

NOTE ON THE MELTDOWN OF THE INDONESIAN ECONOMY: CAUSES, IMPACTS AND RESPONSES

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INTRODUCTION

Indonesia is now suffering from twin interrelated crises, namely:

(1) political crisis:

The removal of long-standing authoritarian regime of President Suharto last May ended the muddling through policies of his government. The present politically weak and technically less competent government, however, cannot take bold, daring, but sometime unpopular demand- and supply-side measures, that are normally required by short-run stabilization program and medium- and long-run economic reforms; *and the latter, it is more committed to implement the IMF program.*

(2) economic crisis, which is the main focus of this note.

CAUSES OF THE ECONOMIC CRISIS:

The economic crisis has been caused by a combination of both external and internal factors. External factors include:

- (a) regional recession, currency realignment, contagion effects, and loss of public confidence that have induced capital flow reversal.
- (b) the abnormal weather phenomena that has seriously affected food output and agriculture incomes in the rural sector;
- (c) negative terms of trade. The present price of oil is the lowest in the past ten years.

This note, however, only focuses on homegrown problems that have contributed to the present economic crisis. The internal issues include external debt problems, fragile financial sector, weak market infrastructure and low quality of investment.

External debt:

✓ The present crisis in Indonesia is revolved around private sector debt, not public debt. Few years prior to the crisis, the authorities had kept the formal budget in 'surplus' between 0,5 to 1 percent of annual GDP. *The consolidated budget of the public sector, however, may be in deficit due to the large 'extra budget' (popularly known as non-budget) expenditures of the public sector at large.*

<TABLE 1>

The stylized facts of Indonesia's external debt:

*Indonesia's external debt
is growing rapidly
from a small amount
in 1988.*

- * grew rapidly following the economy-wide reform, particularly the banking sector reform in October 1988.
- ✓ * over 60 percent of it owed by the private sector;
- ✓ * nearly 90 percent of the private sector debt was to the non-bank private sector;
- ✓ * most of the private sector external debt was short-term in nature and unhedged;

Table 1 shows that as of March 1998 total external debt of Indonesia was amounted to 160 percent of GDP or 215 percent of exports. Debt service ratio was about 33 percent of total export value. These figures are relatively high by international standard and could cause transfer and fiscal problems. [The World Bank considers a debt to GNP ratio of less than 48 percent as low risk, 40 to 80 percent as a medium risk and over 80 percent as high risk. In terms of the ratio of total debt service to exports, the World Bank considers 18 percent as the 'warning' threshold].

Fragile Banking System

- ✓ Table 2 contains indicators of the fragility of the banking sector:

<TABLE 2>

Table 1
 —Who owes what to whom
 (External debt in US\$ billions, March 1998) a/

Debtor	Amount
Public sector	<u>65.56</u>
Government	54.39
State enterprises	11.18
<i>State banks</i>	5.61
<i>Corporates</i>	5.57
Private sector	<u>72.46</u>
<i>Private banks</i>	8.00
<i>Corporates</i>	64.46
<u>Total external debt</u>	<u>138.02</u>
<u>Memo items</u>	
<i>Debt owed by:</i>	
Corporates <u>b/</u>	70.03
<i>Bank credit</i>	64.60
<i>Domestic securities</i>	5.43
Banks	13.61
<i>Interbank lines</i>	12.83
<i>Domestic securities</i>	0.78
<u>a/ As of July 8, 1998.</u>	
<u>b/ Includes state enterprise debt</u>	
<u>Source: Bank Indonesia</u>	

Table 2. Indonesia: Banking Sector Indicators

(in percent, unless otherwise indicated)

	1985	1986	1987	1988	1989	1990	1991	1992	1993	1994	1995	1996	1997
Loans to Deposits Ratio	102.9	96.3	101.9	105.7	112.6	118.2	130.7	129.3	132.4	134.9	137.7	131.0	123.7
LGR Minus GDPGR	14.7	19.8	8.8	23.1	31.2	48.1	-9.9	7.7	6.9	5.7	4.0	4.7	12.1
LGR Minus IPGR	29.0	20.8	35.9	34.4	44.2	61.4	9.0	25.9	22.4	16.0	23.1	22.5	n.a.
NFL to TBL	-20.0	-23.6	-18.2	-14.1	-10.6	0.9	0.7	2.2	4.9	5.8	3.8	2.8	5.2
M2 Multiplier 1/	3.4	3.4	3.8	5.0	5.4	6.7	7.7	7.0	7.8	7.4	8.0	7.5	7.6
M2/Forex Reserves	414.2	415.4	367.5	481.5	597.2	596.8	539.0	552.6	602.3	643.4	690.3	638.6	419.9
Non-performing loan 2/ of which: Bad Debt 2/	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	9.2	n.a.	14.2	12.1	10.4	8.8	14.0
Cash Assets to Deposits Ratio	15.9	13.3	12.4	14.5	11.1	6.5	13.7	3.2	2.6	2.5	2.6	4.7	5.8
Loans to Assets Ratio	n.a.	53.3	58.2	61.5	65.4	73.4	76.2	73.7	75.4	80.3	79.2	77.0	71.9

Notes: LGR; Loan Growth Rate
GDPGR; GDP Growth Rate
IPGR; Industrial Production Growth Rate

1/ Ratio of M2 to Reserves Money.

