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Indonesia Special

When politics fuses with currency panic

Despite the country's "excellent fundamentals," it now finds itself gripped by a crisis of great magnitude

By Iwan J. Azis

Measured by currency depreciation, Indonesia is the most serious casualty among those countries involved in Asia's current financial crisis, which has gone on for more than six months. But how could this have happened given Indonesia's strong "fundamentals"?

Consider the following statistics for 1996: the country's real GDP grew by 7.8%; inflation declined to 6.5%; the current account deficit was at less than 4% of GDP (the lowest among the ASEAN-4, excluding Singapore and Brunei); the government budget showed a slight surplus; and foreign reserves were enough to finance five months of imports. The most recent estimate shows that even for the first two quarters of 1997, GDP growth was over 7%.

Serious faults could not be found on the macro-economic front. Indeed, the country's macro-economic position has been reasonably healthy thanks to tight fiscal and prudent monetary policies. Until the decision to float the rupiah was made on August 14, 1997, the exchange-rate situation had also improved, becoming more market-determined as evidenced by the periodically widened intervention band (the latest being 12%). With such a record, very few economists could point to "weak fundamentals." Surely none could predict a collapse.

What went wrong?

The Indonesian financial crisis evolved in stages, beginning with the devaluation of the Thai baht on July 2, 1997. Mutual fund managers and corporate treasurers from around the world – based not only in Bangkok but also in Jakarta, Manila and Kuala Lumpur – immediately began selling off local currencies, causing the region's stock markets to tumble as well.

In the second stage, expectations of currency depreciation generated a feeling of nervousness within the Indonesian corporate sector as companies scrambled to buy greenbacks to repay their enormous debts, many of which were short term, unhedged and used to finance long-term projects and/or high-risk schemes, especially in real estate.

So how were such loans made in the first place? Thanks to widespread optimism about the region's future growth and the celebrated label of "East Asian Miracle" (popularized by the World Bank), private investors in ASEAN countries, including Indonesia, have been poised to expand their investment activities since 1994. The high domestic interest rate did not dampen their enthusiasm, largely because it was easy to obtain foreign loans at a relatively low rate. The label "miracle" also seems to have swayed international lenders and investors, inclining them towards a certain recklessness.

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It is unclear whether the first or the second stage contributed more to the plunge in the rupiah. What is clear, however, is that early pressures did not come from what some political leaders in the region called "speculators" (i.e., those who attempted to profit from the declining values of a currency). It was only at a later stage that they may have taken advantage of the situation by joining the fray, attacking the already battered rupiah and baht, and further bruising the region's stock markets.

After a frustrating series of discussions in October of last year, lasting as long as two weeks, Indonesia finally reached agreement with the IMF on a reform package involving some $43bn. A major step entailed by the agreement was the decision to liquidate 16 banks, some of which were owned by well-connected businessmen and members of President Suharto's family. People rushed to withdraw deposits from the banks in question, and it soon became clear that market confidence had not been restored. The rupiah continued to dive, and the stock market to plunge. It was only much later that the IMF recognized that its demand to close insolvent banks had backfired in creating a feeling of widespread panic.

As the economic crisis phased into a political crisis, the possibility of systemic collapse became real. The IMF seems not to have anticipated the sudden jump in the political-risk premium. In such a situation, it is not unusual for rumors of all types to spread. When President Suharto canceled his scheduled visits to the ASEAN summit in Kuala Lumpur and to his wife's grave in Solo (only 35 minutes' flying time from Jakarta) in early December, many saw it as a bad sign. Speculation grew that the country was preparing for a debt moratorium. If true, it would shut off completely the country's access to affordable foreign credit for years to come, just as it did for large Latin American defaulters in the 1980s. In late December, another rumor spread that Suharto had had a stroke and there had been a military coup. In no time the stock market did yet another dive, with the rupiah falling to more than 5,200 to the dollar.

Entering 1998, the situation worsened. The market reacted harshly to the 1998-99 budget announced on January 6, which ignored the terms of the agreement Indonesia had reached with the IMF. The number of laid-off workers continued to increase, adding to the already high open unemployment (expected to reach seven million this year). The stock market plunged again and the rupiah hit the unimaginable level of over Rp11,000 per dollar.

Pandemonium ensued on January 8 and 9, when people went on a buying spree to hoard foodstuffs. Meanwhile, perceptions were widespread that Suharto had lost his touch. A popular revolt gained strength, and public attacks on the government and Suharto's leadership were on the rise. Fearing deeper political turmoil, the armed forces were put on special alert.

Only then, when it appeared that political tension in Jakarta could degenerate into anarchy, did the world begin to take notice. The potentially explosive mixture of continuing market panic and political uncertainty prompted an array of world leaders, including US President Bill Clinton, to phone Suharto. High-ranking US and IMF officials rushed to Jakarta to put pressure on him for urgent reform. The question is: which reforms should Suharto make?

