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FINANCING ECONOMIC DEVELOPMENT IN INDONESIA:  
PUBLIC AND PRIVATE MOBILIZATION OF VOLUNTARY SAVINGS

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I. THE MONETARY SITUATION

At the present time a multiplicity of institutions designed to mobilize voluntary savings, hold active deposits and extend credit exist in Indonesia. Despite the abundance of financial institutions to perform these essential economic functions, the channeling of voluntary savings into investment has been virtually nil. This paper will therefore be an inquiry into the potential role of this type of financing in Indonesian economic development and the means by which the effectiveness of private and public financial institutions may be strengthened.

The hypothesis which will be argued is that the recent monetary impact of these institutions has been highly inflationary. Neither public nor private banking institutions have accumulated savings from current income. The greater part of the banking system's reserves against which credits have been extended have been obtained from governmental resources. These resources have by and large provided the capital and deposits from which the monetary system as a whole has created new funds made available to private and public borrowers. In the meantime, the government itself has been operating at sizeable deficits; hence, the banking system has exerted dual inflationary stimuli upon the economy: one generated directly by the government deficit (financed through the banking system), and the other generated by the government providing the financial base from which the banking system has created new funds.

From the point of view of Indonesia's paramount economic objectives--economic development and economic stability--the inflationary quality (credit creation) of the banking system as a whole should be restricted. The role of financial institutions during the period of Indonesian economic development should rather be concerned with channeling of savings from current income into investment. Thus the savings mobilization aspect of their operations should be strengthened.

This view of the role of financial institutions in financing Indonesian development is based on the existing inflationary potential of the Indonesian economy. The imminence of inflation and the existence of inflationary pressures is based on data presented in the following tables. The evidence of inflationary forces are shown explicitly in these tables in the case of expanded money supply and

rising prices in the urban sector. However, the spotty response of prices to newly created money obscures the latent inflationary potential resulting from continuously expanded money supply.

	Currency	Deposits	Total money Supply	% currency	% deposits
1952 December	4349.2	2370.0	6719.2	64.7	35.3
1953 January	4378.5	2619.3	6997.8	62.6	37.4
March	4664.5	2611.9	7276.4	64.1	35.9
June	5020.9	2183.6	7204.5	69.7	30.3
September	5083.6	2383.3	7466.9	68.1	31.9
December	5217.7	2423.8	7641.5	68.1	31.9
1954 January	5256.8	2396.1	7652.9	68.7	31.3
February	5233.0	2323.7	7556.7	68.0	32.0
March	5334.9	2528.7	7863.6	67.8	32.2
April	5534.3	2384.2	7918.5	69.9	30.1
May	6123.2	2265.7	8388.9	73.0	27.0
June	6115.4	2576.3	8691.7	70.4	29.6

Source: Bank Indonesia Bulletin

	1951	1952	1953
Rice irrigated	5,259	5,507	6,023
non-irrigated	546	580	642
Maize (kernels)	2,350	2,611	2,416
Cassava (roots)	7,900	8,232	8,332
Batatas (roots)	1,030	1,344	1,319
Ground nuts (peeled)	184	158	196
Soya beans (peeled)	2701	2811	3041

Source: Bank Indonesia Report

1. Total for 1951, 17,539; 1952, 18,713; 1953, 19,232.

Table 3.

## PRICE INDEX NUMBERS OF FOODSTUFFS AND COST OF LIVING

	Foodstuffs			Cost of Living		
	12 foodstuffs July 1938=100	19 foodstuffs July 1938=100		European middle class Jan. 1950=100	Unskilled worker July 1938=100	
	Countryside of Java & Madura	Djakarta	Medan	Makasar	Djakarta	Djakarta
1952 December	3,611	2,644	2,652	2,315	199	2,394
1953 March	3,140	2,739	2,770	2,416	218	2,362
June	2,956	2,838	2,725	2,427	230	2,324
September	3,065	2,728	2,915	2,358	228	2,267
December	3,501	2,934	2,903	2,435	238	2,421
1954 January	3,429	2,927	2,828	2,451	241	2,529
February	3,261	2,898	2,802	2,502	240	2,580
March	3,116	2,865	2,808	2,512	240	2,573
April	2,877	2,868	2,843	2,514	241	2,514
May	2,722	2,879	2,934	2,529	244	2,496
June	2,690	2,887	-	2,542	244	2,515

Source: Bank Indonesia Report and Bulletins.

