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ECONOMIC CRISIS IN INDONESIA

Abstract

The objective of this paper is to identify the causes of recent economic crisis in Indonesia. The economic fundamentals of Indonesia were quite strong before the onset of the crisis. There were however, some problems in the financial sector. Under the pressure of the IMF in the early 1990s, Indonesia embarked on a hasty financial sector reform programme. This reform led to huge expansion of the financial sector in the country. The ratio of short term debt to foreign exchange crossed the critical marks and made the country vulnerable to any liquidity crisis. The financial crisis started from Thailand. Initially, Indonesia tackled the situation carefully. However, some policy mistakes by the government and wrong prescription of the IMF pushed the country into deep trouble. Political uncertainty and food shortage all aggravated the problem.

1. INTRODUCTION

The present paper is concerned with the current financial crisis of East and South East Asian region. The crisis has been so severe that it is termed as the most serious financial and economic crisis in the world since the Second World War. Over the last two decades, the East Asian region achieved a very rapid and stunning economic growth. As a result, many analysts started to portray the next century as "Asia's century'. At the same time, a popular view also emerged that the Asian model of state-directed capitalism would replace the US model of free capitalism. Probably, because of such

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optimistic views, nobody could foresee the severity and depth of the current crisis.

This paper will primarily focus on Indonesia, one of the most severely hit countries. However, the analysis cannot ignore other countries of the region since these countries are closely interlinked and they were hit by the crisis almost simultaneously. The paper will examine the causes of financial crisis in Indonesia. The following factors are assumed to be responsible for the crisis :

1. Shift in international market conditions;
2. Economic management and Asian capitalism; and
3. Financial market instability.

However, debate continues over the relative importance of the above mentioned factors. The paper will go into a study with empirical data to find relative contribution of the above mentioned factors in the Indonesian crisis. Another objective of the paper is to critically examine the role of the IMF before and during the crisis period of Indonesia. The current debate centered around whether IMF's intervention in Indonesia actually worsened the situation or not. The paper will also examine the impact of the IMF intervention in Indonesia.

Section 2 of the paper reviews the ongoing debate over the causes of crisis in the East Asian region. Section 3 is the core section which analyzes the causes of the Indonesian crisis. The Role of the IMF is examined in Section 4.

2. THE ONGOING DEBATE OVER THE CAUSES OF CRISIS IN EAST ASIA

In the West, the East and South East Asian crisis is interpreted under the banner of two rival themes. One is the 'death throes' of Asian capitalism, and another is panic, triggering debt deflation in a sound but under regulated system[1].

According to the death throes view, the crisis is the outcome of excessive government intervention in the market, especially in the financial market. The proponents of this thesis opines that the crisis marked the beginning of the end of outmoded state directed Asian capitalism and it opened the way for a proper free market system. The most prominent exponent of this view is Alan Greenspan, the Chairman of the US Federal Reserve system[2]. In early December 1997, while talking to New York Economics Club, Greenspan made the following statement :

> The current crisis is likely to accelerate the dismantling in many Asian countries of a system with large elements of government directed investment in which finance played a key role in carrying out the state's objectives... Government directed production, financed with directed bank loans, cannot readily adjust to the continuously changing patterns of market demand for domestically consumed goods or exports. Gluts and shortages are inevitable.[3]

About the effect of Asian crisis, Greenspan said, 'what we have here is a very dramatic event towards a consensus of the type of market system we have in this country."[4] Stanley Fisher, the deputy managing director of the IMF, is another advocate of the death throes theme[5]. He listed several causes

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1. For a detailed discussion, see "Asian Financial Crisis", *World Development*, Vol. 26, No. 8, 1998.
2. For views of Greenspan, see, Testimony of Chairman Alan Greenspan before the Committee on Banking and Financial Services, U.S. House of Representatives, January 30, 1998.
3. *Ibid*.

of the recent crisis. These are : failure to dampen over heating, maintenance of pegged exchange rate for a long time, lax financial regulation, and insufficient political commitment. He holds the view that the basic institutional deficiencies with East Asian economies is the principal cause of the crisis.[6]

Corsetti, Pesenti and Roubini wrote, "central to a full understanding of the roots of Asian crisis is the multifaceted evidence on the structure of economic incentive under which the corporate and financial sector operated in the region, in the context of regulatory inadequacies and close link between public and private institutions."[7] Their view is that the Asian crisis in 1997 reflected structural and policy distortion in the countries of the region, even if market overreaction and herding caused the plunge of exchange rates and asset prices and economic activity to be more severe than warranted by initial weak economic condition.[8]

Jaffrey Sachs, Director of the Harvard Institute for International Development, is the most prominent exponent of the second view on the crisis, which postualted that panic and chaos led to the debacle. He along with Steven Radelet argued:

