

CHAPTER I

MONETARY ECONOMIC DEVELOPMENT IN INDONESIA

1.1 Introduction

The story of economic development in Indonesia, is a great drama, filled with triumph and tragedy. Until the 1997 crisis, the Indonesian economy was hailed for its success since late 1960s onward. It included, a rapid supervision of hyperinflation and transition from a controlled to a market economic system, successful exchange rate management; a rapid transition from heavy dependence on oil revenues in the 1980s; a prudent macroeconomic management. Indonesia economy during this period was part of the so-called” Asian Miracle”. Two decades around 7 percent average annual growth. This growth had been accompanied by relatively low inflation rate and some improvements in various social indicators, like reduction of the number of people living below poverty line and an increase of life expectancy. Indonesia has become more diversified, less dependent on oil, more industrialized, more open, and more urbanized and increasingly driven by private initiative.

The year 1998 saw the worst economic performance of the post thirty-two years, with the economy contracting by about 14 per cent and an inflation rate of 70 per cent. Amongst the crisis-affected countries in East Asia, Indonesia has been hit hardest. Indonesian economy at the beginning of the year 2000 was relatively bright. Sign of

economic recovery had already begun to appear from the third quarter of 1999. Compared to other Asian crisis economies, Indonesia's economic recovery was relatively slow because of several fundamental problems and a high degree of uncertainty continued to hold back the economic recovery process, preventing a more rapid and sustained recovery.

The early 1980s to 1988 was a period of poor performance for the Indonesian economy. In this period the monetary development increased slowly because of the world economic recession followed by a plunge of oil prices and an unfavorable impact on the Indonesian economy, particularly its balance of payments. Deficit in the balance of payments resulting in the decline in foreign exchange reserve causes slow growth in monetary development since 1982 – 1988 (see Figure1.1).

From 1989 to 1996, monetary developments were characterized by faster growth in reserve money or base money (M0) and money supply both in narrow (M1) as well as broad money or called domestic liquidity (M2) compared to period post-oil boom (1982-1988) (see Figure1.1). The faster growth of monetary aggregates (M0, M1 and M2) in these periods caused higher growth in economic activities, higher production, higher investment and non-oil/gas export and higher import and higher domestic demand and larger capital inflow than previous period.

Monetary developments became a source of serious concern by the exchange rate crisis that further developed into a deep financial crisis. The rupiah under onerous pressure following the reversal of massive capital flows triggered by the financial crisis in Thailand. The rupiah further plummeted as a result of increasing demand for dollar, among others, to meet mature external debts, finance import, and speculate against the rupiah. Inflation soared due to a combination of problems on both demand and supply sides, in addition to disruption of distribution. These developments reflected the complexity of the problem in the monetary sector.

The plan of this chapter is as follows. This chapter provides a brief overview of the Indonesian monetary development. The period of this thesis is 1980-1999, covers the three distinct period monetary experiences and financial regimes. The main period are pre-reform (pre-1983), post-reform (post 1983) and financial crisis (1997-1999). In every period, a brief overview about monetary economic development in Indonesia is provided and analyzed by using figures and tables.

1.2 Monetary Development Pre-Reform (Pre-1983)

In less than a decade, Indonesia grew to be one of the world's major producers and exporters of oil and gas at a time when oil prices were reaching historic highs. When the full impact of this development was understood, there was widespread

euphoria. It suddenly looked as if Indonesia's struggle with poverty might come to a relatively quick and easy end.

In the 1970s and early 1980s, the Indonesian economy was very dependent on oil revenue. In fact, the quadrupling in 1973/1974 and doubling in 1979/80 of oil prices had substantially affected the increase in the rate of economic growth. The large amount of funds originating from oil boom has enable government to make major progress in reducing poverty, improving living standards and expanding the infrastructure base. The government also prioritized rural development and substantial expenditures were laid out to support agriculture, especially for rice production. The government also placed strong emphasis on improving the availability of education, health and family planning services.

The period 1970s and the early 1980s was witnessed by rapid growth in the real domestic product at an average rate of 8 per cent annually and in domestic savings that rose from 9.5 per cent of gross national product in 1971 to 32.8 per cent in 1980. The average income of Indonesian's rose from \$80 in 1970 to \$490 in 1980. Oil and gas exports in 1970 are 40.5 per cent and increase to 78.5 per cent in 1980 (see Table 1.1).

While the oil boom enabled the government in accelerating growth, reducing poverty and improving social indicators, it also brought about undesirable impacts most notably is higher inflation rate, reaching about 30.6 and 41 per cent in 1973 and 1974 (see Table 1.2). The main cause of inflation was expansion of money supply growth.

During the period of 1970-1981, the average annual rate of inflation was 17 per cent, while money supply growth rate increased at 35.25 per cent (see Table 1.2). The rate of inflation was quite high; it was due primarily to the rapid growth of money supply, which reflected the expansionary effect of the foreign assets. It was due to cost-push factors associated with the rice crisis of 1973 and the devaluation of 1978. The money supply increased in response to the growth in demand for money, and to validate this price increases. Increase in money supply was also due to higher levels of investment and government domestic expenditures, which led to an increase in aggregate demand, and hence to the rapid growth of GDP.

