# Miranda S Goeltom: Indonesian macroeconomic developments and policy - progressing towards a sound banking system

Keynote speech by Dr Miranda S Goeltom, Senior Deputy Governor of the Bank Indonesia, on the CNBC Strategic Forum, Jakarta, 24 January 2005.

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Distinguished guests and speakers,

Ladies and gentlemen,

At the outset, let us first of all express our gratitude to God Almighty that we are still able to gather here this evening in good health to attend this forum. It is a pleasure and an honour for me to be here in front of such a distinguished audience. On behalf of Indonesian authorities, I would like also to express our thanks and appreciation to CNBC and related parties for organizing such an important event and gathering most important policy makers and business players in Indonesia.

We have just successfully passed the first democratic direct election and is looking forward towards a much brighter future. It is also timely to make a reflection on what we have achieved so far, what structural problems remain and how to make our economy stronger and more resilient in the future.

We all also know what had happened in Aceh and in other parts of the world surrounding the Indian Ocean. It was one of the greatest natural disasters in living memory. Now, we should say that after the tragedy in Aceh, Indonesia should, and it will, regain its new spirit, a new resolution, to develop and to create a better life for the people.

On this occasion, let me share the recent progress on the Indonesian economy, its challenges and opportunities towards a sound banking system. I will first touch the issue on the macroeconomic and financial developments in 2004, and discuss their outlook for 2005. In the rest of this speech I will also emphasis on the banking sector problems and challenges, as well as future policy directions.

Ladies and gentlemen,

### Macroeconomic and financial developments in 2004

As widely known, throughout the last three years the **Indonesia's economy has been developed favourably**. Mutually supportive monetary and fiscal policies have helped maintaining the momentum of economic recovery. **Through prudent macro policies, the growth in 2004 is estimated to reach the upper limit of 4.5%-5.0%, higher than in 2003**. Investment and exports have also started to rebound since the mid 2004, in line with increased public confidence, improved stability in social political condition and stability in various macro fundamentals.

Along with this conducive trend, imports also increased, particularly with regards to raw materials and capital goods in supporting higher capacity utilization. Volume of imports is estimated to grow substantially by 21% relative to only 2.8% in 2003. **Exports were also on a positive growth trend**, albeit moderate. Oil and gas exports have increased substantially thanks to the positive impact of high oil prices, whereas the increase in exports was partly supported by the non oil and gas sector. As a result, the overall exports and imports is expected to generate **US$5.2 billion current account surplus**.

Ladies and gentlemen,

This conducive developments has also facilitated the availability of financing. Credits has grown roughly by 22% throughout 2004 with higher absorption of new credits, particularly by the SMEs. This credit development has led to an **improvement in banking sector performance with prudential indicators remaining at sound levels**. Banking capital structure continues to exhibits significant improvements. Recent review on each bank indicated that each bank manages to maintain a healthy CAR, reaching around 20% as an average for the banking sector. Key banking indicators such as total loans, total assets and deposit funds, maintained their positive trend. Other indicators such as NIM and LDR subtantially improved, while the figures of NPLs keep setting lower to reach an average banking sector of 6.7% gross, or 2.1% net.

The loan expansion was also favored by a **declining trend in interest rates**. Although showing a stable path since mid 2004 due to tight bias monetary policy, the 3 month SBI rate has declined from 8.15% at the end of 2003 to 7.4% by the end of 2004. This declining trend in the central bank instrument rate led to lower banks' deposit rate, including credit rates. In line with the declining trend in deposit rates, interest rates for consumption credit, working capital credit, and investment credit continued to move downward. In addition, the spread between deposit and credit interest rates is narrowing further as a result of declining lending rates in contrast to rising deposit rates.

The increasing **optimism in the money markets was also reflected in the capital markets**. The positive investor expectations regarding the Indonesia's economic prospects has been boosted by controlled inflation, rupiah stability and positive forecasts for economic growth which eventually reflected in the increasing Jakarta stock price index, reaching its peak on December 2004.

That higher domestic demand leading to increased imports, as well as some spill over effect due to external factors have also indirectly affected **exchange rate** fluctuations in 2004, which depreciated around 3.7% to reach on average Rp8.934 per USD in 2004. In line with this, **inflation rate** went up slowly since January from 4.82% (y-o-y) to 6.4% (y-o-y) at the end of 2004, which is still in the central bank inflation target range of 5.5% +/- 1%.