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4. *Ibid.*
5. For IMF view on the crisis, see, "The Asian Crisis: A View from the IMF", Address by Stanley Fischer at the Midwinter Conference of the Bankers' Association for Foreign Trade, Washington, D.C., January 22, 1998
6. *Ibid.*
7. G. Corsetti, P. Pesenti, and N. Roubini, 1998, "What Caused the Asian currency and financial crisis ?", http://www.stern.nyu.edu/~nroubini/-asia/asiacri2.pdf.
8. *Ibid.*

> There is no 'fundamental' reason for Asia's financial calamity except financial panic itself. Asia's need for significant financial sector reform is real, but not a sufficient cause for the panic, and not a justification for harsh macro-economic policy adjustment.
>
> Asia's fundamentals are adequate to forestall an economic contraction; budgets are in balance or surplus, inflation is low, private savings are high, economies are poised for export growth. Asia is reeling not from crisis of fundamentals but a self-fulfilling withdrawal of short term loans one that is fueled by each investoris recognition that all other investors are withdrawing their claims. Since short-term debts exceed foreign exchange reserves, it is 'rational' for each investor to join the panic.[9]

Joseph Stiglitz, the chief economist of the World Bank, expressed his view against the idea of more deregulation when he wrote :

> For the past 25 years, East Asian economies have grown more than twice as fast as the average rate for the rest of the world.... These successes have been fostered by sound fiscal policies, low inflation, export driven growth and effective institutions which in turn helped make east Asia the world's leading recipient of foreign investment....Recent developments, however, underscore the challenges presented by a world of mobile capital even for countries with strong economic fundamentals. The rapid growth and large influx of foreign investment created economic strain. In addition, heavy foreign investment combined with weak financial regulations to allow

9. See, Steven Radelet and Jeffrey Sachs. "The Onset of the East Asian Currency Crisis", unpublished manuscript, 1998.

be on deregulation. but on finding right regulatory regime to reestablish stability and confidence.[10]

> lenders in many South East Asian countries to rapidly expand credit, often to risky borrowers, making the financial system more vulnerable. Inadequate oversight, not over regulation, caused the problems. Consequently, our emphasis should not

The above view of the chief economist of the World Bank sharply contradicted with the statement made by Alan Greenspan. In any case, it will be difficult to explain the Asian financial crisis either in terms of death throes or panic theories because elements of both were present in the initiation and worsening of the crisis.

3. FINANCIAL CRISIS IN INDONESIA

The purpose of this section is to identify the causes of recent financial crisis in Indonesia. The analysis of this section will be based on the following three factors: (i) Shift in international market condition; (ii) Economic management and Asian capitalism; (iii) Financial instability.

Shift in international market condition :

In general, the international market condition seemed to be very favorable before the onset of the crisis. The world commodity market was relatively stable, interest rate in the United States was low, the growth of total volume of international trade in 1996 and 1997, though slower than in 1993-95, was still very strong. However, in spite of such favorable international climate, the East Asian countries faced deterioration in current account balance in 1996. Table-1 gives the current account balance scenario for the East

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10. Joseph Stiglitz, "How to fix the Asian Economies", *New York Times*, October 31, 1997.

Asian countries. All the South East Asian countries excepting Singapore experienced adverse current account balance. In the East and North East region, Korea had similar experiences while China, Taiwan experienced favourable current balance.

Table 1 : Current Account (% of GDP)

	1990	1991	1992	1993	1994	1995	1996	1997
Korea	-1.24	-3.16	-1.70	-0.16	-1.45	-1.91	-4.82	-1.90
Indonesia	**-2.82**	**-3.65**	**-2.11**	**-1.33**	**-1.58**	**-3.18**	**-3.37**	**-2.24**
Malaysia	-2.03	-8.69	-3.74	-4.66	-6.24	-8.43	-4.89	-4.85
Philippines	-6.08	-2.28	-1.86	-5.55	-4.60	-2.67	-4.77	-5.23
Singapore	8.33	11.29	11.38	7.57	16.12	16.61	15.68	15.37
Thailand	-8.50	-7.71	-5.66	-5.08	-5.60	-8.06	-8.10	-1.90
China	3.09	3.27	1.33	-1.94	1.26	0.23	0.87	3.24
Taiwan	6.82	6.94	4.03	3.16	2.70	2.10	4.05	2.72

Source: International Financial Statistics (IFS), issues 1991-1998

In 1996, Malaysia and Korea had current account deficit around 5% of GDP while Thailand's current account deficit was much larger, 8% of her GDP. On the other hand, Indonesia had much lower deficit of around 3.5%. In fact, Indonesia's deficit was the lowest among all the crisis hit countries. Indonesia experienced only slight deterioration in current account deficit from 1995 to 1996. Still it is important to look at causes of such deterioration of current account deficit. One way is to examine the export performance. In 1996 two crisis hit countries, Korea and Malaysia, experienced collapse in the growth of export value. The unit value of these countries export product also fell sharply. Table 2 shows the export performance of different Asian countries.