Since 1974 to 1983 the monetary authorities imposed direct credit control on all banks to stabilize the inflationary impact of oil boom and to control excessive domestic money growth. The monetary policy had been based primarily on two mechanisms: credit ceilings and interest rates controls for state banks, which were major players in the financial market at that time. The government also had determined that subsidized interest rates were necessary to finance priority sectors. By adopting these policies, the growth of money supply slowed down and the growth of time deposits showed a rapid expansion. These monetary policies succeeded in bringing the rate of inflation down to 18.8 per cent in 1975 from 41 per cent in 1974. The annual average rate of inflation is decrease to 14.5 per cent between 1975 and 1983 (see Table 1.2) with respectable economic growth of 8 per cent annually during the corresponding period.

Table 1.1
Structural Change of Indonesian Economy

	1965	1970	1980	1990
As Per Cent of GDP				
Openness				
Total Trade	14.0	22.2	46.8	54.7
Non Oil Exports	4.0	7.0	11.5	15.7
Imports	7.5	10.6	15.5	26.3
Gross Domestic Investment	8.0	10.8	18.7	24.6
Gross National Savings	7.9	9.5	32.8	26.3
Sector Shares				
Agriculture	55.0	47.5	24.4	23.0
Manufacturing	8.5	10.9	13.5	18.8
Other Industry	6.5	8.9	29.8	19.1
Services etc.	30.0	32.7	32.2	39.1
External Debt	50.0	32.5	30.0	66.6
As Per Cent of Exports				
Oil and Gas Exports	40.0	40.5	78.5	44.8
Debt Service	11.0	6.0	13.9	27.3
Private Investment as Per Cent of Total	n.a	n.a	51.0	64.7

Source: Central Bureau of statistics and World Bank Estimates

Table 1.2
Inflation and Money Supply Growth in Indonesia, 1970-1999

Year	Inflation	Money Supply Growth
1970	12.4	34
1971	4	30
1972	6.7	50
1973	30.6	45
1974	41	38
1975	18.8	34
1976	20	29
1977	11	23
1978	8.2	25
1979	20.6	35
1980	18.5	51
1981	12.2	29
1982	9.6	11
1983	11.7	6
1984	10.5	14
1985	4	17
1986	5.9	15
1987	9.2	6
1988	8.1	18
1989	6	40
1990	9.5	18
1991	9.5	10
1992	4.9	9
1993	9.8	27
1994	9.2	23
1995	8.6	15
1996	6.5	21
1997	11.1	22
1998	77.6	29.2
1999	2	23.1

Source: Bank Indonesia and various issues

1.3. Monetary Development Post-Reform (Post 1983)

For almost a decade through the 1970s, Indonesia's economic progress had been sustained through the remarkable windfall of oil boom. With the arrival of new decade, however, this phenomenon was coming to an end. Indonesia's 'easy money' was almost finished. Situation changed drastically since 1982. The slowdown was attributed to a sharp drop in oil price¹ coupled with the world economic recession prevailing since the beginning of the 1982 to 1988 and the deterioration on the competitiveness of domestic products in the international markets. The drop in oil prices led to a sharp decline in government revenues, which constrained the government's ability to provide funds for current and development expenditures. Since government expenditures play a significant role in stimulating economic activity in the near term, a fall in government expenditures tended to depress economic activity.

The Indonesia government confronted the slackening economy with the new determination to launch structural adjustment programs in the different key areas of the nation economy. Adjustment policies were known as deregulation and debureaucratization program. These reforms changed the emphasis of Indonesia's development strategy from heavy reliance on the public sector, import-substitution industrial policy, and financial repression, to export-oriented industrial policies and market based financial policies, combined with for greater emphasis on private sector.

¹ The oil prices rose in 1974 to 1981 (oil booms) and slowed down in 1982 to 1987 (post-oil booms). The oil prices were getting more stable after 1987.

On June 1, 1983 as part of the structural adjustment programs, the Indonesian authorities initiated a financial and monetary reform. Decision to initiate this reform was taken in response to the shortcomings of the previous system in mobilizing domestic funds through the banking sector. The lack of initiative of state banks to mobilize funds from public, because they are only allowed to operate up to their ceilings and excess liquidity in the banking system, driven by negative real interest rate, have encourage private capital outflow and thus exerted pressure on the balance of payments. These reforms were aimed at dismantling the old system of monetary control, replacing it with a more indirect approach based on reserve management through open market operations. In 1984, a new monetary instrument, the Sertifikat Bank Indonesia (SBI), was introduced, followed by the issuance of promissory notes, known as Surat Berharga Pasar Uang (SBPU), in early 1985.

Slow growth in the world economy coupled with uncertainty in the world oil market had an adverse impact on economic developments in Indonesia in 1982 - 1988. The challenges encountered in the monetary sector included an outbreak of speculation of foreign exchange, which put pressure on the balance of payments and caused interest rates to fluctuate markedly. In order to overcome a speculative attack on the rupiah, Bank Indonesia pursued a tight monetary policy. This policy was implemented by raising interest rates on Bank Indonesia certificates (Sertifikat Bank Indonesia or SBIs) and discount facilities, and the rediscount rates on money market securities (Surat Berharga Pasar Uang or SBPU) as well as by gradually lowering the ceiling on SBPU.

