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Financial System Development in Indonesia and South Korea in 1980s and early 1990s: Policies and Outcomes^

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Abstract: This paper examines financial liberalisation in Indonesia and South Korea during the 1980s and early 1990s. The paper provides a brief discussion of a pre-reform political and economic environment in two countries, followed by a description of the state of the pre-reform financial sectors in both countries. The paper then focuses on the respective financial development policies and their pace, sequencing and outcomes in the two nations. The socio-economic impact of financial sector reforms is also carefully considered. The paper concludes by summarising its main findings and drawing out some major policy implications.

Keywords: Financial liberalisation, Indonesia, Korea, financial development, financial reforms

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1. Introduction

Financial systems are an integral part of modern economic systems. The structure, level of sophistication and relative importance of financial institutions differ considerably across countries around the world. However, since money is intrinsic to almost all economic relationships, financial intermediation plays a critical role in economic activity.

The debate on relative importance of the financial system for the broader economy began with publication of seminal papers by Walter Bagehot (1991 (1873)) and Joseph Schumpeter (1936 (1911)), who supported the strong finance-growth link. However, despite considerable attention in the literature, the debate on the importance of finance for economic performance remains unsettled.

Some economists have argued that the finance-growth relationship is unimportant. For example, Lucas (1988) maintained that the role of financial factors in economic growth has been overstated. Moreover, several noted development economists, including Chandavarkar (1992), Meier and Seers (1984) and Stern (1989), have expressed their scepticism over the role of the financial system in economic development. However, a majority of the economics profession contend that there is a relationship between the financial development and economic development, but there is no consensus on the direction of the causal relationship.

Possible directions of causality between financial development and growth have been labelled by Patrick (1966) as the 'supply-leading' and 'demand-following' hypotheses. The supply-leading hypothesis posits a causal relationship from institutions to markets that increases the supply of financial services and thus leads to real economic growth. A substantial theoretical and empirical literature on this subject has sought to demonstrate that financial development causes economic growth. McKinnon (1973), King and Levine (1993a; 1993b), Neusser and Kugler (1998), Levine (1997), and Levine, Loayza and Beck (2000) all support the supply-leading explanation. On the other hand, the demand-following hypothesis postulates a causal relationship from economic growth to financial development. In terms of this explanation, an increasing demand for financial services might induce an expansion in the financial sector as the real economy grows (i.e. the financial sector responds passively to economic growth). Gurley and Shaw (1967), Goldsmith (1969), and Jung (1986) have all supported this hypothesis. A third option is that the relationship between financial development and economic growth is bi-directional, where both supply-leading and demand-following forces occur simultaneously (see, for example, Capasso 2003).

The work of Levine (1997) is particularly notable. He has developed a functional approach to link successful performance of the financial system and economic development. Levine (1997) contends that financial systems facilitate trading, hedging, diversifying, and pooling of risk; allocate resources; monitor managers and exert corporate control; mobilise savings; and facilitate the exchange of goods and services. By fulfilling these functions, financial systems influence economic growth in two main ways: through capital accumulation and technological innovation, which correspond to physical and human capital, respectively, in endogenous growth theory (Jones 2005; Romer 1986, 1990).

Successful economic policymaking relies not only on a thorough understanding of economic theory, but also on a keen appreciation of pertinent economic history. Fortunately, in the present context, there is an extensive scholarly literature on financial liberalisation in developing countries. While it is true that each particular case is perforce unique, important conclusions can nonetheless be drawn from the outcomes of the different approaches adopted in different developing and transition economies.

In this paper, we re-visit the experiences of two developing countries that underwent relatively successful financial reforms in 1980s and early 1990s. The Indonesian financial development programme over the period 1983 to 1992 aimed to transform the country's financial system as a part of a wider economic renewal programme that included reform of the taxation system, international trade regulation and governance. The programme was adopted in response to the deteriorating economic situation, particularly in the oil industry – Indonesia's major export - and was intended to strengthen the economy through greater diversification (Chant & Pangestu 1994).

The South Korean programme of reforms over the time period 1981 to 1992 represents a u nique example of how a car efully designed and gradual path of economic and financial reform can bring growth and prosperity. South Korea (hereafter Korea) chose an export-oriented strategy of economic development, putting substantial resources into priority sectors. A notable feature of the Korean path is its so-called 'one-side openness', which implied active export of Korean goods simultaneously accompanied by restrictive import policies.

The pre-reform environment in these countries differed substantially; nevertheless the purpose of reforms has been similar: to develop a modern financial system that would efficiently cater for the needs of the economy and thus contribute to economic growth. The scope of the reforms has also been analogous. What differed in each case were the pace and the sequencing of the reforms. Accordingly, an examination of the experiences of financial reform in these countries should teach us important lessons and hopefully assist policymakers in tailoring the optimal pace and the key elements of sequencing of financial reforms for their respective countries. The novelty of this paper resides in the way in which we illustrate the proposition that the success of the financial development programmes is clearly linked with ability of policymakers to design and implement wider economic reforms in which financial development plays an important role.

