DIALOGUE SPÉCIAL AU NIVEAU MINISTÉRIEL AVEC DES PAYS INVITÉS

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LA COHERENCE DES POLITIQUES DANS L'ECONOMIE MONDIAL : AVANTAGES ET ENJEUX DE L'INTERDEPENDANCE

INDONESIE

Déclaration

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SPECIAL DIALOGUE AT MINISTERIAL LEVEL WITH INVITED COUNTRIES

26 MAY 1999

POLICY COHERENCE IN THE GLOBAL ECONOMY: OPPORTUNITIES AND CHALLENGES OF INTERDEPENDENCE

INDONESIA

Statement

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INDONESIA : PATH TO RECOVERY

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The OECD Special Dialogue at Ministerial Level
Paris, May 26, 1999
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Honoured guests, Ladies and Gentlemen

I am delighted to have been invited to participate in today’s Special Dialogue between Economic Ministers from both OECD and non-OECD countries. I would like to express my sincere thanks to the OECD Ministers and to our Chairman, Mexico’s Minister of Finance, Mr. Angel Gurria, who have organised this timely event. In today’s rapidly changing economic environment, there is undoubted merit in sharing our recent experiences, observations, and strategies for the future in order to address the opportunities and challenges posed by the increasing interdependence of our economies. I would now therefore like to share with you observation on what we have done in Indonesia since our economy began to change so dramatically nearly two years ago.

We are approaching “the second anniversary” of the economic crisis that began in July 1997. The economic and financial crisis brought to an abrupt end many years of rapid economic growth. With economic upheaval came declining real incomes, higher unemployment and rising poverty which have created social and political stress. The economy, as measured by real GDP, shrunk by 13.7 percent in 1998. High interest rates, damaged economic infrastructure, a battered banking sector, hyper-inflation (77.6 percent in 1998), acutely high debt servicing costs, plummeting assets prices and social and political instability, all contributed to the depression. Despite the competitive exchange rate, exports have failed because of
numerous obstacles, including trade financing problems and the disruption to the country’s economic infrastructure. Meanwhile, imports have been depressed because of the currency depreciation and lackluster domestic demand. The resulting larger trade surpluses have been offset somewhat by Indonesia’s large external debt servicing costs.

In response to this aggravated situation the government has moved quickly and decisively on a number of fronts to lay the groundwork for an economic recovery. We recognized from early on that there are essentially three requirements for a resumption of strong economic growth.

First, the macroeconomic fundamentals must be reestablished. Second, an institutional framework that can support long term domestic growth in the global economic system has to be put in to place. Clearly such an institutional transformation cannot be achieved overnight. And third, investor confidence, domestic and foreign, will only really return once the political situation is clarified.

To establish that condition we have embarked on a broad-based policy package, with the financial support of the international community, in coordination with the IMF, the World Bank and the Asian Development Bank. The policy package included: (i) a tightening of monetary policy, with sharply higher interest rates and strict control over central bank net domestic assets; (ii) and adjusted fiscal framework that took into accounts the less favourable outlook for growth as well as expenditures to cushion the impact of the crisis on the poor; (iii) an action programme for the restructuring of the banking system; (iv) and the restructuring of corporate debt, both external as well as domestic debt; and (v) a number of a far-reaching structural
reform and adjustment programme to strengthen the economic foundation of the country.

Let me touch briefly on the most salient elements of the economic recovery strategy.

Our first and immediate target was naturally the stability in prices and exchange rates, and we devoted our monetary policy and other economic policies to reach that goal. As regards the monetary policy, we set targets of monetary aggregates and established strict discipline to meet the targets. We also stressed the importance of transparency to enhance public confidence, where by the targets as well as the actual numbers are announced on a weekly basis. Interest rate is decided by the market through weekly auction. We are consistently adhering to an open capital account and free exchange rate system. We have just passed law that ensure that it remains the policy whoever is in the government.

We have also passed a law that determines the full autonomy of our central bank. The central bank is now the only authority on monetary policy. The central bank is restricted from providing credits including to the government. The government will have to find other sources of financing, even if it needs bridging funds for it’s fiscal purposes.

These together has apparently improve confidence on our monetary policy management as well on the determination of the government to attain stability.

