Mr Sabirin discusses recent developments in the Indonesian economy

Presentation by Dr Syahril Sabirin, Governor of Bank Indonesia, at the Banque de France, Paris in March 1999.

Good evening, ladies and gentlemen.

It is a great pleasure for me to be here today at the kind invitation of the Banque de France, and to have an opportunity to share with you the most recent developments in the Indonesian economy. The financial and economic crisis experienced by Indonesia since July 1997 was indeed very dramatic and traumatic. But the many steps we have taken have reversed the situation and established conditions for stabilization and a return to economic growth. We have launched and continue to implement an economic recovery program, designed not only to reverse the situation, but also to establish a stronger foundation for sustainable growth in the future.

Let me begin by giving you a brief description of some of the factors which demonstrate that progress has indeed been made and which, as a result, should allow you to make a more positive assessment of the Indonesian economy. First, the value of Indonesia's currency, the rupiah, is the clearest indicator suggesting that the worst of the crisis is believed to be over. As you may know, from a pre-crisis level of around Rp 2,430 per US$ in early July 1997, the rupiah weakened to reach a low of just under Rp 17,000 in June 1998. This represents a loss of about 85% of the rupiah's value at its worst point. No economy could survive such a hard blow without serious harmful repercussions. One of our first priorities has therefore been to strengthen and stabilize the value of the rupiah. As a result, the sharp volatility of the rupiah during early 1998 gradually waned due to actions deterring speculative attacks. The monetary authority's strict discipline and support from the IMF and other international financial institutions played a very important role, pushing up the rate to a range of Rp 7,500–8,000 at end-1998. Despite the more recent weakening of the currency associated with the rumors on China's devaluation, the Brazilian devaluation, and some scattered domestic problems, the rupiah has shown its resilience, signifying the improved confidence on Indonesian economic performance and prospects. From mid-October 1998, the rupiah has moved upward and downward within a range of only around 13%. Indeed, the bank restructuring program, the details and the implementation of which were announced about a week ago, was the latest piece of economic recovery program that contributed to the improved confidence.

Now, let me turn to the macroeconomic indicators. GDP suffered a sharp decline in the aftermath of the fall in the rupiah's value. Indonesia's gross domestic product, which had grown by over 7% per annum for over a decade until 1997, grew by only 4.9% in 1997 and then contracted by about 14% in 1998. This contraction was due primarily to a sharp decline in production, private investment and lower household consumption due to the steep depreciation of the rupiah and high interest rates that had to be introduced to stop the free fall of our currency. We are confident, however, that the rapid fall in GDP growth has now been checked. For 1999 the economy will still post a negative growth around 2% to 3% year on year, and the economy is estimated to have some positive growth in 2000.

Another important indicator, inflation, shows an even more positive trend. During its worst point in early 1998 Indonesia's inflation rate reached almost 13% in one particular month alone, a dramatic rise from the 1997 level of 10.3% for the whole year. In response, we adopted a tight monetary policy, and work in a very tight discipline to adhere to the preset targets of monetary aggregates on a day-to-day basis. These efforts, together with the policy actions to secure the supply of basic necessities, have been rewarded. The monthly inflation rate started to decline to a more 'normal' level in the last quarter of 1998. We even recorded a negative inflation rate of 0.3% in October.

I should also attribute the increased confidence in Bank Indonesia's anti-inflation policy to the much improved transparency in the conduct of our monetary policy. Beginning the second quarter of 1998 we regularly announce, on a weekly basis, the crucial monetary aggregate data and how they compare to the preset targets. These data, as well as much other information, are available to everybody to access through our website.

In June 1998 we recognized the concerns of foreign lenders to the banking system by agreeing to allow these foreign banks the opportunity to exchange loans to Indonesian state and private banks which had already matured or were to mature prior to 1999 into new short- and medium-term loans guaranteed by Bank Indonesia. This measure demonstrated immediately to foreign lenders that the guarantee put in place was operative and the Government's determination to tackle this problem.

