Comments on Jonathan Fiechter and Krirk Vanikkul (2007), "Financial Sector Reform after the Crisis": the case of Indonesia

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These excellent papers analyze the causes of financial crisis in East Asia in 1997-98 and policy responses to rebuild the financial sectors. In terms of assets and branch networks, banking system was the core of financial systems in the crisis-hit countries. At that time, the system in Indonesia was dominated by state-owned banks and banks affiliated with business conglomerates. The paper rightly identifies the origins of financial instability, namely, twin crisis or simultaneous occurrence of a banking crisis and a currency crisis. The crisis was the consequence of short-term capital flows that had been encouraged by both macroeconomic policies and weak implementation of prudential rules and regulations of the banking system. A combination of fixed exchange rate policy and high domestic interest rates in these countries promoted banks and the corporate sector to rely on short-term and un-hedged foreign currency loans for financing longer-term illiquid domestic projects, including in non-traded sector of the economy. Lax bank supervision allowed banks to violate capital adequacy ratio, net open position and legal lending limits regulations. Credits of state-banks were mainly directed or program lending and loans of private banks were mainly connected lending. As they were regarded as arm-length of government bureaucracy, state- owned banks were subject to political influence.

Missed the golden opportunity: The Dutch disease

Indonesia seems not to have changed much since the crisis. It is true that it has made some improvements in its macroeconomic policies. To reduce vulnerability to capital flow induced crisis, the fixed exchange rate system was replaced with independent floating in 1997. The anchor of monetary policy was replaced by inflation targeting. Because of fear of floating, Bank Indonesia gradually increases its intervention in foreign exchange market to stabilize exchange rate. The economic stabilization policy was supported by a prudent fiscal policy by limiting budget deficit to around 1,5 percent of annual GDP. A large share of the budget expenditures, however, is for subsidies on refined oil, debt repayments and internal armed conflicts.

Indonesia misses the opportunity from the on going boom in the prices of primary commodities. The boom has caused the so called Dutch disease: an overvalued exchange rate that favors imports and helps to reduce inflation rates, but reduces international competitiveness of some domestic agriculture and manufactures. Domestically, the overvalued exchange rate raises prices of non-traded goods relative to traded ones. Unlike during the first oil boom in the 1970s, it fails to channel the windfall to modernize its economy and to build economic infrastructure, health care and education that is

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required for economic growth. Mainly because of the boom, economic growth rates have picking up to nearly 6 percent particularly in producing areas outside Java. Partly because of distorted labor policy and lack of infrastructures, long-term investment hardly increased during the past ten years. Increase in productivity is very slow due to low real expenditures on education and health care. The high growth rate induced by the boom creates little new employment particularly in a densely populated island of Java and kills agriculture and manufacturing sectors on this main island.

The rapid increase in export revenues because of the boom and inflow of the short-term capital have allowed Indonesia to build up foreign reserves as self-insurance against the risk of a sudden capital flow reversal. The recent volatile capital inflows are mainly to buy government bonds for financing the budget deficit and Bank Indonesia Certificates (SBI). Extra resources come from the two programs introduced in this region for resource pooling to supplement the IMF facilities. The network of Bilateral Swap Arrangements (BSA) was introduced in March 2000 under the Chiang Mai Initiatives (CMI) and the Asian Bond Funds (ABF) created by EMEAP, the group of 11 regional central banks, in 2003.

Institutional reforms

Institutional reforms have been introduced as an integral part of the financial sector reforms. The first set of policies is aimed to recapitalize the financially distressed banks by an injection of government bonds amounted to 50 percent of Indonesia's annual GDP of 1998. Unlike Japan and China, Indonesia does not have enough external reserves to recapitalize banks. In the case of Indonesia, some of the bonds are illiquid partly because they are non-traded. The second set of the policies is to reduce reliance on short-term financing from the banking system by developing more stable long term financing from local and regional securities and derivative markets.

The third set of policy measures is to strengthen financial infrastructure by upgrading governance, prudential supervision, and establishing safety net for the banking system as well as the more complex institutions that surround bond and capital markets. The bond market in this country is, however, still in early stage of development as both institutional investors and a market infrastructure are needed to be developed. The illiquidity of capital and portfolio of the banks has limited their capability to expand credit. Banks' profit is mainly generated from interest income from these sovereign bonds and central bank's papers and not from interest income.

A number of measures have been adopted to enhance bank supervision capacity by the central bank. These include programs to enhance skill supervision teams, to develop supervision framework that meet international best practices and to set permanent on-site supervisory presence at big banks. New prudential rules and regulations introduced to comply with the Basel Core Principles. Following the British model, an independent Financial Sector Supervisory Agency will be established in 2010 to supervise all financial institutions. On the other hand, the banks have not only assisted to solve their solvency and illiquidity problems but have also encouraged to modernize technology, human resources, including corporate culture. Human resources of the banks are upgraded by removing controlling shareholders and managers found to be “unfit and improper” and by relaxing restrictions for foreigners to work in domestic banks. These help reduce risks of (i) uncompensated wealth transfer, particularly fraud and outright debt (ii) incompetence and (iii) negligence of bank owners and managers.

