

Policy Response to Overcome Crisis: A Lesson from Indonesian Case

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1. Introduction

Discussions on experiences and impacts of government's policy response to an economic crisis in a country are very significant. There are lessons to learn in anticipating and avoiding any potential crises in the future. Reviews on such policies are also crucial in comparing the effectiveness of the policy against the cost borne by the country upon the policy implementation.

Each country has specific economic characteristic and different problems. Thus, the response to the crisis would also be varied in a country to another. Even when the economic characteristics and problems were similar, the policy response might be different depending on the school of thoughts of the governments of the countries.

In 2008 world faced a very deep and wide economic crisis. When in 1997/98 crisis, not all countries suffered from the crises started in Thailand. On the contrary with the current economic crisis, there was almost not a single country unaffected by the crises stated in US when its financial sector collapsed.

Besides, being outspread in almost all countries, the crisis has been believed to be much severe and would last longer than the 1997/98. However, early this year, it was adopted that the developed countries' economy would rebound in the second semester of 2009 as those experts expected that the crises might be localized within the financial sector. The

bad news was that the most recent prediction of the economists said that the economic crisis would be very severe and last very long.

In anticipating global uncertainty, each country would surely take necessary steps to survive. Thus, it means that policy response taken would put national interest into priority. This paper would take Indonesian case as an example of economic situation before the crisis in 1997/98 and 2008, as well as analyze the policy response of the government and the impact on national economy.

2. Pre Crisis, Policy Response and The Impact

2.1. The 1997/98 Crisis

When economic crisis hit Indonesia in 1997/98, its national economy contracted more badly than other countries as Indonesia experienced a series of crises, such as: currency crisis, liquidity crisis, and banking crisis that was followed by business sector bankruptcy in general. In 1998, Indonesian economy contracted more than 12.8 percent, including to the worst beside East European countries.

Many government bureaucrats pointed out external factors as the main reason of the economic crisis in Indonesia. It was understandable as Indonesia still grew at 7.3percent in average (1989-1996). Many multilateral institutions also declared Indonesia one of the Asian Miracles. Nonetheless, it was unjustifiable. At the earlier stage, the economic turmoil was started by crisis in Thailand, but the crisis worsened more by weaknesses in Indonesian economic structure. The Indonesian economic crisis was even more severe as the result of government's failure in anticipating economic crisis development and a series of misjudge and policy errors of the policy makers during the period.

Social and economic costs resulted by policy errors were very expensive. In addition to increasing very vast unemployment and poverty, mass riots and violence in May 1998, such errors had caused banking recapitalization cost up to Rp 650 trillion (including BLBI) and increased national debt of tens billion US dollars to burden the country until

recently. This mistake should be a valuable lesson in facing economic crisis in 2008 as Indonesian economy was still vulnerable.

A. Pre-Crisis: Crucial problems on Financial Sector

Before economic crisis occurred in 1997/98, the economy of Indonesia had already faced a serious problem in financial sectors, i.e.: cross ownership and cross management financial institutions, rupiah over valuation and imprudent loan disbursement.

Cross ownership & cross management in financial sector

The government of Indonesia issued a deregulation package in financial sector in October 1988 (so called *Pakto 88*). One of significant regulation in the *Pakto 88* was that the deregulation facilitated bank establishment by requiring bank capital of only Rp 100 millions. This policy encourages the growth of number of banks in Indonesia from 111 banks in 1988 to 240 banks by the end of 1995.

Loose requirements for bank establishment had generated increasing number of banks. Besides, the policy had also caused cross ownership and cross management in financial industry in Indonesia. A set of data in 1996 showed that most of big banks in Indonesia was affiliated with other banks and financial institutions. In other words, banks and financial institutions ownership during the period before 1997/98 crisis was highly concentrated. Cross ownership and cross management in banking sector was one of the main factors that had increased systemic risk and national economic instability. Since banks ownership was highly concentrated, big banks tend to disburse loans to their groups, violating legal lending limit, that increased systemic risk of banking sector.

In such situation, external supervision by Bank of Indonesia had completely been ineffective. There were many loopholes in the regulation that can be manipulated and engineered to avoid the regulation of legal lending limit. Including into the manipulation and engineering were loan swaps among groups of banks, finance companies, use of layer of co-operations, and ownership and management nominees.

Overvalued Rupiah

Another risk that existed in the economy of Indonesia before the crisis in 1997/98 was increasing current account deficit that had been occurring since the 1980s. Even in the last two year before the crisis, current account deficit had been doubled from US\$ 3.1 billion in 1994 to US\$ 7.2 billion in 1995. The increased current account deficit was a very volatile. A country with huge current account deficit was more vulnerable from speculative attack by rent seekers.

The situation was worsened as the monetary authority at the time tried to maintain the currency rate by fixed exchange rate system at the range of Rp 2,200 – 2,300 per US dollar. In fact, continuous current account deficit ought to be countered by applying a more flexible exchange rate system. In other words, fixed exchange rate applied by the monetary authority before the crisis had resulted in overvalued rupiah or stronger than its real value. In November 1995, we estimated that rupiah was overvalued by 16 percent against US dollar.

Over-leveraged Private Foreign Loan

On of the main factors that gave more pressure to current account deficit was the huge amount of foreign debt repayment, including private foreign debt. Conservatively, foreign debt of Indonesian private sectors was around US\$ 60 billion in 1997, more or less around 50percent of Indonesian total foreign debts. If short term debts included in the estimation, such as: promissory notes, commercial papers and other short-term debt instruments in dollar and rupiah denomination own by foreign parties, private foreign debt should be around US\$ 75 billion.

Thus, Indonesian total foreign debts both government and private in 1997 had reached US\$ 135 billion. The total debt amount was relatively huge when compared with Debt Service Ratio (DSR) which had been over 40 percent. If the government had no adequate information and monitoring system of private sector debts, the accumulation of private sectors debt would increase market demand of US dollar simultaneously. Such a

condition would generate potential turmoil of exchange rate and threaten national economic stability.

On top of that, at that time, most of foreign loan of private sectors was used for consumption and investment in non-traded sectors, such as: speculation in property and consumption sectors. The situation would be on the contrary if the loan accumulation was used in productive sectors that generated foreign exchange.

B. Policy Response: Policy Blunder under IMF receipt

Tight money policy of Bank of Indonesia had a vast impact and created financial instability and bankruptcy. Over-kill tight monetary policy was realized in form of: (1) Suspension of SBI (Certificate of the Bank of Indonesia) repurchase transaction; (2) Suspending SBPU transaction; (3) Relocating state's companies (BUMN) funds from commercial banks to SBI. The method of doing so was very rough by directly debiting the related banks' accounts in Bank of Indonesia; (4) Increasing SBI interest rate (30percent for 1 month, 28percent for 3 month).

