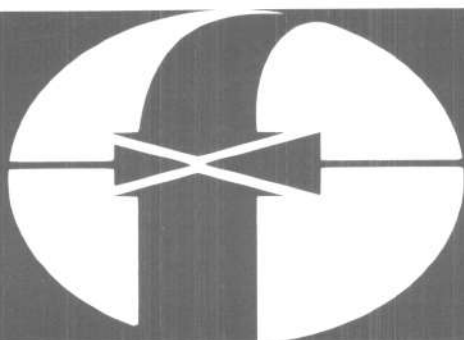


# **Savings and Development**



**“GIORDANO DELL’AMORE” FOUNDATION**

Centre for Assistance to Financial and Credit Institutions of Transitional Countries

Established by



Milan - Italy

Quarterly Review - No. 3 - 1994 - XVIII



# **Savings and Development**

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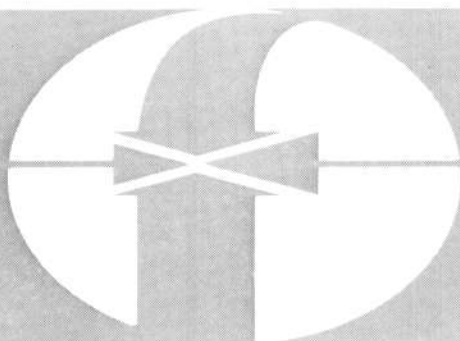
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# FINANCIAL DEREGULATION IN AN OPEN DEVELOPING ECONOMY: LESSON FROM THE INDONESIAN EXPERIENCE

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## 1. Introduction

Interest rate reform and the deregulation of the financial sector have become part of most adjustment programs of developing countries in the 1980s. Reforming countries have been much more reluctant in the financial opening of their economies. Dismantling capital controls is generally presumed to generate economic benefits from increasing opportunities for international trade and cross-border portfolios in assets and liabilities, from imposing macroeconomic discipline on national governments, and from the rising costs and ineffectiveness of controls as economic development proceeds. Among the concerns of abolishing capital controls have been (i) the destabilizing impact of a significant inflow of foreign capital, (ii) a deterioration of the international competitiveness of the economy due to an appreciation of the currency, and (iii), that only large domestic firms will gain access to the international loan market. The highly publicised experience of the Southern Cone countries with financial opening, which ended in a financial crash, was also not encouraging for dismantling capital controls. The potential complications have led to the dominant view in the literature that international capital controls should be lifted only after the domestic financial market has been reformed and domestic interest rates have been deregulated [see, for example, Edwards, 1989].

Among the few developing countries which have not followed this order of liberalisation is Indonesia. Having abolished capital controls already in the early seventies, in the 1980s the government embarked on comprehensive interest rate reform and financial deregulations. The country could not only avoid a widespread financial crisis but was successful in fostering growth, diversifying exports and keeping inflation at low levels. Indonesia's experience therefore provides valuable insights in how financial reforms can be managed in a financially open economy. Chapter 2 describes scope and dimensions of financial liberalisation in Indonesia. The impact of the financial reforms on interest rates, financial deepening, economic growth, financial sector efficiency and stability are analysed in Chapter 3. Chapter 4 discusses the monetary policy dilemma after financial deregulation, and Chapter 5 contains lessons for the sequencing of financial reforms.



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## 2. Scope and Dimensions of Financial Liberalisation

### 2.1. *Financial Openness of the Economy*

An outstanding feature of the Indonesian economy in the last two decades was its high degree of financial openness. Indonesia formally removed all foreign capital controls already in 1971. Since then it was a cornerstone of Indonesian economic policy to avoid controls over foreign capital movements. Hence, foreign nationals and Indonesian citizens were free to open accounts in either the domestic currency (Rupiah) or foreign currencies with banks authorized to deal with foreign exchange transactions. These institutions were also free to extend credits in foreign currencies, with a 15 per cent withholding tax on interest rates. A major reason for relative little restrictions on payments and transfers for current external transactions was the geographical proximity of Singapore and Hong Kong. The presence of these important financial and trading centres would have made any attempts of the Indonesian authorities to enforce foreign exchange controls ineffective.

Despite the formally open capital account de facto access to the world financial markets by the private sector seems to have been limited, mainly because of lack of international creditworthiness. Only multinational firms, joint ventures, and priority Indonesian customers could borrow abroad through branch and resident offices, offices of foreign banks in Jakarta, and non-bank financial institutions. Direct borrowing from Singapore and Hong Kong by domestic companies was rather limited, due to legal complexities and to the reluctance of foreign banks experiencing difficulties in evaluating risks (see Baliño and Sundararajan, 1986). At the same time, foreigners were forbidden to invest in the portfolios of Indonesian firms, before the end of 1988, and were also restricted in many areas of direct investment in the early years of the last decade. In addition, the Ministry of Finance has controlled foreign borrowing of the public sector to take full advantage of concessional funding sources. The limit on foreign borrowing was enforced most effectively over the state-owned oil company (Pertamina), after its excessive external borrowing was curbed in 1976. On the other hand, holdings of foreign assets by domestic residents were always close substitutes to domestic currency assets, mainly bank deposits, and highly sensitive to differentials between domestic and foreign interest rates.



