REPORT ON THE COUNTRY DIALOGUE IN INDONESIA

by the Initiative for Policy Dialogue

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Introduction

The Initiative for Policy Dialogue (IPD) visited Indonesia from Dec. 10th – 16th, 2004, to conduct a Country Dialogue with politicians, the central bank, members of civil society, and international organizations active in Indonesia to evaluate alternative policy options within the framework of the government's new plan. The Country Dialogue was organized in conjunction with the United Nations Support Facility for Indonesian Recovery (UNSFIR).

IPD emphasized broadening the policy set from what is offered by the Bretton Woods institutions so as to promote sustainable, democratic, and equitable development. IPD assessed a broad range of issues in economic policy confronting Indonesia, and promoted debate on alternative ideas. The main topics of discussion included alternative ways to combat corruption, policy measures to increase bank lending, debt management, infrastructure and industrial policy, exchange rate management and prudential regulations.

In addition, IPD's Journalism Program held a two-day workshop on "Covering Labor" from Dec. 13th to 14th. The aim of the workshop was to strengthen reporters' understanding of issues such as international and local labor standards, trade unions, corporate governance, activism, labor disputes, and legal frameworks. This workshop was co-organized by the Pantau Foundation in Jakarta.

Background

Starting in the 1970s, Indonesia experienced two and a half decades annual growth of more than 7% and was considered part of the group of High-Performance Asian Economies (HPAE). However, the country's rapid economic growth came to an abrupt end when a crisis swept over East Asia in 1997 and 1998. By many indicators, Indonesia was the country worst affected by the East Asian crisis. Its real GDP fell by 13.1% in 1998 – more than any of the other countries. Indonesia's recovery was considerably slower than the recovery of other East Asian economies, with average annual growth of only 3.5% from 1998 to 2003.

During the Asian crisis, Indonesia's exchange rate depreciated 80%, which quintupled the value of foreign currency denominated debt. Following the advice of the IMF, Indonesia (like other countries in the region) raised interest rates in a failed attempt to defend the exchange rate. Local interest rates were raised to levels of more than 50%. Asset prices, including most of the assets used as collateral for loans, collapsed. As a result of these three factors, 72 banks collapsed and around 300,000 companies defaulted on their debt.

The government created the Indonesian Bank Restructuring Agency (IBRA) to restructure the collapsed banks by recapitalizing them, merging them or closing them. In addition the agency was responsible for restructuring the bankrupt companies. Total bail-out costs of banks during the crisis amounted to 60% of GDP, which – along with the plummeting exchange rate – significantly inflated the government's indebtedness. By 1998, Indonesia's public debt reached a high of 97% of GDP, mainly as a result of the government bailout of failing banks, i.e. because of the socialization of private debts, and of a falling exchange rate, which blew up the domestic value of debt denominated in foreign currencies. By 2004, the level of public debt was reduced to 58% of GDP through a combination of an appreciating exchange rate, primary fiscal surpluses and growth. However, this debt level is still quite high compared to other developing countries. Over the same period, interest payments on public debt declined from 22% of total revenues to 12%. By February 2004, the IBRA had finished its task of restructuring the collapsed banks and was closed. It recovered only 28% of the total bail-out costs through the sale of the assets it obtained.

By the end of 2003, Indonesia decided to end its program with the IMF. In order to guarantee that the government would still follow sound economic policies and could maintain public and investors' confidence, it published an "Economic Policy Package Pre and Post-IMF," commonly referred to as Indonesia's "White Paper," to outlay economic policy goals for the time after the IMF package. This program set forth three major goals: (i) maintaining macroeconomic stability, (ii) continuing to restructure and reform the financial sector, and (iii) increasing investment, exports, and employment. The White Paper was implemented well and in a timely fashion: by September 2004, 70% of the planned issues had been realized. In general, the implementation of the White Paper has received excellent reviews by the international community, including the IMF, and fulfilled the goal of maintaining confidence in the government's economic policies.

In September 2004 Indonesia elected a new president, Susilo Bambang Yudhoyono, who appointed a cabinet containing a mix of members of different political parties and professionals. The new government announced a 100 day-action plan, which concentrated on the topics of tackling endemic corruption, enhancing peace and security, and improving the country's investment climate in order to boost economic prosperity. To this goal, the government planned to pursue a number of key corruption cases, address procedural barriers to the investigation of corruption, and back a new anti-corruption court. Furthermore, the government is currently working on a new 5 year-development plan for the country.

During the Country Dialogue the IPD team discussed alternative ways of tackling corruption, such as citizens' right to information and participatory budgeting. Special focus was given to the Freedom of Information Act that is currently under discussion in Indonesia's House of Representatives. In addition, IPD evaluated a number of issues relevant for the upcoming 5-year development plan, such as debt management, infrastructure and industrial policy, exchange rate management, and policy measures to increase bank lending. The following report summarizes the policy options and suggestions that the members of the IPD team put forward.

Fiscal Policy

Debt Management and Borrowing Strategy

One of the primary declared goals of debt policy in Indonesia is to reduce and restructure the public debt burden so as to free up the resources currently tied up in debt service for more productive uses. Indonesia currently runs a primary surplus so that no new government borrowing would be required if there was not such a high stock of existing debt to service. In fact roughly 12 % of the government's revenue in 2004 was tied up in interest payments on the existing debt. Once government debt is reduced, more resources will be available to support growth by stimulating demand.

The main strategy of Indonesia to reduce its indebtedness is to run only modest budget deficits and refinance existing debt, so as to grow out of the debt. However, there are also a number of specific other proposals that IPD brought up during the Dialogue to deal with the government's debt:

Some of the recapitalization bonds held by banks that are in government ownership have already been re-profiled, i.e. they have been swapped against longer-maturity bonds. This process can be applied to all recap bonds on the balance sheets of government-owned banks, which would lower the current refinancing needs of the government Recap bonds held by banks that have already been privatized, or those bonds that are traded on a secondary market, are more complicated, since the government is no longer the owner of the bondholders and hence cannot order them to agree to a swap. However, if offered at competitive terms, these bondholders should accept a voluntary debt swap.

It might also be worth considering a swap of the existing government debt into GDP-linked bonds, of which the payoff is a function of Indonesia's GDP growth. That way the government could share some of its revenue risk with bondholders, and the bondholders can enjoy extra returns for the additional risk that they carry.

Some groups in Indonesia, such as a number of members of the Anti-Debt Coalition, have proposed that the country should default on its debt now on the grounds that a large fraction of the existing government debt was created by bad policy advice from outside of the country. In light of the experience of Argentina over the past three years, it can be argued that Indonesia might have had a case for default at the height of the crisis, in 1998. However, at present the country has already reduced its debt burden to a more manageable level and its economy is growing robustly. In determining whether to repay debt a country needs to measure the costs of default vs. the costs of not defaulting. One view presented during the dialogue, was that at present, a default would not be worth the costs: it could lead to a renewed banking crisis and a severe loss in output. It could also strain the country's relations with the rest of the world, since the largest external creditors of Indonesia are sovereign countries, especially Japan.

