CONTROL AND COMPETITION:
BANKING DEREGULATION AND RE-REGULATION IN INDONESIA

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Abstract

Policy changes in Indonesian banking from 1983 through 1990 saw the removal of controls on interest rates, lending, and expansion of branch networks, and of barriers to entry. The dismantling of loan subsidy programmes financed by the central bank ran in parallel with these changes. Private banks have been enabled to erode rapidly the market share of the previously dominant, but less efficient and less customer-oriented, state banks. Despite the impressive progress resulting from these reforms, however, interventionist policy has been making a comeback during the 1990s, and the central bank still maintains its role as a significant supplier of subsidised loans.

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Indonesia's banking sector provides a rare example of extraordinarily far-reaching microeconomic reform in a developing country, implemented over a short period of time. This has not been the result of replacement of one government by another with markedly different views on what constitutes sound economic policy, but has occurred within the historical context of the continuous and virtually unchallenged reign of President Soeharto, which has lasted now for some three decades. The fact that these changes took place is therefore a reminder that governments are not monolithic, but are composed of, and supported by, individuals and groups with competing ideas and interests. Individuals come and go; coalitions flourish and decay; ideas about economic policy evolve in light of experience in the country in question and the world outside. It is beyond the scope of this paper, however, to analyse these underlying forces shaping banking policy in Indonesia. Its more modest aim is to describe the impact of this set of truly dramatic policy changes, and to explain why earlier reforms are now beginning to be reversed.

At the macroeconomic level, the first major instance of financial deregulation occurred in 1970, when the government adopted a unified exchange rate rather than the multiple rates used previously (Arndt 1971:1-2), and opened the capital account to the free inflow and outflow of funds. At the microeconomic level, however, participants in the financial sector, particularly in banking, had to wait many years before significant deregulation was implemented.[1]

Policy regime and structure in the 1970s

Throughout the 1970s, the banking sector was dominated by five state commercial banks,[2] most of which were former Dutch banks which had been nationalised under

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[1] A minor qualification: a small number of foreign banks were allowed to enter Indonesia from 1967, as part of the re-opening of the economy to the rest of the world by the New Order regime of President Soeharto. Strictly, this was the first instance of financial reform. In practice, the foreign banks did not play a big role. They were resricted to operating in the capital city and, even there, they were permitted only two offices.

[2] The state banks accounted for roughly 80% of total commercial bank assets during this period.

former President Sukarno.[3] Regulations effectively prohibited both the establishment of new private sector banks (domestic and foreign-owned), and heavily constrained the expansion of existing branch networks. Only ten of about 70 private domestic banks were licensed to deal in foreign exchange, and it was practically impossible for others to obtain such licences.

The state banks were nominally restricted to operating in particular sectors of the economy (Panglaykim and Penny 1968:76) and so, although the boundaries were loosely drawn, did not compete strongly with each other. They had a huge captive market for both loans and deposits amongst the state enterprises, which were obliged to rely on the state banks for their banking needs. The state banks were not profit-driven institutions, but were seen more as adminstrative extensions of the government, which imposed its own decisions as to where and to whom they should lend,[4] and controlled other fundamentally important aspects of their operations, such as their interest rates (see below). Restrictions on the private sector banks meant that there could be little effective competition from this quarter, either.

Another important element of the banking policy regime of the 1970s was controls over bank lending. These had been introduced in April 1974 as part of a range of anti-inflationary measures (Arndt 1974:9).[5] As Chant and Pangestu noted (1994:228-9),

> the new system came to be used as a mechanism for the allocation of credit, with detailed ceilings by type of credit for each bank…
>
> … the system of credit allocation determined the structure of the banking system because Bank Indonesia [BI, the central bank] could set the shares assigned to any bank.

In short, banking was dominated by state-owned institutions. Not only was the industry closed to new entry, and physical (branch) expansion heavily constrained, but lending policy tended to freeze market shares of existing banks: there was no competition from outside, and little from within.

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[3] Brief details of the history of the state banks are contained in Bank Indonesia 1968:50-4.

[4] As well as explicit policies favouring lending to particular sectors relative to others, the term ‘command loans’ gained currency at the time, referring to loans which the state banks were effectively forced by their political masters to provide to certain borrowers. In 1994, the term ‘*katebelece*’ (‘personal reference’) became popular, indicating that the practice still existed.

[5] It is interesting to note that lending controls had also been used during the 1960s, for the same purpose, but without success. Inflation rose as high as 635% p.a. in 1966.

First microeconomic reform: reserve requirements

A very high reserve requirement had been imposed on the banks during the Sukarno era (Bank Indonesia 1968:63, 260-1),[6] which was carried through for more than a decade from the beginning of President Soeharto's New Order. Banks were required to hold reserves (cash plus deposits at the central bank) amounting to 30% of 'current liabilities' (the precise definition of which changed from time to time). Such requirements are sometimes thought of as a safety measure, to ensure that the banks have sufficient liquid assets to be able to meet unanticipated cash outflows. In fact, banks are well aware of the need to hold liquid reserves without being forced to do so, and the amount required in practice is nowhere near 30% of current liabilities, but closer to 1 or 2%. An alternative rationale sometimes proposed is that liquid reserves provide a cushion of safety for depositors against losses incurred by the bank, but in fact they do not. That function is served by the bank's equity capital, which can easily be dissipated as a result of bad management, regardless of the existence of large liquidity reserves.

A more credible justification for imposing a reserve requirement is that it can be used as an instrument of monetary control: an increase in the ratio can be expected to have a deflationary impact on the economy, and conversely. It follows, however, that the required reserve ratio must be flexible if it is to be used for this purpose; holding the ratio constant amounts to choosing not to use it. In practice, Indonesia's reserve ratio has been held constant for years at a time, notwithstanding occasional changes large and small. In other words, it has been used only rarely as a monetary instrument.

From the microeconomic viewpoint, a regulatory reserve requirement is equivalent to imposing a tax on the intermediation process undertaken by banks, because funds mobilised from depositors have to be invested in the abovementioned non-interest-bearing liabilities of the central bank.[7] This tax tends to restrain the development of banking, since borrowers and lenders can avoid the tax (legally) by reliance on informal finance (such as trade credit) instead.[8]

The effective reserve requirement was pushed even higher in 1974, by increasing the proportions of time and savings deposits required to be included in the measure of 'current liabilities'. The balance of payments, already well in surplus following exchange rate adjustments in 1970, was boosted further by the jump in world oil prices in 1973-4. The resulting build-up in international reserves was causing the

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[6] The requirement was introduced in 1960, apparently as a reaction to liquidity difficulties experienced by banks in 1959, when the government introduced contractionary measures to try to control inflation.

[7] Revenue from the tax of course flows to the central bank in the first instance.

[8] Other forms of formal finance also gain a competitive advantage over banks if they are not subject to reserve requirements, but this was not of much significance in the period in question.

supply of base money to grow rapidly. Increasing the effective reserve requirement meant that the demand for base money was increased, thus tending to offset the inflationary impact of increased supply.

At the same time, however, in its attempt to sterilise the payments surplus, the central bank also introduced a more market-oriented measure designed to complement the increase in the effective reserve requirement, by offering to pay interest on *excess* reserves deposited with it. If we define 'base money' as *zero-interest* monetary liabilities of the central bank, then this new approach can be interpreted as achieving a cut in base money by shifting some of the banks' reserves into an interest-paying deposit at the central bank.[9] Although this has gained little attention in the literature on Indonesia's financial development, it may be regarded as the first step along the road to microeconomic reform in banking. It was the first time the authorities sought to influence the banks' behaviour by creating an incentive to voluntary action, rather than entirely by compulsion, in order to achieve the macroeconomic objective of inflation reduction.[10] (A chronological summary of microeconomic reforms in banking is provided in the Appendix.)

Somewhat surprisingly, the nominal required reserve ratio was cut to half its previous level (i.e. from 30% to 15%) at the end of 1977,[11] and the rate paid on excess reserves was cut from 10% p.a. to 6%. The ratio reduction significantly reduced the banks' demand for base money. At the same time, the interest rate cut tended to increase its supply. The banks would have been induced to lend to their customers rather than to Bank Indonesia at the much less attractive rate now offered by the latter. As loans to customers increased, so did deposit liabilities, with the result that funds shifted from excess reserves into zero-interest reserves, or base money. The changes were therefore bound to have an inflationary impact. Although inflation continued its rapid decline from a peak of 47% p.a. in 1974 to only 7% in 1978, it rebounded vigorously to 30% in 1979.