From 1982 to 1988, monetary developments were characterized by the fastest growth in domestic liquidity (M2) of all main monetary aggregates mainly money supply (M1) and money base (M0) (see Figure 1.1). The growth in domestic liquidity (M2) was accounted for due to higher rupiah deposit rates, which generated large increases in quasi money relative to currency and demand deposits. The slower growth of M1 was closely associated with pursuit of prudent monetary policy aimed at maintaining price stability and easing pressures on the balance of payments. Slower growth in money supply in these years were due to the decrease level of imports, decrease in investment, and decrease in development expenditure and decrease in government expenditure were significant decline in aggregate demand reflected in the much slower growth in money supply. These led to the low growth rates of money supply in these years.

The tightening monetary policy and effect banking reform have led to an increase in interest rates of SBIs, interbank, deposit and lending rate, which in turn had the intended effect of encouraging financial savings and restrained the growth of bank credits. These developments resulted in slowing down the growth of domestic demand, which helped reduce the inflation rate and reduce the money supply growth. While the tightening of monetary control led to rise in commercial banks' deposit and lending rate in terms of government commitment to maintain economic stability, they are certain to caused a further dampening of economic activity as businessmen face further cost increases.

Figure 1.1 depicts during 1981 to 1999 development of broad money (M2) is the highest of all development monetary aggregates. The highest development of broad money because of persistently high interest rates have led to the continued growth of time and saving deposits (quasi money) relative to demand deposit and currency in circulation or called narrow money (M1). Figure 1.1 depicts the development of quasi money is higher than the development of narrow money (M1) because of the improvement of income, the response of savers to higher interest rates on time deposits and saving deposits and increase in the banking services, including the widening network of bank offices and the attractive savings schemes offered by banks.

From 1989 to 1996, monetary developments were characterized by faster growth in reserve money (M0) and money supply both in narrow (M1) as well as broad money or called domestic liquidity (M2) compared to period post-oil boom (1982-1988) (see Table 1.3 and Figure 1.1). The faster growth of monetary aggregates (M0, M1 and M2) in these period was caused higher growth in economic activities, higher production, higher investment and non-oil/gas export and higher import and higher domestic demand and larger capital inflow than previous period.

During the period of 1989-1996, the average annual growth rate of domestic liquidity or called broad money (M2) was greater than the rate during 1982 - 1988 (25.57 per cent versus 23.55 per cent) (see Table 1.3). The increase in domestic liquidity was mainly attributable to the increase in M1 of 18.57 per cent and quasi money of 30.50 per cent (see Table 1.3). The acceleration in the increase in M1

occurred mainly in demand deposits, namely from 11.87 per cent in 1983-1988, to 23.45 per cent in 1989-1996 and the growth of currency in circulation increased 19.16 per cent. Quasi money still registered a significant increase although a tax on interest earned on time deposit imposed on November 14, 1988. The increase was mainly due to the improvement of income and the response of savers to higher interest rates on time deposits. It is noteworthy that most of the increase stemmed from rupiah time deposit.

Table 1.3
Developments of Monetary Aggregates in Indonesia, 1983-1996

Average Annual Growth Rate In Per Cent	Pre-Reform Period, 1983-1988	Post-Reform Period, 1989 –1996
1. Currency	13.52	19.16
2. Demand deposits	11.87	23.45
3. Base money (M0) (1+2)	14.23	12.54
4. Reserve	13.11	29.95
5. Narrow money (M1) (1+3)	12.51	18.57
6. Quasi money	34.58	30.50
7. Broad money (M2 (5+6)	23.55	25.57
Monetary Indicators (Per Cent)		
Interest rates		
Deposit rates ²	29.88	2.13
Interbank call money	2.7	-
Change in CPI	8.23	8
Exchange rate ³ (Rp/US\$)	12.05	3.57

Source: SEACEN, Financial Statistics and IMF, Financial Statistics

² Deposit rates of commercial bank, 3 months

³ Exchange rate at market rate, period average.

Table 1.4
The Growth of Monetary Aggregates in Indonesia, 1981-1999

Year	% M1 (Narrow Money)	% M2 (Broad Money)	% QM (Quasi Money)	% C (Currency)	% D (Demand Deposits)	% R (Reserve)	% H (Money Base)
1981	29.85	26.34	19.84	18.76	38.25	17.89	18.23
1982	9.798	21.69	45.59	14.74	6.56	4.52	8.57
1983	6.291	24	50.81	13.60	1.17	21.96	18.46
1984	13.37	22.33	31.88	11.37	14.94	12.65	12.13
1985	17.75	29.08	39.47	19.61	16.33	17.57	18.38
1986	15.57	19.46	22.48	20.22	11.92	21.16	20.78
1987	8.63	22.50	32.65	8.31	8.89	10.35	9.54
1988	13.45	23.94	30.21	8.02	18.01	-5.05	6.11
1989	39.76	39.78	39.79	18.89	55.76	-79.59	-33.26
1990	18.42	44.16	57.57	22.46	16.05	-2.35	16.34
1991	10.59	17.05	19.57	2.77	15.42	-10.23	2.91
1992	9.25	20.18	24.14	22.81	1.79	9.44	19.25
1993	27.89	21.96	20.07	25.73	29.32	-22.20	19.48
1994	23.96	20.18	19.13	29.14	20.61	2.28	25.84
1995	15.46	27.60	31.61	11.64	18.10	64.79	16.681
1996	21.66	29.61	32.11	8.07	30.53	277.47	33.08
1997	22.24	23.22	23.49	26.40	19.99	53.07	33.95
1998	29.17	62.35	71.72	45.63	32.77	114.84	62.99
1999	23.16	11.92	9.53	40.97	-9.77	9.79	35.50