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## 2.2. *Financial Restrictions in the 1970s*

From 1974 to May 1983, Bank Indonesia's major concern was to 'sterilize' domestically the large capital inflows stemming from oil revenues and aid. The macroeconomic objective was to control the growth of money supply and fight inflation. At the same time a mechanism was created to disperse oil revenues so as to avoid budgetary surpluses and to preserve a continued flow of funds from international borrowers. The major instruments to achieve these aims were (a) a system of credit ceilings for individual banks, with sub-ceilings for various categories of loans, (b) a complex rediscount mechanism, designated to reallocate credit and to provide subsidies, and (c), controls on interest rates of state banks, with private banks remaining free to set their own rates. In addition, there remained a regulation issued in 1967, which required all of the public sector (including state enterprises) to deposit only with state banks, which constituted a very large captive market for these banks because of the dominant role of the public sector in the economy.

The system of credit control and subsidies was designed to pursue both distributive and industrialisation objectives. Farm income should be supported as a political concession to low income and rural people while social stability was a concern in supporting firms with majority Indonesian ownership. Major beneficiaries of preferential credits were state firms such as Pertamina (oil company) Krakatau Steel and Nurtanio (aerospace company). While the system of credit ceilings together with the operation of other monetary policy instruments proved relatively effective in controlling total credit expansion, it resulted in heavy distortions in the evolution of the banking system. Within the banking system, the state bank group had a dominant market power both in the funds market and lending market due to discrimination in sources of fundings, deposit insurance, the licensing system and in credit policy which all favoured state banks. From 1971 to 1988, entry to the banking system was virtually closed and requirements to obtain licences to deal in foreign exchange and to open new branch offices were almost prohibitive. The result of these policies was a highly fragmented financial sector which showed all signs of financial repression, including negative real rates of interest and a highly overvalued exchange rate (see Table 1).

Table 1

INFLATION RATES, INTEREST RATES AND DEPRECIATION RATES, INDONESIA, 1968-1990

Year	Inflation Rate (a)	Interest Rate (b)		Depreciation Rate (c)
		Nominal	Real	
1968	128.8	72.0	-56.8	38.7
1969	15.5	60.0	44.5	0.0
1970	12.3	24.0	11.7	16.0
1971	4.4	24.0	19.6	9.8
1972	6.5	18.0	11.5	0.0
1973	31.0	15.0	-16.0	0.0
1974	40.6	15.0	-25.6	0.0
1975	19.1	15.0	-4.1	0.0
1976	19.9	15.0	-4.9	0.0
1977	11.0	12.0	1.0	0.0
1978	8.1	9.0	0.9	50.6
1979	18.3	9.0	-9.3	0.3
1980	18.0	9.0	-9.0	0.0
1981	12.2	9.0	-3.2	2.8
1982	9.5	9.0	-0.5	7.5
1983	11.8	18.0	7.2	43.5
1984	10.5	18.3	7.8	8.1
1985	4.7	15.0	10.3	4.8
1986	5.8	15.0	9.2	45.9
1987	9.3	17.5	8.2	0.6
1988	8.1	18.5	10.4	4.9
1989	6.4	16.5	10.1	4.0
1990	7.8			

a. Annual change of consumer price index.

b. Interest rate on one-year time deposits of state banks.

c. The annual depreciation rate (DEP (t)) is calculated using the Bank Indonesia selling rate for the US\$ by the formula:

$$DEP(t) = [FE(t) - FE(t-1)] / [FE(t-1)] * 100 \text{ where}$$

FE(t) is end of month rupiah per dollar rate, and FE(t-1) is end of prior month.

Source: Cole and Slade (1990), IMF, International Financial Statistics, Washington, D.C., 1990.

### 2.3. The Interest Rate Reform (1983-1984)

In the early 1980s, the Indonesian authorities decided to implement an interest rate reform, which was motivated by both macroeconomic reasons and specific concerns related to the financial sector (see Baliño and Sundararajan, 1986). In the macroeconomic sphere, the reduced availability of oil revenues had to be compensated by the additional generation of domestic savings. Furthermore, the deterioration of growth prospects asked for a more efficient allocation of available finance. Finally, financial assets in Rupiah had to yield attractive earnings to prevent capital outflows. Among the specific financial sector

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concerns have been the following; firstly, the ceilings on interest rates of deposits with state banks hampered their ability to attract private sector funds. Secondly, the dependence of state banks on liquidity credits from Bank Indonesia complicated the task of controlling domestic credit. Thirdly, increased competition from offshore financial markets, such as Singapore and Hong Kong, led to substantial build-up of offshore deposits.

Beginning in June 1983 and continuing in 1984 an interest rate reform was implemented in Indonesia, with the following major components:

- Elimination of ceilings on bank credits (June 1983);
- Gradual removal of a wide range of loan categories from access to Bank Indonesia's liquidity credits (June 1983);
- Deregulation of state banks' interest rates on most categories of deposits and on all loans except remaining priority loans (June 1983);
- Introduction of rediscount facilities and of government bonds called *Servificats Bank Indonesia* (SBI) as new tools of monetary control (March 1984), and
- Introduction of new money market instruments, *Sura Berharga Pasar Uang* (SBPU) in January 1985.

