and difficult concept, and even more problematic when translated into a set of policy actions. To restore market confidence, the IMF imposed wide-ranging programs, including macroeconomic stabilization policies accompanied by very wide yet deep and demanding structural policies.

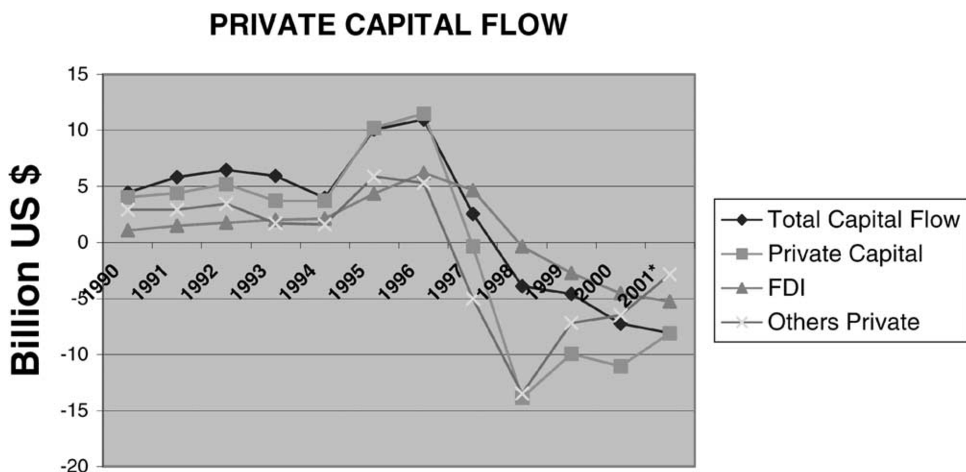

Fig. 1. Private capital flow before and after crisis.

The first IMF program in Indonesia was introduced in October 1997, early on in the crisis, and was subsequently followed by many updated versions. These programs were deemed to be broad, unfocused, ambitious, and most of the time unrealistic, especially considering the fragile and shaky political transition in Indonesia that limited government capacity to implement the programs on rigid schedules. Criticisms of the IMF programs in Indonesia can be classified into two different types. The first set of criticisms involves the technical content of the program and the quality of the recommended policies. The second area of criticism focuses on the appropriateness of the program in terms of compatibility with the policy process, the timing and sequencing of program requirements, and the capacity of government to implement them.

2.1. Technical content of the program

Facing a potential economic downturn that threatened to deteriorate fiscal conditions, the IMF's response was to insist that the government immediately cut expenditures and increase revenues. Indonesia was ordered to generate a 1% of GDP budget surplus for fiscal year 1998–1999, but fiscal contraction created an extreme collapse in domestic aggregate demand in 1998. In response to the situation, the IMF changed its fiscal policy by allowing the government a budget deficit of 1% of GDP. This figure grew to an 8.5% of GDP deficit within less than 6 months from the first recommendation. However, the policy shift did not have the intended impact (Fig. 2), both because the economy did not respond instantly to this policy shift, and because the government was in the middle of a difficult political transition that affected fiscal effort. Such extreme yet ineffectual policy prescriptions have created a negative impact on the credibility of the IMF program.

To defend Indonesia from speculative attack early in the crisis, the IMF recommended a drastic measure of monetary tightening by increasing the domestic interest rate from around 20% to above 80% per annum. Rising interest rates deteriorate a borrower's net worth, leading to massive bankruptcy. This raises non-performing loans within banks, causing credit crunches, and accelerating further economic contraction. A steep increase in the interest rate amplifies the probability of default and commercial risks, and when combined with political turmoil, will induce capital flight. As Furman and Stiglitz (1998) state,

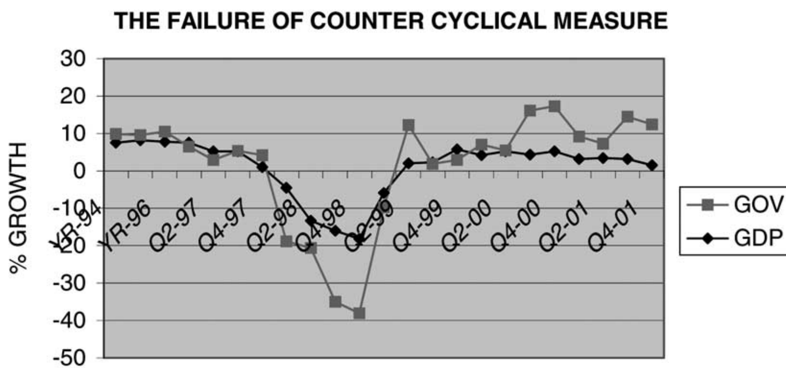

Fig. 2. Failure of fiscal counter cycle.

temporary increase of the interest rate was apparently not helping Indonesia in strengthening its currency, both because the exchange rate problem was more permanent, and because the credibility and commitment of the government in pursuing such policy, and economic reform in general, was sliding drastically during this difficult time. Benefit in the form of a strengthened exchange rate was not realized from the drastic increase in interest rates, rather, negative impacts on the economy were readily observed.

The most turbulent and difficult period during the crisis was in 1998, when massive capital outflow was induced and irrational investor behavior began to manifest. During this period, the IMF demanded that Indonesia keep the free exchange rate and free capital flow policies, while further liberalizing trade policy by lowering tariffs to almost 0% across the board and abolishing many non-tariff barriers. This policy was insisted upon despite the fact that Indonesia's problem was more that of capital account stability, and the fact that Indonesia was among those countries that had already adopted very progressive trade liberalization policies before the crisis. With monetary and fiscal policies that were ineffectual in restoring stability, Indonesia was left with no alternatives to protect her in a vulnerable situation.

