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The Debt Trap and Monetary-Fiscal Policy in Indonesia: The Gathering Storm?

William E. James and Anwar Nasution*

Abstract

The rescheduling of external debt under the Paris Club Agreement aside, the amount of government debt that matures in 2002-2009 is nearly 400 trillion Rupiah (the equivalent of GDP in 1997). The development of a bond market so that much of the domestic debt can be rolled over as it matures faces major hurdles. Parliament has not even considered a sovereign debt law and the government is unable to issue new debt in its absence. The domestic debt resulted from the issuance of recap bonds to shore up the banking system following the monetary crisis of 1997-1998 under the blanket guarantee for deposits. The government has failed to replace the blanket guarantee with a deposit insurance scheme and the financial burden of debt servicing is a direct threat to fiscal sustainability. There is a real possibility of an Argentina-style default unless the necessary legal and institutional changes are made and monetary and fiscal policies are effective in controlling inflation, raising revenue relative to expenditure, thereby lowering interest rates and thereby reducing the burden of variable rate bonds. This paper explores the options.

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I. *External and Domestic Debt*

External Debt: Public and Private

Prior to the Asian Currency and Financial Crisis of 1997/98, the issue of sovereign debt repayment in Indonesia was purely a question of external debt. In particular, there was no public domestic debt, only public external debt in the amount of US$55.2 billion or around 25 per cent of GDP in 1996. Even though the public external debt declined in dollar value to US$53.9 billion (Table 1) in 1997, this was now equivalent to almost 40 per cent of GDP.[1] The ratio of public debt to GDP and the ratio of total external debt increased again in 1998 at the height of the crisis. The sharp rise in the ratio of public debt to GDP in the latter year is mainly the result of the colossal depreciation of the Rupiah and the subsequent ballooning rupiah value of the dollar-denominated foreign public debt and the fact that the nominal growth of GDP failed to keep pace with the drepeciation.[2] The same is true of the total external debt to GDP ratio.

Total external debt, including both public and private, is estimated to have peaked at around $150 billion in 1998 and subsequently has fallen somewhat and is projected to continue to decline gradually.[3] The official external debt is overwhelmingly long-term and concessional with only a small proportion owed to commercial sources of finance. In contrast, the private component of external debt is entirely commercial (mainly in the corporate sector) with a substantial short-term component.[4] The private external debt began to decline following the onset of the crisis. Although the public portion continued to rise,

[1] Recent estimates of total external debt (public and private) vary somewhat depending on the source. However, recent estimates of total external debt are much higher than previous estimates as they take into account the unreported private short-term debt that could only be guessed at prior to the crisis. Private external debt estimates for the years 1997/98-1999/00 are in the range of $70-$90 billion, much higher than had previously been reported.

[2] Even though in nominal terms, GDP increased in 1998 by 52.3%, in constant prices GDP fell by 13.1 per cent (World Bank 2001).

[3] World Bank (2002) projections for CY 2001-2003 indicate a steady reduction in total external debt outstanding.

total external debt outstanding peaked as a percentage of GDP at over 120 per cent and has subsequently fallen a bit as economic growth turned up after the economic collapse in 1998. By mid-year 2001, the external debt to GDP ratio had fallen to 98 per cent, with the public external debt roughly equivalent to that of the private sector (49.9 per cent of GDP). The successful negotiation of the Paris Club Agreements has rescheduled a portion of the official external debt, buying the government some breathing room on its external obligations. Efforts to reschedule and settle private (mainly corporate) external debt are on-going as discussed below.[5] With the trade and current accounts in surplus and with steady and adequate international reserves the external position, while difficult, is manageable in the near-term.[6] Recent strengthening of the Rupiah suggests that private capital may be returning albeit in relatively small amounts. However, the crisis in the banking sector and the government decision to save the banking system from collapse in 1997/98 has resulted in a dramatic change in the profile of public debt with fiscal consequences that are extremely severe.

Domestic Public Debt and The Banking Crisis

The domestic public debt went from zero prior to the crisis to over 50 per cent of GDP by year-end 1999 as a direct consequence of government decisions to prevent a collapse of the banking system, to provide a blanket guarantee for all the liablilities (deposits) of the banks and to restore the capital position of the banks themselves. The blanket guarantee was issued only after a more limited deposit guarantee (limit of Rp. 20 million per deposit) was

[4] J.P. Morgan (1998) reported that the average maturity of private external debt was 1.5 years.
[5] A large portion of Indonesian private corporate debt, domestic and external, (estimated at around $121 billion) remains distressed (IMF 2002: 58). For discussion of the private (largely corporate) debt see Nasution (2002).
[6] External debt to GDP (90%), external debt to exports (195%) and external debt service payments to exports (39%) according to Bank Indonesia (2002) remain uncomfortably high as of year-end 2001.

tried but failed to restore confidence. The blanket guarantee remains in force as of late August 2002.[7]

The rise in domestic public debt can be traced to the banking crisis that began in mid-1997 (table 2) and escalated thereafter, culminating in a panic that shook the foundations of the banking system.[8] Well before the outbreak of the Asian financial crisis, there were strong indications of problems in the Indonesian banking and corporate sectors.[9] Weak supervision of banks, corruption and violation of legal lending limits afflicted both state and large private banks. A number of these banks became insolvent through corrupt practices that led to non-performing loans (state-owned development bank BAPPINDO) or because of large losses from currency speculation (Bank Duta) but were bailed out at the insistence of the Suharto government. Between 1988 and the onset of the crisis only one Bank, Bank Summa, was closed. Even with the crisis close at hand the government refused to close any banks and instead instructed Bank Indonesia to step up liquidity support functions in 1997.[10] However, the announcement of the closure of 16 banks in November of 1997 precipitated bank runs and forced BI, in its legal role of lender of last resort, to provide the banks with overdraft support and additional discounting facilities in order to avoid a complete collapse of the payments system, the banks and the economy. Shortly thereafter, on January 26, 1998 a blanket guarantee was issued covering all third party depositors and creditors including inter-bank liabilities.[11] By the end of 1998, the amount associated with BI attempts to staunch runs on banks and to keep the payments system functioning during the crisis totaled

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[7] See Pangestus and Habir (2002) for background.