In terms of its borrowing strategy it has to be noted that Indonesia has a relatively high savings rate, and that local savings would suffice for government borrowing if the country did not suffer from the severe capital flight that it has experienced since the mid-1990s. Thus reducing – or, better still, reversing – the capital flight from the country would allow it to rely less on foreign debt.

However, the IPD team pointed out that the important feature of the country's debt structure is not whether the debt is held by Indonesians or foreigners, but whether it is denominated in local currency or foreign currency. When policymakers are managing the portfolio of a country, they have to take into account how the portfolio composition affects the country's overall risk and their own ability to respond to a changing environment. A high level of indebtedness in foreign currency takes away an instrument to respond to shocks, i.e. the exchange rate, since the country can no longer afford to devalue. This is a good reason why Indonesia would be better off if it managed to get out of foreign currency-denominated indebtedness over the next five years, by refinancing or swapping some of the debt to local currency while managing the local debt issuance as discussed above.

As Indonesia and its neighboring countries experienced during the East Asian crisis, a currency mismatch between the revenues and debt obligations of a country can aggravate an adverse shift in investor sentiment through balance sheet effects into a full-blown currency crisis. The ideal debt contract for a borrower is dependent on the borrower's economic circumstances and is characterized by high payments when the borrower is doing well and low payments when he is doing badly. Borrowing in foreign currency entails exactly the opposite effect: when a country experiences economic difficulty, its currency depreciates, which increases the value of its debt, thereby aggravating the problems. On the other hand, when there is a boom in the country, its currency appreciates, which reduces its liabilities in foreign currency and feeds back into the boom, thereby risking an economic bubble. Consequently, borrowing in foreign currency can be seen as an *automatic de-stabilizer*.

However, many creditors are wary of lending money in Rupiah because of the higher risk of inflation compared to the US dollar or Japanese yen. But this fear can be mitigated by indexing bonds to inflation. Ideally, official foreign lenders such as the World Bank or the Asian Development Bank, who are less risk-averse and can better diversify their asset holdings than a developing country, could take the lead in this approach and lend money to Indonesia in the form of local currency-denominated inflation-linked debt contracts.

Accounting Framework

IPD also was able to bring the issue of how accounting frameworks affect policy, including debt policy, into the public dialogue. In business, a new investment is recorded as an entry on the asset side of the balance sheet with a corresponding entry on the liabilities side, accounting for the source of the capital employed. Consequently, an investment opportunity is considered profitable if its return is higher than its cost of capital. This is well-founded in economic principles. Traditional government budgets, on the other hand, resemble cash-flow statements in business more closely. The purchase of a long-term asset is typically not capitalized, i.e. recorded on the asset side of the government's balance sheet, but expensed as if it yielded no future benefit. Consequently analysts focus only on the government's accumulation of liabilities, i.e. its budget deficit, but not its accumulation of assets. Wrong accounting leads to wrong decisions, as could be seen in the corporate world in the United States over the past couple of years. This is an issue that IPD has discussed with many countries. It has recently begun to get more press, and the timing is good for Indonesia to be able to shift accounting frameworks to one that better represents its economic activity. For example, Brazil has recently included some issues in alternative accounting frameworks in its discussion with the IMF.

In traditional government budgets, accumulating more debt is – wrongly – viewed as dangerous, even if it enriches the country with very valuable long-term assets. An example for this is investment in education, which has high costs now, but yields very high returns in the future, since good education is a prerequisite for growth. In a standard governmental accounting framework, only the costs of education are recorded in the budget, but not its benefits. Hence education is – wrongly – seen as a money-loser, even though it is in fact one of the most profitable ways to invest a country's money. A parallel argument can be applied to investment in infrastructure projects.

The reverse holds for privatizations or commodity sales: when a public company is sold to private investors at fire-sale prices or when commodities are sold at cheap prices, the government's debt goes down, but the government's assets – or wealth – go down even more. Economically, this is a big loss for the government. However, analysts that focus only on the government's budget deficit can observe a reduction in the deficit and laud this as good economic policy. In a nutshell, privatizations are only welfare-enhancing for a country if the price that the government obtains is fair and/or if the private management is sufficiently more efficient than governmental management.

Privatization

There is usually a presumption that many public services are best provided by the government, whereas industrial activities are usually better located in the private sector. But IPD suggested that many more issues should be taken into account in privatization decisions. Sometimes state-owned industries are remarkably efficient, like the steel company POSCO in Korea. A point that also has to be considered is the private and public corporate culture in the country. In France, for instance, the public corporate culture is very good, which makes it more attractive to keep companies in the public sector. In other countries, the reverse is true.

Often, there is no upside to privatizations: there are many business activities, such as natural monopolies, where competitive markets alone do not work and government regulators and/or strong anti-trust authorities are needed after privatization so as to avoid higher prices. However, private companies can spend a lot of money on buying politicians or regulators; this corruption can undermine the gains from privatization. Furthermore, with high political uncertainty entrepreneurs might have an incentive to strip assets instead of building a business with good long-term prospects, as happened in Russia and much of Eastern Europe.

Fuel Subsidies

An issue that is closely linked with fiscal policy in Indonesia is the question of fuel subsidies. Currently, the government spends 85% of its total subsidy outlays on fuel. These high subsidies have three main effects: First, they encourage the use of more fuel than what is economically efficient and even lead to smuggling of subsidized fuel out of the country, both of which waste public money. Second, petroleum products have a strongly detrimental environmental impact, and subsidizing them increases their use beyond an environmentally efficient level. On the other hand, subsidies also make fuel products more affordable, and raising the price of fuel often has a disproportionate effect on the poor.

The Indonesian government has acknowledged the above arguments. It plans to increase the price of most petroleum products by about 40% in Feb. 2005, but it has exempted kerosene, which is used by the poor for cooking purposes, and certain uses of diesel, which is employed in farm machinery and for public transportation, so as to mitigate the negative social effects of the price hike. This policy will have strong beneficial effects on the government budget with low adverse social consequences. The subsidies that will be abolished, for example subsidies on petroleum products other than kerosene, currently benefit mostly the middle and upper classes and the smugglers. The existing kerosene subsidies – while desirable for social purposes – also subsidize other sectors, which have only little economic or social rationale for such a subsidy, such as the airline industry. This could be mitigated by imposing a tax on them that undoes the subsidy. For example, in the case of the airline industry, the government can charge higher take-off taxes, which could be calculated as a function of the projected amount of kerosene used and the magnitude of the kerosene subsidy.

