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Financial Liberalization and Financial Fragility: The Experiences of Chile and Indonesia compared

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Abstract:

The far-reaching liberalization process introduced in Chile after the overthrow of the Allende regime first met with reasonable success, but in the early 1980s a foreign-exchange crisis and a banking crisis appeared to mark the end of the experiment. Liberalization was resumed in 1985 and has not been plagued by serious crises since. The root of the problem seems to have been an exchange rate policy which had to be abandoned, but not before it had led economic actors to make the wrong decisions. The lack of prudential supervision of the financial system did the rest. So far, Indonesia has been following much more cautious exchange rate policies in its liberalization drive. Crises on the scale experienced by Chile are not very likely to occur. The lessons provided by the lack of prudential supervision in Chile do not, however, seem to have been taken to heart, or not sufficiently. Even if the Indonesian hanks are unlikely to suffer as much as their Chilean opposite numbers from foreign exchange risks, had loans, in particular resulting from intra-conglomerate lending, are an increasingly serious problem. In dealing with troubled banks the Indonesian authorities have not repeated the mistake of the Chileans to provide a full deposit guarantee. Nonetheless, excellent though the banking rules may look on paper, the implementation leaves much to be desired and Indonesia probably has not yet seen the end of its banking troubles. Apparently, market imperfections are such that effective prudential supervision cannot be dispensed with. Also, it appears that low capital-asset ratios in both banks and their clients. as in Chile in the mid-1970s, call for a cautious course in liberalization.

1. INRODUCTION

Ever since the early 1970s countries in Asia and Latin America, and to a lesser extent in Africa, have moved from inward-looking policies with heavy government involvement in the economy to more outward-looking policies that primarily rely on the price mechanism rather than on detailed government directives, protection and subsidies. The road to a more or less free market economy has not always been smooth. The most radical attempt at liberalization, the Chilean experiment in the late 1970s, to all appearances foundered in 1982 and it took the Chileans several years to get their liberalization process on course again. The Indonesian approach by contrast has been much more cautious and so far major crises have been avoided (though in all fairness it should be noted that Indonesia only seriously started her liberalization process after the 1982 worldwide debt crisis).

We will first recount the Chilean experience in financial liberalization in the 1973-82 period in order to find out what went wrong and next trace the Indonesian liberalization process. In the short final chapter, we will try to see what lessons can be learnt from the Chilean and Indonesian liberalization efforts. Our aim is to discover where Indonesia avoided the pitfalls which bedevilled the Chilean approach and in what respects, if any, the Indonesian authorities failed to pay heed to the lessons the Chileans learned the hard way. The description of the developments in Chile until 1982, with their extreme reliance on the unfettered functioning of markets, is meant as a kind of benchmark to contrast the Indonesian experience with .

Our approach thus is a comparative-historical one. The theoretical arguments in favour of a market economy and consequently in favour of liberalization are taken for granted. The transition from a heavily regulated economy to a more market-oriented economy is fraught with difficulties. Deductive logic does not tell us what transition path is best. In financial liberalization, much will depend on initial circumstances and on the institutional framework. Case studies may help to form a mental picture of the various obstacles on the road to liberalized financial markets and how to deal with them (cf Trebat 1991 p. 66). It may be objected that Chile and Indonesia are very disparate countries and that comparisons between very different cases are not very useful. If we start, however, from the premisse that people in different countries and different periods of time react in similar ways to similar stimuli, it seems that comparative history can teach us useful things.' Probably no hard and fast rules can be derived by this method, but it should help in identiying the areas where liberalization efforts run a serious danger of getting stuck.

2. CHILE'S FINANCIAL LIBERALIZATION

2.1. Chicago Macroeconomics

After the overthrow of President Allende and his Unidad Popular regime in September 1973, the new rulers saw themselves confronted with an economy in severe disorder. Inflation had exploded under the Unidad Popular, from 22.1 per cent in 1971 to 487.5 per cent in 1972 and 605.9 per cent in 1973 (figures from Edwards 1986 p. 245). The new government started on a cautiously liberalizing course, but inflation hardly abated after the change of regime: in 1974 it ran at 369.2 per cent and in 1975 at 343.2 per cent. Lacking a clear idea of how to run the economy themselves, the military rulers then turned to the only group with a consistent view of attacking Chile's economic problems, a group of predominantly Chicago-trained young economists. These so-called Chicago kids or Chicago boys took over the management of the economy in 1975 and started to liberalize the Chilean economy at a fast pace. The extremely protectionist and complicated system of import tariffs and nontariff barriers inherited from the Allende administration was swiftly dismantled. Nontariff barriers were simply abolished and tariffs, which had run as high as 1000 per cent or more in September 1973, with a weighted average of 105 per cent, were reduced to a flat rate of 10 per cent in June 1979, except

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[1]. For support we may refer to three other studies on a much larger scale where conclusions are drawn from a comparison of case studies in the banking and finance area: C.P. Kindleberger's famous study of *Manias, Panics, and Crashes* (Kindleberger 1978), and more recent IMF and World Bank studies, which are also referred to elsewhere in this paper: V. Sundararajan and T.J.T. Baliño (1991), and S. Faruqi (ed.) (1993), which explicitly has *Lessons of Comparative Experience* as a subtitle.

for cars over **850** cc capacity (cf *Euromoney* **1978** p. 15; Corbo and de Melo 1987 p. 123). Also, export subsidies and cheap credits for special borrowers were abolished.

The opening-up of the economy went hand in hand with a serious, and ultimately reasonably successful, attempt to fight intlation. Fiscal tightness (see table **1)** and monetary contraction were introduced. which together with a fall in the price of Chile's main export product, copper, led to a sharp reduction in GNP in 1975. At first, the Chilean government saw the exchange rate as a tool for correcting balance of payments problems (*Euromoney* 1978 p. 15). Later on, however, the rate of exchange was primarily deployed to help reduce intlation. In early 1978, the Central Bank extended the preannouncement of daily exchange rates one or two months in advance to a schedule (*tablita*) covering the entire year. It was hoped that inflationary expectations would be revised downwards in this way (IMF 1981 p. 339). In June 1979 the Central Bank went one step further and tixed the dollar exchange rate (Edwards and Edwards 1992 p. 205). It was, however, not before 1981 that the inflation rate converged to the world inflation rate of 9.5 per cent. In the process, the real exchange rate (defined such that a higher real exchange rate means that domestic goods become cheaper vis-a-vis foreign goods) inevitably fell (cf Visser 1993). The fall in the rate of inflation took much longer than expected, probably because of backward indexation of wages which prevented production costs from falling faster, but the capital-import-tinanced boom in the nontradeables sector will also have played a role (Kiguel and Liviatan 1994 p. 174-5).