Another key in the macroeconomic policy of our stabilization and recovery program is to provide fiscal stimulus to compensate for the contraction in the economy and allowing for social safety net programme.
On social safety net the deepening of the crisis harshly affected the poor. To mitigate the social impact on the poor, the social safety net programme was designed to ensure the availability of food and other basic need including education and health services for the poor throughout the country. This brought about an overall fiscal deficit of 5.6 percent of GDP, of which equivalent to 1.7 percent of GDP was spent on the social safety net programme.

We have learned along the way that implementing social safety programme is not easy. There are complaints of inefficiency, ineffectiveness and leakages in the implementation of the program. We have since, together with the World Bank, made improvements to the design of social safety net programmes. For example, the community fund programmes now include strengthened participation of civil society, greater availability of information about fund allocation, and tighter supervision.

The two most challenging problems to getting the economy back on its feet are bank and corporate debt restructuring. Although these are complex areas, there has been significant progress in recent weeks.

A major step in our effort to rebuild our financial system was the creation of the Indonesian Bank Restructuring Agency (IBRA). IBRA has also taken on supervisory responsibility for troubled banks, equipped with an assets management unit. These efforts will further facilitate the restructuring of insolvent banks.

The government has issued blanket guarantees to all depositors and has assumed the obligation of meeting the cost of bank restructuring. Some 96 domestic banks have been found insolvent and their cumulative negative net worth is roughly US$40 billion. About half of the total banking system loan
portfolio is non-performing while many banks are maintaining liquidity, and meeting daily operating expenses by offering deposit interest rates substantially in excess of what is earned from money lent out. This is clearly an unattainable long-term situation.

The bank restructuring plans consist of two broad elements. First, four state-banks, as well as part of a fifth will be merged into a single bank. The resulting state banks, all of which have to be recapitalized, will form part of the core elements of a new banking system. Second, those private sector banks that meet pre-established criteria will be recapitalized while those that fail to meet these same criteria would have to be closed.

The basics of the recapitalisation programme are that the government will inject approximately 80 percent of the funds required to bring the bank to a 4 percent capital adequacy ratio via government bonds. Bank shareholders must inject the remaining 20 percent. Problem loans will be transferred to IBRA Asset Management Unit for workout. All existing shareholders will continue to own their shares in each bank, but these will dramatically diluted. At the same time, the government will enter into a management contract with the existing bank management in which strict performance requirements will be monitored to protect the Government’s investment.

The cost of recapitalizing the banking system will impose a substantial burden on the nation. The future sale of assets recovered from the banking system will help meet part of the recapitalization costs while the remaining costs will be financed through a blend of indexed bonds and conventional notes. Nevertheless, the cost of the bank recapitalization will create a substantial financial burden for years to come. For fiscal year 1999/2000 alone the interest cost of the bank recapitalization is
estimated at US $ 4.5 billion. But we know that there is no other course if we wish to strengthen the banking system.

The foreign ownership limit for private banks has been raised to 99 percent. This should encourage mergers and takeovers of viable but weak domestic banks and lead to the creation of a stronger and more internationally competitive banking sector.

Although establishing the credit worthiness of the banking system is a sine quo non for any resumption of lending to the real economy, issues of corporate governance is of outmost importance. But corporate lending will only become possible after the corporate sector has effectively dealt with its debts. As is true of the other Asian economies in crisis, the Indonesian crisis is primarily a private debt crisis and its resolution will require substantial reductions in the debt overhang.

An important principle, to which the government strictly adheres, is that while it stands ready to help in any debt workout, it will not turn private debt into a sovereign responsibility. Corporate entities that freely took on debt must accept the current situation and seek a fair debt workout with their creditors. This can only be achieved if creditors are willing to negotiate a reasonable settlement and if debtors offer an honest appraisal of the value of assets and of revenue expectations. No debt settlement is possible unless there is a free exchange of information leading to a realistic assessment of corporate values. To assist in this process the government has passed a new bankruptcy law, established a more modern bankruptcy court, and created an agency, INDRA, the Indonesian Debt Restructuring Agency, that will guarantee the payment of restructured foreign debt if the debtor continues to repay the debt in local currency. This modality ensures that the government is not burdened with
debts repayments for unproductive projects. To further assist in the debt workout, including of smaller firms that may find it difficult to negotiate on their own, we have established the Jakarta Initiative. Restructuring is gaining momentum with recent announcements by a few large corporations that they expect to finalize debt restructuring programs with their creditors over the next few months. To accelerate movement on corporate debt rescheduling the Indonesian government has established measures to provide inducements to creditors and debtors to negotiate debt workouts in good faith.

