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Chapter Title: Monetary Policy and Financial Structure

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In examining government expenditure, we surmised from fragmentary evidence that government spending was more likely to display a rural rather than an urban bias. In the absence of more detailed data, disproportionate weight was given to the budget allocations for fertilizer subsidies, irrigation projects, rural school programs, the INPRES village programs, and food subsidies. Because of better data, stronger evidence could be garnered to support the hypothesis that budget allocations were more sensitive to inter-island equity. There is in fact evidence that inter-island equity takes precedence over rural-urban equity. This is consistent with our conjecture that the concern for rural development stems more from a desire to eradicate poverty than to narrow the rural-urban gap.

The analysis of this chapter sets the stage for our forthcoming discussion on the importance of political factors in determining the debt outcome. To the extent that people are consistent in their actions, the fact that the technocrats support, and Soeharto approves of, a fiscal policy which favors the tradable sector means that they would also advocate a similarly-oriented exchange rate policy. We will show in chapter 6 that exchange rate management has been tempered by political considerations, and will quantify in chapter 8 that this exchange rate policy resulted in Indonesia avoiding a debt crisis during 1982–84.

5 Monetary Policy and Financial Structure

5.1 Introduction

The purpose of this chapter is to analyze the conduct of monetary policy and the development of the financial sector since 1966. Along with other economic measures, financial policies have been actively used by the government to pursue its macroeconomic objectives. During the period of prosperity in the 1970s, mainly due to the two oil booms in that decade, there was no incentive for the government to reform the underdeveloped tax and banking systems which were inherited from the Dutch colonial administration. Major reforms to the financial system in order to mobilize domestic saving were initiated only after the bust of the second oil boom. In contrast to the 1966–67 reforms which accomplished a total turnaround of the economy in a relatively short period of time, recent reforms cannot produce quick results.

5.2 Performance of Monetary Policy in the 1970s

As we mentioned earlier, the balanced budget policy of the Soeharto government effectively ended the creation of money to finance budget deficits. This did not mean, however, that monetary creation in the 1970s was truly independent of the state of the government budget. This is because the money stock was also affected by changes in the foreign asset position of the central bank, Bank Indonesia. This balance-of-payments linkage to the monetary supply was what made the stance of monetary policy move in tandem with that of fiscal policy. As will be explained, when fiscal policy was expansionary in the wake of the two oil booms, it induced monetary policy to be expansionary too. The result was a big inflation spurt in the 1970s that had nothing to do with money-financing of government budget deficits, but rather with the lack of instruments to end the balance-of-payments linkage between government spending and the money supply.

Prior to the introduction of ceilings on lending by the banking system in April 1974, the main instrument for monetary control was the extension of central bank credits to the banking system, state enterprises, and private companies. Since the central bank credits were extended for a contracted time period, the government was not in a position to engineer quick increases or reductions of the money stock. This reserve method of monetary control was shown to be grossly inadequate for stabilizing the economy when a large fiscal stimulus occurred, financed by increases in oil revenue.

The reason for the synchronization of fiscal and monetary policy during the 1970s lies in the balance of payments. With the rapid development of the oil sector since 1970, government revenue from oil accelerated (see table 5.1). It climbed from Rp 99 billion in 1970 to Rp 141 billion in 1971, and then to Rp 231 billion in 1972 (oil revenue was actually denominated in U.S. dollars). Since the primitive nature of the Indonesian financial system ruled out the possibility of open-market operations, the maintenance of a fixed dollar-rupiah exchange rate meant that the conversion of oil revenue from dollars to rupiahs in order to finance the expanded government expenditure automatically increased the money supply. This is clearly seen in 1972 when oil revenue increased by 90 billion rupiahs over the previous year. The conversion of this oil revenue (231 billion) led to a 122 billion rupiah increase in the reserve money base because of the monetary authorities' inability to quickly sterilize the monetary consequences of foreign-exchange market transactions to peg the value of the exchange rate. The 1972 growth rate of reserve money was 46 percent compared to the 29 percent of the previous two years.

The price of oil then quadrupled at the end of 1973, encouraging the government to increase its spending. In fact, the government augmented its expenditure well beyond the increase in oil revenue. This was possible because the creditworthiness of Indonesia soared along with the price of oil.