The state banks were now called upon to compete with private banks in attracting funds by offering competitive interest rates on deposits. Furthermore, they were allowed, for most categories of loans, to extend as much credit as desired at interest rates of their choices. Some direct credit controls have, however, been retained to ensure continued state bank funding for a declining number of priority sectors, which continued to benefit from interest rates covered by Bank Indonesia's subsidized refinancing facilities.

#### *2.4. Financial Sector Deregulation (1988-1990)*

The process of financial liberalisation initiated in 1983 reached a climax in late 1988 with the introduction of two wide-ranging reform packages on 27 October and 20 December (see Appendix). The reforms aimed at (a) opening up the entry for new domestic and

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foreign joint-venture banks, their geographical dispersion, and range of activities, (b) stimulating the development of domestic money and capital markets, and (c), promoting a broad range of new types of financial institutions and services. The main objectives of the financial reform were to enhance financial sector efficiency and to increase the availability of long-term finance by promoting the development of the capital market. Steps were also taken to improve the stability of the financial system by strengthening prudential regulations and the Central Bank's supervisory capabilities. Concurrent with these regulatory changes there was a shift to a more flexible management of both the exchange rate and money market interest rates. Lowering the required reserve ratio from 15 to 2 percent was perhaps the most important single measure to increase the international competitiveness of Indonesia's banking system. On the other hand, Bank Indonesia introduced a new selective credit system in January 1990, which mandates domestic private and state banks to allocate a minimum of 20 per cent of their loan portfolios to small-scale enterprises and cooperations. Although this obligation would be a threat to the competitiveness of the banks involved it is not clear how effectively the authorities can enforce these rules, given the bad conditions of the present accounting and legal system as well as the still poor quality of bank supervision.

### 3. Results of Financial Reforms

#### 3.1. Interest Rates

The impact of the interest rate reform in the early 1980s was in the expected direction. After the removal of the ceilings the interest rates charged by the state banks began to rise almost up to the level of those charged by private domestic and foreign banks. Since 1983, interest rates on both deposits and loans remained positive in real terms, mainly because of a favourable turn in regard to the inflation rate, which was halved from 12 per cent in 1983 to 6 per cent in 1986 (see Table 1). Very high and volatile real interest rates were a significant feature of interest rate behavior in the wake of liberalization. The downward rigidity in the real interest rate level was mainly the result of inflationary expectations from a continued expectation of Rupiah devaluations. Nominal interest rates therefore remained high despite subdued inflationary pressures.

In the years after the 1988 deregulation measures, Bank Indonesia allowed the money supply to balloon up with the hope that more liquidity would drag down Indonesia's

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stubbornly high interest rates. As a consequence, interest rates did decline in early 1990 but only at the cost of aggravating inflationary pressures. Since mid-1990, Bank Indonesia has pursued a tight monetary policy in order to keep inflation in check. The subsequent money supply squeeze has pushed interest rates to levels higher than they were before the 1988 deregulation. In early April 1991 good borrowers had to pay 30 per cent for new credits.

### *3.2. Financial Deepening*

The financial reform of the early 1980s had a substantial impact on financial sector growth. Gross assets of the organized financial sector almost quadrupled between 1982 and 1988 (see Table 2). In addition, the expansion and new establishment of savings banks and insurance companies contributed to the widening of noncredit financial services. Or, measured by another frequently used indicator of financial deepening, M2/GDP, the ratio increased from 17.7 per cent in 1982 to 30.1 per cent in 1988 (see Table 3). However, there was a significant shortening of the maturity of time deposits. While before the interest rate reform almost half of the time deposits in Rupiah were held in 24 months deposits, the ratio declined to less than 6 per cent in 1987, where about 43 per cent of time deposits run maturities of less than three months (see Table 4). This was mainly a reflection of the terms structure of interest rates which became flat after the 1983 reform. The interest rate on 6-, 12- and 24 months deposits was at the same level (around 14 to 25 per cent) in 1986. Although it is difficult to find strong statistical evidence one may conclude that the interest rate reform did not improve the availability of long-term credits. The equity market was also no alternative to bank loans, largely because of the unfavorable tax treatment of equities vis-à-vis alternative financial instruments such as bank deposits (see Nunnenkamp, 1986, p. 438).

In the two years following the land-mark legislation of October 1988 which deregulated the banking sector, 63 new private banks have opened for business, bringing the total to 174. The number of bank branches country-wide more than doubled to 4,500, 18 foreign joint venture banks were licensed and hundreds of smaller community credit banks in rural areas were established. The amount of credit extended by banks jumped 465 per cent and 57 per cent in 1989 and 1990, respectively, to reach a total of Rp. 97,3 trillion (US\$ 51 million) by the end of 1990. The big winners in the newly deregulated environment were the private banks. By the end of 1990, national private banks accounted for more than a third of total credit outstanding, compared with a market share of just a fourth at the end of 1988.