What happened can easily be told in terms of the dependent economy model. The Chilean peso underwent a real appreciation, the current account of the balance of payments turned into deficit (to the tune of 13.7 per cent of GDP in 1981, see Corbo 1985 p. 906), capital inflows soared and the nontradeable sectors boomed (Corbo and Sanchez 1985 p. 89). When capital inflows suddenly stopped in 1982 and the fixed exchange rate could not be maintained, a financial crisis broke out, triggered by bad debts and high dollar liabilities. Even if the opening-up of the Chilean economy had proven quite successful, the liberalization of the financial sector that went hand-in-hand with it, ended in disaster. In the next few sections we will try to find out what went wrong.

2.2. Financial Liberalization

Under President Allende, the financial sector had been nationalized. The allocation of credit was not based on clear economic criteria. The switch to a market economy economy which was the overriding policy aim of the Chicago-trained economists under Pinochet did not stop at the financial system. The liberalization of the financial system was one of their top priorities. This liberalization included reprivatization of the banking sector, the lifting of interest ceiling in order to reinstate the market as the allocational machinery for credit with the real rate of interest as the equilibrating mechanism, and encouraging the establishment of new banks and other financial institutions.

year	GDP	M1	M2	inflation	deficit	exchange rate	savings
1970	2.1	52	51	34.9	2.9	0.012	21.6
1971	9.0	99	95	22.1	11.2	0.016	17.8
1972	-1.2	96	91	487.5	13.5	0.025	10.4
1973	-5.6	273	286	605.9	24.6	0.360	9.5
1974	1.0	301	279	369.2	10.5	1.87	25.3
1975	-12.9	233	301	343.2	2.6	8.50	8.5
1976	3.5	213	290	197.9	2.3	17.42	15.4
1977	9.9	165	225	84.2	1.9	27.96	10.7
1978	8.2	88	114	37.2	0.9	33.95	11.6
1979	8.3	60	86	38.0	-1.7	39.00	13.7
1980	7.5	58	58	31.2	-0.6	39.00	15.5
1981'	5.3	33	89	9.5	-3.0	39.00	7.5
1982	-14.1	-5	-15	20.7	-2.3	73.43	

GDP = percentage real GDP growth; M1 = percentage growth rate of narrow money; M2 = percentage growth of broad money: intlation = intlation percentage December - December; deficit = government budget deficit as a percentage of GDP; exchange rate = pesos per US$, end of year; savings = gross domestic savings as a percentage of GDP.
Sources: real GDP growth from Edwards 1986 p. 243, 1982 from *International Financial Statistics*; money growth from Corbo 1985 p. 896: intlation from Edwards 1986 p. 245; budget deficit from Edwards 1986 p. 245; exchange rate from *International Financial Statistics*; savings from Edwards 1986 p. 257.

Table 1. *Macroeconomic data for Chile, 1970-82.*

Liberalization started already in 1974 with the lowering of reserve requirements and the permission to establish non-bank financial institutions (NBFI), so-called *financieras*, which were free of rules as to setting interest rates. In October 1975 the commercial banks also were freed from restrictions as to interest rates. Between 1975 and 1978 furthermore all the banks, except the Banco del Estado and two small banks that were involved in difficulties of a legal nature, were privatized. The public sector was even prohibited to invest in the banking sector (Held 1990 p. 177). A number of banks were sold to conglomerates or *grupos* that used the newly acquired banks to finance their own expansion.

The freedom to set up new banks resulted in an increase in the number of domestic commercial banks from 18 in September 1973 to 26 in 1981 and in the number of foreign banks from 1 to 19. A measure of the increase in financial intermediation is the increase in the total real volume of credit to the private sector over that period by more than 1100 per cent (Edwards and Edwards 1987 p. 56).

2.3. International Capital Flows and the Financial Sector

The liberalization of the current account of the balance of payments was not fully matched by a liberalization of the capital account. Capital controls, in particular controls on external borrowing by commercial banks, were thought necessary in order not to be flooded with capital intlows, which would have made control of the money supply that much more difficult (Sergio de la Cuadra, vice-president of the Chilean central bank, in *Euromoney* 1978 p. 17). In 1977 the banks were allowed to act as an intermediary for medium and long-term foreign capital, provided foreign debt did not exceed 5 per cent of a bank's capital. In 1979 this restriction was lifted and the only restrictions were that foreign debt was subject to a capital-asset ratio of 5 per cent and that capital inflows per bank in any month should not exceed 5 per cent of the bank's capital (Corbo and de Melo 1987 p. 123). The latter restriction in its turn was lifted in April 1980. Restrictions on inflows of short-term capital remained in force until 1982.

Apparently, the restrictions on capital inflows were insufficient and what happened is what McKinnon had already warned against in 1973 (McKinnon 1973 Ch. 11). Domestic interest rates in Chile rose sharply and exchange rates were believed to remain stable for a time at least. The restrictions on capital intlows were far too weak to prevent huge inflows, which reached a peak of no less than some 25 per cent of GDP in the first half of 1981 and resulted in an inflated nontradeables sector and a rapidly increasing excess demand in the tradeables sector, i.e., a huge trade deficit (Corbo 1985 p. 903). True, when capital import restrictions were partially lifted capital intlows at first helped to reduce real interest rates sharply 1979, but in 1981 they soared again (see Table 2), probably at least in part because of devaluation expectations (Galvez and Tybout 1985 p. 972.), but also perhaps because of an unexpected fall in inflation (Corbo 1985 p. 903).

2.4. The Disappointments of Financial Liberalization

Financial intermediation may have undergone multiple expansion, the hoped-for increase in savings failed to materialize. A plausible explanation is that economic agents anticipated high economic growth and spent heavily on consumer goods. Another contributing factor is that the revenue of the sales of public sector enterprises was used by the government to finance current expenditure (Edwards and Edwards 1987 p. 60).

Savings remained at a low level (see Table 1), contributing to real interest rates that rose to dizzying heights. Low savings have been attributed to the rise in asset values in the boom period of 1978-'81, which produced a wealth effect on spending (Corbo and de Melo 1987 p. 133). There may have been a number of other factors contributing to high interest rates. First of all, there may have been a high demand for loans by firms desperate for funds in order to avoid bankruptcy, and those loans were freely given, especially to firms within the same *grupo*. The squeezing of the tradeables sector resulting

Year	Outstanding loans	Debts
1976	50.9	8.6
1977	46.1	17.3
1978	35.9	22.6
1979	15.8	4.7
1980	11.6	5.0
1981	33.2	25.5
1982	30.6	20.5
1983	14.9	3.9
1984	11.0	2.6
1985	10.6	4.1
1986	7.4	1.5
1987	9.0	3.1
1988	8.0	2.4

1988 till October. Source: Held 1990 p. 195.