Table 5.1 Monetary Consequences of Changes in Official Foreign Asset Position

	Oil and Gas Tax ^a	Budget Deficit	Foreign Assets of Central Bank as Proportion of Total Assets	Change in ^a		Rate of Growth of		
				Reserve Money	M1	Reserve Money	M1	Inflation
1969	65.8	91.1	18.3%	60.0	67.0	60.0%	57.8	17.4%
1970	99.2	113.1	21.3	47.0	67.0	29.4	36.6	12.3
1971	140.7	117.0	17.7	60.0	69.0	29.0	27.6	4.4
1972	230.5	145.7	38.9	122.0	155.0	45.7	48.6	6.4
1973	382.2	196.5	41.7	153.0	197.0	39.3	41.6	31.0
1974	957.2	224.2	49.0	308.0	271.0	56.8	40.4	40.6
1975	1,248.0	488.4	12.0 ^b	282.0	332.0	33.2	35.2	19.1
1976	1,635.3	778.3	22.7	248.0	327.0	21.9	25.7	19.8
1977	1,948.7	771.3	31.2	340.0	405.0	24.6	25.3	11.0
1978	2,308.7	1,033.2	32.3	165.0	482.0	9.6	24.0	8.1
1979	4,259.6	1,379.2	39.3	593.0	828.0	31.5	33.3	20.6
1980	7,019.6	1,489.1	46.1	897.0	1,695.0	36.2	51.1	18.5
1981	8,627.8	1,705.0	39.6	545.0	1,463.0	16.1	29.2	12.2
1982	8,170.4	1,937.6	28.4	187.0	646.0	4.8	10.0	9.5
1983	9,520.2	3,878.3	34.5	1,031.0	456.0	25.1	6.4	11.8
1984	10,429.9	3,475.3	39.0	563.0	1,005.0	11.0	13.3	10.5
1985	11,144.4	3,571.8	39.8	1,020.0	1,543.0	17.9	18.0	4.7
1986	9,738.2	3,589.1	32.1	1,449.0	1,507.0	21.6	14.9	5.8

^aIn billions of rupiahs.

^bThe low ratio of foreign assets to total assets in 1975 is because of the bailing out of Pertamina by Bank Indonesia.

External credit, euphemistically referred to as “external revenue,” was pretty much available on demand. This is evident from the large jumps in the budget deficit; it rose from Rp 224 billion in 1974 to Rp 488 billion in 1975, and then to Rp 778 billion in 1976. The constantly increasing amount of oil revenue caused the monetary authorities to lose control of the money supply. Reserve money grew 57 percent in 1974, and the inflation rate for that year was 41 percent. The central bank responded to this monetary anarchy by setting lending ceilings on the banking system.

The government tried to control the inflationary effects of this massive foreign wealth transfer by increasing imports in order to reduce the inflow of foreign reserves. Imports by the public sector were increased by restructuring budgetary expenditures toward those which were import-intensive. The private sector was encouraged to import more through a general tariff reduction and the removal of the ban list. In addition, the government built up stockpiles of imported commodities such as foodstuffs and basic materials.

We want to emphasize that the expansion of government expenditure was not in any way a logical consequence of the balanced budget practice. The government need not have increased expenditures at all; it could have decreased its external “revenue” (external borrowing) in step with the

increase in oil revenue. With access to external credit markets, the Indonesian balanced budget practice was neither a restraint on government spending nor a check on the growth of the money stock. The key point we want to make from the 1973–75 experience is not that the increase in government spending was undesirable, but that the instruments available for controlling monetary aggregates were grossly inadequate. Loan ceilings were a highly inefficient way to solve the problem.

The need for better monetary instruments was again demonstrated in 1979 and 1980 after the doubling of oil prices. The great inflow of oil revenue via the balance of payments caused the monetary authorities to briefly lose control of the money supply. Reserve money grew 32 percent in 1979 and 36 percent in 1980, pushing inflation up to 20 percent in these years.

5.3 Financial Structure

The structure of the organized financial system is shown in table 5.2.¹ The dominance of the banking sector in the system is evident from the data. At the end of 1985 the banking sector (Bank Indonesia and commercial banks) held more than 90 percent of the gross assets of the organized financial system.