The paper itself consists of five main sections. Section 2 looks at pre-reform political and economic environment in two countries. This is followed by description of the state of pre-reform financial sectors in both countries in section 3. Section 4 examines their respective financial development policies and their consequences. Section 5 discusses the socio-economic impact of the reforms. The paper ends in section 6 with some brief concluding remarks.

2. Pre-reform political and economic environment

Political history in Indonesia over last three decades of 20th century was dominated by the late General Suharto, who came into power in 1966 as a result of a military coup. Suharto adopted the term 'New Order' to designate his system of authoritarian rule. The New Order lasted until his forced resignation in 1998. In contrast, the political establishment of Korea since the Korean War in 1950-53 and until 1993 was dominated by military leadership. The political systems of both countries during these periods were stable, thus providing a good foundation to undertake major economic reforms.

The average rate of growth of the Indonesian economy was 8 per cent per annum over the period of 1971 to 1980. Oil revenues accounted for 70 to 80 per cent of government revenues and 80 per cent of exports in the late 1970s, when the decision was made to diversify economy by attracting investments to the non-oil production sector. Domestic savings were 23.8 per cent of GDP during the period of 1971-75, with 5-6 per cent higher rates towards the end of 1970s. Savings were generated largely by the oil revenues accruing to the government, and resources were redistributed to its priority sectors. Investment rates were similar to savings rate levels over 1971-1975, but around 5 percent lower than the rate of savings in 1976-1980. The efficiency of these investments, however, was low (Bisat, Johnston & Sundararajan 1999). The inflation rate was high, though gradually falling in the 1970s, only to rise again in 1979 to 1981. Indonesia has implemented pegged exchange rate arrangements for its currency (the rupiah) since 1971. Initially, the US dollar was chosen as the peg currency and the rate was fixed at 415 rupiahs per US dollar. However, in 1978, following the example of Singapore and Malaysia, it was decided to peg the rupiah to a basket of currencies of major trading partners. However, on a number of occasions the government used currency devaluations as a policy response to external shocks.

GDP per capita has remained low, although rising over the decade from US$245 to US$417. Similarly, life expectancy was relatively low in 53-56 years range, gradually rising toward the end of the period.

In the early 1980s, the price of oil, Indonesia's main export, began to fall, thus creating macroeconomic imbalances in the economy. As a result, the government decided to undertake macroeconomic adjustment and to reduce its dependency on oil through export diversification. Moreover, it undertook financial system reforms aimed at increasing domestic savings and expanding involvement of private financial institutions in financing the country's economy (Juoro 1993).

Korea used detailed five-year plans as a benchmark for economic management. Initially, in the 1960s, Korea decided to concentrate on development of labour-intensive production of light manufactured goods with subsequent exports all around the world. Initially, this strategy paid off well with good rates of economic growth and low unemployment. However, in early 1970s, the government realised that increased competition from other Asian countries and protectionist measures from industrialised countries could ruin its growth achievements. Therefore, it decided to re-orient all efforts in developing competitive heavy and chemical industries and export high-value-added goods to the world market. Moreover, policy makers believed that promoting the heavy and chemical industries could assist in the development of local defence industries and thus reduce the reliance on the US troops stationed in Korea. To assist the development of these industries, the government intervened in resource allocation through taxation, finance and restrictions on imports (Yoo & Moon 1999).

To protect infant industries and support their quick development, the Korean government imposed large tariffs in those sectors and provided policy loans on preferential terms. Moreover, substantial tax incentives were introduced for priority industries that included iron and steel, nonferrous metals, shipbuilding, general machinery, chemicals, and electronics. At first, this policy provided sound returns in terms of economic growth of over 8 per cent. However, the policy led to a disproportionate distribution of resources and to macroeconomic imbalances. Firstly, priority sector resource allocations were often made at the expense of non-favoured industries. Secondly, since smaller companies could not potentially handle the capital requirements of the priority projects, those projects were granted to large business groups, contributing to a high concentration of economic power. Thirdly, a booming credit expansion to the priority industries caused a rapid growth in money supply, causing inflation to rise over the 20 per cent mark in 1980. Since real interest rates remained low, inflation made financial savings less attractive reducing the domestic savings ratio from over 28 per cent in 1978 to under 24 per cent in 1980 (Nam 1994).

The oil shock of 1978 exposed structural weaknesses in the Korean economy and economic growth declined to a negative level in 1980. Moreover, chronic overcapacity and underutilisation caused by excessive competition and overinvestment in the heavy and chemical industries led to high inflation and foreign debt (Shin & Ha 2002). In response, the government introduced a number of measures to return to a high-level of economic growth. A flexible exchange rate was introduced to replace the peg to the US dollar. Measures to combat wage, dividend and interest rate hikes helped to reduce the current account deficit and inflation. Furthermore, gradual removal of subsidies and tax benefits to heavy industries coupled with a reduction of tariffs was implemented. Finally, the liberalisation measures to improve efficiency of financial sector took off.