2/ As percentage of total loan outstanding of Commercial Banks. Non-performing loan data are tend to be underestimated. The decline of non-performing loan to 8.8 percent of total credit in 1996 was mainly due to write-off of the bad loans at state commercial banks and private 'non-foreign exchange' banks.

As end of March 1998, bank Non-performing loan reach 19,8% of total loan.

Sources: IMF, *International Financial Statistics*, various issues.
Bank Indonesia, *Annual Report*, various issues.

- (i) the sharp increase in non-performing loan ratio (now is estimated to hover around 60 percent) indicates the severe economic slowdown and the series of corporate bankruptcies since 1997.

Banks and their customers are in financially distressed because of the following reasons:

- (a) sharp devaluation of the Rupiah, since Bank Indonesia abandoned the intervention band system on August 14, 1997;
 - (b) bank run
 - (c) capital flight;
 - (d) panic buying;
 - (e) high interest rates;
 - (f) plummeted prices of shares, and
 - (g) tight internal and external liquidity
- (ii) 'Over-stretched' banking system as shown by high loan-to-deposit ratio and rising difference between loan growth rate minus GDP growth rate; ✓
 - (iii) Higher exposure of the banking system to foreign exchange risk as is shown by increasing ratio of foreign liabilities to total liabilities. Part of the short-term external borrowings in foreign currencies has been used to finance medium- and long-term domestic credit in the Rupiah. This has caused currency and maturity mismatches; ✓
 - (iv) The franchise value of the banks was actually rising and get stronger as is shown by (a) a relatively low cash ratio or small amount of cash assets, and (b) a relatively high loan to asset ratio.

The stronger franchise value should have given more incentive for banks to monitor and discipline their borrowers to stay liquid. In reality it is not the case partly because of weak implementation of the rules and regulations governing the banking system and large group lending.

Inappropriate policy responses and weak Market Infrastructure

The weakness of market infrastructure and a number inappropriate government policies have also contributed to the rapid build up of the external debt and the banking crisis: ✓

- (1) The rapid financial liberalization was not accompanied by commensurate strengthening of regulation and supervision. The high percentage of group lending, for example, indicates that the legal lending limits regulations were hardly implemented. Inadequate financial regulation also allows banks to make excessive risky loans without adequate monitoring. One manifestation of this was overbuilding in non-traded sector of the economy (such as real estate and infrastructure projects) as well as in traded sector that requires a lot of imported inputs and produces low value added.
- (2) Indonesia adopted a reverse sequence of economic reform. Liberalization of the capital account completed in 1971 long before the liberalization of the current account of the BOP initiated in the second half of the 1980s. In the past, the liberal exchange rate system caused no problem for Indonesia simply because there was no reputable company has an access to international financial markets. In the 1990s, however, such a system has attracted massive vulnerable short-term capital inflows to buy shares and other forms of commercial papers floated by Indonesian companies, both in international as well as in markets.

