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The Transmission Mechanism of Indonesia's 1997-1998 Monetary Crisis: An Integrated Analysis of Exchange Rate Dynamics, Monetary Policy, and the Financial System

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ABSTRACT

The 1997-1998 monetary crisis in Indonesia was a complex economic event that requires an in-depth understanding of intersectoral linkages. This study aims to analyze the transmission mechanism of the crisis through the interaction between the exchange rate, monetary policy, and the financial system. The method employed is a qualitative approach using descriptive-analytical techniques applied to secondary data from the 1997-1998 period. The findings show that the sharp depreciation of the rupiah triggered a domino effect, leading to a surge in inflation and forcing the implementation of tight monetary policy through an extreme increase in interest rates. The novelty of this study lies in the reconstruction of the crisis transmission path by integrating three sectors simultaneously foreign exchange, monetary policy, and banking within a chronological narrative in order to reveal how exchange rate shocks systematically evolved into financial system failure. These findings confirm the existence of an interconnected crisis transmission mechanism, in which instability in one variable was able to paralyze the entire national economic system in a multidimensional manner.

Introduction

The Asian monetary crisis of 1997–1998 remains one of the most significant turning points in the history of Indonesia's contemporary economy. The crisis was not merely a short-term financial shock, but a multidimensional economic disruption that fundamentally changed the structure of Indonesia's monetary, banking, and real sectors. It was marked by an uncontrolled depreciation of the rupiah, the collapse of public confidence in the banking system, severe liquidity pressures, and a deep economic contraction. The crisis also generated extensive social and political consequences, including rising unemployment, declining purchasing power, increasing poverty, and a loss of confidence in economic governance. Although more than two decades have passed, the study of this crisis remains highly relevant because it provides important lessons for understanding systemic risk,

financial fragility, and the effectiveness of policy responses during periods of extreme economic uncertainty (Hill, 2021).

Prior to the crisis, Indonesia was widely regarded as one of Asia's high-performing economies. The country experienced sustained economic growth, with average annual growth rates exceeding 7%, supported by rapid industrialization, increasing foreign investment, and expanding financial intermediation. At the surface level, this performance created the impression that Indonesia had achieved macroeconomic stability and was on a strong path toward long-term development. However, beneath this impressive growth trajectory, the Indonesian economy contained several structural vulnerabilities. These included excessive dependence on short-term foreign borrowing, maturity mismatch in private external debt, weak corporate governance, insufficient banking supervision, and limited transparency in the financial sector. Such vulnerabilities made the economy highly exposed to external shocks, particularly when investor sentiment shifted and capital flows suddenly reversed (Nasution, 2020).

The urgency of this study is rooted in the rapid, destructive, and contagious nature of the crisis. The depreciation of the rupiah occurred at an extraordinary pace. Data show that the exchange rate weakened sharply from approximately IDR 2,450 per USD in July 1997 to around IDR 14,900 per USD in June 1998. This dramatic depreciation created severe balance sheet effects, especially for corporations and banks with large foreign currency liabilities but rupiah-denominated revenues. As the rupiah continued to weaken, the burden of external debt increased sharply, corporate solvency deteriorated, and banking sector vulnerabilities became more visible. The currency crisis therefore did not remain isolated within the foreign exchange market, but quickly spread into the financial system and the real sector.

In response to the rapid depreciation and massive capital flight, the monetary authority adopted a tight monetary policy by raising the SBI interest rate to an extreme level of around 70%. This policy was intended to stabilize the exchange rate, restore market confidence, and reduce pressure on the rupiah. However, the sharp increase in interest rates also created serious consequences for the domestic economy. High interest rates increased the cost of borrowing, weakened investment activity, reduced corporate cash flow, and intensified the problem of non-performing loans in the banking sector. As a result, the policy response designed to defend the currency also contributed to financial distress within the banking system. This condition illustrates the complexity of crisis management, where a policy aimed at stabilizing one sector may generate additional pressure on another sector.

The central problem addressed in this study concerns how the initial shock in the foreign exchange market was transmitted into a systemic banking crisis and eventually paralyzed the real sector. The crisis transmission process involved a chain of interconnected mechanisms. The depreciation of the rupiah increased the foreign debt burden of corporations and banks. This weakened corporate balance sheets and reduced the ability of firms to meet their financial obligations. At the same time, high interest rates placed additional pressure on firms that relied on domestic credit. These conditions increased non-performing loans and weakened bank balance sheets. As public confidence declined, liquidity pressures intensified, leading to bank runs and broader instability in the financial system. The crisis therefore developed through the interaction of exchange rate volatility, monetary policy tightening, banking fragility, and declining real sector activity.

