



WORKING PAPER 98.09

**ECONOMIC CRISIS AND EMPLOYMENT PROBLEMS
IN INDONESIA**

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A joint research project on

**Linkages Between Indonesia's Agricultural Production, Trade and the Environment
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between

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CASER/CSIS/CIES/ANU
joint research project on
policy analysis of linkages between
Indonesia's agricultural production, trade and
environment

Rapid economic growth in Indonesia has been accompanied by significant structural changes, including for its agricultural sector and its unique natural environment. Recently questions have been raised about the impact of Indonesia's agricultural, industrial, trade and environmental policies on sustainable rural development. The nature of interactions between the economic activities of different sectors and the environment are such that an intersectoral, system-wide perspective is essential for assessing them. An international perspective also is needed to assess the impact on Indonesia of major shocks abroad, such as the implementation of the Uruguay Round agreements, APEC initiatives, or reforms in former centrally planned economies. There is increasing pressure on supporters of liberal trade to demonstrate that trade reforms at home or abroad affecting countries such as Indonesia will not add to global environmental problems (e.g., deforestation, reduced biodiversity). Again, this requires system-wide quantitative models of the economy and ecology, because typically there are both positive and negative effects at work, so the sign of the net effects ultimately has to be determined empirically.

To begin to address these issues, the Australian Centre for International Agricultural Research (ACIAR) has generously provided funds for a collaborative 3-year project (to mid-1999) involving the University of Adelaide's Centre for International Economic Studies (CIES) as the lead institution, Bogor's Centre for Agro-Socioeconomic Research (CASER) which is affiliated with the Ministry of Agriculture, Jakarta's independent Centre for Strategic and International Studies (CSIS), and the Economics Division of the Research School of Pacific and Asian Studies (RSPAS) at the Australian National University in Canberra. Being based on Indonesia with its rich diversity of environmental resources (and on which there are relatively good data) and its rapid economic growth, the project could also serve as a prototype for similar studies of other developing countries in Southeast Asia and elsewhere.

The key objective of the project is to assess the production, consumption, trade, income distributional, regional, environmental, and welfare effects of structural and policy changes at home and abroad particularly as they will or could affect Indonesia's agricultural sector over the next 5-10 years. Among other things, the analysis will focus both on the effects of economic changes on the environment, and on the impacts on Indonesia's agricultural production and trade of resource and environmental policy changes. The implications of regional and multilateral trade liberalization initiatives and Indonesia's ongoing unilateral trade reforms will be analysed, along with other potential domestic policy changes and significant external shocks such as the entry of China and Taiwan into the World Trade Organization. The analysis will draw on and adapt computable general equilibrium (CGE) models such as the national INDOGEM Model (built as part of an earlier ACIAR project) and the global GTAP Model.

The project is being undertaken in close collaboration with the Indonesian Ministry of Agriculture and ministries involved in trade, planning, and the environment. A Research Advisory Committee has been established to encourage close collaboration of representatives from those and other ministries.

ACIAR INDONESIA RESEARCH PROJECT

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IN INDONESIA**

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SUMMARY

The paper presents the crisis in Indonesia, which started as a financial and monetary crisis in August 1997, turned to a whole economic crisis in December 1997, and to political crisis and turmoil in 1998. After having 6 percent annual economic growth on average and one digit annual inflation for the last three decades, the economic growth is predicted to be minus 15 percent and the inflation is around 100 percent in 1998. The number of population living under poverty line has doubled from around 26 million (13 percent) to more than 50 million (26 percent). Economic reforms and structural adjustments have been very slow due to the lack of legal framework, weak institutional capacity, and unfavourable political climate. Excessive monetary expansion continues, partly in order to prevent the banking system from collapsed, and in turn leads to further currency depreciation and sky-rocketing inflation. Unemployment is predicted to increase from around 5 million to 10 million people in 1998. However, this unemployment rate does not represent the real employment problems as people could not afford to be unemployed (working for less than one hour a week) and therefore move from the formal sector to the informal sector. It is expected that the process of labor market transformation will slow down, stop, or even reverse as the economic performance continues to deteriorate. There has been massive reverse movement of labor from the manufacturing and construction sectors to the agricultural sectors in rural areas, and from the formal sector back to the informal sector. The crisis has also reduced the real wage by around 30 to 50 percent.

ECONOMIC CRISIS AND EMPLOYMENT PROBLEMS IN INDONESIA¹

Tubagus Feridhanusetyawan²

High water takes you over the rock in a river. But the high water also conceals the objects that could damage the ship. The ship is big and good looking, but it is not built based on strong metal and solid construction. When the water is low, the ship suddenly finds it self sailing in a rocky river. Once the ship hits the rock, the good looking but fragile ship brakes apart, and then starts sinking. The ship is Indonesian economy, the water is the capital flows, and the rocks are the weak banking sector, lack of transparency, and other chronic problems in the economy. It is a national tragedy in the making, and it could be another Titanic at the end of 20th century.

Indonesia's economic performance has ranked among the best in the world for the last decade. The real GDP growth has been around 7 to 8 percent since 1990, as a result of prudent macroeconomic policies, high saving and investment rates, and a market oriented trade policy. The inflation rates have been continuously below 10 percent, and even reach 6 percent a year in 1996. Trade balance increased from US\$ 3.8 billion in 1990 to around US\$4.6 billion in 1996. The only concern was the widening current account deficit from around US\$ 3.7 billion in 1990 to US\$7.8 billion in 1996, reaching around 4 percent of the GDP and reflecting the massive capital inflows, mainly private capital. The net private capital inflow has grown by 11.9 percent annually from 1990 to 1996.

The benefit of economic development for Indonesian workers has also been significant. Employment in the formal sector has grown more than twice of the growth of the labor force, and worker's income has increased significantly, especially for the last decade. Income distribution among workers in different production sectors, and different levels of education, has equalized. In 1970, Indonesia was among the poorest country in the world with roughly 60 percent of population living in absolute poverty. Since then, Indonesia has recorded an impressive record of broad based growth and sustained reduction in poverty. From 1976 to 1990, for example, the proportion of the population living below poverty line

¹ Earlier version of this paper was presented at the Human Resource Development Task Force Meeting, Pacific Economic Cooperation Council, in Taipei, June 20-21, 1998.

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declined from 40.1 percent to 15.1 percent³. The recent official figure of population under the poverty line in 1996 was around 13 percent.

Since August 1997 Indonesia has been having a severe economic crisis, and everything has changed drastically to a situation, which can not be imagined before. The official and the most optimistic estimate for economic growth in 1997 was around 4.6 percent, and the projected growth in 1998 is minus 10 percent. Private estimate, however, ranges from minus 15 to minus 25 percent for 1998. By December 1997, the value of the currency (Rupiah) has plummeted to around 50 percent of its value in the previous six month, and in March 1998, the Rupiah depreciated even further to around 25 percent of its value last year (more than 300 percent depreciation). The currency in circulation has almost doubled from November 97 to May 98, and has partly led to sharp currency depreciation and skyrocketing inflation. For the first five months of 1998, the cumulative inflation rate was 40 percent, and the annual inflation is projected to be around 100 percent or more in 1998. Unemployment rate is predicted to more than double from around 5 percent in 1996 to at least 11 percent in 1998. The crisis, which started as a monetary crisis, has turned to economic crisis, confidence crisis, and then political crisis leading to the resignation of President Suharto on May 21, 1998. Figure 1 presents the movement of the exchange rate which reflects the worsening Indonesian crisis⁴.