Whatever the motivation,[12] and notwithstanding the conflict with the objective of bringing down inflation nor the movement of the excess reserves interest rate well

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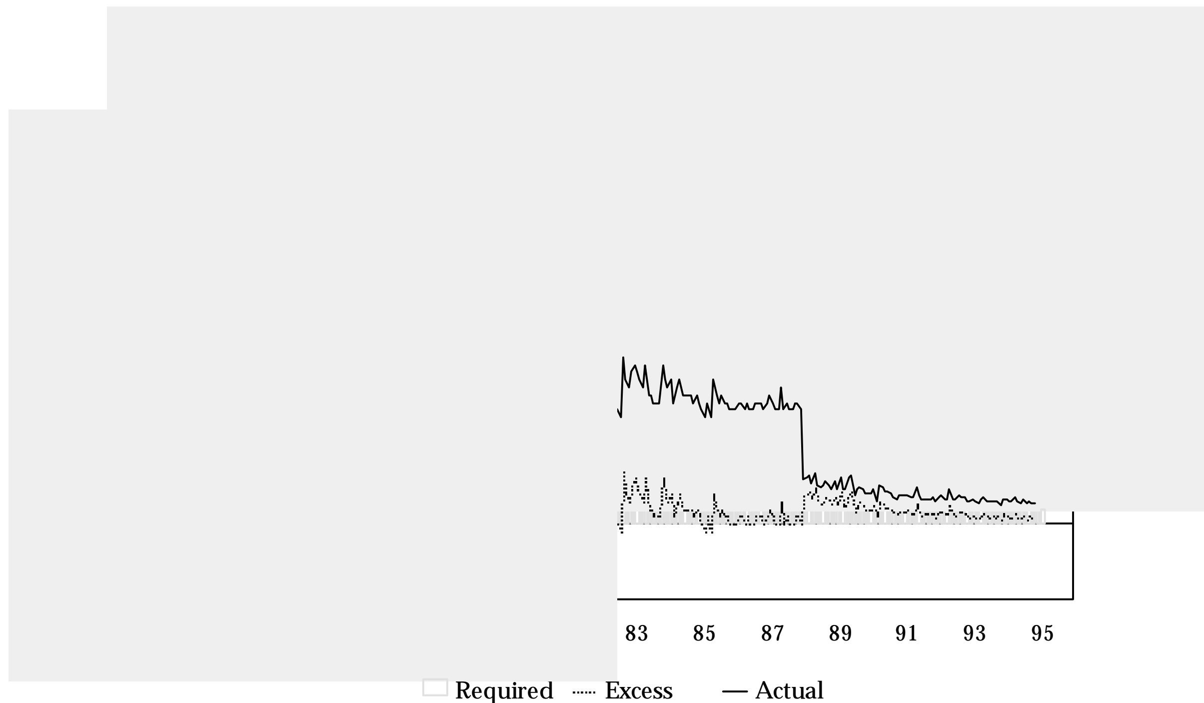
[9] The present day equivalent is the issue of interest yielding certificates by the central bank (see below).

[10] Albeit a tentative step: the interest rate paid was not market-determined, but at 10% p.a. it certainly provided an attractive option to the state banks, which were then being forced to lend at similar—and sometimes even lower—rates.

[11] The effective reserve requirement on time deposits was less than 15%, because less than 100% of such deposits were to be included as 'current liabilities' in the reserve ratio calculation. The portion included also varied across bank ownership groups. For example, at the beginning of 1978, state banks had to include two-thirds of time deposits, making their effective ratio 10%, whereas private banks had to include only one-third, making their effective ratio 5%.

[12] Arndt (1978:21) suggests that the reserve ratio cut was intended to compensate the state banks for an imposed reduction in some of their lending rates.

below free market rates, the halving of the implicit tax on intermediation can be regarded as the second significant microeconomic deregulatory episode in the financial sector. Nevertheless, cutting the required reserve ratio to 15% had less of an impact on the volume of intermediation than might have been expected, because of the direct controls on expansion of bank loans mentioned above, which meant the banks could not fully utilise their reserves. Thus the average level of excess reserves jumped from 5% to 9%, and then trended upwards to over 10% during the next three years (Figure 1). The lack of a strong profit orientation on the part of the state banks also militated against more vigorous expansion of loan portfolios.



The June 1983 package of reforms

Curtailment of subsidised lending programs

More than five years went by before the next major bout of banking deregulation, in June 1983. (This actually had been preceded by two minor moves in the same direction, which went almost unnoticed at the time; see below.) During the oil boom years, one of the means the government had chosen to spread its new-found wealth to sectors of the economy it wanted to favour was to provide them with cheap finance through the central bank and the state banks. The usual technique was for the state banks to lend to these sectors at rates well below free market rates, using funds which were partly or wholly supplied by the central bank at much lower rates still (Table 1).

Table 1: State bank lending rates and refinance terms from Bank Indonesia (prior to August 1982)

Short-term credits (up to 1 year)	Investment Credits (over 1 year)	p	d	n
Supply and distribution of rice, paddy and corn by cooperatives		1.00	3	9.0
Special agricultural programs		1.00	3	12.0
	KIK, KI (up to Rp75m)	0.80	3	10.5
Salt, wheat and flour	KMKP	0.75	4	12.0
Smallholders' agriculture, animal husbandry, poultry farming, fisheries and handicrafts	KI (Rp75m-200m)	0.75	4	12.0
Exports and production of export goods		0.75	4	12.0
Aid financed imports, distribution of food and commodities		0.75	4	12.0
Production, import and distribution of fertilisers and insecticides for use by smallholders		0.75	4	12.0
	KI (Rp200m-500m)	0.70	4	13.5
	KI (Rp500m-1500m)	0.65	4	13.5
Manufacturing, service rendering, sugar stock		0.70	6	13.5
Domestic trade, import and distribution of supervised goods		0.70	6	13.5
Contractors to public sector		0.70	6	13.5
Contractors to private sector		0.60	6	13.5
Imports and distribution of other import goods		0.40	6	18.0
Others (not included elsewhere)		0.25	6	21.0

p = refinance proportion
d = refinance rate (% p.a.)
n = lending rate (% p.a.)

KI = *Kredit Investasi* (investment loan)
KIK = *Kredit Investasi Kecil* (small investment loan)
KMKP = *Kredit Modal Kerja Permanen* (permanent working capital loan)

Experience with these schemes was disappointing. The fungibility of finance means that economic behaviour may not be altered as intended by the provision of subsidised finance: the opportunity cost of finance is still the market-clearing rate, and this will still be the rate which is relevant at the margin to most investment decisions (McLeod 1980:119-24). This being the case, the effect of subsidised loan programs, even if they work well (in the operational sense) is more to redistribute income or wealth to the lucky recipients, rather than directly and significantly to

affect the course of economic development.[13] There is little evidence to show that these programs had much effect on the course of structural change of the economy.

Even as a redistributional device, however, the subsidised loan programs were seriously flawed. Setting borrowing rates well below market clearing levels was an invitation to corrupt behaviour. The banks were necessarily faced with excess demand, and borrowers were willing to pay more than the nominal rate to jump to the head of the queue. In such circumstances, bribes became common, banks could get away with providing poor service, and a culture developed (or was strengthened) in which default was common. If bank officials could be bribed to provide access to cheap loans, the same or other officials could be bribed to overlook failure to repay.

Official policy compounded the problem. The government had established an Agency for Settlement of Debts to the State (BUPN), and the state banks were supposed to hand over cases of loan default to this agency. But the procedures it followed in the attempt to recoup monies owing were notable mainly for the kid glove approach employed, and for their lack of success (McLeod 1980:144-5).[14] At the same time, some of the subsidised loan programs were insured by a government loan insurance company, PT Askrindo (McCawley 1973:14; McLeod 1980:118; McLeod 1983:85). This meant that the state banks had little incentive to ensure repayment, because they could simply hand over difficult cases to Askrindo, and seek reimbursement for a large proportion of their losses.

The subsidised loan programs were disastrous for government finances and the state banks.[15] The ready availability to these banks of subsidised funds meant that they had no incentive to improve the level of service to depositors, nor to offer them attractive interest rates. The fact that they were given the task of dispensing government subsidies in the form of subsidised loans meant that they had no incentive to improve the level of service to borrowers, either. The demonstrated willingness of the government to bail them out when losses accumulated,[16] and the existence of loan insurance, meant that they had little incentive to improve their loan appraisal skills or their capacity to minimise loan losses. Moreover, the conflict

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[13] The amount of wealth redistributed is the nominal amount of the subsidised loan less the present value of all loan repayments, evaluated at market interest rates. For an estimate of the wealth transfers within one of Indonesia's subsidised loan programs, see McLeod (1980:124-7).

[14] These procedures commenced with the sending of a written request to the borrower to repay within one month. If this was not done, the borrower was summoned to appear before a committee of BUPN within seven days. Up to two further reminders were then sent, if necessary. When the borrower finally faced the committee, its further procedures were no less accommodating (Government of Indonesia 1967).

[15] Patten and Rosengard (1991) provide a detailed discussion of one such program, which provided subsidised credit for rice farmers.

[16] See footnote 38 below.

between their commercial (profit) objective and the requirement that they should act as 'agents of development' for the government (undertaking various tasks which were inherently unprofitable) meant that management could not be held accountable for 'performance'—since there was no clear indication of what was meant by this term.[17]

The high cost of the programs, plus the realisation that the oil boom could not be expected to last forever,[18] led the government to introduce a wide-ranging banking deregulation package in June 1983 (see Appendix), the main objectives of which were to put an end to the squandering of oil revenues through program lending, and to force the state banks to compete for their survival against private sector banks.

Removal of interest rate controls

Discontinuance of subsidised loan programs at the state banks implied the removal of controls on their lending rates and stopping the flow of central bank funds to them. This, in turn, meant that controls on deposit rates also had to be removed, if the state banks were to be able to continue to lend based on deposit inflows alone. The first steps in these directions actually had been taken in August 1982 (when BI refinance for lower priority loan programs was discontinued) and in May 1983 (when the state banks' six month time deposit rate was freed). These steps had had little impact, however, nor had they aroused much controversy, so the government perhaps felt little constrained from taking them much further. Thus all remaining controls on time deposit interest rates were now removed, while all but a handful of subsidised loan programs were discontinued. (Or so it seemed at the time. The reality turned out rather differently; see below.)

