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Indonesia: recovery from economic and social collapse

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Indonesia: recovery from economic and social collapse

by

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Abstract

The collapse of the Indonesian economy during the period of the Asian financial and economic crisis of 1997/98, has been one of the most stunning and shocking events to have afflicted a developing country during the past several decades. Despite its remarkable economic success since the early 1970s and relatively strong economic fundamentals, with frequent references by the IMF and the World Bank to it as a model for economic development, its demise occurred rapidly in the second half of 1997 and continued unabated during 1998. In 1998 its economic output contracted by around 14 per cent, among the largest declines recorded anywhere in the world in the post World War II period. Millions of Indonesians have lost their jobs, poverty has increased significantly as a consequence, food production has been disrupted by the crisis as well as the effects of a severe drought in 1997. Prices for many of its export commodities, especially oil, have fallen sharply on world markets, and investors, both domestic and foreign, have fled the country. The banking system is in desperate need of restructuring with many banks insolvent and in need of recapitalisation, and thousands of its business corporations are effectively bankrupt and face closure. These difficulties contributed to a political crisis which culminated in a series of bloody riots in May 1998, and the replacement of President Suharto by President Habibie.

This paper conducts a brief overview of recent macroeconomic developments in Indonesia, identifies some of the key factors behind the crisis, and outlines the IMF rescue program and the country's policy framework. The paper also discusses the short term economic and social prospects for the country, and policies essential for its recovery.

1. Introduction

Indonesia's economic performance over the past three decades has ranked among the best in the developing world, with real GDP growth averaging about 7 percent annually since 1970 resulting in average income more than quadrupling in the space of a single generation. During this period the structure of the economy has become more diversified, as an export-oriented manufacturing base has emerged reducing the country's dependency on the oil sector. The key to this success was a consistent adherence to prudent macroeconomic policies, high domestic investment and savings rates, and market-oriented trade and exchange rate regimes. Macroeconomic balance was maintained: the budget was balanced; inflation contained at relatively low levels; current account deficits were moderate; and international reserves remained at comfortable levels. In addition, broad-based labour-intensive growth, together with sustained government initiated improvements in basic education and health services, dramatically reduced the incidence of poverty from 64 percent in 1975 to 11 percent by 1995. After many years as one of the world's largest importers of rice, the country achieved self sufficiency in production in the late 1980s. Standards of living rose rapidly, with expectations of further continued improvements.

Despite its good macroeconomic fundamentals Indonesia faced an abrupt shift in market sentiment from the middle of 1997, as the currency contagion spread from Thailand. The country faced a major crisis of confidence reflected in a fall in the value of the rupiah and in equity prices, which turned out to be the largest in the region. From mid-July 1997 to early January 1998 the cumulative depreciation of the rupiah reached over 70 percent, with over half of this decline occurring from the end of November 1997. The fall in the Jakarta stock exchange index reached 50 percent over this same period. Despite strong corrective action by the government from the outset, the rupiah remained under pressure. By early 1998 the fortunes of the economy had been transformed. Annual per capita income was down from around US$1,200 to US$300; stock market capitalisation was down from US$118 billion to US$17 billion; only 22 of Indonesia's 286 publicly listed companies were considered to be solvent; only four firms remained with a market capitalisation of US$500 million or more out of 49 from before the crisis; and the country's foreign debt had blown out to US$112.1 billion, most of which was owed by the corporate sector. By the end of 1998 GDP had contracted by around 14 percent after expanding by 8 percent in 1996 and 5 percent in 1997. This single year collapse is amongst the largest recorded anywhere in the world in the post World War II period. Millions of Indonesians, many surviving just over the poverty line during the good times, lost their jobs. Food production was disrupted, both because of the crisis and because of a severe drought in 1997. Prices for many export commodities, especially oil, fell sharply on world markets. Investors, both foreign and domestic, fled the country, and the banking system and corporate sector are both in major need of restructuring.

The objective of this paper is to identify the key factors responsible for this dramatic change of fortune and to suggests measures necessary for the recovery of the economy. It proceeds as follows. Section 2 identifies the macroeconomic background to the financial crisis in Indonesia. Section 3 focuses upon the key factors behind the financial crisis. Section 4 analyses the IMF rescue package and policy framework, focusing upon the need to restructure the banking and corporate sectors. The country's economic and social prospects in the short term are discussed in section 5. Finally, section 6 presents a summary of the major conclusions.

2. Recent macroeconomic developments

Indonesia became afflicted by the Asian currency contagion in July 1997, experiencing a sharp deterioration in its exchange rate and equity markets and a subsequent sharp increase in short term interest rates. This deterioration in the economic outlook followed two years in which Indonesia strengthened its position amongst the best performing economies in South East Asia, hence it looked initially to be in much better shape to weather the storm. The economy was perceived, by the IMF and World Bank for example, as being fundamentally sound and not at risk of suffering Thailand's problems, because it had smaller current account deficits and allowed its exchange rate to float within a wider band. It did, however, share problems of an emerging oversupply in the property market, a relatively weak banking system and, most importantly, the accumulation of short term debt in excess of foreign exchange reserves. Yet by the end of 1997 and into early 1998 Indonesia had suffered most from the crisis.

Table 1 indicates the satisfactory performance of the economy before the onset of the crisis. The country experienced strong GDP growth during the five years prior to the currency contagion, achieving a GDP growth rate of 8 percent in 1996 slowing to 5 percent in 1997 from the effects of the crisis. The country experienced high domestic saving although this was not sufficient to satisfy domestic investment requirements, hence foreign saving was required to make up the difference. While the foreign saving requirements were not excessive they increasingly took the form of private short term unhedged debt, and in particular to the corporate sector. Conservative fiscal policy had resulted in four consecutive years of budget surpluses before the crisis, and hence, unlike the situation in Latin America during the period of the "tequila crisis", this did not contribute to the resulting financial crisis. Indonesia experienced relatively high nominal interest rates during the period of the 1990s. After 1993, high interest rates were engineered by Bank Indonesia to conduct a tight monetary policy with the objective of constraining the growth of consumer credit and thereby: reduce excess demand within the economy; reduce inflationary pressure; and keep the current account deficit at manageable levels. It also enabled the country to increase its trade surpluses and to expand its foreign exchange reserves. However the maintenance of high domestic interest rates also contributed to the build up of the previously mentioned foreign borrowing, particularly by the corporate sector, as a means of circumventing the high domestic costs of funding. The financial crisis in the second half of 1997 produced a sharp increase in the interest rate as the authorities tried to stem the downward slide of the rupiah. This was a key requirement of the IMF rescue package granted to Indonesia after October 1997, but had adverse implications for the highly leveraged corporate sector.