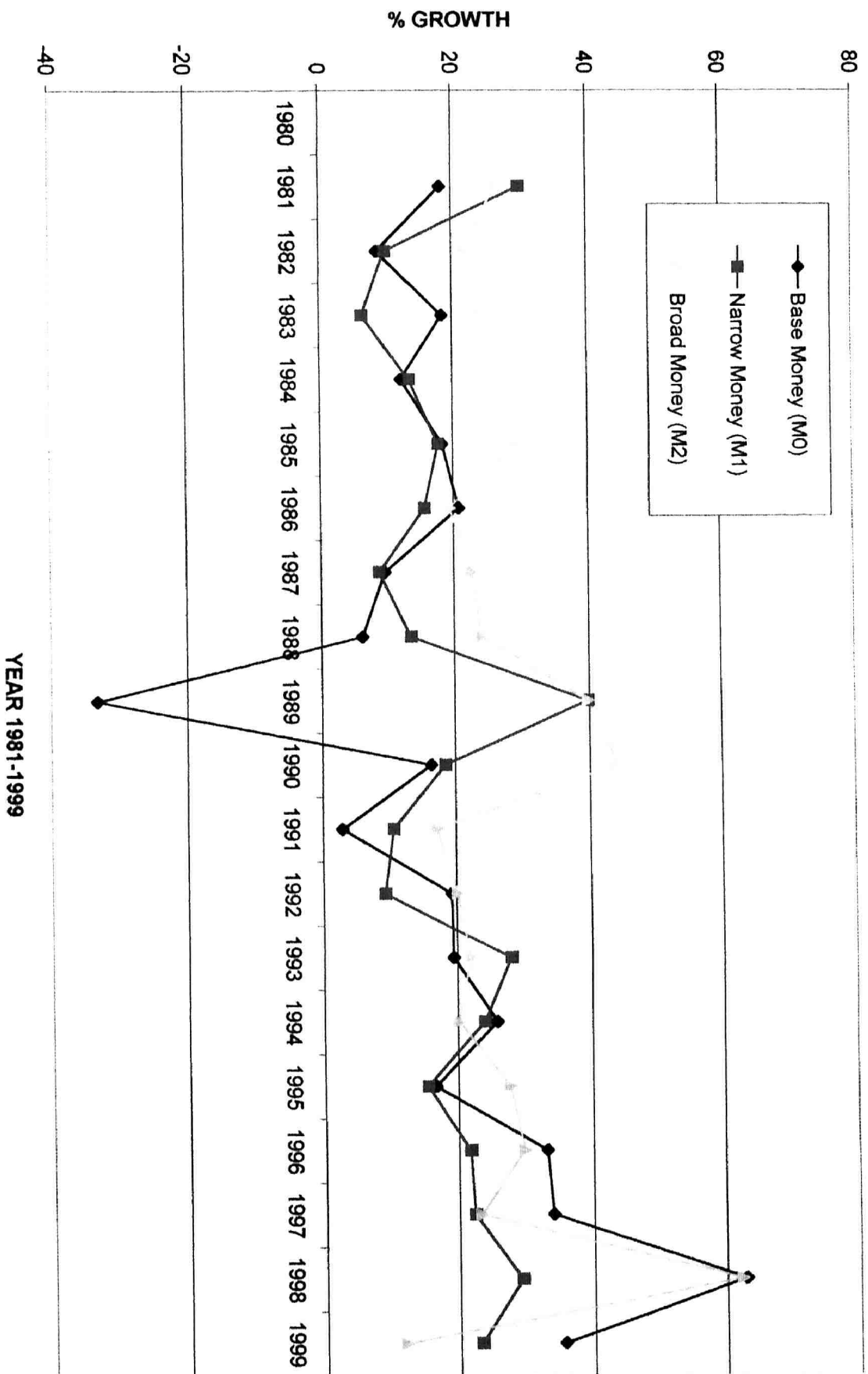
Source: Bank Indonesia, IMF Financial Statistics, SEACEN Financial Statistics, and various issues

The Indonesian economy has been experiencing something near boom conditions in most sectors through 1989. Anticipated benefits from the various deregulation packages of 1983-88 are now obvious. The financial policy package of October 27, 1988 followed by its supplementary regulations has had a positive impact on the financial sector and fostered development of Indonesia's economy as a whole. The positive impact on the financial sector was mainly reflected in the rapid growth of funds mobilization, through banks and the capital market, and in the improvement of banking services along with the expansion of banks' operating network. The

coordination among financial policies and other economic policies has promoted a high rate of economic growth accompanied by a low rate of inflation, strengthened the external balance as reflected in the rapid growth of non-oil/gas exports, and encouraged investment and production.

