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Indonesia's Experiences During the Economic Crisis: Lesson Learned and Challenges

by

Mr. Mohamad Ikhsan
Board Member of the International Food Policy Research Institute and
Special Advisor to the Vice President of the Republic of Indonesia
University of Indonesia, Jakarta
Indonesia

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Indonesia's Experiences during the economic crisis: Lesson Learned and Challenges

Mohamad Ikhsan[1]
Cicilia A. Harun[2]

Introduction

The 2008-09 crisis has shown that the world economy and its recovery are much more bumpy and fragile than was previously thought. We also learned that the world economy is more interdependent and it has a new setup with multiple sources of growth and new powerful links both between developed countries and developing countries and among developing countries. A new structure of (the world economy) is underway and the crisis has obviously accelerated the change in the global economic landscape, in which the developing countries have acquired greater importance in global economic growth and a greater share of the global economy. Nearly half of growth today is created by the developing countries.

By increasing their importance in the global economy, developing countries have a bigger role in determining the state of the global economy. As stated before, the current recovery process will not follow a smooth path as uncertainties are increasing. It is very important for developing countries to respond and navigate during the current turmoil because any crisis has potential to escalate – for example if this current European economic crisis is transmitted to other countries in the continent.

Indonesia is an interesting case study to see how a particular country was able to respond and manage the economic crisis. It has experienced two severe crises, in the mid 1960s and 1997-98, while it has successfully avoided two threatening episodes, the mid 1980s collapse in energy prices and the 2008-09 global financial crisis. As Basri and Hill (2010) pointed out, it relates to a combination of the quality and resilience of the country's institutions, the

1 Office of the Vice President Republic of Indonesia and Professor of Economics at University of Indonesia, Jakarta.

2 Bank Indonesia and Office of the Vice President Republic Indonesia

government's economic management credentials and the adaptibility of the business and household sectors.

This paper is aimed to provide experiences, lessons learned as well as challenges faced by Indonesia in the recent crisis. Indonesia provides a unique situation, in which it was the country that suffered the most during the East Asian financial crisis in 1997/1998 however it is among the strongest in weathering the recent crisis. It is interesting to find the answers to what went wrong then and what happened in Indonesia during the recent crisis.

The rest of the paper will be organized as follows. Part 2 provides some facts, analyses, and lessons learned on Indonesia's performance in the East Asian financial crisis and the 2008 Global crisis . Part 3 lays out Indonesia's conditions as well as lessons learned in the previous crisis. Some of the challenges that will be faced ahead by Indonesia and countries in the region are described in Part 5. Finally, Chapter 5 summarizes the arguments.

Indonesia and Economic Crises

At least since the late of 1960s, Indonesia has generally been able to navigate relatively well over any economic crisis.[3] As a result, Indonesia was one of 13 countries in the world - identified by the Growth Commission under the leadership of Nobel Laureate Mike Spence-, which was able to maintain its economic growth at least 6+ % over 30 years. The progress is also translated in other social indicators like the poverty rate. In the 1960s about two thirds of Indonesia was living below the poverty line. Now only 11 percent of Indonesian households have expenditures below the official poverty line.

The Asian Financial Crisis in 1998 is the exception. During the AFC 1998, Indonesia was recorded as the worst-affected country,characterized by a sharp contraction in output, and a significant increase in open unemployment and poverty. This contrasts with other crises including the 2008-2009 crisis, where the government was able to weather the external shocks.

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3 Following Basri and Hill (2010), Indonesia growth episodes since 1960 could be characterized into four episodes, i.e.,

(1) Mid 1960s : entirely home grown (politic and economic crises), mild contraction, swift recovery
(2) Mid 1980s : mixture of external and domestic factors (purely economic crisis), substantial growth slowdown, swift recovery
(3) 1997-98 : mixture external and internal factors (politic and economic crises), deep crisis, moderately quick recovery.
(4) 2008-09 : entirely external, slight growth deceleration, quick recovery.

In contrast to other Asian countries during the the AFC 1998, Indonesia experienced not only aneconomic crisis but also apolitical crisis and to some extent social crisis as well. The political crisis which then caused a transformation in the Indonesian political lanscape from an authoritarian to democratic regime is the most important factor that explains why the Indonesian economy became the worst-affected among East Asian countries during the AFC 1998.

The roots of the 1998 crisis started earlier in the middle of 1997 when severe weather ("El Nino") hit the Indonesian agriculture sector. Agriculture production, particularly rice, was depleted and caused a hike in food prices which in turn translated into a sharp increase in the inflation rate.[4] Agriculture supply shocks reduced domestic demand through a decline in both rural sector incomes and purchasing power of Indonesian households. As shown by Ikhsan (forthcoming), it was El Nino – not the financial crisis – that was most responsible for causing a significant rise in poverty incidence in 1997-1998. The weakening of domestic demand continued when the financial crisis hit investment and the construction sector where most of the rural population supplement their incomes for their livelihood.

The other key cause of the crisis was capital flight caused by the crisis in confidence along with the social crisis when some riots hit the Chinese minorities who are relatively dominant in the economy. The implication of massive capital flight caused a sharp depreciation of the Rupiah. While weak macroeconomic policies did not play a central role in causing the crisis in Indonesia, the pegged exchange rate encouraged excessive private sector foreign borrowing and poor risk management in the financial sector. In 1997, private sector lending was allocated mainly to sectors that earned very little foreign reserves such as real estate, and short-term external debt stood at about 196.4% of the country's international reserves. At the same time, about 30% of domestic banks' outstanding loans were in foreign currencies and one-tenth of the loans were to the real sector. (Ginting, and Aji, processed) The AFC, which led to massive rupiah depreciation, hit the assets and liabilities of the domestic banks. The collapse of the Indonesia banking sector then transmitted into the real economy (asset side of the banks), where many domestic firms particularly property, construction and import substitution manufacturing came to a halt.