Table 2: Changes in Exports of Selected Countries

	Export Value Growth		Export Volume Growth		Change in unit Value	
	1995	1996	1995	1996	1995	1996
Korea	30.3	3.7	24.0	19.1	5.0	-12.9
China	22.9	1.6	15.3	8.3	6.6	-6.2
Singapore	22.1	5.7	15.7	6.3	5.6	-0.6
Indonesia	13.4	9.7	10.3	4.8	2.8	4.7
Malaysia	26.0	5.8	15.6	13.6	9.0	-6.9
Philippines	31.6	16.7	17.0	18.8	12.4	-1.8
Thailand	25.2	-1.3	14.2	-0.7	9.5	-0.6

Source: Data on value from International Financial Statitics.(1996, 1997) Volume data from Bank of International Settlement report, 1997

Indonesia, the focus of this study, experienced export value growth of 10% which was the second highest after Philippines. The unit value of export product actually rose for Indonesia and Indonesia is the only country in the region which enjoyed the rise of unit value. On the other hand, export volume growth fell significantly from 10.3% in 1995 to only 4.8% in 1996. The fall in Indonesiaís export growth should have an influence on the deterioration of the current account deficit. The reason for the slowing down of export growth may be examined in terms of prices of some strategic commodities. World prices of semi conductor and electronics good fell sharply in 1996 (Bank of International Settlement Report, 1997). The price of semi-conductor dropped by about 80%. Such drastic reduction in the price of semi -conductor was the principal cause for the drop of unit value of export product of Korea and Malaysia which primarily export electronic goods and semi-conductors. However, this explanation can not be applied to Indonesia since Indonesia actually experienced a rise in unit value of export.

The fall in Indonesia's export volume can partly be explained by the emergence of China as a major export power in the region. From $ 20 billion export in 1976, China's export rose to $150 billion in 1996 and it became eleventh largest exporter in the world. Chinese firms compete directly with Indonesian firms in textiles, apparel and the electronics market. Of the total export from 5 ASEAN economies and China, China's share of garment export surged from 37% in 1990 to 60% in 1996. Such increase in Chinese export may displace Indonesia's export from some particular sector like garments. However, the impact may not be of much significance since China's share of export to the six countries was 32% in 1996 which was actually down by two percentage point from 1994. Moreover, China experienced low export volume growth of 1.6% in 1996 and her unit value fell to a large degree.

In 1994, 40% devaluation of Chinese currency Yuan may have had some impact on Indonesia's export growth. However, gradual nominal appreciation of Yuan in the following two years and inflation averaging 20% in 1994-1996 eroded much of the real impact of such devaluation. During 1994-1996, Indonesia had average inflation of around 7.5% which was much lower than Chinese inflation and consequently, Indonesia's export competitive position *vis-a-vis* China did not lose much ground. Sharp real appreciation of U.S. dollar *vis-a-vis* yen and European currencies after 1995 may have some impact on Indonesia's export competitive position. Indonesia followed a policy of real exchange rate targeting. Table 3 gives the picture of real exchange rate fluctuation for selected Asian countries.

Table 3. Real Exchange Rate at the End of Year Data

	1990	1991	1992	1993	1994	1995	1996	1997
Korea	96.00	91.50	87.70	85.20	84.70	87.70	87.20	58.60
Indonesia	**97.40**	**99.60**	**100.80**	**103.80**	**101.10**	**100.50**	**105.40**	**62.40**
Malaysia	97.00	96.90	109.70	111.00	107.10	106.90	112.10	84.90
Philippines	92.40	103.10	107.10	97.40	111.70	109.60	116.40	90.90
Singapore	101.20	105.70	106.00	108.60	111.90	112.70	118.20	114.40
Thailand	102.20	99.00	99.70	101.90	98.30	101.70	107.60	72.40
Taiwan	96.50	95.70	95.70	91.40	92.60	90.4	89.6	89.20

Source: J.P. Morgan, Asian Financial Market, January 1998. The base figure 100 is the average for the year 1990.

Taking 1990 as the base year, it is calculated that by the spring of 1997, the real exchange rate of Indonesia appreciated by 8%. The real exchange rate appreciation figures for Malaysia, Singapore, Hong Kong, Thailand were 19%, 18%, 30% and 12% respectively. On the other hand, in Korea and Taiwan real exchange rate depreciated during the above period. If real exchange rate figure is calculated after 1995, the Indonesian figure gives a much smaller 5% appreciation. It can be guessed that such appreciation, though small, still may have some impact on Indonesia's export performance.

