

External debt of Indonesia: From debt-led growth to growth-led debt?

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Abstract: Indonesia has received external debt as an external source of finance to fill in the investment-saving gap in achieving economic growth to improve social welfare. Despite Indonesian economy is able to recover to some extent, based on Bank Indonesia (2018), Indonesia's external debt at the end of Q2/2018 still amounted to USD 355,7 billion; consisting of government and central bank external debt of USD 179.7 billion, as well as private sector (including state-owned enterprises) external debt of USD 176.0 billion. Therefore, this study aims to examine the trend and impact of external debt on economic growth in the context of Indonesia's economy. If external debt is found to lead to debt trap, or already in the condition of growth-led debt, its benefits for economic development should be reviewed properly and government policies regarding external debt need to be redesigned. This study is a qualitative research in the form of case study of External Debt and its critical impact in Indonesia. Through observation, data comparison and literature study, it is found that external debt of Indonesia has been dominated by US Dollar and Japanese Yen, which assumed to cause surge in debt repayment.

Keywords: External debt, economic growth, over-borrowing.

JEL Classification: F40, F43, H60.

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1. INTRODUCTION

To improve people welfare of a country, development in various fields is needed, especially the economy. The expenditures in economic development financed by government revenues, from within and outside the country. Domestic revenue comes from taxes, natural resource management, and State Own Enterprises profits. While foreign revenues could be in the form of aid, debt, and grants from other countries, or supranational organizations such as the International Monetary Fund, the World Bank, Asian Development Bank (ADB), etc. Theoretically, the expenditure for development in stable country mostly comes from domestic resources. Meanwhile for developing countries, foreign aid still become a crucial component in accelerating their economic growth.

A developing country only has limited capital compared to the population and natural resources. Its characteristics include low levels of income per capita; low savings; low investment; inadequate facilities and infrastructure to support state activities; and less competitive human resources (Todaro & Smith, 2006). Indonesia is one of the developing countries that adheres open economic system. The Government of Indonesia started liberalizing its capital account regime in 1967, when it introduced the Foreign Investment Law No. 1/1967. The government later adopted a free-floating foreign exchange system in 1970 which was followed by further liberalization of the financial sector in 1980s (Kuncoro, 1999). Foreign aid was a key feature of Indonesia's economic development during the period 1967-2003. This component, as well as public revenues from the oil and gas sector, became a pillar for state expenditure back then.

At certain point, Indonesian economy collapsed by the global economic crisis. This is indicated by high rate of unemployment rate, inflation, and the weakening of Rupiah (Indonesian currency) exchange rate. As Indonesia did not provide sufficient domestic savings to fund economic growth and restore economic stability, the government strive to seek for foreign source of financing to cover the large amount of shortages. Indonesia receive external debt as an external source of finance to fill in the investment-saving gap and thus aided the effort to achieve economic growth to improve social welfare. According to Nakatani & Herrera (2007), external debt accumulates because of the servicing requirements and the principal itself. It becomes a self-perpetuating mechanism of poverty aggravation, work over-exploitation, and a constraint on development in developing economies. The natural consequence of commitment to repay debt and its interest is decreasing of domestic consumption, which is impacts on expenditure-reducing policies, such as tight monetary policy, reduction of development expenses, and suspension of mega projects (Kuncoro, 1997). Hence in this case, the logical question is whether the external debt is really needed to boost the economic growth, or vice versa (Basorudin, 2019).

Almost, all scholars are unanimously agreed on the point that capacity of a nation to service its debt is the most important consideration in public debt management. Debt problem in governments arises if debt servicing capacity does not keep pace with the growth of debt (Alam & Taib, 2012). In the late 1980s the principal instalments had to be paid by Indonesian government because of debt maturity, so the total instalments and its interest became greater than the new loans each year. A major share of the foreign currency earned from exports goes just to make the debt payments. As result, the problem of budget deficit has become a major issue in fiscal management. Further, in the Asian financial crisis exploded in 1997, Indonesia was hit very severely, in fact the worst in the region. GDP growth rate dropped by 13.2 percent in 1998 and over a short period, the Indonesian currency, Rupiah, lost 84 percent of its value. The crisis resulted in a significant increase in debt service obligation and debt level, whereby Debt Service Ratio (DSR) rose from 45 percent in 1996 to 58 percent in 1998; while Debt to GDP ratio jumped from 49 percent to 146 percent during the same period (Kusumaningtuti, 2004).

