

THE FINANCIAL SYSTEM OF INDONESIA

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1. Introduction

Under Dutch colonial rule, the financial system of Indonesia remained dualistic and underdeveloped, and the new Republic inherited from the Dutch a characteristically colonial banking structure. The main financial institutions were eight commercial and foreign exchange banks, four of them Dutch, two British and two Chinese. The old-established Java Bank had a monopoly of note issue but few other central banking functions.

During the struggle for independence after World War II, two state banks emerged in republican territory. The Bank Negara Indonesia was established to provide general banking facilities but intended also to serve as the Republic's central bank; and the Allgemeene Volkscredietbank was transformed into a state bank, under the name Bank Rakjat Indonesia, to provide rural and other small-scale credit. In 1952, a third state bank was added to operate as an industrial development bank. In the following year, the Java Bank which the Republic, in the negotiations for the transfer of sovereignty, had reluctantly agreed to retain as the bank of issue despite continued Dutch private ownership and management, was nationalised. Renamed Bank Indonesia, it became the country's central bank but through its banking department retained the status and functions of a commercial and foreign exchange bank. In 1957-58, the three remaining Dutch foreign exchange banks were nationalised, along with other Dutch enterprises. The other foreign banks continued to operate for some years as foreign exchange banks.

For the rest, the financial system of the infant Republic consisted of some 90-100 more or less active private banks, mostly Chinese-owned, some specialised credit agencies of government departments, the postal savings banks and pawn shops inherited from the colonial period, a stock exchange nominally opened in Jakarta in 1952, a variety of small credit co-operatives (village and rice banks in rural areas and the traditional *arisan* credit unions in towns) and the large and important unorganised market of money lenders and trade credit.

In the last and increasingly chaotic years of the Sukarno regime, 1964-66, while inflation propelled by deficit finance got almost entirely out of control, the banking system degenerated into a mere instrument for channelling newly printed money into the economy. Banking reform, therefore, became one of the priority tasks of the new government under Soeharto in 1966. New banking legislation was the first to be drafted after the foreign investment law and was passed in 1968. It consisted of eight statutes, one on central banking, six on the reconstituted state banks and a "basic banking law".

2. The State Banks

Table 1 shows the five state commercial banks which emerged from this reform, their main specialisation and, as an indicator of relative size, the number of their branches. Table 2 gives a conspectus of Indonesia's financial system as a whole.

The state banks dominate the Indonesian financial system. Except in foreign exchange business where the foreign banks are important, the state commercial banks, favoured by a wide variety of privileges, from tax exemptions, subsidies and rediscount facilities to a virtual monopoly of government and other public sector banking business, provide the bulk of banking facilities in their branches all over the country. They hold the major part of demand and time deposits, manage customers' accounts, organise transfers of funds domestically and internationally, cooperate in clearing of inter-bank debts, and conduct the whole range of loan business, from short-term trade credit and personal loans to medium and longer-term loans to the state and private corporate sector.

As in most other developing countries, the system of state commercial banks has been developed on the continental European rather than the British-American model. Whereas in Britain and the United States, deposit banks have traditionally confined themselves to short-term trade credit, leaving longer-term industrial finance to specialised non-bank financial intermediaries and to the market for negotiable securities (bonds and shares), the Indonesian banks have been encouraged to provide such long-term capital for manufacturing, mineral, rural and other development. This objective clearly inspired the areas of specialisation assigned to the state banks, as shown in Table 1.

There has undoubtedly been a considerable improvement in the general level of efficiency of the state banks since the nadir of the mid-1960s, and there have been some outstanding achievements, such as the organisation of rural credit by the State Rural Bank (BRI). But there have also been conspicuous examples of poor performance where a bank would have failed had it not been bailed out by the central bank, and there have at times been doubts about the solvency of some of the other banks with huge amounts of bad debts. Despite notable efforts at staff training, the state banks are still deficient in many of the skills needed for efficient modern banking, and the combination of a tight regulatory framework and comprehensive protection from competition has not been conducive to efficiency. Since the liberalisation measures of June 1983, the banks have enjoyed more freedom to make their own decisions, but they still suffer from a variety of problems which impair their efficiency, especially overstaffing, excessive internal bureaucracy and inadequate capacity to evaluate risks on the basis of informed economic

Table 1

STATE COMMERCIAL BANKS

Name	Main Areas of Specialisation	Number of Branches (1985)
Bank Bumi Daya	Export production, estates, mining	76
Bank Dagang Negara	Export production, mining	93
Bank Negara 1946	Industry, agriculture, export production	218 ^a
Bank Rakyat Indonesia Agriculture, livestock		293 ^b
Bank Ekspor Impor Indonesia	Export production, estates	49

a Including sub-branches

b Excluding payout stations, mobile units and village units

Source: M.E. Hopper, *Banking, Finance and Investment in Indonesia*, Eurasia Media Co., Hong Kong, 1985.

