

## **REVIEW ON GOVERNMENT POLICIES AND THE ECONOMIC CRISIS IN INDONESIA\***

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### **Abstact**

*Tulisan ini berisi review kebijakan ekonomi pemerintah serta observasi masalah implementasi dan institusional yang muncul dari kebijakan tersebut yang diduga merupakan salah satu penyebab utama krisis ekonomi yang bersumber dari kesalahan manajemen kebijakan ekonomi makro.*

*Kebijakan perekonomian yang berorientasi pada ekspor, koordinasi terpusat atas aktivitas produksi, jaminan pemerintah atas investasi swasta serta hubungan erat antara perusahaan dan sektor perbankan merupakan kunci kesuksesan ekonomi Indonesia di masa lalu. Tetapi kelemahan pada institusi keuangan dan regulasinya, terutama sejak liberalisasi sektor keuangan dan perbankan yang diawali oleh Pakto 1988 telah membawa instabilitas perekonomian dan berlanjut dengan keterpurukan ekonomi Indonesia. Ketergantungan yang tinggi pada hutang luar negeri serta dominasi aliran modal jangka pendek terutama yang terjadi sejak tahun 1990-1994 dalam sector bisnis swasta merupakan salah satu alasan utama yang menjelaskan penyebab terjadinya krisis moneter tahun 1997.*

### **INTRODUCTION**

The case of Indonesian economic crisis has been very surprising to many peoples, especially economist. Not many economists could readily understand the case of Indonesian downturn. Macroeconomic indicators have been very convincing and give a very promising future. Many experts believe that Indonesia would become a middle class of newly industrial country in the early 21th century. However, things change instantly, and all the scenarios have to be rewrite. Its started in 1997, when the contagious twin crises in currency and banking spread rapidly from Thailand to other Asian countries, including Indonesia.

Financial systems in East Asia generally share a history of financial repression, which included limits on interest rates and entry and obligatory lending to policy preferred sectors and projects. Of the three types of financial regulation, economic, prudential, and information, financial repression relies

on economic regulation and tends to neglect the tools of prudential regulations such as capital requirement and limits on risky investment and the tools of information regulation such as disclosure requirement (*White 1995a, p.6*).

However, unlike other country in Asia, Indonesian economic crises brought a lot larger damage to the country and remains for a relatively longer period. It also expanse to the non-economic issues, such as social crisis and political turning point. Moreover, the crisis has brought the Indonesia's most powerful leader Suharto withdraw from his presidency. This largest economic turbulence in the history of Indonesia since 1945, has brought a lot of changes in social and economic structure of the country. However, it also brings a number of lessons to Indonesian people.

Indonesian economic has experienced several stages of economic and industrial growth during the "New Order" regime,

since 1969. During the period of 1969-1996, the gross domestic product (GDP) of Indonesia increased at the average rate nearly 7 percent per year. Also there has been a sharp reduction in the incidence and severity of poverty and significant improvements in a range of other social indicators. The number of people in poor households has been reduced significantly from 70 percent of the total population in 1967 to only 13 percent in 1996.

After the period of economic and political stabilization, between 1966 to 1969, the "New Order" Government of Indonesia, started to improve the Indonesia's economic performance through several stages of development plans and programs. From this point, the Indonesia's success stories began. During the early years, ie. 1973 - 1981, GDP growth averaged about 7 percent per annum, which is comparable to other High Performing East Asian Countries (HPEACs). This rapid economic growth was associated with the improvement of the countries' term-of-trade, especially from oil export. From 1973 to 1982, oil and mineral exports were responsible for the success story of Indonesian economy. During the period, the trade regime was import substitution and inward-looking oriented. The Government used their high earning from oil to speed up the industrialization process through extensive public investment in upstream-capital intensive, industry, such as cement and fertilizer.

During the next stages, however, ie. between 1982 - 1985, GDP growth slowed down to about 4 percent. It was because of the collapse of oil prices in the world market, which mounted the Indonesian balance of payment difficulties. As stated before, during most of the 1970s and into the early 1980s, Indonesia's economy depended heavily on the country's oil and gas industries. In 1981 about 70 percent of both government and total export revenues came from the oil and gas industries. These industries also ac-

counted for over 25 percent of the country's total gross domestic product (*Rosul, 1998*). Such pressure on external factors convinced the Government of Indonesia the limitation of oil export as the engine of growth. There was an urgency of shifting the engine of growth from oil export to non-oil manufacturing exports. This policy shift also brought the consequence of shifting the trade regime from inward-looking to export-led-growth oriented.

And, from 1986 to the present, the industrial policies have been attributed by deregulation and reforms and improvement of the role of non-oil sector and private sector industries. The purpose of this policy is to sustain the past rapid economic growth by shifting the engine of the economy from natural-resources based industry, to manufacturing industry, and more modern sectors, where the private sector has the bigger role.

This paper will review sequentially what and how the GOI go about its macro-economic policies in responding the dynamic economic problem. This paper will also observe the institutional and implementation problem arise from each of the GOI economic policies, which is considered as one of the main problem of the Indonesia's macroeconomic management, leading to the economic crisis in the past.

## **ECONOMIC DEVELOPMENT AND PERFORMANCE**

### **The Period of 1945-1966/1967**

During this period, the Government of Indonesia (GOI) allocated most of the country's resources to political activities. Problems on international affairs and national integrity forced the government not to put economic development on top priority. It resulted in underdeveloped economic structure and stagnant structural transformation. In 1951, agricultural sector contributed 55.5 percent to gross domestic product (GDP) and 51.5 percent in 1964 whereas manufac-

turing sector contributed 8.4 percent in 1951 and 8.2 percent in 1966. Meanwhile, per capita income growth was also stagnant since economic growth was offset by an equal rate of population growth (*Sjahrir, 1992; Abimanyu, 1988*).

By the end of the period (1966), the Indonesian economy was collapsed because of the imbalance of monetary and fiscal policies. Government expenditures was increasingly financed by money creation rather than taxation, foreign debt or other type of debt-financed. As a result, the economy was characterized by hyperinflation, deteriorating balance of payments and decreasing production of all kinds of goods.

#### **Economic Stabilization: 1966-1973/1974**

The above situation did not change until the emergence of the new leader (New Order) in 1966. New Order government brought an immense change in politics and economy. The new regime reversed the political and economic priority of the previous regime. Since 1966 the New Order government established a new strong National Government by placing political stability as a foundation for economic development.

From 1966 to 1973, the government introduced several economic rehabilitation and stabilization program by implementing financial and industrial policies toward more liberal economies. The new government re-established financial link with Western economies by utilizing foreign fund such as loan, grants and foreign direct investment. The old regime was reluctant to have financial link with industrial countries. It conducted policies such as self-reliance campaign, nationalization of foreign companies and default on debt service payments.