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Table 2

STRUCTURE AND GROWTH OF THE ORGANIZED FINANCIAL SECTOR, INDONESIA, 1982-90 (END OF PERIOD)

	Number				Gross Assets				Growth in Assets 1982-1990 (annual compound rates of changes)
	1982	1988	1989	1990(a)	1982	1988	1989	1990(a)	
					(in billions of Rupiah)				
Bank Indonesia	1	1	1	1	13.7	42.5	40.1	43.6	15.6
Deposit money banks	114	107	146	163	16.0	63.3	90.1	120.8	28.8
National foreign exchange banks (b)	15	17	22	28	12.7	50.1	71.4	94.0	28.4
Foreign banks	11	11	23	26	1.2	3.2	5.2	8.2	27.6
Other commercial banks (c)	60	51	72	80	0.7	5.0	6.3	9.1	37.4
Development banks	28	28	29	29	1.3	5.0	7.2	9.5	27.7
Nonbank financial institutions (d)	14	14	14	14	0.8	3.1	3.9	4.6	24.3
Savings banks (e)	83	106	121	129	0.5	1.9	n.a.	n.a.	n.a.
Insurance companies (f)	17	83	101	122	0.1	1.7	n.a.	n.a.	n.a.
Other credit institutions (g)	5 808	5 771	5 812	5 994	0.09	0.6	n.a.	n.a.	n.a.
All institutions	6 040	6 085	6 198	6 426	31.6	115.5	n.a.	n.a.	n.a.

(a) As of September 1990.

(b) Includes five state banks; the remainder are national private banks.

(c) National private banks undertaking only domestic currency business.

(d) Nine investment finance, three development finance, and two other finance companies.

(e) One state savings bank and two private savings banks.

(f) Village bank, rural paddy banks, and government-owned pawnshops.

Source: Bank Indonesia (1990b)

The capital market also showed impressive progress since the introduction of the December 1988 policy package. The companies issuing stocks increased from 24 at the end of December 1988 to 124 at the end of December 1990 and the companies issuing bonds increased from 6 to 20 (see Table 5). In the same period, the total value of stock issued at the bourse increased from Rp. 198 billion to Rp. 13 144 billion, while that of bonds rose from Rp. 911 billion to Rp. 1 862 billion.

**Table 3**

MONETARY RATIOS FOR INDONESIA, 1968-1989 (IN PER CENT OF GDP)

Year	Currency	Demand Deposits	Narrow Money (M1)	Quasi Money	Broad Money (M2)
1968	3.6	1.9	5.5	0.6	6.1
1969	4.3	2.5	6.8	1.8	8.6
1970	4.8	3.0	7.8	2.5	10.3
1971	4.6	2.8	7.4	3.4	10.8
1972	5.1	3.8	8.9	4.1	13.0
1973	5.0	3.9	8.9	4.2	13.1
1974	4.1	3.7	7.8	4.3	12.1
1975	4.5	4.5	9.0	5.2	14.2
1976	4.6	4.9	9.5	6.1	15.6
1977	4.8	5.0	9.8	5.5	15.3
1978	5.1	5.2	10.3	5.5	15.8
1979	4.5	5.3	9.8	5.3	15.1
1980	4.4	5.8	10.2	5.5	15.7
1981	4.4	6.8	11.2	5.6	16.8
1982	4.7	6.7	11.4	6.3	17.7
1983	4.3	5.5	9.8	9.1	18.9
1984	4.1	5.4	9.5	10.4	19.9
1985	4.6	5.9	10.5	13.5	24.0
1986	5.2	6.2	11.4	15.6	27.0
1987	4.6	5.5	10.1	17.0	27.1
1988	4.5	5.8	10.3	19.8	30.1
1989	4.6	7.2	11.8	23.5	35.3

Source: Bank Indonesia (1990b)

**Table 4**TIME DEPOSITS IN RUPIAH BY MATURITY, INDONESIA 1978-1990<sup>a</sup> (IN PER CENT OF TOTAL TIME DEPOSITS)

Year	24 months	12 months	6 months	3 months	1 month <sup>b</sup>	Others
1978	65.7	10.4	11.2	4.5	7.8	0.4
1981	47.6	13.2	13.5	9.2	14.4	2.1
1982	44.0	14.6	12.5	8.9	16.3	3.7
1983	15.4	28.5	19.0	13.6	21.0	2.5
1984	6.6	39.1	18.8	14.6	17.6	3.3
1985	3.8	65.3	10.5	9.8	9.3	1.3
1986	6.4	49.7	16.8	13.8	12.2	1.1
1987	5.9	39.4	10.0	21.7	21.7	1.3
1988	10.4	35.0	13.8	21.0	17.6	2.2
1989	8.2	34.8	18.3	19.6	17.3	1.8
1990 <sup>c</sup>	7.8	36.7	19.2	18.3	16.3	1.7

a. End of period

b. Includes mature time deposits

c. March

Source: Bank Indonesia (1990b); own calculations



**Table 5**

STOCK AND BONDS ISSUED THROUGH JAKARTA STOCK EXCHANGE, INDONESIA 1985-1990

End of Period	No. of Companies	Stocks		Bonds		Value (bill Rp.)
		No. of Stocks	Value (bill Rp)	No. of Companies	No. of stocks	
1985	24	58 807 872	138.0	3	273 220	254.7
1988	24	73 824 043	197.3	6	317 205	910.2
1989	51	291 766 267	1 711.6	17	346 864	1 383.2
1990	124	1 338 225 150	13 143.6	20	366 769	1 862.2

Source: Bank Indonesia (1990b).

