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8 Conclusions and Prospects

8.1 Introduction

In this chapter, we attempt to explain why Indonesia did not experience a debt crisis in 1982–84. We do so by comparing the Indonesian debt situation with that of Mexico and Brazil, two countries which have debt-servicing difficulties. In section 8.2 we examine the most common explanation for external crises which puts the blame on excessive budget deficits that force the government to borrow from abroad. Section 8.3 identifies the factors which have prevented an Indonesian debt crisis in 1982–84, and section 8.4 estimates the relative importance of each factor by using Mexico as the reference. In section 8.5 we discuss the prospects of Indonesia avoiding a future debt crisis and the role for policy in ensuring such an outcome.

8.2 A Comparative View of Fiscal Imbalances

When a debt crisis occurs because the government is unable to service the external debts that it has guaranteed, it is a truism to claim that government budget deficits, i.e., fiscal imbalances, are the root of all external sovereign debt crises. By definition, an external public debt can be incurred only when a government borrows from abroad to finance part (or all) of its expenditure. In order for fiscal imbalances to have more than a tautological role in precipitating an external debt crisis, it is necessary to have a criterion which would enable one to assess whether the amount of foreign borrowing being undertaken is excessive in an *ex ante* sense.

The statistic usually cited in support of this fiscal imbalance view is the ratio of official long-term debt to GNP, DGNP.¹ The official long-term debt is taken to represent the cumulated amount of fiscal deficits financed by external borrowing, and the normalization by GNP is to indicate the extent to which the country has been made to live beyond its income by the budget deficits.

The fiscal imbalance explanation of external debt crises points out that DGNP rose very rapidly for those countries which experienced a debt crisis.² From a value of 9.1 percent in 1970, Mexico's DGNP increased 18.7 percent in 1981, the eve of the debt crisis. In the same time period, DGNP went up from 8.7 to 19.5 percent for Argentina, from 8.2 to 17 percent for Brazil, from 8.1 to 20 percent for the Philippines, and from 6.6 to 17.2 percent for Venezuela (see top half of table 8.1). It is true that these governments increased their budget deficits significantly during this period, but it is not true that they have been cumulatively more profligate than the countries in the bottom half of table 8.1, which did not fall into debt crises.

Table 8.1 Public and Publicly-Guaranteed Debt as Percentage of GNP, DGNP, 1970-85

| | 1970 | 1975 | 1978 | 1980 | 1981 | 1982 | 1983 | 1984 | 1985 |
|--|------|------|------|------|------|-------|-------|-------|------|
| Countries with serious debt problems in 1982-85 | | | | | | | | | |
| Argentina | 8.7 | 8.2 | 16.0 | 19.2 | 19.5 | 29.1 | 42.6* | 36.6 | 58.7 |
| Brazil | 8.2 | 11.6 | 14.8 | 16.6 | 17.0 | 18.7 | 30.3* | 34.7 | 35.5 |
| Mexico | 9.1 | 13.2 | 25.3 | 18.8 | 18.7 | 33.3* | 50.1 | 43.4 | 43.4 |
| Philippines | 8.1 | 8.8 | 17.8 | 18.7 | 20.0 | 22.7 | 31.0* | 36.0 | 41.7 |
| Venezuela | 6.6 | 4.6 | 17.4 | 18.4 | 17.2 | 18.3 | 19.8 | 36.7* | 34.3 |
| Countries with no serious debt problems in 1982-85 | | | | | | | | | |
| Indonesia | 25.2 | 25.5 | 26.6 | 20.0 | 17.7 | 20.5 | 28.0 | 26.5 | 33.4 |
| Korea | 21.2 | 27.8 | 22.5 | 26.9 | 28.3 | 29.7 | 29.8 | 30.3 | 35.0 |
| Malaysia | 9.7 | 14.2 | 16.9 | 16.3 | 23.1 | 31.4 | 37.5 | 38.6 | 47.8 |
| Thailand | 5.0 | 4.2 | 8.0 | 12.5 | 14.6 | 17.2 | 17.9 | 18.6 | 26.4 |

Note: Figures for 1978 are from 1985-86 edition of the World Bank's *World Debt Tables*, and the rest are from the 1986-87 edition.

