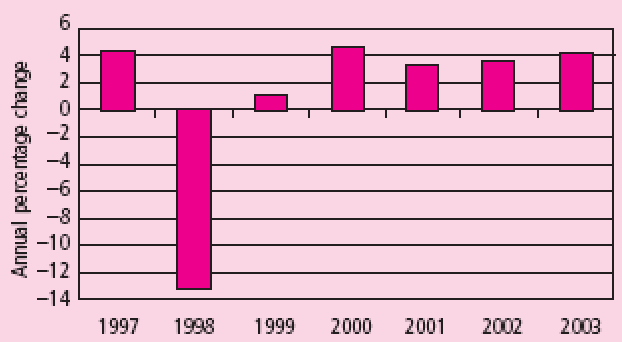
The lessons of financial crisis in Indonesia

Case taken from The International Business Environment, second edition (Palgrave, 2006), by Janet Morrison

Indonesia was particularly severely affected by the Asian financial crisis, which was compounded by social and political turbulence. With a population of 212 million people, Indonesia is the world's fourth most populous country. It is also one of the most geographically dispersed and ethnically diverse. While nearly 90 per cent of its people consider themselves Muslims, there are some 300 ethnic groups clustered on about half the 3000-mile stretch of 13,000 islands that make up the country. Indonesia's colonial legacy was a mixture of Dutch, Portuguese and British, leaving a fragmented structure which is still evident. The 32-year military regime of President Suharto brought national unification and economic growth, but the regime was dominated by patronage and corruption. This legacy has been difficult to overcome. Following the currency and banking crisis of 1997, the IMF launched a $43bn. assistance programme conditional on austerity measures, but the economy deteriorated alarmingly, violent unrest erupted and Suharto was forced out of office. The IMF suspended its assistance until a new interim government could be established in 1998. Critics of the IMF approach argue that, while austerity measures were appropriate in the high-spending countries of Latin America, they were ill conceived in East Asian countries such as Indonesia where they triggered a recession, exacerbating poverty and unemployment (Stiglitz, 2000). Recession in Indonesia was particularly devastating, due to the ethnic divisions which led to social and political turmoil. Indonesia's GDP plummeted in 1998 (see figure), making it the worst hit of the countries affected by the Asian crisis (Donnan, 2003).



Indonesia's GDP: effects of the financial crisis

Sources: Donnan, 19 December 2003; *The Economist* (2004) Indonesia: Economic data, at http://www.economist.com.

The transitional government paved the way for elections in 1999, which saw the first democratically elected president take office. However, economic and political stability still seemed a long way off. The young democracy has faced extreme problems of tackling entrenched interests in pushing through reforms of the banking system, the legal system and corporate governance – all of which have been slower than hoped. Because of the slowness of reform, the IMF briefly suspended lending in 2000, but then altered its policy to one of greater flexibility, recognizing that developed world systems of governance were not realizable instantly and efforts to bring about reforms too quickly could actually deter investors. Among the government's worries are the threats to stability posed by numerous separatist movements, unleashed following the overthrow of the Suharto regime. Formerly Portuguese East Timor has broken away and is now administered by the UN. Gas-rich Aceh province threatens separatism, as do the 'Spice Islands', the Moluccas, half of whose population is Christian.

The government has taken steps to avert a financial crisis in future by building up foreign exchange reserves to $33.7bn. However, the slowness of economic reforms, combined with the weak judicial system and continuing corruption, are still holding back potential foreign direct investors. Indonesia is ranked among the top ten of the world's most corrupt countries by Transparency International (2004). An anti-corruption commission, long recommended by the IMF, was set up in 2003 by the Indonesian Parliament as part of the programme of reforms, but sceptics questioned the credibility of its chairman, a former member of the powerful military faction, which is accused of being embroiled in the country's corruption. Indonesia's prospects of attracting FDI were set back by two terrorist attacks – one in Bali in 2002, in which 202 people died, and one in the centre of Jakarta in 2003, in which 16 people died and 150 were injured. Indonesia's new president, elected in 2004, is aware of potential investors' doubts about Indonesia's investment climate. He has promised firm policies to combat terrorism and corruption, aiming to increase the flows of FDI needed to stimulate economic growth, particularly needed for rebuilding following the devastation of the December 2004 tsunami.

Sources: Mydans, S., 'Indonesia's many faces reflect one nation, divisible', New York Times, 5 September 1999; Montagnon, P. and Thoenes, S., 'Indonesia in a hole', Financial Times, 8 June 1998; Montagnon, P. and McCawley, T., 'Boxed in', Financial Times, 16 May 2000; Burton, J., 'Jakarta blast may deter new investors', Financial Times, 7 August 2003; Donnan, S., 'Relief and resentment as Indonesia prepares to graduate from IMF-dictated reform programme', Financial Times, 19 December 2003; Donnan, S., 'Yudhoyono keen to make reformist mark', Financial Times, 22 September 2004; Stiglitz, J. (2000) 'The insider', New Republic, 22(16/17) (17 April), pp. 56–60; Transparency International (2004) Transparency International Corruption Perceptions Index 2004 (Berlin: Transparency International).

Case questions

In the aftermath of the financial crisis, what reforms have taken place in Indonesia?

What are now the advantages and disadvantages of Indonesia as a business location and investment?

@ Further information on Indonesia's reforms can be found on the website of the Indonesian Ministry of Finance, which is at http://www.depkeu.go.id/Eng