Finally, the impact of this super tight money policy was very huge in the economy, such as:

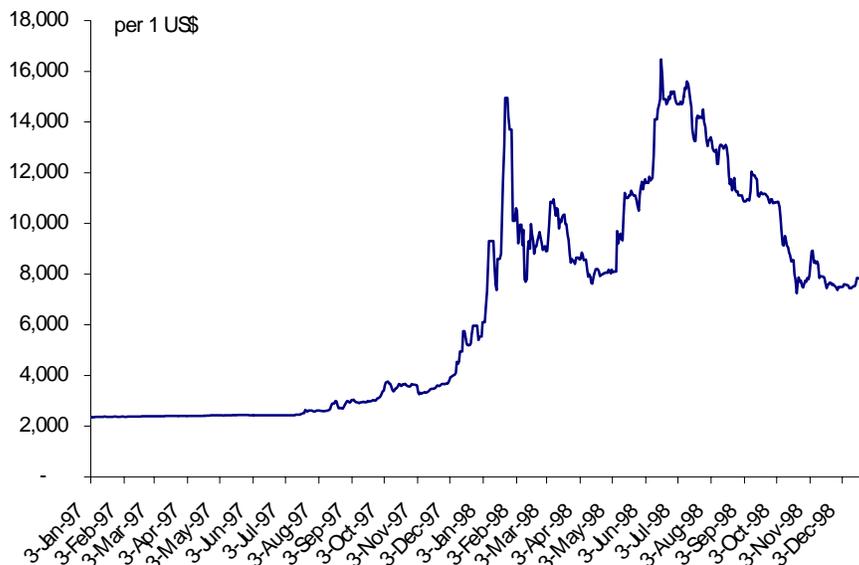
- Interbank interest rate increased very sharply (once reached 75percent-300percent). It was because inter-banks money market was very thin. Many banks depended their daily liquidity on inter-bank money market lending, which had very high interest.
- Many banks experienced liquidity problem, not only small-middle banks but also several big banks, as many banks violated reserve requirement (RR) regulation, many banks experienced clearing payment failure (and walk away without penalty), and some bank had been rushed (bank rush). Thus, many banks suspended loan disbursement and extension.
- Increasing inter-bank interest rate and SBI rates (28-30percent) had resulted in increasing deposit interest rate. Upon the increasing deposit interest rate, as a consequence Jakarta Composite Stock Indices (IHSG BEJ) fell sharply from 740.8 on 8th July 1997 to 493 on 29th August 1997 (around 34percent). Stock exchange had

slowed down as investors preferred depositing their money in banks to investing in stocks.

- Higher deposit interest rate was automatically followed by increasing lending interest rate (40-50percent), credit card interest and housing loan interest. The increase in loan interest rates would also raise banking risk and bad loan as debtors faced liquidity problem to repay their loan.

In such unstable financial condition, the government's policy response was to liquidate 16 banks in November 1997 upon IMF advice. Banks liquidation minus adequate preparation finally ruined public trust to national banks. This policy had also made capital outflow amounted to almost US\$5 billion and triggered rush against tens of national big banks like BCA and Danamon. This policy had also made national banking system collapsed and rupiah value dropped against US dollar.

Graphic 1. Exchange Rate: Rupiah against US Dollar (1997 – 1998)



Uncontrollable rupiah depreciation had happened after the government applied free floating exchange rate system on 14th August 1997. In an unstable condition, free float policy had made rupiah weaker and triggered capital outflow. As a result, business sectors got double hit on the face, i.e.: rupiah depreciation and a very high interest rate.

Following to that, not only banks shut down took place, but also many companies had to close down. Millions labors lay-offs were inevitable. Those policies had forced Indonesia to take hard landing with economic growing minus 13 percent in 1998.

The government burden had become heavier as IMF also advised Indonesia to take over private sectors debts. This policy had made the government debts increased sharply and put up additional cost to government budget until today. Before 1997 crisis, the national debt of Indonesia was 1997 US\$ 136 billion, consisting of US\$ 54 billion government's and US\$ 82 billion private sectors' debts. After the crisis (2001), foreign loan of the government of Indonesia added up to US\$ 74 billion. On the other hand, private sectors debt was reduced to US\$ 67 billion. It meant that after the crisis 1997/98 Indonesian national debt had increased sharply, even eleven years after the crisis, the total of debt stock had grown bigger and bigger.

The bubbling debt was obviously being a problem to the government budget as a large amount of the budget should be allocated for loan and interest payments. With very huge budget, the government faced hard choices. In order to reduce budget deficit, the government of Indonesia had to reduce subsidy, to raise tax, electricity tariff and oil price; in addition to national assets selling. Upon the take over of private debts by the government, private sectors' assets had also been transferred to the government, bot of banking and industrial sectors.

Sales of the above transferred assets were supposed to be the collateral for financing national budget deficit. Unfortunately in the practice, IMF had set the priority of the asset types and time of assets sales. It had been indicated that there were effort to sell such assets at lower price.¹

¹ For example, in the case of BCA selling it had been stated in the performance indicators that the government of Indonesia has to sell transferred assets including BCA in accordance with the schedule. As the deadline was very close, BCA was sold at only Rp. 5 trillion for 51percent shares of the bank. In fact, the government has an invoice to BCA for Banking Recapitalization Obligation amounted to Rp 60 trillion. In other words, the government received around Rp 10 trillion for the selling of BCA, but had to pay for the new owner the debt amounted to Rp 60 trillion plus interest charged to national budget as long as the recapitalization obligation due.

This model of assets selling without strategy had caused huge loss to the government as the recovery rate of assets was only 20 percent. This figure was far below that of Korean at 47percent and Malaysian at 57percent. The government loss was multiplied by the fact that after the national budget was burdened private debt take-over, the government capacity to pay the debt had also reduced as the value of transferred assets were lower than the transferred debt.

Economic capacity was scraped when the government accelerated the liberalization of real sectors. Steps to liberalize trade and industry had been taken simultaneously, such as: liberalizing domestic market of soybeans and sugar; removing Bulog's role as strategic food buffering institution. Other than that, there are many government's policies that were inappropriate, i.e.: fiscal, monetary, trade and industrial policy, which in the end had become more burden to the economy.² It was certain that after eleven years from the crisis, those policy responses have only resulted in economic vulnerability.