### 3. 3. *Savings, Investment, and Growth*

Indonesia's economy was in a good shape during the period of financial repression, mainly because of its status as an oil exporter. The rate of growth of its real GDP was around 12 per cent per annum on average during 1973-1983, a result of booming oil revenues and large amounts of foreign aid. The rate of domestic investment averaged 27.6 per cent of GDP during 1973-1983, and the gross domestic saving ratio averaged 30.0 per cent of GDP. Both government saving (9.3 per cent of GDP) and private saving (14.8 per cent of GDP) were impressive compared not only to other Asian countries but also to the industrialized nations. Obviously, during the years of high economic growth, a substantial portion of the increases in savings was placed abroad.

Real economic growth became more erratic and generally slowed down after the decline in oil prices. At the same time the financial sector was booming. These movements suggest that high domestic financial growth is not necessarily correlated with periods of high real growth of the economy, a result which can be associated with the high degree of financial openness of the Indonesian economy. Much of the change in domestic asset holdings may have simply reflected the shifting of activity from offshore to onshore or vice versa. The high growth of bank assets since 1982 could hardly reflect a comparable real increase in aggregate or financial savings, in a period when GDP per capita was growing at only about 3 per cent per annum in real terms and the terms of trade were strongly against Indonesia.

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### 3.4. *Financial Sector Efficiency and Stability*

The impact of the financial reform in the early 1980s on the efficiency of the financial sector is difficult to judge. Although competition between state banks, private and foreign banks was boosted there remained great segmentation in Indonesia's loan market. In particular the state banks, due to their ownership structure, continued to enjoy a competitive edge over the private banks. Their relative advantage was based on their special relationships with public enterprises and government agencies. On the other hand, state-owned loan exposure was so large that the high refinancing costs made them financially very vulnerable. Cho and Khatkhate (1989) report a decline of the current profit as a ratio of total assets for all banks from 2.7 per cent in 1982 to 1.8 per cent in 1985. This decline could be an indication for increased competition but may also reflect serious losses resulting from nonperforming loans.

Although no precise figures are available, the exceedingly high interest rates suggest that Indonesia's financial system faced a serious problem of nonperforming loans after the interest rate reform. Compulsory areas of specialisation and other aspects of past credit policies have burdened state banks with illiquid financial instruments which carry artificially low interest rates while having a high risk of capital loss. Domestic private banks also suffered from this problem as shown by bank failures which occurred during sharp increases in interest rates which followed interest liberalisation in June 1983. The matters aggravated as banks used affiliated organisations to take excessive risks (see Nasution, 1991). For example, Bank Perkebangan Asia (which collapsed in 1984) invested heavily and disastrously in real estate loans that were booked by a holding affiliate.

An even more dramatic threat to the stability of the financial sector was imposed by the deregulation measures in the late 1980s, which have been accompanied by a tight monetary policy. At the end of 1990 interest rates were back to their level of the 1988 deregulation. The costs of intermediation have also returned to pre-1989 deregulation levels, as the spread between credit and deposit rates has risen from around 3-4 per cent in 1989 to over 6 per cent (Bulletin of Indonesian Economic Studies, 1990, p. 20). The higher cost of money had struck deeply into the profitability of many banks, particularly those that depend on interbank lending to fund themselves. Deregulation has increased overhead costs and operation risks for the whole financial system, stemming from competition for scarce experienced staff, which pushed wages up; fraud or gross

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mismanagement, rush towards expansion of risky, labor intensive, retail banking and consumer financing; establishment of affiliated organisations such as leasing companies and other non-bank financial institutions; and, inadequate systems of internal control of rapidly expanding banks.

The weakness of a banking system that has expanded rapidly in a short time with lax supervision in an open economy can be illustrated by the losses of Bank Duta, the second largest private national bank, in September 1990. Speculative foreign exchange trading has generated losses amounting to US\$ 420 million, twice the amount of the bank's total capital. The collapse of the bank and financial sector crisis could be prevented by a speedy injection of fresh money (grants) provided by their charitable foundations (yayasans) which are major shareholders of the bank. This action also shed light on another critical issue, the role of social foundations in Indonesia's business and financial sector. These widespread institutions enjoy a tax-exempt status and are free from regulation. Moreover, even with a comprehensive legal framework of prudential regulation and supervision the enforcement of these laws continues to be a problem.

Unresolved is also the future role of state-owned banks in Indonesia. Despite a big jump in private sector banking over three years of financial deregulation the seven state banks still control more than 60 per cent of bank credits and over 40 per cent of deposits. Government ownership per se produces no special issue of concern, especially when state-owned banks are faced with stiff competition from private banks and non-bank financial institutions. However, internal management problems as a result of political interference or the lack of expertise and incentives together with a high proportion of nonperforming assets on the books would urge privatisation. Furthermore, it is unclear whether state-owned banks should also meet the guidelines on capital adequacy ratio of 8 per cent of risk-weighted assets by the end of 1993, as claimed in the February 1991 package. For this purpose state banks, whose capital adequacy ratios average 5 to 6 per cent according to figures from the Central bank, would need an estimated amount of US\$ 4.5 billion of new capital and would have to be given access to new ways to raise money. Finally, competition among banks is distorted by the fact that deposits with state banks are explicitly or implicitly guaranteed by the government, and there is no deposit insurance in Indonesia for deposits with private financial institutions.

