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Policy Adjustments in Indonesia During the Oil Export Boom: A Few Puzzles in Its Fiscal and Monetary Policies

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ABSTRACT

This paper attempts to present some plausible answers to the puzzles that exist in the conventional understanding of the government economic management in Indonesia during the oil export boom. It is said that Indonesian fiscal operations have been strictly under the balanced budget principle. However, the government in fact gave up this principle in order to avoid the expansionary impacts which would have arisen from the affluent oil revenues had the principle been held strictly. It is pointed out that the government, while keeping the principle officially, exercised delicate operations in that the budget surpluses were covertly accumulated by means of off-budget accounts. In the monetary policy, the sterilization of extra revenues through the commercial banks was adopted as an important means to avoid inflation. This policy was closely related to the government attitude towards the foreign borrowing during this period. There must have been, behind these policies, the government intention to build up the oil revenues for later spending to deal with structural adjustment problems, including the Dutch Disease, which were expected to arise because of the oil boom. These implicit policies have so far not attracted attention in the Indonesian economic studies.

Introduction

As the Two Gap Theory states, the shortages of domestic savings and foreign exchange are considered as typical bottlenecks for economic development in developing countries. In such a context, an export boom should mean a solution to the bottlenecks and facilitate economic development. If so, the windfall gains of the oil price shocks during the 1970s should have worked in favor of economic development in oil-exporting countries. It was observed, however, that the oil boom brought about in fact adverse side-effects in such oil-exporting countries as Egypt, Nigeria and Mexico [6] [8] [10]. The term "Dutch Disease" refers to the negative effects that an export boom in a certain sector of the economy has on the traditional export sectors.

There could be two symptomatic effects in the disease: "resource movement effect" and "spending effect" [3] [10]. The increase in profitability of an export boom sector bids up the prices of the factors of production. The resulting contraction of other tradable sectors due to the reduction of the production factors is the former effect. To the extent that some extra income from the export boom is spent on non-tradable goods, their prices are bid up relative to the prices of tradable goods, leading to the appreciation of the real exchange rate. The spending effect refers to this further contraction of non-boom tradable sectors resulting from the appreciation of the real exchange rate. These general equilibrium effects of an export boom should be a crucial problem to developing countries, because they have to boost development process through the expansion of these tradable sectors. In this context, one may ask, "Is the oil boom a blessing or a curse ?" [6] [11].

Indonesia experienced the oil export boom from the latter half of the 1970s to the early 1980s, during which period the government budget enjoyed affluent oil bonanza in the form of oil tax increases from foreign oil companies. Indonesian achievement in economic development during this period is in sharp contrast with the other oil-exporting countries such as those mentioned earlier. Her non-oil export base expanded rapidly in fact, and it is rather difficult to find out symptoms, such as the contraction of the tradable sectors, that the Dutch Disease theory predicts will occur. In the most comprehensive survey of this issue [6] [7], Indonesia is classified as one of the exceptional countries which have successfully bypassed the contraction of the non-oil tradable sectors.

The oil sector in Indonesia, as elsewhere, is an enclave in the domestic economy in the sense that there exists no link with the other sectors in terms of factor markets. This simplifies the analysis of the Dutch Disease problem greatly, since there is no resource movement effect. Our concern therefore is only with the spending effect. How serious the spending effect is depends on the marginal propensity to consume non-tradables. The appreciation of the real exchange rate then becomes a key parameter in initiating resource reallocation. As already mentioned, the spending effect hinges on how much of the oil bonanza is spent in the domestic economy. If the increased revenue is not absorbed domestically, there is no spending effect, and no contraction of the non-oil tradable sectors accordingly. In the case of Indonesia, the oil bonanza indeed existed in the government budget. It implies therefore that the fiscal policy must have played a crucial role in this Indonesian success story.

As to the monetary policy during this period, the monetary authority might have tried to sterilize the oil money had they been aware of the inflationary effect of accumulating foreign exchange reserves. With this policy, the absorption of potential benefits of the oil export boom, in terms of increased consumption and/or investment within the domestic economy, is deferred, and the oil bonanza is accumulated as foreign financial assets instead. This policy adjustment, which may be called "exchange rate protection", aims at avoiding the appreciation of the exchange rate, and hence at protecting the non-oil tradable sectors [4].

The purpose of this paper is not to make a complete evaluation of Indonesian fiscal and monetary policies but just to point out three distinct adjustments that the government made covertly in their policies during the oil export boom period. Though not explicitly mentioned thus far in the related literature, all of these policy adjustments have helped the Indonesians to avoid the Dutch Disease that otherwise they might have suffered from with the huge oil bonanza.