In order to reduce the role of the state in directly productive activities, the role of the state enterprise sector is to be reduced through an external programme of privatization. This reflects not only a need to raise fiscal resources but recognition that government is poorly equipped to manage productive facilities. The legal limit on foreign ownership in state-owned enterprises has been effectively removed. The overall profitability of the state-owned enterprise sector has increased as results of effort to cut costs, strengthen efficiency, and promote restructuring.

All the while, we are transforming our economic environment, culture and institutions toward establishing a market economy.

We are pushing ahead with structural reforms, improving transparency, eliminating monopolies, expanding fiscal decentralization for more equitable resource allocation, establishing level playing fields, to assure the efficiency and competitiveness of our economy as well as the sustainability and equitability of our future growth. We are in the process of reforming our legal infrastructure to support good public and corporate governance. Efforts are underway to create a stronger sense of corporate responsibility.
The government has made commitments to lower many tariffs and eliminate many of the remaining restrictions. And in production and trade, not only have many tariffs been lowered, but we have also reformed many markets that had been dominated by special relationships. Monopolistic arrangements have been eliminated or reduced. Special projects that once received not only protection but also preferential access to other resources and facilities now must compete on market principles.

We have reduced or eliminated subsidies, except those that are targeted for the poor, to enhance competition and encourage domestic production and income of producers, especially farmers.

We have now a new law on competition based on the modern concept, learning from experience of other countries. We have just passed law on consumers protection. On governance, the parliament has just passed a law against corruption, collusion, and nepotism, requiring government official to declare their wealth and establishing independent investigation committee.

The new law in the central bank, will make the central bank as mentioned earlier free from government interference. A strong supervisory body will be established to ensure that prudential regulations are enforced and our regulations will reflect international banking standard. Taken together, these reforms that are either enacted or are still being developed represent the commitment to the establishment and protection of an economy that is solidly built on fairness, transparancy and market principles.

The parliament has just passed two very important laws: the local government and fiscal decentralization legislations, providing the regions with greater autonomy and wide ranging authority in
all matters except defense, foreign policy, judicial, fiscal and monetary policies, and religious affairs.

Consistent with this principle, an extensive revenue-sharing arrangements have been made. Although oil and gas revenue will continue to be assigned to the central government budget, regions which have oil and gas resources will receive 15 percent of the government's share in after-tax oil revenue and 30 percent of the government's share in after-tax gas revenue collected in their region. Local government will also receive 80 percent of nontax revenue (fees and charges) from mining, logging and fisheries and 40 percent from the reforestation fund.

Finally not only are we engaged in a major re-engineering of our economy, we are also embarked on a major policital transformation. On June 7th we will hold our first open multi-party election in over forty years. Moving forward on our political reforms is criticaly important in laying the foundations for long term sustainable growth because history has taught us a lesson that a market economy can only flourish in a democratic environment. We have learned from our own experience that the two sets of values are two sides of the same coin; they reinforce each other.

Those policies appear to have paid off. After eighteen months of contraction and volatility, the Indonesian economy is finally showing some signs of stability. For more than six months now, the exchange rate has been relatively stable, currently at around Rp. 8000 per US dollar compared to Rp. 16,000 at the height of the crisis. In the last two months, the consumer price index has declined, indicating that inflation may at last have been squeezed out of the system. We expect the inflation rate to fall below 10 percent toward the end of this year. This has allowed a more rapid reduction in interest rates which have already declined
significantly. The stock exchange is rebounding, helped by growing optimism about the East Asian regional economy, but buoyed in large part by the stream of good news emerging from the Indonesian economy. Most important, GDP statistics for the first quarter in 1997 reached 1.3 percent, indicating that the economy has bottomed out, ahead of expectation. We now expect the real GDP growth to be up to 2 percent in this fiscal year.