Previous studies have generally examined the 1997–1998 crisis using quantitative and econometric approaches. These studies have contributed significantly to measuring the partial effects of macroeconomic variables such as exchange rates, interest rates, inflation, capital flows, and output contraction (Zaiane & Jrad, 2020). However, many of these studies tend to analyze variables separately and focus primarily on statistical relationships. While such approaches are useful for identifying empirical correlations, they often provide limited explanation of the broader causal process through which a currency shock evolved into a systemic economic crisis. In particular, there remains a gap in qualitative studies that systematically explain the transmission path among foreign exchange pressures, monetary policy responses, banking sector distress, and real sector contraction during the peak period of the crisis.

This study seeks to fill that gap by offering a systemic and narrative reconstruction of the crisis transmission mechanism. The novelty of this research lies in its attempt to integrate the foreign exchange sector, monetary policy, and banking system into a single analytical framework. Rather than treating each macroeconomic variable as an isolated factor, this study examines how one shock generated a sequence of responses and consequences across different sectors of the economy. In this sense, the study does not merely describe the chronology of the 1997–1998 crisis, but also reconstructs the underlying mechanism through which sectoral instability transformed into a national systemic crisis.

The significance of this research also lies in its contribution to understanding policy interaction during a crisis. The 1997–1998 Indonesian experience demonstrates that crisis dynamics cannot be understood solely from the perspective of exchange rate movements or monetary policy decisions. Instead, the crisis must be analyzed as a complex interaction between market confidence, external debt exposure, banking sector resilience, policy credibility, and institutional capacity. By examining these interactions, this study provides a more comprehensive understanding of how financial instability spreads across sectors and how policy responses may produce both stabilizing and destabilizing effects.

Therefore, this study aims to analyze the transmission mechanism of the 1997–1998 monetary crisis in Indonesia through the interaction of the exchange rate, monetary policy, and the financial system. More specifically, it seeks to explain how rupiah depreciation affected corporate and banking balance sheets, how monetary tightening influenced financial sector stability, and how banking distress eventually transmitted pressure to the real economy. In addition, this study provides a theoretical contribution by developing an integrated qualitative analysis that explains the transformation of a sectoral shock into a systemic national crisis. Thus, the study not only revisits a major historical economic event, but also offers a critical perspective on the fragility of financial systems in facing exchange rate volatility, sudden capital reversal, and weak institutional supervision.

Method

This study employs a qualitative approach using a descriptive-analytical method. The selection of a qualitative approach is justified by the need to explore policy dynamics and complex causal phenomena that cannot be fully captured through standard statistical tests. The data used in this study consist of secondary data on macroeconomic indicators during the 1997–1998 period, sourced from official reports published by Bank Indonesia, the Indonesia Stock Exchange, the IMF, and the World Bank.

Data collection was conducted through documentation studies of annual reports, monetary policy documents, and relevant academic literature. To ensure data validity and credibility, this study applies source triangulation by comparing numerical data from monetary authorities with policy narratives from international institutional reports. Data analysis was carried out using content analysis techniques, which include data reduction, chronological data presentation, and conclusion drawing in order to construct a conceptual model of crisis transmission.

Results and Discussion

Transmission Mechanism in the Rupiah Exchange Rate

The 1997–1998 monetary crisis in Indonesia began with a shock to exchange rate stability, which subsequently transmitted to all sectors of the economy. Prior to July 1997, the rupiah exchange rate was relatively stable within the range of IDR 2,300–2,600 per USD under a managed floating exchange rate system (Bank Indonesia, 1998). However, this apparent stability concealed structural vulnerabilities, particularly maturity mismatch and high dependence on short-term capital inflows.

Entering the second half of 1997, external pressure in the form of the contagion effect from the depreciation of the Thai baht forced the Indonesian government to widen the foreign exchange intervention band and eventually adopt a free-floating exchange rate system on 14 August 1997. This contagion phenomenon is consistent with the argument of Kaminsky and Reinhart (2000), who state that shocks in one emerging market often trigger investor panic in countries with similar risk profiles. The escalation dynamics of the exchange rate are summarized chronologically in the following table.

Table 1. Dynamics of Rupiah Depreciation and Main Triggers, 1997–1998

Period	Exchange Rate (IDR/USD)	Main Trigger	Systemic Impact
Jun-97	2,300–2,600	Pre-crisis stability	Positive perception of fundamentals
Jan-98	11	Negative expectations and speculation	Imported inflation
Jun-98	14,000–16,800	Political uncertainty	Massive capital outflow

Note: Data are processed from Bank Indonesia Annual Reports, 1998–1999, and the World Bank Report, 2000. Exchange rate figures reflect average values during the peak period of foreign exchange market turbulence.