*Year in which debt crisis began.

In fact, Korea and Malaysia had the highest DGNPs in 1981. There are just not enough differences in the 1981 DGNPs of Mexico, Brazil, and Indonesia to explain why Indonesia alone avoided a debt crisis in the following two years. The huge jumps in the DGNPs of Argentina, Brazil, Mexico, the Philippines, and Venezuela occurred only after they were unable to service their debts, forcing them to devalue their currencies.

It must be mentioned that DGNP is a flawed indicator of public profligacy. First, the stock of long-term official debt can understate as well as overstate the amount of borrowing for budgetary reasons. This is because the government can borrow short-term to finance budget deficits and long-term to finance foreign market interventions. Second, DGNP is a measure of profligacy only in the sense of living beyond income and not in the sense of being unable to service the acquired external debt. An indicator of the latter would normalize the external debt by the level of exports, the foreign exchange earning capacity of the country.

To us, the most interesting fact from table 8.1 is how much the DGNP of each country soared in the year in which its debt crisis happened. Since the big DGNP movement was the result of a devaluation, this suggests that the pre-crisis DGNPs may have been understated and hence provided misleading impressions to policymakers and bankers. This implies that inappropriate exchange rate management may have been a very important factor in precipitating a country's debt-servicing problem. The currency overvaluation not only understated the amount by which the country had lived beyond its means but, perhaps more importantly, debilitated the export sector, the foreign exchange generator for the economy.

8.3 Explaining the Absence of a 1982–84 Debt Crisis

As we pointed out in chapter 1, a debt crisis does not occur only when the government does not have the reserves to service the loans it has guaranteed. A debt crisis also occurs when the government does not have the reserves to enable private domestic residents to convert their service payments on nonguaranteed debts from domestic to foreign currency. When a private borrower cannot come up with the service payments in domestic currency for his private nonguaranteed external debt, we do not consider it a national debt crisis because the government did not cause the default except in the broadest sense of not creating more favorable macroeconomic conditions, if it were able to do so.

For the case of a debt crisis caused by a shortage of foreign reserves to allow conversion of private debt-service payments, we define the total external debt service to be the sum of external short-term debt and the debt service on all external long-term debt, publicly-guaranteed and private nonguaranteed. We include short-term debt in our definition because we are interested in the financial resilience of a country to sudden protracted credit squeezes in international credit markets which make short-term borrowing extremely expensive, if not occasionally impossible. After all, the 1973–74 credit crunch did precipitate the 1975 Pertamina debt crisis, and the 1980–81 financial squeeze precipitated the PEMEX crisis of Mexico.

Since the reserve position of the country is crucial for avoiding debt crises, it is not appropriate to assess the country's ability to pay by looking at the total external debt service with respect to its income. A more appropriate indicator is the debt-service ratio—the debt service normalized by the level of exports—because the official reserve position is determined primarily by the ability of the export sector to earn foreign exchange. This point is well illustrated by parts (a) and (b) in table 8.2. Even though the 1980–82 debt-service/GNP ratios for Brazil and Indonesia are quite close, Brazil had an average total DSR of over 100 percent compared to the Indonesian average of 30 percent. And Brazil experienced a debt crisis after 1982 and Indonesia did not.

One reason why the Mexican and Brazilian DSRs are so much larger than that of Indonesia is because Indonesia is a much more export-oriented economy. The average 1980–82 export/GNP ratio was 27 percent for Indonesia, but only 14 percent for Mexico and 9.5 percent for Brazil (see memo item in the table).

Even if we ignore short-term debt by assuming (unrealistically) that it could always be rolled over, we see in part (c) of table 8.2 that the long-term DSRs for Mexico and Brazil were still very high compared to Indonesia. The 1980–82 average was 40 percent for Mexico, 62 percent for Brazil, and 14 percent for Indonesia.

