

CHALLENGES FACING ECONOMIC RECOVERY IN INDONESIA

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Introduction

I cannot begin without taking note of the anomaly of an outside like myself giving the keynote address at a conference so specifically focused on the complex and extremely difficult problems of the Indonesian economy today. Why, I ask myself, should this task fall to me, rather than to one of the many economists among you who have been present to watch the economic situation develop and evolve, week by week and month by month, over the last several years? What, I ask myself, can I bring to this meeting, that might add to the knowledge, experience and insights already possessed by many in the audience?

As I try to answer this question, two thoughts enter my mind. First, my gray hairs testify to something like half a century of professional experience, much of it spent struggling with the problems and difficulties of many different developing countries. This experience might allow me to bring to the table some insights that will be useful to you. And second, there is the special perspective that may come from the fact that my visits to Indonesia have been spread out over time. In this, I can liken myself to the uncle who arrives to visit his nieces and nephews on occasional visits, well spaced in time. This may give him a different perspective, allowing him to perceive differences that are not so easily captured by others (like the children's parents) whose observations are more continuous.

Having reached this vision of my possible comparative advantage, I found it easy to conclude that I should build on it in formulating my presentation to you today. So what I plan to do is organize this talk around my four most recent visits to Indonesia. This may help me provide the perspective of a visiting uncle, bringing to light some aspects that might be less obvious to those of you who have been steadily rooted here. At the same time it may help jog the memory of some of you, for whom the rush and pace of events may have brought an urgency to focus on each current moment as it went by, to the detriment of the bigger picture of how the saga of Indonesia's crisis evolved through time.

December 1997

My visit of December, 1997 came after a little over a decade of absence from this country. This visit had been planned even before the crisis struck, and was to be focused on Indonesia's long-term prospects and policy issues. But by the time of the conference in which I participated, the crisis had been underway for nearly half a year.

Looking back from today's vantage point, one can recognize that things were nowhere near the boiling point. That was still some months in the future. To give you a little perspective on this, consider the exchange rate. Compared to its pre-crisis level of around Rp. 2500 to the dollar, it reached Rp. 3400 by the end of

September, 1997. By December 1 it was around Rp. 4000. All this seems very modest compared to what was to happen later.

It was similar on the inflation front. Monthly inflation rates had remained below 2 percent all the way up through November 1997, and in December they barely edged over that number. The interest rate, too, had remained in check. Compared to a level of around 9% per year before the crisis, the SBI rate about doubled to around 18% per annum during the last half of 1997.

All these things would get much worse during 1998. But still, I was struck in December, 1997 by the degree to which people were perplexed and disconcerted. They didn't have a clear idea about what was happening or where the economy was going. This sense of perplexity was magnified during my visit, when all of a sudden the exchange rate shot up from around Rs. 4000 to over Rs 5000, hitting Rs 5600 before easing off a bit. People were asking if there was no limit to how high the price of the dollar would rise, or how low the stock market would plummet. Many were on the verge of panic.

What I tried to do in my presentation on that visit was to fill this information gap. My main message was that there were ample precedents for all of this. Indonesia was suffering from a combined balance-of-payments and banking crisis, and several Latin American countries had gone through both of these, during the

1980s. As I was quite familiar with their stories, I tried to give my Indonesian audience a clear picture of what to expect.

The scenario for a balance-of-payments crisis went as follows. The big story was that in the pre-crisis period capital had been flowing into the country at a pretty high rate. Then, for one reason or another, this flow stopped, or was very sharply reduced, in some cases even reversed.

The pre-crisis period of big capital inflows was a sort of economic paradise. Big capital inflows typically bring an economic boom because they reflect a situation where total demand in the economy exceeds total production by the amount of the inflow. This created a situation where dollars were abundant and cheap (i.e., a low real exchange rate), while the market for nontradable goods and services (esp. construction) was booming and expensive.