4 The food price increases were not the only major cause of the skyrocketing of inflation rate during the period. It was a combination between large depreciation of Rupiah, agriculture supply shocks and panic buying. As shown in Graph 2, it took almost 20 months to stabilize domestic prices during the 1998 AFC. This is considered the longest high inflation period since the 1970s in Indonesian history.

Compared to other Asian affected countries, the slow recovery of Indonesia's economy was caused by the combination between the breakdown of economic institutions and the mismanagement of the crisis. As Basri and Hill stated: " the IMF 'over-managed' the crisis, by demanding fiscal austerity and excessive policy conditionality, in addition to displaying a lack of political sensitivity at key moments. The weakened power of President Soeharto along with his decision to form a relatively non credible cabinet made the policy management even worse.

The post Soeharto administration – except during the Abdurachman Wahid period – managed the economy relatively well and took at least four important sets of actions. (Ginting and Aji, processed) First, the government decided to recapitalize the banking sector to prevent the total collapse of this important economic institution. This policy had significant consequences where government debt increased dramatically. The government debt to GDP ratio rose from 23 % before the crisis (1996) to above 100%. To reduce the debt burden, a consistent fiscal consolidation was enacted by gradually reducing the budget deficit from 2.4% of GDP in 2001 to 0.1% of GDP in 2008. This effort was driven by improved revenue collection, reduced subsidies (especially the untargeted fuel and electricity subsidies), and lowered risk premiums and interest rates. This fiscal consolidation was also supplemented by an effort to improve financial management by replacing two Dutch-inherited colonialized budget laws with a series of new modern budget and treasury laws in 2003. Reduced budget deficit along with accelerated economic growth and an appreciation of Rupiah resulted in a sharp decline of the government debt to GDP ratio to about 30 % in 2010.

The other important reform milestone helped to address the core of problem i.e., the financial sector. The government through the Bank of Indonesia as the regulatory agency introduced a new regulatory regime by focusing on risk-based supervision and consolidated supervision of groups rather than traditional monitoring of compliance with regulations by individual banks. The result (of the reform) is quite promissing. Indonesia has made progress in strengthening supervision capacity, off-site monitoring, early warning systems, corporate governance, and responsibilities of boards of directors and management (Lindgreen, 2006). Although the efficiency of financial intermediation still needs enhancement, the performance of the banking system has continued to improve following a series of regulatory reforms and reforms to supervision practices introduced after the AFC.

Third, inflation surged to about 80% at the peak of the AFC. Bank Indonesia managed to restore inflationary pressure to a single digit in 2000 within a relative short period. However, inflationary pressure retuned again shortly thereafter – partly because of fuel price policy adjusments in 2005 and 2008. To improve inflation management, Bank Indonesia adopted an inflation targeting framework in June 2005. After experiencing double-digit inflation in 2005 and 2006, inflation in Indonesia fell to 6.4% in 2007. The unexpected surge in international food and energy prices pushed domestic inflation to 11% at the end of 2008.

Finally, the country's external position has continued to improve. The current account has been in surplus in recent years due to good export performance driven by high commodity prices and strong demand. Consistent with the positive current account position, international reserves holdings have increased sharply, to over $65 billion in June 2008. As in other countries, precautionary is the other important motive for accumulating the reserves in Indonesia. (Ruiz-Arranz and Zavanil, 2008) In addition, the rupiah has become more flexible to changes in the economic fundamentals. This, together with increasing international reserves, has reduced the country's vulnerabilities to external shocks.

As stated before, Indonesia has weathered the 2008-09 Global Financial Crisis relatively well according to most indicators. First, even though economic growth has slowed down, it has still remained positive at 4.5% during 2009. The slow-down period was also limited to 2 quarters beginning Q2 2009. Since then, economic growth recovered and grew back to the 6 % plus growth path. Second, both poverty incidence and open unemployment have continued to fall. The incidence of poverty reduction is down to 12.5 % in March 2011 compared to 14,1 % in 2008 while open unemployment fell to 7.4 % in Februari 2011 compared to 8.5 percent in February 2008. Third, balance of payments recorded a surplus generated by a record expansion of exports both driven by commodities expansion and a recovery in manufacturing exports. The surplus in external balances has resulted in an accumulation of foreign exchange reserves. This accumulation has improved confidence in financial markets, particularly in the foreign exchange market. In the past, Indonesian forex market was excessively sensitive to news and shocks. Now, those sensitivities have reduced significantly,allowing the Bank of Indonesia to conduct a sterilization policy more smoothly.

Comparing the experiences during these two crises, several distinctive factors can be identified as sources of Indonesian resilience during the GFCs. Those factors range from macroeconomic management to microeconomic fundamentals, and at the same time the role of the regional economic environment has also contributed to this favorable development.

First, from a macromanagement point of view, Indonesia has enjoyed greater flexibility to implement aggresive monetary and fiscal policies. Indonesia, like most other Southeast Asian countries, has implemented sound macroeconomic and fiscal policies for over a decade. As a result, the region has a relatively strong fiscal position and low debt levels that have allowed governments to implement larger fiscal stimulus measures. This situation is entirely the opposite of the 1998 ADF, where most countries were forced (or voluntarily) to respond to the crisis by adopting fiscal austerity and/or tight monetary policy. [5]

More importantly, East Asia is fundamentally a relatively competitive region – labor is relatively skilled, labor markets are very flexible and infrastructure in most countries is adequate. So, it is normal that economies that are more competitive are better able to rebound in the face of economic crises.

