FISCAL DISTRESS IN INDONESIA FOLLOWING THE 1997-98 ECONOMIC[1] CRISIS

Anwar Nasution[2]

1. Increasing fiscal deficit

The economic crisis has caused fiscal distress in Indonesia (Table 1) as the inflexible and inefficient tax system cannot generate sufficient government revenues to meet the rising expenditures. This raises concerns about medium and long-term fiscal sustainability. The compression in government non-oil revenues following the crisis has been mainly due to the faltering tax efforts because of the rising company bankruptcy, shrinking trade flows and decreased personal income. Prior to the crisis (FY1995/96), non-oil sector contributed 81.8 percent to domestic government revenues. Of these, 27.4 percent came from taxes on domestic consumption (mainly value added tax), 26.3 percent from (individual and corporate) income taxes, 4.9 percent from taxes in international trade and 11 percent from non-tax receipts. During the period of the crisis, the revenues decreased further with the fall of price of oil. The oil sector generates about 20 percent of government domestic revenues.

On the other hand, the government expenditures have been risen fast, among others, for financing soaring costs of servicing external debt, overhauling financial system, social safety net and subsidies on state vended products. The decentralization plan, implemented since January 1, 2001, adds to fiscal pressures as the central government returns about a quarter of its domestic revenues (mainly from natural resources) to local governments. A mix of slow disbursement of external assistance, their rigidities because of conditionality, and delays in allocating spending authorities has limited the use of fiscal policy as an 'automatic stabilizer' or a counter-cyclical measure to avoid a major domestic recession. As a percentage of annual GDP, the budget deficit rose to 2.5 percent in FY 1998/99, declined to 1.6 percent in 1999/2000 and raised back to 3.2 percent in 2000 and to 3.7 percent in 2001.

The soaring debt repayment has been partly due to the rupiah's depreciation, raising interest rates and inflation rates as both of external and domestic debts are sensitive to developments of these variables. Following the crisis, domestic interest burden rose rapidly from 0.02 percent of GDP in FY1998/99 and 1999/200 (April-March)

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[1] A paper presented at the 14 General Meeting of Pacific Economic Cooperation Council (PECC XIV), Hong Kong, 28-30 November 2001, Concurrent Session 4: How to Deal with Fiscal Deficits and Consolidation?: Pacific Experiences for the 21st Century.

[2]Professor of Economics, Faculty of Economics, University of Indonesia, Depok 16424, Jakarta, Indonesia.

to around 4 percent in FY2000 (March-December). The burden of domestic debt will increase further in 2003 when the government is scheduled to start retiring bank recapitalisation bonds. Part of the government domestic bonds carries either variable interest rates, indexed against inflation rates and hedge against exchange rate change.

The economic crisis has forced the authorities to redefine the scope of government and to change its policy on the role public budget. Prior to the crisis, public budget had been mainly used as a tool of resource allocation. At present, it is a principal instrument of macroeconomic policy. Other major change in government budget is to improve the fiscal transparency and practices by integrating the off-budget transactions into the formal budget. These include explicit and implicit guarantees to third party liabilities of the banking system, to private infrastructure projects, pension funds of civil servant, and contingent liabilities of state-owned enterprises.

To control budget deficit, the authorities cut non-debt expenditures in response to the rise in burden of debt service obligations. Table 1 shows that interest payment of public debts, as a percentage of annual GDP, rose from 1.8 in FY1997/98 to 5.7 in FY 2000. As a percentage of total expenditures, interest payments in these two fiscal years amounted to 15 and 23 respectively. The reduction in non-debt expenditures has been done through deep cut in subsidies on state-vended products, freezing salaries of civil servants and selling bonds to rich regions. The removal of subsidies also promotes efficient use of resources.

As the inflexible tax system cannot be expected to pursue equity objective, the expenditure side of the government budget is also expected to carry multiple tasks, including for pursuing this equity objective. The goal can be pursued by increasing the portion of non-debt budget expenditures towards the non-tradable sector of the economy. Such expenditures include public school, extension and outreach services, public health care programs and labor-intensive public works programs create employment in rural area. The rise in oil and non-oil exports help expand these employment creation programs in FY2000.

To avoid inflation, the government adopted a strategy to finance the larger fiscal deficit by obtaining official development aid from its foreign creditors. Inflationary finance is rule out by Bank Indonesia Act of 1999. To prevent the collapse in the domestic payment system, the government temporary nationalized the domestic banking system by injecting large amounts of government bonds. Non existent prior to the crisis, the value of government bonds stood at Rp659 trillion (roughly about USD659 billion)) or equivalent to 51 percent of Indonesia's GDP in December 2000 (Table 2). This may be the most expensive cost of bank restructuring program in the history! Because of this, stock of public debt rose from 24 percent in 1997 to 60 percent in 1998 and to 100 percent in 2000.Sustainability of the rapid increase in domestic debt stock has been the main focus of concern as the increase in the public sector's external debt has been mainly due to the rupiah's depreciation rather than the real increase in debt stock.