2.2. The 2008 Crisis

The current financial crisis is neither surprising nor unexpected. Our institution has warned the potential crisis in our annual presentation of review and prediction of Indonesian economy, "Economic Outlook 2008". Our report was presented in early January 2007, branded 2008 as *The Year of The Bubble* alerted the government of the negative consequences of allowing the financial bubble to inflate. The rise of the financial bubble was identified in the capital markets, commercial property and consumer credits.

The report noted that the probability of a recession in the United States was very high and rising owing to the structural weaknesses apparent in the American economy. America's massive trade deficit (US\$ 850 billion), current account deficit (6percent of GDP), and

² Beside the pre-requisite in selling the assets, there were 130 other conditions in the IMF letter of intent which determined Indonesian economic policy in trade, industry, finance, etc., in order to accelerate liberalization. See the paper entitled "Neoliberal Didn't Work in Indonesia, What Else?" presented by Hendri Saparini, Ph.D. in International Workshop Seminar on "The Making of East Asia: From both macro and micro perspectives" in Kyoto, February 23 to 24, 2009.

the threat of rising energy prices, all pointed to a correction in 2008. Indonesia cannot escape the effects of a slowing US economy, particularly when the financial sector is weakened by a financial bubble and overexpansion of consumer credit.

Unfortunately the government did not heed these warnings as the top officials believed that Indonesia was not facing a threat of economic crisis. The government's stand was similar to its position when faced 1997/98 crisis as our institution predicted that Indonesian economy has serious problems in financial sector. When a shock hit the sector, the economy would be in turmoil.³ When the prediction that the financial bubble would burst proved to be accurate, the government immediately panicked and closed-opened-closed-opened the Indonesian Stock Exchange. This unwise policy created panic within the business community, and undermined confidence in the financial sector and the economy.

A. The Pre-Crisis: Financial Bubble and Deindustrialization

Indonesia, within the last couple of years before the crisis 2008, underwent a contradiction between improving financial indicators and slowing growth of the real sector combined with accelerating deindustrialization, which is cause for concern. The financial sector is vulnerable to a sudden reversal of fortunes in the absence of productivity growth, improvements to competitiveness and investment in the real economy. When financial flows are not deployed to strengthen the real economy they result in bubbles.

These financial sector bubbles can deflate quickly or slowly depending on a range of internal and external factors. If asset prices stabilize or lose value slowly the economy may experience a soft landing with minimal impact on the real economy. But the advent of an external or internal shock can result in a sharp drop in asset prices, financial instability and a resulting hard landing that can impose massive costs on society.

³ ECONIT was the only think tank that had predicted the economic crisis in 1997. See the ECONIT Economic Outlook 1997 entitled, "The Indonesian Economy in 1997: The Year of Uncertainty," published in November 1996.

The main reason for the emerging contradiction between the performance of the financial and real sectors is the inflow of hot money into developing Asia, including Indonesia. Through November 2007, the amount of foreign capital in financial instruments in Indonesia totaled Rp 891 trillion. The inflow of hot money has strengthened the rupiah against other currencies and bid up the prices of domestic assets. The Jakarta Stock Exchange index increased by 57 percent in 2007, closing on 9 January 2008 at 2,830. The rupiah strengthened to an average rate against the US dollar of Rp 9,142 in 2007. The total value of hot money that has entered Indonesia since 2006 is thought to exceed Rp 140 trillion.

In this economic conditions, an external or internal shock could reverse the flow of money and result in a bursting of the financial bubble. In general there are some reasons why Indonesia susceptible to a shock:

Price driven export growth

In the last five years, Indonesia’s economic performance was fairly good as indicated by the rate of economic growth, the balance of payments and foreign exchange reserves. However, its performance was very vulnerable as the improvement of indicators has been only supported mostly by the rise in export revenues resulting from high commodity prices and inflows of short term capital (hot money) not by economic fundamental development.

Table 1. Hot Money Inflows

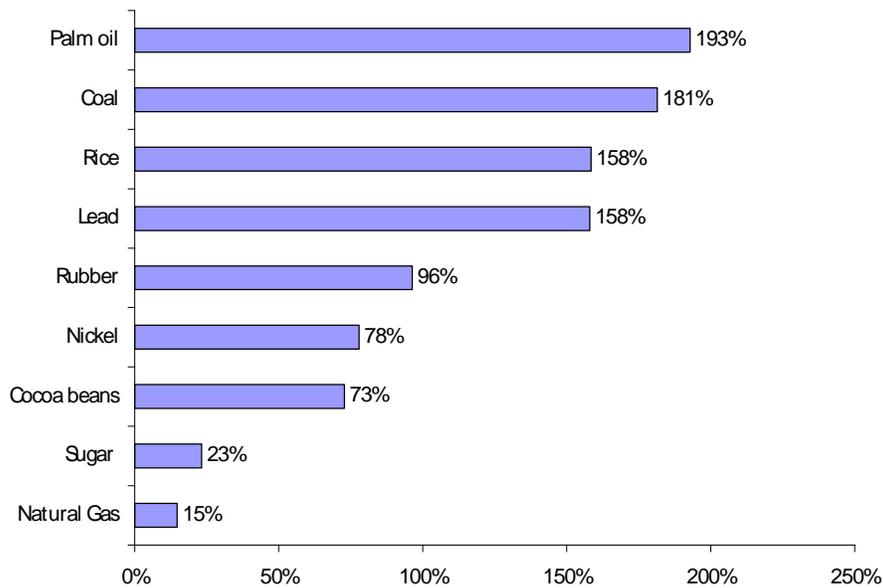
Investment Instruments	Foreign Ownership (Rp trillion)				
	Dec-06	Dec-07	Share (%)	Dec-08	Share (%)
Stock	522.3	804.5	61.96%	452.2	59.7%
Government Obligation (SBN)	54.9	78.16	16.36%	87.6**	16.7%
Bank of Indonesia Certificate (SBI)	18.1	42.7*	15.80%	6.7	3.8%

*) November

** akhir Agustus 08 =106.7 (19.8%)

From 2006-2008, Indonesia's foreign exchange reserves increased from about US\$ 35 billion at the end of 2005 to US\$ 57 billion at the end of 2007 and US\$ 60,5 billion in July 2008. Nevertheless, the accumulation of foreign exchange was not supported by a rise in productivity and export competitiveness, or even an increase in direct investment. The rise in reserves was not supported by export competitiveness or an increase in foreign direct investment. Foreign exchange reserves were built up on the basis of high prices for minerals and agricultural commodities. This was export price driven growth, not productivity driven growth.