Abandonment of lending controls

These were measures which directly affected the state banks only. The intention was to force them to stand on their own feet: their capacity to maintain their loan portfolios henceforth would be determined by their ability to attract deposits, and to make themselves attractive as sources of loans, even in the absence of subsidies to borrowers. At the same time, however, the opportunity was taken to give up the attempt to control inflation by means of controlling bank lending. The policy had been a failure in practice (albeit not as striking as it had been in the previous decade): inflation averaged 18% p.a. during the 1970s (McLeod, 1993a:99). More important, however, was the fact, noted above, that lending controls tended to maintain the *status quo*: well-managed banks were prevented from taking market share from those less well-managed—in particular, the state banks. For there was by now a belief that

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[17] In principle, it is possible to define a measure of 'performance' for banks which have more than one objective, provided each such objective can be quantified. The simplest measure is a weighted average of all the individual objectives' measures. In practice, this approach has never been followed with the Indonesian state banks.

[18] Oil prices had fallen significantly in 1982.

modernisation of the economy required a sound and energetic banking system, and that the state banks could not be relied upon to provide it.

That this rather pessimistic view was also realistic can be seen in the state banks' reaction to deregulation. Given the freedom to set their own deposit and loan rates, their response was almost entirely concentrated on the deposits side. They quickly raised their time deposit rates to almost the level of private bank rates, for fear that the imminent withdrawal of BI refinancing would leave them without any funding base on which to expand.[19] But they appeared loathe to raise lending rates. Thus Figure 2 shows that, although private bank time deposit rates exceeded those of the state banks by only about 1 percentage point on average throughout the second half of the 1980s, the state banks' loan rates remained much further below private banks' rates.[20]

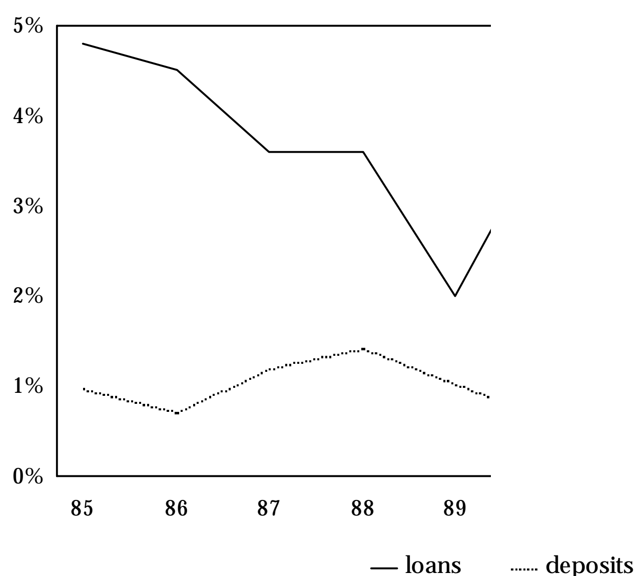
To some extent this may be traced to pressure from the government, which faces a negative reaction from the business community whenever the cost of borrowing rises. The banks themselves tended to argue that they could not raise their rates to match those of the private banks because they were relatively inefficient, and so needed to offer lower rates if they were still to attract borrowers. But the more powerful explanation is the economic rents available to bank personnel as long as the banks' lending rates were well below market rates. To begin lending at market rates would have resulted in a severe reduction in total income for many state bankers.

Raising lending rates was also said to be unnecessary. The banks had a mix of deposit funds—demand, savings and time deposits—and the average cost to the banks of all deposit types combined was a good deal less than the cost of the most expensive category (time deposits). Thus the banks could still make a profit lending at quite low rates—so it was argued—because they relied heavily on low- or zero-rate demand deposits.

[19] Outstanding BI refinance had to be repaid as the associated program loans were repaid.

[20] The private banks were regarded as more risky than the state banks, because of the perceived willingness of the government to bail out the latter if they found themselves in difficulty. The gap in deposit interest rates is believed to reflect this risk differential.

Figure 2: State and Private Bank Interest Rate Differences[21]



The economic logic of this way of thinking was false, however, at least if it is accepted that the banks should have aimed to maximise profits. This requires attention to interest rates at the margin, not on the average. At the margin, it was costing the state banks about 16% p.a. in interest alone to bring in additional time deposits,[22] roughly 10% of which had to be invested in non-interest bearing reserves (which pushed the effective cost to about 17.6% p.a.), while they were lending at roughly 18%. The lack of any significant spread between deposit interest costs and loan rates meant that there was little to cover operating overheads and loan losses, much less contribute to profit. In other words, the state banks were losing money at the margin, and would have been better off cutting back their expansion, or even shrinking their portfolios, if they were not prepared to raise their lending rates.

In any case, the fact that the state banks' loan rates were far below those at the private banks did not result in relatively more rapid growth of state bank lending. On the contrary, their share of loans to the private sector fell from 71% to 62% of the total in the four years from June 1983. Apparently, private sector borrowers preferred to pay significantly higher interest rates to private banks than to pay low interest rates but also put up with poor service and implicit or explicit demands for

[21] It took some years for Bank Indonesia's statistical publications to adjust to the deregulated interest rate environment post June 1983: data on deregulated deposit and loan rates did not begin to be published until 1989. Weighted average rates for the calendar years 1985-88 were first presented at that time. Moreover, consistent data for the private foreign exchange banks (the group most comparable with the state banks) are not available for 1995, because the non-foreign exchange banks (which are generally smaller, and lend at higher rates) began to be reported in the same group from that time. Accordingly, data for 1983-84 and 1995 are absent from Figure 2.

[22] This was the nominal rate offered. It is a lower bound estimate for the marginal interest cost of time deposits, reflecting an implicit assumption that the supply was highly elastic.

'grease money' at the state banks. The latter maintained their almost complete dominance of public sector lending, but this segment of the market was growing far more slowly (Cole and McLeod 1991:91-7).

In practice, the state banks appeared more concerned to maintain their size ranking relative to each other than to operate along profit-maximising lines. In other words, they wanted to set attractive time deposit rates, so as to maintain their total assets growth, even though they could not lend additional funds profitably. It might be thought that the private banks would have lamented the state banks' vigorous efforts to build up their deposit base, since this made it all the more difficult for the other banks to attract deposits themselves. But the sluggish lending performance of the state banks meant that some of them, at least, found themselves with an excess of funds which they were unable to lend, and became chronic lenders to the interbank market, while many private banks became chronic borrowers (Binhadi and Meek 1992:108-9).[23]

This, of course, is not usually the way an interbank market operates. Its normal function is to allow banks to shift funds around on a daily basis, to offset unpredictable cash flows between each other as a result of payments between their respective customers. Provided the aggregate level of bank reserves stays more or less constant, then any bank which finds itself short of funds will be able to find one or more other banks in the reverse position, and it will be to their mutual advantage to engage in a short-term lending transaction so as to ensure that each bank has the funds it needs, while no bank has idle funds in its account at the central bank earning no interest.

A short-lived backward step: new limit on interbank borrowing

By contrast, as just mentioned, a main purpose of the interbank market following the 1983 package (as it had been previously) was to provide a conduit for a steady flow of funds from those state banks which mobilised more funds than they could lend, to the private banks, which seemed almost to face no limit to the amount of lending they could undertake. Such an arrangement was not without risk, of course. Interbank money is very short-term, and banks which used it to fund longer-term loans were heavily exposed to increases in short-term interest rates. Several banks got themselves into trouble in this way in September 1984, when a sudden shortage of system liquidity caused short-term rates to jump to a peak of 90% p.a.[24]

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[23] This appears to have been true even when all state bank loans were subsidised (Binhadi and Meek 1992:104-5).

[24] According to Cole and Slade (1992:89-90), this was caused by a sudden increase in government deposits at BI (causing a reduction in bank reserves), combined with a rapid and seemingly predictable rate of depreciation of the rupiah imposed by BI, which militated against short-term capital inflow that would otherwise have offset the squeeze. The rupiah depreciated at an annual rate of 27% in September, and at even higher rates for shorter periods within the month, making it

The authorities reacted to this episode, not by trying to get the state banks to back away from their rather pointless deposit mobilisation efforts, much less committing themselves to more careful implementation of exchange rate policy in the future (at least, not publicly), but by imposing a limit on the proportion of interbank borrowings in the total funds of all banks. This, along with significant backtracking on winding back the subsidised loan programs, represented another small step away from allowing the free interplay of market forces in the banking industry. Initially (September 1984) the limit was 7.5%, and later (August 1985), 15% (Binhadi and Meek 1992:110), but eventually this limit was dropped, for an alternative means of channelling excess funds from state to private banks had emerged—almost by chance.