Items (b) and (c) in table 8.2 together explain why Mexico defaulted before Brazil even though their total DSRs were almost the same in 1981,

Table 8.2 Debt Characteristics of Mexico, Brazil, and Indonesia, 1978–86
(in percentages)

| | 1978 | 1980 | 1981 | 1982 | 1983 | 1984 | 1985 | 1986 |
|---|-------|-------|-------|-------|-------|------|------|------|
| (a) All short- and long-term debt service as ratio of GNP | | | | | | | | |
| Mexico | 12.0 | 14.1 | 15.5 | 24.8 | 17.4 | 13.9 | 11.8 | NA |
| Brazil | 7.5 | 11.0 | 11.6 | 12.8 | 13.0 | 11.0 | 10.2 | NA |
| Indonesia | 9.3 | 7.5 | 7.3 | 9.2 | 10.7 | 11.1 | 13.0 | 15.3 |
| (b) All short- and long-term debt service as ratio of exports | | | | | | | | |
| Mexico | 105.8 | 103.6 | 117.1 | 138.9 | 80.8 | 69.0 | 66.5 | NA |
| Brazil | 106.5 | 114.5 | 113.6 | 146.0 | 104.5 | 72.1 | 72.6 | NA |
| Indonesia | 40.8 | 25.1 | 26.1 | 39.0 | 41.7 | 43.3 | 51.6 | 67.6 |
| (c) Public and private long-term debt service as ratio of exports | | | | | | | | |
| Mexico | 62.4 | 38.0 | 35.0 | 44.6 | 45.4 | 49.2 | 48.2 | NA |
| Brazil | 57.6 | 56.4 | 56.8 | 71.7 | 46.2 | 34.1 | 34.9 | NA |
| Indonesia | 25.0 | 12.7 | 12.9 | 16.5 | 18.4 | 19.0 | 25.2 | 34.5 |
| (d) Proportion of debt which is short term | | | | | | | | |
| Mexico | 14.0 | 28.3 | 32.1 | 30.5 | 11.1 | 6.8 | 5.8 | NA |
| Brazil | 13.2 | 19.3 | 19.2 | 19.3 | 14.9 | 11.6 | 10.8 | NA |
| Indonesia | 9.9 | 13.3 | 14.4 | 18.1 | 15.6 | 16.8 | 14.8 | 12.2 |
| (e) Proportion of publicly-guaranteed long-term debt which has variable rate | | | | | | | | |
| Mexico | 59.5 | 71.5 | 75.4 | 76.7 | 82.7 | 83.6 | 80.1 | NA |
| Brazil | 56.8 | 61.0 | 67.1 | 69.3 | 70.1 | 73.1 | 71.5 | NA |
| Indonesia | 15.0 | 16.2 | 17.8 | 20.0 | 22.8 | 23.7 | 21.7 | NA |
| (f) Effective interest rate for all long-term debt, calculated by (debt service/debt) | | | | | | | | |
| Mexico | 23.4 | 22.8 | 20.1 | 20.8 | 15.9 | 18.0 | 16.1 | NA |
| Brazil | 18.0 | 23.3 | 23.7 | 23.0 | 13.9 | 11.7 | 11.2 | NA |
| Indonesia | 17.5 | 15.5 | 16.6 | 16.1 | 14.6 | 15.8 | 16.6 | 14.5 |
| Memo item | | | | | | | | |
| Export/GNP ratio | | | | | | | | |
| Mexico | 11.3 | 13.7 | 13.2 | 17.9 | 21.5 | 20.1 | 17.8 | NA |
| Brazil | 7.1 | 9.6 | 10.2 | 8.7 | 12.4 | 15.3 | 14.0 | NA |
| Indonesia | 22.8 | 29.7 | 27.9 | 23.6 | 25.8 | 25.7 | 25.1 | 22.6 |
| One-year LIBOR for dollar deposits | 9.3 | 13.4 | 16.1 | 13.7 | 10.2 | 11.8 | 9.1 | 7.0 |

NA = not available.

117 percent versus 114 percent. This is because 70 percent of Mexican total debt service in 1981 consisted of rolling over short-term loans, as against Brazil's 50 percent, and this was the period when the one-year London interbank offer rate for dollar deposits (LIBOR) reached and remained at historic highs. LIBOR was over 10 percent from 1979 to 1984, with a peak of 16 percent in 1981 (see item d and the memo item in the table).

