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Statement by Mr. Joyosumarto on Indonesia
Executive Board Meeting 98/2
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1. I would like to thank Management for bringing this issue to the Board and the staff on the comprehensive paper. However, I think that the contents in the paper should be considered preliminary instead of final until the forthcoming mission for the review returns to Washington.

2. Even if it is true by some measures that there was an increase in liquidity in Indonesian financial markets in November 1997, the overall stance of monetary policy has remained very tight. Interest rates have not changed appreciably since October 1997 and remain nearly double the rates before the currency crisis. The one month central bank certificate (SBI) rate remains at 20 percent, the same level as in October 1997. Overnight interbank rates have dropped from the extremely high levels that prevailed in the first week of November following the closing of 16 private banks, but remain three times higher than the rates in June 1997. Due to deposits removal from private to state banks, deposit rates at state banks have fallen and those at private banks have risen. Interest rates in Indonesia are the highest in the region and real interest rates are punitive. With an expected inflation rate of 10 percent and lending rates of 25 percent or more, real lending rates in Indonesia are close to 15 percent.

3. Although monetary policy has eased slightly in October and November, it is still extremely tight and the real economy still faces the prospect of a major contraction. The only indication of any expansion of liquidity is in the measure of base money. However, this measure of base money is a misleading indicator of changes in liquidity, because the large increase in negative excess deposits in November 1997 was caused by a run of the banks sparked by the closing of 16 private banks. The increase in negative excess deposits does not represent an increase in liquidity; it represents Bank Indonesia activities as lender of the last resort. IF the central bank had not allowed banks to meet their customers' demand for cash by overdrawing their accounts with the central bank, Indonesia's private commercial banking system would have collapsed in mid-November and an enormous contraction of the money supply would have set in.

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4. In the aftermath of the bank closings and the run on remaining private banks, the banking system's role as a financial intermediary has been disrupted. Many large banks are no longer making new loans. Consequently, changes in liquidity or interest rates in the interbank market are, to some extent, irrelevant. A rapid growth of base money could go hand-in-hand with a collapse of the money supply if banks stop making loans, as the experience of the United States during the Great Depression forcefully demonstrated. Thus, attention should be focused on lending activity, M1 and M2, and not just on base money or interest rates.

While monetary policy in recent months was not expansionary, it is nonetheless true that a sufficiently drastic squeeze on liquidity, combined with very high interest rates, could contribute to a temporary strengthening of the rupiah. This was demonstrated during Indonesia's mid-August liquidity crunch. However, the experience of mid-August also demonstrated that such drastic measures have only a temporary impact on the exchange rate. This is because markets understand that any sustained use of extremely tight monetary policy will cause a collapse of economic activity, and if the economy collapses the rupiah is likely to drop even further in the long run, as even long term investors lose interest.

5. Given the fragility of the financial system, any move to significantly tighten liquidity at this time could result in the failure of many banks, widespread corporate bankruptcies, and the collapse of thousands of small and medium scale enterprises. GDP growth, rather than simply slowing down, could easily turn negative. This would result in massive layoffs in the business sector. It is by no means clear that it is worth throwing the economy into a deep recession in order to prevent further depreciation of the rupiah. The ultimate objective of economic policy should be to balance between the economic growth and strengthening the rupiah.

6. At this juncture, I wish to convey the unwavering commitment of the Indonesian authorities to adopt and implement the policies and measures that have already been incorporated in the Fund's program. Nonetheless, the Indonesian authorities are particularly concerned on the unemployment issue and welfare of poor people for, if not effectively addressed, they could lead to social and even political unrest. The prolonged drought associated with the strong El Nino phenomenon this year has resulted in a significant drop of food production, loss of incomes and rise in unemployment in the rural areas. This is a delicate condition that needs to be carefully handled, so as not to jeopardize the implementation of the whole program.