The central bank in February 1984 had begun issuing its own certificates of deposit, known as SBIs, as a means of reducing banking system liquidity (Binhadi and Meek 1992:108-9).[25] A year later, it had begun buying money market securities issued or endorsed by banks, known as SBPUs, as a means of adding to system liquidity (Binhadi and Meek 1992:110-11). Together these two instruments formed the new basis for monetary policy to replace the previous reliance on bank lending controls—a practical approximation to open market operations in other countries, where government debt is bought and sold by the central bank. For a short period, SBIs and SBPUs were effectively used in tandem to 'recycle' funds from certain state banks to private banks. The former could rid themselves of excess funds by purchasing SBIs, while the latter could add to their deposit funds by selling SBPUs to BI.[26]

The October 1988 package, and a further refinement

The June deregulation package turned out to be only a qualified success. Many of the wasteful subsidised loan programs were brought to an end, and the private banks were able to expand their activities very rapidly. But, surprisingly, the reliance of the state banks on BI for funds remained high. After a brief pause in the aftermath of the June package, BI loans to these banks—the primary target of the reforms—regained their momentum, almost as if nothing had changed (Figure 3).

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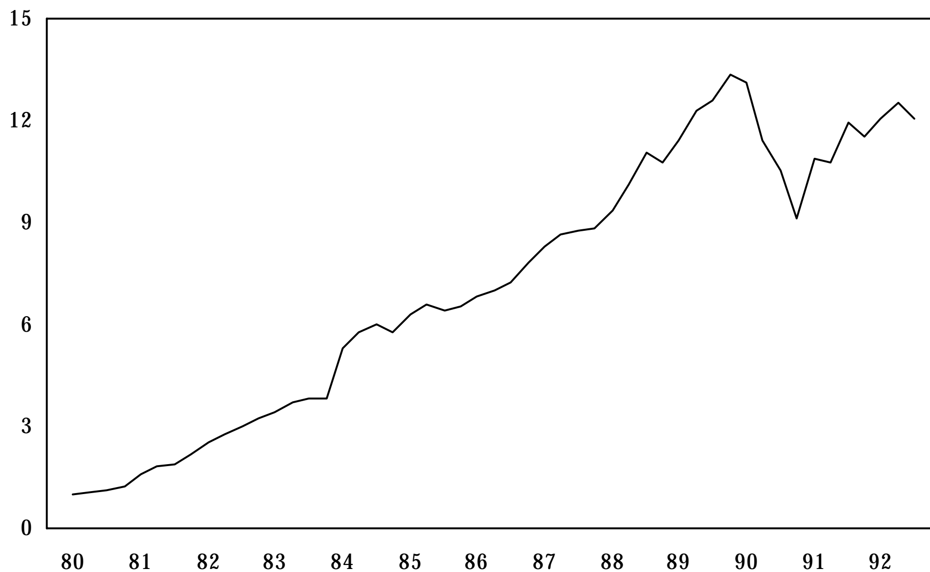
worthwhile to borrow rupiah short-term, even at very high rates, to invest in dollar-denominated assets.

[25] In practical terms, this was similar to the 1974 policy of paying interest on excess reserves. It differed in that excess reserves had been available at call, whereas SBIs (initially) had specific maturities of 1 and 3 months. SBI yields also varied in line with market conditions, although they have never been purely market-determined.

[26] Further evidence of the state banks' lack of profit orientation can be seen here. The rates of interest they were paying for time deposits, when adjusted for the required reserve ratio, typically exceeded the return they obtained on SBIs. They would have been more profitable if they had collected less deposits, and not purchased SBIs. By contrast, SBPUs were as cheap as, or cheaper than, time deposits to the private banks.

The state banks, moreover, continued to grow quite rapidly (while still losing market share quickly to the private banks), and showed little sign of becoming more efficient or more customer-oriented. They continued to focus much of their attention on other state-owned enterprises, which themselves were being left behind by their private sector competitors, and they continued to ignore the retail end of the banking spectrum, where it was apparent to others the greatest scope for expansion lay (Cole and McLeod 1991:154).

Figure 3: Bank Indonesia Loans to State Banks



Despite the reservations just mentioned, the June 1983 deregulation package was fairly widely regarded as making a significant contribution. It did not achieve everything it set out to do, but on the other hand, there were no obvious negative impacts. With a good deal of positive reaction to the package, and perhaps disappointed by the failure of the state banks to improve their performance, the government introduced a further deregulatory package in October 1988 (Government of Indonesia 1988). The contrastingly enthusiastic response of the private banks to the earlier package suggested that further gains were in prospect if the remaining obstacles to their expansion could be removed.

Removal of impediments to competition

Accordingly, the banking industry was at last opened to new entrants, having been closed for seventeen years. New domestic banks could be established, subject only to a relatively small minimum capital requirement and some checking of the character and qualifications of prospective owners and top managers. At the same time, the door was opened to foreign banks willing to set up joint ventures with existing domestic banking partners. For all practical purposes, domestic banks were permitted to open new branches wherever they wanted, without limit (although foreign and foreign joint-venture banks were still heavily restricted).

It was made much easier for private domestic banks to acquire licences to undertake foreign exchange operations, and these licences applied automatically to all branches—by contrast with the previous, somewhat curious arrangements, under which only particular branches of 'foreign exchange banks' were in fact permitted to deal in foreign exchange. State enterprises, previously captives of the state banks, were permitted to place up to half of their deposit funds with private banks. Finally, banks which participated in the national savings program, Tabanas (see below), were permitted to offer new savings deposit products of their own design.

Reduction in reserve requirement

Another aspect of the October package was the reduction of the required reserve ratio to only 2% from a nominal 15% (though in practice, perhaps only about 10-11% for all banks together, since not all time deposits were included in liabilities against which reserves had to be held, as noted above). The impact of this was less than might be imagined, however, because a new withholding tax of 15% on deposit interest was imposed at the same time. The intention of the new tax was to put deposits on the same tax basis as shares and bonds listed on the fledgling stock exchange (Noerhadi 1994:205). The previous discriminatory system of taxing dividends and bond interest earnings but exempting deposit interest from tax was seen to be holding back the development of the capital market.

Removal of limits on offshore borrowing

Further refinement of the new rules came in a supplementary package introduced in March 1989 (Government of Indonesia 1989). Most noteworthy was the removal of controls on banks' offshore borrowing, and the introduction of a prudential limit on banks' 'net open positions'. This term refers to the gap between banks' liabilities and assets denominated in foreign currencies, relative to their capital. When currency realignments occur, the rupiah values of assets and liabilities change by different absolute amounts, resulting in capital gains or losses to the bank. The possibility of gains makes this kind of activity a temptation for some bankers; the possibility of losses makes it risky for depositors as well as the banks' owners.[27]

It is not clear what purpose was imagined to be served by the previous restriction on offshore borrowing by banks. Given Indonesia's open capital account and the close links of Indonesian business to the financial centres of Singapore and Hong Kong, in

[27] The net open position (NOP) limitation has been misleadingly interpreted by some observers as a near substitute for the previous direct control on the volume of offshore borrowing by banks (e.g. Chant and Pangestu 1994:233). The latter constrains the amount of capital inflow in the form of funds intermediated by banks, whereas the NOP merely seeks to prevent banks from taking an unmatched currency position in such intermediation. Under the NOP constraint, banks may bring in as much foreign funds as they like, provided they on-lend them predominantly in the same currencies. The aim is therefore to prevent them from speculating too heavily on exchange rate movements, not to stop them from bringing funds into the country.

particular, preventing them from bringing in as much capital as they needed to satisfy their borrowers' demands simply meant in practice that the larger borrowers went offshore themselves for funding—a kind of reverse protectionism, artificially reducing rather than enhancing local banks' ability to compete with foreign banks.[28]

Impact of reforms

Growth of bank deposits

The results were astonishing. At the economy-wide level, the impact of both the 1983 and 1988 packages can be seen in changes in the ratios of various kinds of bank deposits to nominal GDP (Figure 4).[29] The impact is strongly evident in the case of quasi-money deposits (i.e. time and savings deposits) which, having been stagnant relative to output prior to 1983, suddenly began to increase rapidly—a process which has yet to run its course. Foreign currency deposits also grew rapidly between 1990 and 1992, such that they came to surpass rupiah-denominated demand deposits in importance.

Looking at time and savings deposits separately (Figure 5), it can be seen that time deposits began to boom in 1983, when interest rate controls on the state banks were removed; savings deposits, by contrast, took off in 1989, after the existing banks were exposed to competition from new entrants, and were permitted to expand their branch networks (thus enabling them to tap the retail end of the market much more effectively). The state banks had offered a savings product, Tabanas, since 1971 (Anon 1971:23), but their marketing efforts had been virtually non-existent, so that volume growth barely kept up with inflation. New savings products were now introduced by the private banks, offering both high interest rates and attractive lottery prizes to savers, with the result that savings deposits grew quickly to rival demand deposits in volume. The contrast, in terms of both volume of deposits and number of depositors, could hardly be more stark (Figures 6a & 6b). Clearly, the 1988 deregulation has had an enormous impact in terms of increasing the general public's access to, and familiarity with, the banking system.

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[28] Some observers have incorrectly interpreted this to mean that smaller borrowers with no reputation in, or links to, the international finance market were starved of funds as a result of this restriction. In reality, the fact that larger firms could turn to overseas markets meant that domestic rates did not rise to the extent they would have under full financial autarky. Small firms could borrow as much as they wanted domestically, at going rates.

[29] Focusing on these ratios, rather than the absolute values of the banking aggregates, effectively adjusts for increases which are attributable to growth of the economy and inflation rather than to deregulation.