Table 2

INDONESIA'S FORMAL FINANCIAL SYSTEM

	Number of Head Offices March 1985	Branches	Total Assets Rp billion March 1985
A. Banking System			
Bank Indonesia	1		23,285
Commercial banks	85	1,160	31,056
State banks	5	749	26,469 ^a
National private banks	69	390	2,342 ^b
Foreign banks	11	21	2,245
Development banks	29	224	2,702
State	1	22	
Regional	27	201	
Private	1	1	
Savings banks	2	13	1,290
State	1	12	
Private	1	1	
B. Non-Bank Financial Institutions			
Development finance corporations	3		237 ^c
Investment finance corporations	11		909 ^c
Insurance companies	84 ^c		800 ^d

a national foreign exchange banks

b other commercial banks

c March 1984

d March 1983

Source: Bank Indonesia, *Financial Statistics, Annual Report*. Central Statistical Bureau, *Statistical Yearbook* 1985.

and technical judgment. Upgrading the performance of the state banks remains a high priority task.

In addition to the major state commercial banks, Table 2 shows three other components of the state banking system, a state savings bank (Bank Tabungan Negara), a national development bank (Bapindo) and a network of regional development banks. BTN developed from the post office savings bank established by the Dutch in 1898. It has branches in more than a dozen cities and operates through hundreds of post offices and auxiliaries throughout the country. Its original purpose was to encourage and collect small savings and channel them into loans for development. While the bank still performs this function to some extent, largely through its participation in the national development savings scheme (Tabanas), savings deposits now provide a small part (less than 20 per cent) of its loanable funds. Its main role now is to channel government concessional credit to low cost housing.

Bapindo was established in 1960 as a successor to the State Industrial Bank and was to finance long-term investment especially by *pribumi* (indigenous non-Chinese) enterprises, from domestic and foreign private savings. After a difficult period during the inflation years of the 1960s when it mainly lent for short-term working capital, Bapindo has in the last twenty years grown into a significant source of long-term capital for both private and state enterprises, but its funds are derived mainly from government sources and from the World Bank and other international agencies.

The regional development banks were established in the early 1960s, one in each province and owned by the provincial governments. Like Bapindo, they were supposed to mobilise private savings for development investment, but since each bank's operations have been confined to its own province most of them have made little headway. Only those in the largest cities have grown to a stature comparable with the larger national private banks.

While the state banks dominate deposit banking in Indonesia, there are also two important sectors of private banking, national private banks and branches of foreign banks.

3. National Private Banks

By 1967 a very large number of small private banks had come into existence, though many of them existed only on paper as cover for other activities. Since 1967, the number

of licensed national private banks has declined from 121 to 83 in 1985; but the number of their branch offices has risen from 187 to 390, and ten of them have been granted the status of foreign exchange banks, entitled to conduct foreign exchange business. In the early years after 1967, some national private banks got into trouble through overlending. When the central bank tightened reserve requirements, several were unable to meet their clearing debts. Twenty-four were temporarily suspended from clearing and placed under central bank supervision.

For many years, even after the change of regime, the private national banks had great difficulty in competing with the powerful state banks which enjoyed preference in all government and public sector banking business, as well as tax exemptions, deposit guarantees and other subsidies. In recent years, it has come to be recognised that a vigorous private banking sector is useful as a competitive spur to the state banks and as an alternative source of banking services to customers. The central bank has therefore undertaken a program of upgrading private national banks by encouraging mergers of small banks, cooperation with state and foreign banks in management and staff training and by providing financial assistance.

4. Foreign Banks

One section of the basic banking law of 1968 authorised foreign banks to operate once again in Indonesia. By the end of 1969, 11 foreign banks had established branches in Jakarta. Because of their high quality management and staff and their overseas links, they have attracted most of the banking business of multinational companies in Indonesia and constitute an important part of the Indonesian banking system, especially in foreign exchange business.

