Assessing Indonesia’s Current Exchange Rate Regime

Mochammad Firman Hidayat

Abstract

This paper evaluates Indonesia’s current floating exchange rate regime. I find that Indonesia has enjoyed the benefit of floating with minimum impact on volatility in exchange rate. Utilizing nine criteria of exchange rate regime choice, this paper also shows that the current policy is optimal, under the condition that the country’s central bank can intervene when necessary to stabilize its currency, the rupiah.

Keyword: Exchange rate regime, Indonesia

INTRODUCTION

Copper (1999) argues the choice of exchange rate policy is a country’s most important macroeconomic consideration. It generally impacts a country’s rates of inflation and economic growth, and it also helps to determine its trade balance. In addition, it strongly influences its freedom of action and evolution of its financial system.

A country’s decision regarding its exchange rate regime depends on a myriad of factors. Using a mixed multinomial logit approach, Ondina, et al (2011) find that size and openness of an economy are choice determinants in Latin America. In addition to the two factors aforementioned, Rummel (2010) argues that the type of regime chosen also depends on a country’s economic and financial-system development, vulnerability to real and nominal shocks, production diversification and export structure, divergence of inflation from its trading partners, degree of labor and capital mobility, and extent of fiscal policy flexibility.

In deciding their exchange rate regime, policy makers need to understand the advantages and disadvantages of each option and how their selection fits within their policy goals. Yagci (2001) writes that a fixed exchange rate regime can be used to maintain stability...


and competitiveness if the peg is credible. In accordance with much of the relevant literature, she also notes this policy enables a country to establish greater control over its inflation rate. Another strength associated with a fixed exchange rate includes enhanced trade integration and performance due to its provision of increased certainty for importers and exporters. However, as stated by Williamson (2004), precedent shows that attempts to defend a fixed (or almost fixed) exchange rate against market pressures have initiated financial crises that have often proved extremely costly. A floating exchange rate regime not only has the benefit of more likely preventing currency crises, it also contains the ability to better absorb various other negative shocks, albeit at the cost of potentially higher volatility in exchange or inflation rates. Additionally, with exchange and inflation rate fluctuations in check, a floating regime can improve a country’s rate of economic growth.

Since 1998, Indonesia has been using a floating exchange rate regime. Evaluating this current exchange rate regime, the results show that there are positive net benefits to Indonesia. Moreover, using nine criteria of exchange rate regime choice from the literature, this paper provides evidence that the current policy is optimal, under the condition that the country’s central bank can intervene when necessary to stabilize its currency, the rupiah.

The rest of the paper is organized as follows: section II summarizes past exchange rate regimes in Indonesia, section II evaluates the benefits and costs of Indonesia’s current floating exchange rate regime, section IV analyzes different current economic indicators and their compatibility to a floating or fixed exchange rate policy, and Section V concludes the paper.

PAST EXCHANGE RATE REGIMES IN INDONESIA

Since 1970, Indonesia has implemented three different exchange rate regimes. From 1970 to 1978, Indonesia used a fixed exchange rate regime. In 1970, the rupiah was fixed to the US dollar at Rp378 per US dollar. With this policy, Indonesia also limited the capital mobility. One of the policies used was a 10 percent exchange tax on exports. Following the floating of the US Dollar in 1971, which marked the end of the Bretton Woods and gold standard era, the rupiah was devalued to Rp415 per US Dollar.

Starting in 1978, Indonesia changed to a managed float regime. Under this system, movement in the rupiah was managed by Bank Indonesia within an intervention band. The direction of the middle point of the intervention band was determined by Bank Indonesia, taking into account the real competitiveness of the rupiah against the real exchange rate movements of major trading partner currencies (Goelton, 2008). In 1978, the exchange rate of the rupiah was depreciated by 33.6 percent, adjusted from Rp415 to Rp625 per US Dollar. The value of rupiah per US dollar was depreciated further in 1983 and 1986. In 1983, it became Rp970 per US dollar and in 1986, it was changed to Rp664 per US dollar. During this period, the government still limited capital mobility by using export taxes as one of the main tools. Another policy used was a ceiling on foreign currency swaps between commercial banks and Bank Indonesia, which was lifted in 1986.