Table 5.2 Structure and Growth of the Organized Financial Sector, 1978–86^a

	Number in		Gross Assets (in billions of rupiahs)			Annual Growth of Assets (%)		Shares in Assets (%)	
	1982	1986	1978	1982	1985	1978–82	1983–85	1978	1985
Bank Indonesia	1	1	5,368	13,707	23,285	26.4	19.3	48	38
Deposit money banks	113	113	5,277	15,952	33,758	31.8	28.3	48	55
National foreign exchange banks ^b	15	15	4,115	12,724	26,469	32.6	27.6	37	43
Foreign banks	11	11	505	1,172	2,245	23.4	24.1	5	4
Other commercial banks ^c	50	59	256	720	2,342	29.5	48.1	2	4
Development banks	28	28	401	1,336	2,702	33.1	26.5	4	4
Nonbank financial institutions ^d	13	14	195	805	2,073	42.6	37.1	2	4
Savings banks ^e	3	3	37	452	1,290	86.5	41.8	—	2
Insurance companies	83	—	159	528	694	35.0	9.5	1	1
Leasing companies	34	73	26	114	693	44.0	82.5	—	1
Other credit institutions ^f	—	20	57	86	30	14.6	—	—	—
All institutions	6,106	6,120	11,077	31,615	61,879	30.0	25.1	100	100

Source: Bank Indonesia, *Indonesian Financial Statistics*, various issues.

Note: Dash indicates data were not available.

^aAnnual compound rates.

^bFive state banks and ten national private banks.

^cNational private banks doing only domestic currency business.

^dNine investment finance, three development finance, and two other finance companies.

^eOne state savings banks and two private savings banks.

^fVillage banks, rural paddy banks, and government-owned pawnshops.

About 70 percent of the assets and credit of the banking system are owned and provided by the seven state-owned banks, including Bank Indonesia itself. Until March 1984 Bank Indonesia provided credits directly to economic units, particularly to state-owned enterprises and to quasi-government institutions. The rest of the bank credit is divided evenly between the foreign and joint venture banks and about seventy domestic private banks. The latter include twenty-seven Regional Development Banks (RDB) owned by provincial governments. Each province has an RDB restricted to operating within its own jurisdiction. In reality, RDBs operate like commercial banks.

There are now twelve nonbank financial institutions (NBFI) operating in Jakarta, all established between 1972 and 1974. Nine of them are investment finance companies, and three are development finance corporations. The first type of NBFI acts as an intermediary and underwriter of financial paper and finances medium- and long-term investments. The second type, development finance corporations, concentrates only on medium- and long-term financing and equity participation.

The state commercial banks and the central bank are the majority shareholders of nearly all NBFI. The minority owners are domestic and foreign private companies. An NBFI is required to have at least three foreign partners, each from a different country, with at least one partner an investment bank. Bank Indonesia is a major shareholder in two of the investment finance companies and in all three of the development finance corporations.

The investment finance companies have one big advantage over the commercial banks: they are subject to only two regulations, a debt/equity ratio of 15 and a ceiling on foreign borrowing. The absence of other regulations has permitted the investment finance companies to adapt more rapidly and effectively than the banks to changes in the economic environment. In fact, these companies were used by the state banks and Bank Indonesia to extend credit and to invest in sectors and activities which banks could not service under the old credit regulations.

The Jakarta stock market started operations on 4 June 1952, but it was closed in 1958 due to political and economic instabilities. It was reopened on 10 August 1977. Trading has been virtually inactive. As of September 1986 there were twenty-four equity stocks and three bonds listed in the infant Jakarta stock exchange. Sixteen of the listed companies issuing equity shares were foreign companies and eight were domestic privately-owned firms. The companies issuing bonds were public enterprises. All of the new share issues took place during 1981–84. The main motivation of foreign companies to go public was to comply with the “Indonesianization” process which is required after operating for a certain period of time in the country. Through their overseas networks, these companies had access to international markets. They really did not need to raise money in the small, fragmented, and high-cost Indonesian money market. In other words, raising capital was not

the main reason for foreign companies to issue equity shares in the Jakarta stock exchange. Going public for a foreign company was like “paying an entrance fee” to the Indonesian market. At the same time, these companies derived benefits from the tax concessions offered for going public under the 1983 tax system. The tax benefits actually exceeded the value of the sale of shares! This tax concession has since been rescinded.