In the medium term, it might be advisable to consider a system of fuel subsidies that automatically adjusts national prices to the prevailing world prices at periodic frequencies, e.g. monthly. In order to shield the public from unexpectedly high volatility on world markets, a smoothing mechanism could be built into such a system e.g. by charging the moving average of market prices over the past three months. However, since world commodity prices follow approximately a random walk, it is impossible to keep national prices constant without risking ballooning expenditures on subsidies. (The random walk property implies that the best predictor for the future world price of fuel is the current world price; in other words, once the world price of fuel has increased above a pre-set national price level, it can be expected to remain there, and in expectation the subsidy will have to be paid forever.)

In the long run, petroleum products might even serve as a revenue-raising instrument for the government. Since fossil fuels cause pollution, it is desirable to tax them so as to discourage their use. Again, such policies have to be very sensitive to their social impact on the poor and to their impact on particular industries. The money raised from fuel taxes can be used to improve the living conditions of the poor, e.g. through more spending on food security, basic education, or health. This can be used as an important selling point of a policy package that includes fuel price increases.

Infrastructure Fund

For many years after the crisis, Indonesia's budget was so tight as to allow only very little investment in infrastructure. As a consequence, the state of the existing infrastructure has deteriorated, and capacity has not kept up to the increasing demand. The new government has announced that one of its priorities will be to launch a big new initiative to improve the quality of Indonesia's infrastructure.

In the past one of the major problems of big infrastructure investment plans was that they went hand in hand with big corruption. Hence the government faces a problem of trust in its infrastructure initiative. As outlined in the section on corruption and transparency, IPD underlined that these concerns can be addressed by participatory budgeting rules so as to make sure that resources are spent on the right projects.

Furthermore it is facilitated by a transparent process for the selection of projects, and by making public the details of each project and inviting public participation in monitoring it. A Freedom of Information Act would further support this process.

In addition, IPD discussed how the design of auctions could have an important effect on their susceptibility for collusion or corruption. Describing how to organize collusion-resistant and corruption-resistant auctions has been an important new field in economic research, and lessons from this could be included in the bidding process for infrastructure development in Indonesia. One way of dealing successfully with collusion in the European Union was to be very lenient with companies that reveal a cartel, whereas the other cartel members were punished severely. This way, every company has an incentive to expose its competitors with whom it has colluded and thereby gain a competitive advantage.

In evaluating which infrastructure projects yield the highest returns to society, policymakers also have to consider how the infrastructure helps economic development. Road projects that help farmers bring their products to the national market, where prices often are a multiple of the local price, bring high returns in this respect. In the same manner, ports that connect an area to the rest of the world for international trade can bring substantial benefits in terms of development. However, the reverse can also be true: it is important to analyze who exactly will be the winners and losers of such a project.

As discussed in the section above, it is important that the accounting system of a country considers not only the short-run budgetary costs of investing in infrastructure, but also the long-term benefits of such projects, which are often a multiple of the costs. Another side-effect of infrastructure investment is that it stimulates aggregate demand.

Lastly, whereas investment in physical infrastructure has gained a lot of attention in recent discussions, the IPD also underlined that investment in physical infrastructure is complementary with investment in human capital. Spending on this has been very low in Indonesia in recent years, even though human capital is the most valuable asset for a country and yields higher long-run returns than most other investments. A successful infrastructure initiative should not disregard this link.

Industrial Policy

Industrial policy is frequently met with suspicion nowadays. In the past, it has all too often been used in misguided ways, serving as an instrument of propping up uncompetitive businesses in politically convenient ways or, worse still, providing rents to businessmen with good government connections.

As a reaction, many economists have adopted the view that government should not perform this task and should concentrate merely on creating a positive general business climate, through the provision of infrastructure, basic education, a strong legal system etc. This will – according to the cited view – automatically lead to growth.

However, the IPD team suggested that the experience of many countries, especially in Latin America, suggests otherwise. Many of these economies have followed the Washington Consensus very closely, creating the conditions for what is supposedly an excellent business climate, but growth has not followed. Many of the most successful HPAEs, on the other hand, employed a mix of good infrastructure and targeted industrial policy measures that granted specific advantages to the sectors they wanted to develop. Often these measures promoted exports, which were the main engine of growth in the region.

For industrial policy to succeed, it has to be based on more elaborate principles than in the past. The role of industrial policy cannot be to pick winners – this reduces the economic incentives of the involved companies, which in turn leads to a deteriorated business performance and can cause the failures that are so familiar from the past. The IPD emphasized that industrial policy can be effective when it addresses market imperfections, e.g. when it is based on a thorough investigation of where there are positive externalities and spillovers, or where other market imperfections can be addressed. It should be formulated in terms of general rules instead of targeting selected companies. The success of industrial policy in e.g. Japan and Korea was based on the principle that they did not give subsidies, but instead they provided access to loans, i.e. they addressed an imperfection in capital markets. It has to be assured that entrepreneurs put up a lot of their own money so as to face the right incentives. Also, banks should still face a large part of the risk in such arrangements – otherwise they are susceptible to moral hazard.

There is a danger that Indonesia might be on the way of becoming a resource-based economy like e.g. Russia or Nigeria. Economies that are based on the extraction of resources (such as oil) have traditionally not performed very well because of the so-called resource-curse. First, there is a strong temptation for politicians and businessmen to enrich themselves through the sale of resources, promoting corruption and conflicts. Second, commodity prices are very volatile, which leads to large swings in economic activity. Third, the sale of resources often leads to a high concentration of wealth among a few, with the majority of the population being left behind. Consequently, the domestic market remains underdeveloped, since there is not enough aggregate demand.

Indonesia can resist this danger by encouraging more growth in the industrial and service sectors. A natural area for this is, for example, the processing of commodities. Since Indonesia is rich in resources, there is a strong synergy if these are processed close to where they are extracted, so that intermediate or final goods can be exported instead of commodities. The focus on a processing industry would contribute to creating more jobs in Indonesia, which automatically leads to a more equitable distribution of the benefits the country obtains from natural resources.

An essential task in Indonesia that the IPD team discussed is to support small businesses. In many respects, small businesses are the backbone of the economy. They guarantee more competition, and they are responsible for a large share of innovations and growth. Every large company started out as a small one it the past. The issue of assisting small businesses is of even greater importance in Indonesia, since the country lost 300,000 companies that went bankrupt during the East Asian crisis.

An example for a successful program to support small businesses is the Small Business Administration (SBA) in the United States. The agency assists small businesses financially and provides advice in all areas of interest for small businesses, e.g. management, government regulations etc. Furthermore it fosters business ownership by disadvantaged individuals, it makes sure that a fair share of government contracts and property sales go to small businesses, it lobbies for the interests of small businesses, and it helps them to recover from natural disasters. The SBA also assists small businesses to facilitate technology transfers, to export, and to compete against imports. Despite the United States' rhetoric of free markets, this form of industrial policy has served the country very well over the past 50 years; maybe the SBA could also serve as a role model to Indonesia.