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## 4. The Monetary Policy Dilemma after Financial Deregulation

### 4.1. *The 'Sterilisation' Problem*

After the 1988 financial deregulation the Indonesian authorities were faced with a serious monetary policy dilemma. High domestic interest rates together with improvements in the business and investment climate have fostered both short-term and long-term capital inflows. In the absence of capital controls these inflows had an immediate expansionary impact on the monetary base. While the Central Bank was powerless to control the foreign component of the monetary base financial deregulation has made its influence on domestic credit less effective. Bank Indonesia's liquidity credits have been gradually reduced in the course of financial reform and continue to be provided only for limited purposes such as to support food sufficiency, development co-operatives and the enhancement of investment. Deregulation has also reduced the effectiveness of 'moral suasion' as an instrument of monetary policy, as the scope of special credit programs has diminished the dependency of state banks on the Central Bank. Following the deregulation Bank Indonesia had therefore to rely increasingly on other methods to affect the monetary base, namely open market operations, intervention in the foreign exchange market and direct sterilisation operations.

### 4.2. *Monetary Policy Instruments*

As a consequence of the 'balanced budget rule' under which the Indonesian government balances its budget deficits by foreign aid and by floating foreign currency denominated bonds in international markets there exists no treasury debt that can be used for open market operations. Efforts to develop the money market were undertaken by the Bank Indonesia when it introduced official discount instruments called Bank Indonesia Certificats (SBIs) on March 12, 1984 and a new set of money market securities (SBPUs) on January 28, 1985. The SBPUs consist of promissory notes either issued by customers of eligible banks or non-bank financial institutions or issued by these institutions themselves in connection with interbank borrowing as well as bills of exchange issued by third parties and endorsed by eligible financial institutions. SBIs have been used mainly for monetary contraction and SBPUs for monetary expansion (for the detailed features and trading mechanism of SBIs and SBPUs see Binhadi, 1990, pp. 32 ff.).



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As further instruments for open market operation, Bank Indonesia introduced discount window facilities and improved interbank market regulations. Discount window I provides short-term (three days) liquidity for banks to smoothen their daily management of funds and discount window II provides temporary (sixty days) liquidity for banks experiencing a mismatch between the inflow of fund and the drawdown of long-and medium-term credits. To support banks in smoothening interbank borrowing the Central Bank provides a settlement facility as part of an interbank clearing mechanism enabling banks to obtain funds in the interbank market before entering the discount window. In addition, Bank Indonesia can impose minimum reserve requirements as a means of regulating bank liquidity. Finally, the Central Bank also sets the foreign exchange rate and the premium on the foreign exchange swap facility that is offered to those qualified financial institutions and firms with future foreign exchange commitments.

#### *4.3. Monetary Policy Implementation*

Since implementing indirect monetary policy instruments in 1983, Bank Indonesia faced the dilemma of using these instruments simultaneously with developing the market of these instruments itself (see Binhadi and Meek, 1988). When the new monetary policy instruments were first introduced, the plan was that their issue price would fluctuate according to changing market conditions, and that active secondary markets would develop. In practice, Bank Indonesia stood ready to supply to banks or buy from banks whatever amounts they desired, at an (short-term) interest rate determined by Bank Indonesia. This has prevented the emergence of secondary markets, which could have facilitated Bank Indonesia's control over reserve money. In addition to the absence of an efficient, well developed money market, further complications arose by shaky financial institutions and the segmentation of credit markets.

Following the interest rate reform in June 1983, and, in particular, after the October 1989 financial deregulation, the interaction between monetary and exchange rate policy has become more intensive. With free (private) capital flows and a managed exchange rate, the domestic interest rate over the long-term has become mainly determined by the international interest rate and the expected rate of depreciation of the Rupiah. Among the factors affecting the expected rate of depreciation are the swap premium rate, the differential between domestic and international inflation, and the price of oil. Under these circumstances, monetary policy can affect long-term domestic interest rate mainly by

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maintaining low inflation rates thereby dampening expectations about exchange rate depreciations. In the short-term, monetary policy was used in Indonesia to protect domestic interest rates from destabilizing influences of speculative capital flight. In Indonesia, capital flows responding to interest rate differentials and exchange rate expectations were a major source of monetary disturbances. The new indirect monetary policy instruments that were developed after the financial reform initially played a minor role in affecting the monetary effects of the autonomous factors in 1983 (see Table 6). The Central Bank's ability to control bank liquidity was hampered by the continuation of the liquidity credit scheme and the desire to stabilize interest rates to support the economic recovery.