Graphic 2. Commodities Prices: Increasing Very Sharply



As Indonesian exports are mainly primary products, so the international price hike up of the commodities like mineral has pushed export growth higher. In 2007, when booming of international prices of commodities occurred, shares of primary commodities, such as: nickel, copper, coal and palm oil, were the biggest, very dominant.

Table 2. Share of Non-Oil Export: Dominating by Commodities (Q1-Q3 2007)

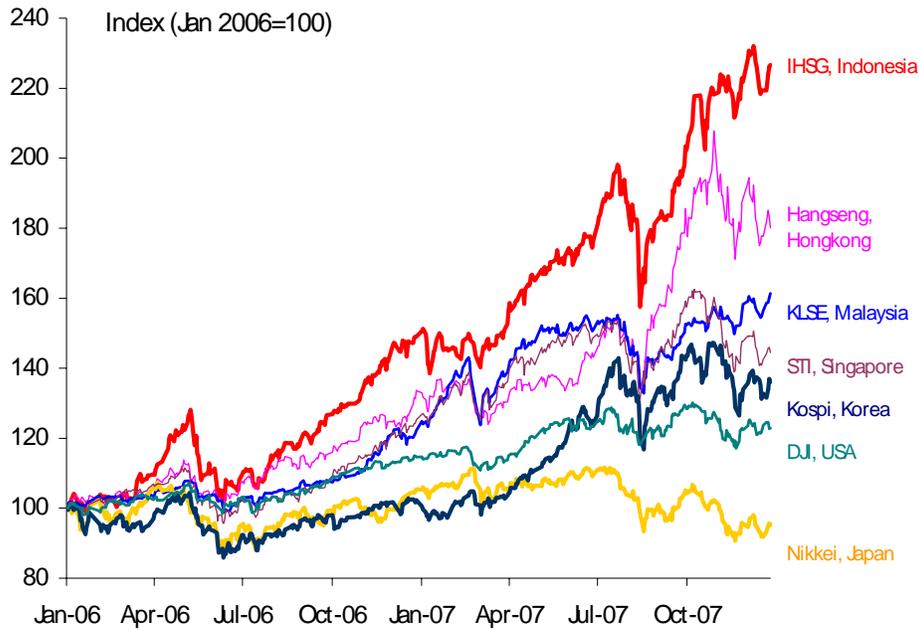
No	Commodities	Contribution to Growth	Share to Non Oil Export	Growth
1.	Nickel	16.3%	3.8%	159.5%
2.	Copper	14.4%	8.5%	31.5%
3.	Machinery and equipment	14.0%	7.4%	36.6%
4.	CPO	10.8%	6.7%	29.8%
5.	Chemical Products	9.6%	7.0%	24.3%
6.	Coal	6.7%	7.6%	14.5%
7.	TPT	3.4%	11.1%	4.5%
8.	Papper	2.6%	4.6%	8.6%
9.	Rubber	2.3%	5.3%	6.6%
10.	Metal Goods	2.0%	1.1%	32.3%
	Total 10 Commodities	82.1%	63.1%	22.6%
	Total Non-Oil	100%	100%	100%

Source: Department of Trade

Share prices increase exceeded the fundamental

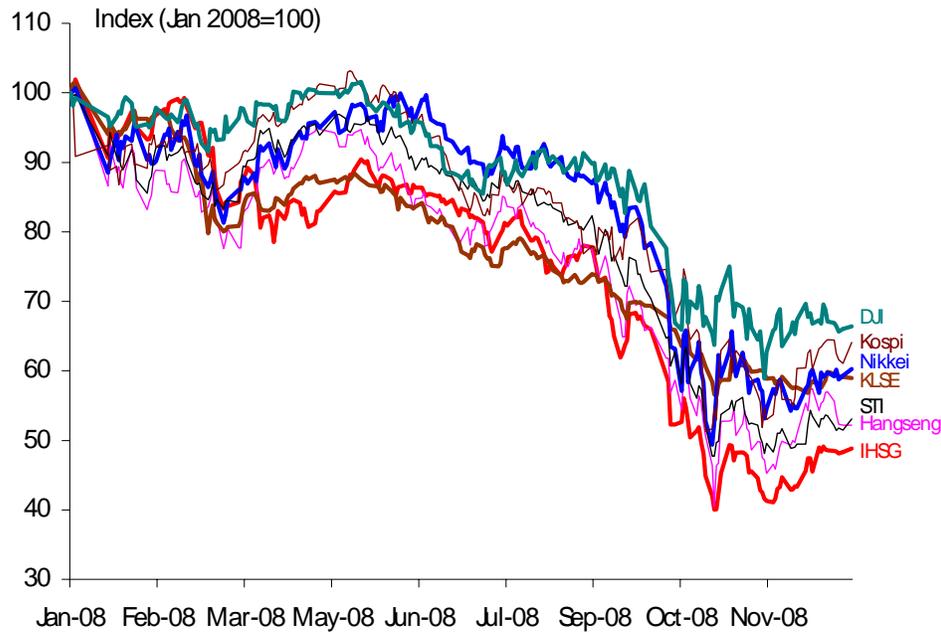
The Jakarta Stock Exchange index rose by 52 percent in 2007. Indonesian stock prices have followed world commodity prices, which have increased company profits in sectors including plantation crops and mining. Investors no longer appear to heed fundamentals and have driven up price-earnings ratios to extremely high levels. One of the examples cited in early 2008 was the fact that 51 listed companies posted price-earnings ratios (PER) in excess of 50, and PERs for a further 26 companies were higher than 100. Incredibly, 11 companies recorded PERs of over 300.

Graphic 3. IHSG Growth at The Highest Pace



The rise of share prices far beyond levels justified by the performance of the companies concerned signaled the formation of a financial bubble. Soaring stock prices not supported by economic performance reflects the formation of a financial bubble. Before 1997/98 crises, Composite Indexes of JSE has experienced the highest growth among Asian stock exchanges, and when the capital out-flow occurred after the US financial market collapsed JSE indexes dropped at the lowest rate.

Graphic 4. IHSG Fell The Lowest after 2008 Crisis



Artificial growth of banking sector

The growth of the banking sector was largely an illusion. Over the last year, the banking industry recorded sharply higher profits. The Net Interest Margin (NIM) for 2007 was 5.7 percent, one of the highest in the world. The wide gap between interest rates on loans and savings generated profits, which attracted investors into the banking industry. The banks' share prices skyrocketed as a result. Yet profitability in the banking sector was not supported by strong fundamentals, for example credit growth. In 2006, bank credit by only 14 percent, followed by 25 percent in 2007. But consumer credit was the fastest growing sector.