Table 1. Indonesia's Recent Macroeconomic Performance 1992-97

	1992	1993	1994	1995	1996	1997
GDP Growth Rate (%)	7.2	7.3	7.5	8.2	8.0	5.0
GDP Nominal (US$Bill.)	128.5	158.5	174.0	192.2	224.3	215.0
GDP Per Capita (US$)	690	840	900	1023	1125	1100
Gross National Saving (% of GDP)	32.3	32.8	31.9	31.4	33.7	35.2
Gross Domestic Investment (% of GDP)	33.9	34.5	33.7	34.8	37.7	39.2
Government budget balance (% of GDP)	-0.4	0.6	0.9	2.2	1.2	-7.0
Interest Rate (%): Discount Rate, End of Period	13.50	8.82	12.44	13.98	12.8	20.0
CPI (%)	7.5	9.7	8.5	9.4	7.9	6.6
Export growth (%)*	16.6	8.4	8.8	13.4	9.7	8.7
Import growth (%)	10.2	9.9	13.8	27.0	5.4	8.8
Current account balance (% of GDP)	-2.3	-1.6	-1.8	-3.4	-3.4	-2.9
Real exchange rate**	92	88	92	89	80	150
Exchange Rate (US$- Rupiah)	2029.9	2087.1	2160.8	2248.6	2342.3	2909.4
External Debt (US$ Bill.)	86.5	88.5	99.2	111.5	120.2	139.9
Short term debt (US$ Bill.)	17.6	17.9	20.6	30.9	37.5	38.4
External Debt Service (% of GDP)	8.7	8.4	8.6	8.5	9.0	10.5
Foreign Exchange Reserves (US$ Bill.)	10.2	11.0	11.8	13.3	17.8	16.1

* Based on nominal US$
** Based on WPI; trade weighted, 1990=100

Sources: Bank for International Settlements
Bank Indoneisa
IMF, *World Economic Outlook*, Interim Assessment, December 1997.
IMF, *International Financial Statistics*, January 1998.
Ministry of Finance, Indonesia.
OECD
Radelet and Sachs (1998)

The government's tight monetary policy after 1993 contributed to inflation remaining well below 10 percent. Year average consumer price inflation was 7.9 percent, in 1996, down from 9.4 percent in 1995. Despite the currency depreciation during the second half of 1997, inflation declined further to 6.6 percent in 1997.

In 1996, in line with developments elsewhere within the region, Indonesia's export growth declined, however this was modest in comparison to its regional neighbours and did not suggest a significant weakening in economic performance. The decline in export growth was a reflection of a number of factors including that of: a loss of competitiveness from an appreciation of the country's real exchange rate; a decline in world demand and in particular that from the Japanese market. Import growth declined even more sharply and hence there was no deterioration in the current account balance, as a percent of GDP, unlike that for other countries in the region including that of Thailand and Korea. At 3.4 percent of GDP the current account deficit was considered manageable by the authorities. A major concern, however, was the increasing reliance on net private capital flows and of the increasing importance of short term foreign capital flows to finance the deficit. This contributed to a steady build up of short term foreign debt in the pre crisis period.

The nominal exchange rate experienced a continual depreciation relative to the US dollar during the period of the 1990s. This was the deliberate policy of the authorities, where a traditional targeted depreciation annually of between 4 and 5 percent existed. Despite this the real exchange rate, due to a more rapid increase in prices, began to appreciate particularly after 1994, indicating a loss of international competitiveness. However, the collapse of the Thai baht after it was floated on 2 July 1997 immediately raised doubts about the viability of exchange rate arrangements in neighbouring countries, including that of Indonesia. The strongest initial pressures emerged in the Philippines and the spill-over effects then spread to Malaysia where the authorities opted to allow the ringgit to depreciate rather than raise interest rates, and also to Indonesia where on 21 July the rupiah fell sharply within the official intervention band. In a pre-emptive move the authorities widened the intervention band from 8 to 12 percentage points, from the previous 2 to 8 percent, immediately following the float of the Philippine peso. Subsequent measures to tighten liquidity conditions in Indonesia failed to stem the growing exchange market pressures, and the authorities allowed the rupiah to float on 14 August 1997.

While foreign exchange reserves rose to almost US$18 billion (around 5 months of merchandise exports) by 1996, they were becoming increasingly dwarfed by the country's short term debt. An indicator of increased vulnerability to a sudden withdrawal of capital. This situation deteriorated further in 1997. By mid 1997, on the eve of the crisis, short term debt stood at US$34.7 billion and foreign exchange reserves at US$19.9 billion.

This brief review of Indonesia's recent macroeconomic performance suggests that the economic fundamentals of the economy appeared to be relatively strong before the financial crisis, and certainly not as bad as the situation in Thailand. It was characterised by strong economic growth, relatively low inflation arising from a tight monetary policy, low budget deficits, high domestic savings, growth of exports despite the slowdown in 1996, a steady accumulation of foreign exchange reserves, a stable external debt service ratio, and a rising but still favourable and manageable current account deficit. Of most concern was the increase in the resource gap between saving and investment, reflected in the rising current account deficit, and increasing reliance on foreign savings to fund this. While FDI played an important role in this process there was an increasing reliance on foreign borrowing. Hence gross external debt increased. About half of this in 1996-97 was owed by the private sector and denominated in hard currency, including US dollars and in particular Japanese yen. This was of an increasingly short run duration and considerably larger than the country's foreign exchange reserves. As a consequence the country had become increasingly vulnerable to developments in the exchange rate, such as through a loss of confidence, and world interest rates, and this vulnerability further intensified during 1997. This, in conjunction with a number of other factors identified in the following section, contributed to a loss of confidence by foreign investors in the economy from July 1997, and the country became embroiled in a creditor panic (see Radelet and Sachs (1998)). This contributed to a devastating impact upon the exchange rate, equity prices and developments in short term interest rates. These developments have contributed to insolvency of the banking system and the highly leveraged corporate sector.

3. Factors behind the financial crisis

Despite the country's strong macroeconomic performance, a number of underlying structural weaknesses existed which made the country vulnerable to adverse external disturbances. These, in conjunction with a lack of transparency in decisions affecting the business environment and data deficiencies, increased uncertainty and adversely affected investor confidence. The relative stability of the rupiah during most of the 1990s, together with high rates of return on domestic investment, encouraged large capital inflows. This was intermediated through a weak banking system and consisted of a high level of overseas borrowing, a significant portion of which was private predominantly unhedged short-term debt. This made the country exposed to shifts in financial market sentiment. Also, the rapid expansion of the financial system since deregulation in the late 1980s had left a number of banks with significant amounts of non-performing loans, straining their liquidity and, in a number of cases, undermining their financial viability. As a consequence Indonesia’s weak banking sector was not in a position to withstand the financial turmoil that swept Southeast Asia from July 1997. Similarly, the corporate sector was vulnerable to adverse external developments. Prompted by large interest rate differentials between domestic and foreign interest rates, private companies had increasingly borrowed abroad to finance domestic operations which, in the context of a relatively stable exchange rate, were largely unhedged. These and a number of other key developments require further elaboration.

1. Structural rigidities

Long standing structural rigidities arising from trade restrictions, import monopolies, and regulations had impeded economic efficiency and caused problems with the country's ability to compete in increasingly competitive global markets, as well as having reduced the quality and productivity of investment. Special interests[1] traditionally exerted considerable influence upon their existence. They increasingly undermined the legitimacy of the Indonesian government's achievements over the past 32 years, ran counter to its professed commitment to deregulation, and caused unnecessary friction with

[1] The Suharto family and business associates.

its trading partners[2]. Critics had long insisted that Indonesia's complex system of special concessions and monopolies surrounding a wide range of consumer, industrial and agricultural products had both encouraged corruption and hampered economic growth.