Table 2. *Real interest rates on fixed-rate 30-89 day loans, 1976-1988.*

from the fall in the real exchange rate will surely have been a contributing factor (Edwards 1990 pp. 8,9), but firms already entered the post-Unidad Popular period seriously undercapitalized (Corbo 1985 p. 899). Secondly, the real-estate boom that started with the fixed dollar rate increased the demand for loans, whereas the rise in property prices appeared to provide sound security for lenders (Eyzaguirre 1993 p. 129). Thirdly, people may have been willing to pay high interest rates because of devaluation expectations. Both explanations are consistent with the jump in real interest rates between 1980 and 1981 (see Table 2; the figures for 1980 do not reflect a jump, but they are an average over the whole year). But they had been high before already. The actions of the *financieras* did nothing to restrain the rate of interest. They were subject to fewer restrictions than the banks and paid higher interest rates to depositors, forcing the banks to follow in their footsteps. High real interest rates made life difficult for many firms and contributed to the proliferation of bad loans that plagued the Chilean financial sector. It has been said, probably with good reason, that the high interest rates resulted in adverse selection, because banks did not make funds available for low-risk, low-return investments (Corbo and de Melo 1987 p. 137, Mirakhor and Villanueva 1993 p. 32: the argument stems from Stiglitz and Weiss 1981). Ultimately, in November 1981 the central bank had to step in in order to rescue four banks and four *financieras*, with between them about one half of the assets of the entire financial system (Harberger 1986 p. 239).

2.5. Prudential Supervision

In hindsight, it appears that grossly inadequate prudential supervision is at least partly to blame for the financial crisis that erupted in 1982. Prudential supervision was below par in several respects (cf. Trebat 1991 pp. 60- 1):

(i) requirements for setting up new banks were anything but strict (see Table 3);

(ii) required capital-asset ratios did not take account of the riskiness of different bank assets;

(iii) accounting systems were not designed to spot debt accumulation in time;

(iv) there was too little legal room for taking action in a crisis situation.

	commercial hanks	development banks	financieras
December 1974	2,500,000	1200,000	400,000
January 1976	3,900,000		3 ,000.000
January 1978	4,000,000	3,000,000	
September 1980	10,400,000		5,200,000
August 198 1		10,400,000	

Amounts in approximate US dollars equivalents on date of introduction. Source: Held 1990 p. 227.

Table 3. *Minimum capital amounts for different financial institutions.*

These problems were compounded by the absorption of commercial banks by *grupos*. The grupos bought many of the privatized companies from the state, including commercial banks. The government had made an attempt to prevent excessive concentration of economic power by stipulating that individuals were not allowed to hold more than 1.5 per cent of a bank's share capital and companies not more than 3 per cent (Held p. 177). The government conceded that these rules were circumvented. Moreover, it discouraged foreign banks from taking an interest in Chilean banks (*Euromoney* 1978 p. 29). Non-financial companies subsequently were not allowed to hold more than 5 per cent of a bank's share capital. The grupos, however, managed to circumvent such rules and at the end of the decade of the 1970s ten big banks, representing 80 per cent of own capital tied up in banking, were directly controlled by grupos (Edwards and Edwards 1987 p. 99).

The banks attracted dollar loans, which they had to pass on without converting them into pesos. In the three years from 1979 to 1982 the external debt of the banks multiplied from $660 million to nearly $7 billion (Trebat 1991 p. 62). Other ***grupo*** companies, however, contracted dollar loans from the banks and provided peso credits. Meanwhile, capital-asset ratios both in financial and nonfinancial firms deteriorated. The government could have given the right signals in 1977 when a number of *financieras* and the Banco Osorno la Union failed as a result of bad loans to companies within the Fluxa ***grupo.*** It took a number of steps, such as increasing the required minimum capital for *financieras* and introducing a temporary deposit guarantee to a maximum of $3000 for each depositor. All creditors of the Banco Osorno, however, were fully compensated. Economic agents interpreted this government action as a *de facto* unlimited deposit guarantee and in their investment policy disregarded the soundness of the financial institutions. Velasco (1991 p. 140) notes that if deposits had not been perceived to be guaranteed, there would have been major bank runs, which did not take place. The government was ambiguous in its statements. Central bank vice-president Sergio de la Cuadra told *Euromoney* in 1978 on the one hand that banks had to function in a free market, with all that this implied, and on the other hand that bank failures would have more serious effects than bankruptcies of industrial firms (*Euromoney* 1978 p. 17). It took the government some years to come to the conclusion that more strict prudential supervision was called for and in the process it created a classical case of moral hazard. Moreover, the monetary authorities failed to deal with the increasingly closer ties between banks and *grupos*. Only in 1980 a begin was made with the classification of outstanding credits according to risk categories and in 1981 the banking superintendent got the right to prohibit some kinds of credits (Held 1990 p. 237). But it was too little too late. In 1981 and 1983, again, banks in trouble were fully bailed out. The sale of bad debt by the banks to the central bank amounted to 28 per cent of their total assets and 18 per cent of GDP in 1985 (Held p. 260).

2.6. The Aftermath of the Crisis

In early 1983 the government saw itself forced to take over the two largest private commercial banks, to close down three banks and to intervene in five others (Eyzaguirre 1993 blz. 132). Even if the government had during the build-up of foreign debt since 1980 declared that foreign debt contracted by the private sector was not its concern (Edwards 1986), it now helped out troubled firms by selling 'prefenterial dollars' at a subsidized rate after the 1982 devaluation had increased the peso value of foreign debt and also bailed out the troubled banks that were saddled with bad debts. It had to give in when, after it had in 1983 reiterated its position, the foreign commercial banks suspended all credit, including short-term trade credit (Meller 1992 p. 58). The central bank bought private banks' nonperforming portfolios in exchange for promissory notes that bore a real interest of 7 per cent, whereas the banks were under the obligation to repurchase thair debt in the future, against a 5 per cent real interest rate. Thus, the central bank subsidized the commercial banks (Edwards and Edwards 1992 pp. 205, 209; Eyzaguirre 1993 p. 132; see for more details Velasco 1991 p. 157).

The Chilean liberalization effort had foundered, or so it seemed even to well-informed observers (Corbo 1985 p. 909, Hanson 1986 p. 232). In April 1984 the Chicago-educated Minister of Finance received his marching orders, and that looked the end of it. In 1985, however, free-market economists were back at the helm and the Chilean economy ever since has been held up as a shining example of the good that market-oriented policies can do. The government did not, however, return to the extreme hands-off policy that had characterized the reign of the Chicago boys (Edwards and Edwards 1992 p. 207). Monetary policy, for example, was aimed at preventing real interest rates from rising as exorbitantly as in the pre-1983 period. It is a moot point, however, how much of the success in keeping real interest rates down was due to monetary policy and how much to increased supply in the credit market, e.g. as a result of the rise of private pension funds (Edwards and Edwards 1992 pp. 207-'8).