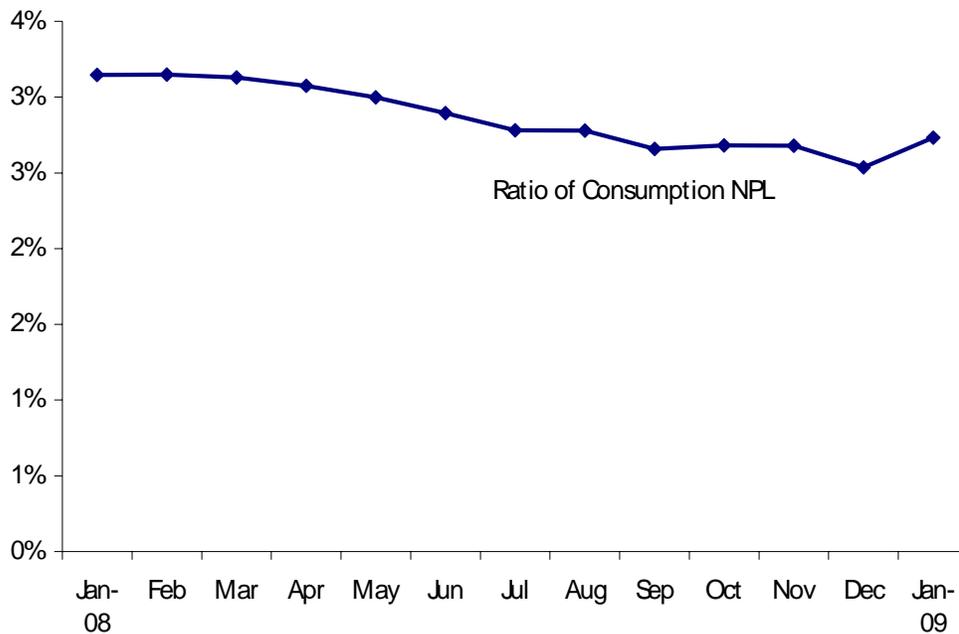
Indonesian subprime loans

Since 2007 the financial bubble has grown quickly and consistently, extending in early 2008 to the property, consumer credit such as motorbike loans and credit cards. One among others was credit on commercial property. The boom in commercial property investment has not been met by an accompanying increase in demand. Occupancy rates have fallen as result of the slow growth of investment. In 2007, gross investment

increased by only 8 percent from the low levels of the year before. If a correction comes in the property market, we can expect rapid consolidation as smaller investors lacking financial muscle and possessing less diversified portfolios are taken over by the bigger players.

Another model of subprime loan is the huge of motor cycle loan. Poor public transportation has caused high cost transportation. This condition has encouraged families of the middle-lower class to prefer using motor cycle. It was inexpensive and practical. As a result, motor cycle loan was booming. Until 2007 at least there were 5 millions motor cycles in Indonesia, of which three fourth were sold through leasing companies. Motorcycle sales were very loose as often executed without down payment and to the lower income group of society. Nearly half of the motorcycle loan was subprime credit.

Graphic 5. NPL of Consumers Loan

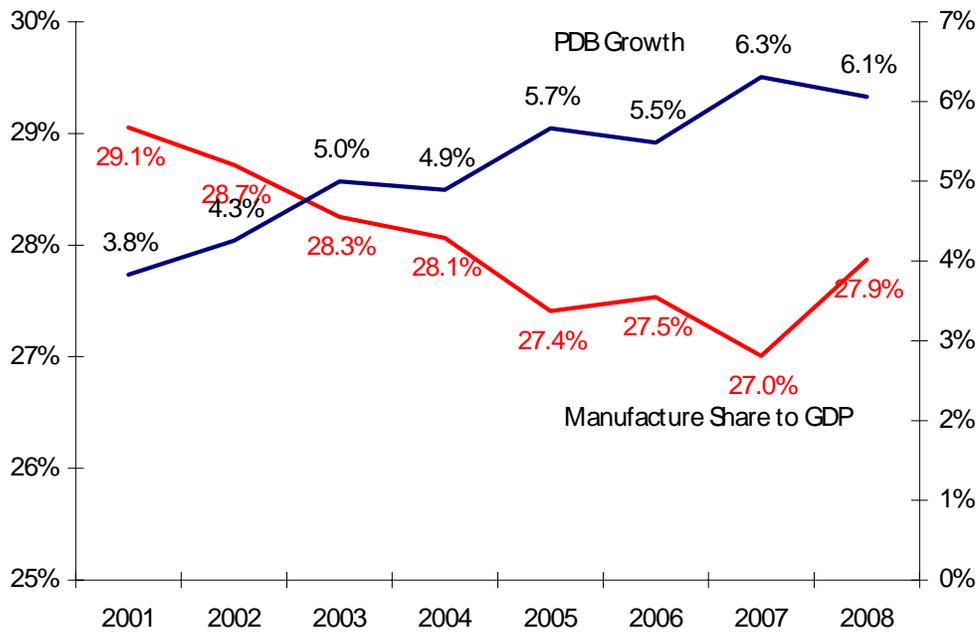


Acceleration of deindustrialization

Sharply rising asset prices slowed down the development of the real sector. The high rate of return on financial assets drew capital out of productive investment and into

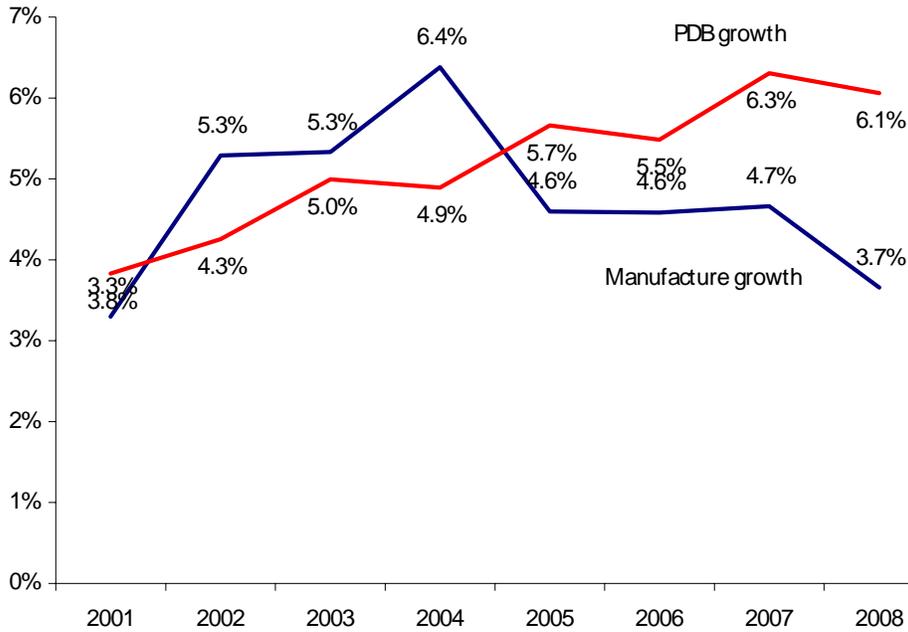
speculative investments in shares and properties. The economy became increasingly unbalanced, with the financial sector forming a bubble amidst a sinking real sector. The relationship between the real and financial sectors became increasingly strained.