Indonesia is not alone in having the crisis in Asia as Thailand, Korea, Malaysia, and other Asian countries are having similar crisis. But it turns out later that Indonesia is really a special case. While economic recovery has started in other countries since early 1998, Indonesia's economy is still deteriorating further in June 1998. It seems that the worst case is not over even though Indonesia has had the worst economic performance, largest currency depreciation, highest unemployment rate, longest drought, and the most horrible riots in the history. In June 1998, many observers predicted that without any significant improvement, the economy could be collapsed within two-three months.

This paper presents the Indonesian economic crisis and employment problems in Indonesia. The crisis is presented in a chronological order to show how the crisis, which started as a monetary crisis has turned to a whole economic crisis, political crisis, and national crisis. Similar to Thailand and Korean cases, the economic crisis has led to political crisis

³ See Mason, Andrew D, and Jacqueline Baptist. (1996) "How Important Are Labor Markets to the Welfare of Indonesia's Poor?". World Bank Policy Research Working Paper, no. 1665. Washington. D. C.

⁴ Figure 1 is taken from World Bank, Indonesia in Crisis: A Macroeconomic Update, July 1998.

and political reforms marked by the change in national leadership. In every case, when the economic crisis was mounting, the political crisis started, and at the same time the country asked for help from the IMF. Based on the agreement with the IMF, economic reforms began, and it gained its momentum when the country had its new national leader. Indonesia has passed all of these steps, but there seems to be no sign of recovery in the economy.

THE CHRONOLOGY OF THE CRISIS

August–September 1997: The economy was sick, but we did not know what to do

While the real cause of the crisis is subject to further research, the chronological events suggests that the Indonesian crisis began through a contagion effect from Thailand's economic crisis, which has started in the mid 1996⁵. By July 1997, economic crisis in Thailand was mounting, and the foreign reserves in Bangkok was depleting fast to defend the currency, which has been pegged to US\$. On July 2, Thai government finally floated the currency (Baht), and as a result, there was massive speculative attack on other Southeast Asian currencies which have also been pegged at a certain degree to the US\$. Soon the global market forced Malaysia and the Philippines to float their currencies, and on August 14, 1997, finally Indonesia had also to float the currency (Rupiah) to save its foreign reserves. The rate was around Rp. 2600/US\$ when it was floated, and this marked the historic date when Indonesia finally joined the club of Asian Economic Crisis.

While the collapsed of Thailand's economy played a major role in constituting Indonesian economic crisis, and the Indonesian crisis might have led to Korean crisis in later months, indeed it is not a domino effect in the sense that one fall would lead to the fall of another. Actually, the problem of the Asian crisis is a general 'cash flow' problem where massive capital inflows, which have fueled Asian economic development for the last decade, suddenly stopped, and even then followed by a massive capital flight out of Asia. It is the massive capital outflows from Asia taking place at the same point in time, which has led to one collapsed after another. Thailand's economic problems might be a wake-up call for global investors and financial markets to scrutinize each of Asian economy more carefully. Having invested heavily in Asia, finally the world capital markets began to realize that there

⁵ It does not mean that Indonesia's crisis would not have happened in the longer run, if there were no crisis in Thailand.

are serious problems, in the form of both the general and country specific anomalies within each economy, and then took the decision to get out as quickly as possible at the same time.

Indonesia has never had any experience dealing with floating exchange rates, and it started a new ball game of macro economic policy where market forces, and no longer the government, who determine the exchange rate. It was clear that the market pressure for depreciation was strong, but there was no sign of follow-up policy to support the currency once the exchange rate was floated. The simple monetary model of exchange rate determination suggests that the spot rate depends on the expectation of the future rates and unpredicted changes in economic fundamentals such as money supply and economic growth. Therefore, the policy to float the exchange rate should have been immediately followed by the measures to break the expectation cycle. When the currency was floated, the interest rate for SBI (Bank Indonesia Certificate) was modestly increased to reduce domestic liquidity, but it was not enough to counter the depreciation. With no sign of supportive policy from the government, the markets saw no hope for currency to appreciate, and the Rupiah hit the psychological border at Rp. 3000/US\$ within a week. Having seen the continued weakening of the Rupiah, the central bank responded by doubling the interest rate from around 15 percent to 30 percent. But, because the market expectation for depreciation was not reversed, the currency continued to slide down.

Tight money policy was not enough to prevent the depreciation because the markets knew well that the problems of Indonesian economy are not merely in the financial or monetary sectors, but more in the real sectors. The market expected clear signals from the authority to reform the economy, but the sign was too little and too late compared to the market's expectation. It was only in early September 98, three weeks after the currency was floated, when for the first time the government outlined the programs to overcome the currency crisis⁶. In general, the programs combined a gradual loosening of the liquidity with efforts to reduce government deficit and to increase the efficiency in the economy, both in the real and financial sectors. Soon after the announcement, the Rupiah stabilized at around Rp 3,000/US\$ in the third week of September.

But this rate did not last long as Rupiah further depreciated to Rp 3400 at the end of the month. There were two possible reasons for this. First, the program turned out to be

⁶ The objectives are: 1) stabilization of the Rupiah at the new equilibrium level; 2) fiscal consolidation; 3) reduction of the current account deficit; 4) strengthening of the banking sector; 5) strengthening of the private sector.

merely an outline, with no clear direction on the detailed implementation. The market expected detailed realization or implementation of the reform program soon after the outline of the program was announced, but there was none. Second, there were increasing reports that private companies were having problems in meeting their debt obligation. There was also increasing number of company hedges to save their outstanding debt positions. These combined factors contributed to further slide-down of the Rupiah.

Another factor which has made the government's responses to the crisis were 'too little and too late' was the uncertainty about the depth of the crisis itself. One example is the unclear size of the private debt. It was suspected that the private foreign debt is not only large in size but also extremely short term in nature, but the actual number of the debt was not clear. Various sources estimated that the outstanding private debt ranges from 55 to 140 billion US\$, of which 50 percent of it was short term. The government did not have any complete record of total private debt because some foreign loans were not reported. The domestic commercial banks did not have the complete record of the debt either, because some loans are processed directly between the foreign lender and domestic companies, without any involvement of domestic commercial bank. It was only in January 1998, five months after the crisis started, the central bank published its first time estimates on the foreign private debt. The uncertainty about the debt figures has contributed to uncertain short term demands for US\$ and further speculative attacks against the Rupiah.

October –November 1997: We went to the doctor, but did not follow the order

On October 8, 1997, the cabinet decided to go to the IMF to seek for help. But the decision itself was not free from controversy. While the markets already interpreted the decision as 'IMF bailout', the finance minister still announced that what Indonesia sought was only technical assistance, even the Minister of State Secretary mentioned that the approach to IMF was only a consideration. These conflicting signals showed the hesitance of the government, in particular the President, to seek help from the IMF, and therefore created another speculative currency trading.