These tables show an interesting relationship between production of basic food supplies, the money supply, prices and cost of living. Domestic production of food supplies in 1953 increased by 8 percent over the previous year. The total supply of food in the economy was not greatly expanded, however, following the reduction of government rice imports in cognizance of the increased domestic production. Although total output figures are not available, it appears that supply of other goods remained relatively constant in the face of relatively small output gains in some sectors and severely reduced imports of all consumer goods. During 1953 total money supply (M and M<sup>1</sup>) expanded by 14 percent. The most noticeable result of these conditions is the variation in price response by sectors. The prices of foodstuffs consumed in the countryside (primarily domestically produced) actually fell between December 1952 and December 1953. On the other hand, the prices of foodstuffs (including some imported goods) in the large cities of Djakarta, Medan and Makassar rose somewhat. The same holds true for the cost of living index of the unskilled labor in Djakarta. However, a significant increase in the cost of living for the European middle class or the Indonesian civil servant group was recorded during 1953. In the first half of 1954, prices and the cost of living pertinent to the countryside and the unskilled worker in the urban sector continued to fall while total money supply expanded by Rp. 1 billion--28 percent above December 1952 and 14 percent above December 1953. On the other hand, the cost of living pertinent to the European middle class or the Indonesian civil servant in Djakarta rose substantially during this period. One of the basic reasons for this result was the increasingly strict import policy followed by the Indonesian government. The value of consumer goods imported into Indonesia fell from Rp. 5,302 million in 1952 to Rp. 3,740 million in 1953. During the first half of 1954 an even more drastic policy of reducing consumer goods imports was implemented. As a result, the 1954 level of imports of consumer goods will fall even below that recorded in 1953. Furthermore, in 1954 the inflationary stimuli working on the economy will be considerably greater than in 1953. This will result from the fact that the government deficit will be considerably larger in 1954 than that experienced in the previous year. On the other hand, the countervailing deflationary force of a deficit in the current account of the balance of payments will be considerably lower in 1954 than it was in 1953.

The paradox of relatively mild price responses to a substantially increased flow of money without significant accompanying increases in total supply of goods can be explained by two important monetary factors. In the first place, the circulation of newly created money resulting from the inflationary forces working on the economy tends to be limited to the urban sector in which it is generated. Government expenditures both for supplies of goods and personnel are undertaken primarily in this sector. Moreover, the expansion of private credit, inflationary in nature as explained above, became an increasingly important factor in the first half of

1954. In great part, this credit is extended to the trading and emerging industrialist groups in the urban sector. In effect, therefore, the income increases resulting from the newly generated additions to the income stream end up in the urban sector. The supply of goods in this sector, against which this new income can be expressed as demand, has been particularly scarce. This has primarily resulted from the restrictive consumer goods import policy followed by recent Cabinets. The consequence has been a reduction in the velocity of money in this sector concomitant with the increased supply of currency and deposits. Thus it can be argued that government policy aimed at import control has been tantamount in effect to anti-inflationary monetary policy since the velocity factor in the monetary equation has been reduced. This result, however, produces thorny problems in developmental financing generally, and particularly for extension of the type of financing provided by the governmental and private banks during the past few years.

The impact of strict control of the import of consumers goods has been tantamount to an enforced reduction in the propensity to consume among the middle and upper income groups in the urban sector. Viewed from the other side, the result has been an enforced increase in liquidity preference. In the institutional environment of post-war Indonesia these factors have resulted in increased holdings of inactive balances, withheld from the monetary stream primarily in the form of cash. Since inflationary tendencies in the economy have not yet produced significant price rises, these balances have not generally been converted to goods. However, it is clear that they have exerted considerably pressure on the black market foreign exchange rates. To the extent that the Indonesian trading and industrial community as well as the foreign (primarily Dutch) civil service group in Djakarta are unable to obtain the imported consumer goods on which they would wish to spend these withdrawals from the income stream, there is some tendency to transfer these balances abroad for purposes of delayed consumption. This pressure has been observed particularly with regard to the Netherlands guilder since the foreign business group as well as the foreign civil service staff continues to be primarily Dutch. Between December 1952 and July 1954 the black market rate for the Dutch guilder rose from Rp. 4 to Rp. 8.1. During the same period of time the black market rate for the U. S. dollar rose from Rp. 22 per dollar to Rp. 28 per dollar. Thus it is obvious that the pressure on the Dutch guilder was considerably greater than that on the American dollar. While the use of inactive balances to purchase foreign currencies on the black market does not exert direct pressures on the domestic price level, it does have some bearing on economic stability and economic development in Indonesia. If the supply of foreign exchange thus dissipated were made available to the foreign exchange authorities (i.e. converted at the official rate), it could be employed to increase the supply of goods on Indonesian markets and/or to finance the import of capital or raw material goods to expand domestic production. Furthermore, in a recent article on this subject, Professor C. F. Scheffer argues that this process in

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1. Bank Indonesia Bulletin, No. 3, First and Second Quarter, 1954, Table 17, p. 14.

fact brings funds from the idle to the active sphere. Scheffer concludes that this activation process is tantamount to exerting inflationary pressures on price levels of imported goods. In his words, "I believe that it is more correct not to say that part of the money supply has been locked up in the financial circulation (which would mean in effect saying that part of the money supply is hoarded), but to say, that part of the money supply is counteracted by increased price level of some imported goods."<sup>1</sup> This argument is made on the realistic assumption that black market transfers place rupiah in the hands of upper income foreign groups, among which a high propensity to import exists.