Graphic 6. Acceleration of Deindustrialization

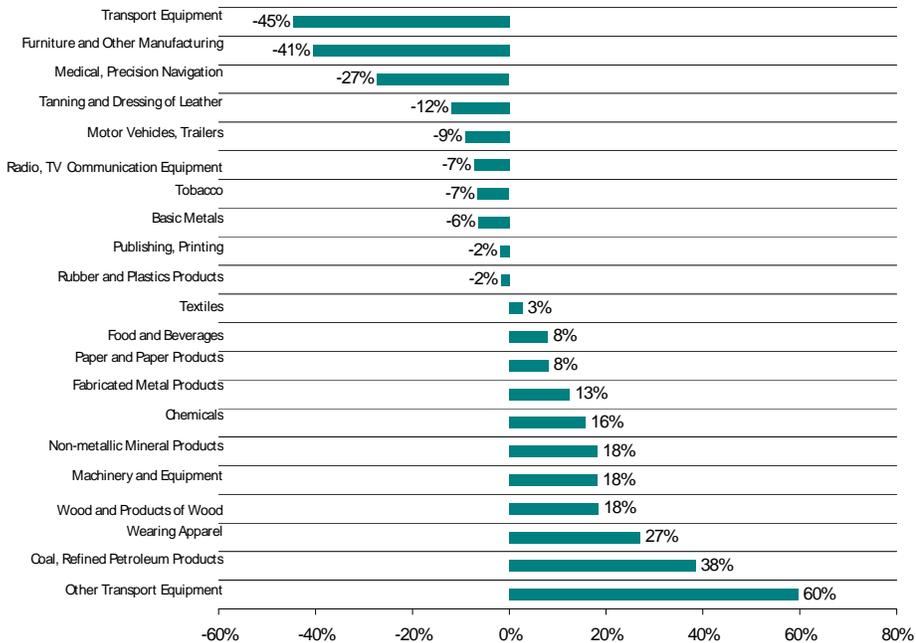


Theoretically, deindustrialization will take place when the share of manufacture to GDP is nearly 50 percent. The role of manufacture industry will be replaced by services. However, it does not occur in Indonesia as deindustrialization prematurely takes place even when its share to GDP is still less than 30 percent. It means that decreasing role of manufacture sector is not caused by industry transformation from manufacture sector into services sector, but because the industry is not competitive. This is also the root of poverty problems and increasing unemployment.

Graphic 7. Manufacture Growth and Economic Growth



Graphic 8. Sectors with Negative Growth



The contradiction between the strong financial sector performance and slow real sector growth including the acceleration of de-industrialization is a dangerous development.

Rising asset prices are vulnerable if not supported by increases in productivity, competitiveness and investment in the real sector. If unsupported by improving fundamentals, rising asset prices will form financial bubbles that will eventually deflate slowly or burst. If the bubble deflates slowly the economy will experience a soft landing with minimal long term effects. If the bubble bursts suddenly as a result of an external or internal shock, the economy will suffer a hard landing with far-reaching and complex consequences.

B. Policy Response: Repeating the Same Blunder and Disengaging Real Sector

Potential blast of financial bubbles should be anticipated by deflating the bubbles very slowly. For instance, to manage hot money flows the government of China implemented capital control policy. This policy was very dynamic by using incentive and dis-incentive to manage the hot money flows. After the post crisis era in Asia, China loosened the policy, while in August 2008 China strengthened the control, for instance: all-cross-border flows of foreign exchange funds recorded as entries of trade account must be truly the results of trade transactions.

The same method has also been applied by other countries like Thailand, which has various measures to prevent Thai Baht speculation. One among others, Thailand implemented policy that financial institution are required to withhold 30percent of foreign currencies bought or exchanged against the Thai Baht, except those related to trades in goods and services, or repatriation of investment abroad (FDI) by residents. After one year, customers can request for refunds. Otherwise, they would be refunded only 2/3 of the amount.

Indonesia did not adopt the same policy. Financial liberalization has been accelerated without applying more prudent regulation. Therefore, hot money flow increased significantly. In the case of 1997/98 crisis, the flow of hot money during the last five years before the crisis was only US\$ 14.8 billion, while of the same period in crisis 2008 was US\$ 24.5 billion. This is one of the reasons for the conclusion that the economic crisis in 2008 would have bigger impact to Indonesia, in addition to other reason, such as:

slowing down world demand, decreasing price of Indonesian export products, ratio of foreign reserve/import, etc.⁴

Increased the interest rate

Having different financial conditions when the crises occurred in 1997/98 and 2008, the government responded with almost similar policy. Firstly, the central bank increased the interest rate. The decision of Bank Indonesia and the government to impose a tight money policy demonstrated that the government had learned nothing from the 1998 crisis and still followed the IMF/World Bank recipe that failed so dramatically in the earlier crisis. The IMF/World Bank line transformed a monetary crisis into a wider and deeper crisis of the real economy.