Fiscal Policy

Having experienced the cumulative inflationary pressure caused by the deficit financing in the government budget in the 1960s, the Indonesian government set a number of 'do's and 'don't's in the field of budgetary policy in pursuit of stable growth and development. The most important one was the introduction of "balanced budget principle" [1] [9]. This new rule contributed significantly to the economic recovery and stability until the early 1970s. During the oil export boom period when the government budget enjoyed huge oil bonanzas, however, adherence to this principle would have created a strong expansionary pressure in the domestic economy. Judging from the official budget data (Table 1), the government budget, net of the foreign borrowing, was on a near-exact balance for all the years during the oil boom. Needless to say, this means all the government revenue, including that arising from the oil taxes, was spent.

It should be remarked, however, that the term "balanced budget" used by the Indonesian government has a different meaning from that used by economists. In the economic sense, a balanced budget is defined as follows:

$$GTE - GTR \equiv \Delta DCGNB + \Delta DCG + \Delta FB - \Delta GD \equiv 0$$

GTE : Budget Total Expenditure
GTR : Budget Total Revenue
ΔDCGNB : Change in Borrowing from the Non Bank Public
ΔDCG : Change in Borrowing from the Banking Sectors
ΔFB : Foreign Borrowing
ΔGD : Change in Government Deposit

In the Indonesian definition of a balanced budget, in contrast, foreign borrowing is accounted as a revenue item. Neglecting the borrowing from the non-bank public, which is negligible due to the fact that the government does not issue bonds to the public, the following identity describes a balanced budget in the Indonesian sense.

$$GTE - \underbrace{(GTR + \Delta FB)}_{\text{Budget Revnue}} \equiv \underbrace{(\Delta DCG - \Delta GD)}_{\text{Net Position Change}} \equiv 0$$

This means that budget deficits are all financed by foreign borrowing and that there is no change in the government net position with respect to the banking sectors. No change in the government net position implies that the government budget is always neutral to the money supply.

The budget data indicates that this relationship was maintained during the oil export boom period. It should be noted, however, the monetary data, or the balance sheet of the banking sectors, shows quite different movements of the government net position for the same period (Table 1). In the late 1970s when the oil revenue began to increase due to the second oil shock, the net position improved drastically through the increase in the government deposit. This fact has a distressing implication in assessing the Indonesian budget stance during the oil export boom: the implication which has largely been neglected in the literature related to the Indonesian fiscal policy. We argue that this improvement in the net position reflected two important facts: the accumulation of budget surplus under the guise of "balanced budget" principle and the sterilization by using the off-budget account.

The first trick is how to accumulate the budget surplus under the balanced budget principle. A delicate procedure is necessary for the government to make this possible. It is conjectured that the procedure is just as follows: First, the government accounted expenditure, which was of course recorded under a certain expenditure item in the budget account. However, this expenditure was not actually expended, and transferred to the government account in the central bank, increasing the government deposit by the same amount.

Table 1. Budget Balance under the Balanced Budget Principle

(billion Rp.)