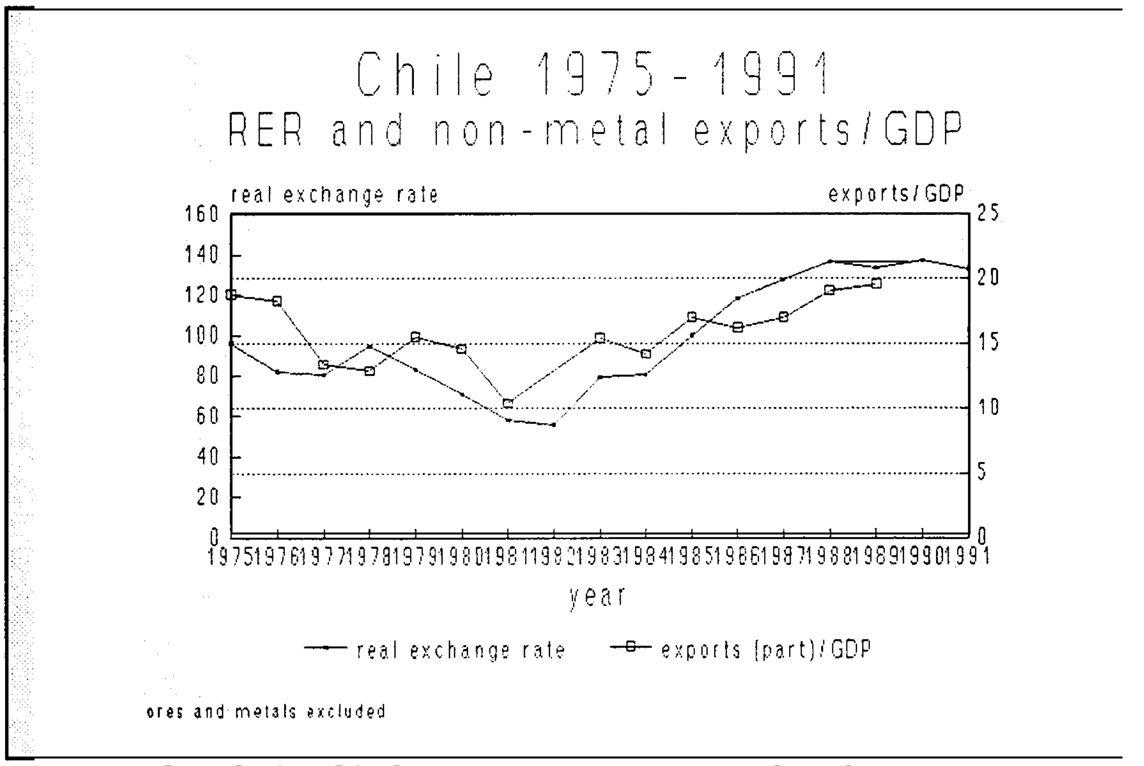

Figure 1. ***The relationship between openness and seal exchange t-ate (RER) for Chile, metals and or-es excluded. Source:*** Visser 1993.

The government also had to give up the fixed exchange rate as from June 1982. It proved possible to depreciate the peso at a much higher rate than the rate of inflation and over the rest of the 1980s the real exchange rate roughly doubled, which went hand in hand with a significant rise in exports as a percentage of GDP (see Figure 1').

It was conceded that prudential supervision had been lax, or rather lacking, and steps were taken, inter alia, to introduce risk-weighted capital-asset ratios and reduce the (de facto) coverage of deposit guarantee, culminating in the 1986 revision of the banking law (see Ramirez 1991; Eyzaguirre 1993 pp. 136-'8).

2.7. Preliminary Conclusions

In the financial climate in the world in 1982 a debt crisis was hard to avoid for any heavily indebted country, and heavily indebted Chile was: the debt service ration jumped from 43.1 per cent in 1980 to 71.3 per cent in 1982 (World Bank 1989 vol. 2). By late 1981 the cracks in the Chilean economy had already become visible, in the guise of nonperforming loans (i.e., loans on which interest had not been paid for at least three

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[2]. Note that the figure for exports/GDP for 1982 is missing, which gives the probably wrong impression that the curve starts already rising sharply in 1982.

months) and an extremely high real interest rate (see Table 2). Ceilings on foreign borrowing by banks or higher and more effective required capital-asset ratios would have resulted in less foreign borrowing. Also, if there had been no indexing of wages, inflation would probably have fallen faster and the real appreciation of the peso would probably have been less. Furthermore, there would have been less of a financial crisis if prudential supervision had been more effective and if the government had not given de facto full deposit insurance. This gave rise to moral hazard problems and it forced financial institutions with a prudent loan policy to pay the same high interest rates to depositors as their more risk-loving brethren.

It took several years before inflation was reduced to single figures. A major contributing factor was backward wage indexation. Severe shocks of other kinds also hit the economy, such as the sale of nationalized firms. The macroeconomic instability was thus compounded by an upward pressure on real interest rates, through an increased demand for credit meeting with a still restricted supply of savings. It is doubtful whether under such circumstances it was a wise decision to leave interest rates completely free. As noted above, it is highly probable that adverse selection took place. Even McKinnon himself, who started, together with E.S. Shaw, the debate on financial liberalization in 1973, now argues against letting real interest rates rise without limit (McKinnon 1988 pp. 401, 407; McKinnon 1992 pp. 77-83, see also Villanueva and Mirakhor 1990 pp. 510, 513). Apparently, after a shockwise regime change, it may take many years before the economy, and the financial sector in particular, can be left to the discipline of the market.

3. THE INDONESIAN FINANCIAL LIBERALIZATION

3.1. The Underlying Philosophy

year	GDP	MI	M2	inflation	budget	exchange rate
1966	2.3	764	743	920	n.a.	
1967	2.3	132	140	171	n.a.	176/235
1968	11.1	125	137	128	n.a.	*2771326*
1969	6.0	58	82	16	2.8	*2771326*
1970	7.5	37	42	12	1.9	3401378
1971	7.0	28	42	4	2.3	374/415
1972	9.4	49	49	6.5	2.4	*3741415*
1973	11.3	42	43	31	2.0	374/415
1974	7.6	40	46	41	0.9	415
1975	5.0	35	39	19	3.2	415
1976	6.9	26	31	20	1.5	415
1977	8.8	25	18	11	I.0	415
1978	7.8	24	22	8	0.5	625
1979	6.3	33	35	21	0.5	627
1980	9.9	51	49	18.5	2.4	*626.75*
1981	7.9	29	28	12	I.4	644.0
1982	2.2	10	14	9.5	2.2	692.5
1983	4.2	6	32	12	1.4	994
1984	7.0	13	22	10.5	0.6	*1074*
1985	2.5	18	46	4.7	0.3	1125
1986	5.9	15	6	5.9	2.7	1641
1987	4.9	9	23	9.2	1.0	1650
1988	5.8	13	24	8.0	3.2	1731
1989	7.5	43	39	6.5	2.0	*1797*
1990	7.2	16	45	7.4	-0.4	1901
1991	6.9	12	17	9.4	-0.4	1992
1992	6.4	8	20	7.5		2062
1993	6.5			9.7		2110

Sources: GDP growth calculated from *International Financial Statistics*, *1986-93:* from *World Economic* Outlook. October 1994, p. 126 (1993: forecast). Money growth: calculated from *International Financial Statistics*. In flation: calculated from CPI figures in *International Financial Statistics*. Budget deficit defined as borrowing requirement excluding foreign aid, calculated from *International Financial Statistics*. $ exchange rate: end of year. from *International Financial Statistics*, *1967-1973* rates apply to exports and to imports. respectively.