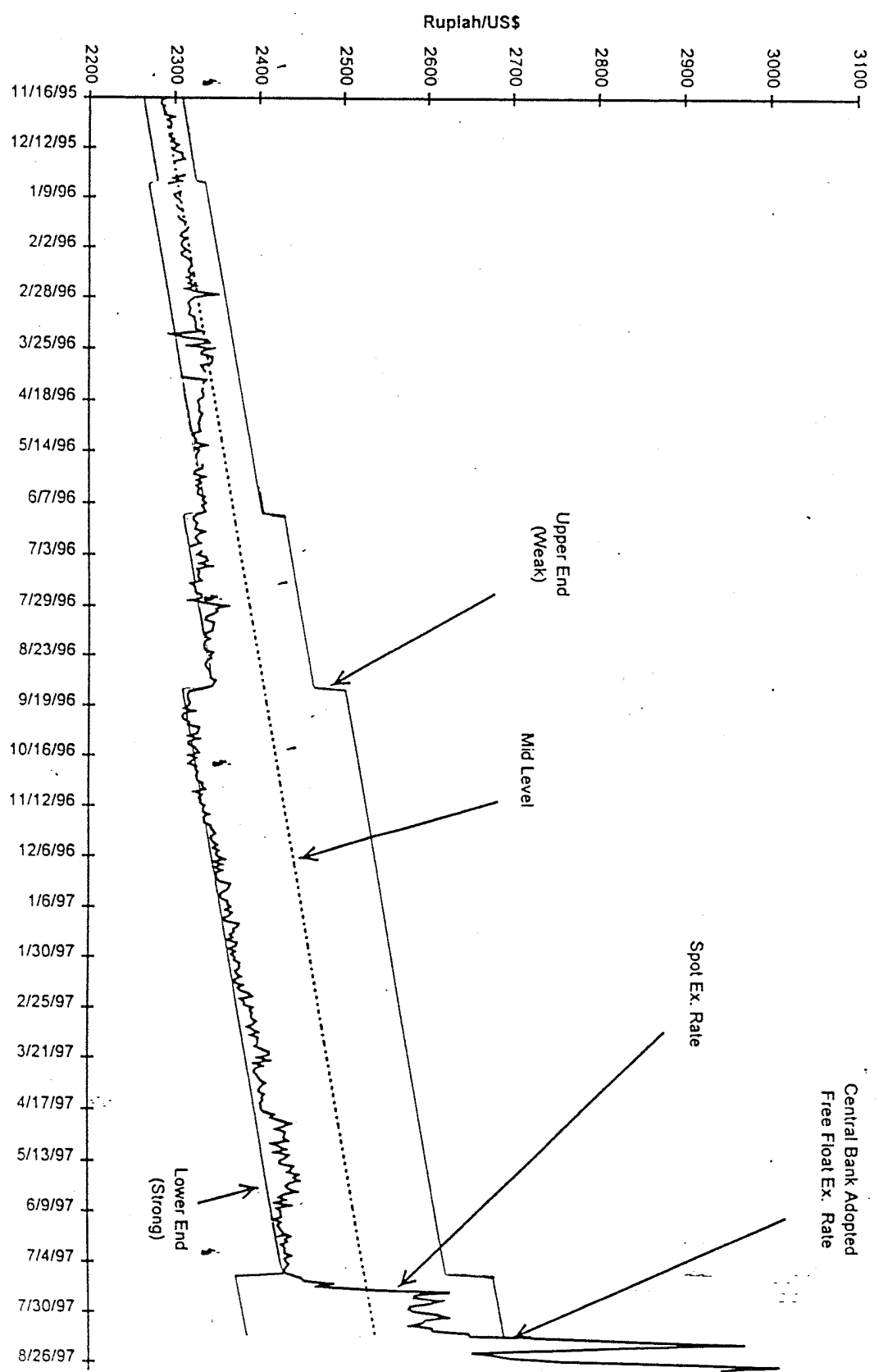
As an illustration, Steady Safe, a taxi company in Jakarta received massive loans from Peregrine, a Hong Kong based investment bank.

- (3) The exchange rate peg. In theory Indonesia adopted a managed floating exchange rate system. The central bank intervened in the foreign exchange market by buying and selling the rupiah in 'an intervention band' round the central rate. In reality, however, prior to August 1997, devaluation was predictable hovering around 5-7 percent per annum. In real terms, the real effective exchange rate (REER) was modestly appreciated in the 1990s. This reduces international competitiveness, squanders savings, and encourages allocation of resources into non-traded sector of the economy.