Another important component of industrial policy is to guarantee the diffusion of technology into the country. In many sectors this is best accomplished by attracting foreign direct investment (FDI). For many years after the East Asian crisis, FDI has been negative or very low, as investors took out money from the country. FDI has still not much recovered since the crisis, but it is slowly increasing now. In some areas, such as investment in oil exploration, oil processing or infrastructure, it might be worthwhile to have the government analyze the different risks that foreigners face when doing business in Indonesia and guarantee some of them so as to attract more FDI. However, IPD pointed out that a blanket guarantee, as it is suggested by many foreign investors, is not useful, since it creates a risk for moral-hazard. Some foreign companies are wary of doing business with state-owned enterprises, since they are afraid they might not be able to enforce their contracts.

Monetary Policy

Objectives of monetary policy

There is currently a discussion going on in Bank Indonesia whether the central bank should adopt inflation targeting as its monetary policy strategy. IPD brought a cautiously critical position to this debate. The most important argument against inflation targeting is that inflation is not the only objective of macroeconomic policy. In fact, in a functioning democracy, it is very questionable why a central bank would only focus on inflation. Furthermore, it is easy to imagine situations where the best response to an inflationary shock is not tightening monetary policy but tightening fiscal policy. There is a strong link between monetary policy and inflation, but there is no theorem that says that monetary policy is always the best instrument to address inflation.

In the United States, the official objective of monetary policy is inflation, growth, and employment. In Europe, on the other hand, the objective is only inflation. As a result of these institutional differences, the European Central Bank has neglected the dismal growth and employment record of Europe to a large extent, whereas the Fed can act aggressively to stimulate the economy in the United States – the results are apparent.

In a sense, central bankers often have to "fly blind," since a lot about the monetary transmission mechanism is unknown. Hence they have a tendency to adopt certain rules as an article of faith. An implication of this is that monetary economics is strongly subject to fads: Twenty years ago, monetarism was en vogue, which was based on the prescription to increase the money supply at a fixed rate. In the United States, the Fed applied this in the early 1980s, when it wanted to reduce inflation. The result was one of the largest recessions since the Great Depression. However, the Fed learned from this and has acted much more moderately since.

Today, the article of faith of many monetary economists is inflation targeting. As a dogma, this is better than monetarism, but it is even better if policymakers do not choose either of these dogmas. How inflation targeting is managed can also have an impact. If a country experiences a shock to its economy, e.g. an oil shock, it is questionable whether the central bank should immediately raise rates. The oil price might come down again – therefore the central bank does not have to increase rates mechanically.

The IPD team noted that a similar argument can be applied to the planned increase of fuel prices in 2005, or to a VAT increase, or a devaluation of the exchange rate. All these phenomena cause a temporary shock to inflation, but they will probably not lead to inflation inertia. There is a strong argument for accommodating such one-time shocks, for temporarily accepting higher inflation rates and not raising interest rates mechanically if there is no case for inflation inertia.

In this context, it is important that the central bank manages expectations well. Policymakers have an important impact on public opinion, so if they speak for example about rising inflation in response to an increase in fuel prices, this might affect expectations negatively. The central bank could rather talk about something like a core inflation rate, which subtracts the effect of oil prices. The Bank can then publish both numbers and assert that – after accounting for the one-time effects of the reduction in fuel subsidies – the inflation rate remained constant or increased only little. This can combat inflation inertia.

How worried should Bank Indonesia be about inflation? This is a hotly debated question, but it can be analyzed by discussing the following points:

1) Does inflation hurt economic growth? So long as it is below 8 – 10% there is no evidence for this. The World Bank has performed a cross-section study and concluded that there is no evidence that moderate inflation hurts growth. There are even some countries, such as Turkey, that have grown well at a 40% inflation rate.

2) Is there inflation momentum, i.e. does inflation systematically go up next period if it goes up this period? There is no evidence for this.

3) Assume that a central bank committed a mistake, and thought that it could expand the economy without inflation, but then inflation suddenly increased, so that the central bank had to engage in disinflation next period. What are the costs of such a mistake? Technically, the answer depends on the concavity or convexity of the Phillips curve. An analysis of this question in the US yielded that the Phillips curve seemed to be linear, or maybe slightly convex, which would imply that the benefits of an inflationary shock outweigh the costs of disinflation. There is thus no reason not to be slightly aggressive on the front of lowering interest rates. If a central bank does not let interest rates go down in such a situation, it keeps resources unemployed – at an enormous social cost.

Bank Lending

One of the major challenges for economic policy in Indonesia is to stimulate bank lending so as to obtain higher investment and growth. The country's banks have been recapitalized since the crisis, and most of them now have sound balance sheets and a very low rate of non-performing loans, but they still have excess liquidity and are hesitant to extend credit. The aggregate loan to deposit-ratio in Indonesia is currently around 60% and is increasing only slowly.

Banks are the major source of external funding for companies in Indonesia. The role of banks is to gather, process, and disseminate information, on the basis of which scarce capital is allocated. Banks are much better as a repository of information than capital markets, because they do not suffer from free-rider problems to the same extent. Often the advantage that security markets have in terms of diversification of risks is over-emphasized relative to banks' advantage in the collection of information.

IPD observed that a low loan to deposit-ratio is in a sense typical for countries that have experienced the sort of financial crisis that Indonesia has seen. The United States was in a similar situation after the Savings & Loan crisis in 1989. As a reaction, they passed new laws to strengthen their regulatory framework. At the same time, bank capital was weakened, and banks were not willing to lend. Banks preferred lending to the US government instead of firms, which led to a recession. Initially, the Fed did not realize that there was something wrong with the financial system. However, the Clinton administration re-adjusted banking regulations: they intensified banks' supervision to make sure that they were not gambling, but then relaxed their regulation to increase their lending. This was one of reasons for the recovery in 1993. This regulatory behavior can be observed in many countries that are affected by banking crisis: as an immediate reaction to the crisis very strong banking regulations are introduced. Later it becomes clear that the tight regulations inhibit credit growth. They have to be fine-tuned and often relaxed to allow more lending. It is important to recognize that tight regulatory policy has the same macroeconomic effects as tight monetary policy.

The availability of credit is also the major channel of monetary policy. Monetary economics has focused on money for a long time. However, research over the past decade has shown that it is not money that drives the economy, but credit. The two are highly correlated, since they are two sides of the same balance sheet: when a bank gives credit, it also creates money. This is the reason why econometric studies that focus on money do very well even though it is credit that counts for economic growth. Money is on average a good indicator for credit, but the link between the two breaks down in very critical times: In times of crisis there is often excess liquidity, but nobody is lending. This leads to a recession, even though the money supply is more than sufficient.