To summarize, before the onset of crisis, Indonesia suffered setback in export sector which was partly responsible for the deterioration of current account balance. However, such setback was much milder than experienced by other crisis-hit countries of the region. The slowing down of export volume growth might have dampened investor confidence about Indonesia's potentiality to service foreign debt. Emergence of China as an export power, the devaluation of Yuan, the appreciation of U.S. dollar are considered to be the factors responsible for Indonesia's export setback.

Economic management and Asian capitalism :

The second major hypothesis is that the weakness in Asian economic management brought in the crisis. However, before blaming "fundamental weakness" for the crisis, there is the need to explain two relevant issues: (i) the apparently unanticipated nature of the crisis; and (ii) the continued high level of capital inflow into East Asia until the very brink of the crisis.

In an attempt to reconcile these factors, Paul Krugman argued that the foreign investors expected that they would be bailed out from East Asia's faulty use of loans.[11] According to this argument, the foreign creditors lent to Asian banks in the expectation that the central bank and the IMF would provide fund to Asian banks to prevent their collapse during any crisis and consequently, the foreign creditors invested recklessly in East Asia without paying much attention to the future debt service capability of the borrowers.

To examine this theory of Krugman in the context of Indonesia, the paper checks whether the pattern of lending sharply deteriorated in Indonesia during 1990s. Table 4 provides information on the growth of bank lending to the private sector for selected Asian countries.

11. Paul Krugman, "What Happened to Asia?". Unpublished Manuscript. January 1998.

Table 4. Bank Lending to the Private Sector(% growth)

	1991	1992	1993	1994	1995	1996
Korea	20.78	12.65	12.94	20.08	15.45	20.01
Indonesia	**17.82**	**12.29**	**25.48**	**22.97**	**22.57**	**21.45**
Malaysia	20.58	10.79	10.80	16.04	30.65	25.77
Philippines	7.33	24.66	40.74	26.52	45.39	48.72
Singapore	12.41	9.77	15.15	15.25	20.26	15.82
Thailand	20.45	20.52	24.03	30.28	23.76	14.63
China	19.76	20.84	43.52	24.58	24.23	24.68
Taiwan	21.25	28.70	19.46	6.18	10.00	6.00

Source: International Financial Statistics. (1992, 1997)

It is seen that during 1990s bank lending in Indonesia grew at a steady rate of around 22% and there is not much fluctuation in lending behavior. The rate of growth of lending in Indonesia is comparable with other crisis-hit countries and the rate is even lower than that of China, the country which escaped the crisis. Figures for lending boom measurement will also show that there was no excessive bank lending in Indonesia(Table 5). The lending boom is indicated by the rate of growth between 1990 and 1996 of the ratio between claims on the private sector of the deposit money banks and nominal GDP. Table 5 shows that among the crisis-hit countries, Indonesia had the lowest measurement of lending boom suggesting that there is little evidence of excessive lending by banking sector. One way to judge the quality of lending is to look at the sectors where loans are going. Table 6 shows the shares of commercial bank lending by sector for Indonesia in 1990 and 1996.

Table 5. Lending Boom Measure

Korea	11%
Indonesia	**10%**
Malaysia	31%
Philippines	14%
Singapore	4%
Thailand	58%
Hong Kong	26%
China	7%

Source: IFS (1991, 1997)

Table 6 . Loans and Advance by Sector (% share)

	1990	1996
Agriculture	9.0	6.0
Manufacturing	35.0	27.0
Construction		
Trade	34.0	24.0
Finance & real estate	18.0	31.0
Household	3.0	11.0

Source: IFS (1991, 1997)

The data show that between 1990 and 1996, there was clear shift in lending toward the finance and real estate sectors, while lending towards the manufacturing and agriculture sectors fell to a large extent. This is alarming since debt repayment capability depends on the performance of manufacturing sector which earns foreign exchange through export. However, the data should be treated cautiously as in Indonesia there is a large non bank financial sector and without the data of this sector one can not come to any conclusion about lending pattern. Price behavior of land market and stock market can give a clue whether lending was actually concentrating in real estate and financial sector. Table 7 gives the stock and land price indices for Indonesia.

Table 7. Stock and Land Values

Period	Stock price Index	Capital Value Grade A office space
Q2 90	92	$2525
Q4 90	56	$3019
Q2 91	45	$2911
Q4 91	33	$2788
Q2 92	41	$2482
Q4 92	33	$2327
Q2 93	44	$2279
Q4 93	67	$2402
Q2 94	54	$2358
Q4 94	55	$2358
Q2 95	61	$2200
Q4 95	64	$2179
Q2 96	72	$2136
Q4 96	75	$2250
Q2 97	80	$2267

Source : Data Stream & Jones Lang Wootten, January 1998

The land price remained almost the same in June 1997 as they had been in June 1993, displaying no evidence of either a sharp rise or fall. The stock price rose steadily after 1992 and continued to do so until 1997, without a bust preceding the crisis. So the land market and stock market do not show that there was much pressure on prices resulting from the concentration of lending in these sectors. The stock market behavior also does not support Krugmanis hypothesis that

"In all of the afflicted countries there was a boom bust cycle in asset market that preceded the currency crisis: stock and land prices soared, then plunged".[12]

Another possible indicator of loan quality is the share of non performing loan to total loan. The data of this indicator are shown in Table 8.

