

Indonesia's Road to Recovery

by

Prof. Dr. Ir. Ginandjar Kartasasmita

Coordinating Minister for Economic Affairs, Finance, and Industry

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Ladies and Gentlemen:

Given the chaotic conditions of the global financial markets there are very few things of which one can be certain. It may be that the only certain prediction one can make is that innumerable analysts will produce innumerable studies of the economic events of the past two years in an effort to find out "*what went wrong*." This may well be a worthwhile effort if it allows us to develop a policy regime that will result in stronger and more sustainable future growth. But even if we are successful in discovering the root causes of the current global financial upheaval, we would do well to remember that financial crises, even of the magnitude we are witnessing today, have occurred before. And, I regret to say, they will undoubtedly recur again. Let us not lose sight of the fact that only two years ago analysts not only lauded Asian policy-makers but felt that the world had much to learn from Asia's experience in generating growth with equity. Indeed, Asia's "*economic miracle*" was hailed as a new development paradigm. In the end while some valuable lessons were learned, we now know that the unbounded optimism was unfounded.

I will leave it to others to write the definitive history of the Asian financial crisis. Let me only suggest three lessons that we have already learned. *First*, this was a crisis that was largely unforeseen. Many, indeed I would suggest most, analysts who focussed on the East Asian economies were dazzled by the long period of rapid growth which we enjoyed. Some even suggested that the Asian economies were so well managed that they were immune from financial crisis. Others suggested that the reliance on "*relationships*" rather than on profits, on "*guidance*" rather than on a search for the most profitable investment opportunities, had created a new type of economic structure that challenged the traditional Western model. One can only wish that such analysts had been right; in the end they were all wrong. When the financial crisis came it only proved that economies with poorly supervised banking systems, with substantial funds invested in unproductive projects, and with allocative decisions that reflected "*who one knew*" more than "*what one knew*," were not immune from basic laws of economics.

Second, not only did we not foresee the crisis, we failed to recognize its depth and severity. The assumption that the crisis that began in mid-1997 was merely a "*bump*" on the road of economic progress was very wide off the mark. I know of no one who predicted that Indonesia's output would fall by nearly 14% in 1998 or that the economies of Korea and Thailand would each shrink by 7%, while Malaysia's economy would contract by 5%. Even Singapore and Hong Kong, two of the more open and well-managed economies in Asia, were not immune from the economic turmoil. What we now know is that despite our increased analytic capacity, our increasingly sophisticated forecasting techniques, and our vast and growing access to data, all of us severely underestimated the size, duration, and the contagion effect, of the crisis. And consequently all of us underestimated the resources needed to deal with it.

Finally, and this is a point I will return to at the conclusion of my comments, there is a growing recognition that economic recovery requires not only sound macroeconomic policies but a serious and sustained effort to strengthen the legal and governmental framework that support economic activities. Perhaps this is the clearest lesson to be learned from the current economic debacle: *sound economic policies built on a weak structure of governance provide a poor buffer*

against economic shocks. Let me put this another way: *while good economic policies are necessary, they are, in themselves, no guarantee of the long-term sustainability of growth.*

If we look back at Indonesia's policies over the period from the mid-1980s on, it is clear that the government formulated, and on the whole followed through with, a series of "good economic" measures. Having developed a sound and stable macroeconomic framework the government implemented a series of deregulation measures that reduced bureaucratic interference and unleashed the entrepreneurial talents of our people. As a result Indonesia recorded an annual rate of growth of nearly 8% between 1985 and 1997, one of the fastest sustained rates of growth among developing countries. Not only did this lead to a sharp rise in incomes per capita but it also led to a sharp reduction in the number of Indonesians living below the poverty line. And our rapid growth laid the foundations of a modern economic structure. The share of manufacturing output in our total gross domestic product rose from less than 8% in 1975 to nearly 25% in 1996, while the ratio of non-oil exports to total exports went from 7% in 1985 to 21% in 1996. In the current mood of gloom and doom we tend to forget that much was accomplished during this period of rapid growth. And these accomplishments provide a foundation on which we can rebuild our economy. During this boom period Indonesia invested heavily in infrastructure, creating a new and modern road system, upgrading port facilities, extending the electric power network, and making vast improvements in telecommunications. Indonesia also invested heavily in human resources, training an entire generation of skilled professionals and semi-skilled industrial workers. As a result our workers became endowed with the capabilities needed to compete in the modern global economy. One thing I would urge you to remember: *the human and physical capacity, created during our period of rapid growth, has not been destroyed.* Our economic infrastructure remains very much in tact and provides one element of the foundation for our resumption of growth.

But if Indonesia is to create the policy framework that will allow growth to resume it is important that we have a clear understanding of the principal causes of the current crisis. In broad terms they are easy to identify.