[8] Feridhanuseyawan (2002) also traces the cummulative rise in domestic public debt associated with the rescue of the banking sector beteween late 1998 and year-end 2000.

[9] See James and Nasution (2002) and James (1998).

[10] Bank Indonesia Liquidity Support (BLBI) should be distinguished from Bank Indonesia Liquidity Credits (KLBI). KLBI were used to support various programs well before the crisis. Two examples are the national car project and the domestic clove monopoly, both intended to enrich the youngest son of the President (Pangestu and Habir 2002). Both of these projects failed leaving behind large losses to the state and private banks. BLBI liquidity support in the form of discount facilities and open market operations have been available prior to the crisis, consistent with the role of the central bank as lender of last resort.

over Rp.173 trillion and by year-end 1999 the amount stood at over Rp. 178 trillion.[12] This sum however, was dwarfed by the amounts necessary to recapitalize the banks following a period of consolidation, closure, takeover and mergers.[13]

At present, the outstanding stock of domestic bonds issued as a result of the crisis is Rp 703 trillion, composed of Rp. 435 trillion in bank recapitalization bonds and Rp. 267 trillion in variable-rate indexed bonds. As of December 2000, the stock of domestic debt (Rp.664.2 trillion) was equal to 51.46 per cent of year 2000 GDP. Combined with the official external debt (Table 1), this means at the end of year 2000, total public debt was equivalent to 107.13 per cent of GDP.[14] This ratio is quite high by international standards For example, US public debt, including inter-governmental debt, was equivalent to 56.10 per cent of year 2000 GDP, excluding inter-governmental debt, debt held by the public was equivalent to 34.2 per cent of GDP. Of Indonesia's domestic public debt, Rp. 134.5 trillion are government bonds issued to Bank Indonesia in compensation for its BLBI credits. This amount may be regarded as inter-governmental and may be converted into redeemable bonds held in perpetuity. The interest on these instruments will be paid out of Bank Indonesia's surplus, removing this burden from the taxpayers. If this amount is subtracted and if the disbursed portion of IMF credits (equal to $11.73 billion as of September 2001), then the

[11] Not all inter-bank facilities were covered by the guarantee. For example, inter-bank loans aimed at concealing loans to bank shareholder group companies were not covered (Pangestu and Habir 2002: 19).

[12] The funds included advances to the government to pay small depositors of failed banks and to refund bank arrears to foreign creditors.

[13] There are many stories, no doubt true, that the liquidity support was abused by some bank owners and shareholders but, according to observers on the scene such as World Bank representatives and USAID officials, Bank Indonesia and the government had no choice but to provide liquidity to the banks in the face of the panic and the contagion effects from the regional crisis (Aten 2002). BI lacked adequate measures to control and make accountable bank owners and shareholders beyond accepting the bank's assets as collateral and personal guarantees of repayment. The guarantee did not include bank liabilities to affiliated companies or shareholders with at least 10 per cent of bank equity.

[14] GDP figure is from World Bank (2001). The external public debt was converted using the 2000 year-end Rupiah-US dollar exchange rate from IMF (2001). The World Bank country office estimates the public debt to GDP ratio at year-end 2000 to be 98.92 per cent (see source in table 1) but this excludes IMF credits.

public debt to GDP ratio is reduced to 77.16 per cent (with public external debt 41.63 per cent of GDP and public domestic debt equal to 35.52 per cent of GDP).[15]

Between 2002 and 2009, over Rp. 400 trillion in recap bonds will mature (table 3). Interest and principal payments in the state budget are estimated at Rp. 88.5 trillion in 2002 and Rp. 80.9 trillion in 2003. About two-thirds of this amount is accounted for by the domestic public debt. Interest and principal payments will ultimately add up to a staggering sum but the amount will vary depending on market interest rate and the amount of recap bonds that are swapped for restructured assets. The ultimate fiscal cost of the banking crisis may be the most costly the world has yet seen in terms of the percentage of GDP. The final fiscal outcome will also depend on the ability of the government to collect on debts owed it by bank owners and shareholders who availed of liquidity support during the crisis.[16]

Nominally offsetting the recap bonds issued (now held by banks as their major asset) was the transfer of assets and collateral (including equity in the banks) to the government. The government established the Indonesia Bank Restructuring Agency (IBRA) in 1998 to manage these assets with a face value of about RP. 550 trillion. IBRA's task was to manage these assets with a view to recovering as much as possible in value in order to ease the fiscal and debt burden through loan recovery and asset disposal through privatization. However, IBRA made slow progress as a result of political interference by vested interests.[17] As a result by 2002, IBRA still retained assets with a face value of Rp. 475 trillion. However, the

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[15] If one uses World Bank debt figures and adjusts them accordingly, the year end public debt to GDP ratio in 2001 is 78.36 per cent. The World Bank figure for central government external debt exclusive of IMF credits is larger than the figure given in Table 1 less IMF disbursed credit by $3,759 million. The reason for this difference is worth exploring but doesn't change the picture all that much with respect to the stock of public debt to GDP estimate. See the homepage of the World Bank Countrry Office in Indonesia.