2. Corruption and lack of transparency

Until recently critics, including the World Bank, were forced to concede that while corruption might be slowing the country's growth it had not come close to stopping it. While corruption had added to the high cost of conducting business in Indonesia[3], and contributed to a loss of competitiveness for the corporate sector, in a rapidly expanding economy this was tolerable. However the financial crisis exposed these as major problems requiring urgent attention. One way in which this could be overcome is with the entrance of foreigners into domestic markets, but this will require greater transparency by the government, the corporate sector, domestic banks, and the stock markets, with the objective of attaining confidence by foreign investors in the country. To date confidence has been adversely affected by inadequate disclosure of information and data deficiencies.

3. Financial liberalisation, changing capital flows and the accumulation of private sector debt

Liberalisation of Indonesia's domestic financial system, banking sector and capital account, began in the late 1980s. This arose partly to accommodate the needs of foreign investors for modern banking services such as international remittance and payment facilities and currency hedges for their imports and exports. Opening its capital account guaranteed that non-residents could easily withdraw their investments without having to obtain permission from the authorities to convert their local currencies into foreign exchange. This encouraged portfolio and equity investment by foreigners in short term domestic assets, such as foreign currency deposits and in the local stock market, which were very different from that associated with FDI investment. Firstly, they were encouraged by higher returns in domestic financial markets as opposed to lower production costs. Second, they could be withdrawn easily if the returns on the investment, which consisted of the interest on the asset plus the currency appreciation, were lower than returns on investment elsewhere. In hindsight this set the stage for the 1997 currency crisis. Over the period 1988-94 most capital flows were in the form of FDI. After 1994 Indonesia, and the region in general, relied increasingly on the more liquid, and in hindsight more volatile, portfolio and equity investments from abroad. The twin liberalisations in banking and the capital account enabled domestic financial units to offer any interest rate they deemed fit in order to obtain funds. Previously, domestic banks could not offer interest rates higher than legal ceilings. With the ceilings removed, these banks could offer foreign funds interest returns higher than those available in the industrial economies. Financial liberalisation freed local banks from the strictures of credit ceilings and government credit allocation rules, encouraging rapid lending for property

[2] Monopolies, cartels, government subsidies and protected markets, many involving family members and business friends of Suharto, existed for cloves, plywood, the national car project, the Chandra Asri petrochemical complex, glass, fertiliser, wheat and sugar. The latter two were the monopoly of the National Logistics Agency (Bulog). The national car project also became the subject of a complaint by Japan that it represented a violation of the terms of Indonesia's accession to the WTO.

[3] Two international studies, one from Germany (Transparency International (Berlin)) and Political and Economic Risk Consultancy (Hong Kong), into global corruption ranked Indonesia as one of the world's most corrupt countries. For example the German study ranked Indonesia forty sixth out of a sample of fifty two countries, where the lower the ranking the greater the degree of corruption.

development. In Indonesia property development was growing at annual rates of 20 to 35 percent before its government reimposed controls in mid 1996.

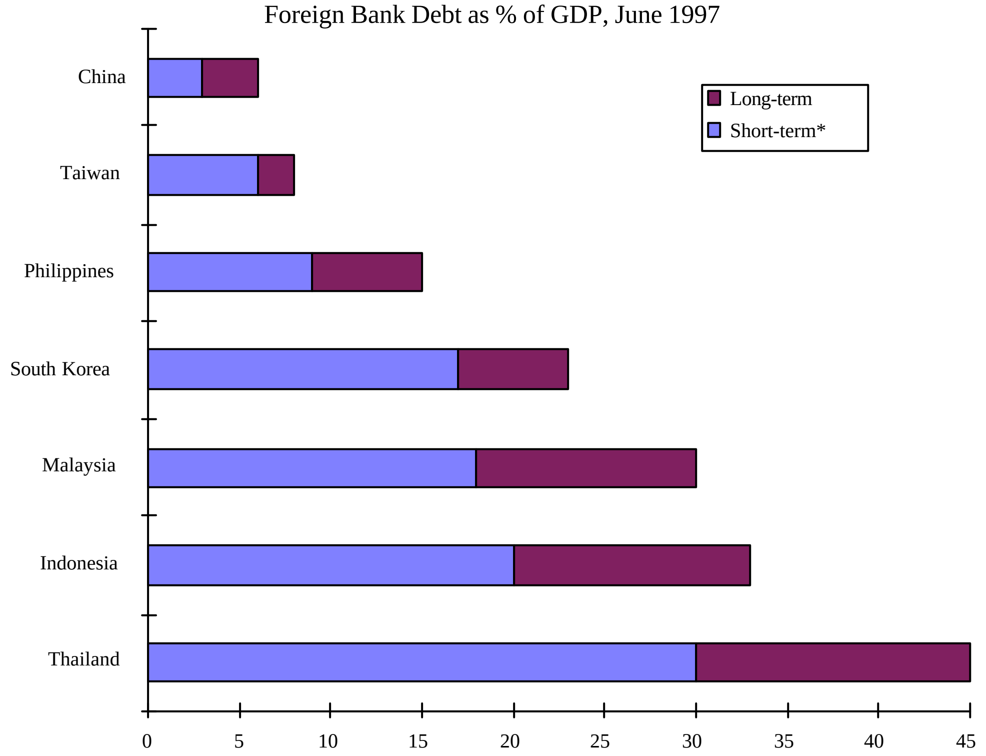
While the banking system has contributed to the accumulation of private sector debt and hence to the financial crisis, the major contribution has in fact been by the corporate sector. The latter lies at the heart of Indonesia's financial crisis. The biggest part of the debt problem is the unregulated, very short term, commercial paper market which grew rapidly in the year prior to the financial crisis as Indonesian companies attempted to escape high interest rates in their home currency. This involved foreign currency borrowing on terms typically between one and three months. Indonesian companies who needed foreign currency to repay their debts drove the sell-off of the rupiah in early October 1997, which precipitated the appeal for IMF assistance.

By the end of 1997 Indonesia's total private sector debt stood at US$74 billion, to some 100 foreign lenders. Of this between US$59-65 billion was estimated as being due for repayment in 1998. The average tenure of most of these loans was 18 months. This debt is split between Indonesia's banks and the corporate sector (US$10-15 billion to Indonesia's banks, which are now guaranteed by the government to be repaid, the remaining US$50 billion is owed by the corporate sector). However Indonesia's total exports in 1997/98 amounted to only US$56.2 billion, and with foreign exchange reserves of around US$17 billion, of which nearly US$8 billion is committed towards government repayment of debt, and an import bill of US$42 billion the arithmetic did not look promising. The time frame for this debt repayment was unrealistically short even under normal business conditions, and there was little prospect of Indonesian companies making repayments unless debt maturity was stretched. The need for agreement with creditors, foreign banks, to extend the debt maturity, particularly to the corporate sector, was the key cause of the country’s continuing financial crisis in the second half of 1997 and the first half of 1998. Indeed every time the rupiah showed signs of recovery it set off a wave of buying dollars by Indonesian corporations and businessmen, as they sought to buy dollars to meet the pressing demands of their creditors. This sent the rupiah plunging to new depths and made debt repayment even more difficult.

As indicated in Figures 1 and 2 foreign bank debt stood at around 33 percent of Indonesia’s GDP in June 1997, with most of this of a short term duration. The country’s ratio of short term debt to foreign exchange reserves stood at around 180 percent, ranking the country second only to that of Korea in terms of vulnerability using this measure.