The scenario gets to be very different when the capital flow is cut or reversed. Then, the trade balance swings sharply from deficit to surplus. As the economy moves from a situation where total demand exceeds total production to a new position where total production exceeds total demand, the market for nontradables goes into a big slump, and the price of foreign exchange (now much scarcer than before) soars. Indeed, in more than half the cases of a balance-of-payments crisis, the real exchange rate undergoes a major overshooting. I presented examples

of such real exchange rate overshooting from the experiences of Argentina and Mexico.

None of us, not even I, imagined in December, 1997 how well the Latin American pattern would predict what was going to happen in Indonesia in 1998. The pattern called for a major drop in real GDP. In Indonesia in 1998 the fall was by 13.7%. This compares with drops of 14.1% in Chile (1981-82) and of 12% in Peru (1982-83).

The scenaria called for a shift in the trade balance from deficit to surplus, with the overwhelming brunt of the adjustment coming through imports. Thus, in Indonesia in 1998 the dollar value of imports fell by almost 33%. This compares with a drop of about 33% in Chile (1981-83), about 50% in Argentina (1981-83) and by around two thirds in Mexico in the same period.

In contrast, the standard crisis scenario does not call for much of an export response. True to form, Indonesia's exports fell by about 8% in 1998. This compares with drops of 16% in Argentina (1981-82), 8% in Peru (1982-83), and 3% in Chile (1981-82). Please do not jump to the conclusion that a balance-of-payments crisis calls for a reduction in export receipts. Quite the contrary. The rise in the real exchange rate should operate as a very strong stimulus to export expansion. The problem is that the export response tends to occur only gradually over time, as productive and market effects bear their fruit. Meantime, the observed cause of

export sales is dominated by other factors, like market conditions abroad, changes in world prices of primary exports, etc., etc.

But the lag in export response does help explain the overshooting of the real exchange rate that often occurs. In this dimension, however, Indonesia became an instant champion, outstripping all its Latin American competitors. When Indonesia's nominal exchange rate reached Rp 15,000 per dollar, this represented about 6 times the pre-crisis level. Yet in the interim the general price level had only increased by about 67%. So the real exchange rate peaked out at something like 3.6 ($= 6 \div 1.67$) times its original level. By comparison the normal exchange rate is now around 3 times the initial level, while the general price level has about doubled. So now, after the overshoot, the real exchange rate is hovering around 1.5 ($= 3 \div 2.0$) times its pre-crisis level.

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The second type of crisis is the banking crisis. I tried to describe, in December, 1997, a typical banking crisis scenario. The essence of my story was that bad paper in a banking system makes money for good credits scarce. This drives up the level of real interest rates, which in turn makes life difficult even for good, otherwise healthy firms.

The reason why the presence of bad credit makes good credit scarce is that the credit-giving capacity of a banking system is limited by the amount of real

monetary balances that people are willing to hold. By real monetary balances I mean a broad concept of money like what economists refer to as M2, expressed of course in real terms. If people are ready to hold balances equal to, say, 20% of a year's GDP, those balances have pretty much to support the banking system's net foreign assets, plus its holdings of government obligations, plus its holdings of private sector obligations. The latter category includes both good and bad credits, so it had credits take up half of its total amount. That restricts the sum of good credits to the other half of that same total amount.

This picture of a banking crisis scenario was "right" for Indonesia in that credit indeed became scarce and expensive here. But other aspects were to bring surprises – surprises that revealed themselves on my later visits to this country.

September, 1998

By the time of this visit, Indonesia had passed through the breathtaking overshoot of its real exchange rate. The nominal rate was fluctuating around Rp 11,000 = U.S. \$1. Meanwhile, the consumer price index was rising at rates between 4 and 6 percent per month, so that the real exchange rate was being squeezed from both sides.

