Flexible Exchange rate: beneficial or problematic? : the case of Indonesia

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Questions to be addressed

- Why was Indonesia able to weather the Global financial crisis, Taper tantrum, so much better than the AFC?

- There were some similarities between the responses to the Asian Financial Crisis (AFC) and Taper Tantrum (TT) (expenditure reducing policy, monetary tightening and expenditure switching policy). Why were these effective during the TT but not the AFC?

- What was the role of flexible exchange rate?

Exchange rate regime in Indonesia

- Adopted Fixed exchange rate until 1978 (Dutch Disease)
- Managed floating 1978-1997 (to support export with 5% IDR depreciation)
- $\Pi_{Idn} > \Pi_{w} \rightarrow i_{Idn} > i_{w}$
- This led to an increase in short-term external debt. Short-term borrowings were used to fund long-term projects in non-tradable sectors. Double mismatch: both currency and maturity.
- Adopted freely floating exchange rate (June 1997 due to AFC). Balance sheet effect when Bank Indonesia adopted the flexible exchange rate
- BI adopted an inflation-targeting regime with a flexible exchange rate.

Why did Indonesia survive GFC and TT, but not AFC?

ANNEX 2.1. INDONESIA: CRISES AND FINANCIAL SHOCKS

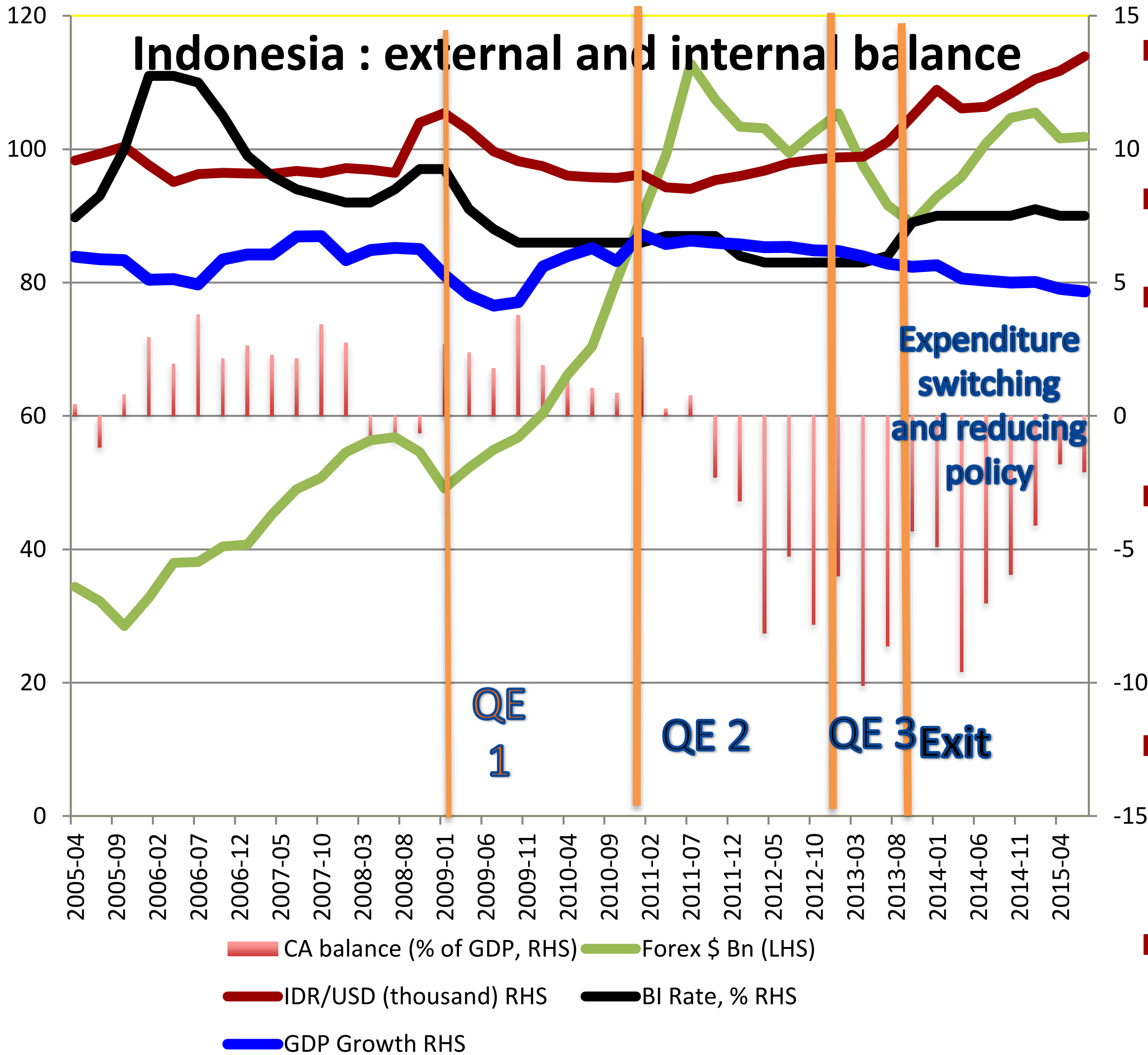
The following table shows a comparison of the effects of the Asian financial crisis, the global financial crisis, and the taper tantrum.