Political and economic policies conducted by the new government were able to solve the problems of large government budget deficit and slow economic growth. IMF's initial assistance to government pro-

gram and budget during August and September 1966 was able to start up the economic engine. In 1965, the budget deficit was nearly 7 percent of GDP and in 1966, this ratio was still over 5 percent, but in 1967, the ratio was reduced to 0.3 percent. Indeed, the budget deficit and the associated rate of inflation-induced money creation were reduced significantly.

The New Order government started to conduct planned economic development called Five Year Economic Development Plan (*Rencana Pembangunan Lima Tahun or Repelita*). The First Plan (Repelita I) began in 1969/1970 and ended in 1973/1974. The main aims of Repelita I were to stabilize the economic system through a reform of monetary and fiscal policies, to rehabilitate strategic economic sector damaged by the previous government policy and to establish substantial rate of growth of per capita income. The period under Repelita I known as the period of "stabilization, rehabilitation and development."

*To finance its development efforts for Repelita, the Government of Indonesia (GOI) was heavily dependent on foreign funds. About 59 per cent of its development expenditure was financed by foreign aid, 14 per cent by private capital inflows, with the government saving and domestic private saving accounting for only 16 and 11 per cent respectively of the development budgets (Azis, 1994).*

The development emphasis of Repelita I was on agriculture (especially rice) production. Aside from agriculture development, under Repelita I, the GOI also concern with the development of necessity, such as clothing manufacture, improvement in infrastructure and housing, expansion of employment, and expansion of natural resources and manufacturing industry. About 30 per cent of the development budget was allocated to the agricultural sector where it was use mainly for rehabilitation of agriculture infra-

structure, such as irrigation facilities. All these initiatives were basically intended to give the farmers greater opportunity for economic self-improvement. (*Firdausy, 1995*).

During this period, economic growth was targeted at 5 percent annually. In fact, economic growth reached 8.6 percent annually. This impressive economic growth was partly due to the fact that Indonesia was still in the transition period of development. In the transition period, investment needs a relatively low figure on Incremental Capital Output Ratio (ICOR). For a densely populated country like Indonesia, basic needs are strategic factors for economic stability. Therefore, in the First and Second Plan, the national economic development programs were focused on building strong agricultural sector, especially foods. The target of these two Plans was to achieve self-sufficiency in food production.

#### **Oil Boom: 1973/1974 - 1981/1982**

The OPEC's decision to increase oil price in 1973 and 1978 have directly topped Indonesian oil price. In the beginning of 1969, Indonesian oil price was only 1.67 US\$ per barrel but in November 1973, it reached 6 US\$ per barrel, and in July 1974, it reached 12.60 US\$ and topped at 35 US\$ in January 1981. The increase of oil price raised domestic revenues and government saving. In the period of oil boom, instead of reducing foreign debt or increasing the debt service payment, Indonesia continuously increased the amount of foreign debt. In 1973, oil export revenues increased by 210 percent (from US\$ 1680.7 billion to US\$ 5211.4 in 1974). At the same time, Indonesia's foreign debt also increased by 111.9 percent from the previous fiscal year. The momentum to reduce the debt burden was beaten by the momentum to pursue economic growth. The government priority was to build an extensive public investment on capital intensive, resources based industry such as fertil-

izer, petrochemical and cement. These industries were strongly protected by the government since the decision makers in investment conducted import substitution and inward looking strategy. Besides, most players in the protected industries are State-owned Enterprise (BUMN). Investment in capital intensive industries is expected to support self-sufficiency in food production program and other basic needs (for example, housing) for the majority of Indonesian people, and also to accelerate the pace of industrialization in Indonesia.

During this period, oil and gas revenues contribution to domestic revenues increased. In 1973/1974, oil and gas sector contributed 39.5 percent to domestic revenues, while in 1981/1982, it contributed 70.6 percent. During oil boom period, the economy grew at 7.94 percent annually. This oil bonanza to a large extent has changed the appearance of the second Repelita (1974/75 - 1978/79). Under the second Repelita, the GOI give greater attention on the aspect of social welfare and general aspect of economic development, while maintain economic stability in place and less focus on economic growth. During these years the government spending allocated more to the education and health services, while reduce the allocation of resources to agriculture, industry and mining development. New allocation categories such as trade and cooperatives, manpower and transmigration and regional development appeared in Repelita II. These new categories appear in the Repelita II, were also influenced by the social unrest in January 1974, locally known as Malari 1974, which specifically concern about equity issues of the economic development. Greater emphasis was placed on obtaining a more equitable distribution of income, greater employment opportunities and "non economic" goals.

Equity issues were taken even more seriously in Repelita III. In Repelita III, the

development objectives were an equitable distribution of development activities to produce widespread social justice (equity), high rate of economic growth and a sound, dynamic state of national stability. These three interrelated development goals were locally known as "*trilogi pembangunan.*" (Firdausy, 1995). This period of oil boom has also changed the GOI political performance. Strong financial support from oil revenue on one hand and low target of Repelita II and III on the other hand, has greatened the tendency of the GOI to spend money through his non-budgeted government expenditure system, known as "strategic expenditures". Since the system is not transparent, this "strategic (non-budgeted) expenditures", in the future, become the important post for civil servant's corruption.

#### **Sluggish Economic Growth and Transition of Financing from Oil to Manufacturing Sector: 1982-1985**

So far, the current account balance was dominated by surplus from oil export revenue, leaving non-oil sector export relatively small and unchanged. However, in 1982, the international oil price sharply declined. As a result, Indonesia faced balance of payment difficulties and sluggish economic growth. The Indonesian current account deficit in 1982/1983 reached US\$ 7.2 billion (7.7 percent of GDP). Economy only grew at 4 percent a year. Sluggish economic growth continued until 1985 when the government started to conduct industrial deregulation and reforms. To overcome these problems, the GOI used both fiscal and monetary policies simultaneously. GOI utilized resources mobilization improvement program through comprehensive financial and fiscal reformation, improved efficiency in custom, port and shipping. Meanwhile, public expenditures were cut significantly by rephasing many large projects and cutbacks in budgetary subsidies. Expenditures cut included.

Civil service employment and salaries were restrained.

To reduce the current account deficit, various import license were increased significantly during 1983-1986 period. At the same time, monetary policy was conducted to improve Indonesia's competitiveness on non-oil export. In March 1983, the GOI devalued Rupiah by 28 percent. This policy is followed by managing the exchange rate more flexibly. Unfortunately, the monetary and fiscal policies conducted by GOI were inconsistent with policies on trade and industrial sectors. Trade and industrial policies became even more inward oriented and more strongly intervened (Pangestu, 1993).

In general, the industrial structure during this period did not yet very much rely on the role of private sector and market mechanism. Most of business actors were playing inefficiently. Rigid State-owned Enterprise played a major role. Monetary and fiscal policies did not work effectively since the real sector had no ability to capture business opportunities due to more liberal policies. Moreover, the policies led to even a larger current account deficit and higher Debt Service Ratio (DSR).