First, Indonesian companies and banks borrowed heavily in overseas markets where interest rates were lower than they were domestically. Indeed international bankers were all too eager to lend to Indonesian companies even when short-term funds were applied to long-term projects. The deregulation of our financial sector, and the establishment of a capital market, created a framework that allowed us to attract large capital inflows that powered our economic progress. But it failed to create a framework that would ensure that borrowed funds were invested in the most productive uses.

Second, while Indonesia did not peg its currency to the US dollar, neither did it allow market forces to set the exchange rate. Rather the rupiah was linked to a basket of currencies dominated by the dollar. This policy led to unintended consequences. For years the central bank saw to it that there was only a gradual, and fairly predictable, depreciation of the currency. Unfortunately, the presumed certainty of the exchange rate movement, together with the access borrowers had to relatively low cost offshore funds, made it seem as if the cost of hedging was an unnecessary burden. Events soon proved these assumptions to be seriously flawed. When, in August 1997, Bank Indonesia was forced to let the rupiah float in the face of large withdrawals of short-term capital, the debts of banks and corporations soared to unsustainable levels. George Soros put it correctly and succinctly when he wrote that: "*In times of uncertainty capital tends to return to its place of origin.*" And so it was with us. When doubts began to emerge about the soundness of the Asian economies, the impulse to withdraw capital from Indonesia turned into a financial rout.

And *third*, as capital fled the economy, the weaknesses of the banking system became ever more glaring. A strong and sound banking system serves not only to mediate between savers and investors but also should act as a shock absorber when the economy is subjected to an exogenous shock. Unfortunately our weak financial sector not only failed to buffer the economy from the initial shock of the exchange rate depreciation but actually amplified the impact of the initial

shock. We now know that many of our banks engaged in lending practices that violated all prudential regulations. Perhaps this was inevitable. In a banking system where state-owned banks play a large role, bureaucratic interference is likely to be a serious problem. I believe it is fair to conclude that when government plays a significant role in the financial system, government officials will be tempted to direct loans to favored firms. Such directed credits undermine the potential for any careful assessment of risks and potential benefits. But the Indonesia banking system was not only characterized by a substantial government presence but also by close links between a number of banks and some of the politically well connected “conglomerates.” The combined use of directed loans and the links between the conglomerates and their banks reduced the likelihood that loans would be objectively evaluated. Even more damaging perhaps is the fact that pressure was placed on bank regulators not to report some of the most flagrant violations of our own banking laws. Even where government pressure was absent, and where banks did not engage in intra-group lending, loans were rarely subject to even the most rudimentary economic and financial analysis. Indeed such analysis was probably impossible to carry out given that we lacked adequate disclosure requirements and accounting standards that would make it possible for analysts to make reasonable risk estimates.

In such a situation, financial institutions fail in their most basic function: to serve as an efficient intermediary channeling savings to their most productive use. Of course all investments have associated risks. But when savers, domestic or foreign, have no real capacity to evaluate risk, the real cost of capital is understated while the return on investment is overstated. As a result, scarce funds are allocated to low-return, high-risk activities. An obvious indication of this failure was the rapid build-up of luxury housing, hotels, shopping malls, and chemical factories, well in excess of any reasonable demand forecast. But even where capital was allocated to more directly productive assets, the funding for such projects reflected neither the true cost of the capital nor the relevant risks associated with the venture. In retrospect it is not surprising that our financial system was unable to moderate the impact of the exchange rate shock and instead served to amplify the initial effect, thus contributing to our economic collapse.

The economic crisis has forced us to deal with a number of critical issues including the development of a broad social safety net, but much time has been spent on developing a policy framework that will deal with the issues I just noted. It will, I am sure, surprise no one that a major part of our policy reform work has focussed on addressing the structural weaknesses in our banking system and the establishment of a framework for corporate debt restructuring.

We have assigned highest priority to our efforts to restructure and recapitalize our financial institutions. It is clear that whatever the merits of financial sector deregulation, deregulation can never achieve its goals without a strong and effective regulatory framework. Improved financial supervision and regulation are critical in any successful development strategy in today’s globally integrated financial markets. And we are taking the necessary steps to improve the soundness of our financial sector. We are moving rapidly to establish a truly independent central bank that will have as its primary objective the management of our money supply so as to ensure low inflation. A strong supervisory body will be established to ensure that our prudential regulations, which meet common international standards, will be enforced. To improve monetary management, the sale of our primary monetary instrument, the *Bank Indonesia Certificates* is now done through an open weekly, auction. We are still some way from developing the range of monetary instruments that Bank Indonesia will eventually need to manage money supply. At the moment our primary monetary instruments are one-month SBIs, although we have tested the waters by auctioning some three months certificates. Over time, as Bank Indonesia gains confidence and strength, it will develop the full range of monetary instruments needed for effective monetary management.