[16] There are numerous complex risks that remain and will also determine the outcome. These include exposure to risks arising from exchange rate and interest rate volatility, liquidity and maturing mismatches, price risk (particularly for oil and gas), and political risk. The presence of hidden deficits as a result of off-budget contingent liabilities is also a serious potential risk (World Bank 2001).

[17] The checkered history of IBRA and some of the scandals surrounding IBRA would, in themselves, require a separate paper. For a sanitized version see IMF (2002: 28-50).

market value of these assets is a good deal lower than the face value and further delay will only worsen the condition of these assets.

The sale of Bank Central Asia (BCA) in early 2002 to a US-led consortium was a step in the right direction, but further sales of IBRA-managed assets have been limited to minor shareholdings and NPLs. Unless privatization moves forward more expeditiously, asset values will decline and IBRA will provide little in the way of help in the retirement of the recap bonds when it closes shop in 2003. The central government's failure to respond effectively to the challenge to privatization and asset sales in the case of Semen Gresik Padang does not bode well for privatization even if IBRA improves its performance.

Public Debt Servicing and Sustainability

The government faces a major challenge in maintaining fiscal sustainability as the crisis left the government deeply in debt. A combination of the sharp depreciation of the rupiah, rising domestic interest rates, erosion of real income of the government and the drop in exports has steeply increased the burden for repaying the associated principal and interest servicing cost of the debt. To be able to repay its domestic and external debt, the public sector has to accumulate a primary budget surplus as well as a surplus in the balance of payments.

In the short-run, the accumulation of a primary budget surplus can only be achieved through cutting non-debt expenditures, including subsidies on state-vended products. The cut in non-debt expenditure limits the use of the budget as a tool to stimulate the economy and an instrument for income distribution. Raising revenues through taxation, collecting of rents and selling of state-assets requires much effort. The more visible policy for raising revenues in the medium run is through expansion of the coverage of taxation of domestic transactions using the value added tax. It is also possible to enhance revenues from rents derived from the exploitation of natural resources, such as mining and logging, and on monopoly rights to investors in infrastructure projects. Declines in import volume aldong with reduced tariff rates and removal of non-tariff barriers has eroded the tax base on external transactions. The base has been further eroded with the increasing illegal cross border transactions and smuggling activities. Raising revenue from personal income tax is more difficult due to the weakness of tax administration. At present, only about 2.5 million, out of the over 200 million population of Indonesia, have tax numbers.[18] As pointed out earlier, the sale of state assets, including privatization of state-owned enterprises and divestment of IBRA's assets, is a slow process due a combination of the weaknesses in the legal system and resistance to asset sales from pressure groups.

Resolution of External Debt

It is true that the bulk of the public sector external debt is long-term in nature. But, the associated principal and interest servicing cost of it still runs high, at some $9 billion a year. Indonesia has many times openly stressed it will repay its external debt obligations. Nevertheless, to easure the pressures of transferring a large share of Indonesia's fiscal resources, export earnings and GDP to foreign creditors, Indonesia pursues a voluntary, negotiated and selective debt reduction scheme. The scheme has two main approaches. The first approach is through negotiated changes in terms and conditions of the contracted external debt. This includes rescheduling of the public sector's external debt which delays the debt service payments by extending the maturity and grace period of official loans. The second approach, debt reduction may also be done through reducing the level of the present value of the external debt. This approach, includes market-based debt conversion schemes and debt to equity swaps and is mainly applied to the private sector's external debt obligations. On a limited basis, some of the debt is converted into obligations denominated in domestic

[18] However, as companies operating in the formal sector directly contribute payroll tax to the government, this does not imply that no tax is collected on those without tax numbers.

currency for the financing of nature conservation maintenance under the Debt for Nature Swap scheme.

Rescheduling of Public Sector's External Debt

The Paris Club creditors since 1998 had agreed three times to rechedule the principal repayments of Indonesia's public sector debt. The first agreement was signed on 23 September 1998 to reschedule $4.69 billion of debt falling due between 6 August 1998 and 31 March 2000. The second agreement was concluded on 13 April 2000 for $6.2 billion of debt falling due between 1 April 2000 and 31 March 2002. Concluded on 12 April 2002, the third Paris Club agreement restructured $5.8 billion of debt falling due between 1 April 2002 and 31 December 2003. In August 2002, Indonesia's private creditors under the London Club agreed to reschedule private sector external debt amounting to $1.3 billion.

Private Sector's External Debt

The private sector's external debt is relatively more difficult to settle as there are a big number of both foreign lenders and domestic borrowers. Because of the wide array of administrative measures to limit external borrowings of commercial banks, the non-bank companies directly borrowed from foreign lenders. Foreign lenders include banks, instutitional investors and other non-bank entities. Information on the amount and terms and structure of private sector's external borrowings is very limited as, until recently, they were not required to file reports even for statistical purposes.

External debt of the private sector has also been practically nationalised by the government. The external debt of the banks is taken over by the government under the blanket guarantee scheme. The government agreed to fully guarantee, under the Frankfurt Agreement of June 1998, the trade credit extended by international private bankers to Indonesian banks and companies. In return, the lenders aggreed to restructure and maintain access of Indonesia to such a facility.

There are three institutions that have been established, under the auspices of the Ministry of Finance, to deal with the corporate sector restucturing, namely: IBRA, JITF (the Jakarta Initiative Task Force) and INDRA (Indonesia Debt Restructuring Agency). IDRA, howver, has closed as so far it only has one customer. In addition, Bank Indonesia set up a Special Task Force to work out the sour bank credit, mainly in rupiah. Modelled after the London Club, the JITF is a private agency, financially supported by the government, to facilitate resolution of debts among international creditors and domestic debtors outside the court system.