Helplessly facing the extreme volatility of the exchange rate, thoughts of the possibility of adopting capital control in order to stabilize balance of payment and Rupiah currency were frequently broached by the public. Restrictions on capital mobility as a means of reducing macroeconomic instability have been discussed since the initialization of the Bretton Wood system. Tobin introduced global tax on foreign exchange transactions to reduce destabilizing speculation in international financial markets. Several economists, such as Krugman (1998), Stiglitz (2000), and Eichengreen (1999), also support limiting capital flows for developing countries under certain market conditions.

Still, capital control policy is not without opposition. Some studies suggest that capital control may lead to a destabilizing effect by encouraging capital outflow and precipitating increased financial instability. Capital control acts like a form of investment irreversibility, i.e., by making it more difficult to get capital out in the future, controls may make investors less willing to invest in a country. This situation could even further worsen the condition of the current balance of payment in Indonesia. Bartolini and Drazen (1997) state that imposing capital control can send a signal of inconsistent and poorly designed future government policies. This is especially true when the reputation and credibility of government commitment to economic policy is stumpy and doubtful, as in the case of Indonesia. Capital control can easily be circumvented by domestic and foreign residents and firms, and will lead to economic distortions and government corruption. This will even further erode the credibility of the government and the Central Bank, contributing to economic instability. Capital control has a significant negative effect on foreign borrowing and can be interpreted as a means of enforcing financial repression in the economy. It is also associated with a lower domestic interest rate, thus, limiting international arbitrage in asset markets.

As shown in the Indonesia case, capital control provides scant effectiveness in averting currency crisis if not accompanied with other economic policies. Some observers noticed that the motive of the Indonesian government, especially that of President Soeharto, in initiating any policies relating to exchange rate and capital control, was mainly to avoid the implementation of economic reform, or even to expel the IMF from Indonesia. Lack of trust and conflicting positions between President Soeharto and the IMF made it impossible to

establish an environment conducive to a policy dialogue that would help identify the best alternative policies to protect the interests of Indonesia. Any attempt to introduce alternative policy even on a temporary basis, such as capital control policy, was declined by the IMF. The IMF allowed Indonesia to put a limit of only $5 million per customer on forward foreign currency trading between banks and non-residents. This situation raised a strong public perception that the IMF declined alternative exchange rate and capital flow policies for Indonesia on the basis of political, rather than technical, economic reasoning.

Financial restructuring is at the heart of the IMF program in Indonesia. As mentioned earlier, Indonesian banking conditions, even before the crisis, were in bad shape. The IMF prescription to remedy these banking problems consisted of closing insolvent banks and recapitalizing and restructuring viable banks. Strengthening bank supervision and establishing Central Bank independency also became an important part of the program. The first, and apparently the most controversial, step in the financial restructuring program was the closing of 16 banks in November 1997. That decision was seemly based on simple but sloppy logic. These banks were very small, comprising only around 2.5% of the assets of banking sector, hence it was believed that this action would not create complicated problems and would definitely be supported by the market.

Indonesia has had no experience in bank closures since the early 1970s, with the exception of one bank closing, which was motivated by political factors. It was known to the public that some banks that had suffered serious difficulties or even solvency problems before the crisis were never disciplined in the form of closing. Instead they received capital injections from Bank Indonesia. Bank Indonesia had no credibility in enforcing bank supervision and prudential rules, and repeatedly acted as lender of first resort to banks. These situation created a moral hazard for both bank managers/owners and depositors. Depositors never expected any bank closing, regardless of how poorly the bank was managed, and bank managers and owners engaged in excessive and careless lending practices despite prudential regulations.

Under a legal and judicial system that was not functioning, and with pervasive, morally hazardous attitudes of depositors, bankers, and owners, the IMF forced Bank Indonesia to close 16 banks as the first action of the bank restructuring program. Without appropriate public explanation regarding the overall bank restructuring program, clear and credible criteria defining bank closure candidacy, or any preparation to handle post bank closing effects in the form of a reliable guarantee scheme for depositors, the IMF decision to close these small banks only triggered a subsequent banking disaster. Public trust in domestic banks crumbled because of the uncertainty regarding the future fate of any domestic, especially private, bank. Bank runs in the form of transferring deposits from private to state banks occurred pervasively, threatening bank liquidity and the functioning of payment systems.

The Indonesian government and the IMF were totally unprepared for the negative and unintended consequences of a serious loss of confidence in the market. The blunder of closing banks in this initial IMF program was mainly due to: (a) miscalculation of the underlying (political and legal) factors of the Indonesian banking system, (b) a failure to understand public perception about the domestic banking system, and (c) underestimation of the magnitude of the consequences. This initial failure exacerbated banking conditions rapidly and in the end forced Indonesia to bear a very costly bank reform program.

2.2. Policy process and government capacity

The October 1997 decision to invite the IMF to help with the Indonesian economic situation, although formally agreed to by President Soeharto, was in fact not fully supported by him. Thus, a lack of ownership of the economic reform strategy was apparent from the very beginning of the IMF's involvement in Indonesia. This problem was exacerbated in the subsequent months, partially by the IMF's failure to properly address the ownership issue. President Soeharto perceived the IMF programs as a specific attack upon the interests of his family and cronies. Many policy steps lacked clear correlation with the capital account crisis, including abolition of the national car project, elimination of monopoly and cartel practices (such as those in clove and cement trading), and cancellation of many big infrastructure projects. Indeed, the IMF program received popular political support from the majority of Indonesian people, who for many years had felt discontent and injustice under the leadership of President Soeharto.

Besides popular support from the Indonesian people, the IMF was not able to achieve significant progress. President Soeharto was apparently becoming part of the problem rather than a source of solution for the economic crisis. To deal with this, the IMF demanded a stronger personal commitment from President Soeharto himself. Under unusual protocol, the IMF asked President Soeharto to sign a second letter of intent, which he did on January 15, 1998. The famous headline picture of President Soeharto signing the letter, in front of IMF Managing Director Michel Camdessus, was seen as a humiliation both to the President personally and to the country at large. From this time on it was just impossible to get the support and cooperation from the President and his government to implement the 50 policy actions prescribed by the IMF; now there was a *definite* lack of ownership of the programs. Half-hearted support of IMF program initiatives from the President evolved into more open confrontation after President Soeharto was reelected in March 1998. The outcome was a continued worsening of market confidence. President Soeharto's battle against IMF programs and against increasing political pressure was ended by his resignation in May 1998.