#### **The Deregulation Period: 1985-Now**

In 1986, another sharp decline in oil price and continued degeneration in primary commodity price resulted in an even worse situation for Indonesia's term of trade. The DSR jumped from 26 percent in 1985 to 37 percent in 1986. To overcome these problems, the GOI, again, devalued Rupiah. The difference from the previous devaluation was that the 1986 devaluation was accompanied by consistent and supportive trade and industrial measures. Trade and industrial policies were purposed to promote non-oil investment and exports by reducing trade barriers and other institutional regulations which led to a high cost economy.

Since 1985, serial deregulation and reforms have been conducted in order to remove several handicap in promoting export. Such deregulation were conducted to change the direction of trade policy away from the previous trade regime, which was characterized by inward-looking with high and variable effective rate of protection for importable and negative rate for exportable. Although these deregulation series give a very promising future for Indonesian manufacture industry, there were so many problems in the implementation level. Removing tariff and trade barrier involve so many changes in business culture of government and private enterprises.

Deregulation package in October 1986 eliminated import licensing for 197 items accounted for 19 percent of import value. It was the beginning of a series of deregulation and reformation program conducted by the GOI to limit the role of inefficient bureaucracy and to promote the role of efficient private sector in the economy. Overall trade and industrial policies were shifted from inward and import substitution oriented to outward and export promotion oriented.

There were at least three types of measures conducted by the GOI to broaden and deepen the deregulation and reformation process:

- To reduce non-tariff barriers and the level of tariff protection. These reforms were supported by a series of deregulation in infrastructure services, such as maritime sectors and custom services.
- To relax license requirements and foreign investment restrictions. These measures were aimed to bring a better competition atmosphere in domestic market and to encourage more efficient private producers.
- To reduce entry barrier for new private banks and to increase competitiveness among financial institutions by abolishing credit ceilings, eliminating interest rate controls and reducing subsidy and directed credit program in 1990.

The impact of these deregulation series were very impressive. It generated a very strong response from the private sector as indicated by the boom in private investment, rapid growth in non-oil exports, employment, labor productivity and output (Karseno, 1994).

Deregulation packages have created a new dimension in Indonesian economy. Structural transformation has emerged. The change in sector contribution to GDP from 1971 to 1996 can be observed in the following table:

Table 1.  
Structural Change (% of GDP)

	1971	1980	1985	1990	1991	1992	1993	1994	1995	1996
GDP	100	100	100	100	100	100	100	100	100	100
Non-Oil GDP	73	72	77	80	80	88	89	90	91	91
Agriculture	33	24	23	22	21	20	18	17	16	15
Industry:	37	46	45	46	47	47	46	46	47	47
Mining		24	18	15	16	12	10	9.4	9.2	9
Utilities		1	1	1	1	1	1	1	1	1
Manufacture	9	11	16	19	20	22	22	23	24	25
Non-oil Mnf	6	8	11	15	16	18	19	20	21	22
Other		10	10	11	11	12	13	13	13	13
Services	30	30	32	32	32	34	35	37	37	38

Sources: Central Bureau of Statistics, various issues

To sum up, key words to describe Indonesian economic policies was continuity and change. On one hand, there are several policies which are characterized by high continuity (*Sjahrir, 1992; Abimanyu, 1988*):

- balanced budget policy
- inflation control policy by controlling money supply and limiting government expenditures
- sound management policy on deficit balance of payment
- policy of financing the government expenditures by foreign debt (government budget deficit).

On the other hand, there are also changes in economic performance during the New Order, i.e. structural transformation and deregulation.

#### **Pre-crisis Macroeconomic Developments, 1990-96**

Over-investment in the non-tradable sector, a highly protected manufacturing industry, particularly state-owned enterprises, and a weak financial system are the roots of Indonesia's present financial crisis. The investment was founded by massive capital inflows that lead to a widening current account deficit and mounting external debt. Capital inflows increased almost two and one-half times from 1990 to 1994, reaching \$14.7 billion. The annual net inflow of capital averaged 3.9 percent of GDP from 1990 to 1996. Over-investment in less efficient project misallocated resources away from enlarging the productivity capacity of the economy, which would have increased the ability to service debt and reduce external liabilities. Moreover, over-investment caused other distortions, such as asset overvaluation, particularly in the real estate sector (*Nasution, 1998*).

The changing composition of capital inflows significantly added to Indonesia's vulnerability. The share of short-term bank

borrowings and portfolio flows invested in the stock market and in private sector instruments expanded rapidly during the 1990s. In 1997 when local interest rate surged and the Rupiah depreciated, the cost of renewing or rolling over short-term, floating-rate dollar and yen loans in real terms skyrocketed. To some extent, the authorities controlled the size and composition of volatile short-term capital inflows by imposing ceilings and raising their cost (*Nasution, 1998*).

The financial liberalization policy and advance in technology and information processing had made it easier for Indonesians to denominate deposits in foreign currencies. A large proportion of foreign currency denominated debt makes it difficult to manage the macro-economy as well as bank portfolios (*Calvo, 1994; Mishkin, 1997*). Maturity mismatched happened when banks use short-term foreign currency dominated borrowing in the inter-bank market to fund longer-term bank loans.

Indonesia's financial system, particularly the banking system, is plainly dysfunctional because of the rotten central bank and direct government intervention in selection of bank credit customers. Private sector banks are also involved in moral hazard behavior, as they do not exert on discipline on affiliate companies. Rebuilding the system requires measures on strengthen both the central bank and commercial banks. State-owned banks (and state-owned non-bank enterprises) need to be de-linked from the government bureaucracy and corporatized. In addition, market infrastructure needs to be improved to enforce the implementation of prudential rules and regulations, to promote competition, and to encourage strict credit policies (*Nasution, 1998*). Beside that most of East Asian financial systems suffer several critical weaknesses as a result of the dominance of banking. They are not suffi-

ciently flexible to cope with rapid and wide fluctuations of asset prices and economic conditions, particularly in more advanced economies, because of their dependence on debt. When businesses are mainly obligated to creditors, rather than equity holders, they are less able to withstand fluctuation in asset prices and economic conditions (*Masuyama, 1998*).

### WHAT EXPLAIN THE FAILURE OF INDONESIAN ECONOMY Highly dependent on Foreign Debt

In the process of modernization, *ceteris paribus*, the economic mechanism of the Harrod-Domar growth model has suggested that the mobilization of domestic savings and inflows of foreign capital are needed to generate investment sufficient enough to accelerate the process of modernization. However, most of the LDCs suffer either from a shortage of capital and/or a shortage of foreign exchange, as represented in the well-known two-gap model (*Kindleberger and Herrick, 1977, pp. 296-298*).