When it was clear in 1980 that short rates would remain high, long rates rose too. Since almost 70 percent of Brazilian publicly-guaranteed debt was on variable rates, the effective interest rate on Brazilian long-term debt rose from 18 percent in 1978 to over 23 percent during the 1980–83 period (see items c and f in table 8.2). The additional interest payments, together with the collapse of its exports due to the deep global recession in 1982, brought about the Brazilian debt crisis in 1983.

Many authors have cited capital flight as a major cause for the external debt crisis in some of the Latin American countries.³ Part 1 of table 8.3 reports two sets of capital flight estimates. These estimates ought to be treated with caution; different studies have come up with significantly different figures.⁴ Sometimes the sign is not even certain; for example, estimates for capital flight from Brazil ranged from $-\$0.2$ billion to $\$3.9$ billion.

The point we want to make here is that imprudent maturity structure management may have contributed more to the Mexican debt-servicing difficulties than capital flight per se. To see this, we allow capital flight to have maximum impact on the actual DSR by assuming that Mexico financed the capital flight entirely by short-term debt. Part 2 of table 8.3 shows that Mexico's DSR in 1982 would have dropped from the actual 138 percent to 64 percent if financing had been done with long-term loans instead. Without capital flight, the DSR would have been 45 percent. In short, the major reason why Mexico's DSR was so high was because the way in which the government financed the capital flight added 74 percentage points. Capital flight per se added only 19 percentage points.

Our conclusion of imprudence in the management of maturity structure can be shown in another way. To see that much of the Mexican short-term debt was from borrowing by the government rather than from commercial credits to finance imports, we make use of the fact that the Indonesian

Table 8.3 The Role of Capital Flight in Precipitating Debt Crises

Part 1: Cumulated capital flight amount up to 1982 (in billions of dollars)

| | Khan-Haque Estimate | Morgan Guaranty Estimate |
|-----------|---------------------|--------------------------|
| Mexico | 29.4 | 36.0 |
| Brazil | -.2 | 3.0 |
| Indonesia | NA | 6.0 |

Part 2: Constructing total debt service/export ratios in 1982

| | Actual Ratio | Counterfactual Ratios | |
|-----------|--------------|--|-------------------|
| | | If capital flight had been financed by long-term instead of short-term loans | No capital flight |
| Mexico | 138.9 | 64.2 | 44.6 |
| Brazil | 146.0 | 143.2 | 133.2 |
| Indonesia | 39.0 | 20.1 | 16.5 |

Note: Counterfactual ratios were calculated by assuming that capital flight had maximum impact on the actual debt-service ratios. This means that capital flights were assumed to have been financed entirely by short-term borrowing. The maximum amount of capital flight was the actual short-term debt of the country. For Mexico and Indonesia, capital flights were assumed to equal actual short-term debts in 1982; and for Brazil the Morgan Guaranty estimate was used.

NA = data not available.

government, since the Pertamina crisis, has avoided short-term external borrowing as much as possible. Assuming that the Indonesian ratio of short-term debt to imports reflects normal trade financing, we can attribute 77 percent of Mexican short-term debt in 1981 and 1982 to government borrowing. The 1981 and 1982 figures for Brazil are 68 percent and 57 percent, respectively.

There is a tradeoff in external debt management between generally lower interest payments and predictability of debt-service payments. Short-term liabilities pay lower interest rates most of the time, but it is risky to rely on a strategy which rolls over large amounts of short-term debt every period. An unforeseen credit crunch would force the country to increase borrowing in order to cover its interest payments. If the credit squeeze persisted for more than three years and was accompanied by a prolonged fall in the country's exports, this extra borrowing would be difficult to sustain because the situation smacks increasingly of a Ponzi game.

Capital flight can be an important mechanism in bringing about a debt crisis, but we cannot view capital flight as an exogenous shock in the Latin American debt crises. Enders and Mattione (1984) and Dornbusch (1987) have emphasized that the large capital flight in Mexico and Argentina was the result of highly overvalued exchange rates. Even with overvalued exchange rates, our discussion based on table 8.3 concludes that capital flight would not have hurt Mexico's debt-service capacity if it had been financed by long-term, rather than short-term, external borrowing.