<FIGURE 1: NOMINAL ER>

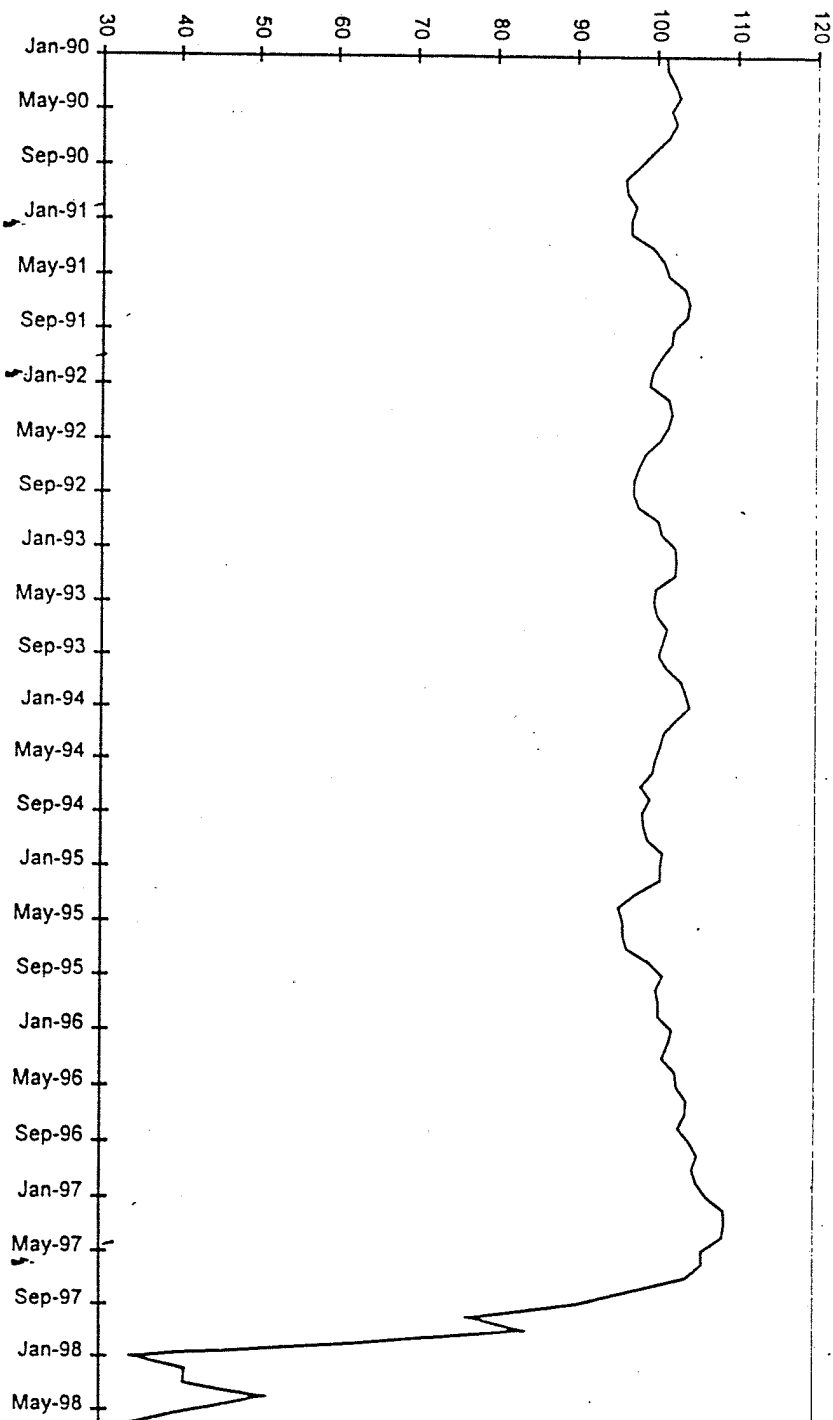
<FIGURE 2: REER>

Figure 1.
 Indonesia: Rupiah Exchange Rate and its Intervention Bands,
 November 1995 - August 1997



Sources: Bank Indonesia, Indonesian Financial Statistics, various issues.
 University Of British Columbia Data Base, Canada

Figure 2. Indonesia: Real Effective Exchange Rate Index
January 1990 - June 1998 (1990 = 100)



Source : JP MORGAN, *Emerging Markets Data Watch*, various issues.

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- (4) The sterilization operation of capital inflows. This entails high domestic interest rates thus driving a large wedge between domestic and international interest rates, creating an additional incentives for companies to borrow from overseas.

<FIGURE 3>

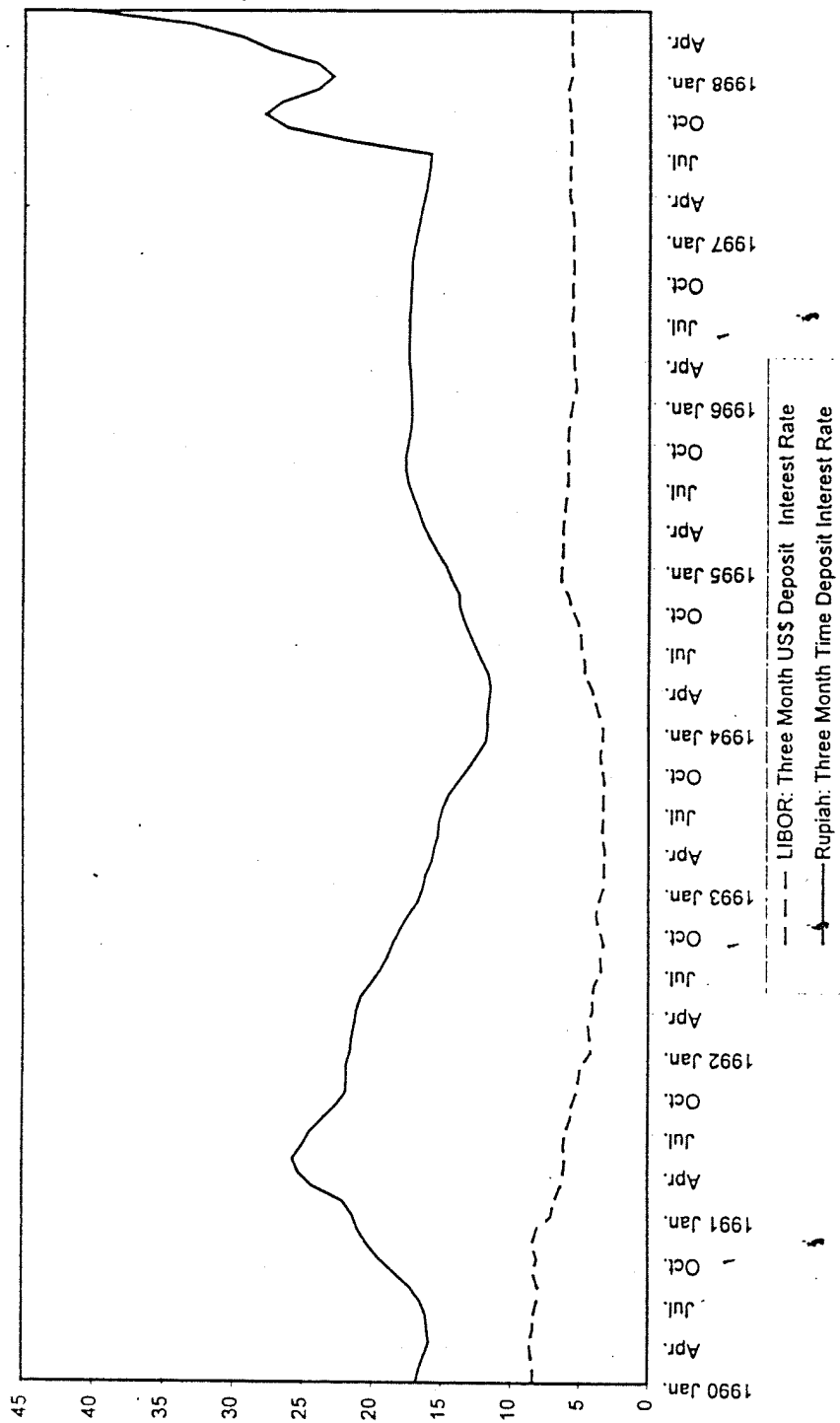
Bank Indonesia bears an expensive interest burden of the sterilization operations as its certificates of deposits (SBIs) are the principal instruments being used in the sterilization operations. [Remember the collapse of the central Bank of the Philippines in 1993 because of the losses from similar operation as well as from intervention in exchange markets and unrecovered credit to distress commercial banks].