Domestic debt

Reducing the stock of the domestic debt and extending its maturity structure have been the main policies adopted by the government to ease the fiscal burden of its repayment. Policies to reduce the stock of the domestic debt include privatization of state-owned banks and divestment of the banks now controlled by IBRA. IBRA also has bought back some of the debt and swapped them with its assets. The government bonds, amounting to Rp. 134.5 trillion, that have been received by Bank Indonesia for repayment of its liquidity supports provided to financially distressed banks in 1997-98 is about to be converted to redeemable long term bonds. Such a bond is similar to an equity share as it is redeemed by the surplus of its recipient.

To absorb the large amount of government bonds, and make them more liquid, the government promotes the rudimentary domestic financial market. This, however, requires rebuilding of institutional investors, particularly insurance companies and pension funds, that have been melted down during the recent crisis. Meanwhile, again, the government capability to pay needs to be strenghtened by raising the primary budget surplus.

II. Macroeconomic Environment and Debt Sustainability

Inflation Performance and Rupiah Interest Rate and Exchange Rate[19]

Indonesia has experienced the most lethal combination of exchange rate depreciation, price instability with high inflation, and, as a result, high real interest rates. The bench-mark one-month SBI interest rate rose to 17.62 per cent in December 2001 as inflation and base money growth were both above targets set at the beginning of that year. However, in 2002, with base money growth coming under control, interest rates have fallen to about 14 per cent on one-month SBI's and are expected to fall a further 100 basis points this year. Macroeconomic stability has been restored with inflation coming down into close to the target range of 9-10 per cent and a strengthening trend in the Rupiah.

Since 2000, the real interest rate in Rupiah has hovered at around the level of five per cent. From the microeconomic perspective, persistently high interest rates reflect the difficult financial condition of the banks. The bank's portfolios are heavily concentrated in recap bonds and SBIs, and less on loans. For example, among the state banks, as of September 2001, nearly 53 per cent of assets were in recap bonds with a further 3 per cent in SBIs and only 31 per cent in loans (before provisioning). IBRA banks correspondingly held 48 per cent of assets in recap bonds, 5 per cent in SBIs and only 26 per cent in loans. By October of 2001 the loan to deposit ratio of the banks was 35 per cent and for state banks, which account for 60 per cent of all bank branches and 77 per cent of all bank assests, was a mere 28 per cent. The capital adequacy ration (CAR) of the banks has been restored about

[19] The difficulties facing Bank Indonesia in implementing monetary policy in the crisis years have been elaborated upon elsewhere, see Nasution (2002) and Djiwandono (2001).

6 per cent in state banks, 7 per cent in IBRA banks and over 8 per cent in the provinicial development banks. However, these ratios are based on the par value of the recap bonds not on actual market value. A large portion of the recap bonds carry a fixed interest rate of 12 per cent per annum still below the bench-mark SBI rate. Restoration of intermediation in the banking sector is slowly occuring but the liquidity and lending of the banks depends on further reductions in inflation and nominal interest rates. Fiscal discipline is crucial for the objective of improving the financial condition of the banks as it allows some easing of monetary conditions.

Fiscal Stabalization Through Revenue Enhancement and Expenditure Control

The fiscal budget outcomes during the last three fiscal years (1999-2001) have been more conservative than those allowed for under the IMF program, even though central government budget's have run modest deficits in each year. The conservative outcomes in FY 2000 and FY2001 however, are largely due to higher than expected oil/gas prices and revenues, as the non-oil primary balances have exceeded programmed levels (IMF 2002).[20] The actual current central governement budget deficits in FY 1999 and FY2000 turned out to be much smaller than the programmed levels of –5.0 per cent of GDP, however in FY2001 at -3.5 per cent of GDP, the deficit was larger than in the previous two years but smaller than the -3.8 per cent programmed. The government is walking a fine line between the need to stimulate a sluggish economy and the need to maintain fiscal discipline in light of the serious situation with regard to public debt. Indeed, external and internal public debt servicing now constitute the largest component of current expenditures and interest and principal charges on domestic and external public debt have jumped from Rp. 16.7 trillion in 1997/98 to Rp. 42.3 trillion in 1999/00, with domestic interest and principal payments jumping from zero to Rp.

22.2 trillion over the same period. Interest and principal payments on the debt are projected at Rp. 89.5 trillion in 2001, with most of the increase resulting from the cost of the domestic debt.

The government, in order to ensure fiscal stability, is considering its options with regard to expenditure reduction and revenue enhancement. It has taken the decision to phase out fuel, transportation, telephone and electricity subsidies over a number of years, starting in early 2002. This decision is reflected in the immediate improvement in the 2002 budget balance and will help contain the projected budget deficits in the coming years. Other large expenditure items include personnel (including pension liablilities), military expenditures, and transfer payments to the regions. Understandably, these items are difficult to cut particularly as national elections are scheduled for mid-2004. The priority on revenue enhancement is thus seen as politically expedient even though there is strong resistance to acceptance of higher taxes on income and consumption. On the revenue side, the tax to GDP ratio is targeted to be only 13 per cent in 2002 and 13.3 per cent in 2003, with income tax inclusive of oil & gas (6.2 per cent), VAT (4.2 per cent) and excise (1.3 per cent) the most important tax sources. International trade taxes account for only 0.7 per cent of GDP and are almost entirely comprised of tariff revenues. Non-tax revenues (4.9 per cent of GDP) consist mainly of natural resources (oil & gas) and profit of state-owned enterprises. Losses from some SOEs could be eliminated with improved management and political will to run the companies on a purely commercial basis. Tax collections are projected to rise from Rp. 185 trillion in 2001 to Rp. 220 trillion in 2002 and Rp. 261 trillion in 2003, with large gains in non-oil income tax and in VAT and Excises offsetting a decline in oil and gas income tax and in non-tax revenues from oil and gas. The budget targets for tax revenue will require improvement in tax administration.

