

**High-level Regional Policy Dialogue on
"Asia-Pacific economies after the global financial crisis: Lessons learnt,
challenges for building resilience, and issues for global reform"**

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Country Experiences 3: Net Energy Exporters

Presentation

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

by

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INDONESIA'S EXPERIENCES DURING THE ECONOMIC CRISIS:

Lesson
Learned and
Challenges

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WHAT I WANT TO DISCUSS TODAY

1. Discuss Indonesia's experiences during the crisis period
 - Facts (Global, Regional and Indonesia)
 - Policy responses (Indonesia)
2. Draw some lessons and challenges from Indonesia's experiences
 - Identify the policy mistakes and source of resilience
 - Describe future challenges

GROWTH EPISODES AND CRISES

Indonesia: Growth Episodes: 1970-2011

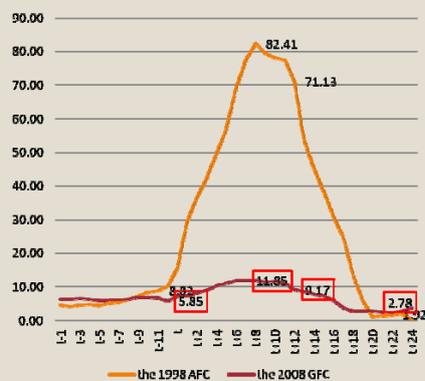


THE 1998 AFC AND THE 2008 GFC COMPARED AND OUTCOMES

INDONESIA: Economic Growth during the two crisis Episodes



Indonesia: Inflation during two episode of crisis, 1998 and 2008



THE 1998 AFC AND THE 2008 GFC COMPARED AND OUTCOMES

Exchange Rate Development during Two Crisis episodes



External Exposures

| | The 1998 AFC | | | The 2008 GFC | | |
|-------------------------------------|--------------|------|------|--------------|------|------|
| | 1997 | 1998 | 1999 | 2007 | 2008 | 2009 |
| Current Account Balance (% GDP) | -2,27 | 4,29 | 4,13 | 2,43 | 0,02 | 1,99 |
| Reserves (USD billion) | 16,6 | 22,7 | 26,4 | 55,0 | 49,6 | 63,6 |
| ST Debt (% Reserve) | 187,9 | 85,2 | 73,2 | 27,1 | 36,9 | 28,2 |
| External Private Debt (billion USD) | 44,4 | 54,8 | 47,3 | 46,4 | 47,4 | 52,8 |
| Public Debt (% of GDP) | 72,3 | 65,9 | 82,9 | 36,9 | 33,9 | 28,6 |
| - External (% of GDP) | 72,3 | 50,3 | 41,4 | 16,5 | 17,1 | 13,3 |

Source: World Bank and IMF

THE 1998 AFC AND 2008 CRISES: GLOBAL AND REGIONAL PERSPECTIVES

Box 1. Then and now: comparing the 1997-98 Asian financial crisis and the current crisis

| | 1997-98 Asian financial crisis | Current global financial and economic crisis |
|----------------------------------|--|--|
| World output | ... rose robustly. | ... is contracting sharply. |
| Global trade volumes | ... slowed only modestly in 1998. | ... set to contract in 2009 by the largest amount since 1982. |
| The crisis | ... started in the region. | ... started in the U.S. and developed economies. |
| GDP growth in the region | ... affected some countries in developing East Asia severely, while others were affected more modestly. | ... has affected virtually all countries in the world. |
| Contraction reflects | ... bounced quickly, thanks to robust world markets and export growth. | ... is projected to recover slowly as global recovery takes time. |
| Export volumes | ... drop in domestic demand despite large positive contribution from net exports. | ... contraction in exports, weaker investment, despite government stimulus. |
| Commodity exporters | ... expanded strongly in most EAP countries. | ... are set to contract with almost no exception. |
| Current accounts | ... benefitted because of robust global demand. | ... are suffering because of a drop in prices and global demand. |
| Capital flows | ... adjusted sharply during the crisis. | ... except in China and Malaysia, worsened modestly in 2008 due to oil prices and the contraction in exports. |
| Currencies | ... fell sharply in Indonesia, Korea, and Thailand. | ... have weakened sharply in all countries. |
| Foreign exchange reserves | ... weakened in several countries, led by a depreciation of 11.1 percent from the end of 1996 to the weakest point in Korea, 86 percent in Indonesia and 56 percent in Thailand. | ... have weakened by 10 percent since the end of 2007 in Thailand, 23 percent in Indonesia, and 48 percent in Korea. |
| Foreign exchange reserves | ... were depleted in many countries. | ... remain strong, very modest reductions thus far in some countries. |

