BAB IV

CONCLUSIONS AND RECOMMENDATIONS

4.1 Conclusions

The early 1980s to 1988 was a period of poor performance for the Indonesian economy. In this period the monetary development increase slowly because of the world economic recession followed by a plunge of oil prices had 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 (see Figure1.1) since 1982 – 1988.

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 this 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.

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 Indonesian government has implemented a gradual reform agenda in monetary and banking. In the first stage, by mid-1983 interest rates control and credit ceilings were removed. The monetary policy was shifted from direct control to indirect control through reserve money management. In the second stage, started at the end of 1988, barriers to entry and expansion of banking activities were eased. Alternative sources of finance, in particular the stock markets, were revitalized. Reserve requirement was dramatically lowered. These changes have had a profound effect on the Indonesia financial system.

The implementation on indirect monetary control in Indonesia using especially open market operation as an active monetary instrument had proven the ability of the monetary authority to control reserve money in accordance with the achievement of immediate targets (commercial banks' reserves), and in turn through the existing money multiplier and also intermediate targets (narrow money and broad money). In addition, the indirect monetary control also made possible for Bank Indonesia to target interest rate in the short run, which is an important factor in enhancing economic activities and reducing pressures on the balance of payments.

Monetary policy in general is a short term issues, dealing with short run variables, even though it has long term implications. Tight or loose monetary policy is a short run issue. It deals with macroeconomics variables.

Prior to the crisis, Indonesia's monetary policy framework was mainly conducted using base money as the operational target. While the ultimate objective of monetary policy was formulated rather vaguely and multiple objectives in fact existed – such as a low level of unemployment, high economic growth, sustainable balance of payments position, and a tolerable rate of inflation – the anchor of monetary policy during this period (prior to the crisis) was clearly the nominal exchange rate, which was managed heavily within a relatively narrow band that depreciated at a fairly steady rate.

Targeting of the monetary base after the crisis was adopted by Bank Indonesia as a temporary framework mainly aimed to absorb the monetary expansion originating from liquidity support to the banking system, rather than being based on more fundamental considerations such as a stable relationship between inflation and base money.

The three determinants of the money stock reflect the behavior of three sectors the economy. The high-powered money reflect the behavior of the government, the serve ratio reflect the behavior of the commercial banks and the currency ratio reflect e behavior of the public.

Our empirical results suggest that the money supply may be controlled if the igh-powered money can be controlled and high-powered money is the most important ctor influencing money supply in Indonesia. From these empirical results, we can rove the theory that, there is a negative relationship between money supply with eserve ratio and currency ratio, and there is a positive relationship between money upply and high-powered money.

The high-powered money, from the source of base can be classified into two main categories: net foreign assets and claims on central government. It is obvious that foreign assets should be treated as exogenous. Our empirical results show that in Indonesia, net foreign assets would play a central role in affecting high-powered money. Thus, it is very important for Indonesia to keep a favorable atmosphere to attract foreign investment. This atmosphere should come from political, economic and social stability, tax reduction and exemptions, and other laws that facilitate foreign investment.

One of the factors determining money supply is the reserve ratio. Our empirical results reveal that variable time and saving deposits is the most important factor influencing bank reserve in Indonesia. Another of our empirical results reveal that currency ratio for the narrow definition of money supply is affected by number of bank offices. For the broader definition of money supply, per capita income plays a central role in currency ratio. The currency ratio would tend to decline as real income per capita rose. In Indonesia, the income elasticity of demand deposits is greater than the income elasticity of currency. The use of checks are not limited, therefore Indonesian people prefer demand deposits to currency.

4.2 Recommendations

To create good monetary aggregates as indicated targets; a stable and good monetary development is required. A politically credible and technically competent government is also required for consistent implementation of monetary policy.

Sound macroeconomic management and a robust banking system are the two pillars of macroeconomic stability. This underwrites the structure of economic growth and exports and the subsidy cost of low inflation rates.

In Indonesia the public's psychology or the public expectations about government policies, and the state of the economy in general, is fairly unstable. It is easily disturbed by rumors, which often lead to extreme responses to the otherwise fairly normal events. There are several things that can be done to reduce volatile expectations. First, drastic actions should be avoided as far as possible. Second, to improve continually the public perception of the competence of policy makers themselves. The public must also be convinced that government policies are based consistently on some set of basic principles of proven efficacy in many successful countries.

The first priority for Indonesia is still on how to end the crisis or how to make a turn around. For Indonesia, this means dealing squarely with the food problems, social unrest and politics. In other words, the issues are outside economics and finance. The main problem lies in the capability of the national leadership to establish and maintain political and social stability to facilitate the national efforts for ending the crisis and to turn around the slide down for economic recovery.