

Dr. Sabirin talks about efforts to save Indonesian banks

Presentation by the Governor of Bank Indonesia, Dr. Syrahil Sabirin, at The Indonesian Executive Circle (IEC) Forum in Jakarta on 7 April, 1999.

1. It is a great honor for me to be here today to speak before this forum, The Indonesian Executive Circle. This afternoon, I would like to share with you some thoughts on the recent developments of the Indonesian banking industry - how the current situation and problems came about, what alternatives were available to deal with them, and how I see the prospect of our banking industry in the coming future.

2. The problems we are currently facing, including the banking problems, came onto the surface after and as a result of the currency crisis beginning in mid 1997. The magnitude of the currency crisis perhaps has not been matched by any other countries in modern time. As you know, from a pre-crisis level of around 2,430 rupiah per US dollar in early July 1997, the rupiah weakened to reach a low of just under 17,000 in June 1998. This represents a loss of about 85% of the rupiah's value at its worst point. Clearly, no economy could survive such a hard blow without serious harmful repercussions. And it was only to be realized that a crisis of confidence, which was what Indonesia has really been suffering from, could do such a dramatic impact. The sharp decline in national output, massive increase in unemployment, and the deterioration of confidence on Indonesia's financial institutions, corporations, and economy in general are among the impact.

3. To the banking sector, the currency crisis, and subsequent events, have produced two major repercussions, directly or indirectly, namely:

Loss of confidence on banks that resulted in bank runs, loss of deposit base, and liquidity problems.
→ closing down of 16 banks in November 97.

Run down of banks' capital base. In this case the effects of the crisis were transmitted through the following ways:

- 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;
- The economic crisis put banks' customers (debtors) in problems which depressed the value of banks' assets; and
- The tight monetary policy to stabilize the exchange rates, and the resulting high interest rates resulted in negative spreads for the banks.

Those effects further resulted in many other negative impacts on the banks as well as on the economy at large, such as the unwillingness of banks overseas to accept L/C issued by Indonesian banks, credit crunch resulted from the low capital base, etc. And such declining trend in the banking sector reinforced the trend in the real sector, and vice versa.

4. Efforts to remedy the crisis of confidence on banks:

Long term; Undoubtedly, this would have to be dealt with by adopting some measures to improve the confidence, both from within the country and from offshore. And, the comprehensive policy package covering economic and non-economic areas was designed for that purpose. However, the recovery of confidence cannot be obtained overnight. It takes time and continues efforts. In the meantime, the economy would have to bear the cost., among other things the high interest rates and/or instability in exchange rates. In this regards, in the short run, we do have a choice, i.e. either to aim at a stronger

and more stable exchange rate while bearing the cost of higher interest rate, or aiming at lower interest rate while bearing the cost of weak and unstable exchange rate.

Short-term (emergency): the government provides guarantees to all depositors and creditors of locally incorporated banks. This is designed to stabilize the situation so that an orderly work-out of the banking system problems can be carried out. This measure enables banks suffering from lack of liquidity due to massive withdrawals to get liquidity support from the central bank as the lender of the last resort.

5. On the low (mostly negative) capital base. Quite logically, something has to be done. The banks would not be able to do much, to say the least, without anything being done to help recover their capital base. Therefore a re-capitalization program has been introduced, whereby the Government is willing to subscribe to up to 80 percent of the additional capital needs of viable bank. This is likely to be a very expensive exercise, although in a longer run there is a chance that the money invested can be largely recovered. The funds that need to be provided for the re-capitalization may exceed 25 percent of GDP. Although the costs of similar restructuring process in other countries do not differ much from what I cited earlier, and in fact the cost in some countries were much higher, the figure itself may raise eyebrows. But, is there any alternative? There is apparently no workable alternative one could think of. One extreme alternative is, of course, not to help the banks with re-capitalization. But, given the blanket guarantee provided by the Government on deposits and other banks' liabilities, this is certainly much more costly. And it is more so since it will not provide any solution. Many of the banks will likely go bankrupt, and the economy is left with no one to finance.

6. In the meantime, a question often raised to me as well to my colleagues in Bank Indonesia as to why the bank restructuring program came much later in the process to heal the crisis, since – the argument goes – if the condition was dealt with much earlier when the problems in the banking sector were not so deep, it would have been much easier to resolve the problem. The answer is clearly that bank restructuring program would make no sense if the exchange rate is still fluctuating wildly, inflation rates are very high, and interest rates are still producing large negative spreads. So we had to undertake the program of macroeconomic stability first before being able to produce a realistic program on banking sector restructuring.