Table 4.*Macroeconomic data for Indonesia, 196692.*

The introduction of liberalization in Chile marked an extremely sharp break with the past. In Indonesia too a regime that had allowed inflation to rise to around 1,000 per cent was replaced by a new group of rulers, but the transition was much less of an earthquake, in the sense that Indonesia did not develop into a testing ground for a pure version of some policy approach. After the failed coup of 1965, Suharto assumed power in March 1966 as a member of a triumvirate and only in March 1968 he succeeded Sukarno as President. Again, a group of US-educated people, this time from Berkeley, took over the commanding posts in the area of economic policy, though to all appearances this 'Berkeley maffia' got much less of a free hand under President Suharto than their Chicago counterparts got under President Pinochet, and they were not such dogmatic laissez-faire proponents anyway. Even if not motivated by the, for the period, extreme free-market principles of the Chicago kids, the New Order government nevertheless energetically attacked Indonesia's economic problems. The Indonesian economy remained strongly regulated, but with technical and financial help of the IMF a Rehabilitation and Stabilization was drawn up and put into practice over the 1966-'70 period, aimed at reducing inflation, developing the infrastructure and improving the supply of basic goods and services. Inflation fell surprisingly fast and economic growth did not suffer under the anti-inflationary policy. One problem the Indonesians had not to cope with in the first years of their reign, unlike the Chileans, was a precipitous fall in the price of their main export. Indeed, the opposite happened: the oil price hike of 1973-4 contributed to a return to double-digit inflation. However, oil prices did fall in the early 1980s, and it was felt that more serious measures were called for to put the economic house in order. Indonesia now started, ever so cagily, on the path to liberalization (Booth 1992 p. 25).

3.2. Financial Liberalization

The 1980s started with the Indonesian financial system characterized by severe financial repression. There were hardly any financial institutions outside the commercial banks, which held 95 per cent of financial assets. The five state-owned commercial banks and Bank Indonesia, which acted both as the central bank and as a commercial bank, between them held 80 per cent of all financial assets. The playing field for the state banks and the private banks was far from level: state banks had easier access to Bank of Indonesia credit, were allowed a much more extensive branch network and were the only banks where public enterprises could hold accounts. Foreign banks were even more disadvantaged in that they had no access whatsoever to Bank of Indonesia credit and could not open more than two branches. Credit allocation was heavily influenced by all kinds of special programmes. Subsidized directed credit accounted for 48 per cent of all bank lending in 1982 and this so-called *liquidity credit* would be refinanced at low rates by Bank Indonesia. Indeed, refinancing was the main source of funding for the state banks, as they were subject to an interest ceiling for deposits of over three months, whereas the private banks were free to set their own rates. In 1982 state banks paid on average 6.0 per cent interest on 6-month deposits, against 18.5 per cent for private banks. Credit allocation

year	nominal rate	real rate
1968	72.0	-24.0
1969	60.0	35.7
1970	24.0	10.4
1971	24.0	19.2
1972	18.0	10.6
1973	15.0	-12.0
1974	15.0	-18.4
1975	15.0	-3.2
1976	15.0	-4.2
1977	12.0	0.9
1978	9.0	0.7
1979	9.0	-9.6
1980	9.0	-8.0
1981	9.0	-2.9
1982	9.0	-0.5
1983	18.0	5.5
1984	18.3	11.1
1985	15.0	12.8
1986	15.0	0.6
1987	17.5	4.7
1988	18.5	9.6
1989	16.5	9.8

The real rate has been calculated by deflating by the CPI of the current year.

Table 5. *Rates on one-year time deposits o state banks in Indonesia, 1968-89*. Source Cole and Slade 1992b.

was also affected by the credit ceilings imposed by Bank Indonesia on individual banks (see on all this, as for the rest of this section, Hanna 1994).

Credit allocation was opaque and inefficient, both in the sense that loans did not always reach intended beneficiaries (or that it was even well-nigh impossible to judge if the allocation met any intention at all) and in the sense that projects with a low return were financed. This latter effect came about through low, subsidized interest rates and through subsidized credit insurance from a state-owned insurance company, which led to moral hazard problems in that banks had no incentive to closely monitor a project (Hanna 1994 p. 8).

The fall in oil income made it imperative to mobilize domestic savings and make more efficient use of available financial resources. A step in the direction of liberalization was taken in 1983, when directed credit was substantially reduced and interest on such credits were increased. Other interest ceilings were abolished. Liquidity credits, though, were not abolished overnight, but were reduced at a very slow pace: they fell gradually from 37.1 per cent of all bank credit in March 1983 to 11.9 per cent in March 1992 (Hanna 1994 p. 5). Monetary policy, which until June 1983 had relied on credit ceilings for individual banks, now had to find other instruments. For lack of sufficient government debt, Bank Indonesia introduced *Sertifikat Bank Indonesia* (SBI), debt issued by themselves, in order to create paper eligible for open-market operations. To the same end, Bank Indonesia stimulated the market for bank acceptances or *Surat Berharga Pasar Uang* (SBPU) (Binhadi 1990 p. 61, Sundararajan and Molho 1988 p. 44, see also Van Herpt, Ruhe and Visser 1994). Bank Indonesia was, however, handicapped by the shallowness of the market (Woo and Nasution 1989 p. 25).

The next step in financial liberalization again was a reaction to adverse external developments. 1986 again saw a sharp fall in oil prices. What with the appreciation of the yen and imports to a large extent coming from Japan, the current account of the balance of payments deteriorated and the budget deficit went up. A substantial devaluation (see Table 4) went hand in hand with a substantial liberalization of international trade. Non-tariff barriers were replaced by tariffs and those tariffs were then lowered. Also, direct foreign investment was made easier. Again, there were no sweeping across-the-board policy changes, but rather a series of measures that followed each other over the years. In the process, the authorities managed, with the help of fiscal tightening, to keep inflation in the one-digit range. Then, in October 1988, a set of reforms for the financial sector was introduced, denoted as PAKTO 27 (the 27 October 1988 package). This included a drastic lowering of entry barriers into the financial sector. Both domestic and foreign banks received more opportunities to increase their branch network, state enterprises henceforth could hold one half of their assets in private banks and both banks and NBFI were allowed to issue certificates of deposit. Also, the competitiveness of banks relative to NBFIs was improved by a reduction in reserve requirements from 15 per cent to 2 per cent, to which NBFI were now subject too. In order to prevent a sharp credit expansion, Bank Indonesia required the banks to invest 80 per cent of the funds that became freed through the reduction in SBIs (Binhadi 1990 pp. 17-18).

Again, liberalization measures were taken in a continuous flow, rather than as a shock therapy, and PAKTO 27 was followed by three other packages within 15 months. In March 1989, e.g., absolute limits on foreign borrowing by banks were replaced by a limit of 25 per cent of equity to the net open position of banks in foreign exchange. Banks could, under this rule, freely borrow abroad as long as they lent domestically in foreign exchange. January 1990 saw a further reduction in directed credit, with a reduction in the numver of priority programmes and interest rates set closer to market levels. The subsidized credit insurance was abolished. Against this, banks were required to make 20 per cent of their loans to small borrowers.

