

## Chapter III

# The Background and Causes of the Current Financial Crisis in Indonesia

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### 1. Introduction

The current financial crisis in Indonesia originated mainly from its excessive reliance on foreign capital flows and the weak banking sector. This paper attempts to explain the background and to analyze the causes of the current financial crisis in Indonesia through discussions on the following major questions:

- (a) Why have massive capital inflows continued over the last 10 years? Does interest rate arbitration, as many economists assume, take place in less developed countries (LDCs) ?
- (b) Do all players in the LDCs' financial markets play consistently with the modern market discipline? Are there critical inconsistencies among the modern market mechanism, existing financial institutions, and the traditional social behavior which may cause a moral hazard in the banking system?
- (c) Are macroeconomic policies, i.e. orthodox monetary and fiscal policies, effective in managing Indonesian economic problems in the 1990s?

The next section explains the changing structure of financing Indonesia's balance of payments in the 1990s and the mechanism of rapid external debt accumulation, which has made the Indonesian economy extremely vulnerable to external shocks. The third section analyzes a

typical bank behavior which caused non-performing assets to accumulate in the Indonesian banking sector. The fourth section documents the macroeconomic policies introduced by the Indonesian Government and assesses their limited effectiveness. The fifth section summarizes the above discussions.

## **2. International Capital Flows, External Debt, and Appreciation Pressures**

### **2-1. International Capital Inflows**

Over the last 10 years, international capital inflows to Southeast Asian countries have been spurred. In particular, private capital flows have surged rapidly<sup>1</sup>. In sharp contrast, net official flows declined as a source of external finance during this period. Private capital flows have far exceed official flows in the 1990s. The countries in this region have entered a new age of globalized and integrated international capital flows. This is evident from changes in the financing structure of the Indonesian balance of payments. (see **Table-1**) The government's role in financing Indonesia's balance of payments became negligibly small (in net basis) during the 1990s, while the private sector's role increased substantially from almost nil in 1989 to over 13 billion dollars in 1996. The shift of capital flows from official to private sources matched the shift from the government taking the leading role in economic development to the private sector taking the lead during the last 10 years.

The changing composition of capital flows has weakened the ability of Indonesia's external debt management system and the role of international aid consortia (Consultative Group for Indonesia; CGI) in supervising its external debt. The Indonesian Government and the international consortia have not developed a system to manage external debt under the new age of globalized and integrated international capital flows.

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<sup>1</sup> See World Bank. 1997. Private Capital Flows to Developing Countries. Oxford: Oxford University Press.

**Table-1 Balance of Payments and Its Finance**

Unit: million US dollars

	Current account	Capital account		
		Government	Private	Change in reserve
83/84	-4,151	4,783	1,192	2,070
84/85	-1,968	2,227	499	667
85/86	-1,832	1,788	572	30
86/87	-4,051	3,343	1,232	-738
87/88	-1,706	1,526	1,709	1,586
88/89	-1,859	2,825	-211	-677
89/90	-1,599	1,830	575	248
90/91	-3,741	924	5,856	3,302
91/92	-4,352	1,418	4,133	981
92/93	-2,561	915	4,284	1,439
93/94	-2,940	1,063	4,648	727
94/95	-3,488	105	4,645	616
95/96	-6,987	-209	11,672	2,651
96/97	-8,069	-820	13,488	3,898

Source: Bank Indonesia, "Indonesian Financial Statistics," Sept. 1997

A continuation and concentration of capital inflows have been closely linked to the macro economic performance of the recipient countries and the economic boom in the Southeast Asian region. In theory, the potential benefits of international capital inflows are clear. The capital flows are directed toward the world's most productive investment opportunities, thus increasing economic growth. On the other hand, there is an increasing vulnerability in the LDCs' economies because of heavy dependence on foreign capital and exposure to excessive external debt as a consequence of the integration into international financial markets.

Despite government policies to slow down overheating economies and to curve capital inflows, private capital flows appeared surprisingly robust and continuous until the summer of 1997 when the financial crisis hit Southeast Asian countries. The next section discusses the mechanism of such capital inflows into the Indonesian economy.