Ladies and gentlemen,

### Macroeconomic outlook for 2005

The above macroeconomic conditions inevitably underlie the brighter economic performance in the near future. The prospect for growth in **2005 seems to be much stronger along with** improvements in the components of GDP. On the demand side, projected growth would be supported by higher investments while a stable trend is projected for private consumption. Export performance is predicted to improve slightly, despite conducive world trade conditions. This favourable development is expected to sustain in line with the improvement of market confidence and optimism in the implementation of the development program set by the new Government. With the competitiveness of the rupiah, **GDP growth is forecasted to be around 5.0 – 6.0%**.

**Private consumption is projected to increase** by around 5.5%, in line with higher expected disposable income. An increasing trend on both consumer confidence and household expectation is expected to generate higher private expenditures and subsequently higher private consumption. In parallel, total investment, including **private investment, is forecasted to grow substantially** to around 13.5%. In line with the established democratic government and a more conducive investment climate driven by infrastructure development programs, the private investor confidence is expected to increase. **The improvement in risk premium** is also considered as an underlying indicator for a better investment climate. In addition, **the improved access to the banking sector** and the positive trend in equity markets would be expected to play a significant role in boosting investment activities. Macroeconomic stability has provided Bank Indonesia some room to adjust interest rates at stable low levels over the last two years. In addition to increasing bank credits of 20% in 2005, the sources of financing investment activities are predicted to come from the stocks and bond markets. Added to this, FDIs are expected to increase as well. As a result, private investment is predicted to grow by 14%, close to pre-crisis levels, whereas ratio of investment to GDP is forecasted to rise from 19% to 23%.

**Government consumption** growth is predicted to be slower, in line with government efforts to reduce its deficit to GDP ratio. Despite its limited ability to stimulate the economy, the government remains firmly committed to continuously support investment activities through the reallocation of subsidy spending towards capital expenditures. Therefore, the total amount of funds allocated for **government investment** is estimated to reach Rp199.2 trillion in 2005, or 11.5% higher than the previous year.

In addition to domestic financing sources, **the 14th Meeting of the Consultative Group on Indonesia (CGI)** held in Jakarta last week has pledged to provide assistance a huge assistance, higher that previously expected. On top of this, USD 1.7 billion is provided for the recovery programs in Aceh and North Sumatra. This assistance will support the Government of Indonesia's medium-term reform program aimed at improving the investment climate, creating jobs, and reducing poverty. Development partners also underscored their commitment to help the Government response to the tsunami-catastrophe in Aceh and Northern Sumatra, with recovery and rehabilitation programs. It is expected that the commitment from the CGI will support the government budget and improve the balance of payments condition, which in turn will support the Rupiah exchange rate.

Ladies and gentlemen,

With regard to the external balance, favorable global economic activity and high international commodity prices are predicted to **strengthen the Indonesia's balance of payments performance for 2005, especially exports**. The surplus continues to spur positive expectation for the availability of foreign currency supply in the domestic market. Supply of foreign currency is also contributed by short-term capital inflows in the form of portfolio investments, which are predicted to remain strong. Potential capital inflows in the form of foreign direct investment are predicted to come gradually in the second semester of 2005, albeit still low. Moreover, non oil-gas exports are predicted to be stronger, consistent with the favorable conditions in the international economy, a competitive exchange rate for the Rupiah, and increasing access to international trade financing.

The good progress of Indonesian **trade financing is expected to be better** in 2005 due to the improvements in macro condition, banking performance, and higher international confidence. This positive progress of trade financing is reflected by increasing number of credit line provided by foreign banks, decreasing cost of trade financing and increasing trade finance facility from domestic banks to private sector. However, the challenges are to be overcome in order to optimize the trade finance facilities from the banking sector. Bank intermediation is yet to be improved in order to maximize the credit line utilization from international banking community. In addition, efforts should be made through assurance of legal certainties and diplomacy to counter the inclusion of Indonesia as country under the **Non Cooperative Countries and Territories (NCCTs) list**. These positive efforts would eventually lower the trade financing costs.