3.3. International Capital Flows

The capital account of Indonesia was liberalized in 1970 already. Capital flows were liberalized, with the exception of direct foreign investment and portfolio investment through the domestic capital market (Sabirin 1993 p. 153). For the rest, restrictions were abolished, mainly because the government had little hope that it could effectively monitor and control capital flows (Cole and Slade 1992b p. 122). However, out of a concern about liquidity growth it imposed ceilings for foreign borrowing by banks and nonbank financial institutions (NBFI) in 1974, which remained in force until 1989 (Sabirin 1993 p. 154). It is curious that a repressed financial system, with real interest rates often negative over the 1973-1983 period, and an open capital account could go together. It has been suggested that capital flows were not one-way traffic. Both banks and non-bank firms deposited inactive balances abroad, whereas firms that were hit by domestic credit limits borrowed abroad (Cole and Slade 1992a pp. 86-7). A contributing factor was the credibility of the exchange-rate policy, with a tixed dollar exchange rate since 1971. Because of booming oil exports the current account of the balance of payments did not suffer too badly from the fall in the real exchange rate that occurred as Indonesia still had double digit inflation until 1977. In 1978 the rupiah devalued, possibly with an eye to increasing employment in the export industries, which had suffered from Dutch disease phenomena (Woo and Nasution 1989 p. 26). The dollar link was replaced by a link with a basket made up of the currencies of the main trading partners. Bank Indonesia now opted for a gradual depreciation. The 1978 devaluation came as quite a shock, but seems, if anything, to have stimulated foreign borrowing, because further steep devaluations were thought to be very unlikely. Non-oil exports reacted very positively to the devaluation and the government let the rupiah depreciate gradually vis-à-vis a currency basket.

One wonders why, with financial liberalization and real interest rates shooting up, no massive capital intlows followed. One cause probably was the failure of the state oil company Pertamina to refinance $400 million short-term debt, which prompted the government to require the state companies to ask permission from the Ministry of Finance and Bank Indonesia before borrowing abroad. Woo and Nasution (1989 pp. 86-7) see the Pertamina crisis as a blessing in disguise, as it may well have been a main factor in saving Indonesia from the fate that met Chile in the 1982 developing country debt crisis. Other contributing factors were the limits on foreign borrowing by banks and NBFI and the fact that only very few nonfinancial firms were able to borrow abroad. The authorities had kept budget deficits small and there had been no runaway money growth through foreign borrowing (as the Pertamina case shows, perhaps more from luck than from design). The exchange rate policy had prevented a serious overvaluation of the rupiah and exports were healthy enough service the foreign debt when oil prices took a tumble in the early 1980s. Also, Indonesia was favourably placed compared with the Latin American countries in that suffered much less from the dollar appreciation, only about one third of her debt being denominated in dollars against some 90 per cent for countries such as Mexico or Brazil (Woo and Nasution 1989 p. 30). Also, much of its debt was on concessional terms. Nevertheless, in 1982 the current account ran into deficit to the tune of 6 per cent of GDP (Woo and Nasution 1989 p. 107) and capital outtlows increased as a result of increased devaluation expectations. Finally, in March 1983 a 38 per cent devaluation was put through.

In 1989 the limits on foreign borrowing by banks were abolished, but as banks were too eager to borrow abroad new contraints were put in place, this time in the guise of a limit to the net foreign liabilities of a bank and a limit of 30 per cent of own capital for short-term borrowing (Binhadi 1993 pp. 13-14). Borrowers also had to queue. More or less free capital tlows force the authorities to follow credible policies. Fear of devaluations had led to speculative capital outflows in 1987 and 199 1 and it was decided that henceforth no sizeable devaluations would take place. Since 1989 the exchange rate is left to market forces, with Bank Indonesia intervening only to prevent sharp fluctuations (Van Herpt, Ruhe and Visser 1994 p. 150).

year	ratio
1980	13.9
1981	14.1
1982	18.2
1983	20.2
1984	21.4
1985	28.8
1986	37.3
1987	37.0
1988	40.2
1989	35.4
1990	31.0
1991	32.6
1992	32.1

Source: World Debt Tables 1989-1990, vol. 2, Washington, D.C.: World Bank 1989 and *World Debt Tables 1993-1994*, vol. 2. Washington, D.C.: World Bank 1993.

Table 6. *Debt-service ratios for Indonesia, 1980-92.*

The large debt accumulation by Indonesia in the 1980s was to a large part a result of borrowing by the government itself. The political elite that took over after the Sukarno era imposed a constitutional prohibition of domestic debt finance. The state therefore was dependent on foreign capital to finance its deficits, which averaged roughly 2.5 per cent of GNP over the 1970s and 1980s. The rulers acted out of fear of inflation, but one wonders if they did not realize that foreign-financed deficits swell the money supply as much as domestic credit from the banking sector. The idea probably was that foreign funds were mainly used for development projects with a high import component. But the private sector also borrowed abroad, and the debt-service ratio shot up when Indonesia was hit in 1986 by a fall in oil prices and a depreciation of the dollar vis-à-vis the yen. Exports were largely paid in dollars, whereas imports to a much greater percentage were in yen and debt also was to a large degree yen-denominated. The current-account deficit of 1982 was met by a devaluation but at the same time by increasing protection. The 1986 near-crisis turned the tables in favour of the more free-trade oriented technocrats centered in the Ministry of Finance and Bank Indonesia. A 50 per cent devaluation combined with trade liberalization helped non-oil exports to steeply increase over the next few years, reducing the debt-service ratio again.

3.4. The Results of Financial Liberalization

The liberalization measures taken in 1983 and 1988 and after have had a great impact on the banking scene, just as Finance Minister J.B. Sumarlin had expected. His policy objective was to vitalize the commcercial banks. Competition by these banks would force the state-owned banks to improve efficiency and the whole banking system would function with fewer market imperfections. The number of national private banks doubled from **63** to 126 between 1988 and 199 1. The branch network of those banks even increased from 559 to 2639, against a small rise from 815 to 960 for the tive state banks and a jump from 21 to 53 for foreign banks and joint ventures (Bank Indonesia 1992 pp. 108-9). Lending ballooned. Whereas total lending rose by 109 per cent, the domestic commercial banks saw their lending soar by 290 per cent and the foreign banks and joint ventures by 345 per cent, which resulted in a fall of the state banks' market share from 65.1 per cent to 52.7 per cent (Bank Indonesia 1992 pp. 38-9).