The difficulty to implement such policies with market-based monetary instruments can be illustrated by the following episode. After the 1988 financial deregulation Bank Indonesia pursued an expansionary policy in order to lower interest rates and to smoothen investments in the real sector. The result was a dramatic expansion of credit demand with a corresponding boom in housing, consumer goods and stock markets. At the same time capital outflow rose as rising inflation rates fuelled expectations for a major devaluation of the Rupiah. As a consequence Bank Indonesia tightened monetary expansion by increasing interest rates on both SBIs and SBPUs. But since the outflow continued unabated, a non-market based monetary contraction move was launched on February 27, 1991, when the government obligated 12 state enterprises to buy SBIs worth Rp. 8 trillion. Since the funds absorbed by Bank Indonesia could be used for the purchase of SBPUs from banks in need of liquidity to the extent of 75 per cent, the effective monetary squeeze amounted to Rp. 2 trillion. A similar intervention took already place at the end of June 1987, when the government ordered four state enterprises to withdraw deposits from the state commercial banks and to buy SBIs from the Central Bank (so-called first Sumarlin shock).

Table 6

FACTORS AFFECTING RESERVE MONEY, INDONESIA 1984-89 (A)  
(CHANGE AS A PER CENT OF RESERVE MONEY AT BEGINNING OF PERIOD)

	1984	1985	1986	1987	1988	1989
Autonomous factors	19.7	-19.0	12.9	-18.6	17.3	-17.6
Net foreign assets	55.0	30.5	5.0	14.7	39.7	-26.7
Net claims on Government	-38.5	-50.7	17.9	-26.2	22.3	8.5
Net claims on private sector (b)	-10.8	-3.0	2.1	2.9	2.2	1.8
Net other items	14.0	4.2	-12.1	-10.1	-46.9	-1.1
Policy factors	10.2	31.7	16.8	33.3	-23.1	-3.2
Liquidity credit to banks	12.4	25.0	16.4	15.6	16.5	31.8
New indirect policy instruments	-1.1	3.4	0.2	8.9	-19.8	-17.5
New Bank Indonesia facilities (c)	-	7.1	19.9	-7.4	-12.2	0.2
Open market operations (d)	-1.1	-3.7	-19.7	16.3	-7.6	17.8
Reserve money	31.0	9.3	29.5	5.8	14.0	-3.3

(a) Year ending March. Positive sign indicates an increase in assets or a decline in liabilities, that is, an expansionary factor; negative sign indicates a decrease in assets or an increase in liabilities, that is, a contractionary factor;

(b) Until 1985, data include claims on nonfinancial and financial public enterprise and the private sectors. From 1986, data include claims on public enterprises and the private sector;

(c) New central bank facilities for discounting of money market papers;

(d) Central bank debt certificates - Sertifikat Bank Indonesia (SBI).

Source: Tseng and Corker (1991, Table 5).

Further financial deregulation therefore requires the establishment and deepening of money and securities markets. Presently, various factors discourage the development of these markets. The taxation of interest income on bank deposits is at a rate of 15 per cent, while government securities are subject to the income tax where the top rate is 35 per cent. In addition, government securities carry below-market yields and are often sold to captive buyers, such as the public pension fund which is owned by government employees and the state banks. Finally, the balanced-budget policy and the still heavy reliance of government revenues on concessional borrowing and aid act to create a shortage of government securities on the domestic market.

## 5. Lessons for the Sequencing of Financial Reforms

Indonesia's experience with financial deregulation in the framework of an open capital account provides some important insights for the ongoing debate on the optimal sequencing of financial reforms in developing countries:



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Firstly, contrary to the sequencing suggested in the literature, financial opening can well proceed domestic financial deregulation without major pitfalls. The open capital account has certainly imposed restraints on both fiscal and monetary policy in Indonesia over the last two decades. But this constraint was healthy by imposing a discipline to maintain a certain degree of macroeconomic stability. However, the Indonesian case also demonstrates that an open capital account requires a good and flexible macroeconomic management.

Secondly, it is worth to keep some institutional characteristics in mind that explain Indonesia's success in keeping inflation low and exchange rates competitive in spite of open capital markets. In the past, the Indonesian government controlled a high share of foreign exchange earning through oil and gas receipts which could be used to counteract movements in the private capital account of the country. On the other hand, the private sector lacked creditworthiness on offshore markets until recently. Growing exports have allowed Indonesian companies to gain international credit standing while the government share in foreign exchange has been shrinking. These developments have raised the need to interfere into the liquidity of the domestic banking system.

Thirdly, the Indonesian example points to the need of developing money markets with a significant depth before domestic financial deregulation takes place in a financially open economy. It has proven to be extremely difficult to use monetary policy instruments and to develop their markets at the same time. Therefore, such markets should be established before the Central Bank loses its direct control on the monetary base in the course of financial deregulation.

Finally, what should have been a prerequisite for financial reforms, is only now a primary concern for Bank Indonesia; the strengthening of prudential regulation and the improvement of bank supervision. As risks in the financial system increase as a result of more intensified competition, greater market volatility and uncertainty after deregulation and liberalisation, the authorities have to establish 'rules of the game' for commercial banks, to provide guidelines for minimum capital requirements, and to develop early-warning systems.