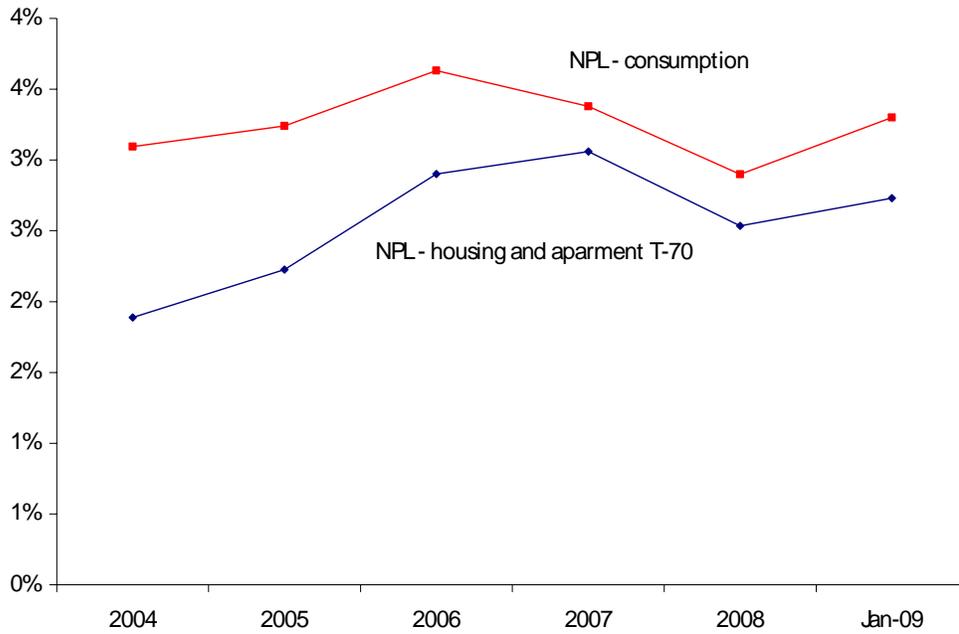
As we have discussed about the policy response on 1997/98 crisis, recommended by the IMF and imposed by Minister of Finance and Bank Indonesia Governor, Indonesia implemented the super tight money policy in September and October 1997. This policy spelled the end of the Indonesian financial sector. Banks desperate for liquidity were hit with interbank rates that doubled, tripled and quadrupled. Healthy banks were drained of liquidity, leading to bank runs, made worse by the recommendation of the IMF to close 16 troubled banks without adequate preparation. This was a fatal move that pushed the Indonesian economy over the edge.

Amazingly, the IMF's flawed recommendations of 1997 are being implemented once again in October 2008. Interest rates are being raised even as the US, Europe, China, Japan, Malaysia and just about every other country affected by the crisis lowers rates and pumps liquidity into the financial system. Bank Indonesia with the support of Minister of Finance decided to raise interest rates because two months before the IMF had suggested that Indonesian should do so. Bank Indonesia's decision to raise interest rates demonstrated that Indonesia did not learn from past errors.

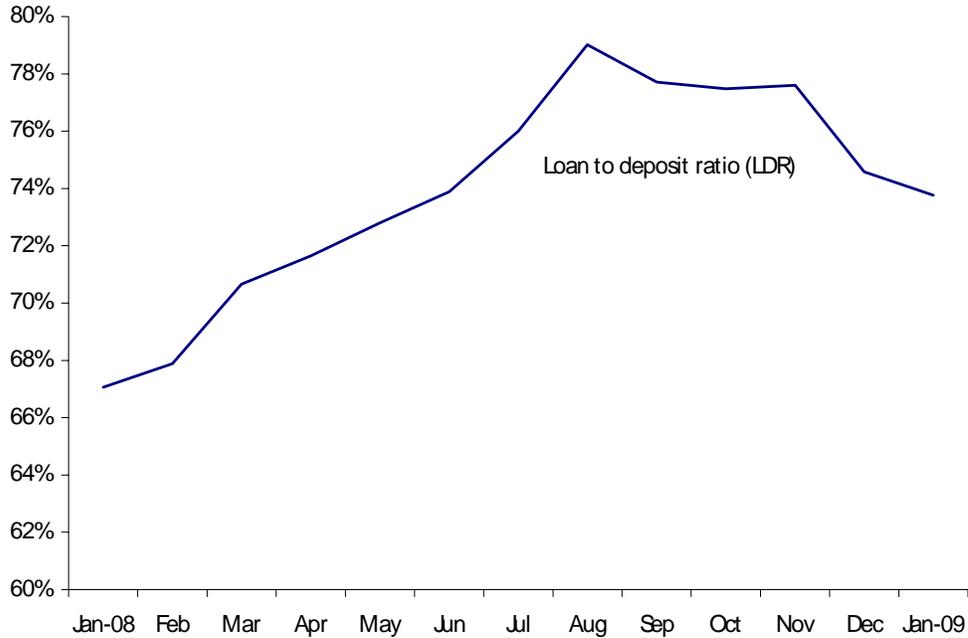
⁴ See discussion on the comparison of Impacts of Crisis in 1997/98 and crisis in 2008, "Neoliberal Didn't Work in Indonesia, What Else?", Hendri Saparini, Ph.D.

This decision was taken to encourage capital inflows and compensate for the fall in international commodity prices. But it is fatal for the wider economy. The burden on borrowers has risen and the business community would be forced to pay high rates for access to credit. Our concern was proven, business activities have been affected, while the growth become slowing down even until recently.

Grafik 9. Non Performing Loan, Consumption and Housing



Grafik 10. LDR Loan to Deposit Ratio



The buy back policy

Another excessive response of the government was that the government prepared Rp 4 trillion in government funds and has encouraged State Owned Enterprises (SOEs) to buy back shares to lift equity prices. It was not an effective action to cure the economy turmoil, even for only in the capital market. First, the amount was far too low to save the financial market against the waves of capital outflow. The decision to push SOEs to buy back stocks up to 50 percent without General Share Holders meeting shows imprudent action in decision making. This decision has also shown unsupportive policy to small investors as 60 percent of Indonesian money market was controlled by hedge fund and foreign investor. The government is therefore prioritizing the use of SOE funds and the government budget to bail out financial elites. Funds that should be used to create jobs and promote real sector growth for small and medium scale enterprises is being used to protect speculators.

Secondly, this policy response represents misuse of public funds and will turn into the tragic story of Bank Indonesia liquidity credits in 1998. All sources of public funds,

including SOEs and the national budget, must be used to strengthen the domestic economy through infrastructure development, the promotion of growth in the rural economy, and the development of strategic industries that are competitive and labor intensive.

Fiscal stimulus policy

As other countries have also taken into action, Indonesia has also given fiscal stimulus to the economy to boost up economic growth. Despite the huge amount of the stimulus, around Rp 71,3 trillion (US\$ 7 billion) or 6.8 percent of the government budget, 81 percent of the fund is realized in the form of tax saving, tax subsidy and import substitution. By applying this allocation strategy, fiscal stimulus will not be effective to save Indonesian economy. Firstly, this policy scheme will reduce the potential tax income, and the number of citizens to receive the stimulus was quite limited since the number of tax number holder (NPWP) was only 10 millions out of 230 millions people. SMEs would not enjoy the stimulus since the majority of SMEs were not tax number holder. And the number of people belonged to this group was very vast, around 99 percent of 40 million business unit in Indonesia are grouped into medium, small and micro business with no tax number holder.⁵

Secondly, in the current economic condition, stimulus effectiveness not focused on direct spending program would be very low as it would not give direct effect in creating new jobs and increase power purchase of public at large. The effect of fiscal stimulus would be quite different if the stimulus program was prioritized on government spending. This method would create significant multiplier effect on domestic economy. In the United States, President Obama even required that fiscal stimulus must be used to buy American products.