Table 8. Non-Performing Loan(% of total loan)

	1990	1994	1995	1996
Indonesia	**4.5**	**12.0**	**10.4**	**8.8**
Korea	2.1	1.0	.9	.8
Malaysia	20.4	8.1	5.5	3.9
Thailand	9.7	7.5	7.7	n.a

Source: Bank for International Settlement. (1991-1997 issucs)

In Indonesia, the volume of non performing loan (NPL) peaked in 1994. After 1994, banks became more profitable and many banks written off the loans. The NPL ratio was also helped when a large state owned bank (Bank Nagara) cleaned up its balance sheet prior to listing share publicly. The World Bank in Indonesia in its country report (May 1997) noted "The quality of commercial bank portfolio continued to improve during 1996, albeit slowly". Incremental Capital Output Ratio (ICOR) is a crude macro economic indicator to judge quality of investment. Generally , when investment quality deteriorates, this ratio increases as more investment is needed to support given increase in output. Table-9 provides the ICOR for Indonesia and other countries.

12. *Ibid.*

Table 9. Incremental Capital Output Ratio

	1987-92	1993-96
Korea	3.8	4.9
Indonesia	**4.0**	**3.8**
Malaysia	3.7	4.8
Philippines	6.0	5.5
Thailand	3.4	5.1
China	3.1	2.9
Taiwan	2.4	3.9

Source: JP Morgan, Asian Financial Market, January 1998.

The ratio increases for all of the crisis-hit countries except Indonesia. In fact, for Indonesia the ratio declines indicating improvement in investment quality over the period from 1987 to 1996.

To summarize the above analysis, it can be said that there is no conclusive evidence to suggest that investment quality in Indonesia had deteriorated sharply and banks were lending recklessly. The next problem is whether foreign lenders actually perceived that financial condition of Indonesia was unsustainable. It is very difficult to find answer of this problem. Therefore, an indirect method of examining reports from different rating agencies is adopted to solve this problem. If lenders perceived a growing risk in Asia, spreads on Asian bonds should have increased in the run up to crisis. A recent study by William Cline and Kevine Barnes showed that both bond spreads and syndicated loan spreads actually decreased in South East Asia between mid 1995 and mid 1997.[13] The BIS annual report of 1997 also shows decline of spreads.

13. William Cline and J.S.. Barnes Kevin, "Spreads and Risks in Emerging Market Lending", Institute for International Finance Research Paper, No. 97-1, 1997.

Another source to learn about the risk perception by International Market is the rating report prepared by different agencies. In the Euro Money country Risk Ratings, Indonesia maintained steady position until 1997. Market Credit Worthiness Report prepared by Standard and Poors showed stable outlook for Indonesia even before the crisis. Table 10 gives the expected export growth figures for different countries prepared by Goldman Sack.

Table 10. Expectations of Export Growth

	Expected 96	Outcome 96	Expected 97
Indonesia	**14.3**	**4.9**	**15.0**
Malaysia	18.0	7.3	15.0
Philippines	25.0	17.7	23
Thailand	22.0	-1.7	7.7

Sources : *Goldman Sachs Investment Bank Forecast, 1996*

Goldman Sack expected that Indonesiaís export would grow by 15% in 1997. They held such high expectation inspite of the fact that Indonesian export grew at around 5% in the previous year. All these reports suggest that international market had positive expectation about Indonesian economy even just before the onset of crisis. Still one more question is left to be answered: Was there any expectation on the part of the foreign creditors that they would be bailed out if there were any crisis? In the East Asian region, the banks and firms had close ties with governments. The state owned banks obviously could expect to be bailed out if there was crisis. In Indonesia lending was heavily to non-bank corporate sector. International banks might assume that lending to bank was at least partly protected by the lender of last resort facilities, both domestic and international (IMF). The same might be true for a portion of private sector firms with strong government connection. However, there is no reason to suppose that foreign banks expected such guarantees on lending to the majority of non bank private corporations. In sum, it can be concluded that there is enough reason to believe that foreign investors thought too little about the risk of investing in Indonesia because they expected rapid growth and high profitability to continue, not because they expected a bail out.

Financial market instability :

The third hypothesis is that the crisis was triggered by dramatic swings in the creditors expectations about the behavior of other creditors, thereby creating a self-fulfilling, though possibly individually rational, panic.