As Scheffer's article indicates, observers in Indonesia are becoming increasingly aware of the presence of the dangers of excessive liquidity. Yet it is difficult to estimate the volume and distribution of these volatile balances. In addition to the indirect evidence presented above, however, the banking system has reported that there has been a significant increase in demand for safety deposit vaults during past months. They have interpreted this to mean that hoards are held in large part as cash and that the holders of these balances are willing to sacrifice interest to keep the size of their holdings from the surveillance of Indonesian officials.

Recent literature on the financing of economic development has frequently suggested that the existence of such inactive balances (monetary and non-monetary hoards) represents a pool of financial resources which could be mobilized to finance economic development, given a network of monetary institutions to collect them. The following quotation from a widely distributed United Nations document is representative:

We deal first with the possibility of financing of the required capital investment not by increasing savings, but by using the gold and foreign exchange which lie in the hoards of some private individuals in underdeveloped countries. It is not possible to be certain about the size of these hoards. Inquiry suggests that they are specially important in two areas, namely in South and Southeast Asia and in the Middle East. It is estimated that in some of the countries in these areas, private gold hoards are as large as 10% of the national income. These hoards could of course be used only once; if spent over five years, they would contribute, on this estimate, 2% of the national income to capital formation during five years. This figure is small but it certainly

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1. C. F. Scheffer, "A Note...", Ekonomi Dan Keuangan Indonesia, Vol. 7, No. 10, October 1954, pp. 652-657.

not to be neglected.

It is very desirable that governments should try to get these hoards used for capital formation. It is however also very difficult. They cannot easily be requisitioned because information about their whereabouts is scanty. In our opinion, it is unlikely that the release of private hoards will contribute much to capital formation in the near future.<sup>1</sup>

Activation of these inactive balances either through the private banking system or through sale of bonds to the holders of these balances would be tantamount to inflationary financing of development, to the extent that these balances are residual from past incomes rather than savings from current income. If one could be assured that these balances would continue to remain inactive, it would be much simpler to offset their existence by the simple creation of new money. The problem is, however, that these balances will not necessarily remain inactive; in fact, experience with this type of monetary overhang in other countries demonstrates that balances held primarily as cash tend to be extremely volatile. If inflationary financing of the government and economic development were undertaken on a large scale, resulting pressures on supply would inevitably produce substantial price rises. It is believed that a rapidly upward trend in price would set in motion a flight to commodities. This is based on the simple proposition that it is more advantageous to hold one's liquid assets in the form of goods than in the form of cash in the face of price rises. This trend would accentuate the shortage of supply, already apparent in the urban sector. In our opinion, therefore, unrestricted use of this type of financing would lead to all the political and economic dangers inherent in open inflation. These dangers could be averted if the scope of such financing could be limited to approximately the level of current withdrawals (savings) from current income. If this policy were to be effective, such withdrawals from current income should not be offset by consumption expenditures (by others) financed by private activation of idle balances held residually from past incomes.

## II. THE INDONESIAN MONEY MARKET

I would now like to review the existing institutional devices for mobilization of voluntary savings against the background of the existing inflationary potential of the Indonesian economy and the

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1. United Nations, "Measures for the Economic Development of Underdeveloped Countries," New York, May 1951, pp. 35-36.



complicating factor of large but unmeasured holdings of inactive balances. It is clear that the problem of mobilizing voluntary savings in Indonesia is not one of a shortage of financial institutions. If anything, Indonesia is plagued by a proliferation of banking institutions resulting in considerable duplication of lending functions, and extension of credit with little coordinated monetary control. The Indonesian financial system consists of a complex series of banking and monetary institutions, including a core of government financial institutions, a network of foreign banks and finally a number of private Indonesian banks.<sup>1</sup>

The government banks include the Bank Indonesia, the Bank Industri Negara, the Bank Negara Indonesia, the Bank Rakjat Indonesia and specialized governmental lending agencies (Bank Desa, Lumbung Desa and Jajasan Kredit), all almost exclusively financed by funds allocated through the central governmental budget. There is some specialization of function among these governmental institutions. The Bank Indonesia has been designated as the central bank since 1953. Although lending functions are eventually to be transferred to other banking institutions, it continues to do a significant amount of commercial business. Its central banking functions currently include the exclusive right of note issue and its role as the primary source of direct credit for the government. The Bank Industri Negara is primarily concerned with extension of long-term credit to Indonesian estate agriculture, industry and mining. The Bank Negara Indonesia specializes in the extension of credit to Indonesian exporters and importers. It is thus used as a policy arm of the Ministry of Economic Affairs in carrying out its benteng policies.<sup>2</sup> The Bank Rakjat Indonesia was originally established in 1946 to succeed the Dutch colonial Algemene Volkscrediet Bank. Originally, it was intended to replace the Dutch institution in extending credit primarily in the rural sector. However, its function was redefined in 1951; since that time it has been designated as the agency to extend credit to medium sized and small commercial and industrial firms. Since 1951 the percentage of this bank's total credit offerings extended in the rural sector has fallen from 49 to 21 percent, while the percentage extended to medium-sized and small commercial and industrial concerns and industries has risen from 43 to 66 percent. Both the Desa banks and the Desa Lumbungs have been revitalized since 1952. The Desa banks are primarily concerned with extending small monetary loans to

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1. This is not the place to undertake a detailed review of financial institutions in Indonesia. The interested reader may refer to C. F. Scheffer, Het Bankwezen in Indonesie Sedert het Uitbreken van de Tweede Wereldoorlog, Djakarta, January 1952, or to the review of credit institutions given in recent Reports of the Bank Indonesia (formerly Java Bank).