The fourth set of policies is to consolidate the banking industry, privatize the assets taken over by IBRA (Indonesian Bank Restructuring Agency) from the sour banks and to allow greater penetration of foreign financial institutions into domestic financial market. Between 1997 and 2007 total number of banks reduced from 237 to 130: state owned banks reduced from 7 to 5; domestic private banks from 160 to 71; foreign and joint venture banks reduced from 43 to 28. Each province in Indonesia owns a regional development bank. With independence of the now Timor Leste in 2000, the number of regional development banks reduced from 27 in 1997 to 26 at present. The newly seven created provinces have not set up their owned banks.

The economic crisis has also encouraged painful structural changes, including radical restructuring of high leveraged companies. The controlling families of the conglomerates and are now inviting outside shareholders, including foreign investors, and are forced to sell companies unrelated to their core business and diversify into new high margin businesses. To survive in more competitive markets, they have to cut costs, improve efficiency, to upgrade quality of products and to increase marketing abilities as well as brand image. The traditional lifelong of employment is replaced with performance, merit and results rather than seniority and age.

Equipped with good reputation, wide international network, advanced information technology and rapid product innovations, foreign banks attract prime customers. By appointing knowledgeable and experienced personnel in the relevant fields and using local expertise, foreign banks out compete local competitors in serving SMEs and in developing new markets such as the Islamic banking which is mainly based on risk-sharing. The fifth set of the policies is to strengthen legal infrastructure for enforcing contracts and improving bankruptcy laws and proceedings. The sixth measure is to establish a debtor information system or a credit bureau as a venue for sharing information among bankers. The seventh set of the policies is to replace the generous blanket guarantee, that was introduced in 1997, with a regular limited deposit insurance scheme.

To conclude, new regulations are now in place to implement the New Capital Accord as required by Basel II. The regulations have set minimum capital requirements and clearly define what constitutes capital. A supervisory review process has been established that recognizes the correlation between regulatory capital and the strength as well as effectiveness of internal control and risk management processes. Market discipline has been improved with the improvement of transparency and disclosure and timely reporting.

Back to old bad habits……………

While many institutional reforms look good on paper, they have in fact remained quite limited. State influence remain strong particularly on state-owned enterprises (SOEs), including banks. As the state still holds ‘golden share’, managements of the SOEs are still appointed by and accounted to the government. This has prevented the needed corporate government reforms that would enhance transparency and accountability, protect minority share holders and remove the old practices of crony capitalism. The legal system remains very weak that makes enforcement of contract, accounting standards virtually absent and bankruptcy resolutions insufficient.

Both governance of Bank Indonesia, the central bank, and implementation of bank’s prudential rules and regulations are markedly deteriorated in the past three years. The report prepared by the State Audit Board of Indonesia to Corruption Eradication Commission (KPK) indicates a serious bookkeeping manipulation or fraud and alleged bribery by Bank Indonesia in 2004. In June 2004, there was a withdrawal of funds by Bank Indonesia amounted to Rp100 billions (roughly equivalent to over USD100 millions at the exchange rate Rp9,290 to the US dollar) from its training foundation (YPPI). The funds were not recorded as revenue in Bank Indonesia’s book, not reported in its Financial Statement for the Year of 2004 and disappear from the foundation’s book. Of this amount, Rp68.5 billions was allegedly used to influence prosecutors at the Attorney General to drop the cases of former Directors of Bank Indonesia who managed the central bank during the time of crisis in 1997. They might also involved in other alleged criminal cases with regards to shady enforcements of capital adequacy ratio, legal lending limits and net open positions that had led to the banking crisis. In addition, there are allegations of their involvements with the misuse of export credit facility during the crisis.

During their terms in office, Bank Indonesia was directly involved in many transactions of NV Indover of the Nederland that can be classified, using today’s terminology, as money laundering. The money laundering includes the refinancing of PT Bank Duta that was collapsed due to foreign exchange speculation in 1990. In the beginning, Indover injected USD115 millions to rescue the bank with full guarantee from Bank Indonesia. The loan was repaid by four cronies of President Suharto who injected USD425 to *Yayasan Supersemar*, one of the three foundations controlled by the President which own the bank. Part of the injected funds was originated from credit received by the cronies from the now defunct state-owned bank, PT Bank Dagang Negara. Until now the credit has not been repaid. Fully owned by Bank Indonesia, NV Indover is a commercial bank based in Holland. Its main source of funds comes from the placement of external reserves of Bank Indonesia in that institution. The rest of YPPI funds (Rp31.5 billions) withdrawn by Bank Indonesia in 2004 has been spend unclearly.

Compliance with prudential rules and regulations has also been sharply eroded recently. Those who seriously violated prudential rules and regulations governing the banking system before and after the crisis in 1997-98 are now being allowed to become controlling shareholders and manage banks and even sit in the Supervisory Board of Bank Indonesia.