Annex Table 2.1.1. Indonesia: Comparison of the Effects of the Asian Financial Crisis, the Global Financial Crisis, and the Taper Tantrum

	Asian Financial Crisis	Global Financial Crisis	Taper Tantrum
Monetary policy	Very tight; Bank Indonesia greatly increased interest rates; deposit rates soared to 60 percent at the peak of the crisis; liquidity squeeze	Bank Indonesia lowered interest rates by 300 basis points from 9.5 percent to 6.5 percent Sufficient liquidity	Bank Indonesia increased interest rates by 175 basis points from 6 percent to 7.75 percent
Fiscal policy	Initially targeted a budget surplus, then revised to allow a large budget deficit	Implemented a fiscal stimulus; budget deficit grew, and taxes were reduced	Tightened by cutting fuel subsidies
Banking health	Weak banking regulations; NPLs were at 27 percent, and LDR was above 100 percent	Relatively tight banking regulations NPLs were at less than 4 percent, LDR was at 77 percent, and CAR was at 17 percent	Relatively tight banking regulations; NPLs were below 4 percent, LDR was at 90 percent, and CAR was at 17 percent
Response to banking	Closure of 16 banks, resulting in a bank run	Increased deposit insurance from Rp 100 million to Rp 2 billion per account	
Policy focus	Structural reform through liberalization, dismantling monopolies, and licensing	Maintain a relatively open trade regime	Maintain a relatively open trade regime
Exchange rate regime	Managed floating; Economic actors were unaccustomed to exchange rate risk and did not hedge	Flexible; economic actors were accustomed to exchange rate risk	Flexible; exchange rate was allowed to depreciate in line with market forces

Source: Based on Basri 2015.
Note: CAR = capital adequacy ratio; LDR = loan-to-deposit ratio; NPL = nonperforming loan.

Why is it so difficult for Indonesia to implement a completely free-floating exchange rate?



- Differing monetary policy objectives
- Volatile floating exchange rate
- Balance sheet effects
- Commodity super cycle and pro cyclical fiscal policy
- During TT IDR depreciated by 15-20% during TT, but did create panic
- Policy credibility and communication played critical roles.
- Capital Flows Management

Source: Basri and Sumartono (forthcoming)

Conclusion

- Indonesia did much better in the GFC and TT than in the AFC because: (more flexible exchange rate, prudent fiscal policy, banking reform). Indonesia can minimize the effects of financial shocks by having a more flexible exchange rate.
- However, Indonesia cannot use the exchange rate as the only shock absorber. Indonesia needs policy mix: Concern exchange rate overshoot; multiple objective monetary policy; balance sheet effects; commodity super cycle, CFM
- Policy credibility and communication

Thank you