- (5) Other policies that help encourage high debt equity ratio. These include tax, regulatory and banking and credit policies;
- (6) Mishandling of the crisis and muddle through policies (such as the revival of infrastructure projects owned by the first family after the signing of the IMF standby arrangement in October 1977; the way the authorities closed the banks in November 1977 and threat to use the currency board system as an alternative to the IMF program). These have cause confusions and loss of public confidence manifested in (a) bank run; (b) panic buying; (c) capital flight, and (d) rejection of foreign banks on letter of credit opened by Indonesian banks.

IMPACTS:

- 1. Short term effects:
 - * deep economic recession, economic contraction in 1998 is predicted between -15 to -20 percent ;
 - * fiscal distress (1998/1999: fiscal deficit is amounted to 8.5 percent of GDP):
 - # meltdown of government tax and non-tax revenues;

Figure 3. Indonesia: Differential Between Domestic Deposit Rates and LIBOR



Source: Bank Indonesia, *Indonesian Financial Statistics*, various issues.

- # sharp increase in government expenditures, for: external debt repayment, subsidies and recapitalization of the banking system.
- * high inflation rates (1998: over 80%), due to:
 - # the increase in prices of imports due to the Rupiah devaluation;
 - # rapid growth of money supply;
 - # rising velocity of money: panic buying and bank run.
- * corporate bankruptcies;
- * rising unemployment rate;
- * rising number of population under the poverty line.
- * import compression;

Prior to the crisis, the authorities boasted that Indonesia have strong economic fundamentals: low inflation rate, high economic growth and respectable growth of non-oil exports. It turns out that all of these are artificial. The low inflation rate was bought by high price in form of subsidies to state-vended products.

The high rate of economic growth (6 percent plus per annum) was mainly generated in non-traded sector of the economy (such as: land based industry, physical infrastructures and financial system).

< TABLE 3 >

Most growth of non-oil exports during the 1990s was consisted of those sectors which relied the least on domestic inputs and were associated with foreign firms. In contrast, those which are domestically owned and relied on domestic inputs fared poorly.

<TABLE 4>

Table 3. Indonesia: Share and Rate of Growth Real Gross Domestic Product by Industrial Origin
(at 1983 constant market prices for 1985-1993, and 1993 constant market prices for 1994-1997)