INDONESIA: THE 1998 AFC AND THE 2008 GFC COMPARED

| Characteristic | The 1998 AFC | The 2008 GFC |
|--|--|---|
| 1. Was the political crisis involved ? | Yes, deep political crisis led the regime change and some levels of social crisis and confidence as well | No , but problems of democratic transition was still present |
| 2. Other crises occurred? | Yes, severe Elnino attacked agriculture sector; rural production and income hit hard, poverty and rural unemployment rose | No, rice production hit the record and domestic food market was isolated. |
| 3. Macroeconomic policy | | |
| • Fiscal policy | Fiscal conservatism applied both before and during the crisis eventhough later being relaxed but not effective due to institutional constraints | Sound and anti cyclical fiscal policy applied but again not too effective because of implementation constraints. |
| • Monetary Policy | Tight policy applied | Moderate |
| • Exchange Rate | Crawling peg led to an excessive taking risk behavior and most loans were unhedged | Flexible exchange rate; private sector relatively prepared and hedged the loans except several publicly listed firms |

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| Feature | The 1998 AFC | The 2008 GFC |
|-----------------------------------|---|---|
| 4. Policy Management | | |
| • Crisis Preparation | No preparation; lack of information in many aspects | Preparation done well before the peak of the crisis including crisis protocol. |
| • Crisis Management | IMF did a poor job and Soeharto – as in the end of his legacy – as well | Relatively well but domestic politic and the stigma from the 1998 AFC crisis reduced the flexibility. |
| 5. External Balance | In a deficit mode about 2.2 % of GDP (1996-97) | In a surplus situation about 2 % of GDP (2007) |
| 6. Size of international reserves | USD 23 billion or 50% of short term debt (1997) | USD 57 billion and of 157 of ST Debt (2008) |
| 7. Presence Capital Flight | Yes, huge and led to a fall in reserve from USD 23 b (Dec 1997) to USD 15 b (June 1998) | Yes but relative small. Reserves fell by 16 % in 2008 |

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| 8. Banking and Financial Sector | NPL hit 48% before the crisis, Governance problem – interlocking ownership Banking sector collapsed ; government has to bail out led to a significant increase in public debt. Responsible for export financing problems after the crisis | Banking sector was in a good shape, NPL was low only 4 % before the crisis. Governance improved. |
|---------------------------------|--|---|
| 9. Public sector debt | 23% of GDP (1996 and mostly external debt | about 30 %, equally distributed between domestic and external ones |
| 10. Private sector debt | Unknown at the beginning but later found that about USD 55 billion or 20.6% of GDP | About USD 47 b or 9.4 % of GDP and mostly hedged. |

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| SOURCES OF RESILIENCE: PUBLIC FINANCE APPROACH | | |
|---|--|---|
| 1. Maintain fiscal sustainability (First Generation) | <ul style="list-style-type: none"> • Raise primary fiscal surpluses since 2000 and continue at least until 2014 • Improve the quality of spending by improving expenditure composition • Continue to strengthen the revenues side by adopting tax and non tax administration reform • Strengthen fiscal institutions | <ul style="list-style-type: none"> • 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 deficit is still justifiable. |

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SOURCES OF RESILIENCE: PUBLIC FINANCE APPROACH

2. Insure against shifting market sentiment and possible sudden stop and reversal (Second Generation)

Build up foreign exchange reserves

Current level of reserves are considered "ideal" at one particularly measures and bit excessive when benchmarking to other measures (% of import)

- 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.