According to some commentators, banks in Indonesia engage more in risk avoidance than in risk management, which should be their actual job. It seems that banks are overly pessimistic about lending to corporations and prefer to give loans to consumers, even though this latter category also has its own risks. The most commonly cited reasons for banks' reluctance to lend are the following:

1) Modern risk management systems and regulations caused banks to act in a much more risk-averse way. Capital adequacy requirements now weigh bank assets by risk and are more stringent than before the crisis. At the same time, it is harder for banks to quantify their risks, since their risk assessment capacity is rather low, while the creditworthiness of borrowers is subject to enormous uncertainty as a result of the crisis.

2) There are difficulties in forcing debtors to repay in case of default, since debtors can challenge banks. Also, there are fears that bankruptcy courts are easily bought off.

3) Banks still enjoy very good earnings from the interest rate differential between deposits (currently around 5%) and government bonds (up to 12%) or notes of the central bank (8%).

4) There is also a problem on the demand side: lots of loans are approved, but never taken out by borrowers.

It is very difficult to disentangle the relative importance of these reasons. However, there are a variety of policies and microeconomic measures that can serve to increase bank lending no matter what is the exact reason for the currently low rate of lending. The government cannot micro-manage the economy, but it can change the incentives facing banks so that they provide more credit, which will stimulate growth and investment. The following policy options were discussed by the IPD team:

- The government can impose a tax, or the central bank an additional reserve requirement on banks' excess liquidity.

- Bank Indonesia can restrict or forbid banks to lend to the government. Banks' specialty is not to give money to the government, but to ascertain credit-worthiness. Lending to the government can be done just as well by other institutions, which would free up banks' capital to be lent to the private sector. The government could also impose a higher tax rate on banks' interest income from government bonds, or could stipulate that banks that lend to the government will receive only a service fee of no more than 1% on top of the rate they pay to their depositors.

- Strengthening the system of bankruptcy and increasing legal certainty can contribute to stimulating credit growth. The observation that credit to consumers is booming, while banks are reluctant to lend to corporations might in fact be an indication that the legal system is part of the problem: with consumer credit, banks can repossess the collateral very easily, since the legal construction is typically such that banks remain the owners of the goods bought and rent or lease them to the borrower until the full amount has been repaid.

  One way to decrease legal uncertainty and simplify bankruptcy procedures is to move away from court discretion to a system of rigid rules. The United Kingdom has a system of bankruptcy that might serve as a role model in certain respects: in case of default, the main creditor of a company, the floating charge holder, can appoint an administrative receiver who is directly put in charge of the bankrupt company. This holds the involvement of courts to a minimum, which entails that this bankruptcy procedure is relatively immune to corruption.

- Banks seem to have difficulty in determining the credit worthiness of potential borrowers. This is an informational issue. The establishment of a credit rating agency or credit bureau for both consumers and corporations might be a big help in this context.

- While it is important to ensure an adequate overall supply of credit, it is also desirable to make sure that there is enough availability of credit to certain sub-groups of the population, including micro credit, small business credit etc. In many countries, financial services liberalization and the sale of banks to foreigners have decreased the supply of credit to small and medium-sized enterprises, since foreigners do not have as much local information as local banks. In the United States such concerns have been addressed by the Community Reinvestment Act, which forces banks to lend a certain fraction of their total loans to disadvantaged communities.

  A similar mechanism could also be applied to banks in Indonesia, including foreign banks operating there. They could be instructed to lend e.g. 5% to rural farmers, 10% to disadvantaged or under-served areas, 20% to small businesses, or to small and medium-sized enterprises, etc. Banking regulation does not have to rely exclusively on negative constraints, but can also impose positive constraints. In India for example, banking regulations obliged banks to open branches in under-served areas, which was very successful in providing banking services to a larger fraction of the population.

Aside from a sufficient supply of credit to the private sector, the IPD team discussed that it is also important that loans are granted at low interest rates in order to guarantee healthy growth in an economy. The interest rates that matter are not the government borrowing rate, but the lending rate for corporations. Hence central banks also have to focus on the spread between the two, which has risen remarkably after the crisis due to the increase in risk and the higher general level of interest rates. In Indonesia, the government borrowing rate has already been brought down quite far, but the borrowing rate for private enterprises has not fallen as much. One question that might be worthwhile to investigate is what the costs are that banks face, whether they contribute significantly to the size of the spread, and if so, whether these costs could be lowered. On the other hand, high lending rates can also be a symptom of low competition in the banking sector: typically, a borrower can access only a small number of banks, often only a single bank.

It is also important to note that what matters in determining if there is a lack of credit is actually not the loan-to-deposit ratio of banks, but whether there is excess capacity in the real economy. If the economy is already working at full capacity, then an increase in loan supply leads to inflationary pressures, even if banks are holding a large amount of government bonds or central bank notes, i.e. regardless of how low their loan-to-deposit ratio is. What matters is not whether there is idle money in the economy, but whether there is idle productive capacity. In that case increasing bank credit can strengthen the economy because it breaks a coordination failure of non-production. The excess capacity in the economy can be mobilized through the banking system. The question of whether there is in fact idle productive capacity is often very contentious, as exemplified by the case of Russia in 1998. Many international observers asserted that the country had no excess capacity, but after it devalued there was an enormous growth response, which proved that there was in fact insufficient aggregate demand before the devaluation.

Capital Market Liberalization

One of most important factors that contributed to the East Asia crisis was capital market liberalization. It is often argued that a lack of transparency was the main reason for the crisis. However, the last major set of financial crises in the late 1980s and early 1990s occurred in Scandinavia, where all countries are very transparent. Transparency is important, but it is unconvincing that the critical factor leading to the East Asian crisis was lack of transparency.

Capital market liberalization opens a country up to short-term money. The country typically experiences a quick boost of inflows of capital, which often goes into consumption or speculative real estate. Then the irrational exuberance is followed by irrational pessimism and the money flows out again. The IPD pointed out that capital market liberalization exposes the country enormously to the risks associated with this boom-bust cycle.

In September 1997, ASEAN finance ministers met to discuss closing their capital markets to speculative flows in a concerted effort in light of the impending confidence crisis. However, before they could act, the crisis hit the region. Malaysia was the only country that imposed capital controls, and it was affected least by the crisis.

The IMF pushed countries to open their capital accounts during the 1990s, but this seemed to be based not so much on evidence that free capital accounts increase welfare, but rather on ideology. In 2003, the IMF changed course and released a report that showed that capital market liberalization did not lead to faster growth, but actually to more instability. There is still some pressure on Indonesia to keep its capital markets open, but based on the evidence that was produced even by the IMF research department itself, it is advisable to be suspect of that pressure.

One type of capital flows that can be particularly dangerous is short-term capital flows. One has to ask what the costs and benefits of restrictions on short-term flows are, and what the costs and benefits of keeping the flows are. In general, short-term capital flows do not bring much benefit at all. Factories can't be built with money that flows in and out over night. According to the aforementioned IMF study, there is no association between capital market liberalization and growth, but there is one between capital market liberalization and instability.