Vice President Habibie succeeded Soeharto as President despite strong political opposition. To appease those exerting political pressure against him, President Habibie decided to cooperate with the IMF almost totally. Faced with a weak bargaining position from the government and a willingness to cooperate from the economic team, the IMF took an opportunistic approach by pushing further economic reform and broadening the coverage of the program to more than 110 policy actions. Under the Habibie government, the IMF imposed a policy action matrix that gave very detailed accounts of actions that should be taken, with specific and most of the time very unrealistic target dates for each of the actions.

Within the first 18 months of his presidency, Habibie passed hundreds of new laws and regulations, many among them designed to implement IMF programs. Examples include the new bankruptcy law, intended to prevent massive bankruptcy during conditions of economic crisis, and the new banking and Central Bank laws, which give extreme independency to Bank Indonesia, though these two laws are inconsistent with each other. Many of these laws and regulations were not prepared, designed, reviewed or debated adequately and thoroughly in the public sphere. Flawed laws and regulations create serious confusion for the succeeding government who has the responsibility of implementing them.

A long list of policy actions, already signed and agreed to by the transition government under Habibie, created an unfavorable burden for the newly elected government under reform era. This new government, under President Wahid, had limited or even no alternative policy options left open. President Wahid, having been popularly elected via the new democratic mechanism, was very displeased with the rigidity of the IMF program and, thus, also suffered a lack of ownership and commitment to these economic reform policies. His choice of an economic team revealed his displeasure toward the IMF, and initiated another period of IMF–Indonesia confrontation. His government lasted less than 2 years, yet during that period almost all progress was wedged, resulting in another cycle of confidence crisis that threatened the beginning of a fragile recovery process.

President Megawati, the fourth president since the crisis outbreak, has non-confrontational political views toward international institutions such as the IMF; this has already been clearly displayed through her choice of economic team members. But her government term spans only a 3-year period. Indonesia's next election is scheduled for 2004 and is sure to produce further political complications. The following section discusses the economic recovery process and its challenges.

3. The recovery process

Suffering from a relatively long and difficult political transition, Indonesia's economic recovery has been a slow, fragile, and unpredictable process compared to other countries experiencing the same crisis. At the early stage of crisis, when a denial episode was evident, macroeconomic equilibrium collapsed with the deteriorating balance of payment condition. Although current account balances turned into a surplus (due to an import decline of 5%, while exports still enjoyed more than 11% growth), massive private capital outflow of more than $20.7 billion created a total deficit of more than $7 billion. The Indonesian economy suffered a very deep contraction, 13.1% in 1998, with both aggregate demand and aggregate supply collapsing dramatically. Fig. 3 shows the domestic demand dropping at the rate of −17.2%. The drop was fueled by declining household consumption (−6.17%), plummeting

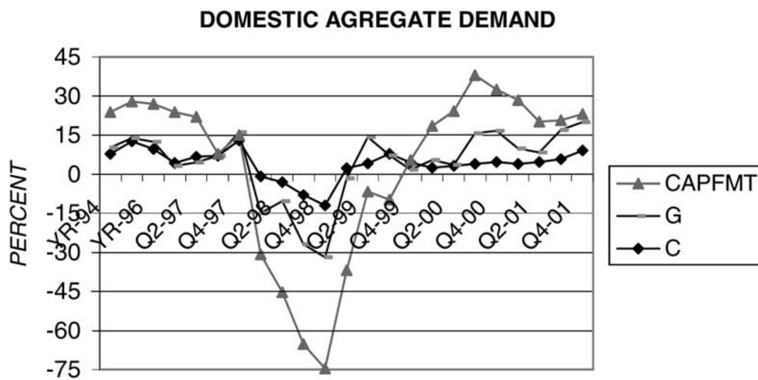

Fig. 3. Component of domestic aggregate demand.

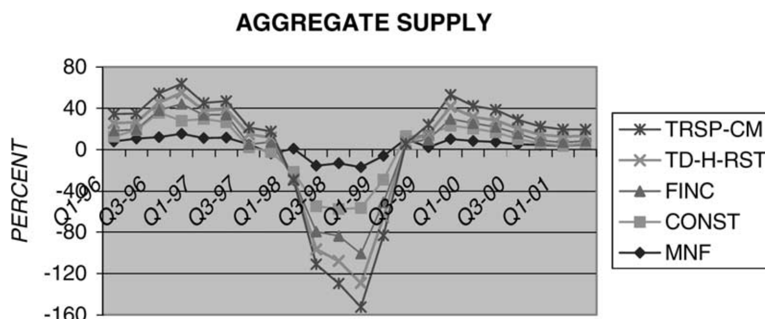

Fig. 4. Component of aggregate supply.

gross domestic capital formation (−39%), and contraction of government consumption (−15.1%). As discussed earlier, this last fact is an indication of fiscal policy failure to use counter cycle measures to lessen economic downturn.

All sectors of aggregate supply except utility (electricity, gas, and water) experienced deep negative growth. Construction and financial services suffered the most, with contractions of more than 36% and 26%, respectively as shown in Fig. 4. After more than a year of economic turbulence, the situation began to stabilize, albeit at very low levels of output equilibrium and exchange rate. Although all other factors of the domestic aggregate demand, especially of the gross domestic capital formation, continued to shrink, private consumption started to grow positively. This growth coincided with the first democratic election, which created a growing excitement and optimism among the Indonesian people and gradually restored consumer confidence. Exports were still experiencing rapid decline, but imports were decreasing at a faster pace, resulting in an increasing current account surplus. Rupiah exchange rate appreciation of more than 50% was driven by the calming and encouraging political situation, and commodities prices were firmly stabilized, producing annual inflation of only 2%. Production started to resume with the manufacturing sector and trade as the main contributors to positive growth, while other sectors still struggled with further contractions. The economy grew only 0.8% in 1999, but price, exchange rate, and interest rate variables were showing a strong, encouraging trend and solid stability.