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SOURCES OF RESILIENCE: PUBLIC FINANCE APPROACH

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 involved

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LESSONS LEARNED : LESSON 1: APPROPRIATE INSTITUTION IS NECESSARY

- **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.**
- **the importance of developing adequate supervision systems that can keep pace with market development**

LESSON 2: STRUCTURE MATTERS

- **A Balance Structure** between Domestic and Export Market increase the resilience.
 - Most the Asian countries which less affected during the 2008 GFC have a more balance structure e.g : **India, Indonesia** vis a vis **Thailand, Malaysia**
- **A large country like Indonesia** needs to focus to develop a **strong domestic economy** to sustain long term economic growth.

LESSON 3: SOUND ECONOMIC POLICIES IS PAID OFF

- **Fiscal Conservatism Culture** is an important asset for Indonesia.
 - Cost of crisis is minimum
 - Recovery Process takes relatively short period.
- **Forward Looking Monetary Policy** is also important for restoring confidence
- **Managing Perception** is essential during the crisis period. Coordination between MOF and Central Bank is the key for restoring the confidence.
- **Being Transparent is also important.** Most of the problems in mini crisis 2005 and 2008 are originated from misinterpretation of data – typically budget and private debt position.

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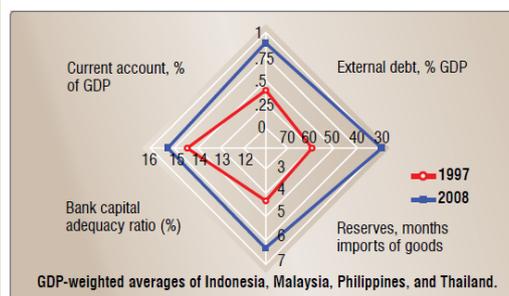
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LESSONS 4: BEING WELL PREPARED TO THE CRISIS REWARDED

Figure 1. The region's middle-income countries withstood the financial turmoil well because they were better prepared than in 1997-98

(farther from the center is better on all indicators)



Source: Datastream and World Bank staff calculations.

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LESSON 5: PREPARE FOR THE WORST

- Financial crisis will eventually hit the “main street” and the common and poor people.
 - **Social Safety Net is necessary** because at the end the poor will hit hardest.
 - The availability of SSN during those two crises distinguished the outcomes of the crisis

| | Before | After |
|--------------|---|----------------------------------|
| Poverty Rate | 1998 AFC: 18% (1997) 2008 GFC: 14,1 (2008) | 1998: 24% (1999) 2009: 13,5 % |
| Unemployment | 1997 : 2008: @ Mohamad Ikhsan | 2000: 2010: |

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FINALLY THE CHALLENGES

- **Managing capital inflows:** take the maximum benefit; better composition
- **Need to keep inflation low** at the regional peer: handling food inflation, inflation targetting and Bank Indonesia’s credibility
- **Improve fiscal policy effectiveness:** capacity to implement
- **Tackling infrastructure gap and connectivity problem:** involved private sector more.
- **Improve investment climate** in general: now focus on legal reform and beraucratic reform

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**ADDRESSING THE CHALLENGES IS MORE DIFFICULT
BECAUSE INSTITUTIONAL CONSTRAINTS**

| | Pre-1998: under the New Order | | Post-1998: in a democratic and decentralized Indonesia |
|---|--|---|--|
| Coordination in decision-making regarding policy formulation and implementation | ▶ Centralized decision-making | ▶ | ▶ Difficult because of multiple stakeholders and multiple axes along which coordination needed |
| Accountability structures within government | ▶ Vertical and hierarchical structure, strong incentives | ▶ | ▶ Dispersed and multiple vertical and horizontal lines of accountability, weak incentives |
| Capacity in terms of policy formulation, implementation, and service delivery ¹⁹ | ▶ Good given centralized state and tasks at hand | ▶ | ▶ Weak in context of decentralized state and "second-generation" challenges |

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ADDITIONAL SLIDES

INDONESIA DURING THE 2008 GLOBAL CRISIS: CONTROL IN THE FINANCIAL MARKETS

Supporting the Banking and Capital Market Systems

- Place **government funds with state-owned banks** to increase liquidity in the banking system
- Increase the amount of **deposits guaranteed** by the government in the banking system
- Strengthen the government's supervisory and enforcement capacity** over capital markets
- Prepare **crisis protocol** (implementation of the Financial System Stability Committee)