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[20] The primary balance is equal to domestic revenue and grants minus current and development expernditures (excluding interest payments on debt). Balanced funds which include revenue sharing and funds for special

The underlying assumption in the forward projections is that tax revenue is fairly buoyant (in the range of 1.2-1.4 per cent) with respect to a one per cent change in GDP.[21] These assumptions may seem reasonable given the relatively low tax to GDP ratio (roughly 12 per cent in recent years) and therefore, the room for broadening the tax base. Nonetheless, if targets are to be met tax administration must be improved and the tax base must be enlarged along with non-tax revenues. In this regard, there are several areas that merit reform. Some of the areas that could yield budgetary gains of significant amounts are in government procurement, state enterprize management and in reform of the bureaucracy, particularly the tax office and the customs.

The Directorate General of Taxation has established a new tax collection facility aimed at large taxpayers, including foreign enterprises. The projections of rising corporate and individual income tax payments will depend on how effectively the new unit operates. Non-oil income tax payments are forecast to rise by 27 per cent in 2002 compared with 2001 and by 26 per cent in 2003 compared with 2002, rates of increase that are well in excess of those projected for nominal GDP. These collections need to be stepped up because of a projected 33 per cent decline in oil and gas income tax collections caused by declines in the dollar price of oil and gas and further by the expected strength of the Rupiah. The methods used to increase collections are a cause of some worry to members of the foreign business community and the use of legal, transparent and objective methods of assessing tax must be observed if the effort is not to backfire on the government. In this context an even more severe problem lies in the customs service, where corruption and institutional failures may not just reduce state revenue but also may undermine the competitive position of domestic producers.

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authonomy are included in expenditures. See World Bank (2001).

[21] See W. Wallace (1999) for estimates of tax buoyancy from 1985-99. He generally finds that most major items of tax revenue are above unity, however, with some evident dropping off in the crisis years.

The Customs Service has been under fire in recent years as it is viewed by the business community and public as being unable to accomplish its job effectively. Under-invoicing of imports and rampant smuggling of goods into the country also depresses both domestic VAT and tariff collections.[22] A short-term solution to increasing revenues (tariffs, VAT and luxury tax) on imported and dutiable goods would be to re-instate a private contractor with responsibility for carrying out customs valuation and collection of taxes due on imports under the law.[23] The use of a private contractor to undertake the duties of the Customs is an acceptable solution under the World Trade Organization's rules and, currently, over 30 countries make use of such services for the main purpose of enhancing reveunue. The private contractor provides the government with an independent source of information on imports that when acted upon can eliminate under-invoicing or false declarations on import values. The system needs to be supplemented by an independent panel to review any complaints or disputes between exporter/importers and the contractor. Again this dispute settlement body is a requirement under the WTO agreement.

Decentralization, carried out with a "big bang" in Indonesia is another potential source of fiscal illdiscipline. In Argentina, state and local governments along with the central government, borrowed heavily in order to provide employment and generous remuneration to public employees. This contributed mightily to the Argentinian public debt. Fortunately, Indonesia has been able to avoid a situation where the provincial and district (kabupaten) governments issue debt on their own and rely upon transfers from the central government instead. However, decentralization in Indonesia needs to be followed up by civil service reform. Reducing the size of the bureaucracy and improving skills and management are

[22] The extent of the problem can only be guessed at, but there is ample evidence that smuggling of consumer electronic products, items of textiles and apparel, and luxury sedans is serious and is conducted with the protection of corrupt high-level officials in the customs, military and police. In general, tariffs and taxes in excess of 10 per cent provide sufficient incentive for evasion through smuggling, Tariff reform is no longer the easiest way to curb such practices, as the value-added tax (10 per cent),a luxury tax (up to 20 per cent) and a

vital to creating a more effective civil service. Addressing the widespread problems of corruption and enhancing performance will be crucial given the limited resources for development in the regions.

Fiscal stabilization—meaning movement towards a balanced budget through elimination of subsidies and wasteful practices along with strong discipline in the area of expenditures—will ease the situation with regard to monetary policy by making it possible to reduce interest rates in a non-inflationary environment. Price stability is mandated as the goal of Bank Indonesia and this rules out any attempt to inflate away the debt as was attempted in previous episodes in Latin America (resulting in even more severe crises). With inflation coming down this year, interest rates have eased. In turn, favorable developments in fiscal policy and some relaxation of credit conditions will in turn encourage private investment including a return of capital from abroad. Thus fiscal and monetary stability is really crucial to restoration of private investment and particularly of inflows of private capital from abroad.

Prospects for Moving from Consumer-Driven to Investment and Export-Led Growth

Economic growth projections in the 2002 and 2003 budgets indicate that growth will accelerate to 4 per cent in 2002 and 5 per cent in 2003 from an estimated 3.3 per cent in 2001. The optimism of the government regarding growth prospects is apparently not shared by many Indonesian economists who regard the projections as too high. The outturn in the first quarter of 2002 was growth of 2.5 per cent in 1993 constant prices. In the second quarter preliminary estimates are that growth reached 3.5 per cent. This is not considered a bad outcome considering the world economic slowdown that has led to a contraction of exports (-

retail sales tax (2.5 per cent) are often applied in addition to tariffs. Smuggling goods in order to evade domestic taxes undercuts tax-paying local producers.

[23] Pre-shipment inspection (PSI) was instituted in 1985 until 1997 with the Swiss company SGS.

7 per cent in real terms).[24] Investment was also off during the first quarter by about 6 per cent year on year but in the second quarter was only 1 per cent down year on year. Still it is likely growth for the year as a whole will not be far below the 4 per cent target. This year's growth remains driven by domestic consumption which raced along at about 10 per cent in the first quarter before moderating to about 6 per cent in the second quarter. The prospects for a shift towards export-led growth are improving as regional economies are restoring growth and are importing more. The level of exports in the second quarter had fully recovered to the level of the second quarter of 2001 and non-oil exports actually expanded by about 4 per cent year on year.