2. These policies are designed to promote the handling of export and import business by Indonesian nationals. Special licensing and credit arrangements are offered to encourage this development.

agriculturalists, while the Desa Lumbungs are concerned with extending rice loans in the rural sector. The Jajasa Kredit (Credit Foundation) is essentially a governmental guarantor agency. Its purpose is the extension of financial assistance in the form of guarantees to worthwhile economic enterprises which are unable to provide collateral for ordinary commercial bank loans. Guarantees are provided primarily to amounts loaned through the Bank Negara Indonesia and the Bank Rakjat Indonesia. In addition to these agencies with commercial banking functions, the government operates a postal savings bank, Bank Tabungan Pos, and a state pawnshop service. The postal savings bank, which is a continuation of the Dutch service, has been increasingly successful in collecting small-scale deposits throughout Indonesia. The state pawnshop service continues to expand gradually both in terms of the number of pawn shops in existence and the total amount of loans outstanding. All of the governmental financial institutions with the exception of the Bank Indonesia have local offices throughout the archipelago.

Lack of coordination in the operations of the governmental financial institutions has been intensified by the recent entry of several government ministries into the credit field. In a recent report on the government's credit policy,<sup>1</sup> former Minister of Economic Affairs Iskaq pointed out that his Ministry granted credits to small firms in several areas of enterprise. Such credits are administered through a number of specialized agencies including: Jajasa Kredit (State Credit Agency), Djawatan Koperasi (The Department for Cooperatives), the Crediet Industri Ketjil (Small Industries Credit Bureau), Jajasa Fonds Kerajinan (Office for Handicrafts Credits), and the Bank Rakjat Indonesia (Indonesian People's Bank). Other ministries in the government have felt obliged to follow this lead. The Ministry of Agriculture grants credits through the Kantor Gerakan Tani (Office for Peasant Movement) and through the Jajasa Perkebunan Rakjat (The Smallholders Bureau). The Ministry of Internal Affairs performs a similar function through the Biro Rekonstruksi Nasional (Bureau of National Reconstruction) while the Ministry of Labor has its own credit agency in the Djawatan Penempatan Tenaga (Labor Exchange Office). The fact that these agencies engage only in the extension of credits rather than collection of resources from which credit may be extended underscores the necessity for reorganization which would simplify the whole structure of government credit operations.

There are seven important foreign private banks in Indonesia. This foreign group performs banking services for the foreign community and is primarily concerned with the financing of foreign enterprise. Along with the government financial institutions, they dominate the banking business in the country. At the end of 1953, the foreign

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1. Antara, November 1, 1954.

and government banks had outstanding loans amounting to Rp. 2,758 million while private Indonesian banks held only Rp. 76 million in outstanding loans. The emergence of private banks (now totalling about 20) is predominantly a postwar phenomenon. Statistics on the operations of these banks were first collected and published by the Bank Indonesia in 1954. Their credit has been largely extended to small exporters (in Sumatra) and to small traders (Java).

The final component of the financial system in Indonesia is the newly organized stock exchange in Djakarta. This exchange began business at Djakarta on June 4, 1952. It has provided some service by providing facilities for turnover of securities now outstanding. However, no new government or industrial issues have been floated on the exchange, hence it has not been instrumental in mobilizing domestic savings. In the recent report of the Bank Indonesia, the Governor of the Bank describes the activities of the stock exchange in these terms:

Unfortunately it must be admitted the stock exchange business here in Indonesia is still of little significance... This state of affairs must be attributed in large measure to the public's general unfamiliarity with the possibilities of the stock exchange, and to the great inclination to invest savings in real estate and movables.<sup>1</sup>

Table 4. CREDIT OUTSTANDING: BANK INDONESIA, BANK NEGARA INDONESIA, BANK INDUSTRI NEGARA, AND SEVEN FOREIGN PRIVATE BANKS (JAN. 1953 TO AUGUST, 1953) (Rp. million)

	January	March	June	August
Semi-government enterprises	434.8	275.7	313.0	340.7
Autonomous bodies	0.3	0.3	0.7	1.0
Banks and credit institutions	130.6	54.4	57.2	58.1
Insurance companies and saving banks	3.9	1.8	5.5	5.8
Rice--mills	6.1	6.3	6.9	7.7
Trade in domestic products	52.8	56.4	50.7	50.3
Exporters	221.1	190.4	261.0	269.7
Importers	527.5	602.7	571.6	581.7
Sugar Plantations	487.8	480.0	533.0	575.9
Other plantations	184.9	155.4	205.8	197.9
Industrial enterprises	149.9	202.0	277.2	239.1
Storage and transport enterprises	98.1	106.4	92.2	102.5
Other enterprises	84.2	74.9	132.5	129.5
Individuals	15.1	16.5	12.1	12.7
<b>TOTAL</b>	<b>2,369.8</b>	<b>2,223.2</b>	<b>2,519.4</b>	<b>2,572.6</b>

1. Report Bank Indonesia, 1953-1954, p. 75.

Table 5. CREDIT OUTSTANDING: TWENTY INDONESIAN PRIVATE BANKS (Rp. '000)		
	1953	
	September 30	December 31
Trade	51,599	54,211
Industry	12,021	11,857
Transportation	4,506	4,013
Estate agriculture	2,660	3,013
Individuals	1,217	1,601
Sundry	3,571	1,244
Total	75,574	75,939

Source: Report Bank Indonesia, 1953-1954.