In 1970-1980, Korea remained middle-income economy with GDP per capita rising from US$2253 to US$3558. Similarly, life expectancy rose from 63 years at the beginning of the decade to 67 years at the end. The comparative statistics of the key economic and social variables 1971-1982 are presented in Table 1.

Table 1. Key economic and social indicators in the pre-reform period

Indicator	5-year average	Annual average						
	1971-75	1976	1977	1978	1979	1980	1981	1982
GDP growth, %								
Indonesia	8	6	9	9	7	9	8	1
Korea	7	11	10	9	7	-1	6	7
GDP per capita (constant 2000 US$)								
Indonesia	275	313	333	355	372	397	420	417
Korea	2253	2709	2934	3158	3322	3221	3367	3558
GDP per capita (PPP, 2005 international US$)								
Indonesia	na	na	na	na	na	1351	1432	1420
Korea	na	na	na	na	na	5176	5410	5717
Gross domestic savings to GDP, %								
Indonesia	24	27	29	27	33	38	32	29
Korea	19	25	28	29	29	24	24	26
Investment to GDP, %								
Indonesia	24	24	23	24	25	24	27	28
Korea	27	27	29	33	36	32	30	29
Inflation, %								
Indonesia	20	20	11	8	16	18	12	9
Korea	15	15	10	14	18	29	21	7
Exchange rate,								
Indonesia, Rupiah/USD	415	415	415	442	623	627	632	661
Korea, Won/USD	405	484	484	484	484	607	681	731
Unemployment (% of labour force)								
Indonesia	na	na	na	na	na	na	na	3
Korea	na	na	na	na	na	5	4	4
Life expectancy (Years)								
Indonesia	na	53	na	na	55	na	56	na
Korea	63	na	65	na	65	66	66	67

Source: W*orld Bank Development Indicators Online*, *International Financial Statistics Online* databases and the author's calculations

3. Main characteristics of the pre-reform financial sectors

Since taking power in 1966, the Indonesian New Order government took steps to reduce its control over the extremely centralised financial system. In 1967, foreign banks were allowed into the market, but with substantial restrictions on their operations. In 1968, a separate central bank - the Bank Indonesia - was established.

In 1974, a programme of direct credit control and allocation was introduced by the Bank Indonesia. Initially the system of direct credit control was designed to control aggregate money and credit to limit the expansionary pressures caused by the oil boom. Later, however, the system was increasingly used as a mechanism for credit allocation, with detailed ceilings by type of credit, category of assets, previous performance, and aggregate monetary targets (Chant & Pangestu 1994). However, state-owned banks had larger and easier access to priority loans at highly subsidised interest rates. These loans in 1982 amounted to 27 per cent of total loans.

State-owned banks were also subject to deposit ceilings and interest on deposits was often negative in real terms. Foreign and domestic private banks, as well as NBFIs, were free to set their deposit and credit rates. As a result, the share of domestic currency deposits attracted by the state-owned banks fell from 82 to 56 per cent in 1978-1982. Foreign currency deposits were not subject to interest rates control. Consequently, their share in total deposits rapidly grew to 17 per cent in 1982. No private banks had access to foreign exchange licenses due to prohibitive conditions set by the regulators (Bisat, Johnston & Sundararajan 1999; McLeod 1991).

The branch network management policy of all financial institutions was subject to detailed regulations and restrictions depending on the ownership structure of each institution. The interbank money market was small and lacking liquidity.

Prudential regulations and banking supervision were poor until reforms were introduced. Reliable information was lacking and basic regulations on capital adequacy, loan concentration and provisioning, and interest accrual rules were weak. NBFIs were under the supervision of the Ministry of Finance (Bisat, Johnston & Sundararajan 1999).

Money and capital market were underdeveloped. The Indonesian stock market, reopened in 1977, was largely inactive due to complex regulations related to equity issues, including disclosure requirements, minimum dividend rates, and a maximum trading range for most stocks (Beng 1993).

Monetary indicators in Indonesia in the 1970s stood at a level common for economies with a repressed financial sector. For example, the broad money to GDP ratio was a meagre 16.1 per cent. Open market operations as an instrument of monetary policy were largely unused. Instead, monetary policy was based on direct interest controls, credit ceilings, and access to central bank liquidity credits. The effectiveness of the central bank refinancing policy was weak due to the development-oriented objectives of monetary policy and the automatic availability of credit for this purpose (Bisat, Johnston & Sundararajan 1999).

The structure of the Indonesian financial sector in 1979-1983 is summarised in Table 2. Over that period, the financial sector was largely dominated by state-owned banks, which accounted for over 84 per cent of the financial sector assets. The share of the market for private and foreign banks was less than 12 per cent, while non-bank financial institutions accounted for only four per cent.