Pressure on the rupiah reached its peak during June–July 1998, when the exchange rate moved within the range of IDR 14,000 to IDR 16,800 per USD. At this point, the analysis indicates that the crisis had gone beyond a purely technical economic problem and had entered a socio-political dimension. The decline in public confidence in the authorities triggered bank runs and capital flight, which theoretically worsened the balance sheets of domestic firms with unhedged foreign currency debt.

Theoretical Comparative Analysis: Why Was Indonesia the Most Severely Affected?

To understand why the impact of the crisis in Indonesia was far deeper than in other Southeast Asian countries, a cross-theoretical review is required.

1) The first-generation model suggests that fiscal imbalance is often the main trigger of a currency crisis, as explained by Krugman (1979). However, Indonesia's pre-crisis

macroeconomic indicators were relatively sound. This indicates that the 1998 crisis was not merely caused by government budget failure.

2) The second-generation model emphasizes the role of self-fulfilling market expectations, as developed by Obstfeld (1996). This framework is highly relevant in explaining the mass panic among investors. Nevertheless, this theory does not fully explain the structural damage that occurred at the microeconomic level.
3) The third-generation model provides the sharpest explanation for Indonesia's condition. By focusing on balance sheet effects, this model shows that rupiah depreciation automatically multiplied the debt burden of the private sector. As emphasized by Krugman (1999), exchange rate shocks can be transmitted into a full-scale financial crisis when the banking system has large foreign currency liabilities while its assets are denominated in domestic currency.

This study concludes that the Indonesian crisis represented a unique combination of contagion effects, a sudden collapse of market confidence as explained by the second-generation model, and chronic balance sheet vulnerability as emphasized by the third-generation model.

Monetary Policy Response, Interest Rates, and Inflation

As discussed earlier, the 1997–1998 monetary crisis created an extreme policy dilemma for Indonesian monetary authorities. This study finds that the phenomenon can be explained through the framework of the Impossible Trinity, or monetary trilemma. In an effort to maintain exchange rate stability amid massive capital outflows, Bank Indonesia was forced to sacrifice monetary independence by increasing the Bank Indonesia Certificate interest rate, or SBI rate, to an extreme level of 70% in mid-1998.

Theoretically, this high-interest-rate policy was intended to attract foreign capital back into the economy and suppress speculation. In practice, however, the policy created shocks in the banking sector and accelerated contraction in the real sector. The contradictory dynamics between monetary policy and real sector indicators are presented in Table 2:

Table 2. Monetary and Inflation Indicators at the Peak of the Crisis, 1997–1998

Indicator	1997 (December)	1998 (June/July)	Impact on the Real Sector
SBI Interest Rate	20%	70%	Credit crunch and rising non-performing loans
Inflation Rate (y-o-y)	11.1%	77.6%	Massive decline in purchasing power
GDP Growth	4.7%	-13.1%	Deep economic recession

Note. Data diolah dari Badan Pusat Statistik (1999) dan Bank Indonesia (1999).

The surge in inflation to 77.6% year-on-year in 1998 was a direct consequence of exchange rate pass-through. Rupiah depreciation caused imported goods prices to rise sharply, which was then followed by an increase in domestic production costs through cost-push inflation. This study argues that inflation during this period was not merely a monetary phenomenon, but rather a "bridge" that transmitted the crisis from the financial market directly to the level of public welfare.

Banking Sector Vulnerability and Systemic Risk

The banking sector became the accumulation point of all macroeconomic shocks. In addition to the problem of balance sheet mismatch, this study highlights the role of

asymmetric information in deepening the crisis. Uncertainty regarding the financial health of banks triggered a collective loss of public confidence. The phenomenon of massive deposit withdrawals, or bank runs, at the end of 1997 demonstrates that asymmetric information generated investor panic that was difficult to contain, as depositors were no longer able to distinguish between solvent and insolvent banks.

The impact of the high-interest-rate policy, with the SBI rate reaching 70%, became a "double-edged sword." On the one hand, the policy was intended to stabilize the rupiah. On the other hand, it caused a negative spread, in which the interest burden on deposits that banks had to pay was far higher than the interest income generated from loans. This condition automatically paralyzed the banking intermediation function and sharply increased the ratio of non-performing loans, or NPLs.

Discussion of Findings and Previous Studies

To strengthen the validity and scientific position of the findings in this study, the author conducted an in-depth discussion by comparing the identified transmission mechanism with previous studies.

First, Nasution (2020) is consistent with the findings of this study. Nasution emphasizes that Indonesia's banking crisis was exacerbated by the accumulation of supervisory weaknesses and the enormous fiscal burden of bank rescue programs. This discussion strengthens the author's argument that the banking channel represented the most fragile point in the national financial system.

Second, Hill (2021) supports the finding regarding the multidimensional nature of the crisis. Hill argues that Indonesia's economic shock was unique because it coincided with political turbulence. This confirms the author's analysis that massive capital flight occurred as a response not only to economic pressures, but also to non-economic uncertainty.