The credits extended by the major components of this system of financial institutions are presented in Table 4 and Table 5. The data in Table 4 indicate that approximately one-half the credit extended by the government banking complex and the large foreign banks flows to the government and trading sectors of the economy. Similarly, over two-thirds of the credit extended by Indonesian private banks was absorbed by the trading sector (Table 5). The other important consumer of organized credit--agricultural plantations--relied heavily upon the resources of the foreign banking system.

This description of the Indonesian money market would be incomplete without some reference to the unorganized money market. One of the distinct features of the credit system in Indonesia is the significant differences in conditions and terms of credit extended through these components of the money market. Small producers and traders (particularly retailers) are still forced to rely on the unorganized money market for short-term, unsecured credit. In random interviews with these borrowers, I found that even credit facilities made available by the government (e.g., Bank Rakjat) are impractical when ready access to credit is required. It was emphasized that it takes considerable time to get a loan from a governmental or semi-governmental institution processed. Furthermore, strict collateral requirements are maintained. Similarly, the standards demanded by private foreign and Indonesian banks cannot be met by many small borrowers. The guarantor provision of Jajasan Kredit is also selective. Thus they are forced to rely on private lenders. Interest rates on credit from this source vary between two

and ten percent per month depending on informal conditions surrounding the loan--personal contacts, prestige and status. Since there is little flow of financial resources between the organized and unorganized money markets, a discontinuous interest rate structure emerges. Interest rates on loans extended through the government banks and the private banking system tend to be relatively low since these loans are offered primarily to relatively secure borrowers. On the other hand, interest rates obtained in the informal financial sector are several times as high as the rates in the organized sector of the money market. Credit is not available on terms or at rates between these extremes. These symptoms of the undeveloped credit system existing in Indonesia have significant bearing on the prospects for mobilizing savings through public or private devices. Savings voluntarily withdrawn from current or past income streams may be loaned out through the informal money market at extremely high rates of interest. Since the existing financial institutions do not mobilize savings on a large scale, their resources are inadequate to provide credit on a scale adequate to force these rates down. The net effect is that savings loaned in the informal sector are associated with a high rate of return. To the extent that interest rates induce savings in Indonesia, this factor tends to keep them out of the organized money market. Where rates on time deposits are relatively low this complicates the problem of monetary control and allows credit to be extended for purposes (i.e. increased consumption) not consistent with developmental objectives. In short, credit extended from deflationary sources (savings) tends to be used in large part for consumption purposes; credit extended from inflationary sources (the banking system, financed by the government deficit) may be for primarily productive purposes, but is restricted to prime borrowers. Hence it is critical that efforts be made to channel the resources now dissipated through the unorganized sector of the money market to the organized sector where credit is subject to the control of monetary authorities.

### III. THE MONEY MARKET AND MOBILIZATION OF VOLUNTARY SAVINGS

The degree of efficacy of the organized governmental foreign and private banks in mobilizing savings from current (and past) income can be demonstrated by comparing their holdings of time and savings deposits with the total money supply. These data are presented in Table 6.

Statistics for time deposits accumulated through cooperatives are not available. However, there are indications that cooperatives have been relatively effective in mobilizing savings from current income.<sup>1</sup> Table 6 indicates that the postal savings banks have been more successful than any other component of the banking system in accumulating actual savings.

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1. Java Bank Report, 1952-1953, pp. 77-78.

Table 6. TOTAL MONEY SUPPLY AND TIME DEPOSITS December 1953 (Rp. million)		
	December 1951	December 1953
Time Deposits:		
a. Combined figures <sup>1</sup>	85	119
b. Twenty private banks <sup>2</sup>	12	14
c. Postal savings banks <sup>3</sup>	65	123
Total time deposits	162	255
Money Supply: <sup>4</sup>		
a. Currency	3,328	5,218
b. Deposits	1,804	2,424
Total money supply	5,132	7,642
Ratio: Time deposits to money supply	.031	.033

The ratio of savings mobilized through the banking system (defined as savings or time deposits) is alarmingly low even when compared to other underdeveloped countries. The ratio as computed from Table 6 is shown as only three percent. In recent years, this ratio has been about 19 percent in India (as an example of an undeveloped country) and about 45 percent in the United States. The ratio of time deposits to money supply has remained relatively constant over the period observed, in spite of fairly strenuous efforts to increase time deposits. These efforts have been unimpressive because they have been offset by rapid expansion of the total money supply. The figures in Table 6 do not include the amounts of savings accumulated by private savings banks. These have been reported for the first time in 1954. At the end of 1953 savings in private savings banks stood at Rp. 18.5 million, by the end of September 1954 they had risen to Rp. 20.7 million.<sup>5</sup>

1. Bank Indonesia, Bank Negara Indonesia, Bank Industri Negara and Seven Foreign Private Banks; Source, Bank Indonesia Reports 1951-1952, 1952-1953.