Under such an improved and stable environment, the government made a strong effort to proceed with financial restructuring programs. Criteria and rules, based on capital structure, were established to recapitalized banks. Banks with more than 4% capital adequacy ratio (CAR) were treated as (temporarily) healthy and were not subject to any government intervention. Banks with CAR between 4% and −25% were eligible for recapitalization, and banks with CAR below −25% were to be closed. The government recapitalized 7 eligible private banks, and 12 systemic banks were taken over. Despite candidacy for closing based on the aforementioned criteria, all state-owned banks were merged—from seven into four banks. This was obvious evidence of the *too big too fail* policy. These steps increased the portion of state-owned banks from 42% to 72%, as measured by total banking assets, and from 37% to 61% as measured by total bank liability. The number of private banks shrank to about a half, from 160 to 81, as shown on Table 1. Progression of these difficult tasks was not at all smooth. Many bank owners tried to use political connections to

Table 1
The result of bank restructuring program

Banks	June 97	June 2001	Market share (% liabilities)	Share net worth (%)
State-owned banks	7	5	48.2	46.8
Regional (government) banks	27	26	3.4	4.2
Bank takeover	0	5	17.5	17.4
Private banks	160	60	30.9	31.6
Foreign and joint venture	43	37		
Total	237	149	100	100

Source: Bank Indonesia.

protect their banks from closing or from being taken over, and many others tried to get favorable terms on the recapitalization process. The cost of the financial restructuring program eventually grew to be enormous; the program is considered among the most costly bank reforms in the world.

Positive growth across most economic activities only started in the year 2000. This coincides with the beginning of the new democratic government under President Wahid and Vice President Megawati. The peaceful political process ignited a sheer of optimism on both the domestic and foreign fronts, enabling the boost of economic activities. Since 2000 Indonesia seemed to be keeping up with the general economic recovery taking place in other Asian countries hit by the 1997 economic crisis. Higher-than-expected growth of 4.8% in 2000 was mainly due to gross capital formation, which for the first time since the crisis began exhibited a bold positive growth rate of 18% annually, spurring government fiscal expansion. Private consumption also grew positively, though at a more modest level of 3.6% per annum. Beginning in the year 2000, external accounts displayed an encouraging recovery trend, with exports growing at more than 16% and imports showing strong growth of more than 18% annually.

But another political factor presented an obstacle to these positive trends. President Wahid's leadership, and his shaky government, failed to give positive coherent support to the recovery process, initiating additional political turbulence. Vice President Megawati replaced President Wahid in July 2001. Nevertheless, real economic activities have already been affected by the political turmoil and have exhibited concerning drift. Aggregate supply is exhibiting a declining trend at an alarming pace. Non-oil manufacturing has shown declining quarterly growth since the last quarter of 1999 and the construction sector has suffered a dramatic drop in quarterly growth from 13.0% in the last quarter of 1999 to near 0% in the year 2001. The financial sector, especially banks, after concluding a very expensive restructuring and recapitalization program, have also failed to perform satisfactorily, with growth declining from above 6% to below 3% during 2001. The slowing down of economic activities was confirmed by the deterioration of domestic aggregate demand, especially in gross domestic capital formation, which dropped from almost 18% to only slightly above 3% at the end of 2001.

Managing and continuing a recovery process is not an easy task in any case. A wide variety of external factors can be blamed for hampering the country's economic performance. Foremost is, perhaps, the September 11 tragedy, which accelerated the recession already starting to drag down the U.S. and world economies. This accelerated

economic slowdown has dampened the most important driver of the recovery process in the economies of Southeast Asia—which are based primarily on export growth. As the second largest contributor to aggregate demand in the economy, at 41%, Indonesian export growth has declined significantly. This decline was particularly marked in the last two quarters of 2001, with exports finishing the year only 1.8% higher than at the end of 2000. A similar pattern was also seen in import growth, which collapsed from growth of over 34% at the beginning of 2001 to a 23% contraction in the last quarter of 2001. All categories of imports were hit, from consumer goods to raw materials and capital goods. The contraction in imports seen in the last quarter of 2001 indicates a trend that will eventually lead to declining aggregate production, as well as poorer export performance, in 2002. This is because there is a strong correlation between raw materials and capital goods imports on the one hand, and manufactured exports and domestic manufacturing production on the other. On the capital account, constant pressure is still coming from the private sector. This tendency is accompanied by declining net official capital from $9.9 billion (1998), to $5.4 billion (1999), and further down to $3.8 billion in 2000. Declining trade surplus and growing capital deficit, combined with huge external debts, especially in the private sector, contribute to the continuing weakening of the Rupiah.

The only engine of growth that remained robust in 2001 was private consumption, with a growth rate of almost 6%. Yet, consumer confidence indicates a strong declining trend, especially since September 2001. An important factor contributing to deteriorating consumer expectations has been serious anxiety regarding unemployment, followed by a weakening in the general economic outlook and a rapid increase in inflation. Inflation has been increasing since mid 2000, from a 2.1% annual rate to a troubling 15.1% rate early in 2002, a level far in excess of the targeted 9.0%. As a result the interest rate on Bank Indonesia certificates has been pushed above 17% per annum.

Taken together, all of these factors pose serious questions over the sustainability of economic recovery. Economic recovery in Indonesia depends on two important programs. First is the maintenance of stability in the macroeconomic environment, while second is the implementation and execution of a sound and credible restructuring of corporate debts and strengthening of banking financial conditions. Stability and a solid macroeconomic foundation are necessary conditions for a successful restructuring program. But maintaining macroeconomic stability post crisis is not an easy task, given that lots of vulnerabilities still cling to the economy.