Currently, Indonesia is the world's fourth most populous nation, the world's 10th largest economy in terms of purchasing power parity, and a member of the G-20. According to the World Bank's October 2017 Indonesia Economic Quarterly, real GDP growth of Indonesia is expected to reach 5.1 percent in 2017, climbing to 5.3 percent in 2018, on a supportive global economy and stronger domestic demand as reforms continue and gradually start paying dividends. Though Indonesian economy is able to recover to some extent, based on Bank Indonesia (2018), Indonesia's external debt at the end of Q2/2018 still amounted to USD 355,7 billion; consisting of government and central bank external debt of USD 179.7 billion, as well as private sector (including state-owned enterprises) external debt of USD 176.0 billion. Indonesia's external debt at the end of Q2/2018 grew at 5.5 percent (YoY).

Table 1. External Debt Position by Group of Borrower (in Million USD)

External Debt	2011	2012	2013	2014	2015	2016	2017	2018-Q2
Government & C. Bank	118.642	126.119	123.548	129.736	142.608	158.283	180.622	179.738
Private	106.733	126.245	142.561	163.592	168.122	161.723	172.277	176.012
Total	225.375	252.364	266.109	293.328	310.730	320.006	352.899	355.740

Source: External Debt Statistics of Indonesia (Bank Indonesia, 2018)

Theoretically, it is expected that the marginal product of capital should be higher than the world interest rate for developing countries, so that such countries would benefit from external borrowing (Eaton, 1993). However, external debt only helps to exploit the potentials of a country, it does not enhance it. Thus, the only guideline is that the rate of return on spending should exceed the marginal cost of borrowing on the assumption that debt is paid (Indermit & Brian, 2005). For that reason, this

study aims to examine the trend and impact of external debt on economic growth in the context of Indonesia's economy. Sustainable economic growth is crucial to alleviate poverty, also generating revenues to service the debt. If external debt is found to significantly lead to the debt trap, or already in the condition of growth-led debt, its benefits for economic development should be reviewed seriously and government policies regarding external debt need to be redesigned. The finding of this study is expected to shape decent policies for Indonesia in particular and developing countries in general related to external debt.

2. LITERATURE REVIEW

Numerous studies have been carried out on the relationship between external debt and economic growth by utilizing different econometric models and tools to identify and verify their relationship. In previous study, Asley (2002) stated that high level of external debt in developing country negatively impact their trade capacities and performance. Debt overhang affects economic reforms and stable monetary policies, export promotion and a reduction in certain trade barrier that will make the economy more market friendly and this, enhances trade performance. Furthermore, debt decreases a government ability to invest in producing and marketing exports, building infrastructure, and establishing a skilled labor force. While Cohen (1994) analyzed foreign debt and economic growth from a different angle. He found that marginal productivity of capital in poor countries is higher than in the rich countries, suggesting there is a room for foreign finance to increase economic growth. He also argued that there are empirical reasons to believe that foreign finance could affect growth through productivity.

Another view examined the impact of domestic debt and external debt on the economic growth of Pakistan, separately over period of 1980-2010. The findings suggested an inverse relationship between domestic debt and economic growth, also the relationship between external debt and economic growth was found negative. The results also concluded that external debt slows down economic growth more as compared to domestic debt (Atique and Malik, 2012). However, Cohen (1993) failed to find any evidence in favor of a negative relationship between external debt and economic growth in a set of 81 developing countries during the period of 1965-1987. In Indonesia, Ainiyah (2015) in her thesis concluded that in short term period, foreign debt makes a significant contribution to the financing of national economic development. On the other hand, long-term foreign debt repayments by the government could decrease the level of welfare and prosperity in the future. Another study conducted by Cholifihani (2008) has analyzed long-term and short-term relationships between public debt service and GDP in Indonesia by applying co-integration analysis of time series data from 1980-2005. The result indicated that Indonesia faces a debt overhang problem in the long- run since increasing the public external debt service makes sluggish economic growth

Frank (1966) found a concept of dependency which based on the global relation of economic domination and exploitation by the more economically powerful countries over the less economically powerful countries. As a result of the unequal distribution of power and resources, some countries have developed at a faster pace than others. He argues that we cannot formulate an adequate development policy for a majority of the world's population without knowing how their past economic and social history influenced their current underdevelopment. Frank envisions this world – economy as being divided into two major components, "metropolis and satellite". In his view, the underdeveloped countries have become and remain underdeveloped because they are economically dominated by developed capitalists' countries that have continually been extracting wealth from them. The greatest benefits go to capitalists in the metropolitan countries, as well as to the agricultural and industrial elites of the satellite countries. As a case study, Frank focuses on the economy of Brazil and describes how its capital, Sao Paulo, became one of the largest and most developed industrial hubs in Latin America. Despite the rapid development of Brazil, Frank argues that Brazil will not break out of the cycle of underdevelopment due to its continued reliance on the more developed nations as a way to export its resources.