Underlying this hypothesis is the illiquidity-insolvency model developed by Cooper and Sachs which states that creditors act on the basis of the actions of other creditors, not on the basis of debtor's fundamentals, as perceived by the individual investors.[14] To understand this approach it is needed to make distinction between illiquidity and insolvency. An insolvent borrower lacks the net worth to repay outstanding debt out of future earnings while an illiquid borrower lacks the ready cash to repay current debt servicing obligations even though it has net worth to repay debt in the long run. According to this model, a liquidity crisis occurs if a solvent but illiquid borrower is unable to borrow fresh funds from capital market

14. Richard Cooper and Jeffrey Sachs, "Borrowing Abroad : The Debtor's Perspectives" in Gordon Smith and John Cudington (eds). *International Debt and the Developing Countries*, World Bank Symposium, 1985.

in order to remain current on debt service obligation. Since the borrower is solvent, the market could in principle provide new loans to repay existing debts with the expectations that both the old loans and new loans will be fully serviced. The inability of the capital market to provide fresh loans to the illiquid borrowers is the crux of the problem. The prime cause of such market failure is a problem of collec-tive action. Liquidity crisis arises when creditors as a group would be willing to make a new loan, but no individual creditor is willing to make loan if other creditors do not lend as well. One possible equilibrium is that no individual creditor is willing to make loan to an illiquid borrower precisely because each creditor expects that no other creditor is ready to make such loan. It will be pertinent to examine whether the illiqui-dityinsolvency theory can interpret the recent crisis in Indonesia.

It is very difficult to get exact measure of solvency since the concept needs information about future earning capability. One crude way is to extrapolate past trend to get future figures. In the case of Indonesia, the most pertinent figures should be past GDP growth rates, savings rates and investment rates. Table 11 gives the growth rate of GDP , investment and savings rates for Indonesia.

Table 11. GDP, Investment and Savings Rates for Indonesia

	1991	1992	1993	1994	1995	1996
GDP growth	6.95	6.46	6.50	15.93	8.22	7.98
Investment	38.15	35.50	35.87	29.48	31.06	31.93
Savings	31.75	31.10	33.41	28.66	29.52	27.65

Source: IFS (1992-1997)

Throughout 1990s until the crisis period, Indonesian economy progressed with remarkable GDP growth which was consistently above 6%. The rate of investment was always above 30% level and savings rate was also very high hovering around 30% of GDP. There was no reason to believe that such trend will not continue in the future. The other factors such as government fiscal balance and inflation rate also did not show any discouraging trend. The government maintained consistently surplus fiscal balance with the exception of 1992 when it went into slight deficit. Given such positive scenario, Indonesia cannot be termed as insolvent borrower. The next question is whether Indonesia was illiquid borrower. To deal with this question data on debt, foreign reserves, debt service situation are needed. Table 12 shows World Bank data on Indonesia's total debt as percentage of GDP and short term debt as percentage of total debt.

Table 12. Foreign Debt (% of GDP) and Short Term Debt (% of Total)

	1990	1991	1992	1993	1994	1995	1996
Foreign Debt	65.89	68.21	68.74	56.44	60.96	61.54	56.74
Short term debt	**15.92**	**18.00**	**20.52**	**20.17**	**18.05**	**20.87**	**24.98**

Source : World Bank, *Global Development Finance Report*, 1998.

The Table suggests that foreign debt as percentage of GDP was falling during 1990s. However, the share of short term debt was continuously increasing. This is a alarming sign since short term debt is the most volatile form of debt and accumulation of such type of debt was partly responsible for financial crisis in Mexico and Argentina. Table 13 gives figures for debt service as a ratio of exports for Indonesia.

Table 13. Debt Service Ratio

	1990	1991	1992	1993	1994	1995	1996
Indonesia	**33.40**	**34.30**	**32.60**	**33.60**	**30.70**	**30.90**	**36.90**

Source: World Bank. *Global Development Finance Report*, 1998.

Indonesia's debt service ratio was the highest among all countries in the region. Philippines had the next position with debt service ratio of around 20%, a much lower figure than Indonesia. However, real problem lies with the position of short term debt. A solvent country may suffer a short run liquidity problem if the available stock of reserve is low relative to the overall burden of external debt service. Liquidity problem can arise when panicking external creditors in response to rapid devaluation become unwilling to roll over existing short term debts. Table 14 gives information about the situation of short term debt *vis-a-vis* foreign exchange reserve for some selected Asian countries.

Table 14. Short Term Debt (% of foreign reserve)

	1990	1991	1992	1993	1994	1995	1996
Korea	72.13	81.75	69.62	60.31	54.06	171.45	203.23
Indonesia	149.28	154.82	172.81	159.70	160.38	189.42	176.56
Malaysia	19.54	19.05	21.12	25.51	24.34	30.60	40.98
Philippines	479.11	152.31	119.37	107.68	95.00	82.85	79.45
Thailand	62.55	71.31	72.34	92.49	99.48	114.21	99.69
China	31.49	24.68	66.78	68.33	33.04	29.62	23.74

Source: World Bank, as in Table 12.