When the consultation with the IMF finally turned into a negotiation, the expectation was high. The entrance of the IMF was seen by the market, and especially by the international community, as the great opportunity to reform Indonesian economy. While it is realized that the benefit from the reform would be a long run goal, it was expected that the

international confidence would be restored given that Indonesia fully committed to the reform consistently implemented the IMF prescription. The agreement was reached on 31 October 1997, and up to US\$ 43 billion bail out package was available for Indonesia. This larger than previously predicted package consists of \$23 billion first line fund from the IMF, World Bank, and Asian Development Bank, and the additional US\$ 20 billion fund provided by bilateral donors (see box IMF Agreement: Package 1).

This first economic reform package agreed with the IMF included efforts to restore the health of the financial sector, adjustment in fiscal, monetary and exchange rates policies, and also structural reforms in the real sector such as the elimination of state and private monopolies. On November 1, one day after the agreement was reached, the government announced the closure of 16 commercial banks, which created panic in the country and sudden withdrawals of savings from other healthy banks⁷. On November 3, the government issued other macro and micro economic policies to implement the deregulation part of the structural reform package. The initial reaction from the market was positive, and combined with the IMF led intervention in the offshore currency market by the Monetary Authority of Singapore and the Bank of Tokyo Mitsubishi brought the Rupiah up to around Rp. 3200/US\$ in the first week of November.

The positive trend did not last very long as the Rupiah depreciated to around Rp. 4000/US\$ by the end of November. There were several reasons for this declining optimism in November. First, the outlined reform programs agreed with the IMF announced in the first week of November was remained to be an 'outline' with no detail implementation plan and schedules. There was no real measure on how to strengthen the financial sectors, after 16 banks were closed. The structural reform part of the package was scrutinized by the public and was generally found that it did not go far enough. Private debt problem, one of the most serious problems in the economy, was basically untouched.

The second source of pessimism was inconsistent implementation. Several decisions were made in the mid of November which raised great doubt on the seriousness of the government, the president in particular, to implement the reform. One of the 16 banks, which were closed in early November, was back in operation under different name within a week. This bank was partly owned by President's son. Several large government infrastructure

⁷ While it might be true that the bank run was caused by the lack of deposit insurance scheme at the time, it was also believed that people actually expected more than 16 banks be closed. They were not sure that all of the remaining banks were solid, and took their fund out from those suspected banks.

projects, which were cancelled by the September reform plan, were put back on track. These projects were also partly owned by the first family.

The third problem was the beginning of the Korean economic crisis in late November, which creates stronger external pressure for Rupiah depreciation and regional market instability. This external shock has made it difficult for the central bank to intervene in the exchange rate markets.

The fourth problem was the decreasing credibility of domestic commercial banks as a result of bank liquidation in early November. There was increasing number of cash withdrawals from banks since late November. Part of the reason was the lack of deposit insurance scheme or government guarantee to depositors when the banks were liquidated, which created insecurity for depositor.

December 1997 – January 1998: Emergency Situation

In early December, the speculation over the size of private debt started to emerge and created further pressure for Rupiah depreciation. There was no official figure of the debt, but private estimates showed that the size was extremely large and very short in nature. The estimate ranged from \$50 to more than \$100 billion, of which 40 percent of it has to be paid within a year. It was later found out that the total outstanding private debt at the end of 1997 was around US\$87 billion, of which US\$ 20 billion was short term in nature. This is clearly much larger than the official foreign reserves at around \$19 billion at that time⁸. Facing uncertainty, exporters tended to hold their dollar revenue, while at the same time the domestic demand for dollar increased as firms started to hedge and to repay they debt obligation.

The emergency situation in December and January started when there was strong rumor that the president was sick in early December. He cancelled his trip to attend the ASEAN summit in Kuala Lumpur. In the previous week there was controversy over the use of the IMF loan. After meeting with the president, the chairman of Kadin (Indonesian Chamber of Commerce) issued a statement saying that the IMF-organized fund should be used to help smaller banks and firms faced with liquidity problems.

By the end of the year, there was increasing demand for debt repayment. Because the domestic supply of dollars dried up, foreign lenders started to accept the payment in Rupiah at

⁸ See Soesastro, Hadi and M Chatib Basri, Survey of Recent Development, Bulletin of Indonesian Economic Studies, April 1998.

a discounted exchange rate. This debt payment was immediately exchanged to dollar in the offshore market and created stronger pressure for Rupiah depreciation. The uncertainty caused by all the above has created further weakening of the Rupiah up to around Rp. 6000/US\$ in the third week of December. The currency strengthened to Rp. 5000/US\$ by the end of December despite heavy intervention by the central bank.

The emergency situation in January was well represented by the movement of the exchange rate, which depreciated from around \$6000 in the first week to around \$15000 in the fourth week of January. The January emergency crisis started from the presidential address to present the draft of the state budget to the House of Representatives (DPR). The draft assumed the exchange rate at Rp 4000/US\$ while the market rate for that day was already around \$8000/US\$. The draft also predicted the economic growth at around 4 percent and inflation at around 9 percent for 1998. These unrealistic assumptions created negative respond in the market and as a result the Rupiah continued to weaken reaching the psychological level at \$10000/US\$.

When the Rupiah hit the psychological border at Rp 10000/US\$, people began to expect the coming of higher inflation and shortage of goods in the market. The middle class rushed to the grocery stores in the mid of January, and within two days all the basic food items were disappeared from the stores.

Soon the second negotiation with the IMF began, and the objective was to formulate the second reform package to support or revise the previous one. On January 15, the IMF package in the form of a Letter of Intent was signed by the President. The reform package was the attachment to the Letter of Intent and consisted of 50-point Memorandum of Economic and Financial Policies (MEFP). This new package was stronger and far reaching than the previous one in November. Different from the first package, which was formulated without any involvement by the World Bank, this second package was formulated by the IMF under consultation with the World Bank. To carry the implementation of the reform program the President established a high level council, called the Council for Economic and Financial Stabilization, chaired by the President himself. (see box on IMF Agreement: Package II)

While the good program seemed to be in place, the market was not easily convinced. After the implementation, the Rupiah was even plummeting to around Rp 17000/US\$ by the third week of January. There were several reasons for this. First, there was strong concern over the independence of the stabilization council from the vested interest surrounding the

President. Based on the experience with the first package, there has been great doubt over the willingness of the President to consistently follow the reform package.

Second, the reform package itself was lack of real policy to deal with two important issues: debt rescheduling and bank restructuring. The market realized that the value of the Rupiah would depend on the real solution to these two crucial problems. At the same time, the process of debt rescheduling needs strong Rupiah, solid banking sectors and credible government. There is a triangle cause and effect mechanism between the exchange rates (value of the Rupiah), debt rescheduling, and bank restructuring, but the reform package failed to address these issue in detail. By the end of January several subsequent policies were introduced to solve the banking and debt problems, but the market only reacted by wait and see attitude.

Third, there was political cloud hanging over the country as presidential election approaching in March. Prof. B. J. Habibie was nominated by Golkar as it's vice presidential candidate on January 22, and the Rupiah went down to all time low at Rp 17000/US\$. This is not a market friendly decision, partly because some of the large and projects (such as state owned aircraft industries) under Mr. Habibie were part of the economic inefficiency negotiated with the IMF.