As Indonesia’s economy opened further with the rising volume of capital inflows, the intervention band was progressively widened. From September 1992 to August 1997, Bank Indonesia widened the band on several occasions. In 1993, the exchange rate was allowed to deviate by Rp2 a day, an increase from the previously Rp1 a day. In 1994 and 1995, the spread expanded by Rp15 and Rp22, respectively. A year before the Asian Currency Crisis, Bank Indonesia further increased the intervention band to Rp118 (5 percent) in June 1996 and to Rp192 (8 percent) in September 1992. Despite this, capital inflows, particularly short-term, continued to mount rapidly. The intervention band expanded again in July 1997 to 12 percent, a month later the Central Bank decided to move to a floating exchange rate regime.
In order to cope with massive sell-off, Bank Indonesia increased the intervention band and interest rates. Despite the central bank’s best efforts, the rupiah plummeted to Rp2,000 per US dollar post-Thai baht devaluation. In January 1998, it fell to Rp14,000, while it depreciated further to Rp16,000 by June 1998.

With a floating regime, the exchange rate of the Indonesian rupiah theoretically should be determined solely by the supply and demand in the market. However, as stated on its website, Bank Indonesia cannot try to maintain a stable exchange rate by sterilization in the foreign exchange market, especially during an irregular fluctuation of the rupiah.

Figure 1. Indonesia’s Economic Growth and Exchange Rate (1994-2011)

Figure 1 shows how the adverse shocks were absorbed by adjustment in the exchange rate. During those periods of shocks, the rupiah was depreciated, on average, 21.8 percent in 2001, 8.6 percent in 2005, and 7.1 percent in 2009. These exchange rate movements improved export performance and incentivized purchases of relatively cheaper domestically produced goods; this latter fact kept output from sinking further.

Figure 2. Indonesia’s Economic Growth and Change in Money Supply (1994-2011)

Another advantage of a floating exchange rate regime is the freedom it grants to a central bank to conduct independent monetary policy. Using the change in M2 as an approximation of Indonesia’s expansiory/contractionary monetary policy, figure 2 illustrates that in response to adverse shocks in 2001, 2005, and 2008-2009, Bank Indonesia increased the country’s money supply (M2) as stimulus for its economy. This policy flexibility would not be granted under a fixed exchange rate regime.

HAS INDONESIA ENJOYED THE BENEFIT OF A FLOATING EXCHANGE RATE REGIME?

From literature, the main advantage of a floating exchange rate regime is the ability to neutralize adverse real/external shocks through adjustment of the exchange rate. Rummel (2010) explains, in the face of negative real/external shocks, a depreciation of the exchange rate would help reduce real wages and ensure expenditure switching from more expensive foreign goods to relatively cheaper domestically produced goods, thereby maintaining employment and output. The more that real shocks predominate over the nominal shocks, the more exchange rate flexibility is needed.

Post Asian Crisis, as shown in figure 1, all of the adverse shocks experienced by Indonesia were real shocks. In 2001, economic growth fell from 4.9 percent in the previous year to 3.6 percent. This drop occurred due to the US dot.com bubble bursting. The economy had another shock in late 2005, which translated into slightly lower economic growth in 2006 (5.5 percent in 2006 and 5 percent in 2005). The shock came from the increase in the world oil price that forced the government to cut its fuel subsidy. The latest shock happened in 2009. Economic growth fell to 4.5 percent in that year, the Global Financial Crisis starting in 2008 was the driving force why.

Figure 2 shows this measure for Indonesia; based on this graph, in 2012, Indonesia possesses more than enough reserves (2012). This implies that Bank Indonesia has room to use some of its reserves to stabilize the rupiah.

CONCLUSION AND RECOMMENDATION

This paper shows that Indonesia has benefited from a floating exchange rate due to the regime’s provision of protection from real, external shocks and flexibility to conduct monetary policy independently. Nevertheless, the country has had to endure volatile exchange rates with this regime, which at times has hurt exports.

Using nine different criteria and considering current economic conditions, six of those criteria, trade openness, inflation differential, economic development level, size of the economy, dominant trading partner, and diversification of export products are in favor usage of a floating exchange rate regime. The other three, capital mobility, high foreign currency denominated debt, and international reserves support implementation of a fixed exchange rate.

Based on the two points above, this paper argues that a floating exchange rate remains the most appropriate regime for Indonesia under this one following condition: the central bank can intervene to stabilize the rupiah if there is an unusually high volatility in the exchange rate.