There was no reason for panic with respect to the real exchange rate, because it was still in September more than double its June 1997 level. But the dynamics were a matter of concern to me. The nominal exchange rate fell almost 30% from

around Rp 15,000 in June to around Rp 11,000 in September, while the consumer price index rose some 20% from 164 to 176. Overall, the real exchange rate fell by about 40% in just ??? months! It was obvious that continuation of this trend could quickly create the stimulating effect on exports -- and on tradables production generally -- of a dollar that was for now quite expensive in real terms.

Motivated by this concern, I worked through a set of hypothetical scenarios, in which the rupiah price of the dollar continued to fall while the CPI continued to rise. If such trends continued, the economy would sooner or later pass through square one, as it were. That is, the real exchange rate could get to be as low as, or lower than the level it exhibited before the crisis hit.

To avert this outcome one needed a firm and reliable piece of "preventive medicine". My recommendation was: a) that the authorities remain alert to the problem of real exchange rate erosion, b) that they set themselves a target level below which they would try to prevent the RER from falling, and c) that they contemplate entering the market to buy foreign exchange (i.e., accumulate international reserves) to the extent that the RER was threatening to fall below the target levels. As an illustration that I thought was reasonable in its order of magnitude (though in no sense a magic number), I used 1.3 times the pre-crisis level as a potential "intervention point" for the real exchange rate.

The thought was that the government (presumably through Bank Indonesia) would introduce its own demand into the picture at this point. Economists should realize that I do not at all suggest that we can attain a "real" objective like the real exchange rate by using a nominal instrument, like the nominal exchange rate. This is not at all my stance. I firmly agree with the basic principle of policy economics that one needs a real instrument in order to pursue a real objective. The real instrument in this case is changes in the real level of foreign exchange reserves.

This is an instrument that can lose much of its appeal, if international reserves get so big as to render further increases virtually redundant. But luckily for us, that was not and is not the case for Indonesia, then or now. \$15 billion or \$16 billion of net reserves is a genuinely low level for an economy of this size and potential volatility. So there is nothing troublesome about the thought of using a one-sided intervention rule. Do not spend your scarce international reserves in order to keep the exchange rate from rising, but, yes, do accumulate reserves as necessary so as to prevent the real exchange rate from falling below a level identified as a "danger point".

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A couple of other issues came up during my September, 1998 visit -- a) the idea of a currency board and b) the matter of capital and foreign exchange controls.

With respect to the first, the wonder is how anybody could have taken the idea of a currency board seriously, in a circumstance where foreign exchange reserves were at such a low level. We all know that one needs ample reserves to establish the credibility needed for any fixed exchange rate system. The requirement is even greater with a currency board, which is the most exaggerated form of a fixed rate system. Moreover, under a true currency board, the central bank is precluded from functioning as the lender of last resort, and from otherwise intervening to support or "rescue" a failing banking system.

I took pains on this visit to point out that Argentina, often touted as a modern paradigm of a currency board, has really been nothing of the kind. Indeed, it was only by violating the principles of a currency board in two major ways that Argentina survived the cold blasts from Mexico in the wake of that country's so-called tequila crisis of 1994-95. The violations consisted of: a) the Central Bank's decreeing a sharp reduction in the reserve requirements imposed on commercial banks; thus permitting M2 to be held almost constant in the face of a loss of half of the country's net foreign exchange reserves, and b) taking full advantage of a sly provision of the convertibility law, which permitted a significant quota of the country's base money to be backed not by real dollars, but by Argentine government obligations denominated in dollars. Had it not been for these two violations of currency board rules, Argentina would surely have been plunged into a

huge depression, as M2 would have had to be cut to something like half of its prior level.

On capital and foreign exchange controls, my main observation was that no country, to my knowledge, had been able to prevent the massive exodus of capital when that capital really wanted to leave. At the individual level, black and gray markets in currency provide a sufficient vehicle. At the macroeconomic level it is the overinvoicing of imports and underinvoicing of exports that provide the means of converting financial transfers into real resource transfers. To date, no economy has been able to prevent capital from flying out through these two "windows"! Much less could we expect that a new precedent could be set in an economy as huge and porous as Indonesia, with its thousands of islands and thousands of miles of seacoast.