Table 2. Structure of the Indonesian financial sector

	Number of institutions		Number of branches	Assets (Rp billion)	Assets (%)
Indicator	03/1979	03/1982	1980	1983	1983
Total of financial institutions	>139	215	na	49256	100
Central Bank	1	1	na	20348	41.3
Deposit money banks	127	118	866	27116	55.1
State-owned banks	33	33	685	21308	43.3
Commercial banks	5	5	403	18570	37.7
Development banks (including regional)	27	27		1919	3.9
Savings banks	1	1	282	819	1.7
Private banks	94	85	281	5808	11.8
Foreign	11	11	20		
Domestic	83	74	261		
Non-bank financial institutions	>12	97	na	1792	3.7
Insurance companies	Unknown	83*	na	471	1.0
Other financial intermediaries	12	14	na	1321	2.7

*Data for December 1981.

Source: Beng (1993), Bisat, Johnston and Sundararajan (1999) and McLeod (1991) and author's calculations.

The financial system of Korea before 1980 c an be characterised as being highly regulated and controlled by the government in line with its five-year economic plans. The powerful Economic Planning Board (EPB) used the banking system as an instrument of its developmental policies by setting interest rates and directing loans to priority sectors. Moreover, it served as an intermediary between foreign and domestic capital by controlling the inflow of foreign capital (Shin & Ha 2002).

The financial sector was rather versatile and consisted of nationwide, local and specialised banks, branches of foreign banks, a capital market, various non-bank financial institutions, and an active informal credit market. Non-bank financial institutions come to existence in early 1970s and rapidly developed towards the end of decade to complement and compete with banks (Park 1994).

Due to high barriers of entry, the number of local banks remained largely unchanged. However, it was compensated by a substantial expansion of branch networks and increased presence of foreign banks. Nonetheless, foreign banks had substantial restrictions on branch expansion and the range of activities allowed. Banks were used by the government as a m ean to finance investments and guarantee foreign investments in the priority sectors (Bisat, Johnston & Sundararajan 1999). The structure of the Korean banking sector in 1975-1985 is summarised in Table 3.

Table 3. Structure of the Korean banking sector

	Number of Banks	Assets (billion won)	Number of Banks	Assets (billion won)	Number of Banks	Assets (billion won)
	1975		1980		1985	
Nationwide	15	2890	38	11938	60	29772
Domestic	6	2485	5	10494	7	26646
Foreign	9	405	33	1442	53	3126
Local	10	na	10	na	10	na
Specialised	6	na	6	na	7	na
Total	31	na	54	na	77	na

Source: Bisat, Johnston and Sundararajan (1999:175) and Park and Kim (1994)

The entry barriers for NBFIs were smaller than for the banking sector and were further relaxed in the mid-1970s to reduce the importance of the informal sector. As a result, the number and variety of NBFIs grew rapidly, but despite all efforts, the informal sector remained active.

The role of the central bank was executed by the Bank of Korea. Its functions included conducting monetary policy and bank supervision. In the conduct of monetary policy, the Bank of Korea largely referred to direct instruments, like interest rates and individual bank credit ceilings, a varied reserve requirement ratio, direct credit allocation to priority sectors and subsidised central bank rediscount operations. Prudential regulations on banks were strict, though to a lesser degree on NBFIs (Bisat, Johnston & Sundararajan 1999).

The interest rate in Korea remained highly regulated. The authorities were trying to keep ceilings on deposit and lending rates in line with the rate of inflation. However, with inflation hitting 29 per cent and 21 per cent in 1980 and 1981 respectively, the real interest rate turned negative in these years. The difference between preferential and non-preferential loan rates remained roughly flat during the period of 1970-1980 and stood within the range of 0.8-1 percent. NBFIs had higher credit ceilings than banks and were also less burdened by limits in charging fees and commission.

4. Financial sector reforms and their outcomes

4.1. Indonesia: 1983-1992

During the period of 1983-1992, Indonesia introduced comprehensive adjustment and liberalisation programmes that included exchange rate devaluations, deregulation of the trade, industry and financial sectors, as well as greater fiscal discipline. The programmes were described by Ariff and Khalid (2005:141) as 'genuine reforms to restructure the economy on a balanced basis'. The reforms were implemented during two main phases.

The first phase of reforms took place during 1983-1985 and represented a partial step towards restoring the market mechanisms. It was intended to improve the efficiency of the financial system by relaxing the constraints on the activities of existing banks. The reforms included the elimination of the credit ceilings system, the removal of interest rate controls on most categories of deposits and on all loans, except on those refinanced by the Bank Indonesia, and extensive modification of the liquidity credit system. The 1983-1985 reforms effectively eliminated the direct instruments of monetary control used by the central bank. This made it necessary for the authorities to urgently develop the government debt market required for open-market operations. Second stage commenced in February 1984. Bank Indonesia resumed issuing central bank certificates (SBIs) - short-term debt instruments to be used as a main monetary tool. A year later, to improve the liquidity of the money market, a new instrument, banker's acceptances (SBPU), was introduced, and a publicly owned investment company was founded to act as a market maker in the money market (Juoro 1993).