2. Ibid.

3. Ibid.

4. For December 1951: Java Bank Report, 1951-1952; for December 1953: Bank Indonesia Bulletin, No. 2, Fourth Quarter, 1953, p. 5.

5. Bank Indonesia Bulletin, No. 4, Third Quarter, 1954, p. 12. These accounts should be distinguished from time deposits in private Indonesian (commercial) banks, included in Table 6.

During 1954 particularly gratifying results were shown by the post office savings bank and the national private banks. Savings deposits at the post office savings bank rose from Rp. 123 million at the end of 1953 to Rp. 146 million at the end of September 1954. Time deposits in the twenty national private banks rose from Rp. 14 million at the end of 1953 to Rp. 37.3 million at the end of September 1954. However, since statistical reporting by the private banks is only now getting underway, this increase in part may be attributed to a more effective statistical coverage. Including the newly recorded savings at private savings banks and these increases in time deposits at the post office savings bank and the private Indonesian (commercial) banks, the ratio of time and savings deposits to the total money supply continued to hover near three percent at the end of September 1954. Once again, significant achievements of the banking system in accumulating savings were offset by greatly expanded money supply (from Rp. 7,642 million at the end of 1953 to Rp. 9,666 at the end of September 1954).

These figures suggest that the Indonesian banks are not serving as financial intermediaries, mobilizing their own resources for extension of credit. This problem is underlined by the fact that Indonesian banks have not been able to dispose of their capital stock by sales to the public, but have rather had to rely on government capital provision. The Governor of the Bank Indonesia referred to this problem in these terms:

In general I have to state that insufficient attention has been devoted to what I have described above as the first essential--sufficient capital of their own in private balances. There was still too persistent an inclination to open up banking and credit businesses with capital which had been advanced by the government or the central bank. Attempts to attract credit balances from the private individual were not sufficiently fostered. Instead the chief inclination has been to try and obtain government deposits.

My own view is that this tendency is to be regretted because it is alien to the standards of a sound banking system which stands or falls according to the contribution of the bank's own capital and the attraction Giro (clearing) balances and money deposits from third parties by the private Indonesian banks is an absolutely essential first step towards building up of capital funds in the Indonesian community. The Indonesian banks will have to prove their social function and their usefulness by being in a position to inspire public confidence and attract money from third parties, nothowever, by lending money--which obviously regard as their main object--from funds provided by the government or by the

central bank. By so doing they would in the end become mere branch offices of the government or the central bank. At the same time every attention must of course be given to the establishment of a well-equipped and efficiently functioning administration.<sup>1</sup>

In short, practically all of the funds which are available to the government and the private Indonesian banks are obtained from government subscription to capital, government advances or advances from the Bank Indonesia. Capital subscription in the case of the government banks has been almost exclusively provided by the government. In addition, the government has deposited its own funds or authorized the Bank Indonesia to deposit its funds in the government financial institutions. It is these funds from a combination of government sources which by and large provide the working capital for Indonesian banking operations rather than funds withdrawn from the monetary stream in the form of savings or time deposits.

It should also be pointed out that the ratio of demand deposits to total money supply is considerably lower than in advanced countries.<sup>2</sup> In fact, this ratio has fallen during the past few years, indicating that assets are being held in even more liquid form than demand deposits. The ratio of demand deposits to total money supply fell from 49 percent at the end of 1947 to 41 percent at the end of 1950. By the end of 1951 this ratio had fallen to 35 percent, and during 1954 averaged 30.7 percent. In part, this trend reflects the fact that money newly generated through the government deficit is ordinarily put into circulation as cash rather than through deposit currency. However, a more basic reason lies beneath the recent changes in the composition of the total money supply. As the new Indonesian government has become more firmly established, enforcement of direct taxes has been increasingly tightened. To a large extent taxation of the upper income groups has depended on visible evidences of wealth, of which bank accounts are one of the most obvious indicators. Firms liable to taxation are not required by law to register with tax authorities. The administrative staff available to check reported statements of income and assets is inadequate to undertake thorough checks. Hence, accounts held at government private banks have been utilized to estimate current income and assets for both the direct income taxes on individuals and business and for the capital assets tax. As this policy has become more generally employed by tax authorities the upper income groups have tended to shy away from the use of bank deposits. Banking authorities in Indonesia indicated to

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1. Java Bank Report, 1952-1953, p. 78.

2. In the United States this ratio has averaged about 80 percent.



me that there had been a noticeable shift from the use of deposits to the use of safety deposit boxes, the latter being outside the surveillance of tax authority.