In the scramble for market share, the banks seem to have been less than prudent. As in Chile, huge sums were lent to finance real-estate investment and to intra-conglomerate firms. Also, consumer credit rose sharply. Combined with an anti-inflationary restrictive monetary policy, high real interest rates have been the result. If the private banks became saddled with bad and nonperforming loans as a result of this fast expansion plus high

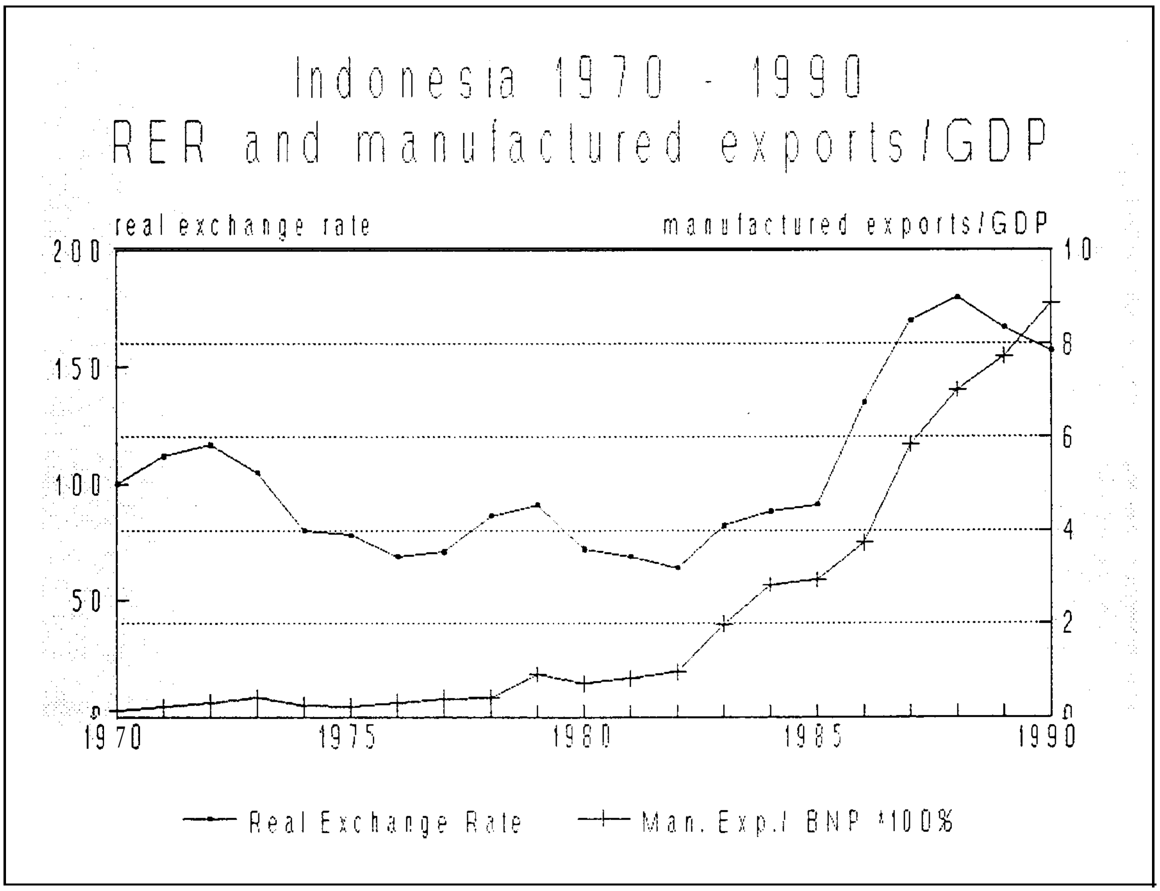

Figure 2. *Real exchange rate and exports of manufactures, Indonesia 1970-90. See* **end of paper for note on the construction of RER.**

interest rates, the state banks got their fair share of troubles from politically-influenced credit allocation (the *katabelece* or memo system). The plight of the state banks was such that the World Bank had to provide a $307 million loan which the Ministry of Finance used to recapitalize them. It seems, however, that 15 to 20 times this amount is needed to fully recapitalize them, according to World Bank calculations (Sender 1993a p. 76).

The private commercial banks were not unaffected either. In September 1990 the Board of Directors of Bank Duta was forced by Rank Indonesia to resign after it had become known that foreign-exchange transactions had cost the bank $419.6 million, or twice its capital, in one year. There are signs of behind-the-scene manoeuvring which put a big question mark over the levelness of the playing field and the public availability of information in Indonesian banking. First of all, the foreign-exchange losses imply a level of foreign-exchange transactions far in excess of official limits. Then, Bank Duta was back on its feet in a remarkably short time, after a large capital injection from large shareholders in the form of gifts, the source of which remains somewhat mysterious. It has been suggested that Bank Duta is at least politically strong (Soesastro and Drysdale 1990 p. 21). Another shock was the failure of Bank Summa in December 1992, as a result of real-estate loans and loans to low-quality borrowers, in particular intra-conglomerate loans. The attempts by the Soeryadjaya family, the main owners of the Summa Group of which Bank Summa formed part, to save Bank Summa from the proceeds of the sale of healthier parts of the Summa Group came to grief (though in the end all depositors with a deposit below Rp 10 million were fully compensated). This sent quite a shock wave to the financial community, as it had always been thought that conglomerates were strong enough to save their banks if these landed in trouble.

3.5. Prudential Supervision

In PAKTO 27, attention was also paid to prudential supervision, with limits to the volume of lending to any individual person, firm or conglomerate. Other measures followed. In March 1991, e.g., prudential supervision was made more comprehensive, with, inter alia bank directors having to meet professional standards, restrictions as to the number of relatives of shareholders in the Board of Directors and to the loans to shareholders, limits as to foreign-exchange exposure and the adoption of the Basle Agreement risk-weighted capital-asset ratios foreseen for the end of 1993 (later extended to 1994) (Parker 1991 p. 31).

All these measures look fine on paper, but it appears that something is lost in the execution. Rules can be circumvented, e.g. by granting a loan from a bank's pension fund instead of by the bank itself, and apparently supervision often lacks bite, pointing to a lack of political power of the monetary authorities. This played a role when in mid-1992 the Ministry of Finance replaced all state bank president, with the exception of the president of Bank Bumi Daya, even if Bank Bumi Daya was one of the greatest problem banks (Sender 1993a p. 76). Apparently in the Indonesian political culture it is well-nigh impossible to stamp out the *katabelece* system. One scandal follows another and Finance Minister Mar'ie Muhammad estimated the volume of non-performing loans at 21.2 per cent of the state banks' outstanding credit (McBeth 1994 p. 25).

Against this, the monetary authorities made it clear at the time of the Bank Summa debacle that they did not stand ready to rescue troubled banks or guarantee their debts (Sender 1993b p. 77). Furthermore, under the new Bank Law of Febuary 1992 insufficient information from the side of the banks can be punished with two years in jail and/or a Rp 1 billion fine, and bank activities that are not allowed by the law carry the threat of a 15-year term in jail and/or a Rp 10 billion tine (McLeod 1992 pp. 119-122). But even if such measures may help to reduce moral hazard problems and bring down the number of cases of violations of the law, other attempts at shoring up the financial system are half-hearted. State banks. e g., may under the new Banking Law issue shares, provided the state retains a majority share. The state banks can in this way try to attract new capital, in order to meet the capital-asset ratios as prescribed by the BIS. Now state bank shares do not look like an attractive investment, given the prevalence of bad loans, and Bank Indonesia subsequently redefined the rules in such a way that the banks, first of all the state banks, have less trouble meeting the capital-asset norms McLeod 1993).