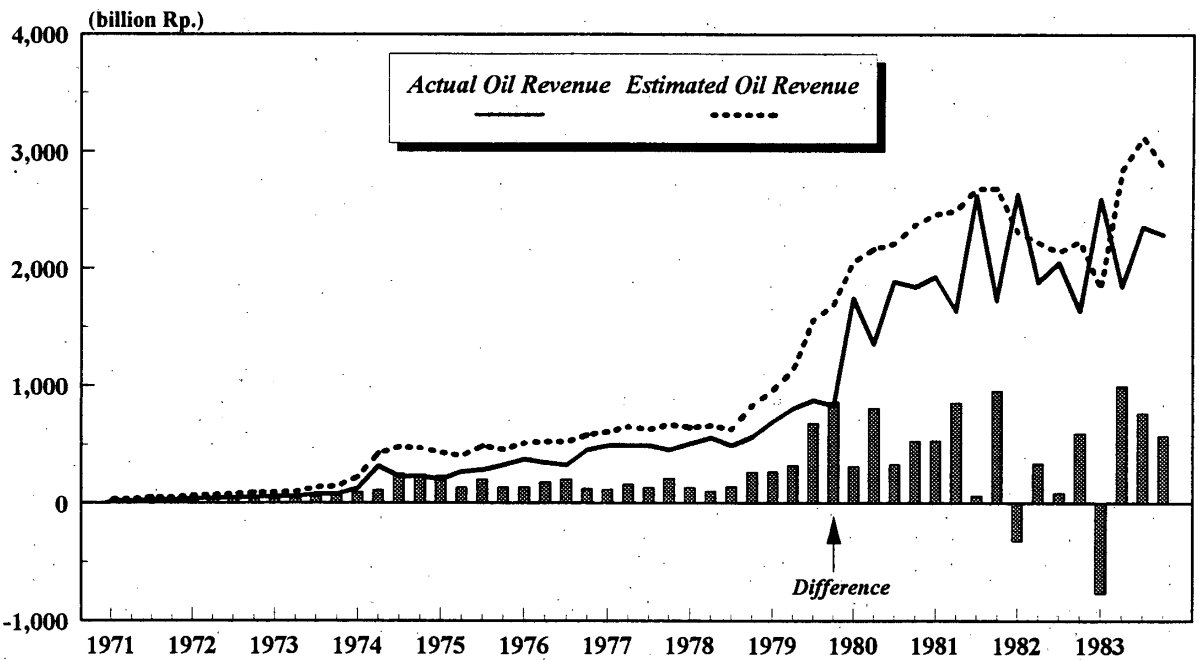
Fiscal Year	***Budget Data***						***Monetary Data***			
	Total Expenditure	Total Revenue	(of which Oil Tax)	Actual Budget Deficit	Foreign Borrowing	Indonesian Budget Deficit	Claims to Government	Changes on Government Deposit	Changes on Government net Position	(% to T.Exp.)
1971/72	541	428	112	-113	131	18	18	2	-16	-3.0
1972/73	736	590	199	-146	158	12	59	26	-33	-4.5
1973/74	1,164	968	345	-196	204	8	13	0	-13	-1.1
1974/75	1,978	1,754	973	-224	232	8	28	32	4	0.2
1975/76	2,730	2,242	1,249	-488	492	4	133	6	-127	-4.7
1976/77	3,684	2,906	1,619	-778	784	6	-33	104	137	3.7
1977/78	4,306	3,535	1,948	-771	773	2	140	235	95	2.2
1978/79	5,301	4,266	2,309	-1,035	1,036	1	175	193	18	0.3
1979/80	8,076	6,697	4,259	-1,379	1,381	2	-10	856	866	10.7
1980/81	11,716	10,227	7,020	-1,489	1,494	5	267	1,318	1051	9.0
1981/82	13,918	12,213	8,628	-1,705	1,709	4	638	490	-148	-1.1
1982/83	14,356	12,418	8,170	-1,938	1,940	2	91	164	73	0.5

Sources: Bank Indonesia. Indonesia Financial Statistics.

Through this procedure the government could build up the budget surplus without 'violating' the balanced budget principle.

The next trick we should make clear is the existence of an off-budget account in Indonesia. In the oil export boom period, the budget revenue was blown up significantly by the oil taxes from foreign oil companies. These companies were responsible for oil production under the contract arrangement that determined the distribution of oil proceeds in US dollar between the government and the companies; 85% to the former and 15% to the latter [5]. This government share is accounted as the oil taxes in the budget account. It is conjectured, however, that some part of this share was not appropriated for the budget revenue and went to the off-budget account directly. This conjecture can be confirmed by comparing the oil revenue actually accounted in the budget with the amount of the oil tax estimated from the contracts described above. Fig.1 shows that the discrepancy between these two figures became noticeable from the late 1970s to the early 1980s. Some part of the oil revenue must have been hidden in the budget and gone to the off-budget in this period. The flow of the oil money of this sort must have been instrumental in the improvement of the government net position in the banking sector during the oil export boom period.

Many studies on the Indonesian fiscal policy have pointed out the importance of the balanced budget principle, but it seems that they have failed to recognize the economic impacts of the covert operations in the Indonesian budget management. It can be said that the Indonesian government deliberately gave up the balanced budget principle with a view to avoiding the expansionary effects possibly brought about by the abundant oil revenue. Unfortunately, banking statistics gives the data on the government lending and borrowing only in terms of net figures, and there is no way of knowing gross revenues as well as gross expenditures. It is also impossible to establish a clear connection between the government



Note; The estimation of the oil revenue are derived from the oil export value and the distribution ratio determined by the contract.
Sources; Ministry Finance. unpublished quarterly budget data, Bank Indonesia. Indonesian Financial Statistics,
Far East Oil Trading Co.,LTD. Oil Industry in Indonesia.