On the supply side, there are many reasons why the supply of marketable securities is so limited in Indonesia. The government has never floated bonds in the domestic market because its budget deficits since 1968 have always been financed by foreign aid and loans. Only four of the 220 state-owned enterprises have floated bonds in the Jakarta stock exchange, and none of them has issued equity share. The capital needs of these public enterprises have been financed by direct government investment, foreign loans, and subsidized bank credit. For domestic private companies, debt financing was less expensive relative to the costs of raising and servicing equity because credit from the state banks carrying subsidized interest rates was plentiful and could be easily rolled over. During the period of high international inflation rates and low nominal interest rates in the 1970s, it was not hard to tap foreign financial centers such as Singapore and Hong Kong. Working capital could be obtained by issuing promissory notes to the NBFIs (merchant banks). In a country where the data base on taxpayers is poor, tax administration is inefficient, and the legal and accounting systems are underdeveloped, tax evasion is an important source of internal financing. For all of these reasons, the opportunity costs of going public (disclosure, regulation, tax liability, dividend payout, dilution of ownership and control) for corporations is too high.

On the demand side, the general public is still unfamiliar with the function of modern financial institutions, including the stock exchange, and the benefits to be derived from them. This, and a history of financial instability and repression, have made investment in stocks unattractive. An example of financial repression in the Jakarta stock exchange is the excessive controls by PT Danareksa (the National Investment Trust), a public company, in stabilizing the stock prices. In order to avoid large capital losses, PT Danareksa stabilizes the share prices within a narrow band (4 percent daily maximum variation) to make a share similar to a fixed price (fixed coupon) marketable asset like a time deposit or bond.

5.4 Financial Repression of the 1970s

The financial system in Indonesia was repressed for almost a decade after April 1974, up until the financial reforms of June 1983. To control the increase in money supply resulting from monetization of government oil revenue denominated in dollars, Bank Indonesia set ceilings on bank credits and other domestic assets. The original purpose of the credit ceilings was to

directly control the expansionary impact of the oil boom in the 1970s since a reserve management approach was shown to be insufficient. Then the government realized that this rationing method of monetary control could also be used to address several important items on its political agenda.

Over time, Bank Indonesia was instructed to introduce detailed ceilings by type of credit for each bank through an extensive selective credit system featuring subsidized interest rates. For example, banks were assigned a civic function insofar as they restricted certain credit only to *pribumis* and made establishing credit for them a priority in order to enhance *pribumi* participation in economic activities.

With the allocation of credit in mind, the Bank of Indonesia set up complicated rediscount financing, rediscount rates, and state banks' loan rates. For Bimas (a government rice-intensification program) and food-related activities, Bank Indonesia provided 100 percent of the funds loaned by state banks. For this rediscount financing the state banks act as agents of the government to finance its program. For other sectors, rediscount percentages range from 20 to 80 percent of the state banks' loans. The higher the priority of the sector, the higher the percentage of financing. (Discount facilities for nonpriority sectors were subsequently made available in January 1978.)

To encourage state banks to extend credit to the priority sectors, Bank Indonesia ensured them adequate profits by charging low rediscount rates ranging from one-fourth to one-half of their loan rates. High rediscount percentages and low rediscount rates increased the rate of return on state banks' own funds. Because the discount facilities were primarily available to state banks, these facilities were another form of subsidy to their operations. The true subsidy was higher, taking into account the government's share in the burden of bad debts of state banks.

The bad-debt ratio of state banks was quite high. For example, of the Bimas loans made by Bank Rakyat Indonesia (BRI) in Java (85 percent of the total for Indonesia) during 1970–74, around 7 percent remained unpaid two years after the loans were made. Loans were supposed to be due at most seven months from disbursement. The proportion of unpaid debts rose to 13 percent for the 1974–75 crop and 22 percent for the 1975 dry season crop. Approximately Rp 7 billion (U.S. \$17 million) was written off or rescheduled during 1974–77 because of crop failures. Risk-bearing in the Bimas loans was shared by Bank Indonesia and Bank Rakyat Indonesia (25 percent each) and the rest (50 percent) by the government. According to Bank Bumi Daya's 1976 annual report, about 28 percent of its loans were rescheduled and 8 percent had to be written off in that year. The Bank Bumi Daya is the biggest state bank, and most of its unrepaid loans were investment credits.

Since most priority credits were handled by state banks, the policy of ceilings with selective credit became one of the major tools protecting state

banks from competition with private banks. In addition, state banks and RDBs are depositories for government institutions and state enterprises. Since they also have a wider network of branch offices than private banks, state banks and RDBs have great advantages in tapping domestic savings. These institutional features discouraged competition, preserved the status quo, and guaranteed the dominant positions of the state banks.