## 2-2. Interest Arbitration

Economists assume the basic principle of the "law of one price". It means that under free capital mobility an asset's price must be equal wherever the markets are. In this context, a domestic interest rate must equal an interest rate in international markets plus forward cover. This relationship can be expressed in the following equation:

$$i = i^* + fp \quad (1)$$

(  $i$  : domestic interest rate;  $i^*$  : interest rate in international markets represented by the US dollar at the Singapore Inter-bank Offering Rate, SIBOR;  $fp$  : a forward exchange rate premium )

Forward foreign exchange was traded only on a bilateral basis in Indonesia and there were no official statistics for forward premium available. Through various discussions with Indonesian banks and institutions, it can be concluded that the level of domestic interest rates ( $i$ ) has remained far higher than the sum of the international interest rate and the bilateral forward exchange rate premium ( $i^* + fp$ ) for most of the time during the last 10 years. In theory, the forward premium can be divided into two factors; expected exchange rate and risk premium, since there was no indicator for the expected exchange rate, an actual rate of rupiah depreciation was used as a substitute for the expected exchange rate changes. Then the above equation can be written as follows:

$$i = i^* + e + rp \quad (2)$$

(  $e$  : actual change in foreign exchange rate changes as a substitute for the expected depreciation rate;  $rp$  : risk premium)

This is a typical equation explaining interest arbitration, and it appears in economic textbooks. The last item of the equation (2),  $rp$ , or ( $i - i^* - e$ ) represents an implicit risk premium. It is evident that the risk of holding Indonesian rupiah, i.e. the risk premium, has declined over time as the Indonesian economy continued to develop. It is also evident from observing the behavior of domestic and foreign investors, exposed to the foreign exchange risks that their perceived risk premium has declined to a negligible level towards the mid 1990s. However, as you see from **Table-2**, the calculated implicit risk premium reached around 12% between 1990 to 1993 and remained at around 6% between 1993 to 1996. These calculated risk premiums were much higher than the risk investors perceived. In other words, the left hand side (domestic interest rate) of the equation (2) has been continuously higher than the right hand side (covered international interest rate)<sup>2</sup>. This implies that the interest did not take place throughout the last 10 years. Therefore massive capital inflows continued and the external indebtedness increased without

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<sup>2</sup> See Komatsu, Masaaki. 1995, "Some Issues in Financial Sector under Financial Liberalization and Free Capital Flows: Case of Indonesia", in Ito, Kazuhisa edited, Reform and Internationalization of Developing Countries, February 1995, Tokyo: Institute of Developing Economies . (in Japanese)

limit. The above imperfection in the interest arbitrage may have resulted from imperfect adjustments in underdeveloped domestic financial and foreign exchange markets, including the forward markets.

**Table-2 Interest Rate Differentials**

End of period

Unit: rupiah, %

	rp/US\$	Change in rupiah rate(e)	Change in CPI(pc)	Change in CPI in US(pc*)	SIBOR (i*) 3 months	rp deposit rate (i) 3 months	i-i*	i-(i*+e)	i-(i*+pc-pc*)
85/86	1,133	2.60	5.70	3.80	8.00	14.70	6.70	4.10	4.80
86/87	1,652	31.40	8.80	1.90	6.40	15.20	8.80	-22.70	1.80
87/88	1,663	0.70	8.30	3.73	7.40	17.40	10.00	9.30	5.40
88/89	1,753	5.20	6.60	3.97	10.20	18.00	7.80	2.60	5.20
89/90	1,823	3.80	5.50	4.82	8.50	16.20	7.70	3.90	7.10
90/91	1,932	5.60	9.10	5.38	6.40	24.20	17.80	12.10	14.00
91/92	2,017	4.20	9.80	4.28	4.40	21.30	16.90	12.70	11.40
92/93	2,071	2.60	10.00	3.00	3.82	18.21	14.39	11.79	7.39
93/94	2,144	3.52	7.04	2.98	3.38	13.42	10.04	6.52	5.98
94/95	2,219	3.50	8.57	2.53	4.91	13.63	8.72	5.22	2.68
95/96	2,338	5.36	8.86	2.82	6.00	17.22	11.22	5.86	5.18
96/97	2,419	3.46	5.17	2.92	5.52	17.09	11.57	8.11	9.32
97 Sept.	3,275	\(35.39\)	Sept(3.45) Year(6.9)	-	5.76	17.16	11.40	-23.99	

Perfect arbitration in interest rates under the free capital mobility, in other words the "law of one price", assumed by typical economic textbooks did not hold in Indonesia over the last 10 years. This fact was also observed in many other countries, particularly in developing countries where domestic financial markets and foreign exchange markets are still in the early development stage. As a result, one sided capital inflows continued for a long period until the crisis burst.