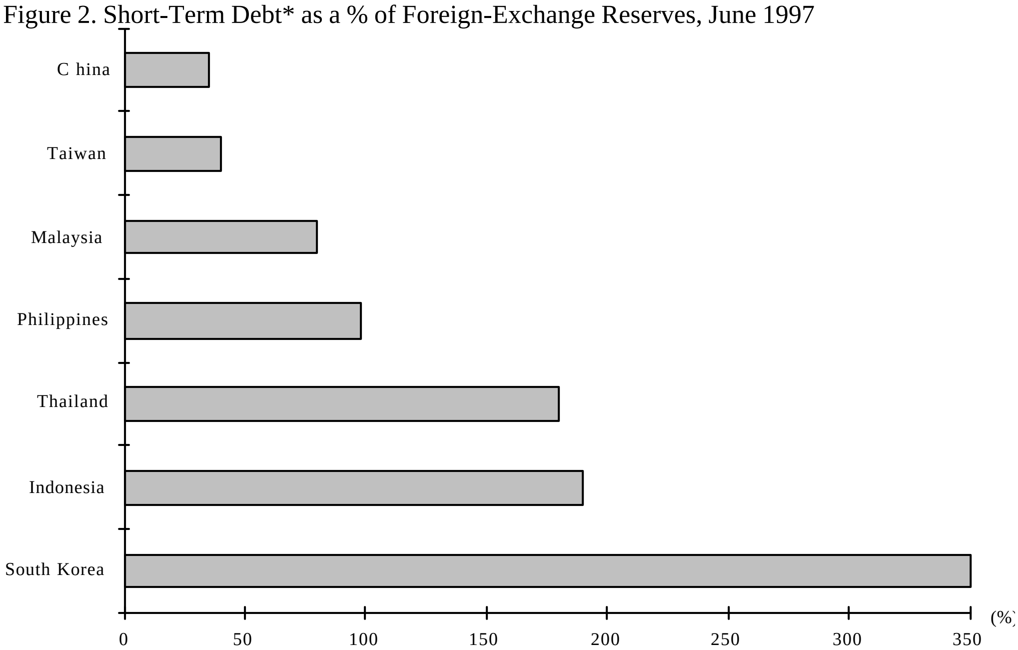
Figure 1. Foreign Debt

Foreign Bank Debt as % of GDP, June 1997



Source: BIS; IMF, Peregrine Securities
* Less than 12 months' maturity

Figure 2. Short-Term Debt* as a % of Foreign-Exchange Reserves, June 1997



Source: BIS; IMF, Peregrine Securities
* Less than 12 months' maturity

4. Weak banking system and the accumulation of non performing loans

Deregulation of the banking system during the 1980s resulted in a rapid expansion of commercial bank numbers, to around 237 by mid 1997, although it was still dominated by seven state and 10 private banks which controlled 70 percent of total banking assets. This rapid expansion of bank numbers occurred in conjunction with a rapid expansion of non-performing loans, primarily held by the seven state owned banks. Over the period 1992-97 bad debts increased by an average 32 percent per annum, to total around US$4 billion by 1997. Non performing loans accounted for almost 14 percent of total loans at state banks at end June 1997, and a number of insolvent institutions were permitted to continue operations with central bank subsidies. Currency mismatches made the net worth of financial institutions vulnerable to depreciation of the domestic currency, as subsequently became all too apparent.

Table 2. Key Indicators for East Asia's Banks

	Bad-Loan Provision as % of Pre-Tax Profit			Shareholder Equity as % of Total Loans			Liquid Assets as % of Total Assets		
	1994	1995	1996	1994	1995	1996	1994	1995	1996
Singapore	3.0	1.8	2.7	22.0	22.0	20.6	41.1	38.3	36.7
Hong Kong*	4.5	5.2	8.3	22.3	22.9	22.0	45.8	43.5	42.0
Philippines	6.2	12.8	11.3	25.3	22.8	21.1	31.0	26.7	23.9
Malaysia	20.4	15.5	20.3	11.7	11.2	11.1	38.1	32.0	29.1
Indonesia**	27.7	24.3	24.2	11.2	10.7	10.4	16.1	18.6	20.8
Thailand	15.9	13.9	32.7	9.4	9.7	10.0	9.9	9.1	7.8
South Korea***	47.2	56.1	47.1	9.6	9.0	8.1	35.8	37.3	34.3

Source: Thomson BankWatch Asia.

* Excludes Hongkong Bank.
** Private banks only.
*** National banks only.

Indonesia's banks are among the region's weakest (see Table 2). While only one bank has collapsed since the 1988 deregulation of the sector, several others before the crisis were considered to be in very poor shape. Most of the banks were small and sourced funds from the inter-bank market as they did not have a substantial deposit base. They were squeezed when short term interest rates soared to over 40 percent after the rupiah's devaluation in August 1997. Higher than desired loan growth, imprudent and excessive lending to the property sector, and non performing loans, particularly by the state banks, resulted in considerable financial fragility. The financial crisis in Thailand resulted in Indonesia's banking sector coming under intense scrutiny by investors. With the country's central bank, Bank Indonesia, reluctant to let insolvent banks go bankrupt, and thereby forcing the pace of consolidation, foreign investors had severe reservations about the situation in Indonesia. They faced mounting loan defaults as high domestic interest rates and the economic slowdown affected the ability of businesses to service their obligations.

5. Poor central bank governance

One lesson is clear from the Asian financial crisis, that vigorous central banks, in terms of supervision and regulation, are crucial to financial health. In the recent crisis the economies which fared relatively better were those where the regulators were competent and independent of political interference. Where they were not, financial systems collapsed. In Indonesia the central bank, firmly under the control of the Suharto government, found its operation were highly politicised, and it became impossible to enforce the rules intended to keep both borrowers and lenders healthy. As a consequence Bank Indonesia failed to be a good watchdog of the nation's savings and ensuring that the country's banks were sound also. It failed miserably to monitor the build up of corporate debt, and therefore failed to recognise that floating the rupiah in August 1997 would likely cause the currency to plunge. This in part was due, in fairness, to a lack of transparency in corporate financial affairs.

Despite Bank Indonesia measures to cap bank property loans, increase capital adequacy ratios, and to open up the banking system, many commercial banks reeled under bad debts. This, in conjunction with the build up of corporate debt, left the economy's finances in a devastated position. Economic recovery in Indonesia hinges in large part on restoring the central bank's credibility in the eyes of investors, and the key to this will be to reinvent it as an institution. This will require freeing it to set monetary policy, protect its currency, and supervise and regulate effectively the banking system. This can only be achieved by freeing it from political interference. Until such a change occurs, market confidence and the return of foreign investment funds needed to fuel a recovery in the economy and to strengthen the exchange rate are unlikely.

4. Indonesia's IMF program and policy framework

On 6 October 1997 the rupiah sank to a new low of Rp. 3,845 against the US dollar and the Indonesian government announced that it would ask the IMF for financial assistance[4]. On 31 October 1997 Indonesia's IMF rescue package was unveiled in Jakarta[5] providing US$43 billion in financial assistance over a three year period in support of an agreed upon macro-economic stabilisation and structural reform program. Of the total finance available about US$3 billion was available immediately with a further US$3 billion to be made available after 15 March 1998, provided that end-December performance targets had been met and the first review of the program completed. Subsequent disbursements, on a quarterly basis, would be made available subject to the attainment of performance targets and program reviews.