Despite these reforms, competition in the banking sector continued to be constrained in several ways. First of all, entry requirements for new banks were not eased. Therefore the total number of banks changed little over the period 1983-1987. Secondly, the state-owned banks retained monopoly powers over the deposits of state enterprises. Moreover, only state and a handful of large private local banks had access to the foreign exchange business. Lastly, the Bank Indonesia continued to be a major provider of cheap credit, used by financial institutions for lending to the private sector.

A third phase of financial reform commenced in 1988, following a deterioration of the external sector. The main elements of the reform included: (i) lifting barriers for entry by new banks; (ii) permitting unlimited branch expansion to existing local banks that met soundness standards; (iii) extending the limit of branch expansion for foreign banks and NBFIs from one to seven cities; (iv) streamlining foreign exchange licensing procedures; (v) allowing state enterprises to invest up to 50 per cent of their deposits into non-state banks; and (vi) unifying the reserve requirement among various classes of banks and deposits, and reducing it to 2 per cent.

Prudential measures to strengthen the financial system were also included in the reform agenda. Legal limits to a single borrower or a group of related borrowers were introduced; capital requirements were raised; central bank supervision was extended to the rural banks and NBFIs; and a beginning was made with the introduction of a comprehensive supervisory system (Chant & Pangestu 1994).

Since first phase of reforms primarily targeted banking sector, development of capital market has not really progress in early 1980s. The growth of corporate securities market was constrained by reluctance of private corporations to go public prior to substantial reforms in this sector. However, with third phase of reforms, several measures were also taken to improve the money and capital markets. Interest income from bank deposits became subject to a withholding tax, thus removing the privileged tax treatment of bank deposits over other debt and equity instruments. Banks and other NBFIs were permitted to issue shares. The Bank Indonesia organised a network of dealers and agents to trade with SBIs and to act as market makers on the secondary markets. All money market operations of the central bank were to be conducted through this network. In 1990, c omprehensive institutional and regulatory reforms were initiated, including the privatisation of the Jakarta Stock Exchange (Bisat, Johnston & Sundararajan 1999).

4.2. Korea: 1982-1991

After the economic decline in the early 1980s, Korea launched extensive reforms to bring the economy back to a pattern of growth and reduce the inflation rate. The reform package included currency devaluation, tight monetary policy, strict wage guidelines, and partial liberalisation of administered prices. Moreover, the Korean government introduced macroeconomic stabilisation, financial reform programmes, liberalised the external sector and improved allocation of public investments. The decision to liberalise the financial system was due to belief that the inefficient allocation of financial resources exacerbated imbalances in the economy.

The financial reform package included institutional reforms to encourage competition in the financial sector, further liberalisation of interest rates and credit allocations, wider use of indirect instruments in conducting monetary policy and gradual capital account liberalisation. To promote institutional development, the government eased the regulations related to organisational, budgetary, branching and business practices of the banks. This enabled commercial banks to undertake wider range of activities, including sales of commercial bills, credit cards, sales of government bonds under repurchase agreement, factoring, mutual instalment savings, trusts, negotiable certificates of deposits, as well as the acceptance, discount and sale of trade bills (Oh & Park 1998). In 1981-1983, the government sold its share in all five nationwide banks. Entry barriers for new financial institutions were lowered. Two new nationwide commercial banks were founded in 1982-1983, many finance and mutual savings companies were established, and a number of foreign bank branches were opened.

A number of reforms were implemented in the area of monetary and credit management. In addition to direct monetary tools like rediscount mechanisms, reserve requirement directed credit, and interest rate ceilings, the indirect instrument in the form of stabilisation bond s ales started to be developed. Moreover, the direct monetary mechanisms were gradually loosened. In 1981, t he central bank unified reserve requirements for all banks and types of deposit and reduced the rate to 3.5 per cent. In 1982, i ndividual credit ceilings of nationwide banks were abolished. Moreover, directed credits to priority sectors were progressively reduced by gradual abolishing preferential rates applying to various policy loans.

Interest rate liberalisation began in 1982 with the reduction of the differential between general and preferential lending rates. Another significant step was taken in 1984, when financial institutions were permitted to set up their lending rates according to their assessment of creditworthiness but within the set range. The set range was gradually widened from 0.5 to 3 per cent. In 1988, the authorities introduced further interest rate liberalisation measures. These included decontrol of most bank and non-bank lending rates, some long-term deposits, interest rates on f inancial debentures, corporate bonds, asset management accounts and funds and some money market instruments. Rates on some priority loans and short-term deposits, however, were not deregulated. Moreover, the liberalisation measures were not fully implemented due to adverse economic conditions in 1989. T he revised the four-phase interest rate liberalisation programme was announced in 1991. A ccording to the programme, the liberalisation was to start with loan rate liberalisation, followed by gradual deposit rate liberalisation. Long-term and large deposits were to be liberalised before short-term and smaller deposits.