### 2-3. Pressures on the Rupiah Exchange Rate

The continuous massive capital inflows caused upward pressures on foreign exchange rates. Since a major devaluation of the rupiah in September 1986, the Indonesian Government has taken an exchange rate policy of maintaining the real effective exchange rates at a constant level. In other words, the Central Bank has been adjusting the rupiah exchange rate vis-à-vis to the foreign currencies according to the inflation rate differentials

(Figure 1 to be inserted on this page)

between domestic and foreign markets. In practice, the rupiah exchange rate has been adjusted downward on a daily basis to about an annual rate of 3 to 5% between 1986 and 1996. This policy has maintained the real value of rupiah to a roughly constant level for more than 10 years. (see column 2 of **Table-2**)

During the last few years, however, there have been upward pressures on the real value of the rupiah. The first factor of upward pressures stemmed from third currency movements, i.e. the appreciation of the US dollar vis-à-vis to the Japanese yen, and the second factor came from foreign exchange market pressures.

From 1986 to the mid last year, Indonesia was under the managed floating system. The rupiah exchange rate was set on a daily basis by the Central Bank, and the rate was allowed to fluctuate within an intervention band. The Central Bank set the upper and lower intervention bands at which the Central Bank was prepared to intervene to sell or buy US dollars. Since 1992, the Central Bank has widened the intervention band incrementally in order to provide more room for exchange rate fluctuations to absorb shocks. When the Central Bank widened the intervention band, the rupiah exchange rates appreciated and remained at around the upper intervention band (in other words, appreciated) during the last few years.(see **Figure-1**) These upward pressures on the real value of the rupiah stemmed from massive capital inflows, which has resulted in an over supply of the US dollar in domestic foreign exchange markets and thus caused appreciation of the rupiah.

### **3. Banking Sector Problems<sup>3</sup>**

#### **3-1. Problems of the Banking Sector - Accumulation of Non-Performing Assets**

The financial deregulation policies introduced in 1984 and 1988 have accelerated development of the Indonesian financial sector. However, rapid financial development and sharp increases in commercial banks' credits in the 1990s resulted in an increase in

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<sup>3</sup> See Komatsu, Masaaki. 1996, "Financial Development in Developing Countries", in Ishikawa, Shigeru edited, Appraisal of Policies for Development Cooperation, March 1996, Tokyo: Institute of Developing Economies (in Japanese).

non-performing assets and weakened the banking sector. The weak banking sector is one of the major causes of the current crisis. This chapter discusses the mechanism of accumulating non-performing assets in the banking sector.

Over the last decade, Indonesia has recorded remarkable economic development and shown rapid financial deepening. This is also the process of transforming the Indonesian economy from a traditional family group economy to a modern market economy. However, all factors involved in this process does not necessarily develop consistently at the same speed.

The Indonesian banking sector remains in its early stages of development, and in some aspects it is immature. Therefore, the financial sector is not functioning as well as that of the international market. Financial transactions are bound by the existing financial institutions and institutional settings (e.g. legal system). Community traditions and customs also effect the players in the markets. Under these circumstances, financial deregulation and integration into the international financial markets have tended to develop financial technologies without the development of social and institutional factors. These inconsistencies among the modern market mechanism, financial institution, and traditional social behavior have caused an increase in non-performing assets in the banking sectors.

### **3-2. State Owned Banks**

#### *(1) Structure and Behavior of State Owned Banks*

**Figure 2-1** shows the structure and behavior of state owned banks. This explains the typical mechanism of accumulating non-performing assets in state owned banks before the deregulation. However, after deregulation, the management of state owned banks and, particularly, the typical behavior of managers remained without major change.