Discrimination in access to Bank Indonesia's liquidity credit by bank ownership has encouraged the banking system to hold excess reserves, both in rupiah and in foreign currencies. With their loans financed primarily through liquidity credit facilities, most of the funds generated by state banks contributed to excess reserves. With the secured loan refinancing, there was little need for state banks to mobilize domestic saving. On the other hand, savings were not attracted to these banks where deposit rates were set by authorities at levels which usually lagged behind inflation. Many RDBs also had excess reserves. The excess reserves of state banks and RDBs, channelled through the interbank market in Jakarta, have been an important source of funds for private banks and NBFIs.

In theory such credit policies add to the distortion of resource allocation and preserve fragmentation in the financial market (see McKinnon 1973, Gablis 1977, Nasution 1983). An extensive ceiling is similar to credit rationing, i.e., a ceiling on what customers can borrow, regardless of their willingness to pay higher interest rates. It is hard to judge whether Indonesian authorities succeeded in allocating credit according to their original design. For one thing, there are no detailed data on how credit was allocated according to various government objectives or a scale of priorities. Second, there were too many simultaneous objectives the government had wanted to achieve with the selective credit policy: to redress racial, sectoral, firm size, and technological imbalances; to equalize distribution of income, increase employment, stabilize prices of basic commodities; and so forth. If not accompanied by other policies, these objectives were not likely to be achieved since their number is much greater than the number of instruments available to use in pursuing them. For example, without any talent, skills, or experience, a person cannot be turned into an entrepreneur overnight by credit provision alone. Also, real resource allocation might not be similar to the credit allocation.

In order for selective credit policies to be effective, the degree of banks' credit fungibility would have to be zero. This means that long- and short-term credits from the banking system are exclusively utilized by business firms to finance fixed assets and working capital, respectively. Fungibility in this context is defined as the ability of business firms to borrow credits for a particular purpose but to effectively use it for another. Another type of fungibility is when business firms use low-cost funds from the banking system to finance (bank-) approved uses, thereby releasing their own funds for purposes that otherwise could not be pursued without the

availability of bank credit. For example, BRI provides low-interest credits for the purchase of hand tractors, and a farmer who receives such credit uses it for that purpose and uses his own funds to buy a color TV set. Although easily evaded by big borrowers such as Pertamina and the multinationals, credit ceilings are thought to have contributed to slowing the rate of growth in the Indonesian money supply (Arndt 1979).

There is one extremely interesting puzzle in the credit ceiling experience, and most of the answers to it are rather damning to the dominant presence of the government in the financial sector. The puzzle is that state banks, unlike the private banks, seldom used up all of their prescribed ceilings and had to lend out their excess reserves in the interbank market.

One can speculate, first, that the demand was actually high but bad bank practices by the state banks made them unable or reluctant to reach out to small customers because it involved cumbersome operations and low profit per customer. Second, it could be the inability of the officers of the state banks to select projects which were acceptable both economically and politically. Third, the officers may have demanded too high side payments from prospective borrowers (to divide the implicit rents from a negative, zero, or low real interest rate). It has been suggested that the graft could have been as high as 15 percent of the volume of the loan granted (Gray 1979). This would have resulted in the real cost of interest rates from state banks becoming too high either for prospective borrowers or to be competitive with interest rates at private banks. If the interest rates at state and private banks were about equal, borrowers would have preferred to borrow from the latter, especially from branches of foreign banks or NBFIs, to avoid long delays and harassment from state banks. All of these factors could have reduced the rate of growth of credit expansion to less than the permissible ceiling without necessarily satisfying demand.