Figure 4: Impact of Deregulation on Bank Deposits

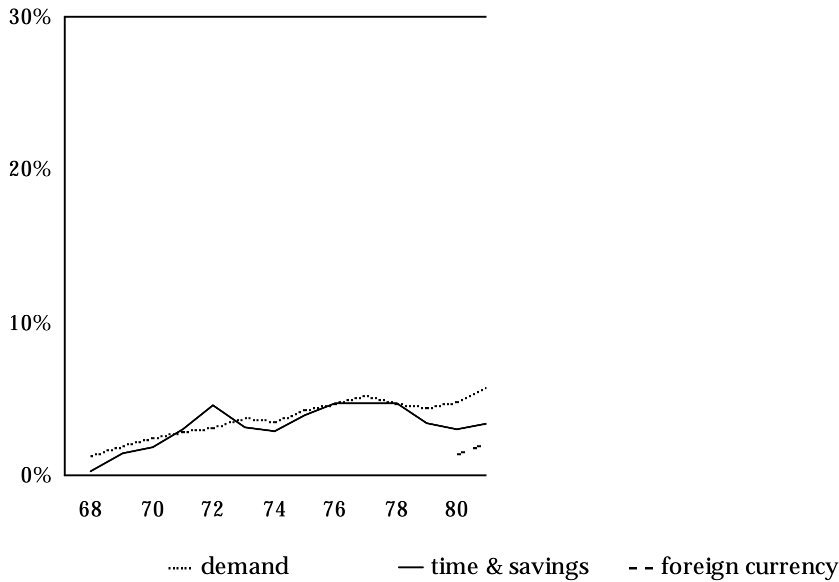
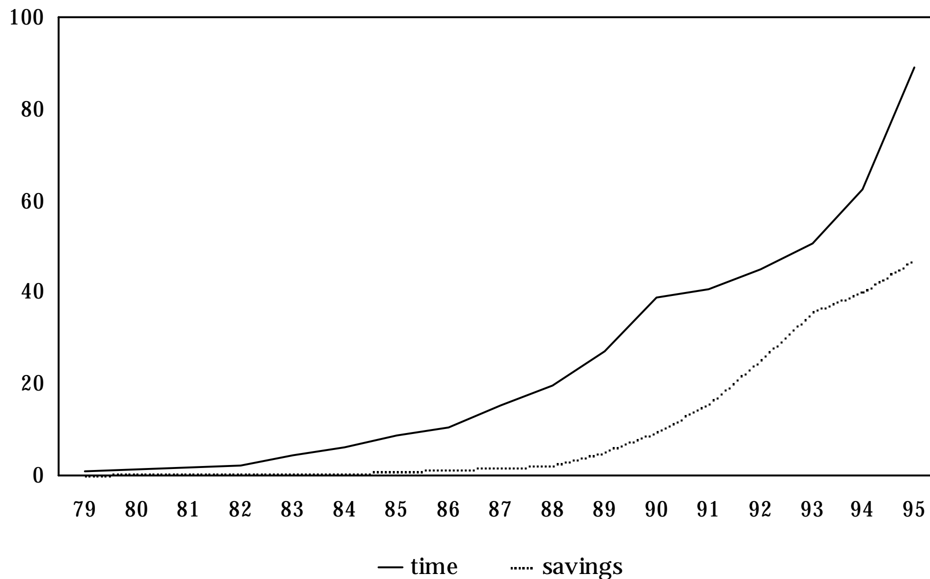


Figure 5: Impact of Deregulation on Time and Savings Deposits



The impact on demand deposits of the two major deregulation packages has been much less striking. The first package caused an initial decline, as bank customers took the opportunity to shift out of low- or zero-interest demand deposits into now highly attractive time deposits. But this process was constrained by their need to maintain a certain minimum level of demand deposits for transactions purposes. The second package seems to have attracted a great many new customers to the banks as branch networks expanded rapidly, and banks otherwise improved the quality of services offered. But this process, too, soon stabilised.

Figure 6a: Savings amounts
(Rp trillion)

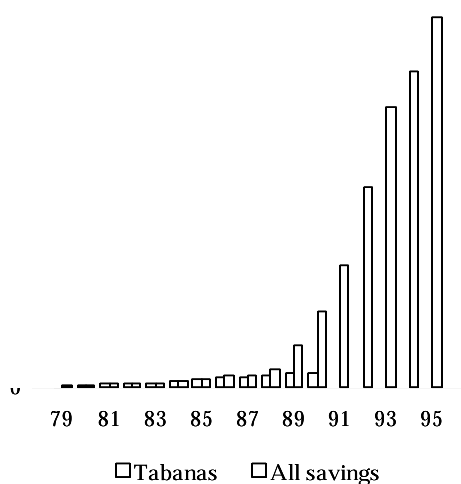
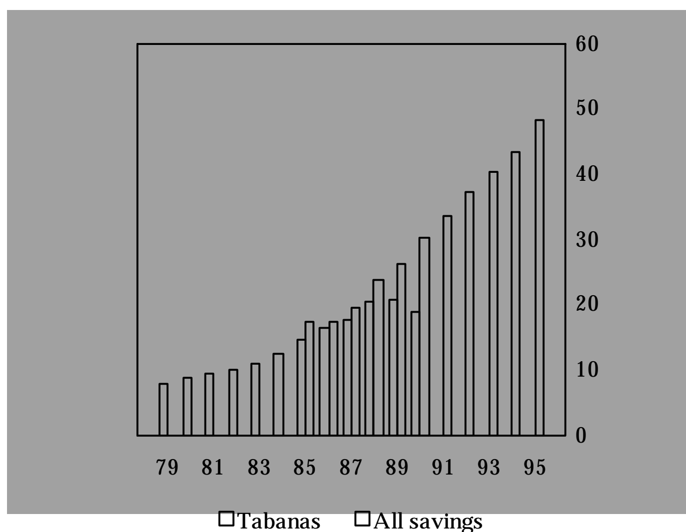


Figure 6b: Savings accounts
(million)



Physical expansion of the banking industry

If previously the state banks could turn a blind eye to the inroads being made to their market share by the private banks, now the process became obvious for all to see. Many new banks were established, both domestic and foreign joint ventures, and new branches of the private banks seemed to spring up on every street corner (Figure 7).[30]

The combination of the June '83 and October '88 packages took Indonesia's banking system in just five years from state bank dominance and bureaucratic suffocation to being an effervescent, private sector-driven collection of institutions, remarkably free of government intervention—a transformation so dramatic as to have been virtually unthinkable in the early 1980s (McLeod 1984:107-8). Even by the end of 1988, however, some controls still remained. Not all the subsidised loan progams had been discontinued,[31] and the state banks had proven adept at finding ways to include their borrowers in those that remained.[32] Among remaining distortions were the virtual prohibition of branching by foreign and foreign joint-venture banks, whose operations were restricted to seven major cities, and to a maximum of two offices in

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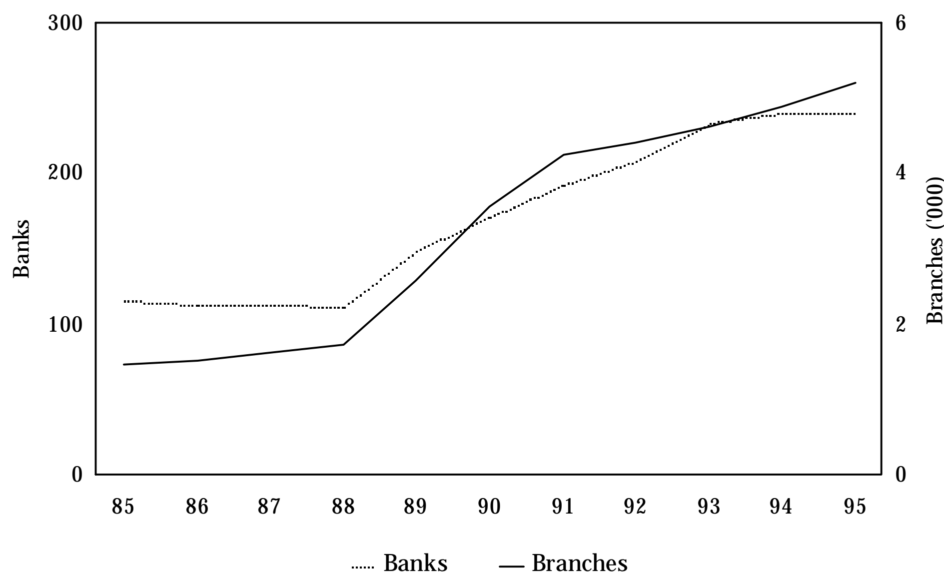
[30] The state banks managed to retain almost all deposits of the state enterprises, however, even though the 1988 package permitted movement of such deposits to the private banks.

[31] Chant and Pangestu (1994:251) note that the government made additional borrower categories eligible for subsidies very soon after the 1983 reforms.

[32] The incentive for borrowers to be included is obvious. Chant and Pangestu (1994:251) suggest that the incentive driving the state banks was access to BI funds, which were by now far cheaper than deposits. This may have been true if the state banks had been profit maximisers, but they were not. The better explanation is that the subsidised loan programs were sources of rents to bank officers.

Figure 7: Numbers of Banks and Branches



each of these, and the remaining obstacles placed in the way of banks wishing to obtain foreign exchange licences.