The government appoints section management of the state owned banks, and some of them also hold posts with the government or the Central Bank. Some senior managers were once government officials. Government guidance and instruction strongly affect management strategy. Banking decisions are often made from a political point of view, which may contradict the commercial and the financial discipline. Under this situation, the most important factors affecting the decision of the managers is to know the intentions of the government and the politicians,



rather than develop financial intermediation like credit analysis, which is a major banking function. Such loans without sufficient credit analysis tend to become non-performing. In such case bank managers incline to hide them by rolling them over or by creating new loans. This is a typical "forbearance policy". The ministry of finance and the Central Bank are responsible for bank supervision. As the structure and behavior discussed above, the ministry of finance and the Central Bank supervision appears to be insufficient.

From the point of view of depositors and international lenders, state owned banks are the safest of all; there seems to be the government safety net under them. A tacit understanding exists that the government will not let the state owned banks go bankrupt. With such understanding depositors and lenders continued to provide funds into state owned banks without reviewing their risks, which led to the rapid expansion of bank credits.

The above relationship among the bank managers, the depositors/international lenders, and the supervisors is called "moral hazard". As explained above, political intervention and bureaucratic behavior of the managers caused non-performing assets to accumulate in the state owned banks. This is a classical case of governmental failure.

## *(2) Accumulation of Non-performing Assets in State Owned Banks*

Government failure is not the only reason for the accumulation of non-performing assets in state owned banks. State owned banks' accumulation of non-performing assets has accelerated since 1990. It suggests that even under the financial deregulation process the state owned banks' lending turned into non-performing assets.

Under financial deregulation, state owned banks must compete with other banks based on the market mechanism. Both state owned and private banks offered high interest rates to absorb domestic deposits, and they also increased overseas borrowings, and in turn increased their lending. Lending without proper credit analysis increased, and consequently, non-performing assets increased drastically. This is one of the reasons why non-performing assets accumulated in the state owned banks during the early stages of financial deregulation.

### 3-3. Business Group Banks

#### *(1) Structure and Behavior of the Business Group Banks*

In Indonesia, two types of bank exist, state owned banks and private banks. Most of the private banks belong to business groups such as overseas Chinese groups. Chinese business groups take hold of the Indonesian private economy. Some big business groups already had their own banks before deregulation, but many established after the deregulation.

Capital and management are not clearly separated in the business group banks. A member of the owner family or a person close to him usually becomes the senior management of the bank. These business group banks absorb deposits from the public and lend them mainly to firms within the group.

In these cases both lenders and borrowers belong to the same group and have a close relationship. It is not a modern market transaction with financial intermediation, but it is more like bilateral financing within a group. The business group banks are not undertaking financial intermediary function, which is a core role of the modern banking system. Within the group, the information is symmetrical and perfect, however, for the concerned depositors, who are certainly outside the group, the information is asymmetrical.(see **Figure 2-2**) This situation creates a moral hazard in the group banks, which is explained below.

#### *(2) Accumulation of Non-performing Assets in Business Group Banks*

Non-performing assets of private banks are relatively low compared to state owned banks, but they are increasing rapidly in the 1990s. However, several private banks went into troubles in the 1990s<sup>4</sup>. Most of them were group banks with a high concentration of loans to its own group.

Business group banks are family firms, but they are taking the form of modern limited companies as listed on the Jakarta Stock Exchange, while these banks are established to channel funds to group firms. Consequently, the ratio of loans to group enterprises are excessively high, often higher than the legal lending limit set by the Central Bank. However, there are number of ways to circumvent the prudential rules.

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<sup>4</sup> Bank Summa is a typical example of this case.

Within the business group, the firm holds a close relationship similar to a family structure where the members bear unlimited obligation to each other, while the bank in a form of limited company, bears limited liabilities to their depositors and international leaders. So it is natural for the group bank to give priority to firms within the group. When loans to group firms turned into non-performing assets, the bank tended to continue injecting funds, even at the high cost of funding, in order to rescue the troubled firm. This is called "adverse selection" by the banks. Once the member firm collapses, damages are serious and often lead to failure of the bank, while the bank's liability is limited to its own capital.