Where capital controls have gotten a moderately good press in recent years is in the institution of modest deterrent controls with respect to capital inflows. I am very familiar with the Chilean case, where such controls took the form of a review of large direct investments by the Central Bank, and of a modest 3% "tax" on portfolio inflows. Neither of these interfered significantly with movements in and out of Chile over the fully legal free market in foreign exchange. All this goes to show that Chile's controls were never anything but gentle. And recently, in the wake of the Asian, Russian and Brazilian crises, Chile has actually eliminated its

longstanding 3% "tax" -- the reason being that the current stance of Chile's government is to welcome any foreign exchange inflows that may come her way.

Indonesia's current circumstances seem to bespeak an even greater need to welcome capital inflows than currently prevails in Chile. Hence it seems to be the wrong time for discussing the question of how to keep capital from coming to the country.

December 1998

The key items on this visit were: a) a continued concern with developments connected to the real exchange rate, and b) a new concern with developments in the market for bank credit to the productive sector of the economy.

On the exchange rate front, the nominal rate had fallen from around Rp 11,000 to around Rp 7,500 between September and December, while the price level had barely moved. So here was yet another major erosion of some 30% in the real exchange rate. I hope that you can all appreciate that my real exchange rate concerns were motivated by real events, and that a further projection of its downward trend was, to say the least, scary.

Why scary? Because I see no better engine than a very attractive (to the export and import substitute sectors) real exchange rate to pull the Indonesian economy out of its present depressed state. It is hard to imagine how growth would get started if the real exchange rate were to return to (or near) its pre-crisis

level, any time in the near future. Yet that is precisely what would happen if the trend between September and December of 1998 were to be extended for the next quarter or two.

So I felt constrained, in my observations on this visit and subsequently, to call attention to what I thought were relevant experiences from other countries. These experiences took the form of bad examples and good examples. The bad examples were from Argentina and Brazil in the late 1980s. Each of these countries embarked on a series of stabilization plans, which were based on the idea of pegging the nominal exchange rate, using it as a so-called "nominal anchor" that would lead to a generalized stabilization of the price level. But these repeated efforts in both countries led only to failure. The price level in each such case continued to rise, leading to a steadily deteriorating real exchange rate, and culminating in the necessity for a huge nominal devaluation, which amounted to an open recognition that the stabilization plan had failed. The underlying reason for the failure of these plans (labeled "Austral Plans" in Argentina and "Cruzado Plans" in Brazil) was the incapacity of the fiscal branch of the government to do its share in the stabilization effort. (Interestingly, it was not so much the central government operations that were at fault. Rather it was the provincial governments in Argentina and the state governments in Brazil that were the major cause of each country's fiscal hemorrhage.) It was owing to the lack of fiscal discipline that monetary

discipline could not be maintained, causing the architecture of each successive stabilization plan to crack.

The good examples were taken from Brazil during 1968-79 -- the period of the so-called "Brazilian miracle" -- and from Chile during its recent period (1985-97) of recovery from its debt-crisis depression. In both these cases policy priority was given to the real exchange rate, and the ensuing boom was in both cases export-led (with exports growing significantly faster than GDP).

These cases show that it is indeed possible to build a policy structure that places high priority on maintaining the real exchange rate at what I call export-incentive levels, and to manage such a policy so as to produce a genuine economic boom.