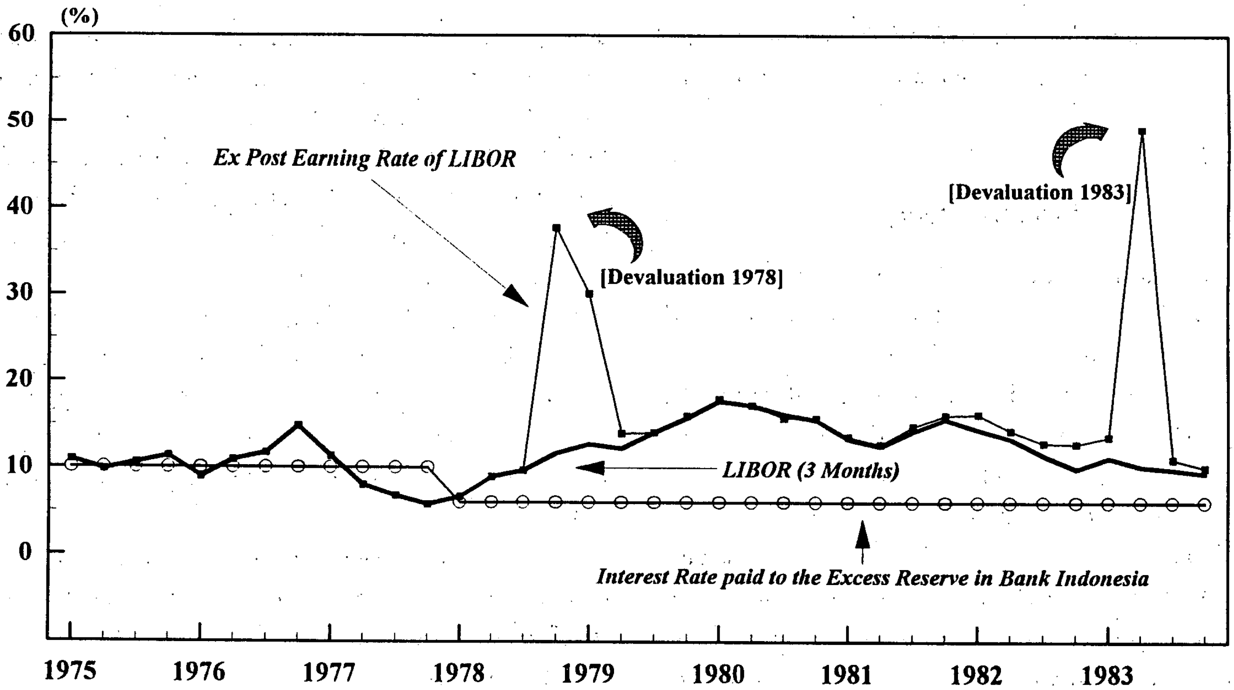
Fig. 1 The Difference detween Estimated and Actual Oil Revenue in the Budget net position and the building up from the budget surpluses and the sterilization by using the offbudget.

Monetary Policy

Indonesian monetary system has been characterized by the dominance of five state commercial banks. These banks occupied about 80% of the total financial assets in the country during the oil export boom period. The oil money in the government budget flowed into the priority sectors determined by the government through these commercial banks with no default risk for them. Moreover, most public entities were required to keep their deposits in these banks. There have been no need for them to make any effort to increase the source of funds. Before the oil export boom period, the monetary authority controlled the money supply by using the mandatory reserve ratio and other indirect methods. While this system operated reasonably well until the early 1970s, the increase in the reserve money due to the oil boom in 1974 made the reserve requirement (30%) quite inadequate to prevent excessive expansion on the bank credit. Open market operation, another conventional money supply control technique, was also not applicable, since the government did not issue bonds. Under these circumstances the monetary authority abandoned the indirect control policy and reverted to the direct control over bank credits. A credit ceiling was imposed in 1974 as the effective instrument for credit control during the oil export boom period. All of these facts are well-known. What we want to point out here is the fact that the government adopted during the same period another deliberate adjustment in the monetary policy, i.e., the sterilization through the commercial banks.