Macroeconomic stability depends on how successful the government is in managing its budget risk. Government budget structure after the crisis changed dramatically and lost its flexibility because of three factors: the implementation of progressive decentralization policy, ballooning interest payment on government debts, and soaring oil subsidy. On the other hand, the fiscal condition is quite vulnerable to external changes. Indonesia's high public debt exposure mainly consists of foreign and domestic debts and subsidy on oil and gas, which are sensitive to both the exchange rate and international oil price. Domestic debt in the form of long-term government bonds are dominated by flexible-rate bonds, which follow the Bank Indonesia Certificate (SBI) 3-month interest rate and the rate of inflation. Worsening macroeconomic indicators that have so far led to higher interest rates and inflation will automatically translate into higher costs for the government in terms of

domestic debt servicing. However, if the macroeconomic condition improves it will generate a positive spiraling effect to the economy.

3.1. Managing public debts

Economic crisis has impacted government debts severely and unfavorably. As a result of the total bail out and restructuring of the banking sector, the Indonesian government issued long-term bonds amounting to Rp 657 trillion, or around 50% of GDP. Rp 218 trillion was for financing liquidity support policy and Rp 438.9 trillion was for recapitalization. Maturities of government bonds vary from 5 to 20 years (Fig. 5). The position of external public debts before crisis (1996) was only 26% of GDP; but it has now jumped to 59% of GDP because of new debts from the IMF and other multilateral and bilateral creditors. The increase of external debts to GDP ratio was partly caused by the depreciation of Rupiah currency. Combining foreign and domestic debts created a ratio of public debts to GDP of around 110%, a level threatening to fiscal sustainability.

Reducing the public-debt-to-GDP ratio from the current level to a safe and affordable level is a daunting task and has become the most critical challenge facing the present government. The success of this effort will depend on number of factors. First, macroeconomic conditions need to be stabilized via very specific macroeconomic targets, such as an annual inflation rate below 5%, a nominal SBI rate of less than 11%, and economic growth above 5% annually. Second, fiscal policy should be able to generate a surplus that is sufficient to reduce the public debt. An improvement in the level of government revenue will play a crucial role in sustaining the budget and should become the government's most important policy banner. Improvements in tax administration and the intensification of the tax collection effort is the main policy ingredient. However, this should be accomplished over the medium term, without jeopardizing the fragile recovery process and undermining the remaining incentives that exist for investment in the Indonesian economy.

3.1.1. Domestic debt problems

Issuance of government bonds is one of the consequences of the banking crisis, and the value of the bonds issued was enormous. The government was unable to design a suitable

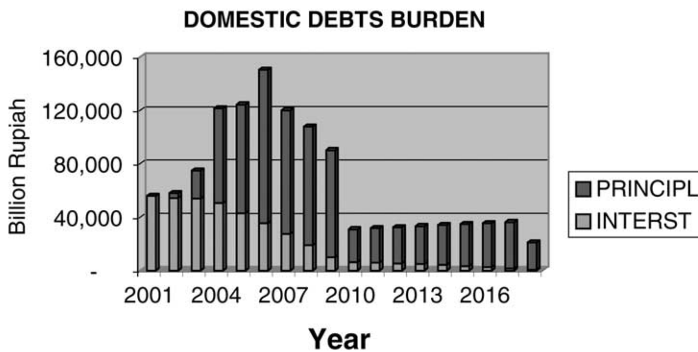

Fig. 5. Government bonds profile.

and affordable cost and risk structure of the bonds, and was also unable to implement appropriate preparation and sequencing for issuing of the government bonds. This 'defect' in the process and preparation of bond issuance will create serious constraints and place heavy burdens on those responsible for future fiscal management. Currently, the primary market for bonds is captive. Further distortion has been created by allowing pension funds to invest all of their assets in government bonds. The absence of a liquid and efficient bond market could create potentially huge problems in liquidity management and budget risks. Building appropriate and effective market infrastructure and a regulatory framework for a bond market will require nimble coordination between the Ministry of Finance and the Central Bank, since the issuance of bonds will also affect monetary policy going forward.

One politically sensitive aspect of government bonds is the high level of interest that needs to be paid on them. Steps to reduce the cost of bonds for the government will create a severe tradeoff to the capital structure of banking sector, which is also owned by the government. Replacing current flexible government bonds with lower risk or fixed-rate (staple) bonds is necessary to reduce budget cost, but it will erode the capital adequacy of recapitalized banks. Reducing the value of bonds outstanding in the banking system by swapping bonds with restructured assets from the Indonesia Banking Restructuring Agency (IBRA) would help to reduce the government's debt burden. The difficult part of this exercise is how to measure the quality of IBRA-restructured assets that could be swapped for government bonds. A sound restructuring process will lead to an improvement in the performance of the banking sector, while also reducing the cost of government debt. Conversely, a poor quality and careless asset restructuring process will only increase the final cost by augmenting the level of non-performing loans held by the banking sector.

Indonesia's government has no past experience in the issuing of domestic bonds, hence, solid institutional support, including a market for secondary bonds, and a regulatory framework for government bonds, has not yet been established. This situation makes controlling the final costs of the recapitalization program and the subsequently entailed risks an even more difficult endeavor. Due to the nature and number of bonds issued during the crisis, for the next two decades, managing government bonds will be one of the government's most intricate and challenging tasks. Building a credible and effective institution to manage public debt is one of the most important hurdles facing the current government, especially in view of the increasingly active involvement that can be expected from the House of Representatives (DPR) in the country's state-budget process in future.

