

## RETHINKING OF MY EXPERIENCE AS A MINISTRY OF FINANCE: STABILIZATION IN A PERIOD OF TRANSITION; INDONESIA 2001 –2004

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### ABSTRAK

*Artikel ini menggambarkan bagaimana proses kebijakan ekonomi dilakukan dalam praktek berdasarkan pengalaman di Indonesia sewaktu masa pemerintahan Megawati 2001-2004. Pada tahun 2001 ekonomi Indonesia mengalami ketidakstabilan makro yang bersumber dari hilangnya kepercayaan para pelaku ekonomi terhadap kebijakan pemerintah. Di sini ditunjukkan langkah-langkah apa yang diambil untuk mengembalikan kepercayaan tersebut, hambatan-hambatan apa yang dihadapi dalam praktek terutama karena Indonesia juga sedang mengalami masa transisi politik yang mendasar. Prinsip ekonomi yang melandasi kebijakan pemerintah cukup sederhana, namun yang rumit adalah penerapannya dalam praktek. Hambatan politik-ekonomi itu satu per satu diselesaikan dan hasilnya adalah ekonomi Indonesia yang stabil dalam tahun 2004. Satu hal yang belum dapat dicapai pada waktu itu adalah bagaimana meningkatkan investasi dan pertumbuhan ekonomi yang cukup tinggi untuk mengurangi pengangguran dan kemiskinan. Ini memerlukan pembenahan struktural untuk memperbaiki iklim usaha dan iklim investasi yang sifatnya berjangka menengah dan panjang. Inilah tantangan yang harus ditanggulangi oleh pemerintahan sekarang tanpa mengorbankan stabilitas ekonomi yang sudah dicapai.*

**Keywords:** *Government policy, fiscal policy, monetary policy.*

This paper is about government policies to stabilize an economy suffering from prolonged consequences of a financial crisis while the country is undergoing a profound political change. That problem setting is a rough depiction of what Indonesia has been facing in the past seven years or so. My story relates to the last three years of that period, drawing on my own experience as a member of the economic team in the Megawati government. My account of the events will inevitably be personal and therefore subjective. I do not know whether lessons can be learnt for other countries, but I do think that Indonesia should learn from the experience. I will proceed by describing first the basic thoughts behind the policy, then the environment in which the policy had to be implemented and finally the results of the policy.

### THE POLICY

Let me start with the background that influenced the policy.

Indonesia has passed the worst of the crisis, thanks to the early efforts at stabilization. However, when the Megawati government took office in August 2001, that is full four years after the crisis began, the economic situation of the country was still far from normal. Growth was feeble at the annual level of 3 per cent, the Rupiah was excessively depreciated and very volatile, inflation and the basic interest rate were at the high teens, our public debt was as big as our GDP, and although the worst had past capital was still flowing out of the country on a significant scale. Our relation with the IMF with whom we still had an ongoing program, and by

extension our relation with the international community at large, was at a low point, which of course did not help.

Since most of us in the economic team were close observers of the country's development before we joined the cabinet, we were able to quickly come to a diagnosis of the problem. We agreed that the cause of all the troubles was in fact a general lack of confidence among economic actors in the prospects of the economy. It was the case of runaway expectations that needed to be anchored. More specifically, we saw that the root of the problem was the widespread perception that there was no credible economic program with credible implementation.

As the first step in our bid to restore credibility and regain market confidence we immediately reopened our negotiation with the IMF. After a marathon discussion for two weeks, we were able to come to an agreed program. We were also aware that the negative perception was partly caused by the fact that in the past numerous policy actions were promised but undelivered. So we took extra care in negotiating the details of the program. We wanted to minimize the risk of broken promises. We in the economic team agreed to deliberately tone down our rhetoric, especially when we talked to the market.

Without going into the details, the core of the program focused on two themes: fiscal consolidation and financial sector (especially banking sector) restructuring. These were the two areas where, in our view, the market most wanted assurance from the government. On these two policy themes we were in substantial agreement with the Fund. The main objective was to trigger a kind of "virtuous cycle" where improved confidence would lead to more stable and stronger Rupiah, lower inflation, lower interest rate and higher growth. We were hoping that the improved confidence would eventuate as the market began to believe that we meant what we said.

Given the prevailing situation at that time, we frankly did not see any alternative "models" that could give us better light or more helpful guide for actions than the one implied in the program. Our study indicated that similar mechanism had worked in other crisis hit countries, and I learnt it also had in the United States during the first Clinton period. So we launched the program with a bit of confidence of our own.