Pulling all of the observations about tables 8.2 and 8.3 together, we attribute the absence of an Indonesian debt crisis in 1982–84 to three factors:

1. A high proportion of Indonesia's external debt was borrowed at fixed concessionary rates from IGGI. This *IGGI effect* explains why the effective interest rate on Indonesian long-run debt averaged 16 percent against the 20 percent paid by Mexico and Brazil (part f of table 8.2). Another result was that only about one-third of Indonesian debt was denominated in dollars compared to 90 percent of Mexican and Brazilian debt. This meant that the large appreciation of the dollar from 1979 to 1982 did not raise the effective interest rate paid by Indonesia as much as it did for that paid by Mexico and Brazil.
2. The high degree of *export orientation* in Indonesia prevented its debt-servicing capacity from collapsing as did Mexico's when the price of oil dropped in early 1982. Appropriate exchange rate policies by Indonesia, exemplified by the 1978 devaluation, ensured a diversified export bundle as well as a high export orientation. Indonesia's political concern to keep the agricultural sector vibrant no doubt helped to maintain the observed export orientation.
3. The shock of the 1975 Pertamina crisis caused official borrowing in Indonesia to take place very cautiously with regard to exposure in the

short-term credit market. The resulting Indonesian *prudence* is the major reason the maturity structure of Indonesian debt was so drastically different from that of Mexico. We could also refer to this factor as the *Pertamina legacy*.

8.4 The Relative Contribution of Each Factor

To get a sense of the relative contribution of concessional IGGI loans, prudence in debt management, and export orientation in explaining the absence of an Indonesian debt crisis, we decompose the average 1980–82 DSR. This is done by comparing the Indonesian debt situation with that of Mexico. We chose Mexico over Brazil because the former is an oil-exporting country like Indonesia. On the eve of the debt crisis, oil was the chief foreign exchange earner and the biggest source of government revenue in both Indonesia and Mexico.

We calculate what the DSRs would have been if Indonesia: (i) paid the same effective interest rates as Mexico; (ii) had managed its debt such that its maturity structure was the same as Mexico's; and (iii) had the same export/GNP ratio as Mexico. In the construction of these counterfactual DSRs, we assume that the total debt of Indonesia remained unchanged in these alternative scenarios.

Item (i) in part A of table 8.4 reports the DSRs normalized by the actual export level after the IGGI effect and the prudence factor were removed. Item (ii) normalizes the different debt services by the level of exports that would have come about if Indonesia had the same export/GNP ratio as Mexico. The last entry in item (ii) reports that if the Indonesian debt and economy assumed all three Mexican features, the resultant DSRs in 1980–82 would be two to three times larger than the actual, making a debt crisis highly probable. On average, Indonesia's DSR would be 54 percentage points higher if it had all three Mexican features.

Part B of table 8.4 reports the range of values assumed by each factor in six decompositions of their effect, along with the average contribution of each factor. We use average contribution in our discussion because theory gives us no guidance as to which decomposition is most natural. The results show that the export orientation of Indonesia is the most decisive factor in why Indonesia's total DSR is so low compared with Mexico's. Export orientation explains 31 of the 54 percentage point difference, accounting for 57 percent of the gap. The prudence factor was of moderate importance, contributing 18 percentage points and thus accounting for almost one-third of the gap. Concessional interest rates and the currency composition of debt played only a minor role in reducing the DSR, explaining less than 6 percentage points.

Our finding that the IGGI effect contributed so little toward the reduction of the 1980–82 debt-service/export ratio is surprising because many of the

Table 8.4 Relative Importance of IGGI, Maturity Structure, and Export Orientation