The relative size of the assets of the foreign banks shown in Table 2, less than one tenth of those of the state banks, understates their role, as financial links between Indonesia and the rest of the world and as a competitive spur to efficiency for the state banks. Their operations in Indonesia, however, continue to be severely restricted, partly for fear of undue foreign influence in the economy and partly to protect the state banks. Foreign banks may establish branch offices only in Jakarta. Outside Jakarta they may operate only in joint ventures with Indonesian banks and, in a limited way, through local branches of state and national private banks.

Besides the eleven foreign banks with Indonesian branches, over 50 foreign commer-

cial and merchant banks have representative offices in Indonesia. These, through financial advice and contacts, constitute important links between Indonesian business and international financial markets, particularly in the negotiation of foreign loans and foreign direct investment.

5. Non-Bank Financial Institutions (NFI)

With the object of encouraging the development of a more diversified and specialised money and capital market, the Indonesian Government has been active in establishing, or encouraging the establishment of, a range of non-bank financial institutions and markets. Among them are development and investment finance corporations (DFCs and IFCs), the inter-bank money market, the stock exchange and the insurance industry.

The function of the two types of finance corporation is essentially the same, to provide medium and long-term finance to Indonesian enterprises. The difference between them is that the former are in the main domestically owned, while the latter were intended to operate as merchant banks tapping foreign finance and expertise and are in most cases joint ventures between Indonesian banks and foreign banks or NFIs.

There are three DFCs of which two are public sector institutions (with Bank Indonesia as a major shareholder) while the third is owned by private (local and foreign) shareholders. In the late 1970s, the prevailing very high interest rates made it profitable for the DFCs to invest a large proportion of their funds in short-term promissory notes which tended to finance working rather than fixed capital.

There are about a dozen IFCs, all established in the years 1973-4. Their main function was supposed to be to act as intermediaries in issuing and underwriting business. But the slow development of public issues of shares by Indonesian companies has compelled them to find most of their business in meeting working capital requirements of joint venture firms and the largest Indonesian companies. While the DFCs have obtained most of their funds from government and international aid sources, the IFCs generally raise theirs by the issue of their own notes in the money market.

Considering the importance of insurance — socially for protection from the financial hazards of old age, illness and accidents and economically for the spreading of risks of all kinds — it is unfortunate that the insurance industry has been slow to develop in Indonesia. In terms of premium income per head of population, Indonesia ranks about 50th in the world and is well behind its ASEAN partners. In the 1950s most of the foreign

insurance companies in Indonesia had ceased operation or been nationalised, and in the following years of inflation and political uncertainty, few Indonesian insurance companies managed to operate effectively. In the 1970s, with government encouragement, the industry revived, so that by the end of the decade there were nearly eighty firms. Most of these were private national companies or joint ventures, but in both the life and non-life insurance sectors the single state enterprise accounted for about two-fifths of total assets. The least developed part of the industry is social insurance. Three of the five state-owned bodies manage compulsory superannuation schemes for military and civil government employees; the other two, concerned with workers' compensation and health insurance, are still very small.

6. Organised Securities Markets

Indonesia has as yet no government bond market, chiefly because the government's principle of balanced budgets precludes the sale of bonds to the public. As an alternative open-market instrument of indirect control of bank liquidity, Bank Indonesia in 1984 revived the issue of securities of its own. Since 1974, also, a short-term money market has operated in Jakarta, and since 1977 there has been a rudimentary stock exchange.

Bank Indonesia Debt Certificates (SBIs), which had first been issued in 1970 but suspended with the reversion to direct control of bank liquidity in 1974, are now sold by auction, with 1-3 months maturities, and thus carry market-determined interest rates. Although SBIs are available to the non-bank public, no secondary market has got under way. Rediscountable with Bank Indonesia or its investment-finance subsidiary Ficorinvest, their main role is to replace foreign assets as the chief outlet for the banks' excess reserves.

The function of a money market is to facilitate the flow of short-term funds from those who have more to those who have less than they need on any day. The Jakarta money market is still almost entirely an inter-bank market, the main borrowers being the foreign bank branches and private national banks and the principal lenders the state and regional development banks. To encourage the development of the market, the government has granted tax exemption to money market paper, and the central bank provides re-discount facilities to banks and NFIs on commercial drafts, acceptances and promissory notes.