	Share					Rate of Growth									
	1985	1995	1990	1991	1992	1993	1994	1995	1996	1997 a)					
Gross Domestic Product	100.0	100.0	7.2	7.0	6.5	6.5	7.6	8.1	8.0	4.6					
Gross Domestic Product non Petroleum	78.7	91.3	7.6	6.5	8.4	7.8	8.1	9.1	8.3	5.3					
1. Agriculture, Livestock, Forestry and Fishery	22.6	16.1	2.0	1.6	6.7	1.4	0.9	3.8	3.2	0.6					
1.1. Farm Food Crops	14.0	8.6	0.5	-0.5	7.7	-1.2	-2.1	4.6	2.4	-1.8					
1.2. Non-food Crops	3.6	2.6	4.9	5.4	4.8	5.8	5.1	4.7	4.2	4.3					
1.3. Livestock & Products	2.4	1.8	3.7	6.0	7.9	5.6	4.0	4.2	6.1	4.1					
1.4. Forestry	1.0	1.6	3.0	0.0	-2.2	1.7	0.5	0.0	1.3	-0.6					
1.5. Fishery	1.6	1.6	5.0	5.2	5.8	5.7	8.8	1.9	4.6	5.0					
2. Mining & Quarrying	18.2	9.3	5.2	10.2	-1.9	2.2	5.6	6.7	5.8	1.6					
2.1. Crude Petroleum and Natural Gas	17.1	6.2	4.2	9.3	-4.5	-0.3	2.6	0.0	1.4	-1.4					
2.2. Other Mining and Quarrying	1.1	3.1	18.0	20.1	24.0	20.8	13.9	23.5	14.6	7.0					
3. Manufacturing Industries	15.8	23.9	12.5	10.1	9.7	9.3	12.5	10.7	11.7	6.2					
3.1. Non-oil and Gas Manufacturing	11.5	21.3	13.0	10.9	11.0	11.6	13.5	13.0	11.7	7.4					
3.2. Oil/Gas Industry	4.3	2.5	11.0	7.4	5.3	1.3	5.6	-5.4	11.1	-3.4					
4. Electricity, Gas and Water Supply	0.4	1.1	17.9	16.1	10.1	10.1	12.5	15.5	13.2	11.8					
5. Construction	5.3	7.6	13.5	11.3	10.8	12.1	14.9	12.9	12.8	6.4					
6. Trade, Hotel & Restaurant	14.6	16.7	7.1	5.4	7.3	8.8	7.6	7.7	8.2	5.5					
6.1. Wholesale and Retail Trade	12.2	13.4	6.8	5.1	7.4	9.0	6.8	7.7	8.2	5.9					
6.2. Hotels and Restaurants	2.3	3.3	8.7	7.0	7.2	7.7	11.1	7.9	8.2	3.8					
7. Transportation & Communication	5.3	7.2	9.6	7.9	10.0	9.9	8.3	9.4	7.8	8.4					
7.1. Transportation	4.7	6.0	8.6	7.3	10.0	8.9	6.5	7.3	6.4	6.5					
7.2. Communication	0.5	1.2	16.9	12.3	10.0	16.4	20.4	21.1	14.5	17.3					
8. Financial, Ownership & Business	6.4	9.0	10.1	9.7	9.8	10.3	10.2	11.2	8.8	4.8					
8.1. Banking and Other Financial Intermediaries	3.5	4.7	14.1	13.1	13.0	13.0	13.8	13.9	9.6	3.5					
8.2. Building Rental	2.9	2.8	4.2	4.0	4.3	5.0	4.0	5.5	5.8	5.0					
8.3. Business Services	n.a.	1.4	n.a.	n.a.	n.a.	n.a.	12.0	14.2	12.1	8.5					
9. Services	11.3	9.2	4.7	3.7	4.3	4.3	2.8	3.3	3.4	3.0					
9.1. Public Administration and Defense	7.6	6.0	4.6	3.1	3.0	2.0	1.3	1.3	1.3	1.2					
9.2. Private Services	3.7	3.2	5.0	5.2	7.3	8.9	5.8	7.2	7.4	6.3					
Traded Sector b)	40.2	38.9	8.5	9.3	4.5	6.2	9.5	8.5	9.1	4.7					
Non-traded Sector c)	59.8	61.1	6.4	5.3	7.8	6.7	6.5	7.9	7.3	4.6					

Notes : a) Very preliminary data.

b) Comprise of Non-food Crops, Forestry, and Fishery, Mining and Quarrying, and Manufacturing Industries.

c) Comprise of Farm Food Crops, Livestock & Products, Electricity, Gas, and Water Supply, Construction, Trade, Hotel, and Restaurant, Transportation & Communication, Financial, Ownership & Business, and Services.

Source: Central Bureau of Statistics, *Economic Indicators*, various issues.

2. Medium and long-run effects:

Depended on the structure of the expenditure cut. Growth potential is depended on: (i) human resource development (ii) capital stock, including economic infrastructure and (iii) institutions including market infrastructure (legal and accounting systems).

POLICY RESPONSES:

Alternative solutions:

*At the end, the part follows
the IMF paper. This
program consists of
3 parts.*

(a) standard IMF program, which is a combination of:

- (i) short-term stabilization policy to reduce domestic absorption *→ domestic demand*
- (ii) medium-term economy wide reform to remove economic distortions for improving productivity and efficiency, and *→ this is also known as supply side measures*
- (iii) measures to strengthen market infrastructure (accounting and legal systems) to improve asymmetry of information and reduce transaction costs;

(b) currency board system that would:

- (i) peg the Rupiah to US dollar;
- (ii) constraint the monetary policy to operate like in gold standard, the money supply is directly linked to the balance of payments developments;
- (iii) stop the operation of the central bank as the lender of last resort;

(c) control on capital account transactions, at least short-term capital inflows:

- (i) market based mechanism: Tobin tax, Chilean way (freeze one year in non-remunerated deposits at the central bank);
- (ii) foreign exchange control system; the communist system (as being adopted in a semi-open economy of the People Republic of China) or the recent Malaysian way. At least in the short-run, the control cuts the link between interest rates and exchange rates. This gives more freedom for policy makers to pursue domestic policy objectives.