The Asian financial crisis in 1997/98 taught the countries about the importance of a healthy financial sector. As mentioned previously a set of reforms had already been implemented to strengthen the financial sector, and to better finance the economic sectors.

- When the crisis hit in 2008, most banks in Indonesia had a very low level of non-performing loans – a very different situation compared to 1997/98. The condition of the banking sector continued to improve during 2009-2011. Most of Indonesia banks recorded record profits in 2010 and were able to strengthen their capital base.
- Financial intermediaries and financial markets have improved. Good corporate governance has been the rule. To make sure that good corporate governance is in place, as part of the economic reforms, the government of Indonesia has sold some of its shares in state-owned banks to capital markets. The government has also transformed back the bail-out banks into private hands. State-owned Banks' dominance has eroded. As a result, competition in the banking sector has gradually improved.

5 In the Indonesian case, the effectiveness of fiscal stimulus is constrainted by the institutional capacity to spend and implement both at the central level and local levels of government. Therefore, even though the budget was designed relative loosely, in the realisation most of the budget was not spent. This situation occurred both during the 1998 ADF and the 2008 GFC periods.

- The crises in 1997/98 created a larger government and central bank debt market. This development has allowed the central bank to implement more efficient monetary policy. The government debt market can also provide a benchmark for the private debt market to become more efficient.
- The accounting and auditing standards of intermediaries and borrowers have improved. Investors are better informed. There is also better information on small borrowers as Bank Indonesia initiated the establishment of a public credit bureau since 2006. To improve better access to information, Bank Indonesia has encouraged the private sector to open a private credit bureau; thus far, some investors have shown their interest but the realization has not yet been achieved.
- Overall, prudent regulation and supervision from the Bank Indonesia is much better than in the 1990s even though the Bank Century case reveals more efforts must be made to improve banking supervision.[6]
- Banks in the region have little exposure to the US and/or EU housing market

These factors have made the financial system in the region resilient throughout the global financial turmoil in 2008. They will also play an important role in supporting private sector activities as the fiscal stimulus measures are gradually withdrawn.

The other distinctive characteristic of the situation in the 1998 AFC and the current GFC is that households and firms are not over-borrowed, and thus, are in a better position to sustain consumption and investment. Households saving-investment behavior in the current crisis is almost the opposite of the 1997/98 crisis. During the previous crisis, many countries faced overconsumption and investment through the bank and financial sector channels, which led to a real appreciation of the exchange rate.

The other important feature that contrasts between the two crises is the level of international reserves. In 1998 the level of reserves was relatively limited, at USD 23 billion or only 50.6 % of short-term debt. In contrast, in 2008, the level of reserves reached USD 51.6 billion or 140.2 % of short-term debt. The self

6 One important effort to improve the supervision is by establishing an integrated financial sector supervision agency outside Bank Indonesia. Even though international best practices show that the location of the agency does not matter, GOI moves have to be seen as an effort to distance the supervision practices from the problematic regime of Bank Indonesia. The finalization of this law is currently underway in the parliament.

insurance practices adopted by Indonesia – and other Asian Countries - have proven to be rewarded. Eventhough Indonesia has lost about USD 6 billion its reserve in 2008, however it quickly recovered and in May 2009, the reserves was back to the original levels around USD 57 billion and continued to build up since then. Following the recovery in capital inflows, the rupiah has recovered much of the loss experienced during the market turmoil of late 2008 and early 2009 and back to the original position within 9 month later.

The China factor has played some role in stimulating demand in the region. Figure 5 shows that China has been able to recover early in the third quarter of 2008, thanks to a substantial fiscal stimulus. At the same time, increased intra-regional trade in Asia has also become the push factor behind the demand of the region. Intra-regional trade in Asia – led by China- went up from 32% of total exports in 1995 to 50% in 2008. Therefore, proximity to China and China's strong growth has certainly helped the region. In addition, rapid trade liberalisation in the region has also improved market access, enlarged markets, attracted more investment and contributed to higher incomes in the region.

To close this section, we summarize what Indonesia has done in responding to financial crisis, adopting a public finance framework (Aizenmen and Pinto, 2011). The first column addresses the primarily objectives of crisis reponses of Indonesia – and other emerging countries – which is consistent with all three generations of crisis frameworks. To address the first generation of crisis which is related to public debt sustainability, Indonesia has responded and committed to continue to adopt a sound fiscal policy and maintain a sizeable primary fiscal surplus in a prolonged period while improving expenditure composition and tax and non-tax revenues. The primary objective of Indonesia's sound fiscal policy is to maintain a balanced budget regime over the business cycle. To finance necessary public invesments, the government plans to gradually limit the energy subsidy and shift savings from the subsidy toward expanding financing for public goods including upgrading infrastructure.