It worth noting that in order to enhance international perception on the more conducive Indonesian business environment, Indonesian authorities have showed the strong commitment and seriousness in **building-up anti-money laundering regime in Indonesia**. Some progress on the implementation ant-money laundering regime can be described s follows. ***First***, issued new regulation instruments in order to strengthen its supervision function, concerning KYC/AML Supervision Framework, assessment and imposition of sanction on the implementation of KYC, Standard Guidelines on KYC Principles for rural bank, and application of KYC Principles for Money Changers. ***Second***, conducted Socialization and training programs continuously for Bank Indonesia supervisor and examiner, and for banking industry. ***Third***, completed examination programs on 32 commercial banks, consisting of 5 foreign banks, 2 state owned banks, 21 domestic and joint venture banks, 1 regional bank, and 3 Islamic banks. ***Fourth***, conducted seminars/ workshops/MOU for/with law enforcement agencies (National Police, Attorney General's Office (AGO), Supreme Court and Judges), to promote and foster the effectiveness of the handling of banking and money laundering crime. ***Fifth***, promoted public campaign program on KYC/AML, in cooperation with AusAID.

In 2005, we **will continue and intensify KYC/AML program**, through 2 channels, namely designing and budgeting an Initiative Program, as well as conducting supervision and examinations for all banks to ensure compliance with the KYC/AML regulations. In this regard, designing and budgeting an Initiative Program will be implemented through: (a) Delivering an intensive public campaign program; (b) Reviewing and formulating KYC/AML regulations and references; (c) Building KYC/AML core teams of supervisors and examiners within Bank Indonesia, both in the head office and branches; (d) Arranging training and seminars for the banking industries and public; and (e) Promoting cooperation between Bank Indonesia and other institutions.

With the above explored conditions, **the exchange rate is estimated to appreciate slightly** compared to 2004 with some positive factors would contributed to the recovering of rupiah, including the favourable long-term risk indicators, strong economic fundamentals, and adequate foreign reserves. **Inflationary pressures** may even be higher considering the likely reduction of oil subsidies in the central government budget. The impact of this policy on inflation will depend on the magnitude of the prices hike, the timing of the implementation and the magnitude of the secondary effects. Central bank estimates have indicated that for each 10% rise in domestic oil prices, overall inflation would at first increase by 0.2%, then leading to a further increase of 0.36%. Taking into account the likelihood of higher oil prices, **inflation in 2005 is targeted to be 6% + 1%**.

Anticipating pressure on inflation, monetary policy would be directed to achieve the medium term inflation target while maintaining the momentum of growth. To enhance the effectiveness of monetary policy, Bank Indonesia is planning to use **interest rate as its operational target** in mid of 2005.

Ladies and gentlemen,

### Banking industry environment, problems and challenges ahead

Looking ahead, it is envisaged that sustained macroeconomic stability will pave the way for the banking system to **strengthen the bank intermediary function**. **Investment credit**, which began to pick up in 2004, is predicted to expand further particularly as infrastructure projects get under way. As I mentioned earlier, the banking system can play a key-financing role in the Government plan to accelerate the construction of infrastructure. In this regard, I call on banks to keep a close watch on their funding structure and experience and capacity in project financing. In the consumer sector, credit expansion is predicted to remain strong and will be the first choice for private banks and foreign banks as more banks enter into cooperation with multifinance companies. In the property sector, banks need to exercise greater caution in lending because of the higher risk of default on loans for purchase of apartments and office premises.

In the **SME and microenterprise sector**, lending soared in 2004 and this trend can be expected to continue in the years to come. Going forward, the banking industry need to examine and develop innovations to assist the development of SMEs. These innovation could extend the scope of financing to SMEs and at the same time reduce the risks of extending credits to the sector. In this connection, it may be noted that since recent time, we have launched a pilot project in cooperation with local governments and ASKRINDO to explore the possibility of creating a guarantee scheme for credits extended to SMEs. It is our hope that the pilot project could be expanded to more regions.

Ladies and gentlemen,

As I have mentioned, our goal is to develop a banking industry that would be strong and proactive in order to be able to support a sustained growth of our economy. In the years ahead despite the progress we have achieved, we are fully aware that we will continue to face a series of **problems and challenges**.

***First***, we observe the problem of relying excessively on short-term fund leading to the predominance of short term credits.

***Second***, we recognize the exixting problems with information concerning the debtor soundness have eroded the confidence of the banking industry in the real sector, hampering the intermediary function.

***Third***, we also realize that the credibility of the banking system will be contingent on the ability of the banking industry to strengthen good corporate governance, including management of operational risk.

***Fourth***, moreover, we understand that the implementation of deposit insurance scheme requires banks to strengthen market confidence.

***Fifth***, and more importantly, the banking industry is constantly challenged by competition from non-bank products, such as mutual funds, bonds, and insurance.