⁵ Definition of business in Indonesia: micro business has less than 5 labors; small business has 5-19 labors; medium business has 20-99 labors. As the characteristics of micro, small and medium business mostly work on labor intensive industry with simple technology, the definition shows tht the size of SMEs in Indonesia is relatively smaller than that of developed countries.

3. Conclusion

Reviewing the policy response of the government of Indonesia in two economic crises, it can be concluded that, **first**, the government has not taken the experience in 1997/98 crisis as a lesson to learn. The government of Indonesia made the same blunder in anticipating and curing the crisis. Even after more than 10 years, the government of Indonesia sees the financial bubble as an achievement to be proud of and promotes the hot money flow, directly or indirectly. As a consequence, there is no effort to closely manage the hot money flows.

On one side, hot money is able to bubble-up the financial assets in Indonesia, while on the other hand it can also deflate the financial system. The absence of regulation on hot money – or even considering hot money as an achievement – has brought Indonesia to a more vulnerable condition. The more hot money flows in to Indonesia, the more risks Indonesia has to face. There are many Asian countries have realize the danger of hot money in-flows, therefore Indonesia has to control the flow of hot money.

Secondly, another lesson from the crisis management in 1997/98 was fiscal management during crisis. As previously explained, Indonesian crisis in 1997/98 had burdened with additional huge debt. In anticipating current crisis, the government should minimize the amount of new debts as the nation's debt stock has been very huge. Although the ration of debt stock to GDP has been decline from 46% (2004) to 33% (2008), the amount of debt stock has been very huge, Rp 1.666 trillion or 1.6 times government budget. That amount has surely burdened the government budget. In the government budget 2009, total amount of debt and its interest is estimated to reach Rp 162 trillion (16% of total budget), the biggest expenditure of the government. For the comparison, development expenditure of the government is only Rp 71.9 trillion. Bigger debt burden would become a potential harm to the economy when Indonesian export weakens and investment stagnant.

The first step to hold budget increase is by reducing budget deficit. The government response to raise deficit in government budget 2009 to almost 3 times from Rp 51 trillion to Rp 137 trillion will encourage debt increase. There is another measure to use the government budget as economic stimulus without raising deficit, i.e.: reallocating inefficient government budget. Instead of taking necessary measure without increasing debt stock, the government of Indonesia has done otherwise. At the first stage, the government has adopted agreements with countries and institution involving new debts of US\$ 5.5 billion.

It is estimated that the amount of new debts committed by the government of Indonesia in responding the crisis will still grow. As publicly known in G-20 meeting recently, the main proposal of the government of Indonesia was encouraging the IMF members to increase IMF funds and requesting bigger loan from IMF. Indonesia should have taken an important lesson from 1997/98 crisis. At that time, attached to IMF loan was 130 requirements and conditions of policy that had made the economic structure of Indonesia unstable and unjust. Therefore, any new debt should be avoided by Indonesia for any debt must be followed by a set of requirements that bring consequences to the economy.

Thirdly, policy response has given more concern to financial sector and neglected the real sector as the government chose the hand-offs policy on the real sectors. This will harm the economy. The in-flow of hot money will make financial assets grow very high, but decelerating real sector development. When the return on investment rate in financial sector grows much higher than that of the real sector, investors will tend to invest in financial instruments than in the real sector. As a consequence, the gap between financial and real sectors will grow wider and wider.

For supporting real sector growth, a measure that should be taken by the government is keeping the financial sector stable. Thus, prudent capital control or management must be the first priority requirement of the government. So far, efforts to manage the hot money flows – as other countries have – have never been done. As a matter of fact, if the government wants to push the development of industrial sector in the country, it will need

not only hot money management, but also evaluation on foreign exchange and currency regime.

Fourthly, besides reorienting policy in the financial sector by strictly managing the hot money in-flow and encouraging real sector investment at the same time, the government of Indonesia has to re-orient its industrial and trade policy. As Indonesia is facing a structural problem in the economy, high rate of unemployment and poverty, it needs a new strategy to reposition the role of industrial sector in the economy.

The absence of clear strategy and trade policy, as well as industrial policy, has finally put Indonesia as merely an exporter of raw material. The impact of undeveloped processing industry is the limited room for completely settling unemployment and poverty problems. When the processing industry grows, other benefits will also be obtained. Beside job creation that reduces unemployment, valued added generated from the industry will help foreign exchange balance supported by productivity, instead of hot money in-flow or other external factors.

Indonesia, which has been well known as raw rattan producers, has to develop value added and high competitiveness for rattan-based industries. Raw rattan is not only for export, but more importantly for value added creation. Prior to 1997/98 crisis, Indonesia was the main exporter of rattan furniture and other goods made of rattan, but it changed soon after IMF involved in the crisis recovery process. Under IMF advice, Indonesian raw rattan market had been liberalized, which had forced Indonesia to export raw rattan and made national furniture producers experiencing raw rattan shortcoming. The same is also applicable to tin. As one of the biggest world producer of tin ore, value added must be generated by crating tin processing industry. Indonesia has to play a more important in tin industry, not merely as tin-ore exporter, but also as tin processing center, starting from smelting and finally as a center for tin-base sophisticated products. The potential of developing tin-based products is very high as the demand and price are growing.

Global economic crisis that has been occurring should become the best moment for Indonesia to review and reorient its policy on industry and trade, which has been vulnerable and aimless to develop the competitiveness. Currently, in facing severe and long lasting global crisis, every country will choose the best trade and industrial policy for the national interest. Even during the G-20 meeting in London, the future of free trade has been in question, for all countries will surely forget the free-trade construction when it comes to national interests.

Should Indonesia take measures to develop its manufacture industries, Indonesia would recover with much better economic fundament and stronger economic structure. Foreign exchange balance will not be merely supported by primary commodity prices in international market or by hot money in-flow, but by productivity and export growth of value added products. Indonesian economy will recover along with decreasing unemployment and poverty, unlike that of 1997/98 crisis. Post 1997/98 crisis, economy growth at 5-6% per year, but the structure of the economy has been more fragile, while problems of unemployment and poverty have not been solved, yet.