

## Overview of Economic Developments and Trade Policies

by

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### Fellow Ministers, Honored Guests:

The events of the past twenty months have greatly challenged the Indonesian people and its Government. A combination of economic, meteorological, and political events have not only damaged much of the economic infrastructure we had created but tested the capacity of the government to effectively respond to the evolving situation. While the economic crisis affected a number of Asian economies, and now has spread to Latin America, it is important to remember Indonesia was hurt by more than a global economic change of fortunes. We also had to deal with the impact of a serious drought as well as a collapse in world commodity prices. As a nation where agriculture, especially rice agriculture, still plays an important role, and where primary commodity exports, including exports of oil and gas, still constitute nearly half of total exports, these additional events certainly help to explain the depth of the Indonesian economic collapse. In turn the depth of the crisis and its multiple causes help explain the response that the government has mounted and the extent of the recovery we have seen to date.

Four major themes underlie our recovery program. *First*, the government moved quickly and decisively to erect a social safety net to provide a measure of relief to those most severely affected by the crisis. *Second*, the government recognized that the Indonesian financial system, far from absorbing part of the external shock, served to amplify it. The poorly supervised and managed banking sector also channeled funds to projects that, we now know, have little long-term viability. *Third*, we realized very early on that rapid export growth was a keystone to our recovery. Hence every effort had to be made to protect the productive capacity of our export sector. And, *fourth*, although the proximate cause of the crisis was economic, failures of governance also played their role.

All of these issues must be tackled in a forthright manner if confidence and economic growth are to be revived. Let me briefly describe our progress in each of these four areas.

The real tragedy of the Indonesian crisis will be measured in terms of its effects on the poor and vulnerable. Government must have sufficient resources to address the very real needs of the population. The social safety net programs we have put in to place cover a wide-range of activities, some traditional and some new. But all have one purpose in mind: to improve the capacity of the poor to deal with the impact of the economic crisis. The safety net includes subsidies for the cost of basic staples and the funding of labor intensive works program that will create sufficient income earning opportunities for the poor to purchase their basic needs.

The government is also concerned that parents may pull their children out of schools in response to the financial crisis. If this were to happen, the productive capacity of an entire generation would be damaged. This was a cost we could not afford to bear. We therefore are providing financial incentives for parents to keep their children in school. Recent data on school enrolments indicate that there has been no significant decrease in primary school enrolment levels although the picture is less rosy for junior secondary enrollment where some fall has been noted. However, it is not clear whether this is related to the economic crisis or is due to the often-noted fact many children, but especially poor children, do not make the transition from primary to lower secondary school. While these data on school enrolment are mildly encouraging let me add that the economic crisis is still evolving and that we may still face many new social problems.

The strong international response to our needs has given us the resources to finance our social safety net programs making it possible for the government to allocate substantial resources, up to US\$ 3 billion in fiscal year 1999/2000, in support of such programs. I am also encouraged that despite some implementation shortfalls we have managed the social safety net resources so that the target population has received the bulk of the benefits. On balance, we have managed to avoid a serious collapse in social welfare and reduced the potential for social unrest.

Recent data has given us a clearer picture of which income groups and which geographic areas have been most severely affected by the economic crisis. We now know that the crisis has hit urban areas hardest although rural areas on Java are also badly affected. By contrast there are some areas, particularly large parts of Sumatra, Sulawesi, and Maluku, which have experienced minimal negative crisis effects and agricultural areas that suffered minimally from the drought are in fact experiencing an export boom. This is obviously encouraging news. The emerging data provide us with a better indication of the extent of poverty and with its location, making it possible for us to focus our relief efforts more accurately and effectively. This raises our confidence that that we can prevent a major social catastrophe.

Only after a viable and safe banking system has been re-established and after corporate debt has been reduced, will we regain the economic performance that was our past hallmark. We will support our rebuilt banking and our corporate sectors with a strong modern economic legal framework. Only after these elements are in place will we see with modest growth emerging by the latter part of this year and more robust growth by the year 2000.

Improved financial supervision and regulation are critical in any successful development strategy in today's globally integrated financial markets. We are moving quickly and forcefully to improve the soundness of our financial sector. Legislation has been drafted to establish a truly independent central bank that will have as its primary objective the management of our money supply. A strong supervisory body will be established to ensure that our prudential regulations are enforced and our regulations will reflect international banking standards.

In establishing IBRA and in issuing a blanket guarantee to all depositors, the government implicitly agreed to meet the cost of bank restructuring. Unfortunately this cost is likely to be high. Some 96 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 loans while 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.