To make up for such shortages, many LDCs (such as Indonesia) have adopted an outward-looking development policy that encourages free trade and free movement of capital thus utilizing foreign resources in order to pave the way for rapid economic growth. However, foreign capital inflows have often given the impression that the LDCs are economically dependent upon the developed countries. Indonesia's modernization drive depended on foreign capital inflows like other LDC country in the world.

The Indonesian economic development from 1966 to 1997, has shows a dynamic movement. The "engine" of economic growth has been changing from one step of economic development period to another step of development, before finally appear at the period of economic crisis.

- Period 1966 – 1971, the 1<sup>st</sup> economic recovery during "New Order Era", funded by IMF loan.
- Period 1972 – 1983, economic development were supported by the oil bonanza, while keeping the government budget deficit.
- Period 1983 – 1986, government budget deficit accompanying by fiscal and monetary policy reforms; rupiah were devaluated, major cutback in government real capital spending and monetary control, while retain civil servant employment and salaries.
- Period 1986 – 1993, government budget deficit accompanying by deregulation series and major industrial and financial reform. In 1986, rupiah were again devaluated and major reform in banking industry was started in 1988. Opening up stock market for foreign player.
- Period 1993 – now, continues deregulation by opening up the national economy even further; allowing small scale capital inflow into the economy.
- Period 1997 – now, the economic crisis and 2<sup>nd</sup> economic recovery, funded by IMF loan.

### Short run Capital inflow

Perceived as a stable country and one of Asia's success stories Indonesia experienced a surge in capital inflow in the 1990s. Foreign capital was attracted as a result of wide-ranging market reforms undertaken in 1986 (see appendices). Demand for securities of both state-owned and private Indonesian company increase as a reforms allowed foreigners to own up to 49 per cent of the shares issued by listed domestic company (except banks). Reforms also allow domestic company to raise funds by selling securities in local and international stock markets. Capital inflows increase almost two and one-half times from 1990 to 1994, reaching

\$14.7 billion. The annual net inflow of capital averaged 3.9 percent of GDP from 1990 to 1996 (*Nasution, 1998*).

Capital inflows may be induced by widening differential between domestic and foreign interest rate, due to an increase in domestic economic activity or monetary tightening and also because of rising income levels in East Asia due to high rates of economic growth contributed to the propensity to save (*Masuyama, 1998*), and they may arise, without any initial change in domestic interest rate, from an increase in the expected return on domestic capital investment relative to return offshore. It seems that both factors were behind the recent surge in capital flows to Indonesia (*Djiwandono, 1996a*). Although both sources of capital inflows have the same consequences for domestic monetary condition in the short run, in the long run, only capital inflows induced by a higher expected rate of return stimulate growth in domestic demand, output, and capital stock.

Rising capital inflow during the 1990s have allowed Indonesia to grow faster but they also have complicated macroeconomic management. While capital inflows improve balance of payments, they can also generate inflationary pressure (thus interest rate movement), real exchange rate appreciation, and a deterioration in current account. Massive capital inflows may contribute to speculative bubbles in stock and property markets and leads to excessive expansion in domestic credit and threaten financial stability. These problems are likely to intensify if a significant portion of inflows is short term, as the probability of an abrupt and sudden reversal in these flow increase. (*Rosul, 1998*).

The massive capital inflows have occurred between 1990 to 1994, resulted in over investment, particularly in non-tradable sector. This massive capital inflows and over investment situation have created over-

valuation in the asset pricing, especially in real estate and infrastructure projects. The rise of capital inflow in the private sector has drove the equity price up. The excess of liquidity in the money market has driven the price of non-tradable asset increase. Inflation accelerated from 5.97 percent in 1989 to an average of around 9.50 percent in 1990-91. Government policies slowed inflation to 4.94 percent in 1992, but with large capital inflows over the next three years the average rate of inflation returned to levels about 9 percent for 1993-95. The increase in domestic demand stimulated by these large capital inflows also widened the current account deficit from US\$1.28 billion in 1989 to about US\$7.80 billion in 1996. Monetary tightening to control inflation using traditional instruments such as open market operations was made less effective because it was counteracted by capital inflows.

Most of the private debt was short-term loan and borrowed directly from foreign lenders. These, in turn, created complicated financial problem for the firm when the debt due. In the macroeconomic perspectives, these issue created surge on the current account balance of the country.

### CONCLUDING REMARK

During New Order Era, Indonesian people have been experiencing a relatively comprehensive game of roller coaster type of economy. The economies have been changed dramatically for the last 25-year. Even one year before the crisis, Indonesian economic has been considered as the new incoming industrial nation in Asia. However, many economists seem to underestimate the role of structural and institutional weaknesses behind the success of Indonesian economy. The success of Indonesian economic has been the result of economic strategy that emphasized export orientation, central coordination of production activities and implicit (or even explicit) government

guarantees of private investment project, as well as intimate relationship between bank and firms. In addition of that, the financial sectors also exhibiting significant problems (ADB,1999). Weak prudential regulation, lack and inexperienced supervision, low capital adequacy ratio, lack of incentives-compatible deposit insurance schemes, and distorted incentives for project selection all rendered the national financial system weaker than they appeared.

With all weaknesses on the financial regulation and financial institutions, the sudden international mass capital fled in the

second half of 1997 gave credence to panic interpretation of the crisis. The sudden discovering of Indonesian institutional and structural weaknesses of Indonesian economic has created the vulnerability to shocks.

Indonesia and Asian economic crisis have gives us an important lesson on an open economic policy. The open economic policy along with open national financial system would risking the national economy if the policy not followed by enough domestic financial regulation and institution.

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## TABLE & FIGURE

Table-2  
Indonesia: Chronology of major economic events, 1965-1982

Year and Month	Event
<u>1965</u> December	"New" rupiah introduced, equivalent to 1,000 "old" rupiah; petroleum prices increased 250-fold; Indonesia ceased to meet foreign exchange commitments
<u>1966</u> March	Soeharto assumes formal executive authority
April	Indonesia applies for readmission to United Nations
June	Arrival of International Monetary Fund mission
September	First major meeting with non-communist creditors, in Tokyo
October	- Major stabilization and rehabilitation programme announced; import licensing system partially dismantled; "export bonus" - Scheme liberalized
December	- Further meeting with creditors, in Paris
<u>1967</u> January	New Foreign Investment Law announced
February	First official meeting of IGGI in The Hague
July	Major foreign exchange liberalization
August	Banking crisis
September	Widespread rice shortages reported
November	New mining law enacted
December	Major reorganization of state enterprises; new banking law introduced
<u>1968</u> April	Large increases in prices of petroleum products and utilities