3.6. Preliminary Conclusions

Indonesia has not followed a straight course in its liberalization attempts. Policies seem to have been the outcome of a tug-of-war between various groups, in particular the *technocrats*, including the Berkeley maffia, who favour liberal policies, and the *technicians*, such as Technology Minister Habibie, who are backed by the army and want to develop high-tech industries, even if that requires stiff protection (cf Woo and Nasution 1989 p. 22). In some markets - cars come to mind - high protection appears to have been the result of ordinary rent-seeking. Abrupt policy turnabouts on the scale that Chile experienced never took place in Indonesia. Its exchange-rate policy was not used to restrain inflation, but in so far as it was deliberately used as a policy tool, it was deployed as a means to further non-oil exports, with remarkable success. An element of luck seems also to have been involved, especially as regards the 1982 LDC debt crisis, which left Indonesia relatively little harmed as she happened to have stumbled into the right kind of restraints on capital intlows and had relatively little dollar-denominated debt. On the other side of the ledger, the financial system appears to be quite fragile, not because of deficient legislation but because of lax implementation of the law. Good laws do not always make good supervision. Also, foreign debts might throw up problems as soon as export growth is interreputed for whatever reason, though, considering the development of the debt-service ratio, there is no need to start the alarm bells ringing unless a very large shock occurs.

It may be remarked that Indonesia did not follow the conventional wisdom on liberalization in that the capital account was liberalized before the current account. Capital liberalization, however, did not amount to full freedom. there was no hands-off policy and the authorities intervened whenever things might get out of hand. Also, the ruling elite was, and is, not unanimous on the merits of current-account liberalization. Anyhow, high oil export revenues enabled the authorities to substantially liberalize the capital account before the current account. Foreign-exchange crises have been avoided, at least in part by following a prudent exchange-rate policy, i.e., by preventing the real exchange rate falling too much. With relatively low intlation, positive real interest rates and generally little fear of sharp devaluations, domestic financial assets remained attractive and wealth holders had little reason to resort to capital flight. Financial liberalization combined with restrictive macroeconomic policies has led to very high real interest rates, but the situation might have been worse had not the authorities waited five years after the 1983 liberalization to remove entry restrictions into the banking industry. This gave banks some breathing space in which to adjust their portfolios and prepare their personnel for a more market-oriented way of operating (see on this Caprio, Atiyas and Hanson 1993 73-4).

4. WHAT CAN WE LEARN FROM A COMPARISON?

At first sight, Indonesia seems to have put the cart behind the horse in liberalizing its capital account before its current account. Rut there was no quasi-unrestricted freedom as in Chile in 1979-82. So both the Chilean and the Indonesian experience with liberalization seem to suggest that full freedom of capital flows is something that should not be a government's first priority, at least the authorities should carefully monitor the capital account. Free capital inflows in times of a domestic boom can all too easily be used to finance real-estate investments which push up the relative price of nontradeables and leave the country without enough means to service its debt once capital imports dry up. A relatively free capital account is possible if a country does not suffer from serious macroeconomic instability. In particular, exchange-rate policy and domestic inflation should not conflict.

This brings us to another lesson, sc. that a liberalizing country should not use the exchange rate as the main weapon in the fight against intlation, except perhaps for short periods. Both Chile after 1982 and Indonesia provide convincing evidence that inflation can be effectively fought through restrictive domestic macroeconomic policies and that it is possible to engineer a real depreciation. In other words, it is possible to depreciate the domestic currency without provoking a corresponding intlation. It is true that the present Argentinian policy seems to give the lie to this conclusion, but in the first place it was supported by strong and credible restrictive macro-economic policies and by structural policies aimed at breaking up monopolies, and secondly one wonders how long they will be able to hold out, given the real appreciation that has taken place and the increasing current-account deficits. It is a high-risk policy, but so far it has been remarkably successful (see Schweikert 1994, who can hardly believe his eyes either; see for a more positive appraisal of exchange-rate-based stabilizations Kiguel and Liviatan 1994).

A common experience has been financial fragility after financial liberalization. Apparently markets are far from perfect and prudential supervision is of the essence. The main problems seem not to lie in devising appropriate laws and regulations, but in implementing them. Also, it may take time to develop the necessary human capital in the banking industry. There also appears to be a, largely unmet, need for risk management systems (Caprio, Atiyas and Hanson 1993 p. 77). A capital mistake in the Chilean case was the de facto full deposit guarantee provided by the government. The Indonesian government may have sent the right signals to the market in the nick of time, but the memo system, or old tie network, is still prevalent. Presumably private banks can more easily resist this kind of pressure than state banks, at least it is easier for the government to deny private banks an implicit full deposit guarantee and thus subject them to the discipline of the market. Of course, a deposit guarantee system with premiums geared to the riskiness of a bank's assets would be a good thing.

McKinnons advocacy of financial liberalization has been generally accepted, but full liberalization in one fell sweep may rock the boat too severely, as McKinnon himself acknowledges. High real interest rates lead to adverse selection; low-risk borrowers are driven from the market. If the solvability of the financial sector and non-financial firms is weak to start with, severe shocks can be very dangerous. The financial system may well be the weak spot in any economic transition or regime change, and it should be given a number of years to adjust itself. Indonesia was wise in waiting for five years after liberalizing interest rates before it liberalized entry into the banking industry. This may have been one factor in preventing real interest rates rising as high as in Chile. Preventing too severe shocks to the financial sector probably is more important than the sequencing of liberalization. Liberalization of the capital account before liberalization of the current account proves to be quite possible provided the real exchange rate can be prevented from falling too much.

When comparing Chile and Indonesia, one thing that strikes the eye is the very dogmatic hands-off policy followed by the Chicago economists. To let the market sort things out is irresponsible when it is clear to everybody that the exchange-rate policy is bound to founder and that the financial industry is heading for trouble. A government should send unambiguous signals to the market, but it must be flexible enough to adjust its policies if economic indicators take a turn for the wrong.

Finally, a very general lesson may be that after a severe shock, such as the transition from the chaotic government interference under the Unidad Popular government (see Visser 1980) to an extreme free-market economy in Chile, and even more after a transition from a socialist economy to a market economy, complacency as to the stability of the financial system is completely out of place.

NOTE. The Real Exchange Rate of Indonesia in Figure 2 was calculated as follows. Only trade with the main trade partners, Japan. the US.4 and Singapore was considered. From imports from and exports to these countries for 1970. 1975. 1980, 1985 and 1090 average trade weights were calculated, summing to 1, which then were applied to the GDP deflators to calculate the average intlation rate of Indonesia's trade partners. From the nominal exchange rate and the Indonesian GDP deflator the RER follows.

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