7. As you know, the comprehensive program for macroeconomic stability, wherein monetary policy played a very important role, has borne some fruits. → inflation; exchange rates; interest rates; → conduct of monetary policy → prospect.] We attribute much of the progress made in stabilizing the exchange rate and reducing inflation to the tight monetary policy and consistent set of macroeconomic policies we have implemented. A tight monetary stance was required to control the excess supply of money which entered the economy when Bank Indonesia had to provide extensive liquidity support to commercial banks, particularly in late 1997 and early 1998 when many banks experienced panic withdrawals. We implemented a program under which all sources of central bank money creation were carefully monitored and controlled and the excess liquidity already in the system was reabsorbed through open market operations using Bank Indonesia Certificates (SBIs). Interest rates were by necessity high but the policy has been a success. Since July currency in circulation has been on a declining trend. Confidence in Bank Indonesia's anti-inflation policy has steadily increased and, with bank deposit rates more attractive, holdings of currency by the public have been increasingly converted into bank deposits. Bank Indonesia's open market operations have since 29 th July 1998, been conducted by a new system of SBI auctions under which a target amount of SBI instruments are auctioned weekly. Another positive development I can report to you is that as inflation began to contract and the Rupiah strengthened, we have been able to gradually ease our base money target which has allowed interest rates to gradually decline. The one-month SBI auction rate has declined from a high of around 70% in early September to a low of 35% in early January. The rate has now

nudged up a bit to around 37% at the last auction, but the overall significant decline in interest rates has provided a much-needed boost to the real economy.

8. 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 pre-set targets. Mind you, these data, as well as many other information, are available to everybody to access through our website.

9. Turning back to bank restructuring. First on the recapitalization program that was announced on March 13 th . This program had to be designed and implemented very carefully to assure its success, due to the following reasons: (i) the re-capitalization program is likely to be costly; (ii) the recovery of the economy relies upon the recovery of the banking system, and thus on the re-capitalization program; (iii) the failure of the re-capitalization program would amount to the very costly delays to economic recovery. It was for this purpose that the current re-capitalization program carries the following characteristics. (i) The estimates of re-capitalization needs were done realistically, or perhaps conservatively through due diligence process conducted by international auditing firms. The conservativeness of the estimate will provide some cushion to the changing environment during the process of re-capitalization. (ii) The criteria for the banks to be eligible for re-capitalization were made very clear and transparent. (iii) The process of evaluation was conducted by four layers of committees, each layer to work independently of the others, and the meetings of the committees were attended by observers from international financial institutions. This should assure the intensity of evaluation and add transparency to the whole process. (iv) Among those 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.

10. I would like to reiterate at this juncture 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 year time the government's share in the private banks will be divested, and these banks are expected to be mainly privately owned banks once again. During the three to five year time, it is not the intention of the Government either to be involved in the day-to-day operation of the banks. We only need to make sure that the banks are run properly and efficiently. And, the mechanism of the re-capitalization program has been designed as such as to assure that these ideas are materialized.

11. Of course, our work on the banking sector did not stop with the recapitalization. We are still in the middle of the process. Much still needs to be done. We will monitor the development in each individual bank on a day to day basis. We will work with each of them on this, and discuss the way to resolve their problems. For those which may need partners to strengthen their condition, we will function as a match-maker. With regard to prudential regulations, we will continue to monitor their effectiveness, and make adjustments whenever necessary. And, very importantly, we will have to continue to work hard to maintain or improve monetary stability and to ultimately abolish the negative spreads..

12. I should also stress that, along with banks' restructuring, companies' restructuring should also take place at the same time. A number of actions in synergy are being conducted for this purpose. In this regard, the government in June 1998 established the Indonesian Debt Restructuring Agency (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. Aside from the INDRA scheme, the Jakarta Initiative was established to help facilitate the meetings between debtors and creditors, and a special task force to help banks restructure their assets was also set up. We should expect that the restructuring of companies will take place along with the restructuring of the banks, and they should be strengthening each other's progress.

13. As a final remark, bank restructuring formed a complete set of economic recovery program together with: (i) the corporate debt restructuring, (ii) monetary and macroeconomic stability, and (iii) improvement of public and private sector governance. The third point I just mentioned, namely improvement of governance is a very important aspect that needs to be worked out in the near future. The task of restructuring banks and corporations, and improving crucial aspects of governance will be made much easier in a stable macroeconomic environment. So, managing aggregate demand is a crucial task for the government. Here, Bank Indonesia needs to continue to play a very important role. It is believed that as inflation declines, and the Rupiah remains stable, the interest rates will decline gradually, easing the pressure on the corporate and banking sectors. We have seen some encouraging signs. The road ahead may not be that smooth, but we are cautiously optimistic that the crisis has hit its lowest level and we are beginning the climb back to a stable and healthy economy.