Within the business group, both lenders and borrowers share all of the business group's information. The information is symmetrical and perfect. (see **Figure 2-2**) On the other hand, the group does not disclose all of its information to outside depositors. The information is asymmetrical and imperfect in this case. Having insufficient information, outside depositors do not know which bank is vulnerable or sound. They tend to deposit money to in the banks offering higher interest rates. The inconsistencies between development of a modern financial system and traditional social behavior cause moral hazard and thus cause the accumulation of non-performing assets in the business group banks.

## **4. Effectiveness of Macroeconomic Policies**

### **4-1. Monetary Policies<sup>5</sup>**

In Indonesia, monetary policy relied on two main instruments: 1) the quantitative control of liquidity and direct credits, which the Central Bank lends to the commercial banks and also to the non bank institutions; and 2) the rate and amount of SBI (Sertifikasi Bank Indonesia), which the Central Bank issues liabilities against itself. The first instrument became less effective after the government introduced financial deregulation policies in 1984 and 1988, which intended to minimize government interventions into commercial banking activities and announced the fade out of the Central Bank liquidity and direct credits.

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<sup>5</sup> See Komatsu, Masaaki, 1992, "Monetary Policies and Money Markets in Indonesia", Working Paper No. 11,

The second instrument became a major tool to control the money supply after the late 1980s. Control over the second instrument has been weakened to the extent that the monetary authority will fix an exchange rate, thus obliging the Central bank to issue money against the presentation of foreign exchange. As a consequence of massive capital inflows in the 1990s, pressures on supply of reserve money have increased and growth rates of M1 have recorded well above the target rates. This is a first issue in monetary policy effectiveness. (see **Table-3**)

**Table-3 Factors Affecting Money Supply**

unit: billions of rupiah

	Currency in circulation	Gold and foreign assets	Claim of public sector minus gov. account	Claims on banks	Money market securities	Bank Indonesia certificates
86*	985	79	-14,076	1,039	555	222
87	357	3,084	-12,462	1,589	-967	-125
88	462	-718	-10,408	3,211	0	2,974
89	1,436	108	-8,891	1,768	0	364
90	1,963	6,090	-12,456	-1,572	0	1,772
91	520	7,229	-17,485	426	4,343	-9,413
92	2,238	9,414	-18,545	488	-1,470	-9,653
93	3,234	4,978	-17,019	-2,278	-1,446	-2,744
94	4,512	-1,659	-18,183	854	2,482	8,288
95	2,853	5,005	-28,176	4,002	352	3,200
96	2,604	16,854	-36,547	3,466	-4,083	-6,702
97	2,563	23,296	-47,518	2,363	-113	1,774
August						

\* Rupiah devaluation in September, 1 US dollar 1,134 to 1,644.

Source: Bank Indonesia, "Indonesian Financial Statistics", Sept. 1997, Jan. 1994 and Dec. 1990.

Another issue in the monetary policy effectiveness is a controllability of M2. Economists typically construct their economic models on the assumption that the public's demand for money is fairly stable, or the money multiplier (ratio of reserve money to M2) remains stable. The Central Bank constructs its monetary policy based on this assumption. It is, therefore, important to review how stable the public's demand for money is.

In Indonesia, the money multiplier has shown a sharp increase with fluctuations while the financial sector has developed during the last 10 years. (see **Table-4**) The demand for M2 has

grown more rapidly than reserve money as economic growth and financial deepening have accelerated. This has weakened the Central Bank's ability to control M2.

**Table-4 Development of Money Supply**

End of period  
Unit: billion of rupiah, %

	Currency		M1		M2		M2/C
		Change, %		Change, %		Change, %	
85	4,440		10,104		23,153		5.21
86*	5,338	20.23	11,677	15.57	27,661	19.47	5.18
87	5,782	8.32	12,685	63.00	33,885	22.50	5.86
88	6,246	8.02	14,392	13.46	41,998	23.94	6.72
89	7,426	18.89	20,114	39.76	58,704	39.78	7.91
90	9,094	22.46	23,819	18.42	84,630	44.16	9.31
91	9,346	2.77	26,341	10.59	99,058	17.05	10.60
92	11,478	22.81	28,779	9.26	119,053	20.19	10.37
93	14,431	25.73	36,805	27.89	145,202	21.96	10.06
94	18,634	29.12	45,374	23.28	174,512	20.19	9.37
95	20,807	11.66	52,677	16.10	222,638	27.58	10.70
96	22,487	8.07	64,089	21.66	288,632	29.64	12.84
97	24,427	8.63	65,235	1.79	325,911	12.92	13.34
August							