A number of other factors were suggested by banking and business people in Indonesia. They emphasized that the monetary purge of 1950 had left in its wake a fear of holding money in terms of deposits. Although this purge covered both deposits and currency, it is now felt that there would be some advance leakage of a new reduction in the value of money. Hence it is desirable to hold money in the most liquid form so that when these rumors of an imminent monetary purge began to circulate conversion to goods could immediately be undertaken. The same holds true with regard to the desire to maintain liquidity in order to convert to goods if price rises should begin to jeopardize the value of money. In both cases, the fear that a freeze in deposits might be undertaken to prevent shifting from cash to goods was clearly related to the low level of deposits in postwar Indonesia.

With regard to the lower income groups, primarily in the rural sector, it was suggested that such factors as the lack of experience in holding assets in terms of deposits as well as little sensitivity to the interest-earning aspect of deposits were important obstacles to mobilization of savings through the banks. In the rural sector, high liquidity preference, even among the lower income groups, was related to high time preferences and heavy discount of the future. Furthermore, the inducement to save for old age or emergencies reduced by the ability to finance these needs through the family or village, a distinct characteristic of society, in rural Indonesia. In both sectors of the economy, therefore, it appeared clear that the advantages of holding one's assets in the form of bank deposits were either not consciously recognized or it was the considered judgment of the potential depositor that deposits in the banking system would involve distinct disadvantages. Where there is a rational basis for fear of holding one's assets in the form of bank deposits government policy aimed at dispelling the basis for this fear might well be effective in increasing savings. Suggestions to cope with some of these problems will be offered below.

This review of the structure of existing financial and monetary system in Indonesia does not appear to augur well for financing economic development through mobilization of voluntary savings by the banking system. The bold outlines of our analysis are as follows:

1. The need for the extension of credit to private industrial and agricultural firms is great. Although there is a multiplicity of financial institutions in Indonesia, the demand for investment credit is far from satisfied.

2. Existing financial institutions, both public and private, are not effective in mobilizing savings from current income to provide for

the credit needs of the economy.

3. To the extent that credit is offered by the existing institutional structure, it is mainly short term in nature and flows primarily to the public sector and to the trading function in the private sector. Thus the major unsatisfied credit needs are those most closely related to economic development, i.e. long term credit for investment purposes.

4. The basis for the extension of credit by both governmental and private institutions is inflationary in character. The items in the capital and liability account against which credit is offered represent either governmental or semi-governmental subscriptions to bank capital or governmental or Bank Indonesia deposits in the banking system. Since the government during the past few years has been operating at a substantial deficit, its venture into the credit field should be recognized as a major factor in accentuating the budgetary deficit.

5. All of this is against the background of a disproportionately large monetary overhang in the form of inactive but highly volatile idle balances. The objective of mobilizing savings from current income is threatened since expanded deposits in the financial system might achieve nothing more than locking up existing idle balances rather than producing reductions in consumption by withdrawing savings from current income.

These considerations clarify the role which the banking system should strive to assume in the financing of Indonesian economic development. The extension of credit itself is inflationary in character. This is doubly true where credit is essentially a drain on government resources mobilized by inflationary methods. In the present context, this suggests that the use of credit now extended through financial institutions in Indonesia should be carefully scrutinized. Credit for consumption purposes should be strictly limited. Investment credit extended to productive enterprises should be allocated on the basis of a system of priorities, including such factors as the incremental-capital-output-ratios and production gestation periods in firms competing for credit. Moreover, from both the point of view of controlling inflationary pressures and the principles of sound governmental finance, efforts should be made to provide the basis for credit extension from resources mobilized through the banking system rather than through the government budget. Efforts should be made to mobilize time (and savings) deposits to provide for financing of investment through the banking system. This calls for reversal of the trend which was recently developed in Indonesia. As indicated above, financing credit operations of both governmental and private institutions has represented a significant drain on government resources. In addition to limiting the inflationary impetus of credit extension, replacing this subsidy by mobilization of domestic savings would, therefore, be an important

factor in reducing the size of the government deficit. In recent years, amounts budgeted for the provision of capital to financial institutions has averaged from Rp. 1 to 2 billion, or from 10 to 20 percent of the total level of government expenditures. In the 1954 budget something over one-half billion rupiah is budgeted for providing capital to private banking institutions. In addition, the government will continue to provide capital for the governmental banking institutions. Hence, the short-run goal toward which the Indonesian financial system should aim is mobilization of adequate voluntary savings from current income to provide for the credit needs of the private sector of the economy. Let us now inquire into the possibilities of achieving this goal.

There has been some tendency to believe that the performance of this function can be best stimulated by the proliferation of new financial institutions, a tendency which has gained increasing vogue in Indonesia during the past few years. In particular, governmental institutions to lend specialized types of credit to a variety of borrowers have increased at an alarming rate during the tenure of the past two Indonesian Cabinets. This is particularly alarming since these institutions have been designed more to offer credit rather than to mobilize resources from which credit might be extended. In addition, there have been strenuous efforts to increase the number of private banks without developing the framework of a coordinated monetary system. These banks are relatively weak, and, as pointed out above, are dependent upon government subsidization for funds from which to provide credit. A sprawling system of government subsidized public and private financial institutions is clearly not the answer to mobilizing domestic savings to perform a role in economic development. Therefore, the first step towards solving the problem in Indonesia would seem to be coordination of institutions concerned with mobilization of financial resources and credit operations. Branch banking undertaken by the stronger governmental and private institutions might be one answer to this problem.