The Korean monetary authorities have pursued gradual approach to capital account liberalisation since 1981. Initially, they created open-end international trusts to promote indirect investments by Europeans. Then, in 1984, they shortened the list of businesses where foreign ownership is prohibited. Korean firms were allowed to issues convertible bonds and bonds with warrants at international markets since 1985, and permitted to participate in syndicates underwriting foreign securities since 1987. Most significant measures of capital account liberalisation were implemented in 1991-1992, when foreigners acquired the right to buy Korean securities (Bekaert, Harvey & Lundblad 2003; Park 1994).

4.3. Outcomes of the financial sector reforms

As a result of the reforms, financial sectors both in Indonesia and Korea experienced significant growth. In Indonesia, broad money to GDP and bank deposits to GDP ratios more than doubled, whereas both financial intermediation ratios showed substantial rise over the reform period. Domestic credit to GDO ratios more then tripled over the period 1983-1993 to 49 pe rcent. Foreign direct investment boomed since the late 1980s, increasing the dependence of the Indonesian economy on foreign capital.

Similarly, in Korea, the M2/GDP ratio, which remained unchanged in 1970s, grew from 33 per cent in 1983 to 36 per cent in 1993. Financial intermediation ratios (total and private) also grew up to 15 per cent. Improved formal market environment since 1982 as well as excellent growth of the capital market since the 1987 reform contributed to enhanced financial intermediation ratios. Domestic credit to private sector has improved from around 55 percent in 1983 to over 60 per cent in the 1990s. In contrast, FDI to GDP ratios moved into negative territory as a result of active investing abroad by Korea firms. Table 4 summarises financial liberalisation indicators in Indonesia and Korea.

Table 4. Indicators of financial liberalisation

Indicator	1983	1984	1985	1986	1987	1988	1989	1990	1991	1992	1993
M2 (% of GDP)											
Indonesia	17	18	21	25	25	26	28	34	37	39	40
Korea	33	32	32	32	32	33	35	34	34	35	36
FIR total (% of GDP)											
Indonesia	25	27	30	34	36	38	42	52	53	58	57
Korea	45	44	45	48	52	56	61	63	62	62	60
FIR private (% of GDP)											
Indonesia	15	17	19	22	24	28	35	48	47	46	49
Korea	47	47	50	49	50	49	55	57	57	56	53
Domestic credit to private sector (% of GDP)											
Indonesia	15	17	20	24	25	28	35	48	47	46	49
Korea	55	54	57	56	57	54	60	63	62	61	61
FDI/GDP (%)											
Indonesia	0.34	0.25	0.35	0.32	0.51	0.65	0.67	0.96	1.16	1.28	1.04
Korea	-0.07	0.06	-0.37	-0.69	0.07	0.20	0.23	-0.10	-0.10	-0.13	-0.21

Notes: FIR: Financial intermediation ratio = claims on public sector, claims on private sector and foreign assets.
FDI are measured as net inflow.

Source: *World Development Indicators Online*; *International Financial Statistics Online* database and author's calculations

Competition in the Indonesian banking sector, particularly for private banks has substantially benefited from the removal of credit ceilings, interest rate controls, and discriminatory regulations on different financial intermediaries. As a result of competition, less efficient state-owned banks were forced to adopt modernisation programmes. Bank deposit rates became positive in real terms, though real lending rates, initially, did not rise. Banks had to accept a reduction of lending margins under pressure of increased competition. Loan rates on average were around 20 per cent per annum during most of the period, while state-owned banks on average charged lower rates than private banks. The difference, however, has been decreasing and the rates almost equalised by 1990.

In spite of increased deposit rates, the rate of growth of banks deposits fell. This was a result of exchange rate instability and expectations of rupiah devaluations. The lack of liquidity was offset by an expansion of central bank credit to the Indonesian banking system.

Similarly, in Korea, the financial reforms of 1980s resulted in expansion of the formal financial sector, including the rise in number of banks and their branches, and an increase in number of non-bank financial institutions. Increased competition in the financial markets improved the allocative efficiency of financial resources. The structure of interest rates became more uniform, as differentials between credits to priority and non-priority sectors, and between bank and non-bank deposit rates, decreased. However, some legislation, which provided advantages to non-bank financial institutions, remained. Accordingly, NBFIs had higher credit ceilings and were exempt from the burden to provide directed credits (Bisat, Johnston & Sundararajan 1999).

The bank deposit interest rates in 1981 were negative in real terms, due to a high level of inflation. As inflation was brought down to a single digit in 1982, interest rates became substantially positive. During 1984-1987, the real interest rates on one year deposit were in the range of 7 to 8 per cent, and that on general loans exceeded 8 per cent. As inflation rose in late 1980s, the real interest rates fell to a 3-4 per cent range. An interesting feature is that nominal deposit and general loan rates remained unchanged during the period of 1985-1990, despite all liberalisation measures.