Getting growth above 4 per cent in 2003 will depend upon Indonesia attracting new private investment and sustaining growth in exports and consumption at fairly strong levels, with a commensurate decline in the current account surplus. It is vital to social stability for Indonesia to reach growth of 5 to 6 per cent in real terms as there are millions of new entrants into the labor force every year. World Bank (2001) estimates that between 1995 and 2000, the labor force increased by an average annual total of 2.24 million, rising faster than the average population growth of 1.6 million over the same period as participation rates are on the increase.

In this context, retaining flexibility in labor markets and linking wages to productivity will be essential to new job creation along with recovery of private investment. Decisions to raise the minimum wage far above reasonable estimates of productivity improvement as happened in recent years in the formal sector will reduce the amount of new formal sector jobs and, if pushed too far, may even result in a contraction in employment that will spillover into social unrest. Attempts to raise wages without respect to the productivity of the workplace will ultimately be rendered impotent by the response in the foreign exchange

[24] See Athukorala (2002) for details.

market. The flexible exchange rate regime will swiftly signal to the government the market's verdict on economic policy. This element in signaling macroeconomic performance and sentiment was missing in Argentina but is present in the case of Indonesia where the Rupiah is freely traded and capital flows are not generally restricted. Hence, caution in further increases in minimum wages and a determined effort on the part of employers to reward productivity will be important for long-term economic growth and on the strengthening of the government's fiscal and debt positions.

III. Institutional and Legal System Reforms: Toward Creation of a Market in Government Securities

Moving Away from the Blanket Guarantee: Deposit Insurance

The government, because of its January 1998 blanket gurantee of all third party liabilities of the banking system, remains exposed to virtually open-ended contingent liabilities.[25] The blanket guarantee shifts ultimate responsibility for the safety of bank deposits onto the taxpayer and puts the government, particularly the Ministry of Finance, in an uncomfortable situation. Every time a bank becomes insolvent, the guarantee results in a loss to the exchequer as there is no funded deposit insurance scheme in existence. Most recently, Bank Internasional Indonesia (BII), despite being recapitalized twice at a cost of Rp. 21 trillion, is again in trouble with a negative CAR and a huge overhang of NPLs. This means the government which already owns 75% of the bank will either have to re-inject more capital or pay off all the depositors. While under the present stable macroeconomic conditions, a repeat of the systemtic failure of the banking system is remote, the government needs to consider moving away from the blanket guarantee and its replacement with a

[25] As is pointed out by the World Bank (2001), the presence of off-budget contingent liabilities is not limited to the guarantee of bank deposits but includes a number of other obligations such as pensions, off-budget credit programs and to private infrastructure providers and those of state owned non-bank enerprises. The

sensible limited coverage deposit insurance scheme.[26] In the following section, theoretical and practical issues based upon analysis presented in Demugic-Kunt and Kane (2002) with regard to instituting a limited coverage deposit insurance program are discussed.

Theoretical Perspectives on Deposit Insurance

Deposit insurance has attracted policymakers largely because it offers a ready means to stem or avert banking crises with little or no immediate budget expenditure requirements. It also has the virtue of protecting small depositors and of facilitating the operations of small banks that might otherwise be unable to compete with large banks because of their perceived fragility. However, deposit insurance has downside features: it reduces the incentive of depositors to monitor banks; it encourages excessive risk taking on the part of banks; and it creates potential for massive moral hazard (Garcia 1998). The latter problem can be modelled as a multi-party principal-agent contracting problem with at least three levels of participants: bankers, depositors and bank supervisors. If one allows for the fact that governments have often implicitly guaranteed deposits, then the decision to shift from an implicit guarantee to an explicit deposit insurance scheme must also include politicians and taxpayers in the principal agent problem. Moreover, the shift to explicit deposit insurance in the midst of a severe crisis as happened in Thailand (1997), Malaysia (1998) and Indonesia (1998) was done without any limits upon coverage.[27] Blanket coverage schemes have arisen in several countries that were experiencing severe banking crises and effectively have meant the banks and depositors have been able to shift the burden of bank failures onto the backs of taxpayers. The key insight of the model of

government faces risks from litigation by foreign companies with contractual disputes against the state oil company (Pertamina) and against the state electricity company (PLN).

[26] Since the bank runs in 1997 and 1998 were led by large depositors, it is not clear that deposit insurance could have prevented the crisis. It is also unclear to what extent large depositors were pulling there money out in order to speculate against the rupiah versus genuine fear of losing their deposits. See M. Chatid Basri (2002) for discussion.

[27] Korea had introduced deposit insurance in 1996 but was forced by the crisis to also extend a blanket guarantee once the crisis hit.

Demirguc-Kunt and Detragiache (forthcoming) that is reported upon in Demirguc-Kunt and Kane (2002) is that the decision of whether or not to adopt explicit deposit insurance and how to design a program depends critically upon the institutional and regulatory environment in which it must function.

Design Features of Deposit Insurance and Empirical Evidence

The World Bank has constructed a database that now allows researchers to conduct cross-country empirical analysis of the relationship between deposit insurance and banking crises, including detailed analysis of the importance of design features in deterring banking crises. The key design features reported upon in the present analysis are:

1. Explicit coverage limits;
2. Funding of the deposit insurance;
3. Management of the deposit insurance scheme;
4. Moral hazard (taking into account main design features of coinsurance, coverage, scope of coverage, type of funding, source of funding, management and membership).