A more unstable and therefore vulnerable economy could actually drive people out from the market, and conversely, capital market restrictions that are done right can stabilize the economy and make a country more attractive for investment. Of course, if a country puts in place a restriction that prohibits foreign companies from repatriating their profits, then this is going to hurt foreign investment. But the unremunerated reserve requirements of Chile, for example, worked quite well. The country did not experience any adverse effects on long-term capital inflows, or even on lending. This is an excellent example of how capital controls can give policymakers an additional instrument, of which the benefits are enormous and the costs are minimal, if there are any costs at all.

While old-fashioned capital controls are looked upon quite unfavorably by international capital markets nowadays, Bank Indonesia can still take advantage of a number of instruments that have similar, but more targeted effects than capital controls.

The IPD put forward the following examples for such instruments:

1) Prudential regulations for banks: One of the main reasons for the banking crisis in Indonesia was that banks had a currency mismatch between their assets and liabilities, which led to exploding liabilities when the Rupiah started to depreciate. Prudential regulations can be used to make sure that banks do not have a currency mismatch on their balance sheets, e.g. by prohibiting or penalizing foreign currency borrowing by banks, or foreign currency borrowing that is not matched by foreign currency lending.

2) During the crisis, many of the firms that went bankrupt suffered from the same imbalance: their revenues were primarily in local currency, but they had borrowed in foreign currency, and the value of these liabilities exploded as a result of the depreciation of the currency. It is more risky for banks to lend to a firm that has such a currency mismatch, and prudential regulations could be used to curtail or stop lending to such firms. In this way, Bank Indonesia could also stop foreign currency borrowing at the corporate level, or foreign currency borrowing without corresponding foreign earnings.

3) It is important to recognize the economic incentives that play a role in generating capital flows. The economic incentive for investing in real estate was speculation on real estate. One way to discourage such speculation is to tax capital gains.
   It is often regarded as a general tenet that macroeconomic policy should only use macroeconomic instruments – such as monetary and fiscal policy -- but the IPD team pointed out that this view is wrong. The economy is far too complex for this; policymakers need as many instruments as possible. A real estate bubble, for example, can be discouraged by tax policy, i.e. by taxing real estate capital gains. It might also be advisable to decrease the level of this tax depending on how long the real estate has been held, so as to include only short-term speculation, but exclude long-term investments.

4) Bank Indonesia can also impose restrictions on lending. Some economists might claim that this interferes with the efficiency of capital markets, but capital markets are not like ordinary markets; they are characterized by many imperfections, such as asymmetric information; the market for loans is different from the market for steel. Sometimes it can enhance the efficiency of capital markets to put some constraints on it – an example of this is the SEC in the United States.

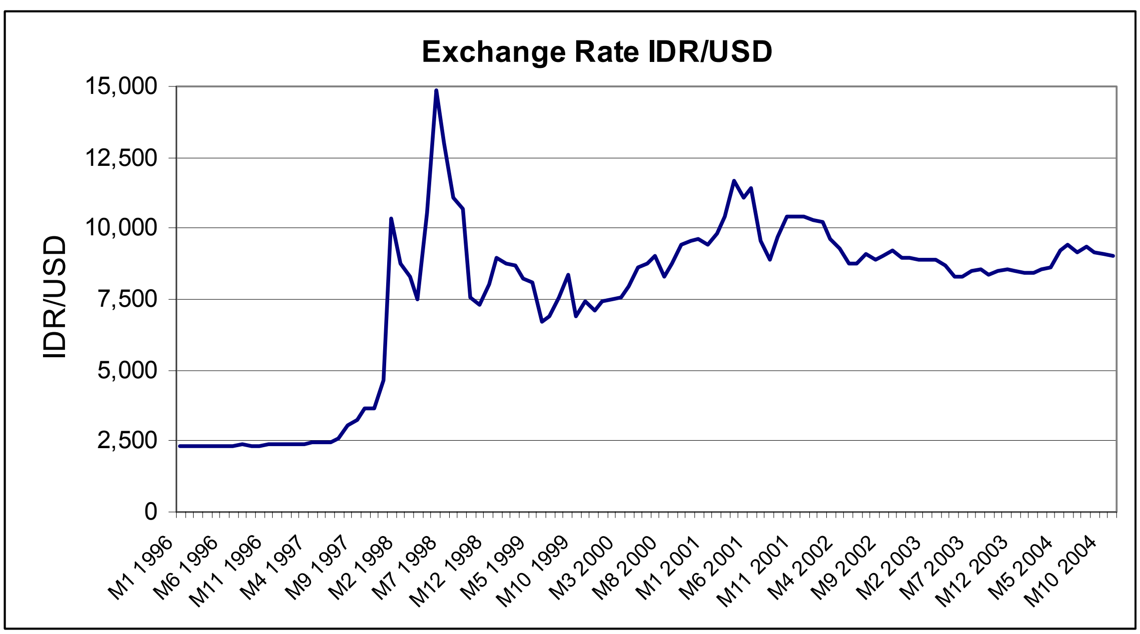
   Indonesia wants money to go into new jobs and new factories. Excess investment in real estate may divert resources from more productive uses. In Thailand, there was a regulation that only a certain percentage of the bank portfolio could be lent to real estate. When the country abolished the regulation, this created the preconditions for the crisis in 1997.

When a country is faced with a real estate bubble (which was perfectly clear to most observers in 1997), it can use two instruments: it can restrict the lending amount to real estate or increase mandatory collateral requirements. This is an example of what was just – successfully – done in China: they used a mix of administrative restraints and a small interest rate increase to slow down the economy.

This is far more effective than just raising interest rates: higher interest rates will not necessarily discourage speculation, because the potential gains are so large. They cannot always stop asset bubbles, but they can very well stop the rest of the economy and put it into a recession. Therefore, if it is evident that a speculative bubble is going on, then all efforts should be concentrated on combating this bubble as directly as possible, i.e. using first-best instruments. For a government, possible instruments for this include taxes on real estate capital gains, increased margin requirements and collateral requirements, and a decrease in the maximum fraction of banks' portfolios that may be lent to real estate.

Exchange Rate Policy

The exchange rate of Indonesia tumbled to less than a sixth of its original value during the East Asian crisis. In the following year it recovered again and appreciated by more than 100% from its low, but it still remained well below its pre-crisis level. During the past two years, the Indonesian Rupiah has stabilized around a level of 9,000 IDR/USD.