But before you start calling me a RER monomaniac let me add that real life does not often present us with panaceas. There are always tradeoffs, and gains in one direction are bought at a price paid in some other direction. Time does not allow me to give you the full story of the Chilean case. But the part that is most relevant for Indonesia today starts around 1990, when Chile started to use the accumulation of foreign exchange reserves as the main instrument for influencing the real exchange rate. Three problems emerged that led the Chilean authorities to see that there were limits to the use of this instrument. All were linked to the fact that, in order to get the resources to intervene in the foreign exchange market,

domestic credit had to be squeezed. In Chile's case, the Central Bank got the funds with which it bought dollars (to add to its international reserves) by issuing purchasing power bonds, called PRCs. The three problems that arose were:

- a) the squeezing of credit itself, in real terms.
- b) the consequent increase of real interest rates in Chile attracted a reflux of capital from New York and elsewhere. (This was one of the motivations for the 3% "tax" on portfolio capital movement. Thus reflux of funds of course reduced the efficiency of the Central Bank's operation, but it must be pointed out that the reflux was far from complete. That is, for every \$100 put in New York as increased international reserves, the induced reflux of capital to Chile was perhaps \$30 – certainly nowhere near the whole \$100.
- c) The Central Bank lost money on its total operation sometimes called "sterilized intervention" in the foreign exchange market. This occurred because the interest rates paid on the purchasing power bonds issued in the Chilean market were significantly higher than those received by the Central Bank in the reserves it was accumulating in New York.

It was these three elements of cost that induced Chile's Central Bank not to press its luck too far. Over time, and beginning as early as 1988, it began to relax its real exchange rate target, letting it drift down from more than double its pre-crisis (1980-81) level to a premium of something like 50% over that same level. But still,

the policy was successful. The economy continued to boom at rates of growth of over 7% per year, all the way through 1998. As a footnote to this story, which has relevance for Indonesia, please note that in the course of this episode of using reserve accumulation to influence the real exchange rate, tiny Chile's international reserves grew to over U.S. \$17 billion at their peak, and stand at over U.S. \$16 billion today. This is around 25% of a year's GDP and around 100% of a year's imports.

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The second problem that came into focus on my visit of last December was the fact that the market for new bank credits to the Indonesian private sector had practically ceased to exist. This problem still exists today, so you can consider this discussion as a sort of bridge between the stories of my visit of last December and this current one.

I will not go into detail as to the origins of this phenomenon. We all know that there were lots of bad credits in Indonesia's banking system, and that the shakiness of the banks was greatly exacerbated (owing to their large dollar-denominated debts) by the large devaluation of the rupiah. Against such a background it should not be surprising that the banks pretty much decided, around October of 1997, that they would stick to safe investments (namely SBIs) for whatever liquid funds came their way. It quickly became a matter of public

knowledge that the banks were, for all practical purposes, making no new business loans.

The response of the business community to this action was no surprise in Indonesia, though it would have been a big surprise in most industrial countries and in quite a few developing countries as well. This response was that the business firms that owed money to the banks simply "went on strike". The good clients continued to pay the interest on their loans, but held up on the amortization payments. In effect, they saw to it that their loans were renewed, period after period, simply by not amortizing the old loans: they did this out of fear that if they paid off their old loans they would never see that money again. The bad clients of the banks, on the other hand, just stopped paying both interest and amortization. Some of these clients were genuinely unable to pay, but many, I am told, simply followed the crowd, not paying even though they were fully able to pay. They were essentially betting that Indonesia's legal system would not in the end impose any severe penalties upon them.

This is now rigor mortis set in, for Indonesia's banking and credit system. And it is a terrible situation, one not widely enough appreciated. We have good evidence to show that organized credit markets are a vital part of any healthy economy. I think of credit sort of as the bloodstream of the economy, circulating around and giving sustenance to the muscles that are working hardest at any given

moment. In this analogy, it is the new needs for credit that have to be attended -- the new projects that have to be financed. And it is precisely the flow of new credits to these new projects that has been cut off by Indonesia's rigor mortis.

Other countries have had serious banking sector problems, with as much as 40 or 50 percent of loans being nonperforming. But in these countries this typically meant simply that only half or so of the ????? amount of funds was available to be bid for by the good borrowers in the market. As a result, it led to very high interest rates, which squeezed out many borrowers and placed heavy costs on the rest.