REFERENCES


High foreign currency denominated debt

On one hand, Indonesia’s external debt to GDP ratio is relatively low compared to other countries in the world. Currently the ratio is 28.2 percent, which includes both private and government debt. Moreover, despite the increasing trend, the share of short term debt to total debt is still relatively low, as it remains below 20 percent (figure 10). On the other hand, more than 60 percent of Indonesia’s external debt is denominated in the US dollars (figure 11). If the rupiah depreciates significantly relative to the US dollar, Indonesia’s external debt can substantially increase. In order to prevent that, a stable exchange rate is preferable to an actively fluctuating one.

INTERNATIONAL RESERVES

In addition to providing insulation from real shocks and allowing for monetary policy independence, a floating exchange rate regime does not require a country to hold large amounts of international reserves. However, in the recent literature, especially post-Asian Currency Crisis, there is a growing view of the necessity of holding international reserves, especially for developing and emerging economies irrespective of their choices of exchange rate regimes. Greenspan (1999) argues that there is a need to take into account the vastly increased importance of capital flows for emerging market economies and to relate the size of reserves to a country’s short term external debt. Bussiere and Mulder (2003) claims that due to banking system’s collapse, exporters faced difficulty buying raw materials and other inputs, and thus they could not take advantage of the sinking rupiah.

SHOULD INDONESIA MOVE TO A DIFFERENT EXCHANGE RATE REGIME?

It has been 15 years since Indonesia decided to move from a managed floating exchange rate regime to a strictly floating exchange rate regime. In those 15 years, the economy has changed. In order to answer the question whether this regime is optimal for Indonesia’s current day economy, this paper uses theoretical criteria of exchange rate regime choice from Poirson (2001).

Because of the lack of data to show labor mobility and nominal flexibility, dollarization, and credibility of the central bank, this paper will drop these criteria in assessing the current exchange rate regime in Indonesia.

TRADE OPENNESS

Compare to neighboring countries, Indonesia has a relatively low level of trade openness. Its total trade volume is around 60 percent of its GDP while Malaysia, Singapore, and Thailand possess trade volumes in excess of their GDP output. For these other countries, high volatilities in their exchange rates will reduce their total trade and domestic outputs. Due to Indonesia’s lower dependence on trade, there is less need for the central bank to stabilize the exchange rate. Based on this criterion, a floating regime is more preferable for Indonesia than a fixed one.

Despite its advantages, a floating exchange rate regime has its disadvantages, chiefly the potential for high volatility in both exchange and inflation rate. Looking at 15 years of the floating exchange rate regime era in Indonesia, volatility in the exchange rate occurred (figure 3), while inflation remained relatively stable (figure 4). Using variance as a measure of volatility, the variance ratio (7.41 percent) during the floating exchange rate regime period (0.17 percent) differed little from that recorded amidst the managed float regime (0.16 percent). In fact, Indonesia during the float period experienced a lower average inflation rate (7.41 percent) than during the managed float (9.32 percent).

Many argue that the increase in exchange rate volatility is one of the reasons behind the post-Asian Crisis poor export performance, despite the enormous depreciation of the rupiah. This view is supported by Listiani (2010), Bustaman & Jayanthakumaran (2006), and Siregar & Rajan (2002) who find a negative relationship between exchange rate volatility and trade performance. However, as shown by Alhukroma (2006), I argue that the poor post-crisis export performance numbers stem from supply side problems and increasing competition from China. Pardede (1999) also supports this argument; he claims that due to banking system’s collapse, exporters faced difficulty buying raw materials and other inputs, and thus they could not take advantage of the sinking rupiah.

Should Indonesia move to a different exchange rate regime?

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shown in economic development level is income per capita. As the indicator used in this paper to describe Indonesia’s development improvement will further develop bring more than threefold from 1994 to 2001. The economic SIZE OF ECONOMY ECONOMIC DEVELOPMENT LEVEL AND SIZE OF ECONOMY The indicator used in this paper to describe Indonesia’s economic development level is income per capita. As shown in figure 6, income per capita has increased more than threefold from 1994 to 2001. The economic development improvement will further develop bring about a more developed factor, goods, and financial markets in the economy. Thus, a floating exchange rate regime’s suitability for Indonesia actually has increased in recent years. Currently, Indonesia has the 16th largest economy in the world, and by 2030, it is projected to possess the 7th biggest (see figure 6 for its recent trend of steady growth). As its economy grows, Indonesia will be less likely to succumb to macroeconomic volatilities that can arise from floating exchange rate regimes. Figure 6 shows the steady increase in the size of Indonesia economy, which represented here using its nominal GDP (2.50) than now (1.18). Currency stabilization regulations implemented by Bank Indonesia largely explains the lower current value. This implies that based on its capital mobility, currently, Indonesia should choose a fixed exchange rate regime.