Figure 1.2 shows that in 1989 the growth rate of base money decreased sharply while the growth rate of narrow (M1) and broad money (M2) increased sharply (refer to Figure 3.2). The growth rate of base money decreased sharply because in 1989 net foreign assets had a contractionary effect of Rp179 billion compared with an expansionary effect of Rp2,359 billion in previous year. This contractionary effect was mainly attributable to the repayment of maturing foreign official debt, caused decreased foreign reserve and decreased base money. In 1989, monetary developments were characterized by a rapid increase in money supply, in broad and in narrow terms. The increase in M2 was attributable to growth in M1 by 39.76 per cent and quasi money by 39.79 per cent. The high increases in M1 and quasi money were not only closely associated with the increase in domestic income but also with the increase in the banking services, including the widening network of bank offices and the attractive savings schemes offered by banks. As in the preceding year, the increase in M1 was mainly attributable to demand deposits owned by the private enterprises and individuals, which were partly associated with the increase in transactions, buoyant economic activities and the attractive interest earned from demand deposits. Meanwhile, currency increases by 18.8 per cent.

FIGURE 1.2 GROWTH MONETARY AGGREGATES IN INDONESIA, 1981-1999



In line with the strong demand for investment and consumption goods, money and credits grew rapidly in 1989. These developments, on the one hand, resulted in a high growth in the production; on the other hand, they added pressure on domestic prices. In an effort to curb inflation pressure, Bank Indonesia tightened domestic liquidity (M2) further by continuing the phasing out of liquidity credits and conducting contraction open market operations. This was reflected in a large increase in SBIs sales. The tightening of monetary policy led to an increase in interest rates, which in turn had the intended effect of encouraging financial savings and restrained the growth of bank credits, particularly during the end of 1989. The lowering the inflation rate helped restore credibility of Government's policy and confidence in the rupiah. Figure 1.2 shows that since 1991-1996 the growth of narrow money (M1), and broad money (M2) relatively smaller than in the years 1988-1989. This was mainly attributable to the declining trend of bank credits since 1991-1996 as a result of the phasing out of Bank Indonesia's liquidity credits and the contractionary impact of the government sector due to higher revenues from taxes.

The Indonesian economy has posted excellent performance in the early and mid-1990s (see Table 1.5). Economic growth was running at 6 per cent to 8 per cent, with manufacturing and construction showing strong growth performance. Massive capital inflows and a shift towards short-term, private sector flows since the early 1990s had caused the economy overheating. Net capital inflow in Indonesia was maintained and inflation was modest at less than 10 per cent.

Table 1.5
Selected Macroeconomic Indicators for Indonesian Economy, 1991-2000

	1991	1992	1993	1994	1995	1996	1997	1998	1999	2000
	Change (%)									
Real GDP	6.9	7.2	7.3	7.5	8.2	7.8	4.7	-13.2	0.2	4.8
By expenditure										
Consumption	7.4	4.1	5.4	4.4	8.6	8.5	7.0	-4.6	1.4	3.9
Gross domestic capital	7.1	3.9	4.9	13.8	14.0	12.2	8.6	-35.5	-20.8	17.9
Exp. goods & services	24.2	17.5	7.8	9.1	8.6	6.3	7.8	11.2	-32.1	16.1
Imp goods & services	14.7	10.4	2.5	14.5	15.8	9.6	14.7	-5.3	-40.9	18.2
By Sector										
Agriculture	1.4	6.5	1.5	0.6	4.2	1.9	1.0	0.8	0.7	1.7
Mining & quarrying	10.2	-1.7	3.1	5.6	6.7	7.1	2.1	-3.1	-0.1	2.3
Manufacturing	9.6	9.7	9.5	12.4	10.8	11.0	5.3	-11.9	2.2	6.2
Construction	12.0	9.3	11.2	14.9	12.9	12.4	7.4	-40.5	1.1	6.7
Other services	7.0	8.3	8.2	7.2	7.9	7.6	3.6	-3.2	2.8	2.2
Monetary	91/92	92/93	93/94	94/95	95/96	96/97	97/98	98/99	99/00	00/01
M2	24.2	22.1	21.2	22.1	28.0	26.7	23.2	62.4	11.9	15.6
M1	15.9	12.0	25.7	18.5	18.4	19.6	22.2	29.2	23.1	30.1
Prices										
Consumer Price Index	9.78	10.00	7.04	8.57	8.86	5.17	11.1	77.6	2.0	9.35
Whole Price Index	5.06	5.35	3.55							
Ratios	Per cent									
Current account / GDP	-3.7	-2.2	-1.6	-1.7	-3.7	-4.0	-2.3	4.3	4.0	5.0
Capital Account Balance	4.9	4.6	3.9	2.3	5.3	4.9	1.5	-4.1	-3.2	
Debt Service Ratio	20.6	18.9	19.0	17.7	16.4	14.6	44.6	58.7	51.9	44.8
Foreign Exch Reserve	5.3	5.4	5.4	4.7	4.6	5.2	4.5	8.9	10.9	
Net Capital Inflow (FDI)	5.0	3.8	1.9	2.4	4.6	5.0	4.7	-0.4	-0.7	1.6
External Debt/GDP, %	58	56	52	51	62	57	64	151	103	95
Unemployment rate	2.4	2.7	3.1	4.4	7.2	4.9	4.8	5.5	6.4	3.4