Source: International Financial Statistics

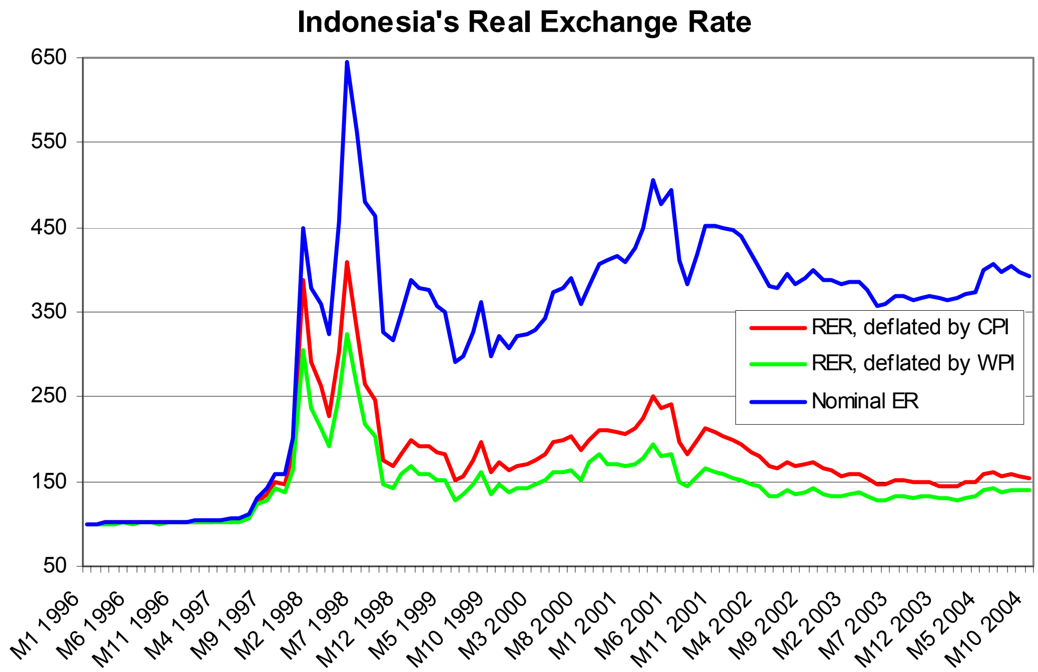
When thinking about the optimal level of the exchange rate in Indonesia, one has to make a trade-off between negative balance sheet effects and the stimulation of the tradable goods sector. In past years, depreciation of the exchange rate was contractionary in Indonesia, since the private sector was still heavily indebted in foreign currency. Also, the fiscal situation came under pressure when the exchange rate went up. However, most of the restructuring process of corporations is already over, and therefore the negative impact of a lower Rupiah is no longer that strong. Indonesia's farmers are mostly small and not indebted, so that they would unambiguously benefit from a lower exchange rate.

It is important to recognize that the benefits of a lower exchange rate can be significant. The IPD noted that it might already be the case that the adverse balance sheet effects would be more than offset by a lower exchange rate, especially if new credit facilities are introduced. On the other hand, the benefits of a lower exchange rate cannot be easily reached by other instruments in a decentralized economy: devaluation is a politically convenient way of redistributing resources from consumers to producers in the country's tradable goods sector, enhancing their competitiveness. Also, exchange rate misalignments can be corrected much more quickly than most microeconomic distortions in the economy. Such a correction can bring strong and immediate benefits in terms of growth.

The balance sheet effects of a lower exchange rate can also be mitigated by getting the sequencing right. Indonesia can first introduce a regulation that borrowers have to hedge against a lower exchange rate. Once everybody has done this, the country can devalue at much lower cost.

Many economists in Indonesia talk about a loss of competitiveness of the country. This issue is also aggravated by the expiration of the Multi-Fiber Agreement (MFA) in January 2005. The MFA has been in place for decades and has allowed industrial countries to impose limits on their imports of textiles and apparel on a country-by-country basis. The expiration of the MFA regime frees countries with very low labor costs, such as China, from their limitations on exports and is likely to lead to increased competition and lower prices in the international textile market. By some estimates, this will lead to the loss of hundreds of thousands of jobs in Indonesia.

Low international competitiveness or too high costs are clearly an exchange rate issue. Looking at Indonesia's real exchange rate (as constructed by subtracting relative CPI differences or WPI differences respectively), one can see that Indonesia has indeed experienced a significant real appreciation over the past four years.



Sources: International Financial Statistics, author's calculations

The IPD team discussed that Indonesia's real exchange rate has to be judged not only against the past, but also in comparison to the country's competitors on the global trade arena. Indonesia's relative competitiveness has been eroded by recent strong gains in competitiveness by other East Asian economies, in particular China.

Foreign Reserves

There is a discussion among the countries in East Asia on how to protect them from crises in the future, and one view is that the best instrument is very high reserves. This issue is very much related to the topic of exchange rate management. A number of other East Asian countries have benefited from a low exchange rate, and they have achieved that low rate by buying US Treasuries. There is an important asymmetry: it is hard for a country to keep its exchange rate high when there is pressure to devalue, but it is quite easy to keep the rate low – by buying dollars – when there is pressure to appreciate.

Since it is a very sensitive political issue to speak of "exchange rate intervention," the IPD emphasized that many countries frame it as: "We need to have more dollar reserves to protect ourselves from future crises, given the instability of international markets." Korea and Thailand have accumulated reserves to keep their exchange rates low, but they would not openly admit that this is their reason for buying dollars.

However, there is also an important opportunity cost to holding a high level of foreign exchange as reserves. Dollar T-bills currently pay only an interest rate of 2%, whereas investment opportunities in Indonesia would often yield a multiple of that. The amount lost this way can reach quite high numbers, as for example in the case of China, which holds roughly US$ 800bn of foreign exchange. The money transferred is essentially “foreign aid” to the United States, who profit by having to pay lower interest rates on their borrowing. The opportunity cost of this policy is quite high. China could use the amount to build roads or other projects, which all yield a much higher return than US Treasury securities. However, in China the lower exchange rate has also had large positive externalities on the economy by stimulating exports.

Corruption and Transparency

Many Indonesians see corruption and arbitrary governance as one of the foremost problems of their country. This view is also supported by international comparisons, such as the Transparency International Corruption Perceptions Index, which ranks Indonesia as 133 out of 146 in 2004, with a score of only 2.0 out of 10. Signs by the government that it is serious about tackling corruption would also have an important positive effect on the investment climate. Corruption is among the greatest problems in many countries across the globe, and the following discussion draws heavily on the experiences that IPD gained in other countries around the world about the best ways to address it. The section below discusses the importance of a Freedom of Information Act in this context and contains the IPD’s evaluation of the draft act that is currently under discussion in Indonesia’s House of Representatives.

Right to Information

In Indonesia there seems to be a view among both policymakers and civil society that corruption and problems of governance can best be sorted out by institutional methods rather than by the empowerment of people. Institutional methods follow a top-down approach: the government establishes a new institution, like the Corruption Eradication Commission, which investigates alleged cases of corruption. However, there are very strong economic incentives for corruption, to which even the institutions fighting it are not immune. In fact, experience across the world has been that it is almost impossible to address corruption by setting up new institutions, because they themselves can become corrupt. This raises the price of corruption, but it does not eliminate it.