Institutional capacity to manage these risks within the Ministry of Finance is inadequate and poorly developed. Improving human resources, as well as setting a clear and unambiguous position, responsibilities and legal framework for the DMU, is urgently needed to improve its performance. Managing the risks of government domestic debts will require including the following steps of development: new fiscal instruments, especially issuance of short-term fiscal instruments (treasury bills or notes); creating a reasonable yield curve; building strong and efficient market infrastructures for government bonds; and preparing and finalizing legal foundation on domestic debts (law on government bonds). These processes will not be easy, given limited understanding and know-how of both the government

economic team and lawmakers on these subjects, and the availability of time to respond to the existing problems given the maturity profile of the bonds (Fig. 5).

3.1.2. Foreign debts problems

Indonesia is experiencing difficulties in servicing its foreign debt due to deep depreciation of the Rupiah. Most government foreign debts come from multilateral institutions and bilateral sources, with Japan among the most important lenders. Since the crisis Indonesia has asked for foreign debts rescheduling three times through Paris Club. The Paris Club is not supposed to deal with the budgetary problems of debtor countries, but is instead intended to help countries experiencing (temporary) balance of payment problems. Yet, in the Indonesian case, government budget problems are more eminent. The fact that Indonesia has had to reschedule its external debt repeatedly, in a similar manner to many Latin American and African countries in 1980s and 1990s, raises serious questions regarding the effectiveness and significance of such steps in helping countries out of debt crises. Currently, a very strong view from NGOs and politicians supported by some foreign institutions suggests that the government should ask for debt forgiveness from external creditors. Such a view is based mainly on the belief that around 30% of the government debt accumulated under Soeharto was corrupt and badly managed. This serious accusation is flawed in substance, but highly attractive politically, especially to politicians eager to seek easy ways out of the current economic mess.

Under strong political and public pressure, the government has an obligation to find the best scheme for managing its debt, especially external public debt. The most recent deal approved by the Paris Club for Indonesia is only slightly better than the Houston rescheduling terms for lower-middle income countries, which were applied to the first Paris Club agreement for Indonesian in 1998. The Houston terms gave 20-year rescheduling and up to a 10-year grace period for Overseas Development Assistance (ODA) debt, and 15-year rescheduling and up to an 8-year grace period for non-ODA debt. The recent Paris Club agreement (Paris Club III) gave 20-year rescheduling and a 10-year grace period for ODA debt, and 18-year rescheduling and a 5-year grace period for non-ODA debt, while also allowing debt-swaps of up to $37 million. This third rescheduling agreement will not satisfy the vigorous demands for debt reduction, or calls to match the rescheduling terms given to low-income countries with much longer maturity and grace periods combined with lower interest rates.

3.2. Fiscal decentralization

While financing of the state budget remains increasingly questionable for a variety of reasons, additional threats also arise in the risks resulting from the implementation of the decentralization program. In addition to the potential increase in spending as a result of the implementation of decentralization through the government's 'Big Bang' approach, the central government is losing valuable flexibility in managing its revenue flows. Table 2 shows the new revenue-sharing of oil, gas, and other sources of revenue between central and local government under the new decentralization law.

Another aspect of fiscal decentralization that may raise potential problems in the future is the permit to do local borrowing. Up until now, local governments in Indonesia have had no

Table 2
The new revenue-sharing under Law No. 25/1999

Sources of revenue	Share of national government (%)	Share of local government
Land building taxes	10	90%
Land and building user right fee	20	80%
Forest		
Forest user right fee	20	16% Province, 64% district
Provision of forestry sources	20	16% Province, 32% forest located district, 32% other districts
General mining		
Land rent	20	16% Province, 64% producing district
Royalty for exploration and exploitation	20	16% Province, 32% producing district, 32% other districts
Fishery		
Fees for exploitation and production of fisheries	20	80% distributed evenly for all districts in Indonesia
Oil mining	85	3% Province, 6% producing districts, 6% other districts
Gas mining	70	6% Province, 12% producing districts, 12% other districts

Source: Law No. 25/1999 and government Regulation 104/2000.

meaningful experience in managing local debts. Learning from the many bad experiences of other countries, national government—under the pressure of multilateral institutions such as the IMF or World Bank—has put in place several strong administrative restrictions on implementing the local borrowing policy. Given that the fiscal condition is still critical, the Minister of Finance has issued two decrees forbidding local borrowing for 2 years, and may be longer. This measure will avoid local borrowing predicaments temporarily, but the current demand for and potency to do local borrowing is certainly high and still growing. Yet, the capacity of local government, as well as that of the central government, to manage public borrowing is still underdeveloped. Hence, the future fiscal risks from the local borrowing debacle are undoubtedly substantial.

Another problem of decentralization policy is the phenomenon of the new law on special autonomy for Aceh and Irian Jaya (West Papua). These two special autonomy laws were created to prevent a separation movement in these two delicate regions. This asymmetrical autonomy policy will create a new benchmark for central–local government fiscal relationships in other provinces and districts, although the central government has insisted that special autonomy is limited to these two provinces only. Review of the two autonomy laws (Law No. 22 and 25/1999) is crucial given the major complaints and problems of the implementations of decentralization policy in the first year. Revision is needed in order to strengthen the institutional capacity of local government, to eliminate confusing division of responsibilities and functions among different level of government, and to safeguard prudential and sustainable fiscal conditions at both the national and local level.

3.3. Monetary policy and the Central Bank

With such clear fiscal inflexibility as a result of the huge public debt level and other policy factors, monetary policy will have to be even more effective in maintaining a stable macroeconomic environment. During 2000, monetary policy was loose, as shown by the expansion of the money base up to 23%, bringing down the interest rate of SBI to below 11% per annum. This policy did not provide much help in the recovery of the banks, judging by the slow expansion of credit and the increase in inflation, which created further deterioration of the Rupiah exchange rate. The IMF insisted that Indonesia continue to maintain tight monetary policy in order to maintain stabilization of the Rupiah. Yet, complaints and objections on tight monetary policy are frequently expressed by many economic players, and are based on the belief that such policy will not help much in strengthening the Rupiah against foreign currencies.