It may seem paradoxical, but a more open and more deregulated banking system is in fact in greater need of administrative control and supervision than a repressed financial system. Policy makers must have access to information not only on the extent of offshore borrowings, but on the maturity structure of such funds. Only with this information in hand can the regulatory agencies properly assess risks and ensure that such risk is adequately reflected in the cost of capital.

We have put in to place regulations that require banks to periodically report offshore borrowings. The data that will become available should provide our authorities with the requisite information needed to take remedial steps well in advance of a crisis. What is still needed is better information on the impact of the myriad new borrowing modalities that have emerged over the past few years. These new instruments have the potential of improving capital efficiency, but they also have the potential to masking the true risks that borrowers assume. This problem is not unique to Indonesia. It affects the management of all monetary systems. A concerted effort to gain a better insight into the risks of such new instruments and the development of new information flows associated with the rising use of such new modalities may help cushion the global financial system from future shocks.

Perhaps the most critical challenge facing us today is how we can reestablish the credit-worthiness of our banking system. It is clear that no modern economic state can operate without a well-functioning banking system. Indeed we can expect Indonesia's economy to recover until the banking system is able to fulfill its function. Unfortunately our banking system came close to total collapse in early 1998. Faced with the strong possibility of a total collapse, the government issued a blanket guarantee covering all depositors and creditors of domestic banks. Some have argued that this broad guarantee created a widespread moral hazard. Perhaps it has. But given the panic that confronted us and the very real possibility that the banking system would collapse, we had very few options. The government also established the Indonesian Bank Restructuring Agency, *IBRA*, which quickly took control of insolvent banks. Those banks, which on the basis of independent audits are so severely damaged that they cannot be made whole again, will be closed or merged and their remaining assets placed with a separate agency charged selling such assets.

While the measures taken have returned some measure of financial stability, the banking system even today remains weak and unable to perform most of the basic functions of financial intermediation. The government is keenly aware that in establishing *IBRA* and in issuing a blanket guarantee to all depositors, it implicitly assumed the burden of meeting the cost of banking sector restructuring. Unfortunately this cost is high. Some 96 banks have been found insolvent and their cumulative negative net worth is roughly 40 billion dollars. About half of the total banking system loan portfolio is non-performing and many banks are maintaining liquidity, and meeting daily operating expenses, by offering deposit interest rates substantially in excess of what earn from money lent out. This is clearly an untenable long-term situation. Dealing quickly and efficiently with our banking system is a top priority for the government.

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, while two other state-banks, with better operating records, will also merge. The resulting three state banks, all of which have to be recapitalized, will form part of the "*core*" elements of a new banking system.

Of the remaining private sector banks, some will require no assistance. Unfortunately this is only a small segment of our total banking sector. Even if we eliminate those banks that are so weak that no infusion of government funds is warranted, we are left with a massive recapitalization bill. The government will issue a variety of bonds to those banks deemed potentially viable and we currently estimate that the interest cost on the debt to be issued will come to roughly 3% of our GDP for the coming fiscal year. Revitalizing our financial institutions will create a substantial financial burden for years to come. But unless we can quickly establish a sound, well-managed and internationally competitive banking system, our economic recovery will continue to be postponed. That option also has a severe economic and social cost.

A second part of the foundation for resuming growth involves our private corporate sector. Unlike other financial crises, the crisis in Indonesia did not result from runaway government expenditures or excessive government borrowing. Our crisis is primarily a private debt crisis and substantial surgery is needed in the corporate sector. The government has established two modalities to facilitate debt restructuring. However let me emphasize that while the government stands ready to help in any debt workout, we remain committed to the principle that private debt

should not be turned into sovereign debt. Corporate entities that freely took on debt now need to recognize the realities of the current situation and seek a fair debt workout with their creditors. Debt restructuring efforts are a two-way street. Creditors must be willing to negotiate a reasonable settlement and debtors must offer an honest appraisal of the value of assets and of revenue expectations. While the precise revaluation of assets will depend on project specific factors, no settlement is possible unless there is a free exchange of information leading to a realistic assessment of corporate values. To assist in this process we have 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 is to ensure that the government is not burdened with debt repayments for unproductive projects. To further assist in the debt workout, especially of smaller firms that have less access to international resources, we have established the *Jakarta Initiative*.

To be frank, progress on debt restructuring has been slow. Nonetheless I am confident that as economic prospects improve, especially after we have successfully recapitalized our banks, debtors and creditors will reassess the costs and benefits of debt restructuring, moving quickly to clear away obstacles to corporate activities.