These variables are introduced into a cross-country pooled sample of 61 countries over the period 1980-1997. The model finds a weak but statistically significant positive correlation between explicit deposit insurance and banking crises. However, the model finds that design features of explicit deposit insurance provide much stronger results in terms of statistical significance. Indeed, the model correctly predicts on average over two-thirds of the crisis episodes in the sample.

Among the key findings (reported upon in Demurgic-Kunt and Kane 2002) are that coverage limits in explicit deposit schemes are important in averting crises. In addition, funding deposit insurance schemes by charging risk-based premiums to the banks also lessens the risk of crisis. Management participation of the private sector including private banks is also associated with mitigation of the moral hazard problem. The positive and significant sign of the moral hazard index reaffirms that a country adopting explicit deposit insurance can offset the moral hazard problem if it has a strong institutional environment and conversely, that the contribution of deposit insurance to bank fragility is significant in countries with weak institutions.

Further analysis reveals that explicit deposit insurance tends to weaken market discipline, particularly in developing countries where there is a lack of transparency, weak bank supervision and absence of accountability in the civil service. The weakened market discipline permits banks to engage in high-risk behaviour and thus raises the probability of crises. Deposit insurance schemes are found to displace market discipline even in advanced countries, however, in countries with underdeveloped institutions and contracting environments adverse effects are likely to be compounded.

Lessons for Indonesia

Clearly, it is too late for Indonesia to escape its past. However, there are a number of lessons about program design that may be derived from the empirical evidence and that should be taken into account once Indonesia finds it possible to roll back the blanket guarantee.

First, coverage limits must be enforced in order to unambiguously send a signal to large depositors and banks that their funds are unmistakably at risk. Inter-bank deposits should not be insured at all in order to encourage banks to effectively monitor one another. Incentives need be provided to enhance market discipline for private parties in order to overcome weak contracting environments. Along those lines, coinsurance involving private parties and making it clear that the banks and not the taxpayers will held responsible for losses will help. Membership should be compulsory in order to deepen the insurance pool and to not allow low-risk institutions to opt out of the system. Such low-risk banks will therefore have an incentive to monitor high-risk behaviour by other banks. Involvement of private parties in day-to-day management of the insurance scheme helps to control moral hazard and financial fragility. Finally, the evidence is that a relatively small amount of liquid reserves is superior to a large pool of reserve funds in limiting moral hazard in countries with relatively weak institutions.

In the near term, moving away from the blanket guarantee will do little to reduce the government's contingent liability because the government still owns a large chunk of the banking system. In order to eventually withdraw the blanket guarantee the government must ensure that banks are safe and strong and then it can provide an incentive for depositors to move their deposits to well-managed banks by binging down the interest rate ceiling on guaranteed deposits.

The government has recognized that it is essential to improve bank supervision and monitoring of the financial institutions. In this context, it is planning to establish a Financail Supervisory Agency (FSA). However, this scheme will require resources that are in extremely short supply: well-trained and competent staff; legal expertise and adequate funding. Bank suprevision duties are now carried out by the central bank.[28] However, rather than trying to create a separate agency, it may be more cost effective to adopt the model of Monetary Authority of Singapore (MAS) and put responsibility for regulation and control of the financial sector under one roof (Bank Indonesia). The idea is to strengthen all the elements essential to the financial safety net: the lender of last resort, bank supervision and intervention, and failure resolution. In this context, establishment of a deposit insurance scheme is important.

Therefore, the government has established a working group between the Ministry of Finance, IBRA and BI to look into the establishment of a deposit insurance scheme. There are several important considerations in backing away from the blanket guarantee that the government must pay careful attention to. First, it needs to have accurate and up-to-date information on the health of the banking system and of all individual banks and to take remedial measures against any that are unhealthy. Second, it needs to prepare carefully the institutional and legal arrangements for establishing a limited coverage deposit insurance scheme and to put in place sufficient resources for it to function effectively, including principally well-trained and capable staff. Third, once a credible scheme has been designed, it should be operated alongside the existing guarantee for a sufficient time for banks to become familiar with what is required and for depositors to gain confidence in the system.[29] A carefully managed phase out of the guarantee should then be implemented.

Once a workable deposit insurance system is in place, additional steps towards developing the financial infrastructure will be possible. Among the most important of these is the development of the government securties markets.

Development of the Government Securities Market

Now that domestic government debt is starting to mature in a more stable macroeconomic environment, the government needs to focus on building a strong debt management capacity. The Ministry of Finance is responsible for managing the government's debt portfolio but has yet to consolidate debt management (external and domestic) into a single unit. The debt management team has to be prepared for the unexpected and needs to continually monitor risks and opportunities. Initially, the government has chosen to redeem maturing bonds through cash payments to bond holders (mainly the banks). However, as larger amounts mature in coming years (and risks of rupiah depreciation, interest rate hikes or fiscal shocks are present), the government will need to be

[28] Garcia (1998) argues, in this context, that for a developing country with very limited numbers well-trained officials, it may be best to concentrate the functions of bank supervision and deposit insurance within the central bank.

prepared to refinance a significant amount. In order to do so effectively the institution of an efficient market in government securities will be essential.

A first and critical step in the process is the passage of the law on sovereign debt now before parliament. The law provides the government with a non-inflationary source of financing deficits and with the ability to cover short-term cash shortfalls in real time. A standing appropriation to service the sovereign debt (all of which is guaranteed by the government) is essential to ensure that new debt will have purchasers. The amount of debt that may be issued will be subject to limits set by Parliament but implemented indirectly (passage of the state budget is one means, setting a maximum net value of securities that may be issued annually is another).

