

Can Indonesia Really Weather the Looming Economic Crisis?

By [Alexander Ugut](#) February 10, 2014.

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Ask the above question to policy makers or supervisory authorities and the most likely answer you will get is an affirmative one. Yes indeed, our banking sectors are better capitalized now, leverage of public and private sector including households are low, foreign exchange reserves are adequate for roughly six months of imports. Our exposure to potentially toxic securitized transactions or shadow banking activities is negligible. Bank Indonesia, the central bank, has also made significant preparations for a much worse situation by signing option contracts with China, Japan and South Korea that give it the right to execute cross currency swap contracts in the total amount of \$49 billion. In addition to that, another \$5.5 billion is ready in the form of standby loans from multilateral financial institutions.

Against this background, Finance Minister Chatib Basri claims that Indonesia is better prepared now to weather a second round of capital flight this year in the midst of the US Federal Reserve's winding down of its quantitative easing (QE) program. Lower inflation and improvement of the current account deficit show that policy adjustments made by the government are effective. So there is plenty of reason to be optimistic that we can really weather another crisis.

But perhaps we should not celebrate too early. The cost of a financial crisis is enormous and it is always the poor who bear the brunt of the impact in the long run. History has taught us that even figures like former Fed chairmen Alan Greenspan and Ben Bernanke didn't anticipate the financial crisis that started in the US housing market in 2007. In Europe, we have witnessed how the tendency to kick the can down the road exacerbated a debt crisis that initially started in Greece and later spread to other peripheral countries quickly.

There are warning signs that require our close attention:

First, while it is true that we are indeed different from Brazil, India, Turkey and South Africa, the international markets still consider Indonesia as one of the "five fragile countries."

Second, the potential knock-on effect of the Fed's QE winding down cannot be estimated ex ante and the gale force will be felt during the process of winding down of the positions the Fed took with its QE program.

Third, unlike the crisis of 2007 and 2008, this time China may have its own problem and the commodity super cycle that we have been blessed with may be over or at least may take a while to recover.

Fourth, as the world has become more integrated, the contagion risk is real even to countries with fundamentally sound macroeconomics.

Prior to the 2007 crisis, Raghuram Rajan, then chief economist of the International Monetary Fund, and a few others such as economist Nouriel Roubini, saw the looming crisis of 2007 coming but they were dismissed as Cassandras or permabears.

Now, as India's finance minister, Rajan is voicing his concern about the risk of policy collapse. More precisely, he is now complaining about the Fed's policy of winding down the QE program without considering the volatility it may cause for emerging markets' currencies such as the rupiah and rupee. He is obviously worried by the full impact of the Fed's policy.

This is the time to examine the presence of what Rajan called the "fault lines" in our economy, because just like earthquakes, financial crises are the results of many things going wrong at the same time. One such fault line is the reluctance on the part of the Indonesian government to address the fundamental problem of the fiscal deficit. The other fault line is the low competitiveness of our products mainly due to poor infrastructure. Combined with the heavy reliance on export of commodities and mineral ores, these two factors will aggravate our current account deficit problem.

Another potential fault line is the inefficiency in our financial sector and the market power enjoyed by our big banks. Such market power offers them little incentive to adopt best practices in risk management especially in assessing potential borrowers' creditworthiness and credit risk management in general. This fault line may have been overlooked, but it certainly needs serious attention.

With these possible fault lines in mind, how might another potential crisis manifest itself?

One possible scenario might be that the winding down of the QE program in the US would cause the rupiah to depreciate further, leading Bank Indonesia to raise interest rates. This in turn would result in higher loan loss provisioning and lower profits for banks. Capital requirements for banks would increase dramatically due to the increase in credit risk. On the other hand, capital level of banks would be lower due to lower valuation of their investment portfolio. Banks that are only marginally capitalized and whose loan portfolios are of lower quality may end up being insolvent. This may trigger banks to stop lending to each other for liquidity and soon we could see even solvent banks collapse, too, due to liquidity problems.

While we all may agree that another crisis is remote, the right attitude is to hope for the best outcome but be prepared for the worst. We also need more self-confidence building measures at the grassroots level to ensure that resources can easily be mobilized.

Together, the government's fiscal policies and the countercyclical capacity of the real and financial sectors should become effective tools to dampen the potential knock-on effect from the unwinding of the Fed's QE program.

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