Fourth, there was a serious bank rush by the end of January as people lost their confidence on domestic banks. Depositors pulled their fund from domestic banks, saved it in the house or transferred to foreign banks. It was found out later that the money that the withdrawal from the bank was up to one trillion Rupiah a day. Because the central bank functioned as the lender of the last resort, the central bank had to print money to provide liquidity support to domestic commercial banks. It was estimated that the currency in circulation grew by about 30 percent only in one month in January. On January 23, to prevent the collapsed of the banking system and to reduce the money growth, the central bank had to provide blanket guarantee to all deposits in all domestic banks at all amount. It means that the banking system is actually nationalized and centralized, and there is only one bank left in the country, that is the central bank. In other words, Bank of Indonesia, the central bank, functioned both as a central bank and commercial banks. An institution called Indonesian Bank Restructuring Agency (IBRA) was established to lead the banking reform.

Many were surprised when the Rupiah could hit Rp 17000 at the end of January. In one occasion the President suspected a conspiracy to destroy Indonesian economy by attacking the Rupiah. It was only in March when the simple answer was clear, there was too

much money in circulation. To protect the troubled banking system, the central bank had provided liquidity support to domestic commercial banks up to Rp. 87 trillion in March 98, which was much larger than M1 at around Rp. 70 trillion. At the same time, through open market operation, the central bank could successfully pulled the currency up to around Rp 70 trillion back from circulation. It means the currency in circulation increased by around Rp 17 trillion from November to March. Therefore, the reason for the 'undervalued' Rupiah was clearly the excess supply of money, and perhaps the exchange rate at more than Rp 10000/US\$ in January was realistic and not overshooting.

February–March 1998: Crisis of confidence was mounting

February was the month of great uncertainty as the crisis had lasted for more than six months with no clear sign of recovery. The Rupiah was only a quarter of what it's worth six month before, inflation rate was picking up, production processes and the economy basically stopped. The shortage of goods in the market, combined with people's expectation on higher inflation and increasing number of currency in circulation led to high inflation rate in January and February. The cumulative inflation rate in the first two months of 1998 was around 20 percent. The price of basic food commodities, such as rice, sugar, soybean, milk, cooking oil, increased by around 50 to 100 percent.

There was no assurance that the second IMF reform package would be implemented consistently. Meanwhile, despite the blanket guarantee to all depositors, people lost their confidence to the domestic banks, and forced the central bank to print more and more money to provide liquidity support to the banking system. The blanket guarantee provided by the central bank, combined with the indecisiveness of the IBRA has created a huge morale hazard problem in the banking sectors.

Frustrated by the condition, the President considered implementing a Currency Board System (CBS) following the suggestion from Prof. Steve Hanke of John Hopkins University, who was brought to the president by the family circle. Based on the CBS, the Rupiah would be pegged at around Rp 5000/US\$ and backed by foreign reserves, while the market rate at the moment was around Rp 9000/US\$. Since the beginning the CBS was considered as a quick fix to the deep and broad based economic problems.

Since the beginning Prof. Hanke admitted that he did not know much about Indonesia, but his economics was the one which raised doubt on the successful CBS implementation for

Indonesia. First, the most obvious reason was the limited supply of foreign reserves to back up the system. By fixing the exchange rate at Rp 5000/US\$, there should be around US\$ 16 billion foreign reserves to support the size of M1 at around Rp 80 trillion. The foreign reserve was just enough to cover the M1 while the size of M2 was around Rp 350 trillion. To prevent the depositors to convert their bank deposit to US\$, the time deposit at the bank has to be frozen, or converted to government bond. Additional measures were also needed to absorb the significant amount of Rupiah in the offshore market to prevent external speculative attacks. This would be difficult and controversial policy and certainly would further reduce government credibility in handling the crisis.

The second concern was the diminishing role of the central bank with the implementation of CBS. The central bank realized that the implementation of the CBS would have to surrender its monetary policy. With the CBS, the central bank could no longer be the lender of the last resort and this would contradict the current policy to save the banking system by providing the blanket guarantee to all depositors. With no confidence in the banking system, there was a great chance that the banking system would be collapsed. In the mid of February, the governor of the central bank who opposed the CBS was forced to resign two weeks before his terms ended. The controversy over the implementation of the CBS once again raised doubt on the willingness of the President to follow the IMF package consistently⁹.

The idea of CBS was still alive when President Suharto was reelected in the mid of March 98. The IMF announced the postponement of the release of the second installment because there was a great concern over Indonesia's compliance to the reform package. In response, the President blamed the IMF for deteriorating condition and said the IMF package could lead to economic liberalism, an economic system that does not fit the constitution. Here came the stand off between Suharto and IMF.

Having negotiated for more than three weeks, Indonesian government and the IMF reached an agreement on the third reform package. The package was written as a Supplementary Memorandum of Economic and Financial Policies released on April 12, 1998. Similar to the Letter of Intent signed by President Suharto on January 15, it seeks to inject more transparency into the system and to allow market forces to dictate the allocation of resources. Different from the second reform package, the new package consist of detailed

⁹ The idea of CBS was finally off by the end of March 1998, and it turned out that Prof. Hanke was paid well for nothing.

time table for implementing the reform. The forecast for GDP growth in 1998 was revised from zero to minus five percent, while inflation was estimated at 45 percent. Many believed that this forecast was too optimistic considering the deteriorating condition in the economy since January 1998. (see box on IMF agreement: Package III)

Widespread protests against the President himself and against government's failure to deal effectively with the crisis started to emerge in March, just after the President announced the composition of the new cabinet. Many called the cabinet as the 'Cabinet Nepotism' because of a strong influence from the first family in the selection of the cabinet member. IMF had to face the continued similar problem in handling Indonesia's economic crisis when the well-written reform package was not supported by strong political will by Indonesian government to implement the reform. The president did not seem to understand that he was part of the problem for the economy.

By early April, it was clear that the central bank had printed excessive amount of money for the last four months. The report from the central bank showed that liquidity support for ailing banks has reached Rp. 100 trillion, or more than the size of M1, and the currency in circulation has increased by about 80 percent. The central bank tried to pull the money from circulation by increasing the interest rate. The policy, however, was ineffective because on the other hand at the same time the weak IBRA had to continually provide liquidity support for the almost collapsed banking system. The choice was either to shut the bad banks, which would hurt many influential people in the country, or to keep printing money to survive. This was clearly another inconsistent policy which lead to a gloomier picture of the economy.

April–May 1998: The political turmoil and another emergency situation

The crisis which started as a monetary crisis in the mid 1997 became an economic crisis in November 1997, and finally led to a political crisis in April 1998. The cumulative inflation rate was around 40 percent in the first five months of 1998, the highest inflation rate for the last thirty years. The prices of some basic food items have doubled at the same period, showing general shortages everywhere. The unemployment rate doubled from 5 percent in 1997 to around 10 percent in the first half of 1998. By April, the economy seemed to be mature enough for a revolution, not to mention a widespread riot, to happen.

There were mounting student protests in all over Indonesia in April 1997 demanding a 'political reform,' a key word for changing national leadership or president's resignation. This proved that the changes in political climate has been very rapid because the words 'political reform' itself was a taboo even in January 1998. On April 15, students march on at least 25 campuses in the largest show of unity. While the third agreement with the IMF was reached in the following week, and all economic targets in the IMF reform package were met, the market's confidence was crumbling, as the political climate became unstable.