5.5 Financial Sector Reform in the 1980s

A series of negative external shocks began in 1982. The world recession and the first wave of weakness in the world oil markets was worse than had been expected. Economic recovery in the OECD countries since 1983 does not appear to have helped economic growth in Indonesia significantly. The price of oil dropped from \$35 per barrel in 1982 to \$25 in 1985, and then to \$12 in 1986 (figure 5.1). This dismal picture was repeated for the prices of Indonesia's nonoil exports. The worst is still to come. Nonoil export prices are expected to continue falling, bottoming out only in 1988 when they would be 25 percent of the 1982-84 level (figure 5.2). The decline in the terms of trade has been aggravated by the sharp currency realignment in 1985-87. Most of Indonesian exports are priced in terms of the U.S. dollar, but a large proportion of its imports and foreign debts are denominated in the appreciating currencies. The dollar depreciation worsened the current

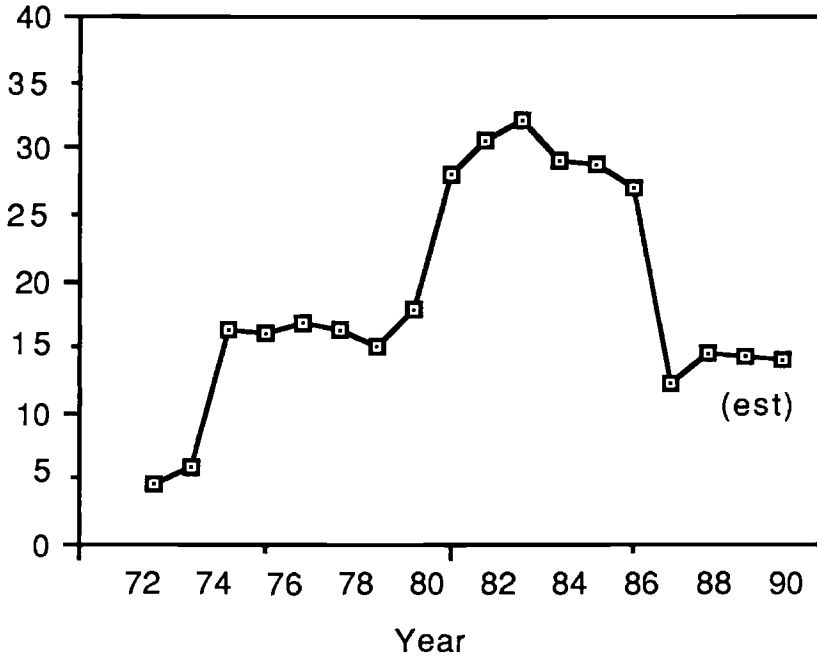


Fig. 5.1. Oil prices 1972-90 (\$/barrel in constant 1985 dollars)

account deficit, added to the burden of foreign debts, and cut Indonesia's real budgetary expenditures. The decline in the terms of trade plus the big reduction in government real nondebt budgetary expenditures produced a sharp decline in economic growth. The annual average real GDP growth since 1982 has declined to one-third to one-half of the level in the 1970s. In short, the end of the oil boom in 1982 made financing the investment-saving and foreign exchange gaps much harder.

In response to the external shocks, the government adopted several economic programs, among which was an overhaul of the financial structure. The financial reforms since 1 June 1983 fall into two major categories. The first category comprises partial deregulation of interest rates, elimination of credit ceilings, and reduction in the scope of Bank Indonesia's subsidized credits to state-owned banks. The second category consists of piecemeal measures. Direct Bank Indonesia intervention in the day-to-day operation of state banks was reduced significantly, and its direct lending to quasi-government bodies and state-owned enterprises was replaced by state bank lending financed by Bank Indonesia's liquidity credits.

At present there is no treasury debt that can be used for open market operations because the government financed its budget deficits solely through foreign aid and foreign loans. To increase the number of central bank instruments for open market operations, Bank Indonesia began reissuing