May	Major overhaul of "export bonus" scheme
September	Positive rates on bank deposits instituted
November	Domestic investment law introduced
December	Eight commercial banks established
<u>1969</u> April	Repelita I commences; start of financial year shifted from 1 January to 1 April
May	Further reorganization of state enterprises
September	<i>Ekonomi dan Keuangan</i> (Indonesia's main economics journal) resumes publication
December	Inflation effectively brought under control (17 percent for the year)
<u>1970</u> April	Major trade policy package; devaluation, elimination of most multiple exchange rates, simplification of export and import procedures' elimination of international capital controls; import bans on commercial vehicles and second-hand automobiles introduced
May	- Bimas Gotong Royong discontinued, replaced with Bimas Nasional and Inmas
December	- Final and complete unification of the exchange rate
<u>1971</u> April	- Import ban on CBU automobiles imposed for Java and Sumatra
August	- 10 per cent devaluation of rupiah now pegged to US\$
September	- Import duties on 459 items reduced
<u>1972</u> December	Serious rice shortage evident; rice prices doubled August-December
<u>1973</u> August	International petroleum prices begin to rise steeply, quadrupling in next six months
September	The Investment Coordinating Board (BKPM) established
November	Preferential treatment by state banks for small pribumi borrowers announced
<u>1974</u> January	Malaria protes occur; import ban extended to all CBU vehicles; state bank medium-term credits henceforth available only to firms with significant pribumi-pribumi partners strongly encouraged, local equity to exceed 50 per cent within 10 years, more sectors closed to foreign investors (the regime was tightened further in March, July and September)
March	Regional development strategy announced, including establishment of Bappedas; state enterprises transferred from the Department of Finance to "technical" depart-

April	ments Repelita II commences; anti-inflation package announced, including increased interest rates and ceilings on (state) commercial bank credit
<u>1975</u> February	Pertamina unable to repay or refinance its short-term debt
April	Major shift in sugar strategy announced, encouraging small holder production
May	Bank Indonesia ceased publication of its weekly and monthly Bulletin (resumed September, 1976)
July	Soeharto and the Japanese Prime Minister sign the Asahan Agreement
October	Imports of 23 varieties of textiles banned
<u>1976</u> February	First ASEAN Summit held, in Bali
March	President Director of Pertamina, Ibnu Sutowo, "dismissed with honour"
April	Export promotion package introduced, most export taxes reduced to 5 per cent
August	Regulations relating to "third generation" mining contracts announced
<u>1977</u> February	Investment licensing regime becomes more transparent, with first official release by BKPM of Investment Priority List (DSP); petroleum investment incentive packages become more attractive
June	Government announces stepped-up anti-corruption campaign
August	Jakarta Stock Exchange re-opened; first major LNG shipment, from Bontang (East Kalimantan) to Japan
<u>1978</u> January	Deposit rates reduced, and banks reserve requirements cut from 30 to 15 per cent
August	Small holder development programme introduced, including Nucleus Estates Scheme and several crop-specific initiatives
November	50 per cent devaluation of the rupiah; extensive price controls introduced
<u>1979</u> January	Export Certificate (Sertifikat Ekspor) scheme introduced, as an incentive to exporters
April	New tax package introduced, affecting company, sales and excise taxes, and tariffs; Repelita III commences
September	Second round of large increases in international petroleum prices commences
October	

<u>1980</u> March	Stage I of PT Krakatau Steel starts production
May	Presidential Decree 14A favours pribumi in government procurements
July	Ban on log exports announced, to be introduced in several phases; 50 per cent increase in domestic petroleum prices
<u>1981</u> November	Indonesia's first textile trade dispute, with the United Kingdom
<u>1982</u> January	Automotive industry plan envisages full local content by 1985
March	Domestic petroleum prices increased by 60 per cent, halving the budgeted oil subsidy; new trade promotion package announced, including counter purchase and export credits
November	Emergency OPEC meeting agrees to production cutbacks
	Import licensing in the form of approved importer system (Tata Niaga Import) commences; sharp increase in departure tax, from Rp.25,000 to Rp. 150,000.

Sources : Firdausy, Carunia Mulya, 1995: "The Development experience of Indonesia; Lessons For the Economies in Transition in Indo-China" in *Macroeconomic Reform in Indo-China*, UN-ESCAP, New York, pp 13-16.

**Table-3**  
**POLICY REFORMS, 1983/84 – 1993/94**

<u>Exchange rate</u>	<ul style="list-style-type: none"> <li>- Rupiah devaluated by 28% in March 1983</li> <li>- Exchange rate made more flexible, since March 1983</li> <li>- Rupiah devalued by 31% in September 1986</li> <li>- Regional exchange rate has depreciated against a falling US Dollar since September 1986, preventing appreciation of real effective exchange rate.</li> </ul>
<u>Fiscal Policy</u>	<ul style="list-style-type: none"> <li>- Large capital and import intensive projects rephased in May 1983</li> <li>- Major cutback in government real capital spending since 1983</li> <li>- Tight control maintained since 1983 on the use of non-concessional import related credits.</li> <li>- A major tax reform initiated, starting in January 1984</li> <li>- Follow-up steps taken to strengthen tax administration</li> <li>- Restrains on civil service employment and salaries</li> </ul>
<u>Monetary and Financial</u>	<ul style="list-style-type: none"> <li>- A major financial reform initiated in June 1983, involving removal of interest rate and credit ceilings for state bank operations and introduction of new instruments of monetary control.</li> <li>- A new set of financial measures introduced in October and December 1988, aimed at enhancing financial sector efficiency and developing capital markets.</li> </ul>

- Improved monetary management to control inflation,
- Improved short term monetary management to curb exchange rate speculation.
- Reduction in directed, subsidized credits starting in 1990
- Intense efforts to improve supervision of financial system, including restructuring capital market regulations (1990)
- Adopted new capital adequacy and provision standards in February 1991.
- Relaxation of prudential standards introduced in May 29, 1993 and the deadline to meet the CAR of 8% was extended to December 1994.

### Trade Policy

- An across the board reduction in nominal tariffs implemented in March 1985
- Measures to provide internationally-priced inputs to exporters announced on May 6, 1986
- Significant reduction in import licensing restrictions outfitted through a series of measures in October 1986, January and December 1987 and November 1988.
- Steps taken in December 1987 to reduce the anti – export bias of trade policy by reducing regulatory restrictions for exporters.
- An across-the-board reduction in most nominal tariffs to a ceiling of 40% in May 1990. The package also a further easing of NTBs.
- Another major removal NTB, covering simplification of licencing procedures in trade, manufacturing, health, and agricultural business, July 1992 and October 1993.
- Replacement import ban built up passenger car with prohibitive 300% tariff rate, further reduction in tariff for other commodities, and relaxation of regulations in trade in agriculture products, June 1993.