At the same time, we recognized that the trade finance arrears that had been built up by some Indonesian banks during the currency and financial turmoil were prejudicing current access by Indonesian entities to trade financing across the entire economy. We agreed to settle these arrears and have paid the due amount. Most recently, in December 1998, we cleared additional arrears. This was, we believe, an important signal to the international banking community. In addition, for those banks that agreed to maintain their trade financing activities in Indonesia, we agreed to guarantee all new trade finance facilities for a year after we received confirmation of these banks' commitment.

Turning again briefly to the corporate sector which had been reluctant to enter discussions with its creditors, we also agreed in June 1998 to set up an agency, the Indonesian Debt Restructuring Agency or INDRA, to provide foreign exchange protection to those borrowers that had renegotiated their debts with their creditors. Strengthening these borrowers by reducing their residual foreign exchange risk improves their creditworthiness, thereby creating an incentive to complete a restructuring. These efforts were followed by the Jakarta Initiative in September 1998 which aimed at setting the right framework and incentives for bilateral debtor/creditor negotiations.

These measures combined, and the real money that has been paid to foreign creditors, in particular by Bank Indonesia, show our real determination to resolve the current situation. Indeed our support has been proven with the expenditure of very large sums of our scarce foreign exchange resources reflecting the high priority we give this subject. I would urge you, therefore, not to adopt a reflexive reduction in your activities in Indonesia. Instead, please do focus on the systems in place now and the opportunities open to you within our new strengthened framework.

Another very important point I would like to mention here is the high levels of capital-backing required in some jurisdictions on new lending to Indonesia. We believe these levels of provisions are excessive and that they constitute a great hindrance to a resumption of activity in our economy.

Let me also take this opportunity to share with you some developments in our banking restructuring program. It is not a secret that the pre-crisis Indonesian financial system was unhealthily fragile and vulnerable to external shocks. We certainly underestimated the vulnerability of our domestic banking system to a crisis in the corporate sector and its potential to paralyze the banking sector; we also probably underestimated the riskiness of many loans in the banks' portfolios. For our economy to recover, we had to create a strongly capitalized and well managed banking sector in line with international standards. This is our objective. To reach it we have first to address the current situation; that is very low capital base and excessive number of institutions which have not been able to institute the necessary reforms and improvements to their financial conditions, management and operational systems.

Clearly, the banking sector has been one of the most seriously affected segments of the economy during the crisis. The effects were transmitted primarily through the following ways.

(i) The sharp depreciation of the rupiah suddenly blew up the rupiah value of banks' liabilities denominated in foreign currencies and put the banks with short position in serious problems;

(ii) The economic crisis put banks' customers (debtors) in problems which depressed the value of banks' assets; and

(iii) The tight monetary policy to stabilize inflation and exchange rates, and the concomitant high interest rates, resulted in negative spreads for the banks.

All the factors I cited earlier imply depletions of banks' capital base. And the longer the problems remain, the sharper the depletion of banks' capital will be. Indeed, the results of the due diligence being run on the banks in 1998 show how deep the impact of the crisis on the banking sector has been.

We fully realize that: (a) the recapitalization program is likely to be costly; (b) the recovery of the economy relies upon the recovery of the banking system, and thus on the recapitalization program; and (c) the failure of the recapitalization program would amount to the very costly delays to economic recovery; then the recapitalization program would have to be designed and implemented very carefully to assure its success. It is for this purpose that our bank recapitalization program carries the following characteristics.

(i) The estimates of recapitalization needs are done very realistically, or even conservatively through the due diligence process conducted by international auditing firms on each and every bank. The conservativeness of the estimate would provide some cushion to the changing environment during the process of recapitalization.

(ii) The criteria for the banks to be eligible to participate in the Government-supported recapitalization program are made very clear and transparent.