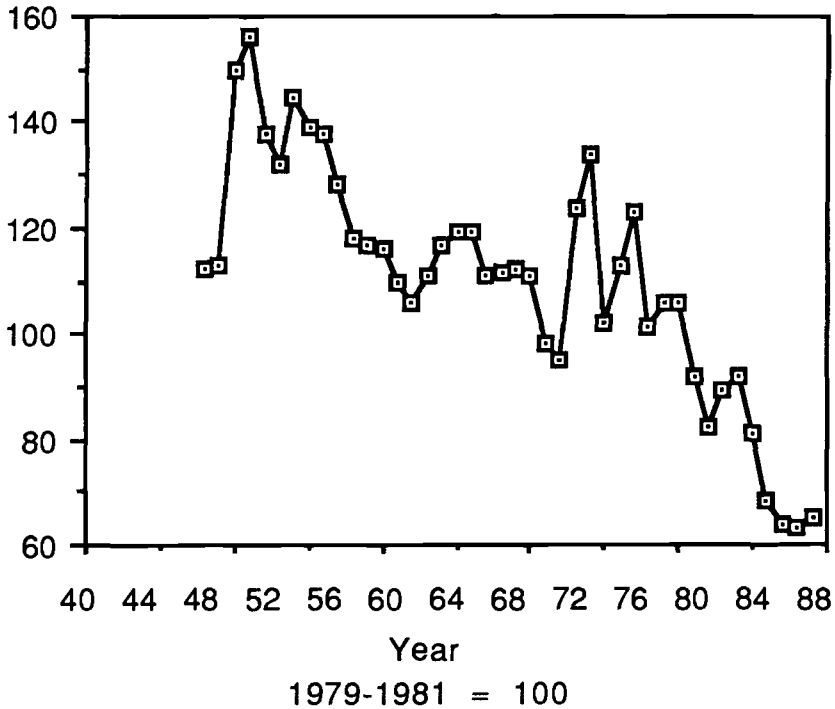


Fig. 5.2 Primary product prices. Index of nonoil commodities (in constant dollars).

Debt Certificates (SBI) in February 1984 and introduced the Money Market Instruments (SBPU) on 28 January 1985.²

The SBI had first been issued on 12 March 1970. However, issue ceased during the oil boom era in the 1970s as the authorities encouraged banks to invest their excess reserves in foreign assets in order to sterilize the inflow of oil money. At the beginning the interest rates on SBIs were set by Bank Indonesia at levels higher than the rates paid on excess reserves held at the central bank, but over time the sales of SBIs shifted to an auction system. Since 1984 the frequency of SBI auctions has increased, and rediscounting can be done either at Bank Indonesia or at Ficorinvest, an investment finance type of NBFIs largely owned by Bank Indonesia. Bank Indonesia guarantees to rediscount the SBIs at their original auction prices, irrespective of their remaining maturities. Despite promotional efforts by Bank Indonesia, SBIs are not yet well accepted by the financial sector. The SBIs can be resold to the nonbank public. So far, however, the secondary market for SBIs is nonexistent. To maximize their profit from holding SBIs, financial institutions usually purchase a large volume of long-maturity SBIs and hold them for a short period before rediscounting.

SBPUs are contingent liabilities of the bank of NBFIs that first endorsed them. There are three types of SBPUs, namely: (1) promissory notes by eligible banks and NBFIs; (2) promissory notes issued by customers of eligible banks and NBFIs when borrowing from them; and (3) bills of exchange issued by third parties and endorsed by eligible banks and NBFIs. Initially the maturity of SBPUs was set between one to three months. However, on 7 August 1985 the upper limit was raised to six months. In reality, 98 percent of the SBPUs are in the form of promissory notes with maturity dates ranging from one to fourteen days. Only institutions which have signed repurchase contracts with Ficorinvest are eligible to endorse an SBPU. The repurchase contract prescribes the upper limit of each institution in rediscounting SBPUs.

There are no data available on the total volume of SBPUs in circulation. However, the growth in the market for SBPUs must have been rapid since there is a high rate of growth of Bank Indonesia's claims on banks arising from the use of the central bank's rediscount facility on these instruments.

As it now stands, the SBPU system is only beneficial for large financial institutions, especially the foreign exchange banks. Its eligibility standards discriminate against small private banks whose customers are mainly small and medium-sized firms. It is also discriminatory against unit banks which operate outside the capital city, since Ficorinvest has no branch office outside Jakarta.

5.6 Evaluating the 1983 Financial Sector Reform

Our first observation is that the financial instruments SBI and SBPU still do not provide sufficient control over monetary aggregates. This is clearly seen in the way that the money supply had to be contracted in response to a speculative run on the rupiah in the first half of 1987. Capital flight began in earnest in the second quarter of 1987 when a higher than expected current account deficit was reported. (This overreaction was mostly due to nervous bankers and investors who had suffered losses in the two closely spaced devaluations of May 1983 and September 1986.) In June 1987 the minister of planning, Dr. Sumarlin, after concluding that open market operations would not be able to raise interest rates quickly enough, ordered state enterprises to withdraw Rp 1.3 trillion from state banks to be placed in central bank securities.³ This action, together with the sale of Rp 800 billion of open market instruments to banks during the month, sharply reduced bank liquidity and forced the banking system to sell its foreign assets in order to meet rupiah funding requirements. Other domestic corporations began repatriating capital to meet current operating needs. This severe credit squeeze succeeded in convincing private agents that the government was prepared to adjust other policies in order to ensure the viability of the existing exchange rate, and the speculation against the rupiah came to an end.