But the end result was that credit funds did circulate and that they tended to be allocated to projects of very high productivity. I have seen situations in Latin America where lending rates of 3 and 4 percent per month -- in real terms -- persisted for two or three or even more years. People ask, how can any business afford to pay such rates and stay healthy? The answer is, not the average business, and not for the average project. But when funds are scarce, they should be allocated to the most pressing project. And here one can certainly find high productivity uses for scarce new credits. A business's truck breaks down and needs a new carburetor. The return on the investment in that carburetor is not 30 or 40 or 50 percent per year -- it is really hundreds of percent per year in real terms. In effect by buying a new carburetor the business gets the use of a whole truck. It

needs those funds urgently, and the productivity of the investment amply justifies its paying a high real interest rate.

This is the kind of credit that kept flowing in Argentina and Chile and Brazil and Mexico and Peru during their periods of credit stringency, when credit was exceedingly scarce and very expensive. This is the kind of credit that gave lifeblood to those economies at the times of their deepest need, and that helped spur their escape from the swamp of a banking and currency crisis. Yet it is precisely this kind of credit that Indonesia's banking system has been incapable of providing over the past nearly two years!!

At this moment let me pause and say thank God for the informal credit market, which is still alive to take care of at least some of these needs. But do not think that the informal market is strong enough so as to obviate the need for revitalized credit from the banking system. Remember that all through the years immediately prior to the crisis, private sector borrowing from the banking system amounted to over 50% of a year's GDP. You cannot take a vast sum like that, and put it in the deep freeze for two years, without imposing a huge cost on the economy.

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To turn now to a good part of the story, I was absolutely shocked, last December, to find that Indonesian banks were paying interest rates of some 37 or

38 percent per year on deposits of 30 days or more. The beginning point here was the guarantee of deposits by Bank Indonesia, back in late 1997. I believe such a guarantee was necessary, for otherwise the banks faced a huge run by depositors which they would not have survived. Moreover, a good chunk of the withdrawn funds would have gone to fuel an attempted flight of capital from the country (much bigger than what actually occurred), with a consequent huge additional pressure on both the exchange rate and the nation's international reserves.

The move of guaranteeing deposits also reflected a wise prescription -- that under such panic conditions the authorities should make every effort to keep M2 -- the broad money supply -- from collapsing. This they did, for which they should be given due credit. But along the way, it turns out that the main reason behind the objective of keeping M2 from collapsing is not M2 itself so much as the huge squeeze in private sector credit that a collapse of M2 would imply.

That is, we want to keep M2 from falling in order to keep the credit system as healthy as possible. An economy should be ready to pay a pretty high price for this. But in Indonesia's case, the price was high, but the credit market was already in the deep freeze. So it was scandalous that such a high price was being paid.

What do I mean by "such a high price"? Given the state of the banking system, the principal source for the interest payments actually being made was the interest received on the SBIs the banks were holding. This was not enough to pay all the

accruing interest on bank deposits, but many accounts were being rolled over, with the interest being added each month to the account balance. But even this interest was in the end going to be paid by the taxpayers, under Bank Indonesia's deposit guarantee.

So in December, 1998 I desperately urged that the authorities seek ways to lower that huge interest cost. Finding such ways was not an easy task, because a rash move could readily precipitate a drastic drop in deposits and even a flight of capital from the country. In this light, what we have seen on this front between December and now is nothing short of a miracle. The SBI rate, which was then in the high 30s, is now in the low teens. And this was accomplished without precipitating any of the dire consequence mentioned above.

I am sure that some good luck was involved in this, particularly the public's willingness to maintain their monetary balances throughout the process. But I think we can gain some insight into the mechanics of what happened. Bank Indonesia was auctioning off SBIs, essentially every week. By controlling the quality of SBIs offered at each such auction, Bank Indonesia certainly was able to influence the rate of interest that resulted. By keeping SBIs in short supply, then, Bank Indonesia created the circumstances where the equilibrium of supply and demand took place at a relatively high price for the SBIs -- that is, at a relatively low interest rate.