\*: Rupiah devaluation in September, 1 US dollar 1,134 to 1,644

Source: Bank Indonesia, "Indonesian Financial Statistics," Sept. 1997, Jan. 1994, Dec. 1990

The increase in M2 directly influenced commercial banks to expand credit, which fueled the overheating of the economy and deteriorated their current account balance by financing imports. By breaking down the liability side of the balance sheet of the commercial banking sector, it is evident that the change in time deposits has played a dominant role in affecting the increase in bank credits in the 1990s. (see **Table-5**) In the 1990s, commercial banks borrowing from the central bank, which was a major source of commercial banks' funding before the introduction of the financial deregulation policies, has slowed down. The commercial banks' foreign borrowing, which suddenly increased in 1989 to 1991, after the financial deregulation policies, has also slowed down since the off-shore commercial borrowing ceilings (PKLN) was introduced in September, 1991. (However, both of the above have not been as tightly controlled as they should be.) On the other hand, bank deposits, particularly time deposits, have increased

rapidly which has resulted in bank credits out of control. The increase in time deposits, in other words a domestic resource mobilization, has been a long standing government development policy objective. Ironically, the long standing development objective has caused difficulties in controlling the money supply and credit expansion. Therefore, the economy overheated, and it was difficult to curb the credit expansion and to control the macroeconomic situation during the 1990s and up to 1996.

Table-5 Changes of Commercial Banks' Assets and Liabilities: Summary

Unit: billions of rupiah

		87-88		
Claims on public sector	17,132	9,584		Time deposit
		1,904		Demand deposit
		618		Foreign borrowings
		3,065		Borrowing from the Central Bank
		89-90		
Claims on public sector	58,423	25,211		Time deposit
		6,500		Demand deposit
		11,486		Foreign borrowings
		332		Borrowing from the Central Bank
		91-93		
Claims on public sector	65,204	36,803		Time deposit
		7,435		Demand deposit
		7,802		Foreign borrowings
		5,095		Borrowing from the Central Bank
		94-96		
Claims on public sector	136,734	92,015		Time deposit
		19,205		Demand deposit
		9,279		Foreign borrowings
		-4,617		Borrowing from the Central Bank

It is suspected, however, that a substantial portion of the increase in time deposits may not be a result of genuine domestic resource mobilization. Some evidence indicated that a substantial amount of banks' certificates of deposits (CDs; bearer's notes) were held by foreign investors. It is also suspected that a substantial amount of time deposits were held by non-residents, although official statistics did not capture the records. As discussed in the previous section, high interest rate differentials continued over the last 10 years, and the international markets' dramatic improvement in confidence towards the Indonesian economy has

resulted in a continuous inflow of foreign capital. Foreign investors investing in time deposits at Indonesian banks would have a similar impact on banks' foreign borrowing, which was restricted by the introduction of the Presidential Decree 39 in 1991. Indonesian banks and international investors appeared to circumvent the foreign borrowing ceilings under Decree 39 by collecting time deposits from nonresidents and by issuing CDs targeting foreign investors.

#### **4-2. Fiscal Policies**

The Indonesian Government maintains a unique fiscal policy discipline called "a balanced budget principle". Indonesian law does not allow the government to borrow from domestic markets nor to issue government bonds in the domestic markets. It does not mean the Government can not borrow nor incur the budget deficits. The Government can and does borrow from donor aid agencies and from the international financial markets. There is no doubt "a balanced budget principle" plays an important role in maintaining Indonesia's sound budget condition, and it effectively prevents the Indonesian economy from falling into hyper-inflation caused by financing budget deficits through the domestic banking system.

"A balanced budget principle", however, tends to cause difficulties in creating budget surpluses when the economy overheats. Indonesia has a strong demand for economic infrastructure, which was in short supply and caused bottlenecks for continuing economic development. These strong spending pressures caused difficulties for the Government to introduce further belt tightening fiscal policies.