The imposition of the credit ceiling in 1974, with the continuous excess reserve in the commercial banks, had made the reserve rate of 30% inadequate as an instrument to control bank credit. The monetary authority suddenly reduced this required reserve ratio to 15% in 1978. This policy change, it was claimed, was implemented in order to compensate the banks for the loss that they had incurred from the reduction in interest rates, another adjustment implemented at the same time for stimulating the domestic economy. This reason, however, sounds just a bit strange, because the bank credit was being regulated by the credit ceiling: It was impossible for the banks to expand their lending to the domestic sectors even if more fund to lend were available to them due to the reduction in the required reserve ratio. From 1974, the Bank Indonesia started to pay interests at 10% to some parts of the excess reserve of the commercial banks, with the concomitant of introduction of the credit ceiling. In 1978, the interest rate was also reduced to 6%, which was maintained until 1983.

Such policy adjustments give some hints about the concerns that the government had in this period. It should be recalled that no exchange control existed in Indonesia so that international money transactions were relatively free. With the changes in monetary policy in 1978 described above, the commercial banks had an incentive to build up the foreign financial assets in Singapore or London money market. The rate of return in the foreign money market, LIBOR (London Inter-Bank Offer Rate), kept a higher level than the interest rate of 6% paid for the excess reserve from the Bank Indonesia. Another important factor that stimulated the commercial banks to accumulate foreign financial assets was the never-ceasing expectation of rupiah devaluation in this period. Fig.2 shows trends in related variables. That the monetary authority well acknowledged these incentives and introduced this type of policy is confirmed by the next fact. In 1982 when Indonesian foreign exchange reserve began to decrease drastically, the Bank Indonesia introduced "Repatriated Fund", in which the commercial banks could enjoy the same interest rate as high as the LIBOR if they repatriated their foreign as sets to the Bank Indonesia. The Bank Indonesia, anyway, encouraged the commercial banks to find outlets for their excess reserve by setting a low



Note ; Ex Post Earning Rate=LIBOR+Changes on Exchange Rate.
Sources ; Bank Indonesia. Indonesian Financial Statistics, IMF. International Financial Statistics.

Fig. 2. The Incentive for Commercial Banks to Build up Foreign Assests

interest payment to the excess reserve during the oil export boom period [12].

The size of net foreign assets of the commercial banks began to increase drastically after 1978, side by side with the accumulation of foreign exchange reserve during the same period as shown in Fig.3. The increase in the net foreign assets of the commercial banks in this period can be regarded as the "secondary or hidden reserve" which played a crucial role in sterilizing the oil money on behalf of the monetary authority. It is in this sense that this policy is termed the sterilization through the commercial banks.

This policy also was closely related to the government concern about the foreign borrowing. As already mentioned, the government budget deficits were financed by the foreign borrowing under the balanced budget principle. With the large oil bonanza, there arose a situation for the first time in which the government could reduce their reliance on foreign borrowing. The government did not move in this direction, however. On the contrary, it wanted to keep the continuous relationship with the foreign donors and lenders, the IGGI (Inter-Governmental Group on Indonesia). An overt realization of large budget surplus and massive foreign reserve was seen as likely to make the Indonesian position weaker in soliciting continuous or even greater assistance from the IGGI. The accumulation of net foreign assets in the commercial banks should have been quite instrumental in such a context. It would not be groundless to assert that this sterilization policy was adopted as one of the strategic policies cautiously designed by the government to deal with the oil bonanza.

Concluding Remarks

This paper describes a few missing management strategies to avoid the structural adjustment caused by the domestic absorption of the oil