The endeavours of the Indonesian government to promote an active stock exchange

have been slow to bear fruit. The Jakarta stock exchange (which had existed in Dutch days but closed during the Japanese occupation and become inactive with the nationalisation of Dutch companies in the 1950s) was reopened in 1977, managed by a Capital Market Executive (Bapepam) under overall guidance by a ministerial Capital Market Policy Council. But private sector companies have been reluctant to go public. They have seen little advantage in raising equity finance from the public while bank and other loan finance was available, often at concessional interest rates, and they have been reluctant to see ownership diluted and their balance sheets exposed to public scrutiny. Nor has the government been willing to privatise its state enterprises by offering shares in them to the public. By December 1985, only 24 equities and 3 bonds were listed. Of the listed companies, 16 were foreign companies which had gone public to meet the «Indonesianisation» requirement after an initial period of operation in the country and only 8 domestically owned private companies. Virtually no secondary market, in which these shares are traded from day to day, had yet developed.

The bond issues have all been by public enterprises. In 1982, as the fall in oil prices highlighted the need to mobilise domestic savings, such issues by public enterprises appeared an attractive substitute for direct government borrowing from the public which was still thought undesirable as implying deficit finance. Three public enterprises, a state-owned toll-road and bridge developer, the state development bank and a state-owned housing finance company, issued bonds in quick succession in 1983. The two issues by the first of these were much the largest, with a total face value of Rp 64 billion (US\$ 64 million), the other two being of Rp 25 and Rp 6 billion respectively. But by December 1985 no further issued had been made, nor has the government so far been willing to embark on privatisation of any state enterprises through the issue of shares.

With the object of «democratising the ownership of Indonesian corporations in order to promote a more equal distribution of income», the government also in 1977 established a National Investment Company (Danareksa) with a substantial paid-up capital (initially Rp 24 billion) to take up shares issued by listed companies and make the equivalent available to members of the public in smaller units, either in the form of its own certificates or through a mutual fund. Even though Danareksa offers these certificates on very favourable terms, standing ready to repurchase them at not less than the nominal issue price, paying a dividend not less than the rate of interest on 12 months' time deposits and virtually guaranteeing the investment against default, public demand for them has been disappointing. The development of an active secondary market in equities clearly depends on increased readiness of both private and state enterprises to make

shares available.

7. The Informal Market

What has been described in the preceding pages is Indonesia's formal financial system, what might be called its modern sector. Just as Indonesia's manufacturing industry consists of a modern sector of medium and large plants using modern technology side by side with a traditional sector of small-scale, cottage and handicraft industry using little capital and traditional labour-intensive methods, so Indonesia's financial system, like that of all developing countries, displays a similar dualism. Besides modern banks and NFIs, there is still a large informal capital market — how large we do not know because the most distinctive feature of the informal capital market is that few records of transactions are kept and there are no official statistics.

Farmers, though increasingly served by the state rural bank (Bank Rakyat Indonesia), still depend for their seasonal and emergency credit requirements on village and paddy banks, on specialised money lenders and on landlords, traders and others able to provide a credit, often secured on the standing crop. Similarly, a great deal of lending and borrowing goes on informally in urban areas, within families, among friends and business acquaintances, and in pawnshops and traditional credit clubs. Personal knowledge and trust take the place of the elaborate administrative and legal procedures by which modern banks secure themselves as far as possible against default risk.

Partly to obey the injunction of Islam against interest, the return to the lender under the Javanese *ijon* system of informal rural credit takes the form of a share of the crop, and the implicit rate of interest is usually very high. But while the money lender is frequently in a strong position to exploit his monopoly power, it is not always appreciated that the return to the lender covers more than interest on capital, in particular transport and marketing costs and some entrepreneurial risk.

The small-scale informal capital market is incapable of meeting the needs of a modern economy for cheap and efficient provision of a wide variety of specialised financial services. But until at least basic banking services can be made available to farmers, small enterprises and households in the towns and villages of Indonesia, the informal market of money lenders performs an indispensable function.

8. Financial Reform

Reference has already been made to the major reform of the Indonesian financial system which the Government announced on 2 June 1983. The state banks were freed from central bank control of deposit and lending rates of interest, except for concessional rates on certain categories of priority borrowers, chiefly *Bimas* farmers, smallholders, small-scale enterprises and private estates. The banks were also freed from direct central bank control of their lending activities through credit ceilings but would henceforth have to do without «liquidity» credit refinancing facilities. Credit ceilings and refinancing facilities would continue to apply to the priority categories (where the ceilings operated as targets rather than constraints) but these categories would be greatly simplified. The Government also announced increases in interest rates on savings bank deposits and, to attract capital from abroad, abolished the 20 per cent withholding tax on dollar-denominated deposits with Indonesian banks.