The other piece of good news of the last eight months or so has been the stability of the general price level. This has served the purpose of reinforcing confidence, and at the same time it has kept the real exchange rate well above the level that would cause us great concern. That is to say, the real exchange rate has throughout this period remained in the range where it is a powerful stimulus to the production of export goods and of tradable goods in general.

August 1999

As the time of this present visit was approaching, and looking at the Indonesian data that my colleagues sent me, my main worry was that things were looking almost too good. I want to emphasize the word looking too good, as opposed to being too good. My fear was, and is, that very good appearances were masking a not-so-good reality.

The problem is that serious underlying issues remain to be resolved. The most critical among them is, in my opinion, how to get the credit market out of the deep freeze. This problem is much more difficult than it may at first appear. In the first place, in order to make new loans to new borrowers and thus inject new resources into the bloodstream of Indonesia's credit system, the banks must have liquid resources at their disposal. These can be projected to come, to be sure, but only in limited amounts. There is the interest banks receive from their holdings of SBIs, but this goes mainly to finance interest payments and current operations. The

same goes for the interest that is currently being paid by the banking systems "good" borrowers, and the modest interest (at a 3% real rate) that will come from the government bonds that have replaced the "bad paper" that is now in the hands of IBRA (the bank restructuring agency).

The big missing element in this picture is amortization payments on existing loans. This is normally the major source of new loanable funds in a banking system, because of the predominantly short-term nature of Bank lending. Yet this is precisely the item that has for practical purposes been cut off by what I have called the "borrower's strike".

But forget for the moment about where the liquid funds may come from, in order to fuel a resumption of new lending. Put yourself instead in the position of a bank manager lucky enough to have some available funds in hand. What motivation would that manager have to extend new loans to new borrowers, if the old borrowers are still "on strike", and the ethos of making no amortization payments still prevails?

The natural answer of most people to such a question would be that the banks should make sure that any new loans they make are backed by adequate collateral. But this is not a good answer from the Indonesian case, since the bulk of the banking system's existing loans was also backed by collateral. The problem is that Indonesia's legal system has not been adequate to the task of seeing either the

banking system or its borrowers through the current crisis to the point where a new start is possible.

I am not the right person to trace the proper path out of the morass in which Indonesia's banking system is now stuck. But let me nevertheless share with you some of the thoughts that came to me as an outsider. To me, not enough of a distinction has been drawn between the "bad paper" that has been taken over by IBRA on the one hand, and the (presumably) "good paper" that still remains in the portfolios of the banks. Some way must quickly be found to "activate" the return of these credits to full circulating status, with timely payments of both interest and principal being made.

To me as an outsider in these matters, it appears that going with the status quo is clearly not a viable path, and that any workable solution is likely to involve both a carrot and a stick. One plausible "carrot" would be a program to convert a part of the outstanding "good" credits into medium-term loans, making it easier for the debtor firms to come up with timely current payments. But the remainder of the "good" credits should be put on a more normal repayment schedule, so that they would be liquidated within, say, a year or at most 18 months. Banks could also reach arrangements with their debtor firms to roll over a part of these credits as they are paid off. But one thing is certain -- the "borrowers' strike" must be brought to an end, creating a substantial class of borrowers who are up to date and in

compliance in their bank loans. Once such a class of current borrowers has been created, the stage is set for lending new money to new borrowers with the expectation that they, too, will remain in compliance with the terms of their loans.

How much and what kind of a "shock"??? will it take to generate this class of old borrowers, maintaining a current status in their perhaps renegotiated loan accounts? I have no answer to this question, but only want to point up the urgent necessity to bring a goodly share of existing bank customers into such a status. Only then is it reasonable to ????? a normal flow of new lending to new borrowers can be restored.