The government along with Bank Indonesia protect the vulnerability of the economy by self-insuring the economy against market sentiment and possible sudden stops by building up foreign reserves. The current level of international reserves stands at USD 125 billion or short-term foreign debt. Whether this level is excessive or not, the fact that exchange rate volatility tends to decline over time which is also depicted by an increase in the Chinn-Ito exchange rate stability index. Investor confidence and positive market sentiments continue to build up despite slow progress in microeconomic reforms and the potential problems of Bank Indonesia's balance sheet.[7]

Finally, to prevent recurrent the third type generation of crisis –lowering contingent liabilities associated with the private sector which are related to the possibility of a bail-out as happened during the 1998 AFC – the government has committed to a flexible exchange rate regime and continues to strengthen financial institutions.[8] While the primarily focus is (and should be) still on the health of state-owned banks – which still control over 40% of banking assets – since 2006 the government has expanded the scope of financial reforms into non- financial institutions. However, no significant progress was made until recently although having a more diversified financial market is more appealing not only to strengten the resilience of the market but also to improve its efficiency.

Table 1 : Indonesia: Evolving Crisis Response since the 1998 Asia Financial Crisis

Goal	Policies	Comments
1. Maintain fiscal sustainability **(First Generation)**	• Raise primary fiscal surpluses since 2000 and continue at least until 2014 • Improve the quality of spending by improving expenditure composition • Continue to strengten the revenues side by adopting tax and non tax administration reform • Strengthen fiscal institutions	Some have criticized this approach since it is not able to address the infrastructure deficit and other important public investment. Raising the primary surplus might be good in the short term but might not be good in the future because it reduces potential future growth and tax bases. While the level of Indonesian debt is already low at below 30%, maintaining some level of

[7] Since Bank Indonesia holds a non-interest bearing government bond on the asset side and at the same time Bank Indonesia has to finance the expensive monetary sterilization operation, its net worth is close to negative when measured at market valuation. Legally, Bank Indonesia is fully protected by the government, where the government has to inject capital when the minimum 8% capital is reached. But this intervention would create a possible turmoil at Bank Indonesia and would obviously affect the credibility of Bank Indonesia.

[8] Before the 1998 crisis, the government public debt was below 20% and mostly used for project financing and almost 100% was foreign debt. The level of public debt increased significantly to a peak of 100 % in 2000 primarily due to financing state bank recapitalization and bail-out of some private banks. The potential of contingent liabilities is still large because the government still owns the majority of state banks and still maintains a sizeable state-owned enterprise sector. During the 2006-2011, the government has injected new capital to some state enterprises, but the impacts of the injection are questionable. This is related to several factors: (i) poor due diligence process; (ii) inadequate injection; (iii) strong political pressures even though the firm has a serious going concern issue

		deficit is still justifiable.
2. **Insure against shifting market sentiment and possible sudden stop and reversal** **(Second Generation)**	• Build up foreign exchange reserves	No clear definition of "ideal" foreign reserves. Optimal foreign reserve levels will depend clearly on the ability of Bank Indonesia to affect private debt, flexibility of the exchange rate, and the extent of currency mismatches Bank Indonesia has very significant room to reduce the need to build up future reserves by improving reserve management.
3. **Lower contingent Liabilities associated with private sector (bail-out)** **(Third Generation)**	• Maintain flexible exchange rates • Monitor private external borrowing and currency mismatches • Strengthen financial institutions	A flexible exchange rate regime will reduce incentives for currency mismatches. Potential contingent liabilities are still large since government still holds a majority of state banks which control 40% of Indonesian banking assets Government still distorts energy market prices including the electricity price.Sizeable contingent liabilities involved.

Source: Adopted from Aizenman and Pinto (2011) Table 3

Lessons from the Financial Crisis

What has the recent financial crisis taught us? The first lesson to draw is that financial sector development including its integration to the global financial system can be an important catalyst for economic development, but this should be done gradually after the necessary institutional changes are in place. We have learned from the previous crisis about the importance of developing adequate supervision systems that can keep pace with market development. The current global financial crisis has reminded us to keep a balance between real sector development and financial sector development.

The second lesson from the current global financial crisis is on the direction of economic development strategies in general. The crisis underscores the importance of keeping a balance between strong domestic demand and export promotion. The integration of the domestic economy and the global economy into global production chains should be part of our national development strategy. However, we should not forget to integrate our economy internally. Having a strong and efficient domestic economy can enhance the competitiveness our products in global markets.

The other important lesson is that being pro active has really paid-off. One reason for the success of Indonesia in navigating this current crisis has been the preparedness of the government. They started to prepare for the crisis as the first signs of turmoil emerged, allowing us to adjust some policies early on and before many of our neighbors. They also took some risks in securing financing for the budget as markets were asking for a premium on capital, which allowed us to aggressively use fiscal policy to counter the crisis.

The next lesson is on the relationship between the food crisis and the financial crisis. Incidently, both the Asian financial crisis in 1997 and the current global crisis were accompanied by food crisis. In 1997, the effects of El Nino depressed food and agricultural production in many countries including Indonesia and Philippines. As a result, the poverty rate increased significantly. In 2008, food production per capita reached its highest level in Indonesian history. Indonesia attained, for the second time, self-sufficiency in rice. The availability of sufficient rice domestically helped to insulate Indonesia from the spikes in rice prices in early 2008. As a result, we were not only able to continue to record a declining trend in poverty, but also in unemployment.

In conjuction with its social impact, we also learn that handling the impact of the crisis was easier because social safety nets were already in place and the government was able to scale them up quickly as needed. The significant impact of the 1997/98 crisis on poverty was partly caused by the unreadiness of social safety nets. In 2008, the situation was very different. Indonesia had put in place over the past few years strong foundations for a social safety net program, ranging from food subsidy, cash transfer etc.