The recovery although still in its initial stage, has been supported by the gradual return of confidence in our economy as indicated by incoming capital flows. The capital market has now reached the "normal" level before the crisis, which shows that investors are coming in. In the process of bank restructuring, a major international bank, the Standard Chartered, has taken over a restructured bank. Other large international banks are considering investing in several other Indonesian banks. Although for large scale capital inflows, especially for direct investment, we may need to wait until after the election, investors are already moving into Indonesia for long term investment. This has been indicated very clearly by private investment in publicly controlled companies. In less than one year we have concluded transactions totaling close to one billion US$ through sales of shares of a cement public company, the Jakarta port and Surabaya port, the domestic telecomunication company, and a food processing corporation.

Aside from those long term investments, we are beginning to attract again short term capital flows. It is of course a sign of growing confidence in the economy. On the other hand it could be said that we are again in danger of the speculative hands, that have brought down the economy in first place. It is indeed a dilemma to a country in need of capital, but vulnerable to sporadic and speculative attacks. And this is a challenge in which
Indonesia, and I think also other emerging economies, can not resolve by itself alone. We need international support and cooperation, hence the renewed call for a new international financial architecture.

It is important to recall that the current financial crisis in East Asia, in Russia, and in Brazil, has its own origins not mainly in a failure of government economic policies but in excessive private debt exposure. Weak or badly managed economic policies may have exacerbated the crisis, but they did not cause it. Obviously the large private capital flows have created substantial benefits. But they come to us with a substantial risk. The problem that confronts us is to ensure that such private capital flows continue while we establish mechanisms that will reduce the risk.

In this respect, I would like to propose three suggestions. The first two, directed toward a longer term, consists of structural reforms to establish better risk management and supervision to improve the financial system’s capacity to weather large scale capital flows.

First, there is a substantial and real need for better and more current information on private capital flows. Individual countries can do much more to collect such information. However, if such data is collected through multilateral cooperation on a fully global scale, the effectiveness of such efforts will be increased and the cost will be minimized. The Bank for International Settlements already provide information on private capital flows. But this effort needs to be expanded in order to provide a more complete picture of a very complex situation.

Second, not only do we need better data on such capital flows, we need to have a better understanding of the risks associated with such flows. The development of evermore esoteric
financial instruments, including derivatives, makes it difficult to trace flows and often makes it impossible for governments and others to understand the true exposure that is created by such instruments. What is required here is not only more information on the volume of private capital flows, but on their structure and risk. Governments and central banks can only monitor their exposure to foreign exchange risks if they have a true assessment of the types of instruments used to access capital, and of their associated risks.

Third, which is our short term priority, is the effort to prevent or cope with contagion. It has been said that it would be wrong to extend substantial help to countries in crisis because it would provide the wrong incentives to the markets. This is a good theory but it fails the test of pragmatism. The cost to the world of the current crisis, first in Asia, then in Russia, and in Brazil will far exceed the cost of a sufficient real money package.

Basically, it all means that without going against market principles, we can not and should not leave the conduct and process of financial liberalisation solely to market forces, let alone fund managers and money traders. Governments must work together to assume their proper and necessary role in directing the pace and course of this process. The international communities must now pursue with even greater vigour the establishment of an effective mechanism to supervise and regulate international money markets so that they would become more open and transparent. Such mechanism should also be able to carry out surveillance of capital markets and international financial operations.

Having said that, we believe that even if finally we are able to restructure the international financial system it is not a substitute to our internal discipline. Indeed this internal discipline
is of paramount importance to prevent damaging and exaggerated moves when a country choose to let financial markets to operate freely. There is nothing wrong with the market system in itself. Indeed, historical evidence has shown that it offers an opportunity to reap the benefits of globalization if it is managed properly. What is important is to eliminate our weaknesses through continues and consistent efforts, so as to prepare a sound economic foundation that will enable us to withstand future shocks. And that is what we are endeavouring to do in Indonesia. We are undergoing a comprehensive reform and restructuring of our society. We are on our way not only to become the third largest democracy in the world but the second largest market economy democracy. The road to that goal will be very hard and we need to go through a painful process, but we are determined to proceed.

Ladies and Gentlemen,

I hope I have presented you with an understanding of the situation we were faced with two years ago and the measures we have taken to put Indonesia back on track for economic growth and prosperity. Based on our experience I have offered some views on the need to reform the international financial architecture. I look forward to hearing your views and to learn how we can better work together to improve the outlook for the world economy.

Thank you, Ladies and Gentlemen.

Paris, May 26, 1999