Table 14 clearly shows that Indonesia's short term debt far exceeded her foreign exchange reserve making Indonesia vulnerable to any kind of liquidity crisis. The short term debt to foreign reserve ratio is very high for Indonesia and her position was only next to Korea in the region. To get a more elaborate picture, Table 15 was constructed which added debt service data to the earlier drawn picture.

Table 15. Debt Service: Short Term Debt (% of foreign reserve)

	1990	1991	1992	1993	1994	1995	1996
Korea	127.43	125.90	110.35	105.66	84.90	204.93	243.31
Indonesia	282.92	278.75	292.03	284.79	277.95	309.18	294.17
Malaysia	63.95	45.87	45.55	42.37	48.73	55.92	69.33
Philippines	667.64	256.99	217.08	212.60	171.98	166.60	137.06
Thailand	103.35	99.34	101.34	120.28	126.54	138.13	122.63
China	53.34	43.70	108.55	113.74	54.08	46.91	38.46

Source: World Bank, as in Table 12

Table 15 draws even more dismal picture for Indonesia. With the inclusion of debt service ratio, the burden measured by the ratio of foreign reserve rose to around 300% which is the highest in the whole region. To further indicate Indonesian financial fragility, another table is constructed that shows the ratio of M2 to foreign reserves (Table 16). A traditional measure of the adequacy of foreign exchange reserves is the stock of reserves in months of imports. Now-a-

Table 16. M2 to Foreign Reserve Ratio

	1990	1991	1992	1993	1994	1995	1996
Korea	6.48	8.33	7.20	6.91	6.45	6.11	6.51
Indonesia	6.16	5.51	5.61	6.09	6.55	7.09	6.50
Malaysia	2.91	2.99	2.64	2.09	2.47	3.33	3.66
Philippines	16.33	4.82	4.35	4.90	4.86	5.86	4.50
Thailand	4.49	4.10	4.10	4.05	3.84	3.69	3.90

Source: IFS. 1991-97

days, rapid outflows of speculative money becomes a more important source of foreign exchange pressure than trade imbalance. Consequently, the above indicator is no longer a good indicator of the adequacy of foreign exchange reserve. Since in the event of an exchange rate crisis, all liquid money assets can potentially be converted into foreign exchange, the ratio of money assets to foreign exchange will give better indicator of the adequacy of foreign reserve.

Table 16 also gives the same picture of Indonesia's vulnerable financial condition. However, a natural question arises as to why there was no such crisis before 1997 despite the fact that Indonesiaís fragile condition prevailed through out 1990s. The reason may be that there was no triggering event before 1997. So the story runs as follows:

In January 1997, Hambo steel of Korea collapsed under $6 billion debts. In the following months Sammi Steel and Kia Motors also collapsed. As a result of such collapse, several Korean merchant banks, through which foreign borrowing was channeled to these companies, faced tremendous financial pressure. Almost at the same time, in Thailand, Samprasong Land missed payments due on its foreign debt in early February, signaling the fall in the property markets. During the next six months , the Bank of Thailand lent over $8 billion to the distressed financial institutions and BOT also committed almost all its foreign exchange reserves in forward contracts. In late June 1997, the Thai government removed support from a major finance company, Finance One, announcing that creditors would incur losses. This announcement contradicted Thai government's previous announcement that it would not allow companies to collapse. This shock accelerated withdrawal of foreign funds from

Thailand and it prompted the currency depreciation on July 2, 1997. The Thai Baht devaluation triggered the capital outflow from the rest of East Asia.

As the currency depreciated, foreign lenders became more worried that their customers would not be able to repay their debts and they began to call in their loans which actually reinforced depreciation. The withdrawal of funds also set off liquidity squeeze and sharp rise in interest rates. The firms that were profitable before the crisis found it difficult to obtain working capital. The foreign creditors became concerned about the profitability of their borrowers and they grew increasingly reluctant to roll over short term debt. The banking system came under intense pressure as non performing loans were rising very fast and depositors were withdrawing their funds either out of concern for the safety of banking system or to meet pressing foreign exchange obligations. To face the crisis, Indonesia at first widened the *Rupiah's* band to 12% and then floated the Rupiah. Consequently, Indonesia did not spend her foreign exchange reserve in a futile defense of the currency. Indonesiaís decision was widely applauded. However, problems arose when government raised rate of interest in August which actually intensified short run pressure. In early September, Indonesia joined Thailand, Malaysia and Philippines in the crisis. Indonesia signed first IMF programme on October 31st and the Rupiah immediately strengthened as a result of large intervention by Japan and Singapore. However, the boost in Rupiah was short lived and between November 3rd and December 4th the Rupiah depreciated by 23%. In December, food prices started to rise and at the same time world petroleum prices fell which sharply reduced Indonesiaís export receipt. Pressure on exchange rate mounted as Indonesia started to import food to meet shortage arising due to severest drought.