Challenges Ahead

The recent crisis experience has left many issues on the table. In the short run, Indonesia faces the challenge of increasing international confidence in the economy to establish economic and financial stability. Sound fundamentals and diversified economic activities proved to be the strength of the Indonesian economy in weathering the crisis. Indonesia is among the emerging markets that have been beneficiaries of capital flight from the developed countries.

There are several challenges faced by Indonesia both in the medium and long term. On the macroeconomic front, in the short run Indonesia has to deal with capital flows. Managing capital inflows is quite challenging particularly if the larger portion of the inflow of capital is still in the form of portfolio investment. There is a need to shift a portion of short-term investment into longer-term investment in the form of foreign direct investment. In the meantime, in order to avoid the risk of sudden reversal, Indonesia has to avoid bubble conditions by establishing more transparent financial markets, and more diversified financial products.

Secondly, we need also to address the problem of inflation. Even though in the recent period Indonesia was able to cope with inflation accelaration, Indonesia has struggled to keep inflation at the level of its regional peers. The level of inflation in Indonesia is the highest among Asean-5 countries. In addition, inflation in Indonesia is considered to be more volatile. The average headline inflation in 2006-2010 was recorded at around 6.8%, lower than the 1996-2000 period (20.9%) and the 2001-2005 period (10.2%). This figure is even lower than that of the pre crisis period in 1991-1995 (8.8%). Looking at the components, it is clear that decreasing core inflation has been the main contributor to the declining trend in headline inflation after the Asian Crisis , whereas volatile food and administered components have still showed a higher degree of volatility.[9] Despite inflation targeting, in a number of occasions, inflation has still exceeded Bank Indonesia's target, due to volatile food prices and fuel price adjustments. Indonesia's inflation, being relatively higher than that of its trading partners, tends to produce real appreciation of the rupiah, reducing competitiveness of the tradable sectors over time.[10] Several studies seem to suggest that the causes of the Indonesian inflation differential vis-à-vis other countries in the region include various structural factors, such as strong inflation inertia and political instability, combined with expansionary monetary policy and currency depreciation. (IMF, 2006) As a consequence of the strong inflation persistence, reducing inflation requires maintaining a consistent monetary framework and asserting the credibility of the policy framework. This persistence of inflation could imply that the

9 A positive inflation differential vis-à-vis other Asian Countries is found in all the main components of the CPI. After the crisis, the differential widened for most of the CPI components, with the exception of food items. Indeed, contrary to the commonly held belief in Indonesia that high inflation is the result of distortions in the agricultural sector and weak rural infrastructure, the inflation differential for food items has decreased after the crisis,while widening for all the other categories in the CPI, particularly housing, education,and transportation and communications. In sum, no single CPI component can alone explain the Indonesian inflation differential with respect to other Asian countries.

10 Tradable sectors refer to agriculture, mining, and manufacturing; nontradable sectors refer to construction, utility, and services.

convergence process to lower regional inflation rates might be slow and costly in terms of economic growth. To reduce this cost and accelerate the convergence process, the central bank has an important role to play, building its credibility and thus affecting the formation of inflation expectations. Aggresive supply side policy like efforts to close the infrastructure gap could also address this problem of persistent inflation. If the relatively high costs particularly logistic cost in Indonesia can be brought down, economic agents would change their beliefs that inflation still can fall. Thus, it is obvious that inflation targeting per se is not enough to address inflation in Indonesia. It requires strong coordination between monetary authorities and the government.

The third challenge is how to make fiscal policy is more effective. Historically, sound fiscal policy has become a policy culture among Indonesian policy makers including members of parliament. In addition, the public financial law limits the general government budget deficit to 3 percent of GDP. Typically, to effectively respond to acrisis, government spending needs to occur in a sufficiently timely and sizeable manner. The experience in Indonesia including with the current budget is thatmost of government expenditures are spent in the last quarter of financial year. In addition, the government fails to spend as much as planned, particularly for infrastructure projects.[11] The other problem of the government budget is the quality of spending. Almost 30% of the spending goes toward an expensive fuel and electricity subsidy. The energy subsidy for 2011 alone amounted around 6 % of GDP which is more than the allocation for capital spending. Should half of the energy subsidy be reallocated to well-performing line ministries like public works, the problem of the infrastructure gap would be partly addressed. The main problem of budget allocation is clearly not a technical one.[12] Instead, it relates to the political spectrum faced by the government during the democratic transition period (see discussion below).

Indonesia has also experienced a serious problem in addressing the infrastructure gap. After being neglected during the fiscal consolidation period, most infrastructureis in poor condition both in terms of quantity and quality. The Government has put forward several special efforts to address this issue. First, they increased the budget portion for infrastructure. However. since

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11 Not all line ministries failed to disburse their budgets. Technical ministries like public works which is responsible for roads and agriculture infrastructure performed relatively well in using the allocated spending.

12 In the 2011 budget draft, the government has proposed to cut electricity subsidies by about 15% . The plan has passed the budget commission but failed to get approval from the energy commission eventhough both the energy minister and the chairman of the energy commission come from the president’s party.

most the spending was stuckin energy spending, the amount of (infrastructure) spending still remains far below the minimum needed. Second, realizing that the government will not be able to meet the need for infrastructure financing and the need to improve the quality of infrastructure, the government made special efforts to encourage public-private partnerships in the infrastructure sector. It started by demonopolizing state enterprises by amending the laws which prohibit private sector participation. Most of the laws have been amended but in practice little progress has been made since many intermediate officials are still reluctant to allow private – particularly foreign – firms to realize their investment.