The measures we have taken have paid off. Although the economy remains depressed, there are encouraging signs. Inflation, which only a few months ago seemed to verge on hyperinflation, has been brought under control. While inflation for 1998 reached nearly 78%, we saw a substantial moderation of price increases in the last quarter of 1998. Commensurate with the decline in inflation, and some recovery in the value of the rupiah, interest rates have declined. The average yield on one-month *Bank Indonesia Certificate* has fallen from a high of 70.6% in early September to 35.4% in January of this year. The December auction of three months *Bank Indonesia Certificates* yielded a rate of 37.9% in December, compared to 50.5% one-month earlier.

Although the rupiah has recently weakened somewhat, overall the currency has rebounded sharply from the very weak levels observed in the first half of 1998. Perhaps less well known but still very important is the fact that volatility in the rupiah/dollar currency market has declined. This reduced volatility, if sustained, should make a positive contribution to our export performance in the coming months.

Given the sharp real depreciation of the currency, exports should grow rapidly. Indeed our non-oil exports in real terms grew strongly during the first half of 1998. More recently export growth has weakened. In part this reflects the continued weak global demand but it also reflects the unfortunate impact of the social unrest and political instability we have experienced. We are well aware that global competition requires not only competitive prices but also an ability to deliver goods “on time.” The potential of disruptions resulting from social unrest obviously will reduce the ability of our exporters to compete in the total global environment. While the government might wish to guarantee social stability, a more open and democratic society cannot easily make such a promise. This is especially so during a run-up to an election. Every effort will be made to ensure social safety and the protection of property. But until we have worked through the forthcoming political process and have established a new and more stable political framework, social tensions will persist. We are committed to ensuring that progress to a more open and democratic society does not undermine the economic progress we have made so far.

While it is heartening to note these positive signs, our efforts to revive the economy will only succeed if there is a supporting international environment. It is critically important, not only for Indonesia but for all emerging market economies, that there be strong growth in the major developing countries. While a recovery of economic growth in Japan is important, it is equally important that the global community not shut its doors to our exports. Freer trade will benefit all participants, but in the near-term, increased exports offer the quickest path to economic recovery.

Finally, as I noted at the outset, we need to ensure that Indonesia’s recovery leads to sustained long-term growth. Obviously a first step on the road to recovery is the establishment of a sound macroeconomic framework. This is well in hand. But the sustainability of growth can only

be ensured if economic measures are bolstered by the development of social structures that encourage the use of private resources for the greatest public good. How can one ensure this?

In part it will call for the development of a legal infrastructure that ensures competition as well as commercial laws that will ease the entry and exit of firms. A competitive economic environment in which large and small players compete fairly will help ensure that resource allocation motivated by the pursuit of profit also serves to maximize social welfare.

A major force in any economy is the public sector. And so it will be in Indonesia. But what role should the public sector play? While it is clear that the government has a very limited capacity for managing productive assets, the public sector must work to create a framework in which the private sector can fulfill its social role. This is an important task for any government. Maintaining and administering an improved legal economic framework requires a modern and efficient cadre of civil servants. Administrative reforms will ensure that our civil service possesses many of the same skills and incentives that motivate private agents. In this way the public sector will be able to support the energy of the private sector and will not be seen as an unnecessary burden or an impediment to private gains. A modern economic state, such as we seek to develop, requires a synergy between the public and private sectors.

Finally, and perhaps most important, we must have an well-educated labor force. Education means more than literacy. Education must be measured by the capacity of our citizens to acquire knowledge with the capacity to use it effectively. To develop such a labor force will call not only for increased funding for our educational institutions but a careful examination of the way students are taught and prepared for their future role.

Broadly these are the elements of our development strategy. Much of what we are doing can be accomplished in the near-term. But other parts will be achieved more slowly. In times of crisis there is a natural tendency to focus on short-term solutions and to measure progress by steps that are presumed to lead to a speedy and quick recovery. But such a short-term focus would not serve us well. Rather a focus on short-term policies within the development of a long term social and political framework will ensure that growth is sustained and produces increased welfare equitably shared.

In closing let me make one final observation. The recent economic collapse has given rise to demands that globalization efforts be reversed or at the very least tempered with social and environmental restrictions and even capital controls. These demands cannot be dismissed out of hand as the last gasps of those who oppose a more open and more integrated global trading system. The instabilities we have witnessed in our financial markets over the past nearly two years demand a serious response. The international financial community needs to seek solutions that protect the benefits of globalization while creating a more stable and less disruptive global economic framework. In Indonesia we have had first hand experience with the benefits of globalization in terms of increased growth and rising living standards. But we also have seen the damage that can be inflicted by these same global forces. Means must be found to assist those hurt by the process of globalization without undermining the benefits of the process itself. This challenge must be addressed if we are to continue to prosper. If we fail, the backlash against global economic integration will have severe economic and political costs for all.

Thank you.