The comparative statistics on exchange and interest rates are presented in Table 5.

Table 5. Exchange rates and interest rates in Indonesia

Indicator	1983	1984	1985	1986	1987	1988	1989	1990	1991	1992	1993
Exchange rate* (mkt)											
Indonesia	909	1026	1111	1286	1644	1686	1770	1843	1950	2030	2087
Korea	776	806	870	881	823	731	671	708	733	781	803
Inflation rate											
Indonesia	11.79	10.46	4.73	5.83	9.28	8.04	6.42	7.81	9.41	7.53	9.68
Korea	3.42	2.31	2.46	2.75	3.05	7.15	5.70	8.58	9.30	6.31	4.75
Interest rates (%)											
Money market rate											
Indonesia	13.17	18.63	10.33	n.a.	14.52	15.00	12.57	13.97	14.91	11.99	8.66
Korea	13.00	11.39	9.35	9.70	8.93	9.62	13.28	14.03	17.03	14.32	12.12
Deposit rate											
Indonesia	6.00	16.00	18.00	15.39	16.78	17.72	18.63	17.53	23.32	19.60	14.55
Korea	8.00	9.17	10.00	10.00	10.00	10.00	10.00	10.00	10.00	10.00	8.58
Lending rate											
Indonesia	n.a.	n.a.	n.a.	21.49	21.67	22.10	21.70	20.83	25.53	24.03	20.59
Korea	10.00	10.00	10.00	10.00	10.00	10.13	11.25	10.00	10.00	10.00	8.58

*Local currency per US dollar
Source: *International Financial Statistics Online* and author's calculations

A crucial ingredient of successful financial liberalisation programme is building a sound and efficient system of prudential regulation and supervision. However, this component experienced serious problems in both countries, particularly in Indonesia. The Indonesian system of prudential regulation and supervision remained weak, particularly at the stage of implementation. In many cases, large conglomerates simply abused their close relationships with politicians. Furthermore, reliance on foreign finance, particularly short-term debt, had increased, exposing it to foreign exchange risks.

In Korea, a prudential regulations and supervision, in particular over NBFIs, remained a notable problem. Prudential regulations and supervision over merchant banks, such as BIS capital adequacy or loan concentration requirements, were virtually non-existent. The sector has accumulated a significant mismatch in the maturity structures (64 per cent of borrowings were short-tern and 85per cent of lending was long-term), which monetary authorities failed to detect (Chang 1998). Moreover, the supervision functions over NBFIs were widely dispersed and competence of supervisors was questionable. This was due to the staff rotating policy in the Financial Supervisory Commission and the Ministry of Finance and Economics. The time horizon of supervisory bureaucrats was too short. Supervisors were thus discouraged from developing new policies and enforcing existing ones (Kim & Lee 2004). Various other problems existed (i) a moral hazard problem in the form of an unstated assumption that the government would not let banks to fail, which often led to the inefficient use of loan funds; and (ii) the lack of a meaningful financial disclosure system (Emery 2001).

5. Socio-economic impact of the reforms

The Indonesian economy underwent dramatic structural changes as a result of carefully designed liberalisation policies that aimed to improve the economic performance. With a rapid growth of income of over 7 per cent during the most of period, peaking in early 1990s, Indonesia moved from an impoverished nation with over 60 per cent of the population living below the poverty line in 1970, to a low-middle income economy with less than 10 per cent of the population living below the poverty line. Indonesia's income per capita trebled during the period. Moreover, the purchasing power of per capita income increased four-fold to reach nearly $2,500 in 1993. This represented rapid growth in wealth (Ariff & Khalid 1999).

Reforms during the period 1982-1992 were a response to the external shock of falling oil prices. This induced the policy makers to maintain high GDP growth rates by improving private investments and expanding non-oil exports. In addition, external and domestic imbalances were stabilised.

Investments have been rapidly growing in line with GDP, forming a powerful engine for economic growth. Inflation rates were brought down to a single digit in the mid-1980s and remained there in late 1980s and early 1990s.

The Korean experience of reforms is unique and phenomenal. Following a cautious and gradual path the Korean economy achieved an excellent growth result and turned from a poor developing economy to an upper-middle level developed economy. After the slowdown in 1980, the Korean economy grew on average by an impressive 7.83 per cent during 1981-1985, and even more impressive by over 9 per cent during 1986-1991. The GDP per capita more than doubled during the period 1983-1993. The purchasing power of GDP per capita also substantially increased and reached US$10,000 by 1993[1]. A high level (over 30 per cent of GDP) of domestic savings and investments rates were major drivers of the growth. Main economic indicators of Indonesia and Korea are presented in Table 6 below.