In general, Indonesia must put forward continuous efforts to create a better investment climate by improving the investment regulations, establishing better services to investors especially in licensing and taxation, and setting up a strong legal system to solve conflicts in business. Indonesia also needs to establish a credible capital market with diversified financial products and improved transparency, establish coordination among financial authorities with the objective of strengthening the banking system, capital markets and other non-bank financial activities (financing and leasing companies, insurance, pension funds, mutual funds, pound shops), including increasing the role of the financial system in contributing to sustainable development.

In the medium to long term, Indonesia needs to formulate and implement strategies toward macroeconomic rebalancing for robust, inclusive and sustainable growth. This is taken from the lessons that we learned from the crisis, especially since the different impacts that countries all over the world experienced have exposed various economic weaknesses in weathering the crisis. Specifically, Indonesia has to pay special attention to the poor by devixing the best policy for poverty alleviation as well as elimination of the poverty trap through better education. Indonesia has to intensify infrastructure development and maintenance in order to keep the momentum of economic growth. Indonesia’s geographical endowment also necessitate efforts to improve connectivity inter- and intra-islands to reduce development gaps between the regions in Indonesia as a top priority. The contribution of the financial system is also important, and Indonesia has already embarked on a national financial inclusion program to facilitate financial broadening along with the objective of providing equal opportunities for the poor and/or those with no access to financial services to increase living standards. This program has to be done with special care as to minimize moral hazard problems that may potentially become systemic risks in the future. As a G-20 member, Indonesia is committed to comply with international standards within the framework of global financial reform. Bank Indonesia and the Ministry of Finance have been participating actively in the international meetings on global financial reform organized by the Bank for International Settlements and the International Monetary Fund.

The most difficult part of policy management is how to overcome the democracy transition process. As mentioned before, Indonesia has conducted three major reforms in responding to the AFC in 1998 namely, economic reform, political reform from an authoritarian regime into a democracy and a big bang decentralization. Judging from the magnitute of reforms, the current outcomes both in terms of macroeconomic and social indicators are considered as successes. However, the transition period has left Indonesian policymakers with several uncertainties when implementing policy (Ikhsan, 2007). The first stem from the political transition to democractic government. No clear majority has yet emerged and this is not expected until the political environment has matured - in another 10-15 years. Indonesia's political fragmentation is likely to limit the capacity of the government to implement the necessary but difficult policies particularly during the crisis period.[13] The political fragmentation has cost the government when they failed to pass one important law of financial safety nets in 2009.

The effectiveness of policy implementation is also hampered by the lack of (implementation) capacity of local governments. The country has undergone a big bang decentralisation, moving from highly centralised to the other extreme (highly decentralised) in a very short period. Decentralization has changed the coordination, accountability and capacity of government in terms of policy formulation, implementation and service delivery. Even though the decentralization aims to improve the effectiveness of policy and service delivery, in the reality over 10 years since the implementation of decentralization, this has not been easy. The coordination is more difficult because of multiple stakeholders and multiple axes along which coordination is needed, and at the same time we also face a situation with dispersed and multiple vertical and horizontal lines of accountability with relatively weak incentives (for local governments) to follow rules. On the other side, the capacity to implement at local levels is highly unequal and generally weak.

The effectiveness of policy clearly depends also on the credibility of the government and its policymakers. The problem of credibility is evident during

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13 One good example is the 2008 global crisis has taken a collateral damage when the President failed to defend his finance minister Dr Sri Mulyani Indrawati's position since she together with Governor of Bank Indonesia (now Vice President) Boediono took an important step to prevent the financial sector stability by bailing-out a small bank – Bank Century. This case has become a political cost for the government and has made other important adjustments more difficult to implement without any political compensation.

the post-Soeharto era. Building credibility is difficult when the foundation of trust is low. The issue of trust is particularly important in Indonesia. Not only do the local and central governments often not trust one another, but the people often do not trust the government (and vice versa). This lack of trust seriously complicates policy formulation and implementation. Even when the rules are agreed upon, considerable misunderstanding takes place in regard to the notions of authority and responsibility.

One final challenge for the region is related to global financial reform and the G-20 agenda for strong, sustainable and balanced growth. Indonesia, along with the other countries in the region, is committed to increase regional and international cooperation in financial surveillance and improved early warning systems for potential systemic risks. This can be done by strengthening regional cooperation in the platform of ASEAN and ASEAN+3, specifically in developing and expanding the CMIM arrangement. Given the increased integration of the financial market in the region, there is a need to have a workable regional financial stability framework.[14] In addition, Indonesia can take advantage of its membership in the G-20 in order to push forward several issues related to establishing a level playing field, cooperation in knowledge and information sharing within G-20 and other fora that can be done through meetings of the representatives of the Central Banks and Ministries of Finance. Establishing balance between the objectives of global financial reform and economic growth is still important in the less-developed-to-poor countries, as global financial reform may tend to put prudential measures as top priority while neglecting the need for financing development. One size cannot fit all. Reform has to be customized to the needs of each country.

Closing Remarks

One common lesson learned all over the world is that although financial development or financial liberalization can be an important catalyst for economic development, the process should be done with prudential measures to avoid excessive risk taking and moral hazard behavior. The recent crisis proved that even developed countries could still failt to address this concern and let systemic risk linger too long, causing major distress to the financial system. With the current integration of the global financial market, financial distress in one country could be channelled immediately to other countries. With the U.S. being the center of the global financial market, the impact of financial crisis originated there impacted the rest of the world.