3. MATERIALS AND METHODS

The research methodology was designed to collect accurate information from observed parameters. This study is a qualitative research in the form of case study of External Debt and its critical impact in Indonesia. Case study method is a descriptive approach that is used to investigate and comprehend a phenomenon or problem that occurs, with a specific subject. This study is conducted by collecting various information which are then processed to develop certain solution so that the problems revealed can be resolved (Creswell, 2013). Descriptive analysis is a simple form of analysis that aims to describe and facilitate the interpretations carried out with provide exposure in the form of tables and graphs. The descriptive analysis used to provide an overview of external debt condition in Indonesia and the development of economic growth as other research variables. Through this descriptive analysis expected to strengthen the econometric analysis discussed later to answer the purpose of this study.

Data collection is done through observation, theories comparison, and literature study. Secondary data is obtained through various sources, including the 2013 International Debt Statistics by The World Bank; 2013 External Debt Statistics: Guide for Compilers and Users by International Monetary Fund (IMF); Government and Central Bank external debt data by Ministry of Finance and Bank Indonesia (BI); and Private external debt data by Bank Indonesia (BI). The triangulation process is carried out throughout the process of data collection and analysis to test the validity of the data and obtain objective findings.

4. RESULT AND DISCUSSION

4.1. Indonesian public finance

Public finance includes government activities and the alternative means of financing government expenditures -- rationing the use of government goods and services and financing their resource costs affect incentives, resource use, and production possibilities. As adherents of open economic system, international trade traffic plays an important role in the economic development in Indonesia. In the 1970s, non-oil and gas exports were a major source of foreign exchange earnings, which accounted for almost 80 percent of export revenues. In 2017, Indonesia exported US\$188B and imported US\$153B, resulting in a positive trade balance of US\$35.1B (OEC, 2017). The top exports of Indonesia are Coal Briquettes (US\$18.9B), Palm Oil (US\$18.2B), Petroleum Gas (US\$8.99B), Rubber (US\$5.68B) and Crude Petroleum (US\$5.34B). Further, domestic investment as a component of investment is a main factor for the economy of a region. Referring to the Law No. 25 year 2007 concerning Capital Investment, domestic investment is an activity of investment to conduct business in the territory of the Republic of Indonesia carried out by domestic investors using domestic capital. Domestic Investment will increase accumulation of capital, while capital is an important component of GDP formation a country.

A simple definition of Foreign Direct Investment is an investment made by investors from other countries. According to Moosa (2002), FDI is a process by which economic actors (individuals and companies from a country (country of origin) obtaining ownership of the asset for the purpose of production control, distribution and other activities of a company in other country (host country). FDI usually carried out by giant multinational companies or commonly called transnational companies, i.e. a large company headquartered in the country of origin, while the operational branch or its subsidiaries are spread over various countries. This investment fund is directly manifested in various form, such as factories establishment, procurement of production facilities, purchasing machinery and so on. According to traditional neo-classical analysis, FDI considered as a positive thing, since it would fill the deficit of internal savings, also increase foreign exchange, as well as supports gross domestic capital. In Indonesia, data on FDI Realization published by Indonesia Investment Coordinating Board (BKPM) comes from Investment Activity Regular Report by investors. Incomplete FDI projects are not recorded yet in the investment realization.

Other than investments, domestic saving also plays an important role in public finance. Gross domestic saving are calculated as GDP minus final consumption expenditure. It consists of savings

of household sector, private corporate sector and public sector. This saving is needed to fund the investment (Pattillo et al, 2002). The saving-investment gap can be filled by the influx of foreign capital to the public and private sectors. Indonesian households only manage to save 8.5 percent, on average, of their total income. This is a very low ratio given most analysts advise that at least 20 percent of income should go towards savings.