Assessing IMF conditions

As noted above, it was decided in the IMF program that 16 problematic banks with large non-performing loans should be closed. While the notion of closing insolvent institutions is legitimate, it is debatable in this case whether the closure of an entire bank (forcing blameless workers to be laid off) is the right way to go, instead of punishing the bank's owners and managers only. In either case, a policy response to minimize the ripple effects of bank closure should have been put in place to avoid panic spreading throughout the entire financial market.

Next is the problem of interest rates. Realizing that pressures on the rupiah also came from a huge local demand for dollars, the IMF believed that interest rates must be raised. The use of liquid assets for the purchase of foreign currency ought to be minimized, or else the central bank must be prepared to defend the currency with its own reserves. Using M2 (broad money) as a proxy of monetary assets, we find that such assets are very large compared to the central bank's foreign reserves (FR) in Indonesia, rendering the country vulnerable to speculative attacks. The M2-FR ratio in Indonesia is around 6, the highest among the ASEAN-4.

The repercussions of this high ratio depend on the way the government responds to the pressure of fund withdrawal. If the central bank takes a firm position not to extend domestic credit to commercial banks, the pressures may lead to widespread

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bank defaults. Credits, including those for working capital that are badly needed by export-oriented industries, would have been scarcer. If, on the other hand, domestic credit is extended to commercial banks, fund withdrawals will not necessarily lead to defaults by banks, but it will be easier to purchase foreign exchange. Pressures on the rupiah will mount and in turn, the central bank will be forced to sell its foreign-exchange reserves. Obviously, this is a serious dilemma.

Actually, the Indonesian interest rate has been persistently high since the financial reforms of 1988. Thus, the country does not seem to fit IMF Deputy Managing Director Stanley Fischer's characterization that "Asian programs started after lengthy periods when monetary policy had sought to keep interest rates low . . ." One of the reasons Indonesia has a high interest rate is because of its open capital-account system, which allows a free flow of foreign exchange. In my opinion, the government should apply a tight liquidity policy in a discretionary manner, exempting the export generating sector and the lower income segment of the population (e.g., those in low-income housing).

Turning to the budget, the IMF's insistence on a non-expansionary fiscal policy is reasonable. When there is no market confidence, as in the current situation, increased government borrowing should not be encouraged. Instead, expenditures must be curtailed and revenues increased. The question is, by how much?

Measured in real terms, the notorious 1998-99 budget announced on January 6 was actually fairly reasonable. Development expenditures were down by 4%, and domestic revenue, up by 13%. The problem lay with routine expenditures. Despite the apparent belt-tightening, including a freeze on government salaries, one third of routine expenditures had to be allocated for external debt service payments. Because of the much-weakened rupiah, this item increased by 64% in nominal terms and 55% in real terms.

In essence, the government seems to be insisting on maintaining a firm position so as not to default on its foreign borrowings. The source of the country's crisis is private borrowing, not government debt. But the consequence of the crisis is also clear; government savings dropped dramatically, to the point where they are now inadequate to finance development expenditures. Hence, increased external borrowing by the government seems inevitable.

The revised budget, announced after the meeting between President Suharto and IMF Managing Director Michel Camdessus, assumes a 20% inflation rate (rather than 9%) and a zero GDP growth (rather than 4%). Even under such a scenario, government savings will be depleted, making borrowings essential.

What's in store?

The corporate financial situation in Indonesia remains fragile after the revised budget. There seems to be no alternative to resolving the debt and currency problem other than subscribing to debt restructuring, which is more desirable than a debt moratorium. Not even strict compliance with the IMF program can help to abate the panic caused by continued pressures on the rupiah. But debt restructuring cannot be applied to all debtors. Only the more prudent and healthier corporate entities – or those which enjoy long relationships with banks – can, and should, restructure. Some have already done so.

Cutbacks in monopolies and special privileges, subsidies and tariffs, contained in the letter of intent signed by Suharto and Camdessus, met with a subdued reaction: both the rupiah and the stock market continued to slip. The timing of Standard & Poor's announcement downgrading 15 Indonesian banks did not help matters either. But most crucial of all is the political factor. The market is waiting to see the extent to which Suharto will actually implement the agreed-on policies in a consistent and more transparent way.

A recovery for Indonesia is feasible – but not in the near future, especially now that the risk of social and political upheaval is so much greater. It is indeed difficult to predict with certainty what will be the speed of the country's economic recovery. A more definite outlook can be had after the presidential elections in March, when the nature of the new cabinet will be made known.

What kind of cabinet that will be is still anybody's guess. However, as I have written elsewhere, we can discern a seesawing between liberalization and protection in the management of the Indonesian economy: the hands of the technocrats are strengthened whenever serious problems are perceived, but when the economy is booming, protectionists often gain the upper hand. GT

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