INDONESIA: Current Economic Crisis

By

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Members of the Indonesian-Netherlands Association,

Distinguished guests,

Ladies and gentlemen,

It gives me great pleasure and honor to be here with you this evening. My thanks to the Association for this precious opportunity to meet with you in celebrating the 20th anniversary of the Association. I believe that during those twenty years there have been a lot of innovative activities and events created to strengthen our long and close relationship between Indonesian and the Netherlands.

Much of my work over the past year has been devoted to developing and implementing responses to the on-going economic crisis. Therefore, this evening I would like to give a little piece of contribution to the Association by sharing a few thoughts regarding the Indonesian economy, particularly on how we cope with the current economic crisis.

When we look back over the events of the last year or so as Indonesian's we have to ask ourselves some very difficult questions. Most analysis of the macroeconomic situation in Indonesia pre-crisis indicated that our economic situation was at least as good as that of our neighbors. Nevertheless for more or less the same stimulus, the crisis in Indonesia reached level of severity far beyond that our neighbors.

For thirty years, the Indonesia economy grew by more than 7% annually. The fact is that seven percent growth is a very forgiving environment; corporations can expand beyond core businesses without concern for efficiency loses, banks can carry bad loans that in lower growth environment would lead to immediate problems, and the government can burden public and private corporations with non-economic objectives without fear that they will be driven to bankruptcy. This led to a lot of complacency and led to a lack of initiative on the part of individuals and institutions.

When the crisis hit our institutions did not respond well. Instead of stepping up to face the difficulties head on, too often it was business as usual as if the problems would some how go away. This was compounded by a lack of belief in the reform programs which generated a willingness to listen to often simple and self-serving solutions. Bit by bit confidence eroded and difficulties mounted.

Perhaps because of the relatively easy growth environment, we have often escaped without making hard choices, and without establishing clear and firm priorities. Growth, equality, and stability are all priorities, and as we have argued, they can and should be complements. But at the same time, we have too often asked people and institutions to do too much thus introducing confusing and sometimes conflicting objectives to their decision making. This confusion of objectives, and lack of priorities was livable, or at least not fatal, until the crisis hit. Once the crisis did hit, priorities needed to be established quickly on the basis of previous experience and belief. Because of the high growth, and due to our often conflicting objectives we were not able to restoring stability. In fact is that we lacked the required determination and consistency as they are born of experience and confidence. In fact too often we vacillated throwing markets into confusion and making the situation worse.

That is the bad news. The good news is that I believe that we have learned from these mistakes and are now positioned to move forward deliberately in creating an Indonesia where the foundations for stability are restored, incentives are improved and institutions strengthened.

The Strategy

To restore confidence, and build these foundations requires the appropriete strategy. Such a strategy is must be designed to stabilize the economy and the political situation, and over a longer time frame develop the basis for sustainable growth.

The economic recovery and political reform are now inextricably linked. Obviously, political stability is the key to restoring economic stability, so is economic stability the key to achieving political and social stability.

Let me add a bit more detail on the economic strategy we are following. As I indicated it involves two agendas, the first relating to the social safety net, and the second to economic recovery.

Maintaining, much less strengthening the social safety net, has proven to be a much more difficult task than we originally envisioned and we are not and can not be satisfied with how we have responded in this area as yet.

The initial program to provide social services in the face of the crisis included efforts to maintain key food and fuel prices through subsidies thus slowing the price adjustment and maintaining affordability. Unfortunately as the rupiah exchange rate moved further away from equilibrium our ability to support many of these subsidies grew increasingly limited. Thus by September, we had to move to limit food subsidies primarily to rice in line with our capability to deliver what we promise. In addition, we have continued to focus the subsidy much more carefully attempting to identify and deliver a monthly ration of rice to a large number of selected poorer families at Rp. 1,000 per kilo. In the longer run this is not the sort of policy that we want though. We would prefer to allow prices to function as incentives to both producers and consumers, and higher rice prices would do this. The key to allowing this is raising the level of income in groups badly hurt by the monetary crisis, or by the drought due to El Nino. This effort is one we have been working on with the international community.

We are putting in place works programs designed to create jobs and income, and have reallocated the our development budget to areas such as regional transfers that are used to maintain infrastructure and are thus labor intensive.

Finally, we have also pledged to try to maintain, to the best of our ability, levels of school attendance and health that are critical to our longer run ability to maintain satisfactory economic growth.

The other element of our economic reform program has been the effort to stabilize the macroeconomic, and in particular the monetary situation, and to address the underlying problems in the banking and corporate debt situation.

Perhaps the key to stabilizing the macroeconomic situation and restoring stability to the exchange rate has been the mix of monetary and fiscal policy that we have been following. As most of you are aware, problems in the economy spilled over into the banking sector and caused many depositors to withdraw their savings, converting them into cash or transferring them to accounts in government or foreign banks. This put tremendous pressure on Bank Indonesia to increase liquidity support to honor deposit guarantees, designed in turn to stem the rapid erosion of confidence in the banking system. Not surprisingly, this led to a very rapid increase in monetary aggregates and might well have resulted in hyperinflation. We had to stem this and our agreement in March with the IMF made two important contributions to stabilizing the monetary situation. First, we agreed to hold the component of base money under BI's control roughly constant. The second and somewhat innovative effort, has involved the publishing of BI's key monetary indicators on a weekly basis. This provides transparency and certainty and I believe that this has helped us greatly.

