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Research Focus

Indonesia's choices facing the global financial crisis

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A favourite saying among Indonesia scholars at the Australian National University is that 'This is a very interesting time to be in Indonesia'. The statement is never inappropriate: it is always an interesting time to be in Indonesia. And with the global financial crisis now beginning to bite, it is even more interesting than usual for policymakers in the central bank (Bank of Indonesia, BI) and ministry of finance. The list of monetary and banking issues with which they need to deal is long, and the appropriate policy solutions are in no case obvious.

Indonesia's inflation was twice as rapid as targeted in 2008, and still needs to come down quite a bit more if the 2009 target is to be met. Rapidly falling commodity prices in the second half of 2008 helped slow inflation. This process is unlikely to go on for long, however, so monetary policy will yet have an important role to play. The exchange rate became quite volatile toward the end of 2008 and, although it is less so now, there has been ongoing depreciation over the last couple of months. This is a problem for domestically oriented firms that have borrowed in foreign currencies, while on the other hand it is a boon for producers of tradable goods and services facing declining demand.

While economic growth was around six per cent last year — a wonderful result in comparison with many other countries — there was a sudden turnaround in the fourth quarter. Growth turned negative, although this was mainly due to seasonal factors affecting the agriculture, livestock, forestry and fisheries sector. Excluding this, growth was a little below zero. A large fiscal stimulus package is now being introduced in an attempt to prevent job losses. But this raises the question of whether monetary policy should also be focusing on growth, in addition to inflation and the exchange rate.

At the very least the authorities want to be sure there is no banking system collapse that would result in a reduction in lending. The size of bank deposits covered by the government's guarantee has recently been increased by a factor of 20, yet the guarantee still covers only about 50 per cent of the total value of deposits. If conditions deteriorate, there is every possibility of a run on the banks by large depositors. Should the guarantee be extended to include all deposits? This would imply a huge contingent liability for the government of around US$150 billion, which cannot be taken lightly. The last time a blanket guarantee was provided, 11 years ago, all the big banks did become insolvent, and the ultimate cost to the government — and therefore the Indonesian public — was about US $50 billion.

If the deposit guarantee is not extended further, and if there is a bank run, this would be accompanied by a run on the currency as well, because it is only overseas that relatively safe assets can be found in large quantities. Should the Bank of Indonesia respond to large scale capital outflow by selling down its international reserves in order to keep the exchange rate from depreciating? Supporters of this approach argue that any depreciation of the currency signals weakness and thus generates more capital outflow. Recall, however, that it was precisely this strategy that led the Bank of Thailand to sell off all its international reserves back in 1996–97, after which it was forced to float the baht — which, in turn, precipitated the Asian financial crisis. Moreover, a fire cannot burn without fuel. If sudden capital outflow is driven by the fear of depreciation, then allowing that depreciation to occur quickly will put an end to the outflow, because the opportunity to avoid a loss or secure a windfall gain will no longer exist.

The Bank of Indonesia is responsible not only for monetary policy, but also for supervision of the banking system. Given this second role, it now needs to think about the current stance of prudential regulations relating to the banks. In particular, it needs to consider whether the regulations on capital adequacy are strong enough. Some of the most reputable banks in the world suddenly have been found to have insufficient capital relative to the risks they were carrying. Only a supreme optimist would imagine that this is not a plausible threat in Indonesia.

As it happens, the average reported capital adequacy ratio is twice as high as the regulatory minimum of eight per cent, so a doubling (say) of this minimum would not be a problem for the average bank. But banks with relatively less capital would be obliged either to inject new equity or to cut back their lending. Would this be inappropriate in current circumstances? The counter argument is that continuing to encourage relatively weak banks to expand their portfolios is a risk not worth taking at the time when world famous banks are having to be taken over and recapitalised by their governments.

Already one small bank has failed and been taken over by the authorities. If it is decided not to provide a blanket guarantee of all deposits, the authorities need to be ready with a plan of action if they happen to be confronted with a run on the banks. One possibility would be immediately to freeze the operations of any bank facing a run, and to appoint an independent, temporary management team. The first task of this team of financial administrators? would be to undertake a very quick, conservative estimate of the value of the bank's assets. If this was judged to be less than the value of its liabilities, the shareholders would be required to inject new equity without delay. Failure to do so would result in the issue of new shares to depositors and other creditors in return for a 'haircut' sufficiently large to restore capital adequacy to an acceptable level. This would allow banks' solvency to be restored within a matter of days, thus removing the cause of the run. Accumulated losses up to that time would be borne by shareholders and creditors of the banks, rather than 'innocent bystanders' — the general public.

Interesting times in Indonesia, indeed!

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Events

18th March, *The Inaugural Crawford-Nishi Lecture to be held at the National Museum of Australia.* Lecture given by the Minister for Foreign Affairs, Hon Stephen Smith MP. The lecture series is organised by the Australian Japan Research Centre (ANU), and the Australia Japan Foundation.

Crawford Seminars

3rd March, *Post-Conflict Governments 1975-2004: Determinants of Success,* Catherine Riordan, Seminar Room 4, Crawford Building 12:30 pm - 1:30 pm

6th March, *ASEAN's response to the Global Financial Crisis*, Hadi Soesastro, Crawford Boardroom 12:30 pm - 3:00 pm

10th March, *China's response to the financial crisis*, Yiping Huang (Managing Director and Head of Asia Pacific Economic & Market Analysis (EMA) in Citigroup, Hong Kong), Seminar Room 4, Crawford Building. 12.30 – 1.30pm

Asia Pacific Economic Papers

No 377, *Expansion Abroad and Jobs at Home: Evidence from Japanese Multinational Enterprises*, Nobuaki Yamashita and Kyoji Fukao (2009)

No 378, *Japanese FDI in China: determinants and performance.* Shiro Armstrong (forthcoming)

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