14 See Harun & Deriantino 2010 for the proposal of the regional financial stability framework.

The general conditions in the Asia/Pacific region should not make countries in the region feel complacent. In the second round of the 2007/2008 crisis, some countries in this region still suffer from the decline of growth. The world economy is more interconnected than we are willing to admit. It is time to realize that a decision made at the national level may have effects at the international level. Given that this region is becoming more influential in the world, the decisions made by countries in this region, are being watched and increasingly affect the strategies of international investors. The agreements and commitments within the region also have an impact on international investors' assessments of prospects for investment in the region.

One of the main attractions for foreign investors interested in investing in the region is the fact that interest rates are still favorable. However, this is a microfinancial view and if this is the only main attraction for the region then we always have to worry about the possible event of sudden reversal. We need to direct foreign investors into a more sustainable investment strategy in the region. This means providing a consistent and credible investment climate. "Consistent and credible" means installing regulations and providing services that are constantly improved to provide a better investment climate. In order to ensure funds stay for a long time into the future, the region needs to provide the sense of stability and a real sense that the future of the region is going to be bright. Investors need to see the commitments of the national governments in the region. The commitments should include maintaining sound economic fundamentals with disciplined fiscal policy. If this is the direction that countries in this region are going, at some point investors will learn that the risk premium in this region can be lowered. At that time, foreign investors will feel more comfortable with their long term investments.

As the East Asian region is becoming more integrated, more concerted efforts in dealing with cross-border crises are highly recommended. Increase the credibility of the regional financial system. Although in the short run a country can benefit by solely paying attention to restoring its own economic stability, we have learned from recent events that instability in one country can influence an entire region. The case of the Euro Zone is a very good example. Crisis management in the region should be treated as a game of many periods, not only as a simple one-period prisoner's dilemma game. More cooperative arrangement in cross border crisis resolution, including conducting periodical simulation with different scenarios, should be done in order to have a well-tested framework that can be used when needed.

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Appendix A
Selected Economic, Social and Financial Indicators of Indonesia

Selected Economic and Social Indicators	1994	1995	1996	1997	1998	1999	2000	2001	2002	2003	2004	2005	2006	2007	2008	2009	2010
Inflation Rate (%)	9.64	8.98	5.08	10.27	77.54	2.01	9.35	12.55	9.88	5.16	6.40	17.11	6.60	5.42	11.06	2.78	6.96
GDP Growth (%)	7.5	8.4	7.6	4.7	-13.1	0.8	4.9	3.6	4.5	4.8	5	5.7	5.5	6.3	6	4.6	6.1
Exchange Rate (Rp/USD)	2,200	2,308	2,383	4,650	8,025	7,100	9,595	10,400	8,940	8,465	9,290	9,830	9,020	9,419	10,950	9,400	8,991
International Reserve (incl. Gold) (B US$)	13.32	14.91	19.40	17.49	23.61	27.35	29.39	28.02	32.04	36.30	36.32	34.72	42.59	56.92	51.64	66.11	96.21
Fiscal Deficit/Surplus (% to GDP)	0.95	1.27	0.73	(1.08)	(1.60)	(2.79)	(1.64)	(2.72)	(1.46)	(1.68)	(1.30)	(0.52)	(0.87)	(1.26)	(0.08)	(1.58)	(0.75)
Government Debt (% to GDP)	36.32	30.09	23.91	71.83	53.79	44.62	100.3	90.9	32.22	29.72	56.60	47.34	39.00	35.17	33.06	28.34	26.936
Unemployment Rate (%)	4.4	7.2	4.4	4.7	5.5	6.3	6.1	8.1	9.1	9.5	9.9	11.2	10.3	9.1	8.4	7.9	7.1
Poverty Rate (%)		11.4	11.3	17.7	24.2	23.4	19.1	18.4	18.2	17.4	16.7	16	17.8	16.6	15.4	14.2	13.3
Food Production index	91	100	100	96	96	97	100	102	108	115	122	126	131	136	140	146	
Selected Financial Indicators (%)	**1994**	**1995**	**1996**	**1997**	**1998**	**1999**	**2000**	**2001**	**2002**	**2003**	**2004**	**2005**	**2006**	**2007**	**2008**	**2009**	**2010**
Non Performing Loans of Commercial Banks					48.60	32.80	18.80	12.10	8.09	8.21	5.75	8.30	6.98	4.64	3.76	3.79	2.89
Loan-to-Deposit Ratio of Commercial Banks		113.72	109.26	111.12	87.24	44.90	45.84	44.97	49.09	53.70	61.79	64.73	64.72	69.22	77.21	74.55	76.79
Credit Growth of Commercial Banks *)			23.70	34.29	22.62	-49.17	15.58	11.89	14.41	16.31	24.70	22.70	14.07	25.54	29.45	8.66	22.11
Capital-Adequacy-Ratio of Commercial Banks		11.85	11.82	9.19	-15.70	-8.10	12.70	20.50	22.50	19.39	19.36	19.47	20.47	19.30	16.20	17.37	16.97
Return of Stock Market (Index Growth)	-20.23	9.41	24.05	-36.98	-0.91	70.06	-38.50	-5.83	8.39	62.82	44.56	16.24	55.30	52.08	-50.64	86.98	46.13
Growth of Stock Market Capitalization (%)						157.11	-42.54	-7.84	12.19	71.51	47.70	17.84	55.89	59.18	-45.86	87.59	60.80