Deregulation runs out of steam

There have been few further deregulatory reforms. One which should be mentioned was announced in January 1990 (Government of Indonesia 1990), at which time a more serious attempt was made to cut back on the various subsidised loan programs. Base money growth had been very rapid during 1989, and inflation was threatening to run out of control. A significant contributor to money growth had been BI's loans to the banks in the remaining subsidised loan programs, so BI was presumably under great pressure to bring the growth of its loans under control in 1990. Thus the bulk of such programs were abolished, and interest rates on refinance from BI were moved closer to market levels (Chant and Pangestu 1994:233). The impact this time was far greater than in 1983, as indicated by the immediate and rapid decline in the volume of outstanding loans from BI to the state banks (Figure 3 above).

The last deregulatory reform of any consequence was contained in the long-awaited new banking law, introduced in February 1992 (McLeod 1992). This permitted foreign entities to acquire shares in domestic banks listed on the stock exchanges, and permitted the state banks to be so listed. In keeping with nationalistic sentiment, foreign shareholdings in listed banks were not permitted to exceed 49% of the total (despite the fact that foreign joint-venture banks could have up to 85% foreign ownership), and the government was required to maintain a majority shareholding in any state bank whose shares were offered to the public. The new law also did away with 'development' and 'savings' banks, by revoking the previous regulation

and laws under which they were established as separate categories. Existing development and savings banks simply became 'general' or commercial banks.

The tide turns

If the possibility of far-reaching deregulation seemed negligible in the early 1980s, its momentum seemed unstoppable by the beginning of the following decade. Again, however, extrapolation of the recent trend of policy-making proved a poor guide to what would happen in the future. Deregulation first came to a halt—in part because there was in fact little scope for further movement—and subsequently began to move in the opposite direction.

A year after the 1990 curtailment of remaining subsidised loan programs, the Finance Minister introduced a severe liquidity squeeze in response to currency speculation (by forcing certain large state enterprises to purchase SBIs; Parker 1991:10-12)[33], which brought about a very significant absolute decline in base money. Monetary laxness was suddenly replaced by tight money conditions, removing the anti-inflation argument against growth of 'liquidity credits' (BI refinance), and thus allowing BI to go back to what it had been doing previously.

As Figure 3 shows, loans from BI to the state banks quickly resumed their upward trajectory, recovering much of the lost ground within a year. By the end of 1995, BI loans to the banks (excluding SBPUs) amounted to some Rp17 trillion—almost a quarter of BI's total assets, and by far the most important asset after foreign exchange reserves. Well over a decade since the first attempt to get BI out of the business of lending, therefore, this objective is not even close to being met. It should be noted, moreover, that there seems to be almost no information about these loans available publicly: their purpose, the recipients, the maturities and interest rates (and implied subsidies) are almost entirely obscure.

In retrospect, it seems clear that there must have been a great deal of opposition to banking deregulation within government, and especially in the part most strongly affected—the central bank. BI may have been indifferent about allowing private sector banks to take market share from the state banks. But it is unlikely that the same can be said about loss of the power that went with the supply of cheap funds and the administration of a scheme which sought to control both the size and direction of bank lending, nor about the replacement of the implicit tax on bank intermediation (which accrued to BI) with an explicit tax on deposit interest (which accrued to the Department of Finance). Moreover, with the abandonment of controls over bank lending and their replacement as instruments of monetary policy by the SBI/SBPU mechanism, the focus of anti-inflation policy shifted from the banks'

[33] A similar strategy had been implemented, for the same reason, in June 1987 (Cole and Slade 1995:131-3). The two liquidity squeezes have become known as the 'Sumarlin shocks', after the former Minister for Finance.

balance sheets to that of the central bank. If inflation were to remain a problem, this would imply that the central bank, rather than the commercial banks, would have to bear the responsibility.

Perhaps overwhelmed by other forces in the bureaucracy pushing to invigorate the banking system (and indeed, the financial system as a whole),[34] government officials who opposed deregulation thought discretion the better part of valour, choosing to accept what they had little chance of opposing successfully, and waiting for opportunities to return to the *status quo ante*. One such opportunity was the enactment of the new banking law already mentioned. Notwithstanding the further liberalising movements noted above, the law contained one particularly worrying section which gave the government the option of obliging banks to engage in certain activities they would not freely choose to undertake (McLeod 1992:117-18):

> The Government may charge General Banks with undertaking Government programs for developing specific sectors of the economy, or giving greater attention to cooperatives and businessmen from the weak economic group/small businessmen in the context of raising the living standards of the masses ...

It had always been understood previously that the state banks had to play a dual role as 'commercial banks' and as 'agents of development'—and the practical interpretation of the latter term, although never made explicit, was along the lines of the above formulation. The new law extended this notion to the private banks as well. The alternative approach, much to be preferred, would be for the government to pay the banks to undertake voluntarily any socially-oriented programs it might have in mind, rather than to coerce them—just as it pays contractors to build roads, for example. In any case, the government has not chosen to bring this part of the new law into play as yet.

Other opportunities to turn the tide of deregulation did not take long to emerge. In 1990, the nominally private sector Bank Duta (actually a quasi-government bank, in so far as it was majority-owned by three foundations chaired by the President) verged on bankruptcy as a result of its involvement in large-scale currency speculation (Soesastro and Drysdale 1990:21-2). This activity directly violated one of the provisions of the March 1989 package: the limitation on the net open position. Bank Duta had acquired a very large net open position, and subsequent exchange rate changes caused it to lose some US$420 million.

The bank was saved by virtue of fresh injections of capital contributed by certain business associates of the President, so there were no losses to its depositors, nor to

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[34] Cole and Slade (1992) provide a discussion of the wider financial reform process.

other creditors.[35] Nevertheless, the episode was a great embarrassment to the central bank, as supervisor of the banking system. Presumably as a result, BI hurriedly put together a mass of new regulations, designed to show that it was acting resolutely to prevent any kind of repetition of unduly risky behaviour by banks, to the potential detriment of their depositors. These were introduced in February 1991.

Prudential concerns as the new basis for intervention

The outcome of this endeavour was a book of almost 600 pages of new prudential regulations (Government of Indonesia 1991). This may have persuaded some observers that banks' behaviour would be brought under control henceforth. In reality it was unlikely to have much impact because, basically, it missed the point. The Bank Duta fiasco did not result from a lack of appropriate prudential regulations: as noted, the March 1989 package quite clearly prohibited banks from exposing themselves to excessive risk through unmatched currency positions. The problem here, clearly, was the bank's failure to abide by the existing regulations, and the central bank's failure either to detect this fact, or to act as it should have done if it was aware of the transgression.[36]

Nevertheless, the episode marked a clear turning point in the policy-making process, putting an end to any further deregulation. An environment had been created in which observers could point to deregulation—however unjustifiably—as the cause of excessive risk-taking by banks, with the implication that deregulation had been a mistake which now had to be corrected.

It is worth noting in passing that the newly introduced system for evaluating bank soundness left a great deal to be desired as a mechanism for initiating corrective action in relation to banks which violated important prudential standards. The first basic problem was that 'soundness' was conceived as a weighted average of the banks' performance scores in a number of areas, so that poor performance in one area could be compensated by satisfactory performance in others. The second was that increasingly poor performance in a particular area did *not* result in an increasingly poor score: no matter how heavily a bank exposed itself to exchange rate risk, for example, it would not lose more than a certain number of points. The far more sensible approach would be to rate a bank 'unsound' (and take immediate corrective measures) if its performance was unsatisfactory in *any* of the major areas of risk management, regardless of performance elsewhere. By contrast, as Habir (1994:179) put it:

> … banks whose capital is negative (i.e. liabilities to depositors and other creditors exceed assets) would score 0.25 points in the capital adequacy

[35] The rescue operation was non-transparent, however, and whether there was any *quid pro quo* for the individuals concerned remains a matter for speculation.

[36] No doubt the bank's ownership structure placed the supervisory authority in a delicate position.

> category, and it is quite possible that they could accumulate enough points in other categories to be still rated 'Fairly Sound'. Similar comments apply to the net open position (exchange risk) category and the lending limits category.

Further ammunition for those wanting to advocate the need for strengthened prudential regulation soon became available in the form of another bank scandal, this time involving actual losses to depositors. Bank Summa, part of the Soeryadjaja family conglomerate, failed because of heavy exposure to property development projects within its own group. Whereas Bank Duta had speculated on the future price of foreign exchange, Bank Summa effectively speculated on the future price of real estate. It offered high interest rates to attract time deposits to fund its property loan portfolio, and when prices failed to rise, it had to offer even better rates in order to maintain a positive cash flow in the face of inability to sell property, except at a loss. Eventually the bubble burst and, after a protracted delay, the Minister of Finance finally revoked the bank's operating licence late in 1991, thus forcing it into liquidation (MacIntyre and Sjahrir 1993:12-16). Small depositors were paid out almost immediately, but larger depositors were forced to await the long drawn-out liquidation process, and did incur some losses (Marshall 1994:199). Again, however, the problem did not stem from any lack of prudential regulation. Both the 1988 package and its 1989 refinements encompassed limits on the extent to which banks could lend to single borrowers or groups of related borrowers.