Furthermore, the Government has implemented privatization policies in which a number of infrastructure projects were pursued. These projects were not included in the government's budgetary expenditures because they were classified as private sector projects. However, the privatized infrastructure projects do not happen without explicit or implicit government blessings. Foreign investors, who played critical roles in the projects, usually requested the host country government participation in various forms with the infrastructure projects. In most cases, the investors required the government to guarantee such projects in order to obtain foreign financing from the international financial markets. Therefore, the privatized infrastructure projects can be classified as quasi-budget and should be under the control of the fiscal policy even though the

private sector manages and invests in them.

Including these privatized infrastructure projects, the government budget has expanded rather than contracted as stated by the government fiscal report.

#### **4-3. External Debt Management**

The Indonesian Government has pursued a prudent external borrowing policies concerning government debt. The Government has maintained a "one window policy." Under which, government external borrowings are allowed only through designated windows, i.e. the Ministry of Finance, BAPPENAS, and the Central Bank (BI). The unified debt management system controlled government external borrowings.

This system effectively controlled the country's overall external debt until 1988. The private sector did not have access to the international financial markets, and foreign investors had much less confidence in the Indonesian economy. As international financial markets have become more mobile and as Indonesia's economic performance and management have improved investors' confidence, private capital inflows have grown substantially. Indonesia's government has not controlled the private sector capital flows since early in the 1970s under a "free foreign exchange system." Together with the economic booms in Southeast Asian regions in the 1990s, external borrowings by the private sector, including privatized government sector and privatized infrastructure projects as discussed above, have increased much faster than the Government expected.

The Government tried to limit external borrowings through various means, including orthodox monetary and fiscal policies. In September 1991, the Government announced Decree 39 to establish a new set of rules for external borrowings from offshore commercial banks. Decree 39 stipulated: (a) coordinating all public sector external borrowing, including borrowing by public enterprises and by the private sector for projects involving the public sector; (b) setting annual ceilings for external borrowing by public and quasi-public sector entities; (c) setting annual ceilings for commercial banks, including state and private banks; (d) establishing guidelines for loan terms; (e) determining the priority, order, and timing of approved loans, and; (f) improving reporting and information about public and private external borrowing. Decree 39 did not set any



controls on purely non-bank private sector external borrowings. However, total Indonesian commercial offshore borrowings has subsequently slowed down because (a) the Indonesian non-bank private sector has limited access to international financial markets, and (b) the strong “signaling effects” of Decree 39 discouraged both Indonesian borrowers and international commercial lenders.

Since then, however, increasing pressure to circumvent the external borrowing ceilings has deteriorated the effectiveness of Decree 39. Particularly, political pressure has increased in the area of state related projects, i.e. privatized infrastructure projects. Politically influential people have promoted a large number of state related capital intensive projects without explicit approval under Decree 39. The Indonesian banking sector continued to rely excessively on external borrowings, probably more than the allocated ceilings set by Decree 39. Effectiveness of Decree 39 has deteriorated toward the end of the Suharto regime’s sixth term. Together with the continued economic boom in the Southeast Asian region, external financing has continued to increase, current account deficits have grown, and vulnerability of the Indonesian economy, which excessively relied on external financing, has increased substantially.

## **5. Summary and Policy Implications**

The Indonesian economy has grown rapidly over the last 10 years. The remarkable economic performance and robust development have been supported by a series of economic deregulation policies and financed largely by foreign capital inflows.

On the other hand, the continued massive foreign capital inflows fueled the overheating of the economy and widened the current account deficits by financing imports during the 1990s. The financial market mechanism, i.e. an interest rate arbitration mechanism, did not work, and large interest rate differentials remained, and it caused continuous capital inflows. The Indonesian economy, which has excessively relied on foreign capital flows, became vulnerable to external shocks.

A series of financial deregulation policies have encouraged financial deepening and

ensured more efficient allocation of financial resources. At the same time, rapid financial development and a sharp increase in commercial bank credits in the 1990s have also resulted in an increase in non-performing assets for the banking sector. Financial deregulation policies did not ensure consistent and simultaneous developments of all factors involved, i.e. financial markets, financial institutions, and social behavior.