2. Dealing with the external debt overhang

The soaring external debt repayments, in the middle of economic crisis, require transfer of larger share of Indonesia' fiscal resources, export earnings and GDP to foreigners. To ease these pressures, Indonesia adopts a voluntary, negotiated and selective debt reduction scheme. The scheme has two main approaches. The first, is through negotiated changes in terms and conditions of the contracted debt. This includes debt rescheduling of public sector's external debt which delays the debt services by adding interest owed to capital and other contractual obligation. The second, debt reduction may also be done through reducing the level of present value of the external debt. This approach, includes market-based debt conversion schemes and debt-equity swaps is mainly applied for private sector's external debt obligations.

(i) Public sector external debt

Mainly because of the surge in private sector direct borrowings, the stock of external debt of Indonesia has been rapidly increased from $66.9 billion in 1990 to $151 billion in December 1998 and $141 billion in December 2000 (Table 3). This level of external debt was alarming by world standards. The World Bank considers a debt to GNP ratio of more than 80 percent as high risk. In term of total debt service to exports, the World Bank considers 18 percent the 'warning' threshold. The stock of external debt of Indonesia in December 1998 was amounted to around 308 percent of export value and about 321 percent of her annual GDP. The debt service ratio was ranging between 30 to 34 percent and the interest payment alone was amounted to 12 percent of total exports between 1990 and 1996. The sharp depreciation of the external value of the rupiah added significantly to Indonesia's debt burden.

Over 55 percent of the external debt in December 1998 ($83.6 billion) owed by the private sector and over 80 percent of it was received by the non-bank corporate entities. The average maturity of this external debt is approximately 1.5 years (J.P. Morgan, *Global Data Watch*, 16 January 1998, p. 70). A significant portion of the private sector's external debts become contingency liability of the government as they are explicitly and implicitly guaranteed by the government. Sovereign guarantees not only covered the external debt of the state-owned banks and non-bank companies. The guarantee also covered foreign liabilities of the private sector, particularly the politically well-connected private infrastructure providers. Afraid of severe damage to international transactions, the authorities, in 1998, introduced exchange offer scheme and extended coverage of the blanket guarantee scheme to include external liabilities of financially distressed domestic banks.

It is true that the bulk of the public sector external debt is long-term in nature. This is because the debt strategy of Indonesia since the late 1960 has been consistently to maximize the inflow of development aid from its Western and Japanese creditors. The 'oil boom' it had enjoyed in the 1970s did not change this strategy: together with the resulting rise in real income, it only shifted Indonesia's position to a less concessional aid package.

The associated principal and interest servicing cost of Indonesia's external debt, however, still runs high, at some $9 billion a year. To be able to repay its external debt, the public sector has to accumulate a budget surplus as well as a surplus in the balance of payments. To ease the pressures on the public budget and the balance of payments, on September 23, 1998, the Paris Club creditor nations agreed to reschedule $4.2 billion in principal repayments of Indonesia's public external debt.

(ii) The private sector external debt

There are three institutions have been established to work out private sector external debt, namely: the Frankfurt Agreement, INDRA, and the Jakarta Initiative. The private sector external debt is, however, relatively more difficult to settle as there is a big number of both foreign lenders and domestic borrowers. Each individual debtor has distinct willingness and ability to pay which different from one to another. Foreign lenders include foreign private banks, institutional investors and other non-bank entities. The progress of external debt work out, however, is very slow partly because of weak and inefficient legal and judicial system, particularly commercial court system and bankruptcy law.

The private sector external debt is to be solved on a voluntary basis based on a combination of Mexico's Ficorca program and the Korean scheme. The Korean idea takes the short-term and non-trade debts of Indonesian banks and restructure them into loans with one to four-year maturity. Interest rates on the new loans will be paid based on Libor plus margin, ranging between 2.75 and 3.5 percent.

In June 1998, the Frankfurt Agreement was signed by the government with international private bankers to restructure and maintain trade credit at the April 1998 level for one year. The trade credit was fully guaranteed by the government (administered by Bank Indonesia) and had been extended for another year to April 2001. The non-bank corporate debt is rescheduled and restructured along the line of Mexican program. A trust institution, called INDRA, was established under the central bank. This institution provides exchange rate risk protection and assurance to the availability of foreign exchange to private debtors that agree with their foreign creditors to restructure their external debts for a period of 8 years with 3 years of grace during which no principal will be payable. By the end of 1998, the program only attracted one debtor with a total debt value of $2.9 billion. As a result, the authorities have decided to close INDRA.