DOMINANT TRADING PARTNER Indonesia has a more diversified set of trading partners now than it did pre-Asian Currency Crisis when it used a managed float exchange rate regime (figure 8). The share of Indonesia’s traditional trading partners, Japan and the USA, has become smaller over time, while China’s share has grown. Since Indonesia has a more balanced group of trading partners, a fixed exchange rate becomes less preferable.

DIVERSIFICATION OF EXPORT PRODUCTS Compared to pre-Asian Currency Crisis, a higher share of Indonesia’s exports now fall in the mining sector, and the country has become less dependent on oil (figure 9). Since Indonesia has more diversified export products, a floating exchange rate regime looks more attractive than a fixed one.

Table 1. Theoretical Criteria of Exchange Rate Regime Choice

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<th>Variable</th>
<th>Likelihood of Selecting Floating ER</th>
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<td>Trade openness</td>
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<td>Countries that trade intensively need a more stable exchange rate than countries that have low trade.</td>
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<td>Inflation differential</td>
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<td>Higher inflation differential would necessitate frequent exchange rate adjustments.</td>
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<td>High dollarization (currency substitution)</td>
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<td>High dollarization occurs when the inhabitants of a country use foreign currency in parallel to or instead of the domestic currency. Hence the economy would benefit from a more fixed exchange rate.</td>
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Figure 5. Four ASEAN Countries Trade Openness

Figure 6. Indonesia’s Income per Capita and Nominal GDP (1994 – 2011)

Figure 7. Indonesia’s Chinn-Ito Index

Figure 8. Share of Indonesia’s Exports by Trading Partner (%)

Source: FRED, St Louis, 2012

ECONOMIC DEVELOPMENT LEVEL AND SIZE OF ECONOMY

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Figure 10. Indonesia's External Debt Profile

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(1999) conclude that higher liquidity can significantly decrease countries’ vulnerability to external shocks in the face of weak domestic fundamentals. Moreover, Fischer (1999) points out that countries holding very large reserves have coped better with the financial crises of recent years than others.

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**PAST EXCHANGE RATE REGIMES IN INDONESIA**

Since 1970, Indonesia has implemented three different exchange rate regimes. From 1970 to 1978, Indonesia used a fixed exchange rate regime. In 1970, the rupiah was fixed to the US dollar at Rp378 per US dollar. With this policy, Indonesia also limited the capital mobility. One of the policies used was a 10 percent exchange tax on exports. Following the floating of the US Dollar in 1971, which marked the end of the Bretton Woods and gold standard era, the rupiah was devalued to Rp415 per US Dollar.

Starting in 1978, Indonesia changed to a managed float regime. Under this system, movement in the rupiah was managed by Bank Indonesia within an intervention band. The direction of the middle point of the intervention band was determined by Bank Indonesia, taking into account the real competitiveness of the rupiah against the real exchange rate movements of major trading partner currencies (Goeltom, 2008). In 1978, the exchange rate of the rupiah was depreciated by 33.6 percent, adjusted from Rp415 to Rp625 per US Dollar. The value of rupiah per US dollar was depreciated further in 1983 and 1986. In 1983, it became Rp970 per US dollar and in 1986, it was changed to Rp664 per US dollar. During this period, the government still limited capital mobility by using export taxes as one of the main tools. Another policy used was a ceiling on foreign currency swaps between commercial banks and Bank Indonesia, which was lifted in 1986.

As Indonesia's economy opened further with the rising volume of capital inflows, the intervention band was progressively widened. From September 1992 to August 1997, Bank Indonesia widened the band on several occasions. In 1993, the exchange rate was allowed to deviate by Rp42 a day, an increase from the previously Rp1 a day. In 1994 and 1995, the spread expanded by Rp135 and Rp22, respectively. A year before the Asian Currency Crisis, Bank Indonesia further increased the intervention band to Rp118 (5 percent) in June 1996 and to Rp219 (8 percent) in September 1992. Despite this, capital inflows, particularly short-term, continued to mount rapidly. The intervention band expanded again in July 1997 to 12 percent; a month later, the Central Bank decided to move to a floating exchange rate regime.

The decision to move from a managed float to a floating exchange rate regime was mainly due to the Asian Currency Crisis following the devaluation of the Thailand baht. As a result of the contagion effect, the rupiah came under severe attack from speculators.