However, gaining control of the rupiah, would not have been sufficient. We need a more pro-active strategy to take pressure off of the rupiah. To do this we have attacked on a number of fronts. First, we negotiated for the assistance to both the balance of payments and the budget under the IMF agreements, and through the regular CGI meeting. Under these agreements our donor partners accepted the need for large and sustained borrowing on our part, of up to 8. 5% of GDP at that point, to support a budget designed to deliver the social services. Further, we have moved to reduce our official obligations with a two year moratorium on a significant portion of official bilateral debt.

The monetary and fiscal program agreed on with the IMF has already delivered a decline in inflation and we expect interest rates to fall in line with continued declines in inflation and exchange rate expectations. Financial support from the multilateral institutions and donor nations through fresh funds and agreements to reduce official debt payments have reduced pressure on the foreign exchange market and this too has helped stabilize the situation.

The two most challenging problems we face in getting the economy back on its feet are in the areas of corporate debt and banking. To facilitate agreement on corporate debt rescheduling the Indonesian government through the Jakarta Initiative has moved to provide inducements between debtors and creditors. In return for agreements that reduce or reschedule debt we have offered a guarantee that reduces exchange rate volatility. At the same time we have moved to strengthen bankruptcy statutes to make them a credible threat. With these in place, and the macroeconomic conditions improving, we are beginning to see companies come to the table.

Difficulties in the banking sector are equally severe. As a result of pre-crisis weakness and the extensive downturn the amount of non-performing loans has become unsupportable. As part of our overall banking strategy we have had international auditors audit all of the substantial banks in Indonesia. We are now in the difficult process of sorting out those banks that have the possibility of surviving and those that do not. Those that can not survive will be closed, their depositors paid off, and their assets shifted to our Asset Management corporation. Those that can survive will be offered the opportunity to recapitalize. At the same time we have passed new banking laws that open the banking system in Indonesia to 100% foreign ownership to allow existing owners the opportunity to tap into these funds as well.

These are the main elements of our strategy particularly as it has evolved over the last six months or so. What has been the result of this strategy to date.

Current Conditions

Currently, I believe we are seeing the first signs of stability. The rupiah has strengthened almost continuously, moving from Rp15,000 at the end of June to less than Rp 8,000 this week. As I indicated with a stronger rupiah inflation has declined significantly and in October the price level even fell slightly. Commodity exports are growing reasonably but unfortunately prices are down and export proceeds are not growing as fast as we would like. However, even this recovery in exports, a better picture in agriculture as the drought has ended and a strengthening of macroeconomic indicators is adding some optimism to the economic picture in Indonesia.

All in all, I believe that we are at or close to turning the corner on economic stabilization. I don't want to leave you with the impression that we are in any way content or worse yet complacent. These signs of recovery are important, even critical after such a long period of discouragement, but they are just the first stirrings of recovery and the roots are not deep. We need this stability before we can take the next step but the real sector continues to decline, unemployment is rising and falling real income are adding to poverty and social instability. The problems in corporate debt and banking need to be resolved if large numbers of Indonesian corporations are going to survive much less grow and provide new jobs.

The New Economic Reality

Let me emphasize that economic policy does not sit in a vacuum. We can and are taking policy steps to try and maintain economic momentum under difficult circumstances, but we need to prepare for the future at the same time. While the situation has not settled down enough to be definitive I believe that we have identified four areas where we believe the "New Economic Reality" will be significantly different from the situation prior to the events of last July.

First, not only has the situation in Indonesia changed, the situation in the entire world has changed. Most commentators expect that relatively volatile capital flows will continue to be a problem for some time to come. These volatile flows create not just changes in financial markets but impact on real activity as well.

Second, the current level of the exchange rate has already vastly changed the profit and loss calculations of Indonesian entrepreneurs. We now expect that the rupiah exchange rate will remain very competitive for quite some time. This level of competitiveness versus our traditional trading partners changes the goods in which we have comparative advantage, strengthening those items based on natural resources, agricultural output and labor.

Third, while many areas have suffered greatly during the crisis, others have profited from these changing terms of trade. We have to acknowledge these differences and we can not impose a uniform set of policies in response to the crisis that addresses issues across the entire country. Thus the nature of fiscal relations between the regional and central governments and regional autonomy more broadly have moved to the government front burner. But I believe that there is a broad consensus on the need to foster more regional autonomy. The MPR acknowledged this with its agreement to share the revenues from natural resource wealth in line with regional contributions, while still equity concerns that address regional needs. We need to accommodate this while developing infrastructure, and cultural linkages designed to maintain the sense of Indonesian unity that we all treasure.

Fourth, our strategy has been and is to remain open to the world, while working to improve our ability to respond effectively to this and future crisis. As I indicated we intend to do this through improved government stabilizer policies, better information flows, and clear and transparent private sector laws and regulations. However, this will result in a much improved incentive system, which I believe will soon be followed by strengthened institutions. Once economic and political stability are achieved we believe that the level of foreign interest will rise rapidly and ultimately result in much greater integration of Indonesia with the rest of the world.

Concluding Remark

I hope my short talk will assist our Netherlands Colleagues in heightened understanding of what we, Indonesian are facing and undertaking at present in these challenging times. I look forward to returning to the cordial and productive relations that our countries have enjoyed for so many years. And on behalf of the Government of Indonesia, I thank and appreciate very much the Indonesian Netherlands Association for its hard work and generous contribution raised among the Indonesian and the Netherlands business communities for their Street Children Charity Project. May God bless us.

Thank you.