Source: Central Bureau of Statistics and Bank Indonesia

1.4 Monetary Development on Crisis Period

Since the middle of 1997, Indonesia witnessed momentous and tragic event. Momentous because nobody-from the pre-eminent Washington institutions, to rating agencies and academics-foresaw the events and still have an imperfect understanding of their origins and future course. Tragic because ordinary Indonesians are suffering a great deal and many has experienced a substantial decline in their living standards. As the 1998 annual World Bank (1998a) assessment of the country soberly observed:

Indonesia is in deep crisis. A country that achieved decades of rapid growth, stability, and poverty reduction, is now near economic collapse. ... No country in recent history, let alone one the size of Indonesia, has ever suffered such a dramatic reversal of fortune.

The current view on causes the crisis could be separated into two.

First, those who look at origin of the crisis as domestically grown, arising from practices of crony capitalism and weak financial structures plus inefficiency macro policies. *Second*, those who look at the crisis as triggered by a shift in the market sentiment, or from an external factor, as the origin of the crisis. The first view could be considered as the structural argument of the crisis as some, like professor Krugman of MIT used to argue. The second view argues that the crisis is basically a financial panic in the Keynesian tradition explained by professor Kindleberger.

According to Soedradjat Djiwandono views the Asian crisis, in particular the Indonesian crisis comes out from a combination of the work of contagion forces from outside the national economy on the one hand and the weak domestic economic and financial structures on the other. The contagion factor of the crisis was emanating from

a sudden change in market sentiment in the region that led to a shock in the currency markets of the region. This had led to panic selling of local downgrading process of the region's sovereign credit ratings and, in the media, the disappearance of the term 'Asian Miracle' to be replacing by 'crisis', or 'meltdown'. (Soedrajat Djiwandono, 2000).

Confronted with the contagion effects, the Indonesian economy which had been suffering from inefficiency in the real sectors (a high cost economy suffering from crony capitalism) and a weak financial system banking in particular-could not cope with the shock. The domino effect of the weakening rupiah adversely affected the financial sectors, and on to the real sectors of the nation economy. Thus, a combination of severe external shocks, triggered by changes in the market sentiments, and financial real sector structural weaknesses had caused a contagious process that ultimately severely damaging the whole economy. Hence, Soedrajat Djiwandono contention about a combination of both external shock and structural weaknesses that caused the work of contagion.

In Indonesia, the spread from economic crisis was also through a contagious process, which was facilitated by inherent weaknesses in the social and political system. The external contagion that hit financial market served to expose weaknesses of Indonesia's banking system that resulted in banking crisis. In turn, the banking crisis that seeped through the payment system uncovered weaknesses in the real sectors of Indonesian economy that was embedded with inefficiencies and corruption from the practice of 'crony capitalism' to result in an economic crisis. And finally, the economic

crisis exposed institutional weaknesses in Indonesia's social and political system and they were both collapsing in a total crisis.

Monetary developments became a source of serious concern by the exchange rate crisis that further developed into a deep financial crisis. The rupiah under onerous pressure following the reversal of massive capital flows triggered by the financial crisis in Thailand. The rupiah further plummeted as a result of increasing demand for dollar, among others, to meet mature external debts, finance import, and speculate against the rupiah. Inflation soared due to a combination of problems on both demand and supply sides, in addition to disruption of distribution. These developments reflected the complexity of the problem in the monetary sector.

Figure 1.2 shows that in crisis period 1997 to 1998 growth of monetary aggregates (M0, M1, and M2) increased sharply as a result of the weakening rupiah exchange rate and the declining in public confidence in the banking system. The increased demand for the rupiah to meet large value of transaction value of transaction as a result of higher inflation on crisis period. Most of the monetary aggregates have been considerably disturbed during the crisis. Base money (M0) fell abruptly almost immediately after the rupiah was floated in August 1997, when the government squeezed liquidity (in attempting to prop up the currency). Narrow money (M1) has followed a similar pattern, through with less violent short-term swings. Over the full period under consideration (June 1996 – May 1999) it has increased by far less than M0. The broad money (M2) has quite different. Broad money (M2) growth accelerated

at the end 1997, although less rapidly; but in contrast to the base money (M0) and narrow money (M1), broad money (M2) was still growing rapidly through 1999.

In the crisis period, the average annual growth rate of base money (M0) was 44.15 per cent, (see Table 1.6) the highest as compared to pre-reform and post-reform period. The robust increase in M0 was bank runs that led to an upsurge of liquidity support. During 1997-1998 liquidity support continued to climb in accordance with the heightened domestic social and political uncertainties. The social unrest followed by a swift shift in the national leadership in mid-May 1998 increased deposit withdrawals from several banks, including a large private bank. Depositors cashed in or transferred their funds and put them in presumably sound banks. As a consequence, at the crisis period liquidity support rose sharply.