On May 4, Indonesia cut fuel subsidies, and the fuel prices increased by around 50 percent on average. This immediately led to 50 percent increase in the cost of transportation everywhere. The next day, widespread of protests and riots emerged in major cities in the country. This marked the beginning of continuous rioting in the month of May. On May 12, Indonesian security forces shoot and killed at least six students at Trisakti University in Jakarta, sparking larger protests in the following day.

Then it came the black Thursday, May 14, 1998 when Jakarta looked like a war zone. Nearly every part of the city was racked by violence as people went on a spree of ransacking, looting and burning. Around three thousand buildings destroyed or burnt, including department stores, supermarkets, police stations, churches, and factories. Thousands of cars were burnt on the streets, more than five hundred people died even though the unofficial number of casualties has reached thousands. The military seemed to be impotent in handling the situation, even though Armed Forces Commander said that the military was in control. This scene of anarchy marked the beginning of President Suharto's final days in his office. On May 21, 1998, President Suharto resigned after 32 years in power, and Vice President B.J. Habibie took the seat.

The new government faces an intimidating array of problems, political as well as economics. While politics will give this new government big headache, the economy does not help either. In order to start the recovery, the economy needs political stability. As long as people are divided over presidency issue, it would be very hard to reach the stability, and the economy continues to sink.

The Worrying Indicators in May 1998

The damage from the riots in Jakarta was estimated at more than three trillion Rupiah, but this is nothing compared to the worrying indicators below.

Government budget. In January 1998, the government announced the draft of state budget for fiscal year 1998/99 by assuming that the exchange rate was Rp. 4000/US\$. The budget was subsequently revised in February when economic reality turned out to be worse than perceived, by using the exchange rate at Rp. 5000/US\$. The total revised budget was around Rp. 147 trillion. However, there have been drastic changes since the announcement, which made the estimated budget unrealistic. Oil prices have declined to levels of US\$ 15 /barrel (assumed to be US\$ 17), salaries of civil service are increased by 15 percent, the economic growth is negative, and the current exchange rate is far beyond the assumed Rp. 5000/US\$.

With all the foreign aids included in the state budget, it is estimated that the deficit would be around Rp 36 trillion¹⁰. When the foreign revenues are not included, the deficit rises to Rp 68 trillion. This, however, has not included the interest payment has to made by the government (IBRA) to the central bank as a result of the liquidity support provided by the bank for the ailing banks at IBRA. The liquidity support given to IBRA has reached Rp 124 trillion by the end of May 1998, and for example with 80 percent interest rate, the government has to pay at least Rp. 100 trillion a year to the central bank. It is hard to imagine that the government debt is going to be about the same size of its budget. There is only one way to solve the banking problem, that is to close and to liquidate all bad banks immediately, issued a government bond to prevent the bank run and to inject fresh capital if necessary, and then set up few solid banks in the country. It would be very painful in the short run, but it is certainly much better than providing 100 percent blanket guarantee, supported by printing money, which has created serious morale hazard problems.

Monetary Expansion. Currency in circulation has almost doubled from around Rp. 27 trillion in October 1997, to almost Rp. 50 trillion in May 1998. In terms of Reserve Money, it increased from Rp. 33 trillion in October 1997 to Rp. 70 trillion in May 1998. It means a hundred percent of money growth in six month, while the annual currency growth before the crisis used to be less than 15 percent a year. The additional Rp 25 billions is the left over money, which could not be pulled out from the circulation by open market operation after the central bank released excessive amount of money to support the liquidity of the ailing banks. Excessive monetary expansion would potentially lead to hyper inflation and currency depreciation. The target of having exchange rate at Rp 6000/US\$ at the end of 1998 would

be very hard to achieve, while the target of inflation rate at around 45 percent for 1998 is out of question (see Figure 2).

Stagflation. Based on official estimate, the economy has contracted by 8.5 percent (q-o-q) in the first quarter of 1998, or 6.2 percent (y-o-y) compared to the first quarter in 1997. The estimated growth for 1998 is minus 10 percent, which looks a little on the optimistic side compared to the private estimates which ranges from minus 13 to minus 25 percent (see Table 1). Combined with around 100 percent inflation, it would lead to the period of stagflation. According to the best scenario where economic recovery starts in the end of 1998, the economic growth in 1999 would still be minus, in 2000 would be zero, and then positive afterwards. It means that Indonesia would need five years to get back the level of income and growth it had in 1997.

¹⁰ Van der Linde, Recalculating the State Budget, SBC Warburg Dillon Read report, May 1998.

EMPLOYMENT PROBLEMS

Unemployment

For the last ten years, workers have experienced sustained increase in employment¹¹. The usual labor market indicators such as total employment and unemployment growth, however, is not very useful information in Indonesia's case. The growth of total employment will be roughly equal to the growth of working age population because people are considered working even if they work only for one hour a week. A better indicator will be the number of formal employee and employer, which captures the size of the formal employment¹². Since 1990, the number of employment in the formal sector has grown at about 5.7 percent annually, larger than the annual growth of the labor force at about 2.5. The annual growth of male and female workers have been 5.6 percent and 5.0 percent respectively since 1990. The number of informal sector employment, which is defined as the sum of small scale self-employment and family workers, increased by only 0.5 percent annually since 1990.

The period of stagflation in 1997-1998 has led to serious unemployment problems. The government's estimate of unemployment is around 13 to 15 million people in 1998. By definition in Indonesia's statistics, open unemployment is defined as 'working for less than one hour a week and at the same time looking for a job.' When the real income is shrinking as a result of stagflation, in the country where there is no unemployment insurance and social security, people could not afford to be unemployed. Therefore the government estimate could be overestimated. Based on employment elasticity, which was roughly calculated based on 1990-96 data, unemployment could reach from 10 to 13 million people in 1998 (See Table 2).

Because people lose their jobs in the formal sector and move to the informal sector, the more relevant issue is to estimate unemployment rate or employment reduction in the formal sector. Assuming that the economy shrinks by minus 15 percent in 1998, the total employment reduction is around 3.7 million in the formal sector, or more than 12 percent (Table 3). The predicted employment reductions, for example, are 1.7 million in

¹¹ See for example, Feridhanusetyawan, Tubagus. "Labor Market Transformation in Indonesia, 1990-96," *Indonesian Quarterly*, forthcoming, and also Agrawal, Nisha (1996) "The Benefit of Growth for Indonesian Workers," World Bank Policy Research working Paper, no. 1637. Washington DC.

¹² In this paper, formal employment is defined narrowly as employee and employer with permanent employee. Informal sectors is defined as the self-employed without any employee, self employed with family or part-time workers, and family workers.

manufacturing sectors (28 percent), 1.2 million in the construction sector (38 percent), and 550 thousand in the trade, hotel and restaurant sectors (22 percent).

While high economic growth in 1990-96 significantly reduced unemployment especially in the formal sector, under-employment has always been severe. It seemed that the number of people under employed has not been affected by economic growth. The definition of under-employed in Indonesia is working for less than 35 hours a week. Under this definition, 35 percent of workers in Indonesia are under-employed in 1996. Underemployment in rural areas is much larger than in urban areas. Around 45 percent of worker in rural areas work less than 35 hours a week, compared to around 21 percent in urban areas. The viewer hour of work in rural areas has been due to the seasonal nature of agricultural work.