| Part A: Construction of counterfactual ratios for decomposition | | | | |
|---|---------------|---|---|-------------|
| | 1980 | 1981 | 1982 | Avg (80-82) |
| (i) Total debt-service normalized by actual exports | | | | |
| Actual maturity structure | | | | |
| At actual interest rates | 25.1 | 26.1 | 39.0 | 30.1 |
| At Mexican interest rates | 31.1 | 28.8 | 43.7 | 34.6 |
| Mexican maturity structure | | | | |
| At actual interest rates | 37.1 | 39.5 | 52.0 | 42.9 |
| At Mexican interest rates | 42.0 | 41.7 | 56.1 | 46.6 |
| (ii) Total debt-service normalized by counterfactual exports | | | | |
| Actual maturity structure | | | | |
| At actual interest rates | 54.6 | 54.9 | 51.5 | 53.7 |
| At Mexican interest rates | 67.6 | 60.8 | 57.7 | 62.0 |
| Mexican maturity structure | | | | |
| At actual interest rates | 80.5 | 83.3 | 68.7 | 77.5 |
| At Mexican interest rates | 91.3 | 87.9 | 74.0 | 84.4 |
| Part B: Relative importance as determined by average of the six possible decompositions | | | | |
| Hypothetical 1980-82 average ratio when Indonesia has all three Mexican features is 84.4 percent. | | | | |
| Actual 1980-82 average ratio is 30.1 percent. | | | | |
| | Average Value | Percent of Gap Between Actual and Counterfactual Ratios Accounted For | Range of Values Assumed in the Six Decompositions | |
| IGGI concessional loans | 5.8 | 11% | 3.7-8.4 | |
| Maturity structure due to Pertamina legacy and absence of capital flight | 17.7 | 32 | 12.0-23.8 | |
| Export orientation | 30.8 | 57 | 23.6-37.8 | |

informed observers we talked to cited foreign concessional loans as the primary reason for the absence of an Indonesian debt crisis. Our point is that while the \$1 billion saved annually in reduced debt service during 1980-82 is a large sum of money,⁵ this amount would have been easily swamped by a Mexico-style loss of reserves if the Indonesian government had tried to prop up an overvalued exchange rate and was then forced to finance capital flight. Similarly, if exports were 12 percent below actual value because of an overvalued exchange rate, as suggested by the 1965-68 experience, the loss in foreign reserves would have also greatly exceeded this \$1 billion saving.

Our conclusion is that the Indonesian exchange rate policy was the most important reason Indonesia was able to meet its debt commitments in the 1982-84 period. The conduct of this exchange rate policy was greatly facilitated by the existence of a political lobby which promotes exchange rate protection and by the memory of the economy-wide negative effects of exchange rate overvaluation. The fact that neither the budget deficits nor the money growth rates went out of their historical range for extended periods also helped to make exchange rate management easier.

8.5 Prospects

Since over 30 percent of Indonesia's public debt is denominated in yen, debt-service payments have jumped in the face of the 68 percent appreciation of the yen against the dollar in the 1985:1Q to 1987:1Q period. Debt management has become more difficult since 1984. Agricultural commodity prices and oil prices have continued to decline, often very rapidly. The price of oil plunged from \$28/barrel to \$10/barrel between January and August 1986. The fall in export earnings from \$21 billion in 1982 to \$15 billion in 1986 has caused the total debt-service/export ratio to soar to 68 percent. The situation is ominous.

While our analysis would place the greatest of emphasis upon an aggressive competitive real exchange policy to reduce the probability of a debt crisis through its effects on exports and capital flight, we strongly feel that there are a number of other policies which must be implemented immediately if a debt crisis is to be avoided in the medium run. The supplementary policies which we recommend can be divided into two groups: (1) those which affect the debt service directly, and (2) those which affect export earnings.

The policy measures which would ameliorate the debt service burden directly, through the reduction of foreign borrowing, are:

1. Cut budget deficits by controlling spending and increasing taxes. The fiscal policy posture must be kept consistent with that of the exchange rate. The tax reforms since January 1984 have raised domestic revenue considerably, but their implementation has not been wholly satisfactory. While the number of registered taxpayers has increased from 550,000 before the tax reform to 995,000 at the end of 1985, only 50 percent of the companies and 70 percent of registered taxpayers actually filed tax returns in 1985 (World Bank 1986, 13). The elimination of this slack in tax collection should not cost too much given that the offenders are already known. The task now is to fully enforce existing tax laws.
2. Maintain an anti-inflationary stance in monetary policy. This would help to keep trade account deficits down by reducing absorption relative to income. Interest rates should be kept internationally competitive to discourage capital flows. Both of these outcomes would make exchange rate management easier.
3. Amend the "balanced" budget rule to allow internal financing of government deficits. This rule was introduced to prevent the reoccurrence of the kind of inflation in 1961-65 that resulted from the monetization of the budget deficits. It may seem imprudent to remove this institutionalized practice but the fact is that the inflation of the final Soekarno years was the result of the breakdown of the political system which made austerity policies impossible. And if political conditions were to really degenerate, no government would deem itself bound to this practice