Source : World Bank, IMF WEO Database, Bank Indonesia, Bloomberg

Appendix B. Selected Indicators of Some ASEAN+3 Countries

International Reserves (including Gold) in Billions USD

	1994	1995	1996	1997	1998	1999	2000	2001	2002	2003	2004	2005	2006	2007	2008	2009	2010
China	57.78	80.29	111.73	146.45	152.84	161.41	171.76	220.06	297.74	416.20	622.95	831.41	1080.76	1546.36	1966.04	2452.90	2622.00
Korea	25.76	32.80	34.16	20.47	52.10	74.11	96.25	102.88	121.50	155.47	199.20	210.55	239.15	262.53	201.54	270.44	291.57
Japan	135.15	192.62	225.59	226.68	222.44	293.95	361.64	401.96	469.62	673.55	844.67	846.90	895.32	973.30	1030.76	1048.99	1096.19
Indonesia	13.32	14.91	19.40	17.49	23.61	27.35	29.35	28.10	32.03	36.26	36.31	34.73	42.60	56.94	51.64	66.12	96.21
Malaysia	26.34	24.70	27.89	21.47	26.24	30.93	28.65	29.85	33.76	44.31	66.39	70.46	82.88	101.99	92.17	96.70	106.50
Singapore	58.30	68.82	76.96	71.39	75.08	77.05	80.17	75.68	82.22	96.25	112.58	116.17	136.26	162.96	174.19	187.80	225.75
Philipine	7.15	7.78	11.78	8.74	10.84	15.07	15.07	15.68	16.32	17.08	16.23	18.47	22.96	33.74	37.50	44.21	62.37
Thailand	30.28	36.94	38.64	26.90	29.54	34.78	32.67	33.04	38.90	42.16	49.85	52.08	67.01	87.47	111.01	138.42	172.13
Vietnam	0.96	1.32	1.74	1.99	2.00	3.33	3.42	3.67	4.12	6.22	7.04	9.05	13.38	23.48	23.89	16.45	13.00

Fiscal Deficit/Surplus (% of GDP)

	1994	1995	1996	1997	1998	1999	2000	2001	2002	2003	2004	2005	2006	2007	2008	2009	2010
China			-1.80	-1.90	-2.86	-3.70	-3.07	-2.38	-2.57	-2.35	-2.12	-1.2	-0.8	0.6	-0.85	-3.38	-2.88
Korea	2.12	2.45	2.60	2.64	1.25	1.33	3.40	1.90	1.98	2.30	2.32	2.29	2.33	4.20	1.84	0.78	2.48
Japan	-3.37	-4.43	-5.51	-4.46	-4.99	-6.46	-7.38	-5.69	-7.02	-7.09	-5.74	-4.56	-3.89	-2.55	-3.64	-7.01	-7.51
Indonesia	0.95	1.27	0.73	-1.08	-1.60	-2.79	-1.64	-2.72	-1.46	-1.68	-1.30	-0.52	-0.87	-1.26	-0.08	-1.58	-0.75
Malaysia	2.30	0.80	1.45	2.92	-0.82	-3.83	-5.95	-4.70	-5.40	-4.88	-4.39	-3.73	-4.05	-3.43	-4.84	-5.84	-5.58
Singapore	12.68	10.64	8.60	9.04	2.66	5.78	7.21	2.70	3.69	1.42	5.32	7.86	6.48	11.47	5.57	-1.45	3.48
Philipine	1.00	0.60	0.30	0.10	-1.90	-3.80	-4.00	-4.00	-5.30	-4.60	-3.80	-2.70	-1.10	-0.20	-0.90	-3.90	5.70
Thailand	1.90	2.60	2.20	-2.20	-7.10	-9.90	-1.01	-0.75	-5.21	3.23	1.87	1.41	1.85	-0.05	-0.76	-2.12	-2.29
Vietnam	-2.20	-1.30	-0.90	-3.90	-1.60	-3.30	-4.30	-3.50	-2.30	-2.20	0.20	-1.10	1.30	-1.00	-1.90	-7.70	-8.02

Government Debt (% of GDP)

	1994	1995	1996	1997	1998	1999	2000	2001	2002	2003	2004	2005	2006	2007	2008	2009	2010
China	6.14	6.14	6.79	6.55	11.40	13.81	16.45	17.71	18.94	19.25	18.54	17.64	16.19	19.59	16.96	17.67	17.71
Korea	9.84	8.70	7.99	9.97	14.26	16.34	16.73	17.37	17.57	20.70	23.83	27.66	30.07	29.65	29.03	32.56	30.86
Japan	84.59	92.43	100.33	107.13	120.09	133.79	142.06	151.69	160.95	167.18	178.06	191.64	191.34	187.65	195.00	216.35	220.28
Indonesia	36.32	30.09	23.91	71.83	53.79	44.62	100.30	90.90	32.22	29.72	56.60	47.34	39.00	35.17	33.06	28.34	26.94
Malaysia	46.91	40.95	35.16	31.78	36.09	36.87	35.31	41.35	43.06	45.08	45.70	44.44	43.16	42.71	42.84	55.38	54.20
Singapore	68.20	68.06	69.56	68.87	82.38	84.92	81.18	95.38	95.51	98.74	96.05	93.42	86.76	85.85	97.21	105.01	97.18
Philipine	62.40	59.57	51.71	54.26	54.68	57.06	62.07	62.77	66.48	71.39	69.73	62.84	55.38	47.80	48.66	49.19	47.34
Thailand			15.19	40.46	49.88	56.59	57.83	57.52	55.05	50.69	49.46	47.35	41.99	38.35	37.27	45.22	44.07
Vietnam								31.65	32.54	33.35	42.26	41.22	41.85	44.58	42.90	51.16	52.85

Source : World Bank, IMF WEO Database