Considering the possible serious miss-interpretation of the unemployment and under-employment problem in Indonesia, a newer definition of unemployment has been explored. One definition is to include **severe under-employment**, namely those who worked for less than 15 hours a week, in the unemployment rate. With this new definition the unemployment rate in 1996 increased to around 13 percent of the work force. The impact of economic crisis on under employment is hard to predict at the moment. Reduction in employment opportunity might reduce the number of working hours and increase under employment. However, sharp reduction in real wages and income might force people to work more hours, and therefore reduce the number of under employment. The number of under employment in Indonesia has always been high, but it has not been sensitive to economic growth for the last ten years.

Labor Market Transformation

Labor market transformation has been following the common pattern in many developing countries where the economy moves from labor surplus to labor scarce economies as the industrial development progresses. The transition from labor surplus to labor scarce economies marks the 'turning point' in the labor market where wages starts to rise faster with the increase in employment as a result of labor market tightening. This framework is also

useful in analyzing the bargaining power of labor, patterns of income distribution, and potential changes in industrial structure associated with economic development¹³.

During the surplus labor phase, wages is low, and the increase in employment does not increase wages by the significant amount. There is also significant income inequality between the skilled and unskilled labor in the economies. As the industrial development progress and the economy moves away from agricultural to more industrial and services based economy, labor becomes scarce in the agricultural sector, the modern sector starts to absorb significant share of the workforce and then the real wages start to rise. There will be shifts from less to more capital and skill intensive industries, and at the same time the difference in wages between the skilled and unskilled labor starts to narrow.

Related to this 'turning point' concept, Indonesia's labor market has been undergoing structural transformation and has begun entering the 'turning point' phase in early 1990s. The first sign is the rapid decline in employment growth in agriculture. From 1971 to 1990, employment growth in agriculture in Java was around 1 percent, and declined to minus 3.4 from 1990 to 1996. In outside Java, the annual growth of agricultural employment was 2.7 percent from 1971 to 1990, and declined to near zero in 1990s. The second sign is the rapid growth of value added and labor productivity in industry, especially manufacturing. The growth of value added in manufacturing averaged more than 10 percent per annum from 1971 to 1990. Labor productivity rose steeply, over 5 percent per annum on average outside oil and mining¹⁴. The third sign is the importance of construction and services sectors, rather than manufacturing, in absorbing employment from new job entrants and from rural areas. Services accounted for around 44 percent of new jobs created in 19971-1990.

Compared to other rapidly growing Asian countries, the turning point of Indonesia's labor market has been late (See Figure 3). One important reason is the greater Indonesia's dependence on natural resources, especially oil, in the early stages of development. Because the lack of natural resources, many other East Asian economies such as South Korea, Malaysia, and Taiwan adopted outward looking and export oriented development since the beginning of industrialization. Their early economic developments were based on cost advantages of labor intensive industries, while Indonesia relied on export of oil and gas. It

¹³ See Manning, Chris. (1995) "Approaching the Turning Point?: Labor Market Change Under Indonesia's New Order." *The Developing Economies*, Vol. XXXIII, No 1, March.

¹⁴ See Manning (1995).

took the recession and oil price drop in the mid 80s for Indonesia to change its economic development strategy and to rely more on labor intensive manufacturing sectors for exports.

It is also important to note that the process of turning point would be a longer process compared to other Asian countries. For example, the growth of real wage in manufacturing in Thailand increased by around 70 percent for the last ten years, while that of in Indonesia increased by only 30 percent. Another factor, which potentially lead to slower transformation process is the lower level of education of Indonesian worker compared to other Asian countries. The lack of education would hinder the process of industrial transformation because people are not flexible to change jobs to more modern sectors.

With the current economic crisis, it is expected that the process of labor market transformation will slow down, stop, or even reverse as the economic performance continues to deteriorate. Labor will no longer move from the agricultural sector to manufacturing and services sectors as formal employment in the manufacturing and services sector sharply decreases. Since the crisis began, there has been massive reverse movement of labor from the manufacturing and construction sectors to the agricultural sectors in rural areas. Another sign of labor market transformation reversal is the movement of labor from the formal sector back to the informal sector.

Wages

From 1990 to 1996, the benefit of economic growth for Indonesian worker is also reflected by the increase in monthly wages, especially for women. The average nominal monthly wages in the manufacturing sectors, for example, doubled from Rp 89 thousand in 1990, to Rp 193 thousand in 1996. The sharp increase in minimum wages for the last seven years has been the major contributor for the sharp increase in wages. For example in West Java, the minimum wages increased by more than four times, from around Rp. 30 thousand in 1990, to Rp.130 thousand in 1996. In general, minimum wages in Indonesia increased by tripled from 1990 to 1996.

The real wages has also increased sharply. The real wage in the manufacturing sector has increased by 33 percent, or calculated annually, the annual growth was 4.9 percent. The wage in the agricultural, forestry, hunting and forestry sectors increased by 52 percent from 1990 to 1996, while that of the community, social, and personal services sectors increased by more than 70 percent. The growth of real wages for women has also been impressive. In

agricultural, manufacturing, services, and even construction sectors, the monthly wages for women grew at faster rate compared to that of the men. In manufacturing sectors, for example, the real wage of female workers in 1996 was 62 percent higher than that of in 1990. These high growth figures for women have been due to the increasing participation of women in the formal sectors and more working hours.

Economic crisis in 1997 and 1998 has sharply reduced the real wages. Nominal wages would be relatively constant, or even lower, while inflation rate could reach 80 to 100 percent in 1998. Therefore, real wage could generally decrease by 30 to 50 percent in 1998. With the decline in real wages, the number of people living below the poverty line increases. Because of 40 percent increase in food prices, it is estimated that the proportion of population living below the poverty doubled from 13 percent in 1996 to 26 percent in 1998. When inflation rate goes to more than 100 percent, it will not be surprising that number of people living below the poverty line could jump to more than 30 percent of population. This sharp correction of real wage and employment adjustment during the crisis will be very painful. The speed of economic adjustment depends on the flexibility of labor market. Compared to other neighboring countries, labor market in Indonesia has been relatively more flexible.

Because of sharp reduction in employment in the formal sector, low skilled labor will loose their jobs in the formal sector and move to the informal sector. Increasing supply of labor would reduce wages in the informal sector. Informal sector mostly consists of small scale self-employment and family workers, and their real income will sharply decrease as a result of economic crisis. Higher skilled labor would also loose their jobs in the formal sectors, mostly in financial, manufacturing, and construction sectors. Most of them would find other jobs in the formal sectors, but surely with much lower wages.

THE LESSONS FROM THE CRISIS

Like many other Asian countries, Indonesia's strong economic performance and good-looking economic fundamentals for the last decade were actually not built based on solid foundation. For sometimes before the crisis started, many economists have puzzled on the relation between seemingly strong macro economic performance and inefficient or distorted microeconomic condition in Indonesia. It is unfortunate that people found the missing link only when the economy starts to deteriorate.

Following the economic liberalization, which started in the mid 1980s, the expectation about future economic growth became excessive, and foreign capital became cheap and encouraged over borrowing. Much of the money was channelled through weak banking sector, used to finance speculative property investment, or the over expansion of industrial capacity. Pegged exchange rate has reduced the incentive of the domestic borrower to hedge their position. Lack of banking supervision led to reckless borrowing where short-term debt was used to finance long term investment project like property. Combined with extremely large proportion of short-term debt, all led to bubble in the financial sector, inflated by inadequate banking regulation and corrupt government.