anyway. Furthermore, at present, while this rule prevents monetization of budgetary expenditure, it does not prevent the monetization of nonbudgetary expenditure, e.g., central bank credits to BULOG. Since bold austerity policies during bad times have never been avoided by the Soeharto regime, it makes little sense not to amend the balanced budget practice in order to reduce reliance on external funds. In addition, the development of a domestic market in government securities would make open market operations by the central bank possible. The existence of this monetary tool would enhance monetary control, and thus macroeconomic stabilization efforts, tremendously.

4. Accelerate the development of the domestic financial system. Besides further deregulation of the financial sector, financial deepening could be boosted by the privatization of many of the state-owned enterprises. The balance-of-payments position would be improved if the government were to allow foreigners to purchase shares in the former state enterprises. A developed financial market would lower intermediation costs, allow better monetary control, and, possibly, encourage savings.
5. Liberalize the controls on foreign investments in the manufacturing and agricultural sector, especially in industries that produce primarily for the export markets. This step will increase capital formation without the need of incurring external debt and will also increase foreign exchange earnings. In short, state and private enterprises should issue equities instead of bonds to foreign investors when financing their capital expenditure. It is important that protection not be used as a means of inducing foreign investments because, in all likelihood, the resulting enterprise would be inefficient and cause a net loss of foreign exchange for Indonesia.

Our proposal for liberalizing foreign investment laws may be a hard one to accept given the prevailing economic nationalism in Indonesia, but it should be seriously considered if the debt situation takes another turn for the worse.

The second group of supplementary external debt management policies are those which focus on the denominator of the DSR. Our analyses suggest that the viability and expansion of the Indonesian export sector depends crucially on:

1. The elimination of the wide array of monopoly import licenses. The present efforts to replace import licenses with tariffs is an improvement but it is still a second-best solution. It is important that tariffs not take the place of the import licenses removed from the imported basic inputs. The growth of manufactured exports, spurred by access to cheaper inputs, will not only increase foreign exchange earnings but will also diversify the export bundle, hence reducing the sensitivity of the DSR to the prices of a few key commodity exports. Furthermore, any Indonesian manufactured export industry that is internationally competitive will be one which uses Indonesia's abundant semiskilled labor force intensively in its

production process. The favorable employment effects alone should be justification enough to eliminate these monopoly import licenses.

2. The expansion of the tree crop sector. Indonesia has cheaper labor than Malaysia, and with additional investments in transportation, Indonesia could potentially outcompete Malaysia in the production of rubber and palm oil. In addition to earning more foreign exchange, the strategy of accelerating the growth of agricultural export industries will also promote a more equitable rural-urban, as well as inter-island, growth pattern and ease population pressure on the urban areas.

A final cautionary word on external debt management from the political perspective is pertinent. The Pertamina crisis has led to close supervision by the Ministry of Finance of external borrowing by all state enterprises, making it unlikely that a debt crisis would ever again emerge from the external adventurism of an economic fiefdom. The danger now may be the absorption of private external debts in order to save large domestic firms when they get into financial problems, as in the Indocement case. As we described in chapter 3, in July 1985 Indocement, the biggest cement company in Indonesia, began to experience cash flow problems because the recession-induced collapse of the construction industry led to a cement glut. The response of the Indonesian government was to inject U.S. \$325 million in cash to acquire a 35 percent share of the company, and to form a consortium of four state banks to “convert into a rupiah liability a U.S. \$120 million syndicated loan that Indocement took out in 1981.”⁶

If a few more such rescues are allowed, then the habit may well be impossible to break without the government having to put to the test an important source of its political power—the cohesiveness of the bureaucratic and military elite. Given the widespread participation in large private business ventures by government officials and their family members, the selective use of financial rescue will threaten the political unity of the group. If such political pressure were able to completely eradicate the already blurred line between public and large private enterprises, then the vulnerability of Indonesia to a debt crisis would be greatly increased. External debt management would become impossible because no one would know what the size of the sovereign debt really was, and the size of this debt could increase very quickly given the openness of the private capital account.

Notes

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