Table 4. Indonesia: Export Value by Commodity Group

	1990	1991	1992	1993	1994	1995	1996	1997
in billions of US\$								
Total Exports	25.68	29.14	33.97	36.82	40.05	45.42	49.81	53.55
Agriculture	2.08	2.28	2.21	2.64	2.82	2.89	2.91	2.88
Industrial Product	11.88	15.07	19.61	22.94	25.70	29.33	32.12	35.30
Forestry base product a)	3.48	3.87	4.53	6.01	5.86	6.00	6.09	5.64
Garments & Textile	2.93	4.08	6.06	6.18	5.80	6.20	6.55	5.27
Electronics	0.29	0.67	1.10	1.64	0.72	0.92	1.41	1.37
Mining and Minerals	0.64	0.89	1.45	1.46	1.80	2.69	3.02	3.11
Others Sector	0.01	0.01	0.02	0.03	0.04	0.05	0.04	0.66
Total non-oil exports	14.60	18.25	23.30	27.08	30.36	34.95	38.09	41.94
Oil and Gas Export	11.07	10.89	10.67	9.75	9.69	10.46	11.72	11.60
as percentage of total exports								
Total Exports	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0
Agriculture	8.1	7.8	6.5	7.2	7.0	6.4	5.8	5.4
Industrial Product	46.3	51.7	57.7	62.3	64.2	64.6	64.5	65.9
Forestry base product a)	13.6	13.3	13.3	16.3	14.6	13.2	12.2	10.5
Garments & Textile	11.4	14.0	17.8	16.8	14.5	13.7	13.2	9.8
Electronics	1.1	2.3	3.2	4.4	1.8	2.0	2.8	2.6
Mining and Minerals	2.5	3.1	4.3	4.0	4.5	5.9	6.1	5.8
Others Sector	0.0	0.0	0.1	0.1	0.1	0.1	0.1	1.2
Total non-oil exports	56.9	62.6	68.6	73.5	75.8	77.0	76.5	78.3
Oil and Gas Export	43.1	37.4	31.4	26.5	24.2	23.0	23.5	21.7
percentage of annual growth								
Total Exports	15.9	13.5	16.6	8.4	8.8	13.4	9.7	7.5
Agriculture	7.2	9.5	-3.1	19.5	6.6	2.5	0.8	-1.3
Industrial Product	7.7	26.8	30.2	17.0	12.0	14.1	9.5	9.9
Forestry base product a)	7.9	11.1	17.0	32.7	-2.4	2.4	1.4	-7.3
Garments & Textile	46.3	39.1	48.7	2.0	-6.2	7.0	5.6	-19.6
Electronics	50.5	133.9	64.0	49.2	-56.2	28.5	53.0	-2.9
Mining and Minerals	26.4	39.8	63.4	0.8	23.0	49.5	12.2	3.0
Others Sector	10.3	35.9	108.0	38.1	54.4	19.2	-22.6	1751.7
Total non-oil exports	8.3	24.9	27.7	16.2	12.1	15.1	9.0	10.1
Oil and Gas Export	27.5	-1.6	-2.1	-8.7	-0.5	8.0	12.0	-1.0

Note : a). Comprise of processed wood, and paper and paper goods.

Source : Central Bureau of Statistics, *Economic Indicators*, March 1998

At the end the new government signed the fourth IMF program in June 1998. The removal of President Suharto from office in May ended the muddling through policies of his government. The IMF program covers five aspects:

- (1) Short-term program to protect the poor from falling primary income, i.e., income derived from labor and assets. To ease the burden of the poor, the authorities raise their secondary or social income by providing food and other basic needs at subsidized prices and create labor intensive public works. These require high budgetary subsidies, but do not reach the needy. At the same time, the subsidies create large wedge between domestic and international prices of the state-vended products and provide incentives for their exportation (smuggling) to neighboring countries;
- (2) Fiscal policies:
 - (i) to redefine the scope of government;
 - (ii) to shift the role budget, from a tool of resource allocation to a principal instrument of macroeconomic policy and the vehicle for providing public goods;
 - (iii) to reduce the government budget to a sustainable level and obtain additional foreign financial assistance for temporary financing the presently large budget deficit.