In addition to the IMF funding of about US$10 billion the reform program was to be supported by substantial financing from the World Bank and the Asian Development Bank, which made notable contributions to the design of the program particularly in the field of financial sector rehabilitation and structural reform. These institutions would contribute to the program through technical assistance and loans, with financing amounting to US$4.5 billion and US$3.5 billion respectively. At the same time, a number of economies including Australia, China, Hong Kong SAR, Japan, Malaysia, Singapore,

[4] At this time the authorities indicated that they needed more the IMF's technical rather than financial assistance.
[5] On November 5 the IMF’s Executive Board approved financial support up to SDR 7.3 billion or about US$10 billion, equivalent to 490 per cent of Indonesia’s quota, over the next three years.

and the United States indicated that in the event that unanticipated adverse external circumstances created the need for additional resources to supplement Indonesia's reserves and the resources made available by the IMF, they would be prepared to consider making available supplemental financing in support of Indonesia's program with the IMF. As the program evolved it proceeded through a number of phases and false starts before notable developments, particularly the pressing need to resolve the foreign debt of the corporate sector, occurred in mid 1998.

The initial IMF program envisaged the government putting in place a policy package designed to restore financial confidence and to arrest the decline of the rupiah. The program of economic reform envisaged: financial sector restructuring, including the closure of non viable institutions, merging state banks, and establishing a timetable for dealing with remaining weak institutions, and improving the institutional, legal, and regulatory framework in the financial system; structural reforms to enhance economic efficiency and transparency, including liberalisation of foreign trade and investment, dismantling domestic monopolies and expanding the privatisation program; stabilisation of the rupiah through a tight monetary policy and a flexible exchange rate policy; and fiscal measures to yield a budget surplus of 1% of GDP in 1997/98 and 1998/99. The fiscal measures included cutting state enterprise infrastructure projects and removing government subsidies.

The initial program was heavily criticised[6]. Under the terms of the IMF package 16 insolvent banks were to be closed, and weak but viable institutions were required to quickly formulate and implement rehabilitation plans. This contributed to a liquidity crunch and deposit runs on remaining banks, forcing many banks to increasingly resort to central bank liquidity support and generally contributing, rather than alleviating, the financial panic. The program paid little attention to the immediate need to restructure the short term debt, primarily held by the corporate sector, which was at the centre of the crisis, instead focusing upon issues the results from which would only become apparent over a longer period of time. This contributed to the fundamental weakness of the corporate sector, its inability to gain access to liquidity to conduct trade both domestic and international, and thereby contributing to the drastic decline in output. As a consequence the financial and economic crisis deepened during December 1997 and into early January 1998 despite the IMF rescue package .

Subsequent reforms and policy have focused upon the development and refinement of the previously identified policy areas.

<u>Stabilisation of the rupiah and monetary policy</u>

Monetary policy primarily focused upon the need to stabilise both the exchange rate and inflation through tight control of base money. This resulted in a sharp increase in short term interest rates, which increased from a little over 10 per cent in mid 1997 to over 50 per cent by the second half of 1998. The level of the exchange rate was to remain market determined. Seen as being essential to maintain market confidence in the economic program and in the demand for domestic financial assets. However, there was much concern about the impact of high interest rates on both the banking system, including the effect of negative spreads between deposit and lending rates which added to the banks' insolvency and the eventual costs of bank restructuring, and the corporate sector. With the strengthening of the rupiah in October and early November 1998, the monetary policy framework allowed significant reductions in the short term money rates. The interest structure of

[6] See for example Radelet and Sachs (1998).

commercial banks continued to decline, with spreads between deposit and lending rates beginning to normalise. In addition, progress was being made in terms of the lengthening of the maturity structure of monetary instruments. However the authorities remained prepared to tighten monetary policy if perceived dangers to inflation and the exchange rate re-occurred.

Fiscal policy

The initial IMF program called for fiscal surpluses in 1997/98 and 1998/99. However with the collapse of the economy it became clear that this requirement was unrealistic and merely exacerbated economic difficulties. The pressures on the budget and fiscal management intensified with the deepening of the crisis due to: the depreciation of the exchange rate increasing the cost of subsidies and debt service; falling tax revenues; declining oil prices; and escalating bank restructuring costs. In addition, given the severity of the crisis and its disproportionate impact on the poor, there was an urgent need to strengthen the social safety net, to alleviate the impact of higher unemployment and underemployment and the greater incidence of poverty. A central feature of the April and June 1998 programs was to limit the budget deficit to a level that could be offset by additional foreign financing.

By March 1999 the overall fiscal deficit is expected to be about 4 percent of GDP for fiscal year 1998/99, well below the mid 1998 program target of 8.5 per cent of GDP, despite fiscal policy becoming more expansionary in the second half of 1998/99. This was primarily because of increased social expenditures. The budget deficit for fiscal year 1999/2000 is projected at nearly 6% of GDP, and has four main objectives: a targeted fiscal stimulus to support demand, especially through higher development expenditure; steps to rebuild the revenue base over the medium term; inclusion of the gross interest costs of bank restructuring of about 3% of GDP; and avoiding domestic bank financing for regular budgetary operations. The framework anticipates additional official external support of about US$5 billion in addition to the project aid that is already committed, as well as implementation of the restructuring agreement with official creditors.

Structural reforms to enhance economic efficiency and transparency

A number of important measures have been implemented to assist structural adjustment of the economy, including that of further liberalisation of foreign trade and investment and the dismantling of domestic monopolies. For example the National Marketing Board (BULOG) has been restricted to monopoly over only rice. By October 1998 the government had completed its preparation of a masterplan for the reform of state owned enterprises, which set out the objectives and framework for restructuring and privatisation, and outlined an action plan for each individual enterprise. The objective of state enterprise restructuring and privatisation was to enable under-performing enterprises to improve their efficiency, profitability, and service delivery, and thereby lay the foundation for growth, as well as to strengthen public finances and broaden ownership. The authorities announced their intention to privatise all but a few selected enterprises out of the present number of 150 state owned enterprises over the next decade, starting with an aggressive sales plan during the next three years. The masterplan includes details of companies to be privatised during the period 1999-2001, focusing upon: hotels; trading, construction, mining and civil engineering companies, and fertilser companies. In the interim state enterprise efficiency is to be improved through greater management autonomy, enhanced competition, hard budget constraints, and the phased elimination of preferential access to bank credit (by end March 2000). Companies to be restructured during this period for later privatisation include the state electricity corporation and the national airline. However by March 1999 the privatisation program had fallen behind schedule largely because market conditions remained unfavourable. Targeted privatisation receipts for fiscal year 1999/2000 are the equivalent of US$1.5 billion or 1 percent of GDP. The government has already clarified that strategic foreign investors are permitted to secure management control, even in cases where the sale of equity investment to foreigners in state enterprises is limited to less than 49 per cent. There is no legal limit to foreign equity investment and the authorities are prepared to allow majority interests, unless strategic or national security interests are involved. In the future the authorities intend to subject all enterprises scheduled for privatisation in the masterplan to financial compliance audits of international standard, so as to improve credibility and investor confidence and, thereby, enhance sales values.