Table 1.6
Developments of Monetary Aggregates in Indonesia, 1980-1999

Average Annual Growth Rate In Per Cent	Pre-Reform Period, 1981-1983	Post-Reform Period, 1984 -1996	Economic Crisis Period, 1997- 1999	Period 1981- 1999
1. Currency	15.70	16.08	37.67	19.43
2. Demand deposits	15.33	19.82	14.33	18.24
3. Base money (M0) (1+2)	14.79	22.79	59.23	27.28
4. Reserve	15.08	12.87	44.15	18.16
5. Narrow money (M1) (1+3)	15.31	18.14	24.86	18.75
6. Quasi money	38.75	30.82	34.92	32.72
7. Broad money (M2 (5+6)	24.01	25.99	32.49	26.70
Monetary indicators (in per cent)				
Interest rates				
Deposit rates ⁴	0.00	15.10	25.69	10.75
Interbank call money	3.4	3.14	24.22	-6.97
SBI's discount rate	-	7.24	56.55	10.15
Change in CPI	13	7.82	30.23	11.89
Exchange rate ⁵ (Rp/US\$)	14	7.76	82.28	20.52

Sources: SEACEN Financial Statistics and IMF Financial Statistics

⁴ Deposit rates of commercial bank, 3 months.

⁵ Exchange rate at market rate, period average.

Both components of M1 have increased considerably during the crisis, but cash much bigger than demand deposits. It is tempting to assume that this reflects a loss of confidence on a part of the public as to the safety of bank deposits, such that they prefer to use relatively more cash for transaction purposes. In, the crisis period the average annual growth rate of narrow money (M1) was 24.8 per cent, (see Table 1.6) the highest as compared to pre-reform and post-reform period. The robust increase in M1 was mainly attributable the increased in currency circulation dramatically. The robust increase the amount of currency in circulation was created by bank runs was due to a delay in the government's announcement of banks closures; the weakened rupiah exchange rate; the declined in public confidence in the banking system; the increased demand for rupiah to meet larger value of transaction as a result of higher inflation; the peoples preparations against possible deterioration of the social and political conditions; and preparations for certain religious holidays.

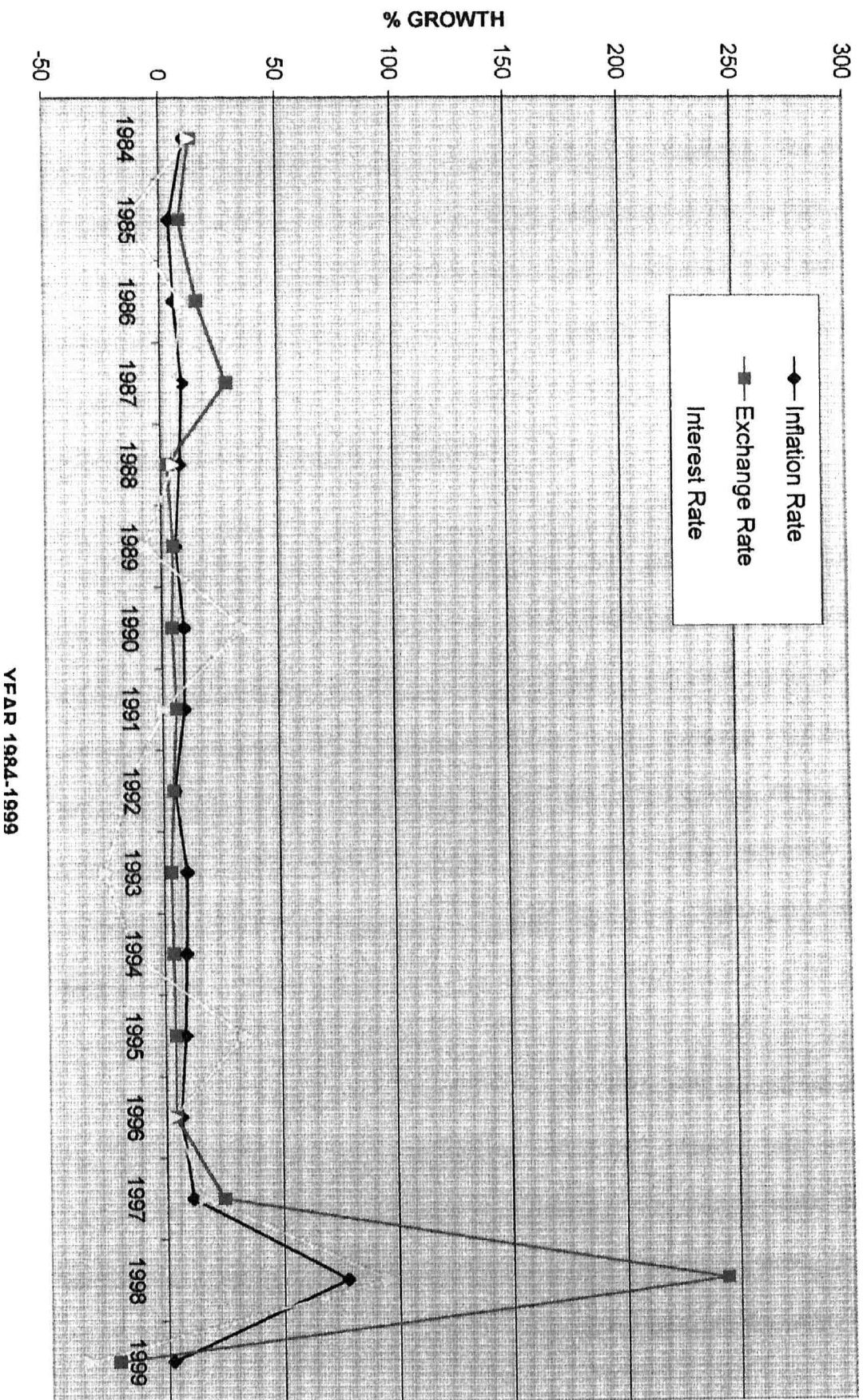
In the crisis period, the average annual growth rate of narrow money (M2) was 32.49 per cent, (see Table 1.6) the highest as compared to pre-reform and post-reform period. The robust increase in M2 was attributable by an expansion of rupiah quasi money, which was mainly attributed to reinvestment of interest earnings into time deposit because of the attractive deposit rate. The growth of rupiah quasi money was mostly driven by banks' efforts to offer more flexible banking services with better facilities. The rise in the rupiah quasi money was also contributed by the conversion of deposits from foreign currency into rupiah especially when the rupiah value plummeted to its bottom.