The swiftly agreed program with the Fund immediately soothed the market. But it presented the government with some problems in the domestic politics. Our relations with the IMF had been a contentious issue all along. In the ambience of prevailing politics, even an agreement resulting from earnest discussions and a long process of negotiation, as it was, could easily be depicted as a proof that the government succumbed to the Fund's wishes. Without appropriate management of the situation, that could spell problems for the implementation of the program. I will come back to this later.

## **THE ENVIRONMENT**

The policy had to be put to work in the real world setting. The environment in which the policy was to be implemented clearly had an important influence on the outcome. Here I can only give you a partial sense of it by describing the implications of three issues: first, the extended process of political transition; second, the controversies surrounding our relations with the IMF and third, the problem of coordination between the government and the central bank.

There is little doubt that the lingering uncertainties associated with the extended process of political transition have been a central factor in Indonesia's slow economic recovery. Complications arise when we implement economic policy in a fluid environment, where the basic rules of the game are not well established. Although some progress has been made, such setting has

generally been the policy environment in Indonesia in the past seven years and likely for some years to come.

During the Habibie period the political situation was very unsettled. I cannot remember a single day passed by without a demonstration in front of my office in Bappenas.<sup>1</sup> When Abdurrahman Wahid took the presidency over noisy public oppositions began to subside but then the relation between the government and the all powerful parliament grew increasingly strained, culminating in a change of government. During the subsequent Megawati administration public protests were still occurring, though more occasionally, but the relation with the parliament began to improve. However, one problem has persisted, namely the rules of the game governing institutions continue to be fuzzy. That has often created problems when a policy is being implemented on the ground. Let me elaborate it a little.

The cabinet was not immune to the “fuzzy rules” problem. As a result, the fate of your proposed policy depended, more crucially than in the more established system, on your personal approach and rapport with key cabinet members and of course with the president.

The “fuzzy rules” problem presented itself most notably in the decision making process that involved the parliament. Although as I said earlier the relation between the government and the parliament during the Megawati period had begun to improve, to secure the necessary approvals from the parliament for a policy continued to be an uncertain and, often, long and winding exercise.

In the environment of change where the balance of power between the executive branch and the legislative branch had been

radically redefined, many grey areas emerged when you put the system into practice on the floor of the parliament. So, when a policy proposal was tabled, a considerable amount of time often had to be expended on agreeing on procedures as much as on the substance. I do not know whether that is also the case in other countries. But being no politician myself, at times I found it to be rather confusing, and a bit exhausting.

In spite of those hurdles we were able to get most of the major policies approved and the necessary legislations passed.

Let me now turn to our relations with the IMF. As I mentioned earlier this was a contentious issue all along. The group expressing disapproval of the IMF, and our involvement with it, was in fact an amorphous one. It included those who were ideologically against international capitalism and globalization, those who had joined in the recent waves of criticisms of the Bretton Woods institutions, those who squarely blamed the IMF for getting us into the terrible crisis, those who did not like to see us being “ordered around” by the IMF, and those who had a general dislike of any Western creation.

Be that as it may, the government was placed in a dilemmatic position. On the one hand, we in the government saw the imperative of getting the support of the IMF in order to implement the necessary policies to win back market confidence. On the other hand, we knew that it was unpopular. But we opted to implement the policies and tried to manage the situation as best as we could.

In the cabinet there was none like a consensus view. Fortunately, there were two things that saved the situation. First, the three ministers most directly concerned with the program with the IMF (that is, the coordinating minister, the minister of finance and the minister for state enterprises) and the central bank governor shared a more or less common view. Second, the presidential cabinet system, even though it was formed through some kind

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<sup>1</sup> For an account of policy making process during the Habibie government, see Boediono, “The IMF Support Program in Indonesia: Comparing Its Implementation Under Three Presidents”, in *Bulletin of Indonesian Economic Studies*, Vol. 3, December 2002.

of coalition building processes, meant that the bottom line for a policy was the consent of the president. Most of our proposals eventually got approval or support from the president, though often only an implicit one.

In the parliament the broad questions relating to our continued engagement with the Fund had of course surfaced from time to time. But it turned out that intensive debates generally occurred on specific policies, such as the fiscal policy stance, subsidies, privatization plan, bank restructuring policy and the many draft laws that the government proposed. I must say that it was a relief to learn that the more political issues on the IMF had not distracted the focus on specific policies. I guess if you are an optimist you may take it as a testimony that however imperfect it might still be, democracy in Indonesia could lead to results. My experience also indicated that even in the rough and tumble of politics the usual human dynamic was at work and personal approach made a difference. As by necessity we interacted with each other more intensively, better rapport developed and smoother discussions followed.