The last is foreign aid, which is a voluntary transfer of resources to fund the international community, including bilateral assistance from one country to another (direct), or multilateral assistance through multilateral agencies (indirect). The aid provided is generally in term of Official Development Assistance (ODA), including loans, grants, technical assistance, as well as other flow of funds with concessional requirements (soft interest, long term). ODA is defined by the OECD Development Assistance Committee (DAC) as government aid that promotes and specifically targets the economic development and welfare of developing countries (OECD, 2019). Since these foreign aids mostly have to be repaid, it is often called foreign loans or external debt.

4.2. External debts

External debt mostly caused by budget gap, saving-investment gap, and current account gap. By the time period, external debt can be divided into: (i) short term debt – one year of original maturity or less, (ii) long term debt – more than 1 year of original maturity, and (iii) use of IMF credits – provided by the IMF Treasurer's Department. According to the type of debt, long term debt could be breakdown to private non-guaranteed debt and public & publicly guaranteed debt. Private non-guaranteed debt is made by private debtors that are not guaranteed by government institutions. While public and publicly guaranteed debt consists of two forms, that is: (a) public debt by government institution, including the central and local government, departments, and autonomous government institutions; and (b) publicly guaranteed debt, which is made by private party that is guaranteed for repayment by public entity. Extra supervision is needed, as the government must bear the consequences if the private party is unable to repay the debt (World Bank, 2018).

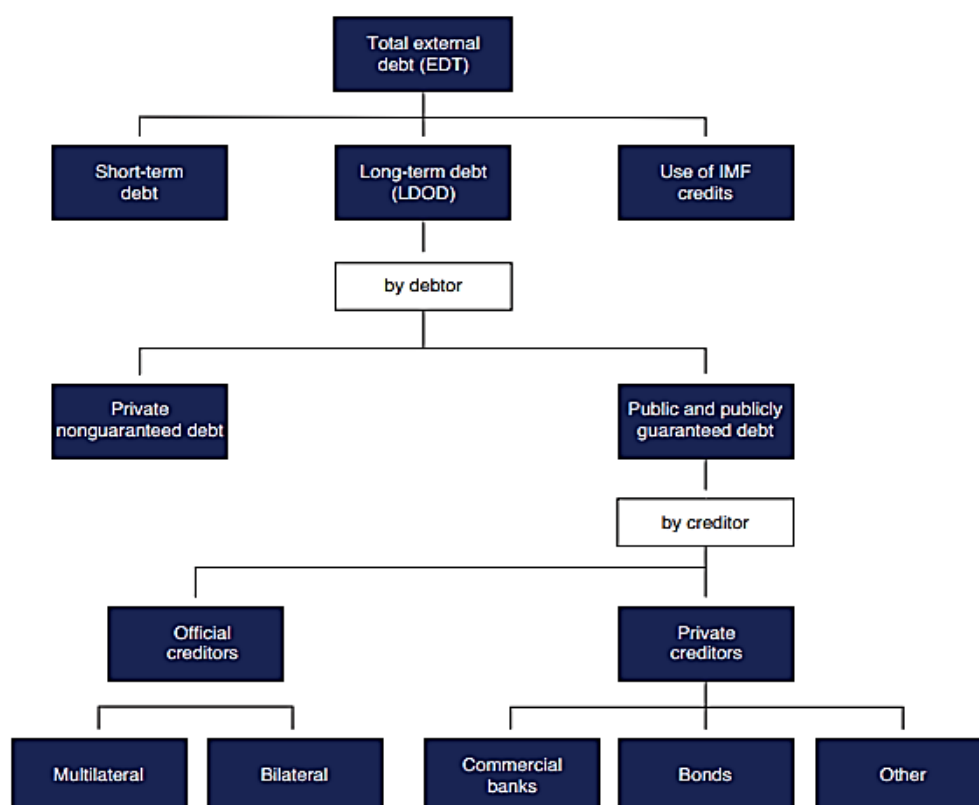


Figure 2. External debt and its component (World Bank, 2018)

In Indonesia, Bank Indonesia (2018) has defined external debt as liabilities that require payment

of interest and/or principal by the debtor at some point in the future and that are owed to non-residents by residents of an economy, the outstanding amount of those actual current, and not contingent, that consists of:

- Government external debt: owned by central government, consists of bilateral and multilateral loans, commercial loans, supplier credit and government securities (SBN) owned by non-residents and issued on foreign and domestic markets. Government securities consist of government debt securities (SUN) and government Islamic securities (SBSN).
- Central bank external debt: owned by Bank Indonesia and is used to support of the balance of payments and international reserves. There is also external debt originated from the issuance of Bank Indonesia Certificates (SBIs), currency and deposits subsequently owned by non-residents, and other central bank's liabilities to non-residents.
- Private external debt: owned by residents of Indonesia to non-residents in foreign currency or rupiahs based on loan agreements or other contractual arrangement, currency and deposits owned by non-residents, and other liabilities to the non-residents. The coverage includes financial corporation and non-financial corporation external debt. One of the components of private external debt is foreign debt arising from domestic issuance of securities owned by non-residents.