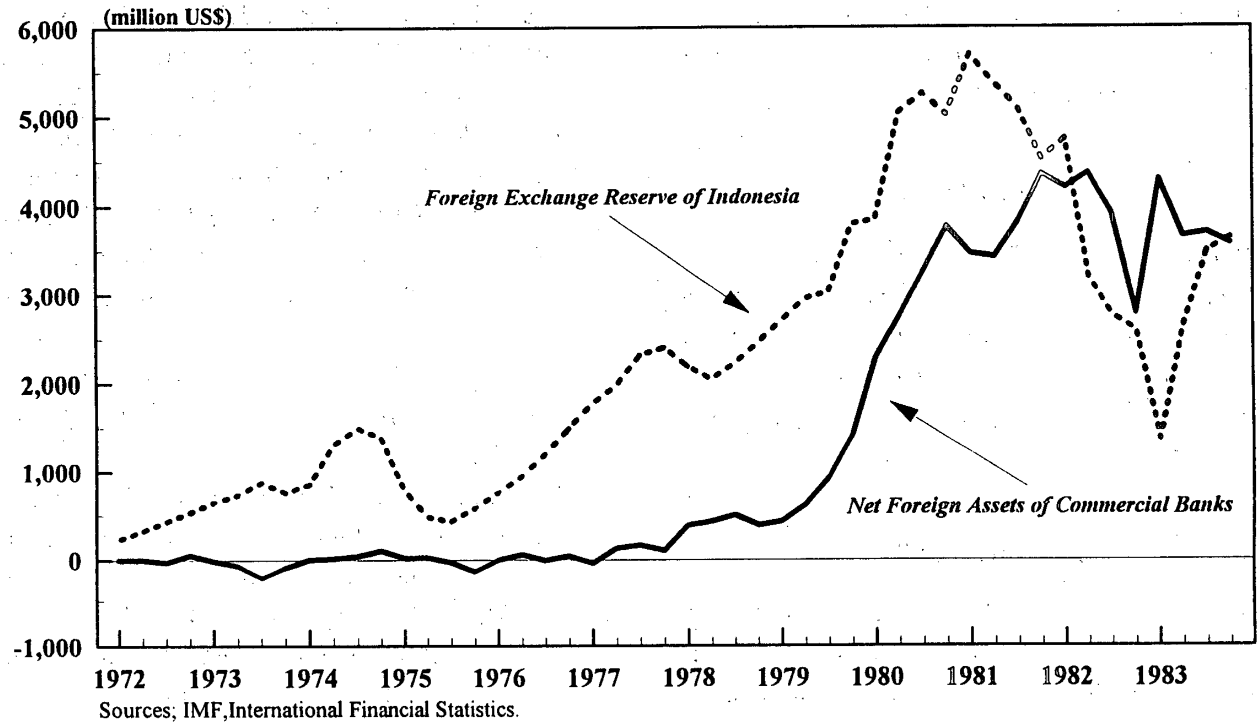


Fig. 3. Net Foreign Assts of Commercial Banks and Indonesian Foreign Exchange Reserve

bonanza, the Dutch Disease. With reference to the fiscal policy, Indonesia is committed to the balanced budget principle. But this is a matter of form. The government has tried to sterilize the oil money by building up the surplus under the guise of "balanced budget principle" and the usage of the off-budget account. There exists, in general, strong political pressure to expand the budget in developing countries. Considering this fact, the balanced budget principle in Indonesia has acted as "a safety valve" to avoid the reckless expansion of the budget expenditure. During the oil export boom, however, this principle was an obstacle which might bring about a drastic increase of domestic absorption. The Indonesian government realized this possibility and responded by careful budget management described above.

On the monetary side, the authority skillfully sterilized oil money through the commercial banks by giving a strong incentive to building up the foreign assets for them. This adjustment was the government strategy to keep the continuous relationship with the donor countries, i.e., IGGI.

Many conundrums of the primary commodity exporting countries can be regarded as issues of managing the economic rents from primary production [7]. In this context, the Dutch Disease is an issue of the cyclical fluctuation of rents. Still more, it can be said that the Dutch Disease has brought to light the difficulty with which the government has to manage short-run rents which arise from export booms without losing grip of their long-run objectives, including the promotion of economic development through the expansion of the tradable sectors. In the Indonesian case, the government reacted to the fluctuation of oil prices by building up the budget surplus and foreign assets for later spending.

More comprehensive research is needed to make clear the reasons for the Indonesian success during the oil export boom period. The purpose of this paper, however, is to present the characteristic features of the fiscal and monetary policy in Indonesia. All of these issues have been neglected, or to be more accurate, missed in many studies for certain unknown reasons.

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インドネシアにおける原油輸出ブームへの政策的対応
財政・金融政策において見逃されてきたいくつかの論点

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摘　　要

本稿ではインドネシアにおける原油輸出ブームを対象として、特定部門の輸出ブームがもたらす経済構造調整問題、すなわちオランダ病を回避するために取られた政策的対応のうちで、財政ならびに金融政策においてこれまで見逃されてきたいくつかの論点を指摘した。財政政策では原則としての均衡主義を表面的に維持しながら、実質的にはデリケートな会計処理ならびに非予算会計によって財政余剰の積み上げが行われてきたことを示した。一方、金融政策に関しては原油輸出ブームによる外貨準備の蓄積が国内経済における過剰流動性へとつながることを回避するために、商業銀行を通じた不胎化が金融当局の意図の下に行われたこと、また、それはインドネシア政府の対外借入に対する姿勢と密接にリンクした対応であったことを示した。これらの政策的対応はいずれも輸出ブームによる所得を短期的に積み上げることによって、急激な国内アブソープションの増大を回避し、しかもオランダ病という構造調整問題を回避する上で重要な意義を持ったものと考えられる。