The Jakarta Initiative Task Force (JITF) is the third institution to deal with private sector external debt. Modeled after the London Initiative JITF is a private agency, financially supported by the government, to facilitate resolutions of debts among international creditors and domestic debtors outside the court system. By October 2001, term sheets had been signed for 60 cases totaling USD12.4 billion in debt and nearly 50 percent of the cases totaling 12.4 billion have enter the stage of formal documentation and implementation.

3. Prospects

The burden of debt service obligations is likely remains high in the years to come, particularly if the economy cannot return to high growth. This and uncertain development in international price of oil requires government to step up efforts to generate revenues from non-oil sources both through raising taxes and selling of state assets. The tax efforts to raise revenues include measures to improve custom and tax administration and to remove VAT exemptions and reduce tax incentives. The tax ratio (1999: 12 percent of GDP) and number of individual tax payers (2000: less than 1 percent of total population) need to be increased. To finance the budget deficit, Indonesia should continue the existing policy to maximize the inflow of development aid from its Western and Japanese creditors. At the same time Indonesia should continue to negotiate for easing the burden of debt services. In addition, market for the huge amount of government bonds needs to be created, its infrastructure needs to be upgraded, institutional investors (such as pension funds and insurance companies) need to be created and strengthened. In addition, it should be made open to foreign investors in order to avoid overcrowding in the narrow and shallow domestic bond market.

Generating revenues from the sale of government assets is another option for financing government budget. Privatization of state-owned enterprises (SOEs) is also part of the process to scale back the role of government in providing the private goods and services. The other source of government revenue is from the sale of assets now controlled by IBRA—Indonesia Bank Restructuring Agency. As noted earlier, with the injection of government bonds, nearly all of domestic banks are nationalized. The IBRA's assets include non-performing loans, non-loan assets and majority equity stakes in 11 recapitalized banks. Privatization of SOEs and returning back IBRA's assets to private sector also serve as an instrument for improving the efficiency and productivity of the existing productive assets and to speed up economic recovery.

The presently slow process of sales of both SOEs and IBRA controlled assets needs to be speed up. The slow process has been mainly due to political uncertainty as the newly founded political freedom allows lively disagreements between political parties and elites on many important issues. The nascent democracy has also caused strained relations between the executive and legislative branches of the government and disharmony between central and local governments and increased labor disputes. Investment clime deteriorates further as social fabrics have begun to be affected by the ethnic, religious and separatist violence. The actual cash recovery of IBRA was only amounted to Rp19.3 trillion or 65 percent of the target for 2001 at Rp29.5 trillion. Since the past two years, 16 (out of some 190) non-bank state-owned enterprises have been announced for sale. In reality, no transaction has been concluded in the past two years. On the contrary, local governments of West Sumatra and South Sulawesi claim ownership of cement plants of PT Semen Gresik located in their provinces and want them spun off. This prevents Cemex, as Mexican based cement company, to exercise an option to raise its stake to 51 percent and assume management control of PT Semen Gresik. Cemex acquired 25 percent of PT Semen Gresik's equity shares in 1998. Such a breach in agreement discourages inflow of private sector's capital to Indonesia.

Table 1.
Indonesia Fiscal Data, FY1996/97-FY2001
(in trillion rupiah)

	1996/97			1997/98			1998/99			1999/2000			2000			2001			
	Actual	As percentage of		Actual	As percentage of		Actual	As percentage of		Actual	As percentage of		Prov. Budget	As percentage of		Budget	As percentage of		Budget
		Total Expend.	GDP		Total Expend.	GDP		Total Expend.	GDP		Total Expend.	GDP	Realization [1]	Total Expend.	GDP		Total Expend.	GDP	
Overall Balance [2]	6.2	8.0	1.1	-5.5	-7.1	-0.8	-25.2	-32.3	-2.5	-17.7	-22.8	-1.6	-29.8	-38.2	-3.2	-54.3	-69.7	-3.7	-42.1
Interest payments	9.9	12.7	1.8	16.7	21.4	2.4	32.6	41.8	3.2	42.3	54.3	3.7	53.3	68.5	5.7	89.6	115.0	6.1	88.5
Domestic debt	0	0.0	0.0	0	0.0	0.0	8.4	10.8	0.8	22.2	28.5	1.9	34.8	44.6	3.7	61.2	78.5	4.2	59.5
External debt	9.9	12.7	1.8	16.7	21.4	2.4	24.2	31.1	2.4	20.1	25.8	1.8	18.6	23.8	2.0	28.4	36.5	1.9	29.0
Primary balance [3]	17.4	22.3	3.2	7.0	9.0	1.0	-0.8	-1.0	-0.1	25.1	32.2	2.2	23.6	30.3	2.5	35.3	45.3	2.4	46.4
Subsidies	1.4	1.8	0.3	20.4	26.2	3.7	33.9	43.5	6.2	65.9	84.6	12.0	59.7	76.6	10.8	66.3	85.1	12.0	41.6
Petroleum	1.4	1.8	0.3	9.8	12.6	1.8	28.6	36.7	5.2	40.9	52.5	7.4	51.1	65.6	9.3	53.8	69.1	9.8	30.4
Non-Petroleum	0	0.0	0.0	10.6	13.6	1.9	5.3	6.8	1.0	25.0	32.1	4.5	8.6	11.0	1.6	12.5	16.0	2.3	11.2
Total Expenditures	77.9			111.5			168.1			231.1			223.9			340.3			344
GDP nominal	551.2			689.1			1006.0			1140.3			937.4			1468.1			1685.4