Bank and financial sector restructuring

The initial IMF program called for the restructuring of the financial sector including: the closure of 16 insolvent banks; the merger of state banks; the establishment of a timetable for dealing with remaining weak institutions; and improving the institutional, legal and regulatory framework for the financial system. On 15 January 1998 the authorities announced the establishment of the Indonesian Bank Restructuring Agency (IBRA), and a government guarantee on bank deposits and credits. In April 1998 the government announced an expansion of the structural and banking reforms agreed in January, involving accelerated bank restructuring with IBRA to continue its take over or closure of weak or unviable institutions and be empowered to issue bonds to finance the restoration of financial viability to qualified institutions. In addition the existing foreign ownership restrictions on banks was eliminated, and there was the issuance of a new bankruptcy law. In June further high priority was given to restructuring the banking system through measures to strengthen relatively sound banks partly through the infusion of new capital, while moving swiftly to re-capitalise, merge, or effectively close weak banks, while maintaining the commitment to guarantee all depositors and creditors. In July further measures to bolster bank restructuring were outlined by the government including: sale of one of six audited banks; transferring assets of seven banks frozen in April to the asset management unit; transferring of responsibility for six state banks from the Ministry of State Enterprises to the Ministry of Finance; and announcing a program for bank recapitalisation of the better banks in exchange for the preparation of business plans and infusion of capital by owners.

In October 1998 the government announced that in the coming months its bank reform strategy would focus upon: the government assisted recapitalisation program for potentially viable private banks; the resolution of the 14 banks taken over in April and August, as well as of the other banks under the control of IBRA; the merger, reform and recapitalisation of the state banks and particularly the merger of four state banks into the newly established Bank Mandiri; measures to recover liquidity support previously extended to troubled banks by Bank Indonesia; strengthening the bank supervision system through the issuance of key laws and prudential regulations. The implementation of private bank recapitalisation required all banks to be classified according to their capital adequacy ratio, which is a key determinant for participation in the program.

By March 1999 debt recovery efforts by the state banks had been intensified. In particular each state bank, including banks and assets controlled by IBRA, had targeted their 20 largest delinquent corporate borrowers for loan recovery, restructuring, or bankruptcy filing. On 13 March 1999 it was announced which private banks would qualify for recapitalisation in line with the previously approved government program. These banks would contribute to retaining an element of private ownership and management in the banking system. The program reached recapitalisation decisions on the basis of pre specified criteria, and required unanimity in the three intereagency committees responsible for the evaluations (Bank Indonesia, Ministry of Finance, and IBRA). It was determined that 73 A category private domestic banks (i.e with capital adequacy ratios (CARs) above 4 percent) comprising about 5 percent of bank deposits, had no need to participate in this program. However there would be a regular six month review of these banks to ensure their continued compliance with the highest prudential standards, using audits by international accounting firms for the foreign exchange banks.

Business plans for all 38B category banks (those with CARs below 4 percent but above minus 25 percent) were reviewed and the eligibility for recapitalisation of 9 banks, comprising about 12 percent of bank deposits, was approved unanimously by the interagency evaluation committees. Twenty one B category banks and all 17 C category banks with a total of about 5 percent of bank deposits, which did not qualify for participation in the recapitalisation program or meet the public interest need for takeover, were closed effective 13 March 1999.

Corporate sector restructuring, governance, and bankruptcy reform

The rapid depreciation of Indonesia's currency with the onset of the crisis meant that most Indonesian companies found it almost impossible to meet their external debt service obligations, and they also began defaulting on their domestic loans. In response to this, corporate restructuring and improved corporate governance became an essential part of Indonesia's reform program. Initially, however, the IMF program failed to address the problem of corporate sector debt, which lay at the heart of the country's financial crisis, and which urgently required to be re-structured. Increasingly during 1998 financial restructuring of the corporate sector was seen as crucial to: bring about economic recovery; establish competitive enterprises; reduce the likelihood of a future crisis; be an essential counterpart to banking system restructuring. Since good firms are necessary if an economy is to have good banks, corporate restructuring had to be linked to bank restructuring, which, in turn, had to be linked to the settlement of external debt problems. In Indonesia foreign private banks hold two thirds and domestic private banks hold one third of corporate debt. Most corporate debt is owed directly by the borrowing firms to foreign banks. The weak domestic banks and their small share of total corporate debt imply that foreign banks will be an important player in any debt workout process.

The Indonesian government has adopted a corporate debt restructuring strategy that contains three interrelated elements: a framework to facilitate debt workouts on a voluntary basis; a new and improved bankruptcy system; and provision of foreign exchange risk protection to debtors and creditors once a restructuring agreement is reached. To support this process, the authorities are also eliminating regulatory obstacles to corporate restructuring. A number of developments regarding these has occured.

In June 1998 Indonesia reached agreement, at a meeting held in Frankfurt, with its principal creditor banks on three elements: a framework to reduce real exchange risk on payments following restructuring of external debts; a scheme to restructure inter-bank debts; and an arrangement to maintain trade finance facilities. The scheme provided a framework through the Indonesian Debt

Restructuring Agency (INDRA)[7] for the voluntary restructuring of the debt of corporations to foreign banks on terms consistent with Indonesia's overall external payments capacity, and provide cash flow relief to domestic corporations. It was envisaged that domestic as well as foreign creditors would participate in debt workouts for individual companies, with all creditors sharing in the burden of providing the necessary relief. In some cases debt write-down was envisaged. IBRA, especially its asset management unit, was anticipated to be a major participant in many workouts.

In September 1998 the Jakarta Initiative was launched. This is designed to provide a framework for out of court negotiations, and to be applied to domestic and foreign creditors in a nondiscriminatory manner. The Jakarta Initiative Task Force is an independent government agency staffed with experienced corporate work out professionals (specialists in formulating plans for the settlement of overdue corporate debts), whose mandate is to facilitate active corporate restructuring and accelerate the approvals required for restructuring plans. If necessary, the task force will be able to recommend to the public prosecutor that it exercises its legal authority to initiate bankruptcy proceedings against debtor companies in the public interest. After successfully launching the Jakarta Initiative the government continued to ensure the appropriate legal and policy foundation was in place for corporate restructuring to occur under the framework of this initiative.

By November 1998 the Initiative began to produce results. Twenty five companies with a combined debt of about US$5 billion sought assistance from the task force for initiating their debt re-negotiations and corporate restructuring. The government envisaged that the number of negotiations would increase rapidly during the future months, especially as firms attempted to obtain an exchange rate risk guarantee under INDRA ahead of the June 1999 deadline. Also, by November 1998, the necessary legal and regulatory changes to overcome obstacles for corporate restructuring were being completed. Also a government regulation providing for tax neutrality for mergers and other reorganisations and removing certain other identified tax disincentives for restructuring was signed on 30 October.

By March 1999 further progress had been made in implementing the Jakarta Initiative. Over 125 companies were seeking assistance from the Jakarta Initiative Task Force in the context of US$17.5 billion of foreign currency debt and Rp7.8 trillion in domestic currency debt. These firms employed approximately 220,000 people. Under the Jakarta Initiative 15 companies had already reached some form of arrangement with their creditors, addressing about US$2 billion in foreign currency debt and Rp 600 billion in domestic currency debt. These firms employ some 17,000 people. Several debt restructuring deals involving SMEs had also been completed.

