Burhanuddin Abdullah: Monetary and banking in Indonesia - developments and challenges ahead

Speech by Mr Burhanuddin Abdullah, Governor of Bank Indonesia, to the Financial Club, Jakarta, 21 August 2003.

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Excellencies members of Indonesian Council of World Affairs
Distinguished Guests,
Colleagues and friends,
Good afternoon, and Assalamua'alamualaikum wr wb.

It is both a pleasure and an honor for me to be here today to speak before distinguished audience. Let me first thank you for inviting me, to share with you some of my thought regarding our current situation that could probably shape our future. If one ponders on our world today and tries to look back for a while to not too distant past, one may find himself in a bewildering circumstances. It seems that the past is to starkly different than that of today and that has no relevance with the present, let alone the future that we know nothing of. Our very existence at the present is in danger of detachment from our historical root of yesterday. And, yet, we know the passage of time is a continuous events that whatever the dynamic of transition in human endeavour, there is always element of continuity.

What is the element of continuity of the economy in transition like the one in our country? Does this element of continuity need to be preserved as such that whatever the social dynamics, it has to be maintained at all cost? Time is the element of continuity for the evolutionary process of nature and macroeconomic stability, in my view, is the element of continuity for the Indonesian economy in transition. The stability is so important that whatever the cost to maintain it, we are ready to pay for it. It is so important simply because we can not imagine what the economy can do without. Macroeconomic stability is the "word" of the day and macroeconomic stability is a regular preaching of central bankers.

As a person who has been in the central bank for years, and so get used to the phrase "monetary stability" and/or "macroeconomic stability" that some time questioning the real meaning of these very words. Especially if we look around and see many of our fellow countryman are out of job and many more becoming parasites of our social web. Should we forego some degree of stability in return for employment opening or should we stick to it, and let the other authorities take care of employment issue.

The mandate that was given to Bank Indonesia by its constitution is precisely "the maintenance of our monetary stability". BI is no longer engage in lending activities known as liquidity financing to be extended by our banking sector to a number of the so called "development program". BI is no longer giving a bridging financing to government. The task of BI is so focused on maintaining stability, that it was granted independence from any policy interference from anybody. BI "has no function in development", but take care and nurture of the foundation of development, i.e., stability, without which there will be no development at all.

Ladies and Gentlemen,

It is within this mandate that BI is now trying to perform. In the past several months, we have been quite successful in curbing inflationary pressures. As measured year-over-year, the inflation rate at the end of July fell to 5.79%. This performance was largely due to the appreciation of the rupiah and slow growth in base money, in addition to favorable supply factors. For the year of 2003 as a whole, we are projecting an inflation rate of 5% to 6%, lower than our target of 9%.

The strengthened rupiah has a positive impact in capping inflation. During the second quarter, the rupiah appreciated over 4% from the previous quarter. After falling in July 2003 when the Federal Reserve's last cut US dollar interest rates, the rupiah has traded in a narrow band around Rp8,500. The appreciation of the rupiah during the first half of 2003 was associated with a positive sentiment towards the country, illustrated by higher dollar inflows, related to privatization, the sale of IBRA assets, and the upgrade of Indonesia credit rating by S&P from CCC+ to B-.

I should add, however, that, despite the recent strengthening of the rupiah, the foreign exchange rate remains competitive relative to regional competing currencies, including the Thai baht, one of our main export competitors.

The drop in inflationary expectations and the appreciation of the rupiah has allowed Bank Indonesia to pursue a monetary policy that is designed to facilitate an accelerated recovery process by guiding interest rates lower. The 1 month SBI rate declined 390 basis points from 12.93% at the end of 2002 to 8.99% on August 20. This has been accomplished while adhering to quantity targeting, whereby Bank Indonesia controls growth in base money within an indicative target range. Throughout the year, the growth of base money has remained within target. This gives us confidence that we will be maintaining the growth in money so that there is sufficient liquidity to satisfy the needs of the real economy, without risking a run-up in inflation.

Ladies and Gentlemen, I would now like to turn to the banking sector.

Supported by improved macro-monetary conditions, banking sector shows stronger condition. This was reflected in a stronger capital structure, improved NPLs, stronger profitability and recovery in bank intermediation. All banks are now in compliance with the mandatory capital adequacy ratio of 8%. This has allowed the banking sector's net income to grow as new credits extended have increased in the first half of the year and non-performing loans continue to remain under control with net NPLs reaching only 1.02% in June.

Given the improved financial condition of the banking sector, the Government is in position to privatize banks to be owned other than by the government. Among our major accomplishments in this area, have been the sales of BCA, and Bank Niaga, the privatization of Bank Danamon, and the initial public offering of 20% of Bank Mandiri. The Government will press forward with the divestment of the remaining IBRA banks with plans to sell majority stakes in Bank Lippo and Bank Internasionel Indonesia by November of this year, and Bank Permata by February 2004. The Government also plans to sell 20% stake in the state-owned Bank Rakyat Indonesia in September of this year.

Ladies and Gentlemen,

Despite all these encouraging development in the area of monetary and financial stability, issues, challenges or even problem remains. These problems will remain with us for some time to come. The issues on the monetary front is on the mechanics and the cost of maintaining stability. In the banking front, reluctant intermediation process and maintaining financial stability in the new environment are the most pressing issues that need to be addressed. On a wider circumstances, we are facing credibility issues in light of the upcoming separation from the IMF program.