Tight monetary policy alone is certainly not enough to defend the Rupiah, since there are other factors contributing to the deterioration of Rupiah value. But without a firm monetary policy, expectations of growing inflation surely will further deteriorate the value of the Rupiah. Hence, monetary policy should not be judged separately from other economic policies, or from the various contributing factors such as political and security problems. The question that should be asked then is not whether the Central Bank should adopt tight monetary policy or not. Given such tremendous pressure to the economy, tight monetary policy is becoming unavoidable. The question then becomes: how tight is too tight? If macroeconomic coordination improves and a concerted effort to prepare and execute improvement of economic stability is employed, then monetary policy will not bear all the burden of Rupiah stabilization. As a result the degree of monetary tightening could be reduced significantly.

The shaky performance of monetary policy was caused, to a certain extent, by serious conflict between the government and the Central Bank Board of Governors. Bank Indonesia (BI), as the Central Bank, was granted an independent position by enactment of a new central bank law (Law No. 23/1998) in the middle of the crisis. But its position is still vulnerable to political pressures because BI suffers from serious credibility problems. Prior to the enactment of Bank Indonesia Law No. 23/1998, no comprehensive financial or policy audit of BI was ever conducted to reveal problems within the Central Bank. BI's involvement in many policy scandals and banking mismanagement in the past have led to criminal charges, creating a loss of the bank's credibility in the eyes of the public. The courts have recently handed Governor of Bank Indonesia, Syahril Sabirin, a guilty verdict, sentencing him to 3 years prison for his involvement in the Bank Bali incident. Despite his legal status, Governor Sabirin refuses to resign from his position and is now in the process of appealing to a higher court. In addition to the board of governors and leadership crisis, BI is also being levied with serious charges of involvement in the liquidity support fiasco, where a total of Rp 140 trillion was given out during the banking crisis in 1998–1999. Such burdens and serious legal accusations have had a demoralizing effect on the Indonesian Central Bank.

With such severe credibility problems, the Central Bank remains an attractive target for political pressure, giving encouragement to power-hungry politicians keen to implement amendments to the new central bank law. The pressure has been so intense that it has resulted in the resignation of all but two members of the board of governors. With politicians

in parliament seeing opportunities to make lucrative political deals, and to gain material rewards by facilitating the political attempt to oust the senior management of BI, barefaced political intervention almost succeeded. Only strong public protests, along with serious objections from the IMF, halted the political intervention.

So far, the IMF's involvement in this issue has been to demand the establishment of an international panel designed to give expert opinion to the government in resolving BI's problems. The first panel submitted its opinion on how to improve accountability at BI: establish an independent committee that can assist parliament in reviewing the performance of the central bank. The second panel is expected to give its opinion on settling the liquidity support (BLBI) problems, especially on the question of the sharing of this burden between the Ministry of Finance and BI. The progress and direction of amendment to the BI law is still unpredictable. This may adversely affect the already poor position of the central bank in national political opinion and will unquestionably influence the government's commitment to maintaining macroeconomic stability, potentially leading to serious erosion of market confidence.

3.4. Corporate restructuring

Restructuring of companies and their debts is the most important policy needed to correct pervasive past failures at the company level, to restore creditors trust, and to sustain economic recovery. But restructuring policy has been the weakest part of the recovery policy in almost 5 years of Indonesian economic crisis. The government has signed three different agreements with the former owners of troubled banks, with the largest values, that were taken over in 1998–1999. The Master of Settlement and Acquisition Agreement (MSAA) was agreed upon with five debtors who submitted sufficient assets—based on estimated value—to the IBRA, to offset total debts of Rp 88.6 trillion. The Master of Refinancing of Issuance Agreement (MRNIA) was agreed to with another five obligors who had insufficient assets to compensate the government for their total debts of Rp 23.8 trillion, and who were, therefore, obliged to supplement the shortfall with personal guarantees. Finally, 'I owe you' agreements were made with 24 debtors who had total debts of Rp 18.2 trillion. The total sum of the debt covered by all three agreements was Rp 130.6 trillion, or around 20% of total domestic government debt. Based on these three agreements, the entire sum is supposed to be settled before 2004.

After more than 3 years since their initial signing, implementation of the agreements is going nowhere. There is neither clear action on the part of the government, nor consistent legal enforcement by the courts. The public and market have observed many questionable *ad hoc* restructuring deals, especially with these biggest debtors under IBRA, including an initiative to lengthen the period of the agreements from 4 to 10 years in order to achieve a higher recovery rate. It is obvious that strong individual interests combined with weak legal institutions and a poor judicial system result in substantial corruption and an appalling restructuring process. Bank and company owners are quick to find plenty of loopholes enabling them to shun obligations of debt repayment. New political parties with severely myopic attitudes, and frequent changes in cabinet formation (especially economic team members and the IBRA chairman) make matters even worse by creating *ad hoc* and inconsistent decisions. Deep involvement of the national parliament in the restructuring—as a consequence of the democratic system—frequently results in the blurring of technical

judgment with political and individual interest. The outcome is a dubious restructuring policy and poor policy implementation.

Since the crisis there has been no clear direction on corporate debt restructuring policies, which should include (among other factors), the main objective of restructuring, the restructure mechanism and reselling of assets under IBRA, policy design regarding previous owner's ability to buy back assets, treatment of foreign versus domestic buyers, and principles of choosing buyers. Equally important is the principle of restructuring state-owned enterprises and the subsequent steps of privatization. Divestment of IBRA assets and the privatization of state-owned companies can serve two important purposes. First, it will generate significant revenue for the government to help bolster its fragile budget. Second, it will show where the government stands regarding private investment, especially from foreign sources, and will open the door to capital inflow, boosting investor confidence.