This was the most far-reaching measure of liberalisation of the Indonesian financial system since 1968. The reform had two main objectives. One was to stimulate private savings by offering savers attractive interest rates. The second was to promote more efficient use of domestic savings for development by channelling more household saving from assets such as gold and land to productive investment through the banking system and at the same time to enhance the efficiency of the banks as allocators of credit. In both respects it constituted an important step away from «financial repression» and in favour of «financial development» in the sense given to these terms by the American economists Shaw and McKinnon*.

The 1983 reform was immediately effective in stimulating the growth of fixed deposits at the state banks, though in part at the expense of deposits with the foreign banks. There are also signs of a more competitive spirit among the banks. But the task of domestic resource mobilisation and efficient allocation of capital remains a formidable one. The financial system remains dominated by the large state banks which suffer from most of the ills of protected and overstaffed bureaucratic institutions and which remain subject to much regulatory control, especially with respect to the large areas of credit to priority categories of borrowers, and to political pressures from powerful clients. The foreign banks which have the capacity to provide efficient banking services

* E.S. Shaw, *Financial Deepening in Economic Development*, Oxford University Press, New York, 1973; R.I. McKinnon, *Money and Finance in Economic Growth and Development*, Dekker, New York, 1976.

remain virtually excluded from all parts of the country other than Jakarta. The national private banks which could serve as a more dynamic sector of the system, are for the most part too small and undercapitalised, although some of the largest have become competitive. The requirements of Indonesian private and public enterprise for merchant banking services are now probably adequately met by the new development and investment finance companies and the branches and representative office of the foreign banks.

But there are as yet little more than the beginnings of an organised market in negotiable securities in the form of the inter-bank money market, the growing volumes of Bank Indonesia certificates and the embryo stock exchange. More substantial and vigorous development of these essential parts of a modern financial system will have to await the growth of sufficient confidence on the part of governments that they can safely undertake regular bond issues for the finance of responsibly managed budget deficits and on the part of business enterprises, public and private, that they can safely meet the conditions, in terms of ownership dilution and disclosure of information, for equity financing.

9. Conclusion

The twenty years since the change of regime in the mid-1960s have witnessed remarkable economic development in Indonesia, with growth rates averaging 8 per cent a year during the 1970s, attainment of self-sufficiency in food, rising real wages even in densely populated rural Java, and sustained improvement in education, health and physical infrastructure. But while this notable record owes much to political stability and competent economic management under Soeharto, it would not have been possible without the windfall of high oil prices during the 1970s which for a decade relieved the country of external and domestic financial constraints. The decline in world oil prices since 1981 has returned Indonesia to the condition normal in developing countries, of development constantly coming up against shortage of financial resources, foreign exchange and domestic saving. In these conditions, high priority attaches to the capacity of the financial system to mobilise domestic saving and ensure their efficient use for economic development. The preceding pages have indicated some of the useful steps that have been taken in recent years to upgrade Indonesia's financial system for this task but also the deficiencies that still need to be remedied.

LE SYSTEME FINANCIER DE L'INDONESIE

RESUME

Cet article analyse le système financier d'un des plus important pays en voie de développement: l'Indonésie. Depuis vingt ans, lorsque le régime de Soeharto hérita d'un système bancaire étatique ravagé par l'inflation et rendu inefficace par les contrôles centralisés, des progrès considérables ont été accomplis.

Le système bancaire continue à être dominé par les 5 banques commerciales d'état qui possèdent et gèrent à peu près les 4/5 des filiales bancaires, des activités financières et des dépôts. Il y a aussi 1) 11 banques étrangères qui bien que localisées exclusivement à Jakarta ont une place importante dans les transactions en devises étrangères (spécialement celles des entreprises multinationales) 2) un grand nombre de banques privées nationales en grande partie de petite dimension et environ 30 banques de développement éparpillées un peu partout sur le territoire national.

Le gouvernement a encouragé le développement d'un plus vaste marché de capitaux comprenant de nombreuses institutions d'intermédiation financière non bancaires, d'un marché monétaire spécialement interbancaire et d'une bourse mobilière. La bourse en vérité n'a pas progressé de façon adéquate car peu d'entreprises privées ou publiques ont la possibilité d'y avoir recours. En 1983 on a fait un pas important en ce qui concerne la libéralisation du crédit bancaire et des taux d'intérêt. On se proposait ainsi de donner plus d'autonomie et de garantir plus de compétitivité entre les banques toutefois leur efficacité laisse encore beaucoup à désirer.