From the government side, the policy of fixing the currency to the US\$ turned out to be a big mistake. For several years, monetary and exchange rate policies have been used to protect the inefficient real sector. The increasing cost of export production is hidden by the depreciation of the Rupiah¹⁵. The Rupiah was depreciated at around 5 to 6 percent annually from 1990 to 1996, which has also created a huge morale hazard problems in the private sector. Not only the protected exchange rates encourage foreign currency borrowing, but the fixed rate also prevented central banks from raising interest rates to reduce the explosion of domestic credit. It was a textbook case where fixed exchange rate leads to ineffective monetary policy. The second apparent problem is the cronyism, lack of transparency in economic policy, business and financial transaction. This chronic problem encouraged the borrower and lender to believe that governments would bail them out if something goes wrong in the future. This is very clear in Korean case.

All countries with economic crisis in Asia have unreliable legal system and lack of transparency. A market economy needs access to reliable information to work properly, and all economic transactions need solid legal framework to be valid. The lack of transparency and accountability, combined with unreliable legal system, surely invite corruption. In Indonesia for example, the first family members and their cronies get first pick of government contracts and licenses, so that paying off the family or well-connected officials would be the best strategy to get the deals. All have long realized that Indonesia was corrupt, but wrongly thought that it did not affect economic inefficiency.

¹⁵ For the criticism for the exchange rate policy, see Feridhanusetyawan, Tubagus. Survey of Recent Development. Bulletin of Indonesian Economic Studies. August 1997.

Indonesia: Why does it take so long to recover?

By June 1998, Indonesia has not seen the end of the tunnel. The economic crisis has lasted for almost a year, and is definitely far from over. With no clear sign and direction for recovery, some believe that the sinking Indonesian economy has not reached the bottom of the sea yet. Because, the economic crisis is far from over, the recovery has not started, and the end of the story is still hard to predict, it might be too early to determine the real cause for the delay in Indonesia's case. However, there are several possible reasons for this phenomenon.

First, Indonesia's effort to have an economic reform has not been supported by a political reform. Both Korea's and Thailand's economies started to recover after they had their new governments. While the political reform might only be a necessary and not a sufficient condition for an economic recovery, the changes in national leadership seemed to provide the momentum to start a successful reform in both countries. Indonesia had its new government in May 1998, but because the new President B.J. Habibie has been a controversial figure in the past, the momentum was not there to start economic recovery. As long as people are divided over the presidency issue, great political uncertainty remains, everyone takes a wait and see position, and no major economic decision is made by economic agents. Many viewed the new government as the 'old wine in a new bottle', which means that the political reform is perhaps not even half way done even though President Suharto has resigned.

Second, government's policy responses have always been considered as 'too little and too late' compared to market's expectation. When the currency was floated in the mid of August, the market expected the immediate announcement of a deregulation package to boost the exchange rate and to break the market's expectation for further depreciation. The announcement to have an economic reform was made later in early September, when the market already expected more than an announcement but a real implementation or action. Since the beginning of the crisis the market expected that the support to inefficient government's pet projects linked to the President's cronies, such as National Car Project and National Aircraft Industries, to be banned. In the first IMF reform package in November, however, these projects were relatively untouched. When the support for these cronies was cut in the second IMF reform package in January, the market already discounted these measures and expected for real actions in foreign debt rescheduling and banking restructuring. While President

Suharto's resistance to economic reform and his continued protection for his cronies have contributed to insufficient government's policies above, many also believe that the government bureaucracy itself does not have the capacity and the authority to deal with the problem. When it comes to big projects, big names, and big amount of money, the president or his family has to be in charge, while the relevant ministers have no authority to make any decisions.

Policy Priorities for Economic Recovery

In the very short run after the riots in Jakarta, the policy priority is to restore the daily economic activity where people could run their businesses and make economic transaction safely, and to provide economic incentives to prevent the future riots. The most important policy is to ensure enough food supply in the market and to prevent the skyrocketing prices of basic food.

In the short run, something like within six months ahead, there are three priorities. First, to restore the confidence in the economy, both at domestic and international level, by consistently conducting the economic reform as planned. Second, to prevent the real sector from collapsed and at the same time to boost the development of the savior sector for the economy, namely the labor intensive, natural resource intensive, and export oriented industries. Third, to seriously reform the banking sector. Special attention has to be given to restore trade financing, which has been broken due to the collapsed of banking system.

In the medium run, the priority of the policy is to fully rehabilitate and restructure the economy by conducting macro-economic stabilization and economic recapitalization. This includes monetary and fiscal policies to reduce inflation, balance of payment management, and exchange rate policy. In the longer run, the priority is to develop solid foundation for economic fundamentals to prevent future shocks. There are three conditions for the economy to be strong fundamentally in a globalized world: 1) solid legal framework, 2) good and corporate governance, and 3) transparent, accountable, and market oriented economic policy.

Policy Priorities for Employment Creation

First, maintaining the flexibility of the labor market is crucial to speed up the economic recovery and to reduce the pain of economic adjustment. Wages have to be allowed to adjust

to changing market condition to reduce unemployment. After being tripled for the last seven years, minimum wage should be frozen in 1998.

Second, promoting the expansion of labor intensive and export oriented industries would be another important priority. Sharp currency depreciation would change Indonesia's comparative advantages. Some industries with high import content would be collapsed, but other industries, especially the labor intensive, natural resource intensive and export oriented ones would survive and even expand. Those expanding sectors should be the savior of the economy by creating export revenues and absorbing employment. Labor would move from the construction, financials, back to agriculture and other primary sectors. Within manufacturing sector, labor will move from the import substitution industries to labor intensive and export oriented industries. Related to the movement of labor from the formal sectors to informal sectors, it is crucial to create incentives for informal sector to expand. Any incentive to promote self-employment creation, such as the development of micro-financing programs and small scale credits, would be useful to support informal sectors.

Third, in the very short run after the riots in May 98, creating subsidized labor intensive public works programs is very important in absorbing those unskilled workers who have been laid off since the crisis began and especially after the riots. Some of foreign financial assistance should be channeled to finance these programs immediately.

However, there are several points worth mentioning with regard to this employment creation crash program. In terms of targeting, the participation of this program should be self selection in nature rather than targeted or assigned by the government. To achieve this, the wage rate offered should be comparable or lower than the minimum wage. The program is opened to every unemployed unskilled worker who thinks that he/she is qualified to the program. This self-targeting approach would be the most effective way to reach the targeted group of population. In terms of organization, the participation of NGO (Non Governmental Organization) in administering this program is important to maintain efficiency and to reduce leakage. Experience from many countries have shown that inefficient government bureaucracy is the main source of leakage. Local NGO would provide an effective control mechanism and provide better information for better targeting.

THE IMF AGREEMENT: PACKAGE I (October 31, 1997)

On October 31, 1997, the agreement with the IMF which was announced by the Indonesian government. There was no official document publicly available, and the targets of macroeconomic indicators were not publicly announced. The announcement itself covered only the broad outline of the program and was lack of detail implementation policies. The actual document itself was not made public, and it was actually co-signed by the Minister of Finance and the Governor of the Central Bank. According to the announcement, the program was made by Indonesian government and then reviewed and agreed by the IMF. Considering President's reservation to go for help to the IMF, it was believed that this was a very subtle way to hide the fact that Indonesia actually asked for help from the IMF. Many also believed that the deal with the IMF was the move by the technocrats to make them more credible so that President would listen to their suggestions. It became more and more clear that the President's protection to his cronies was the major problem in conducting economic reform.