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 will be closed. But even then we will face a massive recapitalization bill. The future sale of assets recovered from the banking system will help us meet part of the recapitalization costs while the remaining costs will be financed through a blend of indexed bonds and conventional notes.

Despite our best efforts 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 have no other choice. Unless we 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.

But corporate lending will only become possible after our corporate sector has effectively dealt with its debts. Our crisis is primarily a private debt crisis, requiring substantial surgery to reduce the debt overhang. The government has established two modalities to facilitate such debt restructuring. 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 need to recognize the realities of the current situation and seek a fair debt workout with their creditors. Debt workouts require that creditors are willing to negotiate a reasonable settlement and 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 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.

Exports, especially the growth of non-oil manufactured exports, has been a major engine of our period of rapid growth. The depreciation of our currency should have provided a major boost to exports. Unfortunately this has not happened. Comparing the first 11 months of 1998 with the same period one-year earlier, non-oil and gas exports declined by nearly 10 percent in value terms. Yet the real message is that measured in quantity terms our exports are doing quite well. The reason for the much stronger growth of export *volume* compared to export *value* is that the price for most of our export commodities has fallen over the past year. *Of nineteen major non-oil export commodities that account for 40% of our non-oil exports, 13 experienced declining prices!* The collapse of world oil prices has further compounded our difficulties. The price for Indonesia's crude oil collapsed from US\$ 19.71 per barrel in mid-1997, when the crisis first erupted, to US\$ 10.99 per barrel at the end of January 1999. This drop of nearly 45% in one of our major export commodities, coming on top of the decline in other commodity prices, has dealt our recovery prospects a severe blow.

It is a measure of the resilience of our economy that despite this very severe terms of trade shock, our exporters continue to market their products. Our export trade financing arrangements have helped support our exporters. Under the Frankfurt Agreement banks are committed to make a "best-effort" to maintain their level of trade credits at the levels prevailing in April 1998. Such credits received a one-year US dollar denominated guarantee from Bank Indonesia. In addition we have received specific export financing support from a number of donors, including Japan. We are making determined efforts to ensure that the trade financing facilities not only remain in place but that small- and medium-sized firms have access to such financing.

Continued weak global demand also has restrained our export growth as it has to other Asian countries. But the continued social unrest and political instability that currently mark our society play a role. Global competition requires not only competitive prices but an ability to deliver goods "on time." The perceived potential for delivery disruptions from social unrest reduces the ability of our exporters to compete in the total global environment. We have experienced no significant delivery delays to date, yet buyers are concerned about the potential of future delivery problems. The upcoming election period may be marked by a rise in social tensions. But we are committed to ensuring that electioneering does not deteriorate into violence.

This leads to my last point. Our recovery, in the short run, but even more over the long run, depends critically on the establishment to a more open and democratic society. It is particularly important that we establish a framework in which private enterprises can flourish and where public resources used are used for the common good. Such an outcome depends on more than our ability to devise and maintain a sound macroeconomic policy framework. It also depends on the establishment and enforcement of a legal infrastructure that guarantees competitive behavior by all parties and is based on commercial laws that will ease the entry and exit of firms. And finally,

a socially just economic system must be grounded in an open political system that gives voice to all its citizens.

Many of our policy steps have already paid off. In recent months key macroeconomic parameters have shown a marked measure of stability and strength. The exchange rate has recovered from the excessive depreciation we saw in June of last year and our very high rates of inflation have subsided. Famine has been averted and agriculture seems poised to rebound after the return of more normal rainfall patterns. Interest rates have declined substantially from their peak levels and some foreign investors are returning to our country. Yet we know that our economic situation remains difficult and the steep declines in per capita incomes, together with rising unemployment, have the potential for creating a great deal of social stress.

Not only are we engaged in a major re-engineering of our economy, we are also embarked on a major political transformation. On June 7<sup>th</sup> we will hold our first open multi-party elections in over forty years. We are keenly aware that in any transition to a more representative political system, social tensions may develop. While such tensions reflect the emergence of a new vibrant democratic society they have the potential of becoming intermingled with the economic and social problems that have been caused by the economic crisis. Moving forward on our political reforms is critically important in laying the foundations for long term sustainable growth. But dealing with our current economic crisis is critical if the election process is not to lead to social chaos.

In closing, let me note that our efforts to revive our economy will only succeed with the support of our immediate neighbors. Equally important for Indonesia and for all emerging market economies, is the continuation of past progress on the establishment of open and free trade. It is still true, despite the economic debacle we have observed in Indonesia and elsewhere, that free trade benefits all participants, and that increased exports offer the quickest path to economic recovery. Let us pledge that our countries will work together to ensure that trade remains free and fair, not only between Australia and Indonesia but also within the global community.

Thank you.