In view of factors affecting broad money (M2), the growth of M2 originated from higher net foreign assets (NFA) of commercial banks brought about by capital inflows from international trade flows, and higher net other item (NOI). The biggest component of NOI stemmed from retained losses of banks resulting from high interest rate expenses paid to depositors. Meanwhile, outside the takeover of liquidity support by the government, net claim on central government (NCG) exerted contraction forces. This was primarily due to higher fiscal revenue from taxes levied on interest rate income and disbursement of foreign aid.

In the crisis period, the growth of interest rate of SBIs (Certificate Bank Indonesia), interbank, deposit and lending surged significantly (see Figure 1.3) as a result of the monetary tightening launched by Bank Indonesia. The average annual growth of deposit rate (3 months) and SBI (1 month) went up from 15.10 per cent and 7.24 per cent during pre-reform period compared to 25.69 per cent and 56.55 per cent during the crisis period. The purpose of increased interest rate was to make real interest rate positive. In effect, it served as an incentive for savers and as means to strengthen rupiah value. Tighter monetary policy and higher interest rate will eventually be needed to combat steady increases in inflation.

Alongside gradual recovery of monetary stability, since September 1998 interest rate continued to decline. The decline in SBI discount rate was followed by decreases in interbank, deposit and lending rates. These favorable developments were accompanied by improved public expectation on price and exchange rate stability.

FIGURE 1.3 GROWTH OF MONETARY INDICATORS IN INDONESIA, 1984-1999



The average annual growth of rupiah exchange rate in the crisis period underwent a strong fluctuation, 82.28 per cent (see Table 1.6), and experienced severe downward pressure impact by the exchange rate crisis in Thailand. The driving force behind the rupiah turmoil included the fall in confidence of the foreign investors as reflected in the large capital outflows to pay external matured debts and speculative transactions. In addition, worsening domestic economic fundamental, due to the crisis of public confidence in the banking system and spiraling inflation was the main contributor behind the currency turbulence.

To stabilize the rupiah exchange rate, the government employed several measures such as restoration of monetary stability, facilitation of trade finance by Bank Indonesia, restructuring of external corporate debt, and sterilization of government expenditures through sale of foreign exchange in the exchange market. The rupiah appreciated significantly in 1999 and display more stability than during the previous year. The main facts were the conduct of monetary policy, especially measures to manage liquidity in the banking system, and a significant improvement in inflationary expectations.

Figure 3.1 depicts that in the crisis period, 1997-1998, the growth of interest rate of SBIs (Certificate Bank Indonesia), interbank, deposit and lending surged significantly as a result of the monetary tightening launched by Bank Indonesia. The growth of rupiah exchange rate in the crisis period underwent a strong fluctuation, and experienced severe downward pressure impact by the exchange rate crisis in Thailand.

During the 1999, the Indonesian economy quite well. Development of monetary aggregates (M0, M1, and M2) (see Table 1.4 and Figure 1.2) and monetary indicators (rupiah exchange rate, inflation, and interest rates) (see Figure 3.1), have been encouraging. The consistent implementation of monetary policy has brought monetary aggregates and monetary indicators to the indicated targets. The rupiah exchange rate first strengthened and then remains relatively stable in line with the controlled amount of money in circulation. This strengthening of the rupiah underwrote a sharp decline in inflation. The decline in interest rates was stimulated by improvements in banking conditions. The declining interest rates had a positive impact on domestic capital market activity.

The process of economic stabilization and recovery in Indonesia is in fact slower than that in other Asian Countries in crisis. This relates to the severity of the damage prompted by the crisis that had paralyzed Indonesia's fundamentals, especially, the banking system, business sector, social and political environment. Indonesia's economic recovery was relatively slow because of several fundamental problems and a high degree of uncertainty continued to hold back the economic recovery process, preventing a more rapid and sustained recovery.