Source: Bank Indonesia

Note:

1) For the period April - December 2000

2) Central Government Operations, negative means deficit and otherwise

3) Primary balance is overall balance exclude interest payments

Table 2.

Financing The Restructuring
As of 31 December 2000

Rp trillion

	Total bonds	Percent of total	Fixed rate bonds Total	5yr	6yr	7yr	10 year	Variable rate bonds	Hedge bonds
Bank Indonesia	218	33	0	0	0	0	0	0	0
Program Credit	10	1.5	0	0	0	0	0	0	0
Recapitalized banks:	423	64	175	60	41	42	33	215	33
State banks	283	67	125	45	26	27	27	125	33
Private banks (7 banks)	33	8	18	6	5	5	2	15	0
BTO in 1998	106	25	32	9	10	10	3	74	0
Regional development banks	1	0	0.4	0.1	0	0	0.4	0.8	0
Non Recapitalized Banks:	9	1.4	7	0	0	0	7	2	
Bonds issued to date	659	100	175	60	41	42	33	217	35

Source: Bank Indonesia

Table 3

OUTSTANDING OF INDONESIA'S EXTERNAL DEBT, 1997 - 2001

(Million USD)

DESCRIPTION	1997	1998	1999	Des 2000	Jun 2001
TOTAL EXTERNAL DEBT	136,088	150,886	148,097	141,693	138,901
A. Government	53,865	67,328	75,862	74,916	72,496
1. (by creditor's institution)	53,865	67,328	75,862	74,916	72,496
- IGGI / CGI	34,663	38,789	44,058	44,099	42,748
- Non IGGI / CGI	19,202	28,539	31,804	30,817	29,748
2. (by types of loan)	53,865	67,328	75,862	74,916	72,496
- Bilateral	19,517	22,373	26,160	24,645	23,223
- Multilateral *)	18,646	26,048	30,294	31,507	29,878 1)
- Export Credit Facility	13,892	15,645	16,106	15,741	15,049
- Leasing	920	874	775	602	527
- Commercial	890	2,375	2,387	2,397	1,989
- Domestic Securities owned by Non Resident		13	142	26	1,831 2)
B. Private	82,223	83,558	72,235	66,777	66,405
1. Based on Loan Agreement	71,952	78,283	69,079	64,606	64,529
a. Bank	14,363	10,769	10,836	7,718	7,684
- State Banks	5,910	4,744	4,705	4,150	4,118
- Private Banks	8,453	6,025	6,131	3,568	3,566
• Domestic Banks	4,124	1,852	3,547	2,326	2,321
• Joint Venture Banks	3,801	3,640	2,018	944	917
• Foreign Banks	529	532	567	298	328
b Non Bank Institutions	57,588	67,514	58,243	56,888	56,845
- State Owned Enterprises	3,995	4,153	5,005	5,082	4,879 3)
- FDI Enterprises	23,473	32,433	29,805	30,264	28,731
- Domestic Companies	16,486	20,140	14,795	13,578	15,121
- Financial Institutions	3,415	2,067	1,035	1,150	1,214
- Others	10,219	8,722	7,603	6,814	6,899
2. Domestic Securities owned by Non Resident	10,271	5,275	3,156	2,171	1,876
- Bank		42	12	2	0
- Non Bank Institutions	10,271	5,233	3,144	2,169	1,978
As perentage of total external debt :					
- Private sector.	60.4	55.4	48.8	47.1	47.8
- Government	39.6	44.6	51.2	52.9	52.2

Source: Bank Indonesia

Notes: *) Including loan from IMF since November 1997

1) Including IMF Loan USD 9,7 billion

2) Consist of SBIs USD 14,9 million and Promisory Notes USD 1.816,1 million

3) Pertamina Figures as of March 2001