Whatever the structure of financial institutions that emerges in Indonesia, it is clear that private financial institutions should concentrate primarily on expanding their demand and time deposits, while the government role in this program should be aimed at mobilizing voluntary savings through attractive government bond issues. New banking institutions should not be licensed and promoted unless they are able to accumulate a minimum amount of their own (private) capital and deposits. In order to insure the enforcement of this requirement, it might be useful to set a minimum capital-loan ratio as well as a minimum time deposit-loan ratio. The latter would be particularly pertinent for those banks which are venturing into the fields of investment credit. These provisions would force the banks to curtail inflationary extension of credit or, alternatively, to expand their holdings of actual domestic savings.

However, it is clear that the initiative for expanding the amount of capital and time deposits supplied to banks does not rest primarily with the banking institutions. Steps should, therefore, be taken to promote the habit of holding liquid assets in the form of bank liabilities (demand and time deposits and bank capital). It is suggested that both negative and positive inducements could be offered. With regard to negative inducements, an extension of a foreign exchange provision now in force might be helpful. The Central Import Office has just announced that beginning January 15, 1955 importers will be obliged to submit a document verifying a statement of their current account with the banks, to demonstrate that their financial position justifies the issuance of an import permit of the size which they are seeking. The intention of this regulation is to prevent Indonesian nationals, who have special privileges in obtaining import permits, from reselling these permits to other importers. This provision could be extended to promote mobilization of voluntary savings by requiring that a certain composition of time and demand deposits exist before the applicant be given an import permit.

With regard to positive inducements, the first step might consist of attempts to remove the obstacles to deposits outlined above. If it is true that the major obstacle to increasing bank holdings of deposits results from fear of disclosure of one's assets to tax authorities, it might be worthwhile to declare one's assets held in banks outside the scope of investigation by tax authorities. This could be replaced, from the tax administration point of view, by requiring that taxpayers submit statements of their current and fixed assets. Intentional misrepresentation could then be punishable by law. If it is true that a fear of loss of value resulting from holding one's assets in the form of time deposits is a major deterrent to the deposit habit, the banking system as a whole might experiment with some system of tying the value of time deposits to the value of a number of basic commodities. Experience with the use of this type parity deposits elsewhere has suggested that this device is extremely effective in increasing the amounts of time deposits. With regard to fear of loss of value resulting from government policy such as the 1950 "monetary purge", assurances could be given that no such "purge" will again be made, or if made, will not apply to time deposits.

An interesting experiment, undertaken by the provincial government of Central Sumatra, might be generalized to promote savings habits through the use of time or savings deposits. Bank collection of savings from current income to provide a basis for credit extension has been greatly facilitated by establishing premiums in the form of savings deposits for prompt payment of loans. If repayment and interest payments are made on time, the borrower from Desa Lumbungs receive half of the interest payments as saving deposits at these banks. Provincial officials reported that this system has been effective both in preventing defaulting on loan payments and in

substantially increasing the amounts of savings deposits collected by the Desa Lumbungs.

#### Public Mobilization of Voluntary Savings:

Finally, the role of the government in mobilizing voluntary savings through the issue of bonds might be briefly examined. Indonesian fiscal officials generally felt that this device could be effectively employed on a wider scale. The government has floated few new issues in recent years; those floated have been well subscribed. It might be advisable for the government to set the precedent of mobilizing savings through the stock exchange by floating its bond issues through this institutional device.

Much has been written about the means by which sale of government bonds in underdeveloped countries might be promoted.<sup>1</sup> The literature has been concerned with incentives for promoting public absorption of government bond issues. Such incentives have included references to increased yields, lottery features, appeal to local interest and, finally, tax incentives. In some underdeveloped countries lottery features have been particularly attractive, although in some areas with particular religious orientations, they may be objectionable on moral grounds. In my personal experience in Indonesia, it was emphasized that voluntary subscriptions could be expanded if some link between personal sacrifice and local interest were established. Thus bond issues for financing of specified local projects might result in increased popular subscription. The scope of tax incentives appears to be limited because of relatively ineffective enforcement of direct taxation against the upper income groups. It appears, however, that incentives adapted to the particular institutional and economic setting existing in Indonesia could be found. With the present high premium on imported goods generally and particularly on imported luxury goods, public subscription to bond issues could undoubtedly be stimulated by special import concessions. This could be done, for example, by allowing recipients of bond interest payments to qualify for duty-free import permits for goods now restricted or on the list of high import surcharges to the extent of their interest earnings.

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1. See for example Part B of "Mobilization of Domestic Capital: Report and Documents of the First Working Party of Experts", ECAFE, Bangkok, 1952. Section B is entitled "Measures for Increasing Sales of Government Bonds".