An effective bankruptcy system is an essential part of the corporate debt restructuring strategy, without which debtors may be reluctant to negotiate with their creditors. A government law to modernise the bankruptcy system and provide for the fair and expeditious resolution of commercial disputes took effect on 20 August 1998. A Commercial Court was established to handle matters under the bankruptcy regulation. The revisions to Indonesia's bankruptcy law include the following: procedural rules designed to ensure that bankruptcy proceedings will be efficient and transparent; provisions that allow for the appointment of receivers and administrators from the private sector to administer the estates of debtors; greater protection of debtors' assets, including protection against insider and fraudulent transactions; and limitations on the ability of secured creditors to foreclose on

[7] Officially launched in August 1998.

collateral during the proceedings, thus making reorganisations more likely. The potential initiation of bankruptcy proceedings by creditors provides an important incentive for out of court restructuring of debt. Moreover, the law provides a useful means by which a debtor can bind dissenting creditors to a restructuring plan that has already received support from the requisite majority of creditors. Some initial bankruptcy decisions have been controversial, and there are ongoing efforts to further enhance the capacity of the judiciary.

In addition to financial restructuring there is also the need for improvement in corporate governance. Estimates suggest that the top 10 families in Indonesia in 1997 controlled corporations worth more than half the country's market capitalisation. As a consequence fundamental cultural and institutional changes are required if a new corporate governance structure is to be established, with arm's length transparent relations between corporations, government and banks. However, changing corporate governance will be a long term process. Necessary steps include broadening the ownership of corporations by liberalising foreign entry and expanding the role of capital markets. Protecting shareholder rights and developing improved accounting standards and bank regulations will also be essential.

<u>Strengthening the social safety net, food security and distribution</u>

The number of poor in Indonesia was anticipated to have doubled during 1998, and the need to protect this vulnerable group within the country from the worst effects of the crisis was seen as imperative. Focus became increasingly placed upon ensuring adequate supplies of basic commodities, on maintaining effective distribution networks, on establishing labour intensive employment programs to ensure the poor continue to have adequate purchasing power, and the implementation of initiatives to maintain access to basic education and health. Strengthening these programs contributed to most of the increase in the country's fiscal deficit, as the government remained committed to protecting the poor. The need for external support, such as that from the World Bank, was also seen as essential.

The government also emphasised the need to ensure that there were adequate supplies of essential commodities, especially rice, and that these were available through the distribution system at affordable prices. A rice scheme targeting 7.5 million very poor families was introduced. BULOG increased its import target for rice in 1998/99 from 2.85 million tons to 3.1 million tons. Special measures were also introduced to ensure that domestic markets had adequate supplies of cooking oil at reasonable prices. Food subsidies in general increased substantially during 1998, as part of a broader effort to ensure food security for the poor. The subsidy on korosene, the petroleum fuel which is most important to the poor, increased sharply because its price remained unchanged even in the face of the rupiah's depreciation. Similarly, energy price increases were designed to protect low volume users as much as possible. As a result of these measures the subsidy on fuel and electricity increased to 2.9 percent of GDP and 0.9 percent of GDP respectively, while that for food increased to about 1.5 percent of GDP.

A critical aspect of the government's efforts to improve food security was the need to rehabilitate and strengthen the distribution system, following the disruptions and damage caused by the social unrest in May 1998 in particular. While private trading returned to normal in may parts of the country, the government felt that additional temporary measures were required to further improve the distribution system. The Ministry of Industry and Trade established a special monitoring unit to identify potential shortages of foodstuffs or distribution networks so that the government could take early corrective action. The government, in key parts of the country, extended special security arrangements for the transportation of essential commodities. Retailing suffered severe dislocation, and the government tried to reactivate the retail network through the rehabilitation and construction of traditional markets.

The government also worked closely with community based groups to expand labour intensive public works programs, with the objective of increasing the incomes of the poor, the unemployed and the underemployed, and to overall enhance purchasing power in rural and urban areas. These programs were moved to the top of the priority list, and their funding was increased. To supplement these efforts, food for work programs were also implemented in drought stricken areas of the country. A micro credit scheme to assist small enterprises was also introduced.

To ensure continued high enrolment rates for children through the first nine years of school, and hence to maintain the human capital stock of the country, a national campaign was launched by the government. This included a five year US$380 million program of scholarships for junior secondary students and special assistance funds (block grants) for the poorest primary and junior secondary schools, and coordinated mass media and interpersonal communications activities. It complemented ongoing efforts to maintain existing levels of quality by providing textbooks, materials and in service training. To sustain basic health care services the government restructured its budget in order to finance essential drugs, including the vaccines and drugs needed for communicable disease control, targeted at the poor.

5. Indonesia's economic and social prospects in the short to medium run

Economic prospects

Although the factors behind the Asian financial crisis is very similar for all of the affected East Asian economies, Indonesia's position is quite different. Its economic collapse is much deeper and more complex than for most of the other countries in the region, and political factors have compounded the difficulties of the country's program of measures in response to the crisis. Table 3 summarises prospective developments in the Indonesian economy during 1999 and 2000, as well as more recent developments in 1996, 1997 and 1998. The collapse of GDP growth in 1998 is anticipated to continue into 1999. By 2000 the economy is likely to experience growth again, although the forecast made by JP Morgan could be considered to be somewhat on the optimistic side. Inflation rose dramatically during 1998, averaging around 60 percent for the year as a whole. By the end of the year the inflation rate was just under 80 percent. However, this is anticipated to abate considerably during 1999. Short term interest rates have, not surprisingly, increased dramatically in line with the rapid increase in inflation, rising to a little under 40 percent by the end of 1998.

The government's fiscal balance experienced a dramatic reversal with a surplus of 1.2 percent of GDP in 1997 becoming a deficit of around 7 percent of GDP for 1998. This is anticipated to improve slightly during 1999 but is still likely to remain relatively large during 2000. This is a reflection of the rising costs to the government of protecting the poor, getting the economy re-started, bank restructuring costs, as well as weaknesses on the revenue side. The extent of such budget deficits is clearly unsustainable, but appropriate in the context of the economic crisis currently facing the country, and will depend crucially upon foreign financial assistance for its funding. By the 1999/2000 budget the government intends having in place a more efficient, selective, and targeted set of subsidy mechanisms.

The dramatic decline in the country's domestic income and expenditure has had an equally dramatic impact on both the trade and current account deficits. The current account moved from deficit in 1997 to sizeable surplus in 1998 equal to 5.4 percent of GDP. This surplus is likely to remain in 1999 and 2000 but will decline as the economy recovers. These surpluses are primarily due to a significant reduction in imports rather than a significant expansion of exports. Foreign exchange reserves increased noticeably during 1998 due to the improvement in the current account, and this is anticipated to continue with further current account surpluses in 1999 and 2000. The major economic difficulty will remain the need to reduce the country's massive increase in external debt, which more than doubled as a percentage of GDP during 1998 in comparison to its level in 1997. However, should the present debt workout and restructuring framework be successful, there is the prospect of a significant reduction in external debt during 1999. The servicing of this debt, as well as the repayment of the debt itself, exerts a major drain on the country's resources, and hence the need to restructure this debt is paramount. Table 3 suggests that short term debt fell significantly during 1998 and that this will continue into 1999 and 2000. This assumes that the country, primarily the private sector, is able to reach agreement with its foreign creditors over extending the maturity of this debt.