Third, Harahap (2020) confirms that the 1997–1998 exchange rate crisis was the most destructive currency shock in Indonesia's economic history. This study sharpens that finding by showing narratively how transmission through high interest rates, particularly the SBI rate of 70%, became a "second trigger" for the collapse of banking sector liquidity.

Crisis Transmission to the Capital Market: The Composite Stock Price Index

As explained in the previous discussion, the 1997–1998 monetary crisis did not only paralyze the banking sector, but also triggered a massive contraction in the Indonesian capital market. This condition was reflected in the sharp decline of the Composite Stock Price Index, or IHSG, as the main indicator of investor sentiment.

At the beginning of the crisis in 1997, the IHSG was still within the range of 467 to 700 points. However, as macroeconomic conditions deteriorated, the IHSG experienced a drastic decline and reached its lowest point of around 256 points in September 1998 (Indonesia Stock Exchange, 1999).

This study finds that the capital market acted as a "mirror" of the multidimensional uncertainty that occurred during the crisis. The dynamics of the stock market decline are summarized in Table 3 below:

Table 3. Capital Market Performance Indicators during the Crisis Period, 1997–1998

Capital Market Indicator	Pre-Crisis Period, 1996/1997	Crisis Peak, 1998	Percentage Change
IHSG Level, Points	467–700	256	>50% contraction

Market Capitalization	IDR 200–300 trillion	IDR 100–150 trillion	~50% decline in valuation
Largest Daily Decline	-	-11.88%, 8 January 1998	Extreme volatility

Note: Data are processed from the Indonesia Stock Exchange, 1999, and the World Bank, 2000.

Furthermore, this finding strengthens investor behavior theory. In conditions of systemic crisis, investment decisions are no longer based primarily on the performance of listed companies, but rather on perceptions of country risk. This analysis is supported by the study of Lubis et al. (2021), which confirms that the Indonesian capital market has a high degree of integration with external shocks. Negative sentiment in the foreign exchange market was therefore transmitted almost instantly into stock price corrections.

In addition, Prasetyo (2020) emphasizes that the recovery of confidence in the capital market after 1998 took a longer period due to investors' psychological concerns regarding long-term legal and political stability.

Overall, the decline in the IHSG during the 1997–1998 crisis confirms that the Indonesian crisis was transmitted in layered mechanisms through the exchange rate, monetary policy, and the financial system. These channels interacted with one another and deepened the systemic impact of the crisis.

Conclusion

Based on a comprehensive analysis of the economic and political dynamics during the crisis period, this study concludes that the 1997–1998 monetary crisis in Indonesia was a systemic, multidimensional, and destructively integrated crisis transmission phenomenon. From a technical-monetary perspective, the transmission path began with the sharp depreciation of the rupiah as a result of the regional contagion effect. Stabilization efforts through an extreme interest rate policy, with the SBI rate reaching 70%, proved to be a double-edged sword. On the one hand, the policy was intended to maintain liquidity and stabilize the exchange rate. On the other hand, it became a catalyst for the collapse of the national banking sector. This was triggered by the emergence of a massive negative spread and a sharp increase in non-performing loans, which paralyzed the function of financial intermediation.

The socio-political and economic impacts then spread in layers to the real sector through imported inflation, which severely eroded public purchasing power. At the same time, the crisis triggered panic selling in the capital market, causing the Composite Stock Price Index, or IHSG, to contract by more than 60%. Furthermore, this study identifies that the depth of the Indonesian crisis was not only caused by external factors, but also reflected the fragility of an economic civilization that had lost its ethical compass. This systemic damage was worsened by acute governance failure, in which the banking and corporate sectors neglected the principles of justice, accountability, and transparency. These findings confirm that moral hazard practices, weak supervisory and audit functions, and deeply rooted connected lending were the fundamental causes of the collapse of national resilience against external shocks.

From this perspective, the 1998 crisis was essentially a crisis of integrity. It represented a condition in which the financial system had become dissociated from the values of morality, honesty, and responsibility that should serve as the main pillars of a

sustainable economic civilization. Theoretically, this study reinforces the relevance of the third-generation crisis model by providing an additional contribution: balance sheet mismatch will always be amplified into a national catastrophe when it is not supported by a strong governance structure.

Practically, this study offers valuable lessons for policymakers. Financial system stability should not rely solely on technocratic macroeconomic indicators. Instead, a comprehensive transformation is required, one that includes the internalization of economic ethics and the strengthening of audit system integrity. Genuine stability can only be achieved through integrated policy coordination that does not merely maintain exchange rate figures, but also safeguards the fundamental health of the banking sector and manages market expectations based on the values of transparency, accountability, and institutional credibility. Such an approach is essential to prevent sectoral shocks from escalating into a crisis of economic civilization in the future.

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