Ladies and gentlemen,

### Future banking policy directions

#### How are we going to respond to these problems and challenges?

Within the banking industry, we have long been aware of these problems and challenges. Responding to this, we have worked together to map out actions and do what is necessary to ensure the sustainability of our banking system. Our desired objective is for the banking system to regain its place as a reliable, trusted industry capable of promoting national economic growth. To accelerate this change and respond to the various problems and challenges that lie before us, we have formulated a number of policy directions for the banking system that we believe will set the course for the future dynamics of the national banking industry. These **policy directions** include the following:

***First*, accelerate the consolidation process in the banking industry;**

In the Indonesian Banking Architecture (API), Bank Indonesia has laid out a series of measures to build the soundness and strength of the national banking industry. Under this policy, the banking industry consolidation program is a key initiative that sets the course for the future of the national banking industry. Within the next 10-15 years, the national banking industry must become capable of serving as a sound, strong, and dynamic backbone to the economy and of delivering results. However, as I explained earlier, the present situation and challenges and an array of unexpected events in 2004 have compelled us to adopt a shorter time frame for consolidation of the banking industry.

In this regard, we must realize that to create a sound, robust, strong, and efficient banking industry, the industry consolidation will not be achieved without first going through a process of consolidation at the level of the individual bank. And, it is this process of individual consolidation that we must strive to complete in 2005. The picture is that an industry putting its house in order and striving for growth must first be sterilized of potential systemic risk that could arise from problems at individual banks.

Before the recent launching of the API, Bank Indonesia put together a range of scenarios for the consolidation program for the building of soundness and strengthening of the banking industry as a whole. These scenarios are:

- Market driven consolidation
- Directives consolidation
- Heavy-handed consolidation

These scenarios are in essence of a sequence of action programs that are mutually complementary, should one of the scenarios earlier in the sequence prove ineffective and fail to deliver the desired results.

Taking into account the developments that have taken place since the introduction of the API in early 2004, Bank Indonesia is now readying itself to apply the second scenario in the consolidation program, which in essence is an acceleration of the consolidation program scenario set out in the API.

The consolidation scenario that we are considering for implementation in 2005 will begin with a process of identifying the medium and large banks that are currently in very sound shape and have adequate human resources to expand market share without sacrificing prudential banking principles. Our expectation is that these will become the **anchor banks** capable of stimulating a process of strengthening among other banks whose future ability to compete is reportedly constrained by a range of factors.

In conjunction with the process of determining these anchor banks, Bank Indonesia will also identify the banks that have or are thought to have lost competitiveness because of their inability to build stronger resources and especially capital. These banks will then be grouped with other banks in reasonably good condition but which lack competitiveness because of limited market share and are experiencing downward trends in both assets and deposit funds. Each group of banks will be offered **3 options**: first, acquisition by an anchor bank; second, merger with other banks in the group; and third, a combination of merger between a number of banks and an anchor bank.

Ladies and gentlemen,

In addition to accelerating bank consolidation programs, **banking policy directions include other measures, namely**:

***Second*, reorientation of the working mechanisms and procedures of the national banking industry to more effectively accommodate the needs of the national economy;**

Parallel with the process of institutional consolidations, banks are also required to revitalize their mode of operation. The process of allocating funds that is practiced by banks have been so far relatively passive. Decisions are not based on accurate research information concerning the sectors they are financing. In the years ahead, banks must be able to identified more clearly the various market niches they wish to operate in and must be proactive in seeking the potential clients in those sectors. The human resources in the bank cannot stand by idly, satisfied with their acquired formal education. They must be trained to understand the realities in the market in which they operate.

***Third*, implementation of steps to strengthen the financial system infrastructure;**

A sound, efficient banking system requires adequate infrastructure. In this regard, it is essential to have an adequate **Financial Safety Net (FSN)**. To move towards the establishment of an adequate FSN, Bank Indonesia and the Government have jointly completed the formulation of the policy framework for the FSN that also encompasses the soon-to-be-established **Deposit Insurance Agency** (LPS). With the establishment of this agency, the responsibilities for management of the guarantee program and resolution of insolvent problem banks will be defined more clearly.

In addition, Bank Indonesia has worked untiringly to promote the application of **Good Corporate Governance** (GCG) at all levels of bank management. Bank Indonesia is currently upgrading the provisions relevant to GCG in the banking system and the new GCG regulations pertaining to the functions of the board of commissioners and board of directors should be ready in the near future. At some point in the future, Bank Indonesia will also consider an intensive study of possibilities for changes to the regulations governing ownership of bank shares.