Another approach to fighting corruption, which is based on a bottom-up concept and which has been successful in many other countries, emphasizes the role of information in governance. The IPD argued that people’s right to information is a very important method by which government can be made accountable to them.

The stakeholders in a public project or public decision suffer most from the adverse consequences of corruption, and if they can be directly involved in the fight against it they face the strongest economic incentives to combat corruption. It is possible for corrupt government officials to pay off prosecutors, who are supposed to investigate them, but it is impossible for them to pay off all the stakeholders of a public project (if this was to happen, then there would be no benefit left to the official for being corrupt, and hence corruption would not pay off). However, the stakeholders often lack the legal means to get involved.

In this context, the IPD team noted that a Freedom of Information Act, which allows citizens to obtain any kind of information in the possession of government, can be a highly effective tool. It empowers the victims of corruption to uncover problems of governance themselves, and they also have the proper incentives to do so. In many countries they are assisted by NGOs, which help them to make use of their right to information.

One sign of the potency of a Freedom of Information Act versus traditional institutional approaches to combat corruption is that government bureaucracies don't usually fight much against setting up new institutions, but some of them fight tooth and nail against citizens' right to information. Of course the political forces to secrecy don't go away with a Freedom of Information Act, but a well designed act changes the relationship between government and society in a fundamental way.

In most institutions in Indonesia there seems to be very little interest in the right to information. A Freedom of Information Act is often depicted mainly as an issue of ethics, human rights, or as a tool for journalists, but it is not only that: in many countries it has been one of the most effective instruments towards better governance. Even though Indonesia has already become much more transparent in recent years, it could still gain a lot from a Freedom of Information Act in terms of improvements of governance. Leaks and voluntary disclosures of information are not a perfect substitute for a right to information. In addition, passing a Freedom of Information Act would also send an important signal to the business world that Indonesia is very serious about fighting corruption.

In general, the criteria that IPD suggested to determine the usefulness of a Freedom of Information Act include its scope or exclusions, the quality of its appeals mechanism, the penalty for non-compliance, and its accessibility by the poor.

The Act that is currently under discussion in Indonesia's House of Representatives states that information from a broad area of institutions would be public, including state-owned enterprises, which is very positive. However, the IPD team cautioned that this act contains very general exemptions in the name of public interest or the reasonable interest and the good name of concerned individuals. These provisions could be potentially abused to protect corrupt government officials. An elimination of these exemptions would make the Act a much more effective tool against corruption. The draft does provide for an appeals mechanism, though not to an independent body. Concerning penalties, the Act contains a provision that criminalizes the use of public information obtained through the Freedom of Information Act in a way that causes a loss for government. This provision is very dangerous in IPD's view, since it could be abused to threaten people who uncover cases of corruption, and it could even discourage people from using the Freedom of Information Act to obtain public information in cases of suspected corruption.

Participatory Budgeting

From IPD's experience, another very effective instrument to combat corruption is participatory budgeting. The idea behind participatory budgeting is that citizens themselves have the best understanding of their own living situation, and they are thus best able to determine on what projects to spend the resources available, with what priorities, and in what exact form. Thereby participatory budgeting is an important instrument to deepen democracy and give a voice to otherwise under-represented groups of the population.

Involving citizens in the allocation of government resources also increases their incentive to monitor these projects, which makes government officials more accountable and hence renders corruption more difficult. The right to information is complementary to participatory budgeting, since it greatly enhances citizens' ability to monitor the implementation of their budgeting decisions. Participatory budgeting has been used very successfully to combat corruption in Brazil and Venezuela. Some participation by citizens might even be desirable in decisions that are made on a national scale.

Checks and Balances

A third way of dealing with governance problems is to create a system of checks and balances. Many issues are sufficiently complex that the creation of multiple institutions to deal with them is useful – if one institution fails to address a problem, then it can be tackled by another one. The United States has used this approach in many areas. In anti-trust cases, for example, the Department of Justice has the competence to bring cases, but so does the Federal Trade Commission. In addition, the private sector has the right to sue companies that engage in anti-competitive behavior for triple damages.

Appendix I: Schedule of Meetings

Friday, December 10th:	
9:00am – 10:00am	Meeting with Ms. Gwi Yeop-Son, DRR, UNDP and UNSFIR team
10:30am – 11:30pm	Meeting with Mr. Syafruddin A. Tumenggung, Former Chair of IBRA
12:00pm – 1:30pm	Lunch meeting with UNSFIR team
2:00pm – 3:30pm	Meeting with CSIS team
4:00pm – 5:30pm	Meeting with Mr. Kevin Evans, UNDP
4:00pm – 5:30pm	Others???
Saturday, December 11th:	
10:00am – 12:30pm	Discussion on "Debt and Transparency" hosted by the Anti-Debt Coalition
19:30pm – 20:30pm	Meeting with Council for Economic and Social Development

Monday, December 13th:	
9:30 – 10:20am	Meeting with Bo Asplund, UNDP Resident Representative
10:30am – 1:20pm	Meeting and lunch with economists at Bank Indonesia
1:30pm – 2:30pm	Meeting with H.E. Ms. Sri Mulyani, State Minister of Development and Chair of BAPPENAS
3:30pm – 4:30pm	Meeting with Andrew Steer, World Bank team
5:00pm – 6:00pm	Meeting with H.E. Mr. Aburizal Bakrie, Coordinating Minister for Economic Affairs
Shekhar	Other meeting
7:00pm – 9:00pm	Dinner with Governor Mr. Burhanuddin Abdullah, hosted by the Indonesia Economists' Association (ISEI)
Tuesday, December 14th:	
7:30am – 8:30am:	Breakfast meeting with Economic Advisors, hosted by the World Bank
9:00am – 11:30am:	Public lecture by Prof. Joseph Stiglitz hosted by ISEI
12:00am – 13:00am:	Lunch meeting with H.E. Ms. Mari Pangestu, Minister of Trade
Wednesday, December 14th and Thursday, December 15th:	
	Bank Indonesia Conference on "Banking Disintermediation and Its Implication to Monetary Policy: Theoretical Views and Country Experiences" in Denpasar

Appendix II: The IPD Team

The IPD team (in alphabetic order) consisted of:

Prof. Patrick Bolton, Princeton University

Mr. Kevin Cassidy, International Labor Organization

Ms. Shana Hofstetter, Initiative for Policy Dialogue

Prof. K.S. Jomo, University of Malaya

Mr. Anton Korinek, Columbia University

Prof. Akbar Noman, Initiative for Policy Dialogue

Ms. Carmen Noriel, International Labor Organization

Prof. Mila Rosenthal, Columbia University

Ms. Dita Sari, Indonesian Centre for Labour Struggles

Prof. Anya Schiffrin, Columbia University

Ms. Agatha Schmaedick, Worker Rights Consortium

Prof. Shekhar Singh, Centre for Equity Studies

Prof. Joseph Stiglitz, Columbia University