The recovery of the Indonesian economy from its desperate economic plight over the short to medium term will depend upon an overall strategy that involves stimulating demand through public spending, overcoming microeconomic deficiencies, and begins tackling the long job of improving governance and institutions. At the macroeconomic level, at least initially, the focus for Indonesia's economic recovery will be public sector spending. Private demand within the economy has dramatically declined and will therefore need to be offset by a period of Keynesian pump priming. The budget deficit is likely to be the primary instrument that will halt the slide in Indonesia's domestic demand over the short term, to be funded from official and concessional sources to avoid inflation.

Table 3 Indonesia's short term economic outlook, 1996-2000

	1996	1997	1998e	1999f	2000f
Real GDP growth (%)	8.0	4.9	-13.7	-3.5	5.0
CPI (%)	7.9	6.2	58.4	24.0	14.0
Short term interest rates (%), end of period	13.3	28.5	37.5	na	na
Government budget balance per cent of GDP, end of period	1.0	1.2	-7.0	-6.0	-6.0
Current account balance percent of GDP	-3.3	-2.9	5.4	2.2	0.2
Foreign exchange reserves US$ billion	24.0	20.5	23.9	26.4	27.4
External debt, percent of GDP, end of period	55.4	62.3	168.6	110.4	84.0
Short term debt, US$ billion, end of period	41.3	36.8	27.3	20.3	18.8

e - estimate
f - forecast
na - not available

Source: J.P. Morgan, Asian Financial Markets, Third Quarter, July 1998, p.44.
J.P. Morgan, Asian Financial Markets, First Quarter, January 1999, p.56.

A number of microeconomic reforms will be needed as well, to ensure that Indonesian firms can compete internationally. These reforms include long needed improvements in regulations and processes affecting business in Indonesia, as well as structural repairs to damage caused by the economic and social shocks which the economy has sustained. The linkage between banks and corporations is the key challenge of the restructuring process. At current exchange rates, interest rates and market conditions, most Indonesian corporations and SMEs are bankrupt. In turn, most banks are insolvent as bad debts climb to unheard of levels. As domestic demand dries up and regional export prospects dim, even exporters with potential markets, and especially newcomers without established contacts, are hard pressed to take advantage of them as trade and working capital finance has all but ceased to flow.

A medium term strategy for Indonesia that embraces efforts to stimulate demand and which incorporates microeconomic and institutional reforms, should consist of the following four elements:

- rebuilding the financial system and restarting the corporate sector
- building on strengths: using agriculture and natural resources as leading sectors
- priority investments in critical infrastructure
- build and improve government institutions.

No economy can prosper without a properly functioning financial system, especially a banking system. Domestic savings and the credit it generates will be the cornerstone of Indonesian investment for the coming decade. The agriculture and natural resources sectors have been the traditional strengths of the economy, and these could be used once again as a launching pad for the recovery and future development of the economy. Economic recovery will also require the need to identify and develop core infrastructure which can form the basis of the government's publics works program, although the financing of renewed investments in infrastructure in the aftermath of the crisis will pose formidable challenges and require foreign assistance. Indonesia's corporate sector and banks are unlikely to be willing or able to conduct such expenditure. Strengthening governance, both corporate and public sector, may be the single greatest challenge Indonesia faces in the coming decade. If Indonesia is ever to regain the confidence of international, and domestic, investors, it must build institutions and adopt regulations that meet international standards. At the core of the governance challenge lie two of Indonesia's most pervasive and most flawed systems, its legal system and its civil service system. The answer to reducing corruption is simple, transparency. In practice Indonesia requires a shift in business culture, and this will require a clear and absolute commitment from the highest ranks of government as well as a properly functioning legal system.

Taken together these four elements will build a recovery program that at once uses public sector spending to augment demand, and at the same time improve productive capacities and create infrastructure and institutions to serve Indonesia in the coming decades. However rebuilding the Indonesian economy will require effort by both the Indonesians and the international community. This will require political stability and especially a political and legal climate that reassures domestic[8] as well as international investors, and gives them confidence they are welcome and can operate safely.

[8] Especially Chinese Indonesians.

Social impact and prospects

One of the most immediate challenges facing the Indonesian government lies in the need to address the humanitarian challenges. Before the crisis the economy had been experiencing high output and employment growth, although the latter did not exceed the growth of the labour force. There were low rates of open unemployment, and improving labour productivity which resulted in rising real incomes. Post crisis developments have led to rapidly rising unemployment, with 5.4 million workers losing their jobs in 1998 and over 20 percent of the workforce without employment. Underemployment has increased, real incomes have declined dramatically due to a fall in labour demand and rapidly increased inflation. Many workers are at risk, particularly women, children and migrants. As many as 50 million Indonesians face a return to poverty as a result of the drought and financial crisis according to the World Bank (1998c), which has called for international donors to support the government's efforts to feed the hungry, sustain health services for the sick, and keep a generation of children from dropping out of school.

The official figure suggests that 75 million, or 37 percent of the total population were below the poverty line in 1998, and according to a report by United Nations this could increase to 66 percent of the population during 1999. Ethnic trouble has intensified under pressure from growing poverty, resulting in disruption of the economic distribution system due to conflict in some urban areas. The Chinese community in particular appears to have been the primary target. Increased crime has occurred and is likely to increase as economic circumstances deteriorate. About 20 percent of Indonesia's poorer children are at serious risk of dropping out of school as a response to shrinking family incomes. This will have a long term deleterious effect upon the country's human capital stock, and a number of measures have been implemented with the objective of reversing this development and discussed previously. The problem of rising poverty has been magnified due to the fragility of social protection, and this requires urgent and sustained attention from the authorities.

These developments suggest that sustained economic recovery of the economy will also require sustained social development. Given the current parlous state of the latter, this will not be easily obtained.

5. Summary and conclusions

It is clear that Indonesia is in a deep economic, financial, political and social crisis. A country that achieved decades of rapid growth, stability, and poverty reduction, is now near economic collapse. Within the space of one year Indonesia saw its currency fall in value by 80 percent, inflation soar to over 50 percent, the economy swing from rapid growth to even more rapid contraction, unemployment climb rapidly, and the stock exchange lose much of its value. Foreign creditors have withdrawn and investors have retreated. Capital and entrepreneurs have fled. Long standing defects in governance, earlier camouflaged by rapid growth, have now been unmasked as fatal flaws. Unfortunately, the crisis hit when Indonesia was experiencing its worst drought in 50 years, and the international oil price was registering a sharp decline. Social unrest has erupted and shaken to its very core the political stability of the nation. Years of development and poverty reduction are at risk.

No country in recent history, let alone the size of Indonesia, has ever suffered such a dramatic reversal of fortune. The next few years will be difficult and uncertain. Recent economic and social developments are of particular concern given that Indonesia is the world's fourth largest country in terms of population, an important anchor of stability in East Asia, and has an impressive past record of development and social progress. Recovering from this desperate situation will be slow and difficult. Much will depend on whether the nation can achieve the necessary political stability for implementing a difficult and complex agenda of economic reforms, both at the macroeconomic and microeconomic levels, and whether it will receive the necessary financial support from the international community.

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