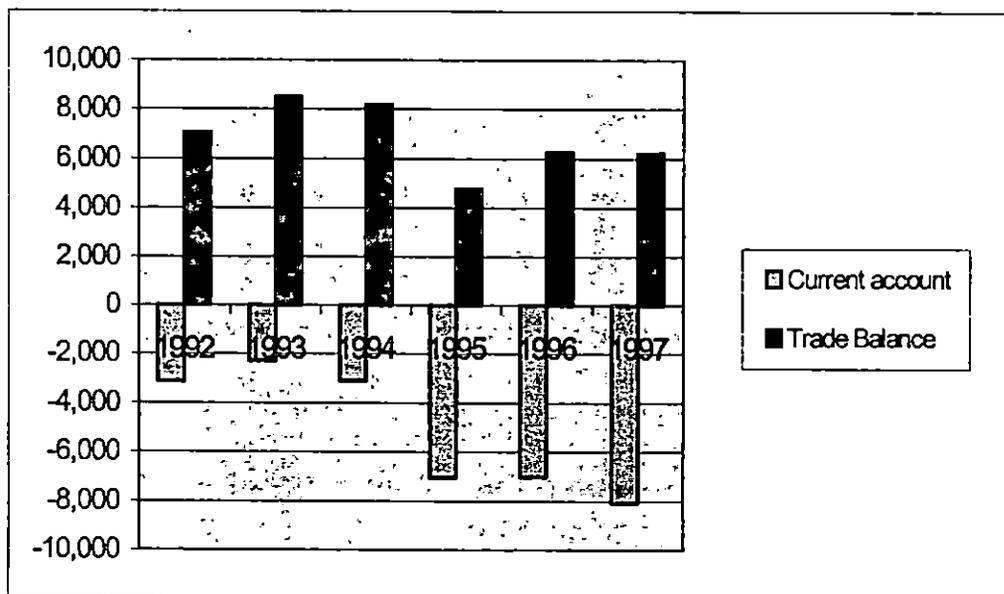
### Other Regulatory reforms

- Reorganization of customs, ports and shipping operations in April 1985 to reduce freight costs and sut processing time.
- Steps taken through the May 1986, October 1986, January 1987 and December 1987 packages to reduce the investment and capacity licensing requirements, relax foreign investment regulations, and reduce the role of local content program.
- Substantial deregulation of maritime activities announced in November 1988 to reduce costs and encourage private sector participation.
- Replacements of restrictive positive list of areas open for investment with short negative list in 1989.
- Initial steps towards Public Enterprise reform.
- Deregulation extended to pharmaceutical and some agricultural activities in the May 1990 package.
- Reduction the number of investment negative lists from 51 to 34, June 10, 1993

**Table-4**  
**Indonesia Balance of Payment (1992-1997)**

Balance of payment (US\$ mn)						
	1992	1993	1994	1995	1996	1997
Current account	-3,112	-2,296	-3,094	-7,023	-6,987	-8,069
as % of GDP	2.5	1.6	1.8	3.7	3.3	3
Export	33,796	36,607	40,060	45,418	47,754	52,038
Import	-26,774	-28,090	-31,880	-40,629	-41,502	-45,819
Trade Balance	7,022	8,517	8,180	4,789	6,252	6,219
Invisibles	-10,144	-10,529	-11,274	-12,489	-13,239	-14,288
Capital Account	6,471	5,962	4,008	9,387	11,463	12,668
Total	3,349	3,950	914	1,687	-4,476	-4,599
Errors and omissions	-1,606	-3,209	-108	-1,113	-1,825	-701
Reserves	-1,743	-741	-806	-574	-2,651	-3,898

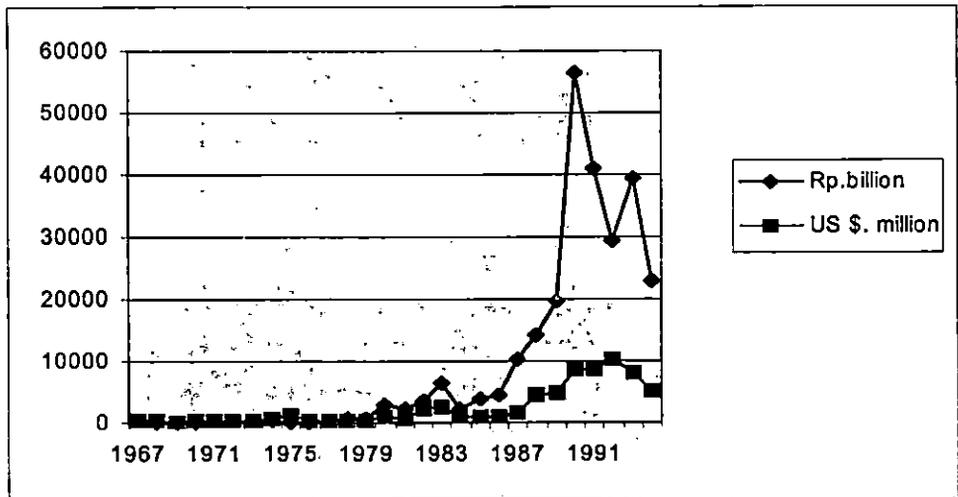
**Figure-1**  
**Balance of Payment 1992 – 1997**



**Table-5**  
**Indonesia: Growth of Investment approval, 1967-1994**

Year	Domestic Investement		Foreign Investment	
	Project	Value (Rp. bn)	Project	Value (\$. mn)
1967			12	207.1
1968	26	38	35	264.4
1969	73	33	37	127.5
1970	176	112.6	83	166.8
1971	214	185.9	62	287.2
1972	268	185.9	47	163
1973	299	469.3	69	323.8
1974	134	170.2	53	542.4
1975	78	158.5	24	1145
1976	75	22.4	22	221
1977	155	483.6	20	167
1978	188	678.8	23	207.1
1979	166	654.8	13	248.6
1980	159	2817.3	20	1074.4
1981	164	2291.8	24	706.5
1982	205	3616	31	2416.9
1983	333	6476	46	2470.8
1984	145	2109	23	1096.9
1985	245	3736.2	45	853.2
1986	315	4411.5	93	847.6
1987	570	10449.6	130	1520.3
1988	843	14201.8	145	4410.7
1989	863	19593.8	294	4713.5
1990	1324	56510.5	432	8751.1
1991	804	41077.9	376	8778
1992	436	29341.7	305	10323.2
1993	548	39450.4	329	8144.2
1994	314	22750.7	131	5019.4

**Figure-2**  
**Approved Investment (Domestic and foreign) 1967 - 1994**



**Table 6**  
**Indicators of External Stability, 1990-1996**

	1990	1991	1992	1993	1994	1995	1996
Current account Balance, % GDP	-2.8	-3.7	-2.2	-1.6	-1.7	-3.7	-4.0
Net Capital Inflows, % GDP	4.9	5.0	3.8	1.9	2.4	4.6	5.0
<b>Portfolio Investment</b>	-0.1	0.0	-0.1	1.1	2.2	2.0	
Direct Investment	1.0	1.3	1.4	1.3	1.2	1.2	
Other	3.3	3.6	3.5	1.4	-0.9	-0.9	
External Reserves, most of imports	4.7	4.8	5.0	5.2	5.0	4.4	5.1
M2/ Reserves, %	514.0	505.7	497.4	557.1	602.9	657.4	633.3
External Debt/ Exports, %	222.0	236.9	221.8	11.9	195.8	205.0	194.0
Short-term Debt/ External Debt, %	15.9	7.9	20.5	20.11.0	17.7	20.9	24.8
Short-term Debt, US\$ billions	11.1	14.3	18.1	1 18.0	17.1	24.3	29.3
Debt-Service/ Export %	30.9	32.0	31.6	33.8	30.0	33.7	33.0
Exports/ GDP, %	26.6	27.4	29.4	25.9	26.0	26.0	26.2
Exports Growth, %	15.9	13.5	16.6	8.4	8.8	13.4	9.7
Price of oil, US\$/barrel	28.64	20.06	18.71	14.14	16.11	18.02	22.78