Following the adoption of the sovereign debt law, the government will need to develop the secondary market in government securities. The World Bank (2001) has argued that this can be expedited by converting fixed rate recap bonds into variable rate bonds. This will improve intermediation margins of banks holding government securities and will induce them to increase the share of securities that are traded, enhancing bank liquidity and lending. The World Bank also points out that the government will need to issue bonds regularly and sell them through transparent auctions. A registry will have to be established to provide a secure trading environment and an effective payments system will have to be put in place. All these technical issues aside, the real question is who will be the buyers? Where are the big institutional investors such as life insurance and pension funds? In addition, evolution of secondary markets presumes the presence of a sound legal system and strong accounting and audit capacity. One wonders where these resources will come from.

The private sector will be the ultimate judge of the success the government enjoys in refinancing the public debt. Hence, measures to strengthen confidence, improve

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[29] For discussion of details of the design of an effective deposit insurance scheme see Demirguc-Kunt and Kane (2002).

transparency in government and to improve governance are all key components in the direction of creating a true secondary market in government securities and in developing successfully the long-end of the market. The next year will be critical in putting in place a law and in developing appropriate regulatory and debt management competencies in the government.

Bank Restructuring, Privatization and Foreign Ownership

Effective supervision of banks is essential to ensure banks operate with good lending practices and risk management practices. Remaining weak banks must be prevented from endangering the entire system through prompt compliance requirements under threat of closure and sale. The state banks, in particular, should be prepared for privatization on a strict time schedule and, in the meantime, their lending practices should be kept under very tight scrutiny to avoid further malpractice and corruption. It is not going to be a simple matter to transfer ownership to the private sector even if transparency and governance structures are improved. Finding buyers that have the expertise to return banks to their intermediation role effectively will entail embracing foreign ownership and management.

IV. Conclusion

Restoring profitability to financial intermediation will require not only completing the successful restructuring of the banking system and creation of a deeper and more liquid secondary market in government securities but will also depend upon restoration of confidence in order that private investment demand pick up. The prospects for timely servicing of the large public debt will be substantially enhanced by higher growth in GDP. Export prospects have indeed improved, however recovery of investment demand is not yet evident.

Institutional change towards greater legal certainty, improved financial supervision and development of the financial infrastructure, particularly elements of the financial safety net will be essential if Indonesia is to manage its public debt burden effectively in the coming years. Improved fiscal performance is also highly dependent on reform of the tax and customs administration. The new government has experienced a year of relative calm as financial markets have stabilized, the Rupiah strengthened and inflation has moderated even as growth has been sustained at a moderate pace. There are clouds gathering on the horizon, however, and the government needs to move effectively on the front of institutional reform if it is to succeed in dealing with the large public and external debt over the coming years.

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Table 1. Indonesian External Debt Outstanding: Government and Private (US $ million, current prices)

	1997	1998	1999	2000	2001
External Debt/a	125,817	145,599	144,798	139,496	135,151
Government	53,865	67,315	75,720	74,891	70,665
Commercial	890	2,849	2,387	2,397	1,989
State Enterprises	3,995	4,153	5,004	5,083	4,837
Banks	14,364	10,769	10,836	7,718	7,864
State Banks	5,910	4,744	4,705	4,150	4,118
Private Banks	8,454	6,025	6,131	3,568	3,566
Non-bank Private	53,593	63,362	53,238	51,805	51,965
Domestic Securities held by non-residents	10,271	5,287	3,299	2,197	3,646
Total External Debt Obligations	136,088	150,886	148,097	141,693	138,797
External Debt/GDP	100.87%	126.69%	94.53%	105.34%	98.04%
Government External Dedt/GDP	39.93%	56.52%	48.33%	55.67%	49.91%

a: Year-end estimates, except 2001 (June). Debt to GDP was calculated using GDP figures from World Bank, with year-end rupiah/dollar rate used as the conversion factor.
The estimates of the central government external debt include IMF credit.

Source:http://wbln0018.worldbank.org/eap.nsf/Countryoffice/Indonesia;
World Bank (2001), International Monetary Fund, IFS, various issues.

Table 2. Indonesian Public Domestic Debt as a Consequence of the Banking Crisis and Recapitalization Program (trillions of Rupiah, current prices)

Period	Issued to Bank Indonesia				Issued to Indonesia Bank Restructuring Agency				
	BLBI	Guarantee Scheme	KLBI	Sub-Total	Variable Rate Bonds	Fixed Rate Bonds	Hedge Bonds	Sub-total	Grand Total
Nov-98	20.0			20.0					20.0
Feb-99	144.5			164.5					164.5
May-99		53.8		218.3	95.1	8.7		103.8	322.1
Oct-99				218.3	98.8	4.2		206.8	425.1
Dec-99			10.0	228.3	10.0	38.4	26.6	281.8	510.1
Apr-00				228.3	22.5	7.5		311.8	540.1
Jun-00				228.3		62.3	7.9	382.0	610.3
Jul-00				228.3		30.2		412.2	640.5
Dec-00				228.3		23.7		435.9	664.2
Jan-02		37.0		267.0				435.9	702.9
Sub-total	164.5	90.8	10.0	267.0	226.4	175.0	34.5	435.9	702.9

BLBI stands for Bank Indonesia Liquidity Support, KLBI is Bank Indonesia Credit Program.

Source: International Monetary Fund (2000), Feridhanusetyawan (2002). Anwar Nasution (2001), International Monetary Fund (2002).

Table 3. Maturity Profile of Government Bonds Issued to Recapitalize the Banks

Year	Value of Principal Coming Due (trillions of Rupiah, current prices)
2002	3.53
2003	13.54
2004	48.80
2005	44.72
2006	59.03
2007	68.10
2008	90.58
2009	101.63
Grand Total	429.93

Source: Ministry of Finance as reported in Jakarta Post, August 27, 2002, p. 13.