4.3. Foreign capital, external debt, and economic growth in Indonesia

As a developing country, development in Indonesia still requires substantial funding support. Especially because of the economic development that had been disrupted during the economic crisis in 1998. The crisis has caused a number of development projects, especially in the infrastructure sector to be suspended. During the crisis, Indonesia's external debt had surged due to exchange rate differences, especially against the US dollar. The solution that is considered reliable to overcome the low mobilization of domestic capital is by bringing in foreign capital, which generally in the form of grants, foreign aid, investment, and soft loans. This foreign capital can be given both to the government and private sector.

External debt in a development context that is characterized by the economic growth of a country becomes an important source of financing. This indicates that the existence of debt is not always seen as a burden on state financing (Lin and Sosin, 2001). External debt as a source of financing for national development is basically a trigger to drive the economy. While the debt repayment obligation should be seen as an encouragement to build a system that is able to utilize debt funds to finance development effectively and efficiently. Unfortunately, external debt in foreign currencies which were aggravated by the high interest and the low value of exported goods caused difficulties to Indonesia in repaying the debts.

4.4. Debt crisis

The emergence of debt crisis at least can be reviewed from three causes, including:

- International monetary system as if dependency between countries, in this case surplus country and country with deficit balance of payments, requires an international monetary system that capable of circulating the funds flow from surplus countries to deficit countries. In the 1970s to early 1980s, this system did not work properly, which was marked by the declining role of IMF in resolving interstate disparities (Gibson and Tsakalotos, 1992). The fund rotation process mostly done by market mechanism that troubles developing country.
- International private banking system as in conducting fund rotation, the market mechanism allows private commercial banks to provide loans to deficit countries. Two things that are considered by private banks are: (1) credit ratio, which is distinguished by the level of risk of borrowing country. The higher the risk of a country, the higher the ratio of credit to be borne, and (2) fierce competition between banks, which causes a tendency for small banks to simply follow the decisions of large banks in lending money and calculating the risks.
- Factors of the borrowing country as the occurrence of debt crisis from the borrowing country is

generally caused by the relationship between loans and investment. Investments made from loans only increase in quantity. As the investment is unable to boost state revenues and exports, so it wouldn't enough to repay the debts. Second factor is capital flight, which was caused by speculation related to devaluation and instability economy. This results in a decline of domestic investment, which makes national output low (Samuelson & Nordhaus, 2010).

4.5. Has the external debt of Indonesia reached over-borrowing?

The Indonesian government should be aware of whether the indicators of Indonesia's external debt has reached the level of over borrowing. Table 2 shows that the total external debt has jumped from US\$141.820 million in 2005 to US\$213.541 million in 2011, an increase of more than 50 percent in 6 years. Meanwhile the short-term external debt increased from US\$11.023 million to US\$38.173 million, an increase by 246 percent, compared to an increase of only 40 percent in the long-term debt which increased from US\$122.649 million to US\$172.327 million during the same period.

Table 2. External debt stocks of Indonesia in US\$ Million

Debt/Years	2000	2005	2006	2007	2008	2009	2010	2011
Long-term external debt	110,818	122,649	123,392	128,821	137,050	152,240	159,075	172,327
Public and Publicly guaranteed	69,649	77,405	76,625	80,315	87,753	97,447	100,292	102,552
Private nonguaranteed	41,169	45,244	46,766	48,507	49,297	54,793	58,783	69,775
Use of IMF credit	11,149	8,148	359	378	368	3,105	3,050	3,041
Short-term external debt	21,688	11,023	12,208	18,655	20,488	24,050	33,047	38,173
Interest arrears on long-term	4,632	0	0	0	0	0	0	0
External debt stocks total	143,655	141,820	135,959	147,854	157,906	179,394	195,172	213,541

Source: 2013 International Debt Statistics (The World Bank, 2013)

In the latest report, Indonesia's External Debt accounted for 36.2 percent of the country's Nominal GDP in 2018, compared with the ratio of 34.7 percent in 2017. The total external debt has rose to US\$354.352 million in 2017. While the long-term external debt also dramatically increased from US\$177.769 million in 2016 to US\$195.691 million in 2017 (World Bank, 2018). Considering this condition, it is normal to think regarding to what extent Indonesia will depend on foreign funds, whether external debt only temporarily applies as an injection, or being a need that have to be carried out continuously to maintain the development.