The agreement covers actions in four major areas: 1) effort to restore the health of financial sector; 2) fiscal policies; 3) monetary and exchange rate policies; and 4) structural adjustment, in the form of extension and deepening of the deregulation program. The agreement was to be implemented over a three-year period and tightly monitored by the experts from the World Bank, IMF and Asian Development Bank. Unpublished macroeconomic targets have been set and the disbursement of the stand-by loan was conditional upon the achievement of those targets.

The IMF assistance was up to US\$ 43 billion, which consists of 'first line' fund of \$ 23 billion provided by the IMF, World Bank, and Asian Development Bank, and US\$ 20 billion 'second line' fund provided by bilateral donors. The first line fund consists of US\$ 10 billion from the IMF, US\$ 4.5 billion from the World Bank, US\$ 3.5 billion from ADB, and an additional US\$ 5 billion which Indonesia itself has placed in the package. To be part of the US\$ 10 billion from the IMF, US\$ 3 billion will be disbursed immediately, and another US\$ 3 billion was to be made available after March 15, 1998. Because the target was not met, the second installment in March was later postponed.

In the structural adjustment program, there were several policy reforms. First, the reduction of import tariffs continued, including the sensitive sectors such as chemicals, iron and steel, and fisheries products. Second, there was trade deregulation for various sensitive agricultural commodities: wheat and wheat flour, soybeans, and garlic. The import of those items were no longer monopolized by BULOG (State Logistic Agency) but opened for private sectors under a General Importer license. Third, barriers to export, including export taxes, would be reduced in stages. Fourth, following the commitments to the WTO, the local content program for automobile, which has provided high level of protection to the industry, would be eliminated by the year 2000. The government would also agree on whatever the WTO decision regarding the controversial National Car Project. Fifth, to improve budget efficiency, the government undertook to review investment and expenditure by the public sector, including that on state-owned enterprises and strategic industries. In addition to this, privatization program would be continued and would include the state-owned banks once merger of these banks is finalized.

Source: Government of Indonesia, press releases; and Soesastro and Basri (1998).

THE IMF AGREEMENT: PACKAGE II (January 15, 1998)

The second IMF reform package was formulated in the form of **Letter of Intent** signed on January 15, 1998. Different from the previous IMF programs, this second agreement was signed by the President and was made public. It was revealed later that the President himself led the negotiation with the IMF. The reform program consisted of 50-point **Memorandum of Economic and Financial Policies** attached to the Letter of Intent.

Regarding to the macro economic framework, the program was designed to avoid decline in output (the target for economic growth is zero), while containing inflation to 20 percent in 1998. The 1998/99 government's budget is revised and expected to be a deficit by around 1 percent of the GDP. The government is expected to phase out many subsidies gradually, by raising fuel and electricity prices in steps. To increase fiscal transparency, the accounts of the Reforestation and Investment Funds, which used to be the off-budget items, would be brought onto the budget in 1998/99. Twelve infrastructure projects that were recently reinstated (after being cancelled by the first IMF reform package) or under reviewed would immediately cancelled. This included the Tanjung Jati power plant, which had a direct linked to the first family business.

The tight monetary policy would be continued with the targeted growth of the broad money at 16 percent in 1998. Specific plans to restore the banking system to financial health and to alleviate the difficulties of the corporate sector would be announced.

The structural reforms under this second IMF reforms package includes the immediate elimination of Bulog's monopoly over the import and the distribution of sugar, and over the distribution of wheat flour. This is a significant improvement because under the first reform package in November, what was to be distributed through Bulog for 3-5 year transition period. Domestic trade in all agricultural products to be fully deregulated, and the Clove Marketing Board (another monopoly by the President's son) would be eliminated by June 1998. Other restrictive marketing arrangement, and specifically the cement, paper and plywood cartels, to be abolished by February 1998. The plywood cartel is operated under Mohammad Bob Hasan, a closed friend of the President. For cement, internal and external trade restrictions will be eliminated. With respect to foreign investment, formal and informal barriers to investment in palm oil plantations to be removed from February 1, 1998.

The government to discontinue special tax, customs, and credit privileges to the National Car project, as well as any budgetary and extra-budgetary support and credit privileges to projects of IPTN (state-owned aircraft industry).

Tariffs on all food items to be cut to a maximum of 5 percent in order to secure food supplies for lower income groups. Local content rules on dairy product to be abolished from February 1, 1998.

Import restrictions on all new and used ships to be abolished. From February 1, 1998, export tax on a wide ranges of products such as leather, cork, ores and waste aluminum to be abolished, and export tax on sawn timber, rattan and minerals to be reduced to a maximum of 10 percent. Other export restrictions such as quotas to be eliminated by the end of year 2001. Export restrictions on palm oil to be exempted to ensure adequate domestic supply, but this exemption to be eliminated by March 1998.

Sources: Memorandum of Economic and financial Policies (MEFP); and Soesastro and Basri (1998).

THE IMF AGREEMENT: PACKAGE III (April 12, 1998)

The revised IMF reform package called the **Supplementary Memorandum of Economic and Financial Policies** was released on April 12, 1998. This memorandum is signed by State Coordinating Minister for Economic, Finance and Industry and is supposed to be the supplement of the 50-point memorandum released on January 15, 1998.

There were three assumptions embedded within the text. First, the government expects that its bold policy program will be reinforced by financial support from international community, including trade financing and the provision of food and medical aids. Second, the government and the donor agencies expect that the economy to start to recover in the second half of 1998. Third, with the projected increase in official external assistance, the cessation of private capital outflows as the program takes hold, as well as the restructuring of corporate debt, the overall balance of payment position is expected to be manageable.

Above assumptions reflect the importance of recapitalization of Indonesian economy to restore the economy.

The authorities targeted the exchange rate to be below Rp. 6,000/US\$, and when the exchange rates deviate from the programmed path, net domestic assets and interest rates will be adjusted as necessary. The GDP growth in 1998 is forecasted at around minus 5 percent with annual inflation at around 45 percent. The current account is projected to be a surplus 3 percent of the GDP. The budget deficit could be as high as 6 percent of the GDP, but the authorities plan to limit this to 3.5 percent and expect to finance it through foreign sources.

Compared to the Letter of Intent signed in January, the new or additional measures include:

- A Law on competition policy providing guidelines for fair business practices and to avoid anti-competitive behavior.
- The government intends to request that foreign banks roll over interbank credit to domestic banks and restore trade financing.
- Bank of Indonesia is putting in place a facility to guarantee letters of credit opened by participating foreign banks for the import of raw materials. This is a type of back-to-back arrangement where the foreign banks will guarantee letters of credit issued by six state-owned banks.
- A special commercial court is being created that will have jurisdiction over bankruptcy proceedings and general commercial disputes.
- A presidential decree will be issued requiring compliance with requests for data by Bank of Indonesia from corporations, especially in terms of data on foreign currency borrowings.

Source: Loo, Rick. "Third time Lucky?." SBC Warburg Dillion Read publication. April 1998.