4. The new role of government

The economic crisis has considerably changed the economic as well as the political landscape of Indonesia. Since the onset of the crisis there have been four changes in the office of President of Indonesia, indicating very radical political changes for a country that was led by only one person for more than 30 years. Change toward a more democratic system swung the power pendulum from domination of one person, the President (supported firmly by military), into various distributed groups, including parliament, that represent different political parties, local governments and local people, NGOs, and other influential groups such as student organizations, professional groups, etc. The positive side of distribution of power to many different groups is the facilitation of a system of checks and balances on the public policy process.

The 1998 election resulted in a new government consisting mostly of new political party members, very few with experience holding cabinet positions. The inexperience and meager capacity of a new crop of leaders threatens to make the national government ineffective and weak. The 1998 election also produced new (and inexperienced) parliament members who's powerful political roles influence all public policy process. Unlike the public policy process during the authoritarian Soeharto era, which was always top down and fully controlling in approach, under the new democratic system the government has to consult with, and seek agreement from, parliament members in order to pursue and execute particular policies. This situation makes for a much longer policy decision-making process and most of the time creates uncertainty of outcome. Such radical changes make the recovery situation more complicated and difficult to manage, frequently hampering the effort of the national government to solve problems or to minimize the risk and cost of the economic crisis.

The quality of checks and balances is dependent upon the quality of both the new government as well as the new political parties, which now control the parliament. It is widely known that almost all political parties in Indonesia competing during the 1998 election had just been established during the crisis and were suffering from poor internal management. Frequently they rely on only one influential (charismatic) leader, lack a cohesive political program and platform, suffer from inadequately low quality of members

and weak party discipline, and are backed by shaky and unsecured financial sources. Most of the political parties also lack a knowledge and understanding of the nature of the economic crisis, of the implications in terms of policy response, and of the impending consequences. The new political parties also have no experience in governing the country and have limited capacity to manage the political process consistently and effectively.

During this radical political transition, in response to strong pressure from regional government and local people, the central government enacted a new law on local autonomy. Law Nos. 22/199 and 25/1999 gave a bigger, broader role and political authority to local government at the district level. Power devolvement to lower level government was theoretically intended to better serve the people. But this can only be achieved if local government capacity has been built up enough to assume bigger responsibilities. This is certainly not the case in Indonesia, since during the past 30 years, under Soeharto, local government roles were limited and their institutional capacity and human resource quality were barely developed. Local governments responded enthusiastically to the decentralization policy, especially to the new fiscal balance between central and local government that gives much greater freedom in spending power to local government.

Euphoria at the local government level also created an awkward situation for policy coordination between central and local governments, with the local government having a greater tendency to refuse policy decisions made by the central or higher level government. Examples of this situation can be seen in the many disputes and policy stalemates related to privatization, such as local government refusing to sell state-owned companies located in their regions, or local government aims for taking over foreign mining companies operated under national government contracts. This situation lends additional uncertainty to many decisions and commitments made by the central government. The new democratic system, in conjunction with a radically decentralized system requires that a new tradition of political dialogue and negotiation between government and parliament, and between central and regional governments, be established for the new Indonesia. Certainly it will take time to develop, strengthen, and refine an effective new political tradition in Indonesia. Unfortunately, post crisis Indonesia faces difficult pending problems, which do not permit time for an appropriate and adequate learning process to occur. Hence, chaotic and messy process is becoming a common phenomenon for Indonesia under the new democratic system.

The economic crisis also created a different economic landscape in Indonesia. In addition to widespread ownership of various state-owned enterprises, the government of Indonesia is currently taking over and controlling enormous private assets and corporations in the economy under the newly established institution of IBRA, as a consequence of the bail out program for the banking system. This agency is supposed to become a temporary center for banking and asset restructuring (for only 5 years), and should then be able to resell these banks and assets to the private sector. But under the new democratic political system, political parties may fiercely compete to gain access to and control over as many financial sources as possible. IBRA and state-owned enterprises then become the most obvious target of political parties seeking easy financial resources. This can be seen in the frequent change (seven times) of IBRA chiefs since its establishment in 1998. Under such a situation, a technocratic solution to the restructuring process, designed to ensure the best outcome for the country, was often defeated by intense political lobbies benefiting only certain groups.

Multiple examples can be seen in debt restructuring deals, asset reselling processes, and privatization of state-owned enterprises, which have been repeatedly tainted by shoddy agreements. Indonesia's legal and judicial system is still very weak, and often unable to safeguard public interest. The new political competition combined with weak quality of institutions, at least in the short run, will cause more policy distortions, with public interest shouldering the burden of cost.

Given its past experiences and the current burden and challenges faced, the government of Indonesia has limited choices in defining the new role of the economy. Political competition will pressure any government to be inclined to more populist policies, which most of the time flow against optimal solutions and prudential policy principles. But Indonesia, under Soeharto, was widely recognized as a country with a strong tradition of prudential macroeconomic management. Hence, reestablishing and strengthening the good old tradition of maintaining macroeconomic stability can be used as a benchmark for policy platforms offered by all political parties. At the same time, correcting past failure in the form of bad governance and policy distortion should become the new political objective and a new habit. Government should limit its role as an effective regulator in the economy by solving the many conflicts of interest through widespread ownership of assets and corporation.

5. Conclusion

Indonesia's painful political transition is likely to remain a dominant factor affecting the sustainability of economic recovery. The effectiveness of the government in implementing economic programs and reform is highly dependent on support of the parliament and the capacity and credibility of the new government. Major handicap lies in the weak institutional foundation in the area of politics, law (including basic constitution), and bureaucracy. Alleviation of these institutional problems requires persistent and consistent effort. Realistically, even under the best cabinet format in the government, a longer time will be needed for the new government to be able to fix the economic destruction and to create significant improvement. That is because, in the past 4 years, many of opportunities were forgone. Even worse, problems emerged that further aggravated the burden and risk to the whole country. While building strong, effective, but accountable institutions will take some time, the explosion of problems can happen anytime. Even with full support of parliament members in execution of difficult policies, the risk of failure is not trivial. These are seriously daunting tasks. Despite their size, Indonesia has no other option but to triumph over them.

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