A different, but equally urgent need is to deal with the genuinely "bad" loans in the system. I assumed that the bulk of these are in the hands of IBRA, so that this issue boils down to how quickly IBRA will dispose of this problem. Most experts appear to agree on the urgency of moving through this phase quickly -- recognizing the true fall in value of the bad loans, and accepting whatever "haircut" that may imply. There is a widespread feeling in Indonesia's financial community that there is a great reluctance for anybody to accept any kind of a "haircut", and that as a consequence, everybody is pretending that somehow an escape route will be found that obviates any such need. But no knowledgeable person believes that such pretending amounts to anything but an impossible dream.

When there are genuinely bad credits in a banking system, it is usually best to recognize the losses quickly, and get on with rebuilding healthy banks and healthy borrowers. Postponing such recognition only piles accruing interest in already bad loans, thus making the future "haircut" even worse than the current one. There is a sense in the financial community that IBRA itself may be an element in the ambiance of delay that seems to be standing in the way of a timely resolution of the bad debt problem. Here one can only urge that IBRA itself move quickly to become a positive agent working for prompt resolution of bad debts, prodding others to take a similar stance rather than itself contributing to the atmosphere of continued postponement.

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As I look today at the issue of the real exchange rate, I find the situation more hopeful than in any of my previous visits. Certainly the real exchange rate is not now in a region that would cause concern. The success of Indonesia's authorities in achieving price level stability has contributed a lot to the improved prospects. At the very least, there seem to be little prospect of a major erosion of the real exchange rate taking place -- a la Argentina and Brazil in the late 1980s -- through a continuing inflation combined with a nominal rate held fixed by policy. Indonesia's case runs the other, and much better way -- a price level kept under control by prudent monetary and fiscal policy combined with a floating exchange rate that has

up to now been high enough to provide a continuing stimulus to tradable goods production.

If any problem exists in this area, it concerns how Bank Indonesia will react in the future, in case the real exchange rate threatens to enter the "danger zone". This question takes on special meaning in light of Bank Indonesia's new independence, and its concentration on a single primary target -- be it the amount of base money, as in the recent past, or a target rate of inflation, as is planned for the future. The problem is, how to fold into a policy defined in this way an added concern with respect to the real exchange rate? My suggestion here is to link real exchange rate policy to the task of building Indonesia's foreign exchange reserves to significantly higher levels. In my opinion this is a significant object of policy concern in its own right, though not one that is under immediate pressure.

The suggestion is, then, for Bank Indonesia to follow a policy of "buying on dips" in the time path of the real exchange rate. This would entail, say, having an intervention point at, say Rp 6500 = \$11 at the present price level. This intervention point would move upward with the price level, reaching Rp 7,150 when the CPI increases (as is planned) by 10%, and reaching Rp 7800 if it were later to increase by another 10% of its current level. These intervention points are based on a target real exchange rate that is some 30% above the pre-crisis level, when the nominal exchange rate was about \$s 2500. The approximate doubling of prices since then

would mean it would now take an exchange rate of Rs 5000 to restore the original real rate. By the same token, a rate of Rs 6500 would at this point in time represent a real devaluation of some 30%.

I believe a free market in foreign exchange will maintain the real exchange rate above this level most of the time during the next few years, while the country is working through the process of recovery. But if, as, and when the market rate drops below the intervention point as defined above, I would urge the authorities to use such opportunities to accumulate reserves. If such accumulation turned out to be excessively rapid, or if reserves gradually grew to a level -- say U.S.\$50 billion -- deemed to be fully adequate for likely contingencies, I would consider modifying downward the real exchange rate at which intervention would take place. A modified target could first be set at, say, 1.25 times the pre-crisis real rate, and if that still produced to create??? of accumulation of reserves, a third line of defense could be set at perhaps 1.20 times the pre-crisis real rate.

Thus I am not suggesting that Bank Indonesia try to do battle with fundamental trends in the market for foreign exchange -- only using its own demand wisely and prudently to keep as clear as possible the real exchange rate signals sent to the productive sector of the economy. This strategy is a useful way to reinforce a process of recovery that is based on thriving markets for exports and for other tradable goods.