Sumber: IMF, International Financial Statistics

Figure-3  
Current Account Balance, % GDP

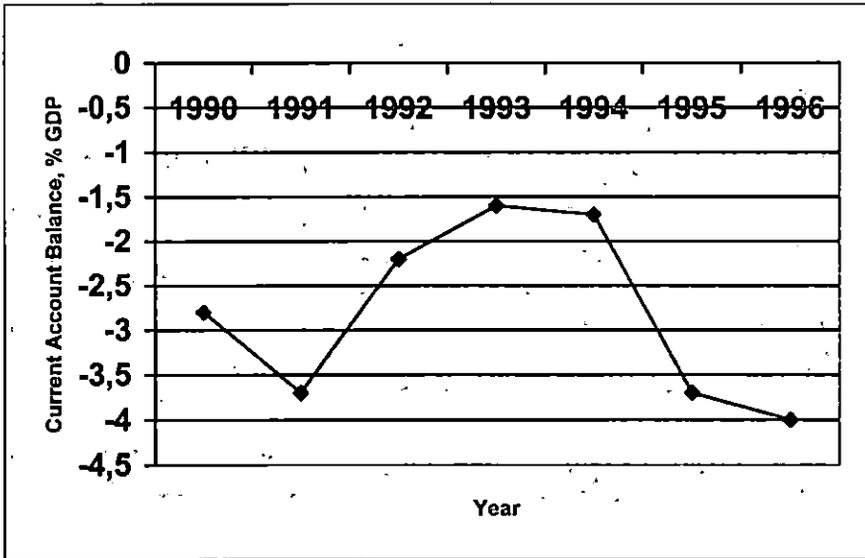
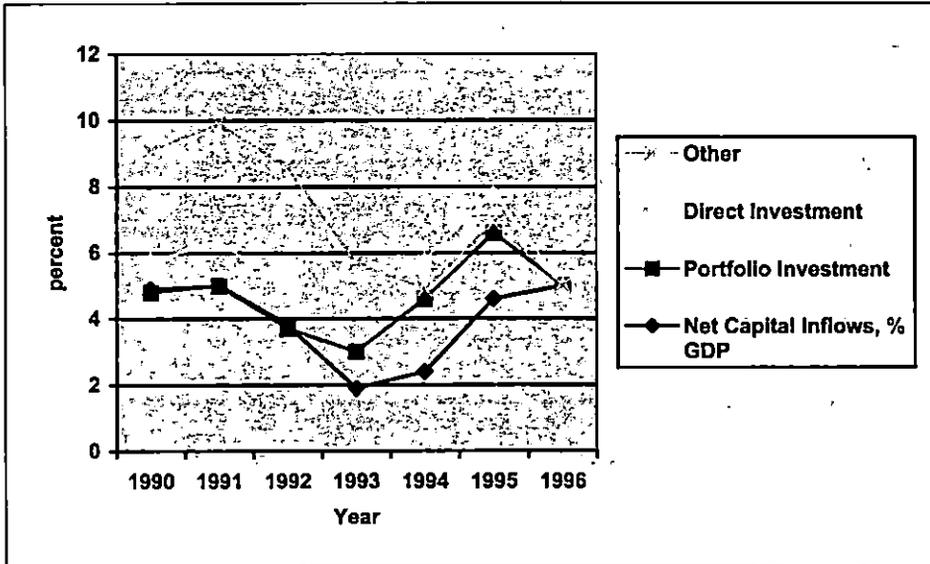
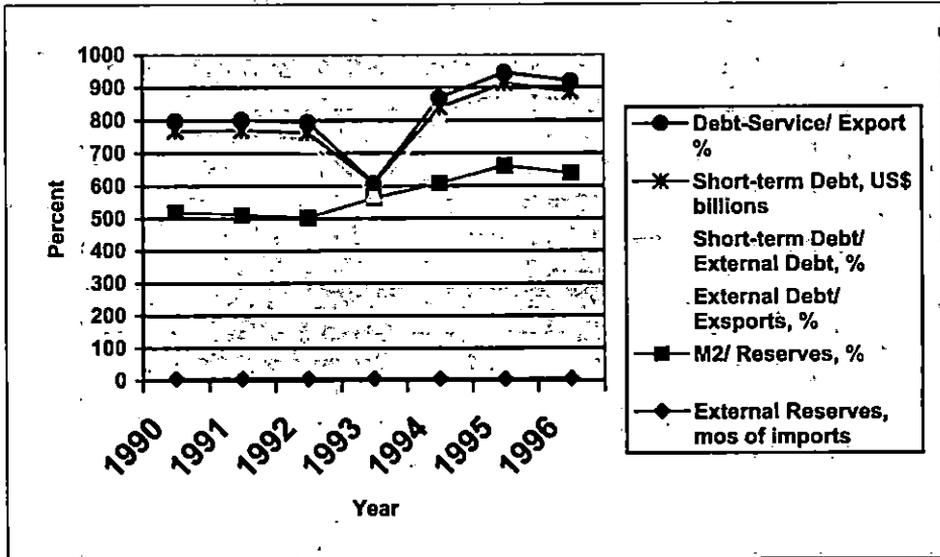