With the Bank Summa episode still fresh in people's minds, yet another banking scandal emerged early in 1994. This time, one of the state banks was involved: Bapindo, the Indonesian Development Bank (Fane 1994:31). Bapindo had made some very large loans to companies known collectively as the Golden Key Group, headed by a relatively unknown entrepreneur, Eddy Tansil. The loans were for the nominal purpose of building three petrochemicals plants, although Tansil had no previous experience in this field; a significant part of the borrowed funds seems to have been diverted to other purposes. Because of the way the transactions were handled, the loans were effectively unsecured; indeed, the funds had been disbursed even without a contract having been signed (*Tempo*, 2 April 1994:25).

Before long, it was revealed that (retired) Admiral Sudomo, the influential former Coordinating Minister for Political Affairs and National Security—who later retired from Cabinet and became Head of the Supreme Advisory Council—had written a personal reference for Tansil. It later transpired that he had in fact written a series of letters over a period of around three years up until late 1993, at least one of which came about as close as possible to issuing a direct order to the bank to provide the loans without actually doing so (*Tempo*, 2 April 1994:22). Moreover, it was alleged that Dr JB Sumarlin—who was Minister of Finance at the time—had lobbied in favour of Tansil (although he strenuously denied this, and there seems to be no documentary evidence to support the claim). Finally, it was revealed that the President's youngest son had been a shareholder in one of the three plants at the time the loan was

negotiated—a factor no doubt taken into consideration, along with the expressions of ministerial support, by officials of Bapindo—although he quickly washed his hands of the affair by stating that he had sold out his share in the venture some time later, when he learned there was an expected cost overrun of some 100%.[37]

Once again, the episode moved some observers to criticise the deregulation process for encouraging or permitting banks to engage in excessively risky behaviour, and to call for further strengthening of the prudential regulations. The reality, however, was that the state banks collectively had a sorry record, long before deregulation commenced, of becoming technically insolvent and having to be saved from actual bankruptcy by further injections of capital by the government.[38] This was no switch to a new form of behaviour. Nor was the behaviour of Bapindo permitted in the newly deregulated environment. On the contrary, as in the case of Bank Summa, Bapindo had clearly violated regulations contained in both the 1988 and 1989 packages, which prohibited banks from lending too much to individual borrowers or groups, relative to their capital.

Reversing deregulation

The new focus on prudential regulations did not represent a step backwards from the earlier deregulation but, rather, extension of regulatory intervention to an area which previously had not had a high priority. In earlier years when the state banks dominated, large losses sometimes were incurred, especially because of loan defaults, but these could be patched over without loss to depositors. It was the taxpayer who suffered, but the losses were not transparent. State banks were not allowed to fail; new capital was injected,[39] and loan losses were hidden from view in the expectation that they could be written off gradually against future profits. In such circumstances, it seemed unnecessary to concentrate much attention on prudential regulation, since the state banks were part of the whole structure of government, and it was the government itself which would make good if they lost money.

Reimposition of foreign borrowing limits on banks

The first case in which a previous deregulatory measure was reversed was that of foreign borrowing by banks. Having lifted controls on such borrowing in 1989, the

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[37] The prices at which these shares were acquired and sold have not been reported.

[38] Anon (1971:25) notes that the government of the day was in the process 'of rehabilitating … Bapindo'. Grenville (1977:28) briefly mentions episodes involving two other state banks, Bank Negara Indonesia 1946 and Bank Bumi Daya, in the early and mid 1970s, respectively, which prompted the government to replace the President Directors and some Executive Directors of each bank. He quotes an anonymous but prescient banker, who was under no illusions that state bank losses would be avoided in the future: 'This is a changing of the guard, and the palace remains.'

[39] This did not necessarily require a call on budgetary funds. A simple alternative involved only some book entries, so as to convert existing government loans to the banks into government equity.

central bank reimposed them in 1991.[40] The pretext was the need to support the work of a newly established, high level government committee which had been given the responsibility of cutting back on Indonesia's foreign borrowing (Muir 1991:15-21). In turn, this was supposedly made necessary by Indonesia's increasing indebtedness to the rest of the world, which was said to pose a threat to the balance of payments because of the implied debt service burden.

In fact, this new policy thrust was an attempt to kill off several 'mega-projects', some by state enterprises such as Pertamina (oil and gas), Garuda (airline) and PLN (electricity utility), and some by the private sector. When state enterprises were directly involved, the policy makers were mindful of an earlier occasion, when Pertamina undertook large-scale borrowing in support of what turned out to be a range of poorly chosen investments, at very great cost to the government (Arndt 1975:3-8; McCawley 1976:2-6). There was a fear that capital spending now in the pipeline was also likely to cause substantial losses to the government. So far as the private sector projects were concerned, policy makers had been becoming increasingly worried that certain very well connected conglomerates were undertaking many huge investment projects, in enterprises that made use of state bank loans, or were to use inputs supplied by state enterprises (particularly Pertamina), or were to sell their output to state enterprises (such as PLN).

In all such cases, there was the prospect of large losses to taxpayers if the investments proved unviable. Loans would not be repaid, low prices would be paid for inputs (if they were paid for at all), or high prices would be demanded for outputs. It was politically difficult to attack these projects directly, but by appealing to the supposed danger to the balance of payments, there was the possibility of attacking them indirectly. Even though the real intention was just to stop a small number of specific, large projects, however, BI was quick to seize the opportunity to reimpose general ceilings on borrowings offshore by the banks—regardless of the projects such borrowings were intended to finance. It is interesting to note, as a consequence, that whereas current regulations protect domestic banks from competition from foreign joint-venture banks operating in Indonesia (by restricting them to very few branches), the offshore borrowing limits prevent domestic banks from competing on an equal footing with offshore banks in financing domestic activity with foreign funds.

Reversion to lending controls

More recently, developments on the macroeconomic policy front have provided the opportunity and rationale for the central bank to move even further in the direction of overturning earlier deregulation efforts. Dogged by its continued failure to bring inflation within the five year development plan target maximum of 5% p.a. (Government of Indonesia 1994, Book I:147), BI has moved subtly to shift the blame

[40] Bank Indonesia Directors' Decree No. 24/52/KEP/DIR, dated 29 November 1991.

for this to the commercial banks. ‘Excessive’ growth of bank lending is seen as the cause of inflation, so control of inflation is envisioned as requiring control over the expansion of the commercial banks’ portfolios. To this end, the central bank has adopted targets for the rate of growth of bank lending, and for the closely related monetary aggregates, M1 (narrow money) and M2 (broad money).

As noted above, there is a long history in Indonesia of trying to control inflation by controlling bank lending, but it is a history of failure. Indonesia suffered hyperinflation in the 1960s and quite high inflation in the 1970s; in both periods, controls on bank lending were central to monetary policy. The alternative view is that rapid growth of lending and the broader monetary aggregates is not a cause, but a *consequence* of inflation, and of deregulation. In regard to the latter, it is unclear in retrospect whether the government anticipated the rapid expansion in bank intermediation brought about by its reform packages. Official statements at the time suggest that the primary intention of the June 1983 package was simply to induce the state banks to mobilise more deposits from the public, in order to reduce their reliance on BI refinancing facilities (Bank Indonesia 1984:1-2). An expansion of the scale of their lending activities does not seem to have been contemplated, and the private banks’ potential response to deregulation seems hardly even to have been considered.

By contrast, the major thrust of the early literature on financial development (e.g. McKinnon 1973) was that getting rid of financial repression (in Indonesia, mainly in the form of various restrictions on competition and expansion of the banking system) would permit a significant increase in intermediation. The possibility that this might have inflationary consequences does not seem to have been entertained—rightly—because it simply involved the transfer of spending power between entities, not an addition to total spending power.

To the extent the authorities seek to control M1, M2 and lending indirectly, by controlling the expansion of base money, this would be fairly harmless. That, after all, was the approach followed from 1983 until quite recently—a period for which the inflation management record far surpasses that of the 1960s and 1970s, with inflation being held fairly consistently to between 5 and 10% p.a. In practice, however, the central bank has not managed to control base money sufficiently tightly to bring inflation even lower (for reasons explained briefly below),[41] and so it has fallen back instead on a variant of its old policy of setting ceilings on loan growth for each of the banks. The banks are now required to submit plans for business growth for the coming year, and heavy pressure is applied to persuade them to keep this growth within the limits set for aggregate banking growth.[42]

[41] McLeod (forthcoming) discusses this in depth.

[42] As the Governor of BI put it: ‘Lending plans should take into consideration the national monetary targets.’ (Djiwandono 1995:3; author’s translation).

Different rates of expansion are negotiated for different banks, but the process is non-transparent.

Increasing the required reserves ratio

For many years it has been government policy to devalue or depreciate the rupiah in order to maintain or improve the competitiveness of Indonesian exports (or, more accurately, Indonesian tradeable goods and services). On the one hand, this policy is much to be preferred over that which has often been followed by other governments, of trying to maintain a fixed exchange rate at all cost, regardless of balance of payments deficits. On the other, it is possible to err by going too far in the opposite direction; this aptly describes the Indonesian case.

This policy has generated chronic balance of payments surpluses (McLeod 1993:106), requiring the central bank to become a net purchaser of foreign exchange in order to keep its price rising (i.e. in order to achieve continuous depreciation). The surpluses, in turn, have generated monetary expansion, which BI has then sought to offset or sterilise by borrowing funds from the public on a large scale through the issue of SBIs: during the three years to January 1994, the amount was roughly $US11 billion (net of a small increase in outstanding SBPUs). While this was successful in the sense that it kept inflation well below what it would otherwise have been, it was extraordinarily expensive to BI, because there was a large negative spread between the interest returns to its holdings of foreign exchange reserves and the interest cost of SBIs on issue.