## Appendix

### FINANCIAL REFORM MEASURES SINCE 1988

#### October (Pacto 27) and December 1988 Package

- permitting the entry of new private banks, including joint-venture with foreign banks;
- allowing domestic banks to open branches throughout Indonesia and non bank financial institutions and foreign banks to open offices in seven major cities;
- permitting new rural banks to be established in districts outside the capital;
- easing the requirements to become a foreign exchange bank;
- allowing state enterprises to place up to 50 per cent of their deposits with private banks and non-bank financial institutions;
- allowing non-bank financial institutions to issue certificates of deposits;
- laying a withholding tax of 15 per cent on time deposits and certificated deposits, which eliminated the discrimination against other securities market instruments;
- establishing an 'over the counter' market to enable smaller firms to issue shares;
- permitting banks and non-bank financial institutions to raise capital from securities market;
- simplifying the entry into insurance, leasing, consumer finance, venture capital and securities activities;
- defining loan concentration ratios for banks and non-banks financial institutions that limit lending to a single borrower or group;
- specifying minimum capital requirements for banks and non-banks financial institutions and solvency ratios for insurance companies;
- eliminating differential reserve requirement for banks and liability categories by establishing a uniform and reduced rate of 2 per cent;
- extending the maturities on monetary instruments and taking steps to develop the secondary market;
- relating the reswap premium on foreign exchange transactions to interest rate differentials;
- establishing stock exchange outside Jakarta, creating more active stocks trading at the Jakarta Bourse and opening opportunities for the private sector to use the stock exchange

#### March 1989 Package (PAKMAR 1989)

- constituted further classification of the deregulatory measures of October 1988;
- abolishing the ceiling on foreign borrowing by foreign exchange banks and non-banks financial institutions;
- introducing a maximum limit for banks' net foreign exchange position of not more than 1.5 per cent of own capital, applicable on a daily base

#### January 1990 Package (PAKJAN 1990)

Reduction of the sectors eligible for liquidity credits. Liquidity credit will only be made available for activities which support cooperatives, investment, and the achievement of self sufficiency in food. Interest rates were raised much closer to market rates. Furthermore, to encourage the development of small scale business and to foster the objective of equitable distributions, all banks (except foreign and venture banks) are required to allocate 20 per cent of their outstanding credit to customers with assets of less than Rp. 600 million.

#### February 1991 Package (PAKFEB 1991)

Programs to strengthen individual banking institutions and to improve the banking supervision system. Among the most important measures are:

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- to establish a bank branch domestically or overseas for the proceeding 24 months, the bank must be rated for at least 20 months as sound and rated fairly sound for the remaining months;
  - the numbers of the board of directors should have sufficient banking experience and do not have family ties either to another member of the board of directors or to a member of the board of commissioners;
  - recognition of prudential principles in bank management, consisting of capital, quality of earnings assets and reserve formation, loan guarantee, limitation for stock's purchasing and ownership, legal lending limit, bank activities in capital market, margin trading, net open position, swap and reswap, as well as electronic data processing by bank;
  - every bank has to meet Bank of International Settlement guidelines on capital adequacy ratio of 8 per cent of risk-weighted assets by December 1993. Beyond that banks should have reserves on classified earnings assets (at least 1 per cent of earning asset plus 3 per cent from sub-standard assets, 50 per cent from doubtful assets and 200 per cent from loss assets);
  - obligation for banks to provide an education budget of at least 5 per cent from a bank's personnel budget in order to develop further professionalism in the banking institution.

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## Abstract

*The article analyses Indonesia's experience with financial deregulation in the framework of an open capital account. A major finding is that - contrary to the sequencing suggested in the literature - financial opening can well proceed domestic financial deregulation without major pitfalls. Indonesia could not only avoid widespread financial crises but was also successful in fostering economic growth, diversifying exports and keeping inflation at low levels.*

*Moderate inflation and competitive exchange rates in the context of open capital markets were mainly achieved by the following factors:*

- *the open capital account imposed a discipline for fiscal and monetary policy to maintain a certain degree of macroeconomic stability;*
- *the Indonesian government controlled a high share of foreign exchange earnings through oil and gas receipts which could be used to counteract movements in the private capital account.*

*The Indonesian experience also points to the need of developing money markets with a significant depth, of strengthening prudential regulation and of improving bank supervision before domestic financial deregulation takes place.*

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## Résumé

### LA DÉRÈGLEMENTATION FINANCIÈRE DANS UNE ÉCONOMIE EN DÉVELOPPEMENT OUVERTE: LA LEÇON DE L'EXPERIENCE INDONESIENNE

*L'article analyse l'expérience de l'Indonésie avec des dérégulations financières dans le contexte des mouvements de capitaux libres. Un résultat important est que - au contraire de le 'sequencing' proposé dans la littérature - l'ouverture financière peut précéder la dérégulation financière domestique sans produire des majeurs échecs. L'Indonésie ne pouvait seulement éviter des crises financières universelles mais aussi réaliser une croissance forte de l'économie, diversifier ses exportations et maintenir l'inflation sur un niveau bas.*

*Une inflation modérée avec des cours du change compétitives étaient le résultat des facteurs suivants:*

- les mouvements des capitaux libres imposaient une discipline pour la politique fiscale et monétaire de maintenir un degré certain de stabilité macroéconomique;
- le gouvernement Indonésien contrôlait une part élevée des revenus de devises par l'exportation de pétrole et gaz qui étaient à disposition pour compenser les mouvements des capitaux privés.

*L'expérience Indonésienne aussi met en évidence l'importance de développer des marchés de monnaie avec une profondeur significative, de fortifier la régulation prudentielle et d'améliorer la supervision des banques avant la dérégulation financière domestique est réalisée.*