Ensuring Foreign Exchange Stability

- Manage state-owned enterprises' foreign exchange** transactions to reduce speculation
- Maintain a **sufficient level of foreign exchange reserves** through trade financing facilities and prevention of illegal imports
- Requiring greater disclosure on large-sized purchases of foreign currency against IDR** to curb speculative pressure on IDR

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INDONESIA DURING THE 2008 GLOBAL CRISIS: STIMULATING REAL SECTOR GROWTH

- Recognize the importance of monetary policy support**, as deemed appropriate for domestic conditions
 - Bank Indonesia lowered the policy rate to 8.75% in Jan-09 when inflation pressure eased
 - Indonesian banks have started cutting their lending rates in response to the central banks' rate cut to accelerate real sector growth
- Accelerate the disbursement of projects** for government and state-owned enterprises
- Implement fiscal stimulus and provide additional fiscal stimulus for business and infrastructure projects**
- Support for real sector and export promotion** such as government guarantees for trade financing
- Reduce fuel prices**, apply an automatic premium gasoline price adjustment and provide diesel price incentives to **reduce manufacturing operational costs**

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MEASURES ARE TAKEN TO ENSURE SUSTAINABILITY OF THE 2009 BUDGET

Indonesia is moving from a defensive to offensive stance while maintaining fiscal sustainability

Defensive Measures

- Earmark expenditure on lower priority projects and imports
- Flexible allocation of provincial government expenditure
- Lower tax revenue growth target
- Redefine "emergency funding" in State Budget Law 2009 based on emergency conditions, government debt security funding costs and banking systemic risk
- Increase fiscal contingency fund to counteract deviations from current macroeconomic assumptions
- Shift financing sources from marketable securities to standby facilities
- Prepare crisis protocol through the implementation of the "Financial System Stability Committee"

Offensive (Counter-Cyclical) Measures

- Additional expenditure on infrastructure projects which have greater impact on employment creation and poverty reduction
- Reduce costs of business through the implementation of the Income Tax Law
 - 2-7% reduction in income tax
 - Introduce tax incentives for selected sectors and regions
 - Relax tax tariffs for selected sectors e.g. crude palm oil
- Provide more direct subsidy for medium and low income households
- Lower energy prices or provide a certain discount on electricity bill for industries
- Upsize financing from bilateral and multilateral organizations

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FISCAL STIMULUS IN PLACE FOR 2009

1

Accelerate job creation and foster growth of small scale businesses

- Support from infrastructure and national programs, such as:
 - Additional peoples empowerment (PNPM) program to alleviate poverty
 - Expansion of credit program (KUR) to accelerate the development of the primary sectors
 - Additional infrastructure projects for job creation

2

Boosting the society's purchasing power

- Subsidies on medicine, and cooking oil
- Direct subsidies (cash transfer and conditional cash transfer) for low-income households
- Provide more direct and indirect subsidies to education and health sector

3

Stimulate trade and promote entrepreneurship

- Import duty facility on selected capital goods and materials
- Export financing and guarantee
- Tax rate reduction on corporate income and individual income, and increase minimum threshold for employee tax
- Discount on electricity peak-hour charge for industries and reduction of diesel fuel price

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INDONESIA'S STIMULUS PACKAGE IS COMPARABLE TO OTHER ECONOMIES

The fiscal stimulus package that Indonesia has put in place is in line with rest of the world

| Country | 2009 GDP Growth Projection (%) | | 2009 Fiscal Stimulus (% of Outlook GDP) |
|------------------|--------------------------------|------------|--|
| | Original | Outlook | |
| Malaysia | 4.8 | 0.2 | 4.4 |
| Thailand | 4.5 | 2 | 1.8 |
| Australia | 2.2 | 1.7 | 1.5 |
| Indonesia | 6.0 | 4.0 | 1.4 |
| USA | 0.1 | -0.8 | 1.2 |
| UK | -0.1 | -1.3 | 1.1 |
| Singapore | 3.5 | -5 | 1.1 |
| Japan | 0.5 | -0.2 | 1.0 |
| South Korea | 3.5 | 2.5 | 0.9 |
| India | 6.9 | 6 | 0.9 |
| China | 9.3 | 8 | 0.6 |

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Source: EEC, Bloomberg

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