MONETARY DEVELOPMENT ON CRISIS PERIOD

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Since the middle of 1997, Indonesia has 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’. But the most telling was the Institute of International Finance’s publication on capital flows for Thailand, Malaysia, Indonesia, the Philippines, and South Korea. The estimate showed a reversal flow of capital of $105 billion in these five countries in a single year, from inflows of $93 billion in 1996 to outflows to outflows of $12 billion in 1997. For Indonesia alone, the reversed capital flow was estimated to reach $22 billion, from inflows of $10 billion to outflows of $12 billion. This has been the financial panic in the Keynesian tradition as explained by Kindleberger. But, the external shock itself does not have to cause a crisis of the magnitude that these countries suffer, if only their domestic economic, as well as social and political structures are robust (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 Djijwandono contention about a combination of both external shock and structural weaknesses that caused the work of contagion.

In Indonesia case, the contagion process had been working not just across geographical or national borders. Within a country, it trespasses different aspects, from economic to social and political. 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 on Indonesia.

In Indonesia, I could say that 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 1.1 shows that in crisis period 1997 to 1998 growth of monetary aggregates (M0, M1, and M2) increase sharply as a result of the weakening rupiah exchange rate and the decline in public confidence in the banking system. The increased demand for the rupiah to meet large 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). Base money (M0) then grew rapidly from November 1997 until July 1998 as a result of massive lending to the banks by Bank Indonesia, and subsequently declined slightly. Narrow money (M1) has followed a similar pattern, though 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 also growth accelerated at the end 1997, although less rapidly; but in contrast to the narrower aggregates it was still growing rapidly through 1999.

In the crisis period annual growth rate of base money (M0) was 59.23 per cent, (see Table 1.1) 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 1997-1999, 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.
FIGURE 1.1 GROWTH MONETARY AGGREGATES IN INDONESIA, 1981-1999

YEAR 1981-1999

% GROWTH

-40 -20 0 20 40 60 80

% M0 % M1 % M2
Table 1.1
Developments of Monetary Aggregates in Indonesia, 1980-1999

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<tbody>
<tr>
<td>1. Currency</td>
<td>15.70</td>
<td>16.08</td>
<td>37.67</td>
<td>19.43</td>
</tr>
<tr>
<td>2. Demand deposits</td>
<td>15.33</td>
<td>19.82</td>
<td>14.33</td>
<td>18.24</td>
</tr>
<tr>
<td>3. Base money (M0) (1+2)</td>
<td>14.79</td>
<td>22.79</td>
<td>59.23</td>
<td>27.28</td>
</tr>
<tr>
<td>4. Reserve</td>
<td>15.08</td>
<td>12.87</td>
<td>44.15</td>
<td>18.16</td>
</tr>
<tr>
<td>5. Narrow money (M1) (1+3)</td>
<td>15.31</td>
<td>18.14</td>
<td>24.86</td>
<td>18.75</td>
</tr>
<tr>
<td>6. Quasi money</td>
<td>38.75</td>
<td>30.82</td>
<td>34.92</td>
<td>32.72</td>
</tr>
<tr>
<td>7. Broad money (M2 (5+6)</td>
<td>24.01</td>
<td>25.99</td>
<td>32.49</td>
<td>26.70</td>
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Monetary indicators (in per cent)

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<tr>
<td>Deposit rates(^1)</td>
<td>0.00</td>
<td>15.10</td>
<td>25.69</td>
<td>10.75</td>
</tr>
<tr>
<td>Interbank call money</td>
<td>3.4</td>
<td>3.14</td>
<td>24.22</td>
<td>–6.97</td>
</tr>
<tr>
<td>SBI’s discount rate</td>
<td>-</td>
<td>7.24</td>
<td>56.55</td>
<td>10.15</td>
</tr>
<tr>
<td>Change in CPI</td>
<td>13</td>
<td>7.82</td>
<td>30.23</td>
<td>11.89</td>
</tr>
<tr>
<td>Exchange rate(^2) (Rp/US$)</td>
<td>14</td>
<td>7.76</td>
<td>82.28</td>
<td>20.52</td>
</tr>
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Sources: SEACEN Financial Statistics and IMF Financial Statistics

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 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 1.1) the highest as compared to pre-reform and post-reform period. The robust increase in M1 was mainly attributable the increase in currency circulation dramatically. The robust increase the amount of currency in circulation were created by bank runs 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 1.1) 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

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\(^1\) Deposit rates of commercial bank, 3 months.
\(^2\) Exchange rate at market rate, period average.
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 Table 1.1) 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.

The average annual growth of rupiah exchange rate in the crisis period underwent a strong fluctuation, 82.28 per cent (see Table 1.1), 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 maturated 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.

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During the 1999, the Indonesian economy quite well. Development of monetary indicators, such as the rupiah exchange rate, inflation, and interest rates, have been encouraging. 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.

CONCLUSIONS AND RECOMMENDATIONS

Conclusions

Since the middle of 1997, Indonesia has witnessed momentous and tragic event. Indonesia is in deep crisis. 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.

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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 rate.

The first priority for Indonesia is still on how to and 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.

REFERENCES