Our second observation is that the response of long-term financial intermediation to liberalization of the financial sector is a slow one, and its initial reaction may even be perverse. While the response by depositors has been very favorable, the response by financial institutions has not been so. The volatility of sources and costs of funds forced the banking industry to adjust its lending terms in order to minimize interest rate risks. This resulted in an increasing share of short-term fixed rate assets and a large proportion of credits carrying adjustable rates. Since interest rate volatility also increases borrowing risks, the banks have become more cautious in extending credit.

The third observation we want to make is that the deregulation should have been preceded by institutional reforms in the state enterprise system. The bureaucratization of the state-owned banks in the protected climate of past credit policy raised their overhead cost and subsequently their cost of intermediation. High arrears in all sectors and all credit schemes is a reflection of high credit risks which resulted from the inadequate selection and supervision of customers. These deficiencies were largely due to the fact that all of their lending risks were passed on to the government. After the reforms, the opportunity cost of funds increased while the cost of intermediation and credit risks remained high. The high cost of intermediation was also caused by the state banks being prohibited from reducing personnel. These are additional reasons why the lending rates of state banks rose after deregulation.

Our fourth observation is that the initial balance sheet conditions of the financial institutions should not have been overlooked. The present newly competitive market requires capital bases stronger than those of many of the financial institutions. Due to the past credit policy of subsidized interest rates, a large proportion of the assets of state-owned banks were extended at negative real interest rates. The weakness of the capital base of the private national banks is clearly shown by several recent bank failures.

The final observation we want to make is that deregulation of the financial sector should have been accompanied by greater supervision of the banking system. The banking system is not insulated well enough in practice from the fortunes of individual clients. This is because the interconnections of family ownership closely link many of the private national banks to the performance of sister companies. Indeed, some of these banks have been established mainly to secure funds for the nonbank business ventures of their owners.

5.7 Concluding Remarks

The emphasis on the development of two open market instruments, SBI and SBPU, is a long overdue step toward better control over monetary growth. An important obstacle to improved macroeconomic management seems to be that open market operations have been mainly geared to keep interest rates constant. Monetary policy was particularly unresponsive to

external interest rate developments. One reason for the capital outflow prior to July 1987 was that Bank Indonesia had kept the SBI rate flat for a relatively long period, causing domestic interest rates to diverge from international interest rates. In a financially open economy like that of Indonesia, it is essential to recognize that external shocks will frequently make tradeoffs among interest rate stability, domestic income stability, and exchange rate stability inevitable.

It is clear from the manner in which the monetary contraction of June 1987 had to be implemented that the market for both SBI and SBPU was still too shallow. It may be difficult to increase their role if the financial markets remain underdeveloped. Financial deepening is an important priority, but not only because of the need to enhance the effectiveness of the monetary instruments. Financial deepening would also better mobilize (and maybe increase) domestic savings, reduce dependence on external credit, and improve the overall allocation of capital within the economy.

One of the first steps that could be undertaken to boost development of the financial sector would be to privatize some of the state enterprises. It would certainly ease Indonesia's external debt burden if a minority portion of these state enterprises were sold to foreigners. The possible increase in efficiency of these enterprises would be an added bonus.

6 Exchange Rate Policy

6.1 Introduction

In chapter 3 we identified an important political constituency (technocrats, Javanese peasants, and Outer Island residents) which is opposed to the maintenance of an overvalued exchange rate. We will show in this chapter that this constituency has been successful in influencing exchange rate policy, with the result that there is an asymmetry in policy response to changes in the balance of payments. It makes good economic sense to devalue the real exchange rate when a balance-of-payments deficit occurs, but due to the existence of this constituency it makes good political sense not to allow the real exchange rate to revalue when a surplus occurs. The fact that the institutional memory was impressed by the potency of the exchange rate in effecting economy-wide resource reallocation and income redistribution during the 1966 economic rehabilitation program helps to strengthen the economic argument for a devaluation whenever the balance-of-payments situation demands it. This exchange rate policy, as we will argue in chapter 7, played a crucial role in helping Indonesia to avoid a debt crisis in