Furthermore, to strengthen the effectiveness of the bank intermediary function, supporting infrastructure is needed that will enable the lending process to operate more quickly and reduce the potential for problem loans. To this end, Bank Indonesia has initiated the establishment of the Credit Bureau set to commence operation in 2005. We have waited long for **the Credit Bureau**, and a great many have repeatedly asked me when this plan will come to fruition.

***Fourth*, improvement of prudential aspects and bank intermediary function;**

On January 2005, Bank Indonesia issued the **"Prudential Banking Policy Package"** with 3 (three) key objectives that I can mention here:

*First*, promote the operation of the intermediary function and consolidation of the banking system in productive business sectors, as reflected in the Bank Indonesia Regulations on the Legal Lending Limit, the Debtor Information System, and Asset Securitization;

*Second*, promote efforts to build bank capacity in credit risk management, application of prudential principles, and sound banking practices that will ensure sustained financial system stability. This objective is clearly reflected in the regulations on Earning Assets Quality, Legal Lending Limit, Foreign Borrowings, and Asset Securitization;

*Third*, measures to improve consumer protection through certainty in the application of standard, secure, and transparent banking services. This objective will be achieved through the issuance of Bank Indonesia Regulations relevant to consumer protection and transparency of banking products.

***Fifth*, bringing the national banking industry to international standard of capital adequacy according to Basel II principles.**

The adoption of Basel II will commence in 2008 by applying standardized models. By adopting this consolidation policy, we believe that the Indonesian banking system will consist of banks with strong commitments and capacity to play an optimum role in the national development process.

Ladies and gentlemen,

### Financial sector outlook

**In line with improving economic performance as well as a strong banking performance**, bank loans are projected to expand about 20% in 2005 (or about Rp106.2 trillion). Based on our projection, banking sector will have adequate capacity to expand loans as targeted without impeding their capital adequacy and liquidity. With loan growth of 20%- 23% and deposit growth of 6%-7% in the next three years, the CARs of banks are projected to stay at 16% and LDR will be approaching 100%. In addition, higher international commodity prices (especially primary non-oil/gas commodities) resulting from rising demand in export markets would have a positive impact on the domestic business climate, which raise demand for loans.

As I have mentioned earlier, we have so far achieved significant progress in putting in place the foundation for economic stability and financial system more in line with challenges in the years ahead. However we are also aware that in our path toward achieving the objective of a more satisfactory financial and banking sector requires time. We are entering a crucial period in the process of transition toward a better future of banking system. The process of consolidating the national banking industry is an objective that we cannot compromise if the stability and resilience that we desire for the banking system is to be achieved.

We must all take note, **first** of all that the coming years will be no time for complacency. Before us lies only one choice, to work hard to fulfill the commitments and sincere intentions to restructure whatever needs to be put right. We should no longer feel comfortable watching as the various problems unfold within our banking industry. In fact, we as the banking authority see that much remains for us to do to be able to meet this demand. The **second** point is that in the future, the public will become more discerning and cautious in the selection of banks capable of serving their transaction needs. They will only be willing to deal with banks that provide a sense of security while also offering returns on the funds entrusted to their keeping. They will also select only those banks that understand their needs and are able to provide a wide range of conveniences in their services. These are the criteria that indeed will build and strengthen public confidence.

Ladies and gentlemen,

Today, **Indonesia remains attractive to portfolio investors** because of the combination of high yield offered, an improving macro-economic position, a diversified economy and stable Rupiah exchange rate expectations. The credit profile is gradually improving. The fiscal deficit appears relatively resilient to varying oil prices, although this issue remains a major question marked by international financial investors. Furthermore, assets sales and privatizations are proceeding forward and Government debt ratios continue to trend down due to the strengthening of the Rupiah and the relatively modest budget deficits. Despite positive recent signs of macroeconomic and political climate in Indonesia, credit agencies point out that the country still faces some credit challenges, namely, high Government debt and overall foreign debt levels, security issues and low levels of investment that limit long-term growth. **Looking ahead**, I am confident that evidence of continued and timely implementation of reforms by the new government and strong commitment to maintain fiscal consolidation will favourably influence the credit ratings on Indonesia.

Much work remains to be done, but we must do so systematically with clear design. The years ahead will not be without challenges, in fact we will face many more challenges than today. **In closing**, it is my hope that this forum will be able to serve as an arena of information exchange. It takes people from different skills and abilities; authorities, investors, bankers, academics, and others to build a sound business environment and I hope our participation here will serve as a notable step in that effort.

Thank you.