In contrast to what happened in the cabinet and in the parliament, in public forums our program with the Fund continued to be a favorite sport for commentators. Here, I think part of the problem lay with the government who had not done well in explaining its policies to the public. The present government seems to realize this and is making some effort to remedy it. But I suspect the question of our relations with the Fund and indeed with the international community at large will continue to be an issue that has to be managed with caution for some years to come.

A good coordination between fiscal policy and monetary policy, and more to the point between the government and the central bank, is obviously key to any successful stabilization program. Yet it was precisely this one thing that was missing during much of the Abdurrahman Wahid period, with the inevitable consequence of continually eluding stability. The relation between the two vitally

important institutions for macroeconomic stability was then under such strain that substantive communications between them practically ceased.

Looking back, the reason for it appears to be as much about substance (that is central bank's independence versus its accountability) as about "practical politics" that had broken loose and clashes of personality. The situation was clearly untenable that its resolution must be at the top of the list for the new government. But to do that some sticking points needed to be ironed out.

The most sensitive matter related to some articles in the revision of the central bank law earlier proposed by the government, which central bank officials regarded as a thinly veiled plot to remove the incumbent governor and some members of the board. The new government agreed to drop the controversial articles thus relieving immediately an important source of tension. However, other items that contained proposed improvements in the accountability of the central bank had remained on the agenda. Although the debates on the law dragged on until mid 2003 when the law was finally passed, the relations between the central bank and the government, thanks to efforts by officials on both sides, had progressively improved since that initial gesture.

The second sticking point was the question of how to share the burden of the liquidity support that Bank Indonesia provided, and much of it was lost, to avert the collapse of the banking sector during the crisis. Since the Abdurrahman Wahid period the issue had become so politicized that it was impossible to come to a rational solution. It was only well into the Megawati era that, after many meetings, the central bank and the government agreed to move forward by seeking the view of an independent party (which happened to be Paul Volcker and associates). It was also agreed, wisely I think, to involve the parliament early to smoothen the approval process. In 2003 the issue was at last resolved.

Again the experience in resolving the coordination problem between the government and

the central bank demonstrates that personal gestures and approaches do matter, sometimes a lot.

## THE RESULTS

We now come to the results of the policy.

Did it work? I think the answer is yes, but with one qualification. Over the three years, from the third quarter 2001 to the third quarter 2004, the Rupiah had strengthened appreciably, the exchange rates had become steadier, inflation and basic interest rate had dropped from high teens to respectively around 6 per cent and slightly below 7.5 per cent, public debt to GDP ratio had declined from close to 100 per cent to around 60 per cent and was projected to continue declining, budget deficit had been contained below 2 per cent of GDP even during the elections year of 2004, overseas funds were returning and one indicator of market confidence – the Jakarta stock price index – had almost doubled from around 370 to over 800 (it has now passed 1000).

Over those three years economic growth had edged up steadily from an annual growth of around 3 per cent to around 5 per cent. But many think, and I agree with them, that this is a rather unremarkable performance considering other economies equally hard hit by the crisis, such as Korea and Thailand, had rebounded very strongly once they passed the worst phase of the crisis. Certainly, that level of growth had hardly made a dent on the biggest social problem confronting us post-crisis – namely, unemployment – which has persisted at around 10 per cent with signs of worsening recently. One estimate suggests that the country has to grow in the range of 6 – 7 per cent for at least 3 – 4 years before one sees a firm turnaround in the unemployment rate.

Why didn't growth pick up more quickly? If we look at the numbers we see that for the most part of the past three years the main driving force of growth was consumption

spending while investment and exports were weak. Seven years after the crisis the investment ratio was still closer to the crisis level of around 20 per cent of GDP than to the typical 30 per cent level before the crisis. And despite the substantial depreciation of the Rupiah, non-oil exports continued to be sluggish.

It is clear that the last link in the “virtuous cycle” that we projected, lower interest rates that would lead to higher growth, was still missing. It seems to me that there existed some “supply side” hurdles and institutional constraints that had stood between the return of stability and lower interest rates on the one hand and the revival in investment and growth on the other.

One important hurdle – political uncertainties surrounding the elections and change of government - is now gone. However, other constraints have remained because many of them by their nature can only be overcome in the medium or long term. This is a vitally important policy theme that should be the focus of the new government. Concrete problems in such areas as legal processes, taxation and customs, labor laws and regional regulations have been a constant complaint by investors. They have to be dealt with. Some steps have been initiated, but much remains to be done. What we need now, I think, is a fully worked out medium term action plan focusing on the improvement in business and investment climate.

## REFERENCE

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