Up till now, external debt of Indonesia is dominated by US Dollar and Japanese Yen. The appreciation of Japanese Yen against the US dollar is assumed to cause surge in debt repayment. Foreign exchange exposure is the financial risk that arises from potential changes in the exchange rate of one currency in relation to another (Mankiw, 2009). Hedging could be an option to avoid this risk, including currency swap and buying a forward contract or currency option. This method might minimize the risk of currency fluctuations in donor countries.

4.6. From Debt-Led Growth to Growth-Led Debt

As an effort to overcome saving-investment gaps and foreign exchange gaps, developing countries normally seek for foreign funds. Broadly speaking, the role of external debt could have a positive impact, as follows: firstly, utilizing foreign funds to accelerate investment and economic growth; secondly, increased economic growth needs to be followed by changes in the structure of production and trade; thirdly, external debt can encourage fund mobilization; and lastly, the need for foreign capital will decrease after structural changes occurred (as they become more productive). For instances, Daseking and Kozack (2003) states that investment returns depend on

how funds are used. If the borrowed funds are prudently used and the development projects are timely completed then it would be a positive sign of the economy. Under such circumstances, the project after its completion would start generating revenues and therefore enhance the debt servicing capacity of the government. These situations reflected "debt-led growth" phenomena that is acceleration of growth driven by external debt.

However, in the process, the creditors were beginning to realize a huge increase in debt that has exceeded the limit so that it can endanger the developing countries. Therefore, they limit the loans policy by tightening the requirements for new loans request. But due to the needs of pursuing economic growth, the government then begin to seek for other sources of funds from private institutions with higher interest rates. A misappropriation of borrowed funds that are used in unproductive means may lead to accumulation of debt at a faster rate than the growth in the economy. This condition indicated that there has been a "growth-led debt" in developing countries. In this scenario, the government would engage in a chain of borrowing phenomenon that signals debt trap. Under debt trap, the government procures new debt just to service old debt thus accumulation of debt instead of accumulation of capital takes place (Alam & Taib, 2012).

Table 3. Comparison of economic growth percentage & external debt of Indonesia (Million USD)

Aspect	2010	2011	2012	2013	2014	2015	2016	2017	2018
External Debt	202,413	225,375	252,364	266,109	293,328	310,730	320,006	352,469	376,839
Economic Growth	6.81%	6.44%	6.19%	5.56%	5.02%	4.79%	5.02%	5.07%	5.17%

Source: Bank Indonesia and Ministry of Finance (Vol. X, 2019)

In fact, the increase in external debt from year to year is not linear with the percentage of economic growth in Indonesia. As seen on table 3, the economic growth's rate keeps decreasing from year 2010, and reached its lowest point in 2014. Furthermore, though it is quite far below the government target, economic growth in 2018 reached the highest number since 2014, with a trend that slightly rise. The disordered curve between both aspects describes the "debt-led growth" causation could not be established in Indonesia, at least for current time. Thus, the external debt could not be used to forecast improvement or slowdown in economic growth in Indonesian context.

5. CONCLUSIONS

For Indonesia, external debt still become one of reliable development capital, as the value of development investment is higher than domestic savings. The amount of Indonesia's external debt tends to increase from year to year. This of course raises various consequences, both in short and long-term periods. In short-term period, external debt must be recognized in contributing to the national economy growth so that the level of income and welfare of the community also grows. But in the long run, external debt is a burden for the government. High interest rates make the debt continue to increase. Currently, productivity and the rapidity of domestic funding increasement in Indonesia cannot compensate with the pace of increase in foreign aid amount. This condition indicates that "debt-led growth" phenomena might has shifted to "growth-led debt". The obsession to pursue growth has led to an increase in the need for debt.

In order to bring sustainable economic growth in Indonesia, it is suggested to implement the active debt management policy. To reduce the negative risk of external shocks, external debt needs to be lessened to a more manageable level. The government could utilize more domestic debt instead of external one. Ideally, the external debt should be invested only for productive projects, the self-repaying projects if possible. This paper mainly focused on case study of external debt in Indonesia as general, and relied on secondary data of government reports and central bank statistics. Future research should be done for a larger group of developing countries with analysis based on primary data.

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