(iii) integrate the non-budget expenses in the formal budget

<TABLE 5>

- (3) To deal with the debt overhang:
 - (i) Public sector debt: It is true that the bulk of the public sector debt is long-term in nature. However, the associated principal and interest servicing cost still run high, at some \$9 billion a year. On September 23, 1998, the Paris Club creditor nations agreed to reschedule \$4.2 billion in principal repayments of Indonesia's public external debt. The debt rescheduling temporarily eased pressures on the public budget and the balance of payments.
 - (ii) The private sector external debt is to be solved on a voluntary basis

Table 5. Indonesia: Government Budget
(as percentage of GDP)

	FY 97/98 (Actual)	FY 98/99 (Revised)
Revenues	16.2	15.7
Oil and Gas	4.6	5.2
Non-oil	11.6	8.9
Privatization	0.0	1.6
Current Expenditures	10.6	17.0
Subsidies	3.1	6.2
Interest	1.7	3.3
Other	5.8	7.5
Government Savings	5.6	-1.3
Development Expenditures	6.6	7.2
Social Sectors 1/	1.0	1.6
Special Employment Schemes	0.0	0.9
Other	4.6	4.7
Budget Deficit	1.0	8.5
Financed by:		
External Finance	1.6	4.8
Domestic Finance	-0.6	...
Exceptional Finance	...	3.7

Note: 1/ Social sectors include education, health, food production and small scale credit.

Source: Dept. of Finance, Government of Indonesia.

based on a combination of Mexico's Ficorca program and the Korean scheme. The Korean idea takes the short-term and non-trade debts of Indonesian banks and restructure them into loans with one to four-year maturity. Interest rates on the new loans will be paid based on Libor plus margin, ranging between 2.75 and 3.5 percent.

The non-bank corporate debt is rescheduled and restructured along the line of Mexican program. A trust institution, called INDRA, is already established by under the central bank which provides exchange rate risk protection and assurance to the availability of foreign exchange to private debtors that agree with their foreign creditors to restructure their external debts for a period of 8 years with 3 years of grace during which no principal will be payable. ✓

- (4) To restructure and recapitalize the banking system. The financially distress banking system cannot lower interest rates and expand credit. ✓
[Temptation to seek 'magic' solutions: the currency board system and control capital account transactions].

The function of lender of last resort has been shifted from Bank Indonesia to Treasury through the IBRA-Indonesian Bank Restructuring Agency. To protect depositors, the authorities provide blanket guarantee for deposits at domestic banks. A private funded deposit insurance company is under preparation and to be placed under IBRA.

IBRA funding, however, comes from Bank Indonesia credit, hence increase money supply. Net claims of Bank Indonesia on IBRA has been rising rapidly, amounted to Rp140 trillion in July 1998 as compared to Rp87 trillion in March of this year. To sterilize this, Bank Indonesia, floats more SBI with higher interest rates.

The Asset Management Unit (AMU) has been established under IBRA with the only role is to purchase the non-performing loans (NPL) from banks. This allows the banks to focus on their traditional activities, namely: deposit taking and lending. The purchase of NPL will significantly add to resources available for banks for lending purposes. ✓

Two models as regards to AMU:

- (i) America's Resolution Trust Corporation (RTC) which mainly protected the interest of financial institutions;
- (ii) Swedish model which try to save both the banks and the borrowers by injecting better management methods and fresh capital into the company.

Indonesia ? not clear.

The authorities however, have allowed greater participation of foreign investors in the ownership of Indonesian bank.

(5) to improve governance system by:

- (i) reviewing and dismantling government contracts that were offered through corruption, collusion, and nepotism;
- (ii) improving domestic competitive policy;
- (iii) privatizing state-owned enterprises;
- (iv) speeding up trade and policy reforms;
- (v) strengthening accounting and legal systems to improve market transparency and contract enforcement;
- (vi) modernizing the antiquated bankruptcy code.

OUTLOOK

In the short-run, Indonesia is still facing a very difficult stabilization and adjustment period. However, there has been a progress in the implementation of the IMF program as the present government is more committed to it than the previous administration of President Suharto. This has helped restore confidence of domestic and international communities on Indonesian economy. This combined with external factors (such as depreciation of the US dollar against other major currencies) has helped strengthen external value of the rupiah, from above Rp10,000 per dollar in early October to presently below Rp8,000. This is much stronger than the originally expected to hover around Rp10,500 by the end of 1998.

Appreciation of the rupiah, along with the progress of restructuring program of the banking system, reduces interest rate, expands bank credit

and improves access of corporate sector to working capital. Cheaper prices of imports help reduce inflation rate. Rehabilitation of financial strength allows the corporate sector to increase capacity utilization, production and non-oil exports. These and the increase in agriculture output when the weather condition back to its normal pattern are expected to led the recovery of economic growth.

The crisis does not seriously affect the conditions which supported the long-run growth potential of Indonesian economy: human and physical capital stock. The high savings and investment emphasis on improvement in human resources are still intact. Deregulation and economic reform that further integrate the economy to international markets will eliminate economic distortions and enhance productivity and efficiency. Improvements in market infrastructure and economic institution will further enhance productivity with the reduction of transaction costs.