[1] In current international US$

Table 6. Main economic indicators of development

Indicator	1983	1984	1985	1986	1987	1988	1989	1990	1991	1992	1993
GDP growth, %											
Indonesia	8	7	3	6	5	6	9	9	9	7	7
Korea	11	8	7	11	11	11	7	9	9	6	6
GDP per capita (constant 2000 US$)											
Indonesia	444	467	474	494	511	534	572	612	656	692	730
Korea	3884	4147	4386	4807	5291	5798	6130	6615	7169	7522	7912
GDP per capita (PPP, 2005 international US$)											
Indonesia	1511	1590	1616	1681	1739	1817	1948	2085	2233	2355	2487
Korea	6664	7047	7724	8501	9316	9849	10628	11519	12086	12713	13675
Gross domestic savings to GDP, %											
Indonesia	30	30	30	29	32	32	35	32	33	33	32
Korea	30	31	34	37	39	36	36	37	36	36	36
Investment to GDP, %											
Indonesia	31	27	28	30	30	29	33	31	32	30	29
Korea	30	30	29	30	31	34	38	40	37	36	37
Unemployment (% of labour force)											
Indonesia	na	na	2	3	na	3	3	na	na	3	na
Korea	4	4	4	3	2	3	2	2	2	3	2
Life expectancy (Years)											
Indonesia	na	na	59	na	60	na	na	62	na	63	na
Korea	na	69	na	70	na	71	71	72	72	73	na

Source: *World Bank Development Indicators Online*, *International Financial Statistics Online* databases and the author's calculations

The high economic growth was reflected in the large positive impact on the lives of Korean people. Unemployment rate remained low and declined to 2 per cent. Life expectancy improved by nearly 20 years during the period 1965-1995. The infant mortality dropped to 11 per 1,000 births. Due to substantial investment in education (21 per cent of the national budget), the illiteracy level virtually dropped to zero (Ariff & Khalid 1999).

In Indonesia, social indicators, like education and health, have also improved over the period: the literacy rate rose by around 20 per cent and the infant mortality rate fell from 132 per 1,000 in 1970 to 69 per 1,000 in 1990 (Hill 1996). Life expectancy grew to a reasonable 63 years in 1992. The unemployment rate remained low at around 3 per cent mark.

In spite these impressive achievements, both countries failed to detect or address a number of problems. These problems were exposed with dramatic consequences later, during the 1997-1998 Asian crisis. In Indonesia, the crisis exposed weaknesses in the financial system, including weak prudential regulations and supervision, over-reliance on short-term foreign debt, and exchange rate mismanagement. Problems with the financial system, coupled with political instability and various natural disasters, brought about a severe reduction of incomes and living standards.

Similarly, in Korea, policy-makers failed to contain a ballooning short-term foreign debt problem, which became particularly apparent after capital account liberalisation. Short term debt grew from 14 billion US$ in 1990 (45 per cent of total debt) to 100 billion US$ in 1996 (64 per cent of total debt). Moreover, unaddressed problems with prudential regulations and supervision as well as political instability contributed to the problem (Dickinson & Mullineux 2001; Wade 1998; Yoo & Moon 1999).

However, the impact of the Asian crisis on Korean economy was relatively mild thanks to the carefully designed approach to the reforms, which involved exposing the Korean financial system to global threats cautiously and strictly in line with well-thought-out industrial and economic policies.

6. Conclusion

Despite numerous common elements, financial sector reform in Indonesia and Korea each has unique features. For instance, each country had its own economic pre-reform conditions, resource endowments, political environment and cultural traditions. As a result, their approaches to financial sector reform also differed. However, the scope of reforms and outcomes of implementing (or not implementing) of specific reform measures for both countries were similar. Some important commonalities are presented below:

- Both countries began their financial sector reforms as a result of ongoing economic problems, caused by the inefficient allocation of resources, rather than starting those reforms to prevent possible resource misallocation problems.

- In both countries, and particularly in Korea, financial sector reform was part of a larger economic development programme. Korea was more thorough in that regard and planned economic development within a five-year framework.

- Both countries, and especially Korea, undertook reforms in a gradual manner, in some instances through 'trial and error'. This facilitated avoiding major crises during the reform period.

- Both countries had the political stability and the political will to undertake reforms. At a later stage, political instabilities in both countries, particularly in Indonesia, hampered the ability of the authorities to react to the problems caused by the Asian crisis swiftly and effectively.

- Both countries were unable to establish an effective prudential regulation and supervision system, which became apparent during the Asian crisis.

By contrast, there were also some differences in the policies approaches adopted in the two countries. Indonesia, for example, opened the capital account early and therefore heavily relied on f oreign investments in its growth promoting policies. Korea relied on i nternal resources for a significant period of the reform process. It opened its capital account later but quickly allowed the huge build up of short-term foreign borrowing as in Indonesia, which was one of the other causes of the Asian crisis.

The fact that dissimilar approaches to financial development can work in different countries strongly suggests that there is no universal or 'optimal' pace and sequencing of financial sector reform. Rather the success of financial reforms depends on the political will and technical ability of local policymakers to design and implement a reform programme based on the existing economic, political and cultural features of the society in question.

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