(iii) The process of eligibility evaluation is conducted by four layers of committees, each layer works independently of the others, and the meetings of the committees are attended by observers from international financial institutions. This will assure the intensity of the evaluation and add transparency to the whole process.

(iv) Among those to be evaluated by the committees, aside from the workability of the business plans, the 'fit and proper' of the management and the controlling owners of the banks is a very important and determining aspect. This process will leave out bad managers as well as bad and improper controlling owners from the post-restructuring banking sector of Indonesia.

It has been on the basis of the principles I cited earlier that we run our bank recapitalization program to recapitalize those banks that we believe have a viable future together with the decision to liquidate those banks that were not viable. Following an assessment by international auditors of the banking sector, we have classified each bank into one of three categories. So-called category A banks have a capital adequacy ratio of 4% or more. Category B banks are those with a capital adequacy ratio of less than 4% and more than minus 25%. Category C banks are the residual.

On 13 March 1999 the Government took a decisive step towards restructuring the private domestic system and bringing it back to financial health: 38 banks – all 17 private category C banks and 21 category B banks – have been closed as they were considered deeply insolvent and as having no prospect of regaining financial viability. Seven large category B banks with extensive branch networks have been taken over by the Government in the public interest to minimize disruption to the payments system. These seven banks will be restructured speedily to improve their financial performance and prepared for later privatization. Nine category B banks have been determined as eligible for recapitalisation by the Government to bring them to the minimum capital requirements. Several committees and international consulting firms have assessed the better financial positions, quality of management and future prospects of these nine banks. Their owners have, however, until April 21, 1999 to inject at least 20% of the banks' capital requirements, the Government providing the remaining capital in the form of bonds. Finally, 73 category A banks have met Bank Indonesia's minimum capital adequacy standards and can compete without any public financial assistance. These category A banks will be reviewed regularly to ensure they remain in good financial health and continue to observe all rules and regulations, focusing on three main criteria: their business plans, the 'fit and proper' test of their owners, and the nature of any capital injection.

With regard to the state banks, all regional development banks will be recapitalized by the Government such that they have a capital adequacy ratio of at least 4%. Mergers between the seven existing state banks will allow us to create some stronger and healthier banks. For instance, four out of the seven state banks will be merged to create Bank Mandiri, which is expected to comprise 30% of banking system deposits in Indonesia. As the restructuring of the state banks takes place, the Government will inject additional capital needed by the banks on a step-by-step basis.

The cost of the bank restructuring program will be significant. However, every effort will be taken to minimize this cost and in particular to recover loans from recalcitrant debtors. In terms of the interest cost to the Government in 1999/2000, it is estimated at a total of Rp 34 trillion or Euro 3.5 billion. Of this amount we believe around Rp 16 trillion will be recoverable from sales of assets pledged to IBRA by the owners of the banks.

I should like to stress that it is not the intention of the Government to stay forever and dominate the banking sector. The Government’s involvement in the capitalization of the banking sector is only temporary to help the sector recover from the deep problems it is currently experiencing. In three to five years’ time the government’s share in the private banks will be divested, and these banks are expected to be pure privately owned banks once again. Nor is the intention of the Government to be involved in the day-to-day operation of the banks during the three- to five-year period. We only need to make sure that the banks are run properly and efficiently. And the mechanism of the recapitalization program has been designed such as to assure that these ideas are materialized.

I can also report to you today that we will continue our efforts in the future to improve the security of our financial system further. We will implement organizational and cultural change in the way we manage bank supervision. We will also review the workings of the amended bankruptcy law and make alterations to ensure that the law works as intended to allow both domestic and international creditors to gain security over the assets of debtors in default. I look forward to reporting our progress in these matters to you in future meetings.

Ladies and gentlemen, I hope that I have given you a balanced picture of the current situation in the Indonesian economy, banking system, and of the treatment of the broader financial obligations of the Indonesian private sector.