<u>In the monetary front</u>, the challenge is rooted in the slow recovery of bank intermediation function. Bank lending is still limited because of high level of risks and uncertainty and the large number of companies still undergoing restructuring. Credit crunch phenomenon has been evidenced and the response of bank loan rates to the SBI policy interest rate is relatively slow and lagging.

With slacking real sector and bank lending, the transmission mechanism of monetary policy to the real economy and inflation faces a number of problems. Since the economy and financial sector are undergoing restructuring, excess liquidity emerges but circulates within the financial markets only, creating a structural breakdown between the real sector and financial system. This problem of excess liquidity, together with market segmentation amongst banks, has put greater risks on exchange rate volatility and difficulties in monetary management. In the condition of excess liquidity in banking sector and non-functioning intermediation, monetary policy is working just like "chasing our own tail". Banks put their excess liquidity in central bank bills (SBIs) and in return BI has to pay interest on SBIs which means pumping in the liquidity in the banking sector.

<u>In the banking sector</u>, one of the main challenges is to recover the intermediation function. In this regards, Bank Indonesia has created the conducive environment by maintaining monetary stability thus providing room for lowering interest rates, thereby delivering positive signals regarding the economic recovery. The positive climate is also an opportunity for the banking sector to re-build its internal condition through credit restructuring and strengthening its capital structure. These will encourage an expansion of bank credits. A decline in interest rates has given businessmen some reason for optimism in the prospects for recovery. Lower interest rates also provided an opportunity for the corporate sector to restructure its financial condition. In the face of limited bank financing, these conditions have provided wider room for reputable corporations to find alternative financing through bond issuance, both domestic and abroad.

The Indonesian financial sector is challenged by seemingly possible countermeasure if the Anti Money Laundering Act does not conform to the Financial Action Task Force (FATF) requirements. We believe that the amendment on the Anti Money Laundering Act is an important part in the efforts to maintain confidence in international financial transaction and trade and simultaneously improve good corporate governance especially by increasing transparency of banking transaction. In this regard, Bank Indonesia and Indonesian Financial Transaction Reports and Analysis Centre (PPATK) has been working closely with parliament to pass the amendment.

Other issue that needs to be addressed is related with our decision to end the IMF program by the end of 2003. The real issues is not to continue or to stop the IMF program, but more on how we can cover the potential financial gap and credibility gap that might be stemmed from the decision. In addressing the financial gap issue, a number of financing alternatives that have been intensively discussed. However, to find the solution for the potential credibility gap, I must remind all of us that it will take more than just a solid program. Credibility can only be built if we can develop a credible program and at the same time be consistently and strictly adhere to it.

Bank Indonesia has been working closely with the Government in developing our own economic program to replace the program currently stated in the IMF Letter of Intent. With the support from all of us, we are confident that we can and we will be able to obediently and consistently implement the program. For monetary policy, we are in the process of preparing the new framework of monetary policy, i.e., inflation targeting framework. This framework provides clarity in our objective and consistency in our monetary policy to pursue price stability, thereby gradually improve credibility.

In banking sector, to maintain financial system stability and improve governance in banking sector, Bank Indonesia is currently in the process of preparing Indonesia's Banking Architecture (API) that can be used as a comprehensive and forward-looking platform for banking policy. The Indonesian Banking Architecture vision is to create a sound, strong and efficient banking system to preserve financial system stability and stimulate national economic development. The new architecture consists of six pillars, as follow:

- A sound domestic banking structure with the capacity to meet public needs and to stimulate sustainable national economic development.
- A strong banking industry that is highly competitive and has a solid core capable of absorbing shocks.
- Good corporate governance as means to strengthen banks' internal condition
- Effective banking supervision and regulations, consistent with the international standards.
- A complete infrastructure in supporting sound banking industry, including preparation for more sophisticated technology in line with a more sophisticated financial transaction.
- Consumer protection and empowerment.

Ladies and Gentlemen,

Before closing my remarks, let me figure out the outlook of our economy. Looking forward to 2004, we will continue to strengthen our macroeconomic fundamentals to be the basis for stronger growth in 2004 onward. While monetary policy will remain prudent, as both the inflation rate and the risk premium decline, fiscal policy will stay focused on achieving sustainability. This will require further steps to increase revenue collection and improve access to financing. But as the recovery continues we can begin to look forward to strategic investments to improve the welfare of the people and support the development of the economy.

Good macroeconomic management, however, is not enough to sustain high rates of economic growth. High growth requires structural reforms to make the economy more efficient. Such reform programs that the Government is undertaking include the strengthening of legal infrastructure, improving governance and increasing transparency in both public and private sectors. The purpose of the program that we have developed is not reform for reform sake, but to restore investor's confidence in Indonesia.

We fully expect our macroeconomic policy, coupled with the consistent implementation of our structural reform, will allow economic growth to reach 4% this year and will establish the base of real growth of 6% over the medium-term.

We do hope our efforts will improve the welfare of our society as a whole.

May God bless us.

Thank you.