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Financial Liberalization and Macroeconomic Adjustments in Indonesia: Review From A Reverse Sequence Reform, 1966-92

Damanik, Difi Sangunan, author

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Abstrak

Following sharp declines in oil revenues in late 1982 and again in 1986, the government of Indonesia recognized the need for major reforms. First, non-oil exports had to be increased to maintain the flow of imports essential for continued development. Second, with the decline in oil revenues, fewer resources were available to the public sector, and therefore it became necessary to stimulate private savings. An integral part of the policy reform was to remove the interest rate ceiling and credit ceiling in June 1983. The general objective was to mobilize the saving and increase the investment. The move from administrative control to market system is also expected to increase the allocative efficiency of credit which eventually increases the economic growth. Yet, Indonesia's experience in liberalizing its financial sector did not result as expected and there was a disruption in the financial sector though this disruption did not lead to the macroeconomic instability or financial crisis as was experienced by the Southern Cone countries. There are at least three causes, according to the literatures, that makes the Indonesian experience in financial liberalization does not completely as expected. First, reform in financial sector is unaccompanied by similar reforms in trade, and industry. Second, the design and sequencing of reform measures have been wrongly formulated. Third, the regulatory apparatus have not functioned in a manner conducive to the smooth progression of reform policy implementation. The main objective of this thesis is to justify the Fry's model of financial development, reviews the financial policy taken by the authorities and spells out what can be learned from empirical evidence in regard to financial liberalization policies and the instruments of their implication in Indonesia. The model developed by Fry shows that the efficiency of Indonesian economy as indicated by IOCR was deterred by a financial reforms. The exceptionally high real interest rates following the fmancial liberalization has caused the bank loans went to nonviable and unproductive projects and, as a result, bad debts became dominant and unsustainable. Review from the economic reforms in Indonesia revealed that the wrong sequence of reform had contributed to the high real interest rates. while the financial infrastructure of financial sector that should come after the financial liberalization was absent. The important lesson that can be drawn from financial liberalization in Indonesia is that although financial liberalization is desirable, its modality, design and sequencing are no less important. In shallow financial markets, full liberalization does not appear to be the first best policy. Until capital market develops and functions effectively and substantial progress is made in regard to structural adjustments in trade, industry and the legal system underlying the financial system as a whole, a second best policy may be to have a diminishing degree of government intervention in financial markets spread over a period of time, derNing guidance from the market-related indicators. The government intervention can be market destroying or market promoting. The former type of government intervention resulted in financial repression in the past in many of the developing countries, the latter may assist them to reach in course of time a fully liberalized, efficient and progressive financial system.