The inconsistencies among the modern market mechanism, existing financial institutions, and traditional social behavior caused a moral hazard in the banking sector and resulted in an increase in non-performing assets. A weak banking sector caused higher interest rates in the domestic markets which encouraged further capital inflows. The weak banking sector also hindered the effectiveness of monetary policies.

During the course of the 1990s, orthodox macroeconomic policies appeared to lose their effectiveness. Massive capital inflows offset the Central Bank's tight monetary policies. The fiscal policies, which appeared to be tightened nominally, were in fact much more expansively, if the off-budget and privatized infrastructure projects were taken into account.

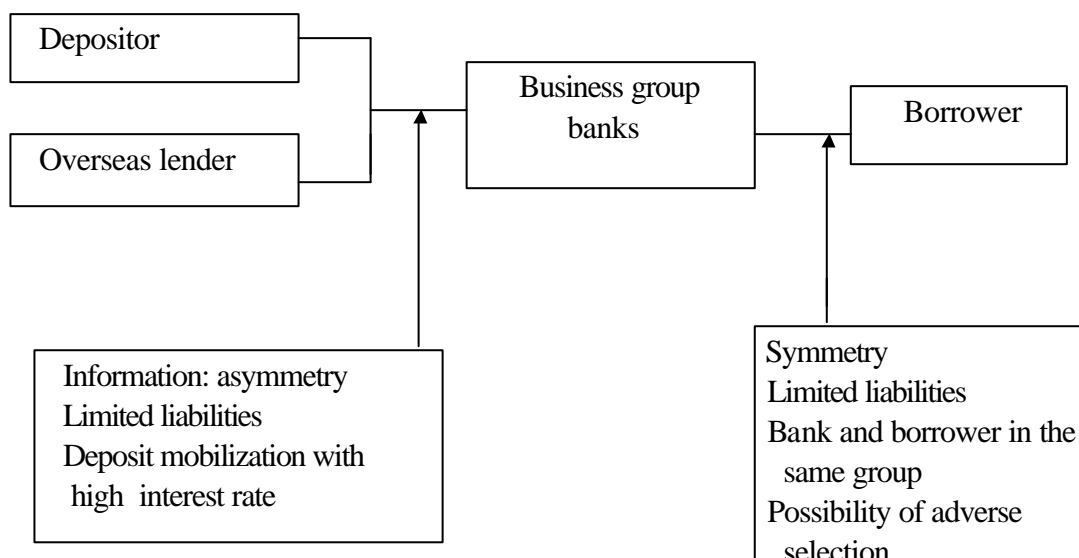
Decree 39, announced in 1991, was an effective tool to control both external borrowings and the domestic economy, but the increasing pressures from both political and market forces have reduced its effectiveness. The above discussions imply that prudent management of external borrowing is a key element of sustaining macroeconomic stability. Reinforcing foreign borrowing ceilings for public and quasi-public projects under Decree 39, in fact, ensures real tightening of the fiscal conditions as well as control of external borrowing. The banks' foreign borrowing ceilings should also be tightly controlled from the point of view of the banks' prudential regulations. The moral hazard resulted from inconsistencies among the modern market mechanism, financial institutions and traditional social behavior of the players, and it should be monitored by improving the rules of bank supervision. Indonesia's tight monetary policies, which have been offset by capital inflows, should also be pursued and supported by consistent fiscal and external borrowing policies.

As discussed earlier, certain limitations exist in controlling external borrowing and managing the overheating economy through market mechanisms and macroeconomic policies. It is necessary to improve reporting and information systems to monitor external borrowing and

capitals flows. Given the current imperfection of the reporting system for external debt, it is recommendable to develop a reporting system that assesses both creditors (international banks) and debtors (Indonesian borrowers) in order to improve timing and accuracy of the reporting. Timely and accurate information concerning foreign borrowings and external debt can be a signal for early warning to both international lenders and the Indonesian borrowers.

**Figure-2 Mechanism of Accumulation of Non-Performing Assets**

2-1. State owned banks (classical moral hazard)



2-2. Private business group banks (mismatch between financial and social developments)