The situation took serious turn on December 5th, when it was announced that the then President Suharto was critically ill. The market fell precipitously, accelerating a fall that had been underway for a month.

4. THE EAST ASIAN FINANCIAL CRISIS AND THE ROLE OF THE IMF

This section will critically examine the role of IMF before and during the crisis period. In part, the financial crisis in Indonesia has its root in attempts at financial reform in early 1990s. The objective of this reform was to upgrade financial institutions. However, such reform left the economy exposed to the instabilities of international financial markets. In Indonesia, financial deregulation packages led to a huge expansion in the banking sector. The number of private banks tripled from 74 in 1988 to 206 in 1995. The rapid expansion in financial services was not matched by careful regulation and supervision. Moreover, the huge expansion in the banking system also made supervision much more difficult. Singapore and Hong Kong have stronger financial systems and they took steps to redress inadequate regulation and poor supervision and consequently these countries succeeded to escape the recent crisis. On the other hand, China and Vietnam had not undertaken significant financial sector reform and they had much less short term capital inflow.

It is IMF which put constant pressure on Indonesia and other East Asian countries to go ahead with financial reform programme. The hasty and partial financial reform is certainly a major cause of recent financial crisis in Indonesia.

As earlier mentioned, Indonesia signed first IMF programme on October 31, 1997. IMF's first action in Indonesia was to a financial panic and a run on the entire banking system other than foreign owned banks. The IMF observed on January 15, 1998:

Following the closure of 16 insolvent banks in November last year, customers concerned about safety of private banks have been shifting sizable amounts of deposits to state and foreign banks, while some have been withdrawing funds from the banking system entirely. These movements in deposit have greatly complicated the task of monetary policy, because they have led to bifurcation of the banking system. By mid November, a large number of banks were facing growing liquidity shortages and were unable to obtain sufficient funds in the interbank market to cover this gap, even after paying interest ranging upto 75%.[15]

Indonesia was required to take fiscal contractionary actions equal to 1% of GDP in FY 1997/1998 and 2% of GDP in FY 1998/1999. This policy was imposed even though Indonesia was already hard hit by the contractionary force of the withdrawal of foreign credit. In the case of monetary policy, the IMF put pressure to increase the rate of interest. The IMF describes the impact of such policies in a note "The liquidity conditions in domestic money markets were tightened signifi-cantly with one month interest rates on central bank

15. International Monetary Fund, Indonesia: Memorandum of Economic and Financial Policies, IMF, January, 1998.

certificates being increased from 11.5% to 30% on August 19. The fiscal policy was also tightened."[16] The note goes on to say:

> This policy response initially had a salutary effect on the exchange rate, but this respite did not last long. The tightening of monetary conditions transferred market pressures to the domestic economy, putting heavy strains on the already weak financial sector. As a consequence, a significant number of banks found themselves without sufficient resources to meet their payments obligations.[17]

Kindleberger wrote:

> With inelastic expectations... no fear of crisis or of currency depreciation... an increase in the discount rate attracts funds from abroad, and helps to provide the cash needed to ensure liquidity; with elastic expectations of change... of falling prices, bankruptcies, or exchange depreciation.. raising the discount rate may suggest to foreigners the need to take more funds out rather than bring new funds in.[18]

Probably this explains the reason of IMF's policy failure in Indonesia.

5. CONCLUSION

We have seen that the economic fundamentals of Indonesia was quite strong before the onset of crisis. There were some problems in the financial sector. Under the pressure of the IMF, in the early 1990s, Indonesia embarked on a hasty

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16. Indonesia, Request for Stand-by, November 1.
17. *Ibid.*
18. P. Kindleberger, *Manias, Panics, and Crashes: A History of Financial Crises*, Third Edition, New York: John Wiley and Sons, 1996.

financial sector reform program. This reform led to huge expansion of financial sector in the country. However, supervision and monitoring system was not developing at the same pace. In fact, this reform can be termed as partial financial reform. This partial financial reform is a major cause of the recent financial crisis. After the reform, the financial institutions of Indonesia were more able to establish connection with international market. These institutions borrowed heavily from international market at cheaper rate and subsequently the short term debt as ratio of total debt rose. The short term debt to foreign exchange ratio crossed the critical marks and made the country vulnerable to any liquidity crisis. The East Asian crisis started from Thailand. Initially, Indonesia tackled the situation carefully. However, some policy mistakes by the government and wrong prescription of IMF pushed the country into a etc. deep trouble. Political uncertainty, food shortage all aggravated the problem.