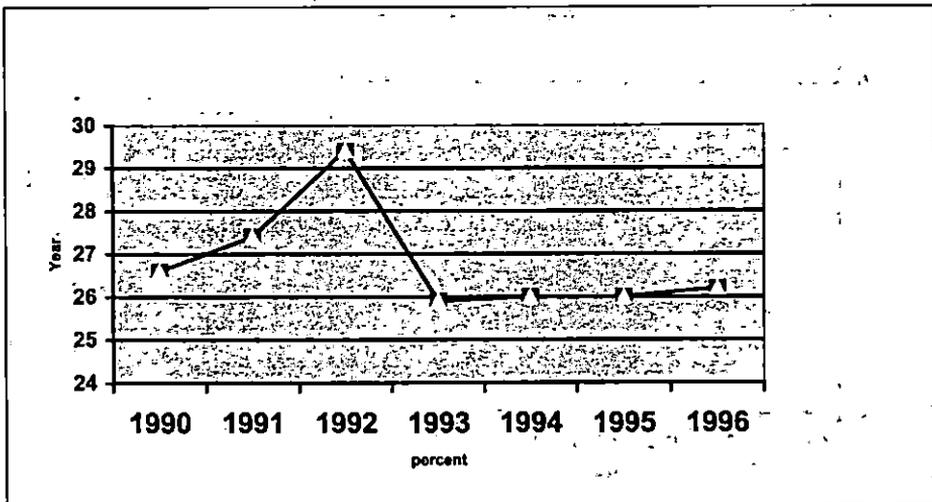
Figure-4  
Capital Inflows, % GDP



**Figure-5**  
**External Reserves, % GDP**



**Figure-6**  
**Exports, % GDP**



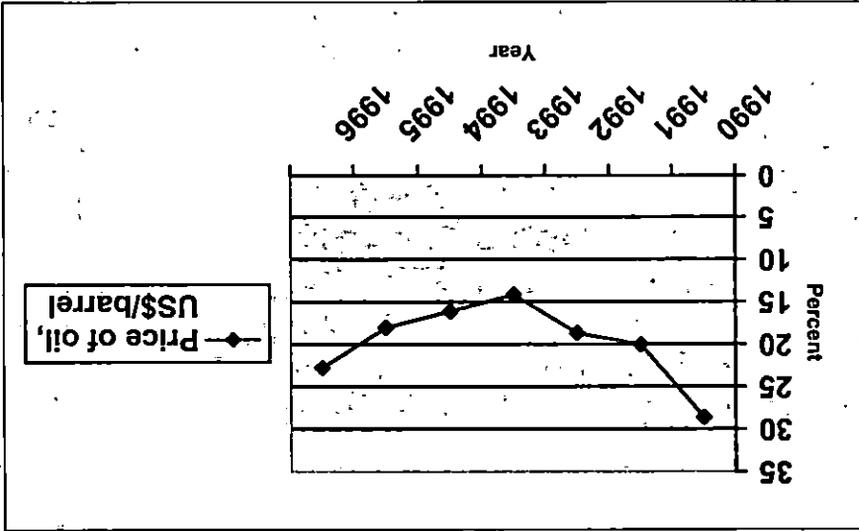


Figure-8  
Price of Oil, US\$/ barrel

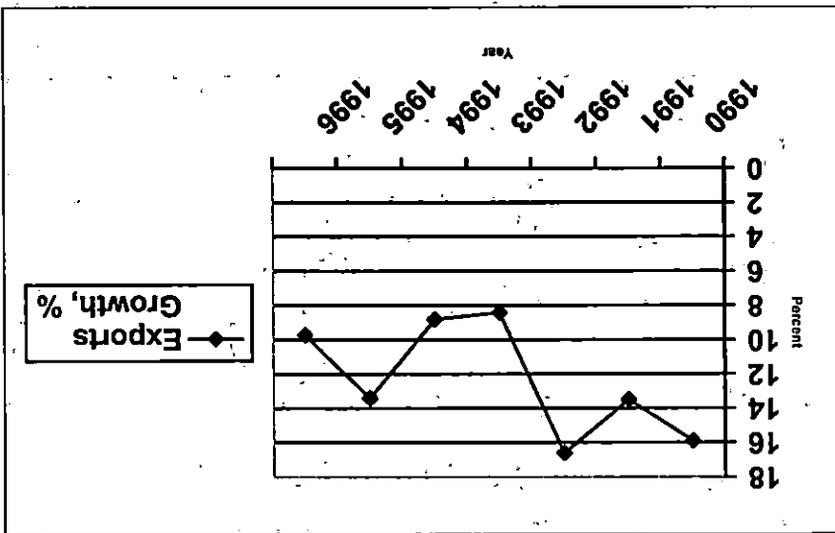


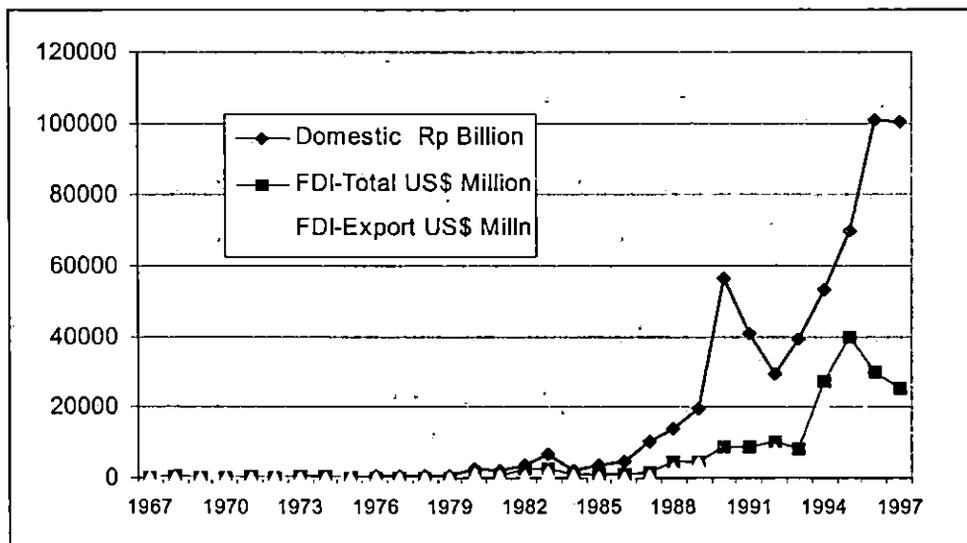
Figure-7  
Exports Growth %

**Tabel 7: FDI Project by Sector 1991-1998 (Million US \$)**

Sector	1993	1994	1995	1996	1997	1998*	Growth 97-98
Agriculture and fisheries	160.1	729.8	1384.2	1251.6	463.7	790.3	70.43
Mining	0	0	0	1696.8	1.6	0.3	-81.25
Manufacturing	3422.8	22367.8	26892.1	16072.1	23017.3	4728	-79.46
Electricity, Gas and Water	2275.6	2397.3	3549.3	3805.5	1839.9	1607.4	-12.64
Construction	96.9	76.5	205.8	296.8	306.8	155.8	-49.22
Trade, restorants and hotels	1087.5	430.3	1029.3	1761.7	472	421.3	-10.74
Transport and comunication	85.4	145.1	5539.5	694.6	5900	70.5	-98.81
Finance and Insurance	598	1027.8	1222	3000.3	1397.6	787.6	-43.65
Other Services	417.9	178.7	122.5	1076.2	433.6	118.9	-72.58
Total	10137.2	29347.3	41939.7	31651.6	35829.5	8680.1	-75.77

Sources: UN – World Investment Report 1999 & BKPM

**Figure 9: FDI and Domestic Investment 1967 – 1997**



**Figure 10 : Cost of Labor related to FDI from 1967 – 1997**