Interest earned on foreign exchange reserves (of the order of 3-4% p.a. on US dollars, for example) was far lower than the rates Bank Indonesia had to pay on its own certificates (typically around 12-13% p.a.), even after allowance for rupiah depreciation of around 4% p.a. With a negative spread of about 5% p.a. after depreciation on an amount of roughly $US11 billion, losses on this part of Bank Indonesia's portfolio would have been running at around $US550 million annually by the end of 1993.[43]

It is not surprising, then, that BI has sought other ways of accomplishing monetary contraction which would not be so costly to itself. What is needed for monetary contraction is to issue central bank liabilities that substitute for its monetary liabilities (i.e. cash and deposits of banks at BI). To issue SBIs for this purpose is expensive to BI, because an interest-bearing liability is substituted for non-interest-bearing liabilities. To avoid this expense, BI has recently chosen instead to force the banks to hold more non-interest-bearing liabilities, in the form of required reserves. The required reserve ratio, which had fallen from 15% to only 2% in the October 1988 package, was raised again to 3% in February 1996 (Bird 1996:9-10). At the same

[43] This estimate cannot be verified, as Bank Indonesia ceased publishing its profit and loss statement in its annual reports in 1992/93.

time, the definition of reserves was changed to exclude the banks' holdings of cash, which previously constituted more than half of the total.

For this reason, the policy change was more significant than it appeared at first sight. The result was to require an increase in the banks' deposits at the central bank from Rp2.3 trillion to Rp6.0 trillion. With the interest rate on SBIs of the order of 15% p.a., this would cut BI's annual interest outgoings by the not inconsiderable sum of about Rp550 billion (roughly $260 million). At the microeconomic level, however, the effect was simply to increase the distortionary tax on bank intermediation, thus increasing the incentive of finance market participants to bypass banks in favour of other financing techniques.

Extension of control to non-banks and non-intermediated finance

Belief that inflation is caused by rapid growth of bank lending extends naturally to the view that lending other than by banks must also be controlled. To this end, the central bank moved to gain control over non-bank finance such as leasing, factoring and consumer finance companies (but excluding insurance and pension funds) in December, 1995. Entry to almost all of this sector was closed immediately. A BI spokesman was reported as saying that the new regulations would

> enable the central bank to control the monetary system more effectively, particularly in checking the money supply at an appropriate level (*Jakarta Post*, 23 December 1995).[44]

At the same time, it has not gone unnoticed that many firms have taken to bypassing banks altogether, by issuing commercial paper direct to investors rather than obtaining loans. The same (incorrect) inflation logic dictates that this form of activity must also be subjected to control by BI, and regulations to this effect were issued in 1995.[45] Under these regulations, any commercial paper issued or traded by banks must have been rated 'investment grade' by a specific domestic rating agency (PT Pefindo), and is limited to a maximum 270 days maturity.

The introduction of such constraints contrasts strangely with their absence in relation to ordinary bank loans. There are no restrictions on the maturity of loans, and banks may lend to firms of whatever 'quality', given that they can charge interest rates commensurate with the estimated degree of risk.[46] Banks routinely undertake their own assessments of potential borrowers' creditworthiness, so why they should have to rely on the opinion of a third party in this instance remains a mystery. In normal circumstances, moreover, the sole incentive which ratings

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[44] How this could be the case is unclear, since the liabilities of non-banks are not part of the money supply as it has been defined hitherto.

[45] Bank Indonesia Directors' Decree No. 28/52/KEP/DIR, dated 11 August 1995.

[46] Indeed, one of the regulations introduced in 1990 obliges domestic banks to devote at least 20% of their loan portfolios to small businesses, probably none of which would be rated 'investment grade'.

agencies have to produce reliable assessments, given that they do not put their own funds at risk in the firms in question, is the threat of losing their customers if they do not. Pefindo—a firm which had been established by the government less than two years earlier (Hendrobudiyanto 1994:165)—having been provided with a captive market by these new regulations, faces no such incentive. Predictably, it seems to have become yet another costly and entirely unnecessary obstacle to doing business in Indonesia.

Tightening of licensing procedures for new bank branches

The most recent example of retrogression in banking policy is the announcement that BI and the Department of Finance were to become 'more selective' in the licensing of new branches, with a view to avoiding 'unhealthy competition' between banks (*Bisnis Indonesia*, 28 June 1996). The Governor of the central bank was reported as acknowledging 'that in certain areas, there were too many bank offices', but it was not explained how this could be other than beneficial to the interests of the general public. Nor was there any reference to the vast expansion of the use of the banking system by the general public following the freeing up of the branching process in the 1988 reforms. The expression of concern about 'unhealthy competition' is, of course, an established strategy for justifying the imposition of controls in order to promote the interests of existing firms in an industry.

Concluding comments

Unquestionably, both the economy and the general public have benefited enormously from the reforms of Indonesia's banking sector undertaken in the 1980s. As a result of these reforms, private sector banks were enabled to compete vigorously amongst themselves and with the previously dominant, but highly inefficient, state banks. They brought great enthusiasm to the task, and have greatly improved the quality, and expanded the quantity, of intermediation and payments services.

On the other hand, however, attempts to get the central bank out of the business of lending have been unsuccessful. Its loans through the banking system are still enormous, and have been growing recently rather than falling—notwithstanding the clearly demonstrated ability of the commercial banks to mobilise financial savings on a large and rapidly expanding scale. Moreover, there is a great lack of transparency as to the borrowers involved, and as to the purpose, maturity and interest rates attaching to the loans.

Various factors now threaten the gains which deregulation has brought. Bureaucrats who saw their power and influence shrinking drastically with the movement away from government intervention in financial markets have been reasserting themselves, and the persistence of inflation has given impetus to reversion to previous forms of intervention. Commitment on the part of the government to the losing cause of trying artificially to make Indonesia more competitive by steadily

depreciating the nominal exchange rate has ensured that inflation remains problem, and thus has brought pressure for more and more controls—on lending by banks and other intermediaries, on non-intermediated lending, on foreign borrowing by banks, on entry to the financial sector, on bank branching, and on the composition of banks' portfolios. Frustration with the central bank's inability to enforce regulations against politically powerful bank shareholders (including the government itself) is resulting in more and more prudential regulation, but little actual progress in improving prudential standards. It will be interesting to see whether the characterisation of policy-making in this field will be best described in the future as 'two steps forward and one step back', or whether the backward steps will continue to predominate, as they have in the last few years.

Appendix: Chronology of Major Microeconomic Policy Changes in Banking

	Pro-market	*Market overriding*
1967	Re-opening of market to small number of foreign banks following era of bank nationalisations	
April 1974	Payment of interest on banks' excess reserves	
December 1977	Cut in required reserves ratio from 30% to 15%	Cut in excess reserves interest rate from 10% p.a. to 6%
August 1982	Withdrawal of BI refinance for lower priority state bank loans	
May 1983	Interest rate on state banks' 6 month time deposit rate freed	
June 1983	All remaining time deposit interest rate controls on state banks removed	(but significant relaxations soon thereafter, such that BI lending to banks continues to grow rapidly)
	Most loan programs relying on heavily subsidised funds from BI discontinued	
	Removal of controls on lending by all banks	
September 1984		Limit imposed on interbank borrowing—7.5% of total funds
August 1995	Interbank borrowing limit increased to 15%	
October 1988	Opening of market to new private domestic banks and new foreign joint-venture banks	New emphasis on prudential standards in relation to concentrated lending
	Banks permitted to expand branch networks with minimum bureaucratic interference	
	Easing of requirements for domestic banks to obtain foreign exchange licences	
	All branches of banks with foreign exchange licences permitted to deal in foreign exchange (rather than only particular branches previously)	
	Reduction of required reserves ratio from 15% to 2%	
	Imposition of 15% withholding tax on deposit interest	
	Removal of limit on interbank borrowing	
	State enterprises permitted to put deposits with non-state banks	

	Pro-market	*Market overriding*
October 1988 (cont'd)	Banks permitted to introduce savings deposit products of their own design	
March 1989	Removal of controls on banks' borrowing overseas	Prudential standards widened to encompass limits on foreign exchange exposure ('net open position')
January 1990	Most remaining subsidised loan programs discontinued	
February 1991		Prudential standards widened to encompass capital adequacy
1991		BI lending to banks begins to rebound after falling significantly
November 1991		Reimposition of controls on banks' borrowing overseas
February 1992	Foreigners permitted to purchase shares in domestic banks listed on the stock exchanges State banks permitted to list on the stock exchanges Distinctions between 'development', 'savings' and 'general' (commercial) banks removed	New banking law gives government the option of treating all banks (not just state banks) as 'agents of development'.
1995		Reimposition of *de facto* controls on bank lending
August 1995		Extension of central bank controls to bank involvement with commercial paper issues
December 1995		Extension of central bank supervisory authority to non-bank finance companies
February 1996		Increase in required reserves ratio, and exclusion of cash from definition of 'reserves'
June 1996		Tightening of licensing of new bank branches

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